Wealth Management
Dominion Securities

The Porretta Group

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Quarterly Update

For investors, this year has been quite challenging. Both from a portfolio and personal finance perspective. Everyone is feeling inflation bite a piece of our wallets every time we go to the grocery store or fill up our cars. The effects of this historical rise in interest rates on both sides of the border has forced us all to feel the pinch in some capacity. While negative rhetoric commands our news outlets and volatility will continue to persist, we do believe that, in the stock market, better times may be ahead.

A look back

As major markets perched near all-time highs early in the year, there was a general expectation 2022 would bring further improvement to economies still emerging from the dislocations set in motion by the COVID-19 pandemic. Then, the rapid arrival of a number of market-unfriendly developments followed:

- The onset of yet another wave of Omicron variant infections, which disrupted the reopening of economies in much of the developed world, and led to a series of output-crippling lockdowns in China that are ongoing;
- Surging inflation well beyond what forecasters had expected as too much money chased an inadequate supply of goods. Shortages were exacerbated by supply chain disruptions, which have taken much longer than originally anticipated to resolve;
- The rapid rise of food and energy prices due to constrained supplies, dramatically escalated by the war in Ukraine;
- Labour shortages that hobbled the reopening of large parts of the service economy; and
- The abrupt shift of central bank policies from tolerating rising inflation to actively trying to rein in price increases through aggressive interest rate hikes and quantitative tightening.

A look forward

With most Western central banks intent on pursuing aggressive policy tightening despite slowing economies, the probability of a recession has increased. Much of this outlook seems to be reflected in current valuations, which have already been compressed by higher interest rates. Consensus earnings estimates will likely be downgraded further as economies slow. We do not expect volatility to subside until there are signs the U.S. Federal Reserve

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(the Fed) intends to reverse its hawkish policy. Government bond yields continue to move higher on repriced Fed rate hike expectations.

As a result, the two-year Treasury yield hit a fresh multiyear high of 4.3% in September, the highest level since 2007. The 10-year Treasury yield approached 4.0% in Q3, but held just shy of that key level. The net result is that yield curves remain deeply inverted as markets price further Fed rate hikes, lower long-term inflation expectations, and heightened recession risks, both in the U.S. and globally, on a 12-month horizon. Something as simple as a pause in rate hikes or a speech from the Fed describing their thoughts to look at pausing would provide the market with some room to breathe.

What we are thinking and doing?

Another quarter has gone by and there still is no shortage of news. The war between Russia and Ukraine continues, inflation still remains uncomfortably high, interest rates on both sides of the border are rising at historical rates, and all of this has been felt in the stock market. All of the factors listed above are forming a heightened amount of volatility. We are currently experiencing one of the worst nine months stretches in history.

While there will be further volatility in the markets, we believe that we are getting closer to an incredible opportunity. At some point, the central banks will have to stop raising rates, and inflation will subdue to more manageable levels. When this does happen, while it may not feel like the right time, being invested in successful, high quality companies will present an opportunity that only tends to come once in a decade.

As seen in Figure 1, since 1937, the average decline in the S&P 500 is 31.8%. This includes the shallow recessions like 1953 and 1980 and the deep ones like the Great Depression (1937) and the financial crisis of 2008. The recovery of each of these dark times created some of the best wealth creation opportunities in history. While this year has been challenging, and the road ahead may continue to be volatile, based on the averages, it's more likely closer to the end than the beginning.

With some of the heavy lifting already conducted throughout the year, we have positioned ourselves to take advantage when this bottoms out. In the past 10 months, we have done a number of things to help combat what is going on in the market. The first being staying extremely low in duration on our fixed income, and waiting to extend duration until later in the year. This has not only decreased the sensitivity of the portfolio during the rise in yields, but has now allowed us to lock in close to 5% yield on the fixed income portion of our portfolio.

We still have one more piece of our fixed income bucket to extend duration on but we will remain patient until the end of the year for what we believe will be closer to the end of the rate hike cycle. For many months, we have been underweight equity and sat at the lowest levels in the past few years. The names we currently hold are large to mega cap names with strong earnings, and an entrenched economic moat around their company or industry and strategic innovators. We feel confident that even if volatility persists over the next six months, our portfolio will be able to stand the choppy waters.

Figure 1

S&P 500 corrections surrounding recessions

Recession dates	S&P 500 decline details			Recession-related details		
	Market peak date	Days to bottom	% Decline	Recession length (months)	Did the market bottom before the recession ended?	No. of months from market bottom to end of recession
May 1937 - Jun 1938	03/10/1937	386	-54%	14	Yes	3.0
Nov 1948 - Oct 1949	06/15/1948	363	-21%	12	Yes	5.1
Jul 1953 - May 1954	01/05/1953	252	-15%	11	Yes	9.1
Aug 1957 - Apr 1958	07/15/1957	99	-21%	9	Yes	5.0
Apr 1960 - Feb 1961	08/03/1959	449	-14%	11	Yes	4.0
Dec 1969 - Nov 1970	11/29/1968	543	-36%	12	Yes	6.1
Nov 1973 - Mar 1975	01/11/1973	630	-48%	17	Yes	6.1
Jan 1980 - Jul 1980	02/13/1980	43	-17%	7	Yes	4.1
Jul 1981 - Nov 1982	11/28/1980	622	-27%	17	Yes	4.1
Jul 1990 - Mar 1991	07/16/1990	87	-20%	9	Yes	6.1
Mar 2001 - Nov 2001	03/24/2000	929*	-49%	9	No	N/A**
Dec 2007 - Jun 2009	10/09/2007	517	-57%	19	Yes	4.1
Feb 2020 - Apr 2020	02/19/2020	33	-34%	3	Yes	1.0
Average		381	-31.8%	11.5		4.8

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