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Wealth Management
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Quarterly Update

Over the last quarter, the markets continued to show immense bouts of volatility. I'm sure we are all experiencing a little bit of queasiness every time we pay for gas or groceries. On a micro level, inflation continues to be the looming cloud over our everyday lives. Yet, on a daily basis, consumers are continuing to spend. This has pushed itself to the macro level as inflation continues to stay uncomfortably high. To combat high levels of inflation data, central banks are increasing interest rates at a pace we haven't experienced in more than 20 years. At the Bank of Canada (BoC) meeting in early July, the BoC took a large step and increased rates by a full percentage point. These actions by central banks are only re-affirming our view of increased caution with our portfolio positioning for at least the rest of 2022.

Inflation outlook

As we have mentioned in our previous quarterly reports, tracking short term inflation is our main focus. We stated in our last quarterly report that we believed that if inflation remains persistently high, central banks will be forced to raise interest rates and it may curb growth. The pace and size of the rate increases will ultimately be the driver of whether or not this cycle continues forward. On both sides of the border, the markets have priced in overnight rates to end around 3.5% by year's end (see Figure 1). If central banks believe that further economic tightening is required to combat inflation, there is a belief that the markets will not be able to bear such a drastic move in a short period of time, and a recession could occur — if it hasn't happened already by that point.

The flip side of this acceleration of rate hikes throughout the end of the year only increases the chances of an eventual rate cut. In our view, the U.S. Federal Reserve (the Fed) will end the rate hike cycle in December at a level around 3.25% before pausing to assess the economic landscape in early 2023. If inflation has shown "clear and convincing" signs of slowing by then, the Fed could deliver a few "insurance" cuts that would take policy rates back to the 2% to 3% "neutral" range — the level at which rates neither boost nor restrict economic growth — a range that Fed Chair Jerome Powell has cited in recent months. Nonetheless, as mentioned above, while this may be a possibility, the main focus should be the rate hikes that precede it and the increase in the chance of a contraction.

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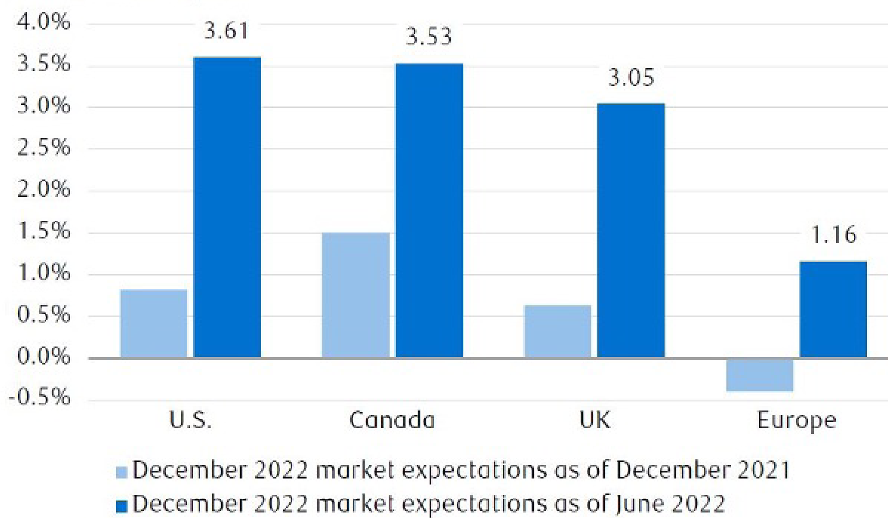
Have we seen rates peak?

Much like the equity markets, the fixed income markets have faced immense challenges this year. Long duration fixed-income investors have already taken the brunt of the hit in the first half of the year. With the continual rate hikes, there was belief that we were going to see 10-year bond yields hit highs that we haven't seen in more than 10 years. That was a little short lived, as we have already seen a substantial pull back from year-to-date highs. It is conceivable that rates can continue to push up from here, but the once hoped-for 5% to 6% 10-year rates may not be in the cards. At the time of writing, the yield curve on both sides of the border has inverted, which is a leading indicator of a recession. While the timing itself cannot be fully known, in an economic contraction, history does tell us that the long term yields will look to come down. In light of this, we have decided to build out the longer end of our fixed income portfolio, and start to lock in rates in the three- to five-year range to give us added protection while also taking advantage of rates we have not seen for some time.

What are we doing?

Over the last quarter, with markets continuing to present high levels of volatility, we have trimmed our equity, especially in the more sensitive names. We saw this as a two-part move to not only remove some of the sensitivity to our equity bucket, but to build our cash allocation until we see this volatility abate. Along with taking further equity off at the beginning of the quarter, we have continued on this path in light of the bounce back in July by removing another international name. We now sit at our lowest equity allocation and highest cash allocation in the last few years. With the dramatic rise in yields this year, we have been fortunate in our positioning being very short in duration. The rise in rates now presents an interesting opportunity, as we have already started extending duration and locking in respectable rates that have been forgotten about for the last 10 years. With the decrease in equities, increase in cash and the ~5% yield our fixed income assets are now getting us, we remain confident in our flexibility in our portfolio positioning, and are now shifting our focus in order to take advantage of this market environment.

Figure 1



Source - RBC Wealth Management, Bloomberg; calculations based on overnight index swaps, data as of 6/21/22

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