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Quarterly Update

Better days ahead for fixed income?

Last year was frustrating for fixed income investors; frustrating enough to consider abandoning the asset class altogether. As we've discussed before, the pain from rising bond yields is front-loaded for investors as bond prices fall in response. However, higher rates are beneficial over time as maturing bonds are reinvested at these higher rates. Higher yields ultimately represent a higher future return potential.

Much of the pain felt by fixed income investors over the last year was primarily caused by aggressive monetary tightening that we think is unlikely to be repeated. Policy rates are much more restrictive now. This is in stark contrast with the end of 2021, when interest rates sat firmly near zero and were expected to remain low for some time. Importantly for policymakers, economic growth and inflation in some regions are showing signs of declining in response to much tighter monetary policy, and we expect the impact of higher interest rates in 2022 to become more forceful over the next year. While we do expect further interest rate hikes in 2023 in most markets, their pace and size should be much smaller than during the past year. Overall, we believe the tightening cycle will come to an end in 2023.

Over the next year, the full effect of rate hikes from the past 12 months is going to be felt in the economy, and bond returns are likely to be bolstered by the likelihood that most developed market economies will fall into recession (if it hasn't happened already). To us, bonds now offer a compelling return potential, especially as inflation cools and economic activity slows. We think bonds should post returns around 5% over the next 12 months.

Outlook on equities

A year ago, the impressive recovery from the pandemic-induced recession pushed the economy into a position of excess demand. But the backdrop is changing, and headwinds have intensified as a result of tighter monetary policy and reduced fiscal stimulus. We continue to look for a deceleration in growth in 2023, with economies likely slipping into recession in the developed world. That said, economic indicators have shown more resilience in the past few months, suggesting that the probability and expected depth of recession might be lower than initially feared. We believe the first half of this year may continue to be choppy, but as we near the end of the rate hike cycle, we will see a clearer runway to a more stable bond and equity market.

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The four main drivers that pushed inflation to multi-decade highs are all reversing course. Supply-chain problems have faded, commodity prices have declined, monetary stimulus has turned to tightening, and fiscal stimulus has been reduced. For these reasons, we expect inflation to continue to soften for 2023. We recognize, however, that other factors may slow its descent. Labour markets remain especially tight, the breadth of the inflation shock may make high prices stickier, and the shelter component of the Consumer Price Index (CPI) changes with long lags. It could take even longer for inflation in the Eurozone and U.K. to come down given the region's unique challenges, mainly weaker currencies and energy shortages.

The quantity of monetary tightening delivered to tame extremely high inflation has been massive across the globe. North American policy rates are already above four percentage points after less than a year of increases. The U.S. Federal Reserve (the Fed) funds rate is expected to peak near 5%, compared with a starting point of about 0%. But most of the hard work has been done, and there is a high possibility that policy rates in developed markets will pause shortly if inflation cooperates and growth slows.

Since 1971, the S&P 500 has had a positive return 41 out of 52 years. During this period, after a negative year, the year that followed was positive eight out of 11 years. This means, while negative years can happen and will occur again in the future, they are rare. As we have seen in the last quarter of 2022 and into January, these days don't last forever and when sentiment turns positive, the market tends to swiftly regain its upward momentum.

What are we doing?

Much of the heavy lifting has been done in 2022. We have already reduced our equities to the lowest point we've seen in the past couple of years, and have now extended and locked in our fixed income allocations for the foreseeable future.

On the fixed-income front, we have a balance between Guaranteed Investment Certificates (GICs), high quality corporate bonds and Principle Protected Notes. By doing this, we have now secured a yield of ~5% on the fixed-income portion of our portfolio for the next few years. This will act as our ballast against any volatility that we continue to endure over the next year. By drawing down our equity throughout last year, we are now in an opportunistic spot to re-invest back into equities either at lower prices, higher dividends or reduced valuations.

For the past couple of quarterly newsletters, we have discussed our stance of remaining conservative until we see two things: inflation moving lower and the end of the rate hike cycle. Inflation at this point, across both sides of the border, is moving lower as the rise in interest rates eats into consumers' wallets. On the interest-rate front, after an historical year of increases, we believe we are nearing the end. While there may be some further rate hikes in the future, the pace and size we have become used to in 2022 should not be repeated this year. At this point, both the Canadian and U.S. central banks will probably look to pause and see the effects of their work from last year take hold. While we remain patient for now, we will continue to look for market opportunities to re-deploy capital when time presents itself.

S&P 500: Negative returns since 1971 and subsequent performance

		Subsequent performance (%)		
Year	S&P 500 Return	1 Yr	3 Yr	5 Yr
1973	-14.7	-26.5	7.7	4.3
1974	-26.5	37.2	16.4	14.8
1977	-7.2	6.6	18.7	14.1
1981	-4.9	21.5	16.5	19.9
1990	-3.1	30.5	15.6	16.6
2000	-9.1	-11.9	-4.1	0.5
2001	-11.9	-22.1	3.6	6.2
2002	-22.1	28.7	14.4	12.8
2008	-37.0	26.5	14.1	17.9
2018	-4.4	31.5	26.0	???
2022	-18.1	???	???	???
Average	*-14.4*	*12.2*	*12.9*	*11.9*
Median	*-11.9*	*24.0*	*15.0*	*14.1*
Average 1971-2022		***12.0***	***11.3***	***11.4***

Source: RBC GAM. Morningstar. S&P 500 TR USD. Annualized returns.

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