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Rate hikes take effect as inflation cools

KEY INSIGHTS

- As the fog lifts, clarity begins to emerge on inflation and rates
- Lower inflation readings confirm a positive trend is intact
- Central bank rate hikes having the desired effect – is the end in sight?
- Employment data remain strong despite calls for recession
- Equity markets stabilize in Q4 but end the year firmly in the red

The fourth quarter was a good one in our opinion. We don't just say this because markets stabilized and moved higher, but because clarity is beginning to emerge on a number of important fronts. In the quarter ending September 30th, inflation was still a huge question mark and, by extension, so was central bank policy. Until we got clear indication that inflation was under control, predicting how high interest rates would go was almost impossible.

In our last newsletter we said "inflation appears to have peaked and we believe that interest rates will top-out sooner than the media would have you believe". Three months later, we can now say with confidence that inflation has peaked (see *Figure 1*) and we believe it will continue to fall sharply over the coming months. A number of key components of the consumer price index (CPI) calculation have leveled off or even fallen in price. For example, this time last year the price of energy was skyrocketing as oil went from $75 to almost $125 per barrel from January to mid-March (see *Figure 2*). Oil is now back in the mid $70's and looks unlikely to repeat last year's surge in price.

Central bankers raised interest rates aggressively last year in order to tame

***Figure 1**: Consumer price index, 12-month percentage change (Source: U.S. Bureau of Labor Statistics)*

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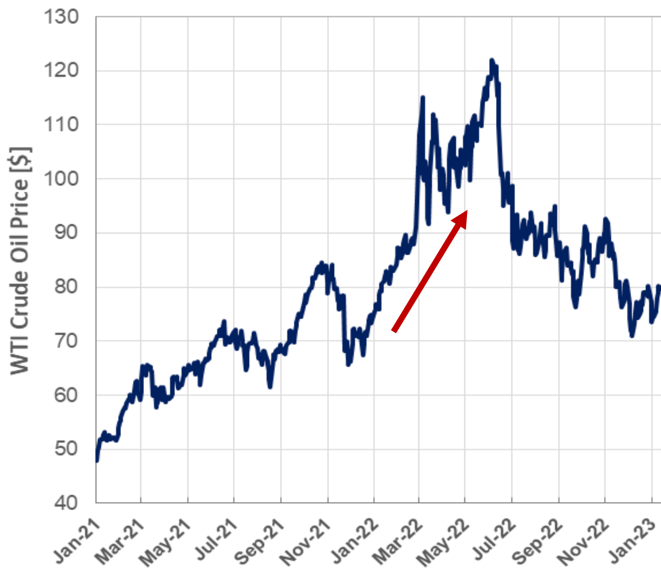

***Figure 2**: WTI Crude Oil (USD$), Jan '21 – Jan '23 (Source: FactSet)*

inflation. With their efforts clearly now taking effect, they will feel validated and should see this as license to ease off on future rate hikes. Markets are now anticipating just one or two more quarter point rate increases before the Fed and the Bank of Canada finally pause (see *Figure 3*). Simply put – there seems to be an end in sight for rising rates.

It's hard to overemphasize the importance of gaining clarity around the ultimate (or terminal, as it's called) level of interest rates. Three months ago it was unclear where the terminal rate would settle; this resulted in huge uncertainty and volatility in markets. Central banks set interest rate policy and as a result they also determine the risk free rate of return (i.e. what an investor receives from a government bond). This "risk free rate" is the yard stick used in calculating the value of every single asset and investment. As you can imagine, using a yard stick is only helpful if you have faith in its length. The emerging confidence that investors are gaining in the terminal rate will allow for a better understanding of market valuations and ultimately, lower volatility.

Recession Watch

A number of key (and reliable) indicators continue to point to the likelihood of recession in 2023. That said, the economy has proved resilient in the face of higher interest rates and, importantly, employment data remain strong. Based on current information, the oncoming recession should be relatively mild and short lived. In fact, a number of economists are now predicting that the US will engineer a soft landing and avoid outright recession.

As mentioned above, the fog of uncertainty has lifted on inflation and is beginning to lift on rates. As the fog eventually lifts on the outlook for recession, investors will begin to jockey for position as they look beyond the end of the current economic cycle. The end of one cycle gives birth to the beginning of the next.

We do not know when the next cycle will kick off, but we are absolutely certain that the time to position for it is before it begins. With this in mind, we believe that while 2023 may be turbulent to begin, it will ultimately turn positive as investors begin to look beyond the current environment towards better times and growth ahead. Keep in mind that the market is always a forward-looking animal. It attempts to forecast the future and profit from those predictions.

2023 Market Outlook

With the S&P500 down almost 20% last year (and at one point down more than 25%), the market is clearly assuming some quite negative outcomes ahead. As the key factors (inflation, rates, recession, unemployment, and corporate earnings) reveal themselves we will gain an understanding whether the market has over or underestimated the negative narrative.

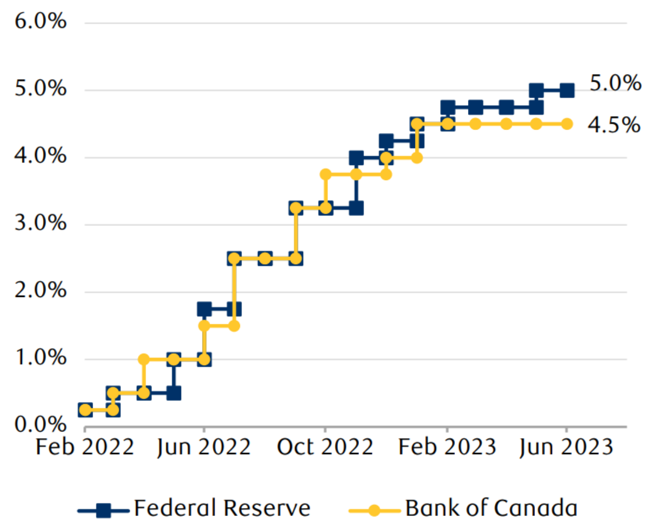

***Figure 3**: Fed and BoC interest rate expectations, as of Jan 6th, 2023 (Source: RBC Wealth Management, Bloomberg)*

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Right now, the emerging clarity described above has been coming in "less negative" than consensus expectations. The result (admittedly in the very short term) has been higher prices for equities to start the year. Remember, we don't need the outlook to be stellar, we just need it to be "less negative" than expected.

As you can likely tell, we are cautiously optimistic for the 12 months ahead. Our conviction increases beyond this year as we look into 2024 and beyond. Historically, equity markets have delivered outsized returns in the years following major market declines. While this seems intuitive in hindsight, it can be hard to remember this in the midst of a steep correction. *Figure 4* below shows the 1, 3, 5 and 10 years returns following all declines of >25% for the S&P500 since 1960. This is not a time to shy away from markets.

Positive on Fixed Income

Only time will tell if our optimism for the equity market is warranted. However, the nature of the fixed income market is such that predicting the future is much easier. For example, buying a 1 year bond today will yield about 5%, no guessing required. Yes, interest rates will move up and down throughout the year, but that bond will pay 5% interest and repay its principal in a year from now.
Longer bonds currently pay less than shorter ones (an anomaly that typically precedes recession). In this kind of environment it can be a struggle to decide between taking a higher yield for the short term or locking into a slightly lower rate for longer. We have chosen to push out our average maturity a little longer. Our thinking (as a hypothetical example) is that while 5% for 1 year is nice, 4.7% for 3 years provides greater certainty. This is particularly important given that rates are expected to fall in 2024.

The bottom line here is that the portion of your investments allocated to bonds will be a meaningful contributor to your overall return in the years ahead. This stands in contrast to the past number of years when bonds provided stability and liquidity but little in the way of return.

A return to growth for equity markets coupled with higher yields on fixed income would make the traditional 60:40 equity/bond portfolio a very attractive prospect once again.

What does all of this mean for you?

While the concepts above may seem quite abstract, it is important to know that these developments have real world implications for each of our financial futures. Now more than ever it is essential to revisit your financial plan (or put one in place if you have not already).
A financial plan incorporates investment returns alongside

				Forward Price Returns			
Peak	Trough	Duration (Days)	% Decline	1 Year	3 Year	5 Year	10 Year
12/12/1961	06/26/1962	196	-28.0%	32.7%	58.8%	75.2%	105.4%
11/29/1968	05/26/1970	543	-36.1%	43.7%	55.8%	30.7%	59.6%
01/11/1973	10/03/1974	630	-48.2%	38.0%	55.3%	76.0%	160.8%
11/28/1980	08/12/1982	622	-27.1%	58.3%	83.2%	224.5%	307.9%
08/25/1987	12/04/1987	101	-33.3%	21.4%	45.7%	93.0%	334.6%
03/24/2000	10/09/2002	929	-49.1%	33.7%	54.0%	101.5%	85.6%
10/09/2007	03/09/2009	517	-56.8%	68.6%	102.6%	177.6%	305.5%
02/19/2020	03/23/2020	33	-33.9%	74.8%	-	-	-
01/03/2022	10/12/2022 (?)	282	-25.4%	-	-	-	-
AVERAGE		**428**	**-37.5%**	**46.4%**	**65.1%**	**111.2%**	**194.2%**

Figure 4*: S&P500 forward price returns following a -25% decline (Source: RBC, Bloomberg)*

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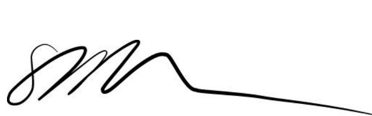
spending, income, taxes, inflation, assets and liabilities. Taken together, a well-crafted plan allows us to project your net worth and spending power at all points in the future. Besides peace of mind, the insight gained can also highlight tax efficiencies and estate planning opportunities

We are eager to meet with you and update or create your plan. Please be in touch with us to book a time to do this.



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Our team was well represented at the TMX Market Centre recently. Alisa Christian rang the closing bell on November 15th!

	Q4	2022
Indices		
S&P/TSX	5.10%	-8.66%
Dow Jones	15.39%	-8.78%
S&P 500	7.08%	-19.44%
Nasdaq	-1.03%	-33.10%
Euro Stoxx	14.33%	-11.74%
Japan Nikkei	-9.37%	-9.37%
India Sensex	5.94%	4.44%
VIX (Volatility)	-31.47%	25.84%
Commodities		
Gold	9.84%	-0.28%
Silver	25.89%	2.77%
Copper	8.87%	-14.13%
Oil	0.97%	4.25%
Natural Gas	-45.19%	-4.71%
Currency		
CAD	2.03%	-6.75%
EUR	9.21%	-5.85%
JPY	10.39%	-12.20%
AUD	6.45%	-6.20%
GBP	8.17%	-10.71%

Values as of December 31st, 2022

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