THOUGHTS FROM HOME

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Evaluating a Market Downturn

"A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."

- Warren Buffett, Chairman, Berkshire Hathaway

April was a tough month for both the stock and bond markets in North America as fearful market participants

sold under the twin pressures of rising U.S. interest rates and the continuing Ukrainian conflict. On the eve of the Berkshire annual meeting, we thought it timely to turn to the wisdom of the Oracle of Omaha to seek guidance during these difficult market days. This month, we will review the markets in the context of Mr, Buffet's advice with a view to both the challenges and opportunities that lie ahead.

We begin with a review of the major market indexes for the month: TSX -5.3%, Dow Jones -4.9%, S&P 500 -8.8% and the Nasdaq -13.4%, its worst decline since 2008. The bond market was also significantly lower as the U.S. Federal Reserve continued their aggressive pursuit of increasing interest rates. Looking past these headline numbers, reasons for optimism still exist. Corporate earnings came in strong for the quarter, with Amazon being the only notable disappointment. Available jobs in the U.S. are at record highs, suggesting the economy remains robust. Worries about stagflation, stagnant growth combined with inflation, have crept into market discussions but given the continued strength of the U.S. economy, this talk seems overdone. We view it as unlikely that the Fed would be willing to push the U.S. economy into recession to fight inflation as this merely trades one problem for a worse one. The market hates uncertainty and will likely remain volatile until we receive more guidance from Fed Chairman Powell as to the number and size of proposed rate increases. However, given the market conditions, it is more likely the information will come sooner rather than later, as political and market pressure grow. Once the market has a handle on interest rates, we expect a return to more normal market conditions and the best managed companies will again rise.

The fear of inflation/stagflation remains the major talking point. The lockdown of major cities in China due to their zero Covid policy has raised inflation fears as this could lead to a further slowdown in goods being delivered and further supply chain bottlenecks for the global economy. On the other hand, China's demand for commodities has also slowed down, slightly easing some commodity based inflation. We continue to monitor these developments and will react as appropriate, depending on the duration and severity of the outbreak.

The next major consideration regarding inflation is the ongoing Ukrainian conflict. As the war drags on, it is becoming increasingly clear that Russia will be largely embargoed from international trade for the foreseeable future, as the European Union has stepped up efforts to end their dependency on Russian fossil fuels. This will keep upward inflationary pressure on many global commodities such as oil, gas, wheat and fertilizer. Given that the war will go on much longer than expected, it will take the combined efforts of global energy producers to step up production as well as any help governments can provide such as the U.S. is doing by releasing one million barrels of oil per day from their Strategic Reserve to help lower the overall inflation rate.

The U.S. government is also trying to fight inflation by raising interest rates thereby getting consumers to reduce their demand for goods. While it is too early to tell if they are having any success, they have managed to flatten the yield curve between 5 and 30 years around 3%. The good news is that the long term rate expectations remain low as the 30 year yield has hardly moved in comparison to shorter maturities. With the Fed currently targeting a 2.5% rate, the market would normally expect long U.S. rates to be closer to the 30 year mortgage rate of 5.4%. However, it seems the market does not believe the current bout of inflation is sustainable. Further, the U.S. Dollar Index has gone to a 20 year high meaning that currencies such as the Euro, yen and British pound are trading at multi-year lows versus the U.S. dollar. The Euro has been particularly weak but we can't see the European Union dramatically raising interest rates with 5.4 million Ukrainian refugees having poured into Europe with more coming every day, while also trying to replace Russian oil and gas supply. The surging U.S. dollar does help reduce U.S. inflation somewhat as the strong dollar makes import goods cheaper but makes global inflation worse because trade in all major global commodities is denominated in U.S. dollars.

As this is the first inflationary investment scenario that most current market participants have ever seen, it is not surprising that market volatility has increased. This is the time we have to focus on the tried and true investment principles to navigate these conditions rather than just worrying about headlines. We continue to look for great companies at great prices but when circumstances change, we take action. For example, last month Boeing posted a disappointing quarter. This happens even with great companies but Boeing surprised the market by losing money on the Defence side of the business, which for years had been a consistent moneymaker. Boeing failed our management test and was sold. We moved to Nutrien, a global leader in fertilizers, one of the key commodities under Russian embargo. We added a great company at a good price while also building some additional inflation protection into the portfolio.

In our overall view, the market has aggressively priced in the war, the Fed and inflation. In fact, market technical indicators show that many sectors of the market are oversold. Despite some signs of slowing, North American economies are still doing well with robust consumers who are now beginning to shift their spending to travel and leisure, which will take some pressure off the demand for goods, as well as unemployment that remains near record lows.

In Canada, our commodity based economy should be very strong over the next couple of years. Oil and gas, pipelines, materials and metals stocks should all continue to perform, as should Canadian banks as their net interest margin rates improve.

We tend to fear things less the better we understand them and this is especially true about the stock market. May 3, 2022, Chairman Powell raised interest rates 50 basis points and later calmed markets by stating that a 75 basis point raise was not on the table for June, only another 50, the Dow rallied 900 points. May 4, 2022, the market worried that he didn't specify how high interest rates might go and the Dow fell 1063 points. We expect better clarity from the Fed in the coming days in an effort to calm investors. With more clarity, our belief is that the market will come to realize the April sell off was overdone and investors will again choose to follow Mr. Buffet's excellent advice.

In conclusion, April was definitely a trying month but served as a reminder that you must stick with your investment discipline. We continue to look for opportunities to add great companies at good prices and ignore media hype and generalized fear. This strategy has worked for Mr. Buffet for decades and will work for our portfolios as well.

As always, feedback, questions, comments and concerns are always welcome. Until next month, stay healthy.

Yours truly,

Trevor, Walter and the Cooper Wealth Management team

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