Just a Blip, or a Change in Market Structure Altogether?

Spanning the better part of two decades, from the mid-60s through the mid-80s, the global economy witnessed modern era inflation highs across three distinct waves. Since that time, investors globally have been on an asset price climb caused by over three decades of falling interest rates and low inflation, optimal conditions for rising stock, bond and real asset prices like real estate. Episodes of financial market turmoil have occurred within this span, most notably the Dot Com era bubble bursting and the Great Financial Crisis, but the general rule of buy, lever up as you wish, and hold has worked in virtually every single asset class.

The global pandemic reset the stage. On and off economic closings for the better part of two years created global supply chain issues, pent up consumer demand and lack of investment into commodities, all of which led to the largest surge in inflation seen in four decades.

One of our external macroeconomic partners, BCA Research, wrote the following regarding easy monetary policy and its likely impact on inflation and future monetary policy:

“Fed policy is likely to proceed in two stages: An initial stage characterized by a highly accommodative monetary policy, followed by a second stage where the Fed is raising rates aggressively in response to galloping inflation. The first stage… will be heaven for risk assets. The subsequent stage, which will feature a global recession, will be hell. In the end, we expect the fed funds rate to reach 4.75%, representing thirteen more 25-basis point hikes than implied by current market pricing.”

The thing is, this statement was published in June 2019, prior to anyone knowing about Covid. The decade leading into these remarks was already underwriting the challenges we faced in 2022. Covid became both a deferral of the anticipated inflation surge and a catalyst to its ultimate severity. Historical precedents of the 1940s / 1950s and then the 1970s / 1980s suggested low likelihood of a one and done single wave inflation problem.

In fact, there are many structural changes at play that would suggest higher and more persistent than normal inflation moving forward. For seven decades in the developed world there have been declining birth rates that are now colliding with the retirement of tens of millions of baby boomers in the U.S. alone. Labor markets have been historically tight as a result, with wages increasing significantly as companies try to attract and retain their most important assets, people. It’s not just a U.S. issue, labor shortages are being experienced around the world, fanning inflationary pressures. At the same time, there is a shift to a green future, whereby low-cost sources of energy are being replaced with more expensive means that require significant investment into infrastructure and grid changes. Lack of investment into energy commodities, combined with the impact war and geopolitics are having on agriculture, is leading to a higher cost global commodity basket than the world had from 1960 to 2000 at which point the Chinese super cycle led to an ensuing ten-year surge. Speaking of geopolitical implications on inflationary pressures, the tailwinds of globalization that led to ever falling prices is now unwinding and reversing. Look no further than in the U.S., where manufacturing plant construction today totals over $200 billion. To put that figure into context, in the past twenty years prior to the recent run up, no period of time saw a mark above $90 billion of ongoing plant construction.

The above forces suggest caution in believing we are returning to a pre-Covid playbook for investment returns supported by zero percent interest rates and no inflation. The world is simply different today than it was in the decade prior to the onset of the pandemic. And while history doesn't repeat, it can certainly rhyme.

2023 Yet Another Example of Challenges in Market Timing

We see 2023 as being two distinct periods in financial markets. The first spanned until late October. Over that first 10 months, global bond markets were all negative, on pace for their third straight year of declines. We do not have data that goes back far enough to capture another three years in a row losing streak for bonds. Over this same period, Canadian stocks, small company stocks and emerging market stocks were all down. In fact, August through October was the first three month in a row losing streak for global stock markets since the onset of Covid. The losses resulted in over half of the world's stocks being down on the year through October 31st. In the U.S., nearly 60% of all companies on the S&P 500 were down by the same time.

U.S. and global stock markets were up over that ten month stretch, but only because of a handful of megacap artificial intelligence themed stocks that led to the tech-heavy NASDAQ rallying into bull market territory. Of the headline 11% gain for the S&P 500 through the end of October, just seven companies resulted in more than that gain, while the rest of the S&P 500 constituents detracted as the summation of their performances was a negative result.

The second period in 2023 began to price in the early weeks of November. Aiding the positives associated with better-than-expected economic data in the U.S. in recent months that was bubbling under the market's pessimism, on November 14th a highly constructive inflation data point was released that changed the market's direction for the remainder of the year. In a little over two months, the NASDAQ rallied another 19%, global stocks were up 16%, bonds all advanced in the high single digits and U.S. small cap companies rallied 24% into year-end. We have found no consistent track record by any investor in history that has timed markets well. This was another example of how quickly the tide can turn.

With the year-end rally, global stocks returned 24.4% in 2023, led by the NASDAQ's +45%. The Canadian stock market returned 11.8% on the year, lagging due to a weak economic backdrop where it is likely we will soon find out a technical recession has begun. Global bond markets returned 5.7%, avoiding a third year in a row of losses, while the Canadian bond market was up nearly 7%. The November market rally was one of the strongest on record for that month.

As of the time of this writing, we are through all-time highs on the S&P 500 and NASDAQ indices. We are approaching the same for the MSCI World stock index.

"We Tend to be Good at Predicting the Future, Except for Surprises – Which is all That Matters"

Investors are expecting interest rate cuts across the developed world in 2024. On October 31st, three more hikes were expected in the U.S., by November 15th no more hikes were anticipated with cuts coming in March instead of the prior May expectation. In Canada four cuts, or a 1% decline in interest rates, are expected by year-end. Five cuts are anticipated in the U.S., with a 40% probability of the first coming in March. The battle against inflation has been won in the minds of investors. Now it is time to revive the economy before a slowdown grows too strong. Measures of investor optimism are reading high, positioning suggests the economic battle will be won next.

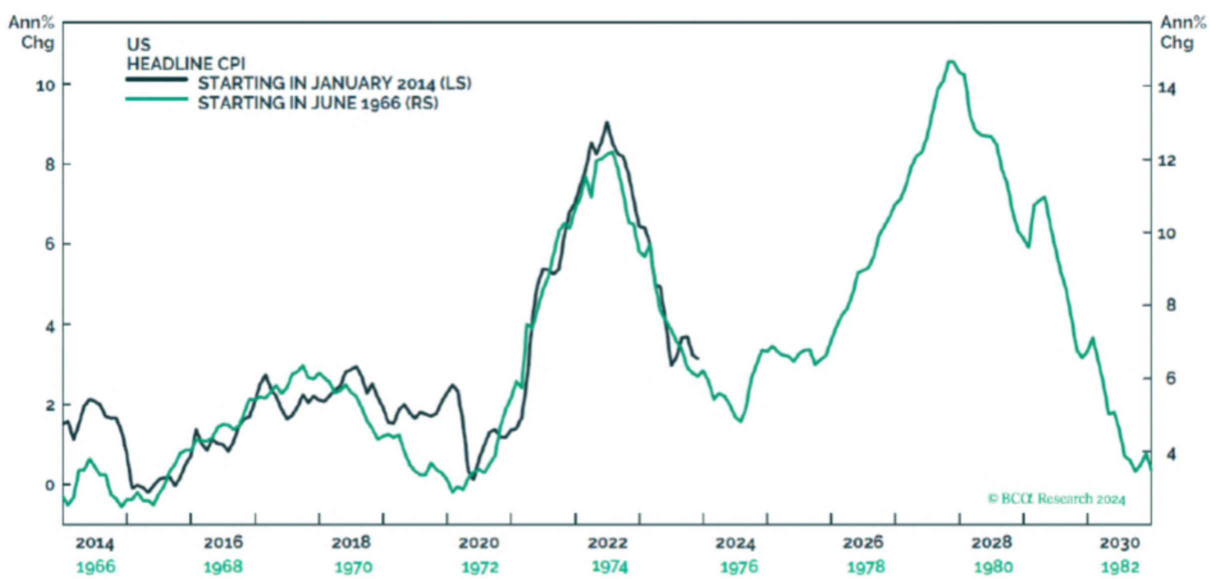
In looking back to 1985, there have been four interest rate hiking cycles in the U.S. with the Federal Reserve pausing rate hikes in February 1989, May 2000, July 2006 and January 2019. In three of these four pause cycles stock markets hit all-time highs, while the fourth also witnessed a meaningful rally. Each of these four cycles ended shortly before a recession began.

The market is now pricing in a soft landing or no recession case in the U.S. given ongoing labor market resiliency and stabilizing economic indicators. The central bank has been able to successfully orchestrate this type of threading of the needle environment only three times back to 1950, one in each of the mid-60s, 80s and 90s. While possible, the balance of history combined with the lagged impact of interest rate hikes on consumers and corporations suggests no sure thing. In looking back at all rate hike cycles to 1955, we found that it takes 27 months on average for a recession to start after the first hike. This would put the average recession start at June 2024. In looking back to 1977, it took 30 months on average for unemployment to begin rising after the first hike. That suggests labor market weakness would begin by year-end on average. In both Canada and the European Union, it appears we are already in or beginning recessions. Looking back to our macroeconomic partners at BCA, they recently briefed us in Toronto that their model that "predicted the surge in inflation of 2021/2022 as well as the immaculate disinflation of 2023…is now predicting that a global recession will begin in the second half of 2024, just when most investors have concluded a soft landing has been achieved."

Perhaps there will be no U.S. recession at all, which would be good for stocks? Not necessarily. Real gross domestic product (GDP) among major developed countries is predicted to grow by only 0.9% in 2024, slowing from the anticipated 1.6% estimate for 2023. In this way, interest rates are having their desired impact on slowing economies around the world. For the U.S., current consensus is for 1.3% GDP growth in 2024 versus 2.4% forecast for 2023. In looking back to 1947, we found nine instances where U.S. GDP growth for a year was between 0% and 2%. In those nine years, the average return for U.S. stocks was -4.3% while the median return was flat. Low to no growth is stuck between high growth being good for company cash flows (and the company share prices producing them) and negative economic growth being good for stocks because Central Banks and governments alike support the economy and stimulate.

Lastly, what if all the reshoring of industry to the U.S. and other developed country allies actually results in ongoing labor market strength, historically low employment and a re-accelerating economy? This is our chief concern, where inflation is back on the table and rates reprice once again for higher for longer. Not good for stocks or bond price performance. Unfortunately, we see eerie similarity between this inflation period and that experienced from the mid-1960s through the mid-1970s.

U.S. Inflation – 1966 vs 2014 Start Dates



Our Philosophy

At Bessette Wealth Management, we try to shy away from risks that are not being compensated appropriately while leaning into areas of the market where we find better value. We do not try to market time, we try to adjust at the margin of a core philosophy and investment process to enhance returns. We also do not try to predict the future in order to make portfolio decisions. We would rather be approximately right than precisely wrong as the famous economist John Maynard Keynes said many years ago. We will point out that just 18 months ago consensus expected a 2023 recession, 12 months ago investors believed the Fed would pivot to cuts before year-end 2023 and just six months ago that there would be more rate increases in 2023. All crystal balls were off the mark.

No matter whether we experience a recession, a low to no growth environment, or a re-acceleration of the economy, little needs to change with our positioning. We will see what the market gives us as opportunities or risks and then use a scalpel, not a sledgehammer, to make portfolio changes.

Through 2023, we re-allocated profits from higher valuation areas of global stock markets to ones that did not rally until late in the year. We de-risked portfolios to lock in historically attractive interest rates on fixed income securities while extending the sensitivity of our bond portfolios (extending our average maturity or duration as recently as Q4) to potential interest rate cuts likely to begin in earnest in 2024.

In the coming quarters, it will be more of the same. We will continue to search for high quality companies that we believe can weather whatever storm lies ahead while out growing the general economy in the five to ten years to come. We will continue to prudently seek yields that are priced for the risks associated with their coupons. Lastly, we will continue to improve portfolio construction as new strategies or funds become available to us and our clients that can enhance performance while reducing overall portfolio risk through increased and optimal diversification.

No matter the waters we find ourselves in, we will continue to provide a steady hand on our clients' capital that we invest alongside our own.

Bessette Wealth Management