Wealth Management
Dominion Securities

RBC Dominion Securities inc.

Bessette Wealth Management
of RBC Dominion Securities

Broken Record

In rereading our last two quarterly commentaries, one could be forgiven in thinking they were written today. High inflation. Central Bank tightening. Falling consumer discretionary income. Eroding corporate margins and profitability. Lower asset prices in stocks and bonds. Looming threat of a recession increasing in probability.

Despite a significant market rally from mid-June through mid-August (peak inflation theory positioning), we ultimately experienced a third negative quarterly return in a row for most of the world's stock markets.

The ongoing tightening around the world by Central Banks continues in their fight against inflation. It is worth noting that the magnitude of recent tightening in the U.S. and Canada now exceeds the magnitude of easing to respond to a one in a one hundred year pandemic.

This quarter, volatility in equity and debt markets remained elevated. The Federal Reserve has been clear on its mandate, to get inflation under control. There have been some positive signs over the summer that have dimmed as of late, particularly in energy starved Europe where the Russian conflict continues to wreak havoc on many consumers and industries.

While it seems this period of time is unique in magnitude from a monetary policy response, in looking back at the long-term we note that we are simply adjusting back to what was normal prior to the Great Financial Crisis. The Federal Reserve expects to reach a target rate of 4.6% by the end of 2023 versus 3.25% today. For context, dating back to 1954 the average funds rate has been 4.6%.

Few Precedents for Financial Market Conditions

Bonds are a less risky area of the investment world, and yet rising rates are negative for bond prices. Bond prices in Canada and the U.S. are now down in the mid-teens. This marks the second year in a row of negative bond price performance. The longer the maturity of a bond in the future, the more sensitive it is to rates increasing. In looking at the long-term bond index in Canada, this is the worst price performance dating back to 1970, a time period which included the elevated inflation of the '70s and '80s. In the U.S., bond yields have risen higher and faster (read: bond prices have fallen further and faster) following the first rate hike than in any year dating back to 1962.

The stock markets globally has been no different from a performance standpoint then their bond counterparts. The U.S. stock market had its third worst start to a year after nine months dating back to 1952. Following the first Federal Reserve rate hike, the U.S. stock market has fallen further over this span of time versus any prior rate hiking cycle dating back to 1954 with the closest year for negative performance being 1973.

If we look at comparative historical performance periods including the Great Depression, Dot Com burst and Great Financial Crisis of 2008, we are in a truly rare time.

The Path Forward

The market is expecting continued aggressive rate hikes by the Central Banks through year-end and into early 2023. Expectations of how fast and how high rate hikes would be has continued to shift higher and faster as we have moved through this year. What is new is that the market now anticipates inflation to peak early in 2023 and a recession to occur in the first half of next year which will require Central Banks to actually reverse course and cut rates by mid-2023.

The consensus view is now a recession is imminent. One of our leading indicators of a recession occurring is yield curve inversion, where bond yields in the near-term are higher than bond yields in the distant future. In the past when this signal has occurred, a recession has occurred on average one year thereafter. Yield curves inverted during the summer across much of the world.

The necessity to move from defense heading into challenging markets like today's into offense for future gains is historically not a long window. Once a bear market occurs (a 20% decline from the peak), the average stock return in the U.S. one year thereafter is 17%. A bear market was technically reached in June. When we look back at recessions over the past sixty years, one year following the end of a recession the average market performance in the U.S. has been a gain of 18%.

In other words, the market will rally before the end of the recession. We do not have precision on when any of these events or to what magnitude they will occur in the future. We are in a good position in our portfolios to preserve capital while waiting for the inevitable upside.

Impact to Portfolio Management

For the first time since the Great Financial Crisis in 2008, we find ourselves in a very typical bond market environment for yields. Forward looking long-term expected returns have also increased substantially due to much more favorable valuation levels for most industries and companies in the world relative to recent years.

Historically bond prices rally into and during recession, and if rate hikes are put on hold for that reason or any other, we expect this to play out much the same. After years of holding shorter maturity bonds in many client portfolios, we are beginning to extend the maturity profile at attractive yields that were not available just a year ago. Furthermore, the high quality companies we look to buy but are often not at very attractive share prices are now at levels we believe will deliver meaningful returns over the years to come.

We are more active during volatile markets as indiscriminate selling creates opportunities for compelling stock and bond purchases. It was a busy summer and early fall in our business and we will continue to shift our portfolios to address near-term economic headwinds while balancing the pursuit of momentary opportunities amidst the broad market weakness which will drive attractive returns in the years to come.

Should you have any questions, please feel free to reach out.

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