SO FAR SO GOOD IN 2022….WELL NOT EXACTLY

We are now past the one third mark of calendar year 2022. During that time period, the global stock markets were down three out of four months. And the bond market - the typically more conservative part of one's investment portfolio - has declined also. Under these circumstances, investors would naturally be curious about three things, in my opinion. Why is the market down? Will the decline get much worse in the short-to-medium term? Should I be worried?

Why is the market down? I have a short three word answer to this question: Rising Interest Rates. Let me provide more context. We know that the spread of COVID required a strong government response back in early 2020. One of the main tools used to avoid a severe recession was to bring rates down close to zero. But now that COVID restrictions are being lifted, the central banks need to return rates back to more normal /neutral levels. This process is never smooth, and more akin to ripping off a band aid.

I should further explain that there is more than one interest rate out there. The most widely followed measure of bond/fixed income interest rates is the yield on the 10 year US Government Treasury. At its lowest point during the peak of the COVID market crisis, it reached 0.50%, a level not seen in 100 years (source: Trading Economics). At the end of 2021, it was about 1.50%. And in 2022, it has essentially doubled and reached 3.00% on May 3rd. Since the movement in bond prices is inversely related to the movement in interest rates, a typical bond portfolio might be down somewhere in the 10% to 11% range year-to-date (source: FactSet, iShares Core Canadian Universe Bond Index ETF). By way of further information, another widely followed interest rate is the US Federal Funds Rate - which is a set suggested rate commercial banks charge each other. I view this rate as a lagging indicator of what is actually happening in the fixed income market, even though this rate enjoys plenty of media attention. This rate was 2.5% for most of 2019, but was intentionally brought down to a 'crisis level' low of 0.25 % in March 2020. That rate stayed at 0.25% until early March of this year. It has recently been raised to 1.00%. I would not be surprised to see it go back up to about 2.5% within the next six months. Importantly, I would add that bond market prices are much more directly affected by the change in the 10 year US Treasury yield, which has already moved up to 3%.

While the impact of rising rates on the fixed income market is direct and measurable, its impact on the stock market is just as real even though it is more indirect. In theoretical terms, higher rates increases the discount rate used to calculate the required rate of return on stocks. A higher required rate of return results in lower stock market valuations. In more simple terms, we could just say that higher rates creates some selling pressure on stocks as some investors might consider selling stocks to invest in GICs and bonds. This selling pressure might be more intense on more aggressive investments (e.g. Shopify, Bitcoin, etc.), and the stocks of 'stay at home' beneficiaries (e.g. Peloton, Zoom, etc.). I also believe that the stock market now has a bit less buying support given that (1) many retail investors are going back to a work place environment (and now have less time on their hands), and (2) government COVID relief programs/ stimulus money is ending.

Will the decline get much worse in the short to medium term? As the old saying goes: predicting something is difficult, especially if it has something to do with the future. It is my belief that both the bond and stock markets have been reacting quickly and in a relatively efficient manner to the rise in interest rates. Furthermore, many other negative headwinds (e.g. higher energy prices) are not likely to get much worse. What this means, in my opinion, is that both the stock market and the bond market have most probably undergone most of their price adjustments to all the widely known negative headwinds - even though declines could continue.

I note with great interest that over the past 10 years, 3% has tended to be the high point of the trading range for the 10 year US Treasury (source: Trading Economics). Well, we are essentially at 3% already. So it is quite possible that the bulk of the carnage to the bond market has already occurred. Mortgage rates have also been moving up, which will cause a slowdown in the red hot housing market. This would be a positive in terms of slowing down the economy. While it is certainly possible that rates might overshoot to the upside - especially with today's high inflation rate - I do think we should be less concerned about major future market decreases when we have already experienced a correction. And speaking of today's inflation, a lot of it comes from supply constraint issues, which means tight monetary policy can do little to alleviate some of the inflation pressures we face today. And let's remember that inflation, by definition, means a rise in prices. If prices stay where they are today and do not move for one year then that means inflation becomes zero. We may even end up with some deflation if some supply constraint problems become less severe.

And for those who are worried about a recession, I would say that (1) the real inflation-adjusted growth rate for the U.S. economy was actually negative in the first quarter of 2022 - so I think today's stock prices already reflect an economic slowdown, and (2) the more we talk about a recession, the less likely it might happen (see quote below from Steve Leisman at CNBC). Finally, a recession is not a leading indicator of the stock market. A recession is defined as two consecutive quarters of negative growth in the economy. By the time a recession becomes official, the stock market is already typically looking six- to-nine months ahead to a potential economic recovery and might have therefore turned positive.

Bottom line: while it is impossible to predict what will happen in the short term, my personal view is that at the end of this calendar year, the markets should end higher than their current levels.

Should I be worried? My experience as an Investment Advisor over the past few decades has taught me that levels of worry can vary greatly from one investor to the next. But ultimately, investors should look at their investment portfolio as a tool to reach their financial goals. Day-to-day, month-to-month, and even year-to-year performance should be less relevant than broader questions such as 'what are my investment objectives?' and 'what is my time horizon?' For many investors, 'maintaining a comfortable retirement' is a primary objective. For others, it might be to 'grow my portfolio in order to increase the value of my estate'. Whatever those goals might be, we certainly welcome and encourage discussions if they have changed for you. In the meantime, and without being presumptuous enough to ask a worried investor not to worry, I encourage all investors to view their portfolios as an important tool to help them reach their financial goals. Markets do go up and down in the short run, but the long term trend favours staying invested!

Insights/Opinions from Experts

In this section, as I often do, I would now like to offer a few very recent quotes/insights/observations from respected market experts that hopefully provide useful perspective during these very uncertain times.

"I think the Fed is fine with the yields rising. I think that is sort of the intention. The Fed is trying to bring forward future tightening. The more tightening it brings forwards perhaps the less tightening it ultimately has to do…..We are experiencing the tightening that might have happened at the end of this year right now. And that is why you see the markets being buffeted by that….. I think it is very hard to have a recession that everybody knows is coming. In some sense, by definition, a recession is a result of factors you do not know are coming. Why? Your inventory gets out of whack, you have to smash down inventories, you have to cut back production. If everybody sees this recession coming in August or sometime in 2023 it's actually going to be very hard to have it. …Travel is surging, autos are coming back amid all of this…The market may call a recession but the consumer and businesses may not show up!"
Source: Steve Liesman, CNBC's senior economics reporter CNBC, May 2, 2022

"I do think that the worst of the excesses have been corrected. The groups that did the best in '20 and '21 have been hit the hardest."
Source: Howard Marks from Oaktree Investments, CNBC, May 3
P.S. I read two years ago that Warren Buffett has tremendous respect for Howard Marks.

And speaking of Buffett….
"*Warren Buffett's Berkshire Hathaway Inc. dove into equity markets in the first quarter, spending more than $51 billion on stocks….The Omaha, Nebraska-based company also said it repurchased $3.2 billion of its own stock in the quarter….Berkshire's disclosures suggest that Buffett has finally found large new uses to dispose of Berkshire's cash pile, which shrank more than $40 billion to about $106 billion."*
Source: Reuters, April 30, 2022

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