Wealth Management
Dominion Securities

RBC Dominion Securities inc.

Team Marchand Filiatrault
of RBC Dominion Securities

JULY 2022

Market update

Jean Marchand, CPA, FCSI
Senior Portfolio Manager &
Wealth Advisor
jean.marchand@rbc.com
450-686-3325

Patrice Filiatrault, CFA
Senior Portfolio Manager
Patrice.filiatrault@rbc.com
450-686-4207

Mario St-Amant, B.A.A.
Associate Wealth Advisor
mario.st-amand@rbc.com
450-686-4204

Philippe Ouellette, B.A.A., CIM, FCSI
Associate Wealth Advisor
philippe.ouellette@rbc.com
450-686-3485

545 Promenade du Centropolis
Suite 200
Laval, Quebec H7T 0A3

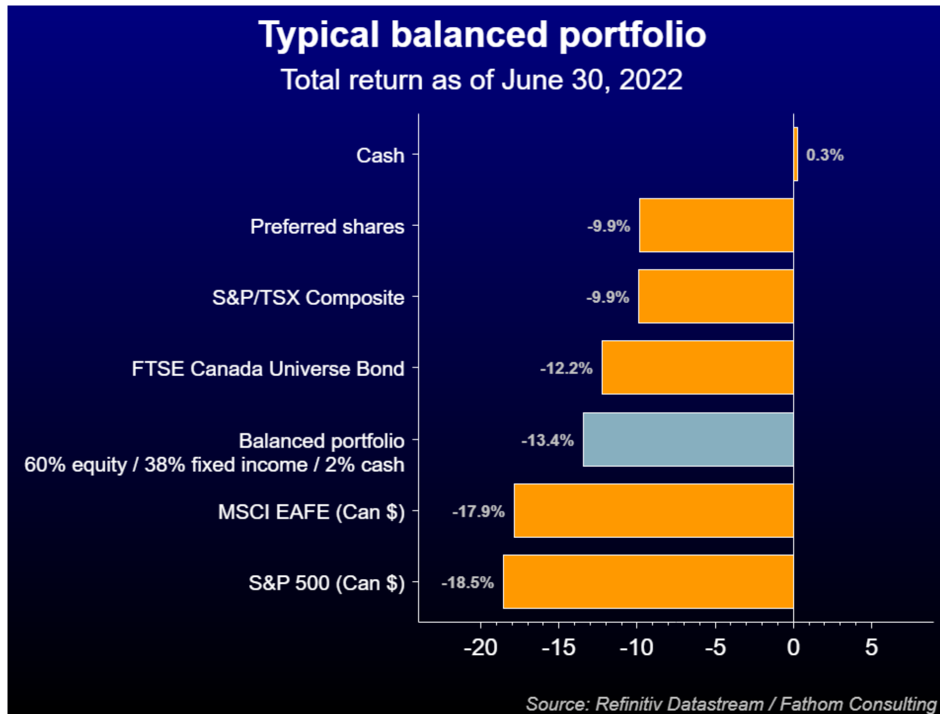
www.equipemarchandfiliatrault.com

Before the invasion in Ukraine clouded the picture, the economic outlook for 2022 was encouraging. Indeed, the world economy was still growing at a pace above its potential and the economy seemed robust enough to withstand the gradual tightening of monetary policies by the world's major central banks. High inflation was a concern, but the post-pandemic normalization of the economy's workings would have helped reduce inflationary pressures in a relatively short time frame.

The outbreak of the Russian-Ukrainian war drastically changed the economic outlook, especially since the conflict seems to be dragging on. The impact of this war has been felt primarily in commodity prices, particularly for oil and natural gas, and inflation has accelerated markedly in recent months as a result. Faced with runaway inflation, central banks have responded with significant interest rate hikes, and investors are now concerned that an abrupt tightening of credit could eventually push the economy into recession.

This environment has been particularly difficult for investors since the start of the year, as they have taken a hit on both stocks and bonds. On the one hand, a potential recession could lead to a deterioration in corporate profits, hence the general decline in stock market indexes, and on the other hand, the rapid rise in interest rates is pushing bond prices down. As a result, the 6-month period ending June 30, 2022 proved to be one of the most challenging for a balanced portfolio of equities, fixed income, and cash. Chart 1 on the following page shows the performance of the various components of a typical balanced portfolio for a Canadian investor.

Chart 1



Based on the performance of the benchmarks for each asset class, we calculate that a balanced portfolio (60% Canadian/U.S./international equities, 38% Canadian fixed income, and 2% cash) generated an overall return of -13.4% as at June 30, 2022. It is worth noting that the performance of the balanced portfolios we manage is well above that of the benchmarks for this first half of 2022. We will come back to this subject in the section that deals with the management of our portfolios.

Outlook for the economy and the financial markets

With inflationary pressures building following the invasion of Ukraine, the Federal Reserve had to accelerate tightening of its monetary policy. After a first increase of 0.25% on March 16, the U.S. central bank followed up with a 0.50% increase in its key rate before following up with two consecutive increases of 0.75% each at its last two meetings. Financial markets saw this accelerated tightening of monetary policy as a sign that the Federal Reserve was losing its battle with inflation and would have to continue to raise rates significantly, at the risk of pushing the economy into recession. These fears of a slowdown are being confirmed, and our various economic indicators show that the growth outlook has indeed deteriorated.

For example, as shown in Chart 2 on the next page, the Conference Board's leading economic index in the U.S. has lost significant ground in recent months, and if the trend continues, the indicator could be in year-over-year decline as early as the third quarter of 2022. Historically, when this indicator shows a decline compared to the same period of the previous year, the U.S. economy enters a recession in the following months. It is important to note, however, that this indicator has come close to the 0% annual variation threshold on several occasions in the past without the economy falling into recession.

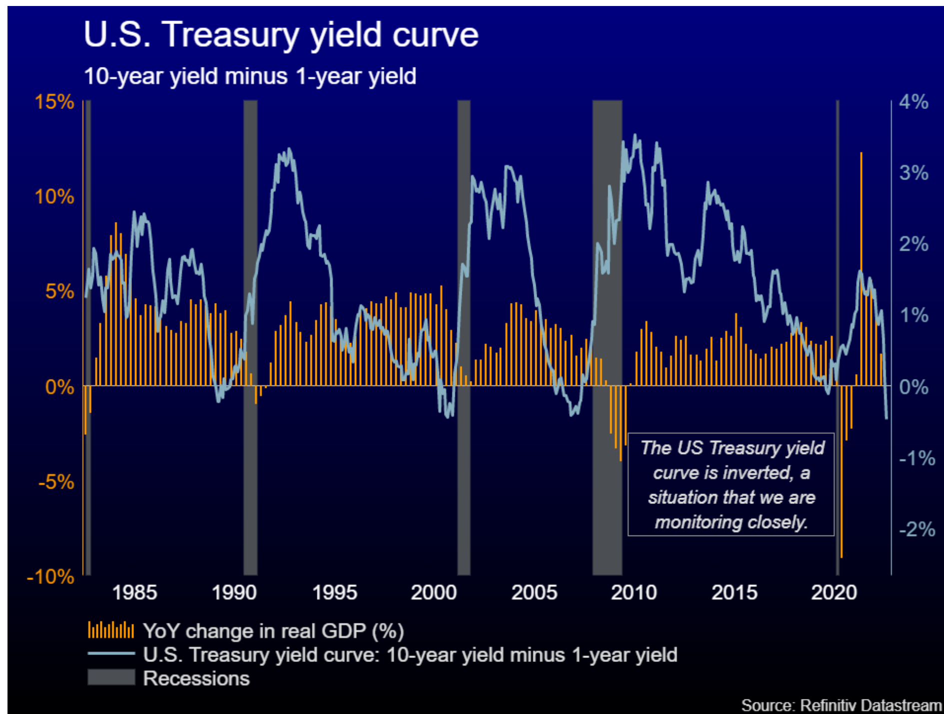
Chart 2

Another reliable leading economic indicator that we are monitoring is the yield curve in Chart 3 on the next page, which suggests a slowdown in economic activity. An inversion of the yield curve, where the 1-year U.S. Treasury bond rate rises above the 10-year rate, is usually an indicator that the economy may be heading into a recession in the near future.

These two indicators are not the only ones we monitor. Several other leading indicators of economic activity are in better shape, including indicators related to employment and business cash flow. Nevertheless, we must acknowledge that the economic outlook has deteriorated rapidly in recent months. While a soft landing is still possible in the U.S., the risks of a short and shallow recession have increased. However, the likelihood of a severe recession remains quite low in our view. Indeed, the U.S. consumer is in good financial health, the job market remains relatively robust, and corporations are in excellent shape with high profit margins and good coverage of their debt financing costs.

As for the stock market indexes, the economic outlook alone is not enough to make a prognosis as to their trajectory for the coming months. It is also important to assess the extent to which the level of the indexes already reflects the ongoing economic slowdown and the risks of a recession. This is never a simple exercise since each economic cycle has its own particularities and therefore, comparisons must be made with caution. When analyzing the last 13 recessions in the U.S., we note that the average market decline from peak to trough is 32% and the median of these 13 recession cycles is -27%. Obviously, the dispersion of the data is large. During the 2008–2009 financial crisis, the S&P 500 lost 57% of its value, whereas the fall of the U.S. flagship index was only 14% during the 1960–1961 recession. By comparison, the S&P 500 declined 25% from its high to its low in 2022, a decline that is close to the mean and median for the last 13 recessions. Without wanting to minimize the impact that a recession can have on employment, corporate profitability, and the financial markets, it should be remembered that such a situation is not necessarily synonymous with a financial crisis. It is quite possible that, in the event that a recession becomes a reality, it would be mild and short-lived.

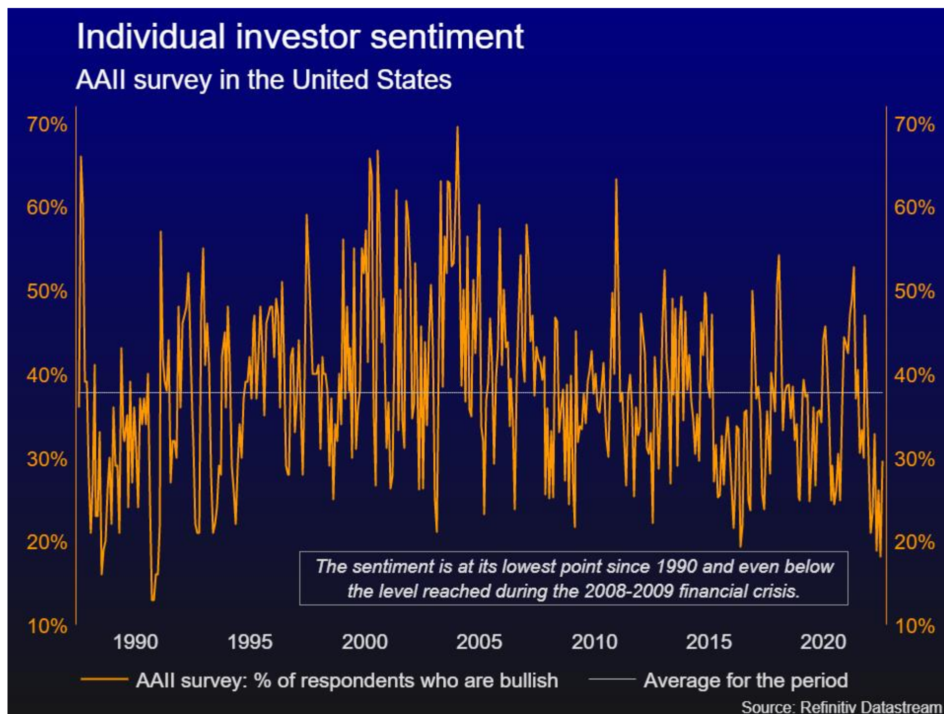
Chart 3



Although the probability of a soft landing has decreased, this scenario is still plausible. Throughout history, several events, including military conflicts, have shaken investor confidence to the point where a recession was feared but did not come to pass. More recently, we have experienced such worrisome episodes as the European debt crisis in 2010, the U.S. debt downgrade in 2011, the oil price collapse in 2015, and the "growth scare" of 2018 associated with the China–U.S. trade war and the tightening of the U.S. monetary policy. During these episodes of uncertainty about the prospects for economic growth, the S&P 500 Index has on average lost 17% of its value, which is less severe than the 25% decline we experienced at one point in 2022. At the risk of repeating ourselves, it is tricky to try to draw conclusions based on historical data, but the exercise still allows us to say that the significant decline in the S&P 500 Index this year already factors in much of the economic slowdown, and even the risk of a mild recession.

What reinforces this assertion is the level of investor pessimism, which has rarely been so high in history. Whether it's the lingering war in Ukraine, persistent inflation, the threat of a recession or recurring COVID-19 waves, there is no shortage of issues of concern to investors. According to the AAII survey of individual investors in the United States, sentiment is at its lowest level since the early 1990s, and this pessimism is shared by institutional investors, whose views are also very negative. As can be seen in Chart 4 on the following page, current sentiment is even lower than that reached during the 2008–2009 financial crisis. Historically, these extreme levels of pessimism are a good indicator that bad news are already factored in, and precede rebounds for the equity market (note that the S&P 500 has just had two very good weeks with a strong rebound).

Chart 4



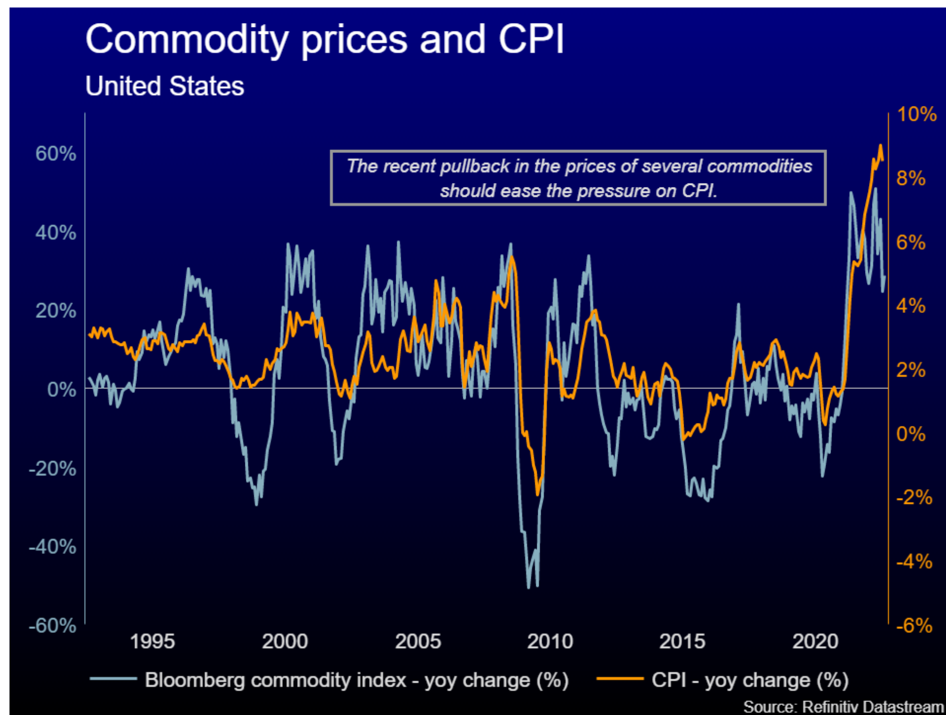
Stock market valuations, meanwhile, have fallen sharply. For example, the S&P 500's price-to-earnings ratio fell from about 21x at the beginning of 2022 to 15.8x at its low in June 2022. After the strong rally of the U.S. index in July, the price-to-earnings ratio now stands at 17.1x, which is in line with the average of the last 10 years. For our Canadian index, the S&P/TSX, the price-to-earnings ratio is 11.7x, which is well below the 10-year average of 15.1x. At first glance, these valuations look relatively attractive, but caution is advised. Indeed, with economic growth slowing, we expect analysts to reduce their earnings forecasts in the coming months. While we are encouraged by the second-quarter results, which began to be released about two weeks ago, we believe that earnings expectations will be revised downwards. Furthermore, the very low price-to-earnings ratio in the Canadian market is explained by high commodity prices that have inflated profitability expectations in the resource sector, a situation that is not sustainable in the longer term.

Lastly, it is important to mention that for some time now, we have been seeing a change in leadership in the equity market. After a period of outperformance in the wake of the pandemic, value stocks have been losing ground to growth stocks more recently. This rotation in investment style can be explained by the slowdown in economic activity, which puts value stocks at a disadvantage as they are generally much more dependent on the pace of economic growth.

On the fixed income side, the correction in the bond market has been severe since the beginning of the year and has made bonds more attractively priced, at least compared to recent years when yields were at their lowest. As with equities, it appears that the worst is behind us for the bond market. However, several scenarios are possible. In an environment with economic activity deteriorating significantly and inflation falling sharply, the bond market would perform very well. However, it would be more problematic for the bond market if inflation persisted at very high levels, which would require central banks to continue their tightening. In such an environment, investors would demand higher yields and bond prices could continue to slide. The economic statistics to be released in the coming months will give us a clearer picture.

In our view, the path of inflation will be the key driver for both bonds and equities in the second half of 2022. If the growth rate of consumer prices, which reached its highest level in over 40 years in the United States in June, does not let up, it is difficult to imagine a sustainable rebound for stocks and an upturn in bond prices. Fortunately, all indications are that inflation may have peaked in June 2022 and economists expect a significant decline by the end of the year. Indeed, commodity prices have fallen significantly since March and such a decline should eventually ease the pressure on consumer goods prices. As Chart 5 illustrates, there is historically a strong correlation between inflation and commodity prices and the recent trend is encouraging.

Chart 5



Beyond commodity prices, it should be noted that the prices of several products and services in the United States have also eased recently, including the price of gasoline, the cost of transporting goods, the price of used cars and several other consumer goods. The reopening of economies has allowed consumers to direct more of their budgets toward services at the expense of goods, leaving some retailers with excess inventory on many items that were in high demand during the pandemic. As we've seen over the past few weeks, giant Walmart and several other retailers have to clear out excess inventory at discounted prices. The return to a normal environment should help rebalance consumer budgets between services and durable goods with beneficial effects for prices in general. Lastly, in light of the comments made by companies when releasing their earnings reports, the supply problems caused by the pandemic are gradually being resolved and the effects on business costs should subside.

Portfolio management

During the first half of 2022, the portfolios under our management were obviously affected by the general decline in the stock markets and the fixed income market. However, our portfolios outperformed the benchmarks by a considerable margin. There are several reasons for this favourable performance gap. First, on the fixed income side, the short duration of our bond portfolio worked in our favour. In an environment of rising interest rates, bonds with longer maturities suffer more than those with shorter maturities. For several years now, we have found bonds unattractive and have therefore preferred to keep our maturities shorter. In addition, we favoured term deposits and preferred shares, and invested in real estate and mortgage alternative solutions. As for preferred shares, the performance of these securities was more difficult and unfavourable to the overall performance of the portfolios. With respect to the private real estate fund, its performance since the beginning of the year is excellent and far superior to the bond market. The properties held by the fund benefited from the reopening of the economy and increased rents. The low level of debt and well-spaced maturities over several years have limited the impact of rising interest rates on the fund. Lastly, on the mortgage fund side, liquidity is being deployed and we will be able to comment further later this year.

As for our equity investments, our stocks performed relatively well in a context of generally declining stock markets. The favourable performance gap of our stocks is largely explained by the quality of the securities in our portfolio. Indeed, with recession fears growing, financial strength, profitability and competitive advantages are attributes that are becoming even more attractive to investors. It should also be noted that our low exposure to more speculative sectors, such as new technologies, has served us well. Canadian equities performed particularly well and outperformed the benchmark. Although our U.S. and international equities declined more sharply than Canadian equities, they still ended the period ahead of the S&P 500, our benchmark for this portion of the portfolio.

With the growing risk of the economy falling into recession, we have made some changes to the portfolios. On the bond side, we decided to extend our duration and take advantage of the significant rise in yields since the beginning of the year to add quality bonds at a discount that benefit from advantageous tax treatment. In a more pessimistic scenario where economic conditions deteriorate beyond expectations, longer-term bonds can act as a counterbalance and thus reduce overall portfolio volatility. On the equity side, we decided to reduce the risk in our portfolio. In an environment of slowing economic growth, we felt it was prudent to reduce our exposure to the commodities sector. As a result, we reduced our investments in Canadian Natural Resources, an oil and gas producer, Teck Resources, a copper and coal producer, Nutrien, a fertilizer producer, and the U.S. Energy Index Fund at good prices. In addition, we eliminated CCL Industries, a manufacturer of containers and packaging. In the industrial sector, we reduced our position in WSP Global after the stock's exceptional performance over the past few years. In the financial services sector, we eliminated Sun Life and reduced exposure to Toronto-Dominion Bank to fund a new position in Bank of Montreal stock, whose acquisition of Bank of the West holds promise for the longer term. In an environment of slowing economic activity, growth stocks are generally favoured and we believe they could regain leadership. These companies, whose growth prospects are less dependent on the economy, have a greater capacity to grow in a more challenging environment. As a result, we initiated three new investments in Costco, Thomson Reuters, and Cargojet. All three of these quality companies have excellent long-term growth prospects and we took advantage of their low share prices to establish new positions. Lastly, we initiated a position in Magna, which operates in the automotive sector. The entire industry has suffered from supply problems and the conflict between Russia and Ukraine. Not only will Magna benefit from the catch-up in car production that is needed to fulfill unmet demand, we believe that it is well positioned technologically to compete with its peers in the coming years.

In conclusion, it is important to remember that in such an uncertain environment, several scenarios are plausible and the consequences for the financial markets can vary greatly from one scenario to another. The economic data to be released in the coming months will allow us to make a more informed assessment. In light of any new information, we will continue to evaluate the potential and risks for each asset class in order to make appropriate adjustments where necessary.

We would like to take this opportunity to thank you for your trust and wish you a happy end to your summer.

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