More of the Same for the Second Quarter

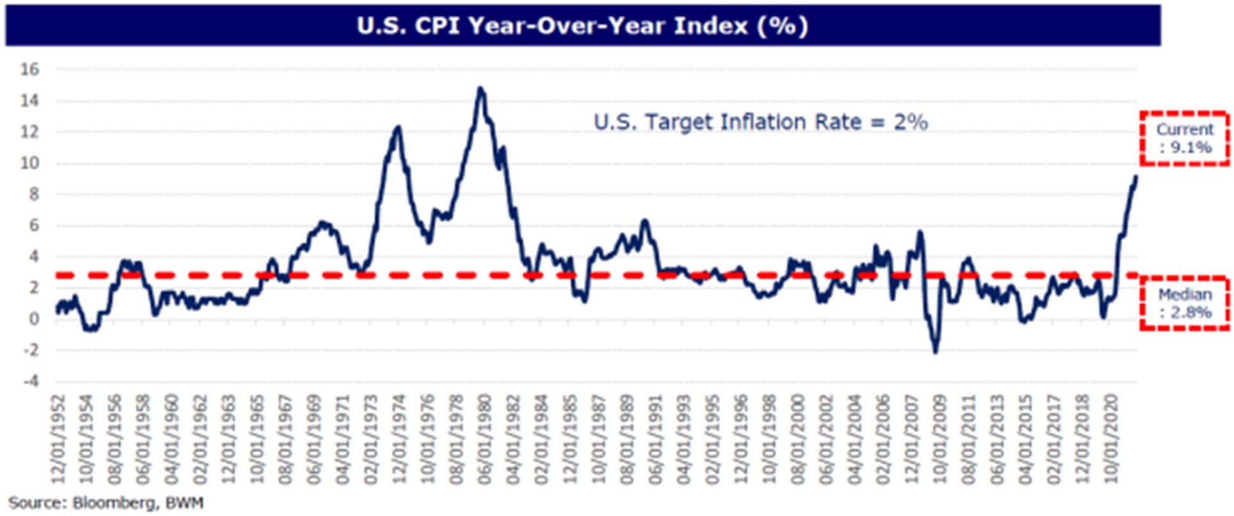
The second quarter suffered from many of the same themes as the first, with the market generally surprised to the downside on important economic and political fronts. Losses for stocks accelerated following the first quarter, with global equity markets down more than 16% in Q2 versus down 5.5% in Q1. The first half saw price losses for the Canadian bond universe of 14%, historically poor performance resulting from the rising rate environment in response to continuing inflationary pressures.

The magnitude of these difficult market conditions is given proper perspective when looking back over the long-term. The S&P 500 index, the major U.S. stock market, had its worst first half performance dating back to 1970, over fifty years. This was the third worst performance dating back over the past 70 years, and very narrowly.

Fortunately for investors, the severity of this correction is very rare. There has been a confluence of factors driving the price pressure. As we highlighted in our last quarterly communication, the primary culprits continue to be inflation, the resulting Central Banks' tightening in response, and factors that are fueling higher than expected inflation including supply chain issues, ongoing Covid lockdowns in the East, high commodity prices from pent up demand and now significant wage inflation due to historically tight labor markets. Evidence of labor constraints are visible across most industries, but are most acute in the travel and hospitality sectors where labor dislocation was most significant during the pandemic. If checking your bag no longer seems attractive given the uncertainty of its arrival, good luck finding overhead bin space. The list of concerns on consumer and investor minds to begin 2022 is quite long in other words.

Have We Been Here Before?

Fueled by a perfect storm of every inflationary pressure one can think of (including an outright war in a key energy and agricultural producing region of the world), inflation has surprised the market to the upside throughout 2022. The latest inflation reading in the U.S. was 9.1%, the highest inflation level dating back over forty years and which compares to the post World War II median inflation rate of 2.8%. In modern history, the only period of time since the Great World Wars with inflation this high was in the mid-1970s to early 1980s. As many of our clients will remember, this was an era of very high interest rates after failed monetary policy from 1970 to 1978 by then Federal Reserve Chairman, Arthur Burns. There was also an energy crisis at this time, albeit the culprit was different than today.



Those with long enough memories for this era will recall the very aggressive monetary policy enacted thereafter under the subsequent Federal Reserve Chairman, Paul Volcker, from 1979 through 1987. The target rate exited 1980 at 18% and was still 6.9% by the end of 1987.

The U.S. Federal Reserve has likely decided the risks of sustained high inflation outweigh the risks of a hard landing or recession (of which the likelihood appears to be increasing after Q1 GDP declined 1.6% with expectations of more of the same for the second quarter). The U.S. target rate sits at 1.75% today, with the next meeting approaching on July 27th. It is expected the next increase will be between 50 and 100 basis points with a 75 basis point increase deemed most likely by the market. Economists foresee further increases south of the border until early 2023 at which point expectations are currently calling for rate cuts as the economy slows, inflation moderates and stimulus would be needed to achieve a soft landing.

North of the border, the Bank of Canada just announced a surprising 1% increase in the target rate which now sits at 2.5%. The market anticipates more of the same in the meetings to come, with current expectations calling for a ~75 basis point increase in September and further but more modest increases in October and December to exit the year at approximately 3.75%.

More Things Can Happen Than Will Happen

Investors, economists and Central Bankers alike, are historically poor forecasters of future rate increases. We have no unique insight into what exact path the global economy and monetary policy will take but in our estimation, there are several possibilities in play today. The implications for investment returns and market volatility depend on which path unfolds.

Stagflation (high inflation remains with low growth) ***… We see as unlikely***

- History on the side of Central Bankers who saw what didn’t work in the 1970s
- If it happens, bad for asset valuations and economy

Recession occurs / inflation abates ... ***We will have a better sense soon based on response of economy to current tightening***

- Central Bankers raise too much, too fast and economy grinds to a halt

- Bad for the real economy short-term, better medium and long-term and asset valuations improve as inflation credibility is restored

Inflation peaks soon with soft economic landing ***… We think most likely***

- Shift in spending away from goods occurring (lowers demand for materials), commodity prices already off highs (-15% for global commodity basket from June peak), economy already showing signs of slowing, nine of past 17 rate hiking cycles ended with no recession
- Positive for markets as a recession scenario is already being priced in (every bear market for stocks associated with U.S. recession for more than 100 years)

Sticking to the Process

As the potential future paths of inflation and monetary policy are varied, we continue to expect heightened volatility continuing in the near-term given varying implications for equity and fixed income valuations.

It has been a challenging start to 2022 after years of robust market gains. We believe we are closer to the end than the beginning of the current state of market affairs. Across virtually all investable asset classes, expected long-term asset price returns have improved meaningfully. Recent times of investors searching for yield to no avail or by taking unnecessary credit risks have at least temporarily passed, with government and corporate bond yields the most attractive they've been in many years. In equities, the risk / return trade-off has similarly improved materially as valuations across many countries in the world are at or below long-term levels creating a significantly more attractive entry point than any recent time outside the lows of the Covid induced sell-off in early 2020.

The increase in expected returns and heightened volatility to begin 2022 has led to more heavy lifting than usual from a portfolio management perspective as the opportunity set of many asset classes has greatly expanded. We look forward to updating you in the months to come on changes we are making to asset allocation and security and manager selection as a result of significantly more compelling investment opportunities.

We are here to provide a steady hand to the oversight of your investment portfolios. We use process and portfolio management decision-making structure to mitigate the impacts emotions can have during difficult market conditions. We look forward to confronting these challenges in the near-term, and providing positive updates as we come out the other end of the current market cycle.

Bessette Wealth Management

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