The Bobb Report

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The Fed Giveth and the Fed taketh away

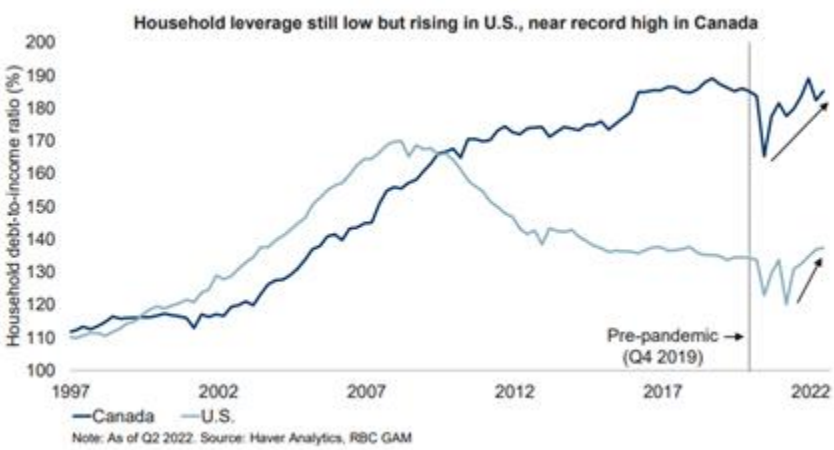
Why are we here (again)? What can we expect? And, how do we position for such an environment?

Let's start by revisiting the issues that plague us. The world of excesses found its way into monetary policy over the last few years. In response to the worst pandemic in a century the Federal Reserve and its global counterparts dropped tens of trillions of dollars into the economy that led to a massive rally in all asset prices in spite of the global economy grinding to a halt. Pervasive optimism fueled by this explosion of liquidity led to excessive risk taking by many, a massive surge in consumption, and most importantly the first major spike in inflation in a generation. There is no worse outcome than runaway inflation, and given the Fed's mandate of full employment and price stability they are attacking the price problem, that they themselves created, with a vengeance and little concern for the short-term repercussions many of which still lie ahead.

As I stated in last quarters note, we were likely to test the June lows in the typically cranky month of September and here we are. Excessive pessimism rivalling the financial crisis lows in 2008 has now taken over the narrative and it sure doesn't feel good. With any hope history can repeat itself with the majority of the market gains in a given year coming from the September trough low to the end of March, as pessimism climaxes and the narrative shifts. While it feels like wishful thinking at present to consider such an outcome, perhaps it is a possibility. We are approaching what is typically a seasonally strong period for the markets and the change in sentiment may have to come from the much awaited peak in inflation and a corresponding shift in the aggressive language and behavior by the Fed in what could be a 'subtle pivot'. The rapid interest rate hikes by Central banks take 12-18 months to show up in the economy, and yet the Fed is using current data to determine policy or in other words driving the car that is the economy straight into a concrete wall while looking in the rearview mirror. In short, the Fed messed up badly by over responding to COVID both in magnitude and most certainly in duration. They are now messing up in a major way in the opposite direction that will undoubtedly lead to recession which the markets are now pricing in. The silver lining here is the markets historically respond very well in the coming quarters to inflation peaking, to corrections of this magnitude and most importantly to peak levels of pessimism such as the one we are witnessing. One of the many famous Warren Buffettisms seems apropos at the moment, stating the best time to 'buy stocks is when there is blood in the streets'. Let us consider all of this further and explore a course of action that should allow us to come out of this period in a productive manner using the 'conservatively opportunistic' strategies that have always been the foundational cornerstone at Skeat Private Wealth.

What should we make of Federal Reserve Chairman Jerome Powell who in response to the Fed's disastrous policy response to Covid, has had a personality shift of epic proportions in a few short months? Clearly the model of stability that they pride themselves on. Once a 'dove' rivalling many of the finest such as Greenspan and Bernanke, Powell is now morphing into a clone of his new 'man crush' Paul Volker as he attempts to unwind the spectacularly calamitous monetary policy that he chose to implement. In spite of the shocking miscalculations both in size and magnitude of the stimulus and the unsurprising inflationary issues that have ensued, what is truly upsetting is the Fed actually hurt those they were most trying to help and they are seemingly setting up for round 2 of the same.

As is typically the case with monetary stimulus, dollars floating around the economy find their way into assets such as stocks and real estate pushing prices up and providing the greatest benefit to those with the greatest exposure, rather than those that were trying to make do during the government induced global shutdown. Adding insult to injury, this historic interest rate hiking campaign, being felt by all of us, is allowing history to repeat itself by once again wiping out a generation of young investors, many of whom embraced the post-Covid market hype by piling into meme stocks, SPACs and crypto. Caveat Emptor I suppose, as sad as that may be. Worse still, should interest rates remain elevated or push ever higher, a huge number of young homeowners may get wiped out, particularly in Canada, as enormous leverage which has become the norm in this country is unlikely to stand up well against price declines coupled with looming spikes in mortgage payments.



Source: RBC GAM

Powell may well be tiptoeing through the economic graveyard if he keeps hiking rates with zero consideration for the eventual outcome of these policies. Interest rate adjustments take 12-18 months to materially impact the economy, so we have yet to understand the impact of the very first rate hike let alone the many others and those yet to come. By all means, regardless of who created the problem, we all have to take the tough medicine to deal with surging inflation, and few if any dispute this. Powell just has to be careful that he does not give himself a lobotomy to cure his headache. We cannot underestimate the profound magnitude of what the fed has done thus far and no one fully knows the severity of the consequences, but if the Fed stays on this course the term 'soft landing' pertaining to the economy will be considered just as comical as his endless iterations of the term 'transitory inflation'. To that end, noted market commentator and professor Jeremy Siegel of the Wharton School of Business, who has called this market to a tee and was supportive of the Fed tackling inflation, is on record daily calling the recent aggressiveness of the Fed, both current and pending, "the greatest mismanagement of the economy the world has ever seen". Throughout these tightening periods in history the Fed stays aggressive until it inadvertently fractures something in the economy which causes the ultimate bottom in the markets after a lot more pain and, in turn, forces a major 'pivot' in Fed policy to prevent contagion from whatever it is they broke. Over the weekend, there were rumblings that Credit Suisse is having solvency issues which would be economically material should it transpire leading to a new bout of volatility that would not be pleasant. This would however, encourage a meaningful change in Fed Policy, that could eventually help us find a bottom to this period. This falls under the 'be careful what we wish for' category as the path forward would be turbulent.

Now on to the markets and then some positive outcomes to consider. The markets are down more than 25% which has only occurred now 9 times in the last 70 years, as they digest the enormous change in interest rates and the possible outcomes to follow. What is unique about this period is that the bond market followed suit with similar declines leaving few places to hide since this cyclical bear market started over a year ago. The declines while painful and not entirely unexpected have brought markets down to some very compelling long-term valuations: the S&P is at 16x earnings, the Equal weighted S&P 14x and the TSX 11x earnings. It should be noted that all previous declines such as this have provided exceptional long-term buying opportunities, with only a couple of exceptions in the short-term in which credit market issues took the markets meaningfully lower and caused the turmoil to drag on a little longer. Could this period be one of those exceptions? It certainly could if the Fed stays this aggressive to the point that something significant breaks in the economy. In all probability however, history suggests the risk of this to be relatively low. Here's why: the exceptions noted above were a function of major credit crises, which are not in place at present. This downturn is related to the recent spike in inflation which is a more common cause of bear markets historically. During inflation induced bear markets, market downturns are typically about half as severe as the reactions derived from credit related crises such as the GFC and dotcom bubble, so at present we have largely priced this in, assuming the credit markets remain stable. Credit related bear markets typically see earnings contract 30-50% while inflationary bear's see contractions in the 15-25% range. Based on what we know today is a significant silver lining and implies most of the damage has been done, with perhaps a final climactic short-term spike lower to mark an end to this frustrating period. RBC, Bank of America and others predict a 10% hit to earnings which is commensurate with a shallow recession that is already in the markets. It is also very important to note that of the 6 major inflationary spikes over the last 100 years there was only one in which the markets didn't bottom **prior** to inflation peaking in spite of subsequent recessions that followed in most of those cases.

Further, once inflation peaks, of which there is significant evidence starting to emerge with approximately 2/3 of the inflationary indicators rolling hard to the downside, the 8 month subsequent return for the S&P is on average 17%, which we would all welcome. The month of September (also known as The Fall Fall) is always the worst month of the year as the market obsessively tracks down the direst of scenarios to focus on. I mentioned in last quarters note the possibility of a September retest of the June lows and here we are. While there may be more chop to come over the next few weeks, markets are very cheap and getting washed out. Examples of this include: record levels in cash related mutual funds, investor sentiment approaching the 2009 lows of the Great Financial Crisis (GFC), valuations already pricing in a typical inflation induced recession, 20:1 new lows to new highs for the S&P last week, volatility levels approaching those of historical reversals, and record institutional short positions on the S&P not seen since the bottom of the GFC. These are all major contrary indicators implying a climax of negativity towards the current environment and suggesting a positive shift in market narrative may be just around the corner which could be quite meaningful, as defensive posturing unwinds. I will state again, the markets will turn when it is least expected!

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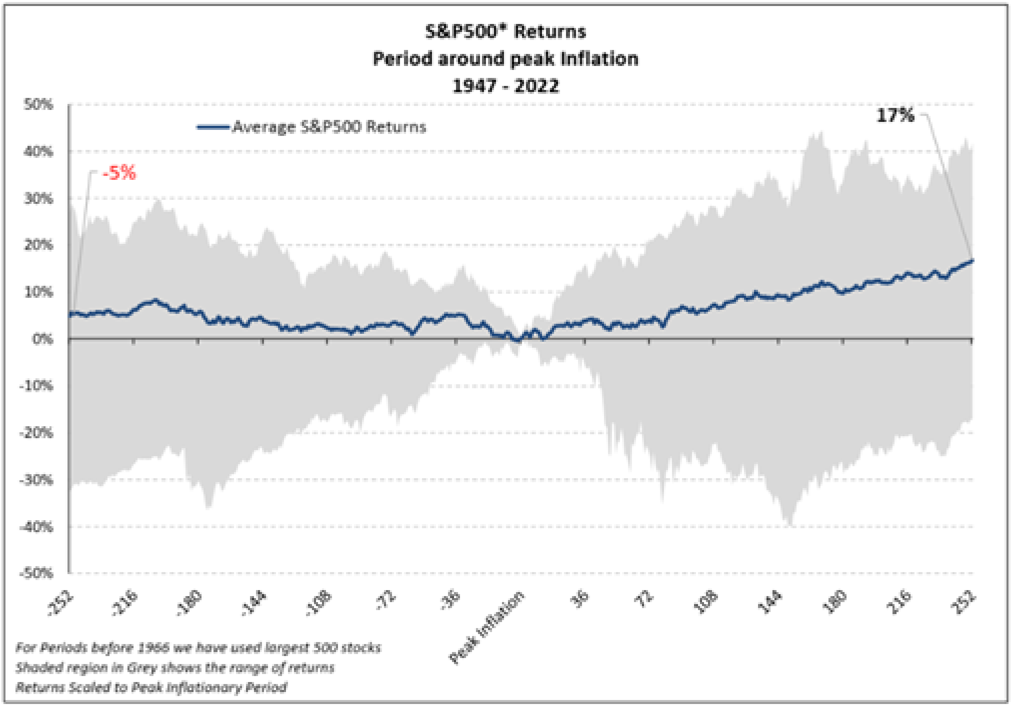
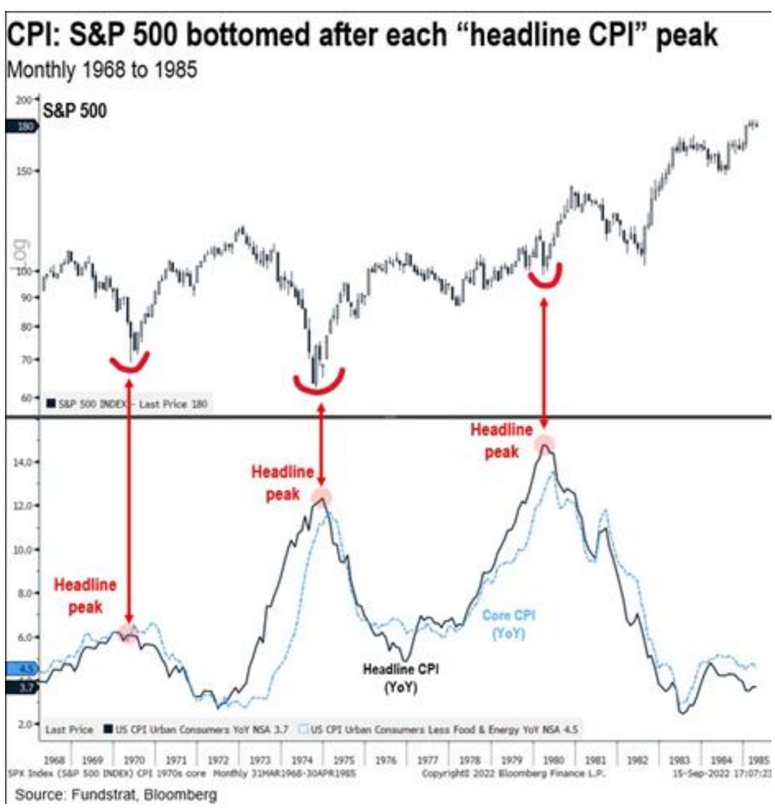
EXHIBIT 5 : **The S&P 500 has outperformed in the past over one year holding periods post-peak inflation**



Source: Factset, CRSP, Bloomberg, OECD, Investopedia, Bernstein Analysis

Source: RBC PAG



Source: Fundstrat

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Unfortunately the near-term remains murky and a further 10% spike to the downside cannot be ruled out but is likely to be very short-lived should it happen, but by all means we will try to catch it if we can. That aside, for the most part as investors we must make investment decisions not with 3 days in mind but rather 3 or more years. Mark my words, looking back 3 years from now current asset prices will look like a tremendous gift and we will lament having not 'backed up the truck'. I still hear from clients 15 years later wishing they had taken greater advantage of the opportunities from the GFC. Keep in mind a few quotes from some of the world's greatest investors:

"The intelligent investor is a realist who sells to optimists and buys from pessimists", Benjamin Graham

"You make most of your money during a bear market, you just don't realize it at the time",Shelby Cullom Davis

"The stock market is a device to transfer money from the impatient to the patient", Warren Buffett

"Far more money has been lost by investors trying to anticipate corrections, than has been lost in the corrections themselves", Peter Lynch

An excellent depiction of why these folks and others have had such tremendous success as investors is depicted in the chart below. Looking at the red bear market periods in history vs the green bull markets, wouldn't one be better off focusing their attention of the green periods instead of perpetually obsessing on and worrying about the red ones?

Source: Investopedia.com, September 2022

So if we were to drum up the courage to explore some long-term investment opportunities what might we consider? The short answer at present is just about anything of meaningful quality, however for today let's isolate a couple of examples. Why don't we start by considering everyone's favorite, the Canadian bank stocks. There was an old rule of thumb that was around years ago and at the time set precedent for how to invest in these wonderful companies. It stated that you buy banks when they are below 10 times earnings with yields over 4% and you sell them when they are over 14 times earnings with yields less than 3%, although my advice has always been to simply never sell them. This adage was deemed out of date over the last decade or so as no one ever expected these companies to trade back to these levels again. As per the chart below, Canadian banks are currently trading at just over 9 times earnings with yields well over 4%, which granted leaves a little room for what is likely some earnings contraction near-term, but is commensurate with previous valuation bottoms. My view of banks at these levels for those investors with an appropriate purview is .... YES PLEASE!

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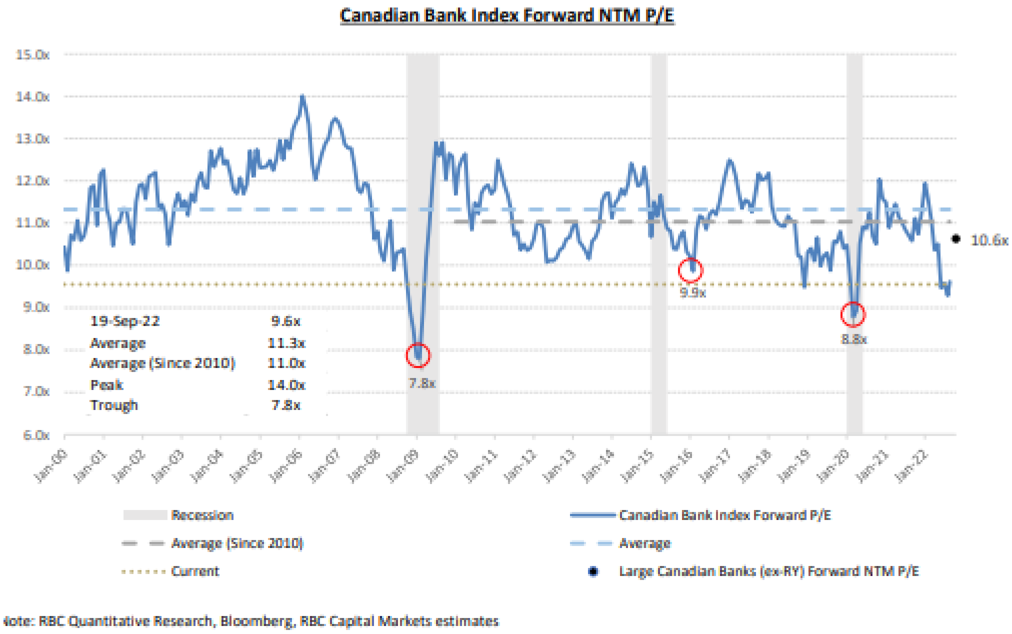

Source: RBC Capital Markets

Another conservative yet opportunistic opportunity that is present in the market place is that of bonds that were issued when interest rates bottomed possessing correspondingly low coupons. These high quality bonds are trading at significant discounts to their maturity value meaning that the majority of their return will come in the form of capital gain. Thus, for taxable accounts and considering a 5 year term on a pre-tax basis you would have the equivalent of a 6.2% GIC and higher still if you happen to have some capital losses tucked away to offset the gains. Pretty compelling for a near risk-free return. Please reach out if you are interested in this strategy as we have excellent options ranging from 1 month to 5 or more years. We are currently working to incorporate these and other higher interest fixed income strategies into many of our portfolios. For the first time since the GFC, ‘there is an alternative’ to equities to generate return and we are using our opportunistic approach to consider some exposure. Further, with a manageable recession on the horizon, given the worst bond market since 1949 and in anticipation of inflation continuing to roll over I believe we are setting up for a growth scare which will lead to a constructive trade in long duration assets like long bonds and technology stocks. To that end, we are beginning to add some duration by nibbling at the US 20 year T-bond ETF which is down over 30% this year, and will look for further opportunities in Q4.

With regard to our portfolios, as is always the case, they are holding up better than the markets themselves on a relative basis, which should provide for a faster recovery as the market narrative eventually shifts. While it is never pleasant to see our portfolios decline and see negative numbers it is part of investing and the tremendous benefit that comes from holding quality equities long-term. We have taken steps to increase the portfolio yield, reduce our overall equity valuation, nibble at some fixed income as interest rates approach what should be a peak relatively soon, and adding more of the world’s highest quality businesses and brands at some incredibly attractive levels. We are not however, at this point, eliminating some of our massive free cash flow generating, world class businesses at fire sale prices as this would compromise our ability to fully participate in the eventual rebound which should be sharp. More changes will be considered as the markets return to a more sanguine state in the coming weeks and months. In this environment, signs of a shift in market narrative is likely to

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come from inflation beginning to ebb, bond yields stabilizing and the very strong U.S. dollar starting to peak and roll over. Should any or all of these things present themselves I would expect a very powerful market rally that could mark an end to this painful bear market. Do keep in mind bear markets always culminate in the birth of a new bull market and with any hope it is sooner than later.

In the interim, don't get too caught up in the negative news driven narrative and fear mongering and remember an old market adage as it is apropos, "Bears sound smart, bulls make money". This bear market started a little over a year ago and at some point will turn when it is least expected and never look back. This may well be a ways off but markets never respond in concert with even the best laid plans so waiting to catch the bottom is a futile exercise. Continue to own and accumulate world leading assets, companies and brands and hold onto them and you will be very happy you did as this is precisely what the world's most successful investors do. While we may not be completely out of the woods and there are no shortage of issues to concern ourselves with, the markets will stop going down at some point, and the velocity of the recovery will make it very difficult to catch. Markets do not go down forever and always price in future events well in advance, as they are doing at the moment. In fact markets go up approximately 75% of the time. Think back to the chart contained in this note and stay focused on the green shaded periods and it will be a much better use of your time. Your portfolios are sound, the investment process we have built over decades is sound, and the assets you hold are world class and second to none. The fog and gloom that is with us at present is here for valid reasons and may be with us a while longer but brighter days will emerge in the coming weeks and months and the scrapes and bruises from this difficult bear market will once again be nothing more than a distant memory.

Thank you for your trust and patience as we get through yet another challenging stretch for the markets. The bad tasting medicine that the economy is currently taking is painful but necessary, and more importantly always allows the patient to heal and life to resume in a much more enjoyable manner.

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