Market Update

Inflation Fixation

All eyes remained on key inflation numbers this week as investors anxiously awaited the U.S. FOMC meeting and ultimate decision around the expected rate hike. Federal Reserve Chairman, Jerome Powell offered a balanced message as he indicated that the Fed remains comfortable with the contraction in the markets thus far, however emphasized that they are not aiming to induce a recession.

The Fed increased rates by 75bp pushing the Fed Funds rate to between 1.5 and 1.75%, largely in line with market expectations and the median projected target range for the end of 2022. Of course, the key factor in future rate hikes remains firmly based on a variety of incoming data and not just CPI, though the Fed signaled that "either a 50 basis point or a 75 basis point increase seems most likely at our next meeting" to contend with multi-decade high inflation.

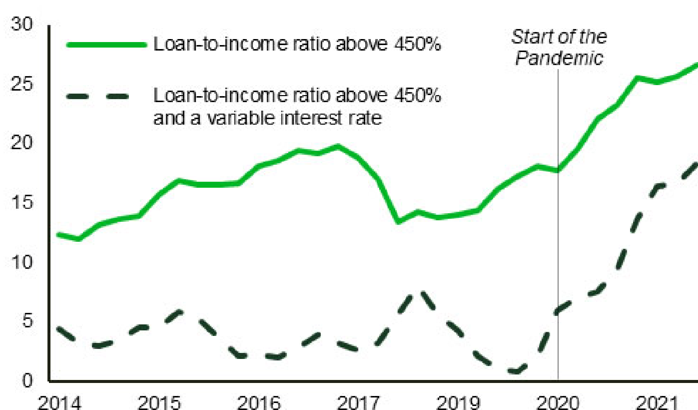
Back on the Homefront, Canadians are experiencing similar headlines around inflation, as May's month-on-month core inflation numbers edged up to 3.6% versus 3.4% in April.

In early June, the Bank of Canada raised rates by 50bp, bringing the overnight rate to 1.5%, also in line with expectations. Similar to the Fed, the BoC maintained that domestic financial institutions remain resilient, while stating their concern about elevated household debt and home prices. Governor Macklem expressed a hawkish tone, stating that the BoC are "not going to sleep easy until Canadians can stop worrying about inflation" and that "the likelihood that the rate will need to go to the top of the 2-3% range or possibly somewhat above it has increased."

The BoC's hawkish stance does create a risk to those Canadians that have overextended themselves and capitalized on historically low rates and record high real estate valuations in recent years. With loan-to-income ratios in Canada at record levels (see below), it puts the BoC in a precarious position of needing to walk a fine line between curbing inflation and ensuring that the residential housing market does not push the country into recession.

The Share of Highly Indebted Mortgage Borrowers Increased During the Pandemic

Share of Low-ratio Mortgages, %



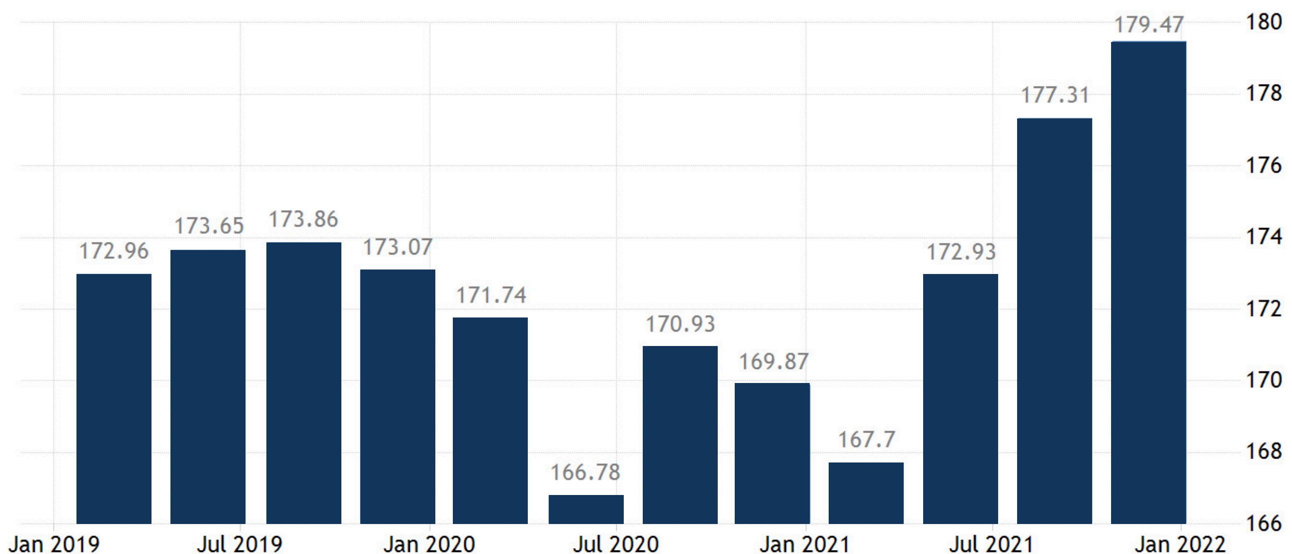
The proportion of Canadians in the category of highly indebted mortgage borrowers has increased significantly over the past 5 years, emphasizing the need for a measured approach.

Source: Regulatory filings of Canadian banks, Bank of Canada, TD Economics

Not to be lost on investors, the BoC has attributed much of the inflation we are seeing in Canada to the economy progressively heating up since reopening and potentially operating beyond full employment, as was exhibited in May's job report with a net gain of 40k jobs, record low unemployment and rising wages. Recession is popularly defined as two consecutive quarters of negative GDP and characterized by a contraction of economic activity and high unemployment rates, neither of which we are seeing, at least for the moment.

In recent days and weeks, we have seen major market averages decline substantially, as the markets digest the prospects of higher interest rates and their broad effect throughout the economy. From a market valuation perspective, the current P/E on the S&P 500 is roughly 18.60, down from a peak of 39.26 in January 2021. The last time we experienced a level below 19 was October of 2014. Even in the years immediately following the Global Financial Crisis, the lowest P/Es for the year in 2009 and 2010 were 21.78 and 15.47 respectively. The fundamentals make a possible case that we may be approaching a market trough, although we are almost certain to experience more volatility in the short run, as analysts - in response to rising rates and changing consumer behaviour - continue to cut price targets and companies revise their earnings lower. We are indeed likely to see economic indicators and corporate earnings soften in the coming months, but as a forward discounting mechanism and leading indicator, the markets will almost certainly "bottom" well ahead of the real economy.

Canadian Household Debt as a percent of gross income



Source: Tradingeconomic.com | Statistic Canada

Corrections in context:

It is also important to take a look back at historical corrections to put things into perspective. The following chart outlines corrections on the S&P 500 dating back to 1928.

Historical S&P 500 Corrections:

Peak	Peak to Trough			Forward Returns After Trough		
Peak Date	Trough Date	Length (Months)	Return	6M	12M	24M
5/14/1928	6/12/1928	1.0	-10.3%	22.8%	38.8%	20.7%
6/15/1932	7/8/1932	0.8	-13.8%	64.0%	171.7%	124.3%
9/7/1932	2/27/1933	5.7	-40.6%	104.1%	95.4%	59.0%
3/16/1933	3/31/1933	0.5	-15.6%	68.3%	84.1%	44.8%
6/12/1933	6/15/1933	0.1	-10.6%	3.5%	5.0%	5.4%
7/18/1933	3/14/1935	19.9	-34.0%	46.1%	81.4%	126.9%
4/6/1936	4/29/1936	0.8	-12.7%	27.1%	18.1%	-27.8%
7/14/1943	11/29/1943	4.5	-13.1%	11.6%	16.9%	55.0%
2/5/1946	2/26/1946	0.7	-10.1%	3.9%	-9.0%	-16.8%
6/12/1950	7/17/1950	1.2	-14.0%	29.2%	31.4%	50.2%
1/5/1953	9/14/1953	8.3	-14.8%	17.5%	37.7%	98.1%
9/23/1955	10/11/1955	0.6	-10.6%	18.4%	14.7%	0.3%
8/3/1959	10/25/1960	14.7	-13.9%	24.9%	30.7%	4.6%
8/22/1962	10/23/1962	2.0	-10.5%	30.0%	36.5%	59.2%
9/25/1967	3/5/1968	5.3	-10.1%	14.8%	13.7%	2.6%
4/28/1971	11/23/1971	6.9	-13.9%	21.8%	29.7%	10.3%
11/7/1974	12/6/1974	1.0	-13.6%	42.3%	33.5%	59.3%
7/15/1975	9/16/1975	2.1	-14.1%	22.9%	28.3%	17.5%
9/21/1976	3/6/1978	17.4	-19.4%	21.3%	12.6%	25.0%
9/12/1978	11/14/1978	2.1	-13.6%	6.0%	11.8%	48.3%
10/5/1979	11/7/1979	1.1	-10.2%	7.3%	29.3%	22.8%
2/13/1980	3/27/1980	1.4	-17.1%	28.6%	37.1%	14.0%
10/10/1983	7/24/1984	9.4	-14.4%	19.5%	29.6%	61.0%
10/9/1989	1/30/1990	3.7	-10.2%	10.1%	5.6%	27.4%
10/7/1997	10/27/1997	0.7	-10.8%	23.9%	21.5%	47.9%
7/17/1998	8/31/1998	1.5	-19.3%	29.4%	37.9%	58.5%
7/16/1999	10/15/1999	3.0	-12.1%	8.8%	10.2%	-12.6%
11/27/2002	3/11/2003	3.4	-14.7%	26.9%	38.2%	49.9%
4/23/2010	7/2/2010	2.3	-16.0%	23.0%	31.0%	33.5%
4/29/2011	10/3/2011	5.2	-19.4%	28.6%	32.0%	52.7%
4/2/2012	6/1/2012	2.0	-9.9%	10.8%	27.6%	50.5%
5/21/2015	2/11/2016	8.7	-14.2%	19.5%	26.6%	43.2%
1/26/2018	2/8/2018	0.4	-10.2%	10.7%	4.9%	28.9%
9/20/2018	12/24/2018	3.1	-19.8%	25.3%	37.1%	57.5%
Average		**4.2**	**-14.9%**	**25.7%**	**33.9%**	**38.3%**
Median		**2.1**	**-13.8%**	**22.9%**	**29.6%**	**44.0%**

Source: Global Financial Data, Inc., as of 4/5/2022. S&P 500 Index price returns during and after corrections, 1/3/1928 - 12/31/2021

Not all corrections are created equal and must be weighed and measured carefully given the context of the day. Having said this, viewed in aggregate, several trends can be observed. An average length of 4 months, and a drop of roughly 15%. Looking 6, 12 or 24 months later, markets have recovered a median of 23%, 30%, and 44% respectively from correction lows.

The above displays why it is important that we emphasize to our clients why having a disciplined and long-term focus, as it relates to their investments, is paramount and should not be understated.

Portfolio Update

Towards the end of March, the Optimize Investment Committee put to action our forecast vis-à-vis rebalances to our model portfolios. For a number of quarters we have speculated on the inevitability of a rising rate environment, a cooling of the high-growth tech sector and central banks having to contend with inflationary pressures within the global economy.

Based on analysis, we elected to make a variety of strategic changes to the Portfolios, including adjusting our core-equity positions, as well as altering the fixed income content to better position the asset mix given current and expected market dynamics.

Overall, within our equity holdings, we remain overweight to financials and have increased our geographic bias towards Canada. We did however take the opportunity in March to make some modest changes, and chose to trim some of our big-tech names, including Amazon, Apple and Google, and also took profits on Costco, as well as closed out our position in Disney.

We have replaced these positions with resilient companies that exhibit strong fundamentals, attractive valuations, and exposure to areas of the economy more likely to outperform during a rising rate environment. Moreover, the secular rotation from growth to value will continue to benefit and favour these changes, as well as our overall long-term strategy.

Since these portfolio adjustments, the tech names that were trimmed and the positions that were eliminated are down between 24.3% to 38.6%. Conversely, the names we added such as Manulife, Enbridge, and Power Corp are down from 16.6% to as little as -1.8%. These proactive changes have certainly minimized risks and downside pressures relative to the major averages.

With respect to the fixed-income component of the portfolios, we chose to reduce exposure to public investment grade debt and other more traditional yield-based assets and increased our allocation towards the Premium Income fund - given its stability, diversification, and reduced correlation to broader markets.

Indeed, this adjustment has provided substantial protection in the face of rising rates, as we have seen investment grade Canadian debt decline approximately 13% year to date. In contrast, the Premium Income fund is off roughly 3% for the year. We attribute this outperformance to several factors, including increased exposure to senior secured floating rate loans, stable income producing hard assets such as infrastructure and real estate, a robust unconstrained tactical approach and selection of world class money managers.

As of the end of May, our flagship Optimized Balanced Growth Portfolio was down 5.95% relative to a benchmark return of -8.24%. In addition, the S&P 500 and NASDAQ were both down 13.8% and 23.7% respectively.

Looking forward

In the world of the 24-hour news cycle, and if-it-bleeds-it-leads journalism, we are inundated with negative headlines at all hours of the day. Current sentiment is overwhelmingly negative, volatility is high and uncertainties remain. We have seen substantial declines in the major indices, particularly in recent days with investors weighing the prospects of a “hard” or “soft” landing. As mentioned earlier, we are likely to continue to see companies revise their earnings lower, as well as analysts cut price targets, as they discount the effect of higher prices and higher interest rates throughout the economy. The markets will likely continue to be volatile in the coming weeks as uncertainty remains elevated and as investors digest each piece of economic data. Again however, it’s also important to remember that market corrections (defined as a decline of 10% or more) are almost always followed by periods of strong returns, i.e. the average one-year return from the low of a correction on the S&P 500 since 1980 is 23%, and the average two-year return is 37.5%. Encouragingly, the labour market also remains robust and should naturally cushion the effects of higher interest rates and reduce the likelihood of a potential recession.

Regardless, we are extremely pleased with how the Portfolios have performed. The benefits of broad diversification and the inclusion of institutional “pension-style” asset classes has resulted in lower volatility, lower downside capture and ultimately higher-quality risk-adjusted returns. The current market dynamics will remain challenging for some time, but the secular rotation from growth to value, will continue to favor our existing allocations and overall long-term strategy. More specifically, the Portfolios emphasis on value, its current overweight to financials, increased exposure to Canada, as well as the combination of alternative asset classes should continue to provide a strong defense against current headwinds, but also ensure consistent and stable returns over time. Clients are well positioned, as we eventually exit this correction and although we will likely continue to see volatility in the short to medium term, clients should keep their long-term financial goals in mind as they are well established for success.

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