

Market Perspectives

'Patience and Perspective'

July 7, 2022

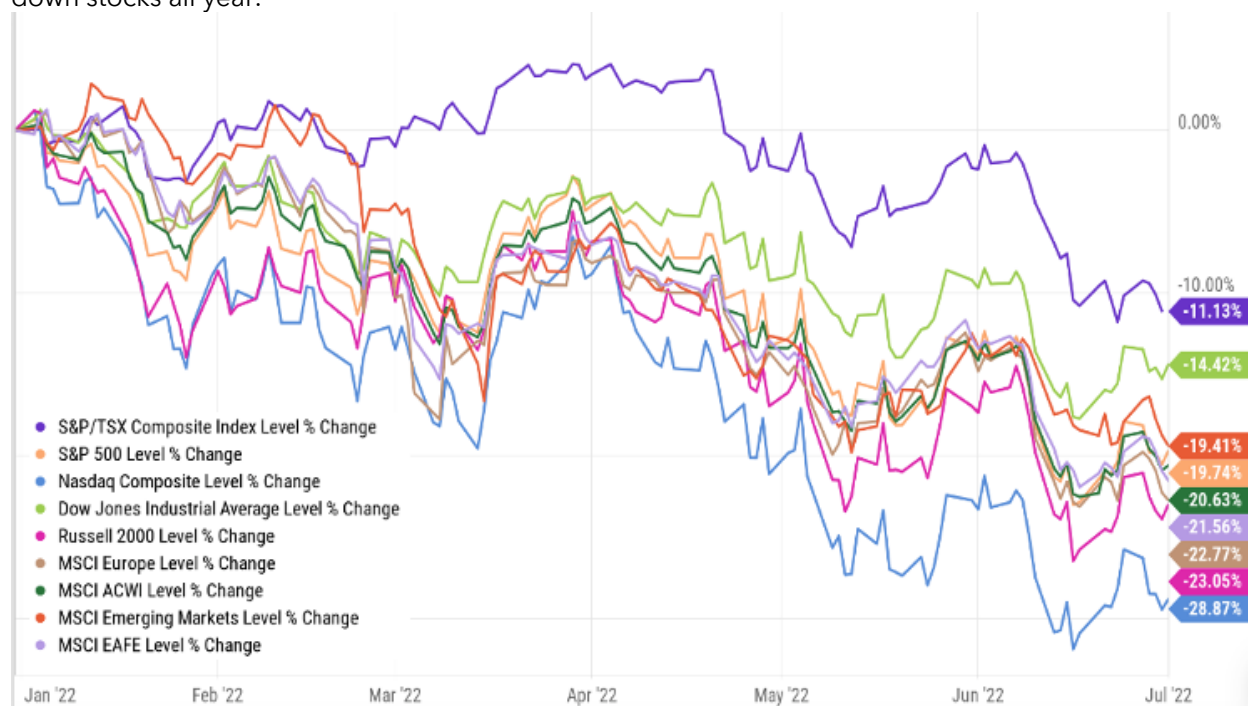
As we wrap up the first half of 2022 it has been rather turbulent, to say the least. The year began with renewed concerns about the pandemic. Thankfully, the omicron variant proved less severe than its predecessors, and our earlier optimism was restored.

While society appeared to be getting back on its feet, the highest inflation in decades emerged. This led to uncertainty as economists and investors tried to predict the impact of the central bank's recalibration of policy in response to inflation that was proving to be less transient than originally expected. The result was spiking yields amid fear that strong medicine was required to tame inflation, which infiltrated the investor psyche.

If that wasn't enough, Russia invaded Ukraine in February, spurring a major geopolitical event that caused another recalibration of earlier assumptions. The importance of Russia's fossil fuels to Europe and the economic sanctions that ensued against Russia sent price shocks throughout the world for oil, natural gas, and coal. Agricultural commodities have also been impacted due to Ukraine's significant production of these products, contributing to higher global food prices.

Thinking back to my January 11th commentary *'2022 Outlook: A Mid-Cycle Market'* I used the analogy that "we'll get to our destination but there will be pit stops along the way." As we surpass the halfway point of the year, it appears we have been stuck in rush hour - stand still traffic in Toronto during a late Spring snowstorm.

So where do we stand and what explains this? Sentiment. Most steep downturns feature one or two big scary stories, like 2020's COVID lockdowns or 2011's euro crisis and US debt ceiling fight. Today, I count at least seven scary stories and none of them are huge alone, but they have taken turns dragging down stocks all year.



The bad news is this was the 5th worst start on the S&P 500 since 1929. The positive, eternal optimist view is that after 5 worst starts the market returned on average 24% the next 6 months.

Yes, 2022's decline is officially a bear market, having closed below -20% from late December global highs. But there is nothing about that "official" -20% threshold that changes what we do moving ahead. Investment decisions must be forward-looking - not backward and being here today doesn't imply big downside ahead or a long decline.

There are no shortage of opinions and hot takes from the 'experts' on wall street, bay street, BNN and the only common factor amongst them is we should expect continued volatility and uncertainty. Setting the tone and expectations moving forward into the back half of the year I expect a choppy summer and rally into the fall/end of the year. We will unpack this later.

Investing can be an Emotional Rollercoaster

The stock market is a mood enhancing drug. When it's going up, we can't get enough invested, we want additional risk, and the sentiment is stocks only go up. The complete opposite occurs when we are in periods like the one we find ourselves in presently. In these periods we need to be mindful, take a deep breath and honestly, stop looking at the stock market every day as its doing nothing constructive for our mental wellbeing. We live in a world where information is at our fingertips and our investment portfolio is on a constant running scorecard. I personally detest this as you wouldn't buy a home and get it appraised in 3 months. Instead, in these times, investors need to get back to the basics such as "what is my investment timeline?"

Why? If you're a medium to long-term investor - do yourself a favour and ignore this. Although painful today, what is going on right now won't even be a blip on the screen in your investment journey.

The cycle to success The cyclical nature of investing and emotions



There are plenty of times in life when being or having an emotional side is beneficial. Unfortunately, that is not the case when investing. As long-term thoughtful and focused investors we make it a habit of removing emotion in every decision to help investors succeed. History shows that investing with emotion is never beneficial.

"Investing isn't hard, you don't need to be a genius, rather you need the right temperament and its years or periods like this where that temperament comes into play. Most of us aren't wired properly to be investing in the stock market"

-Warren Buffett

Consumer Sentiment

I completely agree that the headlines and general mood of the market is enough to the most seasoned of investors. We are not robots, rather human beings with emotions and feelings, but trust you are not alone as the general mood for investors is a state of paralysis. We fundamentally know that when markets are weak and showing deep discounts, as we are currently experiencing, history has shown us time and time again that this is a buying opportunity. But in the heat of the fire, we become paralyzed with fear. In my June 15th communication I highlighted "The US Index of Consumer Sentiment" (ICS), as provided by University of Michigan, which tracks consumer sentiment in the US since November 1952. Currently, sentiment is so negative that it's the lowest it has ever been at a current level of 50.0, down from 58.40 last month and down from 85.50 one year ago.

At this point it's simply a matter of time before sentiment turns around. Since 1970 there has been 8 instances where Consumer Sentiment has plunged. The good news is that in every single instance the market has rebounded the next 12 months on average 25%.

When Sentiment Plunges, Stocks Rally



The contrarian part of me is very hopeful and optimistic that we have reached a point of wash out in sentiment and stocks as markets are trying to reset and set the stage for a spring-loaded recovery.

Recession Fears?

At this point the market is 50/50 deciding if this is a recession or not. If it is, it should be quite mild as its well-advertised and the consumer is entering this in a relatively strong position in terms of a strong labour market, healthy balance sheet and rising wages.

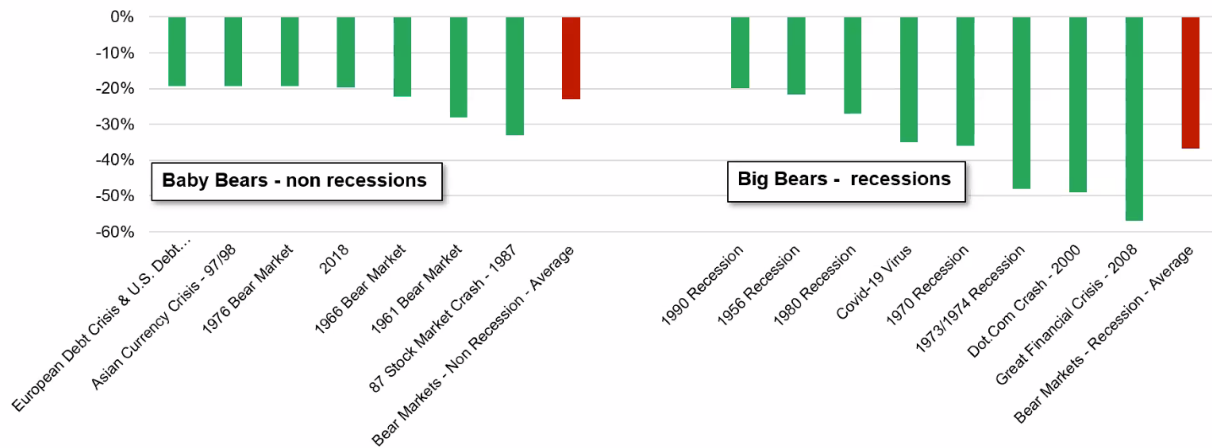
I remain in the camp that this is a deep correction where valuations have gotten way ahead of itself. Yes, we are in a bear market and, to put some perspective on them, the market has had 15 of them since 1950 - so on average every 5/6 years. We can separate these 15 bears markets in two categories; 7 scenarios have resulted in baby bears (non-recessionary) while 8 have resulted in big bears (recessions).

Baby Bear Average Drawdown: -23%

Big Bear Average Drawdown: -37%

Bear market performance can vary depending on whether there is a recession. What's the environment today?

Big Bears (recessions) vs. Baby Bears (non-recession) drawdowns from peak



Bear markets last an average of 9 months, with those associated with recession lasting longer, at 19 months vs. those without an economic recession at 6 months. **The key point is that bear markets with or without a recession are not terminal events.** They are a part of a natural economic cycle. By the time a recession is officially declared, bear markets are often over. This is because markets are forward indicators pricing future cashflows, not the past or present. Although they're uncomfortable, this is normal, provides fresh air in the market and in the end the cost is not that great.

"The biggest obstacle to investing is the space between your ears"

Odds favour long term investors who take advantage of selloffs of bear markets

Forward 1-, 2-, and 3-year Total Return from fall from peak of -10%, -20%, -30%, -40% and -50%

Fall From Peak	Covid-19 Recession			Great Financial Crisis			Dot.com			1990 Recession			1980 Recession			1973/1974			1970 Recession			1956		
	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr	1 yr	2 yr	3 yr
-10%	28%	47%	?	-37%	-22%	-15%	-13%	-19%	-35%	15%	28%	38%	-8%	28%	33%	-16%	-20%	-5%	-21%	1%	11%	-4%	12%	27%
-20%	59%	68%	?	-29%	-19%	6%	-5%	-35%	-8%	29%	38%	56%	10%	51%	47%	-28%	-6%	7%	8%	18%	32%	31%	44%	36%
-30%	71%	94%	?	0%	9.8%	10.2%	-16%	-1%	9%							12%	24%	20%	35%	42%	40%			
-40%				?	18%	28%	31%	10%	22%	36%						19%	43%	36%						
-50%				?	45%	59%	59%																	

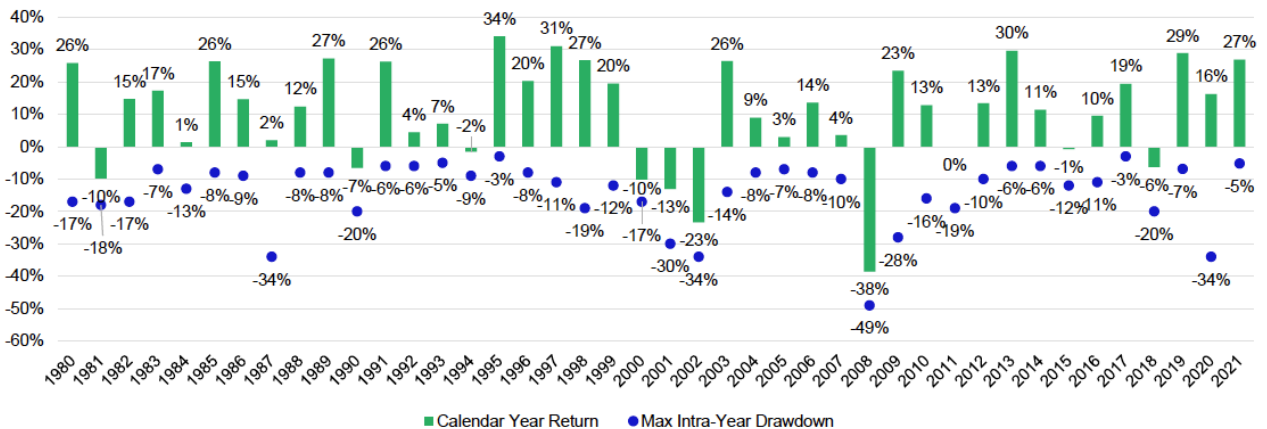
Markets continue to reward the eternal optimist. Odds favour long-term investors who take advantage of these selloffs. Staying focused on your long-term goals, not chasing returns, and staying the course because as history has shown – corrections are normal.

I agree, the chart below is old news and I have used it before, but it is so extremely powerful to help put corrections and market performance in perspective.

Corrections are normal

Stock market corrections are very common and very difficult to predict. Since 1980, the S&P 500 index has fallen an average of 14.3% in any given calendar year but is positive 78% of the time with an average return of 10.3%

S&P 500 Index - Calendar Year and Max Intra - Year Returns (1980 - current)



Why is Nobody Talking about the upcoming Mid Term Elections?

Something that hasn't received much attention is that this is an election year in the United States. Mid-term elections call for the entire House of Representatives and one-third of the Senate to stand for re-election. Mid-term cycles normally lead to the Fed taking to the sidelines so not to be seen as influencing voters, interesting in a year of such dramatic change to the monetary setting. Mid-term election years also follow a rhyme that we see taking shape in 2022. The chart below illustrates the action of the S&P 500 Index in mid-term election years back to 1950. As can be seen, in all 18 scenarios early corrections have occurred (every single time) and have always followed by strong market performance.

Big Midterm Swings

S&P 500 pullbacks in U.S. midterm election years



Source: LPL Research

Furthermore, historically the 2nd & 3rd quarters of mid-term election years tend to be the weakest quarters in any presidential term. In saying that, if history is any indication this would suggest that volatility isn't going to disappear throughout the summer. The positive is that the term 'volatility' works both ways - it's not just negative. For example, where we are today isn't much different than 1998, a mid-term election year. In 1998, the market declined over 19% from mid-July to mid-October only to recoup all those declines by mid-December and finished the year +26%.

Inflation/Rate Hikes and the Fed

Inflation - remember when the word transitory was being tossed around 18 months ago? Although in the end it will come down, and the longer we zoom out in time it will be "transitory", it has been rather sticky and persistent. It is taking much longer than many thought to retract. Headline Consumer Price Index (CPI) latest reading was 8.6% and we expect it to remain above 4.5% through the end of the year. Positive news is core inflation has moderated the past couple of months and is expected to continue to moderate.

One misconception to address is that moderate inflation is bad for stocks. In fact, history has shown that the exact opposite is the case. Stocks do quite well in periods of modest inflation. Companies that have pricing power and those who are "price-makers" can benefit greatly.

Inflation is a greater concern if central bankers take such aggressive action as to force the economy into a recession. In that respect, the equity market is at an elevated level of risk. In the interim, as the Fed has raised rates, equities have historically performed quite well:

Tightening Without Turmoil

How the S&P 500 performs in Fed rate-hike cycles

■ Average annualized return



Source: Truist Advisory Services

Final Thoughts

With both stocks and bonds down 10% at the same time we are swimming in uncharted waters as this is virtually unheard of. A common theme across market experts is that the market won't show much direction until September when it has more data to know for sure where we sit.

At this point, inflation and interest rates have been significantly priced into the market by investors. I would bet by the winter or spring of 2023 the developed world economies could expect to experience a relief rally not if, but when, investor sentiment convinces themselves the fed will have to dial it back to prevent a deep recession.

Bad news won't magically vanish overnight but now is not the time to fall prey to the tricks of the market and fearfully sell. Remember, stock markets tend to look 6-12 months ahead in terms of valuation hence why it is considered a forward indicator. Today's market price is acting as a forward indicator for Spring 2023 which should be significantly more optimistic than it is today. Finally, not to repeat myself but, investment decisions must be forward-looking - not backward and being here now doesn't imply big downside ahead or a long decline. Instead, I am much more optimistic today than I was 6 months ago, and the only thing investors should be doing now is positioning themselves for a spring-loaded bounce. I suspect growth and tech lead the charge so look for it to get more robust as we go into the back half of the year.

Thanks for the continued trust to help you navigate the complexity of financial markets. Although the summer months are a blur for everyone, I am never too busy to arrange a in person meeting or phone call to address any additional questions or concerns you have. My only goal remains providing you sound advice to help you achieve your end destination.

Warmly,

Aaron Pedlar