CYPRESS CAPITAL MANAGEMENT

2022 First quarter review

The first quarter of 2022 saw a return of stock market volatility that was largely absent in 2021. At no point in 2021 were global equity markets down more than 6%, while in 2022 we have already seen markets down double digit percentages, although they have recovered somewhat. The volatility we are experiencing in 2022 is more common than what was experienced in 2021.

Equity market performance varied considerably across geographies in the first quarter. The Canadian market, benefitting from a significant increase in energy prices, was up 3.8%[1]. In contrast the U.S. and International Developed Markets were down 5.9%[2] and 7.1%[3] respectively, all in Canadian dollar terms. Emerging Markets, which are most directly impacted by the conflict in Ukraine, as well as continued concerns around Chinese state involvement in equity markets were down close to 7%[4].

Overall the first quarter of 2022 saw the worst performance for global equity markets since the severe COVID-related sell-off in March 2020.

Looking at the fixed income (bond) market, the first quarter of 2022 *was the worst quarter for bonds in over 4 decades*. Interest rates moved up materially during the quarter which resulted in the broad bond market composite being down 7%[5]. A 7% loss in any given quarter is reasonably common for equity markets, but for bonds, which are typically considered a safe investment, this negative return is likely to come as a surprise to many investors.

The pricing of bonds is too complicated to go into in detail here, but the key thing to know is that the value of a bond is inversely related to interest rates. As interest rates go up the value of existing bonds go down. The longer the term to maturity and the larger the move in interest rates, the greater the price impact.

'Real' returns

Anyone who spends even a moderate amount of time learning about markets and economics, or following the business news, will eventually see the adjective 'real' used to qualify a number of metrics. For example real returns or real interest rates. The 'real' in these cases is simply a fancy way of saying 'after-inflation'.

The concept of real returns is fairly straightforward. It reflects the notion that what an investor should be most concerned about is not just maintaining and growing dollar amounts, but actually maintaining and growing purchasing power.

A very simple example will illustrate the point. If over a certain period a portfolio generates a 10% return and inflation over that same period is also 10%, then the real return is 0% (taxes could make it even worse). Interest rates are often quoted in a similar manner, so if you see economic commentary referring to negative real interest rates, it simply means that inflation is higher than the relevant interest rate.

Many Cypress clients will know that the idea of real returns is central to our investment philosophy and how we build portfolios. A technical definition we often use for investing is 'forgoing purchasing today and deploying the capital with the goal of having additional purchasing power at the end of the contemplated holding period'. Put another way, the goal of investing should be to generate real returns.

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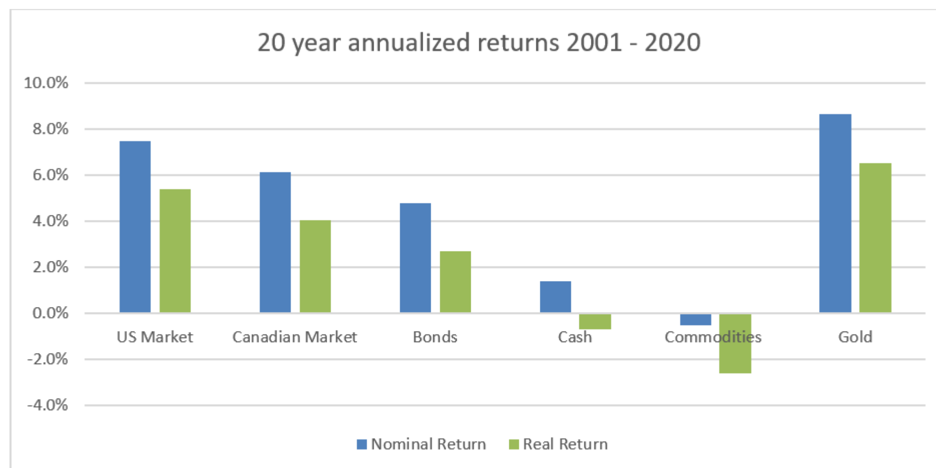
[1] TSX Composite
[2] S&P 500
[3] Morgan Stanley EAFE (C$)
[4] MSCI Emerging Markets Index (C$)
[5] FTSE/TMX Universe Bond Index

Real returns over time

As is always the case when evaluating investments we need to distinguish between short and long-term. If time horizons are short-term then market volatility is a risk. If time horizons are long-term then inflation is the primary risk.

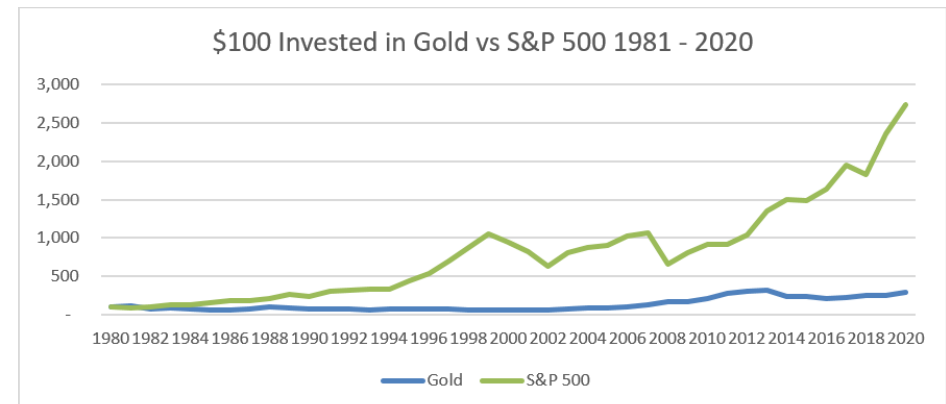
Below are the long-term 'real' returns on several broad asset classes. As you can see cash, commodities and bonds are the clear laggards. In fact if an investor kept their money in a savings account over this 20 year period, that investor actually went backwards in terms of real returns.

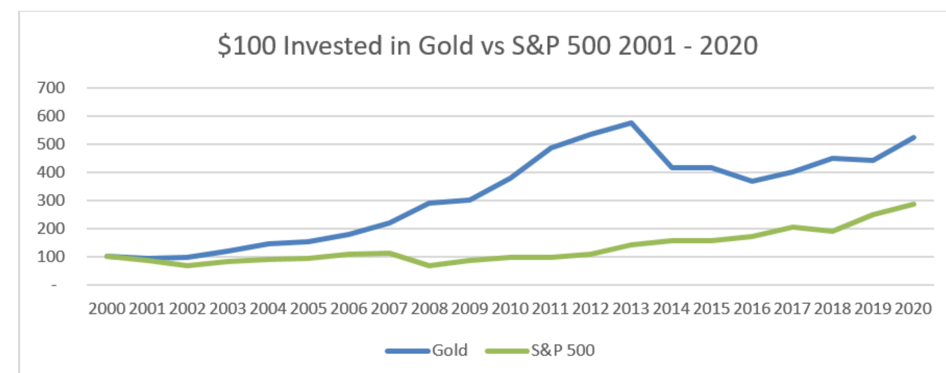


Source: JP Morgan Guide to Markets, RBC

Now many will note that over the 20-year period in question the real return on gold is superior to the real return on equities. We typically do not consider gold a viable long-term investment given the fact that it does not produce any cash flow. So how do we reconcile our view on gold with the long term returns in the chart above?

It comes down to timing. 2001-2020 was historically a very poor period for equities, but a very strong period for gold. Much of this was due to the unwinding of the technology equity bubble that existed in the late 1990s early 2000s, and the fact that gold had fallen close to 50% in the 1990s. If we extend out the time horizon (as can be seen below) then equities are the clear winner. The fact is it took a terrible 20 years for equities and a tremendous 20 years for gold for gold to be the winner.





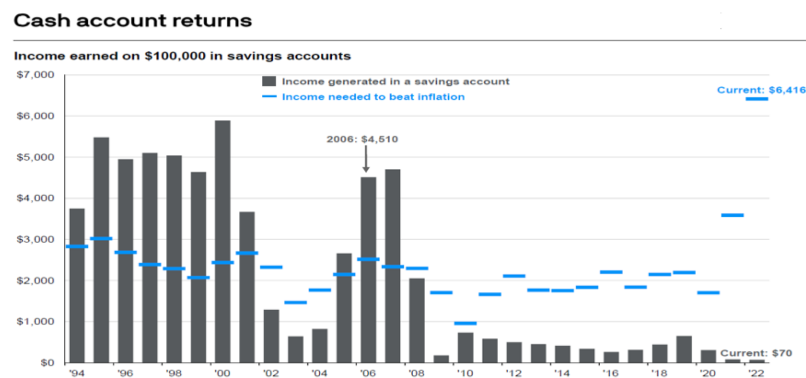
Source: JP Morgan Guide to Markets, Bloomberg

We recently saw it reported that today all the gold in the world is worth $12 trillion, while global equities are worth $115 trillion. In 1980, the ratio was one-to-one, with all the gold in the world and global equities having the same value of $2.5 trillion.

As we have noted in previous letters, it is not that an investor cannot make money in gold. It is simply that the return on any scarce asset that does not produce a cash flow is entirely dependent on future demand which is largely unknowable. It is this unknowability around future demand, and therefore return, that leads us to largely exclude gold from our investable universe.

Negative real returns in cash and bonds

When evaluating the various asset classes, perhaps the biggest concern remains the return outlook for the supposedly safe assets of bonds and cash. Prior to 2008, the returns on the safest short-term investments, such as guaranteed investment certificates (GICs) or money market funds, generated a return in excess of inflation. While equities typically provided better long-term returns, investors could still generate some real return in these safe assets. However, as can be seen below, the income on these safest of assets has been well below inflation for over a decade. In real terms these assets are generating negative returns.



Source: JP Morgan Guide to Markets

In the longer arc of history negative real interest rates (bond yields) is the outlier and we believe it prudent that investors plan for interest rates to continue to rise into the foreseeable future. Rates have remained lower than we would have expected, for longer than we would have expected, so we are not making a short-term prediction on interest rate movements. However, in our view, the probability of interest rates moving higher in the next few years is significantly higher than the probability interest rates stay at current levels or move lower. Given current interest rates and inflation levels it seems very unlikely to us that most fixed income investments are going to generate any real return over the medium and long-term.

Outlook and strategy

We are well aware that we sound repetitive in these quarterly letters when we consistently come to the same conclusion that owning a diversified basket of equities is the best way to protect and grow purchasing power over the long-term. However this conclusion is worth repeating, since failing to understand this one principle is likely to be the single biggest driver of poor long-term investment results for most investors. In a world of negative real yields on most bonds, there really is no good alternative to equities.

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Please see our website www.cypresscap.com for our most current disclosure document.