Third Quarter Market Review

The third quarter saw markets continue to move down globally, though the weakening Canadian dollar has offset some of this for Canadian investors. The downtrend has been broad based in terms of sectors, asset classes and geographies. There is little that we would consider 'investable' that is not down materially on the year. The results of various geographical markets and asset classes are summarized below.

Index	3rd Quarter Return %	Year to Date Return %
TSX Composite (Canadian Market) C$	-1.4	-11.1
S&P 500 (U.S. Market) C$	2.2	-16.7
S&P 500 (U.S. Market) US$	-4.9	-23.9
EAFE (International Market) C$	-3.8	-20.4
Bonds - Canadian Broad Composite C$	0.5	-11.8
US$/C$	7.4	9.4
Gold	-7.2	-7.1

Source: RBC, SS&C

What is going on?

Typically in these client letters we try to focus on ongoing client education about investing and the markets generally, and try to avoid spending too much time discussing the current state of the markets, since getting too caught up in the present is the enemy of long-term thinking. However, given the scale and speed of the drawdown we think it is important to recap, to the best of our understanding, what is going on with the economy generally and the markets specifically, much of this we have discussed in the past.

Post the COVID-related decline of early 2020, which saw equities markets down over 30% globally, the market recovered in historic fashion with global markets up over 100% from their lows in less than two years. In late 2021/early 2022 global equity markets reached all-time highs. Throughout 2021 inflation was rising, but in early 2022 inflation started reaching levels that have not been seen in 40 years.

The root cause of this inflation is a combination of:

- Monetary and fiscal stimulus from governments globally in response to the COVID-19 pandemic;
- Supply disruptions, especially from China (due largely to COVID-19 restrictions);
- Changes in consumer demand (due largely to COVID-19 restrictions);
- Wage pressures as many people have dropped out of to the labour market;
- Energy prices increasing following the Russian invasion of Ukraine.

How much each of these individual components has contributed to inflation is a hotly debated topic amongst economists, but the fact is inflation is very high by recent historical standards and has lasted long enough it that cannot be dismissed as simply a transitory spike.

Typically central banks are tasked with the goals of maintaining: 1) steady economic growth, 2) low and steady inflation, and 3) low unemployment. Achieving these goals is a balancing act, but with inflation running at 40-year highs, the goal of low and steady inflation is clearly not being met. In an effort to bring inflation down the central banks will raise interest rates in order to reduce overall demand in the economy – less demand leads to lower prices.

However, these higher interest rates have a negative impact on most asset classes (as seen by the table in the Market Review) and the reduced demand may mean slower or even negative economic growth and higher unemployment, which runs counter to the central banks' other goals. As mentioned this is a balancing act for central bankers.

The primary concern of the central banks appears to be that inflation expectations do not become 'entrenched'. If consumers, employees and businesses begin to believe that inflation will be materially higher going forward and change behaviour based on that belief, then inflation expectations become a self-fulling prophecy. Expecting higher inflation leads to actual higher inflation through the behavioural changes of individual economic participants.

To combat this entrenchment of inflation expectations central bankers have raised rates significantly in a short period of time, which has been the primary driver of asset prices being down significantly in a short period of time.

Should we have seen this coming?

With the benefit of hindsight it is easy to point out the inflationary pressures that have been building up in the system and argue that it was simply a matter of time before inflation increased materially. However, when one looks at the root causes of inflation, the pressure has been in system for at least a few years, and in some cases more than a decade, and it is only in that last few quarters that inflation has reached atypically high levels. As we have pointed out in previous letters, accurately forecasting inflation is incredibly difficult, bordering on impossible.

We had been expecting interest rates to rise at some point simply because they had been so low for so long. To this end, for years, we have favoured equities over fixed income, and preferred short-term fixed income to long-term fixed income. So while we did expect interest rates to raise, we did not anticipate the speed and magnitude of the rise.

Where does the market go from here?

History has taught us that markets are totally unpredictable in the short-term. To guard against the risk that this short-term unpredictability creates, we have consistently counselled that clients take a long-term view, keep short-term spending needs set aside, and ignore (as much as possible) the short-term movements of the markets. We understand that the market movements we have experienced in 2022 are very difficult to ignore, but our overall approach and advice is unchanged. At some point, the market will find a bottom and once again move higher. This bottom might be today, it might be in six weeks or six months, but it is not going to be years. Below are all the bear markets in the U.S. market since WWII. Putting aside the tech bubble of the early 2000s, which burst on the back of extreme valuations, the average drawdown has been about one year, with two years being the maximum.

Peak	Through	% Decline	# of days
29-May-46	9-Oct-46	- 26.6	133
15-Jun-48	13-Jun-49	- 20.6	363
15-Jul-57	22-Oct-57	- 20.7	99
12-Dec-61	26-Jun-62	- 28.0	196
9-Feb-66	7-Oct-66	- 22.2	240
29-Nov-68	26-May-70	- 36.1	543
11-Jan-73	3-Oct-74	- 48.2	630
28-Nov-80	12-Aug-82	- 27.1	622
25-Aug-87	4-Dec-87	- 33.5	101
24-Mar-00	9-Oct-02	- 49.1	929
9-Oct-07	9-Mar-09	- 56.8	517
19-Feb-20	23-Mar-20	- 33.9	33
Averages		**- 33.6**	**367**
3-Jan-22	????	- 23.9	270

Source: A Wealth of Common Sense

While it can be painful when recessions and bear markets happen, the fact is that anyone investing in the equity market with a 10+ year time horizon should expect to experience at least one or two such periods. Younger investors with 25+ year time horizons should expect to live through several more. Hopefully we have the right asset allocation and internal fortitude to get through these negative periods.

History has shown that once the market does find a through the long-term returns are typically strong. Below are the subsequent long-term returns on the U.S. market post a drawdown of 25% or more going back to 1950.

Peak	Through	% Decline	+1 YEAR	+3 YEARS	+5 YEARS	+10 YEARS
12-Dec-61	26-Jun-62	-28.0	31.2	69.2	94.8	171.1
29-Nov-68	26-May-70	-36.1	32.2	44.3	27.9	97.5
11-Jan-73	03-Oct-74	-48.2	1.4	23.8	42.0	188.4
28-Nov-80	12-Aug-82	-27.1	43.9	81.2	238.6	403.9
25-Aug-87	04-Dec-87	-33.5	14.7	34.1	96.8	387.1
24-Mar-00	09-Oct-02	-49.1	0.2	1.9	21.5	38.3
09-Oct-07	09-Mar-09	-56.8	-6.9	3.7	61.2	209.6
19-Feb-20	23-Mar-20	-33.9	56.4	???	???	???
03-Jan-20	13-Oct-22	-25.2	???	???	???	???
Averages		-37.5	21.6	36.9	83.3	213.7

Source: Ycharts, A Wealth of Common Sense

With regards to inflation, our expectation is that the inflation rate will moderate in the next 6 to 12 months. Whether inflation trends back to the 2% or below, as we have seen for the past 20+ years, or remains more elevated in the range of 2% to 4%, is an open debate and is likely unknowable at this point. However, it seems unlikely to us the inflation rate will remain as elevated as we have seen so far this year. As inflation moderates and interest rates stop rising, and even start to come down, the markets should respond by moving higher.

It is of course possible that our expectations turn out to be incorrect and inflation does become entrenched and stays higher for longer, which would likely mean higher rates and lower equity prices for a more extended period of time. However, we see this as a low probability outcome at this point, given the speed with which central banks are raising rates, and that at least some of the inflationary pressures should ease simply through the passage of time.

Outlook and Strategy

For over a decade we have consistently favoured equities over fixed income. Yields were so low that the expected return on fixed income was unlikely to keep up with inflation. While we continue to believe the long-run return potential remains higher for equities than fixed income, the recent rise in rates does make fixed income more attractive. The yields on bonds are now higher than they have been since 2011. Rates may yet go higher in the short-term, but if inflation moderates as we expect, the rates on offer will provide a positive after-inflation return.

For many clients, their individual circumstances will result in their overall asset allocation remaining unchanged, which means maintaining a long-term bias to equities. However, where appropriate, we will be looking to bring up the fixed-income allocation in portfolios.

As always, regardless of how the markets are performing, portfolios should reflect individual client circumstances, the most important consideration being short-term spending needs. We encourage clients to reach out if they have any questions or concerns about their individual asset allocation or wish to give us an update on their circumstances.

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