2022 First quarter review

Equity markets were up across the globe in the first quarter. In Canadian dollar terms, Developed Markets outside North America led the way, returning 8.6%[1], while the U.S. and Canadian markets were up 7.2%[2] and 4.6%[3], respectively. Emerging Markets continued to lag Developed Markets, and were up 3.9%[4] in the quarter. Fixed income was also up, with the broad Canadian Bond Market up 2.9%.

After the significant sell down in 2022, the modest recovery in the first quarter is not surprising. Hopefully this trend continues through the rest of 2023, but history has taught us not to make short-term market predictions.

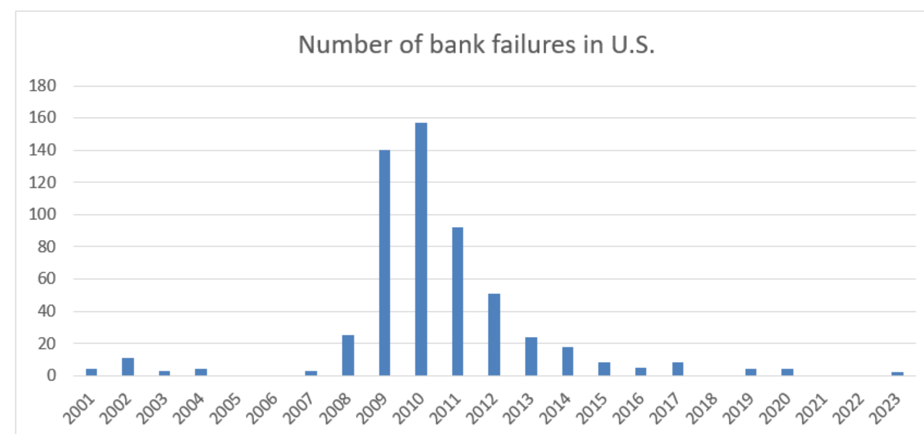
Digging into the headlines and frequently asked questions

Typically, in these letters we focus our attention on long-term trends and investment fundamentals. However, over the past few months we have received a number of questions and comments about some specific events and investments, so we thought we would take this opportunity to address some of these questions and comments. We will then try to tie the responses back to long-term investing and portfolio construction.

#1 - Should we be concerned about banking failures in the U.S.?

Reading the headlines about the failure of Silicon Valley Bank and Signature Bank no doubt reminded many clients of the headlines of banking failures in early 2008 that preceded the Great Financial Crisis, which is unnerving. The fact that these failures represent two of the three largest bank failures in U.S history only increases the level of anxiety. However, when one digs into the specifics of these banks, the conclusion is that their failures are likely not symptomatic of broader issues in the banking system.

We will not get into the minutiae, but from a high level, the important thing for most investors to know is that the regional banking sector in the U.S. is remarkably fragmented when compared to rest of the world. By way of example, as of Dec 31, 2021, there were 4,237 FDIC insured banks in the U.S., while in Canada, there are 35 domestic banks. This is not a perfect like-for-like comparison, but it does show how different the industries are. In addition to the fragmentation, the operations of many regional banks are highly concentrated in specific sectors or business lines. In the U.S., a shift in the economic conditions of a specific sector or product can lead to the failure of a bank. The overall industry structure in the U.S. makes bank failures inevitable and relatively common.



Source: FDIC

#2 - My bank is offering close to 5% on a Guaranteed Investment Certificate (GIC) – that looks pretty good, doesn't it?

The key investment story of the last 18 months has been the rise in interest rates as central banks globally look to bring down the overall inflation rate. One of the results is a significant increase in the rates offered on GICs and similar investments. Below are the current rates on offer at RBC.

[1] MSCI EAFE (C$)
[2] S&P 500 (C$)
[3] S&P TSX Composite
[4] MSCI Emerging Markets (C$)

	1 YEAR	2 YEARS	3 YEARS	4 YEARS	5 YEARS
Royal Bank of Canada	4.8	4.4	4.25	4.15	4.1

Compare this to rates on Oct 1, 2021, which is just before interest rates started to rise, and one can see the significant change.

	1 YEAR	2 YEARS	3 YEARS	4 YEARS	5 YEARS
Royal Bank of Canada	0.65	1.06	1.33	1.56	1.62

4.8% is undoubtedly much better than 0.65%, and for many investors, this may be sufficient to reach their investment goals. However, we should take a moment to examine some of the mechanics of investing in GICs and fixed income generally.

As can be seen above, the current rates on GICs go down the longer the term. What this means is that the expectation is that interest rates will go down over the next year. The current rates suggest that the 1-year GIC rate one year in the future will be around 4%. Future rates are not knowable with certainty, but it does suggest that there is reinvestment risk for those looking at GICs for long term investing, as the rates on offer today are not expected to be available a year from now. If interest rates do come down as expected, it is probable that equities will move higher, but if an investor's capital is tied up in GICs, it may not be possible to shift out of GICs into equities.

Overall GICs do look more attractive than they have in years, but remain, in our view, a poor substitute for equities for long-term investors. In the short-term, those looking to reduce volatility and increase liquidity are likely better off owning a high interest saving account or short-term bonds where the capital is not locked-up the same way as a GIC. For some clients, we have been increasing the fixed-income weighting to take advantage of these higher rates, but the long-term growth of most portfolios will continue to be generated by the returns on equities.

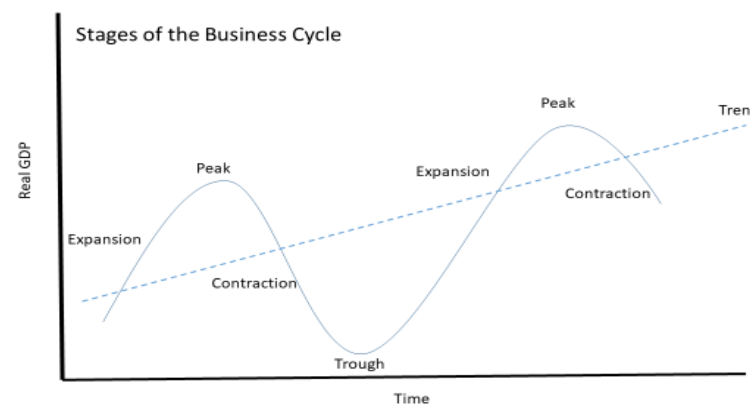
#3 - Are we headed into a recession and where are we at within the business/market cycle?

Since interest rates started rising in late 2021/early 2022 the question of "are we headed into a recession?" has been topical and a common theme in the financial media. We discussed this in our client letter in the second quarter of last year. In that letter we argued:

1) Recessions and the market reaction to a recession are not consistent.
2) As time horizons are extended the impacts of a recession are pretty muted.
3) Markets tend to recover from recessions in a matter of a few quarters, not years.

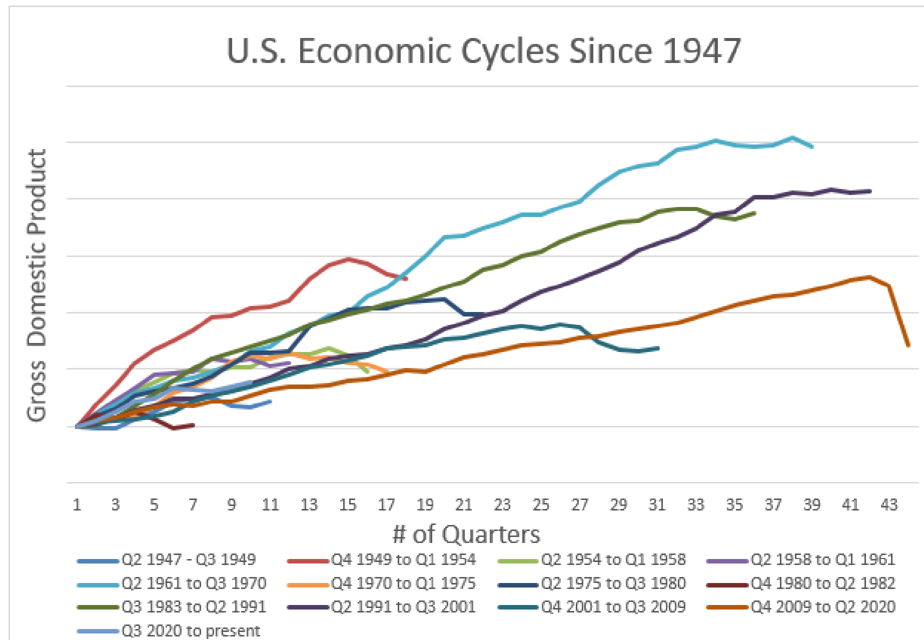
Nine months after writing that letter, the economy overall still has not gone into recession. This illustrates the futility of using broad economic outlooks to predict short-term stock market outcomes. If one cannot predict when a recession is actually going to occur, and history has demonstrated that the market reaction to a recession varies significantly, how does one hope to use the economic outlook to make tactical investment decisions?

With regards to the market and business cycle, those that have spent time reading about business and economics have likely come across some description of the business cycle. The typical cycle is described as having four stages; expansion, peak, contraction, and trough. An illustration like the one below is often used to help explain the cycle.



From an investment point of view, there is some compelling logic to the notion that if one can accurately identify at what point in the business cycle the economy is in, it may help with both strategic and tactical asset allocation.

The problem is that, in the real world, actual economic cycles bear little resemblance to the illustration. Below is the trough to trough of each economic cycle of the U.S. domestic economy going back to 1947.



Source: Federal Reserve Economic Data (FRED), Cypress Capital Management

If readers are struggling to make sense of the graph above, they are not alone. The pace, trajectory and duration of economic cycles have varied tremendously, so as to make drawing firm conclusions very difficult.

Per Economic Cycle			
	Average	Maximum	Minimum
Number of Quarters	**23.5**	**44**	**7**
Cumulative GDP Growth	**22%**	**51%**	**2%**

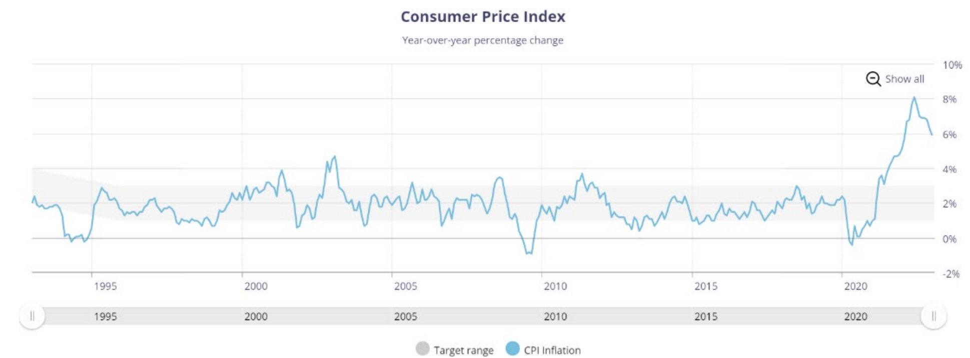
Source: Federal Reserve Economic Data (FRED), Cypress Capital Management

Looking at business or investment cycles has the most merit when evaluating individual companies or sectors where the number of variables to consider is more limited. At the global, economy-wide level, there are simply too many variables to make short-term predictions.

Our best guess is that the economy is currently in the contraction phase of the cycle, which largely reflects the ongoing impact of the rise in interest rates. Whether a trough is imminent or several quarters away, we could not predict, nor could we predict with any accuracy, the short-term moves of the markets based on the trajectory of economic activity. Our view is that the consensus macroeconomic forecast is already reflected in the price of assets, so there is little to be gained in the short-term by trying to reposition portfolios based on those forecasts.

#4 – What is going on with inflation?

As most clients are aware, after decades of historically low inflation, the rate of inflation spiked in 2022, both in Canada and across the globe. Recent data suggest that the pace of inflation is moderating, which is to be expected given the increase in interest rates and as the impacts of some endogenous shocks wear off. Whether the rate trends back below 2% or stays more elevated in the 2% to 4% range we cannot predict, but central banks are committed to getting inflation back within the target range, so we expect inflation will continue to moderate, at least somewhat, from current levels.



Source: Bank of Canada

Outlook

In the medium to long-term, we expect inflation and interest rates to moderate downwards, which should translate into higher equity values. The pace and trajectory of any moderation is not knowable with any certainty, so we cannot predict the path of returns, but over the long-term, the path to higher equity values is reasonably clear. In the short-term, the return on lower volatility investments has moved up significantly and we are adjusting portfolios accordingly for those clients whose time horizons and liquidity needs makes it reasonable to bring up the weighting in these types of investments.

As always, do not hesitate to reach out with questions or concerns.

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