TD Wealth

From the desk of
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Fed: Up

July 2022

Just like that, we are well into summer. It is hard to imagine we are in July with Canada Day behind us. Two years ago today, I recall uncertainty and frustration in my own life and in the voices of everyone I spoke to. As shops, offices, small businesses, and borders were closed, the constant theme of uncertainty dominated the everyday narrative. What is COVID? How bad will it get? When will it end? Those were just a handful of questions that were on our minds. It was tiring.

Fast forward to today, we are faced with new uncertainties and frustration as investors head to the locker room for a break from the first half of 2022.

More specifically, for the first six months of this calendar year, investors felt extreme market volatility due to interest rate hikes by central banks and elevated inflation not seen since the 1980s. Also, the current conflict in Europe and constant threat of COVID rearing its head across the globe is not helping. According to the World Health Organization (WHO), we are still in a global pandemic(1) and will be until the entire world has easy access to a vaccine. We are feeling all of this at the grocery stores, gas pump, and more importantly, in our portfolios.

The new questions we are asking today; Will rates continue to rise? How long will inflation last? How will my portfolio be impacted? The short answer, nobody knows. But we will attempt to address why we are here and how we are constructing portfolios today to be resilient in different market environments.

1. Hitting the breaks

For an investor, COVID was nothing short of remarkable. Almost every aspect of the investing market was up. You name it, stocks, bonds, crypto currencies, art, houses, it was all up! Even the price of Air Jordans were taking off. The moment COVID restrictions were lifted, and people realized they had better things to do with their money like travel, go to restaurants, see a concert, prices for those items also went up.

Figure 1: Performance Market (Year to date)

↓	S&P/TSX 100 Index	19,079	-10.10%
↓	S&P 500 Index	3,819	-19.88%
↓	Nasdaq Composite	11,178	-28.55%
↑	USD/CAD	1.28	1.94%
↓	GOLD	1,812	-1.33%
↑	10-YR Treasury Yield	3.10%	+159bps
↑	OIL	$109.55	59.42%

Source: Bloomberg Finance L.P. As of June 30, 2022.

You may think that's good for the economy. More goods, more services, more 'things' to buy will mean more jobs, right? Maybe, but if wages don't rise at the same rate, it will certainly create a chasm between what people can and cannot afford squeezing out the middle class. And if bare necessities start to join the list of unaffordability, that's a problem for everyone.

To get ahead and stop prices from reaching new highs, central banks around the world decided to take money out of the economy. Yes, the same government that was printing money and sending cheques in the mail a few months prior. How did they put a stop to it? The U.S. Federal Reserve (Fed) raised overnight interest rates, also known as the 'borrowing' rate, forcing consumers and businesses to think twice about spending money they didn’t have. Instead of spending money, it would make more sense to stash that money in a bank account and collect interest. The Bank of Canada (BoC) followed suit shortly after.

From an investing perspective, rate hikes can also impact stock markets and bond markets because many consumers will stop spending money, decreasing company profits. The Fed and other central banks knew this but was prepared to increase rates risking a selloff in the stock market to keep prices of goods and services in check.

1. World Health Organization website: www.who.int/emergencies/diseases/novel-coronavirus-2019

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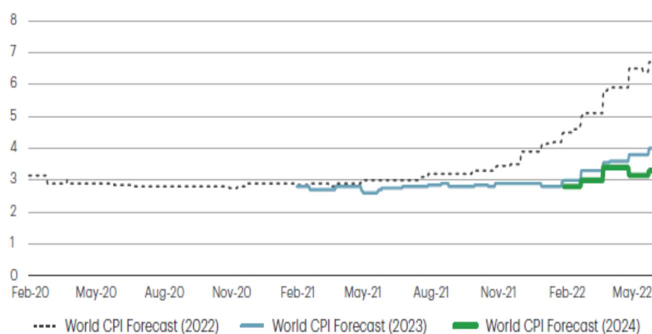
2. Sticker Shock

In 2021, expectation of price increases in early 2022 was a consensus around the world which led to the Fed and BoC to raise rates. The hangover from COVID spending was still alive and was well documented with rising housing costs and wages. Inflation was expected to rise, but only modestly and eventually ease in the near future. This was an opportunity for central banks to begin hitting the brakes early and slowly. However, as we received more information about global prices and supply chain issues, we began to see unprecedented inflation not just in housing costs or wages, but broad-based i.e. all goods and services (see **Figure 2**). Furthering the jump in prices was/is the conflict in Eastern Europe which has boosted energy and food prices around the world. The May 2022 inflation estimate within Canada was 7.6%(2). It hasn't hit that level since 1983, just shy of four decades ago. In the U.S., it was over 9% for the month of June(3).

Figure 2: Inflation Indications (March 2020 – June 2022)



Source: Bloomberg Finance L.P. As of June 15, 2022.

3. Opportunities from a Crisis

Acceleration of rising yields, inflation, and geopolitical strife is the rain on our post-covid parade this year. All these combined together, have lowered expectations of global growth bringing down markets-particularly equity markets-with more challenges ahead. As the Feds and BoC stay aggressive with fighting inflation, we will see stocks, growth companies, and fixed income total returns dragged down further. The bright side, rising yields means bond investors will be able to realize higher income levels. Additionally, harvesting illiquidity premiums from real assets can improve portfolio income and diversification. Also, equities are closer to their fair value today than before creating opportunities to benefit over the long-term.

Knowing this, we have designed our portfolios with a base case of economic deceleration, reasonable valuations in the stock market, and further rate hikes over the next 12-18 months.

- **Equities:** We maintain a quality bias toward equities, Canadian equities specifically, for their potential resiliency amid continued risks. Also, we focus on companies with pricing power so they can transfer rising costs back to the consumer in order to help maintain earnings and cash flow.
- **Fixed Income:** With the significant rise in rates, we believe the focus should remain on providing capital preservation and liquidity. We are favouring high quality corporate bonds.
- **Real Assets:** Rising inflation and bond yields may put some pressure on Real Estate and Infrastructure valuations, however, many of these assets are still attractive on and absolute return basis as well as on a relative basis when comparing their income. Furthermore, real assets can help stabilize a portfolio, particularly during high market volatility periods.

Top 5 Interesting Pieces

1. The Claws of a Bear Market - The Daily, a New York Times podcast
2. Will a cooling housing market solve the affordability crisis? MoneyTalk
3. Pension Income Splitting - TD Wealth Planning Minute Podcast
4. Why Apple Carplay is more important than the Apple Car - Reuters
5. The secret to a more productive life? Better sleep hygiene - Morning Brew

2. Monthly Perspectives June 2022 - TD Wealth Investment Office
3. US inflation surges again in June, raising risks for economy - AP News June 13, 2022

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We make the uncomfortable feel comfortable.
-Adnan Moeed