Monthly Newsletter
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TD Wealth

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Wise Investor – October 2022

Executive Summary

- **The U.S. Fed hiked rates another 0.75% in September but we're closer to the end**
- **Inflation has been persistently high, but analysis suggests a road to normalcy in the mid-term**
- **Focus on earning secure and stable returns with dividends while maintaining some defense**
- **The important statistics of being invested for the market recovery which likely happens long before the economy**

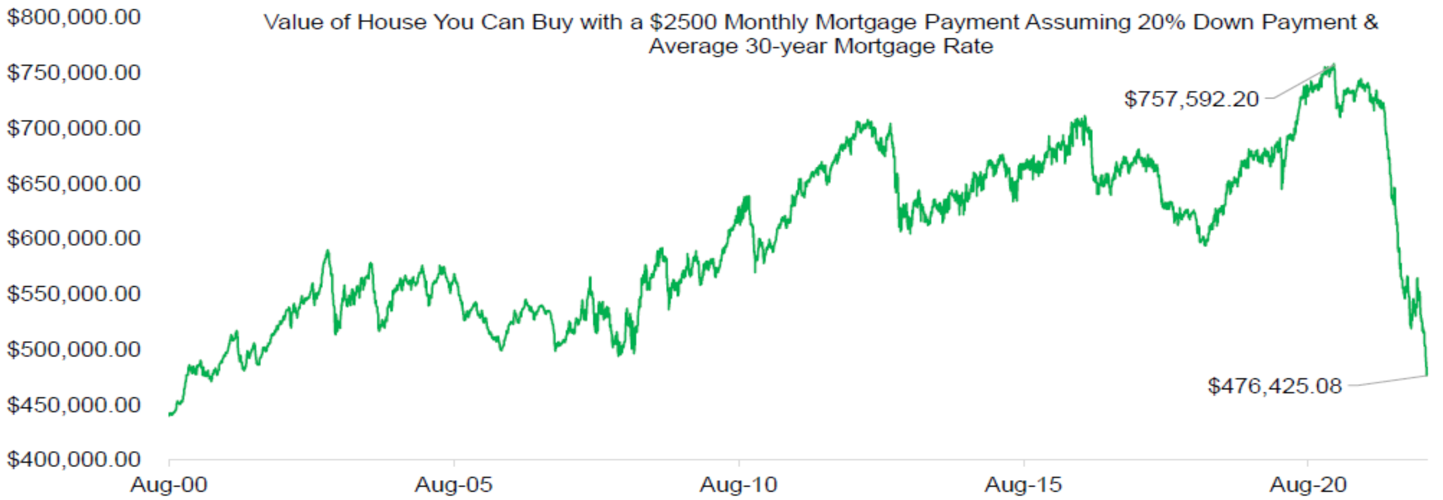
In my July newsletter I told a story of my first negative investor experience as a result of decreasing interest rates. Quite the opposite of today, rates were falling in the early 90's to combat a recession which resulted in lower investment returns for myself as my only investment at the time was Canada Savings Bonds. Thinking about this experience, I was prompted to ask my mother what our mortgage rate was at the time, to which she answered 15%. My first mortgage was closer to 5.00% in the 2000's which was a difference of 1000 basis points! That's quite a difference and the decline in rates provided a huge tailwind for investments over that period. Today the biggest concern is inflation and as we're continually reminded, to combat inflation, rates must go up. Do I think they're going to 15%? Not a chance, but 5% could be a reality. The relationship is as simple as supply and demand in that, higher rates discourage borrowing and the spending of money which depresses prices and slows inflation. As a result, high rates are bad for business, which is bad for earnings and ultimately bad for stocks and at some point, can cause a recession. Unfortunately, there's not a line in the sand or bell that rings and not even the FED (Federal Reserve System) knows how high interest rates must rise to slow inflation or at what point that causes a recession. In this month's publication we'll delve a little deeper into the subject and put some context around the extreme volatility, very challenging year and what could be a little more ahead. Its important to be positioned for the ultimate recovery but also have some defense should a recession ensure. This market weakness may have you feeling uneasy about your portfolio, but I'll review some recent developments that provide some worthwhile reasons to be a little more optimistic.

Late Stage Portfolio Positioning

	Upside Risk		Current Positioning	Downside Risk
Macro Indicator	**Early Stage (22%)**	**Mid Stage (42%)**	**Late Stage (22%)**	**Recession (13%)**
Economic Growth	High	Moderate	Low	Negative
Inflation	Low	Moderate	High	Low to Negative
Monetary Policy	Loose	Neutral	Tight	Loose
Term Premium	High	Moderate	Low	Low to Negative
Credit Conditions	Loose	Loose but Tightening	Tight	Enter: Tight; Exit: Loose
Equity Portfolio Considerations	**Early Stage**	**Mid Stage**	**Late Stage**	**Recession**
Style	Growth	Growth	Value	Value & Income
Business Cycle Positioning	Cyclical	Cyclical	Defensive	Defensive
Sectors	Financials, Technology, Discretionary	Technology, Comm. Services, Industrials, Discretionary	Energy, Materials, Staples, Health Care, Utilities	Health Care, Utilities, Real Estate

Source: TD Wealth, September 30, 2022

Chart 1: U.S. Housing Affordability



Source: FactSet as of September 30, 2022

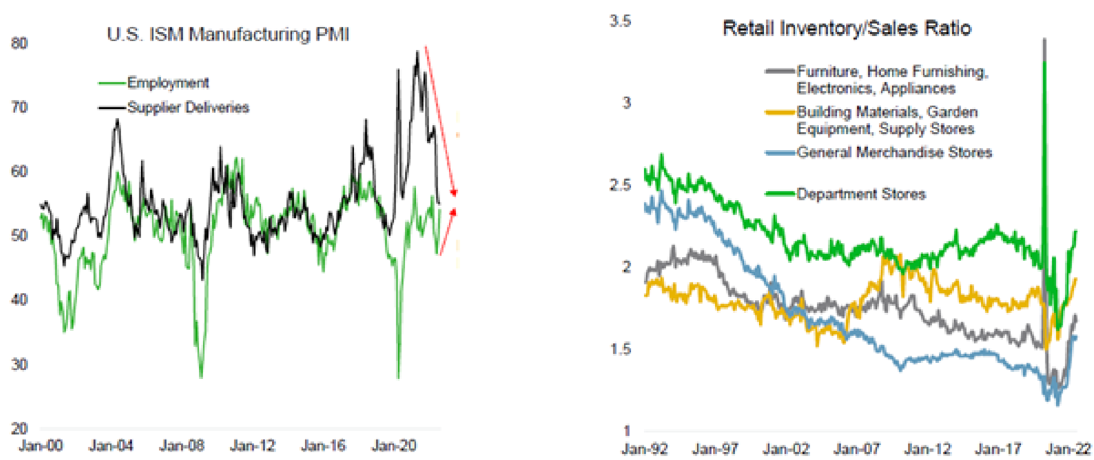
What's Happened Lately

The Fed was firm in their comments of being aggressive when they hiked rates 0.75% again in September which created the latest shock for stocks. Persistent negative sentiment and the steep rise in rates is putting more credibility behind recession scenarios. On the surface, this doesn't inspire confidence, however an assessment of history and some key indicators offer a more optimistic view of the markets with or without recession.

We would start by analyzing the data that factors into inflation. Falling prices are a good indicator that governments are gaining traction on bringing inflation down and we can see that in several prices and markets today. Commodities are a big input and oil and gasoline prices are down over 30% from their June peak. Used cars have declined 18% as stated by Manheim Consulting. Housing is one of the stickier areas of inflation and relevant data can take months to show up. Housing affordability has declined significantly which will eventually factor into the supply/demand metrics and drive prices down, chart 1. Building permits have started to show a significant slowdown and forward indicators such as mortgage applications are down 43% since the 2021 peak, and mortgage refinancing has fallen to levels last seen in 2000. Unfortunately, the stock market has also come down which is a necessary evil to curb excess consumer spending as net worth for many investors comes down temporarily.

We can then look to supply chains and employment. The continued normalizing of supply chain bottlenecks would vastly help to bring more inventory which would lower prices and speed up the drop in inflation, charts 2 & 3. Most importantly, employment remains strong which gives continued strength to the most important lever of the economy, the consumer. Of course, if we get lucky with any sort of peace in Ukraine or reopening of China, we may see inflation metrics come down even quicker and if the central banks could pause on rate increases as a result, we will likely get the sustained recovery we've been painfully positioning for.

Charts 2/3: Supply Chain Improving



Source: FactSet, as of September 15, 2022

Lastly, we can then look to the bond market to determine what expectations for future inflation are. You may hear pundits talk about the TIPS market, which are Treasury Inflation Protected Securities or in simple terms, bonds that index to inflation. The market is down from its March high when the expectation for average inflation over the next 5 years was 3.7%. Today the bond market believes the FED will get it under control with expected inflation to be around 2.5%. In conclusion, the data would suggest that if we have not already seen peak inflation, it is very close baring any exogenous events.

Figure 1: Market Performance Through Previous Interest Rate Hiking Cycles

		Stock Market Performance:				
Period of Hiking Cycle	Total % of Rate Increases	During Final 1% of Rate Increases	During Final 3 Rate Increases	12 Months After Final Rate Increase	24 Months After Final Rate Increase	Post-Rate Hiking Cycle Market Perspective
80-'81	10.5%	0.3%	9.1%	-11.2%	37.6%	End of the most recent high inflation phase
83-'84	3.3%	9.7%	8.7%	18.2%	64.5%	Short interest rate increasing cycle
86-'89	3.9%	-2.9%	4.9%	18.9%	36.2%	Encompassed Black Monday crash
94-'95	3.0%	4.2%	8.2%	35.6%	69.9%	Expansion cycle post 87 crash
99-'00	1.8%	2.3%	2.3%	-10.6%	-22.9%	9/11 and pop in tech bubble - *exogenous event*
04-'06	4.3%	2.7%	-0.2%	20.6%	4.7%	Global financial crisis impacted year 2
15-'18	2.3%	-6.1%	-6.3%	31.5%	55.7%	retuns through global pandemic
Average	***4.0%***	***1.5%***	***3.8%***	***14.7%***	***35.1%***	
2022	3% (thus far)	?	?	?	?	how high rates go could predict recovery timing

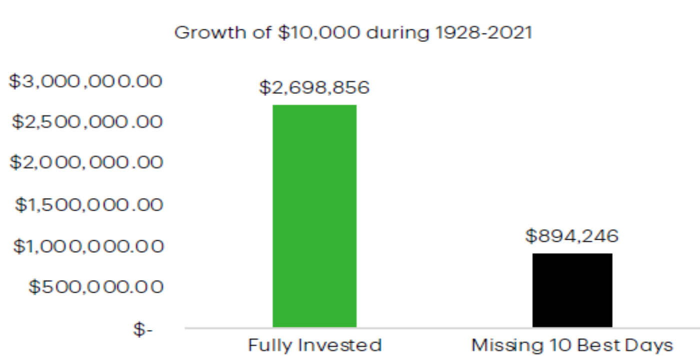
Source: FactSet analysis of the S&P 500 Index as at Sepember 22, 2022

Why Should We Care

Rates hikes because of inflation are of course among the biggest problems for markets today but would be a much bigger problem if left to run hot. It's important that rates go up and the economy feels a little pain now as the alternative is likely much worse for much longer. You see, inflation affects our personal purchasing and investment decisions but more importantly it influences corporate decision making. With the cost of higher capital, corporations may not invest in that next factory or hire that next employee. Therefore, if inflation stays high and unpredictable the economy gets hurt much worse by the continued slowing of companies and reigning-in of investment due to uncertainty.

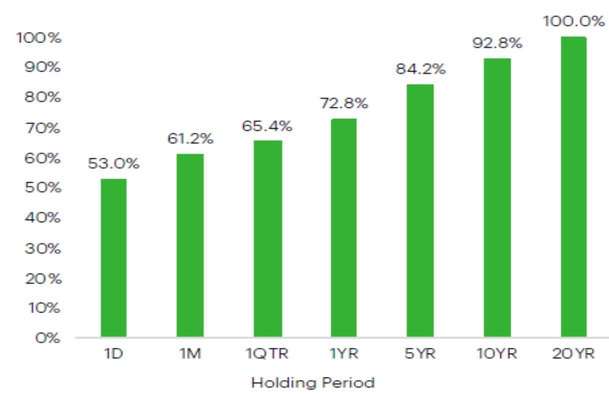
In the real world, we seem to fluctuate between the narratives of "things are pretty good" to "things aren't that great". The investment world follows from what I like to call "zoom" to "doom". The stimulus driven, post pandemic rally was quite the zoom. Even just looking at a simple chart deck of the aptly named Zoom stock (ZM), which is down close to 90% from its pandemic highs, you can see that the zoom has quickly turned to doom in 2022. Currently, the world is dealing with ultra-high inflation and expects high rates to cause a recession and there doesn't seem to be any scenario without a problem. This of course is not a reality. Although many do not believe we can see a sustainable recovery until either interest rates and/or inflation is stabilized, we must remember that although the markets are pricing another 1.00% to 1.25% of interest rate hikes, the Fed has already raised rates by 3.00% meaning we're much closer to the end. History would show us that it's the earlier part of the hiking cycle that produces the most negative markets, figure 1. Also, should a recession ensue, this gives the Fed a ton of flexibility in cutting rates in the future. It's important to remember that markets are forward looking and will have priced in a recession long before it's official. For those number people out there, analysis suggest that around 3,200 on the S&P 500 would price in recession and large earnings decline which is unfortunately another 10-12% down from here and we have targets in place to be more aggressive if that threshold is broken. If we manage to avoid a recession, stocks are already getting cheap and offer a compelling entry point and as indicated, if we're truly in the late stages of the rate hiking cycle, forward returns should be decent.

Figure 2: It pays to stay invested



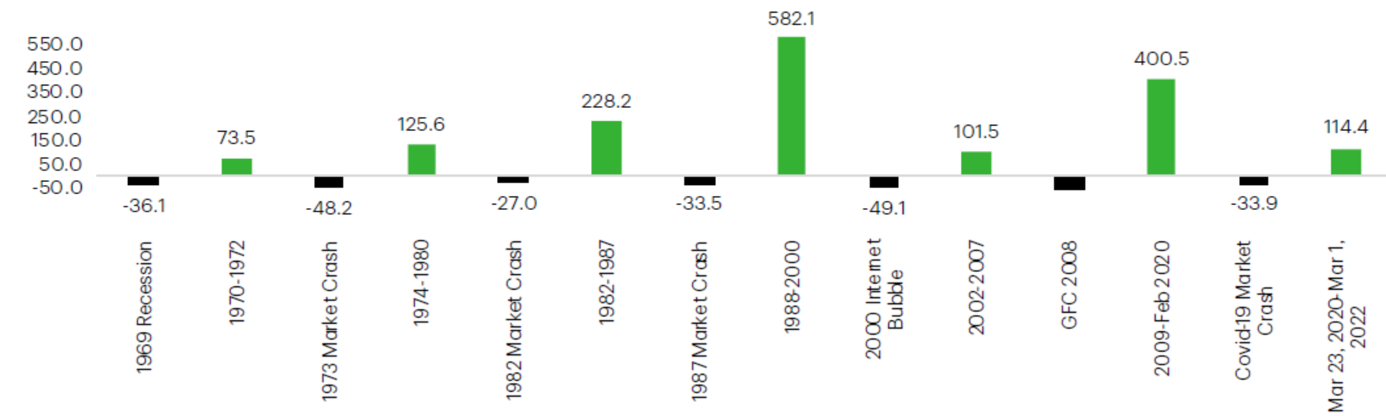
Source: Bloomberg Finance L.P., TD Wealth as of September 2022

Figure 3: Likelihood of Positive Returns over Holding Period (S&P 500, since 1945)



Source: Bloomberg Finance L.P. and TD Wealth as of September 15, 2022

Figure 4: S&P Contractions and Rebounds



Source: Bloomberg Finance L.P., TD Wealth as of May 12, 2022

Currently, corporations and investors are cautious, speculation has dissipated and this all makes for a healthy market. What matters now is how bad the ensuing economic weakness will be and how quickly the economy will recover. In most significant market sell-offs, the lows are hit many months before economic activity bottoms as well as many months before earnings growth troughs. Therefore, if we're expecting the weakest point in the economy, recession or not, to be in the next 6 to 12 months, we're close to a time to look for opportunities. Most bottoms are found when the root cause of the problem, today that's inflation, starts to improve. I would suggest that even a few months of improvement would be enough to bring confidence back to the markets. If you wait for the 'all clear' signal you will have likely missed some of the best days, figure 2 previous page. It's important to maintain some exposure to investments as the probability of positive returns vastly improves if you stay invested over time, figure 3 previous page. Lastly, periods of economic expansion historically last much longer than contraction with the returns far exceeding the declines, Figure 4.

What Should We Do – Investment Strategy

TD Wealth recently hosted a round table discussion with one of the world's most renowned investors, Howard Marks. One of the takeaways that sticks with me as it echoes my views was his commentary on the price of stocks, and I quote:

"The way I think about it, you have rich, fair and cheap – but the 'fair' zone is pretty big, and when the market is in that zone of fairness, there's nothing smart to do because the probability of being right is not that high. Obviously when it's cheap you want to become super-aggressive and when it's rich you want to become quite defensive, but in the middle, I think it's business as usual."

I don't believe it's time to be super-aggressive yet but I think the time to be overly defensive has passed. Our internal TD Wealth Investment Office team uses a series of signposts to help identify a market bottom. The good news is that some of the inflation metrics have continued to move positive and percentage of stocks trading below their 50-day and 200-day moving average have reached an extreme. However, there are a few more fundamental indicators the have yet to flash the green light that have historically helped to identify a bottom in risk assets.

Figure 5: Signposts for an Equity Bottom

Measure	Score
Macro	**Positive/Negative**
• 2-year yields and inflation breakeven rolling over	Inf. BE Lower
• Curve steepening and top in real yields	
Bond Market	
• Top in High-yield spread	
Equity market	
• Valuation – Percentage and discount from long term average	Forward P/E 16.4x
• Reversal in cyclical defensive fund flows and performance	
• VVIX	
• % of S&P 500 above 50 day moving average <10%	September 23, 2022
• % of S&P 500 above 200 day moving average <20%	September 23, 2022
• % of S&P at 52 week low > 40%	
• NYSE Bullish Percent Index < 20%	September 26, 2022
• VIX spike above prior elevated range(cycle target 40+)	*34.88 intraday high September 28, 2022*

Source: TD Wealth, as of September 30, 2022

Figure 5: Quantitative Screening

Sector Rank by Average Equity Quant Score	S&P TSX Composite Index Sector (+Gold)	Ranking Change vs. Prior Month	Average Change in in Momentum Rank	Average Change in in Trend Rank
1	Utilities	0		
2	Energy	0		
3	Consumer Staples	1		
4	Industrials	-1		
5	Consumer Discretionary	0		
6	Materials ex-Gold	1		
7	Information Technology	-1		
8	Financials	0		
9	Health Care	1		
10	Real Estate	-1		
11	Communication Services	0		
12	Gold	0		

Source: FactSet, TD Wealth as of September 22, 2022

What Should We Do – Investment Strategy *con't*

A short-term bounce cannot be ruled out given the extreme oversold conditions, but the bigger picture does not yet support a sustainable recovery therefore we are hesitant to put much of the cash on the sidelines to work yet. October has historically been one of the worst months of the year and will coincide with Q3 corporate earnings reports where we expect to see some signs of slowing growth and potentially, the last shoe to drop.

As mentioned, we raised a little cash on market bounces through the year and will be patient in redeploying it. As markets are 'fairly' valued and with the intent on maintaining exposure for reasons stated above, we want to safeguard as much of the return as possible. One way of doing this is with a focus on dividends. Most positions in our portfolios have historically paid a strong and sustainable dividend as it's a relatively secure and stable way to earn a positive return regardless of the volatile environment. Dividends can make an outsized addition to total returns over the mid to long-term. The goal here would not be targeting the highest dividend payers as they come with their own risks. Rather we want to own those companies that have a long-term track record of growing their dividends and the balance sheet strength to maintain payouts through all economic environments. Sectors that top the list in this category today would include Financials, Consumer Staples, Telecommunication, Utilities, and some Energy Companies.

From there, we leverage our internal teams' quantitative screening tools to see which sectors rank the highest in order to identify which areas of the market to focus on in these challenging times, figure 5. The expectation of this process is not to avoid market turbulence but to dampen it and be in a strong position when things ultimately bounce back.

In conclusion, I believe the most important thing for long term investors is being invested. There are periods to be defensive, as now, and there are periods to be aggressive, soon. In my 16 years managing assets for high-net-worth clients at TD I am yet to witness anyone successfully sell completely out of the market then get back in at a lower price. If perfectly executed, it would mean selling when the news is the most optimistic and buying when it's the absolute worst. In most cases, investors sell when things are bad and get back in when things have improved only to have missed out on some of the best returns. It can certainly be a relief to sell when the world is in chaos but if the intention is to be invested in the future, it’s a low probability strategy. With that said, if you find yourself stressed out about market conditions, then long-term decisions on asset allocation need be made if risk tolerance has changed. When risk aversion becomes the general narrative, the markets are typically beginning to look good again and I think we're close to that point even if the next few months are ugly.

As always, I encourage a review of things should you have any concern at all, and my line is always open and my schedule is always flexible for a discussion.

Personal Note

The beautiful fall weather so far helps ease the sorrow as we reminisce of the amazing summer. Although a late start, 2022 will be one for the memory books for the Snow family. Every year seems to be as our young son slowly grows into a functioning human, but this summer also marked a historic trip for us as we were able to spend a few weeks in Italy. We had fortunately booked flight a long time ago in expectation of attending a wedding in the North which had been delayed over the last few years due to covid. We began our journey in Lake Como which offers views unlike any I've seen.

We had initially left our ticket open-ended in the hopes of convincing some family to join us as those flights are just too long to spend only a few days. Our dreams were answered as my wife's parents eventually made the decision to make the journey. This was amazing as my father-in-law was born just east of Naples and hadn't been back in 30 years and my mother-in-law had never left the continent. We had the unique experience of visiting his native town of Ceppaloni. The quaint castle town is home to a whopping 180 people, none of which seemed to speak English, so we were thankful to have a family translator. I recall the goosebumps up my arm as our son sat on the very same front door stairs that his grandfather, Nonno, sat at the very same age so long ago. I would also suggest you haven't tried pasta until you've tasted local Italian pasta in the back allies of an authentic town.

From the mountains we travelled to the coast to soak up a little sea air and enjoy some fresh seafood. My mother and step-father decided to tie in their official retirement vacation by meeting us for a few nights by the beach then a trip to Rome before heading on their own adventure. I learned that there's a certain way of life off the beaten path in Italy that can feel lost when in the bustling big cities and needless to say, we were happy to come home after a few very hot days exploring Rome. I can happily say that the first time on an international flight in more than 3 years, this time with a toddler, was a success and I pray for a better future for our world to experience many more in years to come.

It looks like the nice weather might be around for a bit so we all need to make sure we get out there and enjoy it on the beautiful west coast while we can. Fresh air and some activity always helps to alleviate the stresses we may face day to day. Of course, if any of those stresses for you, your family or friends are financially related, let's talk! There's reasons to be optimistic, glimmers of hope and better days ahead.

Until next time, best regards,

Marley

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“Wealth is not his that has, but his that enjoys it.”

Benjamin Franklin

We will take as much time as needed to get to know what matters most to you while establishing a strong working and personal relationship. We have every confidence that this relationship can benefit you greatly. We have proven our value time and time again by helping a small niche of high-net-worth Vancouverites realize their lifelong goals.

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