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Commentary – Q3 2022 – The Pandemic Hangover

The stock market tends to rise, the performance of 2022 notwithstanding. On an annual basis, the Standard & Poor's 500 Index (S&P) has increased year over year in three out of every four years on average since 1950[1]. These are good odds. This long-term upward trajectory of the markets has a foundation in the democratic political system and its market-based, capitalist economic system. In theory, the stock market efficiently allocates the nation's capital, generating solid returns. This year, however, the story has been entirely different. Stock and bond markets tend to move in waves and in the short term, with a herd mentality, in one direction or another. As asset prices moved higher, almost in a straight line, from the middle of 2020 to the beginning of 2022, optimism abounded and valuations continued to grind higher. Then the music stopped, and as has happened many times in the past, a wave of over-valuation has now given way to a new landscape of extreme pessimism. Only time will tell for sure, but just as markets tend to overshoot on the upside, this is likely an overreaction on the downside, that will undergo a reversion back to the mean in due time.

We will get to some of the reasons later, but first a non-scientific review of the early fall months and what it can mean for the markets especially in a year as jittery as this one. September can be a transition month even at the best of times. The summer vacation season has passed, and corporations get back into gear after Labour Day. The Bank of Canada (BoC) and the Federal Reserve (Fed) meet and set policy rates and forecasts, which can add to volatility. And sometimes the third-quarter earnings season approaches ominously. By the end of the third quarter of 2022 (Q3), it became clear to market participants that central banks were less and less likely to pivot towards a more accommodative monetary policy and that companies would eventually have to revise their earnings forecasts lower.

Since the beginning of the year, the war in Ukraine and the COVID lockdowns in China have weighed on global growth forecasts. As per the International Monetary Fund (the IMF) global growth is forecast to slow from 6.0% in 2021 to 3.2% in 2022 and 2.7% in 2023[2]. This is the weakest growth profile since 2001 except for the global financial crisis and the acute phase (the first half of 2020) of the COVID-19 pandemic. Although much softer than previously expected, this is not necessarily a recession, and corporate earnings may indeed be more resilient than the market currently expects. The IMF's view is that monetary policy will remain restrictive to restore price stability, and fiscal policy should aim to alleviate the cost-of-living pressures while maintaining a sufficiently tight stance aligned with monetary policy. The IMF also expects global inflation to rise from 4.7% in 2021 to 8.8% in 2022 but to decline to 6.5% in 2023 and to 4.1% by 2024. Structural reforms can further support the fight against inflation by improving productivity and easing supply constraints, while multilateral cooperation is necessary for fast-tracking the green energy transition and preventing costly and inflationary problems to arise as climate change continues to threaten the status quo.

Naturally, as asset prices have fallen, the backdrop has become ripe for pessimism. And this is indeed what central banks want. The Fed and the BoC, amongst others, have signalled that bringing inflation down to target (which has been established at somewhere between 2% to 3% annually) is priority #1, and that interest rate policy will not shift until there is evidence that slack in the economy is increasing. There has been some evidence that this is happening. The modest decreases in GDP in the U.S. and Canada in the first half of 2022 reflected decreases in private inventory investment, exports, and government spending. But more evidence of weakness will likely be necessary before policy makers are willing to change course on rate hikes and in their messaging.

The last two and a half years that have been unusually volatile. As with all volatile market experiences, this period will leave a mark on all who participated. The nervousness that has seized financial markets around the world in recent months has now brought the S&P/TSX Composite Index (TSX) and the S&P500 (S&P) down to roughly the same level they were just prior to start of the COVID-19 pandemic[4]. At the outset, in the early spring of 2020, investors saw markets collapse very quickly fearing the unknown fallout from a pandemic that had struck with a severity not seen in over a century. Then, in a stunning turnaround, spurred on by a tidal wave of government spending and very easy monetary policy, coupled with breakthroughs in vaccine development, markets rushed upwards in a seemingly unstoppable bull run. Now, we enter the "pandemic hangover" phase of the economic cycle, where markets have begun to retreat once again in the face of much tighter monetary conditions. Central banks will emphasize that the fight over inflation will cause short term pain for a much stronger long-term environment, but the net effect of all this turmoil has been to bring us back to asset valuations that are much more in line with their longer-term averages, if not slightly below where they should be.

As always however, the cognitive dissonance experienced by investors in the face of such a powerful and compressed boom-and-bust cycle can be very challenging. Like other market pullbacks, including the global financial crisis of 2008/09 and the bursting of the dot-com bubble in the early 2000's, the uncertainty of outcomes can lead human beings to behave irrationally. Because financial assets are not tangible in the way that real estate is, and can be very easily converted to cash, a common mistake that investors make in times of uncertainty is to think short-term, and sell their positions, to gain some form of control over a situation that is beyond any one individual's control. It is almost always the wrong move.

When runaway inflation ultimately forced the Fed into the fastest rate-hike cycle on record, a brutal reappraisal of the most richly valued assets was soon to follow. The threat of higher than desired inflation has been referenced many times in this column, but has largely been absent from the economic landscape, at least since the early 2000s. Although we have a sense of what is behind this recent shift in price increases, it pays to consider all the factors that have led to this "hangover" that we are now facing. The obvious reason is the COVID-19 pandemic, a once in a century "black swan" event that no one could have foreseen. Simply put, too many individuals and corporations had been supplied with too much money in the form of pandemic support programs rushed out the door by government departments in a "shoot first, ask questions later" fashion. This is not to admonish policy makers for their quick response; this was a *fog -of-war* moment if there ever was one. The stay-at-home orders also created consumption habits that have been slow to shift back to where they were pre-COVID. Another important factor is the significant change in the structure of the labour force since the pandemic began. Many older workers have left the work force entirely, and younger replacements have been slower to jump into these vacancies than they normally would, had government support not been provided. Finally, due to pandemic uncertainty, but also tied into geo-political instability that has been building for much longer, there has been a disruption to established global supply chains. There is a movement afoot to repatriate manufacturing domestically and a turning away from the globalization trends of the last 30 years or so. This will likely keep unemployment rates on the low side for the foreseeable future.

The question is not whether we are in a bear market, which is typically defined as a decline from a market peak of at least 20%. We are. The question now is how successfully governments, corporations, and investors can navigate through these tricky waters with the least amount of long-term damage. In fact, it is healthy to have these kinds of reappraisals of asset valuations from time to time. The market seems to be functioning normally, as speculative "froth" is eliminated, and long-term stock and bond market return expectations are effectively reset.

Historically these bear market episodes last between 12 and 18 months, but there are significant differences in the economy today compared to others in the past. The financial system itself (at least in North America) appears to be quite stable. Corporate balance sheets are much better capitalized then in previous downturns, and unemployment rates remain very low. All good signs of a shallow recession to come, if at all.

Ultimately, money and value are concepts that are shaped by consumer psychology. If policy makers are successful in bringing down inflation expectations, without sending the economy into a deep tailspin, the bear market may be over sooner than we think.

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Best regards,

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Sources: [1] Macrotrends.net – oct 22; [2] International Monetary Fund – Fall Forecast; [3] Argus Research – Market View – sept 22; [4]

Globe Online – oct 22

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