3rd Quarter 2022 Commentary

October 2022

Schacter Palazzi | Wealth Management

TD Wealth

TD Wealth Private Investment Advice

Andrew Palazzi
Senior Portfolio Manager &
Senior Investment Advisor
andrew.palazzi@td.com

Jeff Schacter
Senior Portfolio Manager &
Senior Investment Advisor
jeff.schacter@td.com

James McKinnon
Associate Investment Advisor
james.mckinnon@td.com

Schacter Palazzi Wealth Management
180-2300 Steeles Ave. W.
Vaughan ON L4K 5X6
T: 1 866 831 5501

Building Walls and Looking Ahead into the Future – 3rd Quarter Commentary 2022

We think most would agree if someone asked how to build a wall a first response might well be: “For what purpose am I building the wall?” If then told “To fortify against Hurricane Ian”, some who have residences in Florida might well imagine a wall made of high-quality cement, or an eight-foot deep and eight-foot-high wall of sandbags. Everyone has their own idea of what a “great wall” looks like.

So, how does one build a solid wall when constructing a portfolio? During times of stress, like these ones in the market, we are constantly evaluating and reevaluating the companies we hold. While every family has different goals and aspirations the one constant, we see daily, is a demand for steady income. For more than 10 years, a combination of both interest and dividends has provided that steady source of income. We like to think of the quality of the companies that one holds in a portfolio as like the quality of the cement desired in a wall to protect against a hurricane. One needs to build a solid financial wall.

We are often asked, “What does the future hold?’ From where we sit, we would say that current economic data is very inconclusive. For the most part, companies (including the ones we hold) have not really warned on earnings however earnings season is starting as we write this letter. Unemployment, which usual starts to pick up as a recession takes hold, has remained stubbornly low making it difficult for both the Bank of Canada and the US Federal Reserve to pause the course of tightening monetary policy. Indeed, there are more interest rate increases in the pipeline. Inflation has also been quite stubbornly high but as many of you have seen commodities, in particular oil and gas, have fallen over 30% from their highs earlier this year.

The one possible canary in the coal mine might have been FedEx warning of a possible global recession. Rest assured we continue to look for ways to make our walls even stronger now and into the future.

And now, on to the questions of the month.

Can you please explain why inflation is hurting our portfolio values so much? It seems to us the companies we own just pass along their higher costs by passing them through in selling prices.

We think that most of our clients have noticed that prices are rising whether it be in food or the goods and services we use. The Bank of Canada and more importantly, the U.S. Federal Reserve, have been unrelenting in their approach to inflation. Remember, the higher they raise interest rates the more costly it is do business, borrow for investment or even reinvest in things like new equipment etc. Opportunity costs are definitely looked at differently. While it is evident that central banks on both sides of the border would like us to slow down consumption, which would reduce demand below supply and ease the upward pressure on prices, it does in fact have a very negative effect on our holdings because the effect of reduced demand is reduced sales and therefore reduced earnings. We have previously spoken about the negative effects of interest rates on fixed income so we will just reiterate that when interest rates rise, bond prices drop. On the good news front, fixed income held to maturity will likely recover these drops in market value and the portfolios eventually reinvest into the higher rate environment, so patient investors will likely recover in this arena. Equity is a bit more difficult as rising borrowing costs can affect companies and the economy in a very negative way. Evidence of this is seen in the rising inventory levels at many retailers and the price declines in residential real estate. While we feel that perhaps the Bank of Canada and the Federal Reserve may have already acted more than enough to cool their economies, it seems that a good part of the “shock and awe” nature of the rate rises is at this point is a result of inaction over a year ago when it appeared the economy was running a bit too hot. We expect portfolio valuations will likely remain volatile until the interest rate increases come to an end and we hear from both central banks that they feel their work is done.

Are we in a recession yet? Are you very worried at this point?

While Canada has yet to see a quarter of negative GDP growth in this tightening cycle, our friends to the south (USA) have now had two straight quarterly GDP declines which means the U.S. economy has met one technical definition of a recession (according to Argus Research). That said, official recession definitions are given by the National Bureau of Economic Research and usually are only declared several months after they have begun (in fact often the recession is finished by the time it has been declared!)

While we are always worried about what the future holds, it seems businesses and consumers are behaving as if there is no recession in sight! Several of our clients who had occasion to travel over the summer have reported to us that airports were incredibly busy. There are many signs that discretionary spending in some categories has increased, and overall retail sales in both Canada and the United States remain positive. People are working, unemployment remains stubbornly low and consumer spending has continued to rise year over year.

But, what about the commercial and industrial economy? Here also, there are none of the traditional signposts of recession, credit spreads on corporate bonds remain reasonable, and business loan defaults remain low. This makes it very difficult for us to judge the health of our economy here in North America.

We are concerned about the effects of rising prices of basic goods and mortgages on the average consumer. And we are also concerned about the geopolitical environment which seems to bring its own set of negative headlines every day. We will be watching employment and corporate earnings very closely this quarter.

Do you feel our portfolio will recover by the end of this year?

While the calendar fourth quarter has historically been on average the best performance quarter for stocks, the nervousness of investors both among our clients and within the market indicates that few are expecting the current quarter to be a bounce back quarter.

Historically, a real market bottom has required investor sentiment to hit peak negativity and, so far, that does not seem to have occurred when we review market "fear" gauges such as the VIX (Volatility Index). To date investors continue to be willing to chase risks assets quickly when markets pull back. As Q3 moved into September, growth companies were the hardest hit, but we did see some improvement in companies like Amazon which might suggest consumer spending has not been significantly reduced even amid mounting recession fears.

Can you tell us what we should expect out of the stock market in the months ahead?

While we are not sure who coined the phrase "it is always darkest before the dawn", it goes without saying that the stock market is certainly more attractive today than it was back January 2022. However, inflation and potentially higher interest rates here in North America make the outcome in the short term appear very murky to us. We believe the Bank of Canada and U.S. Federal Reserve will likely have to push the pause button on interest rate increases in the coming months. The major crises we have faced in the past year, COVID-19 pandemic, the supply chain crisis and the ongoing war, demonstrate that the problems we face are global in nature. We also believe that any evidence that inflation is finally coming under control would send a positive signal worldwide.

We would caution everyone who has asked us about our outlook for the months ahead that it is very difficult to project the near-term path of equity markets. Assuming your overall investment plan is sound and diversified, and that your level of risk is appropriate for your family circumstances, staying invested is almost always the proper course of action. If you feel your plan should be revisited or your would like a further review please don't hesitate to reach out to Jeff, Andrew or James to discuss in more detail.

Thanks to everyone for your questions this quarter and know we are facing the challenge each and every day to provide all of you with the very best advice in more difficult markets.

Feel free to reach out at any time!

Andrew, Jeff, James & team

Andrew Palazzi
andrew.palazzi@td.com
Senior Portfolio Manager & Senior Investment Advisor

Jeff Schacter
jeff.schacter@td.com
Senior Portfolio Manager & Senior Investment Advisor

James McKinnon
james.mckinnon@td.com
Associate Investment Advisor

Nino Wijangco
nino.wijangco@td.com
Associate Investment Advisor

Steve Eng
steve.eng@td.com
Associate Investment Advisor

Stacey Espinola
stacey.espinola@td.com
Client Relationship Associate

Jane Chen
jane.chen@td.com
Client Service Associate

Henry Wu
henry.wu@td.com
Client Service Associate

Rose Capito
rose.capito@td.com
Client Service Associate

Schacter Palazzi Wealth Management
TD Wealth Private Investment Advice

BC23-113