August 2022

The S&P 500 fell into bear market territory over the first half of 2022 with the index down -20.6%. This represented a top 10 ranking amongst the most dismal back-to-back quarterly performances going back to 1928. While comparisons have been made to the inflation driven bear market of 1973-74, the economic backdrop today has some significant differences including greater production capacity (factory utilization rates are running about 20% lower vs the 70's) and a meaningful decline in raw industrial prices which have fallen -11% over the quarter. While these economic anecdotes are potential positives for the future, it's important to remain cognizant that prices remain elevated.

As such, the US Federal Reserve seems to be taking every opportunity to telegraph their intentions of raising interest rates at the expense of both market and economic performance, so long as inflation remains a threat. Given this hawkish tone, the market narrative has morphed from fears of inflation to a fed driven recession. As a result, the move in the bond market has been swift with the 10-year treasury yield peaking at approximately 3.5% in June to today's level of 2.7% (lower rates = higher bond prices). This positive bond performance reflects the consensus view that inflation is temporary (2023 CPI forecasts are approximately 3.6% vs the second quarter's 8.7% CPI reading) and could allow the Fed to adjust their higher interest rate trajectory downward. The Fed also remains confident that a soft landing is achievable, and a recession avoidable.

Investors seem less convinced however, given the Fed has never been able to engineer a soft landing before, and so it's no surprise equity markets entered a bear market over the quarter, and currently remain in a technical correction (defined as losses greater than -10%). To better assess future performance, we closely monitor earnings results to understand how companies are navigating these economic trends. With nearly 80% of the S&P 500 reported, the results have been better than expected, but still the EPS beat rate and magnitude of beats (actual vs expectation) remain below 5-year averages. This tells us companies are finding today's economic conditions more challenging than the recent past. Consumer sectors including marketing, retail, autos and textiles posted the 2nd worst performance vs other sectors while the Financials sector saw the greatest challenges with aggregate EPS falling by -15% year-over-year. Wall Street analysts have started to revise S&P 500 forward growth estimates lower, a trend which we expect will continue for several quarters ahead. The forward (12-month blended) P/E ratio of 17.5 times remains 1.5 multiple points above the long-term average which potentially suggests risks may not be fully priced in.

In terms of the S&P/TSX Composite, after declining nearly -14% in Q2 as recession fears around the world jeopardized the global demand outlook, its' since rebounded over 4.0%. Still, valuation remains below longer-term averages at 11.8x forward earnings with the heavier weighted Financials and Energy sectors trading at 9.5x and 7.9x, respectively. TSX earnings expectations have stalled as of late but downward revisions are lagging US and European counterparts. Additionally, the domestic labour market remains tight which has allowed the Bank of Canada to continue its aggressive rate hike path to curb soaring inflation. For most of 2022 the TSX has benefitted from surging commodity prices but an economic slowdown in China resulting from its commitment to a zero-Covid policy and a potential global recession could prove to be a challenge for the Canadian market.

Equity markets on average lose 30% of their value in recession led bear markets. If we use this as a potential road map, it suggests the S&P 500 could have further to fall. Using past performance as a forward-looking tool however is an imperfect technique and used in isolation of what's happening today can often mislead. Accounting for today's backdrop, we come up with three scenarios of varying probabilities. The first is the most optimistic and includes an engineered soft landing by the Fed, meaning no recession and inflation cools. A less optimistic view is the fed tames inflation with higher interest rates but tips the economy into a mild-to-moderate recession. The outcome would be consumer spending and corporate hiring slow as a result of tighter financial conditions, and therefore financial results are negatively impacted. The least optimistic scenario is one where stagflationary conditions emerge as inflation continues to accelerate at the expense of growth despite higher interest rates, in other words the Fed loses control. The net result would be similar to our second scenario but with much more dire results in terms of unemployment, household spending and impacts to corporate profitability. While we don't rule out any of the above scenarios completely, we assign the highest probability to the second one where macro economic issues get resolved at some point in the future, but the full effects of inflation and a possible recession have yet to be priced into the market. Currently, this view translates into a slight underweight equity position versus our benchmark with a tilt towards low volatility and defensive strategies along with an overlay of value and dividend paying securities. In other words, we've de-risked the portfolios relative to our benchmark to manage potential downside risks but remain meaningfully invested an on absolute basis. As always, time in the market tends to overcome trying to time the market, and so employing a strategic and diversified strategy is often the most prudent approach.