CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

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Welcome to our special year-end review

How were the stock markets in 2021? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2022 and beyond.

We hope you find this review informative and useful.

Enjoy!

Stan

Year-End Review

STAYING THE COURSE, DESPITE THE PANDEMIC

By Stan Clark and Michael Chu

Looking back at 2021, we experienced another year dominated by the pandemic. However, the stock market has continued its run from the pandemic lows to record highs. From the last two years, many fundamental themes carried over to 2021 and so far into 2022: the pandemic, opening and closing of economies, low interest rates, strong company earnings and inflation concerns, to name a few.

One of the biggest topics is that inflation in the U.S. is running at the highest pace in almost 40 years. In the past 12 months, the consumer price index rose 6%. Similarly, in Canada, inflation rose at an annual rate of 4.8%.

The World Equity Index, a gauge of stocks around the world, was up 21% (in C$). At home, the TSX was up 25.1%. The chart below shows the returns of major stock markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

	Q1	Q2	Q3	Q4	2021
Canada (S&P/TSX)	8.1%	8.5%	0.2%	6.5%	25.1%
U.S. (S&P 500)	4.8%	7.1%	2.9%	10.7%	27.8%
EAFE (Europe, Australasia, Far East)	2.2%	3.8%	1.8%	2.3%	10.5%
Emerging Markets	1.0%	3.7%	-6.0%	-1.6%	-3.2%
World	3.6%	6.3%	2.3%	7.4%	21.0%

Source: Bloomberg

How did we do?

Our strategies had good returns for 2021, with 4 of 5 models outperforming their benchmarks:

Our Canadian stock strategies (Disciplined Canadian Stock) returned 28.1%; the TSX Index was 25.1%. Our U.S. stock strategies (Disciplined U.S. Stock), returned 27.2%; the S&P 500 was 28.7% (in US$).

Composite	2021 Strategy	2021 Benchmark	10-Year Strategy	10-Year Benchmark
Disciplined Canadian Stock	28.1%	25.1%	12.9%	9.1%
Disciplined U.S. Stock (in US$)	27.2%	28.7%	14.7%	16.6%
Disciplined World Equity	23.5%	19.3%	14.7%	12.4%
Dividend Select World Equity	24.9%	20.6%	13.7%	11.6%
Disciplined North American Equity	28.4%	26.7%		

We also have two global portfolios made up of our multiple stock strategies. The Disciplined World Equity composite returned 23.5%, compared to a benchmark 19.3%. This portfolio is roughly 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned 24.9%, compared to a benchmark of 20.6%. This portfolio has a slightly higher weighting in Canada and dividend payers.

We also have a North American composite, which returned 28.4%, compared to the benchmark of 26.7%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are just for stocks. Clients with less than 100% in stocks will have proportionately lower returns. These returns are also before fees.

Valuations

Stocks had an incredible run in 2021, rising to record high prices. Does that mean stocks are expensive? It depends. There are many models and rules of thumb to determine if stocks are expensive or cheap.

The most common is to compare stock prices to earnings, and then compare this ratio to historical averages or to interest rates. For example, we can look at the forward price-to-earnings (P/E) ratios. This tells us how much we are paying per dollar of expected 2022 earnings. At the end of 2021, this measure for the S&P 500 was 21.4. Interestingly, the P/E ratio has stayed in the 20-22 range since 2020, despite prices rising significantly. How? Because earnings have grown in line with prices, so valuations remain about the same. As a result, some call the market an *E-led bull market*, the E standing for earnings in P/E.

When you compare prices to trailing earnings (i.e., the past year's earnings), the ratios are higher. In the U.S., especially, they're a bit expensive compared to simple historical averages. But if compared to bond interest rates, the prices still look reasonable in the U.S – and very attractive in most other countries. From the table below, you can see that earnings yields and dividend yields are much higher than 10-year bond rates in Canada. This means stocks are better value than bonds. In the U.S., the difference is not as impressive as in Canada; but still good, nonetheless.

	Trailing P/E	Trailing Eanings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	17.1	5.9%	2.7	1.4%
U.S.	26.1	3.8%	1.3	1.5%
Europe	18.0	5.6%	2.5	0.4%
Japan	16.1	6.2%	2.1	0.1%
EAFE (Europe, Australasia, Far East)	17.7	5.6%	2.5	0.3%
Emerging Markets	14.0	7.1%	2.4	3.4%
World	22.7	4.4%	1.7	1.3%

* Weighted average for regions

Source: Bloomberg

Earnings grew very fast in 2021 compared to the pandemic-depressed levels of 2020. They are not expected to grow as fast this year, but are still expected to see positive growth. Earnings for the S&P/TSX index in Canada are expected to rise 8% this year and 5% next year. Earnings for the S&P 500 index in the U.S. are expected to rise 8.5% and 10.4% this year and next (based on estimates by outside analysts as of January 21, 2022).

Inflation

One of the biggest concerns facing many markets is rising inflation. What's causing inflation? Prices rise if demand increases and/or supply goes down. In 2021, both factors – supply chain issues and strong demand – caused prices to rise sharply. Over time, both should subside. Still, the inflation wave is lasting longer and has gone much higher than most, including the central banks, anticipated.

Until recently, central banks have been most concerned about the pandemic leading to depression-causing deflation. For that reason they have been reluctant to act to combat rising prices. But in the early fall, bond markets signalled that central banks were starting to become more concerned about inflation, with five-year Treasury yields increasing from 0.80% in mid-September to 1.34% in mid-November. The bond-market inflation expectation for the next five years rose from 2.41% per year on September 22, to a high of 3.17% per year on November 22.

With recent inflation above 6% and unemployment below 4%, the markets found it hard to justify a near 0% policy rate. Central banks around the world have recently been taking inflation much more seriously. They now clearly recognize the need to tighten.

Markets have been choppy in response to rising rate expectations, but stocks usually perform well in the year that rate hikes begin. Pricing power allows well-positioned companies to pass rising costs to customers. And the markets sometimes welcome higher rates to avoid overheating the economy, which could require more drastic measures later on. So, early phases of monetary tightening don't necessarily signal the end of a stock market rally or an economic recovery.

Interest rates do need to go up. The question is, how fast and how far? Central banks increased interest rates too fast and far in 2018, which caused a major negative reaction from the markets, leading to a reversal in policy and falling rates in 2019. Let's hope the central banks learned from that experience and will find the delicate "Goldilocks" balance with interest rates needed to prevent overheating without killing economic growth.

What happens when bond rates go up?

At the beginning of the pandemic, all interest rates went in one direction – down. After bottoming out at 0.5% towards the end of the summer, 10-year U.S. bond yields are finally on the upswing. That's a concern for the stock market, as it's possible for problems to occur if bond rates rise too much.

Start Date	End Date	Starting Yield	Ending Yield	S&P 500
Jul '54	Oct '57	2.3%	4.0%	60.7%
Apr '58	Jan '60	2.9%	4.7%	40.4%
May '61	Sep '66	3.7%	5.2%	70.8%
Mar '67	May '70	4.5%	7.9%	-1.9%
Nov '71	Sep '75	5.8%	8.4%	2.8%
Dec '76	Mar '80	6.9%	12.8%	18.4%
Jun '80	Sep '81	9.8%	15.3%	11.4%
May '83	Jun '84	10.4%	13.6%	-1.5%
Jan '87	Oct '87	7.1%	9.5%	6.7%
Oct '93	Nov '94	5.3%	8.0%	2.2%
Oct '98	Jan '00	4.5%	6.7%	39.5%
Jun '03	May '06	3.3%	5.1%	39.1%
Jul '12	Oct '18	1.5%	3.2%	127.2%

Source: Ben Carlson

But let's look at what has happened in the past. Ben Carlson of Ritholtz Wealth Management did a study going back to 1950 to see what happened to the stock market when 10-year rates went up by over 1%.

There were only two instances where stocks fell during a rising bond rate environment. The average annualized returns of all these periods where rates rose over 1% was 10%, which is in line for the long-term average of the U.S. stock market.

It's worth noting that some of these rising rate environments preceded very nasty stock market falls: Rates were going up sharply ahead of both Black Monday in 1987 and the dot-com bust in 2000. But for the most part over the last 70 years, the stock market has been just fine in a rising bond rate environment. Of course, things may not always play out the same way as in the past.

Perhaps inflation might provide some extra insight. Since 1928, the average annual inflation rate in the U.S. is about 3%. Based on average returns for the S&P 500, the stock market does better if inflation is below 3% or if inflation is falling.

Rising Inflation	Falling Inflation	Inflation >3%	Inflation <3%
6.7%	16.5%	6.3%	15.7%

Source: Ben Carlson

For years when the inflation rate was rising, the stock market averaged 6.7%. Compare that to years where inflation was falling and the market had returns of 16.5%. Similarly, when inflation was high stocks returned 6.3%, vs. when inflation was low and they returned 15.7%.

Inflation surged this past year due to: ultra-low interest rates; pandemic stimulus; and surprisingly strong consumer demand colliding with mostly pandemic-related problems in production and shipping. However, most of these events are expected to be temporary, which should help the inflation wave subside. Indeed, the bond market is expecting inflation below the 3% level over the next five years.

We do need to be aware of the potential risks. But unless the bond market is seriously underestimating it, future inflation should not be overly damaging to stock market returns.

What does the professor say?

According to Wharton Finance Professor Jeremy Siegel, the Federal Reserve must get "more aggressive" in 2022. To tame inflation, the Fed should increase interest rates and taper down asset purchases, Siegel says. "The Fed is way behind the curve… and should have started raising interest rates by now."

Siegel predicts the S&P 500 will continue to climb in 2022, but at a slower pace than in 2021. He does not regard the market as cheap – but not as wildly overvalued, either. The stock market will face headwinds when the Fed pivots and raises rates. Nevertheless, "stocks are real assets, and you want to hold real assets when there is inflation." Siegel's biggest concern is about containing the double-digit growth in money supply, which he feels is not consistent with desired inflation rates of 2% or 3%. If the Fed can stop the growth of liquidity, then we can get inflation under control.

Panic attacks?

Top economist Ed Yardeni keeps a log of stock market "panic attacks." Since the current bull market in 2009, there have been 71 (three in 2021: Omicron, Evergrande, interest rates). A few have triggered full-fledged corrections of 10 to 20%. Most have caused minor sell-offs, accompanied by a lot of fear they would lead to bear markets. But all have turned out to be buying opportunities.

According to Yardeni, most actual bear markets were caused by recessions, which were caused by credit crunches. He says it's hard to imagine a credit crunch even if the Fed raises rates and stops buying bonds. Since everyone expects this to happen, it won't be a surprise.

Granted, there are elements today of the great inflation of the 1970s, when Fed Chair Paul Volker forced interest rates to go up to whatever it took to bring inflation down. However, Yardeni doesn't believe this will happen now. The big difference is productivity. Productivity collapsed in the '70s, but it's been on a rebound since 2015 – likely due to technological innovations. Productivity growth, Yardeni believes, will help offset some of the inflationary pressures and allow wages to rise faster than prices, without cutting profits.

There could be other surprises this year, e.g., another COVID variant immune to vaccines. This would exacerbate supply disruptions and might cause inflation to move higher and be more persistent. On the geopolitical front, there could also be shocks over events in Taiwan and Ukraine.

If none of these causes a recession, they are unlikely to cause a bear market in 2022. However, they could easily trigger more panic attacks – which, again, Yardeni sees as buying opportunities.

Supply chain unkinking

Supply chain issues are one of the underlying drivers of inflation. A variety of measures still show a lot of stress, including high shipping costs and many ships waiting to unload. Things could get worse, given the uncertainly of the pandemic. Yet we should see some improvement this year. First, air cargo rates have plummeted from December peaks. The urgency to deliver products for the holidays has faded. Also, supply chains can catch up, as post-holiday demand is seasonally weaker. Furthermore, companies have likely front-loaded their purchases in anticipation of a difficulty procurement environment. This could well mean reduced shipping needs later.

Meanwhile, the Supplier Deliveries Index, which reflects businesses' reports on how their supply chains are functioning, has fallen sharply. The index is now at its lowest in 13 months, evidence supply chains are improving.

Selling out

With the stock market being up so much since the Financial Crisis of 2009 and the pandemic lows of 2020, it's natural to wonder when's a good time to sell. Howard Marks of Oaktree Capital recently wrote an article about this. Everyone knows the basic rule of investing: *Buy low, sell high*. But something so important is not that simple; it's just a starting point for a complex process, Marks says. Though investors like gains, it doesn't make sense to sell things just because they're up. The same applies to things that are down.

Marks strongly discourages attempts at market timing, that is, selling when you think the market will go down and then trying to buy back in after it's lower. Sounds easy enough, but it introduces many problems: 1) What if the decline doesn't occur (or worse, goes up more)? 2) Even if it does go down, you'll have to figure out when to go back in. 3) And what do you do with the proceeds in the meantime? According to Marks, it's generally not a good idea to market-time. In any case, very few people possess the skill needed to take advantage of these opportunities. He counsels, "We believe time, not timing, is the key to building wealth in the stock market."

Marks concludes, "Reducing market exposure through ill-conceived selling – and thus failing to participate fully in the markets' positive long-term trend – is a cardinal sin in investing."

Mid-term elections

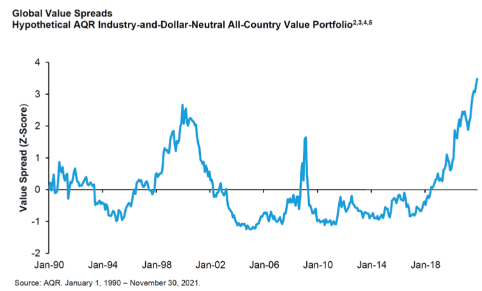
By late 2022, the stock market will become distracted by the U.S. mid-term elections. Leadership in Congress is expected to change. To save Biden's legacy, the Biden administration may cooperate with the new Congress. Wall Street is usually in favour of gridlock, meaning the political environment could be more favourable to stocks.

Emerging markets

Developed markets were very strong in 2021. Emerging markets were weaker. Performance does vary country to country, but one common theme is that China has a big influence on emerging markets. There's been a general slowdown in China's economy, plus the regulatory changes and weakness in its property markets. Developed markets should eventually get back to slower growth environment. We will need to depend on emerging markets to continue that growth.

Growth vs. value

Co-founder and hedge fund manager Cliff Asness of AQR Capital recently published a blog post with just one graph and no words:



The graph shows the spread between growth and value stocks around the world. As you can see, the spreads change over time. Sometimes value does better and sometimes growth does better. But for the past decade, growth has done much better than value – resulting in a record spread over the last 30 years.

We've talked in the past mostly about the widening spread in the U.S., but this graph applies worldwide. The good news is that value stocks look very attractive. No one knows when the spread will revert. But the wider the spread gets, the chances increase of it narrowing soon. There has been a tiny reversion so far in 2022, with most speculative areas of the market deflating somewhat. This is consistent with what Jeremy Grantham of GMO said about "super-bubbles." Grantham thinks we were in a bubble last year, but have now advanced to super-bubble status, which has only happened in the U.S. three times in the last 100 years. Every past super-bubble eventually painfully corrected all the way back to trend.

On top of an acceleration in stock price increases, Graham notes that characteristics of super-bubbles include: a sustained narrowing of the market; unique underperformance of speculative stocks, which are the most vulnerable; and crazy investor behaviour like meme stocks, crypto currencies and non-fungible tokens (NFTs).

What does this mean for us? The stocks in our models show good value, with a higher-than-average earnings yield of 6.8% using 2022 expected earnings, plus have many other positive factors. This should help insulate us if we are indeed in the midst of a correction, as Grantham suggests.

Contrarian thinking

Given the markets recent volatility, bearish sentiment rose sharply in early 2022. But this is actually a bullish development from a contrarian perspective. The Bull/Bear ratio fell from its peak of 4.0 mid-last year to currently about 1.6 and will likely fall near 1.0 soon. In the past, a low ratio of 1.0 or less has been a great contrarian buy signal for stocks.

Looking ahead

Inflation, monetary policy, earnings and the pandemic – going into 2022 there are a lot of big uncertainties. But that's not unusual going into any new year. In fact, we'd be more concerned if there weren't much to worry about! Surprises (good and bad) that we are not even thinking about will be another likely factor causing volatility in the markets.

It's worth reminding our readers that the Stan Clark Financial Team doesn't try to predict the future. Rather, we aim to build diversified portfolios coupled with resilient financial plans. Uncertainty and volatility will always be around: They're just part of investing. But our approach will remain consistent, which includes having a financial plan with an established set of sensible guidelines to help us navigate the future.

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Disclaimer:

Performance results in this document are based on a composite of CIBC Wood Gundy Advisor Managed Account ("AMA") retail accounts with more than $75,000 invested in the "Disciplined Canadian Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined U.S. Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined World Equity (CAD) strategy" (created in November 2008 and includes AMA performance data from January 1, 2009, two months after the Strategy's inception in the AMA program), "Dividend Select World Equity strategy" (created in November 2010 and includes AMA performance data from January 1, 2011, two months after the Strategy's inception in the AMA program), "Disciplined North America Stock strategy" (created in November 2015 and includes AMA performance data from January 1, 2016, two months after the Strategy's inception in the AMA program).

The composite includes open fee-paying discretionary managed accounts where the Strategy has been held for at least two months, through a purchase or a switch from another investment or a different AMA strategy. Also included in the composite are closed accounts that held the Strategy, up to the last full month the Strategy was held.

Composite performance returns are geometrically linked and calculated by weighting each account's monthly performance, including changes in securities' values, and accrued income (i.e., dividends and interest), against its market value at the beginning of each month, as represented by the market value at the opening of the first business day of each month. This Strategy can be purchased either in U.S. or Canadian dollars. Unless specified otherwise, performance returns in this document are expressed in Canadian dollars and are calculated by converting U.S. dollar accounts into Canadian dollars using the month-end Bank of Canada noon rate. Performance returns are gross of AMA investment management fees, and other expenses, if any. Each individual account's performance returns will be reduced by these fees and expenses.

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