

# ARE WE THERE YET?

**December 2022**

By Brahm Satov

I have been saying for quite some time that the probability of a correction is high, and to a certain degree we have seen a market correction, so some may be asking are we there yet? Is it time to get back in? I think everyone is familiar with kids sitting in the back of the car asking their parents “are we there yet”. How much longer until we get there, so I will endeavor to address that question in terms of the stock markets.

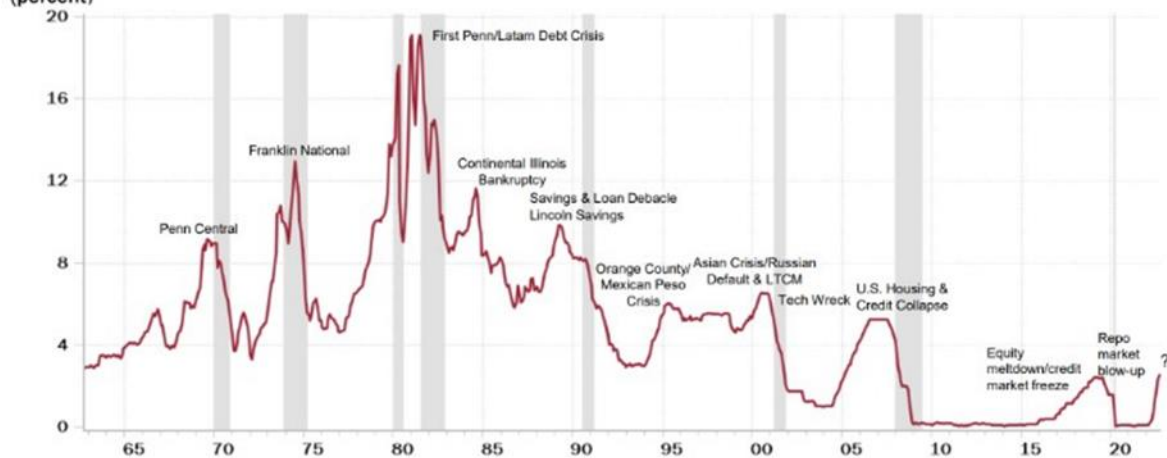
First, for those who like the gold sector, I think we are almost there, and as soon as the Federal Reserve pauses, I expect a significant rally in the precious metals sector. Now, don't forget that this sector is usually a trade and once the economy starts to improve, for those who like to profit from the gold sector, I suggest that they like it less if you know what I mean (lower your exposure once the economy starts to normalize). Similarly, I expect a sizeable rally, perhaps not quite as dramatic, in the bond market once the Fed is done raising rates. And let me be specific, not junk bonds, but those deemed to be safe, as I expect weaker economic conditions and lower prevailing yields to help buoy a rally in this segment.

In terms of the stock markets, and look I could certainly be wrong, but I don't think we are there quite yet. One of the ways to look at valuation is discounted cashflow and based on the change we have already seen in rates alone, it is my opinion that the stock markets still have considerable downside and if we compound an earnings recession on top of that, things could really be difficult for the stock markets. Furthermore, a pause by central banks may create another bear market rally, possibly the biggest one, and we have already seen some big ones, but I expect it to sputter like the others and for lower lows ahead. The good news for the stock markets is that we may once again get a chance to buy great businesses at low prices, something we have not seen for many years.

One more thing I should mention, I do think it is highly likely that we experience a financial crisis as a result of our overdependence on debt coupled with speedy increases in bank rates and quantitative tightening. It is common that tightening cycles lead to a crisis as can be seen in the chart below. I recall in 2007 when I thought we would have a housing related crisis, before we saw or heard any talk of it on any news stations, although it seemed that it took longer than it should have to realize. It would be reasonable to expect a collateralization crisis whereby financial institutions see their asset base diminish and as a result experience liquidity and collateral issues. Let me explain how this works. Banks need collateral to lend against, often that collateral is in the form of interest paying bonds, but we have just witnessed a severe correction in bond prices, many are down well over 20%. Remember as prevailing interest rates rise, the value of existing bonds fall. In other words, if you have a 10 year government bond that is yielding 10%, and a week after you buy it the government increases rates and now a 10 year government bond is yielding 12%, the value of your bond is now worth less, it has just lost value if you want to resell it because instead of your 10 year 10% bond, investors can get a 10 year 12% bond with essentially the same maturity. For financial institutions that lend against their asset base comprised of bonds or perhaps cryptocurrency, this could become problematic as the value of these assets become worthless.

## FED TIGHTENING CYCLES ARE ALWAYS FOLLOWED BY SOME SORT OF CRISIS

United States: Federal Funds Rate (percent)



Shading indicates recession  
Source: Haver Analytics, Rosenberg Research

We have already seen signs of instability with the fall of FTX and the devaluation of Swiss' second largest bank, Credit Swiss. FTX was one of the largest crypto exchanges, where tokens and digital coins could be traded. This company recently filed for bankruptcy as it saw the devaluation of their assets. My understanding is that as the value of crypto rose, FTX used that increase in valuation to expand, however when the value of crypto assets collapsed, they had a liquidity or collateral problem. Although perhaps still unpopular, my belief that all cryptocurrency is worthless has not changed. In terms of Credit Swiss (CS), this Swiss bank was founded in 1856, so well over 150 years ago, it's stock is down about 60% year-to-date and rumors are circulating that it too may have liquidity problems.

(Source: [https://www.wsj.com/articles/credit-suisse-warns-of-1-6-billion-loss-after-clients-pull-money-11669190614?mod=hp\\_lead\\_pos4](https://www.wsj.com/articles/credit-suisse-warns-of-1-6-billion-loss-after-clients-pull-money-11669190614?mod=hp_lead_pos4))

I believe we have already started a negative feedback loop, whereby corporate profits are lower due to rising costs, and as a result companies lay people off to lower costs and improve earnings, with less people working, sales slow, lower sales turns into lower earnings, more layoffs, etc. I do not believe that a pause by the central bank will remedy this negative feedback loop. Although, I do think that the equity markets have not learned from past mistakes and as such, it would be reasonable to expect a market rally on a central bank interest rate hiking pause. However, in my opinion, we will need to see much lower rates and quite possibly a return of quantitative easing before we see a real bottom in the markets. For those who did purchase GIC's this year, remember that you will not see the benefits until they mature. Although, it is nice to know that you have some gains coming your way.

As we approach year-end I would like to reflect if I may. I am truly thankful for my friends, family and for those I work with. I am thankful for the health of those that surround me, their families and my own. I am also thankful for the years that I get, to drive down the highway and see my sons in the backseat, as they ask, "dad are we there yet?"

Thank you for taking the time to read this, please feel free to e-mail me any feedback or comments.

Sincerely,

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