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CIBC PRIVATE WEALTH

Our Views on Inflation, Current Market Volatility and Aggressive Central Bank Moves

June 2022

Since the start of this year, global equity and fixed income markets have experienced large, sharp declines. The sell-off of late was initiated by the latest U.S. CPI reading which came in at 8.6%, a year over year increase that was higher than the market was expecting.

In our previous 'Pope team newsletter', we discussed the risks associated with increasing inflation and the difficult position this puts central bankers in. Central banks need to raise interest rates enough to slow down inflation but also need to be careful about not tipping the economy into a recession.

The market sell-off of late has been largely due to increased fears of not just a global slowdown, but a potential recession caused by aggressive rate hikes. The S&P 500 has dropped over 10% in the last few weeks, a rate of decline not seen since the pandemic related downturn in 2020.

Our position as always, when providing advice, is to give you our objective viewpoints on both opportunities and risk.

Equities

- Markets have continued their sharp YTD (year to date) sell-off with the S&P/TSX Composite Index down 10.2%, compared to losses of 22.7% for the S&P 500 Index and 31.5% for the Nasdaq Index. From previous highs, the average stock in the tech heavy Nasdaq index is down by a whopping 48%. European/Asian market indexes are down 17% year to date.

- The Canadian market has remained strong in relative terms given our exposure to energy and materials. Client portfolios have certainly been affected but are holding in there well, given the extent of this sell off.

- Positive market expectations related to China's reopening were quickly diminished due to China's 'zero covid policy'.

- The war in Ukraine has exacerbated inflation and supply chain problems while also increasing geopolitical risk.

- The yield on U.S. 10-year government bonds has risen from 1.51% on December 31st, 2021, to 3.4% on June 16th, 2022. More central bank (short term) interest rate increases are planned, and we may also see a continued increase in medium and long-term interest rates.

- Despite rising rates and increased market concerns, corporate profits have remained strong and company balance sheets look healthy.

- Consumers still have record levels of savings and net worth.

- Unemployment levels are still at record lows due to a very strong job market and high demand for labor.

- Keep in mind that over the longer-term, equities provide a good hedge against inflation.

- We think that current market volatility will likely continue for a while yet. It will take some time for slowing inflation to be reflected in data. During times like this, owning well-managed businesses at attractive valuations combined with quality fixed income investments is the best strategy for both protecting and increasing wealth over the longer-term, while mitigating as much downside risk as possible.

Positioning

In our previous letters, we talked about over-valuation in technology companies and how they are unlikely to do well in an increasing rate environment. We have

largely seen this come to pass (with particularly large selloffs in unprofitable or less profitable businesses). As interest rates and inflation increase, investors are prioritizing companies that generate more cashflow presently. Higher interest rates heavily discount/erode the present value of longer term cashflows/earnings (which lowers the value of businesses not expecting to earn good profits until many years into the future).

- **Canada:** In our Canadian equity positions, we have always prioritized value based cashflow oriented companies that have a long history of paying dividends (and periodically raising them). We are confident in their ability to pass on higher inflation costs to consumers over time and thus properly hedge against inflation. Increasing interest rates can help some businesses. For example, this improves 'net interest margins' for our banks and increasing interest rates are also positive for insurance companies.

- **Global Equities:** Our view on global equities is similar in the sense that we prioritize valuations and cashflow. We were seeing signs of over-valuation in U.S. equities prior to 2022 and are pleased that we chose to over-weight Canadian equities. We retain this position currently but are keeping a close eye on opportunities as global markets continue to sell off. Our focus remains on buying high-quality businesses at valuations we feel offer a good margin of safety with attractive long-term potential.

Bonds

Bond markets have experienced a steep selloff this year with 10-year federal government bond yields increasing to 3.51% and 3.4% in Canada and U.S. respectively.

The bond market appears to be taking the view that Central Banks have:

1. Waited too long to start hiking rates.
2. Started hiking as the economy was already showing signs of slowing down but with inflation still increasing. i.e., stagflation
3. Have decided that they will bring inflation down at all costs, including potentially causing a recession.

The most recent interest rate hike was an aggressive .75% which we haven't seen since 1994. Markets are pricing in 2.00 percentage points of hikes over the next three central bank meetings in both Canada and the United States.

Poor consumer sentiment, inflation pressures, and hawkish (restrictive) central bank rhetoric are creating lots of volatility across fixed income markets and growing expectations that the economy will tip into recession.

Positioning

We remain steady with our views regarding using less fixed income, than we've had historically… plus we have ensured very low bond duration (to decrease 'interest rate risk').

Short term yields will likely increase further. Should this also translate into higher medium/longer term rates, we will begin to ladder into longer duration fixed income. We are starting to see attractive investment grade corporate bonds in Canada with yield to maturities north of 5%.

We remain cautious on high yield bonds given the potential for much larger 'bond spreads' if a recession were to occur.

Perspective

While we expect volatility to continue in the months ahead, we know from history that this will not continue forever… and that financial markets will stabilize and recover over time. And while many in our industry (including ourselves) feel markets may take a while yet to fully bottom out, often when most investors believe this, the opposite occurs. That's why active market timers almost always underperform patient long long-term investors.

We live in a day and age where news and information are now almost instantaneous. Receiving financial market news every day and seeing our accounts fluctuate on a day-to-day basis can understandably change our thinking from long term to short term. During periods like this, it's healthy to try and avoid frequent online checking of accounts and overly taking in market chatter - which also at times like this, tends to skew to the negative. While we are very cognizant of current short-term risks, markets are very forward thinking and historically have bottomed well before the news turns positive again.

Portfolio wise, we are very confident in our holdings and are positioned appropriately for the scenarios discussed above. We would more than welcome a conversation or meeting should you have any questions or concerns.

Thank-you

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