CIBC

CIBC PRIVATE WEALTH

2022: Regime Change

We would like to spend most of this commentary on what we are expecting for 2022, but we thought we would spend a few moments also reviewing 2021.

The outstanding performance of our portfolios pleasantly surprised us in 2021. If you look under the hood, it is even more impressive when you consider the risk-adjusted returns which were probably the highest in our career.

What worked in 2021?

- Our stock-picking was very good. The explosive year-over-year earnings growth certainly helped stocks in 2021. The individual Canadian and U.S. stock portfolios were the best performing asset class in 2021.

- Preferred shares had an excellent year. Our preferred share ETF's were up over 25% in 2021.

- Our actively managed bond managers did an excellent job of beating the bond index which was negative for the year. Most could gain a positive return, and one did a double-digit return.

- Global mutual funds: Some of our funds lagged the benchmark in 2021 but still generated returns that contributed significantly to the portfolio return. We are confident that the managers that lagged the index in 2021 will do an excellent job of preserving capital if 2022 proves to be volatile (which we are already seeing)

What did not work in 2021?

- The promise of the emerging markets remains a promise. With most of the global population growth, the emerging markets should attract capital for the future. The combination of a strong $U.S. and COVID has put that on hold for the moment. We were roughly even for the year on our EM exposure but feel we need to be in this asset class as we can never predict when it will outperform.

- While our bond managers did an excellent job in a tough market, bonds as an asset class delivered little return in 2021. Their job over the past few years has been to dampen volatility and generate a modest return and they have done a good job doing just that. 2021 was the first year where delivering the modest return was a real challenge (although 2018 was a bit like this under similar market conditions).

- While we did not own any speculative stocks, it certainly has been in the news for 2020 and 2021. The poster child for this speculative fervour was the ARK innovation fund which was up 150% in 2020 and continued up to February 2021 before stalling out and retreating 30% from the high. As we write this, today it has lost over 50% from the high. Many of the stocks with similar "no earnings but a bright future someday," peaked in February and have been steadily declining ever since.

Here are the numbers for 2021, expressed in $CAD*:

Canadian Bond Universe	-2.54%
Preferred Share	19.35%
TSX Composite Index (TR)	25.15%
MSCI all Country World Index	17.97%
Emerging Markets	-3.06%
Alternative Strategy	6.0% (est)

*Source: CIBC Wood Gundy Monthly Index File

The performance of your portfolios over the past three years has been well ahead of the expectations built into your financial plans. We view this “surplus” as a necessary buffer in the portfolios to help us when the markets behave badly. Jenn has been vigorously rebalancing throughout the year so no drastic changes are required. We have also been allocating to Managers that have some downside risk protection against market corrections.

As we will explain next, what has worked in the past may not work as well in 2022, and beyond as we go through a regime change. We shall continue to adjust the portfolios to meet the changing nature of the markets.

Regime Change

We feel that 2022 will probably mark the beginning of a new investment regime. For the last forty years, investors have benefitted from a declining interest-rate investment backdrop that supports asset prices. Since 2000, we have also seen interventionist central bank policies that also suppressed interest rates and injected vast amounts of liquidity. This has inflated the value of assets leading to the occasional misallocation of capital (see the housing crisis).

We may be entering a new regime where interest rates start going up and the Central Banks cannot use monetary policy to support asset prices. Clearly something fundamental seems to have shifted already in 2022. It is like a switch went off on January 3, and investors sold equities starting with the companies with the highest valuations. As we write this, on the 25, we are seeing it spread to the broader market.

So why the sudden shift? Here are our thoughts.

No More “Fed Put”

The U.S. Federal Reserve has a dual mandate: full employment and price stability. Over the past twenty years, it seemed as if it had a third mandate: preserve the “wealth effect.” The wealth effect is a belief that you should support asset prices to provide confidence for consumers and the economy. Over the past twenty years, The Fed has used monetary policy to counter slow economic growth and promote job growth with little or no inflation. These conditions allowed the Fed to continue to move rates lower, and when necessary to intervene to support asset prices. 2018 and 2019 were perfect examples of using monetary policy to preserve the wealth effect. That has changed.

Inflation: It's back

The combination of COVID-induced demand for "stuff," supply chain snafus and labour shortages have resulted in a likely CPI print of over 6% in 2021 in the U.S. This is a multi-decade high for inflation and it clearly is not as transitory as initially thought by Chairman Powell. He is now forced to confront the reality of fighting inflation.

Where did all the workers go? There are widespread reports of labour shortages and competition for talent. This has resulted in a spike in wages, especially in the 15-24 cohort. Higher wages, free tuition, signing bonuses are all being used to attract service workers, truck drivers, distribution center pickers, home builders, and many others. COVID has also resulted in the "Great Resignation" as workers (with potential support from the government) could quit jobs they disliked and search for more meaningful employment. The net result is that over six million jobs are unfilled (according to the JOLTS survey) and wages have increased by about 4% in 2021 (10% for the 15-24 cohort). This is very sticky inflation.

So the "Fed" Chairman is boxed into a corner. He has high inflation and labour shortages (full employment) so can he rescue the equity markets with monetary intervention? We think not, at least not immediately.

Politically it would be quite damaging if he intervened on behalf of stock owners while many of the citizens, who don't own stocks, suffer under high inflation. Any monetary stimulus could also fuel more inflation. Plus, there is apparently no need to provide liquidity to support employment growth.

So the "Fed Put" looks like it is off the table. This has already affected the "hope" stocks trading at multiples of sales, let alone cash flow or profits. It is affecting the large-cap tech names that everyone owns and will probably spill over to the broader market.

Twin Contractions

So while the Federal Reserve cannot use monetary policy, we are also seeing the massive amount of liquidity introduced through fiscal stimulus in 2020 and to a lesser extent 2021 roll-off. 2020 was one of the shortest, if not the shortest, recessions in history. It is no wonder considering most developed economies injected between 15% and 25% of their GDP over 12 to 18 months. In the U.S., it was the first time in history the disposable income actually went up during a recession. This liquidity is drying up which is another headwind for investors in 2022.

No More "Money for Nothing"

At the moment the yields on government bonds are less than the expected inflation over the next five to ten years—hence, the real yield is negative. This means that money is effectively free which encourages investors to borrow money to invest in risky assets. As the "real" yield gets less negative, it forces investors to reduce their leverage and thus sell equity to pay down the debt. We have seen that the combination of the twin contractions has forced the real yield from -1.05% to -0.65% already this year. This may be another reason we have seen such a significant sell-off at the beginning of the year. This real yield bears watching.

A Healthy Correction

Every generation needs to learn a valuable lesson about investing. “Yes Virginia, valuations matter”. Another good one is “trees don’t grow to the sky.” Finally “leverage cuts both ways”. While I know it is painful, I actually welcome this correction so that we can remove much of the excess speculation and leverage and get back to fundamentals.

As we write this missive, the NASDAQ is down around 15% year-to-date, the S&P 500 is down around 9% and the TSX is down a modest 4% as Energy and Banks have countered the effects of the other sectors. We are in the middle of earnings season in the U.S. which will help guide our decision-making in the short and medium term. We are looking for companies that have good earnings reports and strong guidance for sales and margins in 2022. We expect that the companies that we own will do just that in the next few weeks. If they cannot meet either of these metrics, then we can reallocate to stocks that have good reports and have been beaten down prior to earnings.

Portfolio Construction

We feel that over the past twelve to eighteen months we have developed well-diversified portfolios across asset classes, styles and geographies that are resilient in the face of challenging markets. Our recent move into alternative strategies is an example of our forward-thinking. If we are to invest for the future, we need to absorb some volatility from time to time. This is one of those times.

We have lots of liquidity to meet any income or capital requirements for the next few months or years. We can also use some of the liquidity we have sheltering in cash and bonds to add to existing positions if we feel it makes sense. We may trim some of our big winners to bring them more into balance.

Summary

We feel it is important to manage your expectations for 2022. If we can navigate this regime change and preserve capital, then we feel it will be a job well-done. We also feel that if some of the speculative excesses are washed from the system, then our portfolios will have a better opportunity to deliver above-expectation returns in the future.

As they say, two steps forward, one step back.

We usually have a long discussion on geopolitical concerns for the year ahead, and there is lots to write about that, but we will make that a project for next month.

Stay well and stay safe.
CIBC Wood Gundy

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