CIBC PRIVATE WEALTH

Back to “Normal”

We don’t need to tell you that it has been a very eventful few years. With the ongoing political machinations south of the border, the pandemic, the war in Europe, high inflation, more powerful natural disasters, and elevated market volatility, it has felt like everything has been off-kilter. Many of you have expressed a desire to return to something that resembles normal.

So, what is “normal” and how do we get back to that state of being? From an investment perspective, it usually means that investors carefully allocate their precious capital to the opportunities that exhibits the best potential return for the perceived risk. Unwinding some of the abnormal conditions that were present over the past few years has been painful, but the good news is we are making progress.

Here are our thoughts on the move to normal.

Bonds Now Give You REAL Yield!

Back in the good old days, a bond investor would expect to get a yield that would be the rate of inflation plus a little bit for the risk of holding the bond to maturity. For the past few years, the REAL yield (yield less inflation expectations) for bonds has been negative as central banks forced interest rates below inflation to try and stimulate economic growth and avoid deflation.

Investors took advantage of this abnormal condition by borrowing money because the cost of the borrow, net of inflation, was close to zero. Many corporations also took advantage of this cheap money and used the proceeds to buy back their shares thus, increasing the earnings per share. The math worked very well.

Now, that the ten-year U.S. treasury has moved from 0.91% at the beginning of 2021, to around four percent, the real yield has gone from -1.% to + 1.5%[2]. Today, a bond investor can invest in a bond and expect to get a REAL yield. Short-term interest rates have risen dramatically, so even GICs provide an attractive yield with a guarantee to match.

The downside of this normalization has been a massive correction in bond prices this year, maybe the worst one-year return ever in bonds. *The good news is that going forward, we feel that bond investors can generate returns that meet or exceed the inflation expectation in their financial plan. This increases the probability of the plan's success.*

T.I.N.A. Doesn't Live Here Anymore

With negative real yields in bonds, there was this common refrain about the T.I.N.A. (there is no alternative) trade. It was the idea that anyone seeking a return would be forced into riskier assets to beat inflation and meet their financial objectives. This T.I.N.A. trade worked great, until 2022.

With the rapid rise in interest rates and the subsequent decline in bond prices, bonds suddenly represent a true alternative to stocks. This is especially true if you look forward towards a possible recession as bonds tend to outperform equity during recessions.

For asset allocators, it is especially helpful as we can now expect our bond portfolio to generate a return and help reduce portfolio volatility. *This allows us to take less risk with our equity allocation where most of the risk has historically been concentrated.*

Recession

Many people are speculating that we shall soon be entering into a recession. Certainly, the bond market feels that economic activity and inflation are likely to slow down over the next few years. This is reflected in the fact that the two-year treasury has a yield that is 0.70% higher than the 10-year[3]. This inverted-yield-curve is often associated with a recession six-to-twelve months later.

As an investor, we are more concerned with how a potential recession will impact the earnings of our companies. Will consumers change their purchasing behaviour as they adjust to high inflation and rising interest rates? If so, how will this affect earnings?

For many companies, a coming recession often results in lower margins as revenue begins to fall faster than their costs. To reduce costs, they often will start to lay employees off as it is the fastest way to control costs. We are already seeing this happen in the technology industry, which has been one of the worst performing sectors in 2022. As of last Friday, Factset[1] predicts that S&P 500 earnings will grow by about five percent in 2023, down from an expected 9.5% in June. We think earnings estimates could come down even further so, will likely cap the market growth in 2023

So far this year the market has been focused on inflation and interest rates and hasn't been that concerned with slowing earnings. We believe that in 2023 that will change, and the focus will be all on company earnings. It may already have started as we have seen a much larger market response to earning reports and forward guidance for Q3 earnings. According to Factset, companies that have reported positive or negative guidance have seen twice the move up or down versus the five-year average.

It may be that weakening earnings will cap the upside on the overall stock market, but if you are able to overweight the companies that are reasonably priced and grow in a recession, then you should be able to generate decent returns. Dividend yield over the next few years will also be important. We also feel that it is important to look past the potential recession and identify companies that will be able to enhance their market position during a recession and emerge stronger. Their price may be affected by market weakness but could recover quickly.

In the meantime, we like bonds as they respond well in a recession. We have begun to move out of cash and allocate to our bond managers.

Valuation Suddenly Matters Again (or Every Generation Must Learn Their Lesson)

The stock market is a cash flow discounting mechanism. The price of a stock represents the earnings of a company, the future growth of the earnings, discounted by the risk-free alternative investment. The ten-year treasury is often used as the discounting mechanism. When money is effectively free (or the risk-free alternative is negative net of inflation) then the value of that future income stream is almost infinite and you are pricing the stock based primarily on earnings growth.

During the COVID crisis, bond yields collapsed. Plus, we saw massive fiscal stimulus by governments, which resulted in incredible demand for goods. The rock bottom interest rates, the flood of free money, and strong consumer demand saw valuations for many companies increase rapidly. We also saw the rise of speculative fervor in things like Crypto, (the next great "disruptor"), meme stocks, EV car companies, online retailers, the list goes on. Many of these companies were just concepts with a great story but had little or no path to profitability. We also saw companies borrowing very cheap money to buy back shares which helps increase their earnings growth.

Along comes 2022, and we have seen a tremendous washout of many of these stocks and recently we are beginning to see bankruptcies and investors' capital being wiped out. Companies can't borrow money to buy back stock as the math doesn't work well anymore. This was a significant source of demand for stocks over the past few years.

The combination of declining fiscal stimulus, monetary tightening, and higher interest rates has forced investors to seriously consider how they allocate their capital as there is a real cost to deploying cash beyond the threat of losing money. Now, you forgo the yield as well. Equity valuations are fair, not cheap, and don't factor in the potential decline in earnings should a serious recession hit.

We welcome this rediscovered value discipline as it has been difficult for those of us that look to earnings growth at a reasonable price to watch worthless stocks rocket ahead. The recent decline has opened up many different opportunities for us to invest with better return potential and less risk.

Portfolio Construction and Process

As you know, our portfolio construction process starts with an asset allocation that is designed to meet your return needs, at a level of risk that is appropriate for you and your circumstances. This asset allocation will have the greatest impact on your long-term return and the risk of the portfolio. Asset allocation also provides a mechanism to rebalance the portfolio that counters our human emotions.

Once the asset allocation is done then we need to populate each asset class with investments that we feel offer the best risk-adjusted returns and provide another level of diversification.

Since September of 2020, we have made a significant change to our investment management process by moving Jennifer Qui from administration to a role that is responsible for portfolio rebalancing, trading, product and manager research, and overall integrity. We feel that this has added tremendous value to our clients over the past two years.

It is easy to feel like the process that you employ is adding value, it is another thing to actually have outside professionals take a hard, empirical look at it and pass judgement. Over the past three months, we have had two portfolio construction research groups drill into our portfolios to see if they are any weaknesses and if the investments, we have chosen to have added value.

We have excellent news! In both cases the portfolios we have constructed and the process we have employed has added significant value in both return and risk management. Most of that additional value has occurred in the last two years with the addition of Jennifer. Well done, Jenn!

The Gameplan Going Forward? Start with the Jab!

It has been a very difficult year with tremendous volatility in all asset classes, stocks, bonds, and currencies. We are now starting to see some of the failures (see crypto) that these tightening monetary cycles always reveal. To paraphrase Warren Buffet, “it is only when the tide goes out that you learn who has been swimming naked.” We expect to see more and more of these events, especially as the economy slows down.

In my last newsletter, I talked about our rope-a-dope strategy of absorbing the market blows until it gets too tired which will allow us to go on the offense. The next phase of the game plan is to start using a jab to measure the condition of your opponent. The jab to calculate distance and see how your opponent responds. It also is a necessary timing mechanism to set up future combinations.

With 2022 ranking as one of the worst years ever for the bond market, we feel that the bonds offer the best opportunity to deploy our jab. We are gradually moving cash to bonds with the expectation that the new year will bring a slowing economy and more volatility. Our bond managers can capitalize on these pricing dislocations with their ample liquidity. We will still use GIC’s to fill our liquidity needs for the next two years as short-term rates may continue to go up.

We will continue to do this for the remainder of 2022 and into early 2023. We may, for the first time, be overweight bonds for the next eight months as the potential recession begins to become more real, and company earnings start disappointing.

For Canadian stocks, we are really focussing on growing dividends. For those of you that are ok with energy stocks we are adding small positions of high yielding energy stocks.

Our global equity allocation will likely see more significant shifts out of large-cap tech and into industrials, health care, infrastructure, and companies with exposure to the economic transitions. (See the themes in my last newsletter). We are also looking for companies that trade a lower PE multiple to the market with some dividend or dividend growth.

Hopefully, by the middle of 2023 we will see the Federal Reserve begin to respond to a slower economy. This pivot will be necessary for equity valuations to sustainably

increase. At this point, we will start to transition into a more offensive posture with our jab setting us up to use more powerful punches.

Sincerely,

Lisa Applegath — Senior Wealth Advisor

Tom Trimble — Portfolio Manager

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[1]Factset, Earnings Insight, John Butters, VP Senior Earnings Analyst, November 18, 2022
[2]Bloomberg, November 8, 2022
[3]Reuters November 22, 2022