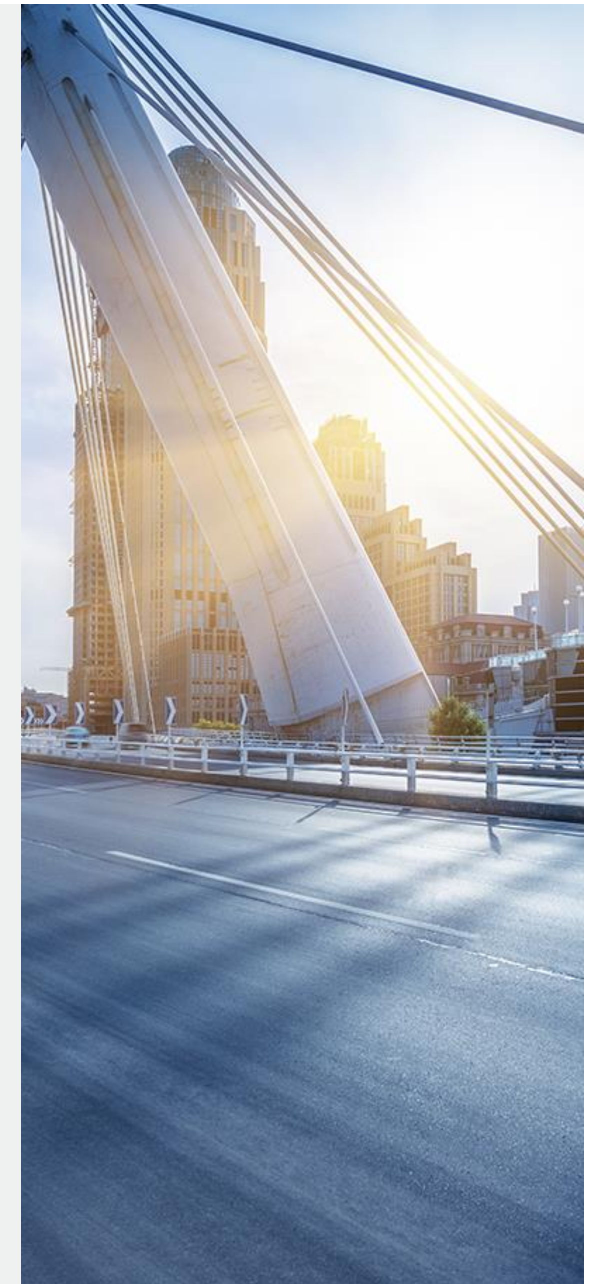
October 6, 2021

Investor Strategy

Challenges ahead

A collaboration between Richardson Wealth and Purpose Investments



Executive Summary

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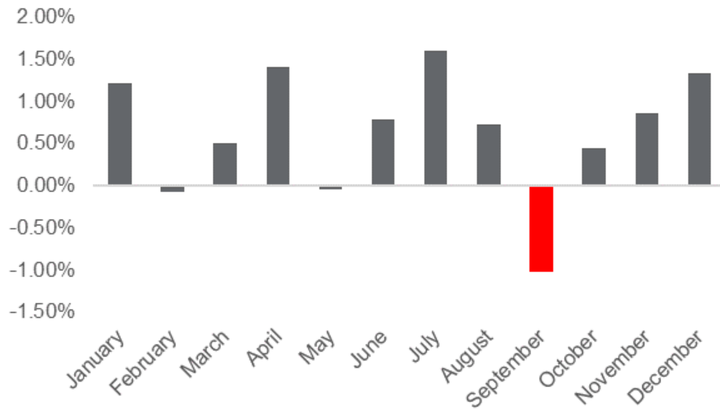
Market Recap – September's reputation

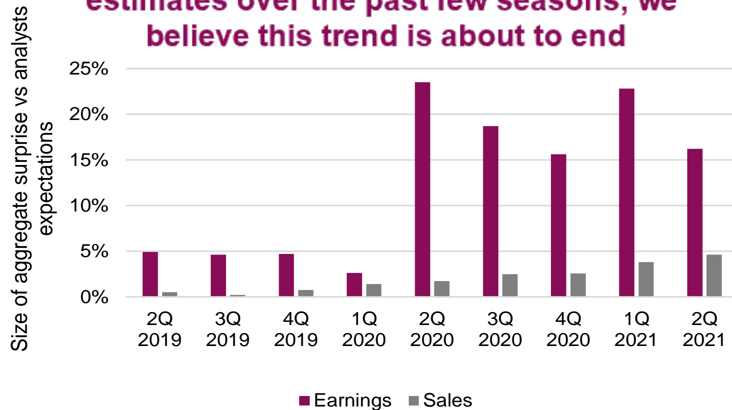
James Price, CFA

Chart 1: S&P 500 Historical Average Return (1928-2021)



Source: Bloomberg

Chart 2: Earnings & sales have crushed estimates over the past few seasons, we believe this trend is about to end



Source: Bloomberg

- As we noted in last month's Investor Strategy, September on average disappoints. September 2021 held true to the data and posted the worst monthly return for equities since March 2020, and we all know what happened that month. It was also the first losing month in the past eight, with only January being the other in the red. Chart 1 shows the average monthly returns distributions.
- Year-to-date returns are still great, although balanced portfolios hit some headwinds with the fixed income complex lagging under rising rates across the curve. With year-to-date total returns for the overall US Bond index about -1.8%, the sector is having what would be a pretty typical bear market. We still preach the benefits of diversification, but September was one of those months that make it look like a bad strategy.
- Energy was the bright spot, continuing its rise on the back of strong crude prices and localized natural gas shortages. This has led to value stocks in general outperforming, but not enough to be positive on the month. The question remains: will value ever make a lasting comeback after a decade of growth outperformance? Our eyes are on treasury yields to provide clues to that answer.
- Emerging markets had an equally tough go, but it was mostly China resuming the decline in equities that pushed the index lower. The collapsing Evergrande has piled onto other concerns that investors already had towards Chinese stocks, including the state internet crackdown and slowing economic fundamentals. This has pushed Chinese shares, as measured by the FXI ETF, down 16% so far this year. Interestingly, that ETF is still well below its 2007 highs, prior to which it had risen fourfold in two years.
- Earnings may hold the key to equity performance over the balance of the year (see chart 2). We believe that the QE-fueled earnings beats over the past year will come to an end. Firstly, subsidies are coming to an end, and new ones are struggling politically. Secondly, broken supply chains could make it difficult for companies to get parts and inventory, leading to sales slowdowns. The risk/reward scenario going forward looks less interesting for equity investors. The big question, which we will discuss later, is that of inflation and exactly how transitory we expect it to be.

Market Cycle & Positioning – good but less good than before

Craig Basinger, CFA

Chart 3: Market cycle indicators have dipped but remain very healthy

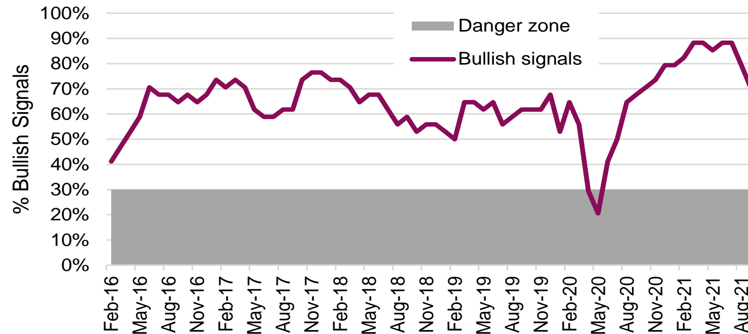


Chart 4: Market cycle indicators

Market cycle indicators

Grouping	Metric	Bull	Bear	Better/ Worse
Rates				
	Net Cuts		✓	
	Yield Curve	✓		+
	Yield Curve 3m	✓		+

Source: Bloomberg

- In any given month, there is a greater likelihood that markets will go higher and the economy will expand. And while there are periods of equity market weakness during economic expansions, these tend to be corrections or temporary pullbacks – often providing excellent buying opportunities to put money to work. However, if the economy is moving into a recession or one is approaching, then the pullback in the equity market is likely NOT a buying opportunity but a trap for investors buying the dip. There are three key ingredients to be a more successful investor: 1) during most periods, maintain your ideal allocation designed to have the highest probability of reaching your long-term goals. 2) during periods of market weakness that do NOT coincide with a recession, use these as buying opportunities. 3) reduce market exposure if the prospect of a recession is elevated.
- The difficult aspect is that a recession only becomes known months or even quarters after it has started – clearly way too late to provide any benefit to the investment or asset allocation process. The Market Cycle framework is a multi-factor, multi-discipline approach that attempts to answer the BIG question – is a recession on the horizon (see chart 3). The framework uses a basket of economic, fundamental and yield/credit indicators that have historically been good recession predictors. Complicating matters, every recession is different and as a result some indicators work in some cycles and others in different cycles. There is no one magic indicator. We believe that combining a diversified basket of indicators offers investors a non-emotional lens to gauge if recession risks are elevated or dormant. This also helps to guide asset allocation decisions in calm markets and during periods of market weakness.

Markets hit some volatility

- Equity markets have once again experienced some weakness during September, a seasonally volatile month. And while markets are down a bit, the standard question during any period of weakness is whether this is the start of something worse or a potential buying opportunity. Good timing for sharing our Market Cycle framework, whether you are already a follower, or new to this concept.
- We categorize our market cycle indicators into four broad categories, Rates, the U.S. Economy, the Global Economy and Fundamentals.
- Rates (chart 4) incorporate the activity of central banks around the world, whether tightening or loosening monetary policy. It also incorporates the slope of the yield curve and its changing shape. At the moment, some central banks have started to tighten (a negative), however the yield curve has steepened of late with the uptick in yields (a positive).

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Market Cycle and Positioning

Craig Basinger, CFA

Chart 5: Market cycle indicators

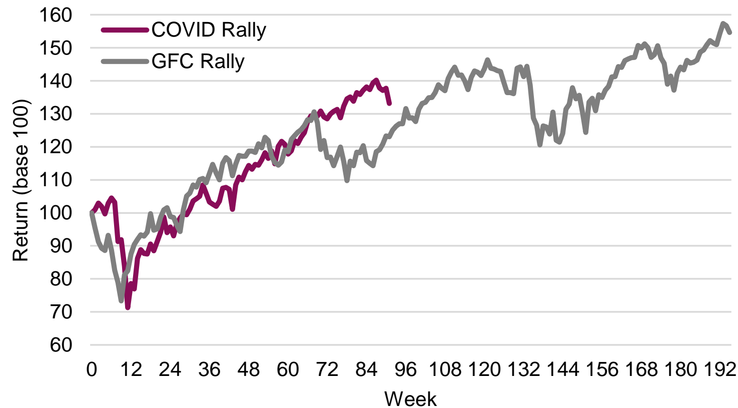
Grouping	Metric			Better/Worse
US Economy				
	Leading Ind (3m)	✓		-
	Leading Ind (6m)	✓		+
	Phili Fed Coincident	✓		+
	Credit (3m)	✓		-
	Recession Prob (NY Fed)	✓		-
	Recession Prob (Clev Fed)	✓		+
	Citi Eco Surprise		✓	+
	GPD Now (Atlanta Fed)	✓		-
	US Unemployment	✓		+
	Consumer Sentiment (3m)		✓	-
	PMI	✓		+
	PMI New Orders	✓		+
	Chemical Activity (3m)		✓	-
	Energy Demand (YoY)	✓		-
	Truck Demand (YoY)	✓		-
	Rail (YoY)		✓	-
	Starts (6m)	✓		+
	Months Supply (6m)	✓		
	Home Sales		✓	+
	New Home Sales		✓	+
	NAHB Mkt Activity		✓	+
Global Economy				
	Global PMI	✓		-
	Copper (6m)	✓		-
	DRAM (3m)		✓	-
	Oil (3m)		✓	-
	Commodities (3m)	✓		+
	Baltic Freight (3m)	✓		-
	Kospi (3m)		✓	-
	EM (3m)		✓	-
Fundamentals				
	US: PE		✓	+
	US: EPS Growth	✓		+
	US: EPS 2FY v 1FY	✓		+
	US: 3m EPS Revision	✓		-
	Canada: PE	✓		+
	Canada: EPS Growth	✓		+
	Canada: EPS 2FY v 1FY		✓	+
	Canada: 3m EPS Revision	✓		-
	International: PE	✓		+
	Int: EPS Growth	✓		+
	Int: EPS 2FY v 1FY	✓		+
	Int: 3m EPS Revision	✓		-

- The U.S. economy has the most signals which are further broken down into broader economic signals, manufacturing and housing. Just about every recession in the U.S. can be traced back to weakness in either housing or manufacturing, given the size of the industries and their cyclicality. Broadly speaking, the U.S. economy remains in good shape (many more bullish signals than bearish). However, signals were stronger a few months back as some weakness has surfaced, mainly in housing.
- The global economy has seen more deterioration of late and is now evenly split with four bullish vs four bearish signals. Further evidence is in the trend from last month which saw six deteriorate versus only two improving. A slowdown in China is having a broader impact on the global economy, as is the recent delta variant wave.
- Finishing on a positive note, fundamentals remain encouraging. All signals are bullish except valuations in the U.S. and slowing earnings growth. International shows the best with all bullish signals and the majority of improvements over last month.
- We have shared all the indicators, their current positioning and whether they improved or deteriorated over the past month. While each signal is not equal, for simplicity and to garner some insights into the trend, we track the percentage bullish versus bearish over time.
- The good news is that while the percentage bullish signals have dipped from very elevated levels, they remain well above what we call the danger zone. Historically, when bullish signals have dropped down below about 30%, there is often a recession that has started or is on the horizon. As a result, if this period of market continues and the bullish signals remain healthy, this could be a buying opportunity.
- If a buying opportunity arises, the next question is how far will markets pull back. For that we turn to shorter-term sentiment and technical insights.

Stresses building

Derek Benedet, CMT

Chart 6: S&P 500 Covid rally outpacing recovery following the financial recovery



Source: Bloomberg

- There has been a not-so-subtle shift in market sentiment the past month. Gone is the perpetual enthusiasm surrounding reopening and the other side of this pandemic. Instead, hawkish bankers are making headlines and other exogenous market issues are creeping into the narrative including supply chain woes, inflation and of course the Chinese property market.
- The upward trend since March 2020 is showing signs of stress. Momentum indicators have deteriorated, as has trend strength. Over the past eighteen months there have been no technical corrections, defined as a 10% decline from previous highs. Few years pass without this claim to fame. The streak of 462 days without being in correction territory should alone cause investors to prepare for potential market volatility. Then again, how many times have you heard over the past year 'the market is due for a correction?' We don't think this is a case of the boy who cried wolf, as a number of market internal indicators have been eroding, increasing the risk of a correction or longer risk-off period for the markets.
- The Covid-19 crisis rally has so far eclipsed the rally following the Great Financial Crisis. Chart 6 plots the three months prior to the eventual bottom and the resulting rally. Thus far it's been a smooth ride that has lasted longer and risen more quickly than back in 2009/10. The Covid rally has yet to face a meaningful slowdown or even what we would characterize as normal market behaviour. The transition to the mid-cycle of a bull market historically means choppier markets. Add on the looming taper, and you have the type of state that breeds investor uneasiness. Although September has not resulted in any sustained violent sell-off, it has produced some of the worst trading days in months and a slew of technical warnings signs.

Sentiment

- Market cycles drive asset prices to extremes in both directions. The psychology of all investors can move quickly from extreme pessimism and fear to hope, overconfidence and greed. Though there is no precise way to measure an investor's state of mind, one of the most widely followed, and with the longest history, is the weekly survey from the American Association of Independent Investors. The survey's bullish bias has slowly been declining for months and the spread between the bulls and the bears has declined to its lowest level since last fall. Though sentiment has fallen steeply recently, it's yet to flash what we would characterize as a contrarian buying signal. Typically, we like the difference between bulls and bears to fall to a level greater than -20. It can be noisy week to week, which is why it is good to add a moving average to reduce the noise. Historically, when the net difference is negative, it's a positive sign for future returns. This is just one piece of the sentiment picture, but one that we like to keep an eye on. Weak sentiment does not mean we can avoid a drawdown event. A full sentiment unwind would take time to play out and won't happen in just a couple of weeks.

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Stresses building

Derek Benedet, CMT

Chart 7: Advance/decline line has been trending lower since earlier this year

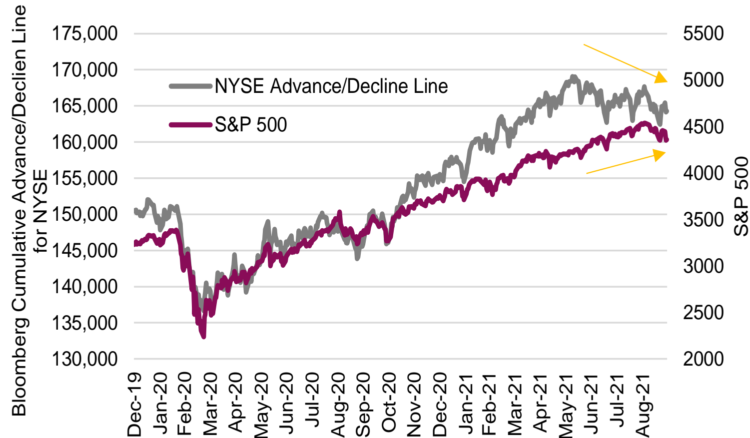
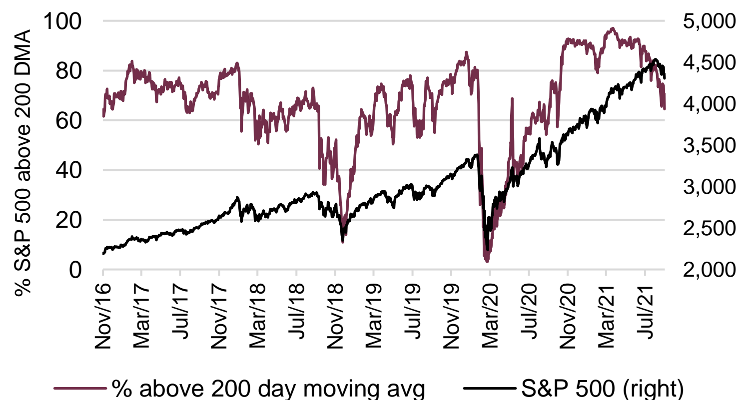


Chart 8: Market breadth is not encouraging



Source: Bloomberg

Breadth

- Trends of investor confidence are responsible for price movements. A market's breadth, or internal strength measures the extent of the current emotional state on the markets. Much can be hidden behind an index level; it's best if stocks are advancing on a broad front. Enthusiasm is no longer as dispersed as it was earlier this year. Given current breadth readings, it's hard to say that the widely favourable view on stocks is pervasive. The fewer the number of stocks moving in the direction of the major averages, the greater the probability of an imminent reversal in trend. These divergences can run for a prolonged period, but they always end at some point.
- It's a narrowly advancing stock market, compared to earlier this year. The NYSE advance/decline line has yet to catch up to its peak in early June. Similarly, the percentage of stocks trading above their 200-day moving average has fallen steadily over the past four months to a current reading of just over 50%. (Chart 7) Approximately 52% of members of the S&P 500 are trading 20% below their highs. Hardly the type of broad-based support to propel markets meaningfully higher into the end of the year.
- At its core, the market is a mean-correcting mechanism; it doesn't continually rise in a straight direction. Since the March 2020 COVID low, the S&P 500 has rallied from 2,200 to 4,500 with only a few periods of pause. Even a moderate correction at this point would bring it back to 4000, well within the confines of a continued bull market without a major technical breach. With pre-Covid highs now 25% below current levels, it is perfectly normal to feel a sense of uneasiness with this air-pocket as support. There are many villains that could be a trigger for a correction, ranging from yields, Fed tapering, inflation, economic data, a tough earnings season or it just may be time. Regardless of the reason, the current conditions surrounding trend strength, sentiment and breadth continue to point to a heighted risk of a correction.

Inflation Concerns and Fixed Income

James Price, CFA

Chart 9: CRB Commodities Index no concerns

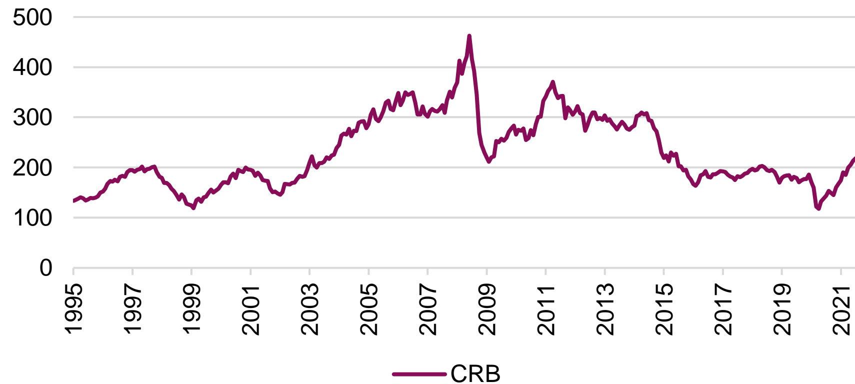
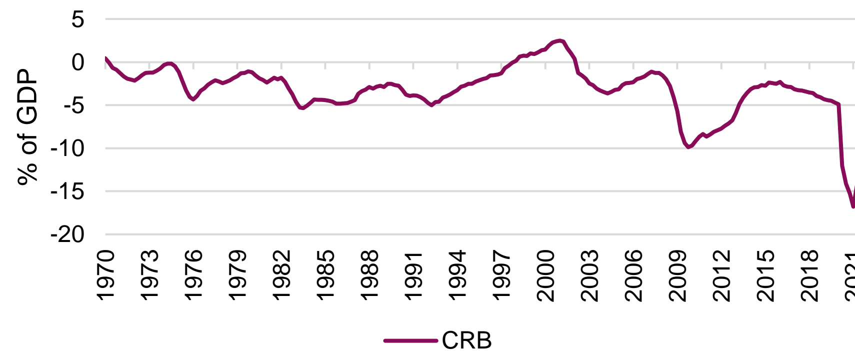


Chart 10: US Budget Deficit



Source: Bloomberg

- It is no surprise that inflation is up. The starting point of a year-on-year series immediately following the great global shutdown would virtually ensure it. The media is spilling lots of pixels over it as well, and we do not want to simply add to that noise. However, we do believe that we have started into a new inflationary regime.
- To be clear, we are not worried about commodity inflation. Just like lumber, commodity prices that have risen (the latest being aluminum and natural gas) will be met with investment and substitution or delay, and they will come back down. To a lesser extent, asset inflation is a similar beast, although housing could be subject to its own investor strategy. No, we are watching labour cost inflation, fiscal pressures and supply chains.
- **Labour Cost:** The Reagan-Thatcher era ushered in a period of political favour to capital over labour, and we feel that coin is flipping. Minimum wages are increasing either due to legislation, public pressure or by necessity. Labour prices are *very* sticky to the downside, and we are seeing jurisdictions all over America raise prices. Once $15 or $18/hr is the baseline, it is very hard to go back. General sentiment around labour in media is leaning this way too – anecdotes about restaurants, for example, that "just need to pay more" to get staffed. Never a mention of restaurants' notoriously thin margins. Never a mention of that restaurant's owners, capital providers, or menu prices.
- Perhaps this is an over-correction to the Trump era, where massive cuts to corporate and high-earner tax rates are being normalized, but that could also have been the last gasp in favour of the capital-labour ratio.
- **Fiscal:** We will be brief here: Political spending is higher than ever. Budget deficits are at their maxes, politicians are talking about UBI (Universal Basic Income) and MMT (Modern Monetary Theory). We will ask you this: When was the last time you heard a political campaign based on reducing the deficit, let alone the debt loads?
- **Supply chains:** Whether it's drug manufacturing, PPE (masks in particular) or port operating logistics, the pandemic revealed that building our supply chains for maximum efficiency and minimum excess capacity was a dangerous game. If we choose to have excess capacity either by mandate or by risk-decision, and build closer-to-market manufacturing, we will be accepting that the "specialization" trade-off of global trade isn't worth it … and prices will go higher. A new computer chip manufactured in Massachusetts will cost more than expanding capacity in Taiwan.
- The big question is not whether used-car prices will normalize. They will. The question is whether we will be in a new regime of 2.5%-3.5% inflation, instead of the 1% to 2.5% we have seen for the past 20 years.

Fixed Income: Challenging road ahead

Joey Mack, CFA

Chart 11: Nominal - Real US Yields

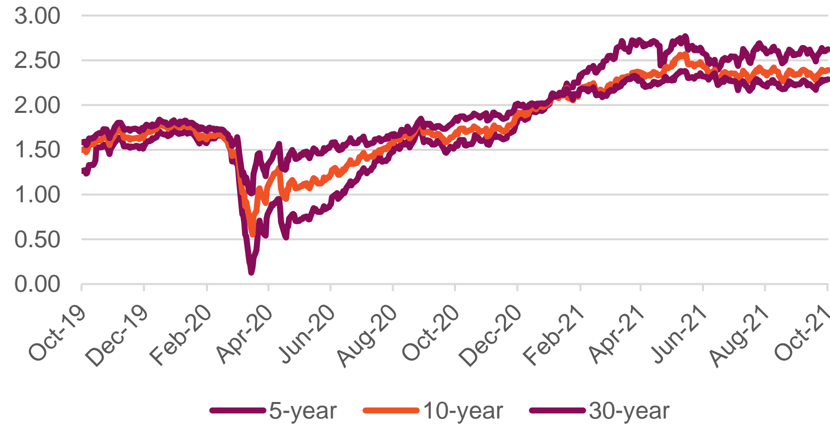


Chart 12: 5-year TIPS Yield

- Inflation will have big implications on asset allocation – namely those that favour short duration (a dollar today) over long (a dollar in the future). This includes value stocks as opposed to growth stocks, as well as short bonds versus longer bonds (discussed below).

Fixed Income

- Yields rose last month, led by the belly of the curve. The key driver was comments from the U.S. Federal Reserve that a reduction of monthly bond purchase will likely begin in Q4, with rate hikes likely to follow, earlier than markets had been expecting. This is in response to still-solid growth data, and as inflation continues to run well above long-term targets.
- However, what has been notable is that, even with above-trend inflation for the past few months, and higher energy prices over the past several weeks, the bond market still is not fearing the inflation we discussed. U.S. inflation expectations as measured by the difference between nominal Treasury yields and Treasury Inflation Protected Securities (TIPS) have held within a fairly narrow range above 2.0%.
- The market has of course priced in higher inflation expectations since global money supply has increased so much via outright bond purchases and higher levels of inflation have been targeted by central banks.
- For governments, this has meant the added benefit of introducing a significant buyer of bonds in order to fund expanding budget deficits, pandemic-related and otherwise. These massive purchases have led to central banks being the largest holder and most significant trader in domestic bond markets.
- We are not yet at the juncture in most countries that Japan is facing, where central bank holdings are so significant that market volumes are muted and there is very little price action or outside buying interest. Yet central policy towards bond purchases and their holdings is going to be the key driver of rates for the near-term.
- The Bank of Canada had already begun to taper its bond holdings, and the U.S., England and Europe are all expected to follow. This lack of buying alone should put upwards pressure on rates.
- The move will likely be driven by real rates rising – meaning that Canada Real Return Bonds and U.S. TIPS will suffer as much if not more than nominal bonds.
- Credit spreads will provide some cushion for now, but in a typical cycle credit spreads do begin to widen as well, once rate hikes are underway.
- This all reinforces our view that returns from fixed income as an asset class will be challenging for the next 12-18 months, and so we continue to recommend an underweight position.

Portfolio Construction: Tactically Defensive

An Nguyen, CFA

Chart 13: Asset Allocation and Current Tilts

Asset Allocation (Balanced)	8/31/2021	9/30/2021	Baseline	-				+
Equities	62.8%	56.1%	60.0%		■			
Fixed Income	27.2%	31.9%	38.0%		■			
Cash [1]	4.9%	6.6%	2.0%				■	
Other [2]	5.1%	5.4%						
Equities	**8/31/2021**	**9/30/2021**	**Baseline**	**-**				**+**
Canada	27.7%	24.1%	30.0%		■			
U.S.	16.4%	13.7%	15.0%		■			
International	18.7%	18.3%	15.0%				■	
Style: Value to Growth					■			
Market cap: Small to Large					■			
Fixed Income				**-**				**+**
Duration					■			
Credit							■	
Alternatives				**-**				**+**
Allocation							■	
Growth					■			
Volatility Management							■	
Alternative credit							■	
Real Assets							■	

Source: Bloomberg

- **Asset allocation:** We moved from an overweight in equities at the end of August to an underweight by the end of September. This was driven by our holding in the Tactical Asset Allocation strategy, a risk-reduction strategy that can oscillate between 100% equity and 100% fixed income. The strategy uses a rules-based approach to allocate to bonds and equity by analyzing a number of economic and market indicators. This systematic methodology ultimately serves to remove investor emotion from the trades. In down markets, the tactical strategy will be defensively tilted to bonds, while in up markets, it will participate, but not to the same degree as an all-equity portfolio.
- **Equities:** Within Canada, we have a healthy allocation to Canadian equity, however remain underweight. Canada has more exposure to cyclically sensitive sectors and should benefit from higher demand in commodities and a higher interest rate environment due to our market's significant exposure to the financials sector. Within U.S. equities, we moved from a slight overweight to a slight underweight position. This was again driven by our holding in the tactical asset allocation fund which reduced its exposure to U.S. equities. For our U.S. exposure, we continue to favour holding an equal-weighted index over market-cap weighted index; the market-cap weighted index has become increasingly top heavy with the top five companies (Apple, Microsoft, Amazon, Facebook, Alphabet) representing over 20% of the index. Moreover, the significant outperformance of these top five names and concentration in the technology sector in the market-cap weighted index warranted a prudent approach that led us to trim the portfolio's exposure in favour of the equal-weighted index after an extended period of very strong performance. Within international equity, we remain overweight. With more exposure to economically sensitive sectors such as industrials, materials, and financials, international equities should benefit. From a valuation perspective, international equities have also underperformed U.S. equities on a three-year rolling basis over the last decade. This underperformance is longer than the historical average. Despite the relative underperformance, we believe compelling valuations and strong global growth should benefit these more cyclically oriented markets over the longer term.
- **Style:** Our core Canadian equity holding is an income-focused strategy that has a cyclical/value tilt. Our U.S. equity holding in the equal-weighted ETF also has a value bias due to its rebalancing methodology (buy low, sell high). We believe value stocks, amidst an environment of higher growth and inflation expectations and subsequently higher yields, will support a continued rotation of growth into value (which we saw glimpses of over the last year).

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Disclaimer

Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.

Authors:

Purpose Investments: Craig Basinger, Chief Investment Strategist; Derek Benedet, Portfolio Manager; Greg Taylor, Chief Investment Officer

Richardson Wealth: An Nguyen, VP Investment Services; James Price, SVP Capital Markets and Investor Strategy, Joey Mack, Director Fixed Income

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