RICHARDSON Wealth | CONNECTED WEALTH

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Investor Strategy

Normalizing

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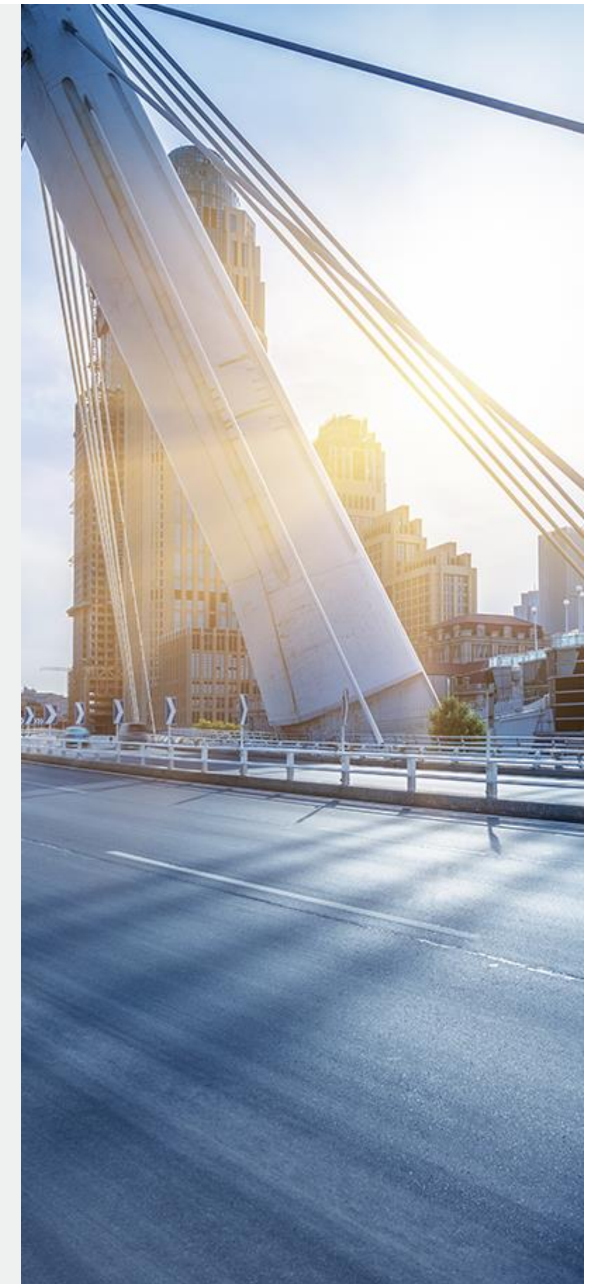

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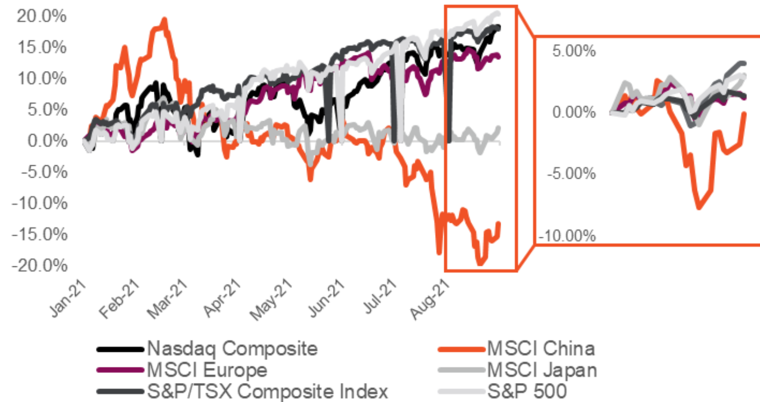
Market Recap – What are these 'Summer Doldrums' you speak of?

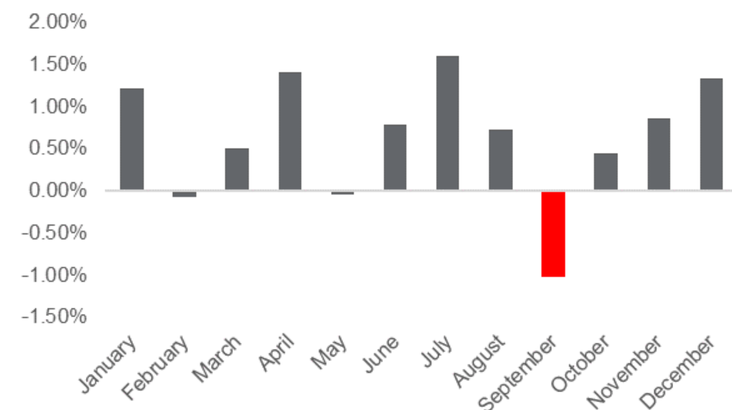
Brett Gustafson

Chart 1: World Equity Indices
(YTD & MTD)



Source: Bloomberg

Chart 2: S&P 500 Historical Average Return
(1928-2021)



Source: Bloomberg

- The equity markets did not disappoint as the summer months have now come and gone. Historically, a term that is used frequently throughout the season is 'Summer Doldrums'. Safe to say the doldrums were nowhere to be found in the year 2021. Particularly in the U.S., markets continued their outperformance on the backs of dovish Fed policy. The S&P 500 climbed +2.9% in CAD terms during the month of August, while the Nasdaq jumped a whopping +4.0% (CAD) in the final month of summer. Investors must be getting more intelligent, as every time there is a dip down to prices seen one or two months ago, the market comes roaring back. Say it with me, "BUY THE DIP!". There, now we can all call ourselves members of the self-proclaimed 'Reddit Army'.
- Turning our eyes north of the border, Canada displayed an excellent month for equities. Posting a return of +1.5% might not seem like a lot when compared to our comrades in the U.S., however this figure feels like more of a normal monthly return number. We have all been victims of recency bias lately, conditioned to expect large monthly performance numbers. Keep in mind, the S&P/TSX is up +18.0% this year and looking back all the way to 2010, that number would be good enough for second place on an annual basis only to 2019 which was +19.1%. Enjoy it while it lasts.
- China continued their struggles amidst a challenging year. The tech crackdown and increased regulations pushed the MSCI China index lower by -0.1% this month, while Japan remains relatively flat on the year after a +3.0% return in the month of August.
- Canadian GDP data was released last week, which saw our economy unexpectedly decline by -1.1% in Q2 on an annual basis. That number is particularly shocking as Statistics Canada analysts had placed their bets on Canada expanding by +2.5%. Looking under the hood, two big standouts came from exports falling by -15% and residential investment shrinking by -12.4%, both annualized. You can be sure the Bank of Canada will be discussing this at their meeting this week as they deliberate the ongoing taper strategy.
- Energy markets endured an extremely volatile month throughout August. Starting the summer month out around $71/bbl, prices corrected down to a low point of $62/bbl amidst rising concerns surrounding the Delta variant. The price for a barrel of oil currently sits at $68.50/bbl. A posted decline of -7.4% for the month is the biggest loss for the commodity this year. Demand recovery has been threatened as economic data has started to roll over, setting the stage for a challenging end to 2021 for oil.
- The Jackson Hole symposium took place in August as investors paid close attention to every word from Fed chair Jerome Powell. CPI remains elevated in the U.S. at 5.4% and talks of tapering were at the top of the agenda. While it was confirmed that tapering is to be expected later this year, he did say there is no reason to rush tightening monetary policy in response to elevated inflation. The speech did not get much reaction from yields as they remain between 1.2% and 1.35%, ending August at 1.30%.
- Looking ahead, September has historically been the worst month for the S&P 500 (Chart 2), but market strength shown this year makes us hopeful stocks can buck the trend. But then again, do the markets really care about our hopes?

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Market Cycle & Positioning – Healthy with some normalizing

Craig Basinger, CFA

Chart 3: Market Cycle losing a bit of mojo

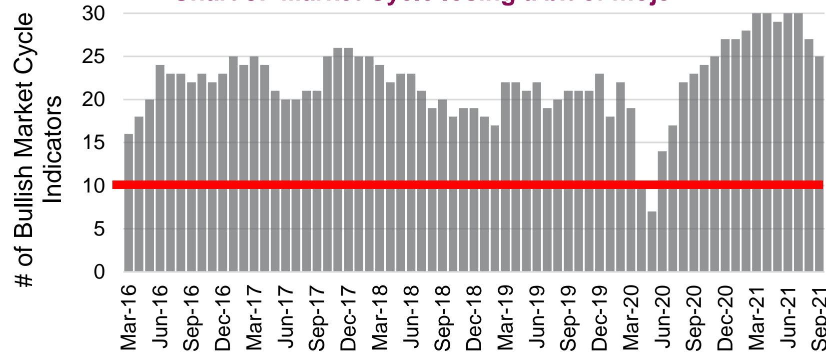


Chart 4: Current Positioning

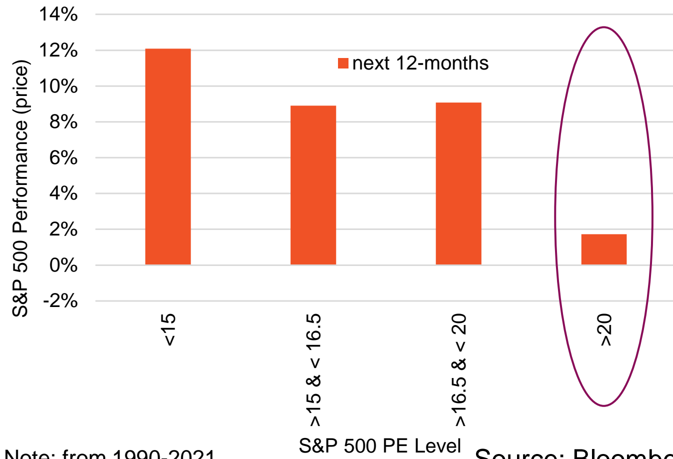
Overall Asset Allocation	Balanced	Baseline	-				+
Equities	64.1%	60.0%				■	
Fixed Income	31.1%	38.0%		■			
Cash	4.8%	2.0%				■	
Global Equities			-				+
Canada	29.6%	30.0%			■		
U.S.	13.8%	15.0%			■		
International	18.5%	15.0%				■	
Value to Growth Tilt				■			
Small to Large Tilt				■			
Fixed Income			-				+
Overall	31.1%	38.0%		■			
Duration				■			
Credit					■		
Currencies			-				+
CAD Short Term (3m)				▨	■		
CAD Longer Term (1yr)						■	
Alternatives			-				+
Overall Allocation						■	
Growth				■			
Volatility Management						■	
Alternative Credit						■	
Real Assets						■	

Source: Bloomberg

- The economic data is certainly starting to normalize, which was largely expected and will continue. From an economic perspective the last 24 months have seen many unprecedented impacts, initially largely negative and more recently largely positive. And while the economy is dynamic and adjusts, reverberations will continue for years given the size of these shocks. The good news is that we are currently in the sweet spot. Aggregate demand has been rising for the past year as economies re-open. Also contributing has been changing consumption behaviors, more housing demand, durable goods, technology and fewer services. The former has a more dramatic impact on economic data and equity markets. Mr. Economy would prefer you buy a laptop instead of spending money enjoying a few pints on a patio.
- The changes in consumption and quick resumption of demand has put a lot of strain on the supply chains while lingering impacts of the pandemic had already slowed capacity responses. These factors are largely driving the inflationary impulse we are currently experiencing.
- But investing is more about what happens next. The supply/demand imbalances are already starting to resolve. Behavioral consumption patterns are starting to gradually get back to normal. The bond and commodity markets have priced in this normalization, though perhaps not as much in the equity markets.
- This slowing may trigger the long-awaited period of market weakness. The good news is even if this transpires in the coming months, the market cycle remains very healthy. While we have seen some normalizing in our bullish signals, the framework continues to favour risk assets.
- This would have us more overweight equities were it not for valuations and such a high degree of optimism priced into the market. As a result, we are slightly overweight, with a greater focus on international markets. Within equities we continue to favour more of a value tilt and less exposure to the megacaps.
- The biggest change from last month is in our currency view. While we have a positive view on the Canadian dollar relative to the U.S. dollar longer term, we are now neutral shorter term. Essentially, 78-82 cents is our rough fair value that makes us indifferent towards hedging or changing currency exposures. Outside this range, our view likely changes.
- We continue to favour a higher cash balance allowing us to be opportunistic when the next period of market weakness materializes.

Tempered Return Expectations

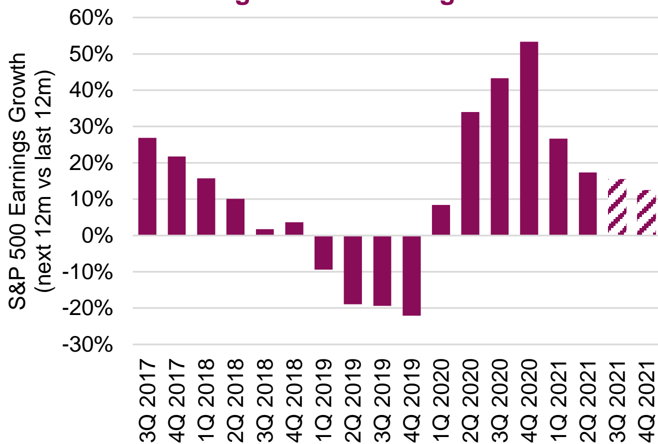
Chart 5: with a PE over 20x, average S&P 500 returns are rather muted



Note: from 1990-2021

Source: Bloomberg

Chart 6: S&P 500 earnings growth, still good but slowing



Source: Bloomberg

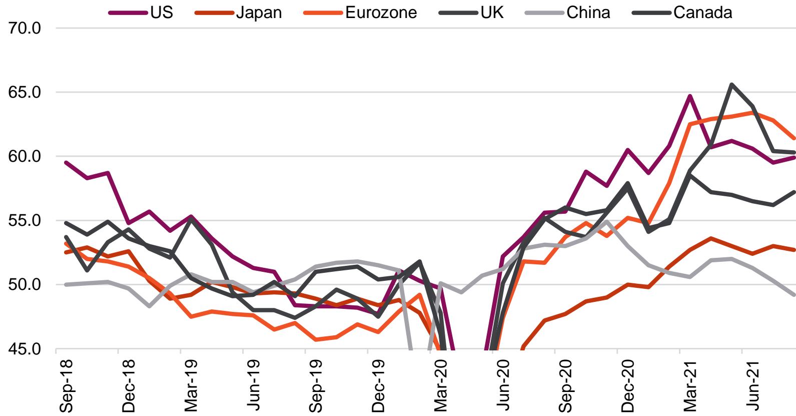
Craig Basinger, CFA

- When it comes to return assumptions for equities, very often numbers such as 8% are thrown around or used in long-term assumptions. Which is fair, as over many of the longest histories available, high single-digit returns for equities has been the norm. And given nobody knows the future, relying on a very long-term history is certainly appropriate.
- However, there are times when near-term return assumptions should be a bit tempered. This could very well be one of those times. Returns have been well above the historical norm over the past year as the S&P 500 is up 28%, TSX up 28% and the euro Stoxx 50 up 21% in local currency terms ,including dividends. But it is not as simple as implying high returns are followed by more muted returns. Here are several factors that will likely prove to be a headwind on near-term market performance.
- 1) Valuations – The U.S. equity market, measured by the popular S&P 500, is trading over 21x forward earnings. That is high on a historical basis, and yet it was even high a year ago when the index went on a strong double-digit advance. The megacap names, mainly technology, are partly the cause of these higher valuations, and are skewing the valuation multiple higher given their weight in the index and relative high valuation. Yet the equal weighted S&P 500 is also historically pricey at 19x. All things being equal, these valuations imply a muted forward return expectation. Over the past 30 years, when the S&P 500 was trading over 20x, the subsequent one-year price return has been pretty much flat, on average. Canada is a bit more constructive, with the TSX Composite currently valued at 16x forward earnings. Similarly, Europe's Stoxx 50 Index is 16.8x. This provides further supporting evidence that investors may find this a good time to look to Canada or overseas markets at the expense of their U.S. equity allocation. But it's not just valuations.
- 2) Earnings – The Q2 earning season, the lifeblood of companies and markets, just finished and was stellar. Revenue growth was strong, helping alleviate any pressure from rising costs to maintain historically elevated margins. But that was peak growth. Earnings are expected to continued expanding, with a slowing pace. A year ago, before the S&P 500 was about to go on its 30% advance, earnings were poised to grow by 34%. Fast forward to today and forecasted consensus earnings growth is now half that at 17%. This is still a good news story, albeit less so than in quarters past.
- 3) Optimism – Have you heard the phrase, 'the market climbs a wall of worry'? This saying is based on the history that many market advances occur as the uncertainty surrounding a dire event begins to fade. The dire event doesn't need to fade, just the uncertainty of the path forward. During the past year the pandemic has not ended, but the path through has become clearer. Monetary and fiscal stimulus became clearer and more certain, as did the economic recovery, all helping the market advance. But today, the wall has largely been climbed. Fear has dissipated as measurements such as credit spreads, the VIX sit at or near historical lows.
- The market may continue to climb but it will be harder to find levers to pull or net new reasons for optimism. In that environment, investors may want to reduce their near-term expectations, or even lean a bit more to defense, lower valuations, quality strategies.

Slowing but still growing

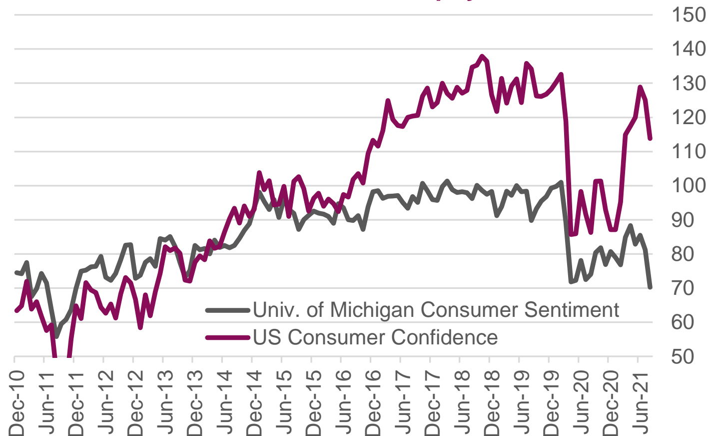
Derek Benedet, CMT

Chart 7: Global PMIs: Messy chart, but you can see a trend



Source: Bloomberg

Chart 8: U.S. Consumer Confidence slips while sentiment falls abruptly



Source: Bloomberg

- Unlike climbing a mountain, a peak in financial markets only exists in the rearview mirror. It's impossible to discern in real-time when you're facing one. As we approach the end of the third quarter, it's obvious that peak growth, in terms of rate of change is behind us. Economic data has lost a lot of momentum led by manufacturing metrics, as well as others including home starts, auto sales, rail traffic etc. Though messy, **Chart 7** show that PMIs from around the world are all coming back down. although they remain well above 50.
- One of the most worrisome aspects of the recent turn in data is the shift in consumer sentiment. The University of Michigan Consumer sentiment index saw its biggest drop in 10 years, even lower than it was at the beginning of the pandemic. **(Chart 8)** For all the worry about the pace of QE and federal spending, the magic formula for economic growth includes a robust consumer. Household finances in aggregate are incredibly strong, yet the recent dip in confidence is a concern. So far, it's just one data point so it could be an aberration, but confidence is key for continued spending.
- The slowdown in growth really shouldn't be a surprise, as the YoY base effect fades. The surge in Q2 growth is as much of a function of the contraction in Q2 2020. Given how terrible the data was last year, lapping that data in the spring was bound to inflate certain datapoints. In financial markets, it's the rate of change that is all important and a slowdown can catch investors off guard, even when growth rates are still positive.
- Commodity and bond markets anticipated what we now see in the data back in the spring. While peak growth is likely behind us, we want to emphasize that commodities are driven by demand levels, not rates, and once we pass through this delta variant, we would expect demand levels to pick up into year end. The bond market remains skittish, though yields have been steadily rising since bottoming in early August.
- So what is next? Delta is a concern, but it's no longer a surprise and we would expect investors are slowly beginning to look past the fourth wave even before it peaks. We will not be basing any allocation changes on the degree of a fourth wave. The markets have cared little about Covid-19's spread for nearly a year and a half, and we don't expect it to abruptly care now. The question is whether the slowdown is manageable, and if it will get worse in 2022. We expect economic growth rates to normalize at a higher level compared to the trend of the past decade as there is still tremendous stimulus in the financial system, as well as elevated savings and potential for infrastructure spending.
- The Russell 2000 is often seen as a risk-on indicator, and it has not moved much the last six months. Relative to the S&P 500, it has trailed by 10% since the end of March. Over the past year, it is up 50% compared to 33% for the S&P 500. Perhaps the pro-cyclical trade had gotten ahead of itself, and while we do not expect the pro-cyclical shift to be as dramatic as last fall, we continue to like cyclical exposure.

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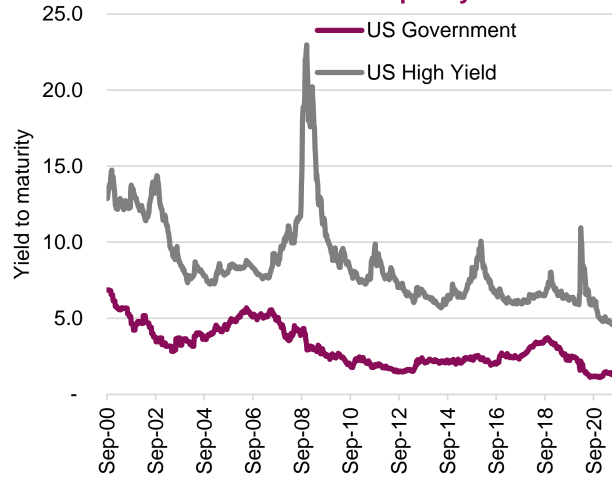
Portfolio Liquidity

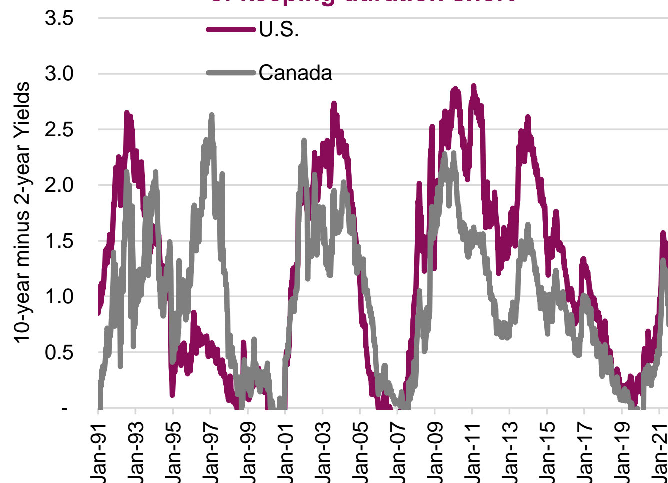
James Price, CFA

Chart 9: Falling yields keep pushing investors down the illiquidity slide



Source: Bloomberg

Chart 10: Term Premium is low, lowering cost of keeping duration short



Source: Bloomberg

- With almost 18 months of gains in risk markets since the COVID-induced equity selloff, it is easy to forget some portfolio construction fundamentals, just as it was in early 2020 prior to that selloff.
- Given investors' propensity to seek more returns, especially following the unbelievable trailing returns of equity indexes, many lose sight of one of the core pieces of portfolio balancing: We own different asset classes so that we can rebalance from one to the other when there are opportune times to do so.
- This brings us to a trend that is particularly prevalent in the fixed-income world, but one that also exists in equity investing: deteriorating one's portfolio liquidity. Most often this is done by giving up government bonds for corporates, corporates for high yield, high yield for leveraged loans, and leveraged loans for private credit. Generally, this action increases the returns profile, but we will use this as an opportunity to remind everyone that correlation with the rest of the portfolio increases, and liquidity declines quickly to zero.
- This ultimately prevents us from those important rebalancing opportunities that long-term investors should look forward to when certain asset classes show weakness.
- While we are firm believers in purposely giving up liquidity to take advantage of the premium that can be earned, we must remain aware of what impact that will have, and stop trying to justify it as a replacement for lower-yielding assets that bring those liquid, and low-or-negative correlation aspects to a portfolio. Like insurance, you won't feel you need them until part of the house is on fire. Also like insurance, it's useless to buy after the incident.
- The most common mistake we see is going to 'fixed-income-like' products such as private credit and structured notes while carving them out of the fixed-income portion of a balanced portfolio. Another is reading the headline and not the fine print about the liquidity characteristics of an investment (i.e. "redemptions provided monthly", but with the managers' ability to limit or eliminate them).
- Instead, try creating a whole allocation. For example, 60/40 becomes 50/30/20, with a good understanding that the "20" must stand on its own in stressful times.
- Lastly, given a low yield complex, being overweight cash at this point of the cycle gives up little yield compared to longer duration bonds or corporates. Despite the returns drag that cash creates, the insurance it buys is relatively greater than at other times.

Fixed Income – Rising yields should lead you to higher cash allocations

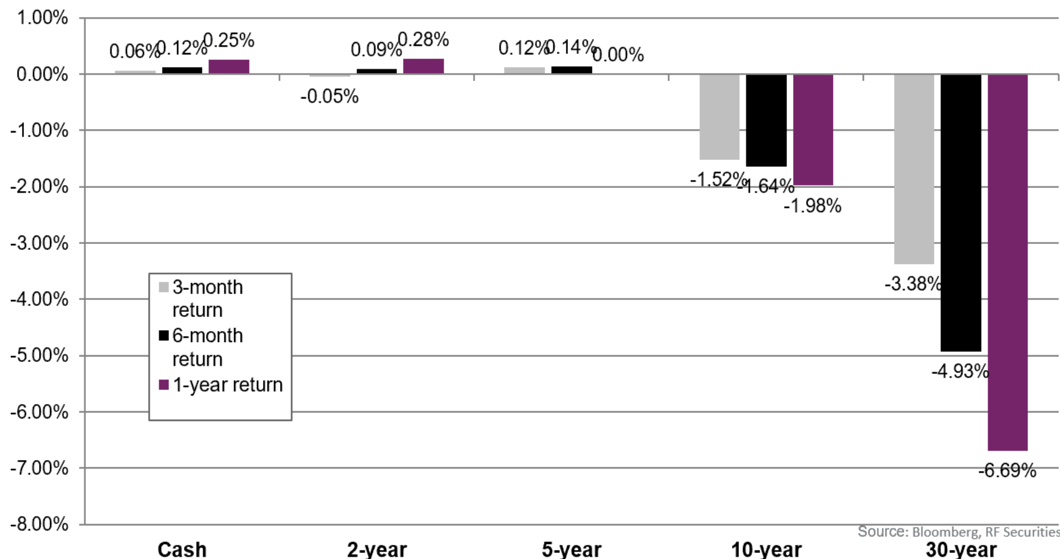
Joey Mack, CFA

Chart 11: Canadian Yield Curve - Changes and Consensus Forecasts

	Last Week	This Week	Change	3-month Forecast	6-month Forecast	12-month Forecast
Overnight	0.25%	0.25%	0.00%	0.25%	0.25%	0.40%
2-year	0.44%	0.40%	-0.05%	0.54%	0.65%	0.88%
5-year	0.83%	0.79%	-0.04%	0.90%	1.01%	1.23%
10-year	1.20%	1.17%	-0.03%	1.51%	1.62%	1.80%
30-year	1.75%	1.73%	-0.02%	1.91%	2.01%	2.15%

Source: Bloomberg, RF Securities Clearing

Chart 12: Consensus Forecast Returns



- Recent comments from European and US officials have hinted at the eventual reduction of stimulus provided in special programs initiated in response to the pandemic.
- The Bank of Canada has already begun to reduce the pace of its outright bond purchases, and is expected to further reduce that pace in the months ahead.
- The eventual end to outright bond purchases will likely be followed by interest rate hikes from the low levels that have been in place for several years. However, that is likely more than a year away in both Canada and the U.S.
- Nonetheless, based on this view, consensus forecasts continue to call for higher bond yields over the next 12-18 months.
- This in turn leads to expectations of low or even negative returns from fixed income as an asset class. By example, we calculate the returns on Government of Canada bonds based on current markets, using consensus forecasts to calculate future bond prices. After including coupon payments and accrued interest, the 12-month total return on government bonds is expected to range from 0.25% for T-bills to -6.77% for long bonds.
- Although we do expect provincial and corporate bonds to outperform, thanks to their additional yield in the form of credit spreads, we do not believe this is enough to offset the anchor that rising rates will have on overall prices and hence, returns.
- As such, we continue to recommend an underweight position in fixed income. This naturally leads to higher allocations to equities and alternative investments, but also to larger cash holdings in order to reduce overall risk exposure.
- In terms of cash, we note that deposits at financial institutions continue to garnish much higher rates of return than those available in bond markets. By example, a 3-month Bank of Nova Scotia Banker's Acceptance is yielding just 0.22%, versus 0.35% for an F Class high interest savings account.
- In addition, the highest rate on a 90-day Cashable GIC today is 1.25% from RFA Bank of Canada, and the highest rate on a 1-year GIC is 1.65%. This is well in excess of 0.27% on a 1-year government of Canada Treasury Bill, and yet for amounts under $100,000, are fully insured by CDIC, the Canada Deposit Insurance Corporation, a federal Crown Corporation. This makes investing in these deposit products a great simple alternative to other cash equivalent investments.

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Portfolio Construction: The reopening trade decelerates, but remains intact

An Nguyen, CFA

Chart 13: Small-cap vs. large-cap and growth vs. value

	1-Month	3-Month	Nov 9/20 to Aug 31/21
S&P/TSX Composite TR	1.6	5.0	29.3
S&P/TSX Small Cap TR	0.3	-1.9	35.9
Russell 1000 TR CAD	4.2	12.6	26.9
Russell 2000 TR CAD	3.5	5.1	35.2
Russell 1000 Growth TR CAD	5.0	19.1	23.7
Russell 1000 Value TR CAD	3.2	6.3	30.3

Chart 14: U.S. 10-year Treasury

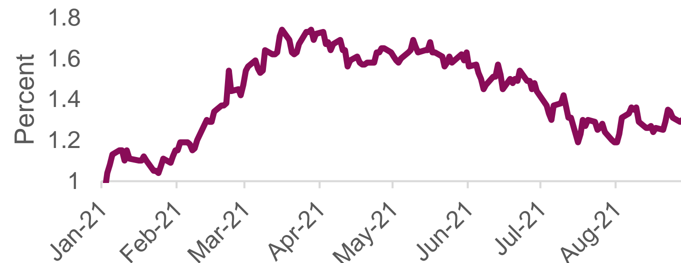
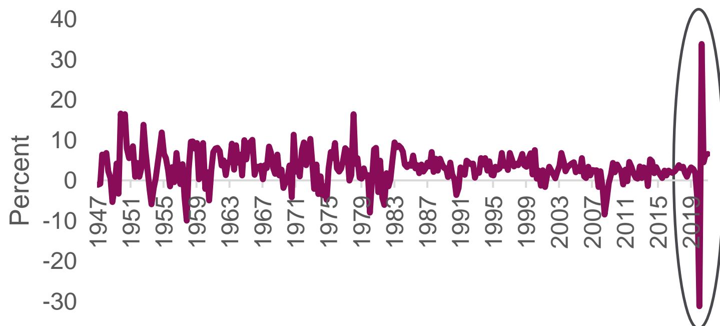


Chart 15: U.S. GDP, % change, seasonally adjusted annual rate



Source: Bloomberg

- A reopening or reflation trade refers to buying assets and securities that typically perform well during an economic recovery when consumption resumes, businesses spend, and growth rates accelerate. During an economic recovery, riskier assets such as small-cap stocks and more volatile assets such as value stocks (which have more exposure to cyclically sensitive sectors such as financials, industrials, and materials) have historically outperformed. We can trace part of the reflation trade back to November 9, 2020, when pharmaceutical and biotech companies Pfizer and BioNTech announced a vaccine candidate that was found to be more than 90% effective in preventing Covid-19 in its test cases. The highlighted column in chart 1 shows the outperformance of small-cap vs. large-cap and value vs. growth since November 9.
- Chart 1 also shows the recent underperformance (1-month and 3-months) of small-cap and value stocks relative to their larger-cap and growth style counterparts. This happened as the momentum in economic growth slowed and growth expectations were revised downward, while remaining at very healthy levels. The soaring Covid-19 delta variant case count also weighed on investors' minds as reopening plans were scaled back, or as in some cases, restrictive measures resumed.
- The bond market has already priced in the decelerating growth and inflation expectations. Chart 2 shows the U.S.10-year Treasury yield going back to January 1, 2020. As of the end of August, it has already retraced half of its meteoric rise. Declining yields also helped to boost the appetite for growth stocks as lower interest rates and a lower growth environment justified higher valuations.
- Does this reversal in small-cap and value performance spell the end of the reopening trade? We don't think so, however we believe that the extraordinary returns earned from the rotation into cyclically sensitive stocks has passed, and future return expectations must be lowered. The resumption of the economic activity we saw last year was unlike anything we've experienced before – a record pace that would obviously slow. Chart 3 shows the two extremes of economic contraction followed by expansion that we witnessed in the second and third quarter of last year.
- We believe the current loss of momentum in economic growth is part of the normalization of the pace of growth, coupled with a confluence of factors including but not limited to scaled back reopening plans, continued supply chain issues and logistical missteps. While these factors may continue to act as a headwind, we believe the Fed's more recent dovish taper tone, continued government fiscal stimulus, and higher global vaccination rates, should bode well for continued economic growth.
- While we acknowledge the "easy" money from the reopening trade has largely been made, we remain positioned for a continued economic recovery, albeit at a decelerating pace. From a style perspective, our portfolio has a slight value bias. Geographically, the portfolio remains overweight in international equity, which has exposure to economically sensitive sectors. Within the U.S. portion of the portfolio, we remain invested in an equal-weighted ETF (vs. a top-heavy market-cap weighted ETF)

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

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