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RICHARDSON Wealth

Market Ethos

The latest market insights from Richardson Wealth

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A challenging week for investors

To borrow from Lenin, last week was one of those market weeks where it seems like there was a year's worth of moves. As of the close, we saw:

- The U.S. Federal Reserve raise the Fed Funds rate by 0.75% – the largest single meeting move since 1994.
- The 10-year Treasury yield climb from 3.05% to almost touch 3.50% then retreat to 3.20%. Canadian yields followed a similar path.
- The S&P 500 fall 6%, 11% in June already.
- Most other major equity indices fall 4-8%.
- Bitcoin fall to just above $20,000, off 30% in a week.

This has been an extremely challenging week for investors, with even treasury bills posting losses.

There are a handful of popular narratives for this accelerated downward pace. The U.S. Consumer Price Index (CPI) – a wide-ranging measure of goods and services prices – didn't get worse but certainly didn't show improvement, the market pricing in a more aggressive Fed tightening path and increasing signs of economic weakness are likely the top three. We don't think any of these are surprises, but when the markets are fragile and jumpy, reactions are dramatic. Let's look at all three.

Inflation

Clearly many market participants thought this was going to be the month where inflation began to ease, but it didn't. Monthly U.S. CPI rose 1.0% bringing the year-over-year pace to 8.6%, both 0.3% higher than consensus forecast and faster than the previous month.

CPI excluding food and energy fell from 6.2% to 6.0%, which is encouraging, but we all have to eat and commute. Food at home is up 11.9% over the past year. **Hold onto your grocery stocks**. Energy prices are high, as we are constantly reminded by the gas station signs. We can blame the war for food, and part of the energy story, but there are also structural issues.

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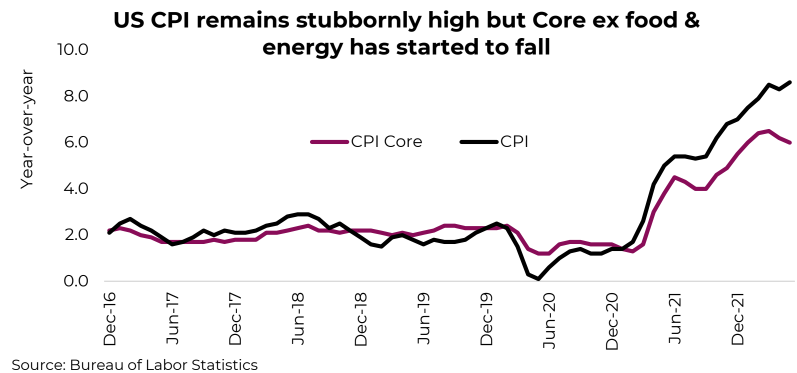
Looking across the other CPI categories, the trend is one of changing behaviours. Months ago, upward CPI was driven by consumers' outsized demand for goods/services that were beneficiaries of "stay at home" pandemic necessity. Appliances, RVs, patio furniture, home décor, tech, streaming services — all things we suddenly wanted more of. This shift played havoc with supply chains that were more fragile because of Covid disruptions. Now however, prices across these categories are broadly coming down.

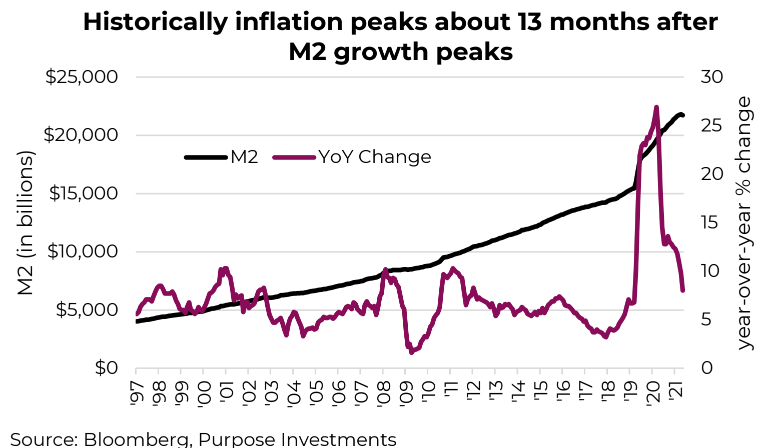


Source: Bureau of Labor Statistics

The shift has also gone the other way. Apparel, airfares, personal care products and services are all up, and the list goes on. **Life is going back to normal, and the demand pendulum has swung back.**

These broad-based changes in demand mess with the economic system, which is taking longer than usual to re-calibrate. But it is re-calibrating, even if slowly. Broadly, this isn't 'aggregate demand-driven inflation', it is more 'changing demand inflation' with a healthy dash (maybe a dollop) of supply issues.

Maybe we are wrong and it's not Covid-induced behaviour changes + supply disruptions, and it is more about the massive spike in money supply. We have been swimming in uncharted monetary waters for years now. Monetarists must also concede that M2 (a measure for the amount of currency in circulation) growth peaked in February of 2021 at a never before witnessed 27% year-over-year growth. Yes, the money supply grew since then but at a decelerating pace and has started to contract of late. More importantly, CPI has historically peaked on average about 13 months after M2 growth peaks. It is noteworthy that core CPI peaked in March and has now declined for two months (March was 13 months after the M2 peak.



Source: Bloomberg, Purpose Investments

Our expectation from here is that inflation will fade as one of the market's primary concerns.

The Fed

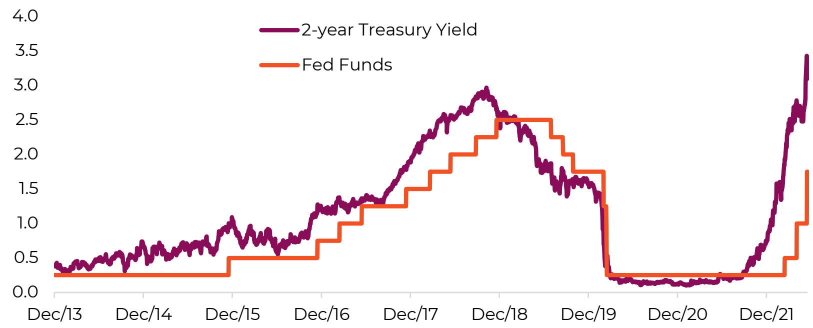
Central banks have made more mistakes than normal this cycle but for all the right reasons. They held rates abnormally low, given the uncertainly of the pandemic (the omicron wave to be specific), despite rising inflation and strong economic growth. Had omicron been like delta, it would have been warranted. Omicron was mild, however, and now central banks are in catch-up mode.

Whether the hike was 25 or 100 bps doesn't really matter beyond a day or two gyration. The short bonds know the path and will likely only change if the economic data gets soft enough (which has already started).

"Don't fight the Fed," is a well touted rule, but maybe it should not be so literal. One reason cited for the 75bps move was recent consumer survey data regarding inflation expectations. Survey data is very valuable — it is often timely and can offer some insight into people's behaviours. Unfortunately, survey data has been a bit squirrely over the past couple

years. For instance, consumer sentiment has been below Covid trough levels for over a year and is currently well below the depths of the global financial crisis (GFC).

During the GFC, people were getting wiped out financially and the core of the financial system was at risk of imploding. Today, gas prices are high, and everyone still has a job. The Fed is raising quickly because they are late … no need for the fluff. So don't fight the Fed's ***actions*** but take what they are ***saying*** with a grain of salt.



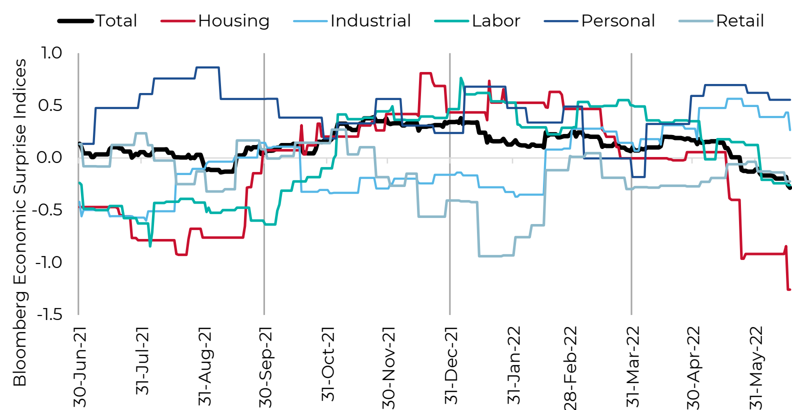
Source: Bloomberg, Purpose Investments

The two-year yield implies that the Fed has more hiking to do. But if the two-year starts to stabilize or tick lower, that may be the sign the Fed will be changing paths, despite what they say.

The Economy

It is slowing, and recession fears may be on the path to overtake inflation fears. You don't have to look very far to see signs of slowing.

This is evident in the Bloomberg Economic surprise indices (a score that measures the degree to which economic data is beating or missing estimates).



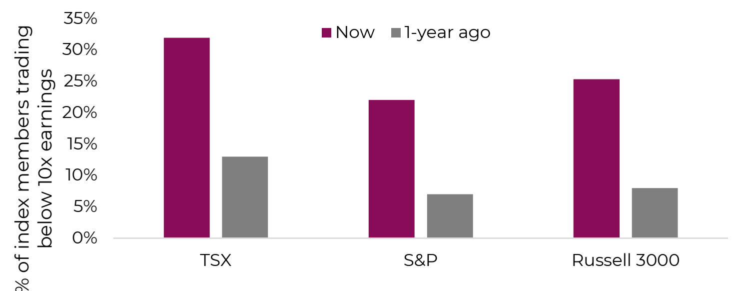
Source: Bloomberg, Purpose Investments

The faster indicators in housing are under a lot of pressure, which is not surprising given the move in mortgage rates and resulting drop in home prices. Other categories are flattish or even positive. Industrial, which captures manufacturing, remains decently strong. Generally, as goes manufacturing and housing, so goes the U.S. economy. At the moment, it's mixed.

European data has started to improve, and China is showing signs of recovery as lockdowns ease and stimulus is added. **Yes, the world is zagging (tightening financial conditions), and China is zigging.** You may not have noticed but while most markets are down over the past month, China is up.

Recession talk will likely grow louder as the year progresses, creating a market headwind. This of course brings up the question: **has the market already gone and priced in a recession?** Probably not, but valuations have become interesting.

Often, we quote the aggregate market valuation; instead, we looked at how many companies are trading below 10x (aka single digit PE ratios) and compared this with a year ago. About 1/3 of the TSX is sub 10x and a ¼ of the Russell 3,000, which captures most of the U.S. market.



Source: Bloomberg, Purpose Investments

Impact on portfolios

The markets have been bouncing from one problem to the next this year, and nobody knows when some stability will return. Markets and risk assets are clearly oversold, and valuations are becoming increasingly attractive. However, this market is cranky and fragile.

Richardson Wealth's base case remains that as the economic data softens, the inflation fears will too, leading to a market bounce.

But we could also fast forward to recession fears as earnings/margins come under pressure. Valuations are increasingly providing some margin of safety, and higher yields in the bond market are starting to look downright attractive. We are certain, however, that this will continue to be a challenging year.

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

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*This report is authored by Craig Basinger, Chief Market Strategist, Purpose Investments Inc. and James Price, SVP Investment Strategies at Richardson Wealth Ltd. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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