

Q3 2022

## The “R” Word

### Equity Markets

In North America, markets rallied handsomely over much of July and August on some economic optimism before retracing over the remainder of the quarter. The S&P/TSX Composite index ultimately fell 1.4%, while the S&P 500 Index rose 1.3%, in Canadian dollar terms. The weakening Canadian dollar added 6.1% to US dollar performance and 3.2% to a basket of foreign currencies. Similarly, the MSCI EAFE Index was down 9.4% in US dollar terms this quarter, with the loss being reduced to “just” 3.4% once converted into Canadian dollars.

The price of commodities generally fell during the quarter as well, with aluminum down 11.2%, copper down 6.9%, nickel down 7.2% and West Texas crude falling 24.8%, following prices rising too fast earlier in the year and the current likelihood of falling demand. A notable exception was the price of natural gas in Europe, steadily ascending as nations struggle to build winter inventories to offset reduced supply from Russia — in Germany, the reference price has nearly tripled in 2022.

Meanwhile, central banks across Europe and North America remain squarely focused on raising short-term interest rates to ward off inflationary pressures, presenting a growing risk to corporate and consumer borrowers, long since accustomed to a regime of low borrowing costs. These higher interest rates had a negative impact on stock prices generally, and particularly on the Real Estate Investment Trust (“REIT”) sector, a group of stocks most directly influenced by interest rates and a notable laggard sector in every region this quarter.

From here, equity market performance will reflect a mix of these risks, with rising interest rates potentially dampening housing prices and consumer wealth, offset by the potential resolution of supply chain bottlenecks that have contributed to inflation. It remains to be seen if this period will result in an economic cleansing to enable the best and strongest to grow and prosper in the future.

### Fixed Income Markets

Fixed income markets were highly volatile in the quarter as inflation spurred central banks across the globe to take more aggressive action to tamp down what they view as excess demand in an effort to relieve pricing pressures. Central banks in every Developed Market aside from Japan hiked rates in Q3, as did the vast majority of those across Emerging Markets (notable exceptions being China, Russia and Turkey).

Against the rise in policy rates and the upward shift in expectations for the path forward, short-term market interest rates shot higher with the yield on the 2-year Government of Canada note hitting its highest level since October 2007. With that said, rising expectations of an economic slowdown that would drive policymakers to reverse course saw longer-term rates end the quarter closer to where they began, resulting in the yield curve inverting across all points (the spread between the 10-year and 2-year yields inverted by its widest degree since 1990).

While the rise in rates has been a clear headwind for bond market performance this year, the higher coupons now available do at least provide some cushion to further adverse movements in yields. Case in point, despite the general rise in rates in Q3, the FTSE Canada Universe Bond Index did manage to eke out its first quarterly increase of the year, rising 0.5% in the three months ended September.

Longer-duration fixed income securities (FTSE Canada Long Term Overall Bond Index +1.5%) fared better than those with shorter maturities (FTSE Canada Mid Term Index +0.8%, FTSE Canada Short Term Index +0.3%), which was a key factor behind the relative outperformance of Government debt (FTSE Canada All Government Bond Index +0.6%) over corporate credit (FTSE Canada All Corporate Bond Index +0.2%) in the quarter.

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The central banks' focus on taming inflation, even at the expense of economic growth, suggests that there is limited scope for a material downshift in rates in the coming months. The uncertain outlook and persistence of risks could provide some support for fixed income securities, especially those of high-quality issuers. At the same time, the higher yields and wider credit spreads arguably appear to offer investors a more compelling risk/reward proposition than they have in a while.

## Commentary

For all the hopes of entering a calmer post-pandemic “normal” this year, 2022 has proven to be yet another tumultuous year with the lingering concerns around the ongoing public health crisis being compounded by geopolitical tensions, aggressive turns by global central banks, the confusion brought on by labour markets and general rising price pressures.

The resultant economic angst has seen forecasters slash their outlooks for growth, which has narrowed the runway for a potential “soft landing” — an outcome where inflation is tamed and economic growth is sustained.

Understandably, the rising prospect of the hardship associated with a recession, the dreaded “R” word, has become increasingly prevalent in financial media and commentary these days. Such messaging has been a driving force behind the increasing pessimism among consumers, businesses and investors, which has weighed on economic activity and financial market performance.

But while a recession is a less-than-desirable outcome, it is important to acknowledge that despite the experiences of the last two decades, a downturn in growth does not necessarily have to represent a significant shock that carries lasting implications — instead, it can just be a temporary lull in the cycle.

In general terms, aside from exogenous shocks (such as pandemics or wars), recessions typically come about due to significant financial imbalances and excesses. In these scenarios, central bank-induced increases in costs of capital make overextended financial positions untenable and, potentially force an unwind that creates negative spillovers, or potential financial mergers of necessity; where individuals, companies and countries have taken advantage of the “cheap” money, which has led to an uncomfortable imbalance.

As things stand, there are limited indications of such significant imbalances. Absolutely— there have been pockets of excess (blank cheque “special-purpose acquisition companies” being able to raise billions of dollars on the open market and the variety of cryptocurrency-related entities are good examples), but no signs of the type of systemic misallocations of capital that preceded the Tech Wreck (2001) and Global Financial Crisis (in 2008).

Consumer finances appear to be in generationally good shape by many measures, with ample savings and elevated net worth that can blunt the impact of rising costs of living and softening job markets. Business balance sheets are also fairly robust with high liquidity, low leverage and negligible interest burdens, suggesting scope to weather a hit to profitability without setting off a harsh downswing in the credit cycle that causes firms to significantly scale back investment intentions or headcounts.

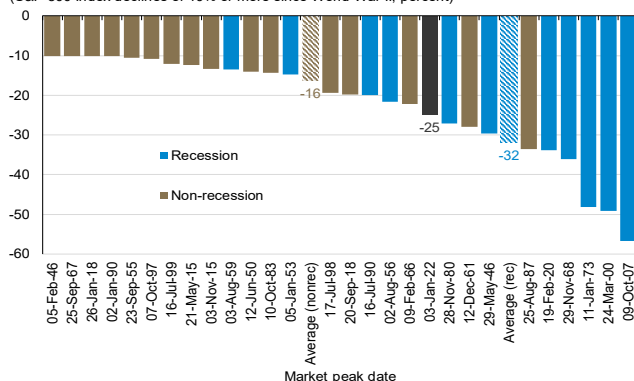
The apparent absence of significant imbalances could limit the likelihood of things going completely off the rails if the persistent headwinds push growth off track, mitigating the risk of a deep and long-lasting hit to activity that weighs on financial markets. Indeed, if history is to serve as a guide, a lack of an imminent systematic shock (and barring a further exogenous shock that impacts the outlook) could suggest that price adjustments seen in equity markets may well be close to done.

Looking at the post-World War II era, the average peak-to-trough decline in the S&P 500 around recessions is 32% (see chart titled “Needle and the damage done”). Removing three major outliers: the recent Financial Crisis (-57%); Tech Wreck (-49%); and the global exchange rate collapse in the early 1970s (-48%), the average is reduced to “just” 26%. We currently stand near the average with a peak-to-trough dip of -24%.

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## Needle and the damage done

(S&P 500 Index declines of 10% or more since World War II; percent)

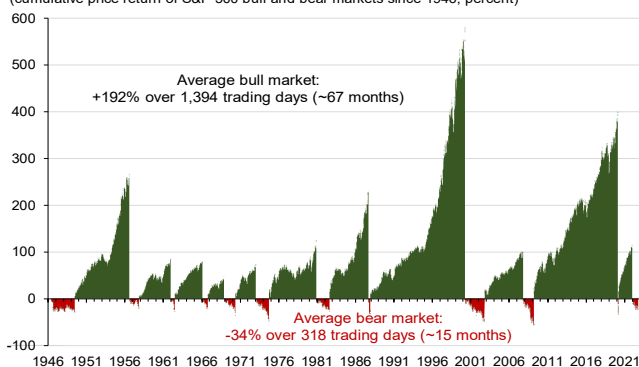


Source: Guardian Capital based on data from Bloomberg to September 28, 2022.

Moreover, the convenient pessimism that is putting undue weight on a “worst case” scenario materializing arguably shifts the balance of risk in favour of potential upsides (see chart titled “Onwards & upwards”). Perhaps the “bad” outcomes may not be “as bad as feared” as the backstop provided by the underlying strength of consumer and business finances is underestimated, while the absence of material imbalances could limit the overall economic fallout.

## Onwards & upwards

(cumulative price return of S&P 500 bull and bear markets since 1946; percent)



\* A bull market is defined as a trough-to-peak increase in excess of 20%; a bear market is a peak-to-trough decline in excess of 20%. Source: Guardian Capital based on data from Bloomberg to September 28, 2022.

The outlook remains acutely uncertain and volatility appears likely to persist, but the significant and broad correction has undoubtedly created opportunities for active investors with a long investment horizon to selectively add to positions or establish positions in high-quality investment assets that are trading at discounted valuations. While these periods of market weakness feel as though they are never-ending, they do not last forever and often give way to better days.

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