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Wealth Management

Quarterly Economic and Market Comments
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After the worst first half since 1970, the third quarter began on a very promising note with the S&P 500 rallying more than 17% from its June low to its mid-August high. Instead, the end of September brought to a close the first quarter since 1938 that the U.S. market ended in the red after being up by more than 10%. At quarter end, the S&P 500 was down almost 25% in 2022, its fourth worst start in the past 100 years. Other indices, such as the technology-laden Nasdaq, Europe, and Emerging Markets did even worse. Equity markets in all major countries and regions fell in the third quarter and are all down year-to-date. Of eleven U.S. industry groups, only energy has a positive return, despite its thrashing in the third quarter when commodities had the worst return among the major asset classes, including a 23% decline in Brent crude. What has made 2022 particularly brutal for investors has been the inability of so-called “risk-off” assets, notably U.S. Treasury Bonds, to offer a place of refuge. An index of long-term U.S. Treasuries is down almost 29% year-to-date, the worst three quarters ever and worse than the S&P 500, something that is not supposed to happen. As a result, a 60/40 portfolio of U.S. stocks and bonds is down 20%, the third worst first nine months behind only 1974 and 1931. If it was bad in the U.S., it was worse in Germany where a 50/50 bond/equity portfolio is down nearly 30% in real terms (i.e., after inflation) from its peak, the worst drawdown since 1948. The Core Bond Index in the U.K. has just suffered its worst quarter ever and dollar bonds of emerging market countries are on track to have their worst year ever. Of seven major asset classes, the median return of minus 22% was the second worst return since data began 50 years ago. Conservative Canadian investors have been sheltered somewhat from the carnage. First, energy, the one winning sector, is a major factor in the Canadian market. Secondly, there has been the foreign exchange gain on U.S. assets as the Canadian dollar, like other currencies, has depreciated against the American dollar.

“Who’ll stop the rain?” asked Creedence Clearwater Revival more than 50 years ago. “Who’ll stop the pain?” ask investors today. The obvious answer is central bankers in general and the U.S. Federal Reserve Board in particular. In the wake of the unprecedented monetary moves deemed necessary by the Great Financial Crisis of 2008-09, the Federal Reserve tried to increase interest rates and normalize monetary policy on at least three occasions. In each case, market turbulence caused them to “pivot” and rapidly return to their quantitative-easing, low-interest-rate, asset-inflationary ways. They were able to justify this by pointing to relatively low rates of consumer price inflation and the need, from their perspective, to see prices rising at a more or less steady 2% rate. Then came the Covid lockdowns and monetary policy, joined this time by fiscal policy (i.e., government spending), went into accommodative overdrive, a posture that was maintained throughout 2021 even though the economy had long since recovered from its hyper-brief Covid recession. The distortions to the world economy caused by Covid and the policy responses to it led to major supply chain problems on the one hand and excess consumer demand on the other. The result inevitably was rising prices. This fundamental reality was exacerbated by a number of important other factors. Record low mortgage rates led to a boom in housing prices. An often inept and uncoordinated transition away from fossil fuels around the world led to a major run-up in energy costs. Sanctions on Russia as a result of the war in Ukraine made the energy problem worse and contributed to higher food prices. The decision of many North American baby boomers to retire during Covid and the trend throughout much of the developed world to restrict immigration led to many jobs going unfilled and rising wage rates. Suddenly, or at least it seemed to be sudden, the world had a major consumer price inflation problem for the first time in four decades.

Initially, central bankers thought, or hoped, that the inflationary burst would be "transitory" and they could stick with their existing policy framework. The persistence of rising prices and the war in Ukraine jolted them out of their complacency in 2022 and the race to come to grips with the inflation juggernaut was on. The Fed Funds rate in the U.S., which was 0.25% throughout 2021 and into 2022, has been raised to 3.25%. Fed officials project short-term rates will rise to 4.25% by year end and markets are projecting a peak of 4.5% in 2023. This is the fastest rate increase in more than 40 years. In addition, the Fed doubled its balance sheet reduction program, dubbed quantitative tightening, in September. Combined, this is probably the most aggressive tightening the Fed has ever undertaken and is reflected in the plunge in the year-over-year change in the broad U.S. money supply and the rise in Barclays U.S. Financial Conditions Indicator to its tightest reading in two decades. Ten-year U.S. Treasuries, which touched 0.5% in 2020, recently hit 4%, the fastest rise in four decades, and 30-year mortgage rates have risen from less than 2.75% to 6.75% over the past year. Although the Fed and the Bank of Canada lead the 2022 Rate Hike Derby, they are far from alone. Of almost 40 central banks, only in Russia, China, Turkey, and Japan was the last interest rate change a decrease. The global central bank rate has doubled since the beginning of the year, up by 1.7%, the largest gain over that period of time since the data began in 2000. Nor is quantitative tightening only a U.S. phenomenon as central bank balance sheets continue to shrink globally. As in the U.S., an index of global financial conditions shows decreased liquidity. Looking at different central banks, the Bank of Japan, despite not raising rates, has allowed the nation's monetary base to plummet; the Swiss central bank tightened policy in September by sharply reducing bank liquidity; the National Bank of Hungary's base rate has soared from 0.5% to a staggering 13%; Mexico's overnight rate has jumped from 4% to 9.25% even as the country's consensus 2023 GDP growth forecast has fallen from 2.2% to 1.5%; and, last, but not least, two-year interest rates in Pakistan have soared from 5% to 45%.

Needless to say, these dramatic changes in the monetary environment have not gone unnoticed by the markets and are the primary factor behind the widespread capital losses so far in 2022. Understandably, investors look back fondly at the past decade and wonder what it will take to cause central bankers to "pivot" to more market-friendly monetary policies. Since the main difference between 2022 and the previous decade is the rate of consumer price inflation, markets are very sensitive to the monthly inflation numbers, hoping - indeed, praying - for an abatement in inflationary pressures that will allow central bankers to declare, "Mission Accomplished", and bring an end to their monetary tightening. However, the Federal Reserve has made it very clear that "Mission Accomplished" means a sustainable rate of inflation of 2% and, at the moment, prices in the U.S. are rising at a far faster rate than that and in many places outside of the U.S. faster still. In August, core PCE inflation, a favourite Fed indicator, rose at a 4.9% rate. However, a Federal Reserve Bank of New York gauge of underlying inflationary pressures rose at a 6% rate and 70% of the components in the consumer price index were rising faster than 6%. This suggests getting inflation down to 2% may take some time. Indeed, since 1980, once advanced economies allow inflation to exceed 5%, it has taken a decade on average to get to 2%. Meanwhile, in Europe, the core CPI in September came in at 4.8%, but producer prices, due largely to soaring energy costs, rose in August at a staggering 43% rate year-over-year.

While 2% inflation may not be imminent, there are many signs that inflationary pressures have peaked both in the U.S. and globally. The September report of U.S. manufacturers was telling. Only 50% of industries reported any growth, down from 94% in May, and only 52% reported inflationary pressures, down from 82% in May. Since 1965, average weekly earnings in the U.S. have grown at the same rate as consumer prices. In August, wages were 3.4% below consumer price inflation meaning wages were falling in real terms, consistent with a weaker economy and reduced inflationary pressure. Disposable personal income growth is running at a mere 2.8% which has historically corresponded to growth in

consumer prices of just 1.5%. Global supply chain pressure (e.g., supplier delivery times) have been falling sharply with the New York Fed's Global Supply Chain Pressures Index at its lowest point since January 2021. Then there are also many signs of economic weakness. The leading indicators of economic activity have fallen for six consecutive months and historically three declines in a row have led to an 80% success rate in calling recessions. Reflecting economic weakness and U.S. dollar strength, many commodities have sold off sharply; for example, lumber which is down 70% from its March highs to a two-year low. The situation globally is similar to the U.S. Inflation in the OECD rose to its highest rate in 34 years in July. Since then, based on the latest indicators, global growth has effectively slowed to a standstill owing to tightening monetary policies, inflation eroding purchasing power and confidence, and excessive inventories. The same indicators, as in the U.S., show output prices peaking in the Spring and in a sharp downtrend since then. Global food prices have fallen from their record high in March just as oil and natural gas are well off their highs, although food and energy prices do remain historically elevated.

It has been said that it is the job of central bankers “to take away the punchbowl”. They avoided doing their job throughout the past decade and especially in the wake of Covid, and, as a result, made their inevitable task more difficult. However, now they're doing it and thereby laying the groundwork for getting inflation under control. The cost, in the first instance, has been a sell-off in the markets, which may not be over, notwithstanding periodic impressive rallies which are the paradoxical hallmark of bear markets. The next phase may well involve an economic downturn which is when the pressure on central bankers to “pivot' will become intense. “The lady's not for turning”, was the famous Margaret Thatcher line from 1980 when she was being urged to do a U-turn from her controversial policies. The Chair of the Federal Reserve, Jerome Powell, who was widely perceived as a Wall Street toady, has sounded a lot like Thatcher of late and he seems to have his colleagues singing from the same hymn book. Their resolve is likely to be tested in the months ahead, but for the time being, they are holding firm.