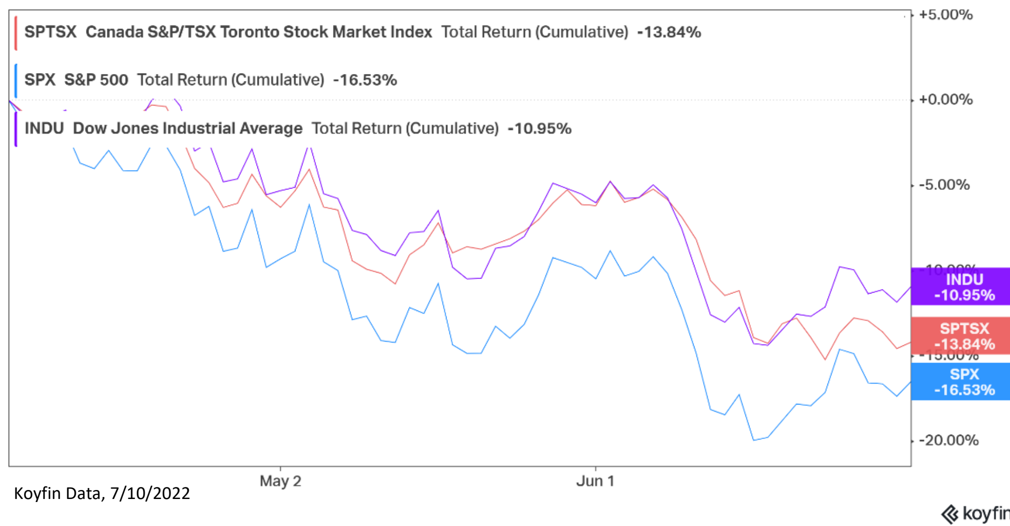
Investment Quarterly - July 2022

Review

"Unprecedented" is a word that has been used frequently in financial commentary over the last couple years and unfortunately there was plenty of material to reference during the quarter. High inflation, recessionary fears, and rising interest rates (the US Federal Reserve raised its rates by a further 0.75% and the Bank of Canada upped its rate by 0.50%), all combined to make a difficult 2022 even more choppy. Added to this came the ongoing uncertainty from the war in Ukraine causing difficulties across the European political and economic landscape. In response, both bonds and stocks sold off in, well, unprecedented fashion.



The S&P 500 was down roughly 16% during the quarter while the Dow Jones and TSX were down 11% and 14% respectively. By sector, recessionary fears caused materials to decline 24% and financials and industrials to drop by 14% and 13%. Companies in the energy and utilities sectors weathered better, declining only 3% and 4% respectively.

Forecast

We continue to believe that inflation remains a long-term concern despite whatever temporary reprieve may result from cooling in the global economy. In some parts of the market, the slowing from the spending binge of the past 18 months has become obvious. Retailers such as Walmart and Target noted significant softening of demand while manufacturers of consumer electronics are now dealing with an inventory glut. Similar issues appear to be developing for a number of industries previously in high demand. But we believe there is a limit to how far this might extend. High oil prices have thus far not produced a major supply response (i.e. investment in new resource exploration and extraction) and barring a major technological development in the next couple years, the rate of demand for fossil fuel energy has not materially changed.

Similarly, despite the increasing cost of living, we have not yet seen early retirees or those who have left the work force, rushing back to find jobs. In the US, people employed or seeking employment still remains below the levels prior to COVID. This lack of "labor supply," evidenced by high rates of employment, has only just started to bump up wages. Crucially, this is before many unions have even begun the process of negotiating wage increases. As with the 1970s, unionization was both a response to and a cause of ongoing inflation and we believe we may be in

for greater unionization in many developed markets as the full brunt of cost inflation begins to be realized. Neither of these factors (wages and energy) point to a sustainable decline in inflation.

Finally, it is our view that the lesson that governments appear to have taken most forcefully from COVID has nothing to do with public health. Rather, it is that government purse strings can loosen with remarkable ease. Regardless of whether you think the speed and scale of the economic response to COVID was justified, the ability to shape the economy with fiscal stimulus is not something that will be easily unlearned. We do not believe politicians will let a recession emerge without responding.

Strategy

For several years, we've avoided bonds except in specific individual circumstances. It is true that other investors made a lot of money through the buying and, crucially, selling of bonds during the period after the Great Financial Crisis, in large part due to the decreasing interest rate environment. But for a long term buy and hold philosophy such as our own, owning bonds in a traditional 60/40 portfolio (60% equities with 40% bonds) did not seem a healthy risk and reward. The risk was not in failing to be paid back—despite recent spending, we expect that the Canadian government is still good to pay—but in the volatility and opportunity cost between buying a bond and having it mature as well as the shortfall risk for clients in need of ongoing income. Despite recession concerns, we remain firmly on the side of not owning bonds. If inflation is 8% and the Canadian 10-year government bond gives you 3%, you are effectively paying the government 5% per year to hold onto your savings. This is not a sustainable strategy for preserving your wealth. Until some part of that calculation changes—either the rate of inflation due to recession or the interest rate—we'll be avoiding bonds.

We remain focused on equities, both commons and preferreds, as well as the income trusts, while also avoiding the most popular parts of the market. Most companies will not be beneficiaries of inflation and it is an ongoing challenge to determine who will handle a sustained inflationary environment unscathed. If every company is raising their prices by 5%, it is relatively easy to pass along your own 5% increase. What is much more difficult is to ensure your costs do not increase at a similar (or greater) rate. We believe the mix of companies and securities in which we invest your savings are appropriate for the current environment but we are very mindful that with changes in the economy, we may have to adjust. That said, we will not act merely for the sake of acting. Economic conditions are like the weather and it is important to use forecasts to help you along your journey rather than make them the focus of your itinerary. Our focus remains strongly on the long-term and any adjustments of the route will not change our intended destination.

Disclosure Addendum

Please see the language below that was recently added to the our Relationship Disclosure Information. Let us know if you would like the complete document now. As ever, if you have any questions for us regarding this or any other topic, please let us know.

- *Client brokerage commissions: We have no obligations to conduct securities trading with any brokerage firm.*

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