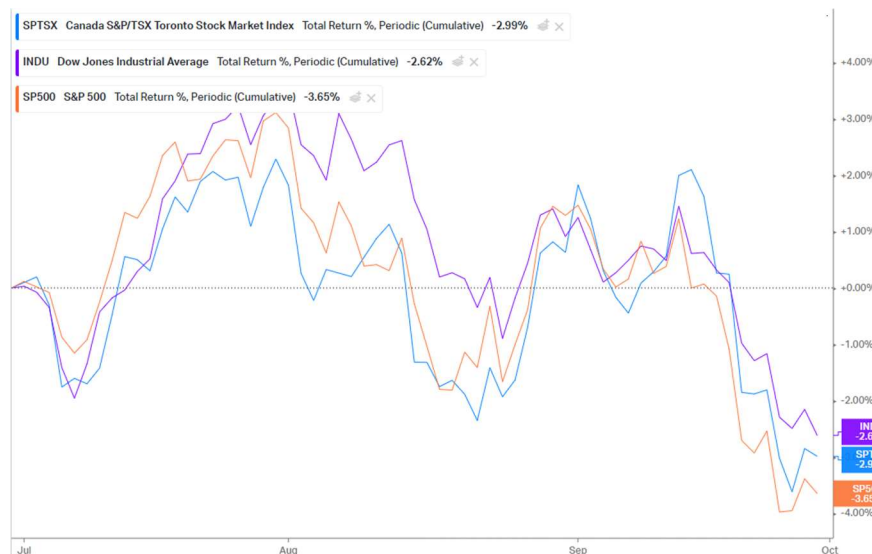




Review

North American Central Bankers endured a cruel summer, but they should just shake it off, we repeat, shake it off. Tasked with a difficult and thankless job, balancing inflation with economic growth, the Banks' performance over the summer was at once deemed ineffective by the financial markets and yet condemned as overly aggressive by populists. Hounded by a strong current of inflationary forces washing over North American economies, both the US and the Canadian Central Banks raised interest rates another 25 basis points (a total of 4.75% since 2022) in hopes of stemming those tides.

Despite increasing costs and decreasing purchasing power, consumers were largely unfazed over the summer when it came to spending on things like stadium concerts, perhaps filling a blank space left by the pandemic. Investors were unimpressed, especially those in the bond market, as they drove bond yields considerably higher as if to say that these rate increases are too tempered to have any hope of turning inflation back to its targeted level. In equity markets, investors were left spooked by the Central Banks' hawkish rhetoric. It generated a performance



also worth shaking off – the S&P TSX closed in the negative, -2.99%. American counterparts the Dow Jones Industrial Average was -2.62%, and the S&P500 was -3.65% at the end of the quarter. Energy was the sole sector generating positive returns this quarter. Other dividend-yielding sectors, namely financials, utilities, real estate, and telecom sold off as higher bond yields lured investors away from equity offerings.

Meanwhile, politicians and pundits all around are complaining that these same set of interest rate increases are overly punitive and will bring on a calamitous economic recession, hurting everyone. We sympathize with both sets of opinions and see merit in either interpretation.

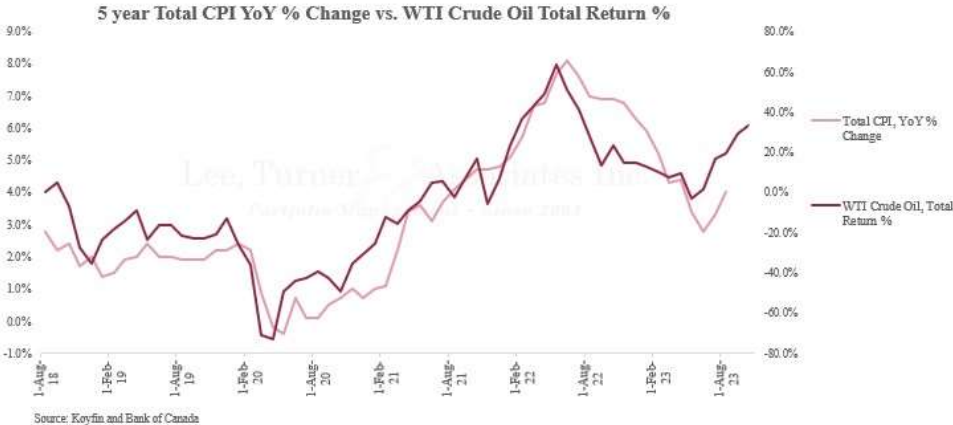
Forecast

Unfortunately, it is a necessary evil that interest rates must be raised to stem inflation expectations, and as interest rates climb, a North American economic recession will be mostly unavoidable. While we would concede that the Central Banks have done as much as they could for now, the fact remains that the beast of inflation is very persistent, well entrenched, and sticky. We have previously discussed the functions of the labour market, including wage hikes and union strikes as contributors to why inflation is not transitory. Post-pandemic spending and the war in Ukraine have undoubtedly driven complications in taming this inflationary environment we have all now become acclimated to.



In our April 2022 quarterly, we also discussed the economic sensitivity to energy prices. These prices declined materially last Spring, and consistently regressed until May of this year. Coincidentally, inflation followed its path approximately a month later and has been following this path ever since. The chart below illustrates the relationship between WTI Crude Oil prices and inflation over a 5-year period (hint: they're very correlated). With WTI data being a leading indicator, we can see where inflation is likely headed in the coming months.

The inflation ball continues to bounce and thus, to avoid replaying the 1970s & 80s, the Banks will need to do more. We would expect more interest rate hikes as the year progresses. As it stands now, without a recession, the Central Banks' top priority of getting both interest rates and inflation rate swiftly back to the 2% level is nothing short of far-fetched; let's face it, they are never ever getting back together.



Strategy

If signs point to inflation staying above the Central Bankers' targets, we will continue to look to equities for long-term returns. When inflation expectations are higher than expected, stocks and bonds should perform negatively. "Expected" is relative. For stocks, the impact of higher-than-expected inflation should be less negative for those firms that can pass on inflated costs, and we believe we are well-exposed to these types of firms. Our financial, industrial, communications, and consumer staples names can largely pass on costs. Regulated sectors such as the utilities space will eventually demonstrate their ability to re-price their services and therefore see growth again. For bonds, yields have been climbing as investors believe the future value of their dollar is worth more in a different security. With further potential interest rates, we would agree with this sentiment. However, these yields are now nearly high enough for us to reintroduce this asset class to your portfolios, just not quite yet.

Despite numerous headline risks to equities year to date, our objective is to look beyond the foggy outlooks and data vacuums. We aim to continue finding high-quality assets to protect and grow your money. With markets dissecting speeches, predicting the arrival and duration of a recession, forecasting soft/hard landings, and wondering if stagflation is on the horizon, we anticipate opportunities to allocate capital will be presenting themselves in the coming months.

Our communication with you

If you would like to opt for emailed quarterly packages and discontinue mailed quarterly packages, please email trevor@lee-turner.com and let us know. Thank you.