The Dream Achiever

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"Sometimes when things are falling apart, they may actually be falling into place."

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Riders of the storm

We hope that you and your families are well and that you have been able to enjoy some of the beautiful summer weather. In the first half of 2022 the markets have not seen much sunshine upon them and could be described as stormy to say the least.

Rising inflation, continuing labour shortages, the ongoing war in Ukraine, high oil prices, and persistent supply chain issues have weighed heavily on equity and bond markets at the same time. Risk-off was a persistent theme as equities underperformed bonds, corporate debt underperformed government debt, and cash held in best. Amidst growing expectations that inflationary pressures will persist, the US Federal Reserve increased rates by three-quarters of a percentage point in June, their most aggressive move since 1994. Monetary authorities are clearly communicating to market participants that they will do whatever it takes, including increasing the risk of recession, to get a better handle on today's inflationary pressures.

In 2022, outside of the energy sector, there has been no place to hide. The equity and fixed income indices swung back and forth but ended the quarter as dark red (very negative) pretty much everywhere across the globe. For Q2, Canada's S&P/TSX Composite Index was down -13.19% (-9.87% YTD), the American S&P 500 down -16.10% (-19.96% YTD), MSCI World down -16.05% (-20.29% YTD), and Barclays Global Aggregate Bond Index (in $CAD) was down -5.26% (-12.09% YTD). The $CAD fell by -2.67% to the $USD in the quarter. *

Most of the big tech names sold-off after disappointing quarterly results. These stocks which have driven the market forward for years have been hit hard as interest rates have climbed and their high price multiples are feeling the pinch. Market leadership has changed. Assets dependent on low interest rates remain vulnerable. But several investment classes now offer starting valuations and yields that lead to attractive longer-term returns.

Crypto currencies fell dramatically in the quarter as speculative investors exited the sector. Cryptos have often been advertised as being a good hedge against inflation and as uncorrelated to the general stock markets which has not played out at all. Gold, often seen as a good inflation hedge, is also slightly negative on the year.

Consumers are also getting squeezed. In May, there was another gloomy data point when the US Consumer Price Index (CPI) rose to 8.6%, the highest in over 40 years (1981). Pent up pandemic savings are being used to fund daily living expenses such as groceries, gas, and housing. Wages have been rising at an above average rate but not at the same pace as the rising cost of living. As a result, workers have less real income today than a year ago. Retail inventories of consumer goods from clothing to hardware appear well stocked but stickier aspects of inflation such as labour and shelter, combined with supply shortages and logistical challenges suggest to us that there is a real possibility that some components of inflation could remain higher for longer. Recent price trends are a major shock to an entire generation of consumers who have become accustomed to little or no inflation.

In an indebted developed world, with rates now rising rapidly to combat inflation head on, risks have tilted towards recession at the expense of inflation getting further out of control. However, containing inflation at 2%, the explicit long-run inflation goal of central bankers, seems unrealistic without a substantial deterioration in housing, a marked improvement in labour dynamics, supply chain normalization, and resolution to the conflict in Ukraine.

The outbreak of war in Ukraine has disrupted the world as we knew it while placing global supply for energy and agriculture in disarray. In early June, the OECD slashed its outlook for global growth from 4.5% to 3% and doubled its inflation outlook to nearly 9% for its member countries, citing the greatest change as the economic impact of the war in Ukraine. Following Russia's invasion of Ukraine, global inflationary pressures have intensified sharply. These pressures largely reflect the steep rise in energy and other commodity prices and continued widespread disruption to supply chains. What the report didn't highlight but is being witnessed acutely in UK politics at time of writing, is that economic instability fuels political instability. It is realistic to expect augmented political instability as we move forward in an environment of negative real wage growth.

For much of the post Financial Crisis era, we have often heard that there is no alternative to equities as bond yields approached record low levels. Individuals in need of income were forced further out on the risk curve to generate income they had previously been accustomed to in government bonds. During Q2, rapid increases in bond yields resulted in income offered from bond strategies reaching levels not seen in nearly fifteen years. For those with more immediate needs for income and stability, fixed income markets are now offering a much more attractive alternative to equities than we have seen for some time.

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Market Overview Continued

In April, the Canadian federal government also released its 2022 annual budget which included increased military spending, home affordability measures, green initiatives, and a tax hike on large banks and insurers.

What we can expect now? This year has been a bumpy ride as we've experienced a market correction with valuations repriced for higher interest rates. While extreme swings are stressful, the worst is likely behind us or at least peaking. A clearer indication will be once we achieve a few months of declining inflation. Currently economic fundamentals including consumer demand, wage growth, job vacancies, and corporate earnings all remain healthy. It might take time, but a rebound will occur and history has proven investors are rewarded over the long-term.

Investors should remember that markets are forward looking, pricing in the probable future. What's more, markets proverbially price off "better or worse", rather than "good or bad". Today's news flow could hardly be worse. Investor's collective sentiment toward stocks and bonds just hit a 35-year low. Upside surprises become far easier to deliver in this environment.

It's important to take a disciplined approach to investing and stay focused on your long-term goals. This strategy helps you keep emotions out of investing, typically buying high and selling low like many investors do. Trying to time the markets with moves to cash is a losing game. Prepare yourself for the weather change, accepting that we may only be in the middle stages of a longer economic cycle.

Planning items

- **RRSP Contribution Room for 2022:** Please provide us your room for the 2022 tax year when you receive your 2021 Federal Notice of Assessment. The maximum limit for 2022 is $29,210. You may need to adjust your automatic savings plans for the coming year accordingly. Note: **You can make us a tax representative** and we'll be able to get this from the CRA for you.
- **Registered Education Savings plan (RESP) contributions:** Quebec beneficiaries get the added 10% QESI grant from the provincial government increasing the overall grant to 30%! 2022 room now available.
- **Tax Free Savings Account (TFSA):** A new $6000 of room available since January 1, 2022. Total room since 2009 is $81,500.
- **Conversion to RRIF account:** Those of you who turn 71 years of age in 2022 (born in 1951) will need to convert their RRSPs into RRIF accounts before the end of the year. We will be in contact to assist you on how to get that done if you haven't done so already.
- **Your Annual Review:** It is important to inform us of any changes taking place in to see the effects on your plan.
- **$2K pension deduction:** Those who turn age 65 in 2022 or older and not already receiving recognized pension income.
- **Estate planning:** The pandemic is a reminder that your **wills and mandates** need to be in order.

The Planning Corner – Are balanced portfolios dead?

Up to now, the year 2022 has been a very difficult year for both equity and fixed income markets. Historically DD Humes clients have felt much less pain than the broad market because almost all our investors have some level of a balanced approach to their portfolios; meaning they hold a mix of both stocks and bonds. Generally, when the stock markets pull back the bonds in the portfolio (which have a negative co-relation) will help ease the pain by providing a positive return on that portion of the portfolio. What is so unique about this year is that both stock and bond markets are falling significantly at the same time, so our balanced investors aren't benefitting very much from having fixed income. Over a 42 year period from January 1980 to January 2022 the rolling 1 year returns of both Canadian stock and bond markets being negative at the same time happened only 1.4% of the time and there has never been a 3-year period where both have been negative.

Under the hood there have been many moves within the fixed income portions of the portfolios to lessen the effects of the current rising rate environment such as lowering the bond durations, looking at floating rate loans, or adding corporate dept with better yields than government bonds just to name a few. The one positive about the current higher rates is that when the bonds in the portfolio mature, they are being reinvested at higher rates providing a better income stream going forward. The higher rates also provide more of a buffer against the possibility of further negative returns. Even though the recent returns on bond portfolios have been historically poor, their value going forward should not be taken for granted. Should we soon enter a recession, the fixed income portfolios will likely increase their duration and investors will be happy that they held onto their fixed income side of their portfolios as it will help offset some of the pain that the stock markets may face.

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*Source: Morningstar