CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

MID-YEAR REVIEW

Volume 13 – Issue 5 **July 2022**

STAN CLARK
Senior Wealth Advisor

Welcome to our 2022 mid-year review issue.

Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2022 – and what the major influences were over the last six months.

We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course.

Enjoy your summer!

Stan

Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Mid-Year Review

INFLATION, RECESSION – AND THE CYCLICAL NATURE OF MARKETS AND ECONOMIES

By Stan Clark, Senior Wealth Advisor and Michael Chu, Senior Wealth Advisor

We trust you are enjoying the summer! As all of us continue to stay careful and safe, the midpoint of the year seems a good time to review 2022 so far – and to look ahead.

After a strong 2021, it's been a rough first half of the year for both bond and stock investors. The primary driver? Inflation concerns and their impact on interest rates. Normally bonds provide some protection to stock market drops, but with bond yields moving up, the result has been lower bond prices. Meanwhile, higher interest rates mean higher discount rates and competition for stocks. That's why stocks, too, are down in the first half of this year.

With 2022's poor start for the stock market, and with all the talk about rising interest rates, inflation and recession – here's what is unusual: company earnings are still growing and unemployment is low. These aren't things you usually see heading into a recession.

	Q1 2022	Q2 2022	H1 2022
Canada (S&P/TSX)	3.8%	-13.2%	-9.9%
U.S. (S&P 500)	-5.6%	-13.6%	-18.5%
Europe	-6.3%	-9.5%	-15.2%
Japan	-8.8%	-12.3%	-19.9%
EAFE (Europe, Australia, Far East)	-6.9%	-12.0%	-18.1%
Emerging Markets	-7.9%	-8.8%	-16.1%
World	-6.1%	-13.7%	-19.0%

Source: Bloomberg

Major stock markets ended the first half of the year with negative results. The World Equity Index, a gauge of stocks around the world, was down 19% (in C$). At home, the TSX was down 9.9%. The chart below shows the returns of major markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

As you can see in the second table, dividends from Canadian stocks are still higher than 10-year bonds. Although the premium is not as high as before, it still shows that there is value when comparing stocks to bonds. With interest rates rising in the U.S., dividend yields are now lower than 10-year bond yields – so, not as much value for U.S. stocks. But for regions like Europe and EAFE, stocks show good value compared to the average yield on 10-year government bonds.

The earnings yield in the second table uses reported earnings over the past 12 months. It's also useful to look at estimates of future (or forward) earnings. According to data from top economist Ed Yardeni, the S&P 500 price-to-earnings (P/E) ratio is 15.9 times forward earnings, which equates to a 6.3% earnings yield. This implies that stocks are about 30% better valued than at the beginning of the year, as earnings expectations remained about the same while stock prices fell. This drawdown in stock prices should help set up investors for better returns in the long term – especially if the current environment is

	Trailing P/E	Trailing Eanings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	13.3	7.5%	3.3%	3.1%
U.S. (S&P 500)	18.9	5.3%	1.7%	3.0%
Europe	13.9	7.2%	3.4%	1.5%
Japan	13.2	7.6%	2.5%	0.2%
EAFE (Europe, Australia, Far East)	13.9	7.2%	3.4%	1.1%
Emerging Markets	12.5	8.0%	3.1%	3.4%
World	17.0	5.9%	2.2%	2.7%

* Weighted average for regions

Source: Bloomberg

reminiscent of the last decade: slow growth, low inflation, low interest rates and high profitability.

After spectacular earnings growth in 2021, earnings are expected to grow more slowly in 2022 as companies face headwinds such as rising wages, higher input costs, higher interest rates and slowing sales. A recession would dent profits, but could create a better long-term environment going forward.

Pandemic still having an impact

The pandemic continues to have a big impact on the economy and markets. You'll recall that policymakers responded with a huge stimulus to keep markets liquid and operating during the lockdowns. The stimulus is one driver of inflation, especially when combined with disruptions to supply chains and shipping channels.

Looking back, the global economy was super-efficient – we're used to having things arrive just in time, which leaves not a lot of room for disruptions. With a huge disruption like the pandemic and rotating lockdowns, the economy will need time to work its way back to where it was. Supply chain indicators do continue to improve – albeit slowly.

Soft landing

Central bankers have a tough job with interest rate decisions. What's especially challenging is that, although policy decisions are made today, the effects aren't seen for many months or even years. Right now, central banks are trying to engineer a soft landing. That means getting inflation back under control without creating a recession – meaning they have to maintain positive economic growth. If central banks clamp down on inflation too hard or fast, they could drive the economy into a recession.

The technical definition of recession is two quarters in a row of negative gross domestic product (GDP) growth. The U.S. has already had a negative first quarter, with a reasonable chance that the second quarter will also be negative – which would meet the technical definition.

That being said, there's a committee in the U.S. called the National Bureau of Economic Research (NBER), which officially determines whether there has been a recession or not. The NBER looks at much more than just the GDP, including personal spending and employment data. Its process is highly complex, which is why we often only hear long afterward that we were in a recession.

While recession talk has been the hot topic, we shouldn't be overly concerned about it – especially long-term investors. This is all part of the regular cyclicality of markets and economics. So, no need to be worried if we end up with a soft landing or mild recession. In fact, a recession might be helpful because it would bring to focus companies with strong characteristics that bode well for our investment style.

Recessions don't happen very often. That, too, might make us feel a bit nervous. But the important message is, again, that what's taking place is fairly normal. Markets react to inflation; we experience the current circumstances; then we start to look forward.

The other important message is not to pay attention to markets day-to-day. In the short term there's more noise than signal – meaning the day-to-days news cycle does not contain much useful information for making important long-term decisions.

Too close to call

Currently, it's close call whether the U.S. will be in a recession. It appears inflation may have peaked in March, with long-term bond yields peaking in June.

Ed Yardeni is forecasting a negative annual GDP growth of 2% for the second, third and fourth quarters. If Yardeni's forecast comes true, it would still technically be a recession, but a mild one. The upcoming U.S. mid-term elections could rekindle some growth. A big trigger would be a ceasefire or peace agreement in the Ukraine war. Continued growth in corporate earnings could also provide a big boost.

The S&P 500 is down about 20% from its all-time highs; the more tech-heavy Nasdaq down over 30%. It certainly feels like the market is pricing in an imminent recession. But it's important to note that the stock market doesn't have a great track record of predicting economic contractions. A famous economist once said, "The stock market predicted nine of the last five recessions," meaning half the stock bear markets do not result in a recession.

According to one survey, 76% of CEOs expect a recession. Fed Chair Jerome Powell and U.S. Treasury Secretary Janet Yellen expect a slowdown, not necessarily a recession.

But let's look at the facts, not just opinions. There are some signs of peak inflation. If that's the case, then the Fed might be getting the ship righted and we should see a boost in stock prices.

Inflation peaking

High inflation is bad because it damages everyone's cost of living. It is also bad for economic growth because interest rate hikes hurt borrowers. In the U.S., inflation remained persistent through June, coming in at 9.1%. That beat expectations of 8.8% and exceeded May's 8.6%. On the face of it, inflation doesn't seem to be peaking. But the core rate (excluding volatile food and energy) came in at 5.9% and has been steadily declining since March, when it was 6.5%.

What are the drivers of inflation? The most important ones are probably commodity prices, supply chain shocks and overly generous central banks. Today, with central banks tightening, commodity prices getting lower and supply chains improving – inflation should be better, or at least less hot, going forward.

The bond market inflation expectations have gone from 4% inflation over the next five years to 2.5% inflation. You can interpret this as the betting line. It's good news for markets if inflation falls below that line with decent growth; bad news if inflation is sticky and growth falls.

Turning hawkish

A rapidly improving job market and persistent inflation have pushed the Fed to adopt a much more hawkish stance. The Fed is now determined to sacrifice growth to combat inflation. In June it increased interest rates by 0.75%, following increases of 0.25% and 0.50% in March and May, respectively.

Current thinking is that there will be cumulative increases of 1.75% this year and 0.50% next year, bringing rates to about 4% by the end of 2023. On the other hand, the Fed expects inflation rates to fall towards its 2% target over the next few years. For their part, futures markets expect the Fed to ease interest rates next spring, reflecting the risk that an aggressive Fed could cause a significant slowdown.

Similarly, in mid-July the Bank of Canada raised interest rates by 1% to 2.5% – the biggest increase since 1998 and the highest level since 2008. The estimated neutral range is 2 to 3%. Many expected that 0.75% was in the works and were surprised by the 1% increase. The Bank may be front-loading rate increases – that is, more increase now and less later, rather than more increase both now and later.

Bonds behaving differently

Since they typically move in opposite directions, bonds usually act as a hedge for stocks. This year has been a little different. Bonds were the cause of the stock sell-off. And it was inflation that caused the bond sell-off. So, both bonds and stocks were falling at the same time, which does not occur often. This was more pronounced at the beginning of the year; now things are starting to look more normal.

Pessimism is good

As of the end of June, the percentage of individual investors expecting stocks to decline further is above 50% for the seventh time in 11 weeks. This is above the historical average of 30% and is unusually high. Why is this good? Historically, the S&P 500 has gone on to realize above-average returns during the six-month periods following unusually high bearish sentiment readings.

The survey of individual investors is conducted weekly by the American Association of Individual Investors (AAII). The survey is a very good contrarian indicator – meaning you should expect the opposite of what the respondents say will happen.

How's the big spender?

Consumers are a big part of the economy. They have been changing their spending behaviour. But overall consumers are still in pretty good shape, because while we have higher inflation, we also have higher wages. Consumers overall have healthy balance sheets, too, though this varies by region.

We tend to focus on American consumers because they are the most consumptive group in the world and the U.S. economy drives a lot of global consumption. We may make fun of our U.S. counterparts from time to time, but since the global financial crisis in 2009 U.S. consumers have in fact deleveraged or reduced their credit. They learned from the experience of being overleveraged, so are in quite good shape today. They have lots of cash (almost $18 trillion compared to $10 trillion five years ago) and the ability to spend – despite inflation taking away some of that spending power.

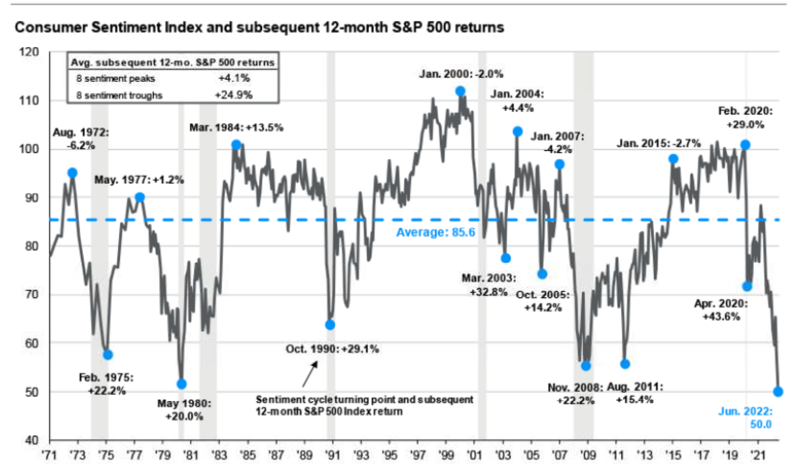
Canadian consumers are still in okay shape too, but not as good compared to Americans. Households in Canada carry more debt, which was made worse with rising interest rates. So, Canadian consumers might be a bit more pressured.

Canadian consumers are still in okay shape too, but not as good compared to Americans. Households in Canada carry more debt, which was made worse with rising interest rates. So, Canadian consumers might be a bit more pressured.

But how do you really feel?

The first half of 2022 has been understandably disappointing for many: the ongoing pandemic, sharply rising inflation and interest rates, falling stock prices and the war in Ukraine. These factors have driven consumer sentiment to a record low (since 1971).

Consumer confidence and the stock market



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.
Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of June 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

As you'll see above, JP Morgan did a study of consumer sentiment and subsequent stock market returns. The study looked at the last 50 years of sentiment data and identified eight peaks and troughs where Americans were especially optimistic or pessimistic. From the subsequent 12-month stock returns, an interesting pattern emerged. When investors felt most confident, the market returned an average of 4% over the next year. By contrast, when investors felt nervous, the market returned on average 25%. This doesn't necessarily mean big returns are around the corner, but rather that astute investors should focus on fundamentals rather than on how they feel.

Over the long term

Over the long term, how you handle corrections, bear markets and market crashes can have a tremendous impact on your investment performance. In the second quarter of 2022, the S&P 500 fell 16%, which is the 16th worst quarterly return in the U.S. since 1926. Ben Carlson of Ritholtz Wealth Management did a chart showing the 20 worst quarterly returns since 1926 and the ensuing one-, three-, five- and 10-year returns.

As you can see, most of the time markets recovered within a few years. The exception was the Great Depression, which took much longer. The point is not to predict every downturn (because you can't!), but to prepare yourself emotionally and financially. Knowing that downturns will occur and be followed by an eventual recovery will help you and your portfolio a lot.

The Worst S&P 500 Quarterly Returns: 1926-2022

Quarter Ending	Performance	+1 Year	+3 Years	+5 Years	+10 Years
6/30/1932	-37.7%	162.9%	170.5%	344.8%	90.5%
9/30/1931	-33.6%	-9.6%	13.1%	118.2%	86.5%
12/31/1929	-27.8%	-24.9%	-60.9%	-40.7%	-16.4%
9/30/1974	-25.2%	38.1%	72.7%	117.5%	296.2%
12/31/1987	-22.6%	16.8%	48.8%	109.0%	465.9%
12/31/2008	-21.9%	26.5%	48.6%	128.2%	338.1%
12/31/1937	-21.4%	31.1%	17.8%	25.4%	207.1%
6/30/1962	-20.6%	31.2%	69.2%	94.8%	171.7%
3/31/2020	-19.6%	56.4%	???	???	???
3/31/1938	-18.6%	35.2%	38.2%	84.5%	149.8%
9/30/1946	-18.0%	6.4%	24.5%	115.4%	442.6%
6/30/1970	-18.0%	41.9%	57.4%	56.3%	127.0%
6/30/1930	-17.7%	-23.4%	-34.7%	-32.8%	-0.4%
9/30/2002	-17.3%	24.4%	59.0%	105.1%	98.6%
6/30/1940	-16.9%	5.7%	51.1%	102.3%	228.6%
6/30/2022	-16.1%	???	???	???	???
3/31/1939	-16.1%	17.6%	-11.5%	49.3%	130.4%
12/31/1930	-15.8%	-43.3%	-19.9%	16.5%	4.1%
9/30/2001	-14.7%	-20.5%	12.6%	40.1%	33.4%
3/31/1933	-14.1%	92.0%	192.1%	84.8%	95.4%
Averages		**18.6%**	**39.8%**	**65.1%**	**134.6%**

Source: Ben Carlson

Bear Market Recoveries

Peak	Trough	% Decline	Peak-to-Trough (Months)	Breakeven (Months)
5/29/1946	10/9/1946	-26.6%	4	36
6/15/1948	6/13/1949	-20.6%	12	6
7/15/1957	10/22/1957	-20.7%	3	10
12/12/1961	6/26/1962	-28.0%	6	11
2/9/1966	10/7/1966	-22.2%	8	6
11/29/1968	5/26/1970	-36.1%	18	20
1/11/1973	10/3/1974	-48.2%	21	46
11/28/1980	8/12/1982	-27.1%	20	3
8/25/1987	12/4/1987	-33.5%	3	17
3/24/2000	10/9/2002	-49.1%	31	48
10/9/2007	3/9/2009	-56.8%	17	37
2/19/2020	3/23/2020	-33.9%	1	6
Averages		**-32.7%**	**12**	**21**

Source: Ben Carlson

Are we there yet?

We find it useful to study history to get an idea of what to look for in the future. The chart on the right shows every bear market since World War II. The chart also shows how long each lasted, the amount of decline and how long it took to recover. The average bear market lasted one year and took two to recover. Keep in mind that is indeed just an average – there's a wide range of outcomes.

Risks

While predicting the economy is always exceptionally difficult, it does seem the probability of a recession has increased. Inflation could be more entrenched as we see wages rising. Global growth and corporate earnings are impacted by rising interest rates, and also by higher food and energy costs. A soft landing is not impossible, but increasingly challenging. Still, many positive surprises could be around the corner: subsiding inflation or a resolution to the war in Ukraine.

Looking ahead

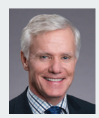
If we look at the more recent corrections in the market, the recoveries happened very quickly. In particular, the pandemic in early 2020 saw a very severe downturn followed by a quick recovery. A lot of that had to do with the quick reaction of policymakers. But the current correction seems not unlike the great financial crisis of 2009, which took a few years for markets to recover from. So, perhaps we should expect a more drawn-out recovery.

A likely trigger for a recovery is when inflation starts to moderate. As mentioned before, supply chain issues are causing a big chunk of inflation; these issues should eventually be resolved.

Nobody likes to see a sell-off, but it's actually pretty healthy. There were some excesses before, such as cryptocurrencies, and some elements of the market were pretty frothy. A correction helps bring things back in line and also presents new opportunities.

With a big dislocation in the markets there's always the temptation to make major changes. But nothing has changed with our approach to planning and investing. For us, it's all about making sure that we're sticking with our financial plan and investment philosophy and rigorously following our processes.

We welcome your comments and questions – and wish you the very best for the balance of the summer!



Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Michael Chu is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

CIBC WOOD GUNDY | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: 604 641-4361 | Toll-free: 1 800 661-9442 | Fax: 604 608-5211 | Email: stanclarkfinancialteam@cibc.ca | www.stanclark.ca