CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

OCTOBER 2022

The more tightening we get, the greater the possibility of an unforeseen financial tail event after the last prolonged period of ultra loose and highly liquid conditions. - ***August Outlook*****.** Risky and safe assets alike have had another dismal month and quarter, and sentiment has continued to worsen after the bear market rally this summer. In the past year, bond prices have dropped. Having accepted the possibility of a cycle peak for the Fed funds target rate in excess of 4.5%, bonds are now reversing a long secular trend of lower peaks in rates.

Equity markets have also dropped. As equities have adjusted to higher interest rates, earnings to date still seem to suggest optimism about a soft landing and/or a near term reversal in central bank policy. Similarly, housing markets are coming to grips with a new affordability issue as mortgage rates rise with interest rates, in the U.S. tipping above 7%. Currency moves have exacerbated weak performance of anything other than U.S. assets. The US dollar (USD) index is up a massive 19% since the beginning of the year to its highest level since May 2002. The yen hit 144 per USD, the weakest level since 1990; the pound tumbled to a record low, while the Euro fell below parity against the USD. The Canadian dollar has depreciated by 8% against the USD year-to-date, but has actually held up remarkably well.

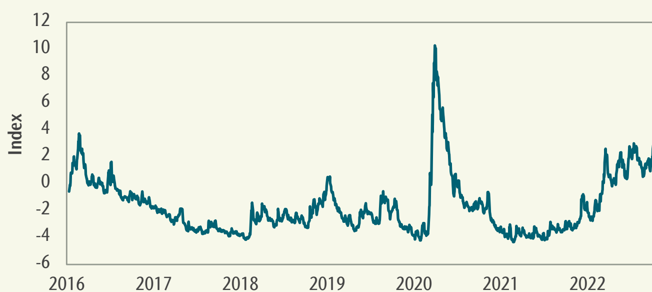
Clearly, volatility is on the rise and several markers of risks are looking strained (see Chart 1). We have seen a wider range in terms of intraday interest rate moves, bid-ask spreads have widened for bonds, and equity sell- offs have become more pronounced. This is an outcome of diminished liquidity. Global USD money supply has been shrinking year-over-year (see Chart 2). Not only are central banks raising rates across the board, they are shrinking balance sheets at the same time. While rising prices sap savings, slowing economic activity is keeping money velocity depressed. Historically, when USD liquidity declines, the potential for something unexpected grows.

In addition to the increase in market volatility, we have begun to see more signs of instability. In late September, the Bank of England (BoE) was forced to come to the rescue of the UK government bond market. A sudden and sharp rise in gilt yields brought on enormous stress among pension funds that utilized extensive leverage. Nominally, the purpose of this leverage was to hedge against interest rate changes that would cause a mismatch in liabilities and assets. But pensions faced unprecedented margin calls on bonds that suddenly fell in value, triggering selling in a market without many buyers. These strategies (liability driven investing) are safe, but are highly leveraged in the UK and proved riskier than anticipated.

The problems that have surfaced so far are unique to the UK. Likely, this is because leverage is employed at a higher rate than other countries, in part because it was encouraged by UK regulators to help plans meet funding goals. Moreover, the size of the UK pension market exceeds nearly all other developed markets (118.5% of GDP vs about 96% for each of Canada and the US, according to the OECD Global Pension Statistics from 2020). For now, the immediate risks appear to be contained – the BoE has not needed to buy bonds beyond the first few days of intervention.

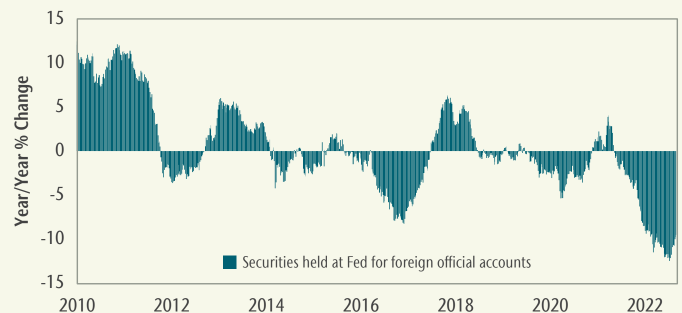
Central banks are ready to take down aggregate demand in the economy, sacrifice jobs and weaken financial conditions – there is no doubt of the resolve to control inflation. But from

Chart 1: Financial Stress is on the Rise



Note: The OFR Financial Stress Index (FSI) measures stress in global financial markets. When the FSI is above zero, stress levels are above average. When the FSI is below zero, stress levels are below average.
Source: OFR, Macrobond

Chart 2: Global Liquidity is Shrinking



Source: Gavekal Research, Macrobond

this episode, we were reminded that unknown risks lurk in unexpected places, and equally importantly, that central banks have mandates that encompass not just inflation, but also financial stability.

It is evident there is a distinction between risks related to financial instability and day-to-day financial volatility and a clear separation to what will cause policymakers to support the system at risk. But in the wake of the BoE intervention, we are observing very early signs of some caution from policymakers. Both the Reserve Bank of Australia and the Reserve Bank of New Zealand, not to mention the BoE itself (the week before the pension debacle), each put through a smaller rate hike than was anticipated by markets. There was also some unusual and rather public scolding on the part of the IMF and UN who expressed concern over both the speed of central bank rate hikes, and the lag in feeling the full impact of these rate hikes, suggesting perhaps that enough tightening may already have been put in place. Taken all together, we believe that market dysfunction may trigger a slowing in the pace of liquidity withdrawal.

But even if central banks do slow or even pause their rate hike cycles in coming months, the bar to reverse policy toward rate cuts remains incredibly high so long as inflation is still above target. They will remain resolute in their battle. In the meantime, we are watchful over unforeseen instability and their implications, but focused on the fundamental outlook.

CAPITAL MARKETS

September is typically a seasonally poor month of returns, and this past month was the worst in an already bad year. Even with an impressive 18% rally off the mid-June lows in the equity markets, they still managed to close the third quarter in negative territory. This now marks the third straight quarterly loss, and the first time the S&P 500 registered this length of consecutive losses, remarkably, since 2008/09. After a September drop of 9.2%, the S&P 500 is now down 23.9% for the year. Similarly, global equities fell 8.4% while the S&P/TSX Composite Index outperformed but was still down 4.3% for the month. The themes driving this are well enumerated: recession concern, defiant central banks that seem determined to tighten policy, declining valuations alongside higher rates, as well as energy shocks. As we enter the third quarter earnings season for equities, 2023 earnings estimates continue to show a growth rate of about 8% year-over-year and any guidance will have greater influence in this poor sentiment environment.

As tough as it has been for equity markets, bonds and currencies have been even more volatile. U.S. Treasury yields, especially, were stung by persistently high readings of inflation and blunt determination by the Fed to bring demand down. Ten-year Treasury yields surged another 63 basis points (bps), though modest against UK yields that saw a 190 bps surge. Canada, in contrast, was rather tame. Two-year and ten-year yields were up just 13 bps and 7 bps respectively, even though the BoC continued to meet lofty expectations for rate hikes. The FTSE Universe Bond Index edged 0.5% lower for the month. The tempered rate moves in Canada were the result of the most recent three-month trends that showed employment losses and easing core inflation rates. Outside Canada, the global coordinated tightening, combined with looser shipping capacity and easing supply chain challenges dampened commodity prices. WTI oil prices fell 24.8% in September to below US$80/bbl (although has rebounded somewhat in early October), while industrial metals such as copper also receded. All these suggest the economy is duly adjusting to the higher interest rate environment.

PORTFOLIO STRATEGY

Risk levels have now risen, with the rise in yields and volatility itself contributing to the market dysfunction. Through the last year, we have been reducing risk exposures in portfolios and we continued to do so with our most recent portfolio asset mix shift.

Our balanced portfolios are positioned to weather a period of bumpy markets, and equities were sold further to an underweight position. Within equities, we maintain a preference for Canadian stocks relative to global equities. We have added to bonds, reducing our underweight, as the yield on universe bonds at 4.2% has become more compelling. Indeed, with rates at current levels, analysis done by Strategas Research Partners shows only one in five companies on the S&P 500 now have dividend yields above the 10-year Treasury yield, which is the lowest proportion in about two decades. We still hold an overweight to cash which we believe is prudent in this current volatile environment. Fundamental equity portfolios have also been positioned more defensively. While valuations in Canada are now around levels similar to prior slowdowns, the earnings outlook remains too optimistic in our view. Downward earnings revisions should further pressure the outlook, and we maintain a focus on companies with resilient earnings profiles. Similarly, in Canadian fixed income portfolios we have increased the underweight position in provincial bonds, drawing in risk at this time. The next period will be a test for both the economy and financial markets in how they withstand the pressure of the rapid-fire interest rate increases that occurred over the past six months. The risks have risen and we are proceeding with caution.

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