1st Quarter Commentary – 2022

**Summary:**

Financial markets love a good narrative. Twelve months ago, the dominant narratives coming out of the Federal Reserve was that inflation was transitory, rates were not going anywhere and the economy and labour market needed time and space to improve. What a difference a year makes; the narrative has now flipped as concerns about elevated inflation have spread, the labour market strength is choppy and still needs time and space to confirm direction, the bond market has priced forward yield curve inversion (growth slowing) and rates are rising fast. None of these narratives have anything to do with the economic cycle we are currently navigating. The reality is more complicated and nuanced than the prevailing narratives suggest. We are in an economic environment of slowing growth, accelerating inflation (for now), and increasingly tightening monetary policy conditions. This is all occurring, of course, when we are about to face uncompable stimulus-fueled earnings and consumer spending comparisons in Q1 and Q2. In other words, a growth and inflation slowdown is imminent Q2 of 2022. Risk managing a growth and inflation slowdown is tricky, but we focus on it from a volatility perspective.


**Recap & Outlook:**

Most participants under the age of 60 investing today have never had to allocate capital in a rising rate environment alongside persistent high inflation prints and geopolitical friction. Capital markets can adjust to good news and bad news but have no easy way to price in true uncertainty. Calander year 2022 is off to the worst year to date start for the S&P500 through April since 1988. Our positioning since the end of last year and for which has only strengthened, and developments in the first quarter have only reinforced our belief that

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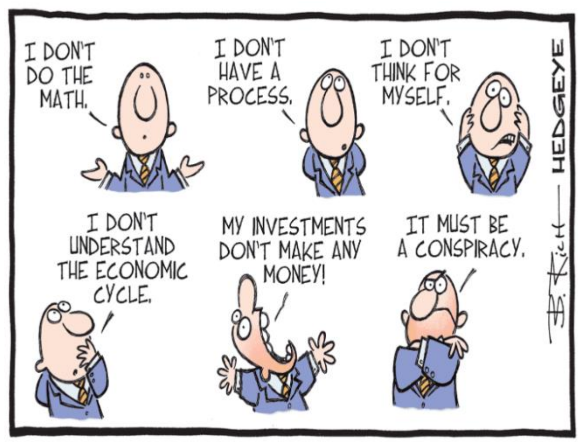
2022 will be a year in which most economies struggle. When the markets are under such pressure from an aggressive change in monetary policy, the only reason to be adding risk is when the interest-rate narrative is perceived to be improving, or if the markets reach an oversold/pessimistic extreme. We believe the current bout of weakness, sour sentiment, and historic spike in rates are part of full cycle investing and should be monitored and potentially taken advantage of, and not feared. While anxious in the near term, periods of extreme volatility often set up attractive entry points for high conviction plays that suffer from short-term drawdowns as intermarket correlations peak.

This past quarter had some challenges for everyone. It was filled with an epic rally in commodities, a fixed income rout, an initial sharp sell off in most risk assets, and then a fierce bear market rally. For the period ended March 31st 2022, the S&P 500 was down -4.6% and the Nasdaq Composite down –8.9%, TSX Composite up +3.8% (mostly due to energy). Gold increased +5.95%. Bonds have been one of the worst performing asset classes, with Long-Term U.S. Treasuries down by -10.6%, and 10-year Treasuries down -6.4%. The latest inflation print (excluding energy and food) came in at 8.5%.

In terms of inflation, the narrative is it will continue to rise because investors/media like to extrapolate too much from recent events. We tend to rely on the data and math to assist with our expectations. On a weighted basis, the components of inflation that are currently driving headline CPI are food (15% of inflation), shelter (32%) and transportation (41%). Adding these 3 up we have 88% of headline CPI being explained by these 3 categories. Turning our attention to energy, oil prices are one of the key inputs for economic productivity and a key input for headline CPI but what really matters is its year over year rate of change. The underlying mechanics is the price you see today, working on a one month lag in reporting. The surge in energy prices helped drive headline CPI inflation up to a 40-year high of 8.5% in March but, with base effects set to become much more favourable and signs that monthly gains in core prices are moderating, we expect that print to be the peak, or close to it. So all the attention given to March's oil price will show up in April's CPI print and it's the year over year rate of change that matters. To put it in context, Q1 2022 move in oil is +118% year over year. To hold oil at its current rate of change of +118% and thus drive the narrative that oil inflation can only rise from here we would need to see WTI oil average $144 in Q2, $154 in Q3, $168 in Q4 and finally $237 in Q1 2023. Given Oil (WTI) has traded much lower post March the probability of disinflation between now and this time next year is probable. The same mathematical exercise can be extended to the other inputs on headline CPI such as shelter and shipping costs. The bottom line is the peak on rate of change basis may have been put in, or very close to it, so the data continues to come out on a lag basis, we should see it contributing to disinflationary pressure. It will begin somewhat slowly but in the second half of the year disinflation will gather momentum. While inflation likely stabalizes, it does so at a higher level then we have been used to for 12 or so years. With FED officials sounding more hawkish by the day, it does support our view that, having been slow to realise that the initial surge wasn't transitory, FED officials are now being a bit too pessimistic about how quickly inflation will drop back.




On March 16th the FED began its tightening cycle with a 25bp hike and looks set to hike rates higher at each of the remaining six policy meetings this year and reduce its asset holdings by around $100bn per month. The pace of tightening is then expected to slow in 2023. The FED is obviously paranoid on headline CPI prints and hoping it begins to back down so the pressure for them to keep tightening reduces, and reduces sooner than the midterm elections in November. Unfortunately FED decisions are based on lagging indicators and they are being reactive instead of proactive that they may be forced to tighten for longer then the economy needs. The more important change has been in the attitude of the FED desperate to see inflation prints begin disinflating. Historically speaking, the Fed funds rate should be higher than the inflation print. For this to take place, even with inflation peaking, we are talking about a Fed funds rate of 8pct or 9pct. There is no precedent for the situation the FED is in. Typically the Fed funds rate is low when in a recession or coming out of one. We are in neither right now. The FED is going to taper, talking about aggressively raising rates at the same time the consumer is potentially restricing consumption. This could be the worst possible time for the FED to move to a monetary tightening policy. The issue is with growth slowing this may cause the recession you are trying to avoid. The swiftness of acceleration in FED policy is likely to break things harder than the economy or the market is prepared for. While their tightening cycles have historically averaged 28 months in the previous 5 inflation shocks, this time they're on pace to get most everything done in less than half that time because they're late and playing catch-up. They may need to come to terms that Fiscal Policy will be needed and given the behaviour of Washington that too is in question. The catalyst for disinflation is a rate hike, the catalyst for deflation is multiple rate hikes while growth is slowing. This is what a policy mistake looks like.


Important signals for our process remains cross asset volatility, USD$ strength, and the activity coming out of fixed income markets. The 10yr-2yr yield curve officially inverted the morning of April 4th, the speed of the collapse has been remarkable, suggesting an economic slowdown is being broadcast by the bond markets. Equity markets will need to pay attention, and the risks of a recession will continue to rise. For us, persistent inversion, perhaps 10 days or more would add credibility but that did not take place. The significance of an inverted yield curve stems from the fact that it reflects the collective wisdom of deep and liquid bond markets. First, it is important to remember why the yield curve is such a good indicator of recession. The yield curve measures the spread between what a lending institution pays for its money vs. what it can make by lending or investing it. When short-term rates are higher than long-term rates (inversion), it severely disincentivizes lending, thereby restricting the supply of money. Opinions on recession risk vary but we remind our readers since the 1950's that while not every inverted yield curve has preceded a recession (11 out of 12), every recession (10 out of 10) has been preceded by an inverted yield curve. Also and more important near term, yield curve inversions have a long track record of predicting equity market corrections and broader economic slowdowns. Often outright recessionary, but always decelerating. The current backdrop appears to be no exception. The time lag of when a recesssion happens varies but the point is those are the pre-conditions. Of interest, within 6 to 18 months after yield curve inversion a recession takes place. As of writing, the US 10yr yield is at 3.01% and the markets are pricing approximately 85% chance of a 50bps hike in May. We could also see another 50bps in June and July. This is unprecendented but this is what the market is pricing in. The crucial point is to understand why the FED is tightening and why rates are rising. If rates rising because positive growth then that's tolerable. If rising rates are to fight inflation that is concerning. The FED seems overly confident in their current approach. Those who think rates cannot materially rise anchor on the point that there is far too much debt/leverage in the system and it simply cannot absorb meaningful rate hikes and that is why we have been in a secular decline in rates for some 40 years and nothing about that has changed. The belief by some is the normalization of monetary policy is unavailable as the burst of the debt and equity bubbles would create systemic havoc and thus the belief is Central Banks are trapped between inflation and bubbles and will invariably be forced to let inflation go in order to protect the bubbles. The fact that we are now dealing with an inflationary shock is temporary and will not alter that long term dynamic. The outlook for disinflation in the back half of the year and 2023 is intact. The FED is late and perhaps the better path is doing nothing. The bears think the FED will cause demand destruction, growth to slow down quicker, bond yields begin to top and stop going up, FED pulls back on rate hike expecations and treasuries roar back. During low inflation, Central Banks are in control. During high inflation, Central Banks lose control. The signal for us remains the activity coming out of fixed income markets. Even though the spot 10/2 yield curve is not, the forward yield curve expectations remain inverted. Our confidence in the FED has been shaken for some time. Not raising rates during the 2021 expansion and elevated inflation was policy mistake number 1. Policy mistake number 2 is aggressively raising rates in 2022 in reaction to past inflation prints. The FED is behind the curve, has been for some time, and so we will continue with our process. All the FED has now are tradeoffs, they can pick price stability or health of the economy, not both. Their communicaiton tells us they are focused on price stability given they no longer have an option to design a policy to do both.

The upcoming slowdown is invevitable and is now unavoidable. We are entering an economic slowdown and the data being released and action out of the fixed income markets are confirming this for us. The more challenging the macro environment the more likely we are to see a flight to safety, slow at first and then suddenly. The depth and duration of this bear market is not going to anchor on Russia/Ukraine, not going to anchor on inflation prints or FED commentary, rather mapping of data. For now the market risk is to the downside until market prices in the decelerating data fundamentals. We have evidence of falling retail sales, deteriorating industrial production and fixed investment and consumer confidence all showing signs of weakness. Markets may not be fully appreciating the complexities of the upcoming earnings season. It is going to be extremely difficult for Industrials, Consumer Discretionary, Technology and Financials sector companies, for example, in matching their triple digit second quarter 2021 earnings per share (EPS) growth in the second quarter of this year. Estimates have EPS still growing but the rate of change slowdown will be dramatic. Corporate P&L's are decelerating and we continue to expect cross asset volatility to misbehave. Being macro aware and data driven, we had pivoted to a more defensive portfolio, adding macro hedges such as being overweight the USD$, real estate, gold, utilities, and shorting select indexes and high yield bonds while monitoring trending cross asset volatility. History of bear markets is there are observable deterioration points across various macro economic variables before we achieve a bottom. The bottoming of the market is a process and not a point. Bear market rallies are vicious and they will perpetuate the downside because volatility remains elevated. We thus need to see lower levels of trending volatility and accelerating volume signalling to us a healthier investing environment. We will continue to be macro aware, showing discipline, and focusing on investible volatility.

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*Sincerely,*

*Christopher Panagopoulos, CPA, CA, CFA*

*The Portfolio Management Team*