FAIRCOURT
Asset Management Inc.

2nd Quarter Commentary – 2022

Summary:

We are in an economic environment of slowing growth, accelerating inflation, and tightening monetary policy conditions. Risk-on assets declined rapidly as market participants withdrew their risk appetite and scrambled to identify the short-term narratives in the market. Current bond market activity is telling us growth is now slowing, USD dollar strength continues and inflation may not yet have peaked. For market direction to change, we will need to see a macro trend reversal, usually driven by a catalyst event like a drastic change in FED rhetoric that causes the market to reposition for a different policy regime and which brings renewed enthusiasm and capital into risk assets. Both the ECB and FED tightening into a slowdown is outright bullish for the USD dollar and bearish for just about anything else. Patience remains our core allocation. It is an extraordinary complex world right now.

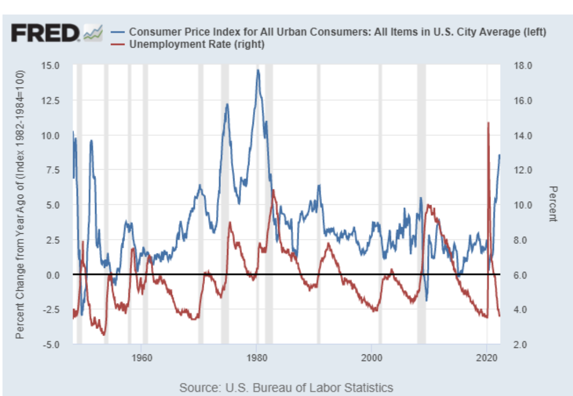
Although elevated inflation is the narrative, the probability of inflation rates beginning to abate as we move out of Q3 and into Q4 and 2023 is probable and rising. The takeways are inflation outlook is disinflationary but remains stubbornly high enough to keep the FED on track to aggressively hike into the back half of the year. This aggressive tightening has been a drag on asset prices all year as liquidity has been significantly removed from financial markets, but the impact seemed to accelerate in the second quarter. Proof is, except for 1932 and 1940, that 2022 was the worst start for the S&P500 through June.

Recap & Outlook:

There were few disinflationary signals to celebrate in the June inflation print. On the morning of July 13th, the June reading of the Consumer Price Index (ex food and energy) showed that inflation continues to be an issue despite the FED's attempts to curb it by increasing the Fed Funds rate and implementing quantitative tightening. June CPI printed +50bps acceleration from May to +9.1% year over year.

The Federal Reserve has a dual mandate - maximize long-term employment and maintain price stability. The official CPI is up to 9.1%

over the past year, which is at four-decade highs. Meanwhile, official unemployment is 3.6%, which is near five-decade lows. For the first time in history there are twice as many job openings for each person looking for work. Strong payroll numbers basically signal the FED can be more aggressive trying to increase unemployment (demand destruction) and rein in consumer spending, in order to desperately see inflation not just peak but decelerate meaningfully. The FED, right now, will sacrifice growth to combat elevated inflation. Given the mistake the FED made in dismissing inflation in all of 2021 we find it extremely unlikely the FED will be accused of being too dovish in 2022 in dealing with inflation. It is entirely possible they hike until they see the inflation prints they want and then some to ensure completion.



Currently we sit at 9.1% inflation and based on internal FED studies, out of the San Fransisco FED office, they believe 3pct+ of the 9pct+ has do with stimulus (excess demand), another 3pct+ has to do with supply chain issues and the remaing 2-3pct+ is considered healthy. The FED is thus suggesting that they can remove 3pct out of the inflation print with quantitative tightening. Supply chain issues resulting from the pandemic are real, complex, and not quickly fixed. Companies are dealing with labour issues, input shortages, rapidly changing demand dynamics at the same time they are trying to “harden” their supply chains through higher inventory levels and a more diversified supplier network. More redundancy in the system will provide more resiliency but at a significant cost. These inflation effects cannot be managed by central bank actions. Chairman Powell keeps telling us what he plans to do and those thinking he will not see rate hikes through are simply not paying attention. The FED will have to keep tightening until the housing and labor markets come off their intensely high prints. The inflation rate is simply too high and Chair Powell is desperate to see it lower. The more he publicly says he is satisfied with the labour market this is the signal to us that he plans to see rate hikes through and continue reduced bond buying.

Prior to the pandemic the FED had been dealing with 2%+ inflation prints and as such they have been focused on maximum sustainable employment, willing to let inflation (price stability) increase somewhat. But the pandemic happened and has fundamentally changed the economy. The FED made a policy mistake in 2021 by not increasing rates and not taking the beginnings of inflation seriously. In 2022 we see the consequences of those mistakes. The single biggest political problem Washington has is inflation. Inflation affects everyone, no one is spared. At this point the FED really has no choice but to follow through. Lower stock prices reduce the wealth effect, and reigns in demand to bring down inflation. This is the the most difficult thing for investors to appreciate and this is why it has been so punishing for some investors. From 2008 to 2021 the FED rescuing capital markets was in play. But now with 9.1%+ inflation that is no longer in play. At this point it is safe to conclude the FED is not ready to support the markets until they see real signs inflation is past it's peak. As we have said before, rates generally in the past have exceeded inflation. And if we give the FED the benefit of the doubt, inflation for the time being will be hovering around 6pct because they will be able to remove the 3pct attributed to excess demand then we still need 10yr rates, currently just under 3pct, to move another 3pct. Rates may not get there exactly although this tells us, directionally, to continue to expect meaningful rate increases. The reality is CPI remains near generational highs and offers little comfort for investors looking for dovish $USD trading or respite from hawkish FED posturing. Real Wage growth remains negative and falling, real consumption capacity continues to decline and the FED will continue hiking into an economic slowdown. As long as the financial system is still functioning, as long as liquidity is still present and we are not seeing systemic measures present nor the system buckling under pressure, rate hikes will continue regardless of what happens to asset prices. Outright recession may not stop rate hikes but broken credit markets or disfunctional treasury markets are the sort of things that could force the FED to pause or pivot.

"This is not a time for tremendously nuanced readings of inflation. We need to see inflation coming down in a convincing way. Until we do, we'll keep going."

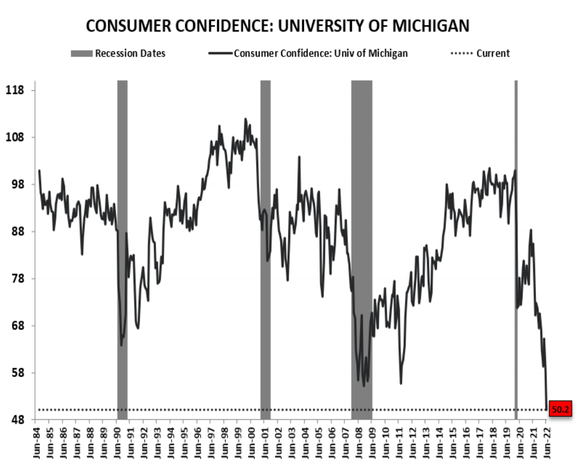
— Fed Chair Powell, Wall Street Journal, May 17, 2022

"I think I was wrong then about the path that inflation would take. As I mentioned, there have been unanticipated and large shocks to the economy that have boosted energy and food prices, and supply bottlenecks that have affected our economy badly that I didn't – at the time – didn't fully understand."

— Treasury Secretary Janet Yellen, CNN, May 31, 2022

Our faith in the FED and Treasury has been deeply shaken by its approach to currency debasement, its inability to stay independent and its failed attempt to dismiss 24 months of elevated inflation prints that was evident to anyone paying attention. While the rate of change of inflation may eventually moderate, the loss of purchasing power is permanent. The free capital markets have to provide the discipline now. FED forward guidance is said to reduce volatility. It's quite the opposite. The FED seems to have the uncanny ability to make moves at the wrong times. 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.

Data is proving the US consumer is not well positioned for this downturn. Consumer confidence and household sentiment are as low as 2008, people's expectations of the future is not promising. Their worries range from not having adequate cash to pay monthly bills, paying rent, making minimum payments on credit card debt to even having enough money for retirement. Americans are responding to these pricing pressures by putting more and more of their expenses on credit cards setting themselves up for failure. We are also seeing the savings rate has been falling in recent months indicating consumers are feeling the pressure of higher prices, forcing them to dip into savings to keep up. A recession seems unavoidable.

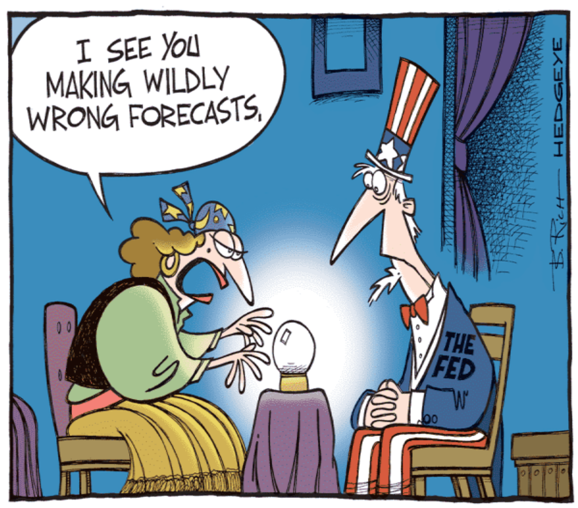


The largest central bank in the world is actively draining liquidity from the financial system while most economic indicators are pointing towards significant economic deceleration by the end of 2022. Interest rates are climbing steeply and are certain to continue climbing into next year. The S&P 500 is dipping in and out of bear market territory. The 10YR/2YR yield curve has inverted and stayed inverted. Wages are not keeping up with inflation. Consumer confidence is falling. Inventories are rising. The odds of another fiscal rescue by Congress, are low. To quash inflation via demand destruction, the Federal Reserve appears to be forcing an economic recession by raising the cost of borrowing. This reflects the new reality of Central Banks forced to hike rates to fight inflation, viewing lower equity markets as collateral damage. Real economic data lags FED decisions and that's why odds of a policy mistake are high. The real risk moving forward is multiple rate hikes during an economic slowdown. The past playbook has always been to support the economy with dovish behaviour but the new dynamic now is inflation sits at 9.1%+. Reducing inflation meaninfully has always been difficult to tackle, its no different today than it was in the 1980's during the Volker years.

Important signals for our process remains cross asset volatility, USD dollar strength, and the activity coming out of fixed income markets. Market participants are still not grasping the scale of the treasury market volatility. This is because the 2-year yield has surged amid expectations of a significantly higher policy rate this year and next, to combat uncomfortably high inflation. The 10yr-2yr yield curve has stayed inverted of late 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 20 days or more would add credibility and that is the route it seems to be taking. 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 since the 1950's virtualy every inverted yield curve has preceded a recession (11 out of 12). 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. The crucial point is to understand why the FED is tightening and why rates are rising. If rates are rising because of 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. The Bulls think rates cannot materially rise based on the point that there is far too much debt/leverage in the system and it simply cannot absorb meaningful rate hikes. 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 to begin to top and stop going up with the FED pulling back on rate hike expecations while treasuries roar back. During low inflation, Central Banks are in control. During high inflation, Central Banks lose control. 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.

Dollar strength is one of the most important variables in how risk assets perform. As macro conditions shift, it is imperative to think of the implications that a stronger dollar will have on risk assets. Since 2015, the U.S. Dollar Index (DXY) has traded within a 13 point range, from 89 to 102, oscillating through multi-year rallies and pullbacks. As the dollar strengthens, it will continue to serve as a headwind for risk assets. If the US dollar begins to weaken, it will serve as a tailwind.

The upcoming slowdown looks to be 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. Since the 4th quarter of 2021, the bond market has been signalling a rising rate environment. Our goal in our portfolios is to be directionally accurate and get allocations correct on a rate of change basis. Yield curves flatten and inverts while headed into a recession and then steepens while in a recession. For now the market risk is to the downside. We have evidence of falling retail sales, deteriorating industrial production and fixed investment and consumer confidence all showing signs of deteriorating. Also, markets may not be fully appreciating the complexities of the upcoming earnings season. This time last year we had economic growth accelerating, inflation accelerating, corporate earnings growth accelerating, monetary easing, and fiscal easing. Now in the back half of this year we will likely see growth and inflation deaccelerating, earnings disappointing, monetary policy tightening and fiscal measures disappointing. It is going to be extremely difficult for Industrials, Consumer Discretionary, Technology and Financials sector companies, in matching their triple digit second quarter 2021 earnings per share (EPS) growth being reported this summer. 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 dollar and shorting select indexes and high yield bonds while monitoring trending cross asset volatility. The U.S. Dollar is the number one asset allocation to have in this market environment. The equity market is directly correlated to the inverse of the U.S. dollar, because people are going to cash, and equities are risk off. History of bear markets is that 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. When the markets are under such pressure from an aggressive change in monetary policy, the only reason to be adding risk occurs 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. 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. For economic growth there needs to be capital available and that currently does not appear to be the case with inflation outpacing wages, cost of mortgage funding spiking, and significant wealth destruction in stocks and bonds. The big headwinds still prevail, the tightening of financial conditions and global liquidity among the most prominent. Liquidity moves capital markets. We will continue to be macro aware, showing discipline, and focusing on investible volatility. Patience remains our core allocation.



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If markets are keeping you up at night and you would like a fresh approach, give us a call at 1-800-831-0304 or 416-364-8989.

Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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