MARKET COMMENT

Murray Leith, CFA

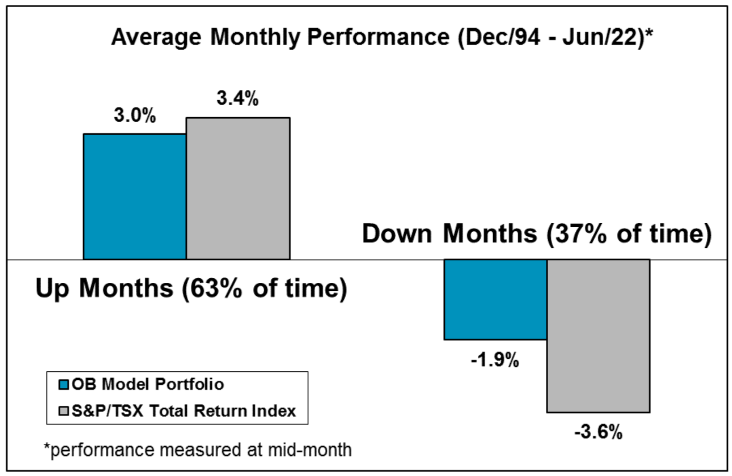
June 17, 2022

The Sugar Crash Will Pass

Stocks have dropped meaningfully due to the rise in interest rates and the possibility of an economic recession. For the year through to mid-June, the Canadian and U.S. equity benchmarks declined 6.5% and 17.8%, respectively. Similarly, the Odlum Brown Model Portfolio fell by 8.4%.

While it's natural to consider exiting the market when headlines are scary and stocks are dropping, acting on that instinct is why the average investor tends to underperform. Humans are emotionally wired to buy high and sell low. Successful investors appreciate those tendencies and resist the urge to act on them.

Our excellent long-term record was not achieved by market timing. Rather, it was accomplished by accepting market volatility and remaining invested though good times and bad. We are thoughtful about the quality of businesses we own and the price we pay. That discipline means we typically don't keep pace in roaring bull markets, but we make up for it when times get tough. The point is quantified in the nearby chart. Over the last 28 years, we have underperformed the S&P/TSX Total Return Index by an average of 0.4 percentage points during up months and outperformed by an average of 1.7 percentage points in months when the market fell. By losing less in tough times, we have more money to grow and compound during good times.



The latest downdraft in stock prices was triggered by the U.S. Federal Reserve's surprise 75 basis point increase in administered interest rates on June 15. The hefty increase is warranted by the continued intensification of inflationary pressures; U.S. Consumer Price Inflation (CPI) hit 8.6% year over year in May. For context, Canada's April CPI was 6.8% year over year.

The media has amplified the significance of the Fed's big rise by highlighting that the last time interest rates rose as much was 28 years ago, in November 1994. The following month, Mexico experienced a currency crisis and Orange County, California filed for bankruptcy protection. The sudden change in interest rates no doubt influenced those events, and it's quite possible that the recent rapid escalation in borrowing costs will cause another financial incident or two.

While that sounds threatening, consider that stocks are typically closer to their lows than their highs when headlines are gloomy. Indeed, that was the case in 1994. We incepted our Model Portfolio on December 15, 1994 and the timing proved to be outstanding. Over the following five years, the portfolio compounded at an annual rate of nearly 21%. The world has greater challenges today, and equity valuations are not as attractive as they were back then, so it's unrealistic to expect super-sized performance over the next five years, but respectable high single-digit returns are quite likely.

The pandemic has caused tremendous dislocations in the world economy, and the war in Ukraine is adding to those disturbances. Unprecedented stimulus from governments and central banks saved the world from a depression, but also exaggerated a lot of trends, both good and bad. The economic and stock market recoveries were exceptional, but they have been accompanied by terrible and unwanted inflation. Investors don't know whether they are coming or going due to all the economic crosscurrents, extreme volatility and intense debate and uncertainty in the media regarding where the world is heading.

Stepping back from the confusion and considering the evolution of events during the pandemic, one can appreciate how investors have been whipsawed by their emotions. Fear in the early days of lockdowns made investors overly pessimistic. Likewise, exuberance during the reopening recovery was overdone. We believe the fear of persistent inflation and higher interest rates will prove unwarranted as well.

When the world locked down, everyone expected economic chaos – soaring unemployment, collapsing incomes, falling home prices, rising loan defaults and bankruptcies. Instead, we saw rapid economic and stock market recoveries thanks to unprecedented fiscal and monetary stimulus – incomes rose, consumer spending accelerated, house prices soared, default rates stayed low and businesses survived. It all makes sense with hindsight. But, the authorities overstimulated the economy and induced an economic sugar rush. It wasn't sustainable because it fueled inflation. That too makes sense with hindsight.

The world is now experiencing an economic sugar crash, as the authorities withdraw stimulus to correct their mistakes and get inflation under control.

Stocks are leading indicators, and their current funk is clearly telegraphing slower economic growth and weaker corporate profits. A recession is possible and likely probable.

Inflation is a lagging indicator, and it will fall as the economy slows. Inventories are rising rapidly on the goods side of the economy, where the early and greatest inflationary pressures exist. Bloated inventories mean that price discounts will likely follow. Service sector inflation has heated up too as economies have opened up, but we think inflationary pressures there will be fleeting. With inflation-adjusted incomes falling, saving rates declining below pre-pandemic levels, credit card balances soaring and the cost of debt rising, consumers can't sustain spending at current levels.

Sugar rushes and subsequent crashes don't last. Odds are good that inflation will abate and the economy will stabilize. Investors were too exuberant during the recovery, and they will probably be too pessimistic as the economy slows. It's obvious with hindsight that many stocks were bid too high during the good times, and it's quite likely that many of today's stock prices will look like bargains in three to five years.

We are confident that the quality businesses we own will survive and ultimately thrive.
