# A Defensive Approach to Volatile Markets

Tej Rai: Inflation is that one particular market environment, that one particular phenomenon where equities and bonds are both negatively impacted by rapidly rising prices, and that's what makes Q1 2022, and potentially the rest of 2022, so interesting and difficult for investors.

**What happened in Q1 and what surprised you most?**

Tej Rai: So Q1 2022 is a very interesting and oftentimes painful times for investors because we started to see inflation on a sustained basis that we really haven't seen in 40 years, since the 1980s. And then in response to that, central banks really got aggressive in combating this inflation, in maintaining their commitment to price stability both in the US and in Canada.

And then as a response to the central banks, we had a rapid repricing of the bond market, with significant knock-on effects to equities, particularly tech and growth names in the equity sector in particular.

And so, what you had in Q1 2022 was a simultaneous decline in both equities and bonds, which has continued on into Q2, leaving investors really nowhere to hide, especially with 60/40 portfolios. And I think what surprised people was not just that these markets dropped in tandem, but I think it was the speed and the magnitude of the drop that surprised investors, in particular in Q1.

Now while that is a painful experience for investors as they watch their portfolios decline, there are some lessons that we can learn from an asset allocation perspective from Q1, and the biggest lesson here is that markets are incredibly dynamic.

The relationship between stocks and bonds is often thought to be inversely related. Negative correlation when stocks zig, bonds zag, and that's how it's been for most of the last 20 or 30 years. But that's in large part because whatever causes weakness in the stock market – whether it's an economic recession, a health crisis, poor earnings, war – doesn't negatively affect the bond market at the same time. And so, when equities drop, investors rush to bonds to find safety. However, inflation is that one particular market environment, that one particular phenomenon where equities and bonds are both negatively impacted by rapidly rising prices, and that's what makes Q1 2022, and potentially the rest of 2022, so interesting and difficult for investors.

**Why would it be a mistake for investors to sell off their bond exposure?**

Tej Rai: So, I think here we have to be careful in distinguishing what the central banks are doing, which is raising interest rates, with what's actually priced in the rest of the yield curve by the bond market. As a reminder, markets are anticipatory. They're forward looking. They're pricing in today what's about to happen in the future. And so, if you look at the pricing that's implicit in the yield curve in the US, or in Canada for that matter, there's something like four 50-basis-points hikes already in the curve. That's 200 basis points of interest rate increases that are anticipated by the central banks that are already in the price of bonds.

In other words, a lot of the pain has already been experienced by investors. And so, if you were in these portfolios over Q1 and into Q2 2022 you've already seen those declines.

Now that's not to say that bonds can't decline further, that the yield curve can't go higher further, but that only happens if inflation and the expectations for inflation come in hotter than what's already priced at pretty high levels in both countries. On the flip side, if inflation were to moderate faster than expected, if prices were to drop a little bit, we could see a relief rally in bonds. As a result, the market realizes, hey, inflation's not going to be as bad as we thought it was going to be.

And so if you're looking at things from a long-term perspective, it makes sense to stick to your asset allocation that's appropriate for your risk tolerance, for your return objectives, for your preferences, rather than trying to time the inflation prints or the markets, because the market moves very, very quickly and it's better to just take a long-term focus in our opinion.

**What are you favouring in this environment?**

Tej Rai: Throughout Q1 2022 and into Q2 we have steadily been reducing our equity exposure to the point that we're now underweight equities as an asset class. At the same time, we've done the same thing on fixed income. We've been underweight for a long time and we've stayed there. And so, at this point we're favouring cash over the other two asset classes.

Now, within equities we do have a little bit of a spread bet on. We're favouring Canada relative to the US for a couple of reasons. First, Canada is heavily exposed to commodities, which generally do well in inflationary times. And so, we think that the commodity producers within the Canadian economy will tend to outperform the rest of the world.

At the same time, valuations in the US have been historically very, very high. There's much more of a reliance on the tech sector in the US. And we can see economic activity in the US starting to fade a little bit in response to the very high inflation in that country. And so, for that reason, we generally overweight Canada and underweight US within the equity space, while remaining underweight equities overall as an asset class.

Now, that's not to say that we're not going to change our positions in the future. We are looking at the markets, both the bond markets and the equity markets very closely to see if there's an appropriate time to dip our toe back into the water, to start getting to neutral or maybe overweight. But that's an ongoing discussion within the team. We're not quite there yet. We remain underweight equities and underweight bonds.

**How can you adapt the portfolios to deal with high inflation?**

Tej Rai: So, in an inflationary environment, there are a few tools that are available to asset allocators like ourselves to mitigate the impacts of inflation on the traditional asset classes, stocks and bonds, for example. As a general principle, we want to invest in things that are either neutral to inflation or that actually have a positive exposure to inflation. On the second part, things that are positively related. I've talked about commodities a little bit. They're a great asset class to invest in. Now typically they're not a big part of people's portfolios but we do have a way to invest a little bit of our portfolio into this asset class, a couple of ways.

We can buy some commodities directly, for example gold, as an example of something we've done in the past and that we have access to in these portfolios. Or we could overweight a basket of commodity-producing equities. Stocks that produce and export commodities should benefit in this environment. Or as I mentioned, we can be overweight countries as a whole that have a big commodity sector. Canada is a big one, Australia comes to mind. Some countries in Latin America also fit that bill.

And so those are some asset-class tools that we have to combat inflation in the portfolios. Now you all know we follow a human plus machine approach to investing. On the machine side of things there are a few systematic strategies that tend to do well when regimes change, when we go from an easy money policy to a tightening cycle by central banks, it's a regime change. Systematic models, trend-following models and momentum models tend to be able to pick up on these shifts and ride the wave as it's happening. And these models are part of the reason that we're currently underweight equities and bonds. And so, we feel that a combination of some asset-class exposures, plus some systemic strategies infused into our portfolios provide an adequate mix in this environment.



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