A Differentiated Approach to Challenging Markets

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How do investor expectations influence the direction of markets?

I think it's accurate to say that financial markets work on a relative basis than an absolute basis. And this is because financial markets tend to be forward looking. They tend to be anticipatory in nature. Put another way, the price of any financial instrument today, whether it's a stock, a bond, a commodity, whatever, today will reflect what market participants expect about the future. And so as news comes out, the market will react not in isolation but relative to what's already anticipated. In other words, what's already baked into or factored into the price.

The easiest way to understand something like this is through an example. We got the July print of the US CPI. Now that number came in at 8.4 percent which is well above the feds' 2 percent target. In isolation this is bad news for the economy and should have been bad news for the stock market. But in response the NASDAQ index rallied almost 3 percent. And the reason that the stock market had such a positive reaction is that going into the print, the market expected an even worse outcome, 8.7 percent. And so seeing relative to this expectation, 8.5 was actually a really good number.

And so you can see from this simple example that the way to understand market movement and to understand market behaviour and psychology is to understand where the consensus view is. And in fact it's not just improvement for understanding market dynamics, it's really important for the success of an active management program. And that's because we as active investors, as active managers have to form views that are different from the consensus in attempts to add value. And how can we form a view that's different from the consensus without knowing where the consensus is?

Do you believe inflation has peaked?

When talking about inflation it's important to be precise with our terminology. In the US and in Canada there's commonly two definitions of inflation, which includes food and energy prices, and core information which does not.

We believe that total inflation has actually peaked, driven in part by the recent drop in energy prices, and slowing economic growth, which further reduces the demand for energy. By contrast we think that core CPI has not yet peaked and will likely stay elevated for longer. And this is because a big component of core CPI is inflation in the prices of services, and that is supported currently by low unemployment, a tight labour market, and a strong [wage? 00:02:44] growth.

Do you think fixed-income yields have peaked?

So our view in the asset allocation team here at iAIM is that short-term yields have not peaked. And this is because even though we've just discussed that some components of inflation, namely the energy part of the equation seem to be moderating, the level of inflation overall is just way too high in most of the developed world. And central banks have been very vocal, repeatedly so, about the commitment to keep raising interest rates until they see a meaningful sustained and broad based decline in price pressures. And we believe their rhetoric and we think that the market does as well.

If you look at market expectations for where the policy rate is going to go in US and Canada, it's somewhere between 3 and 4 percent, which implies that central banks are going to keep raising interest rates at least until the end of 2022.

Now on the 10-year bond, and even longer maturities, the picture is a bit more complicated. If these rate hikes that the central banks are continuing on, cause a recession or cause a so-called hard landing, we expect investors to turn towards long-term bonds as a safe haven asset class. And when they do that we expect that yields on longer term bonds will say muted.

Have you made any tactical adjustments to the iA Wealth Managed Portfolios?

Our tactical views in the iA Wealth Managed Portfolios have been very sensitive to the incoming economic data. We've really followed the economic data very carefully. At the start of the year we were underweight with both equities and bonds, preferring to stay in cash as inflation spiked to levels we haven't seen since the 1980s.

Now more recently we've neutralized our underweight fixed income, we've gone neutral in part because the bond market has started reacting to recession fears driven by the first few rate hikes by central banks. At this point we are neutral fixed income, as I mentioned, we are also modestly underweight equities. But we are going to continue paying close attention to central bank policy, economic data and the overall health of the macro economy to guide our decision making for the rest of Q3 and into Q4.

What are some key takeaways from the first half of 2022?

The first half of 2022 seemed like a very sort of unprecedented event for many investors. And in some ways it was. Because we haven't seen inflation like this, as I mentioned, since the 1980s. It's been 40 years.

However, this episode reminds us of a few key facts about financial markets in general. And the first is that markets go through regimes. There's not just on regime out there. There's many. And regimes can last a long time. You know, in the last 40 years stocks and bonds have moved in an inverse fashion to each other. And bonds have been a reliable hedge to any equity market weakness.

But we have to remember that just because a regime lasts a long time it doesn't mean that it's permanent. And so as we analyze markets and get ready for the different economic environments that can come, it is important to be open to and to consider alternative possibilities.

And in doing so, the judicious, thoughtful and careful use of data, sophisticated tools and analytics can be a real game changer. And the active manager that takes the care, spends the time, learners from and analyzes multiple regimes, builds the longest possible dataset, uses data in analytics, he's likely to be better prepared and less surprised by what happened in the first half of 2022 than a manager that just takes the easy route.

And here at iAIM this sort of discipline, this rigour, this care is in our DNA. Our North Star here at iAIM is to use the best of human plus machine and optimize the blend of expert judgement, data and analytics to position the iA Wealth Managed Portfolios appropriately regardless of what the economic environment might bring.