Finding Perspective After 2022

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VO Voice Over

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GS Welcome again to our listeners. I'm Greg Sweet, Director of National Sales. Today we'd like to bring you a new podcast to help empower our customers when making important financial decisions. Throughout 2022, we've seen increased volatility in both equity and fixed income markets. Right around now, Canadians are receiving their fourth quarterly statement. And after an eventful year, it seems like the natural time to reflect on 2022, as well as look forward to the new year ahead.

We know that our customers crave advice during turbulent times. Today our special guest is Craig Maddock, Senior Portfolio Manager and head of Scotia's Multi-Asset Management team, as well as Wesley Blight, a portfolio manager on Craig's team. Welcome, Craig and Wes. Let's jump into it. The past year was difficult for investors. What were the key drivers that impacted markets in 2022?

CM After a decade of above average returns for balanced portfolios, 2022, it wasn't a good year for investors. Many portfolios were down 10% or more from the peak at the end of 2021. That's because stock markets around the world sold off, as central banks tightened monetary policy. You think of that as code for increased borrowing costs.

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And that was in response to exceptionally high inflation. Major markets like the S&P 500 were down in excess of 20% at some point in time during the year, and we just saw a general negative trend or what we call a bear market environment for equities over the course of 2022.

Unfortunately there were very few places to hide last year, as bond investments, like stocks, also declined in value in 2022. This rapid rise of interest rates wreaked havoc on bond prices, meaning that even the most conservative portfolios lost some of their value in 2022.

There were many contributing factors to the decline that we witnessed in 2022. Part of it was the stronger returns we've enjoyed in portfolios for many years. That had driven both bonds and stocks to very high prices, and interest rates were actually at very historic lows, and in some cases negative in parts of the world. In fact at the end of 2021, you could say that both bonds and stocks were pretty much priced for perfection, when in reality the events of 2022 were far from perfect.

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High inflation is the key driver of this reset in prices. Things like high energy prices, supply chain disruptions, and significant demand continuing after the COVID shutdowns, this really was a perfect storm for markets. We had, on top of that, geopolitics, such as the Russian war in Ukraine, and the resulting global sanctions that shut the Russian economy off from the rest of the world. You get what we saw in 2022.

While every market setback is different, and I can think back through my career and the IT bubble of the late 90s, or the global financial crisis in 2008, 2009, and while the cause is always different, the cycles continue with things priced to perfection, and then something that causes that to reverse, and often quite painfully. However the good news is that the progress that follows the setback often leads to some of the best returns for investors coming out of these biggest declines.

GS We saw large divergences in performance across geographies and sectors throughout 2022. What was driving these differences in performance across different parts of the economy and different parts of the world?

WB It was a very unique environment that we experienced in 2022, and I think a lot of what Craig described sets the background for what occurred across different geographies, different parts of the capital market. It's really rare, but cash was clearly the king in 2022. Within fixed income short-duration exposure provided the most material protection from the drawdowns that were experienced across both bonds and equities.

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The FTSE Universe Bond Index fell almost 12% over the year, and most of that decline happened in the first half of the year. Whereas interest rates didn't really move bond yields all that much in the back half of the year. So we saw relatively flat performance from bonds in the back half of the year. And that came largely as the result of bond investors having correctly predicted that monetary policy was going to dramatically tighten around the world in 2022.

And even though key lending rates continued to rise right through the end of the year, the pace of bond yields, as I just mentioned, didn't really continue because investors had already expected that that policy change was going to occur, and it's unlikely, from investors' perspectives and our perspective, too, that we were going to keep seeing central bank policy rocket higher in future years. So that's all been baked into the bond market.

Then in Europe we saw a dramatic increase in geopolitical turmoil with Russia's invasion of Ukraine. That caused energy prices to soar. And in turn energy stocks, and in Canada in particular, energy stocks dramatically outperformed. In Canada we saw a 31.3% return from Canadian energy stocks when the broad Canadian equity index fell by 6%.

Western Canadian Select, which is the benchmark for Canadian oil coming out of Canada's west, it rose 78% from the start of the year to March. That's as a result of the Russian invasion of Ukraine. And it remained elevated through the first half of the year, and then started to come back down. And it fell so much that for the full calendar year, that index was down 15%.

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The same phenomenon occurred around the world, in that Brent crude was up 7% over the year, and Western Texas Intermediate, the US benchmark, was up just under 4%. Natural gas was up 6% after having increased 153% from the start of the year through until the end of August.

That played out in our pockets, too, in that inflation was rampant, and that year-over-year, energy inflation in Canada peaked at 39% in June. And that's since come down, but it's still at just under 14%, actually, year-over-year. Still extraordinarily high and polar opposite of the dramatic deflation that we saw in the first half of 2020, when we were in the early days of the pandemic and prices were coming down as people's movement was slowing down and the demand for energy was a lot lower at that point in time.

In Europe we saw for the first time since 2011 the European Central Bank raised rates, and they're emerging from negative key lending rates for the first time since March 2014. Rates have been held at -0.5% since late 2019, and are now increasing at an historic pace, with the Euro area experiencing a 10% year-over-year headline inflation. There gas prices are up over 67% year-over-year.

And it's a similar story in the UK, with year-over-year inflation being 10.7%. The difference here is that the Bank of England was a lot more proactive in raising rates earlier. And usually the UK market doesn't have a big impact on global markets, but if you think back to the earlier… I guess early in the fall, we saw policy proposals from the short-lived Liz Truss premiership having a profound impact on global markets when they came out with their mini budget which included significant spending and unfunded tax cuts.

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It was intended to be stimulative for the economy. But with financial conditions around the world having already tightened so significantly, the market response was really profound.

Bond yields spiked. It caused bond prices to plummet by such a large magnitude that pension schemes in the United Kingdom became forced sellers to raise liquidity. And ultimately the Bank of England had to step in with a new purchase program, even though they had started to raise rates. So they were trying to be more restrictive in their policy, but ended up having to ease as a result of the mini budget.

Now ultimately the UK mini budget was quashed. The chancellor of the Exchequer was removed of his duties. And then Liz Truss's premiership also was ended after only 45 days.

Supply-side economics have generally improved since the end of the pandemic, but this has been disproportionate around the world. China is starting to reopen. As you know they had severe lockdowns imposed, and now we're in an environment where COVID spread in China is rampant, as lockdown policies have started to ease. They are continuing to ease. Vaccinations have proved largely ineffective, and we're seeing capacity in hospitals not being sufficient to handle the increase in the requirement to go to the hospital because COVID has dramatically increased in China.

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Manufacturing and production in China have been pretty volatile, but have actually increased, whereas consumer spending on those lockdowns clearly slowed. And you can think back to the experience that we had in North America and even in Europe, where when people were at home or under lockdown, their spending habits changed. You were spending more money on goods, things that could be delivered to your home, and generally consumption was reduced.

There is going to be a rebound. That's likely going to occur in fits and starts. Spending will probably slow from export orders contracting on the back of lower global demand, which we're starting to see. We're still in this environment of an economic slowdown. And liquidity is being tightened by the Bank of China, even though support from authorities has been increased for economic participants like property developers, and it's hard for this to happen with debt levels being so high in China.

The beneficiary of this uncertainty coming out of China for whether they will be in lockdown or not, what that reopening will mean, has been India. And that we've seen multinational companies becoming more keen on turning to India as an alternative for their international expansion, and India has been gaining access to an increasing group of middle-income consumers. It is on track to be the third largest economy in the world by the end of this decade, and we've got multinational companies looking to try and take advantage of that growth.

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Supply chain disruption is probably another angle here, in that we have seen that happen in China, and we're starting to see the appeal of global businesses moving to India on that front as well, with Apple as an example, having warned that COVID restrictions in China were going to interrupt its assembly, and that it would be moving some production to India. A significant portion of Apple's production is intended to move to India.

And then finally I think Apple leads to the next point around stocks on the IT side and some growthier names having a tough year. Valuation has really played a sizeable role here, as past outperformance was significant for IT companies like Apple, in that in 2020, in 2021, they outperformed significantly, partially as a result of valuations having been bid up so significantly.

As consumer spending habits changed, we were consuming more goods at our homes, and that was to the benefit of growth-oriented IT stocks like Apple, and like tech-oriented consumer services like Meta or Facebook, Netflix, Disney, and Google all underperformed as those tailwinds to their outperformance started to unwind in 2022.

GS Obviously a very challenging backdrop. So an important question, how did our portfolios perform throughout 2022? Also how did the challenging environment impact our portfolio positioning? And what changes were made throughout the year?

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WB It was a difficult year for capital markets. Our portfolios were not immune to the difficulties that capital markets experienced. The tough thing in this environment was that both stocks and bonds both declined, and that's very unusual for both of those things to happen at the same time.

Usually bonds act as a counter to equity market drawdowns. But given this year's focus on combating inflation, interest rates rose at a historic pace, and that pushed bond returns lower, and the cost for capital for all companies was increased dramatically. And in turn, as investors started to think about the impact of those rising interest rates and the tightening of financial conditions, fear of an economic recession or at least a slowdown, a slowdown in earnings particularly, caused investors to sell.

The vast majority of that selling was happening in the first six months of the year, in that investors were anticipating what was likely to occur, and a lot of that selloff for both fixed income and equities happened early in the year.

Heading into the year, we were cautiously optimistic, in that we did have a defensive position for fixed income, and that was showing up through a lower allocation to interest rate risk because we did think that inflation was going to be high. It did turn out to be high. But I think the key here is that it was broadly thought that inflation was going to only be transitory.

And then on the equity side, we were neutral to modestly underweight versus our strategic allocations. And as it became clear that inflation was not a transitory phenomenon and that market conditions would continue to worsen, we became increasingly defensive with an underweight equity allocation.

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I should step back and talk a little bit about our strategic asset allocation. I did mention that we entered the year with a moderately defensive position, and that is relative to our strategic asset allocation. And this position is for the long term. It's based on our long-term, forward-looking capital market assumptions for risk, return, and correlation. So how different asset classes move together.

And risk management is really our primary focus, with portfolios being anchored on the required amount of risk to realise a client's long-term investment objectives. Our portfolios are then designed to be robust rather than optimal. And what I mean by that is we recognise that the capital market assumptions are forward-looking assumptions, are not going to be perfectly correct. And it's better to have a structure that will be robust to multiple investment environments as opposed to being only mathematically derived.

It's really an acknowledgement that we don't know exactly what will happen, and we're focused on maximising the probability of realising our clients' investment objectives through time. And we find that through time, over longer time horizons, that results in attractive investment performance. And additionally we have the capacity to deploy tactical decisions, and that's really where the movement that happened through the year came to be.

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We used tactical decisions throughout 2022. We don't typically make giant swings with our asset allocation, but we will make tactical decisions from time to time to try and take advantage of shorter time horizon opportunities. And we did this in 2022 by reducing exposure to equities throughout the year, and we moved a portion of that allocation into cash, trying to be more defensive.

So even though 2022 wasn't the best year for our portfolios, we think that we were able to preserve some capital through the year by being a little bit more defensive from a tactical perspective. And we're confident that over a longer time horizon, the decisions that we made in 2022 have us in a really good spot to be able to meet our clients' long-term investment objectives.

GS It really sounds like your investment process gives you that opportunity to be as nimble as our customers need you to be.

WB It allows us to react quickly when we see unusual market activity or significant drawdowns coming without changing the long-term make-up of our portfolios. We don't try and time the market aggressively because it's extremely hard to do that on a consistent basis, and you run the risk of pulling a client away from the ability for them to realise their investment objectives. Similar to any investor, we don't try and time the markets with sizeable material changes to the portfolio that we believe is going to realise their long-term objectives.

GS The challenging investment year has certainly tested our customers' discipline, and reality is it's painful to see losses and the volatility we've seen throughout 2022.

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I was encouraged to see the markets did much better in the second half of the year, particularly in Q4. How should long-term investors think about their portfolios after such a challenging year?

CM I think investors naturally think in terms of, as you mentioned, quarters or calendar years. While they do slightly influence our behaviour and perhaps the performance of our investments, they really mean very little over the lifetime of an investor. And as Wes just mentioned, what's really important is, can we meet your goals?

And when you think about in the context of that, and we build a portfolio, we're really building portfolios for the long term. And when people worry about short-term performance or weak performance like last year, they can sadly make some decisions that really don't help them in the long term.

We know from long periods of history that stocks and bonds do fluctuate in value, and we know as well that they generally go up in value over time. So although most major indices declined in 2022, if you measure them over long periods, they're actually up.

In fact, if you looked back at the 60s and look at balanced portfolios, they've only really declined 20% at the time. But if you're looking out over three-year periods, they've only declined 2% at the time. And if you get out to five-year periods, there really haven't been any times when, over a five-year period, a balanced portfolio had lost money.

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So while it never feels good when markets decline, we understand that is going to happen from time to time, and that is anchored in our long-term expectations. As Wes talked about, when we build robust portfolios, we know it's uncomfortable when it goes down, but we know it works out over the long term.

And therefore when we build that into our expectations, when we understand that this market volatility does show up from time to time, but yet you know that through the fullness of time, there's a high degree of probability that your portfolio will work, it gives us a lot more comfort to not make rash decisions in the face of the volatility because we expect it's going to happen from time to time.

So in terms of the different quarters in 2022, it's true some of the worst losses were earlier in the year and markets did regain some territory in the fourth quarter. And while there are more reasons for a bit more optimism, I think volatility will likely continue as we move into 2023. We are going to see some economic ups as well as some downs ahead in the year. So we have a plan for that. And as Wes mentioned, our ability to be more tactical, be a bit more nimble as things happen, we're going to manage our portfolios according to that.

GS Craig, one of the other big news items from 2022 was the rise of inflation, and then of course central banks' response to that through increasing interest rates. Where do we see this going? And do you see any other emerging themes impacting markets in fiscal 2023?

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CM Greg, this was a big deal last year. As Wes mentioned, inflation spiked for a variety of reasons. The world's major central banks had an incredible response. So raising interest rates the fastest we've seen in decades. Talking 400 basis points or 4% increase in interest rates in Canada and the US. And of course after many years of low inflation and very low interest rates, this was a real shock to markets.

I think the good news is that central bank officials have made it very clear they are planning on bringing inflation back down. So they will keep interest rates as high as needed and for as long as needed in order to get inflation back to a reasonable level, and we have seen some signs of progress on this front. Inflation has started to come down over the last few months. CPI, which peaked in June, has come down, as these rate hikes from earlier in the year are starting to make an impact.

I'm not going to tell you that inflation is not still a concern. It is. And rates will continue to climb or at least stay elevated through much of 2023 in order to fight that high level of inflation. And there is, however, possibility that sometime in 2023 we might start to see either a pause or, in fact, cuts if we see a significant recession come about as a result of the hikes that have happened already.

WB All of what you just described lead to what was a very dramatic year for bond investments. It does, as you point out, it puts us in an interesting place going forward, with bond yields being so much higher now than where they were at this point last year, or any of the last five years for that matter.

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Bond investments are much more appealing than they were a year ago. And specifically our forward-looking return assumptions are almost 2% higher for the universe of Canadian investment grade bonds than they were last year, at this time, in 2020, at this time. And that means that on a go-forward basis, with starting yields being so strongly correlated with the total return that you assume you will get from fixed income, fixed income investing is a lot more appealing than it has been in the recent past.

GS So as we move here into the new year, it sounds like there's certainly some opportunities and reasons to be excited about 2023. What can investors expect from their portfolios? And how have you positioned the portfolios for success within this environment?

WB What Craig described about the interest rate environment and not having a lot of probability for interest rates, or bond yields in particular, to continue moving up, we have increased our interest rate risk across all of our portfolios, with an expectation that that will allow us to better capture the higher expected return that we're anticipating coming from bonds going forward.

That is very much aligned with our thesis that most of the return that we assume to collect from fixed income is coming from the starting yield. This same perspective around improved performance for equities is also true, in that part of last year's poor performance for equities came from a drawdown in valuation, and that people were not expecting that earnings were going to be as strong as what has been realised, and people were starting to reduce their allocation to equities.

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They were selling off their equities with an expectation that there was going to be a worse outcome. And as a result of that, valuations have come down. And that means that going forward, the probability of there being better returns for stocks because valuations are more attractive today than they were last year, will lead to a better return from a capital market assumption perspective going forward than where we are now.

We still recognise that there is a lot of uncertainty in the immediate short term. But over the long term, we think that equities are going to perform better than they have over the most recent past. And from a fixed income perspective, we recognise that the forward-looking returns for fixed income is meaningfully better than where it was last year, or at any point in the last five years, relative to today.

So from that perspective we've moved more towards our strategic allocation across the board, with an increased allocation to interest rate risk within fixed income, and then more of a neutral perspective around our equity allocation versus strategic asset allocation.

GS Sounds like you're confirming that the views you have on the state of the market really align with what our advisors have been telling our customers. We've been telling them to stay invested, think long term, not to worry too much about the day-to-day fluctuations of the market.

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We've been telling them to focus on their investment plans and talk to their advisor to make sure they have a plan, and that that plan is built to optimise their investment needs.

I'd like to thank you both not only from myself, but also from our customers, who I'm confident learnt a great deal from our conversation today. These conversations can help provide our customers with the knowledge and the confidence to tackle these issues, leading them to make smart decisions with their long-term investments and ultimately help maintain the health of their long-term financial plans. So thank you so much for your time today.

To all of the listeners of this podcast, I want to thank you for investing your time in our discussion. Our goal is to lead with advice and to help our customers for every future. Thanks so much for spending your time with us today. All the best and have a happy and prosperous 2023.

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