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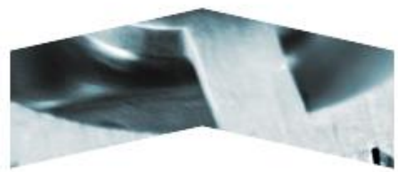
INVESTOR STRATEGY

October melt up

November 1, 2021

October Once Again Proved Volatile, This Time to the Upside

— Greg Taylor



Heading into October, the mood of the market was very cautious. Everyone could recite the fears that would cause an imminent selloff, from earnings misses, to taper plans, to China tensions. But as markets "climbed the wall of worry," the end result was one of the strongest monthly performances for equities of this post-pandemic rally. **Many markets finished October with gains in the range of 5%, regaining all of the lost ground from the September selloff and reaching all-time highs.**

The recent earnings season has been an interesting ride, as unlike in recent quarters, there has been a much greater divergence between winners and losers. Companies were able to show dramatically different results depending on their abilities to handle the supply chain issues and pass along cost increases to customers. Plans to return capital back to shareholders in the form of dividends and buybacks was a welcome theme we have seen amongst some of the winners. The energy sector is a prime example of this trend, as many companies enjoy one of the most historically profitable periods, attracting a new group of investors. However, earnings have come in as expected, albeit with slower overall growth rates, which has brought about a relief rally for investors who had feared the worst.

The gain in asset prices for October wasn't only in equity markets—crypto assets recovered the momentum they briefly lost this summer. **Bitcoin is back over $60k on the back of a +40% return in the month, with many predicting $100k by year end.** One of the catalysts for this move can be attributed to the launch of a U.S. futures-backed ETF, which has brought more investor attention to this emerging asset class. While this isn't the perfect solution for investors, it did take a positive step to open the sector to a new audience.

How investors should use crypto in a portfolio remains a core question. It's hard to view it as a store of value given the volatility, and maybe should be looked at more like a momentum-trading instrument, but given its scale and attention, it's here to stay. New products are being created to take advantage of and profit from its volatility, which in the end could make it more suitable to different mandates and even more investors.

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With so many assets moving up rapidly in value, the push for real assets as a hedge remains. Whether crypto has benefitted from this theme or not is still early to tell, but the traditional commodities could be setting up for a multi-year run of price increases. After years of investors ignoring commodity companies, the result is a lack of new projects coming. Without capital flowing to the sector, it has become difficult, if not impossible, to bring on added supply in a timely manner to meet demand. We are seeing this in copper, oil, natural gas, and lumber. There is no quick fix on the horizon, so everyone should be getting ready for this theme to become "the new normal."

The increase in commodity prices will have an impact on inflation. **Whether it's transitory or not doesn't really matter, as this impacts all asset classes and the path of fiscal policy around the world.** Higher input prices combined with higher wages all increase the pressure on central banks to remove stimulus programs and begin to look at rate hikes. Last month, the Bank of Canada ended its bond buying program—we expect others to do the same in short order. After many years of low and even negative interest rates, it appears the next few years could be the reverse, which will cause shifts from long to short duration in fixed income and towards the cyclicals in equities.

As many begin to think toward 2022, it's important to not forget about the next two months. **Seasonally, November is one of the strongest months of the year, but following such a positive October, we will have to see if this holds.** On a year-to-date basis, many markets are up over 20%, which has made it difficult for many strategies to keep pace with their benchmarks. This can lead to performance pressure that can result in price chasing, making it hard to get too bearish on the market in the short term even at these levels.

However, it is important to note that we remain in the later innings of this bull market, and at some point, the pace of gains will slow. For markets to go up, we need some mix of earnings growth and/or multiple expansion. As central banks change their stance from dovish to hawkish, they become much less market friendly, which could put pressure on multiples, while the recent earnings releases show earnings growth could become more challenging. Does this mean "buy the dip" is done? Hard to tell as their remains record amounts of un-risked capital in the market. For now, it looks like the path of least resistance is higher, but there will be bumps along the road and making a shift to prepare for the coming volatility may become the prudent solution.

The Market Cycle Remains Steady

— Craig Basinger

Equity markets appear to have largely gotten over the China issues, inflation, and slowing economic data…for now. Once again, it seems like good news on the earnings front trumps any other macro concerns. Even with some companies showing the margin strain from higher costs due to inflation or labour, the overall results appear good enough for the market. Again, we have the S&P 500 making a fresh new monthly high, a streak that goes back 12 months now. The record since the inception of the S&P 500 in the 20s (1920s that is) is 15 months in a row with new fresh highs, set recently in 2014. Impressive as are other equity markets with most sitting on 20% gains for the year. A great time to be an investor.

Based on market performance in October, clearly, we should have been more bullish. Sorry. While the market appears resilient to headwinds, they continue to grow stronger, and we want to highlight two that are front and center in our thinking.

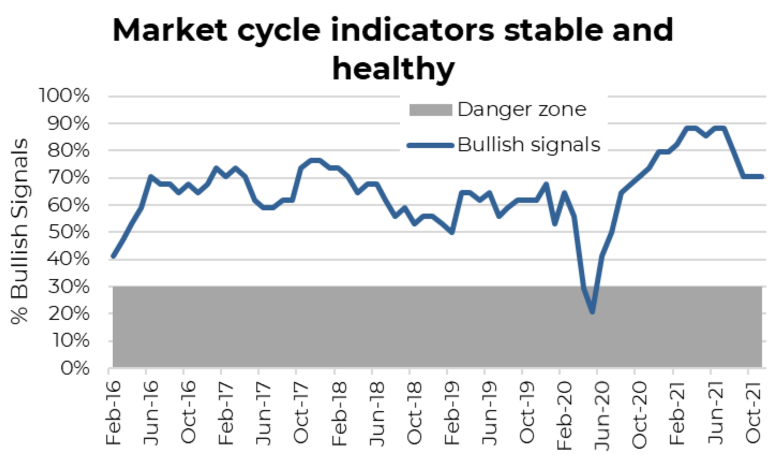
1. **Earnings** - Corporations have again proven adept at managing a very challenging fluid environment with demand volatility and supply issues, but the pressures are building (read on for a look at inflation). And even this earnings season, which is good, shows slowing sales and earnings growth. Margin and cost pressure is coming soon to a company near you.
2. **The Punch Bowl** – Remember the old adage that the bull market would continue until the central banks took the punch bowl away? Oh, how big the bowl has become…in the trillions. Take note that

while the Fed is just starting to taper likely next month, other central banks have been starting to remove the punch bowl. **Among the 25 central banks we monitor, nine have raised short-term rates during the past three months.** One eased, Turkey, but lets just leave that to a unique situation. Pretty much all the hikes are in developing nations but developed ones looks to be not far behind. The Fed will start tapering likely next month. The Bank of Canada abruptly ended its quantitative policy, triggering a sudden flattening of the curve.

The once uniform policy stance of more, more, more is starting to fragment. For now, the heavyweights, the Fed and the European Central Bank, have not budged, but policy outlook is becoming more challenging for asset prices.

The good news is that behind these headwinds is a global economy that continues to improve. The current data shows the lagged impact of the delta variant, which should be less noticeable in the data in coming months, and of course, the supply chain issues. **For instance, the U.S. economy grew at only 2.0% in Q3 but if you add back in the drag from the auto sector, you would have had 4.3% growth.** And inventories declined, which should help future quarters' data.

There is no denying, the market cycle remains healthy. The Market Cycle framework is a multi-factor, multi-discipline approach that attempts to answer the big question: is a recession on the horizon? The framework uses a basket of economic, fundamental, and yield/credit indicators that have historically been good predictors of recessions. Complicating matters is that every recession is different and because of this some indicators work in some cycles and not in others.



There is no one magic indicator. We believe combining a diversified basket of indicators offers investors a non-emotional lens to gauge if recession risks are elevated or dormant to help guide asset-allocation decisions in calm markets and during periods of market weakness.

Market Cycle Review

We would best characterize the current readings as healthy and stable. The percentage of bullish signals have remained at about 70% for the past couple months, after coming down from unsustainable highs. Even if they were to come down a bit further, we would not likely be sounding any alarms.

There's been no real movement on the rate side as a forward indicator. Clearly if we included the Canadian yield curve, which flattened substantially last month, this would be a negative. But in the big scheme of things, our yield curve just doesn't matter enough for the global market cycle. U.S. economic data was down one signal, as GDPNow turned bearish. This measurement for the economy is more focused on high-frequency data to provide a timelier indication. Not surprising, the actual GDP data supports the softening. Counter this, the global economy saw oil price changes turn from bearish to bullish. All in, we're roughly where we were last month.

Again, this framework does not help indicate if we are at heightened risk of a market pullback or correction. We do believe that risk is elevated. The Market Cycle is designed to help provide a signal if we are truly heading into a bear market/recession combination. At the moment, clearly not, which means any pullback is more likely a buying opportunity.

Market cycle indicators

Grouping	Metric			Better/ Worse
Rates				
	Net Cuts		✓	
	Yield Curve	✓		+
	Yield Curve 3m	✓		+
US Economy				
	Leading Ind (3m)	✓		-
	Leading Ind (6m)	✓		-
	Phili Fed Coincident	✓		-
	Credit (3m)	✓		-
	Recession Prob (NY Fed)	✓		+
	Recession Prob (Clev Fed)	✓		+
	Citi Eco Surprise		✓	+
	GPD Now (Atlanta Fed)		✓	-
	US Unemployment	✓		+
	Consumer Sentiment (3m)		✓	+
	PMI	✓		+
	PMI New Orders	✓		
	Chemical Activity (3m)		✓	-
	Energy Demand (YoY)	✓		+
	Truck Demand (YoY)	✓		-
	Rail (YoY)		✓	+
	Starts (6m)		✓	-
	Months Supply (6m)	✓		-
	Home Sales		✓	+
	New Home Sales		✓	+
	NAHB Mkt Activity	✓		+

Grouping	Metric			Better/ Worse
Global Economy				
	Global PMI	✓		+
	Copper (6m)	✓		-
	DRAM (3m)		✓	-
	Oil (3m)	✓		+
	Commodities (3m)	✓		+
	Baltic Freight (3m)	✓		-
	Kospi (3m)		✓	-
	EM (3m)		✓	+
Fundamentals				
	US: PE		✓	-
	US: EPS Growth	✓		-
	US: EPS 2FY v 1FY	✓		-
	US: 3m EPS Revision	✓		-
	Canada: PE	✓		+
	Canada: EPS Growth	✓		+
	Canada: EPS 2FY v 1FY	✓		+
	Canada: 3m EPS Revision	✓		+
	International: PE	✓		+
	Int: EPS Growth	✓		-
	Int: EPS 2FY v 1FY	✓		+
	Int: 3m EPS Revision	✓		-

Inflation Remains Sticky

— Derek Benedet

Current inflation readings are the highest in years, with year-over-year CPI readings in Canada and the United States at 4.4% and 5.4%, respectively. While disconcerting, the current readings can be rationalized by low bases for prices last year, supply chain issues, and a general inability for companies to properly plan and manage an unpredictable 18 months.

More alarming for both investors and consumers are expectations for future inflation. The 10-year breakeven rate, which is found by looking at the difference in yields between nominal Treasury bonds and Treasury inflation-protected securities, suggests that the consumer price index will rise by an annual average of over 2.5% for the next decade. Five-year breakeven rates have also soared, nearly reaching 3% this past week.

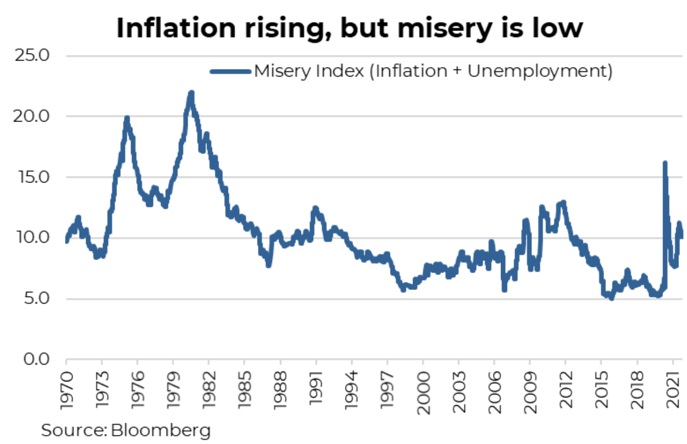
With bond yields significantly below that, investors have reason to worry about future purchasing power. The central concern is that current inflation pressures could last longer than previously expected. "**Transitory" simply means it won't last forever, but the duration of elevated inflation now appears longer than most initially anticipated.**

The Path Is Paved

Central banks are now taking notice and beginning to act. The Bank of Canada surprised the market with an abrupt hawkish stance – quantitative easing is now done and gone, and it accelerated the potential timeline of a rate increase to the middle of next year. This is a clear sign that inflation has their full attention, and that the laissez faire attitude will not suffice. Evidence of this is in their forecasted inflation rate for next year, which jumped a full 1% to 3.4%. The Bank of Canada understands that it is their job to bring inflation back to target, and they want to communicate loud and clear that they are on the job. Many other central banks around the world have already begun to tighten, with 12 of the 36 we monitor already beginning to raise rates. With the path now cleared, expectations are that the Fed will now follow suit, first with a taper. With markets at all-time highs, we don't expect much of a tantrum at this time.

Slow Growth + High Inflation = Stagflation?

Complicating matters is the showdown between slowing growth and rising inflation. No, we don't believe it's the 1970s all over again, despite Google searches for stagflation soaring. Growth is slowing from a high elevated level and inflation is rising from low levels. We are moving towards stagflation, but it is a long way off. The Misery index, which combines current inflation with unemployment, stands at 10.2% — elevated but well off the crippling levels seen in the 70s and early 80s.

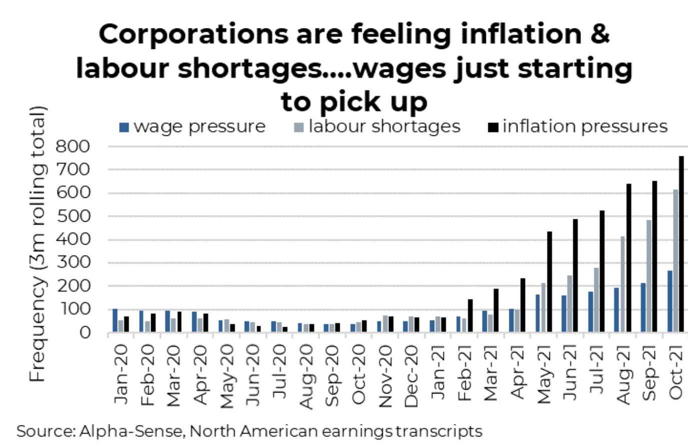


Getting Sticky

Inflation will be sticker than we've seen in our professional careers (depending on your age). Though the supply logjams will work themselves out, it could take longer than just a few quarters. The labour market is tighter than headline jobs numbers would indicate. Companies are feeling this.

The chart below shows the rising trend of three key terms:

1) Wage pressure,
2) Labour shortages, and
3) Inflation pressures in earnings conference calls.



Companies are clearly seeing the inflationary pressures and labour shortages. More importantly, they are starting to see wage pressures as well based on the conference calls following earnings. Rent is the largest component of the CPI, and owners' equivalent rent is accelerating at its fastest pace since the last U.S. housing bubble. Rent increases tend to lag property prices, which are up nearly 20% according to the latest Case-Schiller data. Inflationary pressures are beginning to shift from simply the supply shock to more structural drivers.

Market Reaction

The dominant market narrative is that rate hikes will occur faster than expected. The recent move in Canadian bond yields shows a dawning realization that central banks are going to be more hawkish than most though. While the Fed remains a laggard in terms of communication, rapidly flattening yield curve due to two-year bond yields spiking shows that the market is already beginning to price this in. In Canada's case, the gap between two- and ten-year bond yields flattened the most in almost two decades following the latest announcement. The long end of the curve is falling as there is perceived to be less need to brace for inflation longer into the future.

Real assets including real estate, infrastructure, and gold are beginning to look interesting. Rising rates are a headwind but the correlation of positive returns with inflation is attractive. We favour equities over bonds given rate risk, and within your fixed-income allocation stay short duration. With valuations elevated, we expect further bouts of volatility to continue as the market processes the impact of a potential inflationary regime change. In terms of individual equities, names that benefit from rising demand have pricing power and are less labour intensive should benefit. From a sector perspective, cyclicals like materials are appealing as well as financials given our outlook for interest rising rates.

Portfolio Construction – The Lens

— Craig Basinger

Introducing a new section to our monthly macro:

Portfolio construction will be a recurring section of the monthly strategy publication. This is where much of our macro analysis and thoughts on the markets are translated into insights for constructing and managing multi-asset portfolios. Our views on asset mix tilt, emerging markets, bond duration, credit exposure and alternatives from real assets to portfolio diversifiers. There are no specific investment vehicle recommendations; instead, it is a framework to share our views and help our readers in the portfolio construction process. This is an introduction to our lens.

This is truly the greatest time to be an investor, and not just because markets have been doing so well. Over the past few decades, fees have steadily come down and the quantity of investment options continued to rise significantly. An investor can have market exposure for a few basis points or add strategies previously only available to institutions to better diversify or customize the overall portfolio. S&P 500 exposure for 0.06% cost, add in some crypto and a liquid alternative bond allocation, the combinations are endless. Things have come a long way from building 15 stock portfolios, which is still a viable option.

ETFs, funds, individual holdings, alternatives, commodities, active/passive, or more likely a combination of many different vehicles and strategies comprise most portfolios for individual investors. With all the choices and options, it is only natural to suffer from choice overload. Complicating matters more, there is no right answer, and many paths or combinations of investments can lead to long-term investment success. However, some paths may not. Trying to ascertain material risks to a portfolio and ensure exposure are balanced or at desired levels is what portfolio construction is all about.

With the increased options available, many of which are increasingly complex, truly understanding a portfolio's exposures to various markets, risks, currencies, etc., has become harder to ascertain. Access to more strategies and more investment vehicles has led to less transparency at the portfolio level.

To better analyze multi-asset portfolio, we have created a lens to help cut through and better understand the levers and exposures in portfolios. This also provides a framework for advising on asset allocation, geographic mix, style, duration, credit, currency, alternatives, etc.

The weights represent our baseline or neutral positioning. These are in part based on available investment strategies for Canadian individual investors and generalized objectives. These are not recommended weights but would represent a pretty well diversified and balanced portfolio. We will save recommended tilts for the next edition.

Overall Allocation – Yes, with every analysis framework, it does start with general asset allocations. Our approach is no different and even this general analysis helps determine much of the portfolios risk and return characteristics. Included in the overall allocation is a fee analysis, active/passive split and product manufacturer breakdown.

Equity Allocation – The equity component is then broken down by geography. We do incorporate a healthy Canadian weight into our baseline allocation given in part because this is designed for Canadians, home country equities have less currency risk and enjoy some better tax treatments. Equities are also analyzed on a style spectrum ranging from value to growth, by size, and the developed-market/emerging-market breakdown.

Bonds – The bond component is analyzed based on duration, credit exposure, and geographic mix. The baseline or neutral measures for duration is the market (which is high these days). For credit the analysis separates government, investment grade, high yield and preferreds. Finally, the geographic mix is largely Canadian and some U.S. for the baseline. Typically going international is more of a currency tilt.

Alternatives – Clearly some great strategies for diversifying portfolios, but very difficult to classify. The spectrum of strategies is so great. We breakdown alternatives based on the broader objective(s) of the strategy into Diversifiers, Credit/Income, Growth and Real Assets. Classifying alternatives is more an art than a science.

This lens of looking at portfolios can easily highlight risks and potentially unintended exposures. We use this lens for multi-asset portfolios that we manage along with providing it as a service to advisor teams in our Purpose Advisor Partnership Program. As a generic neutral allocation, we use the allocation below. Next month, we will include our macro portfolio tilts and how they fit into this framework.

Baseline or Neutral Positioning

Overall Asset Allocation		Baseline			Baseline
Equities		50%	Active/Passive	Active	60%
Bonds		30%		Passive	40%
Cash		5%			
Alternatives		15%			
Equity Allocation		**Baseline**			**Baseline**
Geography	Canada	40%	Style	Growth	33%
	U.S.	30%		Core	34%
	Europe	15%		Value	33%
	Asia	15%			
			Size	Large	80%
Developed v Emerging	Developed	95%		Mid & Small	20%
	Emerging	5%			
Bonds		**Baseline**			**Baseline**
Credit	Government	40%	Geography	Canada	70%
	Inv Grade	30%		US	30%
	High Yield	20%		Internationa	0%
	Prefs	10%			
			Duration	7.5	
Alternatives		**Baseline**			
Categories	Diversifiers	35%			
	Credit/Income	35%			
	Growth	5%			
	Real Assets	25%			

Where Does Bitcoin Fit?

— Craig Basinger

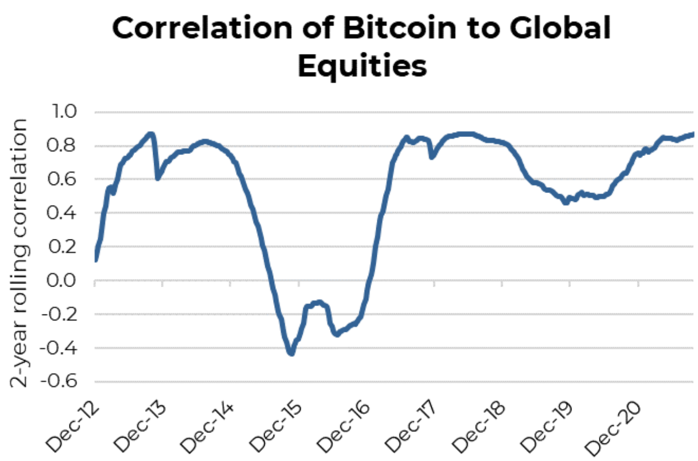
From a portfolio construction perspective, a frequently asked question of late has been where does Bitcoin, or other cryptocurrencies, fit into a portfolio. It is not an easy question either, with very diverse views on the topic. We will share our thoughts, not on whether you should or should not own, but if you do where to allocate the holding in a portfolio. For simplicity we will just talk about Bitcoin as it has the longest history.

By its very definition, Bitcoin has some characteristics of a currency and a real asset. A currency from a utility perspective is typically a median of exchange. Bitcoin fits that description but from a portfolio perspective it does not. Portfolio currency exposure either via a holding or direct currency investment typically doesn't see the volatility that Bitcoin experiences. In other words, you shouldn't call it cash, which should not be a surprise.

On the real asset side, Bitcoin clearly has a limited supply based on its construction. That is a prerequisite to being considered a real asset. We believe Bitcoin will become a real asset at some point but for now it is in the adolescent phase of a new asset class. It is growing quickly, clumsily, and is still a bit unsure what it will be when it grows up.

It is still a new asset class from an adoption perspective. It is still gradually becoming available to more and more investors. It still may face future regulatory hurdles. Even if it is a real asset or diversifier at its core, the price will likely be driven more by the pace of adoption for the time being.

The math is challenging too. Often when combining various asset classes, returns, volatility and covariance become key inputs. Given Bitcoin has enjoyed an annualized growth rate over 200% for the past decade, it does challenge the math when using historical performance. Again, this supports that it is still an asset class that is growing into its final place in portfolios. Volatility is off the map too. Annualized monthly volatility is often the standard, which over the past decade has the S&P 500 volatility at 13.4% or the TSX at 11.6%. Bitcoin, during the same period, has a volatility of 196%. Correlation with other asset classes, namely equities, is actually pretty high. This is the rolling two-year correlation between Bitcoin and global equities.



In the future, Bitcoin could easily grow into become a great diversification tool or a solid real asset. For now, given the stage of adoption, it should probably be viewed in the alternative asset class under a growth sub-category. You own it to hopefully make money and high volatility should be expected.

Source: Charts are sourced to Bloomberg L.P. and Purpose Investments Inc.

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