Wealth Management

Where we are today, and where we might be headed

Tylar Lunke:

Hello everybody, and welcome to a real time update from RBC Wealth Management. We're recording this on Tuesday, May 10th, 2022. My name is Tylar Lunke, and I lead the Managed Portfolio Strategies team. I'm joined today by Michael Schuette, Multi-Asset Portfolio Strategist at RBC. Michael, thanks for sharing your thoughts today. How are you?

Michael Schuette:

I'm very well, thanks for having me.

Tylar Lunke:

Of course. Well, thanks to everybody for listening today, and our goal is really to provide some perspective on the markets as volatility continues here into the second quarter of 2022. We hope to touch on things such as where things stand today, what we're watching, and how to think about investments when it really feels like nothing's working. So Michael, let's just jump right in. And the first question is what's happened so far this year, and really where are we today?

Michael Schuette:

I do think that's an appropriate place to start. It's really been a tough go. Lots of headlines around the equity market performance, so let's begin there. And I'll try not to use a lot of numbers here, but I think there's a couple numbers that will be important when I talk about the equity market performance. Through yesterday, which was May 9th, the S&P is down roughly 16.3% year to date. There's only one sector showing positive performance, and the technology heavy NASDAQ is down more than 25% year to date. So with those type of draw downs, let's give some historical context. For the trailing 42 calendar years, so 1980 through 2021, the S&P has experienced an average intra year drop of roughly 14%, some years are less, some years or more.

But so far, this year isn't really unprecedented in a historical context, and only nine of those 42 years did the S&P 500 end the year with negative performance. Those where the draw downs get larger, I'll concede, tend to end with negative performance. But at this point, the equity markets are more volatile than investors have experienced in a while, and therefore patience, I think, is being tested. So with that in mind, let's transition and talk about fixed income markets that are also negative year to date. And while not as severe as the equity markets, the draw downs may arguably be more unprecedented.

The U.S. Aggregate Bond Index, which is a measure of the U.S. fixed income markets, is down roughly 9% year to date. And again, that is through yesterday. From a historical perspective, you need to go all the way back to 1979 and 1980 to see similar numbers. Between July 1979 and March 1980, the U.S.

Aggregate was down more than 13%. So why is this time similar to 1979 and 1980? Well, it's all about elevated inflation, and I know we'll talk about that in just a little bit. And what we don't yet know about that is how sticky, meaning how long will that be around? If it stays elevated, there may be more pain ahead. However, there is a lot of rate hikes that are priced into the fixed income markets, we'll talk about that in a little bit as well, where you can now actually earn a yield.

Tylar Lunke:

Okay, great. Thanks for walking through and providing that historical context, which I think is important, especially on the fixed income side. So that's looking back a little bit. Now, what are we watching currently within the economy, as well as the financial markets?

Michael Schuette:

A lot of things, but I'll keep my comments really focused to the top three, those being inflation, monetary policy, and growth. Let's start with inflation, it's the gorilla in the room, and the other two are likely dependent upon what happens with inflation. Let's just set the stage for where are we now. Well, headline U.S. CPI year-over-year change was above 8% for March, this was the first time in 40 years. I'll describe the current inflationary environment as a different kind of inflationary environment, which was actually the title of a recent article published in our May Global Insight, and it's a different kind of inflation for a couple of reasons. We experienced a dramatic change in consumer spending from services to goods during the pandemic, and this really created a situation where we saw inflation in goods. Some of that was caused by the bottlenecks that we saw in exhausted shipping lines.

More recently, spending has shifted back towards services, so we're actually now starting to see more inflation within services as consumers want to travel, they want to dine out, et cetera. So we have that kind of goods and services inflation, and how much of that will we see moderate later in the year? But there's a couple of other considerations, rising wages. Labor markets are really tight, so what we're seeing is that, especially in the services side of the book, where a lot of their cost is their labor. Lastly, commodity prices. We were likely to see commodity inflation post pandemic. This has been amplified by Russia's invasion of Ukraine. So summary of inflation, we do think it moderates in the second half of this year. How much it moderates, again, is going to be dependent upon the lockdown in China.

China is a big producer of goods, so we have to see how long those lockdowns last. And then commodity price inflation, how long the conflict in Ukraine can last. Lastly on wage inflation, we're going to watch the labor participation rate. As more people come into the workforce, we may see some of the steam that we see in the wage inflation be taken out. Tomorrow, Wednesday, we're actually going to get the April CPI numbers and we'll get a look to see whether or not inflation has peaked or whether or not we got to wait a couple of months. So that's some comments on inflation. Monetary policy, which tries to impact inflation, given the reality of inflation, the Fed will continue to raise rates. They were criticized as

being behind the inflation curve, so they raised rates in March and May. It's all about how far and how fast they raise rates.

Tom Garretson, our U.S. Wealth Management Fixed Income Strategist, expects two more 50 basis point hikes in June and July. This gets us near 2%. Then the Fed will likely pivot, slow down to raising in smaller increments, getting the rates near 2.5% to 2.75% by the end of the year. We think then the Fed becomes more data dependent as they try to engineer the proverbial soft landing or the point at which monetary policy neither boosts growth nor restricts it. So that's some of our thoughts on monetary policy and where we see rates headed throughout the year, which brings us really to growth which is the second derivative of inflation. And you can think about this in terms of GDP or earnings, and I'm going to focus my comments here on earnings. To date, we haven't seen much notable movement in earnings forecasts for the rest of 2022.

We're actually wrapping up Q1 earnings, and revenue results have been good. But as a colleague, Kelly Bogdanova points out, there has been some notable misses and/or cautious guidance by some high profile firms. So where do we think we're headed with growth through the rest of the year? Slower is the obvious term, both in terms of GDP and earnings, should be expected. This shouldn't be interpreted as no growth, again, just slower growth. And with slower growth may come more modest market returns, and clients really haven't experienced this over the last couple of years. I think there's some of our summary comments on inflation, monetary policy, and growth.

Tylar Lunke:

Okay, so that's breaking down the economy, the markets, and what we're seeing those key elements of inflation, monetary policy, and growth. Now let's turn over and talk more practically about portfolios. I think one of the biggest things our clients see and have experienced is diversification so far this year, seemingly hasn't worked. And so I guess just a general question around asset allocation, is it broken?

Michael Schuette:

It's a very fair question. And given the numbers that I provided earlier, it's likely a top question on the mind of investors. I think my first comment is don't panic. You need to zoom out, and this is especially true when markets are volatile. You don't want to make a short-term decision that could impact your longer-term financial outcomes. What we're seeing today is not unprecedented. In past inflationary environments, the correlation between fixed income and equity markets does oftentimes become elevated. But as markets adjust to the current environment, we will see that correlation come down, although the timing of it is yet to be determined. I think what's important for investors to do is to review your asset allocation and determine if there is an opportunity to add some nontraditional fixed income and/or equity investments to their portfolios. But in summary, no, I don't think asset allocation is broken. I think this too shall pass, but there's always an opportunity to review your portfolio.

Tylar Lunke:

Okay, Michael, good piece of advice there as far as reviewing portfolios. And maybe just one simple question here to close things out, it's easy for me to say, but how should clients think about their investments from here?

Michael Schuette:

Yeah, I just talked about the review of their asset allocation that they can do, but it's easy in these markets to think about selling and holding cash. And just remind investors, again, to zoom out and think long term. But there's also another key thing. Not only to think long term, but investors shouldn't lose the opportunity to think opportunistically. Fixed income markets now have some of the highest yields that we've seen in years. Investors should be thinking about wading into some of these markets. Additionally, on the equity side of things, valuations have become more attractive as the price of markets has decreased without as large an offset to the earnings. Said differently, markets are getting cheaper. Additionally, during these high volatile market selloffs, you oftentimes see an overreaction in the markets, the proverbial baby being tossed out with the bath water, and you see some good companies or good sectors that get over punished and actually have really good earnings, really good cash flow, and it becomes an attractive opportunity to purchase those companies or sectors. So my last comment there would be think long term, but also remember to think opportunistically.

Tylar Lunke:

A good reminder that in times like this, opportunities do arise. So Michael, thanks for the perspective today. We do want everybody to know that we continue to publish both commentaries as well as articles. Some of the most recent that Michael even talked about in this recording are linked from the audio player, but also keep an eye out for additional content from within the Global Insight suite, as well as from across RBC. And of course, as a reminder, if you have any questions about your portfolio or specific investments, we would encourage you to stay in touch with your RBC financial advisor. Thank you all for the time today. Take care and have a great day.

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