The investment outlook and implications for investors

Mark Bayko:

Hello and welcome to an audio recording for RBC Wealth Management. This is being recorded on Wednesday, April the 12th, 2023. My name's Mark Bayko and I lead the Portfolio Advisory Group in Canada. And I'm joined by Jim Allworth, Co-Chair of our Global Portfolio Advisory Committee.

In today's discussion, we'll be addressing the recent economic and market developments, our thoughts going forward, and what investors should be thinking about as the year progresses. With that, let's get into it. Jim, we're more than a quarter of the way through the year and it's been an interesting one to say the least. We've had pockets of stress emerging banking sector and ongoing concerns over recession risks.

Yet, market volatility has actually subsided in recent weeks and even the economic data has been resilient thus far. And global equity and bond markets have actually posted reasonable returns year-to-date. So, I'm just wondering if you could reflect on your thoughts on how you've seen the year unfold so far?

Jim Allworth:

Thanks for having me here. Sometimes it's good to check back and see what you've just come through before you decide where you are now. And I think people maybe have already forgotten some things that occurred in the last couple of years. If you go back to the bottom of the market in the pandemic and the opening weeks of the pandemic where the economy shut down and was shut down by government and endured what was the shortest recession in history, lasted about six weeks, and markets followed the economy down and then rebounded when governments and central banks made it clear that they were going to stand in there.

I don't think people remember explicitly that the S&P 500 from that low was up 120% in 21 months. And the TSX, which was a bit of an underperformer by comparison, was up a pretty startling 100% over that 21 months. And they both peaked at the end of 2021. And then they went through a long stretch of correcting and consolidating. But in a pretty normal fashion and to a pretty normal degree. The S&P 500 gave back about half of what it had gained in that rocket ride, and took nine months to do it. And the TSX gave back about a third of what it had gained, and took the same nine months to do it.

If you go back and look historically, that's a pretty common thing that happens. The market does quite well, and then it consolidates and gives some of that back before it embarks again on something better let's say. So, where we are today, which is nowhere near the high we were at at the end of 2021, but well above the low we were at last October. Should be put into that context. And people also kind of start to expect that what happened yesterday will happen again tomorrow.

So, that run in stocks, by the time we were in the last half of it and the last third of it, it was just what people expected every day was the market would be up again. And then the nine-month correction became painful for people. And by the time we were in the last third of that, people were expecting the market to be down every day. And when the market was at its low in October, people were pretty sure that other large losses were coming right after that. And of course, they didn't.

To me, I look at the stock market and say, "When I look at those two things that have happened, I'm here. Now, I've got to decide whether there's reason to believe that there's another good bull market leg ahead of us or whether there's a reason to believe that there's a challenging time still ahead." And I guess to cut to the chase on that one, I would just say we do expect a recession will get underway in the second-half of this year in the United States. And every U.S. recession for more than 100 years has been associated with a bear market in stocks.

So, it seems likely to us that if we're right about the recession, then we're probably going to have another challenging period for stock prices somewhere along the line. But just as I said before about these other things, things don't go on forever. The recession won't, and the challenging time for stocks won't. And it hasn't necessarily begun yet. And between now and then, there's still room for the stock market to do well. This isn't either the sky is falling or you're on a rocket ride to the moon. It's a market and an economy kind of muddling its way, if you like, forward and usually higher over time.

The other thing I'd just throw out there is the question of interest rates. And I think this is also something worth remembering. Interest rates peaked back in 1980. They've essentially been in a down trend ever since. That meant for more than 40 years, every time you had a bond that you might have bought five years ago or 10 years ago mature and you wanted to reinvest it, you were always looking at a lower rate to invest it at. And that was challenging. There's reason maybe to believe that that long decline in rates is over.

I wouldn't make an argument for a long upward move in rates as necessarily following. But I would point out the fact that I think that the last three years of that, the pandemic period if you like, was not just a question of rates falling, it was a question of rates being suppressed by central banks. Not only did they push short-term interest rates down to pretty close to zero and tell anyone who wanted to listen, they were going to keep them there for quite some time to make sure the economy was getting back on the right footing, but they also embarked on quantitative easing, which meant they were buying government bonds and some corporate paper in massive amounts.

And going out in the marketplace and buying bonds meant that pushed the price of those bonds up, and that pushed the yield on them down. And they got the yields on bonds down to extremely low levels, not that far above short-term rates. In other words, down in the 1% range or less. And if you want conviction that this was an unusual time, you just have to know that there were a number of places around the world where short-term interest rates were negative. You had to pay the bank to keep your money. So, it's very unusual.

And what I liken it to is central banks holding the beach ball underwater and kind of promising that they would hold the beach ball underwater and keep rates low until they were sure they were out of the worst of the damage the pandemic was doing. Well, that's one of the things that had happened last year is that they took their hand away from the beach ball. And long-term interest rates especially rose back up. And if you think about it, I'm going to keep that analogy going.

If you think about it, when you hold the beach ball underwater and you let it go, it pops. There's so much force behind it that it pops and the ball goes right out of the water and is above the level of the water. But of course, it's worth noting that it doesn't keep on going and fly to the moon. It just gets a couple of inches above the water and then it settles back into what would be equilibrium, which is the water level. So, central banks held rates way below the equilibrium level. When they let go, they got a predictable result.

Rates shot up and got above the equilibrium level, and now have backed down to it. We're at rates that are the kind of rates on bonds that were around before the pandemic arrived. And so, I think in a way, the interest rate market has normalized. And yeah, rates could go up from here under pressure of certain things, and they may go down from here under pressure of other things. But they're starting from kind of a normal level. And I think that's worth thinking about. So, here we are a quarter in. And we've got an economy that's still holding together, but it's not exactly vibrant or robust in many ways.

And we've got markets that aren't going down anymore in a disturbing way, but they're not going up either. They're kind of holding their own and looking to see which way the economic wind is going to blow. And I think that we think the economic wind is going to blow towards a more challenging period. And that under the surface of an economy that's still reporting growth, a number of things are deteriorating in the way that they're going to present challenges for the economy later this year and into the next year.

Mark Bayko:

Thanks for that, Jim. Now, I'm just wondering if you could elaborate a little bit on the impact of tighter financial conditions. Because you've repeatedly made the point in the past that the arrival of tight financial conditions has historically led to recessions and bear markets, but usually with some kind of a lag.

And I think maybe it's the world we live in, but people tend to want to see something develop quickly. And yet, the talk of a recession's been out there for a while. But is it that we're just living through this lagged period right now and inevitably at some point will start to see the tighter financial conditions start to have an impact?

Jim Allworth:

So, yeah. I do think that. And I think you've hit on the things to remind ourselves of. The arrival of tight credit conditions where loans are expensive and hard to get has been the deciding factor that pushed economies in recession over, and over, and over again. There's only two exceptions to that sort of tight money rule, if you like. And one of them was the pandemic where it was just government that shut the economy down. It wasn't credit.

And the recession that followed right after World War II where the world was changing from wartime production to peacetime production. With those exceptions noted, all the other recessions have been basically started by the arrival of tight credit conditions. And we have them now. And I'll tell you what we look at. But I'd also tell you that we have seven indicators that we publish as our recession scorecard. Two of them kind of speak to this question.

One of them is the shape of the yield curve, that I'll get to in a second. And the other one is an interesting one that isn't talked about very much, but I'll just mention it. The first one, the yield curve told us a year ago, or not a year ago, but seven or eight months ago, that a recession was on the way. The other one hasn't gone negative yet. But it typically goes negative just before you go into recession. And I'll mention what that is.

And that is that there has not been a recession, certainly since World War II, without the federal funds rate in the U.S., so that's their bank rate, without the federal funds rate getting higher than the growth rate of the economy first. Federal funds rate is out there every day in your face. It's on every screen. It's in every newspaper. It only really changes when the Fed meets. And the Fed only meets eight times a year. And there's a lot of chatter about what they're going to do next.

So, it's something that everyone can be familiar with, and has a pretty good idea of where it is today, and has a pretty good idea of where it might be headed. The second part, the growth of the economy, is a little trickier. Partly because you only hear about it later. The quarterly GDP takes about 30 days before it's computed and released. And even then that's only the first estimate, and there's two more to come, although that first estimate's usually pretty close to the mark.

But the other thing that makes it a little challenging that in this case is that what we're looking for is nominal growth, not real growth. The real growth rate, and by real, that means with the effective price increases taken out, is what we usually hear. The nominal growth rate leaves price increases in. And you normally don't hear that. But you can find it easily enough on a stats scan for Canada or the Federal Reserve data for the U.S. That observation I made, that there's never been a recession without the federal funds rate first getting higher than the growth rate of the economy, the growth rate it's going to get higher that than is that nominal growth rate that leaves inflation in.

And to give you a reference point, last year for the full year, the U.S. economy looked at that way, grew by 10%. And at the end of the year, the federal funds rate was still only up just slightly above 3%, still a long way below the nominal growth rate. Now, in the fourth quarter last year, that run rate had slowed to about 7.5%. So, it'll slow further in the first quarter in all likelihood. And the federal funds rate isn't at 3 anymore, it's at 5.

We think the nominal growth rate of the U.S. economy will be down to 5% or less by the time we're into the third quarter of this year. And the federal funds rate at that point will then be higher than the growth rate of the economy. And that condition then will have been met. If you like, the starting gun will go off then. Now, let's go back to the yield curve. And when we say the yield curve, we mean the relationship between short rates and long rates, short-term interest rates and long-term interest rates.

What's normal is for short-term interest rates to be lower than long-term interest rates. What's abnormal is when short-term interest rates, as they do periodically, rise above long-term interest rates. That's a pretty good sign that credit conditions are starting to tighten. And we can look back and we can see that over the last century, whenever that inversion of the yield curve, that's what that's called when short-term interest rates move above long rates, whenever the yield curve is inverted, a recession has always followed.

And on average, it is followed about 11 to 12 months after inversion. The yield curve inverted last July. The one-year Treasury yield moved above the 10-year Treasury yield last July. So, the clock started. And about a year later, the U.S. would normally be in recession. Now, I'm saying about a year because occasionally, it's been 15 or 16 months down the road, occasionally it's been only 7 or 8 months down the road. But a one-year average is not bad to hang your hat on. And that would indicate about the third quarter that we'd be in recession.

So, go to your comments about dealing with the lag. It is difficult for people to deal with the lag. When the yield curve inverts, there's a lot of chatter about it. People note it. It hits the financial press. There's lots of people talking about it. And they're saying, "A recession indicator says hard times on the way," or something like that. And even if they bother to mention that it's going to be a year later, they kind of downplay that. What that story says is, "You thought we were in good times, but we're telling you bad times are coming, or tougher times are coming."

And so, it gets a lot of press and a lot of people think about it. But not to be disparaging, but I mean, and I'll include me in this, most people don't have an attention span that regularly works at a year or longer. Their attention span's kind of later today. Or, maybe a really mature person can think out a week or a month. Most people give lip service to whatever might be happening a year down the road. So, when people say, "Well, this is telling us a recession's coming a year down the road," people kind of think, "Well, that's not very useful. I mean, what am I going to do with that?"

Well, I know what I do. I go to the closet and get my be-a-bit-more-cautious hat. The yield curve has a perfect track record of telling you when a recession is coming. If there's something that has always happened before a recession is coming, and it's happened, is there a big reason to imagine that this time it's going to be different? Well, I don't think so. Sure it might be. But I think you start with the operating assumption that this thing has been hugely reliable. We'll be close to the mark again this time.

But there's a lot of debate out there, and debate makes news. There'll be people who will say, "This time the world's changed. The computers are running credit markets. It's not the same," and so on. And that has happened over, and over, and over, again whenever the yield curve is inverted. So, that's what's happened. And people in the process have kind of lost interest in this. If anything, our interest is sharpened because we're now that much closer to a year away from when the yield curve inverted. And in our view, we're in the zone where recessions could easily start, and in all likelihood are going to at some point in here.

So, I think it is difficult for people to deal with the lag. But both the yield curve telling us when the recession arriving and that other indicator I mentioned with federal funds rate eventually getting above the growth rate of the economy as the growth rate slows, are both worth noting. And they both suggest, I think, that we should be approaching the recession with an eagle eye, but also, thinking about how we're positioned in investment portfolios. And is there some acknowledgement we should make to the idea that a recession is coming and think about what we'd do?

Mark Bayko:

Yeah. Now, maybe we could finish just on that. With that in mind, what are some of the things that investors should be thinking about as they're assessing their portfolios with the view that there are some challenges still to come with the recession out there on the horizon?

Jim Allworth:

Well, it's not for nothing that we run portfolios that are balanced portfolios. Balance is a good word to use. And it's balanced in a lot of different respects. In our minds, in many ways, what we're doing is always trying to lean away from risks that aren't worth taking and lean towards risks that maybe present good, worthwhile opportunity. It seems to me in this case, you want to identify the kinds of risks that aren't worth taking in a recession. Because they're probably a change compared to the environment we've been in.

Recessions are not the same as a growth environment. And so, figuring out what risks you don't want to take are worth thinking about. And at the same time, acknowledging that bear markets have been associated with recessions, but they usually end before the recession does. Usually, three or four months before the recession ends. And somewhere out there in the lows are some great opportunities.

And this idea that looking for a chance to lean towards risks that are worth taking is something that will happen when we're in recession. So, I think thinking about that. And that puts job one right at the moment, is thinking about risks that might arise in recession. And one of the risks that's out there might be that people have underestimated or overestimated their tolerance for recessions in bear markets. You can talk about them academically. You can show the data, the ups and downs.

You can listen to a guy like Warren Buffet who just says, "Look, just own great companies and own as long as possible. And great companies come back from even difficult times and do well." It's great to listen to those things. And there's lots of arguments and evidence that suggest that's entirely possible and not a bad approach. It's just that you have to understand how people's mind changes during recessions because they don't seem benign, and easy to deal with, and I'll just tough it out for a while.

When you're in the middle of them, they can be very disquieting. News reports become intensely negative. Unemployment is usually rising, people are in distress, businesses are in distress. Unexpected things happen that sort of pile on the pressures. And the longer the recession goes on, the more people become influenced by and in touch with the weaknesses in the economy that they weren't paying any attention to before, but now, are kind of first and foremost.

And you can be sure they're going to be reported on. The tenor of the news reporting on financials in recessions just gets increasingly difficult and negative. And share prices go down. And usually, it's temporary, for sure. And usually, some of the worst damage is done right at the end, and might even be done on the very last day, a lot of the damage. But as those pressures build psychologically and markets drop for a while, then very often people who thought they were not going to have any problem toughing it out and going through that challenging period, don't feel that way.

And they get pushed into making a decision under difficult pressure at the wrong time. So, I think the first thing that everybody should be doing is just getting in touch with their risk appetite. And it's not the easiest thing to do because tough times you might have been through in the past aren't as sharp in your memory anymore. You don't think about them in the same terms or with the same sort of adrenaline push that you did when you were living in the middle of them.

So, I know that majority of our clients have investment policy statements that kind of set out how they want their portfolio to be run. The mix between asset classes like stocks, and bonds, and so on, how far we're willing to let say our target asset mix get offsite before we want to rebalance it. Those sorts of things are all covered in that.

And if you were somebody who is sitting down and working on your investment policy statement with your advisor shortly after the financial crisis ended, my guess is that you were probably writing down things that said you wanted to be comfortable, and you didn't want to take big risks, and you were prepared to forego maybe the biggest returns if you knew that you could construct your portfolio in a way that you wouldn't have to go through periods of great anxiety.

Well, after the financial crisis, we embarked on what turned out to be the longest uninterrupted economic expansion in U.S. history and Canadian actually, pretty well. And the longest uninterrupted bull market in history. And the longer that went on, the longer people forgot the distressing pressure they had been under in the financial crisis. And the less that they wanted to make sure that they could sleep at night and the more they wanted to capitalize on returns that seemed to be out there offered in the market.

And I think it's a good idea always, but certainly at a time if you thought that a recession was coming, even if it turned out that we were wrong about that and a recession didn't arrive, I think it's always a good idea to check in on your risk appetite. And see whether you are feeling your portfolio is structured in a way that that will allow you to deal with challenges when they arise. I think that's the biggest thing to be thinking about.

You can think about different kinds of stocks to own. You can think about stocks not to own. You can think about the degree to which you want to have stocks in the portfolio relative to fixed income. All those things are definitely worth thinking about. But I think in the context, especially of your tolerance for risk over any challenging period that should arise.

Mark Bayko:

Great, Jim. I think reassessing your risk appetite is just a great takeaway to finish with. So, why don't we wrap it up there. Thanks as always for sharing your insights. Look forward to doing this again at some point soon. And thank you everybody for listening. If you have any questions, please reach out to your representative at RBC Wealth Management.

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