Inflation, Market Volatility and Your Portfolio

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

Marcelo: I'm doing great, Keith. This is going to be a good episode. I'm also happy to be back on the show, and summer's going great. Yeah, it's going to be good.

Keith: Yeah. We both took a week or two off in terms of podcast updates. What's going on in the markets? What's going on in stocks, bonds, interest rates, and inflation? What about recession or not? And we'll talk about portfolios, where things are at, and what our recommendations are for investors in terms of how to move forward.

Marcelo: Yeah, it's been quite an interesting year, but the good thing is that we're able to go out and enjoy life, but it seems that it's coming at a cost on the investment side and in the inflation side. But anyways, we'll talk more about it when we get to the show.

Keith: It's interesting that you mentioned that. I remember in the middle of the pandemic having discussions when stock prices were high, but we were all locked in our homes. And I recall saying be careful because when we're all out, maybe we get something on the downside on the investment front. So it's one of these things where you can never be perfectly happy and we're seeing the need to stay patient and to be balanced. So, listen, Marcelo, let's talk about actual returns year to date. So, we'll review fixed income, bonds, Canadian stocks, U.S., international, emerging market, and global real estate.

Marcelo: So there's a few themes in the market. We're officially in a bear market, so that's when markets get down 20% or more. We're officially in a bear market.

Keith: Yeah, but that's a bear market technically only in the United States, correct? And it's one of these things where individuals are hearing this word a lot, but it's really the S&P 500 that's moved into that bear market territory, which is the minus 20% correction. Some other general markets are not in bear market condition. Canada is not, and Europe as well. So, Marcelo, talk to us about actual asset class returns year to date.

Marcelo: Yeah, everybody wants to know those numbers, right? The short-term bonds are down 4%. The Canadian bond universe for bonds, which are longer-term bonds, is down 12%. Then you have the equities. So, Canadian stocks are down 9%, U.S. stocks 18%, international stocks 18%. Emerging stocks are down 16%, and global real estate, believe it or not, is down 18%. So this goes against the common belief that real estate never goes down for those out there who believe in real estate.

Keith: We'll talk about that a little later in this episode, but what I think is a bit unique as well for most investors is that we have negative stock returns but at the same time negative bond returns. And so what they've experienced in past years is when stock markets get a little bit of a shock, bonds usually do well. And so with rising interest rates, that has not been happening. Bond prices have been going down, and equity prices have been going down. So both sides of a diversified portfolio are going down. Yeah. What most people wouldn't necessarily understand is that there are different areas in the bond market and each of these areas is reacting differently. So, for example, long bonds, 20-30 year bonds, are down about 20-25%, which is absolutely shocking. Now, the reality of that is that interest rates have gone from somewhere in the vicinity of 0.6% to just over 3% in a matter of a year and a half. And so that's the middle of the pandemic to where we're now coming out with an inflationary issue.

Marcelo: Yeah.

Keith: These are big themes, like lots of different things are under pressure right now.

Marcelo: Yeah, it's a weird environment specifically for what you said. Clients are used to seeing bonds do well in a period where stocks are going down or we're seeing a lot of turbulence in the stock market, but this is definitely unusual.

Keith: It's unusual, but when you think of what's going on with inflation and federal banks increasing interest rates, it can be explained.

Marcelo: Yes, of course.

Keith: Marcelo, if you recall, we did a show on inflation, an episode in the fall of 2021, so about nine months ago. What were the major themes that we were discussing at that point?

Marcelo: Yeah, so I think in that episode we discussed how a lot of the consensus in the central banks and in the experts was that inflation was transitory and supply was going to readjust with demand, and we were going to have equilibrium pretty soon and inflation was just going to be a transitory thing where people were going to experience it for six months or something like that and then go back to normal. But that definitely hasn't been the case. And you definitely feel that there is a high concern in central banks right now. And that's global, not only in Canada and the U.S. It applies to Europe, it applies to Australia, and many of the emerging markets as well.

Keith: Yeah, you're absolutely right. That was the big theme that we discussed on that show, which was central banks thinking that this is all going to go away in six months. And it goes to show you how hard it is to forecast.

Marcelo: The problem with forecasting is we've talked about this many times, right? Like you're always integrating available information to make projections. And then you have something like the war in Ukraine, which comes completely out of the blue, and it wasn't known at the moment. So that's why predictions don't work, because there's always what makes things move in history and in markets is like this idea of black swan or things that you can't predict. And that's why predictions are futile because you always predict with what you know today, but everything that happens and makes people react in a different way is like unknowns.

Keith: Yeah, absolutely. A hundred percent. What they did predict was that the whole world would open up again. There'd be an opening of economies. And yet here we have China for the first half of the year in complete lockdown with zero COVID, and that affects factories, which then affects supply. And so that was not something that was expected.

Marcelo: The other thing too is the central banks, we obviously look for guidance from them, but at the end of the day, they're dealing with a model, and a model is just an abstraction of reality. And they're trying to predict things in a way that fits the model that they have for predicting inflation and interest rates. But they're human beings at the end of the day, and they make mistakes. And they, I think, there is uncertainty in their models right now as to how to deal with the inflation. And that's creating a lot of uncertainty that's translating into the stock market being very volatile as well.

Keith: Let's switch gears and really talk about the main theme. I know we're edging into it. The main theme for the first half of 2022 is essentially inflation and its impact on so many different things. We did a nice intro in terms of what people were thinking about six months ago, but where are we at now? What are the four main drivers that are being used to explain why we have high inflation?

Marcelo: Yeah, so inflation is right now at 7.7% year over year as of May of 2022. So significantly higher from when we did that show. So I think when we did that show it was trending upwards, but again, everybody thought it was transitory. But I think the four drivers of inflation now are that, one, global supply chains are still facing bottlenecks from COVID-19. There's a surging demand for consumer goods, so a lot of dollars chasing few goods, and that's definitely driving prices higher. Then you have the lockdowns in China, which have slowed production again and ports are closed. So there's still that issue that we haven't figured out. And obviously the war in Europe and Ukraine is causing a lot of disruptions as well in terms of oil, natural gas, grains. So that's adding to the inflationary pressures. And then the last thing is like the government support, the free money that the government gave to support people who were losing jobs during COVID-19. Now that everything's opening up and we're going back to restaurants and traveling, so this money is also affecting the inflation. So I think those are the four main drivers. I don't know if you want to add anything else.

Keith: Yeah, no, those are great drivers for sure. The only thing I would add is maybe it's the labor shortage. You can't go anywhere without individuals saying they need more people either to work in their restaurants, their shops, their companies. Marcelo, I called a restaurant this week to try to book a Sunday night dinner with my wife, and they said they're not taking bookings, they're closed for the entire month of July. This was unheard of. And I was actually speaking to the owner, and he said we're giving our current employees a break, but we also are short-staffed. And you can't help think that no matter where you go, whether it's travel, restaurant, all the things that were shut down before, they don't seem to be working very well. You can't buy items. There's shortages everywhere. It's almost like the economy feels a bit broken.

Marcelo: It's a tough question because inflation is tough to deal with because, again, you have central banks who need to raise interest rates and the cost of borrowing and slow down the money supply, so to speak, but they can't fix supply issues that are out of their hands. And also on the labor side, if you're an employer and you have employees that are demanding higher wages because of inflation, this is only affecting the inflation even more because as you raise wages, people keep their spending patterns. So it just makes the problem worse. So it's not an easy thing to get out of. That's what's going to be interesting in the next few months.

Keith: So, what's being affected right now? Let's go over the main areas of either investment portfolios or a general economic environment. What does inflation affect? So, let's start with bonds. What happens with bonds?

Marcelo: Yeah, so bonds obviously take a hit because as inflation goes up, interest rates go up, and bonds move in opposite directions. So, as you said, if you have a long-term bond versus a short-term bond, the long-term bond takes a higher hit because of this thing called duration. So, they tend to have more of a sensitivity towards interest rate movements. So, when you have a long-term bond, it will have a higher hit than a short-term bond. And that's just because of risk, right? Like when you borrow the money and you have a 30-year time horizon to pay back, the risk is higher, right? It's a logical thing in the bond market. So that takes a hit.

Keith: Fair enough. And so what you're essentially saying is federal banks are raising interest rates around the world to fight inflation, and that will affect bonds.

Marcelo: Correct.

Keith: Let's go to stocks. What happens when interest rates go up? Why are stocks so volatile right now? And why are they off, let's say, 15-20%?

Marcelo: I think inflation, when you think about the business cycle, it's like the pinnacle of the growth business cycle. So when you have an economy that goes through cycles, inflation tends to be like that one last step when you're coming from a growth period. So the natural business cycle is you go through recessions, adjustments, the economy grows, and sometimes it gets overheated. And when you find yourself in a situation like that, it's typically in high inflation periods. And that means is like what goes after that is a recession. So I think the stock market is pricing in this idea that we're going to hit a recession and that central banks raising interest rates is going to cause a recession. So the stock market is not actually pricing a soft landing. They're actually pricing in a recession. And we've said this many times in previous shows, what we have to remember about the stock market is that it's an information processing machine and it's a forward-looking projection machine. So it's integrating all available information today and projecting into the future. So I think that's why the stock markets are down because the inflation is signaling that it's the last step before the recession, so to speak.

Keith: That's still, the jury's out. We're almost suggesting recession for sure, but we know we can't do that. And I know you're chuckling in the background. The reality of it is, is it a recession? Is it a soft landing? We just don't know, but your point is still very valid, Marcelo, which is the rising interest rates. There's a fear that the economy will slow down and central banks are trying to put the brakes on in a way that they'll have a safe soft landing. Whether that will happen is, I think, the big question.

Marcelo: And at the end of the day, consumers get affected by their purchasing power ability. So what used to cost $10 now costs $20. And I think the concern there is that people will slow down consumption and companies will suffer. But the one thing that we know from history is that the one investment that does keep up and beat inflation is stocks. And that's the main reason for that is that if you have a business and prices are going up, you can take that price increase and transfer it into the consumer. Bonds don't have that ability, but businesses do have that ability. So I think that's one of the things that we forget sometimes.

Keith: Yeah, and that's a long-term perspective. Absolutely. Absolutely. So obviously, interest rates affect all sorts of things within the economy. Companies have higher borrowing costs. Individuals have higher costs. And one of the big things in Canada is interest rates going up will affect mortgages, mortgage rates, and mortgage rates going up will affect the affordability of mortgages, whether individuals can buy the same amount of home they were able to buy two years ago. So we're already seeing statistics across the country that are suggesting that home transactions are down significantly from last year and home prices are maybe under a little bit of pressure. So you can see that interest rates affect home prices, mortgage affordability. Within a diversified portfolio, they affect fixed income, they affect equities. And then the big discussion right now is, is there going to be a recession or not? What about inflation long-term, Marcelo? We have a nice chart in here that talks about different periods since 1951, and we've broken it down into lower inflationary periods and higher inflationary periods. And for the most part, lower inflation means anywhere from 0 to 4%, and that seems to represent about 70% of the time since 1951. What comments would you have about that chart in terms of inflation?

Marcelo: I think that's the one that inflation tends to be lower most of the time. So 70% of the time, it tends to be lower than 4%. It's a good sign for people, and it's a good reminder that high inflation tends to be temporary and it does end up coming down in the long term. Then the other thing is what we discussed before is that the only thing that beats inflation long term is stocks. So that's the one thing I take from that chart.

Keith: Yeah, and to add to that, it does appear that you get higher stock returns or investment returns with lower inflation and that real returns may not keep up with inflation during high inflation periods. That's also a takeaway. And the other thing they spoke about in this particular piece was the direction of inflation. So when inflation was tending to be going up, that had a negative impact on bonds, on stocks, et cetera. So direction is a big thing. When inflation appeared to be coming down, asset prices lifted. In other words, they're anticipating continued movement in that particular direction.

Marcelo: Yes.

Keith: So right now the markets are digesting, "Oh, inflation tends to be high and staying high." We need to see a break. It's like a break in a fever. We need to see that break for things to potentially start to improve. So Marcelo, let's switch gears a little bit and speak about our portfolios, how things have done in the last six months, what seems to be working well, and just some wrap-up comments, some suggestions and recommendations for our listeners.

Marcelo: When it comes to our models, I'll give you the two extremes. So the 100% bond portfolio is down 8% and the 100% equity portfolio is down 12%. So everything in between, the 70-30, 50-50, 60-40, 70-30 is in between 8% and 12% down. And I think that's not surprising for what we discussed, right? If you have bonds right now, you're taking a hit the same way you're taking a hit when it comes to equity. But there is a silver lining for how we invest money. And what we've seen, as I mentioned this at the beginning, is we see that value stocks are outperforming growth stocks. And we have seen that anybody who follows the market has seen how the highly overpriced meme stocks or stocks that were very famous during the pandemic have taken a significant hit from highs like back in November. So when we look at our model portfolios, when you look at, say, the Canadian equity sleeve versus the broad benchmark, we're outperforming that benchmark by about 5.9% on the Canadian side. When you look at the U.S. side, we're outperforming by about 1.6%, and on the international side, we're outperforming by about 1%. What's happening there is, yeah, the broad market is down. We're still down on our portfolios, but because we have that tilt towards value and small cap, and that's doing better than growth portfolios or stocks that weren't really profitable but they were doing great because they got hyped, we're seeing that translate into the returns that we're seeing for our portfolio. So that's good.

Keith: Yeah, that's very good. And again, let's say our equity portfolios are down 12% year to date. I recall speaking with a few clients last week and they just assumed that their portfolio was down 20%. And when I say 12%, they go, "What? Really? That's amazing." Yeah. And again, partially this is coming from staying the course, diversifying between Canada, U.S., international. Canadian equities have done much better, relatively speaking. So we haven't been chasing and we haven't been piling into all those securities that were going gangbusters a year and a half ago but have also done a complete 100% reversal. It's part of our longstanding investment philosophy, which we've been working with for 20 years now. And yes, you're right, the tilts towards value—value underperformed for that five-year, four-year lag between '17 and '21, and '21-'22 it's coming back and it's helping protect client portfolios. Marcelo, let's do the wrap-up right now and finish with our recommendations for our listeners.

Marcelo: I think we understand that it's tough to see the markets go down. I think it's one thing to know that the markets go down. The other one is to feel it. So we do understand that it's hard for clients and even for us, right? But I think the one recommendation I would have for clients is timing. The market is extremely hard. So if you feel like you have an urge to get out because you feel like the market will keep going down, you have to resist that urge. And it's very simple because we know from research, and we've discussed this in one of the few episodes we did, Keith, about how timing the market doesn't work or moving things around doesn't work. And it's simple. The research shows that once you have down days in bad periods, most of the time you get the best days intertwined between those bad times. So if you were to miss those times, it could change the whole trajectory of your portfolio. So we've seen data that looks at if you miss one, two, three, five of the best days in the market, it could really change the trajectory of the portfolio for the worse. So obviously, it may seem counterintuitive that you could get out and then get back in at the right time, but you have to be right twice. And we have tons of data that shows that's not the case. So my number one recommendation is just stay the course, stay invested. If you've worked on an asset allocation, just stick to it.

Keith: Yeah, absolutely. And you're talking about these big up days.

Marcelo: Correct.

Keith: And these big up days occur usually when there's a bunch of down days or after a whole series of negative days and negative periods, all of a sudden you get the big up days. And you're saying investors risk losing or missing that.

Marcelo: Yeah. And then the other thing too is, as a second to my recommendation, is you will also have to think that if you've set up a portfolio and if that portfolio, say, in a given year is up 20% and you put a dollar into that portfolio, you're still buying your portfolio, which you believe in, which is good. It's a nice thing, but your expected return on that single dollar is lower than if you buy your same portfolio when it's down 20%. It's just simple math, right? If you buy a portfolio that's down 20%, your expected return of that single dollar is higher. So if you put money now and you believe in your plan and you've worked on your asset allocation and you're confident that's going to get you to the finish line down the line, we're talking long term here, we're not talking one, two years, right? It's something that's smarter to do as well.

Keith: Add to that, when you invest when markets are down 20%, there's so much research out there that shows that after one, three, five years, the portfolios are typically up quite a bit.

Marcelo: A hundred percent.

Keith: And we're going to dedicate an entire show, Marcelo, in the next few weeks on those types of stats and those types of data. But clearly what you're speaking about is expected returns. At this point, with interest rates that are higher and equities that have come down, expected returns for all asset classes are higher. You want those higher returns and so, in fact, if anything, we suggest clients and investors add money to the portfolio at this time.

Marcelo: Yeah. Absolutely. Absolutely. This is the perfect time to be adding money into your portfolio.

Keith: And one caveat there is we're not saying if you're looking at single stocks versus a diversified portfolio, it's a different story. So if you're picking stocks, you have a different element of risk. Whereas if you buy a diversified portfolio, you're just buying that the market will come back. It's more of a simplified approach. So it's not to be confused with just because a stock is down 70% it means that you're going to put it and it's going to recover, right? That's not what we're saying. I just want to make that point clear.

Marcelo: Yeah, absolutely. A hundred percent.

Keith: Thank you, Marcelo. Anything else to add in final recommendations?

Marcelo: No. Now I want to hear yours.

Keith: The only thing I would say is we need to just keep perspective. I'm looking at the data here for June 30th. We've had a bull market really since 2009. So for 14 years, the last 10 years compound returns for our all-equity portfolios are about 9.5% annualized.

Marcelo: Wow.

Keith: And 2021 was a huge year. We're definitely giving some of that back. And in the context of a 9, 10, 11-year bull market, this pullback should be expected. And if we do actually get a recession, it's okay. We will get through that too. And this might be an unusual recession if we were to get one because there's so much demand for employment. Maybe you take a little bit of that edge off and we still end up with a recession that's actually not that painful on the labor front. So regardless of whether we do or we don't, it's full steam ahead with your plan. If you're a retiree and you've done your projections and you have a sustainable retirement, this should not in any way worry you. It is part of long-term investing. So my takeaway is maintain perspective. It is extremely helpful. Yes, inflation is very high. That too at some point will come down and the banks are working very hard to make that happen. So yeah, that would be my final recommendation. With perspective, you have a better sense of being able to stay the course. And that to me is critical at this point.

Marcelo: Yeah, I think that's well said. I have nothing else to add.

Keith: Marcelo, with that, thanks for being on today's show, Mid-Year Review. And to our listeners, enjoy the mid-summer and we'll see you in our next episode.

Marcelo: For sure. Thank you for tuning in.

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