Stewart Financial

Thoughts that count

October 2022

Excitement at the beach

If it were an option, I would choose to return after this life is over as a fish. Or perhaps I was a fish in a previous life. I am fascinated by the ocean and its mysteries. There is an entire world under the waves, and its size dwarfs the one we know here on land. The surface of the Pacific Ocean alone is larger than the combined landmass of every continent and island on earth. The oceans make up more than 70% of our planet, yet only 5% of it has been explored or charted by humans.

This past summer, my kids and I were body surfing waves in Huntington Beach, California. One morning, the waves were strong and eventually I couldn't keep up with their boundless energy, so I decided to get out of the water for a break. Coming out of the ocean and approaching dry land, I noticed the intense collisions between the beach-bound waves and the outgoing wash from shore. This area, a few metres from shore where the waves and backwash meet, is home to perpetual violent interactions. I stopped to watch the sediment laden waves around me crash into waves returning to the ocean. The collisions produce an explosion of water, sand and bubbles and it's mesmerizing to watch.

After a few moments of staring into the shifting surf, I began to feel dizzy. It became hard to track which way the water was moving as the sandy water spun around me in concentric circles. I started to lose my balance. Waves continued to crash down, pulling me forward, then pushing me backwards. The water rushed around me and seemed to pick up pace as I tried to steady myself. I could no longer tell which way the water was moving and was unsure whether I was facing the beach or out to sea. As I felt myself falling, I shifted my gaze away from the water, looked up to the horizon, and saw the beach. As soon as I shifted my focus off the water around me, I was able to secure myself and regain my balance. I snapped out of my mental commotion, walked out of the surf onto the beach and dropped onto the sand for a breather.

The area just off shore is technically referred to as the '*active coastal zone*'. It is defined as "highly dynamic, with up and down redistribution of sand by the action of tides, waves and wind." It plays a significant part of overall ocean functioning and is regulated by the gravitational forces of the Sun and Moon. It is the most dangerous part of the beach, given undertows and rip currents. It is also the most likely place humans are to be swimming, including body surfing, because it's the most accessible part of the ocean. It is both the place beachgoers need to be most careful, and the place where most beach fun occurs.

For many investors, this year has felt a lot like the discombobulating *active coastal zone*. The constant market movements and chatter of interest rates, recessions and war can be just as vertigo inducing. The way to deal with being caught in rough surf is not to focus on the surrounding water but instead raise your gaze to the horizon and look where you want to go. In the same way, when the economic environment is tumultuous, investors need to avoid being transfixed on the shifting and confusing landscape. Instead, they should raise their eyes towards what lies beyond the coastal zone to the place where relief from confusion can be found.

With this in mind, I want to lay out from an economic point of view, why this year has been so erratic, and what we are doing about it.

What is going on this year?
There are too many dollars, chasing too few goods. In other words, demand for goods and services is greater than the current supply of those things. This is a result of many factors; low interest rates for too long, Covid supply chain disruptions and government over-spending top the list. The bill has now come due in the form of heightened prices (inflation). To rectify this situation, governments and their associated central banks are attempting to lower prices by increasing interest rates. This will diminish economic growth, which will in turn hurt corporate profits, which are ultimately the fuel for investment prices. This has happened quickly, causing a sharp decrease in investment values for stocks, bonds, and real estate.

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Is this a recession?
Yes, however let's be clear about what a recession is and is not.

The *active coastal zone* is necessary for a properly functioning ocean to exist. It is part of the larger environmental process which controls all life on earth. Every component of our ecosystem depends on every other component, either directly or indirectly. The loss of any environmental process, including the *active coastal zone*, would be catastrophic.

Similarly, a recession, which is just the technical term for a prolonged economic slowdown, is part of the necessary larger economic process. They cannot be eliminated, nor should anyone want them to be. Recessions are the speed bumps to help us avoid even larger blow-ups. Normally they occur every 5 to 7 years but because we haven't experienced one in close to 13 years, it feels severe. While no one enjoys a recession, they are relatively short in duration; the average recession lasts 10 months, which means we are likely closer to the end of this slowdown than we are to the beginning.

Recessions should be viewed as a pause, and a short correction, to the general upward trend the economy follows. They do not represent the end of the economy, or even a reason to be particularly fearful. They are expected to occur periodically and are part of a healthy business cycle. The period in between recessions is on average 58 months long. In other words, 85% of the time the business cycle spends on an upward trajectory. Rather than fear a slowdown, we can use it to position ourselves for the eventual recovery, which is on average not far away.

Does this mean asset prices will continue to decline in the short run?
If you are swimming in the ocean, should you be more mindful of the wave that just passed you, or the next one to arrive? The wave that has passed is not relevant anymore, while the incoming wave is going to be highly impactful. In economic terms, these are known as lagging (wave that passed) and leading (next wave) indicators. Most economic data, such as economic growth and inflation, are lagging indicators. They tell us something about the period we just experienced but are limited in their ability to help us figure out what comes next. Unfortunately for investors focused on the churning water, lagging indicators are far more available then leading ones, and are thus quoted in popular media constantly.

The good news is that investment markets rebound on average six months prior to the end of a recession, which would mean we are likely closer to the recovery than not. When investment markets rebound, the first move upward is typically significant, which makes timing them so difficult. This also means that the economy will continue to struggle for on average six months after investment markets have begun to move higher. Therefore, investing even though the economy looks shaky is usually the right strategy even when it feels difficult. Waiting for the economic "all clear sign" means likely missing the first few months of the recovery, which is the most robust segment.

What are we doing about this situation?
Our investment process was built to minimize downside risks, while still participating when markets are trending up. To successfully protect downside risks, portfolios must implement protective strategies prior to a market correction. Changes made prior to economic turbulence are far more valuable than those made once the storm has started.

We have been making tactical changes since last year in anticipation of a softer market. Some of the changes we have implemented were; increasing cash, reducing exposure to those bonds which underperform when interest rates increase, and adding hedges, which increase in value when markets fall. As well, we eliminated investments in companies that are not significantly profitable and instead focused our stocks on those that pay and grow dividend payments.

In addition to incorporating defensive changes to minimize downside risks, since July we have added some offensive strategies to capitalize on opportunities. As an example, for more than a decade, interest rates have been held at near zero, which has caused many fixed income instruments to become quite risky. As interest rates have risen, these assets have significantly dropped in value. We have taken the opportunity recently to buy some of these now discounted fixed income vehicles. Because these fixed income instruments have been beaten up this year, they now present minimal future risks, but should generate returns not available in recent memory.

Investment returns are never free; the price of inflation-beating returns is uncertainty and volatility. The volatility of the *active coastal zone* is the price demanded to enjoy fun at the beach. Unfortunately, market corrections are uncomfortable. The good news is they are relatively short in duration and always end. If you want to swim in the water, you have to pass through the *active coastal zone*. If we want to meet our goal of outpacing inflation, we must endure some periodic economic slowdowns too. We should not stare too long at the dizzying water; it is a necessary transition zone we need to pass through. We will make it to the beach, and calmer days are ahead.

Your *trading in the bathing suit for the snow shovel* portfolio manager,

Duncan Stewart, MBA, CIMA, FCSI, CFP, CPWA
duncan@stewartfinancial.ca / duncan.stewart@manulifesecurities.ca