WATERMARK PRIVATE PORTFOLIOS MARCH 2022 COMMENTARY

Stock markets recovered in March with fears of an escalation of the Ukraine war fading, the TSX Composite gained 3.7%, while the S&P500 (in CAD) increased 2.6%. The Canadian Universe Bond Index had one of the worst quarters ever, falling another 3.0% on the month and 7.0% for the quarter resulting in poor performance for the traditional 60/40 portfolio consisting of sixty percent equities and forty percent bonds.

Markets

Inflation continues to be the hot topic, with gas and food prices remaining elevated, hitting us all in the pocketbook. In addition, inflation is leaving its mark in the investment world too, with commodities (wheat, soybeans, oil, gas, metals, etc.) continuing to move higher, while longer-dated bonds are getting crushed. With the war in Ukraine continuing and sanctions on Russia seemingly in place for the foreseeable future, it takes two of the biggest commodity producers in the world out of play, resulting in a shortage of many materials required in production for all types of goods and transportation, and sadly output from farming will fall, potentially leading to a food shortage in 3rd world countries.

Furthermore, with the west putting sanctions on Russia and the USA seizing Russian central bank assets held in USD, one would think that China, Russia, and likely a host of other countries will no longer want their central banks to maintain reserves in USD. This will likely reduce buying of US treasuries, resulting in another factor driving rates higher on bonds. Alternatively, these foreign countries will likely move their reserves to hard assets such as gold, silver, and oil, while reducing trade and economic dependence on the US.

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The result is the 40-year bull market in bond prices (where interest rates have been falling for 40 years) may finally be coming to an end. As we see below, rates have been coming down since the early 80's and every time they moved higher in the past 40 years, they hit the upper blue line and then turned back down:

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Only time will tell if this is the end of the bond bull market but with rates so low since the Great Financial Crisis, we’ve shied away from bonds, again selecting private real estate and private debt for the safety portion of your portfolios. The loans in our private debt pool are typically under 18 months, so roughly 6% of the loans are maturing every month, and if rates move higher, new loans are subsequently priced at a higher rate, benefiting investors. Similarly, as rents increase, the private real estate pool generates more cash flow, which then drives the market value of the building higher, again protecting you from inflation.

The downside to higher interest rates, in addition to the inflation we are seeing, is that it chokes off the economy, with debt payments becoming too onerous for existing creditors and consumers who intend to use credit soon (car, house, large appliance). Consumers then delay or walk away from purchases because they cannot afford the higher level of interest, which slows down economic activity. We are therefore watching rates closely to see if there will be a major trend change, with inflation persisting and interest rates continuing to move higher. It’s currently uncertain if rates can move much higher in the short run, as debt levels have exploded higher since the Great Financial Crisis and raising rates aggressively (which is forecasted by a few banks) will likely result in a recession in 2023.

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Investment Strategy based on risks listed above:

1) Continue to hold private real estate and private debt, both:
   a) Have performed well over the long-run, with low volatility.
   b) Have held up well in past recessions.
   c) Perform well in an inflationary environment, increasing returns with inflation.

2) Minimize bond holdings, until we see what happens to the trend in the chart above. Should bonds remain inside the blue channel, we can potentially add a small position.

3) Continue to be opportunistic on the equity side, reducing equity risk on rallies and adding back to equities after larger drawdowns.

4) Tilt the portfolios towards commodities and cyclical companies, like those in Canada, which should benefit from higher rates and higher commodity prices. However, should inflation appear to peak and interest rates start to fall, then a rotation back into high quality technology companies would likely occur.

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Overall your portfolios held up well in the first quarter as most portfolios did not hold bonds, and on the equity side, we held high quality lower valued companies at the start of the year. The portfolios now have a good sized cash position to protect on the downside should the S&P500 follow the same pattern it had in 2018, (the last time central banks raised interest rates) where it sold off twenty percent from peak to trough (which would put S&P500 around 3,850). A further sell-off would be welcomed to redeploy cash into great companies at more reasonable valuations.

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