WATERMARK PRIVATE PORTFOLIOS NOVEMBER 2022 COMMENTARY

The market continued its strong rally off the October lows, with the S&P500 finishing up 4.3% (in CAD) and the TSX Composite Index increasing 5.5% in November. The bond market appears to have finally bottomed and appears to be pricing in a recession next year (more on this below). Yields fell in November, resulting in the Canadian Universe Bond Index increasing by 2.8%. However, bond market volatility continues to remain elevated, and should inflation persist then bonds may resume their sell-off, leaning us towards holding High Interest Savings Accounts instead of fixed income where we can.

Markets

Markets had another strong month, but caution is warranted with the S&P500 closing right at its 200-day moving average. The 200-day moving average has proven to be a formidable force in 2022, stopping rallies in April and August, and likely this rally too:

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1. The US Federal Reserve will likely increase rates again in December and on February 1st, 2023.

2. The US Federal Reserve continues to remove stimulus from the economy by reducing its balance sheet (selling bonds and retiring cash).

3. Global central bank rate increases from earlier in the year are just starting to work their way through the economy now, so we expect economic reports to weaken.

4. China continues to keep its economy locked down, with civil unrest increasing.

5. The yield curve, which compares interest rates over different time frames is inverted (meaning the interest rate to borrow for 2 years is more expensive than the interest rate to borrow for 10 years) and is approaching its largest imbalance in the last 40 years (see the chart below)

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We’ve spoken about the yield curve in the past and how important it is as a leading indicator of recessions. Looking at the chart above, you can see the yield curve inverted ahead of market sell-offs in 2000 (Tech Wreck), 2008 (Global Financial Crisis), 2020 (Covid Lockdown), and is once again inverted today. As central banks increase short-term rates, they choke off current lending. The bond market realizing growth is falling, rallies as investors move into long-term bonds. Slower growth impacts earnings negatively for companies, and then stock prices fall, which is why we think Q1 2023 earnings may come in weaker than expected, forcing central banks to change their tune later in Q1.

We continue to believe we’re in a trading range with the 200-day moving average being at the top of that range. This month, we took profits on most of our equity ETF’s and moved the proceeds into a High Interest Savings ETF, which yields around 4.08% and we expect that to go higher next week when the Bank of Canada meets. We feel there is a high probability that into Q1 2023, we’ll be able to put those proceeds back to work at lower prices in conjunction with central banks pausing on this tightening cycle. With those gains booked in November, your portfolios have held up well year to date, with some portfolios close to showing gains on the year, unlike the larger losses on the S&P500 and the Canadian Bond market. Our tactical approach to equities is paying off, and we’ll likely remain cautious with higher levels of cash into year-end, waiting for central banks to give us the all-clear.

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