WATERMARK PRIVATE PORTFOLIOS FEBRUARY 2023 COMMENTARY

Stocks and bonds both fell in February as inflationary data surprised the market by coming in higher than expected, resulting in the market pricing in higher interest rates in conjunction with persistent inflation. The S&P500 finished flat at 0.2% in CAD (CAD fell 2.6% over the month), while the TSX Composite Index fell 2.5%. The Canadian Universe Bond Index fell 2.0% for the month, as bonds reverted to last years trend, where they were highly correlated with stocks.

We continue to maintain the Income/Safety exposure of the portfolios in Private Credit and Private Real Estate, as those two asset classes remain less volatile than traditional fixed income, and more importantly, have a lower correlation to equities and bonds. Furthermore, the two asset classes have a strong record of providing positive returns on an annual basis while also providing returns that typically exceed fixed income. In fact, for traditional fixed income to come out ahead over the short run, it would require interest rates to fall from here (increasing the current market value of bonds). However, if interest rates fall, you would once again be stuck with a lower income payment, highlighting the difficulty that traditional fixed income faces in this inflationary environment.

Markets

With inflation data coming in higher than expected in February, the market did a quick reversal from the end of January, as the market now expects the US Federal Reserve to increase interest rates by another 0.75% over the next 4 months. With inflationary pressures persisting, as we face a different global economy coming out of Covid, and a different geopolitical situation, stocks continue to bounce around. Over the past few years, its evident that when interest rates move higher, or the anticipation that interest rates will move higher, stocks fall:

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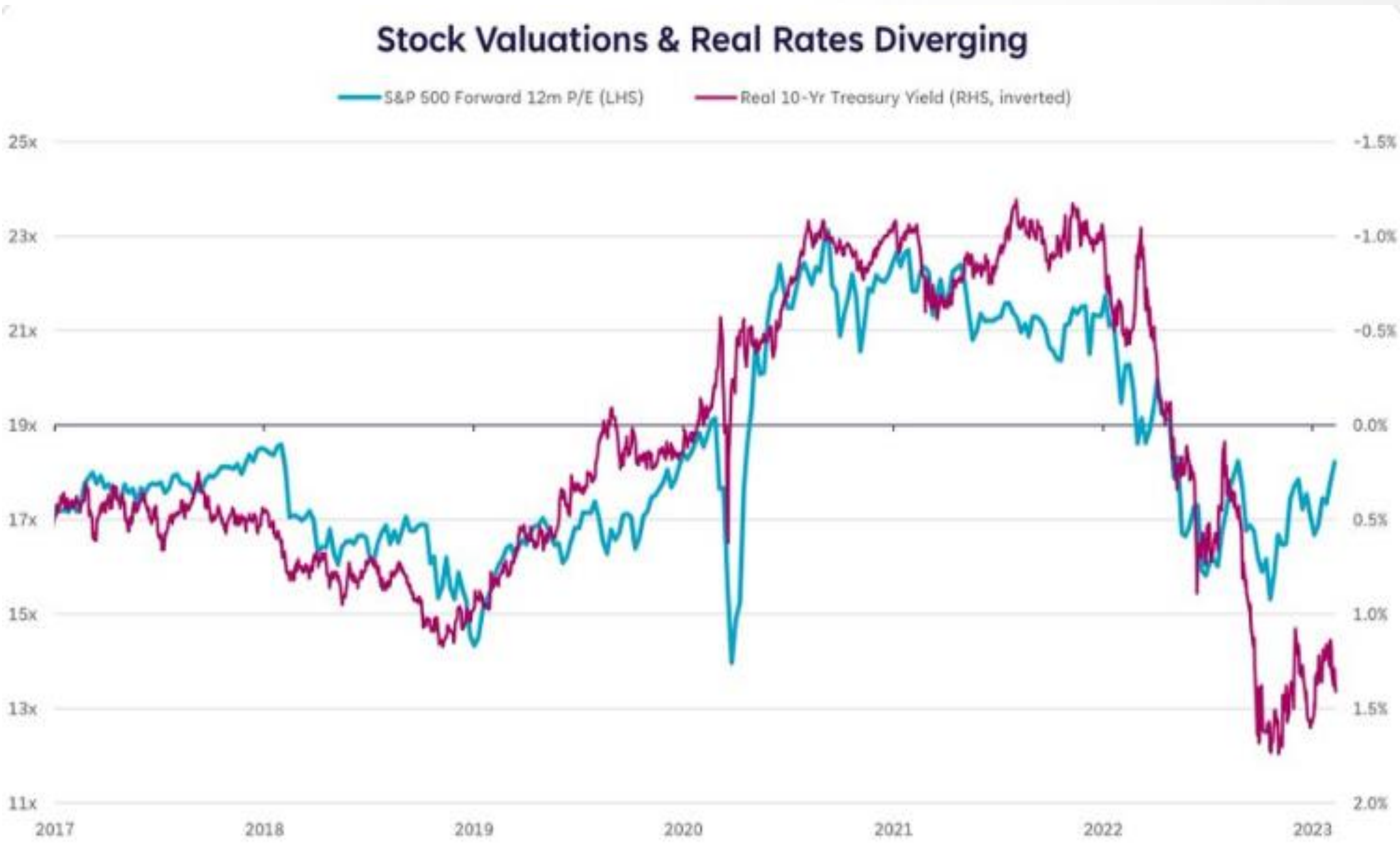

Source: SoFi, Bloomberg

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From the chart above, where the blue line shows the average price that we are willing to pay for future S&P500 company earnings and the crimson line shows interest rates adjusted for inflation (real interest rates), we see that as interest rates fall (the crimson line goes up), the price we are willing to pay for US companies also goes up. This action is intuitive because, with low interest rates, bonds are a poor investment, and stocks are favored. Alternatively, as interest rates rise, bonds become more favorable.

However, we now see the two lines have diverged, such that:

1. Stock prices need to fall (blue line lower) for the correlation to remain intact.
2. Interest rates need to fall (crimson line higher) for the correlation to remain intact.
3. A combination of 1 & 2 needs to happen.
4. The correlation is no longer valid – Likely a small probability of this.

With inflation persisting and real interest rates appearing to head higher (the crimson line falling more), we expect stock prices to fall so that those two lines once again meet. Furthermore, the interest rate increases that started in Q1 last year are now beginning to make their way through the economy, so we wouldn't be surprised to see growth slow some time later this year as businesses and consumers struggle with higher interest payments on debt.

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With uncertainty over the near-term direction in stocks, we moved the portfolios back into defensive mode, trimming stock positions we put on last month for a small gain and buying a short-dated bond position earning roughly 4.8%. This allows the portfolios to “get paid” while we wait and see how the next few months play out as the inflationary narrative continues to create volatility. Should stocks sell off to a level that makes more sense, we can quickly and easily buy companies that will perform better in this higher inflationary environment.

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