MARKETS REFOCUS ON TIGHTENING FINANCIAL CONDITIONS

September 2022

After a significant rally from the June 16, 2022 low, market sentiment turned in late August. The reason? Jerome Powell, Chairman of the U.S. Federal Reserve Board (Fed), warned of the need to continue raising interest rates to fight inflation in a way that might cause "some pain." This dashed market hopes for a near-term pivot (or pause) in monetary policy, which had helped fuel the rally.

Powell made the comments in a speech at the central bank's annual economic symposium in Jackson Hole. In his update on the economy, inflation, and interest rates, Powell stressed that the Fed has an "overarching focus" to bring inflation back down to its 2% target.

Investment teams at CIBC Asset Management remain acutely focused on the evolving market dynamics and committed to achieving the goals of Canadian advisors and investors. They share their outlooks below.

Multi-Asset and Currency Team outlook

Global growth is slowing. Central bank policy tightening in response to heightened inflation risks is expected to cause it to slow further over the next few quarters, to a rate below its long-term trend. The risk of an economic hard landing has continued to increase.

Publication in July of better-than-expected inflation data prompted market hopes of an early pivot in central bank policy stance towards easing, and a partial recovery in equity and other risk markets. Although headline inflation is likely to moderate further in coming months, core inflation—the primary focus of central banks, including the Fed—will likely remain more persistent and well above policy target rates for the foreseeable future. This persistence is expected to reflect the stickiness of housing and labour costs. An end to policy tightening will only likely come once core inflation starts to move meaningfully lower.

With the Fed signaling its intention to stay the course on policy tightening, we see the risk of a further move lower in equity prices. Expectations for earnings, sales, and margins are likely to weaken concurrent to slower economic growth. Some economies will likely be weaker than others. The euro area appears particularly vulnerable. This suggests near-term downside risks are most pronounced for European equities. Bond yields are also vulnerable; in this case, to a moderate move higher as market interest rate expectations align with Fed messaging.

Fixed Income Team outlook

Currently, two economic forces continue to dominate financial markets: inflation and recession fears. We expect that over the coming year, GDP will slow markedly under the strain of a retrenching consumer and a less ebullient business sector. It remains to be seen how far the Fed will push rates in a slowing economy.

The team continues to opportunistically upgrade the fixed income portfolios, partially by purchasing new high-quality corporate bonds, which, due to market weakness, are offered with large concessions at attractive spreads. Fixed income duration has been actively managed with both long and short tactical trades as rates move within our expected trading range. An inverted credit curve and elevated short-term investment-grade credit spreads are providing good value in shorter-dated corporate bonds. We continue to prefer mid-term bonds over long-term bonds, as we expect the yield curve to steepen over the medium term.

We remain cautious on materially increasing our exposure to high yield at this time. We expect better opportunities to arise as fears of recession increase.

Equity Team outlook

Central banks are going to continue to raise interest rates, likely into an economic slowdown. Doing so is the only way to reduce stubbornly high inflation. Therefore, we expect ongoing heightened volatility as future

cashflows and near-term earnings estimates are revised downward. However, there are some mitigating conditions, such as strong labour markets and excess savings that point to a short and shallow downturn.

Companies that have strong pricing power, prudent debt and sustainable competitive advantages are best positioned to survive this downturn and thrive once conditions improve.

In Canada, we continue to favour energy—both oil and natural gas producers, given an expected continuation of market supply/demand imbalances—and financials. These sectors tend to outperform in higher-rate environments. For energy, this reflects an ability to pass through cost increases; for financials, it reflects relatively attractive net interest margins. Despite high prices, we're not seeing the corresponding supply increases (due to ESG and regulatory uncertainty). While prices have declined from their recent high, over the long run this means we will likely experience energy prices at the higher end of the historical average.

Globally, while rising interest rates are expected to put further pressure on valuations, higher growth sectors with long-dated cash flows and sectors with high debt levels will likely be more adversely affected.

We continue to look for well-managed businesses at attractive prices, while focusing on longer-term fundamentals. We believe this is the most effective strategy to accumulate wealth for clients in our equity mandates.

Long-term wealth creation requires a long-term view

Market timing is never a wise endeavour, as markets are always forward-looking, and tend to bottom when sentiment is worst and economic conditions seem most dire. During times like these, it's important to be supported by a large asset management team with the research infrastructure and expertise to navigate evolving markets and look beyond current stresses. As the landscape shifts, new investment opportunities may arise for those with a long-term view.

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