Comments on Recent Markets

Markets started their downturn a couple of days before Christmas, although higher growth and higher technology stocks started falling in November, and markets started swinging pretty wildly in November too. And in January, markets tumbled more. As of Jan 25, 2022, the S&P 500 (the main American index) was down 11%. The Nasdaq Composite index that has more technology stocks was down 17.3% and a US index that includes smaller companies, the Russell 2000, was down 20%. And those percentages don't really tell the story of the fall in stock prices! Because a few very large companies which have a heavy weight in the indices did not fall very much, the indices are actually understating the problem. **The average stock in those indices (not weighted according to the size of the company) fell 18.7%, 46.6% and 39.6% respectively in less than a month.** Of course, our portfolios have not fallen that much (thanks to our core Growth At a Reasonable Price strategy). (Source JP Morgan courtesy of Dynamic Funds)

Corporate earnings are expected to be strong this year, and current stock prices, compared to earnings, are quite a bit cheaper than last year. So why are markets so skittish now, when they weren't last year? Much of this is because of concern about inflation, rising interest rates and worries about what could happen if Russia invades Ukraine. Let's look at each of those factors.

Inflation has been high because of supply shortages due to supply chain disruptions either caused by Covid or as longer term effects of previous Covid disruptions. Some shortages won't go away quickly. As more people get back to driving, more gasoline will be required, but it takes a while to get oil wells turned back on. Manufacturers are ramping up chip production, but demand for semi-conductors has been so strong with technology changes (like electric vehicles) that production just can't ramp up fast enough. Eventually, there may be a chip glut (and then deflation (?) and share price drops for chip manufacturers). Many economists expect inflation to start declining by year end. We're not worried about inflation, because our fund managers have been investing in great, market leading companies that have pricing power and can pass on higher costs. That way their profits shouldn't be hurt by rising costs. And our fund managers have been concentrating on quality more than ever, where quality is defined as having strong balance sheets (not much debt), having competitive advantages, having strong management, and having secular growth.

The US Federal Reserve and the Bank of Canada have been warning for years that interest rates would rise as soon as the economy could bear it. Interest rates were about to increase in 2020 but then Covid hit. Now the economy is finally considered strong enough again to handle higher interest rates. Between 3 and 7 increases (of about .25% each) are expected in 2022 alone. (2 weeks ago economists and analysts were only predicting 2-4 interest rate hikes, but recently, we've been hearing 5, 6 or even 7 hikes this year are possible.) Despite all the warning, people don't seem to have taken the likelihood of rising interest rates seriously till now. So now investors are worried about the effect of rising interest rates on inflation and profits. And rising interest rates have the effect of lowering the present value of growing companies. So, it's been the prices of the fastest growing companies that have fallen the most. If there are fewer interest rate increases than expected, those fast growing companies could have strong price rebounds. On the other hand, if interest rates rise more than expected, those companies could be further devalued. At the moment, it's stocks that are suffering. There could be a bigger problem in the next couple of years, if homeowners who took on huge mortgages didn't plan well enough for rising rates. Those who took out mortgages a couple of years ago will have to renew them in a couple more years and that's when we'll find out.

The possibility of war, or a cold war, is certainly scary one. World War II, the Korean War, the Afghanistan war, and the Iranian wars did not de-rail the stock market. Political issues like that don't change overall corporate profitability. And since profits drive stock prices, not politics, markets can still thrive in wartime, but let's hope it doesn't come to that.

We know that markets are driven by fear in the short-run, and the short-run can certainly last a year. So, markets could continue down. But according to a Manulife Investment Management economist, Macan Nia, there is over an 80% probability of positive returns over the next 12 months. As long as there is no recession on the horizon, a 10% market drop is an opportunity. Since 1970, after a 10% market drop, the market in the next 52% weeks has averaged about 7.5% positive returns. 7.5% may not sound like much after the heady returns we've had in the last 2 years, but economists tell us that returns going forward will not likely be nearly as strong as recent positive returns have been. (Source: Manulife Investment Management and Bloomberg Capital Market Strategy)

Here is some market wisdom that we read recently and thought you might enjoy as well, especially since it's about our favourite investor, Warren Buffett.

"In bull markets, everyone is Warren Buffett. In bear markets, everyone quotes Warren Buffett. During the phenomenal year of 2020, growth was at the forefront of market returns as value took a back seat. Many institutional and retail investors alike outperformed by simply purchasing stocks with momentum and no fundamental justifications. This led to hubris, and many investors were convinced that Buffett's investing style was no longer viable, as Berkshire significantly underperformed growth mandates. Cathie Woods was touted as the modern day Warren Buffett when her Innovations ETF did a staggering 156% return in 2020. Today after a combination of policy scares, and an overall change in the market cycle, Warren Buffett's "boring" fund has caught up to Cathie's flashy and "innovative" ETF." (Source: Mackenzie Financial email Jan 24, 2022) Yeah! Our favourite Growth At a Reasonable Price investment strategy triumphs again!

When super successful investors clearly and concisely express market truths, people remember. Here are a few points that investing giants have made that we would all do well to remember.

1. A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices.
   - Warren Buffett

2. In many ways, the stock market is like the weather in that if you don't like the current conditions, all you have to do is wait a while.
   -Lou Simpson

3. People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences. Calamitous drops do not scare them out of the game.
   - Peter Lynch

4. Stocks go down faster than they go up, but go up more than they go down.
   -David Gardner

5. Volatility is the price of admission. The prize inside is superior long-term returns. You have to pay the price to get the returns.

- Morgan Housel

6. Buy when everyone else is selling and hold when everyone else is buying. This is not merely a catchy slogan. It is the very essence of successful investments.
- Jean-Paul Getty

7. Volatility is a welcome creator of opportunity.
- Seth Klarman

Source: Mackenzie Financial

As usual, we are happy that our clients are not panicking and selling out of fallen investments, thus locking in losses. As long as you have a long enough time horizon and you are holding quality, you should be able to outwait this market downturn. Our fund managers will use this volatility to buy bargains. And if you have money to invest, remember that it's better to buy when the market is down, like it is now, that to invest when the market is high. The market may go lower still, before it recovers, but it is impossible to time the market and know exactly when the market bottom is to buy. The thing is to buy before the market has recovered.

Call us if you want to discuss your portfolio or the outlook for markets.

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