NCM PENSION PORTFOLIOS
MONTHLY UPDATE

Pension Style Investing for
ALL CANADIANS

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Data Point Volatility

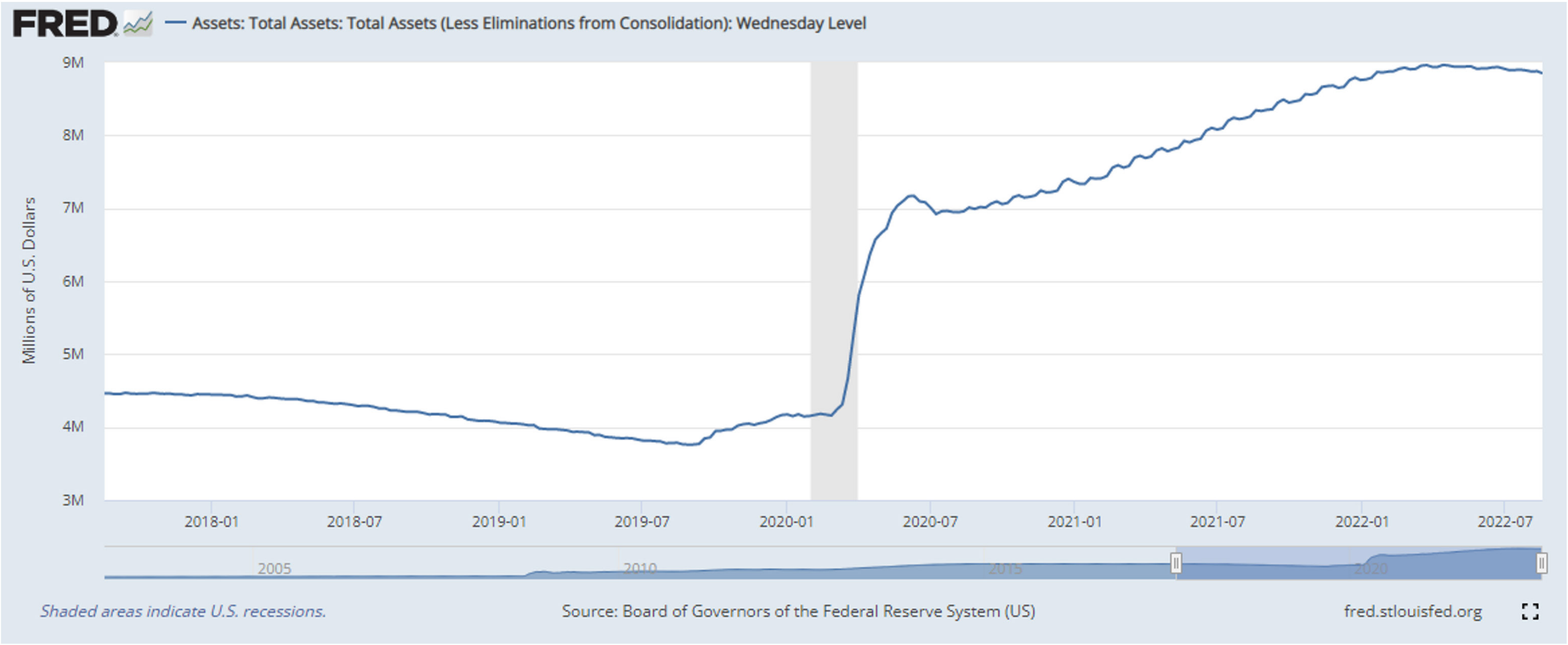
As various pieces of economic and monetary policy news arrive, investors should expect amplified volatility in the coming months. The amplification is due to the high stakes economically, many unknowns hanging over capital markets and bumps in past Quantitative Tightening (QT) experience.

While central banks globally are on a path to QT, the scale of QT in the USA is singularly staggering. The outcome of the Fed's QT at the level scheduled is perhaps the biggest monetary policy risk. The size of Fed's forecasted balance sheet unwinding has never been seen before, and the stakes are high with the risk of the recession worsening. And perhaps more ominously, the risk of a freeze-up in the banking system as lower reserves are directly related to QT.

In its most simple terms, Quantitative Easing (QE) increases reserves through the process of buying securities, thereby injecting cash into the banking system and QT reverses it. The Fed's holding in securities ballooned from $4 trillion to $9 trillion during COVID-related QE and now these holdings need to be reversed. As this occurs, banking reserves will in turn move lower. Lower reserves reduce banking system liquidity. In effect, this tightens up available capital and this naturally could lead to higher interest

We should expect the Fed to be hyper vigilant and be prepared to pump the brakes as needed. QT is not new, and they are very aware and sensitive to QT's potential to lead to unintended shocks. So far, it seems they have avoided "Taper Tantrum" by effective communications and a management of expectations. Furthermore, they are very cognizant of the nasty experience in 2019, where the overnight banking system froze up. This freezing was due to a confluence of normal course factors that resulted in a surprising spike in the repo market. The repo markets allow banks to lend and borrow pools of cash, resulting in increased efficiency in these short-term cash positions. In September of 2019, this system broke. The simplest explanation was that a sudden reduction in cash in the system occurred. It was caused by several simultaneous normal transactions that individually may have been a non-event. Reading about this crisis it becomes clear that a definitive reason is not readily obvious. There are some experts that believe that its occurrence has never been fully understood and that's why we should be nervous.

In contrast to QE, where the Fed buys securities in the market, QT will operate by allowing securities to mature. This intended QT path will involve a run-off. Run-off means that the Fed will simply allow their holdings of maturing securities to come to term without reinvesting that capital into new securities purchased from the market. This process will mean that the Fed's balance sheet will shrink passively and liquidity in the financial system will tighten. The process started in June with $47 billion from the Fed's balance sheet targeted for reductions and it will ramp up September 1st to $95 billion. The following chart shows they have a long way to get back to pre-pandemic levels.



Inflation: Last Quarter's Concern?

Investors don't like surprises. On the other hand, investors can be surprisingly resilient once a negative event is known, and they believe it is being resolved. Recent trends in inflation seem to be falling into the category of a known issue that is being tackled by policy. There are reports and opinions that inflation has peaked. The fact is that inflation headlines are based on year-over-year measures and as we roll into this fall, we will naturally start to get price level comparisons that will show a tapering of the inflationary pressures. There are also other signs that supply chain blockages are getting sorted. It is possible we may see Iranian oil back in the system and there is always the hope that a peace dividend can be surfaced with a resolution in the Ukraine. The foregoing might be overly optimistic, but it seems to me that, at least on the inflation front, we are muddling through.

Of course, the remedy for inflation leads directly to lower economic growth and this is the balancing act that central banks must manage. Technically the USA slipped into a recession using the two down quarters rule.

Interestingly, that proclamation of the dreaded "R" word had its impact minimized by the fact that employment is exceedingly strong. The level of employment is providing a backstop to an otherwise market jarring event. For the first time in years, I'm hearing the term "soft landing" to describe the potential for the future, and I don't disagree that this might in fact be the outcome.

As new data points surface, we should expect heightened volatility, but this doesn't mean that we cannot find decent investment targets. In our equity versus fixed income positions, we have moved back to a neutral position, from a somewhat defensive posture created last year as investment market turmoil was threatening. As I wrote in my last commentary, the price action in various pockets of equity markets had created significant revaluations that are now surfacing new value.

NCM Pension Portfolio Updates:

Our portfolio managers here at NCM are managing towards the joint objective of repositioning in new higher value investments and repositioning in lower beta (meaning lower risk) companies. Additionally, they are focusing on companies that can manage new higher costs with their own pricing power and through this, maintaining profit margins.

NCM Core Global is repositioning to reflect the attributes just mentioned and the NCM Pension Portfolios are recognizing this and reflecting it by bumping up our weight in this fund. The NCM Pension Portfolios' capital being used for this re-position has been sourced in part by a modestly lower investment weight in Canadian investments. In our fixed income allocations, we remain balanced across maturities as we wait for the outcome of increased QT across the globe. The fixed income credit quality also remains balanced between investment grade and higher yielding instruments.

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