NCM PENSION PORTFOLIOS MONTHLY UPDATE

Pension Style Investing for **ALL CANADIANS**

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John Poulter, CFA
Portfolio Manager

Cumberland Investment Counsel Inc., affiliate of NCM Asset Management Ltd.

Holding Pattern

Our last commentary and review of the NCM Pension Portfolios was unusually long. The length was due to the fact that we were in the midst of navigating a significant number of changing capital market dynamics, all occurring at the same time. This review and commentary is shorter, as not much has changed. We remain in a precarious capital markets environment. In a sense we are in a holding pattern as the issues we wrote about are still troubling markets and all but one will likely be with us for the foreseeable future. We had adjusted our portfolios in advance of the major impacts of the events unfolding and feel compelled to remain with our current positioning. We continue to be defensive and diversified and this appears to be working. Looking at our NCM Pension Portfolios' profile, the term "if it ain't broke, don't fix it" comes to mind.

There were 5 issues that we wrote about last month, and they were all very challenging. We noted at the time that individually, each event could upset capital markets and in concert, they were certain to cause trouble. Below is a reminder of the issues that were on our list:

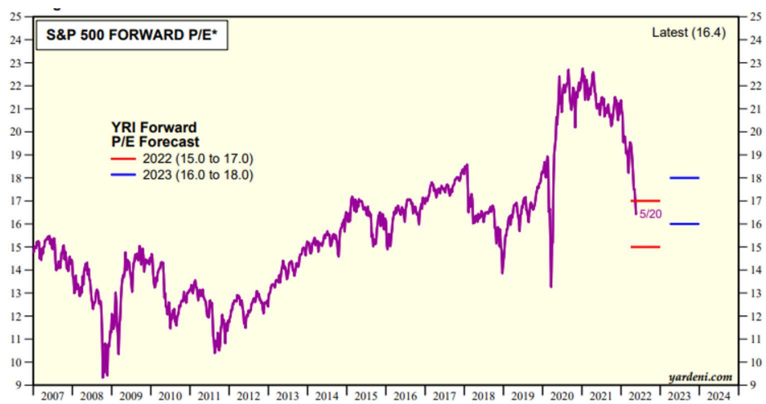
1. A U.S. market performance and valuations both at unusually high levels
2. Inflation (at decades highs)
3. Major Central Bank Tightening – Everywhere
4. World War III Fears
5. Global Pandemic

Since that review, with a lower S&P 500 Index, we've seen one item on the list change. So, one down and four to go. The recent stock market decline in the U.S. has solved a big concern and it was number one on our list. During the month of April, the S&P 500 sold off -8.7%. During May, the S&P 500 finally touched off of the bear market target of minus 20%. The bear market bottom did not hold but that does not guarantee we will not retest that low. As this report is written, the S&P 500 is still down over 12% since the beginning of the year. This means the extreme performance (2X in 3 years) that we opinioned was unsustainable, has corrected to some extent and in turn, valuations have improved as well. Interestingly, earnings forecasts for the S&P 500 have continued higher despite the unknowns we face.

Higher forecasts are supporting the better valuation levels caused by the sell-off. While this is constructive, it doesn't necessarily mean that we should be rushing back into the S&P 500. One of my favorite sayings is that "the pendulum never stops in the middle" so even though the S&P 500 has given up a lot of ground and is no longer premium priced, it doesn't mean that the sell-off stops here. We might expect an overshoot which is often the case when markets decline. With that said, picking off the actual bottom is next to impossible.

Chart 1 below shows how far Price to Earnings (P/E) multiples have come down. P/E multiples measure how much investors are paying for forecasted earnings. A high P/E means they are paying a lot for earnings and a low P/E indicates investors are paying less for each unit of earnings. Getting more earnings for less is a good thing. At the beginning of the year, the P/E was over 20X and now it is just over 16X. Different strategists have various views on what is average or what is fair, but 16X seems to be the common view today. I'm not as generous and look a little further back in history to determine "normal" and my number sits between 14.5X and 15.5X, meaning that I think the market in total is fair around 15X and a buy below 14.5X.

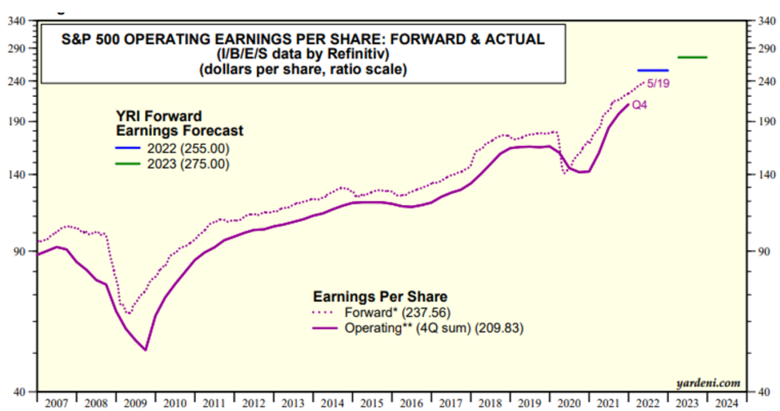
Chart 1



Source: Yardini.com

My assumptions suggest there is a risk prices can go lower. Another concern is that earnings cycle. That means that estimates for price appreciation may be based on peak-of-cycle earnings. Chart 2 below shows how earnings expectations for this index continue to be projected higher. In my opinion, and given the risk of the Fed tightening overshooting, it would not be that surprising to see earnings trend lower. This of course makes the value of the market, based on the P/E, lower. If one uses a longer-term trend in earning, the potential for a 10% earning reduction for 2023 is a reasonable risk.

Chart 2



Source: Yardini.com

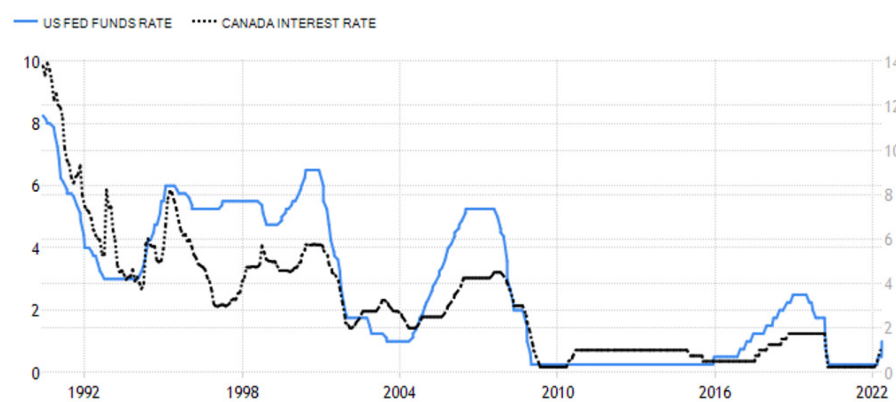
We are not ready to tilt to the U.S. yet and when we do, we might be a little early or perhaps a little late, but we expect the valuations will be better than today or at the very least, the future a little more clear.

Therefore, for U.S. versus Canada and the world, we remain underweight.

What about Bonds?

Our fixed income weights have also remained in a holding pattern. We remain balanced across maturities and balanced across credits. This positioning continues to serve us well and the reasons for it have remained the same. The Bank of Canada and the Fed are tightening, and they are doing it with both interest rates and by reducing debt on their balances sheets. The market seems to have digested the rate tightening news and the chart below puts the tightening in prospective. It is true that central banks are forecasting multiple rate hikes which makes investors nervous, but as the chart indicates, the hikes are coming from extraordinarily low levels. The rate hikes currently being priced into the market are not without precedent and from a 30-year view interest rates should remain much lower than interest rates we've seen in the past.

This does not mean that the longer end of the yield curve doesn't rise more, particularly if inflation remains the threat that it does today. My old school attitudes have me believing that long-term bonds should pay more that long-term inflation. That has not been the case for some time now. If long-term inflation tracks to 3%, which I believe is a real risk, then long-term rates should pay 3.5% or even a little higher. This would lead to continued price risk for longer dated bonds. Higher yields in longer dated bonds leads to lower bond prices in these specific maturities. Risk in longer dated bonds means shorter dated maturities remain a reasonable defense against rates continuing higher.



Source: tradingeconomics.com

There is also another big shoe to drop in capital markets and this will take the shape of Quantitative Tightening (QT). QT is the reverse of Quantitative Easing (QE). QE was part of many central banks' policy responses to Covid-19 and in the past, other financial market crises. QT is a process where central banks sell assets from their balance sheets. This de-levering results in a removal of liquidity from the financial system. In the case of the Fed, in the past, they have done this in a gradual and measured process over a period measured in years. However, this time around, the Fed is targeting to de-lever an amount greater than the total of the last QT (2017-2019) in a matter of months.

The annualized monthly rate of reduction works out to more than $1.1 trillion a year in balance sheet roll-offs once it attains its maximum pace. That means it will likely surpass the total of the entire 2017-2019 QT cycle by early 2023. Many economists see officials targeting about $3 trillion in total balance sheet shrinkage over a three-year span. Our tactic at this point is to wait and see how markets digest QT ticking away at $95 billion a month, as is forecasted, before considering extending our maturities. Our fixed income prescription for the foreseeable future is to remain short and conservative.

Asset Allocations

Our NCM Pension Portfolios remain neutrally balanced between the broadest asset classes, which refers to stocks versus bonds. We realized that while rising rates are generally negative for equities, there are some pockets of equity markets that have the characteristics that will transcend higher interest rate risk. Our relative overweight in Canadian equities reflects this view. Canadian stocks have avoided losses experienced south of the border. While commodity price inflation has fueled major concerns in many markets, it has served to support our markets in Canada. Furthermore, Canadian financials may benefit from higher interest rates.

Again, with my old school attitudes, rising rates tend to positively impact financial institutions through higher net lending margins. Some disagree with this relationship, but I think it remains true. Quite simply, if banks borrow short term cash and lend longer term loans, as they do, then the difference in bank lending and borrowing means more earnings and the prospect of higher earnings leads to higher stock prices. Financials are the biggest sector in the TSX and Canadian banks have a good reputation globally, for being well run safe havens. The combination of Energy and Materials (Ie. Commodities) and Financials (Ie. Banks) account for almost 60% of the stocks in the TSX. This sector profile should support our major index. Canada was positioned as an overweight in our risk modeling due to a valuation differential (remember the P/E argument above) versus the U.S. Importantly, we knew we were loading up on excellent value with a cornerstone representing well run, high dividend paying banks. We did not know that we were to benefit from decade-high price inflation fueled by commodity price increases related to a war, but we'll take it. This is a bonus of portfolio diversification.

Our watch list of negative events has diminished by one. Valuation is less of a threat but the other four remain real and market destabilizing. We have begun to eye longer-dated fixed income and the U.S. as a tilt but we are not ready to move there yet.

At the moment, we are comfortable to remain in a holding pattern.

CONTACT US www.ncminvestments.com

NCM Investments

Calgary
Suite 1850, 333 - 7 Avenue SW
Calgary, Alberta T2P 2Z1

Toronto
310, 99 Yorkville Avenue
Toronto, Ontario M5R 3K5

FOLLOW US

403.531.2650 Phone
1.877.531.9355 Client Services
1.877.431.1407 Toll-Free
info@ncminvestments.com