As at November, 2022

Pension Portfolios Monthly Update

Pension Style Investing for All Canadians

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November 2022 Comments

After spending most of 2022 sounding alarm bells, playing a lot of defense, and generally doing a lot of hand wringing, it may be time to start being a little more optimistic. In my recent webinar message, I used the term "peeking out of the fox hole" meaning that maybe we can start to play a little offense.

As 2022 began, it seemed prudent to position the NCM Pension Portfolios defensively. We did this by tilting to lower beta equities (low beta means less market sensitivity) and in fixed income, we remained tilted to very short-term investment grade bonds, much of this in government issues. Both equity and bond markets spent the year gripped by volatility while making a series of new lows. The plan to be defensive felt right.

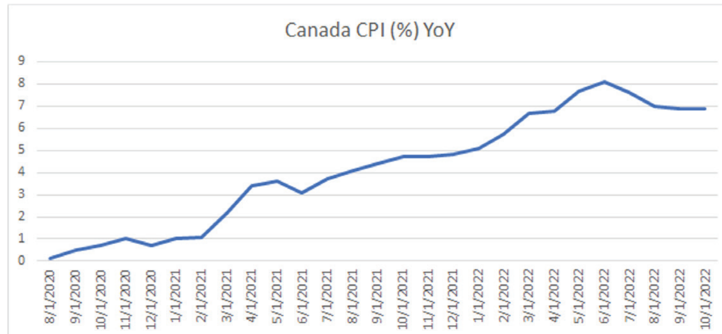
As we close out this year, we have begun the process of setting up for 2023. That means taking stock on what has occurred in capital markets, what policy makers have done in their attempts to navigate turmoil on multiple fronts and what, if anything, can be construed as positive. There are three main ideas that are driving our asset allocation changes and preparations for next year. These include improved equity valuations in North America, Fed policy and inflation and lastly, the ongoing conflict in Eastern Europe.

All Eyes Are on the Fed

Inflation and all of its associated measurements are the most anticipated economic news releases these days. Inflation and the related commentary from the Fed is stealing the headlines away from COVID, a war and thankfully it's even taking media time away from The Donald. Of course, inflation is a metric worth watching as it is at levels not seen in decades and it is driving monetary policy decisions not seen for decades as well.

Chart 1 shows the rapid rise in Canadian CPI and it also shows what might be a peak followed by a couple months of

CHART 1



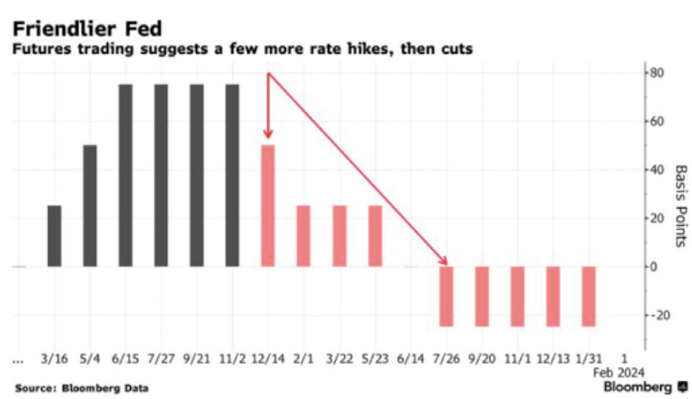
Source: Bloomberg

moderating price increases. While not shown here, the CPI chart for the USA looks pretty much the same except for the fact that it peaked in June at 9%, a percentage point higher than what we have experienced here in Canada. Could this be the first signs that significant interest rate hikes by central banks everywhere might be working?

Usually, inflation continues to rise as the Fed tightening cycle plays out, but we don't seem to be at this cycle's conclusion. Perhaps the Fed's aggressive start and well-communicated targets are accelerating the impact. Alternatively, it is possible that supply bottlenecks are resolving as consumers begin to adjust their behaviour. And if inflation is moderating, does that mean we might speculate about when central banks will start to loosen up?

Chart 2 suggests that bond futures trading is already pointing to the potential for rate cuts to happen in July of next year. It indicates that a 50 basis point hike is next, followed by a series of quarter point moves, then cuts in July.

CHART 2



Source: Bloomberg

Past Fed cycles have been as short as 9 months and as long as 47, so it's quite a wide range. If they start to cut Fed funds rates in July as futures traders now expect, that would mean a 16-month cycle, a little shorter than average. I would argue that the aggressive pace of the first hikes might lead to a shorter overall cycle, particularly if a recession becomes a reality.

When investors get a sense that the Fed is ready to pull in their horns, they will immediately start discounting better days ahead for capital markets. This thinking could accelerate as we shift into a new year.

Preparing for a change in market psychology means incrementally repositioning well ahead of the inflection points. This means adjusting both our fixed income and our equity strategies.

Discount Bonds: Corporate Issues On Sale

Higher inflation, ratcheted short rates, and economic uncertainly have created several opportunities in various segments of the bond market. We have adjusted our fixed income holdings to include a theme we have uncovered in various short-term corporate bonds. We are seeing many corporate bonds now trading at deep discounts to their par value. It is our view that they have been mispriced due to elevated uncertainty and that these short-term opportunities will quickly be repriced as central bankers' hawkish views are toned down. Ultimately, interest rates across the yield curve will find lower levels, but the best opportunities are currently in the short end of the corporate curve. The allocations within our bond holdings reflect our positive outlook for this segment of the market.

Valuation Bubble Solved

For the first time in years, the model I use for the S&P 500 flashed a neutral-to-slightly-bullish signal at the end of the third quarter. Much of this was driven by September's singularly dismal performance. The combination of a 10% one-month slide plus nine months of soft and volatile stock prices sent up a signal.

It was also helped by some devastating numbers from some of the big growth darlings like Meta (-60%), Netflix (-60%) and Amazon(-32%). A lot of risk was wrung out of the S&P 500. For some time now, I have been waiting patiently to start tilting my equity positions back toward the good old US of A. The time has come.

Starting in the second quarter and into the third, we began to switch non-Canadian allocations from a Vanguard ETF (VI.TO) that tracks the FTSE Developed Countries Non-North American Index into NCM Core Global.

As the name implies, NCM Core Global holds global stocks, but it also has close to 60% of its positions in American companies. The Vanguard ETF held no USA, so I've increased my USA allocation by making this shift, while still maintaining a decent global exposure in NCM Core Global's other international investments.

I've made this switch for two reasons. The first, as I mentioned above, is that the valuation profile of the US market has improved measurably over the last year. The second is that while the Non-North American ETF held up quite well through the year, I'm increasingly nervous about the heightened allocation to Europe (58% of the ETF) given the protracted Russian aggression and the possibility Europe might suffer more should there be a recession. Additionally, the ETF I sold holds 15% in British holdings and the UK seems to be having a difficult time trying to get it right ever since they left the EU.

Charts 3 and 4 represent the new allocations for the NCM Pension Portfolios. Chart 3 shows the fixed income allocation with its relative weights by credit quality. Our equity holdings by region are shown in Chart 4.

CHART 3

Fixed Income Allocation

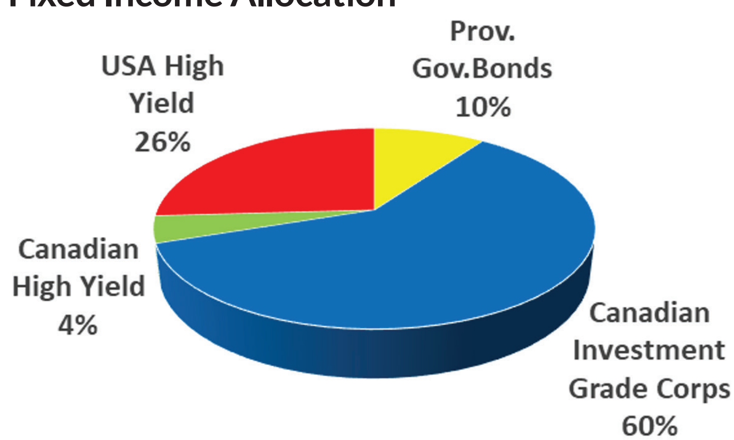
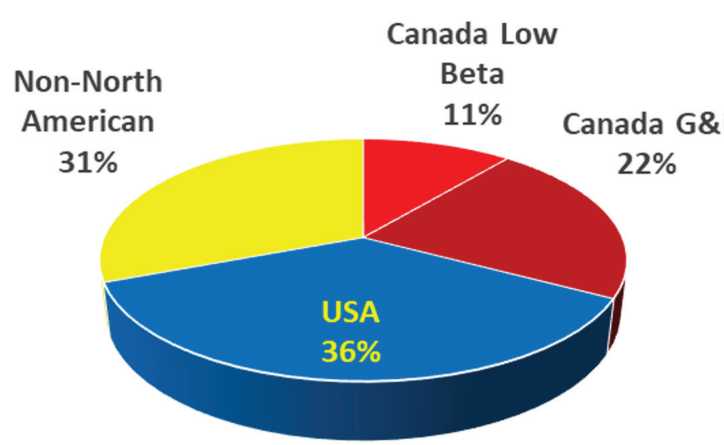


CHART 4

Equity Regional Allocations



In addition to the new tilt to the USA, Chart 4 also reflects a significant shift within the Canadian portion of the equity investments. Toward the end of 2021, allocation decisions were made to tilt into the relatively defensive NCM Core Canadian. This was accomplished by lowering the relative weight of NCM Income Growth Class. The allocation to the more defensive NCM Core Canadian provided some welcomed stability for the Pension Portfolios as NCM Core Canadian performed admirably in a very difficult market.

Now, with our expectations for a more robust equity market on the horizon, we are reversing that trade and once again will hold a relatively higher portion in the NCM Income Growth Class, which is shown as Canada I&G at 22% in Chart 4. NCM Core Canadian (shown on Chart 4 as Canada Low Beta) is designed to be a defensive low beta equity fund whereas the NCM Income Growth Class is designed to hold smaller companies with higher than average growth potential. With the idea that equity markets might be a little more kind to investors in 2023, the decision was to reverse the tilt and once again hold a fund that can provide attractive positive excess returns.

When Will the Bear End?

Our team here at NCM has been through numerous bear markets. The average bear market lasts about 300 days but the range is large: the shortest was 33 days the longest was 929 days. The thing we have learned is that they are all different.

For example, the early 2000's bear market took 929 days to reach its lowest point. However, the bull market leading up to that peak was bubble-driven by many companies that simply disappeared when investors came to their senses. That means large chunks of the market were not going to rebound. Canada lost Nortel and at 33.5% of the index, it was by far the biggest public company. That represented 33.5% of the index that was not going to rebound. Of course, if you lose your biggest company it's going to take time to recover that value. The USA at that time was top-heavy in companies that had next to no revenue. Many of these disappeared and/or suffered permanent capital destruction as well. When companies vanish, it shouldn't be surprising that the bear market is extended.

Our current bear market was preceded by a valuation bubble. The big difference this time is that the companies that were awarded the lofty valuations are not going broke. Investors may not pay the same crazy multiples in the future, but the companies are still around. What we are keenly aware of is that the valuation bubble has had its air released. We don't know exactly when this bear market will end, but it has been our collective experience that the market always gets back on track. Furthermore, back-to-back negative return years are rare. With the 300-day mark for this bear market approaching, it doesn't seem too aggressive to be preparing for better returns.

There is no doubt that a slowing economy will impact companies differently. Companies that depend on strong consumers to drive earnings might be challenged but others such as Staples companies, Healthcare and companies associated Infrastructure and Defense spending among others should remain safe investments. While markets might be a little bumpy as we move forward, the valuation profile has improved considerably over the last year.

NCM portfolio managers are taking advantage of new valuation characteristics and have been repositioning the funds to take advantage of the inevitable market recovery. I watch daily as the profiles of each of our funds are being adjusted to take advantage of the coming year. The NCM Pension Portfolios will also continue to be incrementally positioned for better capital markets ahead.

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