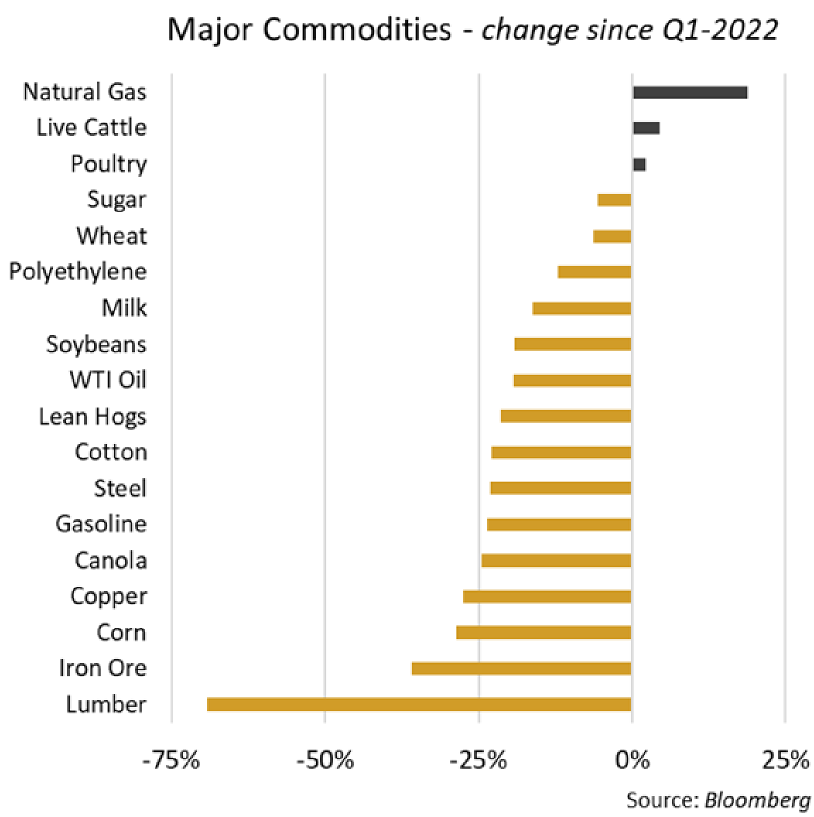
DM PORTFOLIO COMMENTARY

3rd Quarter 2022

The most renowned investor of them all once said, **"I never have an opinion about the market because it wouldn't be any good, and it might interfere with the opinions we have that *are* good. If we're right about a business, if we think a business is attractive, it would be very foolish for us to not take action on it because we thought something about what the market was going to do."**

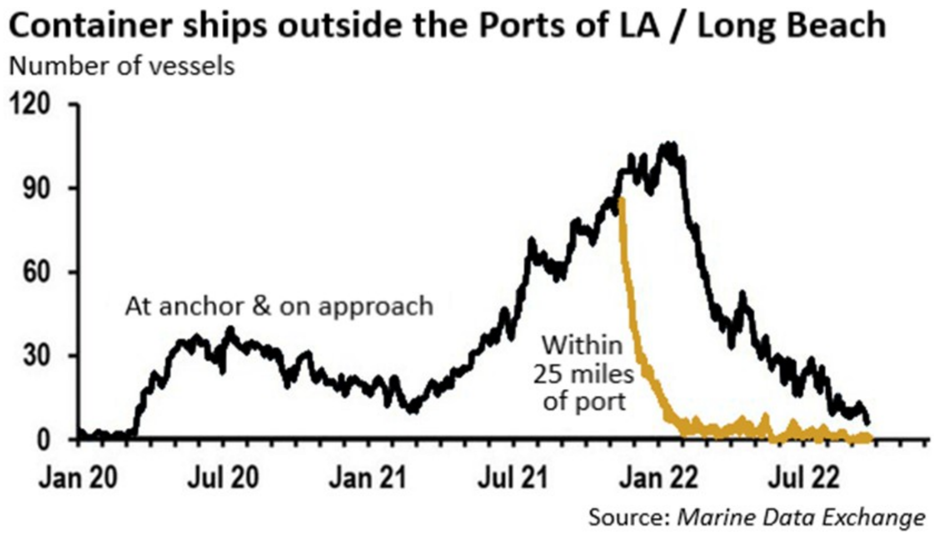
While most individuals understand that durable investment portfolios are the product of patience and focus such as that described above, the temptation to "do something" when the news cycle turns negative and stocks react can become excruciatingly difficult to resist. For most of this year, we've found ourselves mired in one of these mettle-testing environments, as a generational spike in inflation and an accompanying surge in interest rates has pummeled the interim values of virtually all assets. The investor who hasn't fretted over his or her portfolio at some point in 2022, or wondered if previously laid financial plans remain valid, likely doesn't exist.



In such circumstances the first instinct is often to flee and, while temporarily cashing out of equity investments might offer some short-term psychological relief, the odds of getting it right are small. Amongst other problems, one of the reasons that these grand departures most often don't work out is that the human mind is prone to thinking in static terms such as "good" and "bad", whereas markets are more apt to be directionally influenced, responding to whether things are getting "better" or "worse". And so in today's case, while we may be alarmed by sharply higher prices when we visit the grocery store, make an online purchase, or book a vacation, equities are more likely to focus on where inflation's going vs. where it presently sits.

Continuing this thought, if we look beyond current conditions the data aren't necessarily convincing that more of the same lies ahead. The chart to the left shows the behaviour of key commodity prices since the beginning of April which, with the exceptions of natural gas, cows, and chickens, are resoundingly lower. Though these feedstock declines may not have found their way to the end user just yet, it doesn't seem like a reach to believe that they will exert downward pressure on consumer prices at some point in the foreseeable future.

The other inflation driver with which we've all become acquainted during the pandemic can be found in the "supply chain", or the delicate balance of transportation and logistics infrastructure that brings goods from factories and farms to our homes. When plants were shuttered and workers furloughed as covid tore across the globe, this peculiar condition collided with an artificially high level of consumer demand, as households benefitted from both generous income supplements and a surfeit of spare time. Just as commodity prices seem to be on the road to normalization, however, so too do the main components of the supply chain. This is typified by the chart above which shows the backlog (or rather lack) of ships waiting to unload at North America's busiest port system. Not surprisingly, the cost of shipping a 40-foot container from Shanghai to Los Angeles has followed a similar steep descent and is now in the vicinity of its pre-pandemic level.



Within the CPI basket, two components that have been highlighted as troublesome and "sticky" are wages and housing costs. Labour stats, though, are well known to be lagging indicators and if the breakneck tightening programs being executed around the globe have a presumable impact on economic activity, this source of pressure could diminish rapidly. With respect to the cost of housing, this is one area that is probably being *exacerbated* by rate hikes, which tend to (a) raise the cost of owning a home (b) discourage construction and (c) force indebted landlords to raise rents. In other words, the case for more hiking to stem this problem may not be robust.

At the end of Q3, equity markets seemed to be pricing in no foreseeable end to rising inflation and interest rates, and investor sentiment had followed in kind. Though we won't venture to predict where any of these variables will be in the next three, six, or twelve months, a little bit of digging tells us that the story might not be as unequivocal as many seem to believe. If the softening conditions outlined above begin to find their way to consumer prices (and central banker thinking), then altering one's investment course based on today's environment may amount to acting on old news.

Since the Second World War, the S&P 500 has generated three distinct secular bull markets, or periods of prolonged above-average stock price growth, during which neither pullbacks nor recessions disrupt the underlying upward trend. The first of these extended bulls covered the years 1950 to 1968 and, despite coinciding with three recessions, the Korean & Vietnam Wars, the Cuban Missile Crisis, the assassination of President Kennedy, and the race riots of the 1960s, this ascent saw US stocks gain more than 1000% (assuming dividends were reinvested into the index). Not unlike today, interest rates rose over this time, with the 10-year treasury yield climbing from 2.2% to 5.6%.

The second secular bull began following the challenging decade of the 70's and resulted in the S&P 500 generating an extraordinary total return of more than 2300% from 1980 to 2000. In this interval, investors had to stare down two recessions, the bursting of the Japanese equity and real estate bubbles, the Savings & Loan Crisis, the first Gulf War, and the Asian financial and Russian debt crises. Note also that neither of the uptrends above was short of confidence-shaking moments, with each interrupted by three separate market downturns of more than 20%.

The most recent post-war secular bull market began following the Great Financial Crisis and has seen the S&P thus far return a historically modest 175% once its previous peak had been reattained. Of course, this rise has been buffeted by a global pandemic, contemporary geopolitical hazards, and now an inflation and energy crisis. Though it may feel like today's backdrop is unprecedented, neither the gains nor the impediments characterizing this climb seem markedly more significant than those experienced previously when viewed through a dispassionate lens.

The final comparison we'll present is how the S&P 500 has fared following past declines of 25% or more, a result which has occurred nine times since 1950, including this year. The table below imagines that an investor deployed capital as soon as the market had generated a 25% loss (despite stocks often falling further) and then quantifies what would have happened over subsequent intervals. As you can see, the S&P 500 was higher 12 months later in all circumstances except two and, when the investment was held for longer periods, performance was always positive – *often prodigiously so*.

Stock prices could certainly fall further from here, as was frequently the case during other post-war declines of 25%, but the weight of history says that the patient investor will almost certainly be rewarded. As conditions develop in the weeks and months ahead, we'll be monitoring the variables referenced above and making tactical adjustments as warranted. In the spirit of the quote that opened this piece, however, we won't be attempting any broad market calls or timing transactions as we watch over your long term investment capital.

Peak	Trough	% decline	1yr later	3yrs later	5yrs later	10yrs later*
12/Dec/1961	26/Jun/1962	-28.0%	34.0%	70.4%	100.3%	177.8%
29/Nov/1968	26/May/1970	-36.1%	32.9%	44.8%	26.9%	95.8%
11/Jan/1973	03/Oct/1974	-48.2%	-0.1%	24.0%	41.4%	185.8%
28/Nov/1980	12/Aug/1982	-27.1%	61.4%	108.1%	272.4%	484.9%
25/Aug/1987	04/Dec/1987	-33.5%	15.3%	39.5%	98.8%	418.0%
24/Mar/2000	09/Oct/2002	-49.1%	2.2%	1.9%	24.5%	34.9%
09/Oct/2007	09/Mar/2009	-56.8%	-1.6%	12.1%	70.9%	226.1%
19/Feb/2020	23/Mar/2020	-33.9%	55.1%	?	?	?
03/Jan/2022	30/Sep/2022	-25.2%	?	?	?	?
	Averages	**-37.5%**	**24.9%**	**43.0%**	**90.7%**	**231.9%**

* returns assume dividends reinvested into index

Source: *Bloomberg*

Suite 1680, 1055 West Hastings St, Vancouver, BC V6E 2E9 +1 604 669 3136 Toll Free: +1 888 340 3136 DM dixonmitchell.com