Green Private Wealth of Harbourfront Wealth Management is a discretionary portfolio management group focused on helping investors achieve their goals through building wealth and managing their risks.

Month in Review - January 2022

Stock markets had a poor start to 2022 with the S&P 500 having one of its worst Januarys ever, falling 4.8% (in CAD). At home, the TSX Composite fell 0.4%, performing better than the S&P 500 as returns on Canadian banks and oil companies were much stronger than US technology companies. The Canadian Universe Bond Index also had a poor month falling 3.5%, thereby making matters worse for traditional portfolios consisting of bonds and equities. We continue to use private real estate and private debt as the core safety portion of your portfolios and both asset classes held up well in January, giving you better downside protection than bonds, resulting in more diversified and less volatile portfolios.

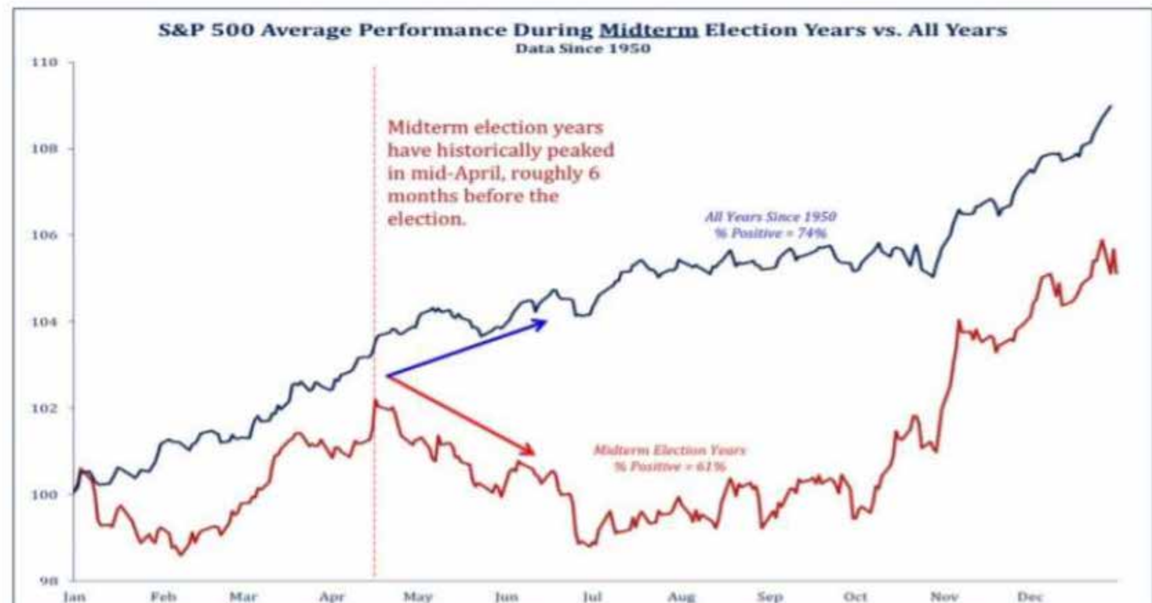
Markets

Markets dropped as the US Central bank, the Federal Reserve (FED), announced it will be tightening economic conditions to fight inflation. With that, markets sold off very quickly, pricing in higher interest rates and money coming out of the system. The FED's importance to the market is paramount, with its actions since the financial crisis in 2008 driving the overall direction of the S&P 500:

1. When they provide easy economic policy (lower interest rates and inject capital via bond purchases) the stock market inflates, which we saw in 2009, January 2019 and March 2020.
2. When they tighten economic conditions (raise interest rates, and/or stop bond purchases and sell bonds) the market falls, as we saw in 2011, 2018 and 2020.

The chart below of the S&P 500, courtesy of well-known technical analyst Sven Henrich, who goes by the name Northman Trader, illustrates the FED's impact, with his notes in blue, tying the S&P 500 to FED actions of buying bonds (also known as Quantitative Easing or QE). You see green bars (S&P 500 is rising) when QE is in place. When QE is stopped and/or they raise rates, you see large red bars, signalling the market selling off:

Based on the history of the FED tightening and stocks selling off, we are likely looking at a more volatile year, where markets can still end the year higher but will likely move both up and down quickly depending on the FED's actions and messaging. Should they sound like they won't tighten as quickly, the market should rally, and if they sound like they will tighten quicker, the market will probably fall. At this point in time, the FED has not committed to anything, other than ending its bond buying program, so we could easily see a relief rally in February based on oversold sentiment indicators. Furthermore, the S&P 500 is following the typical mid-term election year with a poor January, as we can see from the red line below:



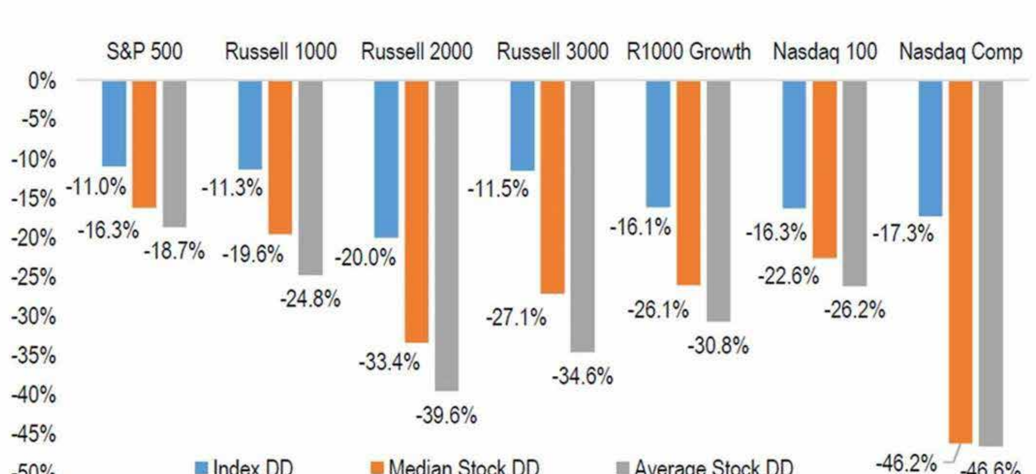
In addition to the oversold sentiment and seasonality on the mid-term election year, the buy-back window for large S&P 500 companies to start buying back their shares opened last week, and 2022 is scheduled to be the largest year of buybacks on record at $1.23 trillion USD of shares to be bought (roughly 2.5% of the current value of the S&P 500), which puts a large buyer back in the market.

While it's been a volatile month, this is always part of investing. Unfortunately, equities do not go up in a linear fashion. Some months and years see oversized returns, which then come back to historical averages. We therefore complement our investments in companies/stocks with private debt and private real estate (namely apartment buildings), as these investments provide more predictable returns because they are focused on producing income, which is easily forecasted. These investments held up well in January, giving us the needed protection when stocks sold-off.

Below is a chart showing the amount of loss since the peak of the market. You can see the mega cap stocks have significant influence on the major indices but when you look at a broader index like the Russell 2000, you get the average stock down 40% from the highs. Take a look at the Nasdaq 100 versus the whole Nasdaq composite, 20% difference on the average stock decline.

Max Drawdown of Index vs. The Constituents

As of January 25, 2022



Source: JP Morgan

Here are some thoughts from Jeremy Fehr (CEO of SIA) about the above chart and what they have been seeing in the charts in general. "We have been seeing this deterioration across all markets since May of 2021. Each and every month has seen weaker numbers for the most part. This lack of breadth being hidden by the market cap indices is the most common trap before bear markets, and why we use Equal Weight Indices. The depth and scope of the differential between the mega caps and the smaller companies has only been this large in one other time, 2007/2008. In July of 2007, the breadth peaked and we saw weakness through all months up to the spring of 2008. There was a slight pop in the spring and the big collapse in the summer. I don't know if we will see as devastating a bear as we saw in 2008, as policy makers have seen that recently and likely have learned from it."

Putting it All Together

Based on continued deterioration and elevated risk, we have made several portfolio changes to address the renewed risk in the markets. Look for an email outlining those changes and rationale shortly. We will be monitoring all activity closely to see if it looks like a significant decline is coming, or if we can expect volatility but no material downward direction in stocks and bonds.

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