U.S. midterms and markets: Investment insights from David Donabedian, CFA

SANCHIA EDWARDS
Hello, everyone. Thank you for joining today's CIBC Private Virtual event. We're doing the US midterms and markets insights from David Donabedian. I'm Sanchia Edwards, the Managing Director for National Office, CIBC Private Wealth and Wood Gundy.

Welcome to all of our clients, guests and advisors. Today as I mentioned, I have the pleasure of speaking with David Donabedian, the Chief Investment Officer for CIBC Private Wealth US, overseeing the internal investment strategies and external manager selection program.

Dave's a leading investment exec expert and frequently appears on TV networks like CNBC and Bloomberg Television. He provides insights in publications like *Barron's* and *The Wall Street Journal*. Prior to his current role, Dave was the Managing Director and Chief Economist at Atlantic Trust while serving on the Asset Allocation, Multimanager and Investment Policy committees. Dave holds 2 degrees from the Wharton School of the University of Pennsylvania and an MBA from Columbia University. He also holds a CFA and is a member of the CFA Institute.

Dave, thanks for joining us today.

DAVID DONABEDIAN
Sanchia, it's great to be with you.

SANCHIA EDWARDS
Great! So Dave has kindly offered to answer a few of our questions about the recent market volatility, possible recession and the impact of what's going on right now in the US midterm elections on global markets. And while Dave is speaking as an expert on the US market conditions, it's an opportunity for us to consider his insights through a Canadian lens to contextualize what's going on at home and abroad.

Why don't we jump right in and we'll start with a question about what's on a lot of people's minds right now, which is what's been happening over the course of 2022, why has the market been so volatile this past year?

DAVID DONABEDIAN
Well, that's a big question and a lot of times big questions have complicated answers, but in this case I think actually it's the answer is pretty simple that the answer to why it's been such a bad year in the markets is inflation. For most of the last decade, in the US and Canada for that matter, inflation hovered around 2%. But over the last two years inflation has accelerated to its highest in 40 years. And one of the questions I think that's important to address is that inflation didn't just rise a little bit, right? It didn't go from 2 to 3%, it went from 2 to 8, it quadrupled. And what's behind that?

The answer I think again is pretty straightforward: it's COVID and the government's response to it. So you go back 2 1/2 years, generally not good memories ,but when COVID began, the Federal Reserve poured trillions of dollars into the economy and the markets, to avoid financial chaos and a potential economic depression. We'll recall people were worried about that and then Congress and two US presidents engaged in, I would call it, radical fiscal policy that poured trillions more into the pockets of American households and businesses, and given what was going on, that may well all have been the right thing to do in the midst of a crisis. But it flooded the zone with money. And of course, one of the many unofficial definitions of recession is that it's too much money chasing too few goods and services. So we had an extreme event that led to extreme policy responses and the price for that this year has been inflation and extreme market conditions as those policies are unwound.

SANCHIA EDWARDS
And it's true, it is easy to forget all of that fiscal stimulus at the beginning, because it does seem like that was a long time ago now. So thanks for that. Digging a little deeper into that, one of the things that I hear all the time here as well, where I work and at home: are we going into a recession and how do we know that?

DAVID DONABEDIAN
Yes, another big and important question. I'll start with something that a famous MIT economist said many years ago. He said, referring to the U.S., he said economic expansions don't die of old age, they're murdered by the Federal Reserve. And over the last 50 years, with the exception of the brief COVID recession, that's pretty much been right. In other words, the Federal Reserve raising interest rates has been a precursor to a recession and so that's one box we can check there if you will. But unfortunately there are some other signs that the economy is probably headed for a fall. So these are other kind of leading indicators that have typically led to or foreshadowed a recession.

The first is an equity bear market and we certainly, unfortunately can check that box. The second would be an inverted yield curve, so when short term interest rates rise above long term interest rates and that condition for the most part is in place. And the third, I would call "declining purchasing power" or "declining take home pay". I think that's an important one on the economy because we hear a lot that we don't have to worry about recession because there's job creation every month and the unemployment rate is low. Those things are definitely true, but we know from looking at past cycles that those kind of job indicators are usually the last thing to fall when the economy goes south so they're almost more of lagging indicators.

What I think typically is a better leading indicator, if you're looking at the job market, is what's happening to the wages of those who are working. Here I think there's a bit of a soft spot in the job market because as much as we know that wages are rising, and that's part of the inflation story, overall inflation is rising faster than wages for most people, so the purchasing power of paychecks is in decline. So when we look at that and the other factors I mentioned, unfortunately we think the conditions are in place for a recession. The timing is always difficult, but we would tend to focus on the first half of 2023 as the most likely timing.

SANCHIA EDWARDS
So if that's going to happen, if there's going to be a recession, I think a lot of people would love to understand your insights on when we could expect interest rates to stop rising.

DAVID DONABEDIAN
Right, and that's been a huge issue and source of volatility in the markets all year. What's that relationship between inflation and when the Fed, Bank of Canada and other central banks are going to say "We've done enough."

Just a quick background on this. As recently as March, the Federal Reserve's key policy rate was zero. As recently as March! But once they hit the inflation panic button, they've raised rates six times since, to a range of 3 3/4 to 4%. That's one of the fastest rate hike periods ever for the Fed. You'll see not exactly the same, but similar policies at the Bank of Canada, ECB and so on. And we look at the Fed today and believe they're not done raising rates yet.

If you look at the last 8 business cycles, to see when the Fed stopped raising interest rates to fight inflation, there's a very clear pattern that emerges. The Fed stops raising rates only when the interest rate they control, the federal funds rate, is above the rate of inflation. But that's not at all where we are today: the Fed's key interest rate is still a little bit below 4% and inflation is almost eight. So either inflation is going to come crashing down tomorrow or the Fed is not done raising interest rates. We think it's the latter and beyond the sort of the mass of it, politically the Fed has dug in and said we're an inflation fighter, that's our job now. I think their attitude is they will bring inflation down, whatever it takes, and while the Fed will never say publicly that they're hoping for a recession, I think they expect that it may take a recession to bring inflation down and we think that's exactly where things are headed.

So when we look at the timing of when rates may stop rising, well, first we think when the Fed gets together in mid-December, they're gonna do another fairly large rate hike, perhaps half a percent instead of the three quarters they've been doing recently. So we would end the year in the U.S. with short term rates around 4 1/2%, but we don't think that's the last one. We think they will have to raise the rates somewhat more in early 2023. If we had to kind of pinpoint when might the rate hikes end, it would probably be around 5% and we would probably target the springtime for when we hopefully have seen enough progress on inflation coming down and enough weakness in the economy so that the Fed would stop.

SANCHAI EDWARDS
Right, well, thank you for that. So with the market volatility we have been seeing, where do you see the bottom in this scenario and further to that, what do you think we would need to see for the markets to start to rise again?

DAVID DONABEDIAN
Sure. So I think to date there have been 3 distinct phases in the bear market. The first phase, I call the inflation panic phase. Early in the year, really almost the first half of the year where it became clear that inflation wasn't going away and that central banks were really going to have to fight it with tight money.

And then we had the second phase over the Summer, the sort of inevitable bear market rally that always happens. Investors got a little bit more optimistic about things, thought maybe the market was oversold, and maybe the Fed was getting close to the end of rate hikes.

And then we had the third phase which was the reality check that all the things that drove that bear market rally were wrong. And so we had a very challenging decline in the market in August and September, but that's where we've been.

I think where we are now is I would call it the fourth and final phase of the bear market which is the bottoming process. I think this began in October. We see some more of it here in November and I think this phase could take a couple of months and probably with a lot of volatility, but it also signals that we're much closer to the end of the bear market than the beginning.

And in terms of when is the bottom, I think a lot of it comes down to whether stock valuations are really cheap enough, where investors feel like they can jump into the deep end even if a recession is looming. Our view on that is we're kind of getting there, but we're not quite there yet. We know from history that valuations in a bear market overshoot to the downside because it's a challenging environment, investor pessimism is obviously quite high so when we look at valuations in the market today, they're not quite washed out enough, compared to past bear markets. So if you look over the last five bear markets, you'll see that stock markets in the US tended to bottom with a price to earnings ratio somewhere between 10 and 14 times, earnings average being 11 to 12. But you can see that today, we're still at about 15 times. So the market isn't screaming cheap for all the pain that there's been. So we're not there yet, on sort of a table bounding buy opportunity, but we're getting there. So it may mean a couple more volatile months, but I do think that we're close to a bottom and that 2023 is setting up for a really good rebound year for equities in the U.S., Canada and other countries. That kind of raises the question of well, what needs to fall into place for a sustainable bull market to begin, not the kind of fleeting rally we saw over the Summer. We've really identified three things.

The first is we need to see clear evidence that inflation has peaked and is on a downward trajectory. And how are we doing there? Well, the October Consumer Price Index report in the US that was released recently provided, I would say, a rare bit of good news. It showed slowing in the inflation rate, but again that's just one month of data. It certainly doesn't qualify as a trend yet. We do think that tighter money is going to lead to a sustained decline in inflation. That's our forecast, but it hasn't actually happened yet.

The second factor that's important, very much related to the inflation story, is when do we finally get some good news or a downside surprise on the peak for the Federal Reserve, how high they raise rates and when they stop raising rates. We talked about this earlier, but today, this year, it's been constant disappointment, whatever the market thought. [The Federal Reserve] ended up having to raise rates higher based on inflation being sticky and new Federal Reserve guidance. We need to get to the point where investors wake up one morning and say “Actually, the Federal Reserve and other central banks don't need to raise rates as much as I thought.” It hasn't happened yet but I think we're starting to get there, where investors expect the Fed to take rates next year to us is fairly realistic, so the inflation numbers start to come in better. We may get to that point where investors say “You know, maybe the Fed is close to done.” It hasn't happened yet, but I think we're on the way to that.

And then the final thing really is profits. I think that one of the things that concerned us earlier in the year was that industry analysts were really unrealistic about the corporate profit outlook. In other words, they were too optimistic. So even though there's a potential recession next year and interest rates are higher and very recently analysts were looking for 8 or 10 percent earnings growth in 2023. To us that looked more like magical thinking than a realistic or credible forecast, but we have finally started to see in recent weeks those profit forecasts being marked down and getting more realistic. That may sound like bad news, profit estimates coming down, but to us it's actually good news because it represents the market embracing a more realistic scenario.

So all in all, when you look at these factors I do think we're in the latter stages of this bear market and we're setting up for higher equity prices as 2023 progresses. One more factor to throw in that's another reason for hope, and it may seem like an odd one, but it's the political cycle. We've just come through our midterm election cycle in the US and we don't think the election outcome, who won or who lost, is all that important for financial markets. What's more important, history tells us, is simply that the midterm elections are over because if you go all the way back to 1950, the return for the S&P 500 and the 12 months following midterm elections has always been positive and with an average annual return of 15%. So despite a really rough 2022, and we're probably going to see continued gloomy headlines, we do think there's something to look forward to for U.S., Canadian and global markets when we look to 2023.

SANCHIA EDWARDS
Yeah, that does actually paint a brighter picture hopefully moving forward. Thank you for all of your keen insights and answering those questions today.

To our audience: we appreciate you joining us today. We hope you enjoyed this event and have a better understanding of what's going on behind the markets and headlines. At CIBC Private Wealth. We're fortunate to have access to world class experts such as Dave working with us and guiding us with our business. We know the past year has been challenging especially in the markets and we're here to support you and those you care about with insights and guidance to help you continue to achieve towards your financial goals.

If you do have any questions, please reach out to your Private Wealth Advisor. Thank you again for joining us and for your continued partnership. Have a great day!

Thank you, Dave.

DAVID DONABEDIAN
Thank you.