September 4, 2022 MONTHLY

Global Investment Letter

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THE BEAR MARKET RALLY IS OVER, NOW WHAT?

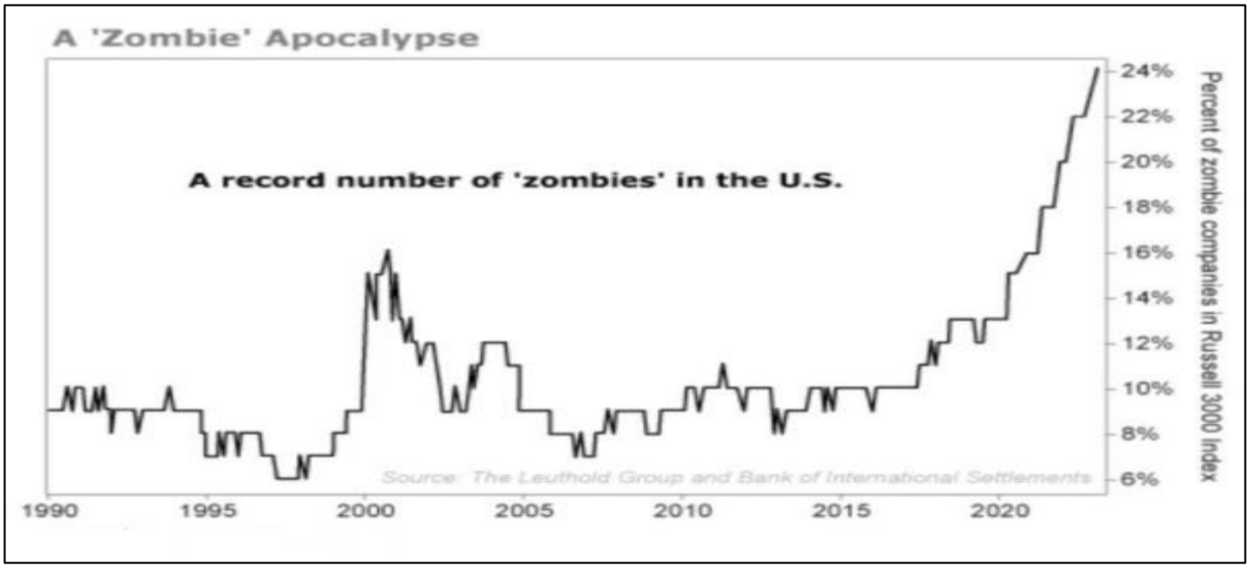
The strong rally in U.S. and global stocks from their June price lows came to a shuddering halt in August in response to the entirely predictable (at least to us) comments by the Federal Reserve (the Fed) that it fully intends to continue aggressively raising interest rates until there is evidence of a material economic slowdown. The bear market rally was based on the widely-held false narrative that the Fed was nearing the end of its rate increases.

We devoted a substantial portion of the last issue to elaborating on the reasons why we believed the consensus opinion on rates was wrong. We'll spare you a repetition of our entire argument other than to say it was (and is) our view that the Fed (and other central banks) intends to raise rates aggressively to produce a sharp recession that will dampen inflationary pressures. Central banks also see this as an opportunity to restore interest rates to something resembling historic norms. Central banks feel they have a limited amount of time to raise rates before economic conditions will force them to halt and begin reducing rates to combat the sharp recession we expect.

Whether the global economy is in recession seems to be a matter of some debate, though it is apparent to us that we are already in the early stages of recession. The world's largest economy, the United States, has recorded two consecutive quarters of negative GDP, which has been a long-standing definition of a recession. The world's second-largest economy, China, saw its PMI Index (a key measure of economic strength) decline to 49.4 in August, which was roughly in line with the July calculation. A PMI level below 50 indicates that the economy is contracting. The Chinese economy is slowing rapidly, a trend that is being exacerbated by China's lockdown of millions of people due to its misguided (in our opinion) zero-COVID policy. The European Union (EU) is already in recession, with most governments already discussing the prospect of rolling power blackouts in the coming months as a means of coping with power shortages resulting from the cutting of Russian energy imports. Thus, to our mind, there should be no debate about whether the global economy is in recession.

More constructive would be a consideration of how severe the recession will likely be.

The global recession appears to be still in its early stages, as unemployment rates remain relatively strong and corporate earnings have yet to be significantly impacted, which we believe will provide central banks with the latitude to raise interest rates more aggressively than many expect. However, we believe this recession will ultimately prove very sharp.



The chart above illustrates that there is currently a record number of "zombie" companies included in the Russell 3000, far more than was seen at the height of the internet bubble. A "zombie" is defined as a firm that cannot service the interest payments on its debt from its operating results. The current 24% level is very dangerous and can be expected to increase as interest rates rise and the recession slows the economy. A wave of corporate defaults can be expected, which will exacerbate the effects of the recession.

I need scarcely remind subscribers that the entire global financial system (personal, corporate, and government) is burdened with an unprecedented level of debt, which will serve to amplify the effects of both rising interest rates and the recession.

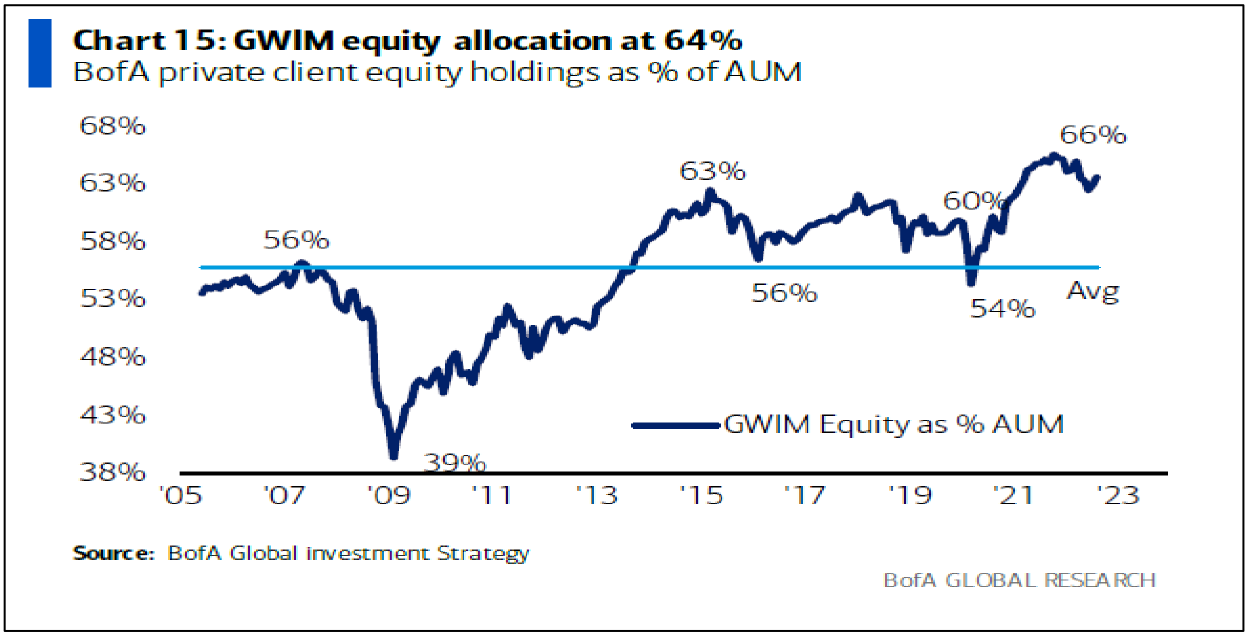
In sum, the combination of aggressive interest rate increases and a very highly levered global economy makes a sharp recession very probable.

THE INVESTING ENVIRONMENT

It will surprise no one that given our expectation of continued rate increases and a worsening recession, we are maintaining our bearish view of markets.

The failure of the summer rally increases the possibility of a sharp market decline as we enter the historically dramatic months for markets of September and October.

A factor that might worsen the acceleration of the bear market is the still surprisingly high level of investor optimism/apathy that produced a summer rally based on the unfounded notion that interest rate increases were at/near an end.



A useful proxy for investor sentiment is the positioning of the private clients of Bank of America (BofA). It is surprising to us that despite the surge of inflation to levels last seen in the 1970s, rising interest rates, and the most troubling geopolitical climate since WWII, the exposure of BofA clients to equities remains near the highest level since the days of the internet bubble at the turn of the century.

It is worth noting how far equity exposure must fall to create a durable long-term market bottom, as was established in March 2009.

We are unlikely to see an attractive long-term buying opportunity in equities until we see a peak in investor bearishness, which will coincide with a significant drop in BofA clients' equity exposure. There are a number of potential catalysts that could trigger an extreme of investor bearishness, with mounting evidence of the severity of the recession and a wave of cuts to earnings estimates by analysts being high on the list.

It is worth noting that the circumstances that could produce a peak in negative investor sentiment could also mark the point at which the Fed (and other central banks) decides to halt rate increases and begin the process of cutting rates to combat the recession. At that point, both of the necessary pre-conditions to create a major market bottom (as we have discussed in previous issues) will have been met.

When the end of the current bear market will occur remains to be seen. As investors, it is our responsibility to practice patience and adopt a defensive investment posture to moderate risk until the risk/reward climate improves.

It can be psychologically uncomfortable to be inactive and wait for events to unfold. This is as true for both professional and private investors. For those who do not have the luxury of moving completely to the sidelines, we suggest adopting as defensive a posture as is practicable.

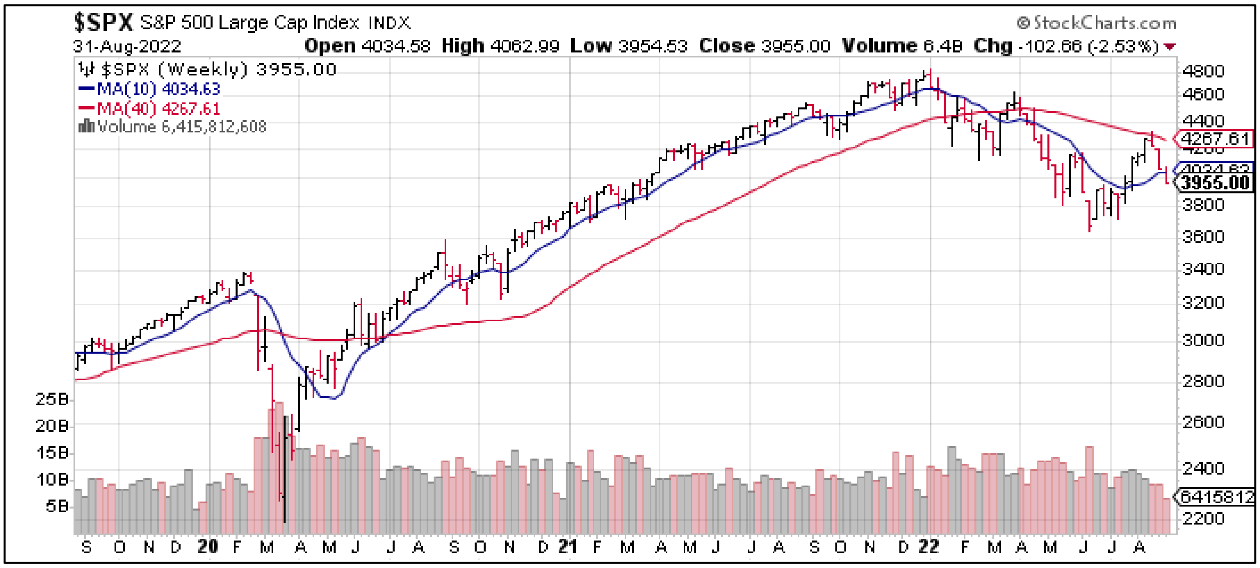
We remind subscribers that bear market declines tend to be back-end loaded, with the greatest market weakness occurring at the end when the collapse of investor optimism creates the great buying opportunity that is associated with the start of a new bull market.

Finally, we leave you with the following chart which confirms that corporate insiders share our reservations about the prospects for the global economy and markets.

Insider sales have been outpacing purchases steadily for some time, often by a wide margin. Various academic studies have confirmed that insider transactions do have predictive value, which seems intuitively correct given that company management can be expected to possess the best perspective on the conditions affecting their respective firms.

EQUITIES COMMENT

S&P 500 (WEEKLY)



The chart above illustrates the end of the bear market rally, as the S&P 500 fell over 4% in August. The technical resistance provided by the 40-week moving average proved to be the reversal point of the rally, with the help of a dose of reality from the Fed!

During our career in money management, we have seen a good deal of drama play out in September/October and we are always attentive for early signs of market weakness during these months.

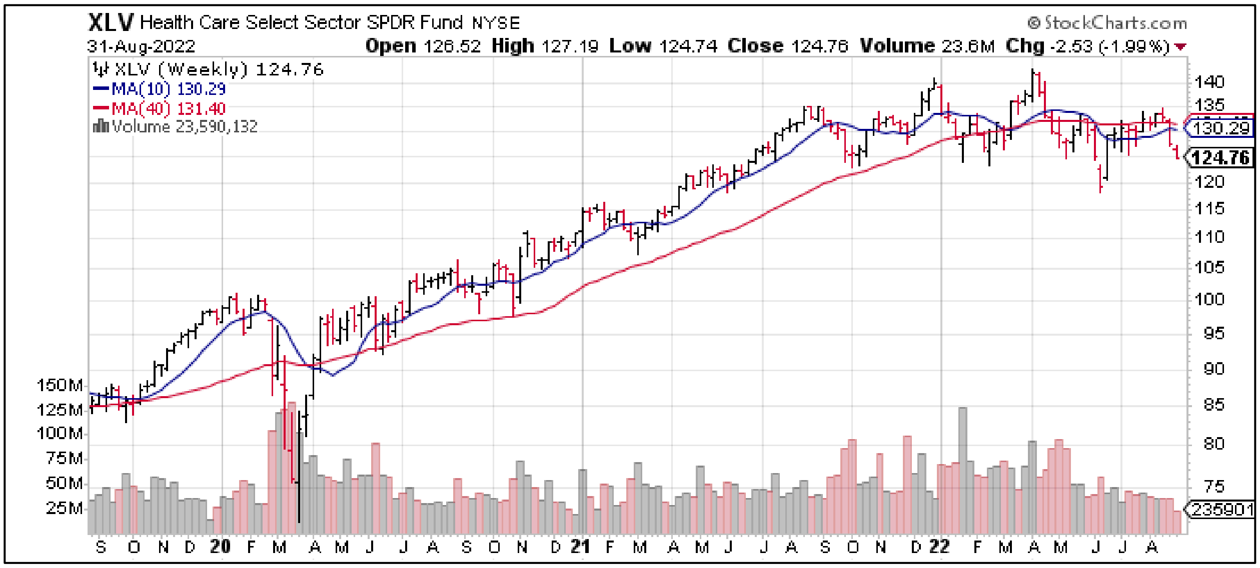
We expect further market weakness with the circa 3700 level being the next level of significant technical support.

If the S&P 500 trades through support at circa 3700, substantial further weakness may be expected, with the next price target being circa 3200.

We will continue to keep our eyes peeled for evidence of an extreme of negative investor sentiment to confirm that a durable market low has been established, whenever that may occur.

HEALTH CARE TRADE

HEALTH CARE SPDR ETF (XLV) (WEEKLY)



Our proxy for the health care sector, the XLV ETF, fell sharply in August and is exhibiting very bearish technical price action by trading below both its 10 and 40-week moving averages. The circa 120 level is the next level of chart support. A move by XLV below 120 would be very negative and suggest much lower prices.

We continue to hold no position in XLV given our generally bearish current view on equity markets, though we remind subscribers that health care remains a core long-term investment theme. It is a sector that has delivered solid profits to us in the past, and we expect it will do so again, but the currently poor risk/reward investment climate compels us to defer taking a position until XLV produces an attractive buying opportunity.

FTSE 100 (DAILY)

In August, the London FTSE 100 index once again approached the massive technical resistance represented by the circa 7500 level, only to see the rally attempt sputter yet again.

Longer-term subscribers will know that we have been bearish on the FTSE for quite some time, with the negative economic implications of Brexit being a major fuel of our concern. To the residual effects of Brexit must be added the economic and social influence of much higher energy costs that will see the cost of heating British homes soar this coming winter. The effect on consumer purchasing power will be substantial unless energy costs moderate.

The global recession that is underway may prove to be especially sharp for European economies, such as Britain, as the influence of higher energy costs exacerbates the negative recessionary effects on corporate earnings.

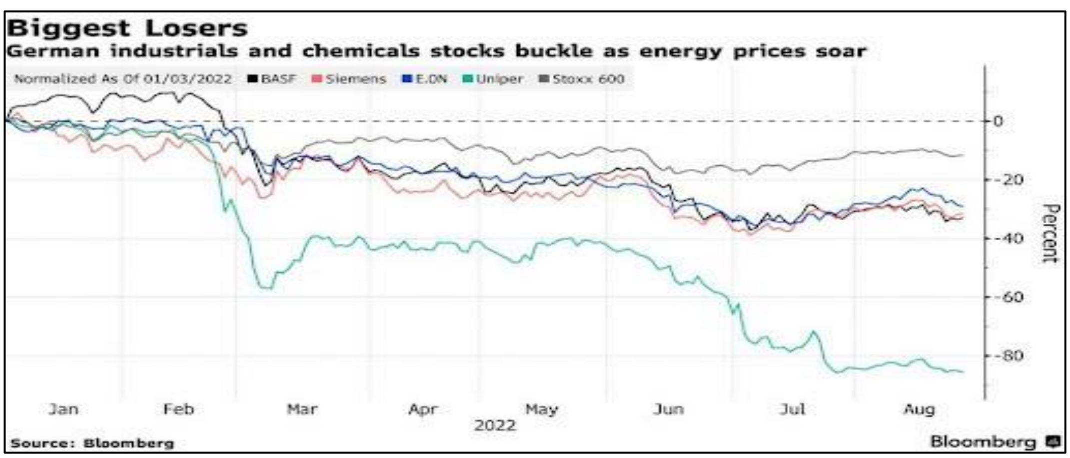
Therefore, we must maintain our bearish view of the FTSE and await an eventual buying opportunity.

DAX INDEX (WEEKLY)

German equities face a very difficult operating environment, as does all of Europe. The current recession is being worsened by soaring energy costs that give us no recourse but to maintain our bearish view of the Dax.

Germany's largest gas importer, Uniper, recently requested an additional 4 billion euro bailout from the government, in addition to the 9 billion euros that have already been drawn down.

Soaring energy prices have caused Germany to record its first monthly trade deficit since 1991.



The chart above illustrates the effects of higher energy prices on German equities.

CAC 40 (WEEKLY)

As with the Dax, the prospects for the Paris CAC 40 index are less than inspiring. The combination of a global recession and the effects of the geopolitically inspired European energy crisis is difficult to construe as bullish.

We remain on the sidelines of this market. From a technical perspective, it is worth noting that the 40-week moving average served as a reversal point for this summer’s bear market rally. Major technical support exists at circa 5750. A move below that level would suggest much lower prices.

As with all other equity markets, we await the eventual buying opportunity, whenever that might arrive.

NIKKEI INDEX (WEEKLY)

The weakening yen, a product of the Bank of Japan practicing the loosest monetary policy of any major nation, continues to support the Nikkei (which has a long-established inverse relationship with the yen).

Though the Nikkei retreated in August, it still trades above both its 10 and 40-week moving averages, an accomplishment that few other markets can match these days.

A look at the yen/dollar comment in this issue will reveal that the yen has declined by 20% against the dollar in 2022, which puts the true performance of the Nikkei in perspective for non-yen-based investors.

The Japanese economy, and the Nikkei, are subject to the same economic and geopolitical headwinds that cause us to have a bearish view of other stock markets. Thus, we continue to wait on the sidelines for events to unfold that will present a fresh buying opportunity for Japanese equities.

SENSEX (WEEKLY)

The Indian Sensex index continued, in August, to be one of the world's best-performing indices in 2022 and continues to trade bullishly above its 10 and 40-week moving averages.

India remains a favourite long-term emerging market candidate for the enormous inherent growth potential of the Indian economy. That bright potential comes with significant economic, social and political challenges that must be overcome, as is typical with developing economies.

Though we currently hold no position in the Sensex, it has been the source of significant returns for us in the past. The index is in proximity to its all-time high at 62500, and a breakout above that level would be sufficiently bullish to prompt us to re-establish a position. We would establish a protective sell price at the 2022 high to protect us from a significant loss in the event the breakout attempt fails.

Whether a breakout by the Sensex occurs remains to be seen. The all-time high represents technical resistance that often acts to reverse rally attempts. The currently difficult environment for global equities certainly diminishes the likelihood of a successful breakout in the near term, though we will remain alert if one should materialize.

EMERGING MARKETS ETF (EEM) (WEEKLY)

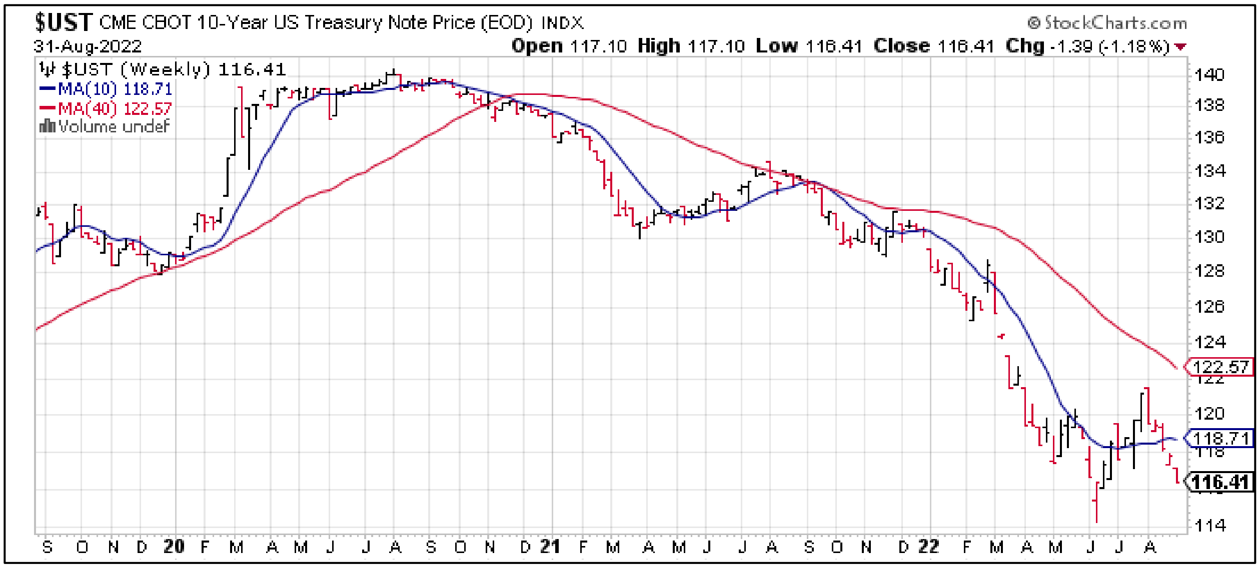
Our proxy for emerging markets, the EEM ETF, continues to trade bearishly well below its 40-week moving average.

The conspicuous strength of the U.S. dollar is creating multiple problems for emerging markets, not least making the cost of their U.S. dollar-denominated debt increasingly expensive in local terms. The continued strength of the dollar will result in one or more defaults by emerging markets, in addition to the existing situation in Sri Lanka.

There is no compelling reason to purchase emerging markets at this time.

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



Our purchase of a position in the last issue of 10-year Treasury Notes at 119.50 proved to be short-lived as we were forced to sell our position when our protective sell price at 118.50 was triggered.

We established the trade on the premise that the short-end of the yield curve would continue to rise in response to Fed rate hikes but that the longer-end of the curve would rally as the developing recession would create the expectation of lower long-term rates because of economic weakness.

That is not what happened, and we were wrong. Luckily, our advocacy of protective sell prices limited our loss to less than 1%, which is especially fortunate given that the Treasury Note ended the month at 116.41.

We were wrong, and we will be again. Sometimes the best-laid plans don't work out. That's where the value of money management through the use of protective sell prices and other techniques we incorporate play a role in maximizing risk/reward.

The trading in 10-year Treasuries has resumed a bearish tone, with the low of 2022 being an important support level. A move through the 2022 low would indicate that significant further downside is likely.

CURRENCY COMMENT

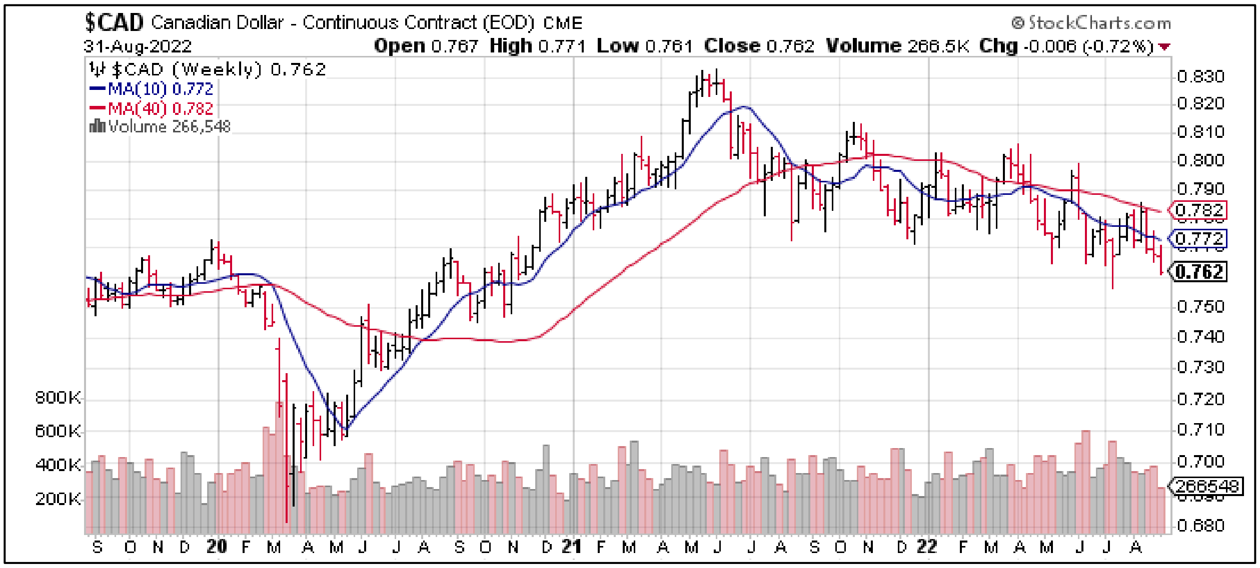
US DOLLAR INDEX (DXY)(WEEKLY)

The U.S. Dollar Index rebounded strongly in August, following its recent price retracement, to close the month near multi-year highs.

The August rally owes much to the market's realization that the Federal Reserve remains intent on continuing to aggressively raise interest rates. A notion took hold (which we did not subscribe to) this summer that the Fed was nearing the end of its rate increase cycle, which resulted in a softening of the Dollar index as well as producing a rally in stocks. Once reality intruded on investors' wishful thinking, the dollar rebounded and the stock market rally fizzled.

We continue to be bullish on the dollar for our oft-repeated reason that there is no credible alternative. As long as the Fed adopts a leadership position in raising interest rates and the geopolitical scene remains troubling (to say the least), we expect capital will continue to flow into dollars.

CAD/USD (WEEKLY)

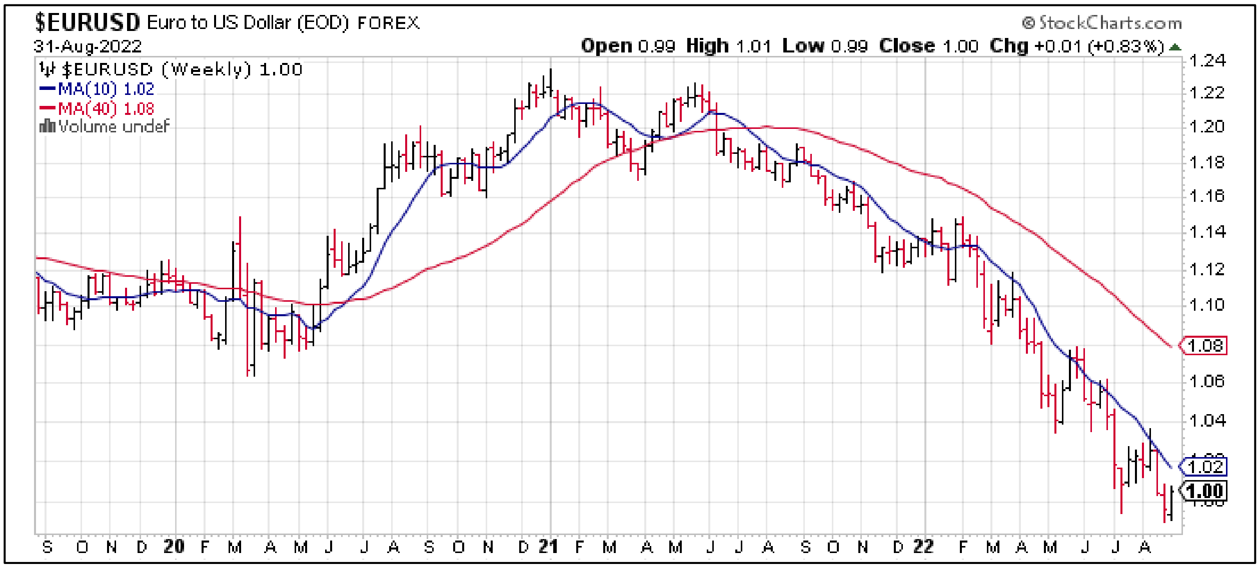


The Canadian dollar traded considerably weaker against its American counterpart in August, as lower oil prices exerted their typically negative influence on the currency. The general strength of the U.S. dollar also played a role.

Since we expect the U.S. dollar to continue to exhibit strength in the current investment climate, the future path of the Canadian currency will be largely dependent on oil prices.

From a technical perspective, the Canadian dollar looks very bearish, trading below both its 10 and 40-week moving averages. Continued price weakness is probable, with the caveat that a geopolitically driven spike in the price of oil could produce a rally in the Canadian dollar.

EUR/USD (WEEKLY)



Our long-held belief that the euro would reach parity with the U.S. dollar was achieved in August, as the euro closed the month at exactly 1.00.

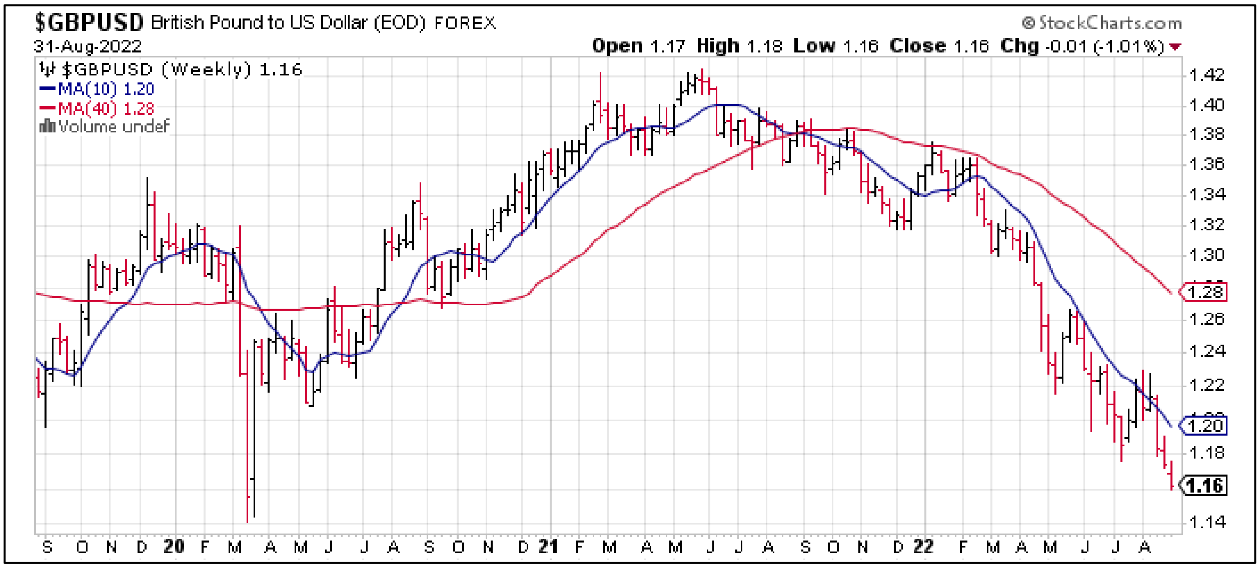
The factors that drove our bearish view of the currency (multiple economic and political challenges in the European Union) remain and have grown more serious, and have been joined recently by energy supply disruptions from Russia and the potential election of a far-right "populist" government in Italy in September (which could be a catalyst for Italy's departure from the European Union).

This winter could be very difficult for Europe in many ways, with EU inflation likely to rise to double-digit levels in response to rising energy costs. The rumoured 75 basis point interest rate increase by the European Central Bank (ECB) seems too little, too late. The anticipated rate increase will bring EU rates to just 0.75%, which is, at best, only keeping pace with the Fed and well below the levels needed to combat inflationary pressures.

The 1.00 level could act as price support for the euro in the near term, and a short-term rally in the euro would not be surprising. However, the strongly positive interest rate differential of the dollar and its role as the world's reserve currency, set against a backdrop of steadily deteriorating geopolitics, suggests that the euro will ultimately trade lower.

Therefore, we remain bearish of the euro.

POUND/USD (WEEKLY)



We commented in the August issue that we considered the rally by the pound against the dollar in July to be but a bear market rally. That certainly proved to be the case in August, as the pound plummeted to end the month at 1.16, not far from the COVID-related low of March 2020 at circa 1.14.

It would not be surprising to see another bounce by the pound as it approaches 1.14, but we expect that it too will prove to be a bear market rally. Our long-term target for the pound continues to be par with the dollar. A break below the circa 1.14 level would suggest further short-term weakness.

The ongoing weakness of the pound versus the dollar is a combination of the challenges faced by the British economy (Brexit, energy costs et al) and the relative strength of the U.S. dollar (the positive interest rate differential and geopolitics) versus essentially all other major currencies. We do not expect these drivers of a weaker pound to change anytime soon.

YEN/USD (WEEKLY)

Per our comments from last month's issue, "*The central issue remains the Bank of Japan (BOJ). If the BOJ continues to practice very loose monetary policy while other central banks are raising interest rates and shrinking their balance sheets then the yen will continue to be weak. In the absence of a change in BOJ policy, we are treating the recent strength of the yen as a counter-trend rally in a bear market rather than a change to a bullish trend.*"

After strengthening against the U.S. dollar early in August, the yen closed the month on a very weak note when it became apparent that not only was the Federal Reserve intent on continued interest rate increases but the BOJ was as intent on maintaining a very loose monetary policy. As long as this dynamic between the two central banks holds, the logical expectation is for the continued weakness of the yen.

YUAN/USD (DAILY)

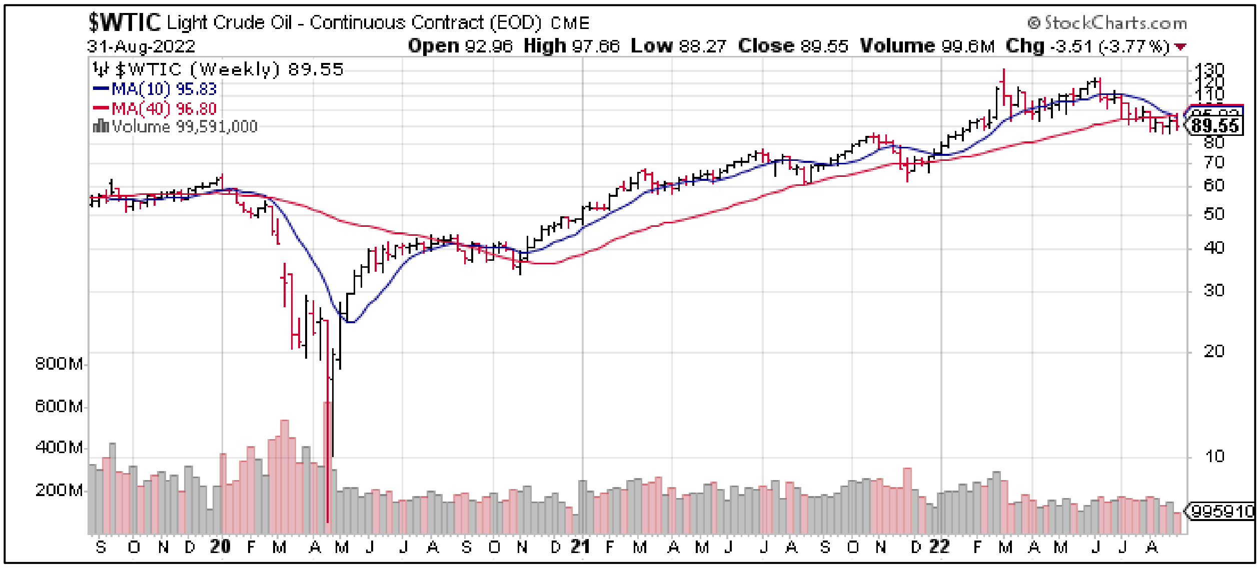
As we wrote in last month's issue, *"The yuan continues to trade in a relatively narrow price range. We continue to believe this constriction of price volatility will resolve with the yuan weakening to the circa 7 level to the US dollar."*

That is exactly what occurred in August, as the yuan seems destined to reach the circa 7.1 level. This should not be surprising given the slowing Chinese economy and the increasingly tenuous relationship between China and the West, both of which imply that a weaker yuan is in Chinese interests. More surprising to us is that it took until May of 2022 for China to begin the process of devaluation.

A move through circa 7.1 by the yuan would be a strongly bearish signal and suggest that China may be considering a significant devaluation. The short position in the yuan has risen substantially since August 1, indicating that our thesis of a weaker yuan is being more widely shared.

OIL COMMENT

CRUDE OIL (WTI) (WEEKLY)



We wrote in last month's issue that *"Our current expectation is that oil prices will trend downward until they eventually spike when Russia exerts its leverage on energy markets to punish Western Europe for its support of Ukraine."*

Oil prices did indeed decline in August, dropping about 10% due to concerns about rapidly weakening oil demand associated with the developing global recession. Oil demand is likely to soften over the months to come, but demand may not prove to be the dominant factor in setting the oil price.

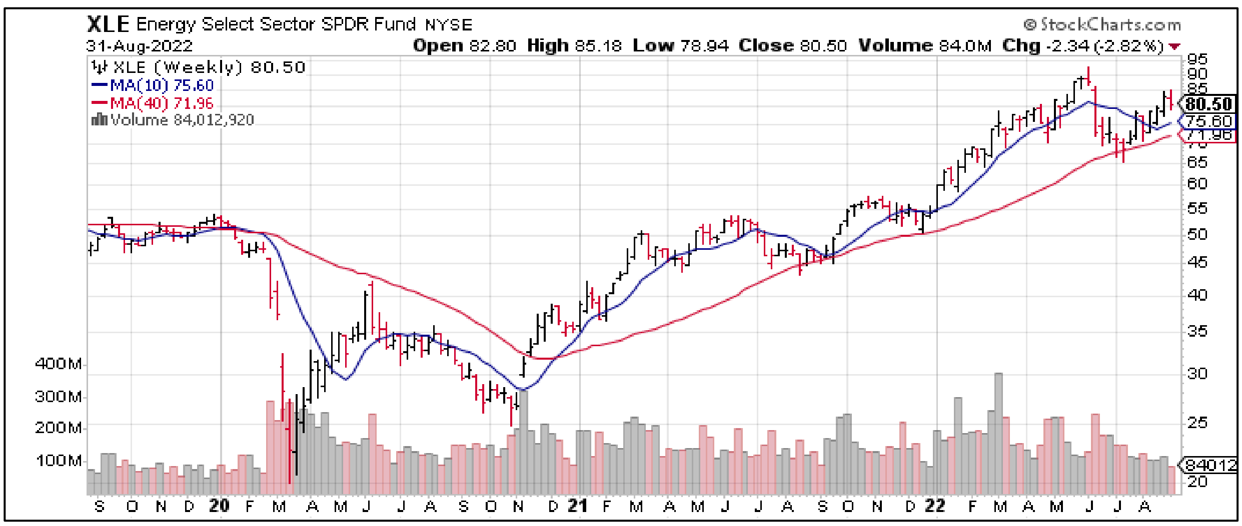
Instead, various geopolitical influences are likely to play a critical role in the oil market. The first to consider is the OPEC+ meeting on September 5 in which it is rumoured that production cuts will be announced to support the price of oil. A cut in production by OPEC+ would not be surprising, as oil prices are likely to decline further without supply reductions given the prospects for continuing weakness in oil demand. Oil revenues are of supreme importance to most OPEC+ members, so they have ample motivation to support prices (especially given the current global economic and geopolitical landscape). The size of the cuts (if they occur) is yet unknown, so there is uncertainty. It is safe to say that if OPEC+ does announce production cuts, and the price of oil does not respond to their liking, further supply reductions can be expected.

The standoff between the West and Russia continues to develop, with the G7 nations agreeing to a price cap on Russian energy purchases as a means of limiting Russian revenues that could be used in its invasion of Ukraine. Not surprisingly, Russia has responded by cutting natural gas exports to Europe through the Nordstream 1 pipeline. Subscribers will know that we viewed this development as an inevitability.

The full effect on energy prices in Europe will not be felt until the heating season begins. It is likely to be an expensive winter for many Europeans.

If forecasting oil prices was just a matter of assessing supply and demand, it would be a relatively simple matter. But the oil market has always been a challenge to navigate because of its historic vulnerability to geopolitical influences. That certainly remains the case today.

We do not have sufficient confidence in the probability of higher oil prices to take a position. The oil market is in a tug of war between the effects of the recession on demand and the geopolitical actions of Russia and OPEC+. That is too uncertain an investment landscape on which to base an investment.



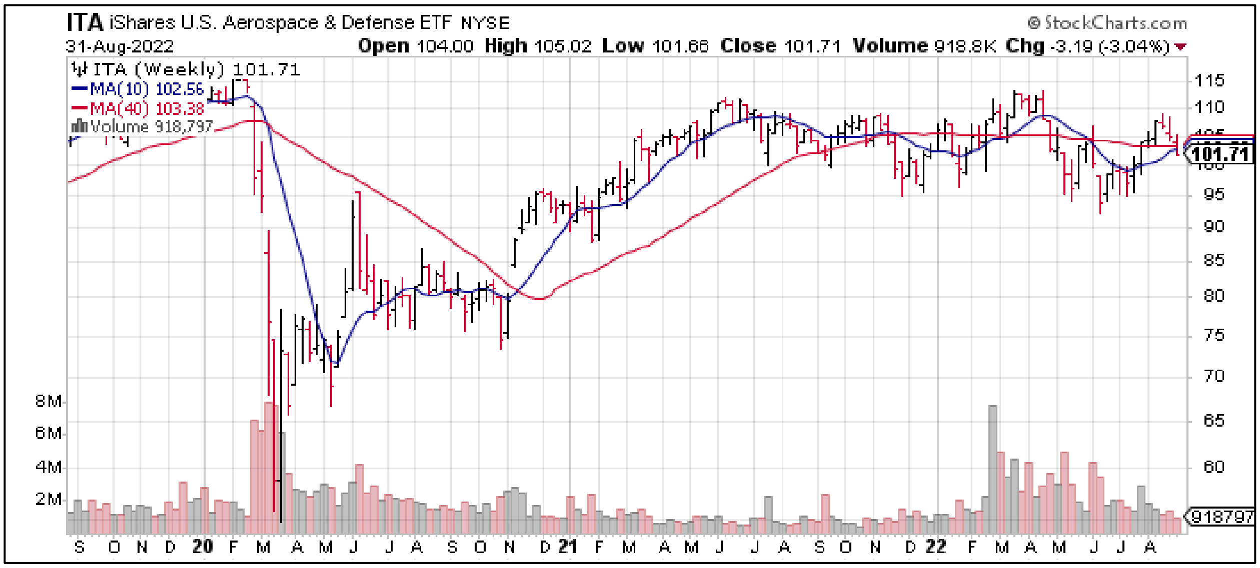
Our proxy for energy shares, the XLE ETF, fared much better than the price of oil in August. XLE rose 2.7% while oil declined circa 10%. The positive performance of XLE is a reflection of the strength of stock markets in the first part of August as well as apparent optimism by investors that the price of oil will rebound.

While the price action of XLE in August was bullish, that it was accomplished with declining volume is not. As well, that it is trading above its 10 and 40-week moving averages is bullish, but that it still trades below its 2022 price high is concerning.

We will continue to stay on the sidelines of this market given our general concerns about equity markets

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA)(WEEKLY)



Our proxy for the defence sector, the ITA ETF, fell back in August and ended the month trading below its 40-week moving average, which is typically a bearish development.

Taking a longer view, it is noteworthy that ITA has yet to surpass its price high of 2020. The significant relative underperformance of the defence sector versus the S&P 500, especially given the concerning geopolitical scene, is noteworthy and somewhat puzzling (at least to us).

Nonetheless, it highlights the importance of waiting for a clear buy signal before entering positions, no matter how compelling they might seem. That we did not perceive a buy signal has kept us out of an underperforming position.

That being said, the global defence sector remains a core long-term investment theme because technological developments and the geopolitical environment argue strongly for strong revenue growth for the defence industry in the years ahead.

To maximize risk/return, we must wait for broader recognition of the merits of this sector before re-establishing a position.

In our opinion, a move by ITA through its 2020 price high would be a very bullish signal and prompt us to initiate a position. In the meantime, we are content to stand on the sidelines.

GOLD & SILVER COMMENTARY

GOLD (WEEKLY)

The price of gold declined sharply in August, ostensibly in response to the effects of the continued strength of the U.S. dollar and confirmation by the Fed that it is not contemplating changing its policy of increasing interest rates. Both of these factors have historically had inverse relationships with the price of gold. A higher U.S. dollar makes gold relatively more expensive for non-dollar-based investors, and higher interest rates raise the cost of ownership of an asset that has no income yield.

Nevertheless, gold's performance remains very poor in an environment that should be ideal for strong gold prices. Global inflation is at its highest levels since the 1970s, and economic and geopolitical risks are higher than at any time since WWII. We repeat an old maxim that we have referenced before: If a market acts bearishly when it should behave bullishly, that is very bearish indeed and should be noted.

We are not "gold bugs" but we are respecters of strong technical support and resistance levels in all markets, for it has been an effective technique for many years. The successful recent test by gold of the circa $1700 support level prompted us to establish a position at $1720 in July.

We will retain our position while keeping our protective sell price at $1690. A move below $1690 would substantially raise the probability of much lower prices.

As the chart of the Gold & Silver Index (XAU) clearly demonstrates, precious metals equities are in the grip of a bear market, as are stocks in general. There is no good reason to own XAU at this point, as lower prices seem highly likely. Poorly performing gold and silver prices combined with a bear market in stocks make XAU an unattractive risk/reward proposition.

The price of silver declined significantly in August and has been a conspicuously poor-performing market. Lower prices seem likely. We will remain on the sidelines of this market until we have reason to do otherwise.

ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award-winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be a discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.