This Month in the Markets

May 2022

Equity Commentary

No Rain… But take an Umbrella

Despite swirling headlines around the war in Ukraine, inflation, and even Monkeypox, the equity markets ended the month of May essentially where they began. The MSCI ACWI Net Total Return market posted a 0.1% gain. The MSCI World Value Index rose 2.1% compared to a 2.3% decline in the MSCI World Growth Index. The S&P 500 eked out a 0.2% gain, while the MSCI EAFE Net Total Return Index increased 0.7%. What has been working for most of the year continued to work in May. The ACWI Energy Sector index was the top performer, soaring 12.2% due to a surge in natural gas and crude oil. Henry Hub's natural gas prices rose above $9.00, and Brent crude once again printed prices above $120/barrel. The MSCI ACWI Real Estate Sector was the under-performer with a 3.8% loss.

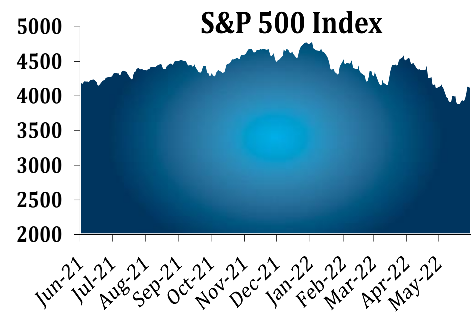
Although markets may not have offered any direction in terms of price, there has been an underlying shift in concern. While inflation dominated discussions surrounding risk at the start of this year (and this still is a discussion point), the significant worry now seems to have shifted to growth. More specifically, will the downshift in global economic growth become more severe, and will we see a recession? Will the Federal Reserve raise rates to the point that will strangle inflation but also suffocate growth? According to the latest Bloomberg monthly survey of economists, the odds of a recession over the next 12 months have reached 30%. We have never found it helpful to try and predict or position for rainy weather but would rather spend time building a portfolio full of umbrellas, rain gear, and boots. In other words, we all know it will rain eventually, so you must own reliable quality companies that can weather any storm – of course, it is never a good idea to be outside in a hurricane. Our goal is to find companies benefiting from larger macro shifts within the global economy – think "climate change" rather than daily weather fluctuations. In doing so we hope to have protection from inclement weather with a portfolio that offers lower valuation, solid business dynamics, and secular tailwinds.

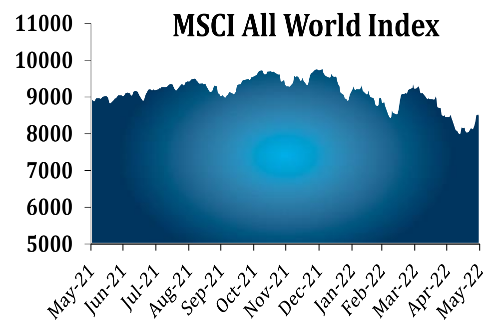
Target Corp. was the largest underperformer in the portfolio for the month, with a decrease of ~29% after reporting disappointing profit margin guidance and inventory concerns. The top performer in the month was Devon Energy, up ~29%, which continues to rally on the back of solid energy prices and attractive shareholder returns.

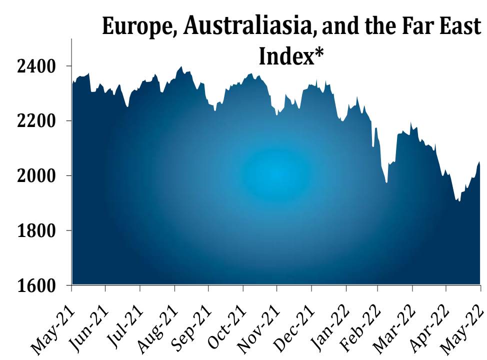
During the month, we exited Amazon.com Inc. ("AMZN"). Our disposal was related to reassessing the post-pandemic trajectory surrounding online sales and durable goods purchases in general. We believe the economy is moving towards more service-oriented spending and "in-person" experiences. AMZN was a significant beneficiary of the Covid restriction environment. Going forward we believe AMZN will be going through a period where it must contend with supply chain issues and labor cost escalation in an environment where overall consumer consumption shifts back towards services and away from goods.

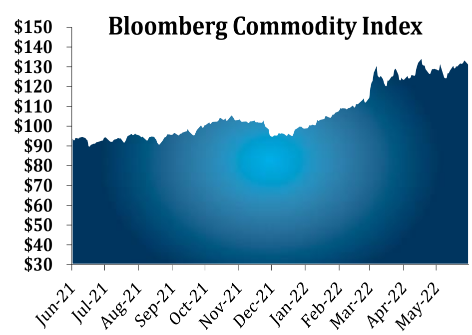
In May, we bought two new positions: Booking Holdings Inc. ("BKNG") and Imperial Oil Ltd. ("IMO"). When we look at Booking, we consider that the Millennials are the largest generation of travelers, and the travel industry is once again one of the fastest-growing sectors of the global economy as people emerge from the Covid restrictions. Booking Holdings is the largest travel website company, with profits expected to rebound from pre-covid levels in the second half of this year. Gross bookings in the first quarter of $27.3B was the travel company's highest quarterly ever, surpassing its prior record of $25B in 1Q19 by 7% and exceeding expectations by 8%. Analysts expect another 34% growth in EPS in 2023. The key to the company's success is international growth. Analysts estimate that international likely accounts for >80% of Booking's total revenue. Exposure to international positions the company to take advantage of more disaggregated hotel markets compared to the domestic market, which makes it difficult for hotels in those markets to take inventory directly in an improving environment.

IMO is a Canadian Integrated Energy company with about half of its earnings coming from its upstream (production) business and a half from its downstream (refining, marketing, and chemical) business. Despite the recent rally in energy companies, including IMO, when looking at discounted cash flows, we believe shares of IMO were pricing in longer-term crude (WTI) in the $60-$65 range. This compares favorably to the forward curve and our longer-term value of WTI, around $83. IMO is Canada's largest refiner in its downstream business and benefits from its relationship with Exxon Mobil ("XOM") as it can utilize XOM's global technological expertise. Historically IMO's refining margins have been superior to US refiners due to the structure of the Canadian market, and we expect this to continue.









*MSCI EAFE Index

Fixed Income Commentary

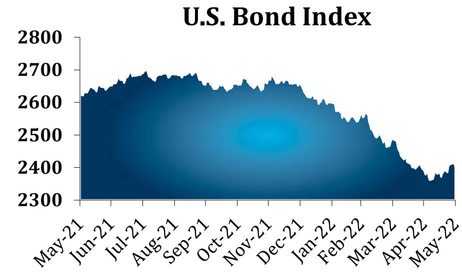
Cracks Appearing?

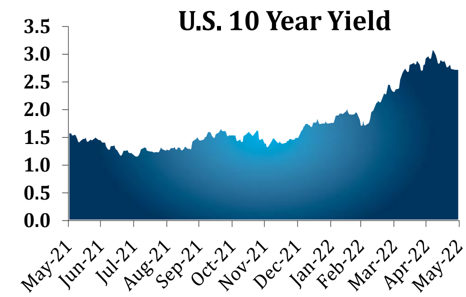
The relentless rise in treasury rates finally took a break in May. It was the first month in 2022 in which the 10-year Treasury yield ended the month lower than where it started the month. It wasn't a steady decline throughout May, however. It traded up to a 2022 high of 3.12%, then steadily fell 0.38% over two weeks, before finishing May at 2.84%. In a speech in late May, Federal Reserve Bank of Atlanta President Raphael Bostic commented that a rate hike pause could be on the cards after 0.50% hikes to come in both June and July (these hikes were all but confirmed by Powell in his May Federal Open Market Committee (FOMC) press conference). However, it must be noted that Bostic is not a voting member of the FOMC, and his comments were contingent on there being a notable easing of inflation pressures by September. The Fed's balance sheet run-off will begin this month, with the Fed capping run-off up to $47.5 billion ($30 billion of Treasuries and $17.5 billion of MBS) a month for three months before doubling thereafter. This is a much quicker pace than the 2018 balance sheet run-off, highlighting the Fed's tightening ambitions.

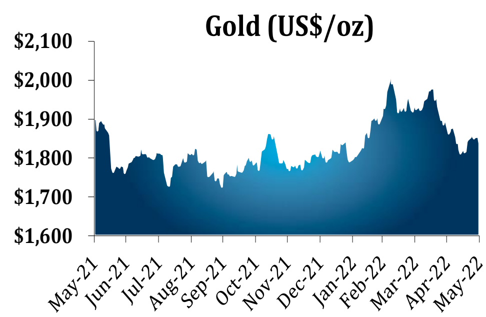
While U.S. rates plateaued in May (at least for now), the same cannot be said of European yields, which continued to rise on the back of increasingly hawkish European Central Bank (ECB) rhetoric amid heavy inflationary pressures (European Consumer Price Index +7.4% YoY in April). The ECB has hinted at moving its benchmark rate (currently -0.50%) to 0% by September. While it would be a welcome sight to see the ECB lift rates out of the negative territory, it will likely be doing so when the European economy is slowing. Also, the ECB will be winding down its asset purchase program, which has helped to keep sovereign debt yields of vulnerable member states in check. For example, in the European Sovereign Debt Crisis (2011/12), the spread between the Italian and German 10-year bond yields rose to approximately +5.50%. For context, in 2021, this spread was only about 1%. It currently stands at 2% at the time of writing. It will be interesting to see if the ECB follows through with the financial tightening and how borrowing costs react.

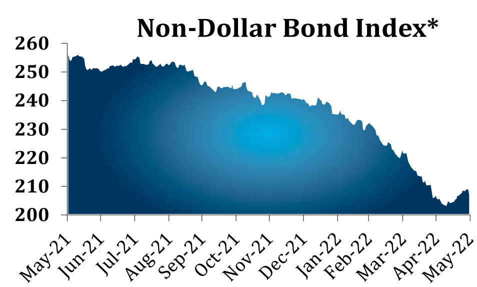
Credit Spreads widened for most of May before generally tightening in the month's final week. However, the lowest-rated cohorts ended the month with wider credit spreads, namely the B-rated and, especially, the CCC-rated credits. As a result, the credit spread differential between the CCC-rated (lowest credit quality) and BB-rated (highest credit quality in the high yield universe) rose by +1.32% to 5.67%. This metric is now above the 10-year average and suggests that credit investors are shying away from the riskiest corners of the corporate credit market. We also saw high-yield companies shy away from the new issue market, issuing only $3.95 billion – the lowest figure for the month of May since 2002.

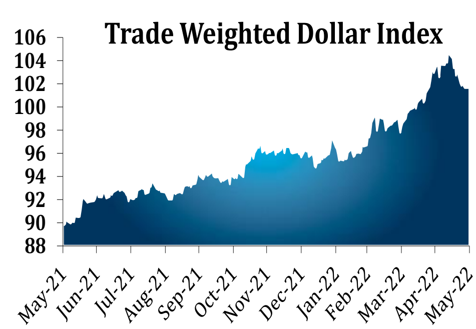
The rise in both treasury rates and credit spreads in 2022 has led to materially higher borrowing costs for all companies. For example, the yield-to-worst on the Bloomberg Aggregate Corporate Bond index (investment-grade corporate bonds) ended the month at 4.15%, two standard deviations above the 10-year average. While we aren't seeing any widespread shunning of credit risk by investors (yet?), our focus continues to be on companies with a strong credit profile. We benefited from one of the portfolio's high yield bonds being upgraded to investment grade in May (HCA) and expect another of our high yield holdings to be upgraded to investment grade in the next couple of months. We continue to believe a conservative view towards credit is warranted, given hawkish central banks that are under intense pressure to tame inflation.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

Disclaimer