Navigating Multiple Liftoffs

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"We have lift-off!"

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

- William Arthur Ward

"We have liftoff." Those words were immortalized by Jack King on the Apollo 11 program in 1969 which landed the first humans on the Moon. In the years since, it has become standard lingo associated with rocket launches, and even making its way into the financial industry, where liftoff most commonly refers to the first interest rate hike by the U.S. Federal Reserve (Fed).

In today's environment, we see simultaneous "liftoffs" occurring – interest rates have begun moving higher, in response to higher inflationary pressures, and amidst an environment with higher geopolitical uncertainty. However despite these multiple liftoffs resulting in greater uncertainty for investors, our belief is that the stock market, whose liftoff occurred in the depths of the pandemic in 2020, will likely continue in the uptrend that began that year. In this note, we will explore these aspects and their implications on the stock market, as well as the growing discussion around the inversion of the yield curve, which has historically been a recession predictor.

The Inflation Liftoff

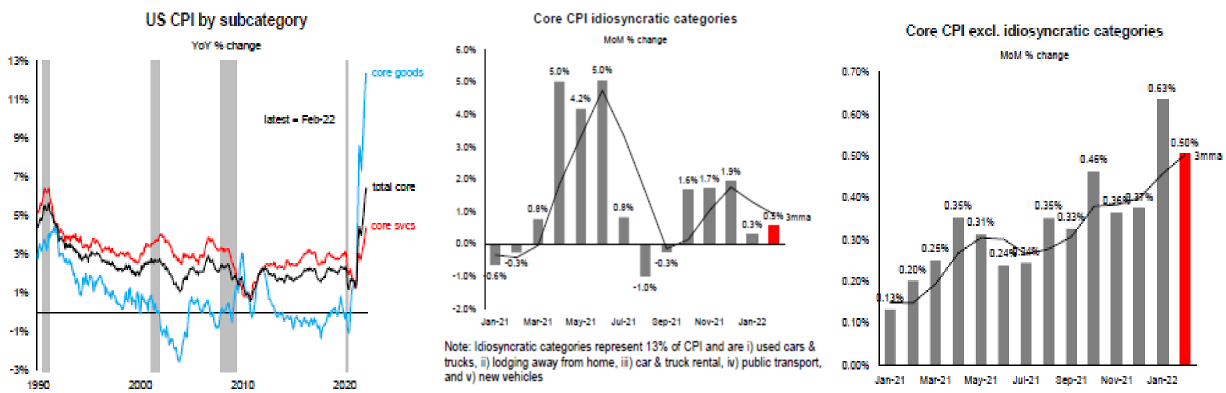
Inflationary pressures have been building and while these pressures have been viewed as being transitory for some time, recently many policymakers have begun to realize that inflation is likely to remain higher for longer. The February U.S. inflation figures, while in-line with expectations, showed a very high level of inflation with the Consumer Price Index (CPI) coming in at 7.9% for the last 12 months[1]. In fact, inflation has not been at these levels since the early 1980's. Part of the explanation for the acceleration in the inflation rate can be attributed to supply channel bottlenecks, along with higher demand associated with an economic recovery from the depths of the pandemic-induced downturn. What can be seen in Figure 1 on the left chart is the sharp pickup in the inflation rate with a notable acceleration in the core goods category which in turn reflected supply challenges. This can also be observed in the middle graph which includes categories such as new and used vehicles, where supply shortages were particularly acute. Categories such as lodging and airfares were also instrumental in contributing to inflationary pressures as prices recovered from deeply discounted levels.

Taking out these pandemic-influenced areas from inflation still leaves us with a disturbingly high level of inflation as seen in the far-right graph in Figure 1. Core CPI does exclude food and energy which unquestionably has also seen sharp price increases. In our view, the Russia/Ukrainian conflict will likely exacerbate current inflationary

[1] U.S. Bureau of Labor Statistics, as of March 2022

pressures and most likely prolong the period for an elevated inflation level and consequently, delay its moderation to the lower single digit levels (3%-5%) where we believe it will eventually settle down to. As such, investors will likely require some patience before inflation can be expected to abate from the current elevated levels.

Figure 1 – Inflation – Core CPI & Idiosyncratic Categories



Source: Macquarie Research, as of March 2022

The Fed Liftoff

In response to these mounting inflationary pressures, the Fed finally increased interest rates for the first time since 2018 at its March meeting, after months of anticipation. Meanwhile, the March employment report showed a solid 431,000 rise in non-farm payrolls along with the decline of the unemployment rate to 3.5%[1]. The strong datapoints may lead to investor expectations of a more aggressive Fed in raising rates in order to fend off further inflationary pressures. With respect to how the stock market might react during this period of rising interest rates, we believe it is useful to look at historical precedence as a guide.

Looking at Figure 2 for those time periods when the Fed has embarked on the path of multiple rate hikes, we can observe that the stock market, on average, has experienced a positive return during those time periods while rates are going up.

Figure 2 – S&P 500 Performance During Fed Rate Hike Cycles

S&P 500 Index Performance During Periods of Multiple Fed Rate Hikes (WWII - Current)

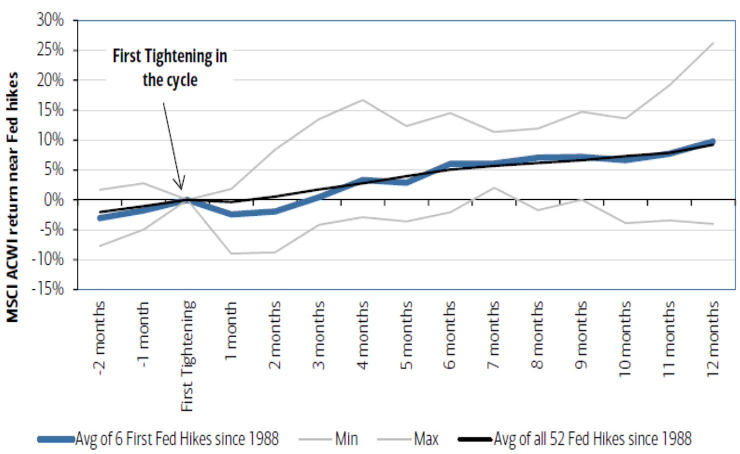
First Hike	Last Hike	Starting Fed Funds Rate	Ending Fed Funds Rate	Total Hikes	S&P 500 Index Returns: % Return During Cycle	S&P 500 Index Returns: Annualized Return During Cycle
4/25/1946	1/16/1953	1.0%	2.0%	5	40.3%	5.2%
4/15/1955	8/23/1957	1.5%	3.5%	7	17.3%	7.0%
9/12/1958	9/11/1959	1.75%	4.0%	5	18.3%	18.4%
4/5/1972	7/5/1974	4.75%	12.0%	34	-23.2%	-11.1%
5/13/1977	12/19/1980	6.25%	21.5%	60	35.0%	8.7%
8/8/1983	6/25/1984	10.5%	13.0%	5	-3.3%	-3.7%
4/1/1987	2/24/1989	7.5%	11.5%	11	-1.8%	-0.9%
2/4/1994	2/1/1995	3.0%	6.0%	7	0.1%	0.1%
6/30/1999	5/16/2000	4.75%	6.5%	5	6.8%	7.8%
6/30/2004	6/29/2006	1.0%	5.25%	17	11.6%	5.6%
12/16/2015	12/19/2018	0.0%	2.25%	9	20.9%	6.5%
				Average	11.1%	4.0%
				Median	11.6%	5.6%
				% Higher	72.7%	

Source: LPL Research, as of March 2022

There were three occasions out of 11 when market returns were negative, with two of those occasions showing only modest losses. The 1972/74 set back in equity prices was also associated with the oil embargo and the quadrupling of oil prices and the resultant recession. One could observe that today we have also witnessed higher oil prices and therefore the risks of recession are elevated. We have recently noted that the U.S. economy is far less reliant on energy for economic growth in part from the services portion of the economy being more important but also from the drive toward great efficiency.

And if an imminent recession is unlikely, the historical experience for equities around rate hikes has been one of positive returns after a brief period of downside risk. Historically, post the Fed's first rate hike, equities see an immediate knee-jerk reaction and bout of volatility, but have then rallied 9.2% in the following 12 months afterwards (as illustrated in Figure 3, LHS). Moreover, looking at the past 70 years of interest rate history, the data shows that in 13 out of 15 previous rising rate environments, S&P 500 Index returns were positive (Figure 3, RHS).

Figure 3 – Equity Performance Post First Rate Hike (LHS), Equity Market Returns in Rising Rate Environments (RHS)



Trough	Peak	Change in 10 Year Yield (bps)	S&P 500 Total Return
Apr-54	Oct-57	168	68%
Apr-58	Jan-60	184	36%
May-61	Aug-66	151	37%
Mar-67	May-70	337	-6%
Oct-71	Sep-75	250	3%
Dec-76	Sep-81	845	38%
Apr-83	May-84	301	-4%
Aug-86	Sep-87	225	32%
Sep-93	Nov-94	260	2%
Dec-95	Aug-96	93	7%
Sep-98	Jan-00	185	39%
May-03	Jun-06	154	39%
Dec-08	Apr-10	143	35%
Jul-12	Dec-13	137	38%
Jul-16	Oct-18	165	30%
Average		240	26%

Source: Bank of America Merrill Lynch, as of December 2021

Another aspect relating to interest rates and the economy, is the considerable lag between the first rate hike and the start of a recession. Figure 4 illustrates this lag, whereby the average time period between the first Fed rate hike and the start of a recession is two years (this does not include the three instances where recessions didn't occur at all. Maybe this time will be different, but history does not seem to favour the odds of an imminent recession.

Figure 4 – Considerable Lag Before a Recession

Tighter Fed policy ≠ imminent recession

Fed tightening cycles and U.S. recessions

First rate hike	Recession start	Months to recession start
April 1955	August 1957	28
September 1958	April 1960	19
July 1963	No recession	
November 1967	December 1969	25
January 1973	November 1973	10
August 1977	January 1980	29
September 1980	July 1981	10
September 1987	July 1990	34
February 1994	No recession	
June 1999	March 2001	21
June 2004	December 2007	42
December 2015	No recession	
	Median	**25**
	Mean	**24**

Source: Ned Davis Research, as of February 2022

Yield Curve Inversion & Recession Worries

More recently, investors have begun to worry around the implications of the inversion of the yield curve, whereby long term rates dip below short-term rates. One common measurement is the difference between 10-year and 2-year U.S. Treasury bonds, which saw inversion in late March.

Figure 5 – U.S. 2/10 Year Yield Curve

Source: Strategas, as of March 2022

This relationship has worried investors because it has historically been a reliable predictor of recessions. As illustrated in Figure 6, on average, equities on average peaked 11 months after the yield curve inverts, with a further rally of 15% after curve inversion until the equity prices peak. Recessions have tended to occur an average of 16 months later.

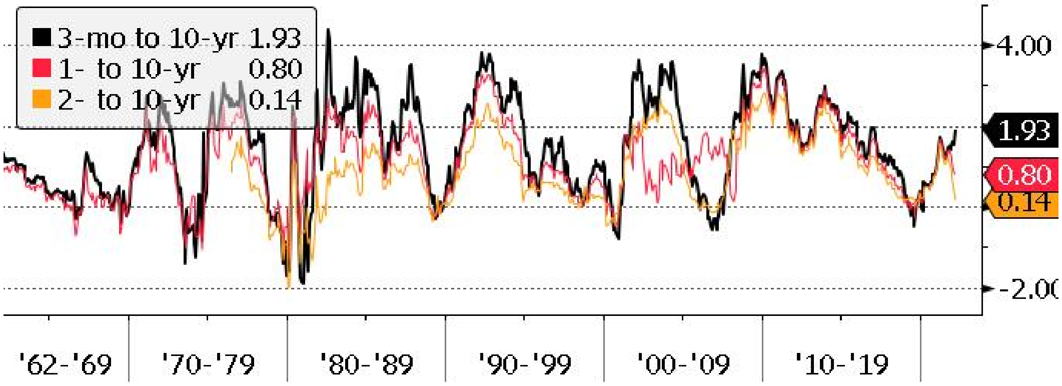
Figure 6 – Equity Returns from Yield Curve Inversion to Market Peak (LHS), S&P 500 Performance in Different Yield Curve Regimes (RHS)

	# months between			
Yield Curve inversion date (10-2Y)	Yield curve inversion & SPX peak	SPX peak & recession	Yield curve inversion & recession	SPX move from YC inversion to SPX peak*
Dec-67	11	13	24	14%
Mar-73	-2	10	8	-4%
Aug-78	18	-1	17	13%
Dec-88	19	0	19	34%
Feb-00	2	12	13	8%
Jan-06	20	2	23	22%
Aug-19	6	0	6	18%
Median	**11**	**2**	**17**	**14%**
Average	**11**	**5**	**16**	**15%**

Source: J.P. Morgan, as of March 2022. Yield Curve Inversion denotes the US 10-Year Yield/2 Year Relationship

Might this time be different? For all the attention being put on the 2-10 year yield curve, another part of the curve has been giving a different signal, with the spread between the 3 month Treasury bills and 10-year bonds steepening. This spread has historically been an even better recession indicator, and though historically there has tended not to be much difference between them, they have recently significantly diverged from the 2/10 year yield.

Figure 7 – US Yield Curve – 3 mo/10y vs. 2/10 year



Source: Brown Brothers Harriman & Co., as of March 2022

This potentially may be because the Fed's bond buying program of the past two years has resulted in a U.S. 10-year yield that is lower than it should be, and that the 10-year yield will start to rise (steepening the yield curve) when the central bank begins shrinking its balance sheet.

In a research paper[2], economists at the Fed wrote in late March that the predictive power of the 2/10 year yield relationship was "probably spurious", and that at best it was a case of "reverse causality". Instead, the Fed researchers wrote that the near-term forward spreads (3 month/10-year) offers "a much more precise view of market expectations". We agree with this view and are therefore watching the 3 month/10 year yield curve very closely.

Conclusion

In summary, the Fed embarking on a path of higher rates after spending the past two years (and much of the past decade) with interest rates at zero should be welcomed as a sign of a return to normalcy. We expect higher rates in the coming periods, but do not believe that it will derail the ongoing bull market. Furthermore, while the inversion of the yield curve is important to monitor, we should also consider the context of the distortion of the yield curve caused by the Fed's bond buying and the signal that the more predictive part of the yield curve is giving, which is steepening and signaling strong economic conditions.

In these confusing times, we will continue to demonstrate the flexibility as an active manager in being able to position the portfolio to have an allocation to those companies that may be better positioned in a higher interest rate environment.

[2] (Don't Fear) The Yield Curve, Reprise, Eric Engstrom and Steven A Sharpe, FEDS notes, March 25, 2022

Figure 8 – Fund Performance vs. Benchmarks and Category Average

CAD (Annualized, net of fees) as of Feb 28, 2022	3 Mo.	YTD	1 Year	3 Years	5 Years	10 Years
AGF Global Select Fund - Series F (Net)	-7.4%	-7.0%	0.4%	18.9%	19.1%	17.3%
AGF Global Select Fund - MF Series (Net)	-7.7%	-7.2%	-0.9%	17.3%	17.5%	15.6%
MSCI All Country World Index	-4.3%	-7.1%	7.8%	12.5%	10.9%	13.2%
Morningstar Global Equity Category	-5.8%	-8.3%	5.1%	10.0%	8.4%	10.2%
Quartile Rank - F Series	3	2	4	1	1	1
Quartile Rank - MF Series	3	2	4	1	1	1

Source: AGF Investments Inc. as of February 28, 2022. Morningstar as of February 28, 2022. You cannot invest directly into an index. MF Series includes a 2.59% Management Expense Ratio (MER), while the Series F version of the fund includes a 1.22% MER, as of September 30, 2021. Morningstar Rankings reflect performance as of February 28, 2022 and are subject to change monthly. The rankings are calculated from a fund's total return percentile rank against others in its Global Equity category for the period of one, three, five, and 10 years. Percentile ranks always range from 1 (best) to 100 (worst), with all intermediate values spread evenly over that range. The quartile ranking and number of Global Equity funds for AGF Global Select Fund for each period are as follows: one year third quartile (485 funds), three years first quartile (422 funds), five year first quartile (404 funds). For greater detail, see http://www.morningstar.ca. **Past performance is not indicative of future results.**

CAD (Annualized, net of fees) as of Feb 28, 2022	3 Mo.	YTD	1 Year	3 Years	5 Years	10 Years
AGF American Growth Class - Series F (Net)	-4.2%	-5.8%	9.7%	20.6%	17.3%	17.9%
AGF American Growth Class - MF Series (Net)	-4.6%	-6.0%	8.1%	18.9%	15.6%	16.4%
S&P 500 Net Index	-4.7%	-7.9%	15.4%	16.2%	13.5%	17.1%
Morningstar US Equity Category	-4.5%	-7.8%	11.9%	13.3%	11.3%	14.0%
Quartile Rank - F Series	2	2	4	1	1	1
Quartile Rank - MF Series	2	2	4	1	1	1

Source: AGF Investments Inc. as of February 28, 2022. Morningstar as of February 28, 2022. On December 1, 2015, the Fund's benchmark changed from the S&P 500 Total Return Index to the S&P Net Return Index. The benchmark change was applied from that date forward. You cannot invest directly into an index. The MF Series includes a 2.66% management expense ratio (MER) while the Series F includes a 1.22% MER, as of September 30, 2021. The number of funds for the Morningstar U.S. Equity Category for each period are as follows: three months – 1,771, YTD – 1,718, one year - 1,671, three years - 1,352, five years – 1,070, ten years – 381. Morningstar rankings reflect performance as of February 28, 2022 and are subject to change monthly. The rankings are calculated from a fund's total return percentile rank against others in its applicable Morningstar category for the period of 1, 3, 5, and 10 years. Percentile ranks always range from 1 (best) to 100 (worst), with all intermediate values spread evenly over that range. The quartile ranking and number of U.S. Equity funds for AGF American Growth Class for each period are as follows: one year third quartile (429 funds), three years second quartile (338 funds), five years first quartile (268 funds). For greater detail see www.morningstar.ca. **Past performance is not indicative of future results.**

CAD (Annualized, net of fees) as of February 28, 2022	3 Mo.	YTD	1 Year	3 Years	5 Years	10 Years
AGF U.S. Small-Mid Cap Fund - Series F (Net)	-8.8%	-8.7%	-10.5%	13.2%	15.5%	15.1%
AGF U.S. Small-Mid Cap Fund - MF Series (Net)	-9.1%	-8.9%	-11.6%	11.6%	14.0%	13.7%
S&P MidCap 400 Index	-2.2%	-6.0%	7.5%	12.0%	9.7%	15.5%
Morningstar US Small/Mid Cap Equity Category	-4.4%	-7.7%	5.1%	9.4%	7.7%	12.0%
Quartile Rank - F Series	4	3	4	1	1	1
Quartile Rank - MF Series	4	3	4	2	1	1

Source: AGF Investments Inc. as of February 28, 2022. Morningstar as of February 28, 2022. You cannot invest directly into an index. The benchmark performance is as of the nearest month-end to the performance start date of the Fund. On December 1, 2013, the Fund's benchmark changed from the Russell 2500 Total Return Index to the S&P MidCap 400 Index. The benchmark change was applied from that date forward. The MF Series includes a 2.53% management expense ratio (MER), while the Series F fund includes a 1.22% MER, as of September 30, 2021. The number of funds for the Morningstar U.S. Small/Mid Cap Equity Category for each period are as follows: three months – 277 , YTD – 277 , one year – 251, three years – 198, five years – 168 , ten years – 65. Morningstar rankings reflect performance as of February 28, 2022 and are subject to change monthly. The rankings are calculated from a fund's total return percentile rank against others in its applicable Morningstar category for the period of 1, 3, 5, and 10 years. Percentile ranks always range from 1 (best) to 100 (worst), with all intermediate values spread evenly over that range. The quartile ranking and number of U.S. Small/Mid Cap Equity funds for AGF U.S. Small-Mid Cap for each period are as follows: one year fourth quartile (63 funds), three years first quartile (49 funds), five years first quartile (42 funds). For greater detail see www.morningstar.ca. **Past performance is not indicative of future results.**

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