Be Tactical, Be Balanced, Be Humble:

How to Navigate a Potential Regime Shift in Markets

Inflation has been the clear focus of investors for much of the past year, but the growing fear of a recession is starting to compete for their attention and shake up financial markets in the process.

Members of AGF's Investment Management team recently sat down for a roundtable to discuss the ebb and flow of the current macro environment and what investors can do to position their portfolios accordingly.

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Vice-President, Portfolio Manager and Head of Global Credit

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Chief Investment Officer and Head of AGFiQ Alternative Strategies

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Equity Analyst

Has the economic cycle entered a new phase this summer?

Andy Kochar: What's been different about this economic cycle from those of the past is the inflationary aspect to it. We haven't seen prices rise this fast in decades and it has forced us – as investors – to consider financial markets in a new light, whether that's in regard to equities, fixed income or at a sector and factor level. But now, over the past few months, it's not just inflation that investors are worried about. In fact, we may be at a turning point in the current cycle, whereby inflation has peaked – yet still remains elevated – and fears of an economic slowdown have emerged as the potentially bigger concern, which, in turn, may be setting up a potential regime shift in markets that will create new winners and losers going forward.

Bill Deroche: Some of the shift in market leadership away from value stocks during the rally earlier this summer is a testament to that. While for most of the year, the primary focus of investors has been inflation and rising rates, market participants are pivoting and want to focus more on the prospects of recession and whether central banks will soon be forced to cut rates or, at the very least, stop raising them so aggressively to combat the potential for much slower economic growth ahead. In doing so, however, I can't help thinking some investors are missing a step in the process. Yes, inflation has probably peaked, but it's going to take a while to get the proverbial "genie back in the bottle" and the Fed has been telling markets that it still needs to raise rates aggressively to get inflation back to where it wants, which is somewhere closer to 2%.

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> **– Bill Deroche**

AK: From January to the middle of June, every piece of negative news on the inflation front was met with more selling by the markets. One of the only places to hide was short-cycle stocks such as energy and materials, while most everything else was abandoned for cash. But, since then, news about inflation has been either positive for markets, or met with a mixed reaction at the very worst.

Mike Archibald: There was a huge rotation to more economically sensitive sectors over the summer. Sectors like Industrials and Consumer Discretionary started to take the lead and some of the defensive sectors that had worked very well started to fade – as did sectors like energy. But that trade has waned a bit over the past weeks, in part because the market is becoming more concerned about how persistent inflation will be even if it has peaked. As such, it's difficult to say whether investors are ready to rotate back into growthier long-duration stocks in a sustained way just yet. Many of these names are still relatively expensive and while the growth profile for them is good, it's not great, and they are sensitive to any economic downturn that might occur. Because of that, it's hard for me to see a full-blown regime change in the works, but it's still going to be hard for some of the defensive sectors of the market and shorter-duration assets to outperform like they did earlier this year given where we seem to be at in the cycle. They may still be a good place to hide for the next quarter or so because they have a much clearer growth path. But once you get into 2023, this trade could give way to one that is more bullish on consumer discretionary, technology and industrials.

Dillon Culhane: The market has become very impatient, expecting this inflationary cycle to be over with quickly. There is a real desire to get back to lower rates and growth stocks, which, for many investors, are much more interesting than investing in commodities or defensive sectors. Still, to Mike's point, there has been a realization more recently that even if inflation has peaked, that does not mean it's suddenly going to drop quickly; in fact, it could stay elevated for a long time still. Looking at the performance of energy stocks since their recent peak in mid-June, they sold off by roughly 30% in just over a month, but have since retraced nearly two-thirds of those losses.

MA: If inflation does persist and rates do keep going up, there is a good chance that markets remain choppy like this. In fact, the last time interest rates went up in the United States, back before the pandemic, the S&P 500 Index was extremely volatile with very big moves to the upside as well as the downside, but effectively traded sideways and gained almost no ground between the start of 2018 and the third quarter 2019.

What about the growth side of the equation? Are investors right to think the economy is set to slow dramatically?

AK: For all the talk of recession, the U.S. economy still seems to be doing just fine based on several metrics, including labour statistics such as the incentive for U.S. employees to switch jobs, which hasn't been as high in the past 30 years as it is today. The U.S. consumer, meanwhile, is significantly more resilient to rising rates than he or she has been in the past, so, as much as the market fears recession and is predicting eventual rate cuts, at least for now the economic environment may be more stable than many investors believe.

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BD: But are we going to be saying the same thing three months from now? It seems clear the Fed is determined to get inflation under control and if they are going to raise rates up to 3.5% or higher, that could lead to a lot more demand destruction and have a negative impact on earnings.

DC: The market may be overlooking the billions of dollars in stimulus still being handed out by governments, which may be counteracting what central banks are doing to curtail inflation. This runs the gamut from fuel tax cuts and other energy subsidies to the recent extension of student loan forgiveness in the U.S., as well as the Inflation Reduction Act and the Chips and Science Act, both of which were passed earlier this year.

MA: If Interest rates keep going up, that puts pressure on household budgets 8 especially if unemployment rates start to rise too. And eventually that's going to negatively filter its way through to corporate revenues and earnings. Granted, this has been slow to take, partly because people have excess savings, but history shows it may be just a matter of time.

DC: The U.S. economy may hold in better than some investors believe, but we need to distinguish between it and other economies. Europe's economy seems on the brink of recession, largely because of the energy crisis that is contributing to a much larger cost of living increase than what is being experienced in North America. This may force the European Central Bank to keep raising rates even though economic growth has already stalled, which, in turn, could mean very different outcomes for Europe's financial markets than elsewhere.

What opportunities lie ahead and how might investors play the near-term macro environment?

AK: The push and pull between inflation fears and growth fears is new for a lot of investors. We're not used to the tug of war, but there's still lot of opportunities to buy good companies across various sectors, and from a fixed income perspective, investors are no longer forced to take excessive duration risk in their portfolios to generate income. They can stay in the short end of the curve and collect a very attractive coupon now.

BD: I do think investors need to be cautious. We are not "risk on" just yet and it's probably too early to go all in when it comes to being long equities. That said, the stock market proves time after time that it is very resilient and may end higher from here by the end of the year.

MA: Yield is going to be important in this environment. I also don't think investors want to be going full out on growth, nor do they want to be going full out on defensives and energy either.

AK: The past few years has been an either/or market. There have been stretches of extreme growth outperformance and more recently stretches of extreme value outperformance, but prior to 2016 when interest rates plummeted, it was not so much about growth or value as it was about just picking good stocks.

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>
> **– Dillon Culhane**

MA: From an equity growth perspective – which is where my strategy tends to skew – it's still a challenging environment. I prefer defensive or high-quality growth names rather than longer-duration assets, but I do believe there are good opportunities on both sides of this equation. More broadly, I think all of us need to be ready for shorter periods of outperformance in one trade over another than we have been accustomed to in recent years. Technology stocks, for instance, were the darlings of investors for several years straight, but going forward there could be more frequent switching in and out of a trade given everything that we've talked about.

DC: A barbell approach that takes both growth and cyclical stocks into consideration seems prudent. Of the former, the opportunity seems ripe for active managers given many high-quality companies have been thrown out with the bathwater so to speak over the past year. On the latter, there's still plenty to like despite some of the poor performance this summer. The energy sector, for example, is still buoyed by relatively cheap valuations and supply/demand dynamics, with spare capacity at all-time lows and demand recovering back toward pre-Covid levels. That doesn't mean there aren't headwinds for the sector. Europe's economic woes – and likely recession—are especially worrying, but there's still a good chance the rest of the world can avoid the same fate. Either way, recessions have had very little impact on oil demand in the past and there's little reason to believe that will significantly change this time around.

BD: Ultimately, it's very difficult to pinpoint exactly what stage we are at in the current economic cycle, but if we understand the dynamics at play – and in this case I think we do – it's much easier to predict the probability of one outcome over the other and position a portfolio accordingly. That doesn't mean going all in on the market regime that we deemed to have the highest probability of occurring. We still need to be thoughtful and disciplined, and manage for the possibility of being wrong.

MA: Agreed. Discipline is always key, and investors may need to be more tactical and balanced in their approach in this environment than perhaps is usual. And to Bill's point about getting it wrong sometimes, it's important that all of us remain humble too.

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> **Mike Archibald**

Andy Kochar, CFA®

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Andy Kochar is a principal member of AGF's Fixed Income Team and serves as the firm's head of global credit. Using a cross-asset framework, Andy is responsible for the research and allocation of credit risk across all of AGF's fixed income portfolios.

He previously served as Associate Portfolio Manager for AGF's credit-oriented portfolios from 2013 to 2018. Prior to that, for more than five years, Andy served as Investment Analyst, Credit Research at Acuity Investment Management, which was subsequently acquired by AGF in 2011.

Andy earned a B.A. in Economics (Cum Laude) from York University. He is a CFA® charterholder and member of CFA Society Toronto.

Bill DeRoche, MBA, CFA®

Chief Investment Officer and Head of AGFiQ Alternative Strategies

Bill DeRoche is Chief Investment Officer, AGF Investments LLC (formerly FFCM LLC)[1], and Head of AGFiQ Alternative Strategies. Bill is co-founder of AGF Investments LLC, a Boston-based investor advisory firm founded in 2009 and subsidiary of AGF Management Limited. He is a leader of AGF's quantitative investment platform, known as AGFiQ. AGFiQ's team approach is grounded in the belief that investment outcomes can be improved by assessing and targeting the factors that drive market returns.

Bill has long-tenured expertise employing quantitative factor-based strategies and alternative approaches to achieve a spectrum of investment objectives. Previously, Bill was a Vice-President at State Street Global Advisors (SSgA), serving as head of the firm's U.S. Enhanced Equities team. His focus was on managing long-only and 130/30 U.S. strategies, as well as providing research on SSgA's stock-ranking models and portfolio construction techniques. Prior to joining SSgA in 2003, Bill was a Quantitative Analyst and Portfolio Manager at Putnam Investments. Bill has been working in the investment management field since 1995. Prior to 1995, Bill was a Naval Aviator flying the Grumman A-6 Intruder as a member of Attack Squadron Eighty-Five aboard the USS America (CV-66).

Bill holds a Bachelor's degree in Electrical Engineering from the United States Naval Academy and an MBA from the Amos Tuck School of Business Administration at Dartmouth College. He is a CFA® charterholder and holds FINRA licenses 7, 63 and 24.

Mike Archibald, CFA®, CMT, CAIA

Vice-President and Portfolio Manager

Mike Archibald is responsible for AGF's Canadian Growth Equity strategies. He uses a bottom-up investment approach that leverages quantitative, fundamental and technical inputs to identify companies with strong earnings growth and momentum, high-quality management and solid free cash flow.

Mike joined AGF as an Associate Portfolio Manager in 2015, focusing on research, analysis and selection of North American equities. Before joining AGF, Mike was a Portfolio Manager with Aurion Capital Management Inc. where he was responsible for research, security selection and portfolio management of equity investments for pension plan clients. Prior to that, he was with Computerized Portfolio Management Services (CPMS), an equity research firm providing fundamental and quantitative investment data to institutional and retail money managers.

Mike holds an Honours Bachelor of Business Administration degree from Wilfrid Laurier University and is also a CFA®, CMT and CAIA charterholder.

Dillon Culhane, CFA®, CPA, CA

Equity Analyst

Dillon Culhane is an Equity Analyst on the AGF North American Equity Team focusing on the Energy sector, particularly oil and gas companies, as well as Utilities.

Most recently, Dillon was an Equity Research Associate Analyst covering the Energy sector at RBC Capital Markets.

Prior to that, he was a Senior Associate at Deloitte & Touche LLP. Dillon earned a B.Comm. from Queen's University and is a Chartered Professional Accountant as well as a CFA® charterholder.

For more information, visit AGF.com

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