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SPECIAL REPORT:
2022 SECOND HALF OUTLOOK

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RECESSION: STILL JUST A THEORY

"The future is certain," starts the old Soviet joke. "It is only the past that is unpredictable". Of course, this quip attempts to bring some levity to the government's propensity for airbrushing history and controlling the narration over public perception.

But whether we like to admit it or not, investment markets share a similar dynamic: they are dominated by narratives. No, an authoritarian regime is not driving the message. Rather, it is what Scottish journalist, Charles Mackay, nearly two centuries ago, called "the madness of crowds." We are astonishingly prone to falling for our own stories; to believing our own propaganda. Regularly, investors become hostage to a dominant narrative — and, often, it turns out to be dead wrong.

All this has become increasingly dangerous in today's digitally-charged era. Online platforms often serve as echo chambers for already held beliefs, enclosing members in an intellectually impenetrable layer of like-minded peers. One's world view remains one-sided with a cult-like focus on certain insider voices. Of course, it's a trap. Never leaving one's world presents a clear and present danger. New realities are never experienced. A potentially rich, textured subject stays one dimensional.

What is the dominant narrative taking hold today? Undoubtedly, it is the notion that the global economy is on the edge of becoming unhinged — that the world faces a deep and imminent recession. In fact, a strong consensus now believes that policymakers overstimulated during the pandemic. Furloughed and fiscally-cushioned consumers also overindulged. Now central banks, spooked by inflation initially dismissed as fleeting, are being forced into aggressive rate hikes. A day of reckoning is apparently nigh.

Meanwhile, macro fault lines marble the entire globe. Supply chains remain tangled by Covid variants and war. Soaring energy prices have pushed Germany into its first trade deficit in more than 30 years. The avalanche of resignations Boris Johnson has just faced is more than any other British prime minister in history. China has turned to its old playbook of driving up growth through public infrastructure projects. And the investment world's whirlwind courtship with cryptocurrencies is over, finally meeting their Minsky moment and destroying an eye-watering amount of wealth (if you are surprised, see me after class).

All of this has forged an easy fraternity for those predicting more macro doom. Global pessimism is now higher than ever. Understandably, the pull of this narrative is powerful. Because the most recent threats to civilization were a pandemic and then an unforeseen war, we expect the next one to take the same existential form. But should we? The history of markets is one of miscalculated extrapolation; of mistaking lagging indicators for the leading variety. And it is one of getting the big regime changes wrong. For years after 2008's big downturn, most expected a global financial crisis to strike again. It didn't.

On many levels, this makes sense. People's perceptions of the past shape their view of the future. Old narratives take time to be replaced by new ones. Humans have a difficult time updating their mental models — overestimating the probability of what has already happened to them, while underestimating new scenarios.

That is why today's investing climate is so dangerous. When the consensus is this strong, investors need to be on high alert to new narratives. These shifts can rapidly change market direction. Yet with inflation and volatility all at elevated levels, price signals become less reliable. The usual economic dashboard is blurry and distorted. As we wrote in the "2020s: The Decade of Living Dangerously", the risk of making bad investment decisions has exploded higher in the current environment.

Last week, we hosted a well-attended webinar where we received a flood of questions. Below, we answer the most common ones.

Question 1.

Forstrong has been in the "recession not yet" camp this year. Given everything that has happened, do you still hold that view?

The recession question is an important one. To see a sustained extension of the current market downturn, we would also need to see a substantial downturn in economic activity. Large and widespread bear markets are just not typical outside of deep recessions.

But what is actually happening here? First, this is not a traditional economic cycle. We just witnessed the mother of all V-shaped recoveries out of Covid lockdowns. It should not be surprising that growth is now slowing. More importantly, investors are underestimating economic momentum out of the pandemic. To be sure, the consensus is right: policy largesse during the pandemic was a significant shock, thrusting the low-inflation 2010s decade into a higher inflation regime.

But consider that the resulting inflation is now serving as a catalyst for more robust aggregate demand. A higher cost environment encourages government and business to invest in labour and energy-saving technologies. In fact, shortages have quietly kickstarted a robust recovery in capital investment. This was a key missing ingredient in the post-2008 recovery and is crucial for lifting capacity and productivity. This new virtuous cycle of rising capital spending and increased wages will lead to higher nominal growth. Eventually, this will mean stronger earnings and sustainably higher interest rates. Investors should expect a shallow slow-down now (we cannot call this recession when the labour market is so hot) with a growth acceleration into 2023.

Finally, keep in mind that the interplay between markets and the underlying fundamental data is what matters. Right now, the recession playbook is currently driving market pricing. Yet markets can only price in a deep recession for so long without the underlying economic data validating it. Expect the mood of markets to change quickly.

Question 2.

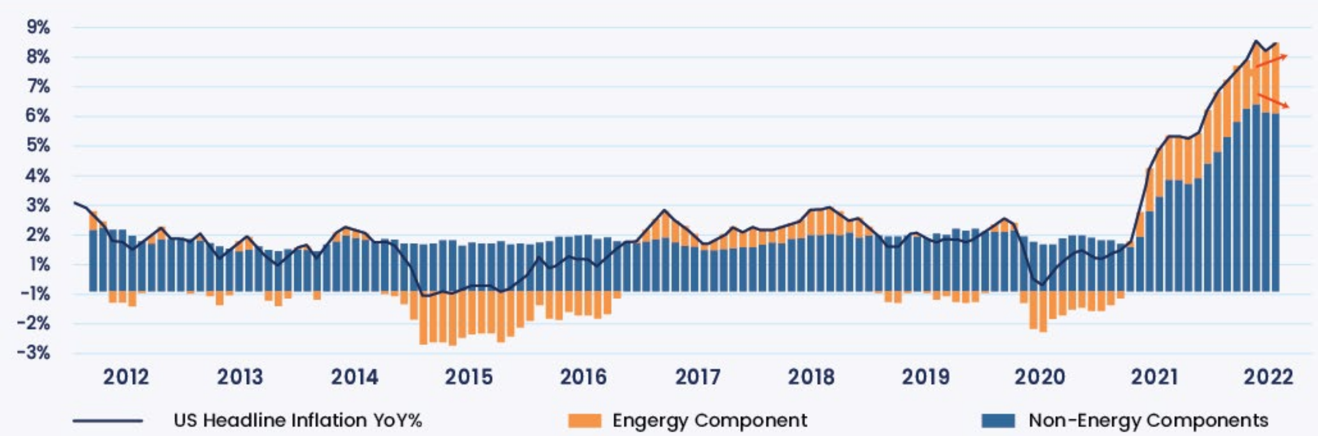
Will inflation accelerate or decelerate from here?

We have written extensively on the topic of inflation over the last year. This is not the 1970s. But central bankers were caught flat-flooted, initially over-playing the supply side (bottlenecks and such) and under-playing the demand side (rising household wealth, stronger capital spending and a structurally looser fiscal stance).

Still, some inflationary dynamics were always bound to be (whisper it) transitory. Lockdown-triggered bottleneck issues are now easing. The supply side is catching up and shortages are being resolved. In fact, rather than scarcity, overcapacity lies ahead for some sectors. That leaves energy prices as the key driver of the overall inflation outlook. Supply conditions remain extremely tight, amidst the Ukraine war shock and glaring lack of capital investment over the last decade. Yet some moderation in global growth will lower demand.

Adding it all up, energy prices are likely to stay elevated but the rapid acceleration phase is behind us. And while inflation is a slow-moving variable which should remain elevated for some time, headline inflation is peaking right now. That will take some pressure off central bank hawkishness and bolster risk appetite.

Energy Prices Propping Up Inflation...For Now



Sources: Macrobond, BLS, Forstrong Global Asset Management

Question 3.

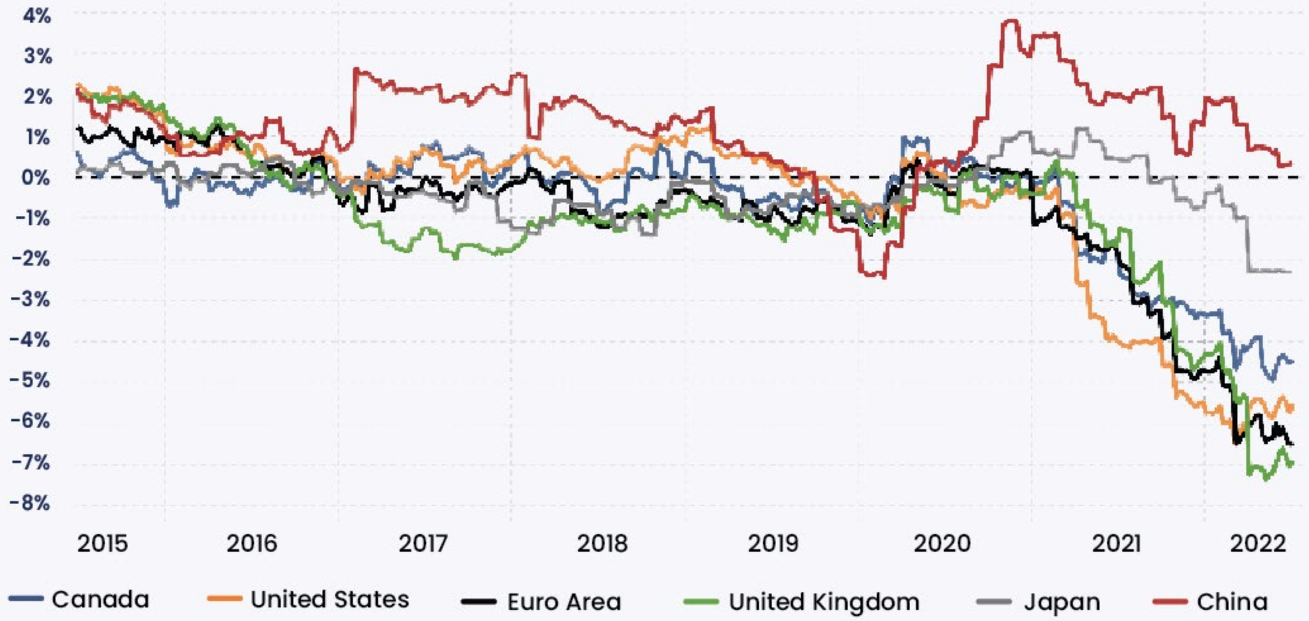
Can the economy actually handle higher interest rates?

Monetary tightening is the leading cause of recessions. But at the risk of stating the obvious, interest rates are still insanely low relative to the growth and inflation backdrop. Real rates remain deeply negative. The Fed and the Bank of Canada are nowhere close to recession-inducing rates.

The real issue is that most investors are still anchored to the secular stagnation period after 2008 — most simply do not believe the economy can ever escape low interest rates. But in the 2010s, the need for consumers to repair balance sheets necessitated a far lower interest rate. An extended period of debt reduction, cleansing of excesses and overall financial system repair was needed.

Today, we simply do not have the same economic and financial imbalances. The economy is actually on far firmer footing and several dynamics are different: a robust labour market, healthier consumer balance sheets and a well-capitalized banking system. Interest rate hikes have landed on a white-hot economy, not one balanced on the edge of recession. The big surprise will be that the global economy can handle "higher rates for longer" without tipping into a deep and protracted recession.

Real Yields Still Negligible in Most Regions
10 Year Government Bond Yields Deflated by CPI



Sources: Macrobond, National Sources, Forstrong Global Asset Management

Question 4.

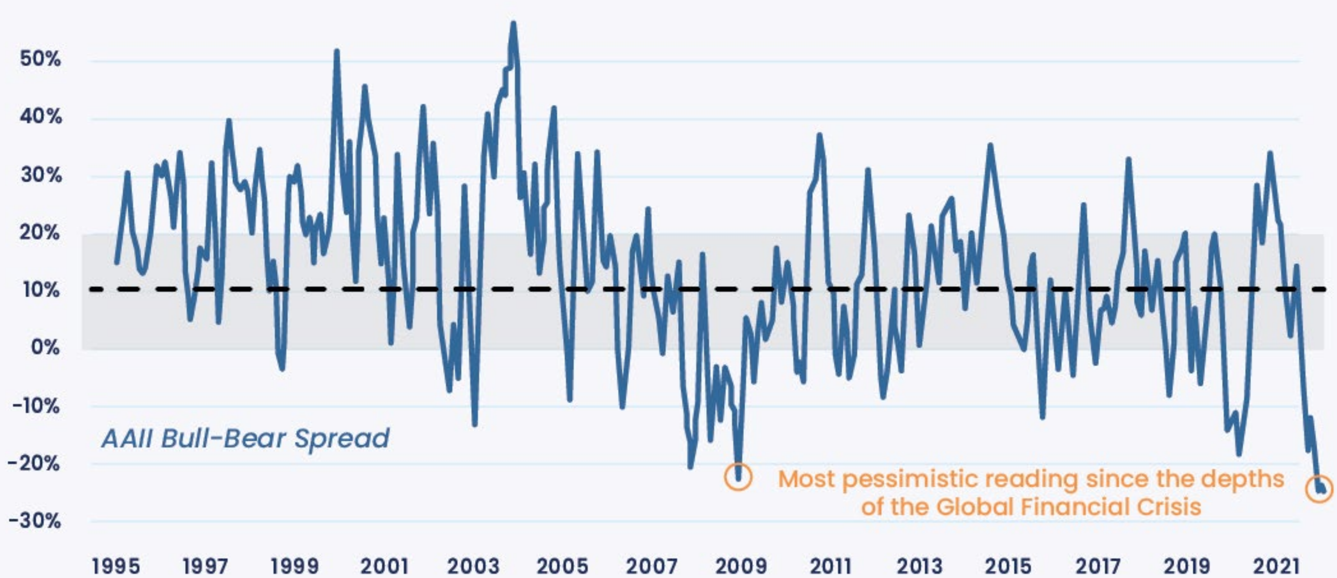
Geopolitics look terrible right now. We have an ongoing Ukraine war, further fears of Chinese lockdowns, etc. How do you view these?

There is no shortage of macro fears right now. But investors should remember that markets move based on expectations and what is already priced in. This is best thought of as "better or worse" rather than "good or bad". Currently, the University of Michigan's consumer sentiment survey is at a 50-year low. Other behavioural indicators show similar levels of fear or negativity.

With such low expectations, it becomes far easier to deliver "upside" surprises. What's more, many macro risks are already "known risks". Consider the Ukraine war. Energy and food independence, enlarged military budgets and a quickening pace of decarbonization are now firmly entrenched as top global policies.

Finally, the outlook can change quickly. Consider dynamics in the world's second largest economy: China. Lockdowns will not last forever. And, quietly, a decisive turnaround in Beijing's fiscal and monetary policy has happened. Full-blown policy easing is underway. The world's second largest country is setting up for a far stronger period of growth in the second half of 2022.

Investor Sentiment is Deeply Depressed



Presented as 2 month moving average. Dashed line: average reading since 1995.

Sources: Macrobond, AAII, Forstrong Global Asset Management

Question 5.

What will be the effect of a global transition to a non-fossil fuel based economy? What is your forecast for the time period when this will occur?

Whether readers agree with climate change or not, it is clear that fossil fuels will be steadily replaced by renewable electricity as the globe's dominant energy. Global governments are nearly unanimous here. This transformation will be enormously capital intensive (with estimates ranging from $100 trillion to $150 trillion over the next three decades) and could be comparable to the post-WWII reconstruction boom, as infrastructure, transportation networks and technologies require vast amounts of fixed capital investment. Russia's aggression against Ukraine only reinforces this trend.

Yet the global carbon transition is not a one-way bet. After years of underinvestment by fossil fuel producers and the stunning collapse of energy prices in early 2020, no one should be surprised that traditional energy prices have rebounded. Big economic downturns have always caused supply-side withdrawals, setting the stage for price increases in the subsequent recoveries.

But the transition to a lower carbon economy was always destined to be clunky. Renewable energy will take decades to build up. What's more, traditional energy companies themselves are strategically buying renewable assets. They, too, will be diversifying their asset mix from fossil fuels into renewables. The path to a green future will be far messier than most think.

Question 6.

Where do you see the best investment opportunities right now?

The key in the coming period will be to orientate portfolios away from assets dependent on low interest rates to assets with strong pricing power (and those that will even benefit from higher interest rates). That means avoiding investment classes that needed cheap funding and secular stagnation to thrive and emphasizing ones that have languished for much of the last decade.

Our investment positioning is summarized as follows:

- Avoid or minimize: US growth stocks which will face years of headwinds due to higher funding costs, the technology sector (as we have recently said, "fantasy investing is out and fundamentals are in") and even residential real estate. Investors should not succumb to the recession panic: keep bond duration short. Broad-based index strategies are also vulnerable as they are all now heavily concentrated in the winners of the last decade.

- Include: International value stocks which trade on far lower multiples and far higher dividend yields and will benefit from a competitiveness boost due to recent currency depreciation, select emerging market equities (the cyclically adjusted P/E ratio for emerging market equities is 12.5 times, compared to 30 times for the US), Chinese stocks (which reliably outperform during periods of domestic policy easing) and sectors with pricing power (banks, industrials, healthcare). Despite recent declines, commodities remain in a secular uptrend. Industrial metals oriented equities will remain well-bid as de-carbonization is highly base metal intensive (Chile, Brazil and Peru all stand to benefit and provide an excellent inflation hedge). High income can be found in floating rate loans and emerging market bonds (many EM central banks were much more pre-emptive in hiking rates than Western central banks, with our favoured ETF holding now yielding over 8%).

The good news for investors is that these preferred investment classes no longer come with demanding valuations. Also, the normalization of interest rates is wonderful news for income investors who can once again secure reasonable yields: our flagship "Global Balanced" strategy now sports a portfolio yield of 4% … a figure we have not seen for years!

Question 7.

Is it time to buy the dip in Bitcoin?

We have watched the crypto bubble unfold, with many ditching diversification, fundamentals and all common sense in pursuit of short-term profits. Now, extremely speculative positions are facing extremely large losses. This is called gambling. We now prefer to use a definition coined by Billy Corben, director of a documentary of the drug trade in 1970s Miami: "crypto is the new cocaine". Just say no kids.