Investing Through Volatility

Achieving optimal outcomes through disciplined long-term investing

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It has been a difficult year for both equities and fixed income. Sentiment has been pessimistic for most of 2022, at times reaching lows last seen during the Great Financial Crisis. Nonetheless, we believe this is no time for long-term investors to become demoralized. Markets are inherently forward-looking and much of the negative headlines and expectations have already been priced in.

In our view, active management is especially important at this stage of the cycle, as market dislocations caused by the volatile geopolitical and macroeconomic environment have created attractive opportunities to add value to investor portfolios. For investors, we believe the best course of action is to stay invested and stick to your long-term asset allocation.

The bad and the ugly

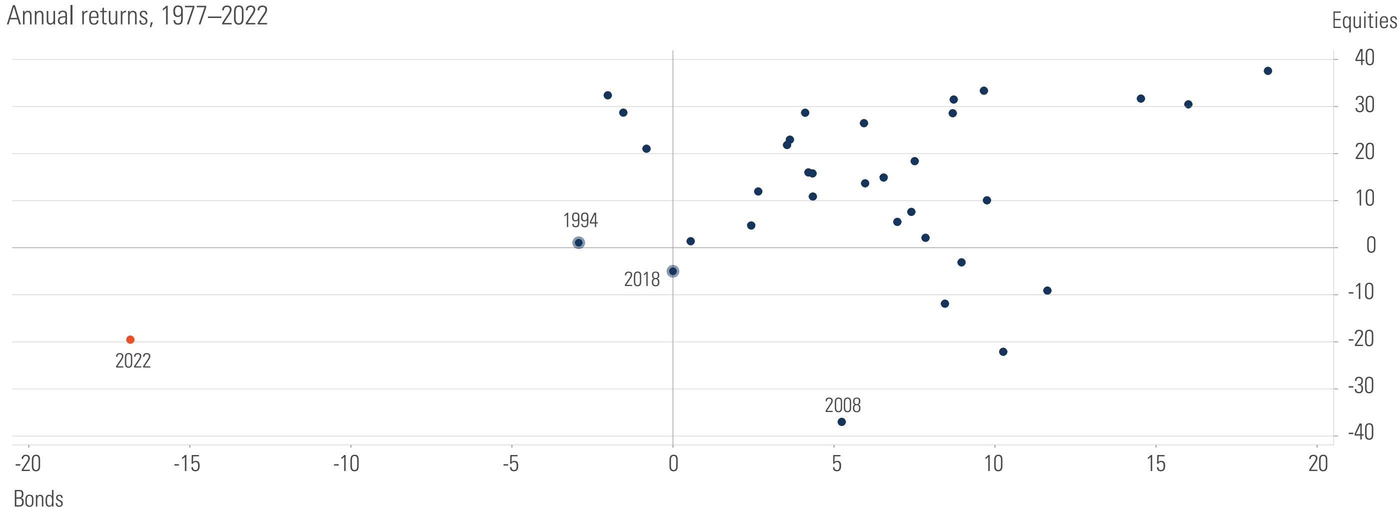
At the start of the year we were calling for a slowdown in growth, but macroeconomic conditions became even worse than anticipated when inflation soared above expected levels. The geopolitical consequences of the Russia-Ukraine conflict, new hotbeds of Covid-19 infections in China, and the European energy crisis have put further pressure on consumer prices. The rapid pace of the central banks' supersized rate hikes has led to higher bond yields, falling equity prices and high volatility. North American households are facing a wealth shock, with inflation eating away at their spending power, depleting their savings, and eroding the value of their portfolios. Higher interest rates are also creating stress in the housing market.

Punitive interest rates and chronic inflation foreshadow a global recession in 2023. Diverging fiscal and monetary policies in the U.K. have rippled through financial markets worldwide, sending asset prices further down and raising systemic risks. The strength of the U.S. dollar – a haven in volatile times – will also be a drag on corporate profits. Given this backdrop, sentiment has been bearish overall, with cash levels elevated and equity allocations at their lowest since the Lehman Brothers bankruptcy.

Not the norm

Investors should recognize that 2022 is an outlier. Historically, in any given year the likeliest outcome is for both equities and bonds to post positive returns, or for diversification to shield overall returns by offsetting losses in one asset class with gains from the other.

U.S.: Equities vs. bonds
Annual returns, 1977–2022



Source: iA Investment Management, Macrobond, as at October 25, 2022.

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The main reason for this year's atypical market behaviour is straightforward: central banks entered 2022 under tremendous pressure to normalize policy at an accelerated pace, following two years of extraordinary fiscal and monetary measures. Stress on commodity and food supply chains resulting from the war in Ukraine, as well as the fiscal regime change in the U.K., added fuel to the fire. However, markets and economic activity are now adjusting back to their long-term trends.

Our expectations are for ongoing volatility into 2023 and our base case calls for a U.S. recession over the next 12 months. We believe the Canadian dollar could remain under pressure in the short term alongside negative market sentiment, declining global growth and reduced oil demand.

However, in the long-term, the Canadian economy is likely to be buoyed by strong secular tailwinds. Favourable demographics, the long-term underinvestment in the oil and gas sector, and the historical tendency of sanctions to be maintained for long periods – contributing to sustained disruption in global commodity exports – are all factors that will benefit Canada. We also expect that the Canadian economy's higher sensitivity to interest rates and high level of household leverage will serve as arguments for the Bank of Canada to reconsider how far it can raise rates, which would reduce the depth of any potential recession in Canada.

There is a divergence underway between the U.S. and Canada, which could be driven wider by the Fed's commitment to bring down inflation at the cost of inflicting pain on the U.S. economy. Nonetheless, we anticipate that long-term rates in Canada and the U.S. will peak in the coming quarters and bonds will then become attractive again from both a yield and capital appreciation perspective.

Furthermore, if the Chinese government's 'bail-out' mechanism for the real estate and housing sectors proves effective, it could provide much-needed support for an economic and market rebound in the region.

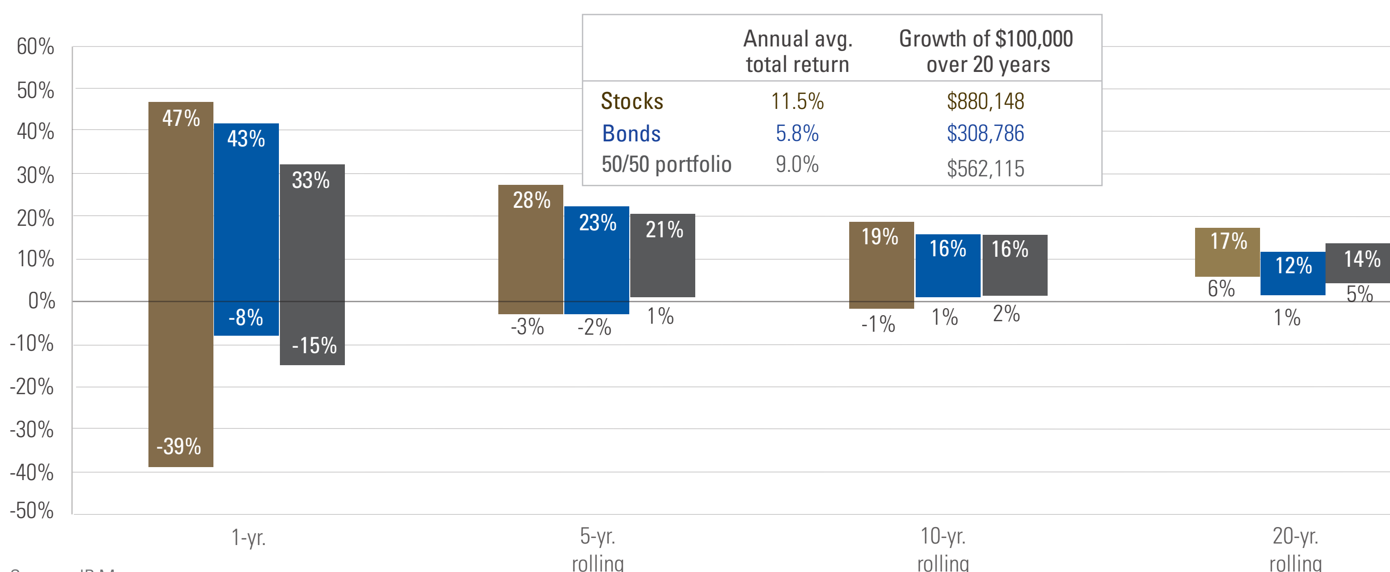
Equity multiples appear to be historically expensive despite the deep correction in stock prices. However, looking deeper into different market segments, small- and mid-cap stocks are already trading well below their historical averages. There are good opportunities to be captured in these segments of the market. In sum, the future is not all bleak.

Patience and discipline are key in volatile markets

Bear markets are tough for investors, but the playbook is simple. They are rarely V-shaped, and you will usually see significant volatility and multiple market rallies. It is important to understand that volatility is unavoidable for long-term investors. Taking an historical perspective, the rolling returns of a balanced portfolio over holding periods exceeding five years have never been negative between 1950 and 2021. The probability of a loss of capital for a long-term investor is thus minimal.

Range of stock, bond and blended total returns

Annual total returns, 1950–2021



Source: JP Morgan.

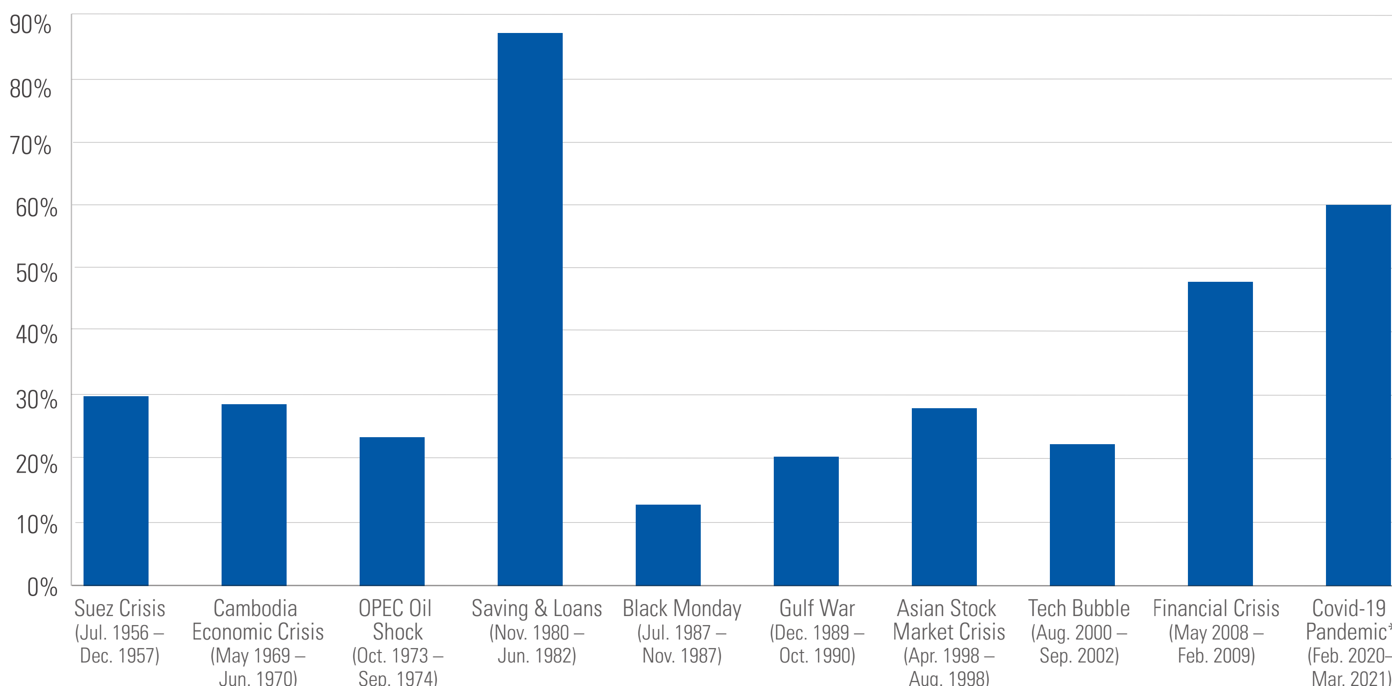
It is essential that investors, in collaboration with their advisors, periodically review their financial plan to ensure that the level of risk they are taking in their portfolio is aligned with their needs and objectives. Though difficult, they must have conviction in their optimal long-term asset allocation and stay the course.

Moreover, market timing – a very dangerous game to play – is not a viable option for long-term investors. Our analysis of stock and bond markets following a bear market shows that recoveries usually exceed previous highs while cash allocations offer limited capital appreciation. The cost of missed opportunities in the ensuing rallies is thus quite steep.

Fine-tuning the risk exposure of a portfolio by capitalizing on volatility and selectively rebalancing – without attempting to time the market – is what allows an active asset manager to add value.

A year after a crisis, markets have been up an average of 36%

S&P/TSX Composite Index Total Return 12 months after market hits bottom



Source: Bloomberg, iA Clarington Investments. *12-month period ending March 18, 2021.

A proven partner

In times of high volatility, macroeconomic complexity and geopolitical uncertainty, iA Investment Management is in a strong position to add value for clients by leveraging our deep expertise across the full range of asset classes.

We are monitoring market signals closely while carefully managing our risks. Within our fixed-income mandates, we have adjusted our duration positioning several times through bouts of volatility since the beginning of the year, taking advantage of the strong rally in bond yields at the beginning of the summer, for example. This helped us add significant value versus the overall market and our peers.

In our equity mandates, despite historically high valuations, there are oversold segments of the market, such as North American small- and mid-cap stocks and heavily discounted tech stocks, where we have taken advantage of market selloffs to increase existing exposure. We have also taken tactical positions in specific asset classes in our managed solutions.

We will continue to take advantage of market dislocations as we look to position our portfolios for an eventual recovery. The best decision for long-term investors in building and preserving wealth is to be disciplined and stay invested.

About iA Investment Management

A magnet for top investment talent, iA Investment Management (iAIM) is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAIM's unifying commitment to strong risk management, analytical rigor a disciplined, process-driven approach to asset allocation and security selection.

Rooted in history. Innovating for the future.

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