Goodreid
INVESTMENT COUNSEL

87 Front Street East
2nd Floor
Toronto, ON M5E 1B8

T. 416 364 0890
TF. 1 888 466 3734
goodreid.com

# The Goodreid Gauge

Summer 2022

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In our 30+ years of writing market commentaries we have only evoked the lyrics of the Dire Straits 1991 hit, "The Bug", a couple of times. It seems timely to reflect on the song's line, "sometimes you're the windshield and sometimes you're the bug," an appropriate metaphor for the cycles of life and the investment landscape. Although normally the windshield, North American financial markets were definitely the bug this quarter and for that matter, all of 2022. The Canadian equity market held up better than other world markets on the back of a strong commodity complex, with energy leading the way. However, it was not enough to thwart other sector weakness and the S&P/TSX Composite fell 13.2% in Q2 2022. Even weaker was the U.S. based S&P 500 Composite Index, off 16.1% in local currency and down 13.4% when translated to Canadian dollars, while the small company Russell 2000 Index, suffered by 17.2% in U.S. dollar terms. The FTSE Canada short-term bond index declined 1.5% in Q2, while the Solactive Laddered Canadian Preferred Share Index retreated by 6.9%.

Financial markets had been on a strong run since the financial crisis of 2008, with short (although nasty) disruptions along the way. While North American economic and corporate performance was impressive, the markets had been particularly strong because of an upward adjustment in valuations. Accommodative central bankers created an era of "free" money (remember the concept of negative interest rates?) which enhanced the attractiveness of equities and provided a boost in confidence. In addition, fiscal policy fed the economy with highly stimulative measures to ensure Covid-related disruptions did not cause generational economic problems. The result was a historically high valuation premium, with all players feeding the asset bubbles.

Those days are over. The underpinnings of that premium have dissipated. Higher interest rates, worrisome inflation, recessionary fears, and heightened geopolitical concerns have led us into a bear market. As the air comes out of stock prices during tough economic times and a bear market, there are the necessary casualties, but investors who have followed a strong and disciplined philosophy of owning quality companies, with stock prices tethered to company performance, will be the beneficiaries in a new economic cycle and bull market.

Bear markets, such as the one we are now in, last an average of 9 months, with those associated with recession lasting longer, at 19 months vs. those without an economic recession at 6 months. The key point is that they are not terminal events. They are a part of a cycle. By the time a recession is officially declared, bear markets are often over. This is because markets are forward indicators pricing future cashflows, not the past or present.

While we at Goodreid do not claim to have a crystal ball and cannot predict the date or level of the bottom of this bear market, we are confident that we are well into it. Necessary market damage has been inflicted. The gambling cohort has largely capitulated. The selling feels overdone and is at historic levels. Chart 1 below illustrates that investor negativity is at extreme levels, a reliable contrary indicator.

Negative investment returns during bear markets must be expected and accepted. That said, we follow our strong disciplines of owning quality companies with above average earnings growth prospects and compelling valuations. This allows us to add relative value regardless of the environment. Certainly, Goodreid's performance during this bear market has relinquished a portion of last year's gain, but it has outperformed our peer group benchmark index , and is just one step in the investment journey. We must remember that stock market volatility is a function, not a flaw, of investing. To create a fair performance perspective multiple cycles must be considered. The result is decidedly favourable.

The bond market and the commodity complex are signaling poorer economic times ahead, but some perspective is required. Ten-year Treasury yields in the United States have fallen from 3.3% to about 3%, perhaps signaling a test of a topping of rates for this cycle. While 3% is higher than the near zero rate environment of a couple of years ago, it is also a long way from the elevated levels of past tightening cycles and is still below average historical levels for interest rates. Also, the recent pull back of commodities gives us indications that economic weakness is ahead, and the Fed may start pulling different levers. Keep in mind though, that it is difficult to imagine a deep recession when the U.S. is producing 400,000 jobs each month. Another quirky aspect of this cycle is that corporate earnings continue to hold up. While earnings are admittedly one of the last things to falter in a weakening economy, CEOs are steadfastly confident. We will all be listening intently to the commentary around this earnings season. Pay particular attention to margins, which have held up well. Other topics of note will be the health of the consumer, the recovery of supply chains, and the negative impact on multinationals of the U.S. dollar being at 20-year highs.

After two quarters of historically significant damage to investors' portfolios, the necessary question is, "what's next"? It would be naïve and pollyannish to declare with certainty that the market has bottomed. Markets have a way of humbling investors and "oversold" can become "more oversold."

At Goodreid, we analyze our position from two vantage points. First, we understand that markets cycle, with the waves of expansion and contraction being a hallmark. Physical laws of action and reaction apply to economic and market cycles as well. Charts 2 and 3 below illustrate how markets have acted historically after periods of extreme selling. As we referred to above, equity markets are a forward-looking vehicle, and it is not surprising that extreme pessimism is followed by a degree of relative optimism.

Our second lens focusses on the companies we own. We are continuously upgrading the quality of our portfolio. This means impressive profitability, strong balance sheets, and resilient business models. We have made several portfolio changes in both the Canadian and U.S. portfolios over the course of the year. Early in the year we increased our exposure to the energy sector, and subsequently added companies which exhibited high degrees of earnings stability. The Canadian portfolio characteristics are attractive, with an average return on equity of 17.5% vs. 14.2% for the TSX. Earnings growth rates are exciting. We expect the Canadian portfolio to grow

**CHART 1**


**CHART 2**

**15%+ Quarterly Drops for the S&P 500: Post WW2**

| Quarter | Quarterly Drop (%) | Next Quarter (%) | Next Half (%) | Next Year (%) |
|---|---|---|---|---|
| Sep-46 | -18.83 | 2.27 | 1.40 | 1.00 |
| Jun-62 | -21.28 | 2.78 | 15.25 | 26.70 |
| Jun-70 | -18.87 | 15.80 | 26.72 | 37.10 |
| Sep-74 | -26.12 | 7.90 | 31.19 | 32.00 |
| Dec-87 | -23.23 | 4.78 | 10.69 | 12.40 |
| Sep-02 | -17.63 | 7.92 | 4.04 | 22.16 |
| Dec-08 | -22.56 | -11.67 | 1.78 | 23.45 |
| Mar-20 | -20.00 | 19.95 | 30.12 | 53.71 |
| Jun-22 | -16.45 | ? | ? | ? |
| | **Average** | **6.22** | **15.15** | **26.07** |
| | **Median** | **6.34** | **12.97** | **25.08** |

**CHART 3**

**20%+ Two Quarter Drops for the S&P 500: Post WW2**

| Quarter | 2-Qtr Drop (%) | Next Quarter (%) | Next Half (%) | Next Year (%) |
|---|---|---|---|---|
| Jun-62 | -23.48 | 2.78 | 15.25 | 26.70 |
| Jun-70 | -21.01 | 15.80 | 26.72 | 37.10 |
| Sep-74 | -32.39 | 7.90 | 31.19 | 32.00 |
| Dec-74 | -20.28 | 21.59 | 38.84 | 31.55 |
| Sep-02 | -28.94 | 7.92 | 4.04 | 22.16 |
| Dec-08 | -29.43 | -11.67 | 1.78 | 23.45 |
| Mar-09 | -31.59 | 15.22 | 32.49 | 46.57 |
| Jun-22 | -20.58 | ? | ? | ? |
| | **Average** | **8.51** | **21.47** | **31.36** |
| | **Median** | **7.92** | **26.72** | **31.55** |

earnings by 13% over the next year, while the whole market will grow at only 7%. Given our average price to earnings (P/E) ratio is 14.5 times, less than the market's 14.8 times, the relative value is apparent. And the companies you own are of the highest quality, with net debt at an exceptionally low 12% of equity.

The U.S. portfolios are equally as impressive. With a P/E ratio of 15.8 times, a 20% discount to the S&P 500 Index ratio, the U.S. large capitalization portfolio sports an average return on equity of 21%. We expect a robust 14% increase in earnings next year compared to the market's 10% growth expectation.

We are excited with the opportunity within our portfolios. As the economy recovers, we expect many of our companies to shine and for their share prices to reflect their promise.