Cidel Asset Management

International Conflict: Time to Change Course?

By Arthur Heinmaa, Chief Investment Officer

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As I walked down the aisle at my wedding 31 years ago, I remember rockets firing in Kuwait marking the beginning of the war and the subsequent high for the oil market and low for the equity market. As fighting has now begun in Ukraine, we can only hope that today marks a bottom in the equity market.

The Russian invasion of Ukraine is the largest European military invasion since 1945, the repercussions of which will likely be reflected in foreign policy and financial markets for years to come. The implications of the Soviet attacks on Hungary in 1956 and Czechoslovakia in 1968, for example, were only the beginning of difficulties, both internal and external. It is my belief that, unlike the Kuwait war, the conflict in Ukraine will not be resolved as quickly. It would not be surprising to see Russia fighting an ongoing war against Ukrainian independence, with the West simultaneously supplying weapons and logistics to Ukraine while imposing sanctions on Russia intended to damage their economy and leaders.

With current events in mind, there are several items to consider from a financial markets perspective. Chief among these issues are inflation and central bank policy. The Russian invasion has caused both energy and commodity prices to soar. Unless there is a quick reversal in commodity prices, the increase in input costs will continue to push inflation higher. Higher interest rates in North America will do little to resolve price increases caused by the Russian war but pressure will continue for the central banks to increase interest rates. Herein lies the risk: If the central banks move too slowly, there is a risk that inflation becomes ingrained in the economy; if they move too quickly, there is risk of a recession. In other words, the central banks have a very narrow path within which to tame inflation and keep the economy growing. With 10-year bonds yielding only 1.80%, fixed income markets seem to be pricing in slower growth in the coming years. In our view, the possibility for a significant policy mistake was high going into the war and has since only increased.

Second, although equity markets are down from their record highs, they are still up almost 30% from their pre-pandemic levels proving that equity market investors have done well throughout the pandemic. It is likely they will continue to do well by staying the course through this period. Judging by the number of commentaries I have read, the pervasive sentiment seems to be that this is the time to go into the market and load up on equities. This is in stark contrast to the bearish view that existed in 1991. At Cidel, we see no compelling reason to be aggressively overweight or, for that matter, underweight in equities. We can hope that today is a replay of the Kuwait war, Iraq war or the Crimean crisis, but trading on historic patterns without an explicit link to valuation is folly. In our view, the risk return from a valuation perspective does not warrant an aggressive equity position. The only exception would be equities that you intended to buy before this crisis. If the investment case remains solid, this downdraft may create an opportunity to buy a good company at a good price rather than on historic precedent.

The third and most important thing to consider is asset mix. At Cidel, we have always advocated for strong diversification of investments to ensure that one theme, one risk, or one market never dominates the risk in your portfolio. In moments like this, exposure to fixed income helps buffer the volatility in markets and provides a source of cash should a good opportunity present itself. Despite the low yields, fixed income plays an important role in a diversified portfolio. The heart of this philosophy is a belief that a focus on cash flow and its relationship to valuation is the best path to strong risk-adjusted returns. Asset mix is not a call on markets but a way to manage risk and liquidity – factors that may be ignored until days like today.

Market turmoil is upsetting for everyone. As the saying goes "when the market is moving up, you always feel like you have too little exposure and when the market goes down, you feel like you have too much exposure". The trick is to set emotions aside and refrain from making any dramatic moves during these volatile times. As tempting as it may seem, this is not the environment in which to make dramatic changes to one's asset allocation. If there are particularly compelling investment opportunities, you can be assured that we will bring them to the forefront as we did in 2020 & 2021. We remain steadfast in our belief that now is not the time to tilt aggressively away from your long-term asset mix. If you have concerns or would like to discuss the markets further, please be in touch with your Cidel Wealth Consultant.

*Cidel is an operating name of Cidel Asset Management Inc.

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