Justwealth 4Q 2021 Market Commentary

Another quarter of living through a global pandemic, another quarter of record-setting equity levels. Positive equity returns were recorded in all major regions in every quarter of 2021, resulting in some very strong gains for the full year. The main stock market indices for both Canada and the United States advanced by more than 25%, while international equities rose by over 10%. Does that seem reasonable for a global economy that continues to struggle with COVID-19, supply-chain disruptions, and rapidly escalating inflation?

Well, it certainly didn't work out well for bonds. The Canadian bond market returned -2.54% for the full year and that includes the rebound experienced in the fourth quarter. That is the worst calendar year return for the bond market since 1994! The sub-par year for bonds and the prospect of rising interest rates has prompted many in the media, and some Justwealth clients, to question the value of bonds. Rest assured, bonds, or more broadly, fixed income, should continue to play an important part of diversified portfolios going forward.

We will be producing a more in-depth commentary on fixed income investing in early 2022, but it is worth mentioning here that Justwealth's approach to managing the fixed income component of client portfolios has resulted in significantly better-than-benchmark returns. The Justwealth Conservative Income Portfolio is our most diversified, 100% fixed income portfolio and it returned +0.65% in 2021.

Economic healing clearly prevailed in 2021, with economies growing and employment demand booming. You can thank central banks for their easy money policies, or you can thank governments for their generous increases in spending, or perhaps both. Maybe some credit should be given to the resilience of humanity, adapting and rising to the challenge of evolving work environments amid shifting industry demand. But have asset prices gotten ahead of themselves? That is another question that we frequently receive.

To answer that question, we can separate assets into one of two categories: financial assets or real assets. Financial assets are your traditional investments like stocks, bonds, and cash. Real assets are physical in natural and include real estate, commodities, and infrastructure among other things. Excluding one's own principal residence, financial assets typically constitute the vast majority of most individual investors' assets. Even most institutional investors, such as pension funds, tend to hold more financial assets than real assets.

Regarding financial assets, stocks are ownership of companies that either make a profit or are expected to make a profit in the future. Individual stocks could be hit or miss, but in aggregate (i.e., the stock market), there is a long history of steady and growing profits gradually being paid to the owners and reinvested in the businesses. Bonds pay interest to lenders and eventually give the lenders their money back. Both of these financial assets increase wealth (ignoring short-term market fluctuations) and there is a clear value to both of these assets.

Cash can be thought of as a very, very conservative bond. It may earn a very modest amount of interest in some cases, but in recent years, it has not even kept pace with inflation. Cash can also be categorized as a currency. A currency is a medium of exchange to facilitate transactions of the purchase of real or financial assets or goods and services. Although cash may have a clear value, it does not meaningfully create wealth.

Turning to real assets, real estate is analogous to a bond except that instead of interest, you receive rent. Infrastructure works in a similar manner: users pay a fee to use the infrastructure asset which results in a stream of income back to the owner. Commodities, like oil and precious metals, are different. For the most part, they are used as an input of production of consumable goods or services, and their prices are based on supply and demand. Commodities, by themselves, do not create wealth, but their prices should increase to keep pace with increasing prices of goods and services (i.e., inflation).

For almost two years now, governments and central banks have injected massive amounts of cash into their countries. Given a relatively constant supply of non-cash assets available, but significantly more cash outstanding, a logical outcome would be higher prices of non-cash assets. It has taken time for some prices to adjust, but it certainly seems obvious now. Real estate prices should be high, stock prices relative to earnings should be high, bond yields should be low, and inflation should be accelerating. All of this has happened/is happening.

So, for those who fear a stock market correction because we are at an all-time high, your fear may be misplaced. In the short term, markets can be irrational, so a correction could very well happen, but our long-term outlook for annualized equity returns is unchanged from last year at 7% despite an abnormally high return in 2021. Similarly, our long-term outlook for bonds is unchanged from last year at 2.5%, even though they may experience another tough year in 2022. While these returns are lower than historical returns, we believe they are realistic for a lower growth, lower inflation environment that we will eventually converge to.

If we were to caution investors about any asset for its future prospects, it would be cryptocurrencies. Cryptocurrency, as the name implies, is a currency – it is not a financial asset as it does not earn interest or generate profit. As we identified earlier, currencies do not create wealth. At the moment, it’s not even a credible currency as it cannot be used to facilitate many transactions. Nevertheless, over the past five years the rate of production of cryptocurrency (using Bitcoin as an example) has been considerably less than the rate of production of fiat currency (using M2 money supply definition for the US Dollar), so there could arguably be a justified price gain of somewhere up to 15% which has been the realized rate of inflation. The actual price gain for Bitcoin has been closer to 5,000% over that time period.

Too much money, a limited supply of assets and a herd mentality fueled by the media and miners/brokers of cryptocurrencies have created a perfect storm for cryptocurrency prices to soar to dizzying heights. The volatility of Bitcoin over the past 5 years has been more than 7 times the volatility of the S&P 500 stock index. We remind investors to always consider the amount of potential downside in any investment, not just the upside as returns can always be symmetric. With that in mind, bonds don't seem so bad anymore, do they?

Wishing everyone a safe and happy 2022!

Here is a recap of market performance as of December 31, 2021*

Asset Class	Market Index	Quarter	1 Year	3 Years	5 Years	10 Years
Fixed Income	FTSE TMX Canada Universe Bond	1.47%	-2.54%	4.22%	3.31%	3.27%
Canadian Equity	S&P/TSX Capped Composite	6.47	25.09	17.52	10.04	9.14
U.S. Equity	S&P 500 ($Cdn)	10.70	27.61	22.83	17.06	19.09
Int'l Equity	MSCI EAFE ($Cdn)	2.39	10.32	10.62	8.25	10.38

** Source: Morningstar. Performance annualized for periods greater than 1 year.*

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