2022 First Quarter Review

The first quarter of 2022 was challenging for global investors as most **major financial markets posted negative returns**. Canada was the only major market to remain in positive territory, benefitting from the rise in oil and commodity prices. It has now been over two years since the start of the pandemic, and COVID-19 still remains a large problem for many countries that have reinstated lockdown measures. Russia's unprovoked attack on Ukraine added even more uncertainty to an already volatile stock market.

Canadian stocks, as measured by the S&P/TSX Composite Index, were resilient, returning 3.8% in Q1 despite many ongoing headwinds. **The energy sector shot up 38.2% in the quarter** largely due to record high exports, which predominately consisted of crude oil and bitumen (up 56% year over year). International sanctions on Russia have shifted demand toward Canadian energy, food, and minerals. The Bank of Canada raised interest rates for the first time since 2018 by a quarter point, followed by another half point to an effective lending rate of 1%. As part of the central bank's effort to control inflation, further rate increases are expected to continue throughout the year.

US equities closed the quarter with their first loss in two years, as the S&P 500 Index, a broad measure of the 500 largest US companies, returned -5.9% (CAD). Of its 11 sectors, 10 finished in the red, with **technology and communications stocks among the key underperformers**. The US Federal Reserve also increased the lending rate for the first time in three years by 0.25% to the target range of 0.25% to 0.50%. The Fed signaled a more aggressive approach to combat inflation, announcing plans for steeper hikes and an accelerated reduction in its US$9 trillion bond holdings.

Russia's widely condemned invasion of Ukraine dominated global headlines. Many European and Western allies were quick to respond with strict sanctions on Russia, President Putin, his high-ranking officials and associated Russian oligarchs. **Investors have steered away from European stocks due to the uncertain outcome of the conflict**. Russian stocks, as measured by the MOEX Russia Index, were down approximately 31% year to date. International developed and emerging market stocks struggled in the quarter, declining 7.2% (CAD) and 6.5% (CAD), respectively.

Global bonds sold off in Q1, with yields moving higher on expectations that central banks will aggressively hike lending rates to combat inflation. The US 2-year Treasury yield recently rose above that of the 10-year Treasury, potentially signaling tough times ahead—typical of an inverted yield curve. Short-term Canadian bonds returned -3.0% (CAD) for the quarter.

Following are the returns for major indices for the period ended March 31, 2022:

	Q1 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	0.1	0.1	0.1	0.7	0.9	0.8
Canadian Bonds (FTSE Short-Term Bond)	-3.0	-3.0	-3.3	0.8	1.1	1.7
Canadian Stocks (S&P/TSX Composite)	3.8	3.8	20.2	14.2	10.3	9.1
US Stocks (S&P 500)	-5.9	-5.9	14.8	16.3	14.5	17.2
Non-North American Dev. Stocks (EAFE)	-7.2	-7.2	0.4	5.4	5.4	8.7
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-6.5	-6.5	-7.5	3.9	4.9	5.9

* Q1, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

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Outlook

The underlying triggers of the market volatility that began 2022—**rapidly rising prices, potential rate hikes, escalating geopolitical tensions**—are expected to persist over the next several months. Russia's unprovoked attack on Ukraine has caused a massive humanitarian crisis; it has also further stoked ongoing inflationary pressures due to sanctions on energy exports and wrought supply-line disruptions for other natural resources and production inputs. The war brings an added layer of uncertainty to the inflation picture, and as a result, central banks appear ready to increase interest rates at a quicker-than-anticipated pace.

While the main objective of the world's central banks is to control inflation by raising rates, upcoming policy decisions come at a time when bond yields along the curve are signaling a potential slowdown in economic growth. This is likely the result of investor concern that a too-aggressive policy response could derail the economic recovery as we emerge from the pandemic. Economic data readings will therefore be top of mind for investors as the year progresses. **Until a more normal rate of inflation can be achieved, administrations will do their best to temporarily alleviate the burdens of higher costs on businesses and consumers**. The Biden administration recently committed to releasing one million barrels of oil a day from the US's strategic reserves over the next six months in hopes of stabilizing gas prices.

With rising rates and prices a seeming trend for the foreseeable future, the Canadian stock market, with its significant weightings in financials and energy/materials, will likely continue to benefit, as it did to start the year. **Higher interest rates are a boon to financial services companies' lending books, while the energy and materials sectors will do well with rising commodity prices**.

The US market still faces myriad challenges. **Rising rates** remain a problem for the growth-focused technology sector and smaller companies, while better-established cash flow-generating businesses are struggling with **rising costs**. Those with an international presence are dealing with complications of the **shifting geopolitical landscape**, where once robust revenue channels are now compromised.

Overseas stocks began the year as a potential area of opportunity in many strategist forecasts because of the relative underperformance of European markets over the last few years. However, the **situation in Ukraine creates a significant hurdle for investors** considering adding to their European stock positions given that the region's markets are the most at risk to the conflict and rising commodity prices.

The **rising rate environment is an issue for emerging economies**, many of which rely heavily on debt. Some of the larger emerging nations are also still committed to a zero COVID-19 policy, which is proving to be a huge challenge given the transmissibility of omicron and the BA.2 variant. Lockdowns in these countries will further impact global supply chains.

Portfolio Strategy

With pandemic restrictions lifting, **economic readings have been relatively strong in North America**, and this will allow central banks to swiftly respond to inflationary pressures. With the benefit of hindsight, it is now clear that they maintained their accommodative COVID-19 policies for too long and have fallen significantly behind inflation. Combined with massive government spending over the past two years, inflation is proving to be far more resilient as demand surges and supply chains struggle to keep up. The war in Ukraine has only exacerbated these issues. The longer such higher inflation persists, the more it builds into expectations, which becomes more problematic.

Since the financial crisis in 2008, inflation remained very modest, and this provided central banks the opportunity to respond to any sign of economic weakness with easing monetary policy to stimulate growth. They no longer have this luxury. **With inflation now in the 5.5% to 8.5% range in North America, central banks will have to move quickly to maintain their credibility**, since price stability is one of their key policy goals. While a response is necessary, overtightening or tightening too quickly can lead to a recession. The bond market is starting to signal this possibility, with short-term interest rates now higher than longer-term rates. This typically foreshadows an economic slowdown in the next 12 to 18 months.

With central banks warning of higher interest rates, the **bond market has weakened**, since prices move inversely to interest rates. While the rise in rates has been dramatic over a short time period, **bond yields are essentially back at their pre-COVID-19 levels**, which is to be expected as the global economy regains its footing. Although recent bond returns have been disappointing, the higher yields now available will translate into higher cash flow going forward as bonds mature and proceeds are reinvested at higher rates. We are also using this opportunity to lock in more attractive fixed income returns with shorter-term GICs having returns in the 2.50% to 3.50% range along with added price stability.

In equity markets, Canada significantly outperformed other markets during the first quarter and over the past year given rising inflation expectations. We may be using this opportunity to rebalance to either reduce overall equity exposure closer to policy targets or to add to international markets where valuations are more attractive. These markets may face more near-term hardships due to the Ukraine situation and inflation concerns, but they offer more compelling value for long-term investors given their significant relative underperformance in the past few years.

Overall, we **expect continued volatility in the months ahead** as the market reacts to the reality of higher inflation and higher interest rates. The ongoing war in Ukraine will also add uncertainty from a geopolitical standpoint and likely extend the period of higher inflation given the impact on food and energy prices. As always, a well-diversified portfolio is the best way to navigate these ongoing periods of uncertainty.