2022 Second Quarter Review

The uncertain investing environment continued into Q2, and US markets posted their worst first half since 1970. The **fiercest inflation in years and fears over geopolitical tensions** and the future of the economy sent US and international stocks into **bear market territory**, commonly defined as a greater than 20% decline in value. Canadian equities, while still lower year-to-date, have fared better due to the resource-heavy composition of our markets.

The Canadian economy continues to be **supported by the energy sector**, up 39% for the year driven by the surging price of oil and other commodities. Despite this strength, Canadian stocks as measured by the S&P/TSX Composite Index returned -13.2% this quarter yet still outperformed other major financial markets year-to-date. The Bank of Canada raised interest rates by half a percentage point, bringing the effective lending rate to 1.5% as inflation climbed to 7.7%, almost a four-decade high. Subsequently, rising borrowing costs have contributed to the slowdown in real estate market activity.

South of the border, US equities painted a similar picture, as the **energy sector was the only one to see positive returns** during the first six months of the year. The US Federal Reserve maintained its aggressive policy approach by increasing the lending rate by three-quarters of a point in June, to a range of 1.5% to 1.75%, in an ongoing effort to curb inflation and stabilize prices. The S&P 500 Index, a broad measure of the 500 largest US companies, returned -13.5% (CAD) for the quarter.

Overseas, international developed and emerging market stocks continued to decline, with returns of -11.9% and -7.6% respectively in Q2. It has also been a difficult year so far for international investors as they contend with the lingering **Russia-Ukraine conflict, soaring inflation, and supply shortages**. Although the European Central Bank is targeting its first interest rate hike in 11 years at the end of July, it has been relatively slow to react in its monetary policy response compared to its Western counterparts.

Bond yields moved higher in the second quarter as central banks increased interest rates in major economies. With more attractive bond yields, investors are locking into higher rates for steady income. Unfortunately, with the inverse relationship between interest rates and prices, investors' **existing bond holdings have sharply declined**. As a result, returns on fixed income have disappointed, with Canadian short-term bonds down 1.5% for the quarter.

Following are the returns for major indices for the period ended June 30, 2022:

	Q2 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short-Term (FTSE 30-Day T-Bill)	0.2	0.3	0.3	0.6	0.9	0.8
Canadian Bonds (FTSE Short-Term Bond)	-1.5	-4.4	-4.8	0.1	0.9	1.4
Canadian Stocks (S&P/TSX Composite)	-13.2	-9.9	-3.9	8.0	7.6	8.2
US Stocks (S&P 500)	-13.5	-18.6	-7.3	10.0	11.1	15.6
Non-North American Dev. Stocks (EAFE)	-11.9	-18.2	-14.7	0.5	2.0	7.9
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-7.6	-13.6	-18.0	1.7	3.0	5.5

* Q2, 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.

Outlook

As we enter the second half of a challenging year, investors remain concerned given the possibility of a slowdown in global economic activity as **central banks continue to raise interest rates to combat inflationary pressures**. Economists have forecast that the US Federal Reserve will boost rates to as high as 3.5% by the end of the year, a level not seen since before the credit crisis began in 2008. The related risk of recession and the ongoing geopolitical conflict overseas are expected to continue to weigh on sentiment and contribute to **continued volatility**.

All major equity markets will face their share of challenges for the rest of 2022. In the US, recent strength in the US dollar might hamper earnings results of the many companies that have meaningful international business—estimated to be close to 35% of US firms. As a consequence of tightening conditions, commodity prices have started to pull back despite supply issues. By way of example, crude oil has fallen from its recent peak of US$120 per barrel to below US$100 per barrel over fears of a slowdown in demand. Housing markets have also started to cool as mortgage rates have surged, resulting in a reduction of household wealth. These two factors represent considerable headwinds for Canada's economic prospects. Market analysts had pegged international markets as an area poised to outperform over the next 10 years after a long period lagging strong US returns. However, an impending change in leadership appears to be delayed as Europe grapples with the fallout from the Russia-Ukraine conflict. China's ongoing battle with COVID-19 continues to hang over the world's second-largest economy as flare-ups of the virus and associated lockdowns have exacerbated global supply chain issues.

Inflation is causing significant stress for nearly everyone across the globe. Central banks understand this and are acting aggressively in response, **rapidly hiking interest rates**. The dramatic and quick increase in borrowing costs is sure to create economic pain in the near term, as debt burdens are at very high levels following years of cheap money. It is, of course, uncertain how severe this pain will be and how long it will last, but it is important for investors to remember that as with all market cycles, these conditions will not last forever.

As demand and supply imbalances eventually normalize, prices will come down and economic prospects will improve. Markets will likely anticipate this and start to bounce back in advance of the economy, and based on history they could do so in short order. Looking at past bear markets in the US back to 1929, the recovery to predecline levels has often been swift, with investors made whole within a year in 9 out of 15 occurrences—and we are already five months into this latest bear market. This shows that **maintaining a long-term perspective on investing is crucial**, as overreacting in down markets could prove costly in meeting investors' financial goals.

Similar to stocks, it would benefit investors to wait out the difficulties in the bond market. Many of the near-term underlying holdings of bond pools will mature at full principal and be reinvested at higher rates. **Bond prices also tend to perform well in periods of recession** where central banks are expected to shift to a more accommodative monetary policy.

Portfolio Strategy

It has been a difficult first half for investors, with **almost all asset classes significantly in negative territory**. Normally in periods of economic and stock market uncertainty, fixed income investments provide positive returns to help offset the weakness in equity markets. That has not been the case this time, with **bonds posting negative returns** as central banks try to wrestle inflation under control with higher rates. What also makes the current environment feel worse is the volatility we have experienced in getting to this point. Recall that stocks fell about 35% in early 2020 and then rallied off their lows to reach all-time highs at the end of last year. Global equities are modestly positive since the onset of the pandemic, but it always feels worse when current portfolio values are compared to the recent highs.

Unfortunately, this **volatility could continue until there is greater clarity regarding inflation**. Central banks have lost valuable credibility in the past year by pursuing stimulative policies for too long, and now they must aggressively reverse course to get inflation down to their desired level of 2% to 3%. They must continue raising rates despite signs that economic growth is slowing.

The dramatic increase in rates so far this year has resulted in significant weakness in bond portfolios. We understand how challenging this is to more conservative investors who have a higher allocation to fixed income. We **focus predominantly on shorter-term bonds** in our portfolios, which have fared much better than longer-dated maturities. A silver lining for investors in this is that we are returning to a more normal interest rate environment, which will be beneficial on a long-term basis with more meaningful returns expected from the fixed income side of the portfolio. To provide more stability, we have also been reestablishing a laddered GIC portfolio to take advantage of the higher interest rate environment. GIC rates for terms of two years or longer are currently over 4%, and they will not drop in value, providing downside protection as a result. Although inflation is currently in the 8% range, it is not anticipated to be higher than 4% over the next several years, so GICs will in all probability provide positive real returns over their term to maturity.

Within the equity component, we remain **focused on global diversification to ride out the current uncertainty**. Even with the recent weakness, North American stocks have returned about 9% per year over the past three years, in line with their long-term averages. International stocks have not fared nearly as well, but this may change in coming years once the current issues are behind us.

For longer-term investors willing to tolerate the higher volatility, this may be a good opportunity to gradually put some idle cash to work in both equity and fixed income markets given the recent weakness and higher interest rates currently available. While the road ahead will likely be bumpy, history shows that **these periods eventually pass and markets move higher**, rewarding disciplined investors.