2021 Fourth Quarter Review

Global stocks had a very strong year despite the ongoing challenges of the pandemic, with most major indices posting double-digit returns. Developed economies showed encouraging signs of recovery in 2021, with unemployment levels trending lower and corporate earnings improving.

The Canadian stock market enjoyed its best year in over a decade, with the S&P/TSX Composite Index gaining 25.1%. A resurgence in the demand for oil as discretionary travel resumed contributed to a **rebound in energy stocks** while soaring prices of production inputs helped support our heavily resource-based market. Two other sectors also outperformed the main index—**financials and real estate**. Canadian banks reported higher revenues along with lower loan-loss provisions and were also given the green light to raise their dividends for the first time since before the pandemic. Like the energy space, real estate benefited from the prospect of an eventual return to prepandemic behaviours. The Bank of Canada held its interest rate steady at 0.25% and remained accommodative in its forward guidance.

US stocks also posted strong returns in 2021, with the S&P 500 Index adding an impressive 27.7% (CAD). The US stock market has been the top performer for three consecutive years since 2019, largely due to the **dominance of technology stocks**. The US Federal Reserve suggested that it may raise interest rates sooner than originally anticipated in order to slow down the effects of inflation. Currently, the key lending rate lies between 0% to 0.25%.

Overseas, **international developed stocks lagged North American markets** but returned a respectable 10.4% (CAD) for the year. The Bank of England raised its interest rate to 0.25%—the first major central bank to do so since the pandemic started. Emerging market stocks fell 3.3% (CAD), having been **rattled by headwinds such as price inflation, new Covid-19 variants, and political concerns**.

Global bond yields rose during the year from their historical lows in 2020. The 10-year US treasury yield began 2021 at 0.91% and ended the year at 1.52%. Similarly, the yield for the Canadian 10-year government bond more than doubled, rising from 0.68% to 1.42% over the same period. Canadian short-term bonds returned -0.9% for the year.

Following are the returns for major indices for the period ended December 31, 2021:

	Q4 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	0.0	0.1	0.1	0.8	0.9	0.8
Canadian Bonds (FTSE Short-Term Bond)	-0.5	-0.9	-0.9	2.5	1.9	2.0
Canadian Stocks (S&P/TSX Composite)	6.5	25.1	25.1	17.5	10.0	9.1
US Stocks (S&P 500)	10.9	27.7	27.7	22.9	17.1	19.1
Non-North American Dev. Stocks (EAFE)	2.5	10.4	10.4	10.7	8.3	10.4
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-1.5	-3.3	-3.3	8.2	8.6	7.8

* Q4, 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 begin 2022, the pandemic continues with the recent emergence and rapid spread of the omicron Covid-19 variant. While the severity of this strain of the virus is not yet known for certain, early evidence suggests a milder outcome for many. However, the transmissible nature of omicron risks the stability of health care systems, as scores of people have been seeking emergency care all at once. Once this unprecedented and difficult wave of infections recedes, there is hope that the pandemic might transition to an endemic, with the prospect of a return to a more “normal” life on the horizon. **Global stock markets appear to agree with this possibility, shrugging off near-term setbacks to the economy caused by omicron**.

US stocks in particular continue to hit new highs, with optimism over the possibility of emerging from the pandemic in 2022 coupled with persistent low interest rates sending prices to what some might view as speculative levels. Unattractive yields on traditional fixed income assets and low borrowing costs have investors looking elsewhere for returns—and taking on more risk to do so. TINA (There Is No Alternative) is an acronym now widely used in the financial media to describe the unabated flow of investor money into stocks. It turns out, though, that in addition to the stock market, **plenty of alternative asset classes are seeing an influx of capital**. Anything scarce with a chance for appreciation is in high demand, such as real estate, collectibles, cryptocurrency, art, rare wines, and so on. This type of investing environment is concerning in that little or no room for error exists in the pricing of assets, so careful attention should be paid to any risk that might cause a market correction or pause.

The most significant wild card over the next year is whether the inflationary pressures we’ve been experiencing are transitory or permanent. If they prove to be the latter, central banks may have to increase rates at a faster-than-anticipated pace. This could be detrimental to any asset class where valuations are stretched and a greater level of sensitivity to higher interest rates is present. Residential real estate and debt-dependent growth-oriented stocks are areas of vulnerability should borrowing rates unexpectedly spike. A worse-than-expected outcome from omicron or the discovery of another Covid-19 variant of concern could also weigh on markets, depending on the economic impact. For stocks, **the US market looks to be the most vulnerable given that it is dominated by growth-oriented companies**, is trading at record highs, and has had a run of annualized returns over the past 10 years almost 10% greater than other geographic regions. All this said, if inflation proves to be less of a concern and the economy improves following omicron, US stocks could continue to rally before the next inevitable pullback or period of flat performance.

While US stocks have played the role of market leader over the past decade, history tells us that this streak is not guaranteed to continue indefinitely. By way of example, after a run of two decades of major outperformance, in 1989 Japanese stocks accounted for 45% of the world’s stock market while the US represented 33%. Due to the bursting of an asset price bubble, the region then quickly became the worst-performing market and remained so over the next 20 years. At the end of 2021, US stocks accounted for close to 58% of the world’s markets while Japanese stocks represented only 7%. The future outcome may not be nearly as extreme for the US as it was for Japan, but could it be time for a change in market leadership? Some strategists believe that overseas stock markets, with their valuations not as extended as US stocks, might be an area of opportunity over the next several years.

Portfolio Strategy

We remain cautious in our outlook for 2022 given the very strong equity returns last year that proved to be much higher than even the most optimistic forecasts, particularly in the US. This once again demonstrates the folly of trying to predict in advance which markets will outperform. **As we look ahead, the tailwinds that have supported equity markets recently will become headwinds this year, which will likely increase volatility**. Central banks maintained their low interest rate and quantitative easing programs last year, but some of these policies will be ending shortly, with interest rates in Canada and the US expected to increase in the spring. To provide some context, the US Federal Reserve has been purchasing US$120 billion per month in bond and mortgage-backed securities for the past few years to stimulate economic growth during Covid-19. In essence, it has been printing money, which has been flowing into equity markets, real estate, and other assets. It is now "tapering" these purchases by US$30 billion per month, so this program is expected to end in March. The Bank of Canada ended its quantitative easing purchases in the fall of last year. As these programs are completed, the next phase will involve higher rates, and expectations are for four quarter-point increases in both Canada and the US this year to combat higher-than-expected inflation.

Rising interest rates will continue to mute bond returns in the short term, but over time this should result in more attractive yields. We continue to emphasize high-quality short-term fixed income to preserve capital and moderate return variability. Bond returns have been disappointing over the past few years given the current low interest rate environment, but it is important to remember that the primary catalyst for higher equity returns has been these low rates. This has resulted in above-average rates of return for portfolios even though returns on the fixed income portion have been lacklustre.

In equity markets, the US once again posted the highest returns, and rebalancing will likely involve reducing exposure to this area, with proceeds being added to Canadian or international markets or to fixed income to reduce equity exposure.

Overall, we anticipate **increased volatility this year as we transition from accommodative monetary policy to higher rates**. Inflation is expected to moderate in the second half of the year, which might limit the number of interest rate hikes ultimately required. But even so, we expect the ride to be a bumpy one this year. The key for investors to navigate the anticipated volatility ahead is to maintain disciplined, diversified portfolios and to avoid the temptation to reach for returns in the current environment.