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First Quarter 2022 Investment Commentary

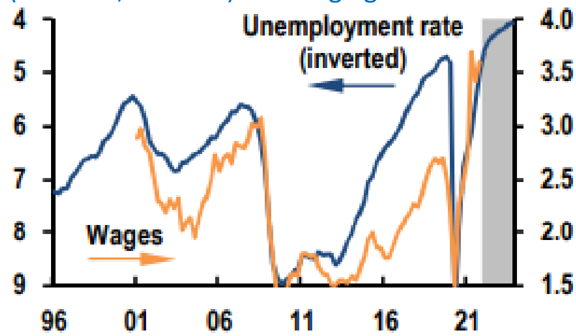
Equity markets delivered mixed results in the first quarter of 2022. The S&P/TSX index managed to post a positive return of 3.8% while the S&P 500 and MSCI EAFE indices finished down 5.6% and 7.6% respectively (in $CAD). Bondholders suffered losses during the quarter as the Canadian Broad Bond Composite declined 7%. We are pleased to write that accounts on board for the full period and migrated to their appropriate models significantly outperformed their respective benchmarks.

Economic Overview

The global economy was thrown more than one proverbial curveball during the first quarter of 2022. Heading into the year, economies around the world were poised to benefit from tightening labour markets, pandemic-related savings transitioning to household spending and a general 'reopening' as lockdowns lifted. While these tailwinds may not have disappeared, Russia's invasion of Ukraine has introduced notable near term risks with the most immediate coming from higher food and energy prices and further disrupted supply chains. Over the past three months, 2022 real GDP growth estimates for developed economies have declined by nearly 25% to 3% (J.P. Morgan Economics). With central banks just starting to remove liquidity from the system, inflation running at multi-decade highs and consumer sentiment deteriorating, even these downwardly revised estimates may prove to be overly optimistic. Fortunately, growth is moderating from elevated levels and ~3% would represent a healthy level of expansion for most mature, developed economies.

The employment backdrop started 2022 more or less where it left off last year – which is to say strong. Unemployment rates continue to edge towards ultra-low levels and employers are paying up to compete for scarce workers (Figure 1). In the U.S., employees are quitting at near record levels for better compensating positions, a telltale signal of labour market strength (Figure 2). With unemployment rates so low we can't help but question what job growth will look like for the rest of the year. Virtually all COVID job losses have been clawed back and economic growth is in the midst of moderating from booming recovery levels to something resembling the long run equilibrium rate. Slowing growth combined with fewer would-be workers on the sidelines lead us to expect a cooling in job growth from here.

Figure 1: Developed Market unemployment rate (inverted, left side) and wage growth



Source: J.P. Morgan

Figure 2: U.S. quit rate and job leavers' wages

Source: J.P. Morgan

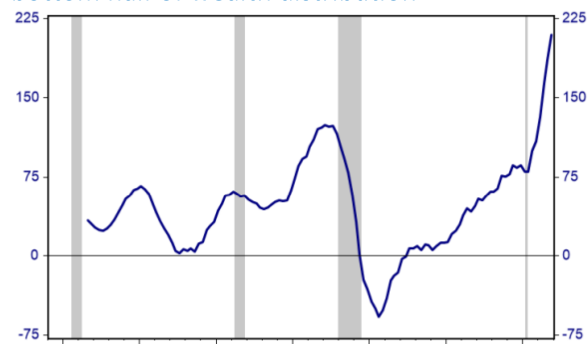
Households have demonstrated unimaginable resilience during the pandemic recovery albeit owing almost exclusively to government support. The prevailing narrative around consumers continues to be that they are "in great shape" and "sitting on mountains of cash." While we aren't prepared to argue that the opposite is true, we no longer subscribe to this line of reasoning and are starting to see cracks emerge within consumer fundamentals. Figure 3 highlights the change in U.S. liquid assets from pre-COVID levels to the latest data point and is categorized by income threshold. Relative to a pre-COVD baseline (i.e. had the pandemic not happened) liquid assets for the bottom 40% are now lower than they otherwise would have been. It is worth considering that lower income cohorts have essentially overspent. Figure 4 shows the change in real consumer durables held by people below the 50th percentile of wealth. We think there is a good chance that an enormous 'pull forward' of goods has occurred thanks to cheap financing (low interest rates) and incredibly generous government support to households. This backdrop, combined with shocking inflation (lower real disposable income), fading government stimulus, and rising interest rates likely puts lower income cohorts at risk.

Figure 3: U.S. consumers' liquid assets by income

Income threshold	Change in liquid assets ($Bil)	Change using pre-COVID baseline	Difference
0-20%	58	191	-133
20-40%	188	204	-16
40-60%	412	85	327
60-80%	771	701	70
80-99%	1877	1005	872
1%	1498	218	1280

Source: Federal Reserve, RBC Capital Markets US Economics

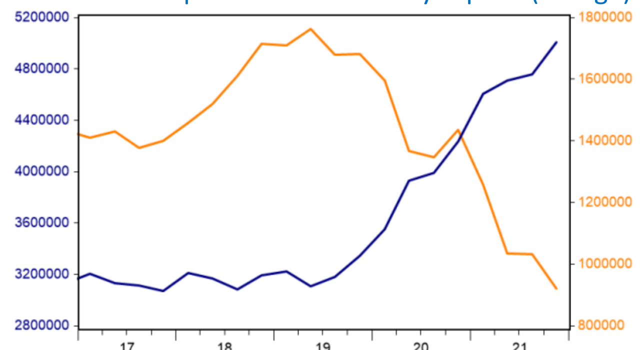
Figure 4: Real consumer durable goods held by bottom half of wealth distribution



Source: Haver Analytics

On the other hand, while it looks like top income earners are in fact sitting on "mountains of cash", we wouldn't necessarily assume that said cash is earmarked for consumption. Rather, it appears that cash levels among this income group are seemingly influenced by prevailing interest rates. As U.S. bond yields began declining in 2019, cash holdings increased and government bond holdings decreased in unison among the top 1% of income earners (Figure 5). We anticipate at least some reversal of this mechanism given the large increase in interest rates over the past year.

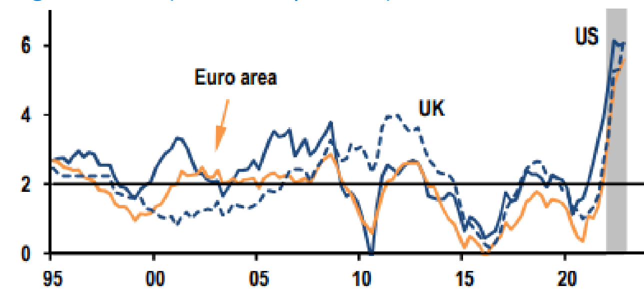
Figure 5: Cash held by top 1% (blue) and U.S. Govt & Municipal securities held by top 1% (orange)



Source: Federal Reserve Board/Haver Analytics

Regardless of how much money consumers were able to save during the pandemic and hold onto until now, households are facing an onslaught of stiff headwinds. Consumer prices are increasing at rates not seen in decades (Figure 6). Bloomberg Economics estimates that the average U.S. household has to spend an extra $5,200 this year compared to the last for the same consumption basket. That's roughly 8% of the median U.S. household income in 2021.

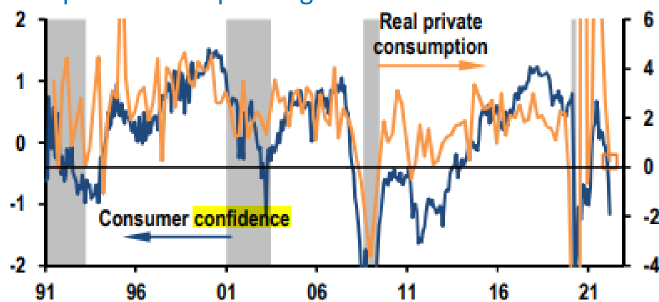
Figure 6: CPI (% over 8 quarters)



Source: National sources and J.P. Morgan

Higher interest rates are also pinching, particularly for homebuyers. Last year in the U.S., 30 year mortgage rates were around 3%, today they are over 5%. Assuming zero price appreciation, the monthly mortgage payment for an average home has gone from $1,189 last year to $1,513, an increase of nearly $4,000 a year (Haver, RBC Capital Markets U.S. Economics). No matter how you look at it, households and by implication consumer spending will be challenged in the near-term. Consumer sentiment has been flagging this as of late (Figure 7).

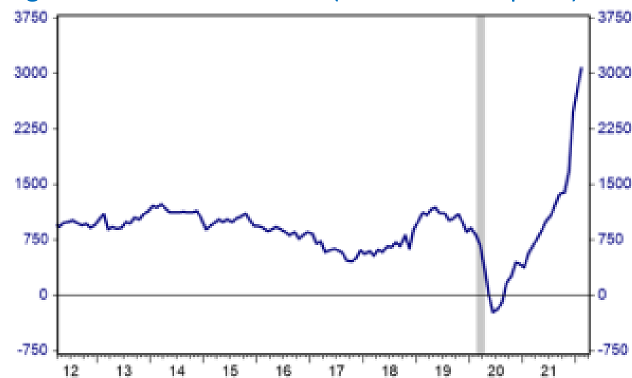
Figure 7: Developed markets' consumer confidence and private real spending



Source: J.P. Morgan Global Economics

On the manufacturing side, a massive inventory build has occurred and was intended accommodate the 'pull forward' in demand that we highlighted earlier (Figure 8). The inventory cycle looks vulnerable to a pullback should consumer spending weaken.

Figure 8: Retail inventories (ex. vehicles & parts)



Source: Haver Analytics

In the aggregate, we don't think that any of what we described above translates into recession. However, central banks are in the driver seat now and they have been forced into tightening mode to deal with inflation (markets are pricing in 7 and 9 more 0.25% interest rates hikes this year in Canada and the U.S. respectively). The odds of a policy misstep (hiking too much or too fast) have increased but we still anticipate patient and 'data dependent' behavior from central banks and do not foresee policymakers tilting the global economy into recession.

Equity Commentary

Equity investors generally suffered in the first quarter of 2022 as most stock markets delivered losses (Figure 9). In the U.S. (and Canada would not be dissimilar), the Technology and Consumer Discretionary sectors lagged the broader index while Energy, Consumer Staples and Utilities performed well. The TSX's heavy Energy weighting benefitted Canadian investors as the price of oil topped $100 due to supply side shocks (conflict in Europe). Broadly speaking, 'value' companies outperformed their 'growth' counterparts.

Figure 9: Benchmark equity returns this year

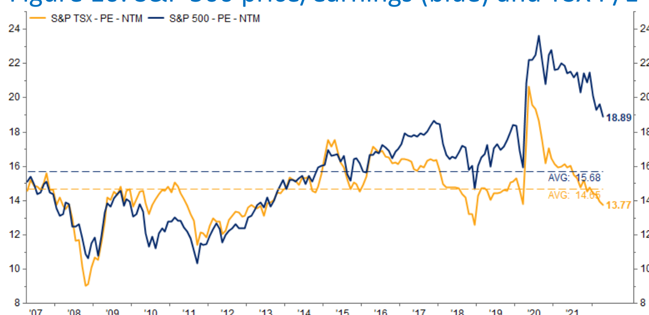
Index	Q1
S&P/TSX	3.8%
S&P 500	-5.6%
MSCI EAFE Index	-7.6%
*returns in $CAD	

Source: RBC Capital Markets Quantitative Research

The devastating war in Ukraine was an obvious shock for markets although North American equities have been fairly resilient. We continue to see downside risks stemming particularly from energy supply and the potential for additional sanctions against Russia. It is incredibly difficult to handicap the war and invest for this environment. We anticipate elevated volatility and think that a cautious approach is warranted.

We entered the year defensively positioned and continued to trim equities and raise cash through the quarter. Our concerns mentioned in the economic section combined with unattractive valuations and hawkish central banks have us somewhat cautious on equities. As we discussed in our Q4 2021 newsletter, valuations are finally becoming relevant and they have come under pressure given the upward move in interest rates. While the S&P/TSX now trades in line with its 15-year average valuation, the S&P 500 continues to trade at a premium (Figure 10).

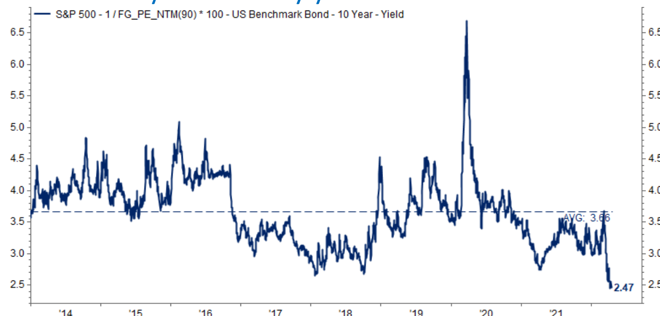
Figure 10: S&P 500 price/earnings (blue) and TSX P/E



Source: FactSet

The Fed Model, which can be used to compare the relative attractiveness of equities to bonds, confirms the expensiveness of the U.S. market. At 2.47% the relative value of U.S. equities versus U.S. bonds is at a 10-year low (Figure 11).

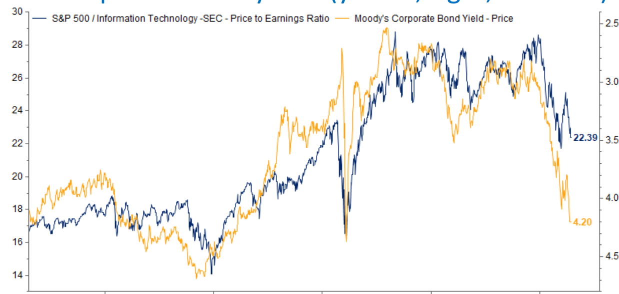
Figure 11: Fed Model – S&P 500 earnings yield minus the U.S. 10-year treasury yield



Source: FactSet

Technology stocks are some of the most sensitive to interest rate fluctuations (negative correlation). Our underweight positioning in this sector has significantly benefitted client portfolios this year. We are maintaining this posture and are concerned that higher interest rates will continue to weigh on the sector (Figure 12).

Figure 12: S&P 500 Info. Tech. sector P/E (blue, left) and corporate bond yields (yellow, right, inverted)



Source: FactSet

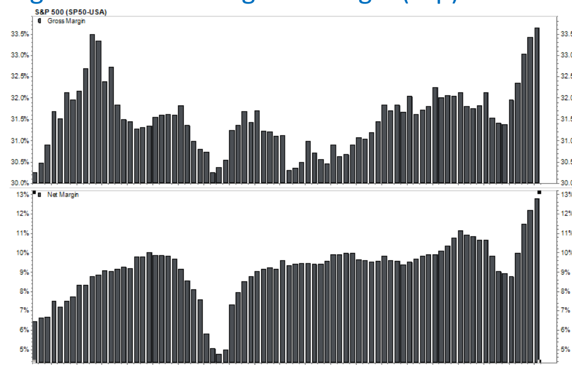
Valuations are certinaly not cheap, and from a top down perspective, it looks like there is a lot of optimism baked into estimates. Figure 13 highlights analyst forecasts for the S&P 500. Over the next three years, analysts are estimating growth rates above the 13-year average as well as margin expansion. These could be challenging targets if inflation continues raising the cost of labour and materials. What's more, margins are already at peak levels (Figure 14).

Figure 13: S&P 500 estimates versus 13yr average

S&P 500	Dec '22E	Dec '23E	Dec '24E	13 Yr Avg
Sales per Share	8.8%	5.2%	5.6%	4.3%
EPS	9.9%	10.0%	10.6%	9.8%
EBITDA Margin (%)	21.5%	21.9%	21.8%	19.3%
Net Margin (%)	13.2%	13.9%	14.5%	10.3%

Source: FactSet

Figure 14: S&P 500 gross margin (top) and net margin



Source: FactSet

For all the reasons above and others that we have not even mentioned (lockdowns in China, hyperinflation and food shortages in emerging markets, etc.) we continue to favour a defensive positioning in portfolios. That is not to say we are out of equities entirely but modestly underweight relative to our benchmark. Client portfolios remain well diversified across sectors, geographies and asset classes, with a bias towards 'value' oriented stocks trading at reasonable valuations and generating visible earnings growth.

Trading in the first quarter was busier than usual.

The war in Ukraine sparked a flight to safety that significantly benefitted gold stocks during the quarter. We exited **Newmont** at the end of February following a large rally in the share's price.

We sold our small position in **Pepsico** in early February after it reached historical valuation highs including a rare premium to Coca-Cola. We originally bought the stock in March 2020 at $105.27 at the height of the pandemic selloff and closed out our holdings at a price of $172.22 in early February while collecting a healthy dividend in between.

In addition, we trimmed large positions in higher valuation, growth-oriented holdings that had increased in size within many client accounts through upward share price movement including Google-parent **Alphabet**, as well as **Costco** and **Microsoft**. We still see all of these companies as market leaders with long-term structural competitive advantages but also recognize that they are more susceptible to share price contraction as interest rates move higher and felt it was prudent to pare from gains at this time. We also took some profits from **Suncor** after a strong move higher in the price of oil.

Fixed Income

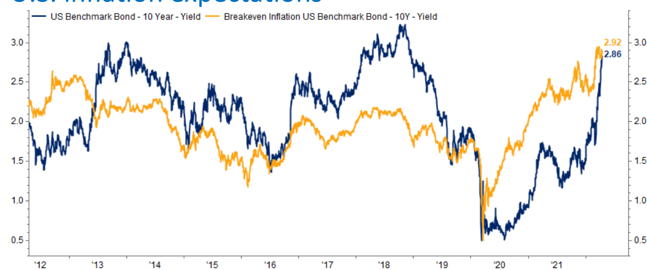
Bondholders suffered significantly during the first quarter with the Canadian Broad Bond Composite down 7%. Bond and equity correlations converged and bonds completely failed to provide portfolio ballast. This was all due to the rapid rise in yields (Figure 15).

Figure 15: 10yr treasuries – Canada (blue) and U.S.

Source: FactSet

Where do yields go from here? Directionally, one has to think that the answer is higher considering the massive central bank tightening that is about to take place. The Federal Reserve recently announced plans to prune its balance sheet by up to $95 billion a month. Less cash in the system = more competition for money = higher rates. Still, yields have moved up significantly and have caught up with inflation expectations (Figure 16). If inflation rolled over here bonds could arguably already be in attractive territory. The opposite would be true if inflation reaccelerated. Unfortunately the inflation picture is incredibly clouded at the moment, though barring another supply side shock (energy/food/consumer products), bonds may have just entered the ballpark of *starting* to offer decent compensation.

Figure 16: 10yr U.S. treasury yield (blue) and 10yr U.S. inflation expectations



Source: FactSet

We added to the fixed income component of portfolios and slightly reduced the asset classes significant underweight relative to the benchmark (31% of portfolios versus the benchmark weight of 40%). Some of the new additions included higher yielding GICs and short-term bonds, which we also used to replace a lower-yielding principal protected note.

Performance

Client balanced portfolios that were fully invested to model posted a slightly positive return on average after fees in the initial quarter of 2022, notably better than the -3.20% performance of the benchmark. The most significant contributor to the relative performance came from fixed income, where client returns greatly outdistanced the benchmark's -7.0%. Our bond position, consisting of a sizable underweight and short duration, was the key driver of positive relative performance as yields spiked higher. Returns from client-held preferred shares were negative during the period but outperformed bonds. Client holdings in preferred shares have been gradually reduced into strength over the past year with several large issues called and not replaced in portfolios. Average weights in preferred shares within client portfolios has dropped from 18% to 11% in the last year.

Canadian equity holdings in client portfolios easily outpaced the 3.8% total return from the S&P/TSX Index during the quarter. It was the third consecutive quarter where commodity-related stocks boosted relative performance with huge gains delivered from **Teck Resources** (+38.6%) and **Suncor Energy** (+28.6%). Pipelines also contributed with **TC Energy** (+19.8%) and **Enbridge** (+16.5%) seeing renewed investor interest. Only one Canadian holding in our balanced portfolio model had a negative return in the first quarter, **Emera** (-2.0%).

The contrast between our holdings in Canada and the United States illustrates the value of diversification. Our holdings in U.S. equities slightly underperformed the S&P 500 total return of -5.6% in Canadian dollars during the quarter. **Meta Platforms** (-34.7%), formerly Facebook, fell after earnings results where the company outlined higher costs to build its Metaverse and admitted that Apple's new privacy policies were hurting more than anticipated. Housing-related stocks swallowed the bitter pill of higher interest rates and **Home Depot** (-28.8%) and **Stanley Black & Decker** (-26.8%) sold off. Offsetting some of these pullbacks were **Newmont Goldcorp** (+11.9% until being sold), **Medtronic** (+5.4%) and **Coca-Cola** (+3.4%).

We held no international equities in our balanced model during the first quarter. This benefitted relative performance as equity markets in the region fell precipitously due to the war in Ukraine.

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- **Will & Estate consultation** – help you structure the succession of your estate in an efficient and tax effective manner
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