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Wealth Management
Dominion Securities

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Quarterly Update

There's been no shortage of headwinds for financial markets thus far in 2022. They include a war and humanitarian crisis in Ukraine, rising inflation, supply chain issues and rising interest rates, among others. To say that this year has been challenging thus far would be an understatement, as we are experiencing the worst start to the S&P 500 since 1939. That said, there are also several positive developments, which should help financial conditions moving forward. These include: easing COVID restrictions, growing corporate earnings and supply chain improvements. While there are still some looming risks that we have been watching for investors over the first half of this year, our base case is that we are not going into a recession at this point in time. However, the risk of one has now also increased, in our eyes.

What's next for inflation?

While the inflation rate should ease back from today's peak levels, it is likely to remain stubbornly high for the foreseeable future. We do expect further improvement through 2023, as the supply chain issues continue to resolve, the demand for services normalizes and the extreme tightness in labour market tightness eases. We expect that both the Federal Reserve and the market's urgency will diminish somewhat in the second half of the year.

By year's end, in addition to – what will hopefully be – an ebbing inflation rate, policymakers will likely be looking at much slower GDP growth, an entrenched slowdown in the goods-producing side of the economy and rapidly diminishing tailwinds on the services side. The pace of any tightening beyond that point is likely to slow. Beyond 2023, we look for inflation to continue to move closer to the Fed's 2% target – though after a decade of running stubbornly below that level, it may well linger modestly above target for an extended stretch.

While the pace of rate hikes was one focus of the Federal Reserve meeting in early May, the other was once again the idea of the "neutral" rate for the economy – or the point at which monetary policy is neither boosting growth nor restricting it. Federal Reserve Chair Jerome Powell noted that the true neutral rate can't be known in advance, and that it's an imprecise number; instead, he offered up a range of 2-3%, which is currently the range of all estimates from the Fed's longer-run rate forecasts. In fact, that range hasn't changed since June 2020, despite everything that has occurred in markets and the economy since then, suggesting policymakers have some level of confidence the neutral level does indeed fall somewhere within that range.

Continued on page 2

All the while, the bond market was caught by surprise in January, as it became clear that inflation was lingering and would require a more direct policy response. The bond market went from expecting very little in the way of rate hikes to expecting hikes at all Fed meetings this year. Bond yields rose in anticipation of these future rate hikes, and bond prices fell considerably. Compared to where they were when the first rate hike happened in March, U.S. 10-year yields have risen by more than 40%. That's in addition to a considerable climb in yields before the first rate hike occurred. From a yield perspective, while this year has been challenging, there is a silver lining here – it's possible the worst is behind us.

Looking forward

While it may not feel like it right now, rising rates don't necessarily mean uneasiness for equity markets. The key factor to whether a hiking cycle challenges stock prices over a sustained period of time comes down to whether the economy enters a recession or not. While that may sound like an obvious statement on the surface, it's important to understand that hikes themselves aren't inherently bad for equity markets. What the stock market is nervous about isn't what the specific central bank policy interest rate will be some months from now. It is already very confident rates will be higher than they are today. Rather, equity markets are watching with a nervous eye to see if the Fed can raise rates in a way that calms inflation without slowing the economy to the point of entering a recession.

The fear is that raising rates ultimately means that a recession will immediately follow. This just isn't the case, historically. There is usually a large gap between the start of the hiking cycle and the commencement of a recession. The main focus of our investment strategy going forward is analyzing if this is the beginning of a recession. If our base case remains intact and we do not believe we are entering a recession, this may present an interesting opportunity over the next 12 months. History shows us that when markets drawdowns of 20% occur without a recession, the average return for the next 12 months on the S&P 500 is 13.4% - and a positive outcome occurs 87% of the time. This also coincides with a very infrequent market drawdown, with the S&P 500 sometimes posting seven consecutive weekly losses. This has only happened seven times since 1935, with the worst being eight consecutive weeks. While this doesn't mean a rebound is imminent, on average, the forward three-, six- and 12-month returns are generally very positive, as seen in figure 1.

Figure 1 | Longest Weekly Losing Streaks in S&P 500 Index

Start Date	End Date	# Weeks	% Change	4 Weeks Later (%)	13 Weeks Later (%)	26 Weeks Later (%)	52 Weeks Later (%)
1/26/35	3/16/35	8	-10.7	10.3	24.8	43.2	77.9
7/24/47	9/11/47	7	-6.7	1.8	0.0	-6.5	5.1
2/17/51	3/31/51	7	-3.4	4.8	-2.1	8.7	13.0
3/25/70	5/22/70	8	-19.5	6.6	9.7	15.9	39.8
2/15/80	3/28/80	7	-12.8	4.5	15.2	25.5	33.7
1/26/01	3/23/01	8	-15.9	9.1	7.5	-15.3	0.8
4/1/22	5/20/22??	7??	-14.2??	N/A	N/A	N/A	N/A
Median			**-11.7**	**5.7**	**8.6**	**12.3**	**23.4**
All Periods Median			**N/A**	**0.9**	**2.2**	**4.0**	**7.3**
% Positive			**0.0**	**100.0**	**66.7**	**66.7**	**100.0**

2022 case not included in summary statistics. Source: S&P Dow Jones Indices.
Ned Davis Research T_SSF22_21.1

Source: RBC Wealth Management, Bloomberg; data through 12/31/21

What are we doing?

From a portfolio perspective, we are considering many variables to assist us in determining our desired asset allocation. One of the most important variables for us is inflation. We continue to believe that if inflation does not peak, most central banks will continue to raise rates higher than already forecasted, which will cause economic growth to slow. Based on the consumer price index (CPI) data that was released in mid-May, it appeared that inflation was moving lower but the reading from the June meeting saw inflation continued to run uncomfortably hot. This promoted the Federal Reserve to raise the Federal Funds rate up 0.75% - the largest rate hike since 1994. Our base case still remains intact, as we believe there is no imminent recession but we want to see more evidence of this before we tilt out asset allocation in either direction. With the heighted level of risk and volatility in the economy, we have already begun raising cash by selling one of our international mutual funds back in early April and we continue to remain cautious around adding to our equity allocation. We have also used this opportunity with rising yields in the bond market to add more to our fixed income and extend duration via individual bonds. Once we see a more clear direction on inflation and the economy, we will continue to shift our asset allocation accordingly.

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