The Porretta Group

Wealth Management
Dominion Securities

Winter 2022

Mark Porretta, CIM
Senior Portfolio Manager &
Wealth Advisor
mark.porretta@rbc.com
905-764-5258

Theresa Bruno
Associate Wealth Advisor
theresa.bruno@rbc.com
905-764-1345

Eric Hoey
Associate Investment Advisor
eric.hoey@rbc.com
905-764-5847

The Porretta Group of RBC Dominion Securities

260 East Beaver Creek Rd.
Suite 500
Richmond Hill, ON
L4B 3M3

www.markporretta.com

Quarterly Update

The global equity market began the year with a swift selloff, with the U.S. leading to the downside, as concerns around the potential for more aggressive tightening by global central banks, persistently high inflation readings, the impact of the Omicron variant and geopolitical threats all converged. Despite these headwinds, we think the economic expansion is intact. Neither our leading economic indicators nor credit markets are signaling that U.S. recession risks have risen, and 2022 S&P 500 consensus earnings estimates have not been impaired. This is the stage of the economic cycle when challenges usually arise, as economic and earnings growth transition from the ultra-strong initial expansion phase to something more normal. When the U.S. economy is devoid of major recession risks, global equity bull markets typically endure, although they often include bumpy periods and normal corrections. We expect equity markets to ultimately regain their composure, opening the way to additional new highs.

Sticker shock

Our near-term inflation outlook is for more of the same: uncomfortably high inflation rates for several months. We anticipate the situation will improve in the second half of the year. The rate of goods inflation seems set to recede as supply chains gradually get back in gear and COVID-19-related anomalies fade further. Even if U.S. inflation were to fall back from its current rate of 7.0% to a forecasted average of 4.0% in Q3 and 2.7% in Q4, it would still be advancing at an above-normal clip.

We think it will take some time for households and businesses to absorb the current inflation shock, not just in the U.S. but elsewhere, even if the year-over-year growth rate of inflation diminishes in the second half of 2022 and subsides further in 2023, as we expect. Looking further out, we acknowledge inflation could remain above the Federal Reserve's 2% target level for some time, possibly for a couple of years. Even after inflation rates start to recede, it could take a number of quarters for financial markets to become confident that elevated inflation is not going to be a long-term challenge. As this gets sorted out, more stock market volatility cannot be ruled out.

In search of a soft landing

In the middle of last year, Fed indications led the market to expect the first interest rate increase wouldn't arrive before

Continued on page 2

late 2022 or early 2023. Fast-forward through a series of shifts in Fed communications, and today we find the market pricing in approximately five and seven hikes this year and one next year, with the first expected in March. As we've mentioned in the past, the Fed doesn't tighten monetary policy with the intent of pushing the economy into recession. It always attempts to engineer a "soft landing" wherein the economy slows enough to reduce inflationary pressures or other excesses but avoids an outright downturn. These concerns typically flare around the beginning of every Fed tightening cycle, despite the fact that the U.S. equity market has historically performed very well in the 12 months preceding the first rate hike and has typically gone on to deliver positive gains in the 12 months following that initial increase.

Could the Fed spoil the party this time around? Yes, eventually. But before that could happen, monetary conditions would have to become much tighter; we think that would be a considerable distance down the road, and involve many more rate hikes than the Fed currently has planned for this year and next.

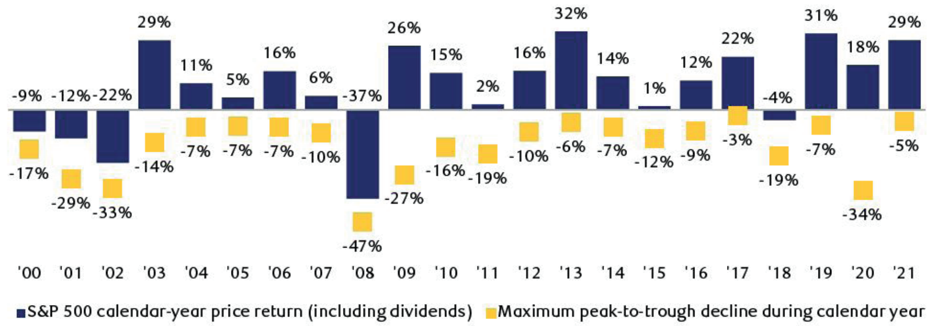
What are we doing?

While periods of negative performance can be challenging for some to go through, opportunistic investors will often see this as an investment opportunity. Taking a look below, the S&P 500 has pulled back 10% or more at some point in over half of the years since 2000. It's important to recognize that pullbacks and corrections are not uncommon even in good years: among the 13 years with above-average annual returns, 10 included periods where the market pulled back 7% or more. S&P 500 companies are not yet seeing inflation eat into their overall index profit margins, nor has it dented 2022 earnings estimates, which are some of our key considerations for the market. While the risks currently facing equity markets have the potential to generate further volatility or downside, we don't think the economic backdrop has deteriorated in such a way that investors should reposition broad asset class exposure in portfolios, as supported by our seven leading economic indicators flashing red (figure 2). This reiterates our thesis of remaining overweight in global equities, with the view that major developed equity markets have the potential to deliver worthwhile gains for the year ahead and probably beyond.

We are now seeing the move in fixed income come to fruition. Rates are starting to rise across the curve with markets now pricing in approximately five to seven rate hikes on both sides of the border. These forecasted rate hikes pushed yields up and prices down, resulting in the necessity (at least for the time being) to continue to be invested in high-quality and short-duration fixed income.

Figure 1 | Reality check: Pullbacks happen even in good years

S&P 500 total returns and pullbacks each year since 2000



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

Figure 2 | U.S. Recession scorecard

Indicator	Status: Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)	✓		
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index	✓		
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories	✓		
Fed funds rate vs. nominal GDP growth	✓		

Source: RBC Wealth Management; as of March 2, 2022

Wealth Management
Dominion Securities