RBC Dominion Securities Inc.

Wealth Management
Dominion Securities

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Same again please

KEY INSIGHTS

- North American equity markets close the year on a high note
- Omicron restrictions unlikely to derail economy
- Consumers and businesses on a solid footing and willing to spend
- Inflation and interest rates continue to dominate the business news cycle
- Markets should grind higher, but investors would be wise to temper expectations

While the two-year-old COVID-19 pandemic has left nasty scars on society, markets have not only survived, they've thrived. North American equity indices in particular posted stellar returns in 2021 without the gut wrenching volatility we have come to expect in previous years. (See *Figure 1*)

With such a great year in the rear view mirror, one naturally wonders what lies ahead. Will the party continue? Or will we wake up with a hangover in the morning?

We remain cautiously optimistic that the year ahead will deliver positive returns. That said, we would temper our expectations considerably versus last year. We do not anticipate a repeat performance. Instead we expect returns to normalize in the positive single digit range.

A return to volatility is likely and we anticipate a market correction in the coming months. Corrections are a healthy part of the market cycle. Since 1980, the S&P500 experienced average intra-year drops of 14%, while actual calendar year returns were positive more than 75% of the time. The largest drop in 2021 for the S&P500 was only 5% - a statistical outlier that is unlikely to occur two years in a row. (See *Figure 2*).

Figure 1 *S&P500,* Jan. 1st, 2020 – Dec. 31st, 2021 *(Source: FactSet)*

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Our well diversified and balanced portfolios typically perform well relative to equity indices in times of volatility. Predicting the timing of a correction is next to impossible; anticipating and preparing for the next one is not. The next correction always falls into the category of "when?" not "if?". Our methodical rebalancing process welcomes a correction as an opportunity to buy at lower prices.

The positive outlook above is based on the fact that there appears to be no sign of imminent recession. All seven leading indicators of a U.S. recession that we follow are pointing in a direction consistent with the current economic expansion having quite a bit further to run. (See *Figure 3*) Powerful tailwinds are driving the U.S. economy and most developed economies forward.

- Credit conditions remain accommodative. U.S. recessions have typically been triggered by the arrival of overly tight credit. When this occurs, higher interest rates discourage borrowing and banks become unwilling to lend. The opposite describes today's environment. Rates remain low enough to encourage borrowing, while banks everywhere are eager to lend to credit-worthy individuals, businesses, and projects.

- U.S. and Canadian households are sitting on excess savings built up over the pandemic of more than 10% of GDP. We expect some of this cash pile will get spent in the coming year and should keep the consumer spending engine powering ahead.

- Inventories of goods are unusually depleted and must be replenished for many businesses to meet current demand. Restocking should underpin industrial production and GDP growth through much of this year.

- Business capital spending has been strong in the U.S. driven by low interest rates, strong corporate profits, and the need for more capacity and more resilient supply chains.

Interest Rates

It seems a foregone conclusion that we will see central bankers begin to raise rates this year. Higher rates will surely steal some of the thunder from the abovementioned factors, but starting from zero it should take some time before they begin to bite into the economy.

Usually the fed funds rate has had to climb above the nominal growth rate of GDP (i.e. the growth rate before subtracting the effect of inflation) before a recession gets under way. The fed funds rate is currently close to zero.

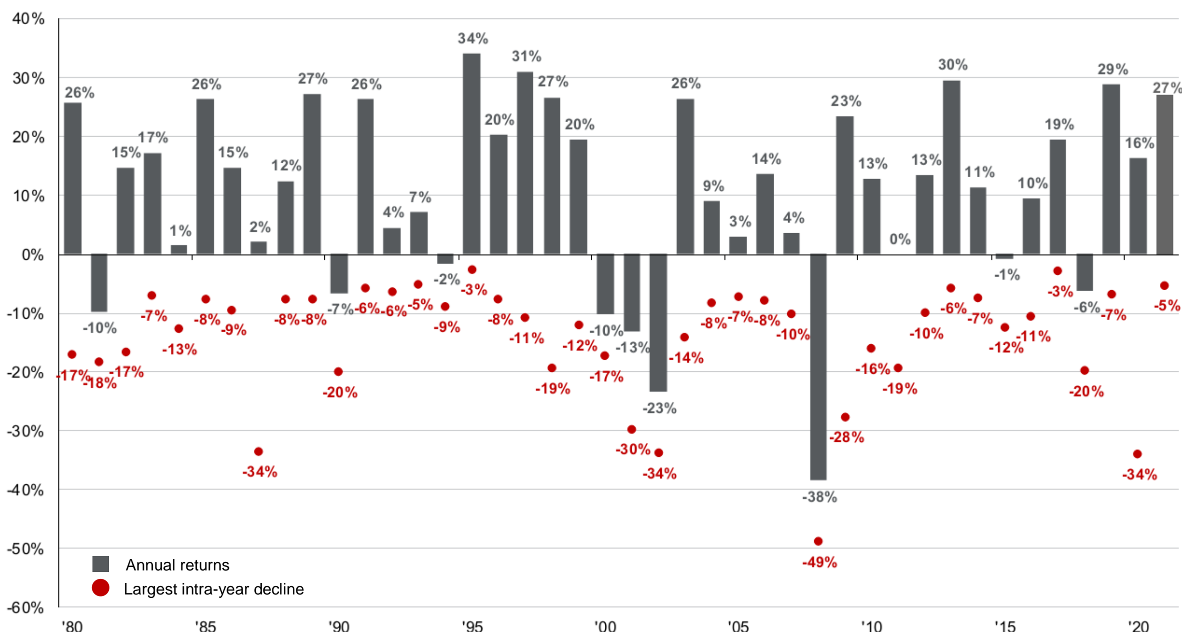

***Figure 2**: S&P500 intra-year declines vs. calendar year returns (Source: JPMorgan)*

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RBC US Recession Scorecard

The Recession Scorecard, published by RBC's Portfolio Advisory Group, has become a key resource in shaping our economic and market outlook. Those who regularly read these newsletters (and there are a few!) will recognise the scorecard as a recurring theme. Attached to this newsletter is a recent report, *U.S. recession scorecard update*. In it you will find an explanation and further detail on each indicator, including a newly added one.

Full Report

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	✓		

Figure 3: *US recession scorecard (Source: RBC Wealth Management)*

Assuming the Fed raises rates three times this year and then raises by 0.25% at each meeting thereafter (far faster than the market currently expects) that would leave the rate at 2.75% by the end of 2023. This is still well short of the nominal GDP run rate, which RBC expects by then to have slowed to 4%-5%.

In other words, we seem to be a long way from the kind of interest rate environment that would tip the economy into recession.

Also of note on interest rates is that one must treat foregone conclusions with some degree of skepticism. We, like most others, believe that rates will move higher, but when everyone is of the same opinion it's usually worth considering other outcomes. Consensus thinking and markets do not have a wonderful track record together. Our portfolios hold investments that will do well in a rising rate environment, but we also have positions that welcome stable or even lower rates.

Inflation

After COVID, inflation surely takes second prize for most discussed topic of 2021. RBC's Portfolio Advisory Group expects inflation to ebb in the second half of 2022 and recede further in 2023 under the influence of:

- *A resolution of factors that have artificially produced shortages*
- *A return of more people to the labour force as benefit programs end and personal safety issues fade*
- *A capital spending boom already under way yields productivity gains that somewhat offset higher employment costs.*

If this proves to be the case and inflation pressures ease, central bankers may be able to end rate hikes before money becomes too tight and tips us into recession. A central banker's dream is to engineer a soft landing; a feat they manage to pull off about 50% of the time. Only time will tell how this cycle ends, but either way it would appear that the outcome won't be known until 2023 and beyond. For 2022, we continue to give equities the benefit of the doubt.

Other Threats

There are always plenty of reasons to stay out of the market. Beyond inflation there are concerns about Omicron, Chinese property defaults, supply chain issues, equity valuations and an over-concentration of mega cap companies in the major indices.

Jim Allworth, our Chief Strategist responds to these potential threats and puts things in perspective:

> *Such potential threats regularly come on and off the stage and it's always worth considering what they might mean for the economy and financial markets. But structuring a portfolio as if one or more were likely to occur soon would have left a portfolio uninvested, or at least under-invested, for most of the past 15 years if not longer.*
>
> *In our view, an investment portfolio diversified across asset classes – where the equity component is diversified sensibly across industry sectors and owns the best, most*

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resilient businesses in each sector – is the most appropriate stance in a world of unpredictable possibilities.

We feel confident that our portfolios meet these criteria. We look forward to the year ahead with cautious optimism for the markets and confidence in our portfolios and investment process.

Thank you,

Ronan & Scott

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TFSA & RRSP Contributions

Tax-Free Savings Account (TFSA)

Consider making a contribution to your TFSA early in the 2022 calendar year to maximize the tax-free growth in your plan. The TFSA contribution limit for 2022 is $6,000. If you've been eligible for a TFSA since 2009 and have not yet contributed to one, your contribution limit would be $81,500 as of January 1, 2022. This TFSA guide is a great refresher and a handy reference.

2022 RRSP Contribution Deadline

The deadline for you to make a contribution to your RRSP that can be claimed as a 2022 tax deduction falls on March 1, 2022. If you have not done so, please let us know if you would like us to arrange for your TFSA or RSP contribution to be made.

We are often asked whether clients should prioritize contributing to their RSP or TFSA, or perhaps pay down debt. This report attempts to answer this question.

	Q4	YTD
Indices		
S&P/TSX	5.74%	21.74%
Dow Jones	7.37%	18.73%
S&P 500	10.65%	26.89%
Nasdaq	8.28%	21.39%
Euro Stoxx	6.18%	20.99%
Japan Nikkei	-6.82%	16.01%
India Sensex	-1.48%	21.99%
VIX (Volatility)	-25.58%	-24.31%
Commodities		
Gold	4.11%	-3.64%
Silver	5.13%	-11.72%
Copper	8.90%	25.70%
Oil	2.61%	58.68%
Natural Gas	-34.05%	53.14%
Currency		
CAD	0.34%	0.75%
EUR	-1.81%	-6.93%
JPY	-3.34%	-10.25%
AUD	0.50%	-5.60%
GBP	0.43%	-1.01%

Values as of Dec 31st, 2021

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