RBC Dominion Securities Inc.

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Yesterday, all my troubles seemed so far away

KEY INSIGHTS

- Russia / Ukraine war drive commodities higher, fueling inflation
- Central banks begin the rate tightening cycle, interest rates rise
- Mixed markets punish high value tech, reward commodities producers
- Western economies awaken from COVID winter as China locks down
- Economic growth remain strong as spending shifts from goods to services

Looking back at the first quarter, it is fair to say that we live in interesting times. While we would surely prefer a more mundane world right now, that is clearly not the case and we must pragmatically face the facts.

So much has happened since the beginning of the year that it's hard to know where to start. A new wave of COVID, interest rate increases, skyrocketing energy prices and inflation (See *Figure 1*), weakness in US and European markets, and of course the tragic conflict in Ukraine.

Many major markets experienced a correction in the first quarter, defined by a drop of more than 10% from recent highs. The tech heavy NASDAQ fell by more than 20% at one point, while energy exposure helped the TSX to post modest gains. (See *Figure 2*)

Our managed portfolios fared well versus US markets while lagging the TSX slightly due to a lack of energy exposure. Following above average returns last year and in light of current events we are pleased with our Q1 result.

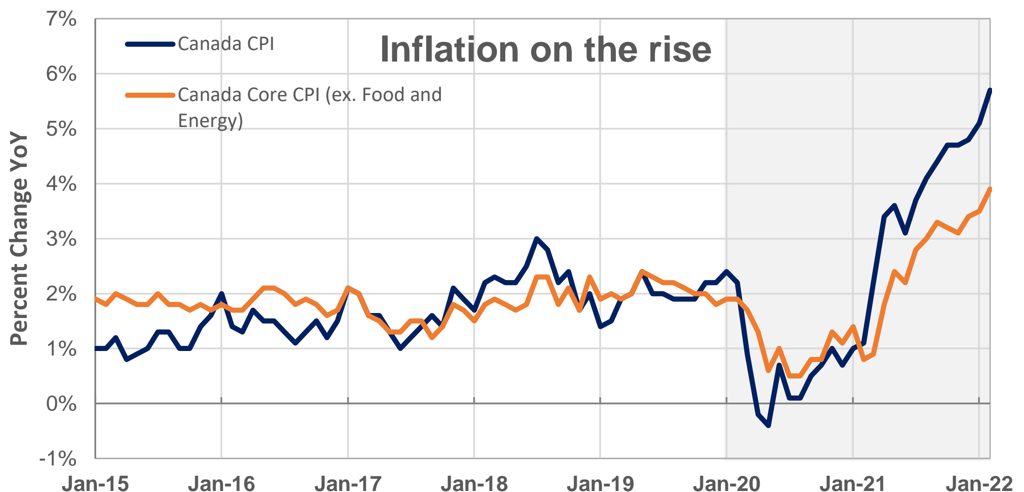

Figure 1: *Canadian CPI, year over year. Jan 2015 – Feb 2022 (Source: Bank of Canada)*

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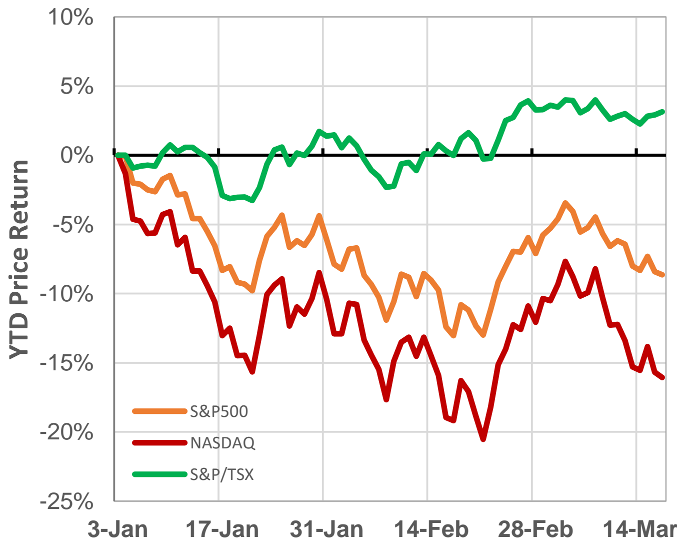

***Figure 2**: S&P/TSX, S&P500 and NASDAQ Composite price returns, Jan 1st – Apr 17th, 2022 (Source: FactSet)*

The issues mentioned above have a clear negative bias. That said, it is important to acknowledge that there are also a number of positive factors playing out at the moment. The global economy continues to grow at an above average rate, COVID restrictions are lifting in the western world, businesses are actively spending to replenish inventories and investing in efficiencies, household finances are robust and supply chain issues are beginning to fade. Additionally, credit remains plentiful and cheap despite the fact that rates have begun to rise. (See *Figure 3*)

For many years we have closely followed Chief Strategist, Jim Allworth's advice to "*give equities the benefit of the doubt*" as long as there is no recession on the horizon. The events of the past few months certainly suggest an increased risk of recession, but has it increased enough to cause us to alter our stance?

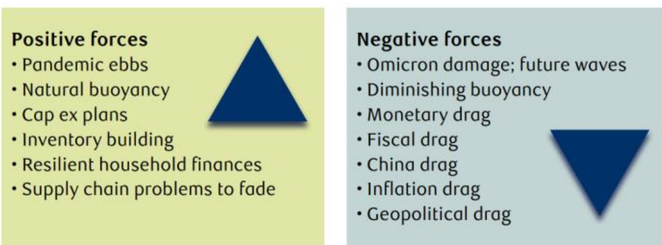

***Figure 3**: Key economic forces for 2022 (Source: RBC GAM)*

To answer this question we must look past the headlines and water cooler conversations. Anecdotes make for great cocktail party conversation but should not inform our long term investment strategy or decision making process.

Recessions typically happen when money becomes "tight". Tight money means that borrowing has become prohibitively expensive and that lenders have become choosier about advancing credit to borrowers. Currently, interest rates are still low enough to encourage borrowing and banks are more than happy to approve loans.

Conditions have tightened somewhat since the beginning of the year as interest rates have increased, driven by the Bank of Canada and The Fed (See *Figure 4*). Central banks raise rates to control inflation and temper an economy that is running a little too hot for its own good. Their goal is to slow the economy down just enough and bring inflation under control, but not to tip economic growth into negative territory.

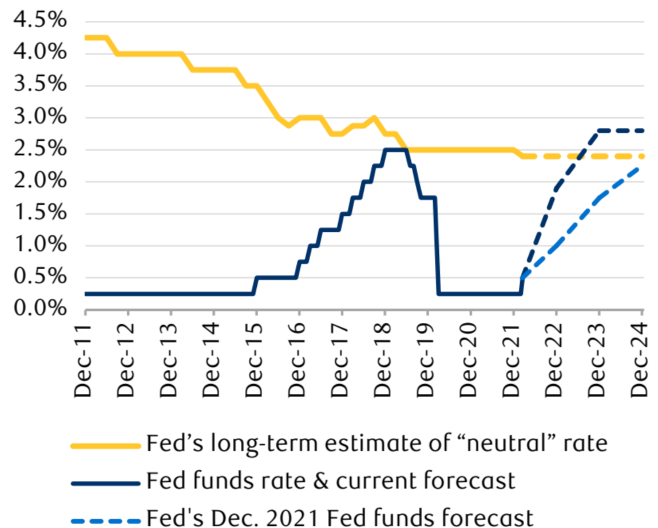

***Figure 4**: US Fed funds rate and forecast (Source: Federal Reserve, Bloomberg, RBC Wealth Management)*

This Goldilocks scenario is what central bankers call a "soft landing". The Fed does not tighten monetary policy with the intent of pushing the economy into recession. Historically, the results have been mixed: of the 17 Fed tightening cycles since 1953, eight ended in recession, while nine succeeded in producing no recession.

There is never a rate hike cycle where investors do not worry and debate whether the Fed will be able to engineer

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a soft landing—this is par for the course. These concerns typically flare at the beginning of every tightening cycle, despite the fact that equity markets have historically performed very well in the 12 months preceding the first rate hike and have typically gone on to deliver gains in the 12 months following the initial increase. (See *Figure 5*)

Could the Fed spoil the party this time around? Yes, eventually. But before that happens, monetary conditions will have to become much tighter. This is likely a considerable distance down the road and will involve many more rate hikes.

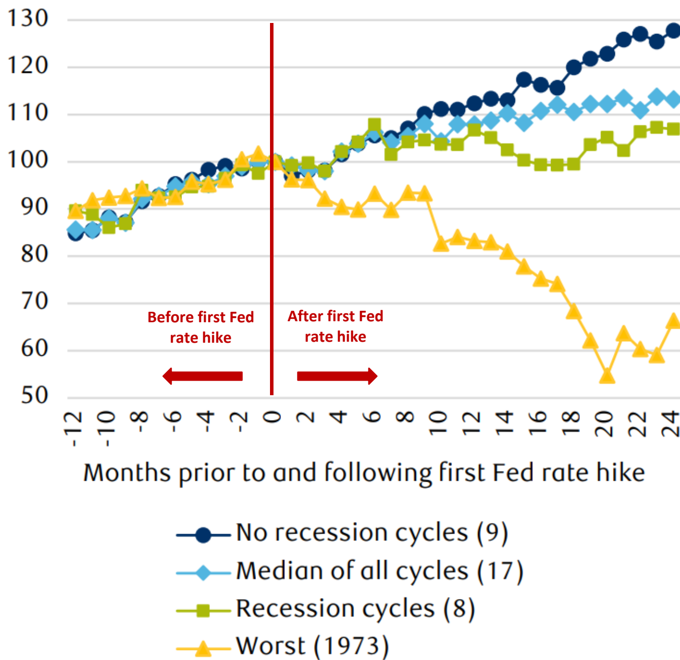

Figure 5*: Median S&P500 level before and after first rate hike, 1954 - 2018 (Source: RBC, Bloomberg)*

That a recession will happen is a certainty. The economy is cyclical and there is always a recession at the end of the cycle. The question is not if, but when? The latest update to the closely watched recession scorecard acknowledges the increased risks but ultimately finds in favour of continued economic growth. (See *Figure 6*)

The attached report *A fresh look at the U.S. recession scorecard*, digs deeper and examines the key indicators that have helped predict recessions in the past.

We remain at or very close to the asset allocation targets as defined in your Investment Policy Statement (IPS). Please discuss your allocation targets with us if there have been any significant changes to your current financial profile or your future plans. It is essential to regularly examine the appropriateness of your IPS.

Interest Rates

As discussed above, interest have marched higher in 2022. In the short run, higher rates have a negative effect on the price of bonds as older, lower yielding bonds become less attractive compared to newer bonds with higher yields. For this reason we have kept our bond portfolio quite short in duration. This will allow us to buy higher yielding bonds over the short to medium term. Being locked into a low yielding 20 or 30 year bond right now would be quite painful.

While the transition to higher rates can pose a challenge, it shouldn't be long before we are rolling into new bonds with attractive interest rates. This is not something that has occurred for many years as we have experienced a prolonged period of ultra-low rates.

RBC US Recession Scorecard

Seeing this, you may feel like you're having déjà vu. We have regularly referenced the Recession Scorecard in the past. With recession risks increasing we are watching more closely than ever. For now, the scorecard gives a passing grade, but watch this space for updates as the data evolve.

[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 6: *US recession scorecard (Source: RBC Wealth Management)*

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Our conservative investment style sees us incorporate bonds into almost all client portfolios. After a long drought, this part of the market looks set to pull its weight from a performance perspective.

Also of note is that higher rates are beneficial to "rate reset" preferred shares. On each five year anniversary the dividend resets using a calculation that includes the Government of Canada 5 year yield. We have exposure to these preferred shares in our portfolios and these too will represent a growing source of dividend income, assuming rates continue to increase.

Inflation

Inflation is extraordinarily high at the moment and is more likely to rise than fall over the next few months as the fallout from the Russian-Ukrainian conflict gets reflected. Inflation figures have not just risen, but have exceeded expectations. The two most important inflation drivers have been surging commodity prices and supply-chain problems. While supply-chain problems seem to be loosening up, commodity prices will likely remain stubbornly high for the time being. (See *Figure 7)*

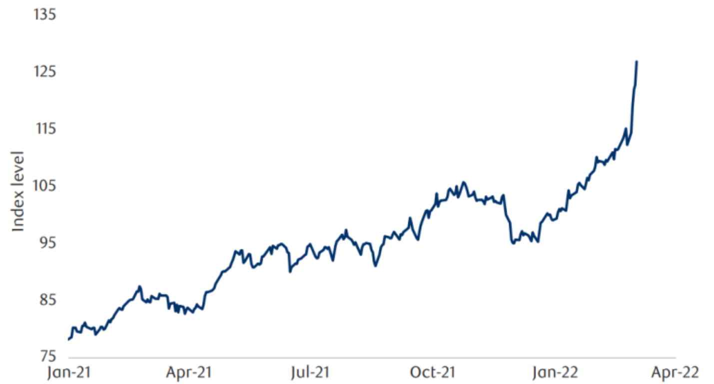

Figure 7*: Bloomberg commodity price index (Source: RBC GAM, Bloomberg)*

Looking beyond the short term, inflation should temper in the medium term as higher interest rates have the desired effect and supply-chain issues improve. A resolution in the Russia-Ukraine conflict would obviously be positive in this regard (and others!). In the long run, RBC estimates that inflation will normalize and possibly even dip below long term averages. This is due to an ageing population and slowing population growth in addition to other factors. (See *Figure 8*)

Higher inflation for a prolonged period has a detrimental effect on future purchasing power. Now, more than ever, it

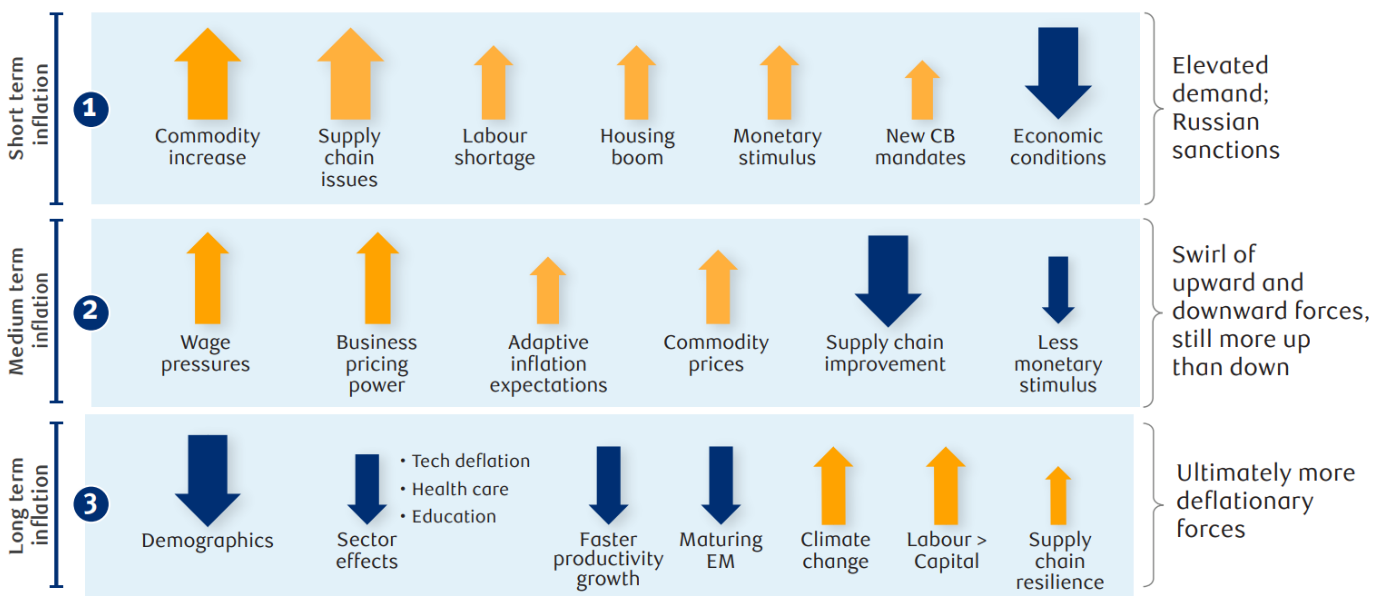

Figure 8*: Short, medium and long term factors affecting inflation (Source: RBC GAM)*

Quarterly Review

Q1 2022

is important to have an updated financial plan. Please speak with us to review your financial plan. This is advisable at any time, but particularly now in light of the current environment.

Wishing you and yours the very best for Spring and all the wonderful things it brings,

Thank you,

Scott Sandler
Senior Portfolio Manager

Ronan Clohissey, CIM
Senior Portfolio Manager

2022 Federal Budget

The recent federal budget did not contain any major changes for individual investors. There were some interesting proposals in the housing and healthcare arenas however. This report details the budget's key proposals and how they may affect you.

Areas covered include:

- Housing measures
- Personal measures and tax changes
- Business tax changes
- Environmental business tax changes
- Changes for charities
- International tax measures

The full report can be found here.

	Q1	TTM
Indices		
S&P/TSX	3.14%	17.06%
Dow Jones	-4.57%	5.14%
S&P 500	-4.95%	14.03%
Nasdaq	-9.10%	7.35%
Euro Stoxx	-9.21%	-0.43%
Japan Nikkei	-3.37%	-4.65%
India Sensex	0.54%	18.30%
VIX (Volatility)	19.40%	5.98%
Commodities		
Gold	5.92%	13.45%
Silver	6.37%	1.54%
Copper	6.44%	17.98%
Oil	30.25%	69.51%
Natural Gas	50.71%	120.39%
Currency		
CAD	1.05%	0.43%
EUR	-2.66%	-5.65%
JPY	-5.41%	-9.02%
AUD	3.02%	-1.53%
GBP	-2.91%	-4.68%

Values as of Mar 31st, 2022

Wealth Management
Dominion Securities

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GLOBAL
Equity

A fresh look at the U.S. recession scorecard

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Equity investors are contending with a confluence of several economically significant developments: war in Ukraine, surging energy and commodity prices, worrying inflation data, central banks intent on tightening, and bond yields rapidly climbing above pre-pandemic levels. All these, and more, have raised concerns about the potential for broad economic weakness down the road. Those concerns have already produced a pullback in equities, and although markets appear to have regained their footing for now, more events of this kind cannot be ruled out as the year progresses. With the exception of the Ukraine tragedy, these crosscurrents seem to us part and parcel of a global economy transitioning from the high growth rates that usually accompany the first year or so of recovery from recession to the less-dynamic "middle innings" of an economic expansion. In that phase, we would expect GDP growth to remain positive (although Europe looks to be headed for some challenging quarters) while corporate earnings and share prices are likely to advance further.

Equity views

Region	Previous	Current
Global	+	+
United States	+	+
Canada	=	=
Continental Europe	+	=
United Kingdom	=	=
Asia (ex Japan)	=	=
Japan	=	=

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

So long as the U.S. economy can avoid recession, we believe global investors should remain committed to equities. Our U.S. recession scorecard continues to give the economy a green light, although some of our seven indicators are now "less green" than others. Below, we outline the arithmetic of each with an assessment of how vulnerable each might be to turning negative.

U.S. recession scorecard

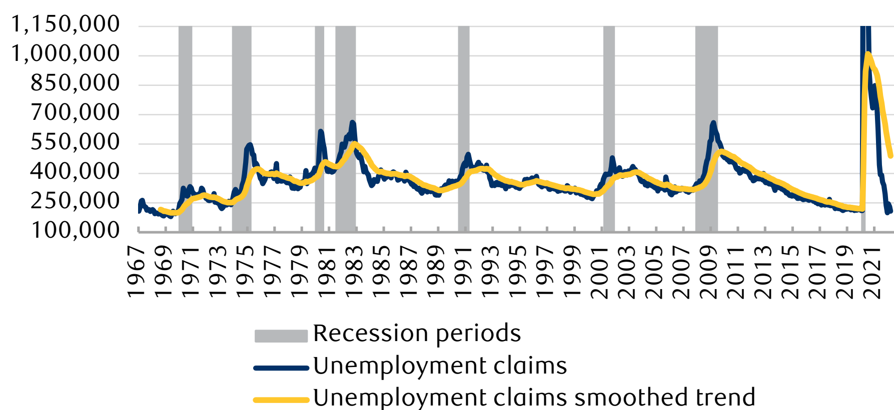
Indicator	Status: Expansionary	Status: Neutral	Status: Recessionary
Yield curve (10-year to 1-year Treasuries)	✓		
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index	✓		
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories	✓		
Fed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

Source - RBC Wealth Management

GLOBAL EQUITY

Strong labor market

U.S. unemployment insurance claims



Note: Shaded areas indicate recessions

Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 3/1/22

Unemployment rate and unemployment benefit claims

These two indicators should be looked at together. The smoothed trend of the unemployment rate has usually turned upward at the start of a recession, or immediately before. It is an unusually timely indicator, as it is reported within a week after the end of each month. Although it gives very little in the way of early warning, its signals have always been visible right at the start of the economic downturn rather than months into it. This is especially useful because the start date of a recession is usually only announced definitively by the National Bureau of Economic Research about a year down the road.

The smoothed trend of the monthly average of unemployment claims has typically turned higher two to six months ahead of the unemployment rate's upward turn, giving fair warning of an approaching recession some months in advance. It has produced occasional false signals, but none of those were subsequently confirmed by the unemployment rate. It is available very close to the end of each month.

Both the unemployment rate and the number of claims would have to double from current levels over the next several months to turn their trends higher. Both are at or close to multi-decade lows, but could go even lower, in our view.

With businesses of all sizes in virtually every sector concerned by labour shortages, and with 11.3 million jobs on offer versus 6.3 million persons unemployed, we think most employers would be reluctant to lay anyone off in the near term. Even if the economy were to slow from here, we believe most businesses would go on hiring if they could find qualified applicants.

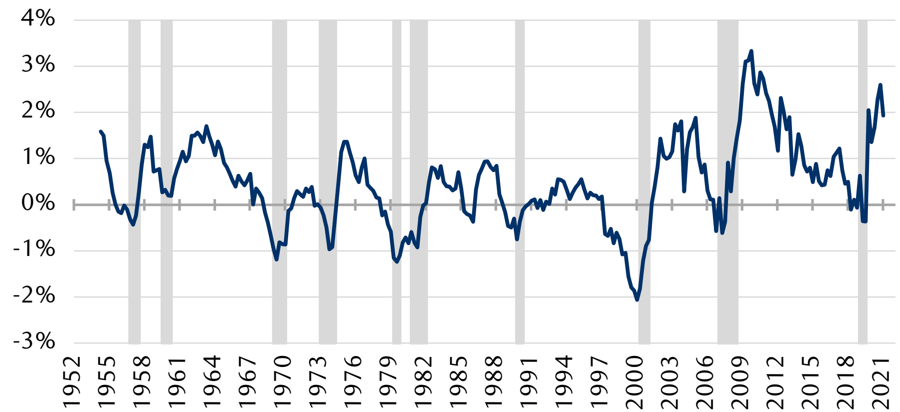
Free cash flow of non-financial corporate businesses

This indicator measures the cash generated by non-financial corporate businesses as a percentage of GDP. It is derived from the Federal Reserve's quarterly Financial Accounts of the United States, and has given only one false positive signal in more than 65 years. In all other cases when this indicator has fallen below zero, a recession has followed—typically, two to three quarters later. More particularly, shrinking corporate cash flows have most often signaled an upcoming period of weaker capital spending, a highly cyclical component of GDP. Today, this indicator looks to be in no danger of signaling an approaching recession any time soon.

GLOBAL EQUITY

Robust corporate health

U.S. nonfinancial corporate sector: Free cash flow as % of GDP (including foreign earnings retained abroad)



Note: Shaded areas indicate recessions

Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 10/31/21

Conference Board Leading Economic Index (LEI)

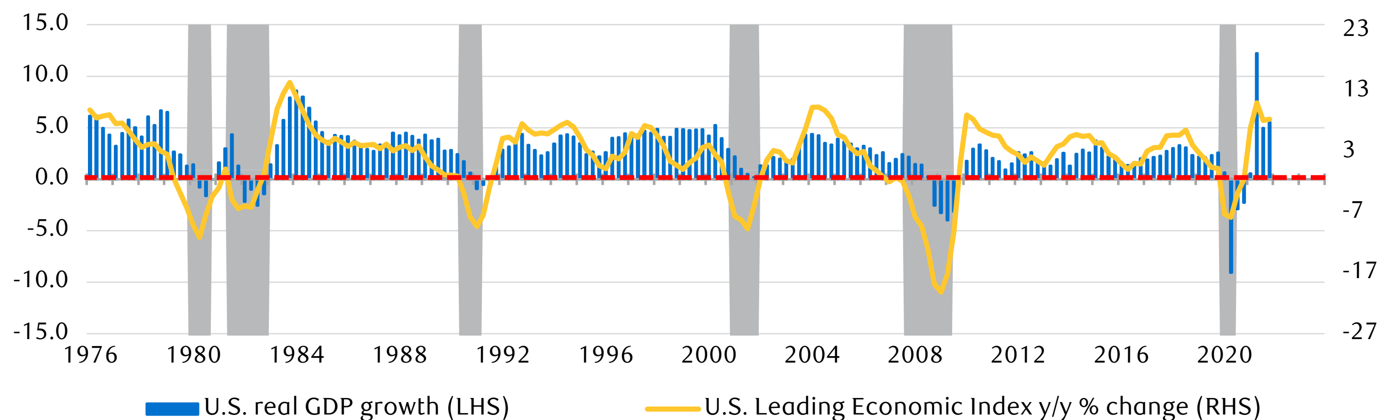
This indicator signals a recession is on the way when it falls below where it was a year ago. It has always done so at least three months before the start of a recession (the pandemic downturn being the only exception), often six months before, and occasionally earlier. The LEI may have peaked for this economic cycle in Q2 of last year, but it remains a long way above where it was a year ago. Arithmetically, we don't think this indicator could turn negative on a 12-month basis until at least late Q2 of this year, or more likely Q3—and then only if the economy were to deteriorate swiftly in the intervening months. It is one of the strongest of the recession indicators we follow, and we think it is a long way from giving a negative signal.

The yield curve

This very reliable indicator laboured in obscurity for decades, but is now followed minute-by-minute by a financial press that apparently needs something to obsess about 24/7. A yield curve inversion—that is, short-term interest rates higher than long-term rates—has preceded the start of every recession for the past 75 years,

More growth ahead

Conference Board Leading Economic Index for the U.S.



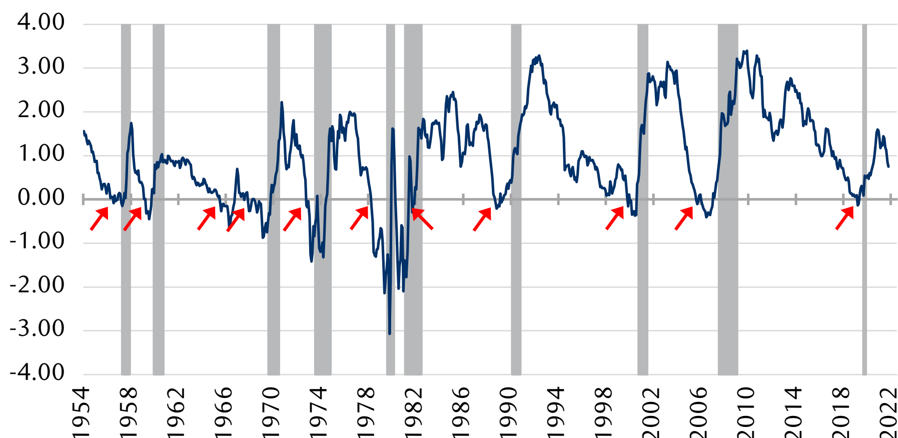
Note: Shaded areas indicate recessions

Source - The Conference Board, U.S. Department of Commerce, RBC Wealth Management; data through Q4 2021

GLOBAL EQUITY

Consistent with sustained growth

Yield differential between the U.S. 10-year Treasury Note and the 1-year Note



Note: Shaded areas indicate recessions and arrows indicate where yield curve inverts

Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 3/1/22

with an average lead time of roughly 11 months.

Bond trading desks typically focus on the relationship between 2-year and 10-year Treasury yields. The Fed, when it comments on this topic, typically refers to the 90-day T-Bill yield versus the 10-year. We use the 1-year Treasury yield, a quieter maturity on the curve, as our short-term component.

Yield curve inversions have occasionally occurred after stock market peaks, but never more than a month or two later, and well before the associated bear markets reached the stage of serious declines. On average, the 1-year/10-year Treasury yield curve has inverted about six months prior to the peak of the stock market.

Today, the 10-year Treasury yield is still roughly 75 basis points higher than the 1-year yield. Inversion, were it to occur, would flip this indicator to red—but as things stand, we think that possibility is a long way off. A narrowing to something under 30 basis points would induce us to shift to a more cautionary yellow (neutral) rating.

The federal funds rate versus the nominal GDP growth rate

Since 1954, the federal funds rate has typically moved above the nominal (i.e., not adjusted for inflation) year-over-year growth rate of GDP prior to the onset of a recession. There have been two exceptions: in 1957 and 2020, the funds rate crossed that threshold one month after the recession began. It is not an ideal timing tool, as there have been several false positive signals, but with the exception of the two “close calls” noted, a fed funds rate in excess of nominal GDP growth has been a precondition of all U.S. recessions.

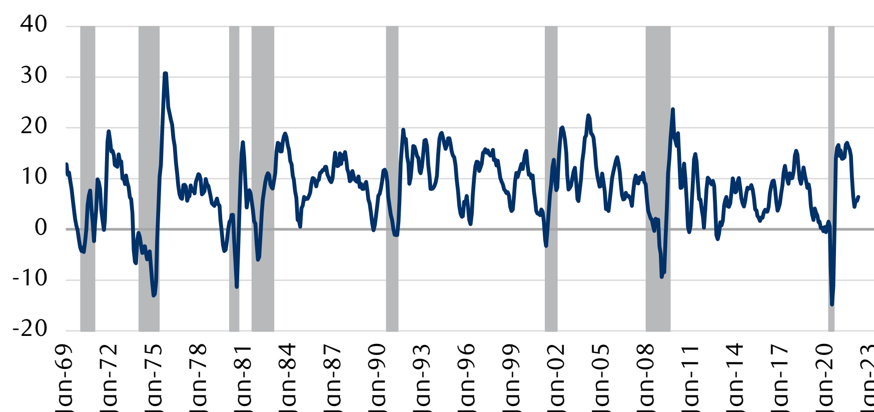
At the end of 2021, the nominal GDP growth rate stood at 10.6%, more than 10 percentage points above the 0.08% fed funds rate. We expect the year-over-year nominal GDP run rate will slow to between 7% and 8% by the end of this year, and decrease further to between 4% and 5% by late 2023.

The Federal Reserve hiked the funds rate by 25 basis points at its March meeting. The market is now pricing in a pair of 50 basis point hikes in April and June, followed by four more quarter-point increases this year and another four next year. That would put the funds rate at 2.25% by the end of 2022, and 3.25% at the end of

GLOBAL EQUITY

Support waning

ISM Manufacturing New Orders minus Inventories



Note: Shaded areas indicate recessions

Source - RBC Wealth Management; Institute for Supply Management; data through 1/4/22

2023—still well short of the projected GDP run rate, by our reckoning.

(Keep in mind that the market's forecasts of Fed rate setting are usually wrong, often spectacularly so. For example, through much of last year the market expected no Fed rate hikes in 2022, with perhaps one sneaking in by year's end.)

The Fed's own "dot plot" projection (which has a similarly uneven record of predicting rate changes) is somewhat more subdued, with the funds rate hitting 2% by the end of this year and 2.75% next year.

Getting the funds rate above our projections for nominal GDP growth within the next 12 months would require GDP to grow far more slowly than we expect, or the fed funds rate to rise much more quickly. Either would be a tall order, in our view.

ISM New Orders minus Inventories

Two components of the ISM Manufacturing Index, taken together, have a helpful track record of signaling recessions as they begin or shortly before. The difference between the New Orders component and the Inventories component has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives, signaling that a recession was imminent when none subsequently arrived. Moreover, this indicator only relates to activity in the manufacturing sector (some 15% of the U.S. economy) and is derived from a survey rather than hard data. Therefore, we view this as a corroborative indicator—one to pay attention to if other, longer-term indicators are implying a recession is on the way. The spread between New Orders and Inventories has narrowed from its post-pandemic peak of a few months ago, but remains well above zero.

Stay committed to equities

We recommend global portfolios remain moderately Overweight equities. However, we recently reduced our recommended exposure to Europe to Market Weight from Overweight, acknowledging that the dislocations of the Ukraine war can be expected to take a toll on the EU economy.

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