RBC Dominion Securities Inc.

Wealth for Life

Wealth Management
Dominion Securities

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The New Year started with anxiety over escalating COVID-19 cases, which retreated in January,[1] offering optimism for easing COVID-19 concerns.

Financial markets soon focused on surging inflation and uncertainties over rising interest rates. Although job growth remained strong in the quarter and unemployment rates declined to levels comparable to pre-pandemic times, inflation (as per the Consumer Price Index) in both Canada and the U.S. hit levels dating back to 1990 and 1982, respectively.

The first quarter of 2022 was characterized by surging commodity prices.

The prospect of economic reopening propelled energy, metals and agriculture pricing higher with concerns about supply availability. Later in the quarter, the tragic Ukraine conflict and ensuing Russian sanctions introduced further commodity supply uncertainties, supporting elevated commodity prices.

On the strength of surging commodity prices, the TSX delivered a 3.8% return for the quarter, outperforming global equities of developed economies. Energy and materials accounted for 186% of the TSX return, highlighting the TSX concentration in the resource sector. After a modest recovery from a mid-year correction, the S&P 500, by comparison, suffered a 4.6% loss (5.6% in Canadian dollars) in Q1, with only energy and utilities producing positive returns.

[1] Source

With inflation taking centre stage in financial markets, interest rates surged.

Not only did the 10-year bond yield (benchmark interest rate) rise from 1.5% to 2.5%, all rates for 2-, 5- and 30-year bonds moved up precipitously. The result was calamitous for the bond market (bond prices decline when interest rates increase). The average bond return for Q1 was -9%, the worst bond performance in decades. Consumers witnessed mortgage rates climbing by 50% or more, to levels dating back to 2016-2018. It is noteworthy that the Bank of Canada (BOC) and U.S. Federal Reserve (the Fed) have only raised short rates by 0.25% and have managed to get all interest rates along the curve (1-, 3-, 5-, 10- and 30-year rates) to increase significantly by just talking. One could argue, –why raise interest rates when the market has already done the heavy lifting?

When inflation is considered, central banks are concerned that "real interest rates" are negative and need to return to a more "normal" level.

Negative real interest rates are seen as artificial stimulus for economies that are functioning at above average growth rates and driving an inflationary spiral. The collective wisdom of central banks considers that now is an ideal time to wean global economies off the sugar-high of artificially low interest rates and put inflation back in the bottle.

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Volatility in financial markets reflects the indigestion in equity markets caused by the uncertainty of just how high central banks must drive interest rates to bring down inflation.

Inflation concerns took on a frenzied tone as U.S. analysts tried to outdo one another with ever increasing estimates of future interest rate increases by the Fed.

Clearly, not even the Fed knows how many times it will need to increase rates to deal with inflation at this stage. As interest rates are increased, economic data will provide information to assess the direction of future inflation. Some think inflation is peaking, and signs of easing supply bottlenecks are beginning to surface. For example, it's been observed that trucking rates have declined by more than 20% in the last four weeks and Institute for Supply Management (ISM) new manufacturing orders declined from 61.7 in February to 53.8 in March. Throughout history, it's also been known that nothing cures high commodity prices like "high commodity" prices. If we look at the price of gasoline, just imagine how much less driving will be done with gas at $6-$8/gallon compared with $3/gallon. In a similar analogy, when fertilizer prices get too high, farmers look to substitute crops that need less fertilizer. With groceries up 7.4% in March – the highest since 2009 – consumers will start looking for substitute items that are less expensive, if they haven't already.

As the prospect for higher interest rates sets in, expectation of a future recession has occupied the direction and tenor of equity markets.

So far, the economy remains well founded: consumer savings and net worth are strong and supportive of consumer spending; even at current levels, interest rates are at historically low levels; job growth and wages are supportive of future consumer spending; corporate earnings are strong; China is targeting lower interest rates to stimulate its economy; and the leading economic indicator is encouraging. So, the real question is, are the Fed and BOC going to raise interest rates enough to undermine future consumer spending and corporate earnings?

Central banks are not in the business of driving economies into recessions.

But, then again, their success at orchestrating a soft landing for the economy is spotty. Central banks are not alone, however. High gas prices – a tax on most consumers -– have already started taking a chunk out of consumer spending and will continue to do so. The surging cost of groceries and housing is also affecting consumers at all income levels. The future is clearly unknown, but there seems to be multiple levers at work already targeting inflation. From 2016 through 2018, the Fed had the occasion to tighten interest rates too much and witnessed the repercussions in a 2019 setback. The Fed is intimately aware that economic data is backward looking, and their actions have a profound future impact, so judging by commentary from the Fed chair, Jerome Powell, the Fed is expected to be measured in its efforts to rein in inflation.

Equity market valuations have declined meaningfully in the first quarter.

Some of the decline is related to over-valuation in relatively new companies with no earnings, or the prospect thereof in the foreseeable future. Other equities have suffered based on expectations for a recession and/or the prospect of aggressive interest rate increases. It's obvious that nobody knows how high interest rates will go or the prospect or timing of a future recession. The uncertainties about the future are also exacerbated by the Ukraine conflict and Russian sanctions. Equities have, throughout history, been the most efficient indicators of future economic conditions and, so far in Q1, equities have been resilient in the face of multiple crosscurrents of uncertainty.

The interest rate cycle will play out over time and we would expect central banks to have success bringing down inflation.

History justifies equities as being well suited to combat during inflationary periods. Companies with sustainable business models that possess pricing power are well suited to weather

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market volatility and inflation. The discipline and diversity of an equity portfolio has proven the most effective over time at navigating market volatility, including recessions.

The economic backdrop still favours equities.

The long-term demographic positioning of millennials is encouraging for future consumer spending, and jobs remain plentiful. The economic reopening from COVID-19 is poised to shift from goods to services, bolstering the travel, leisure and entertainment sectors. The auto sector is running at approximately 13MM-14MM units/year in the U.S., down from an equilibrium level of 16MM-17MM, suggesting pent-up demand in the future. U.S. housing has been running at a deficit for the last decade and has sold all the homes that can be built, which is still not enough to satisfy demand. Higher interest rates may hold auto sales and home sales down for a period, but eventually these purchases are family and necessity driven and interest rates, even now, are still at historically low levels. Equities are well positioned to deal with higher interest rates, and portfolios will be assessed on the prospect of a future recession as the economic direction suggests.

Steve Lester

We salute the unwavering commitment of all our healthcare employees and first responders (including our grocery and essential workers) for the sacrifices they and their families make for all of us!

Our hearts also go out to all those affected by the Ukraine – Russia conflict!

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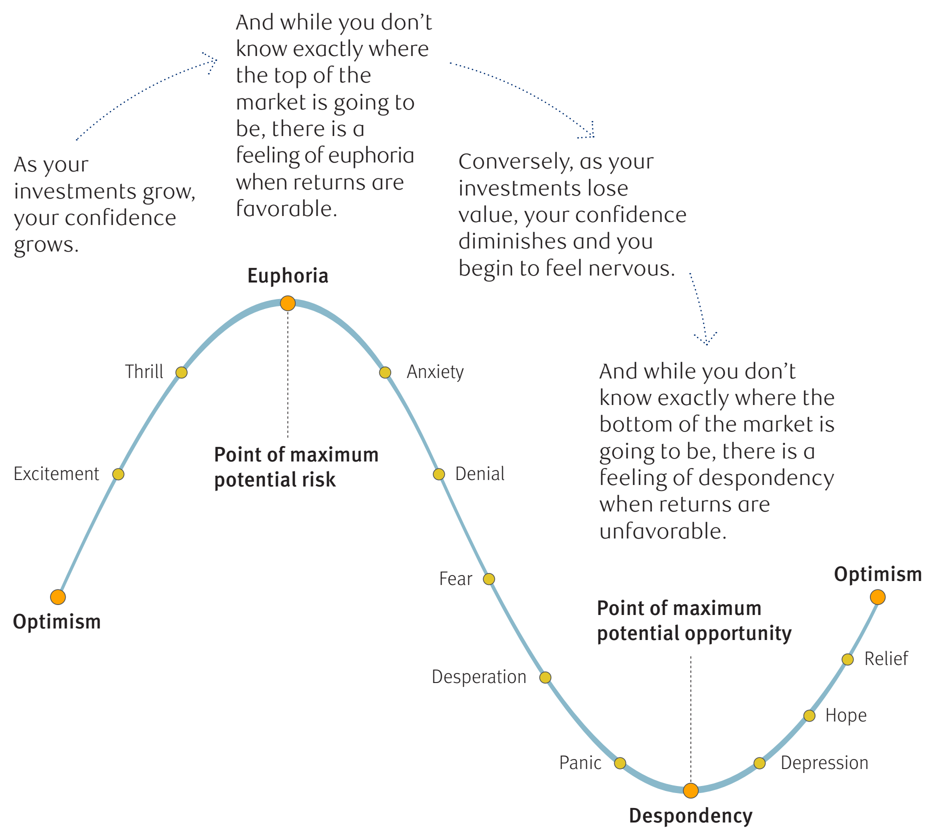
The cycle of market emotions

Human emotion drives financial markets as much or more than market fundamentals.

By following a disciplined approach, you can avoid the pitfalls of emotional investing.



A diversified portfolio can help protect you from the extreme highs and lows of market volatility, which in turn can help prevent you from feeling the extreme emotions as your portfolio expands and contracts. To review your asset allocation, talk to your Investment Advisor.

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