As at December 31, 2021

Group Savings and Retirement

Sailing into uncertain waters in 2022

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What fascinating times these are for global macro! The number of competing storylines right now is so prolific that it's hard to turn off the news. Let's see: the world is fighting Omicron, the fastest-spreading COVID-19 variant we've yet encountered, about 10 billion vaccine doses have so far been administered worldwide,[1] the world has largely reopened (though we are starting to see some countries reinstate lockdowns), and consumption of goods is back full force. The global supply chain – as tightly knit as ever – is now under a lot of stress, and the hottest data point at the moment is the number of ships waiting at anchor in global ports… Not to mention inflation, the logical consequence of the sequence of events of the last two years, which sits at a 30-year high as the year is about to end, despite ample slack in the labour market. What will central banks do?

Well, if 2020 was the year of the virus (alternatively, the year of the stimulus) and 2021, the year of the vaccine, it would be fair to label 2022 the year of uncertainty. Alas, there is no comparable twelve-month period in the history books to guide economists in their current forecasting. As a result, a great deal hangs on how the Federal Reserve (the Fed) navigates through the fog. Let's review what we know.

First, consumers in the developed world are flush with cash, and spending is likely to remain healthy. Second, businesses are willing and able to invest more in their production capacities and inventories; therefore, absent another major shock, global GDP should continue to chug along. Third, global equities are also well-positioned for further gains, as earnings on the MSCI ACWI index are expected to grow about 20% in 2022. Fourth, global monetary policies should continue to tighten, as many central banks have already embarked on a normalization path.

So, how do we transition from 2021 to 2022? Probably with a fair bit of caution, humility, but also not too much pessimism as there should be some interesting opportunities along the way for active investors.

China

The past year has not met expectations for China, as the country is still applying a strict zero-COVID policy. This means that factories, ports, amusement parks, and even whole regions have and probably will continue to go into strict lockdown whenever a case of COVID is detected. This policy is still proudly lauded by the Chinese authorities, who claim that a catastrophe would have been unavoidable had China decided to follow the "Western" way of learning to live with the virus. Not only has this policy probably held back the Chinese economy in the last 18 months, but now represents, in our opinion, one of the main macroeconomic risks in 2022, as the spread of Omicron in China seems hard to prevent. The elevated level of uncertainty surrounding the global supply chain is unlikely to go away in the early months of the year.

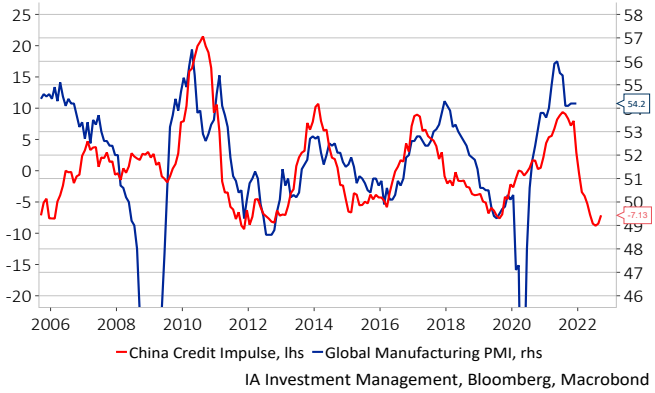
The Chinese economy has been dealing with debt overhang throughout 2021, especially in its property development sector (everyone has now heard of Evergrande, which has finally *de facto* defaulted on its debt in December, after months of struggle).

Deleveraging has been an overarching theme since late 2020, when China's credit cycle started slowing down and its credit impulse (which measures how quickly credit is being added or removed from the economy) shifted downward. As of late 2021, official measures show that aggregate credit is contracting at an annual pace of 8%, a level that typically corresponds to "peak deleveraging." China's credit cycle is particularly important to the global economy as it is very much led by policymakers, and its ebbs and flows are typically a good leading indicator of the global economic cycle (see Graph 1).

Graph 1

World: China's Credit Cycle and the Economic Cycle

Global Manufacturing PMI vs China Credit Impulse (9-month lead)



IA Investment Management, Bloomberg, Macrobond

Europe

The European economy provides an intriguing story as we head into 2022.

It is fair to say that European countries have been among the most proactive regarding COVID management, with lockdowns already starting to pop up again in November in places like Austria. In fact, Germany was considering instituting partial lockdowns even before Omicron was known to the world.

Economic momentum was picking up nicely in the middle of 2021 with two consecutive quarters of 9% annualized growth between April and September. Europe's sound management of COVID should act as tailwind over the next few years, unless the Omicron situation deteriorates, but the bar remains quite low for the Old World to return to strict social-distancing measures, making the next few months highly uncertain.

Against this backdrop, the European Central Bank (ECB) has been among the most transparent of major central banks. ECB President Christine Lagarde has opined that she considered inflation a "passing hump," and thus a 2022 rate hike is "very unlikely." Still, the door might not be completely shut as she did add that the ECB would not hesitate to act, if needed.

Overall, we are expecting European growth to be sound next year, at around 4% for real GDP, which should be in line with projections for Canada and the U.S.

The U.S.

Currently, the U.S. economy is standing out with red-hot consumer spending fuelled by probably one too many stimulus packages in early 2021. We believe

[1] https://ourworldindata.org/covid-vaccinations?country=OWID_WRL

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that inflation worries are more warranted south of the border, as the U.S. is now dealing with a demand problem in addition to global supply-chain issues, leading to empty shelves and skyrocketing prices for used cars.

While the world is keeping a close eye on the Omicron variant, it seems clear that the bar is set quite high for a return to lockdowns in the United States. There seems to be little political appetite – and little chance of general buy-in among the population – for restoring mitigating measures given diverging views regarding the COVID pandemic and vaccination.

The area of the U.S. economy that we find the most interesting right now is its labour market. We have rarely, if ever, seen such a tight job market in the U.S., where businesses cannot find the qualified workers they are looking for, with the participation rate remaining below pre-COVID levels. Luring workers back into the job market has proved difficult so far, and this may eventually lead not only to wage inflation but hold back the country's economic momentum once the effects of recent stimulus initiatives expire.

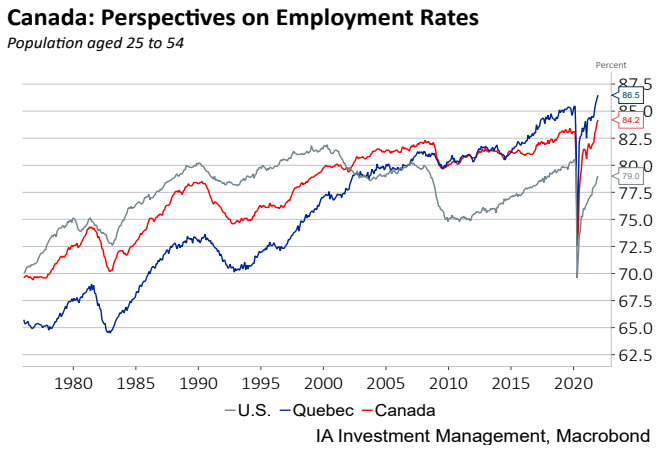
The Fed, with its dual mandate of price stability and maximum employment, is stuck between the proverbial rock and hard place, and its course of action will weigh heavily on risk sentiment next year. Tapering of QE has finally started and even accelerated in December (it should run through the spring), while rate hikes should be next in the spring. How many hikes? It's very uncertain, but we think three or four hikes are likely, in keeping with the Fed's own forecast.

Canada

Canada's economy has picked up the pace in the back half of the year, after a disappointing second quarter. Many things are going right in our country, including exports (prices of the commodities that we export, for example, have been booming this year), but our secret weapon is our labour market.

Canada has entered a virtuous cycle of solid employment leading to more consumer spending, more demand for workers, and so on. The employment rate among Canada's prime-age workers (between 25 and 54 years old) sits at an all-time high of 84%, even above pre-COVID levels (see Graph 2).

Graph 2



The Canadian economy and markets should continue to shine in 2022, with the country's healthy labour market creating the bedrock for solid and sustainable growth. This backdrop also puts the Bank of Canada in a more favourable position for moving ahead with some normalization of its monetary policy and for initiating hikes earlier and at a faster pace than the Fed. This bodes well for the Loonie, which we would not be surprised to see rise to 85 to 90 cents U.S. by the end of the year.

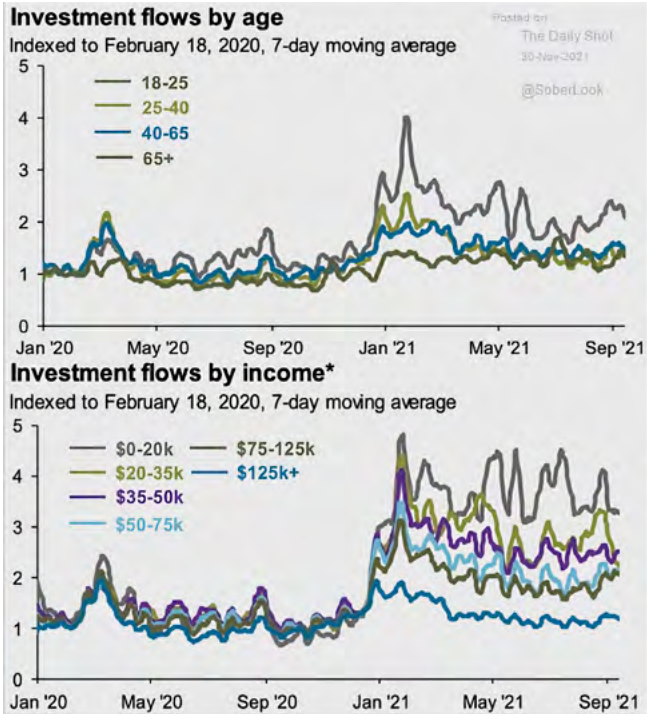
Markets

Global equity markets have not seen a lot of volatility since the 2020 U.S. elections, and "buy-the-dip" has pretty much been the dominant theme in 2021.

Whenever some jitters began to appear in the markets, for example, late in the year with dual fears surrounding Omicron and a repricing of the Fed's tightening expectations, flows from retail investors poured in to seize opportunities. An important question to ponder as we look ahead is how long this behaviour can last, or rather, what would cause it to end.

Well, some data from the world's largest bank, JP Morgan, suggest that retail flows are led by investors aged from 18 to 25, with annual revenues ranging from zero to $20,000 (in other words, the get-rich-quick crowd, see Graph 3). As a result, it is always impossible to predict when behaviours change, but it is likely that an eventual correction of 10 to 15% of the markets, with large swings, may induce a change of heart in this investor segment and likely make the next correction even faster and deeper than what has become the norm.

Graph 3



Within equities, the U.S. stock market was a notable outperformer in the second half of the year, even catching up with the then-leading Canadian stock market. While the S&P 500 and NASDAQ were once again perceived as "the only game in town" in recent months, we see signs of a trend reversal in 2022. If the Chinese credit cycle turns and becomes stimulative, we may see capital flows reversing out of the United States and market leadership shifting to global markets outside the U.S. An important indicator will be the direction of the

American dollar, and any convincing sign of a trend reversal may prove to be the catalyst.

While interest rates have moved higher in 2021, 10-year rates in both Canada and the U.S. remain, at year-end, below the peaks reached in previous months. This shows that despite the recent surge in inflation, fixed-income investors: (1) are still worried about long-term growth prospects; and (2) like to hold long-duration bonds to hedge their balanced portfolios, as can be inferred from the strong demand for Long Treasury ETFs towards the end of the year.

Strategy

Our outlook is favourable for global economic growth in 2022. Also, we expect China to regain momentum. As a result, we should see solid global growth and a shift in market momentum to global equities.

While easy pickings are clearly behind us, we still see the year ahead as more favourable to equities than bonds. Canadian and emerging markets are well-positioned to outperform, while the U.S. market already seems a bit expensive. As global rates remain historically low, 2022 may be another challenging year for bonds, although years of negative returns, as was the case in 2021, are uncommon (see Graph 4). The keys to adding value in 2022 are active management and asset allocation as well as a good dose of discipline.

Graph 4

Bonds: Negative return years are not common

Bloomberg US Aggregate Bond Index, annual returns

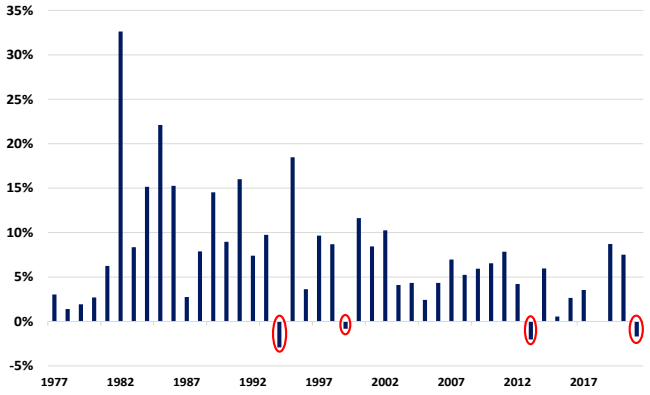


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Chart 1
Returns of the Canadian Bond Market as at December 31, 2021

Index	Returns (%)	
	3 months	YTD
FTSE Canada Universe Bond Index	1.5	(2.5)
FTSE Canada Short Term Bond Index	(0.5)	(0.9)
FTSE Canada Mid Term Bond Index	0.3	(2.7)
FTSE Canada Long Term Bond Index	4.8	(4.5)
FTSE Canada Federal	0.8	(2.6)
FTSE Canada Provincial	2.4	(3.3)
FTSE Canada Municipal	1.6	(2.9)
FTSE Canada Corporate	1.1	(1.3)

Chart 2
Market Returns as at December 31, 2021

Index	Returns (%)	
	3 months	YTD
FTSE Canada 91 Day T-Bill Index	0.1	0.2
FTSE Canada Universe Bond Index	1.5	(2.5)
S&P/TSX Composite Index	6.5	25.1
S&P 500 (Can. $)	10.7	27.6
MSCI - EAFE (Can. $)	2.4	10.3
MSCI - World (Can. $)	7.5	20.8
Exchange Rate (Can. $ / US $)	(0.3)	(0.9)

Chart 3
Market Returns as at December 31, 2021

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector Allocation		
Energy	5.7	49.0
Materials	10.7	4.0
Industrials	5.0	16.5
Consumer Discretionary	7.8	18.4
Consumer Staples	7.8	22.4
Health Care	(18.3)	(19.6)
Financials	9.4	36.5
Information Technology	(1.4)	18.5
Communication Services	4.8	24.7
Utilities	5.4	11.6
Real Estate	9.2	37.4
S&P/TSX Composite Index	6.5	25.1

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Chart 4
Economic and financial scenarios

Economic scenario

							Change since September 30, 2021	
		2019	2020	2021	2022	2023	2021	2022
U.S.	Real GDP	2.3%	-3.4%	5.6%	3.8%	2.5%	-0.3%	-0.3%
	Inflation rate	1.8%	1.2%	4.7%	4.6%	2.4%	+0.4%	+1.6%
	Unemployment rate	3.7%	8.1%	5.4%	3.7%	3.5%	-0.1%	-0.6%
Canada	Real GDP	1.9%	-5.2%	4.6%	4.0%	3.0%	-0.5%	--
	Inflation rate	1.9%	0.7%	3.4%	3.5%	2.2%	+0.4%	+1.1%
	Unemployment rate	5.7%	9.6%	7.4%	5.8%	5.6%	-0.2%	-0.4%

Financial scenario*

			Targets			Change since September 30, 2021	
		Actual	June 22	Dec. 22	June 23	June 22	Dec. 22
Interest rate	Canada 10-year rates	1.42%	1.95%	2.50%	2.80%	--	--
	U.S. 10-year rates	1.51%	1.90%	2.60%	3.00%	--	--
Exchange rate	$US/$CA	0.79	0.83	0.88	0.90	-0.02	+0.02
	$US/EUR	1.14	1.20	1.24	1.25	--	--
	Oil price (WTI). $US	75	80	83	85	--	--
	S&P 500	4,766	4,600	4,900	5,000	+50	+225
	S&P/TSX	21,223	22,070	23,350	24,520	+695	+365

* end of period