Economic and Financial Environment

As at March 31, 2022

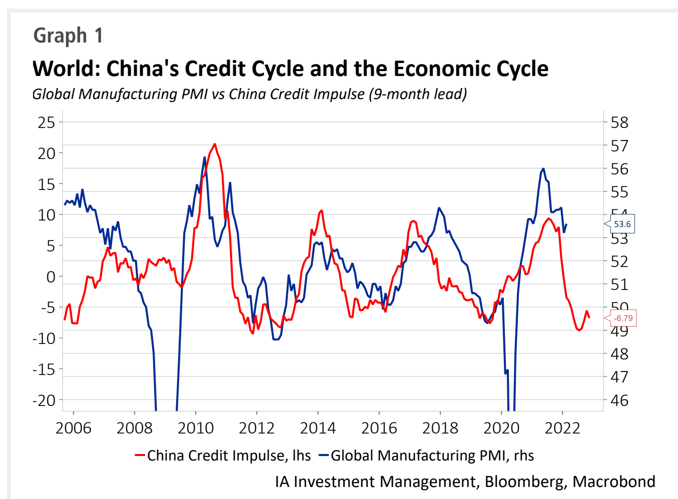
Group Savings and Retirement

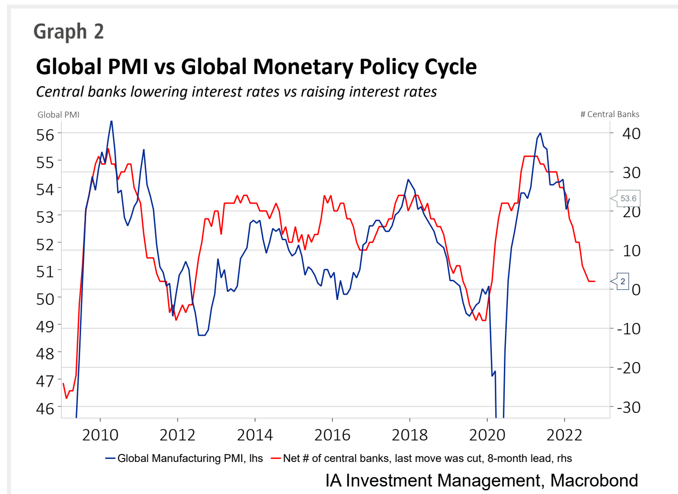
Anyone ordered some volatility?

By Sébastien Mc Mahon, M.E.Sc., PRM, CFA
Senior Portfolio Manager, Diversified Funds and Economist
Industrial Alliance Insurance and Financial Services Inc.

What was already shaping up to be a volatile year has taken a turn for the unpredictable, as the Russian invasion of Ukraine added geopolitical and military risks on top of the already-known inflationary risks. Although we expected some volatility in 2022, we sure didn't foresee the first quarter as being among the worst ever for global bonds AND one of the all-time best for commodities!

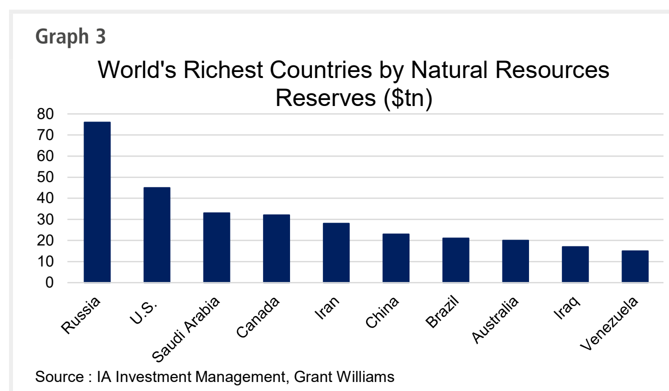
Let's start by saying that our leading indicators were already flagging a global economic slowdown in 2022, whether we looked at the Chinese credit cycle (see graph 1) or the number of central banks tightening their monetary policy around the globe (see graph 2). Of course, we are talking about a mid-cycle slowdown here, which was not especially a negative thing after the historically strong pace of growth post-COVID, and the risks of a recession remained very low by historical standards.





Although we added a layer of risk to the outlook when Russia de facto invaded Ukraine on February 24, the global economic cycle is still moving forward at an above-trend pace. Global GDP growth is still widely expected to be around 4% in 2022, and 3.5% in 2023. But the risks to these forecasts are now clearly tilted to the downside given the lingering uncertainty surrounding the Ukraine situation, and China's potential involvement in it (although China does seem to be walking the diplomatic path for now).

The main macro impact of the Ukraine invasion, for now, is the strong rise in commodity prices. Russia has the largest and most diversified reserves of natural resources in the world by a wide margin (see graph 3). As sanctions are piling on Russia, it has become uncomfortable for many countries and corporations to buy Russian products, leading to an inflationary commodity supply shock. A prime example of the changing perception regarding Russian exports can be found in the decision from Shell plc, the global oil company, to withdraw completely from Russian oil and gas [1].



Even before the invasion itself, everything from oil, gas, metals, and agriculture prices have seen varying degrees of short-term inflation as the world is scrambling to reshuffle its energy mix. For example, the EU plans to cut Russia gas imports by 80% in 2022, a herculean objective.

Ukraine's wheat exports also being key to the regional food chain, the potential for further political turmoil in middle east countries has risen.

The world was finally getting itself through the supply chain disruptions, and expectations for inflation to gradually fade towards a 2-3% range by early 2023 were consensus, but these forecasts are now being pushed back by 6-12 months. In a nutshell, this commodity price shock will act as a growth tax on developed countries, which are generally net resources importers rather than exporters.

China

China currently finds itself in a delicate position. Its relationship with Russia is being put to the test, and reports that it considered supporting the Ukraine invasion by making available some trucks and planes created shockwaves around the world.

[1] https://www.shell.com/media/news-and-media-releases/2022/shell-announces-intent-to-withdraw-from-russian-oil-and-gas.html

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The Chinese business model, since it joined the World Trade Organization two decades ago, is to extend its economic reach and influence to all regions of the globe. For this reason, many geopolitical experts have argued that it would not make sense for a country like China to expose itself to economic sanctions for fighting another country's war, and as of quarter end, China is indeed pushing for a diplomatic resolution to the Ukraine invasion.

China's economy is once again being stimulated by its government. The tap is being open on the credit cycle, the crackdown on big tech and the property sector is said to be almost done, and China is once again looking to attract foreign investors to its stock market. But the risks from COVID are still not over, as China has not yet decided to move away from its COVID-zero policy. Although we are seeing some easing of sanitary rules, multiple provinces, and dozens of millions of Chinese citizens have faced lockdowns in the first quarter of 2022. As we know how viral the Omicron variant can be, the logical thing is to expect further strains on the global supply chain in the coming quarters, keeping the pressure on inflation.

Europe

The economic data from Europe was getting better and better at the turn of the year, and the prudent handling of COVID in the old continent was paying dividends. But it is likely now that the European economy will likely be the most impacted by the Ukraine invasion, given the costs from its plan to change its energy mix. Europe, and Germany in particular, have progressively become quite dependant on Russian energy to the detriment of their own power sources. France and Germany are already putting forth important stimulus packages that could limit the risks of a recession in the coming quarters.

Let's start with a few numbers, sourced from Eurostat, EIA and Statista. In 2020, 57.5% of the energy used in the European Union (the EU) was imported, slightly higher than the 56.3% it imported in 2000. Germany, however, imported 63.7% of its energy in 2020, and was looking to import even more in coming years, in large part from Russia (oil, gas and coal).

Natural gas imports from Russia, for example, were booming in the last few years. According to data from the Observatory of Economic Complexity, the share of Russian natural gas in the European Union consumption went from 30% in 2016 to 47% in 2021.

The recent willingness of Europe to free itself from Russian energy dependency is a drastic shift. Europe was in the process of shutting down many nuclear plants by the end off 2022, as they were considered unsafe and environmentally unfriendly, and were turning even more towards Russian energy for its primary needs. Germany, which used nuclear to supply about 30% of its power in 2000, had reduced its nuclear share to 11% in 2020. On the last day of 2021, it shut down 3 of its last 6 plants, and was aiming at shutting down the last 3 plants by the end of this year. France is obviously an outlier here, as its reliance on nuclear power has remained a mainstay.

These examples show how complicated it will be for Europe, and Germany more particularly, to reach their objective of more energy independence. They also show how complicated it is to sanction Russia, at least in the sort term.

European leaders are now talking about reaching "strategic autonomy", which means further independence on the aspects of military, food, and energy. After 50 years of progress towards a more globalized economy, the European situation shows how the need for local sourcing and self-reliance will be at the forefront going forward. Put another way, the focus on sourcing will likely shift from cheapest, easiest, and greenest to safest, and surest.

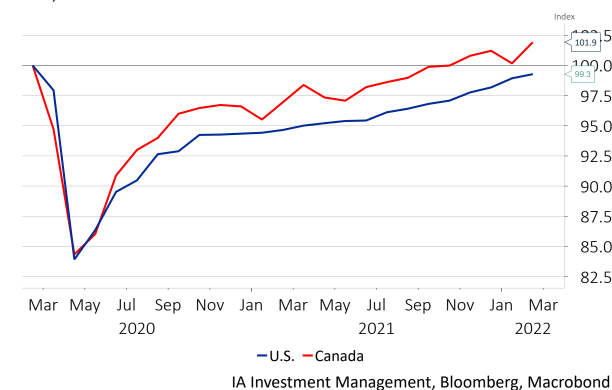
The U.S.

The U.S. economy has quietly had a strong first quarter, with the labour market catching up with Canada despite the Omicron wave (see graph 4). It seems that it was only a matter of time before workers started flowing back and taking on a new job, with the stimulus payments now further in the rear-view mirror and an apparent fading of COVID fear. The participation rate has been making important strides since last fall, but remains far below pre-COVID levels, suggesting potential for more gains (see graph 5).

Graph 4

COVID Impact on Employment: Canada vs U.S.

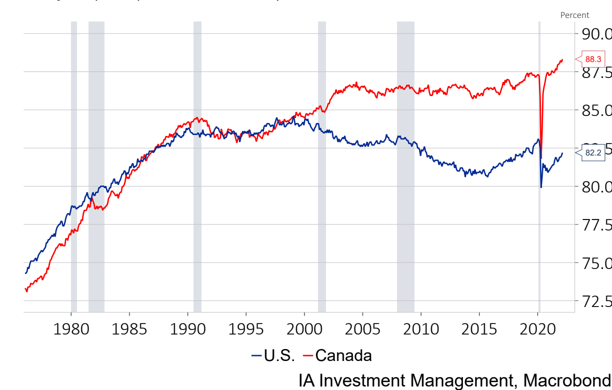
Indices, Feb 2020 = 100



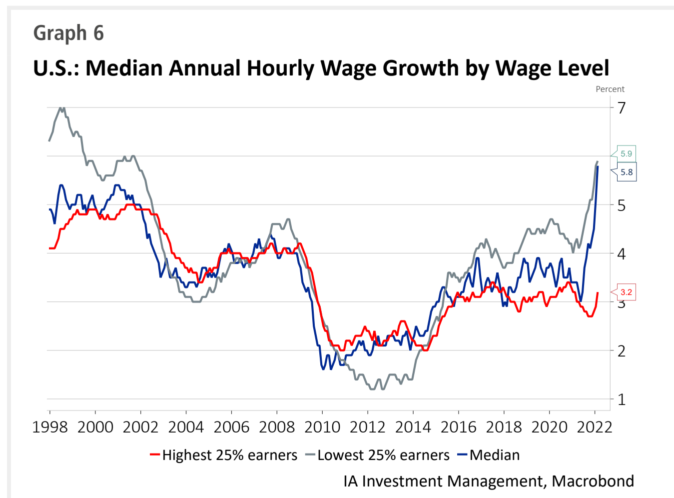
Graph 5

Canada & U.S.: Participation Rates

Labour force participation rate, 25 to 54 years old



We are also seeing a jump in wage growth, especially in the lowest 25% of earners, as services and other low-paying jobs are the hardest ones to fill, leading to fierce competition between employers (see graph 6). Labour shortages and the resulting wage pressures are by themselves inflationary and are adding another layer to the inflation backdrop.



Graph 6

U.S.: Median Annual Hourly Wage Growth by Wage Level

IA Investment Management, Macrobond

The U.S. should also slow down a bit, in the range of 2.5 to 3.0% in 2022, as inflation takes a bite out of consumer demand. Its novel energy independence will likely cushion a good part of the hit from higher oil prices, but the overall impact from higher commodity prices should be negative.

The spotlights were put directly on the Fed and its president Jerome Powell in March. With CPI inflation reaching 7.9% in February (the most recent number available as of this writing), pressure on the Fed to act boldly to rein in inflation expectations is coming from all sides.

The most important thing here for the Fed (and of course most central banks with an inflation target, like the Bank of Canada) is to maintain its credibility in that it can and will get inflation back to its target range, of 1 to 3%. Consumer surveys and market indicators are suggesting that inflation expectations are not yet de-anchored, but we do see a certain drift that should, and likely is, making FOMC committee members nervous.

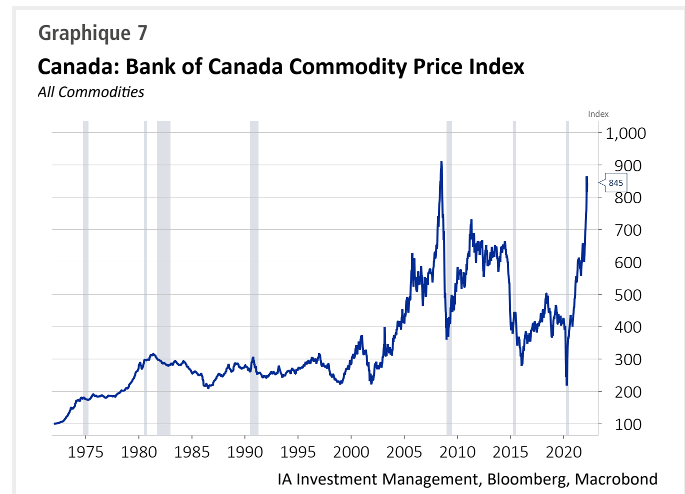
In a nutshell, inflation expectations are very important because if workers and businesses lost faith in central banks' ability to keep inflation near target over the medium-term, then negotiations for work agreements and supplier contracts would start to include higher inflation components, creating a self-fulfilling inflation spiral.

As the quarter ended, markets were pricing in about 8 hikes of 25 bps by December 2022, with 5 of these hikes by July. The Fed is making it clear that it intends to act boldly, and a 50 bps hike is being discussed for the next decision in early May. We do expect the Fed to proceed swiftly with its tightening process, as monetary policy is known to have a lagged impact on the economy and to send a clear signal that it is very serious about reining inflation back in. It remains early in the year, but the leading rate could reach 2 % by the end of the year.

Canada

The current economic backdrop puts Canada in a good position.

As mentioned in the opening section, the main economic consequence for now from the Ukraine invasion is the rise in commodity prices. Canada could thus be one of the most advantaged countries in this context, given that it shares many export products with Russia. We are not talking only about oil, but also other commodities like uranium, potash, and industrial metals. According to the Bank of Canada's commodity price index, the average price of Canadian commodities is now back near the all-time high reached in 2008 (see graph 7).



Graphique 7

Canada: Bank of Canada Commodity Price Index

All Commodities

IA Investment Management, Bloomberg, Macrobond

A very important aspect of Canada's probable renewed attractiveness for foreign investors is linked to responsible investing and its three components: environment, social and governance (ESG).

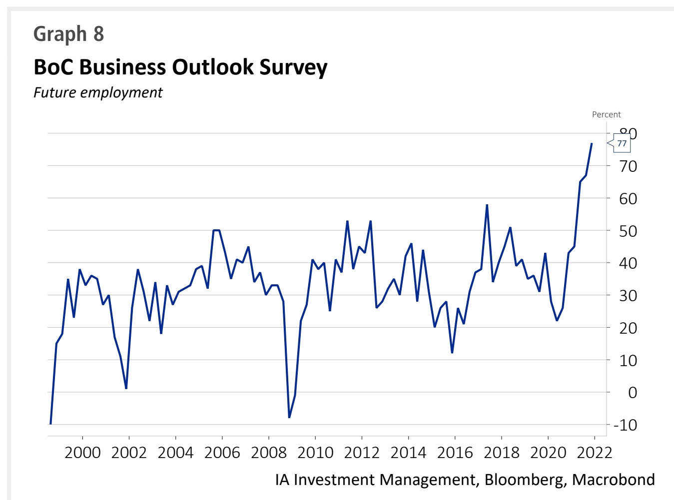
Over the last decade, at least, the rising importance of ESG has weighed on the Canadian energy sector, with oil sands' reputation of being a dirty source of energy. While it has been documented that Canadian oil production does emit more CO2 per barrel than other sources, the "E" component of Canadian oil should, obviously, be only a part of the equation. On the global scale, one can argue that Canada's score on the "S" and "G" components rank highly and should add some luster to the Canadian energy sector.

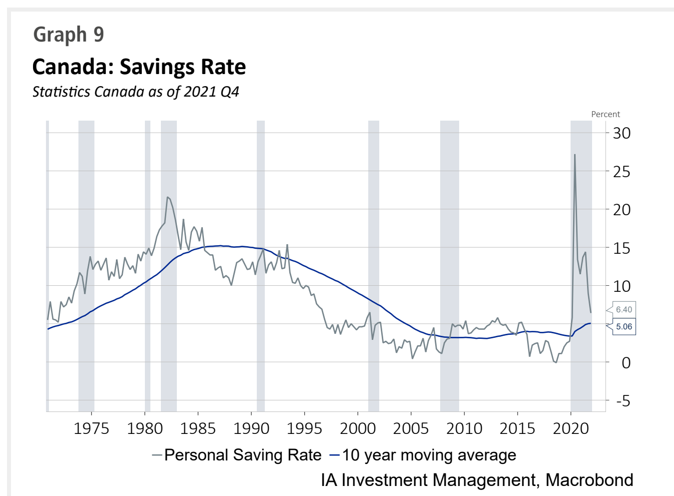
According to research from CIBC [2], the ESG fund universe held twice as much Russian oil and gas companies as Canadian oil and gas companies at the end of 2021. This suggests 1) that environmental metrics have far outweighed the social and governance ones over recent years and 2) the aftermath of Russia's invasion of Ukraine brings to light the unbalanced aspect of the ESG equation. Global investor's interest for Canadian oil, for example, could be rekindled through the ESG lens, as its bad

[2] https://www.bnnbloomberg.ca/esg-funds-missing-the-mark-on-social-and-governance-cibc-analysts-1.1740710

reputation on the environmental dimension could now be balanced against its good rating on social and governance.

Shifting to Canada's domestic economy, we continue to see good things: a strong labour market, with historically high intentions for hiring (see graph 8 BOS) and investment. Canadian households' saving rate remains above the historical average (see graph 9) and the net worth of Canadians is at all-time highs. Housing is still gaining ample attention, especially in the Greater Toronto Area, where prices have skyrocketed since the start of the pandemic. Although we tend to shy away from calling Canada's housing market a "bubble", we do see ample froth as speculative activity from investors has been well documented.

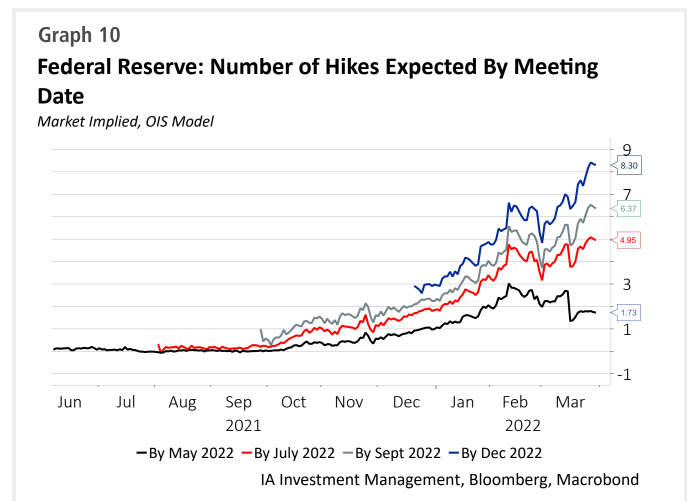




We also see a dire need for more housing supply in key regions of Canada, as Canada's population grew by 1.2%, or 457,888 in 2021 according to Statistics Canada. Macroprudential measures to curb investor activity seems to us an obvious part of the solution, as a complement to rising interest rates, which tend to have an impact with a lag of 12 to 18 months.

Speaking of interest rates, March saw the first rate hike from the Bank of Canada since October 2018. The question now is not whether the leading rate will be hiked again over the next few meetings, but how many hikes will we see in the coming months.

As the quarter ended, and with inflation booming to the tune of 5.7% in February (the most recent figure available as of this writing), market participants are expecting the Bank of Canada to act swiftly and proceed with as many as 8 more 25 bps hikes by December (for a total of 2.25% worth of tightening in 2022, graph 10). While this amount of tightening might be a bit steep, we do agree that it is imperative for central banks to keep inflation expectations well anchored and proceeding swiftly over the next 2 quarters would go a long way in achieving that goal.



Markets

Turning to global markets, volatility has been rampant in 2022 as expectations for monetary tightening coupled with elevated valuations led to profit taking on equities. The S&P/TSX has outperformed, with support from elevated commodity prices and a relatively cheap valuation. On most indices, the pullback happened mostly before the Ukraine invasion on February 24, and most markets are now up since then.

A strong economy and 30-to-40-year-high inflation have pushed central banks to adopt a very hawkish stance. Both the Bank of Canada and the U.S. Federal Reserve got going with one hike each in March, and many more are expected over the next 12-24 months. The ECB is also widely expected to start hiking in the second half of the year, while emerging countries' central banks are well advanced in their tightening cycle. The result: the first quarter of 2022 turned out to be the worst for the Bloomberg global bond aggregate index since its creation in 1990.

While interest rates should remain at historically low levels over the coming cycle, the path of least resistance for rates continues to point higher, although a sizable share of the expected rise in market rates is probably in the books after a record-setting first quarter. The odds of back-to-back negative years for the global bond index are very elevated,

and it would take nothing short of a recession before year-end (something we think is unlikely, but not outright impossible, as we estimate the odds at no more than 20%) to bring them down. We keep keen eyes on corporate spreads, which have widened somewhat in 2022 and are now back slightly above pre-COVID levels. Further deterioration in the credit market would be a telling sign, in our opinion, of rising risks of economic turmoil.

Strategy

The current backdrop of a slowing global economy, geopolitical risks and tightening monetary policies are all pointing towards a rather neutral stance in our balanced portfolios. The questions we are facing as the quarter ends are 1) whether long-term interest rates can continue climbing as quickly as they have in March, and whether it will soon be time to add more fixed income to our asset mix, as well as 2) how much rising rates can the equity market absorb before we see the return of volatility.

These questions are, of course, not easy to answer, but we do repeat again that risk management and position sizing are important ingredients to success in portfolio management.

Still, although our stance is much more neutral than what we're accustomed to, we do find a few interesting opportunities for active bets.

On a more general level, periods of strong inflation fueled by commodity prices favour allocating risk to commodity exporting countries (Canada, some emerging markets, especially Latin America, …) and away from commodity importers (Europe for example). We have thus articulated our strategy around this theme, as the positioning within the diversified funds has favoured Canadian and emerging markets equities, and underweighted U.S. and European equities through most of the quarter.

Looking forward, we believe it will remain appropriate to keep a rather neutral stance towards equities in the coming quarters.

The main reason is that historically, as global central banks accelerate the pace of tightening, valuations (measured for example as the price-to-earnings ratio, or P/E) tend to fall, acting as a headwind to equities. On the flipside, central banks tend to tighten more pre-emptively than the current timing, as the economy is only starting to heat up, and earnings are generally rising at an accelerating pace for a good portion of the hiking process. As we move towards the second quarter of 2022, however, data suggests that the peak in earnings growth is already behind us, meaning that both valuations and earnings could hold equities back in the medium-term.

Turning to fixed income, the violent rise in rates in the first quarter has likely opened an opportunity to start adding some duration to portfolios, through long-term (20 years +) U.S. treasuries, as a source of diversification. The signals sent by the yield curve as the quarter ended argued for some prudence relative to views on the longevity of this economic cycle, with the inversion of the 5 year to 30 year portion of the curve. The 3 month to 10 year segment, which we consider the most timely indicator of an economic downturn, is still suggesting that there's room to hike rates by about 200 bps (close to what markets are pricing in in 2022 alone) before running into trouble.

As at March 31, 2022

Chart 1
Returns of the Canadian Bond Market as at March 31, 2022

Index	Returns (%)	
	3 months	1 year
FTSE Canada Universe Bond Index	(7.0)	(4.5)
FTSE Canada Short Term Bond Index	(3.0)	(3.3)
FTSE Canada Mid Term Bond Index	(6.8)	(5.0)
FTSE Canada Long Term Bond Index	(11.7)	(5.6)
FTSE Canada Federal	(5.6)	(4.5)
FTSE Canada Provincial	(8.6)	(4.7)
FTSE Canada Municipal	(8.0)	(4.9)
FTSE Canada Corporate	(6.4)	(4.4)

Chart 2
Market Returns as at March 31, 2022

Index	Returns (%)	
	3 months	1 year
FTSE Canada 91 Day T-Bill Index	0.1	0.3
FTSE Canada Universe Bond Index	(7.0)	(4.5)
S&P/TSX Composite Index	3.8	20.2
S&P 500 (Can. $)	(5.7)	14.9
MSCI - EAFE (Can. $)	(7.0)	0.5
MSCI - World (Can. $)	(6.2)	9.4
Exchange Rate (Can. $ / US $)	(1.1)	(0.6)

Chart 3
Canadian Market Returns as at March 31, 2022

Index	Returns (%)	
	3 months	1 year
S&P/TSX Sector Allocation		
Energy	28.7	59.4
Materials	20.1	34.1
Industrials	3.9	13.5
Consumer Discretionary	(7.7)	(2.8)
Consumer Staples	5.4	25.7
Health Care	(8.5)	(46.7)
Financials	2.2	22.4
Information Technology	(35.5)	(22.7)
Communication Services	8.8	26.8
Utilities	5.0	13.3
Real Estate	(4.7)	19.1
S&P/TSX Composite Index	3.8	20.2

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Chart 4
Economic and financial scenarios

Economic scenario

		2019	2020	2021	2022	2023	Change since December 31, 2021: 2022	Change since December 31, 2021: 2023
U.S.	Real GDP	2.3%	-3.4%	5.7%	3.4%	2.2%	-0.4%	-0.3%
	Inflation rate	1.8%	1.2%	4.7%	6.5%	3.0%	+1.9%	+0.6%
	Unemployment rate	3.7%	8.1%	5.4%	3.6%	3.4%	-0.1%	-0.1%
Canada	Real GDP	1.9%	-5.2%	4.8%	3.9%	3.0%	-0.1%	--
	Inflation rate	1.9%	0.7%	3.4%	4.8%	2.7%	+1.3%	+0.5%
	Unemployment rate	5.7%	9.6%	7.4%	5.8%	5.5%	--	-0.1%

Financial scenario*

			Targets			Change since December 31, 2021	
		Actual	June 22	Dec. 22	June 23	June 22	Dec. 22
Interest rate	Canada 10-year rates	2.40%	2.50%	2.65%	2.80%	+0.55	+0.15
	U.S. 10-year rates	2.34%	2.40%	2.70%	3.00%	+0.50	+0.10
Exchange rate	$US/$CA	0.80	0.83	0.88	0.90	-0.02	+0.02
	$US/EUR	1.11	1.11	1.14	1.15	-0.09	-0.10
	Oil price (WTI). $US	100	100	95	90	+20	+12
	S&P 500	4,530	4,600	4,900	5,000	--	--
	S&P/TSX	21,890	22,600	23,350	24,520	+530	--

* end of period