Economic and Financial Environment

As at June 30, 2022

Group Savings and Retirement

Out comes the bear

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As 2021 came to an end, we were expecting a much more volatile year in 2022. We viewed the economic recovery post-COVID as being mostly priced in and expected central banks to embark on an aggressive tightening path.

The macro and market landscapes have taken a sour turn right off the bat in 2022. Inflation, expectations for even more aggressive central banks tightening and, equally important, Russia's invasion of Ukraine have all brought a heavy tone on both bonds and stocks. The inflation story has taken many faces already, going from supply chain issues to excess demand, but now seems to reside more importantly in the geopolitical consequences of the Ukrainian conflict. Issues in the production of food (along with droughts in North America) and the shift in the European energy mix are creating a perfect storm that hits at households' spending power, and thus pushes recession risks higher. The result is that US equities are officially in bear market territory.

Central banks and inflation should continue to dominate the news flow in the second half of the year and keep a heavy tone on the stock market. The risks of a U.S. recession are rising, as consumer and business confidence are falling to recessionary levels. The first quarter of the year showed how fragile the growth outlook has become, as the strength in the US dollar led to a drag from trade, which resulted in a negative print. Such surprises could take many forms in the coming quarters, and a technical recession in the U.S. at some point in the next 12 months is our base case scenario.

In equities, we expect the rest of the year to follow the typical bear market playbook. This means that the S&P 500 could continue to pull back (the average bear market has historically seen a contraction of 30% and lasted between 8 and 11 months); however, we don't expect any further drawdown to be smooth as we will likely see multiple bear market rallies along the way.

Interest rates will also be in focus, as global central banks are walking the fine line of trying to fight inflation without pushing the economy into recession. We expect this exercise to be challenging and see the odds of a hard landing as relatively high. Our main scenario is that interest rates will peak somewhere before Q4, which means bonds could become attractive again from both a yield and capital appreciation perspective.

We thus view 2022 as the year of the after-effects from the pandemic medicine of ample liquidity. With the continued volatility for the rest of the year, we expect active managers to be in a strong position to add value for clients.

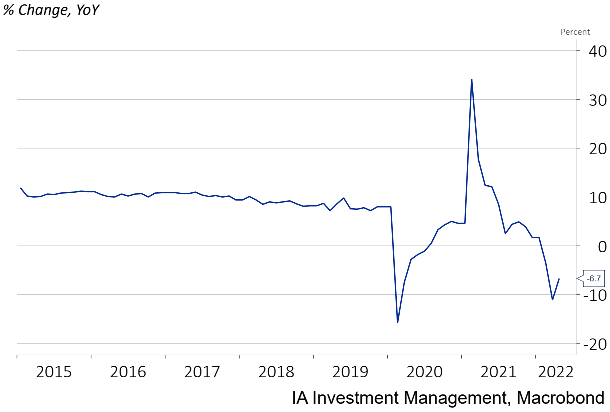
China

The big question regarding China heading into 2022 was whether its government would shift its stance on its COVID-zero policy; would it loosen its grip, given Omicron was recognized as being less lethal, or tighten it, given its virality. Well, it turns out the grip couldn't have become any tighter, and the Chinese economy went back to square one in the second quarter. Industrial production and retail sales, two of the most followed Chinese economic indicators, showed a relapse of growth that was in line with early 2020 (graph 1 & 2).

Graph 1

China Retail Sales

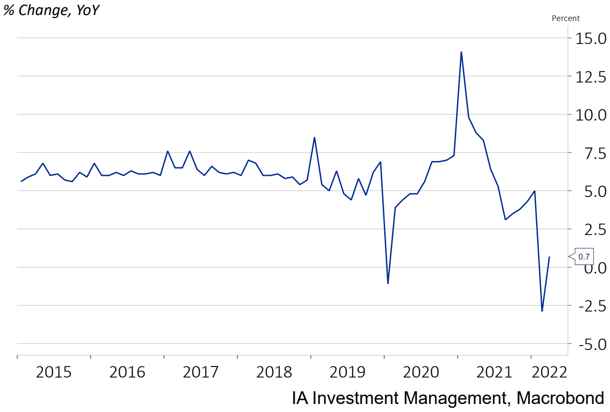
% Change, YoY



Graph 2

China Industrial Output

% Change, YoY

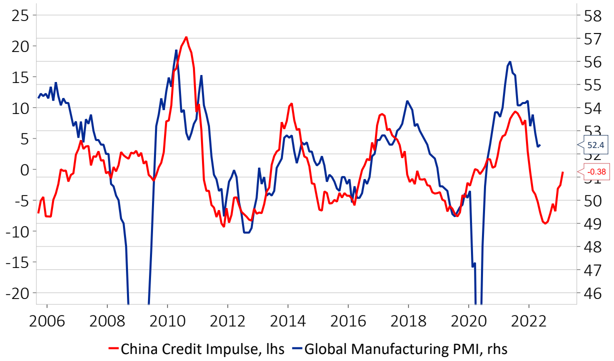


China now finds itself in a weakened position, and this weakness is of course weighing on global growth prospects in 2022 and 2023. The Chinese central bank is doing what it can to support the economy, by injecting liquidity and cutting interest rates multiple times. The government is also opening the credit taps to organize a rebound in H2, but history tells us that these efforts will tip the global economic scale with a delay of about 9 months (graph 3).

Graph 3

World: China's Credit Cycle and the Economic Cycle

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



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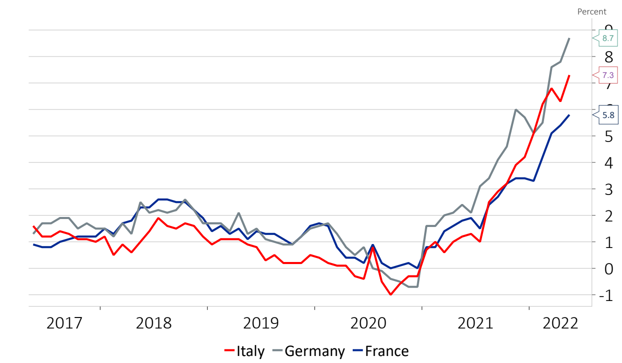
Graph 4

Europe: Headline inflation taking off

Headline HICP, YoY, as at 2022-05



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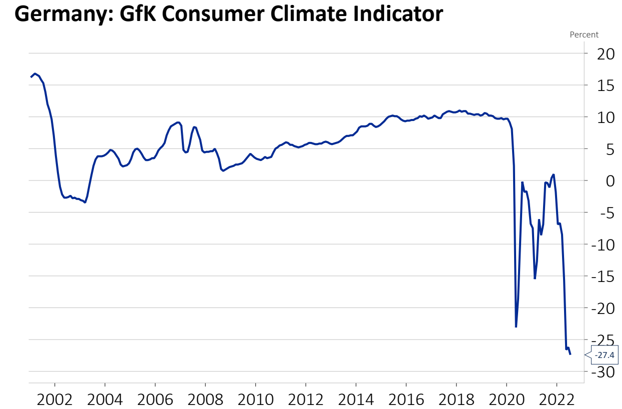
Graph 5

Germany: GfK Consumer Climate Indicator



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As a result, expectations for Chinese GDP growth in 2022 were revised lower, to 4.4% according to the OECD and 4.3% according to the World Bank, which would be the slowest since 1990, excluding 2020.

The silver lining is that 2023 is shaping up to be stronger, with growth expected by the OECD and the World Bank reaching about 5.0%.

Europe

This has been another eventful year for Europe. After having played tough on COVID since 2020, with some of the strictest safety measures in the developed world, Europe was looking to reap the rewards in 2022 with a stronger public health foundation. Now, as the Ukraine conflict continues and with Russia making progress in its invasion, the talk has turned to the energy crisis that could very well push Europe back into recession.

Europe's focus has turned towards energy independence from Russia, something that is easier said than done, as countries like Germany have actually strengthened their Russian ties over the last few years as it looked to decommission its nuclear plants. With Russia's acts of war, the political narrative has turned to quickly cut ties with Russian oil, gas and coal exporters, a process that will likely take years and will be expensive for European households. As it has become taboo for businesses to import energy from Russia, new partnerships must be put into place, meaning pressure on global energy prices, creating even more inflation worldwide.

Inflation in European countries with a larger dependence on Russian energy has in fact been stronger than France, for example, where its nuclear grid continues to be a source of stability. For example, Germany and Italy are the two countries with the most dependence on Russian natural gas, and their inflation rates have surpassed France's by 2-3% over the last year (graph 4). This explains in large part why Germany's consumer confidence has fallen to even lower levels than in March of 2020 (graph 5).

Adding to this is safety risk: many geopolitical observers are worried that Russia might use the menace of, or outright move forward with, shutting down its main gas pipelines in the winter, as a way to pressure Europe to either ease its sanctions, or keeping them from adding to the already long list.

The result from this elevated inflation and the loss of confidence from households and businesses is that the odds of a recession striking Europe over the next 12 to 18 months have grown substantially to now being our base case scenario.

This economic background story is important as it contributes to the waning political stability in countries like France, where Emmanuel Macron has recently lost his absolute majority in government, and where poll results are showing further polarization of the vote. A divided Europe would be a weaker Europe, meaning the conflict in Ukraine and the inflation that it is causing could last longer than initially expected.

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The U.S.

As the second quarter of the year is ending, the question we are asking ourselves is whether the U.S. economy is already in a technical recession. GDP growth in the first quarter surprised to the downside, with foreign trade contracting so much from a strong dollar that growth badly missed expectations and clocked in at -1.5%.

The latest forecasts published in late June point to weakness once again in the second quarter, but coming this time from an inventory overhang and inflation starting to eat into households' spending power. The result is that the U.S. economy is slowing down on many fronts, and the number of actual and potential negative stories in 2022 and 2023 could very well lead U.S. quarterly GDP growth to zigzag around 0% for multiple quarters, meaning that we could even have a few technical recessions in a row before 2023 is over.

We put emphasis on the word "technical" here, as it is likely that unemployment won't jump, as it typically does in recessionary environments. Given the labour scarcity issues that are an everyday challenge across the developed world, we do believe that the bar is high for massive layoffs, and that we could see a more subdued recession than usual. Also, let's not forget that 2008 and 2020 were not the garden variety of recessions; financial crises and global pandemic are closer to once-in-a-century events.

U.S. households are currently facing an unfolding wealth shock, with inflation eating at their spending power, the value of both their fixed income and equity portfolios melting and a possible impending slowdown of the housing market. As monetary policy tends to impact the economy with a certain delay, we are expecting the rise in mortgage rates seen over the last 6 months to drive the price of houses lower by the end of the year (graph 6).

Graph 6

U.S.: Headwinds for the housing market

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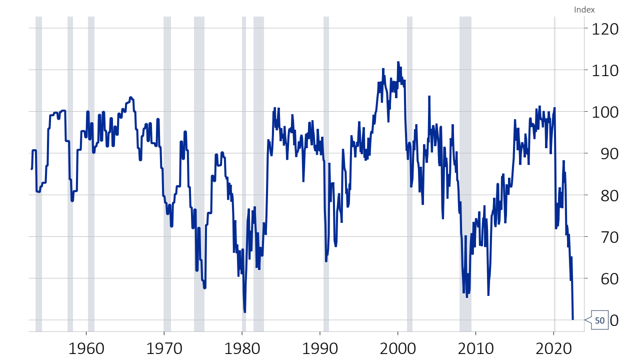
The result is that the U.S. consumer currently shows the lowest level of confidence in over 70 years (graph 7), and the prospects for purchases of "big ticket items" like furniture, cars and houses are dim. As we like to say, a recession can simply be people keeping their money in their pockets…

Graph 7

U.S.: Consumer Sentiment

University of Michigan Survey, 2022-06



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Looking at U.S. businesses, the picture looks eerily similar: confidence is low for small and large firms. One thing that we heard more as the quarter ended was large businesses feeling they carried too much inventory, as expected demand was revised lower. Remember these same businesses were rushing to rebuild their inventories in 2021, pressuring the supply chain, only to find themselves facing a soft demand patch only a few months later. As inventory builds are a tailwind for GDP growth, the reverse means headwinds for the coming few quarters.

Labour scarcity is another important issue for business owners, who see wage pressure mounting, and thus profit margins getting squeezed, albeit from historically elevated levels. Putting all those pieces together, it's natural to expect less contribution to growth from business investment over the coming few quarters.

The last piece of the puzzle regarding expected GDP growth is trade, which singlehandedly pushed the Q1 GDP figure into negative territory. The strength of the U.S. dollar, which acts as a safe haven in periods of market volatility, combined with a weakening global economy means fewer exports, and thus, once again, to softer GDP growth.

The macro environment, which combines strong and broadening inflation with weakening economic growth, is causing headaches to central banks in general, and the Federal Reserve (the Fed) more particularly. As the Fed plays a crucial role in global markets, the wire act of aiming for a soft economic landing while curbing inflation has become front and center.

From March to June, the Fed has tightened on all 3 of its decision meetings for a total of 125 bps already. The aim is to get the leading rate to neutral (between 2 and 3%) as quickly as possible, so that monetary policy at least stops being accommodative. But the Fed is treading carefully here, as too much tightening in too short a time could magnify the economic slowdown and force the Fed to return to cutting its leading rate in 2023…

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Canada

If the U.S. economy is starting to show signs of fragility, Canada's remains in a favourable position. In fact, Canada's real GDP grew by 3.1% in the first quarter of the year, and Q2 is shaping up to be even stronger.

For 2022 and 2023, Canada is expected to outperform most developed countries on the economic chapter, with the OECD expecting growth of 3.75% in 2022 and 2.6% in 2023, while the IMF expects respective figures of 3.9% and 2.8%.

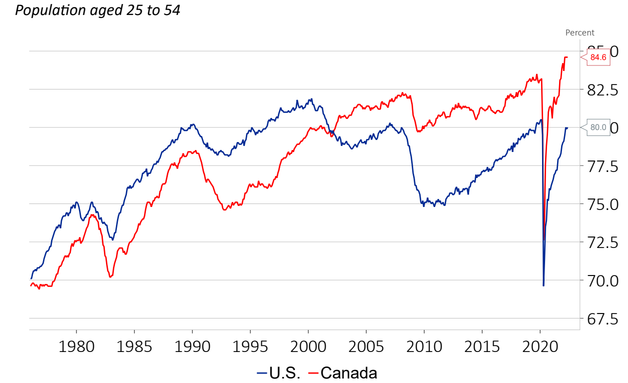
Like we mentioned last quarter, the strength of Canada's labour market is the key tailwind, as well as its terms of trade.

The employment rate of Canadians aged between 25 and 54 years old is currently sitting at an all-time high of close to 87% (compared to 80% in the U.S., see graph 8), showing a broad participation to the positive economic story.

Graph 8

Canada: Perspectives on Employment Rates

Population aged 25 to 54



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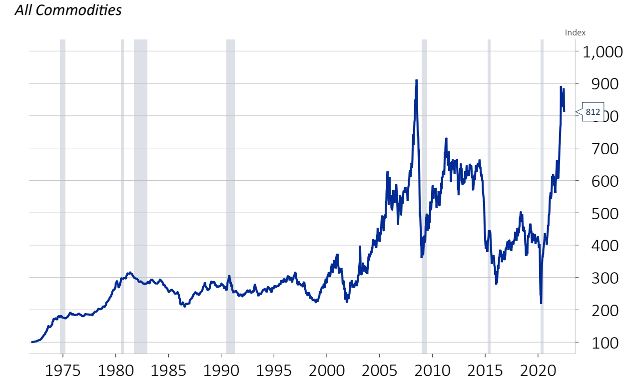
The rise in prices of global oil and material prices is also an important tailwind for Canada, as the Bank of Canada's index of commodity prices is now sitting close to all-time highs, second only to the peak reached in 2008 (graph 9).

Graph 9

Canada: Bank of Canada Commodity Price Index

All Commodities



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Both elements should contribute to shield the Canadian economy from sliding into a recession over the next 12 months. While Canada is a small, open economy and should naturally feel the global economic slowdown, we view the odds of a Canadian recession in that span at about 35%.

That is not to say that Canadians are not facing some important issues. Like everywhere else in the developed world, inflation is eating at spending power and weighs on consumer and business confidence. As the second quarter ended, Canada's inflation rate was still rising, reaching a 40-year high of 7.7% in May, pushed higher by a change in methodology (the price of used cars was included in the calculation for the first time) but mostly by still-growing gasoline prices, which were up double-digits on a monthly basis in March and May.

Just like the Fed, the Bank of Canada is walking a tight rope, with inflation at high levels and consumer confidence fading. As with the Fed, the strong language used by the Bank of Canada is likely a strategy to keep inflation expectations anchored (no central bank wants to suggest that it won't be able to rein inflation back in), but with price gains coming mainly from food and gasoline right now, it is unlikely that higher interest rates is a one-size-fits-all solution.

Markets

The second quarter of 2022 turned out to be one of the worst in history, in terms of market performance.

Over the last 3 months, global equities (represented by the MSCI All Country World Index) posted a return of -13.6%, while global bond prices (represented by the Bloomberg Global Aggregate Index) returned -8.5%. To put these figures into perspective, not even in 2008 had a 60/40 portfolio posted such negative quarterly returns…

Investors should look at 2022 and recognize it as an outlier. Historically, the likeliest outcome in any given year is that 1) both equities and bonds offer positive returns, or 2) diversification benefits kick in, and either bonds or stock are in the green when the other asset class is in the red. Well, 2022 offers by far the worst annual combination of negative combined returns on stocks and bonds.

The reason behind this historical market behaviour is that global central banks entered the year under pressure to massively hike interest rates, following 2 years of extraordinary fiscal and monetary policies. As mentioned in previous sections, the pace at which the Fed and other major central banks are hiking in 2022 is unmatched, leading to much higher interest rates across the curve, and falling stock market valuations. The result: Wall Street is officially in a bear market, after falling by more than 20% since the high of January 3, 2022.

Bear markets are tough times for investors, but the playbook is fairly simple. Looking at data since 1950, we find that the average bear market brings the S&P 500 down by about 30%, in the span of close to a full year. As the second quarter ended, the S&P 500 was down by close to 20%, indicating that we might be 2/3 of the way to the average bear market, but in a span of only about 120 days. As bear markets tend to be volatile and offer multiple bear market rallies (it is common to see between 5 and 10 rallies, some as strong as 25%), this suggests that we could have a negative and volatile second half of the year.

Looking at interest rates, the weakening economic picture and the rising odds that inflation will peak somewhere in the second half of the year could mean that we see the highs for the year on rates, and that we are at a good entry point to add bonds to portfolios. Depending on the how low the stock market can go, and how much of an impact the weakening global economy could have on pushing inflation lower, part of the losses witnessed in global bond indices so far this year could reverse by year-end.

Strategy

As we started the year, our conviction was that value and cyclicals would lead the way, for growth to lag, and more importantly for Canadian equities to be well positioned for an outperformance. These views worked well in our favour and guided us in our general positioning throughout the first half of the year, by for example keeping an overweight position in Canadian equities all through the first half of the year.

Guided by these views, we started the year with a neutral-to-underweight position on equities (OW Canada, neutral/UW US) and a strong underweight on bonds. Both these positions were tactically adjusted as the year unfolded, and we remain in a tactical mood at mid-year.

As we moved forward in the year, we adjusted our positioning multiple times to benefit from the opportunities offered by the markets. While we started with a more neutral outlook on equities, we gradually moved to an underweight, with a growing negative bias towards the US stock market. Regarding fixed income, as interest rates were rising quickly, we shifted the positioning in early H2 from an underweight to a gradually neutral stance. We focused on lowering our exposure to corporate bonds (credit risk) and shifted more toward federal and provincial bonds.

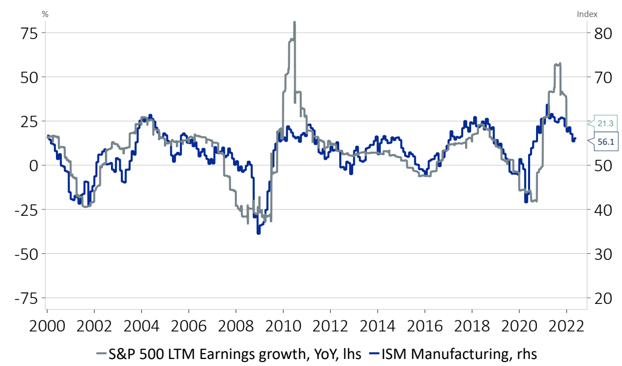
Looking forward, we believe that we should remain in a bear market scenario for the next couple of quarters, and that it will remain appropriate to keep an underweight stance towards equities in the coming quarters.

While the first part of the stock market pullback was caused by falling valuations, the next step should be a downward revision to expected earnings. Historically, as the U.S. economy weakened, 12-month growth in S&P 500 earnings followed suit with a lag of about 6 months (graph 10). Our indicators are pointing to global growth weakening into 2023, meaning that earnings growth could be under pressure over the coming 12 months.

Graph 10

S&P 500: Earnings Growth vs ISM Manufacturing

6 month lead on ISM



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Turning to fixed income, the rapid rise in rates over the first half of the year remains, in our opinion, an opportunity to add duration to portfolios, through long-term (20 years +) U.S. treasuries, as a source of diversification. As markets are pricing the Fed will likely tighten its monetary policy too much and will likely have to proceed with cuts in the latter part of 2023, long-term rates are looking attractive at the current levels.

Finally, as global growth is weakening and market sentiment is still deteriorating, we believe the Canadian dollar could stay under pressure until we see sentiment bottoming.

Economic and Financial Environment (continued)

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Chart 1
Returns of the Canadian Bond Market as at June 30, 2022

Index	Returns (%) 3 months	Returns (%) YTD
FTSE Canada Universe Bond Index	(5.7)	(12.2)
FTSE Canada Short Term Bond Index	(1.5)	(4.4)
FTSE Canada Mid Term Bond Index	(4.8)	(11.3)
FTSE Canada Long Term Bond Index	(11.8)	(22.1)
FTSE Canada Federal	(4.2)	(9.5)
FTSE Canada Provincial	(7.7)	(15.6)
FTSE Canada Municipal	(6.7)	(14.1)
FTSE Canada Corporate	(4.8)	(11.0)

Chart 2
Market Returns as at June 30, 2022

Index	Returns (%) 3 months	Returns (%) YTD
FTSE Canada 91 Day T-Bill Index	0.1	0.3
FTSE Canada Universe Bond Index	(5.7)	(12.2)
S&P/TSX Composite Index	(13.2)	(9.9)
S&P 500 (Can. $)	(13.4)	(18.3)
MSCI - EAFE (Can. $)	(11.7)	(17.9)
MSCI - World (Can. $)	(13.4)	(18.8)
Exchange Rate (Can. $ / US $)	3.3	2.1

Chart 3
Canadian Market Returns as at June 30, 2022

Index	Returns (%) 3 months	Returns (%) YTD
S&P/TSX Sector Allocation		
Energy	(1.9)	26.2
Materials	(23.6)	(8.3)
Industrials	(12.7)	(9.3)
Consumer Discretionary	(10.2)	(17.1)
Consumer Staples	(6.2)	(1.1)
Health Care	(49.6)	(53.9)
Financials	(13.1)	(11.2)
Information Technology	(30.7)	(55.3)
Communication Services	(8.8)	(0.7)
Utilities	(3.5)	1.3
Real Estate	(17.8)	(21.7)
S&P/TSX Composite Index	(13.2)	(9.9)

Economic and Financial Environment (continued)

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Chart 4
Economic and financial scenarios

Economic scenario

							Change since March 31, 2022	
		2020	2021	2022	2023	2024	2022	2023
U.S.	Real GDP	-3.4%	5.7%	2.5%	1.9%	1.9%	-0.9%	-0.3%
	Inflation rate	1.2%	4.7%	7.5%	3.4%	2.3%	+1.0%	+0.4%
	Unemployment rate	8.1%	5.4%	3.6%	3.6%	3.8%	--	+0.2%
Canada	Real GDP	-5.2%	4.7%	3.8%	2.4%	1.9%	-1.0%	-1.5%
	Inflation rate	0.7%	3.4%	6.4%	2.8%	2.1%	+3.0%	-2.0%
	Unemployment rate	9.6%	7.4%	5.3%	5.4%	5.5%	-2.1%	-0.4%

Financial scenario*

			Targets			Change since March 31, 2022	
		Actual	Dec. 22	June 23	Dec. 23	Dec. 22	June 23
Interest rate	Canada 10-year rates	3.22%	3.15%	3.05%	3.05%	+0.50	+0.25
	U.S. 10-year rates	2.98%	3.17%	3.00%	3.00%	+0.47	--
Exchange rate	$US/$CA	0.78	0.80	0.82	0.83	-0.08	-0.08
	$US/EUR	1.05	1.09	1.10	1.14	-0.05	-0.05
	Oil price (WTI). $US	106	110	115	115	+15	+25
	S&P 500	3,800	3,750	3,900	4,200	-1,150	-1,100
	S&P/TSX	18,870	18,900	19,850	21,500	-4,450	-4,670

* end of period