

Quarterly Market Commentary

April 2022



TD Economic Forecasts Q2 2023

10 year Canada bond:	2.30%
10 year US bond:	2.40%
CAD:	0.80
Gold:	\$1818
Oil:	\$80

As of Mar 31, 2021. Source: TD Economics

Over the past few quarters, I have been concerned about the valuation of the equity market and the risk that inflation would not be “transitory.” We positioned the portfolio to mitigate some of the risks that I feared would materialize. Although we were early in our positioning, the first quarter of 2022 proved that valuations in equities do matter, and that inflation can be punishing to both stock and bond investors. In my opinion, the Russian invasion of Ukraine only exacerbated the inflation story and highlighted the fact that the equity market is susceptible to a decline because it was priced to perfection in late 2021. I think we have to be very thoughtful regarding how we allocate capital in a world of stubbornly high inflation, rising interest rates and quite frankly a world that has suddenly become riskier after the Russian invasion. Below I discuss how the bond and stock market have performed and how I’m positioning in each asset class.

Bonds

This has been the worst quarter for the bond market since 1994. In Canada the Canadian Consumer Price Index (CPI) increased by 5.7% year over year in February, up from a gain of 5.1% in January. This was the largest increase since August 1991 (+6.0%.) In the US, the number was 7.5% in February, which was the biggest gain since 1982. The surge in inflation caused interest rates to rise and bond prices to fall. The Canadian Universe Bond index (all bonds) declined by 6.97% in the quarter. The bonds with the longest maturities (10 years plus) suffered the biggest decline in price and the relevant index fell by 11.73% in the quarter.

Where do we go from here? I do think that central banks around the world are motivated to curb inflation. Unlike the past, I think they have resolve in sticking with their plan to reduce liquidity (by no longer buying bonds and even selling bonds) and simultaneously raise interest rates. Over the past 40 years, bonds have proven to be fantastic investments as they not only have provided a hedge against equity market volatility, but they have continued to increase in value as inflation and interest rates continued to decline. 2022 may signal the end of that era. It’s very

possible that unlike the past, instead of being a hedge against equity market volatility, the bond market could be the epicenter of risk.

Since short term rates have already climbed so much, I think owning short term bonds (under five years) offers a compelling risk/reward opportunity, especially for those that need income or capital over the next few years. For most others that are looking for growth, bonds may be a constant drag on performance.

Equities

Low interest rates and inflation are for the most part very beneficial for equities. The low interest rates allow for a higher valuation since investors are willing to pay more for stocks when the alternative (cash or bond) rates are so low. Low inflation also contributes to high share prices as companies have lower input costs and higher earnings. Of course, the reverse is also true in an environment of higher interest rates and higher inflation, and it explains why most global stock markets posted negative returns in the first quarter of 2022. As you would expect the largest declines were in those indices that had the highest valuation, namely technology companies. The Nasdaq declined by 10.38% in Canadian dollar terms in the first quarter alone. The S&P 500, which has a fairly high technology exposure, also declined by 5.97%. Indices outside of North America hardly fared better with the World Index declining by 6.52%.

With the high allocation to energy and resources, the Canadian stock market was one of the outliers posting a positive 3.82% return. I think the broad-based indices are going to struggle as the central banks remove liquidity from the markets. Despite the decline this past quarter, the valuations are still not cheap. However, there are sectors and industries I believe will continue to deliver solid returns for investors:

- Healthcare offers a very compelling risk/reward opportunity for investors. Valuations are reasonable, this sector is generally able to pass on higher costs to consumers thereby maintaining their profit margins and I think we are in an era of transformative healthcare innovation.
- Resources will likely continue to perform as it's not only a hedge against inflation but also many resources are required if we want to "green" the economy. Copper, Lithium, Nickel are in short supply

and for the most part, the sector has been ignored by investors for a long time.

- Historically stable dividend paying companies like utilities and telecom will have a place in the portfolio as investors leaving bonds will seek the safety of those dividends.
- Certain financial companies will also do well in a rising interest rate market.

This is time to be very selective in the companies and sectors to own.

I was quite bullish on Europe last year and thought that the continent was actually starting to act like a union and the Euro could actually be a serious competitor to the US dollar. My view on that has changed. I think Europe will be engulfed in an environment of high inflation since they are so dependent on foreign energy and at the same time a slowing economy. We've reduced our allocation to Europe but I still like the UK given it's not as dependent on Russian energy and it trades at a low valuation and high dividend yield.

I believe the next quarter will again be challenging for equities. We have never been through a period where the central banks are reducing liquidity and raising interest rates when there is a major world conflict. The higher commodity prices and disruption in supply chains will likely continue to drive inflation higher putting further pressure on the central banks. Companies will start reporting earnings and some may already feel the impact of higher input costs. I don't think analysts or investors have reduced earnings expectations.

The war between Russia and Ukraine in my opinion will not be resolved in quick order. Hopefully it doesn't get worse. There are going to be a lot of moving parts. However, I'm very comfortable with our existing holdings, as our portfolio has had a strong performance this quarter and we have capital to take advantage of opportunities in some of the industries or sectors we like for the long term.

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Source:

<https://economics.td.com/ca-quarterly-economic-forecast>

<https://www150.statcan.gc.ca/n1/daily-quotidien/220316/dq220316a-eng.htm>

<https://www.cnn.com/2022/02/10/january-2022-cpi-inflation-rises-7point5percent-over-the-past-year-even-more-than-expected.html>

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