TD Wealth

Commentary – Q1 2022 – The Fog of War

The supply chain for global goods and raw materials was already feeling the upheaval of a global health crisis, now heading into its third year. It hardly needed geopolitical strife in eastern Europe to be added to the mix. Entering the late winter and spring of the new year, global markets are facing input pricing pressure that has not been seen for decades. This can chiefly be explained by supply chain disruptions that have built over the last two years since COVID-19 emerged.

But now, soaring commodity prices, sweeping financial sanctions and the potential for a ban on energy imports from Russia after it invaded Ukraine in late February are threatening to hobble a global economy still trying to emerge from a series of COVID lockdowns. Indeed, it is beyond the scope of this commentary to address the humanitarian crisis that is unfolding now in Ukraine. But that may change if the conflict evolves into something more global.

For now, suffice it to say that these developments are further complicating the task of central banks that had been preparing to phase out easy money gradually over the course of the next few years. On both sides of the Atlantic, inflation is at levels that haven't been seen for decades, and still rising. Global stock markets have been much more pessimistic of late, and the U.S. dollar is strengthening against other global currencies as many investors rush for the safety of U.S. assets, particularly U.S. Treasuries.

On top of this, higher prices for most consumer goods and services will most likely remain high. Forecasters have increased consumer price projections for 2022-2023 to reflect oil prices, core goods inflation and core services prices. That said, TD Economics expects Consumer Price Inflation (CPI) to slow towards 2.7% year over yea, by the end of 2023, largely because of the normalization in crude oil prices. TD Economics also expects the CPI core inflation rate (without energy inputs) to slow and fall back to target (at 2%) but once again, only by the end of 2023 at the earliest. Yes, inflationary pressure was supposed to be *transitory,* but the reality is, all events are transitory. It is what they leave in their wake that matters. And prices have established a new base level that is unlikely to ever decrease materially.

More worryingly, economists are increasingly warning of a possible bout of *stagflation*, particularly in Europe. Stagflation is a situation of high inflation and low growth such as the one that afflicted major economies during the 1970s. Back then, central banks responded to a surge in oil prices with easy-money policies that caused a wage-price spiral. Replace the surge in oil prices back then, with the onset of an unexpected global health crisis and the first major military conflict in Europe in a generation - does this scenario sound familiar?

TD Wealth |

At the outset of the first quarter of 2022 (Q1), the European Central Bank (ECB) and U.S. Federal Reserve (Fed) had indicated that they planned to move rapidly to phase out easy-money policies. Both are now likely to be cautious, however, reflecting the new economic risks, because of the Russia-Ukraine crisis.

ECB officials have signaled they will indeed move cautiously, despite inflation rising to 5.8% in February, almost three times the ECB's 2% target. At the heart of the latest bout of uncertainty is Russia. Russia is the world's 11th-largest economy and a crucial energy supplier to much of Europe. In recent weeks, Western nations have imposed the most sweeping economic sanctions against a major G20 country in decades.

The uncertainty surrounding the fallout from Russia's military campaign against Ukraine has drawn similarities to the financial crisis of 2008 and 2009. It is similar in that there is uncertainty about who has exposure to Russian assets, especially debt, and how much the West's economic reaction to the war will exacerbate already fragile supply chain infrastructure.

Europe, with its geographical proximity to the conflict and heavy dependence on Russian energy, is potentially facing its third recession in two years. The U.S. economy is likely to fare better given its role as the world's top oil producer and still-sizable household savings, but even in the U.S., surging inflation is likely to weigh on consumer spending and growth.

Even before the Russia-Ukraine conflict, Europe's economic recovery had less momentum than that of the U.S., partly because of lower government spending. Eurozone consumer spending and investment are both well below the path they were on before the pandemic, while the U.S. has returned to that path, according to ECB data.

Meanwhile, here at home, the Bank of Canada (BoC) has resumed its hawkish stance on monetary policy. Indeed, governor of the BoC Tiff Macklem has indicated that a series of rate hikes will continue through to the end of the year, barring any unforeseen developments or pandemic outbreaks, to bring policy rates back to neutral. The agreed upon policy neutral rate has been established at between 2% and 3%. Between the lines, it can be inferred that policy makers realize that it is better to risk a mild recession by doing this (although a *soft landing*, where rates are increased gradually, while avoiding economic recession, is preferable), rather than not get ahead of inflation, which has much more destructive longer-term consequences.

The equity markets themselves have been gyrating throughout Q1, largely responding to the shape of the yield curve. The shape of the curve is the spread between short term rates set by the central bank, and longer-term rates, established by the bond market. The spread, or the difference between yields at different maturities, illustrates the flatness, steepness, or inversion of the curve. Most of the time, yield curves slope upwards in a positive spread. A flat curve is one where the spread hovers around zero, while an inverted yield curve implies a downward slope with a negative spread.

An inversion is a strong indicator of recession, but not every spread is created equal: the 2-year/10-year bond yield has historically been held in high regard. When the curve inverts and 2-year bonds yield more than 10 year - indicating interest rates will fall - it's viewed as a recession warning light. While the recent curve inversion is a concern, the future is not entirely predicted by the past and this cycle is already very different.

The U.S. 2-year to 10-year yield curve briefly inverted late in Q1 with the spread trading at about 4 basis points (bps) as of early April. For now, fears of recession in coming quarters are potentially overstated, and the trajectory of inflationary pressure being much more worrisome. It is likely that the impact of inflation on the Fed's monetary policy remains the biggest uncertainty. The market knows that a bit of short-term pain (in the form of tighter monetary policy) for longer-term gain is a good thing. But in the meantime, it will most likely continue to throw tantrums because of these policy decisions.

The spring and summer will probably continue to be volatile, as the war in Europe drags on. Meanwhile, those who take the longer view realize that the bill of inflation is just now coming due after several years of very accommodative monetary policy. The fight to corral inflation and maintain a stable economy has just started.

Best regards,

Cameron Stirling

Cameron Stirling, CIM®
Senior Investment Advisor
TD Wealth Private Investment Advice

Montreal

April 2022

Sources: [1]WIO – Q1 2022 Quarterly Market Review - TD Wealth; [2]Portfolio Strategy Quarterly – TD Wealth – Q1 2022; [3]Jim Kelleher, CFA, Director of Research – Argus Research Corp - March 2022; [4] Global Economy Braces for War's Impact - Tom Fairless – WSJ.com – March 2022; [5] Market Insights: Distortion: Yield Curves and Inflation - Wealth Investment Office, TD Wealth

Information contained herein has been provided by Cameron Stirling, Investment Advisor and is for information purposes only. The information has been drawn from sources believed to be reliable. The information does not provide financial, legal, tax or investment advice. Investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. Certain statements in this document may contain forward-looking statements ("FLS") that

TD Wealth

are predictive in nature and may include words such as “expects”, “anticipates”, “intends”, “believes”, “estimates” and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS. Index returns are shown for comparative purposes only. Indexes are unmanaged, and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

Stirling Wealth Management is a part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank. All trademarks are the property of their respective owners. ® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.

Stirling
Wealth
Management

TD Wealth