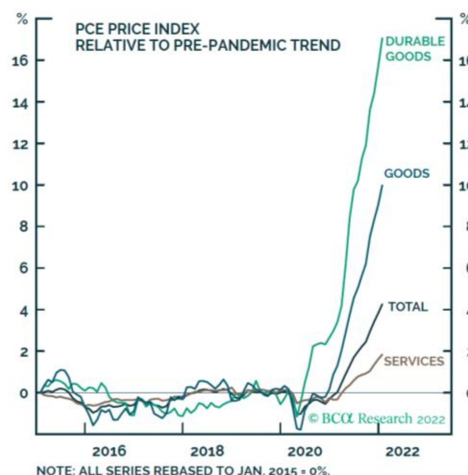
Quarterly Commentary

April | 2022

A challenging start to the year

Chart 1: Durable Goods having the biggest impact on inflation



Source: BCA Research

Entering this year, we were faced with a number of unknowns. COVID remained a primary concern for the markets as daily new cases continued to climb despite increasing vaccination rates. Global new daily cases peaked, four times higher than prior peaks, in the third week of January, but fortunately with fewer daily deaths. Almost two years into the pandemic, people wanted to go out and spend, thanks to rising wealth. With COVID restrictions in place, spending on activities was curtailed, which prompted people to spend on items. The combination of supply chain problems along with strong consumer appetite has led to higher inflation, particularly in durable goods (Chart 1) such as cars, household appliances, furniture, and machinery. Enter the Federal Reserve.

We've used the term "don't fight the Fed" on numerous occasions. Simply put, all else being equal, when the Fed is on the path of lowering rates, stock valuations tend to rise, but when the Fed is on the path of raising rates, the opposite holds true and valuations decline. This is what we've seen in the first quarter. The stock market is a discounting mechanism, pricing in the probability of interest rate hikes and some slowing of the economy. While many factors need to be considered: the state of the economy (hikes usually occur when the economy is strengthening), earnings growth prospects, and bond yields to mention just a few, it sure is a lot easier making ground going downhill on a bike than it is to go uphill. Rates were low because the economy needed a lift due to the pandemic shutdown, but the economy is now stronger and more than able to withstand higher rates.

Russia's invasion of Ukraine adds more uncertainty for capital markets. The volatility seen in stocks in the first quarter reflected the significant near term uncertainties: the war, inflation, and the Fed. The global economy was on strong footing heading into this crisis and was further supported by the diminishing impact of the pandemic. However, sanctions on Russia have indirect consequences for the rest of the world. Russia and Ukraine are major exporters of commodities, to Europe in particular, and disruptions to these exports are leading to surging commodity prices putting even more upward pressure on inflation. This makes the Federal Reserve's (and other central banks) job of maintaining price stability even more challenging. We've seen evidence of this at the gas pumps. Another not so obvious impact of this conflict may be on the ever so important semiconductor industry, and the pricing and availability of semiconductor chips. About half of the world's supply of neon gas, used by semiconductor manufacturers to control specialized lasers to make chips, is from Ukraine. The two main suppliers are based in the cities of Mariupol and Odesa. The former has been under siege by Russian forces. While there are still months of neon gas in reserve, any disruption to supplies beyond this period could lead to an even more prolonged semiconductor shortage. This will worsen the issues plaguing many industries, but in

particular the automobile manufacturing sector. Rising car prices, both new and used, are a significant contributor to inflation. Cars accounted for 27% of the year over year increase in inflation in the past year, versus an average of 8% over the 20 prior years. Should automobile inflation revert back to normal, headline inflation would be pulled down by about 1.5%.

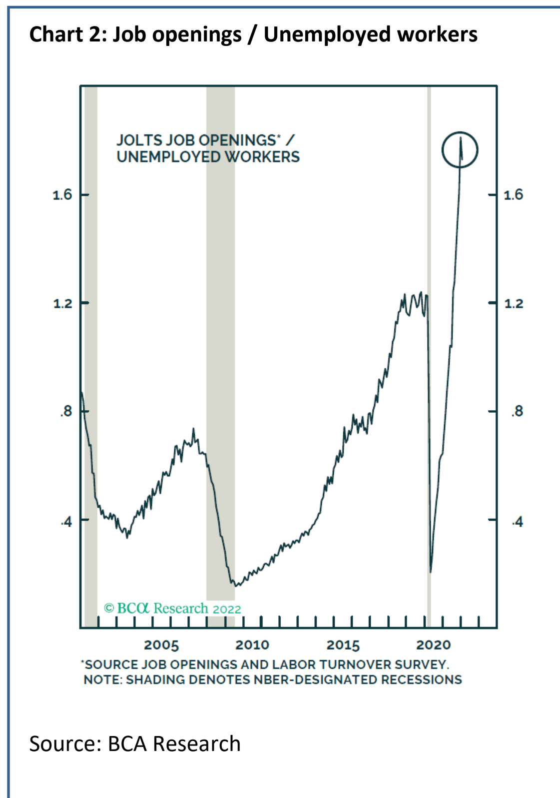
China's policies on COVID have hampered improvement in the supply chain, contributing to this persistent inflation problem. While their zero-COVID strategy helped with controlling the original variant, Omicron has been much more difficult to contain. Some studies have also shown that China's vaccines have been largely ineffective against the variants of the original virus. Businesses and factories in China have been intermittently halted to contain the spread of the virus, but with very little success. Other countries have abandoned using mass lockdowns and strict social restrictions, but their populations have the benefit of access to effective vaccines.

Given these challenges that the capital markets faced in the first quarter, it may be surprising to many that stocks outperformed bonds in the quarter. The rapid rise in bond yields in anticipation of more rate hikes on the horizon led to a -6.97% decline in Canada's Universe Bond Index. This follows a -2.54% decline in the prior year. Stocks were volatile in the quarter and experienced the first correction since 2020. Yet they staged a late month recovery. Plain and simple, stocks are a better inflation hedge than bonds.

A constantly changing outlook

While we continue to expect outperformance in stocks versus bonds in 2022, the absolute upside is likely less than our expectations were heading into the year. We are less bullish given the persistence of high inflation and the factors that could prolong this problem. At the onset of this year, we anticipated outperformance by international stocks given our view that economic growth was broadening and the valuations were much cheaper abroad. The possibility of a greater number of rate hikes than expected, along with global geopolitical conflicts both act to hamper economic growth, even though the economy is strong and growth still above trend at this point. We see a better outlook for the North American economy and for stocks in the U.S. and Canada. U.S. stocks in particular, should benefit from fund flows as worries about global economic growth surface, given their larger sector exposure to the non-cyclical areas of the market, technology and healthcare. Canada's stock market will benefit from the higher exposure to the energy and materials sectors due to the persistent underlying strength in commodity prices.

Chart 2: Job openings / Unemployed workers



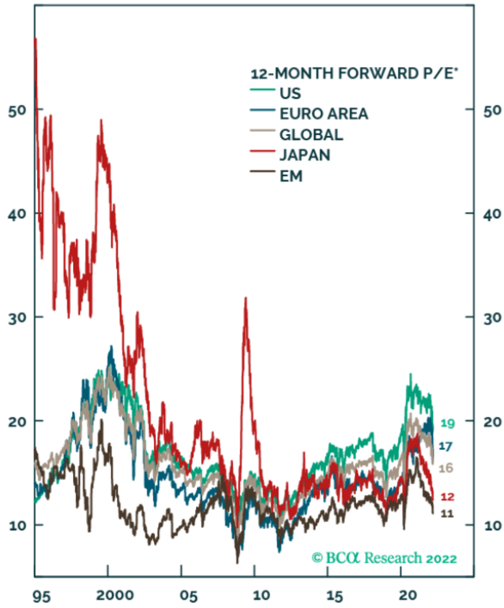
Source: BCA Research

The U.S. $2.6 trillion in excess savings in the U.S. will blunt the impact of higher inflation and rising interest rates. Perhaps spending on some big ticket items may be deferred (in particular car purchases), but people with assets are looking to spend on services, entertainment and travel, and this pent up demand is unlikely to abate. Income is not a problem overall, as there are 1.7 jobs available for every unemployed worker (Chart 2), and wages have risen.

We are positive on the financial markets for the remainder of 2022, particularly after the price correction in *both* stocks and bonds, but also acknowledge that this structural bull market is nearing its final legs. The recent decline in equity prices and increase in bond yields enhances the prospects for better returns in the coming six to twelve months. Global stock valuations are not too demanding (Chart 3), particularly in the

context of the earnings outlook and where bond yields are despite the recent rise. The war in Ukraine and China's troubles with COVID are threats to this constructive intermediate term view and we expect volatility to persist.

Chart 3: Stock valuations have come down



Source: Refinitiv / IBES Data, BCA Research

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2
T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449

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