MACKENZIE Investments

Quarterly Market Matters

Summary for Q1 2022

Brent Joyce, CFA
Investment Strategist

Justin Truong, CFA
Senior Manager, Investment Strategy

Highlights

Stocks record their worst quarterly loss since Q1 2020. Global bond yields moved sharply higher, worsening the rout to start the year.

US headline inflation accelerates to 7.9% y/y. Shorter to medium-term inflation expectations jump sharply. Long-term expectations remain anchored for now, but the Fed has turned hawkish.

Corporate earnings growth remains solid, and profit margins hold up well, but the results take a backseat to inflation and geopolitical concerns.

US 10-Yr less 2-Yr yield curve inverts for the first time since 2018, increasing recession fears.

Covid → inflation → geopolitics

Global equity markets suffered their worst quarterly loss since the depths of the pandemic back in Q1 2020. The invasion of Ukraine dominated headlines and exacerbated the existing overhangs facing the global economy - fears over inflation, slowing growth and uncertainty over future central bank policy. Rising inflation expectations have turned central bankers even more hawkish, pushing global bond yields to pre-pandemic levels. Bond yields spiking higher led to one of the worst quarters for global fixed income and a deep correction in long-duration, interest rate sensitive growth stocks. Value stocks outperformed growth, bolstered by surging commodity prices, rising yields, and a better starting point for valuations. Tech-heavy US indices plunged, while the S&P/TSX Composite was one of the few major indices to record a gain, benefitting from its significant commodity exposure.

Oil and European natural gas prices soared. Brent crude oil prices jumped as high as US$139.13/bbl (highest since 2008), and German natural gas futures at one point spiked over 300% to a record high of US$282/MWh before settling back to US$126/MWh. The rally in commodity prices and US headline CPI inflation clocking in at a scorching 7.9% y/y in February have central banks turning hawkish. At its March meeting, the US Federal Reserve (Fed) raised the Fed Funds Rate by 0.25%, the first hike since 2018. The Committee also released its updated Summary of Economic Projections (dot plot), which now sees a total of seven 0.25% hikes for 2022.

Solid footing entering Ukraine Crisis

Although the full consequences of the Ukraine war are still unclear, it is encouraging to note that the global economy entered the crisis on solid footing. Businesses and household demand and activity remain robust, labour markets are improving rapidly, and corporations and households possess fortress-size balance sheets. The US economy grew 6.9% y/y annualized in Q4 2021, while the global GDP forecast for 2022 remains elevated at 4.0%. We expect corporate earnings to grow in line with the solid economic backdrop. US retail sales are still coming in well above the pre-pandemic trend, and except for China, global purchasing manager indices are well within expansion territory (above readings of 50). Business inventories are slowly rebuilding, but

Canadian Fixed Income	Level	Quarter	1Y
FTSE Canada Universe Bond	1,107	-7.0%	-4.5%
FTSE Canada All Corporate Bond	1,289	-6.4%	-4.4%
Bloomberg Canada High Yield	162	-2.5%	0.5%
Global Equities	**Level**	**Quarter**	**1Y**
S&P/TSX Composite	21,890	3.1%	17.1%
S&P/TSX Small Cap	836	7.9%	16.8%
S&P 500	4,530	-4.9%	14.0%
NASDAQ	14,221	-9.1%	7.4%
Russell 2000	2,070	-7.8%	-6.8%
UK FTSE 100	7,516	1.8%	11.9%
Euro Stoxx 50	3,903	-9.2%	-0.4%
Nikkei 225	27,821	-3.4%	-4.7%
MSCI China (USD)	72	-14.2%	-33.5%
MSCI EM Index (USD)	1,142	-7.3%	-13.3%
Currencies and Commodities	**Level**	**Quarter**	**1Y**
CDN $	$0.800	1.0%	0.4%
US Dollar Index	98.31	2.8%	5.4%
Oil (West Texas)	$100.28	30.3%	69.5%
Natural Gas	$5.64	60.1%	131.0%
Gold	$1,937	5.9%	13.5%
Copper	$4.75	6.7%	19.6%
Canadian Interest Rates	**Level**	**Quarter**	**1Y**
3-month T-bill	0.60%	0.44%	0.51%
GOC bonds 2-yr	2.29%	1.34%	2.06%
GOC bonds 10-yr	2.40%	0.98%	0.85%
GOC bonds 30-yr	2.38%	0.70%	0.40%
Canadian Sector Performance		**Quarter**	**1Y**
Energy		27.4%	52.1%
Materials		19.7%	32.0%
Industrials		3.6%	12.2%
Cons. Disc.		-8.2%	-4.6%
Info Tech		-35.5%	-22.8%
Health Care		-8.7%	-47.1%
Financials		1.4%	18.4%
Cons. Staples		5.0%	24.0%
Comm. Services		7.7%	21.3%
Utilities		4.0%	9.1%
Real Estate		-5.4%	15.6%

Source: Bloomberg & FactSet March 31, 2022 – local currency unless noted, equity price only returns, bonds total return
1. Brent crude 1st futures contract 2. Germany THE Natural Gas 1-month forward futures contract 3. Bloomberg Commodity Agriculture and Livestock Index

there is more restocking needed. March marked the eleventh straight month of at least 400,000 non-farm jobs added in the US. The unemployment rate fell to 3.6%, just a hair shy of the Fed's end of 2022 forecast and the pre-pandemic trough of 3.5%. The tight labour market has propelled wages higher, with average hourly earnings accelerating to 5.6% y/y. Given inflation, real wage growth is negative; however, built-up pandemic savings and a steady climb in wages should help buoy consumer spending. Wages lag inflation, so a rightsizing of real wage growth remains possible.

US corporations showed strength in their Q4 2021 corporate earnings. 77% beat their earnings estimates, while the magnitude of 'beats' was 6.2% q/q. Both figures are solid results and sit roughly in line with their five-year averages. In addition, profit margins, which have been widely forecasted to come down due to rising input costs, have endured and remain at record highs. Nevertheless, the days of spectacular 'beats' appear to be over. Markets are not impressed with just "average" these days. 'Beat' or 'miss,' investors are fixated on inflation and geopolitical risks.

Commodity shock aggravates inflation fears

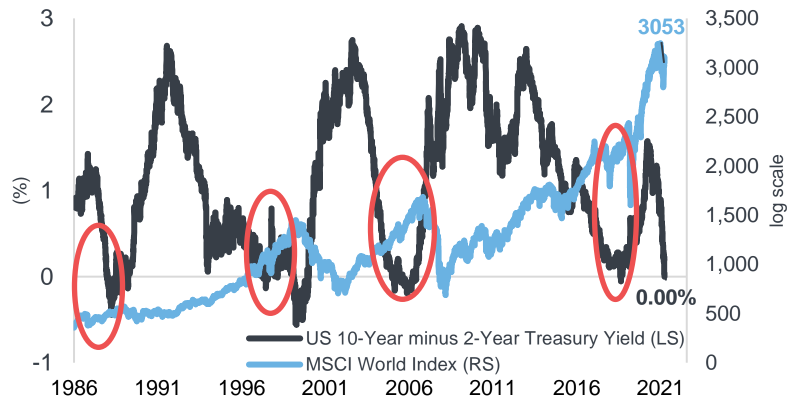
After hitting a 7 (percent) handle at the end of 2021, US headline CPI inflation has soared even higher, reaching 7.9% y/y in February. The invasion of Ukraine has further fueled the broad rally in commodities that began last fall. Overall, the Bloomberg Commodity Index climbed 25% higher in the quarter, led by massive jumps in crude oil (+38%)[1], natural gas (+86%)[2], and agriculture and livestock (+18%)[3]. The energy portion of the CPI basket is up 26% y/y as of the end of February.

The price increases are also not just in energy and food. The Fed's preferred measure, which excludes food and energy prices, the US PCE Core Price Index, accelerated to 5.4% y/y in February, the fastest annual pace since 1983 and towers over the Fed's 2% target. Goods inflation still dominates. Core goods inflation is now up 12.4% y/y, while core services inflation has risen a much smaller 4.4% y/y. However, there is growing evidence that a rotation from goods spending into spending on services is taking place. Real consumer spending on goods (-2.2% m/m) was responsible for the broader decline, with spending on services improving (0.6% m/m). If the rotation continues to materialize as we expect, alongside further easing of supply chain pressures (Fed Global Supply Chain Pressure Index is down sharply to a six-month low), there should be some welcomed relief on prices. Our model calls for inflation to peak soon as the sharpest base effects from 2021 kick in over the coming four months, but it also requires more monthly PCE prints in the sub 0.4% range. The commodity price shock due to the war in Ukraine brings considerable risk to this view, and the peak for inflation may be pushed out a few months.

Inflation - Too hot to ignore

As expected, the Bank of Canada (BoC) and the Fed raised their overnight rates by 0.25%. The BoC sits at 0.5%, while the Fed Funds Rate range is between 0.25% to 0.50%. Expectations for BoC rate increases in 2022 are pegged at ~2% over the remaining six meetings, implying some form of increase greater than 0.25% at one or more meetings. The Fed's announcement and their Summary of Economic Projections, also known as the 'dot plot,' were more hawkish than most analysts expected. The dots now imply 175 bps of rate hikes in 2022, equating to a 0.25% hike at their remaining six meetings. The repricing of central bank rate expectations led to an immense shift up in bond yields. The question facing central banks is whether future policy should focus on supporting growth or fighting inflation, all amid the Russia/Ukraine conflict. For the Fed, they made it abundantly clear the answer is to fight inflation, repeatedly stating they are adamant about "restoring price stability" and left the door open for a 0.5% move if the data warrants. The Fed also mentioned that they had made significant progress in setting a blueprint to reduce their ~US$9 trillion balance sheet (quantitative tightening). An announcement could come as early as May.

Chart in focus: Yield Curve Curveballs



Market participants pay very close attention to the slope of the US Treasury yield curve (the difference in yield between any two tenors across the curve). As central banks increasingly focus on reigning in inflation and re-anchoring inflation expectations, bond yields are shooting higher, and the yield curve is flattening. The yield curve is a powerful leading indicator, and a flattening curve is a recession warning sign. The fear is that to alleviate the pressure on inflation from pandemic and war-related commodity price and supply shocks, central banks will have to tighten monetary conditions such that demand is crimped. The worry is whether slower growth equates to a soft landing or an overshoot into outright contraction/recession. There is debate on which part of the yield curve is most important. Many (us included) believe the more sections of the curve that are inverted, the stronger the signal. As of early April, the front of the yield curve (out to 3 years) is still quite steep, but the 3 to 30-year section is a wavy mix of flat to slightly negative in parts. Let's shore up some historical facts: Historically, it has taken 12-18 months for a recession to arrive after the yield curve first inverts. Stocks would be expected to sell off in advance of the recession as growth deteriorates, but the first point of inversion hasn't necessarily been a time to sell as stock markets can continue to rally. Bottom line, the yield curve currently gives us a reason for caution, but not yet action – just one of the reasons why we maintain a neutral stance in our asset allocation.

Source: Bloomberg & FactSet March 31, 2022 – local currency unless noted, equity price only returns, bonds total return
1. Brent crude 1st futures contract 2. Germany THE Natural Gas 1-month forward futures contract 3. Bloomberg Commodity Agriculture and Livestock Index

Commissions, trailing commissions, management fees, and expenses all may be associated with mutual fund or ETF investments. Please read the prospectus before investing. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated. Index performance does not include the impact of fees, commissions, and expenses that would be payable by investors in the investment products that seek to track an index.

This document includes forward-looking information that is based on forecasts of future events as of March 31, 2022. Mackenzie Financial Corporation will not necessarily update the information to reflect changes after that date. Forward-looking statements are not guarantees of future performance and risks and uncertainties often cause actual results to differ materially from forward-looking information or expectations. Some of these risks are changes to or volatility in the economy, politics, securities markets, interest rates, currency exchange rates, business competition, capital markets, technology, laws, or when catastrophic events occur. Do not place undue reliance on forward-looking information. In addition, any statement about companies is not an endorsement or recommendation to buy or sell any security.

The content of this commentary (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it.

Source: Bloomberg & FactSet March 31, 2022 – local currency unless noted, equity price only returns, bonds total return
1. Brent crude 1st futures contract 2. Germany THE Natural Gas 1-month forward futures contract 3. Bloomberg Commodity Agriculture and Livestock Index