Monthly Market Matters

Summary for January 2022

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Highlights

Global equities and bonds sell-off. Rising bond yields sullied fixed income returns and initially punished growth stocks, but equity losses spread more broadly in the back half of the month.

Bank of Canada and US Federal Reserve on hold, surprising many. Both heavily hint towards a first rate hike in March.

Earnings growth remains solid, and profit margins hold up well, but analyst earnings estimates have caught up to Corporate America.

Global economy showed signs of strengthening toward the end of 2021.

A taste of reality

Global equity markets swooned in a volatile start to 2022, with many broad indices suffering their worst monthly loss since the March 2020 nadirs of the pandemic. Omicron is still wreaking havoc, but that was not the primary reason for the weakness. Instead, it has been the sharp hawkish pivot by several global central banks in the face of the fastest inflation in decades, leaving investors fearful that central banks might go too far, too fast. However, the Bank of Canada and the US Federal Reserve (Fed) opted to avoid raising rates this month despite markets increasingly pricing in a potential rate hike. Both heavily hinted that March would be the month for rate lift-off, aligning their views much more closely to market expectations. This led to a sharp rise in bond yields, initially punishing long-duration, interest rate sensitive tech and new economy stocks before spreading more broadly into other asset classes (see Chart in focus for more). The FTSE Canada Universe Bond Index recorded its worse monthly loss since 1994, down -3.4% (total return). Meanwhile, The People's Bank of China cut borrowing costs for the second straight month and pledged further easing to stabilize the economy. Chinese stock markets initially reacted positively to the news, but uncertainty surrounding the property sector alongside investors preparing for looming Fed rate hikes weighed heavily in the back half of the month. The CSI 300 and Hang Seng Indices have entered a bear market (-20%) from their previous peak set last February.

The rebound in commodity prices has accelerated on fading Omicron concerns and rising geopolitical tensions involving Russia and Ukraine. OPEC and Russia restraining supply and weaker responses to higher prices by North American producers (capital discipline and ESG factors at play) have global oil markets reasonably tight. WTI crude oil rose 17% to US$88/bbl, (highest level since 2014), while natural gas prices surged 37%.

Corporate America is human after all

2021 brought many surprises, but one fact held constant: quarter after quarter, analysts' corporate earnings estimates were repeatedly smashed by the companies' results. Midway through Q4 '21 earnings reporting, the eyepopping, outsized beats appear to be a thing of the past. Fewer companies are beating their earnings estimates (77% versus the 5-year average of 76%), the lowest number since Q1 2020, and earnings are only

Canadian Fixed Income	Level	3 Month	YTD
FTSE Canada Universe Bond Index	1,150	-0.9%	-3.4%
FTSE Canada All Corporate Bond Index	1,337	-1.0%	-2.9%
Bloomberg Canada High Yield Index	166	-0.4%	-0.5%
Global Equities	**Level**	**3 Month**	**YTD**
S&P/TSX Composite	21,098	0.3%	-0.6%
S&P/TSX Small Cap	765	-3.9%	-1.2%
S&P 500	4,516	-2.0%	-5.3%
NASDAQ	14,240	-8.1%	-9.0%
Russell 2000	2,028	-11.7%	-9.7%
UK FTSE 100	7,464	3.1%	1.1%
Euro Stoxx 50	4,175	-1.8%	-2.9%
Nikkei 225	27,002	-6.5%	-6.2%
MSCI China (USD)	81	-11.7%	-3.0%
MSCI EM Index (USD)	1,208	-4.5%	-1.9%
Currencies and Commodities	**Level**	**3 Month**	**YTD**
CDN $	$0.787	-2.5%	-0.5%
US Dollar Index	96.54	2.6%	0.9%
Oil (West Texas)	$88.15	5.5%	14.5%
Natural Gas	$4.87	-5.3%	37.0%
Gold	$1,797	0.8%	-1.8%
Copper	$4.32	-0.4%	-3.1%
Canadian Interest Rates	**Level**	**3 Month**	**YTD**
3-month T-bill	0.29	15	13
GOC bonds 2-yr	1.27	18	32
GOC bonds 10-yr	1.77	5	35
GOC bonds 30-yr	2.04	4	37
Canadian Sector Performance		**3 Month**	**YTD**
Energy		8.1%	12.5%
Materials		0.7%	-3.4%
Industrials		-6.5%	-2.9%
Cons. Disc.		5.2%	-2.1%
Info Tech		-24.6%	-20.4%
Health Care		-21.1%	-9.2%
Financials		7.3%	3.6%
Cons. Staples		6.1%	-2.7%
Comm. Services		5.3%	1.6%
Utilities		1.6%	-2.3%
Real Estate		-3.9%	-6.0%

Source: Bloomberg & FactSet January 31, 2022 – local currency unless noted, equity price only returns, bonds total return beating estimates by ~5% (below the 5-year average of 8.6%). The result is a product of moderating base effects, rising input costs, and for the go-outside businesses, COVID disrupted demand. As we have alluded to in the past, it is typical for analysts to go through periods where they are overly cautious (2021), followed by periods of optimism. It appears the hefty revisions that took place throughout last year have pulled estimates more in line with reality. Nevertheless, earnings results are still solid. S&P 500 earnings are currently growing at a 24% q/q clip. If this pace holds, it will mark the fourth straight quarter of at least 20% growth, and full-year 2022 estimates are holding in. In addition, despite companies citing supply chain disruptions and inflation as significant headwinds, profit margins have held up remarkably well, climbing higher to over 12%.

Global economy finished 2021 strong

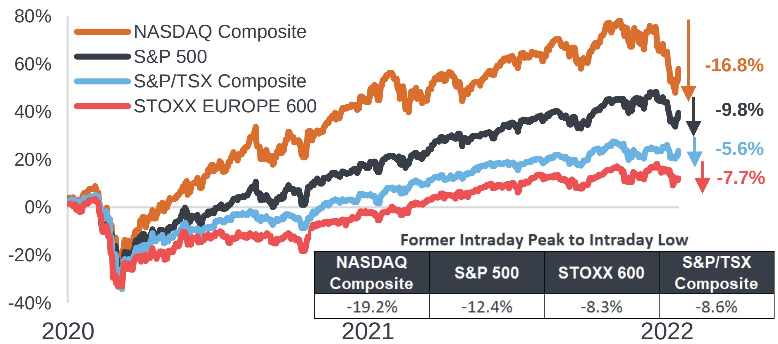
The global economy appeared to be strengthening heading into the end of 2021. Given the rapid spread of the Omicron variant, the data needs to be parsed closely for timing, and a pullback in January 2022 data is to be expected. Nonetheless, US real GDP came in hotter than expected, expanding 6.9% q/q annualized, while December Global PMI figures dipped slightly but remained in healthy expansionary territory. North American labour markets continue to be robust. Canada added 54,700 jobs, more than doubling estimates and bringing the unemployment rate to 5.9%, just shy of the pre-pandemic level of 5.7%. Despite US non-farm payrolls coming in less than expected, the two prior months' already hefty gains were revised higher by a total of 141,000 jobs, while the household survey recorded a 651,000 surge in employment. December's gain also has the US unemployment rate closing in on its pre-pandemic level of 3.5%, down from 4.2% to 3.9%—and there is still plenty of room for the labour market to tighten further, as US job openings remain above a staggering 10 million jobs. With economies appearing to head into full employment territory, it's no wonder central bankers are becoming increasingly hawkish.

Inflation still the name of the game

Inflation sits at the heart of the uncertainty in capital markets, with US inflation running hotter than any, clocking in at 7%, the highest in 40 years. The Fed's preferred measure of inflation, the US Personal Consumption Expenditure Core Price Index (PCE), rose to a near 40-year high of 4.85%. However, forward-looking inflation measures (historically good predictors) from purchasing manager surveys (PMI) paint a mixed picture. The ISM Manufacturing PMI Prices Paid has fallen sharply, while the services reading remains elevated. Central bankers (and us, too) have expectations for inflation to moderate, and there is fundamental support for this argument. Demand is cooling; US real personal consumption contracted -1% m/m in December. This may foreshadow potential relief on goods inflation. However, even if goods inflation eases, the PCE may remain uncomfortably high on services alone. Central banks face a difficult job to normalize monetary policy without upsetting any apple carts (stocks, bonds or the real economy), a task complicated by high inflation. Chair Powell made it clear the Fed takes its price stability goal seriously. Stock markets cheered the Fed's written announcement, only to boo the press conference, where Chair Powell didn't dismiss the idea the Fed could raise rates quickly, or by 0.5%, if they felt they needed. The balance sheet won't shrink until they start rate hikes, but that's soon, and like rate hikes, size matters, but so does the pace. Elevated inflation should be the only reason the Fed might be forced into quicker rate hikes and faster balance sheet reduction - an unfriendly scenario for both stocks and bonds.

Chart in focus: Correction time?

NASDAQ vs. S&P 500 vs. STOXX 600 vs. S&P/TSX Composite
(cumulative return since Dec 31, 2019, arrows are drawdown from peak)



The Fed's hawkish pivot triggered the selloff in equity markets. However, the relative performance amongst the decliners is playing out along the lines we expect. The best performing indices in 2021 have generally performed the worst to start the year, indicating investors are beginning to pay attention to valuations. Value-oriented indices (Europe, Canada) outperformed the growth-oriented NASDAQ and S&P 500. The poster-child for the growth trade is the NASDAQ Composite Index, with its heavy weighting to technology and new economy companies. These growth companies, with their promise of profits farther in the future, are more sensitive to interest rates (those earnings are discounted to today to determine a present value) than companies whose earnings are more consistent in the near term and/or proven, or perhaps better understood. As such, the share prices of growth companies are adapting (re-pricing lower) to the shift up in bond yields (real yields, to be exact). The fact that many growth companies sport high valuations exacerbates this move. The NASDAQ has been weak since late November, and the recent sell-off has driven the Index into correction territory (-10%, but less than a -20% bear market). The move lower in the back half of the month was more broad-based, whereby even the value/cyclical oriented indices are now down on the year, but the damage is more muted. In fact, the S&P/TSX would be flat YTD if not for the weight of the info tech sector. The largest drag comes from Shopify, whose shares are down 29% YTD and nearly halved from their November 19, 2021 high. Single stocks having an outsized impact on the TSX is nothing new, and of course, the pandemic-driven shift to e-tailing has improved Shopify's business prospects. However, now that Shopify shares are up 'only' 50% from their pre-pandemic level, versus ~200% at the peak seven weeks ago, the question is, does this better reflect this positive fundamental shift. *For more of our thoughts on recent volatility, please see our special commentary:* *[Correction time?]*