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Investments

Monthly Market Matters

Summary for February 2022

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Highlights

Stocks extend losses on rising inflation concerns ahead of US Fed and BoC announcements. The Ukraine invasion adds more uncertainty to markets.

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

US headline inflation accelerates to 7.5% y/y. Shorter term inflation expectations surge higher.

Flight to quality ensues after Ukraine invasion, led by US big-tech companies.

Ukraine and inflation front and centre

The objective of this commentary is to highlight the capital market implications of this month's developments. Foremost, our thoughts go out to the Ukrainian people. We hope the situation improves rapidly with the least amount of humanitarian cost.

The escalating geopolitical tensions and eventual invasion of Ukraine dominated headlines. For capital markets, the exogenous shock of the Ukraine crisis exacerbates the existing overhangs facing the global economy - fears over inflation, slowing growth and uncertainty over future central bank policy. It is important to note that the global economy enters this crisis from a solid footing underpinned by robust business and household demand and activity, rebounding labour markets, and fortress-size balance sheets on the part of businesses and households. European and emerging market indices suffered the most in the month. Bond yields climbed higher on rising inflation expectations, hurting tech-heavy US indices. The cyclical rotation firmed, helping the S&P/TSX avoid the otherwise broad-based losses.

Oil and European natural gas prices surged higher. Both WTI and Brent briefly surpassed US$100/bbl, while Dutch TTF natural gas futures spiked ~80% to over US$50 on an intraday basis. All three ended lower to end the month. Soaring commodity prices and US headline CPI inflation coming in at a scorching 7.5% y/y for January had markets briefly pricing in a 0.5% move for the US Federal Reserve (Fed) at the March 16 meeting. However, expectations abated with the January Fed Minutes providing a more dovish tone than expected. The Ukraine crisis further solidified expectations for a 0.25% move.

Corporate earnings take a backseat

Almost all S&P 500 companies have reported Q4 2021 corporate earnings. Of those reported, 76% beat their earnings estimates, while the magnitude of 'beats' is 6.1% q/q. Both figures are solid results and sit roughly in line with their five-year averages, but 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.

In Canada, the Big Banks delivered stronger than expected earnings to start the year. The banks went six for six in toppling

Canadian Fixed Income	Level	Month	YTD
FTSE Canada Universe Bond	1,141	-0.7%	-4.1%
FTSE Canada All Corporate Bond	1,324	-1.0%	-3.9%
Bloomberg Canada High Yield	165	-0.6%	-1.1%
Global Equities	**Level**	**Month**	**YTD**
S&P/TSX Composite	21,126	0.1%	-0.5%
S&P/TSX Small Cap	806	5.4%	4.2%
S&P 500	4,374	-3.1%	-8.2%
NASDAQ	13,751	-3.4%	-12.1%
Russell 2000	2,048	1.0%	-8.8%
UK FTSE 100	7,458	-0.1%	1.0%
Euro Stoxx 50	3,924	-6.0%	-8.7%
Nikkei 225	26,527	-1.8%	-7.9%
MSCI China (USD)	78	-3.9%	-6.7%
MSCI EM Index (USD)	1,171	-3.1%	-4.9%
Currencies and Commodities	**Level**	**Month**	**YTD**
CDN $	$0.789	0.3%	-0.3%
US Dollar Index	96.71	0.2%	1.1%
Oil (West Texas)	$95.72	8.6%	24.3%
Natural Gas	$4.40	-5.8%	25.5%
Gold	$1,909	6.2%	4.4%
Copper	$4.45	3.0%	0.0%
Canadian Interest Rates	**Level**	**Month**	**YTD**
3-month T-bill	0.40	10	24
GOC bonds 2-yr	1.43	16	48
GOC bonds 10-yr	1.81	4	39
GOC bonds 30-yr	2.09	5	41
Canadian Sector Performance		**Month**	**YTD**
Energy		6.5%	19.8%
Materials		12.8%	9.0%
Industrials		-1.2%	-4.0%
Cons. Disc.		-4.3%	-6.3%
Info Tech		-18.0%	-34.7%
Health Care		-2.7%	-11.7%
Financials		-1.2%	2.3%
Cons. Staples		-1.8%	-4.4%
Comm. Services		2.0%	3.6%
Utilities		-0.1%	-2.4%
Real Estate		-1.1%	-7.0%

Source: Bloomberg & FactSet February 28, 2022 – local currency unless noted, equity price only returns, bonds total return their earnings estimates (Scotiabank and BMO reported on March 1, TD on March 3). Investors were cautious leading up to Q1 2022 earnings season. The banks were widely expected to post their smallest earnings increases in over a year and a half amid a slowdown in capital markets activity. Although this was only the case for RBC, the bank managed to surpass expectations, with fee-based wealth revenue a key driver. National Bank, CIBC, and BMO smashed expectations by double-digits, all three bolstered by their capital markets divisions. Notably, Scotiabank and BMO both cited strong loan growth as key drivers. Banks will be further supported by central banks raising interest rates, with the first Bank of Canada hike now delivered, and signals that more are in the offing. The increase in interest rates will help expand their razor-thin lending margins and boost revenue growth. In addition, the lifting of pandemic-era restrictions on dividend increases and share buybacks should provide a tailwind for share prices.

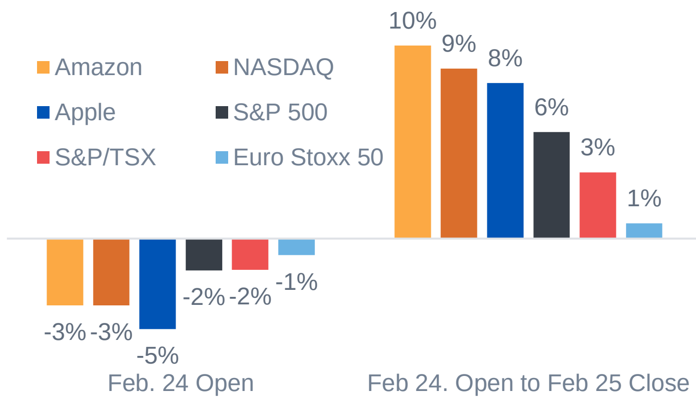
So hot it hurts

US headline CPI came in hotter than expected at 7.5% y/y. Goods inflation still dominates, and the inflation concerns are broadening out. However, once again, a large share of what fueled inflation was the goods/imports categories, areas most impacted by supply-chain disruptions. Core goods inflation rose 1% m/m to 11.7% y/y, while core services inflation rose a still hefty, but much smaller 0.4% m/m or 4.1% y/y. There are myriad signs that goods inflation is set to abate: shipping giant Moller-Maersk's earnings call cited an easing of constraints, the Canadian trade data for December saw imports rise 3.7%, driven by electronic and electrical equipment, a sign supply chain issues are easing in semiconductors (Apple's recent results point to a similar story). US hot-rolled steel prices have fallen 40% from their September high. There is also more evidence that spending is shifting from goods to services. The US PCE data pointed to it, and now despite Omicron, Canadians continue to accelerate their travel abroad – Canadian travel imports (measures trips outside Canada) posted a ninth straight monthly increase in December. It is well known that Russia is a key global supplier of oil and natural gas, but add aluminum, palladium, neon and xenon to the list. The situation in Ukraine adds a significant amount of uncertainty moving forward.

US inflation expectations had been anchored at the same level over the past few months. This no longer is the case, particularly in the shorter term. The US 2-year breakeven inflation rate climbed ~65 bps higher, breaching the 4% level. The increase briefly pushed the US 2-year nominal yield past 1.60%, which has surged nearly 1.4% in just five months.

In turn, markets steadily placed larger and larger bets on the Fed hiking rates at their next meeting on March 16. Expectations peaked on the January US headline CPI inflation release, with markets pricing in a 0.5% hike. Expectations have recalibrated lower as markets now expect the Fed to be patient as the world waits for more clarity surrounding the Ukraine situation; the January Fed meeting minutes also had a more dovish tilt relative to expectations. The Fed will still have February's employment and inflation figures to add to their mosaic before their March 16 meeting. In Canada, the Bank of Canada pressed on with its first 0.25% rate hike on March 2.

Chart in focus: Ukraine invasion sees flows to 'new' safe havens



This month's chart zooms in on the intriguing price action occurring on the few days leading up to and after the invasion. The Russian MOEX Index crashed 33% overnight and has lost over half its value since its all-time high set last fall. European stocks suffered the most outside of Russia, given its reliance on Russian oil and gas (see our special commentary *Seeking clarity in the Fog of War* for a more in-depth analysis). However, outside of Russia, US equities rebounded sharply into the end of the week, more than erasing the earlier weekly loss. The rally was driven on two fronts:

The first was a flight to quality. US growth companies include highly speculative names, but the growth moniker also applies to some of the highest quality companies in the world with pristine balance sheets and mountains of cash. Investors have come to view these companies (e.g., Apple, Microsoft, Alphabet, Amazon) as a safe haven asset, evidenced by the NASDAQ outperforming the broader S&P 500 and cyclically oriented TSX and EAFE Indices.

The other factor was bond yields. The anchoring of the US 10-year Treasury yield near the 2% level (and the eventual drop to 1.8%) further supported growth stocks. The S&P 500 had fallen almost 15% from its January high before the late-stage bounce. Time will tell whether this marked the bottom for markets.

The calamity in Ukraine is unquestionably devasting. However, capital markets have faced these situations many times in the past decades, and they eventually recover. Our advice is grounded in the appropriate management of risk tolerance and time horizon, with time horizon being especially key in situations like this. Having the flexibility to weather any storm is a guiding principle for prudent, well-balanced investors. With an appropriate, multi-year time horizon, the golden rule of investing remains - stick with your portfolio if it reflects your long-term goals and plans. While it is impossible to predict the future path for this conflict, our view is that elevated volatility is expected to remain. If your circumstances cannot sustain higher volatility, then that is a reason to make a shift, not the escalating volatility itself.

Source: Bloomberg & FactSet February 28, 2022 – local currency unless noted, equity price only returns, bonds total return