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Equity Markets

The growing chance of an extended stretch of price inflation spooked developed equity markets in the second quarter, with all major indices falling substantially. Oil prices rose 6% as the Russian invasion of Ukraine continued without any resolution in sight, and the curtailment of Russian oil and gas into Europe now looking increasingly problematic to European nations historically reliant on both. Meanwhile, central banks across Europe and North America are now highly focused on raising short-term interest rates to ward off inflationary pressures, introducing a potential shock to businesses and consumers now accustomed to very low borrowing costs.

In response to these headwinds, the MSCI EAFE Index fell 14.5%, while in the US, the S&P 500 benchmark fell 16.1%, both in US dollar terms. Mild weakness in the Canadian dollar slightly reduced these losses for Canadian investors in these two regions. Despite the backdrop of rising commodity prices, the Canadian market fared no better, with the S&P/TSX Composite Index dropping 13.2% due to weakness in particularly Canadian industries, such as gold mining, financial services and cannabis.

The specter of a sustained rise in inflation is forcing central banks to raise interest rates in 2022, producing a decline in both bond and stock prices so far this year. Although, with only partial supporting evidence so far, concern abounds that this might serve to dampen a strong housing market and prompt a consumer retrenchment in the coming months. The ultimate impact of these rate hikes will depend upon the buffer coming from a strong employment market and robust levels of consumer wealth, both of which buy some time for developed economies while awaiting improvement of supply bottlenecks that could mitigate inflationary pressures.

Fixed Income Markets

Fixed income markets continued to come under pressure in the second quarter, as persistent and broadening price pressures, compounded by the supply-side impacts of the war in Ukraine and the COVID-19-related lockdowns in China. This put added pressure on global central banks to take aggressive actions to combat the destructive effects of inflation.

The Bank of Canada and US Federal Reserve both hiked their policy rates at every meeting in the period (by a cumulative 100 and 125 basis points, respectively) and indicated that further material increases could be expected in the months ahead. The re-rating of the path of policy rates resulted in further sharp increases in market yields across the curve that caused further declines in bond prices.

The FTSE Canada Universe Bond Index plunged another 5.7%, bringing the year-to-date decline to (12.0%), by far the largest year-to-date decline in the broad Canadian bond market benchmark on record since 1980, as aggregate yields more than doubled from their level at the start of the year and breached 4% for the first time since 2008.

As was the case in the first quarter, all bond market segments recorded losses in Q2. The more rate-sensitive long-term fixed income securities underperformed significantly against the increase in yields (the FTSE Canada Long Term Overall Bond Index fell 11.8%). In comparison, FTSE's Mid Term (4.8%) and Short Term (1.5%) bond indices fared comparatively better, though they still declined.

While a more uncertain growth outlook is typically constructive for fixed income — and the higher yields now available are increasingly compelling — the expectation that central banks will continue to tighten financial conditions in order to rein in price pressures, and the apparent willingness to sacrifice growth to get ahead of the inflation curve, is likely to mean continued, albeit possibly diminished, headwinds for bond performance.

Commentary

Market conditions have proven to be quite challenging so far this year. The aforementioned global issues are weighing on economic momentum and exacerbating supply-side challenges that have factored into keeping inflationary pressures stubbornly elevated and forced central banks to move to rapidly unwind their crisis-era policy stimulus.

Elevated costs of living and sharply higher costs of capital have greatly impacted consumer and business sentiment, feeding into reduced economic growth forecasts that have raised the risk of the global economy entering a recession over the coming year.

This backdrop has proven to be particularly difficult for investors as there have been very few places to hide. All major asset classes have turned-in historically poor performance over the first six months of the year. The surge in interest rates has resulted in bonds, traditionally viewed as the “risk-free” asset, recording their worst performance over the last century, while risk assets have come under tremendous selling pressure (for example, the S&P 500 turned in its worst first six months to a year since 1962), as well as markets adapt to the new interest rate and growth regime.

The general environment, understandably, has seen pessimism become the overriding emotion (and guiding force for markets) — measures of consumer and business sentiment have plunged to generational lows in recent months while the bears are the majority in investor surveys.

It is in these situations, however, that some context and perspective are warranted.

For starters, investors have been beneficiaries of a “goldilocks” scenario for markets over the last decade. The central bank-induced zero interest rate regime and record-long economic expansion supported double-digit average annual equity returns over the 10 years before the pandemic (indeed, they even remained above 10% at the end of June). Such returns were roughly double those of the preceding half-century and were only exceeded by the boom following the end of World War II and years leading up to the bursting of the “Tech Bubble” ahead of the turn of the millennium.

With those persistently strong gains, however, there were rising signs of “irrational exuberance” (to borrow a phrase from former US Federal Reserve Chair, Alan Greenspan) that brought the longer-term health of the market reasonably into question. When governments and businesses are able to raise funds by selling bonds that offer negative yields, blank cheque “special-purpose acquisition companies” (SPAC) are able to raise billions of dollars on the open market, cryptocurrency-related entities were cumulatively valued in the trillions and the dominant force in Super Bowl advertising and sports stadium naming rights (a reverberating echo of the “dot com” era), and digital art was fetching millions, it is hard to argue that capital markets are behaving rationally.

So, while corrections (and deeper “bear markets”) are undeniably unpleasant for investors, they do serve as something of a reality check that can bring some sanity back into markets that were increasingly losing their heads.

In this way, the study of the economy mirrors that of ecology: sometimes a burn-off is necessary to clear out the underbrush and unviable plant life that is threatening the longer-term health of an ecosystem — the process ultimately helps to revitalize the area and support renewed growth for years to come.

Right now, the market is still smoldering and green shoots may seem few and far between — and there are undeniable risks that the fire could well flare up and spread further. But for investors with an eye on the future, this environment is actually one in which carefully planting seeds can prove to be the most beneficial.

The outlook is hazy at the moment, but there is still reason to believe that, should a recession actually materialize, it may well be short and shallow — the backstop provided by the underlying strength of consumer and business finances could potentially result in more of a lull in economic momentum than the crisis-induced collapse that has characterized the last two global recessions.

Ultimately, growth will resume and the reset in the marketplace has undeniably made the forward-looking return prospects for all asset classes better now than they were at the start of the year. The near-term may well continue to be challenging, but the return of some sense to financial markets results in cents once again flowing into investors’ accounts.

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