Playing With Fire

Equity Markets

A lengthy stretch of low volatility across developed equity markets came to a halt in early 2022, as investors recognized the potential for extended price inflation alongside escalating hostilities in Ukraine plus associated sanctions against Russia.

Negative impacts from these factors could be widespread, and acutely felt in Europe, a region with close economic links — and in some cases, dependency — on output from Russia and Ukraine, prompting the MSCI EAFE Index to fall 5.9% during the quarter, in US dollar terms. The ramifications for the US market were slightly reduced, although the S&P 500 Index fell 4.6% over the same period, as robust housing and employment tailwinds must now contend with rising interest rates aimed at containing pricing pressures. Mild strength in the loonie slightly amplified these losses for Canadian investors with foreign exposures in the quarter.

More positively, domestic investors were beneficiaries of these aforementioned forces in their home market, as the resource and bank-tilted S&P/TSX Composite index rose 3.8% over the quarter. A gain of more than 30% in the price of West Texas crude oil in the first quarter will create a profit windfall for domestic energy companies, just as recent price strength in corn, copper, steel, nickel and gold will spur rising profits for Canadian producers of these critical raw materials. Canadian banks and insurance companies also look well-positioned to benefit from rising interest rates, although it is less clear how they will fare if these increases come so rapidly that they crimp loan demand.

Weakness in US and international equity markets over the quarter masked an even larger pullback in high-growth stocks that has been underway for several months, reversing a portion of a lengthy uptrend for these market leaders in recent years. This seems to reflect the impact of higher interest rates on stock valuations and, perhaps, simply a correction of some rich valuation levels in favor of more comfortable valuations for moderately growing businesses with decent pricing power and healthy dividend prospects. From here, the outlook, arguably, includes a near equal mix of positive and negative factors, with robust consumer savings and an excellent job market now facing rising interest rates and pricing pressures for some goods that might start to curtail demand if continued.

Fixed Income Markets

The first quarter of 2022 was historically bad for fixed income investors. Indications of persistently rising inflationary pressures (which were further exacerbated by the surge in commodity prices in response to escalating geopolitical tensions in the period) triggered an aggressive hawkish shift in central bank rhetoric (that included the first hike in rates by the US Federal Reserve and the Bank of Canada of the tightening cycle) and resulted in a significant shift in market expectations for the path of policy rates that drove material increases in market yields and weighed on bond market performance.

The FTSE Canada Universe Bond Index plunged 7.0% in the first three months of the year, the largest decline in the broad Canadian bond market benchmark on record back to 1980, as average yields touched their highest levels since 2010.

No parts of the bond market were spared from the selling pressure — FTSE Canada All Corporate Bond Index fell 6.5%, while the government bond gauge declined 7.2% (record quarterly declines for both); despite the notable flattening of the yield curve, the FTSE Canada Short Term Overall Bond Index (-3.0%) fared less poorly than the more interest rate sensitive Mid Term (-6.8%) and Long Term (-11.7%) index benchmarks.

With further rate hikes expected in the months ahead, as central banks look to tamp down on demand and rein in inflation before it starts to have a more material impact on growth, there is more upward pressure on market interest rates, and headwinds for bond performance is expected. With that said, a lot is already priced into the market, arguably shifting the balance of risks for the direction of interest rates to the downside, particularly at the front-end of the yield curve. This is especially the case should there be indications of growth slowing more than already anticipated in response to a renewed wave of COVID-19 infections, ongoing geopolitical uncertainties and/or the impact of higher interest rates, or signs of moderating price pressures.

Commentary

Two years ago, on March 27, 2020, then-Governor of the Bank of Canada, Stephen Poloz, quipped, in response to the central bank's decision to slash policy rates to their effective lower bound and initiate an asset purchase program in response to the emerging COVID-19 crisis that, *"a firefighter has never been criticized for using too much water."*

Though it is the case that preventing the worst-case scenario from happening is clearly better than the alternative, that statement does not exactly ring true — while praise for containing the blaze may be immediate, firefighters would likely face criticism if they left the hose running after the fire had been extinguished and caused damage to the remaining structure.

When the world was blindsided by the pandemic, resulting in an unprecedented shock to the everyday way of life and elevated uncertainty over the economic outlook, governments and central banks could hardly be faulted for bringing in the pumper trucks and waterbombers.

The deluge of aggressive fiscal and monetary stimulus helped to mitigate the impact of lockdowns and other public health restrictions. Such measures, which included, cash transfers to households and corporations, slashing of costs of capital and moratoria on some financial obligations (such as loan repayments), all helped keep the global economy and financial system from burning to the ground.

In fact, the public sectors' stopgap funding for the private sector, combined with the surprising resiliency of the underlying base of the global economy (consumers), actually supported a rapid rebound in demand that meant that the recession, while deep, was historically short-lived.

As the rebuilding gained traction, the persistent uncertainty about whether or not the fire was out meant that the water kept running — government support packages continued to be rolled out and upsized, while central banks continued to pump liquidity into the financial system.

The measures certainly helped prevent any smoldering embers from reigniting in earnest, but the flood of stimulus was starting to cause issues under the surface can have lasting negative implications.

Consumer demand came roaring back, but policy measures did little to support the supply side, which remained constrained. The pandemic and public health measures prevented a return to operating at full capacity, which left businesses, especially those producing consumer goods, unable to keep up. While firms were initially able to rely on stockpiles to meet demand, these quickly became depleted and order backlogs piled up throughout the supply chain.

With demand outpacing supply, pricing pressures began to build — price increases were initially on a narrow subset of goods that saw a disproportionate rise in interest due to changing consumer spending habits in the new reality, but as the gaps between stimulus-fueled demand and pandemic-constrained supply widened, and kinks in the production pipeline grew, these pressures began to broaden out.

Suddenly, with the recovery on firmer footing, policymakers were being forced to reckon with the growing signs of water damage that posed a threat to the longer-term stability of the global economy's foundation. While a little inflation is not inherently a bad thing, persistent and excessive inflation can erode purchasing power and destroy demand, as consumers are forced to spend more to buy less.

For their part, governments have let the majority of crisis-era income supports lapse but the spigot remains open with (much needed) infrastructure investment in the offing, while there is little political appetite for more contractionary policy changes, such as broader program spending cuts and tax increases.

That leaves the bulk of the onus on central banks to try to mop up to prevent a deeper rot from setting in. To that end, there was a marked shift in the approach to policy-setting at the end of last year that intensified in recent months as price pressures proved to be more persistent than previously assumed (and were exacerbated by the bounce in commodity prices in response to recent geopolitical tensions).

Actual moves to date have been modest — both the Bank of Canada and US Federal Reserve have stopped buying bonds and recently increased their policy rates by 25 basis points — but guidance from policymakers suggests that further, fairly aggressive, policy tightening is to come in the months ahead.

The attendant rapid and significant rise in interest rate expectations has resonated throughout financial markets, driving bond yields back to pre-crisis levels (to the detriment of fixed income markets, which experienced their worst quarter in decades) and creating a headwind for equities (particularly for growth stocks that derive a lot of their value from anticipated future cash flows, for which present values are highly influenced by market interest rates).

And, while the impact on the real economy will be felt with more of a lag (notwithstanding some evident effects on mortgage and housing markets), concerns over an imminent policy-driven downturn have already increased materially — central banks have historically struggled to calibrate monetary policy in such a way that financial conditions do not tighten too much, too quickly, ultimately creating funding droughts that drastically increase the likelihood of an economic crisis flaring up.

With that said, the current macro and market backdrop is not overly dour. Policymakers are only willing to reverse course because underlying growth is strong — and likely to strengthen with the easing of restrictions — which continues to be constructive for risk assets like equities and corporate bonds.

So, while market narratives may focus on the fire hazards on the horizon, it is too early to sound the alarm quite yet and premature panic can stamp out near-term return prospects. Instead, this would serve as an opportunity for investors to review risk exposures and portfolio allocations to ensure they have not drifted too far from the guidelines embedded in a well-designed investment policy statement — that statement aims to provide fireproofing amid a crisis, while also protecting returns from getting watered down by inflation.