Quarterly Market Commentary
First Quarter 2022

Consequences of War Drive Record High Inflation

- Global equities delivered their poorest quarterly performance since early 2020. Global bonds fared worse, tumbling by the most since late 2016. By contrast, commodities had their strongest quarter in at least 30 years and Canadian equities were up.
- U.K. stocks earned a positive return for the quarter, while the U.S., Japan and Europe sunk into negative territory. Chinese equities had steep double-digit losses.
- One of the greatest mistakes an investor can commit is to panic and make indiscriminate changes for fear of losing money. In periods of unusual stress, a clear philosophy and process can help guide calm, rational, long-term decision making.

SEI's Domestic View

Energy, metals and agricultural commodity prices are booming. The U.S., Canada's biggest trading partner by far, continues to grow at a relatively fast pace. COVID-19 restrictions are finally easing. All of these developments are good news for the Canadian economy. According to Citigroup, Canada's economy has consistently recorded an uptick in positive economic surprises over the past quarter, both in absolute terms and relative to the trend in the U.S. Exports have been a bright spot, having surged almost 23% to C$642 billion since the end of 2020.

Energy exports have led the way, while non-energy exports have also been climbing despite periodic COVID-19-related disruptions to motor-vehicle trade with the U.S. The surge in exports and a modest appetite for imports through the end of 2021 resulted in Canada's first quarterly current-account surplus since the Global Financial Crisis in 2008.

Surprisingly, the Canadian dollar has not appreciated in response to these currency-supportive developments. There has clearly been a sharp break in the relationship between Canada's currency and the price of oil. Through most of last year, the loonie traded in a rather narrow range against the U.S. dollar, with one Canadian dollar buying about US$0.80. The Canadian dollar has not risen at all since the middle of last year, even though oil prices have nearly doubled. The last time a barrel of oil traded this high (in June 2014), the Canadian dollar was equal to US$0.94.

The narrowing in Canadian-U.S. interest-rate differentials provides at least a partial explanation for the lack of appreciation in the loonie. The two-year note differential has shrunk dramatically. In early November, the Canadian two-year Treasury note held a 0.60% advantage over the comparable U.S. Treasury security. At the end of March, the yields were almost exactly the same.

Of course, this doesn't explain why the Canadian currency was still range-bound even as the yield differential was surging in Canada's favour during the summer and early fall. We think it might have had something to do with the country's more restrictive COVID-19 lockdown measures compared to those in the U.S. Mobility in Canada peaked in September as the Omicron variant became a looming threat.

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Inflation in Canada is accelerating just as dramatically as in the U.S. While the core inflation rate tends to run a bit lower than in the U.S., Canada's latest year-on-year reading of 4.8% as of February is nonetheless the highest in more than 30 years. Like the U.S. Federal Reserve (Fed), the Bank of Canada (BoC) insisted that inflation was a transitory phenomenon and focused its attention on the one measure of inflation (the so-called common core consumer-price index) that remained well-behaved through much of 2021. Unfortunately for the BoC, that measure started to rise rapidly last year, accelerating from 3.7% over the 12 months ended October to its recent reading of 4.8%.

The only question at this point is whether the central bank will "front-run" the Fed and push its policy rate up by one-half a percentage point when the BoC's Governing Council meets next on April 13 (the Fed's next policy meeting is May 3-4). We think the odds are turning in favour of such an outcome. The country's unemployment rate is back to its pre-pandemic lows, which had been the lowest in more than two decades. Speculation in the housing market also has picked up. The property markets in parts of Canada always seem bubbly, yet the extent of the price climb in Vancouver, Toronto and Ottawa in the last two years should be cause for concern. While it is unlikely that Canada faces a recession in the next year or two, the pivot in monetary policy toward restraint is an important economic development.

SEI's Global View

Three months ago, we noted in our outlook that geopolitical uncertainty was on the rise. The Russian troop build-up on the Ukrainian border topped the list of our near-term concerns, and we warned that an invasion would have major economic consequences.

Like the pandemic that hit with full force this time two years ago, no one knows how long the conflict will last or how extensive its impact will be on the global economy. However, our experience with COVID-19 and the economic and financial response to prior geopolitical events serve as a guide.

Pre-invasion, we were optimistic that global economic growth would remain solid as countries eased their COVID-19-related restrictions. Europe was expected to improve at least as fast as the U.S., if not faster. This is now a questionable assumption. We cannot emphasize enough how uncertain the economic environment has become. Instead of seeing a normalization of activity with fewer supply-chain snafus and easing COVID-19 restrictions, we are witnessing a war that is expected to extend and exacerbate the "everything shortage."

Although Russia's gross domestic product (GDP) amounted to just 1.8% of the world's total in 2020 (about the same as Brazil), its importance as a commodity exporter cannot be denied. Disruption to the supply of several globally traded commodities has had a predictable result: yet another leap in commodity-price inflation.

While supply-chain pressures eased in January and February, they were still at exceptionally high levels relative to history. We think the odds favour a return to their previous peaks as freight carriers suspend Russian bookings and increase rates in response to pileups, higher energy costs, and hazardous geopolitical conditions. COVID-19-related disruptions in Asia also remain an ever-present threat.

It is fortunate for the advanced economies that households and businesses were in mostly good financial shape coming into the crisis.

Year-over-year growth in employment was continuing to accelerate heading into 2022 despite the Omicron outbreak. The U.S., Canada, France, and Italy have been recording gains well ahead of their longer-term trends. Job growth in Germany and the U.K. is still at or slightly above the pre-pandemic trend after having experienced smaller year-on-year declines during the 2020 pandemic lockdowns.

Despite this labour-market vibrancy, workers' wages have begun to fall behind the high inflation rates recorded in the U.S. and elsewhere. One would think that a contraction in real compensation is a sure sign that an economic recession is already underway. Yet that is not the case. Median wage growth in the U.S. for the lowest-income quartile is up 5.9% over the 12 months ended February, nearly matching the rise in the Fed's Personal Consumption Expenditures (PCE) Price index for overall personal-consumption expenditures. By comparison, the overall median wage gain for this period amounted to only 4.3%.

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While wage gains are lagging inflation at the upper quartiles, higher-income groups have benefited from the boom in home prices and the long bull market in financial assets; they also hold the bulk of excess saving that built up during the pandemic.

Although incomes in the aggregate are not keeping up with inflation, we anticipate that households will draw down savings and increase debt in an effort to maintain living standards. In the U.S., the household saving rate has already fallen to 6.3% of disposable income from an average of 7.5% over the 2014-to-2019 period. Between 2005 and 2007, by contrast, the saving rate averaged less than 4%. Today, each percentage-point drop in the saving rate would translate into a 4% gain in nominal GDP.

Businesses face a similar scenario. The long period of ultra-low interest rates has allowed companies to engage in a refinancing boom. Earnings before interest and taxes in the U.S. non-financial corporate sector cover interest expense 7.9 times, the highest ratio in more than 50 years.[1]

Meanwhile, Russia's aggression toward Ukraine has placed government leaders in the U.S., Europe and other advanced countries in a quandary. They have been tasked with responding urgently to the crisis by providing support while simultaneously pulling back on monetary and fiscal excesses that are partially to blame for the worst inflation in decades. European governments will seek to mitigate the invasion-induced impact of spiking fuel and electricity costs, the influx of Ukrainian refugees, and make a significant upward adjustment in defense spending.

By contrast, the U.S. fiscal response to inflation is likely to be far less robust as it remains bedeviled by political gridlock. Not only has the U.S. registered one the largest increases in emergency spending among the major economies over the last two years, it also has one of the worst inflation problems at a time when the domestic political environment is in an extremely fractious state. Granted, the Democrats and the Republicans in Congress have been able to work together recently to finally enact a budget agreement for the current fiscal year (almost six months late), along with a debt-ceiling increase and a $13.6 billion aid package for Ukraine. It probably will be difficult to pass additional legislation aimed at supporting the domestic economy between now and the November mid-term elections.

Turning to monetary policy, the move toward higher interest rates and the end of quantitative easing appear to be a global trend (with the main exception of Japan).

Households and businesses were in strong financial shape coming into this rate-hiking cycle at a time when there is a great deal of pent-up demand. It may well take some time to put a big dent in this economic momentum. Of course, the economy will eventually tip into recession if the Fed and other central banks are forced to raise rates well above the inflation rate. That may happen during the current cycle if inflation proves harder to tamp down than currently anticipated.

There is no denying that these conditions present major challenges for financial assets beyond the uncertainties caused by war. This is especially so for long-duration assets such as growth-oriented equities that trade at higher price-to-earnings ratios and longer-maturity bonds.

Commodity markets have been surging due to the shortages caused by COVID-19 disruptions, and now by the war in Ukraine. U.S. value stocks have held up relatively well in the year to date, led by a large absolute price gain in the energy sector and better-than-benchmark performances in financials, utilities, industrials, materials and healthcare (as measured by the S&P 500 Index). Meanwhile, technology companies and equities with high valuations have suffered as earnings multiples contracted amid the climb in bond yields, while the decline in the bond market itself is especially notable.

In emerging markets, Latin America has bucked the trend seen in other geographies as the region generally benefits from the rise in commodity prices. The jump in interest rates in countries like Brazil and Mexico has also stabilized their currencies against the U.S. dollar despite currently high domestic rates of inflation.

[1] According to data from Ned Davis Research Inc.

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Europe and Asia have been comparatively poor performers thus far in 2022. Even before the invasion, the emerging stock markets in Europe were giving ground as tensions ramped up between Russia and Ukraine.

Emerging Asia, a major consumer of commodities, also has lost ground. COVID-19 has continued to exert an impact on economic activity. The technology sector in China remains under pressure, although strong government verbal support resulted in a big rally in the middle of March.

Amid all this variability in performance, emerging markets appear to be fertile ground for active management. Volatile environments provide an opportunity for active managers to review exposures in an effort to weed out likely losers from winners.

Periods of crisis and instability are worrying for all investors, particularly as the turn of events in the short term can be difficult to predict. We saw this in the first weeks following Russia's invasion of Ukraine, as impacts from the crisis overwhelmed more traditional market drivers.

During times like these, one of the greatest mistakes an investor can commit is to panic and indiscriminately make changes for fear of losing money. In periods of unusual stress, a clear philosophy and process can guide calm, rational, long-term decision making.

Economic Backdrop

Investors faced inhospitable conditions on multiple fronts during the first three months of 2022. Global equities delivered their poorest quarterly performance since early 2020—bottoming in mid-March before mounting a sharp partial recovery. Global bonds fared worse, tumbling by the most since late 2016.

U.K. stocks earned a positive return during the quarter, outpacing other major markets. Hong Kong was slightly negative, while the U.S., Japan and Europe had steeper losses.

Mainland Chinese equities bounced higher after plummeting from mid-February to mid-March, but still finished the quarter with double-digit losses. The selloff in Chinese equities was most severe in technology companies, forcing Vice Premier Liu He—China's top economic advisor—to pledge that the government would take a "standardized, transparent and predictable" approach to the regulation of technology; this comes after more than a year of interventions. Beijing also made broader overtures to soothe investors, including prioritizing the stability of capital markets, supporting overseas stock listings, and pledging to manage the risks associated with solvency issues plaguing property developers.

Meanwhile, with commodities markets having been the epicenter of the financial fallout from Russia's attacks on Ukraine, commodities had their strongest quarter in at least 30 years. The price of natural gas spiked by more than 50%, while West-Texas Intermediate and Brent crude-oil prices both climbed by over 30%. The price of wheat also increased by more than 30%. Commodity-producing nations, therefore, were the first quarter's big winners, led at a distance by Latin American equities' double-digit gains.

On the other side of the spectrum was Russia—the greatest loser by a wide margin—as its aggression against Ukraine opened the door to an expansive set of coordinated economic restrictions, imposed rapidly and with a high degree of uniformity across Western powers. The country's banishment from global financial systems translated into massive declines in the value of Russian securities.

Government bond rates increased across maturities in the U.S., U.K., and eurozone during the first quarter. Shorter-term rates climbed by more than longer-term rates, leading to flatter yield curves across the three jurisdictions. An inversion of U.S. Treasury rates that began at the long end of the yield curve in late 2021 broadened in March to include the 3-year/10-year segment of the curve as well.

Bonds delivered an array of negative performances as interest rates climbed (yields and prices have an inverse relationship). Inflation-indexed securities had relatively mild declines, while emerging-market debt and investment-grade corporates tumbled dramatically. The longest-term government bonds in advanced economies posted double-digit losses.

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In the immediate aftermath of the invasion, the European Commission, France, Germany, Italy, the U.K., Canada, and the U.S. committed to taking several actions including removing Russian banks from the SWIFT (Society for Worldwide Interbank Financial Telecommunication) messaging system for financial payments; blocking the Russian Central Bank from deploying its international reserves; limiting the sale of citizenship to wealthy Russians; and launching a transatlantic task force to freeze the assets of sanctioned entities.

The imposition of these coordinated sanctions has effectively blocked Russian entities from trade in major foreign currencies. The Russian Central Bank was forced to increase its benchmark rate by a considerable 10.5%, to 20.0%; offer unlimited liquidity support to banks as they faced runs; raise capital controls on exporters and residents; and shutter its financial markets.

By mid-March, the EU had instituted a broad ban on investments in Russia as well as exports to and imports from the country (although imports of Russian metals and energy are still permitted). Russian state-controlled companies across an array of industries are blocked from trading with the EU, while prominent Russian individuals (including business executives, media personalities and oligarchs) faced asset freezes and travel bans.

The U.S. went a step further in banning all new purchases of Russian energy imports, allowing a 45-day wind-down period for existing agreements.

Also in mid-March, Russia legalized the nationalization of more than 500 airplanes leased to Russian airlines by Western companies. This came after an early-March move to restrict the export of more than 200 products and raw materials until the end of 2022; although its chief commodity exports were not included.

More recently, Russia began to demand ruble payments for gas exports to Europe instead of accepting U.S. dollars or euros, sending European gas prices soaring. The Group of 7 (G7) explicitly rejected the Russian demand in late March. At the end of the quarter, Russia's Transneft—the largest oil pipeline network in the world—alerted local oil-producing companies that it would cap acceptance of oil that had not already been sold as storage capacity was full.

The European Commission announced in mid-March that the electricity grids of Ukraine and Moldova were now synchronized with that of Continental Europe rather than with Russia; this was done in an effort to help the two countries reduce their dependence on Russia and improve their electricity system reliability.

Central Banks

- The BoC raised the policy interest rate by 0.25% to 0.50% on March 2. This move was largely expected as inflation has been running higher than the BoC target, which the central bank reiterated was the mid-point of a range of 1% to 3%. The BoC noted that more rate hikes will likely be needed to bring inflation into the target range. The possibility of quantitative tightening (that is, when the BoC would allow its government bond holdings to decline) in the future is another inflation-fighting tool at the bank's disposal. The BoC's next scheduled meeting is on April 13.

- The Federal Open Market Committee (FOMC) voted to increase the federal-funds rate by 0.25% in mid-March—its first rate hike since December 2018—after making a final $30 billion round of new asset purchases. The central bank had released a statement in January outlining principles for reducing the size of its balance sheet and stated in March that it "expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting." Its latest quarterly Summary of Economic Projections, released in conjunction with its March policy statement, showed a decline in the median real GDP projection for 2022 (to 2.8% from 4.0% in December) as well as an increase in broad inflation expectations for 2022 (to 4.3% from 2.6%) and smaller increases for anticipated inflation in 2023 and 2024. The median outlook for the federal-funds rate increased to 1.9% for 2022 (from 0.9% in December) and 2.8% for 2023 (from 1.6%).

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- The European Central Bank (ECB) announced plans following its mid-March meeting to conclude its Asset Purchase Programme in the third quarter after decreasing net purchases from €40 billion in April to €30 billion in May, and then to €20 billion in June. The final net purchases under the Pandemic Emergency Purchase Programme (PEPP) concluded during the first quarter. Following Russia's invasion of Ukraine, ECB President Christine Lagarde pledged that the ECB "will ensure smooth liquidity conditions and access of citizens to cash," and that it "stands ready to take whatever action is needed to fulfill its responsibilities to ensure price stability and financial stability in the euro area."

- The Bank of England's (BoE) Monetary Policy Committee (MPC) issued three consecutive rate hikes—first in December 2021, then in early February, and finally in mid-March—bringing the bank rate to 0.75%. MPC members voted unanimously in February to begin reducing the size of the BoE's balance sheet by ceasing to re-invest proceeds from its asset-purchase program and through corporate bond sales. The wind-down cannot be completed any earlier than toward the end of 2023.

- The Bank of Japan's (BOJ) policy orientation was unchanged following its mid-January and late-March meetings, with its short-term interest rate at -0.1% and the 10-year government-bond-yield target near 0%, as the country's inflation pressures remained subdued relative to other major developed economies. The global rise in long-term bond yields compelled the BOJ to make standing offers of unlimited 5-to-10-year Japanese government bond (JGB) purchases as the 10-year yield touched 0.25% in late March, reaching a six-year high. Previously, the BOJ announced that it would revert purchases of corporate bonds and commercial paper to pre-pandemic levels beginning in April.

Economic Data (unless otherwise noted, data sourced to Bloomberg)

- According to Statistics Canada, the rate of inflation accelerated (as measured by the change in the Consumer Price Index (CPI)) to 1.0% for the month and 5.7% for the year ending February. The last time annual inflation exceeded this amount was over three decades ago, in August 1991. Gasoline prices were up 32.3% over the past year, significantly contributing to the rise in inflation. Food and shelter prices also rose briskly, at 6.7% and 6.6%, respectively. Producer prices were also up sharply. The Industrial Product Price Index (IPPI) rose 3.1% in February and the Raw Materials Price Index (RMPI) was up 6.0%, while on a year-over-year basis the IPPI rose 16.4% and the RMPI jumped 29.8%. Energy prices were dramatically higher in both the one-month and 12-month periods. With the easing of COVID-19 health restrictions, Canada's labour market added 73,000 jobs in March, as the unemployment rate fell to 5.3%. Full-time employment rose by 93,000, while part-time jobs declined.

- U.S. manufacturing growth started 2022 by continuing to cool from the red-hot activity of last summer, bottoming in January before accelerating through February and March. Services-sector growth jumped to notably high levels in March after recovering in February from a near-standstill at the start the year. U.S. joblessness remained on a multi-year downward path, with the March unemployment rate of 3.6% sitting just above the lows attained in late 2019 and early 2020. The Consumer Price Index climbed to 7.9% year over year in February, while the Fed's PCE Price Index (the central bank's preferred inflation gauge) rose to 6.4%—both measures reaching their highest respective levels since January 1982.

- U.K. manufacturing growth dropped in March to its lowest (albeit still healthy) level since February 2021—falling below the range that defined the fourth quarter of 2021 and the first two months of this year. Growth in the U.K. services sector accelerated sharply in February and March after a low-growth lull as we moved into the New Year. Inflation climbed to 6.2% in the U.K. for the 12-month period through February, the highest level since 1992. The U.K. claimant count (which calculates the number of people claiming Jobseeker's Allowance) continued to improve in the first two months of the year—declining by roughly 125,000, with total claimants representing 4.4% of the population in February compared to 4.6% in December.

- The expansion in eurozone manufacturing stumbled at the end of the first quarter, diluting an otherwise strong start to the New Year as March delivered the slowest monthly rate of growth since January 2021. Growth in the eurozone services sector cooled to still-healthy levels in March, having accelerated in February after slowing to a near standstill to start the year. The year-over-year rate of consumer price inflation in the eurozone climbed to 7.5% in March, hitting an all-time high for the fifth successive month. Labour-market improvements persisted into 2022—with the eurozone unemployment rate declining to 7.0% in January and 6.8% in February, the lowest level since Eurostat began tracking the dataset in 1998.

Market Impact (Referenced Index Returns are in CAD)

Canadian equities were one of the few bright spots amid a global equity rout as resource-rich domestic markets benefited from soaring commodity prices. Developed markets outperformed emerging markets—the U.K. managed a marginal gain, but other major regions and countries, including Europe, Japan and the U.S., were down. Similar to Canada, Brazilian equities rose with commodity prices; in total, emerging markets were down sharply due in large part to poor performance from China.

Fixed income remained challenged in the face of rising interest rates with more central bank rate hikes on the horizon. Despite elevated inflation, real-return bonds fared poorly due to their long-duration profile (higher sensitivity to interest rates). Corporate debt was down significantly, but fared relatively well when compared to government bonds. Short-term bonds and residential mortgages were also down, while 30-day treasury bills had meager gains. Riskier U.S. high-yield bonds slumped as well.

Index Data (Q1 2022)

- The S&P/TSX Composite Index gained 3.82%.
- The FTSE Canada Universe Bond Index returned -6.97%.
- The S&P 500 Index, which measures U.S. equities, slid 5.66%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, lost 6.42%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned -4.51% (currency hedged) and -5.56% (unhedged).
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the “fear index,” swung wildly during the quarter as it moved from 17.22 to 20.56. Intra quarter, the VIX recorded a number of readings above 30, reaching a closing high of 36.45 on March 7 as the Russian invasion of Ukraine roiled capital markets.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, moved from US$75.21 to US$100.28 a barrel to end the quarter. Prices were highly volatile, settling at an intra-quarter high of US$123.70 on March 8, only to plunge to US$95.04 by March 16 before moving a bit higher by quarter end. Oil market volatility will likely remain elevated as war-related sanctions on Russian oil have crimped global supply.
- The Canadian dollar benefited from notably higher oil prices and strengthened to C$1.25 per U.S. dollar. The U.S. dollar was considerably stronger versus the world’s other major currencies. It ended March at US$1.11 versus the euro, US$1.32 against sterling and at 121.38 yen.

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Index definitions

The **Consumer Price Index** measures changes in the price level of a weighted average market basket of consumer goods and services purchased by households. A consumer price index is a statistical estimate constructed using the prices of a sample of representative items whose prices are collected periodically.

The **ICE BofA U.S. High Yield Constrained Index** is a market-value weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3 but are not in default.

The **FTSE Canada Universe Bond Index** is the broadest and most widely used measure of performance of marketable government and corporate bonds outstanding in the Canadian market. FTSE Canada has been in the business of providing the benchmark performance standards for Canadian fixed income investments since 1947.

The **MSCI ACWI Index** is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

The **Personal Consumption Expenditures (PCE) Price Index** is the primary inflation index used by the Federal Reserve when making monetary-policy decisions.

The **S&P 500 Index** is an unmanaged, market-weighted index that consists of 500 of the largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

The **S&P/TSX Composite** is the headline index for the Canadian equity market. It is the broadest in the S&P/TSX family and is the basis for multiple sub-indices including but not limited to equity indices, Income Trust Indices, Capped Indices, GICS Indices and market cap based indices.

Glossary

Bull market refers to a market environment in which prices are generally rising (or are expected to do so) and investor confidence is high.

Growth stocks exhibit steady earnings growth above that of the broader market.

High-yield bonds are rated below investment grade and are considered to be riskier.

Investment-grade bonds are Bonds that are believed to have a lower risk of default and receive higher ratings by the credit rating agencies.

Price-to-earnings (P/E) ratio is the ratio for valuing a company that measures its current share price relative to its earnings per-share (EPS).

Value stocks are those that are considered to be cheap and are trading for less than they are worth.

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