Navigating the Trade Winds

January 2022

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Dear friends,

In spite of the Omicron wave, stock markets have completed their second year of pandemic with impressive results. Including the good performance of 2019, worldwide markets haven't presented three-year returns that good since the 2004-2006 period fifteen years ago. These results were fueled by the ultra-accommodating monetary policies of central banks around the world. The resurgence of inflation allowed certain sectors to come back in the spotlight. Namely, in Canada, energy was the best performing sector in 2021 (+42%), lifted by strong oil prices. In commodities, wood, aluminum, nickel, zinc and copper all gained over 25% in the past year. With a strong 4th quarter, the S&P 500 beat the S&P/TSX to the punch. However, we still think that the Canadian Index will prevail in 2022.

		Closing	Change**	
		31-Dec-21	Quarter	2021
Stock Indices *(% in C$)*				
S&P/TSX		21,223	5.7%	21.7%
S&P 500		4,766	10.3%	25.9%
MSCI EAFE*		2,336	2.0%	7.9%
Currencies				
CAN$ (US$/C$)		0.7914	0.3%	0.8%
Euro (US$/EUR)		1.1370	-1.8%	-6.9%
Commodities (US$)				
Oil (WTI)	$	75.21	0.0%	55.8%
Gold	$	1,822	3.5%	-4.0%
Volatility Index				
VIX		17.22	-5.92	-5.53

** MSCI Europe, Australasia and Far East (US$)*
*** Changes are expressed in C$ for Stock Indices.*

The constant rise in prices and the possibility of sustained inflationary pressures have made the headlines for the last months as future inflation expectations have been constantly increased. The central banks have been quite careful with the state of the economy and have mostly understated inflation concerns since the start of the pandemic. However, they are quickly adjusting now. In its last meeting minutes, the Fed dropped the use of the word "transitory" when describing inflation pressures, a change of tone signaling an imminent tightening of the monetary policy. All committee members are estimating that the Fed interest rates should rise in 2022, with an average forecast of 1% at the end of 2022 and of 1.5% for 2023. Remember that both in Canada and in the USA, current short-term rates are sitting at 0.25%.

Here in Canada, economists are now forecasting five 0.25% raises in 2022, and four are forecasted stateside. This would bring short-term rates, at the end of the year, to 1.50% in Canada and to 1.25% in the USA. One or two more raises could further be added in 2023. A first raise is forecasted in the USA as soon as March 2022 according to the CME FedWatch tool. This would coincide with the end of the quantitative easing started by the Fed in 2020. This will make the stock markets a more challenging environment.

La voie des Alizés
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Gestion de portefeuilles / Portfolio management

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Record jump in EPS in 2021

	Q4 2021	Year 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Year 2022	Forward P/E
Forecasted Earnings Growth (Year over Year) and Forward Price-Earnings Ratio								
S&P/TSX	30.8%	**55.6%**	22.7%	9.9%	6.0%	2.9%	**10.2%**	**14.5**
S&P 500	23.1%	**49.8%**	7.5%	5.2%	7.6%	13.5%	**8.6%**	**21.4**

** Earnings per share (EPS) for the indices* — *Source: I/B/E/S data from Refinitiv (Thomson)*

Canadian companies have reported earnings that grew at a record pace over 12 months in 2021. With crude oil and commodity prices reaching peaks, analysts are again forecasting a strong growth rate in S&P/TSX earnings for the fourth quarter of 2021 (30.8%). As we gradually receive results for Q4, we believe that the latest increase in volatility could continue and that "hyper-growth" stocks could be shaken up considering their current overvaluation. Moreover, for the next four quarters, the consensus is forecasting slower growth rates for the IT and Communication sectors than for the S&P 500 as a whole. The companies from these sectors must report immaculate earnings to avoid being corrected in the markets. If earnings in 2021 have quickly rebounded following the trough of 2020, expectations for the S&P in 2022 are much lower, with an expected growth of 8.6%. In Canada, the consensus expects a strong performance from commodity producers that will translate in an impressive growth rate for the first two quarters of 2022. As EPS for the S&P/TSX have risen substantially, the forward P/E ratio for Canadian stocks is much more reasonable at 14.5, in line with historical averages, than what it is for the S&P 500 (21.4). Therefore, we favor Canadian equities for 2022, but will still consider quality US stocks that are reasonably priced.

After tackling pandemic's risks, focus is on prices

The very contagious Omicron wave rocked the equity markets in the last quarter of 2021, but fears quickly dissipated as studies showed the virus proved to be less harmful than previous variants. Therefore, the recovery of the world economy can continue without the fear of a new confinement. As a result, politicians and central banks can slowly transition away from the quantitative easing and focus on inflationary pressures that are more and more evident. The goal is to tackle inflation and operate a soft landing, which is slowly reducing the growth of the economy without crashing it. It will require a skillful equilibrium between maintaining jobs and rising interest rates. On the longer term, structural adjustments to the COVID from manufacturers will allow production levels to return to normal and therefore reduce the pressure on prices. Meanwhile, we will have no choice but to cope with a rising rates environment.

Conclusion and perspectives

For a while now, we have favored short-term bonds. Some of those positions will mature in 2022 and 2023 and this will allow us to reinvest monies at more attractive rates. At the same time, we continue to invest in non-traditional funds that have performed very well in 2021. Our judiciously selected portfolio of stocks served us well in 2021 and that should continue to be the case this year. We are overweight in equities and favor "value" over "growth" with a bias toward dividend-paying stocks. We are focusing on sectors that have historically performed well with higher inflation and in a rising-rates environment. Episodes of higher volatility are predictable as economic risks related to the pandemic persist, even though we are slowly learning to "live with the virus". Tightening of monetary policies, rising inflation, decreasing operating margins and overvaluation of some markets are risks that could lead to some pullbacks. We are aware of the situation and ready to take advantage of those opportunities should they arise.