

# Markets facing stress tests, but Canada still well positioned

Canada Outlook | July 2022

## Q2 review and outlook

The first six months of 2022 have been characterized by moderating economic growth, high inflation and interest rate hikes by central banks. The war in Ukraine and COVID-19 have also disrupted supply chains, causing commodity prices to surge.

Fears around inflation and higher interest rates have spiked market volatility. Investors are worried that higher commodity prices and the Fed's actions may drive a recession. Concurrently, shocks from COVID-19 and the Russia-Ukraine war are creating structural changes that are bringing more complexities to the table.

Investment markets have been battered by these adverse shocks, and there is significant uncertainty about what happens next. However, on balance, we see Canadian investors weathering the current volatility better than most, based on four positive factors: a strong job market, high consumer savings levels, solid corporate earnings, and robust commodity prices.

The Canadian employment picture is particularly encouraging. There are now more than one million job openings, equivalent to around 0.8 jobs per unemployed person, a level never seen in recent history. In June, the unemployment rate hit 4.9%, a level not seen since the unemployment rate was first recorded in the 1970s.

These factors support our view that Canada does not face the prospect of a recession in the near term. However, longer term, we do see the economic landscape shifting over the next decade, to one where stubborn inflation, higher interest rates, and extended bouts of volatility define how the Canadian and global economies and financial markets will perform.

## Bank of Canada surprises markets with one percentage point hike

At its July 13 meeting, the Bank of Canada raised its policy rate for the fourth time in the rate hike cycle that started in March. The Bank raised its policy rate by one percentage point, from 1.5% to 2.5%. This was the biggest hike since 1998. Market expectations were for a 0.75 percentage point hike. The Bank of Canada wants to quickly get their policy rate to the top end or slightly above the neutral range (2%-3%) to slow excess demand in the economy.

## Recession risk rises on elevated inflation as consumer price index rises higher and wider

Globally, the risk of recession has clearly risen, as high inflation has squeezed consumers' incomes and interest rates are rising toward restrictive levels. Risks are higher for Europe than for the US, where the underlying strength of demand and labour market growth is greater. Since the beginning of the year, inflation has risen higher and broadened out in Canada. The May Consumer Price Index (CPI) rose to 7.7%, the highest since



## Key takeaways:

- The first six months of 2022 have been characterized by moderating economic growth, high inflation and interest rate hikes by central banks.
- We see Canadian investors weathering the current volatility better than most, based on four positive factors: a strong job market, high consumer savings levels, solid corporate earnings, and robust commodity prices.
- We do not expect Canada to face the prospect of a recession in the near term.

1983, as global factors caused price surges in many energy and food items. The ongoing inflationary pressure has also become pervasive, broadening beyond pandemic-related imbalances: almost 70% of the CPI categories now show inflation above 3%. June US Consumer Price Index (CPI) posted a year-on-year increase of 9.1%, the largest gain since 1981.

Against this backdrop of an exacerbated outlook for inflation risk, the Bank of Canada is expected to continue to act forcefully at their next meeting in September.

## Canadian investment strategy and market highlights

### Investment strategy highlights

Global growth is expected to be moderate but remain positive—we forecast 2022 global GDP to be at 3.4%. We don't believe that a global recession is likely as earnings and labour markets remain strong. Inflation levels will persist so long as supply-chain issues and rising wages continue to linger.

We remain invested in energy and materials to take advantage of surging commodity prices. The return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis. We favour provincial bonds over Government of Canada bonds. However, we are trimming some equity positions to buy fixed income.

Overall, we remain underweight domestic bonds and overweight Canadian equities. We have a neutral weighting in US equities and are underweight in global equities. We are also underweight in emerging market equities and fixed income.

### Market highlights

Canadian equities, as measured by the S&P/TSX Composite Index, were down 13.19% in the second quarter. Canadian bonds, as measured by the FTSE Canada Universe Bond Index, finished the second quarter down 5.66%. US equities, as measured by the S&P 500 Total Return Index, were down 13.35% in the second quarter. Global equities, as measured by the MSCI World Index were down 13.44% in the second quarter. (All returns in Canadian dollars.)

- Global growth is expected to be moderate but remain positive—we forecast 2022 global GDP to be at 3.4%.
- We remain invested in energy and materials to take advantage of surging commodity prices.
- The S&P/TSX Composite Index was down 13.19% in the second quarter.
- The FTSE Canada Universe Bond Index finished the second quarter down 5.66%.

### S&P/TSX Composite Index and Sector Performance

(period ended June 30, 2022)

	3-Month	1-Year	3-Year*	5-Year*	10-Year*
S&P/TSX Composite Index	-13.19%	-3.87%	7.97%	7.62%	8.18%
Healthcare	-49.64%	-69.64%	-42.72%	-22.41%	-18.40%
Materials	-23.62%	-4.19%	7.78%	7.09%	1.30%
Energy	-1.94%	37.12%	14.34%	8.05%	4.50%
Real estate	-17.80%	-11.57%	1.34%	5.24%	8.05%
Information technology	-30.74%	-56.49%	3.11%	13.74%	17.81%
Financials	-13.11%	-1.77%	9.35%	8.41%	11.38%
Consumer discretionary	-10.19%	-16.50%	4.86%	4.02%	11.49%
Consumer staples	-6.15%	11.51%	8.67%	8.74%	14.81%
Communication services	-8.77%	4.78%	7.06%	7.34%	10.05%
Utilities	-3.49%	7.81%	13.55%	10.43%	8.97%
Industrials	-12.72%	-1.09%	8.60%	10.15%	13.80%

\*Compound annual rate of return. Source: Bloomberg as at June 30, 2022. Performance stated in Canadian dollar total returns.

## Third quarter outlook: Canadian economic activity expected to remain positive

### Central banks firmly in tightening cycle as inflation continues rising

Although the pace of interest rate hikes is expected to slow down the economy, economic activity has been positive in Canada. First quarter GDP was 3.1%, at an annual rate, in line with the Bank of Canada's April projection, and the data were strong—showing underlying growth at almost 5.0%.

With pandemic-related health restrictions lifted, activity is expected to remain positive in the near term. Many services sectors will continue to see pent-up demand, which will offset some of the expected slowdown in other sectors such as durable goods and housing. Despite market fears, our base case is for a Canadian or global recession not to happen in 2022, although some other countries may enter a recession.

At its June meeting, the Federal Open Market Committee of the US Federal Reserve hiked the target range for the federal funds rate by 75 basis points to 1.50-1.75%, the largest rate increase since November 1994. This followed the 50-basis point hike delivered in May. Federal Reserve Chair Jerome Powell referenced the upside surprises to May's CPI inflation and consumer inflation expectations as key factors that tipped the committee into hiking by 75 basis points.

In June and April, the Bank of Canada raised rates by 0.5 percentage points. The last time there were two consecutive 0.5 percentage hikes was between December 1997 and January 1998, to support the Canadian dollar. The June rate hike was in line with market expectations, which had started fully pricing in a 0.5 percentage point hike after Governor Tiff Macklem explicitly signalled the potential for one during a parliamentary hearing in late April.

The Bank of Canada's commitment to containing inflation with interest rate hikes have seen government bond yields continue to climb in 2022, almost tripling since 2020.

### Canadian five-year bond yields



Source: Bloomberg as at 30 June 2022. Past performance is not indicative of future returns.

### Staying invested but with an emphasis on resilience and diversification

Making short-term investment decisions in a challenging environment such as today's is usually not prudent. Responding to short-term volatility by deviating from long-term investment plans rarely yields positive results. We encourage investors to stay invested, but with an emphasis on building resilience and diversification in portfolios.

- Although the pace of interest rate hikes is expected to slow down the economy, economic activity has been positive in Canada.
- In Canada, first-quarter GDP was 3.1%, at an annual rate, in line with the Bank of Canada's April projection.
- With pandemic-related health restrictions lifted, activity is expected to remain positive in the near term. Many services sectors will continue to see pent-up demand.

## Important Information:

All quoted returns are total returns as at June 30, 2022 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, RIMES, Statistics Canada and the Bank of Canada.

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