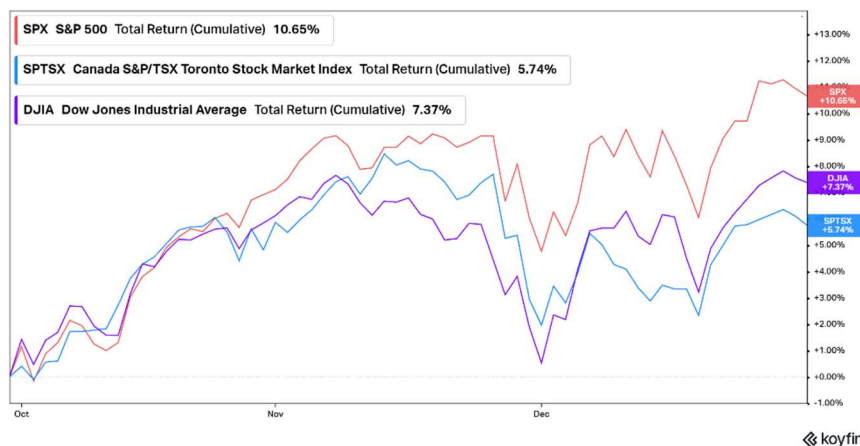




Review

Roughly two years since the initial rumours about a new contagious disease began popping up in our newsfeeds, markets remain susceptible to the whims of a virus. On the COVID roundabout, we've approached the familiar turnoffs for restrictions, lockdowns, vaccinations, and most regrettably, illness. However, while we're reminded of Bill Murray's exhaustion after reliving the same scenario again and again in the film *Groundhog Day*, there have been substantive changes in the markets and economy this go-around. Most crucially, central banks have been more explicit about rate liftoff as inflation expectations have reached their highest point in several decades. Much can change in 2022 to delay US and Canadian central banks from implementing rate hikes but for now, we believe market participants expect the extremely accomodative conditions to be shown the door.

This news, in combination with the fears around Omicron and the government response, led to a modest sell-off in many sectors of the market in the final quarter of the year. The effect was most pronounced in extremely expensive technology and consumer discretionary stocks (read as: companies with lots of recent growth but no path to profitability). Global financial markets have been happy to reward such companies since the lows of March 2020, with retail and growth investors hugely benefitting from the party atmosphere. But when the host announces they will remove the punch bowl, participants tend to leave and the party lags. While this lagging looks set to continue in certain areas of the market, the weakness did not extend very far into more defensive parts of the market. Rather, several areas that we see as more defensive have soared over this period.



During the quarter, the Dow Jones Industrial Average returned 7.4% while the S&P 500 delivered 10.6% growth. The S&P TSX Composite Index returned 5.7% during the same period with oil and gas exploration, mining, and banking industries all clearing 10% for the quarter.

Forecast

We do expect rates to increase during the upcoming year with a minimum of two hikes from Canadian and US central banks and likely more. As an act of policy, we do not think it amounts to very much (an increase of 0.5% in the interest rate is not transformational) but, in combination with finally stopping the quantitative easing program initiated in the aftermath of the financial crisis, it does signal a material change in direction as risks of unbridled inflation have become too concerning to ignore. The nature of this bout of inflation is unlike any previously seen in recent history with perhaps the only correlary over the last century being the immediate post-World War II economy. In our globalized world and a with very different monetary system underpinning



today's economy, it is very hard to call the inflationary period in either severity or length. We do not believe we are in for a period of hyperinflation or anything like it. However, the deflationary forces of the last two decades may have reached a turning point. Technology companies have run head long into political wrangling, tariffs, and security concerns, while China's status as a home of seemingly endless cheap labor and manufacturing has been met with increasing global skepticism.

Judging by the medical commentary from our provincial leaders' and others, Canada and the world have entered into a new and, hopefully, final phase as COVID shifts from a pandemic to an endemic disease. It is an open question though if a slowing to the pandemic will lead to the business world reverting to the practices in play before COVID. The old adage is that it takes two weeks to form a habit. Well, what about two years? A recent article in the Financial Times described how various companies have invested to restructure supply chains and logistics from a "just in time" mentality to now one of "just in case" noting that firms were "abandoning the 'efficiency above all else' mantra" for the pursuit of resilience.¹ You can add to that the changes in work (such as "remote first" jobs), consumption (meal and grocery delivery) and health (telemedicine), among others and ask whether companies revert to pre-pandemic habits or have they moved on to new ones.

Strategy

With expectations for both inflation continuing and modest increases in interest rates, we do not have plans to change strategy too much. In equities, we would imagine that energy and materials related companies will stand to benefit from further reopening (and further inflationary economic activity) after several years of low or no investment in the industries. Ironically, green policies and initiatives around wind and EVs are likely to drive increased demand for some of these foundational materials (and potentially even natural gas). Sentiment, however, can turn on a dime and we are conscious of not being aggressive in extremely cyclical industries. If financials respond as well to *actual* rate increases as they have to the mere anticipation of them, we may also need to trim some weighting in Canadian banks and other financials, which already experienced an exceptional year in 2021. Where we can find opportunistic uses for proceeds in sectors beaten up under the new fiscal and monetary regime, we will do so.

In general, we believe bonds, as a long-term buy-and-hold asset, remain relatively unattractive and currently do not interest us. Aside from situations where clients have specific, sizeable liabilities that are needed in short-order, we believe there are better opportunities for adding income to the portfolio. Certain unit trusts remain attractive in our view and have qualities that would make prices relatively less impacted by new rates increases or rising inflation. While many preferred shares have returned to multi-year highs, the asset class itself is slowly being replaced as many companies would rather pay up and redeem the shares at par than continue to pay 4-5% dividends. With rate hikes on the horizon, the dividend rates for "rate-reset" preferreds would be expected to increase over time. The protections for preferred shareholders are far from those provided to bondholders but they do serve a unique function and we would be loath to part with them when we expect companies will continue to pay up in the future.

¹ Financial Times, "Supply chains: companies shift from 'just in time' to 'just in case'", 12/19/2021