Invasion, Inflation, Recession? A Look Back at 2022

'A Challenging Year for Investors'

January 8, 2023

The Russian invasion of Ukraine, record inflation, potential recession on the horizon – it's fair to say that 2022 has proven to be challenging on many fronts. For investors, this context has resulted in pullbacks for stock and bonds in the first half of the year, followed by a six-month period of ups and downs with no clear direction.

In sum, most market segments showed losses in 2022, with record declines for bonds. In terms of leadership, the best performance came from assets more closely linked to commodity prices, including the Canadian stock market. Conversely, the bottom of the list belongs to stocks that are more sensitive to interest rate movement, such as the U.S. technology giants (Apple, Microsoft, Alphabet, Amazon, Meta, etc.).

As we wrap up the calendar year of 2022, I wanted to look back at the major events that transpired through some key charts to help provide you some perspective on a year, that in a nutshell, investors will remember 2022 as the perfect inflationary storm.

Market Review

Fixed Income

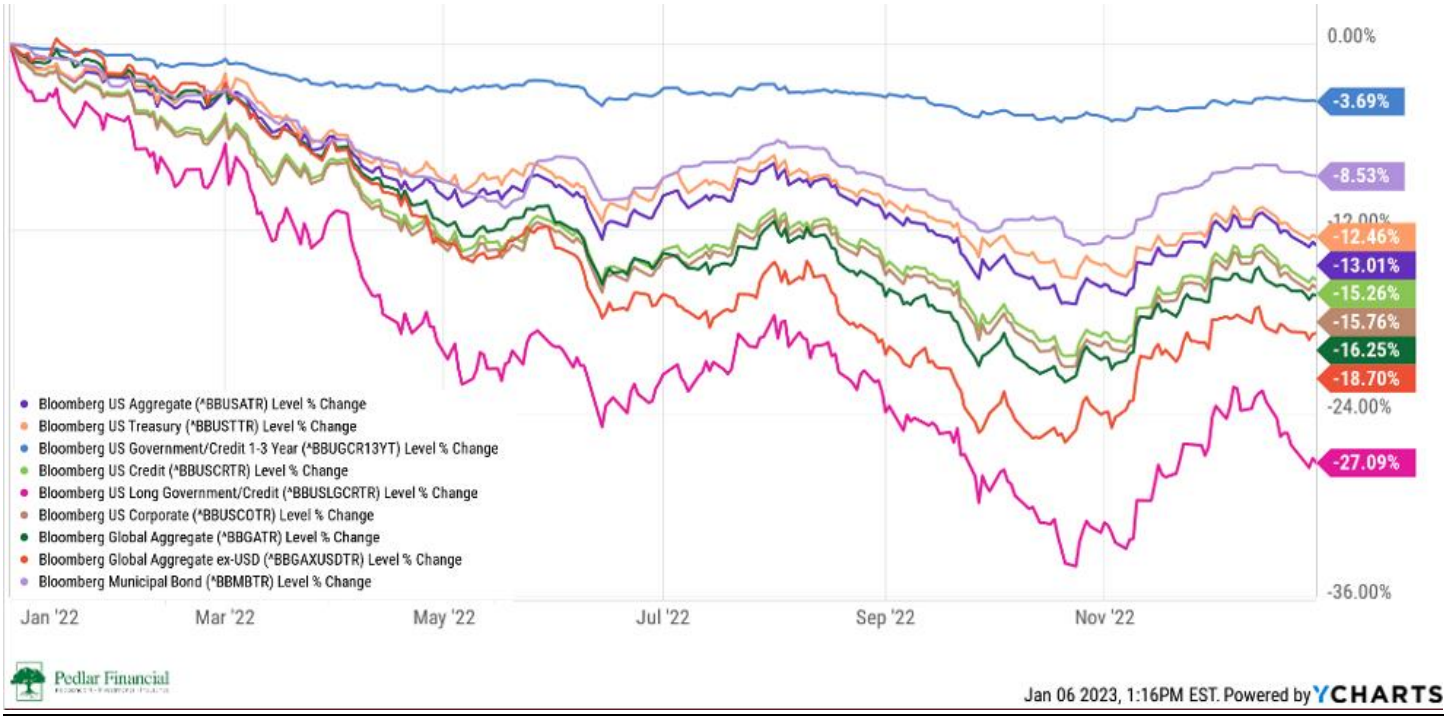
- Canadian bonds posted losses in December as medium and long-term yields rose in the face of hawkish Central Bank discourse.
- 2022 is the worst year in history for the Canadian bond universe (-11.5%).

Equities

- The dramatic stock rebound of the fourth quarter ran out of steam in the month of December, particularly in North America. The S&P/TSX (-4.9%) and S&P 500 (-5.8%) underperformed the EAFE region (0.1%) and emerging markets (-1.4%).
- However, for the year, the S&P/TSX (-5.8%) was an impressive outperformer in part to strong exposure to commodities. It was a much more challenging period for the MSCI EAFE (-14.0%), the S&P 500 (-18.1%) and MSCI Emerging Markets (19.7%), all of which posted their worst annual performance since 2008.

Asset Classes	Dec	Q4	2022
Cash (S&P Canada T-bill)	0.3%	0.8%	1.4%
Bonds (ICE BofA Canada Universe)	-1.2%	0.0%	-11.5%
Short Term	0.0%	0.5%	-4.0%
Mid Term	-1.5%	0.4%	-10.0%
Long Term	-2.8%	-0.9%	-21.5%
Federal Government	-1.2%	-0.1%	-9.2%
Corporate	-0.5%	0.5%	-10.1%
S&P/TSX Preferred shares	-1.7%	-3.2%	-18.1%
U.S. Corporate (ICE BofA US$)	-0.2%	3.5%	-15.4%
U.S. High Yield (ICE BofA US$)	-0.8%	4.0%	-11.2%
Canadian Equities (S&P/TSX)	-4.9%	6.0%	-5.8%
Communication Services	-3.1%	6.1%	-2.6%
Consumer Discretionary	-4.3%	8.8%	-6.0%
Consumer Staples	-1.9%	8.5%	10.1%
Energy	-5.6%	8.9%	30.3%
Financials	-5.6%	3.4%	-9.4%
Health Care	-16.8%	-10.9%	-61.6%
Industrials	-5.7%	7.3%	1.4%
Information Technology	-7.2%	12.6%	-52.0%
Materials	-1.8%	8.2%	1.7%
Real Estate	-2.7%	7.1%	-21.5%
Utilities	-4.5%	-7.4%	-10.6%
S&P/TSX Small Caps	-1.8%	8.4%	-9.3%
U.S. Equities (S&P 500 US$)	-5.8%	7.6%	-18.1%
Communication Services	-7.8%	-1.4%	-39.9%
Consumer Discretionary	-11.3%	-10.2%	-37.0%
Consumer Staples	-2.8%	12.7%	-0.6%
Energy	-2.9%	22.8%	65.7%
Financials	-5.2%	13.6%	-10.5%
Health Care	-1.9%	12.8%	-2.0%
Industrials	-3.0%	19.2%	-5.5%
Information Technology	-8.4%	4.7%	-28.2%
Materials	-5.6%	15.0%	-12.3%
Real Estate	-4.8%	3.8%	-26.1%
Utilities	-0.5%	8.6%	1.6%
Russell 2000 (US$)	-6.5%	6.2%	-20.4%
World Equities (MSCI ACWI US$)	-3.9%	9.9%	-18.0%
MSCI EAFE (US$)	0.1%	17.4%	-14.0%
MSCI Emerging Markets (US$)	-1.4%	9.8%	-19.7%

Fixed Income Indices – 2022 Annual Returns



Equity Indices – 2022 Annual Returns

FX & Commodities

- In December, the price of oil declined for the sixth time in seven months. Despite the Russian invasion of Ukraine and the dramatic rebound that followed, oil prices end the year with a relatively modest gain of 6.7%.

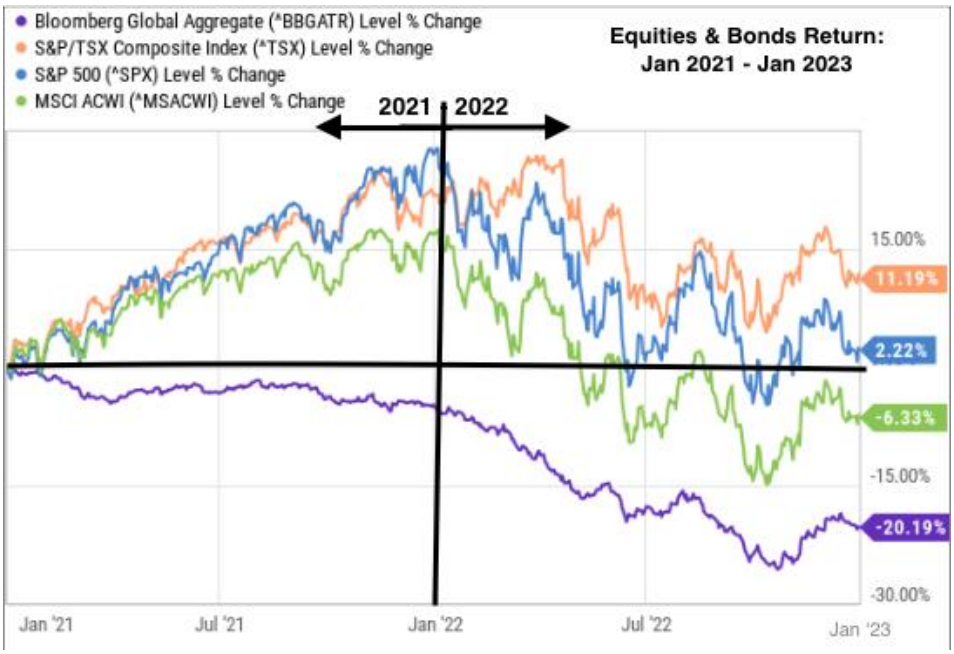
- On the currency front, the U.S. dollar declined in December, particularly against the euro. It was a different story for the year, as the Greenback appreciated significantly amid aggressive monetary tightening by the Federal Reserve.

Asset Classes	Dec	Q4	2022
Commodities (GSCI US$)	-1.4%	3.4%	26.0%
WTI Oil (US$/barrel)	-0.3%	0.4%	6.7%
Gold (US$/oz)	3.4%	8.3%	-0.6%
Copper (US$/tonne)	1.7%	8.9%	-14.1%
Forex (US$ Index DXY)	-2.3%	-7.7%	7.9%
USD per EUR	3.7%	8.9%	-6.2%
CAD per USD	1.1%	-2.0%	7.2%

A Challenging Year for Investors

The Russian invasion of Ukraine, China's covid zero policy, record inflation, global aggressive tightening of interest rates, the crypto currency meltdown, and the fear of recession on the horizon – yes, 2022 was challenging and loaded with headwinds on many fronts. For investors, this backdrop resulted in pullbacks for both stock and bonds for the first half of the year, followed by a choppy back half of ups and downs with no clear direction.

A Down Year Full of Twists and Turns…



That said, the losses in global equities in 2022 given the magnitude of headwinds may not be so dramatic considering they are coming off some solid gains from 2021. In Canada, a second consecutive year of outperformance in comparison to the rest of the world leaves the S&P/TSX with sizeable outperformance over that period. Exceptional market movements were instead observed on the fixed-income side, global bonds in general recorded one of the worst, if not the worst, years in 2022 following a loss in 2021.

To put this in perspective, the performances in the equity and bond markets have resulted in a balanced investors portfolio (60% equities / 40% bonds) with an annual return that is comparable to those recorded during the financial crisis and the bursting of the tech bubble, although the rebound in Q4 has helped limit the damage.

Finally, in terms of leadership, it was generally the commodity-related segments of the equity market that have outperformed their category; think energy within sectors, value and dividend styles within factors, and Latin America and Canada within geographic regions.

Conversely, the bottom of the list belongs to the assets most sensitive to interest-rate movements, which naturally include bonds, but also the equity sectors of technology (Apple, Microsoft), consumer discretionary (Amazon, Tesla), communication services (Google, Facebook, Netflix), and growth stocks in general. In sum, this is essentially a sharp reversal of the major leadership trends seen over the past decade. See below:

A Touch of Green, Fifty Shades of Red

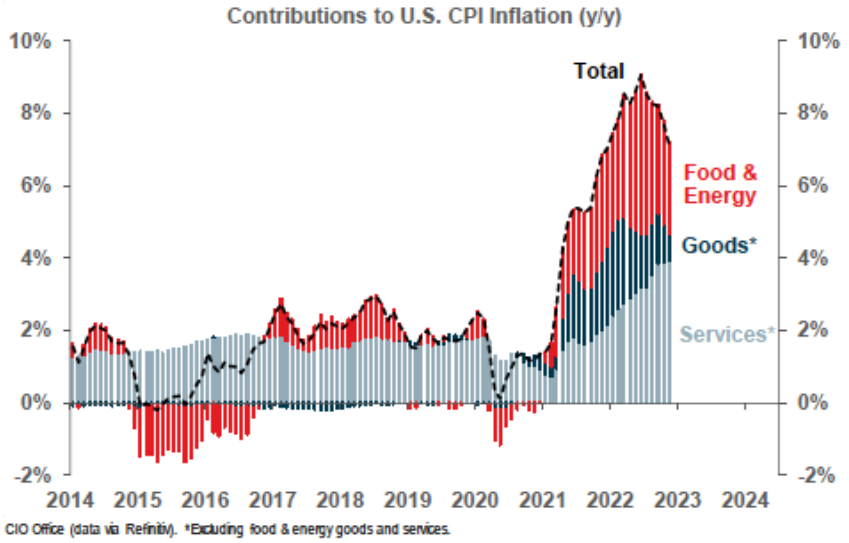
2022 Total Returns						
Cross Asset	**Fixed Income***	**S&P/TSX Sectors**	**S&P 500 Sectors**	**Equity Regions (C$)**	**Canada Factors**	**US Factors**
Commodities	Cash	Energy	Energy	Latin America	Momentum	High Dividend
26.0%	1.4%	30.3%	65.7%	17.5%	3.6%	-3.8%
Cash	Short Term	Consumer Staples	Utilities	Canada	High Dividend	Value
1.4%	-4.0%	10.1%	1.6%	-5.8%	0.6%	-6.2%
Gold	Federal Gov.	Materials	Consumer Staples	EAFE	Value	Low Vol.
-0.7%	-9.2%	1.7%	-0.6%	-7.8%	-0.3%	-14.2%
S&P/TSX	Mid Term	Industrials	Health Care	Europe	Low Vol.	Small Caps
-5.8%	-10.0%	1.4%	-2.0%	-8.3%	-1.1%	-17.2%
CADUSD	Corporate	Comm. Services	Industrials	Japan	Quality	Momentum
-6.8%	-10.1%	-2.6%	-5.5%	-8.7%	-4.8%	-17.4%
Balanced*	*High Yield (US)*	S&P/TSX	Financials	World	MSCI Canada	MSCI USA
-10.1%	-11.2%	-5.8%	-10.5%	-12.0%	-5.8%	-19.5%
US High Yield	Overall Universe	Consumer Disc.	Materials	United States	Large Caps	Large Caps
-11.2%	-11.5%	-6.0%	-12.3%	-12.2%	-6.2%	-19.7%
Canadian Bonds	*Treasuries (US)*	Financials	S&P 500	Emerging Markets	Small Caps	Quality
-11.5%	-12.9%	-9.4%	-18.1%	-13.9%	-9.3%	-22.7%
MSCI EAFE	Provi. & Muni.	Utilities	Real Estate	Asia (EM)	Growth	Growth
-14.0%	-13.3%	-10.6%	-26.1%	-15.0%	-14.0%	-32.0%
Can. Pref. Shares	*Corporate (US)*	Real Estate	Info. Tech.	EMEA (EM)		
-18.1%	-15.4%	-21.5%	-28.2%	-22.8%		
S&P 500	Preferred shares	Info. Tech.	Consumer Disc.			
-18.1%	-18.1%	-52.0%	-37.0%			
MSCI Emerging	Long Term	Health Care	Comm. Services			
-19.7%	-21.5%	-61.6%	-39.9%			

CIO Office (data via Refinitiv). *Canadian fixed income assets, unless otherwise specified.

A Look Back at 2022 in 10 Key Charts

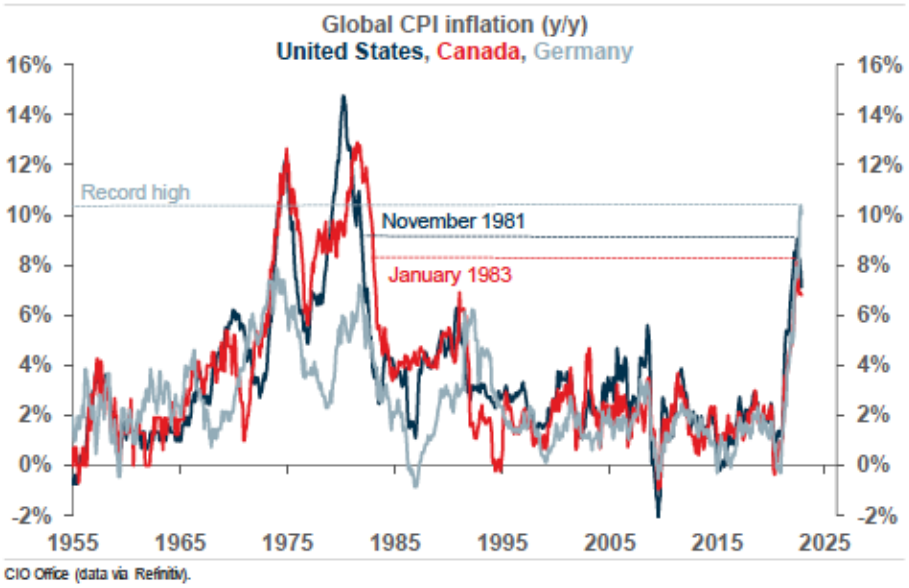
The year 2022 will have been marked, above all, by the wave of inflation that hit the economy with full force. While this perfect storm started brewing in 2021 when major disruptions in global supply chains led to a dramatic rise in the price of goods, the Russian invasion of Ukraine that began on February 24th quickly pushed food and energy prices to record highs early in the year. Ultimately, as a symptom of an overheating economy, inflationary pressures shifted to services over the course of the year, with their contribution to total inflation now more than twice the 2% target of central banks.

1- A Perfect Inflationary Storm…



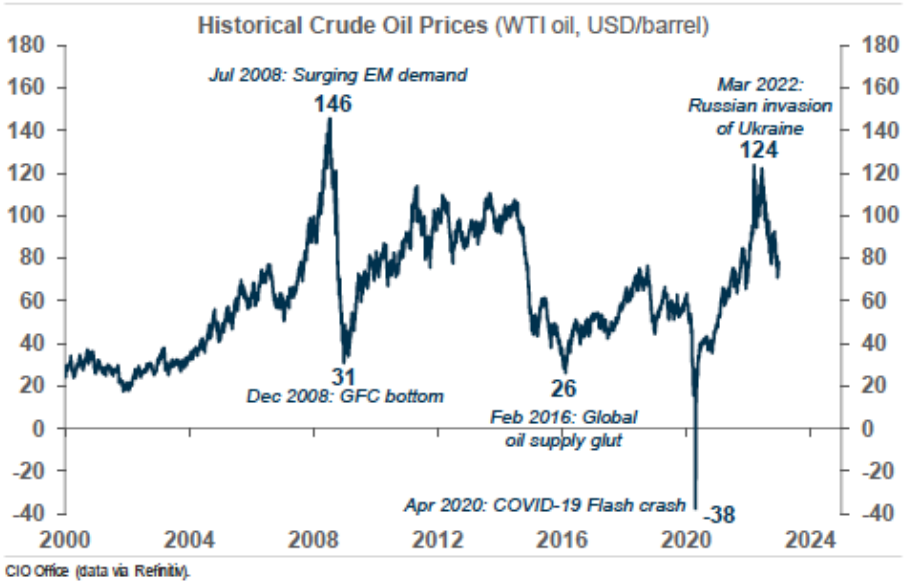
This global phenomenon was not limited to North America, as Europe was also strongly affected. For example, while price growth in both Canada and the U.S. reached their highest levels in nearly 40 years, Germany has never experienced such inflation since data became available.

2- …Unparalleled in Four Decades (or more)



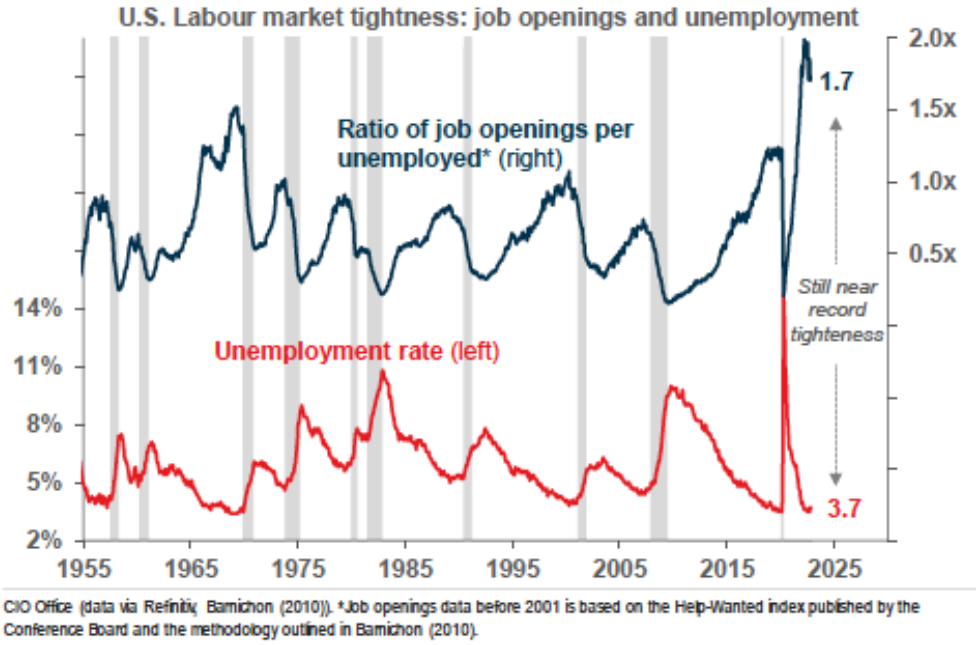
In this regard, much of the blame falls on the beginning of the most significant armed conflict in Europe since WW2 and on its consequences for global commodity markets. As Russia is the world's second largest producer of crude oil and of natural gas, the disruptions have been particularly severe in the energy sector. Specifically, the price of a barrel of West Texas Intermediate (WTI) oil climbed to $124 in March, a level that has only been exceeded once before in history, in the summer of 2008. This is quite the rebound since the negative prices seen during the early days and height of the pandemic of April 2020.

3- Geopolitical Tensions and Volatility for Oil Prices



At the same time, economic overheating was quietly but surely developing, stemming from a strained labour market. In fact, we may have seen the tightest labour market in history, with the ratio of job opening per unemployed worker reaching an all-time high while the unemployment rate remained near its historic low.

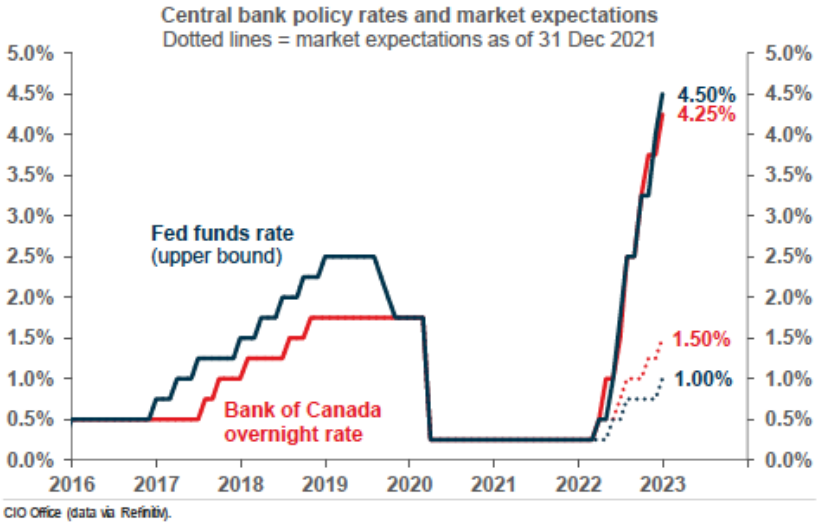
4- The Tightest Labour Market in History?



While a strong labour market is generally good news, it becomes a problem when it leads to significant acceleration in services inflation – which is closely tied to wage growth – and that is exactly what has transpired.

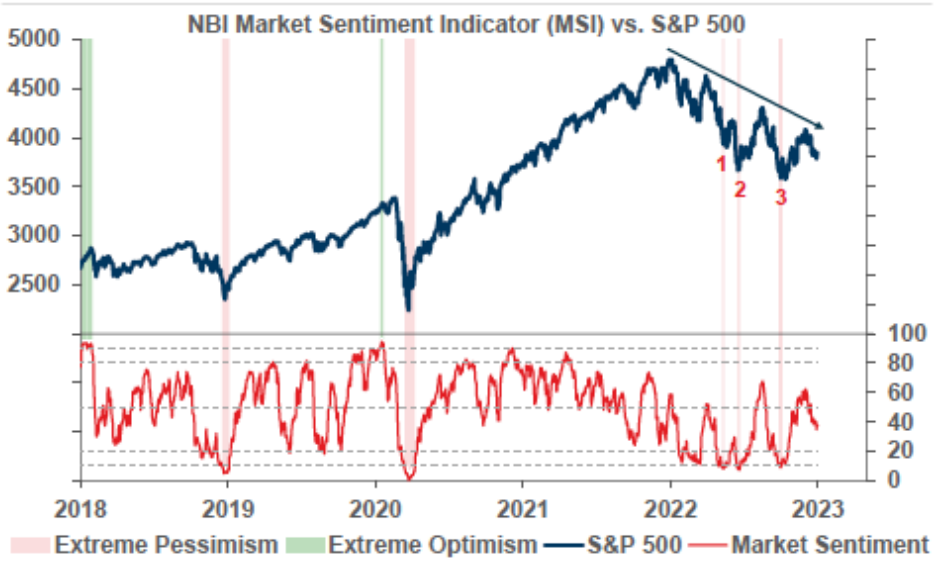
For central banks, this turn of events ended hopes that the inflationary wave would only be "transitory." With the risk of more persistent, sticky inflation now a reality, policymakers quickly went into catch-up mode. As such, while markets initially expected only three - 25 basis point (bps) hikes from the Federal Reserve in 2022, investors were instead treated to a sizeable 425 bps of tightening of the federal funds rate. It was the same story here in Canada where the Bank of Canada also surprised markets with aggressive rate hikes. As a result, North American policy rates are now about twice as high as they were prior to the pandemic.

5- Central Banks Slammed on the Brakes…



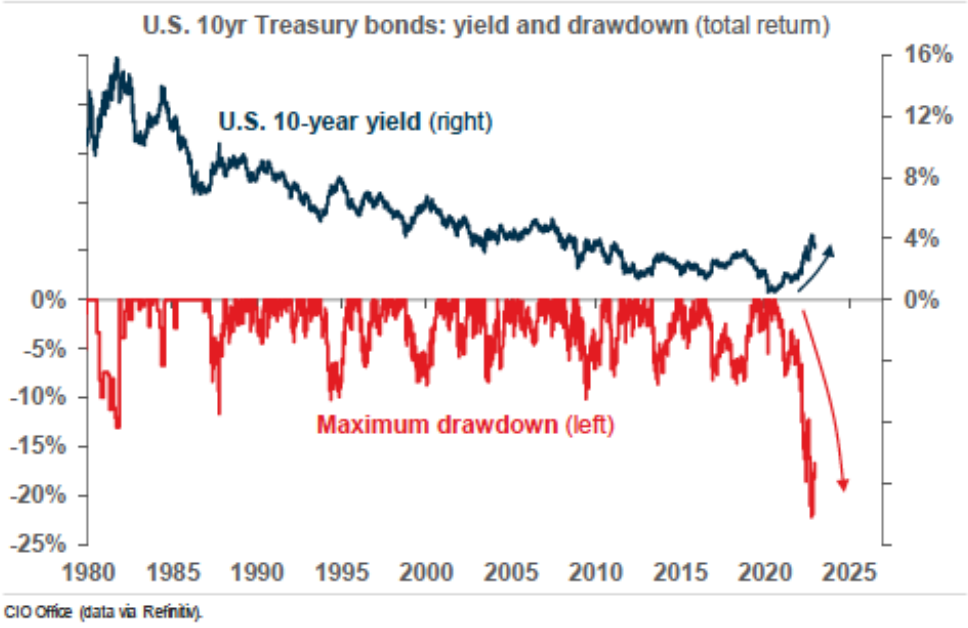
In the stock market, this monetary equivalent of "slamming the brakes" was reflected in a downward trend, with the S&P 500 officially crossing into bear market territory (-20% off its high) in June. This was followed by a period of strong moves, both up and down, with our market sentiment indicators hitting extreme pessimism threshold three times, which this year has proven to be quite effective in signaling a potential short-term rebound.

6- …which Caused a Stir in the Stock Market…



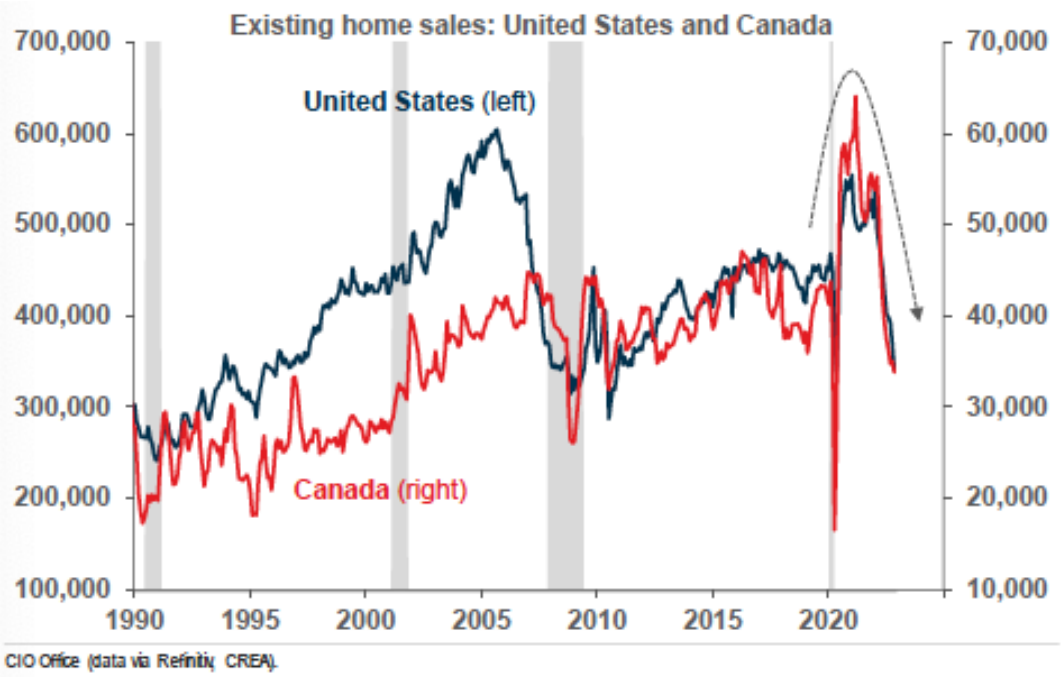
On the fixed-income side, policy rate hikes led to a dramatic rise in bond yield. Although movements of a similar magnitude have been observed in the past, notably around the 1980's, the particularity this time was the extremely low initial level of rates (around 0.50% in 2020). Thus, with record duration risk and no coupon to cover losses, the shock to the bond market was brutal, with U.S. Treasury bonds posting unprecedented losses.

7- Unprecedented Losses for Bonds…



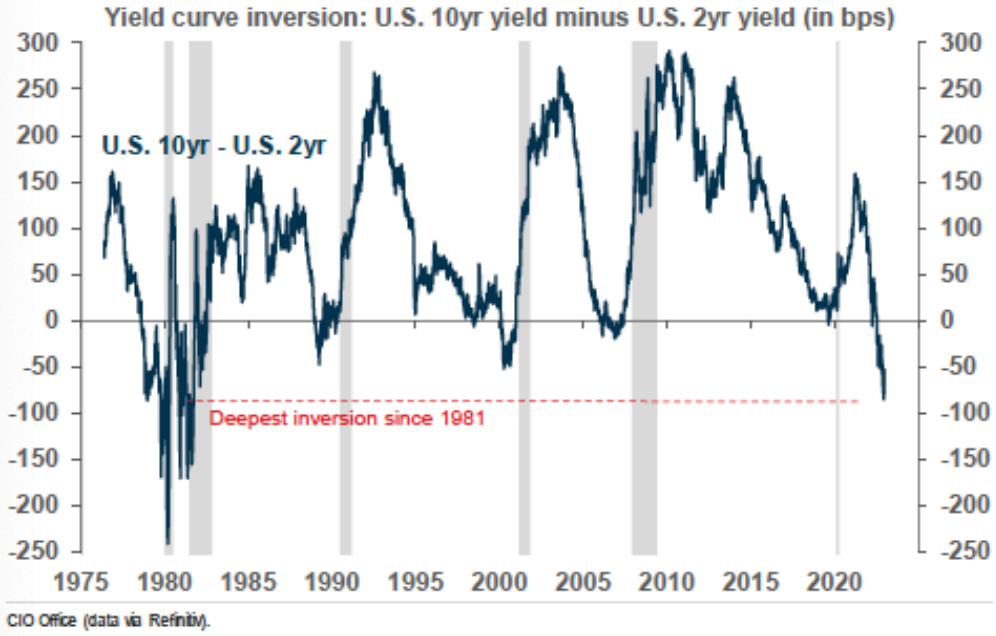
Beyond financial markets, the impact of monetary tightening is also being felt in the real economy, particularly in those sectors most sensitive to interest-rate movements. The most striking case is certainly real estate, which, after starting the year in overheating, is now operating at a much slower pace, as illustrated by the decline in existing home sales on both sides of the border.

8- Pouring Cold Water on the Housing Market



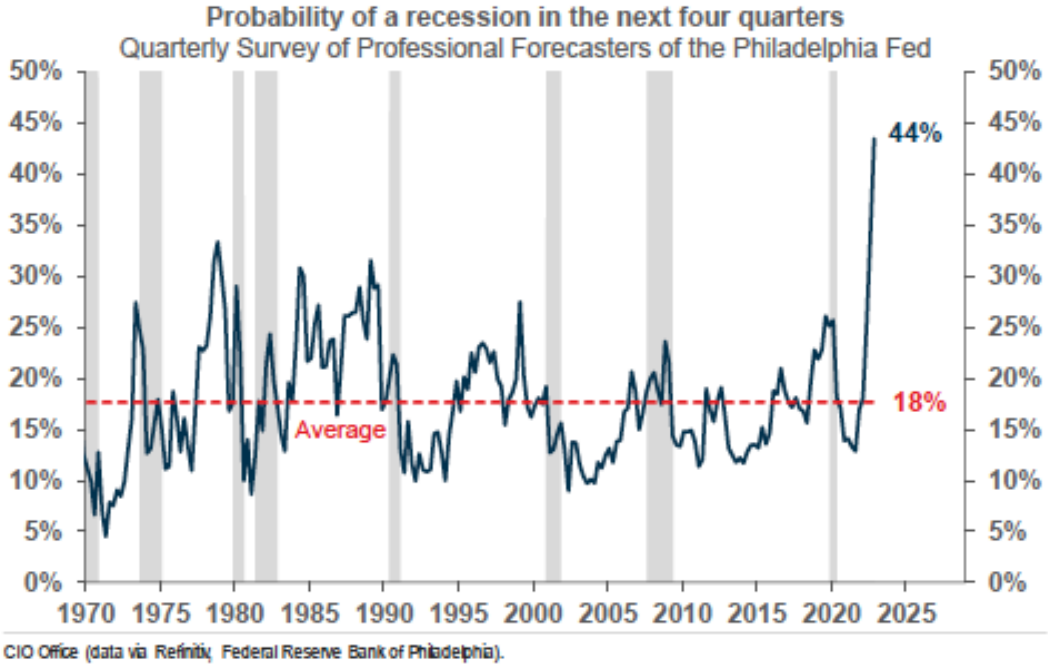
In the end, 2022 concluded with increase recession risks, as the list of leading indicators pointing to a sharp economic downturn on the horizon continues to grow. Among these, the inversion of the yield curve (in the form of the 10-year rate minus the 2-year rate) has a track record that commands respect, having predicted the last six U.S. recessions. Inverted for nearly six months, this yield curve is showing its deepest inversion since 1981.

9- Most Recession Signals are Flashing Red



Notably, the accumulation of early warning signals implies that the coming recession would, if it were to materialize, be the most discounted recession in history, according to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia since the 1970's.

10- The Most Forecasted Recession Ever?



Are these concerns exaggerated? Or, conversely, are there previously unsuspected financial vulnerabilities that only a recession can reveal? No one knows for sure. One thing for certain though, 2023 is shaping up to be (another) eventful year as central banks begin the most difficult part of their fight against inflation: assessing when they should stop, pause, or even reverse, their cycle of rate hikes to ensure a definitive victory against inflation without triggering an unnecessarily severe recession. Not an easy task, but not impossible either. I guess we will have to wait and stay tuned.