The Investment Junction

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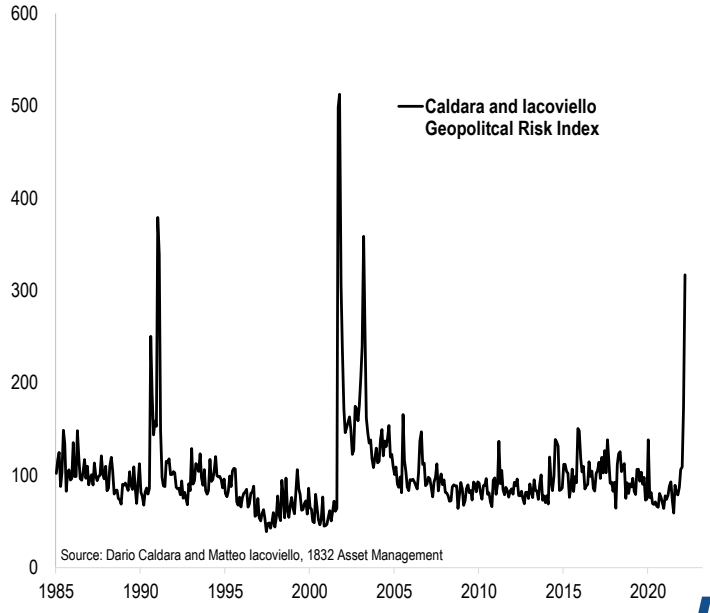
It's getting more complicated. Financial markets have been struggling under the weight of heightened inflation risk, policy tightening, and slowing economic growth. Russia's recent invasion of Ukraine adds another layer of uncertainty to this story (**see Chart of the Month**).

While financial market volatility is likely to remain elevated given the backdrop, these challenges can eventually be overcome by ongoing gains in the world economy. This year's growth expectation has ratcheted steadily lower since the fourth quarter of 2021, but it remains at an above-average level of 4.3%. The message from leading business surveys continue to point to resilient labor demand, buoyant capital spending intentions, and the beginning of a durable inventory restocking cycle.

Make no mistake about it, growth is slowing. Companies with little to no earnings, or those with lofty embedded future growth expectations, are at risk of disappointment. Equities with the combination of reliable fundamental delivery and a reasonable valuation multiple probably represent an important leadership theme through the next few months. A de-risked portfolio might be a happier portfolio until this initial fog of war has lifted.

Our strategic asset allocation has not changed. We believe that stocks are more likely to outpace bonds for as long as economic growth remains positive, and especially when those returns are marked on an inflation-adjusted basis. Alternatives remain at the high-end of our neutral range to enhance the ride during what is likely to be a rockier period for the traditional asset classes. Economic recession is usually what signals a strategic, or lasting, shift from equities to bonds and at this stage the odds of recession still appear low.

Chart of the Month: Low Geopolitical Risk Spikes Higher



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"Only the dead have seen the end of war"

On February 22, Russian troops were ordered to move into Ukrainian oblasts of Donetsk and Lohansk on what President Vladimir Putin initially called a "peacekeeping operation". This decision immediately followed from an official Russian government decree which recognized these regions as independent states. Most members of the U.N. Security Council viewed the Russian troop movements as an unprovoked violation of Ukraine's sovereignty and territorial integrity. The international community was highly skeptical of the Federation's intentions given that Russia had amassed upwards of 190,000 troops and erected several field hospitals along Ukraine's borders. None of this seemed peaceful.

Figure 1: Location of Russian Attacks Reported to February 24

Source: Institute for the Study of War

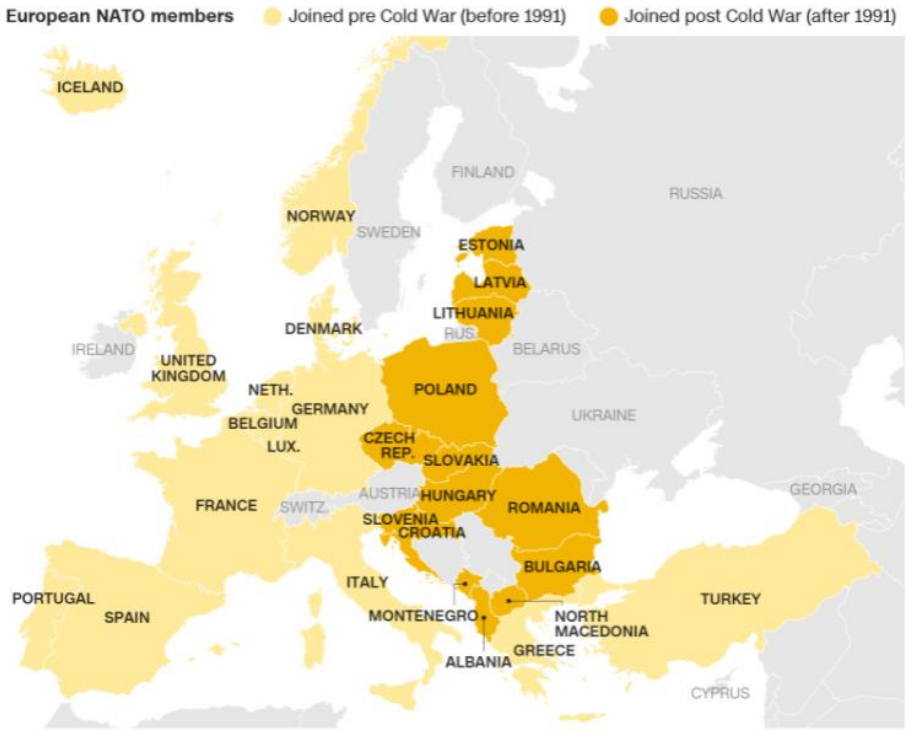
Those doubts were confirmed a day later as reports poured in about strikes on assets and infrastructure across Ukraine (Figure 1). Putin verified the attacks in a public address and warned other countries that any attempt to interfere with Russian action would lead to "consequences they have never seen". When questioned in a succeeding press conference, U.S. President Biden wasn't ready to hazard a guess on what Putin meant by the statement; but everybody seemed to be thinking the same thing.

Legal experts have said that the Crimean annexation in 2014 was in violation of the 1994 Budapest Memorandum. This was an agreement signed by Russia, U.S. and U.K. and designed to provide security assurances to the Ukraine in exchange for leaving its nuclear arsenal with Russia. The Minsk agreements of 2014 and 2015, also signed by Russia, were intended to keep Russia out of the Donbas region of Ukraine. A predator just doesn't play by the same rules.

Ukraine appears to be a casualty of Putin's paranoia regarding NATO's expanding reach (Figure 2). In late 2021, the Russian government presented to the West a list of eight demands which included the cessation of NATO's eastward expansion, rolling back on troop deployment in countries that had

joined after 1997 (e.g., Estonia, Latvia, Lithuania, Romania), and the rejection of Ukraine as a future member of NATO. Several factors seemed to have played a role in Russia's hard line on the Ukraine, perhaps none more than the increased military aid flowing from the West and into the Ukraine. The demands put forward by Putin and his Russian Foreign Ministry were a non-starter for the NATO alliance. As these words hit paper, Russia continues its military advance inside Ukraine.

Figure 2: NATO's "Encroachment"



Source: NATO

Countries representing about two-thirds of the world economy have responded to Russia's assault with sanctions. While the list of actions taken remains fluid, the broad brushstrokes of what's known up to this point are as follows:

- Curbs on Russia's ability to transact in the U.S. dollar, euro, yen, and pound;
- The sanctioning of Russian elites and their families;
- Severing the access of Russia's multinational companies to global capital markets;
- Squeezing Russia's ability to import, with particular emphasis on high-tech goods and services;
- Severe restrictions on the international operations of Russian banks including the exclusion of various lenders from the SWIFT messaging system which is used for trillions of dollars in transactions around the world;
- Sanctioning Russia's central bank which is aimed at complicating the enactment of monetary policy and removing a potential source of support for their banking sector.

President Biden has also shared that there will be no American boots on the ground in Ukraine, but NATO will be moving more forces east to defend its allies located closer to the conflict zone.

Economic and Financial Market Spillovers

The war and its related international sanctions will most certainly knock Russia into economic recession. The sharp decline in the ruble and greater than 50% drop in the Russian stock market tells us that investors have already been leaning in that direction (Figure 3).

The latest actions on the list, cutting off various Russian lenders from SWIFT and freezing Russia's central bank, seem like the two most powerful tools used so far. Russia has about $500 billion in non-gold foreign reserves and $100-130 billion in gold. In principle, it could sell some of those assets and buy rubles to support the currency, but to do so it needs to be able to access those assets which are now held mostly in deposits or derivative contracts with foreign banks. If it can't, and if many Russian banks can't either because they are cut off from SWIFT, foreign exchange interventions become a problem. The intended result seems to be a sharp devaluation of the currency, which would cripple the Russian economy and financial system.

Direct spillovers to the rest of the world are likely to be small given that the Russian economy represents about 2-3% of world GDP. Based on Bank for International Settlements data, the world's banks have about $88.9 billion, or 0.05% of total assets, in direct exposure to Russia. Said differently, the looming economic and financial problems for Russia are likely to largely remain Russian problems. But, perhaps, not entirely.

Figure 3: Russia's Stock Market Crash

Secondary effects for the world economy are much more difficult to gauge. Russia is a major global supplier of industrial metals, grains, and energy (Figure 4). Significant supply disruption risks further sizable increases in commodity prices, an unwelcome development when so many countries are currently attempting to tame already elevated inflation rates. Finding alternative sources of supply could prove difficult were Russia's commodity exports severely curtailed by Western actions.

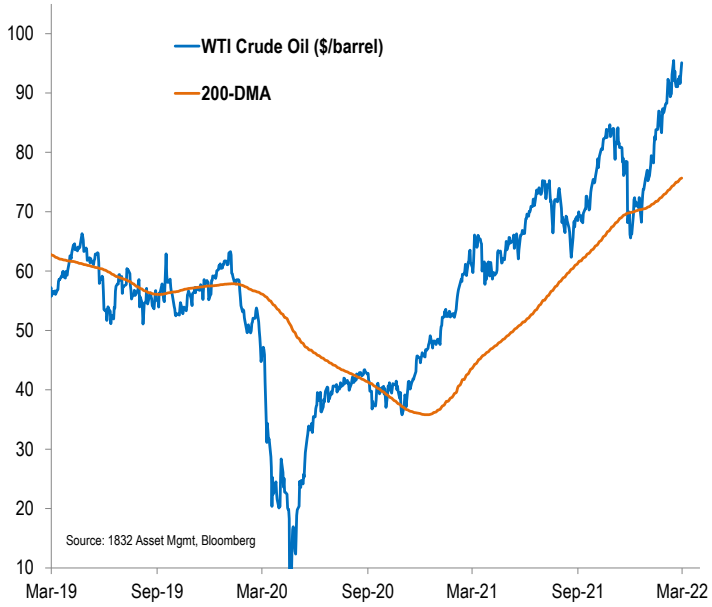
Figure 4: Russia's Share of Global Commodity Production (%)

Russia's Share of Global Commodity Production (%)	2018	2019	2020
Oil	12.2	12.3	12.1
Natural gas	17.4	17.1	16.6
Coal	5.6	5.5	5.2
Copper	4.3	4.3	4.3
Aluminum	5.9	6.2	6.1
Nickel	6.8	6.3	6.1
Zinc	1.9	1.5	1.5
Gold	8.1	9.1	9.5
Silver	5.1	5.3	5.4
Platinum	10.8	11.7	14.1
Palladium	39.4	41.0	43.9
Wheat	9.8	9.7	11.0

Source: J.P. Morgan Commodities Research

Most eyes are on the energy markets, arguably the world's most important commodities (Figure 5). To soften the blow, a deal could be struck with Iran and its near 135 million barrels of onshore and floating oil storage and the U.S. could tap into some of its Strategic Petroleum Reserve. Not applying pressure on Russia today, however, risks an even longer period of geopolitical instability in eastern Europe.

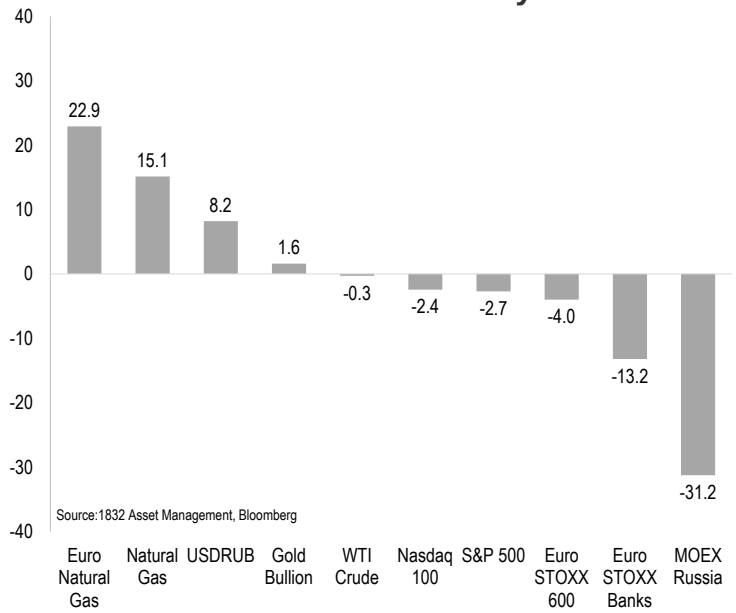
Figure 5: The Surging Price of Oil



As it stands, there are many important questions still outstanding with respect to the Russia-Ukraine crisis. How long will the conflict last? Will the international community fully ban Russian commodity exports? Could other countries get pulled into the conflict? The ambiguity that this tension caused was first reflected in the weakening price of Russian assets, but it then started to appear in many other corners of the world's financial markets. The evidence of spread mounted shortly after President Biden's February 11th warning of an imminent Russian attack on the Ukraine (Figure 6).

While these past few weeks have been challenging, it might seem odd that the headline noise of war, at least to this stage, has been much louder than the price action seen across the global financial markets.

Figure 6: Asset Performance Since Biden's February 11th "Imminent Attack" Warning



Perhaps, we should not be too surprised. History tells us that armed conflict is typically associated with market drawdowns which are relatively small and transitory (Figure 7). However, this performance data hides some important details. When war starts as a surprise, the outbreak of the war decreases stock prices. When there is well-defined pre-war phase, like what has happened through the latest conflict, an increase in the likelihood of war decreases stock prices but then stocks bounce soon after the war begins. It is what many analysts studying market history have referred to as the "war puzzle".

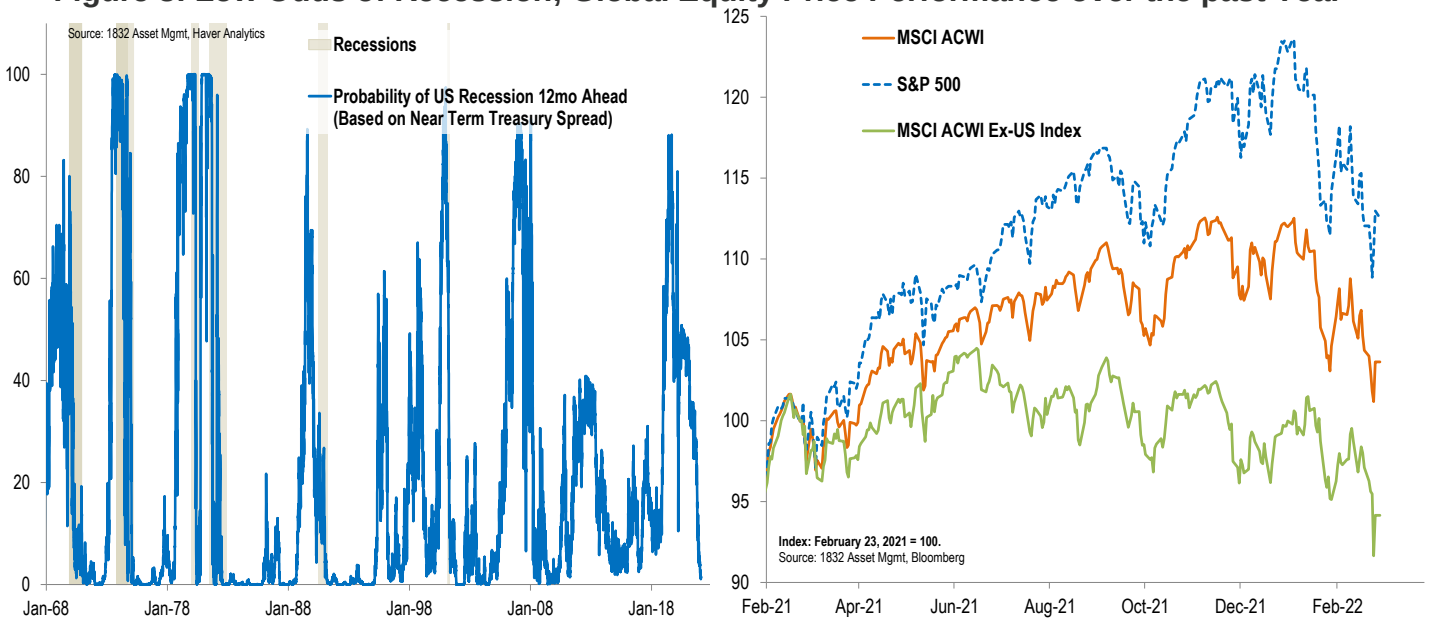
Figure 7: Stock Price Performance during Conflict

Wars and Stocks

Event	Event Date	One Day Return (%)	Total Draw Down	Days to Bottom	Days to Recovery
Iranian General Killed in Airstrike	2020-01-03	-0.7	-0.7	1	5
Saudi Aramco Drone Strike	2019-09-14	-0.3	-4.0	13	26
North Korea Missle Crisis	2017-07-28	-0.1	-0.2	2	3
Bombing to Syria	2017-04-07	-0.1	-1.2	5	11
Boston Marathon Bombing	2013-04-15	-2.3	-3.0	4	11
Madrid Bombing	2004-03-11	-1.5	-2.9	10	14
US Terrorist Attacks	2001-09-11	-4.9	-11.6	5	19
Iraq Invasion of Kuwait	1990-08-02	-1.1	-16.9	50	131
Reagan Shooting	1981-03-30	-0.3	-0.3	1	2
Munich Olympics	1972-09-05	-0.3	-4.3	30	41
Tet Offensive	1968-01-30	-0.5	-6.0	24	45
Six Day War	1967-06-05	-1.5	-1.5	1	2
Gulf of Tonkin Incident	1964-08-02	-0.2	-2.2	4	29
Kennedy Assassination	1963-11-22	-2.8	-2.8	1	2
Cuban Missile Crisis	1962-10-16	-0.3	-6.6	6	14
Hungarian Uprising	1956-10-23	-0.2	-0.8	3	4
North Korea Invades South Korea	1950-06-25	-5.4	-12.9	13	57
Pearl Harbor Attack	1941-12-07	-3.8	-19.8	97	214
	Average	**-1.5**	**-5.4**	**15**	**35**
	Average Excl. Recessions	**-1.3**	**-4.3**	**13**	**30**

Notice also, in Figure 7, that the events associated with a longer lasting and deeper drawdown usually occurred during economic recession. Those included Iraq's 1990 invasion of Kuwait and the 9/11 terrorist attacks of 2001. In both of those cases, it is difficult to separate the effects of the geopolitical shock from the economic shock but the latter probably played an important role. Today's leading economic data point to low odds of an economic contraction over the next 12 months (Figure 8, LHS). This view is supported by global business surveys which suggest resilient labor demand, buoyant capital spending intentions, and the beginning of a durable inventory restocking cycle. It will be important to closely monitor these economic developments since a negative change in the outlook is likely to create even more serious challenges for global financial markets.

Figure 8: Low Odds of Recession; Global Equity Price Performance over the past Year



But let's not fool ourselves. Problems for equity markets started well before this latest round of eastern Europe geopolitical drama (Figure 8, RHS). International equities peaked in June of 2021 and are down by 10% over that period. America's stock market started to roll over seven months later and its 11% slide has been more sudden. These unfortunate geopolitical developments seem to have joined a list of lingering concerns which include uncomfortably high price inflation, a central bank tightening cycle, and slowing corporate earnings growth.

Over the past 12 months, an increasing number of central banks have been raising their interest rates to cool mounting inflationary pressures. The GDP weighted average inflation rate for the world economy stands at 7.8%, its highest level in over 30 years. The picture does not get any better by looking at advanced or emerging countries separately. Inflation has become a worldwide problem, not linked to the developments in any one country. It's probably why we are seeing so many central banks signal in chorus that interest rates will need to rise further (Figure 9). Over the coming year, at least 150 basis points of tightening is expected from many important central banks including those in Brazil, New Zealand, Canada, United States and Australia.

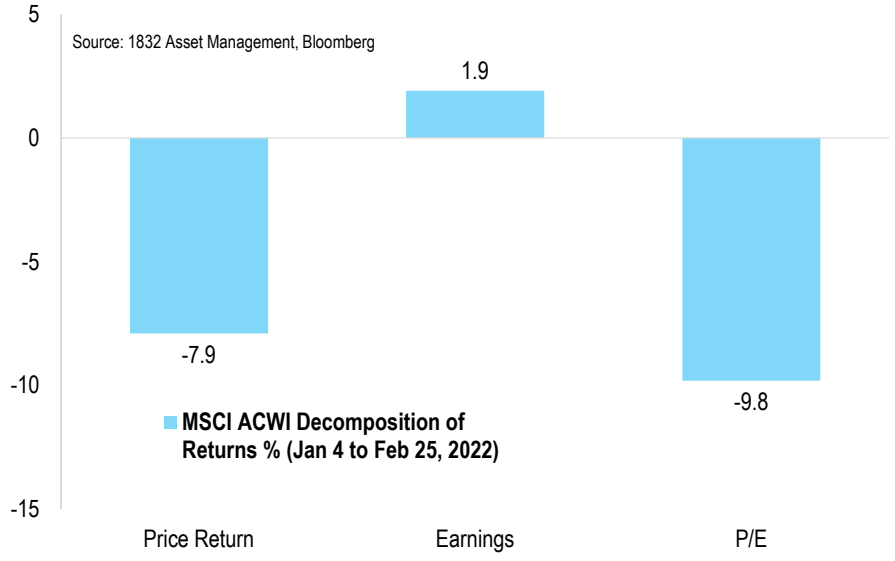
Figure 9: Expected Change in Policy Rates over the Next 12 Months

Central Bank Policy and Implied Rates (%)			
Country	Current Rate (%)	Implied 1yr (%)	Chg in Rate (bps)
Brazil	10.75	12.93	218
New Zealand	1.00	2.82	182
Canada	0.25	2.06	181
US	0.13	1.87	174
Australia	0.10	1.63	153
UK	0.50	1.92	142
Norway	0.50	1.54	104
Sweden	0.00	0.66	66
Eurozone	-0.50	0.00	50
Switzerland	-0.75	-0.44	31
Japan	-0.02	0.01	3
China	2.10	1.81	-29

As of Feb 25, 2022. Source: 1832 Asset Mgmt, Bloomberg

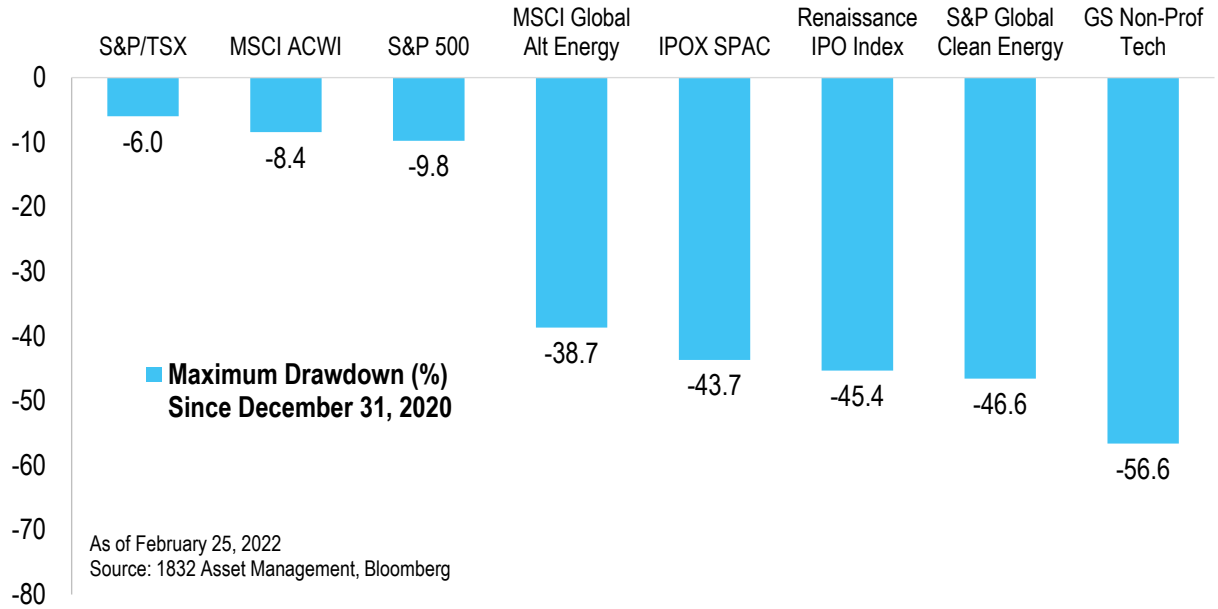
Financial markets have had to absorb what can only be described as an interest rate shock. The expected increase in policy rates has pushed global bond yields sharply higher and weighed on equity valuations. Price-to-earnings compression now accounts for more than all the weakness seen in the equity market this year (Figure 10). If P/E multiples had remained flat, the market would probably be up by closer to 2% from the earnings support alone.

Figure 10: P/E Compression has weighed on Global Equity Returns in 2022



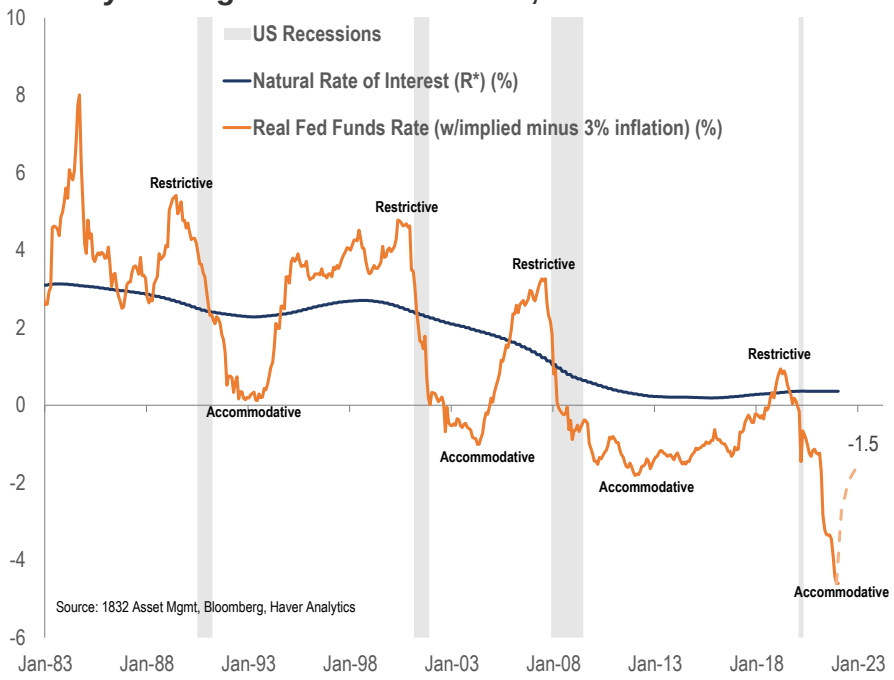
Companies which have relied most on the central banks' monetary generosity have also been hit the hardest by fears of the liquidity drain (Figure 11). These are typically the companies with sky-high valuations and very little earnings support; the concept stocks, many of which can be found among a list of recent IPOs, in the blockchain, and throughout the clean energy industry.

Figure 11: Some Areas have been Hit Especially Hard



The technologies possessed by some of these companies will undoubtedly play a key role in our future and a few of the companies will most likely become incredibly successful; but, certainly not all of them and probably not even most of them. Between early-2021 and into early-2022, investors decided to price the stocks as if they would all be huge winners. That seemed to be a spillover effect from the period of extraordinarily low interest rates, something that is now in the process of vanishing.

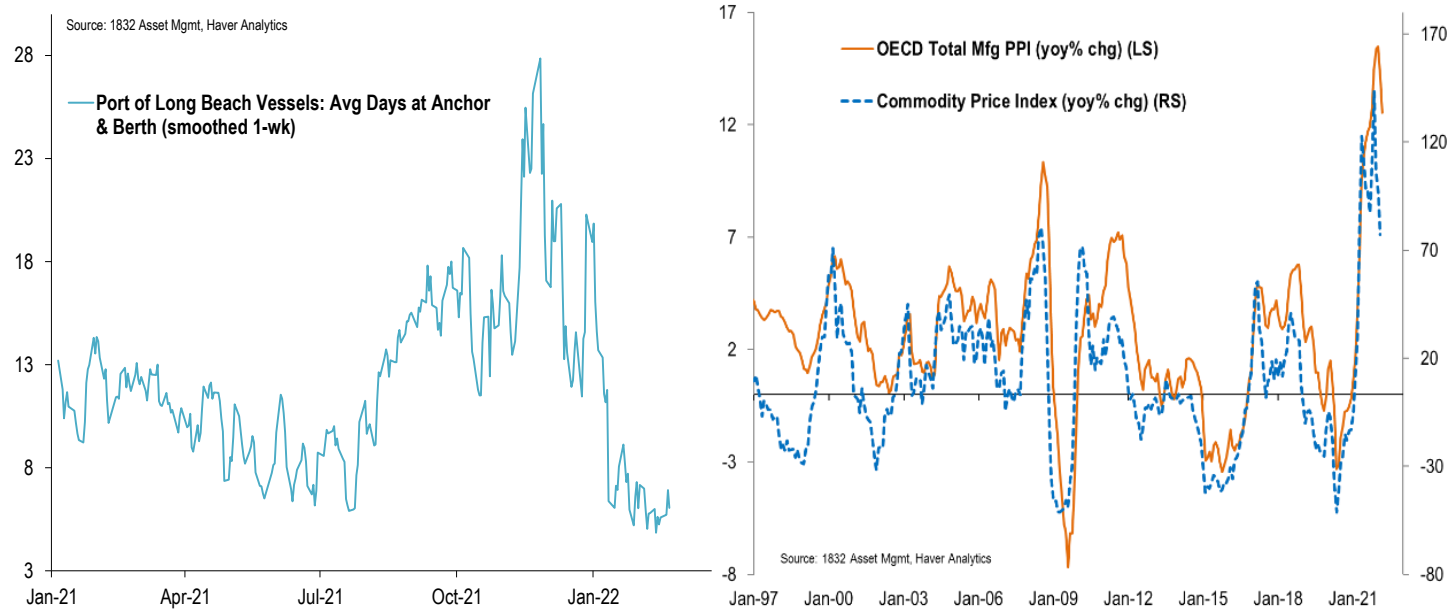
Figure 12: Monetary Settings are Still Generous, Just not as Generous as they Were



Higher interest rates are imposing some discipline on the investment decision-making process. The weakest links are usually those that break first and this time around seems to be no exception. Based on current expectations, policy-set interest rates will increase but seem unlikely to become unduly restrictive to growth even through the next year. Take the U.S. Federal Reserve, for example, which is expected to lift the funds rate by 175 basis points over the next 12 months. After accounting for demographics, productivity, and inflation, the fund rate is likely to remain below a level that has generated economic trouble in the past. How far below? Perhaps still 100-150 basis points below the level which has been associated with an economic tipping point (Figure 12).

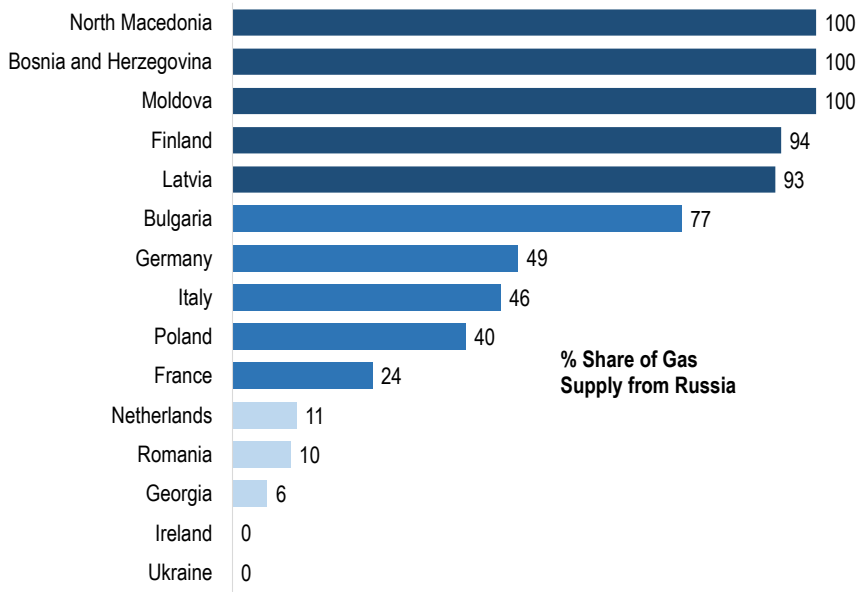
This is not to say that further financial market turbulence will be avoided. Looking at all the monetary tightening cycles since 1970, the S&P 500 did lose some ground around the first Fed rate hike. The maximum previous fall in the three months surrounding the first hike was about 9%, comparable to what we are witnessing today. Typical declines are on the order of 3-5%. In all cases, the corrections tended only to be tactical in nature, and not a regime change. Recessions represent regime changes and, like we have shown, this is not expected over the next 9-12 months. Following the initial jitters, the equity market usually rebounded, not only making up for those losses but ending another 6% higher a year later.

Figure 13: Pipeline Inflationary Pressure Starting to Ease in Some Areas



And, if fortune turned our way and inflation began to moderate, global rate hike expectations might begin to level off, or even take a step backwards. This is not an entirely senseless thought given the fact that supply-chain stress is moderating while pipeline inflationary pressures are starting to ease (Figure 13). Lower inflation risks would take some immediate pressure off the equity market's valuation multiples. Of course, watching how the Russia-Ukraine war plays out and how countries react to this conflict will be important to follow. Further inflationary issues could develop if the world completely cut off Russia's ability to export its commodities. European countries would be in the direct firing line of a sharp rise in energy prices given their dependence on Russian natural gas (Figure 14). As a net energy exporter, America is somewhat better insulated from an energy shock now than it has been in the past.

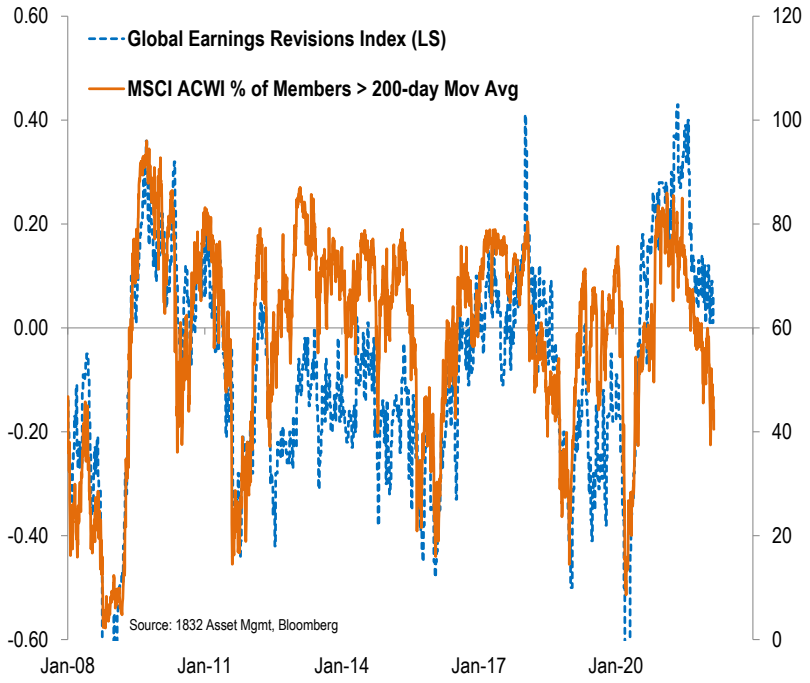
Figure 14: Europe is Susceptible to a War-related Energy Price Shock



Source: European Union Agency for the Cooperation of Energy Regulators

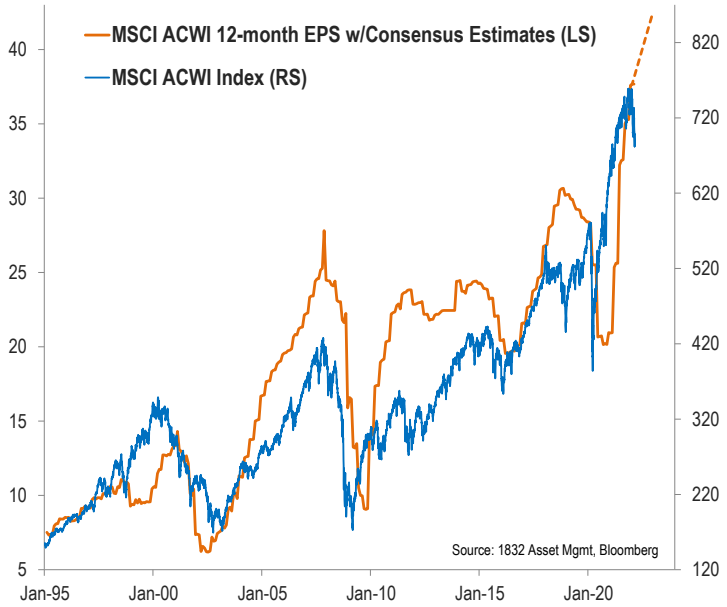
Selectivity within the equity market is likely to remain quite important. As the global economy slows further, and earnings expectations drift lower, we typically see market performance narrow (Figure 15). Those companies with the most unrealistic, and often the highest, embedded growth expectations are at greatest risk of disappointing investors through these periods of time. "Boring" becomes beautiful.

Figure 15: Market Narrowing Alongside Increased Earnings Growth Scarcity



But it is important to keep in mind that somewhat greater earnings growth scarcity is not at all the same as an earnings recession. There is still a fair amount of earnings support under this market (Figure 16). Global earnings per share could be up by 10-15% in 2022, with a similar sort of earnings path expected for U.S. stocks. It has usually not paid to get too bearish on equities when earnings are in an expansionary mode. While it seems appropriate to become more selective, this is a very different thing than turning outright bearish.

Figure 16: Slowing, but positive, Earnings growth still Supports Equities



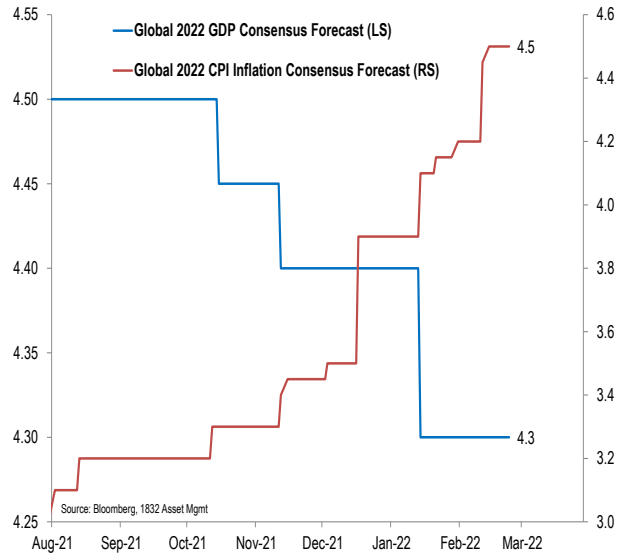
Earnings Growth (%)	2019	2020	2021 Est	2022 Est	2023 Est
World	0.1	-17.5	66.8	12.4	10.2
Emerging Markets	4.1	-5.3	59.8	16.7	11.3
United States	0.0	-15.6	63.0	11.1	11.8
Japan	-9.2	-8.9	37.1	13.7	7.8
Europe	1.5	-36.2	98.4	11.8	5.5
Canada	4.8	-40.1	122.5	11.0	5.6

Source: FactSet

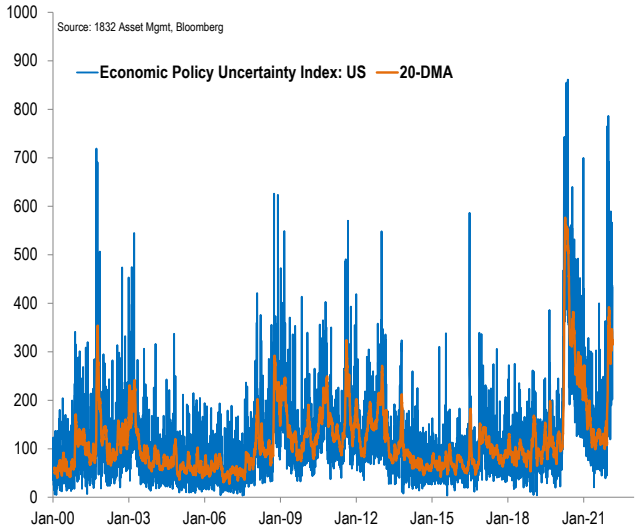
As of February 28, 2022

Bottom Line: Inflation, central bank tightening, and geopolitical conflict are all contributing, in varying degrees, to global financial market volatility. It is difficult to imagine this volatility leaving us until some of these layers of uncertainty are resolved. That said, heightened risk of economic recession is often the key signal of a strategic, or lasting, shift from equities to bonds. At this stage, the odds of recession over the next 9-12 months still appear low. We remain overweight equities relative to bonds. The allocation to alternatives remains at the high-end of our neutral range to enhance the ride during what is likely to be a rockier period for the traditional asset classes.

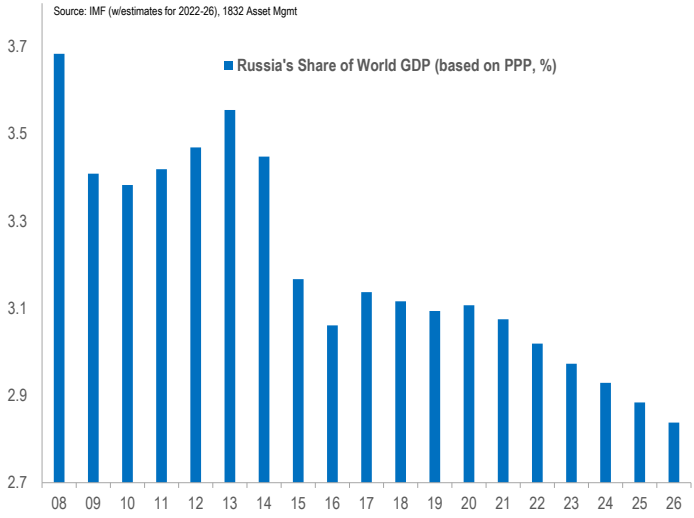
Appendix: Charts of Interest



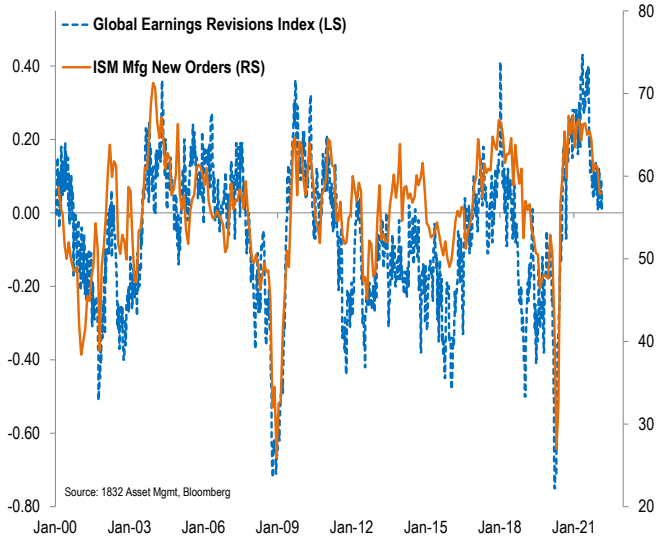
- Expectations for global economic growth have been edging lower while those for inflation have been climbing.



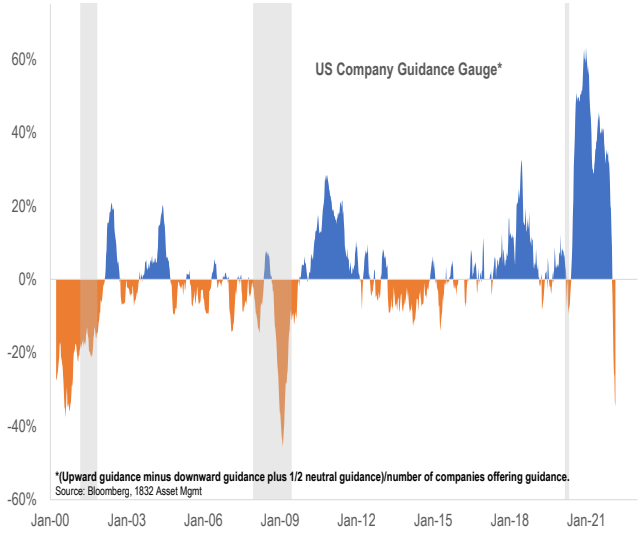
- With inflation expectations up, growth slowing, and geopolitics on the front-burner, measures of policy uncertainty have been on the rise.



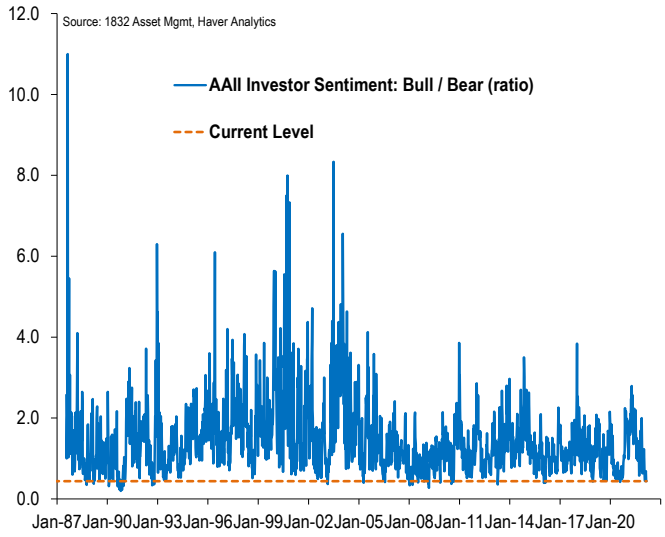
- Russia's share of global GDP has been trending lower for more than a decade and now sits at about 3.1%. Over the next few years, economists at the IMF expect this downtrend to continue.



- Global EPS estimate revisions have moderated alongside indicators of the business cycle. Earnings growth is moderating from its earlier white-hot pace.

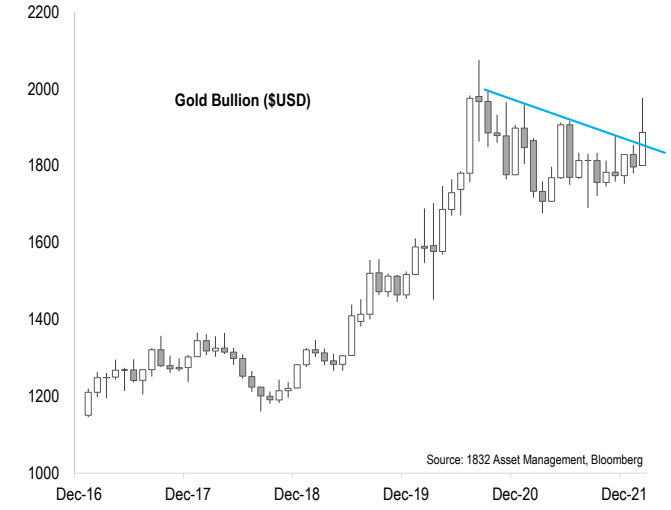


- Companies have been guiding analysts' earnings estimates lower. Expectations are in the process of being re-set after a period of extreme buoyancy.

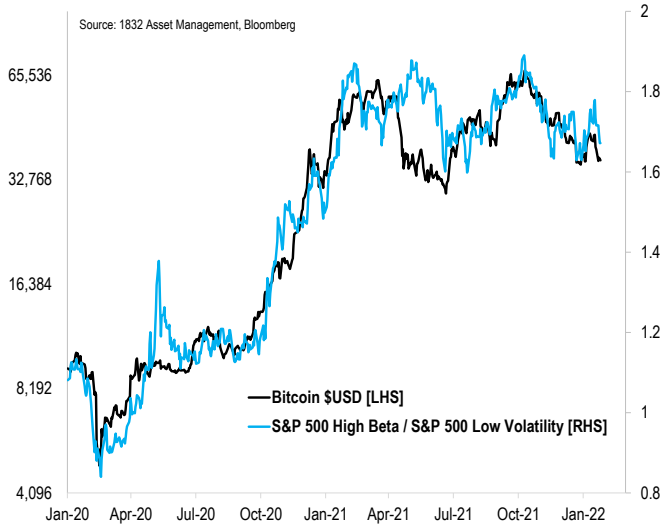


- Sentiment towards equities has turned very bearish. Index-level put activity is high, and sentiment surveys show optimism at the very low end of the historical range.

- Bonds might offer some important portfolio ballast. They are extremely oversold and have been attempting to bounce higher with the rise in geopolitical risk.



- Gold bullion has been acting better during this latest period of elevated financial market volatility.



- Crypto hasn't been much of a hedge against anything, rather it has been acting more like a higher-risk equity asset.

Market Performance

	7 Day	1-mo	3-mo	12 Mo	QTD	YTD
S&P 500	0.6%	-1.3%	-4.8%	14.8%	-8.2%	-8.2%
S&P 400	1.1%	3.2%	-4.2%	6.6%	-6.4%	-6.4%
S&P 600	1.4%	3.5%	-4.4%	2.9%	-6.1%	-6.1%
S&P 500 Energy	3.9%	6.8%	27.8%	48.5%	26.5%	26.5%
S&P 500 Materials	-0.7%	0.0%	-3.4%	13.4%	-8.2%	-8.2%
S&P 500 Industrials	1.5%	0.0%	-3.2%	10.2%	-5.8%	-5.8%
S&P 500 Consumer Disc	-1.6%	-0.4%	-13.5%	7.8%	-13.4%	-13.4%
S&P 500 Consumer Stap	-1.6%	-1.0%	4.3%	20.2%	-3.0%	-3.0%
S&P 500 Health Care	1.9%	-0.5%	-1.4%	15.4%	-8.0%	-8.0%
S&P 500 Financials	-1.7%	-0.6%	-0.6%	19.5%	-1.6%	-1.6%
S&P 500 Technology	1.1%	-2.5%	-7.1%	17.8%	-11.6%	-11.6%
S&P 500 Comm Services	1.8%	-4.8%	-12.4%	0.4%	-12.9%	-12.9%
S&P 500 Utilities	2.5%	-0.5%	1.8%	16.3%	-5.6%	-5.6%
TSX	0.6%	1.9%	0.0%	17.0%	-0.5%	-0.5%
TSX 60	0.4%	1.4%	0.1%	19.1%	-0.7%	-0.7%
TSX Energy	5.2%	7.5%	19.4%	52.4%	19.8%	19.8%
TSX Materials	1.4%	14.9%	12.1%	21.0%	9.0%	9.0%
TSX Industrials	-0.8%	-0.3%	-6.0%	8.5%	-4.0%	-4.0%
TSX Consumer Disc	-2.3%	-2.2%	-2.9%	3.0%	-6.3%	-6.3%
TSX Consumer Stap	-0.8%	-0.3%	3.4%	23.2%	-4.4%	-4.4%
TSX Health Care	-2.0%	1.2%	-20.5%	-50.1%	-11.7%	-11.7%
TSX Financials	-1.3%	0.1%	4.7%	27.2%	2.3%	2.3%
TSX Technology	-4.3%	-5.4%	8.9%	42.8%	6.9%	6.9%
TSX Telecom	-0.5%	1.9%	5.7%	24.0%	3.6%	3.6%
TSX Utilities	1.6%	1.1%	2.3%	8.4%	-2.4%	-2.4%
WTI Crude	6.1%	12.0%	42.7%	72.3%	28.6%	28.6%
Gold	0.0%	6.4%	6.2%	9.1%	3.8%	3.8%
Copper	-1.6%	3.3%	3.9%	10.4%	0.0%	0.0%
US 10-yr Treasury (bps)	-10	6	35	42	31	31
10-yr BoC Bond (bps)	-6	5	21	46	39	39
USD per CAD	0.6%	0.8%	0.9%	0.5%	-0.3%	-0.3%

As of February 28, 2022.
Source: Bloomberg