MARKET COMMENTARY **March 22, 2022**

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By Rob Edel, *Chief Investment Officer*

View the Nicola Wealth Investment Portfolio Returns: February 2022

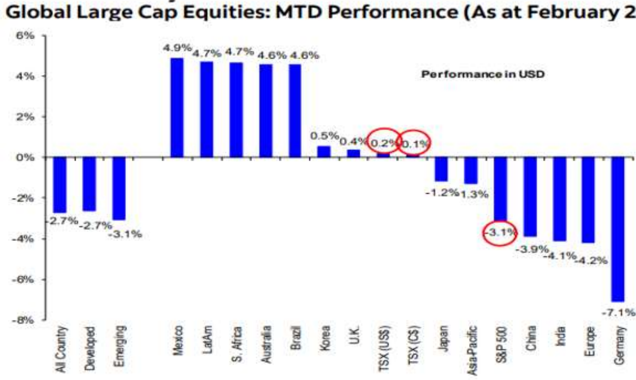
Highlights this Month

- The beginning of a recession? Or just a correction in the markets?
- Geopolitical conflict continues to shake the markets, but may present opportunity to investors.
- The yield curve may be flashing warning signs.
- Russia's attack on Ukraine could push up already sky-high inflation.
- Even before the fighting started in Ukraine, consumer confidence had begun to turn lower.

February in Review

Last month, it was another rough month for markets, with the S&P 500 down nearly 3% in February. Combined with January's 5.2% decline, the S&P 500 has lost just over 8% in the first two months of the year. While negative returns are always disappointing, a slow start does not mean negative returns for the rest of the year. Historical data shown by Strategas indicates that in years when the S&P 500 has been negative through February, returns for the next four and ten months averaged 4.7% and 5.0%, respectively.

Global Large Cap Equities: MTD Performance (As at February 28, 2022)



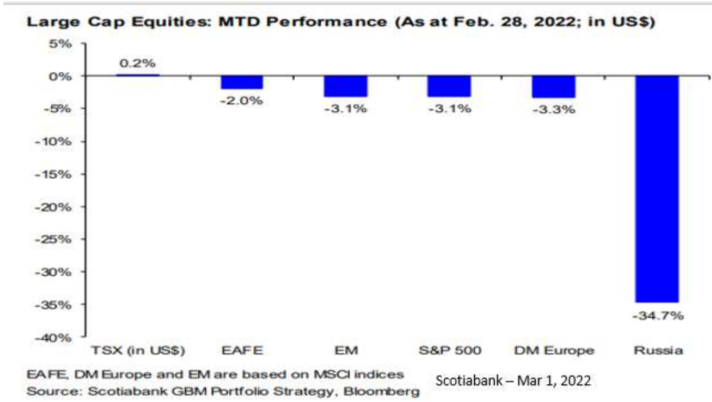
Based on MSCI indices unless otherwise indicated Scotiabank – Mar 1, 2022

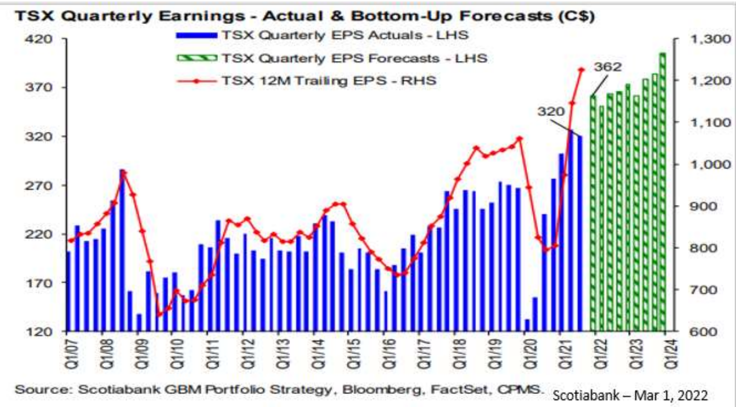
Forward S&P Performance When YTD Perf. Through February < -5%

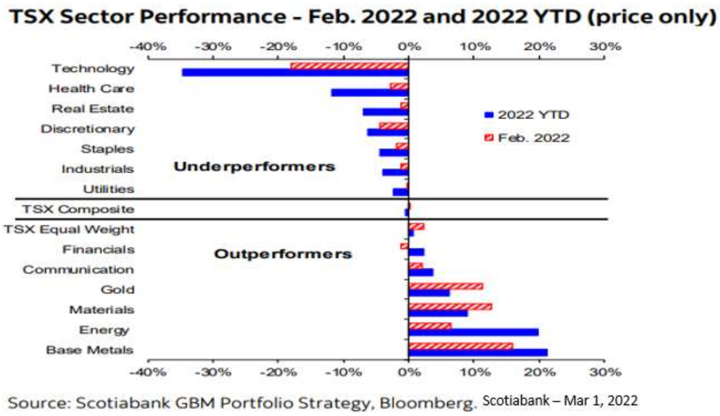
Year	YTD Performance	2/28 to 6/30 Perf.	2/28 to 12/31 Perf.
1957	-7.3%	9.5%	-7.6%
1960	-6.3%	1.4%	3.5%
1968	-7.4%	11.4%	16.2%
1969	-5.5%	-0.4%	-6.2%
1973	-5.4%	-6.6%	-12.7%
1977	-7.1%	0.7%	-4.7%
1978	-8.5%	9.8%	10.4%
1982	-7.7%	-3.1%	24.3%
1990	-6.1%	7.9%	-0.5%
2000	-7.0%	6.5%	-3.4%
2001	-6.1%	-1.3%	-7.4%
2008	-9.4%	-3.8%	-32.1%
2009	-18.6%	25.1%	51.7%
2016	-5.5%	8.6%	15.9%
2020	-8.6%	4.9%	27.1%
2022	-8.0%	?	?
	Average	*4.7%*	*5.0%*
	% Positive	*66.7%*	*46.7%*
	Historical Average	*3.1%*	*8.2%*
	Historical % Positive	*66.7%*	*72.6%*

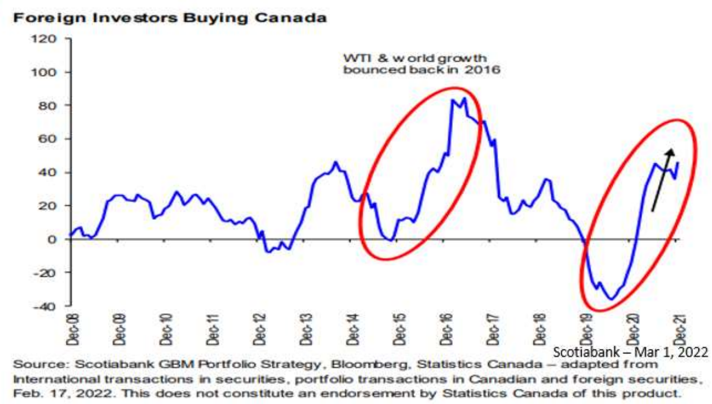
Strategas – Mar 1, 2022

Canadian markets appear to be positioned to do even better. After returning 0.3% in February, Canadian large-cap stocks were one of the few markets in the world to post positive returns. Year to date, the S&P/TSX is flat, with Base Metals, Energy, Materials, and Gold helping offset losses in the Technology and Health Care sectors. The world seems to be looking for more real assets, and Canada has what it may want. According to Scotiabank, foreign investor interest in Canada has inflected higher, as have quarterly earnings estimates for Canadian companies.





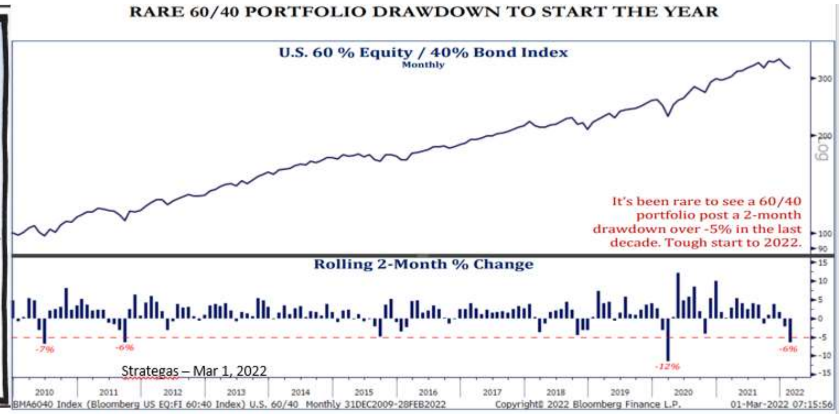


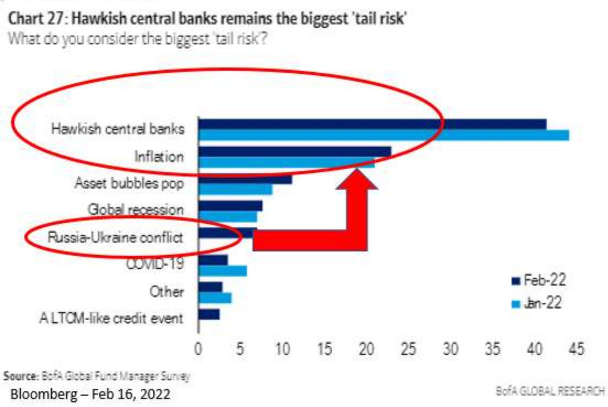


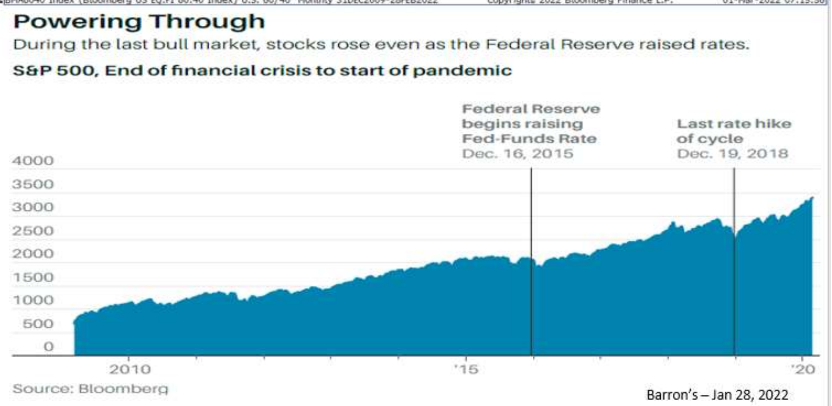
We do not see investor interest in Canada changing anytime soon. In an early-February Bank of America survey, Fund Managers cite hawkish central banks and inflation as the most significant "tail risks" for markets, an environment seemingly well suited for Canada's resource-heavy exchanges. While the survey was before Russia invaded Ukraine, and the conflict will likely move up in the tail risk rankings in next month's survey, we would argue that this will only reinforce the risk of inflation and higher interest rates to markets.

Inflation and higher interest rates tend to be hard on fixed income investments, even when stocks come under pressure. Typically, investors can count on some capital appreciation from bonds when stocks come under pressure and capital heads for the safety of fixed income. Investors don't treat bonds as a haven when inflation is driving higher rates; however, as was the case in the first two months of 2022, a 60/40 portfolio (60% stocks and 40% bonds) suffered a rare drawdown. That said, stocks can still go higher even with the Federal Reserve increasing interest rates.

A recent article by Barron's indicated that the S&P 500 continued to appreciate during the last Fed tightening cycle from December 16, 2015, until December 19, 2018, increasing a total of 28.6%, or an annualized 8.7%. Central banks typically tighten monetary conditions to prevent economic growth from overheating. Stocks begin to suffer only once tighter financial conditions negatively impact corporate earnings. We are arguably not at that point.

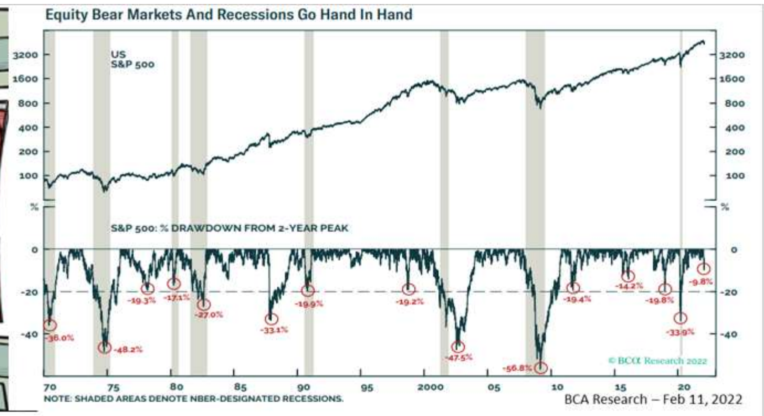


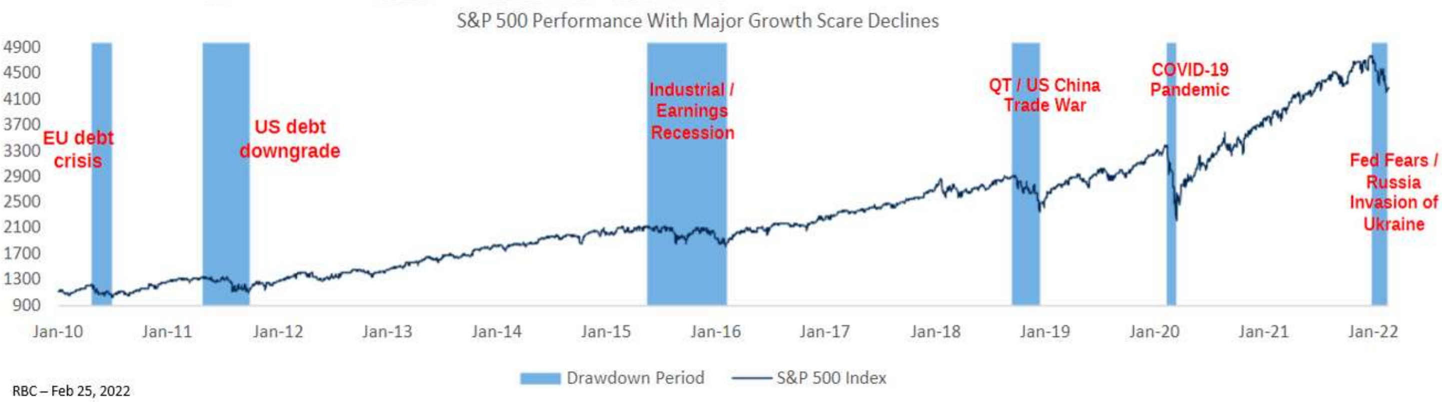




The beginning of a recession? Or just a correction in the markets?

The above does not necessarily mean stocks cannot go down for some time. In truth, a correction can be healthy in a bull market. A vital differentiation for investors to determine in 2022 is if markets are experiencing a growth scare and correction or if it is the beginning of a recession. BCS Research shows that recessions and bear markets go hand in hand. Alternatively, growth scares are barely noticeable on longer-term price charts, even major ones.





According to Strategas, the typical cyclical bear market has historically lasted 115 days and seen the S&P 500 decline nearly 24%. Add in the secular bear market periods of 1968 to 1982 and 2000 to 2013, and the average drawdown increases to almost 40% with a duration of 20 months. Alternatively, BMO's Investment Strategy Group estimates the average market correction lasts a mere 110 days with a decline of just over 13%.

S&P Cyclical Bear Markets

Peak	Trough	Trading Days	% Decline	Days to Reclaim High
1/5/1953	9/14/1953	176	-14.8%	121
8/2/1956	10/22/1957	307	-21.6%	233
12/12/1961	6/26/1962	135	-28.0%	299
2/9/1966	10/7/1966	167	-22.2%	143
8/25/1987	12/4/1987	71	-33.5%	414
7/16/1990	10/11/1990	62	-19.9%	86
7/17/1998	8/31/1998	31	-19.3%	59
9/20/2018	12/24/2018	65	-19.8%	81
2/19/2020	3/23/2020	23	-33.9%	103
Strategas – Feb 24, 2022	**Average**	**115**	**-23.7%**	**171**

S&P 500 Bear Markets

Start Date	Start Price	End Date	End Price	Duration (Months)	Percent Change
9/16/1929	31.9	6/1/1932	4.4	32	-86.2%
3/10/1937	18.7	4/28/1942	7.5	62	-60.0%
5/29/1946	19.3	6/13/1949	13.6	37	-29.6%
8/2/1956	49.7	10/22/1957	39.0	15	-21.6%
12/12/1961	72.6	6/26/1962	52.3	6	-28.0%
2/9/1966	94.1	10/7/1966	73.2	8	-22.2%
11/29/1968	108.4	5/26/1970	69.3	18	-36.1%
1/11/1973	120.2	10/3/1974	62.3	21	-48.2%
11/28/1980	140.5	8/12/1982	102.4	20	-27.1%
8/25/1987	336.8	12/4/1987	223.9	3	-33.5%
7/16/1990	369.0	10/11/1990	295.5	3	-19.9%
3/24/2000	1527.5	10/9/2002	776.8	31	-49.1%
10/9/2007	1565.2	3/9/2009	676.5	17	-56.8%
2/19/2020	3386.2	3/23/2020	2237.4	1	-33.9%
Strategas – Mar 7, 2022		Average		20	-39.4%

The Average Market Correction Lasts 110 Calendar Days and Has a Price Decline of 13.2%

S&P 500 Correction History Since 1970
excludes bear markets

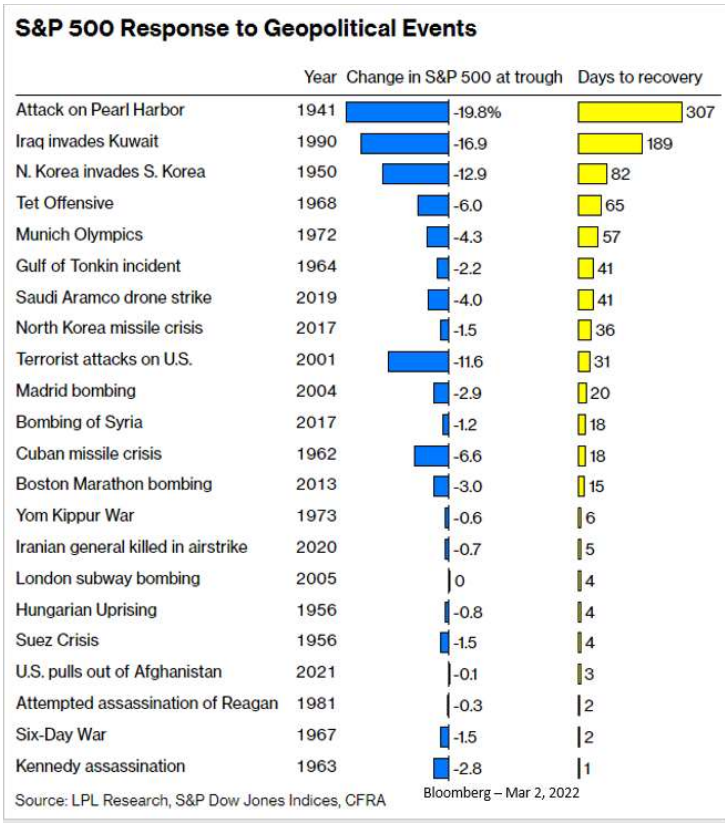
Start Date	End Date	Duration (days)	% Decline	Days since Last correction
4/28/1971	8/9/1971	103	-10.7%	337
9/8/1971	11/23/1971	76	-11.0%	30
11/7/1974	12/6/1974	29	-13.6%	35
7/15/1975	9/16/1975	63	-14.1%	221
9/21/1976	3/6/1978	531	-19.4%	371
9/12/1978	11/14/1978	63	-13.6%	190
10/5/1979	11/7/1979	33	-10.2%	325
2/13/1980	3/27/1980	43	-17.1%	98
10/11/1983	7/24/1984	287	-13.2%	425
2/2/1994	4/4/1994	61	-8.9%	1210
2/18/1997	4/11/1997	52	-9.6%	1051
7/17/1998	8/31/1998	45	-19.3%	462
11/27/2002	3/11/2003	104	-14.7%	49
2/11/2004	8/12/2004	183	-8.2%	337
4/23/2010	7/2/2010	70	-16.0%	410
4/29/2011	10/3/2011	157	-19.4%	301
10/28/2011	11/25/2011	28	-9.8%	25
4/2/2012	6/1/2012	60	-9.9%	129
9/14/2012	11/15/2012	62	-7.7%	105
5/21/2015	2/11/2016	266	-14.2%	917
1/26/2018	2/8/2018	13	-10.2%	715
9/20/2018	12/24/2018	95	-19.8%	224
1/3/2022	*2/22/2022*	*50*	*-10.3%*	*651*
	Average	**110**	**-13.2%**	**362**
	Max	**531**	**-7.7%**	**1210**
	Min	**13**	**-19.8%**	**25**

Source: BMO Investment Strategy Group, FactSet. BMO – Feb 24, 2022

Geopolitical conflict continues to shake the markets, but may present opportunity to investors.

Even geopolitical events have not bothered the markets for very long. According to Bloomberg, the largest geopolitical market event on record was the attack on Pearl Harbor in 1941, which caused the S&P 500 to decline 19.8% and take 307 days to recover. The second worst event was Iraq's invasion of Kuwait in 1990, which resulted in the S&P falling 16.9% but needing only 189 days to recover. Finally, 9/11 caused just under a 12% decline, which the S&P 500 made up in a mere 31 days.

Geopolitical events can also be good buying opportunities. A report by Strategas shows that total returns 12 months after select geopolitical/military events have averaged 13.0%. The Russia/Ukraine conflict may be worse, but markets tend to move on fairly quickly historically; humanity less so.

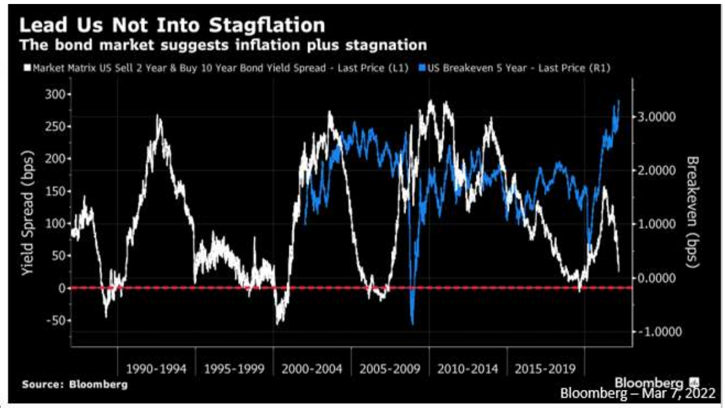


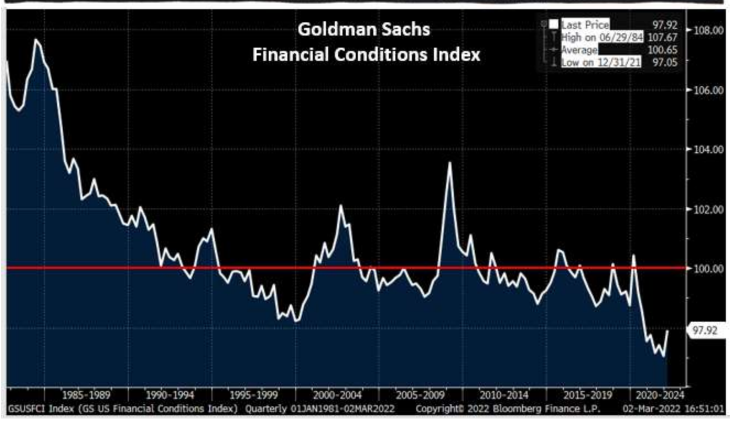
GEOPOLITICAL EVENTS ARE OFTEN BUYING OPPORTUNITIES LONGER TERM

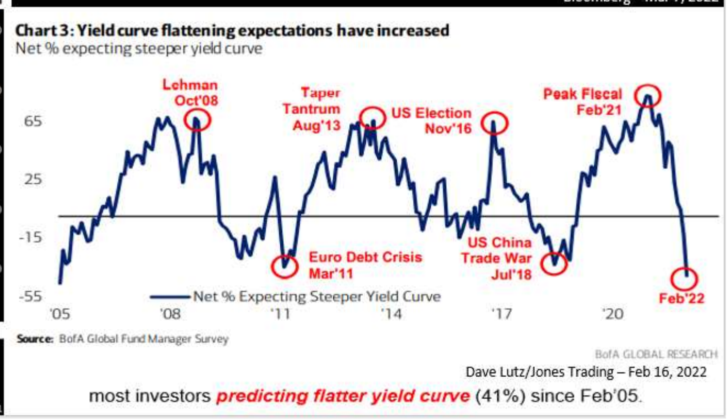
S&P 500 Performance Around Select Geopolitical/Military Events

Date	Geopolitical/Military Event	Total Return After Event			
		+1Mo	+3Mos	+6Mos	+12Mos
12/7/1941	Pearl Harbor	-1.0%	-10.2%	-7.2%	7.3%
10/31/1956	Suez Canal Crisis*	-1.1%	-1.0%	2.2%	-6.4%
10/20/1962	Cuban Missile Crisis	8.7%	18.4%	26.7%	36.3%
10/17/1973	Arab Oil Embargo*	-5.3%	-10.7%	-12.6%	-32.6%
11/3/1979	Iranian Hostage Crisis	3.7%	13.8%	5.9%	32.8%
12/25/1979	U.S.S.R. In Afghanistan	6.0%	-6.7%	11.5%	33.1%
8/3/1990	Iraq Invades Kuwait	-6.1%	-8.7%	1.3%	16.2%
1/17/1991	Gulf War	12.9%	20.0%	18.1%	31.8%
8/17/1991	Gorbachev Coup	0.3%	0.0%	8.6%	12.5%
2/26/1993	World Trade Center Bombing	1.2%	3.0%	5.5%	8.1%
9/11/2001	9/11*	0.6%	4.4%	7.7%	-15.5%
3/20/2003	Iraq War	2.2%	14.2%	19.3%	28.9%
2/20/2014	Annexation of Crimea	1.9%	2.3%	9.1%	17.1%
Strategas – Feb 28, 2022	**Average**	**1.9%**	**3.0%**	**7.4%**	**13.0%**

Unfortunately for investors, the timing of the Russian invasion of Ukraine came at a particularly tricky time for markets. Expectations for how many times the Federal Reserve would increase rates in 2022 had reached upwards of 6 or 7 last month as the realization tighter financial conditions were urgently needed as inflation continues to surge higher. At the same time, the yield curve began to flatten, a potential early indicator that economic growth was starting to roll over. According to Fund Managers surveyed by Bank of America Global Research in early February, most investors believed this trend would continue. More investors expected a flatter yield curve than any period since February 2005. A flatter yield curve in combination with rising inflationary expectations has the potential to be a powerful harbinger of bad news for future returns, as most risk assets suffer in a stagflationary environment.

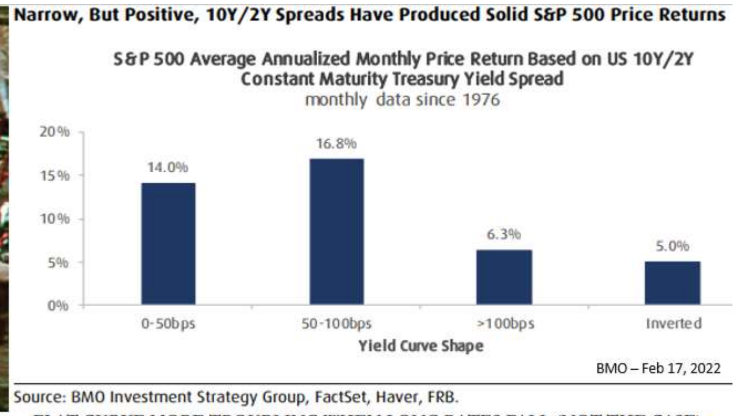


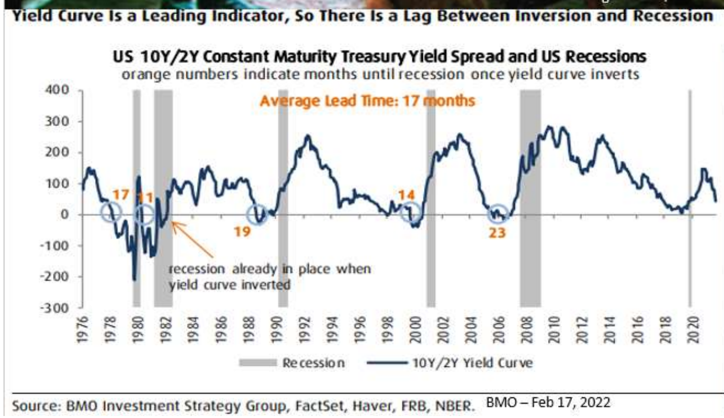




The yield curve may be flashing warning signs.

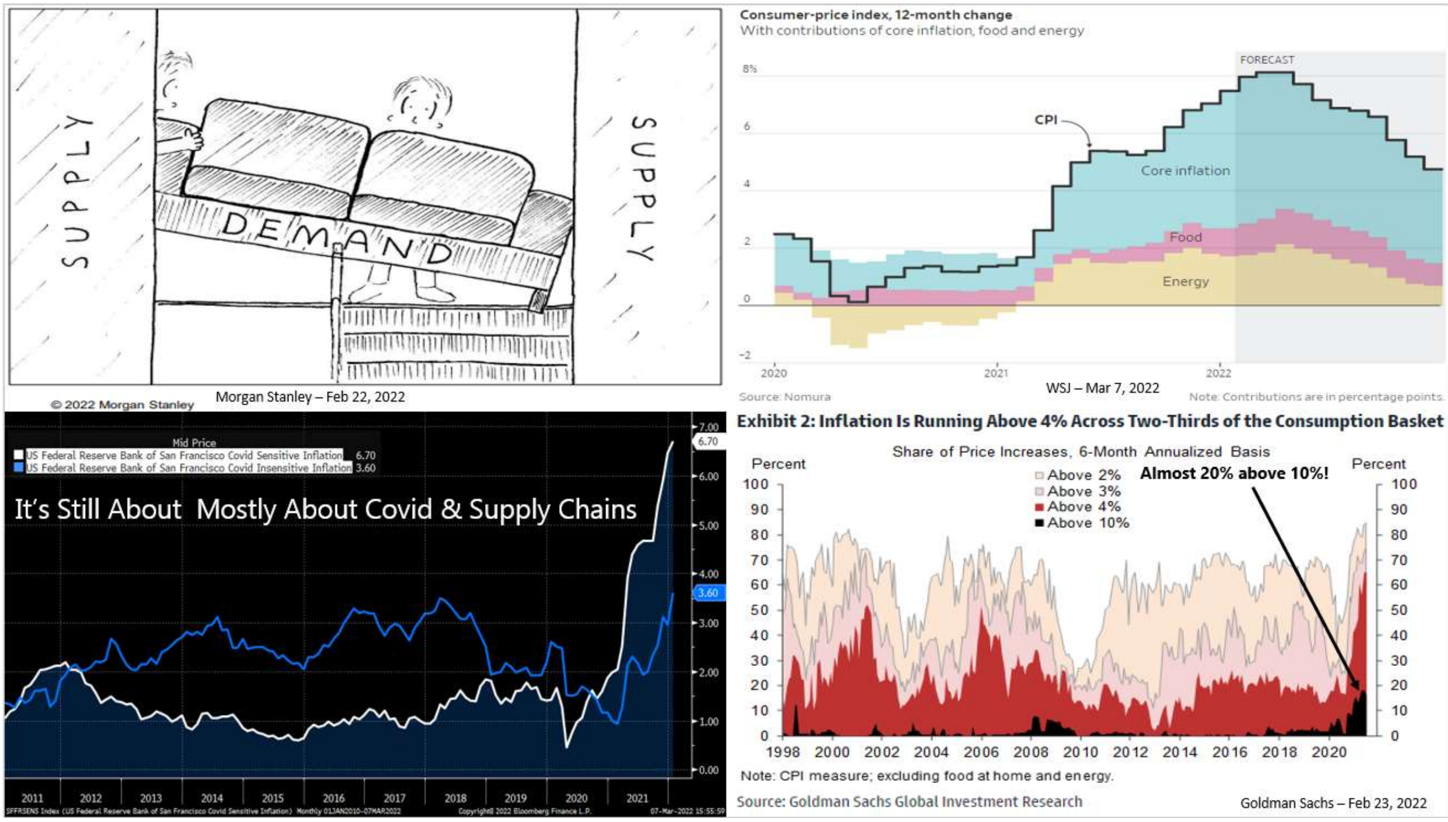
While higher two-year yields and a flatter yield curve are certainly something to notice, they are not necessarily a sign of imminent danger. The S&P 500 has historically performed very well when the yield curve is relatively flat but not inverted. According to BMO's Investment Strategy Group, the market has delivered average annualized returns of 14% when the yield spread between 10-year and 2-year Treasury's have ranged between 0 to 50 basis points. Furthermore, Strategas points out a flat curve is more problematic when long rates are falling, which hasn't been the case. Ten and 30-year yields have been rising, just not as fast as 2-year yields. A flat yield curve can stay flat for an extended period, but even when the curve inverts, BMO estimates the average lead time before the economy goes into recession is 17 months. The bottom line, markets appear to have time.



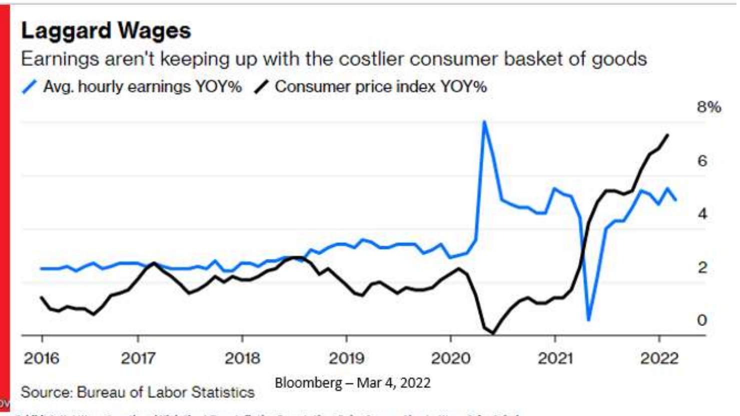


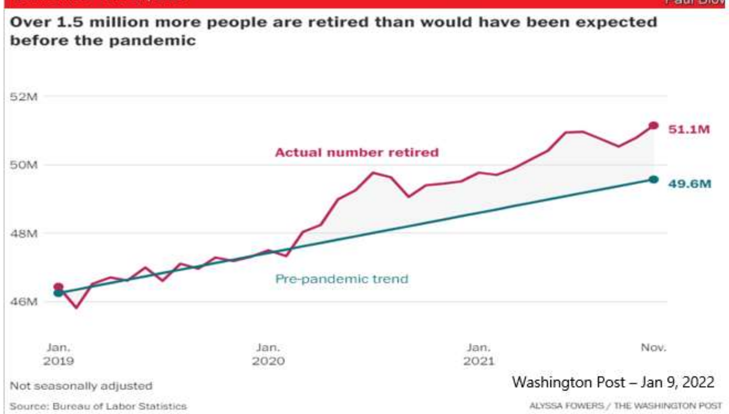
How much time markets have will likely be determined by the future path of inflation. Inflation occurs when there is an imbalance between supply and demand, specifically, too much demand or too little supply. The pandemic gave us a little of both (fiscal stimulus increased the demand for certain goods), but most of the imbalance has stemmed from the supply side. According to the US Federal Reserve Bank of San Francisco, the bulk of the current surge in inflation can still be attributed to COVID and supply chain issues, given their COVID Sensitive inflation index has moved significantly higher. In contrast, their COVID insensitive basket has only recently returned to early 2018 levels.

The belief that inflationary pressures should be transitory and normalized once supply chains ease is reasonable, though a return to 2% or lower is questionable. The longer that inflation remains elevated, the more likely inflationary expectations will permanently ratchet higher. Goldman Sachs highlights that inflationary pressures are broadening, with inflation on two-thirds of the consumption basket above 4% and almost 20% above 10%.



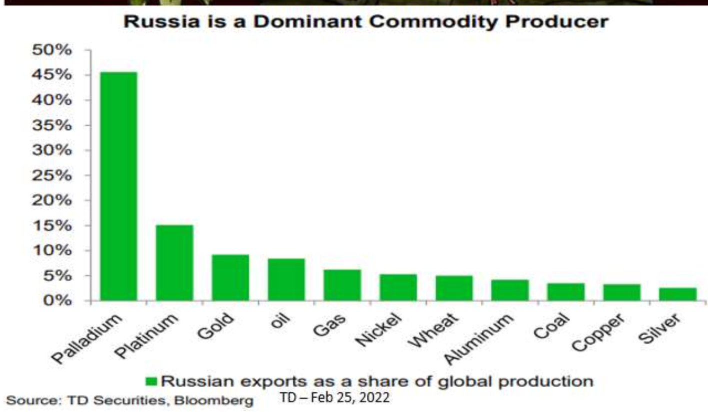
The key to settling the transitory versus permanent inflation debate will be wage growth. According to the Washington Post, over 1.5 million more people retired than expected during the pandemic, leaving companies scrambling for workers. Moreover, according to Goldman Sachs, higher wages lead to higher short-term inflationary expectations and increase concerns about a wage-price spiral. This is primarily a risk given that current wage gains have not kept up with inflation, resulting in workers falling even further behind.

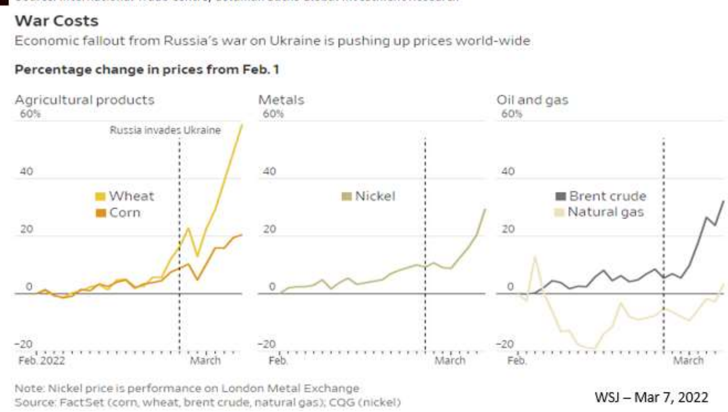




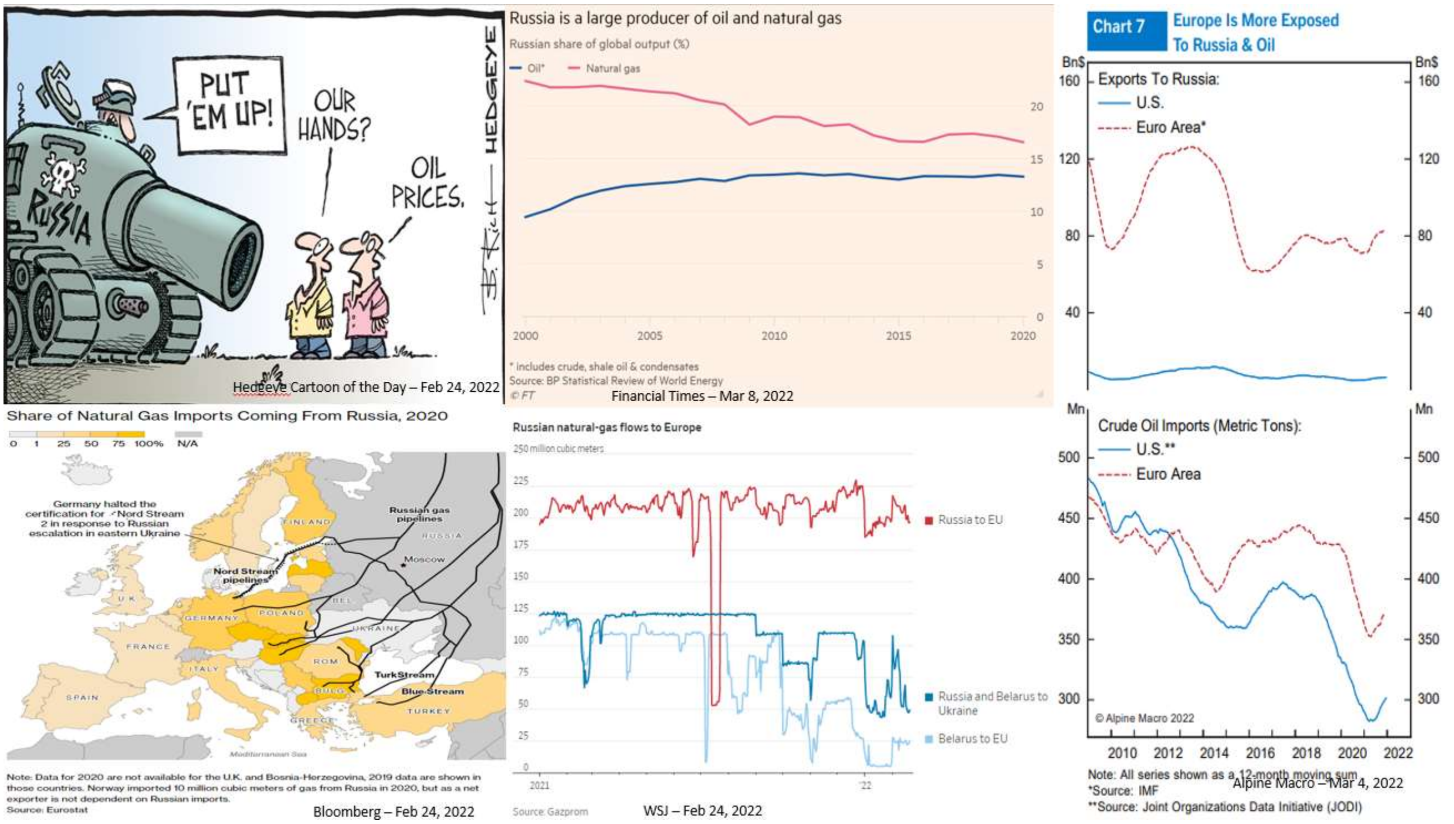
Russia's attack on Ukraine could push up already sky-high inflation.

If markets were concerned about inflation before Russia invaded Ukraine, the war will only raise anxiety levels even higher. Historically wars are inflationary, and this one looks to be no exception. While the US doesn't have significant trade exposure to Russia or Ukraine directly, both countries export several essential commodities. As a result, the price of food, particularly wheat (the Financial Times estimates Russian and Ukraine represent 25% of global production), has moved materially higher. According to Bloomberg, Russian and Ukrainian exports of food commodities such as corn, wheat, and sunflower oil total more than 10% of all calories traded globally. Even semiconductor supply could come under renewed pressure. According to Reuters, 45% to 54% of the world's semiconductor-grade neon gas comes from two Ukrainian companies. Both ceased operations in early March as Russian troops escalated their attacks.

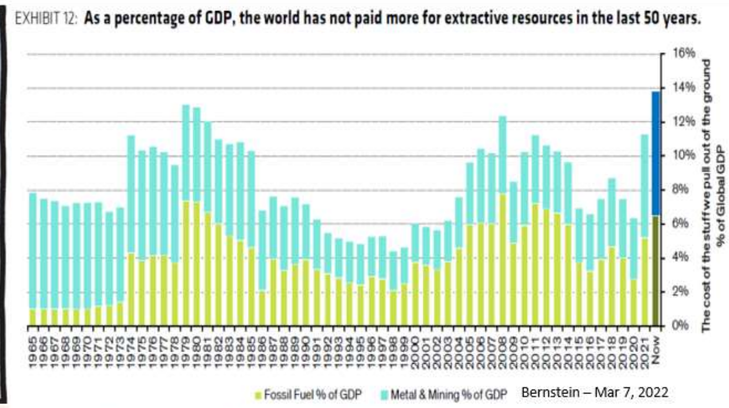


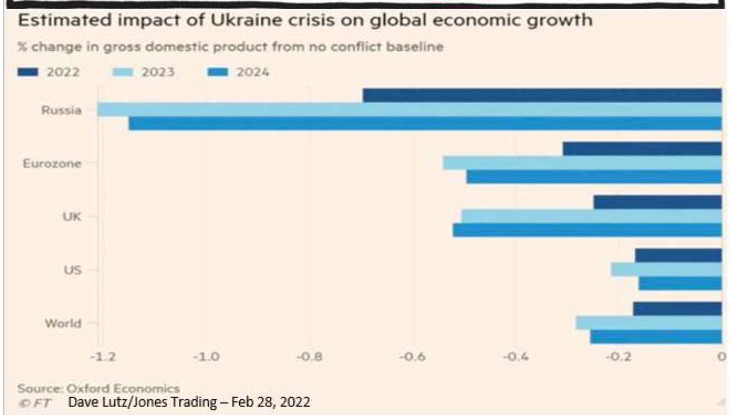


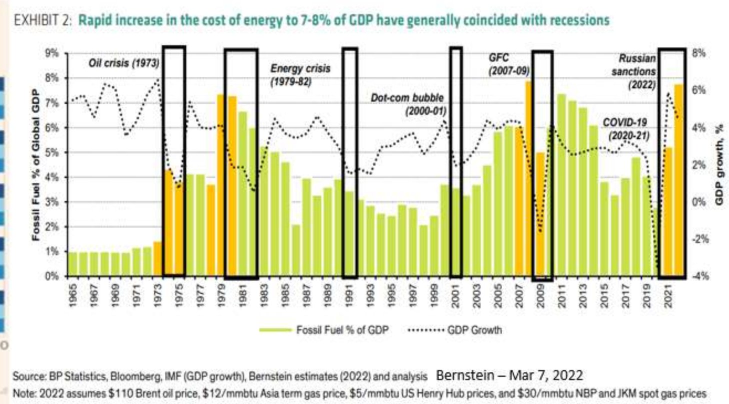
Of course, Russia is also a significant exporter of oil and gas, mainly to Europe. According to Bridgewater, Russia is responsible for 11.4% of global oil production and 17.3% of global natural gas production. However, as the WSJ points out, Russia is the source for 30% of the EU's oil and 40% of its Natural gas demand. For Europe, there are no easy alternatives to Russian gas imports in the short term.



The inevitable rise in oil and gas prices has increased the risk of an economic slowdown or even recession. As a percentage of GDP, the world is paying more for extractive materials than at any time in the last 50 years, shows Bernstein Research. For just energy, recessions have typically followed whenever fossil fuel costs have historically risen rapidly and approached 7-8% of GDP. Bernstein Research indicates that we are at that level. Oxford Economics sees the impact of the Ukraine crisis hurting Europe more than the US, but the pain will be felt globally and likely last beyond 2022.







Even before the fighting started in Ukraine, consumer confidence had begun to turn lower in the US.

Consumer spending has still been strong, but higher prices seem to have taken a toll on consumer sentiment. Even with strong job growth, Americans appeared gloomy, with consumer confidence approaching levels last seen during the financial crisis. Wages are going up, but prices are going up more.

Central banks need to tighten financial conditions to control inflation, yet most price increases are still a result of supply issues. Higher interest rates can help reduce demand but will not fix supply chains.

The crisis in Ukraine only makes inflation worse and puts additional pressure on central banks to act. In addition, higher prices inevitably lead to more demand destruction, which is the goal of tightening monetary conditions. Supply and demand need to fall back into balance, and constraining demand is a more likely outcome in the short term than increasing supply. However, constrain demand too much, and we have a recession, or even worse, stagflation. We do not see this as the most likely scenario yet, but the Fed has not started raising rates yet.

As the pandemic eases and workers get back to work, positive economic momentum should be good for corporate earnings, even if interest rates move higher. However, if inflation stays high and interest rates have to rise too much too fast, humanity and markets might come under pressure. In this scenario, a market correction likely turns into a bear market.

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