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Market Commentary: The Waiting Game

MARKET COMMENTARY February 14, 2022



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In this Market Commentary, CIO [Rob Edel](#) addresses the uncertainty faced by investors after a rocky start to 2022 and analyzes the likelihood of large interest rate hikes in an economy struggling with mounting inflation.

By [Rob Edel](#), *Chief Investment Officer*

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Highlights this Month

- [What was causing such market angst, and what does it mean for the rest of 2022?](#)

- It's time to talk about quantitative tightening.
- Not all equities are created equal.
- Continuing supply chain disruptions mean bad news for inflation rates.
- Earnings estimates for 2022 continue to drift higher, not lower.
- The theme of 2022: How high can rates go?

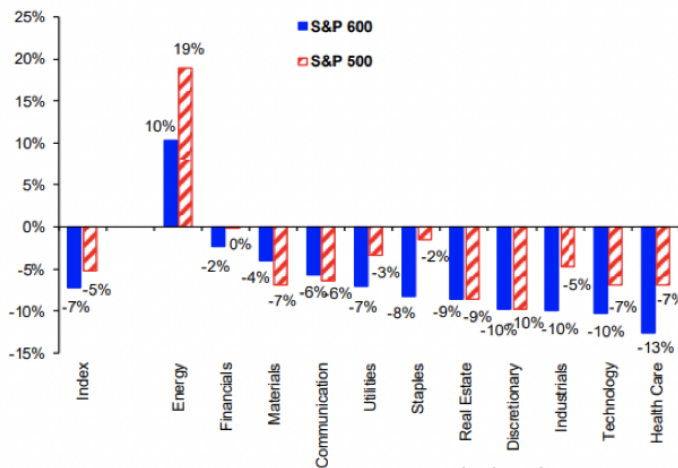
January in Review

Markets stumbled out of the gate in 2022, with the S&P 500 losing 5.2% (in US dollar terms) in January, while the S&P/TSX declined only 0.4% (in Canadian dollar terms). Helping Canadian markets pare losses were gains in energy, base metals, and financials, which were also big winners in 2021. Technology, healthcare (cannabis in particular), and gold weighed on returns. It was much the same story in the US, with energy the only sector managing to gain ground last month.



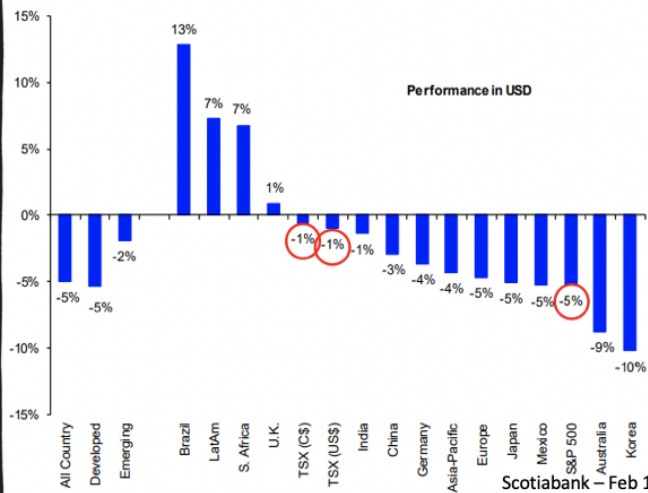
Hedgeye Cartoon of the Day – Jan 26, 2022

31-Jan-22

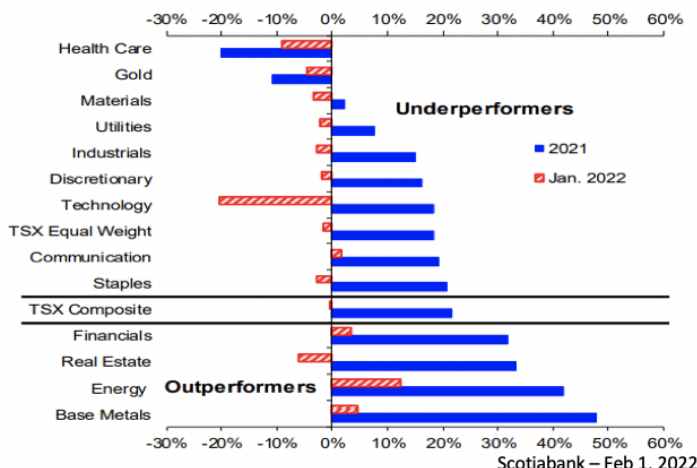


Scotiabank – Feb 2, 2022

Global Large Cap Equities: MTD Performance (As at January 31, 2022)



TSX Sector Performance - Jan. 2022 and 2021 (price only)



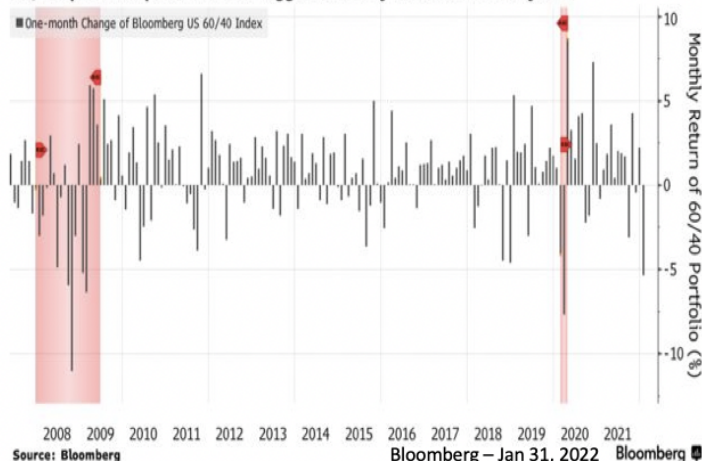
Scotiabank – Feb 1, 2022

According to the Stock Trader's Almanac, January typically sets the tone for the year. Since 1950, LPL Financial reports that the S&P 500 has increased 11.9% during the final 11 months of trading. Unfortunately, average returns fall to only 2.7% when January is negative. However, for nine of the last 10 January's, when the index was in the red, the S&P 500 was still positive over the final 11 months, averaging gains of 13.1%. Perhaps more distressing to investors than the poor start to the year in stocks was the coincidental weakness in fixed income markets, which were also in the red as yields moved higher. Typically, yields head lower (and prices higher) when stocks are weak, providing investors with safe refuge. According to Bloomberg, with both declining last month, the typical 60/40 portfolio (60% equities, 40% bonds) suffered one of its most significant losses in years.



Double Whammy

60/40 portfolio posted one of biggest monthly losses in recent years



How S&P 500 fares rest of year, following January

Final 11-month performance

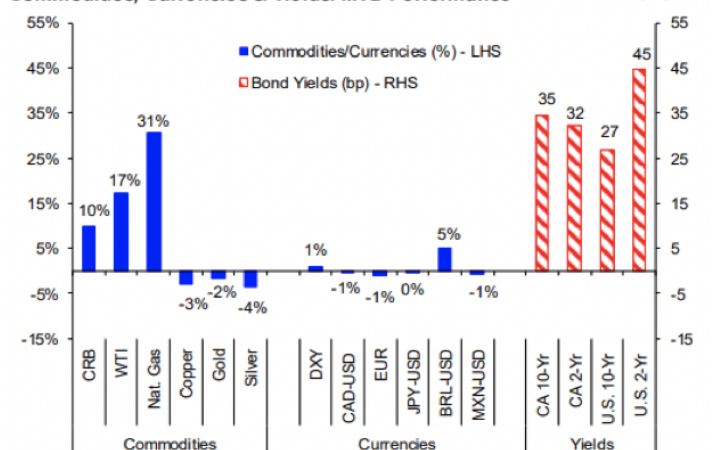
Category	Positive January	Negative January	All years combined
Average	11.9%	2.7%	8.2%
Median	13.3%	4.5%	9.2%
% of times higher	86%	62.1%	76.4%

Source: LPL Research/Graphic by Lewis Krauskopf

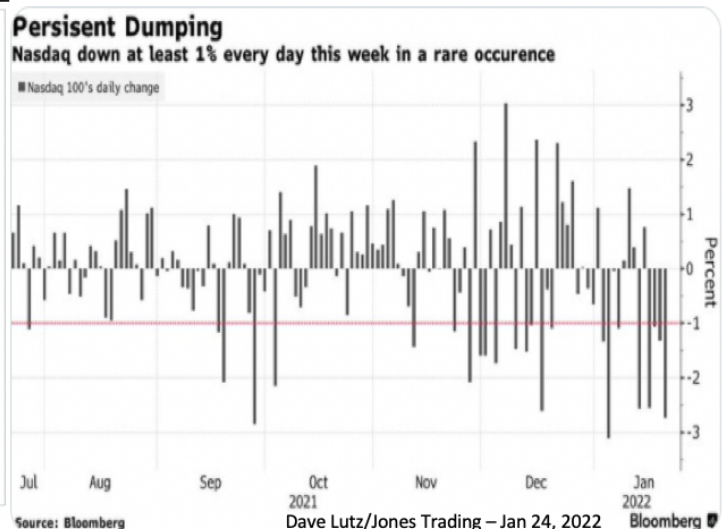
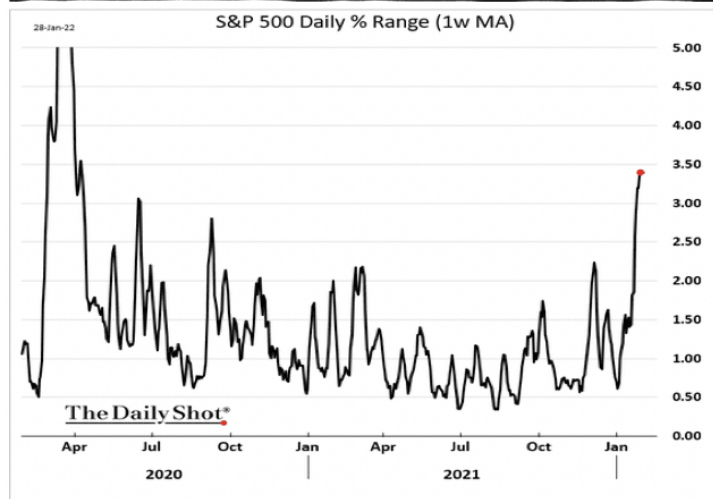
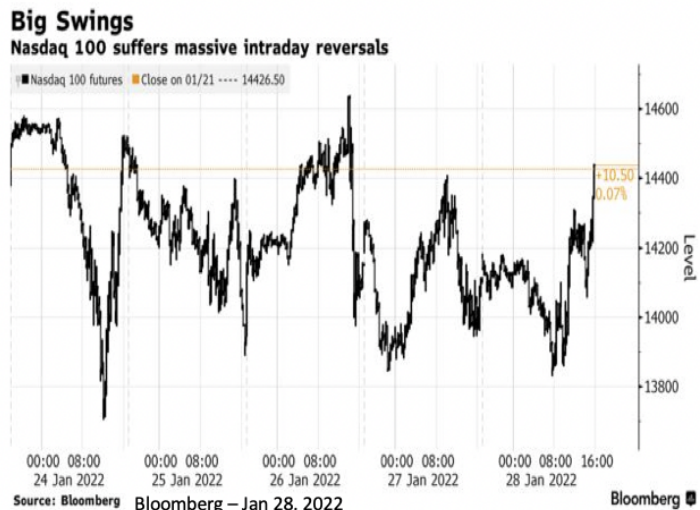
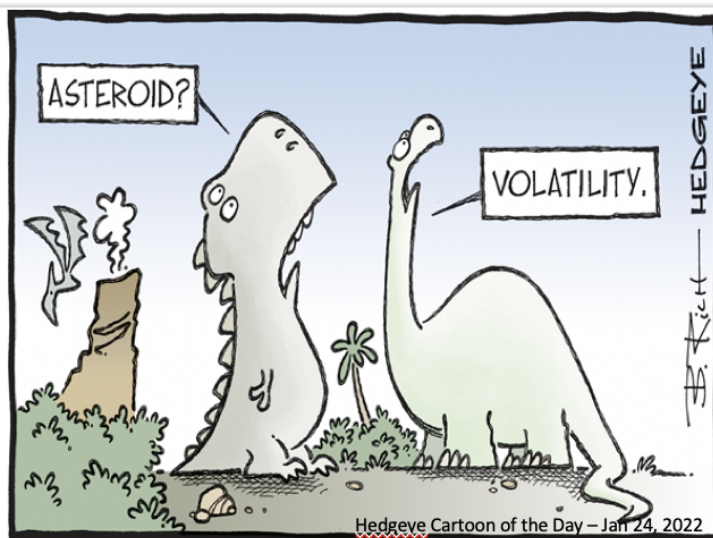
Reuters Graphics

Reuters – Feb 1, 2022

Commodities, Currencies & Yields: MTD Performance



Also challenging investors nerves was volatility, which has been generally subdued during the pandemic but spiked up to levels last seen during the March 23, 2020 market lows. The one-week moving average daily price range for the S&P 500 reached nearly 3.5% last month, while the Nasdaq experienced massive intraday price reversals. During one week in January, the Nasdaq was down at least 1% every day. Thankfully, it was a short trading week due to the Martin Luther King holiday.



What was causing such market angst, and what does it mean for the rest of 2022?

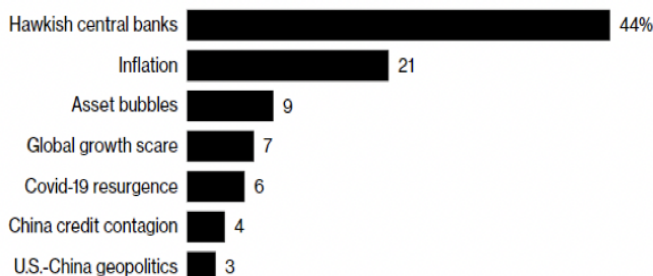
Higher inflation, but more importantly, central bank reaction to higher inflation, was causing investors to re-evaluate market valuations. According to a January Global Fund Manager Survey conducted by Bank of America, investors cited hawkish central banks as the biggest tail risk for markets. Higher bond yields mean the present value of future earnings are discounted at higher rates. The good news is that earning growth rates have been holding firm and could more than offset declines in valuations, as long as rates don't increase too much. This balancing act will likely determine how the market will fare for the rest of 2022 and is where we will concentrate the remainder of our discussion this month.



Fear of Hawks

Fund managers surveyed by Bank of America see hikes as the biggest risk

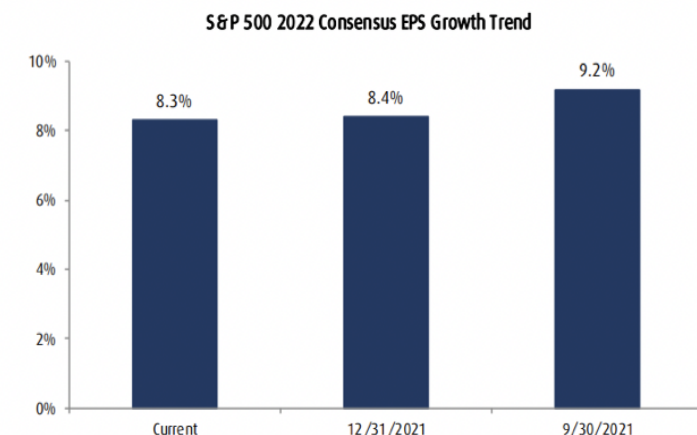
■ What do you consider the biggest 'tail risk'?



Source: Bank of America Corp. Global Research Bloomberg – Jan 18, 2022

Note: Monthly Global Fund Managers Survey carried out between Jan. 7 and Jan. 13, 2022. A total of 329 participants with \$1.1 trillion in assets responded.

2022 EPS Growth Estimates for S&P 500 Companies Has Been Holding Firm



Source: BMO Investment Strategy Group, FactSet, IBES.

Goldman Sachs – Jan 26, 2022

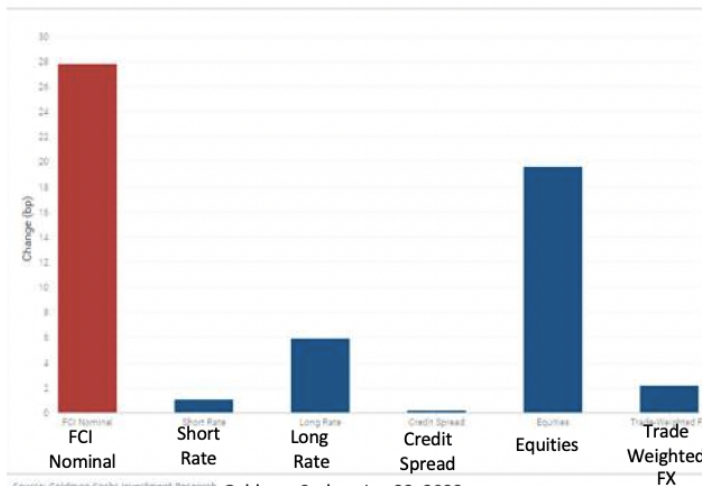
Given current inflationary conditions globally, Central Banks have indicated they will begin tightening financial conditions, most visibly by increasing short-term interest rates. According to Bloomberg, financial markets were discounting nearly a 100% probability that the US Federal Reserve would increase the overnight Fed Funds rate by 125 basis points in 2022. According to Goldman Sachs, the Fed is expected to raise rates 25 basis points in March, May, July, September, and December. While this might appear aggressive, Scotiabank believes the market is discounting nearly six 25 basis points hikes by the Bank of Canada in 2022.

If the goal is to tighten financial conditions, however, higher short-term interest rates are just one component influencing how tight or easy the monetary environment is, and a relatively small one at that. According to Goldman Sachs, policy rates only comprise a 4.4% weight in determining US financial conditions, with 10-year treasury yields carrying a 45.1% weight and corporate credit spreads 39.6%. Equity markets and the US dollar are also factors, but like short-term rates, carry a lower weight. Financial conditions did tighten in January, but Goldman Sachs believes the change was minimal. 10-year yields rose but are still not even back to pre-pandemic levels, and while credit spreads have started to widen, credit markets remain incredibly accommodative. Last month, the move higher in corporate credit spreads appeared to have been more about investors trying to reduce duration than avoid credit exposure, as riskier credit sold off less than safer credit. In January, most of the increase in financial conditions could be attributed to falling equity markets, but stocks will have to drop a lot more to satisfy the Fed's tightening needs.

Exhibit 1: The US GS FCI Weights**GS US FCI Components**

Variable	Description	Weight
Nominal Policy Rate	Target Federal Funds Rate	4.4%
Nominal Riskless Bond Yield	10-Year Treasury Yield	45.1%
Corporate Spread	iBoxx Domestic Non-Financials BBB 15Y+ Spread over 10-year Treasury Yield	39.6%
Equity Price	S&P 500, Scaled by 10-year Moving Average of Earnings	4.9%
Trade-Weighted Exchange Rate	GS Broad Trade-Weighted Index	6.0%

Source: Goldman Sachs Global Investment Research Goldman Sachs – Jan 15, 2022

US FCI CONTRIBUTIONS CHANGE (IN BPS) FROM 13 JAN 2022 TO 20 JAN 2022

Source: Goldman Sachs Investment Research Goldman Sachs – Jan 23, 2022

**Bond Disconnect**

Yield spreads on high-yield, high-risk debt don't show nearly the concern as stocks at the moment

Bloomberg high yield option adjusted spread



Source: Bloomberg BPS = basis points Bloomberg – Jan 31, 2022

It's time to talk about quantitative tightening.

If higher 10-year yields and wider credit spreads are necessary to tighten financial conditions, a more direct approach the Federal Reserve could take would be quantitative tightening, where they actively reduce the size of their balance sheet by selling Treasuries and mortgages. This would bid up yields and credit spreads as liquidity is withdrawn from the market, thus tightening financial conditions. The advantage of tightening through balance sheet reduction is that the Fed can be more targeted in tightening financial conditions. However, tightening financial conditions by raising short-term rates could negatively affect the entire economy, especially given how over-leveraged the US financial system is. Higher policy rates can be a blunt tool as it impacts Main Street and Wall Street. Quantitative tightening, where the Fed is trimming the size of its balance sheet and reducing liquidity, is not so hard on consumers but risks bursting any asset price bubbles that have inflated during the pandemic.

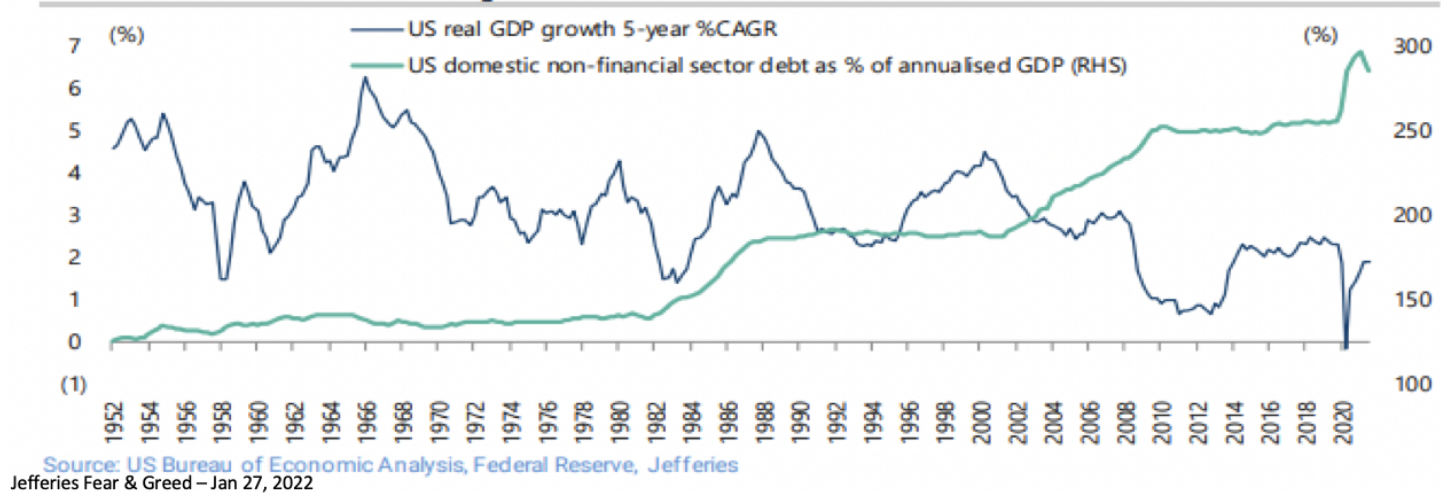


Debt Mountain

QE let governments borrow trillions at ever lower yields



Exhibit 3: US 5Y annualised real GDP growth and non-financial sector debt to GDP



More likely, the Fed will use both rate hikes and quantitative tightening to tighten financial conditions, and while the higher rates will be a headwind for valuations, it doesn't have to mean investors can't achieve positive returns. According to Bloomberg, only during the 1972-74 rate-hike cycle did the S&P 500 decline, and BMO confirms a low-single-digit gain is more typical. Goldman Sachs highlights that the key is positive economic growth; GDP can slow with 10-year real rates rising, but as long as growth is not contracting, equity of around 8% can be achieved.



Exhibit 6: US - Slower (but positive) economic activity and rising real yields has historically driven around 8% equity returns

		Real 10-year Treasury yield			
		Falling	Stable	Rising	All
US real GDP growth	Accelerating	19 %	16 %	19 %	18 %
	Stable	14	15	12	13
	Decelerating but growing	13	9	8	11
	Decelerating & contracting	(3)	(20)	(19)	(11)
All		12	11	11	11

Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research
S&P 500 Registered a Low Single-Digit Annualized Gain, on Average, During Previous Fed Tightening Cycles
 Goldman Sachs – Jan 18, 2022

Tightening Without Turmoil

How the S&P 500 performs in Fed rate-hike cycles

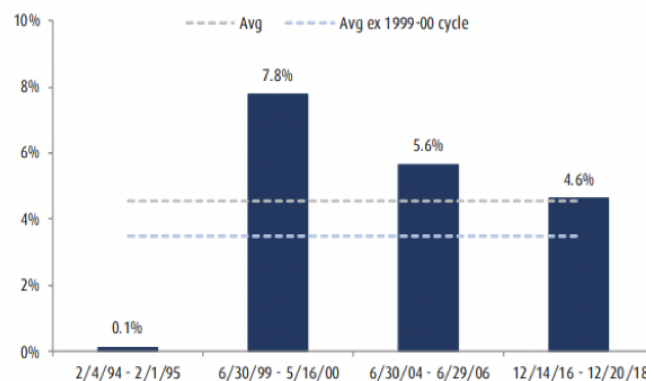
Average annualized return	
1954-1957	13.7%
1958-1959	24.5
1961-1966	7.0
1967-1969	3.7
1972-1974	-8.6
1977-1981	11.5
1983-1984	13.2
1987-1989	16.2
1994-1995	4.1
1999-2000	10.5
2004-2006	8.2
2015-2018	8.4

Source: Truist Advisory Services

Bloomberg – Jan 23, 2022

Bloomberg

S&P 500 Average Annualized Price Performance During Tightening Cycles



Source: BMO Investment Strategy Group, FactSet, Haver, FRB.

BMO – Jan 13, 2022

Not all equities are created equal.

If companies with low or no earnings command higher valuations when interest rates are near zero, it stands to reason the opposite will be true once the wind changes and rates start to normalize higher. While most stocks suffered losses last month, loss-making tech stocks suffered more, and according to Goldman Sachs' non-profitable tech index, they are down 50% from their peak. Small caps have also suffered more given that nonearning stocks comprise a more significant percentage of small-cap indexes like the Russell 2000. Avoiding investments that mimic indexes with a heavyweight in non-earners is a solid reason to avoid passive index investing. In a classic Hare versus Tortoise comparison, the 12-month performance of Warren Buffett's Berkshire Hathaway caught that of high-flying meme stock GameStop last month.



Profits are Back in Fashion

A basket of loss-making U.S. tech stocks has fallen 50% since the peak

Non-profitable tech index



Source: Goldman Sachs

Bloomberg – Jan 26, 2022

Weight of nonearning stocks in index



Note: Based on past 12 months' earnings
Sources: FactSet, FTSE Russell, Jefferies

WSJ – Jan 25, 2022

Hare vs. Tortoise, Stock Market Edition

Over 12 months, GameStop and Berkshire are now in a tie

Normalized As Of 01/25/2021 ■ GameStop Corp - Last Price ■ Berkshire Hathaway Inc - Last Price



Source: Bloomberg

Bloomberg – Jan 25, 2022

Bloomberg

The key for the rest of 2022 will be how much the central banks will need to raise rates and their ultimate impact on economic growth and corporate earnings. The Federal Reserve needs to show they can get control of inflation, and at the moment, they have their work cut out for them. Inflation in December hit early 1980 highs, and while the San Francisco Fed COVID Sensitive and Insensitive inflation indices show the pandemic is still primarily to blame, even prices deemed insensitive to COVID have started to move higher. The Atlanta Fed's "sticky" price index is growing at its fastest rate since 1991, and the Cleveland Fed trimmed mean and median CPI index, which is also hitting 1991 levels. Inflationary pressures are broadening.

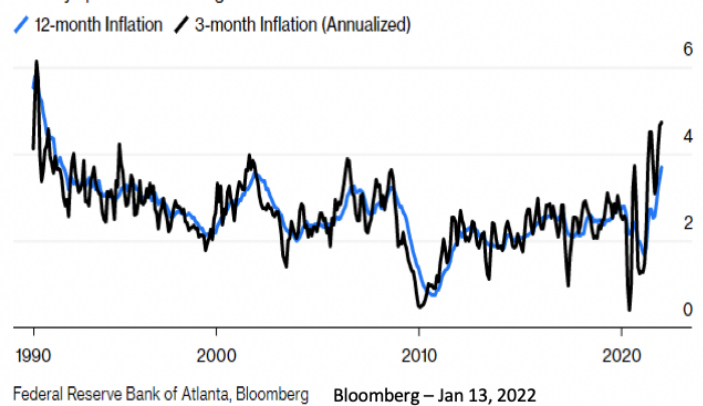
Uncomfortable Comparison

Latest inflation surge takes rate to early-'80s high



View from Atlanta: A Sticky Problem

"Sticky" prices are rising at their fastest since 1991



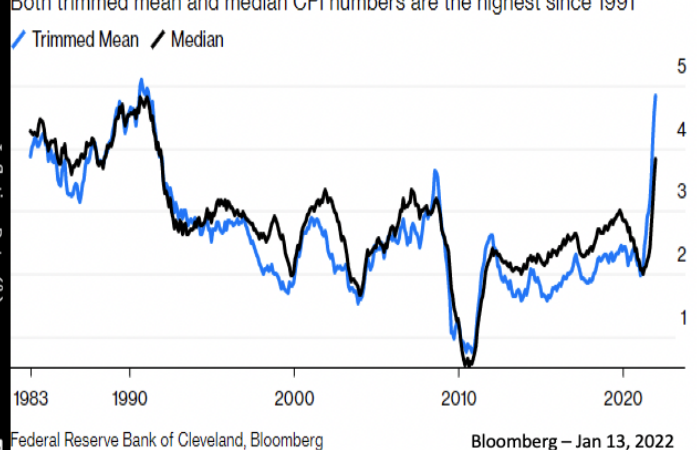
It's Still About Covid (Mostly)

The San Francisco Fed shows that pandemic-sensitive prices are rising fastest



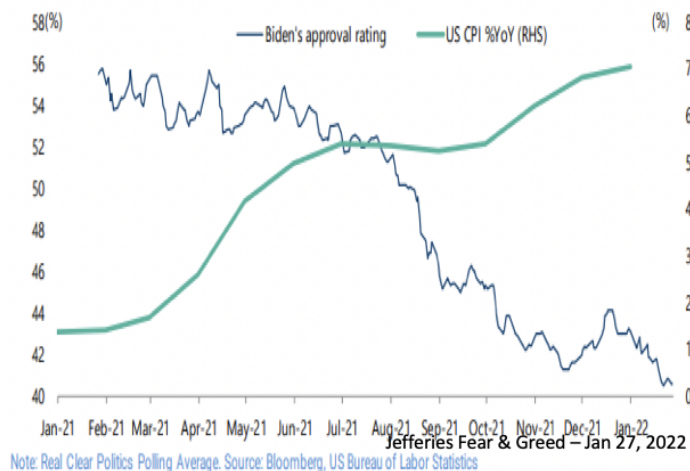
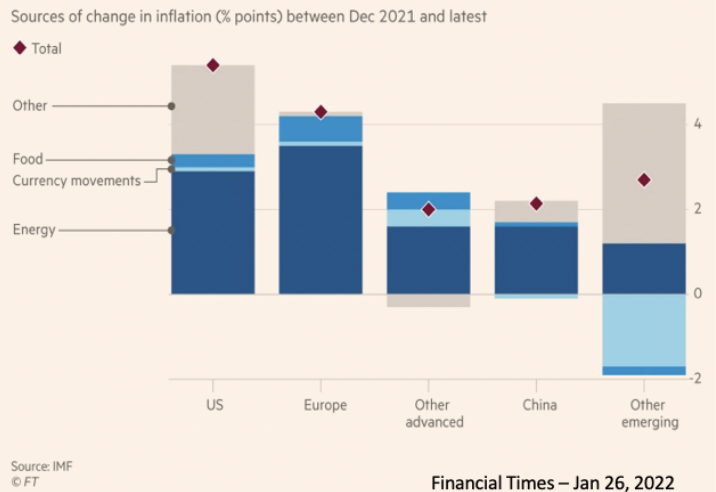
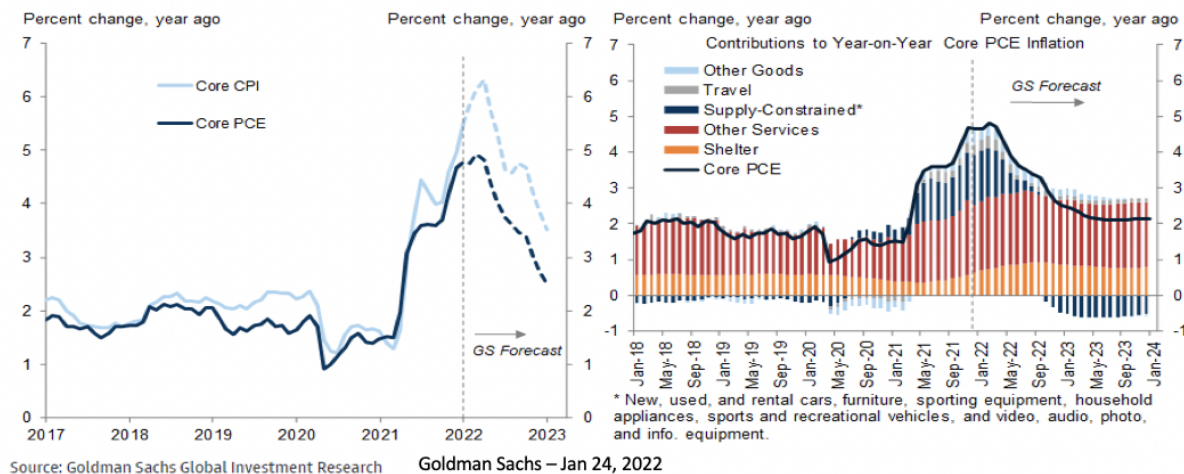
The View from Cleveland

Both trimmed mean and median CPI numbers are the highest since 1991



Continuing supply chain disruptions mean bad news for inflation rates.

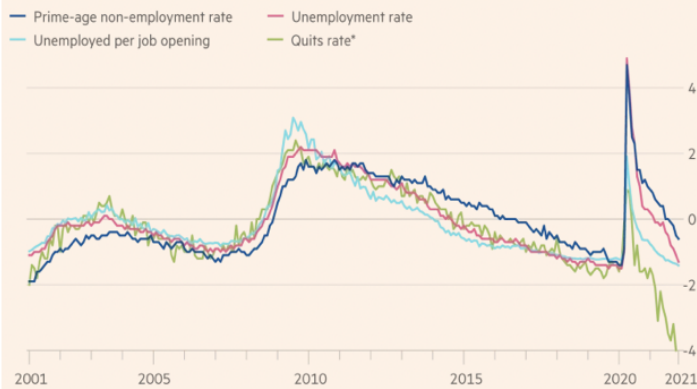
The Omicron variant is helping prolong and worsen supply chain disruptions, thus delaying the inevitable normalization of durable goods prices, while higher energy prices have also started to play a more prominent role in raising inflation once again. While both are likely transitory, the longer inflation remains high; the more likely inflationary expectations will become permanently elevated. This elevation is something central banks and governments want to avoid. For President Biden, inflation hurts his approval rating and risks becoming a significant issue in this year's mid-term elections.

Exhibit 1: President Joe Biden's approval rating and US CPI inflation**Energy prices have played a big role in raising inflation****Exhibit 2: Omicron Threatens to Worsen Supply Chain Disruptions and Delay the Normalization of Durable Goods Prices, Which Would Keep Inflation Higher This Year**

We believe the employment market will be pivotal in determining whether inflation is permanent or transitory and how much inflationary expectations increase. So far, the data is concerning. The labour market is tight, with high quit rates, and nominal employment costs are rising.

Data on US labour markets are confusing but show tightness

Measures of US labour market tightness (standard deviations from the mean)



* Quits divided by employment. Plotted here so that higher values indicate greater slack, in common with other measures

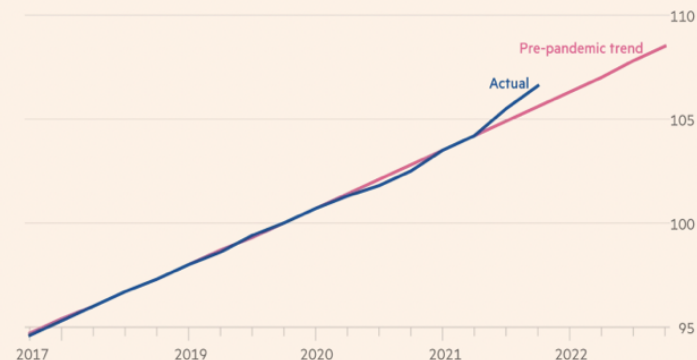
Source: Furman & Powell, Peterson Institute for International Economics, 2022

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Financial Times – Feb 1, 2022

US nominal employment costs are rising strongly

US nominal employment cost index, total compensation for all civilian workers (Dec 2019=100)

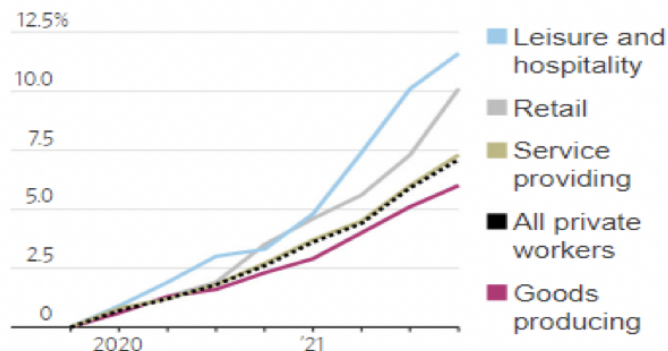


Source: Furman & Powell, Peterson Institute for International Economics, 2022

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Employment Cost Index, change since the end of 2019

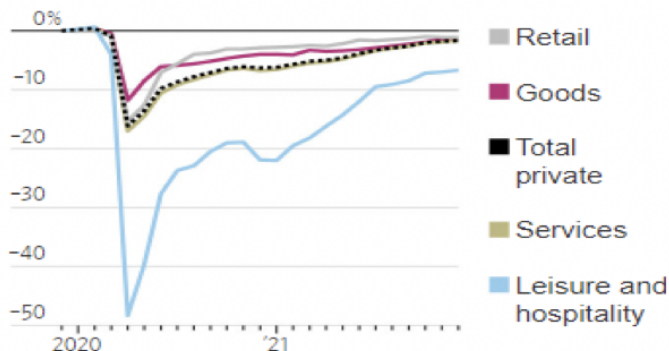


*Seasonally adjusted

Source: Labor Department

WSJ – Feb 1, 2022

Change in the number of employees*, since end of 2019

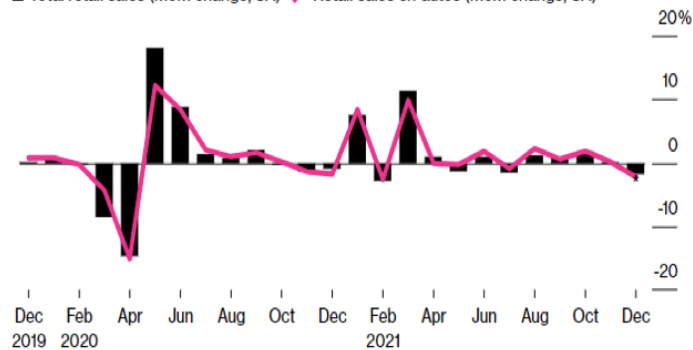


Retail sales in December were disappointing as consumer sentiment had weakened, likely due to the omicron variant and higher inflation. According to a University of Michigan survey, most Americans believe now is the wrong time to buy a major household item. The hesitancy is fine because Americans have likely overspent on consumer durables, but spending on services will be challenging until the pandemic is behind us.

Big Pullback in Spending

U.S. retail-sales measures both decreased in December, missing forecasts

■ Total retail sales (MoM change, SA) / Retail sales ex-autos (MoM change, SA)



* Total sales est. = -0.1% Ex.-autos est. = 0.1%

Source: U.S. Commerce Department, Bloomberg survey

Bloomberg – Jan 14, 2022

Spending on durable goods soared in 2021

Personal Consumption Expenditures, indexed, 2017 = 100



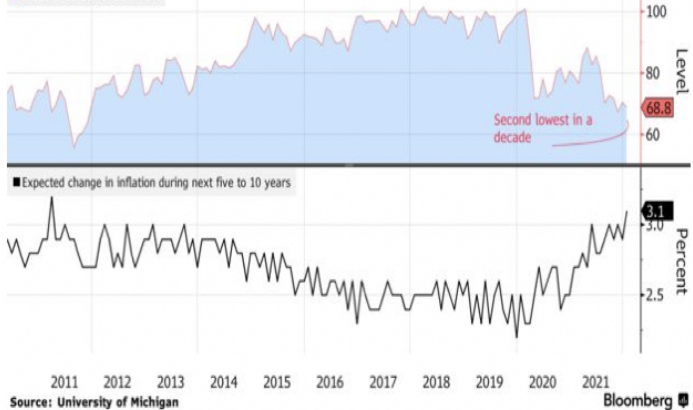
FULL STACK ECONOMICS

Source: Full Stack Economics Mauldin OMS – Jan 26, 2022

Inflation Pain

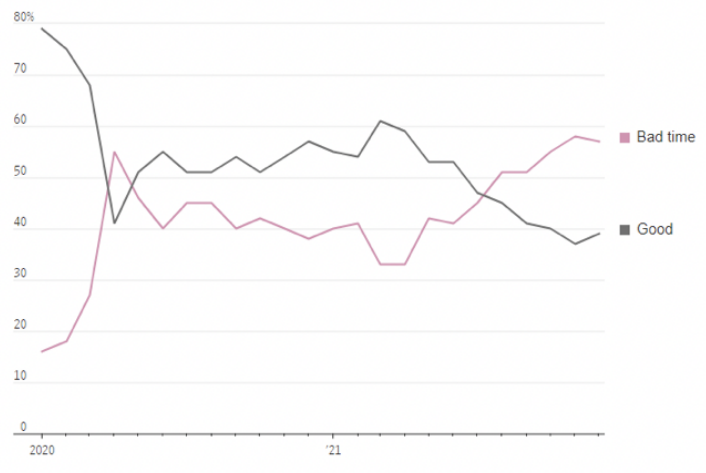
Consumer sentiment fell in early Jan. as inflation, omicron fears mount

■ Index of consumer sentiment



Bloomberg – Jan 14, 2022

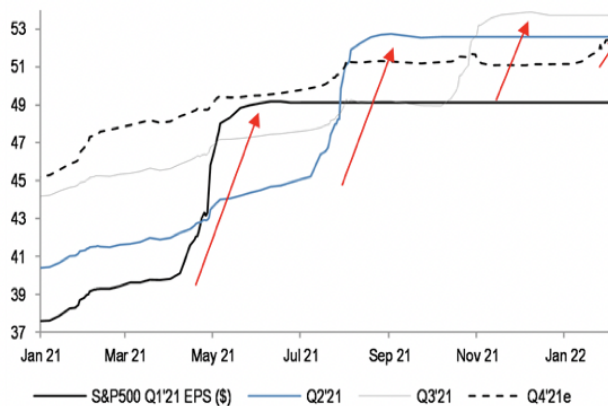
Generally speaking, do you think now is a good or a bad time for people to buy major household items?



Earnings estimates for 2022 continue to drift higher, not lower.

All this will eventually impact economic growth and then corporate earnings. So far, this hasn't been the case. Earnings estimates for 2022 continue to drift higher, not lower, and long-term earnings growth remains near all-time highs. While this is a crucial strength for the market, it is also important to point out the risk that strong earning growth can represent for future returns. Earning expectations were also strong before the financial crisis and the tech bubble. According to a regression analysis conducted by Bank of America, S&P 500 returns over the next 12 months should be solidly negative based on current consensus long-term earnings growth of 19%. While we agree earning expectations have set a high bar, the group of tech stocks primarily responsible for these high estimates are an exceptional collection of companies with the proven ability to compound earnings over multiple years. They will stumble at some point, but it doesn't necessarily have to happen this year.

Figure 1: Quarterly S&P500 blended EPS progression

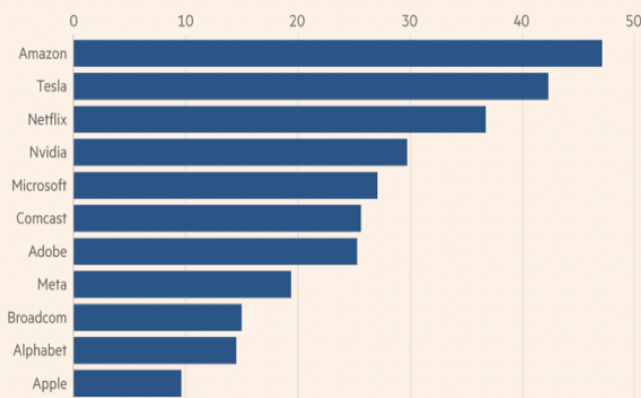


Source: J.P. Morgan, Bloomberg Finance L.P.

JP Morgan – Feb 4, 2022

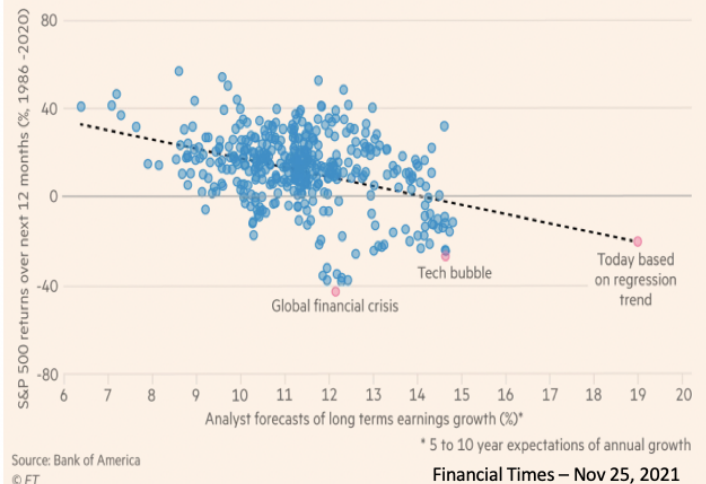
Earnings expectations for largest US tech companies

Earnings per share 2021-2023 (% change)

Source: Refinitiv
© FT

Financial Times – Nov 25, 2021

Strong earnings expectations have preceded previous market corrections

Source: Bank of America
© FT

Financial Times – Nov 25, 2021

Earnings growth forecasts

S&P 500 consensus long term earnings growth (%)

Source: Bank of America
© FT* 5 to 10 year expectations of annual growth
Financial Times – Nov 25, 2021

The theme of 2022: How high can rates go?

Overall, January doesn't have to signal what a recent Bloomberg cover described as the "big chill" for markets. It could, but only if higher inflation requires central banks to tighten financial conditions such that corporate earnings are materially damaged. So far, this isn't the case. Keeping a close eye on the employment market will be necessary, as wage growth is crucial for inflationary expectations and corporate profit margins. As economies and supply chains normalize, so will prices. Same for the labour market. We have to believe at least some of the decline in the labour participation rate is due to COVID and will normalize at some point.

In the meantime, higher inflation is starting to impact consumer confidence and spending negatively. Timing will be essential for central banks under political pressure to act. The longer they wait, the more they risk inflationary expectations becoming unhinged, and further consumer confidence declines. Act too soon and tighten too much, however, and they risk bursting asset bubbles and pre-maturely slowing economic growth to prevent COVID-related inflation pressures that were already set to decline. Five rate hikes in the US and six in Canada during 2022 seem a lot to us.



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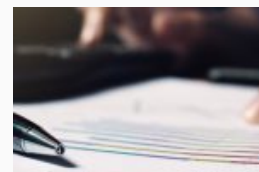


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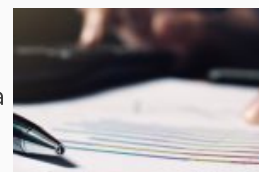


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