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Market Commentary: A Year of Cautious Optimism

MARKET COMMENTARY January 17, 2022



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By Rob Edel, Chief Investment OfficerView the Nicola Wealth Investment Portfolio Returns: December 2021

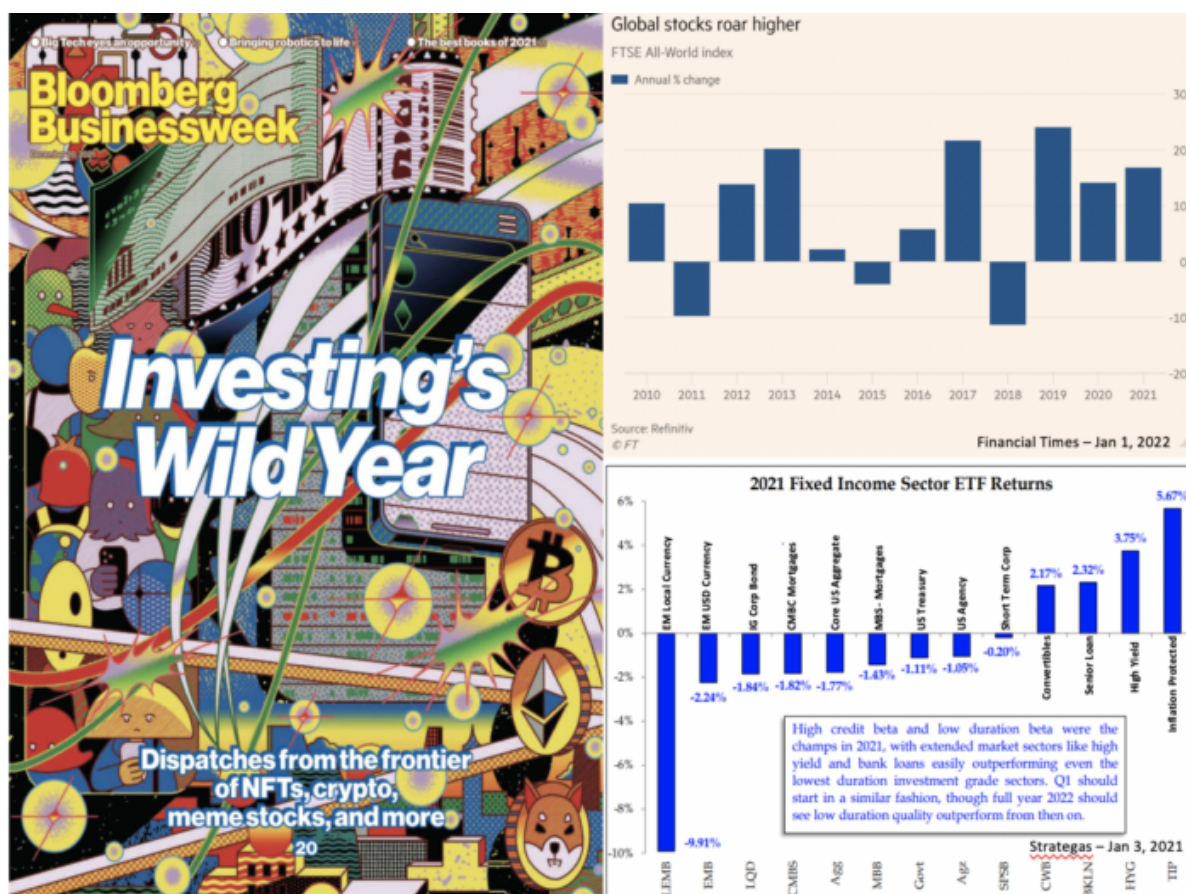
Highlights this Month

- Are massive stocks creating a cause for concern?
- The issues influencing the markets.
- Pandemic-era savings may help the economic recovery.
- Warning signs from the yield curve.
- Frustration mounts as midterm elections loom.
- The fate of the markets in 2022.

December in Review

December closed off a wild year for investors; while cryptocurrency, meme stocks, SPAC's and IPOs captured much of the headlines, we prefer to concentrate on the mainstream, and we will confine our commentary to the significant stock and bond indices.

For stocks, it was the third year in a row that global equities, as measured by the FTSE All-World Share Index, delivered double-digit returns, with the index gaining 16.7% in 2021, but fixed-income investors were not as fortunate. Inflation-protected note ETF's (TIPS) returned nearly 6%, while High Yield Bond ETFs gained just under 4%, but most bonds lost ground last year as yields moved modestly higher. Higher coupon rates and tighter credit spreads helped High Yield and Senior Loans overcome the duration headwind from higher rates (Private Debt also provided superior returns for those investors able to gain access), but Government Bonds and Investment Grade Corporate Bonds were not able to keep up and ended 2021 in the red. A strong US dollar and wider credit spreads hurt Emerging Market debt even more.

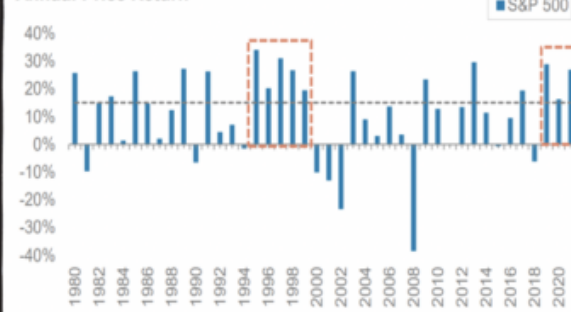


For equities, US Stocks continued to outperform other global markets. The S&P 500 was up 28.7% in 2021, making it the third consecutive year that the big cap US stock index returned over 15%; according to Morgan Stanley, this was the first time since 1929 that the S&P 500 managed this feat and since New Year's 2018, the S&P 500 has doubled in value. Strategas reports that the S&P 500's 2021 28.7% return was the index's 21st best result since 1926, and only the 36th time it increased more than 20%. Optimistically, the average return for the S&P 500, following the previous 35 times it increased more than 20% in a calendar year, has been 11.3%. Not only were returns strong in 2021, but they were also very consistent, with very few setbacks. Strategas notes the S&P 500's most significant intra-year drawdown last year was only 5.2%, the fourth-smallest since 1987, and the S&P 500 set 70 all-time highs, the most since 1995.



S&P 500 Returned >15% For 3rd Consecutive Year

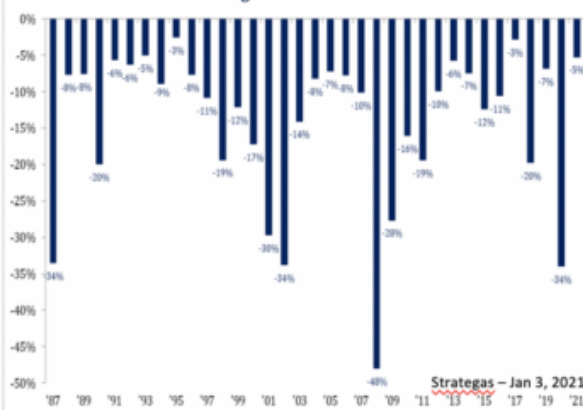
Annual Price Return



Source: Bloomberg, Morgan Stanley Research

Morgan Stanley – Jan 3, 2021

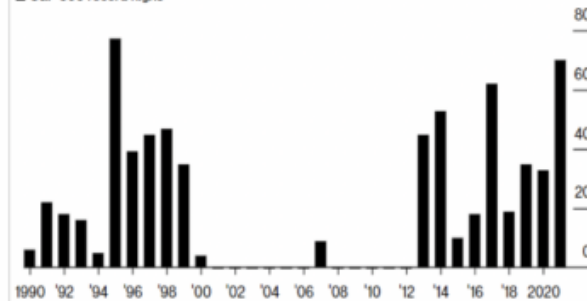
S&P 500 Largest Intra-Year Drawdowns



For the Record

The S&P 500 has notched 70 all-time highs this year

■ S&P 500 record highs

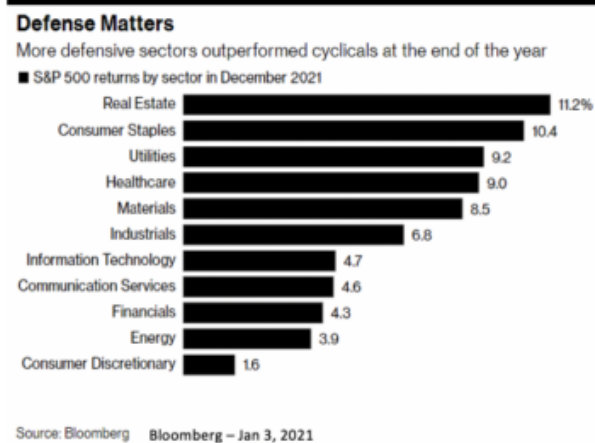
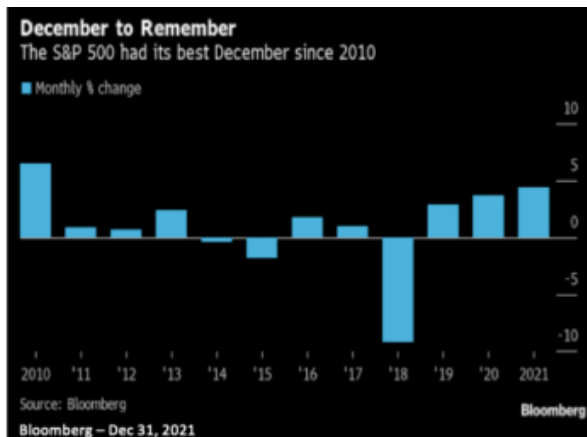


Source: Bloomberg

Bloomberg – Dec 29, 2021

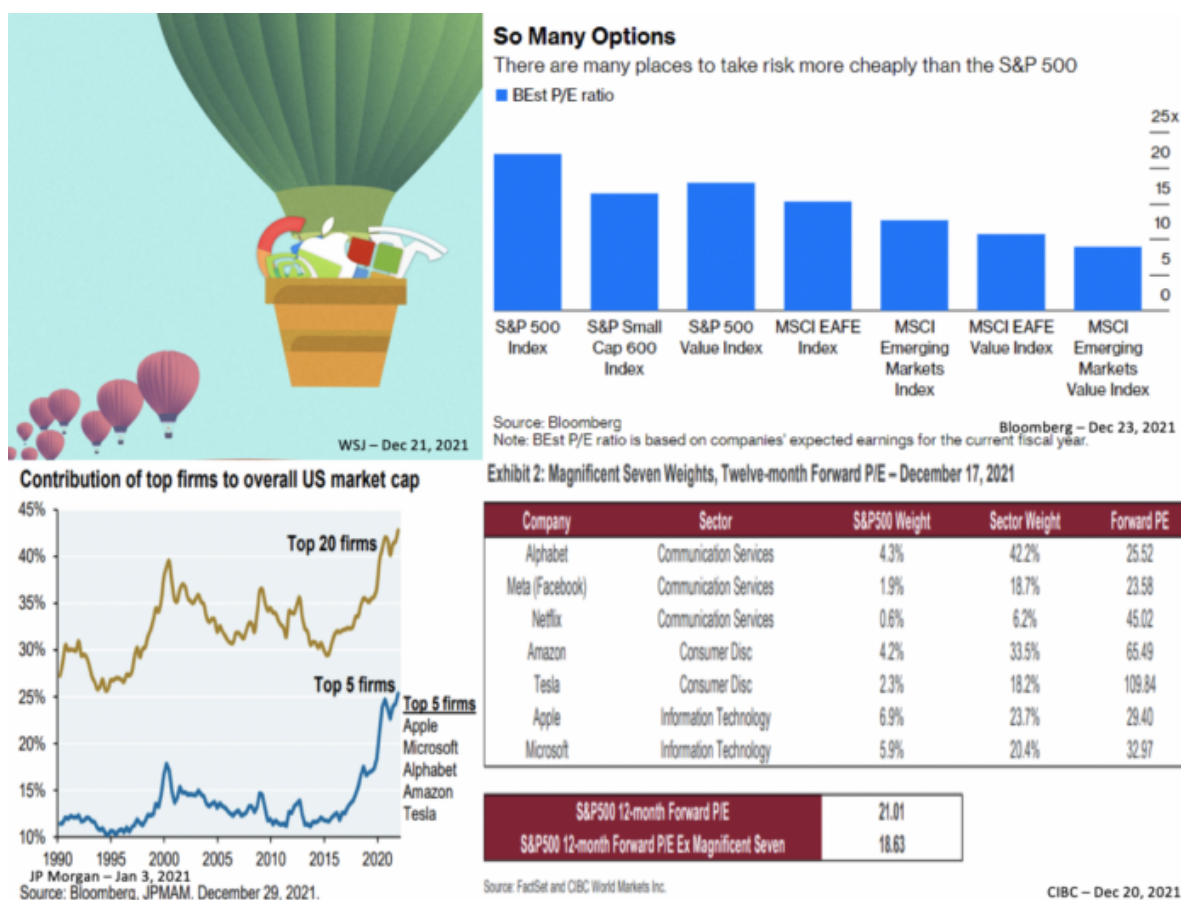
US stocks also finished strong, with S&P 500's 4.5% December return its best finish to the year since 2010, but beneath the surface, some weakness has begun to materialize. Driving returns in December were defensive sectors, like Real Estate, Consumer Staples, and Utilities; not necessarily a bad thing as some sector rotation can be crucial in extending a bull market, mainly if it is a result of a broadening rally with more names participating in the market's rise. Unfortunately, more participation is not what's been happening, particularly in the second half of the year; market breadth has been decreasing, with a smaller group of stocks responsible for moving the S&P 500 higher as fewer NYSE stocks trade above their 200-day moving average, particularly amongst more speculative names. As a result, while the S&P 500 Equal Weighted Index and the S&P 500 Market Cap Weighted indices delivered almost identical returns for the year in total, it was because breadth was strong in the first half of the year, with the S&P Equal Weighted Index outperforming the Market Cap Weighted Index.

In the second half of the year, the broader index has underperformed as market breadth has deteriorated; according to Rosenberg Research, over half the S&P 500's total return since April has come from just five of the S&P 500's biggest stocks. In addition, Goldman Sachs reports that Microsoft, Nvidia, Apple, Alphabet, and Tesla, are responsible for approximately a third of the S&P 500's return in all of 2021.



Are massive stocks creating a cause for concern?

Overall, the composition of the S&P 500 has increasingly concentrated on a smaller and smaller group of names; according to JP Morgan, the top 20 firms in the S&P 500 comprise about 43% of the index, while the top five firms make up nearly a quarter. Not only does this make the fortunes of the S&P 500 highly dependent on a small group of stocks, but it also inflates its valuation. CIBC states that if the seven-largest companies in the S&P 500 were excluded from its valuation calculation, the forward P/E ratio would fall from 21 to 18.6 times. Big cap US stocks are expensive versus small-cap, value, and most international stock indices, but the S&P 500's market cap concentration in a small group of highly valued stocks makes it appear even more so.



Declining market breadth, where fewer and fewer market leaders are driving the overall index returns higher, has historically proved to be a red flag for investors: these market leaders become the last men standing until they too topple over. Alternatively, we could see cheaper, cyclical stocks that trailed the previous year and currently trade at much more reasonable valuations start to catch up. The declining breadth of last year may become the fuel for returns in 2022, this disparity in outlook is evident in the range of Strategas estimated returns for 2022.

According to Strategas, the highest forecasted close for the S&P 500 (which Bloomberg claimed was BMO) on December 31st, 2022, would see big cap US stocks return nearly 12%, substantially lower than 2021's 28.7%, but still pretty decent. On the low end, Morgan Stanley forecasted an almost 8% decline, while the average forecast would see stocks increase just under 4%. According to Bloomberg, the gap between BMO's optimistic 12% return and Morgan Stanley's bearish -8% drawdown is the second largest in a decade. We sympathize with the task of forecasting returns in 2021.

The issues influencing the markets.

There are several issues potentially influencing markets, either positively or negatively. The pandemic, including the new Omicron variant, makes the list, but inflation and its influence on monetary and fiscal stimulus will be the actual driver, in our opinion, and we will take a deeper dive below.



WSJ – Jan 3, 2021

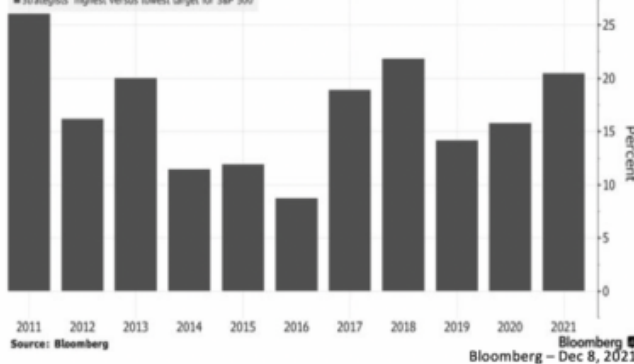
Firm (in alphabetical order)	S&P 500 Forecast (year-end 2022)
Bank of America	4,600
Barclays	4,800
BMO	#1 5,300
BNP Paribas	5,100
Cantor Fitzgerald	4,800
Citigroup	4,900
Cornerstone Macro	4,600
Credit Suisse	5,000
Goldman Sachs	5,100
Jefferies	5,000
JPMorgan	5,050
Morgan Stanley	#16 (last) 4,400
RBC Capital Markets	5,050
Scotiabank	4,800
UBS	4,850
Wells Fargo	Bloomberg – Dec 7, 2021 5,200



Wide Spread

Strategists' year-ahead targets for S&P 500 show second-largest gap in a decade

■ Strategists' highest versus lowest target for S&P 500



Let us begin with the pandemic; the Omicron variant put a black cloud over Christmas last month, as COVID cases spiked globally. However, promising data from South Africa continues to point towards a variant, that while highly transmissible, is also less virulent. Far fewer South Africans infected by the Omicron variant are developing severe disease or being admitted to hospital, and data in the US shows the same trend. With new cases in the US experiencing a near parabolic increase, hospital and ICU admissions fare much better, especially amongst the vaccinated.

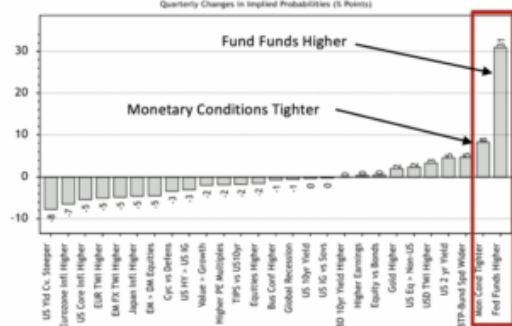
The market has picked up on this trend as well. After initially falling, 10-year yields in early January have started to move higher, anticipating the latest pandemic wave will be short-lived and not result in a material slowdown in the economy. Once again, markets appear to have moved past the pandemic. While case counts will likely pressure the healthcare system in the short term, the market does not see this as a significant risk for economic growth and returns on risk assets.



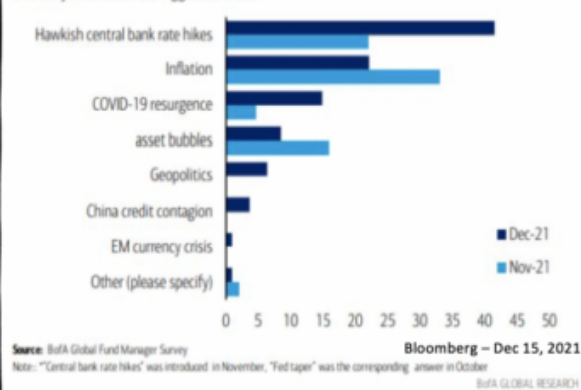
Expect lots of noise from the mainstream media about the Omicron variant, of course, and rightfully so, for the average person, it is very disruptive. Yet, it is inflation and central bank monetary policy for the markets for which investors are focused. According to a December Bank of America Fund Manager Survey, hawkish central bank rate hikes handily took over from inflation as the most significant tail risk for investors last month, and for the first time since May 2018, concerns over tighter monetary policy have taken the top spot. Likewise, a Bloomberg survey of 106 asset managers confirmed investor concerns in December: tapering or policy mistakes are the most considerable downside risks to their main scenario. While a poll conducted by Absolute Return Partners asking fund managers to put a probability on different scenarios confirmed the shift in market perceptions over the past three months, as the probability of higher Fed Funds has materially increased.



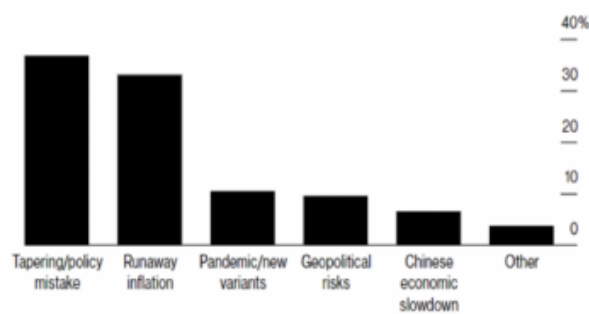
AAS. 1: How Probabilities have Changed since the Previous Survey

ASR Asset Allocation Survey Summary: Dec 2021
Quarterly Changes in Implied Probabilities (% Points)

Source: ASR Ltd.

Chart 20: Hawkish central banks now the biggest 'tail risk', first since May '18
What do you consider the biggest 'tail risk'?

What is the biggest downside risk to your main scenario?



Those results are not just noise, as a hot economy and high inflation have already compelled the Fed to start tightening monetary policy by committing to begin dialling back their \$120 billion a month Treasury and Mortgage purchases. The Fed is now expected to have completed its tapering by March or April of this year. Once the Fed has ended their bond and mortgage QE buying program, the next decision will be how fast they let their balance sheet shrink. Shrinking will happen on its own as bonds and mortgages mature, and new issues are not purchased to replace them, but the Fed can accelerate the process if they decide to sell Treasuries and mortgages actively. Goldman Sachs sees the Fed's balance sheet reaching an equilibrium size of \$5.9 billion by Q2 of 2025 if \$100 billion a month is allowed runoff.

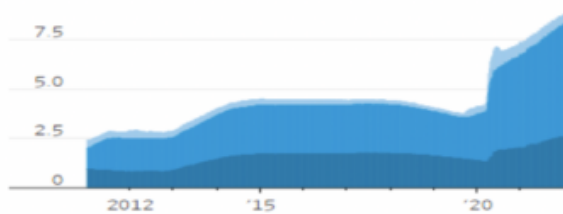


Bond Binge

The Federal Reserve's asset holdings have more than doubled since March 2020

- Mortgage securities
- Treasury securities
- Other assets

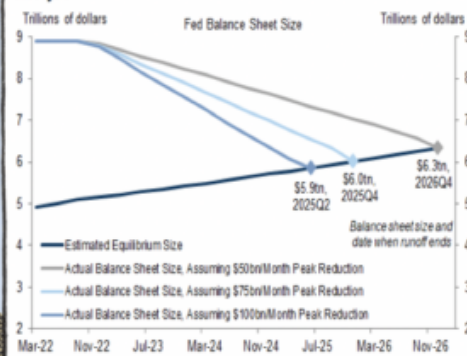
\$10.0 trillion



Source: Federal Reserve

WSJ - Jan 4, 2021

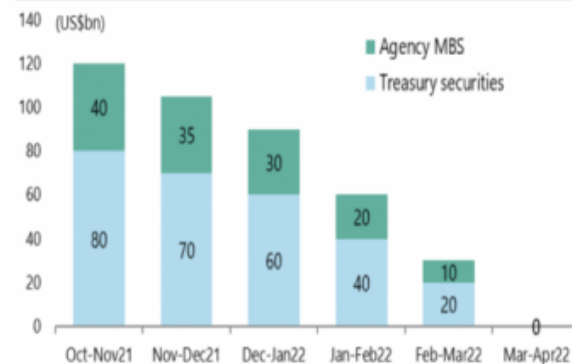
Exhibit 13: We Expect Balance Sheet Runoff to Reach a Peak Pace of at Least the \$50bn per Month Used Last Cycle



Source: Goldman Sachs Global Investment Research

Goldman Sachs - Dec 29, 2021

Federal Reserve tapering schedule: Monthly purchases of Treasuries and agency MBS



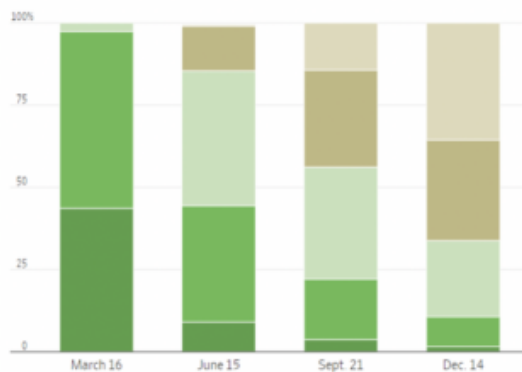
Note: Monthly purchase plans starting from the middle of the month. Source: Federal Reserve

Jefferies Fear & Greed - Jan 3, 2021

A more visible decision for the Fed will be when they achieve liftoff and start raising the overnight Federal Funds rate. The Federal Reserve has signalled that a hotter economy requires tighter monetary policy. As of early January, the market began discounting three rate hikes in 2022, with a greater than 50% chance that the first hike would happen in Q1 during the March 16th Fed Funds meeting. Further increases next year are also likely, with the market expecting another two to three hikes before levelling off.



Interest-rate expectations by Fed meeting



Note: Expected Fed target range for federal-funds rate based on federal-funds futures as of Dec. 31
Source: CME Group **WSJ – Jan 2, 2021**

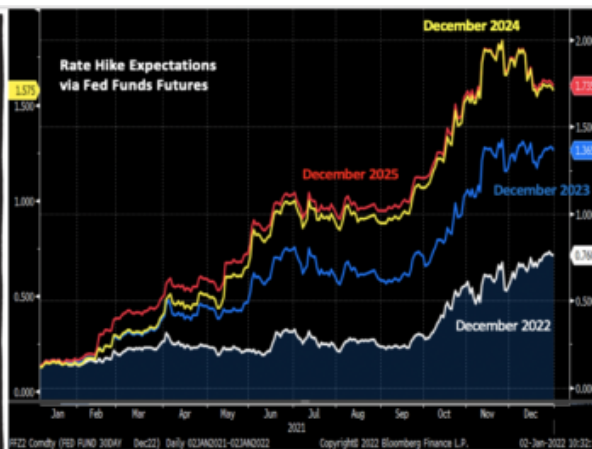
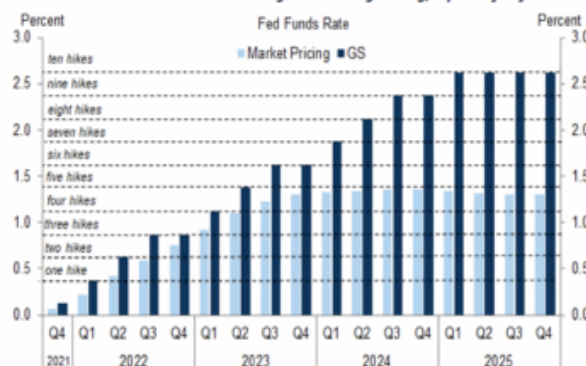


Exhibit 14: We Think the Market Is Pricing Too Little Tightening, Especially Beyond 2023



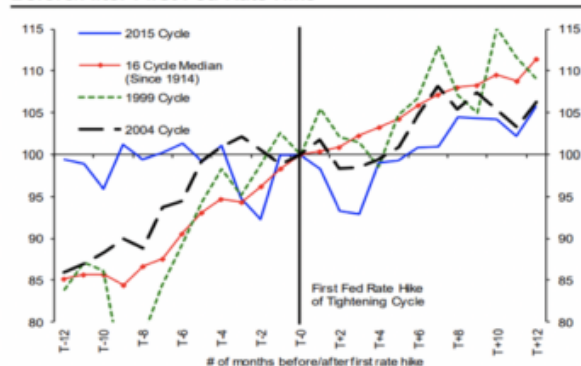
Source: Goldman Sachs Global Investment Research

Goldman Sachs – Dec 29, 2021

Quite frankly, Federal Reserve Chairman Jerome Powell's magic eight ball's ability to forecast rates hikes in 2022 is questionable, let alone one to two years in the future. If the market starts to move lower once the Fed begins raising rates, will Powell have the discipline to continue raising rates? Since the financial crisis, the market has come to view the Fed as an ally, believing the central bank has its back. When the S&P 500 has come under pressure, the Fed has either cut rates or bought more bonds (QE Program), or both. Based on past rate hike cycles, Powell might get a free pass initially. According to a recent Scotiabank chart, the S&P 500 has moved higher the twelve months after the first increase in rates during the past 16 rate hiking cycles since 1914. Strategas confirms the generally favourable market reaction, showing an average 6.6% increase in the S&P 500 six months after the last seven Fed tightening cycles.

This makes sense, given rate hiking cycles are enacted to combat overheating economic growth, which is good for corporate profits until progressively higher rates choke off economic growth. Also helping soothe market nerves is that real Fed Funds are starting at very accommodative levels; according to Strategas, the real Fed Funds rate is well below where recessions commonly end, and thus nowhere near where higher rates would historically start to impede growth.

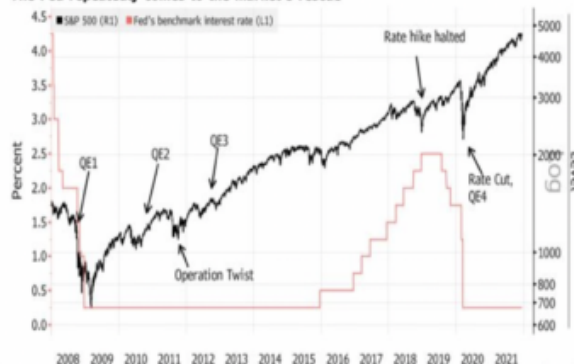
Exhibit 8: S&P 500 Normalized Performance 12M Before/After First Fed Rate Hike



Source: Scotiabank GBM Portfolio Strategy, Bloomberg. Scotiabank – Dec 15, 2021

A Bull-Market Ally

The Fed repeatedly comes to the market's rescue



Source: Bloomberg Bloomberg – Dec 15, 2021 Bloomberg

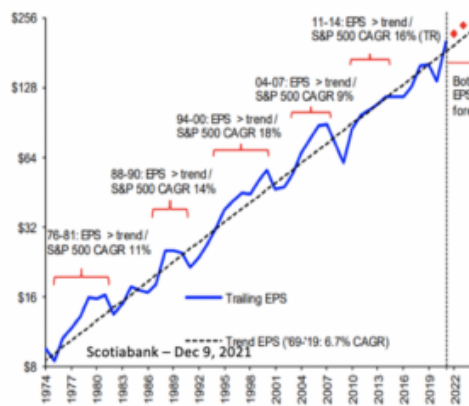
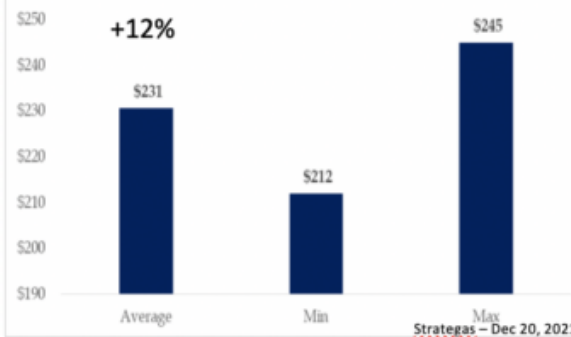
S&P 500 Performance Before & After First Fed Tightening				
Date of First Raise	-6 Mos.	-3 Mos.	+3 Mos.	+6 Mos.
3/31/1983	27.0%	8.8%	9.9%	8.6%
1/5/1987	0.2%	7.9%	19.1%	21.2%
3/30/1988	-19.8%	4.1%	6.0%	5.4%
2/4/1994	4.7%	2.7%	-3.9%	-2.4%
6/30/1999	11.7%	6.7%	-6.6%	7.0%
6/30/2004	2.6%	1.3%	-2.3%	6.2%
12/16/2015	-1.1%	3.9%	-2.2%	0.2%
Average	3.6%	5.1%	2.9%	6.6%
Median	2.6%	4.1%	-2.2%	6.2%

Strategas – Dec 8, 2021

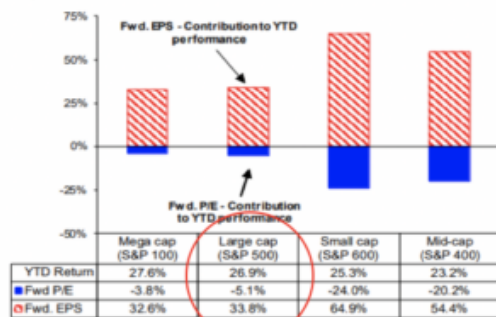
GOOD NEWS: REAL FED FUNDS RATE WELL BELOW WHERE RECESSIONS NORMALLY END RATHER THAN START



The key for equity markets will be corporate earnings which Scotiabank reports have increased at a 6.7% trend rate between 1969 and 2019 and are expected to exceed that over the next couple of years. Strategas reports the average consensus 2022 S&P 500 earnings estimate is expected to increase 12% from last year, while Strategas themselves are a little less optimistic, forecasting a still not too shabby 9% increase. Like last year, valuations might come under pressure, particularly if interest rates drift higher, but stock returns can still be positive due to higher earnings. Scotiabank reports that the S&P 500 in 2021 increased 26.9% (composed of a 5.1% decline in valuation and a 33.8% increase in earnings). Moreover, for the S&P/TSX a valuation decrease of 9.5% was more than offset by a 34.6% increase in earnings, which resulted in a +21.7% return for investors.

S&P 500: Above Trend EPS Tends to Bring Strong TR Performances (USD)**2022 Consensus Strategist Estimates For S&P 500 EPS**
(Source: Bloomberg)**2021 Returns: It's All About EPS Expansion****US Equities: YTD Returns - P/E or EPS Driven?**

12/31/2021

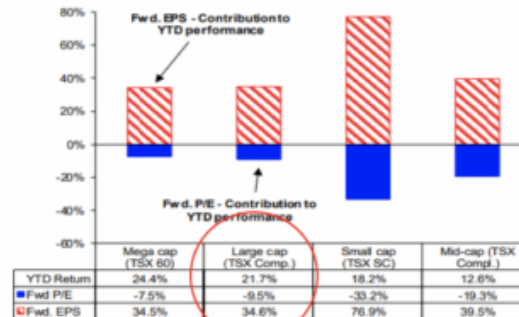


Source: Scotiabank GBM Portfolio Strategy - Bloomberg

Scotiabank – Jan 6, 2021

Canadian Equities: YTD Returns - P/E or EPS Driven?

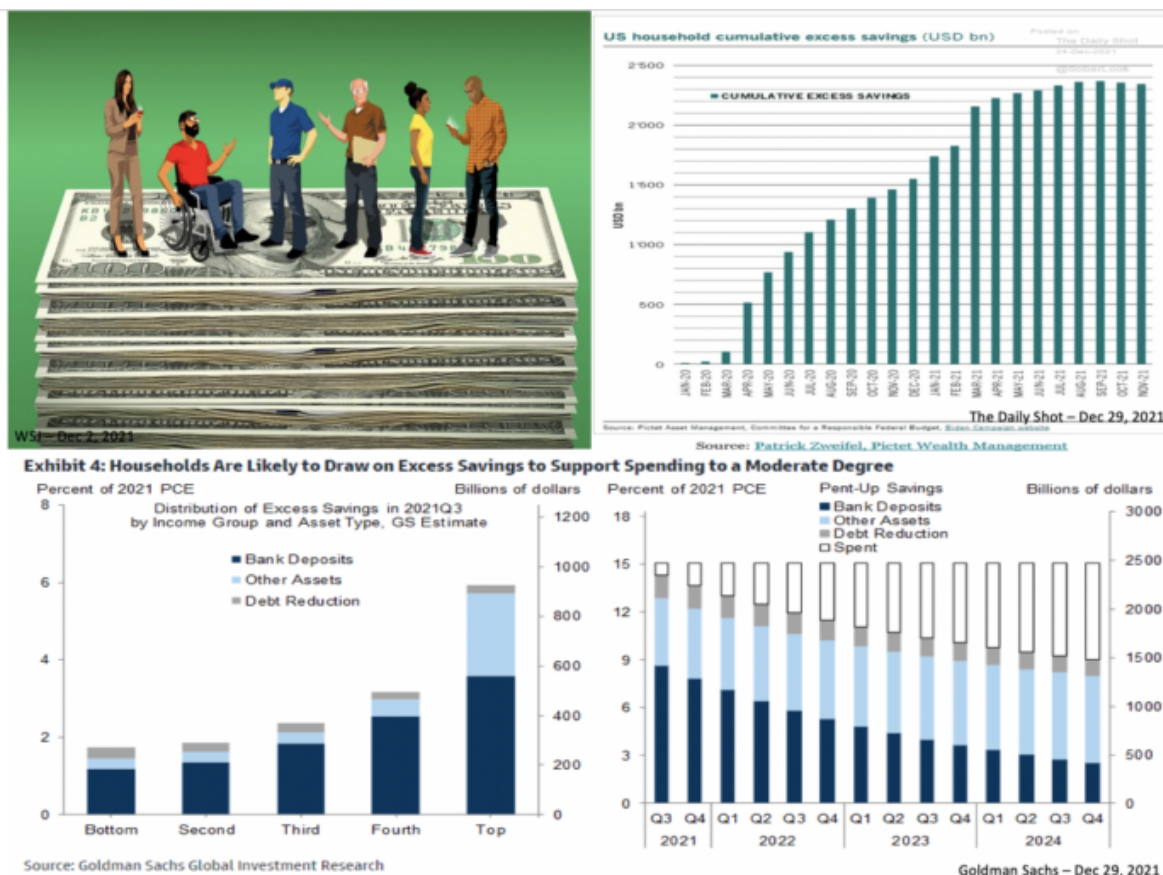
12/31/2021



Source: Scotiabank GBM Portfolio Strategy - Bloomberg

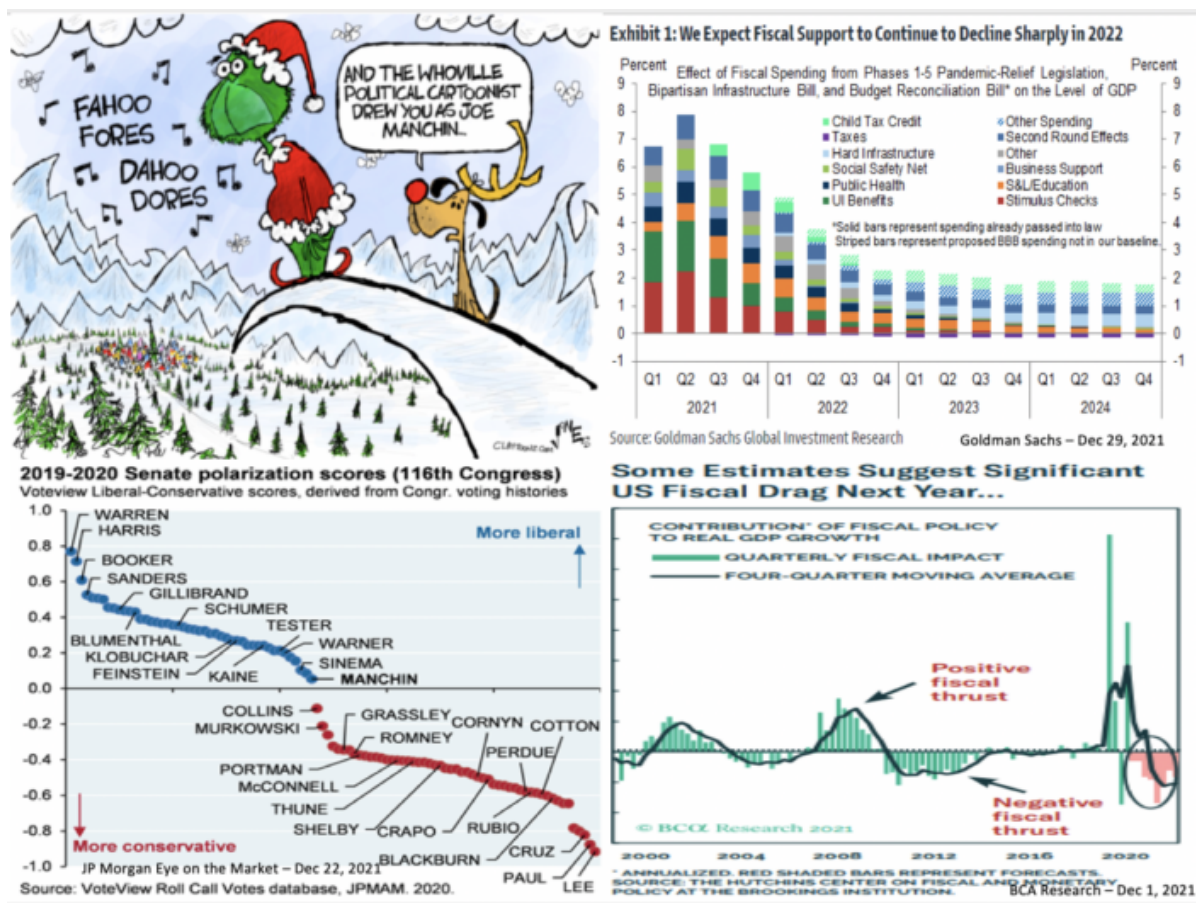
Pandemic-era savings may help the economic recovery.

The strength of the US consumer is also helping keep corporate earnings healthy; many Americans are sitting on extra cash, with cumulative excess US household savings estimated at nearly 2.5% trillion. Moreover, Goldman Sachs shows that households are likely to draw on their additional savings over the next few years, which should help buffer any pandemic-related slowdowns.



The ability to draw on savings will be significant, as a headwind American consumers are likely to face in 2022 is less fiscal support, which has been very generous during the past couple of years and the main reason household excess savings are so high. After peaking at around 8% of GDP in Q2 of last year, Goldman Sachs sees fiscal support continuing to decline sharply in 2022 before levelling off around 2% of GDP in 2023. This is still a lot of money, just less than US households have become familiar with.

There were hopes that more fiscal stimulus would be forthcoming in President Biden's Build Back Better program. However, the program took a hit before Christmas as Democratic Senator Manchin played the part of the Grinch and refused to support what he believed was excessive and inflationary spending. With a virtually split Senate, Democrats need Manchin's vote, and even though he is a Democrat, JP Morgan believes his congressional voting history pegs Manchin as the most conservative Democrat in the Senate.



Warning signs from the yield curve.

Perhaps picking up on the decline in fiscal support is the US Treasury yield curve, which has started to flatten. In a healthy economy, the yield curve is upward sloping as investors demand higher yields for longer maturing issues to compensate for an inflation increase—the stronger the economy and the greater the risk of inflation increases, the steeper the yield curve. Alternatively, a flatter yield curve is a sign of a slowing economy, and if the yield curve inverts (short rates more than long rates), a recession is almost sure to follow.

Last month, the yield curve flattened as short rates, like 2-year Treasuries, increased while 10-year Treasury yields declined. At this point in the tightening cycle, namely, the very beginning, we would have expected 10-year yields to move higher, not lower. Falling 10-year yields would be a more common sight later in the tightening cycle as higher rates slow economic growth and inflation. Lowering 10-year yields now indicate a lack of faith in the sustainability of the current strength in the economy and inflation. The decrease is something for the Federal Reserve to ponder as the spread between the 10-year versus 2-year Treasury yields closed the year at just under 78 basis points. Apart from 1983 and 1999, Strategas indicates that the yield curve has typically been steeper before the first-rate hike. Since the Fed doesn't want to invert the yield curve unless 10-year yields move higher, the current flat yield curve will limit how much the Fed can raise rates to 75 basis points or three 25 basis point hikes. As an alternative, the Fed could more aggressively shrink their balance sheet by buying back bonds, which would also increase bond yields along with tightening financial conditions. However, one thing to keep in mind is the current flatness of the yield curve. While the yield curve has flattened, it is still steeper than last year, and a flatter, but not inverted, the yield curve is consistent with GDP growth.

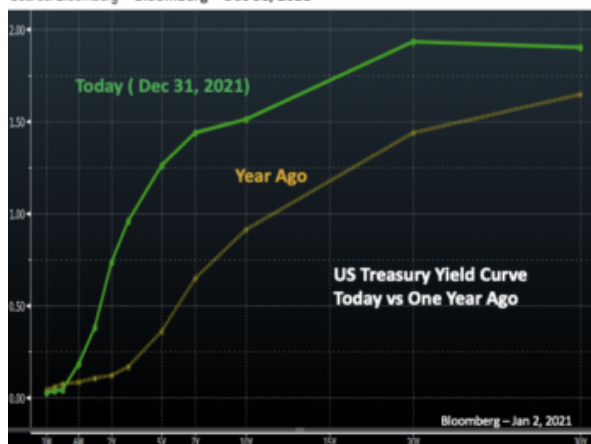
Wrong Direction

The yield curve is headed lower again in an ominous sign for the economy

Yield curve

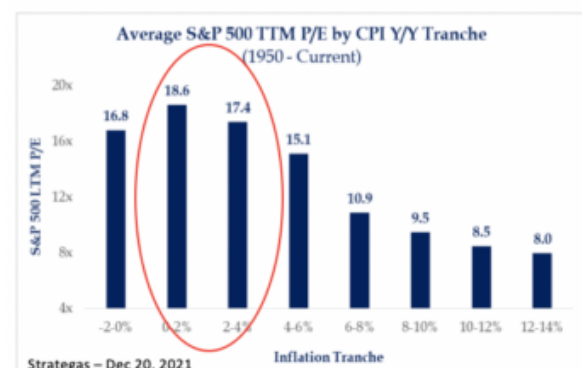


Source: Bloomberg Bloomberg – Dec 31, 2021



The primary factor for markets this year is likely to come down to inflation; with a healthy economy, we can expect a certain amount of it, but too much inflation can be disruptive and hurt corporate profits. While not an exact science, Strategas believes inflation above 4% has historically pressured equity valuations, with 0% to 4% being the sweet spot for investors. Since 1990, BMO found the highest rolling 1-year return periods occurred when CPI ranged from 1.1% to 2.5%. Finally, the December survey produced by Bloomberg of 106 Asset Managers found an inflation rate of more than 4%, but less than 5% was the most popular level chosen for the inflation level it would take to derail the market. Unfortunately, CPI in November was 6.8%, well above levels most believe would be damaging to the market. Fortunately, most still believe the recent price spike is transitory due to pandemic-related supply disruptions.

INFLATION GREATER THAN 4% HAS HISTORICALLY LED TO SIGNIFICANT MULTIPLE COMPRESSION



Inflation in the US has accelerated at its fastest pace since 1982

Annual % change in consumer prices



What level of U.S. inflation could derail stock markets?

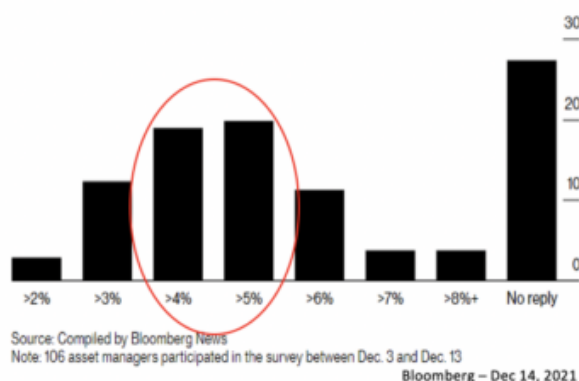
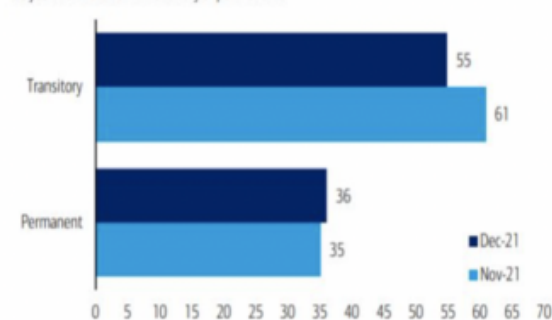


Chart 6: 36% of investors think inflation is permanent

Do you think inflation is transitory or permanent?



While we generally believe many price increases will prove to be transitory, we are wary of inflationary trends that could prove more durable. For example, home prices have moved significantly higher, but because of the quirky way they are calculated in the CPI, higher home prices have yet to impact CPI in any meaningful way. However, as rents begin moving higher, this lack of significant impact will likely change.

Services prices have also started to move up much faster as the economy has continued to re-open, and inflation has broadened and is no longer confined to higher prices in supply-constrained goods. Perhaps most worrying is wages: if inflation is critical for markets this year, wage growth is likely the key factor for inflation. According to the NFIB Small Business Compensation Index, wage pressure has hit record highs, with the Atlanta Federal Reserve highlighting the bottom 25% of workers have benefitted the most. Lower-wage earners spend a larger share of their income, so more of this income will be spent, which is good for GDP growth but not good for prices in a supply-constrained economy. From an income inequality perspective, some rebalancing is sorely needed, but the downside is higher wages can go a long way to increasing inflationary expectations and compel central banks to tighten monetary conditions even more.

Shelter Inflation: The Trend To Watch

Rises in rents have risen to the top of their range since 2007



Bloomberg – Dec 13, 2021

Bureau of Labor Statistics, Federal Reserve Bank of St Louis FRED service

Services Prices Are Rising, Too

Goods prices are rising much faster, but services inflation is also at a record

US PPI Final Demand Services NSA / US PPI Final Demand Goods NSA



Bloomberg

Bloomberg – Dec 15, 2021

Wage Pressure for Small Businesses

Record highs for businesses raising wages and planning to do so

NFB Small Business Compensation Index - Last Price / NFB Small Business Compensation Plans Index SA - Last Price



Source: Bloomberg

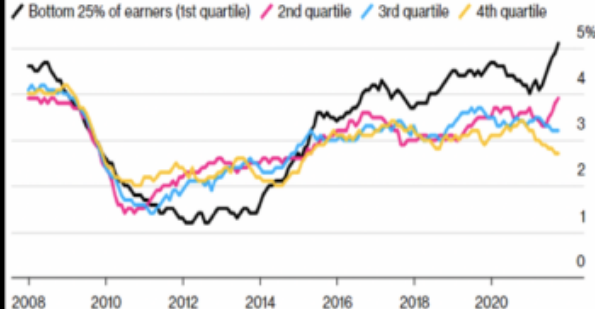
Bloomberg – Dec 15, 2021

Bloomberg

Pay Raise

Wage gains accelerate fastest for lowest income U.S. workers

Bottom 25% of earners (1st quartile) / 2nd quartile / 3rd quartile / 4th quartile



Source: Federal Reserve Bank of Atlanta, Current Population Survey and Bureau of Labor Statistics

Note: 12-month moving average of median wage growth for each category

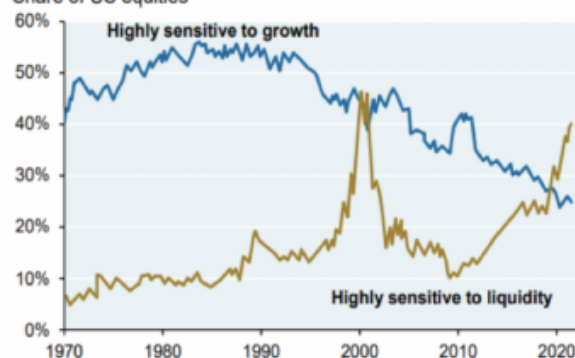
Bloomberg – Dec 9, 2021

When the Fed prioritizes managing inflation over economic growth, the outlook for market returns and leadership changes. According to Bridgewater (via JP Morgan), a more significant percentage of US stocks are now more sensitive to liquidity than economic growth. This worked well earlier in 2021 when real interest rates were solidly negative and central banks were flooding the system with liquidity, but there are signs we may have hit an inflection point. The Meme stock rally, powered by retail investors betting on money-losing companies, looks to be faltering, along with many other FOMO (fear of missing out) trades.

In early January, high-duration stocks, like profitless technology and expensive software companies, started selling off as nominal, and real yields began moving higher. As a result, investors are beginning to discount the impact of higher interest rates on risk asset valuations, and if inflation continues to prove persistent, expect this trend to accelerate in 2022.

US equity market sensitivities

Share of US equities



Source: Bridgewater. December 10, 2021.

JP Morgan – Jan 3, 2021

Extra yield to hold U.S. speculative-grade corporate bonds over Treasuries



Source: Bloomberg Indices

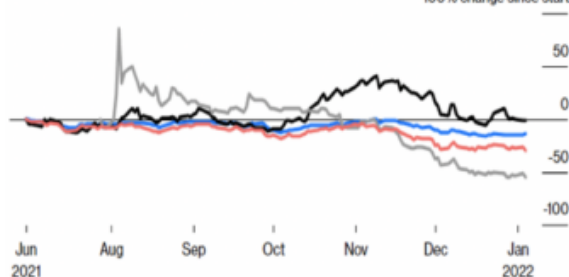
WSJ – Jan 2, 2021

Meme Reversion

Hype over moonshot tech bets, cryptocurrency and memestocks has faded

100% change since start

Legend: FOMO ETF (blue), Coinbase Global Inc (black), Robinhood Markets Inc (grey), ARK Innovation ETF (red)



Source: Bloomberg

Bloomberg – Jan 5, 2021

Tech Wreck

Expensive software, profitless tech firms tumble into the new year

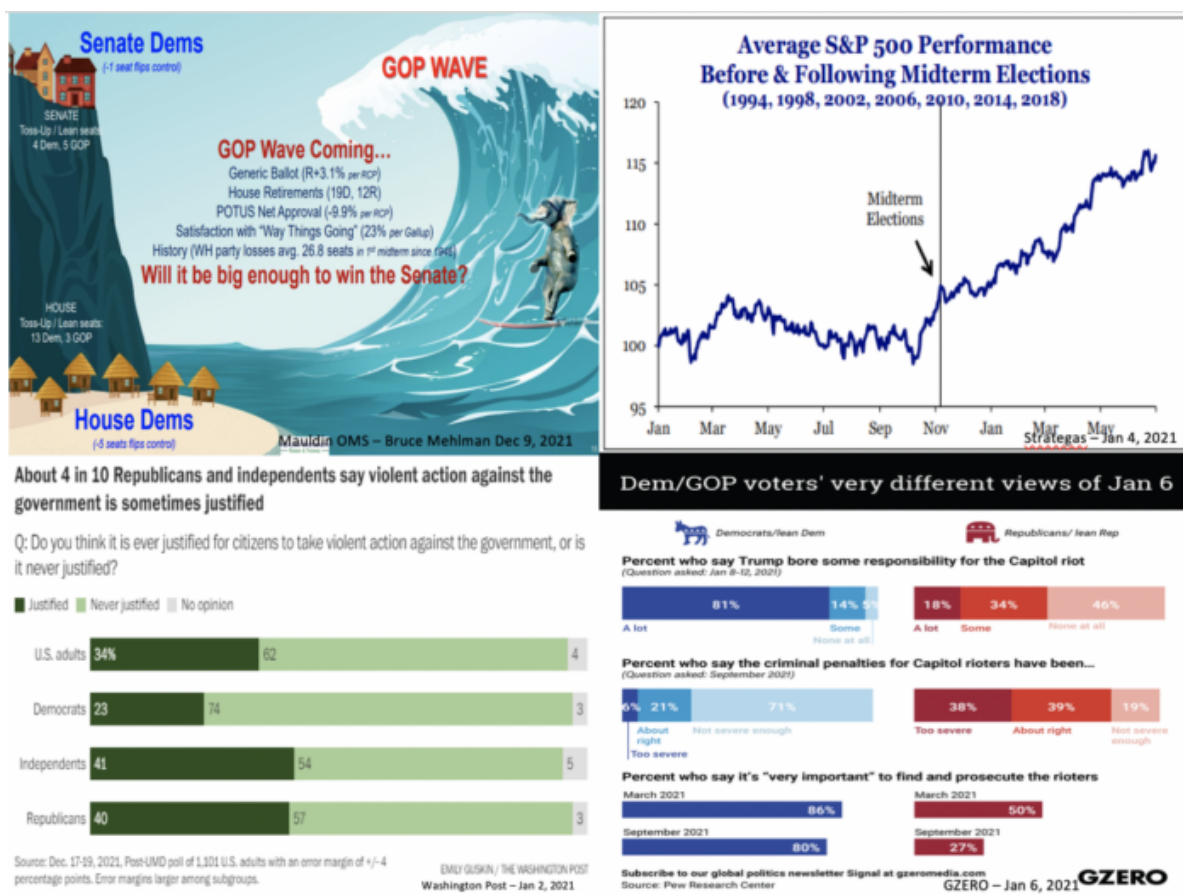


Source: Goldman, Bloomberg

Bloomberg
Bloomberg – Jan 6, 2022

Frustration mounts as midterm elections loom.

One last factor to watch for in 2022 is the upcoming US midterm elections later in the year. A big GOP wave election is possible based on recent polling, and Republicans are likely to take the House and maybe even the Senate. A solid Republican showing could validate claims that the 2020 Presidential election was stolen and set the stage for a very tense 2024 campaign. With the first anniversary of the January 6th insurrection just behind us, we are reminded that the democracy the American people once took for granted is perhaps more fragile than initially believed. A Washington Post survey shows that 34% of US adults think there are circumstances in which it is justified for citizens to take violent action against the government. Another recent poll by Quinnipiac University reported that 66% of Republicans don't consider the January 6th Capital riot to be an attack on the government, while 77% of Republicans don't blame Trump in any way for the attack. Pew Research (as reported by GZERO) has the total a little higher, with 52% of Republicans saying Trump bore some or a lot of responsibility for the Capital riot. Democrats were more resolute; 81% believed Trump was responsible, with a further 14% believing he bore at least some responsibility. According to Strategas, markets tend to perform well after the Midterm elections, but all bets are off in the current highly charged bipartisan environment. Perhaps more of a risk for 2024, but markets could remain on edge at least until after November 8th.



The fate of the markets in 2022.

Overall, we are a little timid in opening the door to 2022. On the one hand, higher corporate earnings could drive higher returns, but tighter monetary and fiscal policy will provide a less favourable environment than last year. On the other hand, financial conditions are likely to remain very loose by historical standards while the average US household has ample savings to buffer shortfalls. The biggest unknown, however, remains inflation. The debate over inflation and whether it is transitory or permanent will likely rage throughout 2022. Even the Federal Reserve is unsure where the inflation debate will end; a fact backed up by the Index of Federal Reserve policymakers' uncertainty over their inflation projections. As employment remains strong, inflation would appear to be the Fed's biggest concern.

If they tighten monetary policy too much and markets start to sell off, will they follow past practice and come to Wall Street's rescue? If the answer to this is no, investors might want to consider cashing out in 2022. Alternatively, if the Fed loses its nerve, or transitory inflation enables them to dial back their monetary tightening plans, markets might have another strong year.



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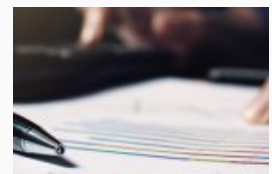


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