Investment Commentary
Q1 - 2022

29 April 2022

Q1 2022 – The Markets

The first quarter provided investors with a painful reminder that markets can turn volatile for any number of reasons. Multiple factors drove negative returns in Q1, from Russia's invasion of Ukraine to the Fed's increasingly hawkish response to elevated inflation. The interconnected nature of today's world means the impacts of these shocks are not limited to the geographies where they occur but reverberate through global economy.

The general theme for equity markets was negative for the quarter but there were select markets that, owing to their weightings in certain sectors, produced positive returns.

The US market was not spared, printing negative returns in January and February, even a bounce back in March could only bring the S&P 500 back to -4.6% for the quarter. Within the market there were some noteworthy differences in performance: large caps outperformed small caps and value stocks outperformed growth stocks. Although some economic indicators were positive (unemployment continuing to decrease) increasing interest rates and the war in Ukraine were headwinds that could not be overcome.

Conversely, the Canadian market was one of the few that produced a positive return for the quarter. The S&P/TSX Composite, benefitting from a relatively heavy weighting to the commodity sector, gained +3.8% in Q1.

Energy and materials were the largest contributors to performance by a significant margin. Those sectors also happen to be the second and third heaviest weightings in the index (after financials).

It is no surprise that European markets, given their proximity to the situation in Ukraine (both geographically and with respect to economic ties), suffered disproportionately. The MSCI Europe index was down -7.2% as reliance on Russian energy and increasing supply chain disruptions proved to be major issues.

The emerging markets also had a difficult quarter with the MSCI Emerging Market Index down -7.0%. Representing a diverse group of countries and sector exposures, performance within the index was a mixed bag. Markets with significant commodity exposure (Brazil, Kuwait, UAE, Saudi Arabia, South Africa) performed well. However, the main driver of performance with a weighting of over 30% was China at -14.2%. In addition to dealing with the previously mentioned global growth headwinds China also instituted new COVID lockdowns in some major cities including Shanghai.

Q1 2022 – Interest Rates and Inflation

The fixed income markets likely did not live up to the expectations of traditional investors who count on their bond allocations to balance out the equity risk in their portfolios. When stock markets are down traditional investors hope that the conservative bond portion of the portfolio will act as ballast. Clearly that was not the case this quarter.

Persistent inflation and the response by central banks of raising interest rates was the key factor driving bond performance for Q1. In March year over year inflation hit 8.5% in the US (a four-decade high) and 6.7% in Canada (the largest increase since January 1991). An increase in consumer demand coming out of COVID, supply chain issues and rocketing energy prices were the main push factors.

The conflict in Ukraine has also exacerbated these issues. There are the obvious supply side impacts of curbing Russian oil imports and other sanctions. There are also less obvious contributors - Ukraine is responsible for producing approximately half of the world's semiconductor-grade neon (used to produce semiconductor chips). Both Russia and Ukraine are not only large exporters of grain and wheat, but also of fertilizer which other countries rely on to maintain the yield of their crops. The conflict created additional supply chain issues just as some of the COVID related impacts were improving.

Inflation is here and the central banks have taken note by increasing rates and signalling a more hawkish policy and quicker rate hikes in the future. Both The Fed and the Bank of Canada increased rates by 25 basis points in March to 0.5%.

Bond markets felt the pressure of increasing rates with the US 10-year Treasury yield rising to 2.3% (up 81 basis points) the Bloomberg US Aggregate Bond Index was down -5.9% and the Bloomberg Canada Aggregate Bond Index down -6.8%.

The primary factor in how these rate increases impact fixed income is known as duration. The duration of a bond (or portfolio of bonds) measures the price sensitivity to changes in interest rates. In general, bond prices move inversely to interest rates. Put simply – if interest rates go up, bond prices go down and vice versa. A higher duration portfolio of fixed income will be more negatively impacted by increasing rates than a lower duration portfolio all else being equal.

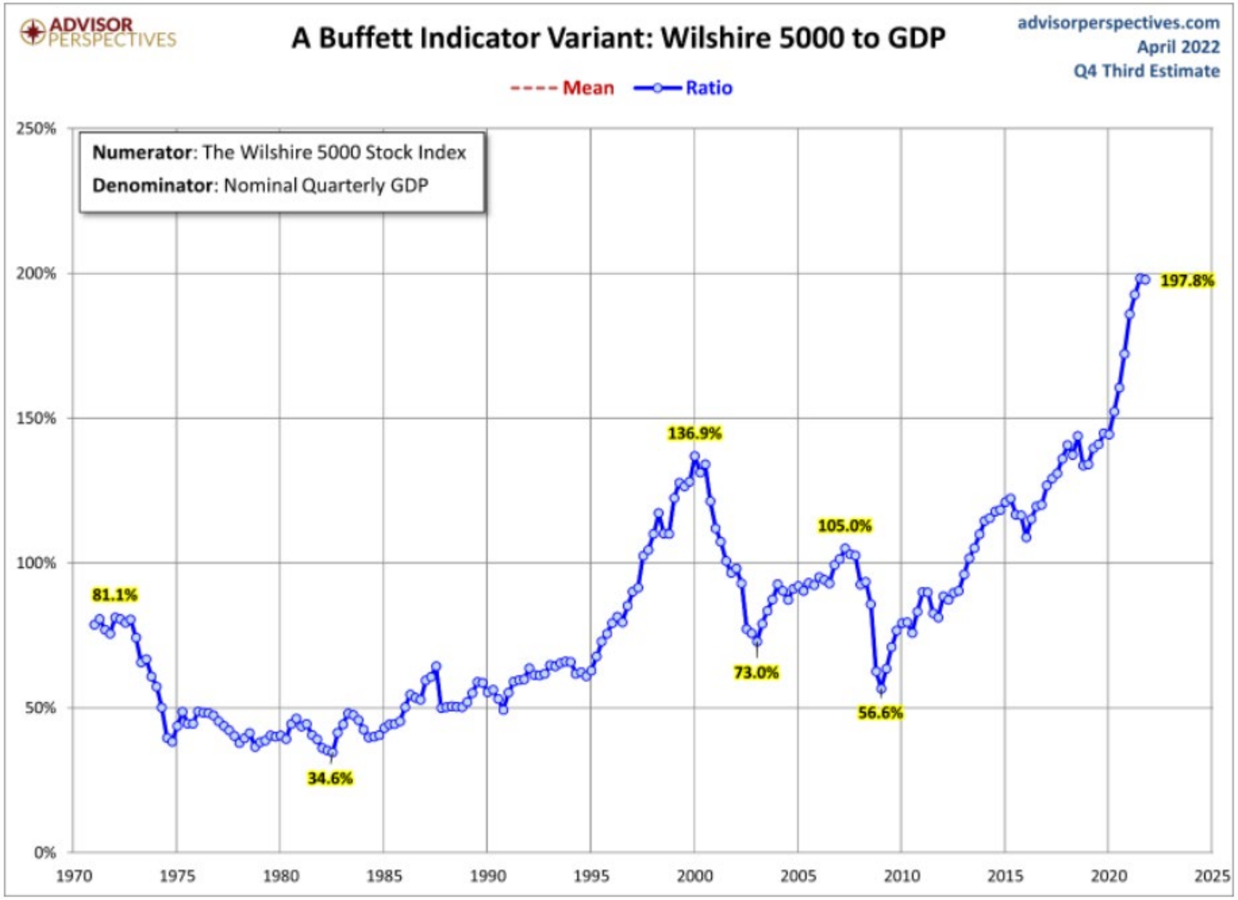
This is one important lever investors can pull to protect their portfolios given the current environment of hawkish central banks and rising interest rates. Reducing the duration of your portfolio can have dual benefits. Firstly, your investments, being lower duration, will be less sensitive to the movement in interest rates (i.e. they will go down less in price if rates continue to rise). Secondly, shorter duration means that fixed income investments will come to the end of their term sooner, and when that principle is repaid it can be re-invested at the new higher rates.

Q1 2022 – Final Thoughts

The makeup of bond and equity allocations in a portfolio are surely important, from diversification to managing duration risk. However, the most important factor in determining returns is not any adjustment that can be made within an asset class but rather the overarching asset allocation as a whole. To weather periods where both of the traditional asset classes fall in tandem, just as the equity and bond markets did in the first quarter, Non-Traditional asset classes must be incorporated.

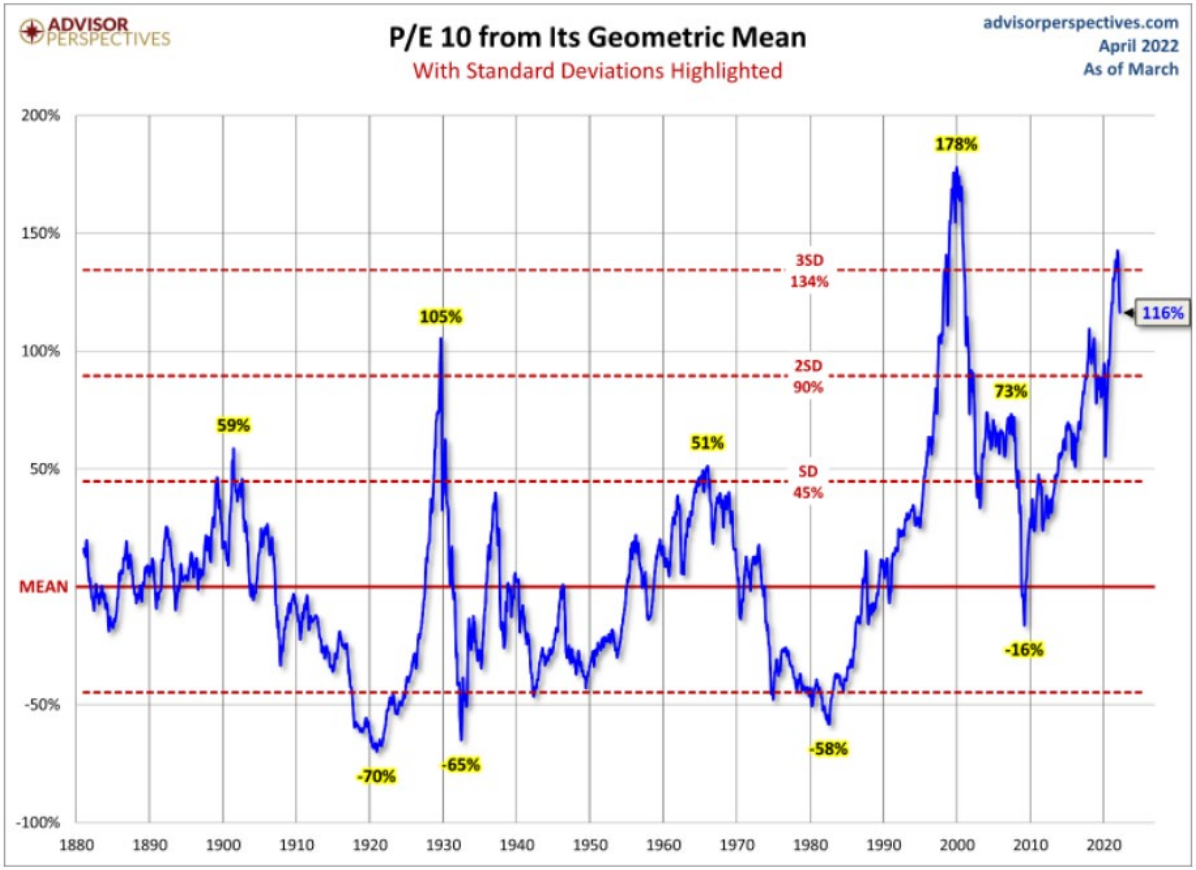
At Our Family Office our portfolios are much lower in both traditional equity weightings and duration of fixed income. This is possible because we are able to select investments from a much wider opportunity set and build meaningful allocations to Non-Traditional asset classes. Many of these investments are absolute return strategies which produce positive returns even in conditions where markets are down significantly. The inclusion of these strategies, which are far less correlated to public markets, allows All Weather Portfolios to protect client capital and achieve superior risk adjusted returns beyond what can be achieved with traditional solutions.

Q1 – 2022 – Charts



- The Wilshire 5000 Index, which is a broad-based stock index, divided by the GDP illustrates how risky the market is relative to the last 50 years
- This indicator of market valuation measures the market capitalization of public equities relative to Gross Domestic Product in the United States.
- When public market valuations are high relative to GDP (100%+), as they are now, that is an indication that markets are overvalued.

Q1 – 2022 – Charts



- The P/E 10 ratio divides the price of the S&P500 by a 10-year average of inflation-adjusted earnings, effectively smoothing out fluctuations in the business cycle.
- This 140-year graph showing the Price Earnings (P/E) Ratio with risk being highlighted, shows that the market is currently priced second only to that of the Tech Bubble (2000).
- When the ratio exceeds 2 standard deviations above the mean, as it currently is, bear markets have historically followed. Unless earnings catch up to close the gap, this should be seen as unsustainable.

Q1 – 2022 – Charts

Chart 1: Ten Year U.S. Treasury Yield (%)

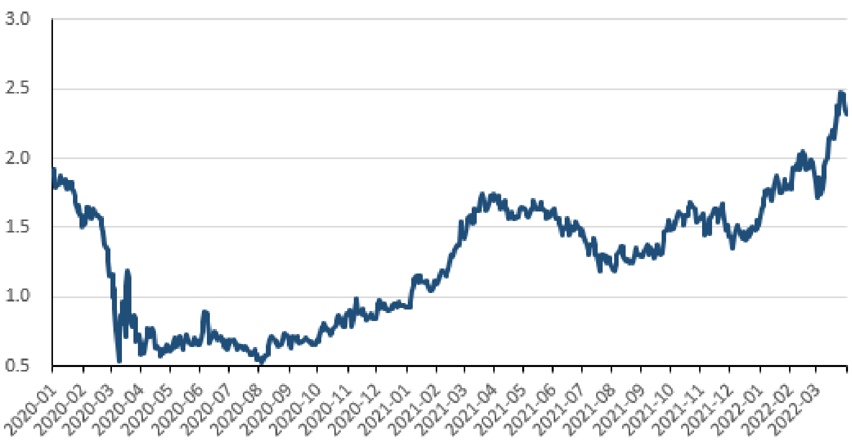


Chart 2: Canadian & U.S. Bond Market Performance

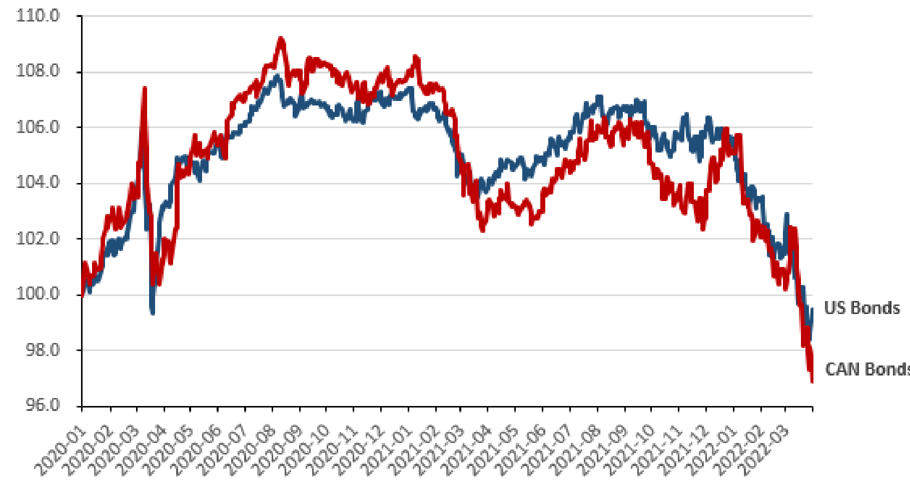


Table 1: Commodities (USD)

	Q1 2022	2021	2020
Commodities	25.5%	27.1%	-3.1%
Agriculture	22.0%	24.7%	14.9%
Copper	6.5%	25.5%	25.8%
Natural Gas	62.4%	35.1%	-45.9%
Crude Oil	33.5%	55.8%	-20.9%
Gold	6.9%	-3.5%	24.4%

Table 2: Summary of Global Equity Returns

	Q1 2022	2021	2020
Canadian Large Cap: TSX Comp	3.8%	25.1%	5.6%
US Large Cap: S&P 500	-4.6%	28.7%	18.4%
US Small Cap: Russell 2000	-7.5%	14.8%	20.0%
US REITs	-5.6%	41.1%	-4.7%
International: MSCI EAFE	-3.6%	19.2%	1.3%
Japan: TOPIX	-1.2%	12.7%	7.4%
UK: FTSE 100	2.9%	18.4%	-11.5%
Eurozone: Euro Stoxx 50	-8.9%	24.1%	-2.6%
Emerging Markets: MSCI EM	-7.0%	-2.5%	18.3%

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