CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

MARCH 2022

Europe has a unique geography. The continent is almost the smallest by land mass (second to Australia) but is home to 44 different countries. It has the highest continental population density. Dense and crowded, it has existed through centuries with different borders and cultures, and often in conflict. The hope was that establishing an economic and monetary union in the Eurozone in the late 20th century, with a single common currency, one central bank and monetary policy, and open labour markets would create an interconnectedness that precipitates peace among neighbours. That hope in the post-war era shattered this past month with the geopolitical shock of Russia's invasion of Ukraine. This violation of the sovereignty of a neighbouring country and indeed the attack on democracy is difficult to fathom. We are appalled and horrified. We stand in support with Ukraine, the brave people fighting for independence and peace, and for those in the midst of this humanitarian crisis. Our employees and the organization, in conjunction with the Connor, Clark and Lunn Foundation, are making donations in support of food, medical and shelter relief efforts.

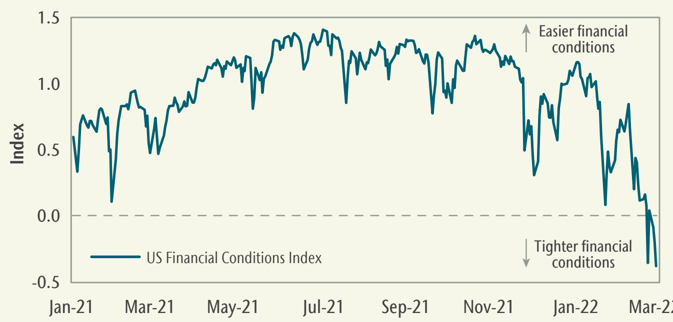
As we consider the consequences of this shock, we can seek to learn something from financial history. Through modern conflicts, such as the Cuban Missile Crisis and the Korean, Vietnam and Iraq wars, we understand the financial and economic backdrop heading into any market reaction matters as much as the shock itself. And so it is noteworthy that at the start of this year markets were already on shaky ground, absorbing a tightening of financial conditions (see Chart 1). Yet the economic backdrop has been one of significant strength that is reflected in the most recent data. Even during the COVID-19 wave caused by the Omicron variant, the US ISM manufacturing index hit 58.6 in February, firmly in expansionary territory above 50, led by gains in new orders. US consumer spending rose 1.5% m/m in January in real terms, helped by the creation of almost half a million new jobs. Despite the economic strength, sentiment has sagged in large part because inflation, especially for necessities, is at multi-decade highs. So the correction in risk assets that began very early in this year was in response to increasingly assertive central banks. Against this backdrop, let us consider the expected implications from the war as we look ahead.

THE MACRO IMPLICATIONS

- On growth: Any potential contraction in energy supply will be felt most heavily in Europe, which imports 20% of its crude oil and 40% of its natural gas from Russia. The last oil price spike in 2011 took West Texas Intermediate (WTI) oil prices to US$125/barrel (bbl) and the Eurozone fell into recession. Industrial production slowdowns will exacerbate supply chain issues. The most significant impact to economic growth in Canada and the US will be through commodities. The US, now largely energy independent, and Canada, a major exporter of commodities, may in fact see a boost in demand and production. Consumer and business balance sheets are strong, but confidence to spend and invest is taking a hit from higher prices. Pulling it together, we are adjusting our outlook modestly lower.

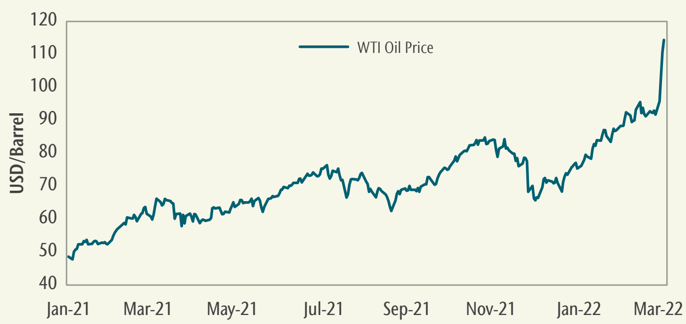
- On inflation: Wars are inflationary. The transmission to Canada and the US will be via commodity prices. A common rule of thumb is a $10/bbl rise in oil prices lifts headline inflation by

Chart 1: Financial Conditions Began to Tighten In 2022



Source: Bloomberg

Chart 2: Oil Price Surge to Impact Inflation



Source: Macrobond

0.4 percentage points, and WTI oil price has already advanced almost $40 year-to-date (see Chart 2). Food prices are also headed north. Russia and Ukraine together account for about one quarter of the world's wheat production. Adding on to supply chain issues, the risk for inflation is to the upside. All of this complicates the central banks' decisions.

- On monetary policy: The Bank of Canada (BoC) raised interest rates one-quarter point earlier this month, and the US Federal Reserve (Fed) is expected to follow and will also work to shrink its balance sheet. The last time the Fed engaged in quantitative tightening in 2018 to normalize policy, it had the luxury of calling it quits when equity markets recoiled, because inflation was at just 2%. Today, high inflation will handcuff the Fed's ability to respond as it might want. For the coming months, high inflation will keep both the BoC and Fed on course for higher rates, though the range of outcomes forecasted by economists is widening, looking into 2023. The European Central Bank (ECB) has an even more complex job ahead, balancing high inflation, potential recession and financial stability concerns. Thus, ECB bond purchases may continue, with rate hikes delayed.

THE MARKET IMPLICATIONS

- Early in the year, bond yields extended the run up that began last year. Canadian 10-year rates rose from 1.5% late last year to 2% and then reversed half of that increase in the wake of the war. It is actually somewhat surprising that, in the face of a major land war, yields are down only a quarter point. This speaks to the growth and inflation pressures and underlying direction of interest rates.

- With equity valuations unlikely to expand with interest rates rising, our view has long been equity markets will be supported by strong earnings. However, extended input cost pressures and possibly slowing consumer growth will curb corporate earnings estimates for 2022. Our view is still fundamentally positive on equities, as we see little risk of a recession over the coming year.

- The US dollar has benefited from a flight to safety and the trade weighted dollar index has gained steadily this year. Only the Canadian and Australian dollars have kept pace. Considering, though, the current price of oil and interest rate differentials, the CAD move has actually lagged relative to what historical relationships would suggest.

Longer term, this conflict is going to augment some secular themes we discussed in our 2022 Forecast. The world will become more disconnected into different economic, technological and financial regions. Moreover, the strong investment cycle, from building infrastructure, securing supply chains, domesticating manufacturing, decarbonizing energy supply and rebuilding of inventories can now also add defense spending. The implications to the world order will be wide ranging and we continue to monitor developments.

CAPITAL MARKETS

The first six weeks of the year had markets contending with the reality of higher central bank policy rates. The Bank of England hiked rates by 25 basis points (bps) -- but by just a slim 5-4 vote by the Monetary Policy Committee, against an otherwise larger 50 bps increase; ECB President Lagarde surprisingly refused to rule out raising rates in 2022; Fed officials speculated about the need for faster and more aggressive tightening which led to the futures markets pricing in 50/50 odds of a half point rate hike at the March meeting. Yields rose at all points of the yield curve and around all developed market economies. The volatility in interest rates was notable day to day, but the trend in the broader picture was to the upside, up until the risk-off environment developed on the heels of the war. Whether in currencies, equities or interest rates, the largest moves were seen inside Russia. But no risk assets globally were immune from the investor pullback. Year-to-date, as of the end of February and in local currency terms, the S&P 500 lost 8.0%; MSCI ACWI has dropped 7% and emerging markets (EM) declined 4.1%.

A seismic shift was felt in commodity prices, which spiked led primarily by oil – Brent crude surged 10.7% to cross $100/bbl for the first time in eight years. Natural gas prices in North America were up 18%, but in Europe have jumped 40% so far this year. Wheat prices surged 22%, taking the Bloomberg Agricultural Commodity Price Index higher by 8.6%, the 7th consecutive monthly increase. Safe havens were found in gold, which rose 4.5%. Industrial metals were also higher. The Canadian equity market's heavy weighting to energy, materials and financials, at about 60%, helped it to outperform global equity markets, declining just -0.1% for the year. The earnings season continued to demonstrate fairly resilient revenue growth, though profit margins were under some pressure.

PORTFOLIO STRATEGY

Taking a step back from the immediate turmoil, we know we are now moving into a more mature phase of the economic recovery. The economy is still booming today and consumers and businesses are in solid shape. However, the latest national accounts and personal income reports remind us that the phase where consumers are accumulating savings and growing wealth is ending, and we are now going to draw down those cushions to maintain spending. Layering on this are both rising interest rates and higher costs for all of our basic needs. Additionally, we are still some distance away before we return to some form of whatever the "new normal" will be. Office workers are only now trickling in to downtown towers, and interest to travel for business or vacations is still below 2019 levels. This latest geopolitical turmoil only adds to the list of cautions. As a result, within all of our fundamental equity, systematic equity, fixed income and balanced portfolios, we have been incrementally moving to a more defensive stance.

The quantitative investment team, in conjunction with CC&L's Investment Risk Management Committee, has been monitoring the Russia crisis closely since tensions with Ukraine escalated, and considered whether intervention in our model was warranted. In early February, we came to the conclusion that proactive management of portfolio risk exposure within Russia was prudent. At that time, the focus was on capital invested directly in Russia via the local exchanges and resulted in the withdrawal of investments locally, while allowing investments in foreign listings of the companies through the use of American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs) that are listed in US and UK respectively. As tensions rose through mid-February, we took additional steps to further mitigate risk in our portfolios by liquidating all Russia positions across all of our global mandates and at that time we decided we would no longer purchase Russian securities for client portfolios. Within days of the invasion, trading in most Russian securities (including both local listings as well as ADRs and GDRs) was effectively halted and we were left with a very small number of Russian securities in EM portfolios following the halt of equity trading. On or about March 9th, major equity indices produced by MSCI, FTSE, S&P and Bloomberg that we use as benchmarks will have removed Russian securities from all global and EM indices.

In our fundamental equity portfolios, we have shifted towards an overweight position in more stable consumer staples, and reduced the weighting to consumer discretionary stocks. Higher interest rates still lead us to be overweight financials. In assessing the Canadian stock portfolio for companies that have indirect exposure to the Russia through sales or investments, we note that no companies have any material exposures. Within fixed income portfolios, duration has been extended through this risk off period and we are now seeing opportunity to step into some higher yielding provincial and corporate bonds in the credit area after some spread widening. Balanced portfolios continue to favour equities which, given the strong economic backdrop, should extend their outperformance through higher earnings. This remains our core view, even as margins come under some pressure. However, we have less confidence in the macro backdrop than we have had in some time, especially as the higher commodity price outlook complicates the inflation picture and by extension the job of central banks. Most notably, the mix of a strong US dollar, high inflation, and normalizing demand expectations for consumer durable goods, all lead us to reduce the overweight to emerging markets in relevant balanced portfolios. While the vast knowledge from history is humbling, we hope never to stop learning. As we move through this difficult time, we will assess prior experiences in financial markets, seek opportunity where possible and manage risk carefully.