Investment Commentary

April 2022

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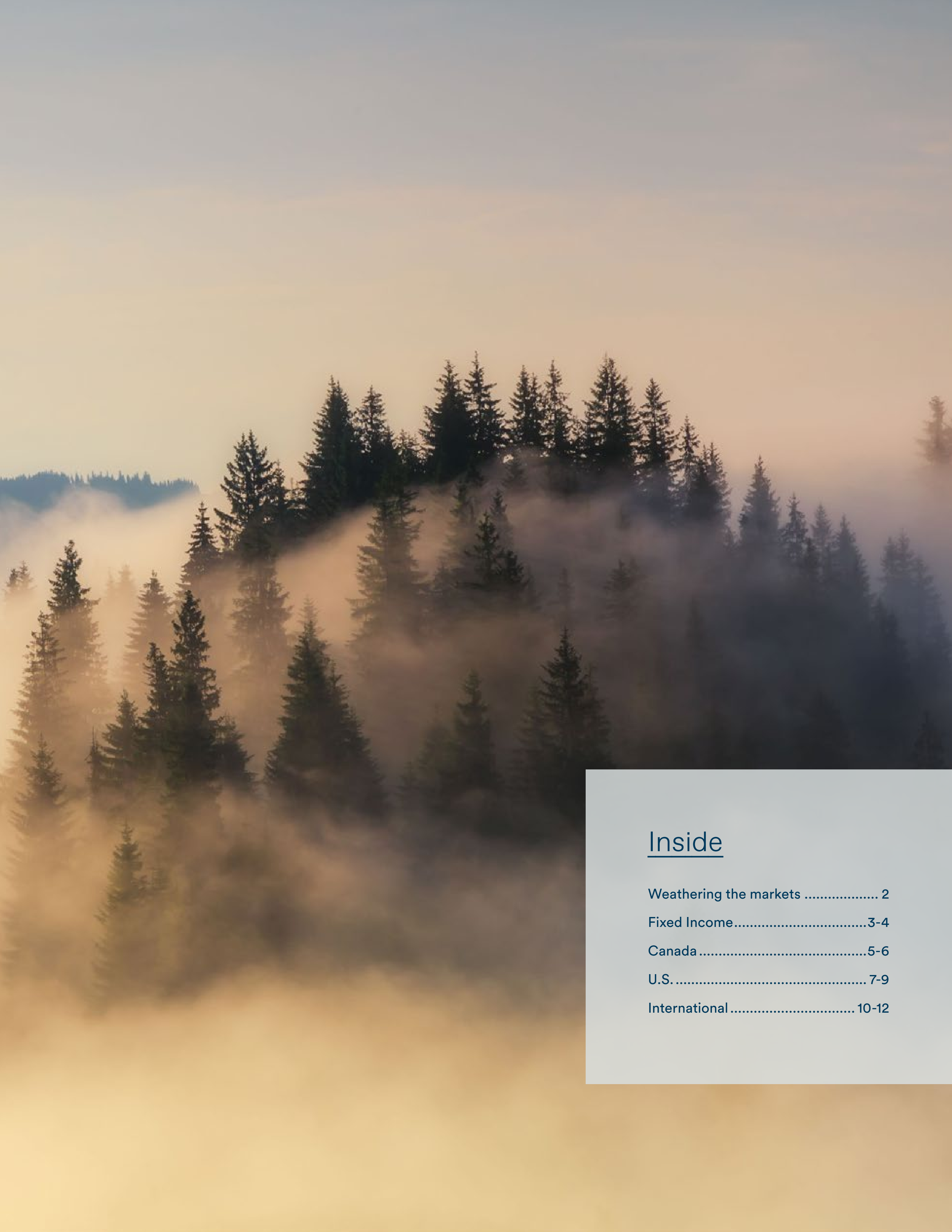
CWB Wealth Management



Inside

Weathering the markets

CWB Wealth Management Investment Team

Going into 2022, many observers (including us) had a positive view on the economy and markets in general. This was predicated on a receding pandemic – which appears to be playing out. On today's economic horizon, a different view emerges.

Economic outlook gets hazy

As the economy reopened, growth was expected to be well above pre-pandemic levels. The switch from our stay-at-home economy to a more normal one was expected to bring down high levels of inflation as the year progressed. This was also a robust outlook for corporate earnings growth, and thus, the stock market. The Russian invasion of Ukraine, however, has caused a partial reset of this rosy economic view. Let's walk through how quickly the outlook has changed.

Russia is a key exporter of oil and Ukraine is a significant exporter of agricultural products. After rising substantially in 2021, commodity prices have continued their upwards trajectory, largely due to the conflict in Europe. For instance, oil and wheat prices have both risen more than 30% this year alone. Commodity markets are forecasting some relief from recent highs as the year progresses, but not much. For instance, oil is projected to be trading at around $90/barrel at year end which is still above 2021 levels. Sticky commodity prices mean inflation pressures will likely persist for longer than previously expected.

Inflation and interest rates heat up

Central banks will look to combat persistent inflation by raising interest rates at a faster pace, and to a higher level than previously forecast. Rates were cut to near zero due to the pandemic, and it was always expected that central banks would look to normalize once the global economy was back on its feet. But, instead of perhaps a 1% interest rate increase this year, the Bank of Canada is now expected to raise rates by around 2%. That's a big increase in a short period of time.

Higher inflation and interest rates are a double whammy for the economy. Higher inflation, especially for essentials like food and fuel, acts as a tax on our disposable income. Similarly, higher interest rates increase our costs of borrowing on lines of credit and variable mortgages, for instance, and limit what we can spend elsewhere. Both will lower the growth forecast of the economy and, indeed, we are seeing economists start to talk about a more "normal" year of economic growth for 2022 in North America instead of the strong growth once anticipated.

Time in the market

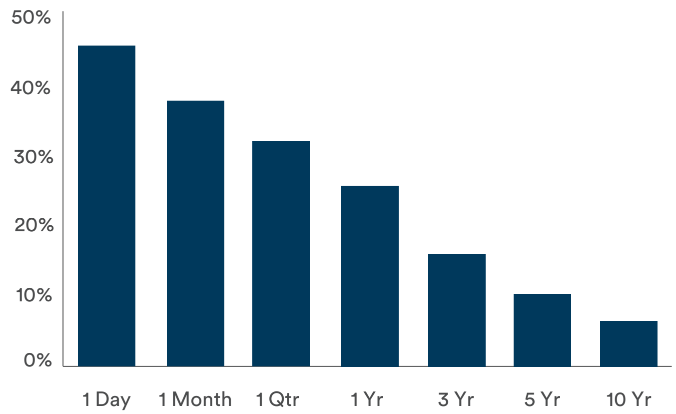
Markets took the first quarter of the year to adjust to the changing and uncertain outlook detailed above and we saw a weaker period for returns. However, Canadian investors fared much better than most as our stock market is heavily weighted towards energy and materials – two sectors benefitting from the inflationary environment. Overall, Canadian investors in well-diversified portfolios weathered the volatility fairly well considering the high level of upheaval in the forecast.

Although slower economic growth is disappointing, we don't think the revised outlook is all bad. The economy is still expected to grow as are expectations for corporate earnings, and if that holds it's good for the stock market. Bond yields have risen substantially in the past three months and although the increase has hurt bond returns, yields are now much more attractive.

What could further change the outlook? In the short-term, the hostilities in Europe will be a key driver with a de-escalation obviously brightening the economic outlook, while an escalation will have the opposite effect. Looking out a little longer term, there's no doubt that risks have risen in the economy with the main fear that rates will rise too high or too quickly, causing a significant slowdown or even a recession as early as next year.

We don't know if this will come to pass. What we do know is that slowdowns and recessions are inevitable over time and that trying to time them is a risky strategy. The data shown in Figure 1 backs this theory, detailing the probability of losing money over different time periods for those invested in the U.S. market.

Figure 1: As time horizons grow, equity losses fall off (based on S&P 500 total returns from 1929-present)



Source: S&P, Bloomberg, BofA U.S. Equity & Quant Strategy

As you can see, anything can happen in a day, month or year, but over longer time horizons your chances of success grows substantially. It's confirmation that the best strategy is to stay focussed on the long term and to try to ignore the noise in between.

Sources: FactSet, Bloomberg

Fixed Income

WATCHING

Government and central bank stimulus helped developed economies find their way through the worst of COVID-19. Now, as the pandemic appears to be receding and restrictions across the globe are subsiding, investors and central bankers are focussing their attention on inflation.

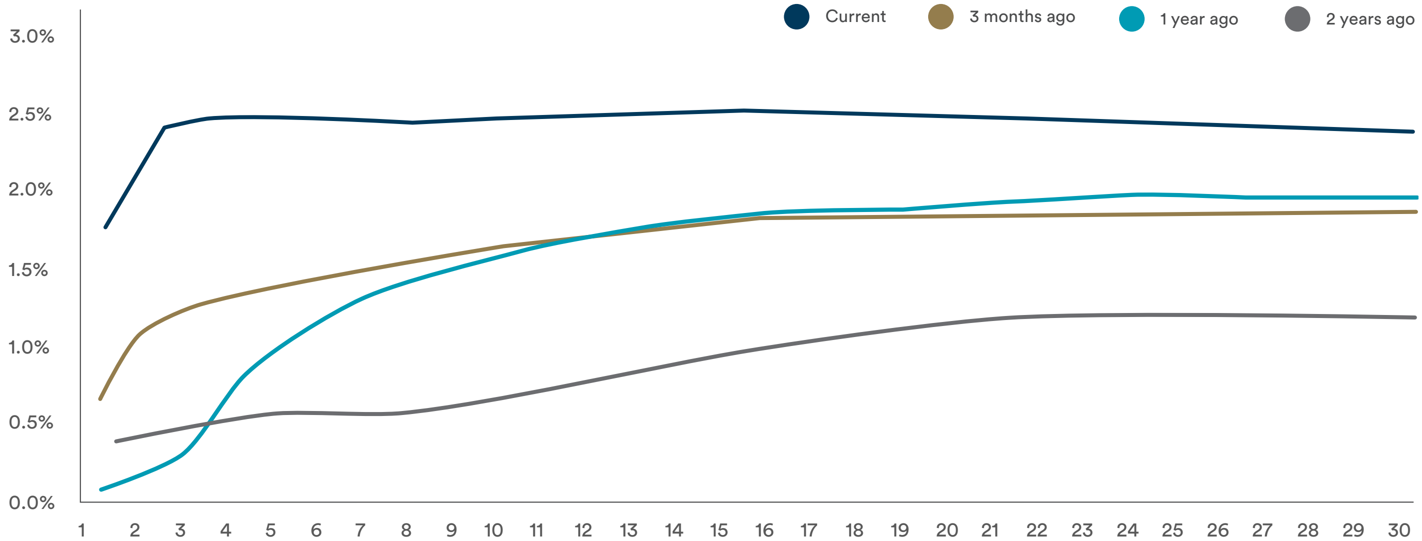
Headline inflation is elevated in many parts of the world. Some of this can be discounted as being due to temporary disruptions in the supply chain, but any hope of elevated inflation as being temporary appears to have gone out the window with the Russian invasion of Ukraine. Market expectations for bank rate increases have risen dramatically in a short period of time, with rates forecast to be about 2% higher at the end of 2022 than they were at the start in both Canada and the U.S.

Malcolm Jones, MBA, CFA
Senior Portfolio Manager, Fixed Income

As the year began, we were anticipating that yields would rise and that short rates would rise faster than long rates. You can see in Figure 2 that this is exactly what happened. We were, however, expecting this change would take twelve months rather than three.

Short rates have been pushed up by rising and more uncertain inflation. Long rates rose due to a recovering economy, but were tempered by concerns about long-term impairment to growth caused by supply chains and by bank rate increases.

Figure 2: Canada Curves – March 2022



Source: Bloomberg

THINKING

There may still be some upwards pressure on yields, but it also appears that most of the movement we were expecting has already occurred. We've maintained a low duration (exposure to interest rate movement) during most of this quarter, having increased our duration slightly as of March 31. Since yields have moved up, we want to gain exposure to higher coupon income.

We've seen corporate bond spreads increase over the quarter. These spreads started the year at historically low levels and have now risen to more normal ones. We don't necessarily feel this is a sign of bad things to come. Earnings are holding in well and companies are reporting a strong "ability to pay". As such, we continue to be overweight credit bonds.

Various provinces are showing an unusual level of fiscal discipline lately. Budgets are improving with an improving economy. Provincial treasurers are using this windfall to restore balance sheets harmed by COVID-19 support measures.

Fiscal discipline at a national level is lacking. This is true in Canada, U.S. and Europe. We feel challenged to find attractive investment opportunities in sovereign (i.e., Government of Canada) bonds, while still acknowledging their role in providing risk control. We continue to maintain very low duration in our sovereign bonds holdings.

We're expecting greater volatility in yields. Inflation and COVID-19 progression are difficult to forecast, and interpretations are likely to change dramatically as information flows in. This may present an opportunity to trade back and forth in some circumstances.

DOING

We still see some upwards pressure on yields, but to a significantly lesser degree than at the beginning of the year. Credit spreads are offering more normal extra return. We don't anticipate a significant downturn in the economy, and so do not expect surging spreads. We're maintaining an underweight exposure to duration, and an overweight exposure to credit.

We decreased duration during the fourth quarter and maintained this lower duration as rates rose rapidly during the first quarter.

Source: Bloomberg

Canada

WATCHING

Though only three months have passed since we last wrote, the world seems a different place. A war has been forced upon the Ukraine in what's proving to be a much more vicious fight than many had forecast. One of the immediate investment-related fallouts from this has been the supply side shock in commodities such as oil, natural gas, potash and ammonia, which have risen in price quite dramatically. This, in an environment where supply was already struggling to meet demand and has been for several quarters.

The much advertised and expected increase(s) in interest rates by the U.S. Federal Reserve, in response to high levels of inflation, have begun and are expected to continue at perhaps a faster rate than previously thought. This has dampened stock market enthusiasm for growth-oriented stocks and, combined with the economic sanctions, has resulted in equity weakness globally.

One notable exception to this was the Canadian equity market where, as measured by the S&P TSX index, a +3.8% total return was realized for the quarter. As one might expect given the themes outlined so far, the energy and materials sectors were the strongest performers.

Canadian oil and gas producers have been generating healthy cash flows, with the price of oil consistently trading above $100. The sector was up over 28% in the quarter. Not far behind was the materials sector, which was up 20%. This was driven not only by precious and base metals miners, but also by strong fertilizer prices as a result of sanctions against Russian and Belarus production.

The war, and sanctions in particular, has resulted in wheat prices globally being up on the order of 30% as well as potash fertilizer also being up a similar amount (see Figure 3). With such large increases in fundamental commodities, in both energy and materials, inflationary forces are likely to be more persistent than we had expected coming out of 2021.

Gil Lamothe, CFA
Senior Portfolio Manager, Canadian Equities

Figure 3: Increase of wheat and potash fertilizer prices

Source: Bloomberg

The area of greatest weakness in the quarter was the technology space, which was down 35% in Canada. These companies are generally valued based on expected future earnings growth. The increasing macroeconomic and political risks have investors concerned that growth will be muted relative to recent expectations, and so have been selling stocks in which this future growth was priced in. The Canadian equity market, which has a relatively small weight in technology stocks and a large one in energy and materials sectors, has benefitted from both of these themes over the first quarter of 2022.

One final trend that's caught our attention is the dividend increases we've been seeing year to date. The strong cash being generated by the energy sector has been flowing back to investors. Outside of energy, we've seen dividend increases as well and expect to see more throughout the year.

THINKING

Developments over the past three months have certainly given us pause for thought. The inflationary pandemic-related forces of labour shortages and global supply disruptions, which were seen as temporary in nature, have given way to increasing commodity prices. The drivers of these more expensive fundamental inputs, being years of pressure on oil companies to limit exploration and development, combined with the increasingly punitive sanctions on Russian production of just about everything, will likely be more persistent in nature.

As previously mentioned, Canada is well positioned for this environment. Furthermore, as geopolitical risk becomes more heightened, North America is seen as a safer place to invest and will attract international flows of capital. This can be a steady tailwind to our equity markets.

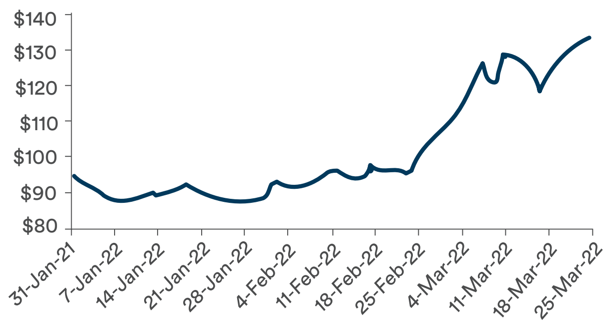
The macroeconomics of oil have been tilted by limited supply in the face of expected demand. Most energy producers are reluctant to invest in expanding either reserves or production, as shareholders have been focusing on environmental issues while also insisting on seeing the profits of higher oil prices flow back to them. This has been the case for some time, and the sanctions related to the Russian aggression in Ukraine have only exacerbated the situation. Until structural changes are made on the supply side, it's likely that oil prices will remain relatively high.

Outside of international sanctions, the macroeconomics of the metals and minerals are much more balanced. Except for the rare earth metals used in advanced batteries, which are truly rare, there are ample supplies of copper, fertilizers, and natural gas (used in producing ammonia fertilizers as well as basic chemicals such as methanol). As such, the price strength in a number of these commodities is more at risk to political decisions regarding the nature of the sanctions on Russia, making them much less predictable.

DOING

Our energy holdings consist of Suncor (SU), Canadian Natural Resources (CNQ), TransCanada Energy (TRP), and Pembina Pipelines (PPL). While we trimmed some of our CNQ overweight in January, as the supply/demand picture for oil became clear, we have been more patient in taking profits from this group. Conversely, the less fundamentally driven fertilizer picture has led us to take profits in our Nutrien (NTR) position on several occasions this quarter, as the stock price rallied from $95 to $130 as shown in Figure 4.

Figure 4: Nutrien stock price rally



Source: Bloomberg

A new position to the portfolio this year is Shopify (SHOP). This company simplifies the process of having an online store for businesses. They've become a world leader at this and continue to grow not only their customer base but also the services embedded in their offering, making them the go-to solution for this service.

With the pullback in the technology sector stocks, we saw an opportunity to add Shopify to the portfolio at a more reasonable price. As March came to a close, we added to the position a second time. Given Shopify's dominance, as well as the still nascent aspect of this industry, we feel fortunate to have been given the opportunity to get exposure here at a reasonable price.

We've exited the Enbridge position in the portfolio this quarter. As we broaden the diversification of the portfolio across industries, it was difficult to justify holding three pipeline stocks. By retaining the TRP and PPL, we get exposure to both liquids and natural gas transmission within the group, along with ample opportunities for growth through planned capital projects.

Despite the mass of uncertainties sprung upon us this quarter, our equity market has been resilient. This is yet another example of the wisdom of thinking longer term in equity investing. While there's likely a period of high volatility ahead, investing across different markets can help to manage the volatility as it did this quarter.

Sources: Bloomberg, CWB Wealth Management

U.S.

WATCHING

U.S. equities ended Q1 2022 down about 5% (6% in CAD). This decline follows an almost uninterrupted rally that began back in Q1 2020 after the brief COVID-19-induced bear market. While COVID-19 cases declined sharply during the quarter and the economy reopened as expected, concerns around inflation intensified with headline numbers coming in worse than feared.

The Russia-Ukraine war that emerged mid quarter has made the inflation situation worse as the region is a sizeable exporter of energy and other major raw materials. The result has been a huge spike in commodity prices. The impact on the supply chain is less talked about but has added fuel to the fire. Short supply of metals such as nickel are compounding shortages in the already tight auto components markets.

During Q1, the Fed embarked on a tightening cycle with a 0.25% rate increase in March marking the first of many planned hikes over the next 12 to 18 months. While this was a well telegraphed event, the expectations for the number of rate hikes increased substantially thereafter. Monetary conditions remain accommodative for now, but the bond market seems to be worried. The yield curve even inverted slightly at the end of March.

That aside, U.S. corporations posted another strong quarter (Q4 2021) and earnings expectations for 2022, in fact, increased slightly during Q1 leading to a P/E multiple contraction following this quarter selloff. Consumer and businesses balance sheets remain in good shape and the labour market continues to strengthen.

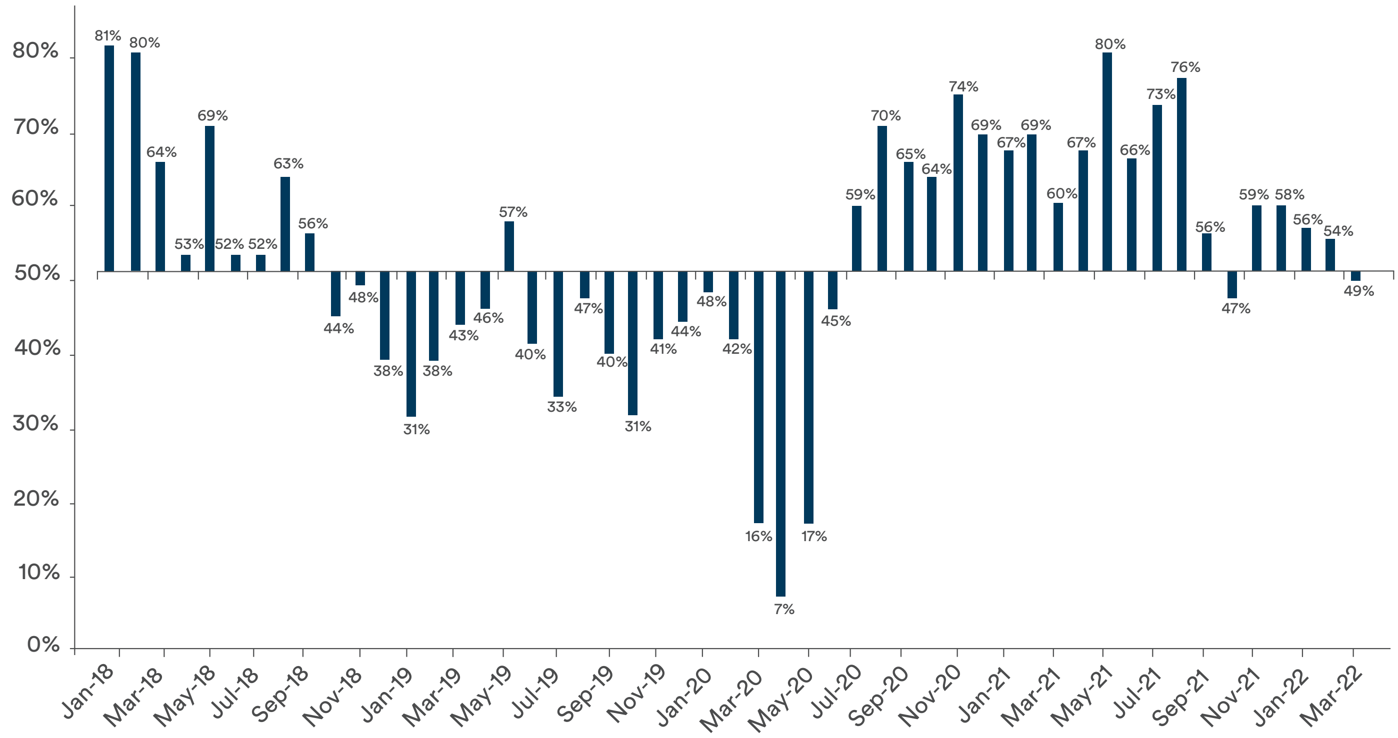
Liliana Tzvetkova, CFA
Portfolio Manager, U.S. Equities

Saket Mundra, CFA, MBA
Portfolio Manager, U.S. Equities

Looking at market performance, it was a risk-off quarter with a wide divergence in sector performance. Only two sectors managed to post positive returns in Q1: energy (due to the spike in oil and gas prices) and utilities (due to a flight to safety). Consumer staples also outperformed on a relative basis due to its defensive nature.

The worst sector was communications services, with Facebook being a huge drag after missing expectations and guiding lower during the last quarter earnings release. Overall, growth underperformed value and sectors that are more growth oriented, such as technology and consumer discretionary, underperformed. Pandemic winners, such as Netflix and Zoom, lagged as well.

Figure 5: Number of companies with positive earnings revisions on decline



Source: Piper Sandler

THINKING

While we're not throwing the baby out with the bathwater, we acknowledge that risks have risen over the past three months. The increase in inflation and energy prices is likely to force a cut in spending elsewhere, leading to demand destruction and/or margin compression for some corporations.

With earnings expectations for 2022 slightly up, we run the risk of downward earnings revisions – the opposite of what we've experienced over the past two years (see Figure 5 above). Stock selection becomes very important at this point in the cycle and our focus on companies with strong brands, pricing power and/or scale and low leverage is helping.

The significant revision of interest rate hike expectations and the Fed members' recent comments suggest increased inflation worries and commitment to tightening. With the yield curve flattening and the inversion of the 2/10 curve, we're starting to hear more investors worry about a policy mistake or the Fed raising rates too much too fast, thereby shortening the cycle and eventually causing a recession.

The yield curve inversion has typically been an early but reliable signal for recessions in the past, although significant amounts of quantitative easing could be distorting the curve. Despite that concern, we also don't want to lose sight of the possibility of a soft landing, which means that the Fed will be able to tighten just enough to tame down inflation without causing a recession.

On the other hand, considering the strong labour market and how healthy both consumer and businesses balance sheets are, we could see the cycle prolong further. It's difficult to predict which of these outcomes will materialize.

Events from the past three months have once again reminded us of how quickly things can change. A common theme among the Russia-Ukraine war, 7.9% February inflation rate, and expected eight to nine interest rate hikes for 2022 is that they were all assigned near zero probability at the end of last year. Yet, they all happened.

So, even though we attempt to forecast the short term, our focus lies in the long term where we feel things are more predictable and fundamentals really matter. As for the short term, we as investors are not willing to bet on any one outcome. Rather, we prefer to invest in a balanced portfolio of high-quality stocks exposed to different drivers so that the portfolio can fair well in the variety of scenarios that could play out.

DOING

During the quarter, the U.S. portfolio performed better than the S&P 500 despite having no direct exposure to the energy sector. We feel comfortable with our positioning and continue to execute on our investment process by deploying capital in areas that we deem attractive over the long run, and where risk/reward is in our favour. We've introduced six new positions in the portfolio: Fabrinet, Intel, Robert Half (RHI), Linde, McKesson and Southern Copper.

Robert Half is a staffing agency that benefits from increasing employment levels and general wage inflation. Due to the dynamics in the employment market, where there's more acceptance of remote work, RHI seems to be getting stronger as they can deliver candidates with deeper skills and more price-point choices.

Fabrinet is a company providing outsourced electronic manufacturing services for other companies, with a focus on optical communications components. Demand for optical communications is expected to grow as components like fiber optic cables make their way into more telecom and datacom infrastructure assets, and we expect Fabrinet to benefit as it has a 50% share in their primary market.

Intel needs no introduction and we deem that under the current management, it's on the path to put its execution issues behind it. In our experience, turnaround situations don't follow a straight path and usually take longer than anticipated with hiccups along the way. However, we find the strategy to be logical and the risk/reward very lucrative at the current price.

Southern Copper is one of the largest and lowest cost copper producers in the world and it's a name that we've owned in the past and followed since. The company has a stellar track record of generating positive returns even at depressed copper prices, and has allocated capital intelligently.

Linde is one of the largest industrial gas producers in the world, operating in a disciplined oligopoly. The company is the return on capital leader in the industry due to exemplary execution and capital allocation by their management.

McKesson is the largest drug distributor in the U.S. and operates in a stable oligopoly. Over the past few years, McKesson has refocussed on its core operations and areas of growth by exiting sub-optimal international operations. Further, with the settlement of recent legal issues, management can continue to focus on its core operations and grow earnings and returns.

In our U.S. portfolio, we focus on long-term investing in high-quality companies with strong returns, healthy balance sheets, and stable cash flows. Staying true to our process, we continued to deploy capital in such businesses whenever risk/reward was in our favour.

Sources: Bloomberg, FactSet, BCA, Piper Sandler, JPM, Bernstein, Credit Suisse

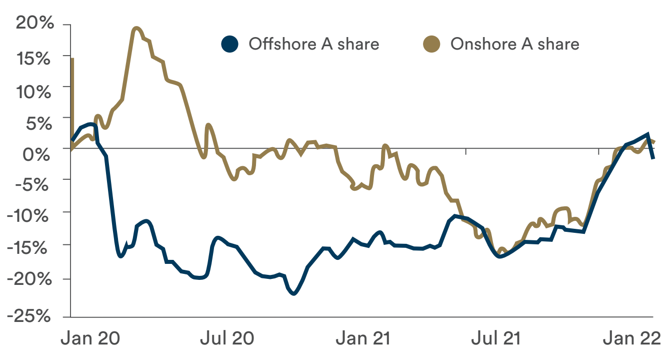
International

WATCHING

The most significant event dominating headlines this quarter was the Russia-Ukraine war, and this had ripple effects on global markets including the Chinese and European markets where the international investments has material exposure.

Chinese equities represent about 15% of the International portfolio and they've seen volatile swings due to Beijing's close ties to Russia (and speculation whether China would support Russia in the war), a growing COVID-19 outbreak and the ongoing regulatory headwinds. Investors appear to have sold Chinese equities (see Figure 6) and while the relative magnitude doesn't appear as large compared to recent selloffs, their effects have been exacerbated by deterioration in liquidity conditions. Short interest is also approaching record levels.

Figure 6: Flows into onshore and offshore Chinese equity ETFs. Cumulative flows as a % of AUM

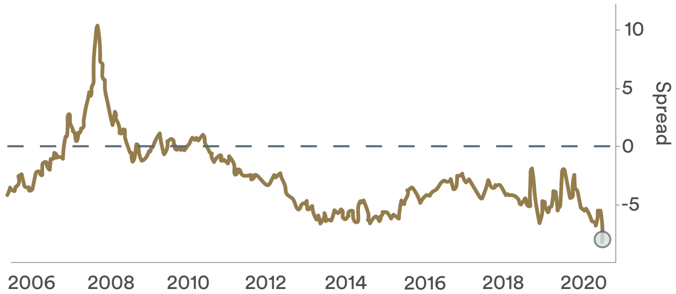


Source: Bloomberg Finance L.P., J.P. Morgan

Ric Palombi, CFA
Senior Portfolio Manager,
International Equities and Alternative Income

However, in our longer-term view, investors are getting adequately compensated for risks at these levels (see Figure 7). The MSCI China Index traded as low as single digit earnings this month, before a two-day rally brought valuations back to around 10 times. That compares to 17 times forward earnings for global developed markets.

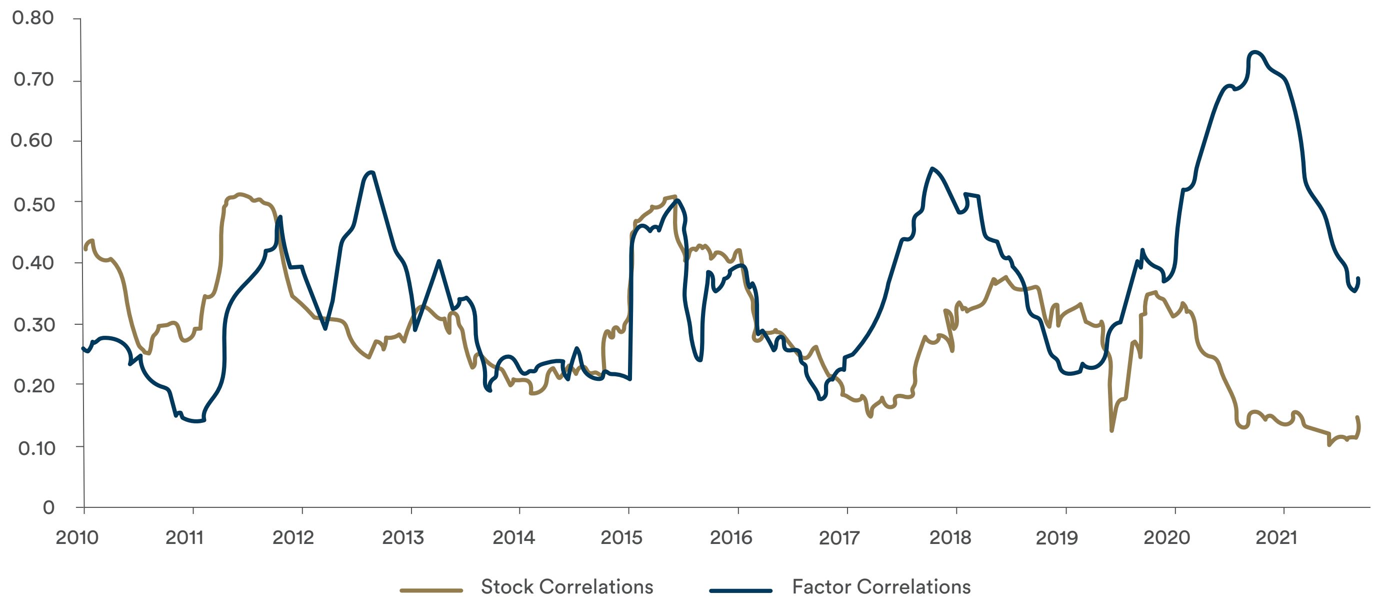
Figure 7: Valuation gap between Chinese shares and global peers at record



Source: Bloomberg

While the current environment is characterized by a lot of uncertainty and volatility, it's also great for active stock pickers like us (see Figure 8).

Figure 8: Market structure for active managers is much better compared to 2012



Source: Bloomberg

The Chinese government's push to stabilize the market helped in the short term. Longer term, we believe investors will want to have exposure to the world's second biggest economy. China has also clarified that it doesn't want to be impacted by Russian sanctions, with Foreign Minister Wang Yi saying that Beijing is 'not party' in the war.

China's policy pivot should further support the economy and equities. This is expected to come in many forms including lower policy rates, higher TSF (Total Social Financing) growth, RRR (Reserve Ratio) cuts, lower mortgage rates and down payment amounts for property, eliminating quantitative targets for decarbonization.

THINKING

When we heard the term "uninvestable" in early March, we took notice. It's not a word that's used often – especially to describe the second largest economy in the world, China. Since then, however, the world has become a different place.

Following a string of dramatic interventions by Beijing, the worst selloff in Chinese markets since 2008 turned into an historic surge, catapulting stocks like Alibaba and other U.S.-listed Chinese tech firms into a rebound not seen before. The verbal intervention caught many investors off guard as China's top financial policy committee vowed to ease the crackdown on technology firms, support the battered real estate market and stimulate the economy.

Then, we have "common prosperity." The initiative which roiled the markets due its opaque nature of how China is going to reduce inequality and redistribute wealth has suddenly become absent in Chinese propaganda. Last year, the term "common prosperity" was everywhere. This year, it turned up only once in a 17,000-word government document delivered by Premier Li.

What do we make of this? We expect that China will prioritize economic growth over regulations, and the Chinese economy will go into expansionary mode with stimulative monetary policy and looser fiscal policy. As for Chinese stocks, to reiterate what we discussed in the 'watching' section: we see opportunity.

DOING

For Chinese e-commerce giant Alibaba, China's regulatory onslaught has affected them both directly and indirectly. Direct measures aimed to erode Alibaba's strong competitive positioning through actions such as limiting Alipay's role in the Alibaba ecosystem, tighter regulation on Alipay's operations and data collection, and anti-monopoly rules helped competitors take market share.

Indirect impacts were felt through the rules aimed to cool the Chinese property market, reduce income inequality, and contain COVID-19. These measures slowed down GDP growth to below 6% and started a decline in property prices. As consumers naturally feel less secure in such an environment, total retail sales slowed to 2% annualized growth rate at the end of 2021. These factors collectively hurt Alibaba's topline growth and profit margins considerably.

Over this period, we've heard many phrases like, "the fundamentals don't matter" and "portfolios must be de-risked" etc. Understandably, it's been a rough ride for many investors. An analyst at one of the largest banks in the world cut his rating on the entire sector to Underweight (sell rating) just recently. While we have a great degree of respect for these analysts and investors, we believe this episode has shown the emotional side of investing. Through the COVID-19 correction and subsequent boom, we've seen both sides of the emotional roller coaster, but this phase is punishing as Chinese stocks have declined for quite some time.

For Alibaba, we concede that the competitive and regulatory landscape has changed, but we don't believe that it's impaired to such a degree that the shares should trade at single-digit, price-to-earnings multiples, where 30% of the market capitalization is in cash. Aside from the core domestic e-commerce business, where we believe profit margins will expand again from next year onwards, Alibaba has a number of other business lines we expect will add value. For example, Alibaba's e-commerce business in Southeast Asia, as well as in their international marketplace platforms such as AliExpress. Also, Alibaba operates China's largest cloud services business (similar to Amazon's AWS).

More importantly, we've seen various actions from the Chinese government which confirm to us that they're not intent on destroying the sector and, in fact, want and need these firms to succeed. The most recent announcement, a very significant signal, was to allow U.S. auditors to have deep access to data of Chinese firms. This has been an outstanding issue for over 10 years now and its resolution under the current geopolitical environment carries weight.

Through this challenging phase, our team has turned to our investment philosophy and process to guide us. We talk often about "seeking the truth" and have done so by taking advantage of the fear and panic, and adding to our Alibaba position.

Sources: Bloomberg, JPM, Bernstein, FactSet

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