Happy Thanksgiving!

Global markets have been volatile in 2022. This has been caused by the Central Banks around the world shifting their focus. They've moved away from providing support that helps offset the economic impact of COVID to attempting to combat inflation.

The United States Federal Reserve and other Central Banks slowly began the process of removing pandemic stimulus by raising interest rates and reducing their easing measures. This fueled an increase in post lockdown consumer demand, which exacerbated supply chain constraints, leading to a spike in the rate of inflation. Along with this, the participation rate in the labour markets dropped and wage inflation began to fuel even higher prices.

The Russian invasion of Ukraine caused oil prices to spike which further muddied the waters. It is hoped that by raising interest rates and reducing the supply of government debt that economic growth will slow, the participation rate will increase and consumers will reduce spending. This could lead to a rise in the rate of un-employment and lead to a recession, however, this should ease wage pressures and ultimately bring down the rate of inflation closer to the long-term target range of 2%.

The issue facing investors is how long this will take to come to fruition. Interest rates on GICs and other guaranteed vehicles have become competitive to the income that can be received from equity investments. We will likely see earnings of listed companies begin to slow even though they have been resilient thus far.

Analysts have been lowering estimates which may be reflected in the current prices. This could put a floor under prices and signal the beginning of the bottoming process as this economic cycle winds down.

The war in Ukraine and the resulting energy shortages in Europe will take spending power away from European consumers. There is the possibility that industrial production will be curtailed to preserve supplies of natural gas in many European countries.

The recent cutting of the Nord Stream 1 and 2 pipelines have also increased energy insecurity. It is important to note that Europe has been successful in finding alternative sources of LNG and are also looking to coal and extending nuclear power plants to see them through the winter. This runs counter to green energy initiatives, however, these measures are likely short term and we will see alternative energy come to the fore once the conflict is resolved.

There have been positive developments recently as Russia appears to be losing the initiative on the battlefield. Attempts by Russia to escalate the conflict by partial mobilization, the illegal annexation of Ukrainian territory and the threat of nuclear aggression are seen as acts of desperation. There will likely be a permanent shift away from Russian energy and an acceleration to renewable power sources once the immediate pressures are faced.

The Chinese economy remains weighed down by the Zero COVID policies. This combined with an increasingly combative foreign policy has created a shift away from China as a secure and low-cost producer of components and goods. There is a movement to bring manufacturing, especially semi-conductors, onshore to North America. There are also growing constraints on transfer of intellectual property. Ultimately this bodes well for North American economies, however, there will be an adjustment period as the economies grapple with rising production and consumer costs.

The political pressures faced by global governments have been illuminated most recently by Great Britain as they are dealing with lower industrial production and continued supply chain issues that resulted from Brexit. At the same time, Government policy undercut the Bank of England by stimulating the economy through tax cuts while the Bank of England was attempting to remove stimulus through rate hikes. This misstep led to a run on the Pound that ultimately caused the Government to back down. This roiled global markets and caused equity prices to drop further as the global financial system came under scrutiny.

In this environment, Government policy must align with Central Bank policy and be restrictive otherwise there is the possibility that we face further tightening and a longer recovery period.

There is a great deal of un-certainty facing financial markets domestically and globally. Central Banks began raising rates and became restrictive too slowly as inflation was seen as transitory. They are now faced with having to be very aggressive. This opens up the possibility that they may go too far and cause a global recession. We have recently seen some signs that central banks may be able to slow down the pace of interest rate increases and ultimately pause and wait for the rate hikes to work their way through the economy. A big challenge faced by central banks is that they need to illustrate their forcefulness, resulting in downward pressure on financial markets. If they lighten up their rhetoric, then financial markets could rebound sharply thus undoing the progress made in slowing growth.

There are indications that inflation has peaked and is starting to come down. It is unlikely that we see inflation hit the 2% target in the near term, however, it is likely that as long as the pressures ease, central bankers will become even more data-dependent and transparent. This should help steady bond yields and ease volatility.

Oil prices appear to have bottomed around the $80 level and this was backed up by production cuts from OPEC. As winter approaches energy prices will likely rise which bodes well for the TSX as does higher rates for the financial services sector. It is important to note that higher energy prices will affect the battle against inflation and may keep interest rates higher for longer.

The rate hikes in the United States have caused the U.S. dollar to spike, affecting the European currencies and emerging markets. This also affects earnings of foreign-national companies and puts pressure on global markets. If the U.S. Federal Reserve does slow the tightening and interest rates do not peak at feared levels, a Bear Market bottom could be established.

Investor sentiment is at a very low level with 60% of analysts being bearish which can be seen as a contrary indicator. Earnings estimates are coming down and many equities are seeing higher lows on pull backs. We are also seeing supply and demand coming closer to their longer term-balance. The number of open jobs positions are coming down and wage inflation should follow. Bond yields also appear to be stabilizing. This bodes well for the longer term as we move through the short term uncertainty. New lows are possible as we move through this economic cycle, however, by focusing on equities that have solid cash flow and a history of increasing dividends, income streams remain stable and in some cases are increasing.

We are cautious short term, however we remain optimistic about 2023 and beyond.

Have a great holiday and as always we are just a phone call or e-mail away.

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