For Every **Action...**

BMO Private Wealth

BROCK & PAPUTSAKIS
Wealth Management

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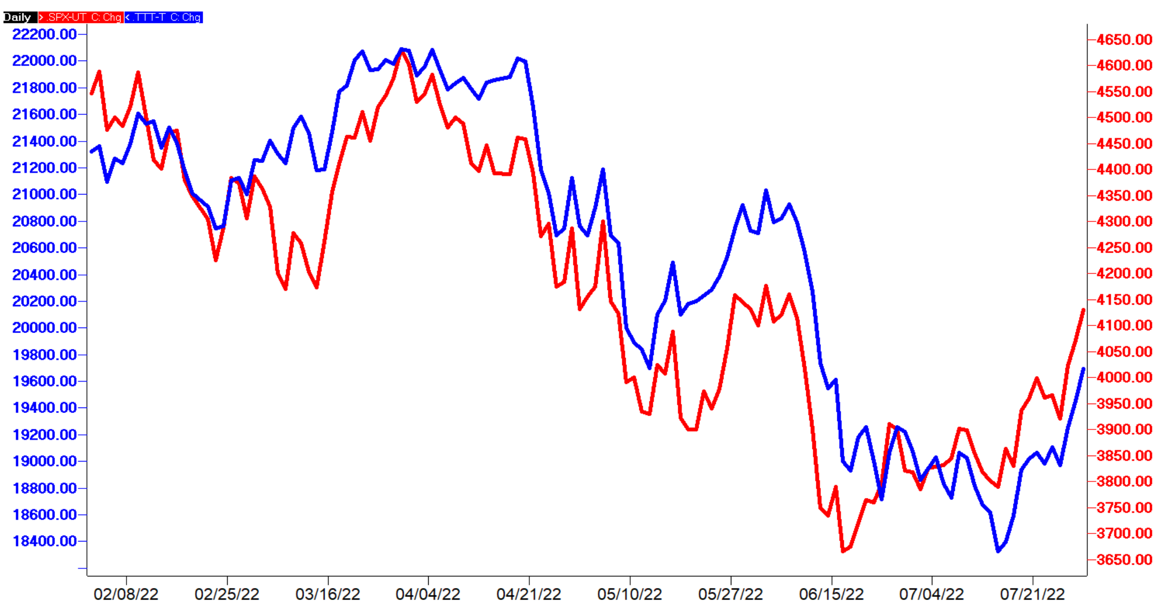
Philip’s Comments

Welcome to the second half of the year! You made it! The six-month period since our Winter 2022 newsletter, titled “*Soft Landing?*” was anything but soft for investors, and the sheer amount of volatility that we witnessed prompted us to publish a special abridged edition of our newsletter in May, which we titled “*Signs of Volatility*”. We rarely take such measures, but we felt that volatility levels and the relentlessness of market pressures warranted such an approach.

Financial markets were invariably weaker over this period. The S&P/TSX Composite, representing Canadian stocks, fell 1,468 points – or 6.9%. South of the border, the S&P 500 was 389 points lower, representing a decline of 8.6% since the beginning of February[1]. Any investor who spent time with their June statements will know that these numbers seemed far worse before a strong July delivered a modicum of relief (see Figure 1).

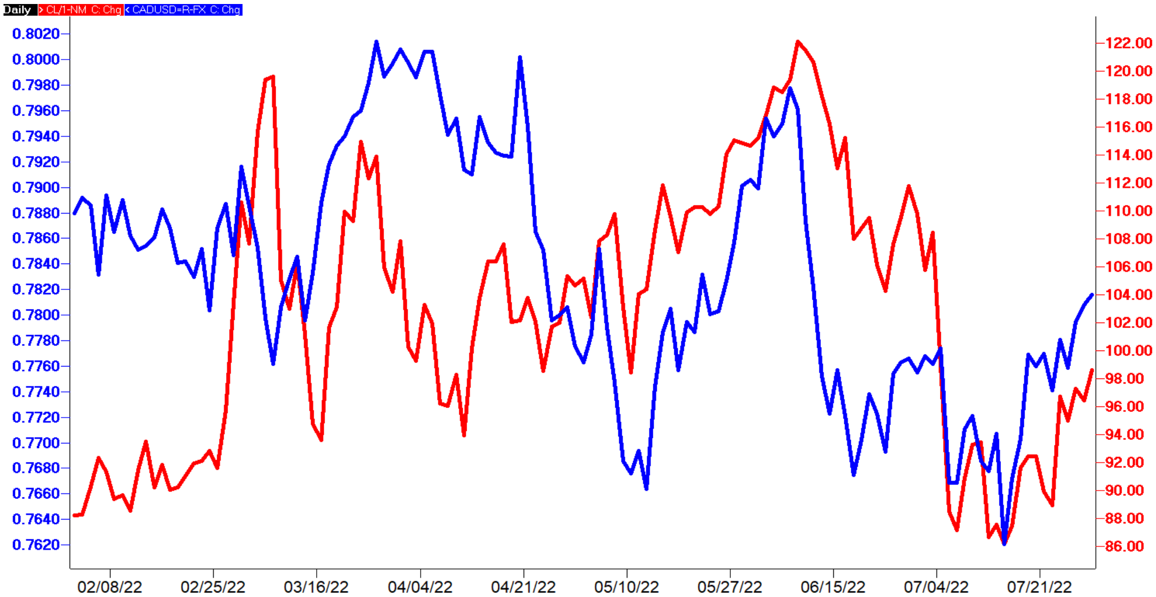
*Figure 1: **S&P 500** & **S&P/TSX Composite Index** (February 1 2022 – July 29 2022)*



Source: Thomson One

While the close relationship between the value of the Canadian Dollar and the price of oil did not completely break down, we saw other factors influence our currency over the last six months (see Figure 2). Oil prices increased by almost 12% since February 1st to approach $100/barrel, but in the immediate aftermath of the Russian invasion of Ukraine, oil prices temporarily surpassed $130/barrel[2]. In this context we would expect a very strong Canadian Dollar, but our Loonie weakened very slightly over the last six months, due primarily to USD strength over this period – the US dollar being seen globally as a refuge asset during periods of heightened geopolitical concern.

*Figure 2: **Oil (Light Crude)** & **Canadian Dollar (CAD/USD)** (February 1 2022 – July 29 2022)*



Source: Thomson One

Unfortunately, equity investors were not alone in facing volatility so far this year, as rising interest rates contributed to push bond values lower, which hurt more conservative or balanced investors on the traditionally "safe" side of the investment portfolio – fixed income securities (see Figure 3). This phenomenon – not seen to this degree since the end of the US Civil War[3] – was directly caused by the market's reaction to a dramatic policy shift from central banks around the world: an all-out assault on inflation through higher interest rates and the end and reversal of post-pandemic quantitative easing policies.

*Figure 3: **iShares Core Canadian Universe Bond ETF (XBB)** (February 1 2022 – July 29 2022)*

Source: Thomson One

It is the struggle against inflation, more than any other current economic concern (and with COVID-19 still with us, and Putin's war on Ukraine still tragically ongoing, there are more than a few other concerns) that is defining our present economy and focusing financial markets' attention.

As Newton's Third Law tells us, *for every action, there is an equal and opposite reaction*. These dramatic changes to monetary policy are having an effect. Like the rhythmic, sequential impacts of the spheres in a Newton's cradle, each effect leads to another, which leads to another, and so-on. In this, our 19th publication on this type, we pay homage to this famous law of physics (or is it markets?) and explore the consequences of these shifts, and how they will impact our investment strategy going forward.

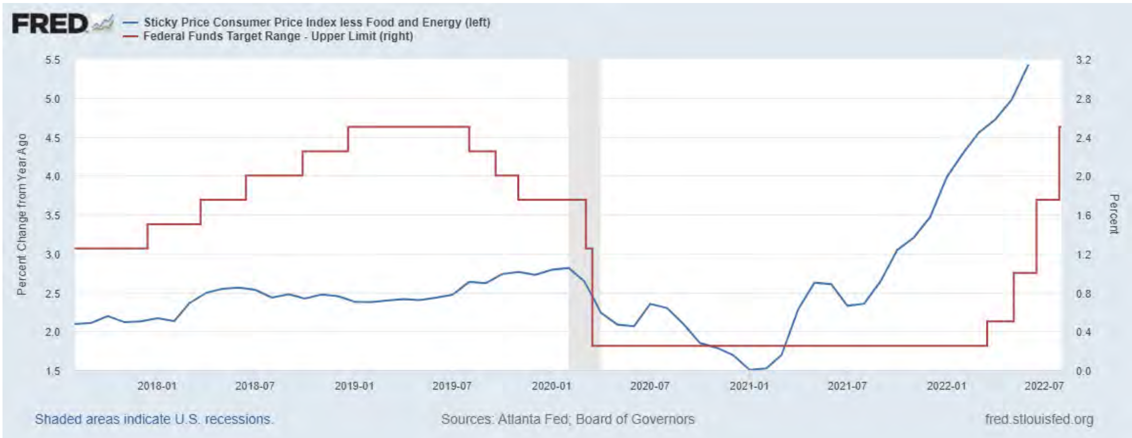
Inflation Up → Rates Up → Assets Down → Confidence Down → Unemployment Up → Inflation Down → Rates Down → Assets Up

If the above sequence of cause and effect (or action and reaction) relationships is making you feel a touch dizzy, you are in good company. It is entirely possible that we are on a similar trajectory – part way down the line – and below we can see evidence of these steps in motion.

<u>Inflation Up → Rates Up</u>

The mandate of the Bank of Canada touches both on the control of inflation and employment – specifically targeting a 2% inflation rate within a range of 1% - 3%; and doing so while maintaining "maximum stable employment"[4]. Similarly, in the United States, the Federal Reserve focuses both on inflation and employment as the two components of its mandate. Inflation in the United States hit a low in early 2021, and has been increasing almost without interruption ever since, recently reaching levels not seen since the early 1980s. After almost a year of watching inflation climb, the US Federal reserve finally acted, and began a series of interest rate increases – including by unusually large 50 and 75 basis point increments – to attempt to catch up with the inflationary trend (see Figure 4). This year-long lag of central bank inaction in the face of climbing prices has been cited by some as a policy error – one replicated around the world as price increases during the pandemic were written off as "transitory". While it is hard to argue that supply-chain disruptions were not at least partially to blame for inflationary pressures, the extended period of very accommodative monetary policy is now seen as the main culprit behind soaring prices. So came rising interest rates, not only in the United States, but around the world – including in Canada where the Bank of Canada took the almost unprecedented[5] action of increasing interest rates by a full percentage point in July (the last interest rate hike of this size in Canada was in 1998).

Figure 4: ***Fed Funds Rate*** **&** ***Core US Consumer Price Index*** *(August 1 2017 – July 29 2022)*



Source: Federal Reserve Bank of St. Louis

As things stand, there is a high likelihood that central banks will continue the path to higher rates, though the pace at which they do so, and the ultimate destination or "terminal rate" is still very much in question. To quote the Federal Open Market Committee (FOMC), from its recent meeting notes it "anticipates that ongoing increases in the target range will be appropriate"[6].

Rates Up → Assets Down → Confidence Down → Unemployment Up

There are consequences to a higher interest rate environment, and we are already seeing some of those play out. The Royal Bank of Canada has stated that home prices in Canada could fall by more than 12%, and that over the next two years the decline in sales could rival the decline seen during the financial crisis of 2008/2009[7]. South of the border, we are witnessing lower housing starts, a higher number of homes for sale, the worst housing affordability in almost 20 years, and existing home sales slow for 5 months in a row[8].

Higher interest rates have the effect of making leveraged investment positions more expensive, which tends to disproportionally hurt higher risk assets. In our special edition of this newsletter *"Signs of Volatility"* published in May, we used Peloton Interactive and Zoom Video Communications as examples of companies currently trading at fractions of their pandemic highs; not to mention the mother of all speculative assets – cryptocurrencies – which have been decimated in recent months by a reversal of fortunes that left us dusty old "stocks and bonds" investors more than a little smug.

As mentioned earlier in this commentary, those old-fashioned stocks and bonds have also been pressured by this year's market – with higher interest rates chiefly to blame.

With the possible exception of gold (which has held up reasonably well), commodities (though the volatility seen in some of these assets has been stomach-churning) and the US Dollar (though inflation has a dilutive effect on cash holdings), most asset classes are currently under pressure – real estate, fixed income securities, stocks, etc. The result is that the current high inflation / high interest rate environment is making consumers poorer, and just as importantly, making consumers *feel* poorer. These asset declines have a real chance of impacting consumer behavior (read: spending) by decreasing consumer confidence though a reverse "wealth effect"[9]. Simply put, when our assets are highly valued, and our investment statements consistently rising, our view of our financial situation tends to be positive, which affords us the self-confidence to spend money. Higher spending means revenue for corporations, which tends to lead to strong earnings for those companies. The opposite is also true: a consumer who is faced with declining assets values will tend to try and save more, rather than spend, which acts as a removal of economic stimulus and contributes to weaker corporate results.

We are already seeing consumer confidence turn lower, using US data as measured by the Conference Board, we have seen a consistent trend lower in consumer confidence (see Figure 5) since the beginning of this year, including three consecutive months with negative readings leading up to the July release.

Figure 5: US Consumer Confidence Index (2006 – 2022)

Source: The Conference Board, NBER

Even more concerning, the "future expectations" component of this reading has declined to a level not seen in almost a decade (see Figure 6).

Figure 6: Present Situation and Expectations Index (2006 – 2022)

Source: The Conference Board, NBER

The buckets of cold water that we have just poured all over future economic prospects do not go unnoticed by the management teams of major enterprises. In an effort to continuously adapt to evolving circumstances, corporate decision makers are taking the steps to “hunker down” and position their companies for more difficult economic conditions. Companies like Tesla, JP Morgan Chase, Oracle, and local darling Shopify have all announced layoffs in recent weeks whereas companies such as Intel, Amazon, and Apple have announced some measures to decrease or freeze future hiring[10].

One bright light in the current gloom is that unemployment, both in Canada and the United states, is measuring at extremely low levels: hitting 4.9%[11] in Canada for the first time since 1970, and 3.6%[12] in the US, rivalling pre-pandemic unemployment lows. However, with companies currently actively reducing their sales force it remains to be seen how long unemployment statistics will remain this positive, as we saw during the financial crisis of 2008 as well as during the COVID-19 economic turmoil of early 2021, the employment situation can shift rapidly.

<u>Unemployment Up → Inflation Down → Rates Down → Assets Up</u>

That brings us to where we are today: in the middle of an economic maelstrom that is caused by seemingly out-of-control inflation.

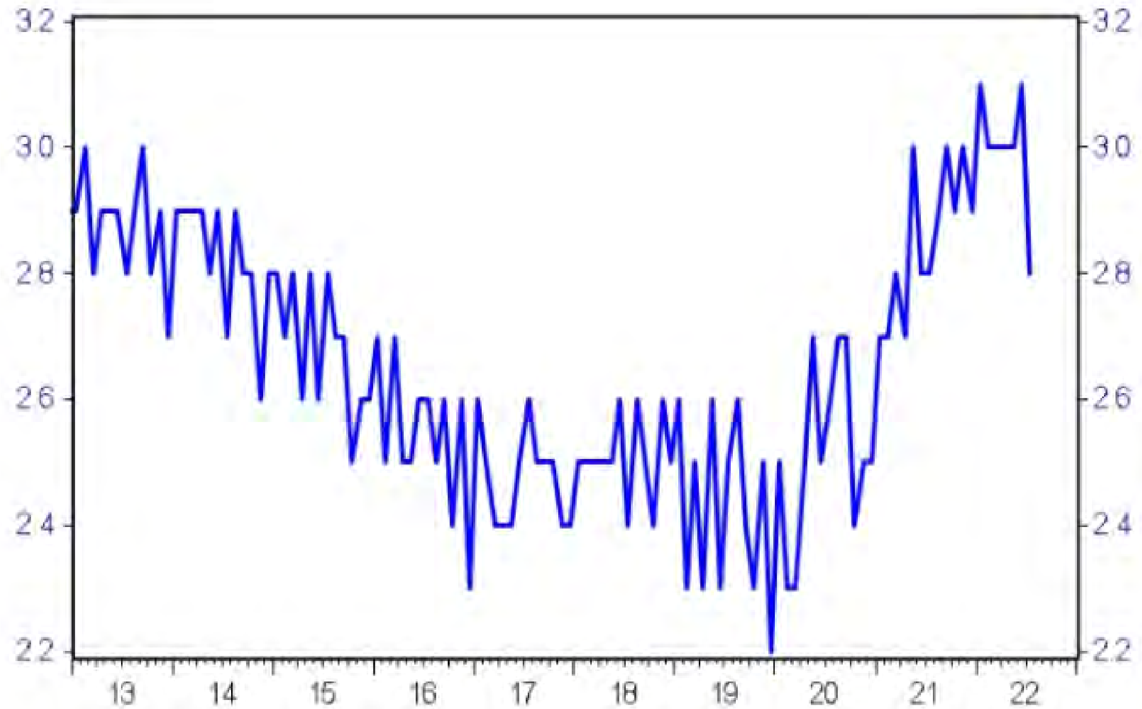
It stands to reason that if we could see a reversal in inflation trends sustain itself over the coming months, the situation would improve. Companies would have more certainty about the future. Consumers would feel more prone to spend their hard-earned money rather than save it.

Unemployment is key in this shift, as labor costs are a crucial component of inflation, and higher wage costs are a meaningful input into a company’s decision to raise its prices. Since the beginning of the COVID-19 pandemic and the apparent shift in the relationship between employer and employee, in particular around working conditions such as “work from home”, the employee has been in a good position to dictate terms. The current low unemployment rate is evidence of this. While this may be open to some debate, there is evidence emerging that there are productivity consequences to these kinds of arrangements. The first quarter of 2022 marked the largest decline in quarterly productivity for the United States since 1947[13]. A second consecutive quarter of productivity decrease, which we will only be able to ascertain around the print time of this newsletter, would represent an unprecedented shift to lower productivity, which is inherently inflationary[14]. If the trend we are seeing in corporate North America towards staff reductions and hiring freezes were to sustain itself, we may very quickly see companies gain traction in their efforts to attract their workers back to the office. To the extent that productivity gains resulting from this would transpire, we could expect to see downward pressure on inflation.

This is not yet the case, and we can all see this as we drive from town to town on family car trips during our summer holidays. The streets of Canadian cities and towns are not littered with shuttered businesses, with particle board over the windows. Rather, it is “Help Wanted” signs that currently wallpaper storefronts. However, the equal and opposite reaction can come quickly. Just ask your neighbor who, until last month, worked at Shopify.

Unemployment rates have not increased, but there are indications that the seller's market for labour maybe facing some challenges. Similarly, inflation has not yet decreased, but there are some indications that we may be at a turning point. Various inputs such as gasoline prices, grain prices, shipping costs, and higher retail inventories, are all pointing to a decrease in future inflation readings[15]. We have also seen a significant decrease in consumer perceptions around inflation, with a marked decrease in future inflation as measured by the University of Michigan (see Figure 7), a measure that US Federal Reserve officials are known to consider in their deliberations.

Figure 7: University of Michigan, Expected Inflation Rate (%), Next 5 Years (2013 – 2022)



Source: University of Michigan, BMO Economics

Remember that the goal of central bankers is not to achieve fame, but rather to avoid infamy. As we described in last winter's newsletter, the objective for Fed Chair Powell and Governor Macklem is to successfully control the inflation problem before them, without plunging their respective economies into recession: thus achieving the elusive "soft landing". As mentioned earlier in this commentary, while their mandates begin with inflation, their attention is also turned to employment considerations.

It stands to reason that if concerns around inflation were to ease, and the economy were to stand on the precipice of a significant recession, the upward pressure on interest rates would at least pause, and possibly reverse. Historically, an environment of falling interest rates would see as a natural reaction rising asset values, whether that be stocks, bonds, or real estate.

Our Next Actions

In the investment field, it is not sufficient to look back at past economic data and explain the world as we see it. The challenge is to look forward. The goal is not to foretell the future, that is an impossible task in today's unpredictable world. The goal is to try to help position client investment portfolios to be resilient to the economic circumstances that may lie ahead.

From an investment standpoint we are operating on the assumption that inflation will remain high for some time, and that consumers will need to adapt to higher levels of inflation, but that there should be a moderation of this pressure over time, possibly starting as early as this fall.

The existence of inflationary pressures and the acceptance of a higher interest rate regime for the time being has guided some recent changes to our Model Portfolio, including the reduction of Chartwell Retirement Residences (CSH.UN), and the addition of Restaurant Brands International (QSR), parent company to well-known consumer brands such as Tim Horton's, Burger King, and Popeyes. While we still believe that there is a strong demographic argument in favor of a company like Chartwell, decreasing our exposure to real estate as these types of companies face increasing financing costs feels logical. Furthermore, consumers adjusting to a higher inflation environment by altering consumption choices could favor some of the brands held in QSR's portfolio.

We have also sought to better diversify the traditionally defensive sector of healthcare by devoting some of the assets we had dedicated to Johnson & Johnson (JNJ) to Pfizer (PFE), officially adding PFE to our Model Portfolio.

On the assumption that inflation will moderate, we must operate based on the expectation that over time interest rates will also moderate. Given this, we will be increasing our use of Guaranteed Investment Certificates (GICs) with longer dated maturities, to help lock-in the currently favorable interest rate environment for our clients. In certain cases, this will mean choosing 4 or 5 year GICs that pay little more than 2 year GICs. While this may seem counter-intuitive, it is done to decrease reinvestment risk after the expiry of a shorter term. Fixed income investing has proven very challenging so far this year, but with rates now higher we should see fixed income portfolios contribute more meaningfully to clients’ total return going forward.

As our clients will know, markets have already fallen considerably this year. In the United States, markets have fallen by slightly over twenty percent (from the highs to the lows), marking an official “bear market”. There is an open debate right now as to whether the economy in the United states is in recession. Recent gross domestic product (GDP) numbers have indicated that the US economy has shrunk for two consecutive quarters: a traditional barometer (though not an official one) of an economic recession. It is important to note however that over this same period, the US has created 2.7 million new jobs[16], and currently boasts near-record low unemployment rates: not a traditional sign of recession. It is the National Bureau of Economic Research (NBER)’s responsibility to determine whether the US economy is currently in recession, and their criteria[17] (**a significant decline in economic activity that is spread across the economy and that**

lasts for more than a few months) will not always corroborate the "two consecutive quarters of negative economic growth" rule-of-thumb.

In Canada, the economic situation has not been quite as dire given our economy's reliance on natural resources, which have largely benefited from higher commodity prices in recent months.

The technical determination of recession is not all that important. What matters are the economic realities that we face. If we were to see a situation that included high unemployment, low consumer confidence, shrinking economic activity, coupled with stubbornly high inflation, then we would need to brace ourselves for further financial market declines. The typical decline in financial markets during an average recession, is approximately 40% from the peak to trough[18] (see Figure 8). We have not seen that yet.

Figure 8: Max Drawdown from Peak to Trough in Historical Bear Markets vs. Drawdown in 2022 by Sector

Canada:

Start Date End Date	1990 3-Jan-90 17-Oct-90 Max Drawdown	2000 5-Sep-00 10-Oct-02 Max Drawdown	2008 6-Jun-08 6-Mar-09 Max Drawdown	2020 21-Feb-20 23-Mar-20 Max Drawdown	Recession Average Max Drawdown	2022 YTD 5-Apr-22 Present 2022 Max Drawdown
TSX	-25%	-48%	-48%	-37%	-40%	-15%
Consumer Discretionary	-29%	-40%	-52%	-48%	-42%	-21%
Energy	-16%	-19%	-58%	-54%	-37%	-19%
Financials	-30%	-26%	-57%	-40%	-38%	-19%
Health Care	-25%	-54%	-51%	-53%	-46%	-56%
Industrials	-32%	-48%	-51%	-31%	-41%	-17%
Materials	-30%	-28%	-62%	-29%	-37%	-26%
Real Estate	-51%	-15%	-66%	-48%	-45%	-24%
Staples	-21%	-19%	-29%	-24%	-23%	-9%
Technology	-27%	-96%	-66%	-30%	-55%	-54%
Utilities	-11%	-15%	-32%	-38%	-24%	-10%
Communication Services	-23%	-63%	-42%	-28%	-39%	-17%

United States:

Start Date End Date	1990 16-Jul-90 11-Oct-90 Max Drawdown	2000 27-Mar-00 9-Oct-02 Max Drawdown	2008 11-Oct-07 6-Mar-09 Max Drawdown	2020 19-Feb-20 23-Mar-20 Max Drawdown	Recession Average Max Drawdown	2022 YTD 4-Jan-22 Present 2022 Max Drawdown
S&P500	-19%	-47%	-55%	-34%	-39%	-23%
Consumer Discretionary	-31%	-43%	-59%	-32%	-41%	-36%
Energy	-12%	-34%	-54%	-61%	-40%	-23%
Financials	-38%	-36%	-83%	-43%	-50%	-25%
Health Care	-16%	-41%	-39%	-28%	-31%	-16%
Industrials	-28%	-45%	-64%	-42%	-45%	-20%
Materials	-26%	-37%	-61%	-37%	-40%	-18%
Real Estate	N/A	-26%	-79%	-39%	-36%	-24%
Staples	-17%	-29%	-33%	-24%	-26%	-15%
Technology	-31%	-82%	-55%	-31%	-50%	-30%
Utilities	-15%	-62%	-47%	-36%	-40%	-16%
Communication Services	-25%	-74%	-48%	-29%	-44%	-32%

Source: Bloomberg, BMO Private Wealth

Thankfully, we have not seen a typical recession, as the low unemployment rate will attest. We may be facing further volatility in the coming weeks, but if inflation eventually moderates, the labour market remains strong, and central banks have the flexibility to take their foot off the interest rate pedal, we may be in for a strong second-half of 2022 and brighter days in 2023.

I would like to take this opportunity to thank all our clients for your patience over the first half of a difficult year, and to emphasize my eagerness to receive your comments or questions. Enjoy the rest of your summer.

Conclusion

Most asset classes (stocks, fixed income, real estate) faced a challenging first half of 2022. We cannot be certain that the worst is behind us, but there are some reasons to believe that there are better days ahead.

- Indicators relating to housing, consumer confidence, and economic growth are all underscoring the difficult economic situation in which we currently find ourselves. Taken in isolation, these variables could lead us to the conclusion that we are in – or will very shortly be in – a recession (in particular in the United States).

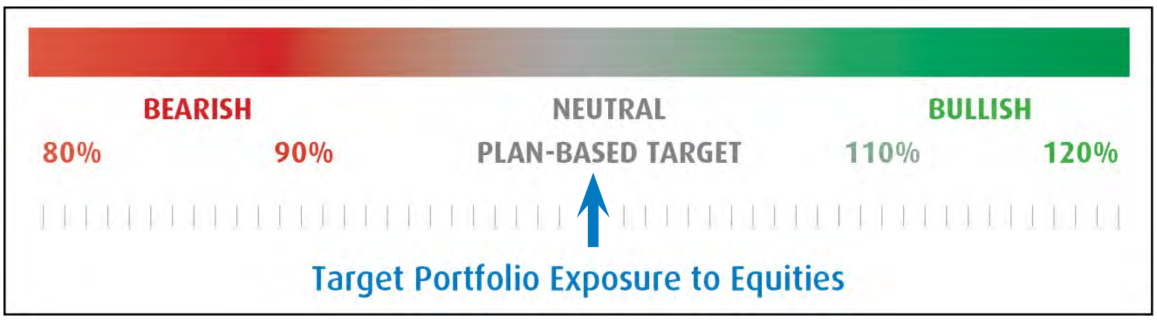
- There are mitigating factors to this however, such as very low levels of unemployment, strong job growth, and early signs of moderating inflation.

- We would expect market volatility to persist over the short term, but stronger investment returns should accompany the gradual cooling of inflationary pressures. We will continue to position clients for this scenario, including selecting longer-term fixed income vehicles (such as GICs) to ensure we are taking advantage of the current high level of interest rates.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):



For example, a portfolio with a long-term strategic target of 60% equity should currently be targeting an equity weight fully in line (100%) with this target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index[19]
Yield*	2.76%	2.20%
Portfolio Beta*	0.90	1.00
Number of Holdings	29	1513
Sector Allocation (Core Portfolio)		
Financial Services	25.0%	13.5%
Real Estate	2.5%	2.9%
Communication Services	7.5%	7.6%
Utilities	8.3%	3.2%
Consumer Staples	14.5%	7.8%
Consumer Discretionary	10.0%	10.6%
Healthcare	6.0%	14.1%
Information Tech.	6.0%	21.1%
Industrials	11.0%	9.9%
Energy	4.3%	5.0%
Materials	5.0%	4.3%

*As at 2022-07-31; source: Thomson ONE

Meet Our Team

Philip Brock, CFA, CFP, F.Pl., B.Com
Portfolio Manager and Financial Planner
Tel: 613-562-6409
philip.brock@nbpcd.com

Philip made his entry in the financial industry in 2004 and joined BMO Nesbitt Burns as an Investment Advisor in March of 2006. Since then, Philip has advised many families on retirement planning, personal credit, and investment management. In addition to his work with clients, Philip served as Assistant Branch Manager for the Ottawa Dalhousie/Lansdowne branch of BMO Nesbitt Burns between 2014 and 2019. Philip holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007 and has held the *Institut Québécois de planification financière*'s F.Pl. designation since 2015. Philip is happy to offer his services in English and French.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He calls Orléans home along with his wife Kathleen and their young sons, David, Jonathan and Nicolas. When he's not providing financial advice to his clients, he and his family can usually be found on the ski hill or off in the woods on a canoe/camping trip.

Pierre Paputsakis, PFP, B.Com
Investment Advisor, Wealth Advisor
Tel: 613-562-6483
pierre.paputsakis@nbpcd.com

Pierre has been an investment advisor with BMO Nesbitt Burns since 1999. During his career, Pierre has developed a well-deserved reputation for honesty, integrity and professionalism while working with his clients. Pierre brings a high level of energy to the team as well a genuine desire to help clients effectively manage their wealth. His keen analysis and disciplined approach keep him abreast of relevant issues. Fluently bilingual, Pierre is happy to serve his clients in both official languages.

Born in Montreal, Pierre has lived in the National Capital Region since 1999. Pierre currently resides in Rockland along with his wife Mindy and their son Zachary and daughter Trista. In his spare time, he can usually be found on the golf course or in hockey rinks.

Patricia Butler, B.A.
Associate Investment Advisor
Tel: 613-562-6487
patricia.butler@nbpcd.com

Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing golf and spending time with her husband and two children.

Clara Augustine, BBA
Investment Representative
Tel: 613-562-6486
clara.augustine@nbpcd.com

Clara has over 13 years of experience in Business Administration and Sales Management. She received her BBA from the University of New Brunswick in 2009, subsequently beginning her career in the financial services industry. Clara worked with several BMO Bank of Montreal branches in a management capacity, joining BMO Nesbitt Burns in 2018. She works closely with each member of the team to ensure your administrative needs are met seamlessly in the pursuit of your investment goals and is pleased to offer her assistance in either English or French.

Clara was raised on the East Coast, and now calls Kingston, Nova Scotia home, where she lives with her husband and their young children. In her spare time, she is passionate about fitness, and enjoys cooking, writing, playing music and travelling with her family.

Diane Clark
Investment Representative
Tel: 613-562-6413
diane.clarke@nbpcd.com

Originally from Montreal, Diane has over 30 years of experience in the financial service industry. In 2015 she rejoined BMO Nesbitt Burns following a tour overseas with her military spouse. She brings excellent organizational and communication skills to the team. Diane is responsible for administration and provides superior customer service to our clients. She is pleased to offer her assistance in English and French.

Having lived in a number of countries, Diane currently resides in Ottawa with her husband and has two grown children. In her spare time, she enjoys travelling, kayaking and hiking.

Megan Labelle, DEC, BBA
Investment Representative
Tel: 613-562-6435
megan.labelle@nbpcd.com

Megan entered the financial services industry in 2016, completing her Canadian Securities Course (CSC) and Conduct and Practices Handbook course (CPH) to become a licensed investment representative. Megan earned her DEC from CEGEP Heritage College in 2013 and was a Dean's List graduate of St. Francis Xavier University's BBA degree with a focus in Leadership in Management. Before BMO Nesbitt Burns, Megan's career was in hospitality with five years of experience in front office operations in hotels of varying size – this positioned Megan to excel in providing a high level of client service and professional communication. She is dedicated to fostering strong client relationships and trust, as well as careful attention to detail – she is pleased to offer assistance in English and French.

Megan was born and raised in Gatineau, lived in Nova Scotia for University, and is now settled in Ottawa. In her spare time, she enjoys walking her Chihuahua by the Rideau River, reading, playing the ukulele, and has a passion for cooking.

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Talk with us

Philip Brock - 613-562-6409
Pierre Paputsakis - 613-562-6483
Patricia Butler - 613-562-6487
Clara Augustine - 613-562-6486
Diane Clark - 613-562-6413
Megan Labelle - 613-562-6435
Toll Free: 1-800-230-9775
Fax: 613-562-6402

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Brock & Paputsakis Wealth Management
www.brock-paputsakis.com

BMO Nesbitt Burns
979 Bank Street, Suite 600
Ottawa, ON K1S 5K5

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