# Soft Landing?

BMO Private Wealth

BROCK & PAPUTSAKIS
Wealth Management

# Table of Contents

# Philip's Comments

In March of 1993, my parents took the opportunity of my school break to take our family of three on a trip to Florida to visit my maternal grandparents who were snowbirds in the Fort Myers area.

Weather reports in advance of the trip indicated the brewing of a storm covering most of the East Coast of the United States. However, as our flights were not cancelled, we departed the Ottawa airport on time headed south to warmer climes. As planned, we landed in Syracuse, New York, to change planes, and as we took off our pilot announced that we were the last plane out before the closure of the Syracuse airport on that day, due to the terrible weather. As we flew south over the eastern seaboard, the pilot would occasionally make use of the overhead speaker to announce which airports beneath us were closing due to the storm's activity. From New York, all the way down the coast, airport after airport ended up shutting operations given strong prevailing winds caused by what would later be dubbed the Storm of the Century[1], a large cyclonic storm that stretched from South America to the maritime provinces.

We did not land at our intended destination that day. Following what seemed like an eternity circling the Fort Myers airport (which in those years only had a single, north-south runway), waiting for westerly winds to abate, our pilot made an attempt at a crosswind landing that took us to what seemed to be the treetops before re-accelerating and climbing back to altitude and then pointing the nose of the aircraft to an airport across the state to take us to a smoother "into the wind" landing in Fort Lauderdale.

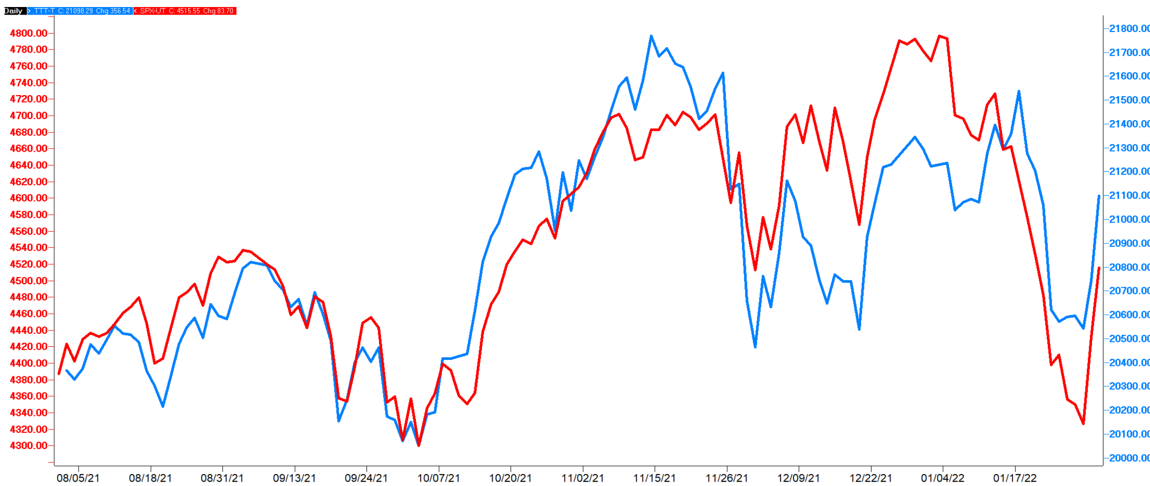
The professionalism of the pilot made us feel safe, but it was nonetheless a nerve-wracking experience for the passengers, and the sense of relief upon landing was palpable as the cabin erupted in cheers and applause.

The execution of a soft landing is no simple matter when the prevailing conditions are difficult. This is as true in economics as it is in aviation. The term "soft landing" is a known economic term, referring to the deliberate slowing of the economy to counter inflationary headwinds without entering into recession territory. It was approximately one year after our trip, in 1994 (and 1995), that the then-chair of the Federal Reserve Alan Greenspan engineered the only known successful soft landing of the US economy through a series of interest rate increases that led to a slight moderation of economic growth, a controlled inflation rate, and, critically, the avoidance of a recession in the ensuing years[2].

It is this very difficult maneuver that the current pilots of the Canadian and US economies, Bank of Canada Governor Tiff Macklem and Fed Chair Jerome Powell, are facing. Once again, inflationary winds are blowing, and interest rate increases lie before us along our flight path. If they are successful, just like our pilot was that day in March, they will have earned a round of applause from everyone on board.

Since the publication of our summer newsletter "*Achieving Liftoff,*" markets have climbed to new heights, though recently they have shown signs of true turbulence for the first time in almost two years. US equity markets have climbed by approximately 2.74%, and Canadian markets by 3.99%[3], though that is inclusive of a very difficult January that saw a drawdown in equity prices on both sides of the border that was significant enough to pull the S&P 500 into “correction” territory (defined as a 10% decline off the highs of early January) for the first time since the market’s pandemic collapse in March of 2020 (see Figure 1).

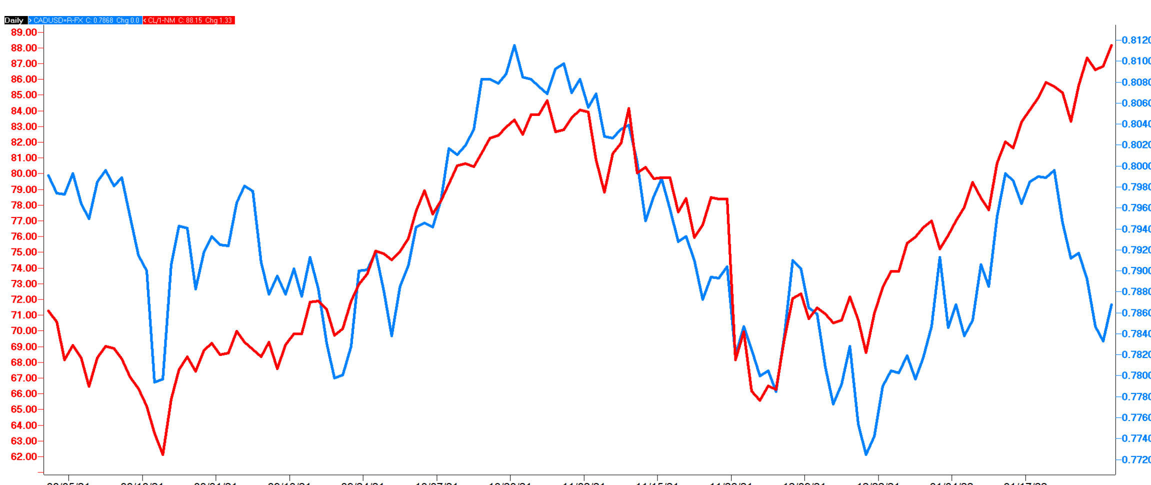
*Figure 1: **S&P 500** & **S&P/TSX Composite Index** (August 1 2021 – January 31 2022)*




*Source: Thomson ONE*

Meanwhile, despite a striking 20% growth in the price of oil over the last six months, the Canadian Dollar (usually highly correlated with the price of crude) weakened against the greenback, declining by 1.78%[4] (see Figure 2). In fact, stronger energy prices did help support the Loonie, as its performance against the US dollar for 2021, albeit slightly negative, proved to be among the strongest currencies in the world against a US dollar which showed remarkable strength[5].

*Figure 2: **Oil (Light Crude)** & **Canadian Dollar (CAD/USD)** (August 1 2021 – January 31 2022)*




*Source: Thomson ONE*

At the time of writing this newsletter, our 18th publication, markets have demonstrated a significant increase in volatility – the highest volatility levels measured in over a year. Periods of market instability afford us an opportunity to question whether our conviction in the long-term trend of markets remains the same, or if a deeper reassessment of our strategy is required. In this edition of our newsletter, we will approach this question by first examining valuations among equity markets and testing the common wisdom that stocks are at near-atmospheric levels. We will also discuss the portfolio impact of one of the of the main challenges to investors in the current environment: the ongoing risk of inflation and its deleterious effects to the creation of wealth.

## Are equity valuations sky-high?

The price you pay matters. Whether you are purchasing a stock, a bond, a piece of real estate or any other asset that has the capacity to hold value, the price you pay is one of a very small number of variables (along with the price you sell, and income earned along the way) that impact your total profit. It makes sense to be keenly aware about the value of the asset in historical terms before making the decision to acquire it. But how does one measure the value of a stock? As stocks trade on the stock market every day there can be little question as to what the price of the stock is at any moment, but its value is harder to measure.

There are multiple ways to try and measure value: we can look at the value of a company based on the history of its stock price or based on the likelihood of its future success; we can compare the value of a company to that of its competitors, or to other goods and services that can act as substitutes. Above all, it is crucial to look at the price of a stock relative to its profitability. The value of the stock as compared to its profit, or earnings, is one of the most used and accepted forms of valuation.

After all, when we are investing in the market by buying individual stocks it's important to remember that we are buying actual businesses. Above all other considerations the main objective of a business is to earn a profit. The distribution of profit determines dividends. The size of the profit permits reinvestment into the company and enables future growth. The absence of profit causes companies to retrench, shrink, and sometimes die. It is therefore logical that above all other measures of value, the price to earnings ratio (P/E) is the most commonly used and accepted metric by which we measure both individual stocks and the broad market. It serves as a common denominator that allows us to compare one stock to another, and also to compare the broader market to its historic precedent.

Price to earnings is extremely easy to calculate, as you simply take the price of the stock and divide it by its recent verifiable annual earnings, on a per share basis. It stands to reason therefore that a high P/E ratio indicates that you are paying a high price relative to the earnings that have been achieved. It also stands to reason that a growing price to earnings ratio can be achieved either through an increase in the share price over a given level of earnings or a decline in earnings as a denominator at a given share price. As applied to the market, we feel more comfortable investing in equities when the market trades at a lower price to earnings ratio; for each dollar invested, we are buying more earnings, whereas higher ratios often characterize a market suffering from overvaluation.

Markets characterized by high P/E ratios are thought of as frothy, overly optimistic, and bubbly. It would have been fair to characterize certain segments of the market as such throughout a good part of the pandemic. The recovery in the period since March of 2020 was so swift that the market overall achieved an unusually high P/E ratio, averaging 30x trailing earnings for the period since March 1st 2020 (see Figure 3), and peaking at 39x trailing earnings in December of 2020[6]. However, the evolution of the market's valuation since the start of last year (January 2021) brings us comfort, as the P/E ratio for the market has been on a gradual decline. At its current level of approximately 25.5x trailing earnings[7] it remains elevated in historical terms, and happens to be almost exactly at the same level as it was in the winter of 2020, when in our 14th newsletter, *Ever Higher?,* we advised that our clients adopt a more cautious approach to their asset mix. We're taking a slightly different approach this time around: we are advising clients to neither underweight equities nor overweight equities, but to adhere to their long-term asset allocation target. This is in part because of the unattractiveness of fixed income securities in rising interest rate environments. As interest rates rise, the value of bonds generally declines.

*Figure 3: Historic S&P 500 Price/Earnings Ratio, using 12-month trailing earnings*


*Source: www.multpl.com/s-p-500-pe-ratio*

An observant reader might be surprised to learn that the market's P/E ratio has been declining since the beginning of 2021, as the market itself has continued to increase (the month of January being an exception to this, of course). A quick study of the ratio itself tells us how this could be possible: for the ratio to decline while the numerator (price) is increasing, the denominator (earnings, or profits) needs to increase even faster. The fact that earnings per share for the market as a whole over the course of the third and fourth quarter of 2021 has increased so significantly has justified our confidence in equities and the current strength of corporations. We referenced this in our summer 2021 newsletter when we discussed the market's "boosters," the first of which we identified as being corporations themselves. As we mentioned last summer, "when corporations are in good health and are reporting strong earnings, we tend to see greater stability and an upward trajectory to the market itself". This helps explain why we can feel comfortable continuing to turn to equities as the centerpiece of most investors' portfolios. Valuations are high, but corporations have justified their increased prices by delivering exactly what shareholders like to see: profits.

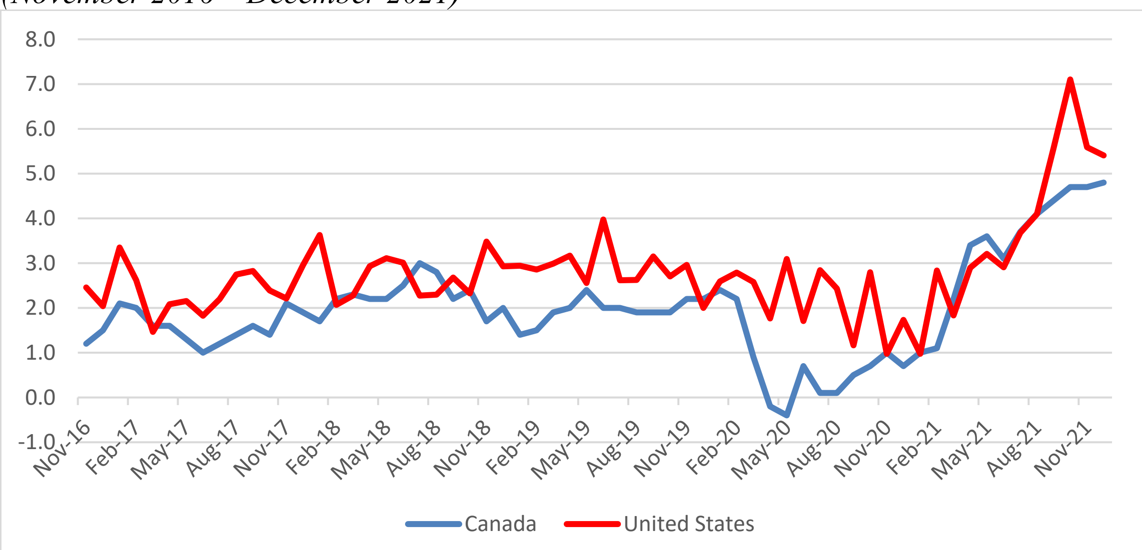
This dynamic between increasing stock prices and increasing corporate earnings justifies why bull markets – periods of reliable increases in equity markets – can be so lengthy. In time, a virtuous cycle can develop where corporate profits justify valuations which in turn justify further investment. The average bull market for the S&P 500 (since 1968) has been 4 years, 10 months in length[8]. In Canada, since 1960, the average has been almost exactly 4 years[9]. Our current bull market is not yet two years old, having started in March of 2020.

As we've mentioned in prior newsletters the value of a stock is simply the present value of its future profits, discounted at a rate that represents the riskiness of those cashflows. Given this, what happens when the actual value of those future cashflows is arrested by the cheapening of future money? What happens when inflation itself is factored into the assessment of the value of a stock?

## The inflation seatbelt sign is on

The year 2021 will have many claims to fame (or infamy), many of which don't exactly provoke fond memories. It began with a riot in the US Capitol and continued with wave after wave of the COVID-19 pandemic. A cargo ship even got stuck in the Suez Canal. What set 2021 apart from an economic and markets perspective was the return of inflation, which posted multiyear highs in Canada and in the United States (and indeed around the world, to varying degrees) (see Figure 4).

*Figure 4: Consumer Price Index (% change) for **Canada** and the **United States** (November 2016 – December 2021)*

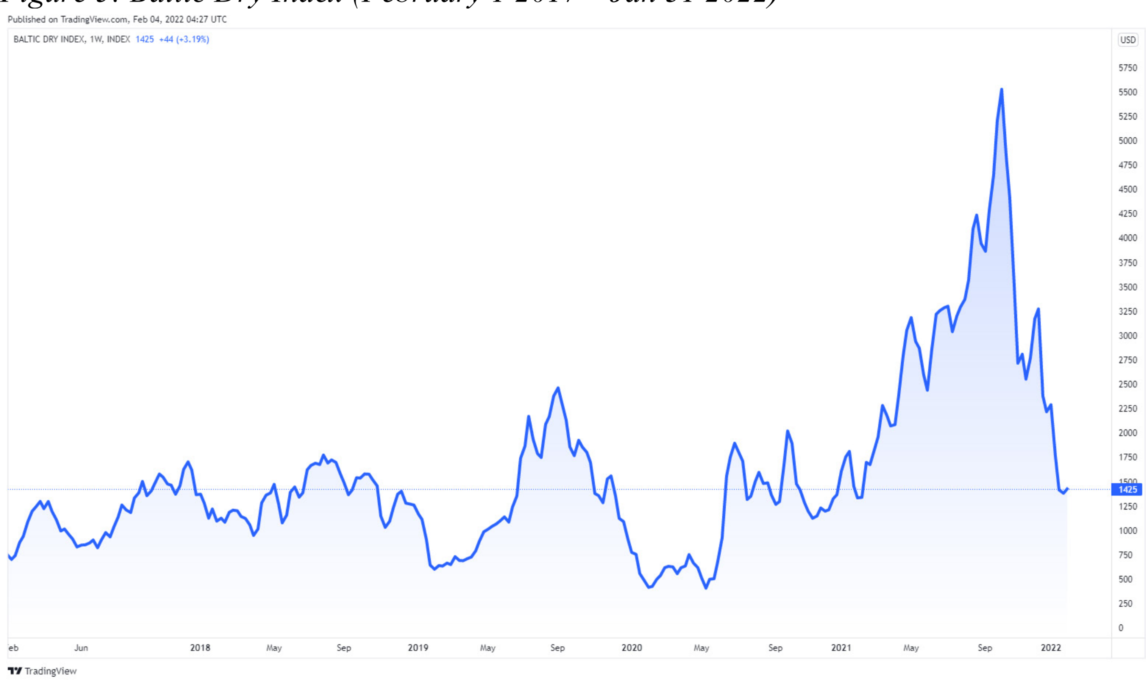



*Source: FRED St. Louis Fed Economic Data; Statistics Canada*

We should remind ourselves that inflation was something that we thought had been all but vanquished not that long ago. In the period that preceded the pandemic, former Fed chair Janet Yellen, now secretary of the treasury, struggled to reignite a base-level of inflation[10], fearing the negative impacts of a deflationary environment, which had catastrophic economic consequences in Japan in the 1990s[11]. It was thought that ample manufacturing supply, globalism, and technological progress were all pulling together to create an environment in which inflation could not exist in any meaningful way. The absence of inflation in the years that followed the 2008 financial crisis was a mystery to some as it could have been expected that the mountains of liquidity poured into the market by quantitative easing policies promoted by central banks around the world would have almost certainly prompted inflation. It would seem that all it took was a global pandemic to reignite our old foe from the 1970s and 1980s. The pandemic also successfully masked the inflationary problem itself by blaming supply chain disruptions caused by economic shutdowns and public safety measures around the world as being the chief culprits for rising prices[12].

There is likely some truth in the argument that supply chain disruptions have caused and are still causing a portion of the inflation pressures we're seeing. There is hope on this front as there is evidence of recent progress in international shipments which are key to allowing global supply chains to work normally. This can be evidenced by the significant decline in the Baltic Dry Index (see Figure 5), a benchmark that helps represent the cost of sea transport of certain commodities. This index had surged to highs not seen since the financial crisis of 2008, due to supply-chain breakdowns during the pandemic, but has now receded significantly.

*Figure 5: Baltic Dry Index (February 1 2017 – Jan 31 2022)*




*Source: Trading Economics (https://tradingeconomics.com/commodity/baltic)*

However, the consensus that is emerging is that while the very high inflation readings measured in 2021 will likely decline somewhat, they will still settle at levels that are meaningfully higher than before the pandemic. If this is the case, then we can expect challenges ahead for equities. As mentioned in the prior section, the value of a stock (its price), can be interpreted as being the present value of its expected future profits. Inflation is insidious. It doesn't necessarily decrease the profitability of a company; it simply decreases the value of each dollar of profit that that company earns. It stands to reason that the longer inflation is with us the more serious the damage to the present value of those future cashflows – the stock prices – will be.

This is especially true for a category of securities that we referenced as "high duration" securities. These are companies which typically pay lower dividends and whose prices are set based on expectations a future profit stretching far into the future, as opposed to companies that have a higher dividend yield and distribute profits more tangibly to investors in shorter time frames. These high duration stocks such as high technology companies, for example, will be particularly sensitive to rising interest rates – the natural by-product of inflation. Other companies that are vulnerable to rising interest rates are companies whose operations are very capital-intensive and therefore operate with structurally higher levels of debt such as utilities, real estate, and telecommunications companies.

High technology, utilities, real-estate, telecommunications… if it sounds like we're describing a significant piece of our model portfolio, you're absolutely right! It is true that we continue to have exposure to industries that would come under greater amounts of pressure if interest rate expectations increase. However, the expectations part of that is important to emphasise. Markets are forward-looking. It isn't automatically true that if interest rates rise, the value of companies in the above noted sectors will fall, because interest rate increases are already the broad market consensus. So, while it stands to reason that these companies will face some turbulence ahead, the increasing interest rates should surprise no one, and this should alleviate some of the negative impacts to interest-sensitive companies beyond some of the price adjustments that we've already seen.

Rising interest rates won't impact every company or industry in our model portfolio in the same way. This is a deliberate characteristic of the model portfolio. It is my view that the construction of a well-built investment portfolio, one that strives to achieve an acceptable rate of return while demonstrating low volatility characteristics, is an exercise in offsets. We know the US dollar to be a safe haven when instability increases, so we hold U.S. dollar denominated assets in the portfolio. We know gold to be a hedge against the US dollar because of the inverse historical relationship between these two asset classes, so we hold a small gold position in the portfolio as a further hedge against U.S. dollar weakness. Similarly, we know that certain sectors are vulnerable to interest rate increases, so we hold exposures to banks and life insurance companies that can benefit from rising interest rates.

I once heard it said that it is redundant systems – backups on backups on backups – that keep planes flying through almost any circumstance. I think that's a good metaphor to describe our approach to portfolio construction.

## The glide-path

With the inflation surprise that came to light in 2021, the most commonly asked question around financial circles these days is no longer if but how fast and how high will central banks increase interest rates.

Increasing interest rates is not likely to be the first step that the central banks will take to fend off the current inflationary environment. First they must end the quantitative easing measures put in place in early 2020, which were intended to be a global emergency measure to maintain the health of the financial sector through an almost unprecedented pandemic. The Bank of Canada took a big step in this direction last October by ending its quantitative easing program and clarified in its January meeting that interest rate increases are likely not too far down the road. We expect interest rates to normalize to pre-pandemic levels over the course of the next two years with the first steps in that direction almost certainly happening before our summer newsletter will be written[13]. While the situation in the United States is similar, they are slightly behind Canada in terms of the conclusion of their asset purchase program. On the whole, the pace of interest rate increases should be comparable on both sides of the border which, coupled with strong energy prices and our very slight head start to ending quantitative easing, may lead to a slightly stronger Canadian dollar.

Since the glide path for interest rates became fairly apparent for all to see, we've been fielding questions from clients in the last number of months on what strategic approach we will take to managing money in an inflationary, rising interest rate environment. The question is timely, as the last two decades have been characterized by far more periods of low inflation and falling interest rates than otherwise. However, while the answer may surprise some, we will maintain many of our key strategies because they are applicable in both a rising interest rate environment and in a falling interest rate environment.

- In periods of low and falling interest rates we prioritize the selection of high-quality companies with responsible and tested management teams and strong competitive positions in their industries. We will also favor these kinds of companies in a rising interest rate environment.

- In periods of low and falling interest rates we have frequently rebalanced our clients' portfolios ensuring adherence to their stated asset allocation targets and using sector allocation as a risk control in the portfolio. As interest rates start to rise, we will continue to exercise this kind of discipline.

- In periods of low and falling interest rates we prioritize the selection of companies paying strong and growing dividends (with a few notable examples such as Amazon, Google, and Microsoft). We will continue to favor dividend-paying companies with sound balance sheets as interest rates continue to rise.

A key element of investment discipline is the tactical deployment of capital during periods of market volatility. We want to be accumulating stocks when fear is the prevalent sentiment in the market, and we want to hold and even in certain cases trim our profitable positions when we see the slightest sign of complacency and overconfidence set in. Our clients should expect portfolios to be rebalanced during moments of market volatility because it is during those moments that value can most easily be unlocked though the acquisition of securities that the market has temporarily undervalued.

It is in part because of this discipline that we chose not to make any changes to our model portfolio since July of last year (when we made three substitutions). As things stand, we believe the current constituents of the model portfolio to be some of the best companies in North America, indeed the world, and while we will not shy away from making changes and substitutions when we deem them necessary, we also won't trade for the sake of seeming active. If the present constituents of the model portfolio meet our quality test, they've earned their ticket for this flight.

## Conclusion

We remain optimistic about the prospects for equity markets in 2022, though the backdrop of high levels of inflation and rising interest rates will likely lead to more moderate growth rates and a more volatile market than what we saw last year.

- Central bankers are attempting to engineer “soft landings” – controlled reductions in economic growth in order to control very high levels of inflation that emerged during the pandemic.

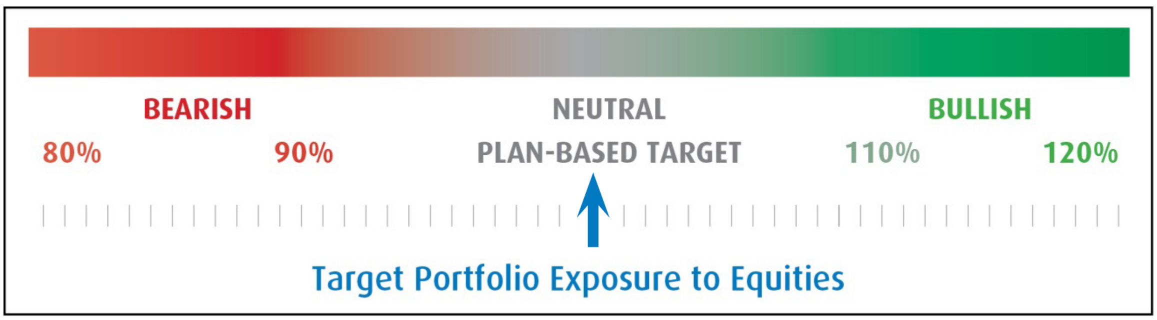
- By traditional methods of market valuation such as trailing Price / Earnings, the market seems expensive, but less so than it seemed earlier in the pandemic. Strong corporate earnings are continuing to help justify the current market multiple.

- Although some elements of the inflationary pressures seem to be abating (such as global shipping costs) and the global supply chain continues to heal, the environment is likely to remain challenging this year. We will face these challenges wielding the same investment discipline as always.

## 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[14] |
|---|---|---|
| **Yield*** | 2.51% | 1.66% |
| **Portfolio Beta*** | 0.90 | 1.00 |
| **Number of Holdings** | 27 | 1546 |

| Sector Allocation (Core Portfolio) | | |
|---|---|---|
| **Financial Services** | 25.0% | 13.2% |
| **Real Estate** | 5.0% | 2.8% |
| **Communication Services** | 7.5% | 8.3% |
| **Utilities** | 8.3% | 2.7% |
| **Consumer Staples** | 14.5% | 6.9% |
| **Consumer Discretionary** | 7.5% | 12.3% |
| **Healthcare** | 6.0% | 12.6% |
| **Information Tech.** | 6.0% | 23.7% |
| **Industrials** | 11.0% | 10.2% |
| **Energy** | 4.3% | 3.1% |
| **Materials** | 5.0% | 4.2% |

*As at 2022-01-31; source: Thomson ONE

# Meet Our Team

**Philip Brock,** CFA, CFP, F.Pl., B.Com
Portfolio Manager and Financial Planner
**Tel: 613-562-6409**
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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
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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
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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
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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
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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
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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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