

# When Easy Money Goes in Reverse

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Let's say it like it is. North American Central Banks have painted themselves into a corner by leaving interest too low for too long. This is what is commonly known as "ultra-easy monetary policy" in the parlance of Bay Street. Well, those days are now behind us judging by the increasingly blunt rhetoric from Central Bankers. To wit, Fed Chairman Powell recently said that inflation would stay high in 2022, but he vowed the central bank will do whatever it takes to bring price increases under control. His Bank of Canada (BoC) counterpart Tiff Macklem admitted to misjudging the strength of inflation at the start of the year and pledged to act "as forcefully as needed" to make up for the mistake. Little wonder interest rates have been rising.

The stock and bond markets have taken notice with unabated volatility so far in the first half of 2022. Government bonds just posted their worst quarterly performance on record, while the S&P 500 and Nasdaq have taken big hits of late. No category of securities has been harder hit than very expensive tech stocks and other so called "high duration" equities (i.e., stocks that get the bulk of their value from projected future growth in cash flows)<sup>1</sup>.

## Being Selective

The silver lining is that over a long period, stocks have always been and will remain the asset class of choice to help investment portfolios withstand the ravages of inflation. So, liquidating stocks in the face of increased volatility is never the optimal long-term strategy. However, being selective in our geographic, sector and company allocation is critical. In this environment we continue to emphasize quality companies with large competitive advantages which provide enough pricing power to offset their own cost increases and protect their profit margins. We strongly advise investors to be especially sensitive to valuations (i.e., do not overpay for stocks) as there are still many technology/communications stocks which we consider overvalued despite significant declines.

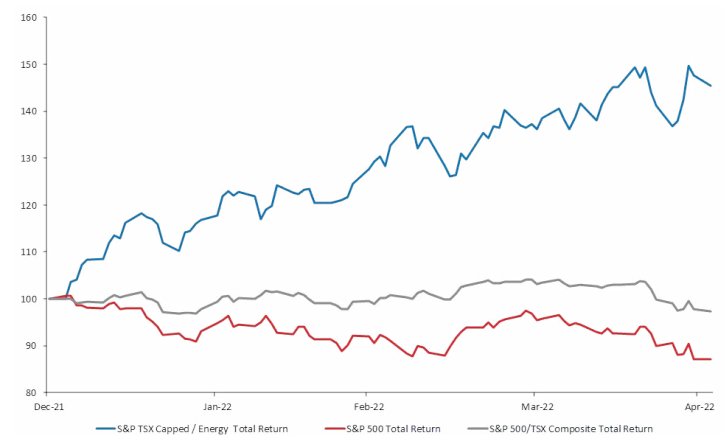
## S&P/TSX Composite Well Positioned

Canadian investors also have grounds for optimism in our view, and we see room for the S&P/TSX Composite ("TSX") to continue outperforming. This is due to the Canadian market's

composition which is well suited to withstand inflation. In fact, we have a far higher proportion of Energy and Basic Materials stocks which tend to do very well in this type of macro environment, and our market still trades at an attractive discount to the S&P 500. The unprovoked Russian aggression has also accelerated a number of trends (e.g., higher energy, grain and metal prices, of course), and forced a fundamental rethink of energy policies in Western Europe. In other words, finding alternative energy and materials suppliers has become of paramount importance and Canada just happens to have massive reserves of those things.

Market action seems to support this opinion as there has been a very wide variance in performance across different sectors. The chart below shows that year-to-date the S&P 500 is down 13% (former tech highflyer Netflix is down over 60%). Conversely, the TSX is almost flat this year and the Canadian Energy sector is showing a gain of almost 45%.

## S&P vs. TSX vs. TSX Energy Sector



## Canadian Economy Outperforming

Importantly, BMO's Chief Economist Doug Porter recently stated that, "amid this dreary [global] growth backdrop, one economy is quietly going the other way. In what may well be a first for 2022, we have revised up a GDP estimate—for none other than Canada. Growth came in even better than the initial take for February, and March's flash read was also solid, pointing

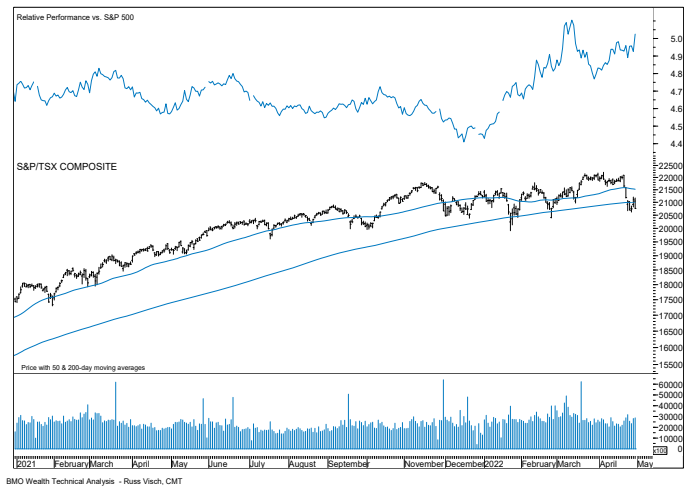
to Q1 annualized growth of 5.5%. As a result, we now see the economy growing by just over 4% this year, versus 3.5% previously, and maintaining a sturdy 3% pace next year—both well in excess of potential growth of less than 2%.”

What explains this counter-move by the Canadian economy? One readily obvious explanation is that Canada produces much of what Russia produces, and has seen its basket of resource prices roar. The Bank of Canada’s commodity price index, for example, is up 28% just since the start of the year. A little less obvious is the fact that, with the loonie largely treading water this year, this commodity surge has turned into a bonanza for producers. In Canadian dollar terms, the BoC’s index is off the charts, and nearly double the median level of the past 20 years.

**Market Technicals**

Our Technical Analyst Russ Visch notes that the TSX has come under pressure over the past two weeks, but his work suggests this slide is likely very near to ending. For example, by the middle of last week the TSX was more oversold on a short-term basis than at any point in the past two years. In fact, we’ve only seen three instances since the beginning of 2020 where the TSX was pushed into deep oversold levels like this and in each case it represented a major trading low. It’s also important to note that the TSX continues to outperform its U.S. counterparts since most of the weakness has been concentrated in the mega-cap technology names.

The TSX has sold off very recently but continues to consistently outperform the S&P 500.



While the environment could remain volatile for some time and more downside is possible, the key is to stay disciplined about the price paid for any assets and to maintain a well-diversified portfolio including cash, bonds, and high-quality stocks.

**Please contact your BMO financial professional if you would like to discuss your investment portfolio.**



<sup>1</sup> Higher inflation erodes purchasing power and pushes interest rates higher. This, in turn, lowers the present value of future corporate free cash flows (which is in essence the fair value for stocks). The more investors believe these cash flows will grow in the future, the more those stocks are negatively impacted by this effect.

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