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2022 mid-year market outlook

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The investment landscape has shifted dramatically since the start of the year. Wondering how to make sense of jammed supply chains, inflation and changing growth outlooks?

*On our latest Canada Life Portfolio Manager Connect Series event, we heard from **Dan Gremonprez**, National Vice-President, Wealth Distribution at Canada Life, and Investment Strategist **Lenny McLoughlin** of Irish Life Investment Managers (ILIM). If you missed the discussion, we've prepared takeaways to catch you up on what investors could see in the second half of the year. Read on for information you can use to help navigate your clients through uncertain times.*

What's in this article:

Helping you expand your global perspective after a challenging first half

Inflation is approaching a 40-year high, war in Europe is exacerbating supply-chain issues and heightened concern about a recession is putting Canadians on edge. The first half of 2022 has been uniquely challenging, illustrating the profound impact global events can have on clients' investment portfolios.

To help us gain a more robust global perspective, Dan Gremonprez, National Vice-President, Wealth Distribution at Canada Life, sat down with 25-year industry veteran, Lenny McLoughlin, in our mid-year market outlook virtual event on July 14, 2022. McLoughlin is an Investment Strategist with Irish Life Investment Managers, a global asset management firm with a reputation for client-led solutions and investment innovation. The team is entrusted with assets exceeding €101 billion across a broad range of asset classes and investment solutions.

The conversation kicked off with the current state of the global economy and some factors fueling financial market declines. "It's a very different landscape compared to where we were at in the beginning of the year," said McLoughlin. "So far in 2022, the global economy has moved from mid-cycle to a late-stage cycle very rapidly." High, persistent inflation around the world has prompted central banks to tighten interest rates in a manner we have not seen in decades. In turn, we have seen yields rise significantly, which has undermined equity valuations.

Turbulent period for both global equities and bonds

Over the first six months of the year, U.S. equities moved into bear-market territory. In the second quarter, U.S. equities represented the worst-performing global equity market, in local currency terms, reflecting the U.S. Federal Reserve Board's ("Fed") more aggressive policy approach. The information technology sector, a heavily weighted part of the U.S. market, led the U.S. equity market's decline.

In contrast, McLoughlin noted the U.K. was the only equity market to post a second-quarter gain (in local currency terms), which was largely the result of the region's heavier weighting in the energy sector, as well as more defensive sectors, such as health care and consumer staples. Similarly, Canada and the Pacific basin (excluding Japan), including Australia, outperformed global equities as a result of those economies' larger weightings in energy.

It was an unlikely first half of the year for fixed income markets, McLoughlin said, since bonds usually post strong relative returns amid a backdrop of slow economic growth. Historically, central banks have reduced interest rates during bear markets, but opposite measures were taken to tackle inflation during this cycle, which caused bonds to underperform along with equities.

Despite that, McLoughlin believes there is still a place for bonds in investors' portfolios, and expects bond markets to post positive returns over the next 12 months. With the yield on the benchmark 10-year Treasury note doubling over the course of 2022 to around 3%, which was close to its highest level in a decade, McLoughlin believes bonds should offer relatively strong returns in the U.S. and Canada over this timeframe. After years of ultra-low yields, however, bond returns should still be somewhat modest, particularly in Europe.

Central banks aggressively pivot to sustain public trust

In July, the Bank of Canada raised its benchmark overnight interest rate by 100 basis points ("bps"), to 2.50%, the largest increase since 1998. This exceeded most economists' expectations of a 75 bp increase. In the U.S., market participants were widely anticipating the Fed would increase its target federal funds rate by 0.75 percentage points at the end of July. These expectations soon changed to a full percentage point increase, which would mark the Fed's largest increase since 1994.

While the European Central Bank ("ECB") was adamant it would not raise its key interest rate at the beginning of the year, financial markets expect the ECB to raise rates at the end of July by 25 bps, which would be the ECB's first rate increase in 11 years.

McLoughlin noted the aggressive policy shifts by central banks demonstrate the growing need to bring down inflation in an effort to stem a loss of the public's confidence in central banks. "If central banks don't manage to contain inflation, they risk losing the credibility they've built up over the last several decades," he said. "The unconventional policies of quantitative easing taken by central banks in recent years may be blamed for the rise in inflation we saw in the first half of 2022."

With U.S. inflation reaching 9.1% in June – its highest level since 1981 – McLoughlin said the Fed needs to raise its rate to 4.00% (or above) to rein in inflation. McLoughlin believes that only when the risk of recession starts to grow substantially will we see central banks begin to pause interest rate increases, perhaps by the second half of next year.

Supply chains could remain under pressure longer term

Supply-chain bottlenecks have clearly fueled inflation and impacted financial markets. Pent-up demand following easing COVID-19 lockdowns, and the failure to keep up with that demand by producers, are largely to blame. A developing trend, McLoughlin pointed out, is that inflation has broadened into the services sectors, which represents a "stickier" level of inflation that will likely be more difficult to bring down.When referring to the Global Supply Chain Pressure Index, McLoughlin indicated supply-chain pressure might have peaked last year, and could be easing. While this easing is a positive sign, China's zero-tolerance policy in curbing the spread of COVID-19 continued to cause spikes in supply-chain pressure. He sees lockdowns in China continuing into the fourth quarter of 2022 and beyond, potentially leading to ongoing supply-chain issues.

As a result of supply disruptions caused by Chinese COVID-19 measures and the war in Europe, businesses are rethinking how they manage their supply chains going forward. To secure long-term supply, many businesses are seeking production facilities closer to home. These measures could improve global supply chains in the long term, but having plants located away from regions in Asia that tend to offer cheaper production could cost consumers and drive heightened inflation on a long-term basis.

History underscores the high risk of recession

McLoughlin said he expects financial markets to continue on a similar trajectory in the second half of the year, and that a global economic recession is a real possibility. To support his case, he pointed to the past 13 tightening cycles by central banks, going back to the 1960s. Central banks have avoided hard landings or recessions following only three of these cycles. So, the track record for achieving a soft landing following the current tightening is not great, he believes.

Confidence in U.S. small-capitalization companies – a bedrock of the U.S. economy – in July 2022 was at its lowest level since the 1970s, suggesting considerable caution over the next several months. Similarly, consumer confidence levels in the eurozone, U.K. and U.S. are all at multi-decade lows.McLoughlin also pointed to the yield curve in the U.S., which has been one of the best indicators for recessions going back to the mid-1970s. As of July 2022, the yield curve inverted to its highest level since 2000, indicating widespread concern over higher interest rates and the risk of inflation.

Reliance on Russian oil makes Europe more vulnerable

In terms of which regions could be at greatest economic risk, McLoughlin believes Europe is most vulnerable because of that region's sensitivity to shocks in the oil supply caused by the Russia-Ukraine war. Gas prices rose in Europe by more than 100% from June to July 2022, and financial markets appear to fear Russia will begin to weaponize gas supplies in retaliation for the support Europe is providing to Ukraine.

"If gas supplies from Russia to Europe are cut off, I think there's a real risk that Europe goes into recession quickly in response to the further rise in gas prices," McLoughlin said. "Countries will need to ration gas if those supplies aren't delivered, particularly Germany and Italy, which rely on Russia for over 50% of their gas supplies." While the risk of recession is real in North America, the U.S. and Canada are less vulnerable to the effects of the Russia-Ukraine war because these countries are less reliant on Russian oil.

Remain invested and disciplined through volatile periods ahead

Gremonprez and McLoughlin took a moment to remind us that, when financial markets become volatile, panic is not an investment strategy. Staying disciplined, diversified and invested has always served investors well over the long run. That said, McLoughlin pointed to sectors that are expected to outperform and underperform as the risk of a global recession grows.

Typically cyclical in nature, energy is the only sector that generated a positive return in the first half of 2022, largely in response to the sharp rise in oil and gas prices. Defensive sectors, such as utilities, health care and consumer staples, performed relatively strongly, which is expected during periods of slower economic growth. Infrastructure also outperformed, largely in response to the sector's inflation-hedging features that tend to help investments within the sector outperform during slower-growth periods. The more cyclical parts of the market – including consumer discretionary, industrials and information technology – underperformed over the first half of 2022.

Responsible investing underperformed over the first half of the year, but by only around 1%. This was mainly in response to the outperformance of energy markets. That said, environmental, social and governance ("ESG") funds have slightly outperformed market-cap indices over the last decade, and have significantly outperformed energy benchmarks, so ESG's history of performance has been positive overall, McLoughlin noted. "We believe the medium- to long-term outlook bodes well for ESG returns, compared to what we've seen from the start of this year. This is supported by investments in renewables and a push towards clean technologies."

As we heard in our mid-year outlook, monumental events around the world have caused the global economy to shift in many new ways. In times like these, clients need your financial expertise to help them understand how global developments may impact their portfolios and long-term financial goals.

We hope the clarity provided to you by our guest speaker on this call helped to enhance your global perspective and ability to address your clients' financial concerns as you help them navigate the rapidly evolving global economic landscape in the months and years ahead. For more information, please contact your Canada Life wealth wholesaler.