YEAR IN REVIEW

2022

In focus

- Runaway inflation and aggressive monetary policy tightening by major central banks dominated the market narrative for the year. China's COVID restrictions and property slump, and the Russia-Ukraine conflict, added to worries about global economic growth, the corporate earnings outlook and consumer and business confidence in general. Global equities declined for the year, but markets surged in the fourth quarter as inflation appeared to have peaked. Global supply chain constraints, a key driver of global inflation, eased as transportation costs and inventory shortages declined.
- Among regions, Canadian equities fared better than most of their developed market peers. The economy benefited from strong export demand, while consumption moderated. U.S. and European equities declined as corporate earnings growth expectations moderated and investors grew increasingly concerned about high valuations, particularly in the information technology sector. In Asia, China was largely untouched by inflation concerns, but restrictions due to the zero-COVID policy resulted in weakening economic growth, while the fallout of regulatory changes and a property sector slump further dampened sentiment.
- On the monetary policy front, the U.S. Federal Reserve (the Fed), the Bank of Canada (BoC), the Bank of England and the European Central Bank announced a series of sharp increases in their policy rates and signalled that rates will need to go higher still, even if at a slower pace. The Bank of Japan, however, maintained its ultra-loose monetary policy regime.
- As interest rates rose, global investment-grade and sovereign debt came under pressure. Bond yields rose to compensate for higher interest rates. Global high-yield bonds fell, but outperformed a larger decline in global investment-grade bonds, due to more attractive yields. Default rates among high-yield bond issuers were relatively muted, and many investors expect the sector to perform well, given generally stronger fundamentals for companies than in previous cycles.

The year 2022 was an outlier, because both bonds and equities performed poorly.

Annual nominal returns of S&P 500 and U.S. ten-year Treasuries, 1870–2022. Data for 2022 are for the year to December 1, 2022. Source: Pre-2021 data from Òscar Jordà, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick, and Alan M. Taylor, "The Rate of Return on Everything, 1870–2015," *Quarterly Journal of Economics,* 134(3), 1225-1298, 2019. Post-2020 data from Refinitiv and Fidelity International, December 2022.

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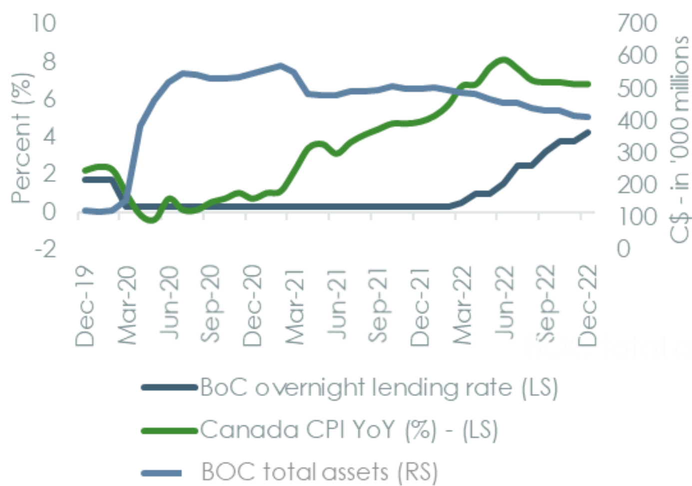
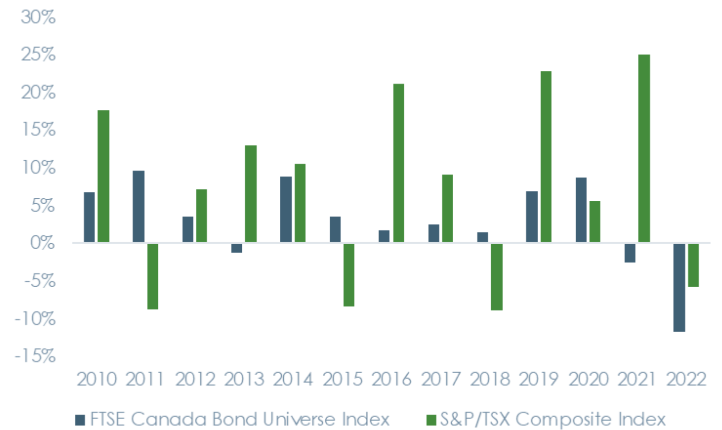
Monetary policy tightening and moderating inflation



Source: Bloomberg, as at December 31, 2022

Equities and bonds declined for the year.



Source: IMF, World Economic Outlook; GDP growth data for 2021 to 2023 based on estimates, October 2021.

A challenging year for investors

Canadian equities declined for the year. At a sector level, health care, information technology and real estate were the worst-performing sectors. However, gains in the energy sector stood in contrast to the broader decline in Canadian equities, with rising oil prices supporting earnings.

Technology names declined, mainly on valuation-related concerns, and real estate came under pressure, because rising interest rates would affect demand for housing. While the big Canadian banks reported higher earnings in October, their share prices declined over the year on the risk of rising defaults and foreclosures due to an uncertain economic outlook. In the final quarter of 2022, signs of peaking inflation helped reverse some of the weakness in equity and fixed income markets.

The BoC raised its target for overnight interest rates to 4.25%. Additionally, the central bank reduced its balance sheet, offloading bonds that it had acquired as part of its COVID-19 stimulus package. The effects of interest rate increases were apparent in interest-sensitive areas of the economy, as demonstrated by reductions in home sales, household spending and business confidence. However, investors do not expect the tightening cycle to end in the short term, given robust labour markets.

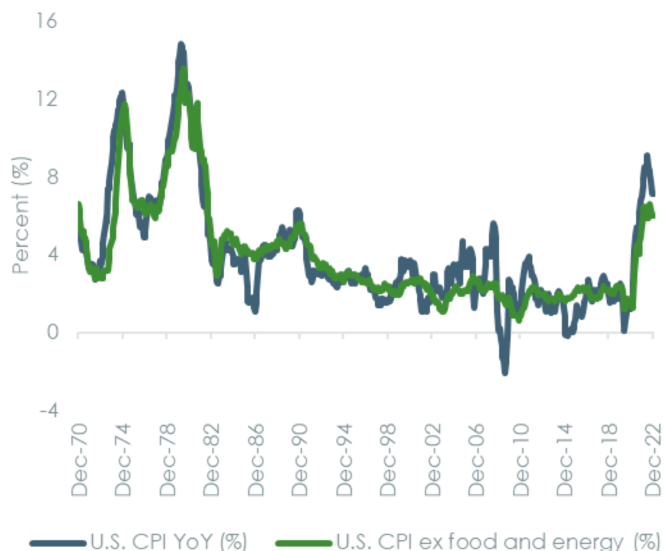
Bonds under pressure

Canadian investment-grade bonds declined for the year as yields rose in line with higher longer-term interest rate expectations. The Canadian investment-grade bond index declined by 11.7%, while yields rose to nearly 4.3% toward the end of the year, from about 1.9% at the beginning of the year. With early signs that inflation could be moderating, Canadian investment-grade bonds gained modestly in the final quarter of the year.

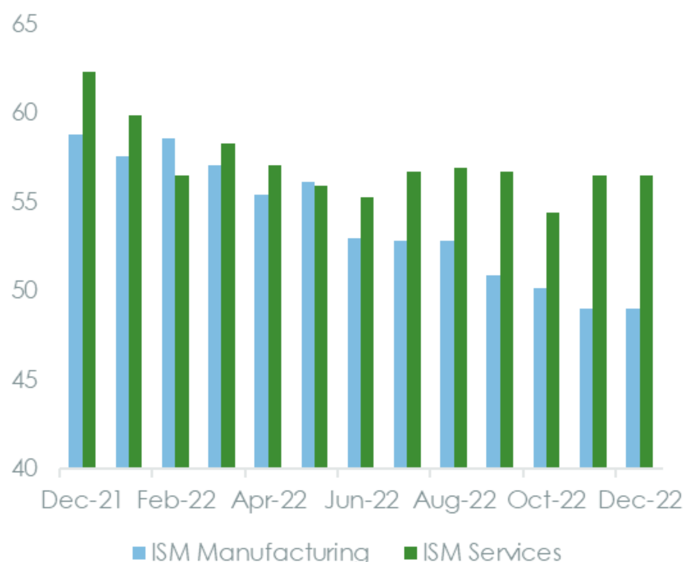
The economy on a sound footing

Canada’s economy continued to show signs of resilience. Preliminary data for November showed that while activity in the natural resources sector declined, wholesale trade growth was robust. The trade surplus also expanded due to higher consumer goods exports.

Early signs of moderating inflation



U.S. ISM services index in expansionary territory



Source: Bloomberg, as at December 2022. ISM Index: An index value over 50 indicates expansion in activity, while a value below 50 indicates contraction in activity.

U.S. equities and bonds declined.

The rising cost of capital (in the form of higher interest rates) weighed on U.S. equity and fixed income markets for the year. Valuations corrected sharply over the year, bond yields rose, and earnings growth expectations moderated as the Fed raised its benchmark rate of interest by 425 basis points over the year. The ongoing Russia-Ukraine conflict added to inflationary pressures, driving up oil prices, which benefited energy producers.

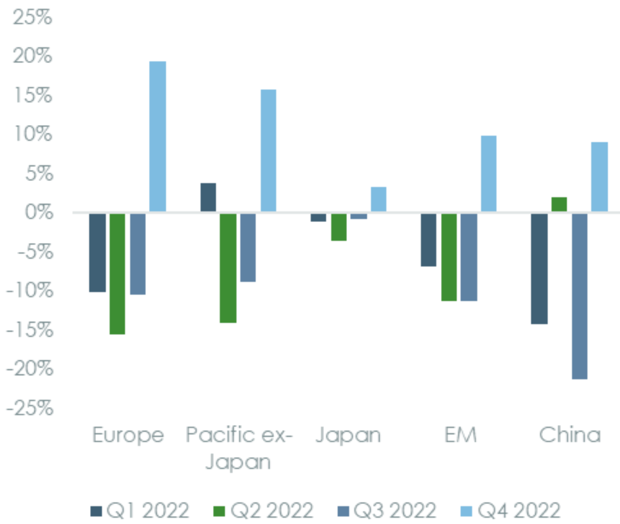
Major technology companies such as Meta Platforms, Amazon and Alphabet (among others) declined sharply. Investors worried not just about their high valuations but also about the outlook for earnings, as rising inflation may further erode consumer purchasing power. Elsewhere, companies exposed to the housing market, including real estate companies and lenders, came under selling pressure.

Investor sentiment turned more favourable toward the end of the year on signs that inflation may have peaked. However, with unemployment rate holding steady at 3.5% in November 2022, job vacancies still plentiful and service sector inflation remaining sticky, many investors remain cautious in their outlook for the short to medium term. Merger and acquisition activity declined over the year, reflecting a more challenging environment for companies seeking to raise funding.

Changing bond investment landscape

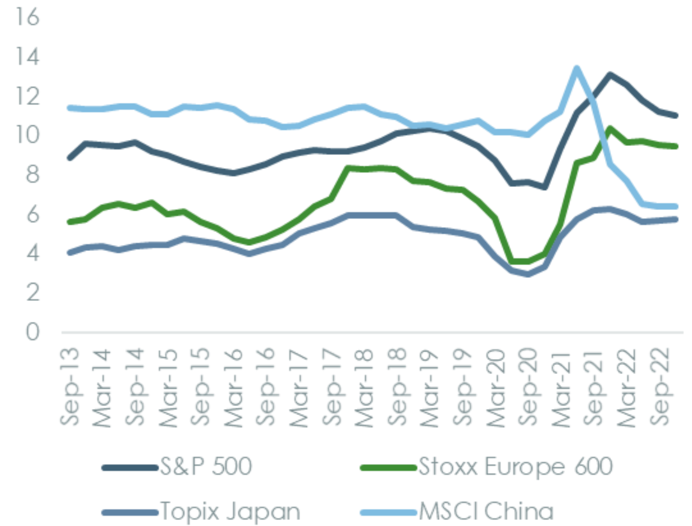
In fixed income, ten-year U.S. Treasury yields ended at 3.9%, after peaking at 4.2% in October. Investment-grade, corporate and high-yield bonds performed largely in line with government bonds. Low default rates, strong balance sheets and the long maturity of issued debt, as well as generally high interest coverage, may have helped limit the downside for corporate and high-yield bonds. Income-seeking investors may now buy yields that are at a par with the dividends offered by big multinationals and that do not carry the same kinds of risk – provided the default rate for both countries and companies remains low.

A strong fourth quarter on signs of softening inflation



Source: Bloomberg, as at December 31, 2022.

Declining profit margins



Source: Bloomberg. Quarterly data in percentage points.

Stagflation risk clouds the outlook for Europe.

The diminishing of the reopening boost and fiscal and monetary tightening also affected European and Asian equities. In China, stringent COVID-19 lockdowns contributed to a broad-based decline in GDP growth for the year.

European equities were hit by the ongoing conflict between Russia and Ukraine and by China's zero-COVID policy, which triggered a commodity supply shock that pushed inflation to multi-decade highs, and that also brought increased concerns that the economy is heading toward stagflation (that is, low economic growth combined with high inflation). Central bank hawkishness, record low consumer confidence data and a slowdown in leading indicators then led the market narrative to switch from stagflation fears to recession fears.

Global stock gains in the final quarter of the year, especially in Asia, were aided by steps in China to ease pandemic quarantine requirements, potentially laying the groundwork for a reopening of its economy in 2023. Inflationary pressures from input prices started to ease, even though the effects of the energy crisis continued to be felt. In Europe, there were some positive surprises among corporate results, but price reactions were skewed to the downside. In China, earnings continued their disappointing run, with no sectors exceeding expectations overall. Rising input costs were among factors eroding profit margins globally.

Subdued economic data, but upside potential in China

Business activity for the eurozone continued to weaken in November, and the economy remained in contraction for a fifth consecutive month, with manufacturing and service sector output falling. The eurozone's third-quarter GDP grew marginally, by 0.2%, a decline from the 0.8% recorded in the previous quarter. While new orders fell for the fifth month in a row, supply chain delays have eased, taking some pressure off input prices.

In China, the central bank and the government announced a number of liquidity and economic support measures that are expected to pave the way for stronger growth after a tough 2022.

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Appendix

Global Markets (returns in Canadian dollar terms)			
Indexes	**2022**	**2021**	**Return (%)**
S&P/TSX Composite	19,384.9	21,222.8	-5.75%
S&P 500	3,839.5	4,766.2	-12.42%
NASDAQ	10,466.5	15,645.0	-27.81%
DJIA	33,147.3	36,338.3	-0.38%
Russell 2000	1,761.2	2,245.3	-14.92%
FTSE 100	7,451.7	7,384.5	-0.02%
Euro Stoxx 50	3,793.6	4,298.4	-7.98%
Nikkei 225	26,094.5	28,791.7	-13.80%
Hang Seng	19,781.4	23,397.7	-6.52%
Shanghai Comp.	3,089.3	3,639.8	-14.07%
MSCI ACWI	1943.9	2336.1	-12.25%
MSCI EM	956.4	1,232.0	-14.36%
Fixed income	**2022**	**2021**	**Return (%)**
FTSE Canada Uni.	1,051.2	1,190.3	-11.69%
BBG Global Agg.	445.9	532.4	-10.16%
TSX Preference Shares	1,596.2	1,948.5	-18.08%
Bond yields	**2022**	**2021**	**Change (bps)**
10 yr Canada Govt.	3.30%	1.43%	187
10 yr U.S. Govt.	3.87%	1.51%	236
30 yr Canada Govt.	3.28%	1.68%	160
30 yr U.S. Govt.	3.96%	1.90%	206
Commodities*	**2022**	**2021**	**Return (%)**
Oil ($/bbl.)	80.26	75.21	6.71%
Natural gas ($/Mmbtu.)	4.48	3.73	20.11%
Gold ($/Oz.)	1,824.02	1,829.20	-0.28%
Silver ($/Oz.)	23.95	23.31	2.75%
Copper ($/lbs.)	3.8105	4.4635	-14.63%
Currencies	**2022**	**2021**	**Return** (%)**
CAD/USD	0.7378	0.7912	-6.75%
USD/EUR	0.9341	0.8793	6.23%
CAD/EUR	0.6894	0.6954	-0.86%
USD/JPY	131.12	115.08	13.94%
USD/CNY	6.8986	6.3561	8.54%
USD/MXN	19.4999	20.5294	-5.01%
GBP/CAD	1.6395	1.7107	-4.16%
GBP/USD	1.2083	1.3532	-10.71%

Source : Bloomberg, Refinitiv. Total returns. *Commodity prices and returns are quoted in USD. **Price return.

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