RBC Dominion Securities Inc.

Wealth for Life

Wealth Management
Dominion Securities

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Equity markets proved resilient in the fourth quarter after the September correction.

Concerns about a slowing economy due to rising COVID-19 cases in August gave way to optimism as new cases rolled over and declined in October. In the fourth quarter, equity markets gained 11% in the U.S. (S&P 500) and 6.5% in Canada (TSX). Notwithstanding softening equity markets late in the quarter due to spiking new Omicron variant cases, 2021 equity returns were robust at 28.7% and 25.1% for the S&P 500 and TSX, respectively.

During the quarter, economic activity continued to expand with many data marks posting continued strength.

Job growth in Canada and the U.S. continued at a pro-growth rate, delivering unemployment rates of 3.9% and 5.9%, respectively, in the U.S. and Canada. In fact, employment participation rates in the U.S. reached the best levels since the 1970s while Canadian participation rates approached record levels. With more than 10 million job openings in the U.S. and only three to four million (seven million if we include part-time and discouraged workers) remaining unemployed from pre-pandemic levels, continued job growth and lower unemployment is to be expected in 2022. In Canada, participation rates have recovered to pre-pandemic levels and all jobs lost in the pandemic have been recovered.

The economic backdrop and momentum going into 2022 closed out 2021 very favourably.

The escalation in new Omicron COVID-19 cases did raise concerns in December. Spiking new cases triggered more economic lockdowns, a decline in December retail sales, as well as modestly lower manufacturing and servicing activity in December. However, given the characteristic ballooning of Omicron cases, expectations are for a rapid retreat later in January as experienced in other countries. The slower economic growth witnessed in December is expected to be a temporary event, related to Omicron.

Some easing of supply infrastructure was witnessed late in the quarter, as container shipping rates look to be rolling over from peak levels and semi-conductor shortages appear to be easing, but bottlenecks and depleted inventories persist.

With inventories of everything at depleted levels and underlying consumer demand strong, manufacturing and production of goods and services are poised to continue reinforcing the prospect of continued economic and job growth in 2022.

As the year and quarter developed, the scarcity and strong demand for goods translated into increasing prices.

The cost of fuel and transportation increased the price of all goods and services. December inflation closed the year at 7% in the U.S. while November inflation in Canada came in at 4.7%, an 18-year high. With

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consumer demand remaining strong and inventories low, central banks in developed countries are poised to discontinue easing monetary policy and look to normalizing (increasing) interest rate policy.

With inflation increasing throughout the last quarter of the year, the mere mention of tightening central bank policy was enough to propel the interest rate on the 10-year bond upward from 1.5% to 1.7% at year-end, a large move by market standards.

The upward move in interest rates was swift and, at the time of writing, the 10-year bond topped 1.8%. Equity markets reacted with volatility and to the downside in select industry groups. It's noteworthy to observe that, throughout history, equity markets often react to discussions of central bank tightening policy with volatility. However, corrections and recessions are usually the result of central banks increasing interest rates (tightening) to high. Current conditions suggest central banks will start by reducing/eliminating quantitative easing (bond purchases) activity, and are still perhaps a quarter or more from raising rates. In addition, persisting headwinds from Omicron or easing of bottlenecks could work to ease inflationary pressures, offsetting the central banks' rationale for, or extent of, higher interest rates. With underlying economic fundamentals – corporate and consumer –so strong, any risk of recession from excessive interest rate tightening seems to be in the distant future.

Talk of rising interest rates has sparked debate over valuations and the preference for value or growth.

It's interesting to note that central banks won't even start to raise interest rates for some time yet. At 1.8%, the 10-year bond has already priced in several interest rate increases. Furthermore, the 10-year yield has been below 3% since 2010, and retirees usually need 5% return for retirement income; so, if the 10-year bond goes to 2% or 2.5% or 3%, investors generally have no alternative but to invest in equities. Similarly, corporate investments are made based on long-term interest rates that have typically been higher than current expectations, so rising interest rates are unlikely to influence corporate investments. Consequently, the prospect of rising interest rates is not significant enough to adversely impact corporate growth or demand for equities. Valuation metrics may be impacted in the near term as equity markets digest central bank timing and the corporate earnings outlook.

As I recall, in 2016, with the 10-year bond at 1.5%, the central banks' first rate hike produced a modest correction like that occurring at the time of writing.

Subsequent interest rate hikes through 2016-2018 saw representative value and growth equity investments increase over 170% in that period. Although inflation is higher now than in 2016-2018, expected corporate earnings momentum has the propensity to justify valuation metrics as the economy expands and moves through the evolution of the COVID-19 recovery.

We are hopeful of an evolving COVID-19 recovery.

A resilient consumer is the cornerstone of the expected and continuing economic recovery. The average consumer is in the best financial condition they've experienced in a long time. Consumer savings are at a high, income and wages are strong and growing. Debts have declined, and consumer net worth is at an all-time high. Consumer spending on "stay at home" themes will eventually rotate to services and activities available from "reopening" that deliver enjoyment and social interaction. One can expect consumer demand for entertainment, travel, dining and leisure activities/hobbies to take centre stage. This rotation in consumer expenditures will, in the near term, be influenced by "pent up demand" just as their product consumption was, and will be, the leading driver of equity investments in 2022. It's clear that growth and value investments will benefit, but the focus will be on those companies with economically sensitive businesses.

Now, after a year of stellar equity returns, many are apprehensive about prospects for 2022.

Upon analysis of data going back to 1871, we find that after a year with an equity return greater than 25%, the average return the following year has been 14%, and almost 80% of the years present positive returns the following year (Bloomberg/Shiller). In years without an economic recession, the odds of a positive-return year following a big up year, like 2021, increase to 94%. As no recession catalysts seem likely in 2022, and economic and consumer fundamentals suggest continued momentum, we are constructive on equity markets and returns in 2022.

Steve Lester

As we move through a much-sought-after reopening through COVID-19 variants, we salute the unwavering commitment of all our heath care employees and first responders (including our grocery and essential workers) for the sacrifices they and their families make for all of us!

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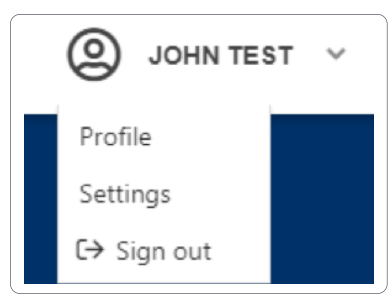

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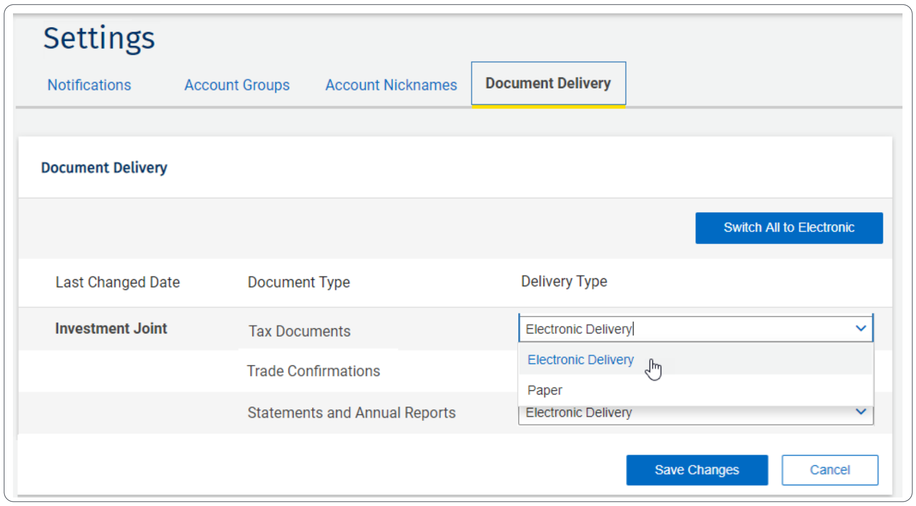

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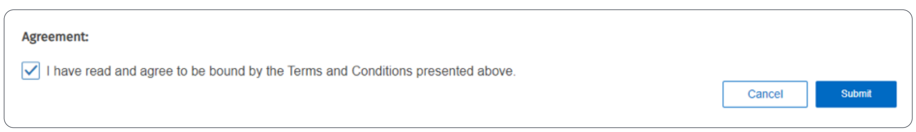

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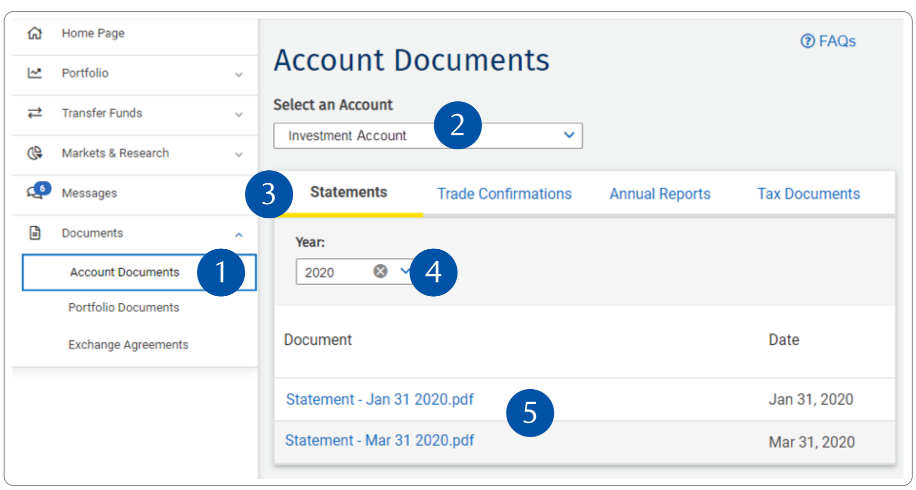

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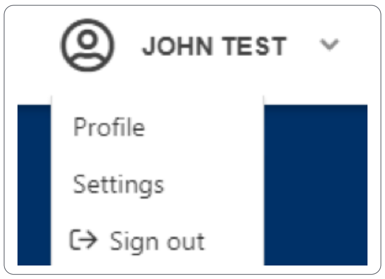

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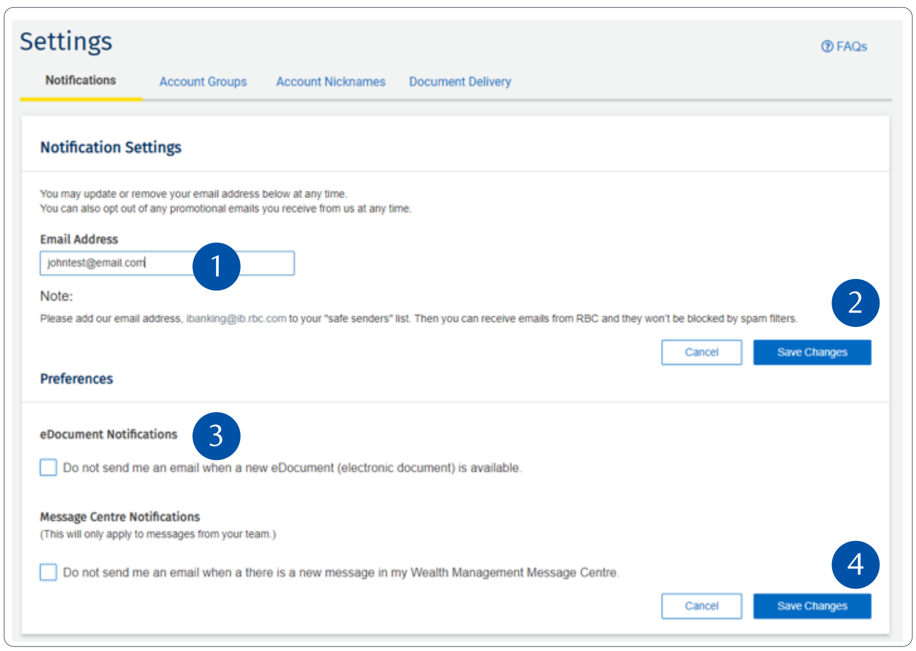

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