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Subject: VALUED CLIENT MAIL LIST: Economic Outlook - SPRING 2022
Importance: High

Source: Google Images

ECONOMIC CLIMATE CHANGE IS COMING

Optimism in 2022 from a diminishing Covid threat is now being severely tested due to changes in the global economy. At the outset of the Covid outbreak in 2020 we spoke about how this was a <u>health, not an economic issue</u>, and that the economic machinery was still all in place for recovery. This proved to be true as we have witnessed healthy growth in all sectors post March 2020.

Yet, in 2022 we now face an <u>economic issue</u> as the fiscal steps that were taken to help overcome the health crisis have worked too well: Low interest rates and government financial

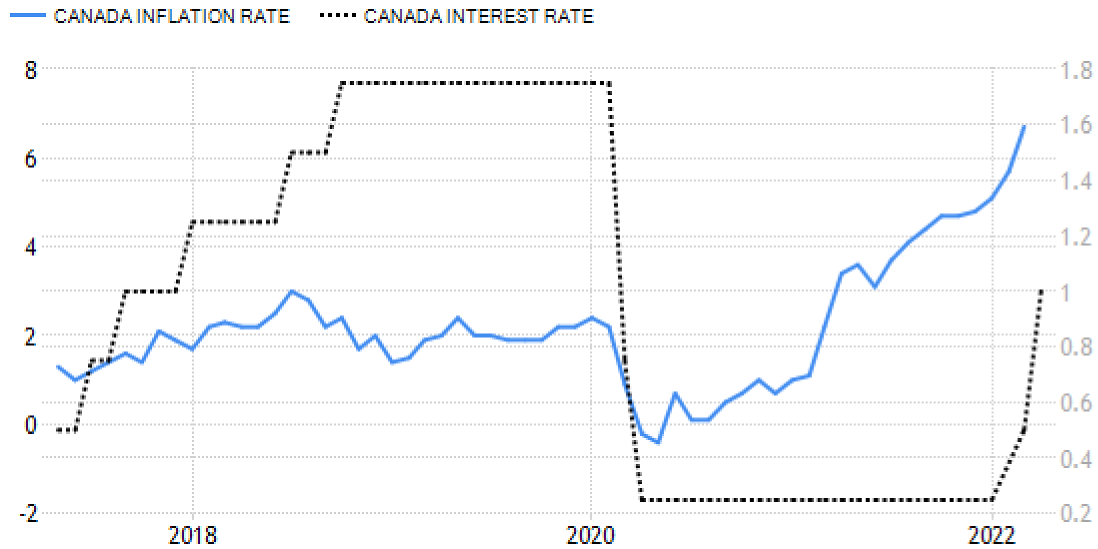
support have allowed populations around the world to weather Covid, return to the working world and demand a return to pre-Covid life. It now appears too much support has been provided for too long so that recovery has become too robust and is threatening a slowdown from an overheated economy.

Imagine driving on the highway and surrounded by slow traffic for a considerable distance when suddenly the traffic lightens and you feel free to accelerate to try to catch up on lost time. Looking down you suddenly realize you have exceeded the speed limit, you see a police radar control car ahead and are forced to slam on the brakes to reduce your speed although the road is clear and you are anxious to reach your destination. This is the consumer who has been constrained for more than 2 years during Covid and increased spending habits in a catch-up bid to get life back to normal. For some goods and services demand has exceeded the ability of the recovering economy to provide the supply. Consequently, consumption has been a primary initiator of core inflation and the excess speed over the limit.

Source: Google Images

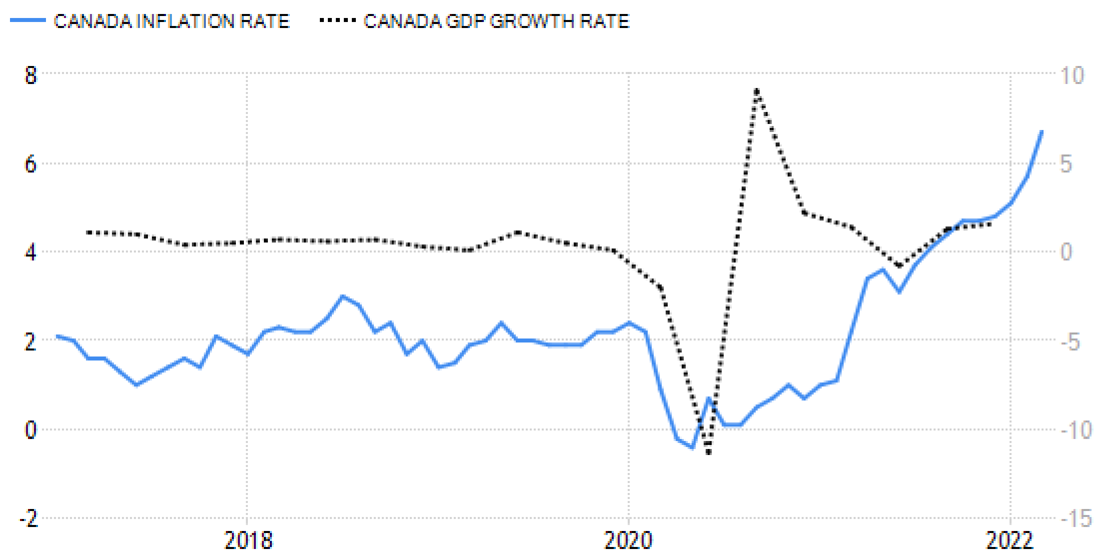
In response the Canadian and U.S. central banks are responding by suddenly and substantially raising interest rates in an effort to slow consumer consumption and reduce inflation pressure. We are likely to experience further and material interest rate hikes until they consider inflation is under control within their 2% range. But, inflation is not real growth and must be separated from GDP to recognize the economy's true underlying performance. We can see how inflation has undermined GDP growth particularly over the last year.

Canadian Inflation Rate vs Central bank rate



Source: Trading Economics

Canadian Inflation vs GDP Growth



Source: Trading Economics

WHAT CAN WE EXPECT THE NEW ECONOMIC CLIMATE TO BE LIKE?

Over the foreseeable future we can expect to see a return to a more moderate pace of life and economic growth. With companies continuing to demonstrate strong earnings and employment

remaining high, the likelihood of a recession or even stagflation is remote. Instead, we are likely to see:

- **Slower GDP growth.**
- **A higher and sustained but not prohibitive level of interest rates.**
- **Lower but not a calamitous decline in prices.**
- **Lower volatility and more stability in markets.**

Even the price of certain commodities such as energy and food, which are controlled beyond strict supply and demand dynamics, will moderate as consumers adjust their spending habits.

WHAT SHOULD WE DO WITH OUR PORTFOLIOS TO ADAPT THEM FOR THE NEW ENVIRONMENT?

The financial markets are reacting to the climate change and have slammed on the brakes pending signs that we will return to travelling within the speed limit. This means commerce, employment, consumption and all other economic dynamics will continue to find their course and re-build positive momentum as stable macro economic levels are achieved.

In the meantime, we should be adjusting portfolio assets according to their level of contribution during and beyond this current cycle:

- **Reduce growth (equity) assets to key holdings that are consistently profitable and provide core services required in all market conditions such as financials, telco and utilities; retain the "crown jewels". They tend to demonstrate lower volatility and are typically first to respond positively to improving conditions. They are also typically good providers of dividends.**
- **Seek and ensure most, if not all, assets are providing a satisfactory dividend, distribution or interest payment as an alternative income form of return to compensate for weak capital appreciation at this time.**
- **Maintain an active defensive cash reserve to help offset interim volatility and capital value weakness.**
- **Increase alternative assets for their contra equity market risk characteristics.**
- **Enhance tax efficiency where possible; a dollar in tax saved is a dollar earned.**
- **Incorporate specific hedge instruments which are designed to offset volatility vs creating returns.**

WHAT'S THE TAKEAWAY?

- **These portfolio measures are really prudent management actions for all conditions although their application AND PRIORITIZATION is more critical DURING WEAK MARKET CYCLES.**

- **ECONOMIC weakness has affected all asset classes and sectors beyond stocks and bonds including real estate, currency and other alternative assets. the key is to preserve capital TO THE EXTENT POSSIBLE by minimizing the volatility impact so that portfolio values DECLINE LESS RELATIVE TO THE MARKETS AND recover sooner and stronger than the most affected types of assets.**
- **IGNORE ALARMIST BUSINESS MEDIA COVERAGE AND THINK IN TERMS OF INVESTMENTS THAT HAVE INTRINSIC VALUE RATHER THAN SHORT TERM SPECULATIVE CLAIMS.**
- **RECOGNIZE THIS IS HOW THE ECONOMY AND THE MARKETS BEHAVE; MAINTAIN A DEFENSIVE POSTURE BUT EXPECT TO SEE OPPORTUNITIES EMERGE AS CONDITIONS TRANSITION AND STABILIZE.**
- **REMAIN COMMITTED TO THE STRATEGY THAT BEST SUITS YOUR NEAR AND LONGER TERM OBJECTIVES.**

Regards

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