Going Back To The Basics ~ Laurel Hickey & Garth Bluekens

Comments from the CIO's office

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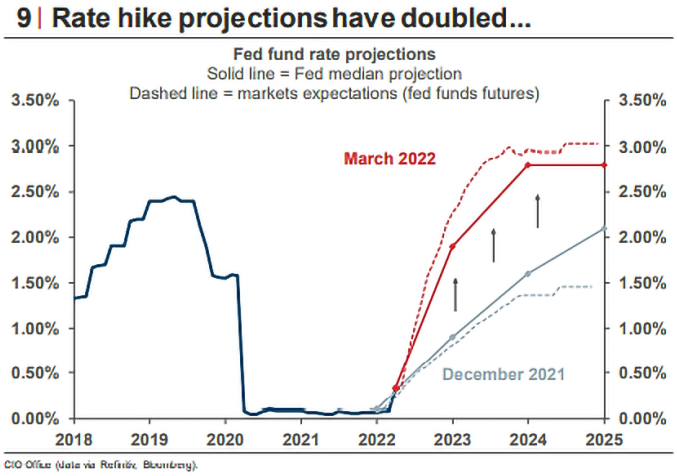
No doubt about it: the Federal Reserve considers that the state of inflation and the job market no longer justify the current level of monetary accommodation. Thus, in addition to delivering its first rate hike in March (unsurprisingly), it is now projecting 6 more increases in 2022, that is at each of its upcoming meetings. For their part, markets are even assuming that 2 of these 6 hikes will be of 50 bps, for a grand total of 225 bps in rate increases in 2022. This is slightly more than double what was expected last December (chart below).



These circumstances led to a meteoric rise in 2-year yields, which settled a few basis points below their 10-year counterpart, also up sharply.

At these levels, it wouldn't take much for the curve to invert. Historically, such a signal has often been followed by a recession within a 6 to 24 month time frame, so it would likely cause concern for many investors. Yet, a nuance is in order. In reality, this phenomenon mostly indicates the market is already starting to anticipate the eventuality that the Fed will be forced to backtrack on its monetary tightening. This always heralds an economic slowdown, but not necessarily a recession.

For instance, the 2019 inversion essentially coincided with the first of 3 rate cuts by the Fed this year. Yet, were it not for the pandemic, it is highly likely that the U.S. economy would have continued to expand in 2020, regardless of the inversion.

Also revealing is the rapid tightening of monetary conditions in 1994 – a period that the influential St. Louis Federal Reserve President James Bullard claims is "the best analogy here." Back then, fearing overheating, the Fed raised its benchmark rate by a grand total of 300 bps in 13 months, a move that also resulted in a precipitous flattening of the 10-2 year curve (stopping a few basis points short of an inversion). Subsequently, economic activity slowed, the Fed backed off its benchmark rate by 75 bps in 1995-96, and the economic expansion continued apace.

This time, will the Fed manage to engineer a normalization of monetary policy – or even a brief period above the neutral rate as Bullard seems to recommend – without causing a recession? The magnitude of the Fed's and the markets' projected monetary tightening raises the risk of a sharp economic slowdown, but talks of a recession seem premature at this stage. After all, the Central Bank is just starting its rate hike process and the last few months have shown that its projections are anything but certain. As such, the Fed will have the opportunity to revise its intentions (which could hardly be more hawkish than what the markets currently expect) based on the evolution of the economy. In any event, it would take a much more broad-based inversion of the yield curve for us to significantly increase the odds of a recession. Inversions with maturities below 2 years could bring this about, but we are not there yet.

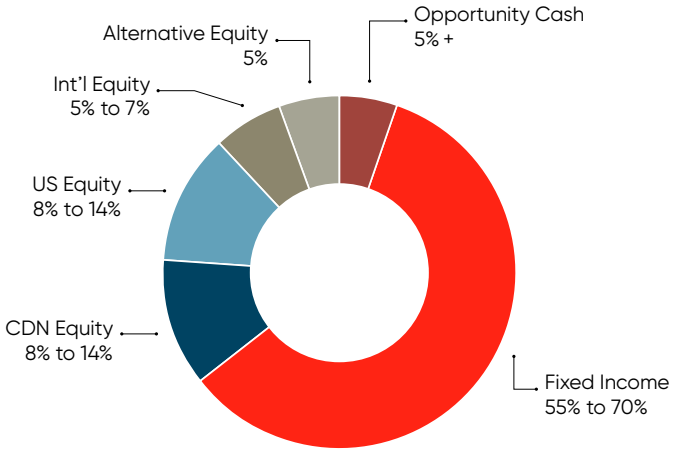
What's Control Got To Do With It?

Market Volatility continues to cause uneasy feelings with investors. With factors like rising interest rates and war, we can feel lost when it comes to how to approach investing and your finances. In situations like these it is important to come back to the basics and look at what you can and cannot control in these uncertain times. First, when it comes to what you can't control, one big factor right now is the inflation rate. We are coming out

of a period of global supply issues and transitioning to a time of higher growth and rising interest rates. The rising inflation lowers our buying power and causes shrinkflation, giving us less of an item for the same cost as before. Higher inflation is also a cause of geopolitical events that are causing gas and commodity prices to be at a high not seen in many years. Usually when you spend more money, it is from your own doing and you have the power to change it, as you can cut back discretionary spending. In the case of higher inflation, you still need to gas up your car and get groceries, but now it comes at a higher cost.

We must also remember there are factors that we can control. First, your risk tolerance and asset allocation. The current market volatility is a great example of why asset allocation is so important. With rising interest rates, the price of bonds goes down. Since all asset allocations have fixed income, this can negatively affect performance especially for more conservative portfolios. Though the US market is down year to date, the Canadian market is slightly positive as of mid-April. The positive Canadian market is due to the rally in commodities. These gains in equities help to offset some of the losses in fixed income. Another factor we can control is managing your life goals and how much you save/spend. When building your retirement plan, we look at how much you want in retirement and what needs to be done to get there. These numbers are fluid, and we can always look at different scenarios to determine how a change in the amount you save or how much you spend will alter your retirement projection.

Conservative Income Investment Goal Allocation



Your Investment Policy

CONSERVATIVE INCOME: On the whole, you want fixed income investments. You want to preserve your capital or create a source of periodic income to finance ongoing expenses. You are not against the idea of investing a small part of your portfolio in equities, mainly to counteract the effects of inflation. If you feel that your risk tolerance has shifted please let us know!

Source: This information is for illustration purposes and subject to change. Your portfolio may not hold all of these positions. We enhance the composition of your portfolio with additional equity solutions that are not illustrated. The weightings change with market fluctuations and model rebalancing.

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