Investor Insights

Geopolitical Uncertainty and Volatility

Our geopolitical situation took a major leap with the invasion of Ukraine by Russia on February 24th. Markets for equities, bonds and commodities have been agitated even more ever since. The S&P/TSX Composite Index, with its strong cyclical and energy weighting recently traded at an all-time high of 22,087 on Mar 29th while in the U.S. the S&P500 Index, was trading at 4,632 – down a few percent from its early January all-time high. In Europe the markets are down even more from their January highs, the German DAX Stock Index was down about 9% and similarly the EURO STOX-–X 50 Index. Volatility is rising in response to reports on events on the Ukrainian front, moves and countermoves on the politicians on either side. Domestically, in North America, it is clear that the fighting in Ukraine has exacerbated the short-term outlook for inflation with sharp rises in energy, metal and agricultural prices. This comes as central banks in North America, Europe and elsewhere had already tied themselves to start raising interest rates to curb demand in their economies and blunt the inflationary advance.

A continued feature of the performance of both the S&P 500 Index and the S&P/TSX Index year-to-date had been the relative weakness of technology stocks (more limited in Canada but with the heavily weighted Shopify pulling down the index). That underperformance may be starting to bottom out. Defensive stocks such as utilities have also started to perform

Rana Lee, CIM

Wealth Advisor & Portfolio Manager

Tel: 604.623.6791
Cell: 778.986.8210
rana.lee@nbc.ca
www.ternionwealth.com

March 31, 2022
Vol. 1, No. 3

better over the recent while, but the strength seen in the Canadian banking sector has started to level off with the worsening outlook for financial markets where activity had been very strong and contributed to records results, looking shakier and yield curves flattening.

With all this geopolitical uncertainty how we adjusting our portfolios?

Unpredictability & Increased Risk

The unpredictability of Putin's plans is prevalent, and no one knows what exactly lies ahead, not even sure if Putin knows himself. What that means is uncertainty will continue to dominate, hence volatility and risk. How do we counteract that? It is our job to mitigate those risks.

In terms of overall asset mix, on a consolidated view of accounts, generally speaking our mix of portfolios at the end of last year provided equity exposure in the 70% - 75% range and fixed income and cash allocations in the 30% - 25% range. With our determination early in the year that financial market risk was increasing and that the future course of the economy, inflation and interest rates were hard to determine with any sort of conviction, we set out a on policy of reducing risk by lessening exposure to equities and increasing exposure to cash and short-term bonds meaningfully. Since early in the New Year, we have progressed methodically along this path. Equity allocations now are in the 55% range on a consolidated view of accounts. The Canadian equity component is considerably less risky as there is a high level of defensive stocks such as the pipelines, utilities, REIT's and telcos. In addition, we have some cyclical exposure to energy and agriculture in names like Canadian Natural Resources, Cenovus, Tourmaline and Nutrien. We have also initiated positions in the gold sector, Agnico Eagle and Sprott Physical Gold & Silver (CEF).

With the price of oil having jumped from $80 a barrel to either side of $130 a barrel since early this year and gold breaking through the $2,000 an ounce for the first time since the summer of 2020, where do we go from here?

Oil prices following the Ukraine invasion have been and continue to be highly volatile. Resulting in energy stock prices to experience huge upswings. If we look back in history and reference the time during the middle east Kuwait invasion, oil prices fell drastically in the tune of 75%, from $40 a barrel to $10 a barrel due to a severe shortfall of production and supply. But that was quickly remedied by additional production from the Organization of Petroleum Exporting Countries (OPEC). In our current situation, no such capacity is available.

Historically, high oil prices have led to demand destruction and a peak in pricing. Some of the best work we've studied suggests that when oil demand gets to 5% of global GDP, you start to get demand destruction. Some suggest that would occur around the $130 a barrel level. To average that price a year would mean oil to rise to $180 a barrel – a price not outside the realm of possibility. Thus, a preliminary strategy to sell out of energy positions at certain levels of targeted oil prices to crystalize the gains we've experienced in that area and to best prevent being caught in a situation of demand destruction of oil prices. Preliminary thoughts would be sustained oil price levels in the $130 level, $150 level and finally the $175 level.

As for the longer term, gold will do eventually better in a deflationary environment, but we currently remain in an inflationary environment. This will likely stop gold from significantly rising past the August 2020 high. However, the prospective further rise in oil prices as well as other commodity prices combined with central bank rate increases run the serious risk of recession developing in North America and globally. We are bullish in gold longer term, and intend to be adding to it over time. Like the energy stocks were last year, this group is historically very cheap on fundamentals and is our best choice to act countercyclically to the market.

Lastly, long-term bond yields have been highly volatile in the last couple months as markets try to wrestle with how persistent inflationary pressures will be. Continued high inflation in the short term will force central banks to curb demand side with higher interest rates. As the consumer becomes less confident and trend continues, recession risks increase. The yield curve between the 2-yr and 10-yr has been flattening and recently inverted, which is a warning light to investors that a recession may be coming. Value stocks moved strongly relative to growth starting early in the New Year as yields rose sharply. The Ukrainian war resulted in yields rising once more and Value outperforming since the outbreak. However, if the long bond yield trend is indeed headed down a sustainable basis as economies weaken, the recent outperformance of the value trend could be ending. If such a decline in long bond yields does occur, it will benefit our US/International portfolio which has been lagging in performance comparatively to our Canadian portfolio. Overall, however, any resolution/ceasefire in Ukraine although highly unpredictable would mean a significant rise in equity markets and a quick dramatic reversal of the recent strength in commodity prices.

Sincerely,

Rana Lee, CIM

Wealth Advisor & Portfolio Manager

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