Johnstone Wealth Management Market Commentary December 31, 2022

For the year, equity markets had to deal with Russian invasion of Ukraine, record inflation, an oil price shock, rising interest rates and a potential recession on the horizon – it's fair to say that 2022 has proven to be challenging on many fronts. For financial markets, this context resulted in pullbacks for stocks and bonds in the first half of the year, followed by a six-month period of ups and downs with no clear direction, leaving the equity markets down for the 4th worst performance year since 1945. The 4th quarter was about recovery with stocks and bonds recording a positive quarter, thanks mainly to investors' general sense of relief that the pace of rising inflation has finally started to slow.

Equity markets finished the year trending on a more positive note, with most major indices posting gains in the fourth quarter. European markets were very strong as receding domestic energy prices and lessened fear of geopolitical contagion led buyers to emerge to take advantage of fallen valuations. Emerging markets were also improved as lockdowns in China were lifted and the country began the process of exiting its zero-COVID strategy. US equity markets lagged others, although they still posted healthy returns in the quarter. The Canadian market posted more modest gains; nevertheless, it remains one of the relatively better-performing regions globally for the year. From a sector standpoint, Energy was once again a relative outperformer globally and continued to substantially lead most major indices year to date. The Financial sector was also strong as investors continued to price in the benefits of higher interest rates for banks and insurance companies. Conversely, the Consumer sector was a laggard as concerns have developed regarding the effect higher interest rates will have on spending.

The last quarter was a positive cap to one of the worst years for the bond markets. The shocking rapid rise in inflation, followed by strong policy stances to curb the rise through interest rate hikes resulted in extreme increases in yields that the market was not ready for. Government of Canada 10-year bond yields more than doubled, rising from 1.45% to 3.30%, while the 2-year yields more than quadrupled, going from 0.95% to 4.05% by the end of 2022. The unprecedented pace of interest rate increases has brought the policy rate to 4.25% in Canada, its highest level in 15 years.

In the last two years, the driving force for economies and financial markets has been the dramatic volatility in inflation. Prior to the pandemic, the 10-year average for inflation in Canada was near 1.5%, and we just recently saw an 8.1% peak in the summer. Ultimately, we expect inflation to come down, this year as the embedded interest rate hikes and reduced fiscal stimulus lead to slower consumer spending. We are already seeing signs of inflation peaking on a monthly basis as growth slows.

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There is a greater than normal level of uncertainty surrounding the current assessment of market risks, overall, the economic fundamentals are pointing to a headwind for equity markets in the near term. Given that the stock market is a leading indicator in and of itself, some of these economic headwinds are already priced into markets. What investors have to decide is whether this margin of safety is enough.

As we move forward, the range of possible scenarios is wide as markets navigate an environment of rising interest rates and slowing economic growth. We believe what's most important is being disciplined in adhering to the variables that we can control, such as risk management, active management and asset allocation. Given the wide range of possible scenarios, we remain balanced in our approach in an effort to build resilience over the long-term and not being overly exposed to any one outcome.

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