Market and volatility information
January 2022

What is causing the volatility and market downturn?

The start of 2022 has not been kind to U.S. equity investors. As of Monday, January 24, the Dow Jones, S&P 500, and NASDAQ Composite index were down approximately 7%, 10%, and 14%, respectively. We believe that this nervousness towards risky assets is primarily caused by the uncertainty surrounding the path of the U.S. Federal Reserve's rate hike in this period of continued high inflation. It should be remembered that markets tend to react negatively in times of uncertainty for fear that the worst-case scenario will materialize.

The U.S. central bank has indeed signaled that it is likely to begin raising interest rates sooner than expected, but we do not believe there is any reason to be concerned. Despite the short-term volatility that a monetary policy tightening will create, this is a positive development for the economy as it is a signal that the economy is now strong enough to stand on its own two feet and no longer needs the ultra-accommodative monetary policy implemented in early 2020. It is important to note that the U.S. Federal Reserve is not changing its policy from a neutral to a restrictive stance, but rather moving from an ultra-accommodative stance as never seen before, to one that remains very accommodative even after the anticipated hikes.

Why the strong market reaction if you say policy remains very accommodative?

It's uncertainty and fear that are the main factors. Investors like to have a clear idea of what they want so they can position themselves to protect themselves from risk and exploit opportunities. We have seen many similar situations in the past where markets react badly to the anticipation of a policy change prior to a U.S. Federal Reserve meeting and sometimes we see a market rebound regardless of the outcome just because the uncertainty is no longer there as people are now better informed.

We are also at the beginning of the 2021 fourth quarter earnings season, and the market seems to be rewarding or punishing individual companies based on fourth quarter results and their 2022 forecasts.

Supply chain issues and high goods costs are also creating uncertainty for some companies over the next few quarters, adding to the temporary pressure on prices.

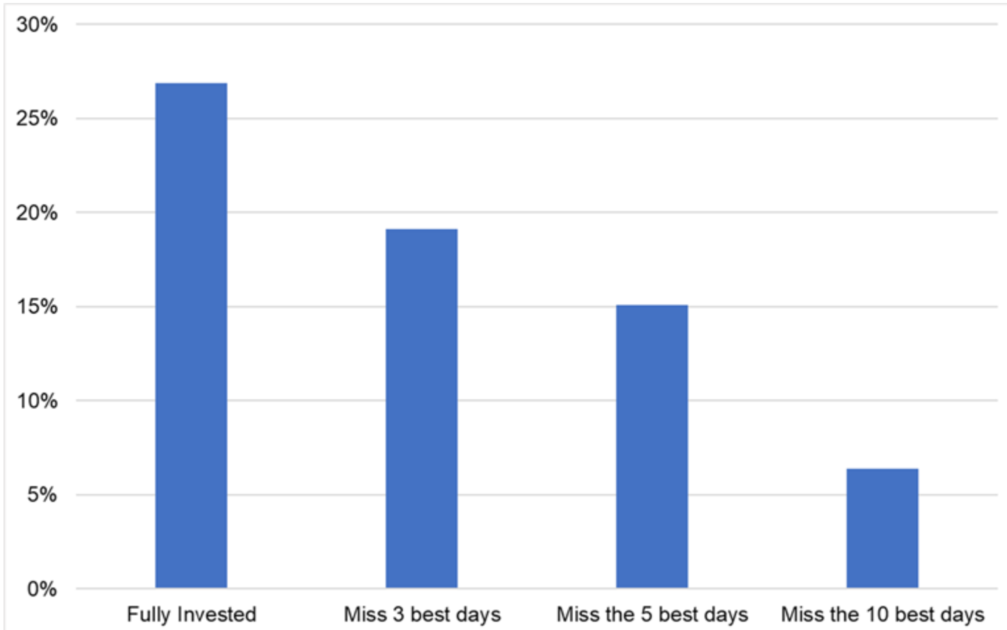
Geopolitical risk is also playing a role in the market turmoil, as renewed tensions between Russia and Ukraine, among others, are making headlines. It is always in the background and when an important one surfaces, we often see a short-term negative reaction. However, recent history shows that these reactions are usually more disruptive in the short-run than in the long-run.

What to do in these volatile times?

In the short term, markets tend to react negatively to the idea of the Fed removing this kind of stimulus, but that doesn't mean the party is over. It implies that the party won't be as entertaining but will still be fun. Many good companies are caught up in the turmoil and that creates many good opportunities. For long-term investors like us, it is important to stay focused on the fundamentals, keep a long-term view and not let the "short-term noise" bother us. Nothing has changed in our opinion and that is why this window is a good opportunity to rebalance portfolios and buy back some stocks to lower the average entry cost and to be able to bounce back better once this stress is behind us.

The recent strength of the stock market can lead to overconfidence. Some investors are beginning to think that they can get ahead of the markets by pulling out and thinking about getting back in at the "right time". What happens if they are wrong?

Value of staying invested (S&P 500), 2021 return profile under various scenarios

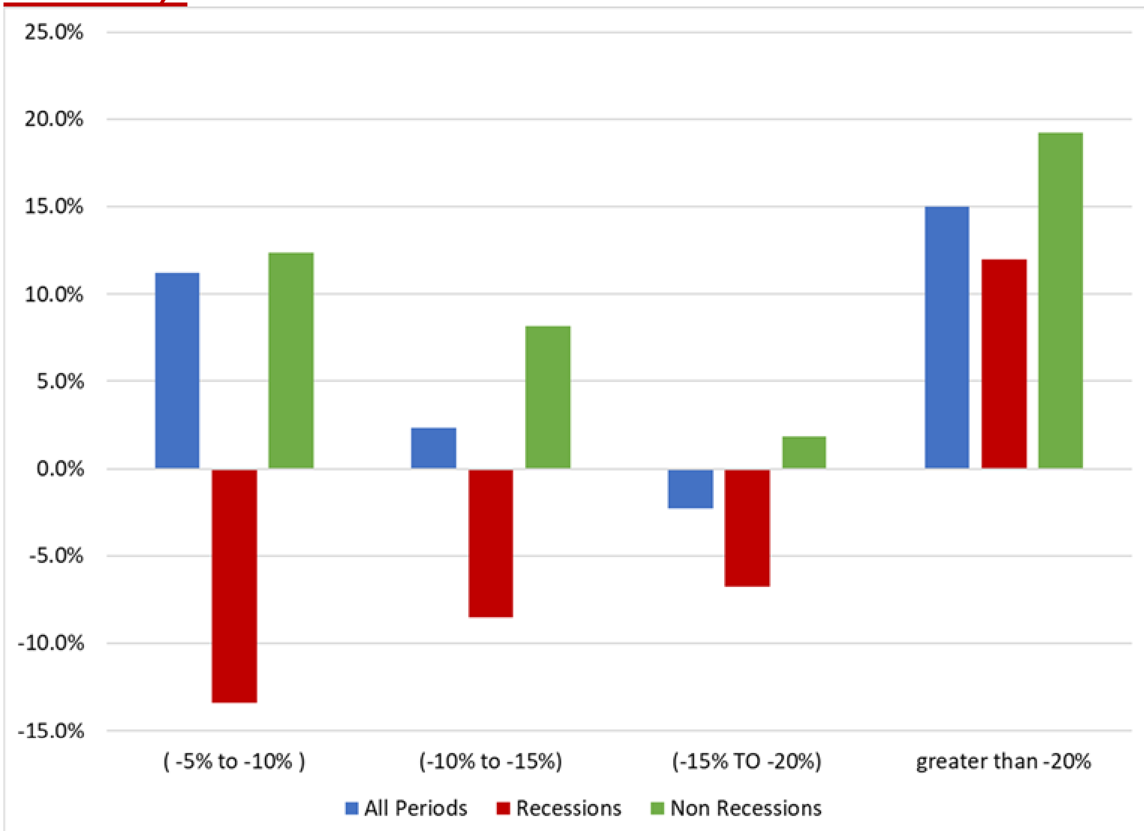


Source: Capital Markets Strategy, Bloomberg, as of December 31, 2021

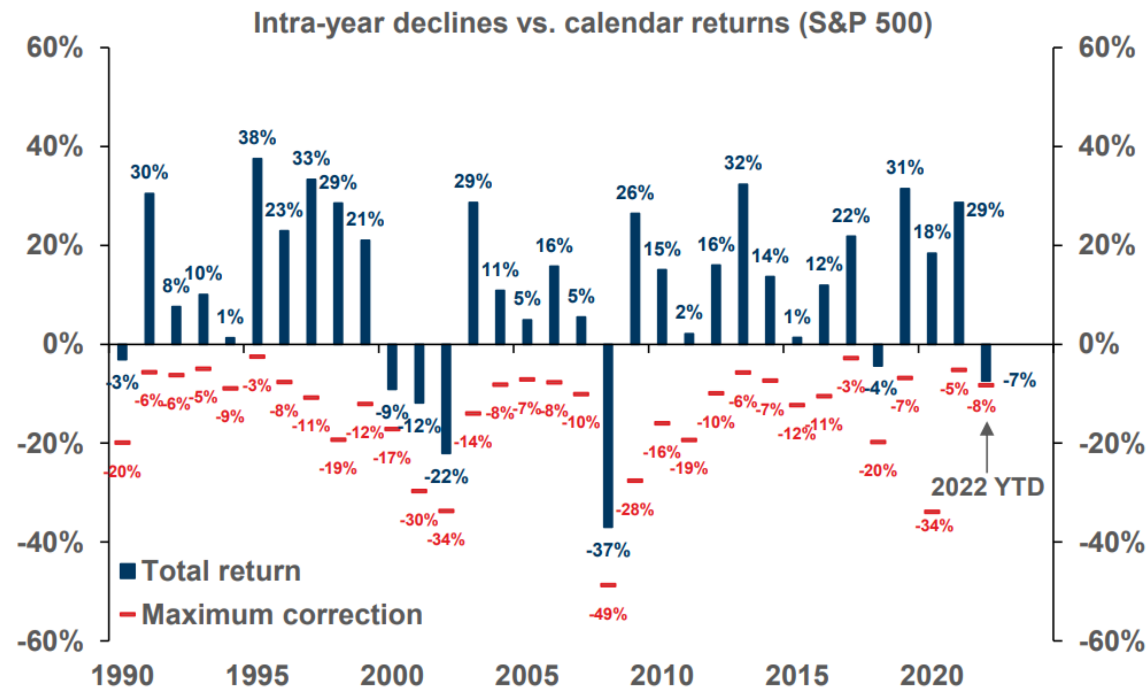
Is it riskier to invest in the stock market during a market correction?

Most people believe that it is riskier to invest in the stock market after a correction of about 10%, as we have experienced in the last few weeks, but the reality is quite different. In fact, the riskiest time to invest in the stock market is after a long period of strong performance when things seem to be going too well and valuations are high and at risk of falling. Inversely, the least risky time to invest is when the market has already fallen since valuations are attractive and stocks offer a better potential return that will be driven by the stock market rebound. It is important to stay invested in a highly diversified portfolio of high-quality stocks and that is exactly what we do!

How do stock markets react during the 12 months following a correction from the 52-week high (1990-Present):



Source: Capital Markets Strategy, Bloomberg, as of December 31, 2021



CIO Office (data via Refinitiv).

Corrections are quite normal, frequent, and difficult to predict but markets tend to end the year in positive territory most of the time.

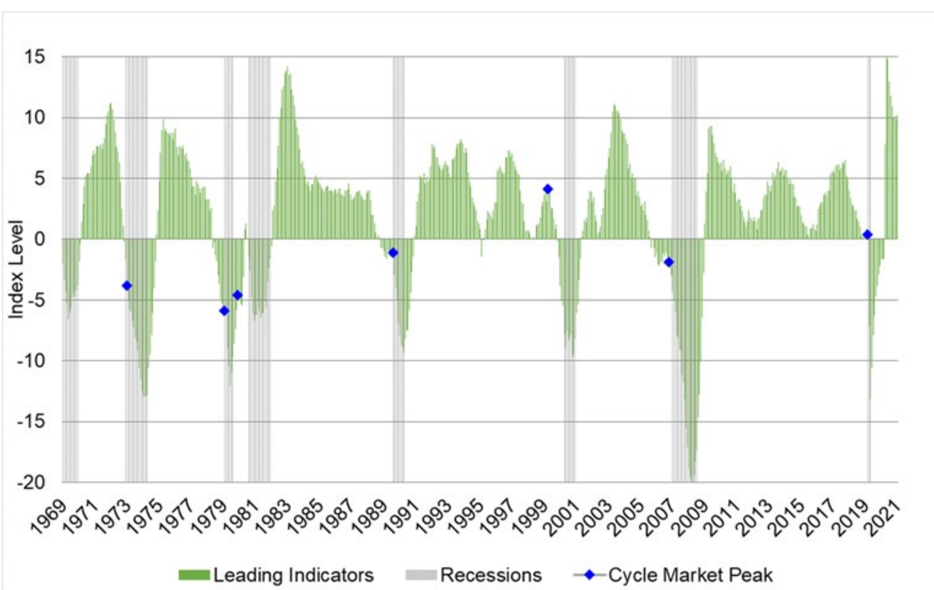
What are the risks of a recession in 2022?

There are generally warning indicators of a recession - the most common being an inverted bond yield curve. Based on our list of indicators below, we currently have only one of the typical signs of a recession and we continue to believe that the risk of a recession in 2022 remains very low. It is of course inflation that stands out on this chart but we must not forget that this inflation was caused by huge stimulus that central banks had to use during the pandemic such as interest rates close to zero and the checks that were given to households to stimulate consumption which remained very high while the supply chain was in difficulty which created a scarcity effect and therefore, a price increase. This situation is quite different from inflation at the end of the economic cycle when the economy starts to overheat before entering a recession.

Sign of Recession	Present today
Inverted Yield Curve	No
ISM Manufacturing PMI Below 45	No
Positive Inflationary Trends	Yes
Tighter Financial Conditions	No
Housing Starts Declining	No
Labor Market Weakening	No
Leading Economic Indicators Negative	No

Source: Capital Markets Strategy, Bloomberg, as of December 31, 2021

We can also consider the U.S. Conference Board's leading economic index as a good economic indicator. The current level suggests that the U.S. economy will be stable in 2022. Since 1970, a recession and stock market peak have occurred on average six months after the leading economic indicators turned negative.



Source: Capital Markets Strategy, Bloomberg, as of December 31, 2021

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