

Q2 2022

# INVESTMENT REVIEW & OUTLOOK

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Headwinds Abound,  
Building a Wall of Worry

Tailwinds To Emerge  
Later This Year

# OVERVIEW

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The headwinds that we discussed last quarter continue to pressure risk assets, but with even more force than we initially anticipated, as a result of several new developments:

- 1 Inflation pressures are not yet abating and even seem to be getting worse each month, souring consumers' views of the future.
- 2 As a result, the U.S. Federal Reserve (Fed) and other central banks have turned very hawkish very quickly, and the usual fears about the start of a new tightening cycle are emerging – namely, that recession will likely be the result.
- 3 Russia's invasion of Ukraine drove commodities even higher, while ushering in a new cold war and nuclear fears not known since the Cuban missile crisis.
- 4 And of course, just as investors were ready to forget COVID, a new surge in Hong Kong that spilled into China is now threatening over a billion people with the prospect of mass infection or countrywide lockdowns.

However, we expect these headwinds to continue into the summer months before beginning to dissipate, and then eventually yielding to tailwinds that could drive the next upward move for stock markets.

# PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
<b>RISK</b>	
Macro risk fell to start the quarter as it became clear that the Omicron wave would not have the same impact as past waves, but then rose again in late February as Russia invaded Ukraine.	<b>SAME</b>
<b>MACROECONOMIC</b>	
<b>GLOBAL REAL GDP</b>	
Global GDP growth has fallen and will likely continue to do so as the impact of China's Omicron wave and the war in Ukraine have a negative impact.	<b>LOWER</b>
<b>U.S. REAL GDP</b>	
Leading indicators of growth continue to decelerate, and markets are fretting the start of a new tightening cycle. Investors are concerned that higher rates will lead to recession, but we believe this fear is still premature and a bounce back later in the year is more likely.	<b>SAME</b>
<b>CANADA REAL GDP</b>	
Pent-up demand continues to fuel economic growth higher as COVID mandates are removed in most of the country. Higher oil prices will likely help the commodities industry.	<b>HIGHER</b>
<b>U.S. INFLATION</b>	
Supply chain issues are resolving and delivery times of goods have improved, while leading indicators of inflation are trending lower. Mortgage rates at 5% are also slowing down housing, while used car prices are also falling.	<b>LOWER</b>
<b>EQUITY RETURNS</b>	
<b>U.S. EQUITIES</b>	
Much of the headwinds to growth are likely priced into equities, although the impact of higher rates is yet to be fully reflected in valuations. Equity weakness may be nearing an end as retail and institutional sentiment looks to be bottoming.	<b>SAME</b>
<b>EUROPEAN EQUITIES</b>	
European equities will likely face headwinds from much lower economic growth expectations as a result of the war and spiking energy prices.	<b>LOWER</b>
<b>CANADIAN EQUITIES</b>	
High commodity prices will likely fuel Canadian equities for some time to come, as the Canadian consumer remains resilient.	<b>HIGHER</b>
<b>BOND YIELDS</b>	
<b>TREASURIES (U.S. 10-YR)</b>	
Higher inflation and a more hawkish Fed continue to put upward pressure on rates as the year progresses, but a peak in inflation will likely also put a peak in rates for now.	<b>SAME</b>
<b>INVESTMENT-GRADE CORPORATE BONDS</b>	
With very little premium over treasuries, investment-grade spreads will unlikely provide much insulation from the impact of rising treasury rates.	<b>HIGHER</b>
<b>HIGH-YIELD CORPORATE BONDS</b>	
High-yield corporate bonds will likely suffer from both increasing risk aversion in the near term as well as higher treasury rates.	<b>HIGHER</b>
<b>OTHER</b>	
<b>WTI CRUDE OIL</b>	
Oil prices surged on the threat of Russian sanctions as the futures curve hit extreme backwardation, implying very strong demand for current oil. However, at these high levels, price elasticity is having a negative impact on demand. In addition, the combination of new production and strategic reserve releases will likely put a near-term cap on prices.	<b>SAME</b>
<b>EPS GROWTH (S&amp;P 500)</b>	
Earnings growth is expected to decelerate in 2022 in step with the economy, but remain positive as leading indicators decelerate, while higher labour costs and inputs prices bear down on profit margins.	<b>LOWER</b>
<b>P/E (S&amp;P 500)</b>	
Multiples will likely see a pronounced decline over the year as real rates rise, particularly in the high-growth sectors with relatively high valuations.	<b>LOWER</b>

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at March 2022.

# HEADWINDS ABOUND, BUILDING A WALL OF WORRY

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The headwinds we outlined at the beginning of the year continue to pressure markets as the second quarter begins, with negative effects being magnified by new developments. Higher inflation, the beginning of a more aggressive monetary tightening phase, a new wave of Omicron and Russia's invasion of Ukraine are now combining to build a significant "wall of worry" for various risk assets.

Inflation has thus far proven to be more than just transitory: prices for goods continue to climb at a pace last seen in the 1980s. Higher costs are pressuring the finances of many households in the short term, while also changing longer-term consumer inflation expectations.

As a result, central banks have turned rapidly hawkish as prices move higher. The U.S. yield curve is flirting with inversion – a potential sign that bond investors believe rising rates in the short term will lead to sharply lower growth in the years ahead. And yield curve inversions have historically proven to be a reliable warning of recession.

Global investors seem to have been forced to discount asset prices in light of the possibility that the Cold War will make a disastrous return. The concentration of Russian political power in a single former KGB Officer makes the Russian army's actions difficult to predict. This lack of transparency has increased concerns about the possible use of nuclear weapons to the highest levels seen since perhaps the Cuban missile crisis.

COVID also refuses to loosen its grip. The surge in Hong Kong cases has spread to China, and officials are taking drastic measures to ensure the pandemic doesn't accelerate – seemingly without regard for the negative impacts on the Chinese economy.

Given the combination of these more vigorous headwinds, economists are now openly discussing the potential for an unpleasant stagflationary backdrop. However, while these pressures are unlikely to dissipate in the coming weeks, we do expect their negative effects to peak in the summer months, before giving way to more bullish tailwinds that could drive the next upward move for risk assets, including stock markets around the world. We explore the issues, and our expectations, in more detail below.

## INFLATION ROARING

Hopes for a post-pandemic normalization of global supply chains, and a subsequent decline in input costs and general pricing pressure, were dashed by the geopolitical events in Ukraine. Humanitarian concerns remain most important, but the economic effects are significant. Ukraine is the source of the bulk of wheat imported by the Middle East, for instance, and the country also produces 80% of the neon gas used for semiconductor manufacturing. Spiking energy prices have taken centre stage, particularly in European nations dependent on Russian natural gas, and in lower-income households without much cushion to handle soaring gasoline costs.

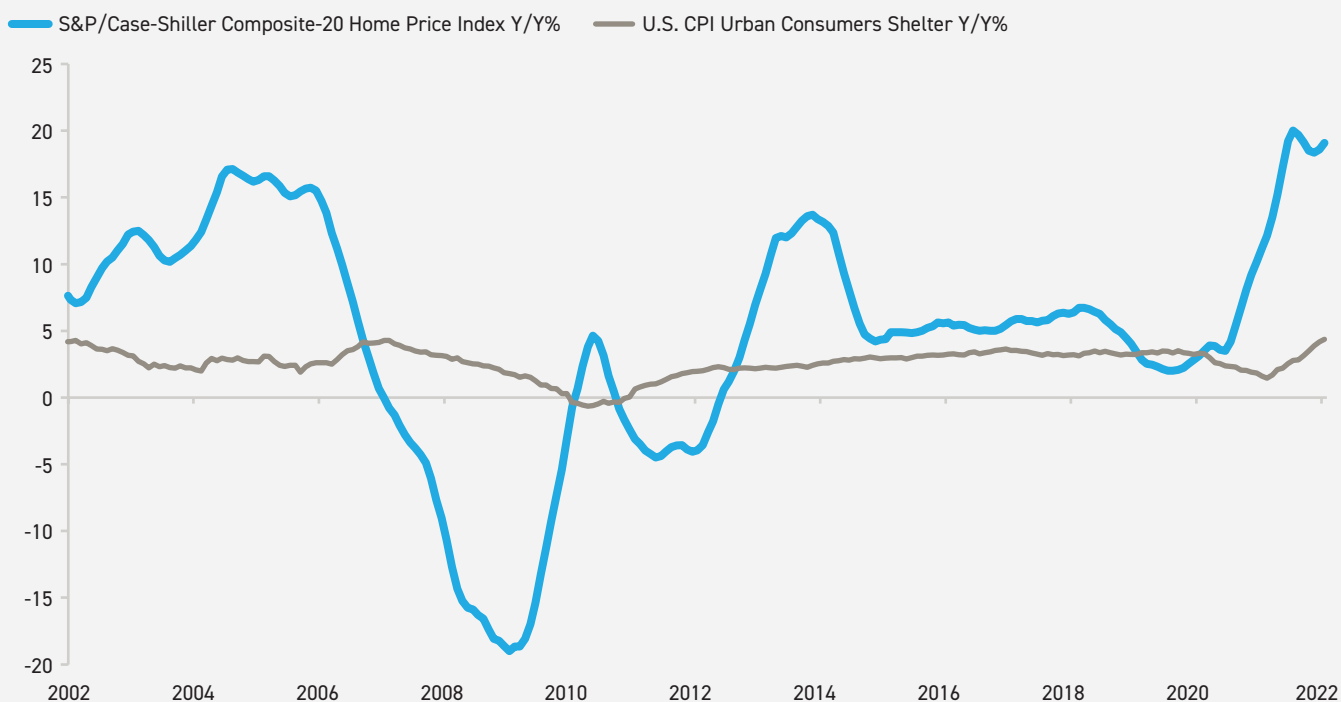
Autos remain scarce and increasingly expensive, thanks to the ongoing global shortage of related semiconductors. February U.S. auto inventory levels hit an all-time low, at 65,000.

The latest report on U.S. wages leaves nominal annual growth at 5.6%. Wage growth must be monitored closely for signs that higher inflation expectations are becoming embedded in the labour pool. Unlike commodity price inputs, wages rarely decline as shortages ease, and large wage increases can become a long-term drag on corporate profit margins, further compounding the negative pressures on stock markets.

Unfortunately, inflation pressures are now widespread throughout developed world economies. The headline U.S. Consumer Price Index (CPI) for March surged 8.5%, the biggest jump since 1982, and the ex-food and energy core reading was not far behind, at 6.5%.

There will likely be further upward pressure on the U.S. CPI from the hot housing market. The housing component of the U.S. CPI accounts for over 40% of the "basket" of goods and services used to calculate the rate of change in prices. Shelter costs alone account for over 33% of the basket, with rental of primary residence accounting for 7.8% and owner's equivalent rent (OER) making up 24.2%. The current inflation reading for the shelter component is an uncomfortably high level of 4.7% – but even so, it understates what is actually occurring in U.S. housing markets. Figure 1 shows the year-over-year percentage change in the S&P/Case-Shiller 20-city composite home price index, compared with the official CPI inflation figure for shelter.

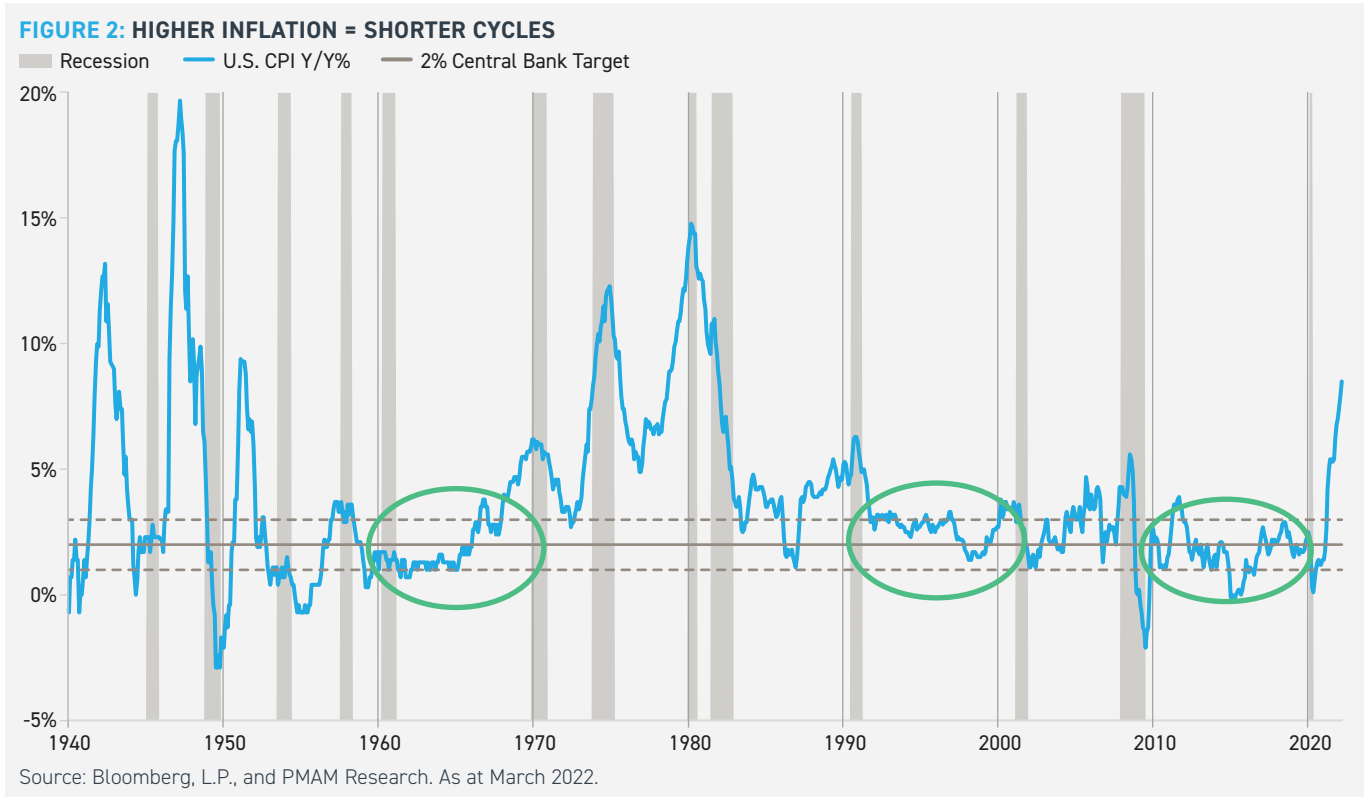
**FIGURE 1: SHELTER CPI IS UNDERSTATING HIGH HOME PRICES**



Source: Bloomberg, L.P., and PMAM Research. As at January 2022.

The discrepancy is significant, although previous divergences did not seem to lead to sudden spikes in the shelter component of CPI. Unfortunately, Figure 1 does not capture rents, which have also soared well above current CPI readings. Some of this is likely due to the survey methodology used to generate this data for the CPI calculation: the approach helps smooth the data in the near term, but suggests future upward pressures on CPI are likely, which could offset eventual declines in other inflation inputs.

Figure 2 helps put into perspective how elevated inflation is relative to what investors have become accustomed to over the past 40 years or so.



In the past three decades, investors have enjoyed fairly benign inflation increases that allowed the Fed to stay accommodative for longer, helping sustain much longer economic cycles. The current inflation readings are more consistent with the post-war and 1970s experiences, when economic cycles had to be blunted much more quickly by more aggressive central bankers. This is contributing to growing concerns about a recession on the nearer-term horizon.

## CENTRAL BANKS PLAY CATCH UP

The Fed has suddenly made taming inflation its clear priority. The significantly more hawkish tone is probably in part a recognition that central bankers dramatically underestimated building inflation pressures in 2021, and are now attempting to make up quickly for lost time.

The Fed has so far hiked the federal funds rate exactly once, for a grand total of only 25 basis points of explicit tightening. Until now, the central bankers have relied instead upon increasingly aggressive communications, not only to prepare the market for more rate hikes, but also to enlist its help in the tightening process. This tougher talk from the central bank about inflation really seemed to pick up last U.S. Thanksgiving. In late November, Fed Chair Jerome Powell began sounding much more hawkish about inflation, even as the new Omicron variant was spooking markets and raising concerns about yet another wave of infection and economic setbacks.

More recently in a speech on March 21, Chair Powell reiterated the central bank's commitment to price stability, while warning markets of the potential for a 50-basis-point rate hike. "If we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings," he said, "we will do so"<sup>1</sup>.

Other members (and even former members) of the Federal Open Market Committee (FOMC) have joined the hawkish chorus. For instance, San Francisco Federal Reserve President Mary Daly described the job market as "tight to an unsustainable level" in a recent interview with the *Financial Times*.<sup>2</sup> Ms. Daly also went on to note that the case for 50-basis-point rate increases was strengthening.

Recent FOMC minutes also highlight that the Fed will soon begin to reverse some of its quantitative easing programs, by starting to reduce the central bank balance sheet by US \$95 billion per month, likely beginning in May.

These missives are having an impact. For instance, since late November, eurodollar futures markets have gone from pricing in four 25-basis-point U.S. interest rate hikes in 2022 to eleven 25-basis-point hikes, while expecting the federal funds rate to reach 2.75% by year-end. Markets have also driven mortgage rates higher, and have pushed out corporate bond spreads, forcing the cost of borrowing much higher in these key areas of the economy. For example, given increases in average home prices in the U.S., combined with the surge in U.S. long-term mortgage rates, the mortgage cost of buying the average house is up a whopping 80% in one year (Fig. 3).

**FIGURE 3: MORTGAGE COST OF BUYING THE AVERAGE HOUSE UP ~80% IN A YEAR**

— U.S. Home Mortgage 30 Year Fixed National Avg.



Source: Bloomberg, L.P., and PMAM Research. As at April 8, 2022.

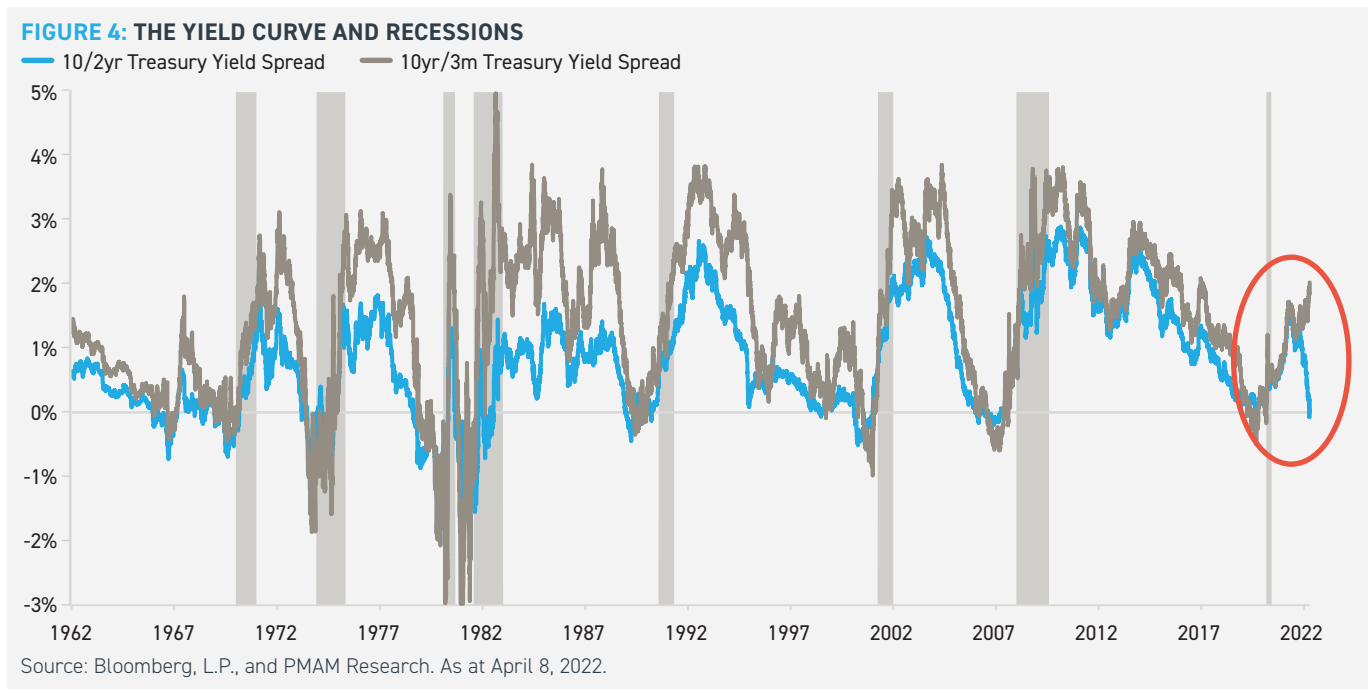
<sup>1</sup> <https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm>

<sup>2</sup> <https://www.ft.com/content/94f23e69-33d4-4688-b5b0-c996fa0d77f1>

## RECESSION FEARS ARE INTENSIFYING

Central banks are attempting to engineer an economic soft landing with continued but slower growth, and with higher borrowing costs that can help suppress excess demand growth and contribute to lower inflation in the system. This is a difficult needle to thread, given the prevailing view that the Fed is “behind the curve” when it comes to dealing with inflation.

The situation becomes even more complicated given the signs of slowing that are already appearing around the world, including in the U.S. Market watchers have become increasingly persuaded that a recession is on the horizon, given the recent inversion of the yield curve. And as Figure 4 shows, inversions of the two-year/ten-year bond yield curve have occurred ahead of all major recessions since the 1960s.



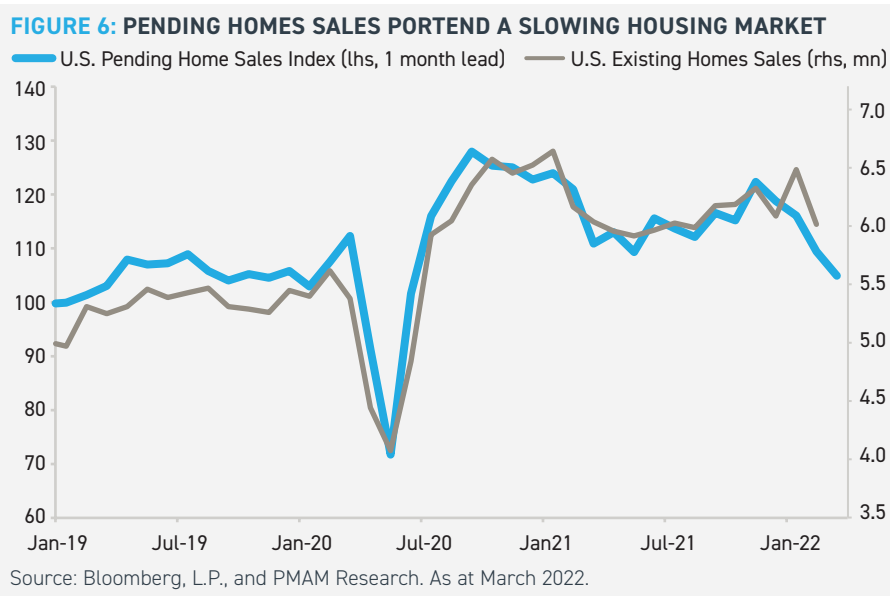
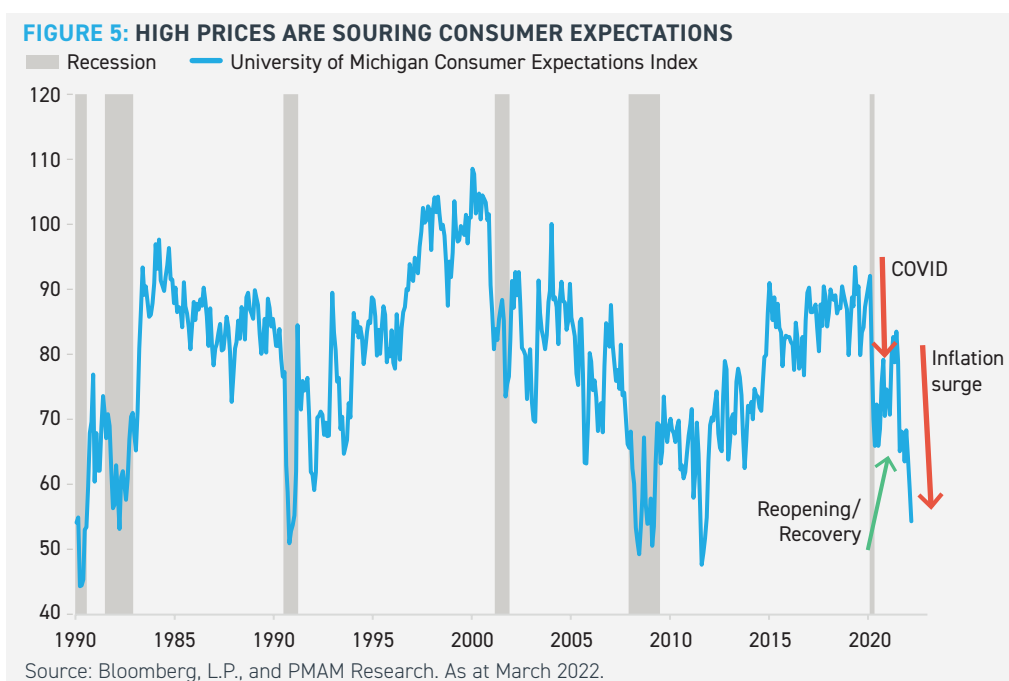
On the positive side, however, stock markets have generally continued to rally when these inversions have occurred, especially when the economic cycle has continued unabated for a couple of years after the inversion, even if the economy does eventually succumb to recession. Also, central bank quantitative easing programs may be distorting the predictive abilities of the yield curve for more recent time periods. The two-year to ten-year portion of the curve did invert, as noted above, but the three-month to ten-year spread remains significantly steeper, which marks an unusual divergence from cycles of the past.

Still, sharply higher commodity prices are adding further pressure to household spending already stressed by general supply chain-oriented goods inflation. Gasoline prices in the U.S. and Canada have more than doubled from the April 2020 lows, leaving consumers with less discretionary spending power after paying for transportation. Global food prices are also stressing household finances. The United Nations Food and Agriculture World Price Index has jumped 50% since June 2020. As Fed Chair Powell remarked at the last FOMC meeting, “High inflation imposes significant hardship, especially on those least able to meet the higher costs of essentials like food, housing and transportation.”<sup>3</sup>

<sup>3</sup> <https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm>



The University of Michigan Consumer Expectations Index has now dropped well below the April 2020 pandemic lows to levels rivaling the recessionary depths of the financial crisis (Fig. 5).



The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) hit a 12-month low in March. The forward-looking new orders component of the U.S. Manufacturing PMI survey fell from 66.4 in June 2021 to 53.8 in March of this year.

The U.S. housing market is one of the world's largest and most important asset classes, and price growth there is now slowing dramatically. Home sales slowed significantly in February, and now pending home sales, a leading indicator for actual purchases, have fallen to a post-pandemic low (Fig.6).

## COVID WAVE HITS CHINA, AGAIN

Meanwhile, against this deteriorating backdrop, the world's second-largest economy is enduring a second COVID wave more intense than the first. Citi economist Xiaowen Jin reported that in March, China recorded 38,527 confirmed Omicron cases and another 67,017 asymptomatic infections.<sup>4</sup> These totals exceeded the first wave that began in Wuhan in 2020. The speed with which Omicron spread from Hong Kong throughout the mainland raises questions about potential economic growth for the entire region, especially as Chinese officials try to stick to their "zero tolerance" policy with regard to infections. Instead of balancing economic growth with human health considerations, policy makers are largely using shutdowns to try to prevent spread, even as fatalities from this round of COVID appear to be quite low.

Ms. Jin expects that the resulting economic disruption will cut first-quarter GDP growth by roughly one percentage point. Prolonged lockdowns would deduct another 0.75%.<sup>5</sup>

The resurgent pandemic led the Caixin China Manufacturing PMI Index to fall into contraction territory in March 2022, at 48.1, the weakest report since February 2020. Price growth in the country's highly speculative and leveraged property market is also decelerating. The China 70 Cities Newly Built Commercial Residential Buildings Prices Index climbed only 1.2% year over year in February 2022, a huge drop from the 11.4% registered in April 2019.

## GLOBAL GROWTH ESTIMATES HAVE ALREADY PEAKED

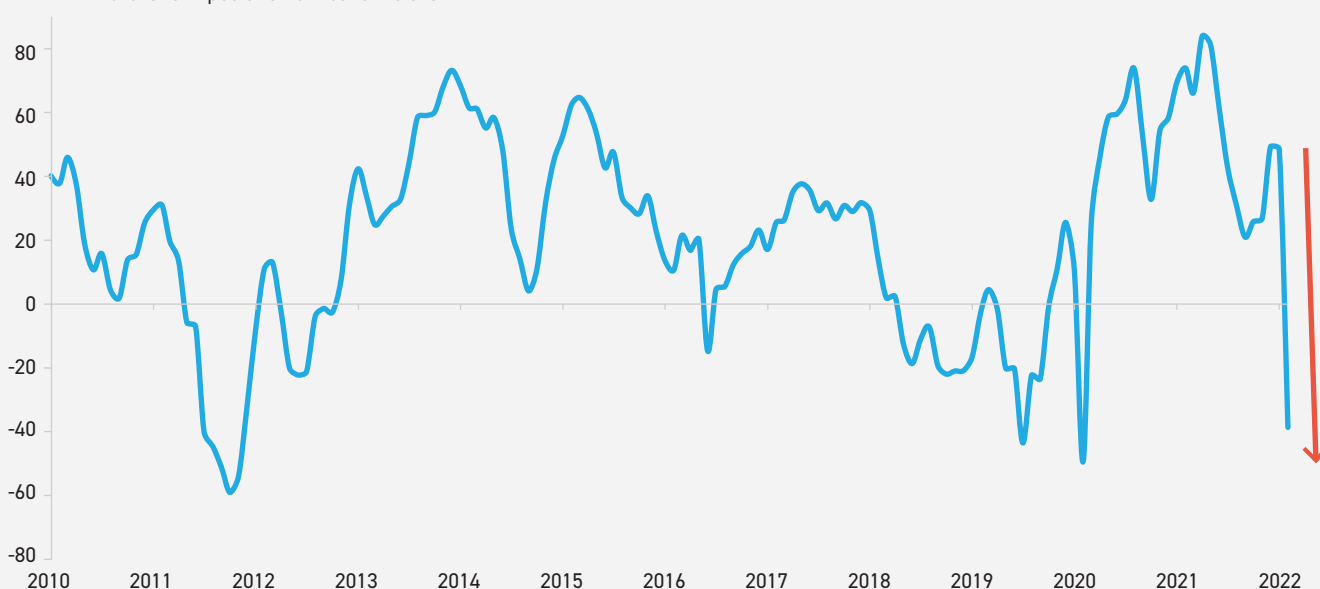
Forecasts for first-quarter U.S. GDP growth dropped sharply year-to-date. Consensus estimates have been slashed from an annualized 4.5% quarter-over-quarter rate at the beginning of 2022 to 1.5% by the end of March.

Quantitative gauges of U.S. growth using frequent data to forecast GDP have shown even more dramatic declines. In late February 2022, the Atlanta Federal Reserve GDPNow Index suggested that GDP growth would be just under 2.0% in the first quarter. However, the same forecast fell into negative territory in early March, implying the potential for economic contraction.

The worst economic deceleration in the world is likely to be evident in Europe, thanks to Vladimir Putin. The ZEW Eurozone Expectation of Economic Growth Index collapsed to a recessionary level of -38.7 in March 2022, from 48.6 in February 2022 (Fig. 7). Since June, 2021, the Eurozone Economic Expectations Index has fallen 120 points, a bigger decline than during the financial crisis (2008). Inflationary pressures have remained stubbornly high in the region despite the increasingly pessimistic growth outlook, adding to economic headwinds.

**FIGURE 7: EUROZONE ECONOMIC EXPECTATIONS HAVE PLUMMETED BECAUSE OF THE WAR**

— ZEW Eurozone Expectation of Economic Growth



Source: Bloomberg, L.P., and PMAM Research. As at March 2022.

<sup>4</sup> Bloomberg, L.P.

<sup>5</sup> "China Economics An Update on Omicron Wave's Impact on China's Economy", March 31, 2022. Citigroup Global Markets Inc.

# TAILWINDS TO EMERGE LATER THIS YEAR

While the current environment has a number of significant headwinds that will likely continue to hurt various risk assets, we expect these headwinds to start to dissipate later this year, eventually yielding to an environment that is much more favourable for stock markets. In other words, we expect headwinds to give way to tailwinds that drive the next upward move for stock markets, likely starting in the fourth quarter of this year.

## PEAK IN NEGATIVE SENTIMENT ALREADY BEHIND US?

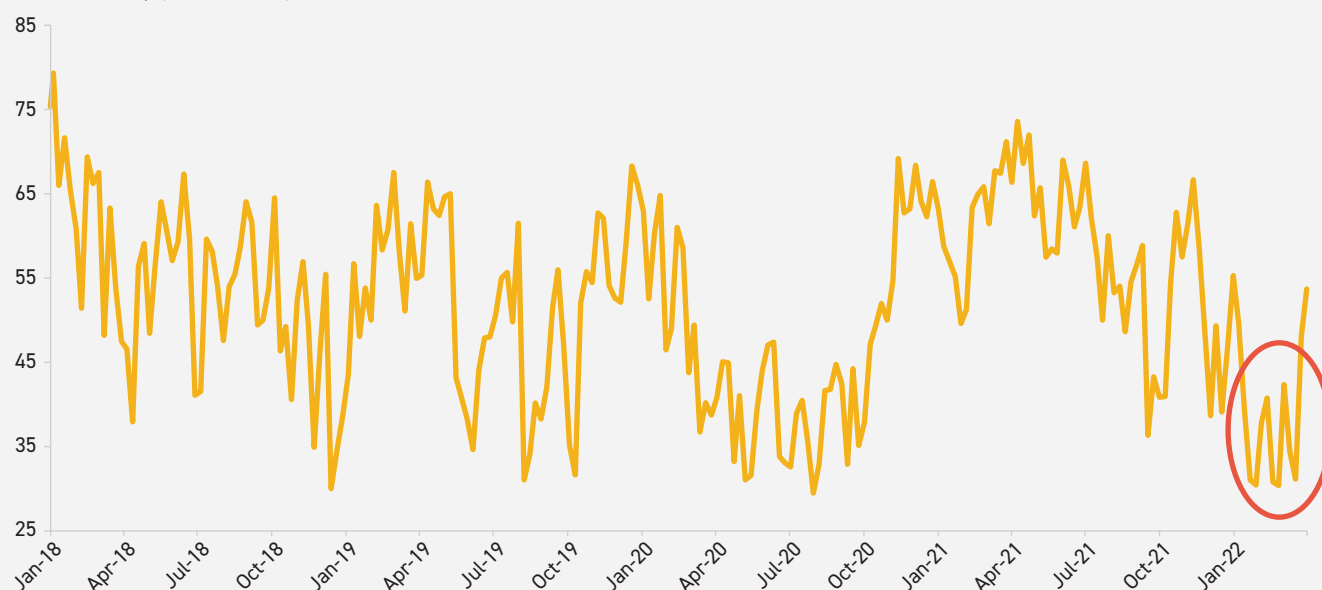
The current headwinds are not favourable for investing, but this is already understood to some extent by the market, and is being discounted in various asset classes and securities. It is quite possible that market volatility peaked

in March 2022, against a backdrop of extremely bearish negative sentiment. On March 7, 2022, fully 16% of S&P 500 companies were trading at new 52-week lows; the ten-year average is that only 1.5% of companies trade at their one-year lows. Things were even worse for the Nasdaq 100, where 22% of constituents were hitting new lows, compared with the historical average of 1.4%. By the end of the quarter, however, only 1.6% of S&P 500 stocks – and no Nasdaq 100 stocks – were trading at new 52-week lows. In other words, a selling climax appeared to occur in February and early March that reset expectations to the current reality.

Bearish sentiment from various surveys reached levels seen at major bottoms in past bear markets. This includes the American Association of Individual Investors (AAII) U.S. Investor Sentiment Survey, shown in Figure 8.

**FIGURE 8: RETAIL SENTIMENT HAS BOTTOMED (%)**

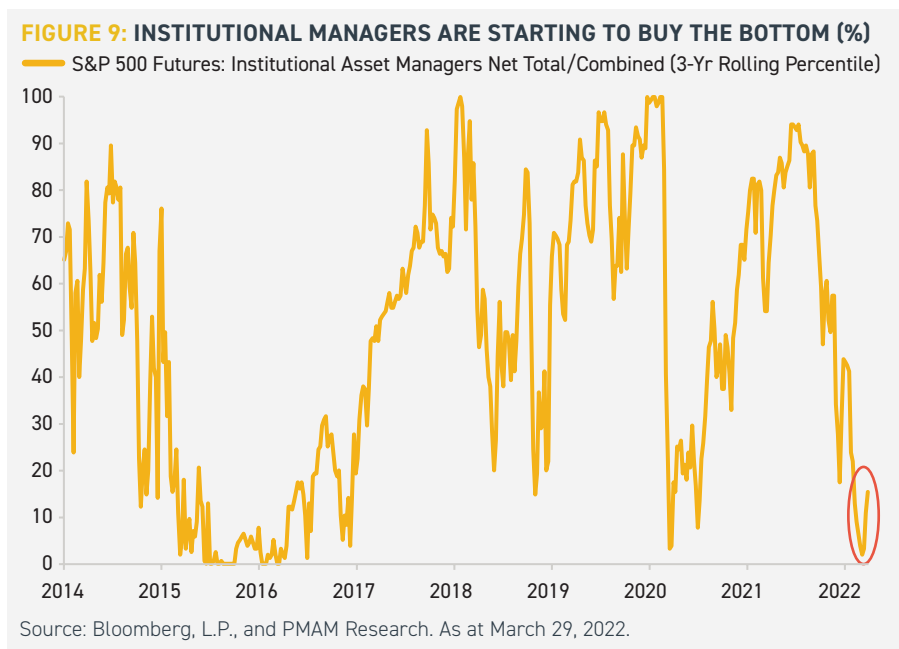
— AAII Bulls / (Bulls + Bears)



Source: Bloomberg, L.P., and PMAM Research. As at March 31, 2022.

The spike in volatility also triggered selling in many systematic strategies that use volatility-based risk systems to increase or decrease exposures (Fig. 9).

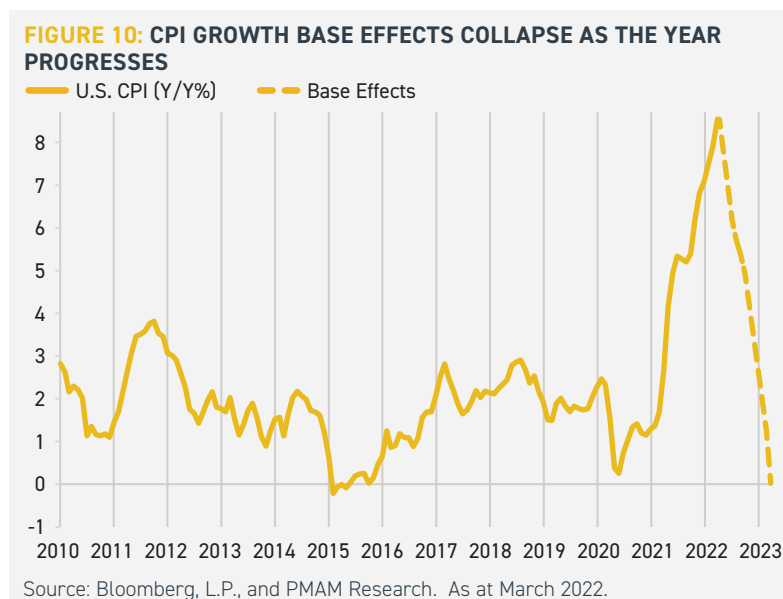
It is entirely possible that the oversold conditions of the past quarter represented a major clearing event for equities that helped discount a significant amount of the current headwinds. However, as in past bottoming processes, stock market lows may be retested in the next few months before the next sustained rally gets underway.



## NEARING THE PEAK IN INFLATION EXPECTATIONS?

While near-term inflation data is expected to stay alarmingly high, we expect that inflation pressures will soon peak leading to much lower inflation rates by the end of 2022. The main inflationary forces – supply chain disruption, rate-driven asset bubbles and commodity prices – should decline in intensity through the year, and perhaps even revert to more deflationary influences.

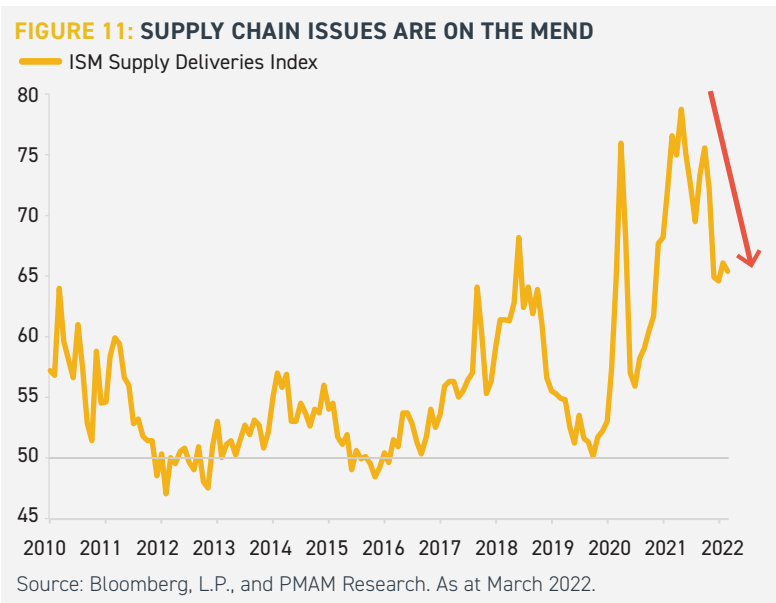
We will soon lap the most difficult year-over-year comparisons of inflation data. Base effects imply that any moderation in pricing pressure will lead to a significant drop in headline inflation data. Figure 10 shows the impact of base effects on CPI growth as the year progresses. It simulates what would happen if prices were completely static for the next year (i.e., completely unchanged, or zero inflation). Because prices are already so elevated compared with the year before, the yearly growth rate for CPI remains high initially, but then falls sharply as the year progresses. Of course, any *additional* price growth will be added to the base effects.



As the global pandemic took hold, regional lockdowns caused severe supply shortages and related supply chain issues in industries such as semiconductors, autos and home furnishings, to name just a few. With services spending largely evaporating during the quarantine, heightened demand for physical goods, combined with pandemic-related production cuts, created severe demand-supply imbalances and much higher prices.

However, despite the recent lockdowns in China, improvements in global supply chains are finally occurring, allowing goods to get to market and resolve remaining pent-up demand issues. This is evident in the sudden drop in the ISM Supply Deliveries Index (Fig. 11).

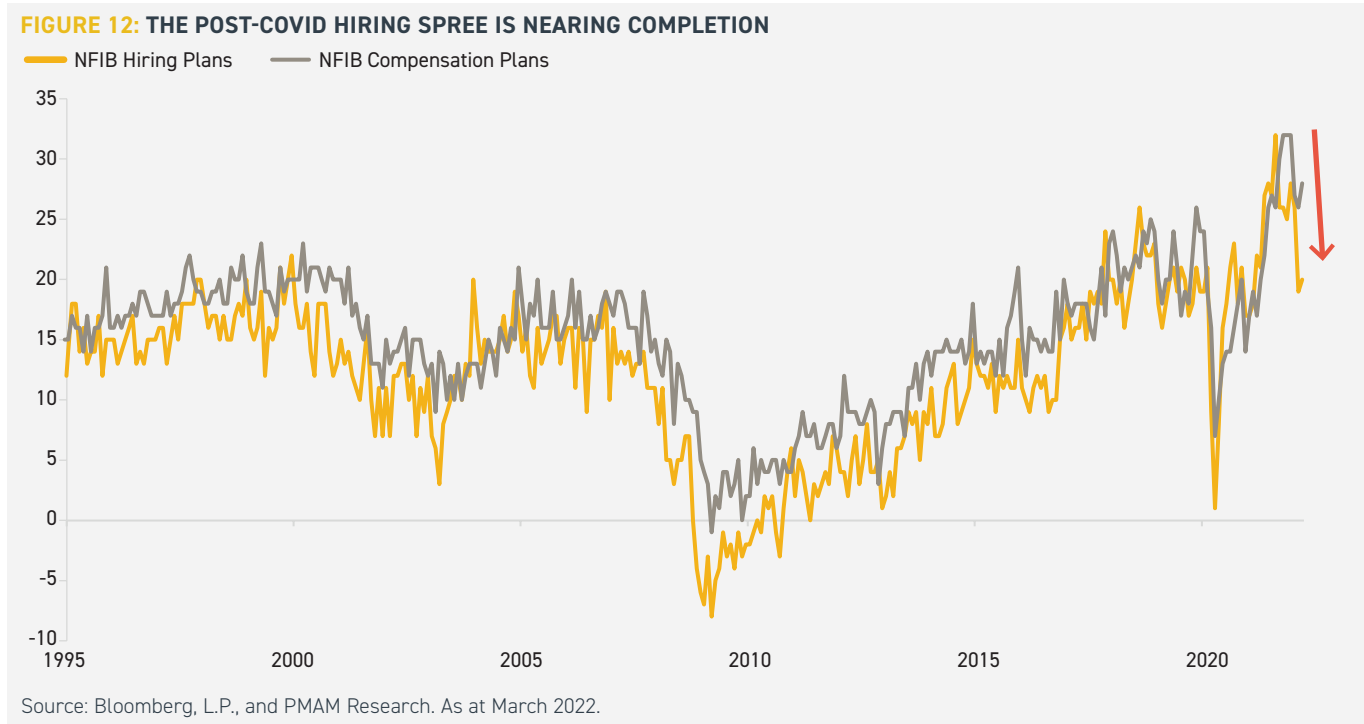
While the Index remains elevated compared with pre-COVID levels, it has fallen significantly below 2021 levels, and will likely contribute to better year-over-year inflation readings as 2022 progresses.



Average hourly earnings surged 5.6% year-over-year in March 2022, after spending most of the past decade stuck between 2% and 3%. A sidelined work force supported by government stimulus measures has been reluctant to re-enter the labour market without significant wage hikes. However, some leading indicators of employment imply that the inflationary impulse from wages may be peaking. A recent National Federation of Independent Business (NFIB) survey found that hiring expectations have fallen back to

pre-COVID levels, and that fewer employers are expecting higher wage costs compared with just a few months ago (Fig. 12).

Commodity prices may take longer to normalize. After years of under-investment, production increases will unlikely be instantaneous, even if current prices are high enough to incentivize management teams to start planning higher production rates. The military conflict in Ukraine certainly



exacerbated concerns about differences between available supply and growing demand, leading to sudden surges in significant elements of the commodity complex. Russia and Ukraine account for 30% of total worldwide wheat exports, 20% of coarse grain exports, 20% of corn exports and 75% of exported sunflower oil. Prices have increased dramatically in these and other commodities, and will likely remain high through the harvest season (barring a sudden peace agreement between the two countries).

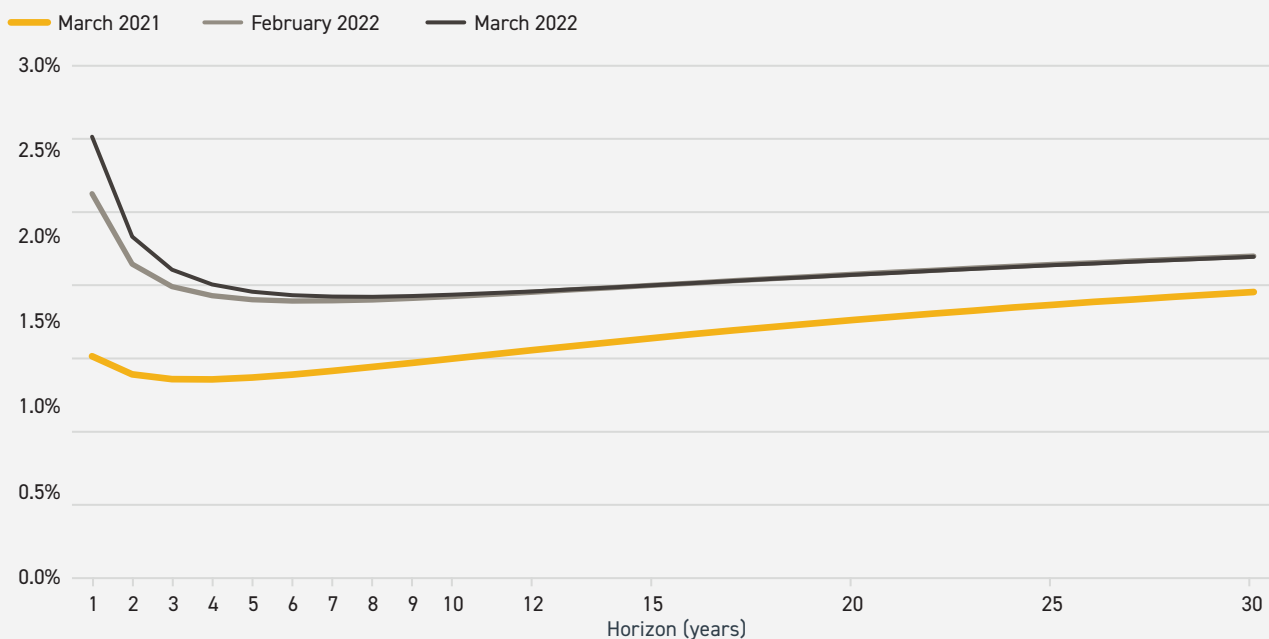
However, the impact of these higher prices is already working its way into higher inflation readings. Unless there is another even more aggressive surge in prices, it is reasonable to assume that this inflationary impact will be front end-loaded, and then will likely stabilize in inflation readings later in the year. In addition, surging prices are already having negative impacts on the economy, with businesses and consumers alike actively trying to find ways to forego consumption or trade down to cheaper substitutes; this will likely curb demand for higher-priced goods at the margin.

So, while current inflation rates are alarmingly high, we believe that some of the major inflation drivers will soon peak in their intensity. When this is combined with easier base effects in the inflation calculation, higher interest rates

and decelerating economic growth, we expect to see much lower inflation readings by the end of 2022. We are not alone in this assertion. The Cleveland Federal Reserve uses data from constant maturity Treasury bills, survey forecasts of inflation and inflation swap rates to generate a curve of expected annual inflation rates for the next 30 years. Its model sees inflation at 3.0% in the next 12 months, and then falling to roughly 2.0 by 2024, and remaining there for the longer term (Fig. 13).

This model could help explain some of the yield curve flattening that investors are currently fretting about. It is very possible that a shorter-term spike in inflation has made investors seek to be compensated for inflation more in shorter-dated maturities than in longer-term bonds – hence the flattening yield curve. If inflation rates were expected to stay elevated for the next decade, then the ten-year yield would be much higher and the two-year/ten-year yield curve would likely be positive, rather than flat or inverted. An inverted yield curve remains, however, an important market concern, no matter how it is rationalized. If we were to see a steepening curve, it would likely remove some of the concerns about impending recession and would be positive for equity markets.

**FIGURE 13: INFLATION EXPECTATION TERM STRUCTURE IS IN BACKWARDATION**



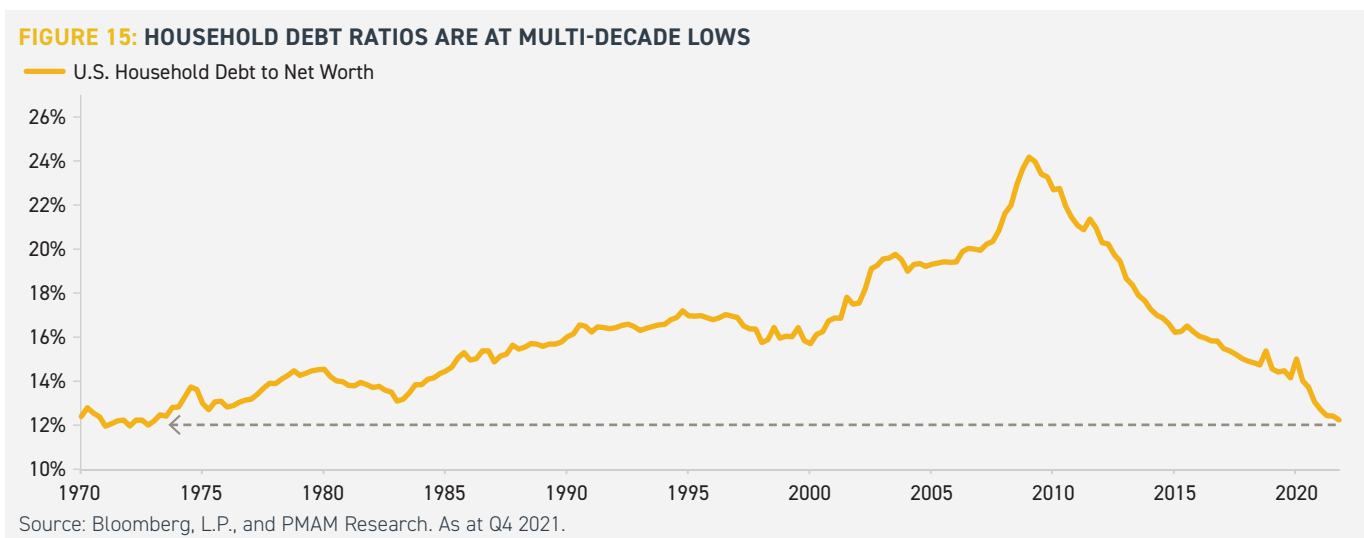
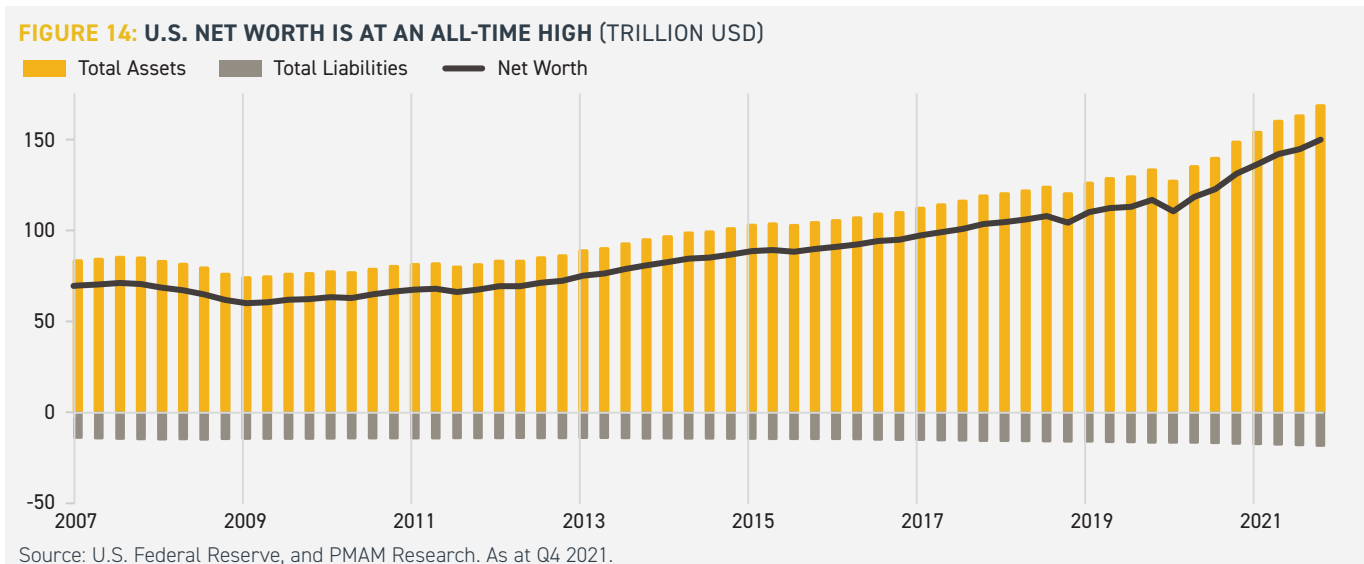
Source: Cleveland Federal Reserve, and PMAM Research. As at March 2022.

## RECESSION UNLIKELY

In the second half of 2022, we expect to see market concerns shift from runaway inflation to fears that an aggressive Fed will cause an abrupt economic halt by tightening policy too quickly. Already, Bank of America (BoFA) Securities global economist Ethan Harris believes the Fed will hike rates by 50 basis points at each of its next three meetings, a far more aggressive pace than other tightening processes in recent memory.<sup>6</sup>

While higher spending for food, energy and housing will have an impact on the outlook for less affluent U.S. consumers, U.S. household balance sheets are the healthiest they

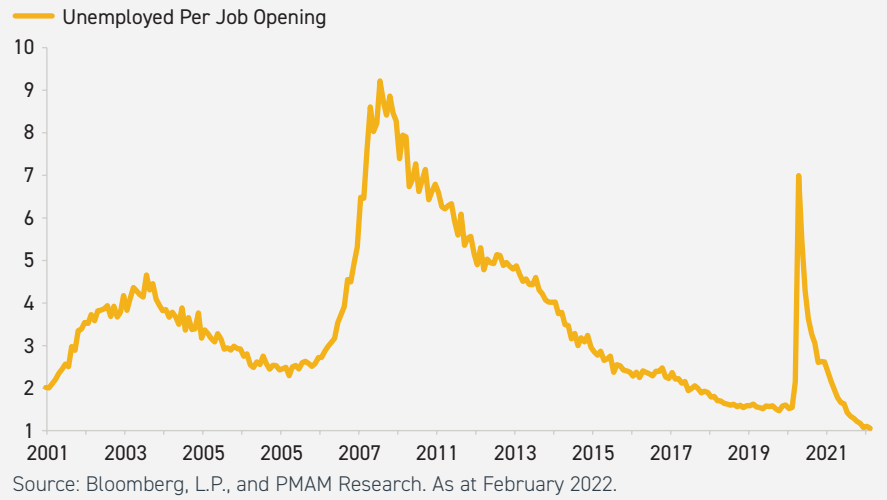
have been in 50 years. Household net worth expanded significantly during the pandemic: the Fed estimates U.S. household net worth at US\$150 trillion at the end of 2021, 36% above US\$110 trillion in the fourth quarter of 2019 (Fig. 14). The ratio of U.S. household debt to net worth has fallen to 12%, a level last seen in the early 1970s (Fig. 15). This will help support U.S. consumption through a reasonable tightening phase, especially spending on experiences that were denied to many people by COVID-19-related quarantines.



<sup>6</sup> US Economic Weekly: PC Thinking on Inflation”, April 8, 2022. B of A Securities

Current levels of strong employment growth will also help sustain the U.S. economy through the initial tightening process. March non-farm payroll data showed 431 thousand new U.S. hires. Job openings remain elevated at 11 million despite more workers entering the labour force as wage support measures fade. The quit rate, a valuable measure of employees' ability to find better-paying positions, is also high at 3.2%. Overall, the number of unemployed per job opening dropped to 1.0, the lowest on record (Fig. 16).

**FIGURE 16: U.S. LABOUR MARKET STILL STRONG**

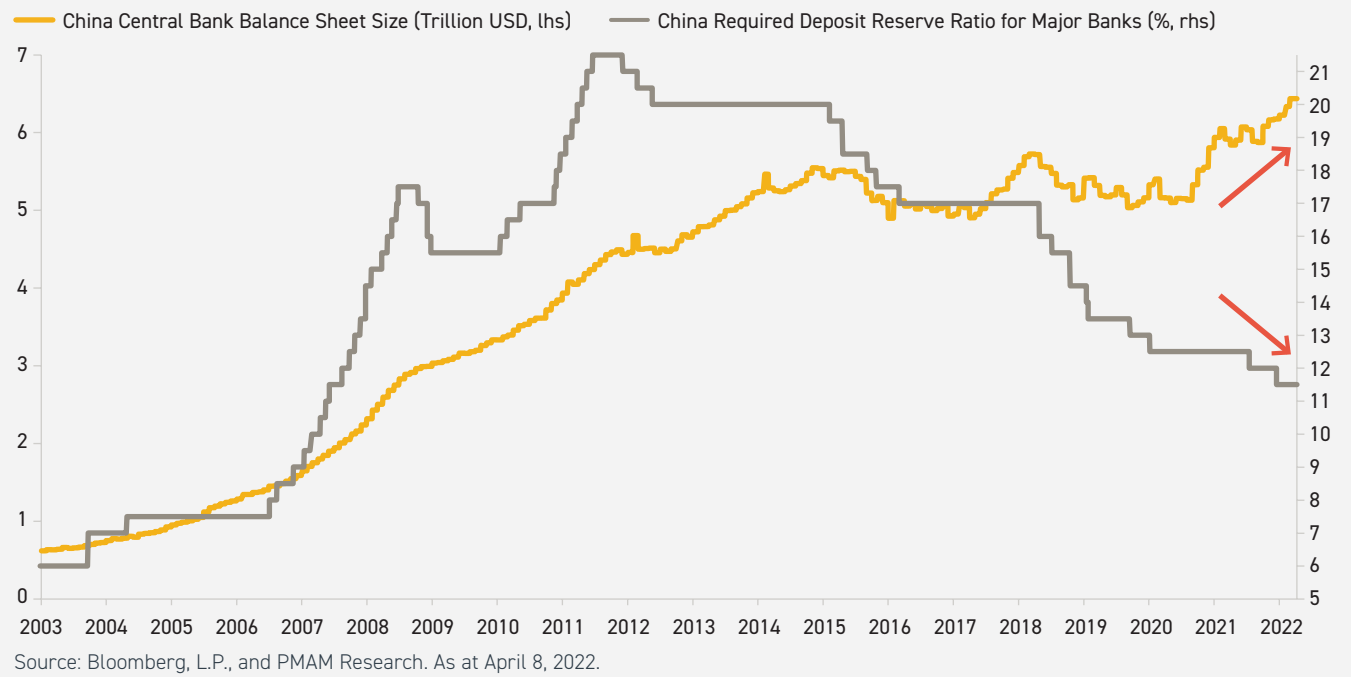


While hiring expectations are moderating, momentum is healthy enough that we believe it would take a sudden, sharp downturn for job losses to overwhelm hiring.

Ukraine-related humanitarian concerns, both in terms of civilian casualties locally and food inflation and shortages globally, will remain top of mind for the rest of 2022. A ceasefire or resolution of the conflict would be a welcome relief to the global economy, especially in Europe. In the meantime, the European Central Bank has maintained policy rates at accommodative levels that are expected to support member economies and help avoid a major economic downturn.

In China, government officials have made strides in curbing real estate-related speculation and are now looking to stimulate growth. The People's Bank of China is expanding its balance sheet while lowering the required reserve rate (RRR) for the nation's major lenders. The positive effects of this stimulus would likely become apparent in the second half of the year, just when the worst of the new Omicron outbreak is likely to fade. The consensus view is China's economy will likely accelerate through the year, from a 4.4% growth rate in the first quarter to 5.4% by the fourth quarter (Fig. 17).

**FIGURE 17: CHINA HITTING THE GAS ON STIMULUS**

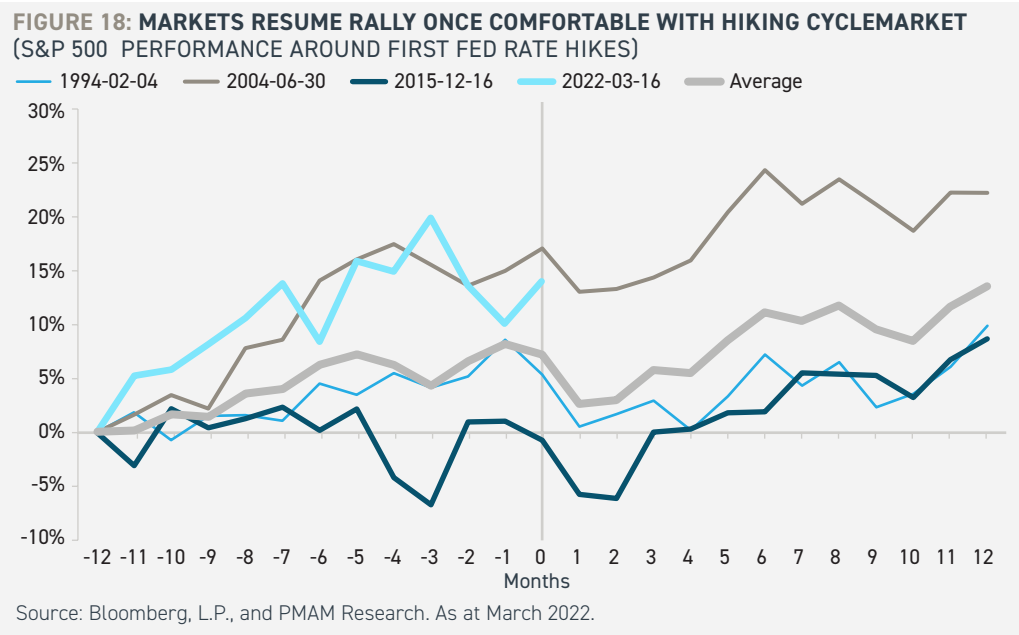




# IN CONCLUSION

## WE BELIEVE THAT INFLATION FEARS WILL MODERATE THROUGH THE YEAR AND THE GLOBAL ECONOMY WILL DECELERATE

This combination will likely allow data-dependent central banks to moderate their current aggressive monetary tightening. As this occurs, the current headwinds that are having a negative impact on markets will likely give way to tailwinds that will help drive up stock prices into 2023. Incidentally, this process would be consistent with what has happened historically around the first rate hikes of recent Fed tightening processes, when a consolidation in stock prices has typically given way to a renewed rally (Fig. 18).



# SECTOR OUTLOOKS

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## INDUSTRIALS

Despite geopolitical concerns and continued supply chain constraints, the demand for construction, machinery and freight is expected to remain fairly strong well into the year. We are poised to reap the benefits of shored-up weightings in our high-conviction compounders and cyclical names within broader secular themes. We are confident the businesses we like – including those with cyclical exposure – will continue to meet our long-term return thresholds.

We continue to favour companies with a history of compounding, idiosyncratic growth angles and/or opportunities to improve returns on invested capital. Toromont Industries Ltd. (TSX:TIH), Waste Connections Inc. (TSX:WCN) and WSP Global Inc. (TSX:WSP) remain preferred names, given their high rates of internal return and their ability to grow free cash flow through cycles. We have also added to our position in Canadian Pacific Railway Ltd. (TSX:CP). The company is on track to complete its acquisition of Kansas City Southern (NYSE:KSU) in late 2022/early 2023. We believe the synergies from the generational acquisition will surpass expectations in both timing and magnitude. Our stake in modular office solution provider Willscot Corp. (NASDAQ:WSC) has significantly outperformed the market since we initiated the position in the summer of 2020; the investment thesis is predicated on its free cash flow-generating potential, bolstered by its merger with portable storage solutions provider Mobile Mini Inc. (NASDAQ:MINI). We also remain bullish on the industrial leasing complex. We believe the companies we own that are exposed to rentals, such as the aforementioned Willscot Corp. (NASDAQ:WSC), Triton International Ltd. (NYSE:TRTN) and United Rentals Inc. (NYSE:URI), are trading at a discount to their intrinsic value and will outgrow the broader market in the coming years.

## MATERIALS

For the S&P/TSX Materials sector, momentum from a strong fourth quarter in 2021 continued through the first quarter of 2022, with the sector once again significantly outpacing the broader S&P/TSX Composite Index (TSX Index). Strength was broad based, led by gains in fertilizers and base metals, which benefited from concerns about supply disruptions due to the escalating conflict in Ukraine and related sanctions on Russia. Precious metals equities also performed well: safe-haven demand more than offset the impact of higher rates and the start of the Fed hiking cycle. One area of weakness was forest products, where supply challenges started to ease; the market became more concerned about the impact of higher rates and home prices on housing affordability and demand.

We continue to believe the structural backdrop for copper is positive and think recent concerns about energy security and independence will support global decarbonization trends, particularly in Europe. While the demand outlook remains robust, we expect supply to remain constrained in the medium term, given limited development pipelines. First Quantum Materials Ltd. (TSX:FM) remains our preferred exposure for copper, and we continued to add selectively to holdings in smaller producers with strong growth outlooks. We grew more positive on the outlook for Nutrien Ltd. (TSX:NTR), given our view that the market was underappreciating the risk of supply disruptions for key fertilizers, the company's advantageous cost position, and optionality related to its excess operating capacity. We remained selective as we increased our gold exposure, focusing on companies that generate strong near-term free cash flow and are better able to manage cost pressures.

## INFORMATION TECHNOLOGY

The MSCI World Information Technology Index decreased 10.3% for the first quarter of 2022, while the Information Technology sector in the S&P/TSX Composite Index decreased 35.5%. Shopify Inc. (TSX:SHOP) was the biggest contributor to weakness in Information Technology in the S&P/TSX Composite Index, down 51% in the quarter, due to a combination of valuation compression and a shift in fulfillment strategy that will likely require higher spending on operating expenses and capital expenditures. Overall, Information Technology sector performance was broadly affected by valuation compression, due to a higher interest-rate environment, and concerns about potential demand weakness due to geopolitical events. Inflationary trends also continued to weigh on the potential outlook for margins. Hardware was the best-performing subsector, down 2%, led by Apple Inc. (NASDAQ:AAPL), followed by internet and catalog retail, down 3%, led by Amazon Inc. (NASDAQ:AMZN). The weakest subsectors were electronic equipment, down 15.7%, and interactive media and services, down 13.5%. Interactive media and services continued to be affected by concerns about digital advertising trends, given industry-wide attribution changes, strong engagement at competitor TikTok and potential spending slowdowns in Europe.

The software and semiconductor subsectors were both down 11% in the quarter, slightly lower than the overall MSCI World Information Technology Index. However, we like Broadcom Inc. (NASDAQ:AVGO) as a lower-valuation, defensive semiconductor stock with strong cash flow, attractive dividend yield and planned stock buybacks. The company is well positioned in its wireless product line with a large customer, Apple Inc. (NASDAQ:AAPL), and the networking product line continues to be sold out. The company is managing the supply-demand imbalance well and is likely to have better inventory levels than its peers if and when supply begins to improve. In the meantime, the software business, at approximately 25% of the company's revenues, will likely provide strong cash flow and margin support.

## HEALTH CARE

The Health Care sector, down 2.2%, marginally outperformed the overall S&P 500 Index, down 3.5%. Macro and geopolitical themes continue to dominate, and the sector's performance remains largely decoupled from fundamentals. Recent geopolitical events, as well as inflationary pressure, have triggered a rotation into large-cap biopharmaceutical names, resulting in contraction of the multiple discount relative to the S&P 500 Index: that discount has narrowed from about 45% to about 25%. However, sentiments seem to be muted across several other Health Care subsectors, due to macro uncertainties such as supply chain constraints, lockdowns in China and inflationary pressures on raw materials. These subsectors include medical technology (down 6.2%), life science technology (down 12.7%), dental (down 16.7%) and animal health (down 19.5%). During fourth-quarter 2021 earnings calls, most company managements had signaled that these macro factors were likely to result in weak first-quarter 2022 earnings, with recovery expected in the second half of the year. The margin headwinds from macro factors could be partly offset by a recovery of procedure volume that would benefit the medical technology segment.

Higher interest rates and the risk-off environment seem to have a sustained negative impact on small and mid-cap (SMID) company valuations and stock performance (down 16.7%). Verticals that are focused on domestic markets, are positively leveraged to inflation and/or rates, and have solid execution history and strong cash-flow profiles, have outperformed the market: managed care is up 2.8%, distributors are up 19.4%, and facilities are up 2.7%.

## CONSUMER DISCRETIONARY

The Consumer Discretionary sector has, unsurprisingly, underperformed both the S&P 500 Index and the TSX Index year-to-date, with the bulk of the underperformance and de-grossing occurring following Russia's invasion of Ukraine. The broader macro implications of this conflict are worrying for discretionary spending globally; they include a combination of slower economic growth married with rising rates and widespread inflation, all while government stimulus is pulled from the system. Additionally, there are real concerns that the conflict may further disrupt global supply chains, particularly for the auto industry, whether through parts suppliers with manufacturing facilities in the region or through disruption to raw material inputs such as palladium or neon.

Against the rising risk of stagflation, it is difficult to be positive on many Consumer Discretionary verticals. With that said, we believe stocks to own in this environment should share some combination of the following characteristics: company-specific pricing strategies or drivers, defensive or less discretionary categories, limited commodity cost exposure, strong balance sheets and free cash-flow generation, alongside reasonable valuations. We see such characteristics in names including Dollar Tree Inc. (NASDAQ:DLTR US), Spin Master Corp. (TSX:TOY CN), Gildan Activewear Inc. (TSX:GIL), Thomas Reuters Corp. (TSX:TRI) and International Game Technology Plc (NYSE:IGT).

Conversely, risks have clearly risen for auto stocks. An already fragile supply chain may come under further stress as parts suppliers struggle to shift capacity to sites outside the Ukraine conflict region, potentially putting auto production and earnings of the first half of 2022 at risk. Moreover, even if supply constraints normalize in the second half of 2022, the risks of a consumer-led slowdown may have risen sharply, so COVID-driven inventory rebuilding may begin just as consumer spending is expected to fall off sharply. For these reasons, auto multiples will likely remain depressed, despite the potential for a strong rebound in earnings once production ramps up.

## CONSUMER STAPLES

In the first quarter of 2022, Consumer Staples returned about 4% in Canada, slightly underperforming the resource-heavy TSX Index for the quarter, while in the U.S., Consumer Staples outperformed the S&P 500 Index by about 3%. While the sector had benefited from a defensive rotation early in the year, the Russia-Ukraine conflict led to a further rotation into Consumer Staples as investors looked for cheap domestic inflation hedges. Grocers and grain handlers saw the largest lift, given their predictability and their ability to pass costs on to customers, along with relatively inelastic demand. Given the risk of slowing GDP growth and persistent inflation, we prefer quality growth names at reasonable multiples.

In Canada, we remain positive on Neighbourly Pharmacy Inc. (TSX:NBLY), a unique growth story with an opportunity to roll up the highly fragmented Canadian pharmacy industry, driving Earnings before Interest, Taxes, Depreciation, and Amortization Compound Annual Growth Rate (EBITDA CAGR) of over 20% until 2025. Early in March 2022, NBLY made a transformative acquisition of a key competitor in Western Canada, growing its store count by 58% and its EBITDA by 70%. NBLY extracts synergies rapidly and is expected to fully integrate within 90 days.<sup>7</sup> We also remain positive on Alimentation Couche-Tard Inc. (TSX:ATD), viewing the convenience store operator as undervalued, considering its consistent earnings growth, which is supported by numerous organic initiatives. The company also has a very clean balance sheet, with over US\$16 billion in debt capacity to support its Normal-Course Issuer Bid and future merger and acquisition.

In the U.S., we remain positive on quality share gainers and structural winners. We believe Walmart Inc. (NYSE:WMT) is well positioned as inflation ratchets higher in grocery stores. The value proposition of an everyday low price will likely become increasingly important to consumers as interest rates move higher, gas prices remain elevated, grocery prices move higher and the consumer has less government support. Meanwhile, Walmart's competitors keep passing on higher costs to consumers, which we believe will eventually lead to a trade down among Walmart stores. Simply Good Foods Co. (NYSE:SMPL) is more of an "offensive" staple, providing exposure to reopening and mobility in the U.S., along with exposure to secular health and wellness trends.

<sup>7</sup> [https://investors.neighbourlypharmacy.ca/files/doc\\_news/2022/NBLY-Announcement-Press-Release-vFinal.pdf](https://investors.neighbourlypharmacy.ca/files/doc_news/2022/NBLY-Announcement-Press-Release-vFinal.pdf)

## FINANCIALS

The Financials sector started the year strong as rates marched higher and expectations of central bank rate hikes continued to build steam. However, following the Russia-Ukraine conflict and an increased focus on recessionary and stagflationary risks, credit-sensitive financial stocks have started to lag. This leads us to be more cautious on the credit-sensitive financials, such as banks, and to prefer less credit-sensitive names that are leveraged to higher rates, such as U.S. retail brokers. We also like select rate beneficiaries in the life insurance group, such as iA Financial Group (TSX:IAG), which is trading at pre-COVID valuation levels, notwithstanding significantly higher earnings, higher ROEs and a more capital-light business model. Outside of the banking and life insurance groups, we foresee another great year for pricing and profitability in the commercial property and casualty market, especially in the excess and surplus line, where Trisura Group Ltd. (TSX:TSU) is our favoured name. We believe the company has multiple levers to maintain 20%-plus EPS growth for the next couple of years. We also believe that the democratization of alternatives is one of the most powerful secular trends within Financials, with all investor segments increasing their exposure to alternatives. We expect Brookfield Asset Management (TSX:BAM) to be a key beneficiary as it builds out new capabilities (e.g., insurance/impact investing) and seeks to penetrate the high-net-worth and ultra-high-net-worth channel.

## COMMUNICATION SERVICES

A rising ten-year return (up about 100 basis points in the first quarter of 2022) was unable to stop telcos from registering a spectacular quarter: the Big Three averaged 12% quarter-to-date, handily outpacing the TSX Index, at 4%. In our view, the outperformance has been driven by a combination of two factors: for Rogers Communications Inc. ("Rogers") (TSX:RCI/B), rising optimism as we near completion of the deal to acquire Shaw Communications Inc. (TSX:SJR/B); for telcos, such as Telus Corporation (TSX:T) and BCE Inc. (TSX:BCE), increased visibility on the timing of peak capex and, consequently, a step-function increase in free cash flow and durability of dividend growth.

Following a few turbulent months, Rogers, our top pick, emerged as the best-performing telco in the first quarter, up 18%, after investors appreciated the new management's guidance and priorities. Thus far the rhetoric from agencies, such as the Competition Bureau Canada, have been along expected lines (nothing unexpectedly negative thus far), and we remain confident that the acquisition deal is on track to close in the second quarter of 2022 and believe that there is likely more upside in the stock as management provides its integration plan and the timeline for synergies. As COVID-19 moves into the rear-view mirror, the reopening of Canada to immigration and international travel will likely also be a tailwind for Rogers' wireless operations.

## UTILITIES

At the aggregate level, it was a solid quarter for the Utilities, and the sector returned 5%, a 100-basis-point outperformance of the TSX Index. While the aggregate performance was solid, the more interesting detail was the divergence of performance within the sector. While big regulated utilities had a rather quiet quarter, with an average return of about 2%, renewables had an excellent quarter, posting an average return of about 11%, driven by a combination of decisions by European and the U.S. governments to stick to their commitment to green energy and high European power prices.

Following a spectacular year, up 52%, it was relatively a quiet quarter for one of our top picks, Altagas Ltd (TSX:ALA), which gained 3.5%. However, our other top pick, Brookfield Infrastructure Partners L.P. ("BIP") (TSX:BIP-U), had a solid quarter, up 8.5%, driven by investors' preference for BIP's contract structures (about 70% of BIP's cash flows are inflation-linked), higher commodity prices that we believe should support BIP's midstream operations, a strengthening Brazilian real and contribution from multiple projects that will likely come online in 2022, and BIP's strong liquidity (at about US\$2.5 billion). Looking ahead, we believe that all these factors should allow BIP to generate FFO and share growth of at least 10% for the next couple of years.

## REAL ESTATE

Following a spectacular year, with a 900-basis-point outperformance of the TSX Index, REITs had a weak start to 2022, down by 0.5% in the first quarter, compared with a 3.8% rise for the TSX Index. It was a weak quarter for Colliers International Group Inc. (TSX:CIGI), our top pick, which returned -13.5%. It was also a tough quarter for commercial real estate brokers, with the group (excluding CIGI) posting -11% for the quarter. In our view, the weakness in CRE brokers was driven by a combination of concerns about transactions in Europe (due to the ongoing Russian invasion) and a widening of credit spreads during the quarter.

Notwithstanding the current concerns, we remain confident in our position in CIGI, given the wall of capital that is looking for a home in real estate; its solid balance sheet (0.3 times net debt to EBITDA); a pickup in leasing, driven by the return to offices; and a business mix that is significantly more resilient than it was a decade ago, given the growth of its asset management and outsourcing businesses.

## ENERGY

Oil markets started the year strong, with demand strengthening as COVID cases peaked and supply tightening as number of OPEC+ countries struggled to meet their additional quotas. In February, global energy prices shifted significantly higher after Russia invaded Ukraine, magnifying supply fears, since Russia produces 11% of the oil consumed globally, and 40% of the natural gas consumed by Western European. While Russian barrels continue to be produced, the physical markets were dislocated, with record discounts on Russian barrels and a premium on other crude. In the short term, technical challenges, such as regional refining complex and transportation costs, limit the ability to re-route Russian barrels to countries without sanctions. At quarter-end, the Biden administration, in conjunction with the International Energy Agency, announced the single largest Strategic Petroleum Reserve release in history, to address rising gasoline prices.

The conflict between Russia and Ukraine has brought the security of energy supply into sharper focus and has led to a more favourable sentiment on uranium and liquified natural gas as sources of base power capacity. In the portfolio, we have added to uranium producers, and hold natural gas producers such as Tourmaline Oil (TSX:TOU). While the response from public North American producers to oil supply issues has so far been limited to higher oil prices, there are signs private players are increasing spending at the margin. We hold Freehold Royalties Ltd (TSX:FRU), which owns one of the largest independently owned portfolios of royalty lands in North America, and we believe that will benefit from additional spending on their lands.

**HEAD OFFICE**

33 Yonge Street, Ste. 830  
Toronto, Ontario  
M5E 1G4

**TELEPHONE:** 416-955-4108  
**TOLL FREE:** 1-866-369-4108  
**RETAIL SALES:** 1-833-955-1344

**GENERAL INQUIRIES**

service@pictonmahoney.com

**INSTITUTIONAL INQUIRIES**

tklymenko@pictonmahoney.com

**VANCOUVER**

Four Bentall Centre  
1055 Dunsmuir Street,  
Suite 3370  
Vancouver, British Columbia  
V7X 1L3

**CALGARY**

10th Floor, Bankers Hall  
888 3rd St. SW  
Calgary, Alberta  
T2P 5C5

**MONTRÉAL**

1250 René Lévesque West  
Suite 2200  
Montréal, Québec  
H3B 4W8

[www.pictonmahoney.com](http://www.pictonmahoney.com)

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