OPTIMUM
Asset Management

Financial Outlook March 2022

By Martin Delage, Canadian Chief Investment Officer

In Brief

- Central banks began tightening their monetary policy, which affected the bond market.
- The FTSE Canada Universe Bond Index returned -6.97% in the first quarter of 2022.
- In Canada, the S&P/TSX Index advanced 3.84% in the first quarter, driven mainly by strong growth in the energy sector.
- In the United States, the S&P 500 Index returned -4.60% in the first quarter, even though the energy sector was up 38.99% during the period.
- Similar to the U.S. market, the MSCI World Index returned -5.04% in the first quarter despite an excellent performance by the energy sector (+31.04%).

Economy

2022 Economic forecast

	2021	Consensus 2022	Optimum 2022
World	5.9	4.3	
Canada	4.6	3.8	3.6
United States	5.7	3.9	3.5
Euro zone	5.1	4.0	3.7
Emerging markets	6.5	5.0	

Source: Bloomberg

Consensus: Data as at February 1, 2022.
Optimum 2022 data are a forecast and may not be accurate.

From the macroeconomic standpoint, even though the world has learned to live with the effects of Covid-19, new risks are emerging. First, the continuing high level of inflation (5.7% in Canada and 8.5% in the United States) is obliging central banks to adopt a more aggressive tone to reduce inflationary pressures. The Bank of Canada raised its rates 0.25% at its meeting on March 2 and followed up with a further increase of 0.50% on April 13.

Geopolitical issues also played an important role in the first quarter with Russia's invasion of Ukraine on February 24. The war could ultimately reduce global GDP growth by 1% this year because of rising energy and commodity prices. These issues had a direct impact on the equity markets; countries rich in energy and commodities, such as Canada, performed better with the significant rise in the price of oil.

At this point, despite some normalization in growth since the post-Covid boom, we do not expect a recession in the next 12 months. U.S. consumer balance sheets are strong (less so in Canada), business inventories are low, and various governments continue to pump money into the economy. Moreover, valuations improved during the quarter; thus, we are more constructive on risk assets.

Bond Market

By Hugues Sauvé, FVP, Fixed Income and
Executive Assistant to the Canadian Investment Officer

FTSE Russell Index Performance/ First Quarter 2022 (%)

	Federal	Provincial	Municipal	Corporate	Total
Short	-2.73	-2.90	-2.95	-3.39	-2.98
Mid	-6.98	-6.52	-6.50	-7.16	-6.83
Long	-12.42	-11.95	-11.41	-10.71	-11.73
Universe	-5.55	-8.57	-7.95	-6.45	-6.97

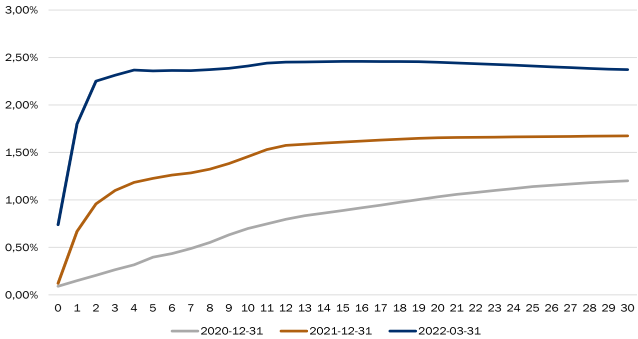
Source: FTSE Russell

Bonds had a very difficult first quarter with the entire yield curve steepening. All the components of the FTSE Canada Index had negative returns during the quarter.

The rise in the yield curve was pronounced, and the yield curve for Canadian federal bonds continued to flatten.

Of note, the curve inverted at the end of the quarter for bonds maturing in more than 10 years, causing concerns about a potential recession. Even so, as stated in the Economy section, we do not think a recession will occur in the coming year.

Canada Yield Curves



Source: Bloomberg

Even though inflation does not appear to be slowing and is expected to put upward pressure on rates in the medium term, market signals cannot be overlooked in the short term. Indeed, most technical indicators are pointing strongly to an oversold bond market. Thus, we think buying opportunities are now available.

Moreover, unless we return to an aggressive stagflation phase, like that of the early 1980s, which we do not expect, the now flattened yield curve usually signals a peak yield. Accordingly, we are now tactically positioned on rates.

STRATEGY

Because we started the year with equity markets near all-time highs, historically low interest rates and low credit spreads, we were positioned defensively with a short-term bias. That being said, as the markets fluctuated significantly, this did not prevent a decline in bond portfolio values. Even though we remain cautious about the global economic situation, we are more constructive on risk assets, whose valuation improved during the quarter. As for our two high-conviction transactions, real return bonds and preferred shares, we remain confident about their potential. We think real return bonds are still attractive, especially in relation to traditional bonds. The break-even point (1.8%) for real return bonds is still low in comparison with the Bank of Canada's inflation target (2%), Canadian inflation expectations (2.8% in 2023), current inflation (5.7%) and the U.S. real return bond break-even point (2.44%). As for preferred shares, their attractiveness has increased as a result of higher interest rates, lower market prices and a slight decompression of credit spreads in relation to comparable credit spreads.

OPTIMUM

Asset Management

Equities

By Nicolas Poirier, Director, Equities

The first quarter of 2022 was positive for the Canadian market (S&P/TSX) but more difficult for the United States (S&P 500) and global markets (MSCI World). With the current crisis in Ukraine, commodity and energy prices have increased substantially, which has benefited producing countries, including Canada.

In Canada, for example, the Energy and Materials sectors returned more than 28% and 20%, respectively. The Information Technology sector declined by more than 35% during the quarter. The table below shows the sector returns and their weight in the Canadian equity strategies.

Canadian Stock Market		Optimum Funds	
Sector Returns		Sector Weighting of Strategies	
	Q1 2022	Canadian Equity	Low Volatility Canadian Equity
Energy	28.8%	0.0%	0.0%
Materials	20.2%	4.9%	2.2%
Communication Services	8.8%	0.0%	12.9%
Consumer Staples	5.3%	12.1%	20.4%
Utilities	5.0%	0.0%	30.7%
Industrials	3.9%	26.6%	9.6%
Financials	2.3%	22.0%	19.4%
Real Estate	-4.7%	8.5%	4.9%
Consumer Discretionary	-7.7%	8.2%	0.0%
Health Care	-8.5%	1.1%	0.0%
Information Technology	-35.5%	16.5%	0.0%
First Quarter Return	3.8%*	-2.85%	3.06%

Source: Bloomberg

* S&P TSX Index
Please read the disclaimer at the end of this document.

STRATEGY

Optimum's strategy for the equity portfolios is to focus on companies with solid financial health, namely a low level of debt and high, stable gross margins over time. Such financial strength reduces the risk of refinancing and capital losses. The strategy largely excludes the energy and materials sectors, which have demonstrated unstable profitability and stock market returns as well as greater volatility over the entire economic cycle.

We think that, in an environment of high inflation, the companies in Optimum's portfolios will be in a better position to protect their profit margins and, therefore, their market value.

As an example, the table below shows the impact of an increase in the inflation rate on the financial structure of Estée Lauder versus Kraft Heinz Co.

Portfolio Holdings			Non-Portfolio Holdings		
Estée Lauder	**Before**	**After**	**Kraft Heinz Co**	**Before**	**After**
% of revenue			% of revenue		
Revenue	100%	100%	Revenue	100%	100%
Cost of goods sold	24%	25%	Cost of goods sold	66%	69%
Gross margin	76%	75%	Gross margin	34%	31%
General and administrative expenses	58%	58%	General and administrative expenses	14%	14%
EBITDA	18%	17%	EBITDA	20%	17%
Impact on profits		**-6%**	**Impact on profits**		**-17%**

We can see that companies with lower gross margins, in this case Kraft Heinz Co., will have a much greater drop in earnings than companies with high gross margins.

OPTIMUM®
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WHO WE ARE?

Combined, our asset management subsidiaries manage $7.8 billion Canadian dollars globally for an institutional and private wealth clientele. These subsidiaries are held by Optimum Group, which employs over 600 employees across Canada, the United States and in France.

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