April 2022

# Canada Outlook

## Geopolitical risks come to the fore as markets remain volatile in the face of conflict

### Key takeaways

- At this stage, there are many uncertainties about how geopolitical events will play out, and we are monitoring the evolving situation very closely.
- Canada's strong energy sector is well placed to ride out the volatility and post positive growth numbers.
- We do not forecast a serious bout of stagflation.

### Q1 review and outlook

Investment markets continue to endure heightened volatility as the geopolitical crisis between Russia and Ukraine unfolds. At this stage, there are many uncertainties about how events will play out, and we are monitoring the evolving situation very closely. Europe is expected to be the most affected region, reflected in the sharper rise in European gas prices and the likelihood of greater effects on investor confidence given its proximity to Ukraine and Russia.

Meanwhile, the US dollar and gold have all rallied, while crypto assets have fallen, and credit spreads have widened. Energy prices have been notably stronger, with oil rising and natural gas prices spiking.

Weaker exports to Russia and Ukraine are also likely to be an issue for some central and eastern European economies. Higher food prices will have bigger economic impacts in many emerging markets. As always, there will be relative winners and losers from higher energy prices, with net energy importers suffering the most. Canada's strong energy sector is well placed to ride out the volatility and post positive growth numbers.

### Growth and inflation may not improve until later in 2022, but we don't forecast stagflation

While the stagflation tone to economic data—lower expectations for GDP growth and profits, along with high inflation—is a concern, we do not forecast a serious bout of stagflation.

Stagflation scenarios point to a mix of heightened geopolitical tensions, high inflation, and policy hikes creating parallels with the 1970s oil shocks and corresponding stagflation. But encouragingly, the key difference today is a more supportive role from central banks even as they raise rates from very low levels. Although rates are rising, there is room for a slower pace if necessary. This allows room for markets to rebound, as they have traditionally done following geopolitical shocks.

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# Canadian investment strategy and market highlights

- A defensive allocation in today's environment means a selective approach to investing.
- We caution against going into cash given the current backdrop of high inflation.

## Investment strategy highlights

A defensive allocation in today's environment means a selective approach to investing. A defensive allocation is more than asset allocation, it looks for stocks and bonds with specific qualities that could help reduce the volatility of returns. One technique, for example, is to target stocks with lower levels of historic volatility.

However, while a defensive asset allocation is appropriate, we are remaining invested and modestly overweight equities. We would also caution against going into cash given the current backdrop of high inflation. We are bracing for continued volatility, being realistic about investment returns, and focusing on the long run. Being defensive and selective is encouraging our focus on the value and quality of the securities we select and hold.

During the first quarter, Canadian equities continued to outperform. In addition, equity valuations in Canada have moved from reasonable to attractive levels. Overall, the return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis. Within fixed income, we favour provincial bonds over Government of Canada bonds.

# 2022 outlook: Despite worsening growth and inflation, picture still looks favourable overall

- Market participants now expect the Bank of Canada and the US Federal Reserve to increase rates significantly before year-end.
- In Canada, consumer price inflation hit 5.7% in February, and remains well above the Bank of Canada's target range.

## Central banks firmly in tightening cycle as inflation continues rising

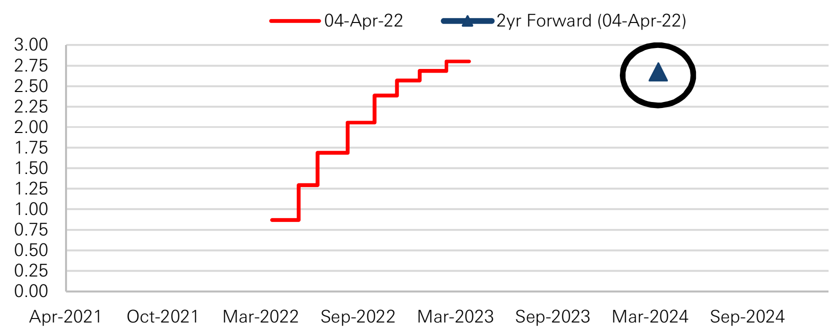
Market participants now expect the Bank of Canada and the US Federal Reserve to increase rates significantly before year-end. At its April 13 meeting, the Bank of Canada raised rates by half a percentage point. The last time there was more than a quarter percentage point rise was May 2000. Upward revisions to inflation and downward revisions to growth both reflect continued supply-chain difficulties and higher commodity prices.

The driving force behind the change in the Fed's policy outlook is higher-for-longer inflation than the Fed had been expecting, rather than reflecting a stronger growth outlook. Indeed, Chair Jerome Powell noted the committee is acutely aware of the need to return to price stability, given that it now expects core personal consumption expenditures inflation to remain above 4% throughout 2022. In Canada, consumer price inflation hit 5.7% in February, and remains well above the Bank's target range. Price increases have become more pervasive, and measures of core inflation have all risen.

- Our second-quarter outlook expects volatility will persist, but overall economic growth should continue trending well.

While markets may be troubled by the thought of central banks raising rates, we encourage investors to consider that these moves from policymakers show their increasing confidence that the long-term trajectory of economic growth still points to less need for stimulus. The recent federal budget echoed this sentiment when it signalled that pandemic supports will be withdrawn. It is also important to remember that on a historical basis interest rates are rising from an extremely low base.

**Bank of Canada Policy Rate Expectations (%)**




Source: HSBC and Bloomberg, as at April 4, 2022. Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. Past performance is not an indication of future returns.

Our second-quarter outlook expects volatility will persist, but overall economic growth should continue trending well. Making short-term investment decisions in a challenging geopolitical environment is usually not prudent. Responding to short-term volatility by deviating from long-term investment plans rarely yields positive results.

We remain keenly focused on the long term and recommend clients remain invested, given the solid fundamentals we expect will carry the markets through 2022.

## Important Information:

All quoted returns are total returns as at March 31, 2022 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, RIMES, Statistics Canada and the Bank of Canada.

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