Economic Outlook

The global economy is poised for another year of above-trend growth in 2022, albeit at a slower pace than 2021. At this time last year, the Organization for Economic Co-operation and Development (OECD) forecast global economic growth of 4.2% in 2021, following an expected decline of 4.2% in 2020. In the end, global growth contracted by a more modest 3.4% in 2020 and, after the smaller than expected recession, the OECD upgraded their global growth forecast for 2021 to 5.6%.

The global recovery has been strong, but it is becoming increasingly imbalanced. While output in most OECD countries has surpassed pre-pandemic levels, global output overall is still well below its pre-pandemic forecast. Low-income economies have struggled to keep up with high-income economies, where capacity for fiscal and monetary support is greater and vaccination rates are higher. Even within advanced economies the recovery is uneven. Labour shortages vary by region and industry. Consumer demand for goods continues to exceed demand for services like travel and other hospitality-related businesses, exacerbating supply chain bottlenecks. A rise in demand for resources as pandemic restrictions eased, combined with market supply disruptions, led to a shortage in energy supplies like natural gas. The shortage was particularly acute in Europe which has become increasingly reliant on natural gas imports, leading European natural gas prices to quadruple in 2021. These factors all contributed to inflationary pressures persisting for longer than was expected even just a few months ago.

Inflation continued to be a dominant theme in 2021. As we head into 2022, many central banks, including those in Canada and the U.S., have announced plans to increase interest rates in response to persistent inflationary pressures. The inflation rate is expected to remain elevated heading into the summer before subsiding through the balance of the year. Consumer spending patterns, the eventual normalization of supply chains, and a continued drawdown in elevated household savings rates should also help ease inflation, although it will likely remain above what the economy has become accustomed to over the past decade.

As we look ahead to 2022, expectations for global growth remain strong albeit more moderate. The OECD projects above-trend growth of 4.5% in 2022 and 3.2% in 2023 – an average year for global growth over the last decade has been around 3.0%. However, any forecast is subject to heightened uncertainty due to the ongoing pandemic. The rapid spread of the Omicron variant has already resulted in renewed restrictions which further clouds the short-term outlook. The economy, however, has proven an ability to better weather successive waves of the pandemic and this one should be no exception. So, after a weaker start to the year, activity should rebound solidly through to the end of 2022.

Regional Snapshots

United States: The U.S. was the one major economy that easily topped growth expectations in 2021. This achievement was largely due to aggressive fiscal stimulus which drove elevated consumer bank balances and spending. It also played a big role in heating up inflation which we anticipate will end 2021 at a 40-year high. In response, the U.S. Federal Reserve (the Fed) is accelerating a plan to end quantitative easing in the first quarter of 2022 and hike interest rates soon thereafter. GDP growth will likely lose some momentum as a result, but it should still rise at an above-trend rate of 3.5% to 4.0%, while inflation should drop from current levels but is expected to remain elevated at around 4.5% to 5.0%.

Canada: Canada looks to have grown its GDP by about 4.5% in 2021 but this gain was less than was generally expected. There were three key drags on the economy – virus restrictions, weak auto production due to chip shortages, and drought conditions in western provinces. A repeat of these severe events is unlikely in 2022 so a GDP growth rate similar to the U.S. could be reasonably expected and this would see the country finally return to trend growth. Despite slower growth and lower inflation than the U.S., the Bank of Canada (BoC) has been leading the Fed in terms of the removal of monetary accommodation and has signalled a more aggressive tightening schedule – no doubt influenced by a renewed inflation mandate, a hot housing market, and a full recovery in jobs.

China and other Emerging Markets: China served as an early example of how quickly an economy can recover when conditions return to some semblance of normal. The world's second largest economy grew by about 8% in 2021 as stringent lockdowns curbed the spread of COVID-19 and allowed for a relatively early resumption of economic activity. However, as the year progressed, retail sales and industrial production cooled somewhat amid regulatory scrutiny on various sectors of the economy, an over-heated property market, and a commitment to lowering carbon emissions, which all conspired to slow growth. These trends are unlikely to reverse themselves in 2022 so a lower rate of growth should be expected. Inflation in China did not increase nearly as much as it did in other major economies and its central bank maintained a higher interest rate, providing more flexibility to ease domestic monetary conditions if required. Emerging market (EM) economies outside of China also saw pockets of financial strain, most notably Turkey, where inflation jumped to 36% in December. While most central banks raise interest rates to cool inflation, Turkey's central bank cut interest rates, sending the Turkish Lira plummeting to an all-time low against the U.S. dollar. Broadly speaking, however, EM economies generally weathered conditions that were more challenging as inflation rates rose, requiring an earlier tightening response from central banks, aggressively so in cases like Brazil and Mexico. Combined with ongoing COVID challenges, uneven vaccination rates, and a slow recovery in tourism, growth for EM economies will likely remain challenged in 2022 relative to the developed world.

Euro area: The Euro area generated strong economic growth of about 5% in 2021. The region ended 2021 facing its largest virus wave which will act as a drag on economic growth in the first quarter of 2022. However, strong employment, a dovish central bank and more moderate inflation relative to the U.S. should be supportive of growth throughout 2022, with GDP growth expected to slow only modestly to around 4.0%.

Japan: The recovery in Japan remains lacklustre as economic growth of 1.5% in 2021 was below pre-pandemic levels amid the waves of COVID-19 and supply disruptions in the auto sector. Given Japan's structural challenges with an ageing population and weak underlying growth trends, only a small improvement can be expected, aided by an increase in auto exports. Unlike other countries, inflation has remained very subdued in Japan as CPI remained mostly unchanged from a year ago.

Market Outlook

From a financial market perspective it felt like a long year despite the strong performance of equity markets as there were a number of events that highlighted the rapidly changing nature of trading and investment.

Fixed Income Markets

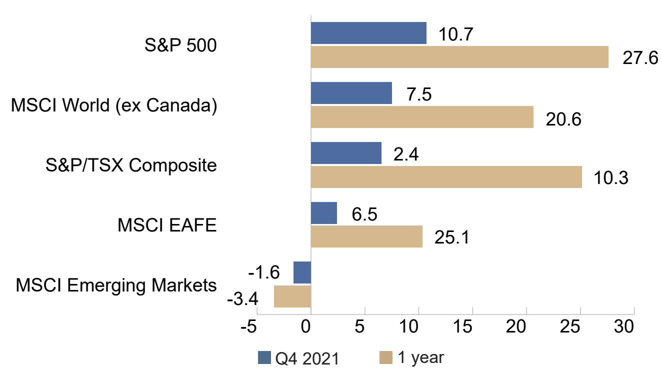
In late February, the auction of seven-year U.S. government bonds – typically a routine event – greatly unsettled financial markets as the weakest demand on record caused sharp price drops (higher interest rates) in bond markets around the world. The incident came at a time when markets were starting to recognize that consumer inflation was set to rise but also illustrated that the world's most important financial market was not as structurally robust as it used to be.

The persistence of inflation finally grabbed the attention of the major central banks: most announced plans to remove some forms of monetary policy accommodation in the coming quarters, accommodation that had been in place since the early days of the pandemic. This more aggressive shift from central banks sent ripples through the bond market, with yields on short-term bond (five years and under) rising dramatically in the fourth quarter. The prospect of less accommodative monetary policy, coupled with uncertainty relating to the spread of the new Omicron variant and its impact on the global economic recovery, had the opposite effect further out the yield curve, where yields on long-term bonds (ten years and longer) fell. The decline in long-term bond yields may also be reflective of investor rebalancing activity, as pension plans de-risk (locking in equity gains and buying long-term bonds) following the strong performance of equities relative to long-bonds in 2021. Overall yields on short-term bonds rose above yields on long-term bonds resulting in a much flatter yield curve, even as inflation expectations remained elevated. Total returns for the Canadian bond market were negative for the year, a rare occurrence, and positive for the quarter. Overall, these changes are consistent with a market that expects assertive central bank activity to address high inflation early in 2022 but believes that this level of inflation will not persist longer-term and that growth will also moderate. Corporate and provincial mid-term bonds underperformed this quarter as spreads to government bonds widened modestly. Preferred share gains modestly outperformed that of the bond market in the fourth quarter and greatly outpaced the returns from all segments of the Canadian bond market over the course of 2021.

Equity Markets

It was an extraordinarily good year for equity markets despite persistent headwinds wrought by the pandemic. Even Omicron couldn't dampen returns as developed markets capped off the year with solid gains in the fourth quarter. U.S. and Canadian markets led the way in 2021. Developed markets in Europe performed well, while Japan trailed. It was a challenging year for Emerging Market equities which lagged the rally in developed economies amid weakness in China. Large cap stocks outperformed small cap stocks, but the S&P/TSX Small Cap Index in Canada and the Russell 2000 Index in the U.S. still generated double-digit returns for the year. The markets' prevailing positivity in 2021 fueled a hefty appetite for risk that lifted more speculative areas of the market as evidenced by a myriad of events: day traders turned to social media sites like Reddit to propel struggling meme-stocks like GameStop and AMC Entertainment to sky-high valuations; cryptocurrency trading in meme-coins like Dogecoin became mainstream; and there was a euphoria for all things electric with Tesla's market value now higher than the entire publicly traded auto industry. With central banks set to increase interest rates in the coming quarters, we believe investor focus will once again turn to whether corporate earnings are supported by fundamentals.

Equity Index Performance (Net, CAD)
(Three months ending December 31, 2021)



Source: TD Securities, MSCI

Currency Markets

In currency markets, the U.S. dollar (USD) performed well again this quarter. The U.S. Dollar Index (DXY), a measure of the value of the USD relative to a basket of U.S trading partners' currencies, continued its strong run of appreciation, reflecting the more hawkish rhetoric coming from the Fed (hawkish policymakers favour high interest rates to curb inflation). The DXY was up by about 6.4% in 2021. The Canadian dollar (CAD) lost some ground against the USD over the past three months but performed in line with the greenback over the past year, reflecting a few different factors including slower economic growth relative to the U.S., lower inflation, and an increasingly hawkish Fed.

Investment Outlook

Our investment outlook remains relatively consistent with prior quarters:

- With interest rates expected to increase in 2022, we continue to project future returns from fixed income to be lower than those from equity investments.
- Equity valuations remain elevated, but even with interest rates set to become less supportive, equities should, in our opinion, continue to outperform bonds.

In this environment we continue to favour exposure to equities overall, particularly the Canadian market given its higher exposure to economically sensitive sectors like Materials, Energy and Financials, which should continue to benefit from the ongoing global recovery. We also continue to favour select corporate bonds and preferred shares as these securities provide an important source of yield in what is still a low interest rate environment by historical standards. Growth for Emerging Market economies will likely remain challenged in 2022, but we believe EM equity markets remain attractive given lower valuations relative to the developed world and potential upside from an eventual post-Omicron reopening as well as strong long-term growth prospects.

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Investment returns and assets under management are expressed in Canadian dollars unless otherwise noted. Investment returns are gross of investment management fees, net of fund expenses for FGP Pooled Funds, and include reinvestment of dividends and income. Returns are time weighted and annualized for periods greater than one year. Values change frequently and past investment performance may not be repeated.

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