Market Commentary
May 20, 2022

In light of the volatility that we have seen in equity markets recently, we felt that it would be useful to provide a more detailed commentary on what factors have been driving the markets so far in 2022 and where we see things going from here.

Background:

In the years leading up to 2022, there have been several factors benefitting equities, bonds, and the global economy, including low levels of inflation and low interest rates. As a result, equity markets reached new highs. A popular measure of the stock market's valuation is the price-to-earnings ratio, which compares average stock prices against the average level of company earnings. From this perspective, we have already seen market valuations (P/E ratios) in the US fall from the highpoint of 22.1 to 16.0 times earnings, while in Canada valuations have dropped from 16.5 to 12.0 times earnings. These valuations are now below their 10-year averages of 16.1 in the US and 14.3 in Canada. Despite these lower valuations and a recent earnings season that was quite strong, market sentiment remains poor, and volatility continues in the stock markets.

What is driving the market?

Supply Chains:

One of the primary concerns driving the market continues to be global supply chain challenges. Supply chain issues surfaced in late 2021 as Covid-19 restrictions were relaxed. Most notably in the automobile industry, when car manufacturers tried to ramp up production to meet increased demand and faced challenges securing the computer chips that they needed. Initially this was thought to be a temporary and isolated issue, but similar shortages began appearing in other industries as well. The Russia/Ukraine conflict resulted in many sanctions on Russian imports and commodities, making the situation even more difficult. Furthermore, recent lockdowns in China have added to the level of concern. Of course, supply chain issues make the production of goods more expensive for companies, which then requires selling those goods at higher prices, contributing towards higher inflation.

Inflation:

Inflation levels have been increasing steadily in the first half of 2022. We have to remember that the main function of Central Banks is to ensure price stability in the economy. The economy functions best when inflation is slightly positive, which is why most Central Banks have a target inflation rate of 2% per year. With inflation levels rising above the 2% level this year, Central Banks have started raising interest rates to help bring inflation levels down (or at least stop them from rising further). Investors have had to assess what the impact of these rising interest rates

will be on the consumer and the economy. We have seen a wide range of opinions from analysts on the subject, some of whom think that we have already seen peak inflation levels while others maintain inflation will continue rising. While over the long term, taking the necessary steps to ensure that the economy remains healthy is certainly appropriate, the short-term uncertainty this creates has contributed to the volatility that we are seeing in the markets today. For those interested in an in-depth look into inflation please see the link to CIBC Capital Markets-Economic Insights- Inflation A Deeper Dive

Interest Rates:

The tool chest of the US Federal Reserve (The Fed) contains many actions which can be utilized to impact inflation. One of these is interest rates. The Fed has increased rates to .75% this month. The Fed has indicated it will be moving rates higher in the coming months. Some of the activity in the equity markets involves borrowed money (leverage). The increase in rates and the promise of higher rates to come will result in some market participants reducing their equity holdings because these are purchased with borrowed funds. This de-leveraging can result in more volatility.

Where do we go from here?

Ultimately, what happens in the short-term with stock markets will depend on how long the rate hike continues, which will depend on inflation levels, which will depend on supply chain challenges. One could argue that much of the recent downturn in stock markets has been based on the market "pricing in" the risk of a potential recession as a result of the above factors. Therefore, if inflation levels cool in the coming months and Central Banks are able to relax their interest rate hikes as a result, it could soften a lot of the worry in today's markets and open up a clear path forward for stock markets to stabilize and increase from current levels.

One key indicator of an upcoming recession is found by looking at the rates offered on government bonds over time, which is called the Yield Curve. In a healthy environment, the Yield Curve should be upward sloping, which it is today. It is very uncommon for a recession to occur when the Yield Curve is upward sloping. It is also important to note that consumer savings levels are still at or near their all-time high levels.

At the moment, investor concern likely stems more from the general level of uncertainty rather than one single problem. While more aggressive investors may have begun buying into much of the negative rhetoric, it is nearly always best to step back and re-assess the situation before acting. Uncertainty tends to breed fear and irrationality and can even evolve into panic. In a recent monthly newsletter, we wrote that investor success comes from "Time *in* the market, not *Timing* the market". The reason is simply that market timers usually end up missing the best days that often follow these corrections. Multiple studies have shown that over time, missing out on those best-returning days tends to far outweigh the losses incurred on the way down. Although market setbacks are inevitable, they can often be overwhelming and stressful for investors. In these environments it is even more important to stay patient and focused on one's longer-term investment objectives.

Protecting Portfolios

We humans try to avoid pain, whether physical, emotional or financial. Financial pain is caused by many situations, declining portfolios would be one. When this occurs one can become trapped into thinking the best course of action is to go to cash. While the thought of cash may seem like a good choice it creates longer term problems for anyone hoping to keep pace with inflation.

Our approach to managing portfolios considers several different aspects to determine the economic environment, valuation of the equity and bond markets as well as considering the relative strength of any investment we are considering. Relative strength considers a security's price relative to all securities in the market. Some securities will have a high relative strength reading (desirable) while others low . First, we consider the state of the economy and current growth, inflation along interest rate projections. We then consider protecting capital by reducing but not eliminating equity exposure during times of heightened volatility. This can be described as being defensive.

Since the beginning of 2022 we have taken steps to protect capital many times. The portfolios currently have the highest cash levels we have seen, and we are waiting for the right time to reposition the cash to take advantage of lower prices.

Dave Morgan and Wes Taylor

"CIBC Private Wealth" consists of services provided by CIBC and certain of its subsidiaries, through CIBC Private Banking; CIBC Private Investment Counsel, a division of CIBC Asset Management Inc. ("CAM"); CIBC Trust Corporation; and CIBC Wood Gundy, a division of CIBC World Markets Inc. ("WMI"). CIBC Private Banking provides solutions from CIBC Investor Services Inc. ("ISI"), CAM and credit products. CIBC World Markets Inc. and ISI are both Members of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. CIBC Private Wealth services are available to qualified individuals. Insurance services are available through CIBC Wood Gundy Financial Services Inc. In Quebec, insurance services are available through CIBC Wood Gundy Financial Services (Quebec) Inc. The CIBC logo and "CIBC Private Wealth" are registered trademarks of CIBC. Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. David Morgan and Wes Taylor are Investment Advisors with CIBC Wood Gundy in St Catharines. The views of The Morgan and Taylor Advisory Group do not necessarily reflect those of CIBC World Markets Inc.