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Russian Invasion of Ukraine and Global Price Pain

The Russian Invasion of Ukraine Exposed a Dormant Geopolitical Rift and the Impacts May Be Many, Pervasive and Enduring

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Quarterly Summary and How We're Positioning for Q2

Our thoughts are with the people of Ukraine and the many Canadians with affected friends and family. We hope for a rapid de-escalation and end of unnecessary human suffering in the area. In March, Raymond James employees and the Raymond James Canada Foundation contributed over $200,000 to the Red Cross's Ukraine Humanitarian Crisis Appeal. As this conflict continues, humanitarian support will be needed more and more. Donations can be made here.

Make no mistake. The world changed forever in Q1. No longer can we pretend that the tensions and scars borne out of WW2 and the Cold War are history. Lines that were drawn in the sand back then remain in the sand now. The façade of global unity and universal respect for sovereignty and humanity allowed global trade to flourish but that façade appears to be fading and with it trade and cordial relations. The price effects and supply chain issues caused by the Russia-Ukraine conflict, some by choice and some not, could persist for generations.

In addition to the tragic suffering of the Ukrainian people, Russia's invasion of Ukraine caused major supply disruptions for many of Ukraine's exports, negatively affecting the well-being of people all around the world. While Ukraine is a lower income and developing nation and is only the world's 57th largest economy (2021 GDP), its significance to the global food chain and base metals industry should not be overlooked. Ukraine is often found in the top 10 food producing countries in the world and is a top 10 producer of many base metals including iron ore, manganese, titanium, graphite and uranium and supplies almost half of the world's neon and krypton gas. Removal of part or all of Ukraine's exports will send the price of basic necessities and consumer goods much higher. Many households around the world now face food insecurity and the risk of famine is now much higher. As a result, the war in Ukraine may cause geopolitical instability around the world.

While a united and firm response to Russian aggression is widely supported, the West's retaliations to Russia's violation of Ukrainian sovereignty may exacerbate the global food and base metal supply crunch, further pushing prices even higher. Various sanctions and other restrictions on the purchase of Russian goods, including energy, food, fertilizer and base metals further restrict global supply. That said, the anti-Russia stance is not a unanimous one, as countries like China, India and Pakistan are hesitant to stop trading with Russia due to their limited ability to switch to new sources of supply without risking higher levels of poverty and malnourishment in their own countries. Further, many Western countries, like Germany, and most Eastern European countries have limited ability to stop Russian trade altogether due to heavy reliance on Russian energy and food exports.

The world will need to balance the almost existential desire to defend a democratic country against aggression with the global poverty caused by taking action against the aggressor. Rock and a hard place indeed.

The rapid price appreciation seen for food and gasoline shortly after a period of rapidly rising global shelter costs, is sure to put stress on many households and economies around the world. Further, expectations are that the US Federal Reserve and other central banks are set to rapidly increase interest rates throughout 2022, leading to rapidly rising debt service costs as well. Needless to say, though we entered 2022 with historically low unemployment rates and strong household and corporate balance sheets, the economic successes we achieved and the financial defenses we built throughout the pandemic are about to be put to the test in historic fashion. The economic stress on the horizon has some market pundits forecasting moderate-to-high odds of recession. We agree that with the headwinds that exist, many of which are out of the control of policymakers, the risk of recession is the highest it has been in a long time.

In addition to the effects of war, COVID outbreaks remain an economic issue. The largest outbreak to date in China pushed policymakers to once again implement targeted but relatively extreme lockdowns, stifling economic growth in China and disrupting supply chains around the world. COVID restrictions may continue to hamper global economic growth so long as the virus remains widespread and threatens hospital capacity.

Equities were mixed in Q1, with the S&P 500, NASDAQ 100 and TSX composite indices returning -5%, -9% and +4%, respectively. The S&P 500 and NASDAQ sunk due to weakness in the technology and consumer discretionary sectors, which often do poorly during periods of rising interest rates and input costs, while the TSX was buoyed by strength in the energy and materials sectors, which benefitted from higher commodity prices.

How To Position Portfolios Going Forward?

US and Canadian fixed income markets were exceptionally weak in Q1, posting returns of -6% and -7%, respectively. While we have exposure to fixed income, our more tactical positions, specifically the Lysander Corporate Value Bond Fund (LYZ801F/A) and CI Enhanced Government Bond ETF (FGO), weathered the drawdown well. The selloff in bonds, especially long-term bonds, has been a historic one and one that continued subsequent to quarter-end. We see opportunity to add to longer term bond exposure in the coming months to help offset future potential equity market weakness. Even GICs are looking attractive again with three to five year GIC yields ranging from 3.9% to 4.0%. By design, due to fixed maturity dates and yields, fixed income and government bonds in particular, are still be expected to anchor long-term portfolio returns and volatility, despite recent volatility.

Alternative investments did what they were designed to do in Q1, rising as a group, and truly the only safe harbour in what was a poor quarter for equities and fixed income. As the economic outlook remains quite weak, we think maintaining a material allocation to alternative investments is prudent.

Our models weathered Q1 well despite being underweight the energy and materials sectors. Overweight positions in the telecom, utilities and consumer staples sectors (relative to Canada) and underweight positions in the technology and consumer discretionary sectors (relative to the US) helped performance relative to the broad markets during the quarter. While the telecom, utilities and consumer staples sectors did not blow the doors off like energy and materials, they were all notably positive in Q1.

We captured some profits on our defensive and blue chip positions in Q1, as they are becoming a bit expensive relative to history, rotating into monopolistic, high growth stocks that have fallen significantly from their highs. We believe the precipitous decline of some US high growth technology stocks may be following the same pattern seen during the dot-com bubble. Stocks that survived and thrived following the popping of the dot-com bubble – Cisco, Amazon, eBay, Qualcomm and Microsoft – fell ***65%-95%*** from the bubble highs to lows, erasing their 1998-2000 bubble era gains. These stocks fell this much peak-to-trough despite continuing to grow at impressive rates throughout the downturn. We believe investing in select high growth US technology stocks may make sense now, despite elevated odds of a US recession on the horizon.

In the aftermath of the dot-com bubble, the five stocks mentioned above bottomed 0-22 months before broad equity markets, some before the recession began and others before the recession was officially over. Monopolistic, high growth stocks like DocuSign (DOCU), Zillow (Z), Zoom Video Communications (ZM), Illumina (ILMN) and Uber (UBER) have fallen as much as 42%-83% from their highs, erasing their pandemic era gains. All operate in industries with massive addressable markets and appear capable of extracting significant value from their monopolistic positions going forward. While high growth stocks are outside of our typical defensive, blue chip investment style, we believe adding a small allocation to these stocks, for clients where higher risk securities is tolerated, will improve long-term portfolio return expectations with limited impact on long-term portfolio volatility.

As always, we are working constantly to position your portfolio appropriately to maximize return, while managing your overall portfolio risk exposure. Please feel free to reach out if you have any questions or concerns.

Sincerely,

Steele Wealth Management