Economic Commentary

Second Quarter 2022

Inflation Remains Key Driver

Inflation remains the key driver impacting global financial markets. It was expected that inflation had peaked and would show signs of receding throughout the balance of the year. The U.S. inflation rate did decline from 8.5% in March to 8.3% in April, however, the market was surprised when the inflation rate moved higher in May to 8.6%, the highest level since 1981. In addition to wanting to see evidence that inflation is receding, the Fed would also like to see expectations for future levels of inflation start coming down. In that regard, the Fed made reference to the University of Michigan Consumer Sentiment Index, which is normally a second tier economic report. Future levels of inflation as outlined in that report were much higher than expected and that report, in combination with the higher than expected CPI print for May, were the major factors behind the Fed taking a more aggressive stance and hiking interest rates by 75 b.p. its June meeting. Inflation in Canada also moved much higher than expected, surging to 7.7% in May, the highest level since 1983. European inflation levels are also continuing to surprise on the upside, with the Eurozone rate at 8.1%.

U.S. Fed & BoC Ramp Up Rate Hikes

The U.S. Federal Reserve and the Bank of Canada have both adopted a much more aggressive path in setting interest rate policy. The projected pace and magnitude of interest rate hikes has accelerated much faster than earlier anticipated. On-going inflationary fears continue to be the major impetus behind the marked change in central bank policy. The Fed raised rates by 75 b.p. in June, moving away from the expected hike of 50 b.p. at the last minute based on worrisome inflation readings. Although the Bank of Canada raised rates by 50 b.p. in both April and June, it is expected that it will raise rates by 75 b.p. in July, matching an expected similar move by the Fed. Fed Chair Powell has stressed that the FOMC will do whatever it takes to bring inflation back in-line with its 2% target rate, even if it means negatively impacting the economy. As recessionary fears began surfacing at the end of the second quarter, investors began to question whether the Fed would have to curtail some of the projected moves, or possibly begin lowering rates shortly after the terminal rate has been achieved.

Recession Risk on the Rise

As a result of the higher-than-expected inflation Economic data have shown signs of softening, contributing to fears that a recession will occur later this year. The Fed has made it very clear that it will continue with aggressive interest rate hikes until inflation has been brought under control, regardless of the impact on the economy. The Fed is confident that it can manufacture a soft landing despite the significant interest rate hikes projected throughout the balance of the year. However, first quarter GDP in the U.S. came in at (1.6%) and data in Canada are showing a potential slowdown as well. One sector in particular which will be impacted by the rapid increase in interest rates is the housing sector, as soaring mortgage rates have led to a softening of the housing market. The housing sector had been the main driver behind the economic recovery coming out of the pandemic. In addition, supply chain constraints due to the Ukrainian conflict, as

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Key Metrics

Indicator	Value	Chg Q1	Chg 1Y
S&P/TSX Composite	18,861.36	-13.2%	-3.8%
S&P 500 (USD)	3,785.38	-16.1%	-10.6%
iShares MSCI EAFE ETF (USD)	62.49	-13.2%	-17.4%
USD/CAD	$ 0.78	-2.8%	-3.7%
WTI Crude ($/bl))	$ 105.76	5.5%	43.9%
GoC 10Y Bond	3.22%	82 bps	183bps
GoC Deposit Rate	1.50%	100 bps	125 bps
Cdn CPI YoY	7.7%	+1.0%	+4.6%
US 10Y Treasury	3.02%	68 bps	155 bps
Fed Funds Rate	1.75%	125 bps	150 bps
USD CPI YoY	8.6%	+0.1%	+3.2%

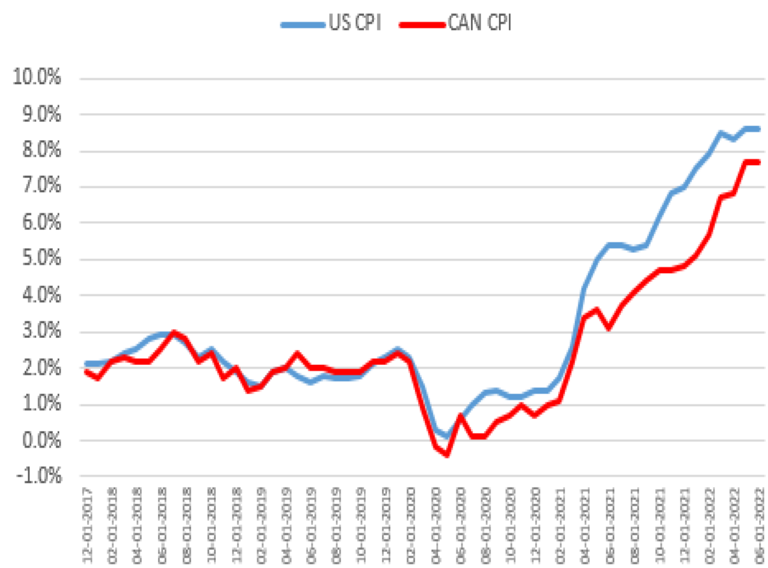
Top Themes

Higher than expected inflation remains the key driver in financial markets

Speed and magnitude of rate hikes increasing around the world

Economic data showing signs of slowing, prompting fears of a recession

Top Chart: U.S. & Canada CPI YoY (%)



Source: Bloomberg, Lincluden

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well as the on-going economic impact of COVID, continue to disrupt economic conditions. One major underpinning in the economy is the fact that North American labour markets remain resilient. Job data will be a key statistic to follow over the course of the summer, as any pullback in labour conditions will increase the likelihood of a recession occurring.

Equity Markets Deteriorate While Bond Yields Drive Higher

Equity markets declined substantially during the second quarter as U.S. indices entered bear market territory. The impact of higher inflation, which led to more aggressive interest rate hikes by North American central banks, was the contributing factor behind the massive decline. In addition, as economic data showed signs of weakening, the potential for an economic recession hit equity markets further. The Canadian stock market performed relatively better than its U.S. counterpart, however, it too felt the brunt of the rough quarter for equities and is now down double digits on a year-to-date basis. Bond yields continued to drive higher for most of the quarter on the back of higher inflation and aggressive interest rate hikes by central banks. The yield on the benchmark 10 year U.S. Treasury bond ended the quarter at 3.02%, up 68 b.p. during the second quarter. The yield nearly hit 3.50% in mid-June before rallying into quarter-end due to recessionary fears.