First Quarter 2022 Review

GLOBAL EQUITY AND INTERNATIONAL STRATEGIES

The first quarter of 2022 was like a rollercoaster for investors. The S&P 500 fell by more than 12% during the first few months of the year, but then rallied by nearly 10% off the lows by the end of the quarter. Given the swift rebound, the S&P 500 stood about 5% below its all-time high at the end of the first quarter. The volatility was even more pronounced in Europe with the Euro Stoxx 600 falling by approximately 15% during the beginning of the year. In similar fashion to the U.S., European stock markets had a sharp rebound such that the Euro Stoxx 600 index sat within 6.5% of its all-time high as of quarter end.

The surge in volatility at the beginning of 2022 was caused by several factors including persistent inflation which led to a more hawkish tone from the U.S Federal Reserve. The outbreak of the war in the Ukraine was also a contributing factor to market volatility. A spike in COVID cases in certain parts of the world also rattled global markets and led to a new round of lockdowns in certain countries such as China. In addition to these factors, some parts of the U.S. Treasury Yield have recently inverted. The yield curve inversion adds another layer of confusion for investors. We will discuss some of these issues in further detail in the Outlook section.

Portfolio Review:

Portfolio activity was busy during the first quarter of 2022. Given the persistence of inflation and the outbreak of the war, we have tilted our Global & International portfolios to be incrementally more conservative. We increased our weight in the Consumer Staples sector and reduced our exposure to the Consumer Discretionary and Technology sectors. As part of these changes, we initiated a new position in Nestlé.

Nestlé is a high-quality Consumer Staples company with strong market positions in attractive categories. The company has #1 or #2 market share positions across 75% of its portfolio. Nestle's major product categories include premium coffee (Nespresso, Nescafe, Starbucks), premium pet care (Purina One, Purina Beyond), and premium water (Perrier and San Pellegrino). In addition to these categories, the company's Health Science division has become a key area of focus. Nestle aims to empower healthier lives through nutrition, with a particular focus on the areas of healthy ageing, metabolic and obesity care, paediatric and acute care, and gastrointestinal and brain health. The company's management has been very active in recent years in terms of acquisitions and divestitures. Over the last 5 years Nestlé has completed more than 75 transactions, which is equivalent to nearly 20% of group sales. As a result of these actions, the company is better positioned to drive sustainable growth over the long term. This portfolio transformation has increased its exposure to higher-growth, higher-margin categories. We are excited about the growth prospects of the company and believe this addition adds another layer of stability to our portfolios.

Outlook for 2022:

As we think about the rest of 2022, we see a balanced mix of positives and negatives. Stubborn inflation, rising interest rates, and the situation in the Ukraine give us some reasons to be concerned. On the other hand, the economies around the world continue to recover from the recession of 2020, consumer balance sheets are strong, and there is significant pent-up demand in certain pockets of the economy including travel and hospitality.

As we all know, the war in the Ukraine will have significant implications for the global economy. The degree to which this conflict impacts the global economy will depend on how long the war lasts and whether the sanctions imposed against Russia become permanent in nature. In the short-term, the war in Ukraine will slow the global economy. JPMorgan estimates that the Euro area will generate GDP growth of approximately 2% in 2022. This compares with an expectation of 4.5% earlier in the year and prior to the invasion, so the war is having a huge economic impact on Europe. The U.S. economy will also be impacted although to a much lesser degree than the Euro area. JPMorgan economists expect U.S. GDP growth of 2.5% for 2022, which compares with a previous forecast of 3%. In terms of the long-term implications, the war in the Ukraine is likely to be a game changer for the world order. In addition to the humanitarian crisis and the tragedy for the people in the Ukraine, the conflict has led to turmoil across commodity markets including energy, agriculture, and base metal commodities. These disruptions have led to additional inflationary pressures which comes on top of elevated inflation that existed prior to the invasion. As each day passes, it is becoming increasingly obvious that global trade agreements and the world's supply chains will need to be restructured. The wheels were already in motion for this to happen prior to the invasion in the Ukraine. The vulnerability of global supply chains was on full display during the COVID-19 pandemic. A good example of this phenomenon is the severe shortage in the United States for personal protective equipment that was needed by healthcare workers as they were fighting the pandemic. At the height of the pandemic healthcare workers protested and compared themselves to firefighters putting out fires without water. One of the key factors that led to the severe shortage is that the US is the world's largest importer of face masks, eye protection, and medical gloves, making it highly vulnerable to disruptions in exports of medical supplies. In the years ahead, we believe that global supply chains will be restructured so that mission critical products can be accessed closer to home.

The sanctions that have been placed against Russia have wide reaching implications because Russia is a significant producer of various commodities including energy, metals, and grains. In terms of energy, it has been estimated by UBS that Russia provides 40% of the European Union's gas imports and 30% of its oil imports. With regards to agricultural commodities, Capital Economics estimates that Russia and Ukraine combined make up nearly 30% of the world's wheat exports. In terms of fertilizers used for agriculture, Russia and Belarus collectively account for more than 35% of global potash production. Russia is also a significant producer of nickel, iron ore, palladium, and many other commodities. Regardless of the outcome of the war, we expect a significant restructuring in the sourcing of global commodities given the high levels of production in Russia and other countries that were part of the former Soviet Union. Even with a peaceful resolution to the war in the Ukraine, it seems highly unlikely that countries will maintain the status quo that existed prior to the invasion of Ukraine and act as if nothing transpired.

Although inflation and the war have dominated the headlines thus far in 2022, the recent inversion of the U.S. Treasury Yield curve has caught the attention of investors. A yield curve inversion occurs when interest rates on long-term government bonds fall below short-term yields. The recent inversion has led to concerns about what it may be signaling for the economy and the stock market. History has shown that a recession typically occurs after an inversion of the yield curve. That's the bad news. The good news is that stocks continue to perform well between the onset of an inverted yield curve and the recession that typically follows. The reason for this is that monetary policy works with a lag, so it takes time for monetary tightening to take effect on the economy. Over the past six decades, the average amount of time between the initial inversion of the yield curve and the onset of a recession has been approximately 18 months. While an inverted yield curve has been a reliable indicator in terms of predicting a recession, it has not been a very good timing tool for equity investors. As seen in the chart below, the median return for the S&P 500 from the date in each cycle when the yield curve inverts to the market peak is about 19%. Over the last six decades investors who sold their stocks right after a yield curve inversion typically missed out on further gains in the stock market.

Inversion Date	S&P 500 Index Peak Date	S&P 500 Index % Change	# of Months from Inversion to S&P 500 Index Peak	Recession Start Date	# of Months from Inversion to Recession
Dec. 17, 1965	Nov. 29, 1968	17.69%	35	December 1969	48
March 30, 1973	Jan. 11, 1973	NA	-2	November 1973	8
Aug. 17, 1978	Jan. 30, 1980	9.63%	17	January 1980	17
Sept. 11, 1980	Nov. 11, 1980	11.83%	2	July 1981	10
Dec. 14, 1988	July 16, 1990	34.02%	19	July 1990	19
May 26, 1998	March 24, 2000	39.62%	22	March 2001	34
Dec. 27, 2005	Oct. 9, 2007	24.56%	22	December 2007	24
Aug. 26, 2019	Feb. 19, 2020	19.13%	6	March 2020	7
	Median	19.13%	18		18

Sources: National Bureau of Economic Research, Bloomberg, L.P. The S&P 500 Index is a market-capitalization-weighted index of the 500 largest domestic U.S. stocks. Indices cannot be purchased directly by investors. Past performance does not guarantee future results.

Given the inflationary backdrop, the war in Ukraine, and the inversion of the yield curve, investor anxiety has increased. This fear has been reflected in various sentiment readings which have reached extreme levels of pessimism in recent weeks. Although the backdrop is concerning, it's not all doom and gloom. There are some scenarios that could transpire that would cause investor sentiment to shift from pessimism to optimism. It is very much in the realm of possibility that we could get a ceasefire in the Ukraine. COVID could also fade into the background, which would go a long way in alleviating global supply chain bottlenecks. If supply chain bottlenecks are resolved, it would have positive implications for inflation. And this would put less pressure on central banks to raise rates. Under this scenario the focus of the market could return to corporate earnings, which have been very strong and are one of the key drivers for global stock markets over the long term.

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In our view inflation will eventually subside although we are uncertain as to the timing of when this will happen. Until we reach that point, we remain confident that our companies can manage through the current environment. The businesses we own across our portfolios are industry leaders with strong pricing power. This will allow them to grow their revenue and profits in an inflationary environment. Although the Price-to-Earnings ratios for our companies are likely to remain lower in an inflationary environment, faster growth in earnings should act as an offset to that. As always, we remain confident in the long-term earnings potential of our companies and the ability of these companies to compound in value in the years ahead.

Phil D'Iorio
Lead Manager,
Cumberland* Global and International Equities
April 5, 2022

Invesco
https://blog.invesco.ca/what-could-a-yield-curve-inversion-mean-for-stocks/
Five key takeaways from Jamie Dimon's letter to JPMorgan's investors
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COVID curbs bite at Chinese ports, threatening global supply chains
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2-year Treasury yield tops 10-year rate, a 'yield curve' inversion that could signal a recession
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