Monthly Market Insights

Data and opinions as of December 31, 2021

Stocks rise on seasonality; central banks send policy signals

Equities rose to another all-time high on the back of a customary December "Santa Claus" rally. The Omicron variant of COVID-19 had initially generated some market volatility, but equities recovered amid low volume over the holidays. In fact, the S&P 500 Index hit its 70th all-time high for 2021 and the S&P 500 Index returned an impressive 27.6% for the year, in Canadian-dollar terms. The final month of 2021 was also characterized by central bank actions. Market attention was focused on the various major central bank meetings that occurred in December as markets sought a clearer picture on the path of rate hikes to come. The Bank of Canada renewed its inflation mandate with an increased focus on maximum employment, and the U.S. Federal Reserve announced a faster pace of asset purchase tapering.

The NEI perspective

Stocks make customary holiday gains. Pandemic concerns generated some market volatility, but equities recovered amid low volume over the holidays. Stocks rose to another all-time high on the back of a "Santa Claus" rally.

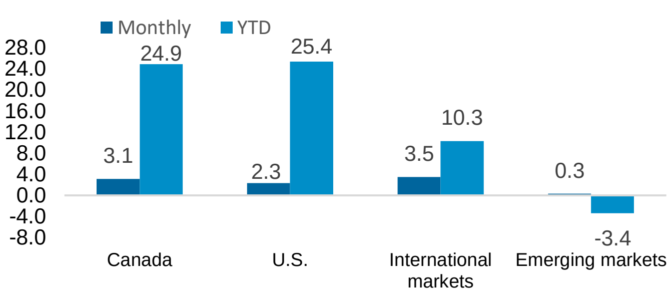
Global responses to Omicron. The rapid spread of the Omicron variant of COVID-19 led to governments across the world reintroducing restrictions. Booster shots are being pushed by various governments as a means to contain the outbreak.

Eyes on policy moves at 2021's end. Market attention at the end of last year was focused on various central bank meetings as markets look to better understand the path of future rate hikes. Despite Omicron, central banks are pushing on with tightening policy as inflation remains elevated and the labour market tightens.

From NEI's Monthly Market Monitor for January. Read the full report for more insights.

Equity

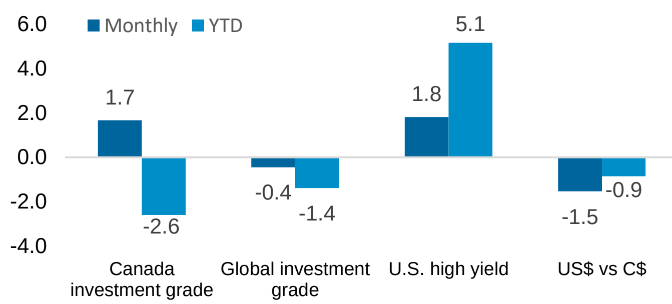
% return in C$



Canada: MSCI Canada; **U.S.:** MSCI USA; **International markets:** MSCI EAFE; **Emerging markets:** MSCI Emerging Markets. Source: Morningstar Direct.

Fixed income and currency

% return in C$



Canada investment grade: Bloomberg Barclays Canada Aggregate; **Global investment grade:** Bloomberg Barclays Global Aggregate; **U.S. high yield:** Bloomberg Barclays U.S. High Yield. Source: Morningstar Direct.

The market impact of central banks and interest rates

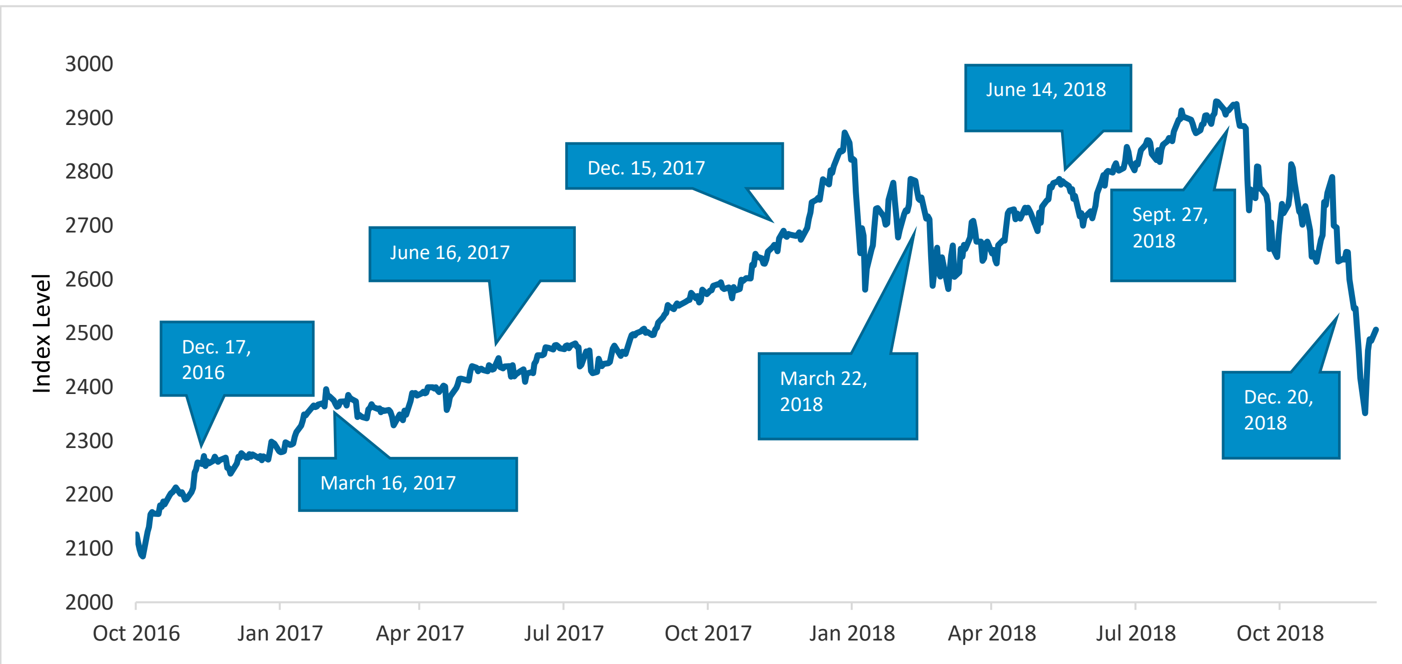
On November 3, 2021, the U.S. Federal Reserve first announced plans to taper its bond purchases. Just a month later at its December 15 meeting, the Fed doubled the pace of tapering. Under this framework, asset purchases will end by the first quarter of 2022, setting the stage for the first rate hike as soon as the second quarter of 2022. Market pricing implies there will be three rate hikes in the upcoming year. But what does this mean for your investments and for markets overall?

Central banks (e.g., the U.S. Federal Reserve, Bank of Canada, Bank of England, and European Central Bank) are primarily responsible for monetary policy and money supply in an economy. They control this money supply by influencing the short-term rate (e.g., the Federal Funds Rate in the U.S.), which is the interest rate that banks charge when lending money to one another. As central banks raise rates, borrowing money becomes more expensive, and this translates to higher interest rates on loans to consumers (e.g., mortgages, credit card debt, car loans). This is known as "tightening" in credit markets. Higher interest rates slow economic growth as consumers are discouraged from spending, with loans for big ticket items becoming more expensive and higher interest rates encouraging saving.

Higher rates are can also impact stock market valuations. Higher interest rates encourage investors to allocate more assets to bond investments. Furthermore, the intrinsic value of a given stock can be negatively impacted as well. Simply put, the value of a stock is the present value of future expected cash flows. As the interest rate used to discount cash flows increases, the value of future earnings diminishes. However, this doesn't have an equal effect on all sectors. The present value of cash flows for high-growth companies in which future earnings are much higher than they are today generally will be hit harder than companies with low growth rates. That is why the tech-heavy Nasdaq index often falls more than a more blue-chip index like the Dow Jones Industrial Average when rates increase.

Finally, given the indirect effect of rate hikes on financial markets, central banks typically only hike rates at a time when the economy itself is strong and businesses are doing well. In fact, regional market indices may not actually experience a correction as a result of rate increases. Central banks seek to find a balance, where interest rates rise enough to curb spending but not to a degree where the economy would not be able to grow. This balance is not easy to find, and in some cases central banks hike too much and start an economic contraction. For example, the following graph illustrates the impact of prior Fed rate hikes on the S&P 500 Index over a three-year period.

Fed rate hikes do not always have a cooling effect on U.S. stocks



Source: Bloomberg, S&P 500 Index, as of Dec. 31, 2021.