BMO Global Asset Management

March 14 to March 18, 2022

Oil Embargo, Market Reactions to War, Central Banks

Weekly Commentary

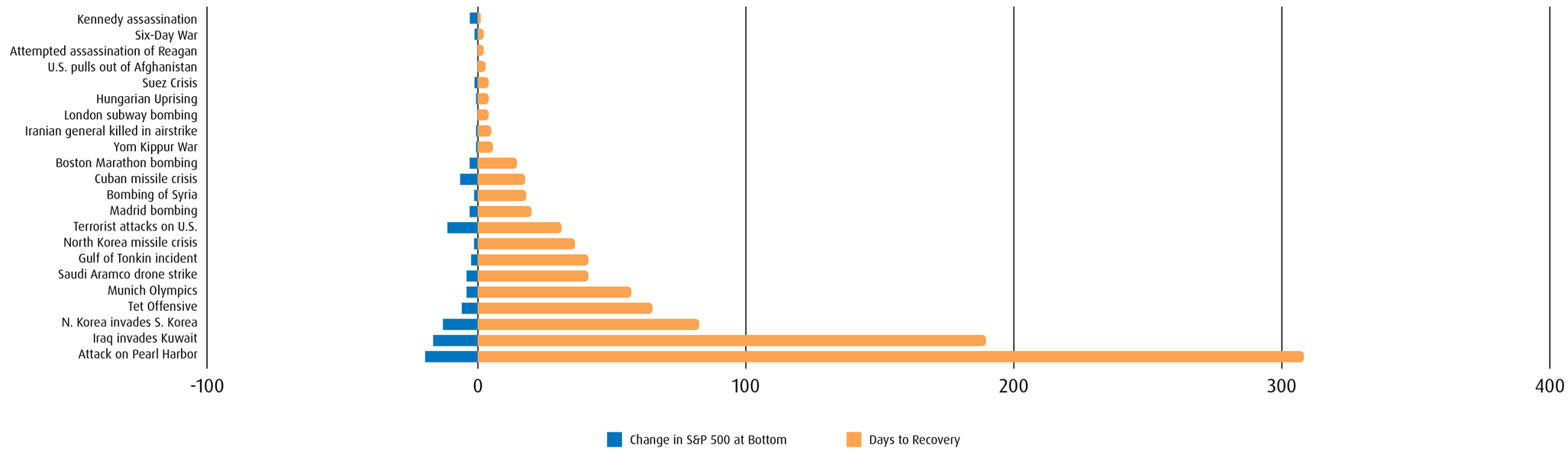
Oil Embargo

This past week, the other shoe dropped in the ongoing story of international sanctions against Russia, as the US embargoed Russian oil and the UK announced plans to phase out Russian oil imports by 2023. Previous sanctions had included carve-outs for energy in an attempt to avoid any significant impact on the global economy, and markets have reacted appropriately to these new developments. It's worth noting that the US is not a net importer or oil, so an embargo will not affect them as negatively as it would Europe. The supply of oil was somewhat limited even before the embargo, so most likely we'll see the imbalance between supply and demand continue to worsen. That's why we've seen the recent shock in oil prices. Looking three or four months out in the futures market, however, the price of oil is significantly lower than it is today. That tells you investors expect the value to come down at some point, but the question is how much it will come down. It's not as simple as turning off one tap and turning on another—any deal with Iran, for instance, will take time, and while OPEC can increase its production, it won't happen overnight. In the meantime, we'll continue to see high prices at the pump, which could further drive inflation and reduce consumer spending.

Bottom line: Oil prices will likely remain high for an extended period of time, but the recent spike should ultimately prove temporary.

Market Reactions to War

The war in Ukraine has prompted questions about how equity markets have historically responded to, and recovered from, armed conflict. Generally, we see an immediate market sell-off due to uncertainty. But on the positive side, charts of past performance show a recovery taking place within six months of the inciting event.



Sources: LPL Research, S&P Dow Jones Indices, CFRA.

Expert

Sadiq S. Adatia
Chief Investment Officer BMO Asset Management

Mr. Adatia joins BMO AM from Sun Life Global Investments, where he most recently held the role of Chief Investment Officer. Prior to that, he held investment roles at Russell Investments Canada and Mercer Canada. He holds an Honours Bachelor of Mathematics degree in Actuarial Science & Statistics from the University of Waterloo. He is also a CFA Charterholder and is a Fellow, both of the Society of Actuaries (Investment Specialty Track) and the Canadian Institute of Actuaries.

Is a recovery in store following the current crisis? That remains to be seen at present, because this isn't merely a boots-on-the-ground war between two nations. Other counties have imposed extensive economic and financial sanctions, and companies have stopped doing business in Russia or with Russian firms. These measures have longer-term effects, including on the future growth and earnings of companies that have chosen to divest. In that respect, there's still some uncertainty on the timeline for a recovery.

Bottom line: Equity valuations have recently pulled back across the entire market, but some of the great companies have seen unreasonable declines. These gems may rebound in the next six-to-twelve months.

Central Banks

Central banks are in a tough spot, having to consider knock-on effects from the war in Ukraine on top of their inflation concerns. Last week, in a somewhat surprising move, the ECB said that it is more worried about inflation than the economic impact of the conflict. This means that in Europe, we're likely to see a faster exit from stimulus than we previously expected. On this side of the Atlantic, the Federal Reserve will almost certainly raise interest rates its next meeting, and the Bank of Canada will likely continue to raise rates as well. The question is the pace of the rate hikes. If the Fed, for instance, were to even suggest a 50-basis-point hike, that could spook markets. Ultimately, central banks need to be consistent in their communication, highlighting the need to address inflation while sending a clear message that the long-expected rate hike cycle is now underway.

Bottom line: Central banks will likely express caution but stay on course with their rate hike schedule.

Positioning

Recently, as a result of geopolitical developments, we've made some positioning changes to the **BMO ETF Portfolios**. We've slightly reduced our overweight allocation to equities, though our tilt toward Canada and the U.S. remains intact. The recent sell-off in Europe and Emerging Markets has, in many ways, validated our long-held North American bias, with major indices such as the Nikkei 225, CAC 40 and DAX falling 9.1%, 10.7% and 11.6%, respectively over the past month. While we remain bullish on equity markets, the Ukraine-Russia situations adds to a growing list of uncertainties. How long the conflict will last? What will the Fed's messaging be on interest rates? How higher oil prices will impact consumer spending? We can expect greater clarity in the next three-to-six months, and we'll continue to evaluate on an ongoing basis.

As Chief Investment Officer, Sadiq S. Adatia's views directly influence the **BMO ETF Portfolios**.

Market Update

- Equity markets endured another choppy week, which included a wild ride for oil prices amid ongoing uncertainty in Ukraine.
- The S&P 500 fell 2.9%, with all sectors but energy in the red.
- The TSX added 0.3%, another relative win, as gains in materials, energy and utilities outweighed softness almost everywhere else.

Asset class views, as of March 2022

Monthly Perspectives

At BMO Global Asset Management, we recognize that asset allocation is the primary driver of long-term portfolio performance. That's why our Multi-Asset Solutions Team (MAST) has developed a simplified "Five Lenses" view to help explain what is driving their asset allocation decisions.

-3	-2	-1	0	1	2	3
Very Bearish	Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish	Very Bullish

Asset Mix

- COVID-19 and Omicron are lingering but no longer posing a material threat to the economic outlook.
- We expect global growth to cool but to remain above trend in 2022 while inflation remains elevated.
- Excessively pessimistic investor sentiment is signalling a good entry point for long-term investors.

EQUITIES				0	1		
FIXED INCOME			-1	0			
CASH				0			

Equity

- Canadian equities are positioned to benefit from rising commodity prices.
- The Russia/Ukraine crisis will continue to produce market volatility, but the direct impact on North America is smaller than International markets.
- We downgraded Europe and EM to underweight as the Russia/ Ukraine conflict will be an overhang for these regions.

CANADA				0	1		
USA				0			
EAFE			-1	0			
EM			-1	0			

Fixed Income

- March is widely expected to see the Fed and BoC start normalizing interest rates, probably at a fast pace throughout 2022.
- Government bonds and bond duration remain unattractive as central banks are about to hike while the growth and inflation outlook remain strong.

IG CREDIT				0			
HIGH YIELD				0			
EM DEBT				0			

Style/factor

- Anxiety over Fed hikes and geopolitical tensions favours higher quality stocks, whose revenues and earnings are more predictable and less sensitive to swings in economic expectations.
- As we move past the worst of the global COVID pandemic, we added a bias towards the value factor.

VALUE				0	1		
QUALITY				0	1		

Implementation

- Bank of Canada may hike interest rates sooner than other central banks which would support the currency, versus heavy commodity-importing currencies such as the Euro and Japanese Yen.

Thank you for reading!

Disclosures:

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