VESTCOR

QUARTERLY MARKET UPDATE

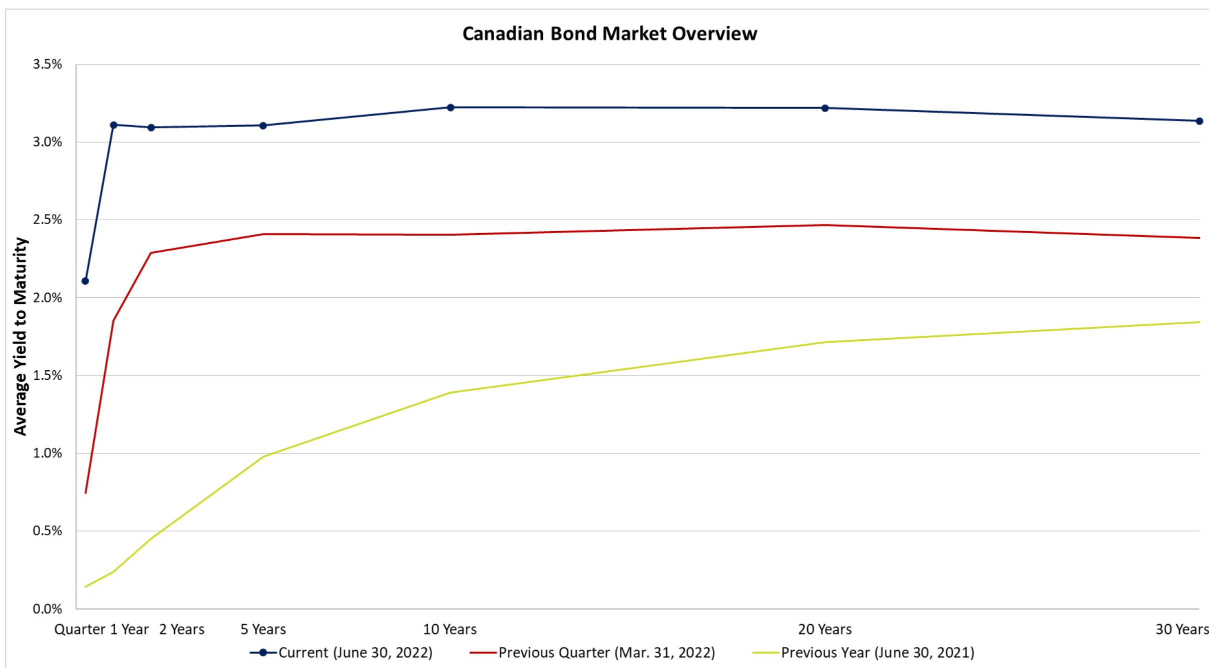
AS AT JUNE 30, 2022

The following information is being provided as an overview of Vestcor Inc.'s (Vestcor) investment activities and the general financial market conditions experienced during the noted reporting period.

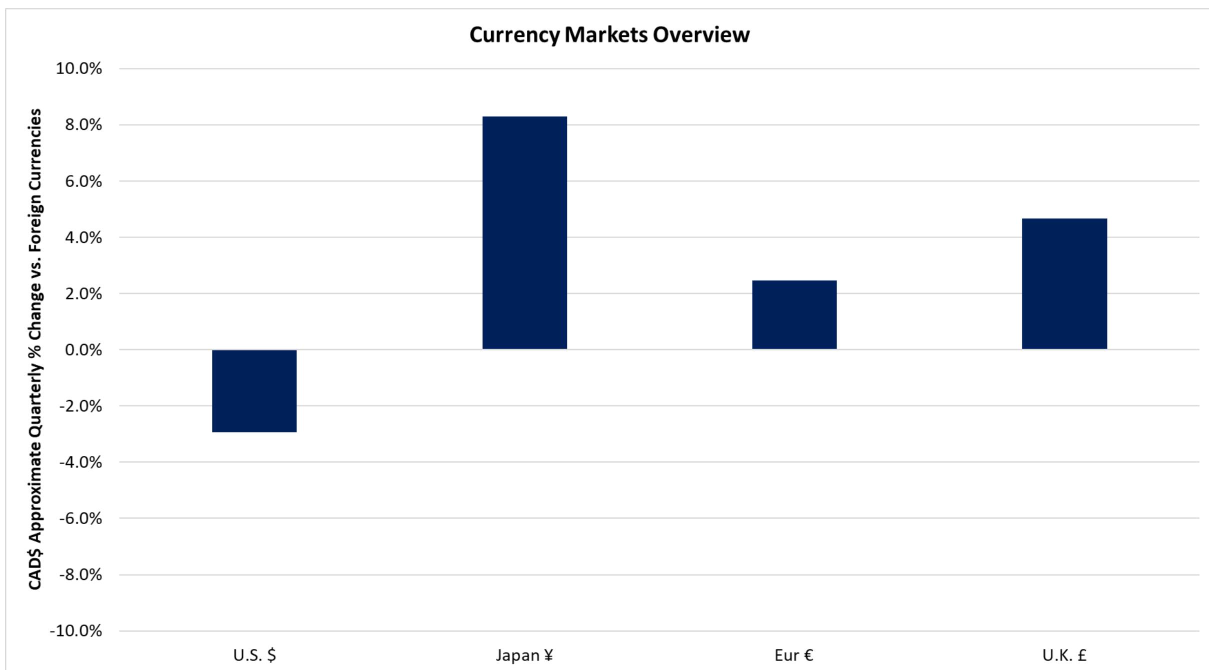
Please note that the following material is specific to Vestcor activities and is presented for information purposes only. It does not constitute investment advice in any way, and no guarantee is provided as to its completeness or appropriateness. We recommend that readers consult a professional advisor with respect to their own specific financial matters.

Performance Overview

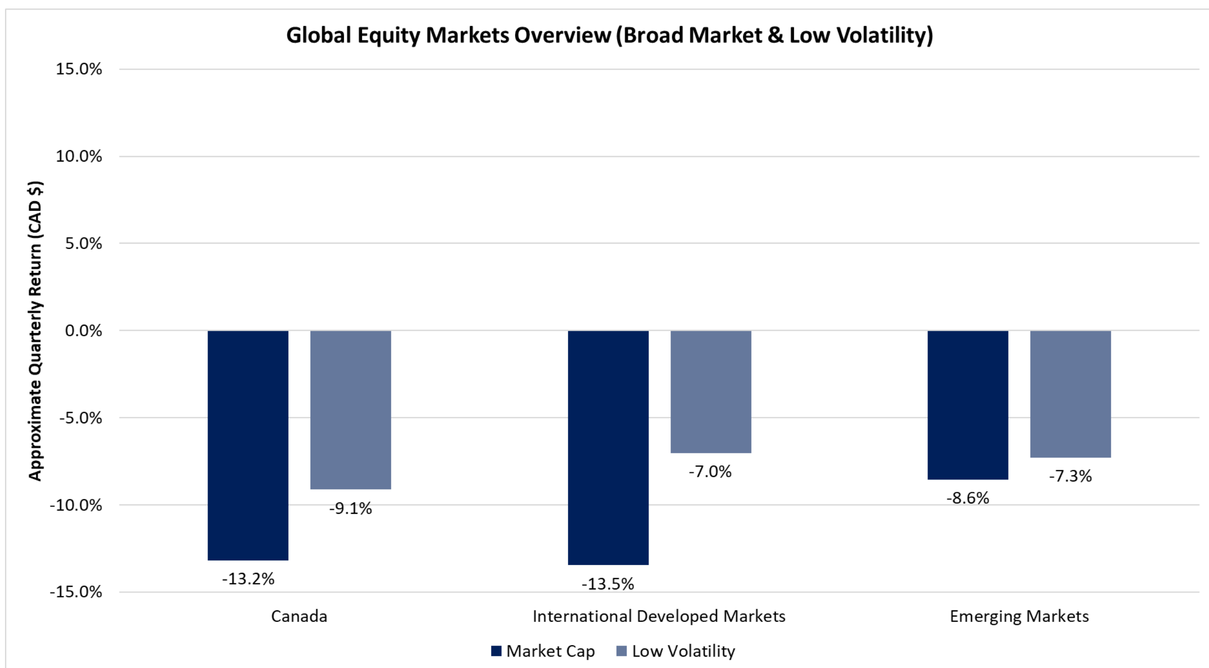
- The quarter represented a challenging environment as both equities and fixed income asset classes continued to have negative returns. Aggressive central bank tightening due to persistent inflation pressures led to higher bond yields which negatively affected all fixed income strategies. Projections for further interest rate increases dimmed the economic outlook and coupled with continued geopolitical tensions sent equity markets lower.
- The yield curve shifted sharply higher again over the quarter becoming slightly inverted with the 1-year yield of 3.11% marginally surpassing both the 2-year and 5-year yields. Yields rose as the Bank of Canada increased interest rates by 50 bps at both the April and June meetings with continued outsized hikes expected. To further aid in curbing excessively high inflation, the Bank of Canada began "Quantitative Tightening", a program which will reduce the size of its balance sheet through ending the replacement of their maturing bonds.
- Given this backdrop, fixed income indexes experienced significant losses with a Canadian Government Bond index down 5.96%. Despite rising credit spreads over the period, a Canadian Corporate Bond index outperformed government bonds, declining 4.83% due to a lower sensitivity to rising yields. A Real Return Bond index had a weak quarter, down 8.90%, underperforming Canadian Government bonds mainly due to a higher exposure to increasing yields. Another influence was falling long-term inflation expectations which lowered demand for inflation protected assets as the Bank of Canada tightens monetary policy.



- In currency markets, the Canadian dollar depreciated versus the US dollar while gaining against other major currencies during the quarter, resulting in a positive impact on US dollar denominated assets and a negative impact on other major foreign denominated assets.



- All public equity markets and strategies incurred negative returns during the quarter as investors weigh the impact of high inflation and monetary tightening on the global economy. As expected over periods of market turbulence, low volatility equity indexes outperformed their market-capitalization weighted counterparts in all regions.



- Both Vestcor's absolute return strategies preserved their diversifying characteristics in an atypical market environment and experienced a strong quarter. The quantitative strategy and event-driven strategy earned a positive return of 3.22% and 1.58% for the quarter, respectively.
- Private market investments including, real estate, infrastructure, and equity outperformed their public market counterparts however caution is warranted as private markets tend to lag public markets in terms of valuation impacts.

Market Environment & Outlook

Summary:

- The first half of 2022 was the worst in recent history for diversified investors, with significantly negative performance for both stocks and bonds on the back of economic volatility and spiking inflation.
- Inflation remains the most significant concern for investors, not just for the direct effect on prices but for the impact that central banks will have on economies and markets in trying to gain control over price increases.
- With geopolitical, economic, and market noise at the forefront, market volatility has been significantly above normal so far in 2022, and a prudent outlook would expect higher than normal volatility to continue for quite some time as markets continue to digest news about ongoing conflict in Ukraine, COVID & supply chain issues, and the impact of higher rates on economic activity.

The first half of 2022 produced the worst 6-month return for stock & bond investors in the past 60 years. A portfolio of large cap stocks and government bonds returned approximately -14% in the period from January to June, nearly twice as bad as the next closest experience of approximately -8% in the second half of 1987. With interest rates rising and equities experiencing losses at the same time, the first half of 2022 was one of the few times where investors received essentially no diversification benefit from holding both stocks and bonds in their portfolios.

Inflation has continued to show an increasing trend throughout the first half of the year, with Canadian Year-over-Year CPI rising to 7.7% according to the May release. While today's inflation is clearly a result of both demand and supply driven factors, it is now apparent that central banks were "behind the curve" in tightening policy in 2021 to offset increasing consumer demand, which significantly contributed to the above normal inflation so far in 2022. Although the Bank of Canada has already raised its overnight rate by 1.25% to a level of 1.5% so far in 2022, as of mid-year markets were pricing in the likelihood of an additional 2% in rate increases before year end. If achieved, this would bring short term interest rates in Canada to 3.5%, a level not seen since the spring of 2008. The delayed response by central banks has placed the global economy at greater risk of a slowdown than might have been the case if policy had been tightened earlier in 2021.

While so far volatility has been observed mostly in stocks and bonds, higher interest rates will necessarily have secondary effects on all financial markets. Rising mortgage rates can occasionally induce a short term burst of activity in real estate as buyers rush to avoid further rate increase, but in the medium to long term will likely have a negative impact on real estate activity and ultimately valuations. Ultimately, higher rates will have the effect of slowing transaction volumes in both the residential and commercial real estate sectors and will potentially reduce risk taking in most segments of financial markets. This adjustment period is likely just beginning and depending on the path of rates, could be an ongoing challenge for investors for several quarters or years to come.

While the overall market story has been significantly negative for investors so far in 2022, there are areas of the markets that provided some measure of protection. Canadian equities, while not immune to the value declines, did outperform global equities significantly with a return of about -10% in the first half compared to a -19% decline for the MSCI World ex Canada Index. Additionally, Low Volatility strategies, which had struggled to keep pace with higher risk indices during the COVID recovery period also outperformed strongly, with the MSCI World Minimum Volatility Index dropping about 10.8% in Canadian dollar terms from January to June, outperforming by about 8% and capturing only about 55% of the downside in higher risk investments. In general, with bonds providing no diversification benefit for investors, the primary source of benefit for portfolios so far in 2022 has been a lower risk positioning. Investors with significant allocations to alternative investments and lower risk strategies have likely outperformed the averages year to date.

Looking forward, it is important to differentiate between short-term and longer-term expectations. In the short term, higher than normal volatility is likely to continue, as investors continue to deal with conflict in eastern Europe, ongoing trade negotiations between the U.S. and the rest of the world, the continual stop-start nature of the COVID reopening globally, and a significant among of uncertainty about the ability of central banks to control inflation (that has been at least partly caused by non-monetary factors) without putting the global economy into a severe recession. As of June 2022, the median forecast of the probability of recession in the U.S. within the next 12 months has increased to approximately 33%.

However, while the short-term outlook is obviously cloudy and requires careful management of portfolios, the longer-term outlook has improved somewhat for investors, at least in terms of nominal returns. The expected return on a 50/50 stock bond portfolio had declined to record lows during the 2020-21 period, as nearly record high equity valuations combined with concurrently record low interest rates. Since 2021, while the true valuation of equities is quite uncertain due to the economic volatility around the globe, the rise in interest rates has resulted in a significant improvement in nominal expected returns on a diversified portfolio over the long term. While the losses of the first half of 2022 are unpleasant for investors, portfolios that maintained a lower risk positioning throughout recent years would have avoided a significant amount of the short-term declines and would now be poised to take better advantage of any potential recovery in the coming years.