Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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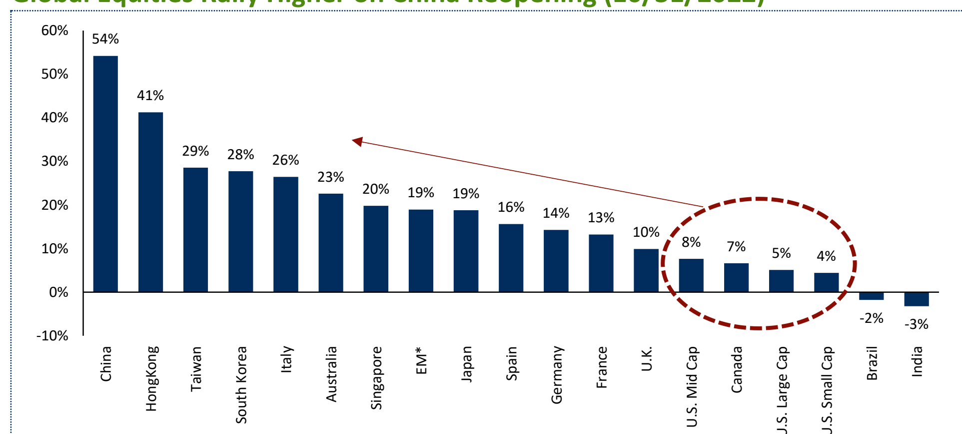
A Slingshot Market to Start 2023

And just like that, global equities are off to a strong start this year, rallying higher, similar to slingshot bands pulled to their max and then released. Many investors are likely puzzled by the strong rally in risk assets – i.e., equities - to start 2023, especially given the rising probability of recession risks across several economies globally, including Canada, the U.S. and the U.K. in 2023. However, we think this rally makes sense, especially as China reopened for business and abandoned its economically destructive zero-COVID-19 policies on October 31, 2022. This has been, by far, the single biggest catalyst driving risk assets higher, resulting in a material outperformance of global equities (excl. North America) vs. the S&P/TSX Composite and the S&P 500 Index.

While no one could have predicted such a massive pivot after three long years of COVID-19 lockdowns across China, those of you who followed our guidance to remain globally diversified from our **December Insights & Strategies report – 2023 Outlook – It's Complicated…** – "We are now seeing a more compelling risk/reward profile for both **stocks and bonds globally** than we did at the start of the year" and "**for 2023, we suggest investors maintain a diversified allocation to global equities and remain highly selective**" – have been rewarded in only a few short months.

As an extension of these recommendations, we delved further and discussed our constructive view on global equities (excl. North America) in our recent asset allocation report, Quarterly Outlook: The Seventh Inning Stretch. In this report, the Raymond James Ltd. Asset Allocation Committee suggested investors maintain a neutral stance to equities as a whole, but given their softer outlook for the U.S. dollar index, they expected value stocks globally to outperform growth over the near-term, **with developed markets (e.g., MSCI EAFE) and emerging markets (e.g., MSCI EM) likely putting up a good showing in 2023, especially as China abandoned its zero-COVID-19 posture.** Moreover, the committee noted that attractive relative valuations and a low bar for earnings across several markets globally made for a rather compelling case for equities outside of North America. While these views have largely panned out as the committee anticipated, it has been more material and has occurred a lot quicker than expected.

Global Equities Rally Higher on China Reopening (10/31/2022)



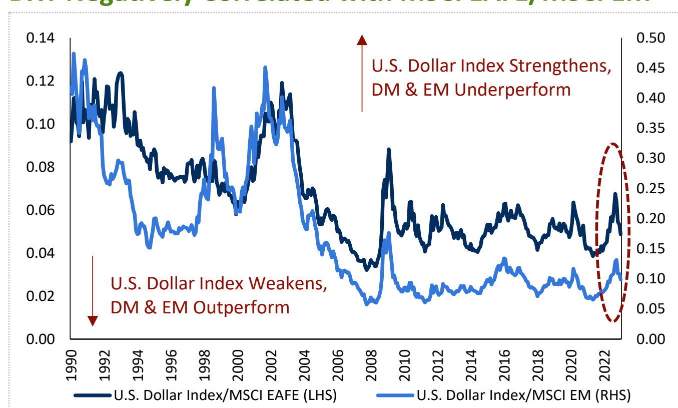
Source: FactSet; Raymond James Ltd.; Returns are calculated from October 31, 2022 to January 27, 2023; *EM: emerging markets.

RAYMOND JAMES®

We expect the U.S. Dollar Index (DXY) to weaken further as the Federal Reserve's (Fed) tightening cycle comes to a close in H1 of 2023. We expect this to be supportive for developed and emerging market equities outside of North America, including economies with large USD-denominated debt and/or which are net importers of energy.

As we demonstrate below, since 1990, developed market equities (e.g., MSCI EAFE) and emerging market equities (MSCI EM) have moved in opposite directions – i.e., are negatively correlated – to the performance of the DXY, which is a measure of the value of the U.S. dollar against a basket of global currencies.

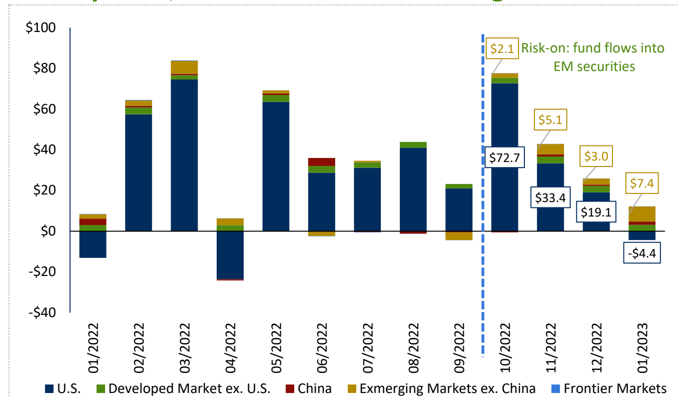
DXY Negatively Correlated with MSCI EAFE/MSCI EM



Source: Bloomberg; FactSet; Raymond James Ltd., as of January 31, 2023.

Since China reopened in October 2022, the bands of the slingshot have been released, which has fuelled the rally higher in global equities, like a projectile moving at a breakneck speed. This is the reverse of the significant risk-off posture by global investors for the better part of 2022, with capital flows primarily directed towards U.S. assets and away from emerging market securities. That is, until now.

Emerging Market ETF Fund Flows Turn Positive in January 2023, While U.S. Flows Turn Negative



Source: FactSet; Raymond James Ltd.; Data as of January 27, 2023, in billions of U.S. dollar.

Reduce the Odds of Slingshot Band Failure

While economic uncertainties remain, with recessionary pressures mounting and more likely than not to materialize in 2023, we suggest investors focus on allocating capital to markets with the most attractive relative risk/rewards – i.e., markets with lower valuation compression and earnings contraction risks. For example, Canadian equities broadly speaking look attractive from a risk/reward perspective with the exception of growth stocks – i.e., MSCI Canada Growth index. We also see good value across U.S. small- and mid- cap equities, while across the pond in Europe, we believe the FTSE 100 and the German DAX indices are attractive. Finally, despite the strong rally in Chinese equities since October 2022, we still see reasonable upside for the Hang Seng Index from here.

Compelling Risk/Rewards Across Global Equities

Select Global Equity Indices	YTD Return	2022 Return	P/E NTM vs. Historical Median*
Canada			
MSCI Canada Value (Canada)	8.1	1.6	-1.9
S&P/TSX Composite (Canada)	7.1	-5.8	-1.2
S&P/TSX 60 (Canada)	7.0	-6.2	-1.1
S&P/TSX Small Cap (Canada)	8.5	-9.3	-3.4
MSCI Canada Growth (Canada)	6.1	-14.0	1.6
U.S.			
S&P Composite 1500 Value (U.S.)	5.0	-0.9	2.4
S&P Mid Cap 400 (U.S.)	6.1	-6.7	0.3
S&P Small Cap 600 (U.S.)	6.2	-10.0	-2.3
S&P Composite 1500 (U.S.)	4.5	-11.8	1.8
S&P 500 (U.S.)	4.4	-12.2	2.1
S&P Composite 1500 Growth (U.S.)	4.0	-24.2	0.6
NASDAQ Composite (U.S.)	9.3	-27.6	3.0
Europe			
FTSE 100 (U.K.)	5.3	-3.9	-1.9
CAC 40 (France)	9.7	-6.1	0.3
Euro STOXX 50 (Europe)	10.1	-11.2	0.1
DAX (Germany)	8.7	-12.5	-0.4
Asia Pacific			
Hang Seng (Hong Kong)	12.5	-6.3	-1.2
Nikkei 225 (Japan)	4.8	-14.3	-0.9
MSCI China (China)	15.3	-16.1	1.1
Major Aggregates			
MSCI EAFE (Developed Markets ex U.S. & Canada)	6.8	-7.8	-0.6
MSCI World (Global)	5.4	-11.8	0.3
MSCI EM (Emerging Markets)	8.2	-13.9	0.9

Source: FactSet, Raymond James Ltd.; Data as of January 27, 2023. All returns are in CAD, equities are ranked by the 2022 calendar year returns. *Historical median: 12/31/1999 – 1/27/2023. Premium (RED) / Discount (GREEN).

Irrespective of the investing climate, we advise clients to allocate capital to opportunities that are aligned from both a risk/reward and time horizon perspective, while avoiding places to hide or markets which are susceptible to valuation compression and earnings revision risks (shaded in red above).

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

An Introduction to ESG

We, Canadians, love our acronyms and phrases. BLT for a bacon, lettuce and tomato sandwich or a double double meaning coffee with two creams and sugars. ESG has become a hot and trendy, but important, acronym over the last few years. It refers to "environmental, social and governance" factors. ESG metrics incorporate non-financial data and are both a corporate governance and an investment framework the investment community uses to decide whether to invest in a company. ESG is also a risk mitigation and an opportunity optimization tool.

The E, S and G

Environmental issues may include corporate climate policies in consideration of their direct and indirect greenhouse gas emissions, energy consumption, waste management, pollution and air quality as well as biodiversity and natural resource conservation. Compliance with environmental regulations is becoming an increasing priority as mandatory disclosure policies by governments and regulators evolve.

Social issues relate to the company's relationship and programs with its internal and external stakeholders including employees, customers, communities, suppliers and other stakeholder groups. In addition, internal factors such as diversity, equity and inclusion (DEI) initiatives and programs, Indigenous Truth and Reconciliation actions, employees' health and safety, labour standards, human rights and hiring practices are also considered.

Governance is a key driver of ESG and provides oversight on the "E" and the "S". Governance standards consider board composition, diversity and membership selection, executive compensation, shareholder rights, corporate transparency and accounting as well as audit procedures. ESG integration is also incorporated into the risk management framework and general accountability to stakeholders.

Sustainability and ESG

The term sustainability is sometimes used interchangeably with ESG, however, those terms are different. Sustainability is divided into three pillars known as the "3 Ps of Sustainability": people, planet and profit. However, while sustainability is about doing good, the parameters and reporting associated with it can be lacking. ESG has evolved from corporate sustainability, and the main difference is ESG has specific criteria to measure the scope, benchmarking and disclosure of data on environmental, social and governance issues.

Stakeholders, including investors, customers, employees and regulators, have increasing expectations that ESG considerations be embedded across the organization and that they be measurable, verifiable and complete. Without the data and reporting of meaningful proof, organizations will be called out for "greenwashing", meaning that the company is trying to make people believe that they are environmentally conscious, while they are actually not taking any meaningful action.

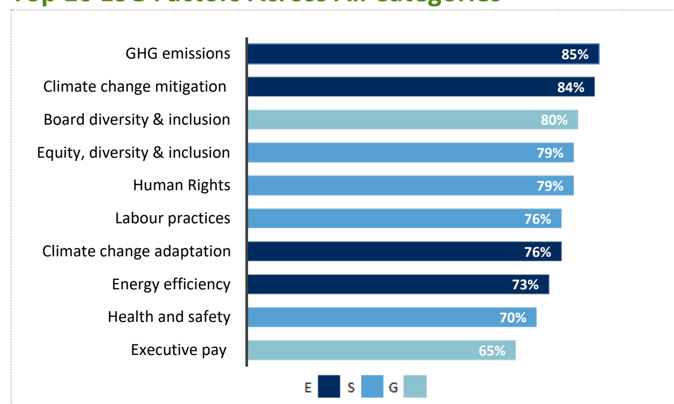
ESG and Investing

For investors, ESG criteria are a tool increasing in popularity due to the growing assumptions that a company's financial performance is impacted by environmental and social factors – factors that do not appear in financial statements. ESG is also a term used by capital markets regarding responsible investing and specifically sustainable finance.

In its Canadian Responsible Investment (RI) Trends Report for 2022, the RIA – another acronym for you that refers to the Responsible Investment Association – reported on the trends and expectations for responsible investing (RI) or investments that take environmental, social and corporate governance (ESG) considerations into account during the selection and management process.

The report confirms that RI continues to be well established in Canada, where reported assets under management are $3 trillion and 94 per cent of respondents to the survey use ESG integration as an RI approach. Respondents also indicated what ESG factors/screens they incorporate into their investment decisions as shown in the chart below.

Top 10 ESG Factors Across All Categories



Source: 2022 Canadian RI Trends Report

As companies continue to optimize, strive to reduce risk and be responsible stewards in the communities in which they operate, ESG will continue to be a driver and an opportunity for stakeholder engagement and business transparency.

Eric Saarvala, MBA, G. Dipl. SR&S, CSR-P
Head, Corporate Sustainability, Raymond James Ltd.
Executive Director, Raymond James Canada Foundation

Dividend Growth for Long-term Investors

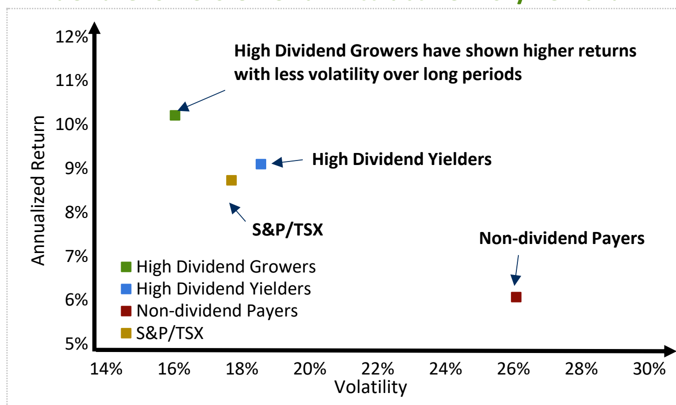
As we highlighted in November's edition of the *Insights & Strategies* titled *Dividend Treats*, investing in dividend-paying companies offers investors attractive long-term returns combined with overall lower volatility, especially during times like today when there certainly is no shortage of volatility amid rising interest rates, hot inflation and geopolitical risks. However, not all dividend stocks are created equal.

A Smoother Ride

Dividend-paying stocks can fit into two categories: the high dividend yielders (stocks that have a high dividend yield) and high dividend growers (companies that grow their dividends at a faster rate). Our preference lies with high dividend growers, as our research shows that these stocks exhibit less volatility and similar-to-better returns versus the market. In other words, dividend growers may offer investors attractive returns on a smoother ride.

Performance. We calculated the annualized return for the top quartile (top 25 per cent) of high dividend-yielding stocks in the S&P/TSX Composite Index and the top quartile of high dividend-growing stocks (using the average dividend growth rates over one-, three- and five-year periods) in the index over the past 20 years. We found that stocks with high dividend growth rates performed better than the S&P/TSX, high dividend-yielding stocks and companies that did not pay a dividend altogether. In fact, the same was true over a 10-year period.

Dividend Growers Offer an Attractive Risk/Reward



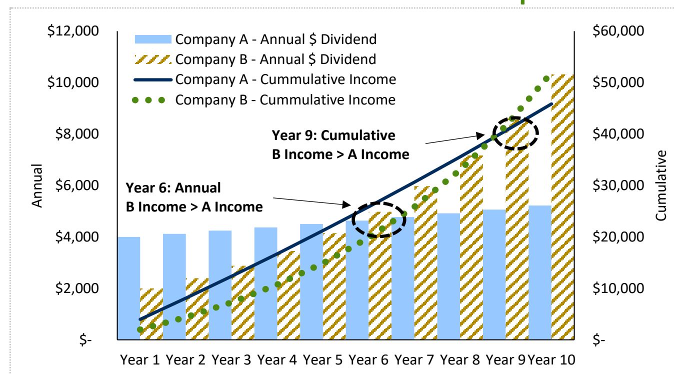
Source: FactSet, Bloomberg, Raymond James Ltd.; As of December 31, 2022.

Volatility. Dividend growers also exhibited less volatility not only compared to their high dividend-yielding counterparts but also compared to the overall market and non-dividend payers over the 20-year period. For instance, the annual standard deviation of the top quartile of dividend growers over the past 20 years was ~16.0 per cent, less than the top quartile of dividend yielders, non-dividend payers and the S&P/TSX. We found the same was true over a 10-year period.

Think Long Term

We believe investing in companies that despite having a low dividend yield, can increase their dividend over time, presents an attractive risk/reward trade-off for investors with a long time horizon (+10 years).

Income from Dividend Growers Catches Up Over Time



Source: Raymond James Ltd.

For example, take the following scenarios involving two investors with a 10-year time horizon. Each makes a $100,000 investment. Investor A purchases stock of Company A that yields four per cent and has experienced a dividend growth rate of three per cent. Investor B purchases stock of Company B that yields two per cent and has experienced a dividend growth rate of 20 per cent. Assuming no change in the companies' price or yields and that both companies continue to grow their dividends at the same rate they have been historically, Company B's future income will be greater than Company A's before the 10-year period is up. In fact, by year six, the annual income potential from Company B is expected to exceed Company A's. By year nine, the cumulative income from Company B (the sum of all previous annual income) is expected to exceed Company A's. While the current income of dividend growers may seem too small, patient long-term investors may see their income grow at a faster clip.

Consider Dividend Growers

We have a clear preference for dividend growers given their attractive risk/reward profile relative to the overall market, high dividend yielders and non-dividend payers, with overall lower volatility. Investors with a long time horizon, who can forego current income and focus on dividend growth, may consider allocating to dividend growers within their equity portfolios.

Larbi Moumni, CFA
Head of Portfolio Advisory and Portfolio Manager

Balanced Fund Managers' Comments

Oscar Belaiche, Dynamic Dividend Income Fund

"While it's never fun to lose capital in the short term, investing is a long-term journey. 2022 was a hinge point for financial markets. The era of easy money came to an end. In the long term, this sea of change is a major win for savers. Free cash flow, dividend yield and sustainable income have led the way. We made a decision back in December 2020 to lower our fixed income to 29 per cent and in March 2021, we reduced this weight further to below 20 per cent. Today, we are gradually increasing fixed income, now at 26 per cent, as valuations have become more attractive. Our equities include an allocation to alternative investments and options writing. We seek to build a portfolio that is anti-fragile in which the companies can continue to perform well in more difficult economic times. The biggest risk is inflation not continuing to 'deflate' primarily due to wage pressure, resulting in the Fed not pausing their tightening program. The biggest opportunity is that the Fed pauses, the market anticipates a reduction in the Fed funds rate and the market looks through to the recovery of the economic cycle."

Rob Taylor, Canoe Asset Allocation Fund

"Heading into 2023, we are underweight bonds, overweight cash and overweight equities. We believe we are in the later stages of a bear market for equities, and while volatility is likely to continue, there are attractive valuations among some stocks that are priced to reflect a deep economic contraction. We believe bonds are now trading at more reasonable valuations, but won't offer the same protection as equities in an environment of structurally higher inflation in the coming years. While we are likely in the later innings of an equity bear market, corporate earnings have been relatively resilient. Should the lagged impact of higher interest rates lead to a deeper economic downturn, then equity returns could be challenged. In addition, geopolitical risks are high. Any further disruption could reverberate through financial markets. On the other hand, investors are cautiously on the sidelines, and cash levels are high. Moderating inflation and a favourable outlook for earnings could lead to a reacceleration in economic growth and stock returns.

We believe we are in the early stages of a major market rotation: from growth to value, from paper assets to hard assets, including commodities and commodity stocks, and to high free cash flowing businesses. We also expect outperformance in small caps over large caps, in non-U.S. equities and in dividend over non-dividend-paying stocks."

Capital Group Global Balanced Fund

"Looking ahead, we expect market conditions to remain volatile in the short term as markets react to possible further government and central bank policy. We remain cautious about the outlook for inflation and interest rates amid a growing expectation of a synchronized global recession in 2023. We also expect the earnings season to be mixed, including an earnings recession led by downgrades. Hence, our focus is on holding companies where we have a strong conviction and where we believe earnings growth will remain relatively strong. Within fixed income, the massively inverted treasury yield curve provides an attractive investment opportunity. The yield curve is expected to eventually steepen, a reversal of the huge flattening we saw in 2022. In terms of top fund holdings, tobacco companies have once again taken a lead position, as they tend to hold value in difficult macro and market conditions in a strategy where long-term capital growth and income form the main objectives of our equity investments. We maintain high conviction in select healthcare companies, which present strong innovation/development and are backed by sustainable and growing cash flows. Within fixed income, duration has extended a bit, where we now have a greater exposure on the short end of the yield curve. We anticipate, however, the yield curve to steepen in 2023 following a significant inversion in U.S. Treasuries. We maintain a significant underweight exposure in euro and U.K. pound-denominated bonds. We have also reduced our cash exposure, having invested in existing high-conviction holdings and new equity positions following the market correction."

Vanguard, VBAL.TO

"VBAL is an all-in-one diversified, professionally managed portfolio designed to simplify investing while managing risk. Regular rebalancing maintains the portfolio's strategic asset mix of 60 per cent equities and 40 per cent fixed income, avoiding drift and keeping risk levels in line with investors' goals and risk tolerance. Within the equity sleeve, VBAL maintains an equity exposure of around 26 per cent U.S., 18 per cent Canada, 12 per cent international and four per cent Emerging Markets. Within the investment-grade only fixed income sleeve, VBAL maintains around 24 per cent Canada and eight per cent U.S. with the remainder eight per cent allocated to international bonds including nearly one per cent in emerging markets. VBAL is low cost with a 0.24 per cent MER, helping investors potentially earn more over time. Instead of pursuing niche exposures, VBAL is designed to stay fully invested across all market conditions. It is composed of seven all-cap, globally diversified index-tracking ETFs that provide exposure to nearly 95 per cent of the world's investment universe (over 25,000 individual securities)."

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

A Little Cross Talk!

Following the recent Bank of Canada (BoC) rate decision, where we may have received a final 25-bps blow for the time being as the central bank takes pause to analyze the economic fallout from its unprecedented hiking cycle, we believe the CAD still has room to shine. The market is currently pricing in a rate cut near the end of the year, however, we believe that any potential rate cut will be pushed out to 2024. We also believe the China reopening story will continue to be bullish for commodities and sticky inflationary pressures may still keep a subsequent rate hike alive. These factors should help to provide a decent tailwind for the loonie going forward. As for the USD, it certainly has enjoyed its time in the sun, to say the least. With signs that the U.S. economy may be slowing in a more meaningful way, coupled with an impending Federal Reserve (Fed) pause, it is not surprising to see that the DXY U.S. Dollar Index has slid over 10 per cent at the time of writing, after hitting a near 20-year high last September.

China Arrives Fashionably Late to the Party

The reopening of China has been an important macro tailwind, which has reverberated through the FX space. Just over the past month alone, almost every major Asian currency has been posting gains against both the CAD and USD, with the recent pullback in the broader U.S. dollar also being a major contributing factor. While we remain mindful of the influential impact from broader moves in the USD, revamped Chinese demand for Asian exports and the return of the world's largest outbound tourism market may bode well for the Asian FX bloc as this region copes with weakening demand from the West (e.g., the United States, the United Kingdom and Europe). With many anticipating USD weakness to materialize this year, we remain constructive on both Asian and select emerging market currencies, especially against the CAD.

One-Month Performance of Key Asian Currencies

Asian Currency	1M % Change	
	vs. CAD	vs. USD
THB - Thai Baht	4.07%	5.65%
IDR - Indonesian Rupiah	3.22%	4.78%
MYR - Malaysian Ringgit	2.65%	4.21%
CNH - Offshore Chinese Renminbi	1.87%	3.41%
KRW - South Korean Won	1.54%	3.08%
PHP - Philippine Peso	1.24%	2.78%
SGD - Singapore Dollar	1.16%	2.70%
CNY - Chinese Renminbi	1.06%	2.59%
JPY - Japanese Yen	0.98%	2.51%
INR - Indian Rupee	0.04%	1.55%
TWD - Taiwanese Dollar	-0.42%	1.09%
HKD - Hong Kong Dollar	-1.85%	-0.36%

Source: FactSet; Raymond James Ltd.; Data as of January 26, 2023.

How Do the GBP and the EUR Stack Up Against the CAD?

Sticking with the CAD, we wanted to focus our discussion here on our outlook for some of the major CAD crosses. Last year's U.K. government's radical fiscal plan fiasco, which forced the Bank of England (BoE) to intervene to save the U.K. bond market from the brink of collapse, saw GBP/CAD whipsaw nearly nine per cent on the day and hit its lowest level in history. Despite making a recovery to some degree since then, the fundamental economic backdrop for the GBP remains a troubled one. With many anticipating the Canadian economy to slow down this year, we believe it has shown to be just resilient enough to avoid a hard landing, a favourable contrast with some of its global peers. On the other hand, the United Kingdom is still in the early rounds of its inflationary bout, which is the highest among its G-10 peers. As a result, the BoE has been forced to act decisively and, with soaring interest rates adding yet another headwind to economic growth, households are naturally feeling the squeeze with respect to their ability to spend. Thus, we look for GBP/CAD to trade on the defensive and look for the pair to trade within the mid-1.50 range.

Across the English Channel, Europe's economy is actually faring better than that of their U.K. neighbour. Natural gas prices, which have plunged to levels prior to Russia's invasion that sparked a global energy crisis, and the easing of supply chain pressures may very well provide Europe's economy with some much-needed cover to avoid an entrenched recession this year. As the region continues to grapple with stubborn inflationary pressures, the European Central Bank (ECB) has been ramping up its hawkish rhetoric. However, given some of the moderation in immediate recessionary concerns, the ECB likely has the flexibility to act with some latitude with respect to monetary policy. As a result, we see room for hawkish market expectations for the ECB to be dialled back a bit, which would imply some downside risk to the EUR. Looking at EUR/CAD, the pair has enjoyed decent momentum to the upside after trading around the 1.30 range last August for the first time since 2013. While we are not ruling out more upside in the pair, we believe any short-term retracements to the downside may provide better entry opportunities.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Holding Steady

The BoC may have put in their last rate hike of the cycle. On January 25, as expected, the BoC increased the overnight rate by 25 basis points to 4.50 per cent. More notable, however, was the shift in guidance, where the Governing Council stated they expected “to hold the policy rate at its current level while it assessed the impact of the cumulative interest rate increases”. Although they still left the door open for additional rate increases by reiterating that their decisions are data dependent, this strongly signals that the BoC has reached the peak overnight rate unless inflationary pressures force their hand.

An Increase in Transparency

For the first time, the BoC will be publishing minutes of their meeting, two weeks after the rate announcement (in this meeting's case, February 8). Other central banks, including the Fed, already release meeting minutes. By allowing these summaries to be released, the central bank will increase transparency into their process, such as any debates or discussions, and attempt to quell concerns that policymakers are victims of "groupthink" where problems or alternative ideas are not pursued to allow for consensus to be reached.

The Rough Ride

Bonds were under pressure in 2022, as we witnessed one of the fastest hiking cycles put forth by the BoC in history. Given the rising interest rate environment, bond prices had no choice but to adjust accordingly. Today, we believe there is an opportunity to purchase bonds when the risk/reward has become quite attractive. Key inflationary pressures are starting to fall, and both the BoC and the Fed have indicated that a slowing pace of rate increases, or a period of holding rates, may be upon us.

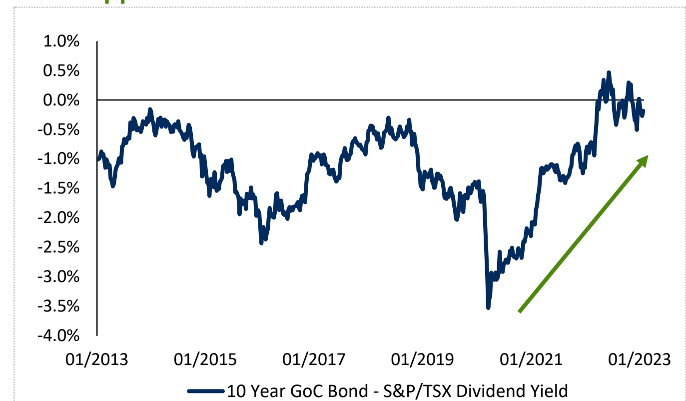
The effects of interest rate increases can take quite a while to manifest in the larger economy – approximately 18 months by some accounts. This lag adds to a central bank’s problem, as their combatting efforts are not immediately apparent making it harder to judge if rates are at a suitable level to resolve concerns. However, it is encouraging that recent CPI reports indicate that inflation is slowing, and it is expected that the BoC will pause rate hikes for now. As we wrote in our December 2022 *Insights & Strategies*, “*We believe the BoC prefers to maintain a stable rate environment when possible. Thus, we do not foresee a rate cut in 2023. Allowing for a steady overnight rate would give previous increases more time to work themselves into the end economy and display their effects more clearly before the bank feels it must act again.*”

Portfolio Positioning

When you look at your fixed income allocation in 2023, we suggest you add duration through longer maturities to lock in today's rates. Although you may give up yield vs. a shorter-termed security due to the inversion of the yield curve, your position will stay outstanding for a longer time, capturing a higher total return. Investing for longer reduces your reinvestment risk – buying a bond that will mature in a year's time requires reinvesting that capital at prevailing (and currently unknown) rates, which could be lower.

The relative value of fixed income has improved since the start of last year, shown by the spread differential between the S&P/TSX dividend yield and the Government of Canada benchmark 10-year bond. We note that the spread remains in favour of equities. However, for the added safety of capital and known return of principal at maturity, the parity position may be favourable to many investors, especially those who have been underweight in this asset class due to the low-yield environment. In addition, investing in high-quality corporate bonds should provide a yield pickup over the benchmark security, meaning your end yield may be higher.

Bond Appeal Has Increased from Recent Lows



Source: FactSet, Raymond James Ltd.; Data as of January 27, 2023.

Lastly, we highlight a comment from the most recent *Asset Allocation Quarterly* that says, “*History shows that interest rates typically begin to fall once CBs [Central Banks] have stopped raising rates.*” Thus, if history repeats itself, we can expect interest rates and bond yields to fall, increasing the value of fixed income securities overall.

Charlotte Jakubowicz, CMT, CIM
Vice President, Fixed Income and Currencies

Important Investor Disclosures

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Information regarding High, Medium, and Low-risk securities is available from your Financial Advisor.

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