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Asset Management

Silver linings emerge as Canada remains relatively well positioned for 2023

Canada Outlook | January 2023

Q4 review and outlook

Most investors are happy to put 2022 behind them for good reason. The year was perhaps the most challenging that many of us have experienced in a decade. High inflation, rising interest rates, the Ukraine war and COVID-19 lockdowns in China all fed a sense of pessimism across stock and bond markets around the world.

Looking into 2023, specifically at central bank policy, we may soon see a silver lining to recent interest rate hikes—in the form of easing inflation, which could in turn spell positive economic and market news.

Markets have tried several times to anticipate peak interest rates without success. However, lower than expected US inflation numbers for October signalled that we are getting closer to peak rates, even if we're not quite there yet. At its December 14 meeting, the US Federal Reserve hiked the target range for the federal funds rate to 4.25%-4.50%. In a statement, the Fed said it still anticipates the need for rate hikes to contain inflation.

The Bank of Canada hiked its target for the overnight rate by 0.50 percentage points to 4.25% on December 7. The Bank's accompanying statement said economic data released since October support its outlook that growth will essentially stall through the first half of 2023.

This supports our view that the Bank is likely to see one or two more rate hikes in this tightening cycle. Commodity price inflation, transportation costs and supply chain issues are all easing. Rents are still rising but should plateau in coming months, as they tend to follow house prices, which have been falling.

Meanwhile, as expected, the European Central Bank raised all three of its main policy rates by 0.50 percentage points to 2.50%, 2.75% and 2.00% at its December 15 meeting. In a statement, it said interest rates will still have to rise significantly and at a steady pace to ensure a timely return of inflation to the 2% medium-term target. Overall, the ECB sees the eurozone economy growing by 3.4% in 2022, 0.5% in 2023, 1.9% in 2024 and 1.8% in 2025.

Consumers remained upbeat even in the face of tepid economic growth

The US economy shrank in the first half of 2022, with GDP declining in the first and second quarters, stoking worries of recession. But inventory woes and lower demand from a locked-down China were to blame for much of this weakness. The Canadian economy also slowed, but GDP managed to stay mildly positive over the first three quarters of the year. Consumer spending, which accounts for 70% of GDP in the US and 60% in Canada, remained positive in both countries despite rising prices and interest rates. A mid-December upward adjustment to third-quarter US GDP suggests economic activity was even more robust in the second half of the year. Strong consumer demand and a low unemployment rate should help economic growth in 2023.

Global equity markets move up and down to close 2022 and set the tone for early 2023

Market volatility in the fourth quarter of 2022 showed how investors were alternating between ongoing pessimism and flashes of optimism fuelled by hopes that central bankers will ease their rate-hiking campaigns. With inflation still

Key takeaways:

- The year was perhaps the most challenging many of us have experienced in a decade.
- We may soon see a silver lining to recent interest rate hikes—in the form of easing inflation, which could in turn spell positive economic and market news.
- Markets have tried several times to anticipate peak interest rates without success.
- With inflation still stubbornly high and the US Federal Reserve intent on reducing it with higher interest rates, we see equity rallies remaining transitory for the near term.

stubbornly high and the US Federal Reserve intent on reducing it with higher interest rates, we see equity rallies remaining transitory for the near term as markets work toward getting on a more sustainable path to solid longer-term returns.

Canadian investment strategy and market highlights

Investment strategy highlights

We remain invested in energy and materials in large measure to take advantage of strong commodity prices. Demand for oil and gas remains strong in the wake of ongoing sanctions on Russia in response to the invasion of Ukraine earlier this year. The war means Europe is still struggling to replace gas from Russia and improve its future energy security.

The return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis. We favour provincial bonds over Government of Canada bonds. However, we continue to trim some equity positions to buy fixed income. Globally, corporate bonds could rally as interest rates and inflation are tamed against a backdrop of mildly positive full-year economic growth.

This story could play out nicely in Canada, where we see a wider than usual gap between corporate credit rates and Government of Canada bonds. If corporate credit issuers start to perform better, they will be able to issue debt with lower rates, which will benefit long-term corporate bond holders.

Overall, we remain underweight domestic bonds and overweight Canadian equities. We have a neutral weighting in US equities and are underweight in global equities. We are also underweight in emerging market equities and fixed income.

- We remain invested in energy and materials to take advantage of strong commodity prices.
- The return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis.

Market highlights

- Canadian equities, as measured by the S&P/TSX Composite Index, were up 5.96% in the fourth quarter and down 5.84% on the year.
- Canadian bonds, as measured by the FTSE Canada Universe Bond Index, finished the fourth quarter up 0.10% and down 11.69% on the year.
- US equities, as measured by the S&P 500 Total Return Index, were up 6.07% in the fourth quarter and down 12.16% on the year.
- Global equities, as measured by the MSCI World Index were up 8.24% in the fourth quarter and down 12.19% on the year. (All returns in Canadian dollars.)

S&P/TSX Composite Index and Sector Performance
(period ended December 31, 2022)

	3-Month	1-Year	3-Year*	5-Year*	10-Year*
S&P/TSX Composite Index	5.96%	-5.84%	7.54%	6.85%	7.74%
Healthcare	-10.90%	-61.59%	-38.04%	-29.18%	-20.77%
Materials	8.18%	1.73%	8.65%	7.58%	1.80%
Energy	8.95%	30.27%	12.51%	7.21%	4.05%
Real estate	7.05%	-21.54%	-0.52%	4.26%	7.47%
Information technology	12.60%	-52.02%	0.89%	13.86%	17.57%
Financials	3.37%	-9.38%	7.93%	6.71%	10.41%
Consumer discretionary	8.82%	-6.03%	9.22%	4.76%	12.05%
Consumer staples	8.48%	10.08%	12.00%	10.39%	14.67%
Communication services	6.11%	-2.59%	5.36%	5.55%	8.85%
Utilities	-7.42%	-10.56%	4.80%	7.58%	7.27%
Industrials	7.35%	1.44%	11.42%	11.12%	14.01%

*Compound annual rate of return. Source: Bloomberg as at December 31, 2022. Performance stated in Canadian dollar total returns.

Canadian investors still have potential to ride out volatility perhaps better than most others

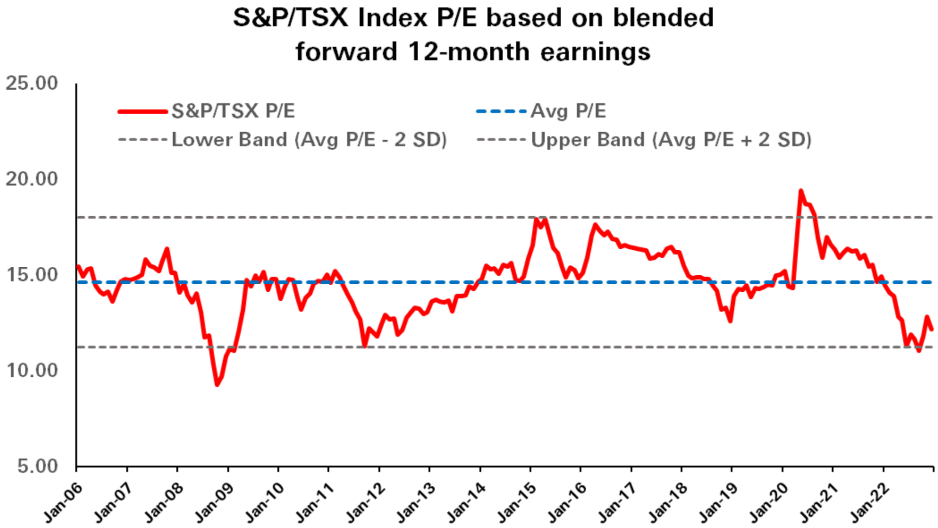
Corporate earnings show Canada has a positive story to tell

We agree with consensus forecasts for a mild recession in Canada in 2023, but there are still many factors that point to avoiding a deeper recession. On balance, we still see Canadian investors weathering the current volatility better than most, based on four positive factors: a continuing strong job market, high consumer savings levels, robust commodity prices, and solid corporate earnings.

Looking more closely at corporate earnings shows that Canada also has a positive story to tell when it comes to equity valuations. Canadian stocks are trading at a price-to-earnings (p/e) ratio of roughly 12 times forward earnings, versus a more typical p/e ratio of 15. Currently, this means investors pay $12 for every $1 in earnings. As p/e ratios move back to more normal levels, long-term investors may be positioned to benefit.

The global earnings picture is less positive in many markets outside Canada. Around the world, economic momentum continues to slow, with the Eurozone and UK in recession, US growth well below normal, and China's 2023 recovery likely to be shallow. This cyclical headwind largely determines how we feel about stocks. We expect consensus earnings growth to slow further.

From a cyclical perspective, we foresee a possible bottoming of global economic data around the second or third quarters of the year, but little upward economic momentum from there. On the earnings side, we think consensus forecasts need to come down further, but once analysts forecast zero earnings growth or a small earnings recession, and earnings momentum stabilizes, this could be the signal for markets that enough pessimism is priced in. This would be a key milestone allowing investors to add back to equities and take a less defensive sector stance.



Source: Bloomberg as at December 31, 2022. Past performance is not indicative of future returns.

Emphasizing resilience and diversification to stay invested long term

As always, regardless of current market conditions, making short-term investment decisions in a volatile environment such as today's is usually not prudent. Responding to short-term volatility by ignoring long-term investment goals rarely yields positive results. In 2023, we encourage investors to stay invested, but with an emphasis on building resilience and diversification in portfolios.

Important Information:

All quoted returns are total returns as at December 31, 2022 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, RIMES, Statistics Canada and the Bank of Canada.

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