

Asset Management

Canada looks set to chart positive long-term course amid choppy global waters

Canada Outlook | July 2023

Q2 review and outlook

After rallying at the beginning of the quarter, Canadian equities struggled and finished with a small positive return over the last three months. Meanwhile, US equities spent the second quarter moving higher, primarily on the back of some key technology market leaders.

While this divergence may have been unwelcome for Canadian investors, the underlying valuation story points to the positive long-term potential for Canadian equities. US and global stock markets look expensive, with valuations remaining above long-term averages. Patient Canadian investors, on the other hand, are facing an undervalued market that could be set to shine despite the expected short-term volatility.

Still, our central scenario is for a recessionary environment in western economies, including Canada, and a difficult, choppy outlook for markets. We see this happening for two reasons.

First, we have the rapid tightening of financial conditions — the fastest interest rate hiking cycles from the Bank of Canada (BoC), US Federal Reserve (Fed) and European Central Bank since the 1980s.

Second, while equity valuations look slightly rich outside Canada, markets do not appear to be pricing in a particularly pessimistic view of the world. So the news and data over the next six months may dent investor confidence. Negative news about the economy could be tough to digest for a market that is pricing in a soft landing.

A shift to an outright hard landing scare could happen as we move towards the end of the year. However, again, Canada may be more of an outlier and find itself contending with only a mild recession.

The hands of central bankers are still firmly on the tiller

We forecast limited tightening will continue in the near term, driven by central bankers' inflation concerns. We think Fed policy rates will peak at around 5.5%. Ultimately, we believe central bankers, including the BoC, will then have to ease policy by more than markets currently expect in 2024 as recessions bite.

The BoC resumed its rate tightening cycle at the June 7 meeting by raising rates from 4.5% to 4.75%, the highest level since 2001. At the July 12 BoC meeting, as expected, the Bank delivered another quarter point rate hike, bringing the overnight rate to 5.0% signalling its commitment to bringing inflation down to the 2% target.

Inflation remains top of mind, as the Canadian economy has been stronger than expected so far this year compared with the BoC's forecast. The Consumer Price Index rose 3.4% year-over-year in May, following a 4.4% increase in April. Some comfort can be found in the fact that it


Key takeaways:

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was the smallest increase since June 2021, but price pressure clearly remains.

The Bank of England (BoE) surprised markets at its June 22 meeting, raising the bank rate by 50 basis points to 5%. This latest move marked a departure from smaller quarter-point increases in the last couple of meetings.

The BoE cited the scale of recent upside surprises in wages and service sector inflation and “more persistence in the pricing process” as the main factors behind its more aggressive posture. The latest statement reiterated that further policy action would be implemented if inflation pressures persist but did not signal a pre-commitment to a particular course.

S&P/TSX Composite Index and Sector Performance

(period ended June 30, 2023)

	3-Month	1-Year	3-Year*	5-Year*	10-Year*
S&P/TSX Composite Index	1.10%	10.43%	12.42%	7.62%	8.43%
Healthcare	0.46%	-15.52%	-29.59%	-28.83%	-23.09%
Materials	-6.92%	11.59%	3.81%	7.02%	5.68%
Energy	0.04%	0.84%	25.95%	5.71%	3.73%
Real estate	-2.85%	2.99%	8.18%	3.77%	7.84%
Information technology	16.60%	58.34%	-2.20%	18.22%	19.98%
Financials	2.00%	5.87%	15.89%	7.81%	10.31%
Consumer discretionary	6.35%	26.15%	17.57%	6.28%	10.99%
Consumer staples	-2.64%	16.94%	13.36%	12.07%	13.65%
Communication services	-1.09%	0.16%	9.47%	7.08%	9.09%
Utilities	-1.46%	-7.12%	7.18%	10.09%	8.26%
Industrials	2.10%	21.68%	16.06%	11.56%	13.44%

*Compound annual rate of return. Source: Bloomberg as at June 30, 2023. Performance stated in Canadian dollar total returns.

Canadian investors have potential to sail through 2023 volatility perhaps better than most others

We sense that investors are perhaps overly pessimistic on the Canadian market. This could be based on a negative perception that corporate earnings will not grow as fast as they have historically. But a closer look at the data suggests a more positive scenario.

Canadian equities, as measured by the S&P/TSX Composite Index are trading at a price-to-earnings (P/E) ratio of roughly 13 times forward earnings, versus a blended five-year rate of 15 times and 10-year average rate also of 15 times. This means investors are now paying \$13 for every \$1 in earnings. As p/e ratios move back to more normal levels, long-term investors may be positioned to benefit. The current P/E ratio therefore provides compelling opportunities this year for entering the market.

We believe the earnings picture for Canadian companies will improve in 2024 suggesting more sales being generated, which could mean companies will see their profits increase as well. Myriad companies

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boasting strong balance sheets could potentially position them for expansion and share buybacks.

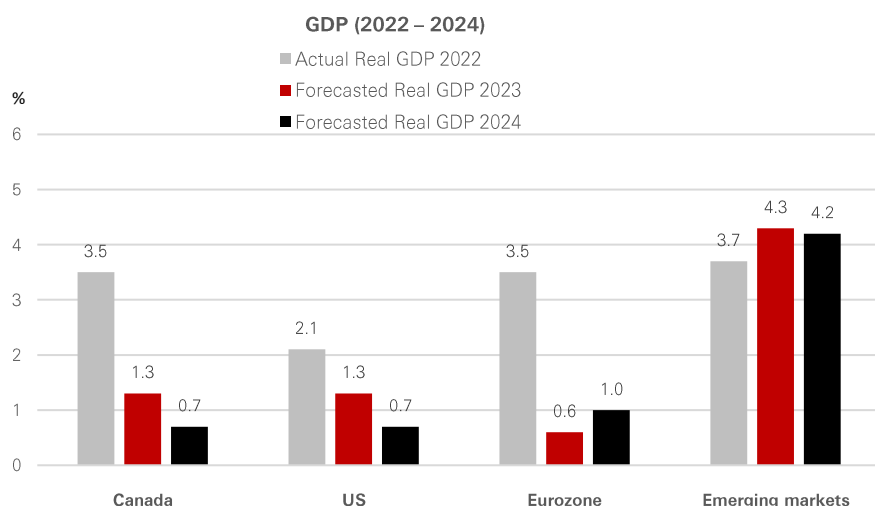
Canadian bond yields are at their most attractive (highest) level in 15 years. As the probability of even a mild recession starts to be priced in, interest rates should move lower. In this environment, fixed income prices are likely to rise, a development that will be welcomed by today's bond holders.

Third-quarter outlook: Canadian stock and bond markets have potential to reward patient investors, domestic economy also looks relatively robust

The Canadian economy so far this year has been stronger than had been expected in the BoC's forecast. First-quarter GDP growth was 3.1%, higher than the 2.6% projection in the BoC April Monetary Policy Report. Household consumption was surprisingly strong, at 5.7% — the fourth highest quarterly growth of the last decade. Added to this is data showing that growth was broadly based, with strong housing prices and steady job gains.

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Consensus GDP forecast



Source: Bloomberg, June 30, 2023

Cautiously positioned and focused on uncovering promising long-term opportunities for capital appreciation

On balance, we remain cautiously positioned, and our asset allocation is best described as defensive. Short-duration fixed income is preferred, and we are focusing on high-quality credits and conservative companies with quality balance sheets. We believe the way to get through volatile times is by being fully focused on quality in ways that encourage long-term capital appreciation. We also retain our ongoing commitment to building diversification and resilience into our portfolios in order to encourage investors to remain confidently invested for the long term.

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Important Information:

All quoted returns are total returns as at June 30, 2023 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, RIMES, Statistics Canada and the Bank of Canada.

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