Putting the Pieces Together

2023 Outlook

2022 marked the end of cheap and easy money which started back during the Financial Crisis. We believe 2023 will be a year of normalization. Like the adage states when the pendulum swings too much on one side eventually you get a return to the mean.

Regarding inflation, as we stated in our previous two newsletters, we are passed peak inflation. The last U.S. CPI was welcomed news at the Fed, as two out of three of Powell's key inflation categories (core goods, shelter, and core services ex-shelter) are now moving in the right direction: down. And it's only a matter of time before the shelter component rolls over. Three months of relatively lighter core inflation figures is starting to form a trend... one that could spur the Fed to slow the pace of tightening further on as they have announced on February 1st. In our last newsletter we highlighted four variables that the FED had earmarked that they wanted to see happen for them to stop increasing rates. Three of the four variables had already occurred and the last one being a softening in the labour market. The last employment report of December was still relatively strong but since then, a series of large layoffs have been reported, especially in the technology and financials industries.

The Bank of Canada delivered 25bps increase as expected and is once leading the way among global central banks as it's the first to signal a pause. The shift was a bit more dovish than anticipated. While policymakers haven't shut the door on more hikes, the bar for further tightening is quite high. It looks like a March move is off the table barring some wild data. BMO Economic's base case remains that the BoC is on hold through the rest of 2023. As we enter 2023, we remain very slightly overweight equities and find good value in bonds (we raised our allocation to fixed income a few months back). Interestingly, in the Canadian market, approximately 75% of bonds now have a price of less than $100. Since these bonds will mature at $100 (assuming they are high quality), investors have a rare opportunity to increase the tax efficiency of their portfolios.

BMOCM states that a forecast for the S&P 500 establishing a new bear market low sometime during the first half of 2023 has become an increasingly consensus call. While they do not entirely rule out the possibility, an examination of market history suggests this would be a very low probability event. Therefore, they continue to believe 10/12/22 likely represents this cycle's price low and that we are in the early stages of the next bull market. However, they also believe that the path will be bumpy in the coming months, but any potential weakness is unlikely to push the S&P 500 below its October price low given the current set of market circumstances.

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The year 2022 was volatile and difficult to navigate with seemingly very few places to hide both for equity and bond investors. This created an understandable general feeling of anxiety and pervasive bearishness among investors. While we recommended a very defensive positioning all year, we are now looking ahead and are moving portfolios to benefit from the unavoidable recovery we foresee in 2023. We expect the next few months to remain volatile but economic momentum should pick up (from low levels) in the second half of the year with an associated far stronger performance from risky assets and stocks in particular. As we repeatedly stated, securities markets are primarily influenced not by absolute numbers but by the trajectory of key macro variables. On that front, the situation is already improving for inflation – though it will take some time to get back down to the 2-3% range. The missing ingredients are an improvement in growth and housing momentum, and that's what we think will happen in the new year. As always, the stock and bond markets will discount these improvements well before we see the evidence in the "real world".

In the spirit of leading with our conclusions:

1. We expect continued strong relative performance from the TSX vs. the S&P 500 following a better than 10% outperformance in 2022 (because the Canadian market is far cheaper, the sector weights are far more favourable since we continue to like Energy and Materials far more than Technology, and we consider the Canadian dollar to be substantially undervalued currently).

2. We believe high-quality, low-duration (i.e. reasonably valued vs. profitability and growth) stocks remain the place to be.

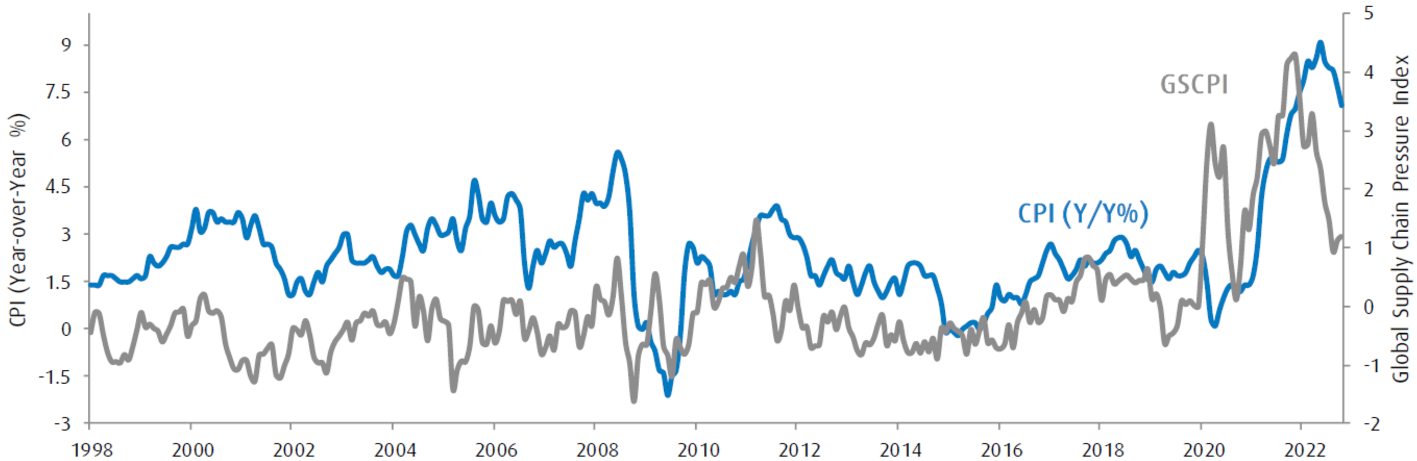
3. We continue to see room for Energy and Materials (especially Agriculture plays) to do well along with some oligopolistic Industrial and Consumer Discretionary stocks (e.g. Honeywell, Finning, Home Depot, Raytheon, CN Rail).

4. Defensive but interest-rate-sensitive sectors like Utilities, REITs and Telecoms should recover nicely from a difficult 2022 if we are right in our view that interest rates will be rangebound and even potentially drift lower (i.e. we do not see another huge spike from current levels).

We are already seeing some optimistic signals. First, BMONB (BMO Nesbitt Burns) recession probability model has shown some improvement with odds of recession ticking down to about 50% currently. Not great to be sure but moving in the right direction.

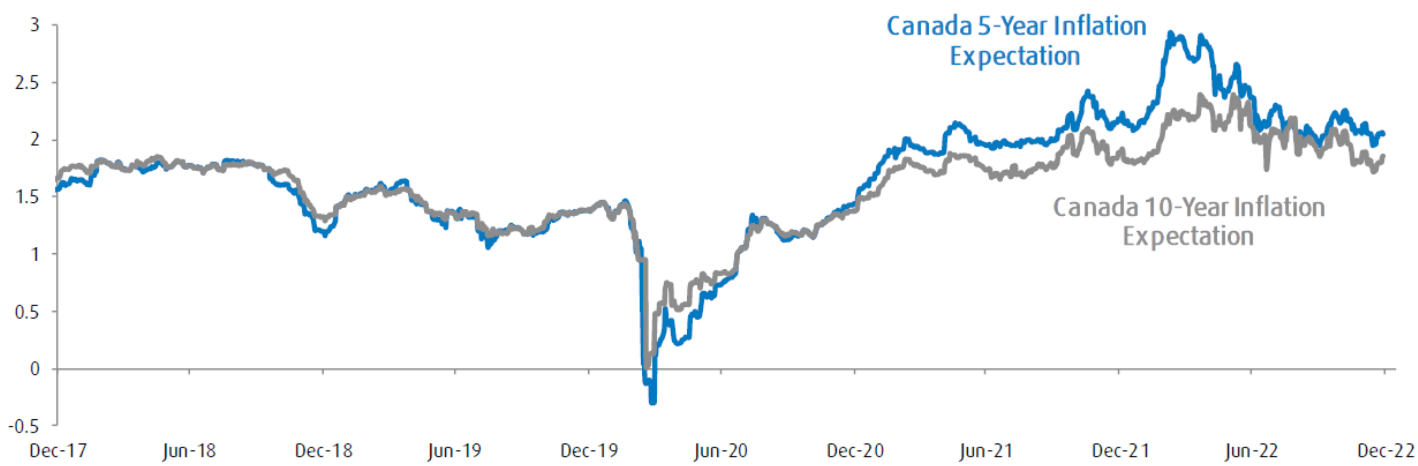
Also encouraging is that the job markets at large and consumer confidence are still holding in strongly. Maybe this delays an eventual Federal Reserve (Fed) pause in rate increases but it does have the benefit of keeping the North American economy afloat. Case in point, The U.S. **Conference Board's Consumer Confidence Index** brightened for the first time in three months, up 6.9 pts to an 8-month high of 108.3 in December.

Looking at China, it is now clear that the zero Covid policy has been a failure and policy makers will continue to reopen their economy as they have effectively lost control of the virus. This should help support global growth.
CPI vs. Global Supply Chain Pressure Index – More Room for CPI to Pull Back



Source: BMO Private Client Strategy, Bloomberg

Inflation Expectations in Canada and the U.S. are Moving in the Right Direction



Source: BMO Private Client Strategy, Bloomberg

Selected 2023 Sector Outlooks from Sector Equity Analysts at BMO Capital Markets

1. Oil & Gas – *Cash Distributions Poised to Accelerate*

2022 was an excellent year for oil and gas investors. The group managed to materially outperform crude oil prices, which were relatively flat. As we enter 2023, the key question for oil and gas investors is how much upside is left after two-years of outperformance, especially against the backdrop of a recession. We think the sector has more upside to offer. Valuations remain attractive and the oil and gas group is in the strongest financial position in its history amid what we believe is a multi-year up cycle in crude oil prices. In 2022, the oil and gas group was focused on paying down debt alongside raising cash returns to investors; in 2023, we think that the group will pivot to more aggressive cash distribution strategies.

2. Metals & Mining – *Transition Ongoing, but Leaning on the Old Guard*

Despite growing economic headwinds, most metals & bulk commodities prices remain at healthy levels by historical norms. While 2023 metals demand growth is unlikely to be stellar, on a six-month view we do expect improved Chinese demand will offset weakness in the developed world. We see the recent general price rally as somewhat ahead of fundamentals, particularly given typical first quarter demand weakness. However, BMOCM (BMO Capital Markets) raised most 12-month forward commodity forecasts as 2023 balances are incrementally tighter than might have been thought two months ago.

3. Fertilizers & Chemicals – *2023 on Our Mind; Ferts, Ag and Lithium Outlook*

Amid a strong ag dynamic, we believe crop chemicals (e.g. Corteva and FMC) offer the best risk/reward in the sector in 2023, but we remain constructive on fertilizer and large-cap lithium (Albemarle and SQM) stocks. First, crop chemical producers Corteva (BMOCM's top pick) Second, fertilizer stocks look attractive at least through H1/2023 with the potential for prolonged strength, if the assumption remains that further fertilizer price normalization doesn't quickly transpire (plus fertilizer prices have fallen sizably so ferts stocks seem de-risked). Third, we still prefer N.A. nitrogen names CF (2022 outperformer) and Nutrien with lofty European gas premiums. Fourth, large-cap lithium trades at attractive single-digit multiples on 2023 numbers (which may surprise to the upside even if lithium prices ultimately moderate).

4. Industrial Products – *2023 Outlook: Strong Fundamentals Despite Heightened Economic Uncertainties*

While the long-awaited economic pullback in North America may finally be starting to materialize, we believe there are limited remaining benefits from the 'defensive trade' that have played out in 2022. We believe investors should begin to unwind defensive positions and selectively add stocks with strong fundamentals and cyclical upside. BMO Nesbitt Burn's preferred ideas for 2023 are Stantec, Finning, and WSP.

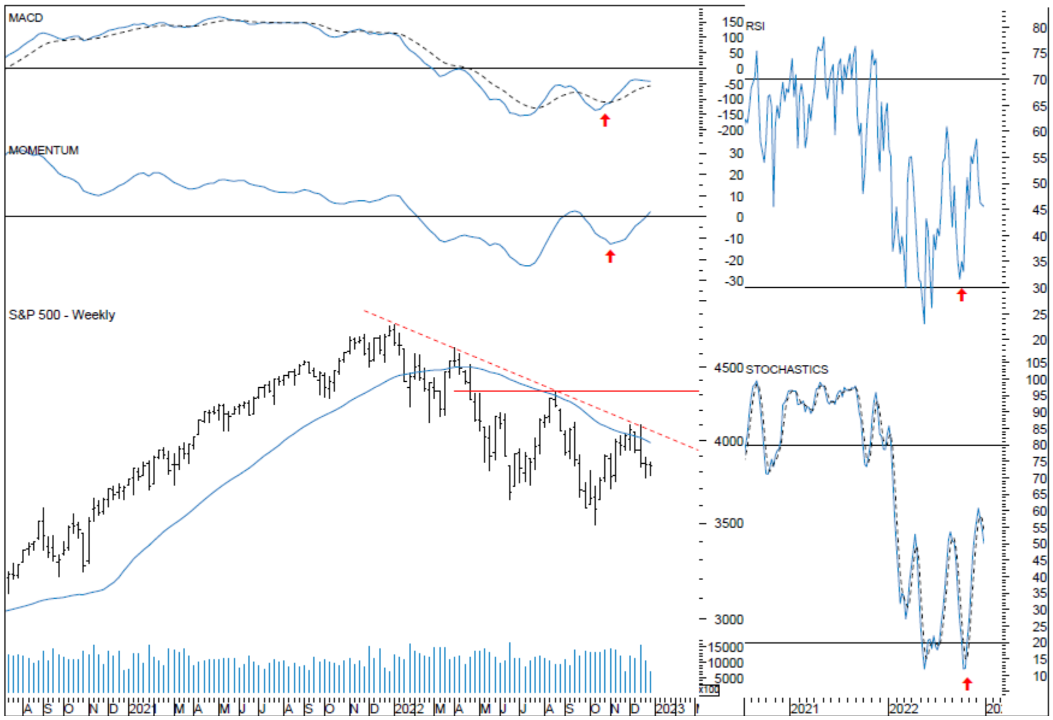
5. Machinery – *Where do we go from here?*

Company backlogs are near historically high levels, while demand has generally stayed resilient. Meantime, supply-chain holdups and logistical constraints that have plagued most companies over the past couple of years are gradually improving, which should lend itself to greater volume upside just as most price-cost pressures (ex-labor) ease. With these issues moving further into the background, we suspect that the first half of 2023 will show solid results for most companies.

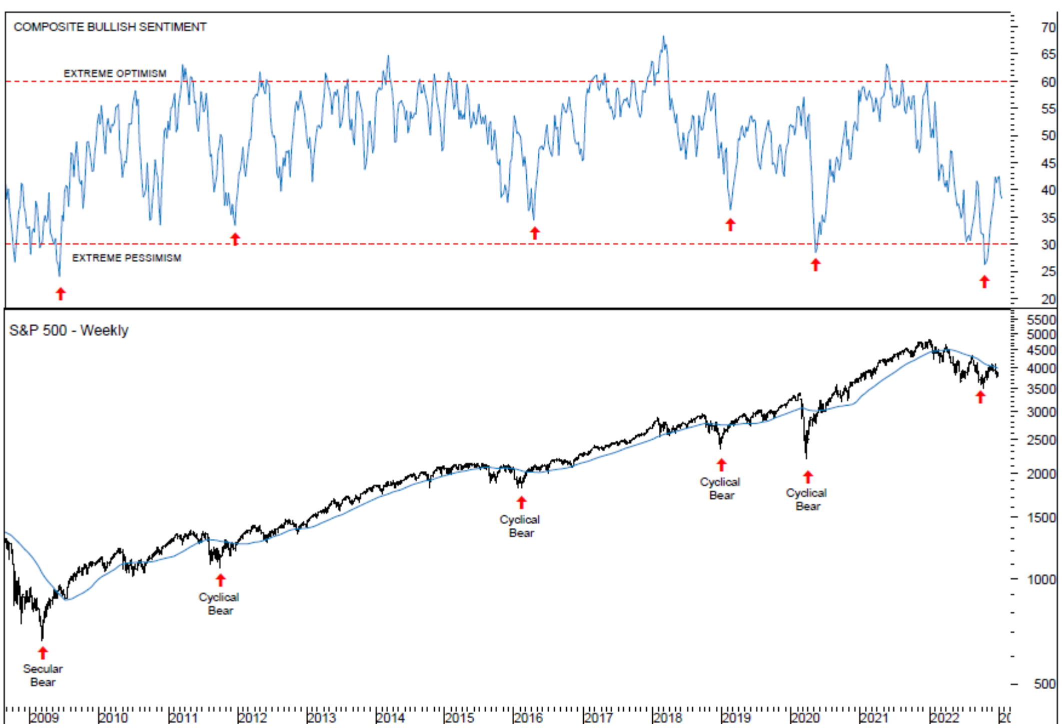
Technical Analysis

According to our Technical analysis team, the second half of December was certainly much weaker than they had expected it to be, given the strong historic seasonality and the state of their medium-term timing model (which was fully bullish) coming into the month. Still, the 5.90% decline in the S&P 500 had no material impact on those weekly gauges. Momentum gauges remain mostly positive after giving new medium-term buy signals earlier in the fall, there was minimal deterioration in breadth oscillators such as the percentage of S&P 500 stocks trading above 50- and 200- day moving averages and there was only the slightest of dips in our Composite Sentiment indicator.

S&P 500 Weekly Momentum



S&P 500 Weekly – Sentiment



Perhaps the most telling aspect of December's action though is the performance of economically sensitive pro-cyclical areas such as Industrials which just made a three year high in relative performance versus the S&P 500. It's also teetering on breaking out of a massive "double bottom" reversal pattern with an upside target that measures 22% higher than the December 30th close. The Equal Weight S&P 500 Consumer Discretionary Index (which removes the AMZN/TSLA "skew") also just made an 8-month high in relative performance vs. the S&P 500 and drilling into that group a bit we see that housing stocks such as DHI, PHM, and TOL are outperforming the S&P 500 and already in new long-term uptrends. This is essentially the polar opposite of what we would expect to see if the economy was tilting into a major recession next year. i.e. – the markets are telling a very different story than the doom and gloom we see in the news these days. It's also in line with how these groups have performed coming out of every bear market since (and including) the credit crisis.

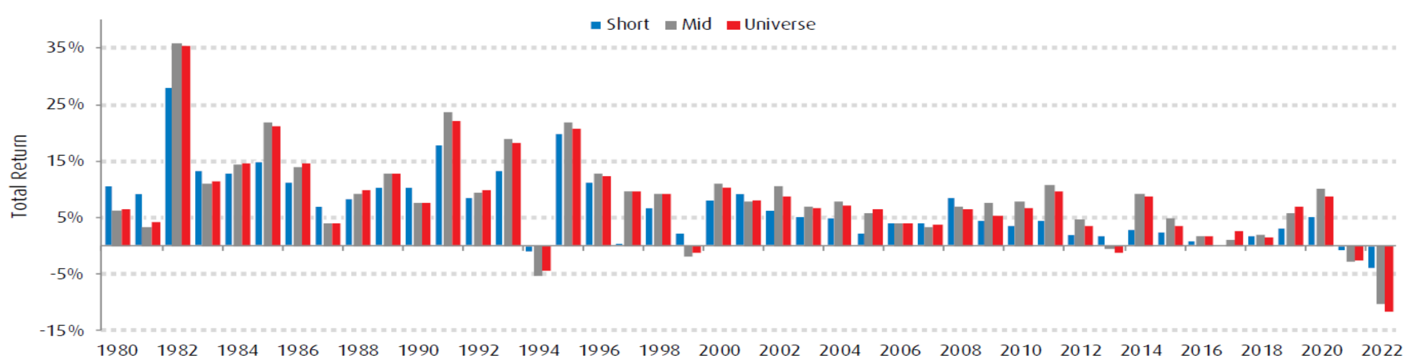
Post-Bear Sector Returns

	2009		2011		2016		2018		2020	
	13-wk	26-wk	13-wk	26-wk	13-wk	26-wk	13-wk	26-wk	13-wk	26-wk
S&P 500	37.56	48.73	10.59	20.99	9.75	17.12	14.03	18.35	18.4	29.79
Cons Disc	10.75	13.32	10.39	24.16	12.12	17.64	16.58	22.32	29.09	49.76
EW Cons Disc	33.94	35.27	11.38	26.07	7.99	16.56	16.54	17.48	24.3	47.36
Cons Staples	-17.91	-23.17	7.2	13.31	6.21	9.8	11.6	14.92	6.48	17.79
Energy	-8.49	-22.45	15.49	15.41	16.43	21.95	15.94	11.64	27.46	5.3
Financials	64.1	84.9	13.51	31.49	11.77	16.67	8.96	17.05	7.49	11.85
Healthcare	-21.11	-19.58	10.19	17.79	7.43	16.22	7.59	8.61	14.81	21.31
Technology	3.32	8.52	7.57	27.09	7.98	21.11	20.51	27.32	29.11	44.98
Industrials	17.47	15.87	14.69	22.34	10.51	17.38	17.81	21.41	12.32	29.82
Materials	12.68	14.91	12.15	17.74	13.16	20.54	10.56	16.89	23.34	41.19
Telecomm	-25.63	-35.07	4.92	7.41	4.79	12.69	13.94	18.67	19.23	31.88
Utilities	-20.36	-23.6	5.1	4.62	8.35	11.65	10.09	13.04	-0.9	5.44
REITS	N/A	N/A	N/A	N/A	N/A	N/A	16.67	18.52	8.06	11.11

Important Market Divergences to Keep Interest Rate Volatility Elevated In The Near Term

Good news for bond investors: the year 2022 is now in the rear-view mirror! This will be one for the history books. The rising inflation, significant monetary policy response and the sharp increase in global interest rates combined with weak risk asset performance led to the worst portfolio performance in years. Even balanced portfolios which normally tend to provide some stability in times of global market volatility underperformed significantly; never in the last 50 years had we seen both the U.S 10-year treasury and S&P 500 generate negative returns in the same year!

FTSE Fixed Income Universe Indexes – Annual Total Returns

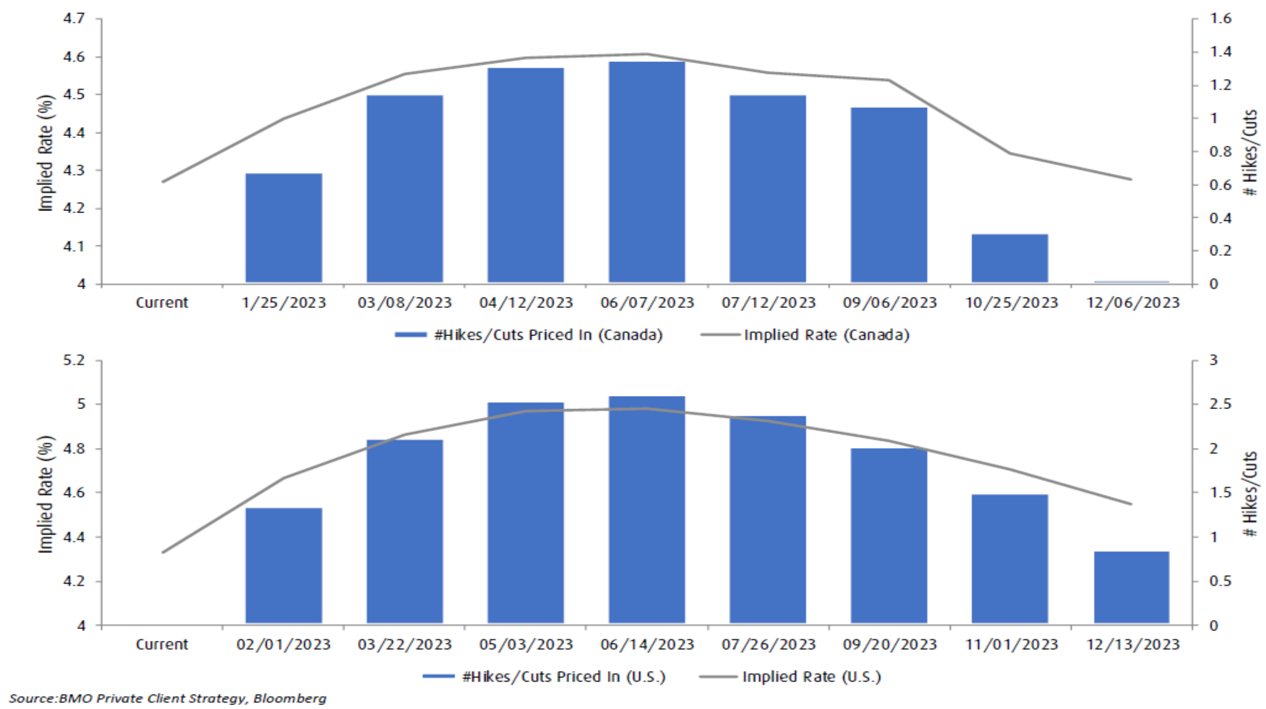


Source: BMO Private Client Strategy, Bloomberg

Leaving the gloom behind, investors can take comfort in much-improved prospects for fixed income returns. First, interest rates start the year at much more attractive levels than early 2022, providing higher income potential and a greater buffer against price volatility. Government of Canada 2- and 10-year yields are at their best levels in 15 and 10 years, respectively. As for longer-term investments, we admit that the 30-year yield slightly above 3% may not seem as attractive in the context of headline inflation above 6%, but it is nonetheless the best we have seen since 2013.

Looking forward, particular attention will need to be given to the diverging opinions developing in markets: monetary policy and corporate credit valuations. The bond market seems to be taking a different direction than currently dictated by central bankers. Market pricing continues to lean toward the Bank of Canada (BoC) and the Fed starting to cut rates as early as next summer, which does not align with current narratives.

Canada and U.S. Policy Rate Hike Expectations

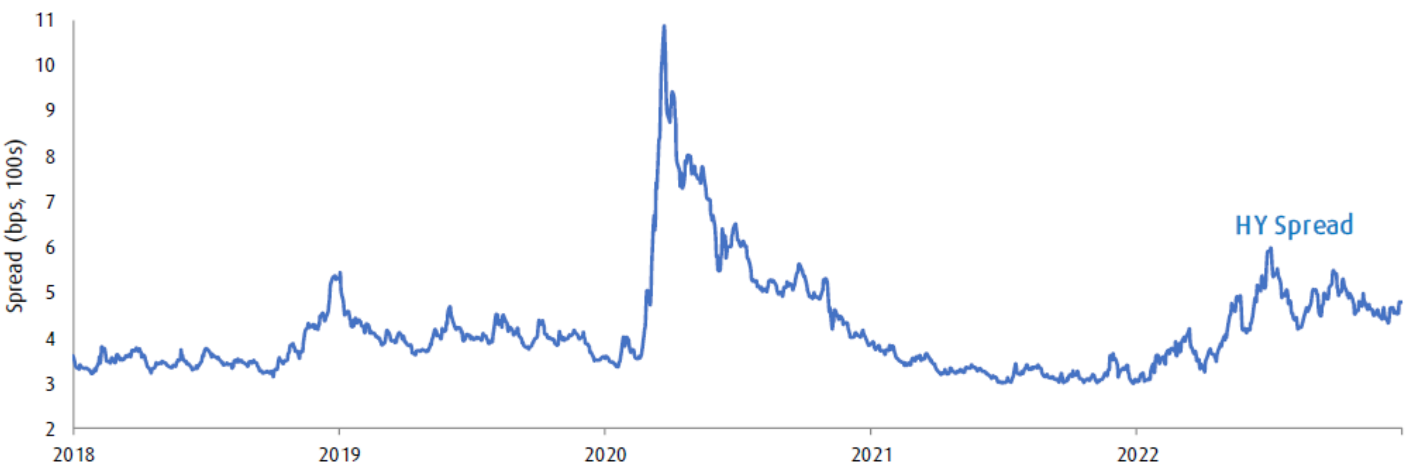


Whether we look in the UK, Europe or even Japan, major central banks around the world are actively fighting inflation by tightening financial conditions. The Fed may have downshifted from 75 bp to 50 bp in December but the rhetoric remains hawkish. Policymakers haven't even shifted to being 'cautiously hawkish' yet and continue to see the need for more tightening. The BoC seems to be closer to a pause with the potential for one more 25 bps hike in Q1. In both cases however, the issue remains that not only is the headline CPI elevated but core prices also; while goods price pressures are slowly abating, services are stickier along with wages. This may take more than one or two quarters to improve and open the door for rate cuts which are expected to be more a 2024 story. This is not well reflected in markets. This disconnection between the investors and central bankers' timelines could continue to apply upside pressure on front-end rates and subject markets to higher volatility.

The second divergence is credit, where market optimism (as expressed by relatively tight yield spreads) do not reflect the gradual deterioration of credit conditions in the lower rated sectors amid rising recession risks. While our BMO economists give approximately 50% odds of a mild contraction and a 25% probability that our economies will avoid a recession, they do also see a 25% odd that conditions could get much worse. There is a big wall of high-yield issuances ahead in 2024; but it is expected that companies will need to start refinancing earlier to avoid overcrowded markets. For some, this will be a rude awakening after benefitting from years of cheap money.

So far, the default rate has only inched up and remain well below the previous peaks during downturn. However, we are starting to observe increased stress in credit markets following the significant monetary tightening. As reported by Bloomberg, distressed debt in the U.S. has increased by 300% over the last 12 months and leverage ratios have reached record levels. Bloomberg also reports that globally, it is close to $650 billion of bonds and loans that are in distressed territory which is the biggest test for credit markets since the Financial Crisis.

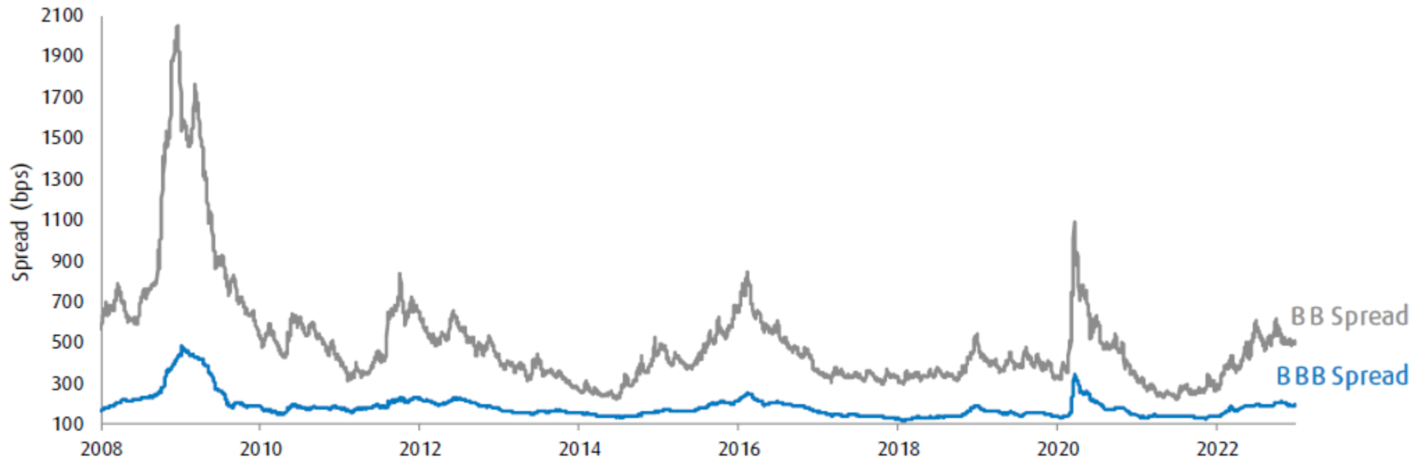
U.S. High Yield Spreads: Complacency



Source: BMO Private Client Strategy, Federal Reserve Bank of St. Louis

With average U.S. High Yield spreads at 481 basis points over treasury yields at the end of 2022 (now 4.30%), we do not believe valuations fully reflect current and expected fundamental trends and show some complacency toward risk. We would not be surprised to see a re-test of the summer's wide credit spreads (around 600bps). We are not debating the attractiveness of average yields between 8% and 9%, but we believe that the risks remain tilted toward wider spreads in the near-term and would continue to adopt a more conservative strategy and maintain a better-quality bias. Nonetheless, it is important to note that today's credit spreads do not compare to those that we had witnessed in the 2008 Great Recession.

Today's Credit Spreads are a Fraction of 2008-2009 Levels



Source: BMO Private Client Strategy, Bloomberg

In summary, dividend-based strategies meaningfully outperformed in 2022, with dividend-paying stocks in the TSX down just 2% on average during the year, ahead of the -6% total return seen by the S&P/TSX composite and well ahead of the 17% average decline seen by non-dividend-paying stocks. Yes, we have seen a reversal in 2023 so far, with non-dividend paying stocks outperforming and dividend-paying stocks slightly lagging. However, from our perspective, this has more to do with the market recalibrating to a softer landing in 2023 as opposed to a shift away from income-based strategies. Overall, despite the slight underperformance year to date, we believe income-based strategies remain well-positioned to outperform again in 2023, particularly as the market struggles with the end of the interest rate tightening cycle, elevated but declining inflationary levels, and recession risk.

The effects of the pandemic are still being felt in our daily lives and in the stock markets. However, your team will remain alert to developing trends and remain active to keep your short- and long-term plans on track.

Hope to talk to you soon.

Team Roux & Associates

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