CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

OUTLOOK

DECEMBER 2022

Our true north strong and free. The near-term economic deterioration story for Canada has been well documented. Canada's citizenry is engaged in a love affair with real estate. Not needing, yet still benefiting from the global drop to near-zero interest rates, we embraced home ownership, taking on massive mortgage debt to pay for increasingly expensive homes. The commonly used metric of household debt to disposable income marks Canada as the highest of the G7 (184%) and among the most elevated in the entire OECD (Organization for Economic Co-operation and Development). And it really does boil down to housing costs and associated mortgage debt. Mortgage debt now makes up 74% of all household debt, compared to 62% in 2005. Non-mortgage loans have been flat or down over the past few years and cash from the pandemic has been used to pay those down.

In the pandemic era, new mortgage originations tilted away from fixed rate and into variable rate mortgages, leaving debtors even more exposed to rising interest rates. Thanks to tough borrowing restrictions (macroprudential rules) instituted in recent years requiring buyers to be able to withstand a 2-percentage point rise above posted 5-year mortgage rates, broadly speaking, households have managed so far in the current rising rate environment. Nonetheless, mortgage holders with renewals over the next year, and those with variable rate mortgages, who in total comprise a sizeable 52% of total mortgage debt outstanding by our estimates, will experience a shock in terms of higher payments.

According to the latest data available in 2019, just under two-thirds of Canadians are homeowners, and of that group, only about 55% have a mortgage. Putting it all together, the aggregate impact seems smaller than headlines suggest. A recent paper by a major bank modeled the bottom-up impact on debt payments from higher interest rates and the cumulative negative shock to be about 1% of total disposable income (even assuming higher rates than were in place when the analysis was done). Notably, this is below the aggregate personal savings rate which was at 5.7% last quarter. Of course, the pain will be felt unevenly and the adjustment will be difficult for many. We are also not complacent about how higher rates will impact spending – indeed the goal of all the rate hikes is to slow spending through rate-sensitive parts of the economy. Nonetheless, it is worth noting the broad impact may not be as bad as initially thought, especially within the context of high excess savings from the pandemic and strong job creation.

WHERE IS CANADA GOING FROM HERE?

As a starting point, the country benefits from:

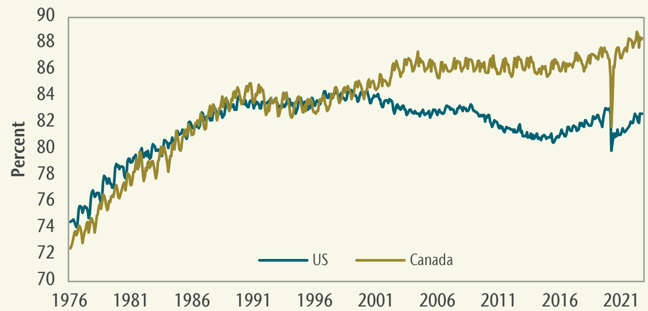
- High rankings on various metrics of economic and personal freedoms,
- A wealth of natural resources whose export value has risen relative to its imports, as well as
- The proximity to the world's largest economy.

Not only are oil and natural gas filling a temporary gap in energy supply, but demand for metals is also benefiting from the green energy revolution. Furthermore, while there is a limit on the conversion of land for crop production in the short term, we can contribute through our position as one of the world's largest global producers of both potassium and nitrogen fertilizers. The list of primary staple goods in high demand today goes on from there, for example, wood, pulp, and fish.

Perhaps one of the strongest economic arguments for the medium-term outlook is demographics. While the retiring baby boomer cohort has reduced labour supply as it has elsewhere, there will be several unique and positive offsets:

1. Canada's labour participation rate has actually been rising and is consistently higher than the U.S. (see Chart 1).

Chart 1: Canada's Participation Rate is Solid
Labour force participation rate for population aged 25-54



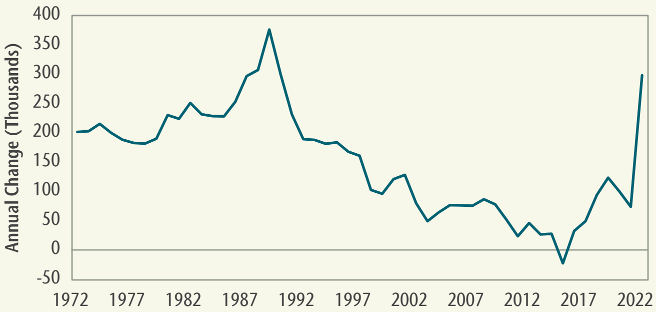
Source: BLS, StatsCan, Macrobond

Analysis by the San Francisco Fed found that working-age females, helped by better maternity policies, accounted for about three-fourths of the difference.

2. Immigration targets were updated in late October and the target number of new immigrants was raised to 465k in 2023 and 500k by 2025. This growth outpaces the other G7 countries in absolute terms, even with the smallest population. The majority will come in the economic category, those who should find jobs easily in industries where we have shortages.

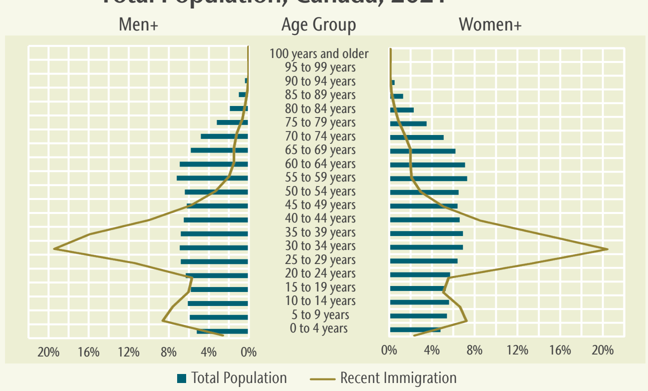
3. Other developed market economies are struggling with declines in the prime working age population. This 25-54 age cohort accounts for the bulk of immigrants in Canada (see Charts 2 and 3), a group that will support the tax base, consumer spending, and real estate markets.

Chart 2: Strong Demographic Profile
Population aged 25-54



Source: Statistics Canada, Macrobond

Chart 3: Age Pyramid for Recent Immigrants and the Total Population, Canada, 2021



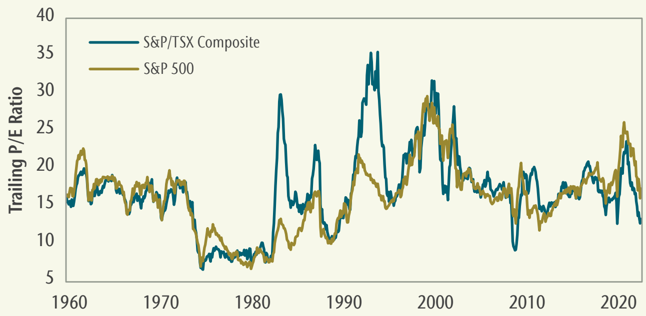
Source: www150.statcan.gc.ca

All this bodes well for the potential output of our economy, which helps to raise the pace at which the economy can grow without sustained inflation.

BUT IS CANADA A GOOD PLACE TO INVEST?

This all translates into fairly positive macroeconomic prospects for Canada, and we think is positive for investors too. Indeed, in this extraordinary year of declining asset market values, Canada has been a good place to hide. The S&P/TSX Composite (TSX) has fallen just 1% in the first 11 months of the year, outperforming the U.S. and global markets even accounting for a weaker dollar, which are down 6.7% and 8.4% respectively in Canadian dollar terms. Even with that outperformance, valuations are more favourable than in other markets (see Chart 4). In a broad sense, the recent liquidity-driven, ultra-low rate cycle has thrust valuations in high duration growth stocks to nosebleed levels. The mega cap tech stocks have been among the worst performing as equities have derated.

Chart 4: Canada Equities Attractively Valued Relative to United States

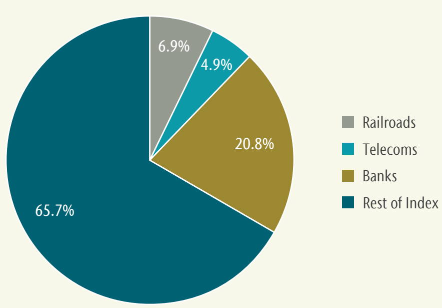


Source: TD Securities

In the short term, the sector structure of Canada's equity market, the TSX Composite Index, is a positive factor. Canada has more exposure than other countries to sectors that will do well in an inflationary environment. Roughly 30% of the TSX has commodity exposure which tends to do better during periods of higher inflation. The share of technology is steady at about 5%, up only slightly over the last 15 years. The global transition to clean energy sources will also support investments directly into renewable electricity companies, as well as toward inputs into the energy transition, such as copper producers.

Finally, several industries benefit from a small number of large companies with dominant market share. This structure is favourable for revenue and margin stability. We assess that about one-third of the market weight of the TSX today is part of this oligopolistic theme, with sectors including banks, telecom, and railway companies (see Chart 5).

Chart 5: S&P/TSX Exposure to Oligopoly Markets



Source: S&P Global, CC&L Investment Management

Canada's bond market, along with most others globally, experienced a particularly difficult negative return year to date. This was partially attributable to the Bank of Canada, which responded more quickly and aggressively than other central banks in enacting tighter monetary policy. We have moved faster to a neutral and now restrictive stance, and rate hikes are drawing to a close, as we saw with the latest statement accompanying the 50 basis point (bps) rate hike in December. With yields at about 4% for the benchmark index, bond markets are entering a more balanced period.

CAPITAL MARKETS

The market rally extended into November and gains across asset classes were broad and steady. Moderating inflation metrics continue to raise hopes that central banks will end their rate-hiking cycles. Federal Reserve Chair Jerome Powell's speech at the end of November– affirming that the December FOMC (Federal Open Market Committee) meeting may be "the time for moderating the pace of rate increases"– bolstered this sentiment. Yields have declined materially, with shorter-term rates in the U.S. down 47 bps while 10-year interest rates have fallen by an even larger 56 bps from their peak in mid-October. Canadian rates saw marginally smaller declines, but the yield curve inversion is now pushing -100 bps between the 2-year and 10-year terms, sending a strong signal for weak economic conditions ahead. Credit spreads continue to hold in well, and in all, the FTSE Universe Bond Index gained 2.81% in the month.

Equities have surged. After a 5.2% gain in November, the S&P 500 has now rallied by about 14% off its mid-October lows, a sharp reversal of the negative tone throughout this year. In addition to the potential for a slower pace of Fed hikes, there were initial signs of China's economy starting to normalize (before COVID cases climbed again). The Government announcements on the intention to vaccinate the elderly helped Asian equities surge (the Hang Seng for instance surged 26.8% in November). Global equities similarly rallied, with the MSCI ACWI up 6.3%. Even with best the two-month rally since March 2020, equities remain in negative territory year to date.

PORTFOLIO STRATEGY

Canada's positive outlook over the medium- and longer terms remains in our opinion, worthy of consideration in global portfolios. However, in the near-term, we are positioned in anticipation of a slowdown that will not only be in line with the global economy, but in fact, perhaps come earlier than other countries. Our balanced portfolios maintain an underweight to equities overall and within that a larger underweight in global stocks against Canadian equities. As we have discussed at length in past issues of Outlook, sentiment surrounding corporate earnings remains too bullish and has not begun to reflect the coming economic slowdown. The underweight to bonds that has persisted for the past year was reduced earlier this quarter and we maintain that position with an eye to the stronger yield that bonds now bring. Within Canadian fixed income portfolios, we maintain an underweight position in provincial and corporate credit. Fundamental equity portfolios remain defensively positioned and are overweight the utilities, healthcare, and consumer staples sectors. Further out, we are more bullish on Canada's prospects and will look for opportunities to rotate back to Canadian equities and increase risk in the new year. We will explore this in our Forecast 2023 publication.

In the meantime, from everyone at CC&L, we wish you and yours a happy holiday season!