CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

FORECAST

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This year's *Forecast* looks at the secular themes that underpin our outlook, and considers the shorter-term cyclical factors influencing the outlook for the economy, inflation, and monetary policy. We examine market valuations and taking into account all these factors, we set the framework for our portfolio strategy. Throughout the next year, updates to our *Forecast* will be highlighted in our monthly newsletter, *Outlook*.

INTRODUCTION

The COVID-19 pandemic is largely in the rearview mirror. The last major country to accept “living with the virus,” China, is now dropping its longstanding zero COVID policy. The Russia-Ukraine war displaced health as the primary concern over the year. War-induced increases in in food and energy prices added to supply/demand imbalances that were already driving inflation higher globally.

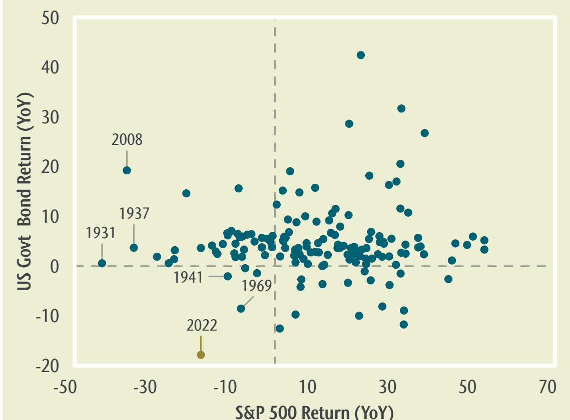
For financial markets, high inflation triggered a forceful response from central banks that pushed interest rates up and led to asset class revaluations. 2022 will be remembered as the first year that both US stocks and bonds declined more than 10% in the same year. The year also saw an end or reversal to many longstanding trends in markets:

- Multi-decade long secular stagnation characterized by low growth and benign inflation came to an end
- Flexible average inflation targeting, introduced in August 2020, ended before it could even get going
- The confident extrapolation of cheap borrowing costs far into the future is behind us
- Negative yielding bonds vanished after hitting a peak globally of US$18 trillion in mid-2020
- Liquidity excesses achieved through quantitative easing are now in full reversal globally
- The extended bull market propelled by growth stocks and high valuations ended
- The negative correlation between stocks and bonds broke down

What are we to make of this as we look forward to the coming years? The answer depends on the path of inflation from here. Fifty years of history tells us that when a country has dealt with inflation rates of 8% or more, the shock takes more than two years to settle to a moderate rate (below 3%). The expectation of a return to target inflation in the next 12 months is therefore optimistic.

Typically, a recession and higher unemployment are needed to rein in demand. With central banks resolutely focused on inflation, a recession is likely. But beyond this next downturn, we remain apprehensive about the long-term prospects of returning to the 2% inflation targeted by central banks. For four years, our secular themes have projected that we will not return to a secular stagnation world and that higher inflation will take root. If anything, the events of the last few years have accelerated these secular trends. We will discuss these trends and assess the shorter-term cyclical themes including the inflation outlook and the monetary policy response, highlighting risks to our view. Finally, we will outline our thinking on market valuations after a tumultuous 2022 and discuss broad portfolio strategy.

CHART 1: 2022 WAS AN OUTLIER FOR STOCKS AND BOND RETURNS



Source: S&P Global, U.S. Department of Treasury, Macrobond

THE SECULAR ENVIRONMENT

The Great Moderation was the period experienced since the mid-1980s. It was characterized by increased stability in economic data, low inflation, and modest economic growth. During this period, geopolitical risks were low, companies benefited from lower-cost alternatives through globalization and employed increasingly complex supply chains. COVID highlighted the fragility of the existing system in times of stress. Some of the secular forces that we first identified four years ago were inflationary in nature – reversal of globalization, aging demographics, actions to reverse climate change and the growing importance of fiscal policy. These have been strongly reinforced by the events over the past three years. Our secular themes each lead to a shift away from a broad disinflation environment to one where inflation – not a temporary cyclical response to the supply-demand imbalance but sustained upside pressure – complicates the work of policymakers.

1. Security matters in geopolitical climate

- After several years of instability from trade wars, health challenges, politics, war, staffing problems and broken supply chains, the security of business relationships will now take priority as global relationships realign. Globalization reached an apex in the 1990s with free trade agreements (WTO, NAFTA, Maastricht Treaty), but is now in reversal with little prospect of being stabilized. An extended period of relative global calm allowed businesses to move toward increasingly efficient supply chains focused on lowest costs globally. Both consumers and governments are now demanding more nationalist policies related to goods production and companies are now putting value on increased resiliency in a more uncertain geopolitical world and will pay higher costs to achieve that.
- The China – US realignment is the most critical of these relationships by virtue of their size as the world's two largest economies. In 2000, China's joining the WTO was a driver of global disinflation for 20 years. China supplied the US with cheap manufactured goods and labour, flattening the global Phillips Curve. In recent years, even prior to the Trump administration's trade wars, global trade was already slowing, as the ratio of US to Chinese wages fell from 34x to just 5x in those 20 years, leading to dwindling mutual gains. Thus, even though US goods imports surged 38% since COVID, the result of the boom in purchased goods, the proportion of those goods imported from China has fallen. The China-US relationship has now morphed into competition – for technology, financial services, commodities and geopolitical dominance. Just as globalization helped provide access to a global workforce, aid disinflation in goods prices, reduce inventory investment and business cycle volatility, the reversal of globalization implies the opposite of these effects.

CHART 2: SHARE OF IMPORTS FROM CHINA HAS DECLINED

Source: BEA, Macrobond

- Russia has supplied western Europe with natural gas, oil, and coal supporting Europe's manufacturing industry. However, most alternatives to Russian energy are costlier and the current economic sanctions placed on Russia are unlikely to disappear immediately, even if the war was to end. The war has also catalyzed countries into restarting defense spending. Trade and finance are being shaped by tactics in geopolitics as well, with countries freezing FX reserves of other central banks, restricting access to payment systems, asset expropriation, self-sanctioning by many companies, and restricting commodity exports. Taken altogether, a focus on security, resilience, and relationships leads to higher costs.

2. Beneficial but costly capital investment cycle

- The direct outcome of the security concerns is that a demand-driven capital expenditure cycle may be upon us. Part of the demand will be securing reliable and nearby supply chains, the importance of which the pandemic starkly demonstrated first through vaccines and medical supplies, and later general goods and services. This should pull manufacturing away from the lowest-cost mentality. With investments in machinery, technology, and innovation, the hope is this will pay dividends through a productivity surge.

- A second driver is the rethinking of energy sources. Europe must replace Russia with another source for energy, but all countries are looking for ways to pivot away from carbon-based fuels to address climate change. Renewable energy is more costly and generally less reliable overall (it is not always sunny or windy when needed), while nuclear power requires large investments. However, the International Energy Agency (IEA) notes the current energy crisis could act as "an accelerant" to clean energy transition in its 2022 report. Global energy investment is expected to reach US$2.4 trillion this year, an increase of 8%, of which three-quarters is directed to clean energy. Among the many commitments globally, the US delivered a US$370 billion climate and energy security package through the Inflation Reduction Act in August 2022 to make public money available for research and investments in renewable energy. The European Commissions' REPowerEU plan is investing €210 billion into renewables and fuel switching. More broadly, public sector infrastructure investment will also grow, with the path already underway in the US following the US$1.2 trillion *Infrastructure Investment and Jobs Act* passed in late 2021.

CHART 3: CLEAN ENERGY INVESTMENT TO RISE MEANINGFULLY

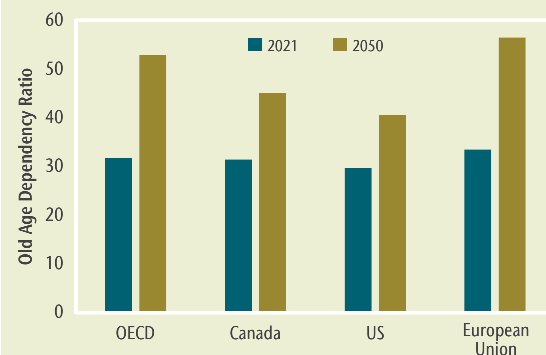
Source: IEA

3. World labour supply will diminish

- The world's population hit 8 billion on November 15, 2022 according to the UN. The world's population took 70 years to grow from 2.5 billion to 8 billion, and in the next 70 years, is still projected to grow but at a much slower pace, reaching about 10 billion. This matters because growth in the share of the working-age population, defined as 18 to 65 years old, contributes to economic expansion. However, in most advanced economy countries this is no longer going to occur. Indeed, the dependency ratio, the share of the population over 65 years of age relative to the working-age population, is projected to rise starkly, from 10% in 2022 to 16% in 2050.

- Population projections are well understood, but even within the labour force, trends are indicating a slower pace of participation. In the US, the proportion of working age Americans in the labour force declined sharply from 67.3% in 2000 to 62.1% at the end of 2022. About half the decline was due to the retirement of the baby boomer generation and this should continue to be an important force until 2030. Canada's participation rate of 65% remains near its longer-term average, even with the same baby boomer influence. The country has made aggressive changes to its international immigration policy to shore up the demographic profile of the country, which does augur well over the medium term. We have seen consequences of demographics on the workforce through the pandemic. Workers retired early or dropped out of the workforce to either take care of their own health or a loved one. As the size of the global labour force shrinks, this naturally raises the bargaining power of labour for the first time in decades. These trends should bias wages higher.

CHART 4: DEPENDENCY RATIOS TO WORSEN IN DEVELOPED REGIONS



Note: Old age dependency ratio is the population over the age of 65, relative to the population aged 15 - 64. 2050 projections represent the UN's medium population scenario.

Source: UN, www.ourworldindata.org

4. Importance of fiscal policy will grow, but needs to be managed carefully

- Prior to the pandemic, monetary policy was constrained by the zero-interest rate bound and central banks were already purchasing bonds at a large scale. At the time, monetary policy was reaching the limits of efficacy and the job of managing business cycles, we believed, would be handed off to fiscal policy. The pandemic turbocharged that, with massive government intervention in the form of social support programs that led to ballooning deficits. Monetary policy played a critical but secondary role, buying the

bonds being issued to fund government spending. Yet even when faced with high inflation into 2022, governments were enacting wide-ranging spending programs, sending cheques to help families cope with high inflation, forgiving student loans, creating national dental care programs, and providing direct support for renters. Thus, while in the big picture, fiscal deficits improved markedly from the worst projections coming out of the pandemic, government deficits continue to be larger than pre-pandemic levels underscoring their impact in this very late-cycle environment.

- It is always easier to enact stimulative fiscal policy with virtually no end to the demands on government. But to finance this properly and organically, it helps to have the combination of strong economic growth and low interest rates which we benefited from in the 2020-21 period. Indeed, if debt levels are shocked suddenly higher – as they were during the pandemic – high inflation also reduces the real value of outstanding debt. As we barrel towards a period of below trend economic activity and slowing but not low inflation, it's worth recalling two notable events of 2022 that raise warning flags on unfettered fiscal spending. First, the release of the UK budget showing significant spending plans caused a historic surge in gilt yields that nearly caused a collapse in the UK pension funds. This reminds us that in an era of quantitative easing, governments can run large deficits if the central bank is a major purchaser of those government bonds. As liquidity is withdrawn from the system, governments must check those impulses and place constraints around borrowing. Second, the Bank of Japan doubled the allowable trading range of 10-year Japanese Government bond yields to 0.5 percentage points on either side of the 0% target, widening the effective cap on yields. Being the last major central bank to budge on higher interest rates, this was perhaps the death knell for zero-interest policy and a sign of structurally higher yields globally. Taken together, fiscal policy will remain a potent force, however unchecked spending coupled with higher servicing costs of debt are unlikely to be tolerated by market participants.

THE CYCLICAL ENVIRONMENT

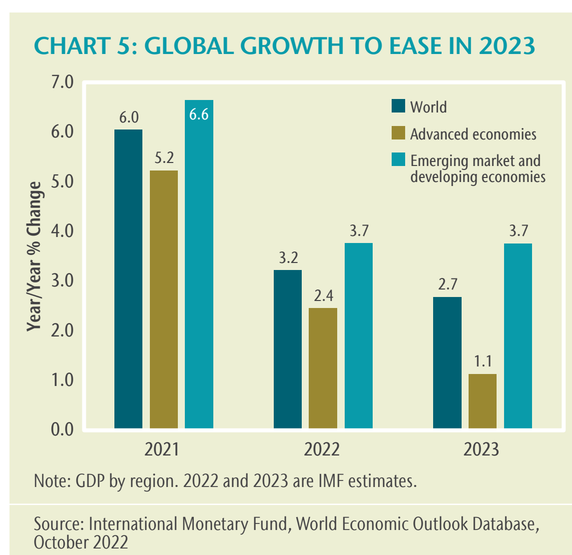
World: Short cycle, short recession

- The head of the IMF believes that one third of the global economy will be in recession in 2023. The US, EU and China are all slowing at the same time. World economic growth is expected to decelerate from 3.2% in 2022 to 2.7% in 2023. If that comes to pass, the current cycle will register as one of the shortest on record, marking a return to a sort of boom-to-bust cycle that was more common during the 1980s and 1990s. Aggressive monetary tightening to combat inflation is expected to induce the third worst year for global growth this century, behind the pandemic in 2020 and the aftermath of the Global Financial Crisis (GFC) in 2008.

- However, just as the 2020 recession was, unusually, driven by extraordinary measures to close down an economy otherwise humming along, the 2023 recession will, unusually, be characterized by still-large caches of savings and vibrant labour markets. Indeed, savings, wages, employment, overall asset prices (housing and equity prices as compared to the 2019 levels) and commodity prices all augur for a mild recession. The typical markers of a serious downturn – corporate and household bankruptcies, unintended inventories, saturated demand – are not present.

- The recession of 2023 could also be the first since 1980 that is absent some major financial shock, and turn out to be a true policy-induced, plain vanilla recession (though this remains to be seen). Encouragingly, no major government has actively refuted central bankers' efforts to reduce inflation because inflation is highly unpopular. It is not hard to see why – inflation destroys nominal wage gains and asset valuations, hurting the full spectrum of households. Thus, we are willing to accept short- term pain to get inflation back to target.

CHART 5: GLOBAL GROWTH TO EASE IN 2023



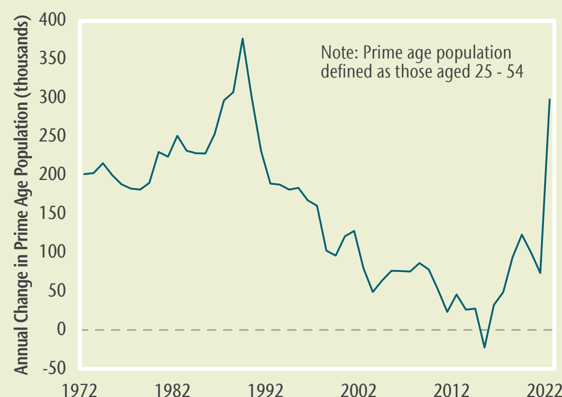
Note: GDP by region. 2022 and 2023 are IMF estimates.

Source: International Monetary Fund, World Economic Outlook Database, October 2022

Canada: Recession, then a Dawn

- Having been one of the first central banks to recognize the need to reduce policy stimulus, the Bank of Canada ended asset purchases in late 2021, started reducing its balance sheet in 2022 and raised rates earlier than its peers. Under the weight of higher interest rates, highly indebted households will slow spending to manage higher debt service costs. Consumer spending is expected to contract, but strong labour markets, nominal incomes lifted by higher wages, and high savings will moderate what otherwise might have been a precipitous decline. Personal saving rates were 5.7% of personal disposable income in the third quarter of 2022, well above the 2015-19 average of 2.3% and continue to add to the excess savings cache built up during the pandemic. Federal and provincial governments alike have been sending income support, particularly to lower-income Canadians, extending pandemic relief to inflation relief.

CHART 6: CANADA PRIME AGE POPULATION HAS SURGED



Source: Statistics Canada

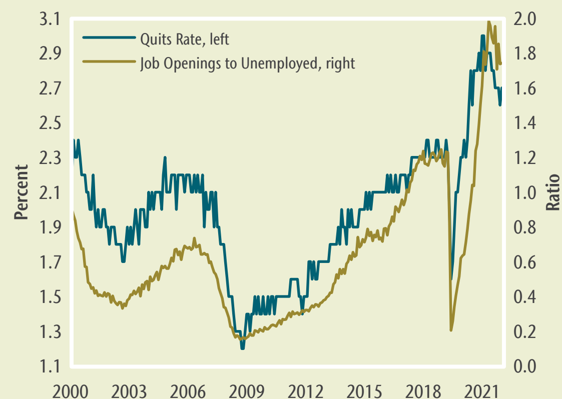
- Housing markets will continue to deteriorate with posted five-year mortgage rates having surged from 3.2% in late 2021 to 5.9% in 2022. House prices have already declined but are holding in near 2019 levels and could see some support from high immigration levels that should help keep demand for homes strong amid dwindling supply. While the global recession reduces demand for Canada's exports, strong commodity prices will support national income, through higher terms of trade. Business capex will stall, but in line with our secular outlook, look brighter in the next cycle.

- Canada's economy outperformed expectations in 2022, leading to a positive handoff to 2023. But under the hood, domestic demand is contracting due to both consumption and investment declines. The full force of higher mortgage and consumer borrowing rates is likely non-linear and households could retrench more dramatically. The risks to the outlook are to the downside. Beyond that, a number of factors, notably Canada's export breakdown, trading partnerships and most notably perhaps demographics, all suggest Canada could well shine in the next cycle (see December *Outlook*).

US: An irrepressible consumer

- The US represents one of the more important unknowns in the global economy, because it is still somewhat unclear how far the US Federal Reserve (Fed) must tighten before inflation can be controlled. Growth does not have much room to slow from a moribund pace of about 0.2% in 2022 and strictly by the numbers will be posting back-to-back weak years of growth. Much of last year's slowdown was due to weak international trade, while domestic demand was decently strong. Consumer spending is helped by having reduced debt and lowered servicing costs relative to pre-GFC levels, even with the recent rise in interest rates, while having grown excess savings. While spending on services has held up, rate sensitive parts of consumer spending did contract. The volume of home resales has dropped one-third from its highs, due in part to the structure of the mortgage market where low interest rates have been locked-in for the long-term, and any move results in having a new mortgage taken out at current rates of over 7%.

CHART 7: METRICS SHOW TIGHT US LABOUR MARKET



Source: BLS, Macrobond

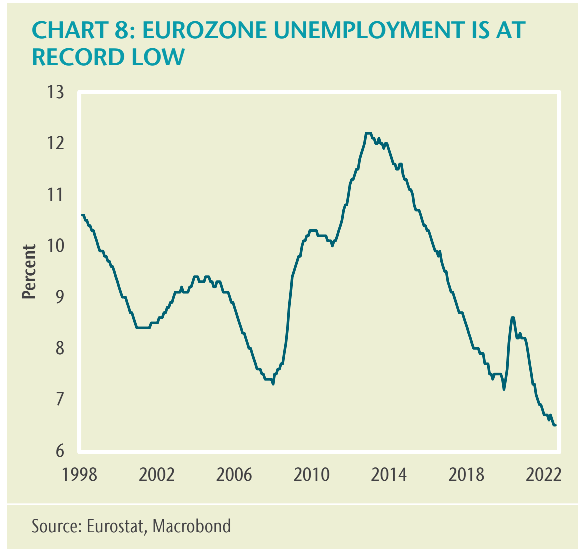
- A key question is whether the magnitude of the slowdown in the US will be enough to bring inflation back under control. Given inflation today is largely driven by the price of services, excluding shelter costs, and critically, given how important wages factor into this, this cycle depends greatly on how much labour markets will need to weaken to bring wages in line with inflation targets.

Historical experience suggests this requires at least a 1 percentage point increase in the unemployment rate which has always implied a recession. While absolute job growth and hours worked have so far held stable, the gap between job openings and available workers has been historically large, reaching nearly 6 million, about 4x the level from before the pandemic; quit rates remain elevated as the market for workers is competitive. Given the unusual strength in labour demand this cycle, the Fed appears to still have considerable work to do and will prioritize labour market data to determine when it will be able to pause its hiking cycle. The risks to the downside will grow with the current strength of the labour market.

Europe: Stagflation while retooling energy supply

- The Euro area will be the one region likely to experience stagflation. Growth will slow from a better-than-expected 2022, which was buoyed by fiscal support and a buildup of gas storage. Governments offered some cushion to the high energy prices through a combination of tax cuts, energy subsidies and income support measures before finally moving to direct price caps. There will still be some fiscal supports going forward, but it will be constrained, with public deficits in France, Italy and Spain already in excess of 4% of GDP. Leading indicators and consumer and business confidence show the eurozone economy is contracting. Further down the road, any recovery will likely be a weak one. The decline in energy supply has slowed industrial production and high energy prices have squeezed real household income. Labour markets, however, are a positive, holding generally tight; the unemployment rate is at a record low of 6.6%.

CHART 8: EUROZONE UNEMPLOYMENT IS AT RECORD LOW



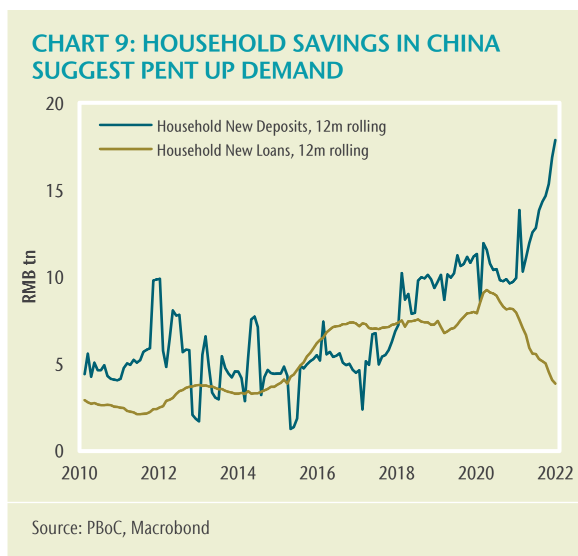
Source: Eurostat, Macrobond

- Inflation was already higher in the eurozone than nearly all developed market economies around the world. Headline inflation peaked at 11%, and the largest countries within the eurozone continued to post double-digit inflation rates into the fourth quarter of last year. In contrast to the breadth of CPI that is being experienced in other countries, the surge in food and energy prices were the main drivers of the headline CPI, accounting for almost 70% of the increase. Both moderated towards the very end of 2022, but could still see upside surprises due to supply shocks, while a weak euro implies higher imported prices. Even with a meaningful economic slowdown, headline and core inflation are likely to remain in the upper single-digits, well above the ECB's comfort zone. Inflation expectations risk becoming unanchored, causing broad upside wage pressures. The outlook remains fragile in the region.

China: Challenges will take time to address fully

- For the first time in 40 years, China may post growth in 2022 that lags the world, as activity is hampered by the outcome of a tumultuous two years. In 2021, the government instituted decisive structural policy changes in China's tech sector, for-profit education and excess debt in shadow banking. This was followed by an extended COVID-lockdown and real estate correction. By mid-November 2022, China ended its zero-COVID policy, and is transitioning to an endemic state. As with other reopenings, this will likely be a difficult process worsened by limited hospital capacity, and lower vaccination rates of its elderly population. Nonetheless activity in China should rebound in 2023, but likely not until at least the second quarter as the reopening will lead first to a rise in hospitalizations and cautious mobility before full normalization. While consumers did not get the same fiscal support as in other countries, limiting "revenge shopping and travel," they have been raising precautionary savings which should allow for a rebound in retail sales.

CHART 9: HOUSEHOLD SAVINGS IN CHINA SUGGEST PENT UP DEMAND



Source: PBoC, Macrobond

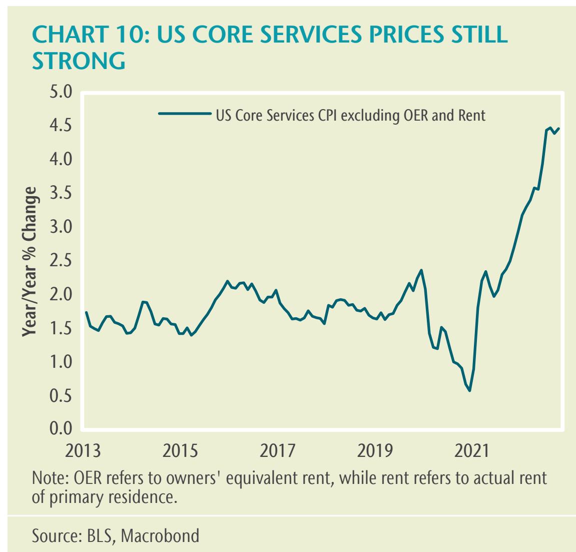
- The second challenge for China is the liquidity crunch facing private property developers that has been exacerbated by a sharp drop in new home sales, typically used to finance future projects. Sentiment among homebuyers is low. Deleveraging in the property sector will be a multi-year process, which will eventually reduce longer-term financial instability but requires a painful adjustment.

- Longer term, the new strategic relationship between the US and China, including limiting trade and semiconductor controls, will reshape exports (lower) and domestic business investment (higher). The weakest growth in 40 years is the near-term economic cost to the longer-term global repositioning. Policy may ease, but moderately and in a targeted way. China will no longer provide the countercyclical expansion for the world economy.

INFLATION

- After 40 years of decelerating inflation, including fears of outright deflation in recent years, 2021 showed that inflation can be generated with enough fiscal stimulus and money supply growth. In 2022, we learned inflation can be longer lasting once expectations become unanchored – as some consumer and business surveys demonstrated. As we enter 2023, inflation has peaked broadly around the world and will continue to decline in coming months.
- In our forecast horizon, headline CPI inflation in the US and Canada falls to below 4%. Much of the easy work will be done by goods prices (already falling 0.4% m/m in the latest US release), after the inflationary effects of clogged supply chains reverse. Shelter costs, while lagging the actual market movements in house prices and rent, will flow through to CPI over the course of about a year and as a result will also help ease headline inflation. However, Fed Chair Jerome Powell has highlighted that the most critical category in the inflation outlook will be core services prices excluding housing costs. This accounts for more than half of the core PCE price index. Critically, this category is driven by wages, which constitutes the largest cost in delivering these services. Wages are still elevated, and show little sign of easing.
- Overall core prices will be slow to ease, particularly in the US where the trimmed mean and median core gauges of CPI have only eased back to between 6% and 7.5% in the last three months. In contrast, Canada's trimmed mean and median core inflation are now growing between 2.9% and 3.2% on a three-month annualized basis, a testament to the sensitivity of the economy to high interest rates. Euro area inflation has been among the highest in the world, 10.1% y/y in November, where in addition to the positive demand shock the rest of the world has seen, it copes with a negative supply shock as well.

CHART 10: US CORE SERVICES PRICES STILL STRONG



Note: OER refers to owners' equivalent rent, while rent refers to actual rent of primary residence.

Source: BLS, Macrobond

- Normalization after high inflation usually takes years, not months. Consumer balance sheets and labour markets are generally healthy. All in all, inflation risks are skewed to the upside and the inflation fight will take some time yet. We see both the Bank of Canada (BoC) and the Fed continuing to hike until their target policy rates reach 4.5% and 5% respectively, and will then keep them at these levels for much of the rest of the year.

RISKS TO OUR OUTLOOK

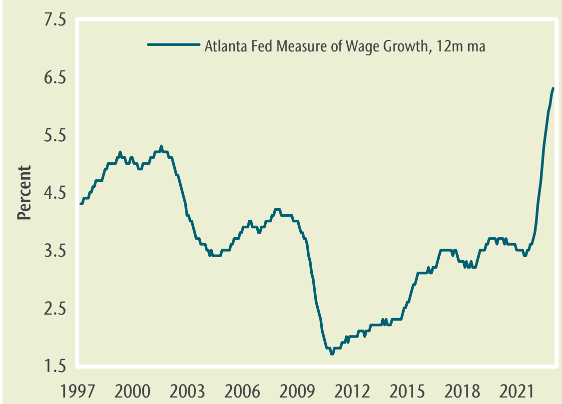
1. Inflation is sticky / labour markets stay strong

- Persistent inflation is a material risk to our outlook. As noted above, Chair Powell has called focus to core services prices excluding shelter costs, implying the path of wage growth remains critical. The San Francisco Fed estimates the natural rate of unemployment could be about 6%, considerably above the 3.5% registered today. Combined with other metrics like quit rates, unemployment insurance claims and the ratio of job openings to available workers, it is clear current labour markets are extraordinarily tight. This presents a notable challenge to central banks that may have to persist longer than they would otherwise want in a tightening stance. This, in turn, requires a sharper global economic slowdown with more countries pulled into a deeper recession.
- The persistence of war and geopolitical tensions could catalyze a rebound in commodity prices. China could also see a more rapid than expected reopening, leading to a powerful rebound in consumer activity. Globally, inflation expectations could remain elevated, posing an upside risk to actual inflation.

2. Disinflationary pressures faster to emerge without recession

- High interest rates impact countries differently depending not only on absolute debt levels, but also the structure, term and distribution of debt. The range of mortgage types, for example, extends from largely variable rates in Australia, the UK and Spain to majority 30-year fixed rates in the US. While Canadian mortgages are typically a fixed five-year term, the period of record low rates more recently that prompted rapid appreciation in housing markets saw an unusually high proportion of new mortgages (just over half) use a variable rate. No doubt, Canada stands out in terms of debt relative to incomes and overall debt servicing costs, but the worst of the impacts from higher rates has been buffered by prior prudent mortgage lending rules and an overall cautious consumer sector. Nonetheless, risks to the consumer from high interest rates are particularly elevated, especially if unemployment jumps. While we believe the risk of a housing crisis resulting in forced liquidations is low, this scenario would result in a deeper downturn in Canada and a faster pace of disinflation.
- We highlighted in last year's Forecast that inventory overbuilding is a risk coming out of businesses that faced limited supply, engaged in fierce competition for scarce resources (including labour) and are in the process of building cushions within their businesses. There was some evidence of this inventory rebuilding towards the tail end of last year, with supply chains easing materially and measures of inventory levels rising in both Canada and the US. Together, these prompted discounting into the holiday season. Looking forward, consumer spending is likely to dwindle in response to higher interest rates, which in turn places continued downward pressure on retail prices.
- While a boom in capital expenditures would be short-term inflationary via the competition for resources, in the longer-term this is a potential force for disinflation. Technological innovation could be a positive outcome of the capex cycle and could help mitigate future inflationary pressures that come from labour shortages or supply bottlenecks. Associated productivity gains will help improve potential output allowing economies to grow faster without generating inflation. This is a medium-term risk.

CHART 11: WAGE GROWTH SHOWS LITTLE SIGN OF EASING YET



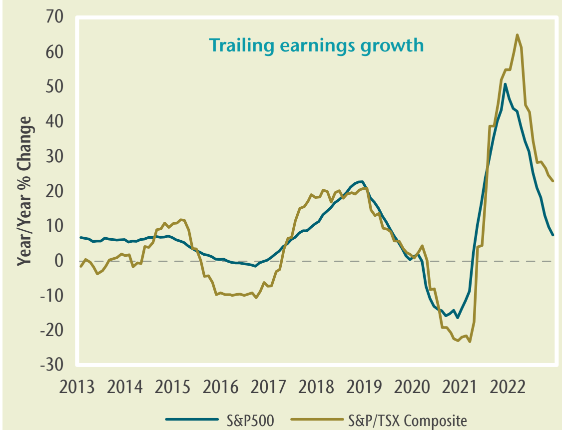
Source: Federal Reserve Bank of Atlanta, Macrobond

VALUATION

VALUATIONS: Negative earnings growth in 2023

- Corporate profits continued to grow in 2022, but the pace of growth decelerated throughout the year alongside slowing economic momentum and a rising probability of recession. Resilient labour markets and consumers with improved balance sheets kept demand strong even as businesses raised prices to offset higher costs.
- Looking ahead to 2023, corporate earnings growth is expected to deteriorate further and actually contract, consistent with a recession and therefore worsening top-line sales. However, given we do not expect a deep, extended recession, the contraction in earnings is likely to be fairly moderate, with an improvement in the latter part of the year as inflation pressures ultimately ease. The net result will be negative profit growth for 2023.

CHART 12: EARNINGS GROWTH TO CONTRACT



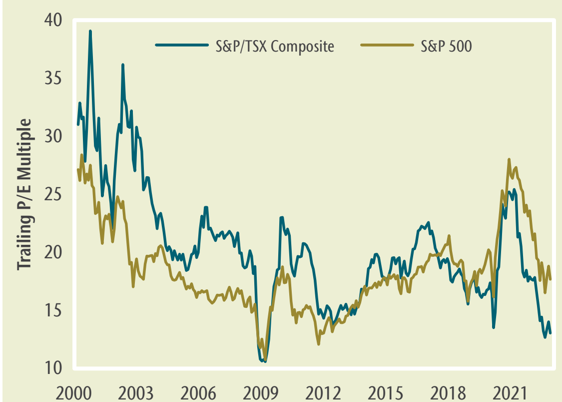
Source: I/B/E/S, TD Securities, Macrobond

- Profit margins peaked in early 2022 and we expect margin contraction in 2023 particularly in the first half of the year. Margins will be negatively impacted by negative operating leverage. As inflation decelerates and demand slows, companies cannot lower costs as quickly as they are forced to lower prices. While this will continue to weigh on margins, there will be some offsets as labour markets loosen, and supply chains slowly improve.
- In the US, we expect annual earnings per share (EPS) to post -6% contraction for the S&P 500 in 2023. Canada is less exposed to volatility in technology earnings. However, demand for oil is likely to wane with deteriorating economic activity and given the significance of oil prices on the S&P/TSX Composite (TSX), we expect a contraction in EPS of -6%. Our forecasts for the US, at $205 per share for 2023, and for Canada, at $1,400 per share in 2023, are slightly behind the consensus forecasts of US$230 and CA$1,595, respectively.

VALUATIONS: Multiples to face pressure

- Valuation multiples contracted significantly in 2022 driven by tightening financial conditions (rising interest rates), high inflation, slowing economic growth, and geopolitical shocks. We believe the equity risk premium remains too low given the economic uncertainty. As a result, price-to-earnings ratios (P/Es) are likely to face pressure in 2023, particularly in the US, where the P/E remains higher than its historical average. However, the main drivers weighing on multiples in 2022 should begin to reverse in the latter part of 2023 (inflation decelerates and monetary policymakers dial down aggressive rhetoric), which should provide some stability for P/Es. Canada has experienced a more significant multiple contraction in 2022 relative to the US, and we expect more pronounced normalization later in the year, leading multiples to expand, though end the year below the long term average. Outside of Canada, our expectation is that P/Es will be unchanged to slightly lower at year-end, although the path will not be a straight line.

CHART 13: MULTIPLES LIKELY TO FACE PRESSURE



Source: I/B/E/S, Connor Clark & Lunn Investment Management

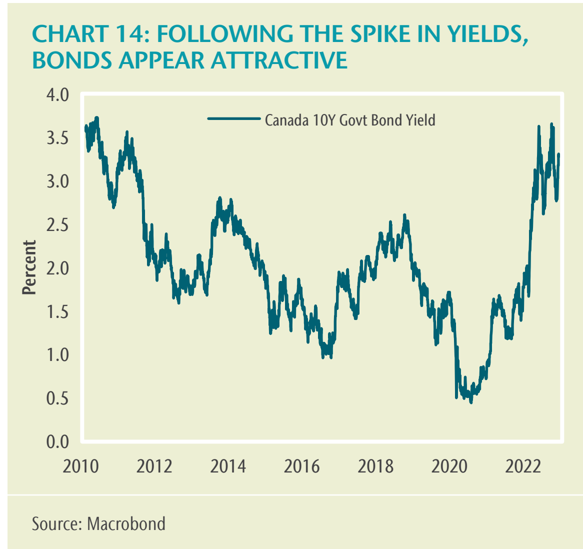
- Our year-end index estimate for the S&P 500 is 4150, which is based on improved earnings expectations in 2024 following a difficult 2023, and a relatively unchanged forward P/E multiple compared to the current level. For the S&P/TSX, we expect a higher P/E multiple from 2022 year-end levels, resulting in a year-end index level of approximately 21,850. Our price targets imply a positive return in the US and in Canada from year-end levels, with Canada outperforming.

- Global equity market valuations have contracted. Europe, Australasia and Far East (EAFE) and emerging markets P/E multiples are now below historical averages. The energy supply issue in Europe fueling ever higher inflation has prompted the European Central Bank to proceed with interest rate increases and restrictive policy. Emerging markets have been weighed down by China's stringent zero-COVID policy. A reopening could provide a boost to its economy. Additionally, Chinese policymakers have announced targeted stimulus measures. With a backdrop of a peaking US dollar and the positive impact of China reopening, we have a positive outlook for emerging markets in the second half of 2023.

VALUATIONS: Bonds are more fairly valued

- Since the GFC, ultra-accommodative monetary policy suppressed yields, causing bonds to be expensive for more than a decade. This ended in 2022. Excessive monetary and fiscal stimulus in response to the COVID-19 pandemic in 2020 combined to fuel the highest inflation rates in decades. This eventually drove monetary policymakers to tighten policy aggressively (in both pace and magnitude) through 2022, causing a significant shift higher in bond yields. The move was so dramatic that by the start of 2023, the total amount of outstanding negative-yielding debt— which peaked at US$18.4 trillion in 2020— had been eliminated. Relative to the low yields that characterized the post-GFC backdrop, bonds now offer a positive real return (as inflation recedes) on a safe investment that competes with riskier assets. In short, bonds are no longer expensive relative to the last 10 years. Upwards momentum in bond yields is likely to persist until policymakers determine their terminal rates. However, the mild recession we expect in 2023 should provide offsetting downward pressure on bond yields, particularly at the shorter end of the curve.

CHART 14: FOLLOWING THE SPIKE IN YIELDS, BONDS APPEAR ATTRACTIVE



Source: Macrobond

- The Canadian 10-year bond yield rose 1.85% in 2022 to close the year at 3.33%. While we believe secular forces are likely to keep bond yields structurally higher relative to recent history, an economic downturn and deceleration in inflation in 2023 suggests some downward pressure from current levels over the next 12 months. Higher interest rate structures overall may trigger inflows as investors seek safe and attractive income streams. There are technical factors to consider as well that run counter to lower rates. Central banks have now transitioned to quantitative tightening (QT), a contractionary policy that reduces the assets on a central bank's balance sheet (in this case by allowing bonds to mature, rather than actively selling them). QT has removed a large buyer of bonds from the market, thereby reducing demand for bonds. This will continue into 2023.
- The FTSE Canada Universe Bond Index declined 11.69% in 2022, posting the worst annual loss since 1980, and the first time the Index has ever delivered negative returns for two consecutive years. Following a very difficult year, we have an improved outlook for bonds in 2023. Our expectation for some downward pressure in government bond yields, offset by a widening in corporate spreads as a recession triggers a default cycle, suggests slightly lower yields for 2023. We expect the FTSE Canada Universe Bond Index will return +2 to +5% in 2023.

PORTFOLIO STRATEGY AND STRUCTURE

Many of the drivers that led to negative returns across stocks and bonds in 2022, including high inflation, tight financial conditions, and slowing economic activity, remain in place at the start of 2023. The macro backdrop calls for further economic slowing, alongside additional rate hikes and continued withdrawal of liquidity. However, with inflation showing signs of peaking, and the Fed and BoC in the later stages of their rate hiking cycles, we do not expect a repeat of the dismal returns from last year. Equity and bond markets alike were rattled in 2022 in response to the historic interest rate shock from aggressive monetary policy. While central banks may raise interest rates further, the magnitude and urgency will not be nearly as extreme.

However, one market driver that is expected to worsen through the year is economic activity, as we expect a recession to take hold mid-2023. In a mild recession scenario (our base case), we would expect a downturn to be shorter than recent contractions, as healthy consumer balance sheets and strong job markets provide a cushion. However, we expect equity markets to face downward pressure, largely in the first half of the year as most central banks will maintain their restrictive policies despite a slowing economy. This should be followed by a recovery later in the year as the conditions for a stabilization in the economy take hold.

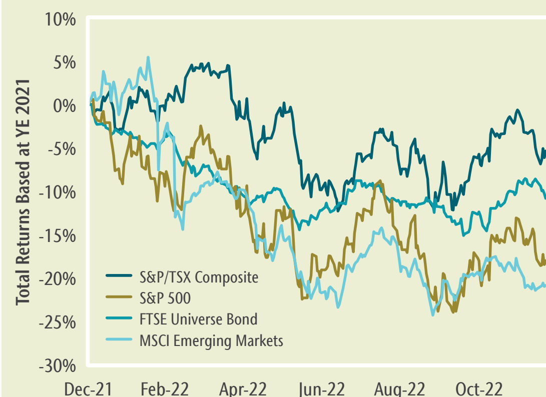
We assess that equity market valuations broadly will remain under modest downward pressure as interest rates and inflation remain elevated and that the conditions for an equity market bottom have not yet been met. Equity markets are not reflecting the decline in earnings that is typically associated with a recession. However, the latter part of the year should favour equities, as pronounced economic weakness and the resulting lower inflation should lead to some anticipation of central bank rate cuts and importantly the early stages of an economic recovery. Regionally, we expect developed and emerging markets to perform similarly heading into this recession, as China's relatively rapid reopening presents some upside risk. We would expect emerging markets to outperform during the recovery, with China's reopening adding positive momentum, as well as a US dollar that may ease somewhat as the Fed slows rate hikes.

Small capitalization stocks tend to have higher earnings risk going into a recession and are more cyclical in nature relative to large cap stocks, although entering the year, they reflect more attractive valuations. Large cap stocks generally have more stable earnings profiles relative to small caps, however they are also fairly concentrated in the technology sector in the US, where the impact from high interest rates is being felt the most, and valuations are likely to derate further. As a result, small caps appear more attractive, as their valuations already reflect a higher probability of an economic recession relative to large caps.

Canadian equities should continue to benefit from the TSX's composition, with a relatively high weighting to energy and materials stocks that perform well in inflationary environments (although to a lesser extent compared to 2022) as well as less exposure to the tech sector, compared to the US. Additionally, Canada began its rate hiking cycle earlier than its developed economy peers, and now looks to be positioned to move away from interest rate increases sooner. Although not enough to overcome a global recession, we expect these factors to lead to outperformance for the TSX relative to the S&P 500. Outside of Canada and the US, developed market equities will also be challenged in the near term as we head into recession in a number of advanced economies.

Bond market valuations appear considerably more favourable today relative to the beginning of 2022 following the spike in interest rates. Although the path to these levels of interest rates was difficult, fixed income markets now yield a return not seen since the 2000s. Further upward pressure on bond yields should be limited and yields are likely to ease in a recession. Asset mix within balanced portfolios will continue to underweight equities relative to benchmark targets and to a lesser extent this is the case for bonds as well. This will persist until the economic backdrop deteriorates and markets more fully reflect that reality.

CHART 15: HEADWINDS REMAIN FOR EQUITY MARKETS



Source: TSX, FTSE Global Debt Capital Markets Inc, S&P Global, MSCI

Asset Class Returns

- Our base case is for the 10-year Government of Canada bond yield to ease moderately over the year, although we expect a range between 2.6% to 3.5%. Secular factors and conservative central bank reactions (not wanting to ease too quickly for fear of resurgent inflation) are catalysts for higher

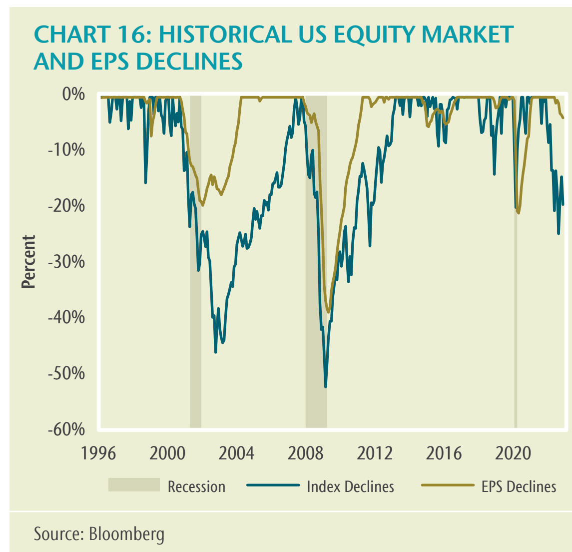
bond yields. However, we expect the cyclical factors to dominate in a slowing growth environment, causing government yields to ease, and credit spreads to widen, from current levels. As such, we expect total returns for the FTSE Canada Universe Bond Index to range between +2% and +5%, compared to the running yield of 4.25%.

- Despite the worsening economic outlook, we expect positive equity market returns for 2023, although our outlook is not optimistic in the near-term. Top line corporate revenues should decline and margins are likely to contract further. We forecast a return of 8% for the S&P 500 and a higher return of 13% for the TSX relative to year-end 2022 levels. EM equities, particularly in China, have some positive tailwinds and small cap stocks have priced in a higher probability of a recession and appear attractive from a relative value perspective.
- The asset mix in balanced portfolios currently favours cash, helped by its more attractive yield than we have seen for some time. Both equities and bonds are underweight relative to benchmark target levels (although the underweight in bonds has been reduced and is smaller than equities). Within equities, we have a preference for Canadian equities relative to global equities.

Stock and Sector Selection

- We have a cautious outlook for equity markets in the near-term, in light of our view of slowing economic growth over the coming months. The lagged response to central bank tightening, declining leading indicators combined with lower inflation all point to a worsening in top line sales. Company surveys show declining new orders and rising inventory levels. Expectations for corporate earnings are growing more pessimistic.
- Market valuations, while not overly stretched due to the contraction experienced last year, still appear to have more room to decline. This is particularly true in the US, where current P/E ratios remain above their historical averages, but also in Canada in the near-term. Combined with a contraction in earnings, the outlook for risk assets across developed markets over the first half of the year remains negative and the risk-reward on equities is skewed to the downside.
- As a result, within equity portfolios we favour companies that can deliver resilient earnings growth in a moderating inflation and low-growth environment. These companies are characterized by strong balance sheets, higher liquidity and stable earnings and margins, and are typically more defensive. As the period of adjustment persists, we are increasingly looking to add companies that are more cyclical in nature, where valuations have become favourable and in particular those companies who will benefit from a strong global capex cycle and the global recovery later in the year.

CHART 16: HISTORICAL US EQUITY MARKET AND EPS DECLINES

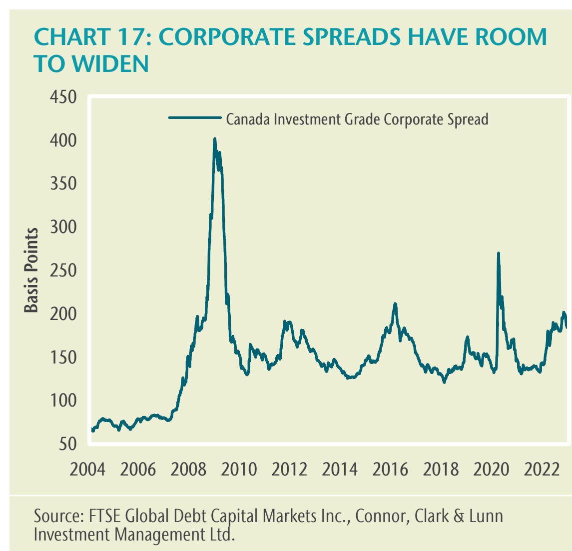


Source: Bloomberg

Corporate Credit

- It has been a difficult year for corporate credit mostly due to the large move in interest rates, though spreads have also widened. Credit spreads represent a pickup of about 180 basis points above sovereign bonds. While this is above the long-term average spread, it is still some distance below the highs experienced during the 2015 recession and tighter than experienced in a typical recession. Credit spreads overall have outperformed other risk assets, and could continue to see some further widening as corporate earnings deteriorate.
- The environment of higher policy rates, a global recession and importantly the withdrawal of liquidity is expected to weigh on corporate credit. QT policies will extend through much of the year, with many central banks in the process of reducing the size of their balance sheets. The BoC's purchases did not directly support corporate and provincial credit in a

CHART 17: CORPORATE SPREADS HAVE ROOM TO WIDEN



Source: FTSE Global Debt Capital Markets Inc., Connor, Clark & Lunn Investment Management Ltd.

material way (although its signal of standing ready to support the market was beneficial to spreads). Nonetheless, the buying of Canada bonds pushed investors up the risk curve in order to achieve even a modicum of yield. It is notable, though, that all-in yields in investment-grade bonds represent an appealing return, with valuations looking favourable. Nonetheless, an outlook for any material spread narrowing is not currently within our forecast horizon.

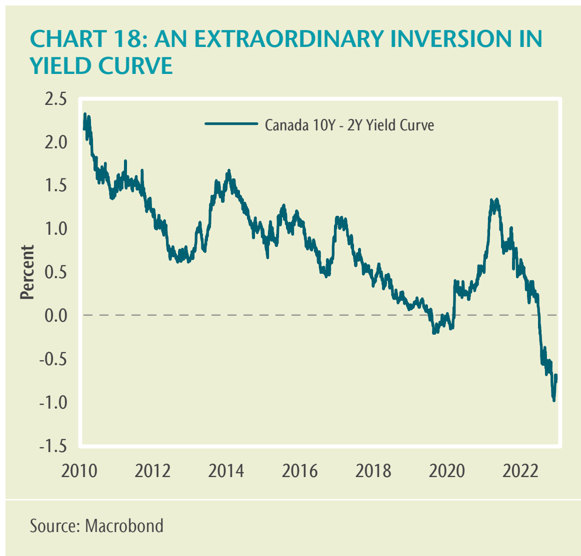
- As a result, fixed income portfolios are positioned to start the year underweight both corporate and provincial credit relative to their benchmarks. In the near-term we look for opportunities for bonds to outperform within some of the more defensive sectors. However, given the overall risk-reward prospect of a further widening of spreads offsetting additional yield, we will calibrate portfolios to take advantage of spread tightening later this year once markets more fully adjust to the recession environment.

Duration and Yield Curve

- Globally, nominal bond yields have risen aggressively, as central banks ended their ultra-accommodative policies. Looking ahead, markets have priced in further rate hikes for the Fed and BoC, with an eventual pause by Q2 of this year. By that time, it is expected that despite the lags in policy, economic growth and inflationary pressures will have slowed materially. Markets will then expect central banks to be biased towards easing policy to manage the pending slowdown. Bond yields typically peak around this time (shortly before rate hikes come to an end). However, we anticipate the path to rate cuts will be bumpier than markets currently expect, keeping volatility in rates markets high for the year.

- As a result of higher central bank policy rates pushing up short-term yields combined with the expectation of a recession pulling down long-term yields, the yield curve has inverted to its most negative point since the early 1990s (about -100 bps between Canadian two-year and 10-year yields). As the environment moves into recession, the yield curve will begin steepening again, and persist in that direction. However, the timing of recession may be later than market participants currently expect, given fourth quarter GDP in both US and Canada have been tracking much stronger than anticipated. Thus, we will look to add duration and enter into steepening yield curve positions but will be patient to assess the evolving situation.

CHART 18: AN EXTRAORDINARY INVERSION IN YIELD CURVE



Source: Macrobond

SUMMARY

Through the past year, financial markets have undergone a rapid series of changes in response to the surge in interest rates. Public market asset classes have adjusted to higher interest rates and the year saw a shift in many longstanding market trends. This is not over. The coming year is likely to see developed market economies fall into a synchronized recession. While we optimistically look at the unique aspects of this downturn to allow a mild recession, much depends on the path of inflation and there are clearly risks on both sides. Further out, secular themes support upside risks to inflation overall, and central banks will have a tougher job ahead, particularly as they fight to regain credibility. The combined slowdown in growth and inflation will present a challenge for company margins, pressuring earnings. This will be the main driver of markets over the coming year. Valuations have become more attractive but are likely to face downward pressure. While the outlook remains very tenuous, we continue to see positive prospects ahead, particularly in the ability for high quality companies with stable earnings to shine. We will adjust our thinking and our portfolio positioning through the year to capitalize on opportunities.

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