CONNOR, CLARK & LUNN
INVESTMENT MANAGEMENT

FORECAST

WHAT'S INSIDE

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

We are entering year three of the COVID-19 pandemic. While immediate thoughts on this subject fall to the dominant variant currently making its way around the world, and the potential for more variants down the road, we note that in many respects the globe is now in a better state than it was a year ago. We have a diverse set of highly effective vaccines and treatments that have limited the direct health impact of the virus in many countries, and over 9 billion doses have been administered worldwide. However, the health crisis remains far from over, particularly amongst poorer countries, but with global vaccine production forecast to double to about 22 billion doses in 2022, there is potential to make up significant ground in arresting the pandemic. Research continues on wider coverage of vaccines, combinations of COVID-19 and flu vaccines, and different vaccine delivery mechanisms. New treatments have been developed for the afflicted, both antibody and most notably antiviral drugs. The objective is for the virus to eventually move to an endemic phase.

Risk assets on average had another very strong year in 2021, benefiting from the ongoing extraordinary government and monetary policy support that has been the dominant force during the pandemic that prevented a financial crisis. The bounce in economic activity since the trough in 2020 has helped shift the driver of equity performance from valuation multiple expansion to earnings growth. Economic activity should continue to advance strongly at an above trend pace, although the short term upward pressures on input prices and labour costs will necessitate a normalization in policies. Even though we expect diminishing supply chain difficulties and an easing of prices, we are not anticipating a return to the pre-pandemic disinflationary world.

In the pages that follow, we outline our thought process, starting with four key secular themes. We then assess the shorter term cyclical trends and dominant risks to watch. Finally, we outline our market expectations after the strong performance of the past two years, and discuss our broad portfolio strategy.

THE SECULAR ENVIRONMENT

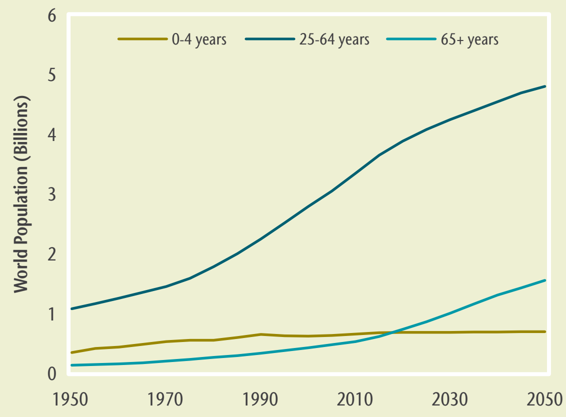
Over the past two cycles, there have been a number of dominant forces that have limited the upside to inflation. These include demographic shifts, globalization, technology, a debt supercycle, and in turn debt deleveraging. Two years ago, we introduced new secular themes that shifted our expectations away from a disinflationary environment toward one that would likely see higher inflation. These themes remain relevant today: a notable rise in populism and reversal of globalization; actions to reverse climate change; the growing importance of fiscal policy as the cycle moderating tool; and shifting demographics resulting in a smaller global workforce. All of these forces auger for a continued shift away from a disinflationary to an inflationary environment, and in turn will have implications for interest rates and corporate financial results.

1. Labour supply growth has peaked

- Demographics marked a milestone in 2018. For the first time in history, the number of people 65 years and older outnumbered the number of children under the age of 5. Individual countries have varying experiences – in the US, this happened in 1966, and in India and South Africa, it is projected to happen about ten years from now. The average world population grew 1.8% annually between 1950 and 2000. Going forward population growth is projected to slow to just 0.74% from 2020 to 2050. As a result, the world will experience a major shift that will result in a net reduction in the supply of labour.
- The old age dependency ratio, which measures those over the age of 65 as a percent of the working age population is projected to increase, and some of the biggest increases will be in the G7 economies. For instance, in the most extreme case, Japan will hit a high of almost 100% by 2050, up from 69% today. An underappreciated development last year was China's census that revealed a faster aging population than was previously understood to be the case. This implies that the working age population in China is already in the process of peaking and will no longer contribute to the global workforce in a disinflationary way.

- The decline in the workforce has been accelerated by the pandemic. The financial position of the middle-age cohort has improved with the rising value of their assets and savings, allowing for a reduction in debt levels. This has contributed to many people choosing to leave the workforce sooner. Before the pandemic, there was considerable ink spilled around the flatness, or even the death of, the Phillips Curve, which describes the negative relationship between unemployment and wages. It's likely that in the coming cycle, we could see a steeper curve than last cycle, with labour enjoying more pricing power than it has in the recent past. On the margin, the pandemic is also changing societal tolerances for being sick at work, reducing the overall availability of workers. In sum, potential output and actual activity will slow. The effect on asset prices remains to be seen. Short-term interest rates will be under upward pressure as monetary policy normalizes as a result of more inflation rates that are above central bank targets, but longer term rates could experience downward pressure from the reduced output. Historically, asset prices do well when savings rates are high.

CHART 1: RETIRED AGE POPULATION GROWING



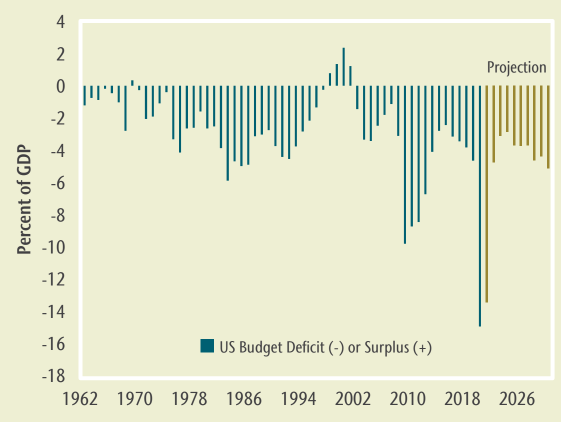
Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Online Edition. Rev. 1.

2. Policy measures will normalize but remain supportive by historical standards

- Last year, all signs pointed to a hand off in the management of the business cycle from central banks to governments. Monetary policy had reached its efficacy limits at zero interest rates and massive quantitative easing (QE) while fiscal policy looked to pick up the baton through large infrastructure and investment programs, following the already extensive pandemic relief programs. The new flexible average inflation targeting policy (FAIT) and dual employment mandates mean central banks are, by design, behind the curve, and inflation at or around the higher end of the inflation target range will be tolerated. The current inflation shock is testing that theory, and indeed policymakers look to be reestablishing inflation fighting credentials and simultaneously creating room to respond to the next downturn by tightening policy.

- Big government arrived with the pandemic. The acceptance of government decisions affecting our daily lives – shutdowns, curfews, quarantines, travel and testing – has grown. Financially, governments around the world put up an aggregate of US$17 trillion in loans, guarantees and new programs, equivalent to about 16% of global GDP, to protect the economy and ensure that the health crisis would not morph into a financial crisis. The US federal government budget deficit, at an already massive USS$1 trillion before the crisis, has now exceeded $3 trillion for two straight years. Furthermore, in the long term, ageing populations will require higher healthcare and pension spending and in the US, the current debates surround student loan forgiveness, pharmacare and universal basic income. It appears there are very few voices left concerned with fiscal conservatism.

CHART 2: LARGE DEFICITS MORE WIDELY ACCEPTED



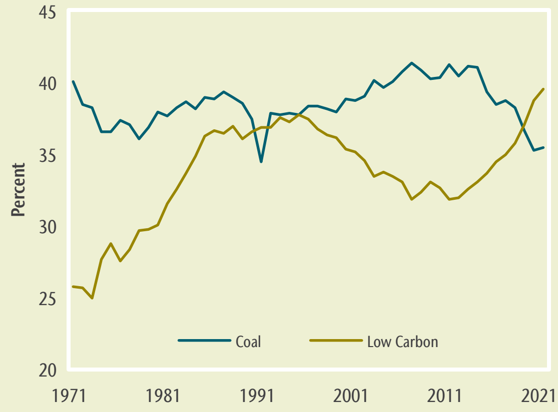
Source: U.S. Congressional Budget Office (CBO), Macrobond

- When government debt levels are high, it helps to have strong economic growth, low interest rates and, in fact, high inflation to help finance that debt. These will all factor into finding the appropriate balance between fiscal and monetary policy over the next cycle. Therefore, while policy has begun to tighten and will continue to normalize, calibrating the appropriate mix may tend toward undershooting rather than overtightening. Given the choice, when debt is high, and interest rates are at the zero bound, the preference is to err on the side of inflation over deflation, leaving policy likely to remain supportive overall.

3. The climate change fight will be costly

- An extension of the prior big government theme is the growing climate change movement. According to the United Nations (UN), more than 130 countries (representing four-fifths of the world economy, up from two-thirds last year) are now subject to a net-zero emissions target by 2050 with aggressive interim targets to be met over the next decade. The UN Special Envoy for Climate Action estimates the financial cost to decarbonize will be over US$100 trillion, paid for in large part by capital investment funded by companies.
- The International Energy Agency (IEA) estimates that global energy demand increased 4.6% last year, just about entirely reversing the decline in 2020. Fossil fuel related commodity prices have surged along with the global rebound in activity. However, investment in energy exploration and production has stagnated despite the increased demand, and arresting the climb in the global temperature will actually require closing off assets in the carbon economy like oil rigs and coal-fired power stations. The share of renewables in electricity generation is expanding rapidly, more than 8% year over year (y/y) in 2021 with solar and wind set to contribute two-thirds of that growth. Despite their rapid growth, renewables still represent less than 30% of total electricity generation globally. Capital and resources will be increasingly diverted to achieve Climate Action goals, testing labour shortages and scarce supplies.

CHART 3: PROPORTION OF LOW-CARBON SOURCES IN WORLD ELECTRICITY GENERATION NOW EXCEEDS COAL

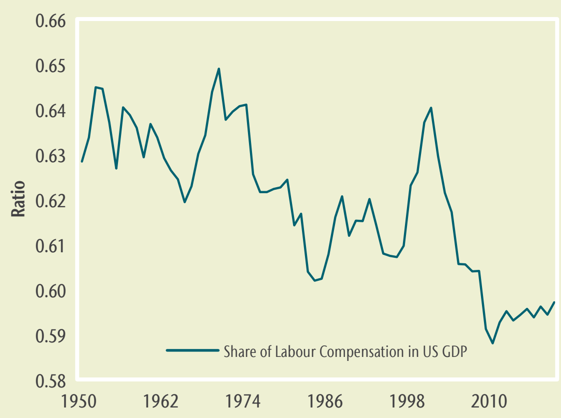


Source: International Energy Agency

4. Populism and de-globalization

- Overall, the pandemic crisis has been better than feared for low income households. The job and income losses early in the health crisis were dampened by government programs, with cheques mailed directly to individuals, or short term schemes in which the state paid the wage bill for firms to retain furloughed workers. Today, the strong economic recovery is leading to improved prospects for workers, as evidenced by the quits rate and better wage bargaining power that is manifested in the number of work stoppages and strikes.
- The recent years' trend of growing income inequality and lack of mobility between income groups has been at the root of populism globally. Even though policymakers stepped in during the pandemic forcefully to limit the downside, the pandemic has nonetheless seen material wealth effects. Lower income households, as well as young people, have found themselves increasingly priced out of the housing market and inflation will erode nominal wage gains. The liquidity provided by central banks has supported asset prices which in turn benefits the higher income quartiles the most. But policies to help redistribute public funds should be expected to continue.
- Related to the rise in populist movements is the reversal of the longstanding trend of globalization that peaked at the end of the last decade with the US-led trade war. Worsened by the surge in demand for goods, supply chains are now undergoing a retooling, pulling away from the cheapest-to-operate, just-in-time manufacturing model. There is also a recognition of the strategic importance of industries in technology, medical equipment and pharmaceuticals. Higher prices accompany the break in disinflationary globalization trends.

CHART 4: LABOUR'S SHARE OF GDP REMAINS NEAR RECORD LOW



Source: University of Groningen, University of California, Davis, Federal Reserve Bank of St. Louis

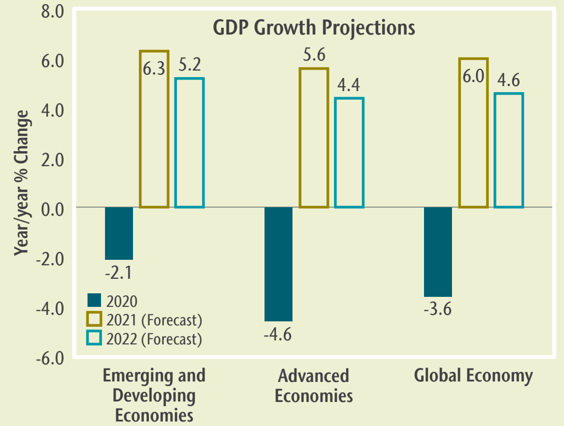
THE CYCLICAL ENVIRONMENT

World: Continued above-trend growth

- The recovery out of the pandemic-induced recession is absent the usual outcomes – bankruptcies, high inventories, and prolonged unemployment. Economic activity has been growing rapidly and will remain solidly above the trend pace of growth over the past cycle. If the Omicron variant of Covid-19 is disruptive to activity in the first half of the year, it should be made up in second half. All of the key markers for growth, such as leading economic indicators, purchasing managers' indices and financial conditions, suggest a continuation of the above-trend pace of growth. Output gaps will close this year across most developed market economies.

- Spending on services will depend on government restrictions to contain virus mutations. However, wealth effect, high incomes, high savings and low borrowing costs will continue to reroute spending towards goods until movement normalizes. Both businesses and governments are likely to kick off a capex cycle that will bring much needed improvement in productivity. Accommodative policy will be withdrawn, but will remain supportive overall.

CHART 5: GROWTH PROJECTED TO REMAIN ELEVATED



Source: International Monetary Fund (IMF), Macrobond

Canada: Tighter policy won't derail the recovery

- All the conditions are present for another strong, above trend year for Canadian economic growth. The gap from the prior peak level of GDP seen in Q4 2019 will close in 2022. The country's vaccination rate ranks among the highest in the world and should help guard against severe lockdowns. The labour force participation rate has encouragingly bounced back to 65%, which is just shy of where we ended 2019 but has not prevented the unemployment rate at 5.9% from falling to well below its historic average. Household balance sheets have improved, with household savings totaling C$277 billion or about 12% of GDP, while the debt to total asset ratio fell from 17.5% in Q1 2020 to 15.3%, its lowest level in 20 years. Housing markets have surprised with further strength late last year and show little signs of easing given the low inventory levels of homes available for sale.

- Both labour and housing markets should see further tightening with a reopening of borders and international in-migration. After borders were closed in 2020, immigration trailed off. In 2021, ambitious new goals allowed for about 403k new immigrants to the country, and for the first time ever, this surpassed (in absolute numbers) every other G7 nation, despite our population being about half the size of the next largest country. In-migration is expected to remain at these high levels for another couple of years and will support the growth in jobs and housing.

- The Bank of Canada (BoC) was among the early central banks to fret over inflation and assess that less monetary support was appropriate, ending large scale asset purchases in Q3 of last year. We expect rate hikes to begin within the BoC's guided period, between April to September, but likely on the earlier side given the pressure on inflation and recovery in labour markets. Nonetheless, the BoC will be mindful of the high consumer mortgage and debt levels, and tighten only slowly. We anticipate rate hikes once per quarter for a total of three increases in 2022, and a similar pace in 2023. This will still leave rates low in historical terms and accommodative relative to fundamentals.

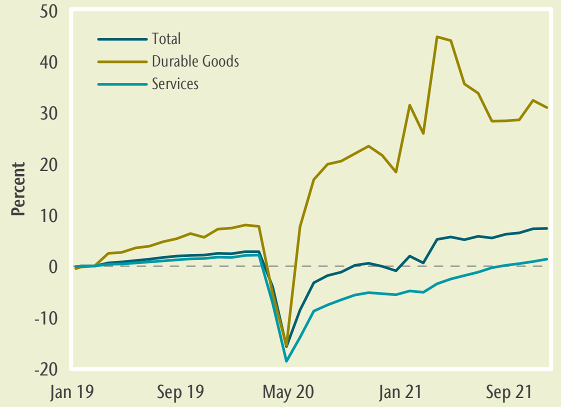
CHART 6: CANADA'S POPULATION GROWTH IN 2021 WAS THE FASTEST IN THE G7

Source: Statistics Canada, U.S. Census Bureau, World Population Review, Macrobond

US: Labour and consumers in a healthy position

- US growth will roughly double the pace of the last cycle, driven by both business and consumers. The US consumer, the largest economic force in the world, is in very strong financial shape, having reduced debt, lowered debt servicing costs, and benefited from rising asset values and savings. Net worth has grown US$31 trillion, to US$142 trillion, over the five quarters to mid-2021. That totals the same rise in net worth as over the five years preceding the 2020 recession. Consumers have already deployed some of those gains into elevated spending, particularly in goods and this should broaden out to services this year.
- With sustained demand and persistent shortages, business investment should finally be a driver of demand. Capex will be focused in a number of areas including: clean energy, reshoring of supply chains, digitization and restocking and securing of inventory. Profits have been high, and cost of financing is low. Longer term, this leads to a boost in productivity. It has already begun, with business investment running at about 11% in the first half of last year, driven by equipment and intellectual property.

CHART 7: SERVICES SPENDING IS STILL CATCHING UP



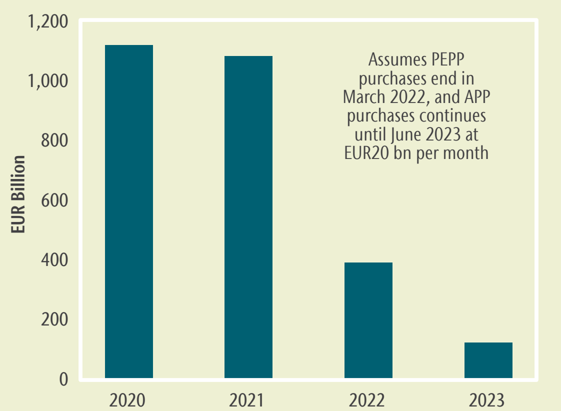
Source: U.S. Bureau of Economic Analysis (BEA), Macrobond
Note: Growth in Real Personal Consumption Expenditure

- Federal Reserve (Fed) Chair Powell's second term will be more complicated than the first, and the tone in communication has already shifted in the new year. The latest Summary of Economic Projections showed rate hikes to come in the middle of 2022, after the quicker drawdown in quantitative easing (QE). Fed officials are discussing allowing bonds to mature without reinvestment, thereby shrinking the balance sheet. This is considerably faster than in October 2017, the only other time the Fed aimed to reduce its balance sheet. That period lasted until August 2019, drawing down approximately US$700 billion from a starting point of a US$4.8 trillion balance sheet. A more aggressive Fed remains a risk today.

EU: Caution on Covid leading to a more durable recovery

- Despite some of the more stringent lockdowns over the turn of the year, which have reduced growth forecasts by one percentage point for the coming year, the Eurozone should see strong and balanced growth of just under 4% for 2022. Like the rest of the world, they will contend with supply chain issues and the resulting higher inflation. In this case, the challenges will be augmented by questions over a reliable energy supply, given its dependence upon imported energy. The Harmonized Index of Consumer Prices (HICP), the euro area's measure for consumer price inflation, reached a high of 4.9% y/y in November, though the ECB's latest inflation forecasts suggest an easing back to 3.2% y/y in 2022. This is actually an upward revision from earlier in the year due for the most part to surging energy prices.
- Even with the strong inflation, the ECB has been among the world's least hawkish major banks to date, signaling a desire to ensure a sustainable rise in inflation. The first steps will be to slow asset purchases and move away from the emergency pandemic policies (Pandemic Emergency Purchase Programme and Targeted Long Term Refinancing Operations) and ultimately return bond buying back to its pre-pandemic levels, the equivalent of EUR20 billion/mo. The medium term goal will be an eventual exit from negative rates. They will remain cautious with labour markets still recovering and unemployment rates at about 7.4% for the Eurozone as a whole. Fiscal spending actually presents an upside risk, as the NextGeneration EU – a EUR800 billion temporary recovery package - will support reforms and investments across member countries and the investments may actually raise the post-pandemic potential pace of GDP.

CHART 8: TOTAL ECB ASSET PURCHASES TO SLOW MATERIALLY



Source: ECB (European Central Bank), Macrobond

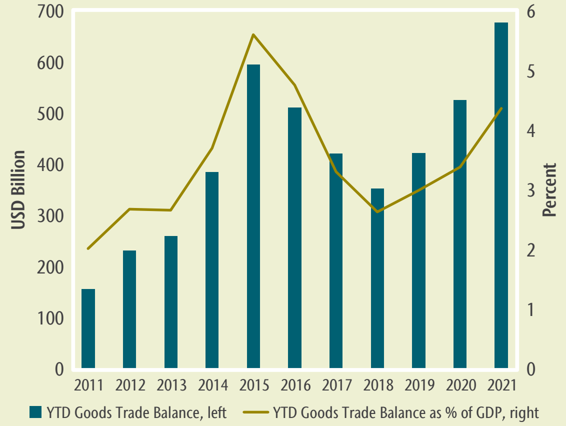
China: Repositioning for the new world

- The last year saw a series of structural policy changes that in turn clamped down on internet businesses, for-profit-education, excess debt in shadow banking and property, and carbon emissions. The broad contours were telegraphed earlier, while the specific adaptation became clear with the benefit of hindsight. The policy measures are designed to focus on promoting resilience in more vulnerable areas such as demographics and hardware technology, and at the same time focus on boosting 'common prosperity' by creating a large middle class. This marks a shift away from championing GDP growth above all else. Slowing growth is the near term economic cost to the longer term repositioning, and the changes will limit cyclical upside in 'old economy' sectors in particular.

- Investment continues to be in excess of 40% of GDP, and remains a cornerstone of economic activity. However, property construction will be a drag on activity, likely declining about 10% y/y and instead will be replaced by new investment required in order to achieve the climate action plan. Strength in the developed markets consumers' purchases of durable goods supplied by emerging markets has delayed a global rebalancing. Chinese goods exports surged 28% in 2021, and should continue to rise with the inventory accumulation likely to occur.

- Policy has already begun to ease, but only moderately and piece meal. It will no longer provide the countercyclical expansion for the world economy. Annual growth rates look to slow from an average of about 8% per year to 5%.

CHART 9: CHINA'S TRADE POSITION STILL GROWING



Source: China Customs Statistics Information Center (CCS), China National Bureau of Statistics (NBS), Macrobond

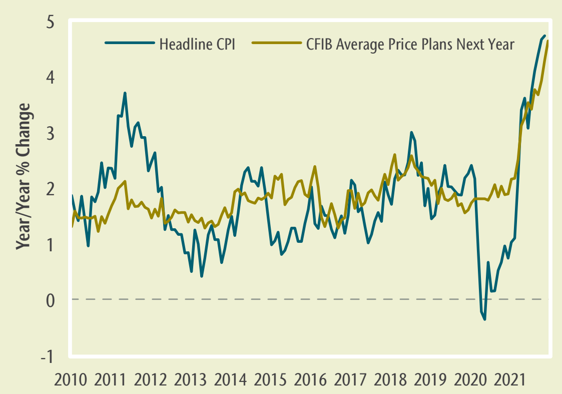
INFLATION

Prices globally are being distorted by a combination of the large shifts in demand for goods at the expense of services, combined with the disruption in global supply chains. While at the start of last year, the higher inflation was confined to a narrow group of sectors – autos, hotels and airfares – there has since been a wider breadth of CPI components posting meaningful price increases.

Overall inflation will stay high for a few months yet. In the first quarter, the effects of increased Omicron-related cases and new regional containments have the potential to exacerbate supply chain issues that in turn put additional pressure on inflation. However, pressure on goods prices, especially durable goods, will subside as supply chains unclog, shipping costs decline and direct fiscal stimulus stops. Prices for goods should ease simply as demand reverses with spending shifting back to services. Base effects should also help. At the same time, the services components of the CPI will take up some of the slack later this year. This will come in the form of three factors. First, shelter costs, which due to their calculation take time to be seen in inflation figures. Second, wages are the main costs for all businesses and gains of 4% y/y is broadly consistent with 2% inflation; the last few months, the US has seen the pace even higher at about 5-6% annualized. Finally, health care costs have been very low as much of the day-to-day care has been deferred and should also reverse.

For central banks, what matters is not that prices have risen over one period in time. The key lies in inflation expectations, or the second order effects from higher prices developing into an expectation of higher wages and companies building these higher costs into recurring price increases. On this measure, surveys of business and consumer inflation expectations are telling, each having surged. Market based measures of short and medium term inflation expectations have surged, though longer term expectations have only drifted up towards 1.75% - 2%. This has central bankers worried that if they dismiss this signal, they risk having to tighten much more later on.

CHART 10: CANADIAN BUSINESS INFLATION EXPECTATIONS SURGING ALONGSIDE CONSUMER PRICES



Source: Statistics Canada, Canadian Federation of Independent Business (CFIB), Macrobond

RISKS TO OUR OUTLOOK

1. Policy error in a world where growth is low but inflation is elevated

- There is considerable judgement that goes into unobserved variables. Uncertainty around the persistence of inflation, the level of full employment or the neutral policy interest rate can very easily lead to policy errors. Over the coming year, most central banks will be transitioning away from reduction in bond purchases and perhaps into shrinking balance sheets, as well as moving towards rate hikes off the zero bound, with the start of rate hikes occurring right around the peak of core inflation readings. Likely, the easing in the path of inflation will allow the Fed and BoC to normalize policy at a slow pace. Indeed, our current view is that the market is pricing in a bit too much policy tightening up front.
- Looking further down the road, the most concerning and likely alternative scenario to us is the uncomfortable policy choice if inflation remains high while growth is in retreat. This forces central banks into difficult decisions. We expect they will ultimately continue to tighten because there is little political will to allow high inflation through persistently easy policies. Either a premature or an over tightening clamps down on what would have been an exit out of the decades long low growth / low inflation / zero rate environment. Following a period of stagflation, we return to secular stagnation.

2. Inventory overbuild

- A second cyclical risk is that inventory overbuilding arises out of businesses competing for limited supply. It is not uncommon for a supply glut to follow a shortage and price surge. Businesses typically invest to ramp up production and retailers over order in an attempt to secure product. This may be augmented by a desire to build resiliency and redundancy into supply chains.
- The timing is important. The current difficulties through the supply chains are the result of many problems, notably labour shortages. However, the rolling lockdowns seen in parts of Asia should slow. Air travel should also resume consistently, which helps alleviate some of the air cargo issues as passenger flights typically account for about 15% of air cargo shipments. Finally, this inventory rebuilding could come alongside a saturation in durable goods demand. A full reopening in the economy should push spending outside the home, to restaurants, sporting events, movie theatres and vacations and in turn reduce demand meaningfully enough to restart aggressive discounting of goods prices.

3. A renewed scare related to the virus or vaccines

- It almost goes without saying that all forecasts are subject to unpredictable developments in this current health crisis. Two years ago, no one had thought a novel coronavirus would be the dominant influence over world events. Last year, the vaccines had the world on a clear path to a better 2021, though in the end, the year saw unfortunate and discouraging developments that have delayed the return to normal. Nonetheless, as we look ahead, an endemic stage of the virus should emerge, along with better ability by the scientific and government communities to combat the virus.

VALUATION

VALUATIONS: Earnings Growth to Decelerate

- Corporate profits were boosted substantially in 2021. Solid consumer demand supported earnings for many companies despite myriad challenges, including higher input prices, ongoing supply chain issues, waves of new COVID-19 variants, and the end of many pandemic-related fiscal stimulus programs. In fact, earnings in aggregate soared past pre-pandemic levels to record highs, and drove all of the stock market gains in 2021.
- Corporate earnings growth is expected to be positive in 2022, but should decelerate from the impressive rates achieved in 2021. Strong economic fundamentals remain firmly in place, and our constructive view for consumer and business investment suggests continued economic growth, albeit at a more moderate pace relative to 2021. This should translate to solid top-line revenue growth. The potential change to corporate tax policy, outlined in the Build Back Better Act that has passed the U.S. House of Representatives but has not been signed into law, introduces a risk to the earnings outlook. However, the headwind from any significant adjustments to corporate taxation is likely to be felt in 2023, although the magnitude and timing remains uncertain.
- Profit margins recovered in 2021 to new record levels. Going forward, we expect margins to remain near current levels. Many of the drivers for profit margin expansion in 2021, including solid real GDP growth, positive operating leverage, company pricing power, and cost controls through automation, remain in place in 2022. We expect that the benefit from these factors will be enough to offset rising input costs driven by tighter labour markets and persistent supply chain constraints.
- In the U.S., we expect annual earnings per share (EPS) growth of 11% for the S&P 500 in 2022. In Canada, where earnings should benefit from higher inflation through the commodity channel, we expect a 10% rise in EPS for the S&P/TSX Composite. Our forecasts for the U.S., at $230 per share for 2022, and for Canada, at $1410 per share in 2022, are slightly ahead of consensus, which are coming in at US$227 and CA$1350, respectively.

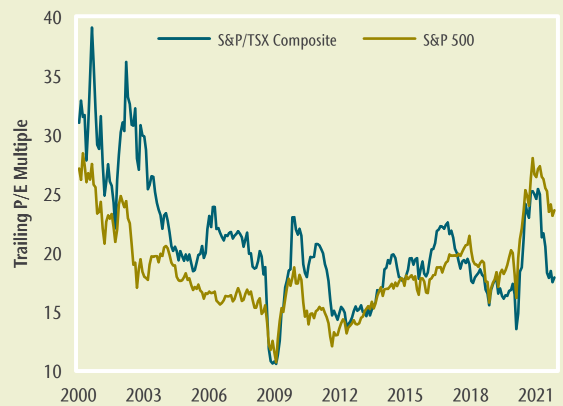
CHART 11: EARNINGS GROWTH TO DECELERATE

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

VALUATIONS: Pace of multiple contraction to moderate in 2022

- Valuation multiples contracted in 2021, with price-to-earnings ratios (P/Es) coming off 20-year highs. Much of the contraction was driven by higher and more persistent inflation than was originally expected, and the expectation of less accommodation from central banks. Given monetary policymakers will actually begin to raise interest rates in 2022,; we expect further multiple contraction from here, particularly in the U.S. where the technology sector is especially vulnerable. However, the magnitude of the contraction should be less than was the case in 2021 given the gradual pace of tightening we expect from monetary policymakers. Additionally, while inflation is likely to remain elevated, the inflationary base effects suggest consumer price inflation may be peaking.

CHART 12: MULTIPLE CONTRACTION EXPECTED TO BE MORE MODERATE IN 2022



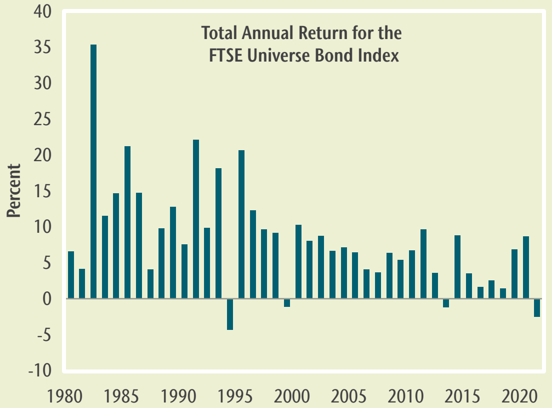
Source: I/B/E/S, Connor Clark & Lunn Investment Management

- The consensus P/E multiple of 22 times for S&P 500 earnings is a slight contraction from year-end levels, but is well above average. The consensus P/E at 17.7 times for S&P/TSX Composite earnings is actually an expansion from year-end levels, and is slightly above the historical average. The above consensus earnings estimates, combined with these P/E multiples suggest the S&P 500 should trade to around the 5,000 level and the S&P/TSX Composite should end around 24,000.
- Our year-end estimates are in line with consensus for the S&P 500, although we expect marginally better earnings growth, combined with slightly more multiple contraction, relative to consensus. For the S&P/TSX, we expect a modestly lower P/E multiple from year-end levels, at 16.5 times, resulting in a year-end index level of approximately 23,300. Our price targets imply a 5% increase in the U.S. and a 9% increase in Canada from year-end levels.
- Global equity market valuations remain mixed. U.S. market valuations are broadly above historical averages, while EAFE and emerging markets P/E multiples are in line with historical averages. Emerging markets in particular have become favourably valued after last year's underperformance, and the slowdown in the pace of regulatory tightening and strong demand should support markets overall. Finally, sentiment indicators for equity markets have turned bearish (a contrarian indicator). As a result, we are positive on global and emerging markets as we begin the year.

VALUATIONS: Bonds Are Expensive

- Bonds by most historical measure have been expensive for more than a decade. Yields are low in nominal terms relative to the robust economic and inflationary backdrop, while negative real yields also represent a large deviation from fundamentals. Yields have been suppressed by ultra-accommodative monetary policy, including target policy rates near or below 0%. Indeed, the amount of negative yielding debt outstanding globally grew in 2021. Additionally, quantitative easing programs have provided a technical underpinning for lower longer-term yields. However, the moderate to high current inflation environment combined with the shift from policymakers toward removing excess stimulus suggests yields should rise from current levels.
- The Canadian 10-year bond yield rose 0.76% in 2021 to close at 1.48%. While yields should rise further, we expect a more modest increase in the next year. Although monetary policymakers will raise short-term policy rates in 2022, we expect the process to normalize policy to be gradual. There also remain a number of secular forces, including high debt levels, that may limit how high yields can rise. Finally, rising yields may attract investors globally, triggering capital inflows.
- The FTSE Canada Universe Bond Index declined 2.54% in 2021. The index has never posted two consecutive years of losses since its inception in 1980, although that may change in the coming year. Given our expectation for a modest increase in bond yields, we expect 2022 returns for the FTSE Canada Universe Bond Index in the range of -1% to +1%.

CHART 13: BOND RETURNS TO BE MUTED



Source: FTSE Global Debt Capital Markets Inc.

PORTFOLIO STRATEGY AND STRUCTURE

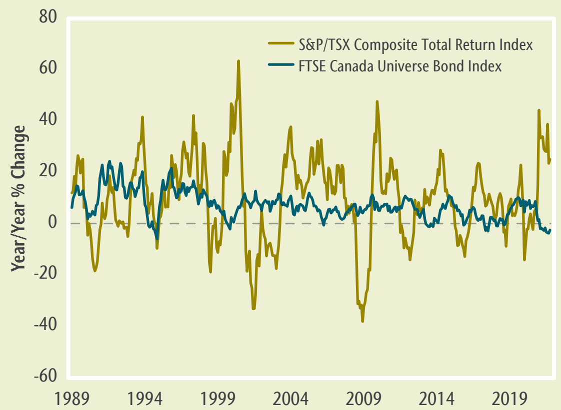
The conditions in place in 2021, in particular strong underlying economic fundamentals, supportive monetary policy, and expectations for a transitory period of higher inflation fueled impressive earnings growth that drove the rally in most equity markets, despite periods of uncertainty and volatility. As we look ahead, with the pandemic still with us, policymakers are set to temper the highly beneficial financial conditions. Global developed equity markets are likely to face a bumpier road ahead after posting two consecutive years of double-digit gains. Some of the economic tailwinds are abating and we do not expect a repeat of the same magnitude of strong equity market performance in 2022. Higher inflation has persisted for longer than anyone originally expected and policymakers are no longer sanguine about the potential for it to develop into higher inflation expectations.

Rising bond yields are typically associated with periods of equity de-rating (lower valuation multiples), which we did start to see in 2021. We expect valuations to continue to face pressure, though our outlook for the equity risk premium, a measure of the additional return investors should receive for holding more risky stocks relative to risk-free bonds, suggests equity markets are close to fair value. Valuations will not experience a significant contraction when combined with a modest increase in the risk-free interest rate because the risks overall are declining in this strong growth environment. The moderate tightening by central banks will be accompanied by this rebound in activity and employment, allowing markets to absorb higher rates and still perform well. Similarly, we expect earnings growth to moderate with the increased cost pressures that businesses face. The outcome of these two factors should be positive but more modest equity market returns in 2022. Regionally, we expect U.S. stocks to underperform relative to Canadian and emerging market equities given the higher weighting of the technology sector in the U.S., which is particularly sensitive to multiple compression in a rising rate environment. Additionally, Canadian and emerging market equities should benefit somewhat in an environment where inflation is higher than the post crisis average, as commodity prices remain elevated. In this mid-stage of the cycle, there is less preference for portfolio themes or investment styles, although smaller capitalization stocks continue to provide attractive value. Bond markets have experienced significant interest rate volatility, and we expect bond returns to be muted as the overall trend for rates is expected to be modestly higher. The asset mix within balanced portfolios remains overweight equities and underweight bonds, with a tilt toward Canadian equities, emerging market equities, and small cap stocks, which should all benefit from more favourable valuations and sector exposures.

Asset Class Returns

- Our base case is for the 10-year Government of Canada bond yield to rise moderately over the year, building on last year's move off the lows, remaining within a range of 1.5% to 2.25%. Given our secular outlook for inflation over the coming years, the risks for interest rates are tilted to the upside, though we believe the Bank of Canada (BoC) will act prudently, minding both the massive expansion in aggregate debt levels and the desire to support continued employment gains. As such, we expect total returns for the FTSE Canada Universe Bond Index to range between -1% and +1%, below the running yield of 2.1%.
- Even after a couple of years of strong returns, our optimistic outlook on the global economy is leading us to remain bullish on Canadian, U.S., and global equities. Top line revenues should remain well supported by nominal GDP growth and margins should remain near current levels. We forecast a gain of 5% in the U.S. and a slightly higher return of 9% for the S&P/TSX. Pro-cyclical equity markets, notably EM and small cap stocks are expected to see even better gains.

CHART 14: EQUITY OUTPERFORMANCE TO MODERATE



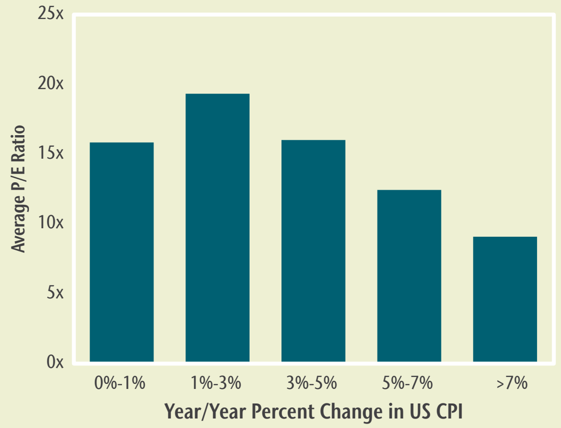
Source: Toronto Stock Exchange, FTSE Global Debt Capital Markets, Macrobond

- The asset mix in balanced funds favours equities, with a tilt towards Canada, emerging markets, and small cap, over global equities. We are also underweight bonds given the expected return will be muted. We believe the environment of ultra-accommodative policy is ending, though overall policy stance will still be supportive for risk assets.

Stock and Sector Selection

- We maintain a constructive outlook for equity markets, and favour companies that are levered to global growth, and those who may benefit from rising interest rates and maintain some degree of pricing power. We anticipate strong global growth will allow companies to benefit from positive operating leverage, and that earnings will grow.
- Market valuations are not overly stretched for the moment, and on a relative basis, Canada and EM have more favourable valuations than the U.S. Central bank policy will be a key factor in the next year as policymakers walk a fine line between allowing inflation to run too hot and pulling back too much on policy. As a result our expectation is for a continued but more modest contraction in valuation multiples. We see this phase as a mid-cycle environment, where economic growth rates have peaked but share prices will continue to be rewarded as companies are able to expand earnings.

CHART 15: P/E MULTIPLES LOWEST WHEN INFLATION IS HIGH



Source: Deutsche Bank

- Inflation remains a risk for markets. Historically, equity valuations contract when inflation rises. Equities still perform well, provided earnings growth more than offsets multiple contraction, which we do expect in the coming year. Sectors that outperform in inflationary environments include commodity producers, inflation hedges such as real estate and gold, and transportation companies as an example of businesses poised to benefit from consumers willing to pay for goods to be delivered. Financial companies, such as banks and life insurers, will also do well in an environment of higher interest rates.

Corporate Credit

- It has been a steady year for corporate credit with very little movement in corporate spreads. Credit spreads have held in about 140 basis points (bps) above sovereign bonds, not far off the tightest level experienced since the 2008 financial crisis. In this low-yield environment, that spread looks like a decent yield pick-up. Elevated nominal GDP growth will also support earnings growth and balance sheets look strong.
- However, from our lens, the withdrawal of stimulus and liquidity may start to weigh on corporate credit. QE policies have ended or are being managed lower in just about every country with only the European Central Bank (ECB) and Bank of Japan (BoJ) still actively buying at high levels. While the BoC's purchases did not do much in the way of directly supporting corporate and provincial credit, it did stand ready in the event of a market downturn, and the buying of Canada bonds pushed investors up the risk curve. The pullback in policy raises the risk of a deterioration in spreads. This is particularly so in an environment where some of the risks we highlighted above come to pass, such as a material slowdown in GDP growth (possibly related to the inventory cycle) or high inflation forcing central banks' hands in slowing the economy.

CHART 16: LIMITED UPSIDE IN CORPORATE CREDIT

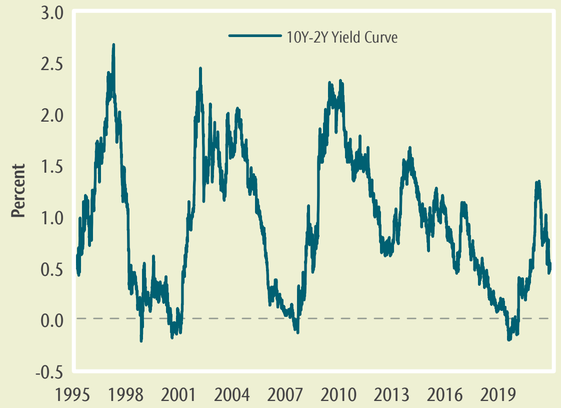
Source: FTSE Global Debt Capital Markets Inc., Connor, Clark & Lunn Investment Management Ltd.

- As a result, we start the year with our overall sector positioning in line with benchmarks. We maintain only a modest overweight to corporate bonds, a lower level than we normally would have mid-cycle. The risk-reward looks middling for now, with our forecast for a modest widening of spreads that would offset the additional yield.

Duration and Yield Curve

- Canadian nominal bond yields have risen throughout last year, at first longer term yields rose with the anticipation of a normalizing economy, and then later short term yields jumped higher on central bank rate hike expectations. This has brought the entire yield curve off its lows. We believe the intent to withdraw policy stimulus will dominate bond markets. In its simplest form, higher policy rates imply flatter yield curves as short- term rates rise. A focus on combating inflation early, and if we are right about an easing off of inflation this year, will together imply the central banks have time to move at a measured pace. A separate form of policy tightening will come as central banks attempt to shrink their balance sheets in a quantitative tightening move. Typically, longer-term interest rates can be expected to rise, alongside more issuance from governments at the longer end. Thus, rates are expected to increase moderately, but we have a fairly neutral view on the yield curve as we start the year.

CHART 17: YIELD CURVE TO FLATTEN AS WE APPROACH TIGHTENING



Source: Bank of Canada, Macrobond

- We had a constructive view on the value of real return bonds in Canada. These had done well through the end of last year as inflation rose. We will look to add back to this positioning on any pullback, as they provide a good hedge against inflation. The 30-year break-even inflation rates started the year around 1.75%, and some 50 bps below their U.S. counterparts, even as inflation today is in excess of 4%.

Scorecard (Macro Inputs)

	Economy	Monetary	Inflation	Valuation	Total
US	+	N	-	N	N
Canada	+	N	N	N	+
Europe	+	+	N	+	+
China/EM	N	+	+	+	+
Total	**+**	**+**	**N**	**+**	**+**

+ Positive; – Negative; N Neutral; N/A Not applicable

SUMMARY

There have been a number of setbacks over the past year with the surge of the Covid-19 variants, strained supply chains and extraordinary weather events. These have dampened our economic outlook for the coming year, but we still have a solidly positive forecast. We anticipate the overall pace of real GDP growth to be roughly double the pace of the past two economic cycles as we continue to move along the path to a full reopening of the economy. The growth path will look broadly similar across most economies around the world. The current high rates of inflation should persist in the very near term before being alleviated to some extent by the unclogging of supply chains, rebuilding of inventories and rebalancing of demand away from goods consumption and back towards services. Nonetheless our key secular themes continue to support a pro-inflation outlook, though the debt supercycle remains an ever present and ever growing concern. In the near term, central banks will look in the current year to firmly establish credibility in fighting inflation, but be somewhat more prudent in the medium term given the large public debt buildup and desire to support full employment. The combination of strong growth and higher inflation implies a strong nominal GDP pace which in turn helps top line revenue growth for companies. Margins may face some pressure with the large wage gain growth accompanying tight labour markets. The pull back from ultra accommodative policy means interest rates should move higher and volatility in markets is almost certainly going to rise. But in aggregate, earnings will continue to perform well amid modestly contracting valuations. However, after two very strong years of gains, equity returns will likely be lower in 2022. Among markets, we see outperformance from Canada and other cyclical economies. Overall, even as the pandemic has dragged on and weighed on optimism, the outlook for the year ahead is bright. We have an optimistic outlook for equity markets, in particular high quality stocks with leverage to economic growth and pricing power. As setbacks often present new possibilities, we continue to look for opportunities as we turn the page to a new year.

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