INVESTMENT MANAGEMENT

OUTLOOK

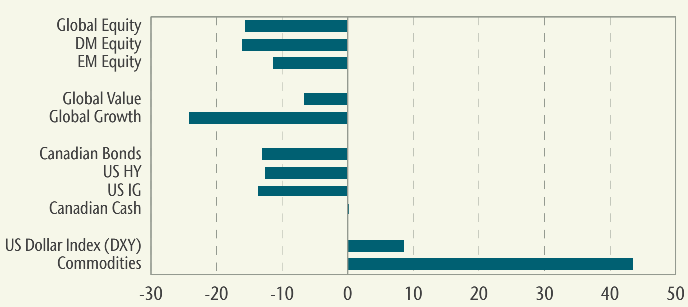
JUNE 2022

It seems like nothing has worked. We are nearing the halfway point of 2022, and what a year it has been. After posting remarkably strong economic growth and market returns in 2021, this year has been far more challenging. For the first five months of the year, developed market (DM) equities, emerging market (EM) equities, value stocks, growth stocks, bonds, investment grade (IG) credit, high yield (HY) corporate credit, and all currencies other than the US dollar are in negative territory (see Chart 1); only commodities have risen this year. The selloff has accelerated into June and US equities moved into bear market territory. Given the macro backdrop, the market moves have been understandable as Fed tightening cycles, resulting slowdowns (and potential recessions), as well as high inflation are all bad for markets. The inflationary backdrop has caused yields to surge and bond prices to post equity-like losses because of the expectation of an especially aggressive tightening cycle. Meanwhile, equities are falling because the tightening of monetary policy is primarily de-rating equities by compressing valuations. The price-to-earnings ratio (P/E) on the S&P 500 has fallen from 23x to 17.5x (see Chart 2), taking the valuation for the market down from excessively high to a more normal level. In a typical market downturn, the pullback of P/Es is about 25% from peak to trough, and this move so far is right in line with that. Yet, it is worth noting that the S&P 500 P/E is still sitting above its long term average, suggesting the possibility of further compression, a scenario that is especially likely if inflation remains persistent. Elsewhere, P/E multiples in Europe and emerging markets have eased near or below longer term averages. Thus, global equities are becoming more fairly valued, but are certainly not cheap.

So far, the de-rating in equity valuations has been offset by earnings growth that is holding up really well. Consensus forecasts for earnings and margins are near all time highs. Earnings per share (EPS) estimates for 2023 have continued to rise, even over the past month as growth concerns have weighed on market sentiment. Consensus earnings estimates for the S&P 500 for 2022 sit at US$229 and for 2023 have actually edged higher to US$251. Based on historical experience, it is possible earnings, if well supported, can be enough to keep the downside to equities limited, as was the case in both the 1994 and 2004-06 cycles.

But this is a key risk to the equity outlook. Earnings typically fall in a recession, on average by just over 30%. Even in a soft landing scenario, whereby the global central bank tightening cycle is able to raise rates enough to slow inflation but not push the economy into recession, earnings could be vulnerable. A key gauge of US activity are the ISM indices, which have fallen, and notably the manufacturing New Orders Index is down from 67.4 in December 2021 to 55.1 in May 2022. However, input costs have been growing as have all costs recently, leaving S&P profit margins vulnerable. While S&P 500 trailing earnings have grown at a record pace over the past year, the economy wide measure of corporate profits has started to slow (see Chart 3). Indeed profits, even outside of a recession can drop as they did in 1985, 1999 and 2016.

Chart 1: Nearly All Asset Classes Uniformly Negative



Source: MSCI, S&P DJI, ICE, Bloomberg, FTSE Global Debt Capital Markets Inc.
Note: Year-to-date returns (%) ending June 10, 2022 in local currency terms.

Chart 2: Equities De-rate

Source: I/B/E/S, Macrobond

Today, markets are not pricing in a recession. In addition to resilient earnings forecasts, it is notable the yield curve did not stay inverted after a brief period of inversion in early April. Even as short-term rates are pricing in a rapid pace of tightening, they have not sustainably exceeded long term rates. Moreover, both investment grade and high yield bond spreads have moved just modestly wider, implying default fears are well contained. Similarly, equity indices have dropped, but the move has been rather orderly with the VIX index below prior crisis levels. Finally, cyclical stocks versus defensive stocks have underperformed, but not yet suggesting a recession (see Chart 4). We would agree, but do see increasing risks ahead.

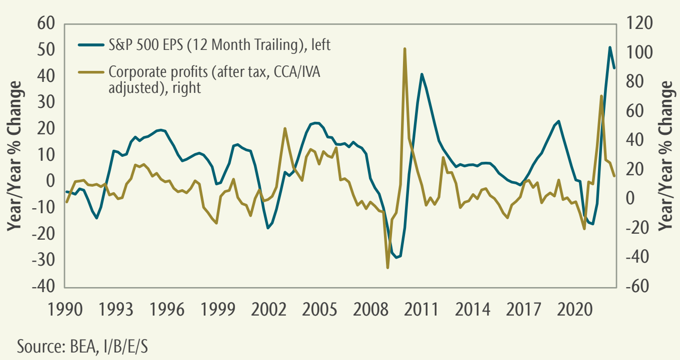
CAPITAL MARKETS

While the year-to-date returns have been poor across the board (outside of commodities), May marked the first month this year where we saw some glimmer of short term stabilization. A number of risk assets ended the month without posting another material decline, notably the returns on the main US equity indices and Treasuries were generally flat (though markets have resumed their sell off in the first weeks of June). The reprieve in May came as investor focus shifted slightly, with the main narrative moving from high inflation risks to downside growth risks. The mid-month Fed hike was accompanied by Fed Chair Powell pushing back against market expectations of a 75 bps rate hike and this coupled with marginal easing of COVID restrictions in China helped to buoy overall sentiment. This meant that weak economic releases were treated positively by markets – and vice versa – as weak data fueled growth concerns, implying a less aggressive pace of monetary tightening. For the first time in 10 months, the Fed Funds Eurodollar futures implied rate for the end of the year actually downgraded expectations for rate hikes, falling 13.5 bps to 3.10%. As a result, US Treasury markets were flat overall. The US 10-year yield surged early in May and reversed course to close the month down about 4 bps at 2.9%, with a similar pattern seen in Canada. Corporate and provincial bond spreads also widened initially but later retraced that move alongside a broader risk rally. This left the FTSE Canada Universe Bond Index declining a modest 0.07% in the month. Equities also closed the month with subdued returns. The S&P500 and Dow Jones were up 0.2% and 0.3%, respectively, while the Nasdaq posted a 1.5% decline. The MSCI ACWI Index fell 0.2% in local currency terms, and the S&P/TSX Composite edged higher by 0.1%. These modest moves were due to a late-month risk asset rally that held hope for a more moderate global tightening cycle.

PORTFOLIO STRATEGY

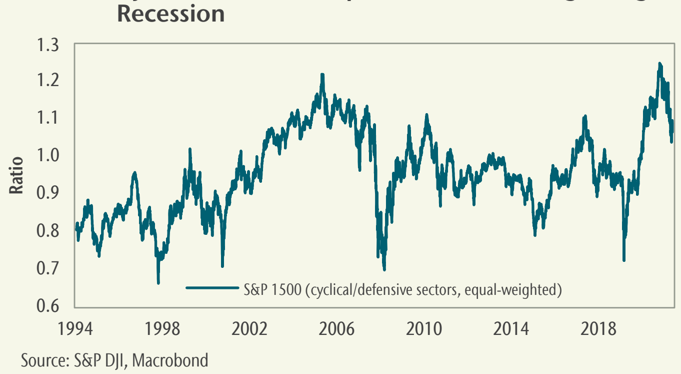
The market shifted its focus from inflation to growth with investors hoping that policymakers would take a more gradual approach to tightening policy. This stabilization, though, is likely a temporary phenomenon. Early June has seen risk assets resume their decline, supporting this thesis. While the risk of recession is still clearly present, so is elevated inflation. The annual change in consumer prices topped 8% this month in Europe (the highest since the formation of the common currency) and the US, while Canada's CPI exceeded 7%. Ever higher energy prices remain a material concern – the biggest gains in all asset prices were in oil. Brent crude surged 12.3% in May, topping US$120/bbl at the end of May, while WTI was up 9.5%. Thus, central banks continue to face strong pressure to hike rates and those same Fed Funds futures have surged in early June, prodded along in fact by hawkish Fed speakers, most notable Vice Chair Brainard and Governor Waller, who continue to suggest that sizeable rate hikes will persist. Policymakers view this current period as a short window within which to keep inflation expectations from running away, and they have a strong resolve to affect change. As a result, policymakers will continue on their tightening path. We continue to expect economic growth to slow, but for 2022 at least, the risk of recession is low.

Chart 3: Corporate Profits Starting to Slow



Source: BEA, I/B/E/S

Chart 4: Cyclical Stock Underperformance Not Signaling Recession



Source: S&P DJI, Macrobond

Equity market valuations are down from lofty levels but in the US are not yet cheap. Indeed, there is still room to decline further from these levels as policy rates may have to exceed their long run neutral rates for some time. Further, downside risk associated with lockdowns in China, war and inflation remains. The outlook, therefore, continues to be predicated on earnings growth. Even without a recession, the risk of a negative earnings revision is material given how high expectations have become. In the US, key parts of the market will remain under pressure, notably growth stocks like technology and consumer discretionary, which should temper overall US equities. However, in Canada, high commodity prices are helping earnings. Energy, materials, fertilizer, and agriculture prices are doing well. However, not all commodity sectors are thriving, notably lumber and gold. Moreover, the risk of an economic slowdown is weighing on the banks. We remain defensively positioned in our fundamental Canadian equity portfolios, favouring high quality companies, and moving cautiously into areas with good value and stability that will do well in a late cycle environment. We are positioned with overweights in consumer staples and industrials, as well as property and casualty insurance companies. Our fixed income portfolios are positioned for further spread widening, remaining underweight corporate and provincial bonds. We expect a flattening in the yield curve to persist. Our duration position, which had been very modestly longer than the benchmark, has been brought to neutral, as rising inflation risks are taking hold of market sentiment again. In May, we continued to reduce risk across our balanced portfolios. We now have a modest overweight to equities, entirely in Canadian stocks, and we have reduced the fixed income underweight. We have increased slightly the underweight in global equities. As we look ahead to the balance of the year, we are not expecting a recession, but we remain cautious with risks tilted towards slowing economic activity and the related outcomes for risk assets.

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