Market Perspectives

'What You Need to Know'

March 10, 2023

After an optimistic start to the year, investor sentiment deteriorated slightly in February as a series of economic data challenged the rosy picture that markets were trying to portray. Investors hoping for a less volatile experience in 2023 were reminded in February that 'hope is not an investment strategy'. Last month, I outlined several factors that I believed led to a strong equity market rally in January but were less likely to be supportive moving forward. A main point highlighted was that in January, expectations of rate cuts beginning this year were likely overly optimistic.

Despite U.S. CPI falling to 6.4% in January (the lowest reading since the high of 9.1% set in June), the magnitude of the decrease seems to be slowing in the short term. This led to a recalibration of expectations of Fed hikes with more smaller hikes being priced in leading into the summer. Today, the markets are pricing in a 100% chance of a 25 bps increase in March, a 100% chance of another 25 bps increase in May and a 75% chance of an increase in June. In February, the markets may have finally realized that cuts are unlikely this year. In Canada, the markets believe that there will be no additional increases or cuts this year as they signalled a 'pause' after their January 25 bps increase.

At its source, this succession of monthly ups and downs appears symptomatic of a market stuck in a "land of confusion." This period we find ourselves in today is where any signs of a strong economy is not automatically good news given the inflationary concerns and where every data point is subject to over-interpretation. This is indeed the story of the start of the year, and it will probably remain so for a few more months.

- Remember, through February, markets are still positive YTD.
- From a technical standpoint, as it relates to the S&P 500, that 4000 number has been a very important barrier and although we closed February just below it after some weakness the market, it has been hesitant to variate much below this threshold.
- The Nasdaq and 'growth' names have been leading the charge thus far. Remember, these were the names that were hardest hit in 2022.
- Canada had a good run last year in terms of outperformance largely in part to the outsized weight it has in energy and raw materials. Thus far, names that are more closely tied with the U.S. have done better.

February Market Review

Fixed Income

The Canadian fixed-income universe suffered a setback in February as bond yield rose on strong U.S. inflation data. Long-term bonds, which are more sensitive to interest rate movements, underperformed the overall universe.

Due to their duration, U.S. investment-grade corporate bonds underperformed riskier high-yield securities.

Equities

The strong start to the year for equities ended in February, with all four equity regions posting monthly losses in the face of markets' realizations that central banks still have work to do in their fight against inflation. Emerging markets lagged sharply.

Within the S&P 500, Information Technology was the only sector to end the month is positive territory. With the continued decline in oil prices, the energy sector underperformed.

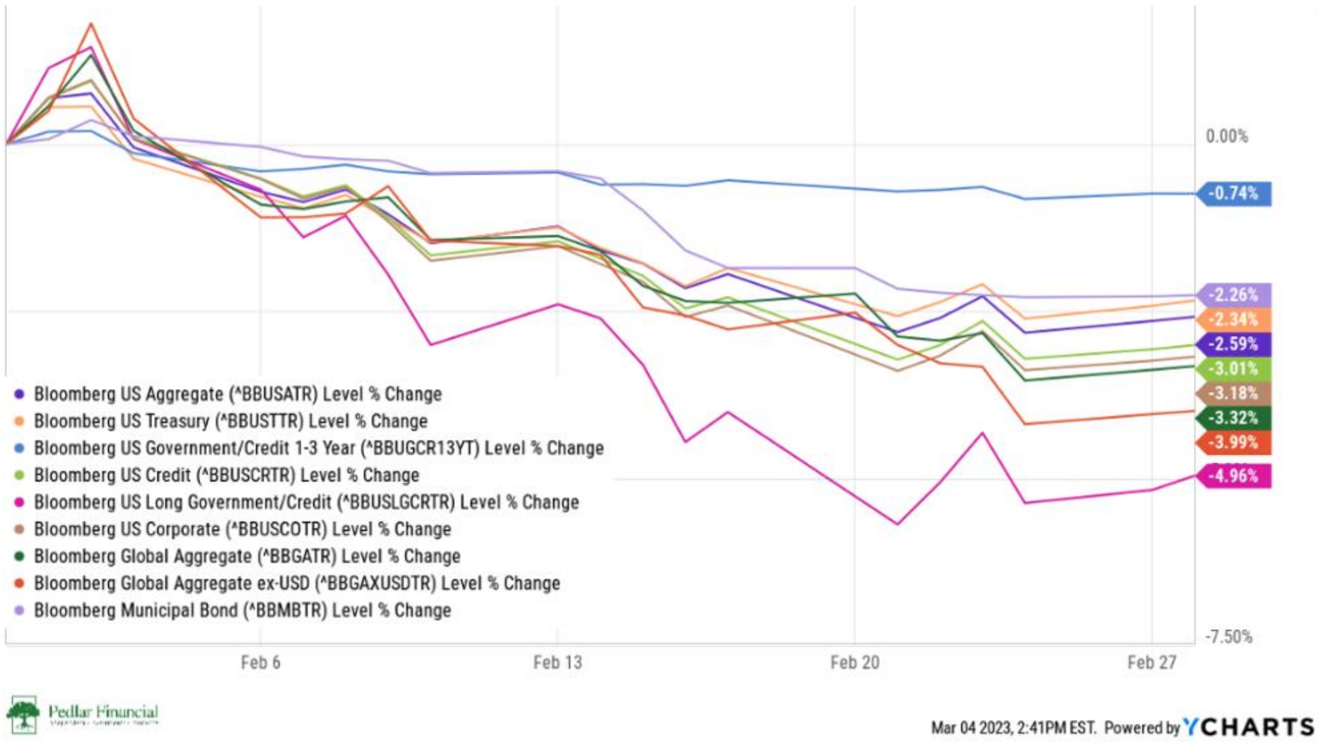
FX & Commodities

Oil declined for the eighth time in nine months. Several other commodities, including copper and precious metals, also posted declines.

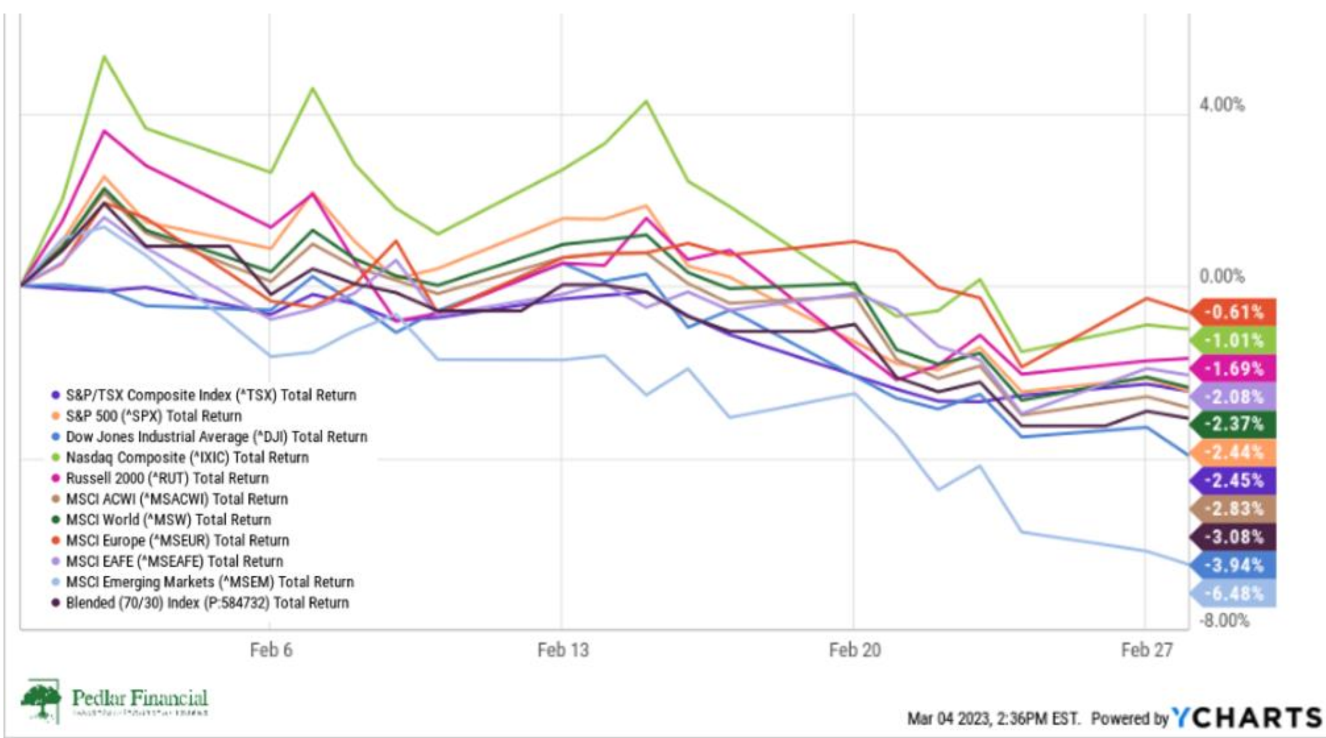
With the prospect of more aggressive monetary tightening by the Federal Reserve, the U.S. dollar appreciated significantly during the month.

Asset Classes	Feb	YTD	12M
Cash (S&P Canada T-bill)	0.3%	0.7%	2.2%
Bonds (ICE BofA Canada Universe)	-1.9%	0.9%	-7.1%
Short Term	-0.7%	0.5%	-2.5%
Mid Term	-2.5%	0.5%	-7.0%
Long Term	-3.1%	1.7%	-12.9%
Federal Government	-1.9%	0.4%	-6.3%
Corporate	-1.2%	1.4%	-5.6%
S&P/TSX Preferred shares	-1.0%	6.2%	-10.9%
U.S. Corporate (ICE BofA US$)	-2.9%	0.9%	-10.0%
U.S. High Yield (ICE BofA US$)	-1.3%	2.6%	-5.5%
Canadian Equities (S&P/TSX)	-2.4%	4.8%	-1.2%
Communication Services	-2.9%	2.5%	-3.8%
Consumer Discretionary	-2.0%	4.2%	4.3%
Consumer Staples	1.5%	3.4%	19.0%
Energy	-4.4%	-0.1%	8.1%
Financials	-0.5%	8.1%	-4.8%
Health Care	-0.7%	13.7%	-50.6%
Industrials	0.7%	4.4%	10.3%
Information Technology	-4.7%	13.9%	-16.3%
Materials	-8.6%	1.1%	-5.7%
Real Estate	0.3%	11.1%	-6.7%
Utilities	-2.2%	1.3%	-7.8%
S&P/TSX Small Caps	-3.6%	4.9%	-8.8%
U.S. Equities (S&P 500 US$)	-2.4%	3.7%	-7.7%
Communication Services	-4.7%	9.2%	-24.8%
Consumer Discretionary	-2.1%	12.6%	-18.2%
Consumer Staples	-2.4%	-3.3%	-1.1%
Energy	-7.1%	-4.5%	24.0%
Financials	-2.3%	4.4%	-5.4%
Health Care	-4.6%	-6.4%	-0.6%
Industrials	-0.9%	2.8%	2.9%
Information Technology	0.4%	9.8%	-11.0%
Materials	-3.3%	5.4%	0.5%
Real Estate	-5.9%	3.4%	-12.2%
Utilities	-5.9%	-7.8%	-1.3%
Russell 2000 (US$)	-1.7%	7.9%	-6.0%
World Equities (MSCI ACWI US$)	-2.8%	4.2%	-7.8%
MSCI EAFE (US$)	-2.1%	5.9%	-2.6%
MSCI Emerging Markets (US$)	-6.5%	0.9%	-14.9%
Commodities (GSCI US$)	-3.8%	-3.9%	-0.3%
WTI Oil (US$/barrel)	-2.4%	-4.1%	-19.6%
Gold (US$/oz)	-5.3%	0.6%	-4.1%
Copper (US$/tonne)	-2.7%	7.0%	-9.8%
Forex (US$ Index DXY)	2.7%	1.3%	8.4%
USD per EUR	-2.4%	-0.6%	-5.6%
CAD per USD	2.6%	0.7%	7.7%

Fixed Income Indices – February 2023



Equity Indices – February 2023



Economy

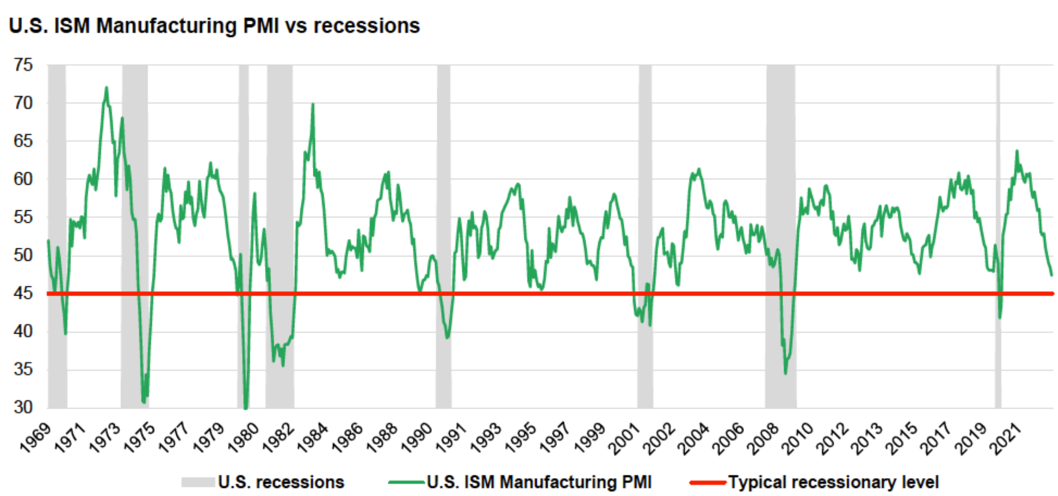
Rates and Recession

The most common concern investors have today are focused on the words "rates and recession." As the latter is concerned, looking at the 7 leading indicators the signs have certainly increased over the past 18 months. Historically, there are warning signs of an upcoming recession and we use the colours of a traffic light to illustrate how close they may be. Green indicates 'no sign', yellow is 'neutral but trending in the wrong direction' and red is 'recessionary'. Currently, we have three of the typical signs indicating recession with others potentially moving into red.

Signs of a recession	Present today?
Inverted yield curve	Yes
ISM Manufacturing PMI below 45	Neutral
Positive inflationary trends	Yes
Tighter financial conditions	Neutral
Housing starts declining	Neutral
Labour market weakening	No
Leading economic indicators negative	Yes

- There are usually leading indicators to a recession; the most prevalent is an inverted yield curve.
- Currently, we have three of the typical signs indicating recession. As such, the risk of recession in H1 2023 has increased.
- Equity markets are pricing in the risk of a shallow recession.

U.S. manufacturing measured by the 'ISM Purchasing Managers Index' hitting a level below 45 is a good example. At 47.4 in January, it isn't recessionary yet. But when you look at leading indicators of manufacturing including new orders / inventory spread, the chart clearly indicates, see below, that the broad-based measure is likely to head below 45 over the next few months.



In terms interest rates and the current hiking cycle that commenced early last year, it's important to understand it takes approximately 12 to 18 months for changes to Fed interest rate policy to be felt by the broader economy. The overnight rate was at 0.5% a year ago, the majority of rate increases that we have seen so far have yet to be fully absorbed by the broader economy which is why economists believe will likely lead to a further deterioration of the U.S. economy.

Although the ISM PMI is just one of many data points that lead economists to believe that the U.S. will still experience a recession, albeit mild due to a resilient labour market, it is usually wise to pay attention to the traffic lights.

Employment

Speaking of employment and the resilient labour market, despite a growing number of tech layoffs that have made headlines, the U.S. economy is employed at historically high levels. Furthermore, the wages that they are earning are highest ever. Last point is you have basically everyone employed, and earning more money than ever so naturally, consumer spending is also at the highest ever. Not a real standard recipe for those that are firmly in that recession camp!

Circling back on the announced tech layoffs, this development is a bit misleading. Layoffs so far are literally a fraction of the amount of hiring many of these mega-cap tech companies undertook over the past two years. When they compare total headcounts from January 2020 to current, the five companies with the most announced layoffs over the last two quarters expanded their workforces by 73%. In contrast, in that same time frame, companies in the aggregate S&P 500 Index expanded their headcounts by a much more modest 4%. While it may be tempting to associate sizeable 'Big Tech' layoffs with a deterioration in the labor market, these companies are simply scaling back and trimming the excess froth on their work forces after significant binge hiring. Furthermore, these 5 companies contribute just 1.6% of total U.S. full-time workers (private and public).

Earnings

Despite higher interest rates and historically elevated levels of inflation, Q4 2022 company earnings remain resilient. For the S&P 500, in the fourth quarter of 2022, revenues grew at 5.6% while earnings declined by -2.5%. In Canada, as it pertains to the S&P/TSX, revenues grew at 7.5% while earnings were essentially flat. The results varied among sectors and companies and is likely to continue moving forward leading to a great environment for stock pickers.

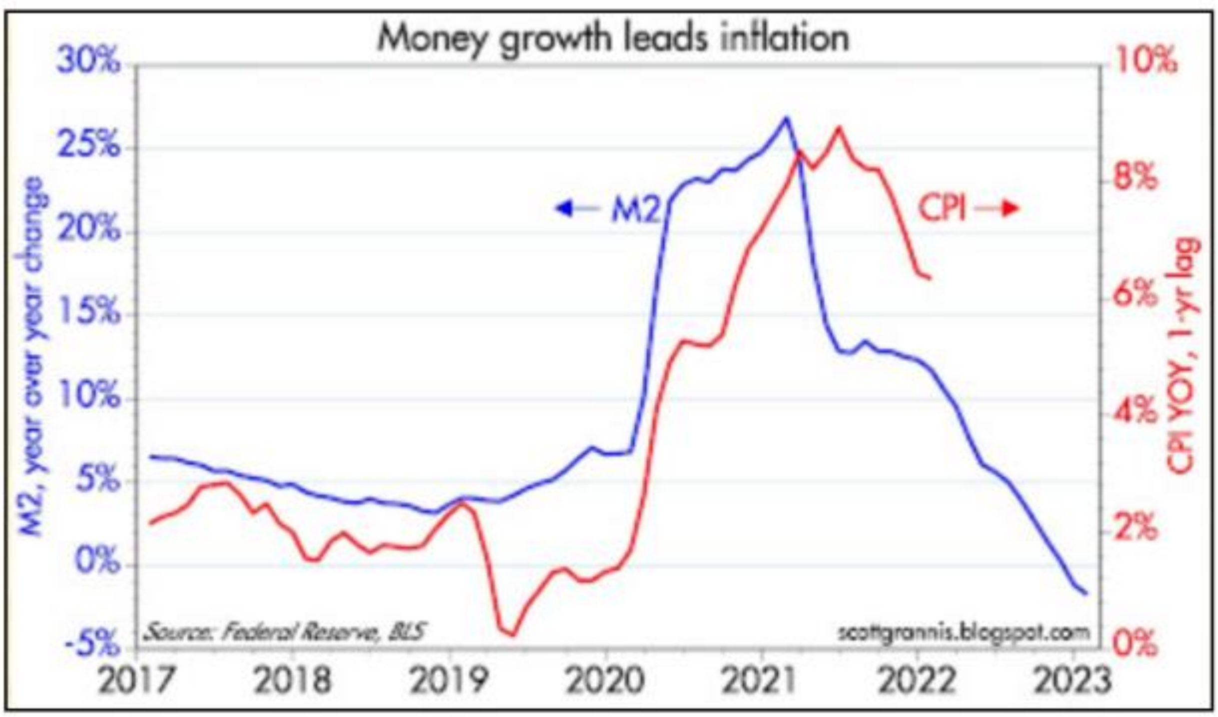
M2 Money Supply and Consumer Price Inflation

Despite what we learned in February, when all the inflationary indicators ticked up slightly (CPI, PPI, PCE), I'm of the view that not only has it, inflation, peaked and is coming down but it could come down a little quicker than most are expecting which would certainly be positive for risk assets. Inflation has been steadily coming off the boil since last summer and nothing in life is linear so I believe what we saw in February was simply a small uptick and I personally wouldn't give it much more thought. Why do you ask? "Money Growth Leads Inflation."

As goes money supply, so goes inflation. Recent data from the Federal Reserve indicates that M2 money supply is falling 2% YoY, down significantly from last year's 26% peak related to stimulus payments during lockdowns. This matters because CPI, consumer prices, ALWAYS, ALWAYS, ALWAYS follows M2 money supply by 6 months.

https://www.longtermtrends.net/m2-money-supply-vs-inflation/

The recent and significant decline in M2 should result in a return to low single-digit inflation over the coming months. Lower inflation means rate hikes will stop, possibly even decline at some point, and asset prices will stabilize and start trending more positive – from homes, to stock and bonds.



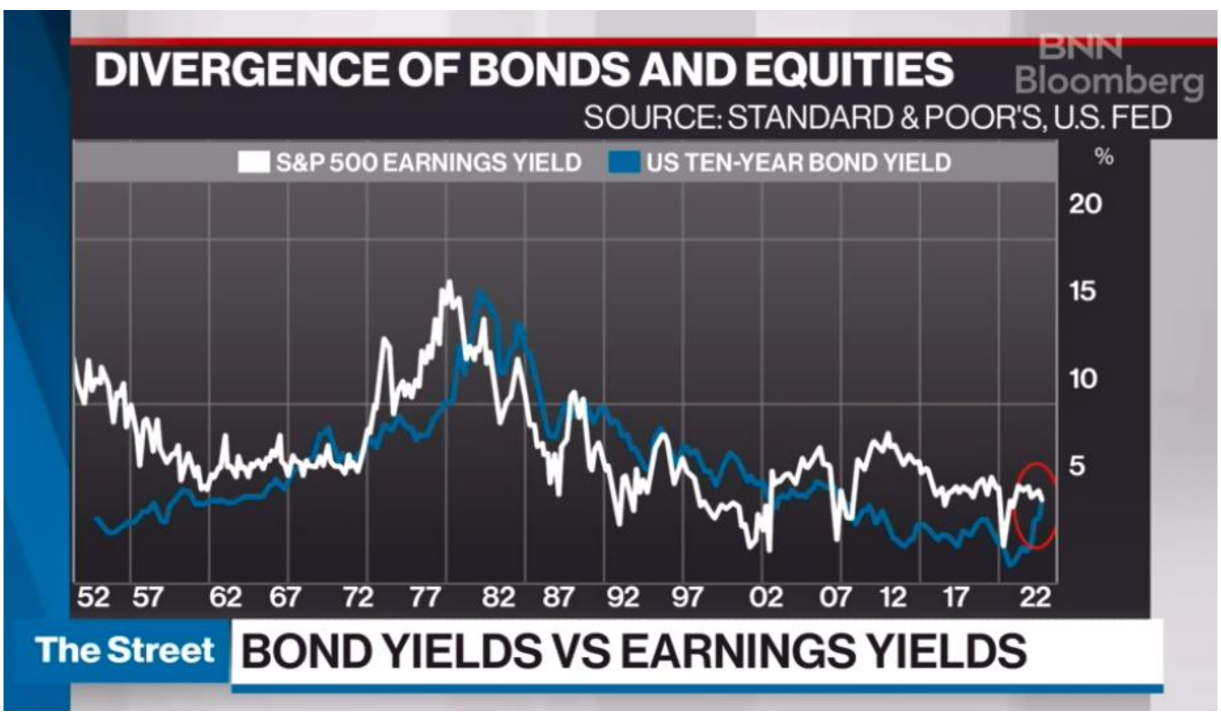
The bond market is effectively telling the same story. Fed fund futures say we may go as high as 5.35%, today we are at 4.75% and last January (2022) we were at 0. In other words, we are another 60 bps away or 2-3 hikes from the federal reserve before they likely indicate a pause. Markets are always forward looking and in terms of where we are today in comparison to where the terminal rate is an optimistic sign for markets.

Bond Yields vs. Earnings Yields

Making the Case for Fixed Income

The P/E Ratio (Price/Earnings) is a popular metric in understanding the valuation of a company. Essentially, the P/E ratio is a valuation metric of a stock indicating how much investors are willing to pay for each $1 of earnings. It also represents the number of years it would take to earn back the price of your investment assuming current earnings do not change. For example, a P/E of 20 would indicate that an investor is paying $20 for each $1 of earnings and in turn, it will take 20 years of current earnings to cover the price you paid. Investing is a touch more complicated than this oversimplified example, but I tell you this so you can understand the inverse equation.

If we take the inverse relationship of the P/E, the same data but flip the numbers around, you will get an E/P (Earnings/Price) and it becomes an earnings yield. Using the same example as above, you would have an E/P of 1/20 or 5%. Unlike the past handful of years, 5% becomes comparable to today's bond market because it is a yield on your money.



So not surprisingly, there is a correlation between bond yields and earning yields. Understand, as bond yields rise, the more it costs to borrow or buy money. In turn, the less money corporations earn and as a result they don't trade as expensively therefore driving their valuation or P/E down. Last year the damage in the stock market wasn't derived from poor corporate earnings rather with interest rates rising it was in large part attributable to valuation compression.

If you refer to the chart above, you may notice from 2008 to 2021 we saw a noticeable divergence between earnings and bond yields. Recall, between this same time, we experienced an ultra-low interest rate environment sponsored by monetary and fiscal stimulus. The monetary support brought on by central banks and government because of the pandemic only helped magnify this divergence. As a result of super low bond yields, the acronym 'TINA' was frequently used in the investing world to elude that 'There is No Alternative' to the equity market. Investors couldn't rely on bonds producing a desirable yield they required inside their portfolio and, in turn to find return, were forced to stretch and take on more risk, via equities, to offset the lackluster bond performance.

On the far-right hand side of the chart is where we are today, and what you may notice is that the lines are coming together. Why I point this out to your attention is because for the first time, in a long time, the stock market has competition with the bond market offering competitive rates. It's true, the fixed income market is meaningful again.

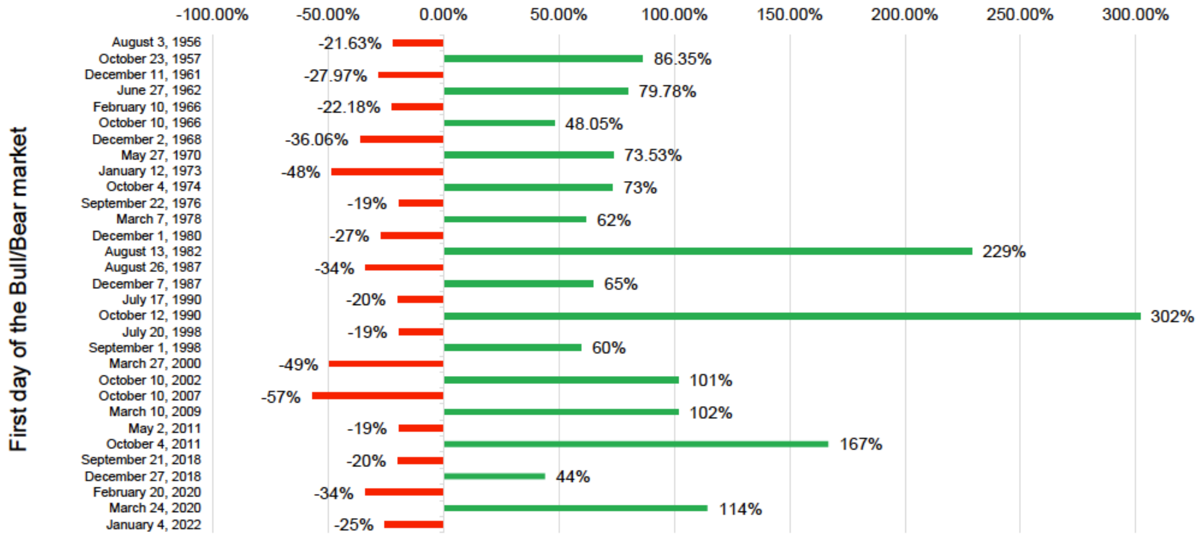
Death and taxes, the only two guarantees in life....Or is there a third?

Within investments there are rarely, if ever, any guarantees. However, one thing we can count on is that every bear market has ended with a new bull market. And since 1950, each of those bull markets have been stronger and have lasted much longer than the preceding bear market.

Have we already hit bottom? Are we in the early stages of the next bull market? Will we hit a third new low of this bear market? Lots of questions and lots of uncertainty when it comes to the equity market.

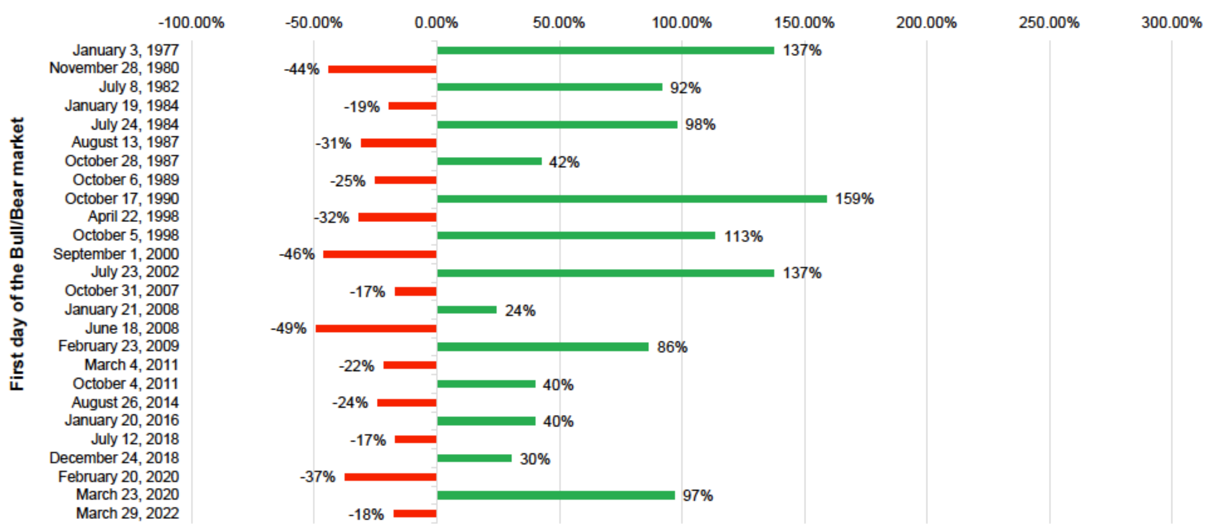
While I believe it is still possible but unlikely to make a new low or even retest the low in October, we are more likely in a period of choppiness in the near term with still some risk to the downside. And perhaps there is a fourth guarantee, that it is impossible to time that next great entry point. A bull market, think as most recent as the COVID bull run, does a wonderful job of not letting you in.

S&P 500 Index Price Returns Bull and Bear Markets (1956 – current)



Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy. As of December 31, 2022

S&P/TSX Index Price Returns Bull and Bear Markets (1977 – current)



Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy. As of December 31, 2022

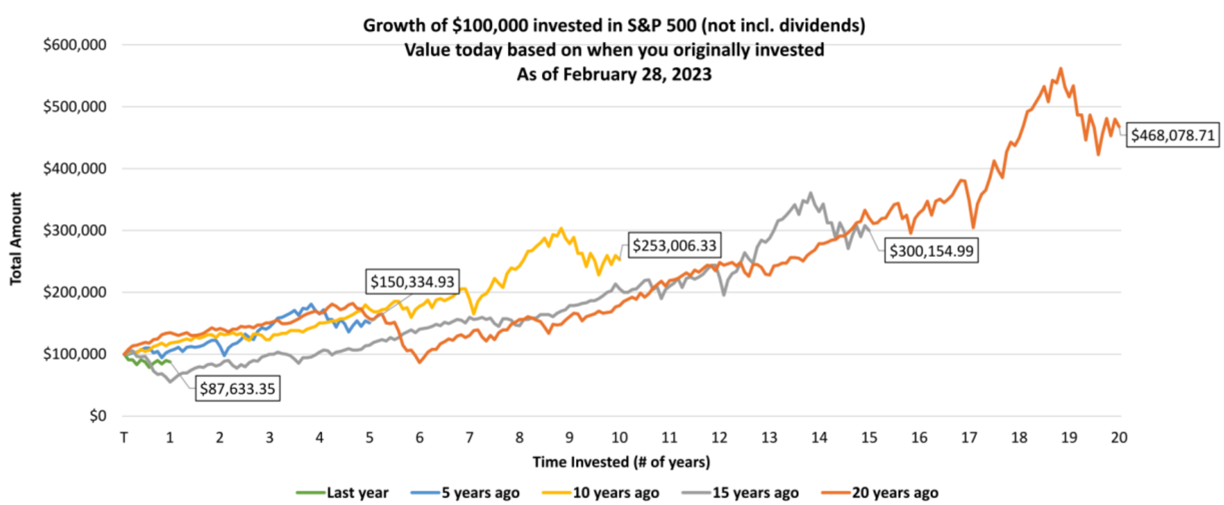
I am reminded of the ancient proverb, "The best time to plant a tree was 20 years ago. The second-best time is now."

Like a tree, investments need time to grow. Markets may continue to be volatile but putting money to work as early as possible will allow the benefits of compounding to take effect.

Although 2022 was a tough year for investments, those that invested only 5 years ago are still positive. An investment of $100,000 - 5 years ago in the S&P 500 is worth $150,334 today.

For those investors that remain hesitant, a good way to remove emotion from your investment strategy is to use dollar-cost averaging. Don't let recency bias cloud your judgement.

Benefits of compounding over time



Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy. As of February 28, 2023

Looking Forward…

Despite a Ying and yang start to 2023, I remain optimistic for the full year for both equities and fixed income as have likely already seen the bottom in both. Investors should continue to expect choppiness over the near term as more data on earnings, inflation, economic growth, and the Fed's ultimate response to those comes to light. In this environment, and as I have been repeating for many months now, I tend to prefer a dollar-cost averaging approach to investing with the flexibility to increase market exposure should we get any material downturns.

Warmly,

Aaron Pedlar, HBA, CHS, PFA