Insights & Strategies

Private Client Solutions

August 2, 2022

Contents

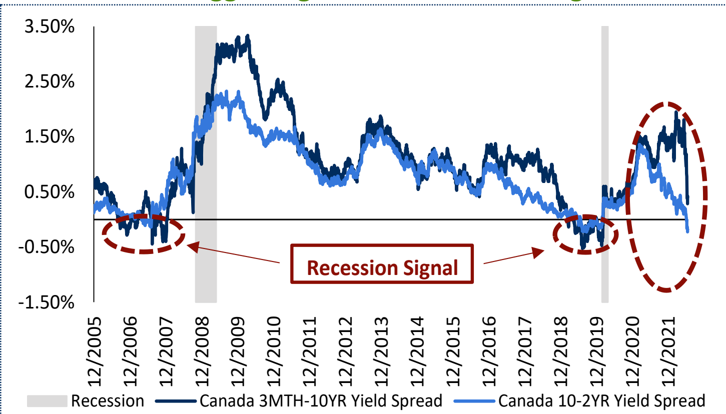
"Winter Is Coming"

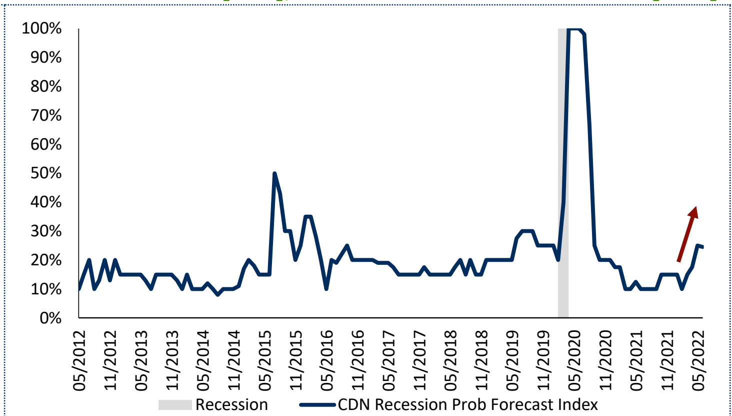
It was House Stark of Winterfell that ruled the North from their fortress in Winterfell, in the hit fantasy TV series Game of Thrones. Ned Stark, also known as the Lord of Winterfell and Warden of the North, popularized the term "winter is coming", which became a common phrase used throughout the series to suggest that tougher times were ahead. While we too expect the upcoming winter to be a harsh one here in the North, in a similar vein, we believe investors should be prepared for a more challenging, volatile, and unpredictable economic and market climate heading into 2023.

Moreover, as we discussed in detail in our latest **Quarterly Asset Allocation report: Stop! Hammer Time**, we continue to anticipate the level of uncertainty to remain elevated as central banks continue to tighten policy despite the growing risks of a hard-landing/recession on the horizon. Canada's inflation rate continues to run hot and remains elevated with the latest reading of the Consumer Price Index (CPI) for June rising +8.1% year-over-year (YoY). We expect CPI readings for the remainder of the year to hover around +7% which is ~2-3x above the neutral range of ~2% that the Bank of Canada (BoC) has historically targeted - the level of inflation which is neither expansionary nor restrictive for the economy. But with the level of inflation well above this target range and labour markets still extremely tight, aggressive policy tightening efforts are currently the only tool the BoC can use to help bring down inflation towards more reasonable levels. However, we remind investors that changes in monetary policy (i.e., rate increases/decreases) not only have a delayed impact on the real economy, but they also do very little to help alleviate temporary and/or structural inflationary impulses associated with China lockdowns, Saudi/Texas drilling, quarantines, refining capacity, war, supply-chain on shoring, etc. We expect this aggressive pace of tightening to weigh heavily on domestic demand, with measures of spending growth falling sharply including with residential investment, which we believe will fall back to pre-pandemic levels.

The bond market, which historically has been a fairly accurate predictor of recessions, is currently signaling a higher risk of a recession for the Canadian economy over the next 12 months. We see the odds of a recession increasing from here, especially if the BoC continues to tighten monetary policy aggressively into year-end.

Bond Markets Suggesting a Recession is Coming: Canada Yield Curve Flattens [LHS]; Canada Recession Odds Rise [RHS]



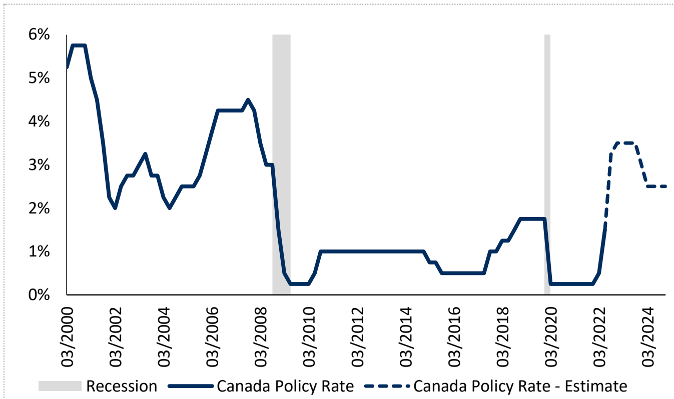


Source: FactSet; Raymond James Ltd.; Yield spread data as of July 22, 2022; Canada Recession Probability as of June 30, 2022.

"There is only one thing we say to ~~death~~ recession: Not today."

While there has been much talk of a recession already underway in Canada, we tend to disagree with this view, though as we noted above, the odds have risen considerably over the past several months. In fact, investors are currently pricing in that the BoC will continue to raise overnight rates to 3.5% (up from 2.5% today), pause, and then begin slashing rates beginning in 2023 as the recession arrives.

What's Priced In - BoC to Slash Rates in 2023 as the Recession Arrives



Source: Capital Economics; Raymond James Ltd.; Date as of July 24, 2022.

Confusing investors further on whether or not a recession has arrived is the sell-off in the S&P/TSX index since the April 2022 peak. This decline has been rather swift with the broad market down -13.3% as of July 22. Comparing this performance to the past two recessions as defined by C.D. Howe Institute, the recent performance of the S&P/TSX has been much larger and has occurred more quickly than during both the 2008/2009 recession and the COVID-19 recession in 2020.

S&P/TSX Performance From 2022 Peak vs. Recessions

Performance	Financial Crisis (Oct 2008 - May 2009)	COVID-19 (Feb 2020 - Apr 2020)	2022 Sell-off from Peak (April 2022 - Current)
Canada S&P/TSX Composite	**8.7%**	**-8.5%**	**-13.3%**
Communication Services	-17.3%	-4.5%	-10.5%
Consumer Discretionary	-6.7%	-10.7%	-4.8%
Consumer Staples	3.7%	-1.0%	-2.0%
Energy	9.5%	-21.9%	-6.3%
Financials	-0.4%	-16.9%	-13.1%
Health Care	-5.1%	-16.6%	-48.2%
Industrials	-7.0%	-5.5%	-6.6%
Information Technology	34.6%	16.8%	-26.9%
Materials	52.0%	19.7%	-29.5%
Real Estate	-5.8%	-23.6%	-13.4%
Utilities	-9.9%	-6.2%	-2.8%

Source: FactSet; Raymond James Ltd; Data as of July 22, 2022. Financial Crisis: October 2008 - May 2009; COVID-19: February 2020 - April 2020; 2022 Sell-off: April 2022 – July 22, 2022.

Moreover, according to the C.D. Howe Institute – considered Canada's most influential and independent think tank **- they define a recession as broadly speaking, a pronounced, persistent, and pervasive decline in aggregate economic activity. In other words, to identify a recession three dimensions need to be considered simultaneously: amplitude, duration, and scope – or how widespread is the downturn.**

While markets have sold off aggressively, with signs of weakness/cracks emerging across several corners of the economy, we do not believe factors present today meet this broad definition of a recession **yet**. That said, we find it interesting that markets and investors have gotten ahead of themselves with investors already discounting a recession. We note, valuations for the broad S&P/TSX index is trading in line with valuations observed during the past two recessions.

Sector Forward P/E: Current vs. Recessions

Median PE NTM (Absolute)	Current (7/22/2022)	Recession*	Premium (+) / Discount (-) vs. Recession
Canada S&P/TSX Composite	**11.5**	**11.2**	**0.3**
Communication Services	17.9	11.7	6.2
Consumer Discretionary	13.0	11.1	1.9
Consumer Staples	16.3	13.6	2.7
Energy	7.9	14.4	-6.5
Financials	9.6	8.3	1.2
Health Care	15.7	12.6	3.0
Industrials	24.2	10.1	14.0
Information Technology	32.2	13.7	18.5
Materials	9.5	15.5	-6.0
Real Estate	15.2	11.7	3.5
Utilities	24.0	15.2	8.7

Source: FactSet; Raymond James Ltd.; Date as of July 22, 2022; *Recession: recession periods identified by C.D. HOWE. October 2008 - May 2009; February 2020 - April 2020.

As we have noted since the beginning of the year, staying **selective**, especially during this period (mid-to-late cycle) in the broader economic cycle, is extremely important. **We continue to prefer sectors that are trading at a discount (green) over those trading at a premium (red) as noted in the above chart.** Moreover, identifying good quality stocks within these sectors may offer investors lower risk to the downside from further valuation declines/multiple compression and/or from downward revisions to earnings as the economy and even global economies slow in the months ahead. On a stock-specific level we continue to prefer high-quality businesses trading at attractive valuations, with durable earnings and cash flows, which are led by strong and reputable management teams. **Stay vigilant, opportunistic, and long-term focused……………………………………………. as winter is coming!**

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

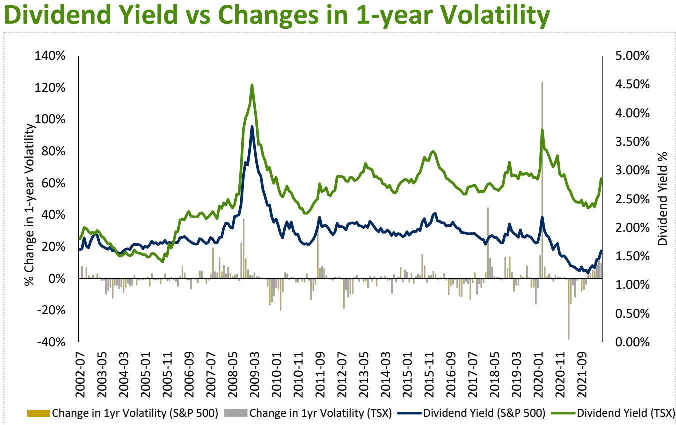
Dividend Opportunities Amid Heightened Periods of Volatility

For a long-term investor, dividends play an important part in the total return for equities, accounting for ~30-40% of the cumulative total return over a 20-year period for standard global equity portfolio. In the analysis below, we will look at how dividend yields change with market volatility, and suggest opportunities on a sector level to take advantage of during these periods of uncertainty.

Dividends are more resilient than earnings during market downturns. Earnings can fluctuate because of changes in profitability, which can be influenced by several factors including product/labour costs (inflation), interest rates, competition, demand, and more. However, management teams are much more reluctant to reduce their dividend per share (DPS) even during periods of market stress, and usually only consider dividend reductions as a last resort. This creates a scenario where, as equity prices fall, the yield increases, and can provide opportunities to purchase companies at a higher dividend yield.

Looking at the correlation between the changes in dividend yields to 1-year implied market volatility, we can see they are positively correlated with the S&P 500 and S&P/TSX index having 20-year correlations of 0.43 and 0.49, respectively. In short, as volatility in markets increase, so do the dividend yield of companies as prices decline.

Dividend Yield vs Changes in 1-year Volatility



Source: Raymond James Ltd., FactSet., Data as of June 30 2022

Sector-level Review

High-dividend paying companies tend to appear across both cyclical and defensive sectors. During market downturns when capital gains are harder to achieve, the dividends received can be considered a return of capital to investors, helping offset losses during market declines. Given the recent volatility in markets, we highlight sectors that have dividend yields greater than their historical average, reflecting an opportunity to deploy new capital and receive a higher dividend yield for the portfolio.

For the S&P/TSX, energy, materials, communication services, and health care sectors all have dividend yields that are over 10% higher than their historical 20-year average. Companies we favour in these sectors are **Canadian Natural Resources (CNQ-CA)**, **TC Energy (TRP-CA)**, **Enbridge (ENB-CA)**, **Nutrien (NTR-CA)**, **Telus (T-CA)**, and **Sienna Senior Living (SIA-CA)**.

For the S&P 500, only two sectors provide a yield above their historical 20-year average, energy and financials. Companies we favour in these sectors are **ExxonMobil (XOM-US)**, **ConocoPhillips (COP-US)**, **BlackRock (BLK-US)**, **JP Morgan & Chase (JPM-US)**, and **Wells Fargo (WFC-US)**.

Sector Dividend Yields For the S&P/TSX and S&P 500

	Jun-2022	20-year Average	Premium/ (Discount)
S&P/TSX	**2.9%**	**2.6%**	**11.5%**
Energy	3.6%	3.1%	16.0%
Materials	1.8%	1.2%	49.1%
Industrials	1.2%	1.6%	-23.5%
Consumer Discretionary	2.2%	2.1%	7.2%
Financials	3.7%	3.5%	7.7%
Information Technology	0.3%	0.3%	-6.6%
Communication Services	4.4%	3.7%	18.0%
Utilities	3.4%	3.9%	-13.8%
Real Estate	3.3%	3.9%	-15.1%
Health Care	1.9%	1.7%	13.6%
Consumer Staples	1.3%	1.3%	3.6%
S&P 500	**1.6%**	**1.9%**	**-15.8%**
Energy	3.2%	2.8%	14.5%
Materials	2.1%	2.1%	0.8%
Industrials	1.7%	2.1%	-16.1%
Consumer Discretionary	0.8%	1.1%	-29.9%
Financials	2.2%	2.1%	6.6%
Information Technology	1.0%	1.1%	-8.1%
Communication Services	1.0%	2.1%	-49.5%
Utilities	3.0%	3.7%	-18.4%
Real Estate	2.8%	3.0%	-6.3%
Health Care	1.6%	1.8%	-13.0%
Consumer Staples	2.5%	2.5%	-1.2%

Source: Raymond James Ltd., FactSet., Data as of June 30 2022

Key Takeaways

Dividends play an important part of a well-diversified equity portfolio over the long term. We recommend investors use periods of higher market volatility to add positions in quality companies at a reasonable valuation, which can increase your portfolio's overall dividend yield.

Peter Tewolde
Equity Specialist

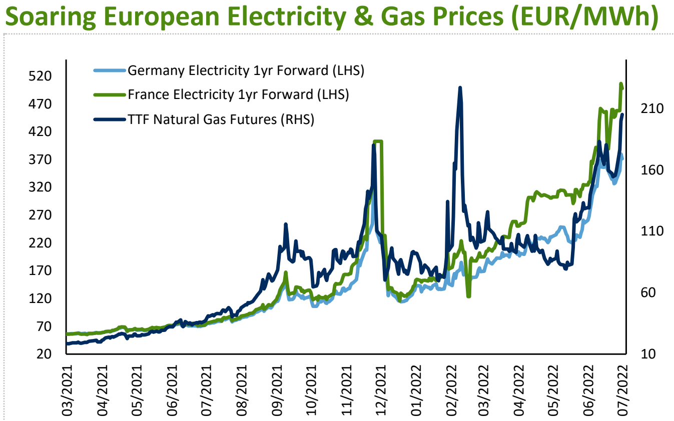
In the Bleak Midwinter

For the first time in over a decade, the European Central Bank (ECB) joined its global peers by raising its deposit rate from -0.50% to 0%. In addition to ending eight years of experimenting with negative interest rates, the ECB also unveiled a new anti-fragmentation tool, the Transmission Protection Instrument (TPI). This tool is designed to ensure that the ECB's monetary policy stance is transmitted "smoothly" and can be activated by member countries to "counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area." In essence, it will attempt to shield indebted countries from elevated borrowing costs. Eligibility will be based on what the ECB calls a "cumulative list of criteria," albeit they are quite vague on the surface. Nonetheless, this puts quite a bit of power in the hands of the Governing Council.

A Troubled Economic Outlook for the Eurozone

The ECB also decided to ditch its forward guidance on rates and will now take a more data-dependent and meeting-by-meeting approach to its policy decisions. This will make the euro more volatile and reactive to incoming economic data and statements from ECB officials. We saw this play out following disappointing July PMI data out of the region. The composite PMI reading, a barometer of overall economic health, slipped below the 50 mark, indicating that it is now in contraction territory. With inflation currently sitting at a record high 8.60% as of June, the road to curbing inflationary pressures will indeed be a bumpy one and we believe the ECB will face an uphill battle on getting interest rates where they need to go. Despite its efforts, there is little the ECB can do to avert a looming energy crisis this winter, coupled with Italy's political turmoil on full display, the Russia/Ukraine conflict, and a challenging backdrop of weaker economic growth, higher inflation and tighter financial conditions.

Soaring European Electricity & Gas Prices (EUR/MWh)

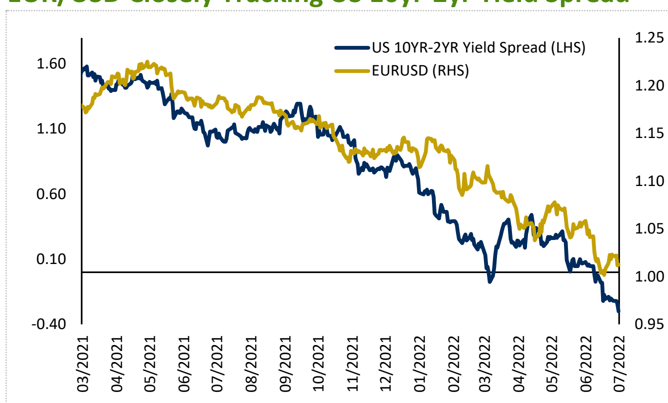


Source: FactSet; Data as of July 27, 2022

Europe's Energy Nightmare Continues to Unfold

One of the most pressing uncertainties facing the region is Russia's continual squeezing of gas supplies to Europe. Russia has been engaged in a game of "gas politics" and is expected to continue weaponizing its natural gas supplies as the continent braces for heightened demand this winter. As Russia continues to limit its flow of natural gas via the Nord Stream 1 pipeline below capacity, benchmark European gas prices have continued to soar, underlining rising recession concerns. One-year out electricity forwards in both France and Germany have hit record highs, and European natural gas futures tied to TTF, the European benchmark for wholesale gas prices, are trading at their highest levels since March when prices hit a record high of €345/MWh. Just recently, EU energy ministers reached a deal that would introduce a 15% reduction in gas consumption across the bloc from now until spring. However, the risk of gas rationing, particularly in Germany, still poses a significant risk for the Eurozone.

EUR/USD Closely Tracking US 10yr-2yr Yield Spread



Source: FactSet; Data as of July 27, 2022

How Low Can the Euro Go?

With a slew of headwinds facing the euro, we expect EUR/USD to remain on the defensive amidst a waning economic outlook for the Eurozone, a relatively more hawkish Federal Reserve, surging energy prices, political turmoil in Italy, and whether the widening spread between Germany and Italy 10yr yields will compel Italy to call on the TPI lifeline. We expect EUR/USD to continue trading around par, with a convincing break to the downside opening up the 0.90-1.00 range of the early 2000's. Interestingly, the recent slide lower in EUR/USD has been tracking the spread between US 10yr and 2yr yields, which continues to trade in inverted territory. This just exemplifies that deteriorating risk sentiment and a cloudy global economic outlook has been a strong factor for EUR/USD performance.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Mutual Fund Style

A common strategy that mutual fund managers utilize to differentiate and attract interest in their funds is to adopt a particular style of investing. The style of investing can vary in many ways, and these characteristics are identified in the fund's prospectus. Some of the most common fund characteristics include whether the fund incorporates a sector, geographic or market capitalization focus. Another distinguishing investment characteristic that is sometimes misunderstood is whether the fund incorporates a value, growth, or blended investment style.

What is the difference?

All else being equal, **value fund managers** seek underpriced opportunities and will typically hold companies that have higher dividend yields and lower-than-average P/E ratios. These types of managers will aim to purchase companies that are trading at a discount to their intrinsic value (even if earnings growth is somewhat modest).

Growth fund managers seek to buy companies that are expected to grow at above-average rates compared to their industry or broader market. Growth-oriented companies will typically reinvest their earnings to expand operations (rather than pay dividends). As a result, it has been common to see many growth managers hold technology, health care and consumer discretionary companies in recent years.

Blended strategies fall in the middle between value and growth. Oftentimes, managers that utilize a GARP (Growth at a Reasonable Price) approach which incorporate elements of both value and growth as they focus on companies with earnings growth but avoid paying high valuations. An example of a strategy that uses this approach is the **Fidelity US Focused Stock Fund**.

Why is it important?

It is important to distinguish which investment style is used because this can have a significant impact on returns. Depending on the investment approach, the fund can have a different level of risk that can lead to a difference in returns (compared to other funds in its peer group). In addition, many times the compensation for a fund manager depends on their ability to outperform a benchmark that is predetermined by the investment style. As an example, within the US Equity category, the **Dynamic Power American Growth Fund** (US Equity growth) utilizes the S&P 500 as its benchmark, whereas the **Epoch US Large Cap Value Fund** (US Equity value) uses the Russell 1000 Value Index as its benchmark. A fund's benchmark can be found in its prospectus.

Performance

Below is the annual performance of IVW (iShares S&P 500 Growth ETF) representing growth-oriented US companies and IVE (iShares S&P 500 Value ETF) representing value-oriented US companies since 2013. Over this time period, we have seen growth outperform value with IVW outpacing IVE in every year except for 2016 and 2019. In addition, whether it is because of increasing rates, inflationary worries or the recent correction in the tech industry, we have seen a revival of value investing YTD after an almost decade-long dominance of growth stocks.

Annual Returns of IVW vs. IVE

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
IVW	32.5%	14.6%	5.4%	6.8%	27.2%	-0.2%	30.8%	33.2%	31.8%	-20.1%
IVE	31.6%	12.2%	-3.3%	17.3%	15.3%	-9.2%	31.6%	1.2%	24.7%	-7.0%

Source: Morningstar, Raymond James Ltd. Data as of July 28, 2022 (USD)

There are many theories and beliefs explaining why value or growth oriented strategies will lead the charge moving forward. Investors have long debated over which investment style is superior, and it appears this debate is still far from over. What is certain is that no one has a crystal ball and only time will tell whether value continues to beat growth for the remainder of the calendar year.

Which Strategy to Use?

Depending on one's investment objective and risk tolerance, both value and growth strategies may be suitable options. For an investor looking to satisfy monthly income needs, a value-oriented manager seeking higher dividend yields will likely be an appropriate solution. For an investor with a longer-term investment horizon and a higher risk tolerance, a growth-oriented strategy may be more appropriate. Lastly, an investor may land in between these styles and, in that case, GARP strategies that incorporate both elements may be best.

Final Thoughts

It is worth noting that as of June 30th, 2022, IVW held a 43.84% sector weighting in the technology sector whereas IVE held an 11.12% in the technology sector. This comes as no surprise as technology companies have traditionally always gone hand-in-hand with growth-oriented strategies. However, depending on tech industry valuations, it is possible that value managers find more opportunities within this sector in the future. In other words, a continued downward trend in technology, coupled with potential slower growth rates could mean that long-standing technology companies (usually found in growth funds) could theoretically start appearing in value funds.

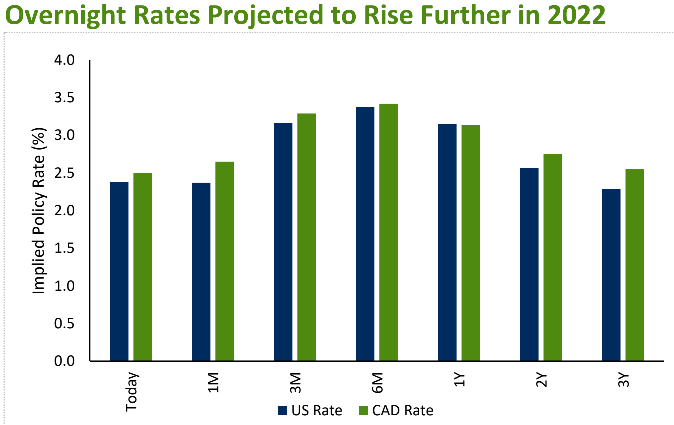
Luke Kahnert, MBA, CIM
Mutual Fund & ETF Specialist

Come On Down!

The phrase "Come on Down!" is often associated with the popular game show, The Price is Right. The host would use the line when an audience member was chosen to be a contestant, giving them the opportunity to win cash and/or prizes. Today we could use this famous statement when looking at inflation, especially after a visit to the grocery store or gas station – a hope that prices fall after months of steady increases. Rising prices have continued to be a headwind despite central bank attempts at fighting inflation by raising interest rates. Given the drastic rate hikes in 2022, investors are left trying to determine what may be already priced in fixed income markets, and more importantly, is the price right to buy now?

As discussed at length in past publications, central banks utilize tools such as monetary policy to attempt to promote consistent economic growth and steady inflation. This can be carried out through raising or lowering interest rates. Taking a contractionary stance, both the Bank of Canada (BoC) and the US Federal Reserve (Fed) have increased overnight rates with larger-than-average amounts at scheduled meetings. Despite these attempts at quelling inflation, the CPI basket continues to increase on a year over year basis at a historic pace. If central banks continue to raise rates in this manner, there is an increasing chance that they overshoot the "right" amount of support for the economy, leading to a hard landing, or recession.

Overnight Rates Projected to Rise Further in 2022



Source: Raymond James Ltd. As at July 27, 2022

When we examine what is priced into the fixed income markets, the answer is, a lot. Consensus estimates for future Canadian and US interest rates is decidedly higher, with the overnight rate ending the year at around 3.4% in both countries. In the coming years, it is predicted that the overnight rate will moderate slightly, back to current levels. With expectations for so many additional rate hikes, it does leave us in a situation where they could under-deliver. BoC Governor Tiff Macklem and Fed Chair Jerome Powell have consistently communicated that their strategies are data dependent. The BoC's mission is to keep inflation in check, whereas the Fed has a dual mandate – they must attempt to maintain price stability while also targeting sustainable employment. If rising prices are still a concern, neither will shy away from bold policy changes to accomplish their mandate(s) – their actions have reflected this stance thus far. If we see inflation die off, the path of rate hikes will be moderated.

We can look at the most recent rate announcements in both countries to see how fixed income markets reacted. On July 13, when the BoC surprised markets with 25 basis point increase more than consensus (100bps vs 75), markets moved very little. On the other hand, last week the Fed delivered a 75bp hike, in line with market expectations. However, the FOMC hinted that future rate hikes may be slower than previously anticipated, causing bond yields to fall and equity markets to rally. This underlines how important expectations and forward guidance can be to the equation in addition to the headline number.

Given the uncertainty of the short to mid term, and the healthy yield increases we have seen when compared to the start of the year, we suggest investors revisit their investments and determine if adding to fixed income holdings makes sense in the context of their portfolio and situation. Those who have delayed fixed income purchases due to the extremely low yields for quite some time may be surprised when they revisit current rates (sample yields below).

Current Fixed Income Yields by Term

Term	Yield	Product Type
90 days	3.05%	Banker's Acceptance
1 year	4.12%	GIC
2 years	4.48%	GIC
5 years	4.65%	GIC
10 years	4.50%	Corporate bond, A rating

Source: Raymond James Ltd. As at July 27, 2022

Ultimately, when evaluating a security, determining if the price is right is no simple task. You need to consider the current situation, future prospects, and both entity-specific and more general factors that can contribute to price fluctuations. On top of that, each investor's situation is unique to them, so a fair price can vary from one person to the next. But for long-term investors, purchasing quality fixed-income securities at reasonable yields can be a great strategy to provide some diversification and stability to one's portfolio.

Charlotte Jakubowicz, CMT
Vice President, Fixed Income & Currencies

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