Insights & Strategies

PRIVATE CLIENT SOLUTIONS

June 1, 2022

Are We There Yet?

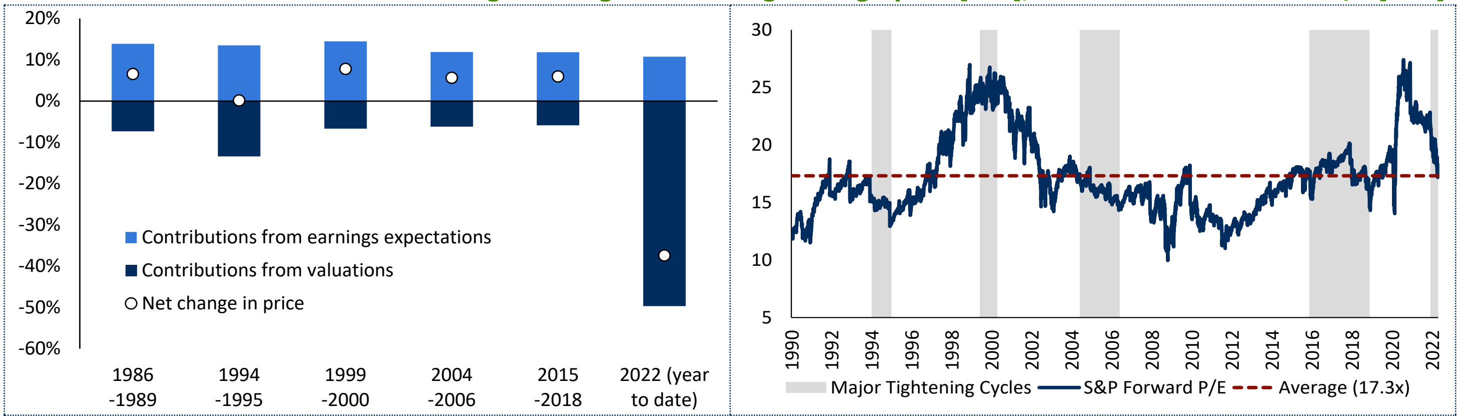
Contents

As the summer holidays approach, it brings back happy childhood memories of the many road trips my family and I embarked on during our summer breaks. I fondly remember the days when my father would enter the living room with such excitement to surprise my sister and I with plans of a road trip adventure, similar to Clark Griswold from the National Lampoon's hit film series. Although, instead of packing up the green wood-panel station wagon, we loaded up our grey 1989 Dodge Caravan with all our travel essentials. My dad even removed the center bench seat so we could sleep on the floor or play games while he drove us to our vacation destination – i.e., our road trip adventure - as he liked to call it.

In those simpler times, with no iPads or iPhones in sight to help pass the time, my sister and I quickly became bored and would annoy my father with frequent requests for washroom breaks, even though in many cases we had just stopped for one. Funny enough, we never had to go at the same time, but my father rarely found the humour in this. And, of course, there was the constant question of, "are we there yet?". My father's response would often be "no son, we are not there yet". I see a parallel to the recent communication we have had with investors who are wondering the same thing, but as it relates to the sell-off in markets and the pick up in volatility observed across asset classes since the start of the year. As we have warned, volatility will remain a key theme for 2022, especially as central banks raise interest rates/tighten policy to cool the economy and, more importantly, inflation, which has soared to levels not seen in almost 40 years!

As demonstrated below, the net price impact to the S&P 500 index during past tightening cycles since the 1980s was flat to positive (i.e., the negative impact from multiple compression due to higher rates was more than offset by positive earnings growth), which has not yet played out the same way during the current tightening cycle. We suspect that this is due to not only the recent pace of interest rate increases, which has been more substantial than in past cycles, but also the extreme starting valuations at the beginning of this tightening cycle versus past cycles (excluding 1999-2000).

S&P 500 Estimated Breakdown of Changes during Historical Tightening Cycles [LHS]; S&P 500 Index Forward P/E [RHS]



Source: Capital Economics; FactSet; Data as of May 26, 2022. All the returns are annualized.

Are We There Yet, No Not Yet!

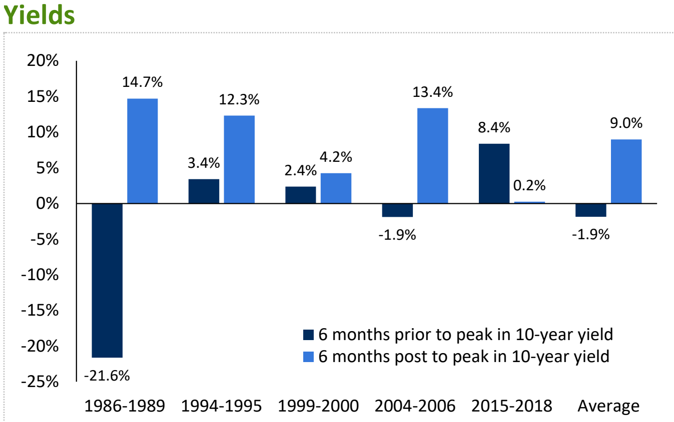
While the sell-off in the S&P 500 index has been ~15% since the peak reached in January, with the compression/contraction in the forward price/earnings multiple for the index largely responsible for the negative return for the index so far this year, we still see further downside to the multiple as the US Federal Reserve (Fed) maintains its hawkish posture/tightening rhetoric. Recent remarks from Fed Chair, Jerome Powell suggests at least two more 50 basis point increases in interest rates at the next couple of meetings scheduled for June 14 and July 26.

Typically, we have observed a trough in valuations around the same time when markets witnessed a peak in long-term bond yields (in particular US 10-year government bonds), which has generally occurred a few months before the last rate hike.

Based on our forecast for the federal funds rate of 2.5% by the end of 2022 versus the current rate of 1.0%, that would place the trough sometime early next year in our view. Equities could, in theory, rally before then if investors' earnings expectations increased sharply. But based on how optimistic those expectations already seem to be, and the many risks/uncertainties on the horizon (e.g., supply chain/labour challenges, COVID-19 lockdowns, consumer mix shifts, the ongoing Russia-Ukraine crisis, China slowdown, etc.), we don't think this is likely.

As we demonstrate below, in the 6-month period prior to a peak in 10-year yields, the S&P 500 index has fallen by an average of 1.9%, and risen by 9.0% in the 6-months post a peak in 10-year yields over the past five hiking cycles. Excluding the 1986-1989 tightening cycle, both the pre-and post 6-month periods have corresponded to an S&P 500 index rising, by 3.1% and 7.5%, respectively.

Change in the S&P 500 Index Pre/Post Peak in 10 Year Yields



Source: Capital Economics; FactSet; Data as of May 26, 2022

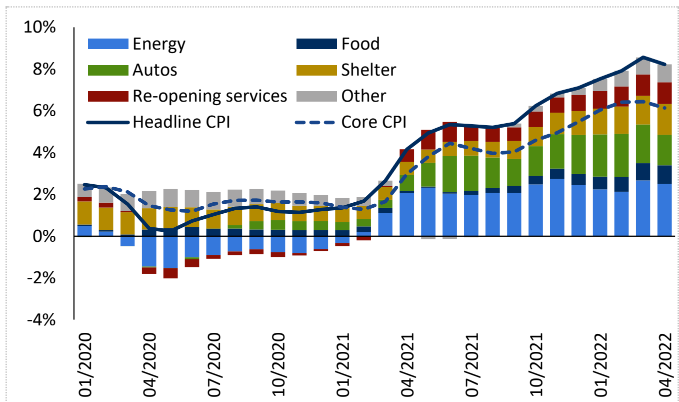
What to Look for When We Arrive…

We believe investors should watch for the following signals to help gauge when the selling pressure has likely peaked out for the S&P 500 index:

1. ***A genuine sign of inflation peaking;***
2. ***The Fed becomes more dovish in its tightening campaign; and,***
3. ***There is greater certainty that a worst-case scenario in Europe and China can be avoided.***

The April US CPI print showed another hotter-than-expected inflation report. Both overall inflation rose (+8.3% Y/Y) with the "core" measure of CPI (at 6.2% Y/Y, which excludes volatile food and energy prices) coming in higher than anticipated. Food, energy, supply-chain constrained goods like autos, and reopening categories (e.g., leisure, travel, etc.) continued to move higher relative to last year.

Contribution to US CPI (% Y/Y)



Source: U.S. Bureau of Labor Statistics, data as of April 30, 2022. Re-opening services include lodging away from home, transportation services, and food away from home.

With inflation still running hot and well above the Fed's 2% target, we expect the hawkish rhetoric to remain relatively strong until there are durable signs of cooling in inflationary pressures. As a result, we expect yields to move higher and remain a headwind for equities. <u>That said, while we have already seen a very big move in rates so far, with a meaningful contraction in valuations for the S&P 500, we suggest long-term oriented investors capitalize on this opportunity to add to their equity allocations. Remain selective, and stick to high-quality stocks/business franchises trading at reasonable valuations and with durable earnings and cash flows.</u>

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

The Retail Selling Frenzy

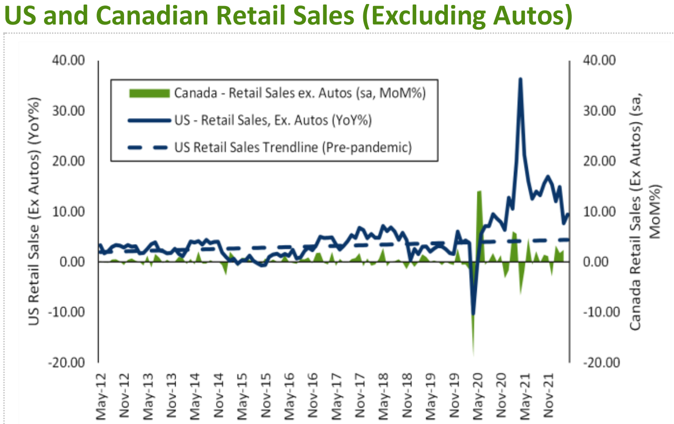
The retail sector in Canada and the US have been negatively impacted by inflationary and supply chain disruptions that continue to remain a headwind for the group in 2022. Companies like Target (TGT-US) and Walmart (WMT-US) have reported earnings and lowered their forward guidance on profitability because of margin pressures from increasing costs and supply chain disruptions. In the analysis below, we will look into the recent quarterly results, company-level growth forecasts, and valuations to identify pockets of risk and highlight some interesting ideas investors could consider.

Macro Indicators – Retail Sales Trends Moderating

In the US, retail spending growth (excluding autos) is moderating but remains above pre-pandemic trends. In Q1/22, demand for goods remained strong despite high price inflation in categories like furniture, sporting goods, and general merchandise. When considering other factors like the current low unemployment rate, wage growth, and strong demand for goods, consumers remain resilient in the face of inflation at current levels. We expect demand to moderate in the near term, but remain supportive of growth in 2022 and 2023 for the sector.

In Canada, headline retail sales came in flat for March, missing consensus estimates. However, excluding autos, which have notably greater supply disruptions than other sub-industries, retail sales grew 2.4%, driven mainly by higher prices and was offset by a modest 1% decline in volumes. The strongest sub-industries were building materials and clothing, which showed the strongest growth from the previous month. The clothing segment was also supported by higher spending in service consumption and return to office employees looking to update their wardrobes.

US and Canadian Retail Sales (Excluding Autos)



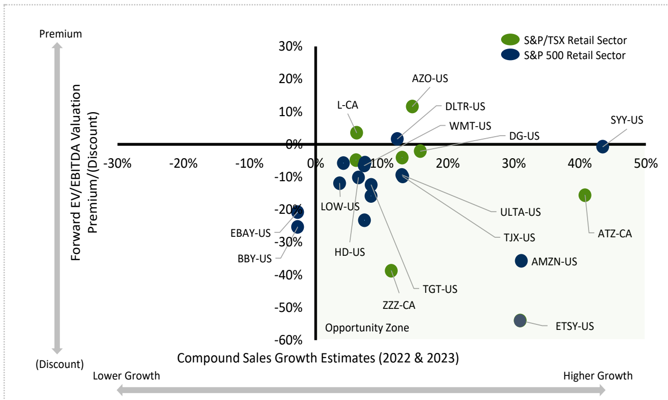
Source: Raymond James Ltd., FactSet; Data as of April 30. 2022

Quarterly Results & Outlook

Looking at the S&P/TSX and S&P 500 retail sectors, there are a total number of 36 companies, 67% of which have reported Q1/22 earnings. Of the 24 companies included in the analysis below, 71% and 67% beat consensus sales and EBITDA estimates, respectively. Sales growth guidance has remained robust, with 92% of the group expected to grow the top-line by an average of 12.9% over the next two years. In terms of valuations for these companies, 88% are trading at a discount to their historical 5-year forward EV/EBITDA multiples.

Below, we have identified firms that have a strong sales growth outlook and are trading at a discount in the bottom right quadrant.

Valuations vs. Consensus Sales Forecasts



Source: Raymond James Ltd., FactSet.

Key Takeaways

The current risk-off nature in markets has resulted in what we view as a compelling risk/reward opportunity within the retail sectors in Canada and the US. The top five names we remain constructive on today include:

- **Amazon.com (AMZN-US);**
- **Canadian Tire (CTC.A-CA);**
- **Home Depot (HD-US);**
- **Target (TGT-US), and**
- **Dollar General (DG-US).**

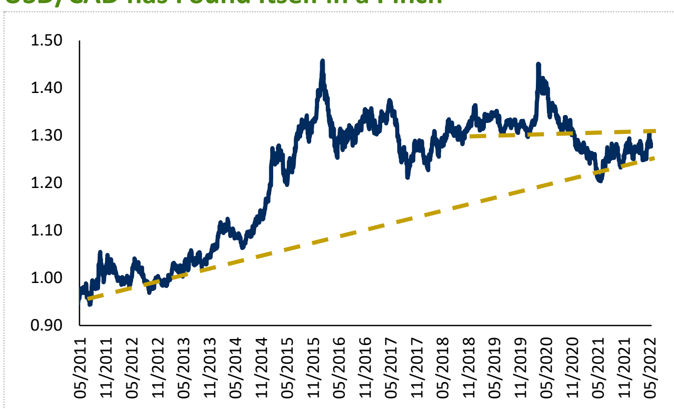
Peter Tewolde
Equity Specialist

Taking A Moment to Pause, Reflect And Recalibrate

The US dollar index (DXY) hit its highest level in nearly 20 years in early May as a combination of aggressive tightening from the Federal Reserve (Fed) and broad risk aversion gripped markets. There are plenty of macro factors to choose from, namely a Fed that is at peak hawkishness, a cloudy economic outlook in Europe, China's "zero-COVID" policy that has disrupted a wobbly recovery in global supply chains, as well as the Russia/Ukraine confrontation and its impact on the commodity space. As a result, we anticipate the USD to remain on the firmer side in the months ahead as financial conditions tighten and the pace of the global economic recovery slows.

Shifting gears to USD/CAD, you can see from the following chart that we have been on an uptrend since 2011. The pair has tested trend-line support at various points in time; however, it fell short of making any convincing break to the downside. To the upside, we are watching the 1.29-1.30 range. The 1.2950 level is an important marker in our view, as this provided some support prior to the 2020 pandemic. When the pair broke through this level in late 2020, it then became a key level of resistance to the upside. It tested this level three times but failed to make a sustained break back to the upside. We believe momentum still points to the upside, given all the macro risks at play.

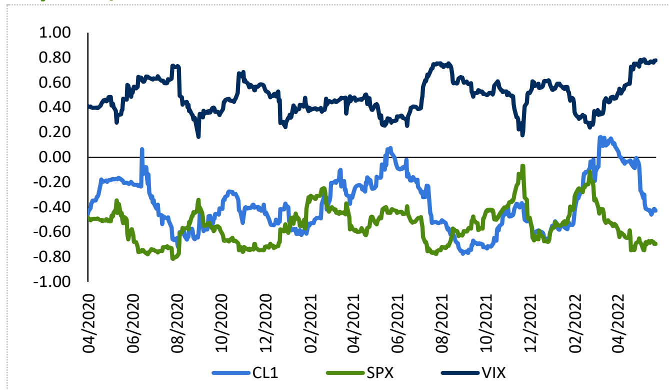
USD/CAD has Found Itself in a Pinch



Source: FactSet; Data as of May 26, 2022

We believe it is also important to explore what has actually been driving the pair. The following chart shows the correlation between USD/CAD and oil (WTI), broader risk sentiment (SPX) and volatility (VIX). It is clear that broader risk sentiment and volatility are in the driver's seat; this may help to explain why CAD has not been able to see more strength with WTI trading north of $100/bbl. Front-end yields are another historically important factor to consider when one looks at relative FX performance. The rise in US front-end yields has been closely matched with that of most other G10 markets, so yield spreads have not necessarily moved in the USD's favour.

Key USD/CAD Correlations



Source: FactSet; Data as of May 26, 2022

So where do we go from here? Well, central banks are moving full speed ahead, which has naturally led markets to worry about a possible hit to growth resulting from higher rates. As for USD/CAD, both the Bank of Canada (BoC) and Fed are expected to tighten monetary policy over the rest of the year. Their respective paths are likely to be close enough to impede any material impacts on USD/CAD, which will leave broad risk sentiment and overall USD direction as the primary drivers for the pair. We believe a realignment to market pricing for the terminal rate for both the Fed and BoC may present an additional two-way risk for USD/CAD. Looking at USD and CAD 1y1y forward swaps, or the interest rate beginning in one year and lasting for one year, the market was expecting terminal rates to be in the 3.5% range back in early May. However, while expectations for both respective terminal rates have declined a bit since, expectations for the BoC remain slightly above that of the Fed. Should the market feel there is a mis-pricing here and that the BoC terminal rate should be lower, then this may lend some additional strength to USD/CAD over time.

Despite the recent strength in the USD, CAD has actually held up relatively well amongst its G10 peers. Therefore, while USD/CAD sentiment remains bullish, the BoC's hawkishness and a supportive economic backdrop may help curb some of the greenback's strength. As for tactical levels to watch, we would consider moves back into the 1.29-1.30 range as opportunities to layer off some USD exposure. To the downside, we are eyeing 1.26-1.27 as a short-term range as this represents a key retracement zone, with trend-line support coming in just below that at around the 1.25 level.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Smoother Roads Using Low Vol ETFs

We've all experienced those long highway road trips where everything seemed to go as planned until we hit a dreadful traffic jam. However, we don't always have to take the highway and sometimes taking the back road, albeit slower, can be a more enjoyable ride. In the same way, we believe Low Volatility ETFs (Low Vol) can offer an alternative route for investors in search of a lower risk option relative to a plain vanilla benchmark ETF.

Low Volatility Portfolio Construction

It should be noted that not all Low Vol ETFs are created equal. Each low vol strategy utilizes a unique methodology to reduce the level of volatility in the ETF, resulting in a wide dispersion amongst peer performance. The one common characteristic of these strategies is their focus on managing risk. Two popular low vol ETF strategies are offered through BMO and iShares. BMO's low vol strategy measures an investment's sensitivity to fluctuations in the broad market by focusing on a metric called beta. For example, the S&P 500 index has a standard beta value of 1.00, whereas an investment with a beta less than 1.00 indicates it has less risk relative to the broad market and vise versa. By constructing ETFs with lower beta securities, BMO aims to reduce market risk in their low vol strategies. Similarly, iShares leverages the MSCI Min Vol methodology, which incorporates several portfolio constraints to help reduce the risk in the ETF relative to the benchmark index. This approach also considers risk metrics and primarily looks at an investment's variance instead of beta.

Taking a Look under the Hood

Using the Canadian and US low vol offerings at BMO and iShares, the following data illustrates how these ETFs have performed relative to the S&P 500 and S&P/TSX benchmark indices over time (Vanguard S&P 500 ETF and BMO S&P/TSX Capped Comp ETF).

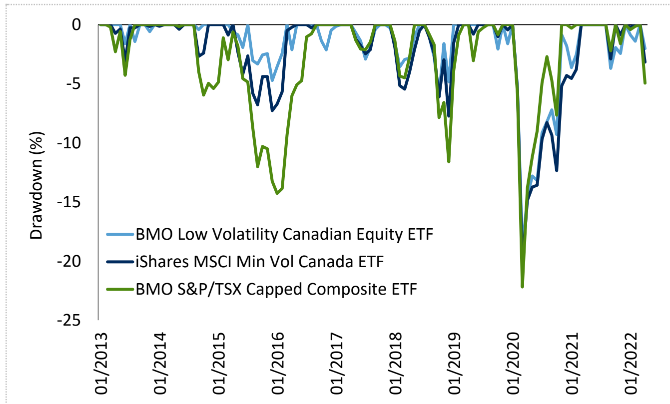
Performance Comparison

Name	Ticker	MER
BMO Low Volatility Canadian Eq ETF	ZLB	0.39%
iShares MSCI Min Vol Canada ETF	XMV	0.34%
BMO Low Volatility US Equity ETF	ZLU	0.33%
iShares MSCI Min Vol USA ETF	XMU	0.33%

	Performance				5 Year Risk Metrics		
Name	YTD	1 Year	3 Years	5 Years	Std Dev	Beta	Sharpe
US Comparison:							
BMO Low Vol US Equity ETF	1.77	16.45	10.78	10.03	10.99	0.59	0.85
iShares MSCI Min Vol USA ETF	-7.89	7.03	6.52	8.73	11.09	0.71	0.74
Vanguard S&P 500 ETF	-11.67	4.32	11.88	11.88	13.17	0.98	0.86
Canadian Comparison:							
BMO Low Vol Canadian Eq ETF	1.14	11.96	10.51	9.06	11.92	0.73	0.72
iShares MSCI Min Vol Canada ETF	2.14	17.17	10.70	8.50	12.26	0.81	0.66
BMO S&P/TSX Capped Comp ETF	-1.34	11.50	11.07	9.13	14.09	0.98	0.63

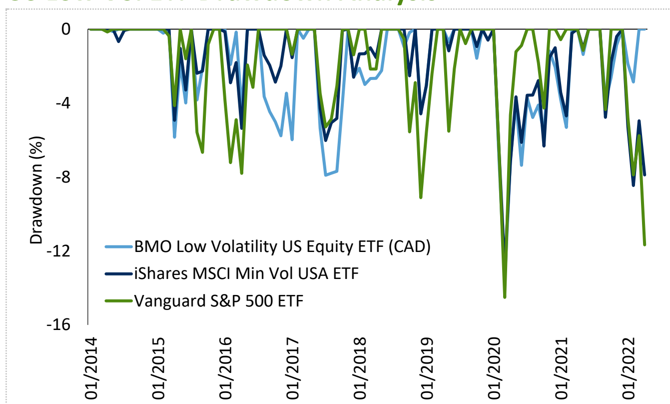
Source: Morningstar, Raymond James Ltd. Data as of April 29, 2022.

Canadian Low Vol ETF Drawdown Analysis



Source: Morningstar, Raymond James Ltd. Data as of April 29, 2022.

US Low Vol ETF Drawdown Analysis



Source: Morningstar, Raymond James Ltd. Data as of April 29, 2022.

How Low Vol ETFs Differ from Index ETFs

- The defensive nature in Low Vol ETFs tends to outperform in periods of heightened volatility and during market selloffs.
- Low Vol ETFs tend to offer better risk mitigation characteristics over the long term.
- Low Vol Canadian ETFs generally have more exposure to the Consumer Staple sector and less exposure to Energy and Materials sectors compared to the S&P/TSX.
- Low Vol US ETFs generally have more exposure to Consumer Staples and Utility sectors with less exposure to the Technology sector compared to the S&P 500.
- The benefit of the low volatility overlay comes at a higher cost/MER than its comparable plain vanilla benchmark ETF.

Luke Kahnert, MBA, CIM
Mutual Fund & ETF Specialist

Navigating An Ever Difficult Bond Market

Are you unsure where to invest assets in this bond market? One disciplined method that financial advisors have been using for years is to use a laddered approach. Using this strategy, investors only need to decide the issues and longest term to invest (furthest maturity). We would suggest, at this time, to invest in a 1-5 year ladder made up of corporate issues. We like the term of a maximum of 5 years because of the flatter yield curve that is currently present. We also prefer investment-grade corporates over governments bonds given the yield pickup of 85-120 basis points.

Bond Ladders as a Solution

A laddered portfolio is structured by purchasing several bonds with consecutive maturities (often annual maturities). As each bond matures, proceeds are reinvested in a new bond having a maturity that corresponds with the longest term on the ladder, which often is near the highest point of the yield curve. Bond ladders containing non-callable bonds may be more predictable as the term of the investment is fixed. Within a laddered portfolio, investors may choose to stagger interest payment dates to create a monthly income stream, allowing for a recurring income stream throughout the year.

Bond ladders provide the benefit of blending higher long-term rates with short-term liquidity. The resulting diversification helps to reduce risk, improve returns and allows for reinvestment flexibility, while also providing liquidity and a predictable cash flow stream. Therefore, if rates rise, investors can take advantage of rising rates, and if rates fall, investors are reinvested 1 year longer than the longest maturity in the portfolio. During a rising rate environment, investors have the opportunity to take advantage of the best rates available at the time of reinvestment.

Sample Laddered 1-5 year Portfolio

Issuer	Cpn Rate	Maturity	Rating	Par Value	YTM	Term	Duration
BNS bail-in	2.38%	1-May-23	AA low	$ 10,000	3.10%	0.92	0.90
BMO bail-in	2.85%	6-Mar-24	AA low	$ 10,000	3.49%	1.77	1.70
Wells Fargo & Co.	3.87%	21-May-25	A high	$ 10,000	4.18%	2.98	2.78
SmartCentres REIT	3.44%	28-Aug-26	BBB high	$ 10,000	4.45%	4.25	3.86
Royal Bank bail-in	2.33%	28-Jan-27	AA low	$ 10,000	3.96%	4.67	4.31
Total Portfolio (weighted)			A high	$ 50,000	3.83%	2.89	2.69

Source: Raymond James Ltd. Values as at May 25, 2022

A New Bank Bond

The portfolio above contains some Canadian bank bail-in issues; systemically important Canadian banks can no longer issue deposit notes into the market that are longer than 400 days in term. There are a few additional key differences between these types of bonds:

- **Credit rating:** Bail-in debt is rated one notch below deposit notes of the issuer because if there is a "Non-Viability Event" that affects the Total Loss Absorbing Capacity (TLAC), and all the issuers' NVCC debt has been converted to shares already, then OFSI can decide to convert bail-in bonds to shares of the underlying issuer. We think this is a very remote possibility and is worth the risk.
- **Yield pickup:** you are compensated for the "risk" which is approximately 35-50 basis points depending on term.

For investors looking for additional ideas or a single ticket solution, consider the Raymond James Moderate Guided Portfolio. The Moderate portfolio currently has a modified duration of approximately 4.04 years and is a laddered diversified portfolio from 3 years to 5 years in term.

Moderate Guided Portfolio Holdings

Issuer	Cpn Rate	Maturity	Rating	Par Value	YTM	Term	Duration
TD Bank NVCC	3.105%	22-Apr-25	A	$ 10,000	4.22%	2.90	2.72
Thomson Reuters	2.239%	14-May-25	BBB high	$ 10,000	3.79%	2.96	2.82
Wells Fargo & Co.	3.874%	21-May-25	A high	$ 12,000	4.18%	2.98	2.78
SmartCentres REIT	1.740%	16-Dec-25	BBB high	$ 12,000	4.27%	3.55	3.35
Bell Canada	2.900%	12-Aug-26	BBB high	$ 11,000	4.01%	4.21	3.87
Cdn Natural Resources	3.420%	1-Dec-26	BBB high	$ 12,000	4.02%	4.51	4.06
Royal Bank Bail-In	2.328%	28-Jan-27	AA	$ 12,000	3.99%	4.67	4.31
Enbridge Inc.	3.200%	8-Jun-27	BBB high	$ 12,000	4.33%	5.03	4.50
Prov. Ontario	1.050%	8-Sep-27	AA low	$ 15,000	3.12%	5.28	5.04
Hydro One Inc.	1.410%	15-Oct-27	A high	$ 14,000	3.68%	5.38	5.08
Brookfield Infastructure Fin.	4.193%	11-Jun-28	BBB high	$ 12,000	4.48%	6.04	5.17
Total Portfolio (weighted)			A low	$ 132,000	4.03%	4.39	4.04

Source: Raymond James Ltd. Values as at May 25, 2022

Speak to your financial advisor for more details on constructing a bond ladder or a customized fixed income portfolio.

Harvey Libby
Head Trader, Fixed Income

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