GUARDIAN CAPITAL

Economic Outlook

Fall 2022

SUMMARY

- The year so far has been a victim of expectations — once again, as is almost always the case, things rarely ever turn out as great as hoped.

- But that disappointment — and again, things in general are good, if not as good as anticipated at the outset of the year — has bred rampant pessimism that seems to be skewing the risks in the other direction.

- This sort of backdrop sets up the potential for a positive surprise (for example, end of the war in Ukraine or a shift toward a more pro-growth stance in China) since the flip-side to the truism of high expectations is that it is also rarely, if ever, the case that things end up being as bad as feared. A recession may well materialize, but it appears as though it will be a mild and short-lived lull rather a deep and long-lasting hit.

- From a market perspective, a lot of "bad" has already been priced into markets, suggesting that risks for forward performance may well be asymmetric. There is definitely a possibility that bonds and equities could continue to struggle, but the magnitude of the declines so far, and the fundamentals underlying the outlook, suggest that any further weakness would be comparably limited, while there is room for upside.

- Clearly, the outlook warrants caution, but the broad valuation adjustment across asset classes has created ample opportunities for active investors with longer time horizons — the near term is likely to see volatility persist, but there is scope to anticipate that performance broadly improves in the year ahead.

- As such, it appears prudent to maintain a continued bias toward more conservative and high-quality investment strategies, but with potential for adding to risk exposures as the market outlook is likely brighter than that of the broader economy — and it is the case that forward-looking markets typically find their bottom first.

Managing expectations

More than anything, high initial expectations and subsequent significant revisions to the outlook have been the reason why 2022 has proven to be such a challenging year for markets.

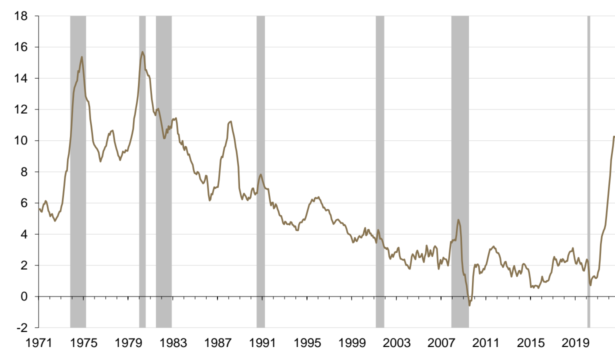
At the outset of the year, general economic momentum was solid and hopes were high as the significant headwind of the pandemic that plagued the last two years appeared to be subsiding.

The positives for economic activity associated with the further rollback of public health restrictions, however, have been restrained by the impact of broadly rising price pressures — in part a function of lingering pandemic-related supply chain issues, related supply/demand imbalances (crisis-era stimulus underpinned spending), and exacerbated by Russia's invasion of Ukraine, which drove a surge in commodity prices.

The generationally high inflation rates that have resulted across the world are eroding spending power and create the real risk of more permanent demand destruction should they persist and cause expectations to become unanchored.

CHART 1: LIVING WITH THE COSTS

Consumer price inflation, OECD[1]
(year-over-year percent change in consumer price index)

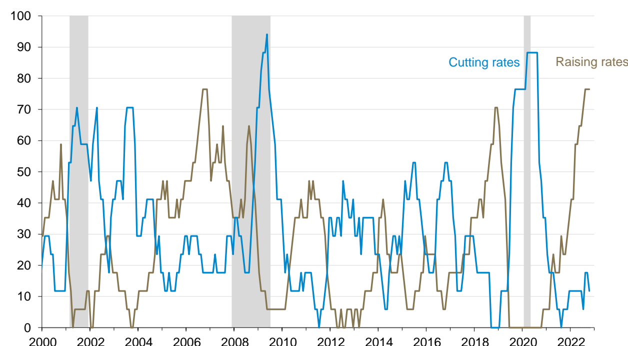


Source: Guardian Capital based on data from Organisation for Economic Coordination and Development and Bloomberg to September 2022; shaded regions represent periods of US recession

In response, global central banks — whose hopes that pressures would prove fleeting were disappointed — have been forced to undergo an aggressive shift in their approach to policy this year. This shift, especially in recent months, has seen sharp increases in policy rates and guidance that further tightening is in the offing in the months ahead and rates will remain elevated for longer. No more zero rates or gradual tightening.

CHART 2: POLICY TURNAROUND

Central bank policy rate direction, G20[2]
(6-month rolling percent of G20 central banks)

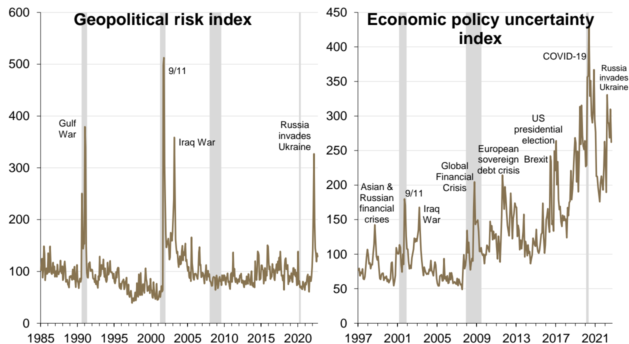


Source: Guardian Capital based on data from Bloomberg and the Bank for International Settlements[3] *to October 21, 2022; shaded regions represent periods of US recession*

As well, geopolitical tensions have been increasing and spurring rising uncertainty with respect to global economic policy. In addition to the shock from Russia's aggression, concerns are rising about the consolidation of power in China following the recently-adjourned National Congress; relations between the US and Saudi Arabia have tensed amid a disagreement over oil production, and the UK's domestic political backdrop is exceptionally unstable. Add to this, political uncertainty surrounding elections in the Emerging Markets (EM), where incumbents have been rebuked in favour of more populist candidates (Brazil's election was the latest to see the sitting leader replaced), and the US midterms.

CHART 3: RISKS ABOUND

Geopolitical risk index[4] & Economic policy uncertainty index[5], World
(index; pre-2019 average=100) (index)

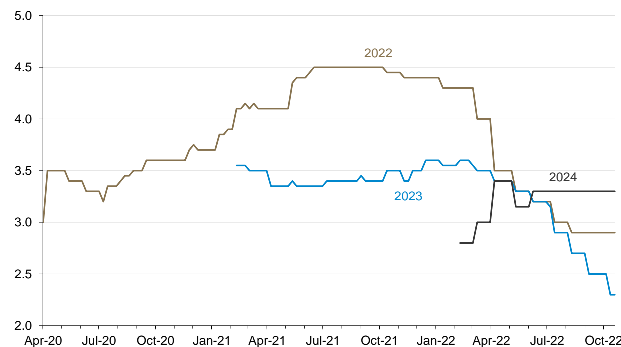


Source: Guardian Capital based on data from PolicyUncertainty.com to September 2022; shaded regions represent periods of US recession

All of these factors have combined to further constrain growth momentum that was already on track to slow, as the economic cycle graduated from last year's "recovery" to the "expansion" phase, resulting in increasingly sharp downgrades to growth forecasts this year, and more notably, 2023.

CHART 4: KNIVES OUT

Consensus real GDP growth forecasts, World
(percent)



Source: Guardian Capital based on data from Bloomberg to October 21, 2022

Expecting the worst

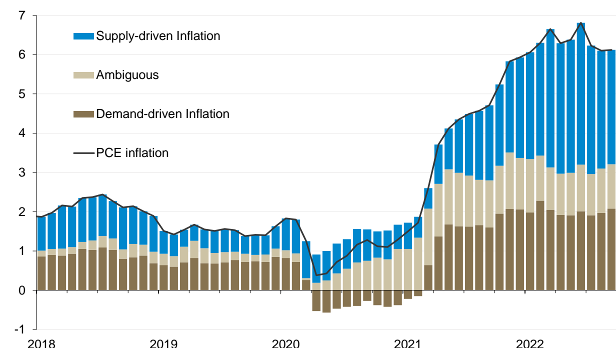
Embedded in the waning growth expectations are rising odds that policymakers are unable to navigate a "soft landing" — an outcome where inflation is tamed and growth is sustained — instead piloting a harder fall where economic activity declines outright.

Concerns about such an adverse outcome — in which demand declines, corporate profits fall, credit quality deteriorates, and unemployment rises — are even more top-of-mind lately. That is, it is a given that every recession in the post-World War II era has the fingerprints of central banks on it as policymakers have done too much too quickly to rein in surplus demand, instead pushing into deficit and the economy over the edge.

The risk of a policy mistake looms large in the current environment given that issues on the supply side — which is largely immune to monetary policy in the short term (central banks cannot immediately boost commodity supplies or smooth out kinks in supply chains) — share the blame for the current inflation pressures. For example, the Federal Reserve Bank of San Francisco estimates half of the increase is due to the supply side, while the impact is larger in Europe against the energy crisis there.

CHART 5: SHARING THE BLAME

US personal consumption expenditure inflation by source
(year-over-year percent change)

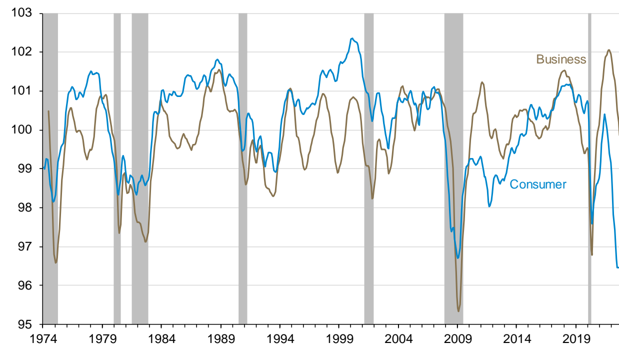


Source: Guardian Capital based on data from Federal Reserve Bank of San Francisco to September 2022

The prospect of a broad and sustained downturn is clearly less than ideal and the increasing prevalence of the word "recession" in commentaries and discussions, no doubt, has been a factor behind sentiment among both consumers and businesses falling sharply so far this year. In fact, more so for the former, which has plunged across the aggregated OECD to levels never before seen.

CHART 6: HURT FEELINGS

Consumer & business confidence, OECD
(index; long-term average = 100)



Source: Guardian Capital based on data from the OECD to September 2022; shaded regions represent periods of US recession

With that in mind, it seems to be the case that recency bias is skewing general views about what a recession means. Despite the experiences of the last two decades, a downturn in growth does not necessarily have to represent a significant shock that carries lasting implications — instead, it can just be a temporary lull in the cycle.

In general terms, aside from exogenous shocks (i.e. pandemics or wars), recessions are the result of significant financial imbalances and excesses.

In these scenarios, central bank-induced increases in costs of capital make overextended financial positions untenable and force an unwind that creates negative spillovers — and the extent of the hit is a function of the magnitude of the imbalance.

As things currently stand, central banks are for sure playing their role by aggressively tightening monetary policy, but there are limited indications of significant imbalances — there have absolutely been pockets of excess but no signs of the type of systemic misallocations of capital that preceded the Tech Wreck and Global Financial Crisis.

The apparent absence of significant imbalances could mean that things are not likely to go completely off the rails if the persistent headwinds push growth off track, mitigating the risk of a deep and long-lasting hit that weighs on markets.

Further to this point, when seemingly everybody is on the lookout for a significant shock to the system and acting with caution by limiting risk exposures, the odds of such an outcome are greatly reduced.

Or, put more colourfully, if all crew and passengers are vigilantly watching for icebergs, it makes it unlikely that the ship will hit one dead-on — though, given that the bulk of an iceberg is hidden from plain sight, there is no guarantee that a more glancing blow can be completely avoided.

Moreover, as the weight assigned to the possibility of worst-case scenarios has increased in recent months and the bar of expectations has been lowered, it has (perhaps unsurprisingly) been the case that general dataflow has proven to be consistently better than anticipated.

CHART 7: A PLEASANT SURPRISE OF LATE

Economic surprise index, World
(diffusion index; >0 denotes “better than expected” dataflow)

Source: Guardian Capital based on data from Bloomberg to October 21, 2022; shaded regions represent periods of US recession

Differing opinions

To this point, the focus has been broad, and while the slowdown appears fairly synchronized, the risks to the outlook are not quite evenly distributed across the world.

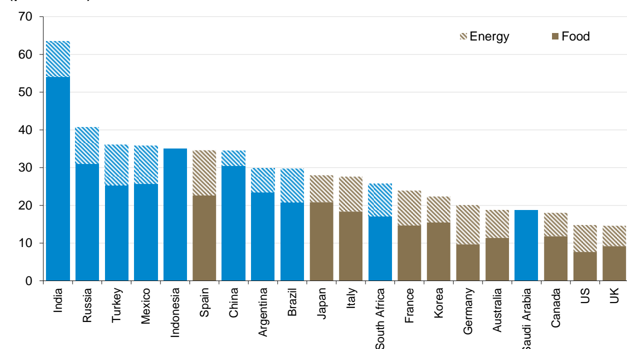
First off, the nature of the inflation differs from region to region. While things may indeed be tough all over, the underlying drivers of price pressures vary and create different risks to the outlook.

The surge in prices for energy and agricultural commodities this year, in response to the war in Ukraine, has disproportionately impacted those economies that are more sensitive to higher costs of the necessities of life.

The pain is particularly acute across EM where grocery and gas bills account for relatively large shares of household budgets, but also notable among Developed Markets (DM) across Europe and Asia. DM are highly dependent on energy imports to meet domestic needs; the fact that Europe, in particular, is so dependent on Russia for oil and gas makes the situation even more difficult there as the potential for supply shortages looms.

CHART 8: THE BARE NECESSITIES

Share of consumer price index on food* & energy, G20**
(percent)



**food= food and non-Alcoholic beverages; **energy= Electricity, gas & other fuels and fuels & lubricants for personal transport equipment. Source: Guardian Capital based on data from the OECD for the year 2021*

This makes inflation among these regions more "cost-push" — not so much the product of excess demand but driven by supply-driven costs of living.

In contrast, inflation on this side of the Atlantic Ocean is more a function of "demand-pull". The Canadian and American economies have generated stronger growth since the onset of the pandemic, in no small part due to their respective governments having provided comparatively generous support to fill the income void caused by lockdowns.

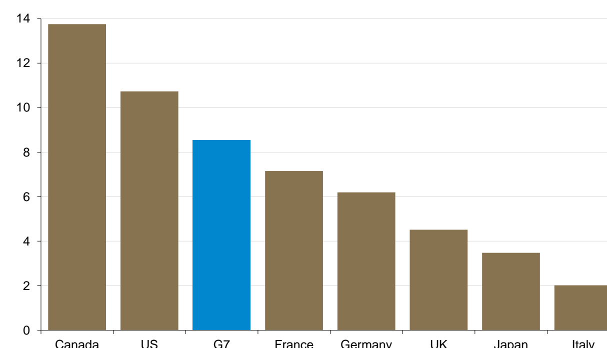
The combination of the unprecedented transfer of funds from the government to households and a rapid recovery of labour markets with reopening underpinned demand throughout the pandemic.

Even more, the restrictions that constrained spending (especially on services, which accounted for two-thirds of household budgets prior to the pandemic), meant that a substantial stockpile of savings was generated.

Since the start of 2020, households across the G7 cumulatively socked away nearly US$4 trillion in savings over and above pre-crisis trends — that is a stockpile equivalent to almost 9% of the value of the output of these key DM economies, with a noticeable skew toward North America.

CHART 9: SAVING GRACE

Excess* personal savings, G7
((percent of nominal gross domestic product))

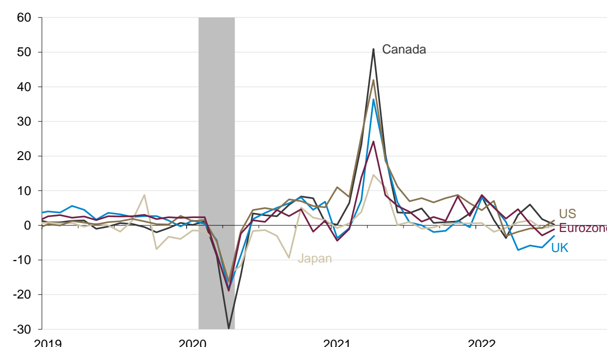


**Cumulative personal savings from Q1 2020 to Q2 2022 in excess of 1999 to 2020 trend savings rates. Source: Guardian Capital based on data from Bloomberg and the OECD to Q2, 2022*

That enhanced rainy day fund has given added support to consumer spending in the face of rising price pressures — no doubt a factor in the divergence in real (i.e. inflation-adjusted) retail sales seen this year, with Canada and the US sustaining growth while activity in Europe has slumped.

CHART 10: SPENDING TIME

Real retail sales growth
(year-over-year percent change)



Source: Guardian Capital based on data from the OECD to July 2022; shaded region represents a period of US recession

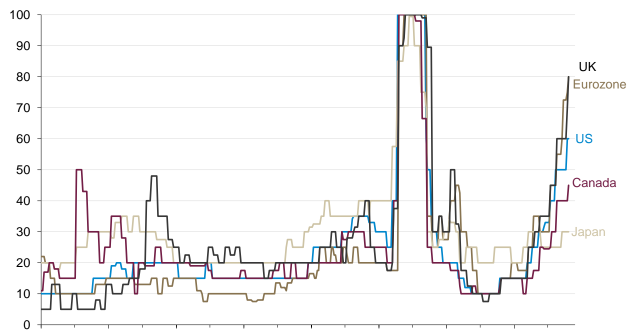
As mentioned, supply cost-driven inflation is more difficult for central bankers to address and raises the risk of a policy mistake — rising costs of capital just aggravate cost pressures that are already impinging on activity and accelerate the decline.

Central banks, however, have more margin for error in an environment where prices are rising due to "excess demand" as there is more capacity to absorb the impact of tighter financial conditions.

This, combined with the comparably slower growth momentum, is why the estimated probabilities of an imminent recession are higher in Europe (now viewed as a near certainty) and closer to a coin flip for Canada and the US. Odds are lowest for Japan, one of the few countries in which inflationary pressures remain relatively benign and their central bank remains on the sidelines.

CHART 11: RISING RECESSION RISKS

Consensus-expected probability of recession in 12 months
(percent)



Source: Guardian Capital based on data from to October 21, 2022

Cutting costs

It should be evident at this point that the road ahead is largely going to be determined by how consumers are able to manage in the months ahead.

One positive for the outlook is that underlying cost pressures are showing signs of subsiding.

Commodity prices, while remaining elevated, have fallen more than 20% in aggregate from the highs hit in the second quarter.

CHART 12: A LESS HOT COMMODITY

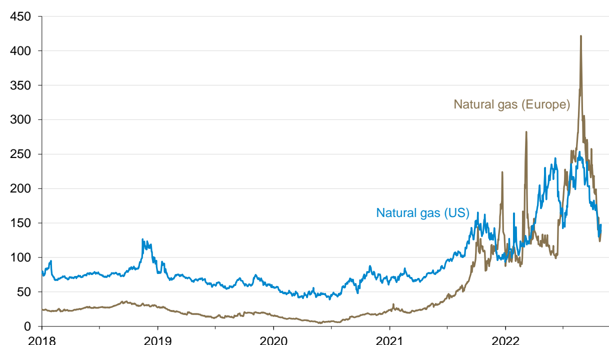
S&P Goldman Sachs commodity price index
(index)

Source: Guardian Capital based on data from Bloomberg to October 21, 2022; shaded regions represent periods of US recession

More positively for the beleaguered Europeans, energy prices have fallen sharply in recent months after governments met their commitment to build inventories early to protect against Russia-related supply shutdowns ahead of peak winter usage.

CHART 13: LOSING ENERGY

Natural gas benchmark prices
(index; January 3, 2022 = 100)



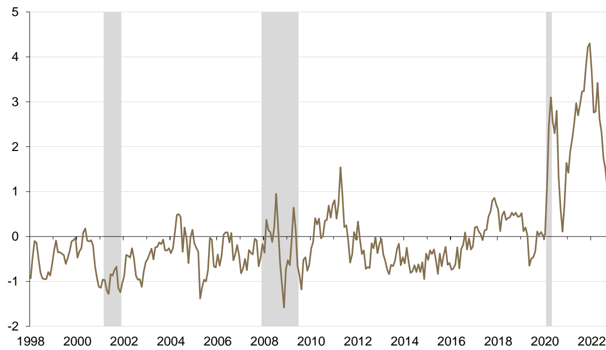
Source: Guardian Capital based on data from Bloomberg to October 21, 2022

There are growing indications that the pressures on other links within the global supply chain are easing as well. Production is increasingly able to run at a higher capacity as public health restrictions are scaled back globally, goods are flowing more freely as shipping bottlenecks subside (easing shipping costs) and transportation hubs face less congestion.

The aggregated gauge of global supply chain pressures compiled by the Federal Reserve Bank of New York has moderated notably in recent months and is within reach of historically "normal" levels.

CHART 14: PRESSURE RELEASE

Supply chain pressure index, World
(standard deviations from the series' average)

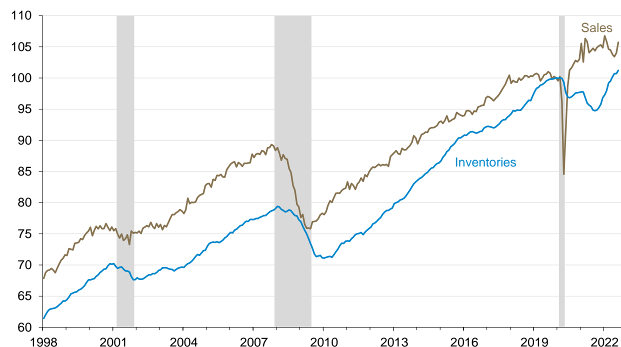


Source: Guardian Capital based on data from Federal Reserve Bank of New York to September 2022; shaded regions represent periods of US recession

These easing supply constraints have allowed businesses to rebuild inventories that were depleted in efforts to meet the earlier surge in demand for goods. That this has come as consumer spending transitions back in favour of the previously restricted (and lower inflation) services, that dominated the household budget prior to the pandemic, points to more balance that will lead price pressures to ebb.

CHART 15: PLAYING CATCH-UP

Total business* real inventories & sales, US
(index; December 2019=100)

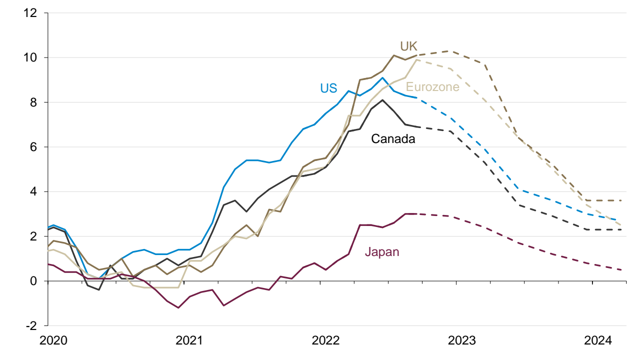


**Total business=manufacturing, whole & retail trade. Source: Guardian Capital based on data from US Census Bureau to August 2022; shaded regions represent periods of US recession*

Taking it all together, these trends support the view that inflation is either at its peak (Europe) or past it (everywhere else), and appears likely to trend lower to something more broadly consistent with central bank inflation targets through the next year.

CHART 16: GOING DOWN…

Consumer price inflation
(year-over-year percent change)



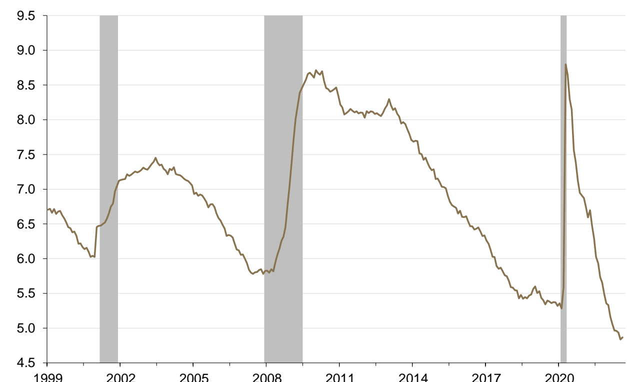
Data to September 2022; dashed lines are Bloomberg consensus forecasts as at October 21, 2022. Source: Bloomberg, Guardian Capital

Income & wealth

Lower inflation would boost real household incomes, which are already getting support from drum-tight labour markets worldwide, with unemployment rates plumbing historical lows across the globe.

CHART 17: TIGHT AS A DRUM

Unemployment rate, OECD
(percent)



Source: Guardian Capital based on data from Organisation for Economic Coordination and Development and Bloomberg to September 2022; shaded regions represent periods of US recession

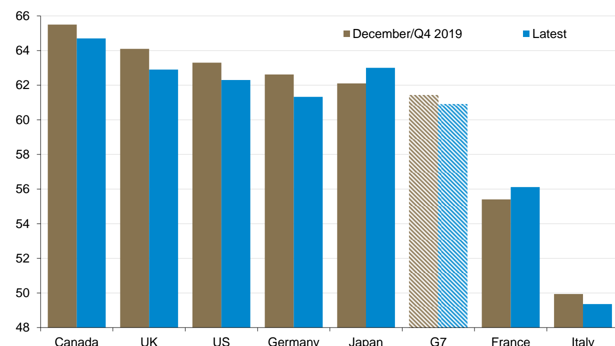
Demand for labour has been strong as economies reopened — with countries like Germany, Japan, Canada, and most notably, the US seeing record highs in job openings — but this has not been met with a commensurate increase in the supply of workers. One of the main issues facing businesses worldwide is widespread job shortages.

Labour force participation has struggled to return to pre-pandemic levels across most countries due to a combination of demographics (aging populations

across DM and a trend toward early retirement), a dearth of immigration flows over the last two years, and pandemic-related illness and concerns still keeping some workers sidelined.

CHART 18: A LACK OF PARTICIPATION

Labour force participation rate
(percent)



Source: Guardian Capital based on data from US Census Bureau, Statistics Canada, Eurostat and Bloomberg to September 2022

The resultant wage gains are another factor compounding global inflationary pressures — and risk feeding into expectations and stoking a dreaded "wage-price spiral" — but they do offer support to consumer spending and ease the strain in terms of financial obligations.

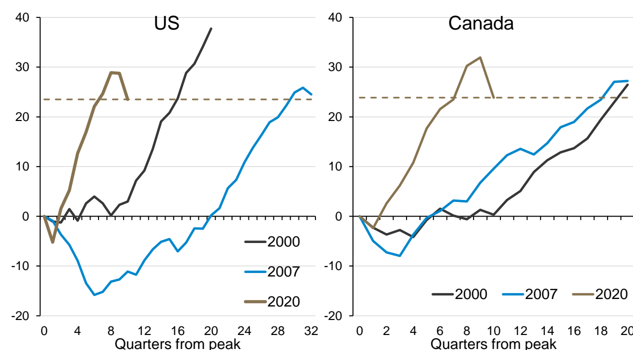
On the topic of consumer finances, the strong labour markets amplify what are, generally, healthy household balance sheets — historically a source of destabilizing financial imbalances.

Household wealth has experienced a hefty run-up since the pandemic, with the earlier discussed "excess" savings coinciding with the strength in global financial and residential real estate markets.

Even with the pullback in broad asset values so far this year, aggregate household net worth remains elevated relative to other recovery periods and still implies positive wealth effects to be reaped.

CHART 19: A WORTHY INCLUSION

Household net worth, US & Canada
(percent change from pre-recession/crisis peak)



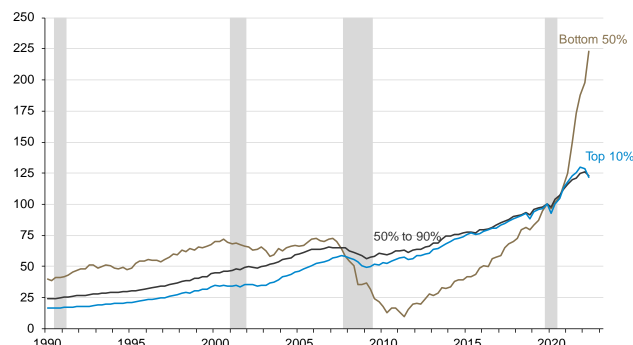
2000 peak = Q3 2000; 2007 = Q3 2007; 2020 = Q4 2019. Source: Guardian Capital based on data from the US Federal Reserve Board and Statistics Canada to Q2 2022

Further to this point, it is noteworthy that through this cycle those at the lower end of the wealth spectrum have recorded disproportional wealth benefits.

For example, aggregate net worth among the bottom 50% of US households has more than doubled from the early 2020 crisis lows (compared to gains closer to 25% for the top half). As well, their comparative lack of exposure to markets and ongoing income gains has meant that their wealth continued to rise this year — a stark contrast to their richer, more invested peers.

CHART 20: SPREAD THE WEALTH

Household net worth by percentile, US
(index; Q1 2020 = 100)



Source: Guardian Capital based on data from the US Federal Reserve Board to Q2 2022; shaded regions represent periods of US recession

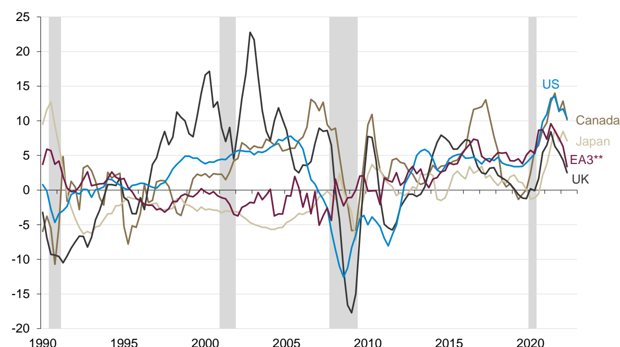
That the less well-off have participated in the wealth gains (unlike the post-financial crisis period a decade ago) has undoubtedly been a big reason why consumer spending in general, has been so resilient — these households have a higher marginal

propensity to consume (i.e. they spend a higher share of additional funds they receive either via increases in wealth or income).

Of course, one big concern on this front is the increasing softening in housing markets in response to higher interest rates. Sales activity has slumped from pandemic highs and taken prices off the boil.

CHART 21: OFF THE ROOF

Real* house prices
(year-over-year percent change)

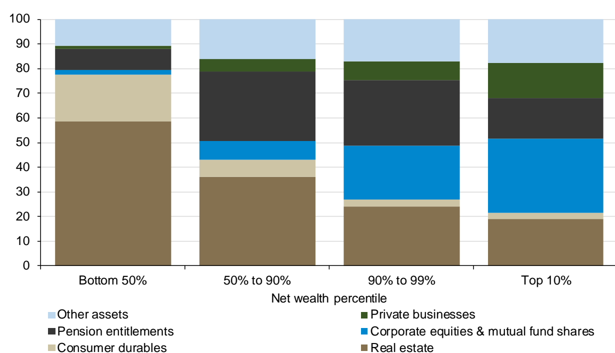


**Real house price is the ratio of the nominal house price to the consumers' expenditure deflator in each country; aggregates are GDP-weighted average; **EA3=France, Germany & Italy. Source: Guardian Capital based on data from the OECD to Q2 2022*

Falling housing prices clearly represent a hit to net wealth — and this is particularly the case for lower-wealth households for which real estate accounts for the bulk of their assets (and net worth).

CHART 22: CONCENTRATED HOLDINGS

Household asset holdings net worth by percentile, US
(percent of total)

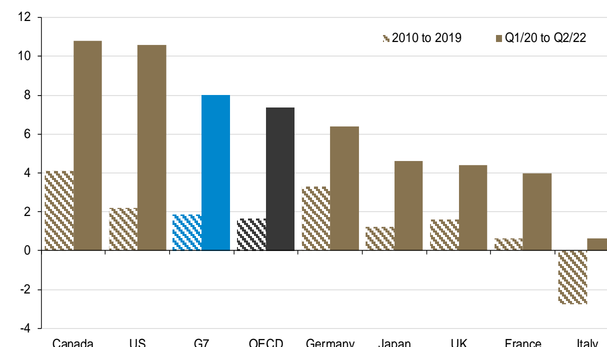


Source: Guardian Capital based on data from the US Federal Reserve Board as at Q2 2022

But there is clearly a need for a reset in many markets as the low-interest-rate-fueled run-up in house prices over the last decade — especially in the last two years as consumers diverted their excess savings into real estate — has created some froth in markets (and impinged affordability) that requires an adjustment.

CHART 23: SIGNS OF EXCESS

Change in real* house prices
(annualized percent)



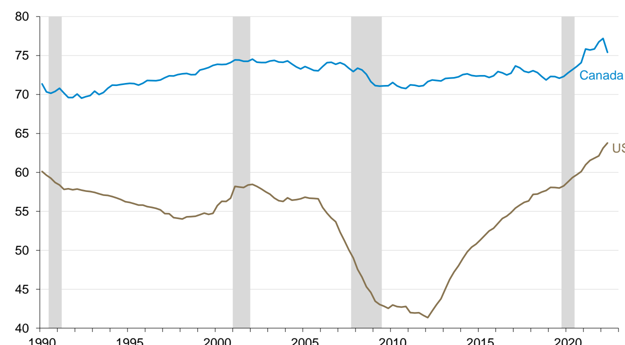
**Real house price is the ratio of the nominal price to the consumers' spending deflator in each country; aggregates are GDP-weighted average; source: Guardian Capital based on data from the OECD to Q2 2022*

Adjustments, however, can be painful and, as in the not-too-distant past, have the potential to escalate into greater problems for the financial system.

Thankfully, in contrast to the housing crisis of a decade and a half ago, mortgage markets are far sounder. As well, the rise in prices has not been met with a corresponding rise in debt, meaning homeowners' accumulated equity in their homes provides a cushion against any price depreciation.

CHART 24: EQUITY OWNERSHIP

Homeowners' equity in real estate assets
(percent of total)



Data to Q2 2022; shaded regions represent periods of US recession. Source: US Federal Reserve Board, Guardian Capital

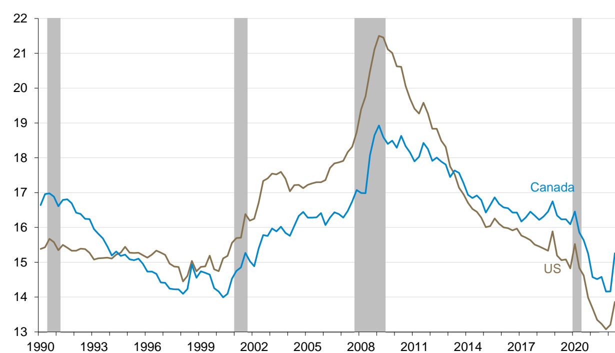
Further, while higher mortgage rates negatively impact housing affordability, the fact that a 30-year fixed-rate mortgage is the standard in the US means most current owners are not impacted. That fixed-rate[6] mortgages are also the norm in Canada and

the UK[7] (albeit with a shorter typical 5-year term) offer some insulation as well; the higher prevalence of variable-rate borrowing in the core of Europe[8] does pose greater concerns, however, renting tends to be more common than homeownership.

More generally, improvements on the asset side of the ledger have outpaced more modest increases in debt, meaning that household solvency is actually in good overall shape, mitigating any broader hit.

CHART 25: PULLING THE LEVER

Household debt-to-asset ratio*
(percent)



*Data made comparable following Statistics Canada's guidelines[9]
Source: Guardian Capital based on data from the US Federal Reserve Board and Statistics Canada to Q2 2022; shaded regions represent periods of US recession

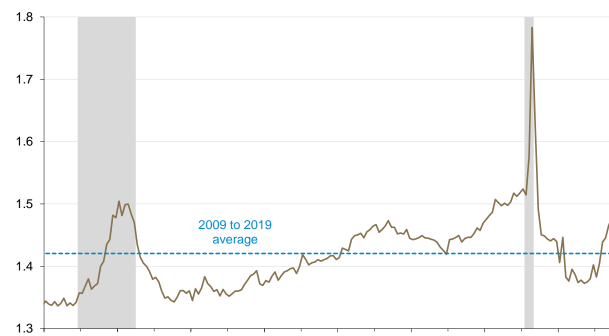
Business prospects

Housing is one area where the impact of the hiking cycle has been most evident. But while other parts of the economy have so far only experienced limited pressure, and most indicators of current business activity (and profits) outside of real estate have proven surprisingly resilient to this point, forward-looking gauges point to growing concerns for the road ahead.

For starters, as discussed, goods inventories have been building at a time when sales growth has been slowing — the ratio of inventory-to-sales has been creeping up as a result, and this bodes poorly for future production (and profit margins, with markdowns likely), even assuming that the recent supply chain pressures prompt businesses to hold more stock on hand.

CHART 26: FILLING THE SHELVES

Total business* real inventories-to-sales ratio, US
(ratio)

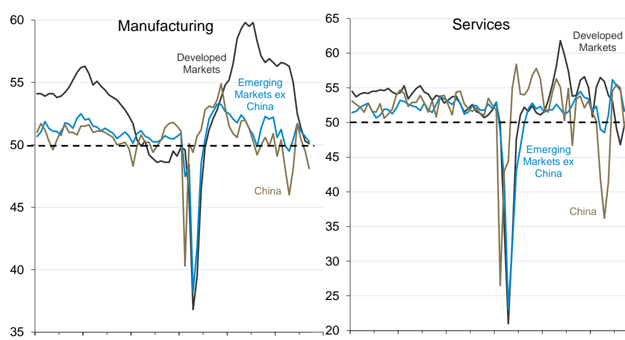


*Total business=manufacturing, whole & retail trade. Source: Guardian Capital based on data from US Census Bureau to August 2022; shaded regions represent periods of US recession

Echoing this, business sentiment has rolled over from earlier peaks and purchasing managers' indexes[10] (PMI) across sectors and regions have taken notable turns for the worse in recent months, pointing to a considerable loss of momentum. Over the summer, China has seen a particular slowing in response to lockdowns amid their ongoing "Zero COVID" policy.

CHART 27: ROLLING OVER

Purchasing managers' indexes
(diffusion index; >50 denotes expansion)



Source: Guardian Capital based on data from Bloomberg to September 2022; shaded region represents period of US recession

Considering that central banks are trying to tap the brakes on the economy, this slowing is not inherently a negative development so much as things are going according to plan (so far).

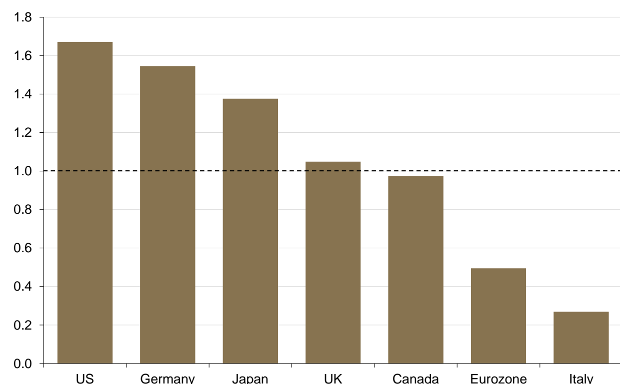
Any indications of a loosening on the jobs front would not necessarily be viewed in a bad light either, given the imbalances in labour markets.

Most G7 economies currently have more job

openings than people actively seeking employment, so even if some companies start to pare their headcounts, these workers could well be readily absorbed elsewhere.

CHART 28: HELP WANTED

Job vacancies per unemployed person
(number)



Source: Guardian Capital based on data from the Bloomberg, US Bureau of Labor Statistics, Statistics Canada and Eurostat to Q2 or August 2022

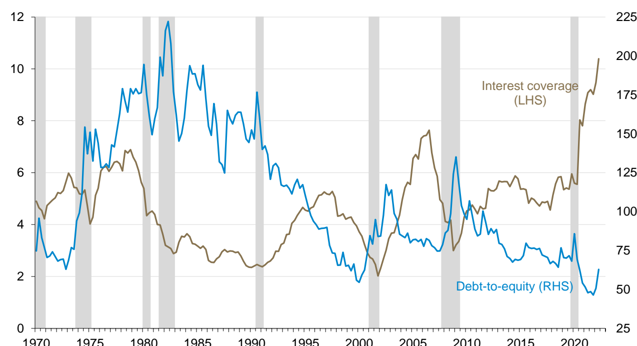
At the same time, given the difficulties in finding workers of late, it is possible that firms could continue to hold on to talent even in the face of more challenging conditions — and the strong financial positions of companies provide the scope for this type of decision-making.

Despite the tumultuous last couple of years, corporations have been generating record earnings, which they have used to shore up balance sheets, while also taking advantage of the previously historically benign financial conditions to raise funds at low rates for extended terms.

The net result is that firms, in aggregate, have high liquidity, low leverage and negligible interest burdens — positive fundamentals that suggest the capacity to weather a potential hit to profitability without setting off a particularly harsh downswing in the credit cycle that causes firms to aggressively scale back investment intentions or headcounts.

CHART 29: BUSINESSES ARE NOT BURDENED

Nonfinancial corporate interest coverage & leverage, US
(times interest earned) (percent)



Source: Guardian Capital based on data from the US Federal Reserve Board & Statistics Canada to Q2 2022; shaded regions represent periods of US recession

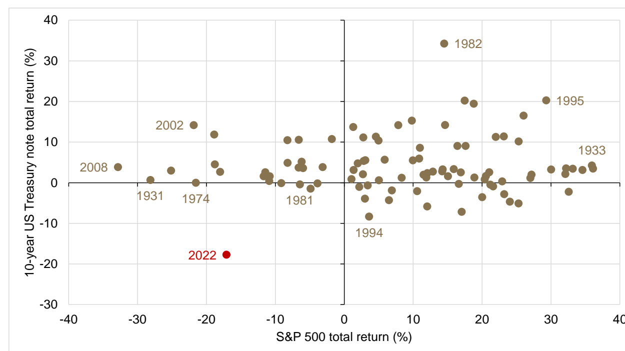
Hitting reset

The shifting macroeconomic landscape and reassessment of expectations has clearly had significant impacts across financial markets.

Indeed, the disappointment of great expectations failing to materialize has resulted in a historically bad year for stocks and bonds — and while the weakness in equity markets has been historically extreme to this point, it is the bond market carnage that really sets this year apart from the rest of the last century.

CHART 30: AN OUTLIER OF A YEAR

Year-to-October* stock and bond market performance

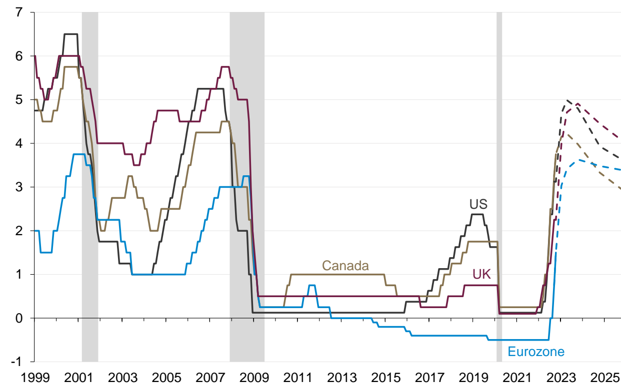


** 2022 is year-to-October Source: Guardian Capital based on data from Bloomberg to October 28, 2022*

The persistent and broad inflation, and central banks' reaction to it, has seen expectations for policy rates shift sharply from "low for long" to "higher, faster and for longer" — while a lot has already been done, the job is not viewed as over and more is to come.

CHART 31: HIGHER, FURTHER, FASTER

Overnight index swap (OIS)-implied forward policy rates
(percent)



Source: Guardian Capital based on data from Bloomberg to October 28, 2022 (dashed lines represent OIS data as at October 28); shaded regions represent periods of US recession

The resultant upward adjustment in market interest rates is not without precedent. However, the fact that it started from a level of yields such that there was (literally) no cushion for performance, meant that investors have been dealt a blow from an asset class that has previously been treated as "risk-free."

Looking forward, the likelihood that policymakers continue to keep upward pressure on market rates in the near- term means that bond performance will likely remain constrained in the months to come.

That said, any further damage is likely to be modest in comparison to what has already been done given that current expectations indicate that the vast majority of the expected rise in yields is done.

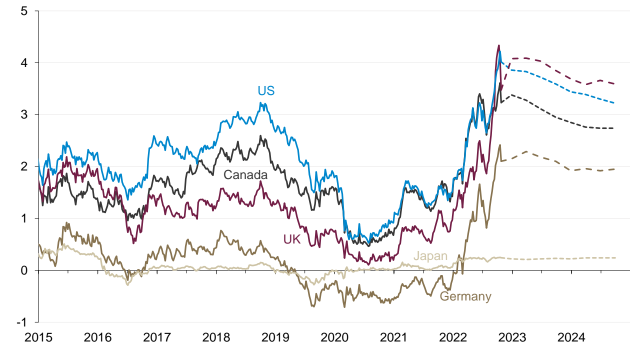
Markets are increasingly thinking that central banks are edging closer to the end of tightening, with only limited further increases in short-term rates anticipated.

As such, the odds of a significant shift higher in rates appear fairly low. A broad reversal in policy is not yet likely either given the resiliency in both inflation and job markets, meaning a sustained rally in rates is not likely in the cards soon.

Accordingly, consensus expectations are for longer-term yields to remain more-or-less range bound for the foreseeable future around current levels.

CHART 32: STEADY AS SHE GOES?

10-year sovereign bond yields
(percent)



Source: Guardian Capital based on data from Bloomberg to October 28, 2022 (dashed lines represent consensus forecasts as at October 28)

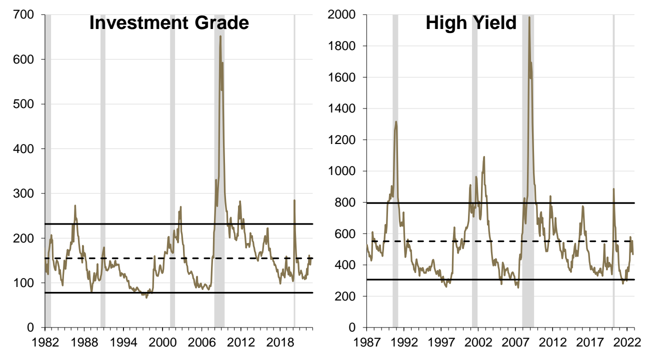
While that does not exactly suggest a lot of upside, the return prospects are far more compelling than they were 10 months ago.

Bond yields now sit at levels that offer investors a degree of cash flow not seen in more than a decade, which represents some actual compensation for the risk of changes in market rates and the erosion in purchasing power that comes from inflation (yields on inflation-protected bonds, for example, have turned positive for the first time since 2011).

Corporate bonds offer even more compelling yields as credit spreads have widened from their post-crisis lows back to their longer-term historical averages while also generally carrying lower sensitivity to changes in interest rates.

CHART 33: SPREAD 'EM

Investment Grade & High Yield credit spreads, US*
(basis points)

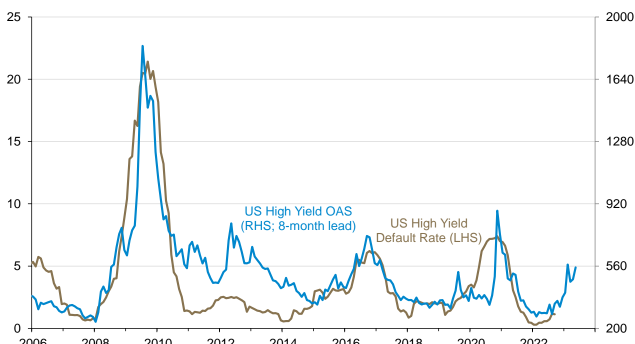


**Bloomberg bond index option-adjusted spreads. Source: Guardian Capital based on data from Bloomberg to October 28, 2022; shaded regions represent periods of US recession*

Of course, the better return opportunities in credit also come with added risks. While defaults (which would wipe out bondholders) remain historically muted, and there is scope for the credit cycle to not become particularly harsh, rising rates and a downgraded economic outlook still suggest that lower-quality issuers will face rising pressures in the months ahead, suggesting a preference toward the higher end of the credit quality spectrum.

CHART 34: THE TREND IS NOT YOUR FRIEND

High Yield bond par-weighted default rate & OAS*, US
(basis point difference in annualized return vs. MSCI World Index[11]) (basis points)



**OAS=option-adjusted spread; Source: Guardian Capital based on data from Bloomberg & Bank of America to September 2022*

Equity markets have likewise undergone a painful reset this year in the face of rising interest rates.

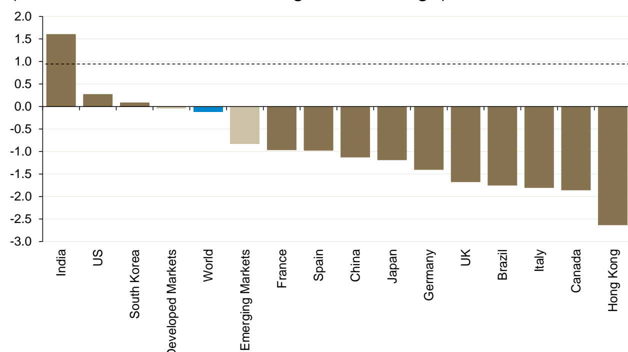
From a technical perspective, higher market yields translate into a larger discount rate for future cash flows upon which stocks are valued, resulting in lower prices with all else the same.

For their part, overall earnings have so far held up better than anticipated against the numerous headwinds, as companies have been able to not only pass through cost increases but expand margins.

As such, the sharp decline has primarily been due to multiple contractions that have brought highly elevated valuations, generally, back on the “cheap” side of historical averages — with those markets outside of the US trading at steep discounts.

CHART 35: BETTER VALUE

MSCI All Country World Index (MSCI ACWI)[12] forward price-to-earnings ratio
(standard deviations from long-term average)



Source: Guardian Capital based on consensus data from Bloomberg to October 28, 2022

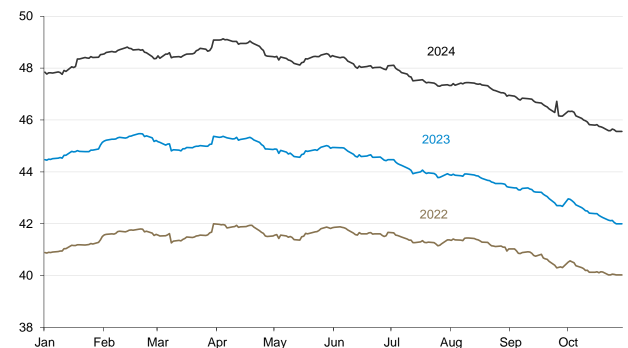
As with bonds, the valuation adjustment in equities creates much more compelling forward return prospects than were previously available and therefore represents a good opportunity for investors with longer-time horizons to selectively add to positions.

That said, the path to prosperity for stock markets is not likely to be straight and easy, but one rife with volatility and risks.

In particular, it is anticipated that the impact of slower economic growth, tighter monetary policy and margin pressures will become more prominent, resulting in downward pressure on earnings — profit forecasts have been scaled back of late and there is scope for further cuts to come.

CHART 36: ERASERS AT THE READY

Consensus earnings per share forecasts, MSCI ACWI
(US dollars)

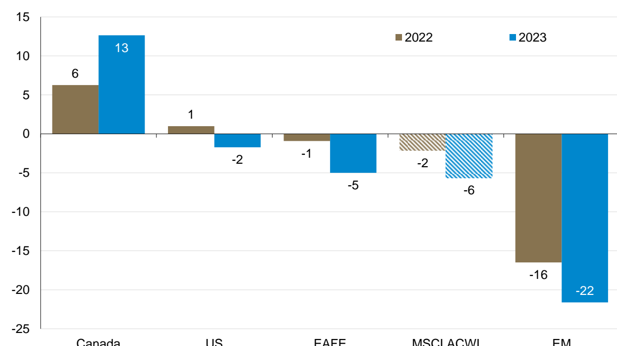


Source: Guardian Capital based on data from Bloomberg to October 28, 2022

As with the macroeconomic outlook, the changes to earnings expectations have been far from uniform, on a regional basis, with EM (tied to the prospects for China) and Europe, Asia & Far East (EAFE) bearing the brunt of the downgrades — Canada and its market's bias toward natural resources has benefitted from upgrades.

CHART 37: REGIONAL VARIATION

Change in consensus earnings per share forecasts
(percent change since January 1, 2022)



Source: Guardian Capital based on data from Bloomberg to October 28, 2022

Add in the potential for further price-to-earnings multiple compression from higher interest rates and it may prove difficult for any sustained rallies such that they can bring about the end to the equity bear market.

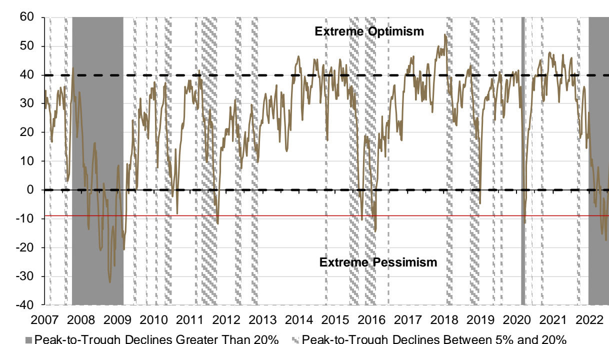
With that said, however, short-run "bear market rallies" appear increasingly possible.

Just as expectations being set too high can result in disappointment, excessive pessimism often results in pleasant surprises, as even "bad" outcomes prove to be not as bad as feared.

As it stands right now, many indicators are pointing to sentiment being extremely negative, which, combined with elevated cash balances held by investors and the positive seasonal factors following the considerable weakness at the end of the summer, would appear to set the table for a bounce for risk assets in the near-term.

CHART 38: NATTERING NABOBS OF NEGATIVITY

Investors Intelligence bull-bear differential
(percentage points)



Source: Guardian Capital based on data from Investors Intelligence, Ned Davis Research, Wall Street Journal and Bloomberg to October 20, 2022

From a more medium-term perspective, the ability to continue to exert pricing power will likely become of increasing importance to sustaining earnings — and supporting asset performance in the absence of a markup in valuations.

On that score, there would be support for exposure to the securities of high-quality companies that offer a layer of defense against a more adverse shift in economic conditions. Their more dominant position within markets and industries provides pricing power that may protect margins and profitability, while solid balance sheets and low leverage provide insulation to higher interest rates and a more challenging environment. These traditionally perform well amid more uncertain and volatile environments.

Finding the middle ground

So, 2022 has been a victim of expectations — once again, as is almost always the case, things rarely ever turn out as great as hoped.

But that disappointment — and again, things, in general, are good, if not as good as anticipated at the outset of the year — has bred rampant pessimism that seems to be skewing the risks in the other direction.

This sort of backdrop sets up the potential for a positive surprise (for example, the end of the war in Ukraine or a shift towards a more pro-growth stance in China), since the flip side to the truism of high expectations is that it is also rarely if ever, the case

that things end up being as bad as feared.

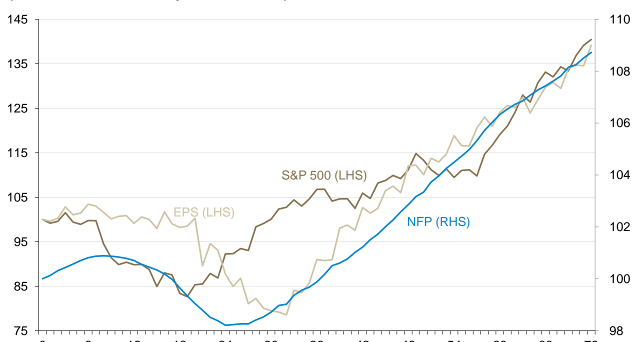
From a market perspective, a lot of “bad” has already been priced into markets suggesting that risks for forward performance may well be asymmetric. There is definitely a possibility that bonds and equities could continue to struggle, but the magnitude of the declines so far, and the fundamentals underlying the outlook, suggest that any further weakness would be comparably limited, while there is room for upside.

Clearly, the outlook warrants caution, but the broad valuation adjustment across asset classes has created ample opportunities for active investors with longer time horizons — the near term is likely to see volatility persist, but there is scope to anticipate that performance broadly improves in the year ahead.

As such, it appears prudent to maintain a continued bias toward more conservative and high-quality investment strategies, but with potential for adding to risk exposures, as the market outlook is likely brighter than that of the broader economy — and it is the case that forward-looking markets typically find their bottom first.

CHART 39: MARKETS THINK FORWARD

Macroeconomic & market trends over the last four cycles
(indexed; market peaks=100)



**average of cycles started June 1973, December 1980, December 1989, March 2007. Source: Guardian Capital based on data from Bloomberg*

Endnotes

[1] The OECD is comprised of 38 member countries that provides information on future developments, based upon opinion surveys on developments in production, orders and stocks of finished goods in the industry sector.
[2] The G20 is an intergovernmental forum comprising 19 countries and the European Union. It works to address major issues related to the global economy, such as international financial stability, climate change mitigation, and sustainable development.
[3] The Bank for International Settlements (BIS) supports central banks' pursuit of monetary and financial stability through international cooperation, and to act as a bank for central banks.
[4] The Geopolitical Risk Index, created by Dario Caldara and Matteo Iacoviello, is a measure of adverse geopolitical events and associated risks based on a tally of newspaper articles covering geopolitical tensions. The index reflects automated text-search results of the electronic archives of 10 newspapers related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles).
[5] The Economic Policy Uncertainty (EPU) Index is an index developed to measure economic policy uncertainty and is calculated by calculating the relative frequency of each country's newspaper articles, including terms' economy', 'policy', and 'uncertainty'.
[6] Bank of Canada, Financial System Review - 2022, June 7, 2022, https://www.bankofcanada.ca/2022/06/financial-system-review-2022/#Box-1-The-potential-impact-of-higher-interest-rates-on-future-mortgage-payments
[7] UK Finance, *How the bank rate affects mortgage rates*, https://www.ukfinance.org.uk/news-and-insight/blogs/how-the-bank-rate-affects-mortgage-rates
[8] OECD Library, OECD Economics Department Working Papers, Mortgage finance across OECD countries, Frank van Hoenselaar, Boris Cournède, Federica De Pace and Volker Ziemann, 14 Dec 2021, https://www.oecd-ilibrary.org/economics/mortgage-finance-across-oecd-countries_f97d7fe0-en;jsessionid=bUFnmNfFURmejefDqKxVER-17Mwo7KEBDyIaOY9Q.ip-10-240-5-79
[9] Statistics Canada, *Reconciling Canadian-U.S. measures of household disposable income and household debt*, November 27, 2015, https://www150.statcan.gc.ca/n1/pub/13-605-x/2012005/article/11748-eng.htm
[10] The Purchasing Managers Index (PMI) is a measure of the prevailing direction of economic trends in manufacturing; a monthly survey of purchasing managers to determine whether business conditions are improving, unchanged, or deteriorating compared to the previous survey. A level above 50 represents improving conditions, while a level below 50 represents deteriorating conditions, and a level of 50 represents no change from the previous survey period.
[11] The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.
[12] The MSCI ACWI is a market capitalization weighted index of equities in both Developed and Emerging Markets

Market Returns at September 30, 2022 All returns in CAD.

CANADIAN EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
S&P/TSX Composite	-4.3	-1.4	-11.1	-5.4	6.5	7.3
S&P/TSX 60	-3.9	-1.7	-11.2	-4.3	7.3	8.0
S&P/TSX Completion	-5.7	-0.1	-11.0	-9.3	4.1	5.1
S&P/TSX SmallCap	-7.1	-2.5	-16.3	-13.8	2.4	3.2
S&P/TSX Composite High Dividend	-5.5	-5.1	-3.9	3.3	7.1	7.2
S&P/TSX Composite Dividend	-4.1	-1.3	-5.2	2.3	7.3	8.1

S&P/TSX SECTOR RETURNS (%)

Sector	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Communication Services	-6.1	-7.5	-8.2	-3.8	5.2	8.7
Consumer Discretionary	-5.2	4.2	-13.6	-6.9	3.9	11.7
Consumer Staples	-2.8	2.6	1.5	9.4	9.9	14.7
Energy	-8.6	-5.3	19.6	26.3	5.5	3.1
Financials	-2.5	-1.2	-12.3	-4.1	7.2	10.7
Health Care	-6.7	-6.4	-56.9	-64.8	-21.8	-19.6
Industrials	-4.4	4.2	-5.5	-0.8	10.5	14.0
Information Technology	-6.2	-4.7	-57.4	-58.0	11.9	17.0
Materials	3.3	2.5	-6.0	4.1	6.9	0.3
Real Estate	-8.5	-6.4	-26.7	-19.9	4.1	7.1
Utilities	-9.4	-4.6	-3.4	1.8	9.8	8.2

U.S. EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
S&P 500	-4.7	1.3	-17.2	-8.3	11.3	15.5
Dow Jones Industrial Average	-4.3	-0.1	-12.7	-6.1	9.5	14.2
NASDAQ	-6.1	2.1	-26.5	-20.6	12.3	16.8
Russell 1000	-4.8	1.6	-18.0	-10.2	11.1	15.4
Russell 2000	-5.1	4.2	-18.5	-17.0	5.5	12.2
Russell 3000	-4.8	1.8	-18.0	-10.7	10.7	15.2
Russell 1000 Growth	-5.3	2.7	-24.6	-16.0	14.3	17.6
Russell 1000 Value	-4.3	0.5	-10.5	-3.9	7.3	12.9

S&P 500 SECTOR RETURNS (%)

Sector	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Communication Services	-7.8	-7.0	-33.7	-33.9	3.9	7.3
Consumer Discretionary	-3.5	11.2	-23.7	-14.2	12.6	17.0
Consumer Staples	-3.5	-0.5	-4.1	8.4	9.6	13.2
Energy	-4.8	9.0	46.8	58.0	8.1	7.0
Financials	-3.2	3.2	-14.3	-10.7	7.5	15.2
Health Care	2.2	1.0	-5.5	4.8	12.3	17.5
Industrials	-6.1	1.5	-13.8	-6.6	6.9	14.1
Information Technology	-7.7	-0.1	-25.4	-13.2	18.9	21.1
Materials	-4.9	-1.1	-17.0	-4.7	7.9	12.2
Real Estate	-8.9	-5.2	-22.6	-9.3	7.8	N/A
Utilities	-7.0	0.1	1.7	14.5	9.9	13.6

INTERNATIONAL EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
MSCI World Index (Net, C$)	-4.8	-0.1	-18.9	-12.8	7.3	11.8
MSCI EAFE Index (Net, C$)	-4.9	-3.4	-20.7	-18.8	1.0	7.2
MSCI ACWI (C$)	-5.1	-0.7	-19.1	-13.9	6.4	10.9
MSCI France (C$)	-4.1	-2.9	-22.8	-17.6	1.5	8.7
MSCI Germany (C$)	-4.3	-6.9	-32.2	-31.8	-4.9	4.7
MSCI Japan (C$)	-5.9	-1.7	-19.9	-23.3	1.3	8.4
MSCI UK (C$)	-4.4	-4.9	-11.5	-6.8	0.8	5.3
S&P/IFC Investable (Emerging Markets)	-6.9	-4.4	-19.7	-20.7	0.9	5.5
MSCI EAFE Growth (Gross, C$)	-5.3	-2.5	-26.9	-24.1	2.9	8.6
MSCI EAFE Value (Gross, C$)	-4.4	-4.3	-13.6	-12.8	-0.3	6.5

Sources: Bloomberg Finance L.P., FTSE Bond Analytics, TD Securities, Thomson Financial

INTERNATIONAL EQUITIES

MSCI EAFE SECTOR RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Communication Services	-5.7	-8.1	-17.8	-22.6	-2.5	4.8
Consumer Discretionary	-7.5	-4.0	-28.4	-26.5	0.4	8.4
Consumer Staples	-2.7	-1.0	-14.5	-10.3	1.7	7.4
Energy	-3.7	1.2	16.0	15.0	2.7	4.1
Financials	-4.3	-3.7	-16.2	-15.5	-1.7	6.2
Health Care	-2.3	-4.7	-15.2	-13.0	5.3	9.8
Industrials	-6.0	-2.3	-27.4	-25.7	0.6	8.0
Information Technology	-6.9	-2.3	-36.0	-33.7	4.1	11.9
Materials	-3.6	-2.9	-19.1	-14.6	3.6	6.9
Real Estate	-13.9	-7.4	-22.5	-23.1	-3.6	N/A
Utilities	-7.4	-7.7	-20.3	-13.5	1.9	6.1

Market Returns at September 30, 2022 All returns in CAD.

CANADIAN FIXED INCOME

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
FTSE Canada 91 Day TBill	0.2	0.5	0.8	0.9	1.0	0.9
FTSE Canada Short Term Overall Bond	-0.1	-0.3	-4.7	-5.2	0.9	1.3
FTSE Canada Mid Term Overall Bond	-0.2	0.8	-10.6	-10.3	0.9	1.9
FTSE Canada Long Term Overall Bond	-1.5	1.5	-21.0	-17.2	0.1	1.8
FTSE Canada Universe Bond	-0.5	0.5	-11.8	-10.5	0.7	1.7
FTSE Canada High Yield Overall Bond	-1.0	0.7	-7.4	-7.4	3.6	4.9
FTSE Canada Real Return Bond Overall	-2.5	0.9	-16.7	-11.3	1.5	0.8

SECTOR RETURNS (%)

	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
FTSE Canada Federal Bond	-0.2	0.3	-9.2	-8.5	0.3	1.0
FTSE Canada Provincial Bond	-0.6	1.0	-14.8	-12.7	0.5	1.9
FTSE Canada All Corporate Bond	-1.0	0.2	-10.8	-9.8	1.3	2.3

GLOBAL FIXED INCOME

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
FTSE World Government Bond	-0.4	-1.6	-14.4	-15.6	-1.2	1.6

COMMODITY

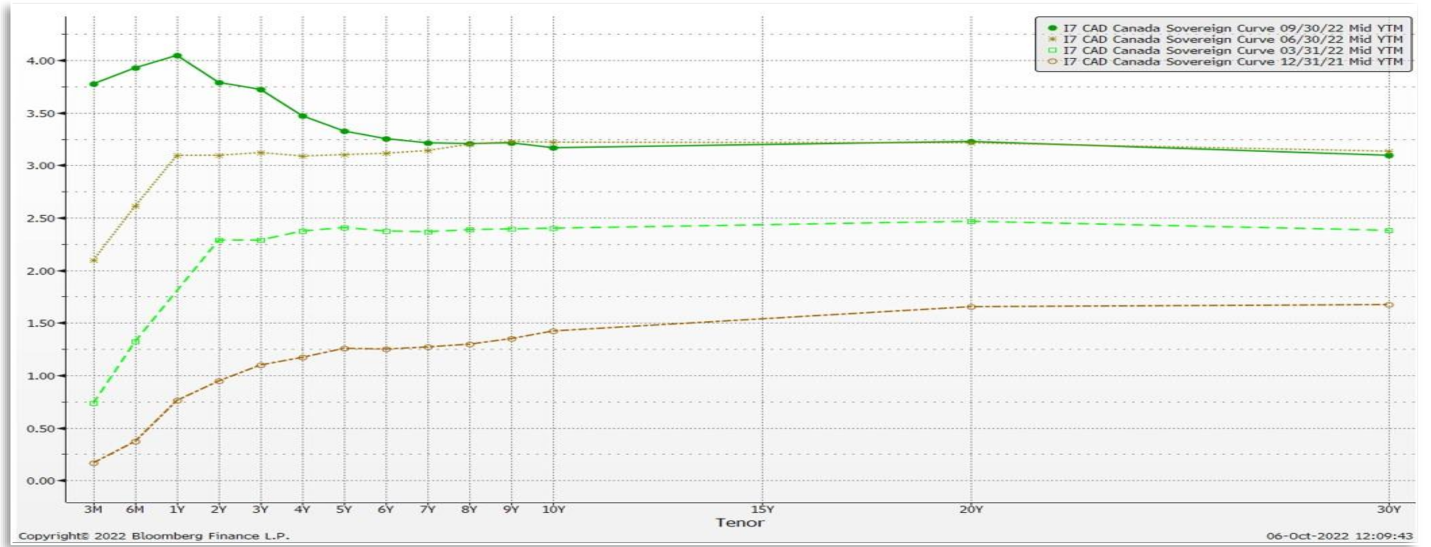
	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Bloomberg WTI Cushing Crude Oil Spot Price	-6.9	-19.9	12.3	14.9	11.1	1.9
Bloomberg European Dated Brent BFOE Price	-5.6	-20.2	21.0	18.6	10.9	0.6
Edmonton Crude Oil Syncrude Sweet Blend FOB Spot	-5.3	-18.3	28.0	26.1	12.0	1.7
S&P GSCI Nat Gas Index Spot	-22.2	32.9	97.3	25.1	19.8	11.0
S&P GSCI Copper Index Spot	2.3	-1.6	-14.7	-7.3	5.3	2.7
S&P GSCI Gold Index Spot	1.6	-1.5	-0.5	3.2	7.4	2.8

CURRENCY

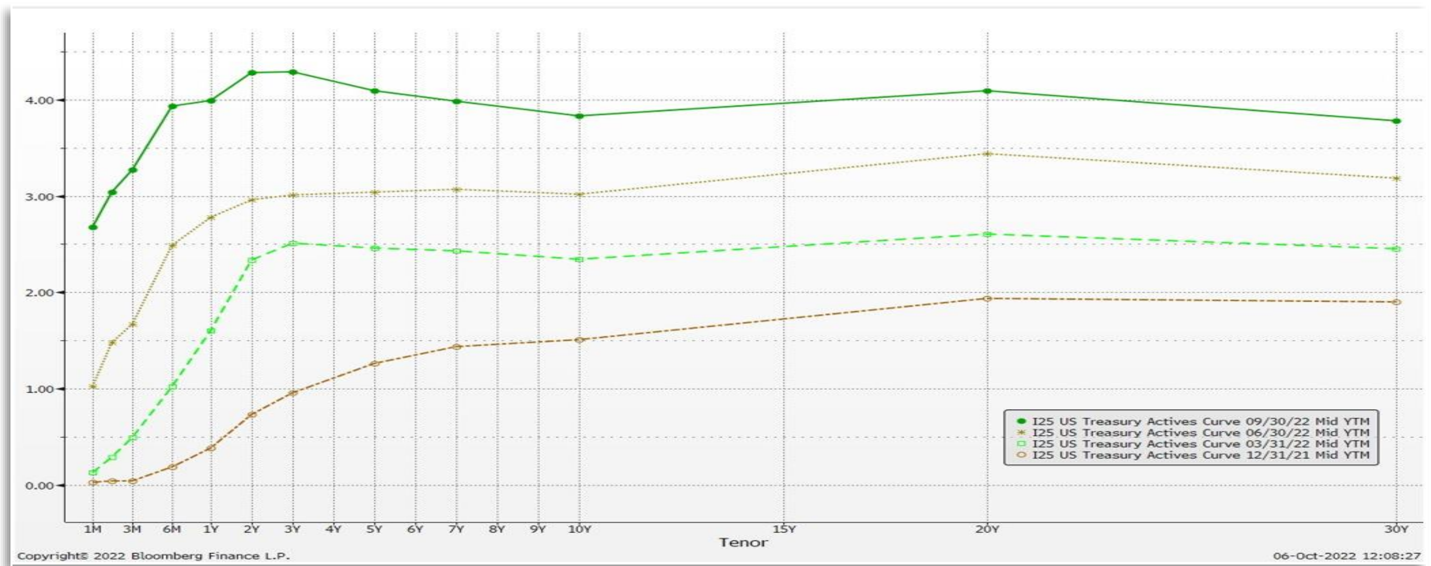
	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
CAD/USD (% chg)	4.9	6.5	8.8	8.5	1.9	3.4
CAD/Yen (% chg)	0.5	0.0	-13.5	-16.4	-3.1	-2.8
CAD/GBP (% chg)	0.7	-2.1	-10.3	-10.2	-1.8	-0.3
CAD/Euro (% chg)	2.2	-0.2	-6.3	-8.3	-1.9	0.6

Yield Curve at September 30, 2022

GOVERNMENT OF CANADA YIELD CURVE



U.S TREASURY YIELD CURVE



Sources: Bloomberg Finance L.P., FTSE Bond Analytics, TD Securities, Thomson

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