Regional focus

GLOBAL

Insight 2023 Outlook

Canada

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For important and required non-U.S. analyst disclosures, see page 8.
All values in U.S. dollars and priced as of market close, Nov. 22, 2022 unless otherwise stated.
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Global Insight 2023 Outlook

Canada

The Canadian economy is likely to slip into recession in 2023, but markets are starting to look past this threat. The equity market, including bank stocks, is already pricing in a modest economic contraction and housing market retrenchment. In our view, the recent surge in fixed income yields has returned the Canadian bond market to an environment where investors can achieve reasonable levels of income, including from historically lower-risk investments.

Canadian equities

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Recession likely in 2023; household debt and housing in focus

Tighter monetary policy and its impact on financial conditions throughout the Canadian economy have meaningfully slowed economic growth expectations, as household consumption begins to feel the pressure of higher interest rates and elevated inflation. As a result, RBC Economics is expecting Canada to slip into a recession in early 2023.

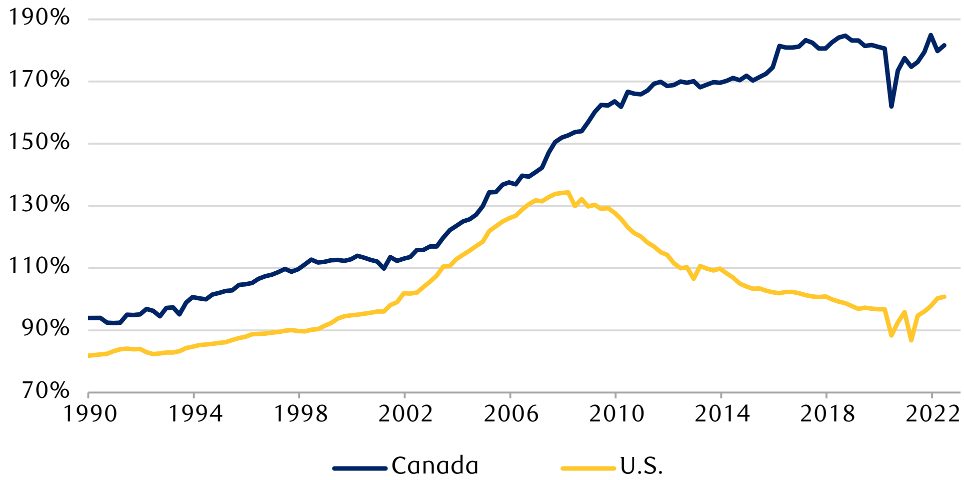
It can be argued that at current valuations the S&P/TSX Composite Index is already pricing in a modest recession. The index trades at an approximate 25% valuation discount to its longer-term averages. However, Canada has the idiosyncratic risks of elevated household debt levels coupled with an outsized economic contribution from housing that we believe warrant additional consideration.

At this time last year, we pointed to the Canadian housing market as the single largest risk to the Canadian economy heading into 2022. However, identifying a catalyst that could have shifted the positive momentum remained a challenge. We clearly found that catalyst this year in dramatically higher interest rates.

According to RBC Economics, Canadians amassed CA$3.9 trillion in net wealth during the pandemic, largely due to a real estate boom. As of Q2 2022, roughly

Elevated household debt levels a key risk to the Canadian economy

Household debt-to-income ratios



Source - Statistics Canada

CA$900 billion of that had been lost as housing markets retrenched under the weight of rising interest rates, with further losses expected through 2023. The dramatic decline in net wealth, combined with high inflation and elevated interest rates, is expected by RBC Economics to cut roughly CA$15 billion from household spending in 2023.

How much of the housing- and recession-related doom and gloom is already accounted for in Canadian bank valuations? We would argue a reasonable level. Canadian banks as a group trade roughly in line with the valuations that prevailed at the tail end of the 2014–2016 oil collapse, and at a mid-teens discount to the average over the past decade. That said, current valuations are approximately 20%–25% higher than those at the worst of the 2008–2009 global financial crisis and the pandemic in early 2020. We would argue that the group is already capturing a moderate recession in its valuation. Typically, we would favour buying Canadian banks when credit losses peak rather than at the early stages of a credit cycle where we are today. However, for those with an income focus who can see through the valley of the upcoming recession, we believe the Canadian bank group provides an interesting opportunity.

Energy was the best-performing sector in the S&P/TSX Composite in 2021, and that has continued in 2022. Although West Texas Intermediate crude oil prices have weakened from their peak earlier this year, Canadian energy equities have held up well. In our view, the underinvestment in oil development over the past decade has resulted in a supply outlook that is expected to remain tight, underpinning our positive multiyear outlook on the commodity. We think the solid commodity outlook paired with attractive free cash flow generation and the potential for favourable capital allocation decisions (increasing dividends, share repurchases, debt reduction) support maintaining allocations to the industry. With respect to base metals, we believe caution is warranted heading into a slowing global growth environment in 2023. That said, given near-term physical supply tightness in base metals such as copper and positive longer-term fundamentals, we believe opportunities could emerge in this sector in the new year.

Canadian fixed income

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Returning income to Canadian fixed income

2022: Government bond yields surge, credit spreads widen. Canadian fixed income was by no means spared from historically poor performance across asset classes in 2022, with elevated inflation forcing the Bank of Canada (BoC) to rapidly withdraw monetary stimulus and hike rates substantially faster than markets initially expected.

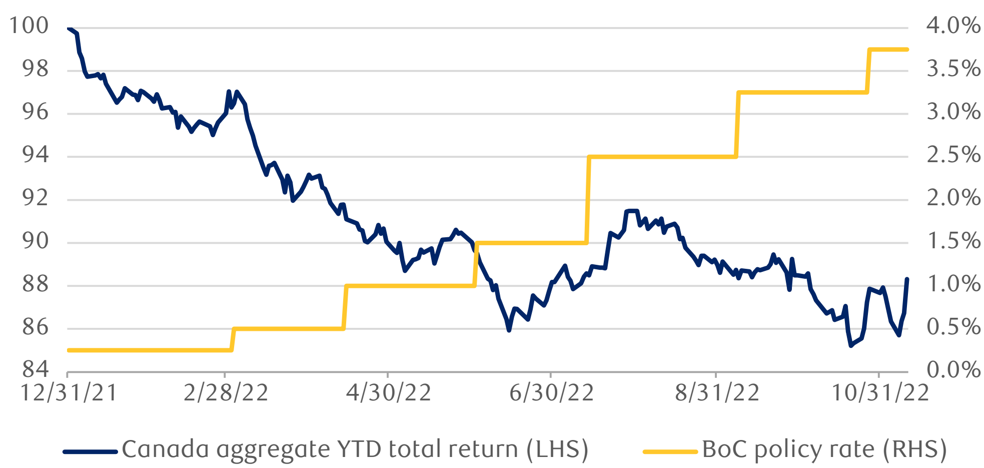
In previous years, government bond yields typically fell when equities and other risk assets sold off—this decline in yields often partially or completely offset losses in corporate bonds. That correlation did not materialize in 2022, with government bond yields surging while credit spreads—which measure the additional yield demanded by investors to assume credit risk—widened to multiyear highs. The result of the breakdown in this historical relationship was that every major part of the Canadian fixed income market saw meaningful declines in 2022.

Return expectations improve. Bonds that do not default must eventually reach par value on maturity, so poor trailing performance has led to improved return expectations going forward. For investors whose investment horizon is longer than the average term of their bond portfolio, this past year's price declines are likely to result in higher total-return figures over that investment period.

The sharp repricing of Canadian bonds is particularly apparent when looking at corporate bond yields. The yield on the average BBB-rated Canadian bond

Hiking with haste

Faster-than-expected rate hikes led to historically poor bond performance in 2022



Source - Bloomberg

Income returns to fixed income

Average yield on investment-grade Canadian corporate bonds

Source - Bloomberg; data through 11/11/22; yield represented by Bloomberg Canada Aggregate Index

nearly doubled in 2022, and now pays investors more than at any point since the global financial crisis. This surge in yields has returned the Canadian bond market to an environment where investors can achieve reasonable levels of income, in our view, even from historically lower-risk investments.

Another advantage for Canadian bonds, in our opinion, is that the average issue now trades at a significant discount to par. Bonds source yield from two places: fixed cash coupon payments and a built-in capital gain or loss as the price of the bond approaches par value at maturity. For this reason, taxable investors can benefit from discount bonds since they receive more of their yield in the form of a capital gain (this feature does not apply to strips, Treasury bills, or other zero-coupon securities that were issued at a discount).

Opportunities in 2023. We see three-to-seven-year investment-grade corporate bonds as particularly attractive heading into 2023, with yields that offer a reasonable level of income while keeping both credit and interest rate risk modest. This is also where many of the most tax-efficient discount bonds can be found, which further informs our conviction on high-quality intermediate-term corporate bonds.

Rate-reset preferred shares also look relatively inexpensive, in our view, given prices have declined significantly over the past year despite a substantial increase to the 5-year yield they are reset off of. In contrast, fixed-dividend preferred share valuations look somewhat rich to us, and we think long-duration positioning would be better expressed through bonds rather than fixed-dividend preferred shares. For both rate-reset and fixed-dividend preferred shares, we expect volatility to remain elevated in the coming quarters, and believe investors should only allocate to this space if they are willing to assume equity-like risk.

High inflation remains the key risk. We believe the primary risk to fixed income in 2023 ultimately comes from the same source that drove asset prices lower in 2022—high inflation. Although goods inflation has shown signs of moderating substantially, prices for services have remained stickier and present the risk of further repricing in bonds should the BoC need to keep rates high for a longer period than markets expect. Given an unusually wide range of potential economic outcomes in the near term, we see the balance of risks as favouring intermediate-term bonds that lock in improved yields today, but without taking on excessive interest rate risk should inflation prove to be more persistent than expected.

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