Équipe Marchand Filiatrault de RBC Dominion valeurs mobilières

JANUARY 2023

Market update

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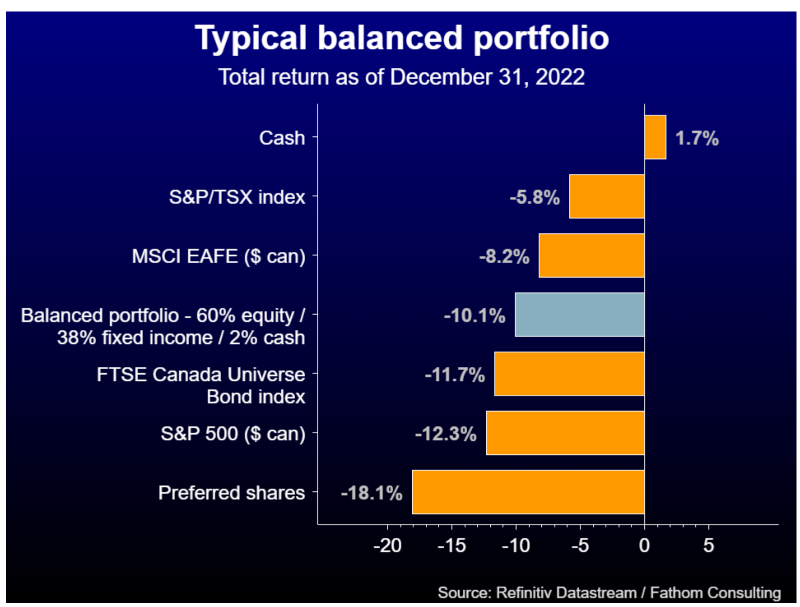
Investors and consumers will remember 2022 for quite some time, as the Russian invasion of Ukraine left a strong impression and triggered a fair amount of uncertainty. At the same time, the conflict also helped push inflation to its highest level in over 40 years. Faced with galloping inflation, central banks the world over hurried to tighten up their monetary policies, and financial markets suffered accordingly. Not only did the abrupt rise in interest rates slow economic activity and erode the growth potential of business profits, it also affected the valuations of all revenue-generating assets, including less risky ones like bonds. As you can see in Chart 1 below, a traditional balanced portfolio replicating the performance of the benchmarks had a tough year—in fact, one of the worst in its history, with a return of -10.1%.

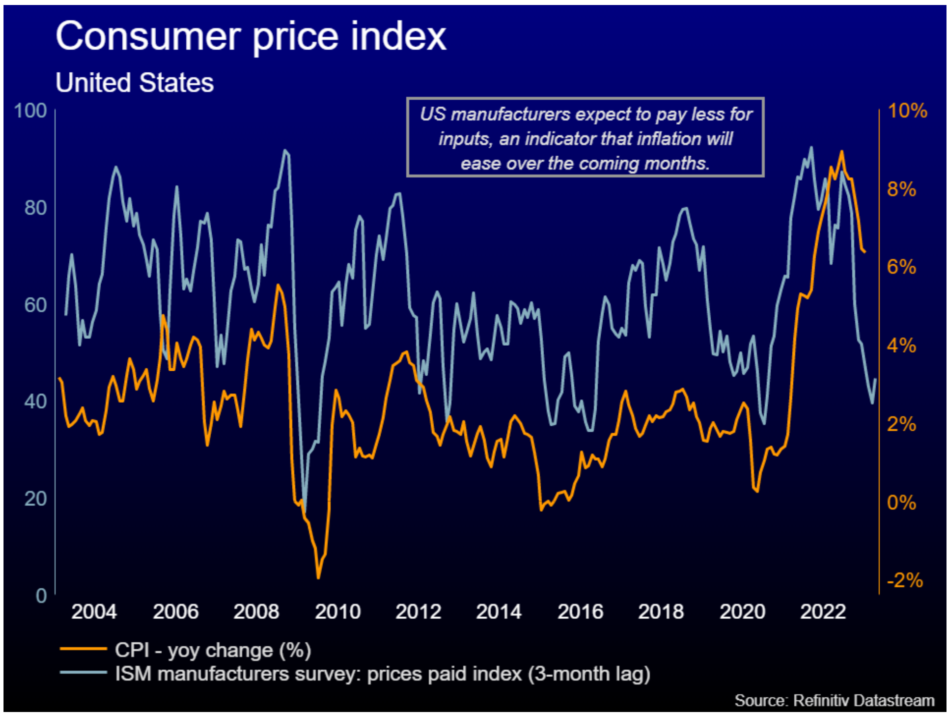
Chart 1



Outlook for the economy and the financial markets

Although inflation is still high, the trend is encouraging. After peaking at 9% in the United States in June, the inflation rate has dropped substantially, down to 6.4% in December 2022. Inflation may continue to go down in 2023, an assertion backed up by a number of indicators. First, commodity prices have fallen dramatically since their peak in the weeks following the outbreak of the war in Ukraine. This drop in commodity prices is having a positive effect on production costs for businesses. In a survey of U.S. manufacturing companies conducted by the ISM, as shown in Chart 2, purchasing managers confirmed that inflationary pressures on the prices paid for inputs are dissipating, which should help ease inflation for consumers.

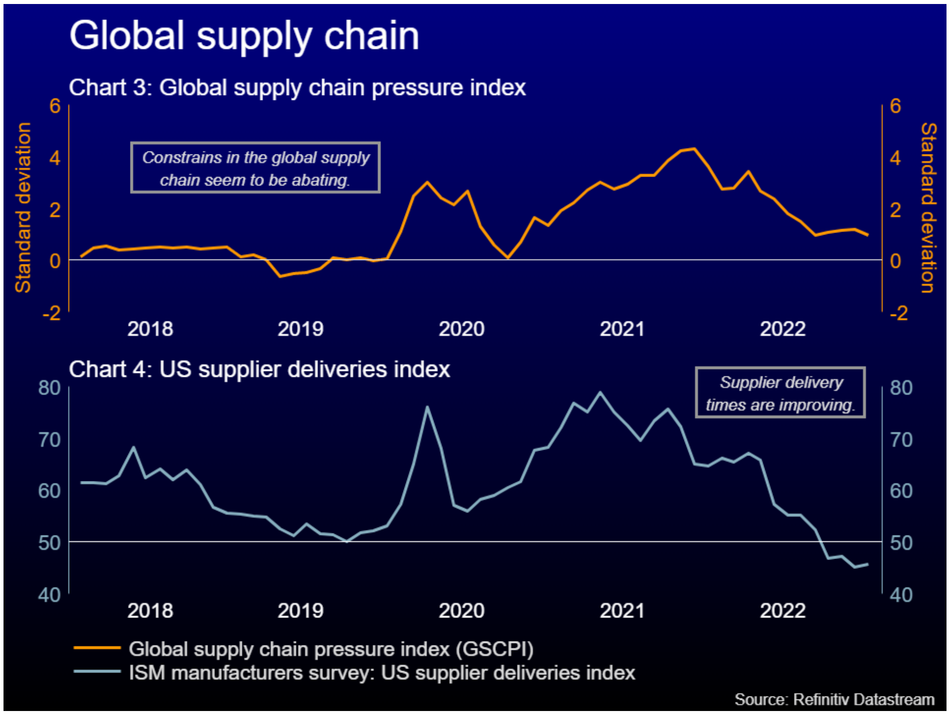
Chart 2



Another factor serving to bring down inflation is the return of better fluidity in global trade after the disruptions caused by the pandemic and the war in Ukraine. As shown in Chart 3 on the next page, the Global Supply Chain Pressure Index created by the Federal Reserve Bank of New York indicates that the various logistical problems are lessening. This normalization of the global economy has a number of benefits. Transportation costs are sharply down, shortages of certain products and components are being resolved, and manufacturers' delivery times are improving, as can be seen in Chart 4 on the next page. With China gradually abandoning its zero-COVID policy, the pressures on the supply chain should continue to decline over the medium term.

Beyond the price of commodities and the improved fluidity of the supply chain, it should be noted that the prices of a number of products and services in the United States have also fallen significantly over the past few quarters. They include gasoline, used cars and various other consumer goods. The reopening of economies has allowed consumers to spend more money on services rather than goods. As a result, inventory levels of certain products that were in high demand during the pandemic are now too high. A better balance between services and durable goods in consumers' budgets will have a positive impact on prices in general.

Charts 3 and 4

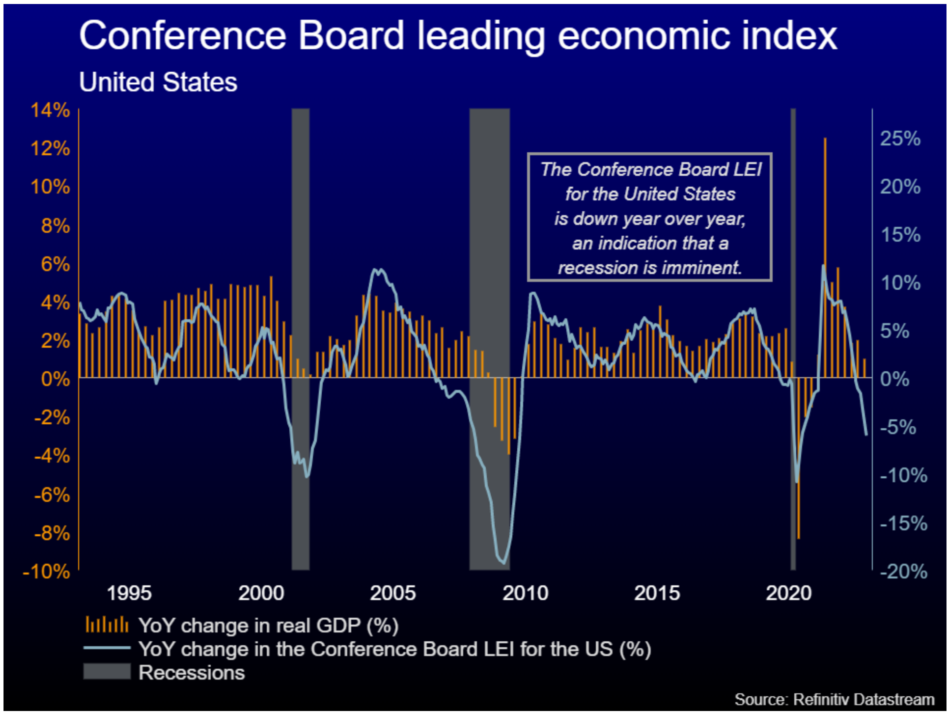


Lastly, it is worth noting that housing costs, the largest component of the U.S. Consumer Price Index (CPI), are still showing strong year-over-year increases even though the average U.S. home price has been declining since July 2022. Because of the complexity of the housing cost calculation, it is slow to reflect the actual situation on the ground. Many experts believe that this important component of inflation is about to weaken and will gradually contribute to the overall decline in inflation in 2023.

In order to combat the inflationary pressures that worsened following the invasion of Ukraine, the Federal Reserve quickly raised rates. Since March 16, 2022, it has upped its key rate eight times, with a cumulative increase to date of 4.50%. This significant tightening of credit conditions is probably one of the most aggressive in the history of the U.S. central bank. At the same time, it is continuing to reduce its balance sheet by selling part of its inventory of government bonds (quantitative tightening). However, with inflationary pressures fading, investors are becoming increasingly confident that the Federal Reserve will soon decide to pause and take stock of the impact of its actions on the economy. This scenario is entirely plausible. That is the logic behind the hold that the Bank of Canada announced in its most recent decision on January 25. The positive outlook on inflation together with the hope that the monetary tightening cycle will end account for a large part of the improved performance of the stock and bond markets in the last few months of 2022 and these early days of 2023.

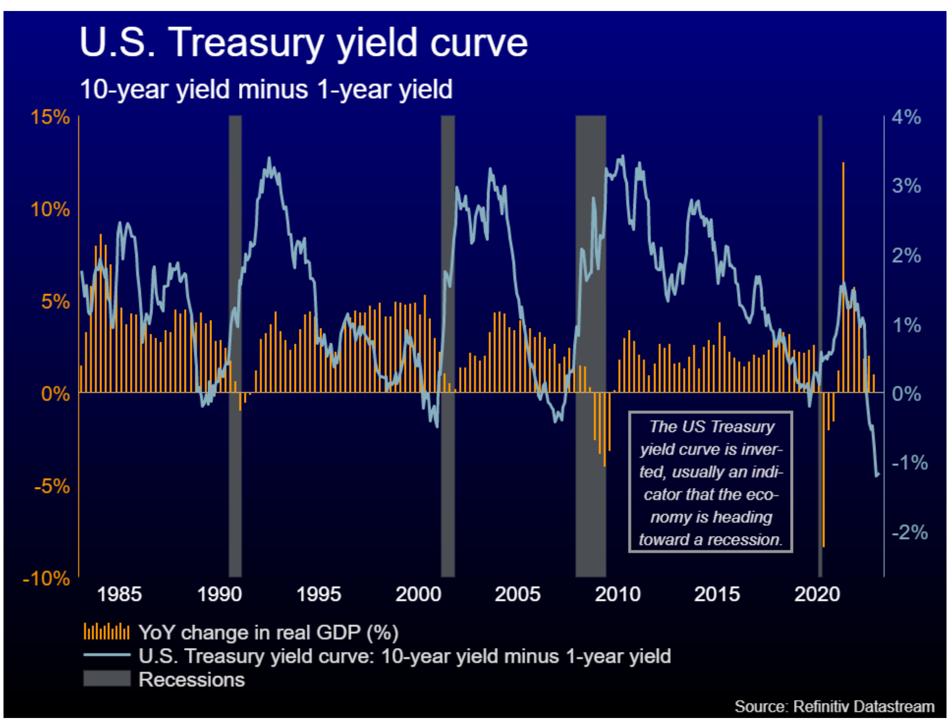
As fears about inflation and the Federal Reserve's actions diminish, investors have now turned their attention to the risk of a recession and the implications for corporate profitability. The repercussions of this monetary tightening will take some time to be fully felt throughout the economy, and in a few months we will have a better understanding of the extent of the economic slowdown caused by the central banks' strong dampening measures. The vast majority of strategists and economists are already expecting a short, mild recession later in 2023. A number of leading economic indicators support this view. For example, as Chart 5 on the next page illustrates, the Conference Board Leading Economic Index in the U.S. is now clearly on a year-over-year decline. Historically, when this indicator shows a decline compared to the same period of the previous year, the U.S. economy enters a recession in the months that follow.

Chart 5



The yield curve in Chart 6 below is another very reliable leading economic indicator that we are monitoring and that shows that a recession is on the horizon. An inversion of the yield curve, where the 1-year U.S. Treasury bond rate rises above the 10-year rate, is usually an indicator that the economy may be heading into a recession in the near future.

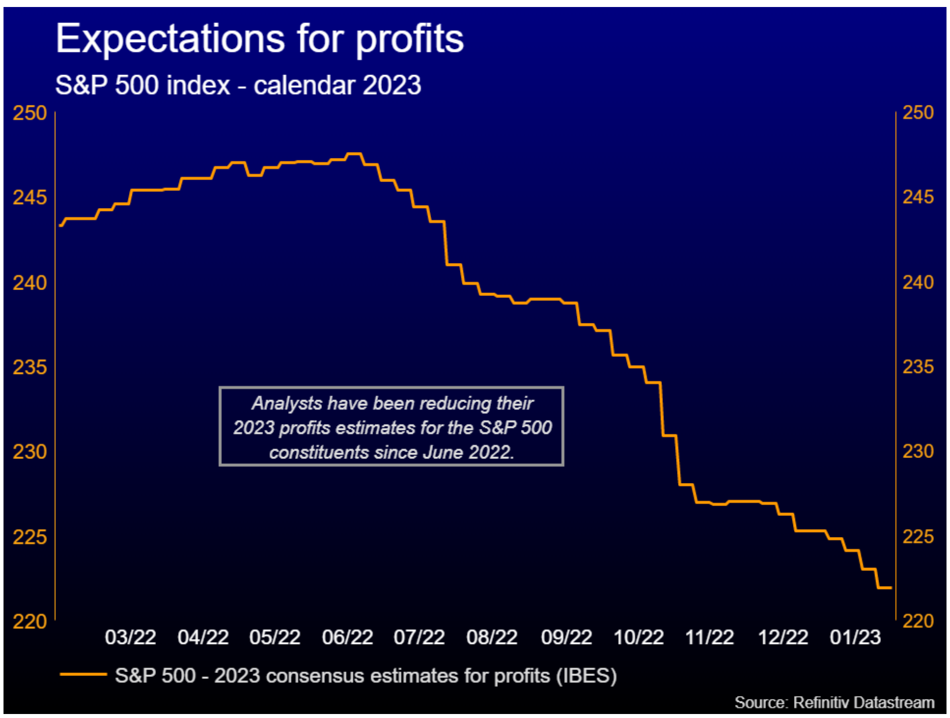
Chart 6



These two indicators are not the only ones we monitor. A number of other leading indicators of economic activity are more positive, including indicators related to employment and business cash flow. Nevertheless, it is undeniable that the economic outlook has deteriorated with the rapid rise in interest rates over the past year. While a soft landing is still possible in the U.S., a short, low-level recession is now the most likely scenario. Fortunately, the likelihood of a severe recession remains quite low in our view. Indeed, the U.S. consumer is in good financial health, the job market remains relatively robust, and corporations are in an excellent position at this time, with high profit margins and good coverage of their debt financing costs. Elsewhere in the world, China's abandonment of its zero-COVID policy should stimulate economic activity in that country, while Europe seems to be weathering the energy crisis better than expected so far.

In such an environment, in which the prospects of recession are very real, the risks are obviously greater for the financial markets, and stock markets in particular, given that their prices are supported by corporations' profitability levels. However, with the leverage effect, both financial and operational, even a small decline in economic activity can significantly impact corporate profits. As can be seen in Chart 7 below, analysts are continuing to lower their earnings expectations for 2023, and we believe this trend could continue over the next few months.

Chart 7



With the strong rebound in global stock markets since early 2023, the valuations of the various benchmarks have swung closer to their historical averages. In the U.S., the S&P 500 is currently trading at a price-earnings ratio of 17.82x expected earnings over the next 12 months. As shown in Chart 8 at the top of the next page, the S&P 500 valuation is even higher than its 10-year average of 17.37x. In the context of a mild recession, in which expectations of profits could continue to decline, we believe that the potential return on equities is limited in the shorter term and that opportunities will arise for certain stocks in the upcoming quarters, when a number of companies may revise their forecasts downwards.

Chart 8

After a difficult 2022, we believe the worst is over for the fixed-income market. The rates of return offered by this asset class have risen to much more attractive levels following the sharp drop in prices in 2022. After a long period of very low interest rates, when investors were constantly looking for alternatives to fixed income and were willing to take on more risk, the expected returns on high-quality bonds are now more attractive. We believe that with inflation easing, the world's major central banks will soon be able to take a break. At the very least, future decisions will be more predictable, and any rate changes will be much more gradual. This calmer environment will reduce bond market volatility. In fact, the normalization of volatility is already under way, and this bodes well for the fixed-income market in the first half of 2023.

The course of inflation will remain a key factor for bonds over the course of 2023. The rebound of the last few months will be sustainable only if inflation continues its downward trend: a very plausible scenario especially in the general slowdown in economic activity that is currently taking place.

Portfolio management – performance

In 2022, the portfolios under our management were obviously affected by the general decline in the stock markets and the fixed-income market. However, our portfolios still outperformed the benchmarks by a considerable margin. There are several reasons for this favourable performance gap. First, on the fixed-income side, the short duration of our bond portfolio worked in our favour. In an environment of rising interest rates, bonds with longer maturities suffer more than those with shorter maturities. For several years now, we have found bonds unattractive and have therefore chosen to keep our maturities shorter. In addition, we have favoured term deposits and partially replaced bonds with alternative solutions that have performed better. As for preferred shares, the performance of these securities was more difficult and was unfavourable to the overall performance of the portfolios. Nevertheless, they have performed strongly since early 2023 and the outlook is good for the coming months.

With respect to the private real estate fund, its performance in 2022 was excellent and was far superior to the bond market. The properties held by the fund benefited from the reopening of the economy and higher rents. The low level of debt and well-spaced maturities over several years limited the impact of rising interest rates on the fund. With regard to the mortgage fund, the deployment of the remaining liquidity will be completed in the coming weeks as mortgage rates are now at higher levels.

As for our equity investments, our stocks performed relatively well in a context of generally declining stock markets. The favourable performance gap of our stocks is largely explained by the quality of the securities in our portfolio. Indeed, with fears of a recession growing, financial strength, profitability and competitive advantages are attributes that are becoming even more attractive to investors. It should also be noted that our low exposure to more speculative sectors, such as new technologies, has served us well. Canadian equities performed particularly well and outperformed the benchmark. Although our U.S. and international equities declined more sharply than Canadian equities, they still ended the year ahead of the S&P 500, our benchmark for this portion of the portfolio.

Portfolio management – changes

In the face of deteriorating economic conditions, we gradually reduced the risk and volatility of the portfolios over the course of 2022 and into January 2023. First, in terms of the weighting of the various asset classes, we reduced the proportion of equities and increased that of cash. Despite recent investor enthusiasm for the equity market, we believe that the issues are still very real and that the next few months will remain volatile. As companies release their results, there will surely be some opportunities to buy back certain stocks at more attractive valuations.

We also made changes within each asset class. On the bond side, we extended our duration partway through the year and took advantage of the significant rise in yields to add high-quality bonds at a discount that benefit from advantageous tax treatment. In a more pessimistic scenario where economic conditions deteriorate beyond expectations, longer-term bonds can act as a counterbalance and thus reduce overall portfolio volatility. We believe that the worst is behind us for the bond market and that 2023 should be both more profitable and less volatile.

On the equity side, we progressively reduced the risk in our portfolio by focusing on quality and opting for stocks that are less sensitive to the pace of economic growth. In addition, we gradually increased our exposure to growth stocks. These companies, whose prospects are less dependent on the economy, have the capacity to grow even in a more challenging environment. In order to reduce portfolio exposure to the commodities sector, we exited a portion of our investments in Canadian Natural Resources, an oil and natural gas producer; Teck Resources, a copper and coal producer; Nutrien, a fertilizer producer; and the U.S. energy index fund. We also eliminated CCL Industries, a container and packaging manufacturer, as well as Dow, a petrochemical company. In the industrial sector, we reduced our positions in WSP Global, Honeywell and Waste Connection after strong gains in these three stocks over the past few years. On the other hand, we initiated a position in Thomson Reuters and in Cargojet, an airline specializing in scheduled cargo flights. In the financial services sector, we eliminated Sun Life, Onex and Berkshire and reduced exposure to Toronto-Dominion Bank in order to fund a new position in Bank of Montreal, whose acquisition of Bank of the West holds promise for the longer term. In addition, we reduced JP Morgan Chase and increased our exposure to US Bancorp. Finally, still in the financial sector, we sold the shares of Brookfield Asset Management distributed by the parent company Brookfield Corporation following a reorganization of the group. To make the portfolio more defensive, we increased our exposure to Telus in the telecommunications sector and initiated a new position in NextEra, a major player in the renewable energy sector that offers excellent growth prospects. On the real estate side, we took a more conservative stance by replacing Allied Properties with First Capital Realty Income Trust. In the healthcare sector, we added CVS Health to the portfolio and funded this purchase by reducing our weighting in Johnson & Johnson and Stryker. In the consumer sector, we initiated positions in Costco and in Magna, a company in the automotive sector. This industry is recovering from the supply problems caused by the pandemic and the conflict in Ukraine, and we believe that Magna will benefit from the catch-up in vehicle production that is needed to meet the unmet demand. In addition, we reduced our weighting in Couche-tard after the stock's excellent performance. Lastly, in the technology sector, we initiated a position in Shopify and in Roper, a developer of software and high-tech products.

In recent years, we have directed funds into the alternative investments category. The objective at that time was to replace a portion of the fixed-income securities that offered very low potential for returns. We therefore added the RBC Canadian Core

Real Estate Fund and the RBC Commercial Mortgage Fund to most of our mandates. Despite the rise in rates and the better return potential of bonds today, we believe that these high-quality alternatives remain attractive, as they provide important diversification to portfolios. The year 2022 provided a good example of the role that some alternative investments can play. Throughout the year, the correlation between stocks and bonds remained high and the two asset classes had simultaneous negative returns. On the other hand, with positive returns in 2022, our two alternative solutions not only made progress but helped reduce portfolio volatility. Over the next few years, financial markets are likely to experience further episodes of high correlation. With inflation likely to stabilize at a higher level than in the past, the spotlight will be on central bankers' monetary policies, and simultaneous movements among different asset classes could be more frequent. As part of this diversification effort, we are currently exploring the possibility of adding a private infrastructure fund to the portfolios to add to our current exposure to alternative investments. Of course, as with real estate and mortgages, the manager's strategy must align well with our philosophy of focusing on investment quality. Unlike the real estate and mortgage funds already in the portfolio, we believe that the infrastructure fund is more of an alternative to equities, and the source of funding for this investment will most likely be this portion of the portfolio. In closing, it should be noted that private alternative investments are not very liquid and require a longer-term commitment. We must therefore balance the weighting of this asset class in portfolios. But in our view, alternative investments are attractive and could represent up to 10% of a portfolio with a long-term investment horizon.

We hope that this account of our management has been useful to you, and we invite you to contact us for any questions or clarification. We also want to take this opportunity to thank you for your trust in us.