2023 Economic Outlook

Stephan: I'm Stephan Bourbonnais, President and CEO of iA Private Wealth. It's my great pleasure to welcome you to our 2023 iA Private Wealth Market and Economic Outlook.

Looking back at 2022 it's certainly been a very complex and challenging environment. We still had to deal with the pandemic, and the lockdown.

We've seen increased volatility in markets. Especially when you're looking at equity and bond returns for the year.

Inflation was hot topic for the year, reaching a 40-year high. We've seen central banks aggressively raising interest rates. We had to deal with lockdowns in China, putting pressure on an already strained supply chain. And the tragic war in Ukraine that continued to send shockwaves across the globe.

As we look ahead to 2023, as investors what should we expect? To help us make sense of all that uncertainty we have the pleasure to welcome our very own Sébastien Mc Mahon. Sébastien is our Chief Strategist and Senior Economist at iA Investment Management. And he now joins us to talk about the macroeconomic and market outlook for 2023.

Sébastien, welcome.

Sébastien: Thank you Stephan, it's great to be here. I'll be covering the economy, the markets. Maybe looking back first to 2022, but spending more time looking ahead at 2023 what we could expect. And you know, there was some negative returns last year. A heavy tone in the market, inflation all over the place. But I'll share that you know, the overall story is pretty simple. It's a bit of a waiting game right now to understand when to jump back into risk assets. But we are very much in a transition period here.

I'll start here with a look back at the returns in 2022. So here, two columns here in this table.

2022, and 2021 because we need to remember what happened in 2021 to have a good understanding of how and why 2022 happened the way that it did.

So if we go back to two years ago, or early 2021 the markets were enthusiastic, rates were at all-time lows. Inflation had not yet started to rise. Liquidity was everywhere because rates were low. Central banks still had some programs in place for quantitative easing supporting businesses.

So we had exceptional returns in 2021. Rates were very low, but they started to rise. Not the leading rate from central banks. But market rates started to rise as the year went on. In anticipation that central banks would have to tighten in 2022 because of inflation. So we had negative returns for fixed income in 2021, but we had very strong returns for equities.

Now when 2021 ended valuations were very, very high. So bonds were expensive because interest rates were still very, very low on a historical basis. And the price-earnings ratio, or any valuation measure that you like to look at for equities were very elevated. And we had the start of an aggressive tightening cycle that was even more aggressive than the market anticipated because inflation was stronger, more widespread than expected mostly because of Russia's invasion of Ukraine, and the impact on commodity prices, and all the uncertainty and the strain on supply chains that pushed inflation to peaks that we reached last summer.

So expensive markets and tightening liquidity gives you what you see on the left. Very negative returns for both equities and bonds.

Now the story of course through the year, what caused all of this on the next slide here, central banks you know the year of jumbo rate hikes. So it wasn't just 25 basis points increments like we're used to. We saw 50, 75 and even 100 basis points a clip both in the U.S. and in Canada.

So central banks were very accommodative at the beginning of the year. Leading rates were at the floor. After that they needed to go from accommodative to neutral. Which is somewhere between 2% and 3% on the leading rate. All the way to restrictive which is anything above 3%, and now we're at 4.5% in Canada – 4.25% in Canada, 4.5% in the U.S. as we're recording this on January 17.

Now some more hikes are expected in 2023. Maybe one in Canada, maybe two in the US. I'll discuss that in a few minutes, but we're just about at the end of that. So that makes us more constructive for 2023. Especially for fixed income after two negative years of returns. Maybe 2023, at least this is our best case, we'll have positive returns, interest rates are high. And if we do have a recession which is the forecast that we have and I'll talk about that in a few seconds. Then you could have some positive returns like capital gains from fixed income. So it's good news.

So 2022 was a year for the ages as I just said. Negative returns of both equities and bonds. This was a one-off. Here you have all the data points since 1977. Every year is – every point here is a calendar year. So returns for bonds on the horizontal axis, vertical axis is equities. We're at that bottom left here.

So 2022 was alone by itself. Looking, going forward we still think that the rest of the picture here will hold. Meaning that we'll either have positive returns for both asset classes, or at least some diversification between the two asset classes. Meaning that the 60/40 or balanced portfolio, this is still a winning strategy. 2022 was a fluke, was an outlier, but going forward balanced portfolios should do the job again.

Now looking towards 2022/2023 on the left here and what you see is that last year was negative. Not one of the worst years in history, but still a pretty negative one. But looking forward, 2023 on the right, instead of presenting you know our forecast here we thought maybe we'll bring you know, a view at what Wall Street is seeing, and the current level, the red line that's there. That's the level as of the end of 2022. And as you can see some firms are quite optimistic, some are pessimistic.

But you know, the middle part of the distribution is pointing towards probably single-digit positive returns. So this is also our scenario. We think that we should have positive – small but positive returns in 2023. But H1, first half of the year, could be more volatile. The second half of the year could be more positive. More on that in a few minutes, but you know, it pays to wait before going all-in into equities right now.

But you know, when you have the end of a bear market that means that a new bull market rises. And if we have the end of this bear market somewhere in 2023 you don't want to miss the first few months, or first few quarters of a bull market.

So being invested in funds, I mean our job is to be tactical with the positioning. So trust us to find the right moment to turn more aggressive with your money. But being invested in you know, in GICs, and staying on the sidelines for all of 2023? Maybe at the end of the year you'll find yourself with a loss of opportunity here.

So to wrap this part up here, 2023 when you look at the news likely you'll be hearing bad news again on the economic front. We'll be hearing about a recession materialising. Maybe unemployment rising. So this is the impact of monetary policy tightening.

So on the left here we have our leading indicator, or the red line pointing lower. So this is pointing towards tougher times on the economic front. This is our monetary policy cycle that we built in-house. So it is pointing towards tough times.

On the right this is the forecast from the IMF. The stick on the far right shows that they're expecting about 2.5% growth next year. We are expecting a revision from them any day now, but 2.5% and less for the global economy is considered a global recession. So we're just about to hit that, so there's no escaping it. But markets are pricing things ahead, and most of that is already priced in, so that's the good news.

But one of the most important macro indicators that you'll hear in the news in 2023 likely is going to be housing, and you know if rates are rising that means that mortgage rates are rising. It's less easy to – it's less attractive to buy a house. House prices need to fall because you know interest rates are higher.

So to have access to a house people will be less aggressive in bidding for a house, and on the right you see that the drawdown in prices is already at about 10%. And don't be surprised if we go to -15%, -20%, -30% when it's all said and done. Because housing prices rose up so quickly with low interest rates over the last two years that now that we've more than normalised monetary policy should be moving down.

So it's not the bubble that's bursting. It's just you know, a return, a swing of the pendulum here that is a normal way for the economy to behave. But in 2023 we'll hear lots of that, and falling housing prices means that the wealth effect is negative for consumers. So they are less willing and able to spend. This is the kind of story that brings us into recession territory.

So financial markets now, how many hikes to come in 2023? So the chart here? This is the terminal rate. This is what's expected by the market for the peak of leading rates in 2023. The blue line is the U.S., so about 5%. Now we're at 4.5% so maybe two more hikes should be expected in 2023 from the Fed. And in Canada we're at 4.25, leading rate – the terminal rate expected here is 4.5% so maybe one more hike probably on January 25 with the labour market that is still pretty strong.

So we could have another hike there, but we're almost done. So that's the good news. The market agrees, the Fed, the Bank of Canada signals that we're almost done. This is well-aligned, but the most important story of 2023, and that's why we expect some volatility in the first half of the year is that the message and here I'm focusing on the Fed because of its importance for financial markets. But the message is that first the Fed says that it would be imprudent to start cutting rates prematurely. Or in other words when you fight inflation you need to fight it until the end.

And on the right you see the market pricing for the Fed rate. And the markets are pricing that the Fed will start cutting after July, and then even they're pricing 50 basis points of cuts in the second half of this year. And the Fed is fighting strongly against that and at some point you know, there is always risks that the Fed bends to market pressure, but we tend to believe the Fed on this one. And that means that at some point markets will have to you know get with the program. Make up their mind about that, and that could cause volatility for market adjustment or you know in other words maybe some more pressure downwards and we could test the lows of last October.

This is our base case scenario. That's why we're getting more constructive, but we're still on the defensive side, at least for the first half of 2023, within our portfolios.

The second important message from the Fed is that they're trying to tighten monetary conditions, financial conditions. They're not trying to ease them. And the chart on the right shows you know, that the line is rising. That means that financial conditions are getting easier. That means interest rates are falling on the lower, longer end of the curve. And the stock market is rising. So the Fed, you know we used to have something in the markets over the last 20 years that was called the Fed Put.

So that whenever the stock market would fall a little bit you know the Fed would do or say something to prop up the market, and you now off we go. Maybe now it's the opposite of that, when the stock market gets too excited. We could have the Fed coming out, and we're already starting to see that, but the market is not really listening. At least so far this year.

And just to you know, stop the movement, and push the stock market down. So until we see resolution on that we remain careful.

So here very quickly even though we are more – we are still defensive on the U.S. stock market, we are getting pretty constructive on the Canadian stock market. If the bear market ends in 2023 that means a new bull market will start, and usually cyclicals, the indexes that are cheaper, they tend to benefit from that.

If we have a recession in 2023, and this is our base case, after that the new economic cycle starts, and you know that's when commodities tend to do best and Canada is well positioned for that so, the Canadian stock market.

So on the left, the S&P 500 price pretty much in line with the average of the last 20 years, but on the right the TSX, it's very cheap compared to the U.S., and it's cheaper than pretty much any moment over the last 20 years. Except for the worst of the 2008 recession.

So we tend to favour the TSX. We love the TSX for the long run, and we're warming up.

So when we go to our current positioning, the next slide here. So there's a few messages here. So this is as of early January, and we did make a few changes over the last two weeks. Which I'll flesh out here.

So we were overweight money market. So that means that we have some cash on hand for opportunities that may arise. So meaning we still think this is an opportunity – this is a thing to do in 2023 because the opportunities will abound.

Fixed income, we like bonds because rates are higher. And if there is a recession we'll have some capital gains there.

We were max underweight equities. That was about -5% in our funds. And if you look at relative equity beneath, in H2 of 2022 we decided to not take any geographical bets because cross-asset correlations were pretty strong, but now we're getting warmed up to a few things. So we upgraded Canadian equities from underweight to neutral just last week. We did the same thing with international equities.

So EAFE, Europe. Same thing with emerging market equities, but to compensate we went to an even lower – so a stronger underweight on U.S. equities. So now we think that to the upside, or the downside TSX, EAFE, emerging markets which are all cheap on a historical and relative basis should do better than the U.S. stock market, and we'll see in 2023 how if we do retouch, retest the lows of

October, maybe that would be a time to warm up again to U.S. equities, but you know their recent rebound? We thought it was a good idea to sell some more.

So maybe just to end with the web page iA.ca/economy. So you can always find us there, and if you haven't done so already you can subscribe to the newsletter if it's something that you'd love to receive. One email a week on Friday afternoon. You get podcasts. You get Finance 101. And also pretty present on social media.

So I just squeezed everything into this presentation. Now maybe it would be a good time to have a conversation with my friend Stephan here. So Stephan, back to you.

Stephan: Thank you, Sébastien. Great update and yes I do have a couple of questions for you. Love to go back to 2022. You know, looking back from your perspective, anything that happened in 2022 that actually surprised you? Or anything that you thought would happen that didn't happen?

Sébastien: Yeah, the surprise of 2022 was how well behaved the market was during the drawdown. When you think about it, when you look at the chart of the stock market you know, it's going down. There were some relapses. Some bear market rallies, but we did not really have any big panic event in 2022.

And we were expecting at some point to have such an event. Because the story, one of the main stories that we had in late 2021 was that the retail sector, and you know the speculators like the Reddit crowds, with the meme stocks and all of that, how present they were in the markets. How over-represented they were in late 2021.

And we were thinking that when we'll see you know pullbacks of 5%, 10%, 15% and at some point we could have you know a mass exodus of retail, creating a panic.

And we have not seen that. So that was a surprise. That's good news for the market, but now when we look in 2023 we do also know when we do our historical studies that bear markets, they tend to end. Usually the last lows of a bear market coincide with the panic event. And people panic, they sell out and you know, the market becomes so cheap that you know, it's a good time to buy.

So maybe we'll have that in 2023 because retail is still very present in this market. But you know this time may be different.

Stephan: Thank you for that. As you mentioned earlier the markets are forward looking. The start of the year's been pretty good so far. We still have some question about the momentum that we could get. Especially from an earnings perspective I would think. What's your view on what we're seeing currently in the market?

Sébastien: Well you're right that the momentum is strong. Looking at what's outperforming right now there are some signs of fragility. Like for example the meme stocks that I just mentioned. The AMCs, and GameStop, and Bed, Bath & Beyond and all these names. They are getting bid quite a bit.

So maybe we're seeing again the activity of short-term speculators. Also the most shorted stocks are also reacting pretty strongly. So maybe there's some short covering here. When we look at it on a sector-by-sector basis we don't really see the kind of breadth that we love to see of you know, long-term, buyable.

Also we still remain careful, but we are warming up? We're less underweight than we were. And we're mostly outside of the U.S. But we are warming up quite a bit. Well, slightly, not quite a bit yet.

As for earnings, we do expect to see some more downward revisions. So there's a process here and the market needs to make up its mind about whether a recession will happen, and what's going to be the impact? And we think earnings expectations are still a bit high. So until this is settled in the markets, we tend to stay away from what's expensive. And that means the S&P 500 and the NASDAQ.

Stephan: Thank you Sébastien. I'd like to hear you on a couple of things that I think our clients will see popping up on the news over the next little while. There has been conversation about potentially looking at a double-dip on inflation. Look, I'd love to get your point of view on that.

Sébastien: Yeah, well it's a risk. That's why I don't think, and we don't think that the Fed will blink, and will start hiking prematurely. Because every central banker in the world right now is quoting the 1970s, and the work of Paul Volcker. And remember that in the 1970s it was Arthur Burns that was chair of the Fed. Inflation was strong, fought inflation. When it started to look like inflation was cooling off they started easing too soon and inflation picked up again, and that's why that's the lesson why you need to fight inflation until the end.

So if we believe that this will be the modus operandi of central bankers, well indeed they will fight inflation until the end. While it's unlikely that inflation will get back to target in 2023, it's a 2024 story. So very likely rates will stay high in 2023. That will create some economic weakness. We will go into a shallow recession, not a big recession but a shallow one. Markets need to adjust to that. Inflation will be fought off and then we can start easing in 2024. So this is our base case.

If they do start to ease before it's going to be good probably for your portfolios out there with the stock market liking it. But probably that just means that there's going to be a bigger fight to come down the road.

Stephan: Hopefully we've learned a lesson. And hopefully we won't celebrate too early by cutting rates and obviously going through more issues on the inflation side.

Last question for me, Sébastien. We've seen a lot more conversation and talk about potential stagflation. Would you put in context for our clients what stagflation means? And should we be concerned about it?

Sébastien: Yeah, well of course I think where we have both feet in stagflation right now. Because the definition of stagflation, at least the one I was taught in school that I use is that when inflation is strong enough to you know, mute growth. So you have an economy that's stagnating because of inflation. And it's easy to see, inflation makes it so that you know, we're losing spending power. So we're spending more dollars, but to buy fewer goods and services.

And you know, recession is a real phenomenon. So they look at the quantity of goods and services that are traded, not the value of goods and services that are traded. So eating away at spending power. So economies slowing down. Businesses, they're delaying some investment opportunities. So slowing economic growth because of the uncertainty coming from inflation, and inflation and wages making businesses having difficulty to hire people. And they're not able to meet demands, so slower growth.

So where we have both feet in there, when we solve the inflation issue. And if the economy, if we do have a bit of a recession then we'll still have some structural headwinds with labour shortages. But you know, the stagflation period that likely started in early 2022 might last all the way through late 2023. But after this will be in the past.

So I think where we have both feet in there, and the work that the central bankers are doing will get us out of that.

Stephan: Fantastic, Sébastien thank you very much for your insightful perspective as always. I invite you all to follow Sébastien and have access to the valuable content that's provided by his team, and our economic team. And as always if you have any questions or concerns, reach out to your advisors. They're there to be on your side. To counsel you. To guide you through all this uncertainty, and they're doing it with skill, conviction, and resolve. So hope you have enjoyed the presentation and we will see you next time.

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