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ASSET ALLOCATION QUARTERLY

- Global economic slowdown and mild recessions expected in many developed countries
- Inflation has pulled back, but the fight to get from ~3 per cent to 2 per cent targets will drag on
- Rate increases still being absorbed through the economy, but expect "higher for longer"
- Opportunities in fixed income

It's All about Inflation

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Quarterly Outlook: It’s All about Inflation

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Key concerns in the first half of 2023 focused mostly on central banks raising interest rates to tackle inflation brought on by stimulus from fiscal and monetary policy pandemic relief efforts, supply chain disruptions and commodity volatility. Recession concerns have also been a persistent theme for over a year, and a few notable bank failures and U.S. debt ceiling uncertainty raised anxieties further. Despite this backdrop, some equity markets have surprised many by surging, most notably the NASDAQ and S&P 500, with the caveat that seven notable technology stocks were responsible for the majority of those gains.

As we enter the second half of the year, we are primarily focused on the fight against inflation as central bankers try to drive that measure down to their two per cent targets. Although we have seen relatively rapid retrenchment from the peak inflation numbers in mid-2022, employment and wage growth have remained strong, making further progress slow, with the Bank of Canada (BoC) expecting to achieve its target now only in mid-2025. This could lead to interest rates that stay higher for longer as the risks of easing up too soon are seen as greater than the potential benefits.

As the global economy slows and previous rate hikes continue to be absorbed by the economy through 2024, we remain generally conservative regarding equity markets in the short term and recognize certain opportunities in fixed income.

Key Takeaways:

- **Growth is slowing.** Most developed countries are expected to enter recessions as interest rates have risen to slow spending and tackle inflation. Most recessions are forecast to be mild and short lived, with some economies (Canada’s included) expected to navigate a soft landing, getting inflation down to two per cent target levels without having real GDP growth slip into negative territory.

- **Equity markets have generally done well so far in 2023.** For the most part, equities have done well, especially companies that focus on technology and specifically Artificial Intelligence (AI). Broader indexes have been more modestly positive, but have recently shown signs of picking up.

- **Expect volatility.** As economies slow, we could still expect to see negative surprises in quarterly results or forward-looking guidance. We are cautious short term but positive about opportunities as we look past this recessionary environment, recognizing that the path may be rocky.

- **We favour a defensive posture.** Within the context of staying invested, we favour sectors that have generally fared better during downturns. In Canada, we would consider consumer staples, communication services and utilities. In the U.S., we would look at healthcare, utilities, consumer staples and real estate.

- **Inflation is going to persist.** In Canada, the battle to get from ~3 per cent to the 2 per cent target will likely drag well into 2025. That leaves the BoC with both the latitude and impetus to keep interest rates higher for longer and/or further raise rates. The risks of lowering rates too soon outweigh the risks of not doing enough.

- **Higher rates provide opportunities in fixed income.** If we accept that yields, especially those of longer maturities, have peaked, adding duration or extending maturity to fixed income portfolios could provide attractive yields and lower re-investment risks as well as capital gains potential when rates decline in the future.

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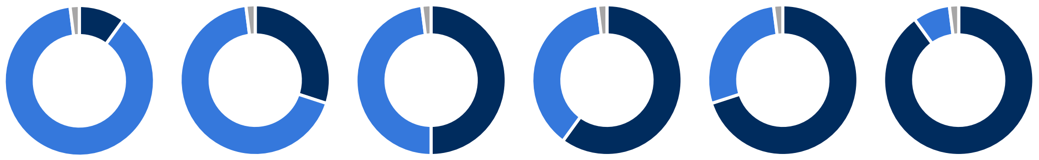


CURRENT POSITIONING	Ultra Conservative	Conservative	Moderate	Balanced	Balanced Growth	Growth
Equity	**10%**	**30%**	**50%**	**60%**	**70%**	**90%**
Canadian Equities	4.0%	10.0%	20.0%	25.0%	25.0%	30.0%
US Equities	4.0%	10.0%	15.0%	17.5%	20.0%	30.0%
Developed Markets Equities (ex NA)	2.0%	10.0%	15.0%	17.5%	25.0%	30.0%
Fixed Income	**88%**	**68%**	**48%**	**38%**	**28%**	**8%**
Canadian Aggregate Fixed Income	60.0%	45.0%	30.0%	38.0%	20.0%	8.0%
Canadian Short-term Fixed Income	28.0%	23.0%	18.0%	-	8.0%	-
Cash	**2%**	**2%**	**2%**	**2%**	**2%**	**2%**

ASSET CLASS DEFINITIONS

Canadian Equities: S&P/TSX Composite: the benchmark Canadian index, representing roughly 70% of the total market capitalization on the Toronto Stock Exchange with about 250 companies included in it. The Toronto Stock Exchange is made up of over 1,500 companies.

US Equities: S&P 500: is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

Developed Markets Equities (ex NA): MSCI EAFE: is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The Index is available for a number of regions, market segments/sizes and covers approximately 85% of the free float-adjusted market capitalization in each of the 21 countries.

Canadian Aggregate Fixed Income: FTSE Canada Universe Bond: tracks the performance of investment-grade (BBB or better), government and corporate bonds in Canada.

Canadian Short-term Fixed Income: FTSE Canada Short Term Bond: intended to represent the Canadian short-term bond market. It contains bonds with remaining effective terms greater than or equal to one year and less than or equal to five years.

Cash: FTSE 91 Day T-Bill: tracks the performance of 3-Month Government of Canada Treasury Bill. The index is designed to reflect the performance of a portfolio that only owns 3-Month Government of Canada Treasury Bill, the current on the run T-Bill for the relevant term, switching into the new T-Bill at each auction.

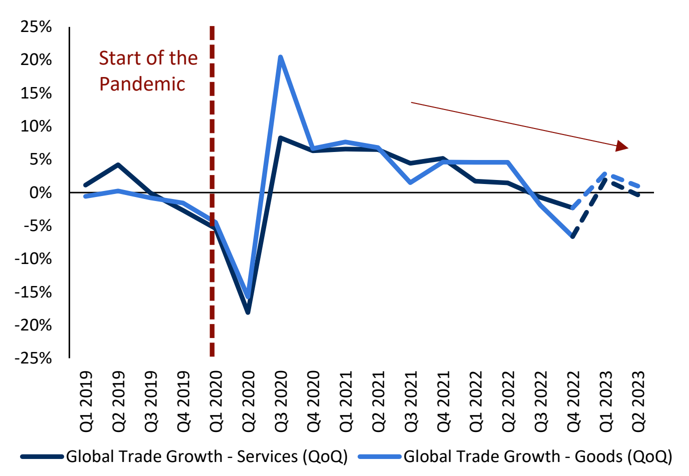
Market Commentary

Global Economic Outlook

From a global perspective, we are watching most developed economies continuing to tackle inflation brought on by monetary and fiscal policies that were enacted to deal with the pandemic. This is slowing the global economy, as the increased borrowing costs and tighter financial conditions have intended. Global inflation is easing, helped by lower energy and goods prices, although services remain more stubbornly resilient with generally tight labour markets driving up wages and costs. The BoC is projecting the global economy to grow 2.8 per cent in 2023, by 2.4 per cent in 2024 and 2.7 per cent in 2025. This is slightly below the consensus view detailed in the table below.

Global trade has started to decrease (see LHS table below), as many businesses are more conservative in their spending/investing. Most developed countries are expected to fall into some kind of recession, although the general consensus is that recessions will all be mild, lasting only two or three quarters, allowing full-year numbers to remain flat or positive.

Global Trade Growth Remains Weak [LHS]; Real GDP Growth Faces Mounting Headwinds [RHS]



	Average			Forecasts	
	2000-2020	2021	2022	2023	2024
World	**3.2%**	**6.9%**	**2.2%**	**3.2%**	**2.6%**
Advanced Economies	**1.4%**	**5.4%**	**2.7%**	**0.7%**	**0.3%**
US	***1.8%***	***5.9%***	***2.1%***	***1.3%***	***0.4%***
Canada	***1.8%***	***5.0%***	***3.4%***	***1.5%***	***1.0%***
Euro	1.0%	5.3%	3.5%	0.0%	0.3%
UK	1.2%	7.6%	4.1%	0.1%	0.2%
Japan	0.6%	2.2%	1.0%	0.8%	0.0%
Australia	2.6%	5.2%	3.7%	1.2%	0.5%
Emerging Economies	**4.7%**	**7.9%**	**2.0%**	**4.7%**	**3.9%**
Emerging Asia	6.1%	8.7%	1.4%	6.4%	4.7%
China	7.3%	8.4%	3.0%	6.0%	4.6%
India	6.4%	8.9%	6.7%	6.3%	5.5%
Russia	3.6%	5.6%	-2.1%	1.3%	1.8%
Brazil	2.1%	5.0%	2.9%	2.3%	0.8%
Mexico	1.6%	4.7%	3.0%	2.5%	1.3%

Source: UNCTADstat; Capital Economics; Raymond James Ltd.; Data as of July 16, 2023.

These manufactured slowdowns are all to contend with the excessive inflation that resulted from things like pandemic-related fiscal stimulus and supply-chain issues. As inventory levels have mostly corrected and manufacturing capacities have been restored, inflation is generally down from recent peaks, with three per cent inflation rates within sight in North America in the coming months or quarters. However, getting down to the desired two per cent range is looking more challenging as we have lapped the monthly spikes in 2022 and now have to contend with longer-term and stickier wage-related pressures, tight labour markets and still strong consumer demand. If we don't see continuous progress towards those two per cent inflation targets, we should expect more rate hikes, at least in the short term.

Higher unemployment rates, or at least lower wages, are expected to be the prescription to slow inflation enough to allow central banks to ease off interest rates and set the stage for more stable long-term economic growth.

In the European Union, despite growth in the services sector, we are seeing contraction in manufacturing, weak retail sales and declines in housing prices.

Elsewhere, we are seeing disappointing growth in China after a surge early in the year, which was expected to somewhat offset slowing growth in developed economies. Chinese exports have slowed, and the country's property sector has weakened, although the government appears to be stepping in to support the real estate market and boost consumption as concerns of deflation arise.

Another narrative playing out is a technology trade war between the U.S. and China as each puts restrictions on imports/exports, partnered with the U.S. moving towards re-industrialization. This is intended to reduce reliance on countries such as China and to avoid the kind of supply-chain strains that were evident through the pandemic. These "on-shoring/friend-shoring" efforts include securing domestic sources of critical materials such as elements required to achieve ambitious electrification goals.

As tensions with China mount, eyes are turning to India, with a young and rapidly growing working-class population, rising education/technology/manufacturing skills and growing consumer market, driven by a rapidly growing middle class. The risks of focusing too much on EM would be in that recessions throughout developed markets could reduce risk appetites of international investors, which could shift funds to less risky assets and economies. As we move into the next business cycle, we also look at Latin America and specifically Mexico as being potential beneficiaries of a "near-shoring/friend-shoring" push.

Inflation Still Remains Elevated [LHS]; But Markets Are Expecting Interest Rate Relief into 2024 [RHS]

	Average			Inflation Forecasts	
	2000-2020	2021	2022	2023	2024
World	**3.6%**	**3.5%**	**6.9%**	**5.4%**	**3.4%**
Advanced Economies	**1.7%**	**3.2%**	**7.5%**	**4.6%**	**2.3%**
US	2.1%	4.7%	8.0%	4.0%	2.2%
Canada	1.9%	3.4%	6.8%	3.7%	2.2%
Euro	1.6%	2.6%	8.4%	5.5%	2.5%
UK	2.0%	2.6%	9.1%	7.5%	2.0%
Japan	0.1%	-0.2%	2.5%	3.0%	1.6%
Australia	2.5%	2.9%	6.6%	5.9%	3.3%
Emerging Economies	**5.0%**	**3.8%**	**6.6%**	**5.8%**	**4.0%**
China	2.6%	0.9%	2.0%	0.5%	2.0%
India	5.9%	5.1%	6.7%	5.3%	4.7%
Russia	10.5%	6.7%	13.8%	5.3%	5.8%
Brazil	6.2%	8.3%	9.3%	4.8%	5.0%

			Interest Rate Forecasts	
	Current	2022	2023	2024
Advanced Economies				
US	5.25%	4.38%	5.38%	3.38%
Canada	5.00%	4.25%	5.00%	3.00%
Euro	4.00%	2.00%	4.00%	3.25%
UK	5.00%	3.50%	5.25%	4.50%
Japan	-0.10%	-0.10%	-0.10%	-0.10%
Australia	4.10%	3.10%	4.60%	3.35%
Emerging Economies				
China	3.55%	2.00%	1.80%	1.80%
India	6.50%	6.25%	6.50%	5.50%
Russia	7.50%	7.50%	8.25%	8.25%
Brazil	13.75%	13.75%	12.50%	9.75%

Source: Capital Economics; Raymond James Ltd.; Data as of July 16, 2023.

Global Equity Markets

Major international equity markets have generally fared well through the first half of 2023 (in local currencies) with Japan's Nikkei 225 up ~29 per cent on a strong domestic economy, weak currency and low interest rates, although foreign exchange rates reduced those gains for Canadian and U.S. investors. The inflation problems facing many other countries are actually somewhat welcome in Japan, which has struggled with deflation for decades. Structural labour reforms and improving corporate responsiveness to shareholders could make Japan a good area of focus going forward, although being one of the last countries to lift COVID restrictions, we may still be seeing benefits of revenge spending and inventory restocking temporarily boosting recent results. Elsewhere, the EURO STOXX 50, Germany's DAX and France's CAC 40 were all up in the mid- to high-teens, showing similar resilience as the U.S., with lower energy costs, supply chain improvements, easing inflation and strong labour markets shrugging off (severe) recession concerns. In contrast, Hong Kong and China have been the laggards, with the U.K.'s FTSE 100 up only modestly as the country continues to struggle with persistently higher inflation and the potential of more interest rate hikes slowing its weak economic growth.

Global Equities Performance

	First half of 2023			2022			Current	Historical	Discount /
Select Global Equity Indices	(in LCL)	(in USD)	(in CAD)	(in LCL)	(in USD)	(in CAD)	P/E NTM	P/E	Premium
Canada									
S&P/TSX Composite	5.7	8.2	5.7	-5.8	-12.2	-5.8	13.2	14.6	-1.3
S&P/TSX 60	5.7	8.3	5.7	-6.2	-12.6	-6.2	13.4	14.3	-0.9
S&P/TSX Small Cap	-0.3	2.1	-0.3	-9.3	-15.4	-9.3	12.9	16.8	-3.8
Canada Growth*	10.0	12.7	10.0	-13.0	-18.9	-13.0	19.9	18.0	1.9
Canada Value*	-0.4	1.9	-0.4	-1.3	-8.0	-1.3	10.2	12.2	-2.1
U.S.									
NASDAQ Composite	32.3	32.3	29.2	-32.5	-32.5	-27.6	27.9	19.6	8.2
S&P 500	16.9	16.9	14.2	-18.1	-18.1	-12.2	19.3	16.1	3.2
S&P Mid Cap 400	8.8	8.8	6.3	-13.1	-13.1	-6.7	13.8	13.6	0.2
S&P Small Cap 600	6.0	6.0	3.6	-16.1	-16.1	-10.0	13.7	15.4	-1.7
S&P Composite 1500	16.2	16.2	13.4	-17.8	-17.8	-11.8	18.7	15.8	2.9
S&P Composite 1500 Growth	20.3	20.3	16.7	-28.7	-28.7	-24.2	21.3	18.6	2.7
S&P Composite 1500 Value	11.7	11.7	7.9	-5.5	-5.5	-0.9	16.4	13.9	2.4
Europe									
Euro STOXX 50 (Europe)	19.2	18.5	15.8	-8.8	-17.2	-11.2	13.0	13.2	-0.2
FTSE 100 (U.K.)	3.2	6.8	4.3	4.7	-10.4	-3.9	10.5	12.5	-2.0
CAC 40 (France)	17.4	20.0	17.2	-6.7	-12.4	-6.1	13.8	13.3	0.5
DAX (Germany)	16.0	18.6	15.8	-12.3	-17.4	-12.5	11.4	12.6	-1.3
Asia Pacific									
Hang Seng (Hong Kong)	-2.7	-3.1	-5.4	-12.5	-12.6	-6.3	9.1	12.5	-3.4
Nikkei 225 (Japan)	28.6	17.4	14.7	-7.3	-19.1	-14.3	18.7	16.4	2.3
MSCI China (China)	-4.3	-5.4	-7.6	-20.6	-21.8	-16.1	10.2	10.9	-0.7
Major Aggregates									
World (Global)*	15.1	15.1	12.4	-18.0	-18.0	-12.0	16.9	15.6	1.3
EAFE (DM ex U.S. & Canada)*	12.5	12.5	9.9	-14.4	-14.4	-8.1	13.1	13.5	-0.4
EM (Emerging Markets)*	5.2	5.2	2.7	-20.6	-20.6	-14.8	12.3	11.7	0.6

Source: FactSet; Raymond James Ltd.; Data as of June 30, 2023, ranked by YTD returns in CAD. LCL: listed in local currency. Historical P/E Median: 1/1/2000 – 6/30/2023. *Indices are represented by their corresponding iShares ETFs, serving as proxies.

In the last column of the table above, we consider current price-to-earnings multiples (on next-12 months EPS forecasts) against the median since 2000. As you would expect, the NASDAQ Composite is trading at the highest premium valuation, while small cap in Canada is trading at the greatest discount.

Canadian Economic Outlook

Last week, we received an economic update from the BoC, along with a 25-bps increase to its policy rate, bringing it up to five per cent. While rate hikes have helped to bring down inflation (total CPI) from its 8.1 per cent peak in June 2022 to 2.8 per cent in June 2023, the timeline to achieving the two per cent target is expected to now last until mid-2025. This means we could expect rates to stay higher for longer.

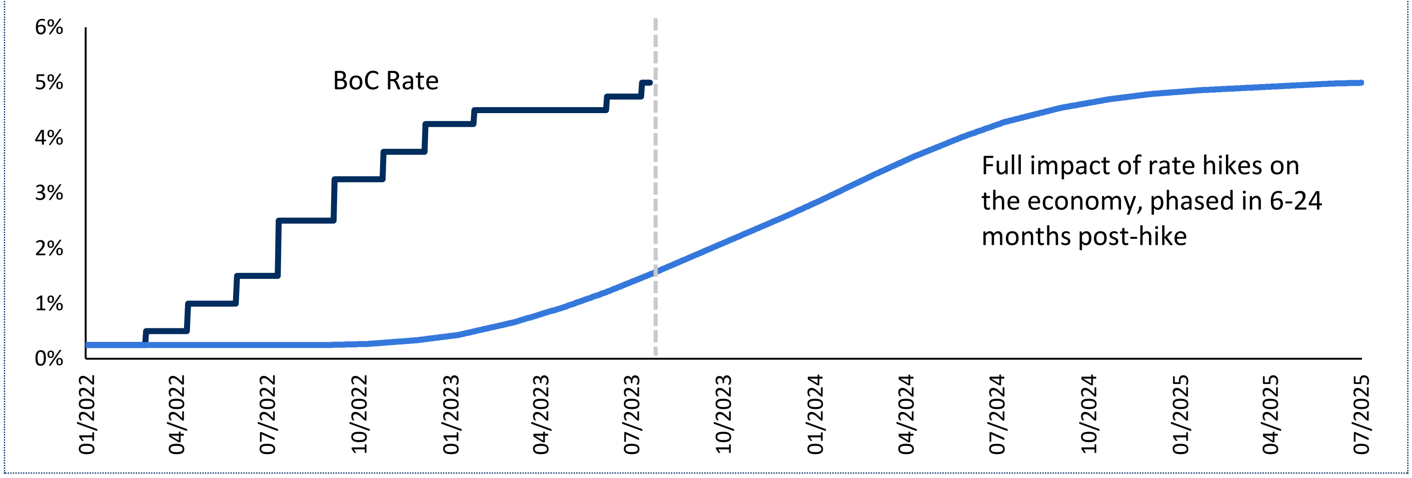
It should also be noted that much of the inflation measure (28%) is related to shelter costs. As well, with high immigration, limited housing supply, low levels of new construction and mortgage renewals rolling over and increasing monthly payments, we could see some upward pressure on CPI while a still relatively tight labour market, with wage growth of 4-5 per cent, keeps service costs higher.

CPI YoY Growth (%) by Category: Shelter Remains the Primary Factor Driving the Elevated Level of Inflation

		2021							2022													2023					
	Weight	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June
All Items	100%	3.1	3.7	4.1	4.4	4.7	4.7	4.8	5.1	5.7	6.7	6.8	7.7	8.1	7.6	7.0	6.9	6.9	6.8	6.3	5.9	5.2	4.3	4.4	3.4	2.8
Shelter	28%	4.4	4.8	4.8	4.8	4.8	4.8	5.4	6.2	6.6	6.8	7.4	7.4	7.1	7.0	6.6	6.8	6.9	7.2	7.0	6.6	6.1	5.4	4.9	4.7	4.8
Food	17%	1.3	1.7	2.7	3.9	3.8	4.4	5.2	5.7	6.7	7.7	8.8	8.8	8.8	9.2	9.8	10.3	10.1	10.3	10.1	10.4	9.7	8.9	8.3	8.3	8.3
Transportation	16%	5.6	6.6	8.7	9.1	10.1	10.0	8.9	8.3	8.7	11.2	11.2	14.6	16.8	14.4	10.3	8.7	9.5	8.5	6.0	5.4	3.1	0.3	1.3	-2.4	-3.4
Household Operation*	14%	0.9	1.1	1.5	1.5	1.8	1.6	2.0	1.9	2.7	4.5	4.1	5.5	5.6	5.0	5.1	5.4	5.1	5.2	4.6	3.7	4.1	3.3	3.0	1.1	0.3
Recreation**	10%	1.5	2.9	2.2	2.1	3.4	2.5	1.9	2.5	4.1	5.8	4.1	5.4	6.2	6.2	5.7	5.2	4.1	4.1	3.4	2.9	2.3	1.6	3.1	3.1	1.2
Health & Personal Care	5%	3.4	3.6	2.9	3.0	2.8	2.7	2.6	2.9	3.1	3.4	3.4	3.6	3.9	3.9	4.4	4.4	4.9	5.5	6.1	6.2	6.2	6.5	6.4	6.4	6.2
Clothing & Footwear	5%	1.1	1.0	-0.2	0.2	0.6	0.7	1.1	1.6	1.2	0.9	0.2	2.2	2.7	1.4	1.4	1.5	1.8	0.4	1.8	0.4	1.9	2.4	2.5	0.7	0.3
Tobacco & Alcohol	5%	1.9	1.7	2.6	2.1	2.1	2.6	2.5	3.3	3.1	3.3	3.1	3.0	3.0	3.8	3.5	3.8	4.1	4.5	4.8	4.7	4.9	5.4	5.3	5.5	5.4

Source: Statistics Canada; Raymond James Ltd.; Not seasonally adjusted; *Household Operation and Furnishings **Recreation, Education, and Reading.

Rate Hikes Will Continue to be Absorbed into the Economy Through 2024



Source: Bank of Canada; Raymond James Ltd.

As we consider the speed and severity of this rate hiking cycle, we want to remind readers that monetary policy takes time to work its way through the economy, and we typically look at only achieving the full impact 12-24 months after the rate hike. In the above graph, we show the recent rate hiking cycle by the BoC and cumulative effect of those increases if we phase each hike in, on a straight line basis, 6-24 months after the effective date. We can, therefore, expect to see growing impacts through the next 12 months, specifically attributed to the largest hikes that occurred in July and September last year. As both retail consumers and businesses further absorb this weight, concerns over inflation could shift to concerns over EPS, as we could see broader pressure on both sales and earnings as results are released over the coming quarters and into 2024. This, in turn, may provide headwinds to some equity valuations.

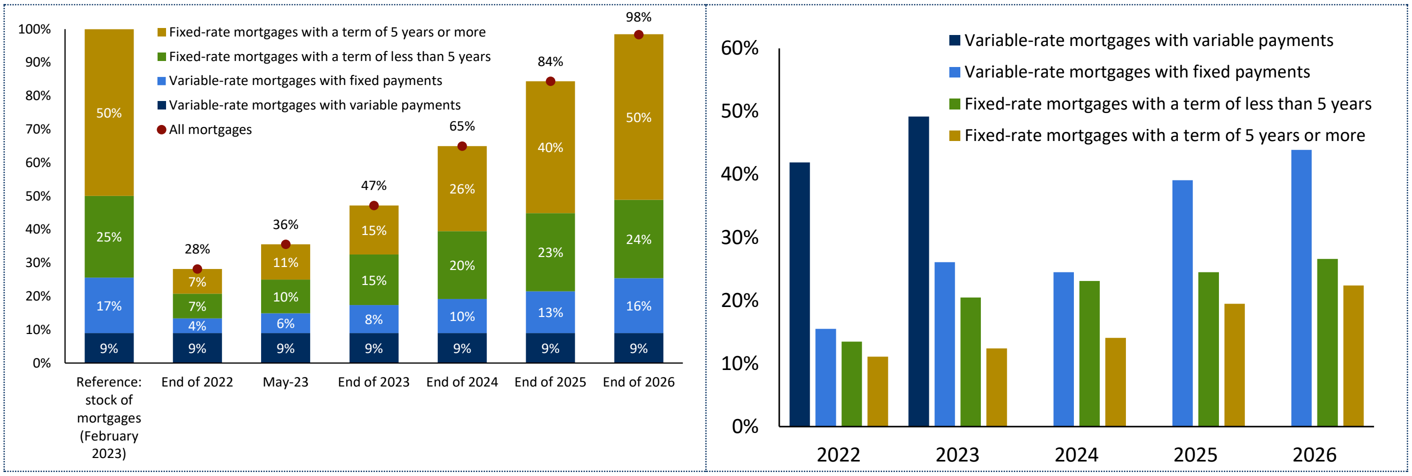
Canada's economy has been stronger than expected through the first half of 2023, although the BoC continues to forecast a slowdown in growth to around one per cent (annualized) over the next 12 months as the impact of previous rate hikes is absorbed by the economy. This would put real GDP growth at 1.8 per cent in 2023, 1.2 per cent in 2024 and 2.4 per cent in 2025, avoiding a recession.

Lastly, we want to touch on the impact of rising rates on mortgages, the ensuing burden on homeowners and how Canadians have taken on more debt. In Canada, we generally see shorter mortgage maturity terms than those in the U.S., which means impacts to mortgage rates and thus mortgage payments can impact consumption habits (and GDP) sooner. But many homeowners have still not felt the effects of rate hikes that started in March 2022.

In Canada, we have variable rate mortgages that have already seen monthly payments rise, but we also have variable rate mortgages with fixed payments. Under rising rates, even if the fixed monthly payments don't increase, more of those payments are attributed to interest and less to paying down principal. That means a higher balance than originally anticipated at renewal. Other fixed rate mortgages are better positioned until renewal when higher rates will come into play only at a later date. In either case, this staggers out the impact of those rate increases as these terms mature.

In the BoC's Financial Systems Review from May 2023, approximately one third of mortgages had seen an increase in payments from a baseline of February 2022 before rate hikes started. The review outlined how homeowners with variable rates and variable payments experienced payments increasing close to 50 per cent in 2022. It also pointed out that variable-rate borrowers with fixed payments will need to increase their payments by 40 per cent, assuming renewal in 2025-2026 in order to maintain the same amortization schedule. Holders of fixed rate mortgages could expect payments to increase 20-25 per cent on renewal in 2025-2026. As the BoC is looking to mid-2025 before inflation is back down to its two per cent target range, we could see further pressure on consumers, spending expectations and multi-year forecasts.

More Borrowers Will See Increased Payments as They Renew Their Mortgages [LHS]; Average Increase in Mortgage Payment Relative to February 2022 [RHS]

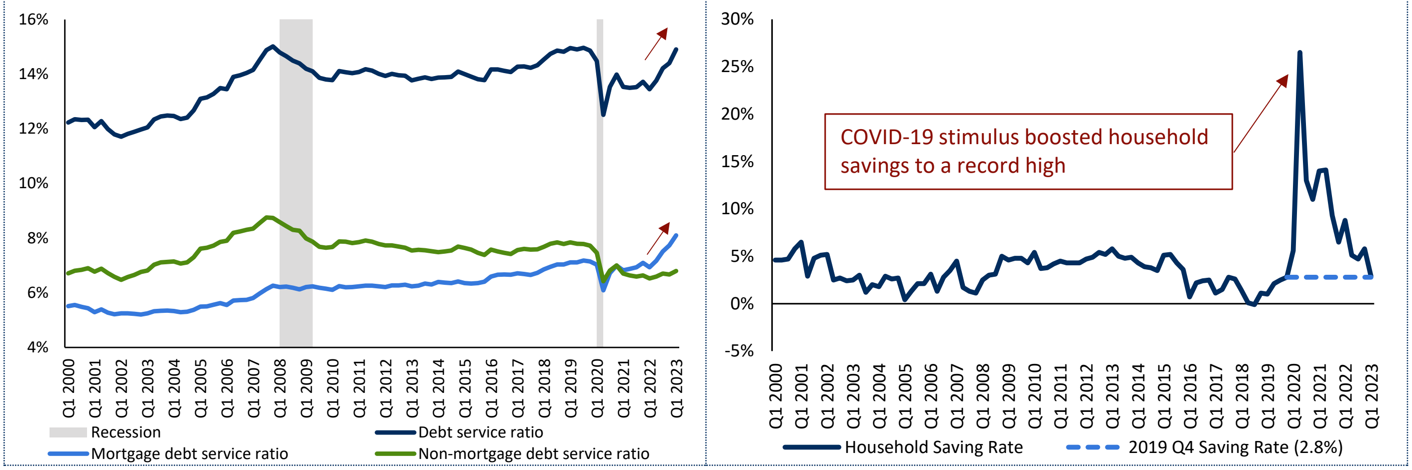


Source: Bank of Canada; Raymond James Ltd.

Moving from mortgage payments to household debt in general, we do see high levels of borrowing overall in Canada, where debt-to-disposal income is at 181 per cent of income versus 137 per cent in the U.S. Consumers are relying more on borrowing to sustain spending levels after exhausting government-provided fiscal stimulus from the pandemic relief efforts.

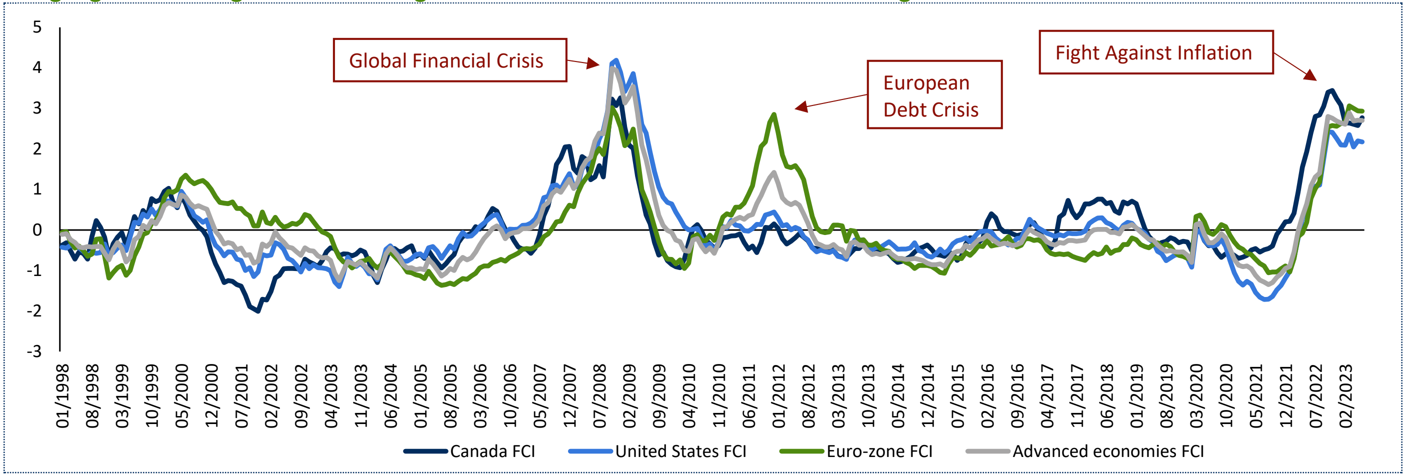
Despite still strong employment levels, our concern would be that the combination of higher shelter costs and debt servicing could quickly restrain consumer spending, providing a shock to the economy, or if interest rates do stay higher for longer, longer-term pressure on spending. If this is combined with any significant job losses as companies adapt to a global slowdown and reduced trade, we could see some quick downward revisions to sales and earnings expectations.

Household Debt Surged as Interest Rate Went Up [LHS]; Saving Rate Has Returned to Pre-COVID Levels [RHS]



Source: Statistics Canada; Raymond James Ltd.; Data as of March 31, 2023.

Surging Borrowing Costs and Tightened Financial Conditions Reaching Levels Similar to Those of 2009

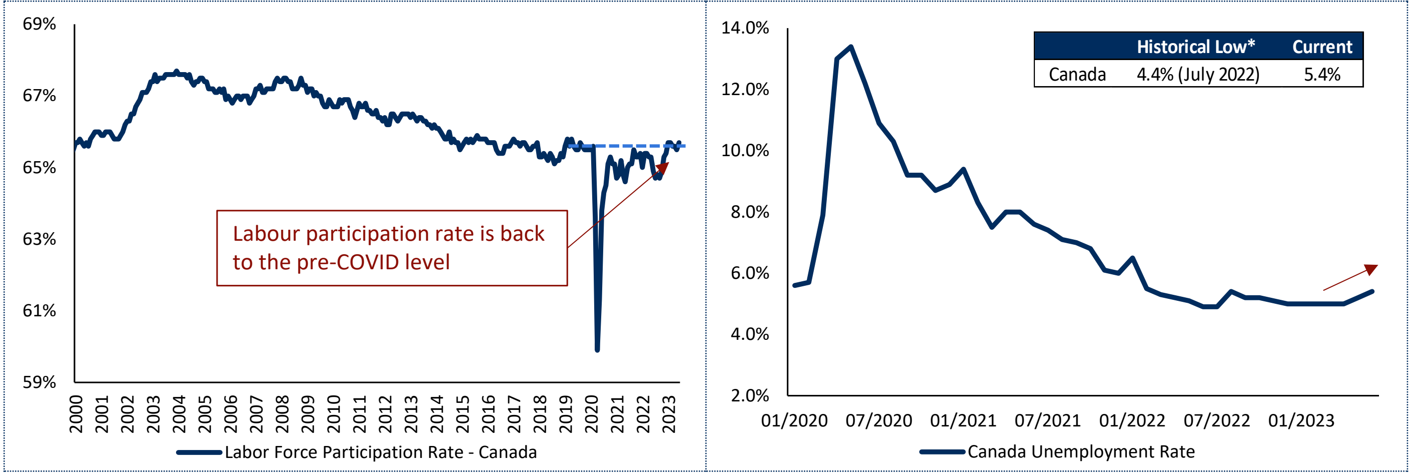


Source: Capital Economics; Raymond James Ltd.; Data as of June 30, 2023. FCI: Financial Conditions Index, standardized from 1998 and expressed as Z-scores, with higher levels pointing to tighter conditions (mean = 0), consist of government benchmark rates, borrowing costs, collateral, market functioning (spread, volatility), credit risk and credit availability.

On the labour front in Canada, we saw a 59,900 increase in employment in June, beating the consensus expectation of 20,000 and reversing the 17,300 decline recorded in May. Strength in employment numbers typically helps an economy from falling into recession, but hours worked were unchanged.

As immigration has continued to grow and the participation rate (people working or actively looking for work divided by total working age population) has increased, with the labour force growing by 114,000, the unemployment rate nudged up 0.2 per cent in June to a 16-month high of 5.4 per cent. This helped to slow wage growth to 4.2 per cent (YoY) from 5.1 per cent in May. Adjusting for seasonality, wages were generally unchanged from May. A rising unemployment rate and weaker wage growth should help to ease inflation pressures. What has helped Canada fare better than some other countries on reining in wage growth is that higher level of immigration.

Participation Rate Is Back on Track [LHS]; Modest Signs of Labour Market Conditions Easing [RHS]



Labour participation rate is back to the pre-COVID level

	Historical Low*	Current
Canada	4.4% (July 2022)	5.4%

Source: Statistics Canada; Raymond James Ltd.; Data as of June 30, 2023. *Unemployment rate historical low time frame: 12/31/1969 – 06/30/2023.

U.S. Economic Outlook

The growth of year-over-year inflation is now less than half of what it was a year ago, and it is likely to continue to trend lower as shelter costs slow down in the second half of the year. Despite positive news on the inflation front, Fed officials remain very hawkish, and the June Summary of Economic Projections suggests that the Fed is likely to move one or perhaps two more times before the end of this tightening cycle. While the unemployment rate ticked higher, the labour market remains very strong. This, combined—but to a lesser extent than before—with excess savings left from the pandemic, continues to support consumer spending, which could be a headwind in the Fed's journey of bringing inflation lower over the long term. Higher interest rates have sent the more interest-rate-sensitive manufacturing and housing sectors into recession, but the service side of the economy continues to expand, albeit at a slowing rate. Despite some volatility over the last quarter, the U.S. dollar remains at the same level as it was 40 years ago. Central banks globally continue to tighten monetary policy to fight inflation. Additionally, differences in inflation as well as interest rates between the U.S. and the rest of the world are likely to keep the U.S. dollar from weakening too much from current levels.

A Pulse Check on the U.S. Economy

Economic Indicator	Status	Comments
GDP Growth	Neutral	GDP growth is expected to continue to moderate over the next several quarters and we expect the recession to start in 4Q23.
Employment	Neutral	Nonfarm payrolls have remained strong during the year's first half, but we do expect the labour market to cool down during the second half of the year.
Consumer Spending	Neutral	Consumer spending has remained relatively strong, supported by a very tight labour market, slowing inflation, and complemented by continued strong credit card lending. Excess savings from the pandemic continue to positively contribute to consumer spending, but they are starting to wane in many segments of the population.
Business Investment	Neutral	Higher interest rates for longer will continue to negatively impact the strength of business investment in the near future.
Manufacturing	Concerning	Although the ISM manufacturing index remains in contraction, manufacturing output, as measured by the manufacturing production index, has remained positive but weak.
Housing and Residential Construction	Neutral	The housing market continues to find its footing and is no longer falling. However, we expect the sector to remain weak in the coming quarters as interest rates and affordability reduces the pool of potential buyers.
Inflation	Neutral	Inflation is likely to continue to slow down as economic activity weakens in the second half of the year. Furthermore, we expect shelter costs to slow down considerably and push headline inflation lower.
Monetary Policy	Neutral	The Fed remains very hawkish and is likely to have at least one more hike, likely after the summer months, before reaching its terminal rate and keeping rates higher for several more months.
Long-Term Interest Rates	Neutral	The yield curve remains deeply inverted as expectations for Fed rate hikes continue to linger. We expect the curve to remain inverted until the Fed pivots to an easier policy stance next year, however, longer-maturity yields should gradually decline as growth and inflation decelerate.
Fiscal Policy	Neutral	The debt ceiling issue is now in the review mirror, and contributions to GDP from government spending this year are unlikely to change significantly.
The Dollar	Good	The U.S. dollar has weakened somewhat compared to the levels experienced last year but has regained some traction as of late, and positive macroeconomic data is likely to support this trend further.
Rest of the World	Neutral	We continue to expect a weakening global economy during 2023 as central banks continue to increase interest rates.

Source: Raymond James & Associates; Raymond James Ltd.; Data as of July 11, 2023.

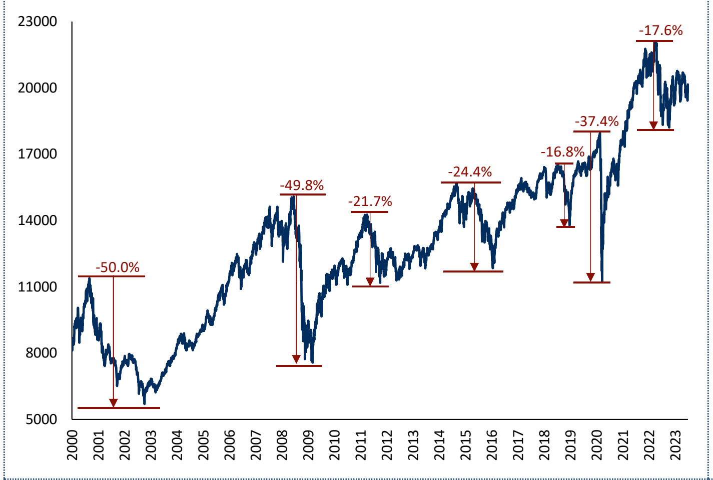
Canadian Equities

The major Canadian stock indices were muted compared to the mega-cap tech-stock driven U.S. benchmarks. Both the S&P TSX 60 and the broader Composite were up 5.7 per cent in the first half of 2023. The Venture Exchange Composite, however, was a brighter spot gaining 9.0 per cent.

Information technology was the standout sector in the first half, posting a 47.5 per cent gain, driven by Shopify and Blackberry. The second best sector was consumer discretionary at 11.3 per cent, pushed by Canadian Tire and Sleep Country. Overall, the TSX Composite is heavily weighted towards financials and energy, which contributed 3.7 per cent and -2.3 per cent, respectively.

As we look toward the remainder of the year, we continue to expect pressure on earnings amid the global slowdown. Valuations are attractive on a historical basis, although we remain cautious of negative surprises and guidance adjustments through the Q2 and Q3 earnings seasons. In the short term, we generally favour sectors that have fared better than others in market pullbacks, including consumer staples, utilities and communication services.

S&P/TSX Comp Historical Drawdowns > -15% [LHS]; Defensive Sectors Generally Outperformed During Significant Market Downturns [RHS]

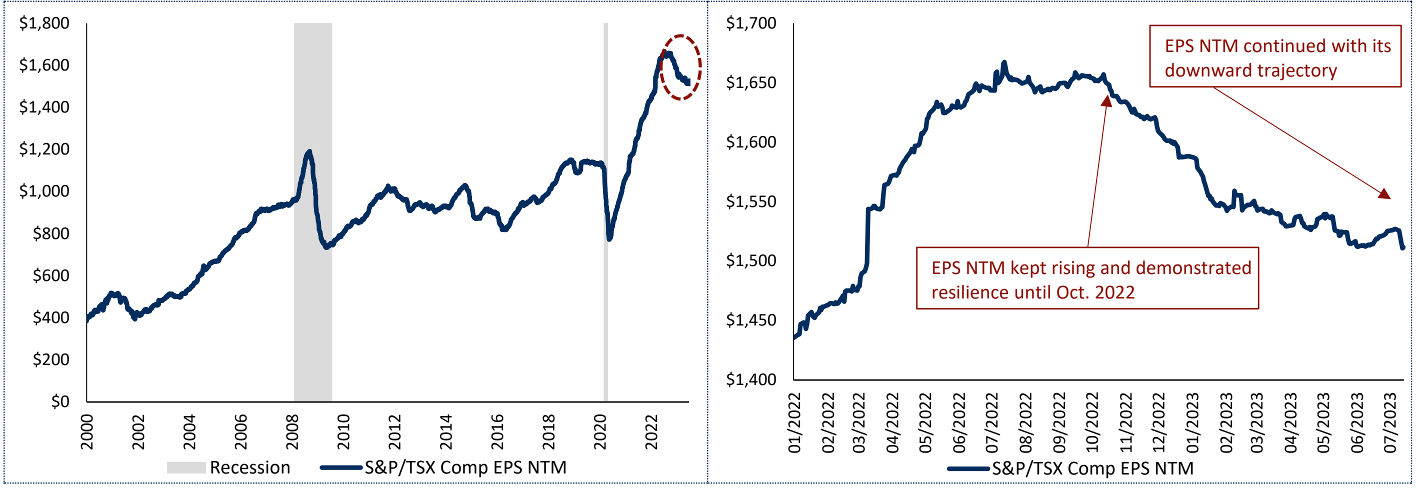


	9/2000 - 10/2002	6/2008 - 3/2009	4/2011 - 10/2011	9/2014 - 1/2016	7/2018 - 12/2018	2/2020 - 3/2020	3/2022 - 10/2022
Duration (Months)	25.2	8.7	6.0	16.5	5.4	1.1	6.5
Canada S&P/TSX Composite	-50.0	-49.8	-21.7	-24.4	-16.8	-37.4	-17.6
Consumer Staples	51.9	-11.4	-2.9	28.8	-3.0	-23.4	-2.7
Utilities	37.2	-34.0	-1.0	-9.8	-10.7	-37.9	-15.8
Communication Services	-49.9	-32.9	3.6	3.6	-4.0	-28.4	-18.9
Real Estate	12.5	-56.6	-8.8	-1.9	-9.3	-47.4	-26.6
Financials	-4.9	-53.0	-17.3	-15.9	-13.6	-39.9	-20.6
Materials	-0.3	-43.2	-23.3	-40.3	-14.3	-23.8	-22.0
Consumer Discretionary	-39.7	-37.0	-17.0	-4.3	-24.0	-44.6	-7.6
Industrials	-45.9	-47.2	-19.7	-22.1	-15.7	-30.7	-10.6
Energy	19.8	-54.8	-30.2	-50.7	-29.2	-52.1	-5.9
Health Care	-51.1	-27.3	-25.4	-3.8	-18.0	-42.6	-55.8
Information Technology	-96.3	-65.4	-42.9	19.0	-20.1	-27.0	-39.3

Source: Bloomberg; Raymond James Ltd.; Data as of June 30, 2023. Sectors are ranked by historical drawdowns (descending).

We have seen EPS expectations decline since the most recent market bottom in October 2022. Lower EPS expectations have helped to bring the overall P/E multiple back up towards the median. While still below that level, the market does not look overly expensive. However, the question remains if expectations are lowered further through the next couple of earnings seasons or if they already fully reflect the global economic slowdown.

S&P/TSX NTM EPS Has Pulled Back [LHS]; A Closer Look at the Recent Downside Revisions [RHS]

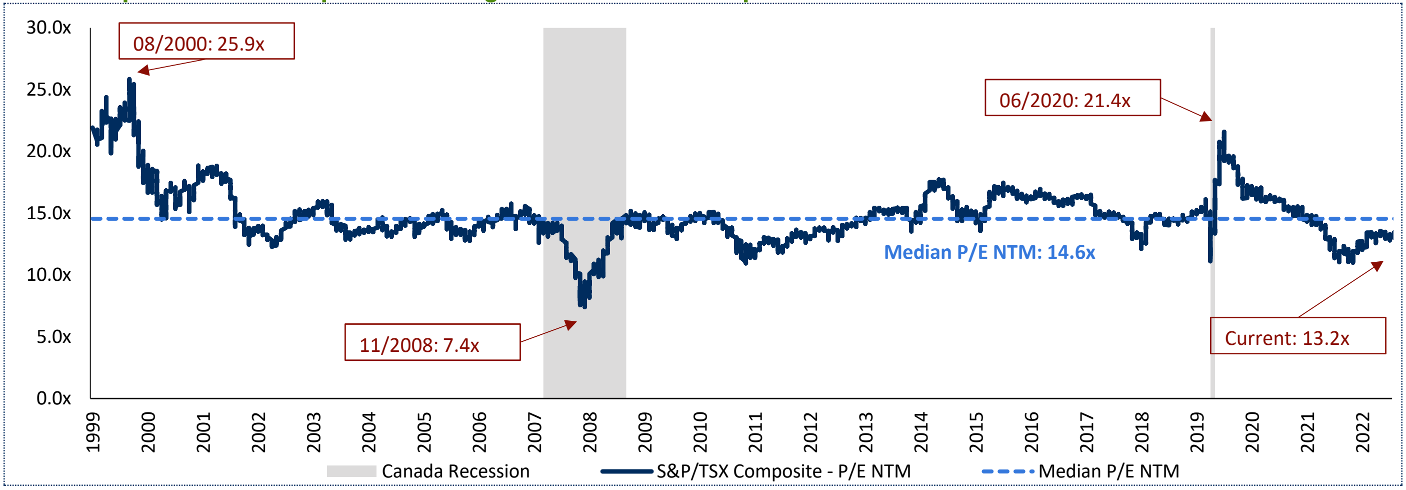


EPS NTM continued with its downward trajectory

EPS NTM kept rising and demonstrated resilience until Oct. 2022

Source: FactSet; Raymond James Ltd.; Data as of July 14, 2023.

TSX Composite P/E Multiple Increasing as Stock Prices Improve and EPS Forecasts Decline



08/2000: 25.9x

06/2020: 21.4x

Median P/E NTM: 14.6x

11/2008: 7.4x

Current: 13.2x

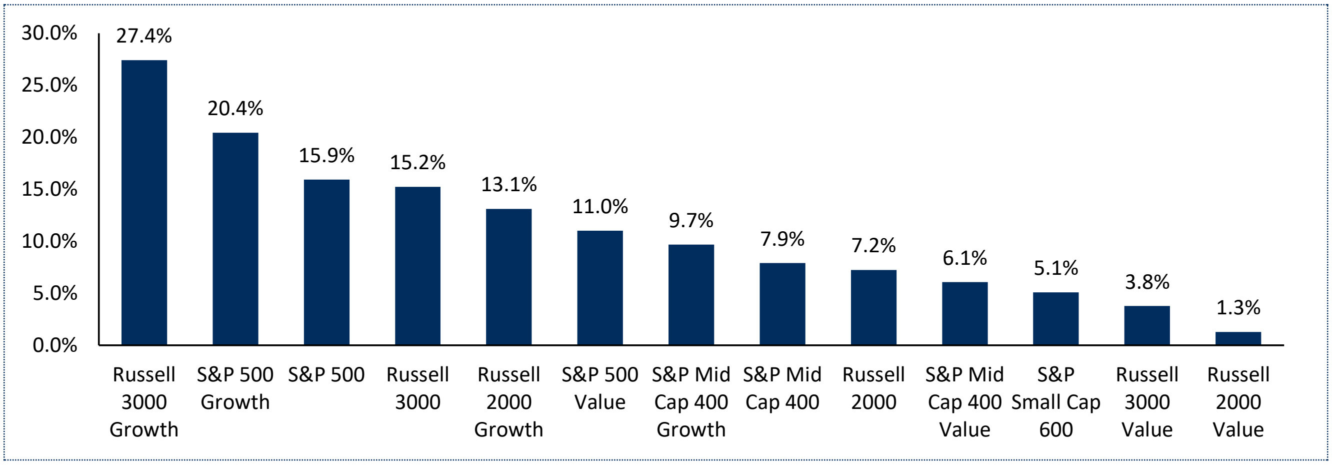
Source: FactSet; Raymond James Ltd.; Data as of June 30, 2023.

U.S. Equities

Banking crisis, China's economic drama and "AI Fever" highlight the first half, but a decelerating global economy toward a mild recession will likely dominate the narrative in 2H23.

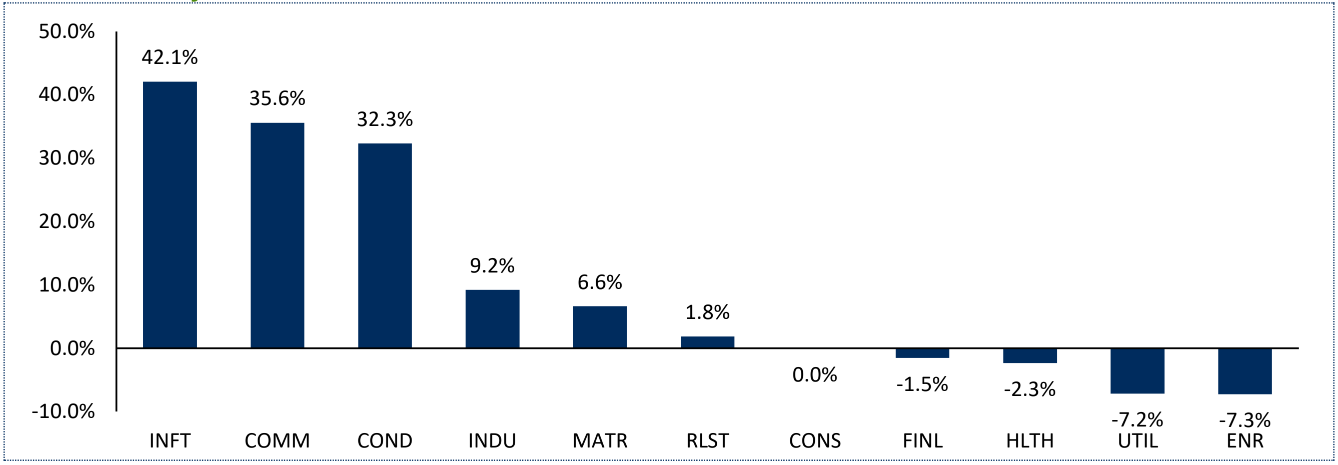
The first half of 2023 in the U.S. equity market has been marked by three significant events: the regional banking liquidity crisis that took place in March, the weaker-than-anticipated re-opening of the Chinese economy and finally the Artificial Intelligence (AI) investment craze. Broadly, these trends have disproportionately hurt financials, while aiding technology, specifically "mega-cap tech" stocks with potential near-term positive earnings revisions due to AI investment. However, the macro economy continues to slow, and inflation continues to dis-inflate, with last year's major narrative for a "soft landing" and a resurgence in growth in China not panning out as planned. That's because the export and capital spending driven Chinese economy is having trouble transitioning to a consumer-led economy, especially with a severe property bubble deflating in the background. However, in recent months, a new hope that AI-related investments combined with spending related to the Inflation Reduction Act (IRA) in the U.S. could create enough growth in the economy, even with higher rates, leading to the creation of a "soft landing".

Absolute Performance of U.S. Benchmark Indices YTD



Source: FactSet; Raymond James & Associates; Raymond James Ltd.; Data as of July 1, 2023. YTD returns are in USD.

Performance by S&P Sector and Index YTD



Source: FactSet; Raymond James & Associates; Raymond James Ltd.; Data as of July 1, 2023. YTD returns are in USD.

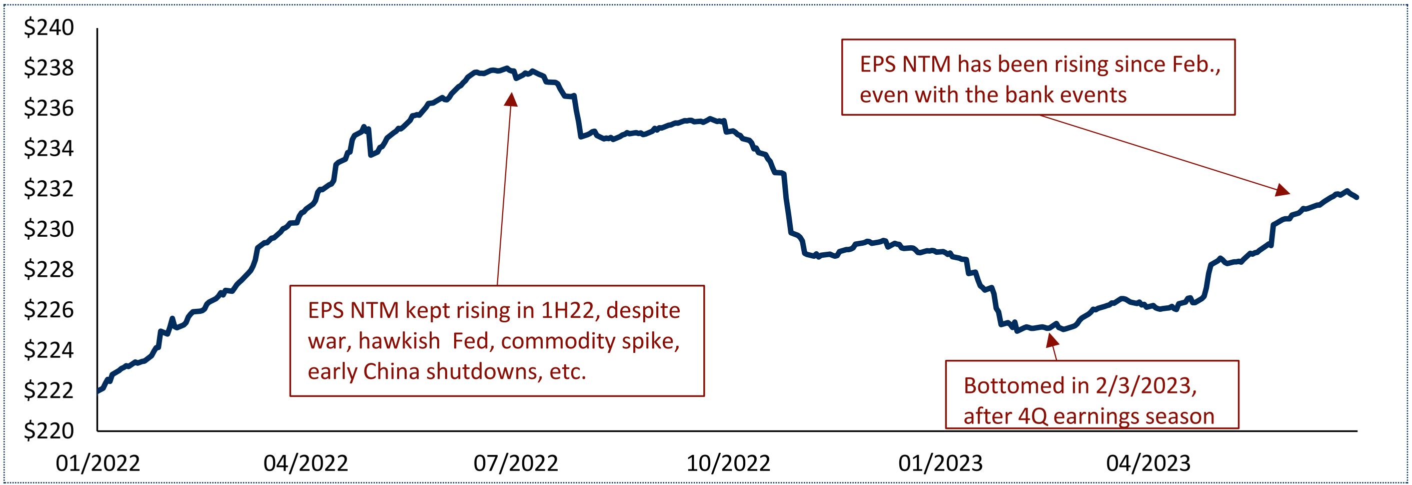
As shown above, YTD returns have been very biased to tech and tech-related sectors as well as growth over value. Both trends are aided by the AI theme as well as China's economic weakness, which has likely driven global capital into mega-cap U.S. tech stocks.

So, for the year, the S&P 500 is up ~15 per cent, with approximately two thirds of that gain due to seven large tech stocks. The rest of the S&P 500, Midcap 400 and Small Cap 600 has rallied mid-high single digits in the first half of the year, in line with a slightly better economy than expected. It's unclear how significant of a role AI will play in the longer term, but it couldn't have come at a better time for an economy struggling to find a near-term growth catalyst with China's recovery stalling. Additionally, with wage inflation and a tight labour market assumed to be lasting for some time, the potential productivity benefits of AI provide a narrative to offset the equity market's two perceived limitations near term (growth decelerating and inflation too high). It's unclear how AI will play out near term, but we suspect this slowing of the cyclical economy will dwarf any near-term benefits from AI or the IRA. This slowdown is what will likely take centre stage across the media narrative as the year progresses.

This is starting to feel a little bit like the market is a bit too focused on rosy potential scenarios. Regardless of near-term AI investments, economies around the world are slowing as interest rates are ratcheted higher and COVID-related fiscal spending slows. Most economists expect this slowdown to become very severe within a couple of quarters and start leading to negative real growth and likely some labour market weakness in late 2023/early 2024.

Additionally, after ~6 months of not issuing any new Treasuries due to the debt ceiling, the U.S. Treasury has been issuing Treasuries at an accelerated rate since June 1, with Treasury yields increasing materially at both the front and long end of the yield curve, which ultimately should serve as a headwind for equity prices.

S&P 500 NTM Consensus EPS



EPS NTM has been rising since Feb., even with the bank events

EPS NTM kept rising in 1H22, despite war, hawkish Fed, commodity spike, early China shutdowns, etc.

Bottomed in 2/3/2023, after 4Q earnings season

Source: FactSet; Raymond James & Associates; Raymond James Ltd.; Data as of June 30, 2023.

Finally, consensus NTM EPS for the S&P 500 has been modestly increasing since February. S&P 500 equity prices have been correlated at ~94 per cent since 2000 with NTM consensus EPS. So it's not surprising this equity market has rallied as consensus EPS has increased. However, we take the recent optimism on re-accelerating EPS growth of analysts with a grain of salt. First and foremost, consensus NTM EPS continued to rise last year until mid-June even though it was plainly obvious that higher rates and a commodity spike were going to hurt earnings in 2022/2023. Secondly, if one puts the same seasonality on S&P 500 EPS that occurred in 2022, 2023 consensus EPS would be $209 rather than the published consensus of $220. Right now, consensus EPS for the S&P 500 calls for increases from $217 in 2022 to $220 in 2023 and $240 in 2024. To us, this makes very little sense in a rising rate and slowing nominal GDP environment. We expect EPS will come down this year and the next one as 2023 rolls on, and with it, equities could be under modest pressure after the rally in 1H23.

So the equity market is likely pricing in a rosier scenario for EPS and/or rates than we are likely to experience over the next year or so.

There are only two yield curve outcomes from the current level of yield curve inversion. There has been much made of the inversion of the yield curve in July of last year, and what it means for the economy. But we would point out that economies tend to struggle 1+ years after the inversion, as yield curves return to being positively sloped. Since 1985, every yield curve inversion has preceded a recession, but it's worth noting, the recession and job losses that accompany it did not occur until the yield curve became positively sloping again. In this regard, it's not important to recognize the current yield curve as inverted, but important to wonder in what way the yield curve will return to positively sloping again. There are broadly two ways.

1) **Soft Landing** – In a soft landing, the economy can handle higher rates than most believe, and the 10-year Treasury yield will keep moving up until the whole curve becomes positively sloping between five and six per cent. In this scenario, EPS would likely be fine, or even better than expected, but P/Es would likely come down. Generally, we view this scenario as unlikely, but it is a possibility. In such a scenario, one would expect cyclical companies to outperform from today's valuations (financials, energy, materials and consumer discretionary).

2) **Classic Recession** – In this scenario, the economy keeps weakening, likely faster as COVID benefits continue to come to an end for consumers, ultimately leading the Fed to lower rates to stoke demand. In this scenario, equity markets are under pressure because earnings expectations are coming down, though P/Es may actually expand. Generally, we would expect defensive/interest rate sensitive sectors to outperform (healthcare, utilities, staples and real estate), while growth indexes should modestly outperform value.

We believe the second scenario is more likely to unfold next year and, thus, prefer those sectors of the equity market.

Canadian Fixed Income

The Canadian bond market has experienced challenging times. Heightened levels of uncertainty with respect to the future of inflation and interest rates have resulted in elevated volatility in yields across the curve, making it more difficult for investors to get a handle on how to best move forward. But trickier does not equate to opportunity free, as we continue to see areas of value in the Canadian fixed income market.

The BoC kicked off the year with a rate hike at its January meeting, but then held steady for the following two announcements before returning to its hiking cycle in June. We see that the spring period underscored the central bank's willingness to let higher rates work their way into the economy. But evidently, inflation remained at a level that the BoC was not comfortable with, being driven by factors like lower energy prices rather than a wider list of underlying factors. Like the U.S.', Canada's CPI also peaked in June 2022 (at 8.1 per cent), with the most recent print sitting at 3.4 per cent. CPI has fallen drastically from its highs, but it is still above the target of two per cent. Given its mandate, the BoC remains committed to combatting inflation with the most recent (largely expected) rate hike accompanied by a statement viewed as more hawkish than anticipated. In their most recent monetary policy report (MPR), the BoC extended its timeline for returning to the targeted two per cent inflation out six months to mid-2025.

Looking ahead, then, we anticipate that the period of higher yields will remain for a while longer. Despite the large inversion seen in the Canadian benchmark yield curve today (the difference between two-year and ten-year treasuries is 120 basis points, with the two-year yielding more), we believe that buy-and-hold investors should look beyond the short end of the curve and extend duration. Although it is not intuitive to turn down a higher rate in favour of one that is lower or equal given the generally upward-sloping nature of a yield curve, there are benefits. When you are holding a longer-maturity bond, you will receive that rate for longer and reduce the need to worry about prevailing interest rates when a shorter-termed security matures and you reinvest.

Similar to our U.S. counterparts, Canadian corporate securities have a flatter yield curve when compared to federally-issued product and offer a substantial pick-up in yield, so the penalty for extending term is not as severe as the benchmark curve. We do recommend that investors who are looking to capitalize on corporate bonds focus on higher-quality names, especially when buying individual bonds directly.

Inevitably, we anticipate that rates will decline once the economic slowdown/recession is underway and more accommodative policy is back in demand. This opens the door to a new opportunity to generate capital gains if yields fall (and prices rise).

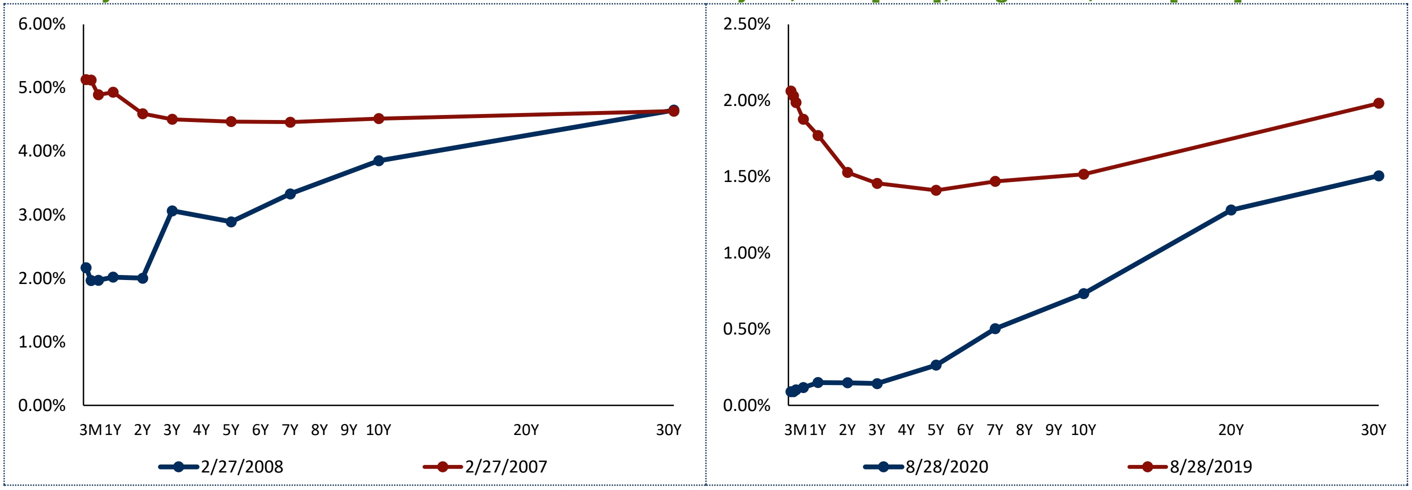
U.S. Fixed Income

The U.S. bond market continues to be rocked with uncertainty, and thus volatility, as investors appear to maneuver toward what they believe the future will provide. Although wrought with contradicting indications, economic data has generally shown a resilient strength in many segments, in particular on the services side. The economy's spirited potency has many wondering if a soft landing is upcoming or whether North American markets will dodge a recession altogether. With mostly positive employment numbers, the Fed has, in essence, been permitted to continue its battle against inflation.

The CPI has been declining for 11 consecutive months since peaking at 9.1 per cent in June 2022. However, a 3.0 per cent CPI remains above the targeted 2.0 per cent level, a level that the market hasn't seen in over 26 months. Fed Funds futures have traded with the probability of anything from two more rate hikes to four rate cuts by the end of this year. However, the

Fed has proclaimed its battle against inflation, indicating the likelihood of at least two more rate hikes. Given the Fed's strong track record of transparency, we believe betting on this prospect might be the shrewd move.

Treasury Curve One Year After Peak of Inversion: February 27, 2008 [LHS]; August 28, 2020 [RHS]

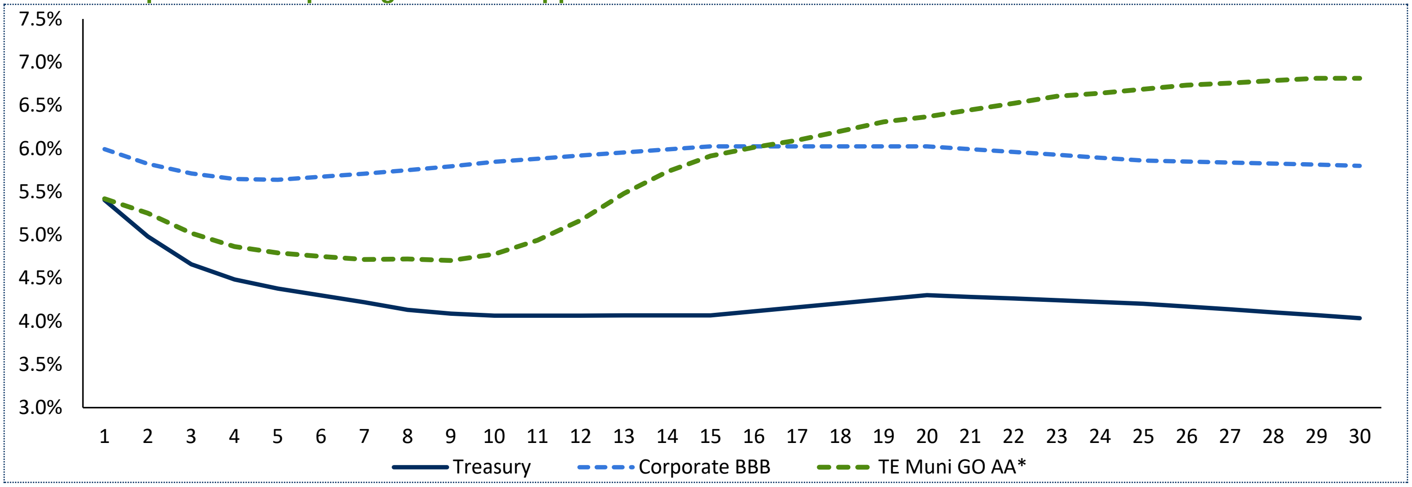


Source: FactSet; Raymond James Ltd.; Raymond James & Associates.

The Fed's actions are keeping interest rates elevated. As equity markets struggle with wobbly footing, unreliable earnings forecasts and untethered pricing, higher interest rates, which translate to higher fixed income yields, are a welcome trend for investment portfolios. The 10-year Treasury has once again breached four per cent, a yield level not reachable in over a decade, since the Great Recession period from 2007-2010. We trust that this fixed income window of opportunity will exist for a limited period. Whether you believe that North America is headed for a recession or just a slowdown in economic activity, it is plausible to consider that interest rates will decline significantly in the not-too-distant future. Therefore, while the Fed resumes its tightening policy and interest rate levels remain high, investors can capitalize on securities with attractive income.

The scenario may play out to help income investors as well as total return buyers. Buy-and-hold investors stand to gain current and prolonged attractive income. It is recommended to extend the duration and lock into yields for longer. Moreover, should the markets follow the pattern of sustained higher rate levels during the Fed's tightening period followed by lower interest rates as we head toward a slowing economy, increased pricing may provide well-liked positive total returns through appreciating bond prices.

Curve Comparisons: Exploring Different Opportunities in Various Curves



Source: Raymond James & Associates; Raymond James Ltd.; Bloomberg; Data as of July 7, 2023. *Tax Equivalent U.S. General Obligation AA Municipal bond, tax equivalent yield: 37% Fed tax bracket + 3.8% Affordable Care Act.

The various curves are dissimilar in shape, presenting different opportunities. The Treasury curve is inverted (short-term rates are higher versus long-term ones), which presents value to investors' short-term liquidity and/or other funding needs. High quality, government, highly liquid Treasuries are federally taxed, but state tax-exempt. (Canadian investors should consult their advisor or tax specialist before investing in these types of U.S. vehicles.)

The corporate yield curve is very flat, yet elevated with handsome spreads to Treasuries. This creates a favoured income range in the short to intermediate part of the curve. Although the very short end (inside three years) of the municipal curve is inverted, the greater part of it is upward-sloping. This signifies greater income rewards for investors whose financial strategy aligns with taking on increased duration with longer maturity bonds.

In summary, rates will remain higher for longer than expected although this window is likely to close quickly when most market pundits foresee the policy change. Since inflation remains sticky, the Fed mandate for price stability is likely to be addressed with continued Fed tightening. Whether the market eventually succumbs to a recession or a slowing economy, lower earnings may squeeze consumer enthusiasm. In the present though, all parts lead to overweighting fixed income whether you are an income or total return investor.

Washington Policy: The End of Globalization? Risks and Opportunities of a New Economic Era

Are the U.S. and Chinese economies decoupling, or are we seeing a more strategic approach to national security priorities and supply chain resiliency? The answer to this question depends upon the policy decisions over the next several years and could have massive implications for the global economy and equity markets. We are of the view that a broad-scale decoupling and the formation of regional economic blocs are less likely, but a trend of reindustrialization and de-risking will be a market theme that investors will navigate in the years ahead. We also argue that recent U.S. policy decisions are the foundation for an industrial renaissance aimed at building up the economic base of the U.S. and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years—most acutely felt during the COVID supply chain shortages of critical materials. Key aspects of this industrial renaissance are a series of "carrots" in the form of tax subsidies and direct support vs. the initial phase of "sticks" in the form of tariffs, blacklisting and tech restrictions.

U.S. and China at a Crossroads: A Shift in the Global Economic Order

Concerns over China's longer-term geopolitical ambitions and the threat posed by China's military to the U.S. and its key allies have been a major focus of U.S. policy in recent years. During the Trump administration, concerns about China's unequal market access and intellectual property theft led to the 2018 "trade war" with tariffs levied against a broad set of China's imports into the United States. A key concern was that U.S. technology designed for civilian use could be repurposed for military application. This led U.S. policymakers to view technology as a national security asset, thereby implementing new export restrictions and blacklisting various Chinese companies from receiving access to U.S. technology, especially in the semiconductor space. The flow of U.S. capital into critical sectors in China that finance China's economic competition with the U.S. also came under enhanced scrutiny. While this economic confrontation was initially driven by national security considerations, the COVID-19 pandemic exposed additional vulnerabilities around global supply chains, particularly with technology components and medical goods that drove shortages and spiked prices. These conditions set the stage for a rethinking of U.S.-China economic relations that quickly became a bipartisan consensus in Washington.

Government Response: Securing Supply Chains and Investing in the Domestic Industrial Base

In response to the dynamics, the U.S. government has enacted policies with both "sticks" and "carrots" that create challenges and opportunities for investors navigating the shifting global environment. Export controls, tariffs and economic restrictions through the blacklisting of certain companies have created revenue and cost challenges for U.S. companies with significant exposure to China's market. However, policymakers have also unleashed more than US$1 trillion in domestic investment across pandemic relief measures and new funding for domestic infrastructure, semiconductor manufacturing and the energy transition. These new policies direct federal funds and catalyze private sector investment toward what we refer to as the "reindustrialization" of North America. The goal of these policies is to fortify the U.S. domestic industrial base and limit future economic dependencies that can drive economic disruptions or be used against the U.S. as economic leverage. Even with this level of new investment, we still see significant appetite in Washington to build on and supercharge certain aspects of the domestic economic agenda, including permitting reforms, investing in critical minerals and preserving a role for legacy energy to limit transition risks. Vulnerabilities experienced by countries with oil and gas dependencies following Russia's invasion of Ukraine have prioritized projects that build out legacy energy infrastructure and limit potential vulnerabilities around critical minerals as the energy transition gains pace. In this sense, policymakers are wary of replacing dependence in the oil and gas space with critical mineral dependencies with supply chains heavily concentrated in China.

Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington – with clear winners and losers from an investment perspective. As federal funding is deployed and the reindustrialization theme plays out, we expect industrials to be a beneficiary. New investment and market opportunities for the energy transition will be a material boost for clean energy equities. We see the transition as balanced across the energy space with permitting reform boosting the buildout of energy infrastructure and increasing demand for liquified natural gas. In terms of potential headwinds, the technology sector will be a space exposed to risks as the policy impact unfolds. Emerging technologies such as artificial intelligence, quantum computing and robotics will be in the crosshairs of new controls and regulations, which can limit the ability of certain companies to scale and penetrate China's market. Biotechnology and pharmaceuticals are other areas to watch as they could see similar controls in the future.

What's Next?

Investors should be aware of critical trends that will impact the evolution of this emerging theme. First, China's response (such as targeting U.S. companies as a retaliatory step) can increase market risks if U.S. policy actions are seen less as "de-risking" and more as "decoupling" by another name. The fate of Taiwan and the outcome of its presidential elections in January 2024 will also be important to watch. While the Biden administration is taking steps to de-escalate tensions around Taiwan, China perceiving Taiwan as moving closer to independence could accelerate the timeline for a regional conflict that could drive global economic disruption on a significant scale. Lastly, the inflationary impact of a shifting global economic order will have important consequences for the direction of monetary policy. Higher costs and elevated spending could weaken the Fed's tools to fight inflation and prolong high interest rates—a "higher for longer" scenario. We expect attention to increase on those issues over the next year, especially as the U.S. prepares for the 2024 presidential election campaign that will help determine the trajectory of a changing macro investment environment.

Asset Allocation Committee

Neil Linsdell, CFA (Chair)
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