RAYMOND JAMES®

PRIVATE CLIENT SOLUTIONS

ASSET ALLOCATION QUARTERLY

- **Global Economic Growth to Weaken Further**
- **Odds of a Global Recession Have Rising for 2023**
- **Higher Rates Across Most Advanced Regions**
- **Expect Elevated Volatility**
- **Remain Selective and Well Diversified, Shifting to Government Debt > Corps.**

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Quarterly Outlook: Too Fast, Too Furious

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Too Fast, Too Furious accurately depicts the current investment backdrop with soaring inflation (but moderating from the peak), rapid increases in interest rates/yields, whip-saw markets, and a material deceleration in the global economic growth outlook. We believe it is now clear that central banks in advanced economies will raise interest rates even further than our prior above consensus expectations, making the current tightening cycle the most aggressive we have observed in three decades. While this may be necessary to tame inflation, it will come at a significant economic cost. In particular, we see a high probability of a global recession unfolding in 2023, which will be more severe in some regions and milder in others. Moreover, we see the risks of a more prolonged and deeper recession as higher today than at the beginning of this tightening cycle, with the potential for this cycle to end with some unintended and unforeseen consequences. These would be similar to the unforeseen consequences that followed the most recent easing cycle during the depths of the COVID-19 crisis (e.g., record supply chain disruptions, inflation soaring to 40-year highs, labour shortages, etc.).

However, as we look ahead over the next 9-12 months, we continue to expect the level of uncertainty to remain very elevated, which has only been further complicated by the war in Europe and a material slowdown in China. But while we see "few places to hide" amid all the worrisome headlines or "wall of worries" as we like to refer to them as, for longer-term-oriented, patient, and prudent investors, we see many opportunities to invest in today and more to come in the months ahead.

Key Takeaways:

- **With interest rates still poised to move higher, a further slowdown in global growth will be hard to avoid.** All said, we expect global growth to be much weaker than our prior forecast of 2.5 per cent in 2023 and quite possibly below two per cent. And while this level of growth would meet the IMF's old technical definition of a global recession, we suspect that global economic conditions will meet newer and more sophisticated criteria too, given widespread increases in unemployment, a likely decline in world trade, and falls in various asset prices. Given the uncertainty, we expect real GDP growth of between -1.0% to +1.5% for the U.S., and -1.0% to +1.0% for Canada, in 2023.
- **Equity positioning lowered slightly to neutral – focus on the cleanest dirty shirts.** We suggest investors remain selective and well diversified as well as focus on de-risking their portfolios (i.e., close/reduce portfolio blind spots and/or tighten active relative bets). We continue to prefer high-quality and durable businesses that are trading at reasonable valuations, with a preference for value > growth stocks and a preference for the broader S&P/TSX and the S&P 500 index > MSCI EAFE index and the MSCI EM index.
- **Raising fixed income positioning to neutral – reducing corporate bond exposure with a preference for U.S. yields.** The implication of an upcoming recession is increased credit risk, so we have reduced our corporate bond holdings alongside an increase in quality and defensive positions. Also, in relative terms, U.S. yields are higher across the board than Canadian yields, so we prefer holding U.S. treasury over Canadian sovereign bonds.

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RAYMOND JAMES®

Asset Allocation Recommendations

Tactical (9-12 Month) Asset Allocation Recommendations

	- Neutral +	Comments
Equity	Neutral (moved down from slight overweight)	We have reduced our weighting in equities to neutral from a slight overweight as risks outside of North American have risen. That said, we continue to see good relative risk/reward opportunities, despite the elevated level of uncertainty. However, we suggest investors remain highly selective & well-diversifed.
US Large Cap (S&P 500/ Russell 1000)		The US large cap space represents some of the highest quality businesses in the world, with strong competitive attributes, high levels of profitability, and strong enduring growth profiles. As valuations for the index have come down from peak levels and now trading back in line with historical valuations, we view this segment of the US market as attractive especially given the alternatives.
US Small-Mid Cap (Russell 2000/Russell Mid Cap)		We see good growth and relative valuations across the US small-mid cap space. In particular, we are seeing the most compelling risk/reward opportunities within the US mid-cap space. However, the level of market uncertainty has picked up in 2022, with investor capital flows shifting towards more risk-off areas of the market or those better positioned amid the current backdrop.
Canadian Large Cap (S&P/TSX 60)		We see good value across the broad Canadian market relative to US/global equities. In particular, we have a favourable view on high-quality-equities and select defensive equities trading at reasonable valuations with durable earnings/cash flow profiles.
Canadian Small-Mid Cap (S&P/TSX Composite)		We see good value across the broad Canadian market relative to US/global equities. In particular, we have a favourable view on high-quality-equities and select defensive equities trading at reasonable valuations with durable earnings/cash flow profile.
Developed (MSCI EAFE)		It remains a mixed bag for most developed markets outside of North America with uncertaintgies still quite high. As a result, we have increased our underweight to develop markets this quarter. We note Some regional equity markets are facing tremendous pressure/capital outflows from the fallout of the Russian-Ukraine war/Russian sanctions and/or the slowdown/COVID-19 lock-downs in China. However, other regionial markets across the Middle East and Asia Pacific region are peforming better given the commodity-centric tilt of their economies/equity markets.
Emerging (MSCI Emerging Market)		It remains a mixed bag for emerging equity markets, with select economies with a strong commodity-tilt performing better than regions directly/indirectly exposed to the Russian-Ukraine war, the slowdown in China, or which have US$ denominated debt. These and other headwinds in 2022 have made emerging markets a less attractive region to deploy capital in today despite compelling relative valuations. Uncertainties remain high and are likely to remain elevated over the short-term with global capital flows continuing to move to more defensive markets or those better positioned amid the current uncertain geopolitical/economic environment. As such we have increased our underweight to these markets.
Fixed Income		With growing risk of the latest central bank tightening cycle ending in a recession, we suggest investors increase their weighting to neutral. We see the most attractive oportunities in longer duration bonds, particularly in the 7-10 year part of the curve.
US Government (Bloomberg US Treasury Total Return)		We suggest investors increase weigthing to a neutral allocation to US government bonds as the risk of recession have increased. However, we would avoid the shorter end of the curve (1-3 years) and begin to add US government bonds between 7-10 years.
US Corporate (Bloomberg Barclays U.S. Corporate Bond)		US investment grade corporate bonds continue to offer good risk/reward characteristics especially as credit spreads have widened out more recently. However, with the risk of recession increasing, we suggest reducing credit risk to neutral. We suggest investors maintain exposure to bonds with a duration profile between 3-7 years.
Canadian Government (FTSE Canada All Government Bond)		We suggest investors increase weigthing to a neutral allocation to Canadian government bonds as the risk of recession have increased. However, we would avoid the shorter end of the curve (1-3 years) and begin to add US government bonds from 7-10 years.
Canadian Corporate (FTSE Canada All Corporate Bond)		Canadian Investment grade corporate bonds continue to offer good risk/reward characteristics especially as credit spreads have widened out more recently. However, with the risk of recession increasing, we suggest reducing credit risk to a neutral stance. We suggest investors maintain exposure to bonds with a duration up to 2-years.
Currency (USD/CAD)		The Federal Reserve is expected to have a higher terminal rate this cycle than many of its major peers. The Bank of Canada on the other hand has a relatively highly-leveraged household sector to contend with, which supports the market's expectation that it will have a lower terminal rate than our neighbors to the south. A higher terminal rate amongst its developed market central bank peers and support from the safe-haven channel as the backdrop for risk assets continues to deteriorate, underpins our bullish outlook for the broader USD and USD/CAD.
Cash		Maintaining a neutral allocation to cash.

Market Commentary

Global Economic Outlook: A Global Recession in 2023?

Too Fast, Too Furious accurately depicts the current backdrop with soaring inflation, rapid increases in interest rates/yields, whip-saw markets, and a material deceleration in the global economic growth outlook. To say that the environment has changed quickly since the beginning of the year would be an understatement, rather it's been Too Fast, Too Furious.

That said, it is now clear that central banks in advanced economies will raise interest rates even further than our prior above-consensus forecasts, making the current tightening cycle the most aggressive we have observed in three decades. While this may be necessary to tame inflation, it will come at a significant economic cost. In particular, we expect a global recession to unfold in 2023, which will be more severe in some regions and milder in others. Moreover, we also see the risks of a more prolonged and deeper recession as higher today than at the beginning of the this tightening cycle, with the potential for this cycle to result in many unintended and unforeseen consequences. These would be similar to many of the unforeseen consequences which followed the start of recent easing cycle during the depths of the COVID-19 crisis (e.g., record supply chain disruptions, inflation soaring to 40-year highs, labour shortages, etc.).

However, as we look ahead over the next 9-12 months, we continue to expect the level of uncertainty to remain very elevated, with "few places to hide" amid all the worrisome headlines or "wall of worries" as we like to refer to them as. But for longer-term-oriented, patient, and prudent investors, we see many opportunities to invest in today and more likely to come in the following months. Since our last update (***click link to the left***), we have observed a coordinated slowdown as a result of policy tightening efforts by central banks globally. This has resulted in downward revision to 2022 and 2023 global real GDP growth forecasts across both advanced and emerging economies, which we believe has room to fall further. All said, we expect global growth to be much weaker than from our prior forecast of 2.5 per cent in 2023 and quite possibly below two per cent. And while this level of growth would meet the IMF's old technical definition of a global recession, we suspect that global economic conditions will meet newer and more sophisticated criteria too, given widespread increases in unemployment, a likely decline in world trade, and falls in various asset prices.

Real GDP Growth Faces Mounting Headwinds [LHS]; Real GDP Growth Revised Lower QoQ [RHS]

13-Sep-22	Average 2000-2020	Real GDP Growth Forecasts 2021	2022	2023	2024
World	**3.2%**	**6.3%**	**2.4%**	**1.5% ~ 2.5%**	**3.1%**
Advanced Economies	**1.4%**	**5.1%**	**2.3%**	**0.7%**	**1.7%**
US	***1.8%***	***5.7%***	***1.9%***	***-1.0% ~ 1.5%***	***2.0%***
Canada	***1.8%***	***4.5%***	***3.2%***	***-1.0% ~ 1.0%***	***2.0%***
Euro	1.0%	5.2%	2.8%	-0.5%	1.3%
UK	1.2%	7.4%	3.4%	0.2%	1.7%
Japan	0.6%	1.7%	1.6%	1.3%	1.3%
Australia	2.6%	4.9%	3.9%	1.3%	1.3%
Emerging Economies	**4.7%**	**7.0%**	**2.4%**	**3.7%**	**3.9%**
Emerging Asia	6.1%	7.6%	2.9%	4.6%	4.2%
China	7.3%	8.1%	0.0%	4.0%	3.5%
India	6.4%	8.3%	6.7%	6.3%	5.5%
Russia	3.6%	4.7%	-7.0%	-3.5%	3.5%
Brazil	2.1%	4.6%	2.5%	0.8%	1.5%
Mexico	1.6%	4.8%	2.3%	1.8%	2.0%

Change (p.p.)	Real GDP Growth Forecasts 2021	2022	2023	2024
World	**0.3**	**-0.4**	**-2.2 ~ -1.2**	**-0.1**
Advanced Economies	**-0.1**	**-0.5**	**-1.0**	**0.1**
US	***0.0***	***-0.9***	***-2.5 ~ 0.0***	***0.5***
Canada	***-0.1***	***-0.7***	***-2.7 ~ -0.7***	***0.3***
Euro	-0.2	0.5	-2.3	-0.5
UK	0.0	0.1	-1.2	0.2
Japan	0.0	-0.7	-1.4	0.1
Australia	0.2	-1.0	-1.3	-0.3
Emerging Economies	**0.5**	**-0.4**	**-1.1**	**-0.3**
Emerging Asia	0.7	-1.4	-1.2	-0.6
China	-0.1	-2.0	-2.0	-0.5
India	0.2	-2.6	-0.2	-1.5
Russia	0.0	5.0	-2.0	0.0
Brazil	0.0	1.2	-1.0	0.0
Mexico	0.0	0.5	-0.2	0.2

Source: Capital Economics; Raymond James Ltd.; Raymond James Financial; Data as of September 13, 2022.

Inflation Fever Not Breaking Fast Enough

We are now three quarters into the year with the "transitory" term used to describe the inflationary backdrop completely abandoned. Instead central bankers globally are scrabbling with great vigour to hike rates and tighten policy quickly to contain inflation. While signs of cooling in inflationary impulses (e.g., commodity prices, supply-chain disruptions, etc.) have occurred and have been viewed by market participants as a positive, this has come at the cost of much lower future growth. For investors, we believe it is a bit too premature to assume that the return towards more normal levels of inflation will be a smooth descent from the peak. Rather, we expect the path forward will be a volatile one with many ebbs and flows along the way. Current inflation forecasts peg a return to trend inflation across the advanced economies (including U.S., Canada, Europe, etc.) no sooner than mid-2023/early-2024. In contrast, below trend inflation is expected for most emerging markets in 2023. Across the G7, labour markets still remain extremely tight – which we believe will continue to support central bankers in their tightening effort – even as consumer confidence has collapsed quite rapidly in recent months.

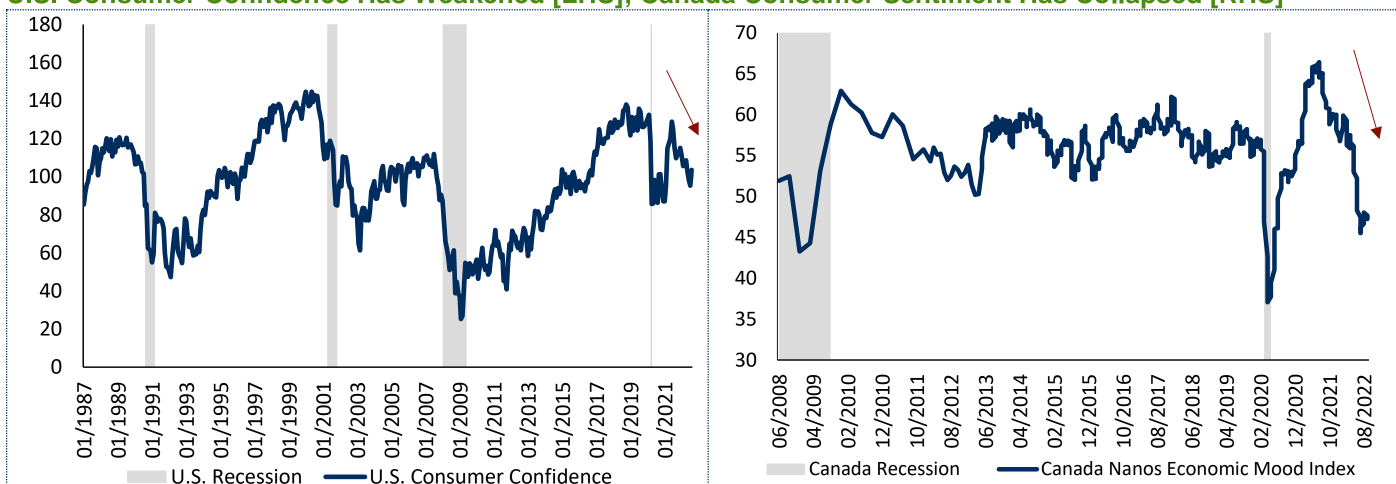
Inflation Still Running Too Hot [LHS]; Labour Shortages for G7 Countries Show Modest Improvement [RHS]

13-Sep-22	Average 2000-2020	2021	Inflation as of 8/31/2022	Inflation Forecasts 2022	2023	2024
World	**3.6%**	**3.5%**	**7.7%**	**6.7%**	**3.8%**	**2.5%**
Advanced Economies	**1.7%**	**3.2%**	**7.9%**	**7.1%**	**3.2%**	**1.5%**
US	2.1%	4.7%	8.3%	7.6%	2.5%	1.5%
Canada	1.9%	3.4%	7.6%	6.7%	2.6%	1.6%
Euro	1.6%	2.6%	9.1%	8.3%	5.0%	2.0%
UK	2.0%	2.6%	9.9%	9.3%	6.4%	2.7%
Japan	0.1%	-0.2%	2.6%	2.3%	1.6%	0.2%
Australia	2.5%	2.9%	6.1%	6.6%	5.0%	2.2%
Emerging Economies	**5.0%**	**3.8%**	**7.6%**	**6.5%**	**4.1%**	**3.1%**
China	2.6%	0.9%	2.5%	2.0%	1.0%	1.0%
India	5.9%	5.1%	7.0%	6.6%	5.3%	4.8%
Russia	10.5%	6.7%	14.3%	13.9%	5.7%	4.8%
Brazil	6.2%	8.3%	8.7%	9.8%	5.3%	3.5%

Geography	Jun 2021	Jul 2021	Aug 2021	Sep 2021	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022	Mar 2022	Apr 2022	May 2022	Jun 2022	Jul 2022
US	3.1	3.4	3.4	3.4	3.4	3.2	3.2	3.0	3.0	3.0	3.0	3.1	3.0	3.1
Canada	0.6	0.5	1.1	0.6	0.9	0.6	0.4	0.9	0.7	0.2	0.6	0.9	1.5	2.0
UK	3.2	3.3	3.5	3.6	3.6	3.7	3.6	4.0	4.2	4.2	3.9	3.6	3.7	
Japan	0.4	0.4	0.6	0.9	1.2	1.3	1.4	1.5	1.5	1.6	1.5	1.6	1.5	
Germany	1.9	2.2	2.4	2.5	2.7	2.9	2.9	2.9	3.0	3.0	3.1	3.2	3.3	
France	-0.1	-0.2	0.1	0.6	1.1	1.2	1.0	1.3	1.2	1.4	1.0	1.0	1.2	
Italy	1.9	2.4	2.8	3.0	3.3	3.4	3.6	3.6	3.6	3.6	3.4	3.7	4.3	
Euro-zone	1.8	2.2	2.5	2.8	3.1	3.2	3.2	3.2	3.3	3.5	3.6	3.7	3.9	
G7	2.3	2.5	2.8	3.0	3.3	3.3	3.3	3.4	3.4	3.4	3.3	3.5	3.7	

Source: Capital Economics; Raymond James Ltd.; Raymond James Financial; G7 Labour Shortage as of September 13, 2022.

U.S. Consumer Confidence Has Weakened [LHS]; Canada Consumer Sentiment Has Collapsed [RHS]



Source: FactSet; Bloomberg; Raymond James Ltd.; U.S. Consumer Confidence Index as of August 31, 2022; Canada Nanos Economic Mood Index as of September 23, 2022.

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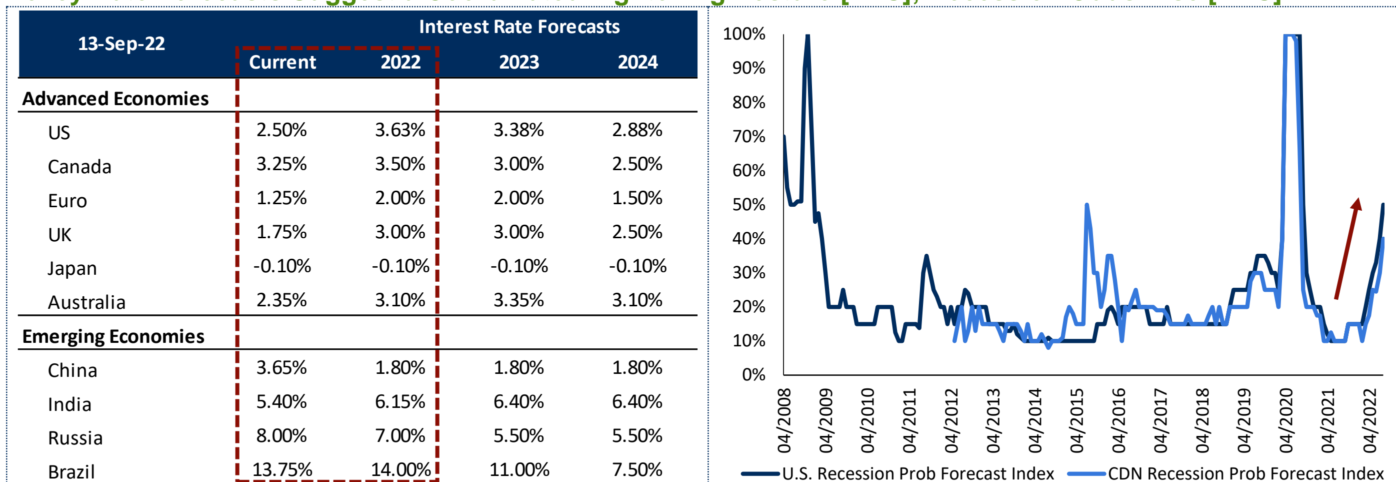
Monetary Policy and Financial Conditions Have More Room to Tighten Further

We have observed a significant increase in policy rates globally so far this year, but quantitative tightening (QT) or the reduction in central bank balance sheet assets has yet to occur in a material way. Taken together, these are the only blunt and imprecise tools available by policymakers to cool the economy and slow the pace of inflation. However, with inflationary pressures still running uncomfortably high, coupled with still very tight labour markets, we believe more tightening is on the way. In fact, in the latest statement by the U.S. Federal Open Market Committee (FOMC), the committee remains committed to tightening policy further while also continuing to reduce their holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet issued in May. The assets on the balance sheet sit currently at US$8.8 trillion today versus US$8.9 trillion in May – only a modest improvement since the announcement. This hawkish tone is relatively consistent across most advanced market central banks. However, as we have mentioned many times in the past, the lag effect of policy changes on the economy has the potential to result in an overshoot on the tightening process, resulting in what we believe will be a hard landing/recession – the odds of which have only increased since the beginning of the year for the U.S, Canada, and now the global economy.

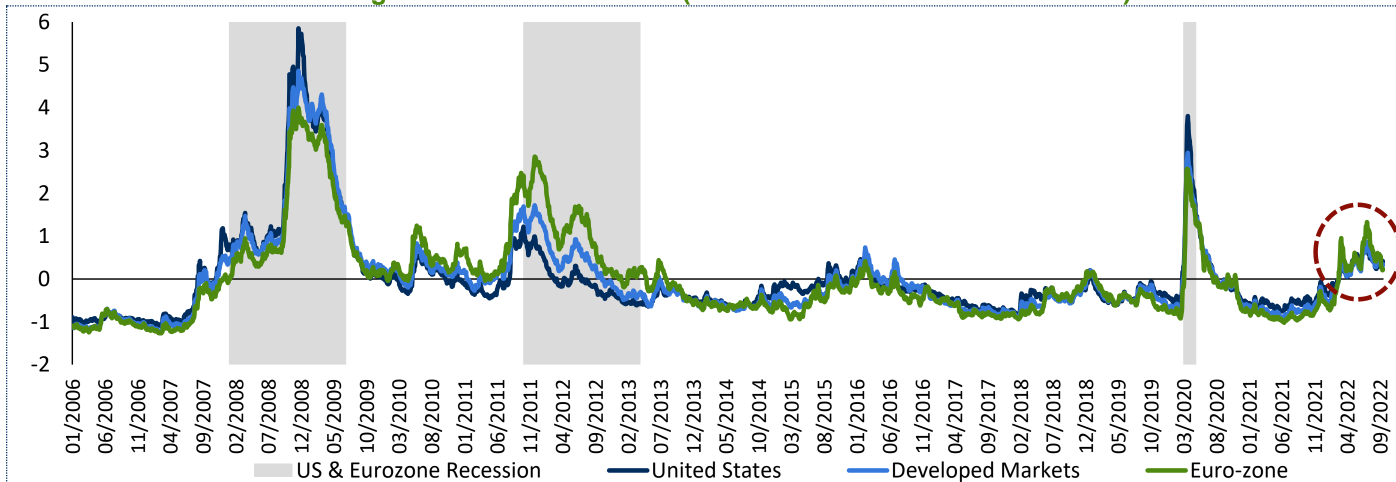
Policy Rate Forecasts Suggest a Coordinated Tightening Posture [LHS]; Recession Odds Rise [RHS]



13-Sep-22	Interest Rate Forecasts			
	Current	2022	2023	2024
Advanced Economies				
US	2.50%	3.63%	3.38%	2.88%
Canada	3.25%	3.50%	3.00%	2.50%
Euro	1.25%	2.00%	2.00%	1.50%
UK	1.75%	3.00%	3.00%	2.50%
Japan	-0.10%	-0.10%	-0.10%	-0.10%
Australia	2.35%	3.10%	3.35%	3.10%
Emerging Economies				
China	3.65%	1.80%	1.80%	1.80%
India	5.40%	6.15%	6.40%	6.40%
Russia	8.00%	7.00%	5.50%	5.50%
Brazil	13.75%	14.00%	11.00%	7.50%

Source: Capital Economics; Bloomberg; Raymond James Ltd.; Raymond James Financial; Recession probability as of August 31, 2022.

Financial Conditions Have Tightened Since Mid-2021 (Standard Deviation from the Mean)



Source: Capital Economics; Raymond James Ltd.; Raymond James Financial; Data as of September 20, 2022

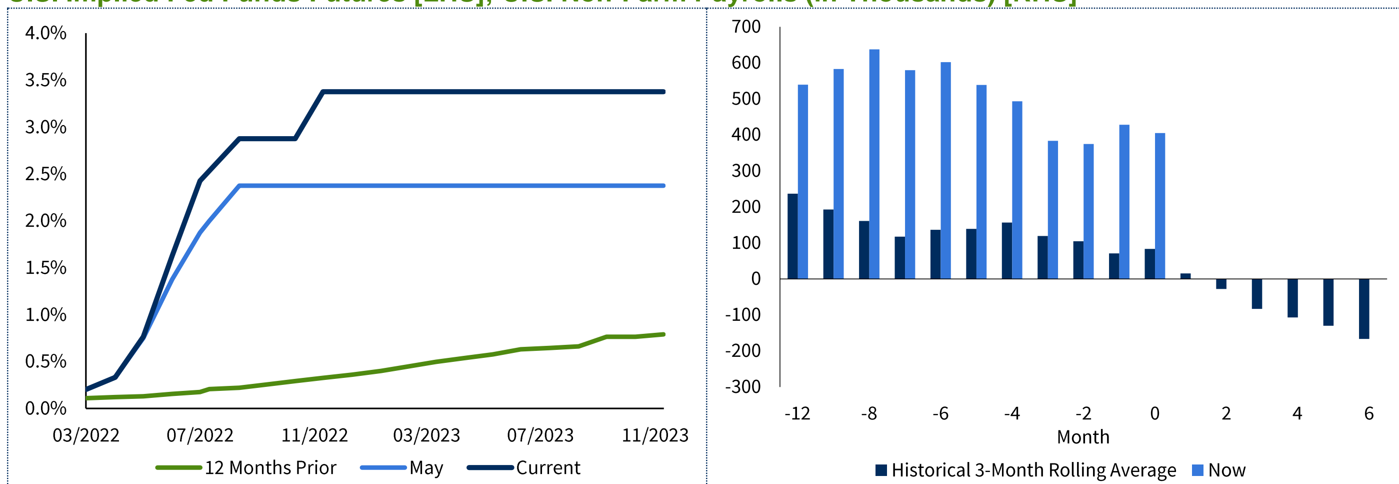
U.S. Economic Outlook: Not-WYSIWYG

For anybody watching the behaviour of the U.S. economy during the last couple of years, it is clear that it is not-WYSIWYG (What You See Is What You Get). The presumed technical definition of two consecutive quarters of negative GDP growth is not the real definition of a recession, according to the NBER. Never mind that we believe that the NBER would never call for a recession during a period, the first half of 2022, when employment grew by 3.5 million jobs or by 438,000 jobs per month. Or 5.8 million jobs during the last 12 months at an average of 487,000 new jobs, or recovered jobs lost to the COVID-19 pandemic.

We do believe that the U.S. economy is slowing down and will continue to slow down as the Fed continues to increase interest rates and as inflation continues to bite into real incomes. Today, the U.S. economy is being helped by a recovering service sector economy, a very strong export sector, and a very weak imports sector that are taking advantage of the full reopening of the economy and of the strong need of energy resources by European countries, respectively. But the investment sector has been weakening considerably, especially investment related to residential construction. Thus, our expectation is for the U.S. economy to continue to weaken as the year ends and then go into a recession until the Fed is able to bring down inflation convincingly and on a sustained basis. Since the August Jackson Hole Symposium, the Fed has cautioned that the tightening cycle was far from over and that “some pain” would be ahead for the economy. Even though the narrative of the Federal Open Market Committee (FOMC) statement shifted only slightly, it was the increase in the terminal rate (e.g., potential peak) forecasts for 2022 and 2023 from 3.4 per cent and 3.8 per cent to 4.4 per cent and 4.6 per cent respectively that got the markets’ attention. We believe that taking rates to 4.5 per cent or higher would increase the probability of a recession next year.

Bottom Line: The last two recessions—the Great Financial Crisis and COVID-19—were severe but caused by “Black Swan” events. However, if we have a recession (75 per cent probability of a mild recession and 20 per cent of a severe recession in 2023), there are two reasons it is likely to be mild. First, there are no “excesses” like a housing or dot-com bubble. Second, the current level of job openings (two per every person unemployed) will reduce the likelihood of significant layoffs. Given that total employment remains below pre-pandemic levels, hiring freezes are the more likely scenario. That is why our base case for the U.S. economy includes a mild recession lasting from the first through the third quarter of next year.

U.S. Implied Fed Funds Futures [LHS]; U.S. Non-Farm Payrolls (in Thousands) [RHS]



Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of August 31, 2022; For the U.S. Non-Farm Payrolls chart, “0” indicates the start of a recession.

Washington Policy: A Split Congress Following the Mid-term Elections May be the Goldilocks Outcome for Markets

The State of the U.S. Mid-term Election Race: Red Wave or Blue Wall?

The political setup at the beginning of 2022 carried significant warning signs for Democrats in the U.S. with a political prognosis that a "Red Wave" is coming favouring the election of Republicans in Congress. Democrats, now holding the White House and both houses of Congress (narrow majorities of five seats in the House and tie in the Senate), are not only battling history (the party controlling the White House has lost an average of 23 House seats in the mid-terms over the last 40 years), they are battling a macro environment that traditionally is a political albatross for the party in power. Polling shows near-record levels of dissatisfaction with the direction of the country among voters, historically low approval ratings for President Biden, and inflation concerns are dominating headlines.

However, while there are still significant structural factors that favour Republican candidates in this mid-term cycle, we are seeing signals that the floor is rising in terms of expected Democrats' performance that could present an unexpected "Blue Wall" of resistance for Republicans' chances of significantly altering control of Washington. While we continue to expect that Democrats are likely to lose the House (and with it, their Congressional majority), prospects for Democrats retaining the Senate have materially improved into the fall. This will have important U.S. market impact in terms of the Biden administration's regulatory agenda and confirmation ability for key posts if Democrats ultimately maintain or expand their Senate majority.

In Summary, Republicans See Favourable National Environment, but Don't Discount Dems

The overall trend in national political factors has been one of a Democrats' recovery relative to the national environment seen earlier this year. The increased prominence of social issues, sustained labour market recovery, and the potential peak of inflation (if the downward trend in domestic energy prices holds) alleviate some of the pressure that has capped Democrats' prospects. While we continue to see material Republican gains (most likely in the House), the likelihood is growing that the earlier forecasted "Red Wave" is dampened by a reinforced "Blue Wall", particularly when it comes to improved chances for Democrats to hold the Senate. In effect, the result of a split Congress following the mid-term elections may be the goldilocks outcome for markets. With this setup, any further threat of significant tax adjustments will be off the table until 2025. Headline risk on budget/debt ceiling battles will also be less of a factor, as these fights are likely to stay within Congress and be resolved, rather than pit a unified Republican Congress against a Democrat White House.

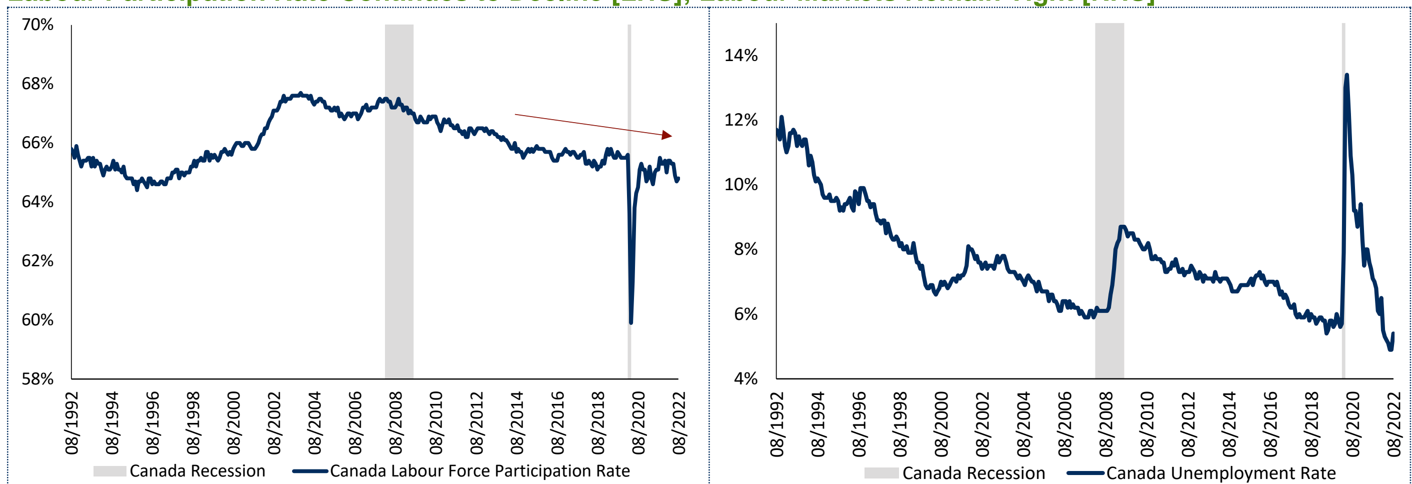
While we view a scenario of Democrats controlling both the House and Senate in 2023 as the possibility with the lowest odds, this would also be the scenario that would drive an outsized market reaction. Legislative risk driven by tax increases as part of the Democratic reconciliation and social policy agenda is now largely viewed as a non-factor by the market given the current political setup, but would be poised for a resurgence on the off-chance that Democrats over perform and maintain control of both chambers of Congress. We caution that the electoral landscape will continue to be fluid up until the elections, and recent cycles have shown that "unprecedented" results cannot be fully discounted.

Canadian Economic Outlook: The Trade-off Is Lower Growth

Canadian real GDP growth is expected to close off the year +3.0 per cent YoY, but is expected to weaken materially in 2023 to between -1.0% to +1.0% per cent as a result of the lag effect of higher rates, tighter financial conditions, weaker investment, exports, etc. Overnight rates have already risen by 3.0 per cent in seven months, the fastest in 26 years, while the BoC has continued to unwind its balance sheet - reduced its holdings of bonds by $64 billion since January 2022, also known as quantitative tightening. However, with inflation still running too hot – the August CPI-headline print rose by 7.0 per cent YoY vs. the 7.6 per cent YoY increase in July and vs. consensus at 7.3 per cent YoY - we expect further tightening to remain on the horizon including another 50-75bps increase in overnight rates by year end. This hawkish tone is consistent with the comments from the BoC's latest policy meeting on September 7th. The BoC not only raised its target for the overnight rate to 3.25 per cent and continued its quantitative tightening program, but they also indicated that more rate hikes were warranted and further tightening was on the horizon since the Canadian economy continued to operate in an excess demand posture with labour markets remaining still very tight.

But, as we noted in our last quarterly update and also again in the August Insights and Strategies report "Winter Is Coming" (***click link to the left***), engineering a soft landing – the goal for most if not all central bankers – has been and will continue to be very difficult as history has shown. Given this, we see a growing risk of a hard-landing/recession for the Canadian economy in 2023. We note that while the interest rate-sensitive parts of the Canadian economy have held up better than we would have anticipated (e.g., housing), the deterioration in global manufacturing as well as signs of weaker growth and increased risk of a recession in the U.S. are likely to translate into weaker Canadian business investment and exports. In this environment, we expect the unemployment rate to rise more sharply, back towards six per cent. Despite the hawkish message from central bankers that interest rates will need to be kept high for a long time, we still see scope for the bank to start cutting them again in the second half of 2023 as it becomes clear that core inflation is declining and wage growth is moderating. But the key point is that there will be a high hurdle to the policy rate being cut anywhere below 2.5 per cent, the bank's neutral rate estimate – because even if central banks are convinced that (core) inflation is heading toward two per cent on a sustained basis, they will need to spend some time regaining credibility.

Labour Participation Rate Continues to Decline [LHS]; Labour Markets Remain Tight [RHS]



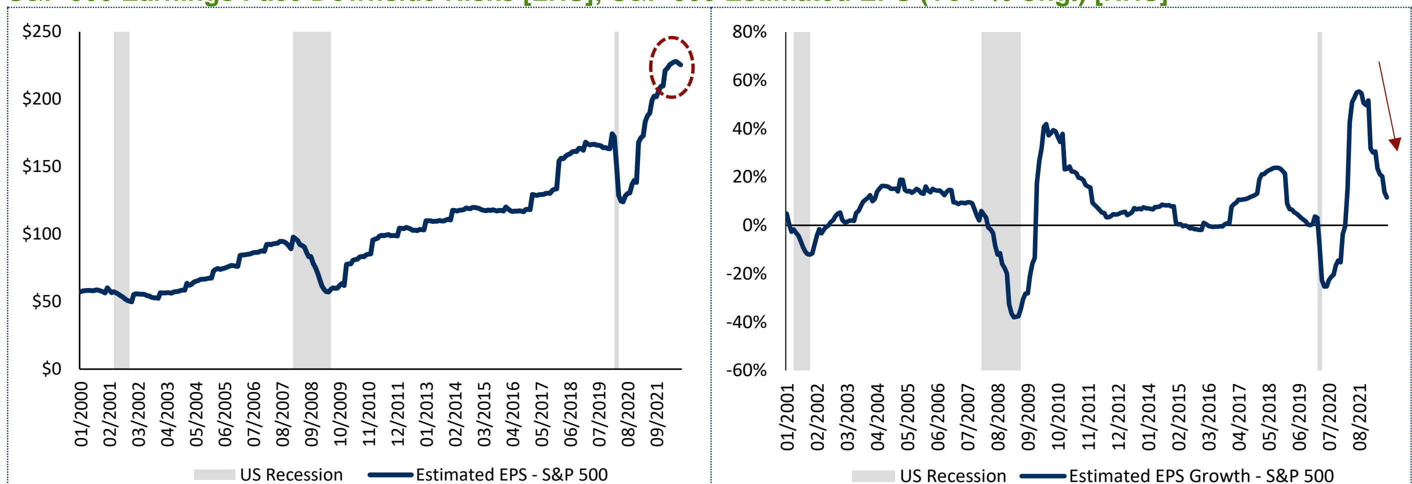
Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of August 31, 2022.

Equity Allocation (Neutral): Remain Selective

U.S. Equities (Overweight)

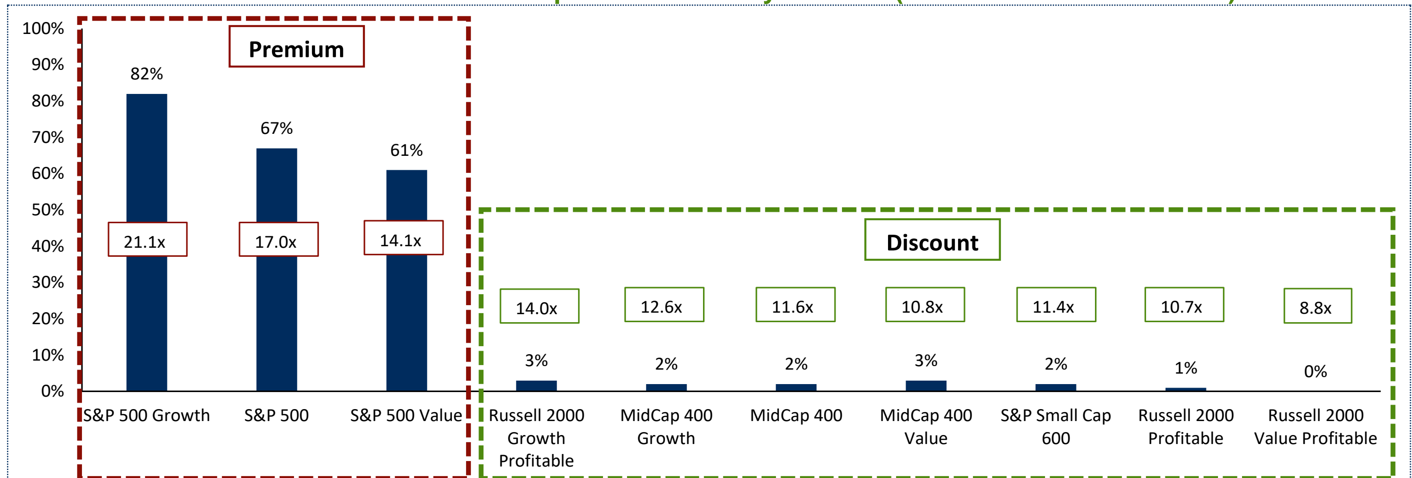
The equity market in the U.S. and globally continues to remain weak in 2022 (essentially returning to/below June lows) due to a combination of global inflation, very aggressive central banks, the Russian/Ukraine war, and impacts from zero COVID-19 policy in China. Most notable of late is central bank hawkishness from around the world, as the Fed leads a wave of higher rates in order to cool demand around the world, even as supply broadly continues to improve across the economy. Although a “soft landing” is always a potential, it is clear from the Fed’s messaging that they intend to stay in a relatively restrictive monetary policy until inflation drops to acceptable levels. Earnings expectations are just starting to come down for U.S. corporations, but P/E multiples have been decimated over the past year, for smaller- and mid-cap indexes, down to levels that are essentially as low as any time in the past 25 years. Small- and mid-caps are cheap across value and growth, which is very different than early 2021, and likely pricing in 20-40 per cent EPS decline. Larger-cap U.S. stocks (S&P 500) have seen P/Es compress meaningfully over the past year, but are still above long-term averages.

S&P 500 Earnings Face Downside Risks [LHS]; S&P 500 Estimated EPS (YoY % Chg.) [RHS]



Source: FactSet; Bloomberg; Raymond James Ltd.; Raymond James Financial; Data as of August 31, 2022.

Index Level NTM P/E Relative to 20-Year Experience for 9 Style Boxes (R2K LTM Ex-Non-Earners)



Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of September 21, 2022.

Looking at significant equity declines in the last 25 years, there have been two conditions that needed to be met every time (2003, 2009, 2016, 2018, and 2020) the equity market has bottomed, and this included a Fed that has stopped raising rates, and importantly, consensus earnings expectations starting to increase once again. We are likely several months away from either of those conditions being met. While this year started in a strong early cycle recovery from COVID-19 restrictions, we are now clearly in a late economic cycle as market participants and monetary authorities wait for the slowing of the economy to what will likely ultimately be a recession. Although this outlook in the U.S. is less than rosy, it is still materially better than the outlook in Europe, Asia, and emerging markets, which we suspect will continue to lead to outperformance of U.S. indexes vs. most international equities. From a style perspective, we still view value as likely performing better than growth, as it has for most of the past two years, even if the market weakens. We still view the risk/reward of smaller- and mid-caps as more attractive than large caps over any meaningful period of time, unless an extremely severe earnings recession unfolds. From a sector perspective, late in an economic cycle, typically investors move into sectors with less earnings sensitivity to overall economic conditions. These include utilities, consumer staples, and health care. These sectors have been outperforming on a relative basis, and we would expect them to continue to until Fed rate increases pause, but note that some these sectors are trading at significant premiums to historical valuations.

Total Equity Returns Since 1/1/2018 – The World's Capital Has Been Flooding into North America

Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of September 21, 2022.

S&P 500 Sector Valuations: Current vs. Historical PE NTM

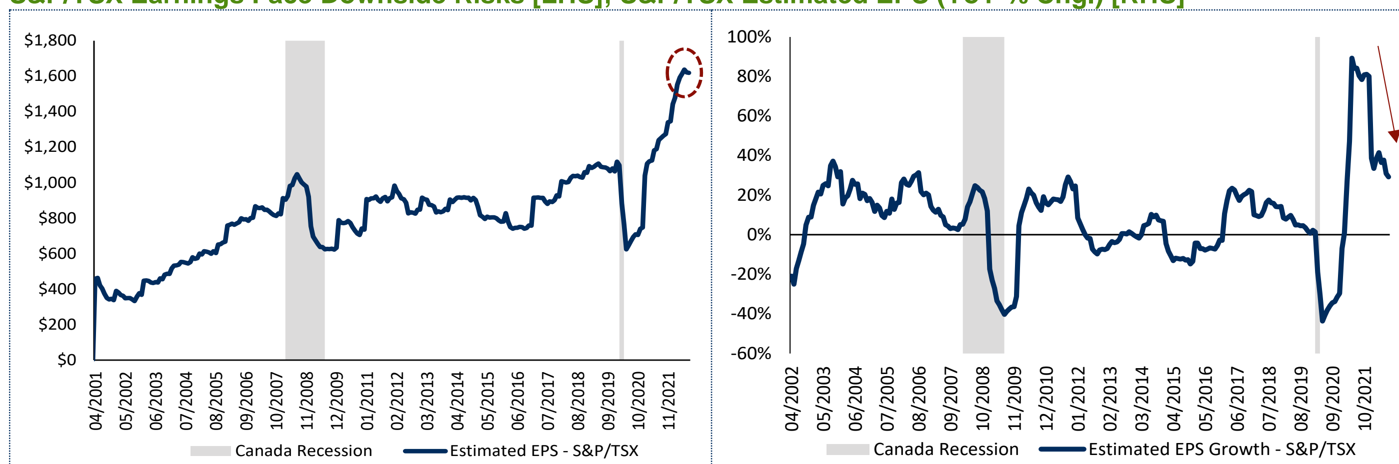
	Sector Weight	Current PE NTM	Historical PE (Since 2000)	Premium (+) / Discount (-)	YTD Return
S&P 500		**17.3**	**15.9**	**1.3**	**-16.1%**
Communication Services	8.5%	15.9	18.0	-2.1	-30.6%
Consumer Discretionary	11.7%	27.5	17.7	9.7	-23.8%
Consumer Staples	6.6%	20.7	18.0	2.7	-4.2%
Energy	4.1%	9.1	13.7	-4.7	48.7%
Financials	10.5%	11.9	12.4	-0.5	-14.6%
Health Care	14.2%	15.8	16.1	-0.3	-10.8%
Industrials	7.8%	17.4	16.0	1.4	-11.4%
Information Technology	28.2%	21.6	17.8	3.8	-22.1%
Materials	2.5%	13.8	15.4	-1.6	-15.9%
Real Estate	2.8%	18.7	18.0	0.7	-18.1%
Utilities	3.0%	20.6	14.6	6.0	5.5%

Source: FactSet; Raymond James Ltd.; Data as of September 1, 2022.

Canadian Equities (Overweight)

On a relative basis, the S&P/TSX index has outperformed many of its U.S. and global peers in constant currency terms so far this year. And with the continued rise in yields globally, valuations have fallen in tandem, including for the S&P/TSX index, which is trading at ~11x NTM earnings (versus the 20-year historical median of ~14.4x). On a relative basis, we also see a much more compelling risk/reward profile for the S&P/TSX vs. the S&P 500 index, which as we mentioned above is still trading at a premium relative to history. That said, while we expect earnings globally to continue to weaken as we look further into 2023 and eventually head into a recession, earnings are starting from a much higher starting point +29 per cent YoY for the next twelve months vs. +11 per cent YoY for the S&P 500 index. From a sector perspective, the only place investors have found solace in has been the energy sector, along with some of the traditional defensive sectors including utilities and consumer staples. However, while earnings in these sectors appear to be more resilient throughout the entire market cycle, we note that several of these sectors are now trading at very elevated valuations. While over the short term this may not present much risks for investors, valuation contraction risks are very real and likely to occur over the medium to long term. That said, we continue to recommend investors focus on sectors trading at lower relative P/Es and more importantly companies that are reasonably priced with very durable earnings/free cash flow streams throughout the entire business cycle.

S&P/TSX Earnings Face Downside Risks [LHS]; S&P/TSX Estimated EPS (YoY % Chg.) [RHS]



Source: FactSet; Bloomberg; Raymond James Ltd.; Raymond James Financial; Data as of August 31, 2022.

S&P/TSX Sector Valuations: Current vs. Historical PE NTM

	Sector Weight	Current PE NTM	Historical PE (Since 2002)	Premium (+) / Discount (-)	YTD Return
Canada S&P/TSX Composite		**12.1**	**14.5**	**-2.4**	**-7.2%**
Communication Services	4.9%	18.0	15.7	2.2	-2.2%
Consumer Discretionary	3.5%	13.3	14.3	-1.0	-8.9%
Consumer Staples	4.2%	16.3	15.8	0.5	4.4%
Energy	17.9%	8.6	15.2	-6.6	30.9%
Financials	31.6%	9.8	11.5	-1.7	-10.1%
Health Care	0.4%	2.9	16.5	-13.6	-53.8%
Industrials	12.8%	24.6	15.5	9.1	-1.1%
Information Technology	6.1%	31.6	21.3	10.2	-54.6%
Materials	10.7%	11.3	17.2	-6.0	-9.0%
Real Estate	2.8%	15.1	14.7	0.4	-19.9%
Utilities	5.2%	24.0	17.9	6.1	6.6%

Source: FactSet; Raymond James Ltd.; Data as of September 1, 2022.

FX: A Hot U.S. Dollar Continues to Paint the Town Red

The Federal Reserve (Fed) delivered its third straight 75bps hike and an accompanying dot plot that elevated terminal rate projections above consensus into 2023. This, coupled with an extremely uneasy risk-off environment, has pushed the DXY U.S. Dollar Index to its highest levels since 2002. Looking at the USD's performance against some of its major peers, the GBP is trading at its lowest level since 1985 and has par within its sights at the time of writing, while the EUR is trading at its lowest level since 2002 and drifts further below par. The JPY has also been trading at its lowest levels against the U.S. dollar since 1998, which prompted the Japanese Ministry of Finance to intervene in the FX markets for the first time since 1998 in order to prop the yen up. Given the deteriorating global economic outlook as central banks continue to ramp up rate hikes in order to ease inflationary pressures, we have seen material risk-off shocks to global markets and heightened volatility across asset classes. As a result, we are increasing our positive outlook for the USD at this time.

As for USD/CAD, we are now seeing the market price in a higher terminal rate for the Fed versus the Bank of Canada (BoC). We anticipated this re-pricing in the past when this relationship was flipped in the BoC's favour, which supported our bullish outlook for USD/CAD. As domestic consumer headwinds persist, along with unavoidable pain for a highly leveraged household sector, the market is anticipating an earlier end to the BoC's tightening cycle than for the Fed's. This, along with a strong USD that will continue to benefit from a safe-haven bid and relatively higher U.S. Treasury yields, underscores our view that USD/CAD will continue to trade higher going forward and thus recommend buying into any USD weakness.

Fixed Income (Neutral): Governments > Corporates

We have been expecting the U.S. and Canadian yield curves to continue to flatten with shorter-term securities' yields rising faster than longer-term yields. This yield curve twist has been occurring and will likely do so as central banks raise rates. The longer-yielding securities are more sensitive to inflation and recessionary potential but in opposite direction. Because we have not seen enough indications that a recession is near, but we have seen stubborn inflation, longer rates have been pressured higher. Again, however, shorter rates continue to have a faster run rate to higher levels than the longer end. Inflation expectations for the next two years continue to slide, but they appear to be stabilizing. The U.S. will enter a period, beginning in November (using October inflation data), that will make it more difficult for inflation to show increases because of the rapid rise in monthly inflation data in the last few months of 2021.

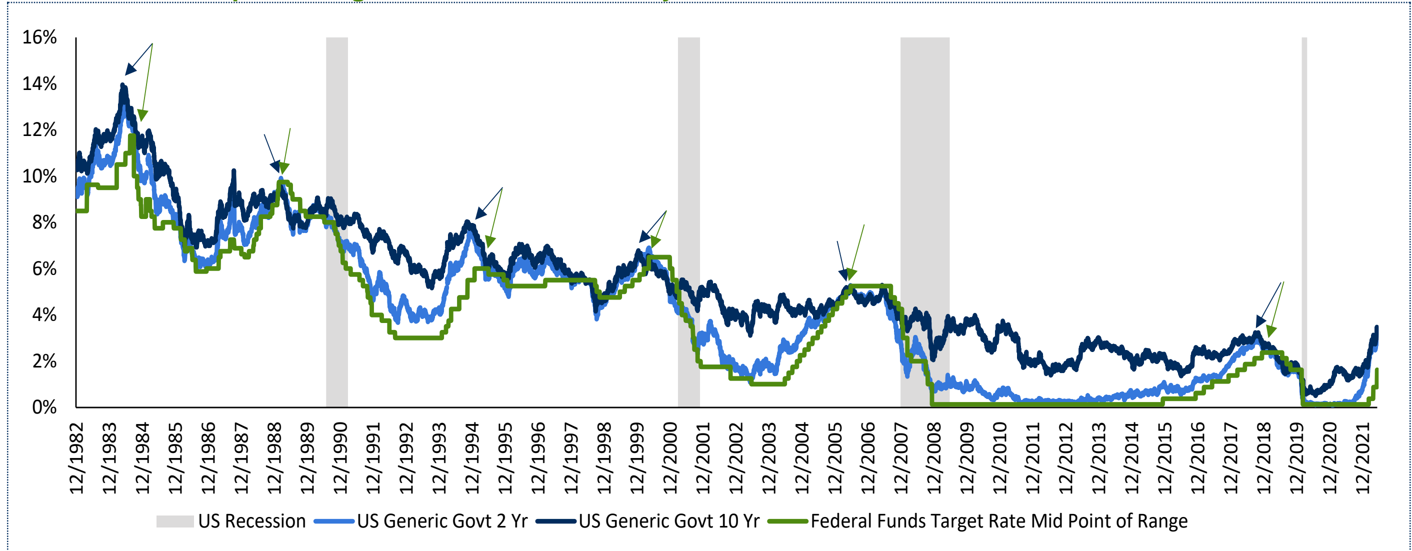
With the central banks continuing their fight and with the recent comment from Fed Chair Jerome Powell at the Fed's annual Jackson Hole where he said, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses", the U.S. economy looks more likely to enter a recession than not. The Fed Chair's comments have migrated from optimism over a soft landing to households and businesses feeling "some pain". In his 9/21 post-FOMC press conference, he reiterated the Fed's resolve to fight inflation and said, "The path that we actually execute will be enough -- it will be enough -- to restore price stability."

As we move toward a recession, which will likely be a global recession, the rate of central bank rate hikes will slow and, eventually, stop. When that happens, the yield curve is usually inverted, meaning shorter rates are higher than longer rates. While investors tend to like to buy shorter-term bonds at higher yields than buying longer bonds at lower yields, history shows us that buying longer-term bonds typically results in better overall returns for investors. The reason is that the shorter-term bonds have less sensitivity to falling rates and their shorter maturities mean the proceeds need to be reinvested more often, typically at lower rates after central banks stop raising rates. The chart below shows that yields typically peak just before or concurrently with the Federal Reserve pausing rate hikes.

You can also see that when the Fed stops raising rates, this historical record shows that a recession typically ensues. The only time that has not happened was in the post-1994 Fed hiking regime. With the Fed no longer raising rates, overall interest rates fell without experiencing a recession. For the above reason, we favour increasing fixed income holdings as well as shifting maturities further out the curve.

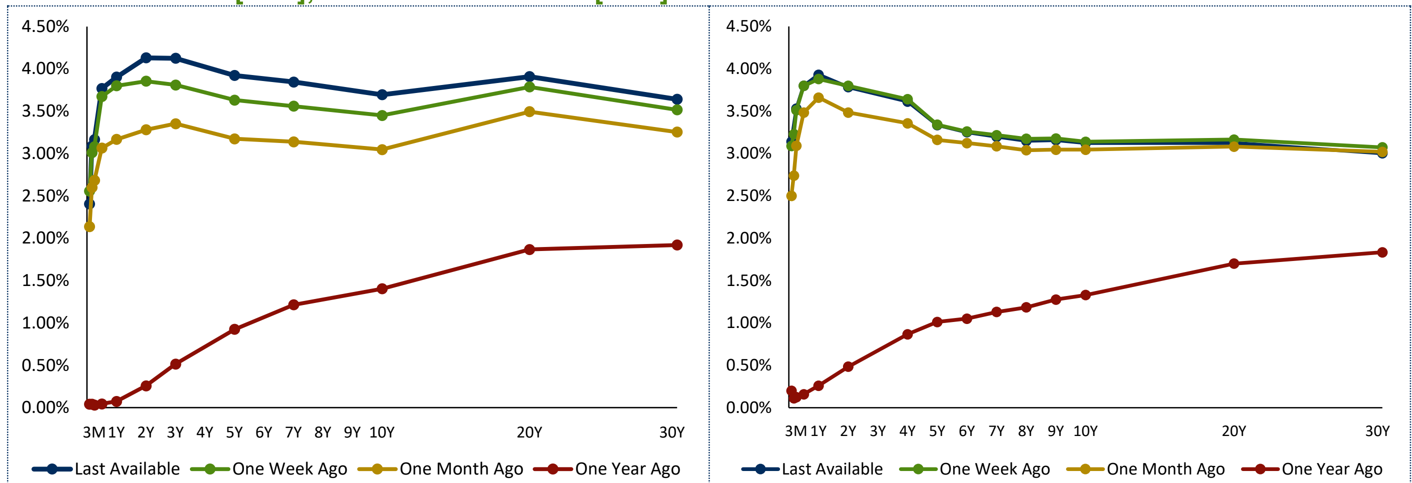
The other implication of an upcoming recession is increased credit risk, so we proposed that corporate bond holdings be reduced in total alongside an increase in quality and defensive positions. In relative terms, U.S. yields are higher across the board than Canadian yields, so we prefer holding U.S. treasury over Canadian sovereign bonds.

When the Fed Stops Raising Rates, Winter Is Usually Just Around the Corner …



Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of September 21, 2022.

U.S. Yield Curves [LHS]; Canada Yield Curves [RHS]



Source: FactSet; Raymond James Ltd.; Raymond James Financial; Data as of September 22, 2022.

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