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PRIVATE CLIENT SOLUTIONS

Insights & Strategies

Hawks Pounce as Doves Cry

RAYMOND JAMES®

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Contents

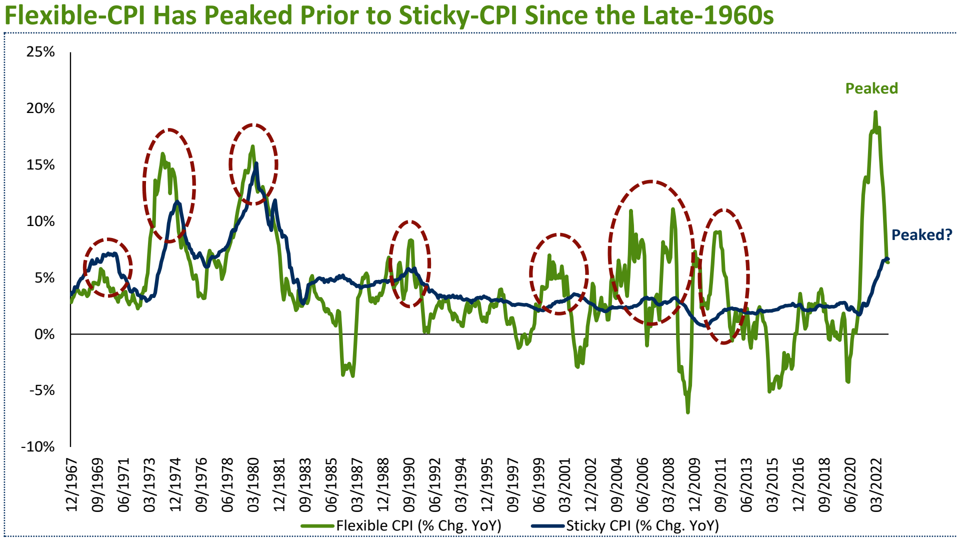
Investors entered 2023 hopeful and, in some cases, even convinced that the fight against inflation was largely a 2022 story with both the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) set to end their tightening efforts with an eventual pivot towards rate cuts in H2/2023 if not sooner. However, to investors' surprise, the hawkish narrative has resumed, following stronger-than-expected economic releases on both sides of the border for employment, inflation, consumer spending, etc. This, in the aggregate, suggests that the inflation fight which began in 2021 is far from over and will likely continue to remain a central theme for markets and investors in 2023.

However, while we believe the peak is in for inflation, the path forward will be anything but a straight line down back towards the historical trend. This is why we have maintained our call that a mild recession in Canada and the U.S. is likely to occur in 2023/2024 versus a no-landing scenario, which, not surprisingly, has made headlines recently.

In our view, the lag effect of the aggressive policy changes in 2022, in particular the ~400-450 bps-increase in overnight rates – coupled with the imprecise impacts of these policy changes on the various components within the consumer price index (CPI) bucket and the broader economy – makes predicting the end of the fight very challenging and a game we choose to avoid playing. Rather and more importantly, for investors, we believe these factors, at the very least, suggest to us that central banks will likely need to maintain higher rates for longer than most had expected versus the dovish outlook of cuts that many had hoped and wished for as we entered 2023.

For example, within the U.S CPI basket, sticky-price items (e.g., food away from home, rent, and recreation) represent ~70 per cent of the overall basket. These items do not respond quickly to changing market conditions compared to more "flexible-price" goods (e.g., new/used vehicles, gas and electricity, lodging away from home) that represent the remainder of the CPI basket. As we demonstrate in the chart below, U.S. flexible-CPI has typically reached a peak prior to sticky-CPI since the 1960s. Rate increases and fiscal tightening impact these CPI basket components much sooner than they do for sticky-priced goods.

Flexible-CPI Has Peaked Prior to Sticky-CPI Since the Late-1960s

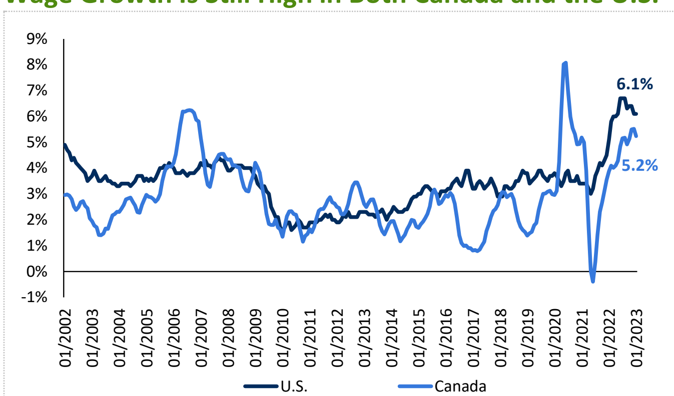


Source: Federal Reserve Bank of Atlanta; Raymond James Ltd.; data as of January 31, 2023.

Tightness in Labour Markets is Evident in Wages

The tightness in labour market conditions is another challenge that central bankers will attempt to address with changes in policy rates. For example, today, there are ~1.0-2.0 job openings for every person actively looking, while the unemployment rate on both sides of the border are hovering at 50-year lows. Simply put, the challenges we are experiences in labour markets are more reflective of longer-term structural issues, which were also present prior to the pandemic, but will not be easily or effectively fixed by changes in policy rates. As we show below, wage growth, as a result of these imbalances, has accelerated from the pandemic lows and is now hovering above the longer-term trend of 3.4 per cent and 2.9 per cent year-over-year (YoY) for the U.S. and Canada, respectively.

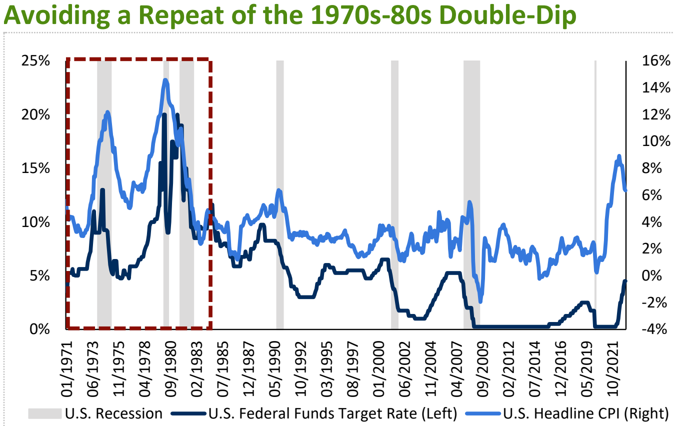
Wage Growth Is Still High in Both Canada and the U.S.



Source: Statistics Canada; Federal Reserve Bank of Atlanta; Bureau of Labor Statistics; Raymond James Ltd., as of January 31, 2023; % Chg. YoY, smoothed (3-month average)

While policymakers were arguably late to the inflation party, the hawkish rhetoric since late 2021 has remained mostly consistent throughout much of 2022. With doves flying high as inflation appears to have peaked, avoiding a repeat of the double-dip 1970s-80s inflation conundrum will be a key focus for central bankers in 2023 and even more so for investors.

Avoiding a Repeat of the 1970s-80s Double-Dip

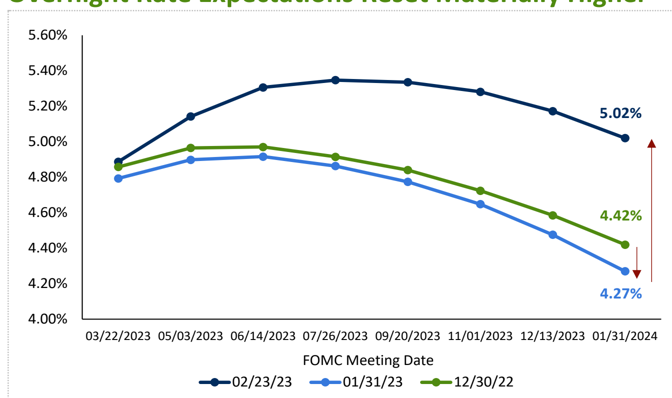


Source: FactSet; Raymond James Ltd.; Data as of January 31, 2023.

When Doves Cry, Markets Reprise – i.e., Selloff

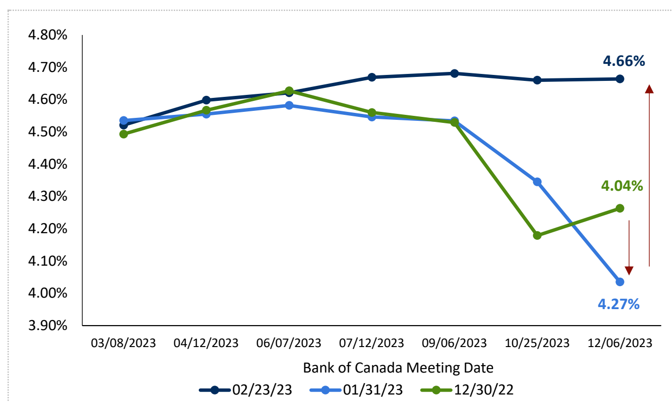
Investors' dovish tendency was best reflected in forward interest rate expectations for each of the Fed/BoC policy meetings over the next year. For example, the **green** and **light blue** lines below show investors' forward expectations for the path of overnight rates as of December 30, 2022, and January 31, 2023, versus expectation as of February 23, 2023 in **dark blue**. What is clear is that investors have repriced their expectations for the path of overnight rates following each of the upcoming meetings in 2023. Also, the commonly watched interest-rate barometer – 10-year yields – has moved higher as risk assets (i.e., equities) have sold off aggressively.

Overnight Rate Expectations Reset Materially Higher



Source: Bloomberg; FactSet; Raymond James Ltd.; Data as of February 23, 2023.

Similar Case in Canada



Source: Bloomberg; FactSet; Raymond James Ltd.; Data as of February 23, 2023.

We expect uncertainties and market volatility to remain high in 2023. However, we suggest investors use this opportunity to focus on what is in their control – i.e., allocating capital towards global investments, which offer compelling risk/rewards – versus focusing on the uncontrollable, examples of which are many (e.g., when will the Fed pivot).

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

Equity Selection and Inflationary Periods

If we lean on the wisdom of Warren Buffett in managing investment portfolios, he is a firm believer in staying invested in stocks. However, he has also warned about the impacts of inflation on stocks for investors. His annual letters to shareholders in the late 1970s and early 1980s, during a period of very high inflation in the U.S., provide valuable insights into the impacts of inflation on stocks, corporate balance sheets, markets, etc.

In short, he cautioned that high inflation rates can make corporate investments unwise and that earnings are not the only variable to consider for investors during extended periods of high inflation. He suggested looking for businesses that generate cash and can increase prices without fear of significant loss of market share or unit volume. Buffett's wise words on inflation should be considered as part of an investor's broader investment due-diligence process.

Methodology and Screening Process

We conducted a screening exercise where we filtered for companies on the S&P/TSX and S&P 100 with a high cash conversion ratio (CCR) and cash return on invested capital (Cash ROIC).

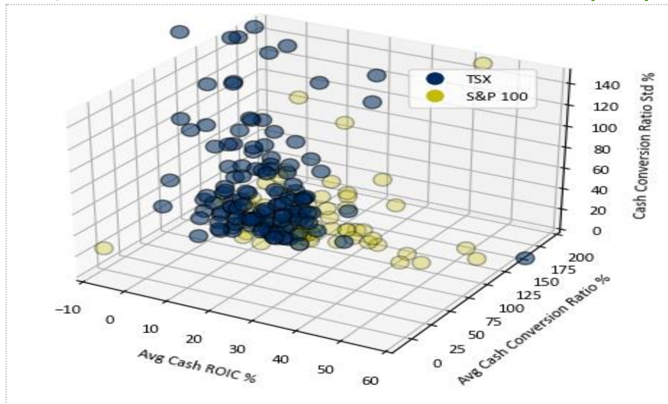
The cash conversion ratio helps to identify how much of a company's operating income (EBITDA) is converted to cash from operations. In this screening exercise, we also looked at companies that exhibited the lowest level of variation for this metric over the past 10 years. Additionally, we looked at cash ROIC for these companies, which measures the cash profits of a company as a proportion of the funding required to generate them.

To complete this screening exercise, we pulled 10 years' worth of quarterly results as of Q3/22 and excluded companies with missing or incomplete information. This analysis resulted in a list consisting of 64 per cent and 78 per cent of S&P/TSX and S&P 100 constituents, respectively. Lastly, after the data was complied, we ranked the list to identify companies that ranked the strongest on both of these metrics.

Quantitative Findings

When we combine all the companies in both the S&P/TSX and S&P 100 and viewed the data in a three-dimensional scatterplot, we noticed that S&P 100 companies have historically exhibited lower levels of CCR standard deviation and have delivered higher cash ROIC, on average. This means that, in general, S&P 100 companies have shown more consistency than companies on the S&P/TSX, when it comes to converting operating income into cash on a historical perspective.

S&P/TSX & S&P 100 – Cash ROIC vs. CCR vs CCR (Std.)



Source: Raymond James Ltd., FactSet; Data as of September 30, 2022.

The top five firms by rank in the aggregate list are **Apple (AAPL-US)**, **Meta Platforms (META-US)**, **Texas Instruments (TXN-US)**, **Adobe (ADBE-US)** and **Microsoft (MSFT-US)**.

The top five firms on the S&P/TSX are **Constellation Software (CSU-CA)**, **Enghouse Systems (ENGH-CA)**, **CI Financial Corp. (CIX-CA)**, **Dollarama (DOL-CA)** and **ARC Resources Ltd. (ARX-CA)**.

The top five firms on the S&P 100 are **Apple (AAPL-US)**, **Meta Platforms (META-US)**, **Mastercard (MA-CA)**, **Accenture (ACN-US)** and **Texas Instruments (TXN-US)**.

Top Five Firms on the S&P/TSX and S&P/100

Company Name	Sector	Avg Cash ROIC	Avg 10 Year Cash Conversion Ratio (CCR)	CCR Historical Standard deviation
S&P/TSX				
CSU-CA	Info Tech	71.7	87%	38%
ENGH-CA	Info Tech	25.3	81%	26%
CIX-CA	Financials	23.0	71%	16%
DOL-CA	Con Disc	33.6	70%	28%
ARX-CA	Energy	20.1	102%	29%
S&P 100				
AAPL-US	Info Tech	44.2	93%	15%
META-US	Comm Serv	31.8	105%	21%
MA-US	Info Tech	49.8	79%	18%
ACN-US	Info Tech	58.0	90%	34%
TXN-US	Info Tech	37.9	90%	19%

Source: Raymond James Ltd., FactSet; Data as of September 30, 2022.

Key Takeaways

Warren Buffett's advice can help you find quality companies with resilient business models for periods of high inflation. This illustration seeks to help provide some useful ideas to identify quality companies with favourable cash flow characteristics.

Peter Tewolde
Equity Specialist

Equal-weight Index ETFs

An index weighting methodology determines how much each security is included in an index ETF and has a substantial impact on the overall performance. For instance, the industry standard S&P 500 is **a cap-weighted index** in which the weight of each constituent is determined by dividing its market capitalization by the total market capitalization of all 503 securities in the index. Another simple index weighting method is the **equal weight** methodology where each security is assigned an equal weight, regardless of its market capitalization.

Equal Weight: Advantages and Disadvantages

An equal-weight approach can help reduce exposure to concentrated market leaders and potentially overvalued sectors compared to a traditional cap-weighted index. By weighing companies the exact same, it will overweight smaller-cap companies when compared to their cap-weighted alternative.

As the prices of each company naturally fluctuate over time, a key factor to consider is the frequency at which the index rebalances. Regular rebalancing will ensure the index maintains its equal weight construction. With this additional management, it is typical to see a higher management fee associated with these products.

S&P 500 – To Equal Weight or Not?

If you look at the S&P 500, the 10 largest positions represent 25 per cent of the index, while the technology sector alone represents around 27 per cent of the total sector allocation. An equal weight approach can be useful to reduce this company and sector concentration risk in uncertain market environments.

S&P 500 (Cap-Weighted): Top 10 Constituents

	Constituent	GICS Sector	Allocation
1	Apple Inc.	Technology	6.65%
2	Microsoft Corp	Technology	5.60%
3	Amazon.com Inc	Consumer Discretionary	2.54%
4	Alphabet Inc A	Communication Services	1.64%
5	Berkshire Hathaway B	Financials	1.63%
6	Tesla, Inc	Consumer Discretionary	1.61%
7	Nvidia Corp	Technology	1.54%
8	Alphabet Inc B	Communication Services	1.45%
9	UnitedHealth Group Inc	Health Care	1.37%
10	Exxon Mobil Corp	Energy	1.35%

Source: FactSet, Vanguard S&P 500 ETF (VOO.US), data as of January 31, 2023.

Sector Breakdown Differences

GICS Sectors:	S&P 500 Equal Weight Index	S&P 500 Index
Technology	15.2%	26.5%
Industrials	13.9%	8.4%
Financials	13.6%	11.7%
Health Care	12.5%	14.7%
Consumer Discretionary	11.6%	10.6%
Consumer Staples	6.1%	7.8%
Real Estate	6.0%	2.8%
Materials	5.9%	2.8%
Utilities	5.7%	2.9%
Energy	4.8%	5.1%
Communication Services	4.6%	7.8%

Source: SPGlobal.com, data as of January 31, 2023.

All things being equal, if the largest companies outperform, concentration in the S&P 500 will continue to rise and the equal-weight index will likely underperform a cap-weighted index. Alternatively, if smaller companies outperform larger ones, an equal-weight index will likely outperform a cap-weighted index.

The Amen Corner

In a few weeks, the world's top golfers will meet again at the iconic Masters Tournament. In this contest, there is a famous three-hole stretch, known as the "Amen Corner", that is thought to be the most difficult section of the course. Golfers are challenged as they look to avoid all types of water, tree and bunker hazards while also managing the psychological risk-reward stress these holes present. It can be a pivotal moment for scorecards where tournaments are decided. Similarly, market leaders over the past decade may be experiencing their own version of the "Amen Corner" as many of the top tech giants continue to seek new footing in 2023. By leveraging an equal-weight index ETF, investors can reduce concentration risk as we continue to see the effects of 2022's unprecedented pace of rate hikes. In the Canadian marketplace, Invesco offers a handful of ETFs that leverage an equal-weight index methodology.

Equal-Weight Index ETF Solutions

ETF Name:	Ticker	MER
Invesco S&P 500 Equal Weight ETF	EQL	0.26%
Invesco S&P Europe 350 Equal Weight ETF	EQE	0.34%
Invesco NASDAQ 100 Equal Weight ETF	QQEQ	0.28%

Source: Directly from ETF Provider, February 27, 2023.

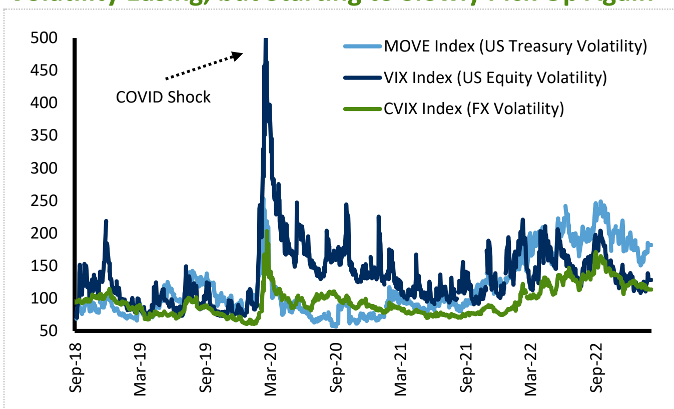
Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

The Fed Still Has Its Work Cut Out

As stronger-than-expected economic data continues to roll in out of the U.S., hawkish market expectations for future rate hikes from the U.S. Federal Reserve (Fed) have underpinned recent strength in the greenback. Just when you think bullish repricing of Fed rate hikes may have likely peaked, you get another hot inflation print - i.e., the core Personal Consumption Expenditures Price Index (PCE), the Fed's go-to inflation gauge - which sent market participants scrambling to further bolster their Fed terminal rate expectations.

The economic resilience of the United States may very well keep the U.S. dollar on a firmer footing in the near term. However, we continue to believe that factors such as heightened recessionary risks in most developed markets, the Fed's eventual pause on its rate hiking cycle and an easing of volatility across financial markets will weigh on the U.S. dollar later on down the road.

Volatility Easing, but Starting to Slowly Pick Up Again



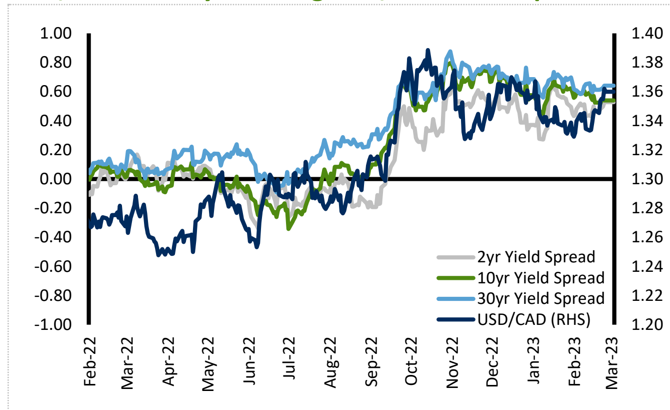
Source: FactSet; Raymond James Ltd.; Data as of February 23, 2023.

Inflation is Still Very Much in the Fight!

As the Fed continues to throw jabs in its fight against stubborn inflationary pressures, the Bank of Canada (BoC), on the other hand, has decided to sit out for a few rounds in order to gauge the lagged effects of its rate hikes on the broader economy. At the time of writing, markets are pricing in a 25bps-rate hike for the BoC at its September meeting and three 25bps-rate hikes for the Fed at its March, May and June meetings.

Market pricing for the terminal Fed funds rate reached new highs after the most recent PCE print came in stubbornly hotter than expected, with upward revisions to the prior print as well. As a result, short-end U.S. rates should remain more vulnerable to subsequent Fed rate hikes, which will feed into some sustained greenback strength going forward. This makes upcoming economic data releases south of the border even more of a key priority for markets.

USD/CAD Closely Tracking U.S./CDN Yield Spreads



Source: FactSet; Raymond James Ltd.; Data as of February 23, 2023.

What All This Means for USD/CAD Going Forward

Near-term uncertainty surrounding the market estimates of where the Fed's terminal rate would need to reach in order to bring inflation back within its target range has been a prominent factor underpinning recent USD strength. We expect this to continue for the time being. As a result, we see no reason to deviate, at this stage, from our prior call for USD/CAD strength in the near term, with some possible weaknesses to ensue at the back end of the year.

As for when the USD may go back on the defensive, markets will likely want to see enough evidence of a sustained pullback in U.S. economic growth and inflationary pressures prior to calling an end to the Fed's tightening cycle. At that point, attention will turn to other countries that may not be at the end of their respective tightening cycles just yet, namely Europe.

The correlation between USD/CAD and broader risk markets continues to remain elevated while also closely tracking U.S./Canadian short-end yield spreads. It comes as no surprise that broader commodity prices have not been providing CAD with any cover against recent USD strength. The Bloomberg Commodity Index and West Texas Intermediate (WTI) have been on a gradual decline since June. Many were anticipating an immediate surge in commodity demand from China, following the rollback of their zero-COVID policies.

However, it appears that any material uptick in both consumer and industrial activity and subsequent demand for commodities and material inputs will take a bit longer to return to pre-pandemic levels. As a result, we are looking for USD/CAD to trade within a 1.3300-1.3700 range over the coming months.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Taking Advantage of Higher Rates

In 2022, we saw one of the fastest rate hiking cycles in the Bank of Canada's (BoC) history as the central bank worked to keep inflation under control. The Canadian preferred share market, as a result, came under heavy pressure and underperformed Canadian equity and bond markets. Most preferred shares are now trading at a discount to par value compared to the beginning of 2022 when they were trading close to par value.

What Are Preferred Shares?

Preferred shares are a special type of equity that combines aspects of both common shares and bonds into one security. They are traded on the Toronto Stock Exchange with a par value of $25 and typically offer a fixed dividend payment, which is consistent with characteristics of a bond. Moreover, preferred shares pay out dividends which are taxed more favourably than interest payments from bonds. In the capital structure of a Canadian corporation, holders of preferred shares would rank behind bondholders in priority of payment but would be ahead of common equity holders. Companies in the financial, energy and utility sectors dominate this market and are also the largest issuers of preferred shares.

A subset of preferred shares worth highlighting is fixed reset preferred shares. After the initial five-year period post-issuance, the issuer has the option to either redeem the security or extend and reset the dividend rate at a pre-determined spread over the benchmark. Unlike its perpetual preferred share counterparts with its dividend rate set in perpetuity (hence its name), a fixed reset's dividend rate would reset every five years.

Higher Rates Create Opportunities for Investors

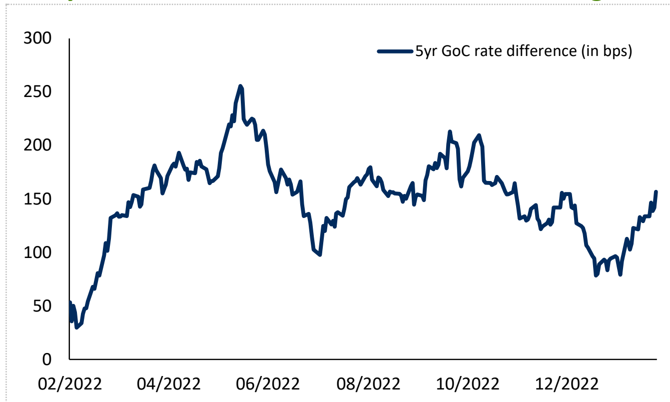
Taking a closer look at fixed reset preferred shares which were issued or had their last rate reset in a low interest rate environment, most of these offer a compelling current yield today, however, that yield could become even more attractive when they reset. The five-year Government of Canada (GoC) rate, the most common benchmark for fixed reset preferred shares, is substantially higher today compared to five years ago. The new dividend rate is expected to be higher as well. We have seen the average preferred share coupon rate increase by 1.48 per cent in recent months.

We believe there is an opportunity in fixed reset preferred shares that are expected to reset in 2023 or early 2024. By selecting a preferred share that resets sooner, investors would lock in a higher current rate for the next five years and increase their cash flow with this higher coupon payment.

It would be safe to say that the Canadian preferred share redemption trend that dominated 2021 and early 2022 might be over now. The pricing of these preferred shares issued by the big banks and insurance companies reflects this – i.e., they are trading at a steep discounts to their par value, implying the market no longer expects they would be redeemed.

However, should market conditions change – i.e., yields/interest rates fall – a preferred share purchased at a discount has the potential for capital appreciation in the event that issuers choose to call them.

Five-year GoC Rate Difference from Five Years Ago



Source: FactSet, Raymond James Ltd.; Data as of February 24, 2023.

Final Thoughts - Be Selective

The Canadian preferred shares market can be complicated with some securities and many features and options attached to them. Some of those shares are traded at a steep discount for a reason. It is important to note that even preferred shares from the same issuer can differ greatly. Be selective and consider the following factors:

- **Reset Spread:** Consider the reset spread of the fixed reset preferred share. Generally, a higher spread is more attractive.
- **Timing:** Pay close attention to the next reset date. Given the uncertainty in the market, locking in a rate sooner would provide more certainty to the investor's yield to the next reset date.
- **Credit Quality:** It is always prudent for investors to upgrade credit quality when possible.

Risks

Like most investments, preferred shares come with some drawbacks, such as interest rate risk, call risk, credit events and liquidity risk. Please speak with your investment advisor to understand the risks involved.

Erik Yep, CFA
Investment Specialist, Fixed Income

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