Connor, Clark & Lunn
INVESTMENT MANAGEMENT

OUTLOOK

NOVEMBER 2022

"Patience is the art of concealing your impatience." – *Guy Kawasaki, entrepreneur.* One of the hallmarks of this current business cycle has been how quickly things have progressed. It is under that impatience that we now encounter the famously long and variable lags of the effect of monetary policy. Indeed, the largest influence on markets has shifted since the beginning of the year, away from inflation and towards the global synchronized rate hike cycle. According to the World Bank, the global economy is in its steepest deterioration since 1970. But after pushing through a rapid-fire rise in rates, this tightening cycle is maturing towards an endpoint. As a result, investors are anxious to catch the inflection point.

This enticing possibility had assets on a roller coaster in October. It started with a two-day rally in equities that delivered the best performance since April 2020, on hopes the US Federal Reserve (Fed) would slow the pace of its rate hikes. The Reserve Bank of Australia's 25 basis point (bps) rate hike and the Bank of England's smaller than expected 50 bps hike fueled the narrative.

Mid-month though, Fed speakers were out in force to downplay the potential for a slowing in rate hikes. Minneapolis Fed President Neel Kashkari, for one, is more concerned with under tightening than over tightening and is not seeing an end to rate hikes until the Fed Funds Rate is above 4.75%. A surprisingly strong US CPI print at 8.2% y/y in September bolstered the expectation for another 75 bps rate hike in November, the fourth straight outsized move (which did occur). The futures market pushed the expected end point for Fed rate hikes up to above 5%. However, news reports hinted the Fed was discussing "how to signal plans to approve a smaller increase in December."

The Bank of Canada (BoC), a leader in global tightening, surprised the market with a smaller-than-expected 50 bps rate hike, and markets took note. Similar concerns were expressed at an ECB press conference. All of this led to a shift in sentiment in late October that ultimately fired up financial markets. Bond yields dropped sharply at the end of the month and ultimately, risk assets had a banner rally, the second such hefty rise in four months, but all within a dismal year. Phew! Incoming information certainly tested investor patience.

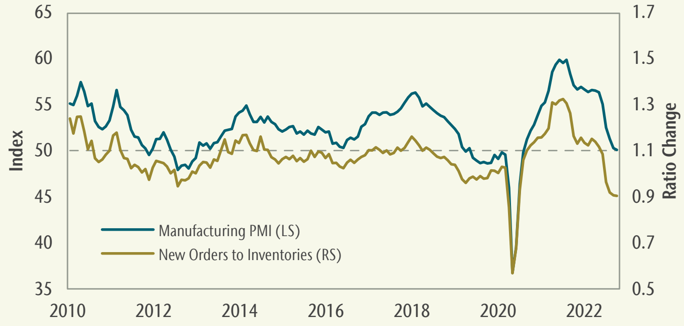
So, against that backdrop, is now the time to buy equities? We do not think so. First, we are concerned that the signals coming from the macro backdrop are deteriorating. Developed market PMIs are now turning lower and leading indicators are pointing to more downside (see Chart 1). Around the world, the picture is not much better. China is an economy facing deflation risks, while Europe may be the one region that will grapple with a period of stagflation as higher energy prices remain a key risk.

Second, not all central banks have made the shift in their policy. The US consumer continues to benefit from fairly healthy balance sheets and strong employment, preventing the Federal Reserve from slowing. In fact, the pace of hikes has the 3-month to 10-year yield curve tipping into inversion, one of the key signals the Fed has noted as a predictor of recessions ([see April *Outlook*]).

Third, financial stresses are rising alongside the reduced liquidity, as we discussed last month. Any issues that arise could lead to selling in liquid assets, such as stocks and bonds.

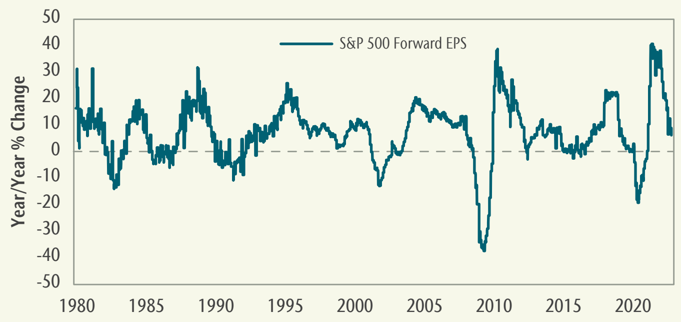
However, the fourth and critical point for equities is that this slowdown has not yet been factored into earnings (see Chart 2).

Chart 1: On the Cusp of an Economic Downturn



Source: IHS Markit, Macrobond, CC&L Investment Management

Chart 2: Earnings Still Too Optimistic



Source: S&P Dow Jones Indices, Macrobond, CC&L Investment Management

Specifically, S&P 500 EPS growth continues to hang in very well, with analysts expecting a roughly flat outlook for 2023 at $224. This has been revised down by over 5% from its peak, but typical recession periods imply an outright contraction. Historical averages point to a decline of 30%.

Indeed, equity bull markets typically restart within recessions, along with some combination of rate cuts, yield curve resteepening, and multiple expansion due to falling discount rates. Market declines do not end before recessions start. While market bottoms often happen before earnings begin to recover, we are not even at the point of pricing a proper slowdown into earnings yet. Indeed, all of this tells us that the October bounce is not quite the end of the drawdown.

CAPITAL MARKETS

Following on a dismal third quarter and year to date across asset classes, central bank commentary has injected a great deal of volatility just in the past month. Contributing further fuel was some relief in energy prices in Europe, notably, natural gas futures prices dropped by about one-third from its peak, as well as some hoped for stability with new UK Prime Minster Rishi Sunak and Chancellor Jeremy Hunt that pushed UK bonds to the best monthly performance for gilts since January 2020 (though they are still down for the year by 23.8%, underperforming against all developed market sovereign bond markets).

In the US, the S&P 500 posted an 8.1% gain in October, despite the continued setback in large tech stocks. The highly anticipated Q3 earnings results suggest continued growth of around 4% over last year, with much of that arising from energy companies. The mega-cap tech stocks that have a heavy concentration of about one-quarter of the S&P 500 did in fact already report poor third quarter results. Of the mega-cap tech stocks, all but one saw profits drop materially, leading to a selloff between 8-25% in each company on the day.

More broadly, the earnings results were expected to be challenging, given the strong US dollar will lower earnings derived from overseas. Negative guidance was more common, especially in cyclical sectors. The S&P/TSX Composite was also strong (up 5.3%) with most sectors registering positive gains. Canadian bond prices were modestly negative: the FTSE Universe Bond Index fell 1.0% in October. Even with a massive drop in Canadian yields of 30-36 bps across the curve in the wake of the BoC surprise 0.5% rate hike, interest rates still finished 8 to 24 bps higher for the month. Canadian bond yields now trade almost 0.75% below the US, in a very sharp reversal from earlier this year when Canadian yields were above the US.

Outside Canada, the global monetary tightening and weaker economic outlook, combined with looser supply chains are all dampening commodity prices, though energy prices remain supported as a result of continued supply issues. The WTI oil price rose 8.6% in October due to a surprisingly large OPEC+ production cut of approximately 2 million barrels per day. However, natural gas prices fell on warmer temperatures. Meanwhile metals prices such as copper and gold have fallen for seven straight months.

PORTFOLIO STRATEGY

The broad trends are undeniable – inflation should be feeling the effects of slowing demand. In Canada, the early indications are that inflation has peaked and a coincident economic downturn will now call for a shift in policy in the near future. Beyond that, interest rates should remain in restrictive territory for longer than many anticipate because, while headed in the right direction, inflation metrics are still feeling the lagged impact of prior stimulus. The resilient employment gains and wages are acting as strong buffers and will hopefully blunt the worst effects of a recession.

Our balanced portfolios remain conservatively positioned with an allocation to cash. We remain underweight equities overall, with a further underweight in global stocks against Canadian equities. We will maintain a cautious outlook for equities until company earnings forecasts reflect a slowdown in activity. While underweight bonds for some time, we reduced the underweight and maintain that position for now. Fundamental equity portfolios have shifted to more defensive positioning, increasing exposure to real estate, utilities, healthcare and consumer staples. We anticipate downward earnings revisions and thus are searching for high quality companies that will maintain stable earnings in this environment. Canadian fixed income portfolios similarly maintain an underweight position in corporate and provincial bonds. Policy, whether easy or restrictive, acts on the broad economy with long and variable lags. Even if in the next phase of the cycle, the rapid-fire interest rate increases turn to periodic smaller hikes, stock prices have still to reflect the bad news yet to come. Caution is the order of the day.