iA Investment Management

Monthly Macro & Strategy

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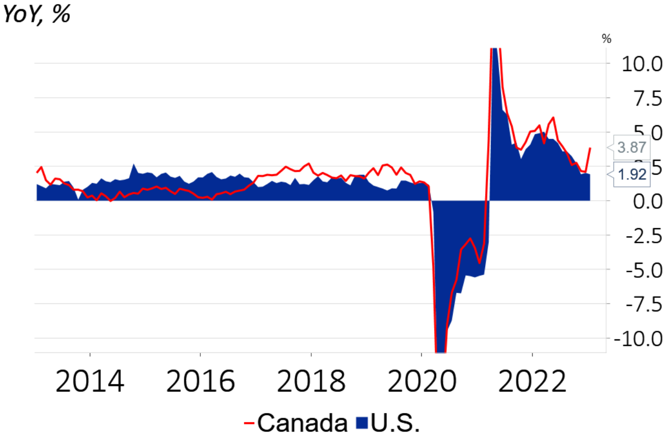
The case for more rate hikes

February brought a few surprises that have prompted us to review some of our convictions for 2023.

Front and centre, of course, is the labour market. Job creation in January turned out to be much stronger than any of the consensus surveys had expected, in Canada and the United States alike, and, in our view, significantly dampened the odds of a recession in 2023. We previously placed the odds of a recession in North America at 70 to 80% but have reduced them to 30 to 50%.

Canada & U.S.: Change in employment

YoY, %



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The rationale is simple: The lagged impact of aggressive monetary tightening since March 2022 should continue to have ripple effects throughout the economy, but the timing of the effects is getting harder to discern. We are in the early phase of the reaction function, as activity stalls and prices fall in housing, weighing on GDP in the first half of the year and create a negative wealth effect. This context will in turn reduce consumption toward mid-year, leading to less industrial production and, incidentally, job losses.

As these circumstances remain at play, the labour market's recent behaviour suggests that the process may unfold more slowly than we expected, and that it might be prudent to delay the call for a recession to 2024. Retail sales are also sending a clear signal that the consumer remains willing and able to spend, adding another source of resilience to an otherwise shaky macro picture.

What is most revealing about the labour market is that workers are finally coming back to the workforce, and hours worked have picked up significantly.

Highlights

- We continue to recommend a defensive stance despite the markets' strong start to the year.
- The recent strength of economic data and inflation lead us to downgrade the odds of a recession in 2023…
- … and upgrade the odds of new rate hikes by the Bank of Canada in the coming months.

Global Asset Allocation Views (March 2023)

	--	-	N	+	++	Δ
Asset Classes						
Money Market				■		
Fixed Income				■		
Equities		■				
Alternatives			■			
Relative Equity						
Canadian Equities			■			
U.S. Equities	■					
International Equities			■			
EM Equities			■			
Relative Fixed Income						
Government Bonds					■	
IG Corporate Bonds				■		
HY Bonds	■					
Other						
Oil				■		
Gold			■			↓
USD (trade weighted)				■		
CAD/USD			■			

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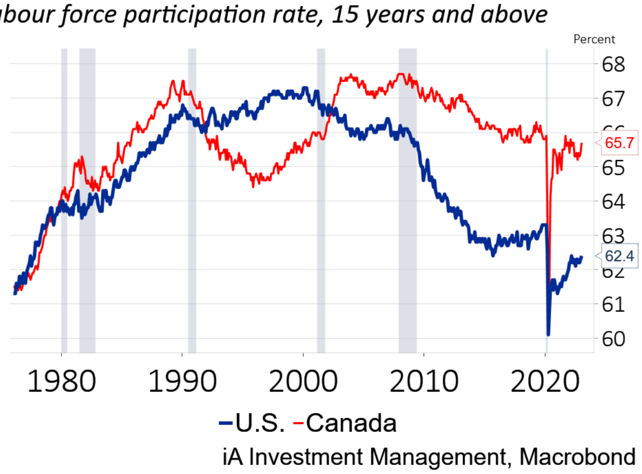
Canada: Total Hours Worked, All Industries

% Change, YoY

The participation rate is back on an upswing after stalling in the United States and contracting in Canada in 2022 – very good news in a context where labour scarcity can be seen as one of the main obstacles to economic growth in the coming decade. Thus, we have an unexpected tailwind in our economic sails, and the recent uptick in job creation, hours worked, participation rate and employment rate, therefore, warrants an adjustment to our view.

Canada & U.S.: Participation Rates

Labour force participation rate, 15 years and above



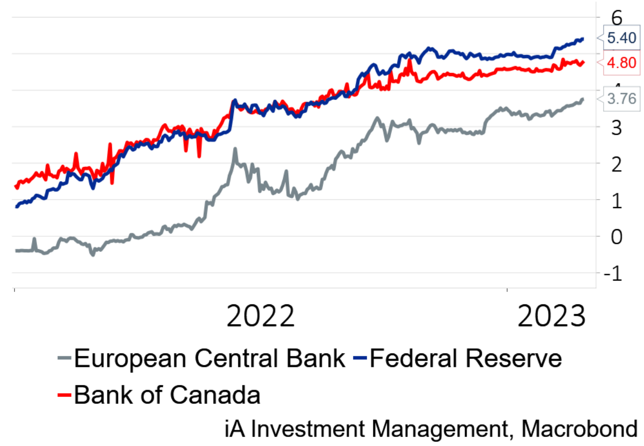
Even so, we are reluctant to reduce the odds of a recession further. The global macro picture is still fraught with challenges, and we could be unpleasantly surprised if (or rather, when) the lagged effects of monetary policy begin to dominate the newsreels. Could the recent jump in job creation be due to volatility in seasonality adjustments? Or are businesses simply hoarding labour now that people are returning to the workforce? The next few months should be informative on this front.

As we know all too well, nothing is ever simple in the world of macroeconomics, and once again good news often comes with bad news.

A stronger economy in 2023 should mean, you guessed it, more persistent inflationary pressures and, thus, more rate hikes. In a seemingly unending cycle of self-regulating forces, it is quite possible that the recent economic resilience from the rise in the participation rate will create a second inflation wave, pushing central bankers to hike beyond the currently estimated terminal rates and triggering a deeper economic slowdown sometime in 2024.

Terminal Rates

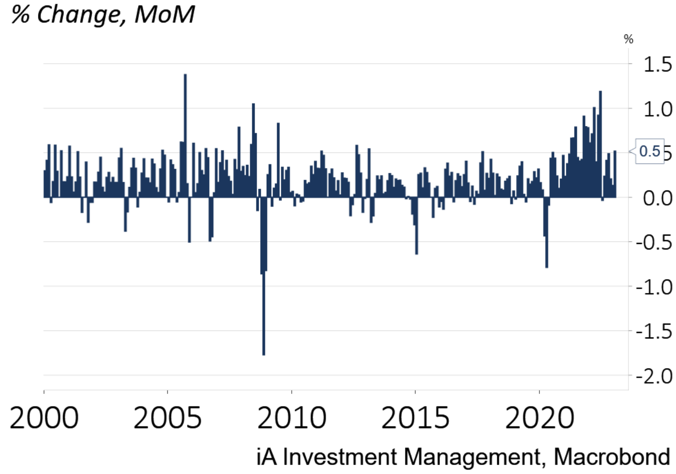
OIS Implied as of 2/27/2023



Our analysis suggests that, currently, the year-over-year numbers do not give an accurate picture of the underlying inflation dynamics because of the fading of the base effects. Even though the headline year-over-year inflation rate continues to slow, as we compare the current price levels with periods that showed the strongest pace of inflation in 2022, the recent monthly pace of inflation has, in some instances, reaccelerated or remains uncomfortably high.

U.S.: Total Inflation

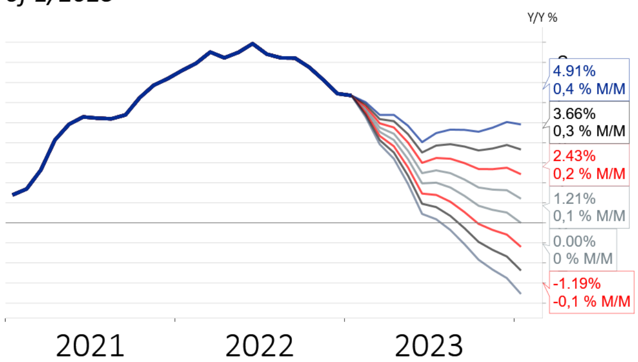
% Change, MoM



As shown in the chart below, even if the US total CPI continued to grow at a monthly pace of 0.4% starting now, the headline annual figure would slide to 4.0% by mid-year and then pick up speed. In fact, for the annual pace of total inflation to keep easing toward the 2.0% target range midpoint by year-end, we would need to see an average monthly pace of 0.2% during the rest of the year. The most recent figures go in the opposite direction, with the latest monthly print coming in at 0.5%, and the annualized 3-month change still stubbornly above the top of the range at 3.5% for total inflation and 4.6% for core inflation.

U.S.: CPI forecast based on MoM scenarios

As of 1/2023



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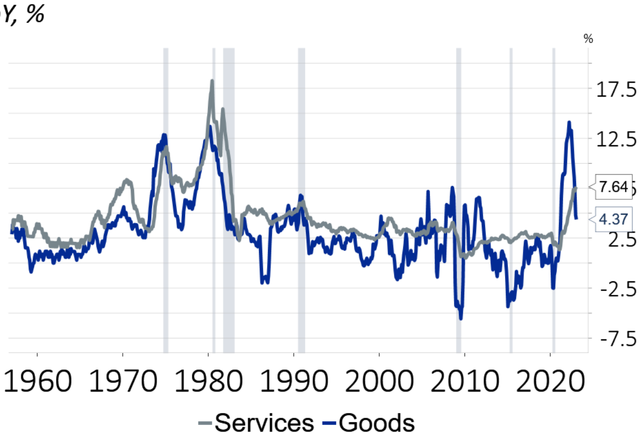
There are good reasons to think inflation will not come back down quickly enough for the Federal Reserve and the Bank of Canada to remain idle too long.

Of major importance is the service sector, specifically the core services CPI, which the Fed's chair Jerome Powell has cited as a key metric in their decision process.

The service sector is more labour intensive, and its CPI is quite sensitive to wage growth. The long-term picture shows that, in the inflationary environment of the early 1980s, services inflation took much longer to tame, and the second inflationary wave was fuelled by sticky wage gains.

U.S.: Inflation in Goods vs Services

YoY, %



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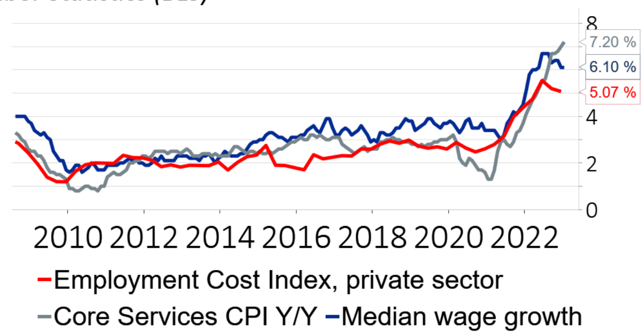
The short-term picture shows that history is repeating itself, as wage pressures continue to push service sector inflation higher. The return of workers to the active population is a welcome sign and should marginally deflate wage growth over the long run, but with the labour market gaining steam in recent months it is reasonable to expect too-hot-for-comfort wage gains to persist in 2023. At 6.8%, the annual change in the median US wage rate has a long way to go before comfortably returning to the 2-3% range.

U.S.: Faster wage growth to keep services inflation elevated

Source: Federal Reserve Bank of Atlanta, U.S. Bureau of Labor Statistics (BLS)



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Canada offers a compelling example of how wage spirals unfold. The received wisdom is that the minimum wage should be 50% of the average wage; therefore, provincial governments tend to simply follow the pace of the average wage when they make adjustments.

With Canada's average hourly wage rising by about 5.0% over the past year, multiple provinces have increased the minimum wage by a similar amount, with Quebec even raising it by 7.0%. The services sector has more workers at or close to the minimum wage; thus, many business owners are warning that their prices will have to explode upward if they are to survive. This context leads to more inflation, hence more adjustments to the minimum wage, and on and on…

The way out, of course, is to put the breaks on the economy with the rate hikes continuing until we close the output gap and, hopefully, put a lid on the labour market. How many more hikes is an open question, but we would not underestimate the odds that we see the Fed and the Bank of Canada push their leading rates beyond 6.0% before all is said and done.

We close this argument by citing three more inflationary factors: the used car and truck market, where underproduction of new vehicles during the pandemic years is leading to scarcity in the secondary market; the price of food, where inflation is still stuck at close to 10.0% in Canada; and the price of gasoline, where our call for higher oil prices in the coming years should translate to inflation tailwinds.

Strategy: Are we still in bear market rally no. 6?

Our call for a defensive positioning has been wrong so far in 2023. The balance between staying true to your process and being pragmatic when the market doesn't behave as expected is vital in asset management; therefore, we reduced our underweight in equities by half in January, as detailed in the previous edition of the IAIM Monthly Macro and Strategy.

First, we have to say that the diverging behaviour of the stock and bond markets is striking, because the narrative in support of the current rally in equities is predicated on Fed rate cuts in the second half of the year and a rather soft landing. Equity market leadership is also inconsistent with the rise in yields. Interestingly, low-quality and long-duration themes, such as technology (and growth in general), are leading the way, and risk appetite for the most speculative themes, such as cryptos and meme stocks, is up sharply.

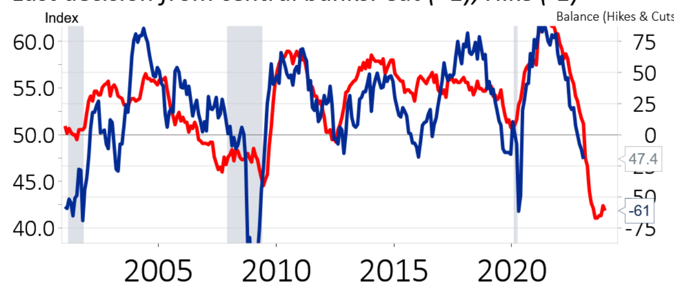
This month, we focus on the rally that has persisted since mid-October 2022 and ask the question: Are we still in a bear market rally? Or has a new bull market emerged from the ashes?

The median S&P 500 bear market…	The current S&P 500 bear market…	Comfort level about the possibility the bear market is over
… lasts 19 months	… is 14 months old	Slightly positive, within the confidence interval
… sees a 33% drawdown	… reached a drawdown of 25.4% in October 2022	Slightly positive, within the confidence interval
… ends within a few months of the bottom on the ISM manufacturing index	… last saw a low in October, while our leading indicator (see below) suggests ample downside for the ISM index	Negative, 2-3 months between market and ISM lows is more consistent
… sees a spike of volatility (VIX above 45) before ending	… remains relatively well behaved, with the VIX generally staying near the 35 level during the worst of the selloffs	Negative, bear markets tend to end in panic events, making the market cheap enough to build a foundation

In the first edition of this monthly publication in November 2022, we identified some stylized facts of bear markets to guide us through the volatility. Below is a short checklist of some of the most important elements we're keeping in mind.

US PMI vs Global Monetary Policy Cycle

Last decision from central banks: Cut (+1), Hike (-1)



–US ISM PMI, lhs

–Central banks decision index - pushed forward by 11…

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In fact, the current environment has two elements that cause us to question the sustainability of this rally: 1) the ISM index is below 50 and still falling; and 2) the yield curve is deeply inverted.

Historical data suggest that both types of environments are synonymous with wide swings in the S&P 500's cyclically adjusted price-to-earnings ratio (CAPE), often to the downside, as investors move out of risky assets. The table below shows that this is especially true in the case of a contracting and deteriorating economy, as illustrated by the first column dealing with the ISM index. The yield curve inversion environment is different in nature: the direction of the effect is closer to a coin flip, but the moves are more extreme.

Even though, to our surprise, this exercise is less conclusive than we initially expected, we still derive two takeaways: 1) historically, a deteriorating economic environment tends to come with contracting valuations (not the case in this episode, beginning in November 2022); and 2) the drawdown in the CAPE ratio since the yield curve inverted in July 2022 is only about half the historical average for drawdowns, meaning further contractions could be in play.

The current environment is still a bit puzzling, given how quickly some of the economic data have contracted since early 2022, how deeply inverted the yield curve is, and how resilient the labour market and consumer spending remain.

Our thinking is that a scenario where the economy truly avoids a recession (a no-landing scenario) needs to account for stickier price pressure and further rate hikes. To be clear, this scenario could be the most bearish for risk sentiment, with valuation multiples and earnings getting crushed and prices most likely retesting the October 2022 lows.

	ISM < 50 and falling	Inverted yield curve
Period covered *excluding current episode*	1948-01 to 2022-10	1976-06 to 2022-06
Number of episodes	32	7
Number of times CAPE ratio contracted	23 (72% of cases)	4 (57% of cases)
Average drawdown in CAPE ratio	-9.1%	-14.0%
Worst drawdown in CAPE ratio	-34.0%	-16.8%
Number of times CAPE ratio did not contract	9 (28% of cases)	3 (43% of cases)
Average gain in CAPE ratio	9.4%	7.5%
Best gain in CAPE ratio	15.8%	10.6%
Current episode	CAPE ratio expanding, maximum gain of 6.4%	CAPE ratio contracting, maximum drawdown of -6.8%

The Fed and the Bank of Canada have both stated clearly that they intend to hike until inflation is defeated, and doubting their resolve continues to look like a risky proposition. We recommend being wary of the recent momentum, as most of the move seems like a combination of deeply oversold conditions to start the year and excessive confidence that central bankers are done with their rate hikes.

Bottom line

Equities

We stayed the course during the volatility in February.

We remain underweight equities, with a cautious tilt, and are maintaining a more favourable inclination toward global markets versus the United States. With growth leading the way despite rising rates, meme stocks making a comeback, and bitcoin catching a bid on the way to its highest level since July 2022, we would rather stay true to our framework and bide our time before calling the all-clear on the bear market.

Fixed income

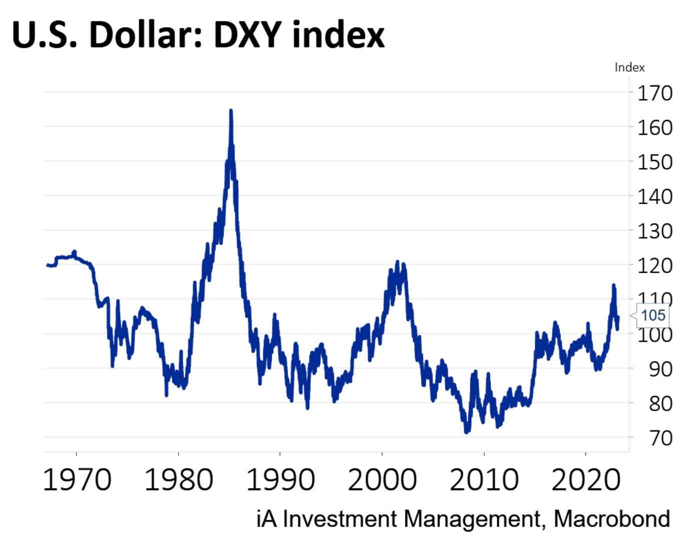
The yield-curve inversion reached new extremes in February, with an accumulation of economic surprises and signs that inflation could be stickier than recently expected. The move higher was more important on the 2-year rate as market participants are quickly depricing the odds of rate cuts in the second half of the year. It's a message that the equity markets do not yet seem to have heard.

The year could be volatile, but we continue to recommend holding government bonds (with a bias toward longer duration) and short-term, high-quality corporate credit. If we are right that more hikes are in the cards in 2023, we expect long-duration sovereign bonds to outperform as recession risks will most likely be revised higher.

Commodities and FX

The U.S. dollar's volatility continued to dominate the markets in February, with more positive economic surprises leading to expectations of potentially tighter monetary policy before too long.

We continue to hold an overweight position in the greenback, as history suggests that it tends to perform decently until risk sentiment ultimately finds a bottom.



We recently moved to an overweight position in gold, but price action has already pushed us to close the position after a decline of more than 5% from the highs reached in January.

The swift reversal in the U.S. dollar coming from the repricing of more hikes is clearly the main culprit, and our view that more repricing could be in the cards advocates for prudence on that call, for now.

Market Performance

(Total return, in local currency)

As of February 28, 2023	MTD%	QTD%	YTD%	Δ1Y%
Equity				
S&P 500	-2.4%	3.7%	3.7%	-7.7%
S&P/TSX	-2.4%	4.8%	4.8%	-1.2%
NASDAQ	-0.5%	10.1%	10.1%	-15.4%
MSCI World	-1.6%	4.8%	4.8%	-4.9%
MSCI EAFE	0.6%	7.0%	7.0%	5.5%
MSCI EM	-4.6%	1.6%	1.6%	-10.1%
Commodities				
Gold	-5.3%	0.2%	0.2%	-4.3%
CRB	-1.5%	-1.1%	-1.1%	-10.0%
WTI	-2.3%	-4.0%	-4.0%	-19.5%
Fixed Income				
FTSE Canada Universe Bond	-2.0%	1.0%	1.0%	-7.0%
FTSE Canada Long Term Bor	-3.2%	2.1%	2.1%	-12.8%
FTSE Canada Corporate Bon	-1.5%	1.4%	1.4%	-4.8%
Currency				
DXY	2.7%	1.3%	1.3%	8.4%
USDCAD	2.6%	0.7%	0.7%	7.7%
USDEUR	2.7%	1.2%	1.2%	6.1%
USDJPY	4.7%	3.9%	3.9%	18.4%
USDGBP	2.5%	0.5%	0.5%	11.6%

As of February 28, 2023	MTD%	QTD%	YTD%	Δ1Y%
S&P/TSX Sectors				
Financials	-0.5%	8.1%	8.1%	-4.8%
Energy	-4.4%	-0.1%	-0.1%	8.1%
Industrials	0.7%	4.4%	4.4%	10.3%
Materials	-8.6%	1.1%	1.1%	-5.7%
Information Technology	-4.7%	13.9%	13.9%	-16.3%
Utilities	-2.2%	1.3%	1.3%	-7.8%
Communication Services	-2.9%	2.5%	2.5%	-3.8%
Consumer Staples	1.5%	3.4%	3.4%	19.0%
Consumer Discretionary	-2.0%	4.2%	4.2%	4.3%
Real Estate	0.3%	11.1%	11.1%	-6.7%
Health Care	-0.7%	13.7%	13.7%	-50.6%
S&P 500 Sectors				
Information Technology	0.3%	9.6%	9.6%	-11.9%
Health Care	-4.7%	-6.6%	-6.6%	-2.2%
Consumer Discretionary	-2.3%	12.4%	12.4%	-19.0%
Financials	-2.4%	4.1%	4.1%	-7.3%
Communication Services	-4.7%	8.9%	8.9%	-25.5%
Industrials	-1.2%	2.5%	2.5%	1.1%
Consumer Staples	-2.5%	-3.5%	-3.5%	-3.7%
Energy	-7.6%	-5.1%	-5.1%	19.3%
Utilities	-6.4%	-8.3%	-8.3%	-4.3%
Real Estate	-6.1%	3.2%	3.2%	-14.9%
Materials	-3.5%	5.2%	5.2%	-1.6%

12-Month Market Scenarios (As of March 2023)

Baseline (55%)	The recent acceleration of the North American labour market shows the economy is more resilient than expected, and the resulting wealth effect is potentially large enough to help the macro landscape avoid a recession in 2023. Global inflation remains more persistent than market participants are currently expecting. Base effects bring annual inflation between 3 and 4% by mid-year, before we see a slight reacceleration in the second half. Central banks realize their work is not done and continue to tighten in the second half of 2023. The Bank of Canada ends its pause in April or June, with at least a couple of safety hikes by year-end. The first rate cuts by central banks do not come until 2024, when inflation finally gives evidence of being tamed. The slowdown in housing stemming from the accumulation of higher rates creates a negative wealth effect, keeping the global economy relatively soft. Unemployment rates rise slightly in the second half of 2023, when the full impact of the rate hike paths of 2022 is realized. China's reopening gives some support to global growth but does not change the overall trajectory. The slowdown is more pronounced in Europe, where fiscal space is limited and governments have less room to stimulate the economy. The premium on energy prices rises as the global economy proves to be unexpectedly resilient. The war in Ukraine, global droughts and high fertilizer prices continue putting upward pressure on food prices. The bear market in equities continues to its resolution in the form of a capitulation event, with a likely bottom in 2023. Sovereign yield curves remain inverted for most of the year. Long rates have risen substantially and present an interesting value proposition given the growth and monetary policy outlook. **Overweight duration and USD, underweight equities.**
Bearish Sticky Inflation (20%)	Inflation expectations become deanchored from central bank targets, and leading rates are hiked higher and faster than current market expectations. Central banks keep their leading rates at the terminal level well into 2024. The economy slows materially in the second half of the year, leading to a more material deterioration in employment. The recession is deeper in Europe, where fiscal space is limited and governments have less room to stimulate the economy. The bear market continues, but drawdowns are larger. The absolute low for equities moves to 2024. The bond bear market is prolonged as market participants are forced to reprice bonds in the wake of higher terminal rates. **Underweight equities, duration and fixed income. Overweight cash and USD.**
Bullish Falling Inflation and Pivot (10%)	Inflation returns to target more quickly than expected, allowing central banks to start easing in the second half of 2023. Less monetary tightening is necessary over all, and terminal rates are slightly lower than currently expected. Most advanced economies avoid a recession. Energy prices are supported by strong demand. Base metal prices enter a new super cycle, given their role in the energy transition. Stock and bond markets rebound as a recession is avoided. **Overweight equities, base metals and bonds. Underweight cash and USD.**
Other (15%)	Escalation or resolution of the conflict in Ukraine. Escalation of tensions between China and the United States. Unexpectedly fast global economic slowdown.

About iAIM

A magnet for top investment talent, iA Investment Management is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAIM's unifying commitment to strong risk management, analytical rigor a disciplined, process-driven approach to asset allocation and security selection.

Rooted in history. Innovating for the future.