iA Investment Management

Monthly Market & Strategy

January 2023

Sébastien Mc Mahon, MA, PRM, CFA
Chief Strategist, Senior Economist and Vice-President, Asset Allocation & Portfolio Manager

Adil Mahroug, M.Sc.
Senior Strategist and Director, Asset Allocation

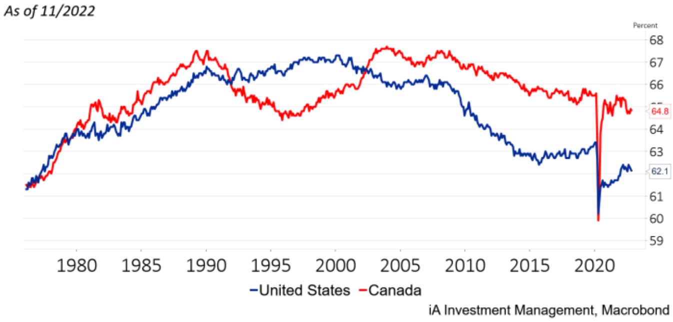
Highlights

- The Federal Reserve clearly has its sights set on the tightness of the labor market. Our deep dive suggests that clouds are starting to form and that the picture might be distorted.
- Contrary to 2022, we do not expect that valuations will play a key role in relative equity performance in 2023
- We keep a defensive positioning, and temporarily downgrade the CAD/USD to neutral

A deep dive in the labour market

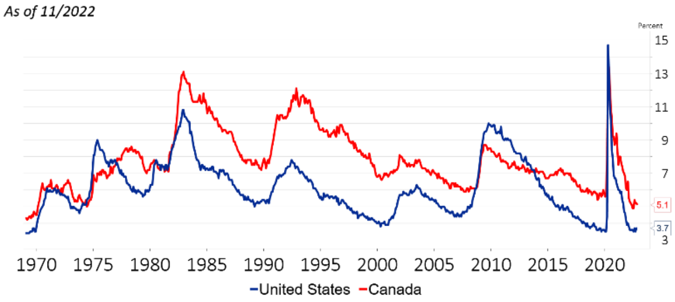
The R word is on everyone's mind. The leading economic indicators are trending downward, and most of the U.S. yield curve is inverted. The Federal Reserve of Atlanta has a one-year-ahead recession probability of 70%, which is in line with our own models.

Labour Force Participation Rate
As of 11/2022



In last month's edition of our Monthly Macro & Strategy report, we discussed the growth outlook and concluded that every component of the GDP accounting equation should be facing headwinds in 2023, making a recession likely. This month, we've decided to take a deep dive into one of the most important economic sectors: employment.

Unemployment Rate
As of 11/2022



The labour market has been sending mixed signals of late. On the one hand, we see very low unemployment rates; on the other hand, we see massive layoffs on a weekly basis. To get a clearer picture of the labour market, we need to go beyond anecdotal evidence, dig into the data and discuss the methodological issues causing this lack of clarity.

Global Asset Allocation Views (January 2023)

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

The first building block is the labour participation rate, namely the number of people either employed or looking for a job as a percentage of the population, representing the pool of workers available and willing to work.

Regardless of the jobs offered, it is becoming more and more difficult for employers to find workers when this pool shrinks. In Canada and the United States, the labour force participation rate remains lower than before COVID (the difference is more notable in the United States, where the rate has fallen from 63.4% pre-COVID to 62.1% now).

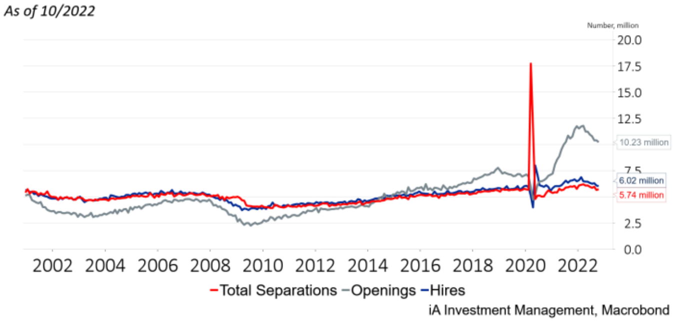
As the labour force participation rate has shrunk in North America, the unemployment rate has also decreased significantly. In fact, we have to go back to the 1970s to see such record low unemployment rates.

Focusing on the U.S. labour market, the U.S. Bureau of Labor Statistics publishes the monthly Job Openings and Labour Turnover Survey, better known as JOLTS, which surveys more than 20,000 businesses and government offices to estimate the number of US job vacancies, hires and separations (namely employees leaving their jobs, being let go, retiring or dying).

The job openings index is still at a historically high level, even though it started a downward trend In March 2022. Thus, job openings remain very elevated but seem to be slowly coming off all-time highs. In contrast, hires and separations have been stable.

Bureau of Labor Statistics Openings, Hires and Separations

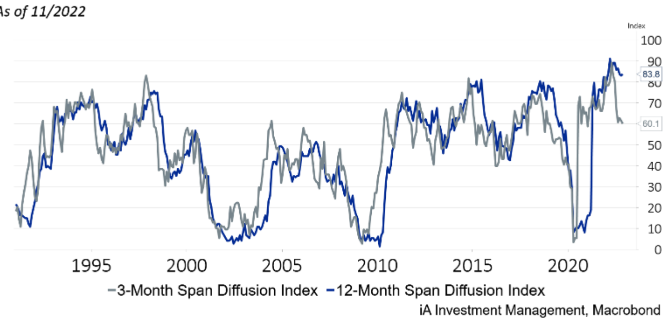
As of 10/2022



Turning now to job creation, the diffusion index of the US labour market, showing the share of sectors adding jobs over the previous 3 and 12 months, respectively, indicates that the weakness observed in some sectors is slowly starting to spread to the rest of the US economy.

United States Nonfarm Payrolls Diffusion Index

As of 11/2022



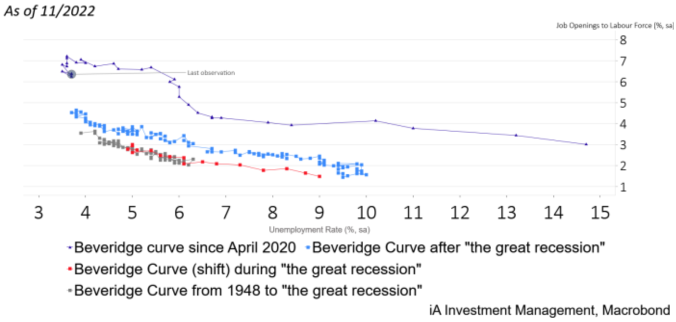
Anecdotal evidence goes both ways. We've all heard of massive layoffs in the tech sector, but we've also heard of businesses forced to shut down for lack of qualified workers. Taken at face value, these examples may seem contradictory, but they are in fact symptomatic of a mismatch between the jobs on offer and the workers seeking jobs.

Therefore, we can simultaneously have a lot of jobs open and a lot of people looking for jobs. The Beveridge curve is a particularly useful tool to understand this phenomenon. Put simply, it is the graphic representation of the relationship between the unemployment rate and the job vacancy rate (job vacancies as a percentage of the labour force).

As can be seen below, we are currently in the top left quadrant, meaning we have little unemployment but ample job vacancies. This somewhat puzzling situation confirms that the US labour market is behaving differently than at any time in recent history.

The US Beveridge curve

As of 11/2022



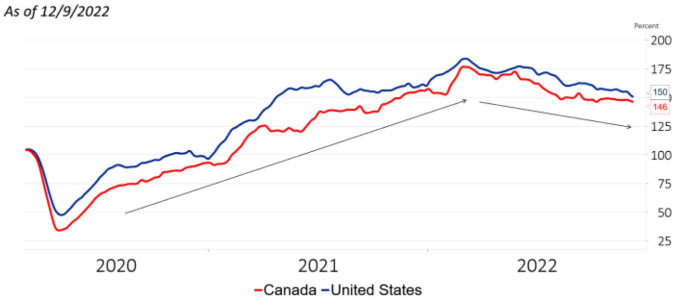
The picture presented by the combination of these statistics and the Beveridge curve is that of a tight labour market where job openings are still historically elevated, the pool of available candidates is smaller than pre-COVID levels and job separations are happening at a slower pace. In the words of Voltaire's Candide, "All is for the best in the best of all possible worlds." Or is it?

In the best of all possible worlds, the surveys used to gather some of the data previously discussed would not contain some serious methodological flaws. In fact, we find the pandemic has created some major statistical issues. For instance, many of the workers who have been laid off and have received severance packages still show up as being employed. This results in a lag between the unemployment rates published by the BLS and the actual number of people who are unemployed. It also creates a bias in the payroll numbers. Indeed, as long as employees receive severance, they will show up on payrolls.

In the best of all possible worlds, data would be available at a higher frequency. Luckily, firms such as LinkedIn and Indeed can monitor, in as close to real time as possible, the evolution of the labor market.

Indeed New Job Postings Index

As of 12/9/2022



Indeed publishes statistics about job postings on a daily basis. These data suggest that the United States and Canada have had a marked decline in job creation since the their December 2021 peak, signalling a slowdown in the pace of job openings.

So where do we stand? The labour market is, at first glance, strong. The unemployment rates are at record lows, payrolls and the JOLTS are showing strong numbers. But excessive optimism about the labour market should be tempered by the lagging nature of most indicators previously discussed. The methodological flaws could lead to weakness appearing faster than one might expect in the next few months, which would be seen as the desired development by central banks.

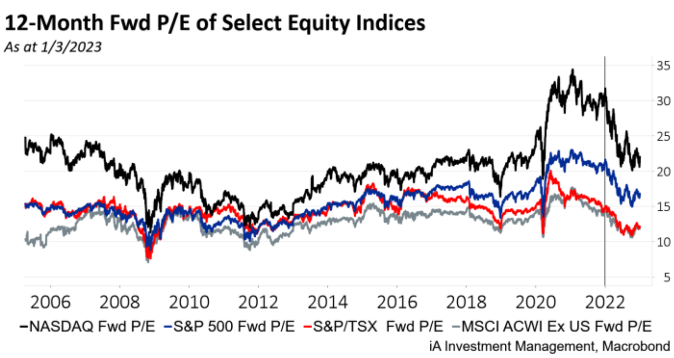
While the labour market is very strong, some grey clouds are starting to appear in "the best of all possible worlds".

Strategy: Do valuations matter?

Going back to January 2022, our thinking went like this: valuations are historically stretched, and markets have become vulnerable to an interest rate shock. While a normalization of monetary policy throughout the year was our base case then, we were still surprised by the magnitude of the tightening cycle.

In hindsight, the combination of expensive valuations and historically aggressive tightening of financial conditions led to 1) the first year of negative returns for both US bonds and equities since 1969; and 2) strongly positive cross-asset correlations. In other words, a recipe for a tough year on the global markets.

Let's start with equities. Most equity indices were showing expensive valuations at the close of 2021, especially in the United States, where the S&P 500 and the Nasdaq were trading near 15-year highs on a 12-month forward P/E basis.

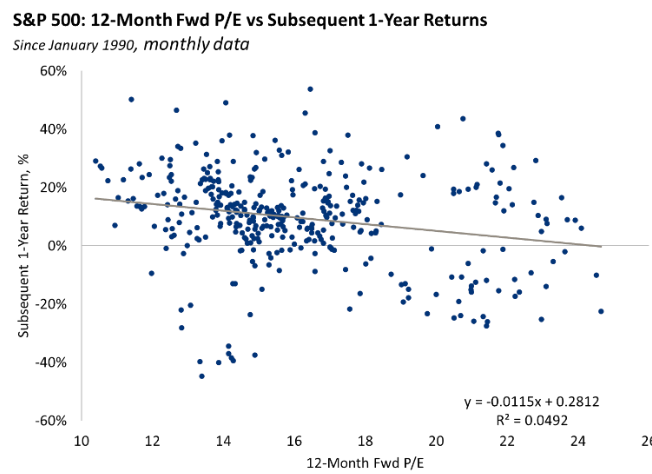


As can be inferred from the table below, most of the pullback in global equities in 2022 came from falling valuations.

Decomposition of price return in 2022

Index	Beginning of year NTM Fwd P/E	Beginning of year NTM Fwd P/E Historical Percentile	Change in NTM Fwd P/E (%)	Change in NTM Fwd Earnings (%)	Price return in 2022 (%)
NASDAQ	30.5	95	-30.8%	-3.3%	-33.1%
MSCI China	12.2	61	-12.8%	-12.3%	-23.5%
Russell 2000	24.5	88	-18.4%	-3.9%	-21.6%
MSCI ACWI	17.9	90	-20.1%	0.4%	-19.8%
S&P 500	21.1	92	-22.3%	3.6%	-19.4%
MSCI EM Ex-China	12.4	45	-4.8%	-15.1%	-19.3%
MSCI ACWI Ex-U.S.	14.1	86	-16.3%	-2.4%	-18.3%
MSCI EAFE	15.0	88	-20.0%	4.0%	-16.8%
MSCI EM	15.2	89	-25.0%	14.0%	-14.5%
MSCI Europe	15.2	87	-23.0%	14.5%	-11.9%
S&P/TSX Small Cap	14.1	12	-17.0%	7.0%	-11.2%
Nikkei 225	16.3	63	-11.7%	2.6%	-9.4%
S&P/TSX Composite	14.7	58	-18.4%	11.9%	-8.7%

But, as hinted above, elevated valuations are not sufficient for subsequent returns to be low, or even deeply negative as they have been over the past 12 months. In fact, market valuation has historically been close to uncorrelated to 1-year subsequent returns. We can illustrate this by running a linear regression on 1-year ahead realized returns versus forward 12-month P/E ratios, as shown below.



Even though the above analysis shows an insignificant relationship between valuations and 1-year ahead returns, this doesn't mean that valuations do not matter at all. Given the proper context, for example, during a coordinated tightening cycle by global central banks, as in 2022, elevated valuations effectively translate into vulnerability.

As we move into 2023, we thought the time was right to take a fresh look at market valuations and see whether we can infer anything about what lies ahead.

2022 Year-End NTM Fwd P/E Ratios

Index	Current NTM Fwd P/E	Current historical percentile	Available history
NASDAQ	21.1	51	2001-
MSCI China	10.6	39	2005-
Russell 2000	20.0	46	1995-
MSCI ACWI	14.3	45	2001-
S&P 500	16.4	62	1990-
MSCI EM Ex-China	11.8	31	2020-
MSCI ACWI Ex-U.S.	11.8	30	2005-
MSCI EAFE	12.0	24	2005-
MSCI EM	11.4	27	2005-
MSCI Europe	11.7	29	2005-
S&P/TSX Small Cap	11.7	4	2002-
Nikkei 225	14.4	16	2005-
S&P/TSX Composite	12.0	7	2001-

As the table above shows, global markets are trading at valuations well below those seen 12 months ago. The Canadian indices stand out, with valuations near historical lows, while the S&P 500 index remains expensive.

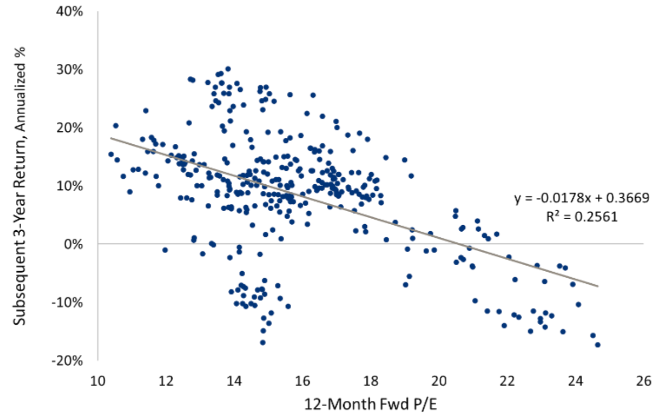
But, contrary to 2022, monetary policy tightening should not be as important over the coming 12 months, meaning that valuations might play less of a role.

Our expectations are that global central banks should soon complete their hiking cycles and then most likely keep rates elevated for the remainder of the year. This scenario should keep financial conditions tight, probably creating recessions in most regions of the world and keeping investor sentiment under pressure.

But as central banks are moving from autopilot to data dependence, we could see cross-asset correlations pull back from extremes, and markets reconnect with the macro fundamentals. In other words, more "normal" behaviour from markets, meaning that current valuations are unlikely to be the main drivers of returns in the coming year.

S&P 500: 12-Month Fwd P/E vs Subsequent 3-Year Returns

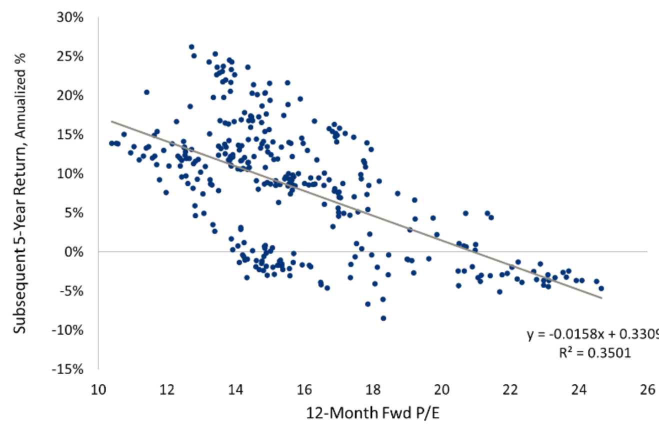
Since January 1990, monthly data



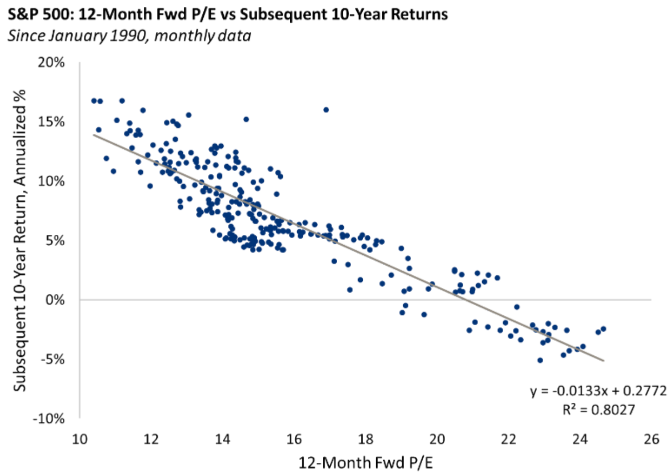
As for longer time horizons, we find that in the absence of aggravating factors, such as rapidly changing liquidity conditions, one needs to look out about 10 years before the relationship between current valuations and future returns becomes solid enough to be considered predictive. This result holds for most markets of interest, although we limit the graphical analysis to the S&P 500 in this document.

S&P 500: 12-Month Fwd P/E vs Subsequent 5-Year Returns

Since January 1990, monthly data



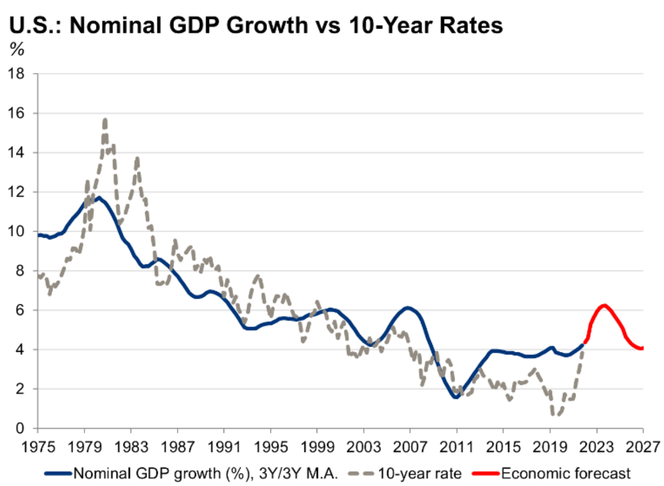
So, what can we take away from this thought experiment? While valuation metrics are important components of any investment decision (to quote Warren Buffett, "Price is what you pay, value is what you get"), their use needs to be put into context and their univariate predicting power mostly holds over the long run.



As the charts above suggest, the only thing we can confidently infer with some precision is that the next 10 years should deliver annualized price returns of about 5% on Wall Street, given the current forward P/E ratio of about 17x.

Turning to fixed income, the problem of estimating fair value is even more complex. While multiple approaches and models exist, we have yet to find one that is universally accepted as reliable for short-term investment decisions. But, as with equities, we can infer market valuation by looking at long-term structural relationships, and thus support investment decisions.

One approach, which we'll be focusing on in this document, is that 10-year government rates tend to generally follow the smoothed[1] annual growth rate of a country's nominal GDP. Put simply, this is explained by the fact that, in the aggregate equilibrium, the cost of money (the interest rate) should move in line with the marginal rate of return of the investment it can service (the growth rate of the nominal economy).

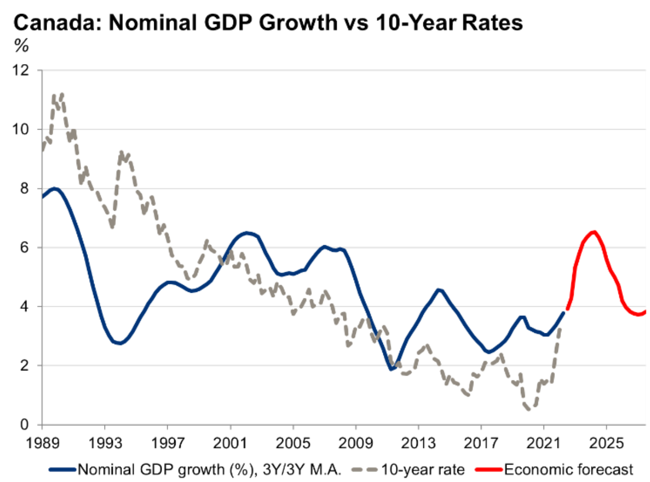


As can be seen from the chart above, this relationship is useful as a general guide and should not be used for short-term positioning. We also clearly see the impact of quantitative easing over the previous decade, as interest rates stubbornly stayed below their long-term fair value.

Focusing on current valuations, we find that even though US 10-year rates have risen sharply in 2022, they have simply converged to the smoothed growth rate of nominal GDP, meaning that 10-year US treasury bonds should currently be considered fairly valued.

Looking ahead, using the most recent forecasts from the Oxford Economics Global Economic Model, we find that the likely direction for US 10-year rates is up, as the extraordinary monetary and fiscal measures deployed during the pandemic have most likely pushed nominal GDP growth higher for the next few years.

The same approach does not seem to translate well to Canadian interest rates, but for completion purposes, we provide the chart below.



The reason is that two very distinct fiscal regimes have marked Canadian history over the past 30 years.

First, Canada had a debt crisis[2] in the 1990s, which led to a significant risk premium and caused Canadian bonds to trade at a discount for most of that decade.

Second, Canada was successful in turning its fiscal situation around and has had a AAA debt rating since 2002. This means that despite Canada's small economic size on the global scale, its bonds represent a relatively large share of the sovereign AAA-rated debt pool and, therefore, trade at a premium. Thus, the Canadian bond market's pricing tends to be distorted, and it is not trivial to estimate a fair value using traditional approaches.

[1] We used the 3Y/3Y moving average growth rate in the presented charts

[2] An insightful read on the topic can be found at https://www.bankofcanada.ca/2001/01/canada-economic-future-what-have-we-learned/

Valuations: Useful or not?

The moral of the story is that assessing the fair value of assets is, indeed, an important part of asset management, but valuation methodologies tend to be better suited for long-term investment purposes.

As illustrated above, cheap or expensive valuations can hint at over- or underperformance in the short term but mainly in conjunction with other factors. Looking at valuation in isolation has proven to be useful when we assess the return potential of financial assets over the long run (for example, over a 10-year period for equities), but the predicting power shrinks as the time horizon gets shorter.

Bottom Line

Equities

December turned out to be a tough month for equities, as market participants readjusted their perspective on rate hikes in 2023 and what the terminal rates should be. The latest rally on Wall Street started fading at mid-month, after the Fed's December 14 rate decision.

Interestingly, the softness of the CPI print published just one day before the Fed's decision led to short-lived exuberance. The Fed found itself forced[3] to push back against the rising view that the end of the hiking cycle was within reach and that rate cuts could come as early as mid-2023, or in other words, against further easing of financial conditions.

The Fed used its latest "dot plot" to signal that its leading rate could end 2023 at about 5.1% (above the market's 4.9% estimate as of the day of the Fed decision). The plot also showed that seven out of 19 FOMC members are eyeing an even higher end-of-year rate, meaning there is upside risk to this call.

The upshot is that the rally that started in mid-October is at risk of fading, meaning we may witness the end of the sixth bear market rally of this cycle. History suggests that a typical bear market comprises 8 to 10 such bear market rallies before an absolute low is reached, so we advise caution before adding risk to a portfolio.

S&P 500
Bear market rallies in 2022

iA Investment Management, Macrobond

Another interesting development for equities is that the latest rally seems to have effectively lost steam right at resistance and turned down with some momentum. This once again suggests that we could see some headwinds on Wall Street in the short run. Although we do not consider ourselves technicians, nor do we manage our portfolios solely on the basis of technical analysis, we recognize that integrating such tools can be valuable at potential turning points.

S&P 500
Technical resistance through 2022

iA Investment Management, Macrobond

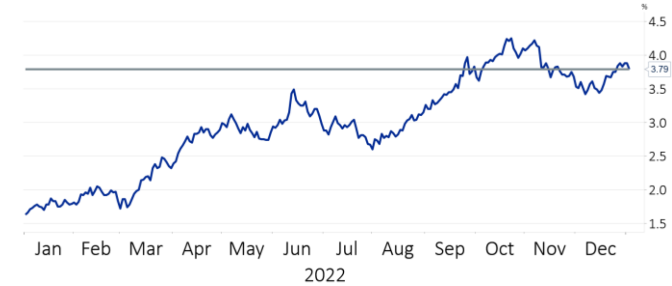
Thus, our hunch from last month turned out to be partially correct: further easing of inflation did keep markets' hopes alive, if only for 36 hours. Now, the clear message from the Fed is that rate cuts are not in the cards in 2023, which could lead to an adjustment phase for risk assets. Prudence remains our call.

Fixed Income

Sovereign interest rates have also been volatile, and generally lower in December, as markets are trying to price in the terminal rate, the expected path of inflation and the odds of a recession. As the year ends, 10-year US rates have more than doubled during the year but have pulled back from their October highs.

[3] To read our views about when the Fed may be expected to pivot, see December 2022's IAIM Monthly Macro and Strategy piece.

U.S.: 10-Year Rate
As at 1/3/2023



The repricing of terminal rates should be the short-term issue for market participants, as central bankers seem to be making a final effort to convey the need to keep rates at an elevated level through 2023.

Still, it seems that news on inflation is getting better, and there's reason to think that the inflation rate could be close to the central banks' target range by late 2023. Thus, we estimate that there could be some resistance as to how high long-term rates can go. Also, the odds of a recession are rising, with PMIs continuing their slide, adding a bid to sovereign bonds.

We expect the yield curve to remain inverted for at least several months, and we are keeping a favourable view on fixed income, with a clear preference for long-duration government bonds and short-duration, high-quality corporates.

U.S.: 10Y - 3M Government Bond Spread (bps)
As at 1/3/2023

Commodities and FX

The hawkish message from the Fed was heard by investors, and the US dollar resumed its upward move in the second half of December. As is well known, the greenback tends to find its peak when the global economy finds its footing, and the new forecasts integrating a tougher monetary stance in 2023 are pointing in the opposite direction.

FX Rates: DXY

The picture remains recessionary for the global economy, especially with Europe standing on shaky foundations. We continued to hear news of an easing of COVID restrictions in China this month, but it seems that this may actually be a 2023 story.

The loonie's recent rally against the US dollar has mostly faded, and our currency briefly returned to the October lows. The swift change in market sentiment added pressure to its performance against the greenback, leading us to downgrade the loonie to neutral for now. Even so, we think 2023 could be a strong year for the Canadian dollar and will adjust our positioning accordingly down the road.

Bloomberg Commodity Spot Index
As at 1/3/2023

Commodity prices have faded quickly in December, as the strength of the US dollar and the more material deterioration of the global economy has removed some lustre from the complex.

Even though we continue to see ample volatility, our outlook remains positive for oil. As for gold, owing to the lack of a clear trend, we are waiting for clear signs that the yellow metal is reacting consistently with movements in real rates and the US dollar.

Market Performance

(Total return, in local currency)

As of December 30, 2022	MTD%	QTD%	YTD%	Δ1Y%
Equity				
S&P 500	-5.8%	7.6%	-18.1%	-18.3%
S&P/TSX	-4.9%	6.0%	-5.8%	-6.1%
NASDAQ	-9.1%	-0.3%	-33.0%	-33.4%
MSCI World	-5.1%	7.5%	-16.0%	-16.3%
MSCI EAFE	-3.0%	8.7%	-7.0%	-7.2%
MSCI EM	-1.9%	6.7%	-15.2%	-14.6%
Commodities				
Gold	3.1%	9.8%	-0.3%	0.5%
CRB	-1.7%	-0.8%	-4.1%	-4.2%
WTI	-0.4%	1.0%	6.7%	4.2%
Fixed Income				
FTSE Canada Universe Bond Index	-1.7%	0.1%	-11.7%	-11.4%
FTSE Canada Long Term Bond Index	-3.6%	-1.0%	-21.8%	-21.3%
FTSE Canada Corporate Bond Index	-1.0%	1.0%	-9.9%	-9.6%
Currency				
DXY	-2.3%	-7.7%	8.2%	7.9%
USDCAD	1.1%	-2.0%	7.3%	6.4%
USDEUR	-2.8%	-8.4%	6.2%	5.8%
USDJPY	-5.0%	-9.4%	13.9%	13.9%
USDGBP	-0.2%	-7.6%	12.0%	11.7%

As of December 30, 2022	MTD%	QTD%	YTD%	Δ1Y%
S&P/TSX Sectors				
Financials	-5.6%	3.4%	-9.4%	-9.7%
Energy	-5.6%	8.9%	30.3%	30.7%
Industrials	-5.7%	7.3%	1.4%	1.4%
Materials	-1.8%	8.2%	1.7%	1.8%
Information Technology	-7.2%	12.6%	-52.0%	-52.9%
Utilities	-4.5%	-7.4%	-10.6%	-10.4%
Communication Services	-3.1%	6.1%	N/A	N/A
Consumer Staples	-1.9%	8.5%	10.1%	9.5%
Consumer Discretionary	-4.3%	8.8%	-6.0%	-6.1%
Real Estate	-2.7%	7.1%	-21.5%	-21.3%
Health Care	-16.8%	-10.9%	-61.6%	-62.2%
S&P 500 Sectors				
Information Technology	-8.4%	4.4%	-28.9%	-29.3%
Health Care	-2.0%	12.3%	-3.6%	-3.9%
Consumer Discretionary	-11.3%	-10.4%	-37.6%	-37.8%
Financials	-5.4%	13.0%	-12.4%	-12.5%
Communication Services	-7.8%	-1.6%	-40.4%	-41.1%
Industrials	-3.1%	18.7%	-7.1%	-6.7%
Consumer Staples	-3.1%	12.0%	-3.2%	-2.5%
Energy	-3.2%	21.7%	59.0%	59.4%
Utilities	-0.8%	7.8%	-1.4%	-1.1%
Real Estate	-5.5%	2.8%	-28.4%	-28.3%
Materials	-5.8%	14.4%	-14.1%	-13.7%

12-Month Market Scenarios (As of January 2023)

Baseline (55%)	Global inflation remains persistent but slows down through the year. Inflation rate remains slightly above 3% in most advanced economies by year-end. Central banks continue to tighten in the first half of 2023, before taking a pause mid-year. The first rate cut by the Fed comes in 2024, while the Bank of Canada starts easing by late-2023. Advanced economies enter a shallow recession around mid-2023, but unemployment rates do not rise as much as during the typical recession. The recession is deeper in Europe, as fiscal space is limited, and governments have less room to stimulate the economy. The premium on energy prices remains even though the global slowdown puts downward pressure on energy demand, as producers have underinvested in capacity over the last few years. The war in Ukraine, the 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 and underweight equity.**
Bearish Sticky Inflation (20%)	Inflation expectations become de-anchored from central bank targets, and leading rates are hiked beyond current market expectations. Central banks keep their leading rates at the terminal level well into 2024. The economic downturn leads to a more material deterioration in unemployment. The recession is still deeper in Europe and, with fiscal space being limited, governments have less room to stimulate the economy. The bear market continues but drawdowns are larger and deeper. 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 quicker than expected, allowing central banks to start easing in the second half of 2023. Less monetary tightening is necessary overall, and terminal rates are slightly lower than currently expected. Most advanced economies avoid a recession, although we still go through a soft patch. 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%)	End of China zero-Covid policy. Escalation or resolution of the conflict in Ukraine. Resurgence of Covid. Escalation of tensions between China and the US. Faster than expected 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.

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