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H2 Outlook: Volatility to Remain A Central Theme

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Key Takeaways

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Our view: *We expect the wind to continue to blow markets in all directions in H2/2022, similar to what we have observed so far this year. Inflation remains stubbornly high with central banks, including the US Federal Reserve (Fed) and the Bank of Canada (BoC) committed to hiking rates and tightening policy to help restore price stability to markets by slowing demand side inflationary impulses. However, given the lag effect of these policy measures on the real economy, we expect these efforts will have a more significant impact on slowing the economy/and corporate/consumer fundamentals in 2023/2024 rather than in 2022. Moreover, over the short-term, inflation readings will continue to remain hot and keep investors and central bankers on their toes.* ***That said, we foresee a period of uncomfortably high levels of inflation and volatility across global asset classes with few places to hide – <u>although there are many places to invest for long-term oriented investors!</u> We suggest investors remain selective, well diversified, and focus on de-risking their portfolios (i.e., close/reduce portfolio blind-spots and/or tighten active relative bets!)***

- **The US Consumer is Likely to Take a Pause:** The US consumer economy is going to slow very rapidly (albeit from a very high level) as soon as savings rates return to normal, which will likely start after Labour Day in our view. The way the math works, if the savings rate is normal in 2023, we'd have essentially flat/low single-digit nominal consumer growth, consistent with a very slow or recessionary economy, vs. ~10% today; this would be a deceleration in growth similar to the Great Financial Crisis (but from much higher levels). Add rapid rate hikes and job losses to this, and it's going to make it much worse. Inflation was unavoidable upon reopening (demand>supply) and typical of past early-cycle environments, it's also largely self-correcting, just give supply 1-2 years to catch up and for excess demand to revert to normal. However, the Fed is clearly not patient.

- **Few Places to Hide:** From a US sector perspective, the only place investors have been hiding is in energy (rightly so) and a few other pockets, but if we end up in a global recession, even that will not be safe. We believe the US-centric revenue streams and lower P/E / value stocks should outperform their higher multiple/growth stocks on a relative basis, and favor certain parts of **communications services, real estate, and value stocks more broadly speaking**. That said, on a relative basis, we continue to have a preference for the S&P/TSX index, which is currently trading at a 12.4x P/E NTM earnings (versus the S&P 500 Index at 16.0x), has a stronger relative earnings profile, and a ~20% weighting to energy (versus 5% for the S&P 500 index) – we expect this to be positive for the index at least over the short term while inflationary pressures remain elevated. From a S&P/TSX sector perspective, we believe that Canadian/North American centric revenue streams, and lower P/E / value stocks could also outperform their peers, and favor certain parts of **Energy, Financials, Materials, and Consumer Discretionary** sectors**.**

US Equity Strategy

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S&P 500 Earnings Face Downside Risks..

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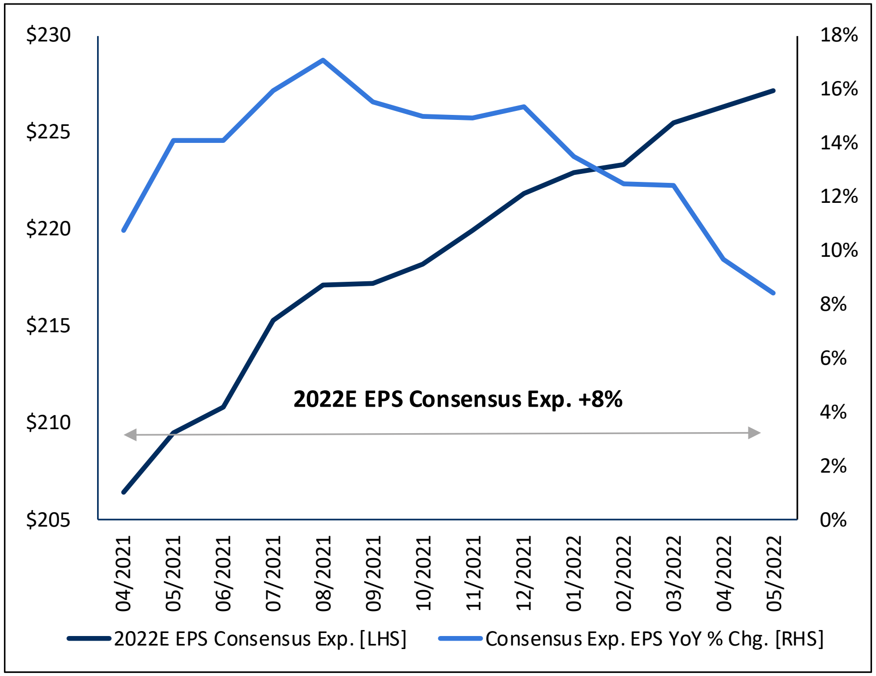
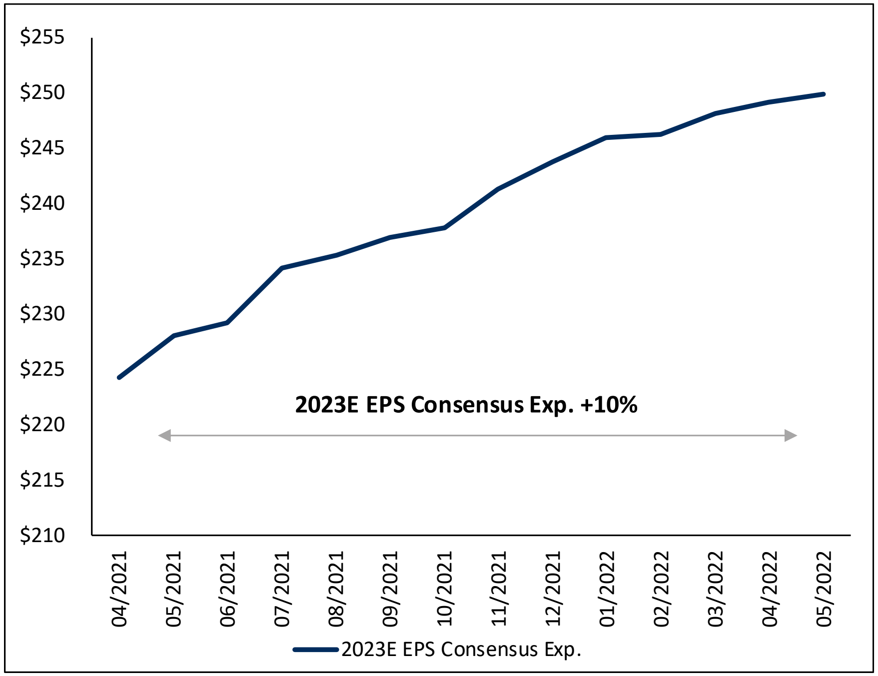
S&P 500 consensus EPS expectations for 2022/2023E have continued to move higher since the beginning of the year, but at a declining pace while stocks have cratered. Street expectations are calling for 2022E EPS of ~$227 (+8% YoY) and for 2023E EPS of $250 (+10% YoY) - both of which remain slightly above the long-term trend of 7.8% YoY growth. **<u>However, there are growing concerns by investors who are increasingly convinced 2022 and 2023 EPS estimates will need to come down meaningfully due to inflationary pressures, rapid rate hikes across the world, and from the impacts of global geopolitical events on consumer and corporate spending plans.</u>**

S&P 500 2022E EPS Consensus Exp.



S&P 500 2023E EPS Consensus Exp.

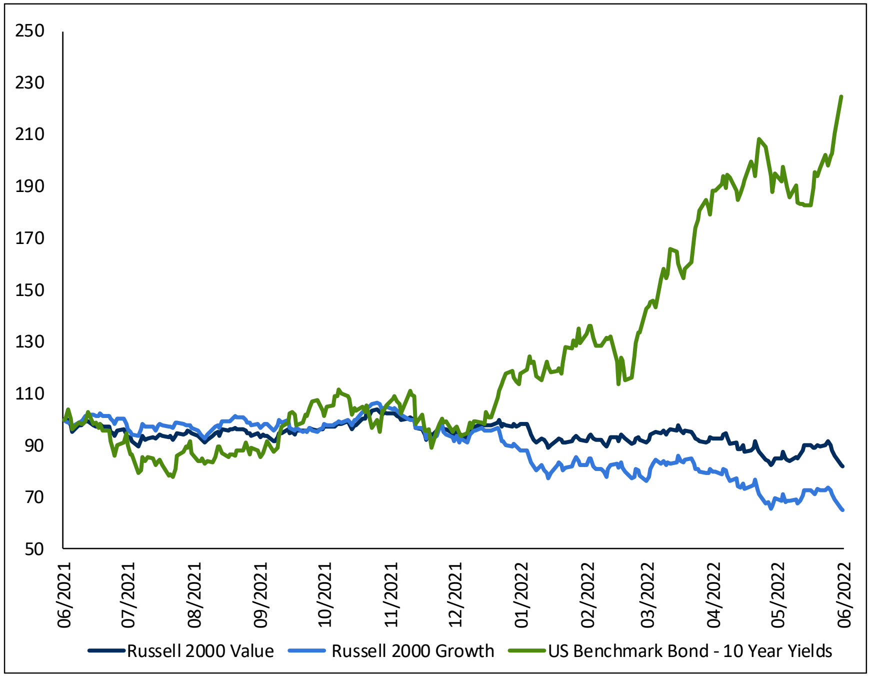


Source: FactSet; Data as of May 31, 2022

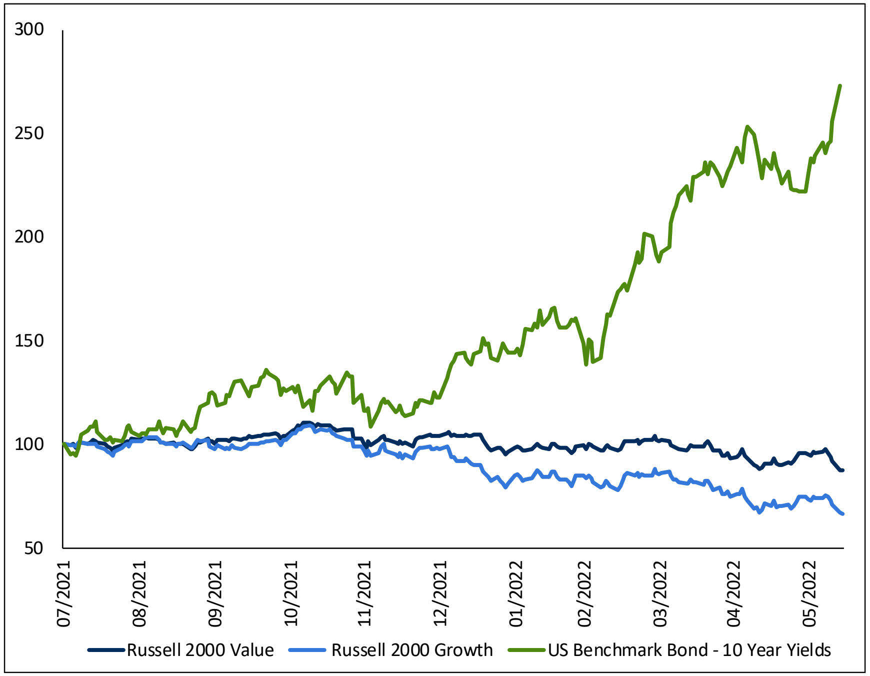
Value Still Outperforming Growth

Value stocks in the US (i.e., the Russell 2000 Value Index) have continued to outperform growth stocks (i.e., the Russell 2000 Growth Index) as yields have moved higher and economic/earnings growth have slowed from peak levels observed in 2021. We expect yields to continue to rise as the Fed aggressively reduces its balance sheet and hikes rates to combat inflation and restore price stability to markets. **We continue to emphasize that valuations matter in a rising rate and economic normalization environment, where growth and earnings slow towards their historical trend. But remember all value stocks are not created equally and neither are growth, so remain selective and factor in a margin of safety should things worsen further from here.**

Russell 2000 Value/Growth Index vs. 10Y Yields (1 Year)



Russell 2000 Value/Growth Index vs. 10Y Yields (Aug.'21)

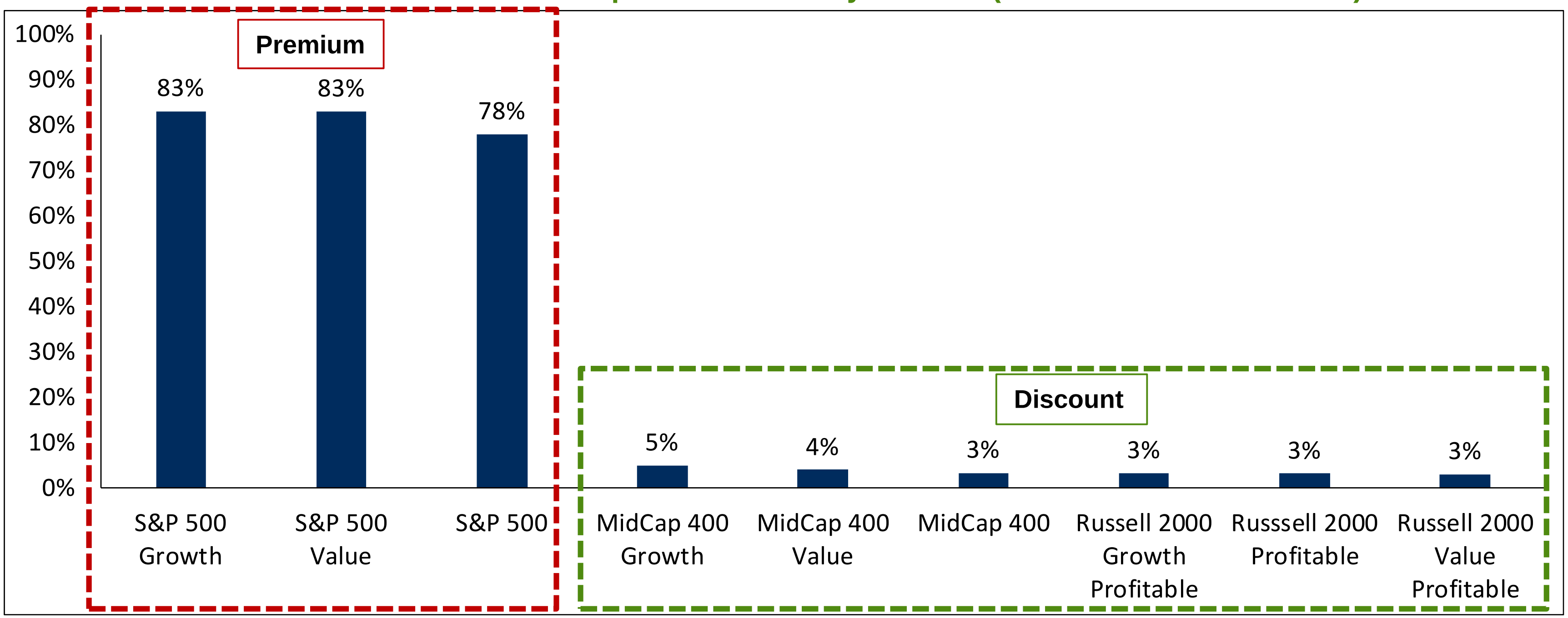


Source: FactSet; Data as of June 14, 2022

Its all Relative - S&P 500 Trading Rich

Following the recent sell-off, the S&P 500 index is now trading at ~16x 2022E on P/E, which is about its average P/E over the past 20 years however, down materially (or by -26%) since the beginning of 2022. We note that small and mid-cap indexes continue to trade at P/E levels that are essentially near their lowest in 20 years. **But we would like to highlight that we are in a very volatile global economic environment with investors increasingly concerned that EPS needs to come down substantially, so it is increasingly likely these indexes are a bit more expensive than what consensus EPS would suggest. That said, remain selective and focus on high-quality businesses with durable earnings/free cash flows trading at reasonable multiples.**

Index Level NTM P/E Relative To 20 Years Experience For 9 Style Boxes (R2K LTM Ex-Non-Earners)



Source: FactSet; Data as of June 3, 2022

S&P 500 Sector Valuations & YTD Perf.

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As yields push higher with inflation remaining stubbornly high, we expect valuations to contract further from current levels - the magnitude of which will depend on how aggressive the Fed is at hiking rates and how high yields inevitably rise. With this in mind and looking at the broader S&P 500 index from a top-down perspective, we see the greatest risks across sectors/industries which are trading at significant premiums to their historical valuations and more so, those sectors which are susceptible to downside earnings revisions as the economy slows, and inflationary cost pressures weigh on consumer and corporate spending.

S&P 500 Sector Valuations: Current vs. Historical PE NTM (since 2000)

	Sector Weight	Current PE NTM	Historical PE NTM (Since 2000)	Premium (+) / Discount (-)	YTD Return
S&P 500		**16.4**	**15.9**	**0.5**	**-20.8%**
Communication Services	8.9%	15.3	18.1	-2.8	-31.1%
Consumer Discretionary	10.7%	24.0	17.7	6.3	-33.0%
Consumer Staples	6.7%	19.8	17.9	1.9	-8.6%
Energy	5.1%	10.5	13.7	-3.2	53.4%
Financials	10.9%	11.5	12.4	-1.0	-18.9%
Health Care	14.4%	15.4	16.1	-0.7	-13.3%
Industrials	8.0%	16.7	15.9	0.7	-16.4%
Information Technology	26.9%	19.6	17.7	1.8	-28.2%
Materials	2.8%	13.6	15.4	-1.8	-13.1%
Real Estate	2.8%	18.0	17.9	0.1	-23.9%
Utilities	2.9%	19.9	14.6	5.3	-4.2%

Source: FactSet; Data as of June 10, 2022

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S&P 500 Sector & Industry Valuations

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	Sector/Industry Weight	Current PE NTM	Historical PE NTM (Since 2000)	Premium (+) / Discount (-)	YTD Return
S&P 500		**16.4**	**15.9**	**0.5**	**-20.8%**
Communication Services	8.9%	15.3	18.1	-2.8	-31.1%
Telecommunication Services	1.4%	11.2	13.3	-2.0	2.3%
Media & Entertainment	7.5%	16.6	22.0	-5.4	-35.2%
Consumer Discretionary	10.7%	24.0	17.7	6.3	-33.0%
Automobiles & Components	2.2%	24.8	10.1	14.6	-39.5%
Consumer Durables & Apparel	0.9%	10.5	16.4	-5.9	-33.1%
Consumer Services	1.9%	29.6	18.9	10.7	-24.5%
Retailing	5.7%	27.8	19.3	8.5	-32.8%
Consumer Staples	6.7%	19.8	17.9	1.9	-8.6%
Food & Staples Retailing	1.5%	19.4	17.5	1.9	-15.6%
Food Beverage & Tobacco	3.6%	18.7	16.9	1.8	-0.5%
Household & Personal Products	1.6%	23.6	19.5	4.1	-16.9%
Energy	5.1%	10.5	13.7	-3.2	53.4%
Financials	10.9%	11.5	12.4	-1.0	-18.9%
Banks	3.8%	9.3	11.7	-2.4	-23.5%
Diversified Financials	5.0%	13.4	15.0	-1.6	-20.4%
Insurance	2.2%	12.5	11.4	1.2	-4.8%
Health Care	14.4%	15.4	16.1	-0.7	-13.3%
Health Care Equipment & Services	6.0%	17.7	17.0	0.8	-16.7%
Pharmaceuticals Biotechnology & Life Sciences	8.4%	14.1	15.4	-1.3	-10.7%
Industrials	8.0%	16.7	15.9	0.7	-16.4%
Capital Goods	5.4%	17.1	16.1	0.9	-14.7%
Commercial & Professional Services	0.7%	23.2	19.2	4.0	-18.8%
Transportation	1.8%	13.9	15.2	-1.2	-19.8%
Information Technology	26.9%	19.6	17.7	1.8	-28.2%
Software & Services	13.2%	23.1	18.9	4.2	-27.2%
Technology Hardware & Equipment	8.3%	18.9	15.8	3.1	-26.0%
Semiconductors & Semiconductor Equipment	5.4%	14.9	17.8	-3.0	-33.4%
Materials	2.8%	13.6	15.4	-1.8	-13.1%
Real Estate	2.8%	18.0	17.9	0.1	-23.9%
Utilities	2.9%	19.9	14.6	5.3	-4.2%

Source: FactSet; Data as of June 10, 2022

S&P 500 Equity Positioning

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- From a sector perspective, the only place investors have been hiding is in energy (rightly so) and a few other pockets, but if we end up in a global recession, even that will not be safe. **We believe companies with US centric revenue streams and lower P/E stocks should outperform on a relative basis, which will favor certain parts of communications services, real estate, and value stocks more broadly speaking.**

- **We suggest in the current environment investors should focus on de-risking their portfolios, being very diversified until the big event happens, which we view as a market moving event that forces the Fed to stop raising rates with many global central banks following suit.** It may be a financial event in Europe or Asia, or an inflation report that shows meaningful progress, or some abysmal US economic data later this year. **When that event happens, investors would want to begin nibbling away at Industrials, Consumer Discretionary, Technology, an or the most severely hit sectors/industries, but when this event occurs, we expect to see everything to shift higher (e.g., Q1/2019).**

  - **Bull Case -** The last time the Fed raised this quickly was in 1994 (the last 75bp move was Oct. 1994). By December 1994, Orange County, CA had gone bankrupt and Mexico was essentially insolvent, and Greenspan had to stop raising rates even though inflation was still 3%+ (there actually was no improvement in inflation from Jan-Dec. 1994 despite a 300 bp increase in rates, which is itself very interesting). So essentially, the bull case is the faster they raise, the faster they'll break something, and the faster they'll have to stop, even if inflation is high, because capitalism will ultimately solve inflation.

  - **Bear Case -** The Fed won't stop until inflation is 2%, Europe doesn't matter, Japan doesn't matter, US employment doesn't matter, politics don't matter, the financial health of allies doesn't matter, the fact that the Fed has no control over China lockdowns, Saudi drilling, Texas drilling, quarantines, refining capacity, war, etc… no longer matters, they are committed to keep raising until inflation is 2%.

Canadian Equity Strategy

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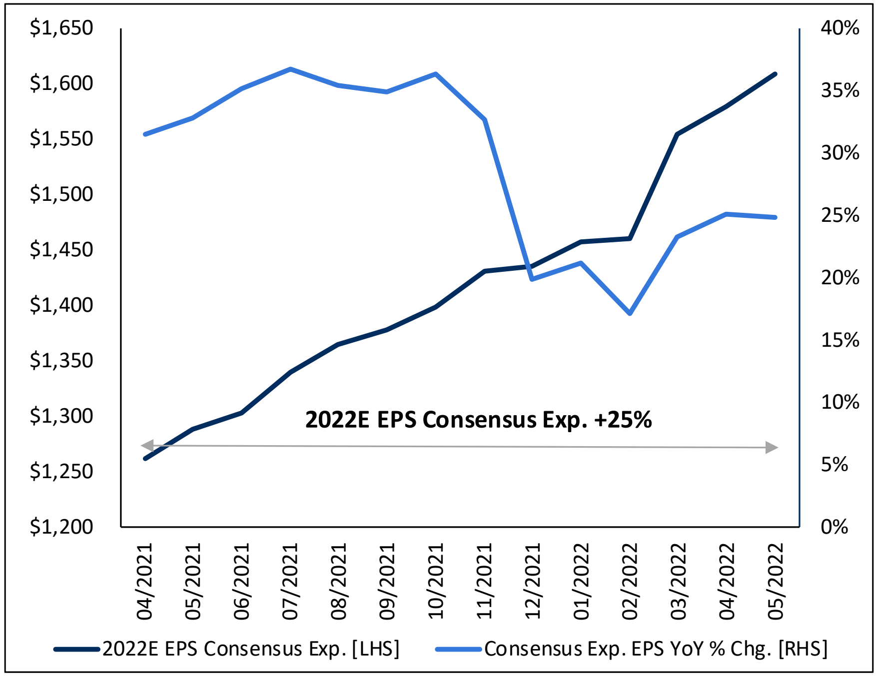
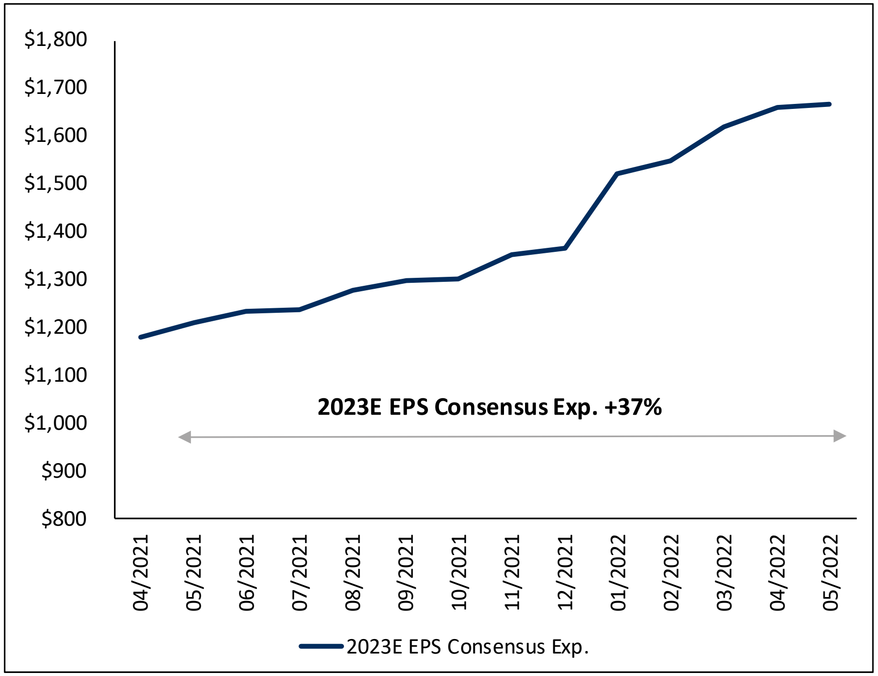
S&P/TSX Earnings Also Moving Higher

The S&P/TSX index 2022/2023E consensus EPS expectations have continued to move higher with Street estimates +25% and +37%, respectively, since the end of 2020, but at a much slower pace. Current expectations are calling for 2022E EPS of ~$1610 (+25% YoY) and $1666 (+37% YoY) for 2023E. But as is the case for the S&P 500 index, we are seeing **growing concerns by investors who are increasingly convinced 2022 and 2023 EPS estimates will need to come down meaningfully due to inflationary pressures, rapid rate hikes across the world, and the impacts from global geopolitical events on consumer wallets and corporate spending plans.** However, given the larger relative weight of Energy stocks on the S&P/TSX, earnings could hold in better than the S&P 500 and outperform in the second half of 2022.

S&P/TSX 2022E EPS Consensus Exp.



S&P/TSX 2023E EPS Consensus Exp.

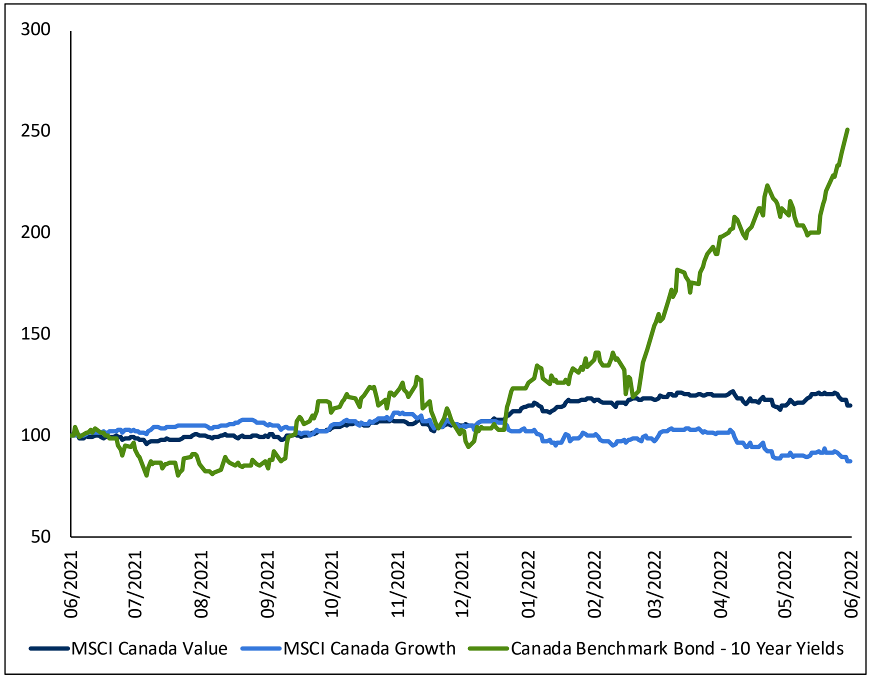


Source: FactSet; Data as of May 31, 2022

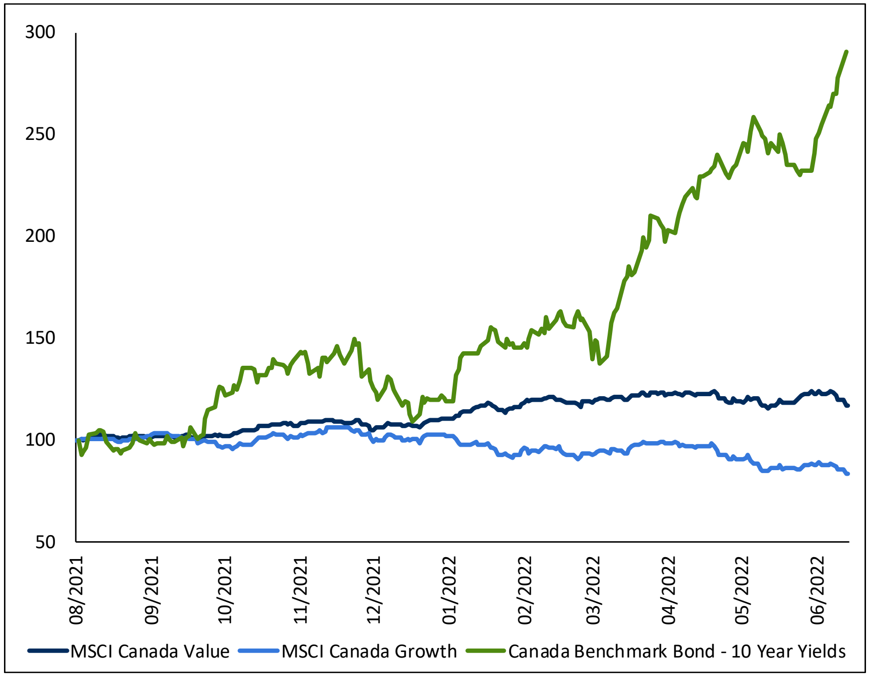
Value > Growth…

Value stocks in Canada (i.e., the MSCI Canada Value Index) similar to the US market have outperformed growth stocks (i.e., the MSCI Canada Growth Index) as yields have moved higher. We expect yields to continue their trend higher as the BoC hikes rates and unwinds its balance sheet. Similar to the US market, we expect value stocks to outperform growth moving forward as yields continue to move higher, with corporate earnings beginning to slow more aggressively in the coming quarters and into 2023. However, given the value tilt to the Canadian market, we expect it to do better and continue to outperform the S&P 500 index.

MSCI Value/Growth Index vs. 10Y Yields (1 Year)



MSCI Value/Growth Index vs. 10Y Yields (Aug.'21)



Source: FactSet; Data as of June 14, 2022

S&P/TSX Sector Valuations & YTD Perf.

For the S&P/TSX, we also expect valuations to contract further from current levels, but to a lesser degree than the S&P 500 index given less extreme absolute, relative and peak valuations. With this in mind and from a top-down perspective, we see the greatest risks across sectors/industries which are trading at significant premiums to their historical valuations including those which are also most susceptible to downside earnings revisions as the economy slows, and inflationary cost pressures weigh on consumer and corporate spending. **These sectors include the Communication Services, Industrials, Information Technology, and Utilities sectors.**

S&P/TSX Sector Valuations: Current vs. Historical PE NTM (Since 2002)

	Sector Weight	Current PE NTM	Historical PE NTM (Since 2002)	Premium (+) / Discount (-)	YTD Return
Canada S&P/TSX Composite		**12.4**	**14.5**	**-2.1**	**-5.9%**
Communication Services	5.0%	18.7	15.7	3.0	0.4%
Consumer Discretionary	3.2%	12.4	14.3	-1.9	-17.6%
Consumer Staples	4.0%	16.3	15.8	0.5	0.5%
Energy	19.5%	10.2	15.3	-5.1	41.2%
Financials	31.4%	10.1	11.5	-1.4	-8.3%
Health Care	0.4%	15.8	16.5	-0.7	-54.9%
Industrials	11.4%	23.6	15.5	8.1	-11.6%
Information Technology	5.0%	30.1	21.2	8.9	-55.9%
Materials	12.5%	10.8	17.2	-6.4	2.6%
Real Estate	2.6%	15.4	14.7	0.8	-21.4%
Utilities	4.9%	24.7	17.9	6.8	2.9%

Source: FactSet; Data as of June 10, 2022

S&P/TSX Sector & Industry Valuations

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	Sector/Industry Weight	Current PE NTM	Historical PE NTM (Since 2002)	Premium (+) / Discount (-)	YTD Return
Canada S&P/TSX Composite		**12.4**	**14.5**	**-2.1**	**-5.9%**
Communication Services	5.0%	18.7	15.7	3.0	0.4%
Telecommunication Services	4.2%	19.4	15.7	3.7	1.9%
Media & Entertainment	0.8%	15.4	16.5	-1.0	-7.3%
Consumer Discretionary	3.2%	12.4	14.3	-1.9	-17.6%
Automobiles & Components	0.8%	9.9	10.4	-0.5	-26.2%
Consumer Durables & Apparel	0.4%	9.3	14.6	-5.3	-31.2%
Consumer Services	0.7%	16.1	19.1	-3.0	-18.3%
Retailing	1.2%	15.4	14.8	0.7	-1.4%
Consumer Staples	4.0%	16.3	15.8	0.5	0.5%
Food & Staples Retailing	3.5%	16.1	15.3	0.7	3.3%
Food Beverage & Tobacco	0.5%	17.3	16.9	0.4	-14.4%
Energy	19.5%	10.2	15.3	-5.1	41.2%
Financials	31.4%	10.1	11.5	-1.4	-8.3%
Banks	21.8%	10.0	11.1	-1.2	-5.8%
Diversified Financials	4.0%	13.8	15.1	-1.3	-21.9%
Insurance	5.7%	8.7	11.1	-2.4	-6.7%
Health Care	0.4%	15.8	16.5	-0.7	-54.9%
Health Care Equipment & Services	0.1%	18.2	17.9	0.2	-11.0%
Pharmaceuticals Biotechnology & Life Sciences	0.2%	15.7	16.2	-0.4	-65.3%
Industrials	11.4%	23.6	15.5	8.1	-11.6%
Capital Goods	1.9%	24.3	16.7	7.7	-18.7%
Commercial & Professional Services	3.0%	30.4	16.4	14.1	-14.4%
Transportation	6.6%	21.3	14.8	6.5	-7.9%
Information Technology	5.0%	30.1	21.2	8.9	-55.9%
Software & Services	5.0%	31.3	17.6	13.6	-56.1%
Technology Hardware & Equipment	0.1%	6.2	15.4	-9.3	-6.2%
Materials	12.5%	10.8	17.2	-6.4	2.6%
Real Estate	2.6%	15.4	14.7	0.8	-21.4%
Utilities	4.9%	24.7	17.9	6.8	2.9%

Source: FactSet; Data as of June 10, 2022

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S&P/TSX Equity Positioning

- Broadly speaking, and as expected the S&P/TSX has outperformed the S&P 500 by ~15% YTD, which has been our called recommendation since 2021. We believe attractive relative valuations, stronger relative earnings, and its ~20% weighting to energy (versus only 5% for the S&P 500 index) should continue to position it well to outperform at least over the short term, while inflationary pressures remain hot.

- From a sector perspective, the only places investors have found solace in has been Energy, Materials, Staples and Utilities sectors. However, several of these sectors are trading at premium valuations and are not immune to inflationary pressures and/or the impacts to a slowdown in earnings from a global recession. That said, we believe Canadian/North American centric revenue streams, and lower P/E stocks should outperform on a relative basis, which argues for certain parts of **Energy, Financials, Materials, Consumer Discretionary and value stocks more broadly speaking.**

Important Investor Disclosures

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