

Multi-Asset 2023 Year Ahead Outlook

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It is December, we think about family, celebrations, food and for us in the investment industry, the investment outlook for 2023. We can attempt to predict based on “known unknowns” and be humbled by the fact the world may also have other “unknown unknowns”.

The boss of the boss: inflation

It is fair to assume inflation is cooling. Supply chain disruption has eased, as evidenced by the falling commodity prices. As interest rates rise, the willingness and ability of consumers to pay up has diminished. We have seen this in the property sector as mortgage rates have more than doubled. However, we recognize the road to 2% target inflation is a long road. Structurally, inflation is likely higher than the previous decade due to demographics, protectionism, and the transition to zero/lower emissions. It is expected that China will significantly reduce COVID restrictions in the coming months and that could boost demand. With interest rates above neutral since the summer of 2022 and likely throughout 2023, North American inflation will likely fall to 3% at year end of 2023.

The boss: central banks

While rate hikes have ran more than half of their course with multiple 75 basis point hikes in 2022, the tone will likely remain hawkish as that is an important component to taper consumer and investor enthusiasm that causes asset bubbles and inflation. We expect the terminal rates to be 4.5 to 5% in both Canada and the US, likely reached by mid-2023. There were calls by the markets for central banks to cut rates quickly as a slowdown or a recession was likely to follow. We do not anticipate higher rates to impact companies’ and individuals’ finances until later as most loans are set for years. This means economies will remain relatively resilient for the next 12 months. However, interest rates at 4.5 to 5% is unsustainable. The longer-term average is probably 2.5-3%.

Fixed income markets

Fixed income has proven to be not so boring with very high volatility in 2022. We expect the near term central banks rates to be 4-5% and long term fallen to 2.5-3%, a 10-year US Treasury is undervalued at 3.6% yield and Canada 10-year is overvalued at 2.8%. We are seeing value in short duration credit as they offer a solid premium and low duration risk.

Equity

It is fair to say the world’s supposed best equity markets: the US, are largely overvalued. We have the S&P 500 Index at 4200 as the level for a soft landing scenario and we were almost there. The US has been favoured as there were too many problems

in other places of the world. Europe was dealing with the impacts of the Russia/Ukraine war, the Chinese economy was slowing rapidly due to very strict COVID policies that kept people from being active. In 2023, the Chinese economy will be on the road to normal with growth likely outpacing developed markets by 4 to 5%. We expect capital flows to return to China boosting the valuations and prices of Chinese companies.

Locally, Canadian markets will benefit from stable commodity prices and attractive valuations. The economy itself will be resilient due to immigration, the tailwinds of the property sector. Energy is interesting. On one hand, everybody hates it as it is associated with pollution, on the other hand, that opposition leads to supply constraint, which supports prices. Normally at higher energy prices, companies will be expanding capacity. This time, they are cutting back capital spending and returning cash to shareholders. They are the “cash cows”.

It is harder to predict Europe. Valuations are compelling but there are more potential problems than other regions: stubborn inflation, low tolerance for higher interest rates, and commodity supply issues, to name a few. Investors need to be selective in Europe and the US. Higher rates helped to taper valuations in the technology sector. Some of them will continue to deliver high growth and eventually be proven undervalued.

Foreign currencies

The US central bank was amongst the most aggressive in hiking rates in 2022 and as a result, the US dollar was the “king”. As the markets expect the Fed to pause sometime in the next six months, the US dollar has probably peaked versus a basket of currencies including the Canadian dollar, yen, the euro, and sterling. Investors should be actively hedging the US dollar. Speaking of yen, after falling dramatically versus all currencies in 2022 as it was the most dovish central bank, it is expected to have some upside as policy may have to shift in 2023.

Finally, we would like to wish you a safe and joyful holiday season.

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