Insights & Strategies

PRIVATE CLIENT SOLUTIONS

January 4, 2022

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Inflation Running Hot Heading Into 2022

It's been almost two years since the onset of the pandemic, with COVID-19 as the primary driver of macroeconomic and financial performance across markets and asset classes globally. The path of the global economic recovery has remained uneven to date, which has largely depended on access to and the administration of vaccines, which, until recently, have been concentrated mostly in advanced regions of the world. Investors and consumers have had to contend with several ongoing issues, including the rise in prices for everyday goods. One thing that has been missing from explanations regarding the path of inflation, which we have attempted to address in past commentaries, is how long these pricing pressures would last. While inflationary pressures have run hotter and persisted longer than most would have expected, we believe these pressures will probably remain above trend in the New Year, with several inflationary impulses (e.g., supply chain bottlenecks, base effects, commodities prices, etc.) softening as we move further into 2022.

However, that said, while recent data points and headlines would suggest a potential repeat of the runaway or hyper-inflationary environment like in the 70s/80s, we do not view this as our base case. It is difficult for us to envision a decade-long period of sustainably higher inflation (+3.0% year-over-year), especially against a backdrop of policy makers tightening/removing stimulus measures aimed at reducing inflationary pressure, including demand driven pressures.

Compared to last quarter, current projections suggest inflation will recede at a slower pace in 2022. Globally, recent forecasts show only a marginal reduction in consumer prices in 2022 relative to 2021 (-0.2% to 3.5%), with inflation expectations suggesting a path towards historical trend beginning in 2023. We caution that uncertainties remain and the risks to our views are to the upside rather than the downside, and suggest investors position their portfolios accordingly for the years ahead.

Inflation is expected to Remain Elevated in 2022

Current Inflation Forecasts	2021	2022	2023
World	**3.7%**	**3.5%**	**2.8%**
Advanced Economies	**3.1%**	**2.7%**	**1.8%**
US	**4.6%**	**3.4%**	**2.8%**
Canada	**3.4%**	**3.0%**	**2.0%**
Euro	2.5%	2.3%	1.0%
UK	2.5%	3.8%	2.1%
Japan	-0.3%	0.8%	0.2%
Australia	2.8%	2.4%	2.3%
Emerging Economies	**4.2%**	**4.2%**	**3.3%**
China	1.0%	1.5%	1.6%
India	5.2%	5.5%	3.3%
Russia	6.6%	6.5%	3.7%
Brazil	8.0%	6.3%	3.3%

Change (%) Quarter-over-Quarter	Inflation Forecasts		
	2021	2022	2023
World	**9%**	**25%**	**8%**
Advanced Economies	**19%**	**42%**	**29%**
US	**10%**	**48%**	**47%**
Canada	**17%**	**58%**	**-5%**
Euro	9%	53%	0%
UK	9%	41%	17%
Japan	-250%	0%	-33%
Australia	8%	26%	10%
Emerging Economies	**5%**	**24%**	**-3%**
China	0%	0%	0%
India	-2%	96%	0%
Russia	5%	30%	0%
Brazil	3%	26%	10%

Source: Capital Economics; Raymond James Ltd; Data as of December 20, 2021

Please read domestic and foreign disclosure/risk information beginning on page 7.

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RAYMOND JAMES

With inflation hovering above target levels for most economies, governments globally have reversed several pandemic-related fiscal measures in recent quarters and central banks have adopted a less-accommodative policy stance. The monetary authorities in a few advanced economies reduced bond purchases (e.g., the Federal Reserve in the US, "Fed"), while others ended their quantitative easing programs altogether (e.g., the Bank of Canada, "BoC"). We have seen interest rate hikes in only a few countries, mostly emerging markets. The UK and New Zealand are the major developed countries that have increased their policy rate. We believe that fiscal tightening and higher rates should release some of the excess pressures propping up inflation.

Monetary Policy to be Less Accommodative in 2022/23

Interest Rate Forecasts	2021	2022	2023
Advanced Economies			
US	0.3%	0.8%	1.8%
Canada	0.3%	1.0%	1.3%
Euro	-0.5%	-0.5%	-0.5%
UK	0.3%	0.8%	1.0%
Japan	-0.1%	-0.1%	-0.1%
Australia	0.1%	0.1%	0.8%
Emerging Economies			
China	2.1%	1.7%	1.7%
India	4.0%	4.5%	5.0%
Russia	8.5%	9.0%	7.8%
Brazil	9.3%	11.5%	9.5%

Source: Capital Economics; Data as of December 20, 2021

Global Growth Still on the Up and Up

We believe the recent announcements by policy makers and central bankers to reduce/remove extreme policy measures from the economy/markets is the right call, especially as the global economy remains on a solid footing when compared to historical standards. While we expect to see higher policy rates and higher yields across fixed income markets, we do not expect these increases to derail the recovery in 2022.

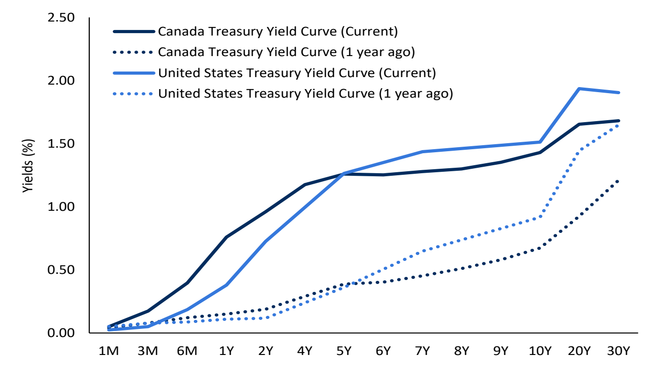
Real GDP Growth Forecasts Remain Above Trend

Real GDP Growth (% YoY)	Ave. 2000-2017	2021	2022
World (CE China Estimate)	**3.8%**	**5.9%**	**4.0%**
Advanced Economies	**1.8%**	**5.0%**	**3.6%**
US	2.2%	5.6%	3.1%
Canada	2.2%	4.6%	3.7%
Euro	1.3%	5.1%	3.5%
UK	2.1%	6.8%	4.8%
Japan	1.5%	1.8%	3.5%
Australia	2.6%	4.4%	5.0%
Emerging Economies	**5.2%**	**6.5%**	**4.6%**
China (CE Estimates)	7.5%	9.0%	3.5%
India	7.5%	7.6%	10.6%
Russia	2.0%	4.3%	2.8%
Brazil	1.4%	4.7%	0.5%

Source: Capital Economics; Raymond James Ltd. Data as of December 20, 2021

Similar to 2021, advanced economies made faster and more substantial progress in getting their populations vaccinated when compared to their emerging market peers. Advanced economies had more leeway heading into the crisis, allowing policymakers to provide more sizeable fiscal and monetary stimulus. The combination of these factors supported our call for a more robust growth profile relative to trend for advanced economies in 2021, even as inflation remained elevated and yields rose. For 2022, we expect advanced economies (e.g., Canada, the US, UK, etc.) to once again lead the way, with developing economies likely to face another challenging year as inflationary headwinds remain elevated.

Yield Curve Steepening with an Upward Shift Expected



Source: Raymond James Ltd.; Data as of December 31, 2021

Investor Recommendations

Against this backdrop and given our view that inflation is likely to remain above trend heading into 2022, with risks to the upside, specifically for 10-year yields, we suggest investors position their portfolios accordingly and **expect greater volatility** as policy makers embark on the road towards normalization. As we highlighted in several of our prior research notes, potential solutions for this scenario in 2022 include:

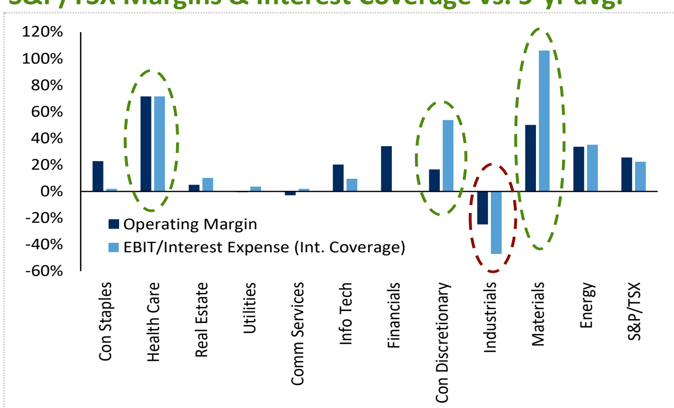
- Remaining selective and focusing on high-quality securities
- Valuation matters, especially as yields rise from record lows; securities trading at extreme levels with cash flows far out in the distant future (e.g., speculative stocks) will fare worse in this environment
- Focus on assets (stocks/bonds) with shorter durations, all else equal
- Look for securities that offer floating rate coupons
- Consider alternative investments (e.g., private real estate).

Nadeem Kassam, MBA, CFA, Head of Investment Strategy

Where Fundamentals Stand

During periods of rising interest rates and bond yields, it is common for investors and portfolio managers to be wary of interest rate risks for companies they own. Larger firms that raise debt in bond markets can manage any short-term increase in rates by ensuring their debts have longer dated maturities, thus helping lock in lower rates for longer. When looking at company fundamentals, understanding where current operating margins and debt coverage ratios sit today compared to their historical averages can help identify any pockets of risk when looking at the potential impact of rising short-term interest rates on earnings per share (EPS). Below, we look at operating margins, interest coverage (earnings before interest and taxes/interest expense), and net-debt-to-total-capital ratios for sectors in the S&P/TSX Composite Index (S&P/TSX) and S&P 500 Index (S&P 500). Using these metrics, we assess how the last 12 months compare with their respective 5-year averages.

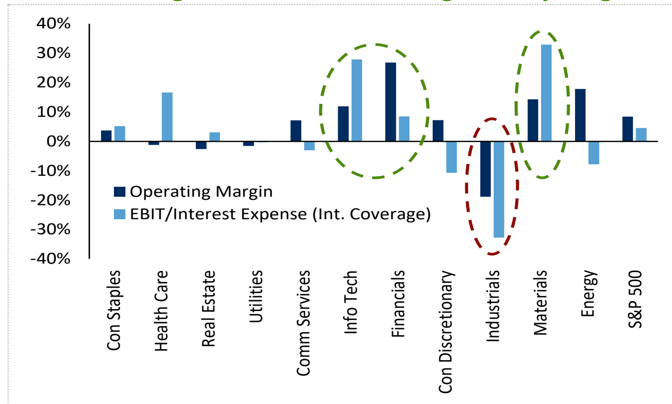
S&P/TSX Margins & Interest Coverage vs. 5-yr avg.



Source: Raymond James Ltd.; FactSet; Data as of September 30, 2021

For the S&P/TSX, operating margins for the market are currently 26% over the 5-year average. Communication services, industrials, and utilities are the only sectors that are currently sitting below their historical averages in operating margins when compared to historical levels. Materials, consumer discretionary, and health care sector profitability and debt coverage ratios are also sitting comfortably above the 5-year average. Most notably, materials and consumer discretionary sectors also saw net-debt-to-total-capital ratios that are 36% and 16% lower, respectively, when compared to their 5-year averages. The industrials sector was the worst performer, showing declines in profitability and debt coverage ratios when compared to historical averages by 25% and 47%, respectively. We chalk up the lagging metrics for the industrials sector to issues with supply chains and higher input prices, including labour costs.

S&P 500 Margins & Interest Coverage vs. 5-yr avg.



Source: Raymond James Ltd.; FactSet; Data as of September 30, 2021

For the S&P 500, operating margins and interest coverage ratios improved 8% and 5% when compared to its 5-year average. The operating margins for the consumer discretionary, industrials, real estate, and utilities sectors were sitting below historical averages. The materials, information technology, and financial sectors showed the strongest improvement in both profitability and debt coverage ratios. In terms of net-debt-to-total-capital ratios, materials and consumer discretionary sectors are currently 16% and 20% lower, respectively, when compared to their 5-year averages. The industrials sector also proved to be the worst performer for the S&P 500, with operating margins and interest coverage ratios declining 19% and 33%, respectively, when compared to its 5-year averages.

Recommendations

Rising interest rates and bond yields are likely to have a limited impact on EPS growth in the near-term. We recommend investors continue to hold companies that show quality characteristics, supported by strong financials and good management teams.

For the S&P/TSX and S&P 500 some of our quality picks in our guided portfolios include: **Open Text (OTEX-CA)**, **CCL Industries (CCL.B-CA)**, **Nutrien (NTR-CA, NTR-US)**, **Wheaton Precious Metals (WPM-CA)**, **Visa (V-US)**, and **Blackrock (BLK-US)**.

Peter Tewolde
Equity Specialist

Cold Temperatures, Hot Inflation

Canadian winters may be cold, but inflation is running hot. Sustained upward pressure on the price of goods and services has caused many central banks (including the BoC and the US Fed) to change their policy stance to one that is less accommodative. Globally, this beats a path to normalization, with reductions in asset purchases and higher interest rates. In this article, we look at US and Canadian rate expectations, benchmark bond yield projections, and provide suggestions on fixed income positioning for investor portfolios.

US Rate Expectations

The Fed recently adopted a more hawkish position to address inflation concerns. It announced the tapering of its quantitative easing program would be sped up and rate hikes may begin sooner than previously targeted. Projections via the dot plot now show that 75 basis points (bps), through three quarter-point rate hikes, could be added to the overnight rate in 2022, versus prior expectations for only one rate hike in the year. This shift in approach could be explained by the higher risk that inflation is posing to the US economy. The Fed acknowledged that COVID-19-related risks remain, and would be prepared to adjust their stance if needed.

Canadian Rate Expectations

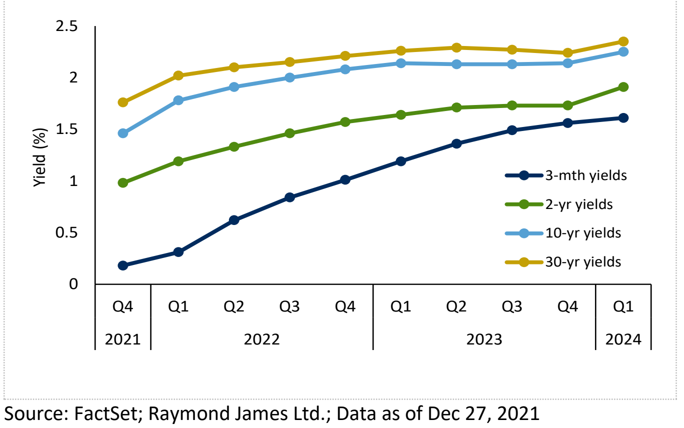
When our December 1, 2021 Insights & Strategies was published, Canadian rate hike expectations sat at around 5 quarter-point rate hikes in 2022. Consensus has fluctuated recently, from 6.82 hikes back to five. The swings in this value indicate to us that market participants' opinions are far from clear and thus we cannot rely on their expectations to forecast the future direction of bond yields. However, as rate hike timing becomes more certain, hike forecasts and yields may become more consistent. It is possible that the BoC could enact their first rate hike of this cycle as early as the January 26 meeting, so clarity may arrive soon.

We caution if rate hike expectations remain elevated, there is a risk that there will be fewer rate hikes than projected. Although raising interest rates will help to combat inflation concerns, the central bank must be cautious of the effects higher interest rates will have on other factors, such as currency valuation or housing costs (mortgages). As the BoC raises interest rates, these elements will be watched closely, and policy will be amended if required.

Canadian Yields Projections

Canadian benchmark bond yields are expected to continue increasing in 2022, with short end rates rising more than the long end. Comparing the projected changes in maturities across the curve, three-month rates could climb by 83 bps; whereas, the two-year, 10-year and 30-year terms could see increases of 59, 62, and 45 bps, respectively, over the year (see chart). Looking further out to 2023, rates appear more stable except in the three-month maturity, where yields are expected to rise again. These moves would be a substantial increase to Canadian benchmark yields across the curve, causing spread products to increase in yield as well.

Select Canadian Benchmark Yield Expectations



Source: FactSet; Raymond James Ltd.; Data as of Dec 27, 2021

Portfolio Positioning

We remind investors of the inverse relationship of bonds and rates–as rates increase, prices fall. Thus, for existing holders of most fixed income products, your holding's current value may be negatively affected. However, a benefit of bonds is that even if the price of the security fluctuates between purchase and maturity, par value is paid when the bond matures. Thus, those who hold a position to maturity don't need to be as concerned with near-term fluctuations in value. To put cash to work now, we suggest investors look to short-end investments in the two to three-year space. This term balances the benefit of a yield higher than one-year product, allowing for a near-term maturity date and lower duration so you can re-invest at the prevailing rate at the time of maturity.

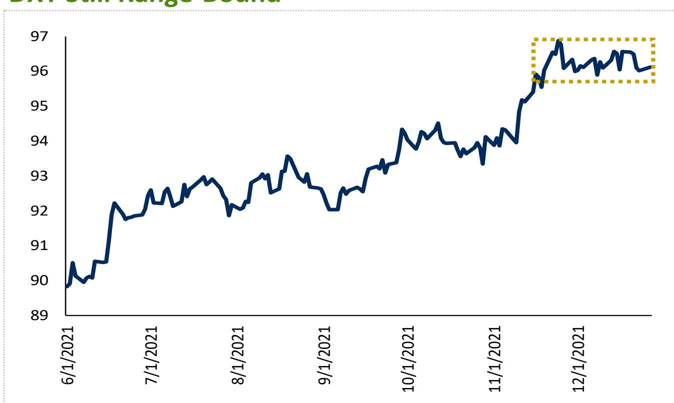
The projected rise in interest rates, and thus bond yields, is promising, but risks remain. Central bank communication has mostly focused on addressing inflation rather than health issues, but the situation around COVID-19 is ever-changing. We anticipate markets will remain sensitive to headlines and setbacks may occur, but the general trend should be positive in the coming months (and years) for Canadian yields.

Charlotte Jakubowicz, CIM, CMT
VP, Fixed Income & Currencies

FX in a World of Normalization

Despite renewed COVID fears, we expect the global economy to continue chugging along on a stronger-than-expected path in 2022. As a result, we remain bullish on the higher-beta/commodity currencies over the longer term. While the US dollar (USD) may receive some support from a myriad of factors in the short term, we expect the greenback to face some downward pressure over the longer term. As for factors to consider, relative growth profiles, interest rate differentials due to central bank normalization, trade and capital flows, relative valuation, and technicals will all play a role in dictating the direction of FX markets. The broader USD, tracked by the DXY US Dollar index, has remained largely range-bound, heading into the year-end. We expect the USD to garner some short-term support on the back of positive interest rate differentials, a favourable relative growth outlook, and a seemingly hawkish Fed. However, a stronger-than-expected global economic outlook can represent a gradual headwind for the broader USD over the longer term, especially against some of its major developed- and emerging-market peers.

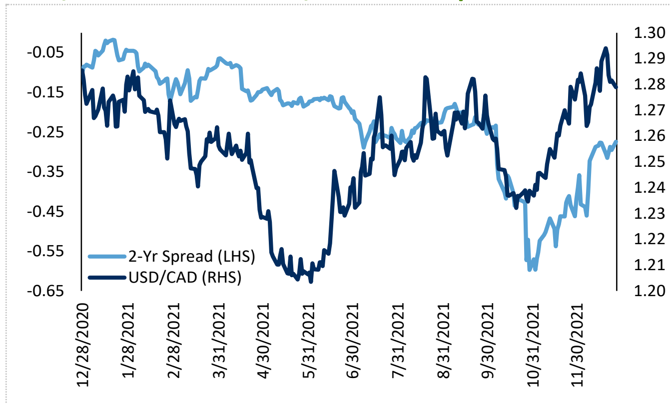
DXY Still Range-Bound



Source: FactSet; Raymond James Ltd.

Central bank action to rein in pandemic-era stimulus and begin normalizing monetary policy will be front and center in the New Year. In Canada, markets have priced in nearly six rate hikes for the BoC, with only three being priced in for the Fed at the time of writing. We expect interest rate differentials, especially on the short-end of the curve, to be a driving factor for USD/CAD. For example, back in late October, we saw both USD/CAD and the US/CDN 2-year spread bottom out. As the market repositioned itself and priced in a seemingly more hawkish Fed, the 2-year spread narrowed and helped lift USD/CAD higher.

USD/CAD and 2-Year US/CDN Yield Spreads



Source: FactSet; Raymond James Ltd.

As it stands, the Fed has elected to speed up its taper of asset purchases, and remove the infamous "transitory" characterization when discussing inflation. Its latest round of dot projections also shows Fed officials calling for three rate hikes in 2022. A repricing of market expectations for the BoC may leave CAD susceptible to some modest selling pressure in the short run, coupled with a potential lack of upside in commodities as demand for oil may be pressured due to the escalating situation concerning the omicron variant. We believe this is a short-term situation, and we expect USD/CAD to have more upside potential in the short term before retreating to the downside in the latter half of 2022.

Positioning Recommendation: USD/CAD is hovering in overbought territory at the time of writing, which may suggest a corrective move to the downside in the immediate near term. However, we recommend holding a modestly bullish view for H1/2022 (+USD) and a bearish view for H2/2022 (-USD). The pair has failed to breach the 1.2965 level to the upside on three different occasions going back to late 2020, so this will be our first key level of resistance to monitor. A convincing break will have us looking at 1.3025 as our next target to the upside (38.2% Fibonacci retracement level from the pairs' downward slide from its 2020 high of 1.4670 to its 2021 low of 1.2000). To the downside, we will be eying 1.2635 as our first key level of support, followed by 1.2300.

Ajay Virk, CFA, CMT
Foreign Exchange

New Year, New Resolutions

The New Year is a time when we reset goals, create new resolutions, and tackle old challenges with a new spirit. For our investments, perhaps we can apply some of that New Year's cheer as well. Setting new resolutions relies, broadly, on two components; we must first understand where we want to be next year, and second, we require some foresight into what we could expect from financial markets in the year to come. The former helps shape the latter, and a good foundation sets us up for success. In this article, we will discuss some ways to create realistic and manageable New Year's resolutions for your investments, and some ways to deliver success over the long-term.

Don't Fix What isn't Broken

Each year, we see a lot of new funds and ETFs (funds) launched for investors to consider for their portfolio. These new investment offerings are typically carefully developed to provide effective and cost efficient exposure to financial markets that may have otherwise been out of reach before. Examples include a robust selection of new responsible investment funds that include detailed environmental, social and governance (ESG) principles; ESG bond funds; as well as enhanced income solutions through covered call and put writing strategies. Innovation has driven the fund space for many years and we expect that 2022 will hold even more choices for investors. The outcome of this is two-fold. More choices means a more tailored and customized solution to help meet your investment goals but, it may make more sense to allow your current investments to do the heavy lifting for you. Sometimes doing nothing at all is the right call.

The best way to tackle a challenge is to break it down into bite-size pieces. With investing, that starts with setting goals and putting appropriate timeframes around them. For longer-term accumulation goals, lower cost passive solutions can be excellent tools in a well-diversified portfolio. For only a few basis points or BPS (100 bps = 1%), you can get immediate diversification into thousands of different securities, both equities and fixed income that can nicely complement your existing portfolio. Selection is crucial here, however, because as noted above, more and more of these types of investments are coming to market and they do very different things. On the opposite end of the spectrum, for those with current income needs and a goal of capital preservation, active management might provide a smoother ride through bumpy times, and a higher stream of income for your needs. Active management comes at a higher overall cost, but if these investments accomplish your goals in a way that brings you comfort and security, then its money well spent.

Planning for What is Ahead

While 2021 was a challenging year to navigate with the continuing pandemic, equity markets fared well with accommodative monetary and fiscal policy. However, as central banks signal an end to accommodative monetary policy and with future rate hikes on the horizon, the environment for stocks and bonds is getting more challenging. As discussed in last month's Insights & Strategies, dispersion is at an all-time high, meaning that individual stock selection has never been more important. Equity index ETFs provided an excellent source of returns in 2021 with most major indices up double digits, but we believe that 2022 could be more of a stock pickers' market. While those with longer-term investment horizons perhaps may be able to handle added market volatility in the coming months and years, shorter term investors may benefit from an active approach to stock selection. In addition, fund manager consensus is starting to favour an overweight to equities outside of North America and, historically, funds provide excellent exposure to this area.

Fixed income has been a difficult space for investors for several years, but there continues to be merit to including it in a well-diversified portfolio. High-quality government bonds remain a hedge against weak equity markets and can provide a meaningful level of stability to your portfolio. Active management in fixed income was a good place to be in 2021, as most managers held shorter duration portfolios compared to the broad market and therefore outperformed as rates rose. With credit spreads at historically tight levels and with possible rate hikes on the horizon for 2022 and beyond, we feel that active management of your fixed income portfolio makes sense. Whether it is for more nimble credit selection, or shorter overall duration, we believe managers have the tools to add value above their fees.

Putting it all Together

Markets rewarded equity investors of all stripes in 2021. While we remain constructive on markets going into 2022, we believe things could look different from this past year. A slowdown in accommodative fiscal and monetary policy with higher interest rates could certainly change the investing landscape. As we start the New Year, now is a great time to review your overall portfolio, short- and long-term goals and objectives, and ensure you are positioned for success next year.

Spencer Barnes, MSc., CIM
AVP & Portfolio Manager, Mutual Funds & ETFs Strategy

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