Private Client Solutions

September 1, 2023

Market Commentary

Expecting Volatility

Neil Linsdell, CFA
Head of Investment Strategy

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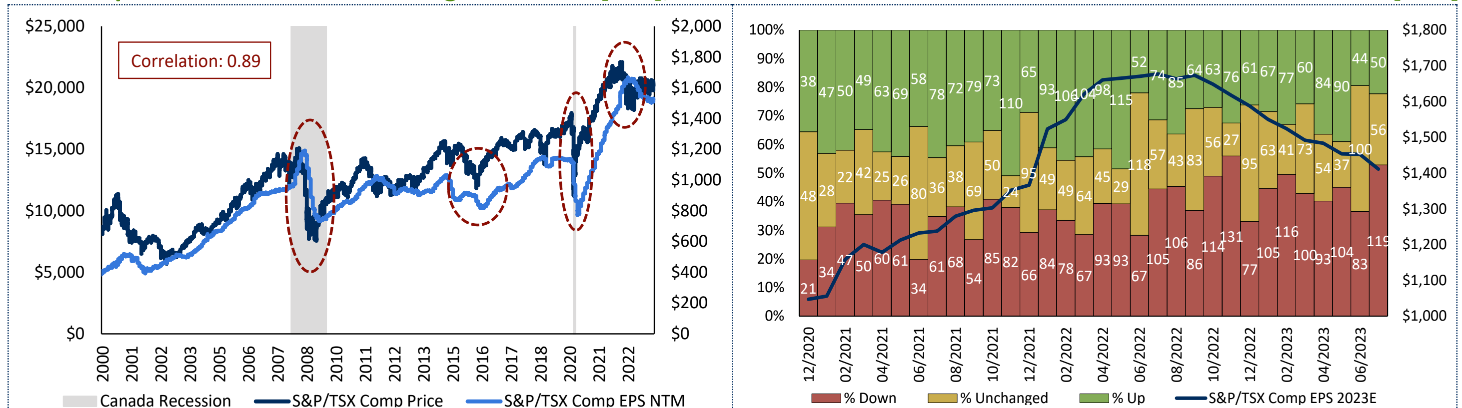
Expecting Volatility

As we move towards the end of the year, we continue to debate how this cycle will end, between the soft landing, mild recession, or deep recession scenarios. Our base case is for mild recessions in both Canada and the U.S., and that inflation-fighting central banks will keep rates higher for longer than many might expect. Although inflation has come down dramatically from its peak in June 2022, the battle to two per cent could drag well into 2024 or 2025, and although we believe we are near the end of the tightening cycle, any short-term resurgence in inflation could prompt further interest rate hikes through the end of 2023. The risk of overtightening remains and as global economic growth is already slowing, this could put even more pressure on the economy.

Now, the stock market is not the economy, and is generally more forward looking, but stocks can still react in the short-term to earnings surprises and guidance revisions. This can set the stage for security prices to be more volatile as we see mixed signals between low unemployment rates with still tight labour markets, and resilient consumer spending including continued demand for travel and entertainment, but with shifting spending patterns as shoppers favour value and trading down. We also see purchasing managers indicating declines in new orders as profit margins start to be squeezed, although many companies are also apparently increasing investments, specifically in technology, to improve efficiencies. This could lead to volatility in the market that might rattle some investors, but be seen as buying opportunities by others. Overall, we remind investors that volatility is inherent in public market investing and that it is important to maintain a long-term plan suited to one's specific goals and risk tolerance.

In the table below, we track monthly changes to EPS 2023 estimates for the S&P/TSX composite index. The forward-looking earnings measure has been consistently declining since the most recent market trough in October 2022, suggesting that analysts are factoring in the pressure on earnings expected from this economic slowdown. The number of companies that have seen negative revisions is also increasing. Although one might expect this deteriorating forecast to pressure share prices, the TSX composite is actually up ~7% from the end of September, and essentially flat YTD. The P/E_{NTM} multiple has increased from 11× in September 2022 to 12× in January and 13× today, while still below the 14.5× median, suggesting improving sentiment as investors look forward.

TSX Composite and NTM EPS Moving in Tandem [LHS]; While Lower EPS Forecasts Reflect More Cautious Outlook [RHS]



Source: FactSet; Raymond James Ltd.; Performance data as of August 15, 2023. Earnings revisions data as of July 31, 2023. Data labels indicate the number of constituents have upward/downward/unchanged earnings revisions. Please be advised that the 2023E EPS data might not be accessible for all constituents, and the number of companies with accessible 2023E EPS decreases when moving further into the past.

The takeaway can be that investors in the companies that make up the TSX composite are looking beyond the projected reduction in earnings related to the ongoing economic slowdown. The rising P/E_{NTM} multiple suggests that investors are also looking beyond the coming recession and more towards the growth of a new business cycle, and with the current P/E_{NTM} being below the median (measured since 2000) there is still room for improvement.

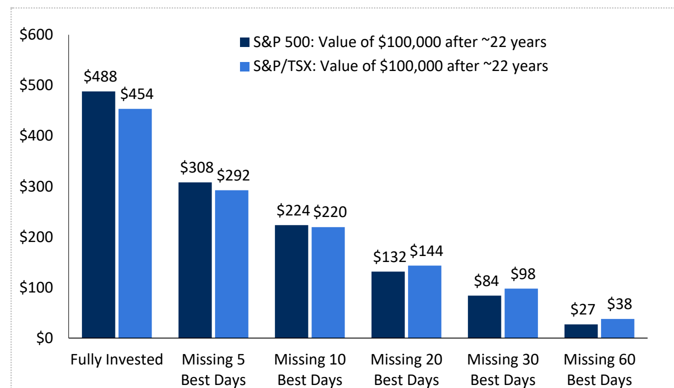
While the TSX composite as a whole therefore looks appropriately priced for our mild recession scenario, there are still some sectors that have fared better than others this year. While the 'Magnificent 7' and AI enthusiasm have driven up the Nasdaq Composite and S&P 500, the TSX has its own information technology sector, which has risen ~37 per cent YTD, although with only 7.5 per cent weighting in the TSX composite this has not exerted the same kind of influence that we have seen south of the border. The TSX composite is more influenced by the 30.5 per cent weighting of the financials sector and 17.7 per cent weighting from energy, which were both essentially flat YTD.

Sectors are reacting differently through this period. As interest rates put further pressure on consumer borrowing/spending, we would generally expect discretionary spending to be constrained. This has been somewhat offset by 'excess savings' from pandemic fiscal measures and reduced spending opportunities during lock-downs that have artificially supported consumer spending. We are watching to see if that effect wanes as those balances are exhausted by the end of the year (in both Canada and the U.S.).

Stocks in the energy sector however are much more impacted by the price of oil, which is influenced by the economy on the demand side, but by OPEC and other producers on the supply side, and while global inventories sit at near six-year lows, surprises in either direction would prompt price movements. Additionally, many investors have been watching the Chinese economy for signs that the government will step in with measures to aid its sluggish growth, which could also impact the price of oil and have a more significant impact on our Canadian index.

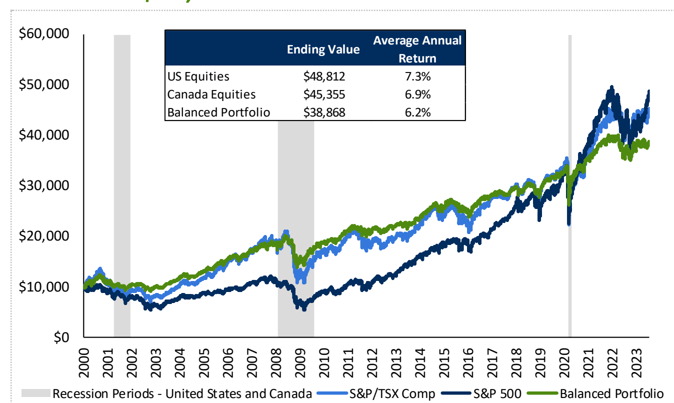
The path ahead is far from clear, and we see many opportunities for both negative and positive surprises as economic data is released, central bankers react, and markets adjust both short-term and long-term outlooks. We are also still waiting for the yield curve to normalize (slope positively) from its inverted state. As interest rates have risen recently, fixed income has become a more viable alternative to equities. Until we see a more normalized environment, we should expect heightened volatility as investors digest somewhat conflicting messages as to how the economy, interest rates, and even different sectors, might fare over the next year.

Stay Invested, Markets Have Always Rewarded Long-Term and Patient Investors



Source: FactSet; Data as of July 31, 2023, in thousands of local currency; for illustration purposes only. Start investing on January 1, 2000 with an initial investment of $100,000.

Growth of $10,000 Since 2000



Source: FactSet; Data as of July 31, 2023. Growth of 10K Chart: For illustration purposes only. Start investing on January 1, 2000 with an initial investment of $10,000. The returns of U.S. Equities, Canadian Equities and Canadian Fixed Income are represented by S&P 500 TR Index, S&P/TSX Composite TR Index and FTSE Canadian Government Bond, respectively. The asset allocation of the Balanced Portfolio is 60% S&P/TSX Composite TR Index and 40% FTSE Canadian Government Bond.

Ultimately, with heightened volatility amid uncertain markets we prefer to focus on timeless advice around long-term planning matching goals and risk tolerance. Additionally, diversification is always a good tool, and with a more attractive fixed income environment, is perhaps more welcome now than in previous years. Staying invested and being patient through market noise remains a solid piece of advice.

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