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BLUE BOOK

2023 MID-YEAR MARKET OUTLOOK

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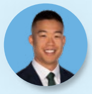
GLOBAL MACRO OVERVIEW

Making sense in the land of confusion



Justin Truong, CFA
Senior Manager,
Investment Strategy

Two quarters into the year and one thing is clear: Goldilocks is still nowhere to be seen. In our Outlook for 2023, we stressed that we weren't holding our breath for a return to the tepid macro environment of the last decade — one characterised by low inflation, a healthy labour market and moderate growth. We predicted that inflation would be sticky, and interest rates would stay high for a while. Fast forward six months later and neither type of landing — soft or hard — has arrived (see Figure 1).

Global growth, while still positive, is trending lower year over year, as developed world economies that benefited from the post-COVID economic recovery are now suffering from more difficult comparisons. Headwinds for economic growth, such as high inflation, high interest rates and lower productivity, continue to support our thesis for a slowing economy (see Figure 2).

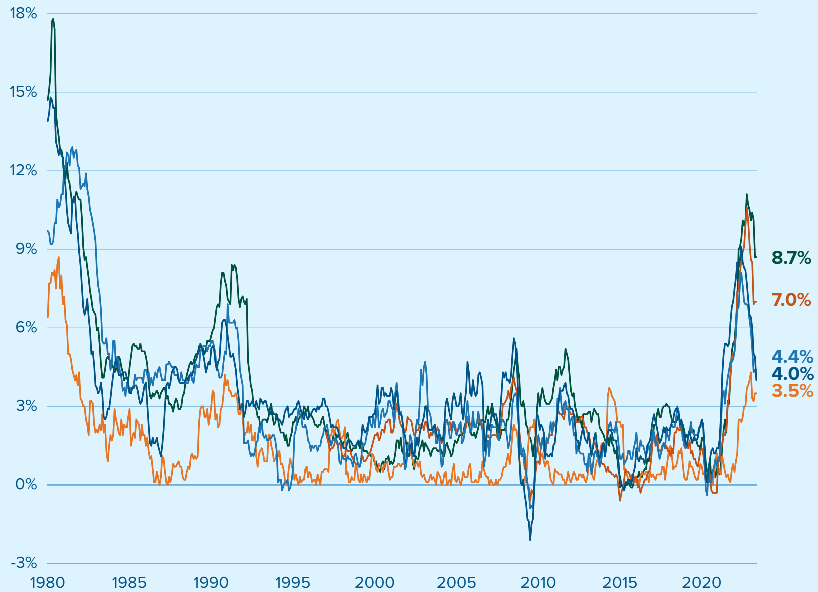
The accelerated tightening cycle by central banks continued into 2023 (see Figure 3). All G10 central banks lifted their interest rates at least once in the first half of 2023, with the notable exception of Japan. Even in Japan, price pressures have kept Bank of Japan officials on their toes, with core inflation averaging above 5% year-to-date. Central banks in emerging markets have, in many cases, reached the end of their hiking cycle. But rate-setters in advanced economies are still working to tighten policy in the face of sticky inflation.

KEY POINTS

- Global growth expectations have increased but are still declining year over year
- Inflation remains elevated despite aggressive policy intended to rein in prices
- Geopolitical uncertainties remain a concern
- Equities to underperform bonds in the near term

Figure 1. Peak inflation in the rearview mirror

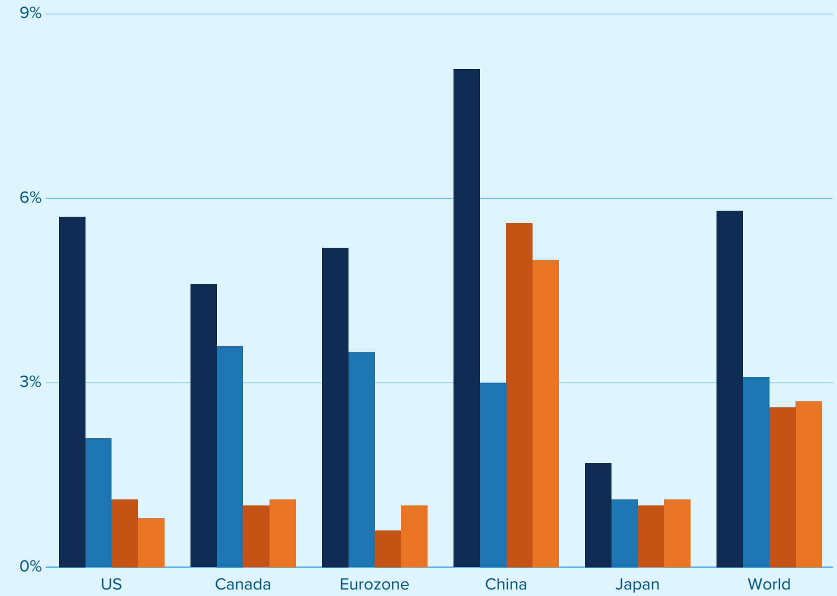
Headline inflation rates (y/y %)



Source: Bloomberg, April 30, 2023 (Canada, Japan, UK) and May 31, 2023 (US, Eurozone).

Figure 2. Growth estimates are sluggish

Real GDP growth (y/y % change)



Source: Bloomberg, May 31, 2023.

In the US, it's been "slowly at first, then all at once" for monetary policy. The Federal Reserve's relentless tightening seemed like it was having little effect on the booming US economy in early 2023 — until a handful of medium-sized regional banks crumbled under the pressure of higher interest rates in March and April. Policy-makers trotted out new, targeted emergency support measures around deposits that reduced bank-run concerns, and temporarily eased financial conditions. Despite this decisive policy response, and a short term reprieve, the longer run impact of the regional banking sector events will undoubtedly be tighter financial conditions.

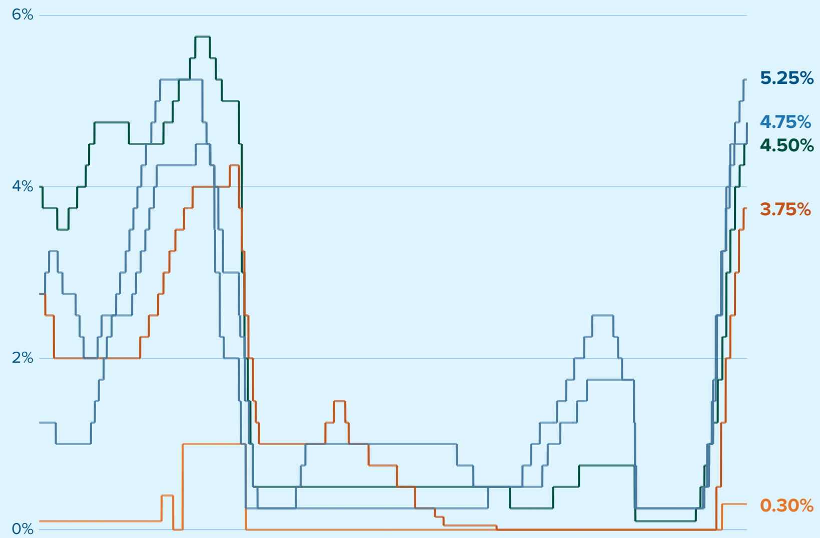
If most forecasters got one thing right about 2023, it was that geopolitical tensions would not simmer down. Russia is still invading Ukraine, even if markets seem to have coldly moved on to the next crisis. Diplomatic ties between China and the US were strained further in February after the US government shot down an alleged Chinese spy balloon hovering over the continent. And at the micro level, government authorities in both the US and China increased focus on sanctioning companies across several strategic industries.

Bonds bounced temporarily as interest rates fell, consistent with expectations for a slowing economy and with the backdrop of the regional banking crisis. This rally fizzled out when the expected economic slowdown did not transpire in the first half of the year.

Equity prices generally surprised to the upside (see Figure 4), barely registering concerns of a slowing economy. Stocks were fueled at first by an oversold rally in technology shares. This then transpired to a more fundamentally driven rally as technology companies benefited from lower interest rates, expense driven upside earnings surprises and emergence of a major secular trend with Artificial Intelligence entering the mainstream. This created a heavy concentration of returns in the largest companies in the S&P 500 and a massive rally in the Nasdaq.

Figure 3. Central banks to keep monetary policy restrictive

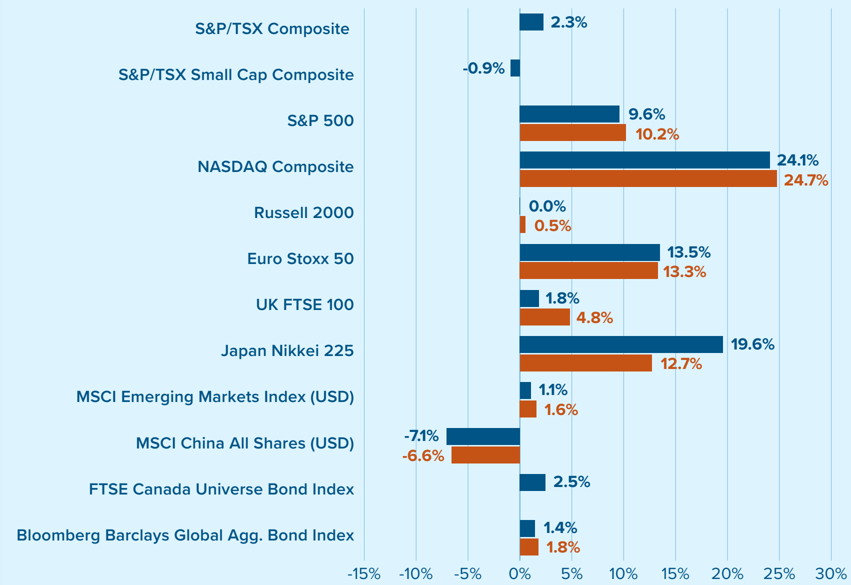
Global central bank policy rates (%)



Source: Bloomberg, June 7, 2023.

Figure 4. Equity returns resilient in the face of expected growth slowdown

Capital market YTD total return (%)



Source: Bloomberg, May 31, 2023.

Our view

While impressive in the face of a deteriorating economic backdrop, the year-to-date move higher in equities is unlikely to be sustained over the near term. The lagged effects of restrictive monetary policy will exert growing pressure on the economy and, in turn, corporate earnings. Moreover, the lack of market breadth off the October lows is concerning and suggests further weakness in equity markets is likely. As a result, we see equities underperforming bonds in the near term.

Financial tightening:
Slowly at first, then all at once

Steve Locke, MBA, CFA
Chief Investment Officer, Fixed Income & Multi-Asset Strategies

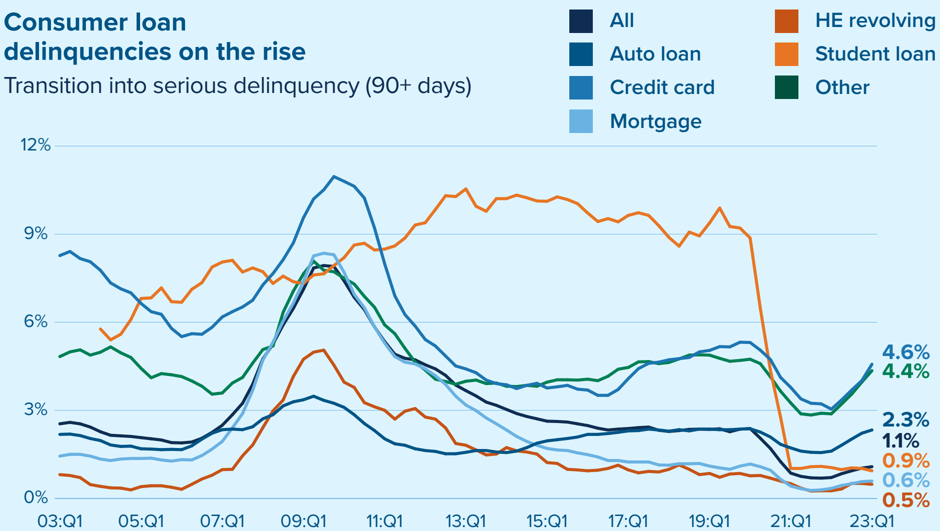
The aggressive monetary tightening campaigns by the Federal Reserve, Bank of Canada and other central banks left their mark in the first half of 2023. The recent, notable US regional bank failures, induced by deposit runs, are evidence that tighter financial conditions are beginning to have an impact.

The post-pandemic wave of corporate profits and personal savings has been a particular support to economic growth as central bank rate hikes kicked in during 2022. With inflation remaining high, the durability of these sources of support for consumption is gradually waning.

Looking ahead, financial tightening is likely to become more visible in the economy as bank lending standards tighten. Areas of consumer lending, including auto loans and credit cards, are experiencing rising delinquencies, albeit from very low levels.

Consumer loan delinquencies on the rise

Transition into serious delinquency (90+ days)



Source: New York Fed Consumer Credit Panel/Equifax, Q1 2023.

Certain areas of business lending, such as commercial real estate loans, are showing some cracks as the economics of financing some property types are now more challenging with higher yield curves and perhaps slowing demand. Commercial real estate loans represent an increasing area of credit risk for some US regional banks.

Although **the credit crunch will likely accelerate the completion of central bankers' most aggressive rate hiking campaign in decades,** investors should not pre-emptively expect an immediate shift to rate cuts. Achieving their 2% inflation target remains the priority and interest rates should remain high to reach that goal.

Credit spreads have only modestly widened over the last year, reflecting the strong profitability of non-financial businesses. The US regional bank failures have pushed bank bond spreads wider as deposits left the banking system in favour of money market funds. Systemic risks are considered low with many emergency lending supports in place. However, uncertainty of funding will pose a challenge to regional banking business models, an important source of funding to small and medium sized businesses. Higher funding costs and gradually rising credit concerns within loan books are banking hallmarks of tightening financial conditions.

Our view

We expect central banks will keep interest rates high for the rest of 2023 as they continue to battle inflation. As a result, bond yields will remain elevated, increasing financial pressure on consumers and businesses from higher interest on debts. It appears likely that reduced availability of credit will continue to slow the economy in the quarters ahead.

Economic slowdown: Where the rubber meets the road

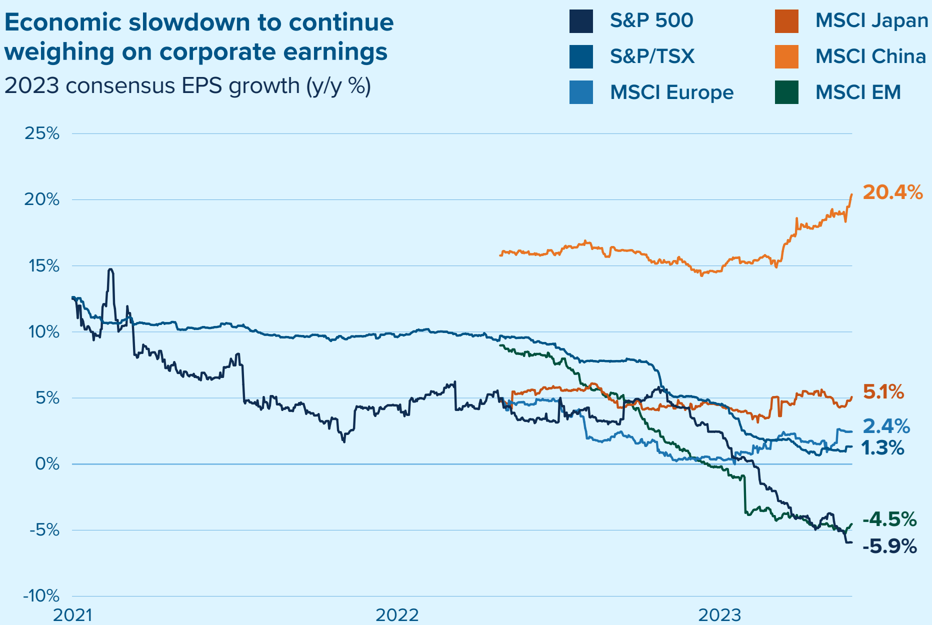
Lesley Marks, MBA, CFA
Chief Investment Officer, Equities

The global economy has demonstrated a surprising amount of resilience in 2023, leading to modest upward revisions in expectations for global growth this year. Several factors have contributed to this strength, including a strong labour market, robust consumer spending and the continuation of the post-COVID recovery.

The strength in the labour market, with low unemployment rates, has ensured that **consumers still have the ability and propensity to spend on goods and services.** A tight labour market has also helped provide wage growth across both Canada and the US — offsetting some of the pain in the pocketbook from higher inflation. Consumers have also shown a propensity to draw down savings in order to maintain spending levels.

Economic slowdown to continue weighing on corporate earnings

2023 consensus EPS growth (y/y %)



Source: Bloomberg, May 31, 2023.

The upside surprise in the economy was not just a North American phenomenon. In Europe, the economy bounced back after a tough 2022 and was aided by declining energy prices due to a warmer than average winter in the region. In China, the reopening of the economy with the exit from the zero-COVID policy that supressed growth over the past three years also provided a tailwind for global growth.

However, **we continue to believe that the future trend for global growth is clearly one of a slowdown.** In Canada, economic indicators deteriorated after a very strong January, and growth now seems to have stalled around zero. Canadians continue to be highly indebted compared with other G7 countries, making the stubbornly high interest rate levels more of a negative for growth. And while China's recovery showed early momentum, recent numbers indicate that the post-COVID recovery has been underwhelming. The labour market is also showing some cracks with a trend of declining job openings in survey data.

Our view

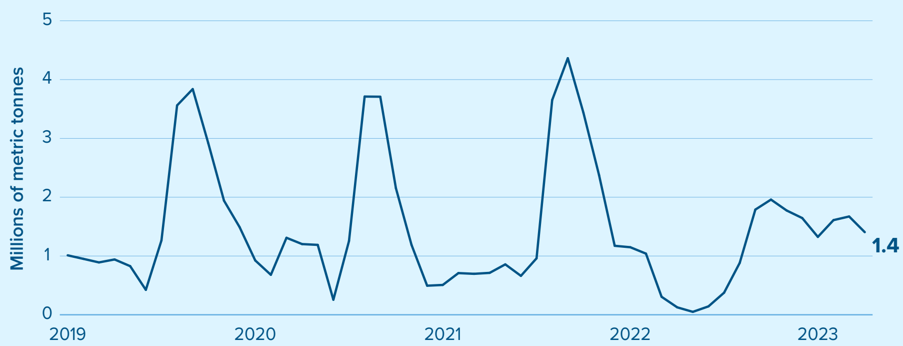
Despite the mixed signals, we continue to believe that the rapid central bank tightening and the steadfast fight against inflation we've experienced over the past 18 months will continue to weigh on the economy through the balance of this year. This will prove to be a headwind for risk assets like equities as the economic slowdown weighs on earnings growth.

Geopolitical dynamics: Fresh challenges arise

Dustin Reid, MBA
Chief Fixed Income Strategist

Higher food prices reverberating across Europe and Globally

Ukraine wheat exports, Millions of metric tonnes, monthly Jan. 2019 – Apr. 2023



Sources: Bloomberg; UkrAgroConsult; Mackenzie Investments. April 30, 2023.

In our 2023 Outlook, we noted ongoing geopolitical headwinds were unlikely to blow over. Fast forward six months or so and, indeed, the world continues to grapple with many of these issues — and a few more.

The ongoing invasion of Ukraine remains a societal and humanitarian tragedy for Ukraine, Europe and the globe; what was expected by many to be a quick and decisive incursion has turned into a long and drawn-out war.

As a result, higher food prices due to agricultural shortages from Ukrainian farmers, as well as volatile energy prices, partially as a result of sanctions on Russian resources, are now reverberating across Europe and globally. Although many European economies increased emergency energy storage this winter, the higher costs of supply shocks are having second- and third-round price implications, with eurozone core inflation climbing higher and looking more structural. **These elevated inflation levels increase the risk of the European Central Bank needing to keep rates higher for longer, and a more significant European recession in 2024.**

Additionally, we believe three geopolitical events involving China remain exceptionally relevant for global markets: reopening from its "zero-COVID" policy, de-dollarization and ongoing trade disputes.

In late 2022, we believed China would shift policy accordingly by dismantling the zero-COVID regime, while concurrently injecting a significant amount of liquidity both via monetary and fiscal channels into the economy. And while there has been more focus on regulation as opposed to stimulus of late, we continue to believe China's growth will help underpin growth in some emerging markets.

China is also playing a key geopolitical role within the de-dollarization theme. The BRICs (Brazil, Russia, India and China) dusted off their dormant alliance to puff their chest at the US and its dominant currency. While we do not foresee the US dollar imminently losing its global reserve currency status, there continues to be a push by some for competing reserve currency status over the longer term, and that pressure is not likely to abate.

The US and China also continue to tussle on technology related issues, with memory chipmakers taking centre stage in the latest back-and-forth trade dispute between the two largest global economies. As chipmakers represent a strategic input into almost all manufactured goods, the significance of any strain on this industry cannot be understated.

Our view

We believe that investors need to continue to heed the potential for elevated geopolitical concerns in their portfolios as recent key geopolitical risks have proven to have staying power but also represent high tail risk due to unpredictable potential outcomes. Asset prices are more vulnerable when there is little regard for geopolitical tail risk.

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	CHANGE*
Equity Stocks will remain volatile as higher interest rates work through the economy. The recent banking turmoil will likely result in a tightening of credit conditions, which we see as a significant headwind for equities moving forward. Although we are tactically underweight equities, we anticipate a more attractive entry point will present itself in the back half of this year, as a slowing economy will open the door to potentially easier monetary policy, setting up the next business cycle and an equity recovery.	●			↓
Canada Canadian equities trade at a much lower valuation relative to their US peers, making them attractive should we see another pullback in stocks. However, being more cyclical in nature (more closely tied to the business cycle) will make them more vulnerable as global economic growth continues to downshift.		●		↓
US US equities have held up exceptionally well in the face of a deteriorating economic backdrop. However, US equities are seen as safe havens during times of elevated market volatility and economic downturns. As a result, investors should have some exposure to the asset class despite current lofty valuations.		●		↑
International European equities have enjoyed strong gains amid an unusually warm winter season, alleviating most of the energy security concerns for the time being. The rapid reopening of the Chinese economy has lifted economic growth expectations for European and Asian economies. However, these tailwinds have been largely priced in. Although international stocks offer attractive valuations, we see the significant rise in energy prices taking an idiosyncratic toll on European economic growth, highlighted by Germany officially entering a technical recession in Q1 — others will likely follow suit.		●		↓
Emerging markets Similar to international equities, attractive valuations and an improved growth outlook amid the China reopening have provided major tailwinds to emerging market equities. However, the Chinese reopening appears to be sputtering, and the reopening trade has likely run its course. The higher volatility of emerging markets and simmering geopolitical risk warrant some caution.		●		↓

*Representing change of allocation recommendation from Mackenzie's 2023 Outlook, published in December 2022.

Fixed income

With the peak for inflation in the rear-view mirror, many central banks are taking a more cautious, data-dependent approach toward tightening monetary policy further. As a result, bond yields have come down from their recent highs, allowing for modest price appreciation. Alongside fixed-income now offering an attractive yield, bonds should outperform equities in the short term, delivering returns more in line with long-term averages in the mid-single digits.

Sovereign bonds

We continue to hold the view that rates will peak in 2023 and have positioned to a neutral duration. After years of absence, the income is back in fixed income. As economic growth slows, pressure on longer yields should abate, providing an opportunity for modest price appreciation. Sovereign bonds provide insolation from the ongoing credit crunch.

IG corporate bonds

Credit spreads briefly widened following the banking turmoil seen in March. However, spreads have come back in as fears of systemic contagion have largely abated. Still, credit conditions are likely to tighten from here as credit becomes less available and more expensive. Combined with the ongoing economic slowdown, we will likely see some further spread widening in the months ahead. Sticking to high-quality companies with strong balance sheets should provide attractive risk-adjusted returns for investment grade bonds.

HY corporate bonds

The economic slowdown and ongoing credit crunch will present a headwind for high-yield and leveraged loans. Tighter financial conditions also pose higher refinancing risks for this group. We expect some additional widening of credit spreads in 2023, and although yields appear attractive overall, we recommend sticking to higher-quality credits.

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	CHANGE*
Fixed income			●	↑
Sovereign bonds		●		—
IG corporate bonds			●	—
HY corporate bonds	●			↓

*Representing change of allocation recommendation from Mackenzie's 2023 Outlook, published in December 2022.

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