PRIVATE CLIENT SOLUTIONS

July 4, 2023

Market Commentary

Favouring a Defensive Game for the Second Half

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Favouring a Defensive Game for the Second Half

As we officially kick off the second half of 2023, we are still waiting for the long anticipated recession to appear. While we watch interest rates, economic data and inflation measures to see indicators of recession impacting the general economy, the stock market looks ahead to economic growth beyond the (possible) recession. Sometimes, however, the stock market gets a little too exuberant, and although generally focused on the longer term, the market can still be surprised in the short term.

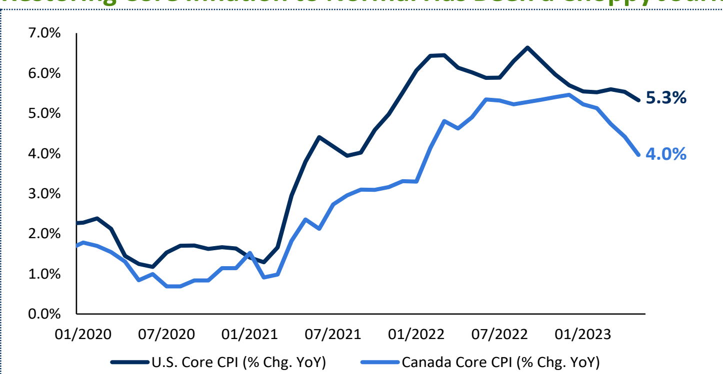
This brings us to our message this month: Regardless of whether Canada (and/or the U.S.) officially dips into recession, we are cautious about short-term negative surprises and volatility in the markets. Now, trying to time the market is a challenging game at best, and staying invested over the longer term is generally a much better strategy, especially through a well-crafted plan suited to an investor's personal objectives and risk tolerances. Staying invested also helps to avoid missing the most rewarding gains through the business cycle, which generally occur early on in the cycle, as market timers that have stepped out of the market debate whether or not to step back in.

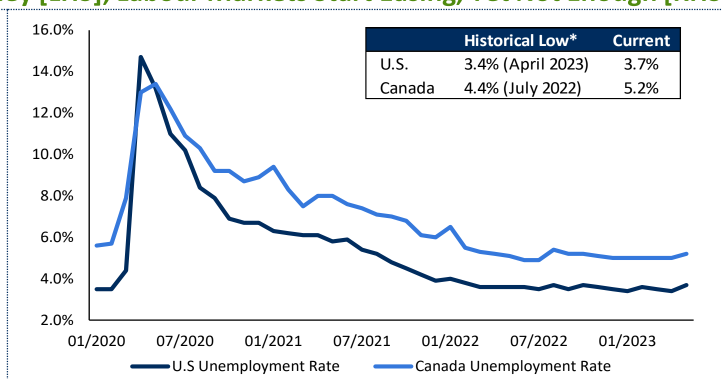
We are also optimistic about longer-term growth opportunities that might be spurred on by factors like the U.S. Inflation Reduction Act, Artificial Intelligence (AI), or an industrial resurgence in North America, as governments look to build manufacturing capacity to protect against future supply chain issues like the ones we experienced through the pandemic. With all that being said, the question is: Are there 'safe' sectors to favour during periods of market volatility and general pullbacks in the market? Looking back over 20+ years we can identify sectors that are likely to fare better than others, while allowing investors to remain invested.

Recession: To Be, or Not to Be

Just before we look at our second-half investment strategy, it's worth reviewing where the economy is currently sitting. In Canada, we saw still positive Gross Domestic Product (GDP) growth, increasing slightly from 2.1 per cent in 4Q22 to 2.2 per cent in 1Q23. April GDP was flat, but May has been estimated as being up another 0.4 per cent from April. It looks like Canada might skirt recession territory as the consensus is for growth to weaken, but remain slightly above zero per cent from 2H23 into 1Q24, before picking up again through 2H24. While in the U.S. the consensus is for a mild recession, but with an ever-shifting start date, now generally considered to be most likely in 4Q23.

Restoring Core Inflation to Normal Has Been a Choppy Journey [LHS]; Labour Markets Start Easing, Yet Not Enough [RHS]





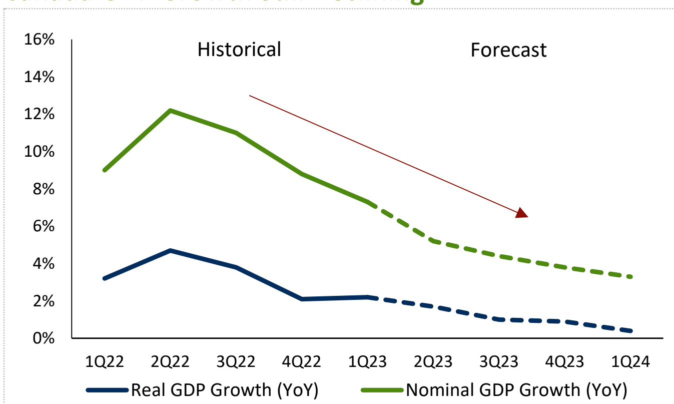
	Historical Low*	Current
U.S.	3.4% (April 2023)	3.7%
Canada	4.4% (July 2022)	5.2%

Source: FactSet; Raymond James Ltd.; Date as of May 31, 2023. *Unemployment rate historical low time frame: 12/31/1969 – 05/31/2023.

How Do We Define a Recession?

A recession is largely described as when the national economy, measured by real GDP (nominal GDP adjusted for inflation), declines for a significant period of time (usually at least six months). To fully satisfy economists, however, we generally also look for that to be accompanied by rising unemployment rates, decreasing consumer spending, and lower manufacturing output (fewer goods being produced). While recessions are a completely normal element of the economic cycle, they can be triggered by events such as the U.S. housing crash, which prompted the 'Great Recession' in 2008-09, and impacted confidence and financial sectors globally. Of course, most recently, there was no escape from the effects of the global pandemic. Since 1970, Canada has gone through six recessions (Dec 74-Mar 75, Jan 80-Jun 80, Jun 81-Oct 82, Mar 90-Apr 92, Oct 08-May 09, and Mar 20-Aug 20).

Canada GDP Growth Still Declining



Source: Capital Economics; Raymond James Ltd.; Data as of June 30, 2023.

The Bank of Canada (BoC) has been projecting approximately one per cent growth in 2023 for some time, avoiding a recession in Canada, and giving it leeway to keep interest rates higher for longer to tackle the stickier-than-expected inflation problem. Annualized real GDP growth (YoY) increased slightly from 2.1 per cent in 4Q22 to 2.2 per cent in 1Q23. Deputy Governor Paul Beaudry noted that the BoC was particularly surprised by growth in household spending on both goods and services. The BoC had expected to already see declines in spending on travel, entertainment, and at restaurants, and more particularly in goods that are normally more sensitive to higher interest rates, such as furniture and appliances. There has also been some strength returning to the housing market. With tight housing supply, the concern is that higher prices further fuel inflation, hence the still real risk of further rate hikes, putting further pressure on consumers, which could still push the economy into a recession.

While we normally also look for a rising unemployment rate as an indicator of recession, the tight labour market leading to wage inflation is more of a concern as the BoC's inflation battle rages on. Although there have been slight increases in the unemployment rate in both the U.S. and Canada, joblessness is still at an extremely low level, which allows the Fed/BoC to tolerate a greater increase in unemployment compared to previous rate hiking cycles.

Favouring Defensive Sectors

Getting back to investment strategy in this environment, rather than looking back to recessions in the 1970's and 80's, we thought it would be more useful to examine periods since 2000 wherein we saw declines of over 15 per cent in the TSX Composite benchmark. There were seven such periods, including three instances where the market fell more than 25 per cent, those being the Great Recession of 2008-09, the Tech Bubble Bursting of 2000-02, and the Pandemic Pullback in 2020. While certain sectors can be driven by specific factors in each time period, overall, we generally see **consumer staples**, **communication services**, and **utilities** being the most consistently 'safest' places to be invested, or at least the sectors that fare better than average.

S&P/TSX Comp Historical Drawdowns > -15%

Source: Bloomberg; Raymond James Ltd.; Data as of May 31, 2023. Drawdown periods are specified in the following table.

Defensive Sectors Generally Outperformed During Significant Market Downturns

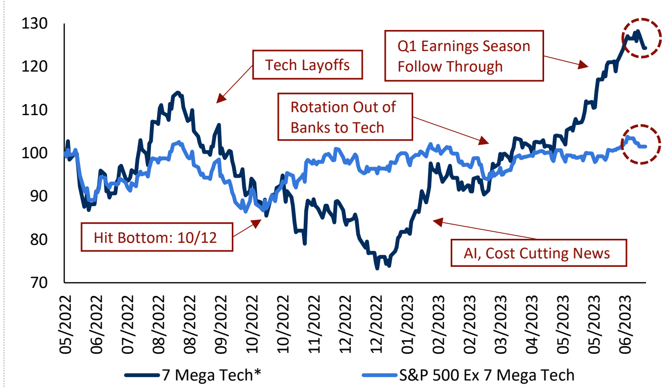
	9/2000 - 10/2002	6/2008 - 3/2009	4/2011 - 10/2011	9/2014 - 1/2016	7/2018 - 12/2018	2/2020 - 3/2020	3/2022 - 10/2022
Duration (Months)	25.2	8.7	6.0	16.5	5.4	1.1	6.5
Canada S&P/TSX Composite	-50.0	-49.8	-21.7	-24.4	-16.8	-37.4	-17.6
Consumer Staples	51.9	-11.4	-2.9	28.8	-3.0	-23.4	-2.7
Utilities	37.2	-34.0	-1.0	-9.8	-10.7	-37.9	-15.8
Communication Services	-49.9	-32.9	3.6	3.6	-4.0	-28.4	-18.9
Real Estate	12.5	-56.6	-8.8	-1.9	-9.3	-47.4	-26.6
Financials	-4.9	-53.0	-17.3	-15.9	-13.6	-39.9	-20.6
Materials	-0.3	-43.2	-23.3	-40.3	-14.3	-23.8	-22.0
Consumer Discretionary	-39.7	-37.0	-17.0	-4.3	-24.0	-44.6	-7.6
Industrials	-45.9	-47.2	-19.7	-22.1	-15.7	-30.7	-10.6
Energy	19.8	-54.8	-30.2	-50.7	-29.2	-52.1	-5.9
Health Care	-51.1	-27.3	-25.4	-3.8	-18.0	-42.6	-55.8
Information Technology	-96.3	-65.4	-42.9	19.0	-20.1	-27.0	-39.3

Source: Bloomberg; Raymond James Ltd.; Sectors are ranked by historical drawdowns (descending).

Are We in a New Bull Market?

A lot of headlines have pointed to a new bull market in the U.S., evidenced by the S&P 500 index gaining 20 per cent from its lows in October 2022. We could debate if we should base that assessment on an index that has been driven primarily by seven tech stocks, or if we should consider a broader base of stocks before making that call. The S&P 500 equally weighted index is up a slightly more modest 15 per cent over the same period. We have indeed seen improvement since October, with some broadening in the U.S. market, but it may be a little too optimistic to expect consistently strong markets just yet. For now we are still waiting to gauge the short-term effects as interest rate increases work their way through the economy and the potential impact to various companies' earnings, revisions, and outlooks over the next couple of quarters.

Reality Check: U.S. Market's Optimism Clashes with Looming Economic Slowdown



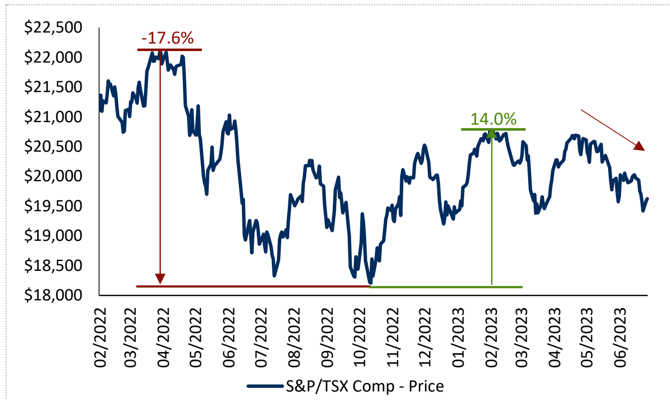
Source: FactSet; Raymond James Ltd.; Raymond James Research; Data as of June 27, 2023 (indexed, 5/31/2023 = 100). *Seven mega tech stocks: Apple Inc., Microsoft Corporation, Alphabet Inc., Amazon.com, Inc., NVIDIA Corporation, Tesla, Inc., Meta Platforms Inc.

Watch for More Volatility in 2H23

In Canada, we saw the TSX Composite dip (17.6 per cent off its March 2022 high) to its most recent low in mid-October 2022 as recession concerns mounted. The TSX Composite peaked at around 14 per cent above the October lows in February 2023, but has now given up half that gain, as economic slowdown concerns return.

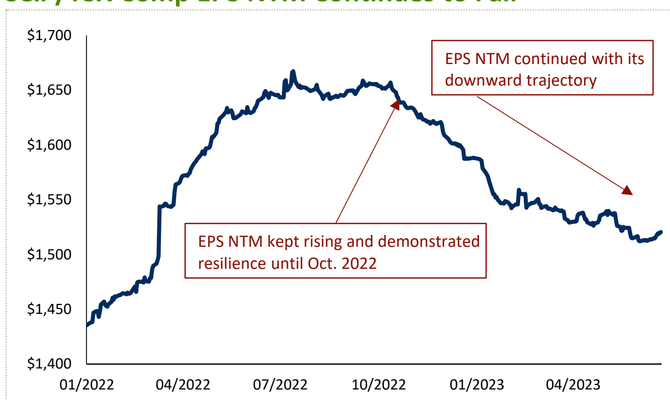
Following a difficult pandemic period, many companies came into 2022 setting low expectations. After a relatively good rebound, we saw a lot of positive revisions, including in March 2022, as oil prices spiked and energy sector EPS forecasts climbed, followed by gold spiking to US$2,000, driving up materials forecasts. Although markets sold off through the middle of 2022 as recession fears mounted and interest rates started to rise, by October we saw the start of negative earnings versions that have broadly continued. Now, as we are about to get into Q2 earnings season, analysts are a bit more conservative as the continuing interest rate hikes impact economic activity (on a 12- to 24-month lag), and we wait, once again, for the impending recession to more significantly hit things like discretionary consumer spending. As earnings expectations come down, the market can react to negative surprises and/or decide to look further ahead to a new economic cycle post-recession, hence the potential for increased volatility.

Recession Concerns Have Impacted Canadian Markets



Source: FactSet; Raymond James Ltd.; Data as of June 27, 2023.

S&P/TSX Comp EPS NTM Continues to Fall



Source: FactSet; Raymond James Ltd.; Data as of June 22, 2023.

Final Thoughts

As the market/economy moves closer to the end of this cycle and into an eventual/potential recession, we believe the defensive sectors (consumer staples, communication services, and utilities) are where equity investors should be focused, within the broader context of well-balanced and risk-appropriate portfolios. As history shows, the defensive sectors – and in particular companies that have durable business models, a sustainable competitive advantage, and high profitability – have performed the best during these types of challenging periods.

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