Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Investment Themes for 2022

Contents

As we embark on a new year, which so far has been anything but sunshine and rainbows, we thought it would be helpful to highlight several investment themes our research teams in Canada and the US have highlighted recently and which we also view as interesting for 2022. **<u>We remind investors to focus on the long-term and leverage periods of volatility to allocate capital towards high-quality and durable investment ideas/themes.</u>**

What's on Our Radar?

- **US Housing:** population movements are driving historic housing demand, which we expect to remain robust for years to come, in particular homebuilding, and we expect companies throughout the residential construction supply chain to benefit (e.g., Canadian lumber companies, US home builders, etc.).
- **Semi-conductors/Hardware:** recent price increases could remain sticky even though many are looking for the "end of the cycle" on units, but we expect companies are likely to experience benefits from price increases for the first time in their history.
- **Commercial Insurance:** following a record year, we expect the earnings trend to be strong in both Canada and in the US.
- **Asset Sensitive Banks:** as rates go up, asset sensitive banks and smaller banks do better than larger (larger banks tend to do better earlier in recoveries). In Canada, we still prefer the big five.

US Housing Fundamentals Remain Strong; less upside for Canadian Housing

The US housing "super-cycle" is still in its early innings with years of growth ahead according to our research team. Here in Canada, we believe housing is much later in the cycle and thus see less upside, though supply challenges and strong demand will continue to persist for the foreseeable future and thus a likely tailwind for the market. Concerning US housing, our team's constructive outlook for the sector includes:

- Positive household demographics, economic growth, and secular shifts in lifestyle preferences – housing demand will outstrip industry production capacity well into the foreseeable future.
- US home prices and effective rent levels, while decelerating from 2021 levels, will both grow above historical trends and likely outpace core inflation in the U.S. economy. The outlook for continued home price appreciation is notably above current consensus projections in the US, with a softer outlook in Canada for 2022.
- Supply chain disruptions will gradually ease as the year progresses, only to be replaced by increasing shortages of skilled construction labour that will prevent more robust growth in total housing starts.
- Mortgage rates will steadily rise in 2022, but at a controlled pace. Affordability will remain reasonably balanced across the US, versus the opposite extreme in Canada with very low levels of affordability observed across the country.

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Semiconductor/Hardware Price Increases likely to Remain Sticky in 2022

Following a mixed performance year for semiconductor stocks, we expect the outlook to remain strong for the broader group for the following reasons:

- Demand continues to far outstrip supply across all semi suppliers and nearly all verticals. While lead times have broadly begun to stabilize, hot spots remain for certain components, and we have not yet approached a supply/demand balance.
- Investment in building out new capacity is in progress, but the long lead times to actual production will keep supply tight through 2022, with most suppliers seeing tightness well into 2023.
- Supply constraints are leading customers to provide longer-term visibility into orders/backlog, including some binding long-term supply agreements or cash deposits – longer-term visibility provides greater security in forecasting demand.
- For the first time ever, the industry is investing in building out incremental capacity for lagging edge process nodes and technologies, which means these products will no longer be running on fully depreciated equipment – driving structural costs, which is set to keep pricing at a premium for several years out. **While we expect a return to normalized annual price declines once supply eases over time, suppliers will never be able to return to the same lower cost structure.**

US Commercial Insurers Likely to See Upside in Earnings following a Banner 2021

The US insurance brokerage industry had a strong performance year in 2021, with the S&P 500 Insurance group up +30%, outperforming the S&P 500 index. We expect another solid year in 2022:

- According to recent Market Scout data, commercial rates increased by 5.8% in 4Q21, compared with 6.8% in 3Q21 and 7.1% in 4Q20. Even though rate increases have peaked, recent results suggest that current pricing exceeds loss cost trends which should lead to strong underwriting results over next 24 months.
- The Raymond James commercial insurance coverage has outperformed broad market indices on a year to date basis and we expect the outperformance to continue through the year as past rate increases continue to flow through the financials, driving improving underwriting results.
- We expect income from investment in partnerships to normalize in 2022 with some offset from the rising interest rates.

Owning the Banks (US & Canadian) Amid a Rate Tightening Cycle

We remain bullish on the banking sector as the economy continues to re-open and the worst of the pandemic is in the rear view mirror (we hope); this includes both US and Canadian banks. In Canada, the banks represent 23% of the S&P/TSX index.

- Several of the key catalysts we have been watching for have manifested, including improving credit, accelerating M&A and increasing capital return. Looking ahead, we see an increased likelihood of rising rates and accelerating loan growth, which are two key catalysts investors are watching for to increase sector weightings.
- We see several catalysts which could lead to positive EPS revisions throughout 2022, including bottoming and expanding net interest margins, further consolidation in the industry, continued capital return, and accelerating loan growth.
- Given the rebound in bank stocks, valuations have returned closer to normal levels, although there remains potential for expansion in our view should rates begin to rise as the Street expects.
- While a “rising tide will lift all ships” in a rising rate environment, we still believe it to be a “**stock picker’s market” for the banks** and generally see greater upside potential in smaller banks vs. their larger brethren. This is largely driven by stronger organic loan growth potential, less regulatory risk, the likelihood for faster liquidity deployment, and solid M&A activity. We currently favor banks that are set up well for post-pandemic life, including those that have better-than-peer growth prospects, are positioned to benefit from rising rates, have differentiated technology/digital platforms/strategies vs. their peers, and/or heightened capital return potential (including share repurchases, increased dividends, and/or opportunistic M&A).

Final Thoughts for Investors

We see several interesting themes unfolding in 2022 as the US, Canadian and global economies move further into the recovery. We continue to maintain a bias towards cyclically oriented investment themes and suggest investors remain selective and opportunistic during periods of volatility.

Nadeem Kassam, MBA, CFA, Head of Investment Strategy

Thematic Stock Ideas for 2022

Thematic investing is a top-down investment approach that targets companies with exposure to certain long-term trends or themes. Themes can range from structural or macroeconomic trends, to ones related to specific target markets. In this article, we highlight a few ideas that have exposure to some of the major investment themes we have identified for 2022, focusing on our highest conviction ideas, and Raymond James analysts' Strong Buy-rated large cap names (SB, +$10 bln).

A Rising Tide lifts all Boats

Homebuilders, as their name suggests, directly benefit from increased demand for new homes as they are primarily responsible for the construction and selling of new residential properties. Raymond James SB-rated homebuilders like **D.R. Horton (DHI-US)** and **PulteGroup (PHM-US)** are solid beneficiaries of increased housing demand. After homes are sold, companies like **Home Depot (HD-US)** benefit from the spending habits of homeowners making renovations. Whether the homeowners prefer to "DIY" or utilize professional contractors for their projects, both drive Home Depot's revenue. Lumber also plays a big role in both new home builds and remodeling/renovation. Lumber prices have been an accurate reflection of housing market strength since the onset of the pandemic, up over 150% from the end of 2019, with lumber producers benefitting from increased lumber demand. **West Fraser Timber (WFG-CA)**, which is SB-rated and on the Analysts' Best Picks for 2022 list, benefits from strong lumber prices.

Got Energy?

Investors can gain exposure to the energy sector by owning companies on both ends of the risk spectrum. On the more risky side, we have the oil and gas producers, which are the price takers, and are inherently more cyclical and volatile as they depend directly on the price of the commodity. On the other end, we have pipeline companies, which we view more like utilities because of the more predictable nature of their cash flows. These companies are involved in the transportation and storage of the commodity. Comparatively, pipeline companies are more defensive and less volatile than the producers. Our preferred names among the pipelines include SB-rated **TC Energy (TRP-CA)**, and **Enbridge (ENB-CA)**. Among the oil & gas producers, we like oil-weighted **Canadian Natural Resources (CNQ-CA)**, also on the Analysts' Best Picks for 2022 list, and SB-rated gas-weighted **Tourmaline Oil (TOU-CA)**.

One Order of Chips

The high demand/low supply backdrop that characterizes the semiconductor chip industry today makes their manufacturers, which also have exposure to secular growth trends, attractive names to own. Trends in video gaming, data centers, internet of things, autonomous driving, and 5G, among others, have long runways for growth. Companies such as SB-rated **NVIDIA (NVDA-US)** and **Qualcomm (QCOM-US)** are strong beneficiaries of these trends.

Elsewhere in the World of Technology

Fintech is technology meant to improve the delivery of various financial services. Payment processors like **Visa (V-US)**, **MasterCard (MA-US)**, and **Fidelity National Information Services (FIS-US)** are at the forefront of some of these improvements and also benefit, in part, from an improving consumer spending environment, secular growth trends in ecommerce, and a resurgence in international travel after COVID-19 impacts. RJA's financial technology & payments team views Fidelity National Information Services and MasterCard as top large cap SB-rated names and Visa as a high conviction idea.

All aboard the Rate Plane

Banks and life insurers are positively correlated to rising interest rates. Banks benefit from rising interest rates as their net interest margins (spread between rates charged on loans and interest paid on deposits) expand, helping enhance profitability. Life insurance companies benefit as they reinvest their policyholder premiums into higher-yielding bonds, thus improving a lifeco's overall investment returns. Our top picks among the banks include **Royal Bank of Canada (RY-CA)**, **Toronto-Dominion Bank (TD-CA)**, and **JPMorgan Chase & Co. (JPM-US)**; and **Sun Life Financial (SLF-CA)** among the life insurance companies.

Conclusion

When picking stocks, focus on high-quality companies with a competitive advantage, which generate strong free cash flows, have management teams that invest in high return opportunities, and with solid growth prospects. Learn more about the companies highlighted above and how each company's products or services relate to each theme. We also want to remind investors of the inherent volatility of some themes such as energy or fintech, and emphasize the importance of diversification in reducing portfolio risks.

Larbi Moumni, CFA
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Diversification – Your Best Friend in Turbulent Times!

Those who follow the markets closely know that it has been a rocky start to 2022. Some names within the S&P 500 index that saw tremendous growth in the last few years, including Netflix, Moderna and Etsy, have all experienced significant drawdowns of more than 30% (at the time of writing) since January 1, 2022. While cherry picking names that have experienced a recent drawdown does not show the full picture, the point is significant volatility can exist for single securities. While most major indices are down to start the year as well, a benefit of owning a basket of stocks is a reduction in risk, and a smoother ride in comparison. This article will show how funds and ETFs can diversify your portfolio while lowering your overall volatility and how reducing volatility may help you remain invested during difficult times.

Power of Diversification

Investors today have more choice than ever when it comes to putting their hard-earned dollars to work. They can choose to “own the market” through index funds, or access some of the most brilliant investing minds through both mutual funds and ETFs (funds). These investment vehicles offer instant diversification with low barriers to entry. One of the best examples of this diversification, in my opinion, is in the Canadian bond market. It is next to impossible for an individual investor to own all of the underlying constituents of the FTSE Canadian Bond index. There are too many names, many of which are illiquid, and it would simply require too much capital to invest. For a current share price of approximately $15 and a management fee of 8 basis points or 0.08%, investors can purchase the **BMO Aggregate Bond Index ETF (ZAG),** gaining instant access to the entire Canadian bond market.

The same is true of course for equities, for mostly every combination of equity market exposure, both from a sector basis, to different geographies and styles, available in an ETF for a few basis points. As your portfolio begins to hold more names, you benefit from the statistical law of large sample sizes and normal distribution, e.g., the frequency and duration of large negative events typically goes down. A drawback of funds is that they can be boring. Well-diversified portfolios tend not to be up multiple hundreds of a percent in a given year as some stocks can be. However, these boring characteristics are precisely what we are after. Continuously compounding a reasonable rate of return over a long time horizon, while staying invested and avoiding significant drawdowns, is an excellent way to build long-term wealth. Sounds complicated, but in fact, it can be surprisingly simple.

The Benefits of Money Management

One of the most difficult things to do in the face of turbulent markets is nothing - remain invested and remain consistent. Watching hard-earned gains disappear can be difficult, and it might be tempting to move your portfolio towards cash. There is at least one major consideration in a decision to go to cash; you need to be right twice. The first decision you need to be right on is when you should go into cash, and the second decision is when to get back into the market. Just like drawdowns, a significant portion of long-term gains tends to be associated with sharp rebounds. If you miss the rebound, it can be difficult to make that lost investment opportunity back. Our view is that remaining invested is not only easier but often the best decision when facing difficult market times. We are not alone in this view. Market timing decisions are exceptionally difficult decisions to make; so much so, that many of the most skilled money managers in the world do not try. They simply remain 100% invested at all times.

One of the key benefits of owning either an active fund, a model portfolio, or market index vs individual equity names is not having to consider the timing of these decisions. It is typically a requirement for fund managers and indexes to be fully invested, with of course a little latitude around portfolio liquidity. Therefore, during difficult markets, these managers are actively searching for new opportunities rather than worrying about market timing. They instead focus on long-term trends, market dynamics and company fundamentals. They look to determine who are the quality names in the market today that can be purchased at a discount? Periods of market stress often represent exciting opportunities to get into names that simply did not exist the day before. Said differently, the requirement to follow an investment process while being fully invested can remove a significant hurdle for most investors in times of trouble.

Putting it all Together

Funds and ETFs provide an excellent opportunity for investors to diversify their holdings. These investment vehicles can provide exposure to market segments that may otherwise be inaccessible, and investors benefit from the expertise of skilled managers who are deft at navigating difficult markets. Times of market turbulence can provide investors an excellent opportunity to evaluate their current goals and portfolio, but sometimes doing nothing is the right choice.

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USD/CAD Amidst Hawkish Holds

January 26, 2022 saw two heavy-hitting central banks, the Bank of Canada (BoC) and the Federal Reserve (Fed), take center stage. Market participants were on their toes to see how BoC Governor Macklem and Fed Chair Powell would navigate their respective central banks through the recent whirlwind of market volatility, COVID-related risks to the economy, and provide some clarity on their projected forward guidance. As currency markets were also patiently waiting to digest and adapt to this new information, while fine-tuning their expectations going forward, we find it prudent to pause to unpack the results and analyze the current landscape to determine the implications for USD/CAD on the road ahead.

Hawkish Holds from Both the BoC & Fed

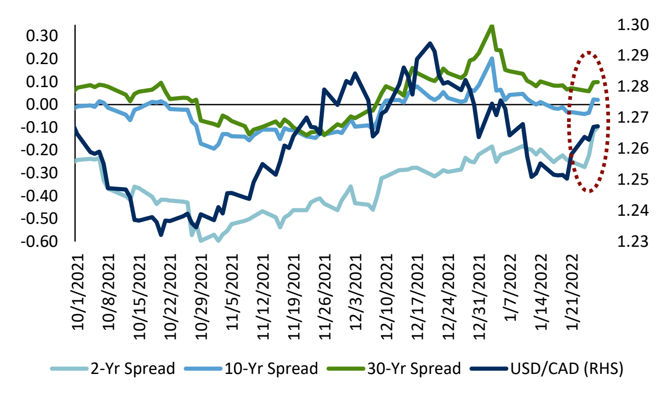
Heading into the BoC meeting, the market was pricing in an aggressive 70% chance of a rate hike. While market spectators were incorrect in the end, BoC Governor Macklem did project one of the most hawkish tones from a BoC head in recent memory. In his opening statement at his press conference, he said interest rates will be heading higher in order to control inflation and that Canadians should, rightfully, be prepared for it. The BoCs quarterly Monetary Policy Report stated that the economy is at full capacity, the labour market is tight, wages are rising and consumer demand is strong. **Needless to say, the market has fully priced in a 25bps rate hike for March, and a total of six hikes for the year.**

While the decision and accompanying statement were largely in line with market expectations heading into the meeting, Fed Chair Powell's press conference was when the fireworks started. According to Powell, there's "quite a bit of room" to raise rates without damaging the labour market and he cannot rule out raising rates at every FOMC meeting. Moreover, as a subtle nod to market expectations for the path of interest rates, he made it clear that he feels the Fed's communications with market participants "are working." All in all, he affirmed the market's path expectations for rates, set up a rate hike for March, and even went as far as releasing a separate note titled "Principles for Reducing the Size of the Federal Reserve's Balance Sheet." This will serve as a preliminary guideline for market participants as the Fed begins the process of allowing bond maturities to run-off and the eventual shrinking of its balance sheet. Markets have also fully priced in a 25bps rate hike for March in the US, with a roughly 20% chance of a whopping 50bps hike, and a total of five hikes for the year.

USD/CAD Being Pulled from Both Sides

The market continues to anticipate the BoC will be embarking on a modestly more aggressive rate hike cycle than the Fed, with an eventual terminal rate that is higher as well. WTI is also up nearly 40% since December of last year, which is always an important driver for the loonie, and CAD is still the only major G10 currency in the green against the USD over the last 12 months, albeit only modestly. More robust risk sentiment and higher crude should provide CAD with some protection against a stronger USD, even as US/Canadian yield spreads narrow.

USD/CAD Catching a Lift from Narrowing Spreads



Source: FactSet; Raymond James Ltd.; Data as of January 27, 2022

Front-end US/Canadian yield spreads will be an important indicator for USD/CAD performance as yields continue to adjust to upcoming rate hike expectations. As far as the USD is concerned, we believe a bullish repricing of the Fed's end point for rate hikes, or the "terminal rate", and the continued push higher in US real yields, which are at their highest levels since mid-2020, can be important tailwinds for the USD in the short term. This will pose problems for low-yielders like the EUR and JPY, with the former trading near mid-2020 levels against the USD at the time of writing. However, the "long USD" trade has quickly become the consensus trade amongst many, with speculative net USD long bets at their highest levels since before the pandemic. Given the various macro themes at play and the fine-tuning of market expectations as it relates to central bank policy, we may see some elevated two-way risk for USD/CAD and the broader USD. We anticipate USD/CAD to test the waters within the 1.28-1.29 range in the short term, which may present a good opportunity to take some profits off the table seeing that the pair has managed to have only short stints within this range going back to December 2020.

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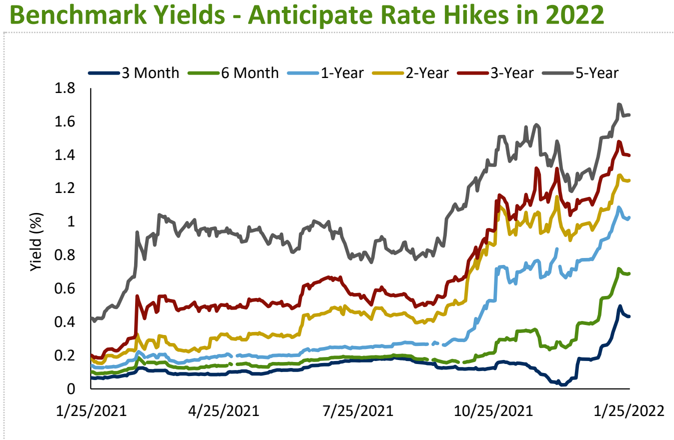
Foreign Exchange

Holding Off on the Hike

Inflation has been a headline story for quite some time now, proving it had more staying power than first anticipated. Hot inflation is largely due to ongoing factors brought on by the pandemic, like supply chain bottlenecks, labour shortages, and rising commodity prices. As the view of higher-than-average inflation shifted from a transitory pressure to a longer-term concern, central banks (including the BoC and US Fed) began to adjust their policy stances. Outlooks have shifted more hawkish, whether it be shown directly through their actions, or in their commentary. Such changes suggested that higher interest rates were coming, and by the start of the New Year, it was not a matter of if the BoC would raise rates, but when. To assist investors as we move into a rising-rate environment, we recap how the fixed income market has responded so far, what we can expect as higher rates materialize, and how to reposition an existing bond portfolio to better perform in the coming period.

In the last quarter of 2021, confidence in rising Canadian interest rates began to grow. In response, fixed income yields increased and the curve steepened from one year to approximately five years out while the long end moderated slightly. With yields and bond prices holding an inverse relationship, prices fell to compensate for rising yields. Current consensus expectations are for six rate hikes in 2022, with some predicting that the overnight rate may exceed pre-pandemic levels by the end of the year.

Benchmark Yields - Anticipate Rate Hikes in 2022



Source: FactSet; Raymond James Ltd.; Data as of January 26, 2022

At their first scheduled meeting this year (January 26), the BoC decided against raising interest rates, instead holding the target overnight rate at 0.25%. Although the BoC did not begin their hiking cycle, they did acknowledge that the global recovery is strong, that slack in the Canadian economy has been absorbed, and that "interest rates will need to increase", signalling that a hike should come soon.

What can investors expect as rates rise in the near future? Although a steeper curve coincides with a rising rate environment, we have already seen an impressive change to the shape of the curve. Going forward, it is predicted that the spread between 10-year and 2-year investments will stay consistent to flatten slightly. We also expect the following will happen:

- **Higher yields** - yields across the curve should continue to increase to match rate expectations.
- **Tighter credit spreads** – credit spreads are tighter in healthy expanding economies, all else being equal.

As the yield landscape evolves, many bondholders may have questions concerning the existing fixed income positions in their portfolios. We suggest that if you are comfortable with the purchase yield to maturity (YTM), do not anticipate needing to sell the position prior to maturity, and believe in the creditworthiness of the company, hold onto the position. Remember that although price volatility will increase going forward, you will maintain your YTM and will receive face value back at maturity. However, if you might need to sell the position before maturity, or the term to maturity is rather long, consider shortening your duration by switching to a shorter-dated issue. We do not view credit quality (within the investment grade space) as a concern at this time, especially for shorter-termed investments. In fact, credit spreads often tighten in healthy economic times.

If you have been holding onto excess cash waiting for rates to rise, look at bonds in the one to three year range, as we see this spot balancing the need to generate a meaningful level of returns with having your capital return sooner rather than later to (hopefully) reinvest at higher prevailing rates. The recent rise in yields has changed the relative attractiveness of some products – for example, bank bonds with convertible provisions (NVCC, bail-in debt) now carry rates that rival GICs. Despite the lack of insurance guarantee, investing in bonds provides higher liquidity, making them more suitable for many investors. 2022 should see the emergency measures that were put in place at the start of the pandemic largely be removed. But where to next? It is hard to say for sure, but we can be certain that the BoC will rely on economic data to guide their next steps, not put the hiking cycle on autopilot. They will look for signs of inflation moderating, while maintaining the economic recovery. We anticipate that the path forward will not be a straight line, but we are ready for the climb.

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VP, Fixed Income & Currencies

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