Insights & Strategies

PRIVATE CLIENT SOLUTIONS

September 1, 2022

Contents

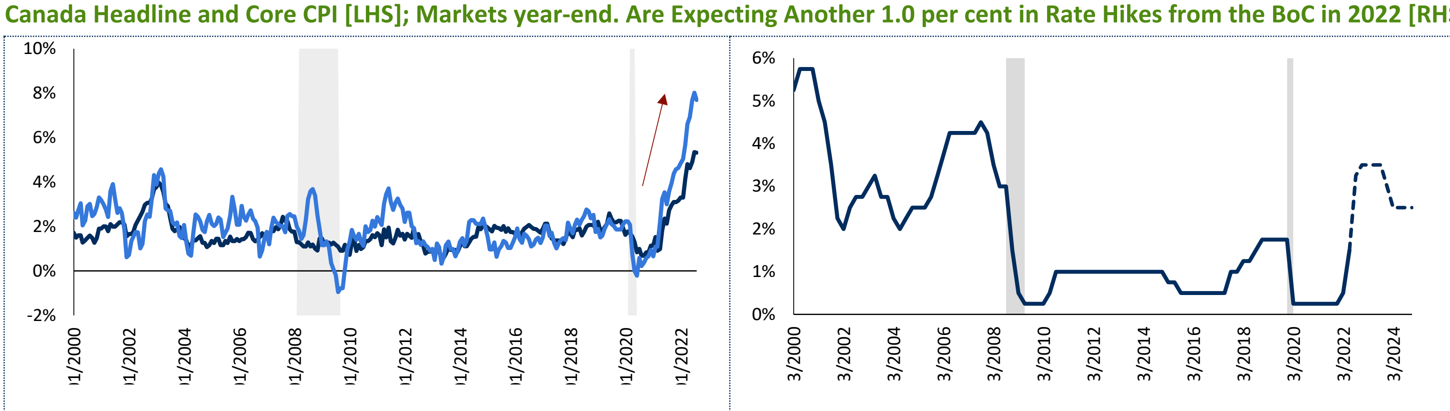
Inflation Fever Breaking?

We are now eight months into the year, and it is not surprising that the "inflation fever" is still top of mind for most. While it's reassuring to see that inflation fever is moderating, albeit from 40-year highs, we believe it is a bit too premature for investors to assume that the return towards more normal levels of inflation will be a smooth descent from the peak. Rather, we expect the path forward to be a volatile one with many ebbs and flows along the way.

As we touched on briefly in our January **Insight & Strategies report,** we anticipated inflation to remain elevated and above the long-term trend of two to three per cent for longer than most were expecting, with risks to the upside rather than to the downside. Fast forward approximately two months following the release of our January report, we have a war raging in Europe with the Russian invasion of Ukraine. This unprovoked invasion of a sovereign nation resulted in a slew of global sanctions imposed on Russia, the Kremlin, President Vladimir Putin, and many close allies to Russia. This, coupled with the continuation of a widely unpopular zero-COVID-19 policy in China, resulted in the exacerbation of ongoing supply chain disruptions that have become a norm since the start of the pandemic. To state the obvious, these two independent events resulted in an upside surprise to inflation expectations, which few were expecting, and prompted central bankers globally to act more forcefully with rate hikes.

While we have seen some moderation in inflationary pressures more recently, including in the July Consumer Price Index ("CPI") report (CPI rose +7.6 per cent year-over-year ("YoY") versus expectations of +7.6 per cent YoY and versus the June CPI release of +8.1 per cent YoY), the details of the report gave us little comfort to change our outlook on the path of inflation. In particular, the month-over-month decline was primarily driven by a drop in gasoline prices, while several other components of the CPI basket continued their ascent higher including food prices and the prices of services most impacted by the pandemic (incl. hotels, air transportation and restaurants). Since the Bank of Canada ("BoC") pays particular focus to the core CPI – which excludes volatile components such as energy and food – when it comes to making monetary policy decisions, we expect the continued uptick in the cost of services to keep the BoC anchored in their hiking path into year end. As shown below, markets are currently expecting rates to rise another +1.0 per cent by year-end.

Canada Headline and Core CPI [LHS]; Markets year-end. Are Expecting Another 1.0 per cent in Rate Hikes from the BoC in 2022 [RHS]

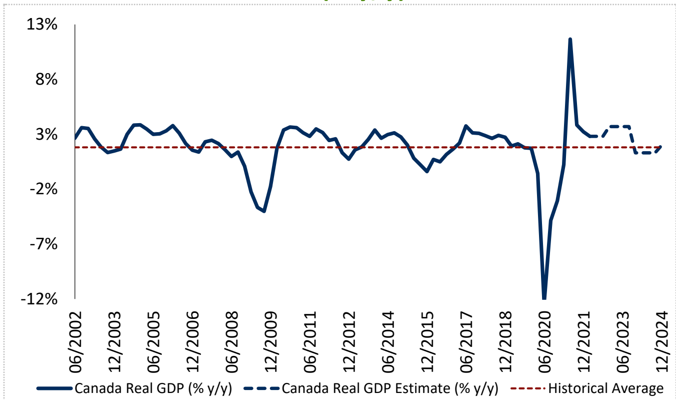


Source: FactSet; Capital Economics; Raymond James Ltd.; Canada CPI as of July 31, 2022; Canada Policy Rate as of June 30, 2022, updated quarterly; Canada Policy Rate Estimate as of August 26, 2022.

Intended Impacts from Higher Rates

As we discussed in the August edition of the Insights & Strategies report titled "**Winter is Coming**", rate hikes still remain the primary tool that central banks, including the BoC, have at their disposal to combat inflation. The challenge with this approach, however, as we have discussed ad nauseam, is that rate increases while useful in slowing down the broader economy (real GDP growth is expected to increase by +3.5 per cent in 2022, and +1.8 per cent in 2023, but down from +4.7 per cent in 2021), they do little to influence vital structural challenges such as supply-side inflationary impulses across the economy.

Canada Real GDP Growth (% y/y)

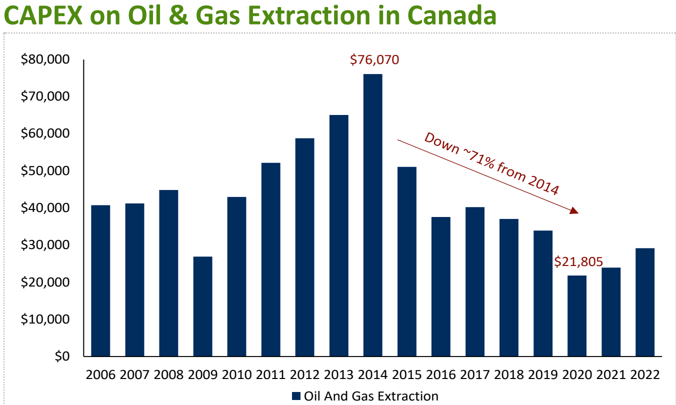


Source: Capital Economics; Raymond James Ltd.; Canada GDP Growth as of March 31, 2022. Canada GDP Growth Estimate as of August 9, 2022.

Energy Prices – Structural Issues

Since 2014, investment in the Canadian Oil and Gas sector has slowed significantly. While we can point to many factors that have contributed to this unfortunate trend – we will save the details and discussion for another piece – the reality is, the significant underinvestment in this sector by companies since 2014 will not be addressed overnight. Furthermore, higher rates will do little to influence/encourage more supply.

CAPEX on Oil & Gas Extraction in Canada

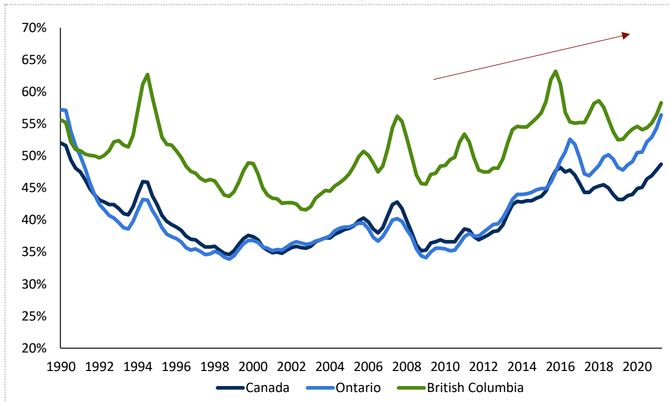


Source: Statistics Canada; Raymond James Ltd; Data as of February 25, 2022.

Shelter Costs – Another "Real" Structural Challenge

With interest rates up over 2.25 per cent since the beginning of 2022 and expectations for further increases on the horizon, home prices have begun their decent from very extreme levels. However, that said, affordability has only worsened as carrying costs have risen, while the persistent shortage of rental stock/supply, coupled with an increase in demand from those steering away from home ownership because of higher mortgage rates, has sent rental costs soaring higher. As shown below, the trend has been only higher for shelter costs as a percentage of disposable income as rates have increased. We believe higher rates will unfortunately do little to resolve these cost pressures over the near term and in our view will keep the Canadian inflation rate above trend for longer.

Shelter Cost as a Share of Disposable Income



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

Investor Recommendations

Against this backdrop of structural inflationary challenges, which have only worsened since the pandemic, we expect a much more volatile path back towards a more normal inflationary environment, with inflation remaining above the neutral rate of two per cent for longer. In this environment, we suggest investors consider some of the following for their portfolios:

- Remain selective and focus 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 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
Eve Zhou, Multi-Asset Analyst

Getting Defensive Using Risk Metrics

Positioning an equity portfolio for the probability of a recession can be a daunting task. Adding to defensive sectors like consumer staples, communication services, real estate, health care, and utilities can help reduce downside risk, but will not eliminate it altogether. Another useful approach that can be taken in selecting defensive equities is by leveraging various risk metrics in order to find those with favourable characteristics.

Methodology & Screening Process

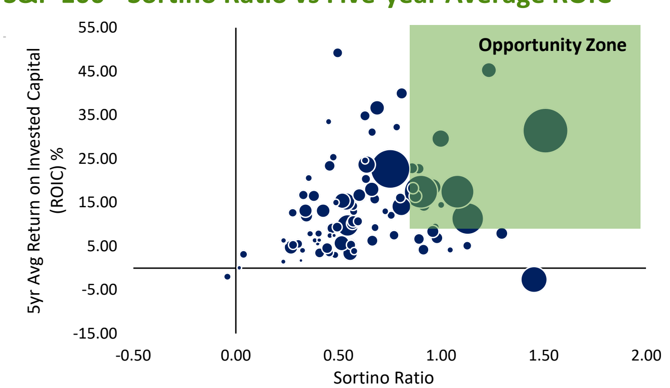
To identify quality companies with favourable risk characteristics, we will look at their Sortino ratio, five-year average return on invested capital ("ROIC"), and total debt to capital. The Sortino ratio is an alternative to the Sharpe ratio, which is simply a measure of risk-adjusted returns. For both ratios, the higher the value, the better, with the only notable difference being that the Sortino ratio only considers the downside risk. This makes it an important risk metric when constructing low volatility equity portfolios. In the analysis below, we will look at companies in the S&P 100 and S&P/TSX with returns over the past 20 years. Our goal is to select companies that have the highest Sortino ratio, above average ROIC, and below average total debt to capital.

Quantitative Findings

For the S&P 100, the five-year average ROIC was 13.1 per cent for the group of companies. The average total debt-to-capital ratio for the peer group was 54 per cent which, after applying these filters, resulted in 23 per cent of constituents in our opportunity zone.

The top five companies in the S&P 100 that meet our criteria and have the highest Sortino ratio are **Alphabet ("GOOGL-US")**, **NVIDIA ("NVDA-US")**, **Visa ("V-US")**, **Nike ("NKE-US"),** and **Costco Wholesale ("COST-US")**.

S&P 100 - Sortino Ratio vs Five-year Average ROIC

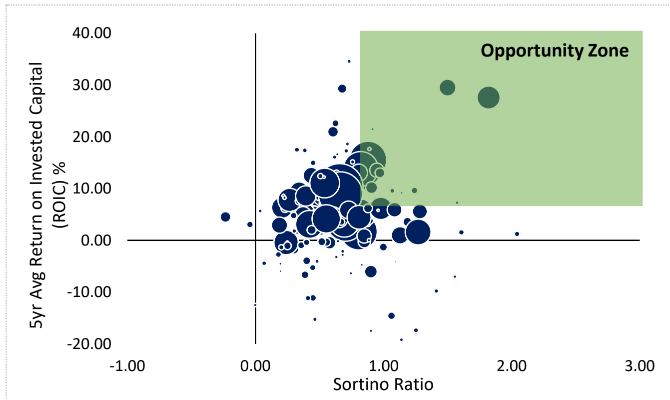


Source: Raymond James Ltd.; FactSet; Data as of July 31 2022

For the S&P/TSX, the five-year average ROIC was 3.2 per cent for the group of companies. The average total debt-to-capital ratio for the peer group was 39 per cent which, after applying these filters, resulted in 13 per cent of constituents in our opportunity zone. We also applied a size filter for the TSX, limiting our opportunity zone to companies with a market capitalization greater than CAD $3 billion.

The top five firms in the S&P/TSX that meet our criteria and have the highest Sortino ratio are **Wheaton Precious Metals ("WPM-CA")**, **WSP Global ("WSP-CA")**, **Toromont Industries ("TIH-CA")**, **TMX Group ("X-CA"),** and **Canadian National Railway ("CNR-CA")**.

S&P/TSX - Sortino Ratio vs 5yr Average ROIC



Source: Raymond James Ltd.; FactSet; Data as of July 31, 2022

Key Takeaways

Navigating through markets in the current environment can be difficult, as most of 2022 has been met with higher interest rates, slowing growth, and an increasing probability of a recession in 2023. While much remains uncertain about the future direction of markets in the short term, investors and portfolio managers can use these metrics to measure the potential downside risk of their positions.

Risk metrics like the Sortino ratio can help identify positions that are more vulnerable to market declines based on their price history. Incorporating more quantitative methods, like the concepts discussed above, can help remove some of the emotional biases when it comes to investing and constructing portfolios. We encourage investors to remain diversified and own both defensive and cyclical sectors for long-term equity portfolios. Incorporating tools like the Sortino ratio can help investors understand the historical risk-reward relationship of the investments they currently own.

Peter Tewolde
Equity Specialist

Commentary from U.S. Equity Fund Managers

A handful of factors has contributed to this year's volatility spike in U.S. equity markets including heightened inflationary pressures, aggressive monetary policy tightening by the Federal Reserve and the devastating effects from the ongoing Russia/Ukraine war. To illustrate, below is the monthly performance of the **Vanguard S&P 500 Index ETF ("VFV")** and the **Invesco NASDAQ 100 Index ETF ("QQC").**

Monthly Returns of S&P 500 (VFV) and NASDAQ (QQC)

Month	Jan	Feb	March	April	May	Jun	July
VFV	-4.7%	-3.3%	2.3%	-6.4%	-1.2%	-6.6%	8.3%
QQC	-8.1%	-4.9%	3.3%	-11.2%	-2.5%	-7.8%	11.7%

Source: FactSet; Raymond James Ltd.; Data as of August 29, 2022

As market volatility continues to play out as a major theme in 2022, we reached out to three U.S. equity fund managers to provide some comments on the environment and how they are positioned to navigate these unchartered waters going forward.

Epoch Investment Partners, Epoch U.S. Large Cap Value

"While we cannot be certain that a recession is imminent, in our opinion, the best course of action to take is to **remain invested in high-quality companies that possess strong balance sheets and ample liquidity**. With this in mind, we have managed to find several high-quality ideas in industries that are generally less susceptible to a slowdown in economic growth including pharmaceuticals and insurance. In pharmaceuticals, patient demand is relatively inelastic, which means that it is not especially price sensitive and often cannot be delayed. Most experts consider the insurance industry to be a recession-proof industry, as people continue to buy life insurance, home and auto insurance even when the financial situation has taken a tune for the worse. Less promising industries include capital markets and financial services. These industries' revenues typically rely on assets under management and trading volume, both of which tend to decline in a recession. **As always, we are committed to investing in quality companies with competitive advantages that we believe can thrive in good and bad economic environments**."

Nadim Rizk, National Bank Investments U.S. Equity

"We remain focused on identifying **quality compounders that are typically held for an investment horizon of 10-20+ years**. **Our focus continues to be on identifying what we believe to be high-quality companies with sustainable competitive advantages, operating in industries with high barriers to entry, contributing to durable pricing power**. During the first half of 2022, we trimmed our positions in PepsiCo and Colgate Palmolive while added to our positions in Microsoft and Alphabet. Additionally, we initiated a position in Adobe. Adobe is a high-quality software name that the team has been closely following for several years. **The recent selloff in technology names presented us with an opportunity to initiate a position at an attractive valuation.** As the investment team focuses on fundamental bottom-up analysis, we evaluate each opportunity and risk on a company-by-company basis. We remain confident that our bottom-up, fundamental research approach will continue to provide steady returns over the long term, regardless of the macro-environment."

Stephen DuFour, Fidelity U.S. Focused Stock

"As of June 30th, the fund's holdings have been dictated by the sharp rise in inflation followed by the drastic reversal in the Federal Reserve interest rate policy. The record first half decline in stock prices resulted in attractive investment candidates across most sectors of the market and most types of stocks. **The current holdings are a combination of attractively priced growth stocks, well-positioned all-weather stocks, cyclical winners and value stocks**. High interest rates led to lower P/Es for many growth stocks over the past year. We narrowed our holdings in this group but **remain excited about the prospects for digital advertising, ETFs and ESG data providers, cloud computing and ecommerce.** Our **all-weather holdings comprise companies that are well positioned to deal with high inflation, rising interest rates, a strong dollar, and slowing economic growth**. This group includes **health insurance providers, credit card networks, soft drink manufacturers and cosmetic companies.** Our value holdings are in industries with a high percentage of recurring revenues and good long-term growth outlooks. This includes aluminum cans, electricity generation, and enterprise software. Inflation and interest rate policy have been dictating stock valuations year to date, as the trajectory of each changes, so too will the fund's holdings."

Luke Kahnert, MBA, CIM
Mutual Fund & ETF Specialist

Showing Interest in Zero-Interest

When investors think about bonds, the majority likely imagine a traditional structure that pays a fixed rate of interest on a set payment cycle, typically every six months, and returns capital at maturity. Although these bonds are very popular, there are other types that also exist. One that investors should consider including in their portfolio is a strip bond – a product that pays no interest over its life.

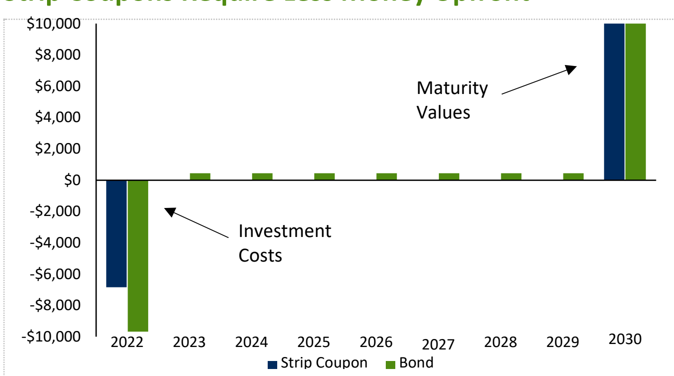
Strip bonds are created by separating coupon (interest) payments of existing corporate, municipal, provincial or federal bonds and making them available as individual securities. Coupons represent the interest portion of the bond, whereas the residual represents the principal portion that is repaid at maturity.

Trading at a Discount

Each resulting strip security is a zero-coupon bond, purchased at a discount to face value. For those who do not require a stream of periodic income, this is an appealing feature as it allows investors to avoid reinvestment risk. Investors do not receive interest payments over the life of the security, so there is no need to reinvest those funds at an unknown yield in the future. The discounted nature of strip bonds implies a smaller upfront cost at the time of purchase. Let us look at an example:

A strip bond maturing in approximately eight years is available at a price of $68.33. To buy 10,000 face value of this bond, an investor would invest $6,833 today and receive $10,000 when the position matures, receiving a yield to maturity of 5.00 per cent (represented by the blue bars in the following graph). Traditional coupon-paying bonds (represented by the green bars) would require a larger upfront commitment since investors would receive an income stream over the life of the security in addition to the final maturity payment.

Strip Coupons Require Less Money Upfront



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

Matching Liabilities

Strip bonds come in a wide range of maturities, from six months to 30 years. This allows investors with known future income needs to align investment maturities to coincide with those future cash requirements. Outlays of capital could be a one-time event such as a future down payment on a house, a series of expenditures such as annual college tuition dues, or retirement funding, where cash needs would span over many years.

To the Nearest Dollar

Unlike regular bonds that must be purchased in multiples of 1,000, strip coupons can be bought to the nearest dollar, allowing investors to achieve two things: invest every available dollar today know the exact amount to be received at maturity at the time of purchase. For example, for a future payment of $9,578 due in 2.5 years' time, an investor could choose to buy a standard bond, but would need to buy $10,000 face value today. With strip coupons, they could instead purchase a quantity of $9,578 so that the exact amount of cash was available when it was needed.

Portfolio Placement

Ideally, strip coupons should be placed in accounts that are tax-sheltered, such as RRSPs and other registered account types. Interest is not physically received every year from strip coupons; however, if strips are held outside these tax-favourable account types, investors are required to pay tax on interest not actually received, which could negatively affect the return yield from these types of securities. Thus, for most investors, the best place for strip coupons are tax-sheltered accounts.

Strip coupons have a number of features that makes them quite different from standard bonds – they always trade at a discount, provide no interest payments, and can be purchased to the nearest dollar. Utilizing strip coupons in accounts with a tax shelter structure can help investor match future cash needs effectively while investing fewer dollars today.

Charlotte Jakubowicz, CMT
Vice President, Fixed Income & Currencies

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: Disclosures https://raymondjames.bluematrix.com/sellside/Disclosures.action

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable, but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may, from time to time, hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Within the last 12 months, RJL has undertaken an underwriting liability or has provided advisor for a fee with respect to WSP Global (WSP-CA).

A member of the PCS team responsible for preparation of this newsletter or a member of his/her household has a long position in Costco Wholesale (COST-US), Wheaton Precious Metals (WPM-CA), and WSP Global (WSP-CA). Some of the securities mentioned in this report may entail higher risk. Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives.

Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives. Some of the securities mentioned in this report may entail higher risk. Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives.

Information regarding High, Medium, and Low-risk securities is available from your Financial Advisor.