RAYMOND JAMES®

PRIVATE CLIENT SOLUTIONS

ASSET ALLOCATION QUARTERLY

ECONOMIC GROWTH TO REMAIN ABOVE TREND

PATH OF RECOVERY STILL AFFECTED BY COVID-19

HIGHER VOLATILITY EXPECTED FROM POLICY NORMALIZATION

OVERWEIGHT EQUITIES, UNDERWEIGHT BONDS, AND UNDERWEIGHT CASH

The Return to "Normal" – Easy Gains are so 2021!

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Quarterly Outlook: The Return to "Normal"–Easy Gains are so 2021!

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In this publication, we discuss our outlook for the global economy and outline our tactical asset allocation recommendations for the next 9-12 months. 2021 was a year for the record books, and the global economy remains relatively strong as we enter 2022 and make progress towards a state of normal. While we continue to recommend an overweight allocation to equities and an underweight allocation to bonds and cash, we expect greater uncertainty this year than in 2021 along with higher levels of volatility (a return to normal from very subdued levels in 2021), as major central banks including the Federal Reserve (Fed) and Bank of Canada (BoC) normalize their policy. That said, conditions remain accommodative historically speaking and encouraging in our view, and we suggest investors use periods of volatility to add to high-quality positions in companies with strong earnings growth potential that are trading at reasonable valuations. For equities, we prefer growth at a reasonable cost and/or value ideas versus growth at any cost; for bonds we prefer lower duration over longer duration securities and corporates over sovereign debt.

Key Takeaways:

- **Strong growth momentum entering 2022, but greater risks than in 2021 as policy normalization efforts take center stage.** The path of the global economic recovery has remained uneven to date, which has largely depended on access to and the administration of vaccines, which, until recently, have been concentrated mostly in advanced regions of the world. We believe this will largely be the case in 2022, but policy normalization efforts will take center stage. For the year ahead, we expect global economic growth to remain above trend with advanced economies (e.g., US, Canada, UK) rising at a healthier clip above historical trend levels (avg. 2000–2017) and versus their developing market peers.

- **Inflation is still running hot (with risks to the upside) but policy tightening is on the horizon.** Inflation continued to run above historical trend in 2021 and likely to remain elevated in 2022. The bond market has finally awoken after hitting the snooze button for much of 2021. Yields have pushed higher as major central banks, including the Fed/BoC, have pivoted away from their transitory narrative and taken steps to normalize policy and get inflation under control. We expect policy changes to result in greater volatility, especially as central bankers look to execute a soft landing for the global and regional economies.

- **US & Canadian economic and labour market conditions remain strong.** U.S. and Canadian real GDP is expected to increase by ~3.0% and ~3.5% (below consensus estimates), respectively, in 2022, down from peak levels in 2021 but still very strong historically speaking. While GDP growth is expected to moderate towards trend levels in the years ahead, it is still expected to remain above trend in 2022. Employment conditions also remain robust in Canada and in the US, with labour market fundamentals at or above pre-pandemic levels entering 2022.

- **Asset allocation recommendations.** We continue to recommend an overweight allocation to equities with a preference for companies that are expected to benefit the most from the recovery process (i.e., cyclical, small-mid cap equities, value, etc.) and from policy normalization efforts. Given relative valuations and the earnings outlook, we suggest an overweight allocation to the cyclically sensitive S&P/TSX versus the tech-heavy S&P 500 index. Investors should also maintain an underweight allocation to fixed income and cash.

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Asset Allocation Recommendations

Tactical (9-12 month) Asset Allocation Recommendations

	- Neutral +	Comments
Equity		We remain overweight equities as we continue to see strong relative risk/reward characteristics, which we believe are supported by strong consumer and corporate fundamentals and a still very accommodative policy environment.
US Large Cap		The US Large Cap space represents some of the highest quality businesses in the world, with strong competitive attributes, high levels of profitability, and strong enduring growth profiles. However, due to elevated valuations we are seeing more compelling tactical opportunities elsewhere.
US Small-Mid Cap		We see strong growth, sentiment and relative valuations across the US Small-Mid Cap space. In particular, we are seeing compelling opportunities within US Small-Mid Cap Value.
Canadian Large Cap		We see good value across the Canadian market including in Large Cap equities. In particular, we have a favourable view on quality cyclical equities.
Canadian Small-Mid Cap		We see good value across the Canadian market including in Small-Mid Cap equities. In particular, we have a favourable view on quality cyclical equities.
Developed		We see good opportunities across several developed economies outside of Canada and the US markets that are still early in their reopening efforts, including across Europe, UK, etc.
Emerging		Strong global growth should be supportive for EM equities, particularly commodity exporters; however, the economic environment and growth outlook is more bifurcated across emerging market equities than across developed world equities. That said, we believe investors can be tactical in adding to select emerging markets across Asia, where we are seeing attractive valuations.
Fixed Income		With valuations and risk reward attributes not particularly compelling, we remain underweight Fixed Income as the Fed/BoC start tapering their bond buying programs, raise rates and unwind their balancesheets. Therefore, we expect more volatility and modestly higher yields in the future.
US Government		We suggest an underweight allocation to government bonds due to the weaker risk/return characteristics across the curve.
US Corporate		Investment grade corporate bonds continue to offer better risk/reward characteristics. However, investors should consider continuing to hold shorter duration bonds as the Federal Reserve/Bank of Canada isn't likely to move rates for two more years and we continue to see upside potential in longer-term rates. We suggest investors maintain exposure to bonds with a duration profile between 3-7 years.
Canadian Government		We suggest an underweight allocation to government bonds due to the weaker risk/return characteristics across the curve.
Canadian Corporate		Investment grade corporate bonds continue to offer better risk/reward characteristics. However, investors should consider continuing to hold shorter duration bonds. We suggest investors maintain exposure to bonds with a duration profile between 3-7 years.
Currency (USD/CAD)		USD/CAD was hovering in overbought territory for much of December of last year, which suggested a corrective move to the downside in the immediate near term. We have seen this play out first hand, with the pair slipping from 1.2965 to 1.2600 at the time of writing. However, we continue to recommend holding a modestly bullish view for H1/2022 (+USD) and a bearish view for H2/2022 (-USD).
Cash		We are underweight cash as an asset class as we see more attractive risk/reward opportunities in other asset classes, including equities and corporate investment grade bonds which offer the potential for higher real returns.

Market Commentary

Global Economic Outlook: Growth above Trend, but Path towards "Normal" Remains Uncertain

It's been almost two years since the onset of the pandemic, with COVID-19 as the primary driver of macroeconomic and financial performance across markets and asset classes globally. The path of the global economic recovery has remained uneven to date, largely depending on access to and the administration of vaccines, which, until recently, have been concentrated mostly in advanced regions of the world. This, in addition to unprecedented levels of fiscal and monetary support largely concentrated across advanced regions of the world, has resulted in a faster and stronger recovery relative to historical trend, and also compared to the developing economies of the world. For 2022, we expect global economic growth to remain elevated with advanced economies (e.g., US, Canada, UK, Euro-zone) rising at a healthier clip above historical trend (avg. 2000–2017) and versus their developing market peers.

Real GDP Growth Rising Above Trend in 2022/23 [LHS]; Real GDP Growth Revised Lower QoQ [RHS]

Select Regional Real GDP Growth Forecasts (% YoY)	Average 2000-2017	2022	2023
World (CE China Estimate)	**3.8%**	**4.0%**	**3.5%**
Advanced Economies	**1.8%**	**3.4%**	**2.1%**
US	***2.2%***	***3.0%***	***2.0%***
Canada	***2.2%***	***3.5%***	***2.1%***
Euro-zone	1.3%	3.6%	1.7%
UK	2.1%	3.7%	3.5%
Japan	1.5%	3.3%	1.9%
Australia	2.6%	4.5%	4.2%
Emerging Economies	**5.2%**	**4.6%**	**4.2%**
China (CE Estimates)	7.5%	3.5%	3.5%
India	7.5%	10.0%	7.5%
Russia	2.0%	2.8%	2.0%
Brazil	1.4%	1.3%	1.8%
Mexico	3.1%	2.8%	2.1%

QoQ % Change	Real GDP Growth Forecasts		
	2021	2022	2023
World (CE China Estimate)	**-6%**	**-11%**	**3%**
Advanced Economies	**-4%**	**-13%**	**0%**
US	***-3%***	***-14%***	***-20%***
Canada	***-8%***	***-13%***	***5%***
Euro-zone	-6%	-20%	13%
UK	1%	-41%	40%
Japan	-22%	6%	0%
Australia	16%	-12%	31%
Emerging Economies	**-7%**	**-4%**	**0%**
China (CE Estimates)	13%	-39%	-36%
India	-16%	-5%	0%
Russia	0%	-7%	11%
Brazil	-2%	-57%	-10%
Mexico	-12%	-20%	-16%

Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial; Data as of January 11, 2022

Inflation to remain elevated in 2022, with risks to the upside

Since the pandemic lows of 2020, extreme policy measures coupled with an unprecedented rebound in demand have resulted in inflationary pressures that have run much hotter than recent history and for longer than expected. While major central banks have abandoned their transitory narrative (e.g., Fed) and begun tapering, and/or rising rates to cool inflation, we still expect inflationary pressures to remain above trend in 2022. While we expect inflationary impacts such as supply chain bottlenecks, base effects, commodities prices, etc., to moderate as we move further into 2022, we caution that uncertainties remain and the risks to our base case scenario are to the upside rather than the downside. Compared to last quarter, current projections suggest inflation will remain elevated in 2022. These forecasts show a marginal tick higher in consumer prices in 2022 relative to 2021 for the world economy, with inflation expectations suggesting a path towards historical trend beginning next year.

Inflation Running Hot in 2022 [LHS]; Upward Revision in Inflation Expectation QoQ [RHS]

Current Inflation Forecasts	2021	2022	2023
World	**3.8%**	**4.0%**	**2.8%**
Advanced Economies	**3.1%**	**3.1%**	**1.8%**
US	**4.6%**	**3.8%**	**2.9%**
Canada	**3.4%**	**3.0%**	**2.0%**
Euro-zone	2.5%	3.2%	0.8%
UK	2.5%	4.0%	2.2%
Japan	-0.3%	0.6%	0.2%
Australia	2.8%	2.8%	2.4%
Emerging Economies	**4.3%**	**4.6%**	**3.4%**
China	1.0%	1.7%	1.6%
India	5.2%	5.5%	3.3%
Russia	6.7%	6.8%	3.7%
Brazil	8.3%	7.0%	3.5%

QoQ Change (%)	Inflation Forecasts		
	2021	2022	2023
World	**12%**	**43%**	**8%**
Advanced Economies	**19%**	**63%**	**29%**
US	**10%**	**65%**	**53%**
Canada	**17%**	**58%**	**-5%**
Euro-zone	9%	113%	-20%
UK	9%	48%	22%
Japan	-250%	-25%	-33%
Australia	8%	47%	14%
Emerging Economies	**7%**	**35%**	**0%**
China	0%	13%	0%
India	-2%	96%	0%
Russia	6%	36%	0%
Brazil	6%	40%	17%

Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial; Data as of January 11, 2022

With growth and inflation considerably above target for most economies, governments have reversed pandemic-related fiscal measures and central banks have adopted a less accommodative policy stance. The Fed reduced bond purchases, while the BoC ended their quantitative program altogether. The Fed will also begin unwinding their balance sheets as soon as late 2022. We have seen interest rate hikes in only a few countries, mostly emerging markets. The UK and New Zealand are the major developed countries, increasing their policy rate.

- **Against this backdrop (i.e., above trend growth and inflation), we expect significantly more volatility and uncertainty as central bankers and policymakers attempt to balance policy normalization efforts with surging inflationary pressures, while supporting an environment for continued economic growth. We suspect advanced economies (e.g., Canada, US, UK, Euro-zone), which are growing well above trend and offer a larger buffer to policy missteps/macro uncertainties to fare better in this environment versus their developing market peers who are facing several other unique challenges (i.e., geopolitical, regulatory, COVID-19 related, etc.).**

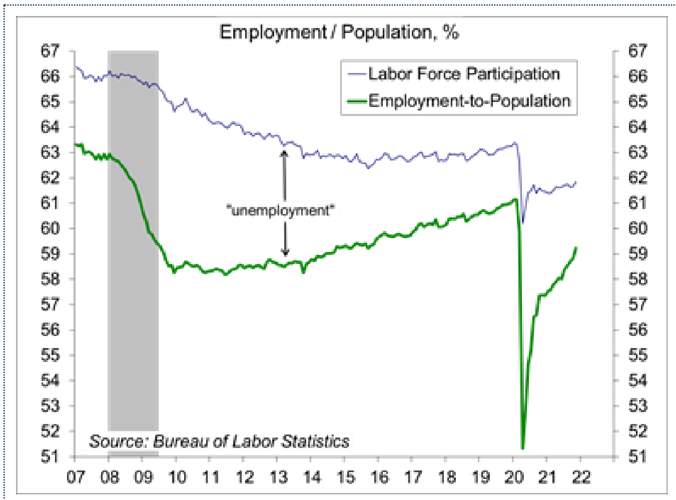
US Economic Outlook–Remain Optimistic, but Prepare for a Shifting Landscape

Economic growth should continue in 2022, but there are several key uncertainties, including whether labour force participation will pick up and how aggressively the Fed will fight the risk of persistently higher inflation. There were several surprises in 2021. Fiscal stimulus was larger than expected. Vaccines arrived sooner than expected, but a significant percentage of Americans refused them. Consumer spending and business investment were very strong in the first half of the year. However, the Delta variant and supply shortages dampened the pace of improvement in the third quarter. Recent data showed a pickup in growth in the third quarter.

The economy is expected to improve further in 2022, but at a more moderate pace than in 2021, reflecting reduced support from fiscal policy and the fact that there is less to come back from (the level of GDP is roughly back to its pre-pandemic trend). The Omicron variant is likely to be a near-term constraint on growth, but a temporary one, as we saw with the Delta variant.

The unemployment rate has fallen sharply (3.9% in November, vs. 6.7% a year earlier, close to the 3.6% average in 4Q19), but labour force participation has trended about flat over the last year, well below where it was before the pandemic. Some older workers opted for early retirement in 2020, although a small fraction have returned to the workforce. Dependent care issues have constrained labour force participation. Fewer older Americans have been going into nursing homes during the pandemic. Childcare is more expensive and less available. Labor force participation should improve, and higher wages could encourage those on the sidelines to return to the workforce, but participation is unlikely to return to its pre-pandemic level soon.

Labour Force Participation Unlikely to Return to Pre-Pandemic Levels



Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial; Bureau of Labor Statistics; Data as of December 15, 2021

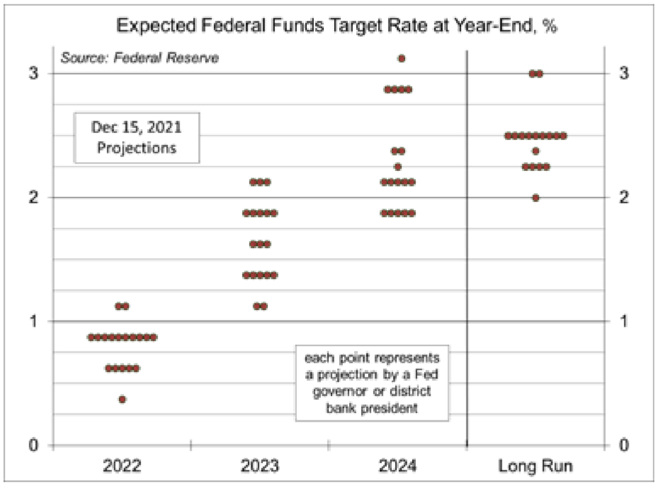
Inflation rose sharply in the spring of 2021, but increases were narrow across sectors. The rise mostly reflected "base effects" (a rebound in prices that were depressed in the lockdowns a year earlier) and restart pressures. Production bottlenecks and transportation difficulties occur in every economic recovery, but are more intense this time due to the effects of the pandemic and the rapid strengthening of the economy in the first half of the year. The shift in consumer spending from services to goods has proven long-lasting (retail sales remain about 15% above the pre-pandemic trend), adding to supply chains difficulties.

Parts of supply chains have improved, but price increases are now evident over a wider range of sectors, suggesting that higher inflation has become more firmly rooted. The risk of persistently higher inflation has increased.

Labour costs have not been the key driver of consumer price inflation, but wage inflation can reinforce higher price inflation–as in the wage-price spiral seen in the 1970s and early 1980s. Over the last few decades, wage bargaining power has shifted significantly from workers to businesses. Wages are rising, but not as much as price inflation. Firms continue to make use of non-wage efforts (signing bonuses, more flexible work schedules or other perks) to attract and keep workers.

Fed policymakers reduced ("taper") the monthly pace of asset purchases in November, but will speed up that reduction in January, and is now expected to end purchases in March (instead of June). The Fed has stressed that the tapering of asset purchases and the lift-off in short-term interest rates are separate decisions. However, the inflation outlook has shifted dramatically in the last few months. Monetary policy is expected to become less accommodative in 2022, with an initial hike likely to come by the middle of next year (if not sooner). Fed rate increases will depend on how the economy develops, but the inflation outlook will be the dominant driver.

The Dot Plot–The Expected Fed Funds Rate by YE2022



Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial; Federal Reserve; Data as of December 15, 2021

<u>The risk of a Fed policy error has increased.</u> It's difficult to engineer soft landings (a smooth transition to a long-term sustainable rate of growth), and there's a chance that the Fed may either raise rates too much and generate weaker growth or a recession, or not act soon enough (and have to tighten even more later on in order to push inflation down).

Despite the fear of inflation, long-term interest rates remained moderate in 2021. That is largely because bond yields are much lower outside the U.S. The end of the Fed's asset purchases might put some upward pressure on bond yields, but most of that should already be factored into the market. At the December policy meeting, Fed officials discussed a possible unwinding of the balance sheet later in 2022. Most likely, this will be gradual, with the Fed reinvesting only a portion of maturing securities (that is, no outright selling of securities).

Consumer spending should be supported by further job gains and wage growth in 2022. Commercial real estate is likely to remain soft, but robust increases in corporate profits should continue to drive growth in business fixed investment. Affordability continues to be an important issue in residential real estate, but mortgage rates are expected to remain relatively low and demand for housing should remain strong.

The virus and its variants will continue to affect the economy in 2022. While economic activity has moved closer to normal for many Americans, the pandemic has changed work and spending patterns. Working from home has been most successful (and more desired) for white-collar workers, although blue-collar workers still have to show up in person. Consumer spending on services, especially travel and tourism, is likely to recover more slowly.

- ❖ **In summary, the 2022 economic outlook is optimistic, but the view may shift several times over the course of the year. Labour force participation, inflation, and Fed policy remain key uncertainties. Geopolitical tensions, potential cyberattacks, and natural disasters are difficult to predict–<u>and it's usually the punch you didn't see coming that does the most damage. Investors should be optimistic, but prepare for a shifting landscape.</u>**

Washington Policy–Mid-Terms and 2022 Political Agenda Add to Risks

2021 created additional risks and opportunities for U.S. markets with the formulation and passage of several pieces of legislation tackling what can be described as the top economic concerns for the Biden administration. They covered COVID-related disruption, infrastructure revitalization and investment, and gaps in the care economy that are limiting the potential for long-term U.S. economic growth (childcare, education, healthcare investment). We expect the 2022 political agenda to focus on longer-term U.S. competitive strategy versus China, modernizing regulations for large technology companies, updating voting rights legislation, examining labour standards, and reforming U.S. cannabis policy. We see the highest probability of China competition legislation and technology policy advancing in 2022, given significant bipartisan interest. Other priorities are likely to be more polarized and drive political messaging to increase voter turnout for the November 2022 midterm elections. Overall, election year politics significantly limit the chances for major pieces of legislation outside of must-pass bills, which should notably reduce legislative and headline risk. A reduction in policy risk coupled with funding being injected into the economy for infrastructure and care economy priorities (if President Biden passes the Build Back Better legislation) further supports DC producing a tailwind for markets in 2022.

A Look at the 2022 Midterm Race and Beyond

Although we are almost a full year from Election Day, it is worth noting the fundamental similarities between the current U.S. political environment and metrics in 2018 that led to Democrats winning the House of Representatives by a decisive margin under President Trump. While this result did not translate to the 2018 Senate race, it offered a first signal of a national environment that shifted control of DC to the Democratic Party and the election of President Biden in the 2020 presidential election cycle. Going back to the 1980s, the President's party averages a loss of 23 seats in the U.S. House of Representatives in the midterm elections. As such, Democrats currently face an uphill battle to maintain their House majority, especially considering just four flipped seats (out of 435 total) shifts control to Republicans. Control of the Senate is likely to come down to eight key races: Arizona, Georgia, New Hampshire, and Nevada (Democratic-held seats); and Florida, Ohio, Pennsylvania, and Wisconsin (Republican-held seats). Democrats will focus significant efforts and resources on improving the national sentiment for vulnerable Democratic incumbents. This is a further moderating dynamic in terms of U.S. market risk for 2022, as the Biden administration seeks to improve economic conditions while launching key policy programs that passed into law in 2021.

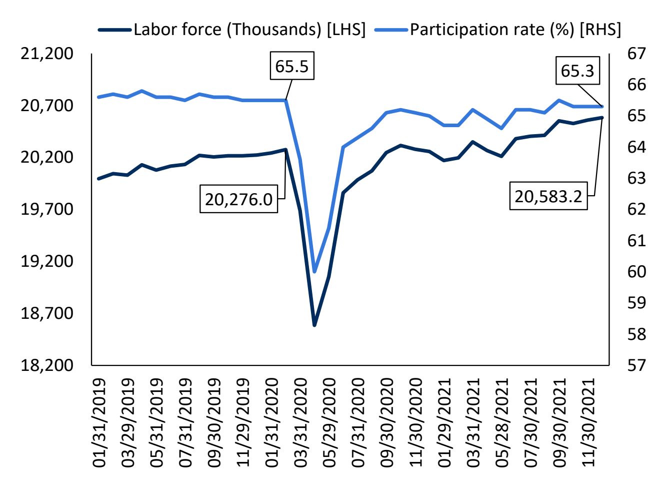
- **To sum up, the policy setup for the year ahead likely boosts DC's impact as a market tailwind. The November election will serve as a marker for both the second half of President Biden's first term and the (early) national environment for the 2024 Presidential election. Significant Republican gains in Congress in 2022 would see a return to a historically market-positive DC gridlock scenario, and investor attention at the end of 2022 will turn to implementation of Biden's first-half legislative agenda and the potential direction of U.S. policy tied to the 2024 election cycle.**

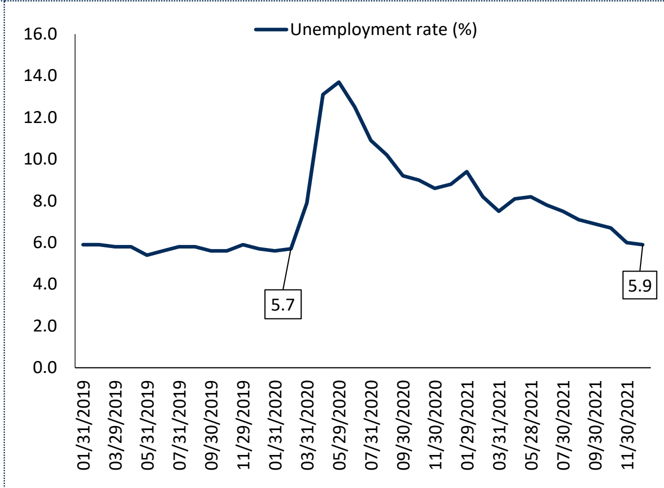
Canadian Economic Outlook–Another Strong Year Expected in 2022 with Some Added Twists

2021 was a banner year for the Canadian economy, which is expected to have grown by 4.5% (or ~2x the long-term real GDP growth rate of ~2.0%). We believe the lifting of public health restrictions on the back of high vaccination levels for the population (highest among the G7), a strong rebound in commodities, a robust housing market environment, and an accommodative policy environment were the main drivers behind the record year performance. For 2022, we expect another solid year for the economy with real GDP growth of 3.5% to 4.0% this year. This is slightly weaker than consensus forecasts (+4.0% YoY) and below the Bank of Canada's (BoC) forecast of (+4.25% YoY). And inclusive of ongoing uncertainties (e.g., Omicron and related restrictions), we still see this as a fairly positive backdrop for the economy.

Likewise, the employment picture has continued to show strong signs of improvement, with the latest employment reading for December 2021 coming in well ahead of expectations. The unemployment rate fell to 5.9%, within reaching distance of the prior cycle low of 5.7% recorded in February 2020 or pre-COVID-19. We suspect the above trend growth coupled with ongoing labour shortages and wage pressures to persist in 2022, with unemployment levels falling below the prior cycle lows/pre-pandemic in 2022.

Canada's Labour Market and Participation Levels [LHS]; Unemployment Rate Likely to fall below Pre-Pandemic Lows [RHS]





Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial; Data as of January 11, 2022

After posting a solid rebound in 2021, commodity prices are expected to moderate from highs in 2022. We expect crude prices to remain volatile and believe some gains in 2021 will reverse this year against a backdrop of a supply rebound. Meanwhile, industrial metals are likely to weaken from highs due to softness in China, while precious metals, similar to 2021, will remain weak/range bound.

We expect above trend inflation and economic growth coupled with near full employment levels to push the BoC to hike two to three times this year, with policy rates heading to 1.00% by the end of 2022 versus consensus expectations of a policy rate of 1.25% by the year end. We expect these tightening efforts, plus the end of the BoC's quantitative easing program in 2021, along with the repricing of relative interest rate expectations between Canada and the US, to push Canada's 10-year yields higher towards 1.80%-2.00% by year end 2022. Overall, while we expect inflation levels to remain elevated in 2022, many of the transitory inflationary impulses should fade in the back half of the year.

- **In summary, policy measures including the pace of tapering/rate increases (i.e., the removal of extreme COVID-19 related stimulus measures) to remain dependent on the path of COVID-19, and policies related to controlling the spread of the virus (e.g., lockdowns, travel/work restrictions, school closures, etc.). While we expect to see another solid year for the economy in 2022, there remains higher levels of uncertainty than in 2021, especially as the BoC normalizes policy while future virus strains (e.g., Omicron) pose new challenges and risks to the economic outlook.**

Equity Allocation (Overweight) – Easy Gains Behind us – Stock Pickers Market Ahead

2021 was a solid year for most investors. That said, it was not all sunshine and rainbows, as the floor fell out under equities in China and Latin America. However, industrial commodities have surged; the US, Canadian, UK and European stock markets delivered strong returns; and US and Canadian treasuries were remarkably resilient despite the sharp rise in inflation.

Looking ahead, we do not think returns over the next couple of years will be as good as in 2021–the easy gains are in! We think that the sell-off in most government bond markets will continue in 2022, as the Fed raises interest rates and unwinds its balance sheet. Meanwhile, with valuations high across most growth style categories in the US, and a lot of good news already discounted in analysts' expectations for earnings, we suspect that the returns from US equities over the next couple of years will be mediocre. For Canada, we see quite the opposite. We expect a more attractive return profile as the recovery continues, especially given the cyclical tilt of the S&P/TSX index versus the S&P 500 index. Valuations are also more attractive on an absolute and relative basis compared to the S&P 500 index.

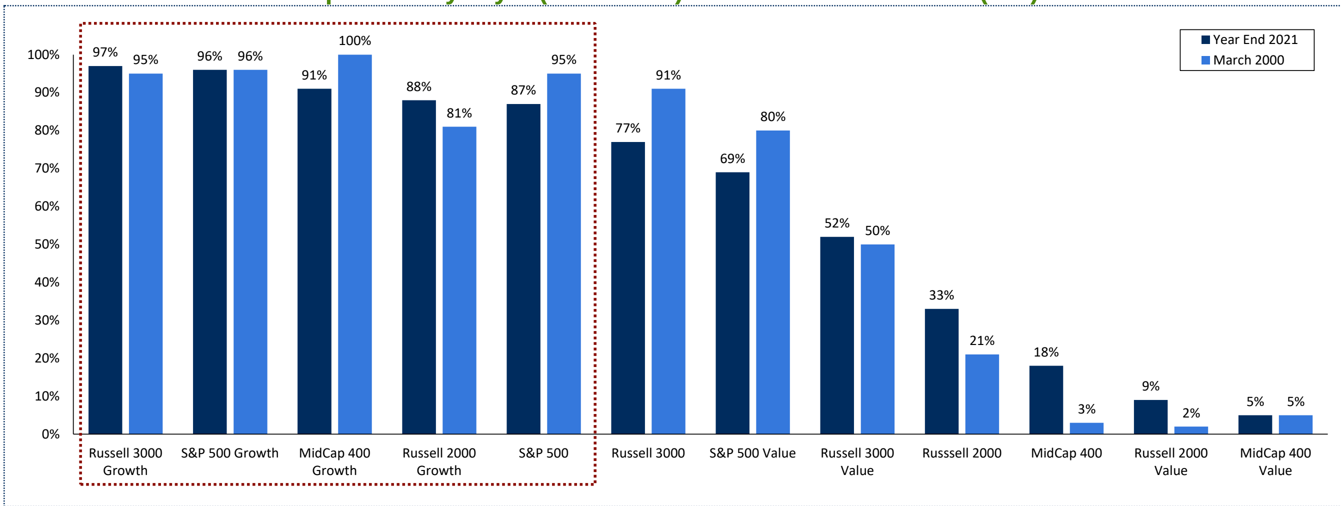
We also expect returns from industrial commodities to be softer, given our downbeat view of China's economy (a major risk to our outlook for 2022), and our forecast that oil supply will rebound considerably next year.

US Equities (Market Weight)

The US enters 2022 with a robust economy and substantial momentum in GDP growth, but also stronger momentum in inflation than policy makers and politicians are comfortable with. Because of this, and the new Covid-19 variant, a sudden Fed hawkishness swept through US equity markets as 2021 ended. We expect EPS performance to remain strong, but that P/E multiples will compress towards more "normalized" levels as the year progresses. However, we expect the degree of this P/E compression likely depends on how quickly the Fed tightens in 2022, which will rely somewhat on the inflation trend, virus variants, health of emerging markets, fiscal policies, etc.

We see the greatest risks across major US growth indexes, which are trading at > 80th percentile of their 20 year P/Es, while small/mid cap value indexes are trading at <20th percentile. The continuation of the move in yields to the upside should further support a rotation out of high growth and expensive equities into more value oriented areas of the market – be selective.

Valuation Percentile Comparison by Style (1999-2021) based on Forward P/E (P/S)



Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial. Data as of January 11, 2022

We largely view the US equity outlook in 2022 as having two distinct possibilities. First, the long-term Treasury rates go up as the Fed raises rates, which is typical as the economy improves. This would be beneficial to equities (up to a point), but specifically for more cyclical and value-oriented equities, with secular growth and interest rate sensitives underperforming. Second, long-term Treasury rates decline as the Fed raises rates, and the yield curve flattens. This ultimately would cause the markets believing the Fed is going to slow demand too much and cause a recession or EPS decline in 2023/2024. We believe the first scenario is the more likely, but the second scenario will be in investor minds all year, as this was exactly what happened in 2018.

Globally, we suspect much will depend on China, as its economy has decelerated; it faces a troubled property sector; and substantial regulation in its tech-related businesses. To what degree China attempts to re-accelerate its economic growth, we suspect will be a key determinant of equity performance globally A re-acceleration would likely lead to stronger emerging markets and even European performance, but continued economic weakness in China would likely shift global investment dollars to the US where the growth outlook appears much more certain.

- **In summary, despite heightened uncertainty in 2022, S&P 500 Index EPS outlook looks great. 2022E consensus EPS is $226 but we suspect $230-$240 is realistic and 2023 EPS are likely to come in between $240-$270 depending on variants and aggressiveness of rate hikes/tapering. The S&P 500 index is trading at ~17.5-19.5x 2023E on P/E, which we view as a little expensive (~16x-18x or ~10% more expensive than typical valuations), but the market is reasonably more expensive in growth areas and historically cheap in more value areas. Growth indexes are trading at > 80th percentile of their 20 year P/Es, small/mid cap value indexes at <20th percentile. And with rates likely moving higher, that is also consistent with lower cash flow duration assets doing better than longer cash flow duration (i.e., value equities should outperform growth in 2022). This occurred in small and mid-cap indexes in 2021, and we could see this spread to large cap equities. Net/Net, the first week of 2022, looks like a likely outcome for the full year, with subdued overall equity returns, higher rates, risk in higher growth/higher multiple assets, and good returns in cyclical/value areas of the market. The biggest risks to the outlook are new Covid-19 variants, China broadly, and the degree and method of Fed tightening.**

Canadian Equities (Overweight)

Similar to the US, Canadian equities are entering 2022 following a banner year with the S&P/TSX Index up +25%. Despite some headlines that suggest a more down beat year in 2022, we believe there is substantial momentum in GDP growth, which continues to charge ahead above historical trend. That said, this above trend growth has been fueling record inflation levels, which are also ticking above historical levels. Given the robust backdrop, we expect monetary programs to wind down and normalize (e.g., BoC ended its QE program in October 2021), with rate increases and the eventual unwind of the balance sheet on the horizon. We expect yields to continue to push higher and likely to result in P/E multiple compression. As we move further into the business cycle, we expect multiples to compress towards historical trend. We believe we are in the early innings of the mid-cycle, and if valuations are to converge towards historical valuations similar to past mid-cycle periods, we see the greatest risk across the Canadian Technology and Industrials sectors.

S&P/TSX Index/Sector/Industry Median P/E Next Twelve Month Valuations (NTM) versus Periods during Past Business Cycles since 2006

Median PE NTM (Absolute)	Current	Historical (Since 2006)	Early-Cycle	Mid-Cycle	Late-Cycle	Recession
Canada S&P/TSX Composite	**13.9**	**14.5**	**16.1**	**14.6**	**14.2**	**12.0**
Communication Services	18.9	15.7	16.6	15.4	16.6	14.1
Consumer Discretionary	15.2	13.8	16.0	13.9	14.7	12.1
Consumer Staples	16.8	15.9	15.5	15.7	16.6	14.0
Energy	10.8	17.2	16.9	17.9	14.5	12.1
Financials	11.6	11.4	11.3	11.5	11.6	9.8
Health Care	16.1	15.5	13.8	14.5	19.4	16.1
Industrials	25.8	15.6	27.5	15.7	15.5	12.3
Capital Goods	23.2	15.3	20.1	15.0	17.2	11.4
Commercial & Professional Services	35.6	17.0	32.7	17.2	15.7	13.8
Transportation	23.7	15.1	27.0	15.4	14.0	12.3
Information Technology	51.8	19.9	54.5	19.0	26.5	17.0
Software & Services	53.4	16.7	55.8	15.9	17.8	11.3
Technology Hardware & Equipment	7.5	12.1	9.2	10.4	26.3	12.1
Materials	11.8	17.3	19.3	17.3	17.4	15.7
Real Estate	18.7	14.5	14.7	14.3	15.4	13.3
Utilities	8.9	17.4	15.4	17.7	17.5	15.7

Source: FactSet; Capital Economics; Raymond James Ltd.; Raymond James Financial. Data as of January 11, 2022

Despite elevated valuation in some select sectors/industries, we see lower risk for multiple compression for the broader S&P/TSX index than the S&P 500 index, which is trading below its historical valuation multiples on P/E NTM. Earnings are also expected to increase by 7% year-over-year (YoY) with earnings revisions likely as we moving further into the year similar to 2021, but not to the same degree. We expect growth to be the strongest across value/cyclical sectors. We expect earnings rather than multiples (expansion/contractions) to dictate the return profile for the markets/stocks in 2022. Similar to our comments above regarding valuation multiples across US equities, multiple compression likely depends on how quickly the BoC tightens in 2022.

Our Canadian equity outlook for 2022, like the US, has two distinct paths/possibilities. First, the long-term Treasury rates go up as the BoC also raises rates. This would be beneficial to equities, in particular the S&P/TSX index versus the S&P 500 index, which is more heavily tilted to cyclical and value-oriented sectors, with secular growth and interest rate sensitives underperforming (major component of the S&P 500 index). Second, long-term Treasury rates decline as the BoC raises rates, and the yield curve flattens. This ultimately would cause the markets believing the BoC is going to slow demand too much and cause a recession, or EPS decline, in 2023/2024. We believe the first scenario is the more likely, which supports our positive bias to the S&P/TSX over the S&P 500 index.

- **In summary, despite heightened uncertainty in 2022, the S&P/TSX Index EPS outlook remains strong and is expected to increase by ~7% YoY. We believe, similar to 2021, earnings can surprise to the upside depending on the strength of commodities/housing, the path of COVID-19/future variants/lockdowns and the aggressiveness of rate hikes/tapering by the BoC. The S&P TSX index is also trading at ~14x 2023E on P/E, which is in line with historical averages, but significantly below the S&P 500 index, which is trading at between 17.5-19.5x 2023E on P/E. We expect the value rotation to continue in 2022 as yields push higher with the S&P/TSX likely to outperform the S&P 500 index in this year.**

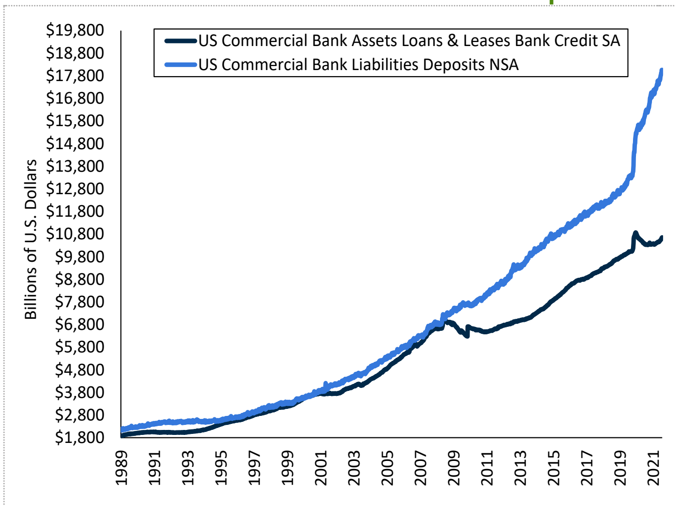
Fixed Income (Underweight); Expect Yields to Move Higher

Inflation and inflation expectations (as measured by US breakeven inflation rates) remain above 2018 peak levels, yet US Treasury yields are substantially below 2018 peak levels. And, after the initial rise in longer-term interest rates, which are the most sensitive to inflation, in the first quarter of 2021, they have been remarkably subdued and remain lower than their March 2021 peaks. Logically, this phenomenon should not happen. If we just assume inflation was at the Fed target rate of 2.00%, 10-year and 30-year interest rates should not be trading below 2.00%. The inflation rate is well above 2.00% and yields on both maturities are below. Adjusted for inflation expectations, interest rates are the most negative they have been since the introduction of Treasury Inflation Protected Securities in 1997.

Of course, inflation and inflation expectations are only two related factors that push yields around. Probably the most significant factor in keeping interest rates low in the current environment has been the massive amount of liquidity in the financial markets coming from pandemic relief, particularly from the US government and the Fed, but globally from other governments and central banks as well. If the basic definition of inflation is too much money chasing too few goods, we have significant inflation in bond market prices, which have driven and kept interest rates at historical lows.

One effect of the stimulus programs has been to help strengthen corporate and household balance sheets. Stronger corporations and households have less need to borrow from the banking system. With stagnant loan growth, banks and other depository institutions have increasingly turned to the bond market to earn interest against their growing deposit base. The chart below shows the high correlation of commercial bank loans and leases with deposits before the Financial Crisis hit. Stimulus programs from the Fed and the federal government have caused the two series to diverge. The stimulus programs related to the pandemic have exacerbated the differences. The near-vertical growth in deposits illustrates the massive amount of liquidity in the financial system. Even as the Fed reduces, and ultimately ends/reverses, bond purchases, the banking system will continue to buy bonds until lending activity strengthens. We are seeing some growth returning to bank lending, but it has a long way to go to catch up to the massive deposit growth.

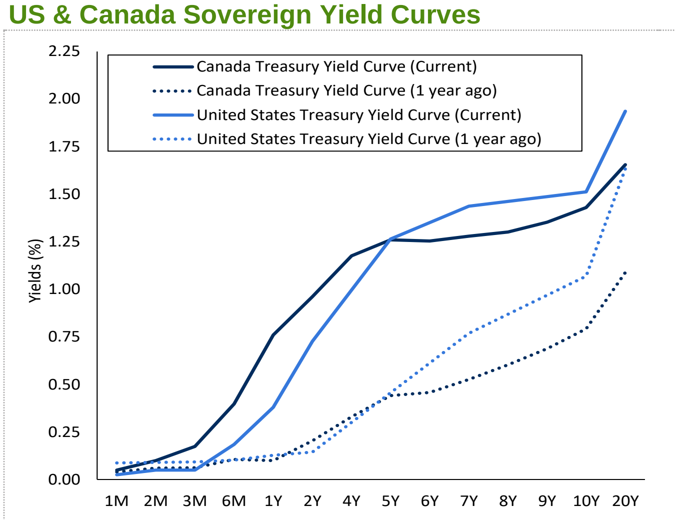
US Commercial Bank Loans/Leases vs. Deposits



Source: FRED; Data as of December 8, 2021

Other factors contributing to low interest rates are continued Covid-19 concerns, rising geopolitical concerns, the scarcity of attractive yield opportunities in Europe and Japan (especially after adjusting for currency hedging costs) driving international investors to the US, and, last but not least, the credibility the market gives the Fed (and other central banks) to fight inflation. With all of this discussion about rates not increasing, the 2-year and 5-year US Treasury note yields are increasing on a combination of expected rate hikes and the higher 2-year and 5-year inflation expectations. The yields on the different maturities are behaving similarly to the Fed's last taper-to-tightening cycle. Once the prior tapering process began, 10-year and 30-year yields declined, 5-year yields stayed relatively stable while 2-year yields increased, flattening the yield curve. Interest rates did not rise across the yield curve until the 2016 Presidential election stirred thoughts of faster growth and accompanying inflation and then again, as the Fed continued to tighten in mid-to-late 2017. So far, all indications from the Fed and market expectations are that this will be a shorter period between tapering and tightening as the Fed is eager to mop up excess liquidity. Of course, the Fed cannot alter the supply chain issues directly. It can only indirectly have an effect by slowing the economy with higher rates.

US & Canada Sovereign Yield Curves



Source: FactSet; Data as of January 11, 2022

- **With expectations that liquidity will remain elevated for 2022, the demand for fixed income globally will remain strong, keeping yield increases overall to a minimum while the yield curve continues to flatten (with short maturities rising faster than longer maturities). Geopolitical issues and virus concerns are likely to remain additional drivers, keeping rates relatively low. With the apparent failure to approve President Biden's Build Back Better Program, there is a less concern for a larger buildup of US Treasury Supply. The US will probably remain a destination for yield seekers. For additional yield enhancement, mortgage-backed securities can be added as well. Mortgage-backed securities also provide cash flow to investors that can be reinvested at higher yields, as short rates continue to climb versus all other rates. Canada's very high correlation between interest rates and economic strength to the US should bode well for Canadian interest rates as well. Comparing Canadian and US Government interest rates, we would prefer to be in short-term (3-7 years) Canadian/US notes. Given the outlook for economic growth in Canada and the US, we expect corporate spreads to perform in line with equities, so allocations across quality should align with equity risk allocations.**

FX – USD/CAD to Weaken into H2/2022

While the US dollar may receive some support from a myriad of factors in the short term, we expect the greenback to face some downward pressure over the longer term. As for factors to consider, relative growth profiles, interest rate differentials, trade and capital flows, relative valuation and technicals will all play a role in dictating direction of FX markets. The broader US dollar, proxied by the DXY US Dollar index, remained largely range-bound, heading into the year end.

Central bank action to rein in pandemic-era stimulus and begin normalizing monetary policy will be front and center in 2022. In Canada, markets are currently priced in nearly 6 rate hikes for the BoC with only 3 being priced in for the Fed. We expect interest rate differentials, especially on the short-end of the curve, to be a driving factor for USD/CAD. As it stands, the Fed has elected to speed up its tapering of asset purchases, remove the infamous "transitory" characterization when discussing inflation, and its latest round of dot projections shows Fed officials calling for three rate hikes in 2022. A repricing of market expectations for the BoC may leave CAD susceptible to some modest selling pressure in the short run, coupled with a potential lack of upside in commodities as demand for oil may be pressured due to the escalating situation surrounding the Omicron virus variant. We believe this is a short-term situation to consider, which is why we envision USD/CAD to have more upside potential in the short term before retreating to the downside in the latter half of 2022.

- **USD/CAD was hovering in overbought territory for much of December of last year, which suggested a corrective move to the downside in the immediate near term. We have seen this play out, with the pair slipping from 1.2965 to 1.2600 at the time of writing. However, we continue to recommend holding a modestly bullish view for H1/2022 (+USD) and a bearish view for H2/2022 (-USD). The pair has failed to breach the 1.2965 level to the upside on three different occasions going back to late 2020, so this will be our first key of resistance to monitor. A convincing break will have us looking at 1.3025 as our next target to the upside (38.2% Fibonacci retracement level from the pairs downward slide from its 2020 high of 1.4670 to its 2021 low of 1.2000). To the downside, we will keeping an eye on 1.2635 as our first key level of support, followed by 1.2300.**

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