MACKENZIE

BLUE BOOK

2023 OUTLOOK

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GLOBAL MACRO OVERVIEW

Adjusting to life after Goldilocks

Investing becomes more selective again

SUMMARY POINTS

- Expect interest rates to be higher for longer
- Central bank actions will slow growth
- Weaker economy will be a headwind for earnings
- Be selective about equity positioning in 2023
- Looking for entry points in short-term bonds

The Goldilocks era for investing of "not too hot, not too cold" — where low inflation and moderate economic growth allowed central bankers to flood the financial system with liquidity — has shifted significantly.

The thesis that inflation was transitory, and would ease once the pandemic-induced supply-side shocks cleared, proved faulty. Although commodity prices have moderated, they have been replaced by high rents and higher wages in a stubbornly tight labour market. This forced central bankers to increase rates rapidly, sending both stock and bond prices lower, and leaving very few places for investors to hide in 2022.

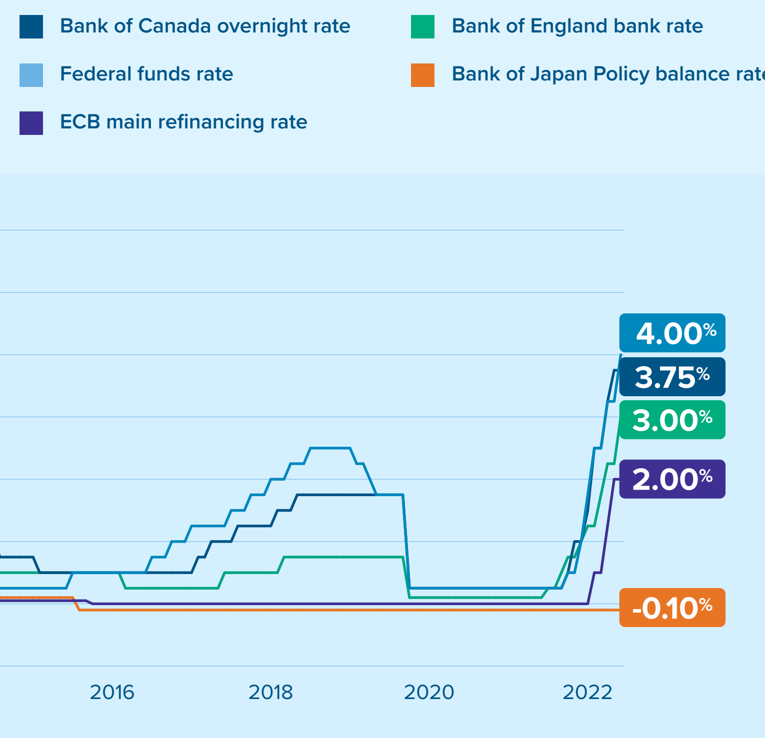
As we enter 2023, investors will focus on signs that inflationary pressures are easing as an indication that much of the heavy lifting by central banks is in the rearview mirror. At the same time, emphasis will shift to assessing how much economic damage will be caused by significantly tighter monetary policies.

The equity rallies observed in the latter half of 2022 were largely driven by a combination of short-term oversold conditions and expectations that central banks, particularly the Federal Reserve, were going to pivot. In other words, **investors were making a bet that central bankers would lose their resolve** in the inflation fight for fear of sending their respective economies into recessions.

Although central banks have recently signalled that the magnitude of rate increases may slow, this change in guidance does not constitute an outright pivot. We see the magnitude of rate increases moderating, but **we believe the market should heed the theme of higher for longer, and act accordingly and that financial conditions will likely tighten further at the start of the year.**

Central banks slamming the brakes

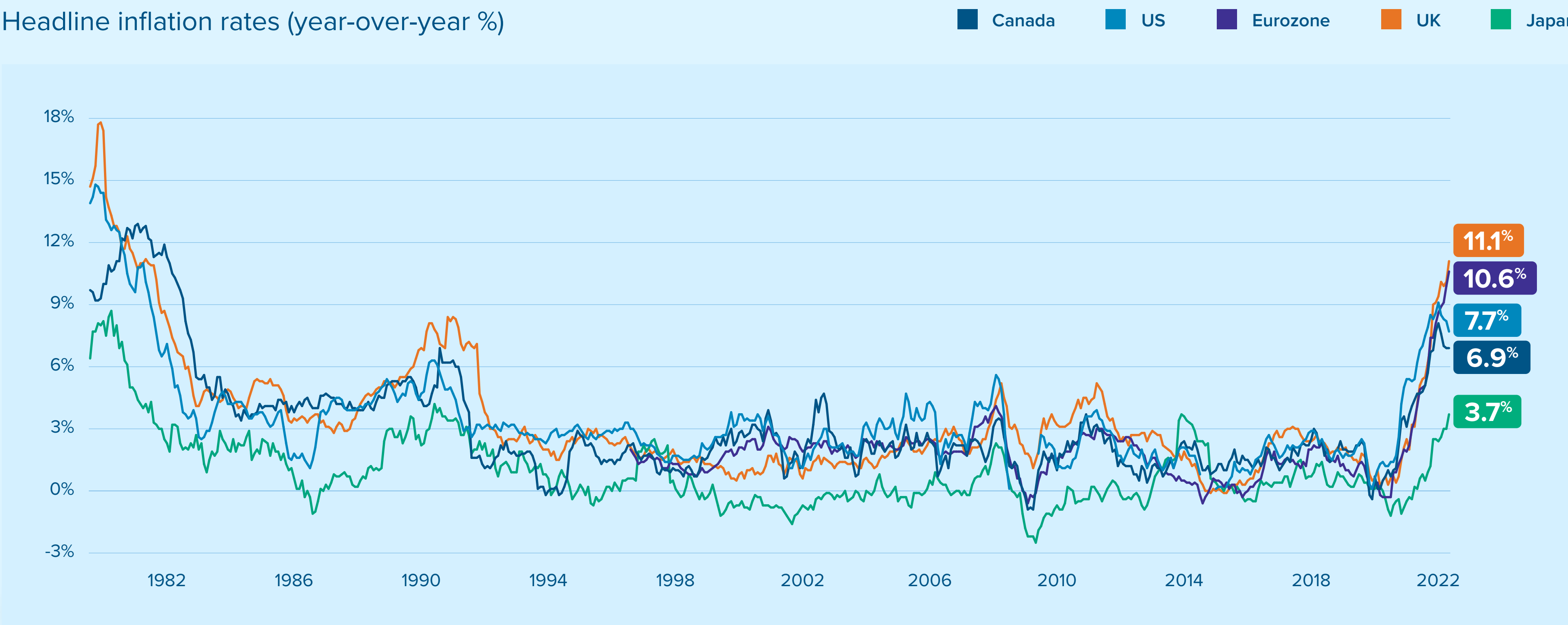
Global central bank overnight rates (%)



Source: Bloomberg, November 30, 2022.

Inflation surges to 40-year high

Headline inflation rates (year-over-year %)



Source: Bloomberg, October 2022.

Inflation could remain stickier than current market expectations, particularly if we see improvement in the Chinese economy on the loosening of the zero-COVID-19 policy and/or ongoing Russian actions to curtail supplies of energy and grain.

This also highlights the geopolitical risks that remain. The Russia/Ukraine conflict has dragged on longer than most expected and potential flare-ups at any given time pose an ongoing risk, particularly for the European economy.

In China, Xi Jinping's consolidation of power may pave the way for better economic conditions, but tensions with the West are elevated, creating the potential for ongoing sanctions and a weaker outlook.

We have also yet to see how central banks, particularly the Fed, will react should inflation remain well above target in the face of lingering inflationary pressures and rising unemployment.

On balance, rates markets appear to have received the message and are pricing in a terminal federal funds rate at approximately 5%, while seeing rates above 4.7% into 2024. As a result, we think **the worst is behind us in the rates market and see some attractive entry points at the short end of the yield curve.**

As we move into 2023 and economic growth slows, upward pressure on longer-term yields should also abate. This sets the stage for an environment of broadly positive bond market returns in 2023, more in-line with long-term averages of low to mid-single digits.

The path for equities will likely be more volatile. Notwithstanding short-term sentiment-induced rallies, we believe earnings estimates for 2023 need to reflect slowing economic growth more accurately, along with signals that the tightening cycle is complete.

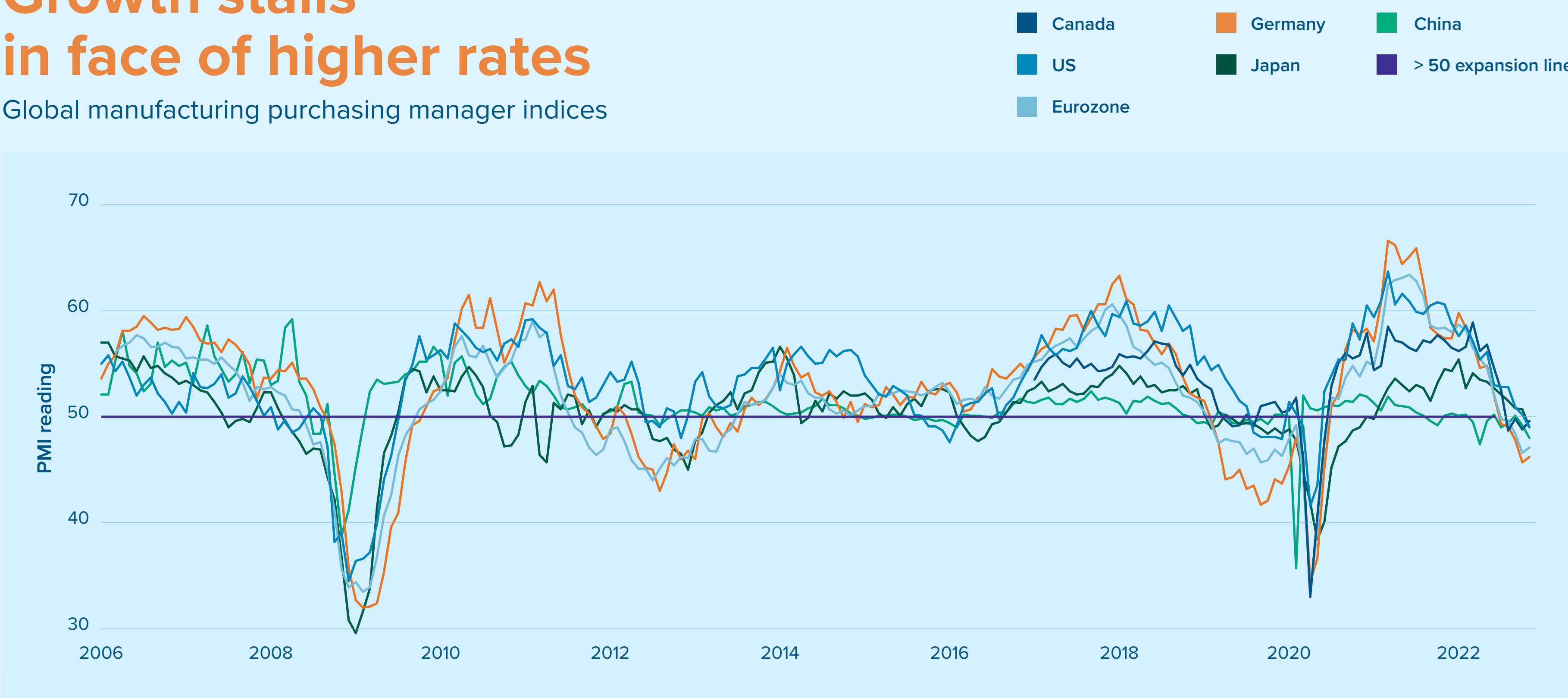
Earnings expectations have moderated as we have seen a flood of weak earnings results in the back half of the year, particularly from large-cap US technology companies. However, we believe the lagged effect of monetary policy, along with the cumulative impact of higher inflation, will result in a weakening economic picture as we move through the new year.

We see evidence of slowing economic growth. Consensus GDP estimates were revised lower, and global manufacturing PMIs are declining and hovering at or below the 50-point expansion line — the level that indicates growth versus contraction. Housing is also slowing at a rapid pace.

A deteriorating economic backdrop will initially act as a headwind to equity prices but ultimately sets the stage for equities to look through the slowdown and begin the road to recovery. As such, **we think equities will remain volatile to start the year, but ultimately form a bottom and put together a sustainable move higher as the year progresses.**

Growth stalls in face of higher rates

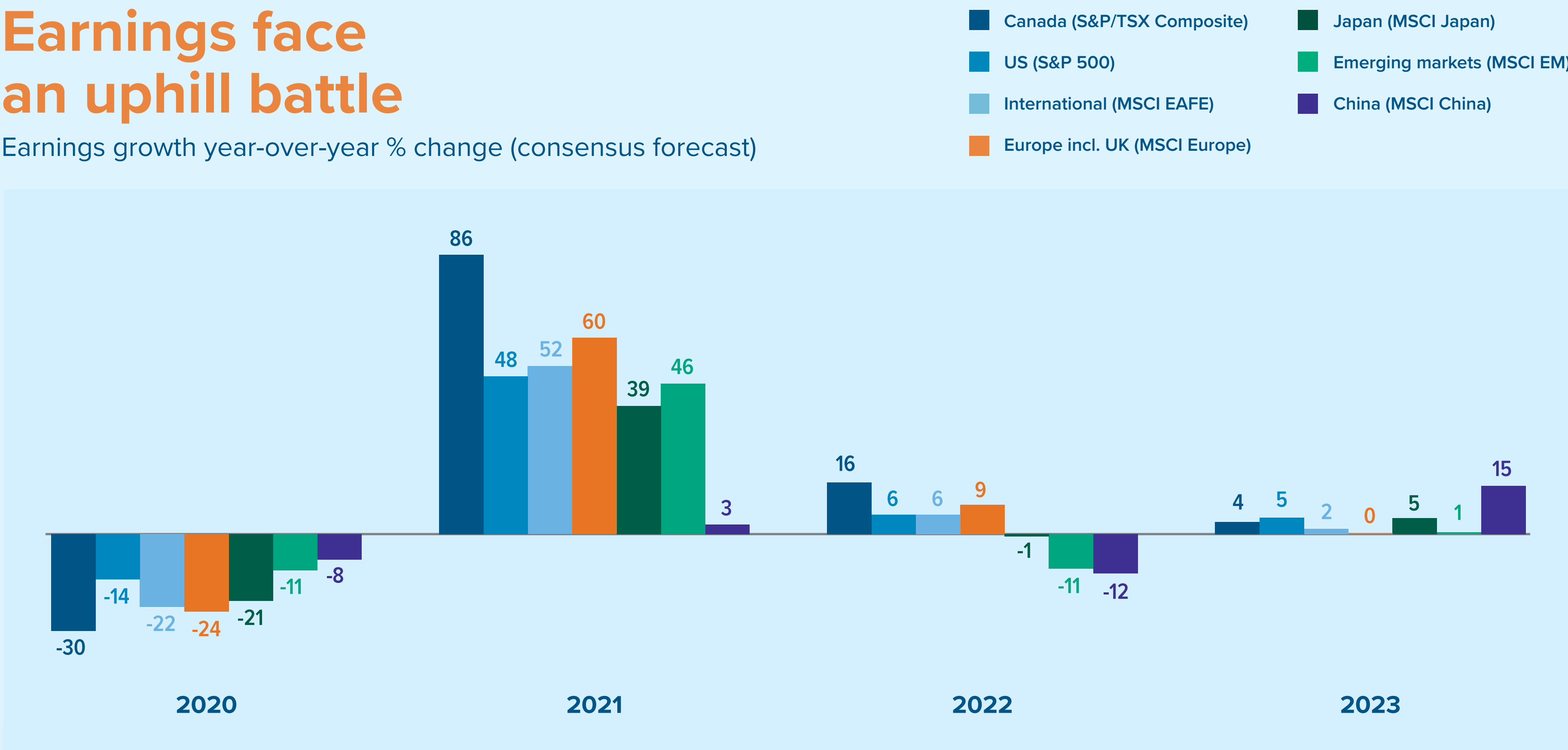
Global manufacturing purchasing manager indices



Source: Bloomberg, November 2022.

Earnings face an uphill battle

Earnings growth year-over-year % change (consensus forecast)



Source: FactSet, December 2, 2022.

Our view

The combined backdrop of a peak in interest rates in 2023 and the likelihood of equities beginning to price in an economic recovery lead us to a neutral stance in allocations between equity and fixed income. Both asset classes offer upside potential this year, although the path and magnitude will likely differ.

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Themes

Theme 1
Financial tightening:
No pain, no gain

Theme 2
Economic slowdown:
How broad, how deep?

Theme 3
Geopolitical headwinds:
Unlikely to blow over

Financial tightening: No pain, no gain

As Federal Reserve Chair Jerome Powell warned in August, consumers and businesses will experience pain in 2023, due to elevated borrowing costs.

Soaring inflation gave central banks little choice but to hit the economy with the largest rate hikes in over 40 years throughout 2022. Markets repriced repeatedly for the expected tightening of monetary policy. As late as the fourth quarter, North American bond markets underestimated the potential peak in rates next year, making 2022 one of the worst bear markets for bonds on record.

The lagged effect of monetary policy means the impact of higher borrowing costs are only gradually felt throughout the economy. **Today's higher yield curve creates tighter financial conditions for households and businesses, slowing borrowing for consumption and investment,** and increasing the cost burden as existing debt coupons reset. It also hinders the carry-trade that supports some lending and speculation.

The Canadian economy is likely to feel the impact well into 2023. Higher household debt has increased overall sensitivity to rising yields, making Canadian households among the most rate-sensitive globally. Demand will slow quickly unless nominal incomes increase to compensate for inflation, including debt costs. Businesses may become cautious given increasingly uncertain demand and elevated costs of inputs and interest.

The leading edge of monetary policy impacts may be seen already in the Fed's Senior Loan Officer Opinion Survey and the Chicago Fed's National Financial Conditions Index — both of which show a much tighter lending picture over the last 12 months, commensurate with past periods of economic strain.

Consumer credit card use has been rising while savings rates have fallen. **Delinquencies remain very low, but there is a greater likelihood they will rise in 2023**, as the benefits from the last two years of stimulus fade and tighter financial and economic conditions set in.

Much like the household economic picture, corporations have benefited from low borrowing costs. Most businesses with fixed rate debt have not seen new-issue debt costs this high since 2009. Many companies should be able to absorb rising debt costs for a while. **We do not foresee a large default wave in 2023, as the refinancing calendar for the high-yield bond market will not be significant until 2025.**

We do not foresee a large corporate default wave in 2023.

– Steve Locke
CIO, Fixed Income and Multi-Asset Strategies

Our view

We believe that if central banks are forced to maintain policy rates at these levels to rein in inflation, tighter financial conditions will be a headwind for business fundamentals in 2023.

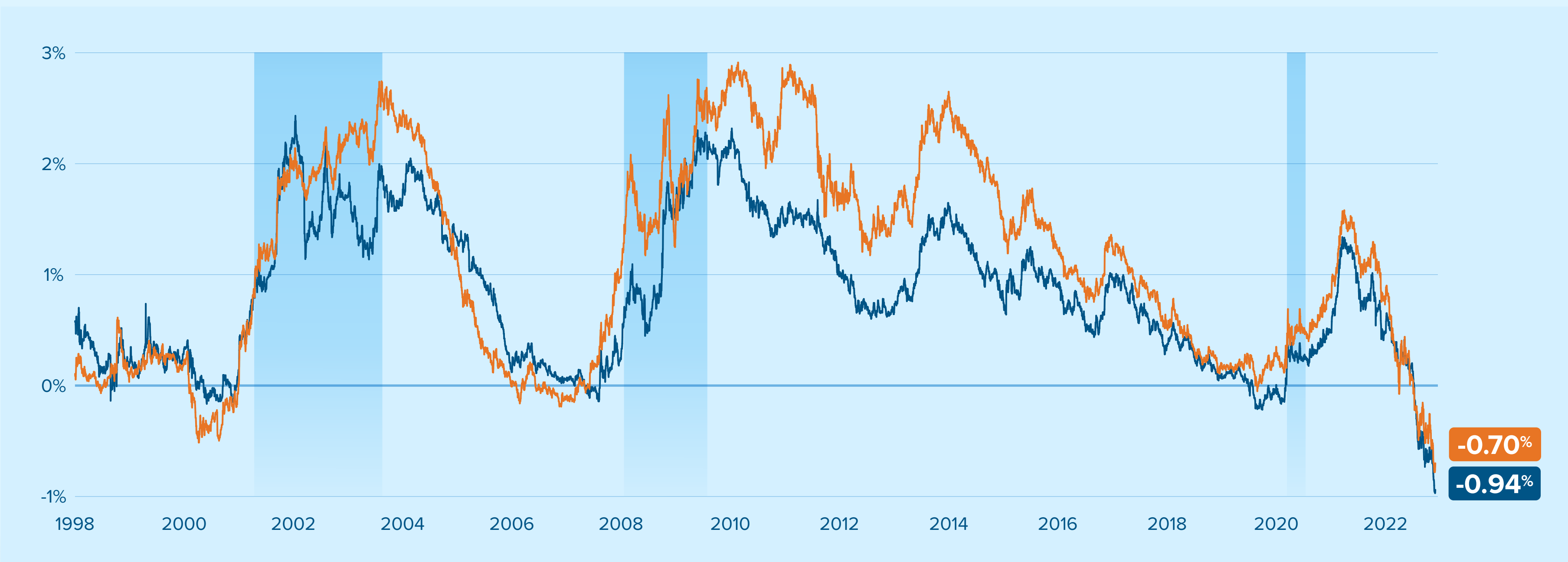
Priced for imperfection: Bond market sees a slowdown

Canada and US 10-year to 2-year spread (%)

Canada spread

US spread

US recession indicator



Source: Boomberg, November 30, 2022.

Economic slowdown: How broad, how deep?

It's not a question of *if* there will be a slowdown, but whether there will be a soft or hard landing and how long the economic malaise will last.

Earlier this year, Federal Reserve Chairman Jerome Powell clearly warned that "fighting inflation will bring some pain to households and businesses." Several months later, the world knows the true gravity of the situation as persistent inflation still threatens the global economy. Some data supports the economic slowdown narrative: a downward trajectory in leading indicators, negative revisions in expected global growth, slowing housing demand, falling manufacturing data and a decline in job openings. But there are countertrend indicators as well: employment is still increasing, as are wages, retail sales and capital spending.

The economic effect of rapid rate increases will only be fully known in 2023, because monetary policy takes time to work its way through the system. Economic growth is watched closely for its impact on corporate earnings — which are facing additional headwinds from higher costs, slowing demand, outsized currency moves and higher financing costs. And the more severe the downturn, the greater the downward revision to earnings.

The path to a soft landing is the reduction of job openings, without destroying jobs. This scenario allows the consumer to continue to shore up the economy and offset a slowing business environment. We believe that a soft landing can be achieved as consumer spending has thus far been supported by a healthy job market, wage gains and the ability to drawdown COVID-19-era savings, but both the Federal Reserve and the Bank of Canada have acknowledged that the path to a soft landing is narrow.

A hard landing would entail a job market that deteriorates to the point of significant layoffs, which would drive up the unemployment rate and destroy consumer confidence and spending. We see this as a lower likelihood scenario.

This economic backdrop also has a regional nuance. Europe has been hurt by the combination of inflationary forces from the post-pandemic recovery and rapid rise in food and fuel costs due to the war in Ukraine. **We expect Europe will be in a recession in 2023.**

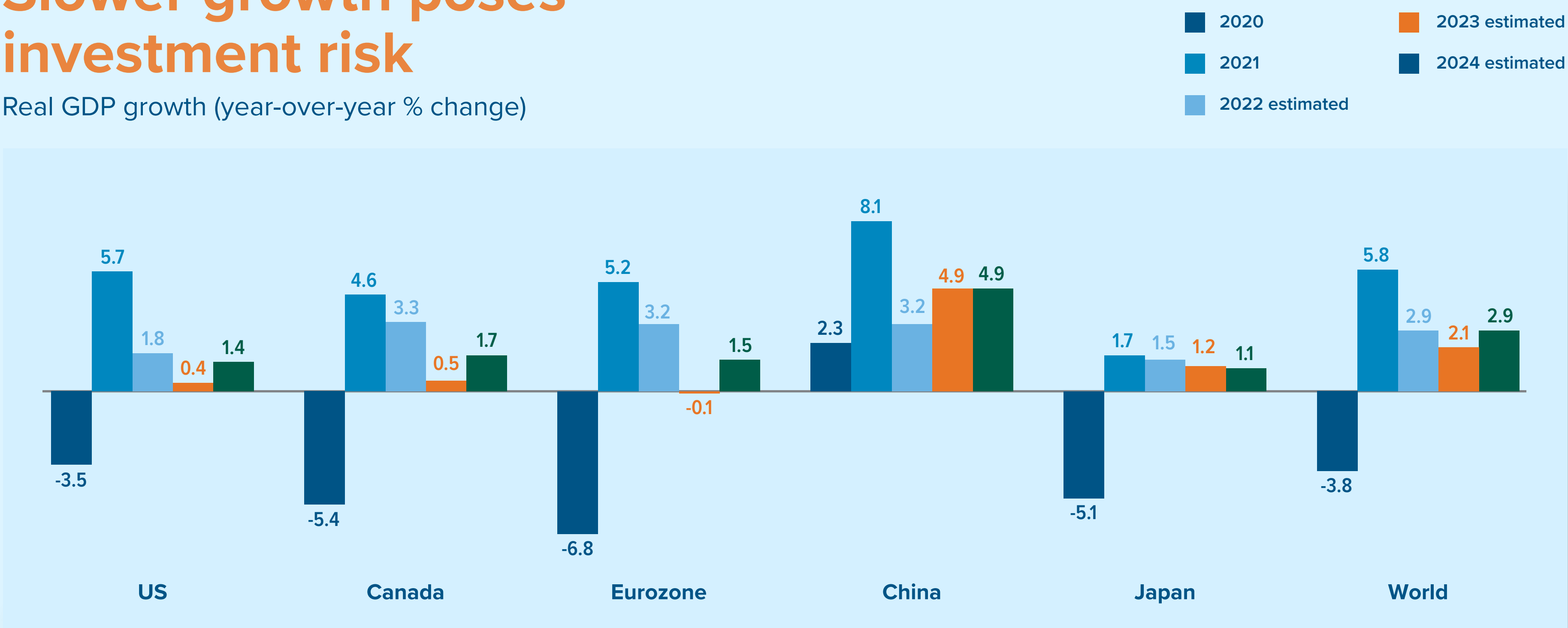
> **We believe that a soft landing can be achieved.**
>
> **– Lesley Marks**
> CIO, Equities

Our view

Despite the clouds building in the economic backdrop, we believe that equity markets will begin to look through the valley of an economic slowdown towards the next business cycle. This will set up for a broad-based equity recovery later in the year. In the meantime, focusing on high-quality companies with near term earnings visibility and low sensitivity to economic growth can provide solid equity returns in the face of higher economic uncertainty.

Slower growth poses investment risk

Real GDP growth (year-over-year % change)



Source: Bloomberg, November 30, 2022.

Geopolitical headwinds: Unlikely to blow over

The turmoil of 2022 will likely have staying power into the next year and beyond.

Russia's invasion of Ukraine in early 2022 was expected to be a quick and destructive war, but instead it has been a long drawn out conflict with Russia's objectives remaining elusive.

This war is significant for the region because it poses severe challenges to Europe's energy supply. To date, the energy crisis has been less dire than expected and European natural gas futures have fallen drastically from their recent peak, but are still above pre-conflict levels. As such, pressure on European businesses and consumers lingers.

Europe's food supply has also been impacted, as European farmers have reduced production in response to elevated energy costs. This has led to increased imports from other regions that will come with a higher price tag. Russia has also weaponized grain shipments by halting access to Ukrainian ports, putting further upward pressure on food prices in Europe.

Geopolitical risks have also been simmering with respect to US-China relations. The ongoing trend of tough-on-China policies deployed by the US is unlikely to change.

When President Xi Jinping secured an unprecedented third term at the 20th National Congress of the Communist Party, he emphasized two long-term goals for the country: **high-quality growth** driven by technology and innovation and **national security** in food, energy, technology, supply chain and defence.

As China sets ambitious goals to boost per capita income to middle-income levels by 2035, the competition and rivalry between the two largest economic powers may be inevitable.

China's dynamic zero-COVID-19 policy has arguably been the more immediate concern for markets as it has stifled economic growth in the region. Whether China reopens will have significant implications for the rest of the world in terms of global supply chains and global demand recovery, and in turn economic growth. Recently, the new party leadership has taken some steps in easing its zero-COVID-19 policy.

Although uncertainty remains high, our base case sees leeway to further ease China's zero-COVID-19 policy and support the economy with easy monetary policy and stimulative fiscal policy. These developments will support economic growth. **At the same time, this will place additional upward pressure on commodities and global inflation as a whole.**

> **The ongoing trend of tough-on-China policies deployed by the US is unlikely to change.**
>
> **– Ron Hanson**
> SVP Investment Strategy and Portfolio Solutions

Our view

Heightened geopolitical risks justify a more defensive position in equities, favouring dividend paying companies and higher-quality businesses that exhibit lower volatility.

Europe braces for a cold winter

Germany natural gas prices (EUR/MWh)

Source: Bloomberg, November 30, 2022.

Asset class views

- Canadian equity
- US equity
- European equity
- Asian equity
- Chinese equity
- Emerging markets equity
- Global fixed income
- Credit
- Currencies
- Commodities

Canadian equities

William Aldridge, MBA, CFA
SVP Portfolio Manager and Team Co-Lead,
Mackenzie North American Equities Team

For most of the last decade, it was a difficult time to be invested in Canadian equities relative to the more growth-oriented US market. This dynamic began to shift in 2022 as inflation and rising interest rates proved to be a significant headwind to growth stock performance. The period of growth stock euphoria we have just come through felt similar to the dot-com era more than 20 years ago. Following the deflating of that bubble, Canadian stocks outperformed the US market for several years (see chart).

As market leadership continues to shift, and investors begin to place greater value on companies with near-term cash flow, Canada is well positioned given its mix of sectors and companies. The benchmark is replete with somewhat slower growing but higher cash generating companies.

The Canadian market has outsized exposure to companies that operate in markets and industries with high barriers to entry, which leads to strong pricing power and the ability to sustain margins. What Canadian investors may give up in terms of somewhat higher growth in the longer term, they gain in the form of a commitment to high dividend payouts today. We expect continued dividend growth from Canadian banks, utilities, energy, railway and consumer discretionary and staples companies.

After years of what felt like a bear market for the energy sector, the sector gained favour in 2022, as companies generated strong cash flow from high commodity prices. Producers began to return capital to shareholders through dividends and share buybacks. Less focus was placed on production growth, though we expect a shift towards modest growth at current prices. One caveat is that an economic slowdown may lead to pressure on energy commodity prices as demand slows.

We expect the state of the Canadian housing market to be a key focus in 2023 if interest rates remain elevated and the employment picture deteriorates. We have begun to see the impact of higher rates on consumer spending. As well, for Canadian equities to continue to outperform, the Canadian banks will need to navigate the economic slowdown, something they've been able to do over the course of many market cycles.

As market leadership continues to shift, and investors begin to place greater value on companies that generate near-term cash flow, and distribute those cash flows to shareholders, Canada is well positioned.

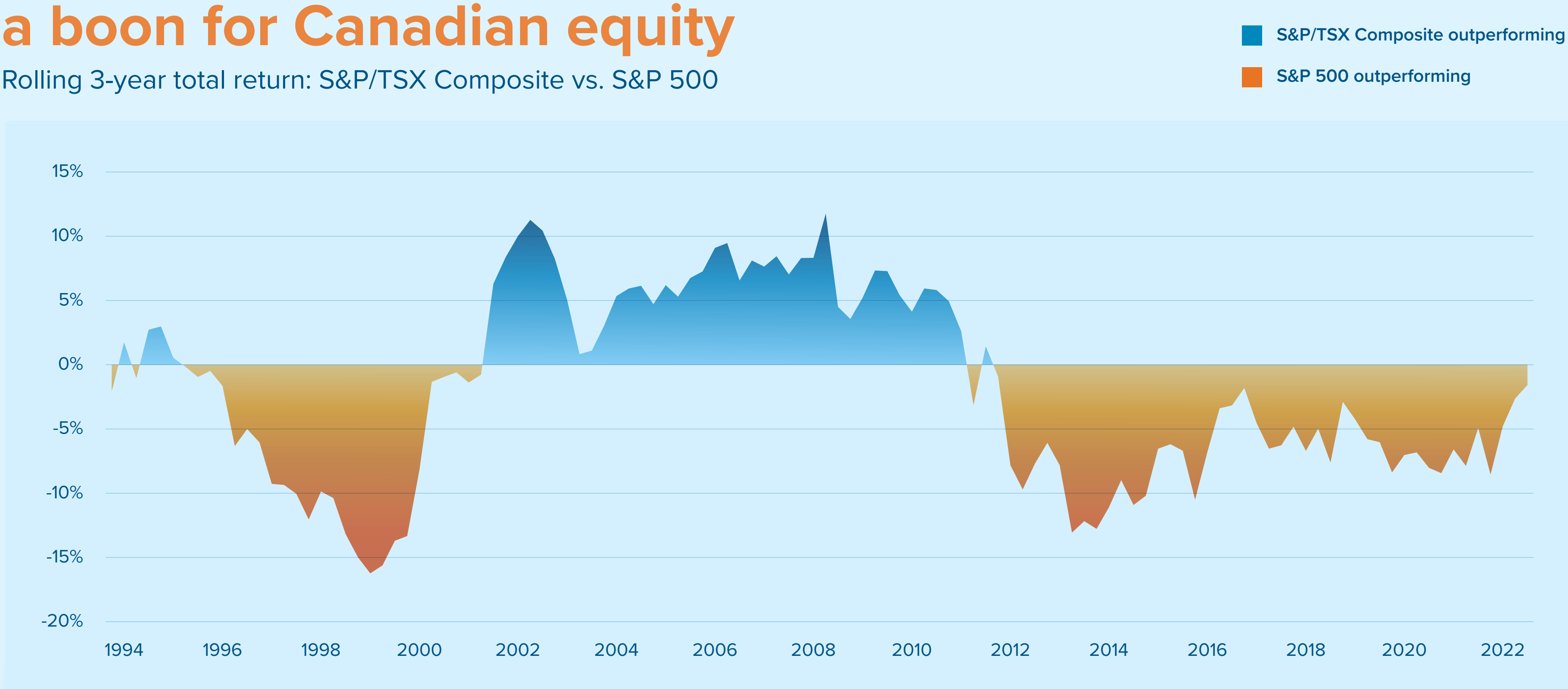
– William Aldridge

Our view

Canadian equities should continue to outperform other regional equity markets, as they did after the dot-com bubble burst.

Last US tech crash was a boon for Canadian equity

Rolling 3-year total return: S&P/TSX Composite vs. S&P 500



Source: Bloomberg, Quarterly Data, Q1 1990 to Q3 2022.

US equities

Katherine Owen, MBA, CFA
VP Portfolio Manager,
Mackenzie Global Equity and Income Team

Investors are faced with an environment of persistent inflation for the first time in three decades due to fiscal and monetary stimulus packages to support economies that were locked down during the pandemic, supply chain disruptions, and geopolitical events. Consequently, the Federal Reserve implemented a series of interest rate increases that may continue into early 2023.

Higher rates and elevated inflation should dampen consumer spending and economic growth. A recession over the coming year is now likely. While valuations in the US equity market have corrected to reflect higher interest rates, they have yet to discount lower earnings as economic growth decelerates. The severity of a potential recession may be a key driver of market performance in 2023. We do not expect a repeat of the Great Recession, during which the functioning of the economy was hampered, as the banking system is now well capitalized. Instead, the recession could be concentrated in those sectors that thrived due to ultra-low interest rate policies but now are unappealing in a more normalized situation. The steep decline in cryptocurrencies and unprofitable technology stocks are examples of speculative excess incited by free money. Businesses in healthcare, consumer staples, energy, materials and financials, that deliver essential goods and services with strong pricing power to pass along cost increases should be well positioned to outperform in 2023.

We are in a transition period from an era of unusually accommodative monetary policy toward one of structurally higher interest rates as de-globalization, onshoring, and increasing geopolitical risks create structural changes in the global economy. Historically, regime shifts create more volatility and can be long lasting.

Stocks that have worked best over the past decade may not be the ones that perform the best over the next market cycle. We have seen a rotation in leadership in the equity market from long duration growth stocks into companies with predictable economics and strong cash flow generation – a trend we expect to continue, favouring companies that pay sustainable and increasing dividends that can keep up with inflation. Historically, dividends have been an important source of returns — accounting for over 40% of the total return of the S&P 500 over the past hundred years. Reinvested dividends, particularly those that grow year over year, should continue to be an important way to compound wealth over time — perhaps more so, in today's uncertain macroeconomic backdrop.

Businesses that deliver essential goods and services with strong pricing power to pass along cost increases should be well positioned to outperform in 2023.

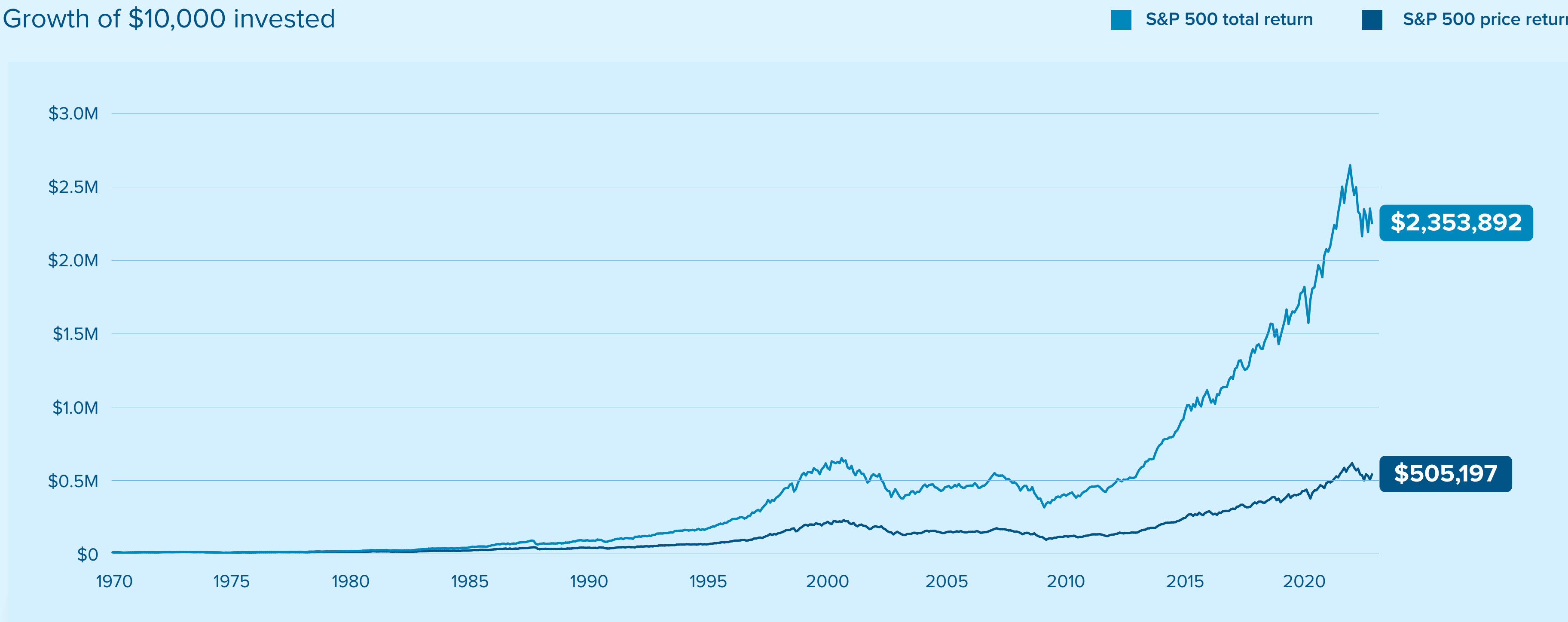
– Katherine Owen

Our view

Amid current market volatility, owning high-quality US dividend payers with resilient business models should help investors weather the headwinds of rising inflation, higher interest rates, and a potential slowdown in global growth.

The power of reinvested dividends

Growth of $10,000 invested



Source: Bloomberg, November 30, 2022.

European equities

Seamus Kelly, MSc
SVP Portfolio Manager and Team Lead,
Mackenzie Europe Team

Rising interest rates and tighter financial conditions signaled a regime change for markets in 2022. Having recorded an all-time high in the first week of January 2022, the MSCI Europe Index reversed course with falling global risk appetite and the significant events unfolding within the region, namely the Russian/Ukraine conflict, the ensuing European energy crisis and UK political turmoil.

Russia's invasion of Ukraine has had far-reaching humanitarian and economic consequences. The most significant economic impact for Europe was the vastly reduced flows of Russian natural gas, resulting in higher energy prices for European industries and households. This crisis will accelerate Europe's energy transition, but that remains a multi-year project requiring significant capital investment and could result in structurally higher energy costs for the region going forward.

Europe will face many challenges in 2023: post-pandemic reopening tailwinds have faded, the energy situation remains a source of risk, monetary tightening and labour shortages are affecting many industries and negative real wage growth is impacting consumer demand. An economic recession is our base case scenario.

The perfect storm of known risks has brought the region's relative valuations to multi-decade lows and leaves Europe in a more balanced risk-reward situation. Given investors have already withdrawn significant capital in recent years, and as European equities did not benefit to the same extent as equities in other regions during the post-GFC liquidity boom, European equities are arguably less vulnerable to the current withdrawal of that liquidity by global central banks.

The European energy situation, while still a significant source of risk, is now in a much better position than anticipated during the summer, with European gas storage levels exceeding 90% of capacity and prices down significantly from the summertime peak after a relatively mild start to winter.

The EU labour market remains strong and while consumer sentiment is negatively impacted by inflation, the unemployment rate remains historically low. Weaker European currencies have bolstered the earnings and the competitiveness of export-orientated corporations. The greatest source of investor anxiety in previous crises has been the European banking sector, which is currently benefiting from increasing interest rates and a strong capital position.

The perfect storm of known risks has brought the region's relative valuations to multi-decade lows and leaves Europe in a more balanced risk-reward situation.

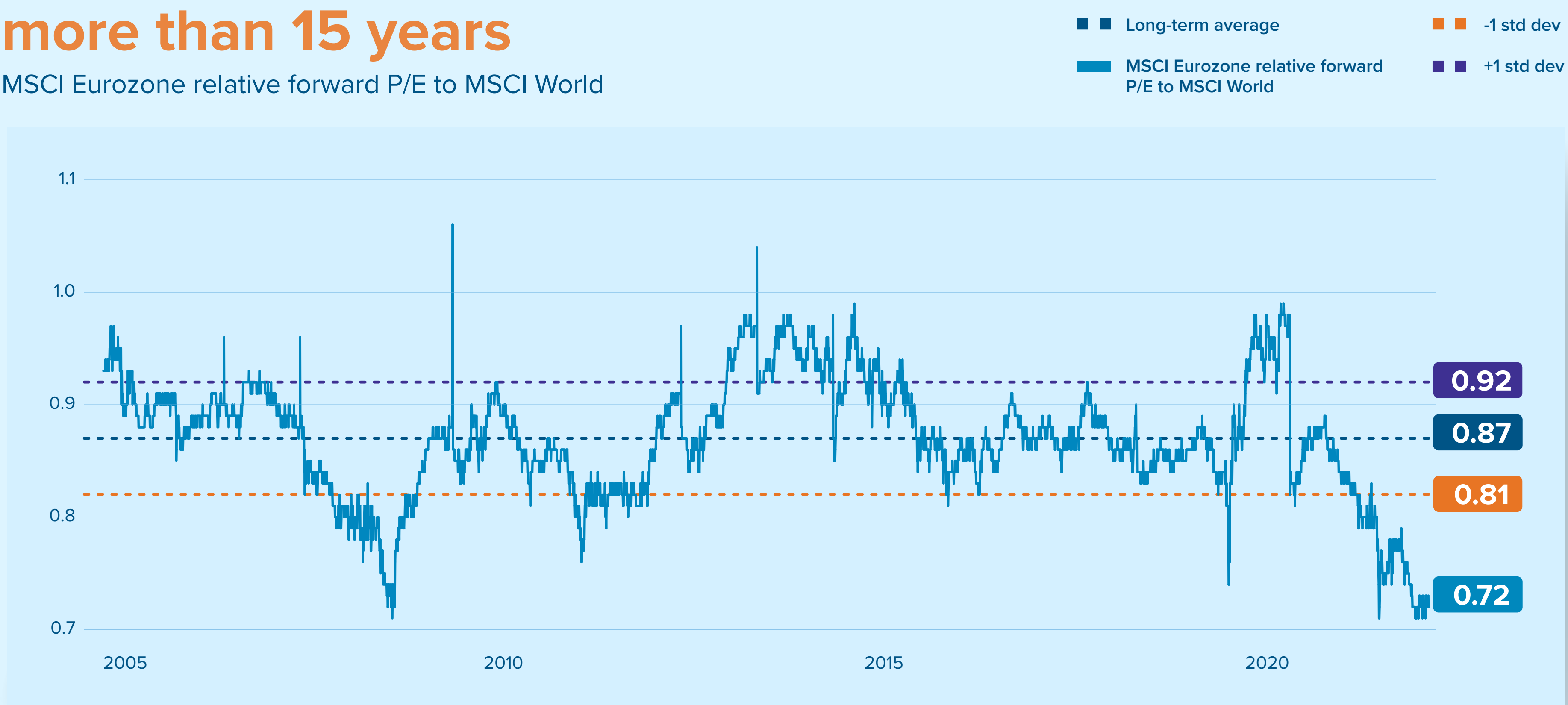
– Seamus Kelly

Our view

The backdrop is challenged, but with a lot of negativity priced into Europe's low valuations, any outcome that is better than feared should see European equities have better relative performance in 2023.

The biggest sale in more than 15 years

MSCI Eurozone relative forward P/E to MSCI World



Source: Bloomberg, November 30, 2022.

Asian equities

Nick Scott
SVP Portfolio Manager and Team Lead,
Mackenzie Asia Team

The Asian equity bear market is well advanced relative to historical downturns. Weak relative performance over the past year has made Asian equity valuations attractive as they now sit in the bottom quartile compared with historical levels going back to 1990. A strong US dollar, continued zero-COVID-19 policies in China and America's decoupling measures with China (including various Congressional Acts targeting China's technology sector) have all played a part in the bear market.

However, on a forward-looking basis, there are macroeconomic factors that we believe should be a positive for Asian equities. For example, Asian economies are less vulnerable to the inflation trends seen in the US and Europe because labour conditions are not as tight and money supply was not boosted by large transfer payments from governments to households. In addition, Asia's inflation has had more of a cost-push element, with the bulk of the increase driven by higher commodity prices. These prices have already fallen from their peak levels.

Therefore, Asia's central banks have more policy independence from the US Federal Reserve compared with the European Central Bank, Bank of Canada or the Bank of England. Contrary to most major economies, China is reducing interest rates and using fiscal policy to boost its economy.

The Bank of Japan is showing its monetary policy independence by continuing its yield curve control and negative short interest rates policy to stimulate economic growth. Japan's currency has been supressed as a result and its real effective exchange rate is now back to 1971 levels.

While there has been minimal wavering from the zero-COVID-19 policy in China, there is a pathway to a gradual reopening in the first half of 2023. We believe that the Shanghai lockdown in the second quarter of 2022 will likely prove to be the peak of COVID-19 disruption for China.

India was a relative bright spot in a depressed global economy in 2022. Even though the stock market has outpaced the real economy, the longer-term outlook is still attractive. The "Make in India" policy focusing on building global manufacturing hubs in 14 industries should help the overall investment cycle and the residential property cycle has already recovered from a seven year downturn.

In my view, Asian economies are less vulnerable to the inflation trends seen in the US and Europe because labour conditions are not as tight and money supply was not boosted by large transfer payments from governments to households.

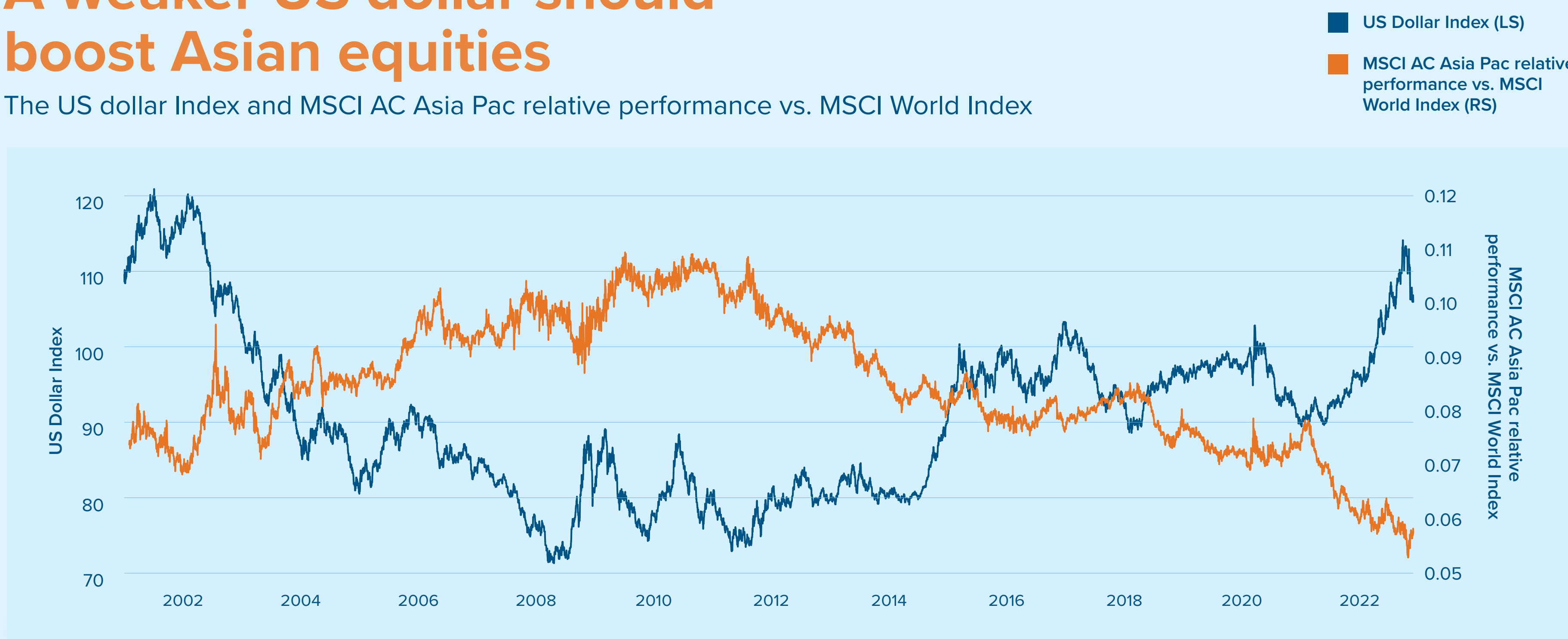
– Nick Scott

Our view

Gradual easing of COVID-19 policies in China over 2023 make certain Chinese equities attractive such as consumption and reopening plays. Indian and ASEAN equities should be direct beneficiaries of a reduction in US dependency on manufacturing in China. The weak Japanese yen also makes Japanese exporters highly competitive, providing a boost to Japanese equities.

A weaker US dollar should boost Asian equities

The US dollar Index and MSCI AC Asia Pac relative performance vs. MSCI World Index



Source: Bloomberg, November 30, 2022.

Chinese equities

Wenjie Ding, Ph.D
Investment Strategist,
China Asset Management Inc.

After nearly two years of weak performance, we are more constructive on Chinese equities for 2023. Resurgence in COVID-19, sliding property sales and investments, geopolitical conflicts and policy uncertainty weighed on Chinese equities in 2022 but are expected to trend more favourably in the year ahead.

We expect China's economy to have a vigorous rebound in 2023, supporting both corporate earnings growth and market sentiment recovery. Manufacturing and infrastructure investment are likely to maintain robust growth, whereas consumption and real estate investment should gradually pick up.

Although China has shown some signs of relaxing its zero-COVID-19 policy, effective containment of COVID-19 remains a high priority for authorities and is viewed as necessary to stabilize both the economy and the equity market. As a result, we do not expect zero tolerance to be meaningfully lifted until the second or third quarter of 2023.

With President Xi Jinping securing an unprecedented third term at the 20th Party Congress in October 2022, China is setting a clearer policy path. The Congress has emphasized high quality growth underpinned by technological innovation, sustainable and inclusive development as well as a special attention to national security in food, energy, technology, the supply chain and defence.

There are risks to our outlook, though, including the threat of prolonged COVID-19 restrictions, further sliding of the property market, and the escalation of geopolitical tensions. Slowing economic growth in Europe and North America may also weigh on China via exports or other economic ties.

Nevertheless, we believe the valuation of Chinese equities relative to other markets continues to be at a discount. Given that China is on a divergent path of monetary policy and inflation from most developed and emerging markets, we believe Chinese equities will provide diversification benefits to global investors.

We expect China's economy to have a vigorous rebound in 2023, supporting both corporate earnings growth and market sentiment recovery.

– Wenjie Ding

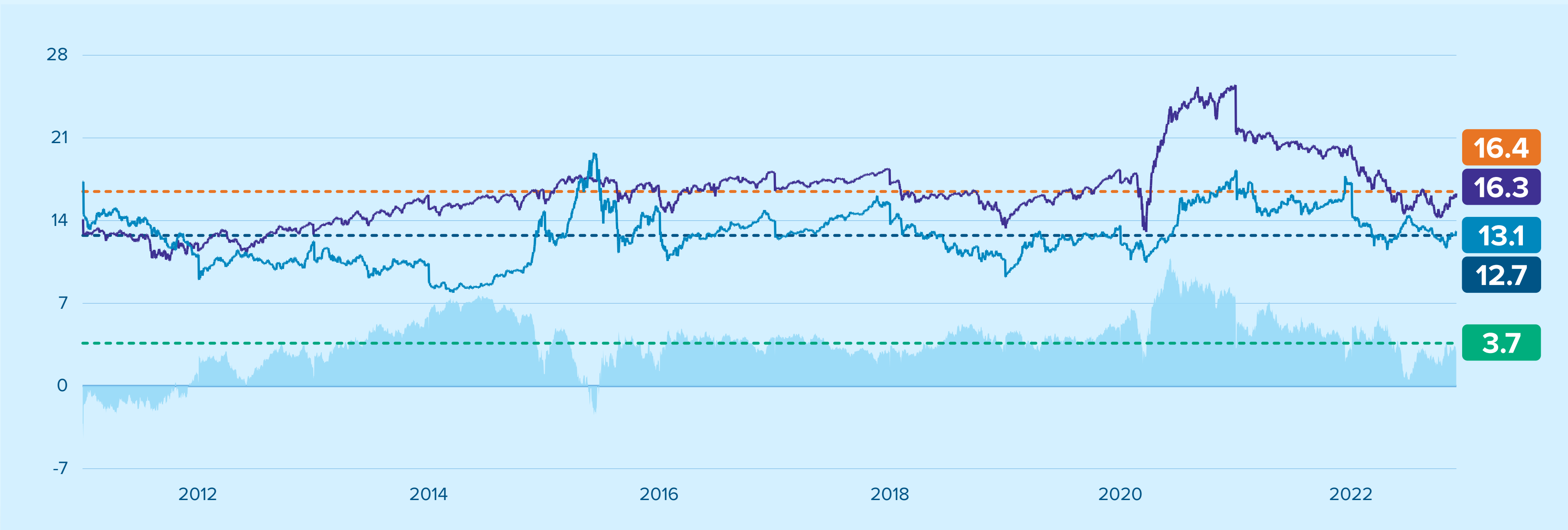
Our view

We expect to see long-term opportunities in advanced manufacturing, technology and renewable energy, which have sound growth prospects and may benefit from policy support. Anticipation of economic reopening will also bring re-rating catalysts to consumer and healthcare sectors.

China closing the valuation gap

Equity valuations: CSI 300 vs. MSCI World

CSI 300 10-yr Historical Average Forward P/E
MSCI World 10-yr Historical Average Forward P/E
CSI 300 Current Forward P/E
MSCI World Current Forward P/E
Valuation gap
Average valuation gap



Source: Bloomberg, November 30, 2022.

Emerging markets equities

Arup Datta, MBA, CFA
SVP Portfolio Manager and Team Lead,
Mackenzie Global Quantitative Equity Team

This past year has been a tough year for emerging markets equities (EM) as the region experienced historic outflows during the first half of 2022 and sluggish performance year-to-date.

Throughout the year market volatility was persistent, as investors remained worried due to rising fears of a global recession and the US Federal Reserve's aggressively hawkish tone. The combination of a stronger US dollar, higher inflation and tighter financial conditions all contributed to the struggles in emerging markets equities.

China, Taiwan and South Korea were the primary detractors from emerging markets performance. The only sizable contribution came from Brazil, however, this did very little to offset the collective losses. A resurgence in COVID-19 infections in China led to further lockdowns, and macroeconomic data continued to point to slowing growth in Asia. In addition, the ongoing Russian war on Ukraine and diminishing relations between the United States and China increased worries over already strained supply chains in EM and globally.

Despite the recent performance of emerging markets and the ongoing uncertainty, there remains strong valuation support, especially compared to the US. We continue to believe that EM is well-positioned for growth over the next decade and that this may be an attractive entry point as valuations remain at a steep discount relative to developed markets.

In 2022, China brought down performance in EM, however India provided a strong offset. Heading into 2023, we continue to believe in the long-term benefits of emerging markets equities within a diversified portfolio, and the diverse nature within the emerging market universe itself has potential to be beneficial.

Despite the recent performance of emerging markets and the ongoing uncertainty, there remains strong valuation support, especially compared to the US.

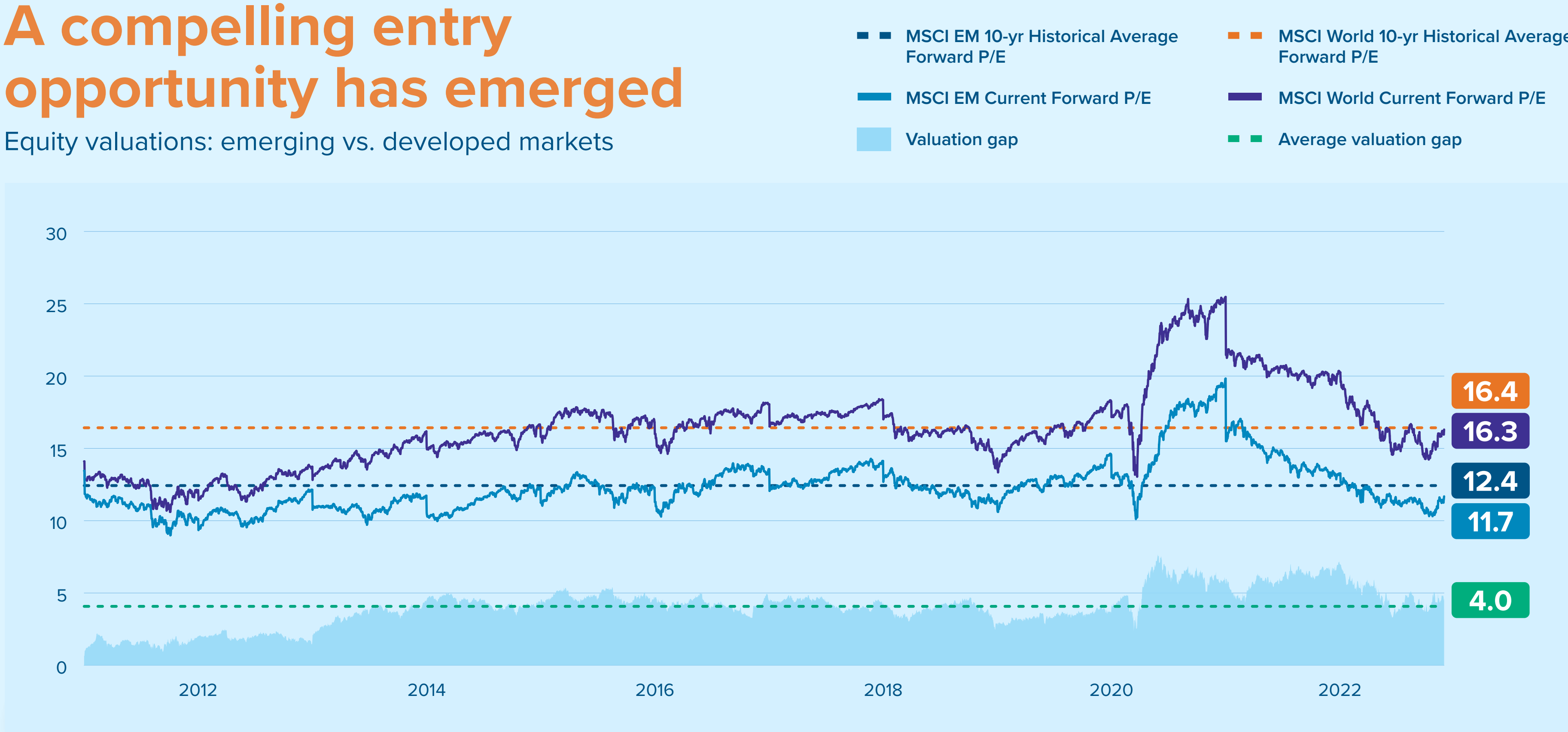
– Arup Datta

Our view

The benefits of diversification in EM will revive in the coming years, as several of the leading emerging market economies are rapidly developing, similar to how the US economy has over time.

A compelling entry opportunity has emerged

Equity valuations: emerging vs. developed markets



Source: Bloomberg, November 30, 2022.

Global fixed income

Konstantin Boehmer, MBA
SVP Portfolio Manager and Team Co-Lead,
Mackenzie Fixed Income Team

Global fixed income markets went through a major adjustment in the first three quarters of 2022. Yields in many markets have corrected significantly higher as central banks across the world have, in many cases, aggressively raised policy rates. This resulted in one of the worst episodes of fixed income performance ever.

The now vastly improved yield levels provide an improved buffer against further losses. Higher income streams generated by bonds will contribute significantly to the future total return experience of fixed income. While we still expect further interest rate hikes by major central banks, much of that is already priced in by the markets. We can envision modest increases above and beyond the current expectations, but recognize that a large part of the rate increase cycle has already occurred and that current yield levels compensate investors well for those risks.

The global economic outlook has likely been downshifted substantially, given the effect of central bank tightening. Increasing the cost of money for a heavily indebted planet should reduce its growth potential and inflationary pressure. As interest rate hikes involve time lags before being fully digested by economies, a significant part of the adjustment is still ahead of us. It appears plausible to expect a greater focus on growth weakness, as opposed to inflationary strength going forward. More economic weakness is expected by our team as economic activity tends to slow in periods of financial tightening. The risk of a recession in many parts of the globe cannot be dismissed. This should, all else being equal, provide a more fertile background for fixed income — particularly as yields have increased substantially.

Not all countries or regions are experiencing the same challenges and pressures. On the one side, we see the most vulnerable countries, like Canada, that have high household debt levels and shorter term-to-maturity of obligations, large government debt burdens, or significant economic exposure to rate-sensitive sectors, such as real estate. On the other side, we see numerous jurisdictions which are still behind the curve in raising their policy rate (eurozone, Japan). For those regions, further interest rate adjustments are likely required.

All else being equal, 2023 should provide a more fertile background for fixed income.

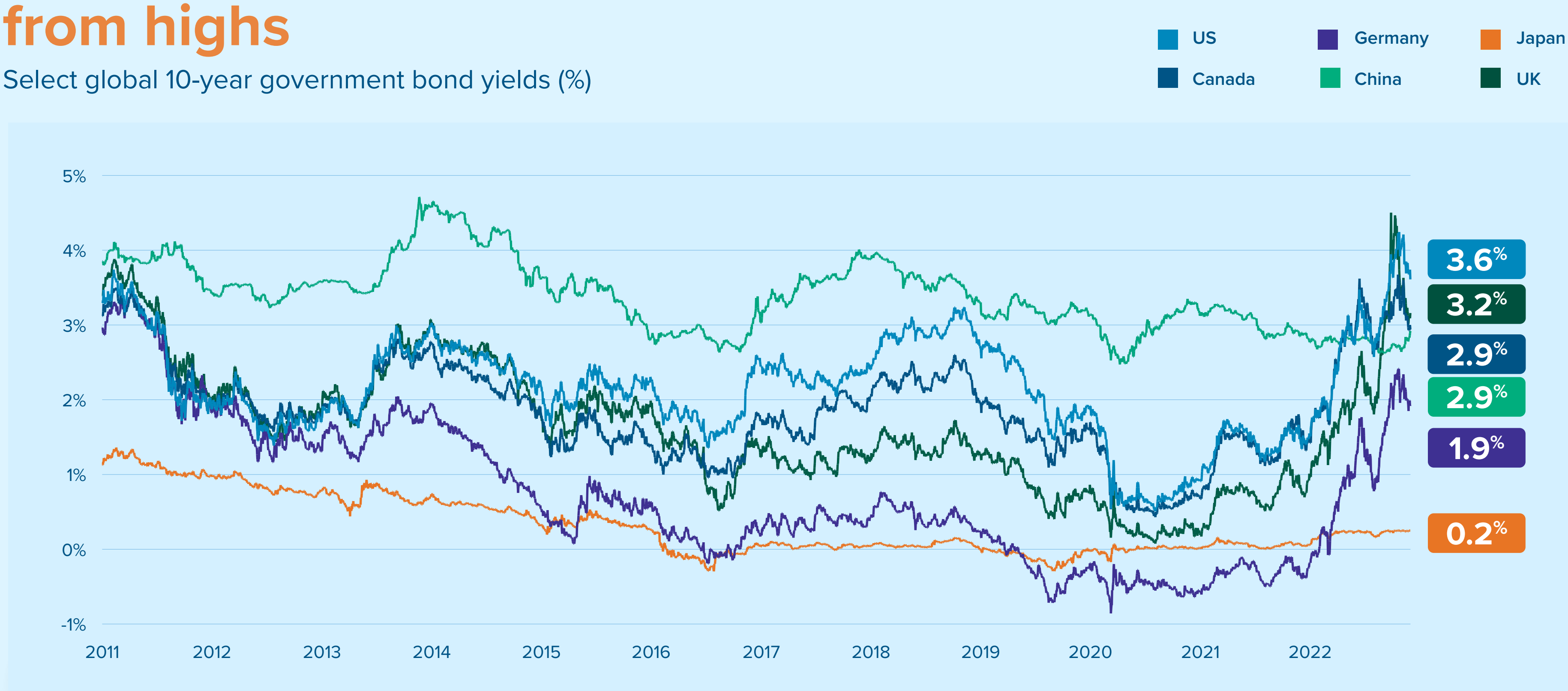
– Konstantin Boehmer

Our view

The trading environment for fixed income will remain volatile, but with greater opportunities to achieve positive performance than in the prior quarters.

Backing down from highs

Select global 10-year government bond yields (%)



Source: Bloomberg, November 30, 2022.

Credit

Dan Cooper, CFA
SVP Portfolio Manager,
Mackenzie Fixed Income Team

After suffering through the worst year in the history of fixed income markets, we are seeing significant opportunities in pockets of the corporate credit market for 2023. Investment grade bonds sustained their worst year on record with double-digit losses and high yield bond markets experienced their worst year since the Global Financial Crisis, providing a set up for attractive total return opportunities.

Although spreads are still relatively tight considering where we are in the economic cycle, both prices and yields have now reset to relatively attractive levels. Corporate credit markets have significant upside from here as current prices in the $80s (and some high-quality issuers even in the $60s) should trend up to par over time as they approach maturity, and currently provide attractive mid-high single digit yields that we haven't seen in years.

We acknowledge that defaults are likely to rise from here as concerns about inflation and rising rates transition to fears of a weakening economy and a potential recession. We feel, however, that the default cycle will likely be moderate given the strong fundamentals of corporate issuers with ample liquidity and limited near-term maturities, the high credit quality of the indices and the recency of the last default cycle.

We currently prefer defensive and higher-quality issuers in the investment grade and high yield market, as we anticipate that certain segments of the high yield market could have significant downside risks. Lower quality issuers are more likely to be squeezed by a combination of slowing growth, inflation that they may not be able to pass on to customers, and higher interest costs, especially for capital structures with a high proportion of variable rate debt.

Outside of the traditional markets, we're also finding attractive opportunities in the Canadian limited recourse capital notes (LRCN) and hybrid market. The issuers in these markets are some of the largest financial institutions, pipelines and utilities companies in Canada. As subordinated debt in these large cap structures, the yields are attractive relative to both what we see in the traditional high yield market and the dividend yield for related equities, despite having less risk and volatility. Given current uncertainties, we believe it is important to manage risk and have the flexibility to move up/down the capital structure, across ratings categories and across different markets to seek out strong risk-adjusted return opportunities as they present themselves.

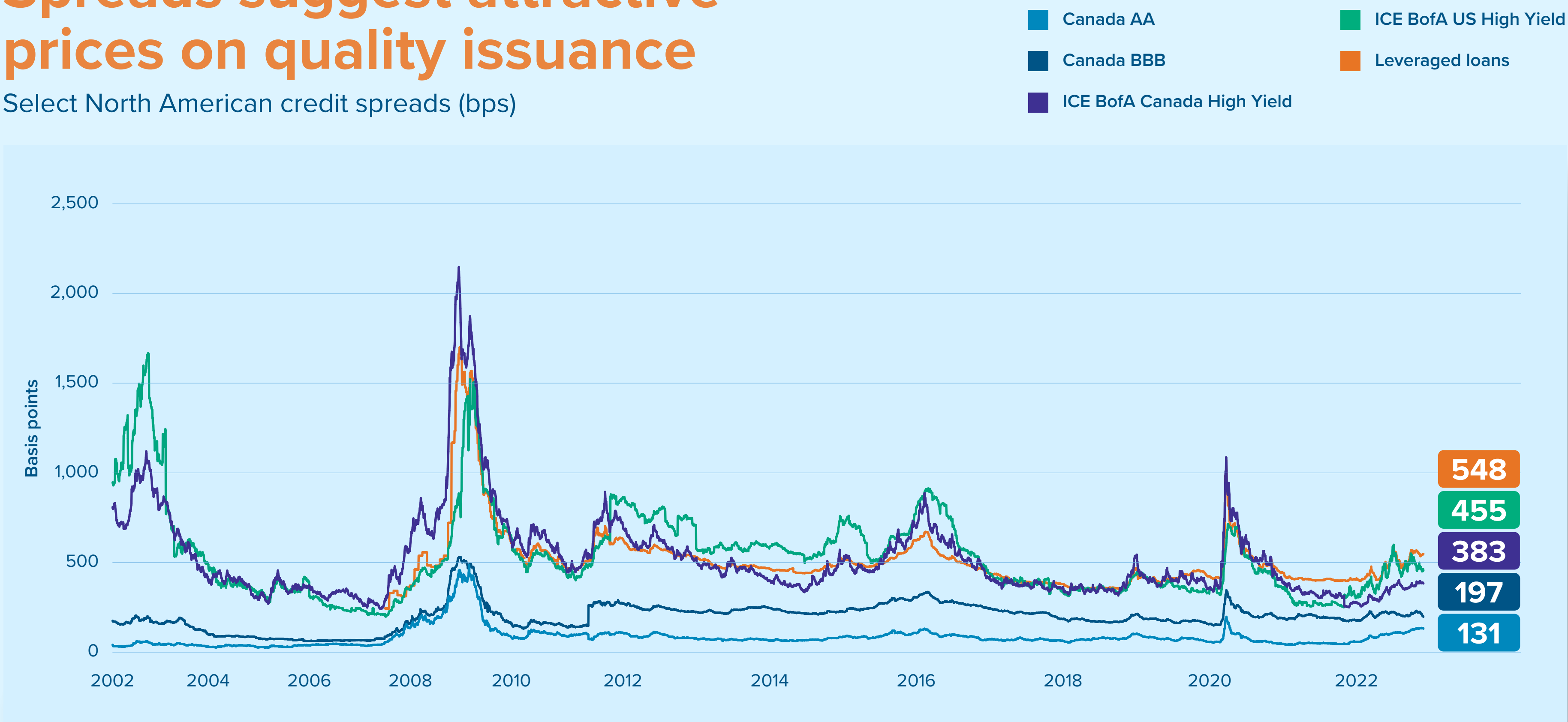
> **We feel the default cycle will likely be moderate given the strong fundamentals of corporate issuers.**
>
> **– Dan Cooper**

Our view

Defensive and higher-quality issuers in both the investment grade and high yield markets are currently trading at attractive prices and yields, and will better withstand the significant downside risks associated with economic slowing.

Spreads suggest attractive prices on quality issuance

Select North American credit spreads (bps)



Source: Bloomberg, November 30, 2022.

Currencies

Todd Mattina, Ph.D
SVP Portfolio Manager,
Team Co-Lead and Chief Economist,
Mackenzie Multi-Asset
Strategies Team

Jules Boudreau, MA
Economist,
Mackenzie Multi-Asset
Strategies Team

The US dollar gained against most major currencies in 2022, as volatility in financial markets and the uncertain macro outlook drove investors to its relative safety and liquidity. In addition, the US Federal Reserve hiked more aggressively than its peers, including the Bank of Canada. As a result, the US dollar is now well above its long-term fair value.

On an inflation-adjusted basis versus trading partners, the US dollar last saw such a large premium relative to its long-term fair value in the mid-1980s. After peaking in 1985, the US dollar index reverted quickly towards its fair value, dropping more than 40% over the following two years. The initial trigger for the devaluation was the 1985 Plaza Accord, when government officials from rich countries met to act on the dollar's overvaluation. But the extent of the dollar's slide over the next few years reflected the disconnect from long-term fundamentals.

The macro surprises and market tremors that have driven US dollar strength in 2022 should keep it elevated in the short-term. We expect US inflation to stick above target as the labour market remains resilient to higher interest rates. As a result, we believe a Fed pivot to lower rates is improbable in the first half of 2023. But over the course of next year and beyond, the US dollar's extreme overvaluation should drag it lower — it can only fight gravity for so long. Plus, in the unlikely scenario that the Fed is forced to pivot, the US dollar could sharply revert towards its fair value.

We expect the Canadian dollar to appreciate versus the US dollar next year. The Bank of Canada will shadow the Fed's rate hikes as Canadian inflation remains hot. The Japanese yen would benefit the most should the US dollar wane. Plus, Japanese inflation is slowly climbing, so the Bank of Japan could bump up the yield cap on Japanese government bonds, boosting the yen.

Over the course of next year and beyond, the US dollar's extreme overvaluation should drag it lower — it can only fight gravity for so long.

– Todd Mattina

Our view

The extreme overvaluation of the US dollar should drag it lower against all major currencies, including the Canadian dollar.

US dollar most overvalued since the 1980s

Deviation from historical average: US dollar real effective exchange rate (%)

Source: Bloomberg, November 30, 2022.

Commodities

Benoit Gervais, MSc, CFA
SVP Portfolio Manager and Team Lead,
Mackenzie Resource Team

During 2022, commodities retained most of the gains made since the start of the pandemic. As we forecasted a year ago, commodities showed resilience in the face of a softening world economy. In fact, most demand supporting themes strengthened and allowed key commodity prices to stay at elevated levels.

Investors, governments and individuals are quickly coming to understand the resource challenges facing society. In 2022, “reshoring” trends grew stronger as it became obvious that Russia and China wouldn’t be the friendly partners they formerly were. Moreover, calls to address climate change only became louder in Europe and the US. In 2023, the large commitment by the US to support the energy transition will take effect and pave the way for other countries to follow and further amplify this commodity-intensive trend.

Despite the increased focus on the energy transition away from fossil fuels, demand for oil and gas continued to be at record levels, creating a tailwind for prices that we expect will be sustained in 2023.

Copper, very often a barometer for commodities but also a strategic commodity needed for the energy transition, saw prices level off with a gain of over 50% above the COVID-19 troughs. In fact, most commodities share a similar combination of fundamentals of strong demand, low inventories, elevated production costs and limited new supply which will likely keep prices well above their historical lows further into 2023.

Gold prices are likely to remain in a holding pattern until real interest rates start to decline. While current real rates have moved higher from depressed levels, they are very low by historical standards. Given the US Federal Reserve’s continued focus on fighting inflation, we believe it will be difficult to see gold prices advance meaningfully.

As a measure of investor sentiment, materials companies underperformed commodity prices by a substantial margin. This is typically a leading indicator of further commodity price declines. We believe that 2023 could surprise and see commodities continue to stay near their elevated floor of 2022, and also pave the way for a rerating of stocks higher as the market comes to understand the new higher cost of producing commodities.

Investors, governments and individuals are quickly coming to understand the resource challenges facing society.

– Benoit Gervais

Our view

Commodity companies are starting a decade-long revaluation period to reflect higher demand associated with the transition to a low carbon economy. We expect to see an acceleration of demand during the second half of 2023 pushing commodity prices and in turn energy and materials' stock prices higher from 2022 levels.

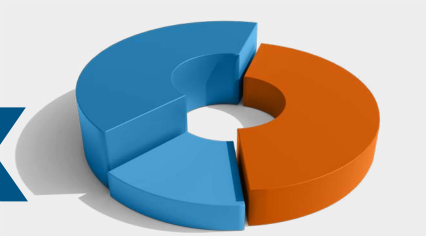
Commodity prices should remain elevated

CRB Commodity Index

Source: Bloomberg, November 30, 2022.

BLUE BOOK
2023 OUTLOOK

Asset mix recommendations



Equity
- Canada
- US
- Emerging markets
- International

Fixed income
- Sovereign bonds
- IG corporate bonds
- HY corporate bonds

UNDERWEIGHT NEUTRAL OVERWEIGHT

Equity

We believe that stocks will remain volatile as higher interest rates work their way through the economy. Down the road, this will open the door to potentially easier monetary policy, setting up the next business cycle and an equity recovery, which we anticipate in the back half of the year.

NEUTRAL

Canada

We believe Canadian equities will outperform US equities. Canadian equities are attractive due to their low exposure to technology (a sector we believe will continue to underperform), higher exposure to energy and lower valuation. A weakening US dollar will also be beneficial for domestic equities on a currency return basis.

OVERWEIGHT

International

International equities offer an attractive opportunity. The European economy is very weak due to significant energy and food inflation, but we expect this to ease as the region adjusts to the sustained war in Ukraine. Asian equities should benefit from the reopening of their economies and China relaxing its zero-COVID-19 measures.

OVERWEIGHT

US

The US economy has been extremely resilient on the back of the American consumer, but we believe this is unsustainable. A weaker US dollar, an expectation for downward earnings revisions and an outsized exposure to the technology sector support our view that US equities will underperform relative to other regions.

UNDERWEIGHT

Emerging markets

A similar story in terms of valuation for emerging markets exists, although not as compelling as Canada or Europe. We see two potential tailwinds in a softening US dollar and easing of zero-COVID-19 policy in China. The higher volatility of emerging markets and simmering geopolitical risk warrant some caution.

OVERWEIGHT

UNDERWEIGHT NEUTRAL OVERWEIGHT

Fixed income

Although there could be some moderate upward pressure on interest rates, we believe inflation has peaked. This should pave the way for a peak in rates in 2023. Broadly speaking, we expect 2023 to be much more in line with long-term average fixed income returns of mid-single digits.

NEUTRAL

Sovereign bonds

We believe that rates will peak in 2023 and have positioned to a neutral duration. After years of absence, the income is back in fixed income. Shorter maturity yields are more attractive and as economic growth slows, pressure on longer yields should abate, providing an opportunity for modest price appreciation.

NEUTRAL

HY corporate bonds

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

NEUTRAL

IG corporate bonds

Credit spreads widened considerably over the past 12 months. As economic growth slows, we could see some further widening, but sticking to high-quality companies with strong balance sheets should provide attractive risk-adjusted returns for investment grade bonds.

OVERWEIGHT

BLUE BOOK

2023 OUTLOOK

MACKENZIE