AGF INSIGHTS

OUTLOOK 2023

The Return of Normal

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The Return of Normal

While volatility is expected to continue in the early part of 2023, the Fed and other central banks are poised to end their respective tightening cycles in the coming year, opening a path for markets to rally with more conviction. But the return to more "normal" interest rates means the next bull market, when it arrives, will likely look much different from the last one driven by ultra-accommodative policies that were put in place following the Global Financial Crisis more than a decade ago.

BY KEVIN MCCREADIE

Kevin McCreadie, MBA, CFA®
CEO and Chief Investment Officer
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"Cautious optimism" may be the most overused two words to explain investor sentiment right now, but there's no better way to express how many of us feel heading into 2023. Over the past year, we've been through the proverbial wringer, suffering bear markets in both stocks and bonds as central banks torridly raised rates to fight an inflation rate that has proven anything but transitory – and has not been this high in decades.

And while the rally in equity markets in the late fall seems like a sign of better days ahead, it also feels too good to be true and that more time is needed before the worst of the upheaval is finally behind us.

No doubt, it's a fragile mindset with which to start the New Year, but a more confident take on the future direction of markets could still be weeks away. The key lies predominantly in the actions of the U.S. Federal Reserve and its global counterparts going forward. Investors need reassurance that the current tightening cycle is coming to an end. But it's no longer enough to believe the Fed will lessen the magnitude of its rate hikes later this month. That's already largely priced in.

Instead, what's needed to push markets discernably higher from here is a true readiness on the part of the U.S. central bank to pause on further increases altogether. And to do that, it likely needs more convincing evidence that inflation is under control and will continue to fall on a month-over-month basis towards a level that is more in line with the Fed's target of 2% on average over time.

That doesn't mean the Fed needs to reach this goal or else. The threshold for a pause is probably an inflation rate close to 4% or 5%. But that's still no easy task, and the longer it takes to get to that range, the greater the risk of markets becoming unsettled again. After all, if the Fed continues to raise rates much longer, even at a slower pace, the spectre of a recession only looms larger.

In fact, while unemployment remains relatively benign in the United States and many other countries, deteriorating global Purchasing Manager Indexes and negative-trending earnings revisions both suggest the current climate of higher inflation and higher rates is already taking a toll on the economy and could point to a more serious downturn in economic activity very soon.

Of course, central bank policy isn't the only uncertainty that investors will face next year. The potential implications of today's increasingly tense geopolitical backdrop must also be considered. This includes, in particular, the ongoing war in Ukraine, which has fuelled not only Europe's energy crisis and continuing destabilization of its economy, but also fiery protests in China that have broken out against the country's severe pandemic restrictions and lend more instability to arguably the world's most important economic growth engine.

"Investors need reassurance that the current tightening cycle is coming to an end.

Given these dynamics, it's hard to see a definitive path higher for markets, at least during the first few months of next year. In turn, investors should expect much of the same volatility experienced over the past 12 months, with range-bound fluctuations in equity prices and bond yields remaining the norm until the Fed and other central banks signal their intent to end the current tightening cycle – likely next spring or early next summer.

Once that happens, the path will open for markets to rally with more conviction, and it is very likely that major stock indexes around the world end 2023 higher than where they started.

That said, the next bull market in equities won't have the same flavour as the last one. Thanks to the normalization of rates over the past year, the era of easy money defined by near-zero interest rates has now been replaced by a macro backdrop that is more typical of what investors experienced in the past.

This "return to normal" will not only have an impact on stock markets and the types of opportunities they afford, but also affect how bond markets perform and are perceived by investors. Indeed, for the first in over a decade, we can find adequate yield without having to take undue risk to get it.

All in, then, we believe 2023 will be another year of transition, but one that should end well for investors who maintain a balanced approach. In this environment, a bias towards equities within a 60/40 portfolio remains the most prudent allocation for now. Specifically, we are overweight the developed markets and see more opportunity arising in the United States and Japan than in Europe, Canada or emerging nations over the next few weeks – if not longer.

That's not to diminish the role that fixed income should play in a portfolio. Bonds are surely more attractive than they were a year ago, largely because of higher yields, but also because of the downside protection they may offer if the economy deteriorates further and falls into recession. Moreover, alternative sources of return, including hedges on equities, may help investors navigate some of the volatility that is expected in the New Year, while also helping mitigate losses in the process.

All in, then, we believe 2023 will be another year of transition, but one that should end well for investors who maintain a balanced approach.

While "cautious optimism" may not sound like a ringing endorsement for what's ahead, we should be feeling a whole lot better about markets by this time next year.

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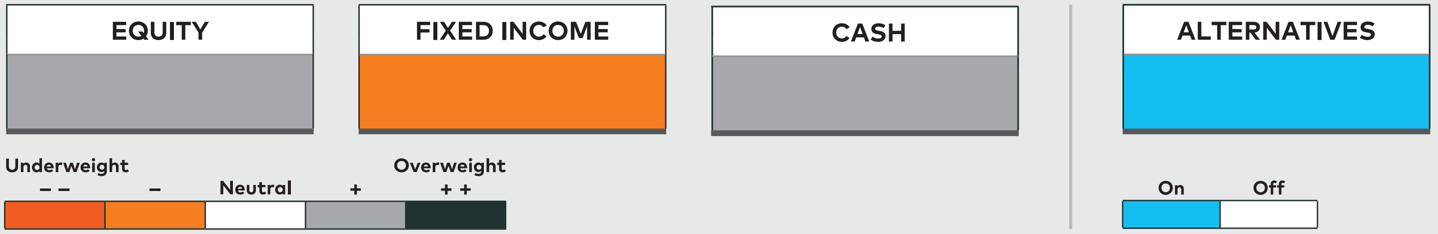
Asset Allocation Overview



Source: AGF Asset Allocation Committee Fourth Quarter Update (as of October 1, 2022). Based on a 60/40 portfolio mix of equity and fixed income. For Illustrative purposes only.

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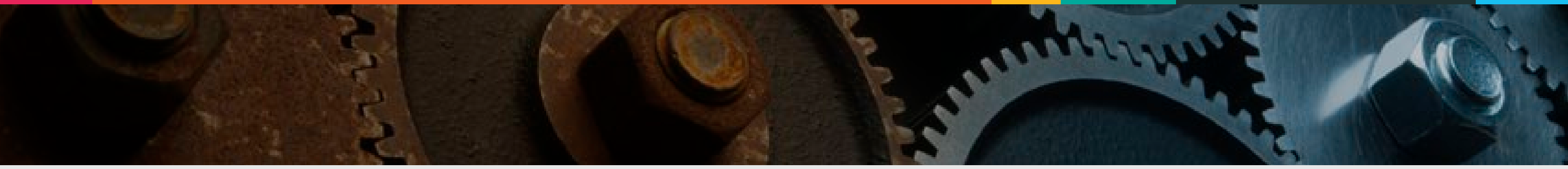
BY TONY GENUA, TRISTAN SONES, TOM NAKAMURA, STEPHEN BONNYMAN, BILL DeROCHE



Equities

A Tale of the Twenties: The Roaring 1920s and the Boomerang 2020s

Historically, investing in stocks after a 20% decline has tended to yield good outcomes for investors.

By Tony Genua

Three years ago, we contributed to the AGF Outlook by looking at the decade ahead, and in that piece we discussed the many innovations that would impact the global economy in the future. Little did we know that around the corner there would be a global pandemic that would not only accelerate many of those trends, but also introduce other market forces, such as inflation and deglobalization.

The first years of the 2020s have seen some tumultuous events, to be sure, but many have a common aspect: they signal a return to previously existing conditions. Indeed, the 2020s remind us of a boomerang, returning some conditions of what we might have thought were in the distant past, but are now influencing the investment landscape.

If we look for precedents, we might turn to the 1920s, an era that also saw a meaningful transition – albeit one that did not end so well. The decade earned its nickname – the Roaring Twenties – by being a time of dramatic change and growth. The stock market boomed, and Western society enjoyed unmatched prosperity and cultural advancement. This included:

- **Real GDP growth averaging 4.2%;**
- **The Dow Jones Industrial Average rising 600% between 1921 to 1929;**
- **A material reduction in taxes, with the top U.S. rate dropping from 73% to 24%;**
- **Car, household appliance and home ownership becoming widespread;**
- **The beginning of commercial aviation; and**
- **Credit exploding with margin debt and consumer instalment payments.**

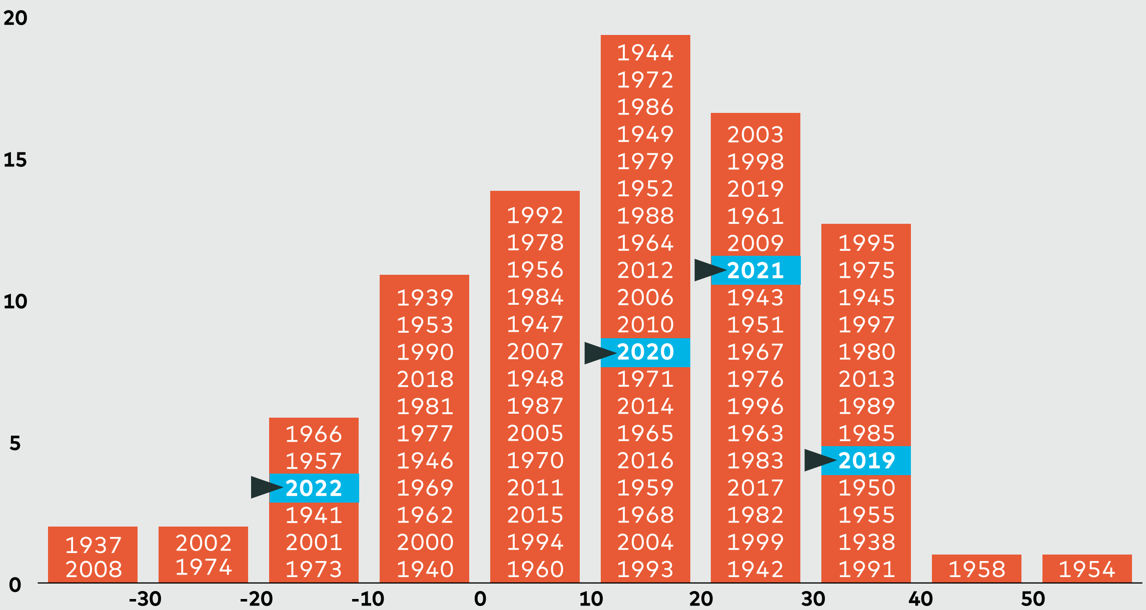
There were other breakthroughs, too. After a difficult start to the decade, farmland productivity and incomes rose sharply. Communications improved with the move from the telegraph to the telephone. Women finally earned the right to vote. The discovery of penicillin improved life expectancy. Pre-sliced breads became available, the TV was invented and radio vastly improved with the introduction of the first commercial station, which in turn helped usher in the Jazz Age. And before the dawn of memes, flagpole-sitting became a thing. As a whole, the 1920s made for a rip-roaring decade – until, of course, its excesses ultimately resulted in the stock market crash of 1929.

Equities

A hundred years later, we are seeing trends that suggest we are boomeranging back to the future. Inflation has returned, reaching its highest levels in 40 years, and interest rates have been rising rapidly in response. Debt as a percentage of GDP has climbed, and energy prices have rebounded. On the geopolitical front, with conflict abroad and escalating tensions, the world is increasingly deglobalizing, reversing the trends of the past several decades. All of this has caused stock market volatility to rebound, with the highest levels of trading days +/- 1% since the Global Financial Crisis.

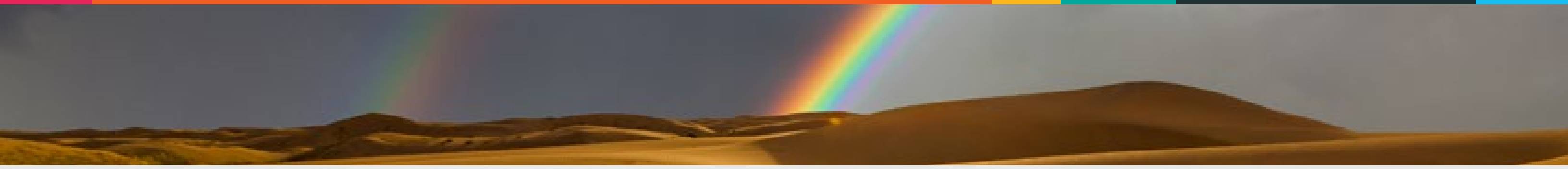
Is this period, like the 1920s, bound to end in disaster? We don't think so. Some important trends are moving us forward. Innovation continues to result in new investment opportunities. Sustainability, precision medicine, autonomous vehicles, robotics and artificial intelligence, among other innovations, represent a ripe landscape for future investment. And despite the whirlwind of global events over the past three years, overall returns so far in the 2020s have been remarkably normal. The annualized return of the S&P 500 Total Return Index since Jan. 1, 2020 (through November 25, 2022) has been 9.7%, according to Bloomberg data, which is close to the long-term total return of U.S. equities of 9.5% over the past 120 years. Furthermore, over the course of history, U.S. equities have tended not to experience two negative years in a row. There are bubble-related exceptions, like the "Nifty Fifty" and the "Tech Bubble" of the early 2000s, but the most common outcome has been returns in the 10% to 20% range in the year following one that saw negative returns.

U.S. S&P 500 Total Returns (1937-2022)



Source: AGF Investments Inc., as of November 28, 2022.

Given widespread investor pessimism today, this is useful context. Historically, investing in stocks after a 20% decline has tended to yield good outcomes for investors. We believe this time will be no different – this does not look like 1929 all over again. And investors will be well served to stay invested and focus on the long term.



Fixed Income

Is the Bond Bear Over Yet?

Slower economic growth should trend inflation lower, providing a tailwind for fixed income in 2023.

By Tristan Sones

With the end of 2022 approaching, many investors are asking themselves, "When is it all going to be over?" The war in Ukraine, high inflation, interest rate hikes? The answer is, unfortunately, "Not yet." But we are hopefully getting closer.

As developed market central banks such as the U.S. Federal Reserve continue to tighten monetary policy, although at a slower pace, 2023 will start out much the same way 2022 is ending. Markets have been quick to get excited about the prospects of Fed tightening – which is still ongoing – coming to an end, even going so far as to price in some easing towards the end of 2023. Markets have not, however, been focused on the fallout from all this tightening. The answer is much slower economic growth, and likely a recession. That is not a good thing, but it should allow elevated inflation to trend lower and provide a tailwind for fixed income in 2023. If China fully reopens, it could provide a partial offset to this slower-growth scenario, but the prospects do not look promising given the current COVID situation and the Chinese government's commitment to its Zero COVID stance.

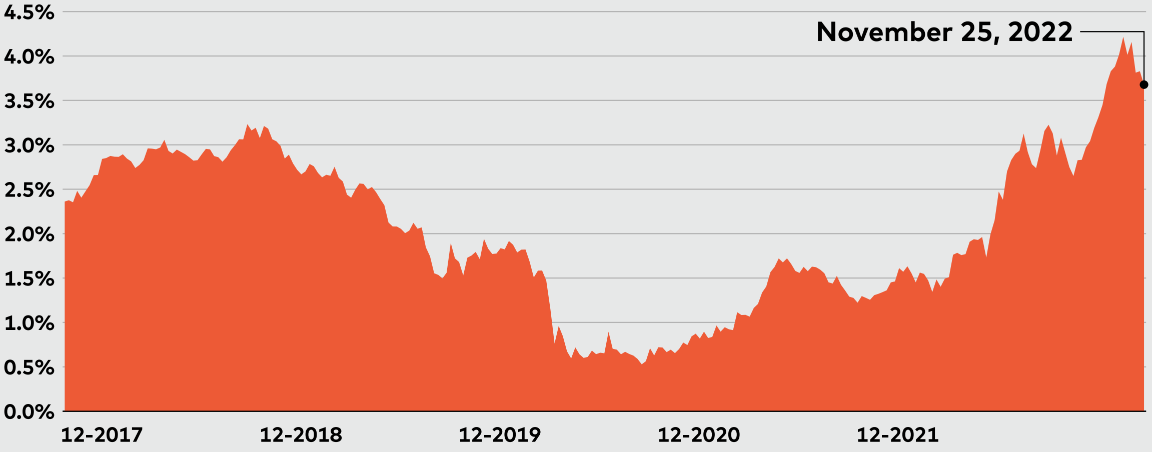
> **If we do end up getting some easing from the Fed, it would be in response to very poor growth – and that reality is not currently reflected in many areas of the market.**

Still, there are segments of the market that seem to be putting too much weight on a soft-landing scenario, which seems too optimistic given the pace, breadth and severity of the global tightening so far. As we move into 2023, the recent relief rally will be replaced by the realities of a slowing economy, and the current inflationary backdrop will initially set the bar for central bank easing very high. If we do end up getting some easing from the Fed, it would be in response to very poor growth – and that reality is not currently reflected in many areas of the market.

Given this outlook, we are comfortable tactically adding high-quality duration, but are still being somewhat cautious on higher-yielding credit and Emerging Markets. Credit spreads are tight given the growth prospects, but they may hold in better this time versus prior downturns. Plus, all-in yields are historically very high thanks to the rise in U.S. Treasury yields. As a result, more emphasis should be placed on the attractive carry in 2023, which is bolstering total return prospects. Finally, Fixed Income

on a price basis, valuations are also more compelling, offering a better risk-reward tradeoff than in years past. There are opportunities to be had, and even though they need to be scrutinized against a much slower global growth scenario, we cannot overlook the fact that the 40% in a typical 60/40 balanced portfolio offers the potential for more yield again, particularly given the rise in U.S. Treasury yields.

10-year U.S. Treasury Yield



Source: Bloomberg LP, as of November 25, 2022

In last year's outlook, we highlighted the fiscal health risks that many countries faced coming out of the pandemic, with higher debt levels coupled with the prospect of slower economic growth to help service that debt. In 2022, we saw these risks fully start to materialize, and it wasn't just Emerging Markets that had to face this harsh reality. The stresses in the United Kingdom proved that developed countries can be susceptible as well, and markets will no longer tolerate material fiscal slippage. More left-leaning governments, such as Brazil's, are flirting with these risks right now and realizing how hard it is to push their spending agendas. The unfortunate fallout is that the ability to spend going forward will be severely hampered at a time when it's really needed. This is the steep price of poor fiscal management in years past, and it also means slower global growth going forward when countries don't have the means to stimulate their economies as much.

On the other hand, we also highlighted previously that there was a huge opportunity to attract capital for those countries willing to enact reforms and seriously address their fiscal shortfalls. In 2023, these risks and opportunities will again be very much on the minds of bond investors, and multilateral lenders will continue to be called upon to help bring debt levels onto a more sustainable path. Unfortunately, with bond yields much higher and growth prospects much lower, the task of achieving that goal has just been made all that much harder. ■

Currency

FX: Eat Your Greens

Currency markets are likely to be broadly rangebound and continue to be characterized by high volatility.

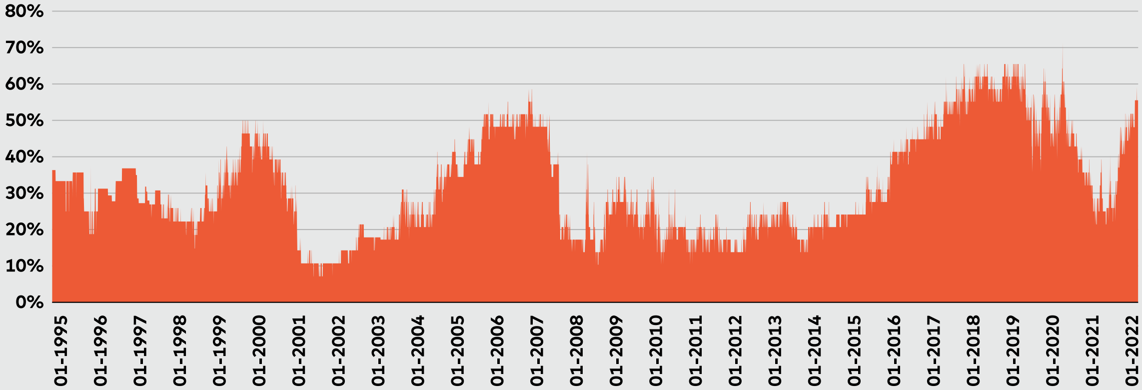
By Tom Nakamura

Every single morsel. Not a grain of rice left in my bowl. Growing up, our dishes needed to be licked clean before dinner could give way to dessert, but the anticipation of a sweet treat kept me going.

Like me, the markets, too, are looking forward to their dessert. If inflation-taming rate hikes are the main meal we have been forced to eat in 2022, the prospect of an after-dinner delight seems a just dessert. But is it even on the menu? The answer to this question will be the key for foreign exchange (FX) markets in 2023, especially for the U.S. dollar (USD).

We project a more subdued year for FX than what we saw last year. The bar is very high to match 2022's large currency moves, let alone exceed them. Rather, we think the FX markets are likely to be broadly rangebound and continue to be characterized by high volatility. Economic uncertainty continues as a major theme for markets. A lot of focus will remain on central bank policies, and how much appetite they will continue to have for ever-tightening policy to combat inflation. A slower ascent in policy rates is likely to culminate in a pause. This consensus scenario will dull the USD rally, but we would need to see more than this for us to be convinced that a bear market will ensue.

Percentage of currencies with a lower yield than the U.S. dollar



Source: JP Morgan

Currency markets are largely driven by economic activity, and the economy is undergoing adjustment. What we transition to will dictate the broad themes that will dominate FX markets. Here are some possibilities:

Currency

Economies avoid recession; inflation recedes, but remains at or above central bank tolerance upper bounds

In this scenario, central bankers will have no appetite to ease policy, and they may even indicate that the next action is as likely to be a hike as it is a cut. The USD benefits from its status as a safe-haven currency, its relatively high yield and an economic backdrop that is likely to see other economies struggle to attract capital.

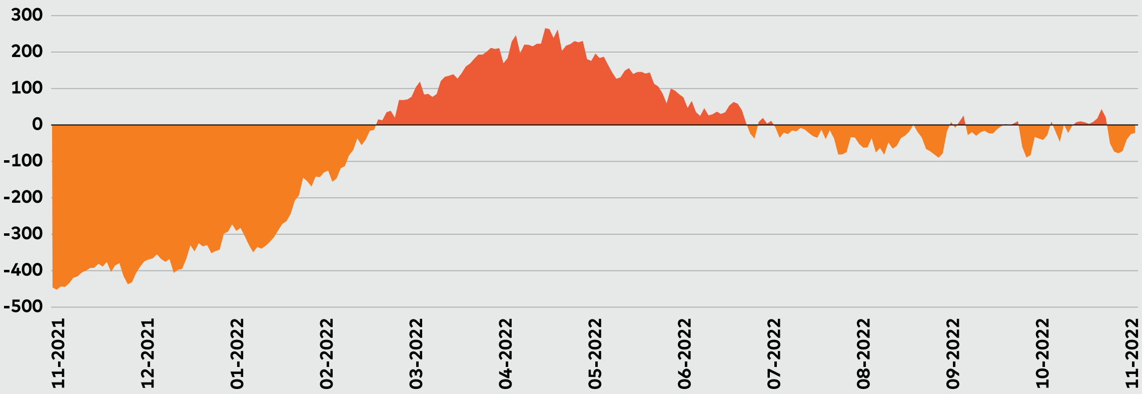
Recession is accompanied with a sharp fall in inflation

Central bankers quickly adopt an easier policy stance. Financial conditions loosen and prospects of a recovery start to percolate. After one last surge higher for the USD, reflationary impacts of easier central bank policy will awaken a taste for risk and lead to flows into economies leveraged to a rebound in growth. In developed markets, we see the Australian, New Zealand and Canadian dollars leading the way in this scenario, while the currencies of Brazil, Korea and South Africa will benefit amongst their Emerging Market (EM) peers. EM currencies would outperform developed market currencies.

Recession is accompanied with stubbornly high inflation

This scenario leads to a dispersion of central bank policies as choices are made between defeating inflation or supporting flagging economies. Economies that balance both and provide a credible path to future growth opportunities are going to attract flows. A combination of monetary policy settings that have room to adjust and flexibility in fiscal policy will be the focus. A lot will depend on the course of actions taken between now and the point it becomes clear we are in this scenario. Policy normalization laggards are likely to be punished, as are those that are already at the limit of credible fiscal policy. Relative growth has been an important long-term factor for the U.S. dollar, and policy choices made will set the tone for the next economic cycle.

U.S. growth not lagging significantly:
Citigroup Economic Data Index: U.S. vs G9 Nations (spread)



Source: Citigroup as of November 24, 2022

While there are other possible economic scenarios on the menu for 2023, we think these are the most likely and important ones to watch out for. As we progress through the year and gather evidence of what lies in store for us, we are ever mindful that we are still in the midst of digesting past tightening moves and that the sweetest course is not necessarily the one that we will get next. ■

Real Assets

Real Assets May Still Outperform, but Be Cautious

Steadying rates and peaking inflation could generate a positive tailwind for much of the Real Assets complex.

By Stephen Bonnyman

Notwithstanding the outperformance of Real Assets versus broader equities in 2022, the outlook for the group continues to appear positive into 2023.

Granted, the market continues to struggle to define a clear outlook for next year. But a consensus appears to be forming that a peak in inflation is within sight, and with it the potential for a cap in rate hikes (and maybe even rate cuts later in the year) and a rebalancing of the global economy. Steadying rates, continued inflation (even after it moderates), a peak in the strong U.S. dollar and the first signals of a China re-opening could generate a positive tailwind for much of the Real Assets complex.

Aside from the specific fundamentals of each industry/commodity, many of the sectors in Real Assets are benefiting from underinvestment in new capacity over the past cycle, leaving inventories low and supply constrained and inelastic to demand.

Steadying rates, continued inflation (even after it moderates), a peak in the strong U.S. dollar and the first signals of a China re-opening could generate a positive tailwind for much of the Real Assets complex.

While the exceptional outperformance of energy will be challenging to repeat in 2023, the sector remains well positioned to deliver positive returns next year. Supply remains largely inelastic, with risk skewed to shortfalls rather than excesses, and demand is not entirely elastic to global GDP (for instance, in the event of a shallow recession). We view this energy cycle as secular rather than purely cyclical, in large part due to the discipline and supply constraints of OPEC+, as well as the capital discipline of U.S. producers. From an equity perspective, we expect to see multiples rise for the group as the market comes to accept the sustainability of the sector's current very high cash flows.

Like energy, a declining U.S. dollar and Chinese restarts should be positive for the commodity materials, but any outperformance will likely occur through the later half of next year. China's steadfast commitment to its "Zero COVID" policy will make the timing of any reopening uncertain and continue to overhang global demand. Still, while the threat of global recession looms large for

Real Assets

Materials, China provides a huge potential catalyst for outperformance in commodities – if and when its economy fully reopens.

We remain cautious on processed materials (chemicals, packaging), at least until inflation begins to wane and interest rates pause or reverse; when that occurs, they should outperform the market as margins widen. For now, we are more positive on extractive materials (mining, fertilizers).

While Precious Metals have performed better than our earlier expectations, in the near term we are cautious on gold. The combination of slowing inflation and rising rates will create a violent inflection in the cost of carry trade, potentially triggering inventory reductions and pressure on pricing. Gold's recent outperformance is largely tied to an abrupt decline in the U.S. dollar and a breakdown in the cryptocurrency markets.

"While the exceptional outperformance of Energy will be challenging to repeat in 2023, the sector remains well positioned to deliver positive returns next year.

Meanwhile, continued high market uncertainty has supported the outperformance of Utilities, but we remain cautious in the medium term. Rising recessionary risk could be supportive for the group, but historically, higher rates have provided an impediment to outperformance. We believe this will be the case through the first half of 2023.

Finally, Real Estate, which underperformed the broader markets in the later part of the year as real rates quickly accelerated, is likely to continue to struggle until interest rates stabilize. While limited, private market Real Estate transactions suggest that public valuations remain discounted, and as interest rate and economic clouds fade, this value gap should narrow.

While uncertainty remains a dominant phrase in the individual sector outlooks, Real Assets as a group should continue to provide solid protection against rising inflation and weaker economic growth, while setting the base for strong potential performance in an economic recovery.

Alternatives

Why Hedging Still Makes Sense in 2023

An equity hedge can provide insulation to shocks by lowering a portfolio's volatility, and over time lower volatility may translate to greater wealth.

By Bill DeRoche

Not surprisingly, anti-beta equity strategies did very well for investors who followed them in 2022 – after all, performing well when the stock market as a whole is doing poorly is exactly what such strategies are supposed to do, and 2022 was a very bad year for equities. Now, investors are hoping 2023 will bring respite from central banks' punishing interest rate hikes and a resurgent stock market, and many might be thinking equity hedging will no longer be a winning strategy. They might be wrong.

In fact, there are several reasons to believe that anti-beta hedging strategies – which, generally speaking, seek to short equities that have higher betas and go long on equities that have lower betas – will remain important tools to counter market volatility and risk in 2023.

Explaining Beta

Beta	Stock vs. Market
>1	Amplified co-movement with market
1	Perfect market movement
<1, >0	Some co-movement with market
0	No relationship
<0, >-1	Some anti-movement with market
-1	Perfect anti-market movement
<-1	Amplified anti-movement with market

Source: AGF Investments Inc.

One is that so many uncertainties still need to be resolved before the risk level in the stock market can begin to move downward. Chief among them is the terminal level of interest rates; U.S. Federal Reserve officials have been clear that they see rates capping out at 4.75% to 5%, but those estimates have been revised upward repeatedly over the past few months. As well, given robust consumer balance sheets and low unemployment, the demand reduction the Fed wants to create could take longer than markets anticipate – and it's quite possible there are no rate cuts *at all* in 2023.

Alternatives

More significant, perhaps, is uncertainty over how severe and lengthy a recession, which looks very likely, might be. Compared to the recent shock-induced downturns of COVID-19 in 2020 and the housing crisis of 2008, the next recession might be longer, though perhaps less dramatic. Granted, equity markets tend to "see through" a recession to a recovery, so we would expect them to bottom out well before the end of the coming downturn. Until that end is in sight, however, we would also expect elevated volatility – which, based on our calculations using Bloomberg data, has been about 50% higher this year than pre-pandemic – to continue.

There are two conditions in which an anti-beta equity hedge does very well: when equities sell off and when interest rates are rising, in large part because the short high-beta portion of the portfolio tends to have a much longer duration than the long low-beta portfolio. Both conditions may still apply at least through the early part of 2023. If so, they may continue to highlight the vulnerabilities of traditional bonds – which were clobbered in 2022 right along with stocks, defying their traditional role as a hedge to equities – and alternative assets like gold or real estate, whose negative correlation to the stock market can fluctuate dramatically.

When considering hedging, investors need to ask how much risk they are willing to take on. Volatility creates significant sequence risk – that is, the risk that market shocks create significant draw-down events at particular points in time. Even though equities over the long term are great wealth drivers, such drawdowns can decimate a portfolio. Hedging provides insulation to shocks by lowering a portfolio's volatility, and over time lower volatility can translate to greater wealth.

In short, even as we look forward to a Fed "pivot" and a rebound in the market, equity hedging as a complement to core stock and fixed income allocations should still be an important portfolio construction tool for investors in 2023. ■

Please see Disclaimer section for full disclosure.

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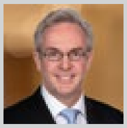

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Four Geopolitical Hotspots That Could Impact Markets in 2023

Russia's war on Ukraine remains the top risk facing investors, but there are other potential threats to keep an eye on.

BY GREG VALLIERE

Greg Valliere
Chief U.S. Policy Strategist
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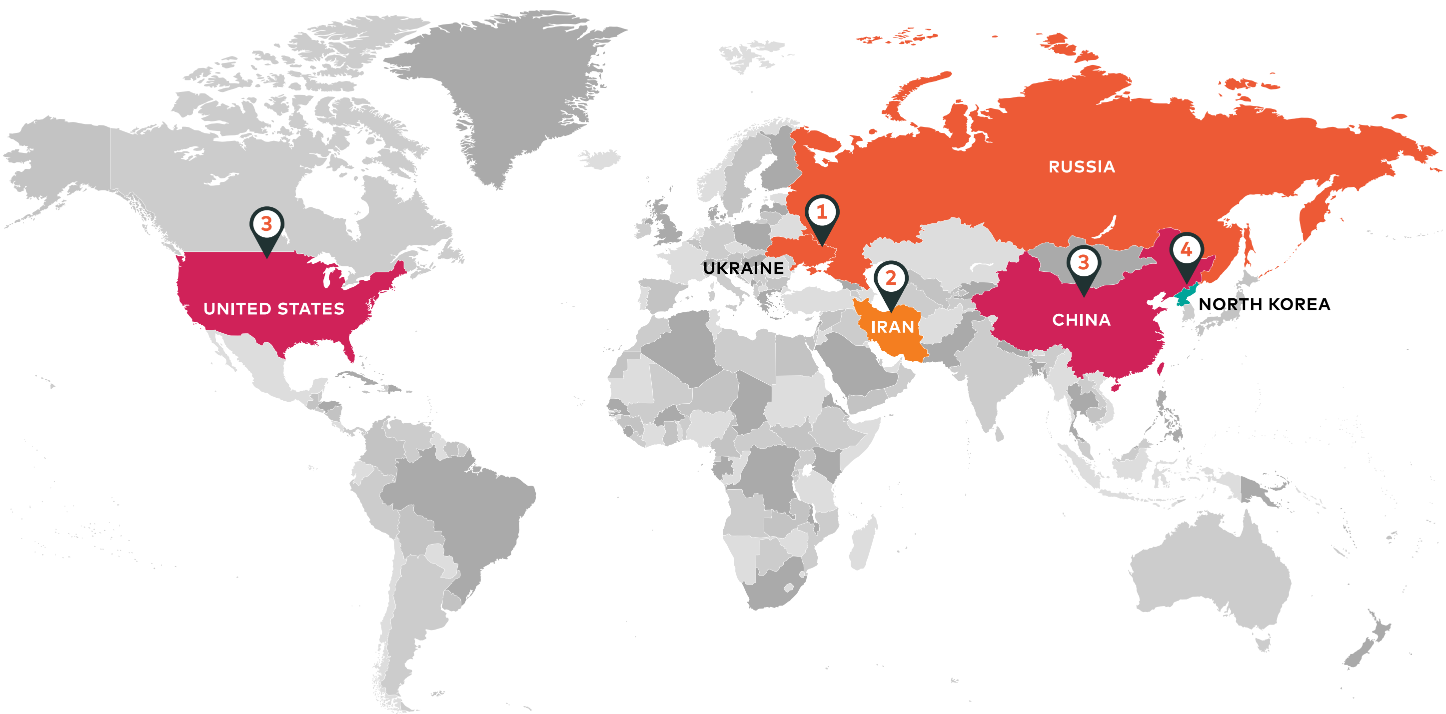
Some major questions for the financial markets may be answered next year: the Federal Reserve seems likely to cease its rate hikes by late winter; the political climate should be relatively quiet before the next U.S. elections in 2024; and the gridlock in U.S. Congress is likely to persist, without passage of radical legislation. That leaves one huge wild card – geopolitics, which the markets will have to carefully monitor next year.



Ukraine War

The greatest uncertainty, obviously, is the bloody war in Ukraine, which could cripple the Western European economy this winter, while exacerbating inflation pressure on grain, natural gas, metals and other commodities that are in short supply.

There are several plausible scenarios in the war: Russia could double down, using more lethal weapons while destroying Ukraine's power grid; the U.S. and other Western European countries could tire of huge contributions to Kyiv; or Vladimir Putin could be ousted. Our sense is that the staggering casualties on both sides will eventually lead to a truce and protracted negotiations, perhaps lasting into the summer. The status of Crimea will be key in any peace talks.

We have believed since last February that Russia cannot win this war, and that still appears to be the case. Quite simply, Russian troops are not willing to die for Putin, while Ukrainian soldiers are willing to die for their country. The humiliation of Putin, as young Russian men flee their country, eventually will lead to a deal – but, unfortunately, a deal does not appear to be imminent.

Iran Protests

Meanwhile, other geopolitical challenges will persist. The Ukrainian war has obscured the slaughter, torture and imprisonment of young Iranian protesters, as Tehran uses live ammunition with impunity. In addition to the domestic unrest, Iran faces a de facto war with Israel, as both countries use drones to attack each other; several Iranian nuclear scientists have been killed as Tehran gets closer to producing a crude nuclear bomb.

A delivery mechanism for an Iranian bomb hasn't been perfected yet, but its uranium enrichment has the Persian Gulf on edge, and Tehran's shipment of missiles to Russia has almost certainly ended prospects for a nuclear treaty between the U.S. and Iran.

U.S./China Trade Relations

A wild card has emerged in recent days: angry protests in many Chinese cities over Beijing's harsh COVID restrictions. We don't think there's a serious threat to Xi Jinping's authority – he's prepared to crack down – but Xi also will have to relent on the lockdowns and focus on improving China's erratic economy, which is a major concern in global financial markets.

Meanwhile, relations between the U.S. and China are unlikely to improve dramatically next year, as the slim Republican majority in the House seeks to crack down on Beijing's trading practices and espionage. In addition, Republican leader Kevin McCarthy has hinted he will visit Taiwan next year, which would be viewed by China as a provocation, similar to – or worse than – Nancy Pelosi's visit last April.

We think Xi Jinping is unlikely to move against Taiwan any time soon, but a meaningful thaw – or trade liberalization – between Washington and Beijing seems doubtful next year. And rocky relations may persist between Ottawa and Beijing.

North Korea

A complicating factor will be the periodic outbursts from North Korean leader Kim Jong-un, which will keep Japan on edge for the foreseeable future. Even China's Xi curbing the erratic Kim is unlikely.

With these geopolitical threats, it's virtually certain that defense spending will continue to rise dramatically in Washington. Outlays may hit US$800 billion in this new fiscal year, with both political parties agreeing to even greater spending in the next two or three years – much of it devoted to shipbuilding, to counter threats in the South China Sea and the Persian Gulf.

Major new spending is increasingly out of favor in the U.S. The new Congress will tighten fiscal policy next year (after a spending binge before lawmakers leave town in mid-December of 2022). By 2023 the focus will return to geopolitics, which will be a source of uncertainty for the markets, which of course hate uncertainty. ■

Please see Disclaimer section for full disclosure.

An Income Investor's Guide to the Return of Normal

Yield is back. So, what does that mean for investors and portfolio construction? Members of AGF's Investment Management team sit down to explore the question and discuss opportunities across asset classes.

BY STEPHEN DUENCH, ANDY KOCHAR, DAVID STONEHOUSE, STEPHEN WAY

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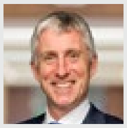

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What has changed for investors seeking yield from bonds over the past year?

David Stonehouse (DS): Inflation ended up being more of a challenge than pretty much everyone anticipated 12 months ago, even for those of us who thought it would be more persistent than transitory. In fact, some central banks still considered the rise in prices to be transitory around this time last year, and the U.S. Federal Reserve hadn't even started raising interest rates to try and combat them.

Of course, that stance was soon abandoned, but, once again, not in the measured way most people anticipated. Instead, inflation has remained stubbornly high which has led to an explosive rise in yields that has been unlike anything we've experienced in several decades. A typical rate cycle, for instance, might see yields rise a couple of percentage points, but this time they've climbed the better part of four percentage points.

Andy Kochar (AK): We've had a definite regime change in markets. Investors needed to "chase" performance and accept a much higher volatility to achieve their long-term objectives over the past decade. But with the significant re-pricing of real interest rates this year, that is no longer necessary. Income is the most certain element of a return profile and, when you have enough of it, there should be less need for excessive risk taking.

DS: That's created a dynamic we have not seen since before the Global Financial Crisis. While in the past 15 years or so, yields have averaged less than 3% – and fallen to zero at times – now we've got sovereign bonds yielding 4 to 5%, or close to it, in some countries, and other categories of fixed income like corporate credit and EM debt yielding even more.

AK: Even when central banks start cutting rates again, they're not likely to fall back to zero. What income investors dealt with over the past decade (i.e., ultra low bond yields) was atypical from a historical perspective and today's higher-yielding environment should be considered a return to normal.

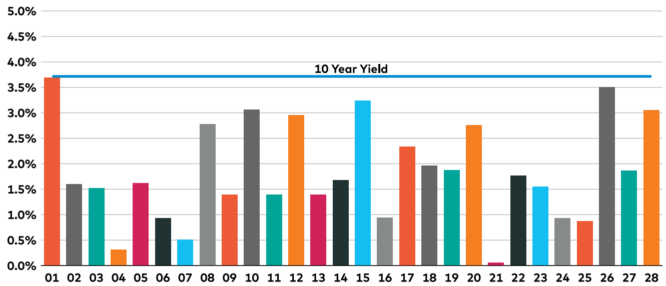
DS: By extension, what has emerged is the return of a more competitive income environment that didn't exist a year ago. In other words, with bonds now paying mid-single digit returns or better, some investors are bound to reconsider their allocation to stocks going forward.

How would you describe the current backdrop for dividend stocks?

Stephen Way (SW): Bond yields are more attractive in relation to dividend yields than they've been in some time, but that doesn't mean an either/or scenario is necessarily at play for investors. If you go back to the 1990s, equity markets performed extremely well despite U.S. bonds yielding 200 to 400 basis points above U.S. dividend stocks for good parts of the decade.

Stephen Duench (SD): The selloff in equity markets this year has created some attractive dividend yield opportunities, but there's no question that it's harder to find stocks that yield more than bond yields than it was when interest rates were near zero. The relative advantage of dividend stocks still exists across certain geographies and sectors of the market, but it's far less prevalent now that bond yields have risen so much.

Dividend Yield vs U.S. 10-year Treasury Yields



Dividend Yield

01 – 10 Year
02 – Universe
03 – Aerospace & Defense
04 – Automobiles & Components
05 – Capital Goods
06 – Commercial & Professional Services
07 – Consumer Services
08 – Consumer Staples Producers
09 – Consumer Staples Retailers
10 – Energy - Integrated & Producers & Refiners
11 – Energy Equipment & Services
12 – Financials - Banks
13 – Financials - Diversified Financials
14 – Financials - Insurance
15 – Financials - Real Estate
16 – Health Care Equipment & Services
17 – Health Care Products
18 – Household Durables
19 – Materials - Chemicals
20 – Materials - Gold & Metals/Mining & Paper/Forest Products
21 – Media Ex Cable & Satellite
22 – Retailing
23 – Semiconductors & Semiconductor Equipment
24 – Software & Services
25 – Technology Hardware & Equipment
26 – Telecommunications, Cable & Satellite
27 – Transportation
28 – Utilities

Source: AGF Investments Inc. using data from FactSet as of November 16, 2022.

SW: One of the attractive characteristics of dividend stocks that often gets overlooked is the potential growth in them over time. The MSCI World Index is expected to grow its average dividend by 6% over the next three years, which gives you a level of protection against inflation that you don't necessarily get with bond yields. Companies that grow their dividends on a consistent basis also tend to be more disciplined and of higher quality, which can result in less volatility over time.

Where do you see the best opportunities to pick up yield in your respective asset classes?

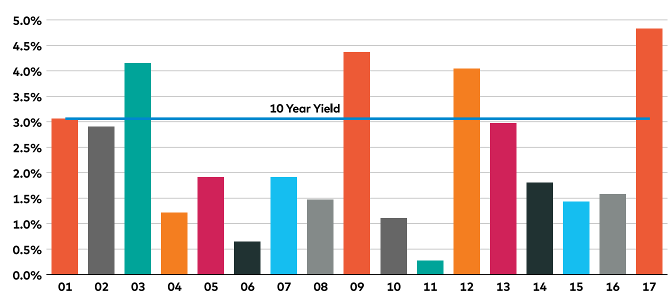
AK: Everything we've talked about so far means that large pools of capital need to be rethought. On the fixed income side, that's true of government, provincial and municipal bonds, but also investment grade and high-yield credit as well as Emerging Market debt. Yes, there is a chance that central banks are going to overshoot, so some of these buckets are going to seem too good to be true. But overall, investors no longer need to reach for yield, meaning they can focus on higher-quality issues across the fixed income spectrum going forward.

DS: It's important to note that bond yields usually rise because the economy is particularly strong. Moreover, companies also look strong in that kind of economic environment and it's usual for spreads between government bonds and corporate credit to tighten. Conversely, when bond yields are falling, it may portend more challenging economic times ahead and spreads widen.

But this past year has been different. As underlying interest rates were reset higher, riskier fixed income assets did too, which resulted in spreads widening, not getting tighter. So, not only are sovereign yields more attractive than they were a year ago, investment grade and high-yield issues are too. Plus, as Andy points out, investors can find quality companies that are paying close to 7% in yield and don't have the same risk as companies they may have owned in the past just to get a yield of 3% – or even less in some instances.

SD: From a dividend perspective, there are regions globally, including the United Kingdom, Europe and Canada, where dividends still have the yield advantage over bonds in select industries. Importantly, this advantage can be found in some of the more defensive areas of the market that can help protect against the possibility of further downside, as well as in cyclicals like life insurance, banks and even real estate investment trusts (REITs) that could benefit from a more positive turn in the New Year.

Canadian Dividend Yields vs 10-Year Canadian Government Bonds



Dividend Yield

01 – 10 Year
02 – Universe
03 – Banks
04 – Base Metals
05 – Consumer
06 – Energy Services
07 – Gold
08 – Healthcare
09 – High Yield
10 – Industrials
11 – Info Tech
12 – Insurance
13 – Energy Integrated and Large Exploration & Production
14 – Diversified Materials
15 – Diversified Financials
16 – Small Cap Energy Exploration & Production
17 – Defensives (Grocers, Utilities, Telcos, Pipelines)

Source: AGF Investments Inc. using data from FactSet as of November 16, 2022.

SW: The areas where you have dividend yield right now – Energy and Materials – are not a slam dunk depending on what happens to commodity prices next year, but reducing volatility through dividends over the next six months will be important in a climate of negative earnings revisions.

SD: Another potential catalyst for dividend stocks going forward relates to tax changes on share repurchases both here in Canada and in the United States. Companies may decide to bulk up their dividends instead of doing more buybacks.

SW: It's also important to note that, over the past decade, a lot of dividend investors bought lower-yielding securities that were growing their dividend at a fast pace, but they weren't buying it for the yield per se; they were buying it for the growth. I think now you're going to get more people structuring their dividend portfolios differently, with more emphasis on the yield component, because you're not striving for an 8% or 12% rate of return to compete against the broader equity market.

DS: The other potential benefit of bonds right now is the cushion they afford against recession. That wasn't the case when yields were at 1% or less. There just wasn't much room for them to go lower without going negative (which, of course, they did in some cases). Yet, now, yields could easily drop 1% in an economic downturn, and not only will an investor still clip a coupon of 4%, but they also stand to make, say, a 6% return from the capital appreciation in the price of the bond. That means a net gain closer to 10%, so, you're not just getting income or compensation for inflation, you're getting better potential downside protection as well.

AK: Just like the good old days.

SW: Especially if you get a real positive yield based on actual realized inflation. That would truly be a "back to normal" environment, and that's where we should be. There's no good reason for negative real yields.

Does the current environment for yield dictate a different approach to asset allocation?

DS: My thinking is that 50/50 could be the new 60/40 – especially if an investor's goal is to achieve a realistic portfolio return of 7% annually. After all, they can now get 5% to 6% from the fixed-income side of the equation, so they only need 8% to 9% from the equity side. Moreover, if one-third of that equity return can be had through dividends, then the capital appreciation requirement is relatively modest and certainly more achievable.

SD: A more balanced approach between equities and bonds is going to be important going forward. A weighting towards dividend stocks, for instance, should give investors the protection they need in the case that inflation remains high, while a weighting towards bonds could be critical in the case of a recession.

DS: It's not necessarily all income all the time – and there are various tax implications to consider – but it's a far more appealing environment for asset allocators who no longer want to focus so heavily on capital appreciation to achieve their objectives.

SW: Of course, a lot of what we've been saying today will depend on the economic backdrop that's been driving the shifting environment for yield this year. Rates have been rising because of inflation expectations and realized inflation being way higher than anybody anticipated. And there is an underlying belief that central banks will get inflation under control. But the question is whether inflation comes down to a range of 4% to 5% in countries like the U.S. or a range of 2% to 3%. It doesn't seem like much, but it can make a big difference in terms of how you approach asset allocation and where the best opportunities for yield can be found going forward. ■

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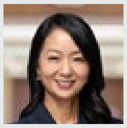
Deglobalization, Inflation and What It Means for Emerging Markets

As economies increasingly diverge during deglobalization, so will corporate fortunes and investment opportunities.

BY REGINA CHI



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For much of the past 75 years, the most significant macroeconomic story, to both developed and emerging economies, has been globalization. In the aftermath of the Second World War, liberal policies and global institutions saw trade barriers weaken, and China's accession to the World Trade Organization in December 2001 – almost exactly two decades ago – accelerated the world economy into a period of hyper-globalization. Aided by new technologies that enabled knowledge dissemination and lowered barriers to entry, the international flow of goods and services increased to a degree never seen before; labour productivity soared.

Globalization promoted economic growth, created jobs, made companies more competitive and lowered prices for consumers, especially in the developed world. It promoted foreign direct investment in Emerging Markets (EM), helping them develop economically, and the combination of strong growth and low inflation allowed central banks to maintain benign monetary policies. Yes, it created inequities and there were crises, but globalization has been a good story for billions of people – including investors.

> **But there is another possibility: that these are markers of a slow deglobalization that will mean higher inflation and a far less productive world for years to come.**

Now, however, the world is changing. Governments are retrenching into protectionism. China – the most vital link in the modern network of hyper-globalization – has become more assertive and less accommodative to Western priorities. Russia has thumbed its nose at the "new world order" with its invasion of Ukraine, further disrupting global supply chains whose fragility had already been exposed by the pandemic. Given the durability of globalization since World War II, it might be tempting to assume those are short-term trends and the world will get back to "normal" once they end. But there is another possibility: that these are markers of a slow deglobalization that will mean higher inflation and a far less productive world for years to come.

There have been periods of deglobalization in the past, and they are instructive comparators for the current environment. After the First World War and again during the Great Depression, the United States hiked tariffs, prompting its trading partners to implement their own retaliatory levies. In both cases, global trade openness (calculated as exports and imports as a percentage of GDP) declined sharply.

Fast-forward to 2018, when we saw tit-for-tat trade wars erupt between the U.S. and Canada, Europe, Japan and China. Notably, the end of the Republican administration in 2020 did not spell the end of the so-called Trump tariffs – the levies against Chinese goods remain in effect, in large part because an anti-China trade stance enjoys bipartisan and popular support in the U.S. China itself has become far more aggressive in its geopolitical positioning, including tacitly backing Russia's invasion of Ukraine. Meanwhile, the U.S. and China are engaged in an ongoing tech war, in which the U.S. is trying to prevent its adversary from accessing high-tech equipment and intellectual property, including in the form of American citizens.

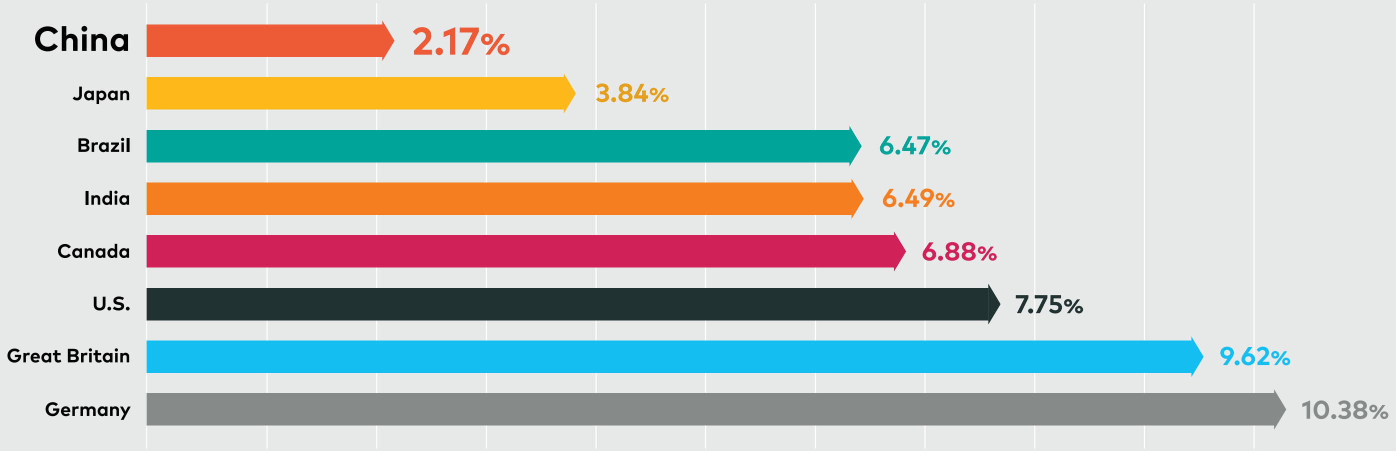
What is the likely impact of these retrograde policies? Perhaps the most significant to investors will be higher inflation. To understand why, consider the *disinflationary* effects of globalization. Over the past couple decades, multinational companies could arbitrage tax rates (which fell to all-time lows in developed *and* emerging markets), low tariffs and low labour costs in EMs to increase productivity and profits, while low interest rates facilitated foreign investment (which also boomed). Not surprisingly, we saw lower inflation volatility during this period, and China was the most important contributor. With more liberal trade policies and a large, cheap workforce, China was a main driver in keeping down prices globally; it also helped cap costs for domestically produced goods in developed economies and effectively weakened workers' bargaining power. Presumably, deglobalization reverses these effects, and that means we could see world inflation be structurally higher over the next decade.

Today, the rise of an aggressive China increasingly distancing itself from Western-dominated trade multilateralism, along with a devastating global pandemic and Russia's Ukraine invasion, is prompting corporations and policymakers to dramatically rethink the value of lean, just-in-time global supply chains. Yet a reorientation towards reshoring or "friend-shoring" will undoubtedly increase production costs as Western workers are much more expensive than China's, even while the latter's average wages have been steadily rising. Multinationals that try to hedge their bets and adopt a China-plus-one (or two or three) strategy by diversifying supply chains to other EMs might find that they lack the scale or the infrastructure that China can offer. No doubt the resulting inefficiencies will eventually get sorted, but in the short-to-medium term the reorientation of global supply chains is likely to be inflationary.

In the same vein, the U.S. and several European countries are enacting policies that seek to incentivize domestic production in strategic sectors. The U.S., for example, this year passed a bill that will provide US$50 billion to its semiconductor industry. Similarly, China has long-standing policies that seek to increase "self-reliance," and it recently adopted a "dual-circulation" strategy to foster growth based on domestic demand and supply, especially in technology sectors. Perhaps such forms of protectionism are valid on national security grounds (they are usually politically popular), yet if history is a guide, they are also likely to result in lower productivity and in higher prices. We might add that "green" incentives and supports for domestic industries will likely also create market distortions.

After a dismal 2022, global investors are no doubt eagerly anticipating a return to "normal" in 2023, a year in which they hope the inflation spike will finally be driven into the ground and central banks will pivot to more accommodative policy. However, to the extent

China Inflation Versus the World



Source: Global Rates.com as of November 22, 2022. Based on yearly Consumer Price Index (CPI) data through October except for India, whose CPI figure is based on September data.

that globalization engendered easy monetary policy, deglobalization may force central bankers to keep rates higher than expected. Time will tell.

We are, however, certain that we can expect more idiosyncratic country returns across Emerging Markets next year. Certain developing countries will stand to benefit more from this new deglobalization trend. For starters, Mexico, India, Vietnam and Indonesia stand to benefit from "near-shoring" as foreign direct investment flows and supply chains are shifted from China. And while it has become fashionable to discount China, let us not forget that the world's second largest economy has one of the lowest CPI rates (at 2.1%) in the world, even as inflation rages on just about everywhere else. Furthermore, its goal to be self-sufficient in many key technologies and strengthen its domestic economy will insulate it from deglobalization's detrimental effects over the longer term. And in the short term, China remains the biggest reopening story in 2023, as the country continues to gradually lift itself out of its self-imposed COVID lockdowns and restrictions, in part, because of public protests against them.

For investors, the potential for "higher-for-longer" interest rates means a higher cost of capital for companies to service their debt and grow their business. Just as investors will have to be selective on the country level, a focus on quality companies could prove critical for 2023 as the world potentially heads into a recession (sans China) next year. As economies increasingly diverge during deglobalization, so will corporate fortunes and investment opportunities.

> **Certain developing countries will stand to benefit more from this new deglobalization trend.**

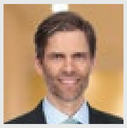
As it stands, globalization appears to be slowing. And that means the world in 2023 is likely to look very different from the one which investors have become accustomed to over the past 75 years.

Please see Disclaimer section for full disclosure.

A New U.S. Law Gives a Boost to Sustainability-Themed Investing

Despite its name, the Inflation Reduction Act may be the most important carbon-reduction initiative yet – and it should create long-term opportunities for investors in the global energy transition.

BY MARTIN GROSSKOPF



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On August 16, 2022, President Joe Biden signed the Inflation Reduction Act (IRA) into law. Despite its name, the bill in reality represents one of the most significant governmental commitments to reduce carbon emissions in history. Most of the IRA's baseline spend of about US$370 billion over 10 years is directed toward a vast array of investments in energy production and manufacturing, including climate technologies such as energy storage and green hydrogen, and it will promote the buildout of cleantech supply chains within the U.S. and its free trade partners, including Canada. Perhaps even more remarkable than all that money is what it signals – namely, that the United States, whose commitment to addressing climate change has for many years been open to question (to say the least), is fully on board the green transition train. Given that the U.S. is the world's biggest, most liquid market, that means the IRA may be the most important carbon-reduction initiative yet. It should also provide a boost for thematic investing in companies targeting the key sustainability issues facing the world.

The IRA's US$370-billion federal baseline spend could be just the beginning. According to research by Credit Suisse, the federal spend could potentially exceed US$800 billion over a 10-year period, more than double the Congressional Budget Office's estimate and translating into a combined public and private spend that could exceed US$1.7 trillion. Already, many companies have committed to large investments on U.S. soil. For example, two electric vehicle battery manufacturers have committed to investing more than US$4 billion and US$2.5 billion, respectively. Such private sector commitments are largely due to the signing of the IRA.

The timing is also quite noteworthy. Even in the case of a recession, the IRA's incentives will be continually accessible for qualifying cleantech projects, effectively creating a safeguard for companies positioned to reap the benefits of the tax credits regardless of the macroeconomic environment. Meanwhile, the U.S. is expected to be competitive in hydrogen, carbon capture and storage, solar PV and wind turbine – and Republican-leaning states are likely to benefit the most from private-sector investments that will take advantage of the IRA. Tennessee, for instance, is set to receive approximately US$18 billion, which will boost the state's job numbers. Similarly, Georgia, South Carolina and a host of other states that lean right-of-centre politically are also set to receive billions in private investments in cleantech. This likely ensures that regardless of which party takes the White House and/or controls Congress, the IRA should remain largely intact and provide stability for the next decade.

Solar and Wind Get a Much-Needed Lift

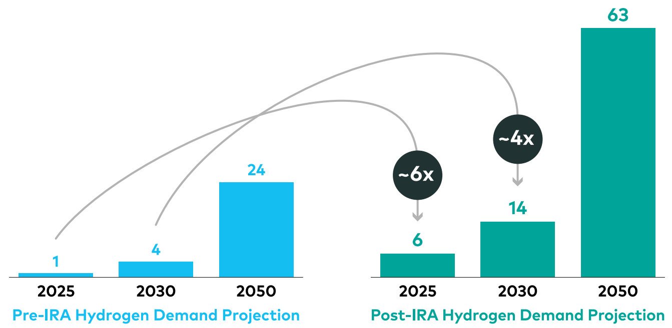
The IRA restores tax credits for solar and wind projects to their full rates and ensures these rates stay in effect for at least another 10 years; that will effectively remove the ambiguity arising from the previous series of two-year tax credit extensions, which were counterproductive to long-term business strategies and investments. The IRA also includes funding for other renewable infrastructures, namely geothermal and hydropower. The technology-agnostic Production Tax Credit (PTC) is capped at US3 cents per MWh for utilities, depending on the greenhouse gas emissions from the power grid. The similarly agnostic Investment Tax Credit (ITC) is set at a 30% discount. Scaling up the production of electricity via renewable sources to the power grids may reduce emissions substantially and decrease associated costs.

Clean Hydrogen May Enter Period of Hypergrowth

The global green hydrogen market is expected to experience hypergrowth driven by increased demand for alternative energy sources and increased support by government incentives. According to the International Energy Agency, clean hydrogen is "currently enjoying unprecedented political and business momentum" and now is the time to scale up technologies and bring down costs to allow hydrogen to become an important component of the clean power-generation mix, along with solar and wind. The IRA provides a means to alleviate much of the cost, and that will drive immense growth. The law offers a 10-year Clean Hydrogen PTC based on the amount of qualifying hydrogen produced at a facility prior to January 1, 2033. The tax credit, broken up into four tiers, goes up to US$3 per kg depending on the carbon intensity of the produced hydrogen.

The IRA could dramatically increase demand. With government support, the demand trajectory is now projected to be some four to six times more than pre-IRA projections, according to McKinsey estimates.

Inflation Reduction Act Impact on Green and Blue Hydrogen Demand



Source: McKinsey, Sept 2022

Tax Credits for Electric Vehicle Consumers

There are U.S. consumer-based tax credits for electric vehicle (EV) models, including battery, plug-in hybrids and fuel cell EVs, within a price point depending on vehicle category, to help drive demand even further. Under the new provision, EV battery-critical minerals sourced from "foreign entities of concern," such as China, will no longer qualify for the tax credit after December 31, 2023.

The IRA also requires batteries to have 40% or more of the critical minerals sourced from the U.S. or a trading partner by 2024 to qualify for any tax credits. The sliding scale increases until 2029, when a much higher share of the critical minerals will have to be sourced from North America. If the battery meets the sourcing requirement, the consumer is eligible for a US$3,750 incentive. Similar rules apply to battery components; an additional US$3,750 could be credited to the consumer depending on where the battery components are manufactured.

These rules are designed to encourage realignment of the EV battery supply chains in favour of North American suppliers. Auto companies up and down the supply chain will need to explore whether and when to make changes to comply with these provisions. The IRA should create new much-needed EV supply chains and get EVs closer to cost parity with internal combustion engine-equipped vehicles.

Policy Tailwinds Support Multiple Sustainable Themes

We expect investors in sustainability to benefit from a growing universe of companies that can take advantage of the IRA, including existing holdings. The IRA provides huge investment opportunities in multiple sustainable themes. For instance, it provides approximately US$20 billion to support agricultural practices that will reduce greenhouse gas emissions and increase carbon sequestration. Also of note, the production tax credit for carbon capture, utilization and storage (CCUS) has been extended for 10 years and expanded to include additional qualifying facilities and increased credits. CCUS offers a way to remove carbon emissions from chemical reactions and is the only viable option to further decarbonize this process even after removing fossil fuels.

Sustainable investors will benefit from long-term tax incentives from the U.S. and other regions targeted for electric vehicles, hydrogen, solar and wind, as well as agriculture and other sectors. That makes the signing of the IRA a watershed moment not just for green policy, but also for investors looking for opportunities in the global energy transition. ■

Please see Disclaimer section for full disclosure.

What Happens When Central Banks Pivot?

AGF analysts explain how a slowing of interest rate hikes (or outright stop to them) could impact key segments of the equity and credit markets in 2023.

BY DILLON CULHANE, RICHARD FISHER, JEAN-SÉBASTIEN NADEAU, LAZAR NAIKER, WAI TONG, WYETH WRIGHT

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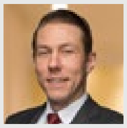

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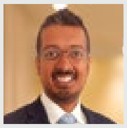

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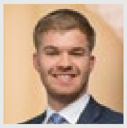

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EQUITIES

ENERGY

Will Energy run out of gas?

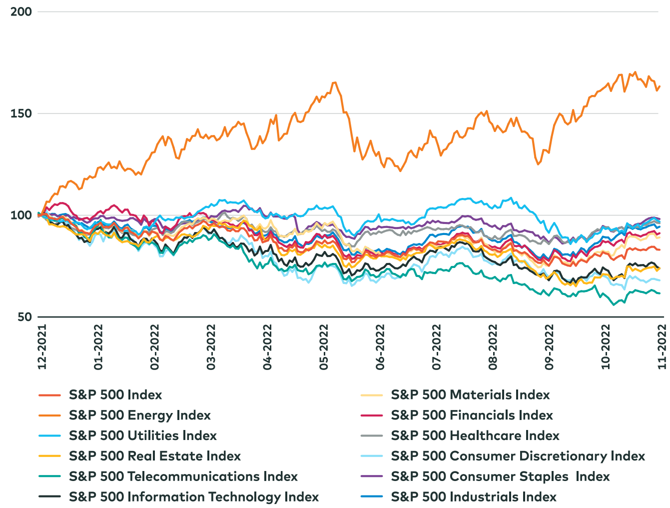
Dillon Culhane

The Energy sector has outperformed broader equity markets over the past two years, driven by post-COVID demand recovery, years of supply underinvestment, industry capital discipline, attractive equity valuations and a refocus on energy security in the wake of Russia's invasion of Ukraine. As inflation and interest rates have risen, Energy has been the only sector showing positive earnings revisions and rising free cash flow, driving increased shareholder returns and decreased balance sheet leverage – and thus it has felt little impact from the rising cost of debt. Of course, rising energy prices are a huge driver of inflation and subsequent interest rate hikes, which are designed to slow the economy down, theoretically reducing energy demand. However, past recessions have shown minimal lasting (or material) impact on oil-and-gas demand.

> **Energy has been the only sector showing positive earnings revisions and rising free cash flow, driving increased shareholder returns and decreased balance sheet leverage**

Once we get a clear line of sight to a pause on interest rate hikes, the Energy sector will likely underperform growth sectors and other laggards in the market.
But that doesn't necessarily mean it will trade down. On the day of the lower U.S. inflation print for October, the S&P 500 traded up 5.5%, with Technology (+8.3%) and Real Estate (+7.7%) the top-performing sectors, while Energy was still up by 2.2%, per Bloomberg. A pause in rate hikes should signal that inflation has bottomed and economic growth will eventually resume, which is positive for energy demand. There are also many structural forces supporting the sector, including Europe's pivot away from Russian energy, OPEC's willingness to manage supply and an eventual China reopening. So while Energy is unlikely to continue outperforming the broader market once central banks turn direction on rates, it's quite feasible that oil-and-gas prices remain in a band around current levels over the coming years, driving very strong profits for energy companies.

S&P 500 Sector Performance



Source: Bloomberg LP as of November 25, 2022.

FINANCIALS

How will Financials handle a slowing economy?

Richard Fisher and Wyeth Wright

For banks, we expect the benefit stemming from increasing interest rates to moderate as we progress through 2023. Nearer term, banks should report solid net interest income growth, driven by higher margins associated with lagging deposit cost inflation, moderating loan growth and reasonably well-behaved credit quality. Financial institutions with the strongest deposit franchises should outperform, as they typically have more diverse revenue streams and the largest securities portfolios on their balance sheets (which generally reprice faster than loans). Earnings moderation follows from a shift in deposit mix towards higher-cost term funding like GICs and a heightened level of competition for deposits and loans as the economy slows under the weight of higher rates. And with that slowing economy, banks will build reserves for performing loans to address possible losses in the future.

> **For Financials that are sensitive to the consumer, a slowdown in rate hikes would have positive effects on stock multiples in the short term.**

For Financials that are sensitive to the consumer, a slowdown in rate hikes would have positive effects on stock multiples in the short term. However, a recession or "harder landing" leading to higher unemployment and a worsening economy would weigh on the entire sector, even in a more liquid financial environment, and we would expect to see delinquencies and charge-offs rise, putting downward pressure on earnings. Bank stock performance would be negatively affected by increasing credit impairments, accompanied by the group valuation re-rating lower. For insurance companies, those that are exposed to personal and commercial lines should outperform their life-insurance counterparts due to the former's lower equity market exposure and defensive characteristics – assuming, of course, that inflation does not increase the cost of claims more than expected. Insurers with shorter-duration books should also see a benefit to earnings as their investments roll into higher rates.

INDUSTRIALS

Can Industrials weather the storm?

Lazar Naiker and Wai Tong

Despite the macro uncertainty driven by the U.S. Federal Reserve's rate path and the potential impact on the economy, Industrials are exposed to secular growth drivers that should result in resilient demand in the medium to long term. The energy transition, encompassing renewable energy, grid resilience, electrification and decarbonization, as well as infrastructure upgrades and water security, will be key areas supporting growth.

> **Industrials are exposed to secular growth drivers that should result in resilient demand in the medium to long term.**

Supply chains remain tight, and many markets are constrained by supply rather than demand. This has resulted in elevated inventory levels. Ordinarily, this would be a concern heading into a potential recession; however, given the experience of supply chain disruptions through the pandemic, a structural shift higher in inventories is likely due to a move towards "just-in-case" rather than "just-in-time" inventory levels. The question is whether demand will slow sufficiently to overwhelm supply constraints in the market and result in inventory levels becoming an overhang.

The most recent quarterly results from cyclical Industrials have shown no signs of demand slowdown.

Most industrial manufacturers are still showing below-historical inventory-to-sales ratios while carrying record backlogs. These backlogs, combined with the demand for inventory replenishment, may maintain more than sufficient demand to carry these cyclical industrial companies through a mild downturn until end-market demand recovers. Logistics cost and raw material costs having peaked and now rolling over should benefit manufacturers' margins and offset the lack of pricing power in a slowing demand environment.

Overall, we believe these longer-term secular drivers will be supportive of Industrials in the next cycle, relative to the market. The extremity of any near-term downturn will determine any downside risks. Slowing growth or a mild recession are unlikely to have a material negative impact, given the structural underpinnings to demand and supply constraints.

FIXED INCOME

CREDIT

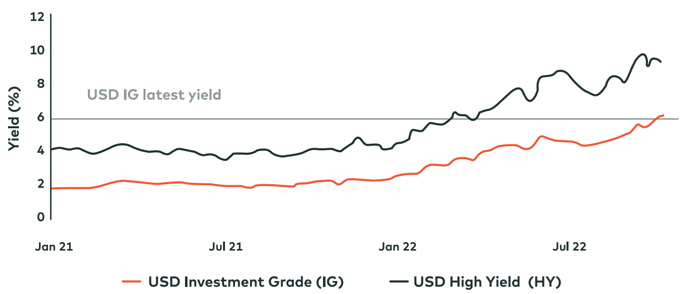
Will quality be more important than yield?

Jean-Sébastien Nadeau

An end to central banks' tightening cycles could be positive for the fixed income market, but we believe investors should remain cautious. The two main roles of fixed income are to generate income and to preserve capital, acting as an anchor in a diversified portfolio comprising both stocks and bonds. Despite a potential end of the tightening cycle, we believe high-quality corporate bonds will outperform lower-quality bonds in the first half of 2023. Central banks are usually behind the curve and pivot when it is already too late; in other words, they usually cut rates once the economy is already in recession. Recessions are usually accompanied by underperformance in lower-quality bonds.

We therefore remain constructive on high-quality corporate bonds due to their attractive valuations and their current high potential for income generation, and we believe they can achieve returns of mid- to high-single digits in 2023. U.S. investment-grade bonds now offer higher yields than high-yield bonds did 12 months ago due to historic interest rate hikes by the Federal Reserve in 2022. On the other hand, once the tightening cycle truly ends, we believe lower-quality corporate bonds could start to outperform high-quality bonds. In general, this market backdrop bodes well for the corporate fixed income market in 2023, as higher income should offset any potential weakness in prices. A central bank pivot does not necessarily mean the end of volatility for the market, but given current valuations, the bond market offers plenty of high-return/low-risk opportunities going into 2023.

U.S. Investment Grade (IG) Versus U.S. High Yield (HY)



Source: HSBC using Bloomberg data

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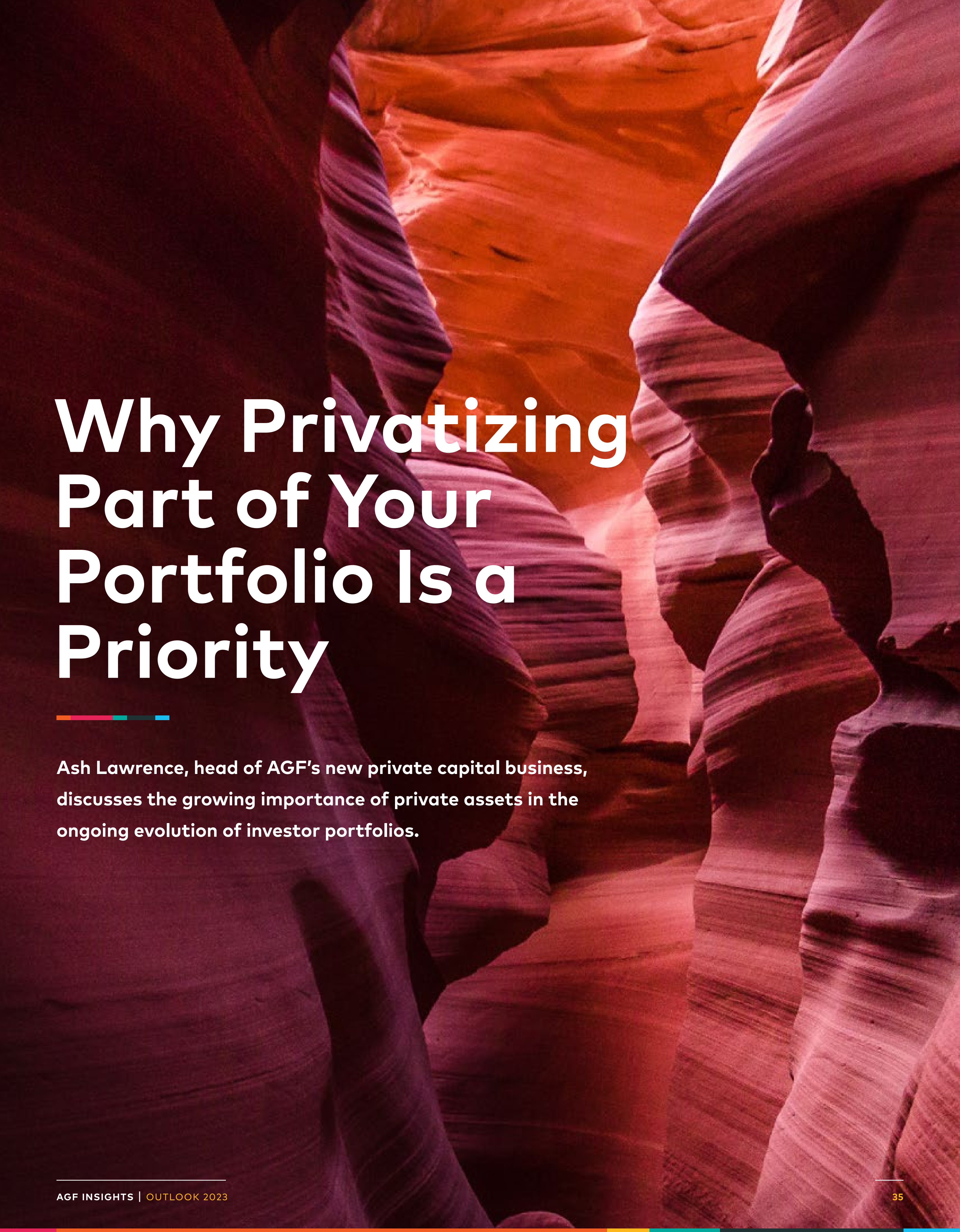

Why Privatizing Part of Your Portfolio Is a Priority

Ash Lawrence, head of AGF's new private capital business, discusses the growing importance of private assets in the ongoing evolution of investor portfolios.

Ash Lawrence
Senior Vice-President and Head of AGF Private Capital
AGF Investments Inc.

AGF | Private Capital™

Why was AGF Private Capital established earlier this year?

The goal is straightforward. We want to be one of North America's top experts in private market investing and put that together in our broader client proposition with our public markets offerings. To build the foundations of that private markets business, we're going to create an investment platform over the next few years that includes multiple private market strategies run by experienced managers within their respective asset classes that we bring into AGF's asset management complex.

How does AGF's legacy ETF and mutual fund business complement that vision?

The broader AGF platform is hugely important. Not many alternative managers are in the same position to leverage the kind of knowledge and experience it affords in areas like product development, distribution and marketing. That said, structuring a mutual fund is very different than a private credit fund that, for starters, may have unique redemption and valuation characteristics. So, it's crucial that our private market business has its own identity and skill set. In this way, we can work better with our manager partners to structure strategies, while also taking advantage of what AGF offers more broadly.

What is the advantage of having a private markets business in addition to AGF's existing line up of strategies that still mostly invest in publicly traded securities?

There are several benefits, the first and most important of which relates to the changing appetite of our clients. It's no secret that investors are allocating more money to private assets than ever before. In fact, by some estimates, the split between public and private is now close to 50/50 among the largest institutional investors in the world. So, if we want to serve clients across the full spectrum of assets they now demand, we need to be in the private capital business. On the retail side, the shifting allocations are in their early stages, but the sheer scale of incremental moves in allocation offers a huge potential growth opportunity for the firm. Assets under management in global private markets hit US$10 trillion in September 2021, representing a five-fold increase since 2007, according to Preqin, a financial data provider. Meanwhile, public markets, which are still far bigger but have grown more slowly, roughly doubled in the same period.

Why has demand for private market assets grown so substantially?

Alternatives – which include private market assets – serve numerous functions in an investor's portfolio. For many, the primary goal is to provide uncorrelated returns to publicly traded stocks and/or bonds, which, in turn, can help reduce overall volatility in a traditional 60/40 mix. But often overlooked is the additional benefit of *direct control* that comes from owning shares in a private market investment.

For example, when a private equity firm invests in a company, they typically buy a 100% controlling interest, which allows them to influence the company's direction in a way that is very difficult for even the largest public-market investors to do. This is especially true these days when it comes to contentious issues like environmental, social and governance (ESG) mandates. They may be necessary to implement, but require complete buy-in from shareholders to achieve.

Moreover, there's an argument to be made that one of the reasons private capital tends to be uncorrelated to publicly traded stocks and bonds is precisely because of the direct control. In other words, private investors can hold their investments through an entire market cycle if they so choose, which only helps differentiate their returns and lowers market volatility in the process.

Why are private markets still mainly the domain of institutional investors?

Institutional investors have been proponents of private markets for years, while retail participation has been much slower to catch on because of issues largely related to education and product structure. Still, businesses like ours are eager for that to change and a new wave of refined private market offerings that cater to the specific needs of retail investors could proliferate and lead to higher allocations among this group.

As such, we see retail as a relatively small opportunity near-term, but one that gets progressively larger in the mid-to-long term. In fact, one of the other reasons we created the private capital business is because of the "white space" for growth in the retail segment.

What structural changes might need to be made to make this happen?

The underlying investments would still be private, but institutions are more comfortable locking up their money, whereas retail investors often demand more liquidity or want cash distributions while they hold an investment to maturity. Private investments that offer that do exist, but structuring yield-producing products has been difficult over the past decade because interest rates have been so low and more attention has been paid to capital appreciation products associated with venture capital and private equity funds.

Of course, that should change if today's higher inflation, higher interest rate environment persists. For certain private real estate with shorter duration contracts, for instance, elevated inflation and higher rates should turn into higher distributions down the road.

What specific asset classes is AGF Private Capital focused on right now?

Our priorities are private credit and mid-market private equity because they both have large and growing investable universes that institutions are well versed in, and which retail investors are becoming more acquainted with over time. Specifically, private credit offers some attractive characteristics in the rising rate, inflationary environment we're in, namely, returns correlated with rates, safety and the prospect of attractive distributions. Additionally, we're looking at potential opportunities with real estate asset managers. Despite some market adjustments in the near term largely related to interest rates, we like the asset class over the long term.

What is your outlook for private markets in 2023?

It depends on your investment style. For more conservative investors that are worried about inflation, infrastructure and private credit may offer some good opportunities. Real estate, as we alluded to above, probably warrants more caution right now due to the impact that rising interest rates is having on the asset class, but we could be looking at a value opportunity in 2023 and a good time to be putting capital to work. Unlike in public markets, it often takes longer for buyers and sellers in the private market to reach agreement when macro conditions adjust like they have over the past year, but in this instance, once they do, it could lead to a new value opportunity for investors.

What about private equity?

Private equity valuations are only just starting to adjust downwards and are still doing so in a measured fashion after a period of being elevated. Yet, if there's a trend to watch, it may be toward cash-flowing businesses, mainly because of the safety they provide, but also because of the yield. Multiples on cash flowing businesses have thus far held up well and there is a considerable amount of "dry powder" that was raised over the past year or two that is looking for a home. This will work to the benefit of more mature, resilient cash-flowing businesses. Meanwhile, if investors want to play it riskier, it may be a good time for venture capital. Asset managers in this space may find some great companies to invest in as capital has become so scarce over the past little while. Similar to real estate, this might yield some good opportunities over the next year if, again, you have dry powder to invest. ■

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