2023 Market Outlook
The End of Free Everything? Could Simply Be a Return to Normal

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Executive Summary

We have endured almost a full year of difficult and volatile equity and bond markets. **Capital markets have been adjusting to the reality of high inflation, higher interest rates, less easy money, slowing growth, and increased geopolitical tensions.**

The global economy is slowing. The post-pandemic pace of economic activity is returning to normal after 2021's juiced reopening pace. During COVID, central bankers and governments saturated the economy with money, but that contributed to high inflation. Now central banks are unwinding easy money policies and raising interest rates to tame runaway inflation.

In our opinion, many equity and bond markets have come a long way toward adjusting to the current reality. Looking ahead, we see better investment opportunities today than we did a year ago.

Equities

Equity markets need to adjust on three fronts: complacency toward risk; a rising risk-free rate; and the future path for earnings growth.

A lot of complacency has been scrubbed from the system. Savvy investors know that investing when there is more fear than greed often leads to good outcomes. Today, there is more fear than greed versus a year ago.

The reset to higher bond yields and a higher risk-free rate is closer to the end than the beginning. Gale-force headwinds for stocks are softening into a mild breeze that is a potential tailwind in 2023.

Expectations for earnings growth in 2023 are modest. Most valuations have reset below their 20-year average. If the economy experiences a soft landing (no recession and inflation cools) or a shallow recession (and inflation cools), both scenarios underpin our base-case outlook. We feel equities can deliver total returns in 2023 in the neighbourhood of 8% to 12%. Our targets are 22,000 for the S&P/TSX Composite and 4,400 for the S&P 500.

Fixed Income

We feel a great deal of recalibration in fixed income markets has been done. Bond markets are pricing in a peak U.S. Federal Reserve Funds rate between 4.75% and 5.0% and a peak Bank of Canada rate between 4.25% and 4.5%. We see these numbers as fully pricing in all the expected moves. If central banks unexpectedly stop short of these levels, it would be a boon for fixed income.

Many of the untenable imbalances due to the extraordinary measures undertaken during the pandemic have been worked off. The fixed income market is currently better positioned to deliver on the dual mandate of providing a return contribution and mitigating risk. The yield inside our fixed income portfolios is more attractive now than it has been in more than a decade (around 5% in our core fixed income solution). The ability of fixed income to provide downside protection has improved.

In our base-case scenario, our end-of-2023 call is for the yield curve to steepen as 2-year and 10-year Canadian bonds lineup to yield 3.25%. There will be volatility across the year as bond yields wobble around on recession and inflation fears, but the income now coursing through portfolios should generate a mid-single-digit return in 2023.

Our Positioning

We remain reasonably close to our long-term strategic benchmarks with some prudent tactical tweaks. For 2023, our bias leans toward increasing our equity exposure.

Our fixed income positions remain at a slight underweight. Coupon income and maturing securities in our bond portfolios are being reinvested at higher yields. We believe our bond positions will provide a level of safety if a recession takes hold.

We remain slightly overweight equities. We are underweight international developed markets (primarily Europe and Japan) and overweight to North American equities, remaining neutral on Emerging Markets equities.

The coming year will begin with downside risk and (hopefully) cooling inflation – but no recession (or perhaps just a mild one). We see better investment opportunities in the year ahead. After this difficult year of volatile equity and bond markets, everyone will welcome a return to normal.

Overview

The world is in adjustment mode, still dealing with the aftershocks of the pandemic and, to a lesser extent, the fading effects of the 2009 financial crisis. This follows many years (decades in some cases) of free, or at least very cheap, access to some key resources – money, carbon, and labour.

These freebies allowed China to pump out cheap goods, which benefitted both China and Western consumers. Free trade pushed down costs for global multinational corporations. With nations working more closely together, free trade made the world a safer place. However, free trade created international competition for labour and eroded the average worker's power. Workers didn't complain much as inflation was tepid (thanks again to free trade and free carbon). Free money brought larger houses, larger cars and larger consumption in general. Ultimately, free trade is good if it happens on a level playing field – it can grow the proverbial pie for everyone.

Free use of carbon meant cheap travel, cheaper transport, and just about cheaper everything. The environment bore the (now, not so) hidden cost. Cheap money pushed up asset prices (real estate, equities, and bonds) and brought larger debt loads for households, businesses, and government.

Now the world is changing, and capital markets are adjusting to the new reality. Some of these changes are simply a welcome return to normal.

The current retreat from free trade is not a positive step, but entering a period of more appropriately priced carbon, labour and borrowing costs will be positive developments in the long run. Higher inflation is, hopefully, a temporary by-product.

Increased wages are good for the lower income strata of society, especially when disparity is causing social unrest. Tight labour markets are the product of many things: demographics (the great retirement is real); immigration; and skills mismatch, to name a few. These are medium-to-long-run issues that society needs to address. There are other supply-side considerations like automation, digitization, and artificial intelligence. Higher wages are the only short-term solution while these other factors adjust. The good news is higher wages buoy consumption.

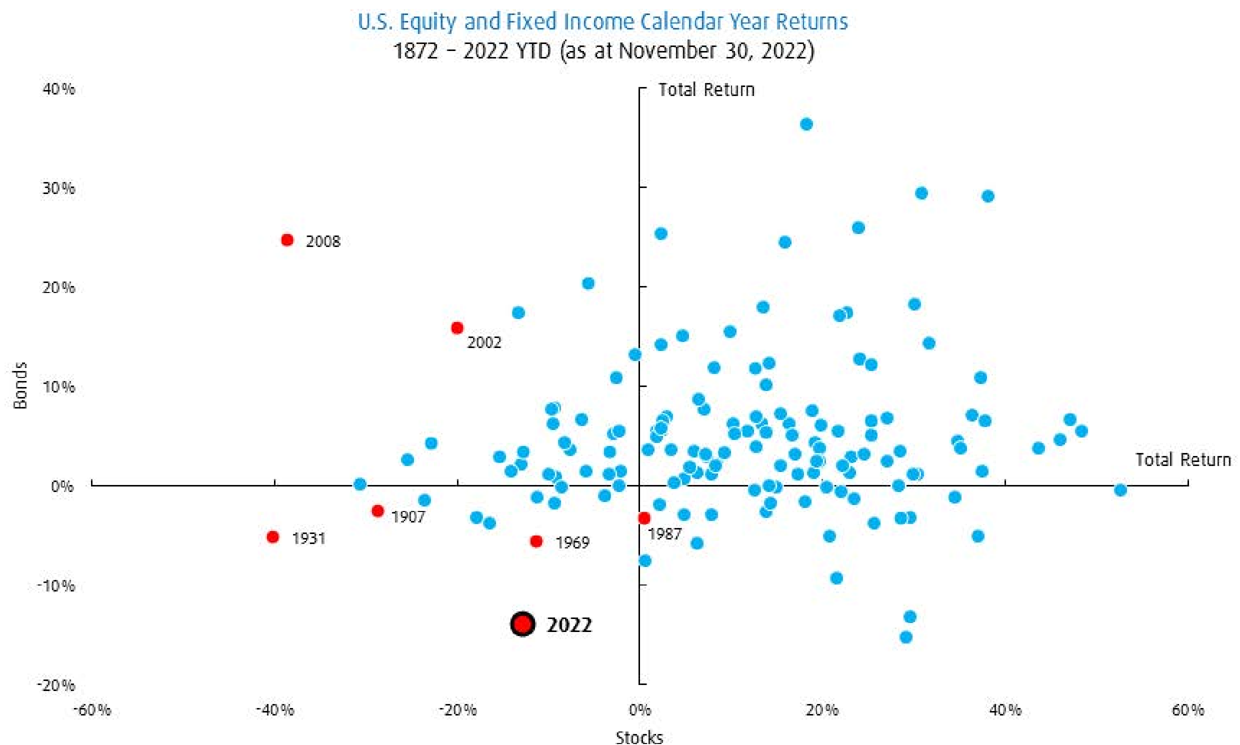
A fair price for the use of the environment is necessary. By historical standards, current oil prices are not sky high. On an inflation-adjusted basis, oil has averaged around US$75 a barrel since 2000. The world can and should be able to function with oil between US$80 and US$100 a barrel. A higher price for oil will curb our appetite and bolster the case for alternatives.

Zero or negative interest rates are neither normal nor healthy. Interest rates in the mid-single digits aren't high; they are normal. Since 1870, the average U.S. government long-bond yield has been 4.5%. The yield on a Government of Canada 10-year bond has averaged 3.3% for the past 25 years; at the time of writing, it sits at 2.9%. Today, investors have a host of more attractive fixed income choices. At the end of Q3, our clients were earning in the 5% range in the fixed income component of their portfolios.

Interest rates are the price of money, and free money is not desirable. Free money distorts necessary price incentives in the economy. Years of cheap money created a false sense of security for businesses that couldn't stay afloat without it. It is a disincentive to innovation, hard work, and competition. Additionally, higher borrowing costs mean higher interest income for others, especially savers.

The adjustment to rightsizing these imbalances has meant an especially painful year, one that delivered a rare tandem-negative result for stocks and bonds. In more than 150 years of data on U.S. stock and bond markets (see Exhibit 1: A Historic Drubbing for Stocks and Bonds), 2022 ranks as one of the worst combined outcomes. **Long-term investors need to recognize that this year's painful results are the exception, not the norm.** In 40-plus years of recorded data in Canada, investors have made money on a quarterly basis from either stocks or bonds (or both) 92% of the time.

Exhibit 1: A Historic Drubbing for Stocks and Bonds



Source: University of Bonn Macrohistory Database (1872 – 2020); Bloomberg (2021 – 2022)

Markets look to the future; it's their nature to over and under shoot. The global economy is slowing. It was expected that 2021's post-pandemic juiced pace of economic activity would calm down. There is now additional, deliberate slowing as central bankers raise interest rates to tame unacceptably high inflation.

We have endured almost a full year of challenging and volatile equity and bond markets. These market environments don't last forever. Many equity and bond markets have come a long way toward adjusting to the current reality. Looking ahead, we see better investment opportunities than we did a year ago.

Inflation

Inflation is a symptom, not the disease. Like a fever that tells us we are sick and contributes to the healing process, inflation is both a sign of trouble and part of the solution. It's simply the result of too much money chasing too few goods and services. Higher prices work to fix this imbalance by curbing demand and encouraging greater supply.

Pent-up savings from the pandemic era contributed to the problem. Yet, this store of money also cushions the economy as higher interest rates and higher prices bite. This is one reason that a recession – if there is one – will likely be mild.

The supply chain, goods side of the inflation problem is rapidly easing. Service-sector inflation remains an issue; wages and shelter costs rank as the most significant concern.

Higher interest rates are having a swift and sharp impact on the housing market. Central bankers know it will take time for higher rates to filter through housing channels and eventually impact inflation. Labour markets are among the slowest to respond. Wages chase inflation (the dreaded wage-price spiral). Unemployment is the last area to respond to a slowdown or recession.

The mandate of central bankers is to create conditions that foster full employment and price stability. These two goals are currently at odds. Price stability is the farthest from target while full employment is at or above target. For now, price stability takes precedence over employment. To avoid the difficult-to-exit wage-price spiral, the coming year needs to see the labour market soften. Job openings need to shrink, and unemployment may need to rise.

Thus far, companies have defended their profit margins by passing on price increases (the very embodiment of inflation), and consumers have kept spending, bolstered by savings and a solid job market. For inflation to cool, this narrative must shift (there are early signs this is happening). When consumers become more price conscious and frugal, then companies will be forced to cut costs through hiring freezes and layoffs instead of raising prices. This delicate balance will impact corporate earnings in 2023.

It is our view that inflation can fall quickly (a subject of great debate). Looking ahead, we see a combination of corporate margin compression, bloated inventories (that will force discounted prices), retreating commodity prices, and sharp slowdowns in the housing market leading to lower inflation. In fact, in the U.S. there are many historical examples of inflation rising quickly followed by an equally sharp slowdown (see Exhibit 2: U.S. Inflation Has a History of Symmetry). Basically, the cure for high prices is high prices. This pattern would see U.S. inflation in the 2.5% to 3% range by fall of 2023. That would be a significant accomplishment. This scenario is not guaranteed, but neither is endless inflation and 5% to 6% interest rates.

Exhibit 2: U.S. Inflation Has a History of Symmetry

The U.S. CPI rose for 16 months in 2021/22 before peaking at roughly 9% in June of 2022.

U.S. Y/Y CPI (SA; %)						
Peak Date	Peak Level	-16 Months	+16 Months	Spread	Rise (% Pts)	Fall (% Pts)
Apr '51	9.60	-1.83	3.21	5.04	11.43	-6.39
Feb '70	6.42	4.75	4.38	-0.37	1.67	-2.04
Nov '74	12.20	5.74	6.06	0.32	6.46	-6.14
Mar '80	14.59	8.87	10.77	1.90	5.72	-3.82
Oct '90	6.38	5.17	2.82	-2.35	1.21	-3.56
Jul '08	5.50	2.80	1.91	-0.89	2.70	-3.59
Jun '22	9.00	1.68	TBD	TBD	7.32	TBD
Average ex-'22	**9.12**	**4.25**	**4.86**	**0.61**	**4.87**	**-4.26**

Based on history: 16 months after the peak, inflation should be just +0.61% above where it started. In this cycle, the starting point was around 2%. If inflation ends at 2.5% or 3%, that's a significant accomplishment for the Fed.

Source: Strategas

Equities

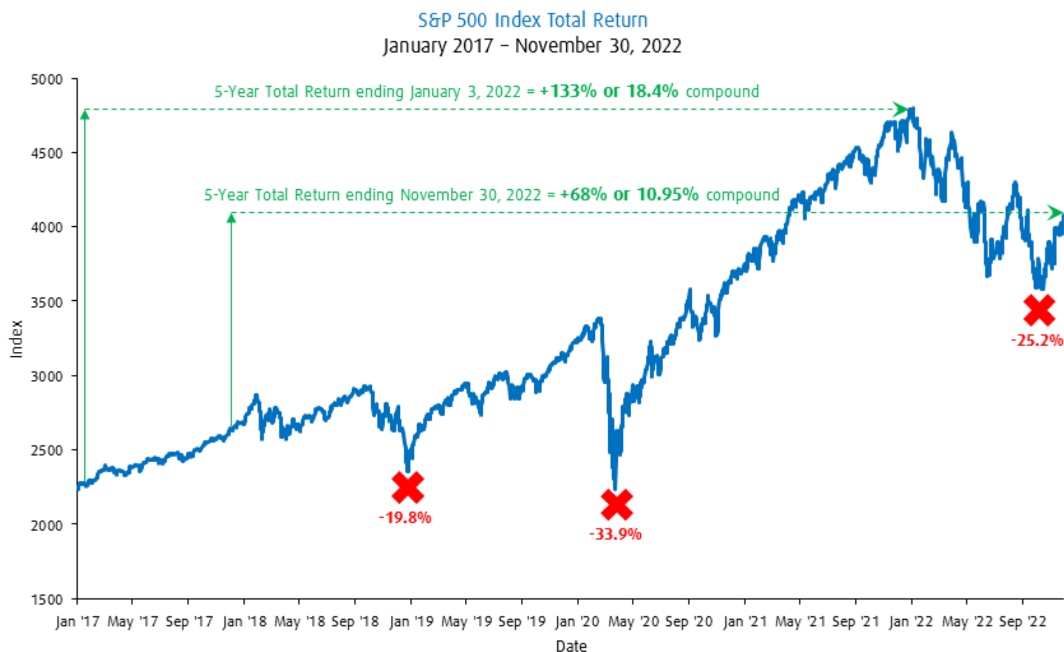
Heading into 2022, equity markets faced a reckoning on three fronts: their complacency toward risk; a rising risk-free rate; and the future path for earnings growth.

Complacency: Risk is part of investing in the stock market. No risk, no reward. Heading into 2022, there was a lot of complacency about risk. Fortunately, this attitude is changing, and we should welcome it.

For examples of ignoring risk, look at what happened to cryptocurrencies and exchanges, meme stocks, and SPACs. *Briefly, a meme stock enjoys dramatic price increases fuelled by social media hype rather than company fundamentals. SPACs (Special Purpose Acquisition Companies) are shell corporations that raise money on the prospect of using mergers and acquisitions to create value*. All that's left of many of these former market darlings are their smoking remains, now carrion for the financial press.

Complacency sent the stock market racing ahead of company fundamentals (see Exhibit 3: S&P 500 Had Overshot). Between January 2017 and January 2022, the total return of the S&P 500 soared 133% (an annualized return of 18.4%). That's twice the historical long-term rate of return from U.S. stocks. Currently, the five-year total rate of return from the S&P 500 to November 30, 2022, is 68% (10.95% annualized), which is much closer to the long-term average. For a decade, setbacks were quickly erased with V-shaped recoveries. This further lulled investors into thinking stocks only go up, and bear markets last weeks, not quarters.

Exhibit 3: S&P 500 Had Overshot



Source: Bloomberg

Protracted downturns in stock markets are infrequent – but they're not unusual. For the disciplined investor, 2022's losses have been painful. However, less-disciplined investors have paid an even higher price for a tough lesson. We see this purging of complacency adjustment as largely complete.

A better price for risk: The risk-free rate of return available to investors collapsed in the depths of the pandemic (the yield on government bonds is the most often cited measure of the risk-free rate). Central bankers' zeal to save the world by lowering interest rates drove government bond yields to unprecedented low levels. Fiscal and monetary intervention worked spectacularly to bridge society from COVID to vaccines, which arrived in record time.

But the unprecedented low interest rates and free money helped fuel the stock market frenzy (and sow the seeds for today's inflation). Share prices of all companies – good, bad, or otherwise – benefitted from low interest rates and plentiful liquidity.

Like a phoenix, the risk-free rate of bonds has risen from the ashes to a more historically normal level. Share prices that were inflated by the low, risk-free rate have had to reverse course, given the now-higher, risk-free rate. The good news is that we see this adjustment as having largely run its course.

Earnings growth: The lifeblood of share prices is earnings growth. Investors buy a share of a business because they believe it will be run profitably: earnings fund dividends and growth, necessary conditions for share prices to increase. Taken all together, corporate earnings are highly correlated with the health of the economy. Not surprisingly, corporate earnings that collapsed in the pandemic rebounded in 2021 and 2022.

Corporate earnings face headwinds going into 2023. The 20% to 40% declines from the peaks that various global equity markets reached in 2022 point to a weak earnings outlook to start 2023.

Where does all this leave us? A good deal of complacency has been scrubbed from the system. Investing when there is more fear than greed often leads to good outcomes. Today, there is more fear than greed versus a year ago – a positive.

The reset to higher bond yields and a higher risk-free rate is closer to the finish line than it is to the starting line. These gale-force headwinds for stocks are softening into a mild breeze and could be a potential tailwind in 2023.

Equity Market Outlook

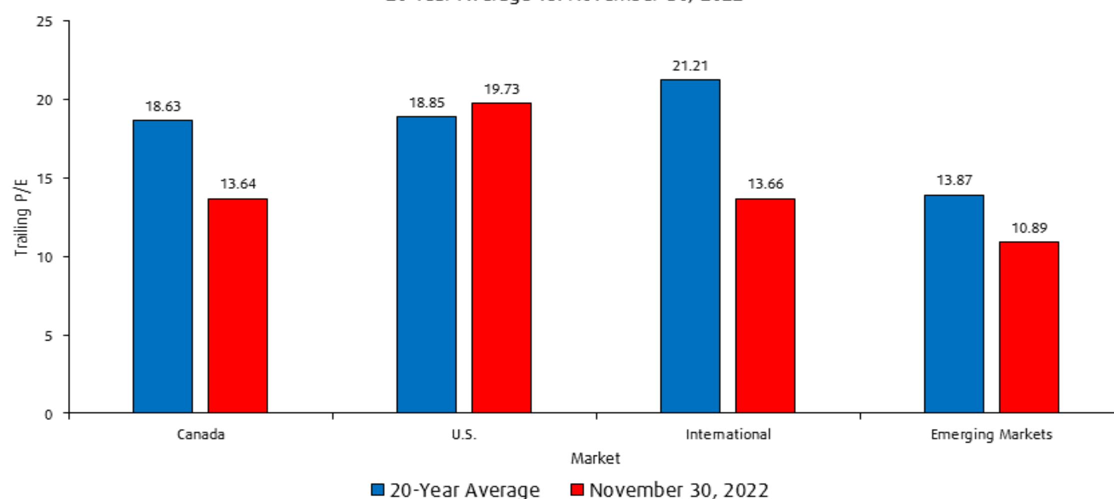
Valuations have reset below their 20-year average (see Exhibit 4: Global Equity Market Valuation Reset). **Expectations for earnings growth in 2023 are modest** (see Exhibit 5: Pandemic Shakeup to Earnings Growth Settling Down). A positive surprise in earnings is possible, given that demand remains robust. Remember, too much demand is a big driver of inflation. Currently, the consumer is healthy, jobs are too plentiful, and wages are rising too much. As far as economic problems go, these are better than their opposite.

Our base-case scenario sees the economy experiencing a soft landing – there is no recession and inflation cools, or we have a shallow recession and inflation cools. In these scenarios, we feel equities can deliver total returns around 8% to 12% in 2023. These return figures are on top of equity markets that have already moved up 10% to 12% off their 2022 lows. Our targets are 22,000 for the S&P/TSX Composite and 4,400 for the S&P 500.

While we are constructive on stocks, the path forward will be uneven. Inflation isn't likely to fall in a straight line. A slowing economy and shrinking margins are generally not fertile ground for stocks. However, new bull markets are born during recessions; the market doesn't wait for an all-clear signal. **Given today's starting point, the way ahead looks brighter in 2023 than it did a year ago.**

Exhibit 4: Global Equity Market Valuation Reset

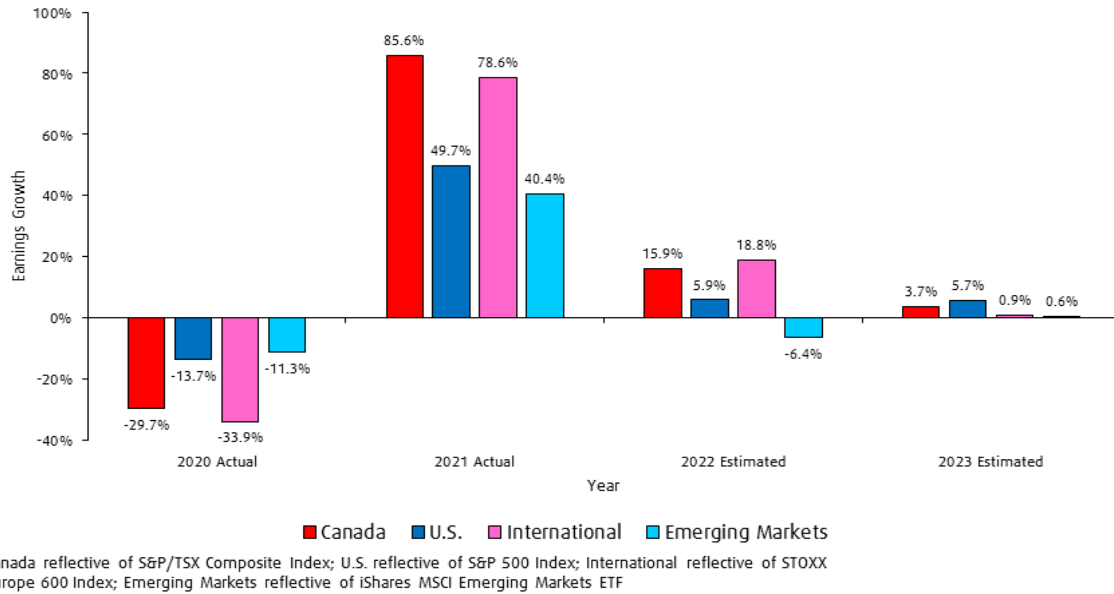
Current Price to Earnings Ratio vs. Historical Average for Selected Global Equity Markets



Canada reflective of S&P/TSX Composite Index; U.S. reflective of S&P 500 Index; International reflective of MSCI EAFE Index; Emerging Markets reflective of MSCI Emerging Markets Index

Source: Bloomberg

Exhibit 5: Pandemic Shakeup to Earnings Growth Settling Down



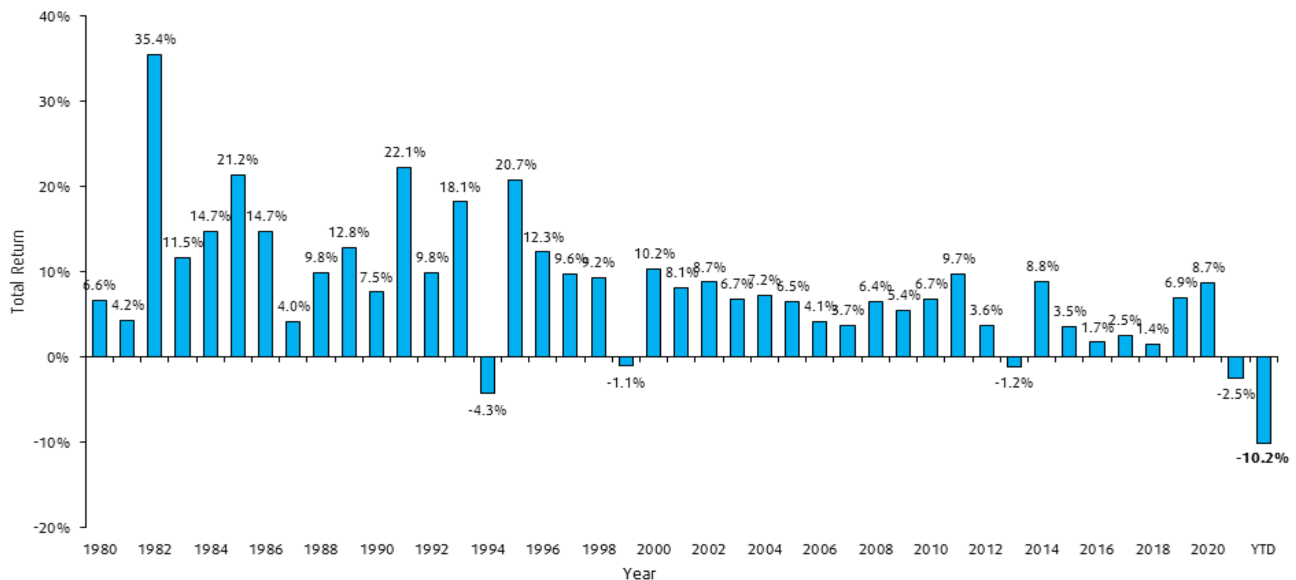
Canada reflective of S&P/TSX Composite Index; U.S. reflective of S&P 500 Index; International reflective of STOXX Europe 600 Index; Emerging Markets reflective of iShares MSCI Emerging Markets ETF

Source: FactSet

Fixed Income

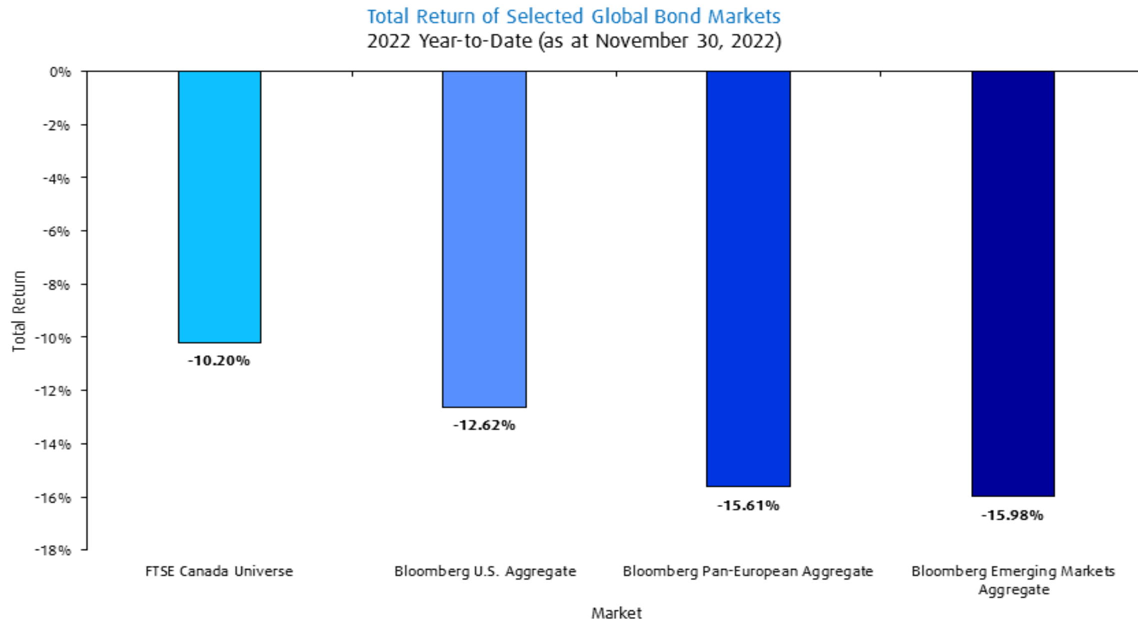
Rising interest rates and bond yields, plus widening credit spreads, have delivered the worst year-to-date return for Canadian fixed income investors on record, and it will likely end up being the worst calendar year (see Exhibit 6: Worst Year On Record for Canadian Bonds). Fixed income investors across the globe have also suffered (see Exhibit 7: In Bad Company, But Canada Has Fared Better). The shared pain reflects the shared starting point. Outside China, inflation is broad based and free money existed in all developed-world markets.

Exhibit 6: Worst Year On Record for Canadian Bonds



Source: Morningstar

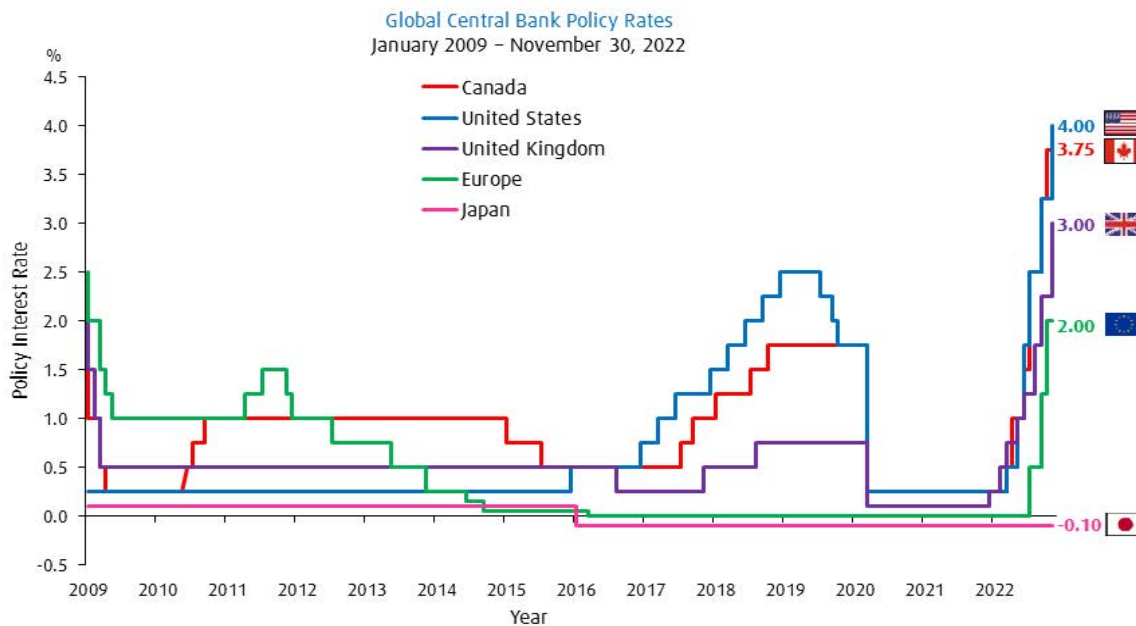
Exhibit 7: In Bad Company, But Canada Has Fared Better



Source: Bloomberg

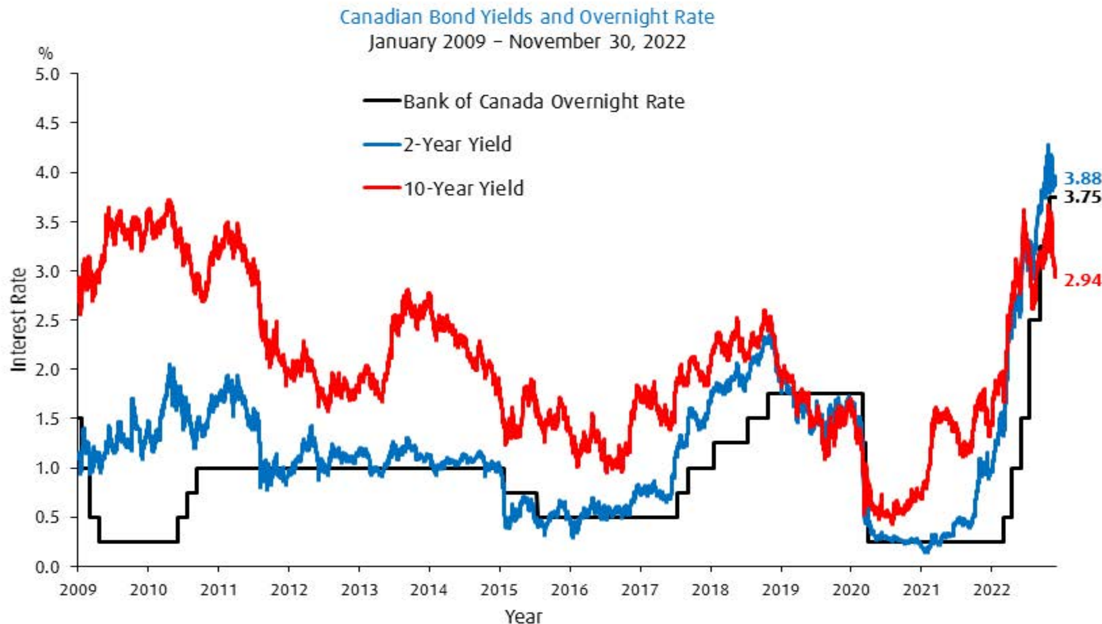
To combat the 2009 financial crisis and then the pandemic, central banks took extraordinary steps to drive interest rates and bond yields to unprecedented low levels and saturate the economy with money. This central bank stimulus became part of today's inflation problem. Central banks are moving to unwind these extraordinary policies (see Exhibit 8: Central Banks Raising Rates to Battle Inflation). As a result, bond yields have moved higher (see Exhibit 9: Canadian Bond Yields In Step With Bank of Canada). Removing extraordinary central bank (and government fiscal) stimulus is also a positive sign that the economy is functioning better and no longer needs life support.

Exhibit 8: Central Banks Raising Rates to Battle Inflation



Source: Bloomberg

Exhibit 9: Canadian Bond Yields in Step with Bank of Canada



Source: Bloomberg

Bond markets are forward looking, so they have incorporated the central banks' moves and expectations of future moves. Bond markets are pricing in a peak Fed Funds Rate between 4.75% and 5.0%, and a peak Bank of Canada rate between 4.25% and 4.50%. We see these numbers as fully pricing in all of the expected moves. If central banks unexpectedly stop short of these levels, it would be a boon for investors in fixed income.

Getting to higher bond yields is painful, but once you are there, the pain subsides as the income component of fixed income makes up for the earlier hard work (see Exhibit 10: What Bonds "Pay" Today).

Exhibit 10: What Bonds "Pay" Today

FTSE Canada Universe Bond Index Yield by Credit Rating		
Rating	November 2021	November 2022
AAA/AA	1.63%	4.74%
A	2.48%	4.91%
BBB	2.86%	5.31%

Source: FTSE Russell

Fixed Income Market Outlook

Many of the untenable imbalances due to the extraordinary measures undertaken during the pandemic have been worked off. The fixed income market is currently better positioned to deliver on the dual mandate of providing a return contribution and mitigating risk. The yield inside our fixed income portfolios is more attractive now than it has been in more than a decade (around 5% in our core fixed income solution), and fixed income's ability to provide downside protection has improved. Should the economy deteriorate precipitously (not our base-case scenario, but the odds have increased), central banks will stop raising interest rates and likely start cutting them. In this scenario, bond yields would be expected to fall, generating high-single-digit, positive returns for bonds.

In our base-case scenario, our end-of-2023 call is for the yield curve to steepen as 2-year and 10-year Canadian bonds line up to yield 3.25%. There will be volatility across the year as bond yields wobble around on recession and inflation fears, but the income now coursing through portfolios generates a mid-single-digit return in 2023.

Our Positioning

We remain close to our long-term strategic benchmarks, with some prudent tactical tweaks. In turbulent times, investors are best served when we stay well balanced on a solid foundation. **Our bias leans toward increasing our equity exposure in 2023** (see Exhibit 11: Our Strategy Summary & Asset Class Outlook).

Our fixed income positions remain at a slight underweight. The downdraft for bond yields into 2022 year-end may represent a near-term overcorrection. By and large, the fixed income market has adjusted to reflect the likely path ahead for growth, inflation, and future central bank actions. Additionally, coupon income and maturing securities in our bond portfolios are being reinvested at higher yields. We believe our bond positions will provide a level of safety if a recession takes hold.

In general, the fixed income portion of our portfolios is structurally designed to favour yield enhancement, diversification, and lower sensitivity to interest rate movements (shorter duration). These qualities have served us well in this year's challenging environment.

Our portfolios feature a combination of traditional fixed income investments (core fixed income) supplemented with alpha-generating satellite strategies (satellite building blocks). Our satellite building blocks provide access to specialty fixed income strategies such as structured notes built exclusively for BMO Private Investment Counsel, preferred shares, high-yield bonds, and alternative fixed income exposures.

We remain slightly overweight equities. Our geographic exposure is well diversified. Our equity investment managers are selected for their geographic and style-specific expertise. Our tactical geographic equity alignments reflect our views on where the best risk-adjusted opportunities lie ahead. We are underweight international developed markets (primarily Europe and Japan) and overweight to North American equities, remaining neutral on Emerging Markets equities.

Canada – Overweight

Historically, Canada's commodity-related companies do well in inflationary environments. In general, the Canadian equity market is levered to the global economy. A positive surprise for global growth in the form of no recession, or a less severe one, would benefit Canadian equities. They remain attractive on a valuation basis versus their global peers and provide an attractive 3.3% estimated 2023 dividend yield.

U.S. – Overweight

The U.S. is home to some of the world's best businesses. The depth and breadth of the sector exposures available in the U.S. market are unparalleled. This year's market pullback leaves U.S. equity markets less expensive, but they aren't as cheap as many other global markets.

The long-standing relative exceptionalism of the U.S. equity market does give us some pause. Historically, these extended periods of outperformance by any market have always come to an end. However, these trends can last for very long periods. This is one consideration of many, and the outperformance is more understandable, given the multinational flavour and global footprint of many U.S. corporations that make up the lion's share of the investment opportunity.

U.S. equity markets and the U.S. dollar have historically offered relative safety in periods of weak global growth. The S&P 500 currently offers a 2023 estimated dividend yield of 1.8%.

International Developed (Europe, Australasia and Far East, "EAFE") – Underweight

Europe is troubled by high inflation, fighting in Ukraine, weak productivity, and political frictions (including lingering Brexit fallout). We see few catalysts for European equities to stage a lasting rebound. Europe's economy is less favourably positioned to handle the rate hikes necessary to quell surging inflation than North America's situation. The odds of a recession here are higher.

European and Japanese equities have significant export exposure to China, which is a potential positive. However, disappointing developments in China likely spell a slower recovery. We prefer to take this potential positive surprise risk in our Emerging Markets exposure.

The euro and Japanese yen are under downward pressure, given that monetary policy and growth prospects in these countries lag those of North America; we see little potential for either currency to gain much ground.

The 2023 MSCI EAFE Equity Index estimated dividend yield is a healthy 3.5%.

Emerging Markets – Neutral

Emerging Markets equities are structurally small positions in our portfolios, given the attendant risk profile in this asset class. The MSCI Emerging Markets Equity Index has fallen 42% from its 2021 peak, leaving valuations very cheap and touching the lowest levels since the financial crisis.

This asset class is heavily influenced by equities in China, Taiwan and Hong Kong. While home to some exceptional companies, these markets face near-term and potentially long-term headwinds. The sagging state of the Chinese economy and zero-COVID policies are the main near-term headwinds. A slowing global economy will weigh on China's export machine as will the switch from goods consumption to services consumption in China's export markets. However, these headwinds are also the source of a potential positive surprise. The global economic slowdown could turn out less severe than expected. China is pursuing measures to stimulate its domestic economy. The opportunity is enormous since China is the world's second-largest economy. Longer term, de-globalization and Chinese relations with the West remain wildcards.

Taking the broadness of Emerging Markets into consideration, some realignment of supply chains away from China to other Emerging Markets is a potential positive. Given our relatively light strategic exposure, we maintain a neutral stance. The MSCI Emerging Markets Index estimated dividend yield for 2023 is 3.2%.

The Last Word

Looking back, 2022 was a year of cleaning house and decluttering, the start of moving on from the uncertainty the pandemic foisted upon us.

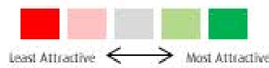
The coming year will begin with downside risk and (hopefully) cooling inflation – but no recession (or perhaps just a mild one). We see healthy equity market returns between 8% and 12%, including dividends. The ability of fixed income to provide downside protection has improved and we anticipate mid-single-digit returns for 2023. After this difficult year of volatile equity and bond markets, everyone will welcome a return to normal.

Exhibit 11: Our Strategy Summary & Asset Class Outlook

Category	Economy	Policy	Valuation(*)	Sentiment	Our Positioning: Under	Neutral	Over	Rationale
Major Asset Class								
Fixed Income	Prior		Prior		○ ●			Great deal of tightening is in the system. Fine tuning remains. Attractive income and defensive qualities given yield reset.
Equities	Prior			Prior		●	○	Inflation showing signs of cooling and earnings remain resilient despite recessionary narrative.
Equities by Geography								
Canada	Prior		Prior	Prior		●		Canadian equities well positioned for inflation and commodity shock. Recession scenario presents a risk.
United States				Prior		●		Earnings growth likely to moderate. Currency and defensive qualities are attractive.
Europe			Prior		●	○		Geopolitical conflicts cause uncertainty in the region. Monetary policy unfriendly. Region is less attractive relative to North America.
Japan				Prior	●	○		BoJ has not begun to tighten, growth remains limited. Weak currency benefits exporters.
Emerging Markets	Prior		Prior	Prior		●		China reopening is a positive. US dollar strength typically a headwind. Tightening cycles have ended.

(*) Valuation based on current trailing P/E divided by 10 year trailing P/E

As of December 2022



○ Changed from prior

Prior: If recently changed

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