2022 Mid-Year Outlook

The Blue Book

MACKENZIE
Investments

Economies recalibrated and what's to come

- The rest of the year will be shaped by decades-high inflation and policy response.
- The Federal Reserve may tolerate a near-recession environment to tame inflation.
- China will likely remain accommodative, favouring growth.
- The outlook for bonds will remain uncertain.
- Surging commodities should support relative outperformance by Canadian equities.

At the beginning of this year, we looked forward to 2022 with a mix of optimism that the COVID-19 pandemic was finally behind us, and trepidation that inflation might continue to creep higher and central banks would tighten policy.

Our optimism that society would learn to live with the pandemic without economic lockdowns appears well-founded. In recent months, many people have returned to their pre-COVID lives – back to the office, dining in restaurants, boarding airplanes, attending events and embracing friends and family.

However, this return to normal has fueled the source of our initial trepidation, with increased spending sending inflation to highs not seen in decades.

Then came the invasion of Ukraine by Russia. The economic sanctions that ensued against Russia sent price shocks throughout the world for oil, natural gas and coal. Agricultural commodities have also been impacted due to Ukraine's significant production of these products, contributing to further upward pressure on global food prices.

China remains the world's second largest economy and an important consideration for our global economic outlook. We expected that 2022 would represent a turning point in sentiment for China after a difficult 2021, when increased regulation in important segments of the economy, like real estate, technology and education, plagued the country's equity markets.

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Instead, another significant headwind emerged – the "dynamic zero COVID policy" to limit the strains that a national outbreak could have on the Chinese healthcare system. Lockdowns in Shanghai and Beijing have impacted the domestic economy, but also created ripple effects to the global economy and its already strained supply chains. President Xi Jinping remains committed to the economic growth target of 5.5% for 2022, implying that multiple stimulus measures will be used, keeping the country out of sync with the balance of major economies that are experiencing tighter financial conditions.

We are watching economies recalibrating in real time.

Don't fight the Fed. This common imperative suggests that when the Federal Reserve is tightening monetary policy, one should be cautious on their outlook for risk assets.

The magnitude of caution is correlated to the current level of easy monetary policy as well as the speed of lift-off. In this case, we had two significant pre-conditions – rock-bottom interest rates and multi-decade highs in inflation that caused central bankers to move quickly and boldly.

The impact of central bank policy has led to spiking bond yields, as fears that more must be done to tame inflation have become embedded in the investor psyche.

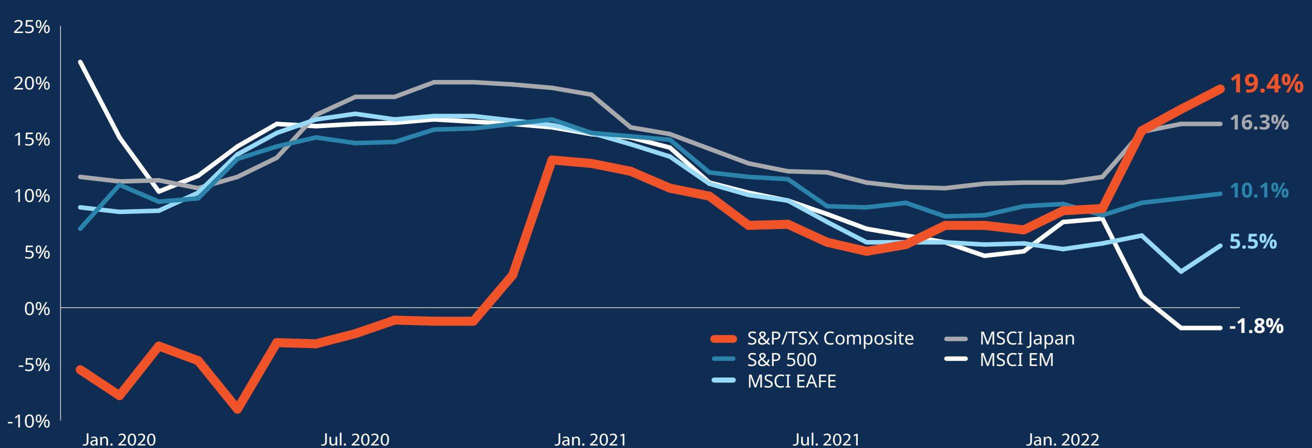
Commodities proved to be a safe haven. From energy to agriculture, they have acted as an effective hedge in the wake of soaring inflation expectations. The commodity complex has been fueled by strong demand as the global economy emerged from the pandemic. This occurred at the same time as tight supply conditions from a decade of under-investment for future production, pandemic lockdowns and a redirection of capital in favour of higher dividends and share buybacks. The outlook for commodities is well supported by the constrained supply, but as commodity investors know, the only cure for high prices is high prices. If demand is destroyed by an economic slowdown, or supply is enhanced through large capital inflows, the commodity cycle will also fall with other risk assets.

Despite this notable economic recalibration, commodity-levered economies like Canada have benefited directly from this backdrop, with Canada being one of the few markets that has experienced upward revisions in its outlook for economic growth as well as earnings expectations for S&P/TSX Composite listed companies.

There's nowhere to hide – except maybe close to home. We still believe that North America will avoid recession this year but have recalibrated expectations for lower economic growth.

Canadian equities are experiencing upward revisions to corporate earnings

2022 S&P/TSX earnings growth expectations over time (y/y % change)



Source: FactSet. May 31, 2022.

> **When the Federal Reserve is tightening monetary policy, one should be cautious.**
>
> **Lesley Marks, MBA, CFA**
> Chief Investment Officer, Equities

We are becoming more concerned about the potential for recession in Europe due to the macroeconomic impacts of Russia's invasion of Ukraine.

Relative insulation from the events of Europe, a stronger commodity backdrop, low unemployment and upside in wages all suggest that the best relative performance will occur in Canadian equities.

Six months ago, our base case scenario assumed that we would experience upward pressure on bond yields, but we underestimated the speed and magnitude of this pressure. We also assumed equity gains would flatten out into 2022 and would be accompanied by volatility as recession and stagflation scares surfaced. Relief would materialize without the occurrence of either of these scenarios.

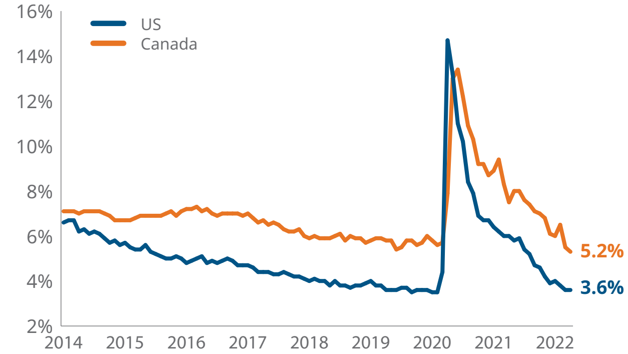
The outlook for bonds remains uncertain.
But the focus away from a rates shock could quickly be replaced by fears of a growth shock if weakening economic data surfaces. This scenario will, at a minimum, provide support for bonds and potentially equities if markets view that the current tightening cycle is fully priced in.

Our macro view: Medium-term we see the environment as challenging. At the beginning of the year, we had identified a potential for a central bank policy error as a risk. This has come to pass, with central banks slow to react to building inflation now forced to tighten aggressively.

This environment presents short-term tactical opportunities, but the best approach is, as always, diversification across asset classes and a long-term time horizon to ride out any short-term turbulence.

Strong Canadian and US labour markets could place further upward pressure on wages

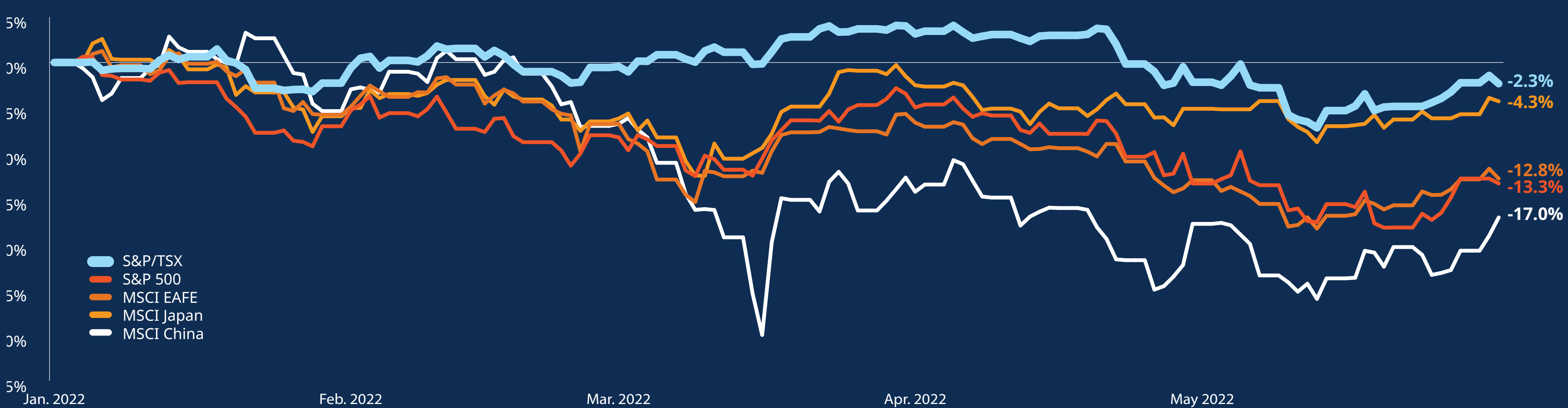
Canada and US unemployment rates (%)



Source: Bloomberg. April 2022.

Canadian equities outperforming global peers

Relative YTD performance of S&P/TSX Composite vs. global equities (cumulative % return)



Source: Bloomberg. May 31, 2022.

Theme 1

Recalibrating for an economy with higher inflation

As 2022 began, our inflation views reflected supply chain disruptions and strong consumer demand, and we expected to see inflation reset over time to a new range above 2%.

It appeared likely that inflation could peak in Q1-2022 and move lower throughout the rest of this year – an outcome that would have been welcome for central banks that had viewed inflation forces as transitory to that point.

Inflation trends proved to be even stronger than expected. Rising inflation persisted through the first half of the year, due in no small part to the war in Ukraine and its negative supply shock on commodities markets. Raw goods input costs, along with strong demand and upward pressure on wages driven by tight labour markets together pushed and pulled inflation rates higher. The US Consumer Price Index (CPI) rose 8.5% year-over-year in March, which could mark the high for this cycle, although we won't know for sure until the summer months.

There's no quick fix for many commodities. Looking ahead, supply disruptions can be expected to persist due to the ongoing conflict in Ukraine. Sanctions on Russia, selective curtailment of energy exports from Russia to Europe, and a major interruption on grains supply this season from this globally important exporting region imply elevated pricing at recent levels of demand. The Omicron COVID wave and resulting temporary lockdowns in manufacturing centres such as China also have the potential to further crimp the supply of some finished goods.

Passing costs on to consumers is no sure thing. Last year's demand response, partly fuelled by low interest rates and high pandemic fiscal spending, is already waning. Borrowing rates have climbed this year in anticipation of continued rate hikes from the Fed. Even though wage gains have been robust, they have failed to keep pace with inflation.

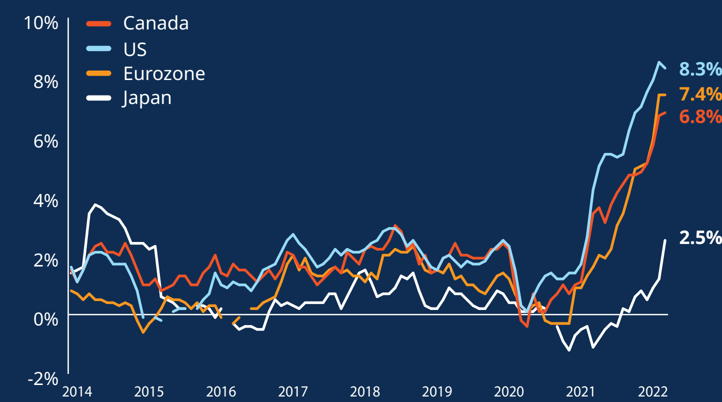
Many central banks are focused squarely on reducing inflation. Among these are the Fed and the Bank of Canada, who can only achieve this by tightening monetary policies to reduce aggregate demand. Although we expect inflation to gradually fall this year, the pace of decline is going to be an important variable in how much and how fast central banks tighten. Combined with global supply issues keeping inflation uncomfortably high, a policy-led slowing of economic growth has raised the possibility of a stagflation scenario.

Longer term market-based measures of inflation expectations have moved higher this year but are not yet considered to be unanchored from the Fed's 2% inflation target. We expect inflation will come down but remain above target by the end of 2022.

In our view, inflation's impact on investments has been double-edged. On the one side, it has hit growth-oriented markets hard, particularly in the technology sector. But rising commodity prices should provide a relative boost to producer economies which have lagged in recent years, such as Canada and much of the emerging markets.

Ukraine war and lockdowns in China lift inflation to multi-decade highs

Global CPI inflation (y/y % change)



Source: Bloomberg. April 2022.

We expect inflation will come down but linger in a range above target by the end of the year.

Steve Locke, MBA, CFA
Chief Investment Officer, Fixed Income & Multi-Asset Strategies

Theme 2

China faces persistent headwinds

We knew China would face a significant challenge as we entered 2022, with issues such as over-extended credit, inflated real estate values, COVID, deglobalization and sluggish consumer demand weighing on growth. Some of these concerns are structural and likely to persist well beyond 2022.

Prolonged COVID restrictions are casting a shadow over China's economic outlook. An estimated 250 million people are under lockdown as part of the "zero-COVID" policy. As outbreaks occur in key cities, more lockdowns could be imposed, directly reducing consumer spending.

Industrial production has likely contracted in Q2 due to logistics disruption and workforce lockdowns. Worse still, transport restrictions have greatly affected travel in many parts of the country. Many economists now believe that China's official 5.5% real GDP growth target for 2022 is a stretch goal.

This is an important year in terms of political history. China will convene its 20th National Party Congress, a critical stage for the Party to showcase its achievements and for President Xi Jinping to cement his legacy alongside past leaders, such as Mao Zedong and Deng Xiaoping. It will be critical for Chinese affairs to be in order, to set the stage for Xi and the CCP at the Party Congress this fall.

So far, the response to inflation has been modest. Despite a pledge to step up policy support from the People's Bank of China (PBoC), credit demand is too weak as COVID restrictions weigh on consumption, production and supply chains. Many investors have called for more aggressive policy easing to boost both credit demand and supply in the economy. To boost both growth and credit expansion, more broad-based monetary easing is needed in addition to the PBoC's current structural, targeted policies.

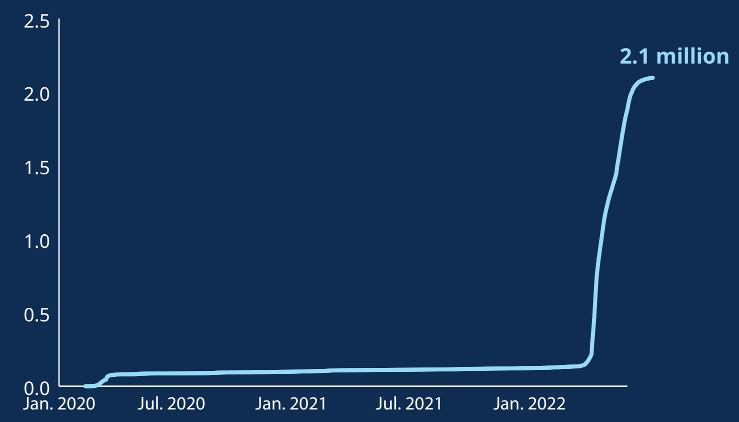
Policy-makers may well be chasing an impossible trinity: 5.5% growth, zero-COVID and credit deleveraging. If China doesn't give up the growth target or relax pandemic control measures, it will be crucial to accelerate credit to stabilize growth. More effective measures including direct subsidies to households and low-cost funding for infrastructure and social housing may be needed.

A Chinese downturn would be another drag on the global economy. China remains the world's second largest economy and it has been an outsized contributor to global real GDP growth over the past decade. Given the rest of Asia's strong economic and supply chain linkages with China, the region's economies would be the hardest hit, followed by the eurozone and the US.

We continue to believe a stable and sustainable growth path for China is beneficial for the world. Government policy will likely promote growth ahead of the 20th National Party Congress. As such we believe the slowdown in Chinese GDP growth will bottom this year and regulatory headwinds will diminish, leaving China in a position to provide a positive boost to global growth.

China's "Zero-COVID" policy threatens policy maker's 2022 economic growth target

China COVID-19 confirmed cases (millions)



Source: Bloomberg. May 31, 2022.

A Chinese downturn would be another drag on the global economy.

Paul Taylor, MBA, CFA
Vice President, Portfolio Manager,
Multi-Asset Strategies

Theme 3

Fed turns aggressive against inflation

Federal Reserve Chair Jay Powell has been so vocal regarding his admiration of Paul Volcker's inflation-fighting policies from the late 70s and early 80s that it has become not only a lens on how the Fed is looking at and starting its hiking cycle, but also a likely roadmap on how it will continue in the second half of this year.

The Fed, by its own admission, was late to the game raising interest rates, as were other central banks including the Bank of Canada, labelling inflation as "transitory" for too long. Now, as the Fed attempts to make up for lost time and tame both demand- and supply-induced inflationary pressures, "expeditiously getting to neutral" has become the new mantra and catchphrase.

We expect the Fed and other central banks to follow a hawkish path throughout the second half of 2022, prioritizing inflation over ebullient economic growth, strong asset prices and easy financial conditions. The Fed will try to prevent a recession, but recent comments have pivoted away from achieving a "soft" landing and towards a "soft-ish" one. We view this subtle but important shift in language as a sign that the Fed and other central banks might need to induce a near-recessionary environment to achieve their inflation mandates.

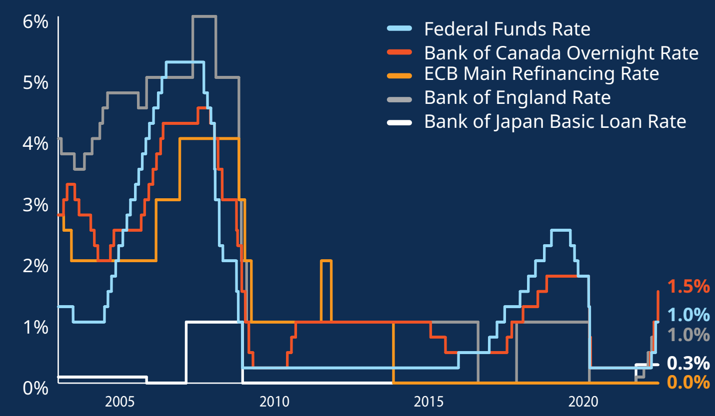
Tighter financial conditions are needed. Not only would this stamp out high levels of inflation, but it would also curtail a frothy labour market, where there are too many job vacancies for the number of unemployed. As a result, wages are rising, potentially undermining the pinnacle of central bank mandates: low and steady long-term inflation expectations. Additionally, the so-called "Fed put", which normally would have already been activated with the S&P500 down about 20% from its highs, is likely further away than the market realizes.

Hawkishness is now widespread. The Bank of Canada, European Central Bank and the Bank of England are all on paths to neutral and possibly beyond. This will likely induce a choppy investment environment in the second half of the year as the market rotates away from its focus on inflation towards digesting slower growth. Looking beyond 2022, we believe there is a strong possibility markets are underestimating central banks' resolve to stamp out inflation, and accordingly, the terminal rate for this cycle could prove higher than currently priced in. If true, this would likely negatively impact high-risk assets while further flattening the yield curve, with Paul Volcker's influence making its presence felt a while longer.

It is our view that after a late start, many key central banks are now playing catchup in the fight against inflation. The impact on markets has already been substantial, but we believe investors may be underestimating how high policy rates may rise.

Central banks begin aggressively lifting rates to fight inflation

Global central bank policy rates



Source: Bloomberg. June 2, 2022.

Central banks might need to induce a near-recessionary environment to achieve their inflation mandates.

Dustin Reid, MBA
Vice President, Chief Fixed Income Strategist, Fixed Income

Asset mix recommendations

Equity*

Equity

The risks of owning equities have increased in the face of higher interest rates, slowing growth and additional geopolitical risk with the war in Ukraine. But with valuations significantly improved and a portion of these risks priced in, we believe a neutral stance on equities is still warranted.

Canada

Canadian equities are levered positively to global growth. We expect strong capital returns to shareholders through dividends and share buybacks. The value and cyclically oriented sector composition is favourable considering rising yields and commodity prices. Valuations are attractive, as is the 2.8% estimated dividend yield.

US

US companies are feeling the dual pressures of higher interest rates and rising costs for both materials and labour. The composition of the S&P500, which is biased toward higher multiple growth stocks, provides a formidable headwind, leading us to our underweight stance for U.S. equities.

International

European equities face a greater negative growth impact from the Ukraine war and higher fuel prices, and the region is expected to underperform other developed markets. We expect some potential upside in Japan due to more moderate inflation, continued easy monetary policy and a weak currency which should help exports.

Emerging markets

Many countries are feeling the inflationary impact of higher commodity prices and weaker currencies relative to USD. China remains a wildcard as it is still subject to a COVID-induced slowdown. However, the commitment to a 5.5% growth target remains in place and financial conditions are easing, which may boost equities.

Fixed income

Fixed income

With many interest rate hikes now priced into the yield curve over the second half of the year, duration can be moved to neutral. Although there is uncertainty as to where central bank rates will peak, current yields imply some financial tightening is likely over the next 12 months.

Sovereign bonds

We expect Canadian and US yield curves now reflect most or all of the policy rate increases for this year, with lower yield volatility ahead. We expect European yields will move higher as the ECB takes a more hawkish stance against inflation. We recommend a mild short duration in North America, and a larger short in European sovereign bonds.

IG corporate bonds

Investment grade corporate spreads have widened since the start of the year, which on top of the rising government yield curve provides more attractive yields than this sector has seen in years. We like the combination of defensiveness and carrying yield from high-quality investment grade corporates as a slight overweight.

HY corporate bonds

Leveraged loans have outperformed other credit sectors year-to-date due to their shorter effective duration and floating coupons. Given the potential for tighter financial conditions, we recommend reducing exposure to loans to neutral. For both high-yield bonds and loans, some added caution is warranted as slowing growth could erode corporate fundamentals.

* All dividend yield estimates are Bloomberg consensus. As of May 31, 2022

Underweight Neutral Overweight