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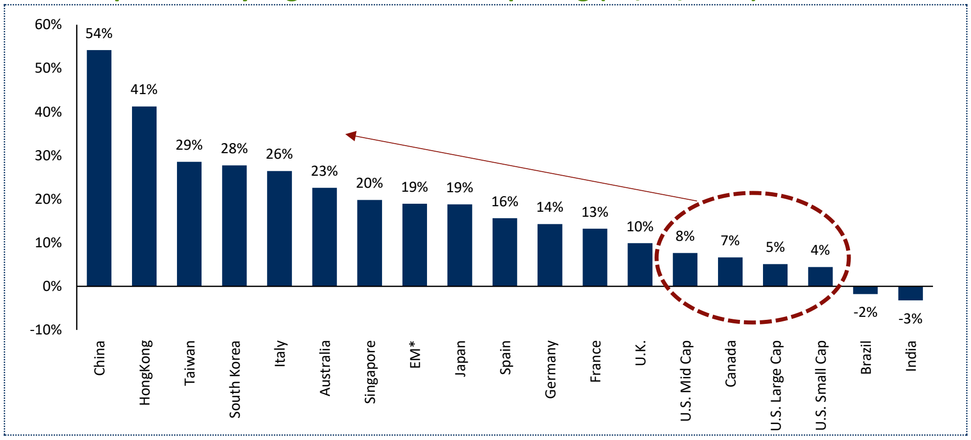
A Slingshot Market to Start 2023

And just like that, global equities are off to a strong start this year, rallying higher, similar to slingshot bands pulled to their max and then released. Many investors are likely puzzled by the strong rally in risk assets – i.e., equities - to start 2023, especially given the rising probability of recession risks across several economies globally, including Canada, the U.S. and the U.K. in 2023. However, we think this rally makes sense, especially as China reopened for business and abandoned its economically destructive zero-COVID-19 policies on October 31, 2022. This has been, by far, the single biggest catalyst driving risk assets higher, resulting in a material outperformance of global equities (excl. North America) vs. the S&P/TSX Composite and the S&P 500 Index.

While no one could have predicted such a massive pivot after three long years of COVID-19 lockdowns across China, those of you who followed our guidance to remain globally diversified from our **December Insights & Strategies report – 2023 Outlook – It's Complicated…** – "We are now seeing a more compelling risk/reward profile for both **stocks and bonds globally** than we did at the start of the year" and "**for 2023, we suggest investors maintain a diversified allocation to global equities and remain highly selective**" – have been rewarded in only a few short months.

As an extension of these recommendations, we delved further and discussed our constructive view on global equities (excl. North America) in our recent asset allocation report, **Quarterly Outlook: The Seventh Inning Stretch**. In this report, the Raymond James Ltd. Asset Allocation Committee suggested investors maintain a neutral stance to equities as a whole, but given their softer outlook for the U.S. dollar index, they expected value stocks globally to outperform growth over the near-term, **with developed markets (e.g., MSCI EAFE) and emerging markets (e.g., MSCI EM) likely putting up a good showing in 2023, especially as China abandoned its zero-COVID-19 posture.** Moreover, the committee noted that attractive relative valuations and a low bar for earnings across several markets globally made for a rather compelling case for equities outside of North America. While these views have largely panned out as the committee anticipated, it has been more material and has occurred a lot quicker than expected.

Global Equities Rally Higher on China Reopening (10/31/2022)

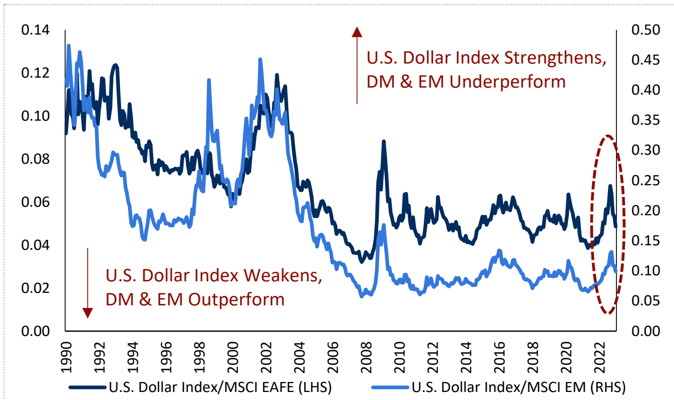


Source: FactSet; Raymond James Ltd.; Returns are calculated from October 31, 2022 to January 27, 2023; *EM: emerging markets.

We expect the U.S. Dollar Index (DXY) to weaken further as the Federal Reserve's (Fed) tightening cycle comes to a close in H1 of 2023. We expect this to be supportive for developed and emerging market equities outside of North America, including economies with large USD-denominated debt and/or which are net importers of energy.

As we demonstrate below, since 1990, developed market equities (e.g., MSCI EAFE) and emerging market equities (MSCI EM) have moved in opposite directions – i.e., are negatively correlated – to the performance of the DXY, which is a measure of the value of the U.S. dollar against a basket of global currencies.

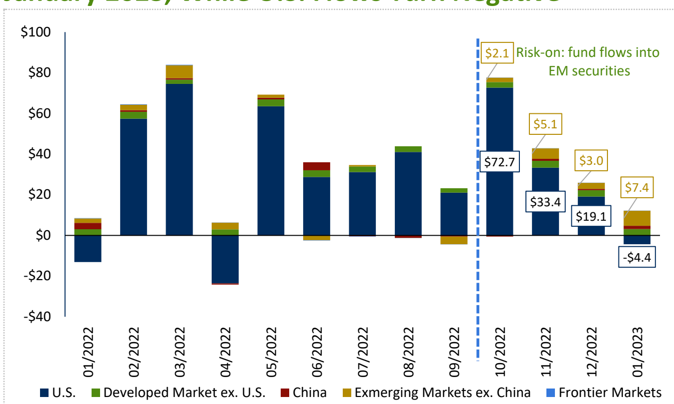
DXY Negatively Correlated with MSCI EAFE/MSCI EM



Source: Bloomberg; FactSet; Raymond James Ltd., as of January 31, 2023.

Since China reopened in October 2022, the bands of the slingshot have been released, which has fuelled the rally higher in global equities, like a projectile moving at a breakneck speed. This is the reverse of the significant risk-off posture by global investors for the better part of 2022, with capital flows primarily directed towards U.S. assets and away from emerging market securities. That is, until now.

Emerging Market ETF Fund Flows Turn Positive in January 2023, While U.S. Flows Turn Negative



Source: FactSet; Raymond James Ltd.; Data as of January 27, 2023, in billions of U.S. dollar.

Reduce the Odds of Slingshot Band Failure

While economic uncertainties remain, with recessionary pressures mounting and more likely than not to materialize in 2023, we suggest investors focus on allocating capital to markets with the most attractive relative risk/rewards – i.e., markets with lower valuation compression and earnings contraction risks. For example, Canadian equities broadly speaking look attractive from a risk/reward perspective with the exception of growth stocks – i.e., MSCI Canada Growth index. We also see good value across U.S. small- and mid- cap equities, while across the pond in Europe, we believe the FTSE 100 and the German DAX indices are attractive. Finally, despite the strong rally in Chinese equities since October 2022, we still see reasonable upside for the Hang Seng Index from here.

Compelling Risk/Rewards Across Global Equities

Select Global Equity Indices	YTD Return	2022 Return	P/E NTM vs. Historical Median*
Canada			
MSCI Canada Value (Canada)	8.1	1.6	-1.9
S&P/TSX Composite (Canada)	7.1	-5.8	-1.2
S&P/TSX 60 (Canada)	7.0	-6.2	-1.1
S&P/TSX Small Cap (Canada)	8.5	-9.3	-3.4
MSCI Canada Growth (Canada)	6.1	-14.0	1.6
U.S.			
S&P Composite 1500 Value (U.S.)	5.0	-0.9	2.4
S&P Mid Cap 400 (U.S.)	6.1	-6.7	0.3
S&P Small Cap 600 (U.S.)	6.2	-10.0	-2.3
S&P Composite 1500 (U.S.)	4.5	-11.8	1.8
S&P 500 (U.S.)	4.4	-12.2	2.1
S&P Composite 1500 Growth (U.S.)	4.0	-24.2	0.6
NASDAQ Composite (U.S.)	9.3	-27.6	3.0
Europe			
FTSE 100 (U.K.)	5.3	-3.9	-1.9
CAC 40 (France)	9.7	-6.1	0.3
Euro STOXX 50 (Europe)	10.1	-11.2	0.1
DAX (Germany)	8.7	-12.5	-0.4
Asia Pacific			
Hang Seng (Hong Kong)	12.5	-6.3	-1.2
Nikkei 225 (Japan)	4.8	-14.3	-0.9
MSCI China (China)	15.3	-16.1	1.1
Major Aggregates			
MSCI EAFE (Developed Markets ex U.S. & Canada)	6.8	-7.8	-0.6
MSCI World (Global)	5.4	-11.8	0.3
MSCI EM (Emerging Markets)	8.2	-13.9	0.9

Source: FactSet, Raymond James Ltd.; Data as of January 27, 2023. All returns are in CAD, equities are ranked by the 2022 calendar year returns. *Historical median: 12/31/1999 – 1/27/2023. Premium (RED) / Discount (GREEN).

Irrespective of the investing climate, we advise clients to allocate capital to opportunities that are aligned from both a risk/reward and time horizon perspective, while avoiding places to hide or markets which are susceptible to valuation compression and earnings revision risks (shaded in red above).

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