March 1, 2023 Nadeem Kassam, MBA, CFA

Hawks Pounce as Doves Cry

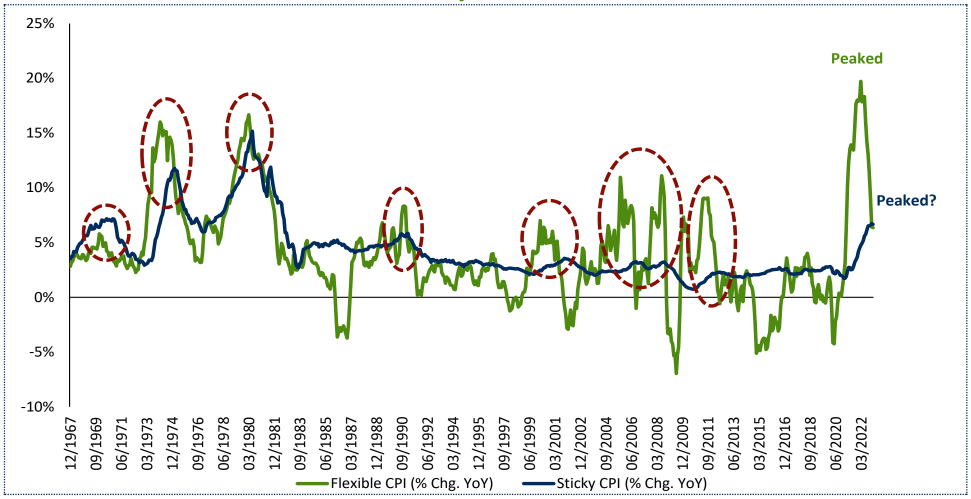
Investors entered 2023 hopeful and, in some cases, even convinced that the fight against inflation was largely a 2022 story with both the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) set to end their tightening efforts with an eventual pivot towards rate cuts in H2/2023 if not sooner. However, to investors' surprise, the hawkish narrative has resumed, following stronger-than-expected economic releases on both sides of the border for employment, inflation, consumer spending, etc. This, in the aggregate, suggests that the inflation fight which began in 2021 is far from over and will likely continue to remain a central theme for markets and investors in 2023.

However, while we believe the peak is in for inflation, the path forward will be anything but a straight line down back towards the historical trend. This is why we have maintained our call that a mild recession in Canada and the U.S. is likely to occur in 2023/2024 versus a no-landing scenario, which, not surprisingly, has made headlines recently.

In our view, the lag effect of the aggressive policy changes in 2022, in particular the ~400-450 bps-increase in overnight rates – coupled with the imprecise impacts of these policy changes on the various components within the consumer price index (CPI) bucket and the broader economy – makes predicting the end of the fight very challenging and a game we choose to avoid playing. Rather and more importantly, for investors, we believe these factors, at the very least, suggest to us that central banks will likely need to maintain higher rates for longer than most had expected versus the dovish outlook of cuts that many had hoped and wished for as we entered 2023.

For example, within the U.S CPI basket, sticky-price items (e.g., food away from home, rent, and recreation) represent ~70 per cent of the overall basket. These items do not respond quickly to changing market conditions compared to more "flexible-price" goods (e.g., new/used vehicles, gas and electricity, lodging away from home) that represent the remainder of the CPI basket. As we demonstrate in the chart below, U.S. flexible-CPI has typically reached a peak prior to sticky-CPI since the 1960s. Rate increases and fiscal tightening impact these CPI basket components much sooner than they do for sticky-priced goods.

Flexible-CPI Has Peaked Prior to Sticky-CPI Since the Late-1960s

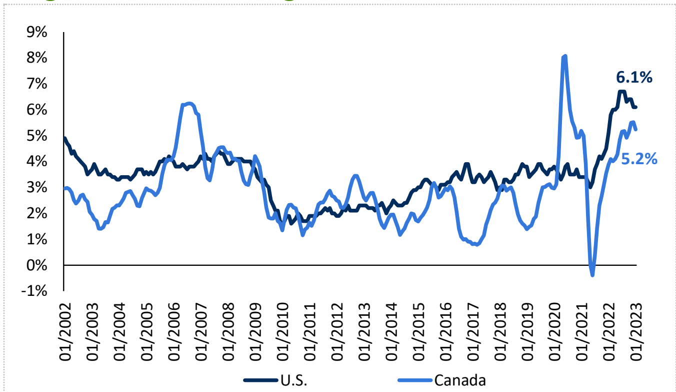


Source: Federal Reserve Bank of Atlanta; Raymond James Ltd.; data as of January 31, 2023.

Tightness in Labour Markets is Evident in Wages

The tightness in labour market conditions is another challenge that central bankers will attempt to address with changes in policy rates. For example, today, there are ~1.0-2.0 job openings for every person actively looking, while the unemployment rate on both sides of the border are hovering at 50-year lows. Simply put, the challenges we are experiences in labour markets are more reflective of longer-term structural issues, which were also present prior to the pandemic, but will not be easily or effectively fixed by changes in policy rates. As we show below, wage growth, as a result of these imbalances, has accelerated from the pandemic lows and is now hovering above the longer-term trend of 3.4 per cent and 2.9 per cent year-over-year (YoY) for the U.S. and Canada, respectively.

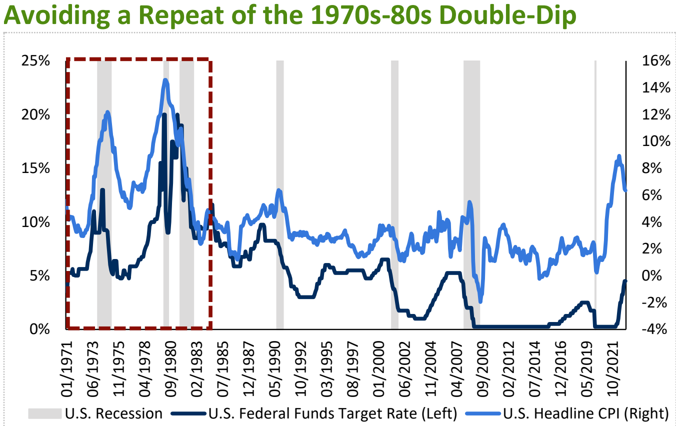
Wage Growth Is Still High in Both Canada and the U.S.



Source: Statistics Canada; Federal Reserve Bank of Atlanta; Bureau of Labor Statistics; Raymond James Ltd., as of January 31, 2023; % Chg. YoY, smoothed (3-month average)

While policymakers were arguably late to the inflation party, the hawkish rhetoric since late 2021 has remained mostly consistent throughout much of 2022. With doves flying high as inflation appears to have peaked, avoiding a repeat of the double-dip 1970s-80s inflation conundrum will be a key focus for central bankers in 2023 and even more so for investors.

Avoiding a Repeat of the 1970s-80s Double-Dip

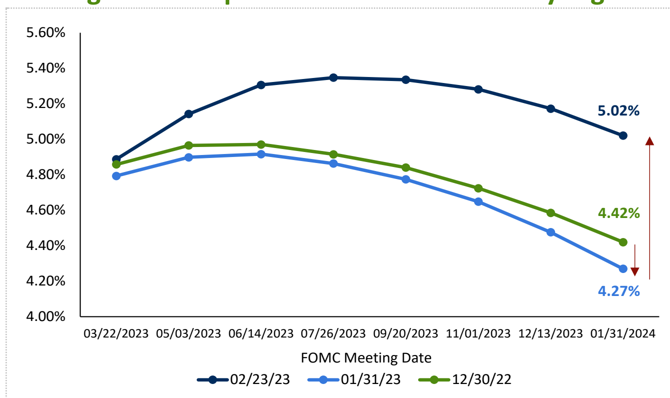


Source: FactSet; Raymond James Ltd.; Data as of January 31, 2023.

When Doves Cry, Markets Reprise – i.e., Selloff

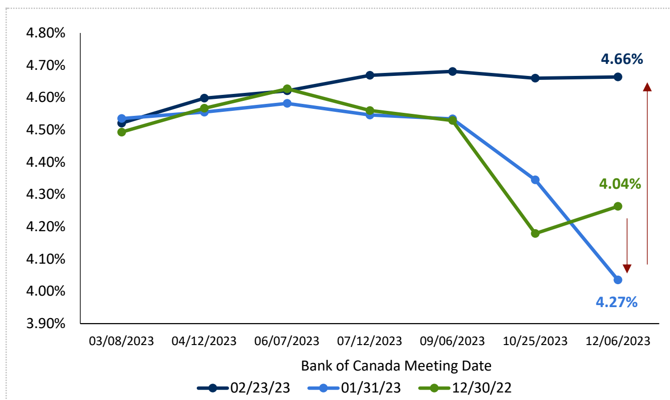
Investors' dovish tendency was best reflected in forward interest rate expectations for each of the Fed/BoC policy meetings over the next year. For example, the **green** and **light blue** lines below show investors' forward expectations for the path of overnight rates as of December 30, 2022, and January 31, 2023, versus expectation as of February 23, 2023 in **dark blue**. What is clear is that investors have repriced their expectations for the path of overnight rates following each of the upcoming meetings in 2023. Also, the commonly watched interest-rate barometer – 10-year yields – has moved higher as risk assets (i.e., equities) have sold off aggressively.

Overnight Rate Expectations Reset Materially Higher



Source: Bloomberg; FactSet; Raymond James Ltd.; Data as of February 23, 2023.

Similar Case in Canada



Source: Bloomberg; FactSet; Raymond James Ltd.; Data as of February 23, 2023.

We expect uncertainties and market volatility to remain high in 2023. However, we suggest investors use this opportunity to focus on what is in their control – i.e., allocating capital towards global investments, which offer compelling risk/rewards – versus focusing on the uncontrollable, examples of which are many (e.g., when will the Fed pivot).

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: Disclosures https://raymondjames.bluematrix.com/sellside/Disclosures.action

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable, but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may, from time to time, hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives. Some of the securities mentioned in this report may entail higher risk. Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives.

Information regarding High, Medium, and Low-risk securities is available from your Financial Advisor.