Investment Solutions Group

October 2023

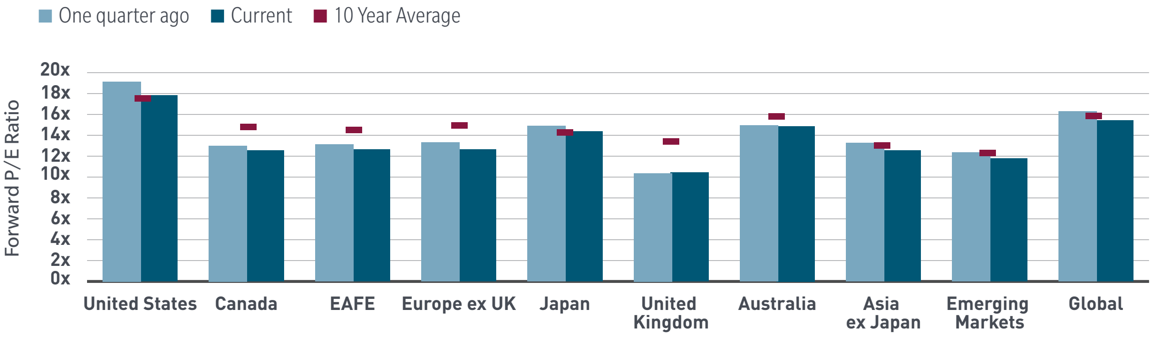
Capital Markets View

GLOBAL EQUITY SUMMARY

Hopes for a soft landing in the United States remain intact and developed markets have proven less interest rate sensitive than feared while inflation continues to moderate, albeit not as quickly as central banks would like. However, after a strong start to the year, it was tougher sledding for equities in the third quarter amid very narrow leadership from a handful of AI-exposed mega-cap stocks. In local currency terms, Japan remains the world's best performing developed market, rising over 23% through the end of Q3, while the US rose just under 12% and Europe ex-UK around 7%. UK equities remain cheap. Prices in emerging markets have lagged amid China's struggles with its debt burden, particularly as they relate to the critically important property sector. We remain concerned that margin pressures will continue to build due to rising interest rates and labor costs. After three quarters of earnings declines, analysts expect the S&P 500 to eke out very modest gains in Q3. At this stage, we like stocks in non-US companies more than US ones. We prefer value over growth, given attractive valuations, though we favor defensives over cyclicals.

For the full story see page 3

Forward Price to Earnings



Source: FactSet as of 30 September 2023. United States = S&P 500, Canada = MSCI Canada, United Kingdom = MSCI United Kingdom, Japan = MSCI Japan, Australia = MSCI Australia, Global = MSCI AC World, Europe ex UK = MSCI Europe ex-UK, EAFE = MSCI EAFE, Asia ex Japan = MSCI Asia ex Japan, Emerging Markets = MSCI Emerging Markets.

	SALES GROWTH (YOY%)		NET PROFIT MARGIN (%)		DIVIDEND YIELD (%)	
	Current	10-Year Average	Current	10-Year Average	Current	10-Year Average
United States	4.5	4.5	12.3	11.2	1.6	1.9
Canada	3.3	5.9	14.1	11.2	3.5	3.0
EAFE	4.4	2.6	9.6	7.7	3.4	3.2
Europe ex UK	3.2	2.7	9.9	7.8	3.4	3.2
Japan	6.5	3.0	6.6	5.6	2.3	2.2
United Kingdom	2.5	2.2	11.2	8.5	4.1	4.2
Australia	4.3	2.2	16.1	14.8	4.4	4.5
Asia ex Japan	5.3	6.7	9.0	9.6	2.6	2.5
Emerging Markets	4.9	7.2	9.8	9.7	3.0	2.8
Global	4.4	4.2	11.0	9.5	2.2	2.4

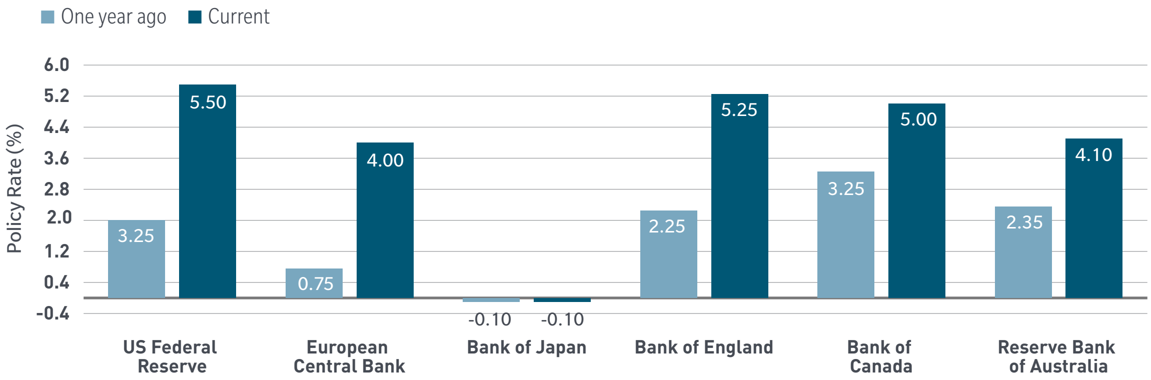
Source: FactSet as of 30 September 2023. Data shown are trailing (last twelve months). United States = S&P 500, Canada = MSCI Canada, United Kingdom = MSCI United Kingdom, Japan = MSCI Japan, Australia = MSCI Australia, Global = MSCI AC World, Europe ex UK = MSCI Europe ex-UK, EAFE = MSCI EAFE, Asia ex Japan = MSCI Asia ex Japan, Emerging Markets = MSCI Emerging Markets.

GLOBAL FIXED INCOME SUMMARY

While a consensus is forming that major central banks are at or near the end of their tightening cycles, it is far too early to declare the struggle against inflation won. As such, market focus is shifting from how high will rates rise to how long will they remain high. The prospect of rates remaining elevated well into 2024 has contributed to a push higher in long-term yields as has a slew of US Treasury bond issuance. Interest rate volatility remains elevated but below the peaks seen this spring amid the mini-US banking crisis. Term premium — the extra yield that investors demand for bearing the risk that interest rates may change during the life of a bond — has increased, adding to the back-up in yields. The US economy has remained remarkably resilient, thus far absorbing 525 basis points of policy-rate tightening, and the economy has proved less interest rate sensitive than many had anticipated thanks, in part, to the pandemic-era refinancing boom by US households and corporations. Other economies, such as those in the United Kingdom, Canada and Australia have experienced below-trend growth given their propensity toward floating rate mortgages. China's sluggish economy has had spillover effects, particularly for Europe, where demand for luxury goods, autos and machine tools have weakened. China has been trimming interest rates, in contrast with the rest of the developed world. Japan has eased the parameters of its yield curve control regime and may move to tighten policy in early 2024 as inflation normalizes, at long last. US investment grade spreads were unchanged from the prior quarter while high yield spreads widened to about 400 basis points, close to their 5-year average.

For the full story see page 6

Central Bank Policy Rates



Source: FactSet as of 30 September 2023.

	YIELD TO MATURITY (%)		DURATION (YEARS)	
	Current	10-Year Average	Current	10-Year Average
US Treasuries	4.9	1.9	5.9	6.2
Global ex US Sovereigns	3.5	1.4	6.8	7.5
Emerging Markets Debt	8.4	6.0	6.6	7.3
Global Investment Grade	5.7	2.8	5.9	6.6
Global High Yield	9.5	6.8	3.8	4.2
US Municipal Bonds*	4.3	2.3	6.4	6.1

Source: FactSet as of 30 September 2023. US Treasuries = Bloomberg Barclays US Aggregate Government Treasury Index, Global Sovereigns ex US = Bloomberg Barclays Global Aggregate ex US, Emerging Market Debt = JP Morgan EMBI Global, Global Investment Grade = Bloomberg Barclays Global Aggregate Corporate, Global High Yield = Bloomberg Barclays Global High Yield, Municipal Bond = Bloomberg Barclays US Municipal.

*yield to maturity unavailable for the municipal bond, so yield to worst is shown instead.

EQUITY INSIGHTS

UNITED STATES

- The S&P 500 retreated in August and September after a torrid climb in the first half of the year.
- Market leadership remains very narrow with the top five stocks comprising more than 25% of the S&P 500 Index. The market cap–weighted index and the equal-weighted index have diverged since the mini regional banking crisis in the spring, with the equal-weighted index essentially flat on the year through September, while the cap-weighted index gained 11.65%.
- The market has started to come to terms with a higher-for-longer interest rate regime, and that higher rates will eventually be reflected in equity prices.
- Core inflation remains well above target and may force the US Federal Reserve to resume its hiking cycle.
- Consumer spending remains strong, but the pinch of a higher interest burden, the restart of student loan payments and elevated energy prices could begin to restrain consumer spending and dampen sentiment.
- Communication services and technology have been the best performing sectors to date while utilities and real estate, hampered by higher interest rates, have been the worst.
- Small caps continue to lag far behind large caps and may present an opportunity in coming months, but they remain vulnerable in the event of an economic slowdown.

CANADA

- Canadian equities have made little progress year to date, trading just slightly above where they started the year. In recent months, higher energy prices have supported the S&P/TSX, of which energy comprises 19%.
- Despite higher mortgage rates and high prices, home demand remains robust with price declines surprisingly modest.
- Economic growth is flat on a quarter-over-quarter basis as the economy grapples with high core inflation and higher interest rates in addition to weak materials demand from China.
- Consumer spending has been surprising resilient, supported by wage growth in the 4% to 5% range.
- Canadian equities trade at just 14x next 12 months earnings, well below the 10-year average of 17x.

EUROPE EX UK

- European shares have traded in a broad range since April, after gaining strongly in early 2023 as fears of a European energy crunch dissipated. Through September, the MSCI Europe ex-UK index has gained 6.9%.
- With economic growth in the eurozone slowing and inflation falling, the ECB has indicated it has likely finished its tightening cycle after raising rates to a record-high 4% in September. However, like the Fed, the ECB is signaling that it intends to keep rates higher for longer. While inflation is falling, it remains more than double the ECB's 2% target, raising fears of a stagflationary environment. This suggests the central bank will need to maintain high policy rates for a considerable period unless Europe slips into recession.
- At 47.2, the composite euro area purchasing managers' index suggests the potential for recession is rising. Weakness in demand from China is being felt acutely in Germany, where industrial production has turned decidedly negative in recent months. Soft Chinese demand for luxury goods is a stiff headwind for the region's consumer discretionary sector.
- From a valuation perspective, European shares remain attractive relative to their US peers, trading at 12.6x NTM, compared with 17.2x for the S&P 500. This compares to a 10-year average EPS multiple of 14.8x.

EQUITY INSIGHTS

UNITED KINGDOM

- Year to date, the MSCI United Kingdom Index price return of 1.7% has dramatically underperformed its global developed peers.
- The value-heavy orientation of the index has contributed to its underperformance due to a lack of exposure to growth and technology stocks.
- Rising oil prices have boosted UK energy shares, making them, along with industrials, a bright spot in an otherwise bleak landscape.
- With its 1% weighting in technology, the UK index has missed out on the near euphoria surrounding the potential for artificial intelligence.
- Hopes are rising that the Bank of England tightening cycle may have come to an end amid a sharp drop in inflation in August and very sluggish economic growth.
- The British pound has relinquished all of its mid-summer gains, lessening what had become a significant earnings headwind for UK multinationals.
- UK equities remain attractive on a valuation basis, trading at 10.4x next year's earnings estimate, below the 10-year average of 13.2x and the 16.x multiple for the MSCI World Index.

JAPAN

- Japanese equities maintained their lead in developed market equity returns through late September, rising 23.4% year to date.
- Through the end of September, every sector contributed to performance in the first nine months of the year, with three returning in excess of 30% (energy, consumer discretionary and utilities).
- A weaker yen continues to provide Japanese exporters with an earnings tailwind as strong foreign currencies are converted into more yen when repatriated.
- Improved corporate governance and an increased willingness on the part of Japanese companies to exert pricing power amid an inflationary global backdrop have been supportive for share prices as have increased dividend payouts and stock buybacks.
- Markets have withstood a modest tweak in the Bank of Japan's yield curve control policy which has resulted in an upward drift in Japanese government bond yields as well as signs that inflation is sustainably reaching the Bank of Japan's 2% goal, suggesting the negative interest rate policy may be abandoned in 2024.
- From a valuation perspective, at 14.4x NTM, Japanese shares trade broadly in line with their 10-year average P/E ratio.

EQUITY INSIGHTS

EMERGING MARKETS

Asia ex Japan

- The region saw widely divergent performance through the end of September, with China, the largest constituent in the index, falling about 8.2% and number two, India, posting an 7.5% gain. AI-related demand for semiconductors helped fuel large rallies in South Korea and Taiwan, which were up 13.1% and 13.7%, respectively.
- Collectively, EM equities have risen 1.8% year to date in US dollar terms, which trailed developed market equities which have risen about 10.6%.
- Investors have been disappointed by the scope and pace of China's efforts to stimulate its flagging economy. The small-scale, piecemeal nature of the reforms announced so far have raised concerns that the government remains more focused on unproductive infrastructure investment rather than in spurring demand among the country's 1.4 billion consumers.
- Consumer and investor sentiment remains muted amid growing concern over China's giant property development sector and the fortunes of highly leveraged local government entities that rely on land sales as a major revenue source.
- Indian GDP growth proved stronger than expected in Q2, rising 7.8% on strong domestic demand, though sluggish global growth is seen as being a headwind for exports as the year progresses. The country has gained manufacturing market share from companies looking to diversify away from China.
- From a valuation perspective, the NTM P/E for the MSCI EM index trades in line with its 10-year average of 12.1x

EMEA and Latin America

- The MSCI EM Europe, Middle East and Africa index has kept pace with broader emerging markets in 2023, rising 1.6% in US dollar terms through September. EMEA performance relative to other EM regions is often driven by the performance of financials. Saudi Arabia, which remains the largest country weight in this regional index, at 33%, is performing below the broader EM market.
- Latin America, has performed in line with other emerging markets, gaining about 1.2% in US dollar terms year to date.

AUSTRALIA

- Australian equities have underperformed their global peers, rising less than 1% year to date after shedding all the early gains made on the back of optimism over China's Covid reopening.
- A slowing economy has given the Reserve Bank of Australia reason to pause though it maintains a hawkish tone.
- Amid rising stress from the expiration of fixed-rate mortgages, consumer spending has dipped though strong employment and wage growth are supportive.
- Basic materials, which represent 25% of the MSCI Australia index, remain heavily influenced by Chinese demand for iron ore. From the May lows, ore prices have recovered more than 20% after modest measures to stimulate Chinese housing demand.
- Since peaking near 8% at the end of 2022, inflation has fallen to 6% and is expected to continue to decline amid tight global financial conditions. A weak Australian dollar is an upside inflation risk as it increases the cost of imports.
- Australian equities trade on 14.9x next year's earnings estimates, in line with their long-term average.

FIXED INCOME INSIGHTS

US TREASURIES

- Treasury yields have risen relatively steadily in recent months as resilient growth and slowly improving inflation data have moved the market beyond recessionary expectations to anticipation of something considerably more benign. At the same time, the market has adopted the Fed's higher-for-longer mindset, maintaining its view that the terminal policy rate is near but pushing back the timing and the magnitude of eventual rate cuts.
- However, we remain unconvinced that the economy will be able to absorb such a sharp rise in rates without consequence. While we acknowledge that certain idiosyncratic and secular forces have dampened the economy's interest rate sensitivity, we anticipate further lagged effects from the 525 basis points of policy tightening over the past year and a half and therefore believe there is a significant risk of recession.
- With rates already high and the Fed signaling that it is nearing the end of its hiking cycle, we feel that the worst of the pain from rising rates may be behind us.
- Treasury issuance has been high and will remain elevated, and that has likely contributed to the bear steepening of the yield curve in recent months.
- Valuation in the Treasury market has improved markedly since the Fed's tightening cycle began. In our opinion, yields on US Treasuries — and especially real yields — are too high for an economy that is slowing into recession. While the very near-term outlook for rates is uncertain, we have conviction that rates will fall, and credit spreads will widen as the economy slows — and this should favor Treasuries over risk assets. We think the sharp increase in rates has set up the Treasury market for better total returns than we have seen in many years, recognizing that long-term performance tends to correlate highly with starting yields, which are now significantly higher than they have been for most of the last decade.

AGENCY MORTGAGE-BACKED SECURITIES

- With spreads widening year to date, valuation in MBS looks historically cheap, and in our view has largely priced in the risk of reduced sponsorship from the Fed and the current level of volatility. With that said, the market is still engaged in the process of repricing spreads for reduced bank participation in the future, which should leave fair value spread in the sector biased to drift structurally wider as the process continues.
- We think MBS spreads are — like those of other spread products — susceptible to widening in the event of recession. However, any fundamentally driven spread widening is likely to be of lesser magnitude when compared to that of the credit markets, suggesting room for relative outperformance versus credit.

FIXED INCOME INSIGHTS

GLOBAL EX US SOVEREIGNS

- We are supportive of a constructive duration position in non-US bonds outside of Japan and China, with overweights focused on intermediate maturity bonds.
- Even after the recent bond selloff, US markets continue to have several cuts priced in for the latter part of 2024. This is not the case for many non-US developed markets, despite worsening relative growth projections in Europe, in particular.
- We like the bonds of countries that are sensitive to tightening monetary conditions due to higher household leverage or inflated real estate values. Examples include New Zealand and the United Kingdom.
- Within Europe, we are favorable towards Swedish bonds and expect the Riksbank could be the first European Central Bank to cut rates in early Q2-24, once underlying inflationary pressures have moderated. Despite recent underperformance, we remain cautious on Italy given increasing concerns over growth projections and rising fiscal deficits at a time when the ECB is reducing its balance sheet. Given these risks, we continue to prefer other expressions of European periphery risk such as Greece and Spain.
- Despite being quite attractive on a hedged-to-USD basis, we are defensive on Japanese bonds because of the uncertainty surrounding future monetary policy. This uncertainty was apparent in Q2 as the BOJ surprised the market by stepping back its commitment to capping 10-year bonds yields.
- We think Chinese bonds are expensive, especially given their recent outperformance, caused by growth and refinancing concerns at the local government level. We feel monetary stimulus might be limited as financial stability is increasingly prioritized over growth.

FIXED INCOME INSIGHTS

EMERGING MARKETS

- We maintain a cautious risk stance in EMD. US data remain resilient, but the sheer magnitude of the US Treasury yield increase in September raises the risk of a hard landing as financial conditions tighten further. Historically, monetary policy acts with a 12- to 18-month lag and substantial US policy tightening continues to weigh on the global economy. In addition, the recent tragic attacks on Israel have introduced a heightened level of uncertainty in the global backdrop. Markets are now evaluating whether this conflict will escalate into a situation with broader global economic implications or remain localized. The initial sharp increase in oil prices and risk-off sentiment in the markets suggests that there is some concern about the former rather than the latter.
- After a modestly more supportive tone from policymakers, seeming resilient US export demand, and a trough in the local inventory cycle, China's economy saw very modest improvement during 3Q, albeit from very depressed levels. However, a cyclical upswing is by no means assured as there remains a crisis of confidence among households and private businesses. Chinese growth into 2024 will also be structurally constrained by issues such as high local government debt.
- Against this global backdrop, emerging markets debt spreads are at historically tight levels if the most speculative countries (*e.g.*, CCC and below) are excluded from the benchmark. Emerging markets debt as well as other risk markets are not priced for a US or global recession — even a shallow one but there has never been a case in which emerging markets spreads tightened during a recessionary environment. What is becoming increasingly evident is that EMD valuations have already priced in a soft or no-landing scenario.
- Select EM local rates present more attractive risk-reward opportunities — as evidenced by the better performance of the GBI-EM asset class over the last year.
- In terms of technicals, EM bond funds have experienced continuous outflows for more than two months, resulting in a year-to-date cumulative outflow of -$20.1 billion. These outflows have primarily been driven by hard-currency funds.
- In an environment where US Treasury yields are at high levels, restrictive monetary policies are nearing the end of their cycles or rolling over, and where the growth outlook remains uncertain, we favor being overweight duration while reducing exposure to EM corporates and currencies while focusing on resilient credits and EM local rates.

GLOBAL INVESTMENT-GRADE CORPORATES

- Global Investment grade spreads continued to hold up well in Q3, tightening 4 bps to end the quarter at a spread of 135 bps despite higher energy prices, a hawkish Fed and the risk of a US government shutdown. Sentiment was boosted by falling expectations of an imminent recession and still resilient fundamentals. While higher interest expenses and wage costs are weighing on margins, balance sheets remain strong.
- Credit spreads between European investment grade bonds and US investment grade bonds have narrowed, driven by a larger spread tightening within European investment grade bonds. Sector dispersion continues to be high in the US, providing some good opportunities for active managers.
- We continue to prefer sectors that are more resilient in a growth slowdown such as pipelines, defense, utilities, aircraft leasing and energy and favor reducing exposure to European financials.
- We prefer investment grade to high yield bonds at this stage of the credit cycle despite low implied future high yield default rates, with the sharp inversion of the US Treasury yield curve still suggesting tight monetary conditions and rising recession probabilities. Refinancing risk is much lower for investment grade bonds relative to the high yield market, where the decline in average maturity represented a challenging market for issuance in recent months.

FIXED INCOME INSIGHTS

GLOBAL HIGH-YIELD CORPORATES

- Fundamentally, the high yield market currently stands in reasonably good stead ahead of any broader economic slowdown with generally decent credit metrics and a manageable maturity profile in aggregate.
- Nevertheless, familiar pockets of weakness persist in certain areas: China property/macro, commercial real estate in multiple regions and US retail.
- Although distressed ratios and default rates remain muted for now, these metrics are off the pandemic-era lows, and peak fundamentals for HY are likely behind us.
- In terms of valuation, spreads across all regions remained fairly rangebound over the summer. Within high yield, CCC risk has continued its YTD outperformance versus the broader market. However, even in a mild recession scenario with a subdued default cycle, HY markets are still likely to widen by hundreds of basis points despite better starting credit metrics.
- In Europe, nearly €70 billion of debt matures in 2025 across the pan-European HY market, nearly triple the refinancing burden of 2024. Issuers have begun to come to market to address their 2025 maturities.

US MUNICIPAL BONDS

- Higher US Treasury and tax-exempt yields buffeted municipal bond performance during the third quarter, driving year-to-date returns for the investment grade tax-exempt muni index into negative territory and effectively to zero for the high yield tax-exempt muni index. The tax-exempt curve shift was higher and parallel, remaining inverted from one- to 12-year maturities. Yields moved to levels last seen in 2008 for the IG index, and muni/US Treasury ratios cheapened somewhat, approaching fairer levels.
- For the taxable muni index, year-to-date total returns remained slightly positive after posting a negative quarter. Adjusted for duration, taxable munis produced positive excess returns for the quarter and year-to-date periods and outperformed corporate bonds in excess return space, signaling spread resilience for the taxable muni asset class. Nominal yield closed the quarter at its highest level since 2011.
- Fundamentals are strong across the municipal market following years of economic growth and federal stimulus during the pandemic. Isolated areas of stress exist, notably in hospitals most exposed to labor cost pressures, where selectivity is warranted.
- With nominal yields high by historical standards, a defensive sector orientation and solid fundamentals, munis appear to be relatively well positioned in slower-growth or recessionary scenarios.

Capital Markets View

October 2023

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