PICTON MAHONEY
Asset Management

Q3 2023

INVESTMENT REVIEW & OUTLOOK

The Fork in the Road

- EQUITIES HAVE GENERALLY BENEFITED FROM DISINFLATION AND A FED PAUSE
- THE ECONOMIC DATA SEEMS 'GOLDILOCKS'-LIKE
- BUT WARNING SIGNS ABOUND
- PERHAPS THE FED'S COMMITMENT TO PRICE STABILITY IS UNDERAPPRECIATED
- THE SETUP FOR STOCK MARKETS DOESN'T SEEM ATTRACTIVE HERE

OVERVIEW

As the third quarter begins, the economy and stock markets appear to be nearing an important juncture. On the positive side, inflation continues to decline, and the U.S. Federal Reserve (Fed), encouraged by this progress, has paused its campaign of rate hikes. Markets have responded bullishly, as they have done historically when such a pause occurs. Now the debate turns to whether the economy will experience a soft landing or a recession. There are myriad arguments for both possibilities, but our reading of the data suggests that the latter is the more probable outcome at this point.

With that in mind, the setup for equities at the start of the second half of 2023 looks challenging. What currently appears to be a 'Goldilocks' economy – not too hot and not too cold – could quickly give way to a recession as the impact of previous central bank tightening continues to work its way through the system. Meanwhile, stock markets are up significantly from their lows and are expensive by most measures, especially a select number of U.S. high-tech stocks that have been buoyed by the generative artificial intelligence (AI) boom. Positioning and investor sentiment have both turned much more bullish, leaving little room for error, and creating the potential for a wave of selling should data and sentiment begin to erode. Finally, investors seem convinced that the Fed will deliver interest rate cuts into 2024, apparently tuning out the central bank's own projections. We believe this constellation of factors suggests that caution is warranted.

PICTON MAHONEY HOUSE VIEW July 2023

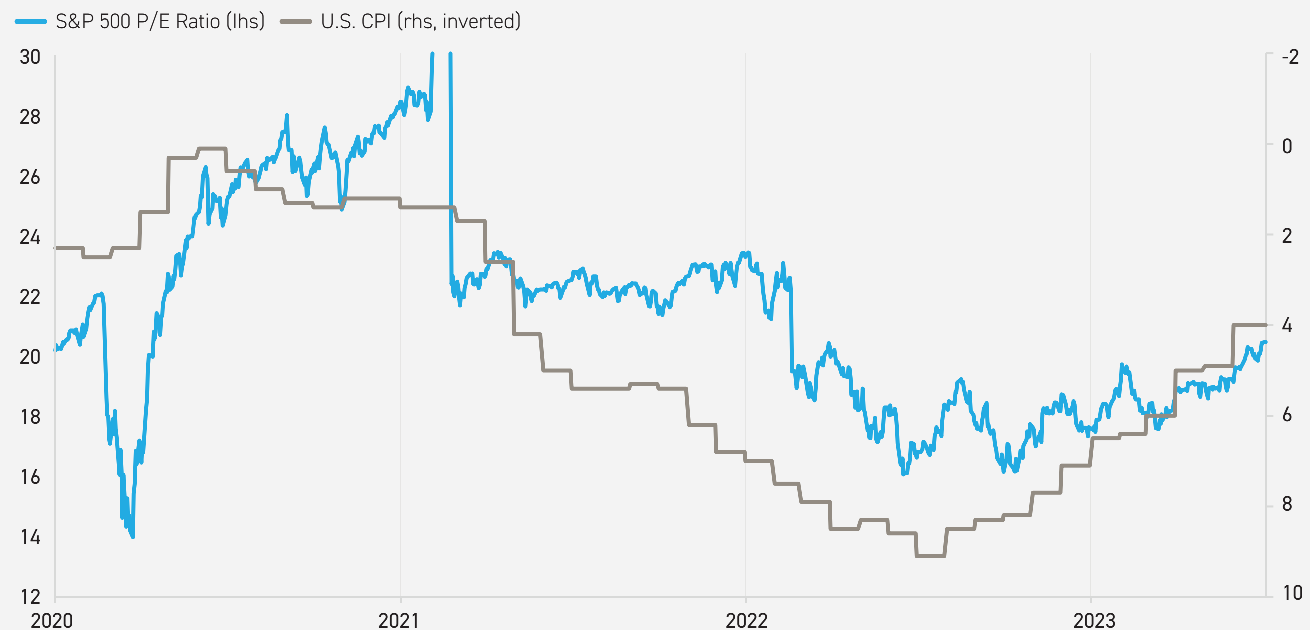
VIEW	PMAM VS. CONSENSUS
RISK	
Macro risk remained very low in Q2, and we expect this trend to reverse as the impact of rate hikes and tighter credit conditions begins to be felt in the economy.	HIGHER
MACROECONOMIC	
GLOBAL REAL GDP Global leading indicators resumed their downtrend in Europe and China. We expect the global economy to struggle with the impact of continued tight monetary policy and waning optimism.	LOWER
U.S. REAL GDP The U.S. Federal Reserve (Fed) paused in June but promised to hike at least twice more in its fight against inflation. Since their stated goal is to bring the labour market into balance, the only way to do that is to raise the unemployment rate at the cost of economic growth, which means GDP will likely continue to head down.	LOWER
CANADIAN REAL GDP The Bank of Canada (BoC) resumed a hawkish path after it paused in January, which we expect will put Canada's housing market and consumer sector in renewed danger of contraction.	LOWER
U.S. INFLATION Consumer Price Index (CPI) will likely keep falling in the next quarter, as suggested by leading indicators, largely due to the drag from energy and falling prices for many global goods. Core Services CPI has been stickier but is showing signs of falling as well.	LOWER
EQUITY RETURNS	
U.S. EQUITIES Equities moved higher in Q2 on higher multiples due to falling inflation, although earnings growth is grinding to a halt and may soon turn negative, which will present fresh headwinds to equities.	LOWER
EUROPEAN EQUITIES Europe officially entered recession in Q1, and the renewed fall in leading indicators there suggests more downside to come for the economy and therefore European equities.	LOWER
CANADIAN EQUITIES The pause from the BoC is over, and as the Canadian economy faces fresh headwinds, so will Canadian equities.	LOWER
BOND YIELDS	
TREASURIES (U.S. 10-YR) Treasury rate expectations are for a marked decline over time, but the exact path forward will be a function of Fed policy and how the economy fares through it.	SAME
INVESTMENT-GRADE CORPORATE BONDS Investment-grade spreads remain resilient and have been able to absorb changes due to government rate volatility.	SAME
HIGH-YIELD CORPORATE BONDS High-yield corporate bonds are at risk from rising defaults, which seem to be on the rise especially in private markets.	HIGHER
OTHER	
WTI CRUDE OIL Weaker global growth has kept a lid on oil demand, even as the Organization of the Petroleum Exporting Countries (OPEC) attempts to control supply output.	SAME
EPS GROWTH (S&P 500) The outlook for earnings growth remains challenged as leading indicators point to a negative second half of the year.	LOWER
P/E (S&P 500) Falling inflation rates have helped buoy multiples for growth stocks, although this trend may not have much legs left.	LOWER

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at June 2023.

EQUITIES HAVE GENERALLY BENEFITED FROM DISINFLATION AND A FED PAUSE

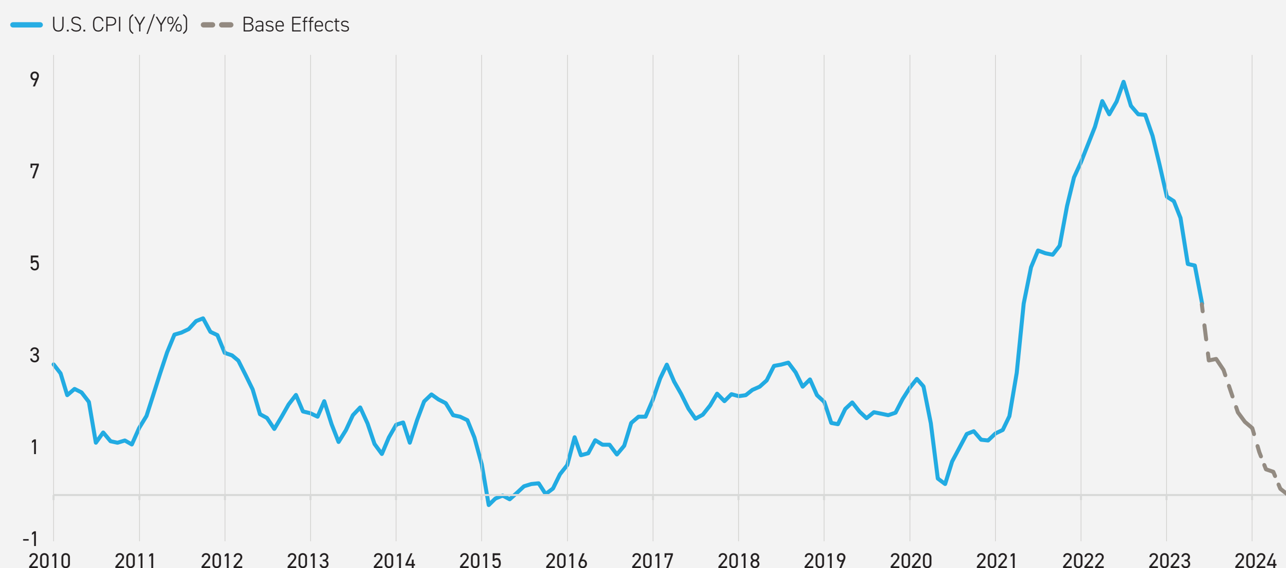
Inflation is falling and the economy is moderating. This has had a positive impact on equities, with valuations expanding (Fig. 1). Growth sectors have been particularly strong, likely due to a combination of discounted cash-flow valuations that are more sensitive to changes in inflation and the bursting of generative AI onto the global scene.

FIGURE 1: THE MARKET'S VALUATION EXPANDS WITH LOWER U.S. CPI



Source: Bloomberg, L.P., PMAM Research. Jan. 2020 to June 2023.

In the near term, we expect more good news in inflation headline numbers, since base effects are expected to be particularly large next month (at -1.1%), meaning June's Consumer Price Index (CPI) will likely show another material decline that could match the large decline witnessed in May, all else being equal (Fig. 2).



Source: Bloomberg, L.P., PMAM Research. Jan. 2020 to May 2023.

Encouraged by disinflation, we believe the Fed appears to be at, or at least very close to, the end of its monetary tightening cycle. Investors have cheered this development. As Figure 3 shows, markets historically have rallied around a Fed pause. This has been true both when the pause preceded a recession (i.e., the pause was too late to prevent a recession) and when the pause preceded a re-acceleration. In either case, equities have bounced for three months after the last hike of a cycle.

FIGURE 3: MARKETS TEND TO RALLY AROUND A FED PAUSE

	S&P 500 Index	S&P / TSX Composite Index	MSCI World Index	U.S. 10 Year Bond Yield	U.S. 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	U.S. Unemployment Rate
Fed Pause (pre-recession)								
Prior 3 months	3.1%	2.2%	1.0%	0.13%	0.39%	-0.26%	0.65%	-0.1
First 3 months	8.3%	9.2%	2.4%	-0.58%	-0.55%	-0.03%	0.06%	0.0
Following 6 months	-0.2%	-2.7%	1.4%	0.13%	0.39%	-0.26%	0.65%	0.2
Fed Pause (re-acceleration)								
Prior 3 months	7.9%	1.9%	4.2%	-0.24%	-0.10%	-0.14%	0.06%	0.0
First 3 months	6.9%	5.0%	4.8%	-0.78%	-0.92%	0.14%	-0.04%	0.0
Following 6 months	12.5%	9.1%	8.2%	-0.71%	-0.66%	-0.05%	-0.32%	-0.1

Source: Bloomberg, L.P., PMAM Research. From June 1982 to June 2023.
* Fed Pause is defined as the last hike of a continuous hiking cycle.

Where it really gets interesting, however, is in the six months that follow. In pre-recessionary environments, markets tend to fall, not surprisingly. By contrast, in times of economic re-acceleration (i.e., soft landings), markets typically continue to march much higher.

If history is any guide, we appear to be nearing a crucial fork in the road, where the impact of previous central bank actions could have a significant impact on the direction of markets for the rest of the year and into 2024.

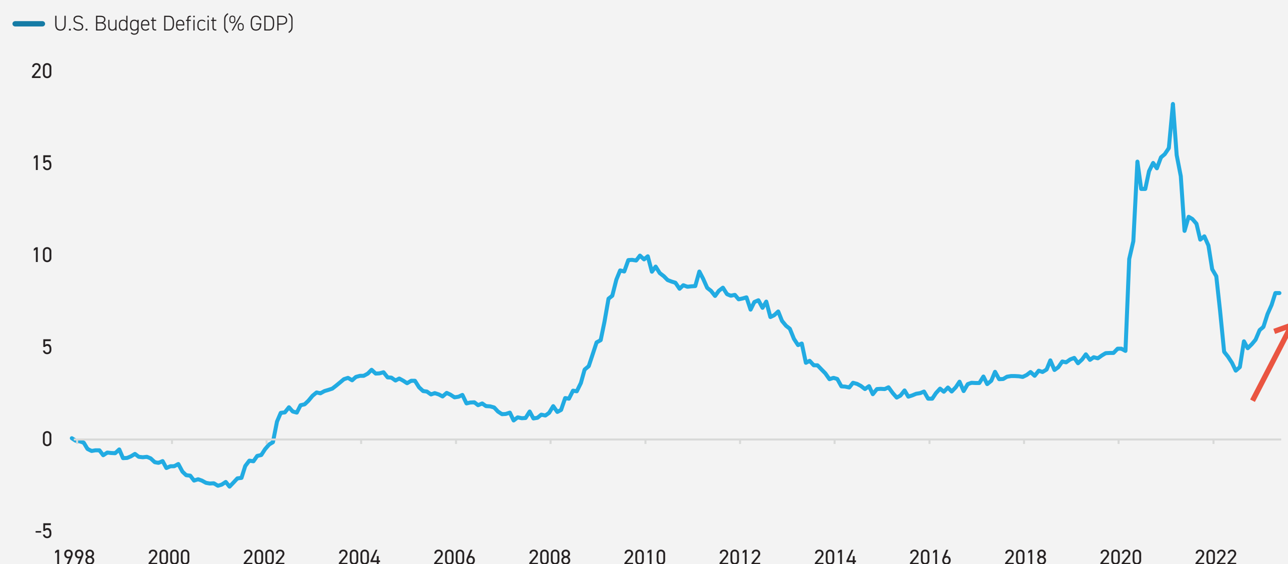
THE ECONOMIC DATA SEEMS 'GOLDILOCKS'-LIKE

Many respected investors and market strategists have been anticipating that a recession would get underway sometime in 2023, yet it hasn't. We have also been surprised by continued strength in the economy and the exuberant tone of equity markets at the halfway point of 2023.

Given the somewhat surprising 'Goldilocks' economic backdrop and the Fed's very aggressive tightening campaign, why hasn't the economic porridge turned cold by this point? One reason could be that central bank tightening affects the economy with a lag, and the Fed's tightening only began a year and a half ago. It stands to reason that if it takes six to 18 months for impacts to occur, we have yet to see the full lagging effects of some of the early interest rate hikes, let alone the more recent ones.

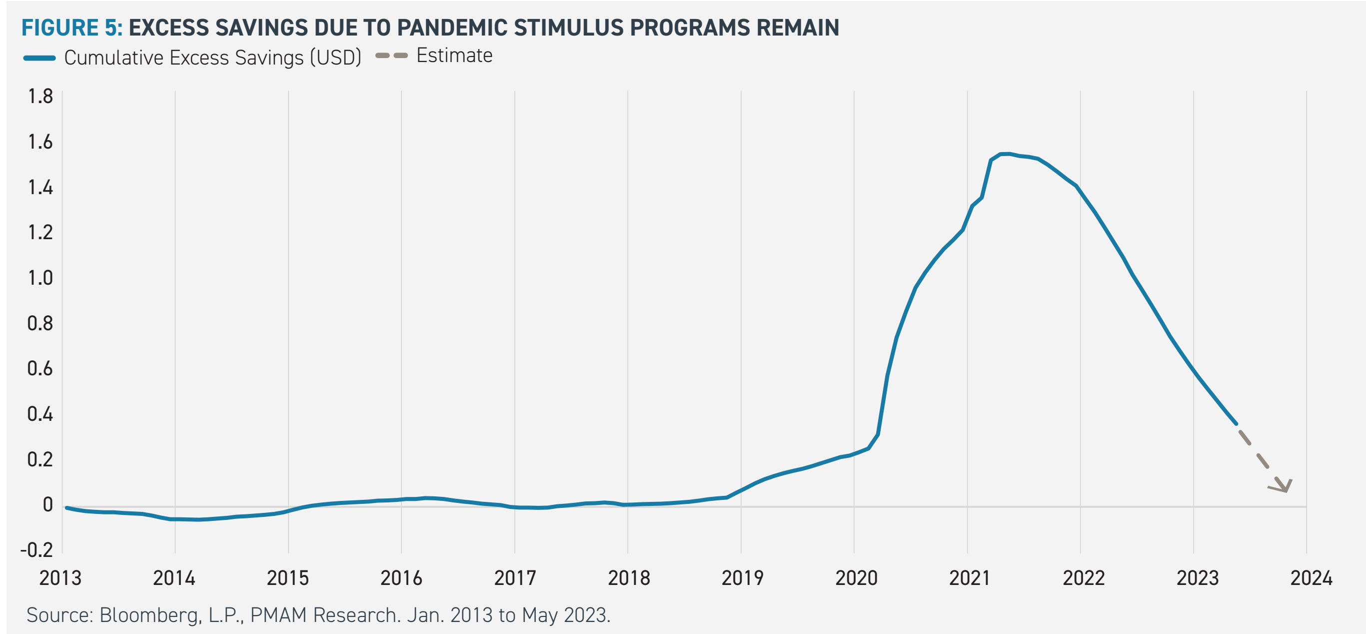
Another possible explanation is that this has been a very different cycle than normal. The pandemic ushered in dramatic changes in the economy, created large pockets of pent-up demand that will take years to satisfy, and saw policy makers introduce tremendous amounts of monetary and fiscal stimulus to counter the almost complete stoppage in many segments of the global economy. Even when vaccines came along and the economic impacts of the pandemic began to subside, policy makers kept the stimulus coming. In the U.S., Congress enacted legislation to provide relief to businesses and individuals, including the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the American Rescue Plan Act. Eviction and foreclosure moratoriums, paycheque protection, student loan forbearance and stimulus cheques were a few key elements of these laws. All told, the U.S. injected fiscal stimulus equal to 27% of Gross Domestic Product (GDP) in 2020–2021. Even now, the U.S. government is poised to run a $2 trillion deficit in 2023, pouring even more fuel into the economy even as the Fed keeps stepping harder on the brakes (Fig. 4).

FIGURE 4: FISCAL SPENDING HAS BEEN AIDING GDP RECOVERY



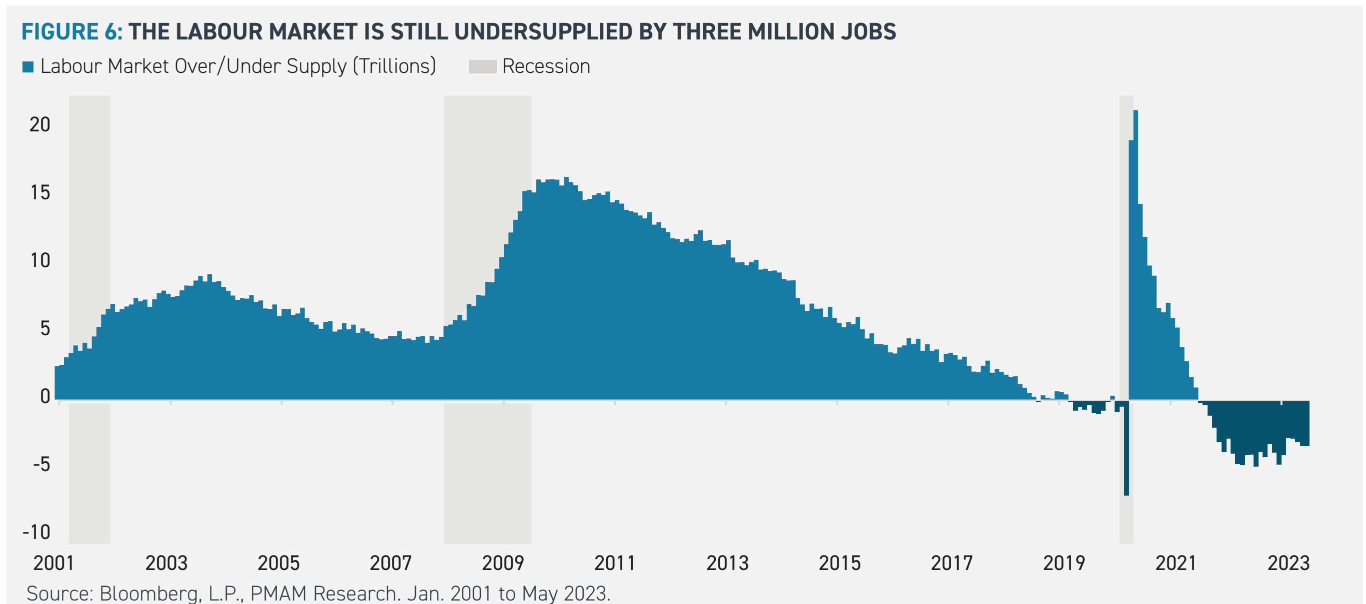
Source: Bloomberg, L.P., PMAM Research. Jan. 1998 to May 2023.

Pandemic stimulus programs created large amounts of excess savings at a time when there weren't many things to spend the savings on, other than goods. Therefore, these savings have acted as a strong buffer, insulating the economy from the full brunt of interest rate hikes. However, while excess savings still remain, they continue to be whittled down fairly quickly (Fig. 5).



Source: Bloomberg, L.P., PMAM Research. Jan. 2013 to May 2023.

There has also been a strong labour market, which has not only been relatively impervious to tightening efforts, but has also helped boost consumption. A general scarcity of labour in many countries, especially the U.S., has contributed to this strength. For instance, while the U.S. Job Openings and Labor Turnover Survey measure of job openings is down approximately two million from its highs, it is still well above pre-pandemic levels. An estimated shortfall of over three million workers has helped keep economic momentum intact, as those who lose jobs quickly find other positions (Fig. 6). So far, we have seen the job opening rate fall without a rise in the unemployment rate. We think the Fed's goal is to get this rate back to its pre-pandemic level. It will hope to get most of the way there without higher job losses, and so far, the Fed is on track to do this.



Source: Bloomberg, L.P., PMAM Research. Jan. 2001 to May 2023.

The housing market has been another notable pocket of strength. A shortage of housing in the U.S. has contributed to decades-low vacancy rates. As the global economy came to a halt in March 2020, central banks lowered interest rates. A key consequence of this easing was that a large proportion of the population either bought, upgraded or refinanced their first homes. Huge spikes in home values ensued around the world, creating value that could be accessed to maintain consumption. This is especially the case in the U.S., where many Americans were able to lock in record-low mortgage rates for 30 years. As long as these homeowners stay in their existing homes and remain fully employed, they are much less vulnerable to rising rates. (Unfortunately, consumers in most other countries are not in this enviable position, and they are increasingly beginning to feel the effects of higher mortgage rates as they renew their shorter-term mortgages.)

European economies have been stronger than initially projected following the Russian invasion of Ukraine. Warmer weather helped alleviate energy scarcity concerns, which then freed up energy reserves, allowing industrial activity to be much stronger. Still, Europe has recently fallen into a mild recession, and the European Central Bank (ECB) continues to increase interest rates. Predictions for a hot summer could reignite gas supply issues, also putting further pressure on growth.

In Asia, Japanese shares hit a 30-year high, helped, no doubt, by higher CPI prints. The only country that seemingly wants inflation is finally getting it, raising hopes that Japan can exit its long debt/deflation trap.

Turning to China, authorities have been increasing targeted stimulus, although they will likely need to do more on this front, given the tepid reopening response there. The People's Bank of China (PBOC) recently cut the banks' required reserve ratio (RRR), as well as short-term interest rates. China has used property and infrastructure investment as an important economic growth lever (after manufacturing and exports), but must weigh the short-term benefits from stimulating property markets with the longer-term systemic risks from high levels of corporate indebtedness and a shrinking population. It's unlikely that China will undertake the massive fiscal stimulus programs of yesteryear to try to stimulate growth; instead, it will likely resort to smaller and more targeted spending plans.

BUT WARNING SIGNS ABOUND

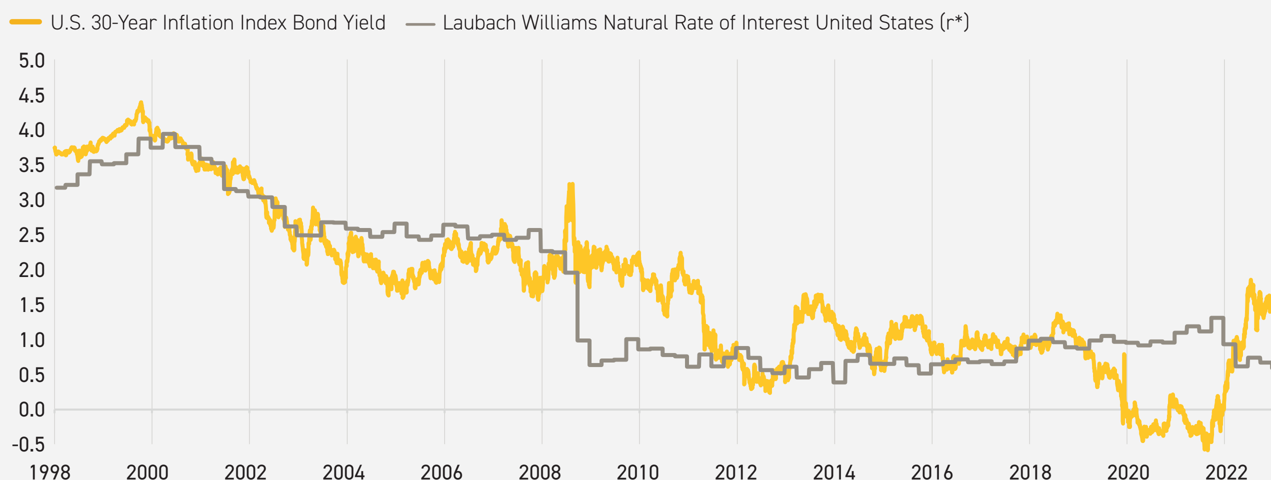
While all appears well, our macro distance model – which looks for similar economic backdrops through history – suggests that the current environment resembles other calm periods before significant storms: notably September 1989 and July 2000. While these periods saw short and somewhat milder contractions, they were accompanied by significant setbacks in risk assets. Deteriorating leading indicator trends, along with an overbought setup for equities, suggest that the risk/reward in owning equities in the near term is not particularly attractive. We believe there is more downside risk than upside potential over the next few quarters.

MONEY AND CREDIT ARE TIGHT

The U.S. Fed has raised interest rates 500 basis points (bps) in a year and a half, while also embarking on quantitative tightening (QT). U.S. monetary policy is very restrictive, but is expected to tighten even further through the end of 2023, according to the Fed's recent communications.[1] While authorities left the Fed funds rate unchanged at a range of 5.00% to 5.25% at the Fed's June meeting of the Federal Open Market Committee, their median "dot plot" showed the target rate moving up to 5.625% for the end of 2023, from 5.125%.

Another way of assessing the tight monetary environment at present is to compare the real 30-year bond yields with an estimation of the "natural rate" (the interest rate that is neither stimulative nor restrictive, otherwise known as "r*"). As Figure 7 shows, real rates have already spiked well above r*, leading to increasingly tighter conditions. Should inflation expectations continue to fall and nominal bond yields remain steady, real rates will increase even further above r*, exacerbating this restrictive situation. We might call this "passive tightening" a scenario in which the Fed stands pat, but real rates march higher.

FIGURE 7: REAL RATES HAVE SPIKED WELL ABOVE THE 'NATURAL' INTEREST RATE



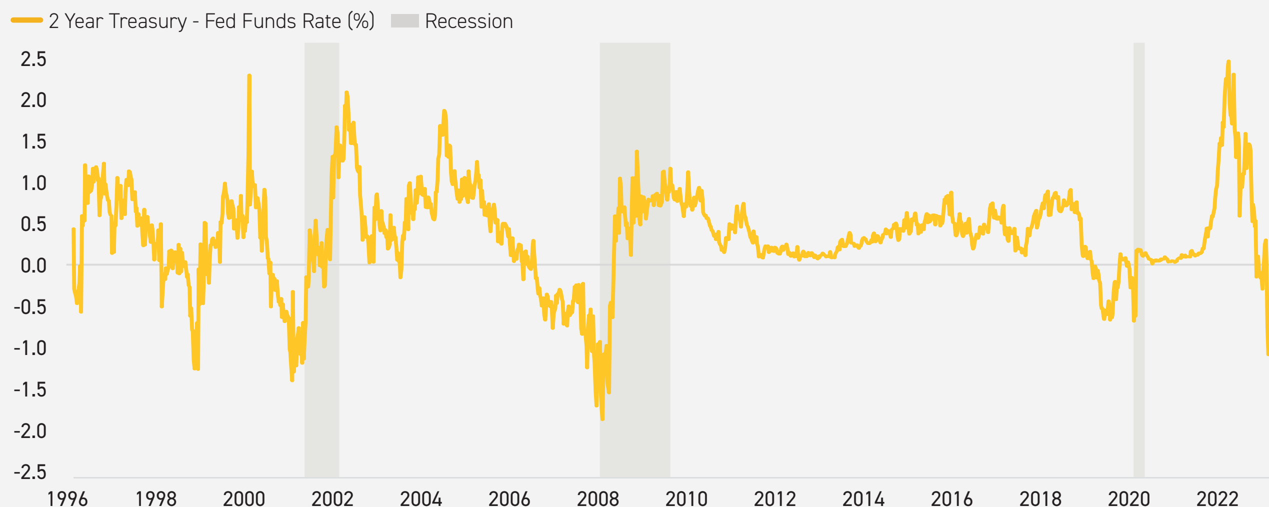
Source: Bloomberg, L.P., PMAM Research. Jan. 2013 to May 2023.

[1] https://www.federalreserve.gov/newsevents/testimony/powell20230621a.htm

THE YIELD CURVE REMAINS DEEPLY INVERTED

As the Fed gets more aggressive, the yield curve keeps getting more inverted — historically, a reliable signal of economic trouble ahead. The traditional measure of the yield curve, the ten-year versus two-year spread, has fallen to extreme negative levels of inversion not seen since the early 1980s, when Paul Volcker was on his mission to tame inflation. The two-year versus Fed funds spread is usually the last to invert, and that generally heralds the beginning of a recession. And as Figure 8 shows, we recently reached that critical inversion point.

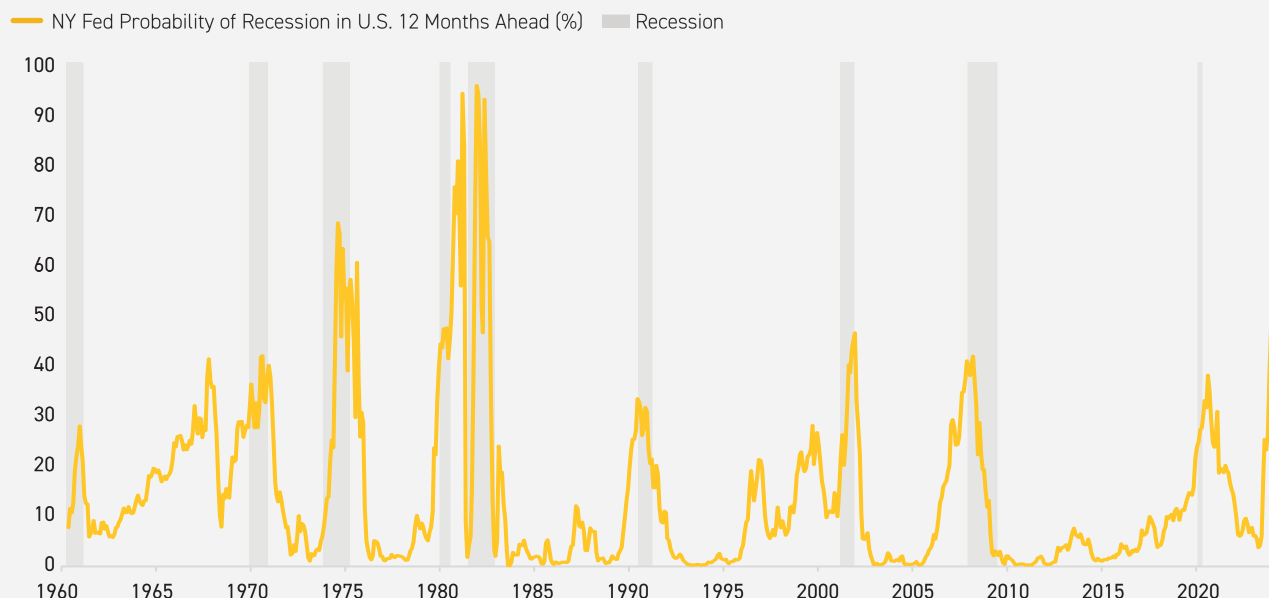
FIGURE 8: THE TWO-YEAR VS. FED FUNDS CURVE IS NOW INVERTED



Source: Bloomberg, L.P., PMAM Research. Jan. 1996 to June 2023.

Just how important is an inverted yield curve? It's the key input for the New York Fed's own recession probability model – a model that has recently hit levels not seen since the early 1980s (Fig. 9).

FIGURE 9: NEW YORK FED RECESSION MODEL IS VERY CONCERNING



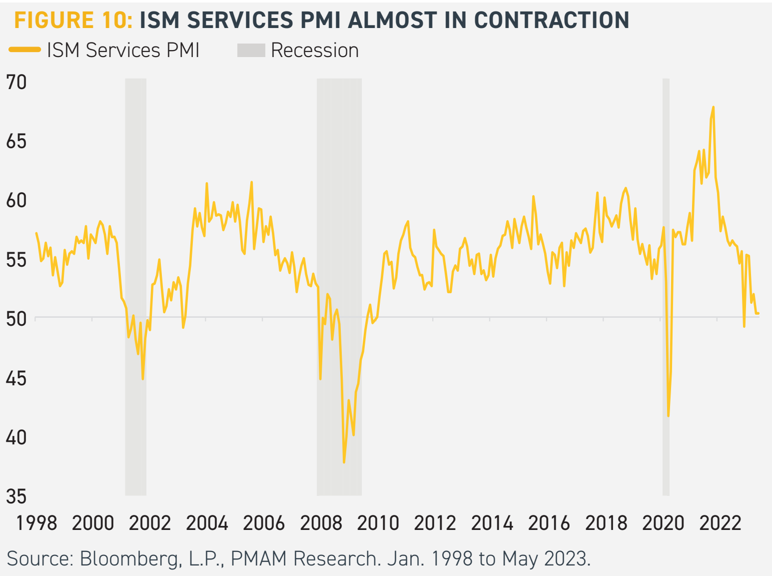
Source: Bloomberg, L.P., PMAM Research. Jan. 1960 to June 2023.

LEADING INDICATORS CONTINUE TO WEAKEN

Current U.S. economic data may support the optimistic perception of a 'Goldilocks' backdrop. However, we think it is reasonable to assume that monetary policy works with a lag, and that current economic data have yet to reflect the full effect of the significant amount of tightening that has occurred, especially in the last year.

In fact, a host of leading indicators suggest that recession risks are continuing to build. Institute for Supply Management (ISM) services indicators have joined manufacturing indicators in deteriorating and were close to falling below the 50 mark (the expansion versus contraction cut-off) in the ISM's last Purchasing Managers' Index (PMI) readings in May (Fig. 10). This may be a sign that the pent-up demand for services that came out of the pandemic is close to being satisfied. In any case, more broadly based recessions are generally associated with a decline in the services sector in conjunction with the more cyclically volatile manufacturing sector.

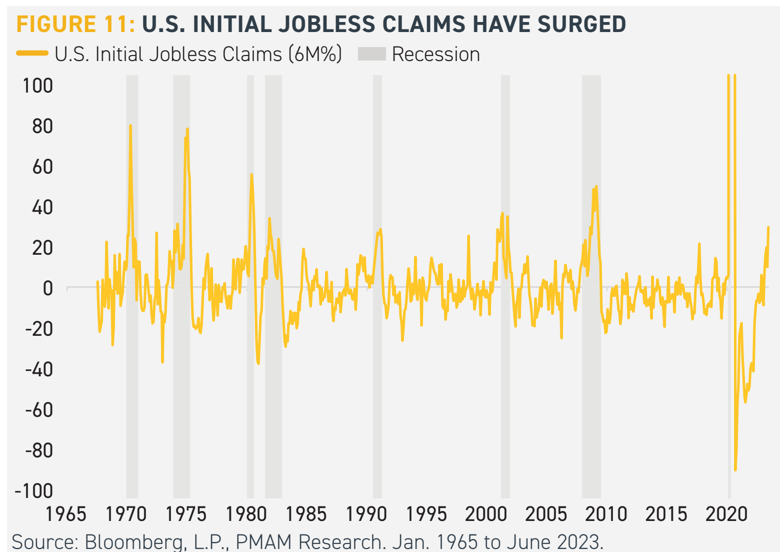
FIGURE 10: ISM SERVICES PMI ALMOST IN CONTRACTION



Source: Bloomberg, L.P., PMAM Research. Jan. 1998 to May 2023.

United States initial jobless claims, which track ahead of U.S. unemployment figures, rose by 28,000 to 261,000 for the week ended June 3, the highest level since October 2021 (Fig. 11). Jobless claims have spiked over 20% in the past six months, a magnitude that has historically been associated with recession. One notable exception occurred in 1998, but at that time the Fed quickly reversed its tightening policy as stock markets plunged in response to various crises that were popping up, such as the Russian debt default and the collapse of Long-Term Capital Management L.P. These were unintended consequences of restrictive monetary policy and a surging U.S. dollar at that time.

FIGURE 11: U.S. INITIAL JOBLESS CLAIMS HAVE SURGED

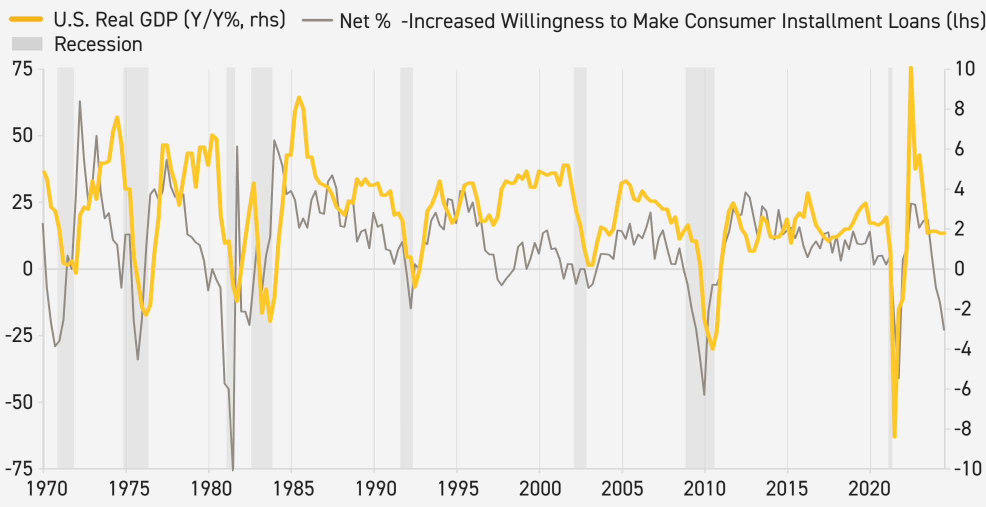


Source: Bloomberg, L.P., PMAM Research. Jan. 1965 to June 2023.

As previous periods of tightening show, economic crises can emerge whether or not they are anticipated by policy makers. In other words, central bankers usually keep raising rates until they break something. The sudden collapses of Silicon Valley Bank and Signature Bank may seem to be extreme and isolated cases of mismanagement, but their demise does have broader implications about what can occur quickly as the Fed aggressively deflates the free-money bubble it had created. As the system tightens, consumers and businesses that are under stress will use their deposits and savings to fund their lives or business operations, increasing funding costs for banks. At the same time, credit losses are likely to increase as individuals and companies fall behind on payments. Other systematic stresses can quickly surface, given the aggressive rise in interest rates and QT over the past year. We think it is inevitable that other interest rate or U.S. dollar-related stresses will emerge in different sectors and countries as the global tightening process expands.

While the recent U.S. regional bank crises seem to be behind us, their impact has meant that U.S. banks' willingness to make consumer loans has dried up, and now stands at levels associated with deep recessions in the past (Fig. 12).

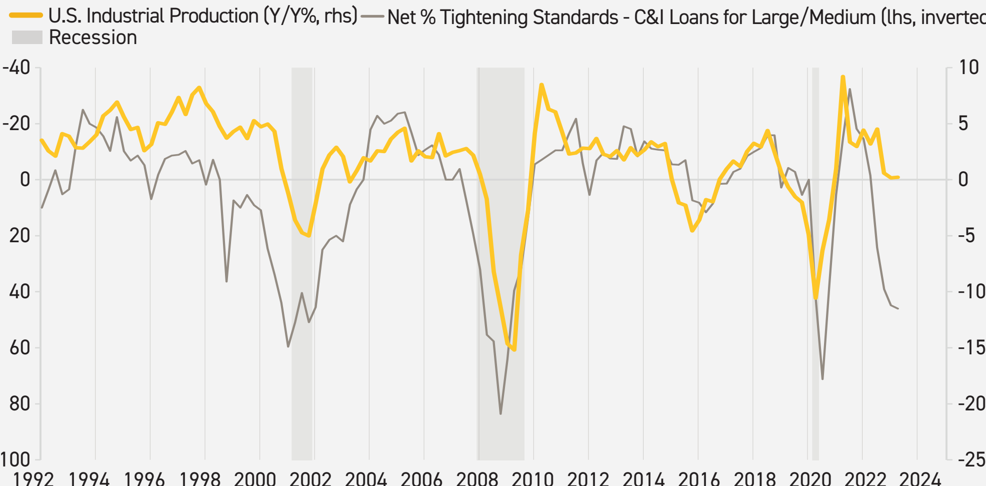
FIGURE 12: BANKS ARE TIGHTENING CONSUMER CREDIT



Source: Bloomberg, L.P., PMAM Research. Jan. 1970 to Apr. 2023.

The corporate sector is also facing tougher loan availability (Fig. 13).

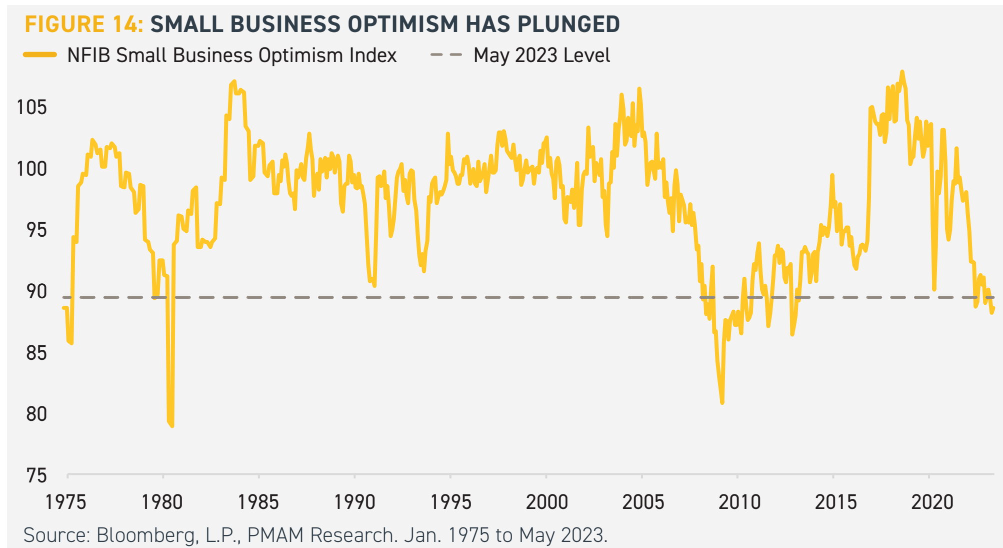
FIGURE 13: CORPORATE LENDING STANDARDS ARE ALSO TIGHTENING



Source: Bloomberg, L.P., PMAM Research. Jan. 1992 to Apr. 2023.

Perhaps this is why U.S. small business optimism is at very low levels, on a par with 1975, 1980 and 2008 (Fig. 14).

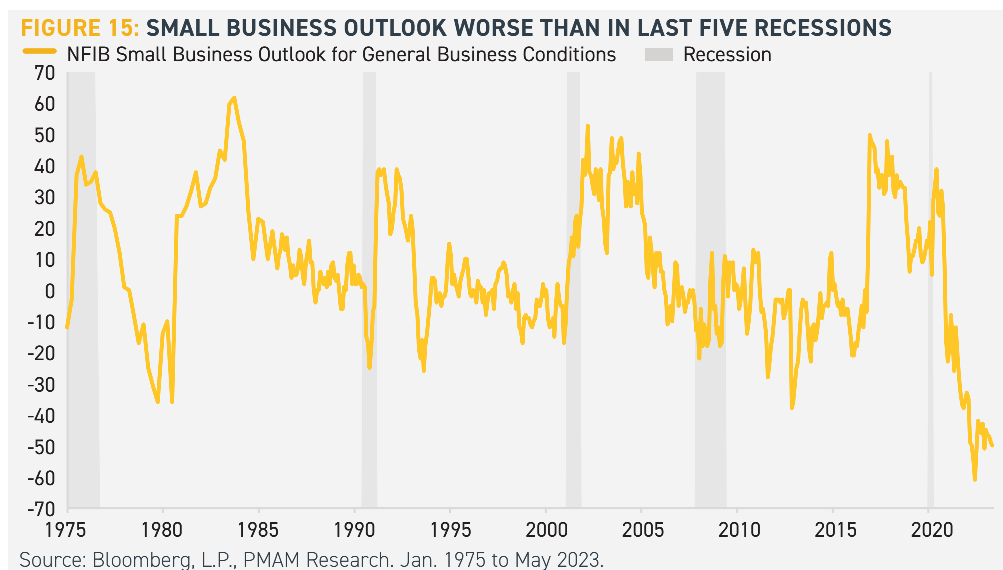
FIGURE 14: SMALL BUSINESS OPTIMISM HAS PLUNGED



Source: Bloomberg, L.P., PMAM Research. Jan. 1975 to May 2023.

Strikingly, small businesses are even more pessimistic about the economy than they were in all the recessions going back to 1975 (Fig. 15).

FIGURE 15: SMALL BUSINESS OUTLOOK WORSE THAN IN LAST FIVE RECESSIONS



Source: Bloomberg, L.P., PMAM Research. Jan. 1975 to May 2023.

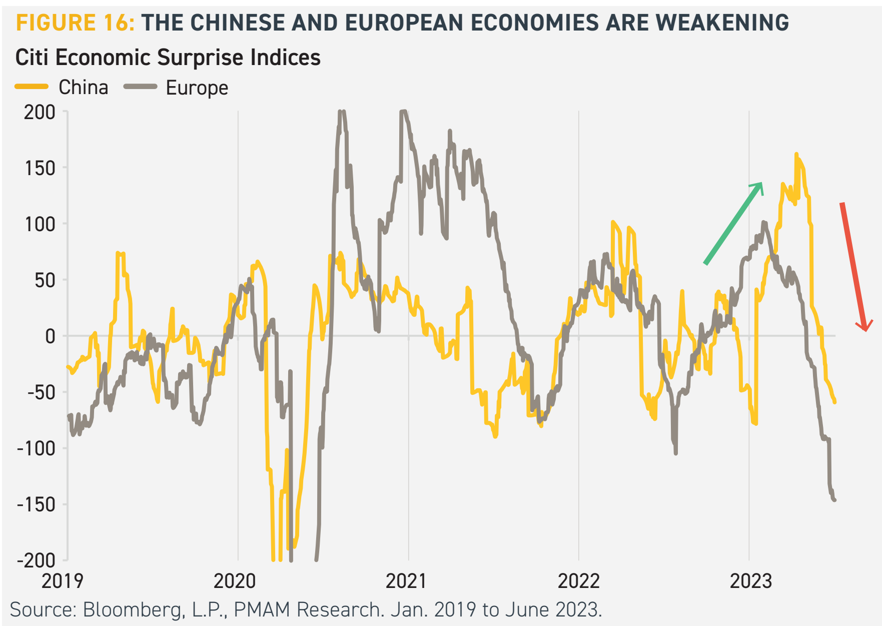
For the economy to continue growing, both the consumer credit and labour markets would need to maintain strength. Yet there's good reason to think both are unsustainable. It stands to reason that the combination of higher interest rates and tighter borrowing conditions should lead to a cooling, followed by an outright decline in consumer credit. Moreover, consumer demand has actually faltered and now lags jobs growth; the upshot is that productivity is falling and unit labour costs are on the rise.

For this dynamic to continue, ABN AMRO's strategists observe, businesses must be willing to accept a compression in profit margins – something they are unlikely to do. They point out that gross layoffs have already risen, a fact that is obscured to some degree because net layoffs are still quite low. Regardless, the strategists note that comparable drops in productivity and rises in gross layoffs have historically led to meaningful job losses on a net basis. As a consequence, more businesses may start making significant job cuts, delivering a one-two punch to both the labour market and consumer spending.

CHINA AND EUROPE FACE A TOUGHER SECOND HALF

Numerous signs suggest that the economic bounces in China and the E.U. are subsiding, leading to a more strained second half for both, and potentially putting further strain on the global economy (Fig. 16).

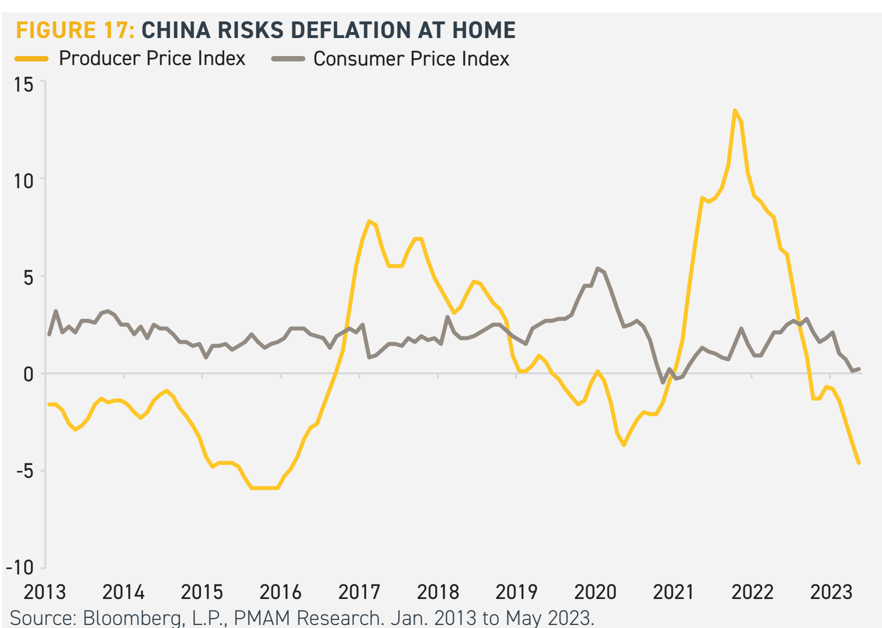
FIGURE 16: THE CHINESE AND EUROPEAN ECONOMIES ARE WEAKENING



Source: Bloomberg, L.P., PMAM Research. Jan. 2019 to June 2023.

Chinese data did improve in the first quarter of 2023 after the country's "stealth" reopening. But weakness in recent macroeconomic data suggests the country is a new source of weakness, rather than growth, for the global economy. In addition to "exporting" deflation, China is now flirting with domestic deflation (Fig. 17).

FIGURE 17: CHINA RISKS DEFLATION AT HOME

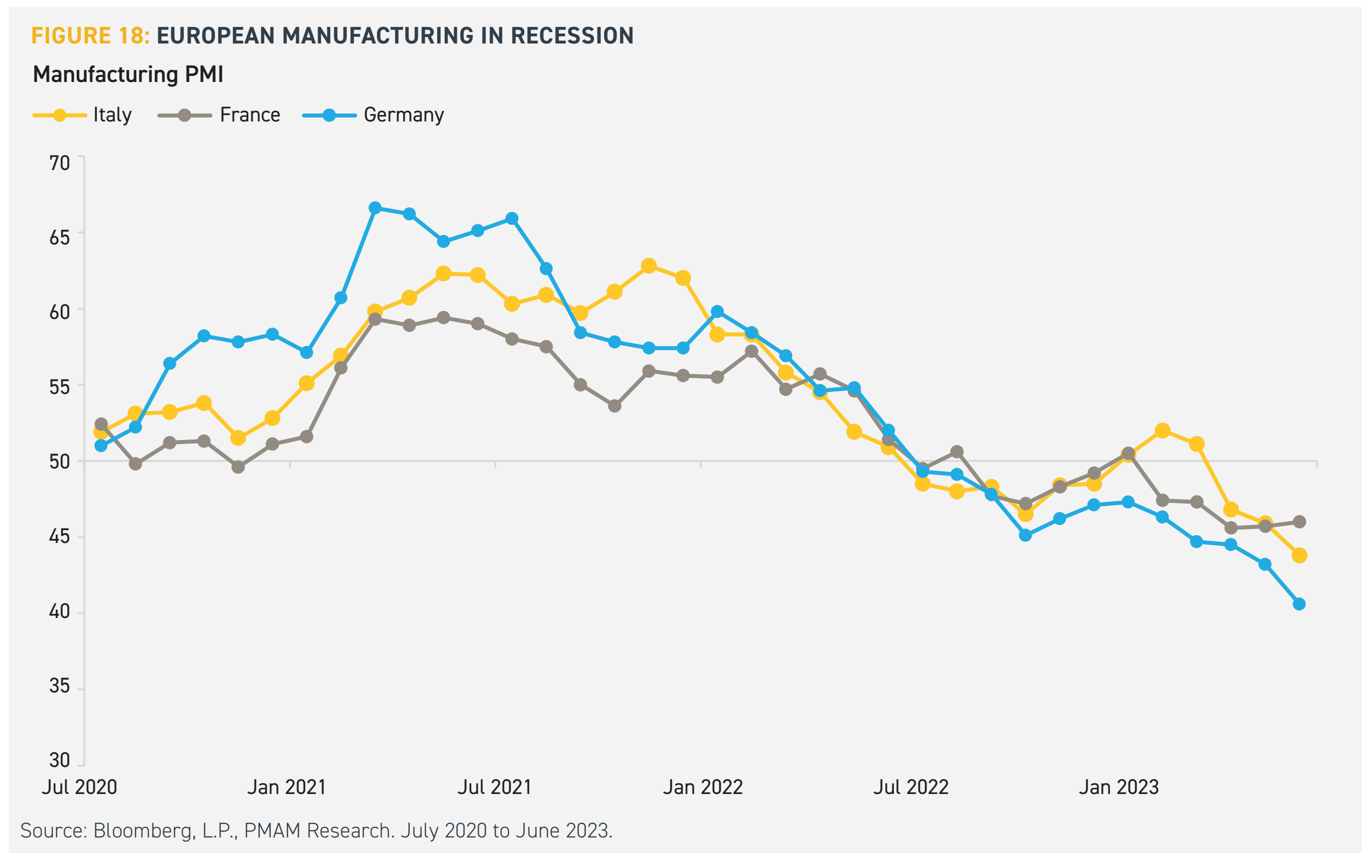


Source: Bloomberg, L.P., PMAM Research. Jan. 2013 to May 2023.

Taiwan's GDP has plunged due to a substantial drop in export orders. This could also be a big concern for the Chinese economy, since Taiwan's economy has often acted as a harbinger for China's.

E.U. economic data, meanwhile, surprised on the upside in the fourth quarter of 2022 and the first quarter of 2023, but are now fading back into negative territory. The region's three largest economies, France, Germany and Italy, have all seen their manufacturing PMIs fall back into contraction (Fig. 18).

FIGURE 18: EUROPEAN MANUFACTURING IN RECESSION



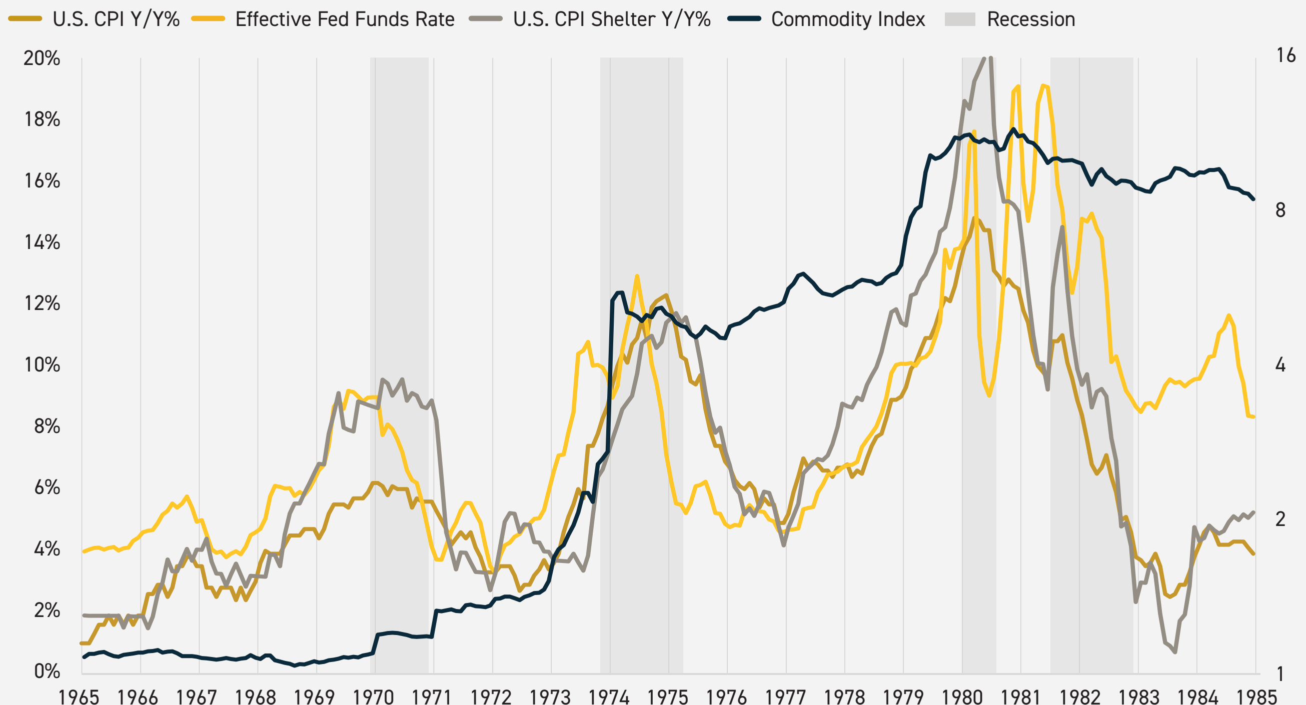
Source: Bloomberg, L.P., PMAM Research. July 2020 to June 2023.

It's important to note that countries such as the U.K., Australia and Canada have seen large increases in fixed mortgage costs, compared with historical levels. The banking systems in these nations, unlike those in the U.S., offer fixed-rate mortgages for terms of only two to five years, after which the rate is reset, largely based on the level of bond yields. At this point in 2023, successive central bank hikes mean that any fixed-rate mortgages coming up for renewal will carry significantly more expensive interest payments. Rates are sometimes two or three times higher than they were when people originally took out their mortgages. Heightened debt servicing costs will significantly weigh on disposable income and, therefore, consumption.

PERHAPS THE FED'S COMMITMENT TO PRICE STABILITY IS UNDERAPPRECIATED

The Fed's aggressive tightening in the face of current disinflation readings shows that the central bank is very concerned that inflation may reignite much more quickly as the economy accelerates – as it did back in the 1970s. Over the past few quarters, we have discussed several of the scarcity parallels that seem to exist between the current environment and that which existed in the 1970s. As in the 1970s, there are currently significant supply issues with labour and housing, as well as developing supply issues in many commodities (Fig. 19). There is little that central banks can do to rectify these issues, other than hammer on demand until it falls into balance.

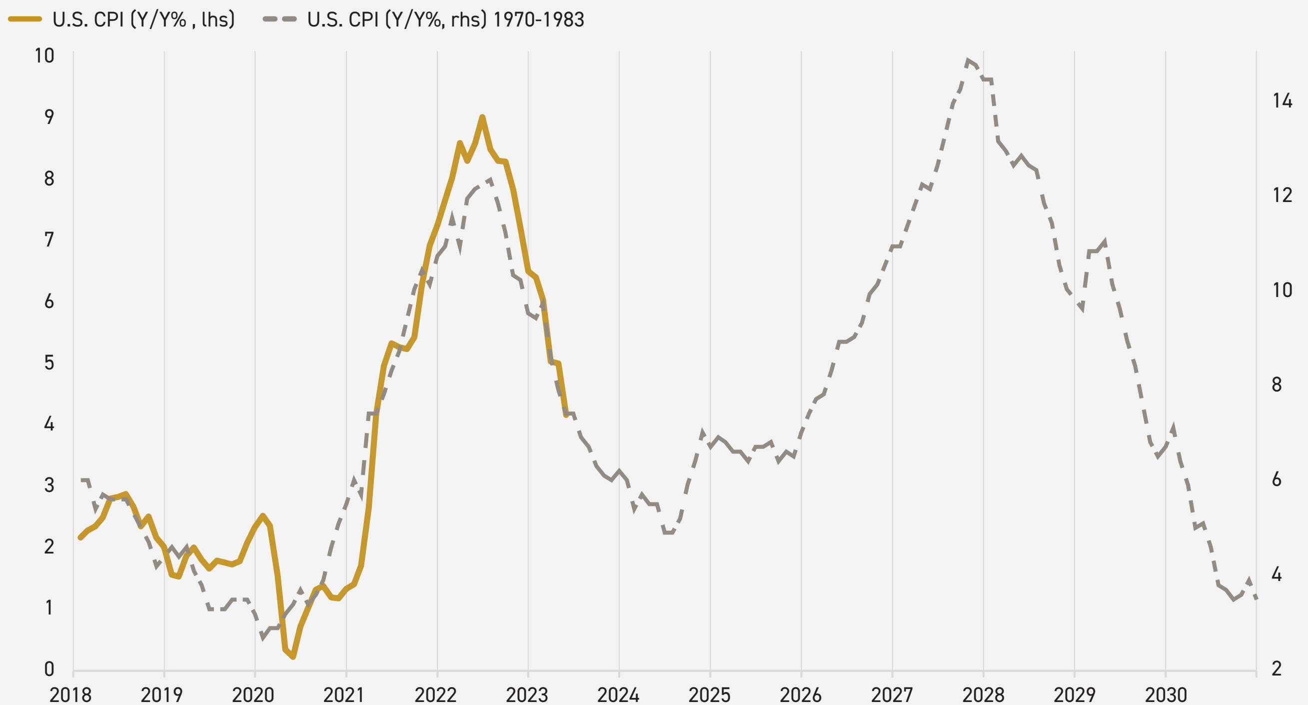
FIGURE 19: ARE WE IN FOR A RERUN OF *THAT '70S SHOW*?



Source: Bloomberg, L.P., PMAM Research. Jan. 1965 to Dec. 1985.

If the Fed wanted to create even more slack to help restrain future inflation, it might be willing to carry out more aggressive tightening than expected, right away, to fight inflation – regardless of the near-term damage it might cause to the economy. Job cuts are something the Fed can control, and are likely part of the Fed's main policy target at this point. Once the job opening rate has been lowered to allow a better match of labour supply and demand, there is not much else the Fed can do to affect inflation. This could help explain why this Fed is talking and acting so much more aggressively than it did in the last couple of recessions: it wants to avoid a repeat of the inflation pattern of the 1970s (Fig. 20).

FIGURE 20: WILL U.S. INFLATION CONTINUE FOLLOWING THE PATH OF THE 1970S?



Source: Bloomberg, L.P., PMAM Research. Jan. 2018 to May 2023.

THE SETUP FOR STOCK MARKETS DOESN'T SEEM ATTRACTIVE HERE

THE LIQUIDITY BOOST FROM DEBT CEILING MEASURES IS SET TO REVERSE

Turning to the markets, we believe that significant expansions in liquidity, both in the U.S. and globally, have acted as a tailwind for both the economy and for risk assets so far in 2023.

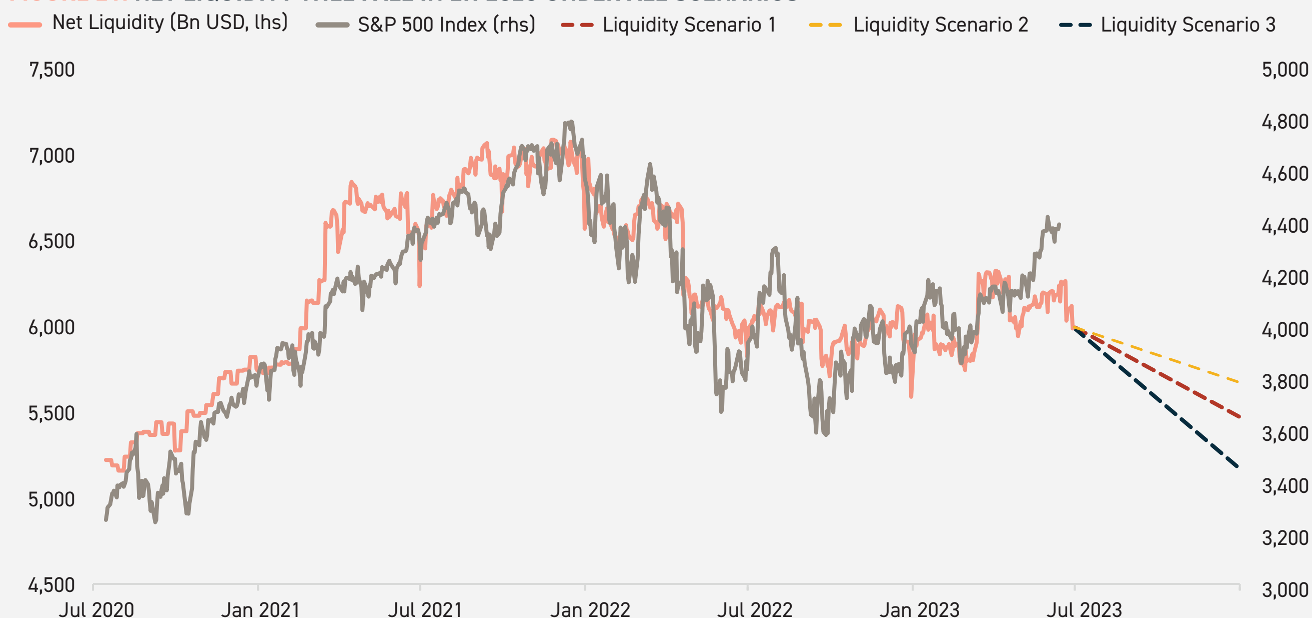
In the wake of the pandemic, the U.S. Treasury significantly expanded its Treasury General Account (TGA) from a customary range of $200–$400 billion to a staggering $1.8 trillion as of July 2020, to finance pandemic-related expenditures. This extraordinary disbursement could be seen as a direct infusion of liquidity into the economy through deposits and reserves. At the same time, the Fed extended the growth of its balance sheet via asset purchases (known as quantitative easing, or QE) until April 2022.

As the tightening process got underway, the Fed modified the terms of its reverse repurchase agreement (RRP) in order to increase program usage and mitigate some of the impacts of over-stimulus. When taken together, changes in the Fed balance sheet (QT/QE), the TGA and the RRP serve as a proxy for changes in U.S. central bank liquidity.

The significance of all this is that despite the Fed's inflation-fighting ambitions, broader liquidity has increased by over $400 billion so far in 2023. Part of this was due to the U.S. Treasury resorting to extraordinary measures as the government hit the statutory debt ceiling. This resulted in a drawdown in the TGA, from just under $500 billion to less than $50 billion by May. Part of it was also due to the response to the regional bank crises in March, when the establishment of the Backstop Temporary Funding Program (BTFP) also led to an expansion of the Fed's balance sheet.

The S&P 500 Index has traded roughly in line with changes in broad liquidity since the summer of 2020, although with a short lag. Throughout 2023, the equity market's relationship with changes in broad liquidity has persisted (at least until the most recent spike in equities at the end of the second quarter) (Fig. 21).

FIGURE 21: NET LIQUIDITY WILL FALL IN 2H 2023 UNDER ALL SCENARIOS



NET LIQUIDITY SCENARIO ANALYSIS

Forecast period	*2023E*		
Period ending	*2023-12-31*		
	Scenario 1	**Scenario 2**	**Scenario 3**
Net Liquidity, June 30	5,995	5,995	5,995
FED BS	-567	-567	-567
RRP	-333	-532	-34
TGA	290	290	290
Net Liquidity, December 31	**5,471**	**5,670**	**5,173**
% Change	*-8.7%*	*-5.4%*	*-13.7%*

| **Scenario 1:** Base case, $95B/month Fed BS drawdown, $1.6T RRP and $700B in TGA by December

| **Scenario 2:** Faster drawdown in RRP

| **Scenario 3:** Sticky RRP

Source: Bloomberg, L.P., PMAM Research. July 2020 to July 2023.

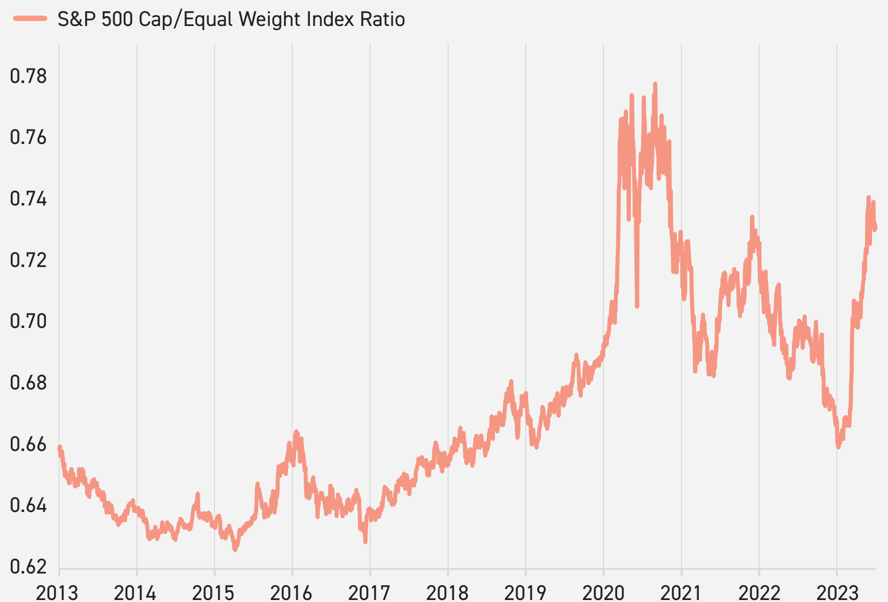
However, broad liquidity is now likely set to decline through the second half of 2023. With the debt ceiling now extended, the U.S. Treasury has indicated that it will rebuild its TGA to a year-end target of $700 billion. The unwinding of the Fed balance sheet (QT) is set to continue at a pace that will target $95 billion per month. These are considerable liquidity-draining measures. A number of complicated dynamics will likely affect these liquidity changes in the second half of 2023; detailed analysis is beyond the scope of this review, but the chart above takes into account a number of the related scenarios. It is sufficient to say that, all else being equal, we expect the net impacts of changes in liquidity will tend to create headwinds for risk assets in the second half of the year.

MARKET BREADTH IS POOR

While the S&P 500 has rallied by approximately 20% off its October lows – a rally that is the traditional signal of a new bull market – we believe the internal dynamics of the stock market reveal reasons for caution. U.S. markets are being driven by a narrow mega-tech leadership that is benefiting from the recent craze for generative AI. In contrast, average stocks are performing much worse. Figure 22 shows the performance of the cap-weighted S&P 500 Index versus the equal-weight S&P 500 Index.

Another concern is the composition of the sectors driving the stock market rally. For instance, bank stocks have not participated in this rally for the most part. This is at odds with the beginning of true bull markets, historically.

FIGURE 22: THE EQUAL-WEIGHT S&P 500 IS UNDERPERFORMING SIGNIFICANTLY

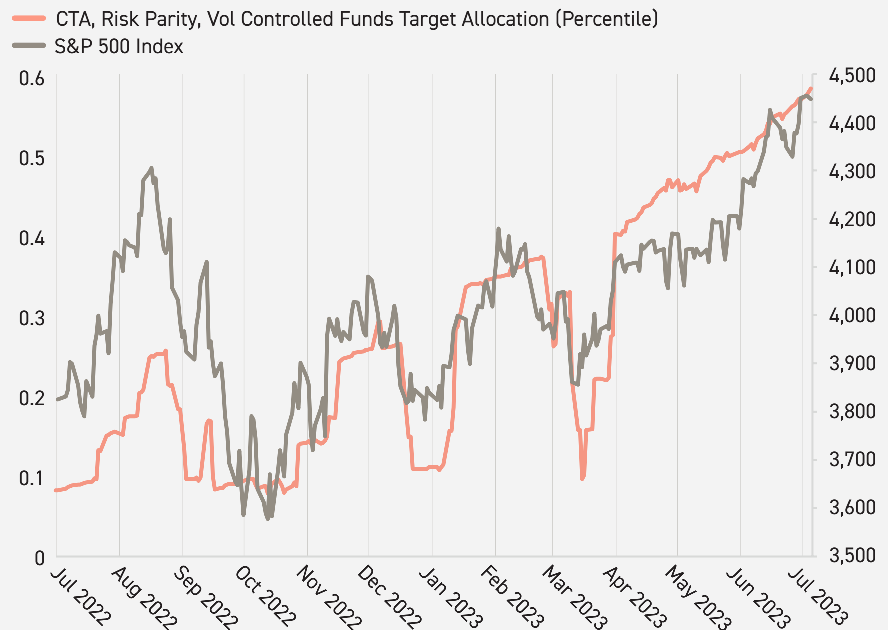


Source: Bloomberg, L.P., PMAM Research. Jan. 2013 to June 2023.

POSITIONING IS BULLISH AND EXTENDED

As for flows and positioning, it appears that systematic investment strategies were strong buyers of equities as volatility declined and stock market momentum moved higher. They may now be approaching their maximum long positions, which will likely translate to markets having limited extra fuel (Fig. 23). This could also turn these buyers into a key source of selling if volatility increases or stock markets begin to decline.

FIGURE 23: SYSTEMATIC POSITIONING IN U.S. EQUITIES SEEMS MAXED OUT

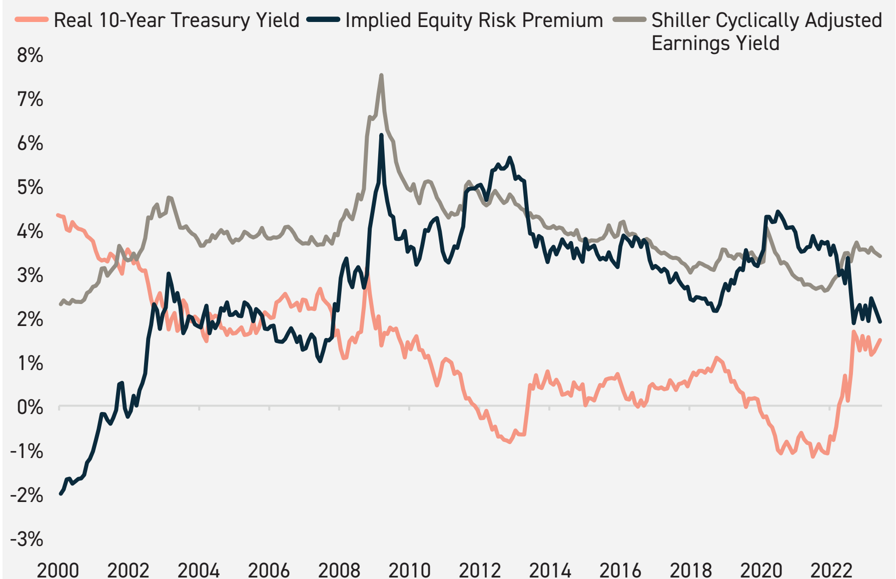


Source: Bloomberg, L.P., PMAM Research. July 2022 to July 2023.

EQUITY VALUATIONS ARE UNATTRACTIVE

The recent surge in equities has occurred against the backdrop of higher short- and long-term interest rates. As a result, stock market valuations are not particularly attractive, especially when compared with current levels of interest rates. Figure 24 compares the earnings yield of the S&P 500 Index (based on 10-year average earnings) with 10-year real interest rates. The difference between them can be referred to as an implied equity risk premium (ERP). This ERP is now approaching lows not seen since the great financial crisis (GFC) in 2008.

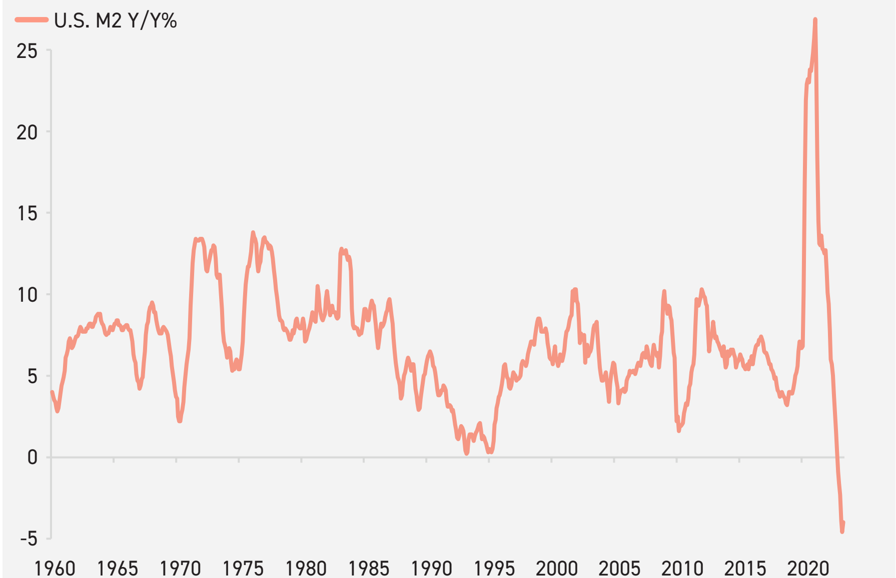
FIGURE 24: IMPLIED EQUITY RISK PREMIUMS HAVE FALLEN TO UNATTRACTIVE LEVELS



Source: Bloomberg, L.P., PMAM Research. Jan. 2000 to June 2023.

It is worth noting that monetary policy is dramatically different now than it has been since the GFC, with money no longer free and abundant. A key metric for this, U.S. money supply (M2), is contracting at the fastest pace since the 1950s, although this follows a dramatic increase throughout the pandemic (Fig. 25).

FIGURE 25: AN UNHEARD-OF DECLINE IN M2

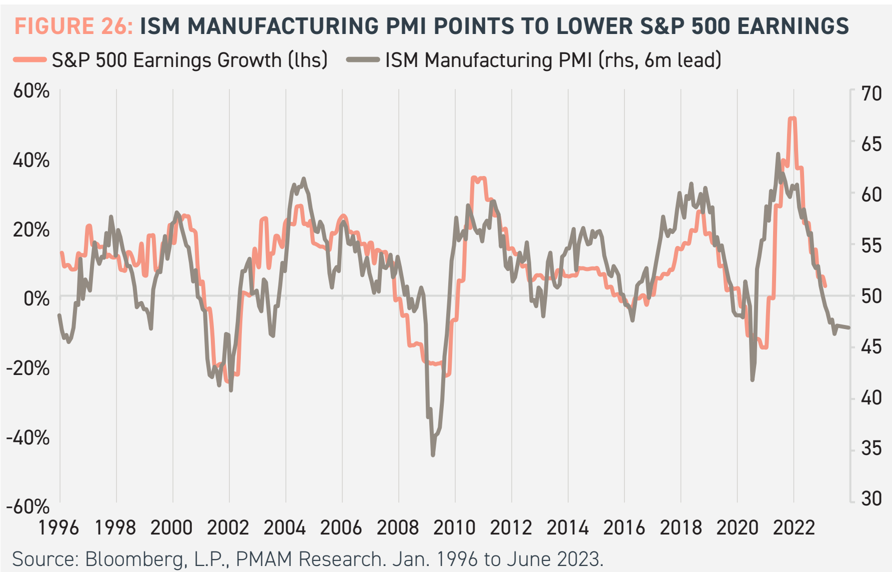


Source: Bloomberg, L.P., PMAM Research. Jan. 1960 to May 2023.

POTENTIAL DOWNSIDE IN EARNINGS FORECASTS

Stock markets are also expensive based on one-year-ahead earnings forecasts, and will appear even more expensive if these forecasts deteriorate. The current level of the ISM manufacturing PMI suggests that S&P 500 earnings could end the year down 10% (Fig. 26). Granted, this would be fairly mild compared with past earnings recessions, but it assumes no further deterioration in expectations.

FIGURE 26: ISM MANUFACTURING PMI POINTS TO LOWER S&P 500 EARNINGS



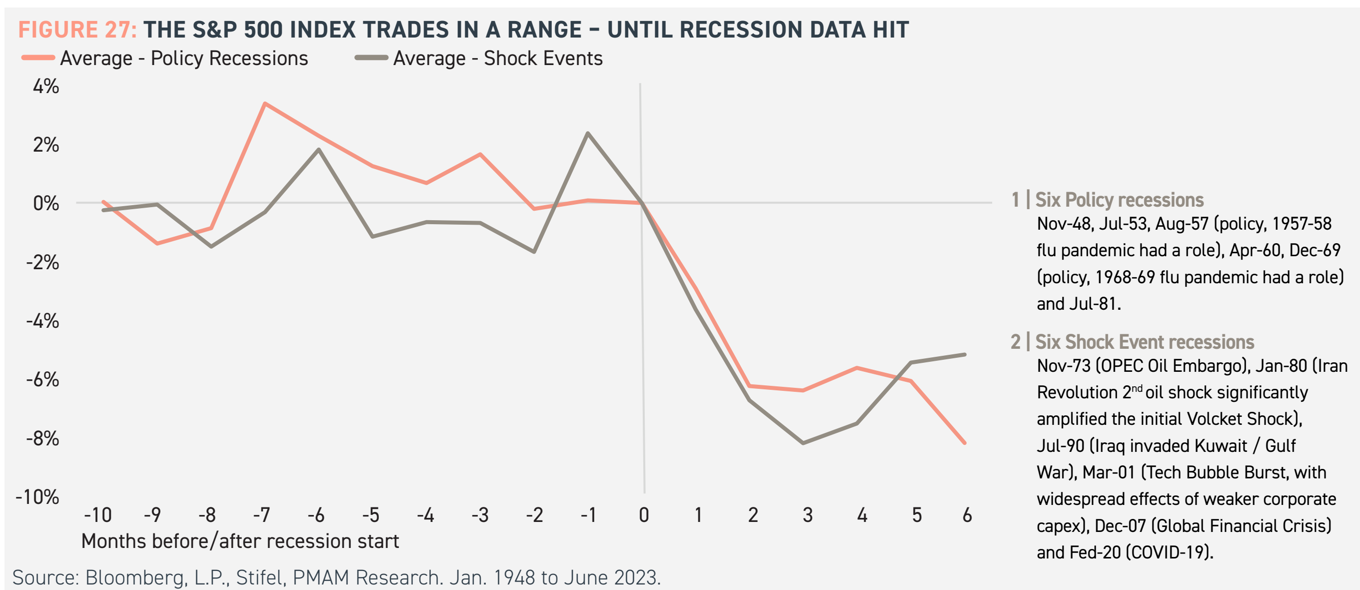
Source: Bloomberg, L.P., PMAM Research. Jan. 1996 to June 2023.

IT IS WHAT IT IS – UNTIL IT ISN'T

Markets seem to be pricing in a soft landing or a mild recession followed by solid recovery. Based on Bloomberg's consensus economic data as of June 2023, investors expect GDP growth to fall to -0.5% for two quarters before the economy bounces back in 2024. Somehow, the recovery is expected to occur despite the fact that leading indicators continue to deteriorate, liquidity is poised to deteriorate, and the Fed speaks of increasing rates further this year, after its recent pause.

An economy can seem fine right up to the moment when it falls apart, and so too can the equity markets. Barry Bannister at Stifel Financial Corp. makes the case that markets have historically remained buoyant until an actual recession hits (Fig. 27). At that point, it doesn't matter whether the recession is "shock driven" or "policy driven": markets tend to tumble fairly quickly thereafter.

FIGURE 27: THE S&P 500 INDEX TRADES IN A RANGE – UNTIL RECESSION DATA HIT



Source: Bloomberg, L.P., Stifel, PMAM Research. Jan. 1948 to June 2023.

We are concerned that this scenario could play out again. From our vantage point, at the midpoint of 2023, we are certainly considering a recession much more likely than the rest of market does.

CONCLUSION

AN UNFAVOURABLE SETUP WARRANTS CAUTION AGAINST AN UNCERTAIN BACKDROP

We will likely approach a fork in the road in the second half of this year. Either the economy will enter a recession and the markets will correct, maybe even significantly, or the economy will manage to pull off a soft landing and equities will sustain their current gains and continue trending upwards over time. We are open to the possibility of a soft economic landing – but that said, our base case is for a recession.

Given that the current setup isn't particularly favourable for markets, we believe caution is warranted. Investors are becoming complacent. It is possible that many of those who expected a recession to start earlier this year have been forced to revise their views and have been putting their money to work to avoid falling farther behind. However, just because a recession has yet to materialize doesn't mean it won't: a number of unusual factors may be delaying its onset.

As noted, we believe the odds of a recession and a market pullback are higher than the odds of an economic soft landing and a new bull market. Given recent performance, a hard landing – although it is now decidedly a minority expectation – will be even more threatening should it occur.

We would therefore expect to see a higher probability of significant pullback than a significant rally from this point forward. Markets could indeed meander higher for a quarter or two, but we think they might then pull back quickly and, perhaps, sharply.

SECTOR OUTLOOKS

INDUSTRIALS

The Purchasing Managers' Index, multi-industry organic growth, transport rates, machinery demand and many other industrial economic indicators have continued to improve. More recently, we've seen lower-quality cyclical names rally on the view that the cycle could be bottoming out and that the Industrials sector may be headed for a soft landing. Erring on the sign of conservativism, we have cautiously increased our short positions in more expensive multi-industrial/transport names recently, while also hedging cyclical long positions in broader secular themes. We are confident that the businesses we like – including those with cyclical exposure – will continue to meet our long-term return thresholds.

We continue to favour companies with a history of compounding, catalyst-driven idiosyncratic growth angles and/or opportunities to improve structural returns on invested capital. Waste Connections Inc. (TSX:WCN), WSP Global Inc. (TSX:WSP) and Toromont Industries Ltd. (TSX:TIH) remain preferred names, given their previous high rates of internal return and their ability to grow free cash flow through cycles. We continue to like Canadian Pacific Railway Ltd.'s (TSX:CP) idiosyncratic story. The U.S. Surface Transportation Board approved the Canadian Pacific Railway Ltd.'s acquisition of Kansas City Southern on March 15, 2023. We believe the synergies from the generational acquisition will surpass expectations in both timing and magnitude. We continue to like ATS Corporation (TSX:ATS), based on the broader automation/onshoring theme, the business mix shift toward life sciences, its consistent contract wins and its margin improvement story. Despite near-term macro weakness, we remain bullish on the industrial leasing complex in the long term. We believe the names we hold that are exposed to rentals, such as United Rentals Inc. (NYSE:URI) and, to a lesser extent, Willscot Mobile Mini Holdings Corp. (NASDAQ:WSC), will continue to outperform over the longer term. We've hedged the cyclicality of rentals with less attractive names that have similar exposures. Lastly, we see potential downward earning revisions across the freight landscape and have added short positions in brokerage and ground transportation accordingly.

MATERIALS

The S&P/TSX Materials sector was under pressure for much of the second quarter, underperforming the broader S&P/TSX Composite Index. The sector faced headwinds from a disappointing reopening recovery in China, as well as the market pushing back its expectations for a more accommodative monetary policy. Lumber names outperformed the group on better-than-expected housing demand, supply curtailments and forest fire risks, and supportive valuations. Copper equities were also supported by merger and acquisition (M&A) interest and expectations of Chinese stimulus. Precious metals names were under pressure from a more hawkish U.S. Federal Reserve (Fed) and declining investor interest. Fertilizers underperformed as crop prices trended down and demand remained weak.

While near-term macro risks could persist for copper, we believe the demand picture has remained stronger than the market appreciates, and we think ongoing M&A interest could support higher through-cycle valuations. We are starting to see initial signs of improvement in the fertilizer market, as well as more compelling valuations, but we are waiting for clearer catalysts before becoming more involved. We expect gold to continue to be driven by macro factors, in particular the ongoing wait for more indications of a dovish pivot by the Fed. We note that equity underperformance relative to the commodity could provide an opportunity if cost pressures start to ease and gold remains steady.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index increased 14.5% for the second quarter of 2023, while the Information Technology sector in the S&P/TSX Composite index increased 16.8%. Sector performance remained strong following the first quarter of 2023 as markets began focusing on the potential benefits of generative artificial intelligence. Broader technology spending trends also remained stable. Semiconductors was the best-performing subsector, up 23.3%, led by Nvidia Corp (NASDAQ:NVDA), followed by interactive media and services, up 21.4%, led by Meta Platforms Inc. (NASDAQ:META). The weakest subsectors in the second quarter were communications equipment, down 1.0%, and electrical equipment, up 0.6%, led by weakness in Juniper Networks Inc. (NYSE:JNPR) and Teledyne Technologies Inc. (NYSE:TDY) respectively.

Our outlook for Information Technology in the third quarter of 2023 is one of relative caution as stocks have performed strongly while overall technology spending is unlikely to rebound quickly this year. Yet if the macroeconomic environment can remain stable, investors will look ahead to the potential for upside growth in 2024. We like Aehr Test Systems (NASDAQ:AEHR), a leading provider of test systems for compound semiconductor devices including silicon carbide whose usage has increased significantly in automotive applications for electric vehicles due to its superior performance at high voltages. Test times for these devices have increased due to stringent reliability requirements by automakers, and Aehr Test Systems is the leader in testing multiple silicon carbide wafers in parallel, which is more cost effective. Aehr Test Systems should be a beneficiary as significant investments are being made to increase silicon carbide production, which will require increased testing.

HEALTH CARE

There is a lack of consensus in investor sentiment on Health Care sector performance, and it is expected to remain mixed for the remainder of the year. A recent investor survey at the Goldman Sachs Healthcare Conference suggests that less than 50% of the participants expect the sector to outperform.[2] The S&P 500 Health Care sector, down 3.10% year-to-date (YTD), underperformed the overall S&P 500 Index, up 15.9%. Factors weighing on sector performance are consistent with previous quarters: macro rotations, recession landing, presidential election-related anxieties, drug price legislation, uncertainties related to the Inflation Reduction Act (IRA) and regulatory risks with M&A activities. The more cyclical health care verticals (medical technology, up 5.92% YTD; animal health, down 0.8%; dental and vision care, up 13.2%; genomics, up 21.2%; hospitals, up 15.8%) are outperforming, while the more defensive subsectors, which outperformed last year, are underperforming: Health Care Select Sector SPDR Fund (NYSE:XLV) down 3.1%; large-cap biopharmaceutical down 4.1%; services up 2.5%; pharmaceutical distributors down 6.9%; managed care down 12.8%.

At the subsector level, stabilizing and increasing procedure volumes is having a positive impact on medical technology and supplies stocks (S&P 500 Health Care Equipment & Services Index up 7.5% YTD) but is pressuring managed care stocks (MCO, S&P 500 Managed Health Care Index down 13.0%) on fears that increased utilization will have a negative impact on earnings. UnitedHealth Group Incorporated (NYSE:UNH; down 9.86%) led the decline in mid-June, following comments on increased utilization of elective procedures by seniors (Medicare business) as pent-up and delayed demands were being satisfied. Other MCOs recently reiterated confidence in the previous guidance on cost trends, and Humana Inc. (NYSE:HUM; down 12.9%), with about two-thirds of its profits coming from the Medicare Advantage plans, recently reiterated their second-quarter medical loss ratio (MLR) guidance. With cost management, MCOs could still meet their year-end earnings guidance, albeit at the low end of the range. The backlog catch-up in pent-up elective surgery demand will not abate in just one quarter, given the sheer volume of procedures that had been put off during the pandemic period. Accordingly, MCOs are expected to build this into their 2024 plan design, for prudence. Medicaid redetermination, initiated in April, is also an overhang on the Medicaid-levered MCOs as companies determine the readjusted size of their book of business. Improving utilization has also boosted sentiment in procedure-levered verticals, hospitals and surgical centres (up 15.8%).

The life sciences and tools subsector has not fared well (down 4.63% YTD): the bioprocessing inventory destocking continues and is now expected to persist past year-end into early 2024, and the biotech funding environment is expected to remain depressed through 2023. Bioprocessing-leveraged stocks (including NYSE:TMO, down 5.73%; NYSE:DHR, down 10.8%; NYSE:AVTR, down 3.60%; NYSE:RGEN, down 16.1%) are down, on average, in the high single-digit range.

A defensive subsector, large-cap U.S. biopharmaceuticals, is underperforming (down about 4.3%) overall, with a few

[2] The Goldman Sachs 44th Annual Global Healthcare Conference, June 12-15, 2023.

outperformers: Eli Lilly and Company (NYSE:LLY), up 26.1%; Vertex Pharmaceuticals Incorporated (NYSE:VRTX), up 20.4%; Regeneron Pharmaceuticals, Inc. (NYSE:REGN), down 0.5%; and Biogen Inc. (NYSE:BIIB), up 3.1%. Numerous uncertainties regarding the implementation and impact of the drug pricing issue (under the IRA legislation) continue to hamper the price performance of large-cap biopharmaceutical stocks. The Center of Medicare and Services (CMS) will not provide specifics on the negotiated prices for the initial set of ten drugs until 2024, which are expected to vary on a drug-by-drug basis.

The small- and mid-cap biopharmaceuticals (SMID caps) are showing signs of recovery (SPDR S&P Biotech ETF [NYSE:XBI], up about 6.6% since mid-March), despite tight funding and the high-interest-rate environment. Even the non-commercial companies are showing some signs of recovery, up 1.2% compared with a decline of 11.7% last quarter. The recovery appears to be largely due to M&A activity. Given the end-of-decade patent cliff for large-cap players, they have a fundamental need to carry out M&A to shore up their revenue streams, and they have the strong balance sheets to support such activities. Acquisition targets are primarily companies with late-stage or commercial assets, since these targets will be able to support the acquirers' revenue growth profile (e.g., Pfizer-Seagen; Sanofi-Provention Bio; Amgen-Horizon Therapeutics; Pfizer-Biohaven; Astellas-IVERIC Bio; Merck-Prometheus Biosciences). The early-stage assets are being targeted more by companies that are not facing a near- to mid-term patent cliff, e.g., LLY's recent acquisition of Dice Therapeutics (NASDAQ:DICE).

CONSUMER DISCRETIONARY

The second quarter was mixed for the Consumer Discretionary sector. First-quarter earnings were reasonably strong to start, particularly within the travel, homebuilding and restaurant industries, but in the second half of the first-quarter calendar, retailers reported slowing trends, leading to broad-based relative underperformance. Notably, commentary from management teams was much more cautious, reflecting tepid first-quarter exit and second-quarter entry rates, and suggesting that consumer spending did ease toward the end of the quarter. This seemed to occur across the income spectrum, with choppy demand from both higher-income and low-income households.

However, discretionary stocks, along with other cyclical groups, rebounded strongly in early June, driven by a combination of market positioning, better employment data, some signs of stabilizing consumer spending trends in May, and investor anticipation of easier summer comparisons as consumers lap last year's elevated gas prices. Still, we remain cautious on the sector as a whole. Despite strong headline labour readings, slowing retail sales suggest cracks are forming. In addition, excess COVID savings that had been meaningfully depleted over the last 12 months are now surging higher. While positive for household balance sheets, this also seems to signal a pullback in spending intentions. Should the economic weakness spread to the job front – and the decrease in U.S. Job Openings and Labor Turnover Survey (JOLTS) job openings suggests this is ever so slowly starting to happen – the overall health of the consumer is likely to get worse before it gets better.

We remain focused on owning high-quality, structural growth stories that share some combination of the following characteristics: company-specific pricing strategies/drivers, structural growth, clean inventory levels, strong balance sheets and free cash-flow generation. These include stocks such as Thomson Reuters Corporation (TSX:TRI) and Restaurant Brands International Inc. (TSX:QSR). We will also look to add opportunistically to small positions in cyclical positive change stories such as BRP Inc. (TSX:DOO) should a soft landing appear more likely.

CONSUMER STAPLES

After outperforming the broad market since early 2022, Canadian and U.S. Consumer Staples underperformed by 4% and 8%, respectively, during the second quarter. We believe the underperformance was driven by a "risk on" rotation that saw Consumer Staples being used as a source of funds.

We saw a strong gross margin inflection for the sector in the first quarter as higher pricing caught up with inflationary cost pressures. However, Walmart Inc. (NYSE:WMT) emphasized on its earnings call that grocery prices need to come down. Investors have become apprehensive that consumer packaged goods (CPGs) will have to give back some of the significant pricing they took since inflation started to spike in 2021.

In Canada, we remain positive on Alimentation Couche-Tard Inc. (TSX:ATD). Fuel margins have shown structural improvement since the onset of the pandemic as the fuel operator industry has become more disciplined. ATD has put its healthy balance sheet to work, recently making acquisitions in both Europe and the U.S. We believe we see further M&A on the horizon. In addition, the company's Investor Day in October should act as

another positive catalyst. We view ATD as a quality long-term compounder with more dry powder to roll up the fragmented convenience store industry.

In the U.S., we remain positive on Bellring Brands Inc. (NYSE:BRBR), which has significant protein shake capacity coming online in 2023–24 to support double-digit sales growth, while its CPG peers are facing decelerating growth. We also gravitate toward multinationals that are less prone to pricing pushbacks, such as Mondelez International Inc. (NYSE:MDLZ) and Colgate-Palmolive Co. (NYSE:CL).

FINANCIALS

The year 2023 continues to be a rollercoaster for Financials, most notably bank stocks. What began as a strong start to the year quickly reversed itself when the markets witnessed a liquidity crisis at Silicon Valley Bank and Signature Bank, which resulted in both banks being put into receivership by the Federal Deposit Insurance Corporation (FDIC). These were truly unprecedented bank runs and sent shockwaves throughout the global banking landscape. Although the bank failures were arguably idiosyncratic, the events further strengthen our view that the banking system remains at risk of deposit outflows and a remixing into higher costs of funds, given the monetary policy tightening at play (450 basis points-plus of cumulative rate hikes in the past year alongside quantitative tightening).

We remain cautious on banks, as yield curves remain inverted, net interest margins seem to have largely peaked, loan growth continues to moderate, deposits are outflowing, credit losses are at trough levels, and capital levels remain relatively thin – something with which regulators on both sides of the border increasingly seem to be taking issue.

Additionally, we believe that there will continue to be major repercussions over the medium term resulting from the regional bank liquidity crisis. We believe that liquidity rules for mid-sized regional banks will likely be tightened, and they will no longer be able to opt out of including unrealized losses on available-for-sale securities in capital. Additionally, we believe that lending standards will continue to tighten more aggressively, which tends to lead the credit cycle.

We favour less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop. Element Fleet Management Corp. (TSX:EFN) and Trisura Group Ltd. (TSX:TSU) are two such companies. Element Fleet Management Corp. (formerly Element Financial Corp.) is a successful restructuring story that is now in the early innings of its pivot-to-growth strategy, generating significant free cash flow, and Trisura Group Ltd. is a fast-growing North American specialty lines insurance business that is benefiting from market share gains and strong profitability in both Canada and the U.S., with a well-constructed growth plan to double its book value over the coming five years.

COMMUNICATION SERVICES

At the aggregate level, sector performance was largely in line with the overall market: an equally weighted portfolio of BCE Inc. (TSX:BCE), Rogers Communications Inc. (TSX:RCI/B), Telus Corporation (TSX:T), Quebecor Inc. (TSX:QBR/B) and Cogeco Communications (TSX:CCA) nudged higher by about 70bps, compared with a 110bps move in the TSX Composite.

However, it was anything but quiet in telco and cable land. We had previously said:

> In the near term, we expect the environment for wireless to remain healthy, driven primarily by immigration and increased wireless penetration (second devices, as well as an increasingly lower age of entry), and also that wireline will remain highly contested as telcos look to monetize their fibre rollout. In the medium to long term, we are unsure about the level of competitive intensity, and it is something we will continue to monitor.

So, while the ratcheting up of competitive intensity was not outside of our expectations, what was surprising was the timeline. That said, after our discussions with multiple telecom managements at conferences, we are more comfortable that the industry is unlikely to engage in a race to the bottom with regards to pricing, and that companies are doing their best to meet their commitment (to government) to lower prices while not structurally damaging the profitability of the industry. While we are not dismissing some of the concerns that have emerged and that we are monitoring, we are currently confident that the chances of sliding into a price war are low, given that Rogers has high leverage, BCE and Telus are in harvest mode following substantial capex, and Quebecor is not yet fully ready to compete on the wireless front.

Our favourite name, Rogers, was the worst-performing stock in the second quarter, down 6%, given that it has the most exposure to wireless. We still maintain our positive view, given that the deal with Shaw Communications Inc. just closed and the accretion from synergies (estimated to be C$1 billion) is entirely in front of us, and that Rogers' current valuation (EV/EBITDA) is at a discount to that of BCE.

UTILITIES

It was a soft quarter for Canadian utilities, which underperformed the S&P/TSX Composite Index by about 275 bps. With regard to our top picks, it was a solid quarter: both AltaGas Ltd. (TSX:ALA) and Brookfield Infrastructure Partners L.P. (TSX:BIP-U) delivered ~7% thereby outperforming the TSX Utilities index and the TSX Composite.

AltaGas offers a relatively derisked earnings profile in 2023, with 62% of its export volumes hedged for 2023, and 71% and 76% hedged for the seasonally weaker second and third quarters, respectively. It is also attractively valued, at about 12.7x P/E based on the 2023 expected EPS of CA$1.90. We were also encouraged by two developments: 1) an announcement that Vern Yu will be the new CEO beginning July 1, 2023; and 2) positive language relating to the Mountain Valley Pipeline (MVP) project. Mr. Yu comes from Enbridge Inc. (TSX:ENB), where he served as CFO, and is well regarded by investors. We view the appointment as one that should add to the credibility of the AltaGas story. On the MVP, we view the elevated odds of a completion as positive, because it will be a blue-chip asset, given the contracting profile, and a non-core asset for AltaGas – a sale candidate that should quicken the pace of delevering for AltaGas.

BIP announced an additional sell-down (12.5%) in NGPL, the largest transporter of natural gas into the Chicago area market and one of the largest interstate pipeline systems in the USA, to ArcLight Capital Partners at valuations consistent with the previous sell-down (also for 12.5%) in early 2021. BIP also sold its ownership in One New Zealand to Infratil Limited (IFT-NZ) for gross proceeds of US$270 million. Given questions in the market regarding BIP's ability to dispose of assets, we believe that these disposition announcements made during quarter – at healthy valuations – should help assuage market concerns.

REAL ESTATE

We mentioned in the first quarter of 2023 that we were surprised that REITs were not even weaker than they already were, given macro concerns, and we remain concerned about the group, given the impact of higher rates on forward estimates and asset valuations. Consistent with our views, REITs had a tough second quarter, underperforming the S&P/TSX Composite Index by about 460 bps.

It was another stellar quarter, however, for our top pick, Boardwalk REIT (TSX:BEI-U), which returned 13.3%. Our optimism remains unchanged for a number of reasons: 1) Boardwalk's superior track record of execution, as evidenced by the fact that Boardwalk delivered positive FFO/share growth even in 2020; 2) favourable and increasingly consistent migration trends into Alberta; 3) affordability; 4) a healthy FFO/share growth of about 8% in 2023, which we view as attainable with reasonable confidence; and 5) a favourable valuation relative to peers.

Colliers (TSX:CIGI) also remains a favourite. We have mentioned that we didn't expect 2023 to be a year of smooth sailing, given the potential for a slowdown in transaction activity, but that notwithstanding any turbulence, we remained positive, given long-term outlook for growing market share, as well as Colliers' ability to compound in the low to mid double-digits over the medium to long term. Turbulence did indeed hit in the second quarter, with Colliers lowering guidance for 2023 due to weaker-than-expected capital markets activity, and the stock declined by 8.7% for the quarter, thereby retracing most of its gains in Q1/23. Looking ahead to the remainder of 2023, we won't be surprised to see weakness in capital markets get worse, given the continued hawkish stance of central banks across the world, but we would view any such weakness in the stock as a long-term buying opportunity, not as something that alters our investment thesis.

ENERGY

In the oil market, prices remained relatively flat over the quarter as the market weighed negative macro concerns. However, the announcement of additional production cuts by OPEC (Organization of the Petroleum Exporting Countries) helped stabilize the market to some extent. Notably, OPEC revealed that Saudi Arabia would implement an additional voluntary cut of one million barrels per day, demonstrating the organization's commitment to market stability. Despite these efforts, ongoing macro worries and soured sentiment weighed on energy equities.

One area of change we anticipate over the next year is in the refining complex. The years 2023 and 2024 will be significant for global refinery capacity additions. These additions will have implications for product spreads and crude pricing differentials. It is worth noting that the net refining capacity additions projected for the next two years will be the largest single two-year period additions dating back to 1977, spanning 45 years. As a result, we have a negative outlook on pure play refiners, and expect that narrow heavy oil differentials will benefit our long position in MEG Energy Corp. (TSX:MEG-CN).

In the natural gas market, pricing rallied during the period, but remains depressed overall. Weather conditions remain a wildcard for natural gas pricing. A hotter summer, combined with bearish sentiment on natural gas equities, could lead to a rally in natural gas names. Our preference in natural gas remains Tourmaline Oil Corp (TSX:TOU-CN).

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