PICTON MAHONEY
Asset Management

Q3 2022

INVESTMENT REVIEW & OUTLOOK

Inflation looks set to fall, the economy is likely to waver, but stocks may rally

SIGNIFICANT HEADWINDS REMAIN IN PLACE

INFLATION IS SET TO FALL SIGNIFICANTLY THROUGH 2023. THE QUESTION IS HOW IT GETS THERE.

RECESSION FEARS BUILDING

CHINA TO THE RESCUE?

EMERGING TAILWINDS TO LIFT STOCKS

OVERVIEW

The thesis that we have outlined over the last few quarters remains generally intact. We still believe that the headwinds that roiled risk assets in the first half of the year will eventually turn into tailwinds sometime in the second half of the year. We are confident that the U.S. Federal Reserve (the Fed) will follow through on its commitment to do whatever it takes to get inflation down to its targeted range in 2023, although this will likely come with increased risks of recession. The question is whether inflation expectations will fall soon enough to allow the Fed to back off its aggressive tightening posture before the economy is seriously affected.

Given peaking inflation expectations, slowing economic growth and developing global economic stresses, we believe that the Fed will have to ease its aggressive tone sooner rather than later in the second half of 2022. Falling inflation and a moderating Fed would turn the significant current headwinds for markets into potentially beneficial tailwinds, especially if the Fed is able to act in time to moderate growing recession risks. With most risk assets already in a bear market and investor sentiment extremely bearish, a switch from macro headwinds to tailwinds could drive a sharp recovery in risk assets including global stock markets.

PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
RISK	
Macro risk hit an extreme peak in March as the Fed began its quantitative tightening process. It has not dropped much since then, as global inflationary pressures threaten the nascent recovery. We expect risk to lower as the year progresses and the current headwinds start to subside.	LOWER
MACROECONOMIC	
GLOBAL REAL GDP Global GDP growth will likely continue to decelerate as central banks ramp up their rate hiking cycles to fight inflation, and while China continues to struggle with renewed COVID outbreaks.	LOWER
U.S. REAL GDP Leading indicators of growth continue to decelerate as the Fed pledges to do whatever it takes to fight inflation, including reducing demand and allowing unemployment to rise.	LOWER
CANADA REAL GDP Rising rates and aggressive central bank tightening will hurt the Canadian economy, while elevated commodity prices will likely help sustain the resource sectors.	SAME
U.S. INFLATION While core inflation is starting to decelerate due to weakening goods inflation, services inflation remains a strong driver. However, the impact of higher rates will likely start to be felt in rate-sensitive sectors such as housing and automotive. In addition, high and rising retail inventories may potentially act as a headwind for prices in certain sectors.	LOWER
EQUITY RETURNS	
U.S. EQUITIES U.S. equities will likely start to find a footing as sentiment and breadth reach negative extremes with investors sitting on the sidelines waiting for a catalyst – a catalyst that we believe will be signs that inflation is falling enough for the Fed to pause or pivot.	SAME
EUROPEAN EQUITIES European equities will likely have greater headwinds than the US as they face a similar inflation spike, but with lower growth potential. As summer ends, reliance on Russian energy will likely be an even bigger issue.	LOWER
CANADIAN EQUITIES High commodity prices should fuel the Canadian resources sector and related equities, offsetting weakness that may be created in the consumer sector by higher rates.	HIGHER
BOND YIELDS	
TREASURIES (U.S. 10-YR) We think rates are already reflecting peak hawkishness, and that the risk going forward is likely to the downside as the economy weakens.	LOWER
INVESTMENT-GRADE CORPORATE BONDS With very little premium over treasuries, investment-grade spreads will unlikely insulate the group much from the impact of rising treasury rates.	HIGHER
HIGH-YIELD CORPORATE BONDS High-yield corporate bonds will likely suffer from increasing risk aversion in the near term, as well as higher treasury rates.	HIGHER
OTHER	
WTI CRUDE OIL Oil prices will likely remain elevated thanks to Russian sanctions and futures that are in extreme backwardation. Strategic reserve releases and other government attempts to ease fuel inflation will likely put a near-term cap on prices.	SAME
EPS GROWTH (S&P 500) Earnings growth is expected to continue to decelerate in 2022 along with the economy, while higher labour costs and inputs prices will likely hurt profit margins.	LOWER
P/E (S&P 500) Multiples will likely continue to decline over the year as real rates rise, particularly in high-growth sectors with relatively high valuations.	LOWER

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at June 2022.

SIGNIFICANT HEADWINDS REMAIN IN PLACE

At the beginning of 2022, we made the case that equities would struggle against a trifecta of headwinds: uncomfortably high inflation, a hawkish Fed and decelerating economic growth. We argued that these headwinds would eventually dissipate and turn into tailwinds for stocks, setting the stage for a new rally in risk assets.

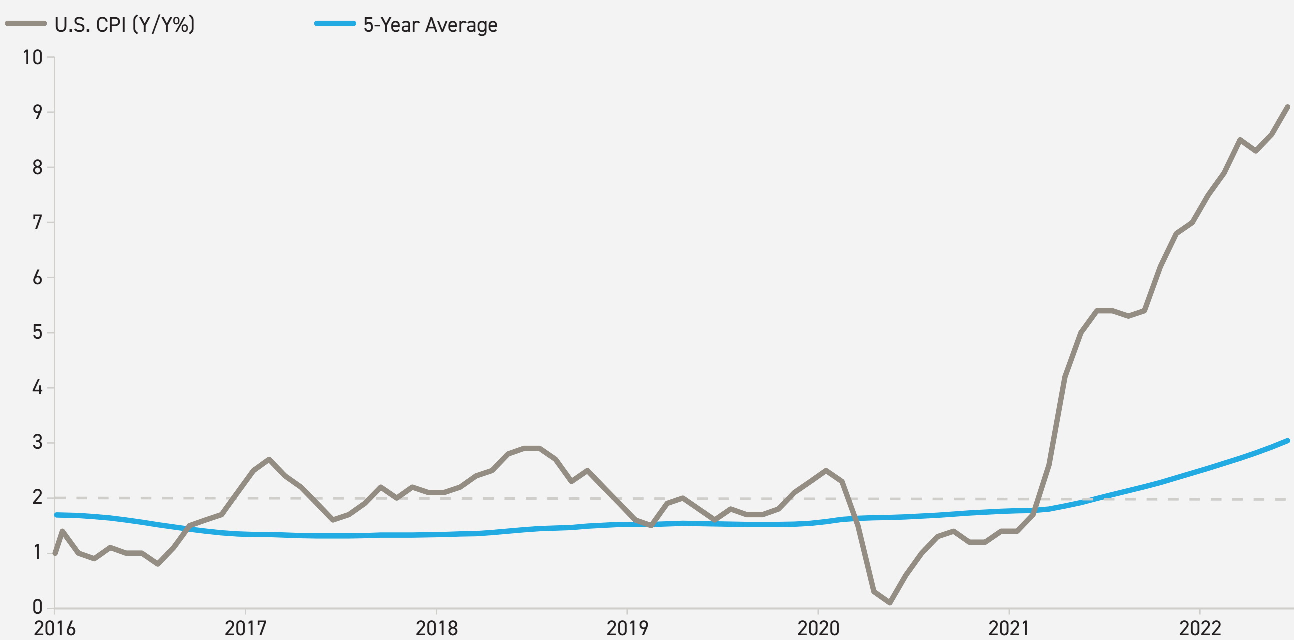
At the mid-year point, the challenges facing stock markets have proven stronger and more persistent than expected. Inflation has remained stubbornly high, exacerbated by Russia's invasion of Ukraine and ongoing supply chain bottlenecks. With upward pressure on prices driving headline Consumer Price Index (CPI) numbers to 9.1% in June, the Fed has been forced to take an even more hawkish stance on monetary policy in order to rein in the demand side of the economy. Risk assets, long accustomed to an accommodative Fed, have been shaken by the speed at which the central bank is taking away the punchbowl.

As it stands today, there has not been any real improvement at the margin with regard to those three key headwinds. This has made it very difficult for investors to feel much optimism or to embrace buying equities, even as their prices become more attractive. We still expect to see tailwinds emerge in the second half of this year, driving markets higher, but patience is required to withstand the current volatility in capital markets.

Headwind #1: Inflation Is Still Red-Hot

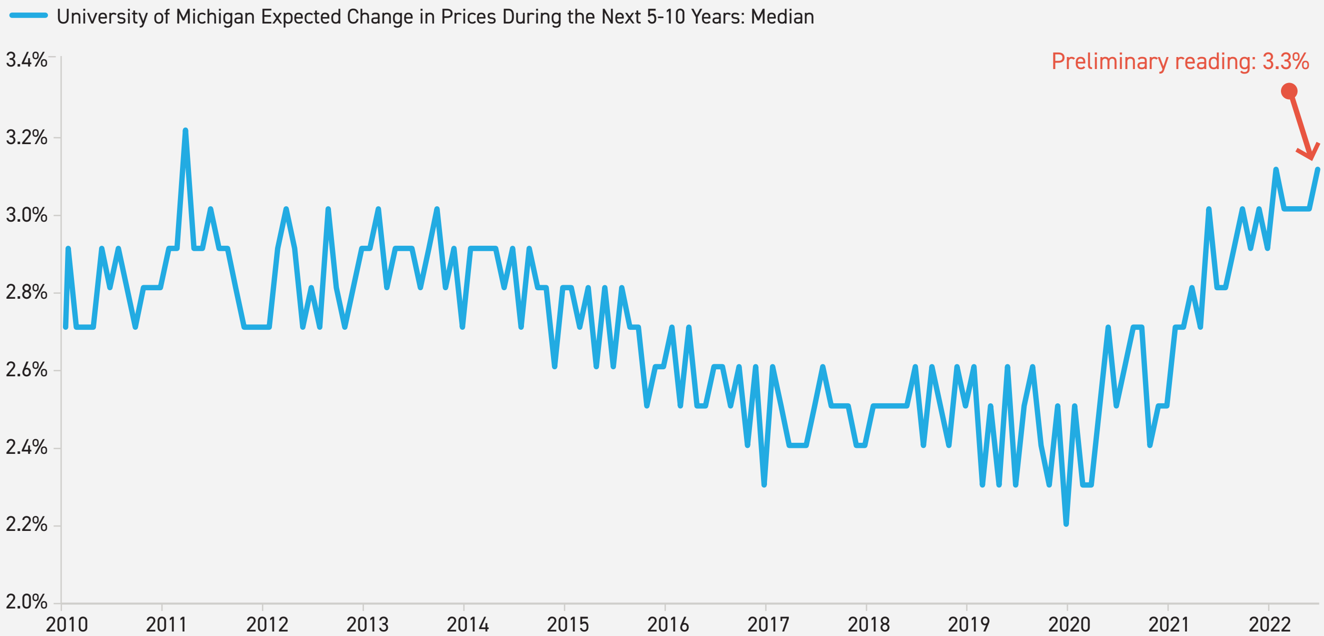
For starters, headline inflation is not rolling over, and the May U.S. CPI print indeed spooked the market. Monthly readings aside, the fact remains that having previously undershot the Fed's 2% target, consumer price inflation on a five-year average basis is currently overshooting it by 1%. Meanwhile, longer-term inflation expectations have also risen, raising fears that they could become entrenched.

FIGURE 1: INFLATION IS STILL RED-HOT



Source: Bloomberg, PMAM Research. From January 2016 to June 2022.

FIGURE 2: INFLATION EXPECTATIONS ARE ALSO RISING



Source: Bloomberg, PMAM Research. From January 2010 to June 2022.

THE CORE OF THE INFLATION PROBLEM

Services are a major driver of surging inflation in the U.S. Labour shortages are exacerbating capacity constraints in many industries at a time when post-pandemic demand is soaring. In the on-again, off-again pandemic economy, businesses found it difficult to reopen with adequate levels of staffing, with many preferring to wait and see how the pandemic would evolve. Now labour is difficult to find, making the return to full capacity very challenging. Costs and prices are soaring in many industries as a result.

Headwind #2: No Signs That the Fed Can Back Off Yet

Given the inflationary backdrop, there are no indications that the Fed can or will be less aggressive in the near term with respect to monetary tightening. Price stability is clearly top of mind for the Federal Open Market Committee, and, at least for now, full employment there is a lower priority in the Fed's dual mandate. Fed Chair Jerome Powell even acknowledged in late June that the pace of U.S. rate hikes could tip the economy into recession, adding that achieving a soft landing would be "very challenging."[1] And the Fed is not just talking tough: it is walking the talk, having raised rates by 75 basis points (bps) at its June meeting, and making it clear more hikes are on the way.

Headwind #3: The Economy Is Decelerating and Needs to Slow Even More to Cut Demand

Last year, the economy boomed, driven by extraordinary fiscal and monetary stimulus, plus a friendly wealth effect as asset prices soared. Today, the story is very different. We believe not only that the economy is slowing, but also that the worst is yet to come as far as data is concerned. Housing is one example of an industry in the midst of significant slowdown. Rate hikes and soaring long-term yields have sharply increased the cost of carrying a home. This, in turn, is putting the brakes on the housing market, which has been contributing significantly to GDP growth. Now the labour market is beginning to soften, with large layoffs suddenly being announced. As for the wealth effect, it's clearly in reverse. Finally, there are signs of inventory building that could lead to cancelled orders for manufacturers.

[1] https://www.bnnbloomberg.ca/powell-says-soft-landing-very-challenging-recession-possible-1.1782346

INFLATION IS SET TO FALL SIGNIFICANTLY THROUGH 2023

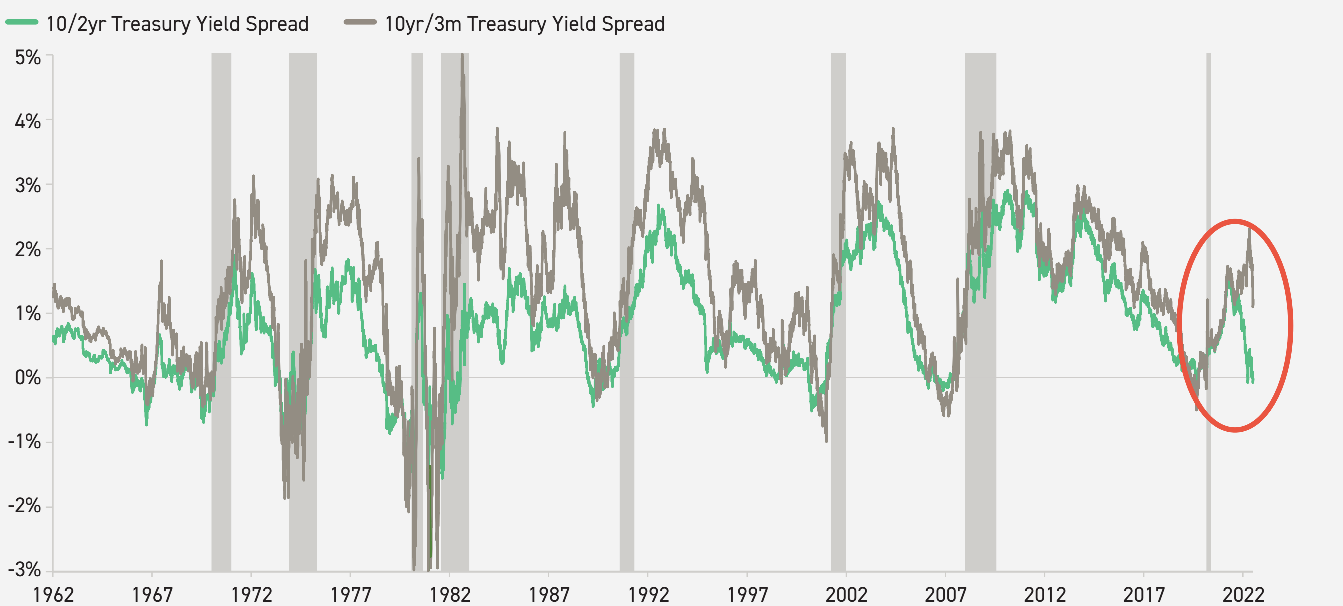
THE QUESTION IS HOW IT GETS THERE

In our view, it is virtually assured that inflation will fall materially by next year. The Fed's more aggressive rhetoric has made it clear that it will do whatever is necessary to get inflation back under control, and to restore its credibility. For now, the Fed is in a fight against both existing inflation numbers and long-term inflation expectations – a fight that it cannot afford to lose. As Charlie McElligott of Nomura explains, investors are now starting to come to terms with this new monetary reality:

> "...markets appear to have recently begun to more completely accept the implications of the Fed's stated commitment to bringing inflation under control, even at the expense of growth."[2]

While the Fed has been behind the curve in its direct tightening, its announcements have already begun to have the desired effect in moderating demand. The central bank has been successful in jawboning markets, which have responded by doing much of the Fed's work for it. Market participants, convinced of policy makers' commitment to fighting inflation, have jumped ahead of the actual tightening implemented thus far by Chair Powell and his colleagues. This can be seen in the yield curve divergence: the market-based measure (the 10/2yr Treasury Yield Spread) is running far ahead of the Fed's preferred gauge (the 10yr/3-month Treasury Yield Spread).

FIGURE 3: YIELD CURVE MEASURES ARE DIVERGING



Source: Bloomberg, PMAM Research. From January 1, 1962 to June 30, 2022.

[2] "Policy Watch", May 25, 2022. Nomura Group.

This is also visible in the U.S. Financial Condition Index (Fig. 4), which shows the dramatic swing in conditions from the most buoyant of the last decade to near the lows of the last decade (excluding the pandemic).

The renewed commitment to fighting inflation is clearly an important factor, and we would not be at all surprised if headline inflation does indeed fall back to the 2%-3% range at some point in 2023. Just how it gets to this level is subject to debate, and will dictate the manner in which markets react. In any case, the simple truth is that demand and supply will have to come back into balance, and this will have to happen reasonably quickly to prevent longer-term inflation expectations from getting out of control.

FIGURE 4: FINANCIAL CONDITIONS HAVE RAPIDLY FALLEN

Source: Bloomberg, PMAM Research. From January 1, 2012 to June 30, 2022.

SIGNS OF A TURN IN INFLATION

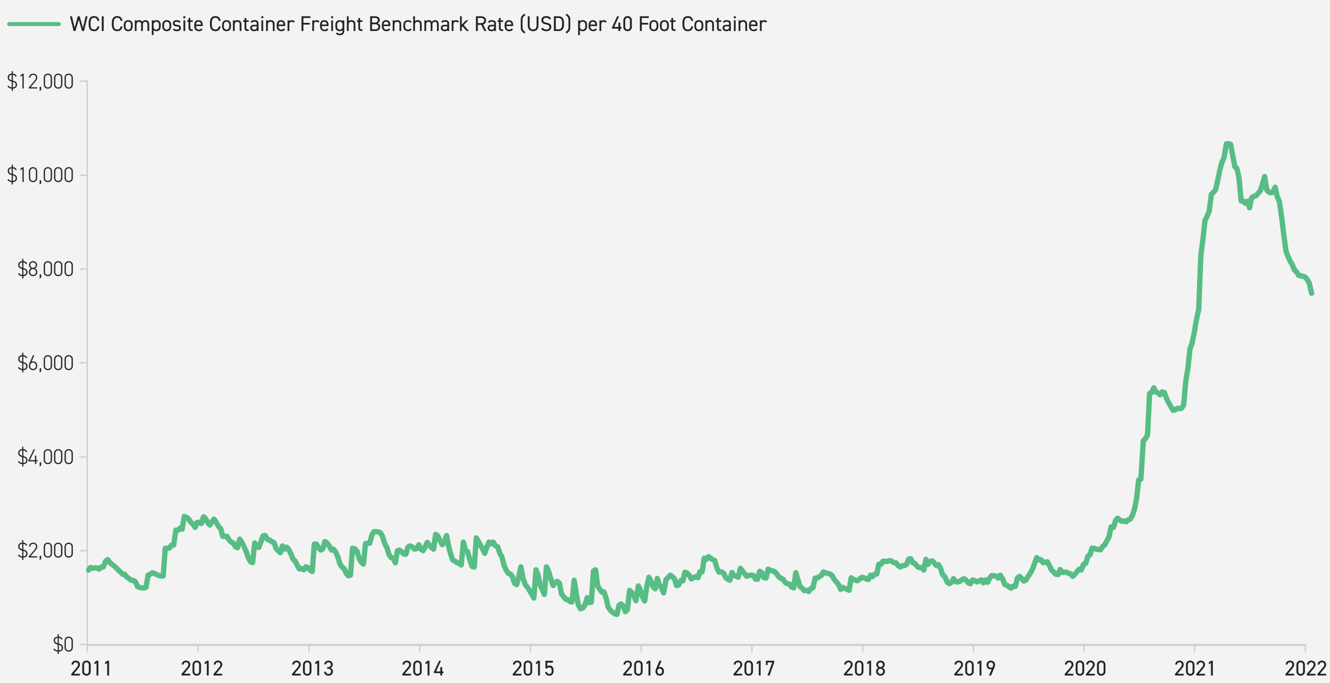
As we have suggested, the market has begun pricing in the Fed's inflation-fighting commitment and has done some of the heavy lifting, and the good news is that there are emerging signs that inflation is already on the way down – despite May's alarmingly high headline inflation number in the US.

Under the surface, the picture is different. For instance, Pantheon Macroeconomics notes that the upside inflation surprise was driven primarily by just two segments: rents and used vehicles.[3] In the former case, the unexpected jump apparently resulted from rent increases in medium-sized cities, but rents in larger cities appear to have peaked.

And the spike of nearly 2.0% in used car prices was likely caused by a 12.6% decline in new car sales, after auto manufacturers limited production because of semiconductor shortages. The pace of vehicle production has now regained pre-pandemic levels, so used car prices are likely to come back down to earth eventually, alleviating some of the CPI pressure.

Even while COVID lockdowns are constraining China's manufacturing industry, global supply chains are continuing to mend. And global container freight rates continue to drop from the pandemic peak, while manufacturers' supply delivery times are almost back to normal.

FIGURE 5: GLOBAL SUPPLY CHAINS ARE SLOWLY BUT SURELY IMPROVING

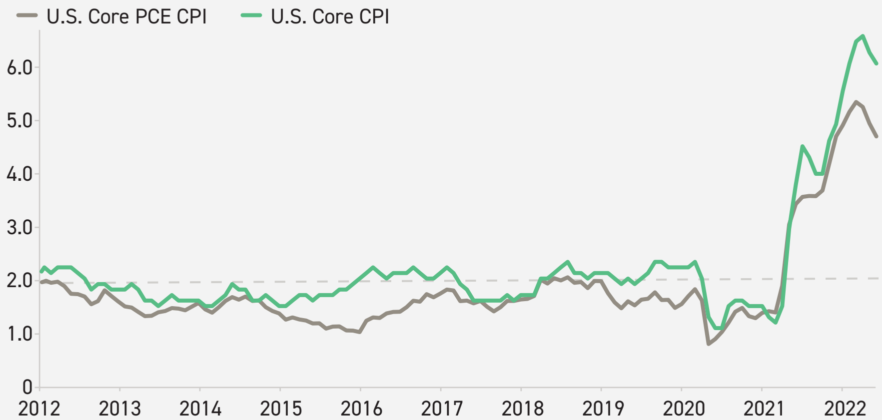


Source: Bloomberg, PMAM Research. From January 1, 2011 to June 30, 2022.

[3] The Weekly U.S. Economic Monitor", June 13, 2022. Pantheon Macroeconomics.

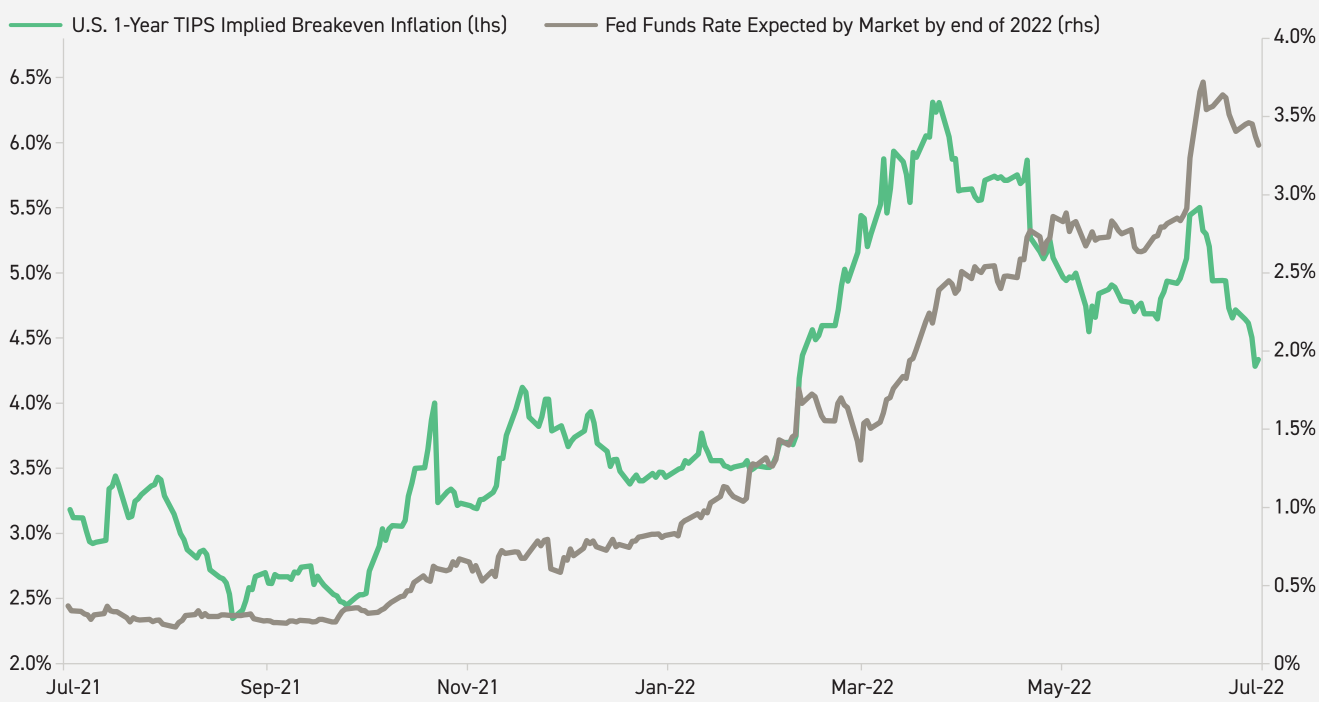
The Core Personal Consumption Expenditures Price (PCE) Index for May was just reported; it came in at 0.3% on a monthly basis and 4.7% year-over-year. The PCE Index, which is the Fed's preferred measure of inflation, measures the costs of goods and services consumed by households (as opposed to just the out-of-pocket costs, which are captured by CPI). Obviously, the annualized 4.7% core rate for PCE is much closer to the Fed's target of 2% than the Core CPI rate of 6.0% reported for May.

FIGURE 6: CORE PCE INFLATION IS AT LOWER LEVELS THAN CORE CPI



Source: Bloomberg, PMAM Research. From January 2010 to May 2022.

FIGURE 7: SHORT-TERM INFLATION EXPECTATIONS AND RATE HIKE EXPECTATIONS FELL IN JUNE



Source: Bloomberg, PMAM Research, Fundstrat. From July 1, 2021 to June 30, 2022.

Market-based inflation expectations have also fallen considerably over the past month. Inflation 12 months forward is down to 4.3%, from 5.6% only one month ago (Fig. 7). The implied Fed funds rate for the end of 2022 has fallen from 3.78% to 3.40% over the same period.

Perhaps these recent changes in market expectations are an indication that the Fed's tone on inflation is in fact too aggressive, and that the Fed may not have to tighten as much as it currently expects, especially given the recent deterioration in economic indicators.

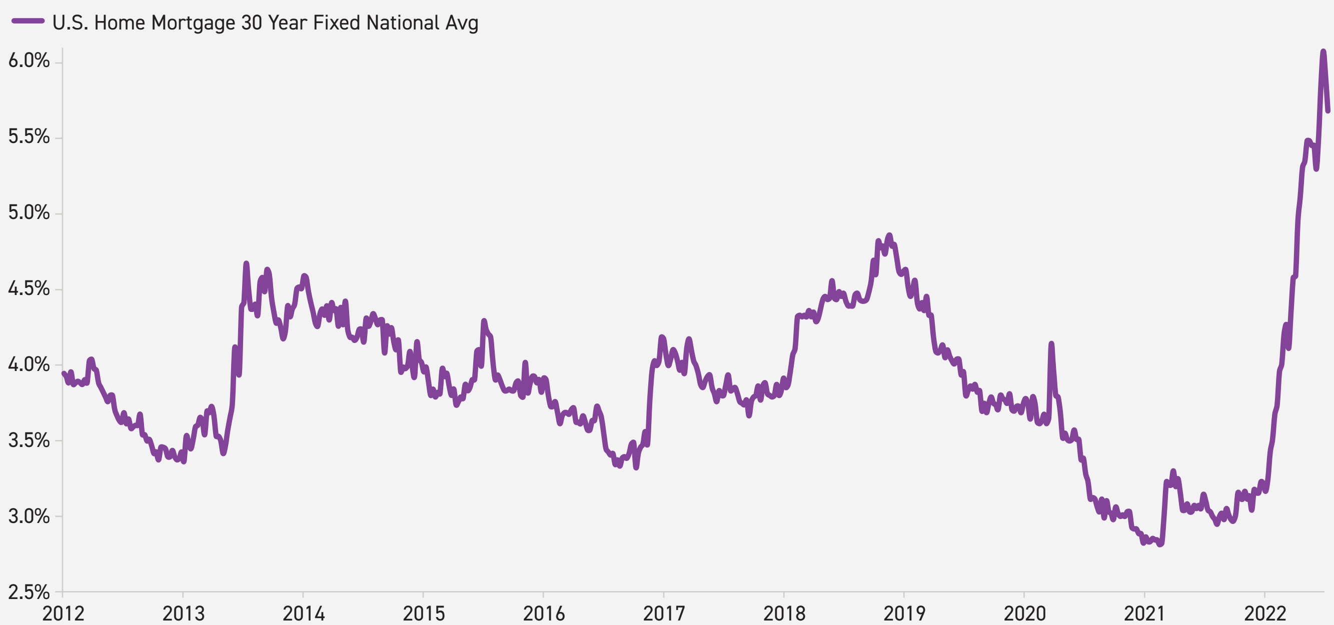
RECESSION FEARS BUILDING

Inflation can be brought down by Fed-induced demand destruction, a supply response or some combination of the two. We expect that significant demand destruction will start showing up quickly in crucial economic data and that the economy will slow faster than consensus expectations. And while this will likely be a near-term negative for earnings and equities, it should help emphasize the peak point in inflation as a headwind for markets. Much softer inflation data will likely lead to a moderation of Fed policy, once the Fed returns to being more data-dependent, in contrast to its current aggressive, target-oriented stance.

HOUSING MARKET COOLING RAPIDLY

The U.S. housing market has proven extremely sensitive to rising borrowing costs. The 30-year fixed mortgage rate jumped from 3.3% at the end of 2021 to roughly 6.0% at the end of the past quarter.

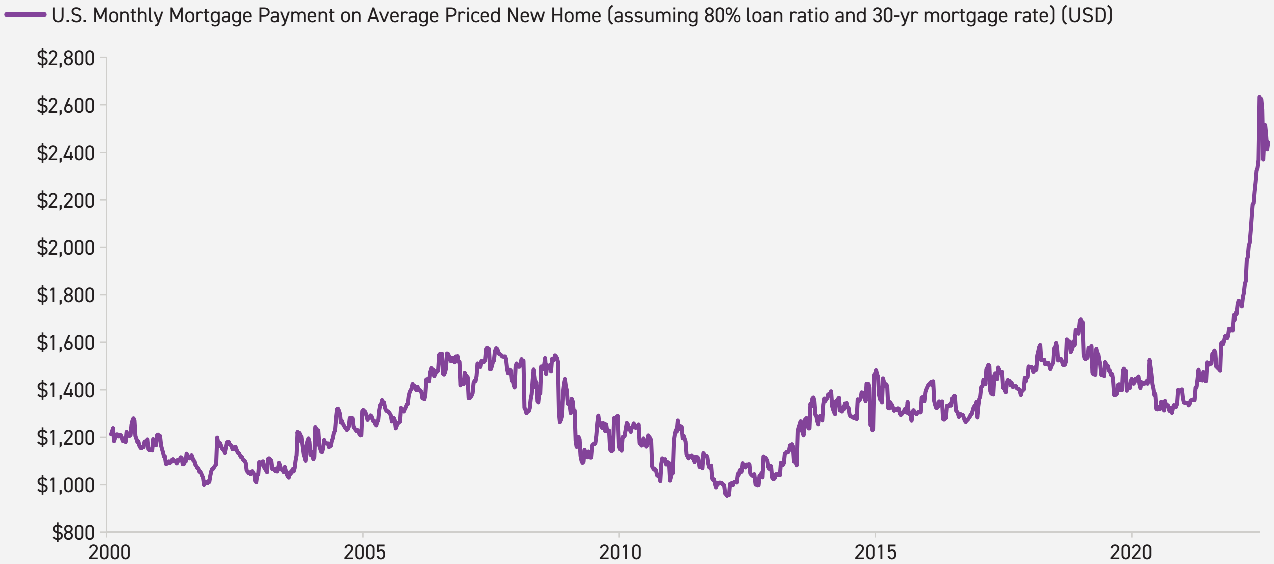
FIGURE 8: MORTGAGE RATES ARE THE HIGHEST IN OVER A DECADE



Source: Bloomberg, PMAM Research. From January 1, 2012 to June 30, 2022.

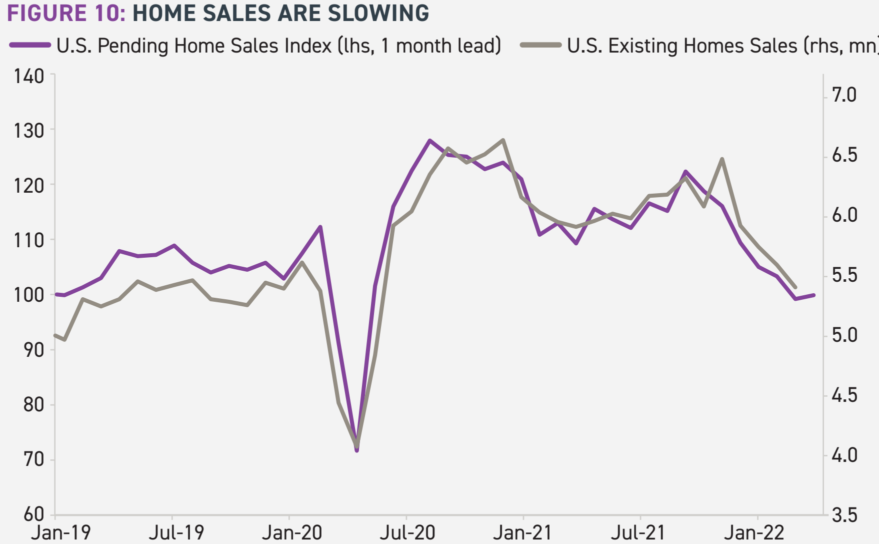
Higher borrowing costs, combined with higher average home prices, have had substantial negative effects on household budgets. The average monthly payment on a new U.S. home has more than doubled to the US$2,700 range.

FIGURE 9: RISING RATES AND HOME PRICES RESULTED IN A STEEP SURGE TO HOUSING AFFORDABILITY



Source: Bloomberg, PMAM Research. From January 1, 2000 to June 30, 2022.

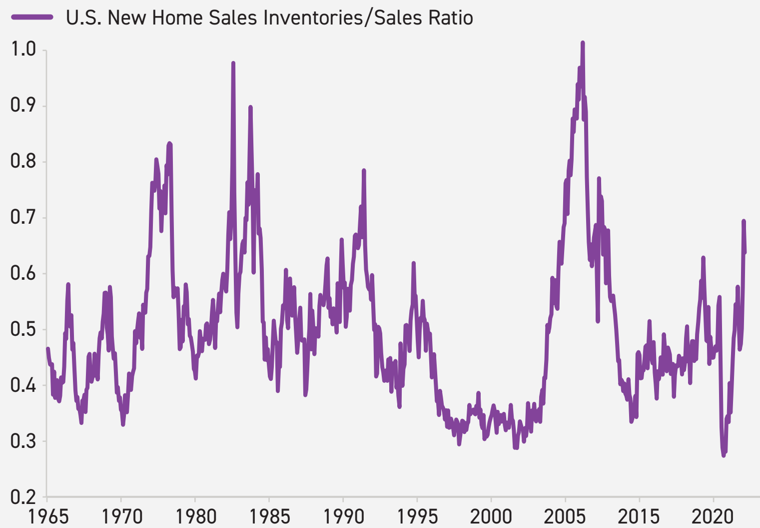
FIGURE 10: HOME SALES ARE SLOWING



Source: Bloomberg, PMAM Research. From January 2019 to June 2022.

Not surprising, there are signs that the U.S. housing market, one of the world's largest and most important asset classes, is quickly slowing. The Pending Home Sales Index, a leading indicator of housing market activity and overall consumption, has dropped 19% since peaking in October 2021. Existing home sales are also now declining, dropping sharply from 6.5 million homes in January 2022 to 5.4 million recently. And the inventory of unsold new homes is climbing rapidly, compared with home sales.

FIGURE 11: NEW HOMES SALES' INVENTORY TO SALES RATIO AT LEVELS LAST SEEN DURING 2005/2006 BUBBLE AND BUST



Source: Bloomberg, PMAM Research. From January 1965 to May 2022.

The Canadian housing market is also showing cracks as borrowing costs climb. The average price of a home in Toronto has declined more than 11% on a seasonally-adjusted basis since February according to recent data from the Toronto Regional Real Estate Board.[4] The second quarter saw the Bank of Canada's 5 Year Conventional Mortgage Index increase from 4.8% to over 6.0%, and many consumers are already reporting extreme levels of financial stress.

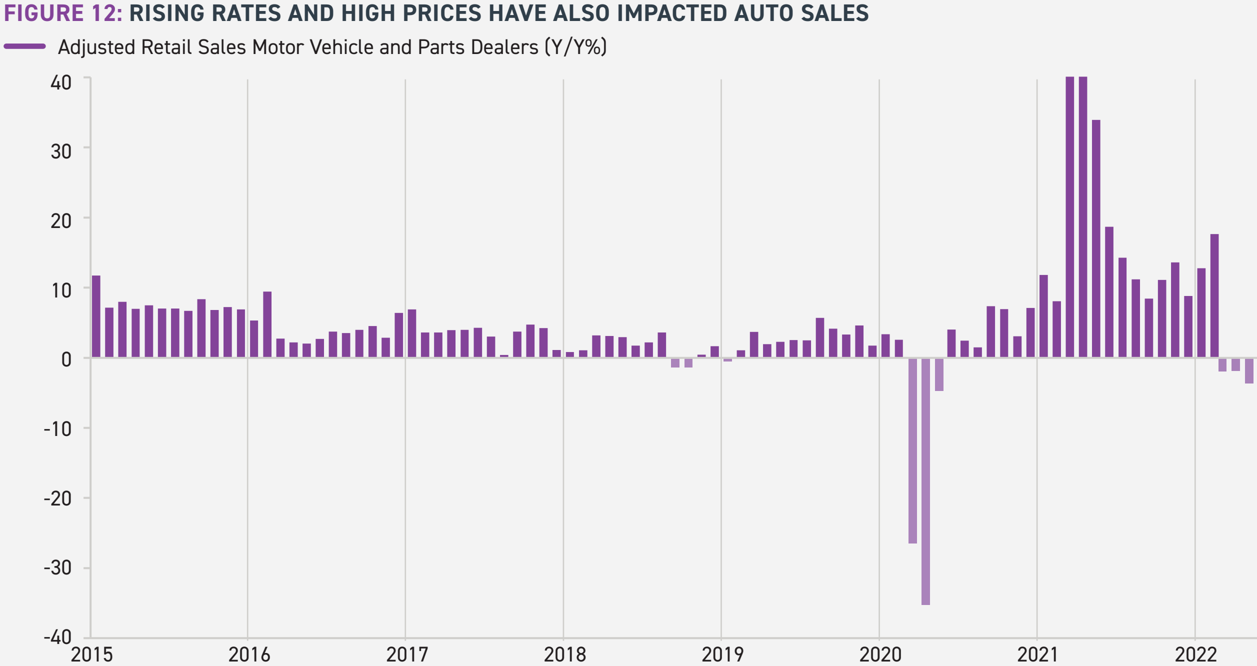
A Manulife Bank of Canada survey found that nearly one in four homeowners reported that they would have to sell their homes if rates climb further.[5] In addition, 18% of respondents feel unable to afford their current homes, and a similar number predicted a "significant negative impact" on their finances due to rising interest rates.

AUTO MARKET SLOWING

Tightening monetary policy will likely hit real estate the hardest, but there will probably be other victims. Autos, the second-largest purchase decision in most homes, are likely to see lower sales as monthly financing payments rise.

Used car prices (which exploded during the pandemic, when new car assembly stalled due to the semiconductor shortage) are already fading. The Manheim Used Vehicle Index is declining despite continued low inventories. Also, advanced retail sales data for autos implies further declines ahead.

FIGURE 12: RISING RATES AND HIGH PRICES HAVE ALSO IMPACTED AUTO SALES



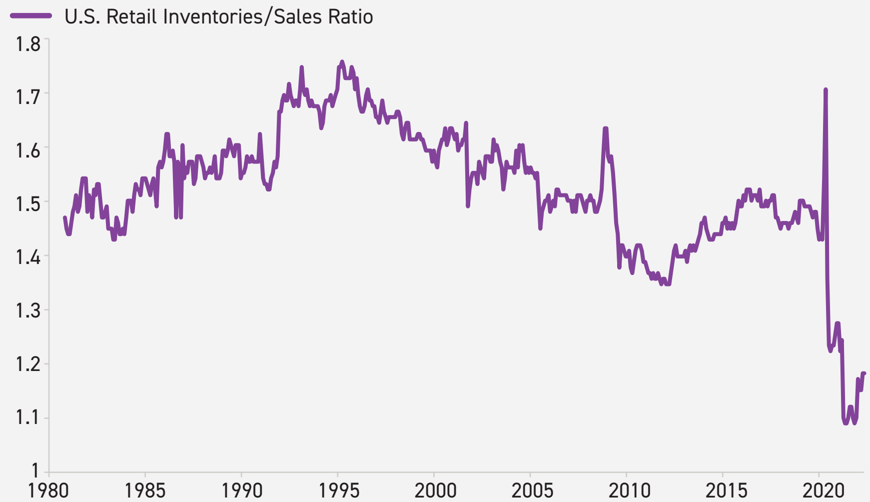
Source: Bloomberg, PMAM Research. From January 2015 to May 2022.

[4] https://trreb.ca/files/news_releases/news2022/nr_market_watch_0622.pdf
[5] Manulife Bank of Canada Debt Survey. June 2022.

SIGNS OF SIGNIFICANT INVENTORY BUILDING UNDERWAY

In the retail sector, the inventory-to-sales ratio is climbing after a long, sharp drop during the pandemic. Industry giants such as Walmart Inc., Target Corp. and Gap Inc. all reported significant excess inventories in their most recent financial results.

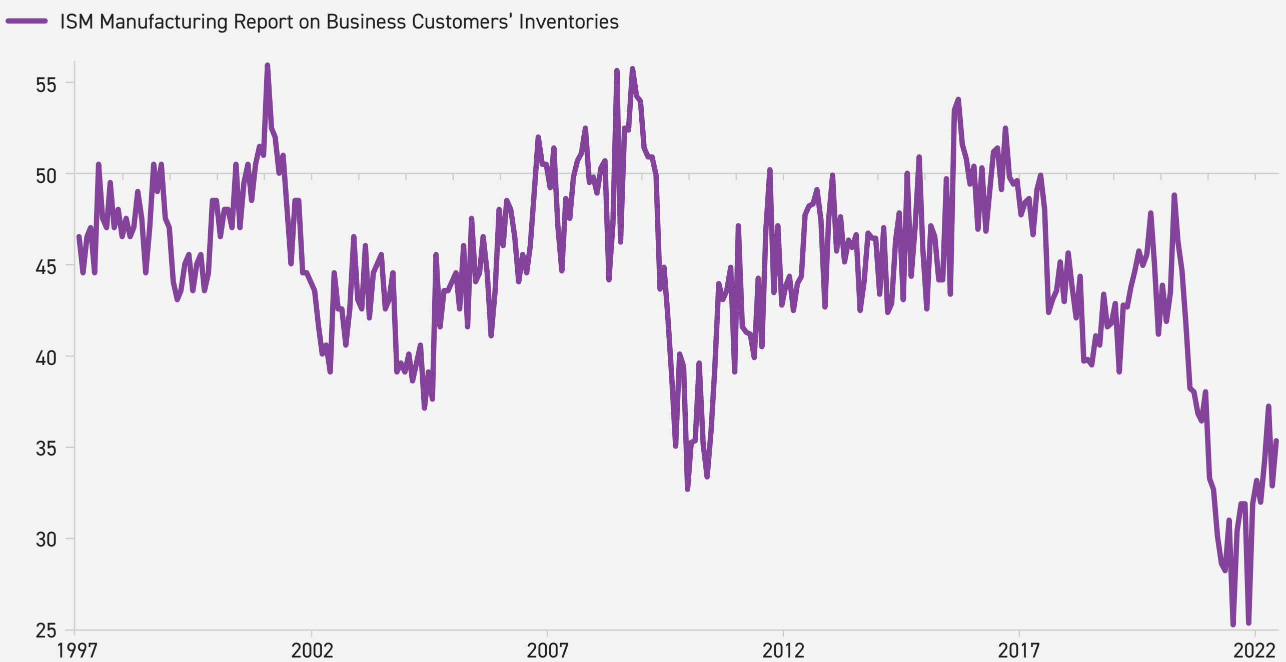
FIGURE 13: RETAIL INVENTORIES HAVE TURNED THE CORNER



Source: Bloomberg, PMAM Research. From January 1980 to April 2022.

The state of business inventories also provides evidence of an economic slowdown and the potential easing of inflation pressure. The ISM Manufacturing Report on Business Customers' Inventories is climbing quickly, after having bottomed in November 2021.

FIGURE 14: SHORTAGES IN THE MANUFACTURING SECTOR ARE IMPROVING



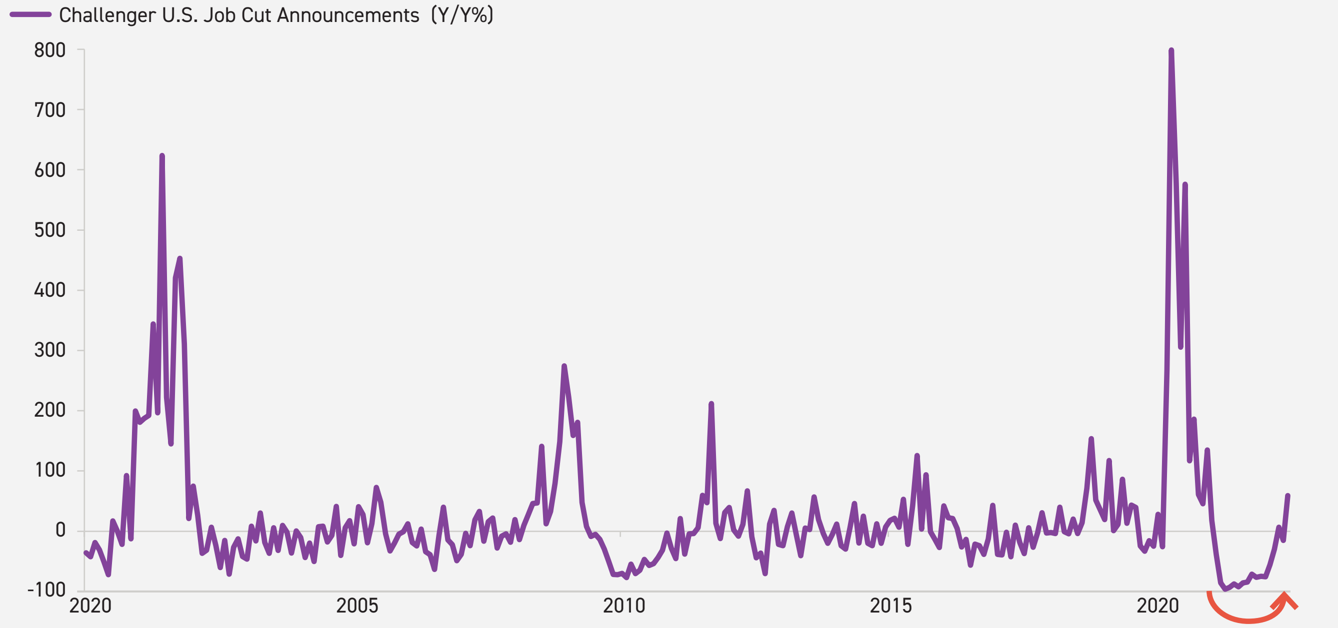
Source: Bloomberg, PMAM Research. From January 1997 to June 2022.

LABOUR MARKET STILL STRONG BUT...

North American labour markets have been very strong. U.S. job openings did fall in April to 11.4 million, but that is still a very robust level and marked a decline from a record high in the previous month. Job openings remain elevated at roughly double the number of unemployed Americans, suggesting employers are continuing to struggle to attract and retain workers.

While this labour market strength provides some cushion against the sudden occurrence of a recession, there are still some early signs of weakening that should be monitored. For instance, the Challenger data on U.S. job cuts is back in positive territory in year-over-year terms for the first time since January 2021.

FIGURE 15: JOB CUTS ARE ON THE RISE AS THE LABOUR MARKET COOLS OFF



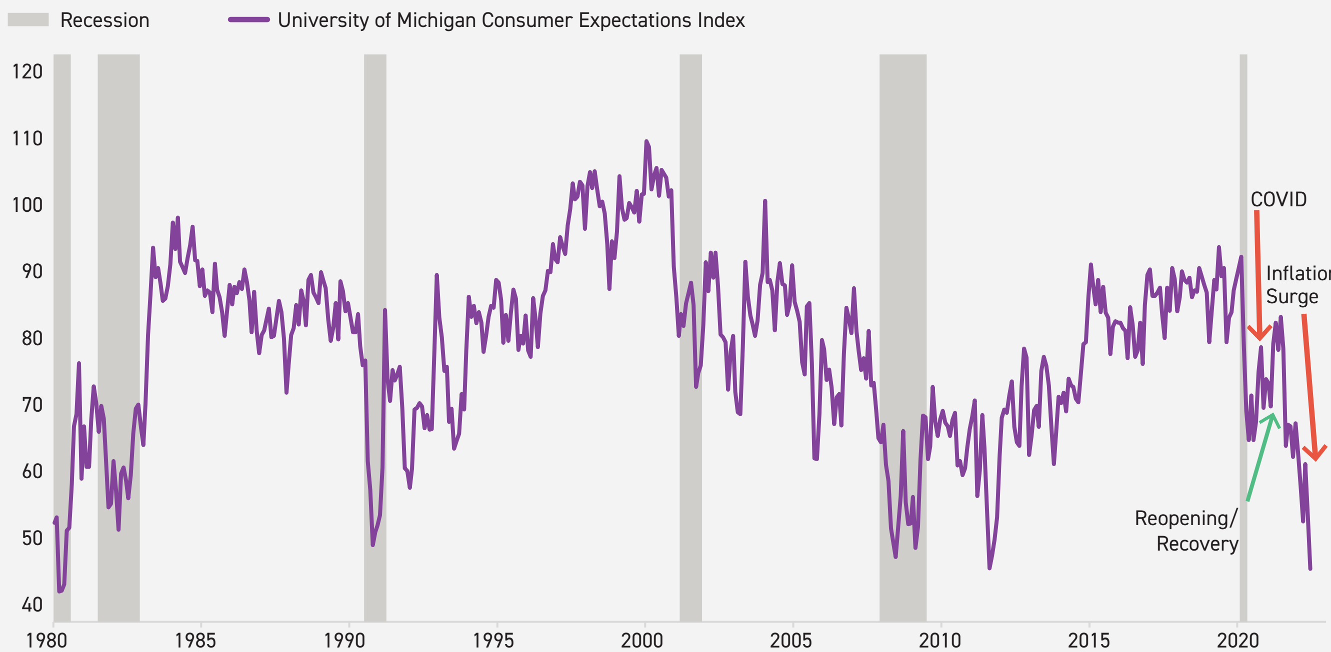
Source: Bloomberg, PMAM Research. From January 2000 to June 2022.

PURCHASING POWER AND PLUNGING CONSUMER SENTIMENT

While labour markets have been strong, wage growth has trailed the CPI by a significant margin, putting a damper on aggregate purchasing power. This is particularly true for lower-income families that generally have a high propensity to spend their earnings on basic consumption and that are less able to absorb higher food and fuel costs.

The impact of inflation and economic uncertainty is being reflected in plunging consumer sentiment. The University of Michigan Consumer Expectations Index has fallen from 83.5 in June 2021 to 47.5 at the end of the second quarter of 2022. Inflation played a big role in the sharp decline in sentiment, but the end of US$1 trillion in COVID-related stimulus programs has also dampened some consumers' moods.

FIGURE 16: INFLATION AND HIGHER RATES HAVE HURT CONSUMER CONFIDENCE



Source: Bloomberg, PMAM Research. From January 1980 to June 2022.

Historically, real consumption has closely tracked the University of Michigan Consumer Expectations Index, and this has also created fears of a recession in the markets.

WEALTH EFFECT HAS DETERIORATED

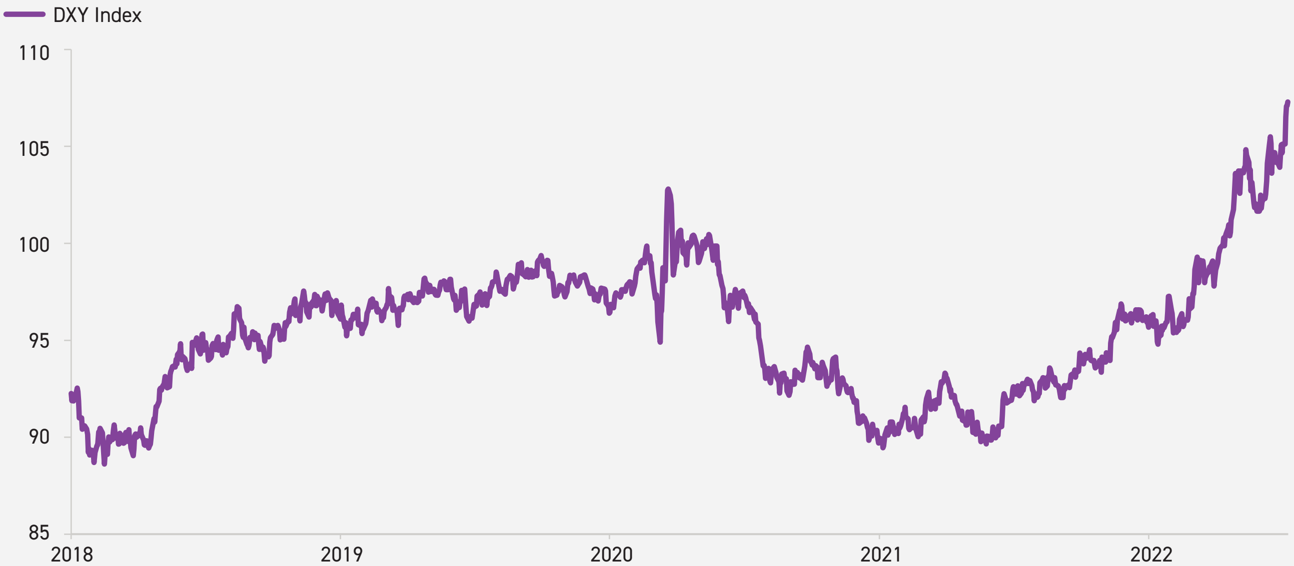
U.S. households held an estimated US$46 trillion in financial assets – equities, funds and debt securities – at the end of 2021. Jefferies believes this value has declined by over US$8 trillion or about 18%.[6] The damage to risk asset prices this year will likely lead to less spending through the "wealth effect." When people feel less well off than they did before, they tend to cut back on spending to rebuild their depleted savings. Fed studies in the past have found that consumers generally cut spending by three to five cents for each dollar that their wealth declines on a sustained basis.

REST OF THE WORLD UNDER PRESSURE

The US is the world's largest economy, and it has been a pillar of strength through the pandemic, aided by significant government spending and incredibly easy monetary policy. While U.S. economic momentum is now slowing and poised to go lower, the situation is worse in many other countries around the world, especially given the strength of the U.S. dollar over the past year.

[6] https://www.investors.com/news/economy/federal-reserve-most-anticipated-recession-in-history-may-be-coming/

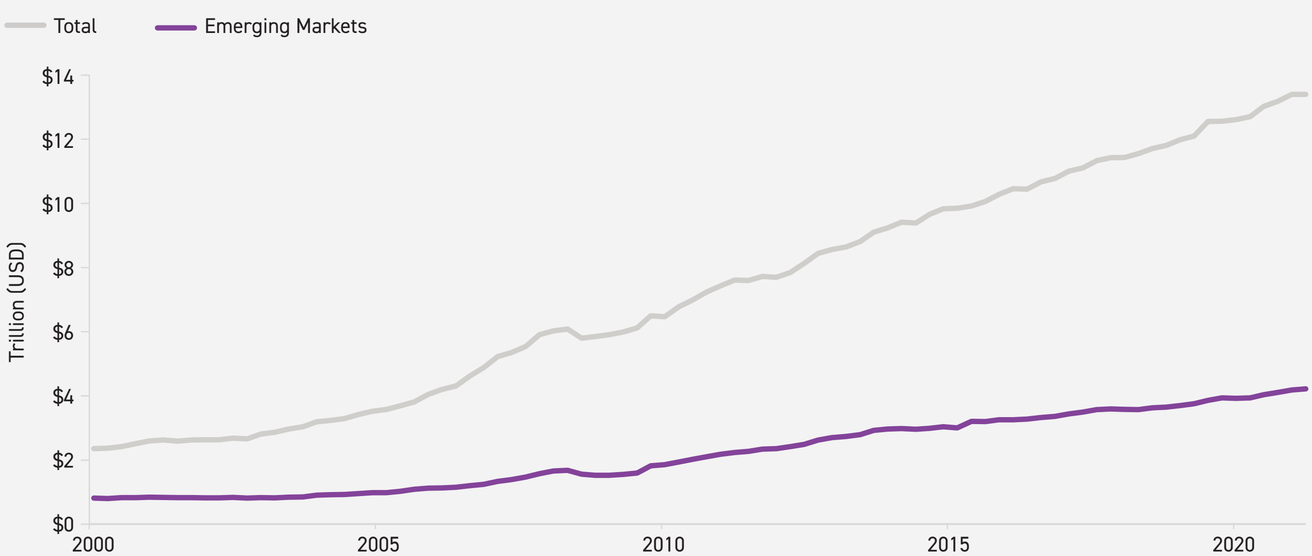
FIGURE 17: THE U.S. DOLLAR HAS SURGED IN 2022



Source: Bloomberg, PMAM Research. From January 1, 2018 to July 8, 2022.

The strong U.S. dollar hurts the rest of the world's economies in a number of ways. Since most commodities are priced in U.S. dollars, a domestic currency that weakens against the U.S. dollar makes these commodities even more expensive, creating an inflationary pressure on the domestic economy. Unfortunately, bouts of U.S. dollar strength tend to expose another structural weakness in certain economies, that is, their exposure to U.S. dollar-denominated (USD) debt. Countries that have chosen to take advantage of a falling U.S. dollar and falling interest rates to issue what appears to be cheaper debt in U.S. dollar terms suddenly become exposed to higher payments when the opposite is occurring: it takes more local currency to pay the same USD interest rate when the U.S. dollar is outperforming. Figure 18 shows the steady increase in USD debt to non-banks outside the US that has occurred since the year 2000. This debt totalled US$13.4 trillion at the end of 2021, with US$4.2 trillion of this coming from emerging markets.

FIGURE 18: USD DEBT TO NON-BANKS OUTSIDE THE US HAS STEADILY RISEN SINCE THE YEAR 2000

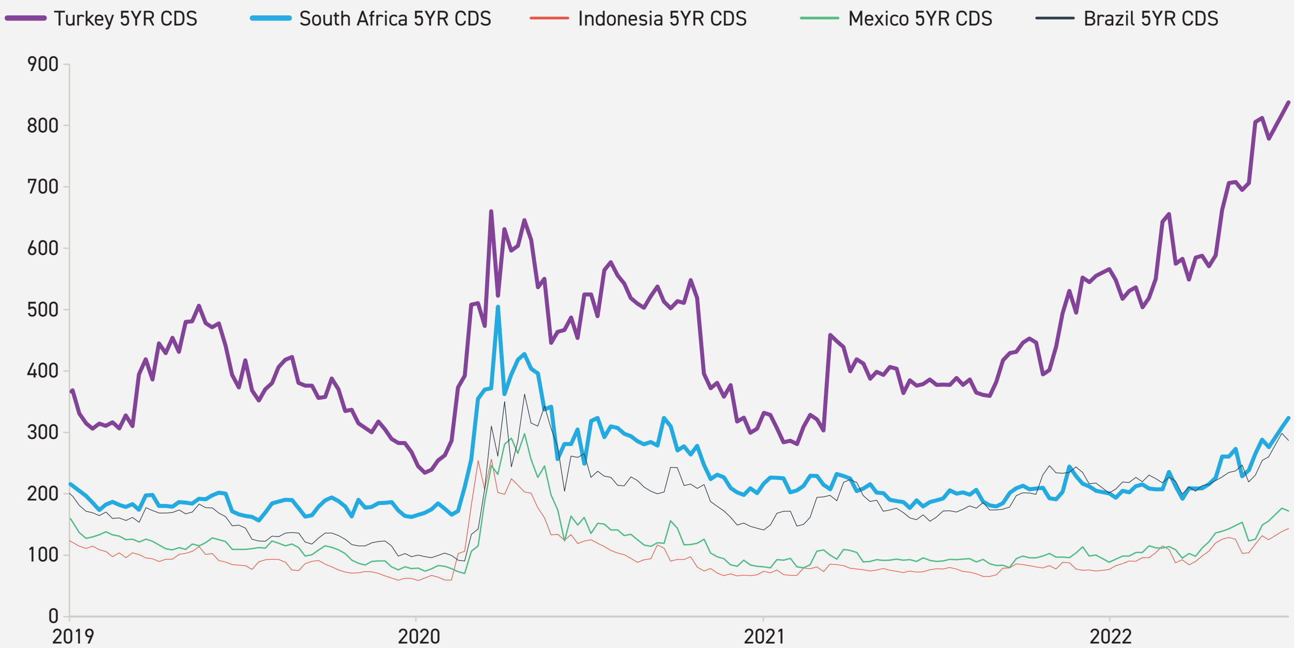


Source: BIS, PMAM Research. From Q1 2000 to Q4 2021.

Some countries are particularly vulnerable. For example, since the global financial crisis, USD debt as a portion of GDP has spiked in Brazil, Turkey, Indonesia, South Africa and Mexico. The recent rally in the dollar coincides with the surging cost of credit default swaps (essentially insurance against defaults) for the sovereign bonds of these countries (Fig. 19).

U.S. monetary policy has massive implications for countries abroad. Continued aggressive tightening by the Fed will likely contribute to significant negative repercussions for many other economies around the world.

FIGURE 19: THE SURGING U.S. DOLLAR IS PLACING A STRAIN ON EMERGING MARKETS' DEBT



Source: Bloomberg, PMAM Research. From January 1, 2019 to July 8, 2022.

CHINA
TO THE RESCUE?

There is a potential for an accelerating Chinese economy to pick up some of the slack due to slowing western economies in the second half of the year.

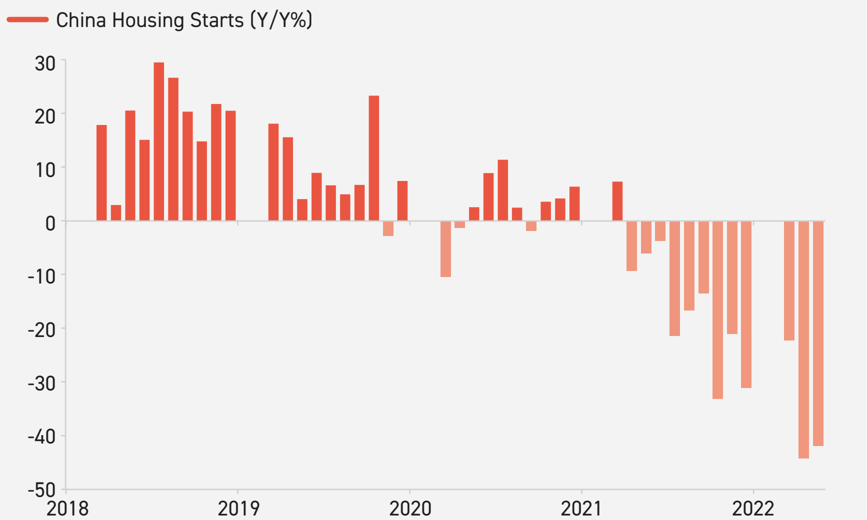
The Chinese economy started to slow in late 2021, driven by weakness in the property sector, and recent COVID lockdowns had a further impact on manufacturing and consumer demand. Until recently, Chinese policy makers have taken a measured approach to easing in response to the property slowdown, attempting on the one hand to support the economy and, on the other hand, to de-leverage parts of the economy where excesses occurred due to previous stimulus measures.

We believe that China has been using the world's excess liquidity and economic strength to try to buy time in which its own property bubble can deflate without having to provide more stimulus to the overall economy that then augments the property problem even further.

However, building financial stress in the Chinese property sector is readily apparent, with the average yield on China high-yield property bonds now 44% (an increase of almost 1,200 bps year-to-date). Two large property developers have defaulted on debt issues in recent months: Zhenro Properties Group Limited defaulted in April, while Sunac Corp. (the fourth largest in the country), defaulted in mid-May after reporting sales down 65% in March and April.

Housing starts are now falling by roughly 40% year-over-year in major cities, and home construction has declined dramatically.

FIGURE 20: CHINA HOUSING STARTS ARE IN DECLINE

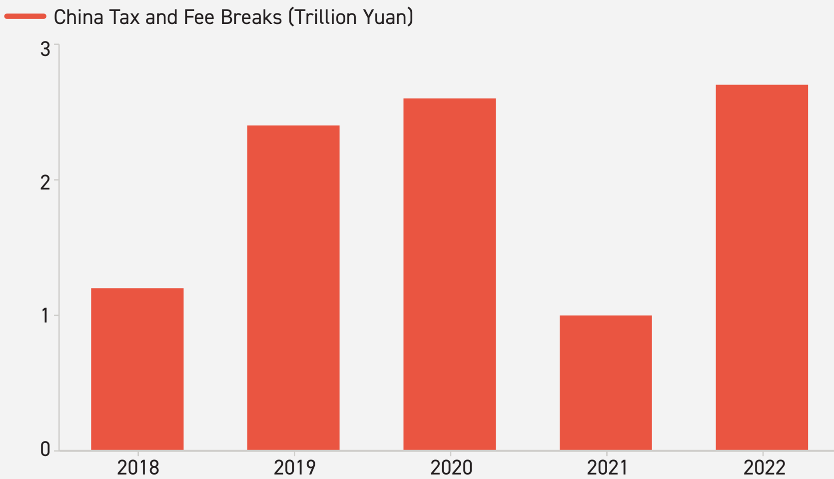


Source: Bloomberg, PMAM Research. From January 2018 to May 2022.

To make matters worse, land sales to property developers have long been a major source of income for local governments in China, and a combination of slowing property sales and pandemic-fighting expenses have now left many governments strapped for cash. For example, The Financial Times reported that the city of Jilin experienced a double-digit decline in tax revenue and a simultaneous double-digit increase in health-related expenditures.[7]

As western economies slow, Chinese officials will likely be left with little choice but to increase stimulus to buttress their own economy against significant stress. It appears that the Chinese Government is now getting the message. Since mid-May, mortgage rates have been lowered, and targeted value added tax (VAT) refunds have taken place. Additional funding has been provided for infrastructure projects through the issuance of Local Government Special Bonds.

FIGURE 21: CHINA'S 2022 TAX BREAKS TO EXCEED 2020'S IN BID TO CUSHION VIRUS IMPACT



Source: Chinese government work reports, China National Radio. From 2018 to 2022.

Infrastructure has been China's go-to growth engine dating back to the global financial crisis. President Xi Jinping recently called for an "all out" infrastructure buildup at April's meeting of the Central Committee for Financial and Economic Affairs. In May, the State Council emphasized infrastructure as an important policy tool for stabilizing the economy. Remarkably, China still has infrastructure needs after more than a decade of massive expansion. The World Economic Forum ranks China 36th in terms of infrastructure quality, with most opportunities available in transportation and water transmission. HSBC is forecasting a backloaded 5.0% increase in infrastructure spending in 2022, up from a 3.8% level before the pandemic.[8]

The recent pandemic lockdowns in China were out of step with the rest of the world in terms of severity and detracted from global growth while further crimping supply chains. The effectiveness of China's lockdown policy is still an open question, but it is fair to assume that considerable pent-up demand has been created within the country. In the first five months of 2022, household savings increased by the equivalent of US$1.17 trillion, an increase of more than 50% compared with the same period a year earlier.

We expect, therefore, that policy support, combined with pent-up demand, will push Chinese economic growth rates higher, and that China will help provide support for growth as the rest of the global economy slows in the second half of 2022.

[7] https://www.ft.com/content/a21aa7f0-860a-45ae-9cef-19b23b9f2292

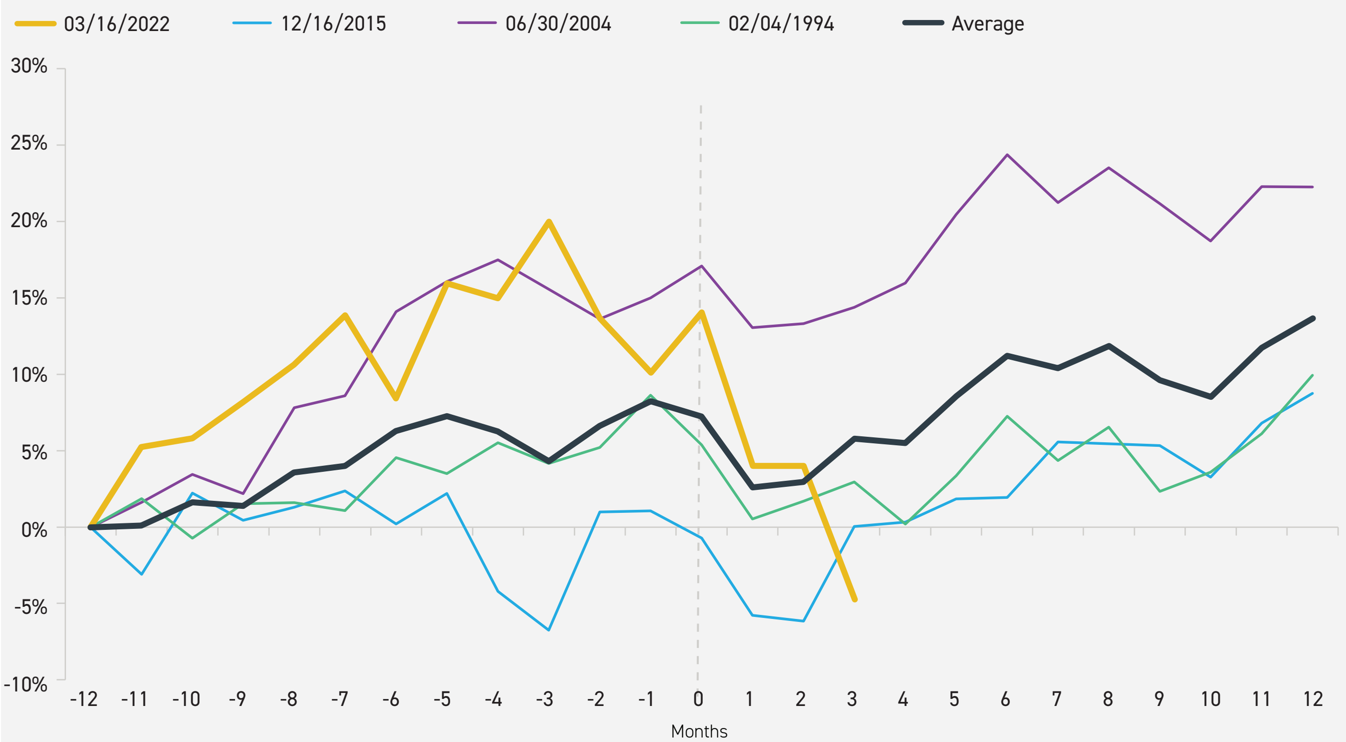
[8] https://www.research.hsbc.com/C/1/1/320/zzSSRSz

EMERGING TAILWINDS
TO LIFT STOCKS

Given declining inflation expectations, slowing economic growth and developing global economic stresses, there is a growing possibility that the Fed will be able to back off its aggressive tightening sooner than expected in the second half of 2022. Falling inflation and a moderating Fed could turn current headwinds for the markets into potentially beneficial tailwinds, especially if the Fed responds soon enough to moderate growing recession risks. This would help to drive the next upward leg in stock prices.

Incidentally, this process would be consistent with what has typically happened around the initial rate hikes in recent Fed tightening processes, when a consolidation in stock prices gives way to a renewed rally.

FIGURE 22: THE START OF A FED HIKE CYCLE CREATES HEADWINDS FOR EQUITIES - S&P PERFORMANCE AROUND FIRST FED RATE HIKES



Source: Bloomberg, PMAM Research. From January 1992 to June 2022.

Should the Fed soon become more data-dependent as the economy slows and as inflation expectations fall, it may pause its tightening process. Historically, a pause in Fed tightening generally results in a stock market rally and lower bond yields in the first three months following the pause. However, the strength and sustainability of these moves tend to be dictated by whether the economy avoids recession or not (Fig. 23). If a recession is avoided, the stock market typically continues to rally (which is consistent with Fig. 22); the onset of a recession leads to more muted returns. Positive economic conditions are verified by tightening high-yield bond spreads as well.

FIGURE 23: A PAUSE IN FED TIGHTENING GENERALLY RESULTS IN A STOCK MARKET RALLY

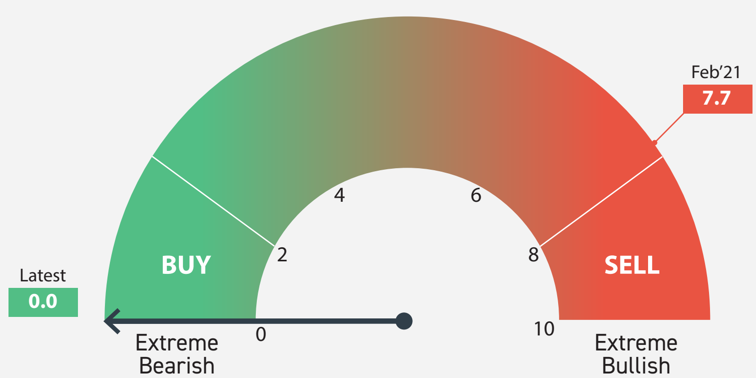
	S&P 500 Index	S&P / TSX Index	MSCI World Index	US 10 Year Bond Yield	US 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	US Unemployment Rate
Fed Pause (pre-recession)								
First 3 months	9.6%	10.2%	4.9%	-0.51%	-0.47%	-0.04%	-0.41%	-0.1
Following 6 months	1.3%	-0.8%	2.3%	-0.58%	-0.90%	0.32%	0.00%	0.2
Fed Pause (re-acceleration)								
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, PMAM Research. From June 1982 to June 2022.
* Fed Pause is defined as a the last hike of a continuous hiking cycle

BEARISH POSITIONING COULD MAKE A RALLY MORE EXPLOSIVE

With many stock markets around the world becoming bearish in the past quarter, it should be no surprise that most market sentiment indicators are currently sending the same signal, with investors exhibiting historically extreme levels of bearishness. The BAML Bull & Bear Indicator currently sits at a reading of zero, a level only observed nine other times since the measure was introduced in 2000. As a contrary indicator, this would suggest markets may be close to some sort of bottom.

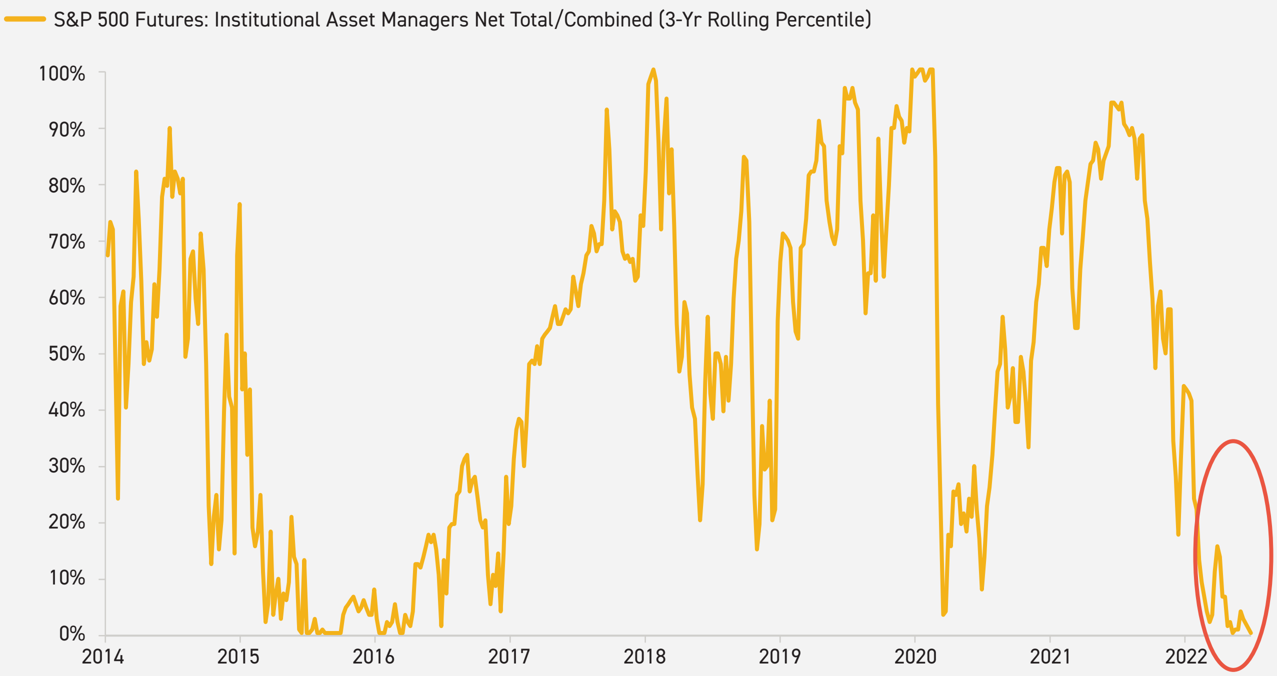
FIGURE 24: SENTIMENT IS AT A BEARISH EXTREME



Source: BofA Global Investment Strategy

It should also be no surprise that different categories of market participants are at various stages of capitulation. Institutional investors are holding low levels of equity exposure. Capital pools that are generally considered "faster money," such as hedge funds and systematic macro, are also carrying low levels of exposure to equities. To illustrate this point, Goldman Sachs reports that U.S. long/short hedge funds are carrying gross exposure at the seventh percentile of gross leverage, and fourth percentile of net leverage. Commodity Trading Advisors (CTA) funds are carrying near maximum U.S. equity short positions, and the lowest levels of equity exposure over the past 20 years (with the exception of the global financial crisis and the second quarter of 2020) are held by risk parity and volatility target funds.

FIGURE 25: INSTITUTIONAL MANAGERS HAVE LOWERED THEIR EXPOSURE TO EQUITIES



Source: Bloomberg, PMAM Research. From January 2014 to June 2022.

Should the narrative about the current market headwinds be replaced by something more positive, there is significant potential for "chasing" the market as these underinvested capital pools are redeployed. One possible setback could be a potentially longer-term headwind stemming from the elevated share of equity exposure held by U.S. households, an exposure that currently sits at levels just below the early 2000 highs. BAML reports that private client equity allocations sit at just under 63%, which represents a 7% excess relative to average allocations since 2005. While the secular trend of household equity ownership has been higher for decades, there is no guarantee this will be sustainable.

CONCLUSION

Bear markets are unpredictable and subject to large "flush out" sell-offs just when macro conditions appear to be at their worst. It is reasonable to expect markets to fall another 5% to 10% before reaching their ultimate lows. However, we believe some of the major headwinds that have helped drive markets lower are on the verge of changing this summer. Given the bearish outlook of many market participants, emerging tailwinds could lead to a much more buoyant stock market environment, especially if central bankers are willing to shift their focus as new information emerges regarding inflation and the economy.

SECTOR OUTLOOKS

INDUSTRIALS

Weakness due to macro concerns and recession fears has led the long-term risk/reward skew for many of our favoured names to improve dramatically. We are poised to reap the benefits of having shored up weightings in our high-conviction compounders and cyclical names within 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, idiosyncratic growth angles and/or opportunities to improve returns on invested capital. Toromont Industries Ltd. (TSX:TIH), Waste Connections Inc. (TSX:WCN) and WSP Global Inc. (TSX:WSP) 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 company is on track to complete its acquisition of Kansas City Southern (NYSE:KSU) in early 2023. We believe the synergies from the generational acquisition will surpass expectations in both timing and magnitude. We have added to holdings in ATS Automation Tooling Systems Inc. (TSX:ATA), based on the broader automation/onshoring theme, the business mix shift toward life sciences, its consistent contract wins and its margin improvement story. We also remain bullish on the industrial leasing complex. We believe the companies we own that are exposed to rentals, such as Triton International Ltd. (NYSE:TRTN), United Rentals Inc. (NSYE:URI) and, to a lesser extent, Willscot Corp. (NASDAQ:WSC) are oversold and trading at a discount to their intrinsic value. It is our view that they have the potential to outperform on better-than-expected results and astute capital allocation.

MATERIALS

The S&P/TSX Materials sector was unable to maintain its momentum from the first quarter and experienced a significant pullback in the second quarter of 2022, underperforming the broader S&P/TSX Composite Index and erasing its year-to-date gains. Weakness was broad based, reflecting easing risks regarding Russian supply, the impact of lockdowns in China, concerns about the potential for a recession in the western world and a stronger U.S. dollar, all of which weighed on the underlying commodities. Industrial metals led the declines, given their sensitivity to macro factors, and equities were further pressured by operating challenges and inflationary pressures throughout first-quarter reporting. Fertilizer equities are the best-performing subsector year-to-date, but did come under pressure in the quarter as a seasonal slowdown in demand tempered prices, and Russian supplies became more easily able to access global markets. Gold equities were under pressure from the significant move up in real rates, as well as the stronger U.S. dollar.

While macro uncertainty and the ramp-up of several new projects may drive near-term volatility in the copper price, we continue to view the structural backdrop favourably. We believe more recent concerns about energy security and independence will only add to the global decarbonization demand for copper. In addition, we struggle to see any material supply growth beyond the current number of in-development projects. We continue to prefer First Quantum Materials Ltd. (TSX:FM) for copper exposure, and have been tactical with our holdings among the smaller producers. We also remain positive on the outlook for Nutrien Ltd. (TSX:NTR), given the potential for an extended agricultural cycle, tight underlying fertilizer balances and optionality in ramping up its excess operating capacity. We remained selective with our gold exposure, focusing on companies that we expect to generate strong near-term free cash flow and that seem to be better able to manage cost pressures.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index decreased 21.9% for the second quarter of 2022, while the Information Technology sector in the S&P/TSX Composite Index decreased 30.8%. Shopify Inc. (TSX:SHOP) again made the biggest contribution to weakness in the S&P/TSX Information Technology sector, down 53% in the quarter due to continued valuation compression and increased spending on product development and fulfillment, which will likely lead to break-even operating profits in 2022. Overall, sector performance was broadly affected by continued valuation compression due to a higher-interest-rate environment and concerns about potential demand weakness as the global economy slows. Inflationary trends also continued to weigh on the potential outlook for margins. IT consulting was the best-performing subsector, down 10.5%, led by IBM Inc. (NYSE:IBM), followed by electronic equipment, down 16.2%, led by CDW Corp (NASDAQ:CDW). The weakest subsectors were internet & catalog retail, down 34.7%, and entertainment, down 33.9%, led by weakness in Amazon.com Inc. (NASDAQ:AMZN) and Netflix Inc. (NASDAQ:NFLX), respectively. The outlook for Information Technology in the third quarter of 2022 is one of caution, due to the higher-interest-rate environment, which could lead to further valuation compression and also begin affecting demand.

Against this backdrop, we like Match Group Inc. (NASDAQ:MTCH), a leading player in the online dating market whose base of paying users has been growing 10-16% along with 6-10% growth in revenue per payer for the past eight quarters. Online dating is generally relatively resistant to recession, and Match Group has the additional positive catalysts of a rebound in the Japanese market, following the lifting of COVID-related restrictions, and some margin improvement due to Google's delay in implementing alternative payment restrictions in the Google Play Store. Longer term, additional margin improvement could come from further reform of App Store fees.

HEALTH CARE

Health Care remained the only defensive sector trading at a discount to the S&P 500 (about 4.7% price/earnings discount). Quarter-to-date performance, down 5.6%, outperformed the overall S&P 500 Index, down 15.5%. The sector's performance remained largely decoupled from fundamentals, with macro and geopolitical themes continuing to dominate. Verticals that are focused on domestic markets, are positively leveraged to inflation and/or rates and have solid execution history and strong cash-flow profiles have been relative outperformers on a year-to-date basis: managed care is up 3.6%, distributors are up 17.8% and large-cap pharmaceuticals are up 5.1%, relative to the Health Care sector overall (down 7.22%) and the S&P 500 Index (down 19.1%).

During the second quarter, managed care organizations (up 0.7%), large-cap pharmaceuticals (down 4.2%) and distributors (down 1.4%) were the best-performing subsectors. Managed care's outperformance was supported by well-controlled utilization trends, with no significant spike in acuity and muted pent-up demand. The subsector also benefitted from rising interest rates, and also navigated an inflationary environment, because it held the balance of power in provider negotiations. Recent geopolitical events, as well as inflationary pressure, triggered a rotation into large-cap biopharmaceutical names, resulting in contraction of the multiple discount relative to the S&P 500 Index: that discount has narrowed to about 25% from about 45% during the 2020-2021 timeframe. Macro factors will likely dominate trading dynamics for large-cap pharmaceuticals, and events such as a renewed focus on drug price legislation in Washington, D.C., will probably have a muted impact.

Macro uncertainties, such as supply chain constraints (including a shortage of components, semiconductor chips and resin), inflationary pressures on raw materials and logistical challenges (oil, freight, transportation), are having a negative impact on the medical technology and supplies subsectors (down 21.9% year-to-date), and this problem could persist through year-end. Facilities are also underperforming (down 29.7%) because of mixed procedure volume recovery trends, which are skewed slightly negative, posing a risk to full-year guidance. The situation is compounded by a clinical labour shortage;

although the clinical labour supply is improving, it is doing so at a slower-than-expected pace. Rising interest rates, an increasingly challenging funding environment and the cash needs of early-stage biotechnology companies, combined with a risk-off environment, seem to have had a sustained negative impact on small and mid-cap (SMID) company valuations and stock performance (down 31.6%). The underperformance of SMID biotech will most likely continue into the second half of 2022, despite any pick-up in merger and acquisition activity as large-cap biopharmaceutical companies try to fill their pipeline and make up for pending losses of exclusivity. The life science and technology subsector's underperformance (down 24.6%) has continued, despite management comments in the tools industry regarding robust end markets, strong demand from biopharmaceutical companies and no stockpiling or pull-forward concerns, as demand remains consistent and durable.

During first-quarter 2022 earnings calls, most company management teams signaled that the negative impact of the macro factors should begin to ease with a recovery in the second half of the year. Recently, however, many companies have been highlighting continued negative pressure from macro factors that could result in weaker second-quarter earnings and potentially delay recovery until 2023.

CONSUMER DISCRETIONARY

The Consumer Discretionary sector again underperformed both the S&P 500 Index and the TSX Index in the second quarter of 2022, with global recessionary fears continuing to accelerate. In particular, the health of the U.S. consumer came under greater scrutiny, with inflation stubbornly high and the Fed forced to raise rates aggressively. Low-income household spending was the first to show signs of stress – no surprise, given the removal of government stimulus programs, lower excess savings and the greater impact of food and gas inflation – but higher-income cohorts may also come under increased pressure. Notably, about 75% of financial assets are held among the top 20% of U.S. households, so the bulk of wealth destruction caused by weaker equity markets is happening at the top end of income distribution.

At the same time, supply chain headwinds have been slow to abate, but we are hopeful that things may improve in the back half of this year. As this occurs, auto and housing inventory will likely also start to rebuild from unsustainably low levels, bringing car and home prices back down to more normalized levels. For now, however, against the rising risk of stagflation, and with heavy inventories elsewhere in the consumer space (e.g., apparel, general merchandise, home furnishings), it remains difficult to be positive about many consumer discretionary verticals. With that said, we believe the stocks to own in this environment will share some combination of the following characteristics: company-specific pricing strategies and drivers, defensive and less discretionary categories, limited commodity cost exposure, and strong balance sheets and free cash-flow generation, alongside reasonable valuations. In our view, these include stocks such as Dollar Tree Inc. (NASDAQ:DLTR), Spin Master Corp. (TSX:TOY) and Thomson Reuters Corporation (TSX:TRI).

CONSUMER STAPLES

Consumer Staples, while down on an absolute basis, continues to outpace the broad market year-to-date in both Canada and the U.S., with the market looking for defensive companies that can manage inflation relatively well. The sector was not immune to the pressure we have seen in the market this year, with broad-based pain felt after Walmart Inc. (NYSE:WMT) reported second-quarter earnings well below expectations. The market was especially concerned that Walmart is getting more aggressive about keeping prices low while pushing back on supplier price increases. This has negative implications for both food retailers and consumer-packaged goods companies, which had been passing on costs to their customers to offset inflation that accelerated once the Russia-Ukraine conflict began.

In Canada, we remain positive on Neighbourly Pharmacy Inc. (TSX:NBLY), a unique growth story with an opportunity to roll up the highly fragmented Canadian pharmacy industry, driving an EBITDA CAGR of over 20% until 2025. Early in March 2022, NBLY made a transformative acquisition of a key competitor in western Canada, growing its store count by 58% and its EBITDA by 70%. NBLY extracts synergies rapidly and is expected to fully integrate within 90 days.[9] We also remain positive on Alimentation Couche-Tard Inc. (TSX:ATD), viewing the convenience store operator as

[9] https://investors.neighbourlypharmacy.ca/files/doc_news/2022/NBLY-Announcement-Press-Release-vFinal.pdf

Inc. (TSX:ATD), viewing the convenience store operator as undervalued, considering its consistent earnings growth, which is supported by numerous organic initiatives. The company also has a very clean balance sheet, with over US$16 billion in debt capacity to support either its normal-course issuer bid or future merger and acquisitions.

In the US, we remain positive on quality share gainers and structural winners. Simply Good Foods Co. (NYSE:SMPL) is more of an "offensive" staple, providing exposure to both reopening and mobility in the US, along with exposure to secular health and wellness trends, while being an attractive takeout target.

FINANCIALS

Financials continued to underperform the market in the second quarter, with markets continuing to make increased odds that central banks will not be able to manufacture a soft landing in their attempt to curb inflationary pressures. Credit-sensitive financial stocks felt the brunt of this underperformance, validating our more defensive positioning in the sector. We continue to prefer less credit-sensitive names that are leveraged to higher rates, such as U.S. retail brokers. We also like select rate beneficiaries in the life insurance group, such as iA Financial Corporation Inc. (TSX:IAG), which is trading at pre-COVID valuation levels, notwithstanding significantly higher earnings, higher ROEs and a more capital-light business model. Outside of the banking and life insurance groups, we foresee another great year for pricing and profitability in the commercial property and casualty market, especially in the excess and surplus line, where Trisura Group Ltd. (TSX:TSU) is our favoured name. We believe the company has multiple levers to maintain 20%-plus EPS growth for the next couple of years. We also believe that the democratization of alternatives is one of the most powerful secular trends within Financials, with all investor segments increasing their exposure to alternatives. We expect Brookfield Asset Management Inc. (TSX:BAM) to be a key beneficiary as it builds out new capabilities (e.g., insurance/impact investing) and seeks to penetrate the high net-worth and ultra-high net-worth channel.

COMMUNICATION SERVICES

It was a quarter in which the markets flipped from concerns about growth to concerns about recession, and those concerns did not spare a rather defensive Communication Services sector: the Big 3 were down about 10%. That said, the sector's defensive characteristics did help it outperform the broader index by about 200 basis points. Looking ahead, telcos are now a push-pull between higher rates, which in the past has commanded lower valuations, and recession concerns, which attracts people to the sector given its relative defensive characteristics compared to the S&P/TSX Composite Index. We believe this would continue to be the case, particularly with the resumption in immigration.

It was not a good quarter for our top pick, Rogers (TSX:RCI/B), which declined about 12% after the Competition Bureau came out against Roger's acquisition of Shaw (TSX:SJR/B), citing concerns about competitive intensity in the wireless market. We believe Rogers' response – engaging with Quebecor (TSX:QBR/B), a proven operator, and finalizing the sale of Freedom to Quebecor – is likely to be viewed favourably by the Bureau, and that the odds that the deal goes through remain high. While our liking for Rogers is driven by attractive synergies (CA$1 billion, which we view as conservative), we would note that even on a stand-alone basis, Rogers is trading at a wide discount to Telus (TSX:T) and BCE (TSX:BCE), one at which it has rarely traded, indicating the cheapness of the stock even without the Shaw acquisition.

UTILITIES

It was a weak quarter for the Utilities sector on an absolute basis, with the sector delivering about -4%. However, as with telcos, the sector's defensive characteristics shone through, with Utilities outperforming the S&P/TSX Composite Index by about 900 basis points.

Both of our picks, Altagas (TSX:ALA) and Brookfield Infrastructure (TSX:BIP/U), registered negative returns on an absolute basis, declining by about 2% and 10%, respectively. Notwithstanding the weak quarter, we retain our positive view on both names. Our conviction on Altagas is driven by a combination of attractive valuation (price-to-earnings ratio of about 13), a deleveraged balance sheet following the sale of its Alaskan utility and positive developments in midstream, such as possible announcement of expansion facilities. With regard to Brookfield Infrastructure, we like its potential to grow earnings by 10% for the next few years, and its ability to make significant accretive acquisitions.

REAL ESTATE

Real Estate was the victim of recession concerns and rising rates; as a result, the sector delivered about -18% and significantly underperformed the S&P/TSX Composite Index. We have stated in the past that among the sectors that are cited as defensive – Utilities, Consumer Staples, Real Estate and Communication Services – Real Estate is one of the most economically sensitive; this quarter clearly underscored that point.

Our top pick, Colliers (TSX:CIGI), delivered a solid first quarter and, concurrent with those results, raised its earnings outlook for 2022. After its earnings release, Colliers also announced a couple of accretive transactions that would add to its recurring revenue mix. However, all the positive factors were subsumed by recession concerns, and the stock delivered -13% in the quarter. Looking ahead, we firmly believe that the brokers of 2022 are materially different (i.e., better balance sheets and higher recurring revenue) from those of 2008 and expect that will be proven in coming quarters.

ENERGY

Energy commodity prices remained volatile during the quarter. For oil, tight global product markets and uncertainties about disruptions of Russian supply led to an intra-quarter rally in global crude pricing. Prices retreated toward the end of the quarter on recessionary fears, given central bank actions and potential demand destruction due to higher commodity prices. For natural gas, European prices remain elevated, after Russia slashed gas flow to Europe. North American gas prices nearly doubled intra-quarter on low inventories and expectations of increased power demand through the summer season. However, prices retreated in June due to a fire at Freeport LNG facilities, resulting in the reduction of gas export capacity until late 2022.

In the portfolio, we added to Suncor Energy (TSX:SU). While Suncor has faced several operational challenges over the past few years, we believe the company has reached an inflection point on improving the reliability and safety of its operations. Further, the emergence of an activist shareholder during the quarter provides support for realizing value, through disposition, management enhancements and/or capital returns.

We have also added to our uranium exposure; sentiment continues to improve, as it is one of the only viable near-term low-carbon energy solutions. Several European governments have shifted to a favourable view on nuclear power following Russia's invasion of Ukraine, with western Europe depending on Russia for 40% of its natural gas supply.

HEAD OFFICE
33 Yonge Street, Suite 830
Toronto, Ontario
M5E 1G4

TELEPHONE: 416-955-4108
TOLL FREE: 1-866-369-4108
RETAIL SALES: 1-833-955-1344

GENERAL INQUIRIES
service@pictonmahoney.com

INSTITUTIONAL INQUIRIES
tklymenko@pictonmahoney.com

VANCOUVER
Four Bentall Centre
1055 Dunsmuir Street, Suite 3370
Vancouver, British Columbia
V7X 1L3

CALGARY
Bankers Hall, West Tower
888 3rd Street SW, 10th Floor
Calgary, Alberta
T2P 5C5

MONTRÉAL
1155 Metcalfe Street, Suite 1502
Montréal, Québec
H3B 2V6

www.pictonmahoney.com