Insights & Strategies

PRIVATE CLIENT SOLUTIONS

December 1, 2021

"I Got You Babe"

Contents

In some aspects, 2021 felt like an extension of 2020. Although economies are almost two years into the recovery, the COVID-19 pandemic has continued to impact people's lives and made some recall the 1990s movie "Groundhog Day". The film, starring Bill Murray, tells the story of a man trapped in a time loop: he awakens every day to "I Got You Babe" playing on the radio, and lives the same events of the previous day. Just like in the movie, the same song will keep on playing in 2022 (i.e., COVID-19 uncertainty), although we expect the performance for markets across asset classes to be quite different than in 2021. In particular, **we anticipate more volatility and a tougher market climate as we move beyond the early phase of the recovery. For equities, we believe the easy gains are behind us and suggest investors think long-term, diversify, and be selective.**

Coming out of the burrow

The COVID-19 pandemic caused a global recession in 2020 and has been the main driver of macroeconomic and market performance ever since. With record low interest rates/yields and +US$17 trillion in global fiscal stimulus, the economy rebounded sharply. Demand has been strong and a boon to equity markets. Most stock indices, particularly in North America and Europe, have performed well above historical returns in 2021. The exceptions are a few markets in Asia and Latin America, mainly due to idiosyncratic factors (e.g., Brazil).

Performance of Select Equity Markets in 2021 (Local Currency)

Index	YTD % Change	20-year Average
Americas		
S&P/TSX	23.1%	5.5%
S&P 500	24.9%	7.3%
DJIA	16.4%	6.6%
NASDAQ	22.4%	11.2%
Russell 2000	18.0%	8.5%
Brazil Ibovespa	-13.1%	10.9%
Mexico S&P/BMV IPC	16.1%	11.6%
Europe		
EURO STOXX 50	20.6%	0.6%
FTSE 100	12.5%	1.5%
France CAC 40	26.9%	2.2%
Germany DAX	16.2%	5.8%
Italy FTSE MIB	21.2%	-1.0%
Switzerland SMI	15.5%	3.2%
Russia RTS	19.8%	10.4%
Asia Pacific		
ASX All Ordinaries	13.0%	4.4%
SSE Composite	3.3%	3.8%
Hang Seng	-9.5%	4.0%
Nikkei 225	8.5%	5.3%
Korea KOSPI	4.3%	8.2%

Source: FactSet; Raymond James Ltd.; Data as of November 23, 2021

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RAYMOND JAMES

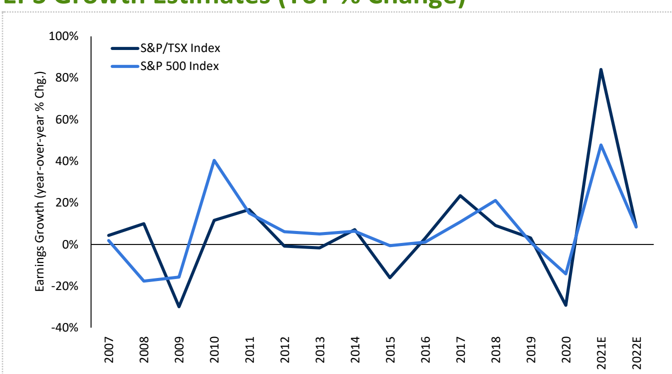
As the recovery enters the mid-cycle, policy makers have started reducing stimulus. Central banks in a few developed economies announced the reduction of bond purchases (e.g., the Federal Reserve in the U.S.), while others decided to end their quantitative easing programs altogether (e.g., the Bank of Canada). We have seem interest rate hikes in only a few countries, mostly emerging markets like Brazil and Russia. New Zealand is the main developed economy increasing its policy rate. At the same time, governments are ending pandemic-related programs (e.g., CRB in Canada).

Is it getting colder or warming up?

When compared to the end of 2020, the yield curve has shifted upwards, with more pronounced increases in its front-end. This means the yield curve as of November 30 has a more traditional logarithmic shape (i.e., steeper in the front-end, from overnight to 5-years, and flatter over long maturities. In fact, for the U.S., the 30-year yield is below the 20-year rate (i.e., inverted), which is commonly viewed as one of many recession indicators. That is yet another worry to be added to investors' "Wall of Worry", which also includes new COVID-19 waves/variants and the potential for more lockdowns (e.g., in Europe), central bank policy normalization efforts, global inflationary pressures, and reforms in China.

The outlook for yields has very important implications for equities, e.g., if yields rise higher than consensus expectations, we could see some compression in multiples of sectors with long duration cash flows, such as U.S. tech. Overall, we expect equity returns to follow a more modest trend in 2022, as policy support and earnings begin to normalize. For the S&P/TSX and the S&P 500, we forecast a rate of return of ~10-15%, which is materially below 2021 numbers, but still above-average. That said, upside to these numbers for Canada could occur if, all else equal, commodities stay strong and gold performs better. For our thoughts and outlook on the gold sub-sector, please refer to our Portfolio Strategy note [Goldilocks and the Three Bears].

EPS Growth Estimates (YoY % Change)



Source: FactSet; Raymond James Ltd.; Data as of November 23, 2021

Given all of the above, we continue to view equities as more attractive than bonds on a risk-adjusted basis, with a slight preference for the S&P/TSX over the S&P 500, given the former is trading at a discount and the latter at a premium versus historical 5-year averages on forward earnings. We also favour developed versus developing equity markets, despite some in the latter having appealing valuations, fundamentals, and rising vaccination rates. From a sector perspective, we see the best opportunities mostly in cyclicals, with pockets of opportunities elsewhere.

S&P/TSX Valuations

	P/E Next 12M	P/E 5Yr	Premium 5Yr
S&P/TSX Composite	**14.6**	**15.4**	**-0.8**
Communication Services	18.6	16.7	1.9
Consumer Discretionary	15.4	14.5	0.8
Consumer Staples	16.8	16.6	0.2
Energy	10.6	16.4	-5.7
Financials	11.6	11.1	0.5
Health Care	24.3	25.5	-1.2
Industrials	29.3	21.4	7.9
Information Technology	68.2	37.0	31.2
Materials	12.8	18.9	-6.1
Real Estate	18.8	14.9	3.9
Utilities	8.9	15.6	-6.7

Source: FactSet; Raymond James Ltd.; Data as of November 23, 2021

S&P 500 Valuations

	P/E Next 12M	P/E 5Yr	Premium 5Yr
S&P 500	**21.5**	**18.7**	**2.8**
Communication Services	21.3	20.1	1.1
Consumer Discretionary	35.0	27.6	7.4
Consumer Staples	20.8	19.6	1.2
Energy	11.6	9.9	1.7
Financials	14.9	13.2	1.7
Health Care	16.9	16.3	0.6
Industrials	21.6	19.2	2.3
Information Technology	27.6	20.6	7.0
Materials	16.9	17.5	-0.6
Real Estate	23.2	19.3	3.9
Utilities	19.7	18.2	1.5

Source: FactSet; Raymond James Ltd.; Data as of November 23, 2021

Investor recommendations

In 2022, many of the factors that have been in place since the onset of the pandemic supporting above-trend economic and equity market performance will normalize (e.g., near-zero interest rates and extreme levels of accommodation). We expect investors will face more volatility and a challenging market climate. The easy gains are behind us. Think long-term, diversify, and be selective.

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Luiz Furlani, PhD, CFA, Associate Investment Strategist

Canadian & US Equity Ideas for 2022

Sector	Top Stock Ideas
Communications Services	**Quebecor (QBR.B-CA)** is a telecommunication, entertainment, and news media services firm with a strong competitive position in the Quebec marketplace, which supports its strong free cash flows and dividend growth potential. **Walt Disney (DIS-US)** is a diversified international family entertainment and media enterprise with a successful record of accomplishments since 1923. The company's strong content library, recent acquisitions, and direct-to-consumer (DTC) platform provide for meaningful growth opportunities.
Consumer Discretionary	**Canadian Tire (CTC.A-CA)** is a general merchandise retailer for gasoline, automotive, sports, and home products. The retailer has a successful history of maintaining market share despite competitive pressures from domestic and international peers. We expect the retailer to benefit from a reopening economy and strength in its e-commerce channel. **Amazon.com (AMZN-US)** is a leading online retailer that also provides technology infrastructure solutions for businesses and developers. The company has a large direct-to-consumer platform, providing movies, music, books, and games to its members. Recent investments in its distribution network provide growth opportunities for its e-commerce platform and stronger competitive positioning.
Consumer Staples	**Alimentation Couche-Tard (ATD.B-CA)** is one of the largest gas station and convenience store operators with a network of approximately 12,300 stores in Canada and the US. The company's focus on both organic and M&A-driven growth has proved successful in gaining market share from a highly fragmented industry. The company has a solid management team and continues to provide a favourable risk/reward profile to investors. **Walmart (WMT-US)** is a merchandise retailer with a wide assortment of goods and services at low prices. The company's focus on being a low price leader supports its defensive business model and market share.
Energy	**Enbridge (ENB-CA)** is one of the world's largest energy infrastructure companies with an enormous pipeline network that provides the company with a utility-like stream of cash flow, which supports its ability to grow and sustain its dividend policy. **Exxon Mobil (XOM-US)** is a global integrated energy company focusing on the exploration, development, and distribution of oil, gas, and petroleum products. The company's management team has successfully navigated a difficult commodity price environment, while reducing its debt profile, initiating a $10 bln share buyback program, and investing in new low-carbon investments to fuel future growth.
Financials	**Intact Financial (IFC-CA)** is a property and casualty insurance provider in Canada, and provides specialty insurance services to businesses in the US. The company has shown industry-leading growth, and management is focused on leveraging its strong financials to engage in strategic acquisitions to expand its business. **Blackrock (BLK-US)** is a leading global investment manager that offers a wide range of products and services for both institutional and retail clients. The company has seen strong organic growth through its iShares franchise, providing equity and fixed income ETFs, and its advice-driven asset management strategy.
Health Care	**Chartwell Retirement Residences (CSH.UT-CA)** is a real estate investment trust (REIT) focused on the ownership and operation of senior housing communities providing a wide range of care services. The company is an established pure-play retirement housing REIT in Canada, which is well positioned to benefit from aging demographics. **Merck & Co. (MRK-US)** provides healthcare solutions through prescription medicines, vaccines, biologic therapies, animal health, and consumer care products. The company has a significant pipeline of new medicines expected to provide vigorous growth in the future.

Industrials	**TFI International (TFII-CA)** provides freight transportation and logistic services. Since the mid-90s, management has implemented a successful acquisition and integration strategy, including its most recent UPS Freight transaction. The company maintains a solid balance sheet, which helps support further M&A opportunities should they present themselves. **FedEx (FDX-US)** is a diversified holding company that offers a broad range of transportation-related services. The company is well positioned to benefit from the reopening of economies through its B2B exposure, and e-commerce trends. Management's recent initiatives to offer six/seven day delivery, and increasing collaboration among its segments, is expected to help volume growth and pricing discipline heading into 2022.
Information Technology	**CGI (GIB.A-CA)** is an information technology and consulting services firm providing solutions to its clients in North America and Europe. The company has strong financials and a robust balance sheet to continue its growth strategy through strategic acquisitions and expanding its service offering. **Visa (V-US)** is a leader in digital payment services, helping facilitate global commerce transactions for consumers, businesses, and governments. The company has an established payments platform, making it a beneficiary of reopening economies and increased trade.
Materials	**Wheaton Precious Metals (WPM-CA)** is a royalty streaming company that focuses on high-quality assets with exposure to gold, silver, and other metals. Its royalty-streaming model provides investors with lower risk exposure to precious metals, and solid free cash flow generation and dividend distribution. **Linde (LIN-US)** engages in the production and distribution of industrial gases used by companies within defensive end markets including health care, electronics, and food industries. The world's largest industrial gas producer benefits from recovering economies, particularly from increased demand for industrial gases.
Real Estate	**Canadian Apartment Properties REIT (CAR.UT-CA)** is a REIT that owns and operates a portfolio of multi-unit residential rental properties across Canada and the Netherlands. CAPREIT generates stable cash flows and has a strong balance sheet, helping fuel further M&A and organic growth projects. **American Tower (AMT-US)** operates and leases essential telecommunication infrastructure assets globally, including wireless and broadcast communications, real estate, wireless towers, and distributed antenna systems. The company recently acquired CoreSite Realty, adding a solid data center platform to its portfolio.
Utilities	**Northland Power (NPI-CA)** is an electric power producer focusing on development, ownership, and management of various wind power generation facilities globally. The company's recent efforts to develop its offshore wind platforms are expected to provide meaningful growth in cash flows and dividends. **NextEra (NEE-US)** is an electric power and energy infrastructure company with a focus on renewable power generation. The company is led by a strong management team, and benefits from its first mover advantage in creating renewable energy assets across North America.

Source: Raymond James Ltd.

Larbi Moumni, CFA
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Peter Tewolde
Equity Specialist

Managed Money Outlook

Broad-based equity indices had a tremendous 2021 with strong positive returns across the spectrum. Fixed income, on the other hand, had a difficult year, particularly passive investors with longer duration positioning. In this article, we will provide a brief recap of 2021 markets and some guidance on positioning your managed money investments heading into 2022.

Fixed income

Rising interest rates and inflation worries dominated fixed income markets in 2021. Most bond market indices suffered negative total returns for 2021 given the movement of interest rates. Long duration investors saw a powerful demonstration of the effect duration has on returns when rates are close to zero. While interest rates only moved 79 basis points higher from a nominal perspective on 2-year government bonds (at the time of writing), that represented a 400% increase from last year, hence the market (FTSE Canada Universe bond index) being down 4%. Active managers traditionally differentiate themselves based on duration and credit quality. Managing to a lower duration in 2021 was key to outperformance. Coming out of the pandemic was also an opportunity for skilled credit managers to add value across the credit spectrum.

Outlook for 2022

As we move into the mid-cycle environment, we believe similar characteristics are required for success. This includes carefully managing both duration and credit quality. We believe it is prudent to have a lower duration to the overall market while active credit managers remain well positioned to outperform. Although interest rates have already moved up significantly from the lows, we feel there is a lot more room for them to run. In addition, while duration can be detrimental to performance in a rising rate environment, it is important to remember the role of fixed income in a broadly diversified portfolio. Fixed income instruments, particularly longer duration government bonds, are a diversifier that provides ballast should equity markets experience turbulence. While we may want to have shorter duration than the overall market, duration can still be an important portfolio characteristic given its lower correlation to equities. Another characteristic of rising rates that can be positive for investors is the higher reinvestment rate for your coupon payments. Rising reinvestment rates can mean the same or higher total return over the long term.

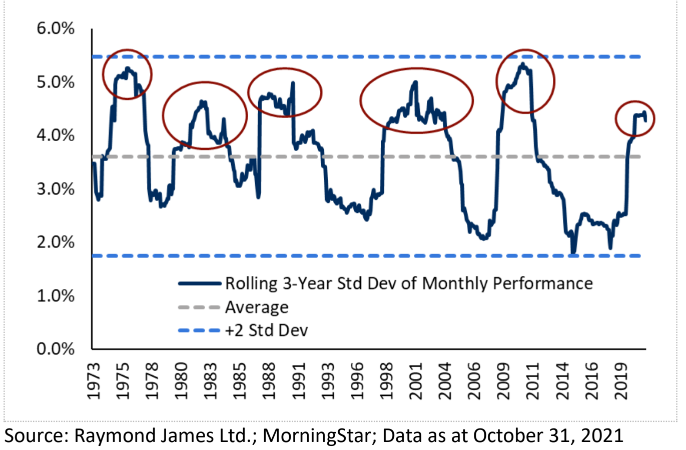
Equities

Accommodative fiscal and monetary policy conditions throughout 2021 helped deliver an excellent year for equity markets across the globe. Most major North American indices are up in double-digit territory with a stronger-than-expected rebound coming through the tail end of the year. Passive and active investors alike were rewarded this year as a rising tide lifts all boats. Although the majority of markets had a strong year, there were pockets of underperformance that could provide investors opportunities going forward, specifically in emerging markets (EM).

Outlook for 2022

Our expectation is that equity markets will be more challenging to navigate going forward and investors could benefit from active management. To forecast our outlook for active vs passive management, we look at a rolling dispersion analysis. Dispersion essentially looks at the distribution and the volatility of returns; in this case, broad equity markets. Lower levels of dispersion favour passive management as markets move in unison, while high and elevated levels provide an environment for active managers to add value. As seen in the chart below, markets remain at elevated dispersion levels heading into 2022. Combined with the view that we are mid-cycle, which for equities traditionally rewards stock pickers as equity market volatility begins to pick up, we believe active managers are poised to add value next year. Those investors who have longer-term horizons could continue to benefit from low cost passive exposure to equity markets, but now might be an opportune time to consider incorporating some active management in less efficient spaces. One opportunity for this is in EM. EM struggled in 2021 for a multitude of reasons, but we believe many of these headwinds could be lifting. Our focus list fund, **RBC Emerging Markets Equity,** could be a great starting point for investors.

Three Year Dispersion Remains Elevated



Source: Raymond James Ltd.; MorningStar; Data as at October 31, 2021

Spencer Barnes, MSc., CIM
AVP & Portfolio Manager, Mutual Funds & ETFs Strategy

G10 FX Outlook: A Wobbly Handoff from 2021 to 2022

2021 has been quite the year for the greenback as it held onto gains against all of its G10 peers. However, the Canadian dollar (CAD) remains the only major currency that is attempting to close the year in unchanged territory versus the US dollar after remaining in the green for most of the year.

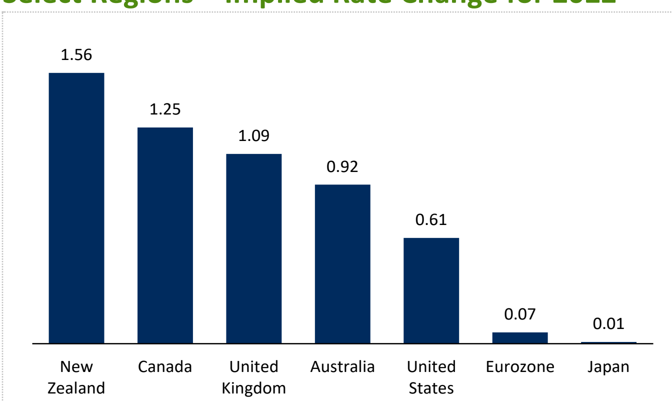
2021 YTD G10 performance vs. the USD

G10 Currency	YTD % Chg.
CAD - Canadian dollar	-0.52%
GBP - British pound	-2.44%
CHF - Swiss franc	-4.11%
NZD - New Zealand dollar	-5.04%
NOK - Norwegian krone	-5.48%
DKK - Danish krone	-7.28%
EUR - Euro	-7.36%
AUD - Australian dollar	-7.42%
JPY - Japanese yen	-8.93%
SEK - Swedish krona	-10.21%

Source: FactSet; Data as of November 26, 2021

The start of 2021 focused on the global reflation trade, which saw risk assets and commodities catching a lift and commodity- and risk-sensitive currencies like CAD reaping the benefits. This theme then transitioned into one of persistently higher inflation and markets' pricing for central bank action. With COVID returning to the forefront, we are anticipating an elevated level of macro risks and a continuing rotation between market-driving themes such as growth expectations, central bank action and rates, to play out in 2022. Persistently higher inflation has pushed markets to aggressively price in rate hike expectations for many G10 central banks; however, we believe central bank response will be somewhat subdued as they may very well act earlier than expected but tighten less than what the market is currently pricing in. This scenario should provide a positive macro backdrop for risk assets.

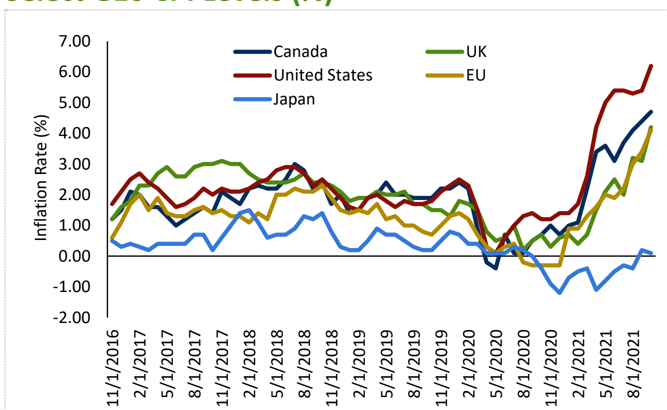
Select Regions – Implied Rate Change for 2022



Source: FactSet; Data as of November 24, 2021

USD: As far as inflation in the G10 is concerned, the United States sits right at the top after the latest CPI print came in at the highest level in nearly three decades. While this pushed the market to price in a more hawkish Federal Reserve (Fed) going forward, markets are actually pricing in similar action for most central banks around the world, with the exception of the European Central Bank (ECB). Fed Chair Powell expressed confidence that when the economy does in fact hit its maximum employment target, the inflation objective will also have been met. However, it is uncertain what maximum employment may look like in a post-COVID world. That alone makes the timing of the Fed's first rate hike and the path for rates going forward uncertain. Given how aggressive the market has been in pricing in rate hikes, we believe a "corrective wash out" will play out to some degree. The central banks of Australia, Canada and New Zealand may push back against aggressive market expectations, which would weigh on short-end rates and their currencies as a result. Any recalibration of expectations in the short term will likely reinforce some modest USD strength in the process. However, if we get a patient Fed and a decent global growth outlook, we may see the USD begin the year on a weaker footing.

Select G10 CPI Levels (%)



Source: FactSet; Data as of November 24, 2021

CAD: While headwinds appear to be piling up for the commodity FX bloc, we believe oil prices should begin to consolidate as a potential gradual return to surplus should help to drive prices moderately lower. However, we do not believe that this will undermine the recovery in the Canadian oil and gas space; Canada should benefit from the global trade recovery as supply constraints ease. In addition, the domestic economic outlook is strong, with employment at pre-pandemic levels, a strong vaccination rollout is resulting in the pulling back of border restrictions, and loose fiscal policy should provide CAD with some tailwinds. The Bank of Canada (BoC) is positioned to act fast after it shifted to a more hawkish stance in October by ending its QE program and pulling forward its first rate hike to 2Q22. Markets are currently pricing in a 25bp rate hike in March and calling for a total of five rate hikes in 2022. Depending on how the BoC inevitably acts, there may be only a limited scope for re-pricing market expectations. Naturally, the risk to this view is if markets have overpriced BoC action and underpriced the Fed for 2022. Seeing how CAD strengthened in the wake of the BoC's October rate decision, followed by a relatively muted response to the subsequent hawkish decision in November, it may be likely that its response will be well below already aggressive market expectations. Nonetheless, we envision USD/CAD to trade within a 1.20-1.24 range.

EUR: ECB President Lagarde continues to state that the conditions for a rate hike are unlikely to be met in the coming year. Unwarranted tightening of financial conditions would certainly be undesirable, introducing unwanted headwinds for Europe's economic recovery. As a result, it is no surprise to see EUR/USD trading at nearly a 16-month low at the time of writing. A widening divergence between the Fed and ECB monetary policies will prove to be an increasing headwind for the EUR. While the ECB's pandemic emergency purchase programme (PEPP) will continue until its March 2022 timeline, ECB apprehension over the maintenance of favourable financing conditions and concerns over peripheral spread widening may push the ECB to maintain bond purchases into 2023. As a result, we believe the ECB will stay put on rates into 2023. This policy gap underscores our bearish EUR outlook as we continue to favour fading rallies and look for the pair to move towards the 1.10 handle over the coming year.

GBP: The market continues to price in around 100bps of tightening over the next twelve months, an overly aggressive expectation by our standards. A moderating macro environment and relatively well-contained inflation expectations point towards a less aggressive rate cycle than what the market is predicting. November's Bank of England (BoE) rate decision, which sent the GBP spiralling downward after it ducked the opportunity to hike rates, provided important insight to market participants' views. The Monetary Policy Committee (MPC) pushed back against market expectations and stated that uncertainty over the labour market remains the MPC's chief concern and that the decision on hiking rates was deferred to "coming months." In addition, the persistence of supply bottlenecks, the ongoing energy crisis, a softer consumption backdrop amid the April tax hike, and Brexit-related risks, will pose as headwinds for the GBP going forward.

AUD: Reserve Bank of Australia (RBA) Governor Lowe stated that, while wages and inflation are expected to increase gradually, this does not warrant an increase in rates as swiftly as the market expects. The RBA also dropped its yield curve control policy tool, which pinned the yield on the April 2024 government bond at 0.10%, citing that it had made faster progress toward achieving its inflation objective. Thus, we believe the RBA will be one of the later banks to hike rates, leaving AUD susceptible to broader risk sentiment and economic data. The first rate hike may come in 2023, albeit risks are skewed towards an earlier move with the market pricing in around 80bps of tightening for 2022. In addition, a rocky Australian-Chinese economic relationship and a further downturn in commodities may prove to be headwinds over the coming year.

NZD: The Reserve Bank of New Zealand (RBNZ) is one of the most hawkish G10 central banks and markets are not shying away from aggressively pricing in rate hikes next year with economic data being exceptionally strong. While current expectations may need to be dialed back a bit, any signs of persistent inflation throughout the year should continue to fuel speculation that the RBNZ's tightening cycle will have to continue well into 2023 and beyond. Similar to its Antipodean peer (Australia), China-related sentiment will be important to watch as well.

Bringing it home

A strong rebound in global growth put the global supply chain to the test, resulting in supply-chain bottlenecks, stronger-than-expected inflation and an aggressive re-pricing of central bank hikes. 2022 will be the year of central bank action and monetary policy normalization. While we expect Norway, New Zealand, Australia, England and Canada all to hike or continue to hike rates, the Fed is only now beginning to taper its QE program and it has yet to reach its hurdle for a rate hike, while the ECB is expected to scale up its asset purchases. Thus, while all major central banks will begin or continue to head for the exits in 2022, the relative speed at which they do will have the greatest impact on FX markets. As a result, we are anticipating some two-way risk for the USD as the market will likely reward currencies with relatively active central banks; however, a continued fine-tuning of market expectations given the broader macro uncertainties at play may muddy the waters a bit. That would imply incoming economic data would be particularly important in helping to fine-tune those expectations.

Ajay Virk, CFA, CMT
Foreign Exchange

Fixed Income: On the Up and Up

As the year comes to a close, we revisit some of the fixed income predictions we published at the start of 2021, based on a combination of consensus inputs and the views of our fixed income team, and summarize notable trends we observed. We then build on these ideas, and discuss our projections for 2022.

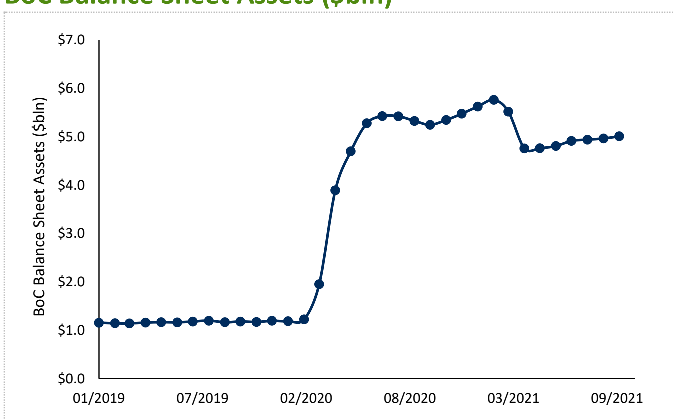
What we saw in 2021

Prediction: Low interest rates would persist due to a fragile but improving economic backdrop and unprecedented levels of monetary aid provided by the federal government and Bank of Canada (BoC). Inflation will eventually show up, but it was not an immediate concern.

Result: As expected, there were no rate hikes in 2021. However, inflation became a topic of discussion sooner than anticipated, hitting levels not seen in almost 20 years by Q3 2021. Factors like supply chain disruptions and rising energy prices pushed costs upwards. These pressures are still viewed as transitory, but have lasted longer than projected.

Extreme liquidity programs introduced at the beginning of the pandemic by the BoC were discontinued as the fixed income markets recovered and their utilization waned. At this time, the BoC maintains an expanded balance sheet, with no immediate plans to sell the securities acquired under such programs.

BoC Balance Sheet Assets ($bln)

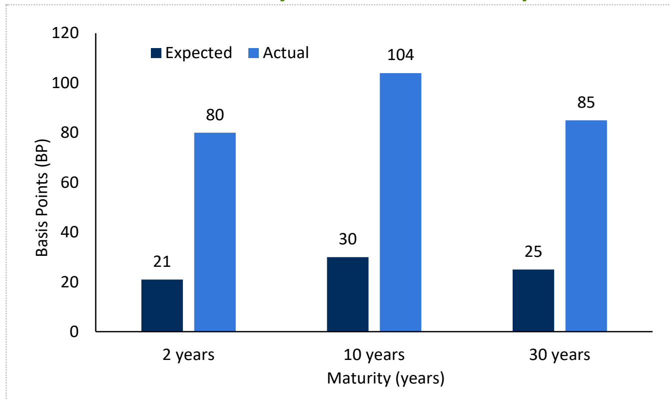


Source: BoC; Raymond James Ltd.; Data as of November 25, 2021

Prediction: Economists forecast benchmark yields would increase from existing levels, with long-dated bonds rising 25 basis points (bps), 10 years by 30 bps, and two-years by 21 bps. This aligned with our view of moderate normalization in 2021.

Results: After bond rates plummeted at the onset of the pandemic, 2021 saw yields rise across the Government of Canada curve, with increases that vastly exceeded expectations. But, when compared historically, yields are still very low, underlining the "lower for longer" trend. Only recently has the 10-year benchmark regained pre-pandemic levels while two-year notes have yet to hit this milestone. The short end of the curve better reflects the current environment; whereas, longer terms build in expectations. As rate hikes materialize, two-year bonds should also move higher.

Yield Increases Handily Beat Economist Expectations



Source: FactSet; Raymond James Ltd.; Data as of November 23, 2021

Prediction: We believed the odds of modest credit spread widening was elevated, with higher yield securities more at risk. This was predicated on our view that they had tightened too dramatically in 2020 and should see a reversion to mean levels.

Result: Counter to our expectations, bonds in the provincial and investment-grade spaces tightened, on average. Our prediction was based on the fact that 2020 spreads had already tightened past pre-pandemic levels and we believed they would moderate. However, the additional tightening may indicate that investors continue to show a preference to spread product over benchmark securities, looking to capture what little pick up is available.

Prediction: Preferred share issuance was expected to slow considerably, exacerbating the supply-demand imbalance. $5 billion in bank-preferred shares could be redeemed in 2021.

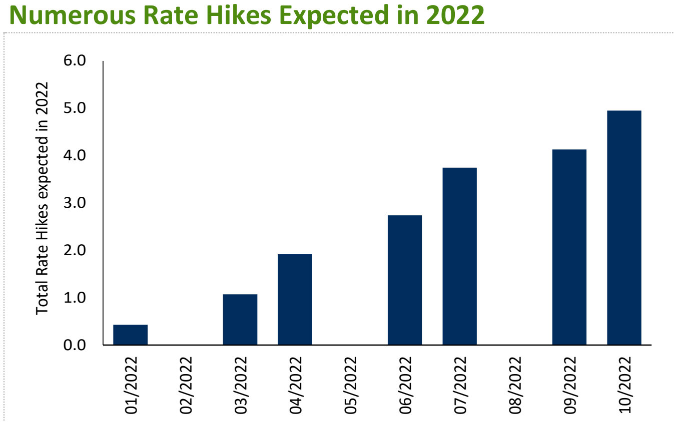
Result: The Canadian preferred share market had a remarkable run with year-to-date returns of 18.21%, which was well above historical averages. Three main factors that contributed to the outsized gains in 2021 were discounted preferred shares being called (thus seeing their values quickly move to par/call price); continued inclination of financial institutions to issue Limited Recourse Capital notes (LRCNs) over preferred shares; and strong investor demand, as they hunted for yield in a low interest rate environment. As predicted, the total preferred shares market shrank, as issues were called without replacement. Since banks and insurers account for ~60% of the preferred shares market, their lack of reissuance when calling their outstanding shares (choosing to refinance with LRCNs instead) was a driving factor. Over $9.7 billion in preferred shares were redeemed, with the majority of that coming from the bank/financial issuers.

What we expect for 2022

In 2022, we anticipate that many of the themes that began in 2021 will continue, including improving bond yields, tight credit spreads, and a more limited offering in preferred shares. With up to five quarter-point rate hikes anticipated in Canada over the next year, we believe that bond yields should continue to rise; however, the breakneck pace experienced in 2021 most likely will not be replicated. A few reasons for the moderation include:

- **Starting point** – Rates entered this year at some of the lowest levels ever seen. A small absolute move translated to a large percentage change in benchmark securities. With these bond yields now at or approaching pre-pandemic levels, the starting point is much higher than at the beginning of the year.
- **Forward-looking** – Bond yields are forward-looking, meaning that they tend to anticipate, and discount, future factors before they actually occur. As the anticipation of rising interest rates grew with the continued pressures of inflation, bond yields would have moved along with them. Thus, unless expectations are pulled forward again, or the number of predicted rate hikes increases, yields may not rise as quickly.
- **Risks on the horizon** – New strains of the virus may continue to threaten the smooth functioning of economies globally. These pressures and others that have yet to be identified may scare investors, pushing them into safer investments like bonds.

Numerous Rate Hikes Expected in 2022



Source: FactSet; Raymond James Ltd.; Data as of November 29, 2021

In terms of positioning investor portfolios, short-end bonds in the two to three year maturity space should provide a yield pick up over shorter product (under one year) while still allowing for a near-term maturity date and lower duration. Having your cash returned to you sooner may be beneficial in an environment of rising rates. For most retail investors, spreading out maturities across multiple years, a strategy called laddering, could provide additional piece of mind.

We also display a preference for corporates over government securities as long as economies continue to see expansion. This is based on our view that credit spreads may remain tight or only widen slightly as investors seek the limited pick up spread product provides. That said, those that prioritize safety over returns may prefer government bonds.

In the preferred shares space, 2021 was an outlier in terms of performance, thus we do not anticipate the same returns next year as some factors that have largely set up the market for the outsized gains have already played out. We expect returns will fall more in line with the five-year average (+7.2%). We reiterate our message from the ***Canadian Preferred Shares Report for Q3 2021*** where we suggested clients look for fixed reset preferred shares with reset rates that are not too high (less than 300 basis points over Canadian 5-year bonds) but high enough that they still compensate the holder if they do reset. Targeting prefs that reset in late 2022 or beyond may allow investors to take advantage of higher rates if they materialize. If interest rates rise more than expected prior to reset, fixed resets, which make up ~67% of the total market, can drive the whole market even higher.

Redemptions are expected to continue in 2022 with limited new supply expected. As financial issuers call their preferred shares without reissuing in the space, a scarcity premium may be built into the price, providing a lower comparable yield, but maintain a pick up over other product types such as bonds and GICs due to their higher risk.

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Alternative Investments: Enhancing the Balanced Portfolio

Alternative investments played an important role in client portfolios this year, as interest rates began to increase and the fixed income component of many traditional portfolios languished. For the appropriate investor, alternative investments can help bridge the gap between equities and fixed income, offering additional diversification as well as the potential to achieve a more favourable rate of return than fixed income, but with less volatility than equities. This was exactly the outcome investors had who adopted a well-diversified basket of alternative investments into their asset mix during 2021. The Scotiabank Hedge Fund Index, which represents 69 funds across various Canadian alternative investment strategies and investment managers, was up 11.28% year-to-date and 21.54% over the last 12 months, as of the end of October. This is in stark contrast to having passive exposure to the Canadian investment grade bond market, with the FTSE Canada Universe Bond Index down -4.96% year-to-date and -3.64% over the last 12 months. While it was another banner year for most equity markets, a well-diversified basket of alternative investments was able to achieve double-digit returns, but with less volatility than equity markets (7.98% 1-year annualized volatility for the Scotiabank Hedge Fund Index vs 14.63% for S&P 500).

What are Alternative Investments?

An alternative investment is an asset that does not fall into one of the traditional asset classes such as equities, fixed income, and cash, and is used to more fully diversify a portfolio (among other objectives). Here are some examples:

- *Real Assets (such as private real estate, infrastructure, natural resources)*
- *Private Equity (includes buyout, mezzanine, venture capital)*
- *Private Debt (such as factoring, asset-backed lending, distressed debt)*
- *Mortgage Products (MICs, mortgage investment trusts)*
- *Hedge Funds (various strategies – directional, absolute return, market neutral, long/short, long-bias, short-bias, risk/merger arbitrage, event-driven, multi strategy, global macro)*

Source: Raymond James Ltd.

While the balanced portfolio (60% equities / 40% fixed income) has been a recipe for success since interest rates peaked in the early 1980s, the return from the bond component of that allocation has largely benefitted from declining interest rates. In today's low yield environment and with rates poised to increase next year, we believe that traditional fixed income investments will remain challenged to deliver returns in line with history. As a result, we think that alternative investments will continue to play a significant role in portfolios in the years ahead.

According to Preqin, global alternative assets under management are expected to increase by more than 60% by 2025 (9.8% annualized). While individual investors typically have a different investment profile and liquidity needs than that of a large pension plan or endowment, it is worth noting that alternative investments are integral to the asset allocation for institutional investors; 38% of Canadian pension assets are alternative investments, tripling since 2004[1].

Since alternative investments should not be thought of as a "one size fits all" asset class, and because there are a number of alternative strategies that will play different roles within a portfolio (each with their own unique set of risks), we continue to recommend that investors diversify across different alternative strategies and investment managers to further reduce idiosyncratic risk and concentration risk from any single investment, keeping overall liquidity risk of the allocation in mind.

Optimal allocation to alternative investments continues to depend on suitability for the investor, being a function of the individual's risk tolerance, investment objectives, liquidity needs, income needs, investment time horizon, current portfolio composition, portfolio size, and the market environment.

Alternative investments strive to lower volatility, enhance returns, generate income, and provide downside protection, or lower correlation (or some combination thereof). We expect investors will continue to gravitate towards alternative investments to further diversify their investment portfolios in light of concerns surrounding a low and rising interest rate environment as well as increased economic and geopolitical uncertainty.

As with all investments, proper due diligence is important before investing, but arguably even more so for alternative investments. Investors should seek the advice of their financial advisor prior to investing in alternative investments.

Emma Querengesser
Senior Alternative Investments Specialist

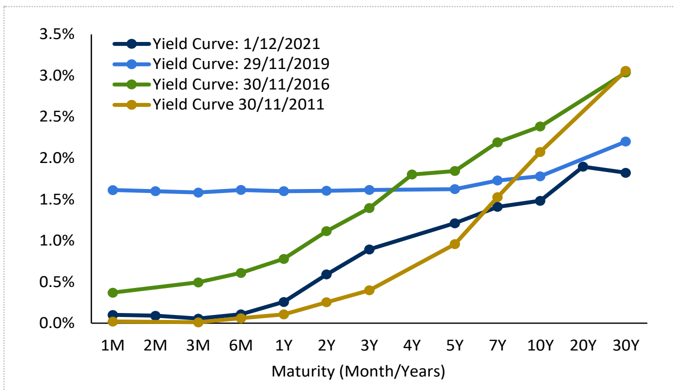
[1] Pension Investment Association of Canada, RBC Investor & Treasury Services' fourth annual survey of Canadian defined benefit pension plans

Structured Products: No Longer the New Kid on the Block

Structured notes have continued to garner a lot of attention this past year as evidenced by the record growth and issuance of this unique product set. The dramatic increase in the overall usage of structured notes in client portfolios can be largely attributed to the ongoing search for income in a low-rate environment.

The note structure that has dominated this space over the year was the auto-callable contingent income note. This note is designed to provide a contingent income stream that is payable monthly, quarterly, semi-annually or annually, so long as the underlying reference asset is trading within a pre-determined range on a stated observation date. In addition to the coveted income stream, the callable feature, and the varying levels of capital protection associated with this type of note is what seems to have resonated most with investors.

Despite the Recent Rise in Yields, Rates still Remain Low



Source: FactSet. Data as of November 30, 2021

Looking forward, we believe that structured notes will continue to play an increasingly larger role in the overall portfolio construction process for investors. Since structured notes come in many different shapes and sizes and can be used to meet specific risk tolerances, time horizons, and investment objectives, they can be a useful tool for investors to consider for their portfolios. And as the search for income continues in the current low rate environment, we expect that the auto-callable income note structure will likely continue to be one of the more attractive note structures that investors gravitate towards.

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