January 20, 2023

Mark Noble:
Hello, my name is Mark Noble, Executive Vice President of ETF Strategy at Horizons ETFs, and welcome to the latest episode of Generation ETFs. On this episode, we are revisiting with one of our favorite guests and commentators, Candice Bangsund, who is the Vice President and Portfolio Manager with Fiera Capital's Global Asset Allocation Team. Candice is here to discuss what could be ahead in the global capital markets after a very tumultuous year in 2022.

I don't think investors quite appreciate how bad things were in 2022. Some stats, just for some reference here, I mean, we had a negative 22% return on the S&P 500, that would put it in the top 10 worst years for stock returns on record. But I think what really impacted investors even more was the fact that you also had the worst calendar year returns for US and Canadian investment grade bond indices. You'd have to go back to before the 1970s, when we started tracking those indices, to see anything that even remotely looked like those kind of negative returns. Both of those indices had double digit losses.

So you had a double hit of losses in stocks and bonds and that really hurt investors who traditionally viewed the two asset classes as the opposite ends of a teeter totter. If we think of the last 20 years of returns, we think about stocks offering one refuge of returns, and if they're not working, well then we could always trust those investment grade bonds and treasuries, and that's simply not been the case in 2022 with, bonds not able to provide an offset. A lot of that to do with the fact that we've had an unprecedented amount of inflation in 2022 that has really derailed most equity return expectations and bonds.

So Candice is here to provide some clarity on what we might be able to expect in 2023. Viewer discretion advised, or listener discretion advised, it's not particularly bullish this time around. There are some things we need to discuss and some real risks in the marketplace, but I think that's what's going to make this conversation so interesting today.

So Candice, a lot of pain from last year, the result of inflationary fears, especially from the incredible speed of interest rates hitting both growth equities and fixed income so hard, but we're starting to see a bit of a resurgence here at the start of January with a bit of a contrarian trade where people thinking that the worst is over. What's your view on all this? Do you expect us to see more of the same? Or what can investors expect for the first six months, or even year of 2023?

Candice Bangsund:
Yeah, well first off, thanks for having me. Great to be here with you, Mark. Like you said, it was an unprecedented year. Equity and bond investors are getting some reprieve here, fourth quarter as well. Both equity and bond markets were actually higher in the fourth quarter, and obviously this year that trend has extended.

In our view, we're meeting that with a little bit of caution. We think it's a bit of a head fake. Markets are clearly underestimating not only inflation, but central bankers' resolve in tackling this inflationary problem that we are seeing every day, whether it's in Canada or the US. So I think this is probably a bit of a short term rally, but we do expect that downtrend regrettably to resume throughout the year, just given the inflationary dynamics and the fact that we believe central banks are going to have to do a lot more to bring inflation back to levels that they're more comfortable with.

Mark Noble:
What are those levels? Because, I mean, we can't really expect for a 2% target.

Candice Bangsund:
No.

Mark Noble:
That just seems insane based on our year-over-year inflation growth.

Candice Bangsund:
I think they'd be comfortable at three, three and a half percent. And to be honest, the market right now is pricing in that goldilocks scenario soft landing where inflation comes down to levels where central bankers can actually take a step back and finish their tightening campaign maybe this month or next month, and then the economy can achieve that soft landing, which would probably be a very mild form of recession. That's what the market is pricing right now, the consensus view that we are going to be able to achieve this soft landing.

Our view, of course, is much more gloomy and our sense is that inflation will not be able to come down to those levels of comfort, that central bankers are going to have to raise interest rates more than they've even guided towards. It's interesting, the Fed has said that they're going above 5% and that they're going to hold rates there for an extended time. The market is pricing rate cuts. So again, like I said earlier, really just underestimating not only the inflationary narrative but also the resolve of central bankers in restoring price stability.

Mark Noble:
Well, just taking the other side of that coin, because I have seen that all the major Canadian banks are basically forecasting that rates have either peaked or in some cases they've got 100 basis point declines, which I was very shocked to see. But I think part of their rationale is that if we have an inflation led recession, that recession will necessitate rate cuts.

Mark Noble:
What is your view on that? Because I think some of the people that are investing in bonds right now are actually believing that we're going to move to a classic recessionary environment where that's actually a safe haven asset class.

Candice Bangsund:
Yeah, well, here's the thing though, what they need to do ... Central bankers actually need to create some demand destruction in order to bring inflation lower. The market has been very excited about the last few US inflation reports, but if you actually look under the hood and look at the details, all of the deceleration has been concentrated in the goods segment, not a big surprise. Supply chains are slowly correcting, commodity prices have edged lower, new/used car vehicle prices are coming off. This is not a big surprise. What is worrisome though is that the more sticky services inflation tied to the labor market, wages, that's actually accelerating. And this is the part of inflation, core inflation, that central bankers are really focused on, and this is the only part of inflation that they actually have control over.

And so how do you cool off the labor market and bring those imbalances back into a better balance by inflicting some damage on the economy and applying more pressure. So that's why we think central bankers have more work to do in order to bring that inflation down, and it's going to necessitate some collateral damage for the global economy.

Mark Noble:
What parts of the economy do you think are probably the most at risk going into this new calendar year?

Candice Bangsund:
Well, obviously the consumer is at risk already, dealing with higher prices cutting into incomes. The housing market, obviously. It's really just the interest rate sensitive corners of the market that are likely going to see a lot of weakness.

It's interesting, though, just to give you a sense for how far behind the curve policymakers are, policy is still actually stimulative when you think about a real rate. And so that's why we're not seeing the labor market cool off to levels that are bringing wages down. Like I said, there's imbalances, of course, there's labor shortages, but the thing is unemployment is still very low, jobs are still being created. This is really underpinning that the environment is still too stimulative and needs more tightening from here in order to cool off those services-driven inflation.

Mark Noble:
So in your most recent annual commentary, you guys highlight a, Fiera Tactical Asset Allocation Team, I should be clear, highlight a 50-55% likelihood of a steep recession. Is that what you're looking at right now, where the market is priced in possibly a recovery, and I guess what you're saying is no, with the labor market so high right now, we are likely not going to be starting to see a recession until that starts to drop?

Candice Bangsund:
Yeah, so our base case is for a deep recession. As you see, all of our scenarios are really revolving around some sort of economic downturn. And now the magnitude really hinges on the inflation backdrop, and, of course, then the reaction function from central banks. So our base case for that deep recession is really that inflation remains elevated. Maybe not at these levels, but like I said, not going back to that three, three and a half percent. Probably somewhere in the four, four and a half percent. Central bankers will not be comfortable going on pause at that time, so they'll have to raise interest rates more and create that demand destruction. That's the deep recession scenario.

The shallow recession scenario, which is the next scenario at about 30% probability, is the consensus view essentially for the soft landing.

Mark Noble:
Have we had a precedent though where we've come off such a nasty year like last year and then it just continues for the next year? Because, this is very simple, but most calendar year returns, you usually get a bit of recovery after a negative year. I think I'd have to go back to maybe '74 or '75 to see a double year hit to stocks and bonds.

Candice Bangsund:
Yeah, it's very rare. So regrettably, the outlook for us doesn't really have history on its side, but like I said, we're in unprecedented times. And while it's nice to see some green on the screen here early on in 2023, like I said earlier, we're cautious, because we don't think the worst is yet behind us.

When you think about equity markets too, Mark, last year, the declines were all driven by PEs, right?

Mark Noble:
Yes.

Candice Bangsund:
PE contraction, tighter financial conditions, higher interest rates, inflation, all of these things drive price-to-earnings multiples lower. What we haven't yet seen is any sort of adjustment to the earning side to reflect this economic reality, even if it is just a slowdown or a moderation, that hasn't yet been baked into the market. So that's where we do see a bit of a disconnect and some potential vulnerability when it comes to equity markets specifically.

Mark Noble:
And that segues really nicely into my next question. So from a tactical asset allocation perspective, your team is underweighting equities, right, going into 2023?

Candice Bangsund:
We are at our maximum underweight stocks. We were underweight all last year, so it's difficult to get too confident when markets are down across the board, like you said. But we were positioned for that. We were overweight cash last year, we were underweight bonds, underweight stocks, and we are positioned that way again, going into 2023 in anticipation of another down leg in the stock market. Even bond markets, we do expect more downside there, just given our expectations for interest rates to move a lot higher than where they are today.

Mark Noble:
Well, let's segue that into the natural follow up to that is, if I am not going to get generally good returns in stocks and I'm looking at risk in investment grade bonds, I believe you got about a negative 8% return forecast for that, what do I buy?

Candice Bangsund:
Well, I mean, it goes without saying that cash is king these days. Every time the central bank lifts interest rates, it's getting more attractive by the day and at a very low level of risk, obviously. So that's a good place to park while we wait this out.

But also the very unprecedented year in 2022, where, as you mentioned earlier, the positive correlation between stocks and bonds, both down double digit, this is historic. This has really underscored the case for private markets and a well diversified portfolio, particularly when in search of stability and yield, something that was very important last year. So while private markets obviously deserve a place in a well balanced portfolio in all macro environments, it's really an environment like this where stocks and bonds are moving in the same direction lower, where they really validate their place in a well diversified portfolio.

Mark Noble:
Perfect. Well, Candice, thank you as always. I think this was a fantastic summary. We kept it pretty short, but you're such a pro at getting to the point really quickly and telling a great story. So I guess we'll have to see what happens in the market outlook. But the good news is that there's no shortage of ETF opportunities to look at how to defensively play. And I think it's really important that investors see what's happening on one side of the market right now, but also keep in mind that these narratives, these cycle changes that we see in the market, they're not just calendar year blips, this could be something that takes a multi-year period as we adjust from, I would say, 20 years of accommodative monetary policy and move into something new, where inflation being on the radar for the first time in probably more than a generation. So these are seismic changes, and I think you've done a great job at highlighting what we need to keep our eyes open for in 2023.

Candice Bangsund:
Well, thanks for having me.

Mark Noble:
Thank you. Appreciate it.

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