Commentary

Canada Outlook

Expansion phase of global economic recovery continues, but investors jittery

October 2021

Q3 review and outlook

Despite recent volatility, the S&P/TSX Composite Index has provided a total return of 17.48% over the first three quarters of 2021. We are now in the expansion phase of the recovery, where expected returns are more modest and driven by fundamental activity levels and overall corporate profits. Pullbacks should not come as a surprise as the market digests incremental news related to these factors. Ultimately, the global economy is in good shape, and with a backdrop of government stimulus spending and low interest rates, we do not see the expansion being derailed.

Our base case indicates that most economies will recover to pre-pandemic levels before the end of 2021. Global economic recovery prospects are also boosted by the rollout of vaccines and vaccine passport mandates.

Sound economic fundamentals, but investors jittery over Evergrande and upward pressure on rates

The global economy, along with Canada, continued to strengthen in the third quarter despite concerns about the recent volatility driven by highly indebted Chinese property developer Evergrande Group, rising pressure on interest rates, and stretched valuations for equities. At the beginning of October, Evergrande's credit rating was downgraded, and its shares remained under pressure.

Concerns about a broader fallout from Evergrande missing debt payments weighed on sentiment, but support from the People's Bank of China in September helped to pare losses. Importantly, most of Evergrande's $300-billion debt burden is local, limiting the risk of broader contagion. We believe there is a low probability of a contagion effect because the Chinese authorities are unlikely to allow the property giant's debt woes to destabilize the Chinese financial system.

At its September meeting, the US Federal Reserve left the target range for the federal funds rate at 0.00-0.25%. On asset purchases, however, the Fed's message changed to say that a "moderation in the pace of asset purchases may soon be warranted." The Fed is following on the heels of the Bank of Canada, which has issued similar guidance and already reduced its asset purchase program three times since the end of 2020. Despite the developments from the Fed and the Bank of Canada, overall, our inflation expectations have not changed significantly, and our positive outlook remains intact. We encourage investors to consider placing higher inflation numbers in the context of the historic drop in growth caused by the pandemic and of the continued excess capacity in the economy.

Key takeaways:

- Ultimately, the global economy is in good shape, and with a backdrop of government stimulus spending and low interest rates, we do not see the expansion being derailed.
- Concerns about a broader fallout from Evergrande missing debt payments weighed on sentiment.
- The Fed signalled that it may begin withdrawing stimulus from the market.
- Our inflation expectations have not changed significantly, and our positive outlook remains intact.

Canadian market and economic highlights

Investment strategy highlights

While markets may be unsettled by the thought of central banks withdrawing stimulus, we encourage investors to consider that these moves from policymakers show their increasing confidence that economic growth is now on sounder footing and in less need of stimulus. It is also important to remember that despite the messaging around tapering, global central banks remain committed to supporting the ongoing recovery, and on a historical basis interest rates remain extremely low.

High-priced stocks, with what could be described as stretched valuations, were another important theme during the quarter. But there are still sectors and securities that are attractively priced. It is also important to note that as the corporate earnings picture improves, the market is growing into its valuation. Commodity prices are also at high levels, this plus the economic backdrop suggest solid long-term potential for some commodity related companies.

Overall, the return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis. In fixed income, we still see value in higher-quality corporate bonds. In equities, we continue to concentrate on companies with strong balance sheets that should be well-positioned to take advantage of a recovering economy. We will continue to patiently make targeted investments in these and other equities that are priced for good long-term value.

Market highlights

Canadian equities, as measured by the S&P/TSX Composite Index, were up 0.17% in the third quarter and up 17.48% year-to-date. Canadian bonds, as measured by the FTSE Canada Universe Bond Index, finished the third quarter down 0.51% and were down 3.95% year-to-date.

S&P/TSX Composite Index and Sector Performance

(period ended September 30, 2021)

	3-Month	1-Year	3-Year*	5-Year*	10-Year*
S&P/TSX Composite Index	0.17%	28.02%	11.07%	9.64%	8.84%
Healthcare	-19.40%	27.94%	-24.12%	-11.47%	-7.78%
Information Technology	-1.29%	29.31%	47.53%	36.27%	24.22%
Materials	-5.62%	-9.47%	12.49%	5.26%	-0.43%
Consumer Staples	4.61%	7.15%	12.71%	7.95%	15.37%
Consumer Discretionary	-6.53%	32.98%	9.35%	9.20%	14.21%
Communication Services	0.72%	23.37%	9.69%	7.44%	10.86%
Real Estate	3.34%	37.96%	9.55%	9.87%	11.61%
Utilities	1.02%	11.89%	18.36%	11.04%	8.43%
Industrials	3.94%	18.84%	12.21%	14.93%	16.54%
Financials	1.14%	45.55%	10.92%	12.02%	12.44%
Energy	2.82%	61.61%	1.35%	0.47%	1.82%

*Compound annual rate of return. Source: Bloomberg as at September 30, 2021. Performance stated in Canadian dollar total returns.

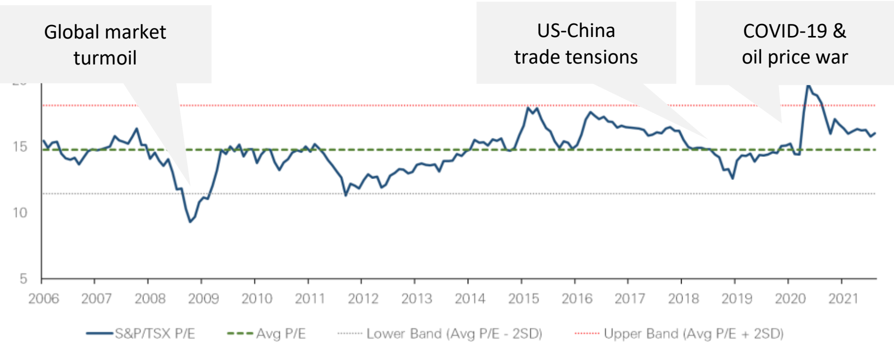
- Global central banks remain committed to supporting the ongoing recovery, and on a historical basis interest rates remain extremely low.
- We continue to concentrate on companies with strong balance sheets that have the potential to take advantage of an economic recovery.
- The S&P/TSX Composite Index was up 0.17% in the third quarter.
- The FTSE Canada Universe Bond Index finished the third quarter down 0.51%.

Q4 outlook: Strong commodity prices have improved earnings prospects for many Canadian companies

Fears about equity valuations appear overblown

As Canadian stocks move higher, many investors are questioning whether stocks are becoming overpriced or, worse, that they are already in a bubble. A stock market bubble is a market trend marked by surges in stock prices to levels significantly above the fundamental value of the stock. Bubbles can be hard to spot because of the difficulty in defining the fundamental value of all the various assets. But looking at the average price-to-earnings (P/E) ratio in the Canadian market—that is, the average of all ratios used to value companies by measuring current share prices relative to earnings per share—suggests current P/E ratios are not wildly inflated on a historical basis. Canadian stocks also looks particularly attractive on relative valuation compared with the US.

Long-term equity view: Canada price-to-earnings (P/E)



Source: Bloomberg. Data as of August 31, 2021. S&PTSX Index P/E based on blended forward and trailing 12-month earnings. Upper and lower limits are two standard deviation (SD) away from the average.

Pace of global economic growth expected to be more moderate

The economic rebound was very strong in the latter part of 2020, but the pace of growth will be more moderate as 2021 draws to a close. Our base case forecast indicates that most economies around the world will recover to pre-pandemic levels before the end of 2021.

Q4 outlook: Canada remains well positioned for growth

The Canadian market tends to do well during times of global economic expansion as demand rises for commodities such as oil. Strong commodity prices have improved earnings prospects for many Canadian companies.

Responding to short-term volatility by deviating from long-term investment plans rarely yields positive results. Achieving your investment goals is more likely with a patient, well-diversified approach. Risks such as COVID-19 and the Evergrande saga can't of course be predicted, but we do know risk comes in varying forms and will always be part of the investing landscape. That's why we remain keenly focused on the long term and recommend clients remain invested, given the strong fundamentals we expect will carry the markets into 2022.

- Current P/E ratios are not wildly inflated on a historical basis. The Canadian market also looks particularly attractive on relative valuation compared with the US.
- Our base case forecast indicates that most economies around the world will recover to pre pandemic levels before the end of 2021.
- The Canadian market tends to do well during times of global economic expansion as demand rises for commodities such as oil.

Important Information:

All quoted returns are total returns as at September 30, 2021 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, Statistics Canada and the Bank of Canada.

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