



# Market Outlook 2023

## Navigating the inflation inflection

Central banks' battle against inflation was the dominant economic narrative in 2022. How consumer demand morphs in response to cost of living increases and slowing economic growth will be focal points for the investment community in 2023.

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# Foreword

As we usher in the new year, it's important to acknowledge the main determinants of economic activity and financial market performance over the past 12 months and how those may shape portfolio risk and return expectations. Last year, we experienced an unprecedented transition away from the era of ultra-low interest rates as policymakers raised rates to contain inflation expectations. Central banks committed to pursuing a 2% inflation target, but what speed, size or duration of monetary tightening is needed to stabilize prices in 2023 remains to be seen.

Debating how long it will take for central banks to beat inflation while engineering a soft landing to cushion the expected decline in economic activity will keep markets on edge. As growth prospects dim, advisors should consider all possible scenarios. These include how long a recession might last, which regions are likely to be hardest hit and what challenges interest-rate-sensitive sectors of the economy – real estate in particular – could face.

Geopolitical uncertainty stoked volatility in 2022 and will continue influencing markets in 2023. In Europe, the war in Ukraine reshaped how governments think about energy security and contributed to the highest inflation in decades. In the U.K, a sudden announcement of unplanned tax cuts contributed to a massive sell-off in U.K. government bonds as the British pound depreciated. Our asset managers may also need to adjust their models with the growing potential for evolving U.S.-China relations to upset economic stability in Asia. Countries in the region may be considering whether they should prioritize

trade ties with one of the superpowers as they walk a tightrope between fierce competition and peaceful cooperation. The gravity of geopolitical tensions over the last 12 months underscores the importance of investing with sub-advisors who have expertise in global markets. They can help provide a clearer panoramic picture of the investment stories that matter the most.

Our 2023 Market Outlook report can inform your asset allocation decisions and help you establish reasonable expectations for risk and return with your clients. We aim to help you understand what lies beyond the current market uncertainty, so that you can prepare for the investment challenges and opportunities ahead. This context can help put you in a solid position to talk to your clients about what's impacting the markets.





## Foreword, continued

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### This edition covers several key topics, including:

- ✓ How companies need to adjust to high interest rates, high energy prices and modest growth.
- ✓ What the latest evolution in U.S.-China relations could mean for Taiwan and the global economy.
- ✓ The impact of a strengthening U.S. dollar on emerging markets.
- ✓ How well-positioned portfolios could protect against potential missteps by policymakers.

To compile this report, we teamed up with some of the most sought-after investment managers from the industry to bring together a comprehensive collection of market insights. No single asset manager is an expert in every asset class. That's why we use a multi-manager approach that draws on several management styles, asset class and regional expertise, investment philosophies and risk management styles. This broad range of input allows us to deliver a truly global perspective.

Our goal is to inform your asset allocation decisions and support you in building more resilient portfolios. This past year we focused on two main objectives to help you do just that. First, we expanded our lineup of funds, so you have more options when creating investment plans. Second, we strengthened our existing fund shelf to deliver stronger investment outcomes for clients. We remain focused on providing competitive and well-positioned investment solutions to meet Canadian investors' evolving needs.

In our view, the best approach for today's economic environment involves staying nimble in both equity and fixed income diversification, leveraging the power of active management, and tapping into the benefits of alternative asset classes. We look forward to collaborating closely with you as you guide your clients on their investment journey through a challenging and unusual global economic transition.



**Steve Fiorelli**  
President and Chief Executive Officer  
Canada Life Investment Management

# Global macro view



Although geopolitical and macroeconomic shocks fundamentally altered market expectations in 2022 and the global economy transitioned from mid to late cycle, Irish Life Investment Managers believe some stability could be restored by the latter half of 2023.

Inflation took centre stage in market commentaries in 2022 and caused trouble in every sector. Price increases drove the most aggressive tightening of monetary policy in several decades. Central banks raised interest rates and reduced balance sheets, pushing bond yields higher, undermining the relative valuation case for equities, and squeezing consumer spending power and confidence. Global equities declined over 21% at their lowest point, while bond markets experienced one of the worst years on record as yields rose to the highest level in almost 15 years.

The positive news about inflation is that it might be peaking in some regions, including the U.S. and Canada. However, it was still well above major central banks' targets of 2% at the end of 2022. Policymakers remain concerned that strong labour markets could keep wage pressures high and prevent inflation from declining quickly. The longer elevated inflation persists, the greater the risk of it becoming more entrenched in the economy.

Instead of being transitory, inflation endured. Similarly, several events earlier last year didn't resolve as quickly as expected. Their influence on investment markets could extend well into 2023.

The largest military conflict in Europe since World War Two (between Russia and Ukraine) prevented hopes of a rebound in European economic growth. Energy prices, especially for gas, surged as Russian supply to the eurozone dried up, constricted by sanctions. Later in the year, business sentiment fell sharply as monetary policy started to squash demand, and inventories grew beyond preferred levels. Europe and the U.K. suffered more than most and consensus forecasts expect both to enter a recession by the end of 2022. In the U.K., the Bank of England has forecast an unprecedented eight consecutive quarters of negative growth.



## Global macro view, continued

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While the U.S. economy is resilient, given its relative immunity to repercussions of the Russian-Ukraine war and its unemployment rate, which remains close to 50-year lows, we expect it to slow in 2023. The interest-rate-sensitive housing market has already slowed. Therefore, a recession is still on the radar for the U.S.

### What do slower growth and a possible recession mean for investment markets in 2023?

Despite the growing risk of a U.S. recession, we expect any slowdown to be relatively short. Today, we don't see the economy struggling to balance surplus capacity as much as during previous downcycles and corporate balance sheets are less stretched. Fiscal support could also counter any deterioration in the growth outlook. Moreover, a resolution to the Russia-Ukraine war and softer implementation of the zero-COVID-19 strategy in China – potentially resulting in more well-oiled supply chains – would boost growth. If the slowdown is shallow, the global economy could begin to recover by the second half of 2023.

Although equities appear attractive with earnings multiples below long-term averages, the slowdown's potential impact on earnings in early 2023 still needs to be considered.

Growth in China, the second-largest economy in the world, slowed significantly in 2022. The government's zero-tolerance policy to COVID-19 resulted in ongoing lockdowns that hampered economic activity. A less effective vaccine and slower vaccine rollout meant that China couldn't reopen like many other countries over the past 12 months. In China's real estate sector, developers struggled for funding, contributing to sharp activity declines and lower house prices. China, however, is an exception among large economies. If COVID-19 restrictions are relaxed and new policies are supportive, growth could rebound to around 4.5% in 2023.

Equity and bond markets have already dismissed much of the bad news on the economic and policy fronts. Just as equities and bonds fell as expectations around growth and policy settings evolved, markets could soon look beyond the challenging economic backdrop and discount an anticipated recovery in late 2023.

# Asset allocation

The starting point for capital markets in 2023 differs distinctly from the baseline a year ago. Higher interest rates, slowly decelerating inflation, and revised equity valuations provide investors with greater yields from lower-risk investments and a more robust margin of safety for equities.

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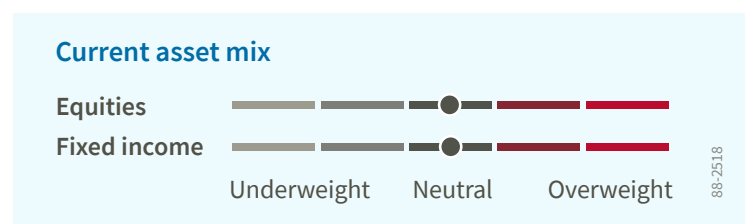
Corporate earnings and global markets will be tested by an economy still processing the after-effects of the pandemic. Despite the growing risk of recession, opportunities exist as we move through the market cycle.

## Fixed income

While the speed and magnitude of rising interest rates depressed fixed income returns in 2022, we expect investors to benefit from a reasonable yield from bonds in 2023. Central banks' actions will continue to be a focus of fixed income managers in 2023. Regionally, if the Bank of Canada decides to pause interest-rate increases and adopt a wait-and-see approach, the domestic market performance could pull ahead of global markets.

In the U.S., the U.S. Federal Reserve Board (Fed) will likely continue its rate-increase path with less aggressive but higher-for-longer rates. As such, we expect the U.S. bond market to fluctuate well into 2023. If some global economies fall into recession, the overall effect on fixed income markets could be positive as investors look for a safe haven in bonds.

**Portfolio positioning:** Neutral to the fixed income asset class and managing a shorter duration in the portfolio. Ready to take advantage of bond positioning along the yield curve in 2023 with long-term domestic bonds and active underlying fund management.





## Asset allocation, continued

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### Equity

Corporate earnings could face pressure as businesses digest the impact of higher inflation, higher interest rates, a strong U.S. dollar, and continued geopolitical uncertainty. Given the forward-looking nature of the market, equity performance could improve as central banks near the end of their tightening cycle. The U.S. and Canada are further along this path than Europe and could see a shallower slowdown. We expect the Russia-Ukraine war, the ongoing energy crisis and changing political landscapes to challenge European markets.

**Portfolio positioning:** Underweight to U.S. equities. Relatively neutral exposure to value and growth equities will provide opportunities to capture returns from the two contrasting investment styles. We strive to strike a balance between earnings profiles and valuations in our holding allocations.

### Global alternatives

The diversification benefits of direct real estate stood out in 2022. Fundamental market conditions, including strong occupancy rates and low lease renewals, remained steady. Multi-family residential and industrial sectors that contributed to strong returns in 2022 are expected to continue driving performance into 2023 in Canada and the U.S.

While private credit managers might face higher credit risk in 2023, we are optimistic that the benefits of higher yields and more favourable terms for lenders will help generate stronger returns.

**Portfolio positioning:** Canadian and U.S. real estate and private credit will continue to play an integral role in our asset allocation. These asset classes can diversify risk in 2023 and potentially enhance returns.





# Canadian fixed income

High inflation is a thorn in the side of the economy and disrupts demand dynamics. In particular, higher priced essentials including food, shelter and energy pull consumers' attention away from segments with more elastic demand, such as travel, electronics and general retail.

Another key risk in fixed income is how much the Canadian economy – led by the housing sector – is sensitive to interest rates. The mortgage market primarily consists of variable and short-term fixed rate products. Rapid increases in the prime rate cause considerable stress for mortgage holders. In addition, investors comprise much of the Canadian residential housing sector. They might reduce holdings if rising yields lead to falling property values. Less homeowner equity could lead to less spending, negatively affecting credit spreads. While reducing high beta credit holdings, we will evaluate opportunities in high-quality, shorter-term, investment-grade credit.

As expected, the Canadian bond yield curve is heavily inverted, driven by aggressive monetary tightening. The market assumes the Bank of Canada's (BoC) tightening can bring inflation (which eroded fixed income performance by leading to higher interest rates) closer to its 2% target. There are two main risks to this assumption. Higher prices could push up wages leading to even higher prices in a wage-price spiral, and long-term inflation expectations could rise. Either would influence central bank policy and thus yields.

Meanwhile, as inflation continues to whittle away at disposable income, credit providers may experience higher default rates. Therefore, we remain cautious on fixed income products backed by payments.



Once the BoC stops raising interest rates, we expect the bond yield curve inversion to reverse as investors switch to lower-risk, higher-yielding assets.

**Portfolio positioning:** Neutral to slightly overweight duration in North America and overweight to inflation-linked bonds in Canada and the U.S. in response to the risk of continued aggressive central bank actions. Focused on high-quality, shorter-term investment grade credit while reducing higher beta credit holdings such as high yield bonds and leveraged loans.



## Canadian fixed income, continued

The most aggressive interest rate hiking cycle from central banks in 40 years has reset global yields higher and caused the largest decline in fixed income returns in the past 30 years.



The bright side to higher yields is that coupons have also reset higher, and fixed income is finally providing income again. The yield on most core bond indices is the highest since before the 2008–2009 global financial crisis. We expect bond investors to be more fairly compensated for higher interest rates. As central banks approach the end of their hiking cycles, fixed income will provide some protection against equity risk in balanced portfolios. We are becoming more positive on 10-year bond yields, as they approach their peak, based on our estimates.

In a rate-hiking cycle, the five-to-ten-year part of the curve usually suffers the most. Conversely, it could outperform once central banks pause raising interest rates and consider rate cuts.

The major risk of moving interest rates so much above neutral into restrictive territory stems from the lagging nature of inflation as an indicator. This means the probability of central banks over-tightening is high, even though they are aware of this danger. If the unemployment rate increases enough over the next six months, the BoC may pivot quickly to cut rates.

**Fixed income returns in 2022, as spreads have widened, highlight the need for investors to diversify their fixed income allocation through active management.**

**Portfolio positioning:** Neutral on credit spreads (difference in returns of debt instruments with similar maturity but different credit rating) over the next six months, given the cycle's likely transition into a 'liquidity' stage. Since the breakeven points are attractive at the short end of the curve, we will continue reducing the portfolio's term to maturity.



# Global fixed income

A key risk to global bond markets is a continued robust U.S. labour market that leads the Fed to raise interest rates beyond market expectations, increasing the likelihood of a recession rather than a soft landing.

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Central banks that act decisively to combat inflation are typically rewarded with lower volatility and lower long-term interest rates. Central banks that operate with less precision tend to see greater volatility, higher long-term interest rates, and a greater risk of capital outflows.

High inflation is like a tax on growth, disproportionately affecting emerging markets, where food makes up a significant percentage of the average consumption basket. As consumers allocate more money to food, less is available for other goods and services.

The spike in global energy prices resulting from the War in Ukraine hurt many energy-importing European and Asian countries. Further restrictions on access to Russian oil could push prices over US\$120 per barrel, detracting from the performance of government bonds. Currencies of energy-importing countries could be adversely affected.

**Portfolio positioning:** We have positioned long duration in high-quality government bond markets and U.S. agency mortgage-backed securities (MBS). We believe most of the yield increases expected for this cycle occurred in 2022, and sovereign bonds and MBS are highly liquid. Considering the risk of recession, we are defensively positioned, with reduced exposure to credit risk, an overweight allocation to the U.S. dollar, and increased liquidity, as we await better buying opportunities.

However, at some point in 2023, we expect the market narrative to switch from inflation to growth. Tighter financial conditions that lead to a recession in many countries should be the signal for central banks to pause interest-rate increases. Credit sectors are likely to become attractive after they better reflect the rise in credit risk that typically occurs in a recession. By the second half of 2023, and possibly earlier, high-yield and emerging-market corporate bonds could become attractive opportunities.

**We expect the impact of inflation to decline in 2023, as a global recession causes energy prices to decline, eases supply chain pressures, and pushes unemployment rates higher in most countries.**



## Global fixed income, continued



Consequential missteps by policymakers marked much of last year's economic landscape.

The mini-budget announcement by the cabinet of former U.K. Prime Minister Liz Truss resulted in a U.K. liquidity crisis and a sharp decline in assets. The Fed's delayed reaction to inflation, which it initially deemed transitory, likely contributed to high inflation lasting for longer. Further errors from stewards of the global economy could be costly for global fixed income markets.

Beyond raising interest rates, the Fed and other central banks have two other tools to rein in inflation. The Fed has supported the first of these – open market operations – since the 2008-2009 global financial crisis. They can purchase (quantitative easing) or sell (quantitative tightening) securities to control the money supply. The Fed recently embarked on quantitative tightening by allowing billions of dollars of maturing treasury and mortgage-backed securities to roll off its US\$9 trillion balance sheet. This move removed liquidity from the market and could be more effective in the long term at slowing growth than raising short-term interest rates.

The second lever to tame inflation is raising reserve requirement ratios for banks, which restricts how much money banks can lend to the market, limiting money supply and liquidity. While this is not used broadly, it is the primary tool used by the People's Bank of China to tame inflation.

**We prefer safe-haven investments such as long-end treasury securities. Attractive yields and prices can also be found in select investment grade and high-quality high yield credit.**

Despite the consensus over-tightening, some central banks might still be forced to pursue quantitative easing in times of distress. Even though these operations can worsen inflation, they are needed to reinforce stability. The Bank of England's purchase of long-dated U.K. government bonds in September is a recent example.

This year, it is important for the Fed to reduce the risk of a policy misstep by carefully calibrating the impact of higher interest rates on the economy.





# Canadian equities

After the sharp decline in equities in 2022, valuations fell to reasonable levels.



We see opportunities in the consumer discretionary and financials sectors, and will use market dislocations as opportunities to improve the risk/reward profile among Canadian equities.

During the pandemic, the bargaining power in the jobs market shifted significantly. Lower labour force participation led to wage increases. More pay increases are likely if the cost of living stays elevated, driving inflation and likely extending interest-rate increases. We expect central banks will be reluctant to ease rate hikes as that could let inflation reignite.

Higher-commodity prices tend to support resource-based sectors. Higher interest rates support the financials sector, with banks experiencing higher net-interest margins. Conversely, rising interest rates are generally negative for highly levered companies, such as real estate investment trusts. Companies with pricing power, like railways, are set to benefit from higher growth.

**Portfolio positioning:** We have a deep focus on using market dislocations as opportunities to improve the risk/reward profile of our portfolios. We do not rely on top-down macro analysis to evaluate when to sell businesses that we believe are fully valued. Our sector positioning reflects our bottom-up stock-selection process that examines micro factors impacting fundamentals.

The Fed and the BoC have committed to doing whatever it takes to bringing down inflation, even if it means higher unemployment, slowing the housing market, or causing a recession. This will have significant implications for stocks too, as we have seen already with the turbulence of 2022. Volatility is likely to be a major factor next year for equities.



## Canadian equities, continued



We expect non-cyclical companies with firmly established businesses and higher dividends compared to Canadian bond yields to present opportunities for investors.

Canadian banks should have enough support from well-capitalized balance sheets and strict underwriting standards to weather a downturn.

Structural issues in countries outside North America have boosted the U.S. dollar's strength, giving an advantage to Canadian-domiciled companies with U.S.-dollar sales and earnings. These issues include the Russian-Ukraine war, the default crisis in China's real estate sector and financial instability as demonstrated by the Gilt crisis in the U.K. Riding on the strength of its currency, the U.S. could sidestep some inflation risk at the expense of more vulnerable, commodity-importing countries that might face greater funding pressure.

The Russia-Ukraine war highlighted the risk of overreliance on one energy source. In response, the oil futures market moved to price in a higher "risk" component. As a large oil exporting country, Canada is uniquely positioned to provide additional barrels of oil to global markets. It could also offer more liquified natural gas barrels from its extensive reserves to world markets. However, export capacity will be a limiting factor.

If elevated inflation persists, central banks could keep interest rates higher for longer, negatively affecting equity valuations. In Canada, the immediate fallout from high interest rates would cool the real estate sector and put the brakes on consumer spending, which has already begun.



Companies will need to adapt to the new reality of tighter monetary policy, high energy prices and modest growth. The adjustment could be uncomfortable, coming in the wake of above-average growth stimulated by government spending during the pandemic.

**Portfolio positioning:** In the short-term, we expect to hold a defensive stance focused on less cyclical dividend-paying companies with larger market capitalizations. Global economic activity is slowing quickly in some areas. Conversely, inflation is not. As higher input costs squeeze profit margins, we expect downward revisions to earnings estimates to provide more compelling entry points.



# U.S. equity

We work to set up the portfolio to be successful in a variety of market and economic conditions.



Growth Team

Our active management approach helps us respond to inflation and other macroeconomic challenges. We remain focused on stock selection and deep fundamental research to understand how businesses are dealing with inflation, and which companies may be best positioned to weather its impact. Not all businesses will be able to adequately cope with the effects of inflation, supply chain disruptions, rising interest rates and other macro factors. As active managers, we pivot towards companies that can withstand these headwinds as well as those that will benefit from the current backdrop.

To help manage risk at the portfolio level, we target companies with a narrow range of outcomes and prefer capital-light businesses. We prioritize those with high levels of recurring revenue, long-term customer contracts, the ability to set price, and a lack of customer concentration. Our aim is to invest in

Instead of calling the market direction, we try to invest in companies with above-average market growth so that our portfolio succeeds in various market and economic conditions.

companies that are competitively advantaged and can grow across a cycle, regardless of the economic backdrop. We believe growth companies are largely responsible for driving innovation in the economy, and many of these companies can be found in our portfolio.

Our thematic approach is a critical part of our investment process. We are excited about our newest theme - "A healthier tomorrow." Across the globe, people are prioritizing exercise, diet, and environmental health, and they want greater access to and control over their personal health data. What's exciting is that this theme encompasses many different industries, including hospital operators, HVAC equipment manufacturers, medical device makers, and workout apparel. We expect demographic trends to drive increased awareness of this theme, and we anticipate that public policy can further support growth in these markets.

**Portfolio positioning:** Our portfolio holdings include many growth companies responsible for driving innovation in the information technology, health care, consumer and industrial sectors. We aim to invest in companies with strong pricing power and recurring revenue that can grow across a cycle, irrespective of the status of the economy.





## U.S. equity, continued



We aim to find companies that have pricing power — the ability to raise prices to cover their increased costs without negatively impacting demand.

We tend to see pricing power in companies with concentrated end markets — such as beverage producers — but for larger discretionary products like furniture and electronics, it depends on whether consumers are willing and able to spend in this inflationary climate. We have also seen retailers cutting prices to move their inventory. We're mindful of other instances where pricing power will be challenged. For example, we've seen banks reporting higher levels of wage inflation. This tends to be a cost that is not easy to pass on, especially in an industry as competitive as banking.

Through careful portfolio construction and stress testing, we seek to manage our portfolios' sensitivity to inflation as well as to interest-rate and bond-yield movements. With our risk management process, we work to keep the portfolio from meaningfully underperforming in a rising-rate environment. We also seek to manage interest-rate risk by maintaining a mix of holdings with varying interest-rate sensitivity.



Value Team

**As portfolio managers, we don't try to predict the duration or magnitude of inflationary forces. Instead, we focus on how inflation might impact the profitability of the companies we own.**

We continue to analyze the overall market environment in the context of how it affects our individual stock holdings. Looking ahead, we believe inflation and unemployment trends are two key indicators that will determine the trajectory of the stock market through year-end. Moderating inflation and an increase in unemployment would be constructive for equities, whereas sustained high inflation and full employment would continue to weigh on stocks. Our focus is on stock selection, while aiming to keep the portfolio as immune as possible to macroeconomic challenges. This includes stress testing the portfolio against different scenarios, such as high inflation, rising interest rates, style rotations and macro trends.





## U.S. equity, continued



Within the utilities sector, the length of the investment cycle needed to upgrade electric and gas infrastructure is a key opportunity that is often underestimated.

More than 80% of natural gas pipelines need replacing and electric grid updates are necessary to support the demand for clean energy.

In terms of risk, the message from management teams is that attracting and retaining labour has become much more difficult. Unemployment remained low and inflation reached the highest levels in more than 30 years. Higher interest rates in the U.S. resulted in a stronger U.S. dollar and a higher cost of debt, which could negatively affect highly-leveraged firms and sectors.

We are optimistic about natural gas-only utilities. Completing safety and maintenance projects will increase the reliability and value of assets, enhancing profit levels permitted by regulators. We are also actively researching digital advertising companies that operate within the communication services value chain.



**Portfolio positioning:** Increased exposure to the utilities sector focusing on natural gas and clean energy leaders. We do not hold any investments in communication services.

We focus on utility companies that aim to replace coal generated energy cost-effectively with some of the best wind and solar resources in the country.

# International equity

Rising bond yields, eroding consumer disposable income and the prospect of a weaker housing market suggest that 2023 could be a low-growth environment. The trends of an aging, less equal and more indebted society are likely to hamper growth.



The global energy transition has been accelerated by the COVID-19 pandemic, the Russian-Ukraine war and growing concerns about climate change. The acceleration exposed both vulnerabilities from a dependence on fossil fuels and the heightened need for alternatives. In Europe, the energy supply has improved, partially thanks to the success of filling liquid natural gas (LNG) storage capacity. Still, suppose Russian gas is unavailable for Europe in 2023 and China reopens after COVID-19 lockdowns and returns to the global LNG market to compete for volumes with Europe. In that case, the supply crisis will likely worsen. Although the investment story might be immature, nuclear power operations could accelerate in the coming decades.

We believe the market will reward companies that can compound growth supported by strong long-term trends in attractive addressable markets.

We are monitoring the negative impacts of policy action in China on companies' ability to generate profits, as well as the geopolitical fallout from China's desired reunification with Taiwan, which President Xi has prioritized. Last year, the U.S. introduced restrictions on semiconductor exports to China. Investors were surprised when the U.S. prevented citizens from working for China's semiconductor companies. These restrictions will likely hinder China's ambitions to compete with the U.S. in the semiconductor space.

Underestimating the economy's reliance on fossil fuels and the speed with which the transition to a carbon-neutral energy system can be achieved could prolong the energy crisis. Currently, the same dollar amounts invested in fossil fuels yield much more energy than when invested in renewable energy. Annual capital investments in renewable energy are much-needed and set to increase substantially by 2040. Well-placed owners and operators of renewable power offer interesting investment opportunities that align with the long-term priorities of governments.

**Portfolio positioning:** Tilted towards high-quality, leading companies with strong balance sheets, a long-duration business model. We focus on assets with strong unique competitive advantages and the potential to magnify returns through the 'compounding' process.



## International equity, continued



The European energy crisis remains a key source of risk for international equity markets. A spike in gas prices undermined the competitiveness of energy-intensive industries in Europe and took a bite out of consumers' discretionary budgets.

In one of the worst-case scenarios, we believe a gas shortage could lead to industrial and residential rationing. The gradual reopening of China – a net importer – may tighten energy supply, especially if it competes with Europe for the same LNG volumes on the spot market.

On a more reassuring note, many companies told us supply chain pressures eased at the end of 2022, with production returning to pre-COVID-19 levels. Freight demand declined as purchases of essentials pushed discretionary items like electronics to the sidelines. Unpredictable supply chains previously meant that some companies could not satisfy demand. However, more recently, companies that double ordered to secure supply have bloated inventories. We are concerned about automotive original equipment manufacturers (OEMs) ramping up production into a weakening consumer environment this year.

There is a striking disconnect between the valuation of internationally listed global franchises and those listed in the U.S. Higher-quality businesses are trading at a significant discount to their U.S. peers. Although we agree that some valuation premium should exist for the U.S. market due to its sector composition and higher aggregate return on investment, we believe the discount's scale is unwarranted.

We are positive on well-capitalized banks and insurers, key beneficiaries of last year's rising interest rate environment. Asset quality deterioration should be manageable, given improvements in underwriting standards following the 2008-2009 global

financial crisis. We are also optimistic on the EAFE equity outlook. EAFE equities trading at lower multiples face less risk of further valuation compression from rising rates.

**Portfolio positioning:** Overweight interest rate sensitive equities such as banks and insurers. Leveraging inflated energy prices with an overweight allocation to oil and gas equities and exposure to energy-price sensitive utilities. Overweight to capital goods and semiconductor equipment equities in anticipation of a reorientation of global supply chains.

To manage trade tensions, companies are rethinking their supply chains by “friend-shoring” or moving capacity away from hostile regimes to allied countries. Efforts to diversify supply chains could significantly boost capital expenditures, driving economic growth.

**J.P.Morgan**  
Asset Management



# Emerging markets equity

Risk profiles vary considerably by country, sector and company across emerging markets (EM).



Accordingly, our approach is highly selective, with a strong focus on environmental, social and governance (ESG) concerns. For 2023, we expect India, South Korea, Indonesia and Mexico to perform well, supported by strong governance, capital market buffers and attractive demographics.

In response to the energy crisis, emerging and developing markets increased renewable investments to reduce reliance on fossil fuels and strengthen energy security. We expect this trend to extend into 2023 and beyond. Although oil and gas companies benefited from the energy crisis, we see two main reasons to remain cautious: long-term demand destruction spurred by climate change considerations and the political risks of resource asset taxation and nationalization.

**We remain cautious on China in response to excessive debt, governance issues and demographic challenges.**

As the U.S. sets the benchmark for EM interest rates, the sharp rise in U.S. rates could trigger an exodus of capital from the EM equity and bond asset classes, coupled with currency devaluations. However, many EM central banks proactively raised rates, helping to stabilize their currencies. We believe that quality EM banks are positioned to grow market share, supported by ample provisions for bad debts and capital adequacy well above regulatory requirements.

Chinese President Xi Jinping's reappointment for an unprecedented third term signalled the removal of any final traces of checks and balances and increased the risk that China could behave provocatively toward Taiwan. Contagion from property sector weakness and potential civil unrest in response to China's zero COVID-19 strategy could be negative for economic growth.

In addition, we are concerned about default risk in China's property sector, which accounts for about 30% of GDP. As sentiment fluctuates, foreign direct investment previously destined for China could be redistributed to benefit countries, including India, Mexico and parts of Eastern Europe.

**Portfolio positioning:** Overweight in sectors exhibiting structural growth. A weighting under 10% in Hong Kong and China, versus the index weight of 30%. Zero-weight in China's real estate and financials sectors and large internet platforms.





## Emerging markets equity, continued



China, Taiwan and South Korea detracted the most from EM equity performance in 2022.

A sizeable contribution from Brazil only marginally offset losses. COVID-19-related lockdowns in China, accompanied by weaker macroeconomic data, pointed to slowing growth in the country. Although EM central banks hope to stabilize prices by limiting demand with higher interest rates, they have little control over external factors like the supply of goods. The Russian-Ukraine war threatens to extend into 2023, which could put extra strain on supply chain networks. Deteriorating relations between the U.S. and China could further damage trade flow.

The strengthening U.S dollar on the back of the Fed's interest-rate hikes played a large role in EM struggles in 2022. The U.S dollar is a common currency for funding purposes in EM and globally. As it strengthened, it squeezed borrowers and pressured liquidity in these countries, and we expect this trend to continue in the near term. As the U.S. dollar still dominates international transactions, imports for most EM countries have become more expensive.



**Portfolio positioning:** Our 'all weather' portfolio construction strategy is managed to outperform in various market environments. We expect bottom-up stock selection to be our entire source of alpha, contributing to above-index/benchmark returns. Any slight country/sector positioning is driven by stock picking.

Despite historic outflows from EM in 2022, we believe the sector is well-positioned for growth over the next decade.



# Global equity

Through a focused lens on individual companies and their fundamentals, we continue to identify those well-positioned to grow capital over the long term.

For example, exciting business opportunities are being created through innovation and disruption at pharmaceutical and biotech companies. These include potential solutions to address widespread health issues such as obesity and diabetes as well as technology platforms to support drug discovery. In addition, managed care companies are transforming how health care is delivered, focusing on value creation and better patient outcomes.

We continue to see investment opportunities in the energy sector, primarily across North America and Europe. Following years of capital discipline, companies with sound balance sheets and strong free cash flow generation can provide meaningful returns to shareholders through dividends and buy-backs.

**Inflationary pressures, supply chain reconfigurations, and energy transition, among other forces, are presenting a new reality. Investment strategies that proved successful over the last decade may look quite different from those that lead to successful outcomes in the next.**

We look for resilience, even at much lower oil prices than the highs of 2022. We also seek opportunities for sustainability and growth, considering reserves, production mix, environmental footprint and technological innovation.

Industrial companies are positioned to benefit from capital expenditure to support mining opportunities, electric grid modernization, automation and supply chain reconfiguration.

Inflation, capacity constraints and monetary policy continue to be important variables to watch, as are the implications of geopolitical tensions on global trade, supply chains and business investment.

**Portfolio positioning:** We prefer companies with features that promote financial strength through tighter conditions, such as sound balance sheets and strong free cash flow generation. At the same time, we continue to look for long term growth of capital through resilient and growing end markets.





## Global equity, continued



Inflation is front and centre with respect to a company's ability to maintain healthy returns and support stronger relative operating performance.

As central banks tighten liquidity in the face of persistent inflation, the extent of the likely slowdown will be a challenge for company profitability.

Value equities remain attractive relative to the investment opportunity set within global equity markets. While high-multiple equities may underperform as economic growth slows. Sectors previously buoyed by unprecedented accommodative policies no longer have this support.

At Setanta Asset Management, we seek to purchase higher-quality businesses at competitive prices that tend to do well during periods of market stress. We also like to embed a margin of safety in our valuation research as a buffer against market weakness.

**SETANTA**  
Asset Management

Instead of focusing on the historical volatility of an asset, we believe the probability of permanent impairment of capital is the most relevant measure of risk. In this way, we seek to maximize downside protection by understanding the risks posed by the valuation, financial, and operational characteristics of the asset.

**Portfolio positioning:** By assessing strong capital returns and low leverage as proxies for company quality, in addition to favourable valuation, the portfolio is positioned favourably versus the benchmark to manage an environment of higher interest rates and inflation. Sector weights are broadly similar to those in the benchmark.

Opportunities may emerge as high-quality companies with excellent secular growth prospects trade down to valuations that offer a compelling risk-reward balance in the long term.



# Sector equity: Canadian real estate

Major central banks raised interest rates through the second half of 2022.



While these conditions constrain economic expansion, the performance of real estate is largely linked to the underlying demand quotient.

We expect high demand for last-mile logistics, low vacancy rates, rising construction costs and limited land availability to support income returns in the industrial sector.

Demand for multi-family residential remains strong, given its inelastic, necessity-based nature together with the robust growth of demand factors.

Conversely, sectors in office settings can see demand softening in the same tightening environment, which constrains investors' willingness to make long-term capital commitments.

**Canada's limited housing supply, aggressive immigration targets and decreased home ownership affordability from rising interest rates are collectively raising demand in the multi-residential family segment.**

The uncertainty of work-from-home trends has unsettled the office market. Tenants have been reassessing the value of the office as a tool to support and grow their business. A flight to quality is occurring as tenants prioritize amenities and location.

On the supply side, a higher interest-rate environment can reduce the pace of new projects. Higher construction and financing costs lower the relative risk-adjusted attractiveness of development. This discipline helps support markets finding equilibrium.

Short-term capital market conditions can be a distraction for some investors. In contrast, those who remain focused on the strategic, long-term role of real estate investing can position to realize attractive, risk-adjusted returns.

Canada joined more than 120 countries in pledging net zero emission targets to the United Nations. With the real estate sector representing 40% of global greenhouse gas emissions, Canada's success in meeting its target will need to target the industry.

**Portfolio positioning:** Increased allocation to the industrial and multi-family sectors while reducing weighting to office space. We screen investments against risks connected to climate change and are committed to reducing the portfolio's energy and carbon footprints. Recognized by the Global Real Estate Sustainability Benchmark (GRESB) as a leading, global sustainability practice.



# Responsible investing

ESG investing has matured over the last decade from its reactive roots into a proactive and holistic movement.

**J.P.Morgan**  
Asset Management

Yet despite this maturation, recent structural challenges threatened the ESG industry's short-term outlook.

Since interest rate volatility makes pricing risk assets difficult, climbing interest rates severely affected global equity markets. Companies with unclear short- to medium-term paths to profitability were most sensitive to this backdrop. ESG investments with similarly uncertain earnings potential, like those in the energy space, suffered.

We believe Europe's failure to achieve energy independence was at least partly the result of an overzealous adoption of renewable energy. The security threat associated with this lack of energy independence shifted the dialogue concerning the transition from fossil fuels, particularly in the U.S. Some policymakers, pundits and investors posited that ESG investing was irresponsible in the current geopolitical climate. Nonetheless, if central banks pause their hiking cycle, interest rate volatility should diminish in 2023. Investors will be better positioned to accurately price risk assets due to a more stable discount rate. On balance, European policymakers will likely respond to energy shortfalls by increasing investments in renewable resources.

Moreover, long-term structural trends that emerged in the previous decade remain intact. Social unrest, the COVID-19 pandemic and extreme weather exposed income and wealth inequality and the tangible threats of climate change. While painful, the transition to renewable resources remains inevitable as fossil fuels deplete. Global governments, too, remain committed to "net-zero" emissions targets by 2050, and will craft policy accordingly.

Ultimately, while ESG investing has come under pressure this year, investors should adopt a longer-term mindset and maintain focus on the big-picture trends.





## Executive summary

# Insights that help you build your business

In 2023, investment markets could face reduced consumer purchasing power, energy emergencies and uncertainty about China's exit plan from COVID-19 policies. Intricate international relationships that dominate the geopolitical world are changing market dynamics more than ever. Furthermore, economic policy tools are not necessarily designed to efficiently address the underlying causes of inflation such as supply shortages.

Under this uncertain backdrop, we are confident in our sub-advisory teams' ability to tilt portfolios to withstand a mix of challenges. We have insights to help you build your business. And the work you do with Canadians every day isn't just about finding the right fund or rebalancing their portfolio – you're setting them up to meet long-term goals and plan for life as they know it.

Helping clients stay on track is harder than ever in today's ever-changing investment landscape. Let us do some of the heavy lifting by delivering market updates straight to your inbox. Save time and energy by starting each week with need-to-know news on the markets and investments.

Our monthly recap helps you make sense of the bigger picture, along with content from investment managers across the globe.

Get the information you need to help clients make sense of market moves, keep their emotions in check and stay invested to meet their goals.

Join thousands of advisors who are already receiving our updates. Get the information you need to help clients make sense of market moves, keep their emotions in check and stay invested to meet their goals.

Visit [canadalifeinvest.ca](https://canadalifeinvest.ca) to learn more.

# Featured investment managers and associated Canada Life funds

Investment managers	Mutual funds	Segregated funds
Aristotle Capital Management	<a href="#">Canada Life Pathways U.S. Concentrated Equity Fund</a>	<a href="#">Pathways U.S. Concentrated Equity</a>
Beutel Goodman	<a href="#">Canada Life Canadian Value Balanced Fund</a>	<a href="#">Canadian Value Balanced</a>
Brandywine Global Investment Management	<a href="#">Canada Life Pathways Global Multi-Sector Bond Fund</a>	<a href="#">Pathways Global Multi-Sector Bond</a>
C Worldwide Asset Management	<a href="#">Canada Life Pathways International Concentrated Equity Fund</a>	<a href="#">Pathways International Concentrated Equity</a>
Capital Group	N/A	<a href="#">Global Equity</a>
GWL Realty Advisors (GWLRA)	N/A	<a href="#">Real Estate</a>
Irish Life Investment Managers	<a href="#">Canada Life Risk-Managed Conservative Income Portfolio</a>	<a href="#">Risk-Managed Conservative Income Portfolio</a>
	<a href="#">Canada Life Risk-Managed Balanced Portfolio</a>	<a href="#">Risk-Managed Balanced Portfolio</a>
	<a href="#">Canada Life Risk-Managed Growth Portfolio</a>	<a href="#">Risk-Managed Growth Portfolio</a>
J.P. Morgan Asset Management	<a href="#">Canada Life International Equity Fund</a>	<a href="#">International Equity</a>
	<a href="#">Canada Life International Growth Fund</a>	<a href="#">International Growth</a>
	<a href="#">Canada Life Sustainable Conservative Portfolio</a>	<a href="#">Sustainable Conservative Portfolio</a>
	<a href="#">Canada Life Sustainable Balanced Portfolio</a>	<a href="#">Sustainable Balanced Portfolio</a>
	<a href="#">Canada Life Sustainable Growth Portfolio</a>	<a href="#">Sustainable Growth Portfolio</a>
Mackenzie Investments	<a href="#">Canada Life Floating Rate Income Fund</a>	<a href="#">Floating Rate Income</a>
	<a href="#">Canada Life North American High Yield Fixed Income Fund</a>	<a href="#">North American High Yield Fixed Income</a>
	<a href="#">Canada Life Canadian Tactical Bond Fund</a>	<a href="#">Canadian Tactical Bond</a>
	<a href="#">Canada Life Canadian Equity Fund</a>	<a href="#">Canadian Equity</a>
	<a href="#">Canada Life Canadian Dividend Fund</a>	<a href="#">Canadian Dividend</a>
	<a href="#">Canada Life Science &amp; Technology Fund</a>	<a href="#">Science and Technology</a>
	<a href="#">Canada Life Pathways Emerging Markets Large Cap Equity Fund</a>	<a href="#">Pathways Emerging Markets Large Cap Equity</a>

## Fund listing associated with Canada Life's 2023 Market Outlook, continued

Investment managers	Mutual funds	Segregated funds
Portfolio Solutions Group	<a href="#">Canada Life Conservative Portfolio</a>	<a href="#">Conservative Allocation</a>
	<a href="#">Canada Life Moderate Portfolio Fund</a>	<a href="#">Moderate Allocation</a>
	<a href="#">Canada Life Balanced Portfolio</a>	<a href="#">Balanced Allocation</a>
	<a href="#">Canada Life Advanced Portfolio</a>	<a href="#">Advanced Allocation</a>
	<a href="#">Canada Life Aggressive Portfolio</a>	<a href="#">Aggressive Allocation</a>
Putnam Investments	<a href="#">Canada Life U.S. All Cap Growth Fund</a>	<a href="#">U.S. All Cap Growth</a>
	<a href="#">Canada Life Pathways U.S. Equity Fund</a>	<a href="#">Pathways U.S. Equity</a>
Northcape Capital	<a href="#">Canada Life Pathways Emerging Markets Equity Fund</a>	<a href="#">Pathways Emerging Markets Equity</a>
T. Rowe Price	<a href="#">Canada Life Global Growth Balanced Fund</a>	<a href="#">Global Growth Balanced</a>
	<a href="#">Canada Life Global Multi-Sector Fixed Income Fund</a>	<a href="#">Global Multi-Sector Fixed Income</a>
	<a href="#">Canada Life Global Growth Equity Fund</a>	<a href="#">Global Growth Equity</a>

## Explore our full fund listing

Investment solutions	Mutual funds	Segregated funds
Fixed income	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>
Canadian equity	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>
U.S. equity	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>
Global equity	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>
Foreign, specialty and alternative	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>
Balanced	<a href="#">Mutual funds</a>	<a href="#">Segregated funds</a>







# 2023 Market Outlook

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