4Q22 | MACROECONOMIC DRIVEN MARKETS SEARCHING FOR THEIR NEXT KEY FOCUS

INVESTMENT ENVIRONMENT

- A potential slowdown is the risk focus for markets with inflation seemingly on a better path. China's reopening should help global growth albeit with a lag.

EQUITY MARKETS

- The prospect of peaking inflation provided a boost for equities to close out the year. Balancing risk and reward is key as sentiment can change quickly.

FIXED INCOME MARKETS

- Elevated volatility in bond yields continued in the quarter as markets remain fixated on the minutiae of central bank communications.

INVESTMENT ENVIRONMENT | SPECULATING ON THE POTENTIAL SEVERITY OF THE ECONOMIC SLOWDOWN

The global economy experienced several challenges in 2022 impacting the growth outlook as the year progressed. Higher-than-anticipated inflation, the ongoing conflict in Ukraine, and disruptions to revenue growth due to labour and supply chain constraints all contributed to the difficulties. Central banks were forced to raise interest rates at a rapid pace in an effort to contain inflation which eventually raised concerns about the possibility of a recession. Encouragingly, the pressure on supply chains is moderating and inflation appears to have peaked in the fourth quarter, though the future pace of deceleration and potential central bank interventions remain sources of uncertainty in the year ahead.

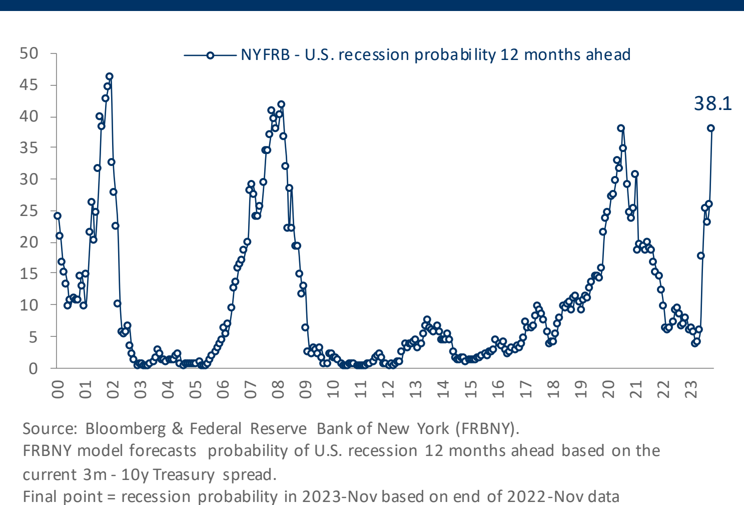
The labour market is also likely to receive significant attention as the year progresses. Unemployment, job growth, and wage growth will be closely watched as indicators of economic health and potential central bank actions. While labour conditions are currently tight and contributing to inflationary pressures, job gains have started to slow, and the rate of wage growth has stabilized. Although unemployment remains too low, it seems to have bottomed. The U.S. Federal Reserve (The Fed) will be keen to observe further evidence that the labour market is on a path towards normalization before being able to breathe easier on this front.

While always keenly reported upon, the unrelenting media attention on macroeconomic updates has been fueled by the recent hypersensitivity of financial markets to the release of new data. **The consensus view of a slowdown ahead is aligned with signals from the stock and bond markets (Figure 1), yet much debate remains regarding the timing and severity of the expected downturn in economic activity.** Our investment framework is biased towards a soft landing, which is to say that should we enter a recession we expect it to be relatively mild.

China's citizens had been living under restrictive COVID-related conditions for a much longer period of time than other developed countries (Figure 2), and voiced their displeasure with memories of severe lockdowns in major cities still fresh in their minds. **Whether in response to protests or due to a sudden pivot in strategy, China's abrupt relaxation of COVID Zero policy should result in a boost to global growth once near-term disruptions related to a surge in infections have been navigated.** China's reopening will not be without challenges, as the medical system is already stretched and was given little time to prepare for the swift influx of new patients. The Chinese government will provide immediate support to industries most impacted over the past three years in addition to enacting broader measures aimed at expanding domestic demand and consumption in the long term.

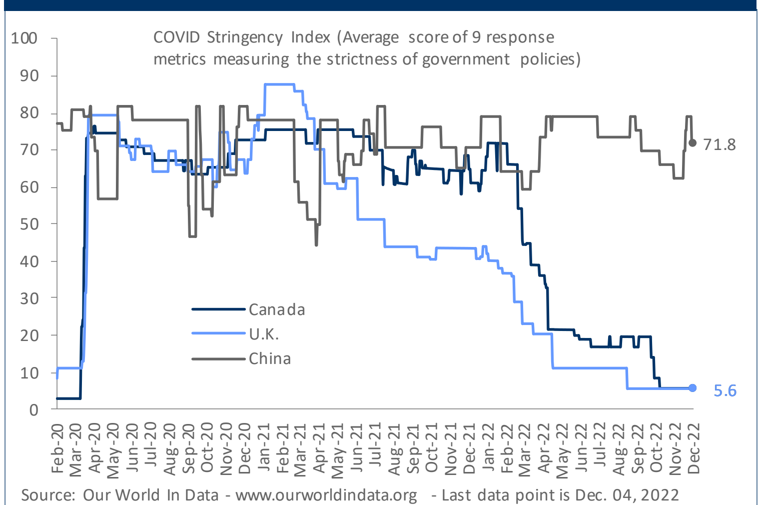
As we enter the new year, uncertainty will continue to be a major factor for the global economy. Positively, the risk of runaway inflation and interest rates seems much diminished. In an economic slowdown scenario, the current talent shortage may influence companies to hold onto skilled labour longer than usual and moderate the prospects for significant job losses. However, challenges do exist, and the near-term health of the economy will continue to be a focus of the markets. Looking beyond the short-term, we remain cautiously optimistic despite these uncertainties though acknowledge the potential for volatile markets particularly in the first half of the year.

FIGURE 1: YIELD CURVE SIGNALLING RECESSION CONCERNS



Source: Bloomberg & Federal Reserve Bank of New York (FRBNY).
FRBNY model forecasts probability of U.S. recession 12 months ahead based on the current 3m - 10y Treasury spread.
Final point = recession probability in 2023-Nov based on end of 2022-Nov data

FIGURE 2: CHINA COVID POLICY DIVERGANCE FROM R.O.W.



Source: Our World In Data - www.ourworldindata.org - Last data point is Dec. 04, 2022

EQUITY MARKETS | A CHANGE IN THE INFLATION NARRATIVE PROVIDES A BOUNCE FOR EQUITIES

Equity Index Returns				
	4Q22 (CAD)	4Q22 (USD)	YTD22(CAD)	YTD22(USD)
Global (Net)	8.2%	9.8%	-12.2%	-18.1%
Canadian	6.0%		-5.8%	
CDN Small Cap	8.4%		-9.0%	

The fourth quarter and the entire year were marked by the interplay between inflation, interest rates, and economic growth. The Fed's aggressive and unprecedented hiking cycle, prompted by higher and more persistent inflation, contributed to a slowdown in growth across industries and regions. Declines in equity markets that ensued were led by a material reset in high valuation growth/tech stocks that do not perform well during rising rate environments. Not seen in recent history, bond prices also suffered significant declines last year for the same reasons. In the fourth quarter, stock prices partially recovered from their yearly declines due to less inflationary data in the US in October and November, leading to the expectation that interest rate increases would moderate in the first part of the following year.

BIM EQUITY FRAMEWORK

Our bottom-up investment process provides us with frequent updates from companies regarding key business and industry trends, which take on even greater importance during periods of macroeconomic uncertainty. While companies have become more cautious about the short-term outlook, their most recent business trend data primarily showed slower growth rates rather than widespread declines. Despite a more cautious hiring atmosphere, job markets remain strong, and contributes to our view that the risk of a major recession is relatively low at this time and underpins our base investment framework. Nonetheless, central bank policies will continue to have an important influence on economic growth.

Though a lessening concern, several companies continue to highlight the challenge of hiring skilled labour. A rebound in the overall labour force participation rate could help remedy the issue, yet the important subcategory of prime age workers has nearly recovered to pre-pandemic highs implying that a skills shortage could persist (Figure 3). We therefore expect that businesses may either delay, or moderate the magnitude of workforce adjustments enacted should a slowdown occur given the potential difficulties they would face if required to rehire again down the road.

GLOBAL MARKETS

As growth slows and the risk of recession increases, earnings expectations and valuations have become more reasonable, potentially presenting opportunities for oversold secular growers that fit our Quality Value framework and companies with global exposure that have faced headwinds in recent years. While a major recession is not currently likely, uncertainty in the economic environment persists. Managing risk in such times requires a disciplined investment process that focuses on quality companies with attractive valuations and hidden attributes not fully reflected in the market, as well as a balanced portfolio construction process that diversifies as much macro risk as possible. An example of this approach is our investment in International Hotels Group (IHG), which has a strong portfolio of hotel brands worldwide and trades at a favorable valuation, with many regions not yet seeing a full return to travel. This is particularly evident in China where IHG's expansion plans have been delayed due to COVID restrictions, which we expect will show improvement.

CANADIAN ALL-CAP MARKET

Banks are important constituents of the Canadian index owing to their significant weighting and impressive long-term track record of returns versus the market. The banking sector has outperformed the market more than 75% of the time on a total return basis since the turn of the century yet has trailed in three of the last four years. 2022 was an eventful year for the group with several regulatory, acquisition, and capital raising updates. In December, the regulator effectively increased the required capital ratios for the group via an adjustment to the Domestic Stability Buffer as a cautionary measure should financial conditions deteriorate. This was significant given the large quantum of capital already assigned to announced but yet to close acquisitions proposed over the last year including Royal Bank for HSBC Canada, TD for Cowen, and BMO for Bank of the West if we reach back into December 2021.

While the banks should continue to build on an attractive history of dividend growth (Figure 4), the pace of future increases may be tempered in the near-term as some additional profits are diverted to build capital. We anticipate a more benign year ahead on the M&A and regulatory front and note that depressed valuations reflect concerns of a potential credit cycle. We view some of these worries as misplaced given the quality of Canadian mortgage underwriting, underappreciated consumer savings rates, and immigration trends that support demand for a wide variety of financial services.

FIGURE 3: TIGHTNESS IN PRIME AGE LABOUR MARKET

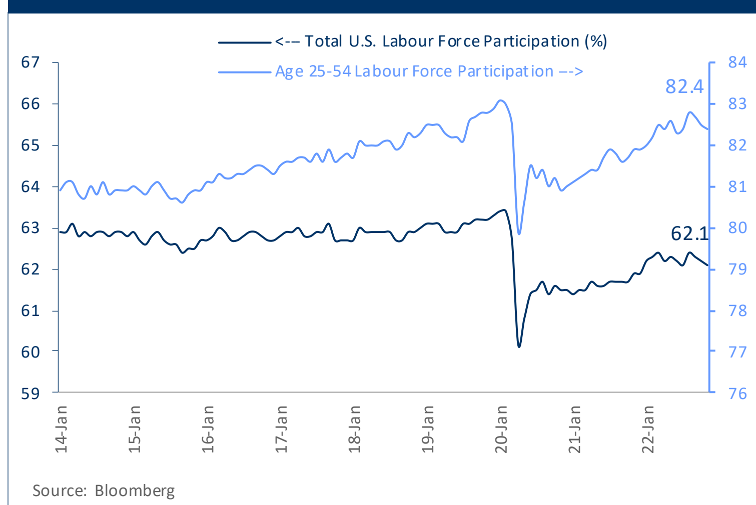
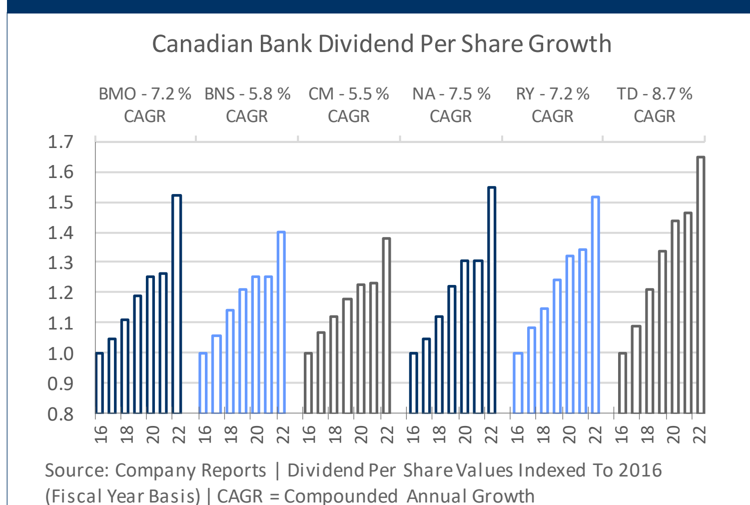


FIGURE 4: A TRACK RECOD OF BANK DIVIDEND GROWTH



CANADIAN SMALL-CAP MARKET

Following a big swing towards a risk-off tone in September, markets rallied for much of the fourth quarter with small caps leading. As previously noted, when fear and volatility spike and worries get (more than) priced in, future prospects improve. Small caps can be unduly punished in the drawdown but then often lead the market as sentiment improves. In this context, it was reassuring to see Canadian small caps outperform the large cap benchmark during the period.

One previously highlighted dynamic of market dislocations that can work particularly well in small caps favour is take-out optionality. In 2022, our portfolio had three announced buyouts: Intertape Polymer (ITP) for an ~82% premium to private equity group Clearlake Capital, LifeWorks (LWRK) for an ~89% premium to strategic buyer TELUS Health and most recently Summit Industrial REIT (SMU-U; discussed below). Anecdotally, it has felt like this phenomenon is more prevalent for smaller companies and our recent review of the data bears this out. Of the 78 buyouts of Canadian equities since the beginning of 2019, ~85% were for companies below $3 bln in value. Importantly, the average takeout premium on the smaller-sized deals was +37% versus the larger buyouts at +18%. This supports the thesis that takeout optionality is both, (1) much more common among small cap stocks, and (2) completed at higher realized premiums than their larger cap peers.

Our principal responsibility is identifying high-quality businesses offered in the marketplace at less than their fair value. Buyouts are never the core part of the thesis on a holding. Nevertheless, this optionality is meaningful to overall portfolio returns and represents another arrow in the quiver for why small cap investing can be so rewarding.

BIM EQUITY THESIS SPOTLIGHT

Summit Industrial REIT (SMU-U) is a Canadian industrial REIT with over 160 properties across Canada with over 90% of the portfolio located in the Toronto, Montreal, Calgary and Edmonton markets. The position was added in Q2 2020 on the strength of favourable repositioning of the portfolio and strong industry fundamentals driven by lagging supply and growing demand from rising e-commerce, fulfillment, and distribution activities. Shares performed well initially given the attractive entry point and growing cash flows and distributions at the REIT. However, in 2022, the unit prices across the industrial REIT sub-sector took a step back as concern around cresting pandemic-related "peak e-commerce" and rising interest rates cooled sentiment. This reaction created an attractive value gap for investors with a longer-term horizon as Singapore sovereign wealth fund, GIC, along with Dream Industrial REIT (DIR-U) offered to purchase SMU-U for a ~33% premium and a ~125% total return to our cost base (~34% CAGR). This was a good result for the portfolio over the ~2.5 year holding period and we'll look to redeploy these gains early in 2023

FIXED INCOME MARKETS | A SECOND SEQUENTIAL QUARTER OF VOLATILITY IN THE BOND MARKETS

Fixed Income Index Returns	4Q22	YTD22
Canadian	0.1%	-11.7%

As we close out 2022, the economic data released in the fourth quarter is signaling that inflation in Canada has peaked and is rolling over in the U.S. With that in mind, the Bank of Canada (BoC) and the Federal Reserve (Fed) have made it clear that they are data dependent, meaning that we have moved ever closer to the end of the rate hiking cycle. **The aggressive rate hikes we have seen in 2022 will continue to affect the economy over time, and representatives from the BoC and the Fed are indicating that a pause may be prudent to allow the economy to respond to the rate hikes we have seen so far.** Nonetheless, inflation remains a top concern for both the Fed and the BoC and may push central banks to continue hiking given ongoing strength in employment data, still positive GDP growth, and some lingering uncertainties with supply chains.

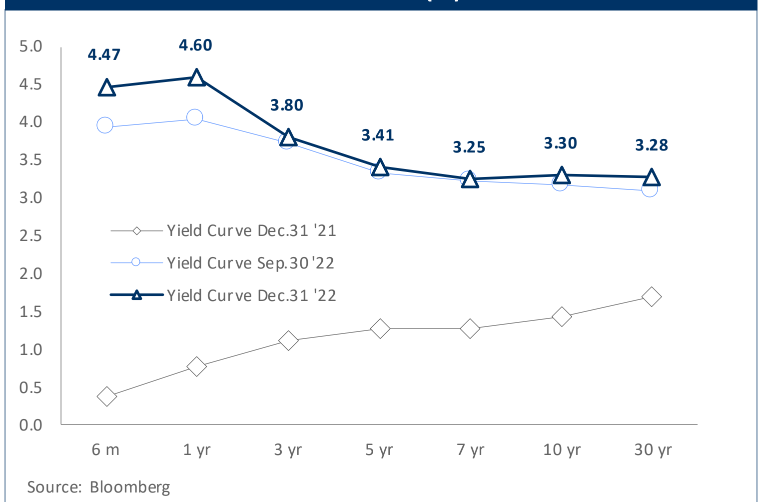
One indicator that seems to be often quoted in the financial press is the spread in yields between 3-month treasury bills and the 10-year government bond. In the fourth quarter we saw that spread invert indicating that there is a greater likelihood of the economy entering a recession in the next 12 to 18 months. The persistence of the inversion has changed the narrative surrounding central banks from how many future hikes there will be to when the first rate cut will occur. With so many investors scrutinizing every word and data point, volatility remains elevated in the fixed income universe. This is evidenced by the movement in yields with a peak to trough change in 10, and 30-year government bonds of over 90 basis points in the fourth quarter. Credit spreads have moved wider over the year indicating that the market is becoming more concerned about the economy, with the largest moves seen in the financials space and banks in particular. Even though we have seen credit spreads widen they are not at extreme levels ending the year slightly above the 2 and 5 year average.

BIM FIXED INCOME FRAMEWORK

With the strong move in yields across the curve, the 1 to 5-year region of the curve outperformed when compared to the middle and long ends (Figure 5). The benchmark returned 0.1% for the quarter and -11.7% for the year.

We increased the duration of the portfolio in the fourth quarter to be inline with the benchmark, and are biased towards further actions in this direction. We remain overweight corporates in the short end and governments in the long end, with a focus on liquidity and quality of the securities. We will be looking to take advantage of any dislocations in the market should any opportunities present themselves.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

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