PRIVATE CLIENT SOLUTIONS

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Insights & Strategies

Expecting Volatility

RAYMOND JAMES®

Inside This Issue:

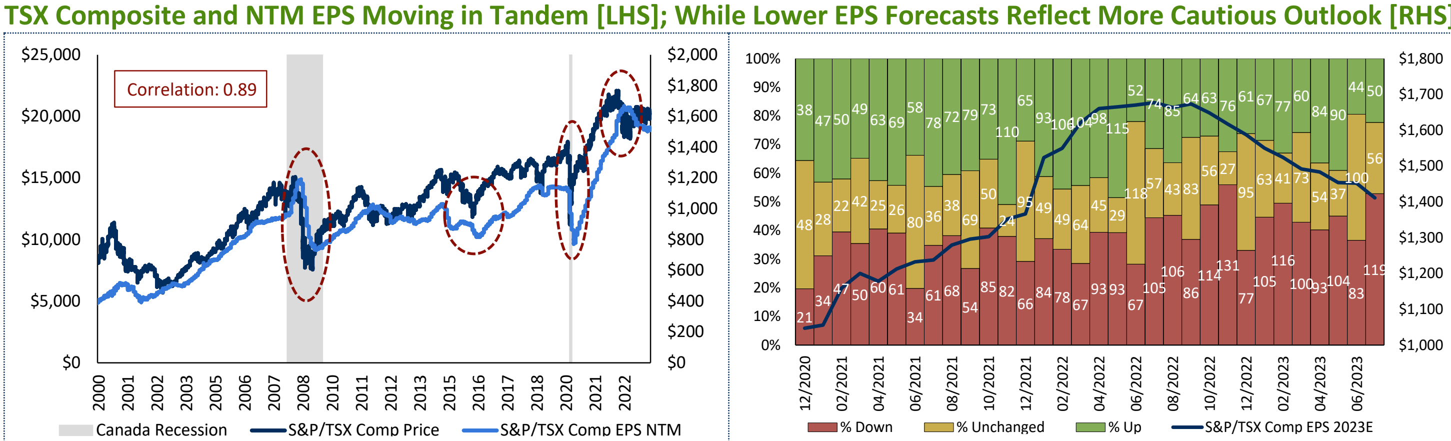
Expecting Volatility

As we move towards the end of the year, we continue to debate how this cycle will end, between the soft landing, mild recession, or deep recession scenarios. Our base case is for mild recessions in both Canada and the U.S., and that inflation-fighting central banks will keep rates higher for longer than many might expect. Although inflation has come down dramatically from its peak in June 2022, the battle to two per cent could drag well into 2024 or 2025, and although we believe we are near the end of the tightening cycle, any short-term resurgence in inflation could prompt further interest rate hikes through the end of 2023. The risk of overtightening remains and as global economic growth is already slowing, this could put even more pressure on the economy.

Now, the stock market is not the economy, and is generally more forward looking, but stocks can still react in the short-term to earnings surprises and guidance revisions. This can set the stage for security prices to be more volatile as we see mixed signals between low unemployment rates with still tight labour markets, and resilient consumer spending including continued demand for travel and entertainment, but with shifting spending patterns as shoppers favour value and trading down. We also see purchasing managers indicating declines in new orders as profit margins start to be squeezed, although many companies are also apparently increasing investments, specifically in technology, to improve efficiencies. This could lead to volatility in the market that might rattle some investors, but be seen as buying opportunities by others. Overall, we remind investors that volatility is inherent in public market investing and that it is important to maintain a long-term plan suited to one's specific goals and risk tolerance.

In the table below, we track monthly changes to EPS 2023 estimates for the S&P/TSX composite index. The forward-looking earnings measure has been consistently declining since the most recent market trough in October 2022, suggesting that analysts are factoring in the pressure on earnings expected from this economic slowdown. The number of companies that have seen negative revisions is also increasing. Although one might expect this deteriorating forecast to pressure share prices, the TSX composite is actually up ~7% from the end of September, and essentially flat YTD. The P/E_{NTM} multiple has increased from 11× in September 2022 to 12× in January and 13× today, while still below the 14.5× median, suggesting improving sentiment as investors look forward.

TSX Composite and NTM EPS Moving in Tandem [LHS]; While Lower EPS Forecasts Reflect More Cautious Outlook [RHS]



Source: FactSet; Raymond James Ltd.; Performance data as of August 15, 2023. Earnings revisions data as of July 31, 2023. Data labels indicate the number of constituents have upward/downward/unchanged earnings revisions. Please be advised that the 2023E EPS data might not be accessible for all constituents, and the number of companies with accessible 2023E EPS decreases when moving further into the past.

The takeaway can be that investors in the companies that make up the TSX composite are looking beyond the projected reduction in earnings related to the ongoing economic slowdown. The rising P/E$_{NTM}$ multiple suggests that investors are also looking beyond the coming recession and more towards the growth of a new business cycle, and with the current P/E$_{NTM}$ being below the median (measured since 2000) there is still room for improvement.

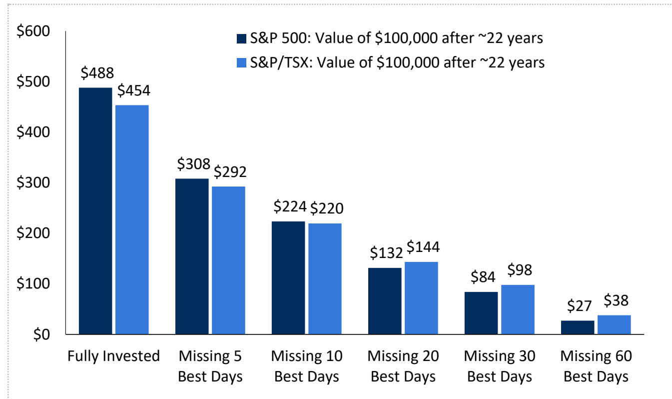
While the TSX composite as a whole therefore looks appropriately priced for our mild recession scenario, there are still some sectors that have fared better than others this year. While the 'Magnificent 7' and AI enthusiasm have driven up the Nasdaq Composite and S&P 500, the TSX has its own information technology sector, which has risen ~37 per cent YTD, although with only 7.5 per cent weighting in the TSX composite this has not exerted the same kind of influence that we have seen south of the border. The TSX composite is more influenced by the 30.5 per cent weighting of the financials sector and 17.7 per cent weighting from energy, which were both essentially flat YTD.

Sectors are reacting differently through this period. As interest rates put further pressure on consumer borrowing/spending, we would generally expect discretionary spending to be constrained. This has been somewhat offset by 'excess savings' from pandemic fiscal measures and reduced spending opportunities during lock-downs that have artificially supported consumer spending. We are watching to see if that effect wanes as those balances are exhausted by the end of the year (in both Canada and the U.S.).

Stocks in the energy sector however are much more impacted by the price of oil, which is influenced by the economy on the demand side, but by OPEC and other producers on the supply side, and while global inventories sit at near six-year lows, surprises in either direction would prompt price movements. Additionally, many investors have been watching the Chinese economy for signs that the government will step in with measures to aid its sluggish growth, which could also impact the price of oil and have a more significant impact on our Canadian index.

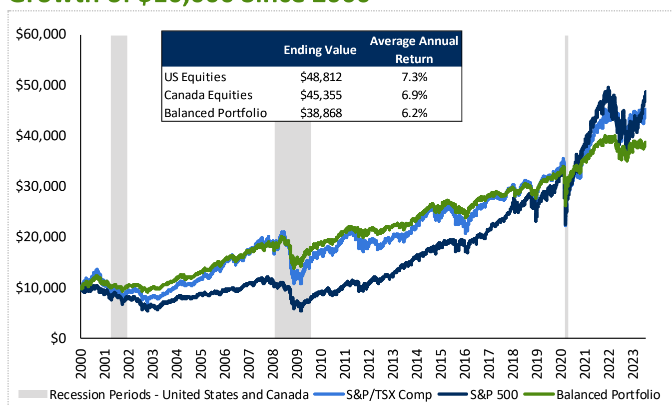
The path ahead is far from clear, and we see many opportunities for both negative and positive surprises as economic data is released, central bankers react, and markets adjust both short-term and long-term outlooks. We are also still waiting for the yield curve to normalize (slope positively) from its inverted state. As interest rates have risen recently, fixed income has become a more viable alternative to equities. Until we see a more normalized environment, we should expect heightened volatility as investors digest somewhat conflicting messages as to how the economy, interest rates, and even different sectors, might fare over the next year.

Stay Invested, Markets Have Always Rewarded Long-Term and Patient Investors



Source: FactSet; Data as of July 31, 2023, in thousands of local currency; for illustration purposes only. Start investing on January 1, 2000 with an initial investment of $100,000.

Growth of $10,000 Since 2000



Source: FactSet; Data as of July 31, 2023. Growth of 10K Chart: For illustration purposes only. Start investing on January 1, 2000 with an initial investment of $10,000. The returns of U.S. Equities, Canadian Equities and Canadian Fixed Income are represented by S&P 500 TR Index, S&P/TSX Composite TR Index and FTSE Canadian Government Bond, respectively. The asset allocation of the Balanced Portfolio is 60% S&P/TSX Composite TR Index and 40% FTSE Canadian Government Bond.

Ultimately, with heightened volatility amid uncertain markets we prefer to focus on timeless advice around long-term planning matching goals and risk tolerance. Additionally, diversification is always a good tool, and with a more attractive fixed income environment, is perhaps more welcome now than in previous years. Staying invested and being patient through market noise remains a solid piece of advice.

Neil Linsdell, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

Staying Steady Amid Market Swings

The recent equity market pull-back, uncertainty around earnings, surge in US treasury yields, and the US Fitch downgrade, have fueled discussions about market volatility in 2023. For investors, such times can be difficult to navigate. Yet, it's during these moments that understanding and appreciating the nature of volatility becomes critical.

Methodology

The analysis below uses two metrics: the 30-day annualized volatility and the relative strength index (RSI).

The 30-day annualized volatility metric measures a security's price fluctuation over a month, scaled yearly. Higher values signal more pronounced price swings, suggesting greater potential risks and rewards, while lower values indicate steadier price movements.

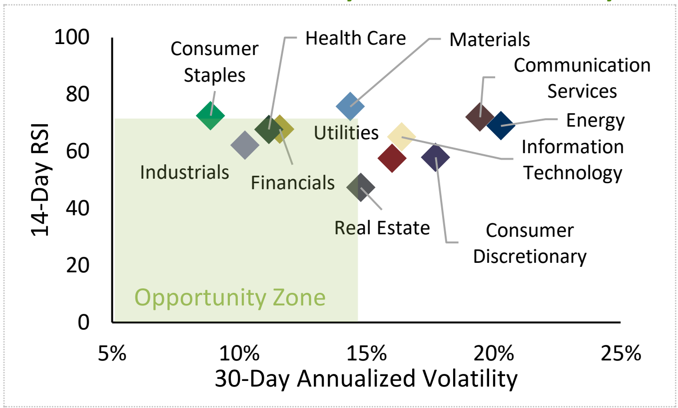
The RSI metric, ranges from 0 to 100, and measures the price momentum strength of an investment. An RSI above 70 suggests potential overbought conditions, indicating a possible price pullback, whereas an RSI below 30 hints at oversold conditions, signaling a potential price uptick.

Findings

Over the past two years, the US and Canadian market sectors have exhibited a varying range of volatility. We analyzed these metrics for the GICs sectors of the S&P 500 and S&P TSX, and isolated for securities that had an RSI below 70 and an annualized volatility of less than 15%.

For the S&P 500, we found that the industrials, financials, and health care sectors satisfied our criteria. Some quality companies we favour in these sectors include **Union Pacific (UNP-US)**, **Wells Fargo (WFC-US)**, and **UnitedHealth Group (UNH-US)**.

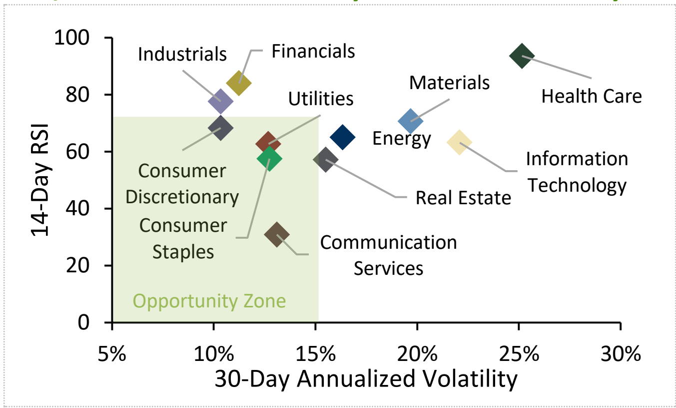
S&P 500 Sector RSI vs 30-Day Annualized Volatility



Source: FactSet. Raymond James Ltd. Data as of July 31, 2023.

For the S&P/TSX, we found that the consumer discretionary, consumer staples, utilities, and communication services sectors satisfied our criteria. The quality companies we favour in these sectors include **Dollarama (DOL-CA)**, **Alimentation Couche-Tard (ATD-CA)**, **Emera (EMA-CA)**, and **Quebecor (QBR.B-CA)**.

S&P/TSX Sector RSI vs 30-Day Annualized Volatility



Source: FactSet. Raymond James Ltd. Data as of July 31, 2023.

Conclusion

Navigating equity markets requires not only knowledge but also a strategic approach. Our analysis underscores the importance of understanding market volatility and leveraging tools like the RSI to understand price trends and momentum.

Diversification is also another important tool for investors, which serves as a bedrock principle when constructing portfolios. By spreading investments across various sectors, investors can mitigate risks associated with any single sector's downturn. In short, diversification can provide a safety net, ensuring that even if certain investments underperform, others might outperform, balancing out potential losses.

Additionally remaining invested, even during market downturns, allows investors to potentially capitalize on the market's eventual upswing. Exiting the market in a downturn might prevent losses in the short term, but it also means missing out on potential gains when the market rebounds.

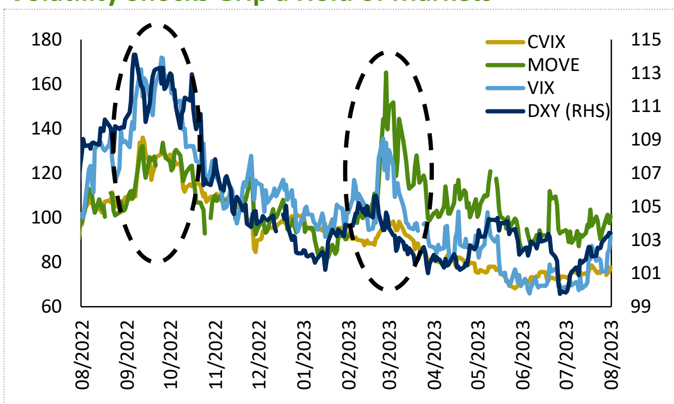
In essence, while the market may be unpredictable, a well-diversified portfolio and a long-term perspective can act as both a compass and anchor. By staying informed, diversified, and invested, investors can turn market volatility from a challenge into an opportunity, helping them chart a course towards financial growth and stability.

Peter Tewolde
Senior Equity Specialist

FX Volatility Gearing for a Comeback?

Cross-asset volatility has largely been on the decline over the course of the past year, despite brief periods of volatility shocks that momentarily gripped a hold of markets. This trend was largely attributed to a synchronization of monetary policy tightening amongst major central banks as all eyes have shifted to forestalling the eventual peak of the Fed's tightening cycle. There were two glaring volatility shocks over the past year, with the first in September of 2022 where the Fed hiked interest rates by 75bps for the third consecutive meeting and an upward revision to its forecast for their benchmark rate. The second shock came in March of 2023 with the collapse of Silicon Valley Bank and the growing fears over financial contagion risk. In both cases, we naturally saw a material spike in volatility across markets and a safe haven bid in the broader U.S. dollar.

Volatility Shocks Grip a Hold of Markets



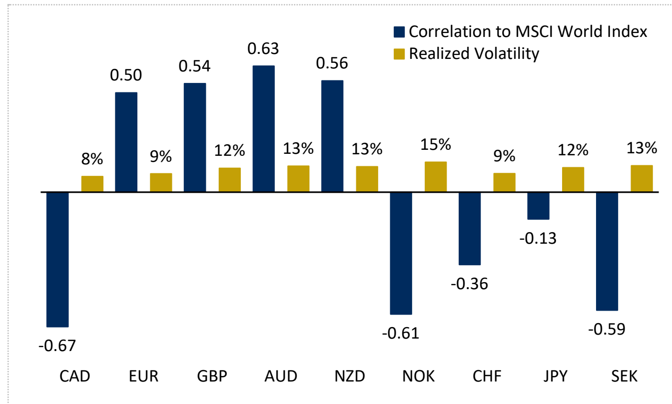
Source: FactSet; Raymond James, Ltd.; Data as of August 17, 2023

A Closer Look Under the FX Volatility Hood

Volatility across currency markets has been on a downward trend since late 2022. However, this trend may very well change going forward as global central banks shift to a more data-dependent stance given the lagged effect of rate hikes on the real economy, increasing the risk of less monetary policy convergence and more uncertainty. We have recently begun to see a modest turn higher in market volatility gauges as concerns grow over China's economy, which many were optimistically looking to for a post-COVID boost to global growth.

Of the G10 currency bloc, the Canadian dollar has exhibited the lowest realized volatility over the past year versus the U.S. dollar. However, while the loonie's beta to the broader U.S. dollar may be low given the close ties between both economies, its beta to global risk sentiment is actually the highest of its G10 peers.

CAD's Sensitivity to Broad Risk and the U.S. Dollar



Source: FactSet; Raymond James, Ltd.; Data as of August 17, 2023

Near-term U.S. Dollar Strength

As for the outlook on the broader U.S. dollar, there are a few important points to consider going forward:

1. The Fed needs to balance its fight against inflation with an economy that, while showing signs of slowing, is still growing faster than expected and with a robust labour market. At the time of writing, the market is only pricing in roughly 10bps of further tightening between now and its November meeting.
2. The notion of other major central banks "outgunning" the Fed may begin to be dialed back to some degree, as more of the Fed's peers shift to a more "data-dependent" approach (like the ECB).

This suggests the possibility of further U.S. dollar strength. Furthermore, we anticipate currency volatility to make a turn from its year-long downtrend on the back of mounting concerns over China's economic outlook, continued pressure on broader risk sentiment, and surging U.S. yields given the string of stronger-than-expected economic data as of late.

Also worth mentioning is the fact that the market has not been pricing in a depth of rate cuts from the BoC to the similar extent that it has with the Fed over the course of next year. This also points to possible upside risk in USD/CAD over the coming months should the market begin to reprice its expectations for the BoC. While we continue to believe that material rallies in the U.S. dollar may present possible tactical opportunities to layer off some exposure, we must take stock of additional risk to the upside over the near term.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Currency Volatility within ETFs

Currency fluctuations for foreign assets in an ETF can be a key factor that contributes to the overall performance and volatility of an ETF. Since the underlying holdings are bought in a different currency, the appreciation or depreciation of the foreign currency next to the Canadian dollar (CAD) can fluctuate and impact returns. One way to mitigate currency fluctuations within an ETF is to use a currency-hedged ETF.

Currency-Hedged ETFs

Currency-hedged ETFs offer a way to reduce the risk of owning investments denominated in a specific foreign currency. The currency-hedged structure will remove most of the downside risk of foreign currency exposure but will also remove any potential capital appreciation from owning the foreign currency. Take for instance the **Vanguard S&P 500 ETF – CAD Hedged (VSP.TO)** and the **Vanguard S&P 500 ETF (VFV.TO)** – both strategies track the S&P 500 index with the former hedging the US dollar (USD) exposure back to CAD. Despite both strategies tracking the same index, it is notable how much the USD has contributed to the difference in performance since 2013. On the other hand, when comparing the **BMO MSCI EAFE Index ETF – CAD Hedged (ZDM.TO)** to the **BMO MSCI EAFE Index ETF (ZEA.TO)**, the currency-hedged structure has provided more value, especially in recent years.

S&P 500 Index & MSCI EAFE Index ETF Performance

S&P 500 Index ETF	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD*
VSP.TO (hedged)	32.6%	13.7%	0.4%	11.3%	20.8%	-6.0%	29.3%	15.2%	28.0%	-19.4%	14.5%
VFV.TO (unhedged)	40.7%	23.8%	20.2%	8.5%	13.6%	3.4%	24.5%	15.6%	27.6%	-12.7%	15.5%
Hedging value add:	-8.0%	-10.1%	-19.8%	2.8%	7.1%	-9.4%	4.8%	-0.4%	0.4%	-6.7%	-1.0%

MSCI EAFE Index ETF	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD*
ZDM.TO (hedged)	25.9%	5.5%	4.5%	6.5%	16.1%	-9.9%	23.3%	0.6%	18.5%	-5.6%	10.9%
ZEA.TO (unhedged)	*N/A*	*N/A*	18.0%	-1.8%	17.1%	-6.0%	16.1%	5.8%	10.3%	-8.3%	8.2%
Hedging value add:	-	-	-13.5%	8.4%	-1.0%	-3.9%	7.2%	-5.3%	8.2%	2.7%	2.6%

Source: Capintel; Data as of August 22, 2023

While it is clear that the unhedged **VFV.TO** structure has benefitted investors since 2013 compared to **VSP.TO**, past performance is no guarantee of future results. The decision to incorporate a hedged ETF or not may largely depend on the investor, the nature of the investment and how the ETF complements other holdings in a portfolio. Some other considerations when exploring ETF currency options include:

1. Outlook on the Currency

The most obvious reason why one may choose a hedged ETF over an unhedged ETF (or vice versa) may depend on one's forecast of a currency. As an example, if an investor believes the USD will *appreciate* against the CAD, an unhedged ETF that provides USD exposure (such as **VFV.TO**) may be a suitable option. On the other hand, if one believes that the USD will *depreciate* against the CAD, a hedged ETF (such as **VSP.TO**) may be more suitable to reduce USD currency risk while still maintaining the desired US equity exposure. An ETF offering that provides both hedged and unhedged purchase options (such as VFV.TO and VSP.TO) can act as a convenient pair to implement a tactical currency management strategy.

2. Time Horizon of the Investment

Given how highly unpredictable currencies can move in the short term, hedging currency risk may be an optimal strategy for those who wish to reduce short term currency volatility and maintain their CAD exposure for short term investments.

3. Tax-Loss Harvesting

Investors may wish to move from a hedged ETF to an unhedged ETF (or vice versa) for tax-loss harvesting purposes. Switching into a hedged (or unhedged ETF) may be considered materially different and may not trigger CRA's "superficial loss rule". Consult a tax specialist before enacting this strategy.

4. MER Considerations

The hedged option may be offered at a higher MER than the unhedged option. The additional fee of hedging may erode returns and is worth reviewing for a long-term investment.

5. Correlation of CAD and Commodities

The CAD has historically been closely tied to the price of commodities – notably crude oil. When oil prices rise, the CAD typically appreciates in value relative to other currencies and when oil prices drop, the CAD typically depreciates in value. Canadians may wish to reduce potential CAD volatility by *including* foreign currencies in their investments through unhedged ETFs. The following chart illustrates the correlation of the **Vanguard S&P 500 Index ETF** and the **BMO MSCI EAFE Index ETF** (both hedged and unhedged) vs. the **BMO S&P/TSX Capped Composite Index ETF**. A lower correlation suggests a weaker relationship between the two variables and the potential complementary qualities the unhedged ETFs have with the S&P/TSX Capped Composite Index.

ETF Correlation Analysis

10 Year Correlation Matrix	**VSP**	**VFV**	**ZCN**
VSP *(Vanguard S&P 500 Index ETF - Hedged)*	1.00	-	-
VFV *(Vanguard S&P 500 Index ETF - Unhedged)*	0.85	1.00	-
ZCN *(BMO S&P/TSX Capped Comp Index ETF)*	0.84	0.70	1.00

5-Year Correlation Matrix	**ZDM**	**ZEA**	**ZCN**
ZDM *(BMO MSCI EAFE Index ETF - Hedged)*	1.00	-	-
ZEA *(BMO MSCI EAFE Index ETF - Unhedged)*	0.93	1.00	-
ZCN *(BMO S&P/TSX Capped Comp Index ETF)*	0.90	0.84	1.00

Source: Capintel, risk data for period ending on 31/03/2023

As we continue to face uncertainty regarding global interest rates, inflation, and the ongoing conflict in Europe, maintaining a well-diversified portfolio of funds across asset classes, sectors and currencies can help reduce portfolio volatility.

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

Spooky Season Starting Early

I think it's still too early for Halloween, despite the numerous displays of costumes and candy in department stores. And yet, the markets also seem like they could be "spooked" at any moment - we are not short of potential drivers to move them. Inflation concerns, corporate earnings, home valuations, bank failures, (Chinese) economic worries, and a constant stream of economic data can quickly change the way market participants view future prospects, up or down. Focusing on fixed income, we look back at recent volatility, attempt to anticipate how the markets may react in the coming months, and suggest how you can tailor your portfolio to take advantage of these trends.

Over the past three and a half years, we have seen Government of Canada benchmark yields move from historic lows to competitive rates today. Rates started to rise slowly, but picked up the pace once the Bank of Canada (BoC) began hiking the overnight rate. You may note that the two year yield is still higher than the 10 or 30 year benchmark yields, indicating that inversion is still present.

And when we explore the standard deviation of these yields, we see how events, like the beginning of the COVID epidemic, surging inflation, and the US banking crisis all added to volatility in Canadian bond markets, as seen as spikes in standard deviation of benchmark rates.

Although the Bank of Canada maintains that their decisions on interest rates are driven by data, the waters become murkier towards the end of a hiking cycle as members may begin to disagree or weigh varying economic data points differently. We believe that the volatility we've witnessed as of late will continue, with choppier trade through the fall season. Hopefully with more clarity around the economy and interest rate direction, we will see the volatility reduce.

A Buying Opportunity

We often believe that volatility can be seen as a buying opportunity. When you combine this with the incredible run up in yields over the last two years, we encourage clients who perhaps have not allocated appropriately to fixed income to consider rebalancing and adding to their bond sleeve.

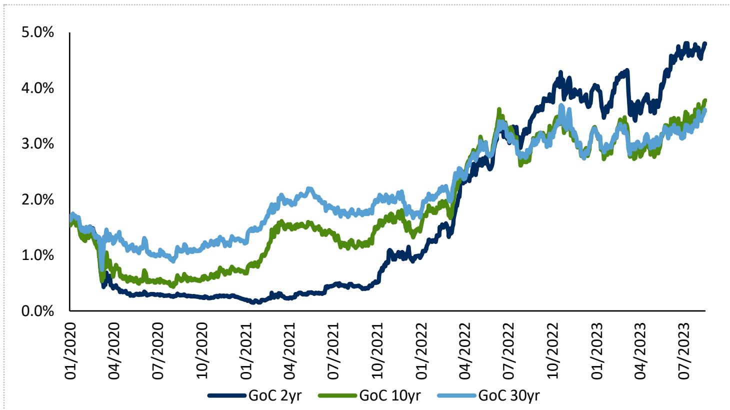
When considering where to look for value, we suggest that investors look to target:

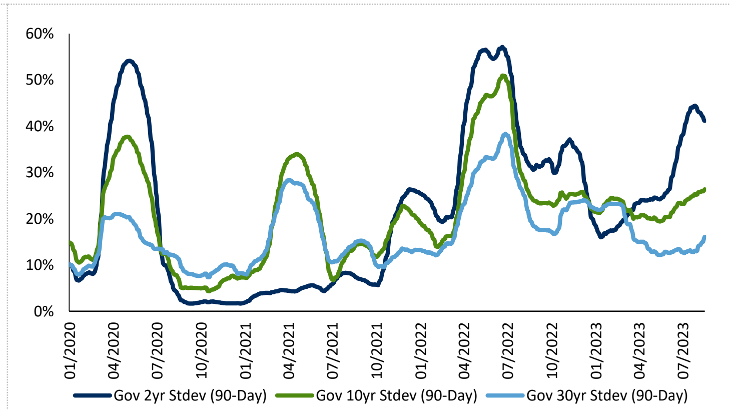
- **High-quality securities** between five and eight years in length. Doing so may give up some upfront yield, but reduces the need to reinvest as funds come due, allowing you to enjoy the higher overall yield for a longer period.
- However, we would be remiss to ignore the attractiveness of products in the **one and two year range**. If you have a shorter-term time horizon, or outstanding cash, consider these maturities.
- For those with non-registered funds, **discounted securities** provide a unique opportunity when compared to securities like GICs where interest is treated at interest only.

Despite the increase in volatility in fixed income, which we expect to continue for the foreseeable future, we encourage investors to stay the course and remember their reasons for investing, whether it be retirement, education, or even a rainy day. Even with the increase in swings, utilizing fixed income can provide a level of stability in your portfolio and some peace of mind.

Charlotte Jakubowicz, CMT, CIM
Vice President, Fixed Income and Currencies

Yields have moved up since the start of 2020 (LHS); with spikes of higher volatility over this time period (RHS)





Source: FactSet, Raymond James Ltd. Data as of August 17, 2023.

Structured Notes in Volatile Times

Structured notes come in many different shapes and sizes and can be a great way to gain exposure to the performance of an underlying index, ETF, a single stock, or even a basket of stocks. They can be fully customized to meet an investor's specific view on the direction of a chosen underlying and can be designed to meet specific risk tolerances, time horizons and investment objectives.

When it comes to creating a structured note, volatility is certainly one of the most important factors involved since most notes either buy or sell options that are ultimately priced based on the volatility of the underlying asset.

Below is a chart depicting the VIX index performance over the past three years. The VIX Index is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

Opportunities Arise in Volatile Times

Source: FactSet; Raymond James Ltd.; Data as of August 22, 2023.

As shown in the chart above, we have witnessed a heightened period of volatility over the last few years and while unnerving, this volatility has generated some attractive opportunities among various types of structured notes. The two key types of structured notes that have benefitted a lot in this volatile environment have been the auto-callable and auto-callable income notes.

The **auto-callable income note** is one of the more common note structures being used today, which is designed to provide an income stream payable either monthly, quarterly, semi-annually or annually, so long as the underlying reference asset is trading within a pre-determined range on a stated observation date. The **auto-callable note** is a similar structure, which instead of providing a contingent income stream, offers the potential to earn pre-defined fixed returns (typically semi-annually or annually) if, and when, the note is called. A key feature of both these types of notes that have resonated with investors is the callable feature, which normally coincides with the coupon payment, whereby the note can be redeemed by the issuer if at each observation the underlying reference asset is at or above a pre-determined level. In addition, both of these notes can be customized to reach a desired level of capital protection, but most often come with a barrier form of partial principal protection, which is to say investor capital remains protected so long as the underlying reference asset is trading within a pre-determined range at maturity.

In summary, both the auto-callable and auto-callable income note are two types of structured notes that benefit from higher volatility, which we expect in the foreseeable future as mentioned in the macro outlook section. As with every investment, structured notes have risk/reward profiles that vary from structure to structure and your financial/investment advisor will be able to help you determine which note structure is best suited to achieve your financial goals.

Christopher Cafley, MBA, FCSI
Senior Vice President
Investment Strategy, Portfolio Advisory, Products & Trading

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