Making Sense of the Mixed Signals

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When I began dating my wife Farrah, (a real life superwoman I might add), what seems like an eternity ago, it was a confusing time for me, especially in the early days of our relationship. Let me explain. I am a big Toronto Raptors fan, and with several of my colleagues being season ticket holders, I would regularly get my hands on tickets for most home games. While Farrah would usually jump at the chance to go on a date with me to see the Raptors play, I found she was usually busy or hesitant when I suggested dinner at a fancy restaurant. After a few dinner rejections, I felt maybe she was just using me for my access to Raptor's tickets. Trusting my gut (the butterflies whenever I was around her), I remained persistent and focused on the great conversations and fun we had at the Raptors' games. Turns out, what I interpreted as a mixed signal was, in fact, Farrah's way of saying she was not the fancy dinner type. Rather, she preferred more interactive dates like attending sporting events, shooting hoops, go-carting, and hitting balls at the driving range/batting cages. Let me tell you, she is the competitive type, and usually wins!

I see similarities in the current market climate, which is plagued with mixed signals across macro-economic variables; equity and fixed income indicators. From calls of a repeat of the roaring 1920s to fears of an imminent recession on the horizon, the market narrative has shifted aggressively in less than a year. This is understandable, given the growing list of worries/uncertainties on the minds of investors including: the ongoing Russia/Ukraine war, stubbornly high inflation, policy normalization/risks of policy missteps, recessionary fears, a significant slowdown in China, COVID-19 lock-downs, etc. We will briefly discuss some of the mixed signals/conflicting messages investors are receiving, and how to interpret these messages, starting with real GDP growth expectations. While global growth has been revised lower for the world economy, US and Canadian real GDP is forecasted to grow in 2022 by +3.0% and +4.2%, respectively, well above the 1.8% historical run-rate. While slowing from record levels in 2021, these figures do not suggest that a recession is on the horizon - viewed as two or more consecutive quarters of a contraction in real gross domestic product - but a return to a more normalized and sustainable economic growth environment.

Real GDP Growth Slowing Towards Trend in 2022/23 [LHS]; Real GDP Growth Revised Lower QoQ [RHS]

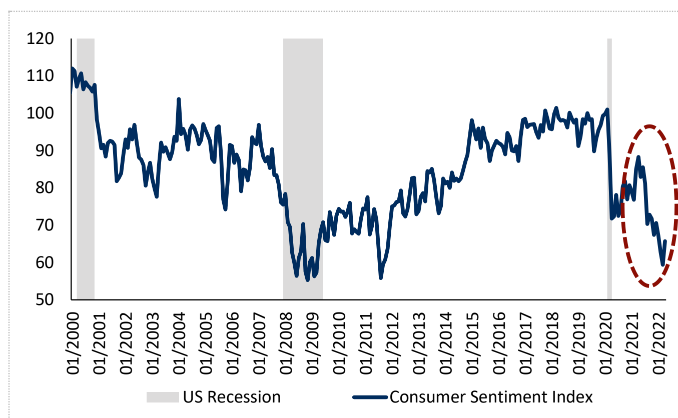
25-Apr-22	Average 2000-2020	Real GDP Growth Forecasts 2021	2022	2023
World	**3.2%**	**5.9%**	**2.8%**	**3.6%**
Advanced Economies	**1.4%**	**5.1%**	**3.1%**	**1.8%**
US	***1.8%***	***5.7%***	***3.0%***	***1.5%***
Canada	***1.8%***	***4.6%***	***4.2%***	***2.2%***
Euro	1.0%	5.4%	1.8%	1.8%
UK	1.2%	7.4%	4.0%	2.0%
Japan	0.6%	1.7%	2.6%	2.6%
Australia	2.6%	4.7%	4.8%	2.1%
Emerging Economies	**4.7%**	**6.4%**	**2.7%**	**4.6%**
Emerging Asia	6.1%	6.9%	4.3%	5.6%
China	7.3%	8.2%	2.5%	5.0%
India	6.4%	8.1%	9.2%	7.5%
Russia	3.6%	4.7%	-12.0%	-1.5%
Brazil	2.1%	4.6%	0.8%	1.8%
Mexico	1.6%	4.8%	2.0%	2.5%

Change (p.p.)	Real GDP Growth Forecasts 2021	2022	2023
World	**0.0**	**-1.2**	**0.1**
Advanced Economies	**0.1**	**-0.5**	**-0.3**
US	***0.1***	***-0.1***	***-0.5***
Canada	***0.0***	***0.5***	***0.0***
Euro	0.3	-1.7	0.3
UK	0.6	-0.8	-1.5
Japan	-0.1	-0.9	0.7
Australia	0.3	-0.2	-2.1
Emerging Economies	**-0.1**	**-1.9**	**0.4**
Emerging Asia	-0.3	-1.3	0.8
China	-0.8	-1.0	1.5
India	0.5	-1.4	0.0
Russia	0.4	-14.8	-3.5
Brazil	-0.1	0.3	0.0
Mexico	-0.9	-0.9	0.4

Source: Capital Economics; Raymond James Ltd.; Data as of April 25, 2022.

On the employment front, we have seen hiring rise to pre-pandemic levels with the March employment report for the US and Canada showing that employers added over 400,000 jobs (for the 11th consecutive month) and 73,000 jobs (for the 2nd consecutive month, rebounding after January losses), with the unemployment rate falling to 3.6% and 5.3%, respectively. Worries of a recession remain top of mind for many, but there has never been a recession without employment turning down sharply. Currently, there are 1.7 jobs open for every person looking for a job in the US; in Canada, its ~1.3 jobs open for every person looking. Yet, consumer sentiment has dipped to levels not seen since the 2007-2008 financial crisis–sending investors a mixed signal.

Consumer Sentiment at 10-Year Low



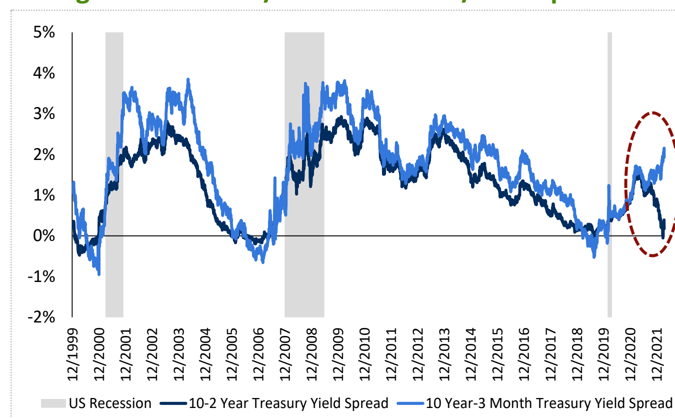
Source: FRED; Raymond James Ltd; Data as of April 25, 2022.

Recent fears of a recession were triggered initially by a brief yield curve inversion last month in the spread between 2 and 10-year US Treasury yields. Inversions occur when yields on short-dated bonds rise above those of long-dated bonds–thus "inverting" the usually upward-sloping yield curve. The curve has inverted ahead of every recession in the US/Canada over the past 50 years, with only one false positive (in 1998). However, inversion of both the 2/10-year US Treasury yields and 3-month/10-year US Treasury yields has been a more reliable indicator of a recession; they are diverging/heading in opposite directions, sending investor yet another mixed signal.

However, compared to history, recently, the yield curve signals have been more distorted by the effects of large-scale central bank asset purchases over the past decade. For example, the US Federal Reserve and the Bank of Canada have both increased their holdings of bonds by US$4.8 to US$9.0 trillion, and $453 to $576 billion (recently, reduced to $487 billion), respectively, since the start of the pandemic. These measures have compressed term premium and pulled down yields at the long end of the curve, thus making it more prone to inverting.

We suspect that the yield curve may have lost some of its predictive power–sending investors yet another mixed signal.

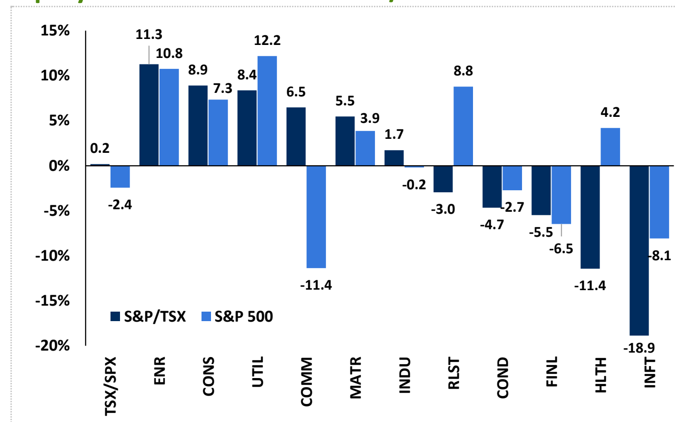
Divergence in US 2Yr/10Yr & US 3Mo/10Yr Spreads



Source: FactSet; Raymond James Ltd; Data as of April 26, 2022.

Since the Russia invasion of Ukraine, we have seen very defensive positioning. Capital has flown to sectors that perform well during recessions–i.e., Consumer Staples, Utilities, Communication Services, and HealthCare. While understandable, given the Wall of Worries, it is a bit puzzling since we have never experienced a recession without corporate profits falling. In fact, current consensus is forecasting EPS growth to expand in 2022 and 2023 by ~10%, for the S&P 500 and S&P/TSX Index.

Equity Returns since the Russia/Ukraine Crisis



Source: FactSet; Raymond James Ltd; Data as of April 26, 2022.

Final Thoughts: We expect volatility to remain elevated, and while our base case assumption is not for a recession in 2022 or 2023, we suggest investors diversify across asset classes, styles, and sectors. Remain selective, think long-term, and remember to buy-low and to sell-high.

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

Don't Sell in May and Go Away

Every year investors who pay attention to seasonality bring up the old maxim of "sell in May and go away", a phenomenon that refers to the six-month spring/summer period after May when market performance has historically been weak. The strategy involves timing the market by selling ahead of the seasonally weak period and buying back ahead of the seasonally strong period starting in November. However, investors who expect the strategy to be rewarding in the long-term may be disappointed. Our analysis shows that remaining invested yields better results than attempting to time the market.

Clear Seasonal Weakness

Looking over the past 30 years of market returns, we have observed a clear pattern of seasonal weakness during the spring/summer period. We found that the S&P/TSX composite index has averaged 1.3% over the summer period, well below the 6.0% averaged over the winter. While it remains unclear as to the primary drivers behind the weak/strong seasonal trend, some have pointed to the low trading volumes over the summer vacation months and the increased investment flows in the winter as probable causes. We also found that the winter period only did better than the summer period 53% of the time. However, when the winter period outperformed, it did so significantly. Does following the "sell in May and go away" strategy yield above-benchmark returns? The short answer is "no". A $10,000 portfolio buying the S&P/TSX in November and selling it in May over the past 30 years would have ended up with a little over $51,500 as at the end of April 2022. However, a portfolio employing a buy-and-hold strategy over that same period would have yielded a more significant result, ending with over $61,800.

Not a Winning Strategy

"Sell in May and go away" may seem like a simple enough rule, but there are many reasons we believe it may not be in the investor's best interest to follow this strategy.

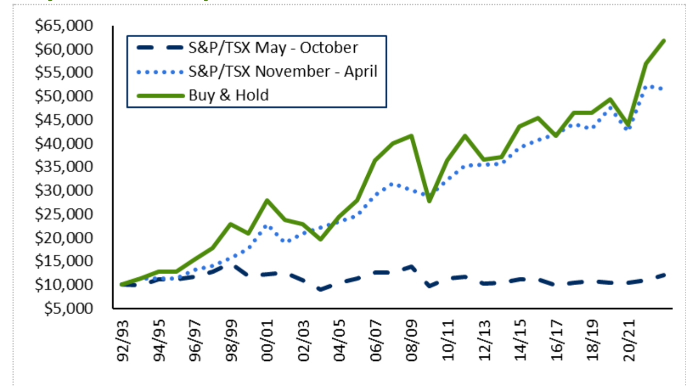
- **TIME IN the market versus TIMING the market**. It pays to stay invested. While it's tempting to sell ahead of a seasonally weak period and avoid losses, such strategies do not always work and may lead to investors missing out on the potential upside. As mentioned above, we believe a buy-and-hold approach is better off in the long-term, sticking with investments through thick and thin, and only selling should there be a change to the underlying security fundamentals.

- **A flip of a coin**. Investors who employed the strategy in 2021 may have been disappointed with their returns over the following six months, as the S&P/TSX increased ~10% from May to October last year. The out-performance of the seasonally strong winter period over the weak summer period has only occurred 53% of the time, which really is a coin flip.

- **Better than cash returns**. While market returns during the seasonally weak period may not have been as attractive over a long period, they are certainly better than cash or short-term investments.

- **Tax implications and transaction fees**. Investors following this strategy in a taxable account may end up with a hefty capital gains tax bill at the end of the year if they sell in May, take their profits, and re-buy again in November. Selling all positions may also lead to more transaction costs.

Buy & Hold Outperforms Favourable Period Since '92



Source: Raymond James Ltd., FactSet.

A Better Approach

We believe a better approach for investors who want to protect their portfolios ahead of what they expect may be a seasonally weak period, is to rotate into, or add more exposure to, defensive areas of the market. This way, investors remain fully invested, allowing them to participate in the upside should summer periods perform well. Defensive sectors hold up better than their cyclical counterparts in times of volatility or economic weakness. In fact, we found that consumer staples, utilities, and communication services have, on average, performed better than the market during the seasonally weak summer period. Some names we remain constructive on within these sectors include **Alimentation Couche-Tard (ATD-CA)**, **Algonquin Power & Utilities (AQN-CA)**, and **TELUS (T-CA)**.

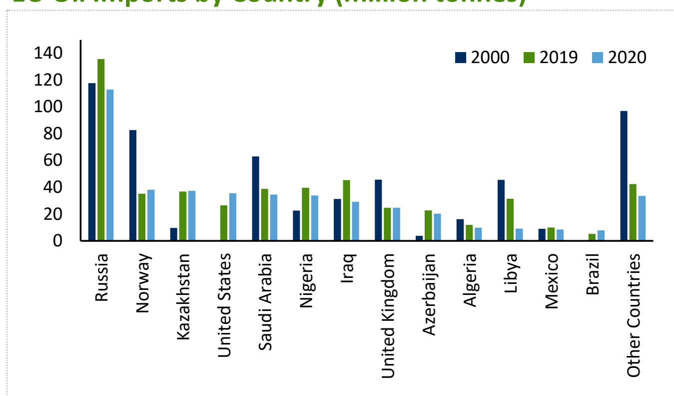
Larbi Moumni, CFA
Portfolio Manager & Senior Equity Specialist

Commodity Currencies Playing in a Sandbox of Sanctions

While the unprovoked Russian invasion of Ukraine is now in its third month, Russia's economy and the ruble continue to feel the pain from Western economic sanctions, although the ruble has recouped much of its early losses thanks in part to capital controls and swift action by Russia's central bank. With inflation soaring to 16.7% in March, purchasing power in Russia has been sharply eroded. For one of the world's largest oil producers, all eyes are naturally on whether key buyers of Russian energy products can shun the nation's exports. Three million barrels per day are already at risk because of crippling sanctions, and Russia may soon be forced to curb oil production by as much as 30% according to the International Energy Agency. The prospect of these types of large-scale supply disruptions can have serious global ramifications.

According to the US Energy Information Administration, as of 2021, Russia was the largest natural gas exporting country in the world and the second-largest crude oil exporting country after Saudi Arabia. On the other end, Europe receives the lion's share of Russia's crude oil and natural gas exports. This energy dependence has naturally put Europe in a tight spot, with EU states preparing to adopt new sanctions against some of Russia's key oil companies, but stopping short of an outright ban on Russia's crude imports. In contrast, both the United States and Canada have banned oil imports from Russia. This was more or less a symbolic action and finger pointing at Russia because the US does not import much energy products from Russia, and Canada has imported no Russian energy products since 2019.

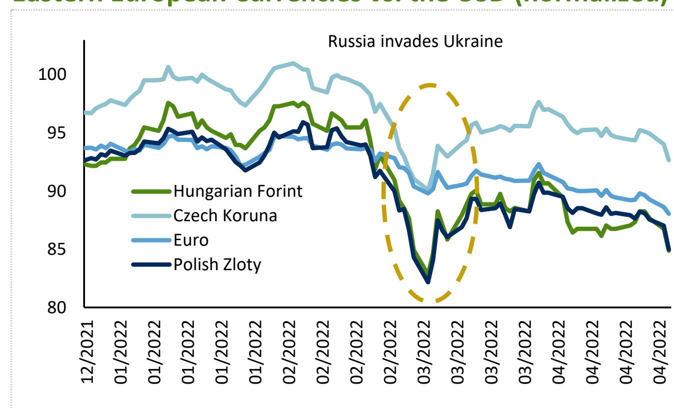
EU Oil Imports by Country (million tonnes)



Source: Eurostat; Data as of April 26, 2022.

More recently, Gazprom, both Russia's and the world's largest natural gas company, halted gas supplies to both Poland and Bulgaria after refusing to settle contracts in rubles, a payment scheme President Putin has been adamantly pushing for in order to support the currency. This latest rubles-for-gas spat may in fact be Russia's way of sending a message to other European countries, which are far more dependent on Russian energy products. As a clear sign of this dependency, it is not surprising to note that ten European gas buyers have already opened ruble accounts with Gazprom. The EU is reportedly prepared to cut itself off from Russian gas supplies; however, Germany will only be on board if the ban is "gradual." Currencies have naturally reacted to these latest developments, with the Polish zloty, the euro, and other currencies from peripheral countries taking a bit of a dive following the announcement.

Eastern European Currencies vs. the USD (normalized)



Source: FactSet; Data as of April 26, 2022.

Scorching energy prices lifted the Bloomberg Commodity Index to levels not seen since 2013. As a result, this exacerbated inflationary pressures, pushing global central banks to ramp up their hawkish rhetoric. We expect the premium in commodity prices to rise again from this latest ruble-for-gas situation. This will put the EUR in an even tougher spot, with EUR/USD already trading at five-year lows.

Against this backdrop of surging commodities, last quarter saw commodity-exporting currencies like the AUD, NZD, CAD, NOK and, in the emerging market space, BRL, ZAR, COP and MXN all pick up strength against the USD. Looking ahead, this theme will probably continue, while a more keen focus on terms of trade dynamics may inevitably come to favour commodity producers and exporters over consumers and importers.

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Head Trader, Currencies

Generating Income from Covered Call ETFs & Mutual Funds

As inflationary pressures continue to challenge income needs, many mutual funds and ETF providers have introduced covered call strategies to help investors generate an additional source of income. The covered call option strategy is implemented by writing (selling) a call option contract while owning an equivalent number of shares of the underlying stock. This strategy caps upside potential in the event of a significant price increase but can be a unique strategy in volatile or sideways market environments.

The Mechanics

1. Fund managers will sell (or write) call options to a second party. This provides the second party with the *option* to buy the stock at a later date at a predetermined price.
2. The portfolio manager will receive income for selling the option (known as the premium) and has the obligation to sell the stock at that predetermined price.

Example:

Let's suppose Jim, a fund manager who employs a covered call strategy, sells a 3-month call option on RBC's stock at $140 (strike price) when the current price of RBC stock is $135. Natalie purchases this option for $2 and Jim will therefore receive a premium of $2 for selling this option. After three months, there are a few scenarios:

1. ***RBC's share price is trading higher than $140***

   Let's imagine it is trading at $143. In this situation, Natalie will exercise her *option* and purchase RBC stock at a discount of $140 and profit from the $3 price difference.

2. ***RBC's share price is trading lower than $140***

   In this situation, Natalie will not exercise her option of purchasing RBC stock at $140 when she can buy the stock at a lower price in the market.

In either case, Jim has gained additional yield through selling a call option for $2. However, keep in mind that he will have to sell his position at $140 in the event Natalie exercises her option.

If the stock price is stable or falls, the seller of the option benefits from selling the option premium. However, selling covered calls is no free lunch; if the underlying stock rises above the strike price ($140 in the example above), the option holder (Natalie) will "call away the stock". Jim will still keep the option premium ($2); however, he will not take part in the full upside of the RBC share price increase beyond $140.

Characteristics of Covered Calls

The word "covered" in the name of this strategy can sometimes mislead to an investor as the fund is not immune or protected from losses on the underlying investment. Therefore, the goal of employing these strategies should be to generate income. Covered call strategies are great solutions to help enhance monthly or quarterly income in sideways markets to complement income needs in a portfolio. Covered call strategies outperform in slightly improving, flat or down markets, and underperform in periods of rapidly rising markets relative to the underlying holdings. A few other characteristics of these ETFs are:

- Volatility and yield will vary depending on the underlying equities and sector.
- These strategies do not provide full protection in a downturn.
- For most investment funds, the option premium is classified as capital gains, which provides additional tax efficiency for non-registered accounts.

Ways to Gain Exposure

Writing calls can be time-consuming, complex, and costly. It's valuable to use an active ETF provider to gain access to these sophisticated strategies. Below is a list of popular solutions in the Canadian marketplace that provide exposure to covered call strategies across various sectors.

Name	Ticker	Sector	12 Mth. Yield.
BMO Covered Call Canadian Banks ETF	ZWB	Can Banks	5.64%
BMO Covered Call US Banks ETF	ZWK	US Banks	7.01%
BMO Covered Call Utilities ETF	ZWU	Utilities	7.17%
CI Health Care Giants Covered Call ETF	FHI	Health Care	7.21%
Horizons Enhanced Income Energy ETF	HEE	Energy	6.20%
Harvest Global REIT Leaders Income ETF	HGR	REITs	6.05%
Horizons Enhanced Income Equity ETF	HEX	Canada	6.20%
BMO US High Dividend Covered Call ETF	ZWH	US	5.91%
Horizons Enhanced Income Int'l Equity ETF	HEJ	International	5.63%

Source: Morningstar, Raymond James Ltd. Data as of March 31st, 2022

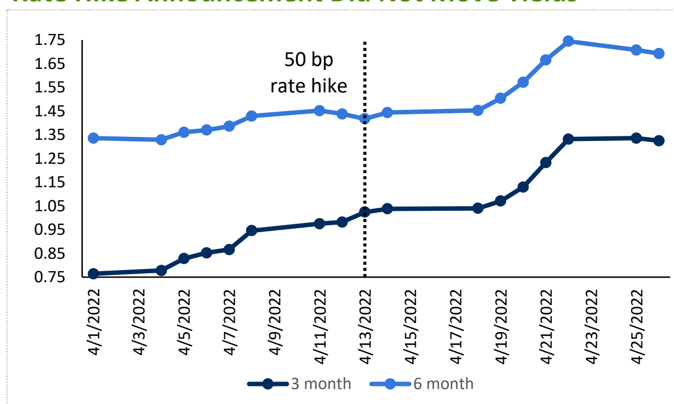
Luke Kahnert, CIM
Mutual Fund & ETF Specialist

Expecting the Expected

On April 13, the Bank of Canada (BoC) announced its biggest single move in over 20-years, revealing that the target overnight rate would rise by 50 basis points (bps) to 1.00%. They also introduced the start of quantitative tightening, where maturing bond positions held by the bank will not be replaced, reducing the BoC's balance sheet. In addition, their inflation forecast was increased to 6% (from 5%) for the first half of 2022, remaining elevated for the rest of the year.

The announcement was widely expected, with almost all in agreement on the oversized move by Governor Macklem and his team. Inflation has remained a key concern for some time and higher interest rates should help to combat it. So how did the bond markets react? It was really a snooze fest, with little to no market action following the release (the chart below shows three and six-month government of Canada bonds at the time of the hike). One might wonder how such a drastic move in rates could have such little effect on an asset class driven directly by them; the answer lies in expectations.

Rate Hike Announcement Did Not Move Yields

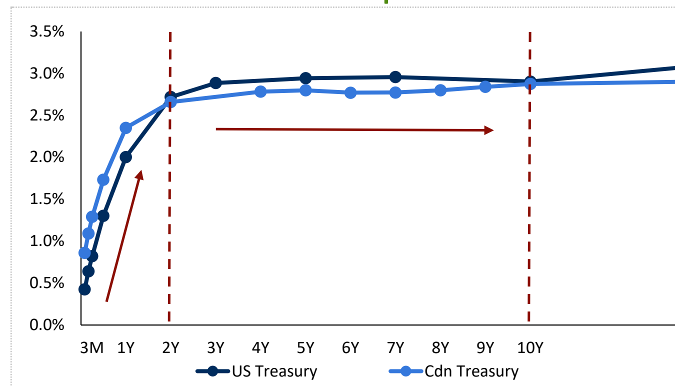


Source: FactSet; Raymond James Ltd.

Managing expectations is something that many of us do every day. We set expectations with those around us (clients, colleagues, family members, etc.) so that there is a mutual understanding on how things may follow. Expectations can become the anchor point for future events and, if reality doesn't live up to expectations, outcomes are affected. A company that misses Street consensus earnings (the expectation) and sees their stock price fall (result) is a common example of this. But if earnings come in right where they were predicted, you would see a more muted reaction, all else equal.

Market participants use many data sources to shape their rate hike forecasts. One source of information that carries a lot of weight is the communication put forward by the central bank– from the horse's mouth, so to speak. Prior to the most recent rate hikes, financial conditions have tightened dramatically on the signalling from the BoC as they set the expectation that higher rates were to follow. As illustrated here, rhetoric from both the BoC and US Fed have driven rates higher, with the yield curve sitting very flat in anticipation of the coming interest rate hikes.

Central Bank Rhetoric Has Shaped Govt. Yield Curves.



Source: FactSet; Raymond James Ltd.

Future Rate Hikes, Coming Soon

Forecasts call for another 50 bps hike at the BoC's June 1 meeting. Last week, Governor Macklem spoke directly to these predictions, stating that the council would consider another 50 bps for the next rate decision, further cementing the likelihood of another larger-than-average hike. Of course, with the meeting almost a month away, day-to-day expectations may fluctuate as new information is worked into the hypothesis. However, the market is primed to expect a 1.5% overnight rate come June 1 and if it is indeed announced, expect another non-event.

For the rest of the year, estimates are calling for interest rates to hit 2.10% by December. Although we believe that much of these upcoming hikes is accounted for in current yields, we expect that the yield curve will slowly move higher as these hikes materialize. Thus, we suggest staying with bonds with near-term maturities, looking for high-quality corporates for yield pickup. We encourage investors to remember that, although headlines might seem impactful, one must compare them to expectations. Results that do not align with expectations have the power to move markets upon their release. And if the outcome is inline with expectations, market action should be limited.

Charlotte Jakubowicz, CIM, CMT
VP, Fixed Income & Currencies

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