

# Perspectives: Is the worst behind for financial markets?

[Energetic music sting]

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So since our last quarterly forecast, central banks have made some progress towards their goal of slowing economic activity and bringing inflation lower.

[A shipping yard filled with shipping crates.]

Economic activity has slowed to below trend growth. Inflation has shown signs of decelerating in the goods sector in particular, as supply chain problems have improved.

[A labourer working with a power tool. Timelapse of an industrial production warehouse, busy with workers on the job. Conveyor belts moving boxes of various types of appliances.]

Commodity prices have declined, lowering headline CPI.

[Industrial farming fields being harvested by combines.]

And we also see tentative signs of peaking in the housing sector with rents and housing prices showing signs of decline.

[Suburban neighbourhoods.]

Yet other parts of the economy remain resilient. Particularly the services side of the economy remains robust, and this is keeping the labour market fairly tight, the unemployment rate at historical lows and wages higher than what would be considered as consistent with price stability.

[Timelapse of a busy shopping mall. A young child eating chicken nuggets. A cashier at a fast-food restaurant. Timelapse of a busy restaurant kitchen.]

So these conflicting economic signals bring more uncertainty about the economic outlook for 2023. But given central banks' inflation focus, this means that central banks will continue to raise interest rates, albeit at a more moderate pace most probably, until they see more evidence

of a slowing in the labour market in particular, and this will likely be done at the expense of economic growth.

[Timelapse of the Bank of England. The U.S. Federal Reserve. A close-up of the seal of the U.S. Federal Reserve.]

[Energetic music sting]

[2023 investment risks]

Our global economic forecast continues to expect well-below trend in economic activity, with a 1.5% global growth and a risk of recession in certain parts of the world, like in the U.S. and Canada. Inflation is also expected to finish the year well above central banks' targets in 2023. Taming inflation remains a priority number one in most developed countries, except perhaps in China.

[The Canadian Parliament building. The Canadian Flag flapping in the wind outside the Parliament Building. Several European-country flags flapping in the wind outside a building.]

Central banks have reaffirmed their focus towards bringing inflation back to their target, which continues to skew the risk on overshooting and triggering a more pronounced economic slowdown. For example, labour demand is slowing but remains at an elevated level with jobs open in excess of labour availability.

[An employee scanning the label on a box. Timelapse of a shipping warehouse with workers placing boxes on a conveyor belt.]

The starting point of inflation remains elevated, and central banks will not be able to relax their monetary policy until inflation is more on its way back to the 2% target. But on the other hand, the scenario of a soft landing remains possible. China's abrupt change regarding its COVID policy is removing some downside risk to the world economy with a rapid reopening.

[Dozens of people wearing surgical masks, walking through an interior area. Timelapse of a busy subway station in China. Timelapse of people going up and down packed escalators. Timelapse of a busy Tiananmen Square.]

China is also relaxing its policy towards the real estate market again, removing some of the downside risk to growth.

[Aerial shot of a downtown core filled with skyscrapers. A residential district with many apartment buildings. Luxury houses perched atop a mountain region, just outside a city centre.]

And finally, in Europe, much warmer weather than normal is reducing the pressure from energy and may reduce the risk of a full-blown energy crisis in Europe.

[An icicle hanging from an eavesdrop, melting. A sun-bathed street in a European city. The Parisian cityscape.]

[Energetic music sting]

[Financial market outlook: Fixed income]

The outlook for financial markets is likely to improve relative to 2022 for a few reasons. Valuation has improved in many asset classes. Fixed income, for example the nominal yields are starting at a higher level than at the start of 2022. Real yields - that is the difference between nominal yields and inflation - are positive where they were very negative at the start of 2022. Spreads have varied. Credit risks have widened, providing better reward for taking credit risk at the start of 2023 and equity market price-earnings ratios have come down to more acceptable levels. So continued deceleration of inflation will help improve the investing outlook as central banks slow their tightening effort and reassure at least fixed income investors that their nominal return will not be destroyed by high inflation.

[Energetic music sting]

[Financial market outlook: Equities]

Equity markets have so far witnessed a marked decline in their valuation in the form of lower price earnings, moving from overvalued to a more fairly-valued level. What is important to assess is how deep the economic slowdown could be to evaluate the earnings outlook. We continue to think that we could see some corporate profit disappointments as analysts revise their earning forecasts lower to account for the coming economic slowdown. Current consensus estimates appear to be relatively high given the challenging economic environment. The last leg of corporate profit adjustment may provide some opportunities for investors to reengage with equity markets, but in the meantime, we continue to recommend with a tilt towards non-U.S. equities. While holding cash has been reducing portfolio volatility, we suspect that opportunities will present themselves over the coming quarters to redeploy this cash given the expected market adjustment.

[A close-up of a Euro paper bill. A close-up of a Canadian \$50 bill. A close-up of a bull of another currency.]

With a continuing challenging macroeconomic environment, investors must build well-diversified, resilient portfolios to make sure they can achieve their financial goals. And as always, staying the course relative to their long-term plan is always the best advice we can give investors, especially during periods of economic uncertainty.

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