Morgan Stanley

WEALTH MANAGEMENT CANADA

Canadian Market Insights | December 2023

INVESTMENT STRATEGY

2024 Canadian Financial Market Outlook: "Dear, Tiff. Are We There Yet?"

Executive Summary

- In 2024, we expect the most frequently asked question amongst Canadian investors will be, 'are we there yet?', with respect to interest rate cuts by the Bank of Canada (BoC).

- Our base-case scenario for the Canadian economy is a soft-landing in 2024, but we see risks skewed to downside, as tighter monetary policy weighs on growth. Employment, housing, and a potential global recession are the biggest threats to our outlook for Canadian growth, inflation, and interest rates.

- While we expect to see the BoC and the Federal Reserve in the US cut interest rates in 2024, we don't expect nominal interest rates to revert to the lows of the prior decade. From a portfolio perspective, this interest rate normalization has implications for both strategic and tactical asset allocation decisions.

- We expect inflation will ebb and flow in 2024, but ultimately, we expect that the BoC will cut interest rates, marking the beginning of the next Canadian economic and market cycle in 2025.

- We expect that bond, stock and commodity volatility will remain high in 2024, as investors digest any surprises in the growth and inflation data, asking again, "are we there yet?" As such, investors need to remain well diversified across asset classes and regions. From a tactical perspective we continue to recommend investors maintain an overweight to fixed income and ultrashort fixed income, while being underweight equities. We maintain a market-weight stance in Canadian equities, based on our assessment of fundamental, valuation and technical indicators.

SECTION ONE: 2024 Economic Outlook – Narrowly Avoiding a Recession

Similar to the US, Canadian monetary policy will stay restrictive well into 2024, but the rebound in 2025 on the back of interest rate cuts is much greater. We forecast growth to slow from a 1.2% pace in 2023 to 0.7% in 2024, before rebounding to 2.0% in 2025. Table 1 provides a summary for several important macroeconomic variables with commentary notes.

Table 1. Morgan Stanley & Co., Base Care Canada 2024 Economic Summary

Canada: Base Case, Forecast Summary	2023E	2024E	2025E	Note
Real GDP (%Y)	1.2	0.7	2.0	Soft-landing 2024 but risk skewed to the downside
Private consumption	2.2	0.2	1.9	Stable jobs, excess savings and immigration growth
Government consumption	0.6	1.4	1.8	Narrowing deficits, but momentum from prior spend
Gross fixed investment	-2.6	0.0	2.2	Flat growth in 2024 given uncertainty with higher rates
Unemp. rate (eop, % labor force)	5.7	6.0	6.2	Slowing but not falling off a cliff
CPI (%Y)	3.9	2.7	2.1	Gradually comes down in 2H24 to target by 3Q25
Core CPI (%Y)	3.8	2.5	2.3	Elevated shelter/housing costs remain sticky
Policy rate (eop, %)	5.0	4.0	2.5	25bps rate cut July '24, additional 75bps in 2H24
General govt. balance (% GDP)	-0.7	-0.6	-0.5	Targeted spending - housing, clean energy
Gross govt. debt (% GDP)	106.4	103.3	100.6	Gradual reduction in outstanding Federal debt

Source: Statistics Canada, Bank of Canada, IMF, Morgan Stanley & Co. forecasts

Consumer spending will likely be weighed down by higher interest rates: We believe that slowing Canadian growth will continue into 2024 as a direct consequence of a record increase in interest rates by the BoC during 2022 and 2023. As forecast in Table 1, the lagged impact of monetary policy tightening likely means that consumption slows in 2024. Under our base-case scenario, we expect consumer spending to make a small contribution to growth as stable income, excess savings, and population growth put a floor under spending. We expect consumption will rebound into 2025 as we forecast lower interest rates will provide some relief to Canadians.

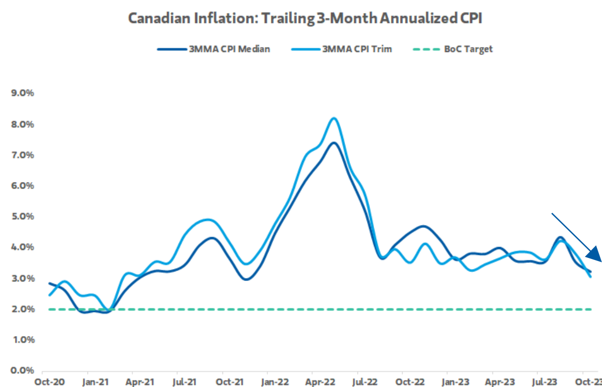
Business investment will likely remain subdued in 2024, also weighed down by higher interest rates: As per Table 1, we expect business investment/gross fixed investment to remain flat in 2024 before rebounding in 2025 given easing monetary policy. The BoC latest Business Outlook Survey for 3Q2023 revealed that the outlook among the business community fell sharply, as firms were concerned about slowing demand and tighter credit conditions. Moreover, firms indicated their intentions to reduce capital expenditures and hiring plans, as uncertainty about the macro environment and higher investment costs weighed on plans. One potential bright spot for corporate spending next year is the Canadian Oil & Gas sector where Morgan Stanley & Co. oil strategists see steady oil prices in 2024 as a support for spending. This may vary based on the underlying supply factors impacting the price of crude oil next year.

As a result of the current slowdown and uncertainty with respect to business investment, we see a slowing labour market for next year: We believe that Canadian businesses will come to terms with a challenging environment in 2024 and slow the pace of hiring. Our base case scenario for the labour market is to see a slight increase in unemployment as job gains are likely to sit below the BoC's estimated monthly replacement rate of 50,000 jobs. On net, this leads to additional slack in the labour market in 2024.

Fiscal policy will be less supportive going forward: Fiscal policy has been supportive to the economy and will remain important in the years ahead. After running a large primary federal deficit of -10.5% of GDP in 2020, -5.0% in 2021, and -1.3% in 2022, we think it will narrow further through the forecast horizon. In the 2023 Fall Economic Statement, the Canadian government showed some fiscal restraint relative to the recent past. The Federal government promised to keep debt as a percentage of GDP on a downward track, while the deficit will still be 1.4% for the current fiscal year.

Inflation will progress towards the 2% target. Under our base-case scenario, we see disinflationary trends picking up during the second half of 2024 and into 2025. In the latest inflation reading for October, core Canadian Consumer Price Index (CPI) declined, along with lower energy prices, while other components of core CPI remained high. Overall, goods inflation continues to decline (outside of food), but services inflation continues to be elevated due to higher shelter costs—that is, rents and mortgage interest costs. The good news, at least for the near-term, seems to be that we've seen 'downward momentum' in the inflation measures most important to the BoC (Chart 1).

Chart 1. Inflation is well off its 2022 peak but slowly retreating towards 2%



Source: Bank of Canada. Notes: '3MMA' = short for Three Month Moving Average. CPI-Trim is a measure of core inflation that excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes. CPI-median is a measure of core inflation corresponding to the price change located at the 50th percentile (in terms of the CPI basket weights) of the distribution of price changes in a given month.

While the trailing three-month annualized CPI Trim and CPI Median were still above the BoC's 2% inflation target, the downward momentum in the trailing three-month measures in October was a positive step forward to lower inflation. In our inflation base case forecast, we see headline CPI slowing from 3.9% year over year in 2023 to 2.7% y/y in 2024, and then reaching 2.1% y/y in 2025.

Regarding monetary policy, we're not there yet: As shown in Table 1, we see the BoC remaining on the sidelines in a hawkish hold at 5.00% policy rate until July 2024, when we see it delivering the first 25 basis points (bps) interest rate cut, followed by another 75bps of rate cuts. The BoC likely maintains a tightening bias for the first six months of 2024, noting in the last few months of 2023 a general concern about the slow trend towards price stability, and not ruling out another rate increase(s) if warranted. Our conviction in the base case to see the first interest rate cuts in July 2024 is fairly high based on more recent acknowledgement by the BoC that growth is slowing under the weight of past interest rate increases, and that excess demand in the economy has diminished. The change in tone from the BoC comes as economic growth has slowed and will continue to slow as the lagging impact of tightening takes hold.

Rate Cuts: When will we be there?

In order to begin the process of lowering Canadian interest rates, we believe that the BoC will want to see core inflation on a sustained path back to its 2% inflation target. That doesn't mean that the BoC needs to see a sustained period of 2% inflation, but rather as the BoC suggested recently, a 'downward momentum' toward its target.

The BoC also considers three other factors in determining the policy rate. These include monitoring trends and levels of inflation expectations, corporate pricing behaviour and wage growth which will all be reviewed when the BoC considers change in policy. In its October Monetary Policy Report, the BoC noted the following on those factors: "*As excess demand eases, inflation is expected to slow. At the same time, inflation expectations should also fall, businesses' pricing behaviour should normalize, and wage growth should moderate. So far, progress has occurred but somewhat more slowly than anticipated. Many indicators remain elevated or have yet to normalize.*"

For now, near-term inflation expectations have eased, but they remain elevated and above the Bank's inflation forecast. While corporate pricing behaviour has yet to normalize. Businesses continue to increase prices more frequently and by a larger amount than normal. High inflation expectations could also feed into wages.

For our base case of the first BoC rate cut in July 2024, we think core inflation will remain on a downward path, near-term inflation expectations must continue to fall and stay around 2%, wage growth needs to decelerate below the current 4-5% year-over-year level, and corporate pricing behaviour needs to normalize. More recently, the Canadian Industrial Producer Price Index (PPI) data potentially suggests less corporate pricing inflation ahead.

Aside from the BoC's own framework for setting policy rate, we would continue to watch for signs of any credit market distress next year as an early sign of potential rate cuts. Historically, central banks have tended to observe trends in credit spreads as signposts of systemic stresses. If credit spreads were to trend higher from here, it's likely the tone from the BoC would be more dovish.

2024 Scenario Analysis: Assessing The Upside Vs. Downside Macroeconomic Risk

We have a fair level of conviction in our Canadian growth, inflation, employment, and monetary policy base-case scenario. However, we fully acknowledge the complexities involved in the forecasting process and therefore reflect a downside and upside scenario for key economic variables within Table 2.

Table 2. 2024 Canada Economic Scenario Analysis: Base, Downside, and Upside Cases

	Base Case	Downside Case	Upside Case
Economic Growth	Soft-landing as households remain constrained by higher debt-servicing costs but personal income from a tight labour market puts a floor under spending. Growth slows in 2024 before rebounding in 2025	A sharp slowdown in housing, coupled with a global hit to demand from China's debt deflation cycle, weighs on consumer and business confidence (recession 1Q-3Q24)	No slowdown in the US, Canadian growth rebounds. A robust commodity complex due to global strength, supports Canadian export growth; Canadian consumer spending continues at a steadier clip than the base case in 2024
Inflation	Expect a slow and non-linear path back to target: Potential cross-currents for headline inflation may include elevated commodity prices versus easing supply chains. See disinflationary trends picking up in 2H24 through 2025, albeit for elevated shelter inflation	Canada imports deflation from China, inflation falls much faster than the base case	Core inflation stops falling, and persists for higher than expected through 2024 before declining in early 2025 amidst higher household stresses on higher interest rates
Labour Market	Pace of hiring slows in 2024, while firms continue to hold onto existing workers, keeping the level of overall layoffs relatively low. But slowing economic activity keeps job gains below the BoC's estimated monthly replacement rate of 50,000 in 2024	Deeper than expected economic slowdown raises unemployment, higher layoffs ensure that wage growth eases sooner than expected	Job vacancies remain above pre-COVID levels as economic growth rebounds from 2023, pace of hiring slows less than the base case
Policy Rate	Canadian policy rate peaks at 5.00% until July 2024, when we see the first 25bp rate cut. At the time of this first rate cut, core inflation has fallen significantly, and GDP is below potential.	The BoC overshot monetary policy. BoC ends Quantitative Tightening (QT) early, and cuts rates by 300bp in 2H24, then another 50bp in early 2025 to revitalize growth in 2025	A resilient economy and sticky inflation forces the BoC to raise rates by 25bp in Dec/23, and a further 50bps during 1Q24. Policy rate peaks at 5.75% and remains there for all of 2024. Higher household stress become evident in 4Q24, BoC cuts rates in 2025

Source: Morgan Stanley & Co., as of November 17, 2023. Notes: Economic growth refers to real GDP growth (%); inflation, Canada core CPI (%); labour, Canadian unemployment, or Canadian labour force participation rate (%); and policy rate (%), the Bank of Canada overnight lending rate.

In 2023, the Canadian economy surprisingly held up to the extraordinary rate hikes by the BoC, the wildfires that impacted a number of provinces, and numerous union strikes. As we look ahead, the housing market may a dominant source of risk to consumption if mortgage rates remain at current levels for the next few years when the majority of households renew their existing mortgages. In addition to housing, a global recession may be an external shock that presents an unavoidable downside recession risk for Canada.

Downside case: **The BoC overshot on monetary policy**. High levels of household debt and highly leveraged corporate balance sheets weigh on the economy, as prevailing interest rates were higher than the equilibrium rate to balance price stability and employment, meaning that the BoC has overshot. A sharp slowdown in housing market activity, coupled with a hit to global demand from China's debt deflation cycle, weighs on consumer and business confidence. The deeper-than-expected economic slowdown raises unemployment.
The economy enters recession from 1Q2024 to 3Q2024. With Canada importing deflation from China, inflation falls much faster than the base case. As a result, the BoC ends balance sheet reduction, or quantitative tightening, early, and cuts rates by 300bps in 2H2024, then another 50bps in early 2025 to revitalize growth.

Upside case: **With no slowdown in the US, Canadian growth rebounds**. Stronger-than-expected growth in the US, as well as a robust commodity complex due to global strength, supports Canadian export growth. The economy sees resiliency in domestic demand that extends into 2024, as household and business spending continue at a steadier clip than the base case. Core inflation stops falling. The BoC raises interest rates by 25bps in December 2023, followed by an additional 50bps in 1Q2024 to a peak of 5.75%, where it remains through the rest of the year. In 2025, lower inflation and higher household stress point to a lower equilibrium interest rate. The BoC cuts rates by 100bps.

Assessing Key Risks For 2024 And Beyond

We discuss the near-term risks associated with the Canadian residential housing and mortgage market below. But there are other risks we see over the forecast period, including the non-zero probability that we see a global recession emanating from the lagged impact of monetary policy tightening around the world. Moreover, China may fail to provide the needed fiscal and monetary stimulus to restore it to potential growth. Plus, there are growing geopolitical risks with wars on multiple fronts and growing concerns around government debt limits, especially in the US. In terms of Canadian sovereign debt, the country still sports a 'AAA' credit rating, but Ottawa should not be complacent either. Since 2015, the Canadian Federal government has run a deficit every year. And in that time, the Canadian Federal debt has doubled from $620 billion in 2015 to $1.2 trillion last year.

There are also a fairly large number of political elections taking place in 2024. According to Bank of America Merrill Lynch, approximately 65% of global GDP will be touched by an election next year. Some of the more prominent elections include Taiwan (Jan. 13), Pakistan (Feb. 8), South Korea Legislative (Apr. 10), India (April/May), EU Parliament (June 6-9), and the US Presidential, House and Senate (Nov. 5).

These items above are not an exhaustive list of potential risks by any means. Historically, the risks that one cannot see ahead of time are the ones that impact financial markets the most. While we do our best to assess potential risk ahead, it's not practical to assume one can anticipate all risks. This is why we build diversified portfolios in the first place. More on that in section two.

Canadian Residential Housing and Mortgages: Potential Risk for 2024-2026

As we look out over the coming year and beyond, one of the larger risks to the Canadian economy and financial markets is the Canadian housing and residential mortgage market. The magnitude of the risk ahead will likely be determined by the direction of interest rates, which in our base case suggests interest rate cuts could mitigate the potential risk ahead.

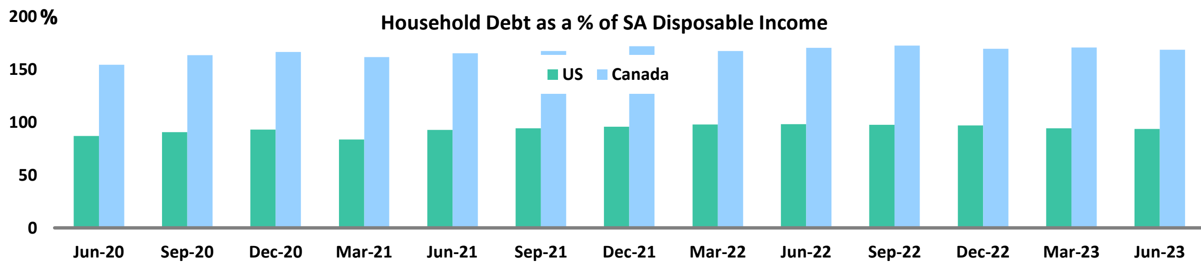
Sizing Up the Canadian Mortgage Market

According to the Canada Mortgage and Housing Corporation (CMHC), Canada's national housing agency, the total outstanding loan value for all insured and uninsured mortgages was $1.96 trillion, across ~7 million loans in Canada. To put that into perspective, the total size of Canada's economy as of July 2023 was $2.1 trillion, according to Statistics Canada. Furthermore, in 2008, US household debt to GDP was approximately 100%, according to the St. Louis Federal Reserve, not far off where Canada's household mortgage debt to GDP sits today.

Canadian Housing and Consumer Balance Sheets with Higher-for-Longer Interest Rates

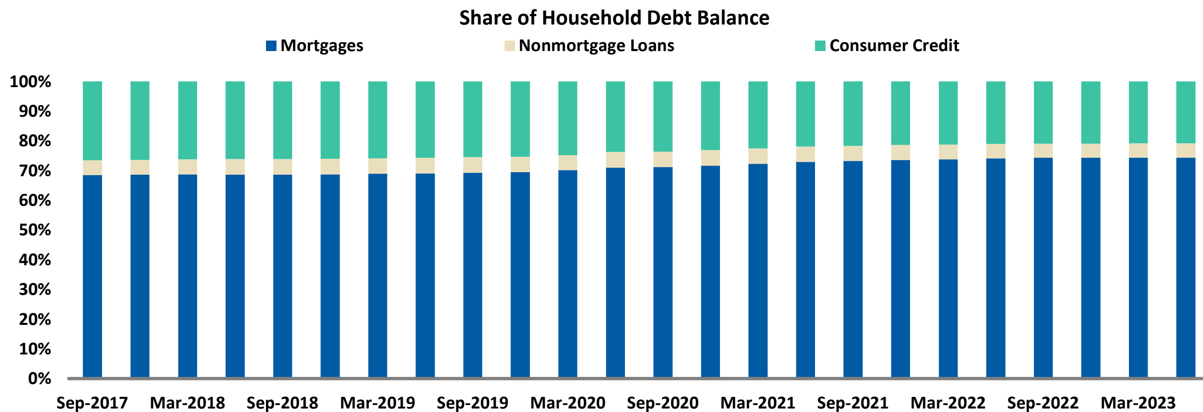
While our base case is for Canada to avoid a recession, we see evidence that Canadian consumers are already feeling the pinch of higher interest rates when it comes to spending on discretionary items. Debt-servicing costs are rising, as Canadians carry more debt as a percent of disposable income than their US counterparts (Chart 2, 3), partly a result of low interest rates and rising home prices over the last decade, which has contributed to larger mortgages.

Chart 2. Canada vs US Household Debt as % of Disposable Income



Source: Statistics Canada, Federal Reserve Board, Morgan Stanley & Co.

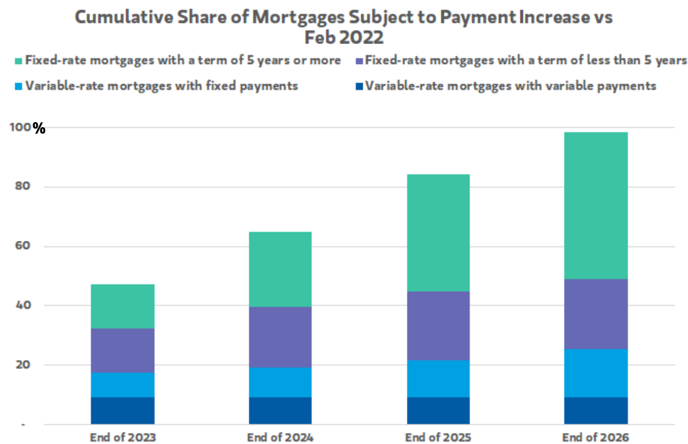
Chart 3. Canadian Household Debt Balance



Source: Statistics Canada, Morgan Stanley & Co.

As we look out over the next few years at the pace of residential mortgage renewals in Canada (Chart 4), and the potential increase in monthly mortgage payments (Chart 5), there is a non-zero probability that a percentage of Canadians may face difficult choices ahead. Under a recessionary scenario where employment rates decline and interest rates remain high, some Canadians may be forced to sell their home, extend amortization periods for several or more years, or ultimately lose their home as they may not be able to afford the higher carrying cost.

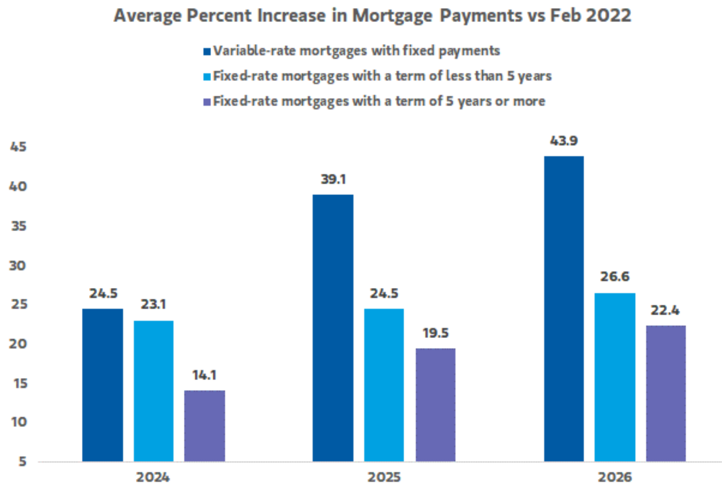
Chart 4. Cumulative Canadian Residential Mortgage Renewals, 2023-2026



Source: Bank of Canada, Morgan Stanley & Co.

As shown in Chart 5, the potential increase in mortgage payments is significant, rising between 23-27% for most fixed rate mortgages, and substantially more for those who took on variable rate mortgages with fixed payments that do not adjust to the change in interest rates. Should our macroeconomic base case for interest rate cuts by the BoC materialize in 2024, it is likely the impact on monthly payments will be lower than this.

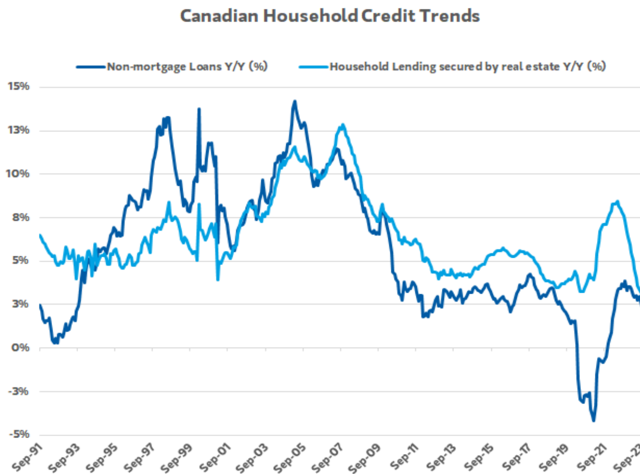
Chart 5. Rising Rates = Increases in Mortgage Payment



Source: Bank of Canada, Morgan Stanley Research & Co.

Canadian household credit trends continue to deteriorate (chart 6) as Canadian banks reduce lending activity. The lagged impact of the BoC's tightening is building as we exit 2023, with negative total household credit growth adjusted for inflation, which historically has been a harbinger of a recession.

Chart 6. Canadian Household Credit Trends Contracting



Source: Statistics Canada

While there is a non-zero probability of rising systemic risk stemming from the Canadian mortgage market due to higher interest rates, there are some risk mitigants in place to help reduce that risk, including the following:

- A fairly well-capitalized Schedule I banking sector relative to global banking peers, which hold the majority of uninsured residential mortgages in Canada
- Canadian banks have been increasing provisions for credit losses over the last year to prepare for potential credit defaults to mitigate the earnings impact from defaults that may arise

- Canadian banks have been working with borrowers to extend amortization periods to reduce payment shock due to higher rates at renewal
- Canadians with uninsured mortgages had high FICO credit scores as reported by the Canadian banks (Nov. 2023), where the majority of residential uninsured mortgages carried a FICO score above 720.
- Wage growth has also been positive over the last two years, averaging 4-5% according to the Bank of Canada, which may alleviate some of the impact from mortgage renewals
- Canadians have a fair amount of home equity which provides options. The uninsured mortgages with Canadian banks carry a range of 50 to 70% loan-to-value (Nov. 2023). Supported by a structural shortage of housing supporting and rising demand from immigration, there may be a relative floor under home prices and by extension homeowner equity.
- Finally, the Canadian mortgage stress tests does add some confidence that mass defaults on mortgages may be a lower probability scenario. While it isn't perfect by any means, the Canadian mortgage stress test, introduced in 2018 and adapted to current housing market conditions on June 1, 2021, may help mitigate systemic risks. The stress test was and is used to determine mortgage approvals based on a borrower's ability to afford their mortgage if interest rates increased. Home buyers with a down payment of 20% or more are subject to a stress test using the Office of the Superintendent of Financial Institutions (OSFI) minimum qualifying rate or the customer's mortgage interest rate plus 2%, whichever is higher.

SECTION TWO: Recommended Portfolio Positioning Into 2024

In 2023, most asset classes have staged a comeback from the declines during 2022. Looking at the Chart 7, the laggards of 2022 have become the leaders, and vice versa. Of course, this is a simplistic view of the investing experience that was 2023, and it does not reflect the underlying crosscurrents that took place. 2023 managed to deliver multiple episodes of significant market dislocation - the volatility in the US regional banking sector, and the unrelenting spikes in long-term developed market government bond yields from August to October, followed by a furious rally in November, just to highlight a few episodes.

Chart 7. Total Returns by Asset Class, 2013-2023 (YTD)

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 (YTD)
US EQ 32.37	REITS 22.81	REITS 7.01	CDN EQ 21.08	EM EQ 37.85	REITS 2.17	US EQ 31.47	US EQ 25.12	REITS 37.51	Commodities 13.75	US EQ 20.98
EAFE EQ 23.44	US EQ 13.67	CDN IG Bonds 2.68	CDN HY Bonds 16.13	EAFE EQ 25.33	CDN HY Bonds 2.04	CDN EQ 22.89	CDN EQ 18.79	US EQ 28.68	Gold -0.28	EAFE EQ 12.07
CDN EQ 12.98	CDN IG Bonds 6.38	US EQ 1.37	Global HY Bonds 14.27	US EQ 20.79	US Treasuries 1.18	EAFE EQ 22.77	EAFE EQ 18.39	Commodities 27.05	CDN EQ -5.75	Gold 9.69
Global HY Bonds 7.33	US Treasuries 5.05	US Treasuries 0.84	US EQ 11.95	Gold 13.53	CDN IG Bonds 1.14	REITS 22.66	REITS 9.2	CDN EQ 25.15	CDN HY Bonds -6.21	Global HY Bonds 8.33
CDN HY Bonds 5.81	CDN HY Bonds 1.22	EAFE EQ -0.28	EM EQ 11.75	REITS 11.36	Global IG Bonds -1.16	EM EQ 18.82	CDN Energy 8.41	EAFE EQ 11.87	CDN IG Bonds -9.5	CDN EQ 6.41
REITS 4.66	Global IG Bonds 0.59	CDN HY Bonds -2.44	Commodities 11.4	Global HY Bonds 10.46	Gold -1.56	Gold 18.31	EM EQ 8.39	CDN HY Bonds 4.74	US Treasuries -12.4	EM EQ 5.3
CDN IG Bonds 1.52	Global HY Bonds 0.01	Global HY Bonds -2.72	REITS 9.06	CDN HY Bonds 8.46	Global HY Bonds -4.2	Global HY Bonds 12.56	Gold 8.35	Global HY Bonds 0.99	Global HY Bonds -12.7	CDN HY Bonds 4.97
EM EQ -2.26	Gold -1.44	Global IG Bonds -3.15	Gold 8.14	Global IG Bonds 8.28	US EQ -5.19	CDN HY Bonds 10.39	Global HY Bonds 8	CDN IG Bonds -1.32	EAFE EQ -13.9	CDN IG Bonds 3.26
Global IG Bonds -2.6	EM EQ -1.97	CDN EQ -8.33	CDN IG Bonds 3.76	CDN EQ 8.26	CDN EQ -9.45	CDN IG Bonds 7.96	CDN HY Bonds 7.03	US Treasuries -2.32	Global IG Bonds -16.2	Global IG Bonds 0.09
US Treasuries -2.75	EAFE EQ -4.32	Gold -10.4	Global IG Bonds 2.09	CDN IG Bonds 2.85	Commodities -13.2	US Treasuries 6.86	CDN IG Bonds 5.61	EM EQ -2.32	US EQ -18.1	US Treasuries -0.62
Commodities -9.58	CDN EQ -4.82	EM EQ -14.6	EAFE EQ 1.59	Commodities 2.44	EAFE EQ -13.3	Global IG Bonds 6.84	Commodities -3.5	Gold -3.64	EM EQ -19.8	REITS -6.22
Gold -28.2	Commodities -17.0	Commodities -24.7	US Treasuries 1.04	US Treasuries 2.35	EM EQ -14.2	Commodities 5.44	REITS -8.69	Global IG Bonds -4.71	REITS -21.5	Commodities -8.06

Source: Bloomberg as of Nov 22/23, all priced in local currency. Notes: "US EQ", US Equities proxied by S&P500 Index. "EAFE EQ", EAFE Equities proxied by MSCI EAFE Index. "CDN EQ", Canadian Equities proxied by S&P/TSX Composite Index. "Global HY Bonds", Global High Yield Bonds proxied by Bloomberg Global High Yield Index. "CDN HY Bonds", Canadian High Yield Bonds proxied by ICE BofA Canada High Yield Index. "REITS", Canadian REITs proxied by S&P/TSX Composite Index Equity Real Estate Investment Trusts. "CDN IG Bonds", Canadian Investment Grade Bonds proxied by Bloomberg Canada Aggregate Corporate Total Return Index. "EM EQ", Emerging Market Equities proxied by MSCI Emerging Markets Index. "Global IG Bonds", Global Investment Grade Bonds proxied by Bloomberg GlobalAgg Index. "US Treasuries" proxied by Bloomberg US Treasury Index. "Commodities" proxied by Bloomberg Commodity Index. "Gold" proxied by Philadelphia Stock Exchange Gold and Silver Index. You cannot invest directly in an index, and past performance is not an indication of future performance.

In Table 3, we present our Tactical Asset Allocation recommendations.

Table 3. Tactical Asset Allocation Recommendations

	WEIGHT RELATIVE TO MODEL BENCHMARK		
	UNDERWEIGHT	MARKET-WEIGHT	OVERWEIGHT
EQUITIES			
North American Equities	■		
U.S.	■		
Canada Large-Cap		■	
Canada Small-Cap		■	
International Equities		■	
Emerging Markets		■	
TOTAL EQUITIES	■		
FIXED INCOME			
Canada			■
Short-Term Fixed Income			■
Core Fixed Income			■
High Yield Fixed Income		■	
Preferred Shares		■	
U.S.			■
International Investment Grade		■	
TOTAL FIXED INCOME			■
ALTERNATIVES			
Real Assets			
Real Estate/REITS		■	
Hedged Strategies			■
TOTAL ALTERNATIVES		■	

Source: All Tactical Recommendations for Canada are provided by Morgan Stanley Wealth Management Canada Canadian Investment Committee (CIC) as of November 30/23. All other recommendations are provided by Morgan Stanley Wealth Management GIC as of November 30/23.

Defensive Growth: Tactical Asset Allocation Reasoning

- **Underweight US Equities:** Still uncertain about forward earnings estimates related to a lack of fiscal stimulus ahead and a tapped-out US consumer. Preference for defensive-growth equities with quality balance sheets.

- **Market-Weight Canadian Equities**: Although our macro base case suggests Canada will avoid a recession, the lagged impact from almost 500bps of rate hikes suggests downside risks to the consensus outlook for the Consumer Discretionary, and the Financials sector in Canada next year. A mixed near-term outlook for commodities—range-bound oil versus forecast upside for copper and gold—may suggest a ceiling on multiple expansion at the index level.

- **Market-Weight International Equities**: The mix of high and sticky inflation, existential risks associated with Russia/Ukraine and the European Central Bank's position that it has limited tools to help suggest that the odds of recession are over 50%. Developed market
- exposure should skew toward commodities and materials exporters, especially those in the Asia Pacific region, including Japan.

- **Market-Weight Emerging Market Equities**: Recent softness in China, including macro uncertainty and deflationary pressures, along with growing opacity around policy direction, have caused concern for the country's growth path. With global growth concerns potentially mounting, we have neutralized a previous overweight to emerging markets.

- **Overweight Canadian Fixed Income**: We believe we are towards the end of the BoC rate hiking cycle, and our base case calls for rate cuts by mid-2024. Our positive outlook for fixed income is based on a "higher-for-longer" regime that creates opportunities to own better risk-adjusted returns in current coupons, with the potential for capital gains if rates fade in 2024, as is forecasted. While there may be an opportunity to rotate into High Yield bonds in the future, we would first look for wider credit spreads as a sign of a greater margin of safety and opportunity for capital appreciation.

- **Overweight US Fixed Income**: Favourable opportunities within investment grade corporate credit, and short- and intermediate-term US Treasuries. Similar to Canada, in the US we are market weight High Yield bonds relative to benchmark given less favourable upside/downside compared to Investment Grade at this time.

- **Market-Weight International Investment Grade Bonds**: Central banks' hawkish pivots have prompted a material move in global nominal rates. While timing and catalysts are still hazy, negative-yielding debt has largely vanished in recent months. However, local currencies have recently weakened against a strengthening US dollar. Moreover, our benchmarks and tactical asset allocation models continue to allocate 0% to this asset class.

- **Market-Weight Real Estate/REITs**: With real interest rates now positive and services inflation remaining quite sticky, we would need to be cautious and selective in adding to this asset class.

- **Overweight Hedged Strategies**: The current environment appears constructive for hedge fund managers who are good stock-pickers and can use leverage and risk management to amplify returns. We prefer very active and fundamental strategies, especially high quality, low beta, low volatility, and absolute return hedge funds.

Explaining our recommended Market-Weight on Canadian Equities: No 'all-clear' signal just yet

We are currently market weight Canadian equities under our tactical asset allocation framework, as summarized below.

- **Fundamentals**: Potential downside risk to consensus EPS estimate in 2024-25
- **Valuation**: Positive real rates may limit near-term P/E expansion
- **Technicals**: Investor sentiment is neutral, especially towards commodities and oil prices which matters most for the TSX long-term return potential.

As we detail next, downside earnings risk in consumer and financials keep us at Market Weight on Canadian equities for now. In addition, while the valuation of the Index isn't demanding, our outlook for positive real interest rates may cap near-term multiple expansion. Finally, we would like to see breadth in the TSX Composite to include both price and earnings momentum before considering a tactical overweight position.

Fundamentals: Assessing the 2024-25 S&P/TSX Composite Index Consensus Estimates

In Table 4 we detail the S&P/TSX Composite Index consensus estimates for 2023 to 2025 by sector, including earnings per share (EPS), or net profit growth rates and the corresponding valuation, using P/E.

Table 4. Bottom-Up S&P/TSX Composite Index Consensus Estimates by Sector (2023-2025) - sorted by Sector EPS Contribution to S&P/TSX

	EPS %	Consensus EPS Growth Y/Y			Price-to-Earnings (P/E) Consensus EPSe				Stressed P/E		
Sector	TSX	2023	2024	2025	2023	2024	2025	LT Avg	2023	2024	2025
TSX Composite	**100%**	**-12.0%**	**12.1%**	**7.4%**	**14.8x**	**13.2x**	**12.3x**	**17.1x**	**14.8x**	**14.0x**	**13.1x**
Financials	27%	-3.1%	8.4%	5.9%	10.7x	9.9x	9.3x	10.8x	10.7x	11.0x	10.8x
Materials	18%	-49.6%	24.5%	8.9%	20.5x	16.5x	15.1x	24.5x	20.5x	19.5x	18.2x
Energy	17%	-26.6%	13.5%	2.5%	12.0x	10.6x	10.3x	20.6x	12.0x	11.4x	10.6x
Industrials	10%	45.1%	3.5%	14.4%	21.9x	21.1x	18.4x	33.1x	21.9x	21.1x	18.4x
Consumer Discretionary	9%	-1.4%	12.9%	13.5%	15.7x	13.9x	12.3x	19.1x	15.7x	15.7x	15.3x
Consumer Staples	5%	8.0%	7.6%	10.3%	17.1x	15.9x	14.5x	25.2x	17.1x	15.9x	14.5x
Real Estate	5%	-55.3%	46.5%	3.7%	21.7x	14.8x	14.3x	16.8x	21.7x	14.8x	14.3x
Information Technology	4%	44.5%	41.8%	18.3%	45.4x	32.1x	27.1x	54.1x	45.4x	32.1x	27.1x
Communication Services	3%	-4.3%	12.4%	13.3%	18.1x	16.1x	14.2x	13.2x	18.1x	16.1x	14.2x
Utilities	3%	20.6%	-2.4%	9.6%	16.5x	17.0x	15.5x	21.2x	16.5x	17.0x	15.5x
Health Care	-1%	n/a	57.7%	21.0%	9.2x	5.8x	4.8x	n/a	n.a	n/a	n/a

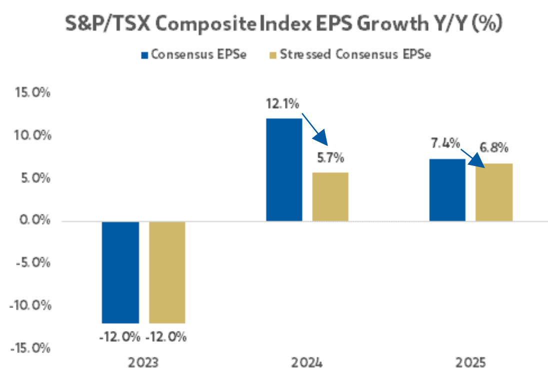
Source and Notes: Bloomberg consensus EPS growth estimates as of Nov 30/23. Price-to-Earnings calculated by dividing the current price as of Nov 30/23 by the estimated Earnings Per Share, EPS or EPSe. "Stressed P/E" calculated by reducing consensus EPS estimates for 2024 and 2025 for Financials, Materials, Energy and Consumer Discretionary.

From our perspective, bottom-up consensus earnings growth in 2024 and 2025 appear somewhat optimistic for the Financials and Consumer Discretionary sectors. The earnings growth/recovery for these sectors in Table 4, is not entirely consistent with our macroeconomic base case, nor the potential risks ahead for the Canadian Housing/Residential sector identified earlier in the report.

On the Resources side, Morgan Stanley & Co. forecasts the price of oil to remain around $85/bbl in 2024, suggesting less near-term upside from Energy. And while Morgan Stanley & Co. expects the price of gold to appreciate to US$2,400 per oz. in 2024 from US$2,000 per oz. currently, the gold mining companies that make about 60% of the S&P/TSX Materials sector have historically underperformed the price appreciation in the metal.

Given these headwinds, we see potential downside risk to 70% of the S&P/TSX Composite earnings (27% Financials, 18% Materials, 17% Energy, and 9% Consumer Discretionary) over the near-term. We anticipate further revisions to consensus estimates over the next three to six months closer to the stressed EPS scenario illustrated in Chart 8. On the positive side, even within this downside scenario we see limited risk to dividends at this time. However, a more bearish scenario where the BoC doesn't cut interest rates for all of 2024 may pose some risk to Canadian bank dividend expectations.

Chart 8. Consensus and Stressed Consensus 2023-2025 S&P/TSX Composite Index EPS Growth Year-over-Year (%)

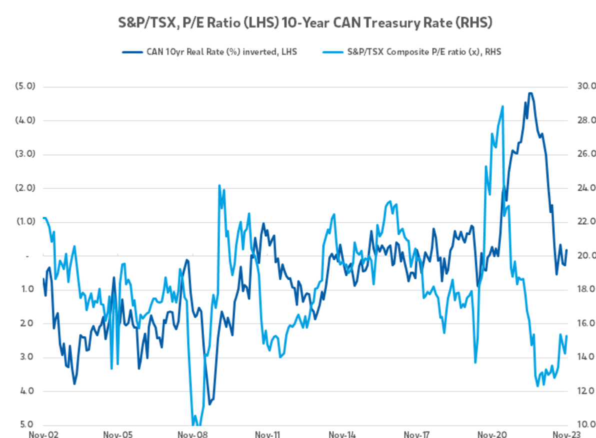


Source and Notes: Bloomberg consensus EPS growth estimates as of Nov 30/23. Price-to-Earnings calculated by dividing the current price as of Nov 30/23 by the estimated Earnings Per Share, EPS or EPSe. "Stressed P/E" calculated by reducing consensus EPS estimates for 2024 and 2025 for Financials, Materials, Energy and Consumer Discretionary.

Valuation: Upside Limited by Real Rates

Returns on stocks can be estimated as a function of changes in earnings growth, or EPS, and changes in the P/E ratio. At different points in the cycle, the return on stocks can be driven by either the EPS and/or P/E in different ways. One of the driving forces behind the P/E is interest rates. There has always been an inverse relationship between real (inflation-adjusted) interest rates and the P/E ratio for stocks, as shown in Chart 9. This means that, when real interest rates are rising, we expect the P/E ratio for stocks to decline, and vice versa.

Chart 9. S&P/TSX Composite Index P/E ratio versus CAN Real Interest Rates (10-yr)



Source Bloomberg as of Nov 30/23. Note the CAN or Canadian 10yr Real Rate (%) on the left-side axis is inverted to show the relationship between real interest rates and the P/E ratio on the right-side axis.

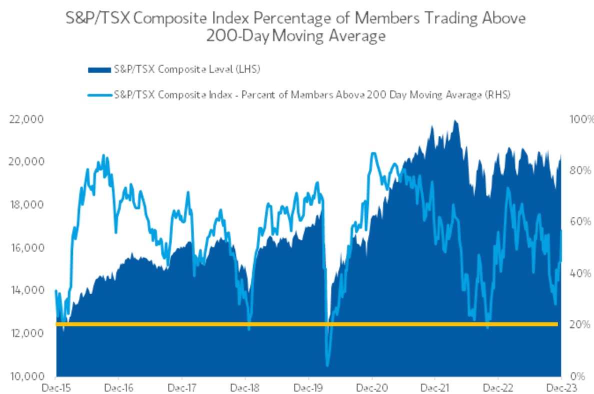
As shown in Chart 9, Canadian 10-year real interest rates have somewhat increased in the last year following the pandemic period when real rates were deeply negative. We expect real interest rates to remain positive for the forecast period and, as such, do not expect multiple expansion for the S&P/TSX Composite due to declining real rates.

Technicals: Limited price or earnings breadth just yet

While we review various technical indicators within our tactical asset allocation framework for equities, in Chart 10, we show one of these

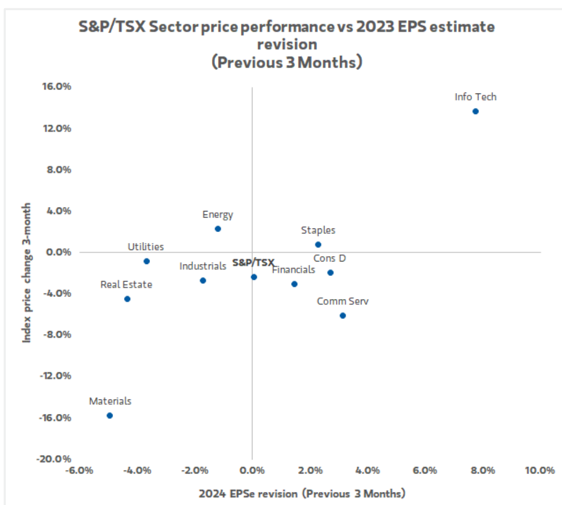
trend indicators. The percentage of S&P/TSX Composite Index members that are trading above their 200-day moving average is commonly used to determine general market trends by giving equal weighting to every trading day in the previous 200-days, smoothing out some of the shorter-term volatility and potentially confirming momentum. A rising percentage of members above the moving average may indicate broad market strength, and vice versa.

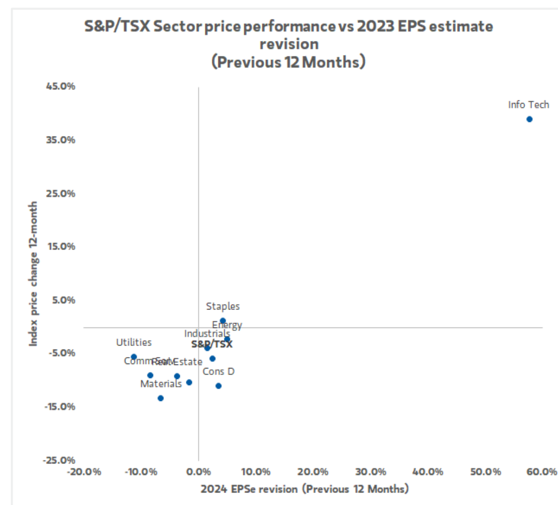
Chart 10. Percentage of S&P/TSX Composite Index Members Trading Above their 200 Day Moving Average



Source Bloomberg as of Nov 30/23.

Chart 11. S&P/TSX Composite Index, S&P/TSX Industry Sectors Earnings Revisions





Source Bloomberg as of Nov 30/23.

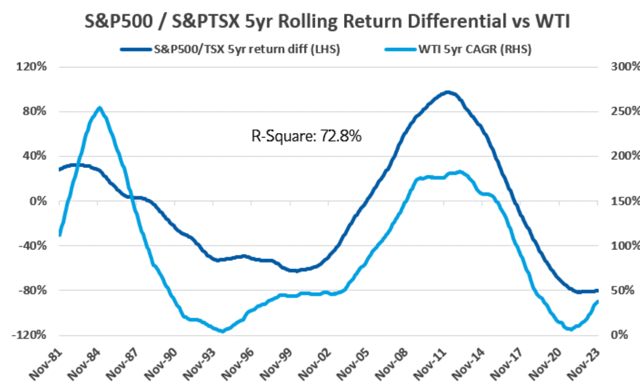
Historically, when the percentage of members trading above the 200-day moving average was low (i.e., below 20%, indicated by the orange line denoting low breadth), price momentum was weak. This low breadth is rare, but it has provided long-term investors with a good buying signal. Since 2000, there were 35 occurrences of 20% or fewer of TSX members traded below their 200-day moving average. The forward 12-month return from those oversold levels was positive 97% of the time, for a median return of 31.6%. Today, about 60% of the TSX members are above their 200-day moving average, not providing us with additional insights to adjust our tactical recommendation.

In Chart 11, we review the breadth of 2024 consensus earnings revisions across the index during the last three months (left) and over the last year (right). In these charts we look for signs that analysts are revising their growth estimates across most TSX sectors to confirm positive index momentum and sentiment. Breadth of revisions has improved in the last three months, but as discussed earlier, we have concerns about near-term earnings for certain sectors.

US vs. Canadian Equities: It Usually Comes Down to Commodity Cycles

Longer-term, commodity cycles have tended to drive the relative performance of Canadian versus US equities, as shown in Chart 12. Looking back over previous cycles, we identified several drivers for Canada-US equity performance differentials. Among commodities, currency, and inflation factors, WTI or Brent crude oil, have tended to influence the performance spread most strongly, while USD/CAD changes have proven to be a lagged indicator.

Chart 12. 10-Year Return Differential for the S&P/TSX Composite Index vs. S&P500 Index and WTI



Source and Notes: Bloomberg as of Nov 30/23. CAGR = Compound Annual Growth Rate. R-Square is a statistical measure in a regression model that determines the proportion of variance in the dependent variable that can be explained by the independent variable. In other words, r-squared shows how well the data fit the regression model (the goodness of fit).

While it is difficult to identify any short-term trends in Chart 11, further signs of an extended rally in energy and commodity demand may be one reason to consider a more favourable view of Canadian versus US equities. As detailed in our report, "Part One. Power Play: Energy Sector Upside Potential on Long-tail Transition," the transition route to Net Zero Emissions (NZE) established by the 2015 Paris Agreement may be a turbulent one given a curtailed supply of traditional energy, while demand has yet to fully adjust. While the supply side of the oil market has become increasingly responsive to expected changes in the far future with reduced capital spending, changes to demand have been less responsive. Combined, this means prices are likely to be higher on average, but probably more volatile as well. We will continue to watch for any signs of increasing demand for energy and commodities to assess our tactical market weight call.

Please reach out to your Morgan Stanley Wealth Management Canada Financial Advisor with any questions.

Disclosure Section

The Global Investment Committee (GIC) is a group of seasoned investment professionals from Morgan Stanley & Co. and Morgan Stanley Wealth Management who meet regularly to discuss the global economy and markets. The committee determines the investment outlook that guides our advice to clients. They continually monitor developing economic and market conditions, review tactical outlooks and recommend asset allocation model weightings, as well as produce a suite of strategy, analysis, commentary, portfolio positioning suggestions and other reports and broadcasts.

Index Definitions

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

S&P/TSX Composite Index: The S&P/Toronto Stock Exchange Composite Index is a capitalization-weighted index designed to measure market activity of stocks listed on the TSX. The index was developed with a base level of 1000 as of 1975.

Risk Considerations

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

High yield bonds (bonds rated below investment grade) may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk, price volatility, and limited liquidity in the secondary market. High yield bonds should comprise only a limited portion of a balanced portfolio.

Companies paying dividends can reduce or cut payouts at any time.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Investing in small- to medium-sized companies entails special risks, such as limited product lines, markets and financial resources, and greater volatility than securities of larger, more established companies.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile. Risks applicable to companies in the energy and natural resources sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Health care sector stocks are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The indices selected by Morgan Stanley Wealth Management Canada to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management Canada retains the right to change representative indices at any time.

Disclosures

Morgan Stanley Wealth Management Canada Inc. ("MSWC") is a wholly owned subsidiary company of Solium Capital ULC which in turn is a wholly owned subsidiary of Morgan Stanley, a publicly traded company listed on the New York Stock Exchange with its global headquarters located in New York City.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance.

Morgan Stanley Wealth Management Canada Inc, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice.

Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

This material, or any portion thereof, may not be reprinted, sold, or redistributed without the written consent of Morgan Stanley Wealth Management Canada Inc. © 2023 Morgan Stanley Wealth Management Canada Inc.