

Canadian Market Insights | September 22, 2023

## Part Two. Power Play: Energy Sector Upside Potential on Long-tail Transition

### Executive Summary

- 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. On the other side of energy transition lies a new, stable system, but the transition also entails risks that may be hedged with exposure to the energy sector.
- 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.
- Investors can participate in the energy transition with exposure to Canadian Energy. We believe that Canada's Oil & Gas industry can play a critical role in energy transition over the coming decades despite a less enthusiastic view from the market. Growth investments in new cleaner energy businesses are in the early stages for most, but supportive policy could allow them to scale more rapidly (and economically) than expected.
- The Canadian Energy sector is currently trading at the steepest discount to long-term average valuations relative to any other sector in the S&P/TSX Composite Index. We believe this pessimistic outlook reflects significant uncertainty related to the future demand for oil and gas, but at the same time, does not reflect the potential for narrowing West Texas Intermediate and Western Canadian Select crude price differential (known as the 'WTI-WCS differential') over the near-term, nor a decline in growth investments of renewable technologies over the long-term. With renewed capital discipline, evident by market leading free cash flow yields (+8%), investors in Canadian energy have exposure to potential dividend growth (+6% current dividend yield).
- Canadian energy producers do not need a high price of oil to be sustainable. Analysis suggests that the producers can sustain capital expenditures, meet dividend payments, net zero emission targets, and retire their outstanding debt with WTI above \$65 per barrel (current price ~\$80 per barrel). While we expect more price volatility for oil in the long-term, the sustainability of the sector above \$65 per barrel provides perspective on the downside case for Canadian energy.

Stu Morrow, CFA

Executive Director, Chief Investment Strategist  
Morgan Stanley Wealth Management Canada  
stu.morrow@morganstanley.com  
+1 416 943-8530

## Transitioning to Net Zero – How and When?

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 energies, while demand has yet to fully adjust. On the other side of an energy transition lies a new, stable system, but the interim entails risks that may be hedged with continued exposure to the energy sector.

**Canada's Net Zero Goals:** According to the International Energy Agency's Canada 2022 Energy Policy Review, *"Canada has made a series of international and domestic commitments, putting the country on a path towards an ambitious transformation of its energy system, while remaining a stable and reliable supplier of energy to the world. Most recently, Canada set a target to cut greenhouse gas emissions by 40-45% from 2005 levels by 2030 and legislated a commitment to reach net zero emissions by 2050."*

Specific targets set by the Canadian Federal Government include:

- Requiring the oil and gas sector to be net-zero by 2050 and setting interim five-year targets.
- Requiring oil and gas companies to reduce methane emissions by at least 75% below 2012 levels by 2030.
- Creating a 100% net-zero electricity system by 2035; and
- Providing support for domestic procurement of Canadian clean technology.

While NZE implies major shifts in the energy sector, we believe that Canada's energy sector may provide investors with sustained dividend and capital appreciation over the coming decade, assuming a reasonable outlook for the price of oil. Alternatives to fossil fuels will eventually scale to compete with traditional energy sources but there are potential headwinds to supply and demand which may lengthen the expected transition period. This may result in greater price volatility to both the upside and downside, a risk we believe investors can hedge with exposure to the Canadian energy sector.

In this two-part series, we discuss important considerations for investors in the energy sector:

- **Part one:** A potentially longer than anticipated transition period
- **Part two:** Hedging the risk of a longer than anticipated transition period with Canadian Energy exposure

## Part Two: Canadian Energy Exposure During a Turbulent Transition

In the second part of our series on the Energy sector, we lay the foundation for a less pessimistic outlook on the Canadian energy sector relative to the market. First, we provide a brief background on the industry, followed by an overview of the sector fundamentals, relative valuation, and portfolio strategy.

## The Energy Industry is Critical to Canada's Economy

Energy is critical to Canada's economy; according to the International Energy Agency (IEA), it makes up 10% of Canada's GDP and is a major source of capital investments, trade flows, and a key generator of middle-class jobs, including for Indigenous peoples. Globally, Canada is a major energy producer, exporting 88% of its oil, of which the vast majority (99%) is exported to the US (average 3.7 million barrels per day). It is also a top ten producer of oil, natural gas, hydropower, uranium, nuclear power, biofuels, and wind, as well as a leading producer of over 60 minerals and metals, including a wide range of critical minerals. Furthermore, Canada is one of the world's largest natural gas producers and has over 200 years of reserves at current production levels.

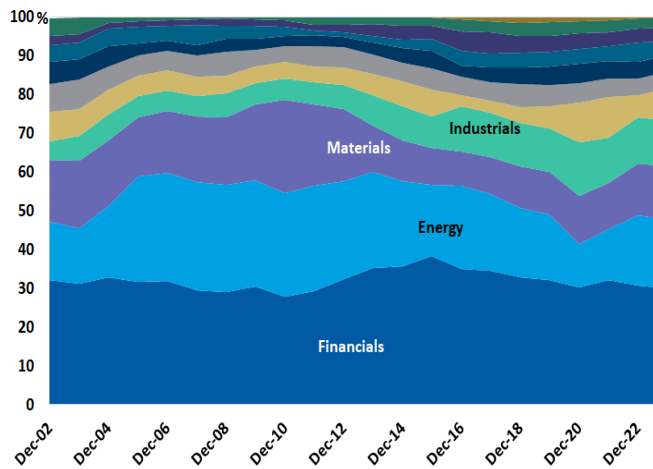
Canada has the world's third largest nationally proven crude reserves, according to Natural Resources Canada. According to the IEA, Canada is among the world's main crude oil producers and exporters, with proven oil reserves (166.7 billion barrels, most of which is in the oil sands), ranking the third largest in the world. Roughly 97% of its reserves can be found in the oil sands, while conventional reserves, including tight oil and offshore reserves, account for the remaining 3%. Production is mostly in Alberta, with additional volumes in Saskatchewan and off the coast of Newfoundland and Labrador. The incremental cost of production for oil sands is low relative to upfront costs, with most projects able to generate positive cash flows at a West Texas Intermediate (WTI) oil price just above US\$40 per barrel.

## Canadian Energy Sector – Also Critical to Canada's Equity Market

The Canadian energy sector's market-capitalization weight in the S&P/TSX Composite Index ('the Index') has ebbed and flowed over time (Chart 1). The principal factor behind the sector's fluctuating weight in the Index is primarily attributable to the underlying volatility in crude oil pricing. This was evident in 2005 when the sector's index weight increased to 27% from 19% the year prior, which was preceded by a 35% increase in crude oil prices over the same period. Conversely, in 2016, the sector weight in the Index decreased to its 2004 weight, following a decline in crude prices which troughed at a decade low of \$30.89/barrel. At the same time, the signing of the 2015 Paris Agreement brought forth the risk of a sector-wide compression in both earnings and cash flows resulting in a divestment of the sector which reached a weighted low of 11.2% in the Index.

Since then, the Canadian Energy sector has reclaimed some of that Index weight, and as of August 2023 it was the second largest sector in the Index by market capitalization at 18%, second to Financials (30%), and ahead of Materials (14%).

Chart 1: S&P/TSX Composite Sector Weights by Market Capitalization (2002-2023)



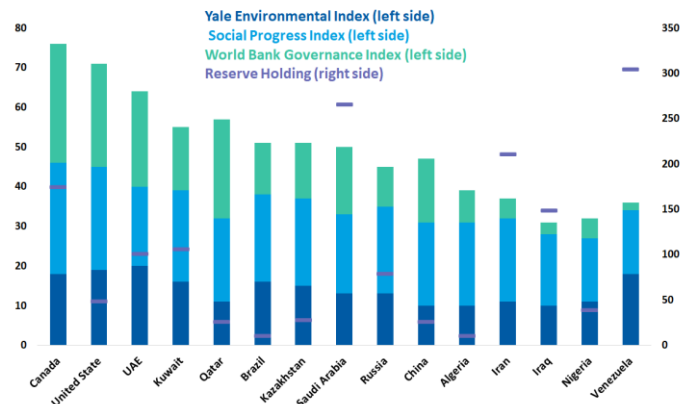
Source: Bloomberg Finance LP. As of August 28, 2023. Data range is Dec 31, 2002 to Aug 28, 20/23, year-end market capitalization weights for each sector as a percentage of the S&P/TSX Composite Index. Note that you cannot invest directly in an index, and past performance is no guarantee of future performance. Other sectors not labelled in the above include Consumer Discretionary (7.5%), Communication Services (4.3%), Consumer Staples (4.3%), Information Technology (3.9%), Utilities (3.7%), Health Care (2.4%) and Real Estate (0.3%) as of Aug 28, 2023.

### Can you participate in the energy transition with exposure to Canadian Energy?

Given the high levels of greenhouse gas emission intensity and absolute emissions associated with Canadian oil production versus global peers, there has been a wave of divestment from international producers and investors alike. Environmental, Social, and Governance (ESG) risks, uncertainty around carbon taxes and the regulatory backdrop warrant a valuation discount vs. less carbon intensive US production. Despite this, **we believe that investors can participate in the energy transition with exposure to Canadian Energy.** We believe that Canada’s Oil & Gas industry can play a critical role in energy transition over the coming decade(s) despite a less enthusiastic view from the market.

Interestingly, when reviewing aggregated ESG scores across several countries, Canadian oil may be considered as the preferred barrel globally (Chart 2).

Chart 2. Canadian Oil & Gas Scores Highest on ESG Measures



Source: Pathways Alliance. ESG Scores – aggregation using an equal weighting (1/3) for each of Yale Environmental Performance Index (2022 EPI Results), Social Progress Index (2022) and World Bank Governance Index (2021, most recent available year). Reserves – EIA, where US reserves are 2020 due to data availability; all other reserves are 2021.

**According to Morgan Stanley & Co. LLC (“Morgan Stanley”) research, Canada is taking a proactive approach to emissions reductions and clean energies investment.** While the current regulatory backdrop presents some headwinds to industry cashflows (e.g., carbon taxes), the collaborative approach between industry and the government has setup a supportive framework and platform to scale new energies businesses, which we view as a competitive advantage versus US peers. Growth investments in new energies businesses are in the early stages for most, but supportive policy could allow them to scale more rapidly (and economically) than expected.

**Canadian energy producers offer a free call option on oil sands “Growth ESG” investments:** Other sectors such as US petrochemicals, utilities and automobiles have seen industry-wide valuation compressions on negative environmental perception, while failing to price in new green investments that had the potential to expand addressable markets. We believe there is a similar story developing in Canadian energy and distill these into two strategies.

- 1) **‘Maintenance ESG’:** Focusing on reducing carbon intensity of existing oil & gas operations. This is necessary to defend margins in a lower carbon future, but in isolation it leaves the business exposed to a shrinking total addressable market (TAM) over time.
- 2) **‘Growth ESG’:** TAM-expanding investments in new energies that offer exposure to new markets in a lower carbon future.

## Carbon Capture and Storage (CCS) projects are expected to help Canada achieve its net zero goals to reduce GHG emissions by 2050.

According to the Pathways Alliance (which consists of Canada's six largest oil sands producers), CCS is a proven, reliable, and safe process that's been used around the world for more than 45 years to mitigate environmental impacts by reducing carbon dioxide ("CO<sub>2</sub>") emissions from fuel combustion or industrial processes. CCS technologies capture CO<sub>2</sub> from a facility before it is released into the atmosphere and transport it by pipeline (primarily following existing rights of way) to a secure location, where it can be safely stored underground in deep geological formations. These formations are typically between one to two kilometers beneath the Earth's surface.

Since 2000, CCS projects in Canada have safely stored more than 47 million tonnes of CO<sub>2</sub>, the equivalent of taking more than 10 million cars off the road. Dozens of projects are currently underway across Canada to utilize CCS technology, however the largest project underway is the 'Foundational Project' by the Pathways Alliance in Alberta. The Pathways Alliance is also working on more than 80 technologies that could potentially be deployed to help further reduce emissions via direct air capture technology, renewable power, clean-burning hydrogen fuel in oil sands operations, and electrification of mining trucks to move materials more efficiently and reduce emissions, to name a few.

## Natural Gas part of the NZE transition plan as well

Though this report primarily focuses on the oil industry, according to the Conference Board of Canada, natural gas is cleaner and cheaper to make than other fossil fuels and is now increasingly sought after to replace coal-generated electricity around the world. Natural gas is also a non-intermittent energy source and is being touted as more reliable than current renewable energy alternatives.

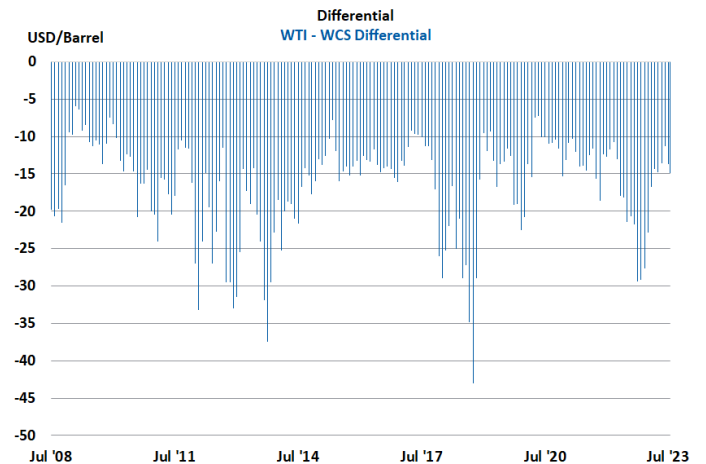
The US Energy Information Administration (EIA) projects that global natural gas consumption will increase by more than 30% between now and 2050. The strongest growth will come from non-OECD countries, notably China and India. In addition to the increased use of natural gases as an input to power generation, new demand will come from industrial uses, such as chemical and primary metals manufacturing. Since Canada is one of the world's largest natural gas producers with over 200 years of reserves at current production levels, it is likely to pose as an appealing trading partner to many countries in Asia and Europe over the long-term.

## The Trans Mountain Pipeline extension project – increasingly throughput for oil sands producers

For Canadian oil producers, the ability to meet American demand for crude has historically been a large driver of profitability. Lack of market access and low egress capacity relative to production has

caused WTI-WCS (West Texas Intermediate minus Western Canadian Select price per barrel) price differentials to expand in the past and drive down Canadian energy producer returns (Chart 3).

## Chart 3. WTI-WCS price differentials per barrel in US Dollars (July 2008 to July 2023)



Source: Bloomberg Finance LP as of August 2023

WCS crude oil differentials this year have ranged from \$10 to \$28 per barrel ("bbl") below the price of US benchmark WTI crude oil, with recent discounts in the \$14-\$16/bbl range.

According to Morgan Stanley research, with Trans Mountain coming online and limited supply growth from Canadian producers, investors can expect relatively narrow and stable differentials with minimal egress congestion in the medium term. The improved outlook for price realizations should strengthen the relative valuation for Canadian vs. US peers, discussed below.

The Trans Mountain project aims to increase pipeline capacity from 300,000 barrels per day ("b/d") to 890,000 b/d and provide access to Pacific Coast shipping terminals in British Columbia. It is projected to be operational by the end of 2023. According to IEA's August, 2023 Oil Market Report, as startup procedures progress, the pipeline will require about 50,000 b/d of heavy sour crude in the fourth quarter of 2023. This will contribute to the demand for North American heavy sour crude which comes from the oil sands in Alberta/Saskatchewan. Once the pipeline begins commercial operations next year, the new access to Pacific Coast markets should allow Canadian oil to be shipped to Asia, potentially removing an additional 500,000 b/d of heavy sour crude from the North American market.

It remains to be seen how Canadian shippers direct heavy crude based on proposed tolls for the pipeline. Lower tolls from competing Enbridge Inc., may persuade shippers from moving crude to the Coast for Asian destinations.

**Overall, we believe that equity markets are not affording Canadian energy producers with any potential market share**

benefits from 'Growth ESG', giving investors a free call option on potential growth in new energies businesses. Longer-term we believe that these 'Growth ESG' investments have the potential to drive multiple expansion within the group. And in the near-term, narrowing WTI-WCS differentials may help to drive relative valuation between Canadian and US producers.

In Table 1 below we provide a summary comparison between the Canadian and US Energy sectors for publicly available companies listed on the S&P/TSX Composite Index, and the S&P500 Index respectively.

Energy Sector Fundamentals, Valuation relative to history/US peers and versus the overall Canadian market are attractive.

Table 1. Comparing Canadian and US Energy Sectors vs Index (Valuation, Cash Flow, and Debt)

| S&P/TSX Energy        | Aug-23 | Dec-22 | 10-yr Median | Aug-23 S&P/TSX |
|-----------------------|--------|--------|--------------|----------------|
| Beta (5yr vs S&P/TSX) | 1.32   | 1.39   | 1.39         | 1.00           |
| Price-to-earnings     | 10.5x  | 9.5x   | 17.8x        | 14.1x          |
| EV/EBITDA             | 6.7x   | 5.8x   | 9.2x         | 9.4x           |
| Price-to-FCF          | 11.8x  | 9.6x   | 10.7x        | 19.1x          |
| Dividend Yield        | 5.6%   | 5.1%   | 4.4%         | 3.8%           |
| Dividend Coverage     | 1.5x   | 2.3x   | 1.5x         | 2.1x           |
| FCF Yield             | 8.4%   | 10.4%  | 3.3%         | 5.2%           |
| FCF/EV                | 6.2%   | 7.7%   | 1.9%         | 5.2%           |
| Net Debt/Capital      | 39.5%  | 39.7%  | 39.5%        | 16.4%          |
| Net Debt/EBITDA       | 2.1x   | 1.8x   | 3.3x         | 2.8x           |

| S&P500 Energy        | Aug-23 | Dec-22 | 10-yr Median | Aug-23 S&P500 |
|----------------------|--------|--------|--------------|---------------|
| Beta (5yr vs S&P500) | 1.08   | 1.09   | 1.09         | 1.00          |
| Price-to-earnings    | 21.9x  | 30.9x  | 21.9x        | 20.5x         |
| EV/EBITDA            | 14.1x  | 17.6x  | 14.4x        | 14.1x         |
| Price-to-FCF         | 111.0x | 93.2x  | 99.0x        | 27.7x         |
| Dividend Yield       | 1.5%   | 1.5%   | 1.5%         | 1.5%          |
| Dividend Coverage    | 3.2x   | 2.8x   | 2.9x         | 3.0x          |
| FCF Yield            | 0.9%   | 1.1%   | 1.0%         | 4.5%          |
| FCF/EV               | 0.8%   | 1.0%   | 1.0%         | 3.7%          |
| Net Debt/Capital     | 29.1%  | 27.5%  | 24.5%        | 27.5%         |
| Net Debt/EBITDA      | 5.3x   | 5.2x   | 4.6x         | 1.4x          |

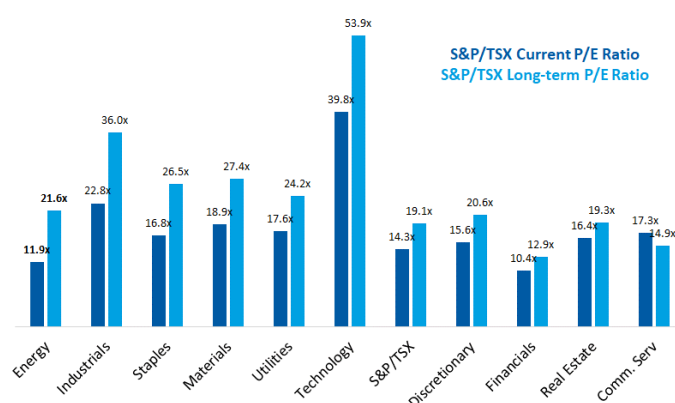
Source: Bloomberg Finance LP as of August 14, 2023.

Takeaways from Table 1:

- **Both dividend yield (5.6%) and free cash flow yield (8.4%) for Canadian energy is about two and a half times the level provided by US peers (1.5%),** and much higher than the overall Canadian equity market (3.8%). Dividend coverage remains healthy in our view, providing income investors with potential dividend growth over time.
- **High free cash flow yields in the sector** should translate into shorter return of capital on investment timeframes which lessens duration risk associated with the NZE transition period.
- **Current leverage ratios (debt) for the sector are in line with historic averages,** but Canadian energy companies are less leveraged relative to operational earnings than US peers (net debt/EBITDA 2.1x vs 5.3x for US energy).
- **Canada's energy sector is currently trading at a discount to 10-year historical measures and US Peers across most valuation measures,** except for price-to-cash flow. As mentioned previously, narrowing of WTI-WCS differentials as Trans Mountain Pipeline comes online, might be a catalyst for some valuation re-rating vs US peers.

Canada's energy sector has the potential to offset the risks associated with a turbulent transition to NZE by providing a secure and increasingly cleaner source of energy to trading partners. Despite this, Canadian Energy companies are still trading at the widest discount to their long-term average (11.9x vs. long-term average of 21.6x) when compared to other sectors in Canada, as shown in Chart 4.

Chart 4. S&P/TSX Composite Index Sectors: Current and Long-Term Price-to-Earnings (P/E) Ratio



Source: Bloomberg Finance LP, as of August 14, 2023. Long-term P/E ratio defined as the last price as of Aug 14, 2023. S&P/TSX Health Care excluded from the above given limited data to measure Long-term P/E.

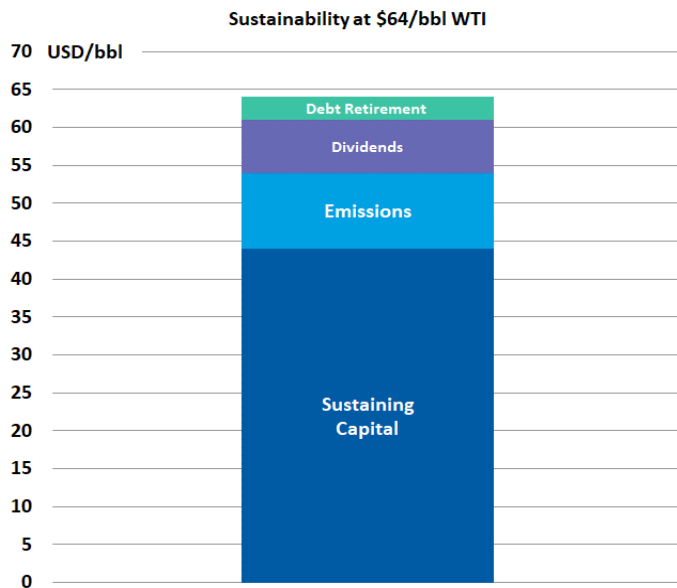


**Canada should trade at a discount to the US, but we see room for some re-rating.** Today, the relative valuation discount on Canadian energy companies versus their US peers is warranted given the higher carbon intensity of Canadian production. However, a look into the future shows that there is opportunity for a narrowing of this metric over time as Canada continues its proactive approach to emission reduction and new investment into emerging CCS technology. Canadian vs. US valuation differences are also linked to WTI-WCS differentials and Canadian pipeline access, which has been lacking and may narrow as discussed previously.

### Canadian producers don't need high oil prices to achieve sustainability

An important question for investors is: - What price of oil do the Canadian producers need to be sustainable, in terms of sustaining capital (i.e., maintenance), to meet all their NZE targets in Canada, to pay shareholder dividends and to retire their outstanding debt? As it turns out, the average Canadian producer requires the price of WTI to be around US\$64/bbl over the coming decade to be sustainable (chart 5).

Chart 5. The WTI price per barrel where the average Canadian producer is sustainable



Source: RBC Global Asset Management Inc. as of April 25, 2023

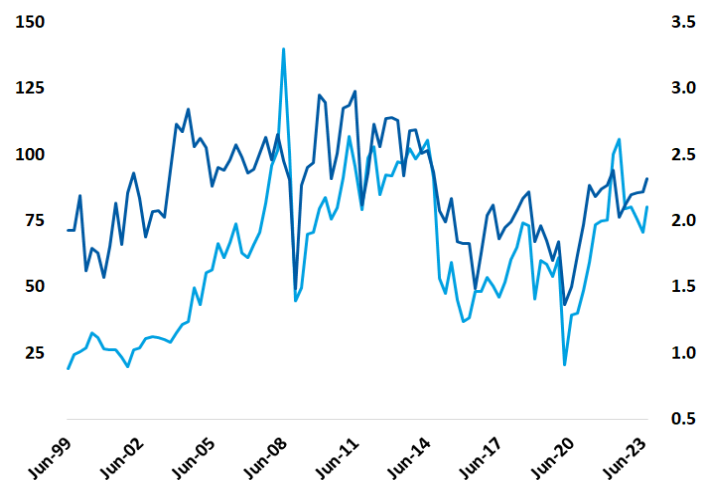
**The downside risk for the Canadian energy sector seems reasonable - considering our view that oil demand will exceed supply over the coming decade, all else being equal.** That said, the demand for oil is not without risk – in the near-term, investors fear that China’s growth will disappoint, potentially pressuring oil forecasts lower. Over the medium-term, concerns of a global recession persist, presenting a possible scenario in which the demand for oil and energy would certainly decline if global growth

were to decline for some period. On the supply side of oil, Iran is expanding oil production to take advantage of production cuts by Russia and Gulf states. Russian production cuts planned for 4Q23 could impact the Global West by raising inflationary concerns while simultaneously increasing State revenues, should the price per barrel increase as a result, according to BCA Research Inc. Saudi Arabia announced unilateral production cuts in July 2023 but left the door open to extending these – likely based on the cadence of Chinese demand, slowing global purchasing managers’ index and Russian production, leaving China as the primary demand influence on oil.

### Exposure to Oil/Energy May Provide an Inflationary Hedge

Investments in the energy sector may offer a hedge to inflation when considering the relationship between WTI spot prices and inflation expectations denoted by 5 year/5 year forward inflation breakeven rates (chart 6). We use the US price of oil (WTI) to proxy Canadian energy prices (WCS) knowing there has been a price differential in the past and the US breakeven inflation expectations to proxy Canadian inflation expectations given limited real-time data in similar Canadian instruments.

Chart 6. WTI (USD/barrel) versus US Inflation Expectation (1999-2023)



Source: Bloomberg Finance LP as of August 28, 2023. Quarterly data from June 1999 to August 2023, in USD. Past performance is not an indication of future performance, and you cannot invest directly in an index. 5yr/5yr forward breakeven rates are a measure of expected inflation (on average) over the five-year period that begins five years from today.

While we expect Canadian inflation to eventually return to the Bank of Canada’s (BoC) target of 1-3% over the next year, the potential for inflation protection with exposure to Canadian energy offers investors incremental diversification over the long-term. This potential inflation hedge may be needed under a scenario where interest rates are higher for longer should inflation persist above the BoC target. While the relationship in Chart 6 may not hold over shorter periods of time, we believe it persists through the cycle as higher commodity prices tend to result in higher inflation expectations.

## Portfolio Strategy: Consider exposure to Canadian Energy from a portfolio perspective

Over the last twenty years the Canadian Energy sector has performed well relative to other asset classes from a total return perspective (i.e., including dividends and capital appreciation). Since 2000, total calendar year returns for the S&P/TSX Energy Sector have ranged from a low of -19.8% in 2018, to a high of 63.0% in 2005, measured in Canadian dollars, owing a significant portion of total returns to the sector's dividend yield component. The Canadian Energy sector has also provided a degree of total return diversification to US, Canadian and Global Equities. Relative to bonds, the Canadian Energy sector displayed a negative correlation to Canadian and Global bonds through a cycle suggesting that exposure to the sector has provided some diversification benefits to investors. This coincides with the relationship displayed in Chart 6 above.

We would note however, that diversification benefits have shifted between the Canadian Energy sector and various asset classes (Chart 7). For instance, during the two most recent bear markets (COVID: February 2020 to January 2021, and the Financial Crisis: September 2008 to March 2009), the Canadian Energy Sector had a positive correlation to cash and bonds, and a negative correlation to non-domestic equity indices.

### Chart 7. Correlation Coefficient: S&P/TSX Energy Sector and Different Asset Classes

| Correlation Coefficient with Canadian Energy | Previous 5 years | Equity Bear Markets | Equity Bull Markets  | Oil Bear Markets     | Oil Bull Markets | Rising Rates / Rising Inflation |
|--|------------------|---------------------|----------------------|----------------------|------------------|---------------------------------|
| <b>Cash</b>                                  | <b>Negative</b>  | Positive            | <b>Negative</b>      | Positive             | Positive         | <b>Negative</b>                 |
| <b>Fixed Income</b>                          | <b>Negative</b>  | Positive            | <b>Negative</b>      | Positive             | Positive         | <b>Negative</b>                 |
| <b>Canadian Equities</b>                     | Positive         | Positive            | Positive             | Positive             | Positive         | Positive                        |
| <b>US Equities</b>                           | Positive         | <b>Negative</b>     | Positive             | Neutral              | Neutral          | Positive                        |
| <b>Global Equities</b>                       | Positive         | <b>Negative</b>     | Positive             | <b>Negative</b>      | <b>Negative</b>  | Positive                        |
| <b>Gold</b>                                  | Neutral          | Neutral             | Neutral/<br>Positive | Neutral/<br>Positive | <b>Negative</b>  | Neutral                         |
| <b>Canadian Real Estate</b>                  | Positive         | Positive            | Positive             | Positive             | Positive         | Positive                        |

Source: Bloomberg Finance LP. Data range referenced is daily gross returns in local currency between Jan 1, 2000, and Aug 14, 2023. You cannot invest directly in an index; past performance is no indication of future performance. Notes: Correlation coefficient is measured on a scale that varies from +1 through 0 to -1 and it is metric that measures the strength and direction of a relationship between two securities or variables. It can be used to identify non-correlated securities, which is important in developing a diversified portfolio. The Correlation Coefficient is positive when both securities move in the same direction (up or down) and negative when the two securities move in opposite directions. Neutral denotes neither positive nor negative correlation. Previous 5 years (Aug 2018-Aug 2023), Equity Bear Markets (Sept 2008-Mar 2009, Feb 2020 – Jan 2021), Equity Bull Markets (March 2004-July 2007, Jan 2009-Feb 2020, Feb 2020-June 2020, Jan 2021-April 2021), Oil Bear Markets (May 2010-June 2010, July 2014-May 2015, June 2022-Mar 2023), Oil Bull Markets (Feb 2016-Oct 2018), Rising Rates / Rising Inflation (Mar 2022-Aug 2023, Dec 2016-July 2019, June 2021-Aug 2023). Proxy Indices referenced: Cash (FTSE Canada 91-day T-Bill Index), Canadian Bonds (Bloomberg Canadian Aggregate Bond Index), Global Bonds (Bloomberg Global Aggregate Bond Index), Global HY Bonds (Bloomberg Global High Yield Bond Index), Canadian Equities (S&P/TSX Composite Index), US Equities (S&P500 Index), EAFE Equities (MSCI EAFE Index), Emerging Market Equities (MSCI Emerging Markets Index), Gold (Bloomberg Gold Index), and Canadian Real Estate (S&P/TSX REIT Index).

One of the takeaways from Chart 7 is that since correlations and underlying returns shift across market cycles, being diversified always is important. Investors need to consider their overall portfolio goals/objectives, risk tolerance, risk capacity, liquidity needs and unique circumstances when deciding on the amount of exposure they may need in any given asset class, region, sector, and currency.

Investors should consider their existing exposure to Canadian active/passive strategies before considering additional exposure to Canadian Energy. Please reach out to your Morgan Stanley 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.