Morgan Stanley

WEALTH MANAGEMENT CANADA

INVESTMENT STRATEGY

Canadian Market Insights | July 11, 2023

Compelling Opportunities in Canadian Equities

Stu Morrow, CFA

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

Executive Summary

- **Canada has had a similar, but delayed, post-COVID recovery compared to the US, leading it to outperform its neighbour to the south in 2022**. Higher commodity prices also helped support trade and energy capital expenditures. In 2023, however, Canada's growth has slowed alongside the US. Its households are constrained by lower home prices and higher debt-servicing costs, but personal income from a still-tight labour market has helped to put a floor under spending. Looking ahead to 2024, less restrictive monetary policy may stabilize housing activity and support consumption and business investment, pushing growth above potential.
- **The lagged effect from 450 basis points of rate hikes, and counting, should lead to slower growth later in 2023 and into 2024**, leading us to build on a base case of no recession, but our non-zero probability bear case has us on watch. Markets have discounted this soft-landing scenario for the Canadian economy in 2023-2024 through a higher equity risk premium.
- **The Canadian economy is especially sensitive to the interest rate cycle, as household and government leverage has increased over the last decade**. Balance sheet constraints for both households and governments will mean less macro flexibility throughout the economic cycle.
- **Long-term growth opportunities owing to investments in infrastructure, energy transition and technology may offer domestic opportunities for Canadian investors**. All of this, in part, is due to a robust US capital expenditure cycle that we expect in the coming decade(s).
- **The Canadian Equity Risk Premium (ERP) is currently twice the US ERP**. This wide dispersion between Canada and the US has only occurred 6.3% of the time since 2000.
- The current low US equity risk premium and an extended period of outperformance versus the MSCI World ex-USA Index urge a degree of caution on being overly concentrated in US equities.
- **Morgan Stanley Wealth Management’s Global Investment Committee (GIC) currently favours greater exposures to developed Asia-Pacific equities, including Japan; emerging market equities; and fixed income and underweight exposures to US equities**, particularly the potentially overextended growth style. The GIC has placed underweight exposures to commodities and real estate/REITs but overweight to hedged strategies, compared to its blended benchmarks.

Macroeconomic Overview: Expecting a Soft Landing, While Acknowledging Downside Risks

Recession risk in Canada over the next two years remains a non-zero probability on the back of continued monetary policy tightening, which likely suppresses economic activity through slower consumption and non-residential business investment. Households remain constrained by higher debt-serving costs, but personal income remains supported by a tight labour market, putting a floor under spending. Looking at the adjacent Table 1, we provide a summary of Morgan Stanley & Co.'s (MS & Co.) Canadian economic forecast across several factors.

Table 1. Canadian Economic, Oil and USD/CAD Forecast Summary (2021-2024E)

Canada: Forecast Summary (base case)	2021	2022	2023E	2024E
Real GDP (%Y)	4.5	3.4	0.9	1.7
Private Consumption	2.8	3.3	0.9	0.9
Government Consumption	1.3	0.4	0.4	0.3
Gross Fixed Investment	1.5	-0.3	-0.4	0.2
Unemp. Rate (eop, % labour force)	7.5	5.3	5.7	6.2
CPI (%Y)	3.4	6.8	3.5	2.0
Core CPI (%Y)	2.4	5.0	3.6	2.2
Policy Rate (eop, %)	0.25	4.25	5.00	4.00
General Govt. Balance (% GDP)	-4.4	-0.7	-0.4	-0.4
Gross Govt. Debt (% GDP)	115.1	106.6	105.1	102.2
Brent Oil (eop, US$/bbl)	79.32	85.91	75.00	85.00
USD/CAD (eop)	1.27	1.36	1.38	1.31

Sources: Morgan Stanley & Co., Statistics Canada, Bank of Canada as of June 14, 2023. "E" denotes an MS & Co. forecast.

Consumer spending – held back by high debt levels, rising home prices

Consumer spending will likely slow in second half of 2023, as the effects of monetary tightening continue to work their way through the economy. Given that Canadian household debt sits at ~165% relative to disposable income as of June 2023—roughly 1.5x the level of US households—we expect that this debt overhang may weigh on household spending, as consumers may need to factor in the effects of higher prevailing interest rates. Some Canadian households are more interest rate sensitive than others. One-third of Canadians who hold a residential mortgage hold variable-rate mortgages, well above the US level of just 3%. Rising home prices over the last 10-plus years has translated into an absolute increase in debt on Canadian household balance sheets.

Residential investment as a percentage of GDP is approximately 10% in Canada, compared to just 4% in the US. Higher lending rates and rising consumer debt levels will likely result in residential investment being the greatest drag on GDP growth over the remainder of 2023, before bouncing back to a near-zero contributor in 2024 as demand for housing remains high, and participants react to fewer rate increases as we reach peak policy. That outcome may occur amid some monetary accommodation from the Bank of Canada (BoC) and a slow trickle of housing supply. Builders continue to face elevated costs related to permitting, zoning, material, and labour costs, along with skilled labour shortages.

Despite the challenges posted by higher debt-servicing costs, we expect excess savings and healthy growth in labour income will provide a cushion for Canadian households, meaning that consumption will likely slow but not collapse this year. MS & Co. expects that Canada's population growth, fueled by net-immigration, may provide a boost to aggregate consumption spending. The government will likely increase its permanent resident targets in its 2023-2025 Immigration Levels Plan, welcoming 465,000 new permanent residents in 2023, 485,000 in 2024 and 500,000 in 2025. Over the longer term, greater immigration will help offset increased retirements and fill job vacancies.

Housing affordability continues to be challenged in Canada, although most recently the Housing Affordability Index has shown marginal improvement. Canada likely requires additional supply of housing and lower interest rates to ensure that affordable and available housing exists to support the expected growth in immigration. While we see structural challenges in the medium term, including supply and demand imbalances, the near-term outlook seems to have stabilized. Housing activity is picking up, which the BoC cited as a contributing factor to its decision to raise rates on June 7, while Canadian households appear capable of handling higher borrowing costs for now.

In terms of mortgage default risk, most Canadian banks have been working closely with borrowers to address the impact of higher rates. In some instances, borrowers face 20-40% increases in mortgage payments by extending amortization periods. We continue to monitor Canadian banks' residential mortgage exposures and, by extension, banks' earnings sensitivity. Keep in mind that more than 40% of Canadian households do not have a mortgage on their primary residence and that, to some extent, labour market tightness is counterbalancing the negative shock of higher interest rates.

In Table 2, we provide a brief snapshot of the MS & Co. base case forecasts for Canada over 2023-2024, along with the potential downside (bear case) and potential upside (bull case).

Table 2. MS & Co.'s Canadian Macroeconomic Scenario Analysis

2023-24 Canadian Macroeconomic Scenarios	Base Case	Bear Case	Bull 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	Recession 3Q/4Q23 driven by worse-than-expected slowdown and high levels of household debt and corporate balance sheets	Above potential in 2024 driven by consumption and residential investment sooner than expected
Inflation	Headline falls for 2023 on lower/stable commodity prices, falls back to 2.9% by late 2023 and 2.0% by 4Q24. Labour market slack leads to wage disinflation	Inflation falls faster than expected in the recessionary scenario; stagflationary scenario isn't our base case but also a non-zero probability	Relief from supply chains drives goods disinflation, core services less sticky than expected
Labour Market	Unemployment rate rises given softer labour demand and rising immigration lifts the labour force participation factor	Unemployment rises as with the base case, but softer demand due to recession means a higher unemployment rate	Unemployment rate rises as under the base case, labour productivity improves from a low base in 2023
Policy Rate	BoC policy rate to peak at 5.00%, then remain on hold until the end of 2023. After which BoC assesses inflationary pressures/slowing demand	BoC not satisfied that core inflation measures are declining fast enough, or inflation may be rising which forces the policy rate to stay elevated for longer-than-expected	Inflation easing sooner than expected which allows BoC to cut rates by end of 2023

Source: Morgan Stanley & Co., as of June 14, 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 terms of inflation, as it remains top of mind for investors**, some recent deceleration in three-month seasonally adjusted annualized trimmed and median CPI measures suggest the path to bringing inflation back to target may be a bumpy one. We continue to expect that by the end of 2024, core Canadian inflation will be within the BoC's target 2.0% range.

- **In the bear case**, high debt levels on household and corporate balance sheets coupled with a worse-than-expected slowdown pose downside risks, leading to an economic slowdown that may push Canada into recession. However, a sharp slowdown could mean that inflation falls faster than expected, and the BoC is forced to end its quantitative tightening (QT) program and cut rates more aggressively in 2024 to lift economic activity. In this scenario, current labour market tightness may help to partially counterbalance the negative shock of higher interest rates on Canadian households' increased debt-service payments.

- **In the bull case**, goods inflation eases more quickly from relief in supply chain pressures, while core services inflation proves to be less sticky than expected, allowing the BoC to start normalizing policy (starting in 4Q2023) and deliver 225 basis points of cuts through 4Q2024. Growth returns above potential in 2024, as consumption remains resilient, and residential investment rebounds sooner than expected.

Canada Should Benefit from a US Capital Spending Supercycle

Canada and the US share one of the largest trading relationships in the world, with nearly $1.3 trillion in bilateral trade in goods and services in 2022, making Canada the US's largest trading partner in goods and services. Canada-US trade is built on long-standing binational supply chains, where roughly 80% of Canadian goods exports to the US are incorporated into US supply chains, according to the Government of Canada.

Earlier this year, Morgan Stanley Wealth Management published a special report titled "The Next American Productivity Renaissance." Following the Great Financial Crisis, Canada, and the US experienced 13 years of secular stagnation. Suddenly, COVID provided a once-in-a-generation productivity shock, transforming the nature of work and accelerating structural changes, demanding new capital investment in the US.

Given Canada's close ties with the US, we believe that is reasonable to assume Canada's economy and financial markets will benefit from this expected American productivity renaissance.

Five major transformational demand drivers will likely power this US capital spending supercycle:

1. Digital disruption and scaled automation of services businesses
2. Structural labour market detachment and the need to substitute capital for labour.
3. Advancing deglobalization and infrastructure spending
4. Accelerating decarbonization and the embrace of a hybrid energy sustainability model
5. Geopolitical adjustments leading to a new world order

Though Canada's total public funds available for green energy initiatives are fractions of those involved in the US Inflation Reduction Act (US IRA), they are also supplemented by growing private sector investments in Canada and Federally supported investment programs, such as:

- **The Strategic Innovation Fund (SIF)**: Funding for large innovation projects across all industries with research and development support. Funded through an annual statutory transfer with an initial budget up to $18 billion.
- **Net Zero Accelerator (NZA) initiative:** Up to $8 billion in funding to support large-scale investments in key industrial sectors across the country to ensure Canada remains competitive in a net-zero economy and reduces greenhouse gas (GHG) emissions.
- **The Canada Growth Fund (CGF):** Up to $15 billion in funding, the CGF will help Canada keep pace with a growing list of jurisdictions that are using innovative public funding tools to attract the private capital required to accelerate the deployment of decarbonizing technologies and stimulate economic growth.
- **Canadian Infrastructure Bank (CIB):** Up to $35 billion in projects, invests in revenue-generating infrastructure, which benefits Canadians and attracts private capital.

Long-Term Opportunities and Risks for Canada

Longer term, Canada needs to accelerate business investment and Research and Development (R&D) spending. For most of the current century, Canadian investment hinged on the demands of the resource sector. After broad commodity prices peaked around 2014, capital investment in Canada experienced a significant decline. Despite some high-profile announcements of foreign investment into Canada's automotive, energy and mining sectors and generous Federal subsidies that followed the passage of the US IRA, Canada remains behind other developed economies in gross domestic spending on R&D. Based on the OECD's latest figures, Canada spent just 1.6% of GDP on R&D in 2022, below the OECD average of 2.7% and the US's 3.5%.

Consumption growth will slow as the population ages, slowing from an average annual growth rate of 2.9% from 2000 to 2020, to below 2.0%, as aggregate consumption shifts to healthcare and leisure sectors. These developments will have implications for government revenues, especially during the workforce-to-retirement transition.

Immigration inflows will eventually decelerate in the next five to seven years, after advancing close to 2.0% annually in the 2020s, from approximately 1.0% annually from 1998-2002. Provided that Canada develops a viable comprehensive housing affordability plan, growth in household formation during the 2020s may offset some of the impact of an aging population on the housing sector, while easing labour market constraints.

Public and private debt may constrain spending. This is especially true under a higher-for-longer interest rate scenario. Though fiscal tax policy must remain competitive on a global scale, we cannot rule out shifts in marginal tax brackets over the longer term.

Shifts to alternative energy sources have negatively impacted the Oil & Gas sector, with investments declining by 20-30% over the last few years, still below 2019 levels of capital expenditures. Canada has strived for a balanced approach between promoting resource development and strengthening environmental performance, including a pledge to reduce CO2 emissions 40% below 2005 levels by 2030 and to achieve net-zero emissions by 2050. Canada's oil sector has faced challenges, with insufficient pipeline capacity to reach consumers and growing opposition to pipelines on environmental grounds. Going forward, as Canada continues its decarbonization efforts, coupled with the uncertainty around the long-term profitability of oil and gas investments, the business investment response to elevated commodity prices may deviate from previous patterns.

Non-energy mining sectors will likely continue to grow, including projects in Saskatchewan (potash) and mineral mining throughout Canada, driven by a rising demand for copper and rare-earth minerals to support the global push towards electric vehicles (EVs). Along with these EV mining opportunities, the transportation sector requires some public, but mostly private, infrastructure investments to support the electrification of the transportation sector.

Canada needs to diversify its trading partners. While close US/Canadian ties have benefited Canadian exporters for decades, Canada could reduce its overall economic dependence on the US by diversifying its trading partners.

Canadian Equities: Compelling Valuations and Long-Term Upside Potential from the US Capital Spending Supercycle

While having broadened their international exposure in recent years, Canadian investors retain significant domestic exposure within their investment portfolios. According to the Investor Economics Household Balance Sheet Report 2022, Canadian investors held close to half of their portfolios in Canadian money market, mortgages, bonds, and equity-like investment funds. When factoring in principal residences, pension plans and bank deposits, the proportion of Canada exposure at the household level is even more significant.

On top of concentration risk, Canada-dominated portfolios forego a variety of international opportunities, given that Canadian bond and equity markets only make up about 3% of global assets. Relative to global equity indices, Canada concentration may lead to overexposure to certain sectors (likely Financials, Energy and Materials) and underexposure to others (Information Technology and Health Care).

A Rare Valuation Opportunity

Year-to-date, last year's laggards became this year's leaders. So far in 2023, Canadian equities have underperformed US and global equities in US dollar terms. Investors' preferences for the growth style and momentum-based investing have reversed 2022's relative performance trends, where commodities and Canadian equities outperformed global and US equities. 2022's sector leader, energy, has been the worst-performing sector in the S&P/TSX Composite year-to-date. Slowing economic indicators in the developed markets and a softer-than-expected rebound in China's economy put a dent in crude oil demand estimates amid tight supplies. Meanwhile, Canada's financial sector has reported slowing growth. Financial conditions have tightened, while the cost of deposits is rising alongside loan-loss provisions and expense growth, as banks offer higher compensation to retain and attract personnel.

As a result of weaker commodity prices and headwinds in the banking sector, analysts have lowered their 2023 earnings growth forecasts for the S&P/TSX Composite by 4.8% since the start of the year driven by negative revisions for Materials, Energy, REITs, Consumer Staples, and Financials, as shown in Table 3.

Table 3. S&P/TSX Composite Index: Earnings Growth and Earnings Revision Trends

S&P/TSX Composite (earnings growth, revisions)	2022	2023E	2024E
Full Year EPS Estimate	$1,569	$1,454	$1,605
Year over year change (%)	27.9%	-7.3%	10.4%
Year-to-date Revisions (%)		2023E	2024E
S&P/TSX Composite		-4.8%	-2.3%
S&P/TSX Energy		-12.0%	-3.8%
S&P/TSX Materials		-3.0%	2.6%
S&P/TSX REITs		-9.6%	-4.9%
S&P/TSX Financials		-5.7%	-5.3%
S&P/TSX Consumer Staples		-4.7%	2.2%

Source: Bloomberg as June 15, 2023. "E" denotes Bloomberg Consensus Forecast

Canadian Equities Offer More Risk Compensation Than US Equities

In Chart 1, we show the historical trend for the equity risk premium in both markets, noting the current spread between the two markets. The equity risk premium represents the spread between an equity market's earnings yield and its government bond yield. Typically, analysts determine the earnings yield from the inverse of the forward price-to-earnings (P/E) ratio, providing an estimate of the earnings expected per unit of price. Compared to the US equity market, on equity risk premium alone, Canadian equities offer a fair margin of safety. While Canada's equity risk premium sits above 400 basis points, the US's has fallen below 200 basis points.

We suspect the Canada-US spread reflects:

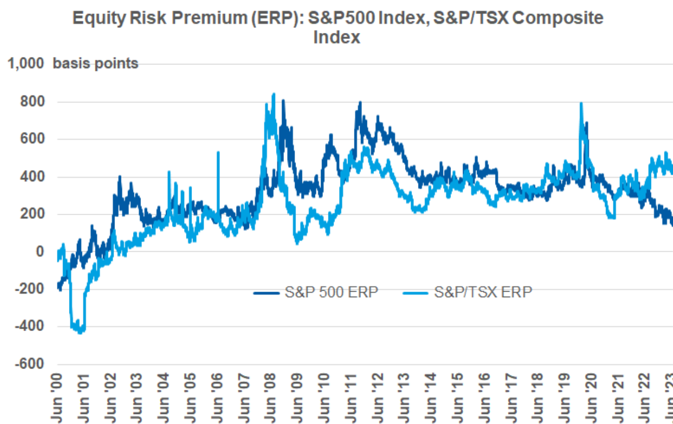
a) Investor preferences for the growth style and the technology sector over financials and commodity-related positioning, reflecting a potential end to interest rate hikes. Commodity price volatility has pressured the valuation and estimates for economically sensitive sectors.

b) Idiosyncratic Canadian economic risk related to the housing market and Canadian bank earnings, especially now as the BoC recently restarted its rate-hiking campaign, tightening financial conditions.

c) Decarbonization efforts, coupled with the uncertainty around the long-term profitability of oil and gas investments.

Please refer to important information, disclosures and qualifications at the end of this material.

Chart 1. Canada vs. US Equity Risk Premium (ERP): Historically Wide Spread Implies a Greater Margin of Safety for Canadian Equities



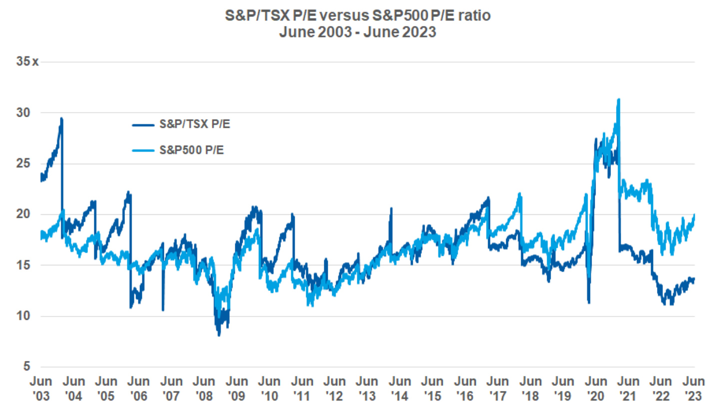
Source: as of June 15, 2023. Equity Risk Premium (ERP) calculation for both S&P500 Index and S&P/TSX Composite Index = Forward Earnings Yield (%) less 10-Year Treasury Yield (%). Past performance is no guarantee of future performance, and you cannot invest directly in an index.

While valuation isn't everything, starting points do matter. Looking back through multiple market cycles, when the Canadian equity risk premiums stood above 400 basis points, Canadian equities generated positive one-year forward returns more than 73% of the time, slightly better odds than the average 12-month period. Indeed, the Canada-US level of ERP divergence has rarely looked this wide over the past 23 years, as shown in Chart 1. The Canada-US ERP divergence has only been above 200 basis points 6.3% of the time over the 23-year history of daily data.

On a P/E basis, Canada shows a material discount to US. We get a similar perspective on Canada's rare valuation benefit by looking at forward P/E ratios for the two countries. Historically, Canada's P/E ratios have typically traded at or even above those in the US. The current discount for Canada likely reflects compositional differences for the indices, particularly Canada's greater weights in Energy and Materials.

At present, Canadian equities trade at historically wide P/E discounts. In fact, the -6.1x P/E discount lies two standard deviations below the long-term average, occurring less than 1% of the time over the 20-year history of daily data (Chart 2).

Chart 2. S&P/TSX Composite vs S&P 500 Index: Historical Forward P/E Ratios



Source: Bloomberg as of June 15, 2023.

A relative easing in financial conditions could provide one catalyst to close this valuation gap. Valuations and financial conditions are closely related, especially given the debt levels for the Canadian government and households. Given our economic base case, policy easing in 2024 could support Canada's P/E ratios.

Moreover, some relative softening in investor enthusiasm for US mega cap technology companies could narrow the valuation discount. Next to Canada, US equities represent the largest holdings for most Canadian investors. The US equity market makes up about 60% of global equity market capitalization, and it is home to some of the most successful companies across different industries.

However, in addition to the valuation spreads mentioned above, Canadian investors may want to consider the following:

Markets tend to move in cycles, and, over the past 15-plus years, US equities (MSCI USA Index) have sizably outperformed the Rest of the World (MSCI World ex-USA).

This period appears as a historical anomaly. There were extended periods in the past where investors were rewarded by holding non-U.S. equities.

Long-term return differences between Canadian and US equities have historically tracked closely with commodity cycles and usually with the strength in the Canadian dollar. We hold a modestly positive outlook on commodities, including gold. Meanwhile, the Canadian dollar may trade more firmly amid a softening picture for the US dollar over the intermediate term.

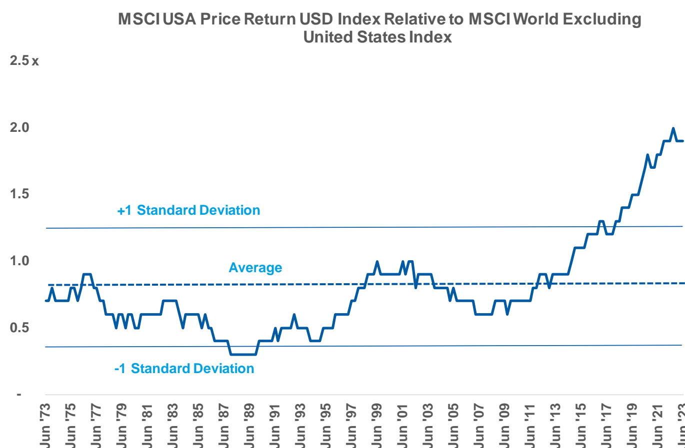
Today, MS & Co. has a less favourable short-term view of US equities, predicated on the negative outlook for earnings growth in 2023, in contrast to consensus expectations. Most asset classes, including the equal-weighted S&P 500, have pointed to a soft landing, accompanied by reduced demand and pricing power—both ingredients for lower earnings. Despite this, the cap-weighted S&P 500, dominated by mega cap tech names, has simultaneously priced in a V-shaped earnings recovery for the next six quarters.

Given the broad deterioration of US leading economic indicators and survey data, we do not find that thesis credible. Rich US valuations combined with high expectations leave plenty of room for disappointment.

US versus Rest of World Equities: Longer-Term Cycle Dynamics May Suggest Reason for Caution

In Chart 3, we look at the long-term picture of US equity performance, compared to Rest of the World equities (RoW). In this chart, instances of a rising line indicate periods of US equity outperformance. Until the Global Financial Crisis (2008), there had been several episodes of US equity outperformance. Since then, however, the US has enjoyed a nearly uninterrupted run of outperformance, bringing the series more than two standard deviations above the long-term average.

Chart 3. U.S. versus Rest of World Equities – extended period of U.S. outperformance



Source: Bloomberg as of June 15, 2023, in local-currency terms. US equities proxy = MSCI USA Index, Rest of World Equities proxy = MSCI World ex-USA Index. Past performance is no guarantee of future performance, and you cannot invest directly in an index.

The US's recent outperformance has developed because of solid fundamental reasons. For instance, key sectors, including Information Technology, Consumer Discretionary and Communication Services, have experienced robust growth in terms of revenue, margin expansion and high free cash flow yields.

From a risk management perspective, however, this period of outperformance may have become overextended on a long-term basis, warranting some degree of caution, should market leadership change.

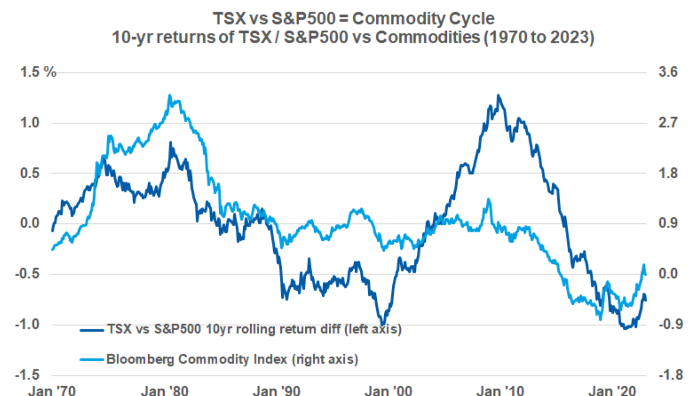
Commodity Cycles Have Driven Canada's Long-Term Performance and Could Support Canadian Equities Here

Looking back over previous cycles, we identified several drivers for Canada-US equity performance differentials. Among commodities, currency and inflation factors, commodities have tended to influence the performance spread most strongly, while USD/CAD changes have proven to be a lagged indicator.

We present in Chart 4 a view of 10-year rolling monthly return differentials between the S&P/TSX Composite and the S&P 500 Index, along with the Bloomberg Commodity Index, going back to 1970. We can see a tight relationship and pronounced period of Canada outperforming the US as the Commodity cycle moves from trough to peak before it busts.

This relationship makes sense, given the heavier weight in commodity-related within the S&P/TSX Composite compared to the S&P500 Index. While a helpful rubric for understanding performance differentials, **investors must wrestle with their conviction on commodities when considering Canada's relative favorability.**

Chart 4. 10-Year Return Differential for the S&P/TSX Composite Index vs. S&P500 Index and Bloomberg Commodity Index



Source: Bloomberg as of May 31, 2023. We represented commodities with the Bloomberg Commodity Index, calculated on an excess return basis and reflecting price movements for commodity futures.

As discussed previously, we believe that the US is about to enter a material capital expenditure cycle, which may benefit the Canadian economy and financial markets. We also have a favourable view of commodities today as a portfolio hedge, given the weaker year-to-date performance of the broad commodity index. Commodities tend to move inversely to the US dollar and real interest rates, which are both higher year-to-date. And within the context of a normalizing inflationary environment, we anticipate a rebound in areas like copper and oil, particularly given secular supply constraints.

Summary Recommendations: Seek Global Diversification but Look to Favorable Outcomes for Canada

Despite Canada's accounting for less than 3% of global equity market capitalization, Canadian investors retain a significant portion of their portfolios in Canadian equities. While Canadian investors should indeed take advantage of global diversification opportunities, we believe there is good reason to be positive on Canadian equities over the near term—and possibly over the coming decade.

Relative to the US equity market, where there are less compelling valuation and earnings arguments, Canadian equities seem to reflect more downside risk to slowing growth, presenting an opportunity for investors with uninvested capital. As identified earlier, given Canada's close ties with the US, we believe that is reasonable to assume Canada's economy and financial markets will benefit from this expected American productivity renaissance.

However, we posit that a "stagflationary" environment presents a material risk to this near-term positive outlook for Canada. Such a setup would likely compel the BoC to maintain higher rates for longer, and or possibly take the policy rate above our forecast. Higher interest rates and rising unemployment would pose downside risks to housing, Canadian banks and S&P/TSX earnings. Under a stagflation scenario, commodities would likewise do poorly and compound earnings declines for the S&P/TSX Composite.

We are not as enthusiastic about US equities today. Solid year-to-date market cap-weighted index performance is obscuring risks around concentration, breadth, and valuation, with exuberance for AI-linked equities exacerbating market fragility. These metrics have reached extremes that have proven to be unsustainable in the past. Not only are a handful of stocks contributing to extended valuations, but expectations for a historic earnings rebound appears baked in, with the consensus implying that a -17% year-over-year profits recession will revert to 27% year-over-year earnings growth by 2024. Narrow breadth and rich valuations are not the stuff of new bull markets; they do, however, offer potential for rebalancing and risk management. Happily, we see quality opportunities across other asset classes, sectors, and regions.

Beyond North American equities, Morgan Stanley Wealth Management currently recommends adding to non-US equity positions in developed Asia, including Japan, and emerging markets. Japan appears to have hit a sweet spot: The momentum of a delayed COVID reopening has coincided with structural changes related to "Abenomics" (Japanese economic policies set out in 2012 by then Prime Minister of Japan, Shinzo Abe, to revive growth and inflation), positive but not unhealthy levels of inflation and shifting geopolitics that have put the country in a unique position vis-à-vis trade and global partnerships. Growth is accelerating on strong domestic demand, and company managements are newly focused on margins, returns on equity and share repurchases.

We recommend emerging markets exposure as a diversifier. While China's incremental stimulus will trail the post-crisis injections that carried global growth, the country's inflation is well-controlled, housing-related debt issues are easing, and the services and consumption sectors continue to recover, providing important opportunities for European and EM trade partners. More broadly, EM equities should benefit as the US dollar weakens, and EM central banks move toward rate cuts. Notably, most EM nations have solidified fiscal balance sheets, becoming healthier than those of developed markets.

Please reach out directly 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.