ARE MARKETS UNDERVALUED? WHERE ARE THE OPPORTUNITIES?

CI ASSANTE PRIVATE CLIENT

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With interest rates likely at or near their peak, the market should move from being priced based on interest rate expectations to a focus on valuations. While certain sectors may be expensive, and future near-term earnings will be impacted by the depth of the recession in Canada, the U.S., and other advanced economies (some data points show the U.S. may actually avoid a recession), we believe that we are in or about to enter a favourable investment environment where investors should earn above average returns, particularly in fixed income (bonds).

Since the end of 2021, it has been a particularly challenging time to be an investor. Inflation proved to be higher and more entrenched than nearly all analysts expected. Central banks have countered high inflation by raising interest rates to a much higher level than ever imagined (remember when most analysts in early 2022 thought rates would peak at around 2%?), and those rates are expected to stay fairly high for a much longer period than initially anticipated. Equity markets reacted by dropping well over 20% before staging a partial recovery in the past year; most bond indices had negative returns in 2021 and 2022, and, so far, a barely positive return in 2023. But out of pain comes opportunity, and we believe long-term investors, particularly those that are income-focused, will be rewarded over the medium to long term (and likely short term) with many asset classes earning outsized returns relative to risk.

RISK PREMIUMS BY ASSET CLASS

Properly functioning capital markets should provide long-term investors with **higher returns for accepting higher levels of risk (volatility).** But, the degree of that higher return or premium varies during different market environments, offering a higher long-term premium when markets are undervalued and some offering a lower long-term premium when overvalued. Generally, GICs and short-term government bonds pay a return that is slightly higher than inflation. Medium- and long-term government bonds should provide a higher return since investors are accepting duration risk (risks associated with holding a longer-dated asset, also called term premium). Investment grade corporate bonds typically offer additional returns of between 1.0%-1.5% over government bonds for accepting credit risk. Equities offer an equity-risk premium, which is a return that is historically 3%-5% higher than government bonds in exchange for equity investors accepting higher risk and volatility. Therefore, when a commentator states that a market is overvalued, it does not necessarily mean that returns will be negative, but that investors generally earn a lower return premium than is typical. **If markets are undervalued, investors should expect to earn a higher return** than the premiums listed above. We believe we are either in or about to enter that type of market, particularly for income-focused investments.

To put this in perspective, we present the following chart and description.

If we assume that inflation will fall to around 2.5% in 2024 and 2025, which is where the Bank of Canada expects inflation to be by the end of 2024 (above the 2% target, but below the high end of the Central Bank's range of 3%), then, based on the traditional return premiums, government bonds should offer a return of around 3%, corporate investment grade bonds should offer all-in yields of 4.0%-4.5%, and high-yield debt should provide a rate of around 6.0%-6.5%. The projected returns of those asset classes today are presented in the center column of the chart. You will notice that current market yields are **significantly** higher.

TODAY'S BOND MARKET IS OFFERING HIGHER RETURN PREMIUMS

Asset class	Historical return premium	Projected return (based on historical risk premium)	Current yields	Excess yield[1]
Inflation	0%	2.5%		
Government of Canada 5-Year Bond	+0.5%	3.0%	4.1%[2]	**+1.1%**
U.S. Government 10-Year Bond	+0.5%	3.25%[3]	4.9%[4]	**+1.6%**
Canadian Investment Grade Corporate Bonds	1.0%- 1.5%	4.25%	6.1%	**+1.8%**
U.S. Investment Grade Corporate Bonds	1.0%-1.5%	4.50%	6.3%[5]	**+1.8%**
High Yield Corporate Bonds	+3%-5%	6.0%-8.0%	9.5%[6]	**+2.5%**

Instead, markets appear to be offering substantially higher potential returns with corporate bonds offering yields of approximately 6% in Canada and over 6% in the U.S., and high-yield bonds are offering yields of over 9%, which is 4.5%-5% higher than government bonds (although a small portion of that premium may be offset by credit losses).

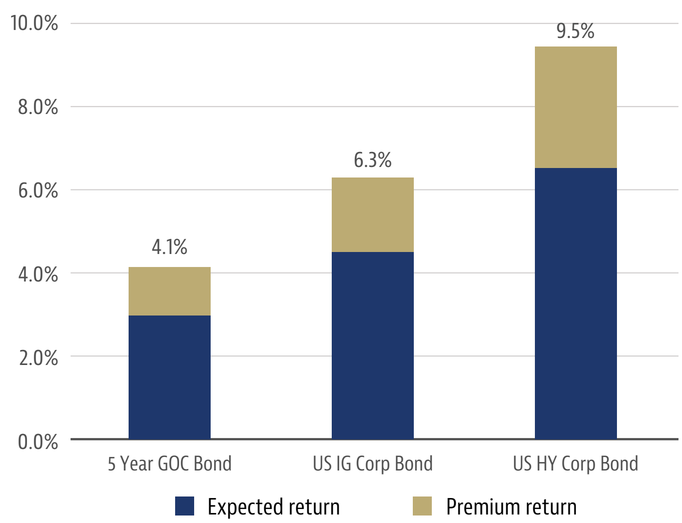
MAIN ADVANTAGES OF INVESTING IN BONDS TODAY

While we would not necessarily call the opportunity in fixed income "once in a lifetime" as some bullish analysts have stated, we believe that, currently, the odds are highly in the investors' favour for the following reasons:

1. **Term premium is extremely high** – The yield on a 5-year or 10-year bond is supposed to reflect interest rate expectations over the entire period to that bond's maturity, i.e., for a 5-year bond, the bond's yield reflects expectations on interest rates from 2024-2028, plus a small premium. This additional return is referred to as the term premium and is generally 0.1%-0.3%. Currently, that premium is over 1.5% for U.S. government bonds. The dot plot from the Federal Reserve, which indicates the average expected interest rate at each period, suggests that rates will average 5.1% in 2024, 4.0% in 2025, 3.2% in 2026 and the long-run expectation is 2.6%, so a 10-year average of just over 3%.[7] Yet, on October 26th, the 10-year U.S. Government bond was yielding 4.85%. That is an extremely high term premium, which bodes well for today's bond investors.

2. **High current yields –** Canadian and U.S. investment grade corporate bonds were offering yields of 6.1% and 6.3%, respectively, and high yield bonds were offering yields of 9.5% as at October 26, 2023. Considering that investment grade corporate bonds have historically had less than half the volatility of U.S. equities, income investors owning corporate bonds are in a position to earn mid-single-digit returns or higher at a low level of volatility. This scenario is the definition of getting something (equity-like return) for nothing (much lower volatility).

HIGHER RETURN PREMIUMS



3. **Higher returns in the next few years as investors realize inflation is under control –** While it is impossible to say whether we are at peak yields, history has shown that when yields on investment grade corporate bonds are over 6%, good things happen for investors. Going back 22 years to 2001, there have been five prior periods when

[1] Please note that the excess yield is an approximation and will ultimately be determined by inflation rate, interest rates, default rates and general economic conditions.
[2] https://www.marketwatch.com/investing/bond/tmbmkca-05y?countryCode=BX. As at October 26, 2023.
[3] Inflation is projected to fall faster in Canada than the U.S.
[4] https://www.marketwatch.com/investing/bond/tmubmusd10y?countryCode=BX. As at October 26, 2023.
[5] As at October 26, 2023. ICE BofA US Corp. Index.
[6] As at October 26, 2023. ICE BofA HY Index. Please note current yields do not reflect potential losses from defaults, but neither does the typical yield premium.
[7] https://www.bankrate.com/banking/federal-reserve/how-to-read-fed-dot-plot-explained/#key-benefits-of-reading-the-fed-s-dot-plot

yields on U.S. investment grade corporate bonds were at essentially the same level as late October 2023 (6.3%). The average 1-year, 3-year and 5-year returns were 9.3%, 7.9%, and 7.2%[8], respectively, following those periods. Since 1997, high-yield bonds have had 22 points where yields were above 8.5% (they are 9.47% currently). The average one-year return for high-yield bonds following those periods has been 10.2%. Investors demand a higher premium in the early years of an interest rate regime change as they are not confident that interest rates will stabilize and then decline. But, as stable then lower interest rates play out, investors begin to accept a lower premium, which means yields drop, bond prices rise, and bond investors generally enjoy the highest returns during this period.

4. **Tax efficiency** – The one positive following a period when bonds have had negative returns is that new bond investors can buy these issues at significant discounts. For example, there are many high-quality corporate bonds maturing in 5-10 years, trading at prices of $75-$90. Therefore, a portion of the return will be taxed as income from the coupon payment, but there will also be a large portion of the return that will be taxed as capital gains, i.e., the gain from the bond's price going up, which is taxed at half the rate of income. Therefore, investors should earn a much higher after-tax return by owning bonds than investments like GICs, where the return is 100% income, even if both are offering the same yields.

5. **Margin of safety** – Prudent investors may ask what the potential downside is if the expected scenario (lower inflation and interest rate cuts in 2024 and beyond) does not occur. In fixed income, there is an analysis called **break even.** This review determines how much interest rates could go up by before a bond investor experiences a negative return at current yields. With the high yields offered presently on bonds, it would take approximately three more interest rate increases (without any subsequent rate cuts) for most Government of Canada and U.S. Treasury bonds to generate a negative return. For most investment-grade bonds, there would need to be at least four interest rate increases, and for high-yield bonds, there would need to be eight rate hikes for investors to not earn a positive return from their bonds at current market yields. Considering that nearly all analysts are expecting central banks to **cut** rather than increase interest rates, the break-even analysis provides investors with a greater margin of safety that bonds should generate not only positive but high returns.

OPPORTUNITIES IN EQUITIES AND HYBRID INVESTMENTS

2023 has been a good year for equities overall, but most of that return has been concentrated in seven mega-capitalization stocks dubbed the Magnificent Seven (including most of the FAANG stocks of Facebook, now called Meta, Apple, Amazon, Google, now called Alphabet, as well as Microsoft, Nvidia and Tesla). As at the end of October 2023, the U.S. equity market (S&P 500) was up 13% year to date, but excluding these stocks, the index would be barely positive. U.S. Small Cap stocks (Russell 2000 index) have had a negative return. Canadian equities were essentially flat and international stocks were up around 5%. These low or negative returns, coupled with the declines from last year, have put clients in a highly favourable position as valuations are low, which typically results in higher-than-average medium- and long-term returns.

BARGAIN HUNTING OUTSIDE OF THE MAGNIFICENT SEVEN

CANADA: Some investors may be too young to remember, but coming out of the 1990s, Canadian equity markets had massively underperformed the U.S. equity market. Boring banks, utilities, consumer, mining, telecommunication, and energy companies had done a fairly good job of growing earnings, but the market was uninterested, so most of these companies traded at very low earnings and cash flow multiples. Over the next eight years, Canadian equity markets massively outperformed the U.S. as investors sought out companies with high dividend rates and stable earnings growth. The large increase in commodity prices due to growth in emerging economies like China and India helped too. While we are not expecting a repeat of the 2000s, Canada's growing population, highly educated workforce, and low equity market valuations could usher in

[8] Please note that if a bond is held to maturity, the investor can only earn the yield to maturity, which for US Corporate bonds would be 6.3% currently, but rates would vary by issuer and issue. Based on analysis from CI GAM.

a new period of Canadian equity market outperformance (after underperforming the U.S. for many years). Canada's 12-month forward Price-Earnings Ratio at September 30, 2023 was just 12.9 times vs. a 10-year average of 14.8 times, — a nearly 15% discount. In addition, many high dividend payers, such as financial companies (banks and life insurance companies), REITs, and utilities, have dropped in value over the past two years as investors who used them as bond proxies sold them aggressively when interest rates increased. As interest rates drop, these are the types of companies that could stage the biggest rallies.

INTERNATIONAL: Europe is also trading at favourable levels. The 12-month forward Price-Earnings ratio was 11.6 at September 30, 2023 vs. a historical average of 14.1 over the past 10 years. Emerging markets, which are expected to be the strongest engine for growth in the world economy, are also trading at just 11.6 times forward P/E. Although this P/E ratio is similar to its 10-year average of 11.8, the last 10 years have been a very weak period for emerging markets, suggesting much stronger returns are around the corner.

U.S.: The U.S. appears to offer substantial value outside of the Magnificent Seven. If we look at the U.S. market on an equal weight basis, i.e., assuming that each of the 500 companies in the S&P 500 constituted an equal weight of that index (vs. weighting the index by the market capitalization of each company within), valuations suggest an attractive investment opportunity. While the S&P 500 was trading at a multiple of 18.4 times forward P/E multiple at November 10, 2023 on a market weight basis, it was trading at only 14.6 times on an equal weight basis, which is well below the historical average of approximately 16.4 times.

Small capitalization (small cap) stocks in the U.S., often defined as companies with market capitalization of $250 million to $10 billion (the Russell 2000 index, which is also called the Small Cap index, has an average market capitalization of approximately $2.7 billion), may be an even bigger bargain. Small cap stocks, as represented by the Russell 2000 index, have historically performed as well or better than large capitalization stocks, but the opposite has happened since the mid-2010s. As a result, based on forward P/E ratios, the small cap index is currently trading at a **32% discount** to the S&P 500. The last time this happened, back in 2008, U.S. small capitalization stocks generated high double-digit returns for 5+ years and dramatically outperformed large capitalization equities. Small capitalization U.S. stocks are also currently trading at a 22% discount to their average P/E multiple (12.5 times vs. 16.1 times).

STOCKS OFFERING DISCOUNTED VALUATIONS

Asset Class	Historical Price-Earnings Ratio (P/E)[9]	Current P/E Ratio	Discount
Canadian Equities	14.8	12.9	-13%
European Equities	11.6	14.1	-18%
U.S. Equities (Equal Weight)	14.6	16.4	-11%
Small Cap U.S. Equities	12.5	16.1	-22%

An additional area of the market showing steep discounts is preferred shares, which are often called a hybrid security as they offer a dividend payment that is guaranteed by the company and a priority position to equity holders (similar to a bond), but trade on the stock exchange (like an equity). Canadian preferred shares are currently offering an average yield of approximately 7%.[10] In addition, preferred shares distributions are taxed as dividends, which are highly tax-efficient for non-registered accounts. There are many REITs (Real Estate Investment Trusts) currently trading well below the value of their portfolio of properties, i.e., at a steep discount to their net asset value. Historically, when these discounts present themselves, investors earn substantial return premiums over the medium term.

WHAT TO DO?

Re-examine your cash position: Cash can be a key component of a portfolio, particularly for those in retirement or withdrawing funds in the near term. Investors also hold additional cash during periods of high volatility (typically down markets) to protect capital and to have "dry powder" available to invest when opportunities present themselves.

Investors should definitely maintain the portion of their portfolio that is in cash-like investments to cover the income or short-term cash needs that their advisor, portfolio manager, or investment counsellor has set out for them (also

[9] Based on 10-year average P/E. Source: GI GAM
[10] As at October 31, 2023. Based on Canadian-listed preferred shares.

called a cash wedge). For clients who are holding cash as dry powder, this may be the period in which to deploy it. The current environment is an advantageous one to earn outsized returns over the medium to long term (and likely short term). For investors that have kept cash for capital preservation purposes, this may be a time to consider reducing that position systematically over time by using Dollar Cost Averaging (investing a fixed portion of that cash position on a regular basis into the investment portfolio). By not remaining invested during attractive market environments, investors reduce their long-term returns. As investment guru Warren Buffet stated in an op-ed piece he wrote for the New York Times in October 2008, "Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value."[11]

Don't time the market: One of the great fallacies in investing is that you can time when a market will bottom. Consequently, investors often hold on to cash or cash-equivalent investments for too long, hoping to swoop in when prices are at their cheapest, often missing out on the first lift, which is typically substantial. The only way to truly know that a market bottomed is when prices go up and never return to that previous level – confirming that you missed your chance.

As Warren Buffet stated in an address at Columbia University, "Don't pass up something that's attractive today because you think you will find something better tomorrow." The top 10 one-day returns for the U.S. equity market in the past 20 years have occurred in just five months: October 2008, November 2008, March 2009, March 2020, and April 2020. The gains experienced on each of those days were between 6.3% and 11.6%, essentially a full year's equity return earned on each of those days.[12] By waiting for the bottom, you could miss these days and a large part of the market recovery.

Be patient: Investors generally have a purpose or goal for their investment portfolio, typically to fund a comfortable and low-stress retirement. This does not happen in a day, a month, or even one year, but rather over time by prudently working with your advisor, portfolio manager, or investment counsellor to build out, monitor, and rebalance a portfolio that should meet your goals, taking into account your personal circumstances, risk tolerance, and time horizon. Financial planning can help assist in this process by focusing on tax-efficiency when investing and withdrawing funds, as well as covering personal risk management, philanthropic, and legacy goals.

We look for bargains on good quality items when we shop. We should do the same with investing – this is the way to put the odds in your favour. The current fixed income market and large parts of the equity market appear to be on sale. Therefore, now may be a good time for astute investors to add investments (particularly income securities) to their shopping carts.

[11] https://www.nytimes.com/2008/10/17/opinion/17buffett.html
[12] Source: JP Morgan, S&P500 Index total returns from January 1, 2003 – December 30, 2022.

GLOSSARY OF TERMS

Credit rating/risk: An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit risk is the risk of default on a debt that may arise from a borrower failing to make required payment.

Duration: A measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

Return (relative): The performance of one investment versus another. The most commonly reported relative returns are mutual fund returns relative to their benchmark indexes.

Yield to maturity (YTM): The total expected return from a bond when it is held until maturity – including all interest, coupon payments, and premium or discount adjustments.

Volatility: Measures how much the price of a security, derivative, or index fluctuates. The most commonly used measure of volatility when it comes to investment funds is standard deviation.

IMPORTANT DISCLAIMERS

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