Canada Equity Strategy

Own dividends, own inflation, own Canada

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Equity and Quant Strategy
Canada

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The 70's playbook: TSX for inflation, SPX for disinflation

With disinflation in 2023, the TSX lagged the S&P 500 by 16ppt (TSX +8% vs. SPX +24%), more than reversing its 2022 lead. This is consistent with the 1970's inflation regime when the relative performance of TSX vs. SPX moved closely with inflation (86% correlation in 1986-81 vs. 26% for the full history since 1928). With the near-record growth differential between Canada and the US expected to narrow and much of disinflation already taken place (see inflation risk), we believe the TSX offers a great entry point at just 15x EPS (see Canada Year Ahead).

Focus on dividends in 2024: TSX yields 2x the S&P 500

We believe 2024 could be a banner year for dividends as cash yields drop and a global recovery cycle lifts beaten-down high dividend stocks. Our Chief Global Quant Strategist Nigel Tupper's Global Wave (see report) has troughed, which is broadly positive for global cyclicals that offer high dividends. Aging population and immense wealth accumulated by older generations (see report: Boomers) are also secular tailwinds for dividends. The TSX offers an attractive 3.2% dividend yield, 2.3x the S&P 500's, a record spread (Exhibit 4).

Hedge against two tail risks: inflation and geopolitics

Inflation and geopolitics are among the biggest risks to equities cited by investors today – see report: Fund Manager Survey. Canada offers a great hedge against both. The three historical upcycles in the TSX relative to the S&P 500 occurred during inflationary cycles, and two of those were during wartime: the 1940s (WWII) and 1970s (Yom Kippur + Vietnam) – see Exhibit 5. War is inflationary.

Canada Cycle Indicator: bottoming process

Our Canada Cycle Indicator has been a reliable coincident indicator for the TSX vs. SPX, especially in recent history (r-sq: 0.5 over the past five years). The indicator remains depressed at the bottom 12th percentile in history since 1950, consistent with the TSX's big lag vs. the S&P 500 in 2023 (Exhibit 7). We believe higher commodity prices will be needed for the TSX to meaningfully outperform the S&P 500.

4Q earnings: last quarter of earnings recession

While the S&P 500 is in an earnings upcycle, consensus expects another down (but improving) quarter for the TSX: 4Q EPS -4% YoY vs. -11% in 3Q. But 4Q is expected to be the last quarter of the earnings recession (began in 1Q23 vs. 4Q22 for the S&P 500), with 1Q EPS expected to be +4% YoY (Exhibit 8). We also see encouraging signs that the inventory de-stocking cycle has inflected and the manufacturing recession is coming to an end (Exhibit 10 and Exhibit 11). Given its heavy exposure to old economy and commodities, the TSX could enjoy a sizable tailwind from a manufacturing recovery this year.

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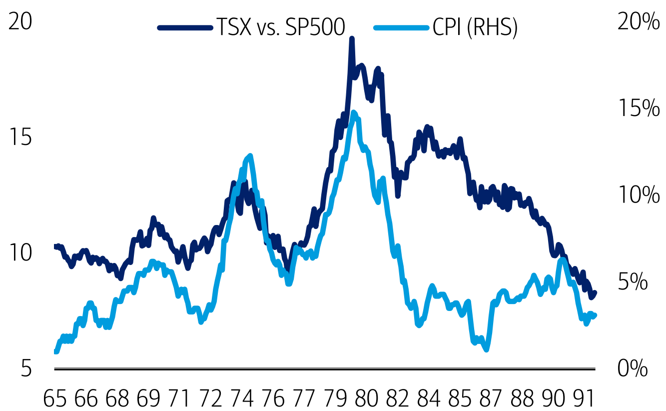
Exhibit 1: 1970s playbook: TSX for inflation, SPX for disinflation
TSX vs. S&P 500 and CPI (1965-1991)



Source: Bloomberg, BofA Global Research
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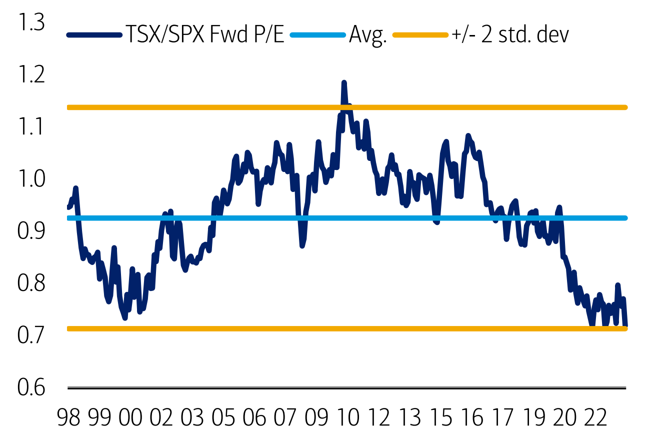
Exhibit 2: TSX trades at a historic discount vs. the S&P 500
Relative fwd PE of TSX / S&P 500 (1998-1/24)



Source: BofA Global Research, FactSet
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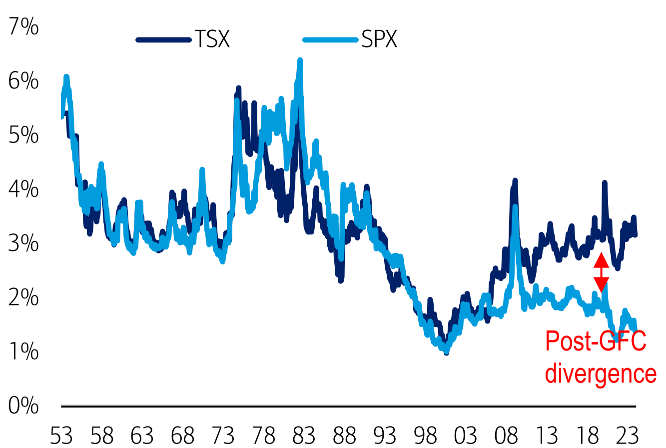
Exhibit 3: TSX's dividend yield vs. the S&P 500 continues to widen
TSX vs. S&P 500 dividend yield (1953-2023)



Source: BofA Global Research, Global Financial Data, FactSet
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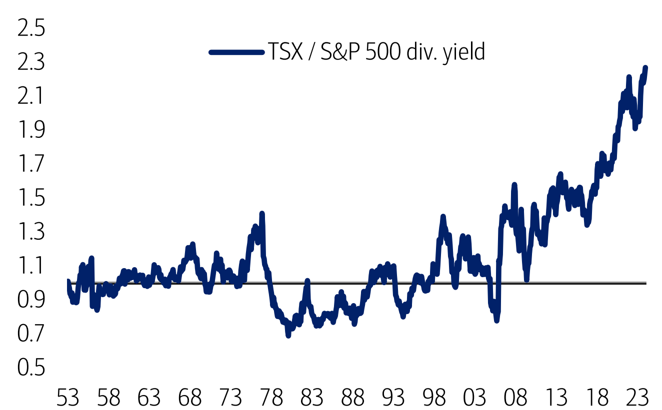
Exhibit 4: TSX's relative dividend yield vs. the S&P 500 is at a record high (2.3x)
Ratio of TSX vs. S&P 500 dividend yield (1953-2023)



Source: BofA Global Research, Global Financial Data, FactSet
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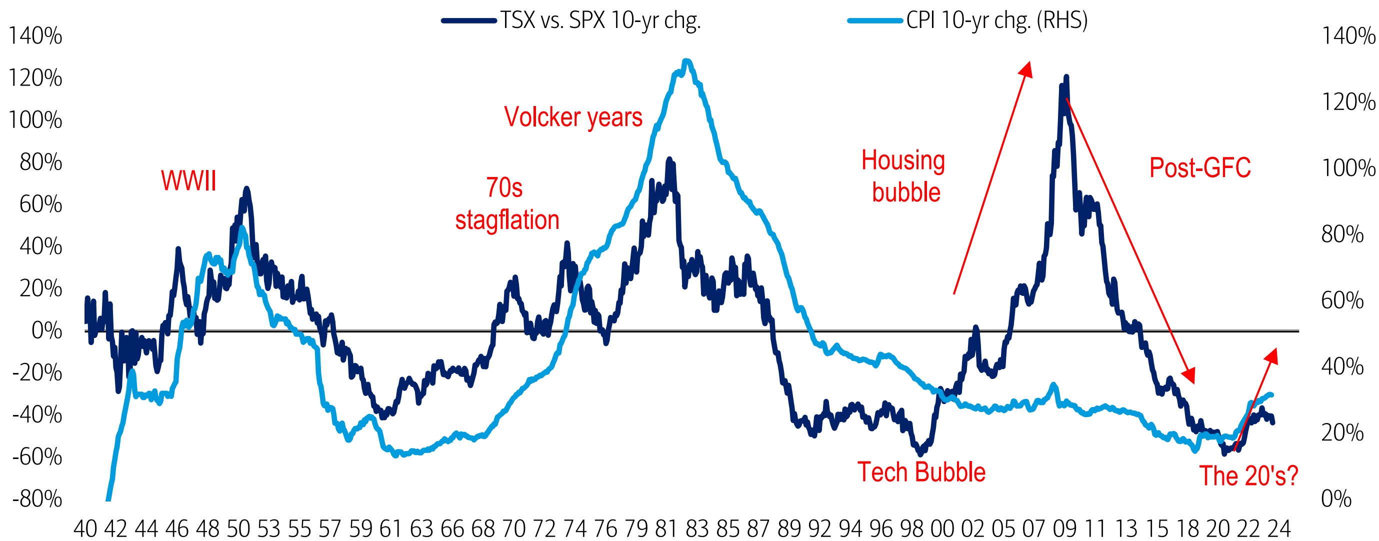
Hedge against two tail risks: inflation and geopolitics

The prior three upcycles in the TSX vs. SPX (50s, 70s and 2000s) were marked by either inflation or commodity upcycles (or both). Inflation and geopolitics are among the biggest risks to equities in 2024, cited by investors – see report: Fund Manager Survey. Canada offers a great hedge against those risks. The three historical upcycles in the TSX relative to the S&P 500 occurred during inflationary cycles, and two of those were during war times: the 1940s (WWII) and 1970s (Yom Kippur + Vietnam). War is inflationary.

Exhibit 5: TSX vs. S&P 500 follows the inflation cycle
10-yr returns of the TSX / S&P 500 vs. CPI (1940-present)



Source: Bloomberg, BofA Global Research

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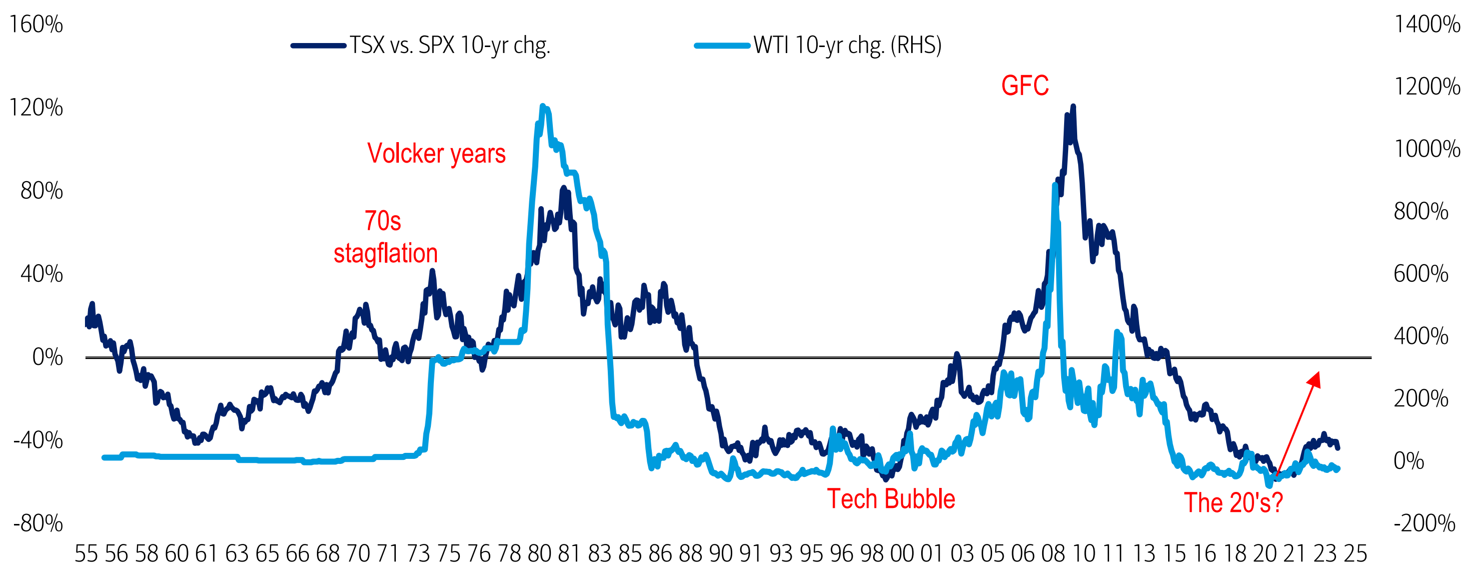
Exhibit 6: TSX vs. S&P 500 follows the commodity cycle
10-yr returns of the TSX / S&P 500 vs. WTI oil (1955-present)



Source: Bloomberg, Haver Analytics, Global Financials Data, BofA Global Research

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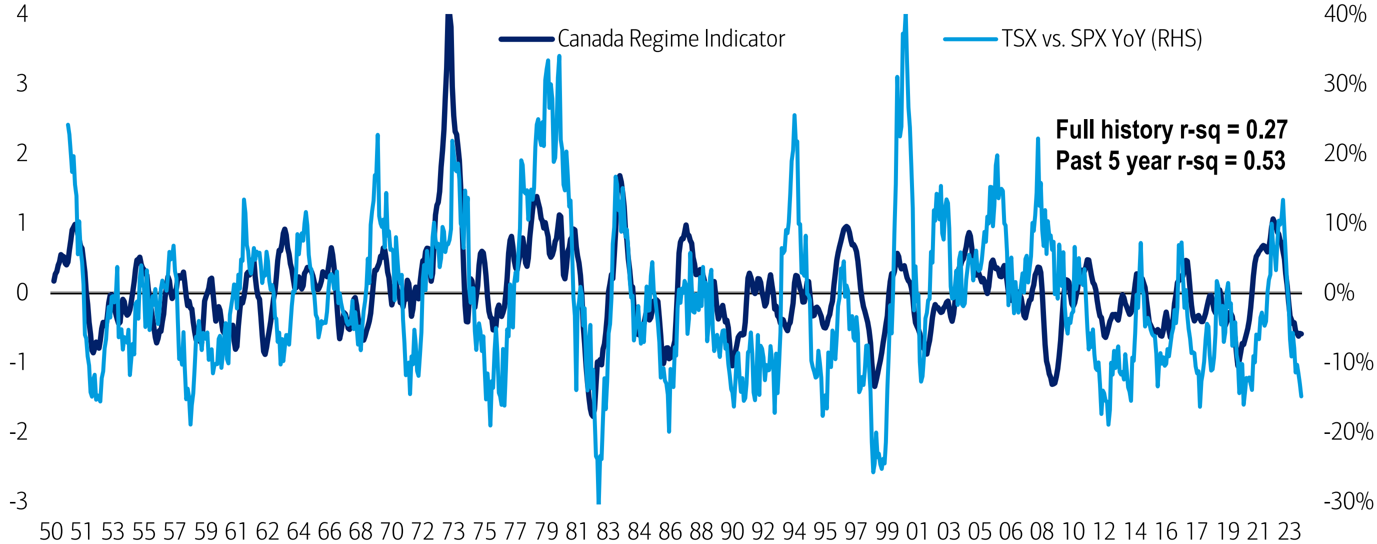
Canada Cycle Indicator: bottoming process

We introduced our Canada Cycle Indicator in our Canada Year Ahead (see report), which has been a reliable coincident indicator for the TSX vs. SPX, especially in recent history (r-sq: 0.5 over the past five years) – see full Methodology. The indicator remains depressed at the bottom 12th percentile in history since 1950, consistent with the TSX's big lag vs. the S&P 500 in 2023. We believe higher commodity prices will be needed for the TSX to meaningfully outperform the S&P 500.

Exhibit 7: Our Canada Cycle Indicator is at the bottom 12th percentile in history
Canada Regime Indicator vs. relative performance of TSX vs. SPX YoY (1950-10/23)



Source: BofA Global Research, Bloomberg, FactSet, Global Financial Data
Disclaimer: The Canadian Cycle Indicator is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Global Research. The Indicator was not created to act as a benchmark.
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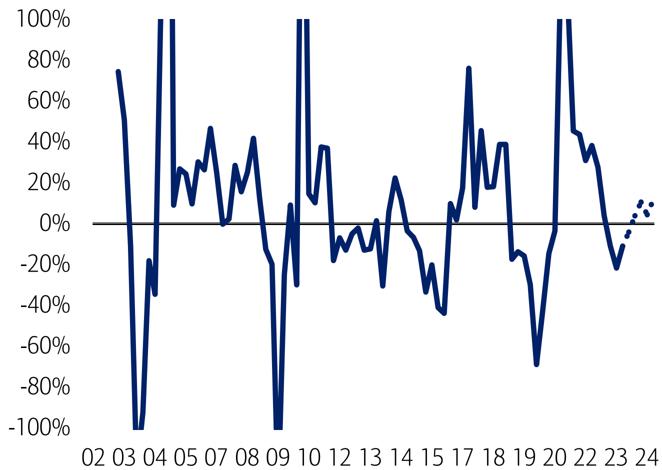
Exhibit 8: TSX earnings have inflected and are expected to accelerate
TSX quarterly earnings YoY (2002-4Q24E)



Source: FactSet, BofA Global Research

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Exhibit 9: TSX 60 earnings are expected to fall 4% YoY in 4Q
TSX 60 consensus 4Q23 earnings YoY

Sectors	4Q23	4Q22	YoY
Comm. Svcs.	1,465	1,437	2.0%
Cons. Disc.	1,610	1,543	4.4%
Staples	2,493	2,340	6.6%
Energy	9,227	9,431	(2.2%)
Financials	19,534	20,869	(6.4%)
Health Care	0	0	na
Industrials	3,603	3,477	3.6%
Tech	1,341	1,136	18.1%
Materials	2,538	3,319	(23.5%)
Real Estate	168	170	(1.3%)
Utilities	862	995	(13.4%)
TSX 60	42,841	44,717	(4.2%)

Source: FactSet, BofA Global Research

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Exhibit 10: Korea exports soared, pointing to a manufacturing recovery
Korea exports YoY vs. ISM Manufacturing PMI (1997-1/24)

Source: Bloomberg, BofA US Equity & Quant Strategy

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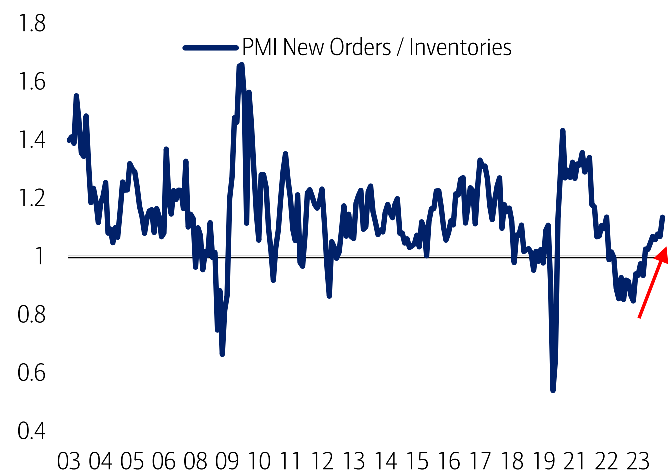
Exhibit 11: We're now in a re-stocking cycle
ISM Manufacturing PMI new orders / inventories (2003-1/24)



Source: Bloomberg, BofA US Equity & Quant Strategy

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Methodology

Inputs for the Canada Cycle Indicator

Inputs for the Canada Cycle indicator include the following five macroeconomic or top-down variables listed below. We calculate the Z-score of each variable and compute the simple average.

- **10-yr Government Bond Yield (spread between the US and Canada)**: Calculated as the spread between the US 10-yr Treasury bond yield YoY and the Canadian Government 10-yr yield YoY in basis points. A lower yield in Canada implies a lower risk-free rate for the TSX vs. the S&P 500.

- **Earnings Revision Ratio (TSX vs. S&P 500):** Calculated as the ratio between the number of companies in the index for which consensus earnings estimates have been raised versus those that have been lowered. A rising ratio indicates an improving economic cycle. We then calculate the ratio of the TSX's ERR versus the S&P 500's ERR and compute the YoY change in the relative ratio.

- **Inflation:** The YoY change in CPI in Canada, represented as the Z-Score. Rising inflation indicates improving economic conditions, benefitting inflationary assets like the TSX.

- **Commodities:** The YoY change in the Bloomberg Commodity Index, represented as the Z-score. Rising commodity prices generally indicate improving economic conditions and benefit commodity-exposed companies, such as Energy and Materials companies. Energy and Materials represent ~30% of the TSX vs. just 7% for the S&P 500.

- **Canada Leading Indicators:** The YoY change in the OECD Canada Leading Indicators, represented as a Z-score. A rising Z-score indicates improving economic conditions in Canada.

For the historic period from January 1950 to November 1960, the Canada Cycle Indicator was based on three inputs that were available (rates, inflation and commodities). The Canada Leading Indicators Index was included from December 1960 and the Earnings Revision Ratio was included from April 2007.

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