AGF INSIGHTS

OUTLOOK 2022

The Rise of Everything

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The Rise of Everything

It should be another solid year for the global economy and financial markets in 2022, but the ongoing rise in everything from groceries and wages to potentially higher interest rates and taxes may also be raising the spectre of higher volatility and could ultimately determine the trajectory of investment returns over the next 12 months.

BY: KEVIN MCCREADIE

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The COVID-19 pandemic remained a dominant force shaping financial markets in 2021, and Omicron, the latest "variant of concern," has surely rattled investors in recent days. Yet, barring another full-scale outbreak that shuts down huge swaths of the global economy again, it's safe to say the virus' toll on our physical, mental, financial and social well-being has receded significantly since the height of the crisis almost two years ago. And at least in the minds of investors, the pandemic should continue giving way to the economic side effects that have been spawned in its wake.

In no way is this shifting focus more evident than in our current fixation with inflation, which has climbed to heights not seen in decades and may now represent the biggest threat to investors' portfolios. While the economy is arguably stronger heading into 2022 than it has been in years, there is mounting concern about the trajectory of future growth, especially if inflationary pressures persist well into the new year.

In part, this is because higher prices for everyday essentials like groceries, gasoline and home heating could eventually cut into demand for discretionary goods and services, which helps drive higher earnings growth in most economies. But perhaps the bigger worry is the eventuality of higher interest rates should inflation continue to rise. In this case, it's less about *distribution* of demand than about a *reduction* of demand, because most everyone's cost base – from consumers and small businesses to the largest corporations – becomes more expensive and cuts into their purchasing or earnings power.

It's to that end that so much attention is being paid to the U.S. Federal Reserve and other central banks these days. While several Emerging Market countries have already raised rates to combat higher inflation, most of their developed market counterparts have yet to pull the trigger. The Fed, for its part, now says U.S. inflation will linger longer than previously anticipated but still believes it will fall back closer to a rate of 2% over time. As such, it remains reticent about raising its overnight lending rate anytime soon, if at all, in 2022, despite market expectations that are predicting two rate hikes next year, likely starting in the late spring.

In contrast, the Bank of Canada (BoC) should meet expectations by raising its key rate sometime in the first

Asset Allocation: Heading into the New Year

Source: AGF Asset Allocation Committee Fourth Quarter Update (as of October 1, 2021). Based on a 60/40 portfolio mix of equity and fixed income.
For Illustrative purposes only.

quarter. However, while the potential timing of its first hike since 2018 jibes with markets, the BoC isn't signaling nearly as many rate hikes as some prognosticators suggest it should make in 2022.

Of course, who ends up being right will be one of the big market-moving questions of the next few months. And to some extent, the answer lies in the ability of global supply chains to right themselves after months of disruptions tied to labour shortages, and pandemic-related manufacturing outages. But whether inflation subsides – and central banks aren't necessarily forced to raise rates – may have just as much to do with rising wages as it does with supply shortages. While the latter seems like an inevitable fix over the next few months, higher labour costs are not so easily remedied and can lead to inflation that is much more persistent.

> **Caution is advised as investors head into 2022 – but not at the expense of optimism.**

Granted, inflation isn't always negative for markets. In fact, it may end up being a relatively positive economic condition if it moderates even slightly and leads to slow and measured rate increases that don't hinder growth over time. Yet investors can't rule out the potential dangers associated with stubbornly high prices, nor should they ignore the prospect of stagflation setting in – at least not entirely. While there's little reason to believe economic growth will collapse over the next 12 months, it's conceivable that it will likely slow from the torrid pace of expansion this past year. This may be true even if interest rates don't rise as expected, or if Omicron only ends up leading to minor restrictions on economic activity around the world.

Beyond these two potential headwinds, global growth will likely continue to grow from here without the aid of more fiscal stimulus from governments. At the same time, many of the spending programs put in place over the past two years may result in higher taxes to pay for them. China, meanwhile, stands out as another potential drain on global growth, not only because the world's second largest economy continues to grapple with production concerns related to energy and material shortages, but also because of its zero-tolerance COVID-19 policy and the ongoing regulatory crackdown on key sectors of the country's economy.

In other words, caution is advised as investors head into 2022 – but not at the expense of optimism. While more subdued economic growth and higher market volatility may be defining characteristics of the year ahead, so too will the pockets of opportunities that arise in this type of an environment. Stock markets, for example, seem more likely than not to climb higher over the next 12 months, albeit hardly to the extent they did in 2021.

As such, we believe a bias of equities over fixed income within a 60/40 portfolio remains the most prudent allocation for now. In particular, we see some strong opportunities originating from countries like Japan and Europe, and view quality companies more generally as being better positioned to navigate the potential for higher interest rates and slower growth down the road.

That doesn't mean fixed income is an afterthought. To the contrary, while government bonds may struggle if rates rise, they can still provide important ballast during periods of volatility. Moreover, alternative sources of yield, including private credit, can help pick up the slack and may mitigate losses.

All in, then, investors have a lot to consider heading into the new year, including the possibility of higher inflation, higher interest rates, higher taxes and higher market volatility. Yet, as long as everything doesn't go too far up over the next 12 months, there's reason to believe investment returns may rise, too. ■

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The Big Picture: Six Decades in Markets

A timeline of key U.S. economic and market statistics to commemorate AGF's 65th anniversary in 2022.

CELEBRATING 65 YEARS

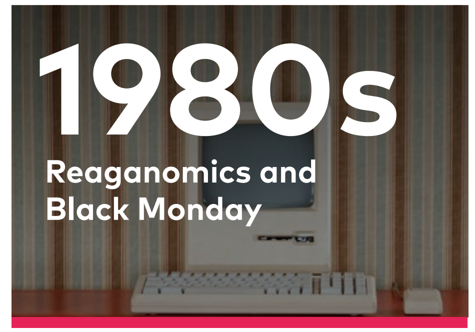
The global economy and financial markets rung up some of their strongest numbers in years over the past twelve months. In the United States, for example, GDP growth is forecast by some to be 5.5% on an annual average basis in 2022, while the country's inflation rate recently soared to 6.2% and its unemployment rate dropped to 4.2%. Moreover, the S&P 500 Index has gained 23% year-to-date through November, the U.S. 10-year Treasury yield is hovering near 1.35% – or 40 basis points higher than it was this time last year – and both oil and gold prices are holding in at US$65 per barrel and US$1750 per ounce, respectively.

Yet, as impressive as all of that sounds, the more interesting question may be how these figures stack up to previous periods. After all, understanding the big picture goes a long way to achieving one's investment goals. With that in mind, here are six full decades of economic and financial statistics highlighting the various market environments that AGF, together with its clients, has navigated since the firm's launch 65 years ago this April.

The following U.S. figures are based on averages and where applicable, rounded to the nearest dollar.

1960s
M&A and the Nifty Fifty

1970s
Oil Embargos and Rising Inflation



1980s
Reaganomics and Black Monday

1990s
Bond Vigilantes and Dot.com IPOs

2000s
The Tech Wreck and Great Recession

2010s
Debt Downgrades and Taper Tantrums

	1960s	1970s	1980s	1990s	2000s	2010s
GDP GROWTH	4.5%	3.2%	3.1%	3.2%	1.9%	2.3%
UNEMPLOYMENT RATE	4.7%	6.4%	7.2%	5.7%	5.8%	5.9%
CONSUMER PRICE INDEX	2.5%	7.4%	5.1%	2.9%	2.5%	1.8%
S&P 500 TOTAL RETURN	8.6%	7.4%	18.0%	18.9%	1.2%	14.0%
US 10YR TREASURY BOND YIELD	4.9%	7.5%	10.3%	6.4%	4.2%	2.4%
OIL US$ PER BARREL	$3	$11	$26	$20	$48	$69
GOLD US$ PER OUNCE	$36	$161	$415	$346	$572	$1,336

Source: AGF Investments Inc. as of November 30, 2021 with data compiled from various sources: Ned Davis Research, Bloomberg LP., U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis and Federal Reserve Bank of Philadelphia. Please see Disclaimer section for full disclosure.

Asset Class Roundup

- Equities
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BY: STEPHEN WAY, TRISTAN SONES, TOM NAKAMURA, STEVE BONNYMAN, RYAN DUNFIELD

Equities

Stocks On Solid Ground

Europe and Japan are two of the most attractive opportunities in developed markets heading into the New Year

By Stephen Way

Global equity markets enter 2022 on what appears to be a very sound footing, supported by a number of positive factors. Above-trend GDP growth is expected as rising vaccinations lead to a further reopening of the global economy and as companies rebuild depleted inventories in the wake of the COVID-19 pandemic (likely a multi-year effort). Capital expenditures could rise as companies invest in disruptive technologies and increase productivity – the key driver of economic growth – to protect against the labour shortages and rising wages that many companies experienced during the pandemic. Finally, fiscal policy should support long-term economic growth prospects, including infrastructure spending and other long-cycle capex projects such as green energy transition and other sustainability-led investments.

The monetary policy backdrop, while changing, should also be supportive. Despite the tapering of several asset purchase programs in 2021 and 2022, many central bank balance sheets are still forecasted to expand by 4.2% on average, during the first half of 2022, according to Credit Suisse research. Monetary conditions are expected to remain very accommodative, even though the U.S. Federal Reserve and other major central banks should raise policy rates in the second half of 2022 or early 2023. Furthermore, corporate credit spreads will likely remain subdued, further supporting equities.

The inflation picture, however, is less clear. Inflation surprises have pushed U.S. price increases to three-decade highs, a key concern for markets that could persist longer than many market participants expect. Several factors may contribute to a more sustained rise in inflation:

- Accommodative monetary and fiscal policies;
- Higher costs associated with deglobalization, such as onshoring and reshoring;
- Rising housing prices, leading to higher rental prices (a significant component of consumer price indices);
- Rising labour costs due to supply chain disruptions, pandemic-related benefits leading to higher quit rates and job vacancies, and lower labour participation rates;
- Higher transportation costs; and
- Rising ESG-related costs, such as decarbonization.

Some of those factors should start to moderate in 2022, but they remain risks. Companies that cannot pass on higher costs to consumers will continue to face margin pressure and likely lower share prices. As major central banks grapple with the highest

Equities

inflation in three decades, the prospects of a policy error markedly increase. Many central banks will continue to be heavily scrutinized as the path of inflation will likely remain a key determinant for the economy, monetary policy, interest rates and asset prices.

Improving economic growth and higher-than-expected inflation could lead to higher bond yields, a steeper yield curve and accelerated policy normalization. In this environment, market participants may continue to rotate from highly speculative companies (for example, non-profitable or highly indebted) to higher-quality companies with stable and more consistent cash flows. However, a modest rise in interest rates still leaves room for growth companies to perform well.

Europe is poised to be one of the strongest-performing regions for equities, as inflation expectations and bond yields rise due to the more cyclical nature of the European economy. The European Central Bank remains the most dovish of the major central banks, so monetary and fiscal policy could support equities in the region. European stock valuations remain the most attractive in over a decade, according to Bloomberg data, while the political environment remains stable, as noted by a decline in popular support for so-called Euroskeptic parties.

“Europe is poised to be one of the strongest-performing regions for equities, as inflation expectations and bond yields rise due to the more cyclical nature of the European economy.

Japan remains one of the most favourable regions. Vaccination rates have now surpassed most global peers, and GDP growth in 2022 should remain well above trend. Japan maintains the highest operational leverage of any region, earnings revisions have turned positive, and valuations remain very attractive. The Bank of Japan (BOJ) is expected o maintain its yield curve control and negative interest rate policies in 2022, according to the BOJ's latest policy statement, which should remain supportive for Japanese equities despite continued tapering of government bonds and risk asset purchases.

Elsewhere, however, we expect geopolitical risk to remain elevated. In 2022, U.S. midterm elections could see the Democrats lose power in Congress, while several electoral cycles in Emerging Markets could lead to unrest and higher levels of economic uncertainty and market volatility. U.S.-China relations are expected to remain tense, although U.S. President Biden's administration could use tariff relief to reduce inflation concerns domestically. Relations could also improve if the U.S. engages China on bigger issues, such as tech conflicts, using a multilateral approach instead of the unilateral one adopted by the Trump administration. ■

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Fixed Income

Ready Already for Rate Hikes?

While rate hikes are largely reflected in developed-market bond prices, recent volatility in fixed income markets is here to stay.

By Tristan Sones

The global economy rebounded strongly from the COVID-19 fallout of 2020, especially in the first half of 2021. Yet in the past few months, inflation has also risen sharply, and it appears to be less "transitory" than many market participants had expected.

In response, most developed-country central banks, including those in Canada and the U.S., have taken a patient approach, beginning with reducing their bond purchases (aka tapering). Patience, however, has been a luxury that few policymakers in Emerging Markets (EM) could afford. With inflation running double their target in some cases, according to Bloomberg estimates, EM central banks have been forced into more aggressive – and varied – policy action. And that is creating a lot of idiosyncratic risk.

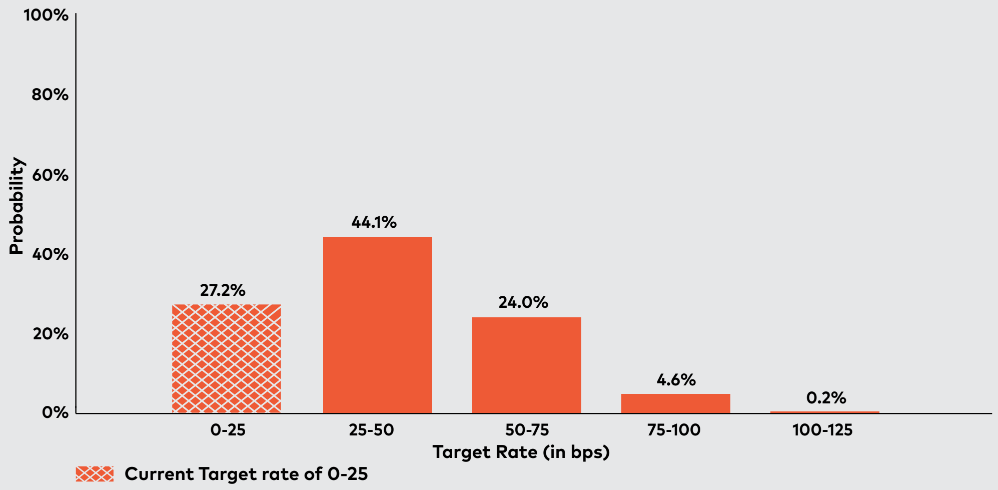
Still, we expect 2022 will start off predictably, with a follow-through of the moves policymakers implemented in 2021. For some developed markets, that means a continuation of tapering followed by an initial policy rate hike. In the U.S., tapering could wind down in the first half of the year and a rate hike could come soon after; in Canada, tapering is out of the way, so a policy hike could happen sooner. In Europe and Japan, the pace of policy adjustment will likely be slower – perhaps a very small move in late 2022 and 2023, respectively.

Rate hikes make fixed income investors nervous, but much of the tightening expected in 2022 (about two hikes in the U.S., and four in Canada) is already reflected in bond prices. Given that reality, investors might consider leaning against the expected policy trajectory – and looking for potential opportunities to extend duration. After all, there is still a chance of no rate hikes in 2022, which might seem more likely if Omicron, the latest COVID-19 variant of concern, becomes a threat to global growth. Remember, after the Global Financial Crisis, it took most central banks, including the Federal Reserve (Fed), many years to raise rates – against market expectations, which proved to be far too optimistic about policymakers' ability to hike.

For Emerging Markets, the aggressive tightening of 2021 will likely spill over into the early part of 2022. Caution is warranted, but tighter policy may lead to a gradual slowing of economic growth coupled with cresting inflation. That could bring a reprieve to the torrid pace of rate hikes we have been seeing, and if inflation falls significantly, some EM central banks may modestly adjust policy rates lower. This backdrop may provide a long-term opportunity to increase exposures to select EMs.

Fixed Income

Target Rate Probabilities for 15 Jun 2022 Fed Meeting



Source: CME Group as December 1, 2021

Regional differences also impact decision-making about bond duration exposure. For some developed and emerging economies, the long end of the yield curve is showing early signs of stabilizing. Another welcome sign: supply chain disruptions might be dissipating. If inflation rolls over and growth becomes more sanguine, the second half of 2022 might bring a much better tone to global bond markets.

There is, however, a yellow flag in all this: the ability of governments to manage fiscal health in an environment of higher debt and lower growth. Many countries exacerbated existing debt problems during the pandemic, and policymakers have generally shown neither the ability nor the willingness to steer their fiscal situation towards a more sustainable path. In developed markets, fiscal pressure likely means policy rates can not be raised too far – and perhaps less than the levels reflected in many global developed-market bond curves. In Emerging Markets, there is a huge opportunity to attract capital for those countries willing to enact reforms and seriously address fiscal shortfalls. For others, however, we can expect continued reliance on the assistance of multilateral lenders such as the International Monetary Fund.

The common ingredient in all these trends is volatility, and it appears that bond volatility is here to stay for some time. Unfortunately, investors will have to get used to it. ■

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Currency

FX Volatility Ahead

Economic uncertainty could favour the U.S. dollar in particular in 2022

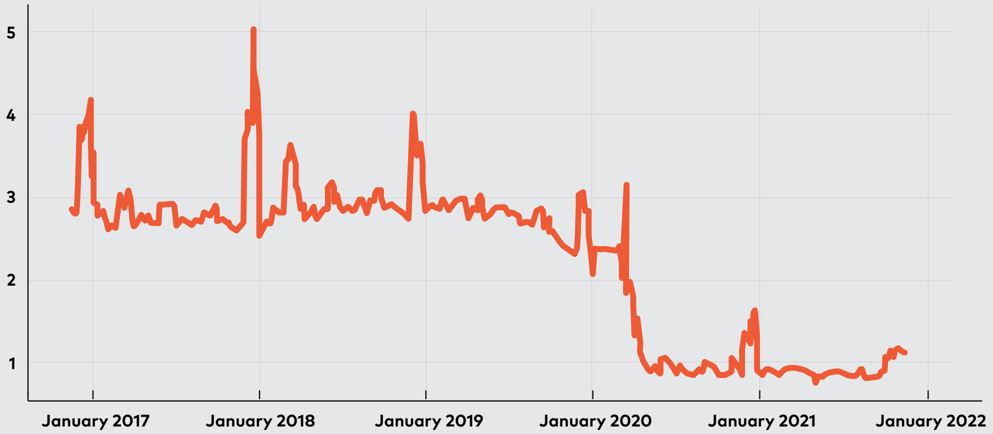
By Tom Nakamura

At first glance, 2022 might be another good year for carry trades. After all, in a rising rate environment, the popular strategy in which investors borrow in a low-interest-rate currency to invest in a higher-interest-rate currency tends to do well, and it appears that many central banks in the developed world are poised to hike next year.

Yet there is a wrinkle: Carry strategies thrive in low-volatility markets, which allow investors to harvest higher rates with less concern for underlying prices. But in today's inflationary climate, foreign exchange (FX) markets are expected to become more volatile over the next 12 months, leaving these strategies to potentially falter.

In fact, this is likely true whether inflation is transitory or not and carry traders hate volatility because it leads to higher risk. Moreover, the rewards for that higher risk may not be very tantalizing. Carry trades make their returns from interest rate differentials, but among G10 currencies, the carry differentials are very narrow. While they may see some widening over the next year as rates rise, they will still be far from pre-pandemic levels. The low reward of developed-market currency carry will likely make such strategies more sensitive to a higher-volatility environment. As a result, we expect them to be put on the backburner for 2022.

Net yield on G10 carry portfolio; %



Source: JP Morgan as of November 22, 2021. Strategy involves buying (selling) the currencies with the highest (lowest) 1-month implied yield calculated from FX forwards vs. USD in equally weighted amounts. A position can be taken on USD if it qualifies in the top/lowest ranking (1m US swap rate used for USD yield). Rebalances at the end of every month.

Currency

That is despite the likelihood that the U.S. Federal Reserve will be among the laggards in terms of delivering aggressive interest rates increases. For currency markets generally, and carry trades specifically, that likely won't matter much. This past year saw markets reward currencies whose central banks were seen to be early to raise rates, or those whose rate hike cycle was seen to have further to run. Given inflation uncertainty, we think these distinctions may be less important for markets in the coming year.

Those factors do, however, favour the U.S. dollar. So do slowing economic growth and a potential rate hike from the Fed in 2022. History suggests that "safe haven" currencies such as the Japanese yen, Swiss franc and U.S. dollar tend to perform better in periods of slowing growth, while currencies that are seen as pro-cyclical, including the Canadian dollar, tend to underperform.

History also shows that the U.S. dollar tends to rise in the lead-up to the first Fed rate hike. Compounding slowing growth and rising rates is the fiscal picture. Current budget estimates suggest that many key economies will likely have lower government spending to support economic growth. The tailwinds that economies saw in 2020 (and to a lesser extent in 2021) are set to turn into headwinds.

"These low-rate settings have caused significant depreciation of EM currencies, while allowing the same central banks to be more responsive to inflation now.

There is an exception to our bullish U.S. dollar call: Emerging Market (EM) carry. In the early stages of the COVID-19 pandemic, EM central banks fought off their usual instincts to keep rates high in order to protect their currencies and instead responded by aggressively lowering interest rates. In combination with large emergency fiscal spending, EM policymakers were able to prevent a more drastic economic drop. These low-rate settings have caused significant depreciation of EM currencies, while allowing the same central banks to be more responsive to inflation now. With a starting point of cheaper currencies and lower interest rates, there is less concern for fueling unwarranted currency appreciation. As such, compared with developed markets, EM carry strategy yields have returned to pre-pandemic levels, according to JP Morgan.

In short, 2022 is likely to bring a great deal of economic uncertainty. This is favourable for the U.S. dollar, for safe haven currencies in general, and for higher-carry EM currencies. ■

Please see Disclaimer section for full disclosure.

Real
Assets

Everything Old is New Again

Real assets are integral to the re-industrialization and greening of the modern economy.

By Steve Bonnyman

Economic signs point towards inflation being meaningful, though it's still unclear whether it will be transitory or sticky. Either way, the impact is likely to resonate through the real economy and financial markets in 2022, and real assets, which have benefited over the past year, should stay the course if prices continue to climb. But inflation is not the only catalyst for opportunities in the asset class. Some consider real assets – from commodities and real estate to utilities and transportation – as "old economy" investments, but the fact is that these sectors will likely be just as integral to the re-industrialization and greening of the modern economy as they were to economic evolutions of the past. This is, as Goldman Sachs analysts put it recently, "the revenge of the old economy."

Real assets are generally cyclical, a function of lower supply elasticity to price and large upfront capital requirements. In the past, many commodities companies have sought to compete with high-growth technology companies for capital by adopting similarly high-growth strategies, which only exacerbated supply overbuilds and resulted in massive wealth destruction. In equity markets, that raised risk premiums, diminished capitalizations and lowered investor interest. Recently, however, management has responded to changing markets – and increased pressure from shareholders to focus on capital return instead of capital destruction – by adopting price-over-volume discipline and return-over-growth strategies. We can see this trend, for example, in the oil markets, where despite a 50% increase in oil prices over the past year, OPEC+ is holding its slowly growing production profile intact; meanwhile, U.S. shale oil production remains below 2020 levels, Bloomberg data show.

Many real assets companies, however, face another apparent headwind. As climate change has become a top-of-mind issue, investors are increasingly focused on environmental, social and governance (ESG) factors. An increasing number of funds (and even lenders) now incorporate ESG considerations into their investment criteria. This is further constraining capital to real asset sectors, which tend to be the most visible (or most upstream) carbon emitters. Many traditional real assets companies have come under pressure to adapt to this changing landscape, while "green economy" companies have been beneficiaries.

Real Assets

A couple of factors might counter this headwind. One is that many central banks have begun to wind down their post-recession quantitative easing (QE) efforts, which tend to stimulate capital markets and generate financial asset inflation, but they do little to boost the "real" economy. The shift away from QE could rebalance demand towards physical assets, which could positively impact commodities demand.

The shift away from QE could rebalance demand towards physical assets, which could positively impact commodities demand.

Moreover, the need for physical "stuff" seems to have been underestimated in the new global focus on carbon constraint. Decarbonization of the economy will require immense volumes of copper, aluminum and nickel; batteries and energy storage will require expanded metals and chemicals demand. A lower-carbon future will mean rebuilding energy infrastructure, retrofitting real estate and developing a broad base of electrification. To ramp up these production profiles and build new industrial bases, the need for energy will continue to grow, which could extend the demand for hydrocarbons well beyond the optimistic forecasts of today's policymakers.

In short, like industrial cycles of the past, the greening of the global economy will depend on the availability and evolution of real assets. That should provide enhanced investment opportunities and improved investor attention through the next investment cycle. ■

Please see Disclaimer section for full disclosure.

Alternatives

Canada's Private Credit Catch-Up

The country is home to one of the least mature private credit markets and potentially one of the most attractive.

By Ryan Dunfield

Private credit is one of the fastest-growing categories of alternative investments in the world. It has doubled in size since 2015 and could hit US$1.45 billion in assets under management by 2025, according to Preqin, an alternative investment research firm.

But what's just as important to note heading into 2022 is the idea that some of the best opportunities to invest in the asset class won't necessarily be in geographic regions at the forefront of its recent growth – like the United States and Europe – but in places that are now playing regulatory catch up.

Canada, for instance, may be home to one of the developed world's least mature private credit markets, yet that's precisely why the runway for growth in the country is so potentially attractive. In fact, while the ultimate size of the Canadian market will never rival those found in larger jurisdictions, it could grow at a faster pace moving forward, as catalysts driving changes in corporate lending take hold just as they have elsewhere in recent years.

Perhaps the biggest kickstart in this regard is Canada's shifting regulatory environment and the impact of more stringent capital requirements to bank lending. Arguably, the "Big Six" banks in the country have been less affected by these changes than large banks facing similar restrictions in other countries since the Global Financial Crisis (GFC) a decade ago. But as time passes and regulations continue to tighten, each of them is now well into the process of tilting their loan portfolios to the most profitable segments. That, in turn, is creating a void that private lending may increasingly fill.

Perhaps the biggest kickstart in this regard is Canada's shifting regulatory environment and the impact of more stringent capital requirements to bank lending.

This is having a particular effect on the part of the credit market servicing mid-sized Canadian companies, which tend to generate less revenue for bank lenders than smaller businesses or larger corporate borrowers. Until recently, Canada's banks have crowded out non-bank lenders by having near-monopoly market share of 85% of loans outstanding in this niche, Government of Canada statistics show, but this weighting

Alternatives

could fall dramatically if the U.S. is a barometer. Indeed, before the GFC, the largest U.S. banks accounted for about 75% of the U.S. mid-sized loan market. Now, that number is closer to 20%, according to Preqin data.

This same story has unfolded to varying degrees in Europe and countries such as Australia, which has a very similar bank landscape to Canada's. And if Canadian banks end up following suit, even to the smallest degree, it's more than likely that private lenders will be needed to pick up the slack. More importantly, many of the opportunities will likely be of high *quality* – so, not just high *quantity* – because mid-sized borrowers in the country have relatively low risk profiles compared with other segments.

Still, investors need to be diligent as more options for investing in private credit begin to surface in Canada. While the primary goal of the asset class is almost always higher yields, it's an objective that often comes at an unreasonable cost – especially when underlying loans in an investment fund or strategy are not senior-secured or lack strong covenants and reasonable loan-to-value ratios to protect against fluctuating market valuations or, worse, default.

All that said, the future of private credit seems bright, both in Canada and other countries around the world. Yet only through due diligence can investors make the most of the opportunity. ■

Ryan Dunfield, Managing Principal, CEO, SAF Group. AGF and SAF Group have entered into an extended partnership that will focus on new private credit opportunities.

Please see Disclaimer section for full disclosure.

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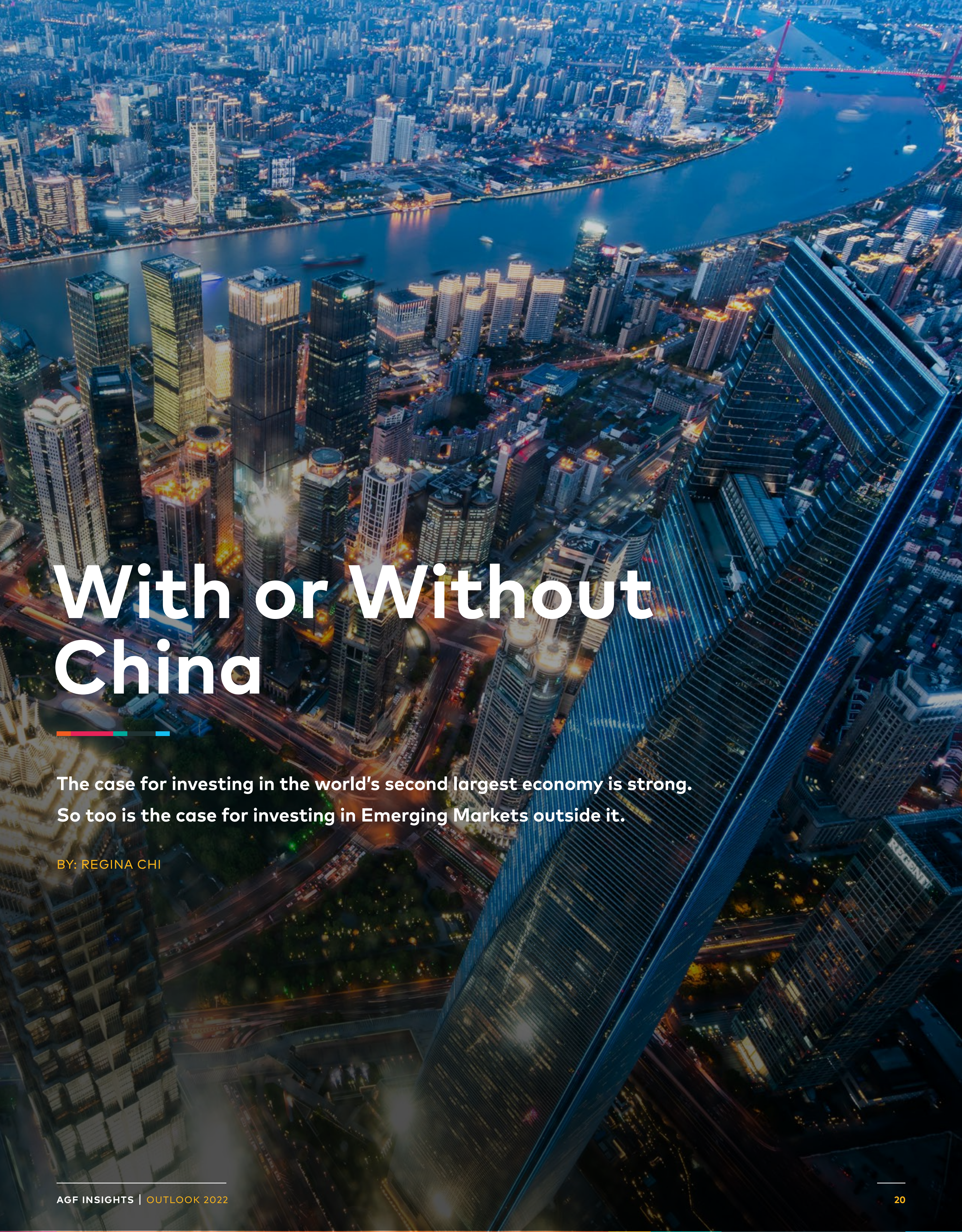

With or Without China

The case for investing in the world's second largest economy is strong. So too is the case for investing in Emerging Markets outside it.

BY: REGINA CHI

Regina Chi, CFA®
Vice-President and Portfolio Manager
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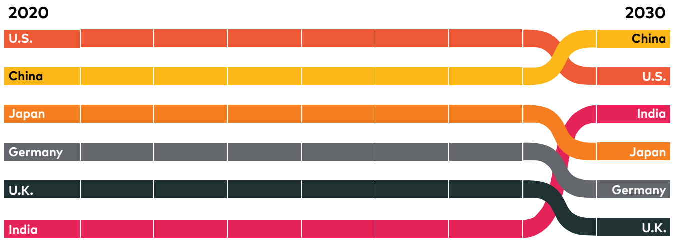
Chinese equities in 2021 have hardly lived up to the promise of one of the world's fastest-growing large economies rebounding from the depths of the COVID-19 pandemic. As of Oct. 31, the MSCI China Index, which captures more than 700 large- and mid-cap companies, was down about 14% in U.S. dollars on the year, according to Factset. By the standard of some other large Emerging Markets (EMs), that is bad. Over the same period, the MSCI Indonesia index was up more than 4%, while MSCI India rose by more than 25%, MSCI Argentina by more than 34% and MSCI Russia by more than 37%.

Perhaps even more concerning for EM investors is the possibility that this underperformance is not just a blip. To many observers, China's government turned more hardline in 2021 on a host of economic and political fronts, from increased regulation on digital-economy firms and an emphasis on wealth-sharing "Common Prosperity" goals to its stand on human rights in Xinjiang province and its contentious position on independence for Taiwan. Those are all potential headwinds for China equities as a group. And when you add in trade tensions with the West, it is not surprising that some Westerners are wondering out loud whether China is uninvestable.

"…it is not surprising that some Westerners are wondering out loud whether China is uninvestable.

The answer to this question is no. After all, "getting out" of China would mean turning one's back on the potential of the world's second largest economy, which is on track to become the world's largest before 2030, according to the World Bank. It would also mean missing the investment opportunities presented by the largest middle class in the world, and China's body of 400 million middle-income consumers is growing. Yet for some investors, that long-term potential might not be enough to keep them exposed to a market over which they have deep economic, political or ethical concerns. So it is worth asking the question: What would an Emerging Markets allocation strategy look like *without* China?

World's Largest Economies by 2030 (Ranking in Nominal GDP)



Source: Centre for Economics and Business Research, World Economic League Table 2021

When we ponder that question and look at China equities' current share of broad EM indexes, a couple of things become readily apparent. One is that China looms large – perhaps too large. Another is that setting China aside from other Emerging Market allocations could produce a more diversified, more balanced portfolio. It may also present investors with significant upside in capturing an important secular trend: the digitization of emerging economies.

First, let's look at just how big China is within the most widely followed EM indexes. China equities comprise 34% of the MSCI EM index – more than twice the next-largest market, Taiwan, at 15% – and 36.5% of the FTSE EM index, according to both index providers. At the market's peak, China represented more than 40% of both. That in itself represents heightened concentration risk, but a related issue is that EM index investors also face heightened regional concentration because of the size of the China allocation. Regionally, 78% of the MSCI EM index is allocated to Asia stocks, with 14.3% to EMEA (Europe, Middle East and Africa) stocks and only 7.3% in

South America. Take China out of the equation, however, and those regional outliers become more important. In an ex-China EM allocation, Asia's share falls to 67%, while EMEA's rises to 21.6% and South America to 11.1%. An ex-China strategy would still be skewed towards Asia, but much less heavily so.

Excluding China, then, could provide better diversification across EM regions. It could also be more balanced across specific markets. As mentioned above, China dominates within the EM index, with a nearly 20-percentage-point weighting difference over the next-largest market. In an ex-China strategy, however, the top three countries achieve roughly equivalent weight: India, Taiwan and Korea all comprise around 20% of the total allocation. That more balanced weighting might be especially important regarding India because its stock performance has tended to be less correlated with China than, say, Korea's or Taiwan's.

Yet the potential benefits of an ex-China strategy go beyond better diversification and a more balanced EM portfolio. Getting out from under the weight of China allocations might also open up secular opportunities in other markets. Consider e-commerce, one of the great yet-to-be-realized opportunities for EM investors – outside of China, at least. According to the MSCI China index, it's dominated by three big players in the Internet and consumer retail/technology space, sectors that account for 45% of the index. Before 2021, China's digital economy stocks were high-flyers as e-commerce boomed, and Internet retailing already makes up 24% of total retail sales in China. But with rising regulatory scrutiny, future sector growth – and the upside for China's e-commerce stocks – might well be capped. This is not the case elsewhere in Emerging Markets. In India, for example, Internet retailing accounts for only about 7% of total retail sales, and in the MSCI EM index excluding China, Internet and consumer retail/technology companies comprise only 6% of allocations. It may be that e-commerce will grow across developing economies, but it has more room to grow – and may grow faster – in markets outside of China.

> **Looking at EM allocations in this way may or may not convince investors to "get out" of China – which, we hasten to add, is not our primary goal.**

Looking at EM allocations in this way may or may not convince investors to "get out" of China – which, we hasten to add, is not our primary goal. But it clearly suggests that they may benefit from looking at China's influence on EM performance in a different light. For instance, U.S. stocks account for more than 60% of the MSCI World index, creating even more concentration risk than China does in the EM index. To address that, investors have increasingly adopted a strategy of making discrete allocations to the dominant U.S. market while gaining exposures to developed markets outside the U.S. through vehicles like the MSCI World ex-U.S.A. and MSCI EAFE (Europe, Australasia, and Far East) indexes. A similar approach with China might provide similar sectoral and geographical diversification and portfolio balance advantages, while allowing investors to pursue specific opportunities in China.

On a broader level, this EM ex-China exercise demonstrates some of the pitfalls of lumping Emerging Markets together under one opportunity set. More than some other asset classes, EM equities' performance and potential are functions of local political, economic and social factors that no broad index – however useful it is as a benchmark – can hope to fully capture. Emerging Markets are not all the same, and China is unlike any other EM. Rather than abandoning China altogether, recognizing that reality might be a more prudent way to begin to address its risks and its potential, while opening the door wider to opportunities elsewhere.

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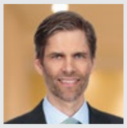
The Great Transition Revisited

"Greenflation" may be a short-term reality, but sustainable investing is not likely to drive prices higher over the long term.

BY: MARTIN GROSSKOPF



Martin Grosskopf, MBA, MES
Vice-President and Portfolio Manager
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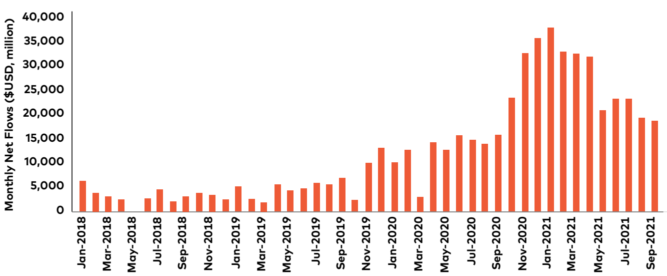
The recent United Nations Climate Change Conference (COP26) in Glasgow may have been a disappointment to many climate change scientists and activists, but it should have made one thing perfectly clear to investors: the energy transition from fossil fuels to carbon-friendly renewable sources is now a global imperative. While the shift may not be aggressive enough for some, it is already having a profound impact on markets and how we invest in them.

In fact, the growth of environmental, social and governance (ESG) investing may have surpassed even the most bullish expectations over the past two years. Net flows into dedicated sustainable U.S. equity funds, for instance, more than tripled during 2020, and they are still double what they were before the COVID-19 pandemic heading into 2022.

Dedicated Sustainable Equity Funds: Monthly Net Flows



Source: RBC U.S. Equity Strategy, using Morningstar data, as of October 2021

Still, ESG is not without controversy. Beyond the usual objections, it is now being singled out as one of the key drivers of inflation, and not only in the immediate term: some see it as a contributing factor to longer-term structural price increases as well. More to the point, "greenflation" is being linked to the spike in energy and power prices, particularly in the U.K. and China, as well as increases in the price of key materials required for the transition to battery propulsion systems.

But this inflation link is dubious. At most, ESG investing may be contributing to cyclical inflationary pressures, yet there's little to no evidence that its impact will be long-lasting or have an effect on economic growth and financial markets over time. To the contrary, the argument for greenflation as a secular force is based on two theories that do not prove out. The first is that higher ESG expectations from investors place greater constraints on how and when a company can increase production, which impacts supply and thereby prices. The second premise is that government intervention through environmental regulation increases development and operational costs, again influencing prices over time.

If either of these were true, it would be reasonable to assume that most ESG strategies are already directing capital away from fossil fuel-intensive sectors relative to more mainstream investment approaches. We would expect to see this in positioning that is meaningfully different from those assets that are passively managed or "benchmark-like" in their allocation. But that hasn't been the case. In fact, the majority of large ESG funds continue to have only small deviations in positioning from their mainstream counterparts, according to research from Jefferies Group.

In addition, the ESG ratings, on which these strategies depend, have been critiqued specifically for their lack of alignment with several standardization efforts underway. And while a great deal of emphasis has been placed on the few large investors who have divested from oil, gas or coal, many institutional investors continue to maintain their positions and focus on engagement and collaboration on key ESG issues. This has ensured that capital is not diverted away from carbon-intensive industries, and even those that have divested from their public holdings often continue to invest through private market exposure.

The spectre of greenflation is also being floated in the context of metals and mining, especially as it relates to the ramp-up in demand for electric vehicles, which is running headlong into a market heavily constrained by regulators. Often, the case is made that tighter environmental and social controls have lengthened time frames for new mine approval and development. This, in turn, is said to create structural challenges and steep changes in the pricing dynamic both for speciality inputs, such as lithium and cobalt, and for bulk commodities, such as nickel and copper.

> **In fact, the majority of large ESG funds continue to have only small deviations in positioning from their mainstream counterparts…**

Once again, it is challenging to reconcile this viewpoint with reality, in part because metal prices have historically remained low despite increased scrutiny from governments to mitigate social and environmental impacts. In addition, the ability of an industry to thrift and substitute materials, or even to pivot entirely, is typically underestimated. Over the course of 2021, some auto manufacturers pivoted from an NMC battery chemistry (high in nickel, manganese and cobalt) to an LFP chemistry that uses lithium iron phosphate and requires none of these metals mentioned above.

All of that suggests ESG's impact on prices is not inherently structural. However, the geopolitical nature of the energy transition may provide a caveat. While some regions such as the Middle East have dictated supply chains for much of the fossil fuel era, others may come to the forefront – including Asia and South America – in a renewables and battery reliant era. Where governments control key materials, they will be highly motivated to accelerate their own advantages. The result could be episodic and unpredictable inflation shocks.

That said, recent increases in power prices within parts of Europe and in China are less indicative of inflationary forces than of the policy challenges of the transition. The retirement of coal-fired power plants, in particular, needs to be balanced precisely with new intermittent sources such as wind and solar, ideally with battery backup. Emissions objectives are unlikely to neatly coincide with perfectly planned changes to the grid.

There is little doubt that the ambition for real energy transition is stronger than ever before, but there is also little evidence that ESG investing or government intervention has fundamentally altered the structure of key commodity markets. More importantly, there will likely continue to be innumerable investment opportunities during the multi-decade shift to a more sustainable future – regardless of whether greenflation is a cyclical or secular phenomenon. ■

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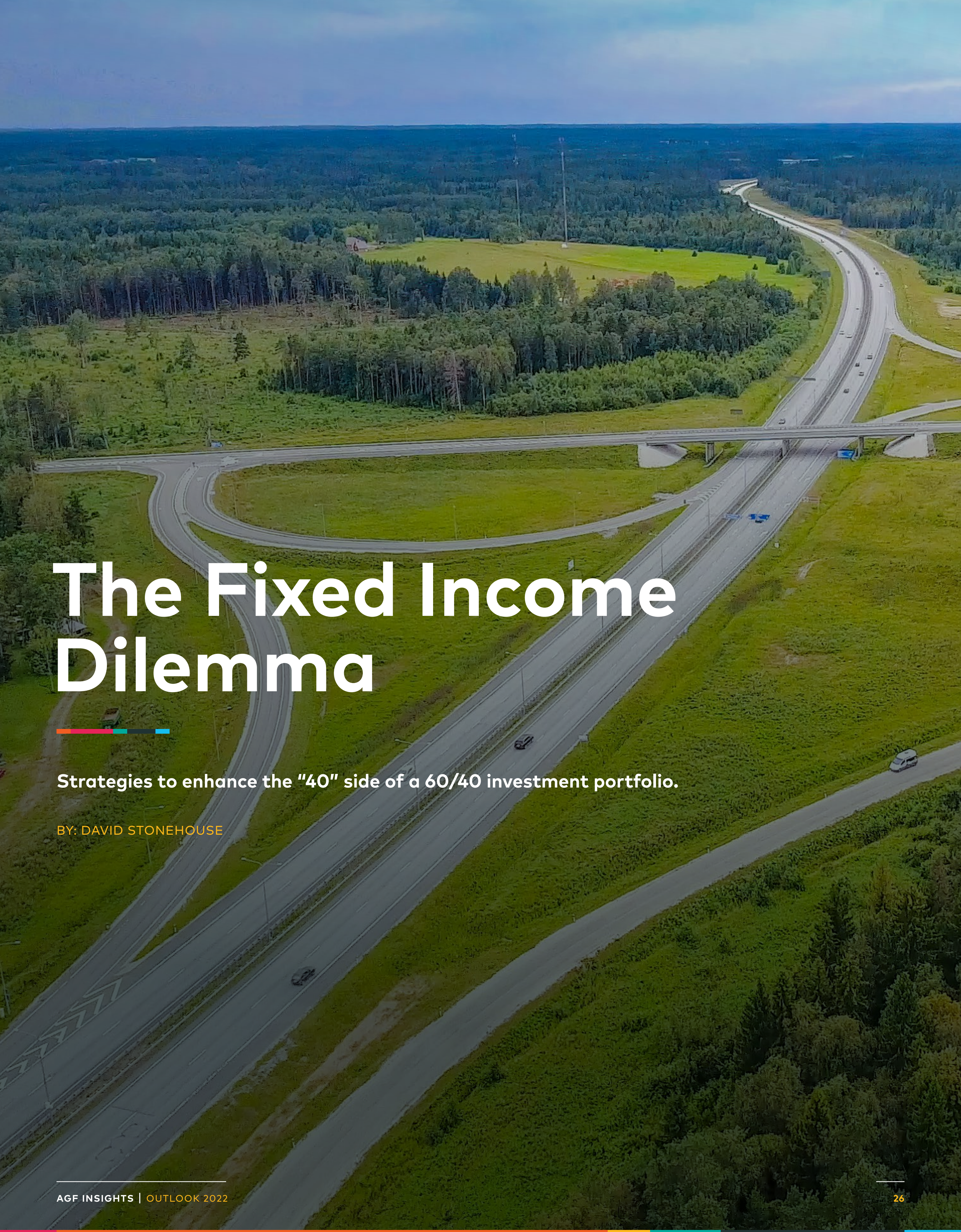
Watch:

Investor's Guide to ESG Integration

By Max Zehrt, Associate Vice President and Head of Environmental, Social & Governance AGF Investments Inc.



The Fixed Income Dilemma

Strategies to enhance the "40" side of a 60/40 investment portfolio.

BY: DAVID STONEHOUSE

David Stonehouse, MBA, CFA®
Senior Vice-President and Head of North American and Specialty Investments
AGF Investments Inc.

The investment industry has long espoused the virtues of the 60/40 asset allocation model – that is, 60% of a portfolio held in equities and 40% in bonds. For decades, through financial crises and stock bubbles, the model has largely rewarded investors' faith, consistently delivering a healthy balance of solid returns and decent risk mitigation over time. Yet today, more and more investors are questioning the wisdom of 60/40, and much of the concern centres on the "40" side of the ratio. With yields low and the prospect of rising rates creating price volatility, many are wondering whether bonds can any longer provide either the returns or the downside protection that they once did – and whether it's time to rethink a simple 40% allocation to fixed income in a balanced portfolio.

> **…many are wondering whether bonds can any longer provide either the returns or the downside protection that they once did…**

We see their point: in the current environment it would be prudent for investors to consider ways to generate yield and mitigate risk that go beyond just allocating 40% of assets into traditional bonds. We also believe, however, that the relevant question is as much (or more) about the assets held in that fixed income allocation as it is about the overall proportion of fixed income in a portfolio. Options beyond traditional bonds do exist, and they may provide investors with strategies for getting more out of fixed income even in these very challenging times – if they are prepared to think a little bit differently.

Before we explore those alternatives, let's look at what bonds are *supposed* to do in a portfolio. Historically, they have had two primary purposes: to provide yield and to dampen volatility. One could allocate 100% of a portfolio into stocks, and that would invariably generate higher returns over sufficiently long time periods. Yet very few investors have the stomach for such risky exposures during major bear markets, and bonds have historically provided a cushion to stock-market blows. In the event of an equity downturn, bond yields usually plummet (and bond prices rise) as investors flee to safety, and that mitigates an investor's losses.

Consider how this works in a 60/40 portfolio. Let's hypothesize a bear market in which stocks decline by 40%. In our model portfolio, that creates a 24% decline in overall value. However, at the same time, bond yields might decline by 2%, translating into, say, a 10% price appreciation in the fixed income part of the portfolio (depending on the starting yield and duration) and generating a 4% positive effect on portfolio value. So, instead of losing 40% (as they would in a stock-only portfolio), the 60/40 investor will end up down "only" 20%. Of course, during strong stock markets, the fixed income allocation would produce lower returns than equities, but it would be less volatile – and may help investors sleep better at night.

Or at least fixed income *should* do that. The trouble is that in recent years, the effectiveness of bonds in generating yield has been impaired, and post-pandemic, their near-zero yields have jeopardized their ability to mitigate risk. The yield problem is clear: yields are very low and will likely remain low even after policymakers finish the tightening cycle that many expect in the next few years. That problem leads to an even more troublesome one: because yields are so low, the effectiveness of bonds to protect against portfolio losses is also lower. If a bond's yield is already at 1.5%, it is more difficult for it to fall by two percentage points in a bear market. If yields have less room to fall, prices have less room to rise, meaning bonds will do less to offset equity losses. It is not that bonds can no longer dampen volatility; it's just that they may not be able to do it as well as they used to.

It's important to note here that bonds still have an important function in a portfolio. They have lower volatility than stocks, and in an adverse environment they should still help mitigate the decline of equities. Low yields, however, cap the downside protection they offer. And today, with the prospect of central banks tightening monetary conditions, bond returns have turned modestly negative – making a challenging fixed income landscape even more so.

How can investors respond? One obvious tactic is to shorten duration in bond allocations, mitigating the risk of rising rates. The challenge, however, is timing. For much of the past 40 years – the secular bull market in bonds – investors have generally responded by reducing duration, simply because they did not believe rates could keep going lower. And yet rates *have* kept going lower. Moreover, there is no guarantee the U.S. Federal Reserve will hike rates as much – or at all – as nearly everyone expects late next year and beyond. A second drawback of this tactic is that short-term bonds usually yield less than longer-term bonds, meaning that investors will be paid even less by focusing on short-duration instruments. In addition, when yields do fall, short-duration bonds don't rally as much as long-duration bonds.

“…we believe a more prudent response for investors might be to “upgrade” it by resetting their fixed income exposures.

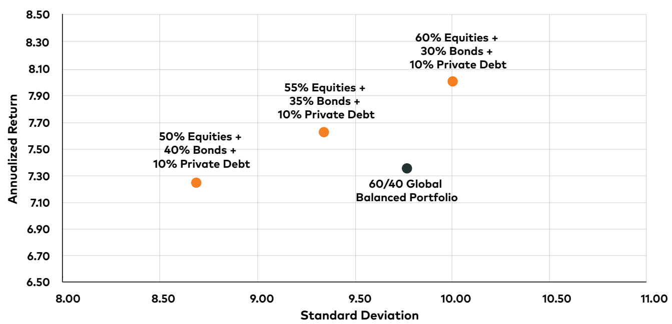
Another response would be to conclude that the 60/40 model is broken and simply allocate a greater proportion of assets to equities. Indeed, some investors have adopted this approach. The problem is that the starting point of low yields has already generated a rush towards stocks. Valuations have moved much higher, so long-run future-expected returns have become more challenged. A higher equity allocation clearly also increases downside risk. Thus the 60/40 investor's dilemma exists on both sides of the equation.

Rather than throw out the baby with the bathwater and abandon the 60/40 model, we believe a more prudent response for investors might be to "upgrade" it by resetting their fixed income exposures. One does not have to hold traditional bonds exclusively, and there are solid options that approximate bonds' benefits while mitigating some of their risks.

- If you believe inflation is going to cause yields to rise, *inflation-linked bonds* are an option. Note that ILBs have enjoyed a stellar run in the past 18 months, and future gains may be harder to come by if inflation ends up being just a cyclical phenomenon.
- *High-yield bonds* and *Emerging Market debt* both offer the potential for higher returns through far more attractive yields, although with higher risk. In high-yield, investors assume more credit risk; in EM debt, they take on more political and currency risk. Nevertheless, high-yield bonds in particular have provided attractive absolute and risk-adjusted returns historically, even after adjusting for defaults (which can be partially offset by recovering some residual value in the company's assets).
- To mitigate rate sensitivity, investors can consider exposures to *floating rate (or senior) loans*, which also can offer higher yields and diversification benefits, although these instruments too involve credit risk.
- *Convertible bonds*, which are corporate debt instruments that can be exchanged for common shares, offer the potential for lower rate sensitivity and better returns than traditional bonds might. They also typically offer much better downside protection than stocks. It is important to be aware that they tend to be more volatile than regular bonds, since convertibles' value is somewhat exposed to the issuing company's share price.

- *Real assets* like infrastructure, while not a fixed income solution per se, can offer inflation protection and the potential for steady long-term returns. Resources can also be a good source of inflation protection, although they tend to be more volatile.
- *Derivative strategies* can hedge against rising interest rates or capitalize on foreign exchange currency opportunities, which have the potential to mitigate risk and boost returns without leverage.
- *Private credit* – corporate debt not issued or traded on public markets – can generate higher yields and enhanced risk-adjusted total returns in a fixed income portfolio, while also providing more diversification and lower volatility, albeit with lower liquidity.

Adding Private Credit to a Hypothetical 60/40 Portfolio



Source: Morningstar Direct and Preqin. For Illustration purposes only. The hypothetical performance presented is based on a combination of index returns. One cannot invest in an index. Hypothetical performance is not necessarily indicative of future results. Based on quarterly performance data as of March 31, 2021. Equities represented by the MSCI All-Country World Index Total Return Index. Bonds represented by the Bloomberg Global Aggregate Bond Total Return Index. Private Debt represented by Preqin's Private Debt Quarterly Index.

Finally, a prudent approach to the challenges of 60/40 might go beyond resetting exposures. It might also involve resetting expectations – on both sides of the equation. Even if the Fed raises rates, fixed income yields will likely remain low by historical standards, and that obviously will be a headwind to income generation, although it will also mitigate capital loss potential from rising yields. On the equity side, returns might also be challenged because valuations are high relative to historical norms. After such a stellar post-Global Financial Crisis run for U.S. stocks in particular, it makes sense to be wary of any assumptions of double-digit annual equity returns over the long term.

That makes thinking differently about fixed-income allocations even more important. None of the options to traditional bonds outlined above is a silver bullet, and all involve both advantages and risks. Yet, when put together in a "group effort," they demonstrate that there is plenty of room for innovation and manoeuvrability – and the potential for enhancing outcomes even within a 60/40 portfolio model. ■

Please see Disclaimer section for full disclosure.

Watch:

The Link No Longer Missing in Sustainable Fixed Income

By Andy Kochar, Vice President and Portfolio Manager, Head of Global Credit
AGF Investments LLC

Not Your Parents' Infrastructure

The new wave of "infra" stocks presents new opportunities for investors

BY: BILL DEROCHE, MARK STACEY AND GRANT WANG

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There is no question that infrastructure investing is on the verge of something big – especially following passage in November of the United States' massive US$1.2-trillion spending plan to fortify the structures and networks that underpin the world's largest economy. In fact, to hear President Joe Biden describe it, the new legislation is a "once-in-a-lifetime investment" that will rival anything built in the country since the interstate highway system in the 1950s.

But the sheer size of the opportunity at hand isn't the only aspect worth noting. What should stand out to investors just as much is how this pledge – and others from around the world – differ in scope from most large infrastructure initiatives of the past. While governments are still allocating a good chunk of the money to the repair and expansion of traditional infrastructure like roads, bridges, railways, ports and airports, they are also earmarking a significant amount for "new wave" projects to facilitate economic activity that is becoming increasingly digital in nature and carries the promise of being more sustainable, too.

"...perhaps the most important question for investors is how best to navigate the growing universe of infrastructure possibilities at hand.

For instance, as part of its new plan, the Biden administration says it will spend US$65 billion to build reliable high-speed internet through broadband infrastructure and US$75 billion to upgrade power infrastructure and move from fossil fuels to renewable energy. At the same time, another US$15 billion is to be spent on electric vehicles and the infrastructure needed to charge them.

While it remains to be seen how quickly these commitments will be tapped, or how they ultimately end up flowing through to financial markets, perhaps the most important question for investors is how best to navigate the growing universe of infrastructure possibilities at hand. From our perspective, a good starting point is to group the newer wave of opportunity into two broad investment categories, each of which can be broken down into sub-categories.

New Wave of Infrastructure

- **Digital Infrastructure**
  - **Telecommunication Towers**
  - **Data Centres**
  - **Cloud Services**
- **Renewable Energy Infrastructure**
  - **Renewable Energy Utilities**
  - **Renewable Energy Equipment**

Source: AGF Investments Inc. as of 02/15/2021

Digital infrastructure, the first of these categories includes three related niches: telecommunication towers, data centres and cloud services. Of the first, the business of building and maintaining cell towers and renting them out to the world's largest telecom providers may not be fully appreciated by investors just yet, but this type of B2B relationship is now commonplace in most of North America and Europe, where it has spawned several real estate investment trusts (REITs) with billions of dollars in revenue and market capitalizations to match.

Moreover, a growing number of REITs and companies are also focused on owning or leasing real estate space for use as data centres. Typically, these agreements include additional revenue-generating services such as power supply and cooling systems, and they encompass a diverse range of customers, from telecom, media and internet service providers to government and various other private enterprises.

Cloud services, meanwhile, make up one of the biggest operational trends of recent years. Many companies are moving away from "on-the-premises" servers towards database hosting and cloud computing services sold and maintained by some of the world's best known tech giants. Those companies, in turn, have experienced a marked increase in total revenues generated from these services as a percentage of overall sales.

The second broad investment category in the new wave is best classified as *renewable energy infrastructure*. In large part, this is an adjunct to more traditional energy infrastructure and includes two subcategories, the first of which is renewable energy utilities that sell an increasing amount of power to consumers and businesses generated by multisource energy platforms, including hydroelectric, wind and solar facilities.

As for renewable energy equipment, the second of these two subcategories, it's clear that makers of solar panels, wind turbines, hydrogen cells and other components used to harness renewable energy have increased dramatically in recent years. Indeed, according to the most recent statistics from Global Wind Energy Council, 93 gigawatts of wind energy capacity were installed globally in 2020, representing a 53% increase from installations in 2019.

Of course, this new wave may end up extending well beyond these two categories in time. *Green infrastructure Services*, for example, is a burgeoning classification that includes its own set of potential opportunities, such as electric vehicle battery manufacturers.

Still, categorization may only be half the battle. Whether it's a more traditional asset like an airport or one more modern like a cell tower, it is widely understood that infrastructure as an investment theme is defined by certain criteria. For instance, most "infra" stocks tend to generate a stable cash flow from some essential product or service with a social benefit. In addition, they often involve the use of capital-intensive real assets and are considered high-barrier-to-entry businesses that have minimal competition.

To that end, both digital and renewable energy infra stocks seem to fit the bill as the underlying trends in support of them have also accelerated. For example, digital infrastructure is a direct beneficiary of the ongoing rollout of fifth-generation (5G) cellular networks that will be critical to bringing new technologies, such as the Internet of Things and autonomous vehicles, to market. At the same time, the global pandemic's impact on digital infra stocks cannot be understated. In particular, shelter-in-place regulations have led to a significant increase in the use of online services and, perhaps, have forever changed the way people work and socialize with one another.

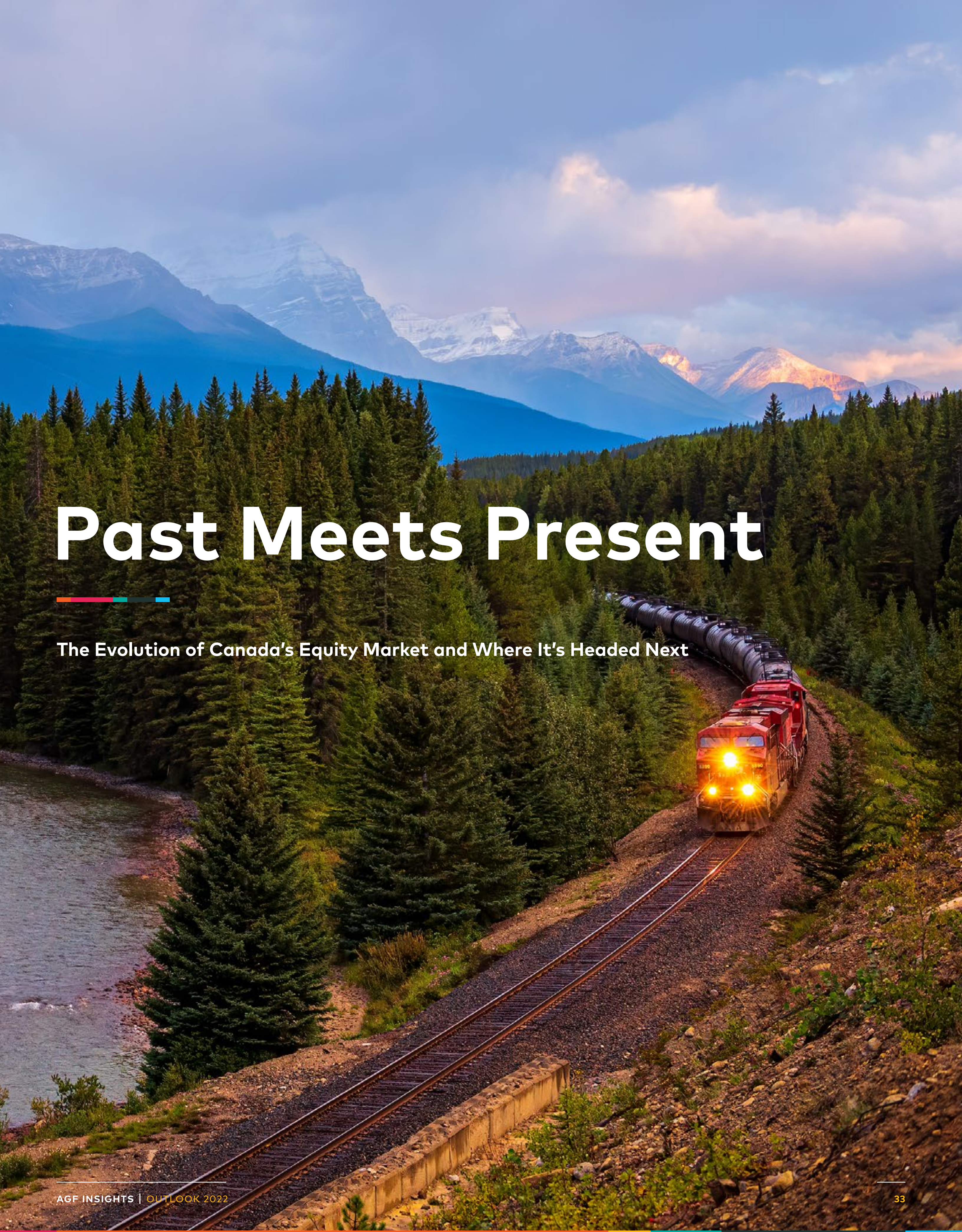
"

...infrastructure is a growing potential opportunity for investors, not just in size but in scope as well.

Similarly, the performance of renewable energy infrastructure stocks has largely been tied to growing public awareness about climate change and ambitious political commitments such as the Paris Climate Agreement, which seeks to limit the global average temperature increase to 1.5°C by 2050 through the reduction of greenhouse gas emissions. In turn, renewables are expected to surpass coal as the largest source of electricity generation in the world by 2025, according to the International Energy Agency.

If anything, then, infrastructure is a growing potential opportunity for investors, not just in size but in scope as well. And while traditional assets like roads, bridges and pipelines are still central to the theme, it may be the new wave of cell towers, wind farms and data centres that will keep infrastructure portfolios on a more solid footing in the future. ■

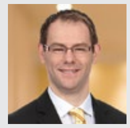
Please see Disclaimer section for full disclosure.



Past Meets Present

The Evolution of Canada's Equity Market and Where It's Headed Next

W. Robert Farquharson
Director and Vice-Chairman
AGF Management Limited



Mike Archibald, CFA®, CMT, CAIA
Vice-President and Portfolio Manager
AGF Investments Inc.

Bob Farquharson was the first portfolio manager of AGF's Canadian Growth Equity strategy. Mike Archibald is the latest. Here's what 60 years of collective experience has to say about investing in one of the world's 10 biggest stock markets.

When you think about investing in the Canadian equity market today versus what it was like 60 years ago, or even just five years ago, what is the most striking difference between now and then?

BOB FARQUHARSON (BF): The market was hugely different at the start of my career, in 1963, from what it was at the end of it, or especially now. The universe of investable securities was very small, and good data was scarce. For example, I could probably count the number of sell-side analysts – at least the good ones – on my hands. I spent a good part of my early career learning how to analyze stocks on my own by reading Graham & Dodd's *Security Analysis*. I don't know if anybody reads Graham & Dodd anymore. Of course, I also studied to become a Chartered Financial Analyst (CFA®). I'm something like the 1,020th charterholder, so there weren't many of us around back then. *(Editor's Note: There are roughly 170,000 active charterholders today, according to the CFA Institute's website).*

All of that said, I spent a good deal of my time just talking to the people who ran good companies. When I started, some companies didn't report sales. So, how do you analyze a company's accounting standards like that? You must find other ways to learn how a company is run and how profitable it is. A big part of that was building relationships with the people who ran them.

MIKE ARCHIBALD (MA): Clearly, my experience to date is quite different. It is a much larger investment community. There are more products and more opportunity sets for investors. What strikes me most is that access to information is unlimited now. Whether you're an institutional investor or a retail investor, it doesn't make much difference. Now, you can find anything you want at the click of a mouse. And the cost of information is effectively zero. And all of this is because technology has advanced so much, and the pace of change is likely to accelerate even faster over the next 10 years.

> **When I started, some companies didn't report sales. So, how do you analyze a company's accounting standards like that?**
>
> **Bob Farquharson**, Director and Vice-Chairman
> AGF Management Limited

On the flip side, is there anything about the market in Canada that hasn't changed much over the years?

MA: If you look at the historical composition, it hasn't changed all that much. Cyclicality is still dominant. Energy, Materials, Industrials and Financials still make up close to 70% of the S&P/TSX Composite Index (TSX). That's probably not going to change anytime soon, and most Canadian equity managers will likely continue to own heavy positions in those sectors.

BF: These sectors were always a big part of my portfolio, too. In particular, we did well owning energy and natural resource companies. We always owned two or three of the "Big Six" banks as well, and that wasn't just because of the numbers, but, again, because we had good relationships with management and were convinced of their vision.

Given this cyclicality, is today's macro environment, characterized by economic recovery and higher inflation, almost the ideal backdrop for Canadian stocks?

MA: Because of the landscape, inflation and rising commodity prices are good for the bulk of the Canadian market. Obviously, it's good for energy and mining firms and it also helps Industrials like the railways, which are moving product across the country and south of the border. The banks tend to make money in this type of environment, too, because yields usually rise, although that hasn't been the case this time around. Perhaps the best example of how powerful an inflationary environment can be to Canada's market is the commodity boom at the start of this century. The TSX was one of the strongest-returning indexes in the world back then.

BF: The Canadian market was also the place to be in the 1970s, which, of course, was a time of very high inflation and commodity prices. Our U.S.-oriented strategies may have suffered during this decade, but it was good time to be an investor in Canada.

What about those periods of time that weren't such a good time?

BF: I remember Black Monday in the fall of 1987, but perhaps the worst stretch was the early 1980s when interest rates hit the high teens. It was extraordinary, and a lot of people I know left the business. But you're not in this business thinking you're going to win all the time, and in my experience it was the people who thought that way who didn't end up lasting long.

MA: Volatility is the cost of entry into the game. Corrections happen and they are impossible to avoid. I've managed through the Global Financial Crisis, the U.S. Debt Downgrade and, more recently, the COVID-19 selloff. And I've learned that the cause of each crisis is always different, but the actions of participants are almost always the same. Emotion drives market bottoms and they are hard to identify, but if you pay close attention, they also result in potential opportunities. The key is not to try timing these opportunities perfectly.

> **Volatility is the cost of entry into the game. Corrections happen and they are impossible to avoid.**
>
> **Mike Archibald**, Vice-President and Portfolio Manager
> AGF Investments Inc.

Putting aside macro conditions, what are the characteristics of a good Canadian stock?

MA: I like companies with a strong track record of success, an improving fundamental backdrop and market recognition. They need to have momentum on their side and understand what is working for them and have a clear plan for future growth. I'm also a big believer in management teams who under-promise and over-deliver. In other words, these are companies that are conservative in their forecasts, but know how to manage through good times and bad.

BF: I loved finding smaller companies that I could invest in for the long term, but, to Mike's point, one of the keys to that was knowing you could trust management to execute. For example, we held some stocks, in part because we had so much faith in the firm's founder or CEO.

MA: I would characterize those types of investments as the long-term compounders that you want to own in your portfolios. The management teams are stellar, the businesses can manage through a full market cycle, and when you get opportunities to buy these companies inexpensively because of an event like the selloff at the beginning of the global pandemic, you want to be aggressive.

What specific trades of yours from the past stand out most?

BF: There are a few, but a certain upstart national airline in the 1990s comes to mind. We first held it when it was still private. That's not something we did a lot of, but again I thought management was smart and the timing was right for building out a new airline in the country.

MA: My first foray in the business was in 2011. This was well before I joined AGF and a few years after the Global Financial Crisis. One of the country's other airlines was going through a difficult re-capitalization and its shares were trading at less than a dollar, but we felt the company would rebound. It was a controversial trade at the time, but the return on it was almost like private equity in terms of magnitude.

Finally, what is your outlook for the Canadian market next year and beyond?

BF: In the broad sense, money is going to get more expensive, but it's still very cheap and that's good for markets.

MA: Agreed. Interest rates remain extremely low and should be supportive of higher valuations and positive flows into the Canadian market if the global economy stays on solid footing. Longer-term, investors should expect more potential to arise from technology hubs in cities like Waterloo, Ontario, which continue to churn out success stories. And the areas of sustainability and green innovation should have a larger influence in the coming years. ■

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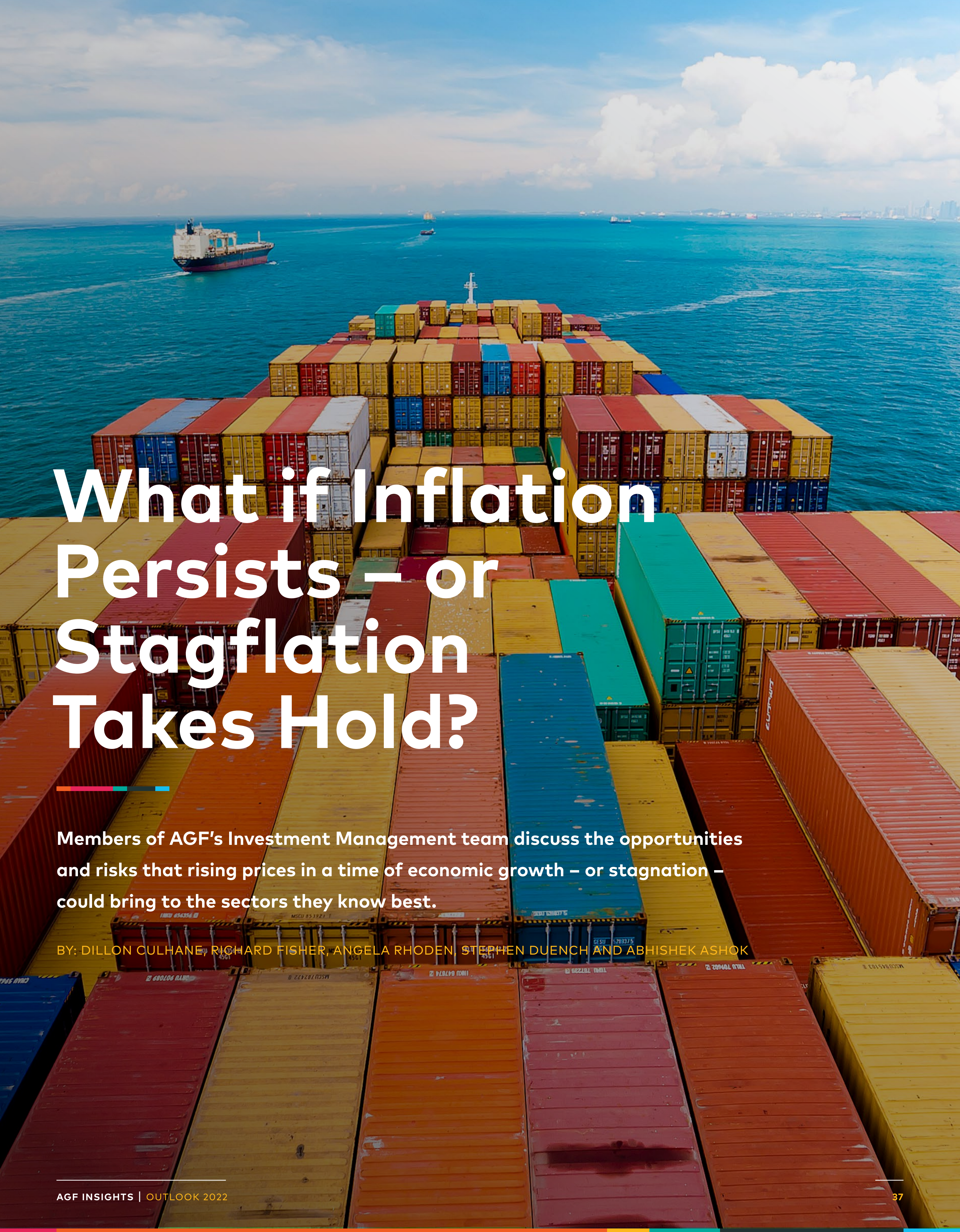

What if Inflation Persists – or Stagflation Takes Hold?

Members of AGF's Investment Management team discuss the opportunities and risks that rising prices in a time of economic growth – or stagnation – could bring to the sectors they know best.

BY: DILLON CULHANE, RICHARD FISHER, ANGELA RHODEN, STEPHEN DUENCH AND ABHISHEK ASHOK

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ENERGY AND UTILITIES

Pass It On

Dillon Culhane

Energy, utility and power stocks are impacted by inflation in various ways depending on the type of business, but there should be opportunities for discerning investors across the spectrum.

Oil and gas producers usually benefit from rising energy prices given the boost in revenue more than offsets inflationary increases in labour, materials and fuel costs. The better-positioned producers tend to be more cost-efficient, with locked-in service contracts and/or low decline rates on production helping drive lower capital re-investment.

In comparison, energy service companies have not benefitted as much, with pricing power limited to passing on higher costs to customers, due to producer capital discipline and spare capacity on equipment like drilling rigs. If inflation persists, the most attractive service companies would be those that operate in business lines with high barriers to entry, disciplined competitors, limited spare equipment and sustained pricing power.

Utilities and power companies have their own nuances in the face of higher inflation. Regulated utilities stocks should hold up relatively well since they can pass on higher costs to customers via rate increases, and also benefit from the long-term potential for higher regulated rates of return.

The impact on non-regulated power producers and renewable energy developers may be more pronounced. While most large developers have not been materially affected by inflation to date, smaller companies are more susceptible given less scale, higher financing costs, and less bargaining power with suppliers and long-term offtake customers. Many equipment suppliers (solar modules, wind turbines, batteries) have also been hit hard by rising input costs for things like steel and transportation.

All of that assumes inflation continues to rise while economic growth remains strong. If growth slows and stagflation becomes a threat, energy demand could fall and put downward pressure on energy prices. Still, this may not be a serious concern given a large portion of energy demand is inelastic (power, heat, petrochemicals), while the more elastic areas like commuting and air travel fell significantly over the past two years and seem more likely to continue rebounding as long as the pandemic doesn't get worse.

Stagflation should also have limited impact on utilities, given their low-growth business models that earn regulated returns on capital spent in areas like grid upgrades, facilities replacement, storm hardening and de-carbonization.

Finally, the strong growth in renewable power is driven by the secular trend of global de-carbonization, making it somewhat insulated from any economic growth slowdown.

FINANCIALS

Level Setting

Richard Fisher

Financials were some of the strongest-performing stocks during the past year and should benefit from a continuing climate of rising prices and wages. But how much they benefit and for how long may depend on where interest rates end up from here.

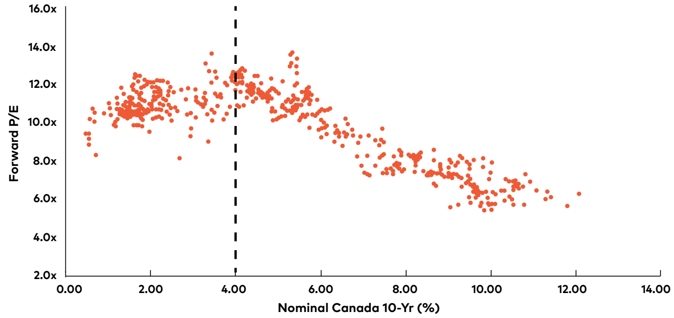
Generally, shares in financial companies with asset-sensitive balance sheets react favourably to the market's anticipation of rate hikes, as well as the decision by many central banks to raise them.

Life insurers, for example, benefit from higher rates – or, more technically, the steeper yield curve associated with them – because the polices they sell require a level of reserves for future claims that is established using an assumed rate of interest. As interest rates increase, the value of reserves required falls because of a higher rate of compounding, and the difference between what was required before the rate increase and what is required after can be "released" into earnings.

For banks, the impact of higher rates is slightly different, but typically still positive, at least to a certain point. The reason? When a central bank begins increasing its benchmark rate, bank margins expand because variable rate loans re-price upwards immediately, while the rates offered on deposits are slower to move – often not increasing much during the first couple of hikes. As a result, the spread between the bank's assets (i.e. loans) and its liabilities (i.e. deposits) widens and earnings increase, driving valuations higher. Perhaps more importantly, banks may forestall their deposit rate increases even longer this cycle given that the system is awash in deposits from various pandemic assistance programs, which is prolonging margin expansion.

But this relationship has always been conditional on the absolute level of interest rates and can work in reverse the higher they go. For instance, the valuation of the S&P/TSX Canadian Bank Index has been positively correlated to the 10-year Government of Canada bond yield when the yield has been below 4%, but negatively correlated when the yield is above that mark, according to research from BMO Capital Markets. Not surprisingly, this is also the historical threshold for when higher interest rates become a drain on economic growth.

Canadian Bank Valuations Versus Canadian Bond Yields



Source: BMO Capital Markets. Each dot of scatter plot represents forward price/earnings multiples for the S&P/TSX Bank Index since 1984. Last data point as of November 15, 2021.

In other words, inflation should remain a catalyst for banks – and financials stocks more broadly – until rate hikes to combat rising prices cause a slowdown or contraction in the economy. Given the U.S. Federal Reserve's current funds rate range between 0 and 0.25% and the Bank of Canada's overnight rate at 0.25%, that tipping point may be a long way off yet.

INDUSTRIALS

Automated Response

Angela Rhoden

Industrial companies have seen increasing cost pressures in recent months as they tend to have exposure to rising commodity prices, rising wages and supply chain constraints. If inflation persists into 2022, there is a risk that margins come under pressure and earnings trend lower.

In this environment, pricing power is critical for companies. By passing on higher costs either immediately or within a three-to-six-month period, they are much more likely to protect profitability. Those with low commodity pricing exposure and/or the ability to realize offsetting cost efficiencies should also be relatively better placed within the Industrials sector. Synonymous with quality, these companies have historically expanded margins and have a leading market position in varied industries that include electrical components and equipment, industrial machinery, building products, research and consulting services and industrial conglomerates.

Persistent inflation could also underpin trends toward automation spending, providing a tailwind to growth for select Industrial companies. U.S. manufacturing wages are rising at the fastest pace since 1982, and unfilled positions are at the highest level seen in the past two decades, according to Bank of America Merrill Lynch research. Historically, companies respond to wage inflation and labour scarcity with higher automation spending to lower costs and increase productivity. Higher automation investment should benefit several industrial and warehouse automation equipment/software providers within the sector.

In the event economic growth slows or halts in a persistent inflationary environment, expect "secular winners" with exposure to trends such as electrification and automation to fare relatively well. That said, we haven't seen classic periods of stagflation in decades, and many of the companies within the industrial complex today did not exist in their current form back then. However, there have been several short-lived periods where the purchasing manager indexes in the United States declined even as inflation pressures rose.

Defense stocks may do well in this scenario, as could oil-sensitive industrials, including machinery companies that sell equipment to mining and oil and gas companies or capital goods companies that offer automation software to the oil complex. Agricultural equipment manufacturers could also do well as farm balance sheets improve, driving demand for equipment.

Ultimately, in this uncertain environment, we would lean toward quality companies, with pricing power, favourable end-market exposures and top-tier management teams that can offset some of these structural headwinds with strong execution. ■

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What About Factors and Inflation?

Stephen Duench and Abhishek Ashok

If inflation impacts certain sectors of the economy differently, the same is true of factors. Based on our research, value is typically the biggest beneficiary of rising prices if the economy continues to grow and both short- and long-term bond yields climb higher. But that's not the case in a stagflation environment. In fact, value – as well as the various subfactors associated with it – has been one of the worst performing factors when prices rise and economic growth sputters, causing long-term yields to drop.

Of course, value isn't the only factor influenced by inflation and economic growth. High beta stocks that exhibit higher volatility than the overall markets, for instance, tend to do better than low-volatility stocks in strong economies with inflation, but worse when there is stagflation. Moreover, growth and quality may hold their own in either of these climates, yet perform at their relative best as prices rise and growth weakens.

S&P 500 Index: Factor Performance During Inflationary Environments

Factors	Sub-Factors	Inflation (w/ Growth)	Stagflation
Growth	Forward Growth	-0.1	0.4
	Revenue Growth	0.0	0.2
	Earnings Growth	0.0	0.1
Value	Deep Valuation	0.4	-0.5
	Cyclical Value	0.4	-0.4
	Income Value	0.2	-0.3
	Quality Value	0.2	-0.2
Quality	Strong Margins	-0.1	0.1
	Capital Efficiency	-0.1	0.3
	Low Average	0.1	-0.1
	Profitability	-0.1	0.2
	Earnings Stability	-0.3	0.2
	Balance Sheet Strength	0.3	-0.2
Risk	Low Volatility	-0.8	0.6
	High Beta	0.9	-0.7

Source: AGF Investments Inc., using FactSet data that measures relative three-month average rolling returns. Periods of "inflation with growth" defined as any week-over-week upward move in both short and long-term U.S. Treasury yields since 2000. Periods of stagflation are defined by week-over-week upward moves in short-term U.S. Treasury yields that coincide with downward moves in long-term U.S. treasury yields.

Six Thoughts on Politics and its Potential Impact on Markets

AGF's Chief U.S. Policy Strategist on the half-dozen political themes to watch for in 2022

BY: GREG VALLIERE

Greg Valliere
Chief U.S. Policy Strategist
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Hopefully Washington won't be as unstable in 2022 as it was in 2021, which featured riots, Congressional dysfunction, a foreign policy debacle and the emergence of a serious inflation scare.

Anything's possible in this city, with both houses of U.S. Congress nearly evenly divided between the two parties, and the public bitterly partisan on everything from masks to immigration. So much what might be in store in the coming year?

1 | A Change of Attitudes

The American public seemingly was satisfied with U.S. President Joe Biden and the economy until summer, when the withdrawal from Afghanistan began a public opinion crash for the president. There's already little support for a "wealth tax," Medicare for all, defunding the police, or packing the Supreme Court, but there could be two surprising shifts in attitudes. First, a growing aversion to big government spending, which the public believes is a major contributor to inflation. Support for trillions of dollars in more spending now seems to be fading. And the backing for climate reform may stall as shortages of fossil fuels – coal, oil, and natural gas – affect public attitudes.

2 | Joe Biden's Brief Honeymoon

It lasted less than a year, and now his approval ratings have sunk into the Donald Trump neighborhood. Biden has been blamed for everything from illegal immigration to urban crime and faces an election setback in the midterm elections next November. The Republicans are likely to capture the House – and possibly the Senate as well.

3 | The Rise of Regulators

Biden has appointed the most radical regulators in recent memory, and it's possible they act aggressively on antitrust policy, energy regulations, financial services oversight, the tech sector, drug manufacturers, etc. As a result, relations between Washington and business may become much more acrimonious.

4 | Donald Trump, Still in the Limelight

He's not going away anytime soon. Despite an avalanche of pending court cases, he will dismiss them as "fake news" and most of his supporters will agree. Will he run in 2024? Probably, but an increasingly vocal minority of Republicans – including Liz Cheney and Chris Christie – will begin to speak out against him.

5 | Energy – All About Shortages

The 2021 United Nations Climate Change Conference held in Glasgow last month produced some agreements, but how ironic that the biggest energy issue today isn't climate change – it's a shortage of fossil fuels that could worsen in Western Europe and elsewhere this winter. Renewables like wind and solar will gradually make a big difference – as will a more engaged private sector – but the simple fact is that the world needs more natural gas, coal, and oil this winter.

6 | Geopolitics in Flux

The good news may be slightly thawed relations between the U.S. and Western Europe, Canada, India and even China; the rhetoric between Beijing and Washington is still aggressive, but may become more civil even as tariffs remain. The two hot spots may be in central Europe, over immigration and natural gas, as Vladimir Putin stirs the pot. And there's always flaring tensions in the Mideast – for now, it appears to be Iran, a provocateur in the Persian Gulf. ■

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Private Credit (pages 18 and 19).

Ryan Dunfield, Managing Principal and CEO SAF Group. AGF and SAF Group have entered into an extended partnership that will focus on new private credit opportunities.

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