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Make It Stop!

Global markets have remained very turbulent over the past several months, which given the prevailing wall of worries for many of us, has only added further to investor nausea. The teacups rides, which are a staple at most theme parks, comes to mind. At first, its all smiles and laughter, but once the spinning gets going and the velocity picks up, it's not too long until riders are begging for it to stop! Similarly, while volatility in markets is normal and in most cases appreciated by investors, who can opportunistically add to new or existing positions at lower prices, the level of volatility in markets this year has been anything but normal. The good news is that you are not alone. Investors across the board from retail to institutional are feeling the pinch and have struggled to allocate capital amid the volatility. The bad news is that the level of volatility won't stop until the ride is over, so hold on for more turbulence along the way.

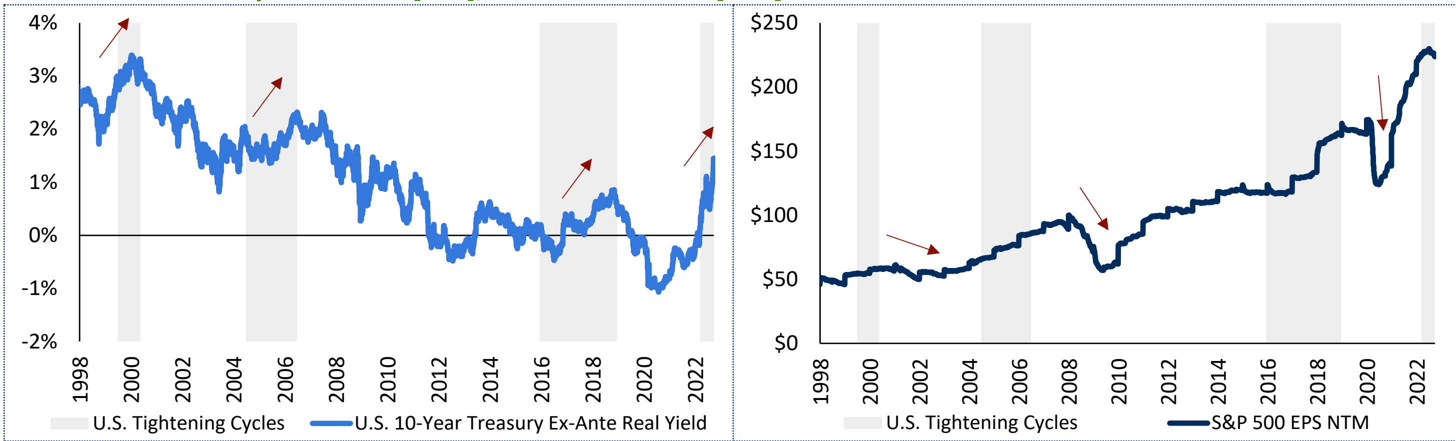
High Inflation leads to Higher Rates, Slower Growth, Lower Valuations and Lower Earnings…

Stubbornly high inflation, rapid increases in interest rates/yields, have caused asset prices including equity valuations to re-rate lower. Elevated inflation, higher rates, a war in Europe and ongoing lockdowns in China have also resulted in a material downside revision to global economic growth for 2023 versus at the start of the year. Additionally, while third quarter corporate earnings in the U.S. have come in better than expected, earnings expectation for 2023E are beginning to be revised lower, with more downside in our view.

When Will it Stop?

Historically speaking over the past 20+ years, each time financial conditions have tightened in the U.S., we have seen a corresponding increase in yields across the curve, including notable increase in U.S. 10-year yields. Corporate earnings, however, have typically weakened with a lag (approx. two years after real yields peak) as rate increases and tighter policy make their way into the real economy. With policy tightening efforts and higher rates only commencing in a material way at the start of this year, we expect earnings to weaken further in the coming quarters even if the pace of policy tightening by central banks moderates from current levels.

U.S. 10-Year Treasury Real Yields [LHS]; S&P 500 EPS NTM [RHS]



Source: BOARD OF GOVERNORS of the FEDERAL RESERVE SYSTEM; FactSet; Bloomberg; Raymond James Ltd.; Data as of September 30, 2022.

We continue to believe that the sheer pace, magnitude and timing of rate hikes (front-loading vs. gradually throughout the cycle) have raised the probability of a recession in 2023. Below, we take a look at the average change (peak-to-trough) for valuations and earnings for the S&P 1500 index and the S&P/TSX index during past recessions since 2000. Moreover, we highlight in blue, sectors that have already contracted in line with past cycles.

Lower Valuation and Earnings Risks for Two Defensive Sectors (CONS & COMM) on the S&P 1500 Index

From our analysis, **consumer staples (CONS) and communication services (COMM)** on the S&P 1500 index have seen their valuation multiples compress in line with the average changes in valuations from peak-to-trough during the past three recessions since 2000. The same goes for earnings. Taken together, we believe these defensive sectors present investors with lower relative valuation and earnings risks, all else equal.

S&P 1500: Historical & Current Drawdown in P/E NTM

	Sector Weight	Total Ret YTD	Average Chg. in P/E NTM*	Chg. in P/E NTM Since 1/4/2022	Difference
S&P 1500		-20.1%	-5.0x	-5.5x	-0.4x
Defensive					
CONS	6.6%	-8.7%	-3.5x	-2.5x	1.0x
UTIL	2.9%	-9.6%	-4.8x	-2.8x	1.9x
HLTH	14.7%	-10.1%	-4.2x	-1.1x	3.0x
COMM	7.6%	-35.9%	-5.3x	-6.6x	-1.4x
Cyclical					
COND	11.4%	-29.6%	-5.5x	-8.3x	-2.8x
ENR	5.3%	61.6%	0.8x	-2.7x	-3.5x
FINL	11.6%	-15.6%	-4.7x	-3.7x	1.0x
INDU	8.9%	-15.3%	-6.5x	-4.7x	1.8x
INFT	25.2%	-28.0%	-8.0x	-8.9x	-0.9x
MATR	2.9%	-17.2%	-4.4x	-2.5x	1.9x
RLST	3.0%	-31.2%	-6.0x	-7.5x	-1.6x

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in P/E NTM during the past three recessions (the dot-com bubble, financial crisis, COVID-19).

S&P 1500: Historical & Current Drawdown in EPS NTM

	Current EPS Grw NTM	3-Mo Rev to EPS NTM	Average Chg. in EPS NTM*	Chg. in EPS NTM Since 1/4/2022	Difference
S&P 1500	7.0%	-2.1%	-24%	6%	30%
Defensive					
CONS	5.0%	-0.5%	-1%	1%	1%
UTIL	6.8%	1.5%	-6%	6%	12%
HLTH	-0.3%	-2.3%	1%	-3%	-3%
COMM	10.1%	2.8%	-19%	-8%	11%
Cyclical					
COND	21.0%	4.8%	-37%	-3%	35%
ENR	22.7%	-37.7%	-58%	83%	140%
FINL	9.5%	6.9%	-29%	7%	36%
INDU	14.6%	-7.6%	-27%	8%	35%
INFT	7.4%	-3.2%	-27%	3%	31%
MATR	-9.7%	-10.3%	-40%	-3%	37%
RLST	6.5%	-2.9%	-25%	6%	31%

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in EPS NTM during the past three recessions (the dot-com bubble, financial crisis, COVID-19).

Two Defensive and One Cyclical Sector Offer Lower Valuation and Earnings Risks on the S&P/TSX Index

There are three sectors on the S&P/TSX index which we view as offering investors lower relative valuation and earnings risk if we are correct in our recession assumption. These sectors include the **consumer staples (CONS)**, **communication services (COMM)** and **real estate (RLST)** sectors.

S&P/TSX: Historical & Current Drawdown in P/E NTM

	Sector Weight	Total Ret YTD	Average Chg. in P/E NTM	Chg. in P/E NTM Since 1/4/2022	Difference
S&P/TSX		-9.0%	-5.6x	-3.3x	2.2x
Defensive					
CONS	4.1%	4.0%	-3.5x	-1.9x	1.6x
UTIL	4.6%	-9.7%	-7.8x	-4.1x	3.6x
COMM	4.8%	-7.3%	-3.3x	-2.3x	1.1x
Cyclical					
COND	3.6%	-9.9%	-4.0x	-2.4x	1.6x
ENR	19.1%	31.7%	-3.8x	-2.4x	1.4x
FINL	30.7%	-12.2%	-3.7x	-2.0x	1.7x
INDU	13.1%	-3.1%	-5.0x	-4.8x	0.2x
INFT	5.3%	-56.1%	-11.6x	-27.5x	-15.9x
MATR	11.8%	-5.5%	-9.0x	-1.4x	7.6x
RLST	2.5%	-26.2%	-7.7x	-5.4x	2.4x

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in P/E NTM during the past two recessions (financial crisis, COVID-19).

S&P/TSX: Historical & Current Drawdown in EPS NTM

	Current EPS Grw NTM	3-Mo Rev to EPS NTM	Average Chg. In EPS NTM*	Chg. in EPS NTM Since 1/4/2022	Difference
S&P/TSX	7.5%	-3.5%	-35%	14%	50%
Defensive					
CONS	8.9%	0.5%	1%	16%	15%
UTIL	7.7%	-1.3%	-10%	10%	20%
COMM	8.5%	1.3%	-10%	2%	12%
Cyclical					
COND	12.9%	-0.2%	-32%	5%	37%
ENR	13.3%	-19.4%	-83%	54%	137%
FINL	6.2%	3.1%	-20%	5%	25%
INDU	35.9%	-2.4%	-29%	19%	48%
INFT	13.5%	5.0%	-3%	-8%	-5%
MATR	-7.7%	-12.3%	-30%	3%	33%
RLST	5.7%	0.0%	-7%	3%	10%

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in EPS NTM during the past two recessions (financial crisis, COVID-19).

Final Thoughts

As the market/economy moves closer to the end of this cycle and into an eventual recession, we believe investors should pay greater attention to the names they own/exposures in their portfolios. We suggest investors remain highly selective and be mindful of valuation and earnings risks, especially given the many uncertainties present in today's markets.

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