2023 Portfolio Manager Outlook.

VCIM Pooled Funds

VCIM Short Duration Bond Fund

VCIM Bond Fund

VCIM Canadian Equity Fund

VCIM Income Fund

VCIM Global Equity Fund

VCIM Global Small Cap Fund

Vancity Investment Management

Year Ahead 2023

2022 was a challenging year for investors. Markets started the year under pressure on inflation concerns and rising geopolitical risk and pressure mounted as central banks started aggressively raising interest rates to cool inflation. As the year progressed, economic activity started to slow under the weight of higher interest rates. While this, in combination with improved supply chains, did turn the inflation trend downward, it remained high and central banks continued to aggressively march interest rates upwards. It wasn't until the fourth quarter of the year, when the pace of central bank tightening slowed, and inflation continued to trend downward that investors were rewarded with positive returns as investor optimism returned.

As we enter 2023, we expect equity markets will remain volatile, as investors continue to assess and weigh investment risks associated with higher interest rates, heightened inflation and slowing economic activity, against lower equity prices. While the downward trend in inflation and slowing pace of rate hikes that started in 2022, are positive for an improved market outlook, the slowdown in economic and business activity brought on by higher rates will remain a headwind. In an environment of slowing growth, companies with demonstrated earnings resiliency, strong business models and balance sheets are expected to gain the attention of investors. While many uncertainties remain, markets are still forecast to deliver positive earnings growth in 2023. This can change if the growth picture deteriorates but could also move up on improving global growth projections. A catalyst for this could come from China's economic re-opening, however, this could also result in increased inflationary pressure.

As for the fixed income market, pricing suggests the Bank of Canada may increase its policy rate one more time before taking an extended pause to fully assess the impact of previous tightening on domestic inflation and the broader Canadian economy. With the Bank of Canada nearing the end of its tightening cycle, we believe current all-in yields offer attractive long-term return potential.

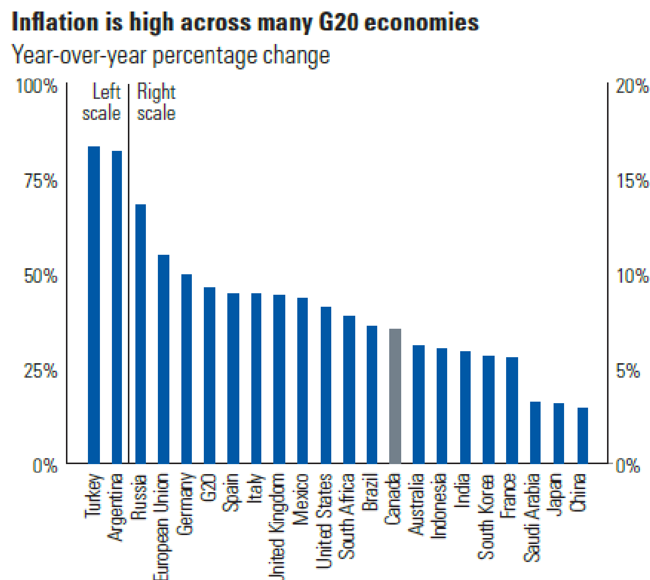
We expect to continue to see increased investor interest in ESG issues in 2023. The recently passed Inflation Reduction Act (IRA) in the U.S. is incentivizing investment in sustainable industries while the rise in human rights due diligence legislation across Western jurisdictions pose financial risks to companies with poor supply chain management practices. At the end of 2022, a notable global agreement to protect biodiversity was reached during COP15, the UN Convention on Biological Diversity, where almost 200 countries have agreed to undertake actions to protect biodiversity accounting for 30% of land and 30% of oceans by 2030. This is similar to how the Paris Agreement for Climate Change was initiated and this agreement is expected to become the standard for global cooperation on biodiversity related issues. These developments are expected to drive increased focus on ESG related financial impacts and companies that have been focusing on their ESG performance are better positioned to navigate this environment.

Corporate managers have had to contend with several challenges over the last few years and 2023 will be no different. Slowing economic and business growth, tight labour markets, heightened inflation and high interest rates will pose a difficult operating environment in 2023. Strong management teams operating resilient business models with pricing power will be key factors in determining the success of a company to drive earnings growth in these challenging times.

Where are the opportunities?

Aside from a brief summer respite, this past year presented a challenging environment for equity investors with most major markets falling by more than 10%. The downtrend in markets was in reaction to mounting and ongoing risks associated with the war in Ukraine, China's zero-Covid policy and rising inflation and interest rates. Additionally, sector performance was widely divergent. The outlier was the energy sector, where mounting supply issues drove prices higher. Even bonds, which generally act as a protector of capital during equity downturns, are on pace for their worst annual return in more than 40 years, with Canada's bond market posting its worst nine-month performance on record.

As with past downturns, the current equity market is providing opportunities for long-term investors. Although we expect continued challenges over the short term, we currently see opportunities in industries such as health care equipment, software, and certain areas within the industrials sector, including renewables. On the flipside, we are avoiding overpriced perceived safety plays that the crowd has jumped into due to macroeconomic concerns. For fixed-income investors, bond yields remain near their highest levels in more than a decade and are finally offering strong income-generation potential after years of depressed yields. Corporate credit spreads have widened, making corporate bonds attractive, with all-in corporate bond yields near their highest levels in more than 12 years.



Source: Bloomberg, as at October 31, 2022.

What are the challenges?

The global slowdown has begun, and corporate earnings are starting to reflect a slowing macro environment. We expect to see a continuation of this in 2023, with a rising risk of a global recession. While the Bank of Canada and Federal Reserve appear to be nearing the end of their rate tightening cycles, inflation remains stubbornly above target, raising the risk that both central banks will continue to hike beyond what the market is currently pricing. Given the lagged effect of policy tightening and the backward-looking nature of inflation data, there is a possibility that central banks will overtighten financial conditions and induce a recession. Even in this scenario, however, we remain positive as markets have already priced in substantial risk. Moreover, any hint that inflation is moderating, or that central banks are near an end to their tightening cycles, could result in a rapid upward repricing of markets.

Rising inflation has also led to a delay in certain clean energy projects, but we see this as a short-term issue. Long-term tailwinds for renewable assets are still in focus as surging energy prices are putting an even greater emphasis on the need to continue expanding renewables, with government policies following suit. The IRA is the most ambitious climate legislation passed in the U.S. to date and is expected to drive increased investment not only in renewables, but also in many other necessary aspects of the climate transition. With incentives for onshoring of battery production, clean hydrogen expansion, and rebates and grants for infrastructure improvements all included in the IRA, we expect to see increasing growth opportunities related to climate transition technologies in the U.S. in the coming year.

Geopolitical concerns and increasing human rights due diligence legislation being passed in the U.S. and many European Union countries highlight the need for investors to increase their own due diligence of company supply chain management practices and the geographic locations of operations. Human capital management is also an increasingly challenging area. Labour shortages in some sectors have continued throughout 2022, while economic uncertainty is driving conservative decision-making on talent expansion as companies try to balance these factors.

How are you positioning the Funds?

Over the next year, earnings releases will provide insight into which businesses truly have the competitive advantages that will allow them to maintain their revenue and margins against a backdrop of macroeconomic concerns. The amount of Leverage on a company’s balance sheet, its pricing power, and its focus on sustainable initiatives, human capital management and barriers to entry, are some of the factors we look at when making investment decisions. We believe the market is going to become increasingly focused on these characteristics, making us optimistic about our funds’ prospects.

In fixed income, we actively managed duration and positioning through a very volatile year in 2022. After starting the year short duration relative to the index, we gradually extended our duration through the bond selloff, ending the period relatively neutral against the benchmark. Given how flat (or inverted) yield curves are, we remain defensively positioned along the curve, with a slight underweight to longer maturities. We increased our overweight to corporates throughout the year as credit spreads widened. With credit spreads at multi-year highs, there is decent scope for corporates to outperform government bonds going forward. We continue to focus our investments on high-quality short- term corporates, with a small exposure to defensive preferred shares to further enhance yield potential.

Why is this the right approach for 2023?

While we expect the operating environment to remain challenging, companies with sustainable and growing competitive advantages should continue to perform well. We expect that these unique companies will continue to grow their market share and reinvest cash flows back into the business, which will drive future return potential. While we expect the operating environment to remain challenging, companies with sustainable and growing competitive advantages should continue to perform well. We expect that these unique companies will continue to grow their market share and reinvest cash flows back into the business, which will drive future return potential. Although the market may not reward the stocks of these companies in the short-term, over the course of the cycle the positive and sustainable earnings growth of these companies has strong potential to generate attractive shareholder returns. Our goal is to grow client capital over the next three to five years, not the next week or quarter.

While many pandemic pressures have generally eased, heightened geopolitical risk, the lingering impacts of unpredictable lockdowns in China, and the increasing frequency of extreme weather events, all continue to highlight the financial importance of environmental, social and governance (ESG) factors. In our view, companies that take a holistic approach to ESG and focus on balancing stakeholder needs will be in a better position to benefit in this turbulent environment. We believe our comprehensive, stakeholder focused ESG strategy will continue to mitigate risks and capture market opportunities over the long term.

For the first time in several years, bonds offer attractive income-generation potential both in historical terms and against other asset classes. Furthermore, with policy rates in restrictive territory and approaching terminal levels, central banks have room to eventually cut rates, if necessary, which should be a tailwind for bonds, allowing them to re-establish their haven status in periods of equity volatility.

Disclaimer

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Vancity Investment Management is located on the unceded territories of the Coast Salish territory, represented today by the Musqueam, Squamish and Tsleil-Waututh Nations. They have been custodians of this land for thousands of years and we would like to pay our respect to the elders both past and present.

Invest in opportunities that contribute to a better world.