2023 Mid-Year 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

What was your outlook in January?

Heading into 2023, we expected the operating environment for companies to remain challenging due to the stickiness of inflation, its impact on central bank interest rate policies, and the ability of the Federal Reserve and other central banks to avoid a recession. Heightened geopolitical risk was also top of mind for us, as was the increasing frequency of extreme weather events which continues to highlight the financial materiality of ESG factors. We were confident, however, that companies with sustainable and growing competitive advantages run by management teams with a holistic approach to ESG factors and balancing stakeholder needs were well positioned to navigate through and potentially benefit from this turbulent environment.

With the central bank hiking cycle well underway and bond yields starting the year at relatively elevated levels, we entered the year constructive on fixed income, expecting a rebound in bond markets after a dismal 2022. Weak consumer sentiment surveys, the inverted yield curve, and the unknown lagged impacts of central bank tightening all contributed to uncertainty in the macro environment entering the year. Accordingly, we positioned the fund neutral duration versus the benchmark and defensively positioned along the yield curve. While we were overweight corporates, our corporate exposure was biased towards shorter-term and higher quality issues.

What has transpired so far this year?

A recession in the U.S. was widely anticipated by economists heading into the year but has failed to materialize, as robust labour markets, including a record low unemployment rate of 3.4% in January and April, continued to support the U.S. economy. Reflecting that economic resilience and core inflation readings remaining stubbornly above target, the Federal Reserve continued raising its policy rate through the first half of the year. After 10 consecutive rate hikes for a total of 500 bps of cumulative tightening since March 2022, the Federal Reserve paused its rate hiking cycle at its June meeting but signaled in its projections that it was not done hiking. Meanwhile, the Bank of Canada, which had been on pause since January, surprised markets in June with a 25-bps hike, taking its policy rate to 4.75%.

Following a strong Q4 in 2022, equity markets have had a good start to the year despite the all too familiar concerns around inflation and rising rates. While markets came under pressure in February in reaction to the regional banking crisis they soon recovered once investors felt comfortable the actions taken by central banks and various authorities were sufficient to stave off further contagion. Markets then had to contend with the risk of a U.S. default if a new debt ceiling limit was not put into place by early June. The debt ceiling essentially caps the amount of borrowing that the U.S. Treasury can do and if this level was not raised the treasury would not be able to finance existing government obligations. These combined risks were enough to put the brakes on the equity markets for most of April and May.

While the risk of a U.S. default occurring was small, as the U.S. government has always found a way to reach a deal regarding the debt limit, the potential implications to the U.S. economy and the financial system if a deal was not reached in time would have been catastrophic. As time closed in on June 5th, the date the U.S. Treasury estimated it would no longer have sufficient funds to meet its obligations, work towards a solution took on a heightened urgency and a deal was struck by President Joe Biden and Speaker Kevin McCarthy. Later in the week the deal passed both congress and the senate and was signed into law by President Biden on June 3rd, removing the risk of a U.S. default.

Spurred on by this near miss, equity markets continued their upward trajectory, with the MSCI World finishing the first six months of the year up +14%. In a complete reversal from last year, energy has been one of the worst performing sectors while information technology has been one of the best. The IT sector has been propelled by investor excitement around the potential growth opportunities associated with artificial intelligence, which gained world-wide attention after Microsoft's launch of ChatGPT in February. Mentions of AI have soared in the most recent round of company earnings calls, making it clear that everyone wants to be viewed as an AI company, or at least a beneficiary. AI is a major secular change, but there will be both winners and losers as there was during the PC boom or the proliferation of the internet, and in this regard, we are very excited about our exposure which includes companies such as Microsoft and Adobe.

Within our bond fund, we adjusted duration versus the benchmark down slightly in April, leaning against futures market pricing, which was pricing rate cuts by the Bank of Canada in the second half of the year. With bond yields up significantly since then and rate cuts in the second half of the year no longer priced in, we have taken duration back up to neutral. We continue to maintain our overweight to corporate bonds but reduced our long maturity corporate exposure further during the period, as credit curves flattened, and long maturity corporate bond spreads approached expensive levels versus similar term government issues.

What is your outlook for the remainder of the year?

We continue to remain cautious on the macro environment, as the major risks outlined at the start of the year remain in place. In Canada, the risk that prior rate hikes have not fully worked through the economy yet is particularly elevated, after it emerged that many lenders have allowed variable rate mortgage holders to defer increasing payments, thereby creating substantial payment shock risk as mortgages get renewed with significantly higher payments. We remain constructive on fixed income as current elevated yields provide attractive income-generation potential both in historical terms and against other asset classes. Furthermore, with central bank policy rates likely approaching terminal levels, eventual rate cuts will be a tailwind for bonds.

Within the equity markets, we expect investors to stay focused on companies with business models that can withstand the current economic environment. Companies with high barriers to entry that provide mission-critical services and/or products should continue to remain in focus for investors in a market where earnings growth is expected to remain muted and consumer spending starts to abate.

As always, we will remain true to our process of investing in ESG focused companies with sustainable and growing competitive advantages. We are also turning over as many rocks as possible looking for new additions to our portfolios by focusing on industries that are being neglected by investors due to short-term concerns or issues. This is the same approach that we used last year when companies in the IT sector were being discarded by the market.

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