Inflection Point: The Case for Canada

Canada has been a diminishing allocation within some investment portfolios since the Canadian government removed the foreign investment limit for registered plans in 2005. The size and cyclical nature of the Canadian market led investors towards foreign markets where better diversification, lower volatility, and higher returns could be achieved.

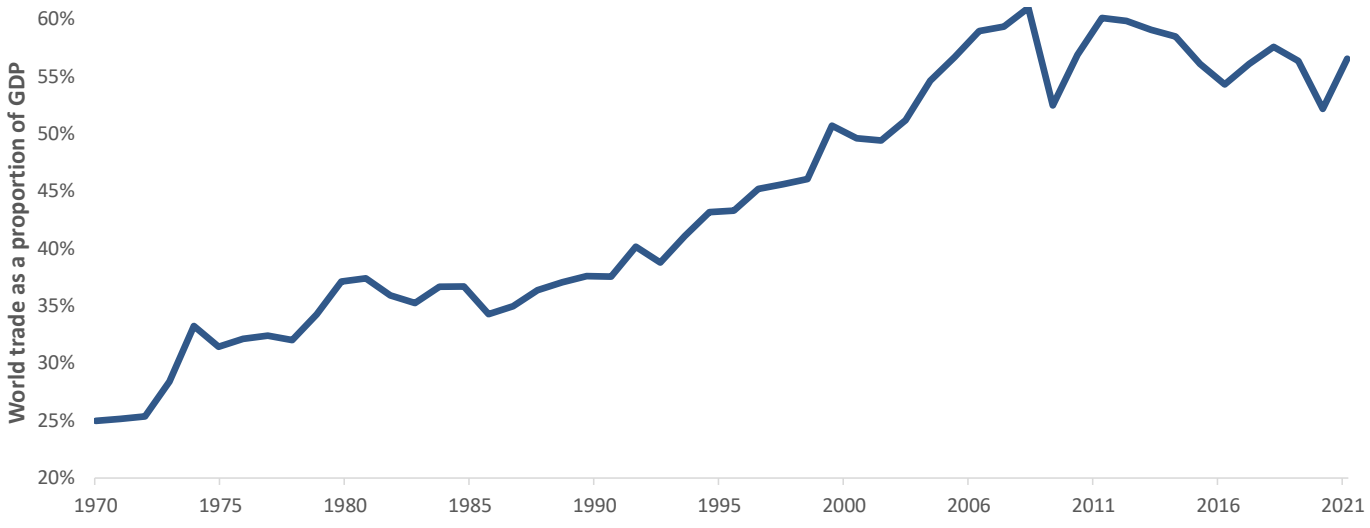
A lot has changed in the world since 2005, and we believe the Canadian market is better positioned to take advantage of this changing world. Trade, interest rates, inflation, energy security, and the climate transition are the dominant themes around the globe today. Consequently, Canada's superior expected growth compared to its G7 peers, its rich resource and commodity diversity, and its historically positive expected returns in inflationary times are all factors that point towards long-term economic prosperity for Canada and its stock markets.

Trade

The COVID-19 pandemic disrupted trade globally like nothing we have seen before. The pandemic halted economic growth and paralyzed trade between countries. These impacts continue to be felt today, three years after the pandemic began. For example, supply from the semiconductor industry continues to lag demand, a situation impacting other industries such as automobile and electronics manufacturing. The Russia-Ukraine war has exacerbated those effects. Countries the world over have been reassessing their diplomatic and economic relations, and energy security is a topic that is front and centre for Europe and, to some extent, the rest of the world.

What has come from all this is a move towards a regionally-based global economy, with less reliance on global trade and a greater focus on maintaining and growing relationships with select trading partners.

Global trade may have already peaked
World trade as a proportion of GDP



Source: World Bank

Interest Rates

We have just gone through a 40-year period where interest rates have been trending down. The last interest rate peak happened in 1980 when the U.S. Federal Reserve (the Fed), the most important central bank in the world, raised the Federal Funds Rate to 20% in an effort to contain high inflation. The yield on the 10-year U.S. treasury bond hit almost 16% that year. What followed was a steady and consistent decline in rates until 2022, when central banks globally began to once again take action to mitigate the threat of spiraling inflation.

Source: www.macrotrends.net

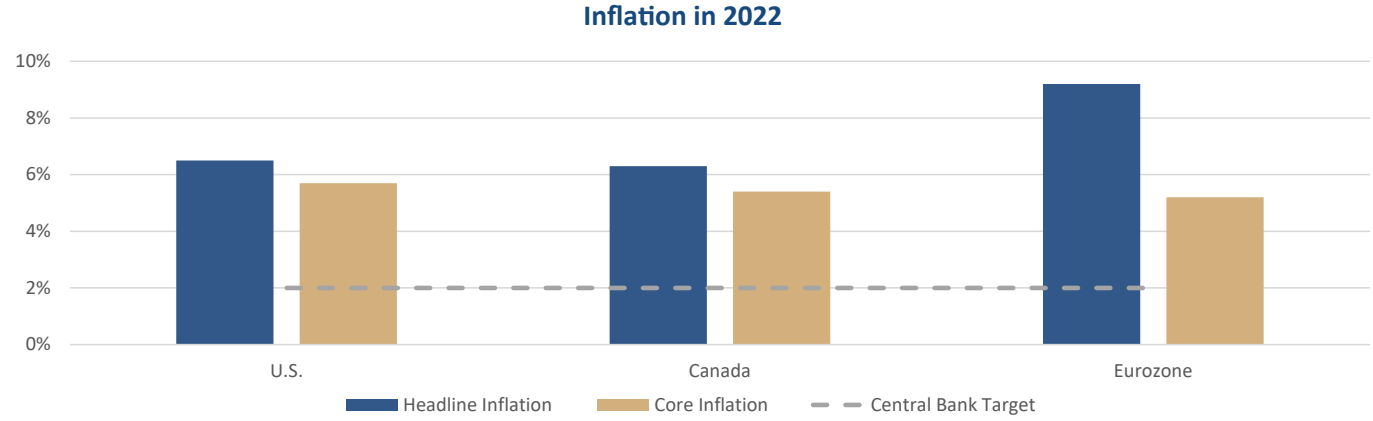
In 2022, the Fed raised the Federal Funds Rate by 400 basis points, reaching 4.25%, the highest level since December 2007. The consensus expectation is that interest rates will continue to rise in 2023, albeit at a slower pace than in 2022.

Money is no longer as "cheap" to borrow as it once was, thus placing further strain on businesses with significant debt on their balance sheets. It is no longer feasible to refinance debt since interest rates are no longer trending downward.

Inflation

Over the 40-year period of declining interest rates, central banks applied monetary policy to successfully manage inflation and maintain a target of about 2%. For example, the Bank of Canada kept inflation between its 1% to 3% range from the 1990s until the end of 2021, when inflation spiked to 4.8%.

The supply and demand imbalance resulting from the global pandemic, and current geopolitical instability, have caused inflation around the globe to soar.



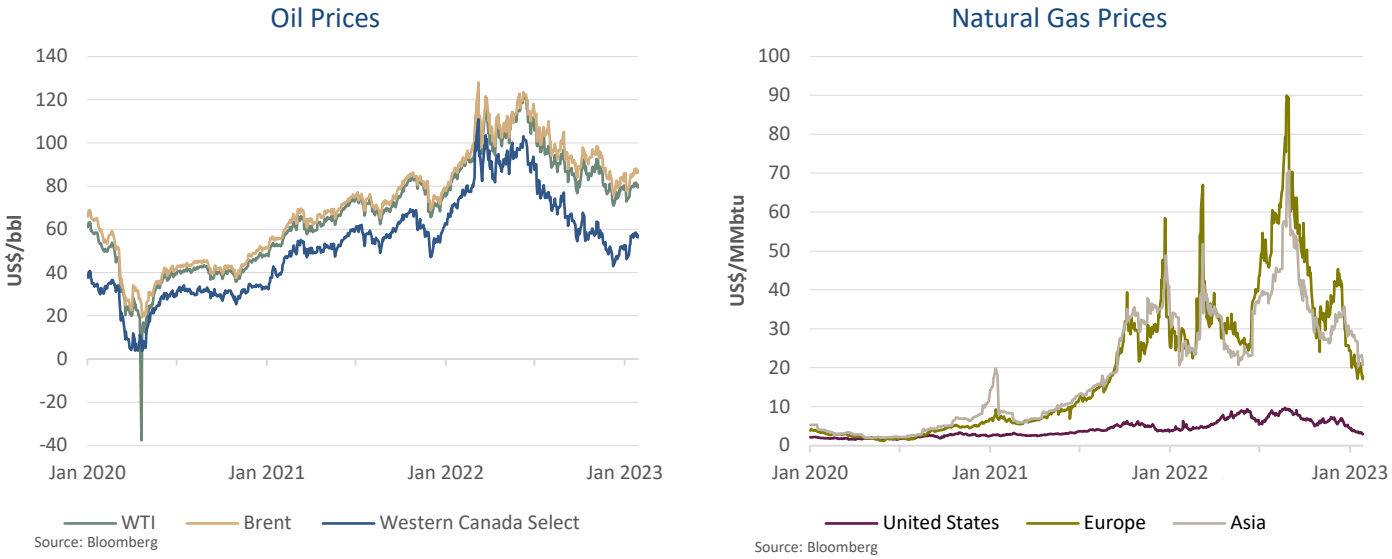
Source: Trading Economics

The eurozone has experienced the most significant rise in inflation due to the current geopolitical environment and a dependence on Russian natural gas. These factors are driving the eurozone's inflation levels higher than those in other regions and are making energy security a key topic globally.

Energy Security

In a world where the geopolitical landscape is shifting, and energy resources are not abundant across regions, a greater emphasis has begun to be placed on energy security. The eurozone's reliance on Russian natural gas is not a one-year issue. Winter is in full swing in Europe, which means natural gas utilization is very high. How much of an impact natural gas prices will have on the overall economy is yet to be seen. What we can say is that natural gas prices will remain well above historical levels until at least 2027 because that is how long it will take to build a new liquid natural gas (LNG) supply chain.

Global Energy Prices



Source: Bloomberg

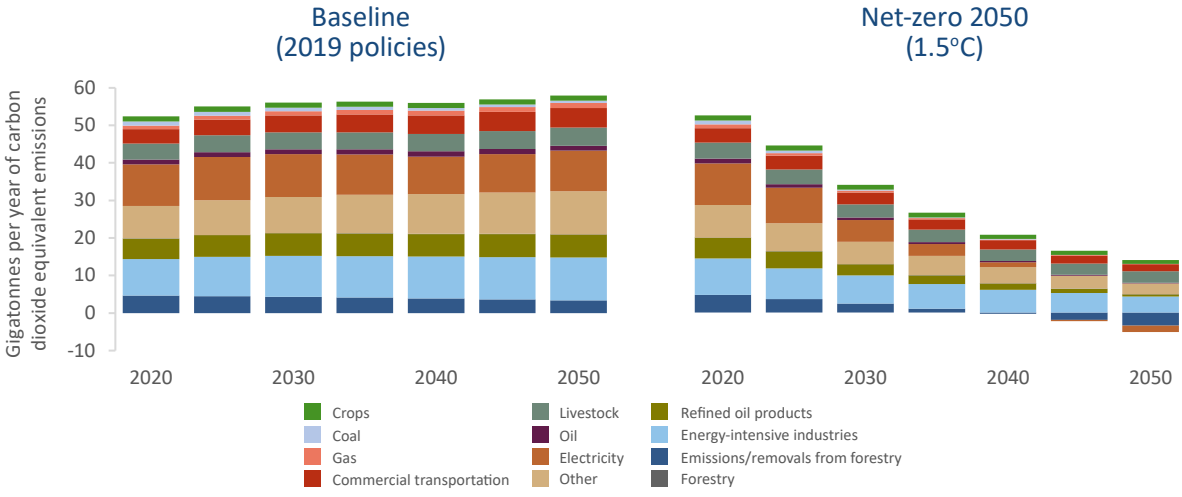
Source: Bloomberg

As trade routes shift due to geopolitical instability and de-globalization, energy security will be key in determining these new trade routes.

Climate Transition

Climate change is a fact that cannot be denied and over the past few years, the energy transition has grown in momentum as we have begun to realize the impacts our actions are having on the environment.

Global Emissions by Sector



Source: Bank of Canada

With the world transitioning away from fossil fuels, the reliance on other energy sources will be key in achieving net-zero targets that are set for 2030 and 2050.

Traditional trends are changing…

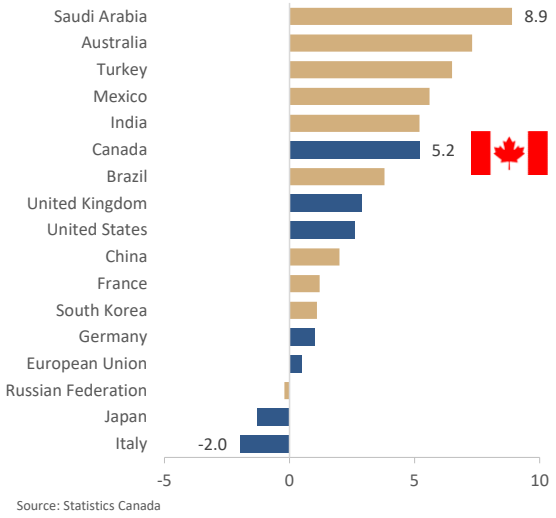
	Trend	Inflection
1	Globalization	Regionalization
2	Declining interest rates "Free money"	Higher interest rates "Money isn't free"
3	Commodities are abundant	Commodities are constrained
4	Energy availability	Energy security & transition

… and we believe **Canada is well positioned to take advantage of these shifting themes**.

Population Growth

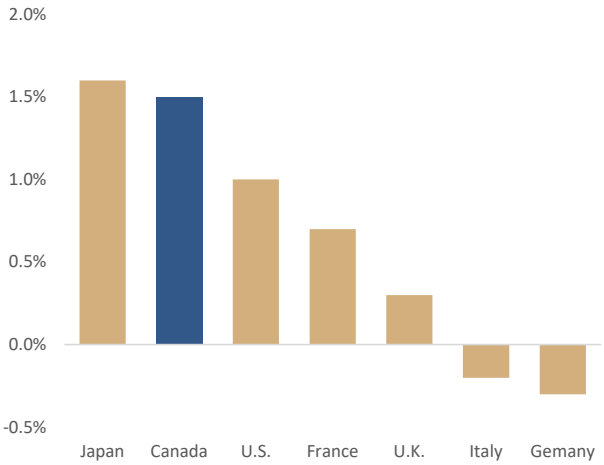
Over the past five years, Canada's population growth, at 5.2%, has significantly outpaced its G7 peers. From a GDP perspective, Canada is now expected to be one of the most rapidly growing G7 countries, ahead of the U.S. and the U.K. Canada is also benefitting from the education, skills, and talent being acquired through its open immigration policy.

Population Growth Rate from 2016 to 2021 (%)



Source: Statistics Canada

Expected 2023 Real GDP Growth



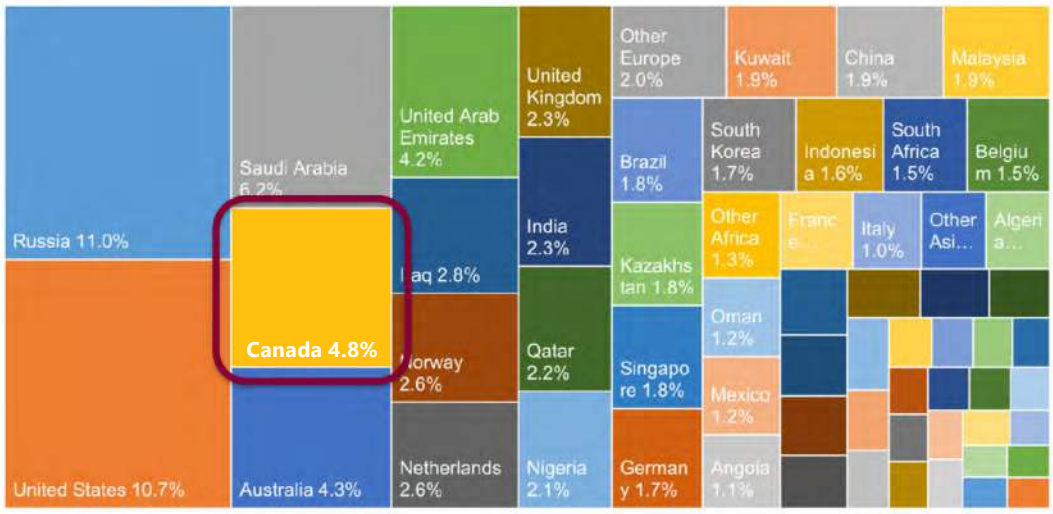
Source: IMF

Canada is well positioned for economic growth from a population and talent pool perspective.

Resources, Commodities and the Climate Transition

Canada is also rich in resources and commodities, a major benefit given changing global demand. Forty percent of Canada's investable market is made up of companies in the energy, materials, and industrials sectors, and it is the fourth largest country with respect to international trade in commodities. Canada holds some of the world's most substantial reserves of many minerals, including some 15 million tonnes of rare earth oxides.

Canada: A "G-SIB" of Commodities



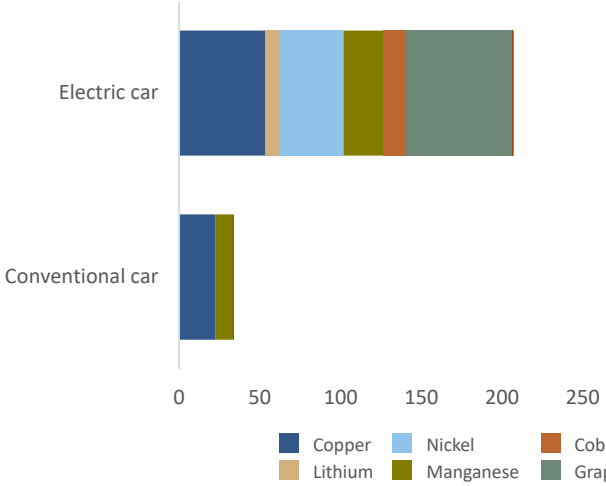
Source: OEC, Credit Suisse

These factors are significant as the world transitions away from fossil fuels and into renewable energy sources. According to the International Energy Agency (IEA):

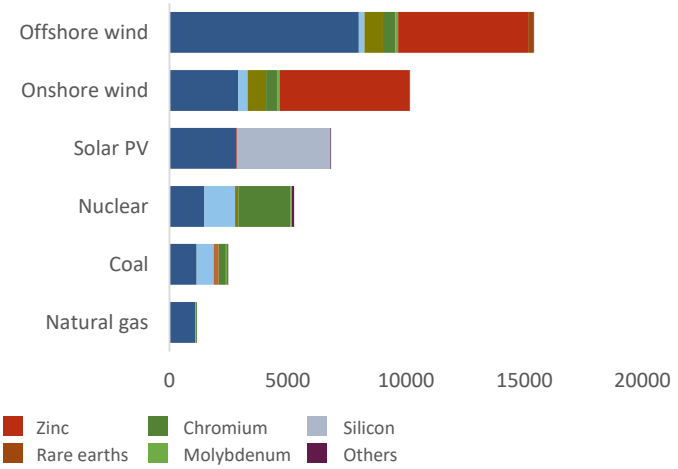
- Electric vehicle sales doubled in 2021, with that segment now representing almost 10% of total automobile sales.
- Onshore wind turbine additions doubled in 2020, and wind generation is expected to grow faster than over the previous five years.

Not only is the climate transition requiring a shift towards more renewable energy sources, but these renewable sources demand a higher amount of minerals compared to current energy sources. The IEA says that it takes six times more minerals to produce an electric car than a conventional car, and nine times more minerals for a wind turbine over a natural gas turbine.

Minerals Used in Electric Cars Compared to Conventional Cars

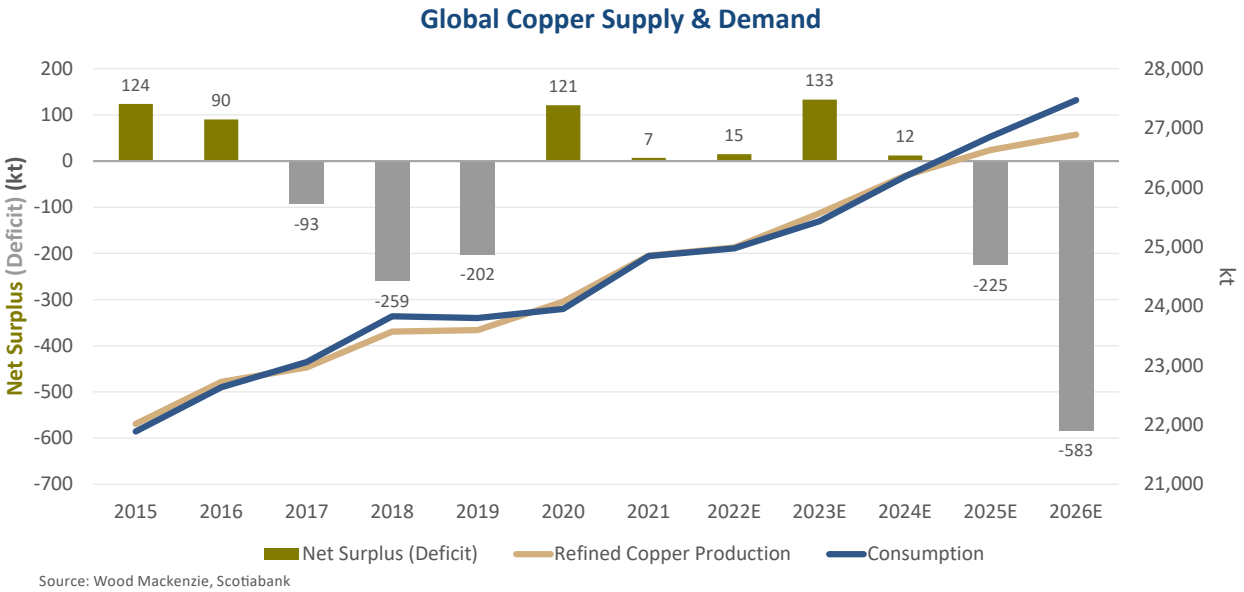


Minerals Used in Clean Energy Technologies Compared to Other Power Generation Sources



Source (both graphs): IEA

We also know that mineral supplies are not abundant, especially now that geopolitical concerns play a significant role in sourcing them. For example, copper is a mineral used across the electrification process. Not only does an electric vehicle require two-and-a-half times more copper than a vehicle with a gasoline engine, but the infrastructure that supports electric vehicles requires copper: the charging cable and the power infrastructure that transmits the electricity to the charging station. This reality is adding significant demand pressure while supply is not increasing because of current prices. Only once prices begin to rise to reflect this supply-demand imbalance will new mines get built to increase supply. Of course, new mines take time to approve and build, so even with more attractive pricing, we would expect supply to begin to catch up over the span of years, not months.

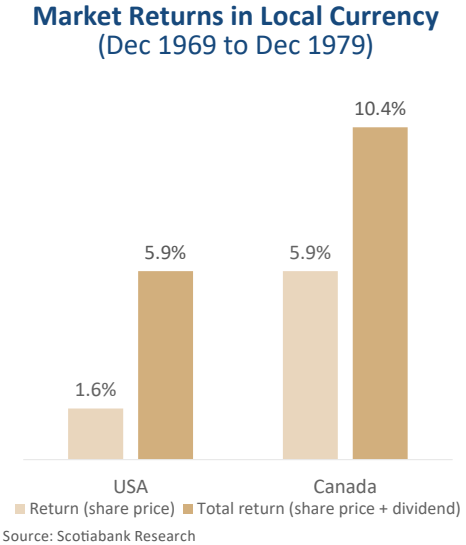


Source: Wood Mackenzie, Scotiabank

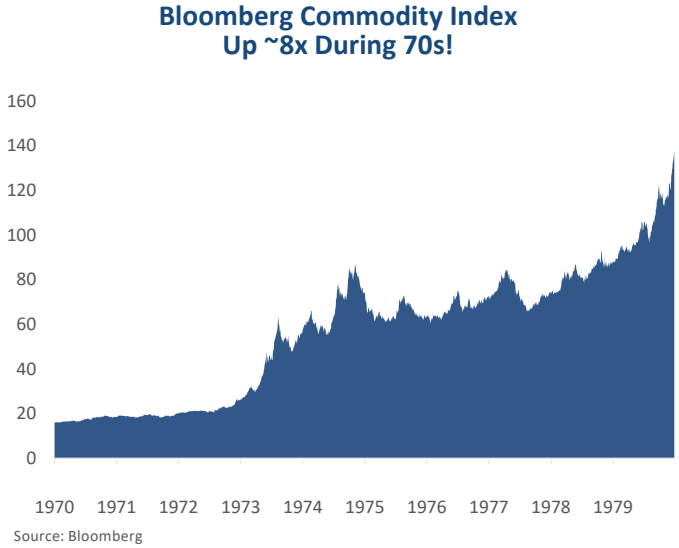
The climate transition will exacerbate the supply and demand imbalance for minerals, and Canada's rich commodity and resource diversity is one of the main reasons why we believe the Canadian market will be more attractive than many other global markets over the long-term.

Inflation Protection

History doesn't repeat, but it can rhyme. In the previous inflationary environment - December 1969 to December 1979 - Canada's market performance outpaced that of the U.S. The commodity index rose eight times during those 10 years and was the main driving force behind Canada's outperformance relative to the U.S. market.



Source: Scotiabank Research



Source: Bloomberg

The Canadian stock market is well positioned to counteract inflation given its commodity and resource heft. As mentioned above, over 40% of the Canadian investible market is in those sectors.

Conclusion

Allocations to Canadian investment assets have been declining for some time – particularly in institutional portfolios that have been favouring non-domestic equities and alternative asset classes. However, global themes that have been changing over the past two years point towards Canada as being a major beneficiary over the long term. Trade, interest rates, inflation and the climate transition are all factors that will drive long-term demand for Canadian assets, and we believe there has never been a better time to invest in Canada!

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