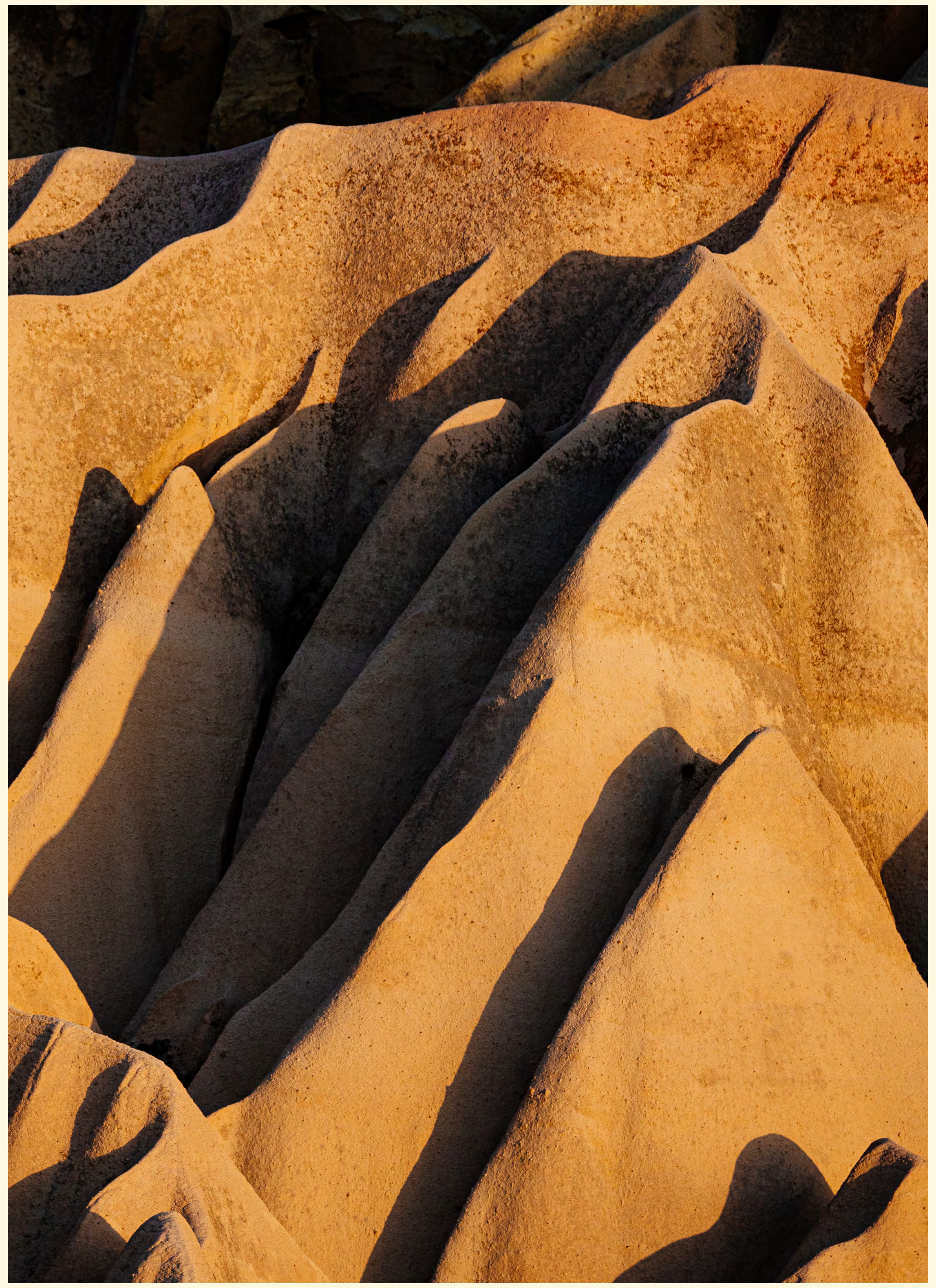
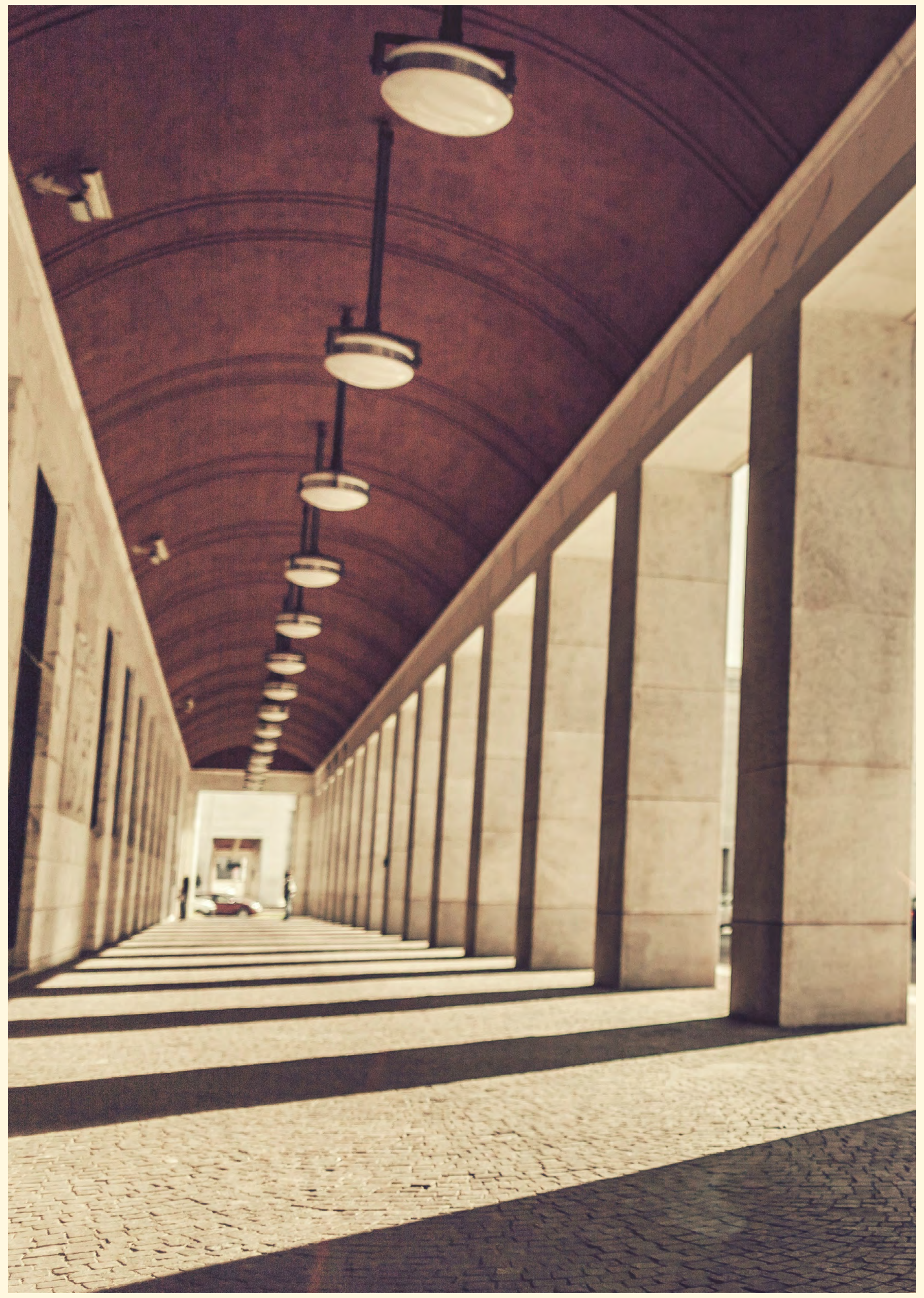
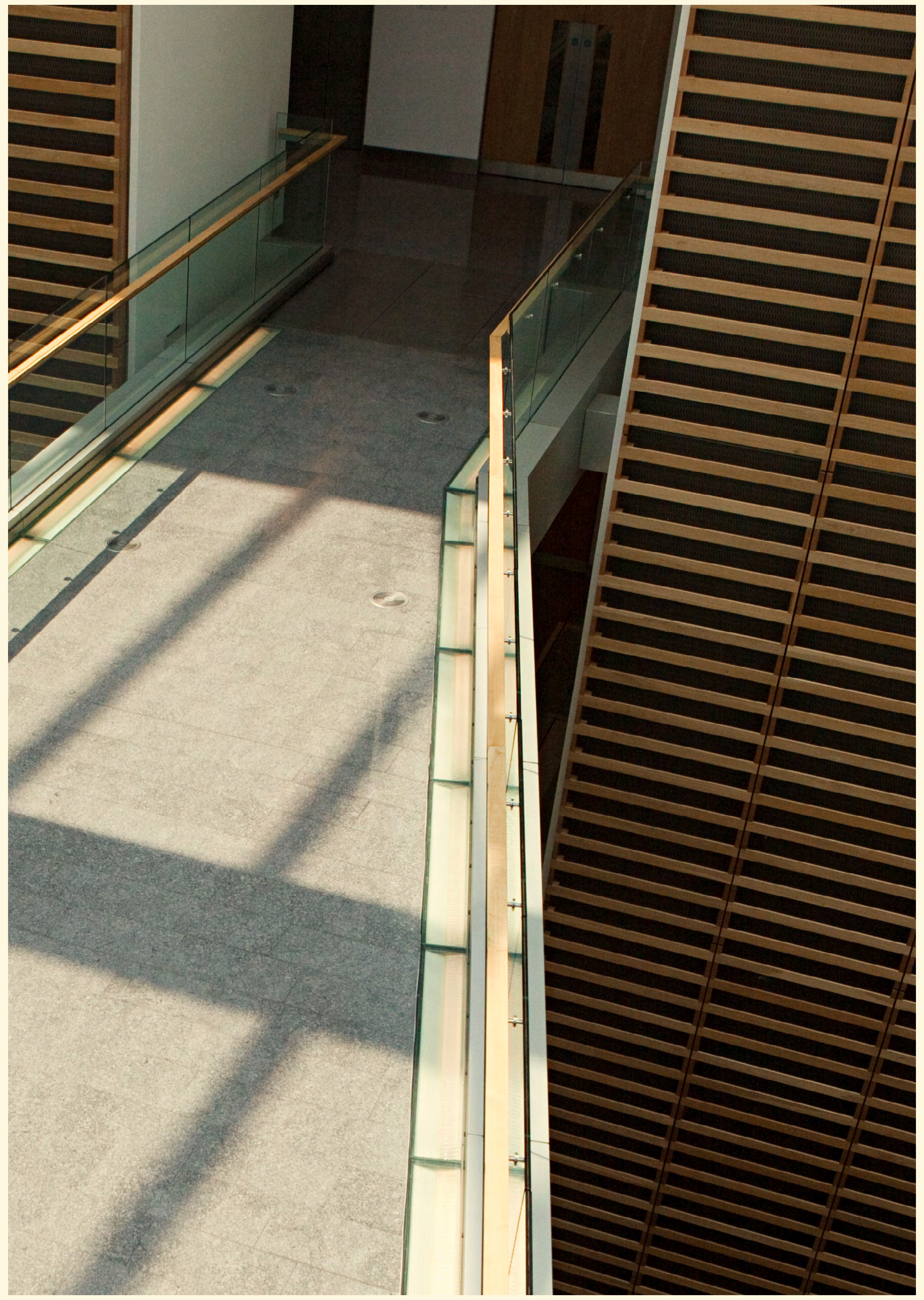
2023 Mid-year

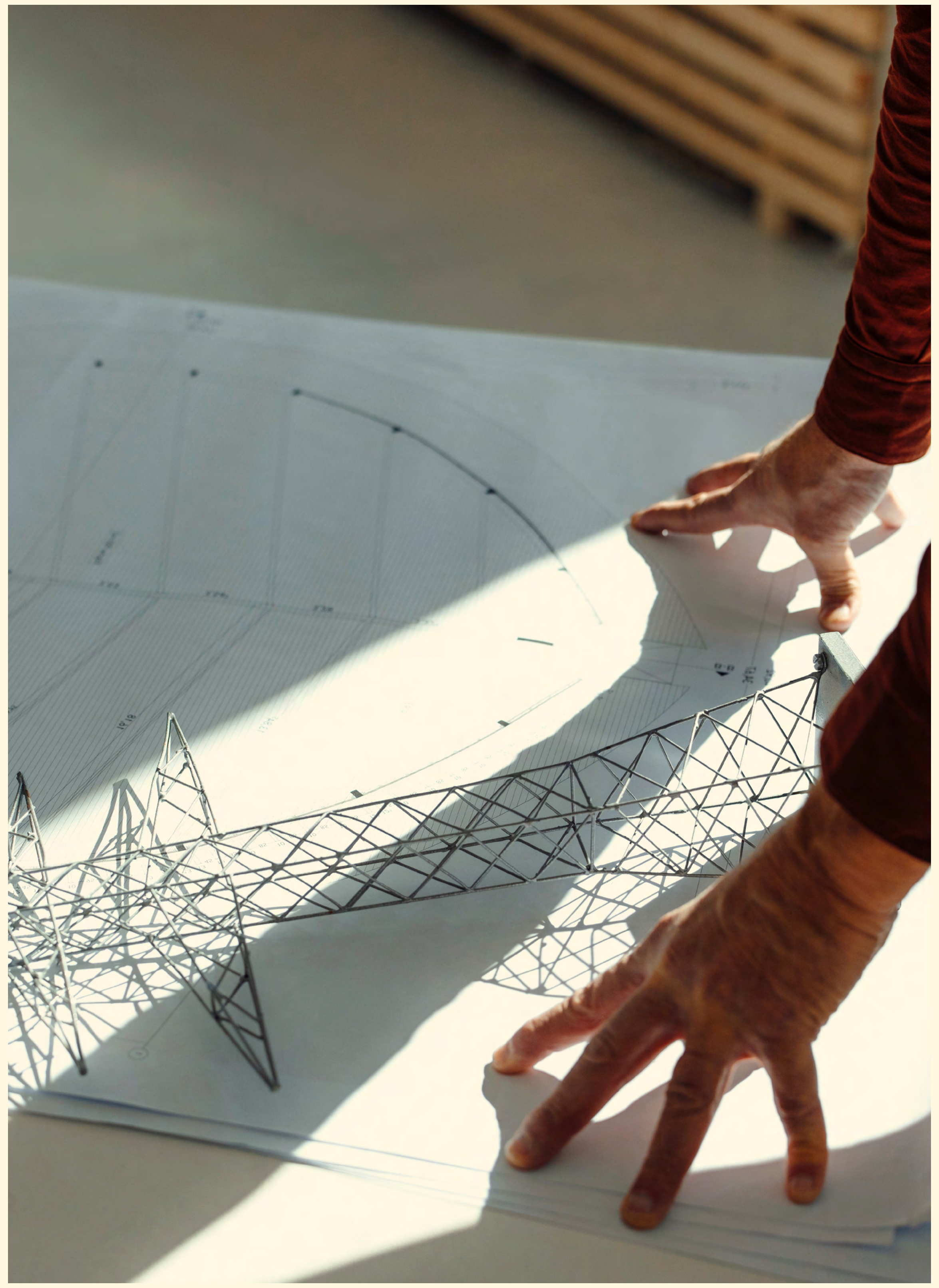
Global Investment Outlook

SLC Management









SLC Fixed Income

CRESCENT

BGO

InfraRed Capital Partners

A letter from Steve Peacher

The term “cautious optimism” is an oft-overheard phrase in asset management during times of change, and there’s little doubt in my view that it best encapsulates the market environment at the midway point of 2023. Following a challenging 2022, for fixed income investing as well as for other asset classes, we have experienced a healthy rebound in financial markets so far this year. But many of the sources of concern that underpinned 2022’s difficulties – from macroeconomic and policy issues to geopolitical matters – remain in place, and in some cases merit greater attention as we head into the last half of the year and beyond.

So amid constructive markets, with both opportunities and risks well represented, where do investors go from here? In many ways that’s the central question we tackle in SLC Management’s 2023 Mid-Year Global Investment Outlook. While we have witnessed strength across multiple asset classes year to date, there has been considerable variation in performance during the semi-annual period, and similarly varied outlooks for the months ahead. I invite you to review the diverse perspectives of our investment and solutions teams as they discuss public and private fixed income, real estate, infrastructure, pension plans and insurance asset management. Our twice-yearly outlook is a rare one-stop window into the insights of the investment professionals across SLC Management, as well as of our affiliate asset managers BentallGreenOak, InfraRed and Crescent Capital.

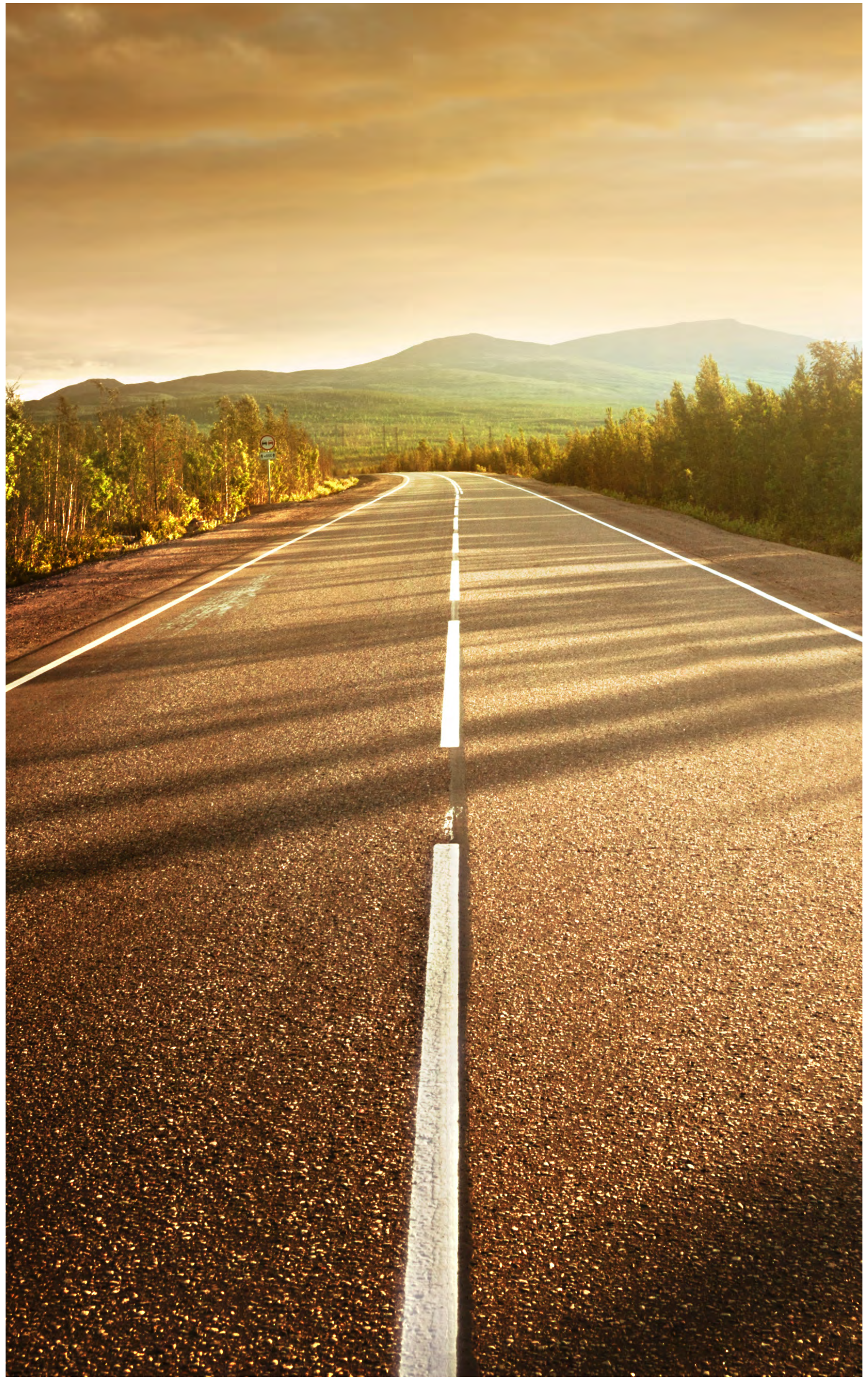
Conditions at the beginning of this year presented considerable opportunities for fixed income investors to pick up yield, and a similarly fertile investment environment is expected to continue to some extent going forward. At the same time, investors searching for additional sources of yield are increasingly looking at non-traditional investments, ranging from real estate, infrastructure and high yield to investment grade and below investment grade private credit.

However, as investors we should also remain mindful of the risk factors that have persisted throughout 2023. The monetary policies that had previously set out to moderate inflation have increasingly had their impact felt this year. The prospect of a recession looms for major economies – including the United States and Canada – even as everyday consumers feel the sting from higher prices. And overall global uncertainty remains, from the ongoing war in Ukraine and its human impact to concerns over global energy security, sustainability and/or a triggering event (e.g., another bank failure, economic data surprise or political impasse) that could spark additional volatility.

Regardless of these uncertainties, at SLC Management we remain committed to seeking out compelling opportunities and providing steadfast solutions for our investors. I hope you benefit from the diverse views of our investment experts as we head into the remainder of 2023 and into the next year.

Regards,

Steve Peacher,
President, SLC Management



Macroeconomic outlook

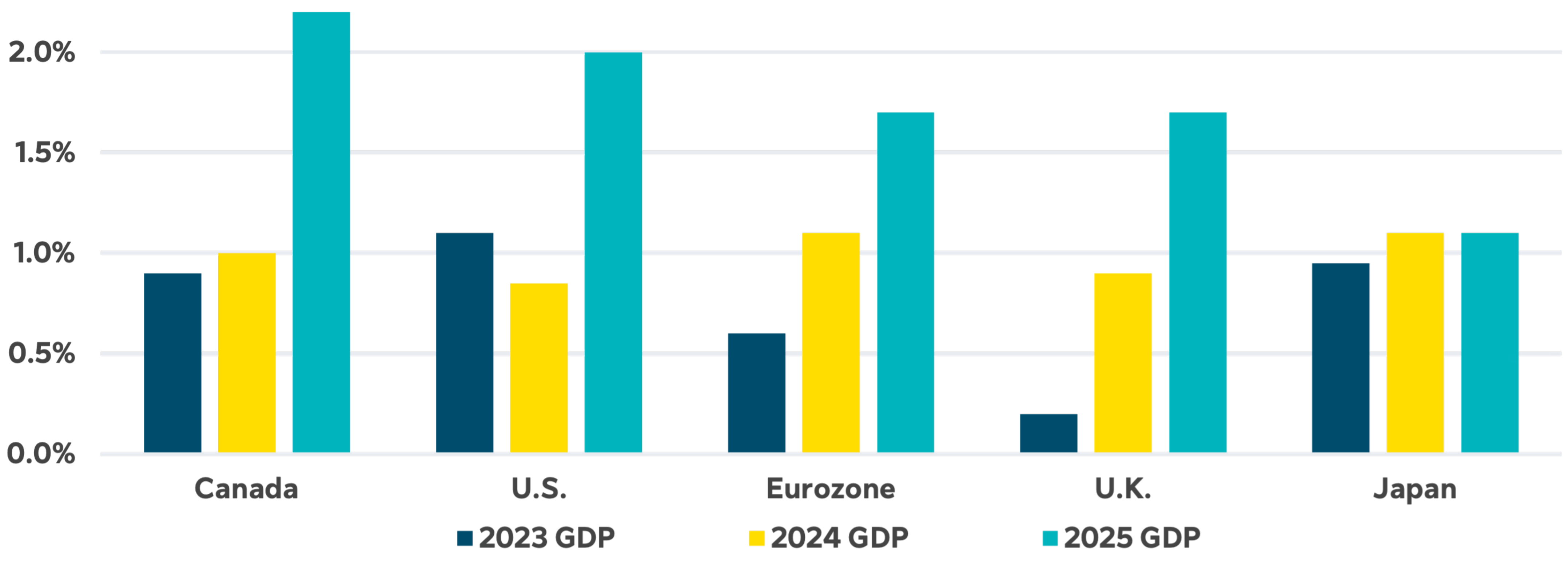
Dec Mullarkey
Managing Director, Investment Strategy and Asset Allocation, SLC Management

Growth expected to be subpar, but strength in employment welcomed by central bankers

GDP projections modest for major economies

At the mid-year point of 2023, central banks remain vigilant and are keeping rates high while inflation lingers well above target. As activity cools, most advanced economies are posting subpar GDP growth. **The U.S. and Canada both expect roughly 1% growth this year**, half their normal target, according to Bloomberg's survey of economists in June.

GDP outlook for major economies



Source: Bloomberg monthly survey, June 2023.

Meanwhile, **the eurozone is expected to deliver 0.6% growth**. This is also well below a normal range, but is an improvement over earlier estimates as Europe has exceeded expectations in managing its energy disruptions.

Meanwhile China's post-COVID economic recovery continues at a tepid pace. After swiftly abandoning its restrictive lockdown policies in January, the world braced for the second largest economy to reset with a bang. But a surge in consumer spending has not emerged and Chinese households appear to remain cautious. Nevertheless, **rate cuts and potential stimulus are expected to guide China to its 5% growth target this year**.

The biggest surprise so far this year is how resilient labor markets have been. Across most regions there are more job openings than applicants. The U.S. is a good example. COVID slowed immigration and drove a surge of early retirements. That shrunk the U.S. labor force and intensified competition for talent. This has made companies reluctant to lay off workers, even as wages rise and growth cools.

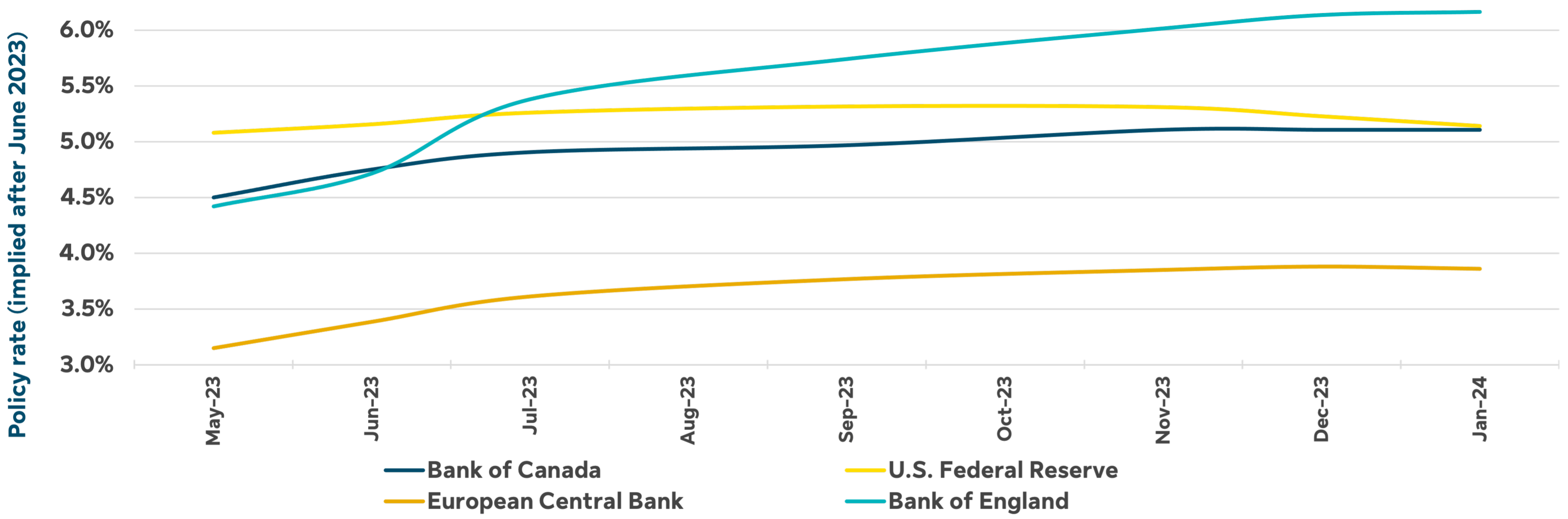
Fortunately, the labor demand and supply mismatches are starting to rebalance. While early retirees have not returned to the work force, immigration has picked up, allowing the labor pool to expand and to help abate some of the demand pressure.

Inflation slowly decreasing

The big challenge for most central banks, and the U.S. Federal Reserve in particular, is to cool activity and inflation without igniting a severe recession. While core inflation has been stubborn it is slowly coming down.

Trimmed U.S. core inflation measures from the Federal Reserve Banks of Cleveland and Dallas, which normalize for outliers, show deceleration across a wide range of goods and services. Improvements in supply chains have helped, as has some cooling in the labor market. Rent costs, which represent a large weight in the inflation index, are down significantly on renewal rates which will pull the average down as in-force leases renew.

Expected central bank rate paths



Source: Bloomberg, implied rates based on futures and swap pricing, as of June 2023.

Core inflation is expected to hit 3.6% by the end of this year and 2.3% by the end of 2024, bringing it close to the Fed's target of 2%.

Central banks close to peak rates

After a busy year of rate increases, the Fed hit pause. But don't assume the central bank is done. The Fed and other major policymakers may find themselves in an advanced endgame as they calibrate how much more tightening is needed. Central bank rate setting works with a difficult-to-forecast lag, which is forcing central banks to become more reflective and data dependent on what remains to be done.

The Fed appears to think it needs to increase rates another 50 basis points this year, while markets think 25 basis points is enough. But both appear to agree that there will be no rate cuts this year, something the market had been slow to accept.

The biggest insight at the mid-year point from Fed Chair Jerome Powell was his praise for the growth benefits of a tight labor market, rather than its assumed corrosive effects. That's in line with recent research from Ben Bernanke and Olivier Blanchard, two titans of monetary thought leadership, showing the tight labor market accounted for only a minority of excess inflation as of early 2023.

However, Bernanke and Blanchard warn that if the demand for and supply of labor are not brought into balance, this could keep inflation above target. One encouraging nugget from their modeling is that an easy way to engineer that could be to reduce the number of job openings below available workers. If that works, then a surge in layoffs could be avoided in getting the economy back to normal. That gives some credence to the Fed's forecast of a soft landing.

Source: Bloomberg, 2023.

Fixed income: investment grade

Randall Malcolm
Senior Managing Director, Portfolio Manager, Public Fixed Income

Economic growth suggests policy action not over yet; shifting landscape for Canadian bonds

Policy expectations shift amid robust growth

Economic data so far in 2023 have shown the Canadian economy to be more resilient than expected. GDP data released during the first half came in stronger than the Bank of Canada (BoC) forecasted, at a 3.1% annualized pace for the first quarter, and unemployment at 5.2% in May still hovered around all time lows. While Canadian house prices have declined in the face of higher mortgage costs, April home sales volumes rising 11.3% year over year suggest that prices may have now stabilized. In addition, inflation seems sticky above the 4% mark, still higher than the BoC's 2% target.

After being on the sidelines since January, the BoC responded with a 25-basis point hike in June, taking the overnight rate to 4.75% – the highest in more than two decades. The BoC remains in data dependent mode, and so far we believe the central bank isn't seeing enough of an impact on the economy and inflation from its rate hikes. While the deep inversion of the 2-year/10-year Canada yield curve is at levels not seen since 1990, suggesting a deep recession could be looming, the equity market seems to be distinctly at odds with this forecast, with North American stocks staying at lofty levels in the second quarter while implied equity volatility continued to move toward the lower end of its range. This year began with skepticism on how high central banks could take rates before triggering a recession, but as the year progresses, the expected terminal level for short-term rates keeps moving higher with markets now pricing in at least one more hike by both the BoC and the U.S. Federal Reserve in 2023.

Volume of new issues steps back, but breadth of opportunities increases

New issuance of Canadian corporate bonds in 2023 so far has fallen behind last year's pace, but the diversity of issuance has improved across corporate sectors relative to 2022, when bank issuance was disproportionately represented. In provincial bond issuance, we are ahead of 2022's pace, and the fiscal situation of most provinces has improved as the high government spending of the pandemic has eased.

In both provincial and corporate new bond issuance, we continue to see lower volume than normal in the 30-year term bucket. It seems to take bond issuers much longer than expected to adjust to 30-year Canada bonds yields at levels that we have not seen since 2011. This is particularly interesting to us, as shorter Canada two-year yields are much higher and are breaching levels not seen since 2007.

Upcoming developments in domestic bonds

The Canadian federal government has continued to re-evaluate its borrowing programs. Last year the government ceased issuing real return bonds that provide a return linked to the Canadian Consumer Price Index. This came at a time when many investors were already seeking shelter from rising inflation. In the Federal Budget for 2023, the government announced that it is considering consolidating the funding for the Canada Mortgage Bond (CMB) program into its broader Canada bond borrowing program. The CMB program provides liquidity to the mortgage market and has been in place using its own funding since 2001. The proposed change would not alter the operations of the program, but would merely change the funding of the program from CMB bonds to Canada bonds. A decision is expected on the fate of the CMB program toward the end of 2023.

Source: Bloomberg, 2023.

Fixed income: below investment grade

John Fekete
Managing Director and Head of Capital Markets, Crescent Capital Group

Market and macroeconomic signals sending mixed messages on the elusive recession

Economic resilience casts doubt on expected contractions

Everyone seems to be bearish these days. Just about every economist is betting higher interest rates will cool the economy, resulting in a spike in corporate defaults and wider credit spreads. More than a year and 500 basis points into the U.S. Federal Reserve's rate-hiking program, an investor might reasonably expect to see a potential recession looming.

However, economic activity has been positive and resilient, and signs of a recession remain elusive. Employers have been hiring aggressively. Equity markets have rebounded, with the S&P 500 Index up more than 11% by June and the NASDAQ up more than 25%. Consumers are spending freely on services such as travel and restaurants, even in spite of rising prices, while the housing market has stabilized given a shortage of homes for sale.

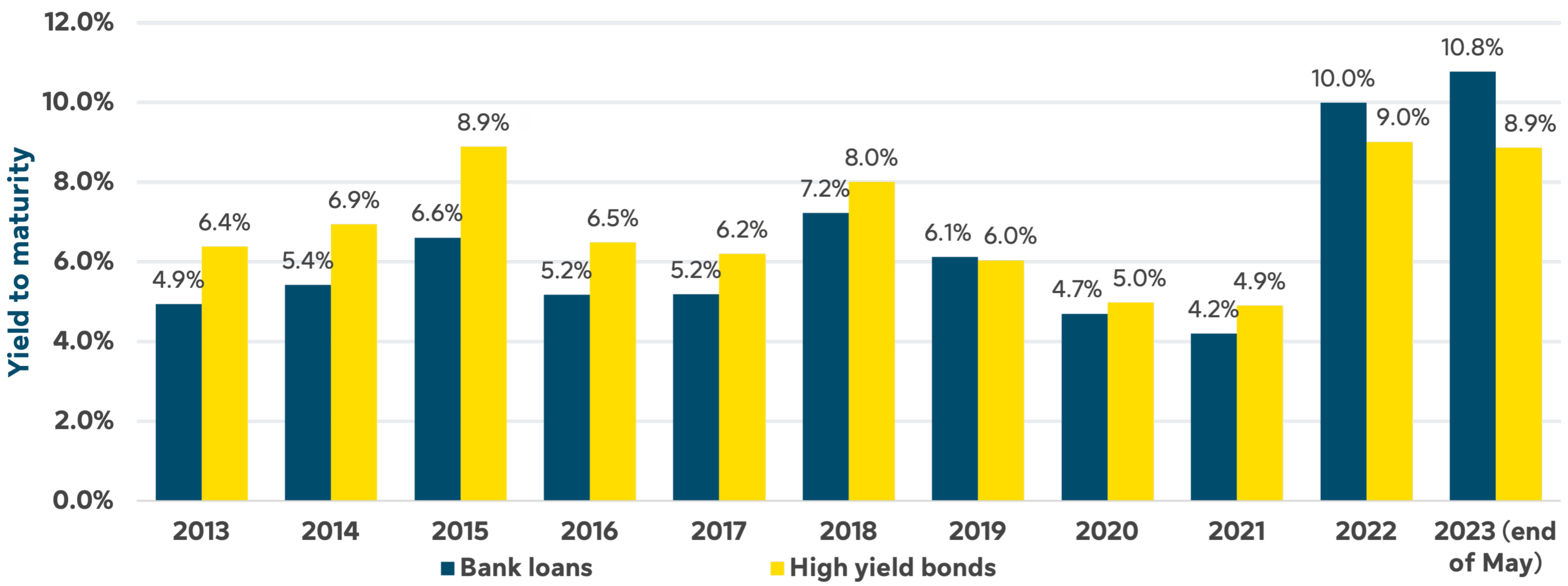
The pessimistic positioning on the scale that we see today can often be a contrarian indicator. When bullish or bearish sentiment reaches an extreme level, sooner or later the market moves in the opposite direction. Could economists have underestimated the lagged effect low interest rates, US$5 trillion of pandemic stimulus spending and a 40%-plus drop in oil prices from recent peaks are having on consumer consumption? We think it's a possibility.

Another sign of strength can be seen in May employment data. The headline number – a payroll gain of 339,000 – vastly exceeded estimates, and sectors with the strongest gains were some of the hardest hit by the pandemic, including leisure, health care and hospitality. In fact, the current U.S. unemployment rate is only approximately 10 basis points higher than when the Fed first started hiking rates last year. This suggests the labor market will likely remain strong for months to come as the labor force participation rate has yet to return to pre-pandemic levels.

The outlook for high yield

It could take several quarters before the labor market cools and the economy shows signs of slowing. Meanwhile, yields on U.S. high yield bonds and bank loans are at or close to their highest levels in a decade and are providing equity-like returns, with high-yield bonds returning close to 9% at the mid-year point and syndicated bank loans returning more than 10% (as represented by the ICE BAML US HY Index and Morningstar SP LSTA Loan Index, respectively). Income will once again be the primary driver of returns given the high carry offered by these asset classes, with yields sitting in the 90th percentile rank of the post-GFC period, according to Goldman Sachs.

Yields on HY, bank loans at or close to their highest in a decade

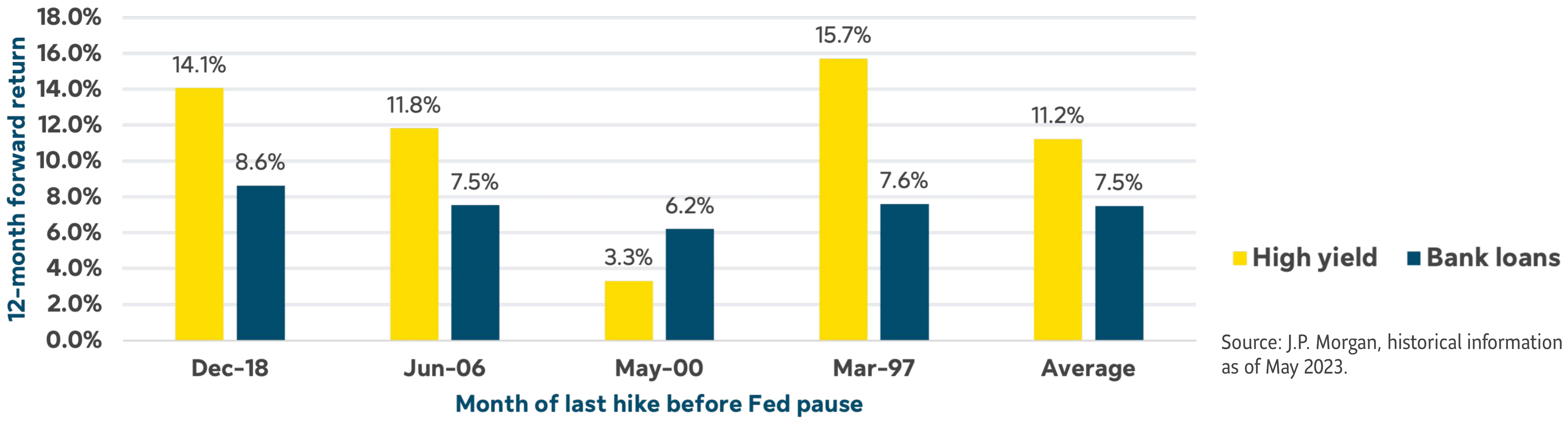


Source: Bloomberg, 2023. Bank loans represented by Morningstar SP LSTA Loan Index, high yield bonds represented by ICE BAML US HY Index.

Despite all of the bearishness, the highest performing segment of the credit market this year has counterintuitively been the lowest quality tier. CCC-rated bonds and loans have outperformed the BB-rated cohort by a factor of nearly two times year to date. In our view, this makes the market opportunity for entering BB-rated bond and bank loan cohorts more attractive than it has been in recent years.

We are often asked what to expect if the Fed pauses and holds interest rates steady. J.P. Morgan examined the performance of high yield bonds and bank loans following a Fed pause. Over the past 30 years, there have been five instances of Fed policy transitioning to a pause, which notably lasted an average of 10 months until the onset of the first rate cut. Historically, high yield bonds and bank loans performed well following a pause with an average 12-month forward total return of +11.2% for high yield and +7.5% for bank loans.

High yield and bank loan performances following pause in Fed rate hikes



Source: J.P. Morgan, historical information as of May 2023.

We see two key factors as contributing to this solid performance over time. First, the historical fundamentals following a policy pause remained favorable and not weak enough to elicit a rate cut. And secondly, rates had been a tailwind for performance, with five-year U.S. Treasury yields declining an average 101 basis points over the next year. The current backdrop has caused credit markets to re-price, creating potential opportunity throughout the rest of the year should an expected recession remain elusive.

Key takeaways for mid-2023

- Credit market bearishness has been pervasive despite resilient economic data.
- Fixed income yields are at their highest level in over a decade.
- The highest quality segments of the credit market have lagged, providing investors with a potentially attractive entry point.
- High yield bonds and bank loans have historically performed well following Fed pauses.

Source: Bloomberg, JP Morgan, Goldman Sachs, 2023.

Private credit: investment grade

Andrew Kleeman
Senior Managing Director, Head of Corporate Private Placements

Elaad Keren
Senior Managing Director, Portfolio Manager and Head of Mid-Market Private Debt

Gary Greaves
Managing Director, Private Fixed Income

Market resilient in first half of 2023

Large deals anchor volumes

Reported volume for the investment grade (IG) private credit market through the first half of 2023 was solid but less than the first half of 2022, driven by lower financial sector issuance that was partially offset by robust issuance in other sectors. The current year started out strongly, with some deals that were postponed from 2022 due to market volatility.

Some of the notable market highlights from H1 2023 include:

- The IG private credit market's capacity to execute large and complex deals anchored total volume as the market completed more issuances of US$1 billion or greater in the first half of 2023 than were completed in all of 2022.
- The IG private credit market was "open for business" throughout the Silicon Valley Bank crisis and the general concerns over smaller banks. At the height of the crisis, the public market was closed and private market pricing required discovery, but that quickly returned to normal.
- Market pricing has largely been rational, in our view, and deal allocations have been good. Underpinning the favorable market tone is decreased competition: the industry has seen less activity by some investors in private credit, reportedly due to slower insurance product sales or overall portfolio strategy.
- Maturities shorter than 10 years as a percentage of total issuance has increased materially since interest rates started to rise. Issuers are seeking to borrow shorter due to expectations that rates may come down in the next few years while investors are seeking longer duration.
- Infrastructure deals in H1 2023 have been stronger than we have seen in recent years, with rational pricing and attractive structures.

Resilience and opportunities for rest of 2023

Looking back at our outlook from January, we were "cautiously optimistic" at that time about the upcoming year. We maintain that outlook mid-year, as **we believe that the market has been resilient and that these investment themes we highlighted at the beginning of 2023 should remain intact**:

- We expect financial sector issuance to continue to anchor volume, although not growing as rapidly as in the last two years. Growth in the sector continues to expand to include smaller issuers and weaker credits. We believe this will create more opportunities, but will also require strict underwriting.
- Deal activity in infrastructure and renewable energy should remain robust.
- Real estate and REIT issuance could struggle as higher interest rates and lower valuations make transactions in private real estate difficult to execute. While real estate activity has been muted, we still see compelling opportunities in structured deals such as credit tenant leases.
- There should also be attractive opportunities in private asset-backed securities and cross-border deals.
- The IG private credit market could benefit from volatility, as this market is a reliable source of execution when other markets falter.
- Investors that have strong deal origination should benefit as the trend in IG private credit has been for more bespoke and narrowly distributed deals with smaller lending groups.

Considerations for clients and consultants

As at mid-year 2023, we continue to stay the course. It's important for investors in private credit to maintain a long-term investment horizon throughout the credit cycle as the IG private credit market benefits from strong underwriting and robust structural protections. Historically, volatility has often yielded attractive investment opportunities.

Sources: Private Placement Monitor, 2023.

Private credit: below investment grade


Chris Wright
Managing Director & Head of Private Markets, Crescent Capital Group


Chris Wang
Managing Director, Crescent Credit Solutions, Crescent Capital Group

The asset class offers sought-after solutions for both investors and borrowers

Why private credit today

Turmoil in the banking sector, rising interest rates, recession fears and geopolitical events have accelerated the secular shift toward private credit as banks and traditional lenders retreat from the credit markets. We expect this shift to continue as banking regulations increase and balance sheet flexibility decreases for the entire banking sector. But what is driving interest in private credit today extends beyond dislocation in the banking system – **we believe private credit offers a much sought-after solution for both investor and borrower needs**.

Why investors are choosing private credit

In our view, private credit can offer a potentially compelling combination of features to investors:

Attractive yields with high current income	**Better lender protections in more conservative capital structures**
Lower mark-to-market volatility	**Resiliency throughout economic cycles**

Higher base rates and wider spreads currently allow private credit investors to reap potential double-digit yields and high current income on senior secured debt, an increase of 400–500 basis points or more over the same time last year. This is due to both private credit's focus on floating-rate debt securities and private credit's ability to capture higher spreads and higher original issue discounts from today's market volatility.

Private credit managers also have the opportunity to conduct disciplined, bottom-up credit underwriting, to put in place conservative capital structures and to directly negotiate stronger lender protections in credit agreements.

Furthermore, as private credit managers tend to be buy-and-hold investors with long investment horizons, marks are typically more insulated from public market price fluctuations and exhibit lower historical volatility.

Lastly, investors who are worried about an impending hard economic landing may choose private credit due to its resiliency through cycles. Private credit can benefit from being senior within a borrower's capital structure, having directly negotiated credit agreements with tighter terms and superior covenant protections, and having access to hands-on monitoring and proactive portfolio management capabilities.

Why borrowers are choosing private credit

Borrowers and private equity sponsors are increasingly turning to private credit as they value the certainty of execution and ease of use that relationship lenders provide. A private credit financing solution can mean no market flex, no marketing meetings, no unknown outcomes and, most importantly, the ability to choose who exactly is in your capital structure.

In periods of market dislocation, borrowers are also choosing private credit due to a lack of bona fide alternatives. When the syndicated financing markets are shut, private credit remains open for business with its committed capital base.

One key difference today is that private credit can rival the syndicated markets in size and scale in a way that had been recently unfathomable, offering a financing solution to a much broader range of businesses through all types of market conditions.

Current market trends and opportunities

This market is seeing the balance of power continuing to shift in favor of lenders with more attractive structures, pricing and documentation.

Valuation expectations between buyers and sellers have remained apart for much of 2023 thus far, driving a decline in overall merger-and-acquisition volumes. That stated, private equity "dry powder" is at record levels and an increasing number of private companies are looking for an exit, often to private equity. As these valuation expectations converge and buyers and sellers acclimate to the new market environment, M&A volume is expected to pick up. Finally, private credit isn't just providing capital for buyouts: demand has grown for private credit in non-buyout financings such as incremental financings and refinancings.

In summary, we believe the growing acceptance of private credit as a bulwark in any investor's portfolio is accelerating in tandem with the momentum it is gaining as a preferred financing solution for borrowers.

Sources: Bloomberg, Private Placement Monitor, 2023.

Real estate

Phil Stone
Principal, Head of Canada Research, BGO

Michael Andrews
Managing Partner, Portfolio Manager, BGO

Housing market remains a key indicator for Canadian economy; commercial fundamentals remain strong

Bank of Canada steps off the sidelines

After pausing at its previous two meetings in 2023, at the mid-year point in June, the Bank of Canada (BoC) raised its target interest rate by 25 basis points to 4.75%. GDP growth in the first quarter surprised to the upside, with consumer spending remaining more resilient than expected. Inflation is easing but remains stubborn, owing in part to a strong labor market, which is driving wage growth. The BoC's hawkish tone suggests that more rate hikes may be required in 2023 to cool the economy and return inflation to its target range, but the central bank still expects inflation to fall to around 3% by the end of summer. The cure for higher inflation may just be to give enough time for the lagged impacts of earlier rate increases to take hold. While the Canadian growth outlook remains largely unchanged, with expectations for slower growth and possible economic contraction in the second half of 2023, further rate hikes would further dampen the outlook.

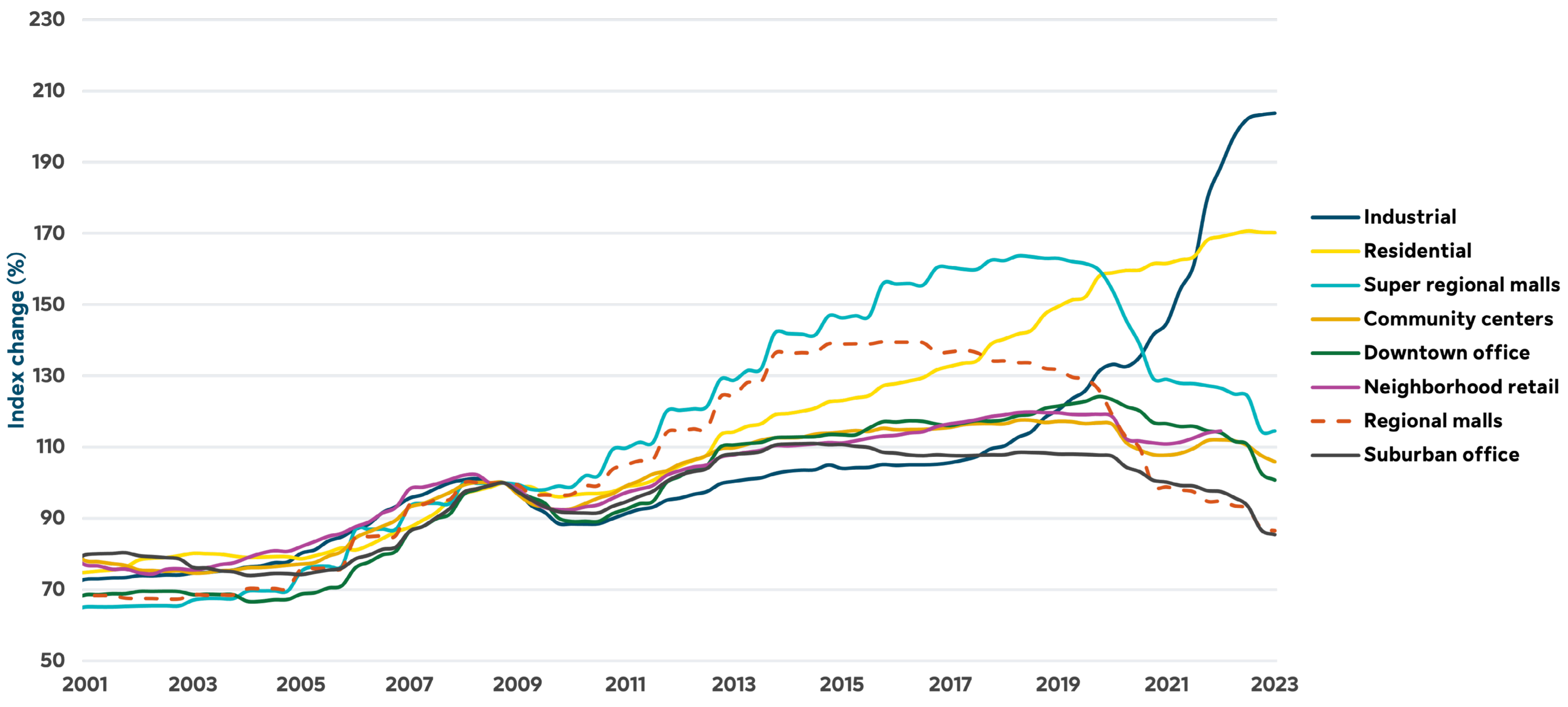
Keeping an eye on housing

The housing market may be the most important indicator to watch to see if a soft landing turns into a deeper correction. Lower bond yields triggered by the regional banking crisis in the United States in March have resulted in lower mortgage rates. This relief ignited a surge in spring demand in the residential real estate market, resulting in higher sales volumes and values bottoming. Prices have now begun to rise in many markets as inventories remain low, but this momentum may be short-lived. At the time of writing, the yield on a five-year Government of Canada bond had risen nearly 100 basis points since the lows in March and mortgage rates have trended higher as a result. As fixed-rate mortgages continue to mature and renew/refinance at significantly higher interest rates, higher debt-servicing costs mean less discretionary income for households already grappling with higher consumer prices. Given that household consumption accounts for nearly 60% of Canadian GDP, economic prospects will be heavily predicated on the durability of the housing market.

Price discovery continues to unfold

Higher interest rates, tightening lending conditions and broader economic uncertainty are all contributing to the ongoing price discovery in commercial real estate markets. Apart from motivated sellers, bid–ask spreads are generally still wide, constraining transaction activity. According to MSCI, capital values have declined 5% from peak in Q3 2022 but decreases have been largely isolated to the office and retail sectors as income growth has outpaced cap rate decompression in multifamily and industrial.

Capital value declines in Canadian real estate attributed to office, retail



Source: MSCI/REALPAC Canada Annual Property Index, as of March 2023. Dec. 2008 used as base year of index value = 100.

Debt capital remains available for commercial loans

In contrast to the negative headlines in the U.S., the availability of mortgage debt in Canada is expected to remain adequate for the balance of 2023, although some lenders are reducing their allocations and/or tightening lending standards in response to the continued possibility of an economic downturn. Demand for commercial mortgages is generally expected to remain driven by the necessity to renew or refinance maturing debt as opposed to acquisition activity in the near term. In some cases, well capitalized borrowers are opting to repay maturing debt from their own resources rather than paying higher interest rates.

Despite near-term headwinds, the long-term fundamentals for high-quality core mortgages remain on solid footing, in our view, and should create attractive risk-adjusted returns in the second half of the year, particularly for lenders that are focused on fundamentals rather than headlines.

Sector outlooks in a softer economy

With interest rate tailwinds firmly in the rearview mirror, we believe outperformance in commercial real estate will require active management to drive income.

The industrial sector is well positioned to handle a mild downturn, in our view, given the near-record low availability rate and challenges for developers to bring new products to market. We're starting to see slower leasing activity as users adjust to higher capital costs and the prospect of decreased economic activity. Any pause in expansion plans, however, is likely to be brief, as population growth remains exceptionally strong, particularly in Canada's primary markets.

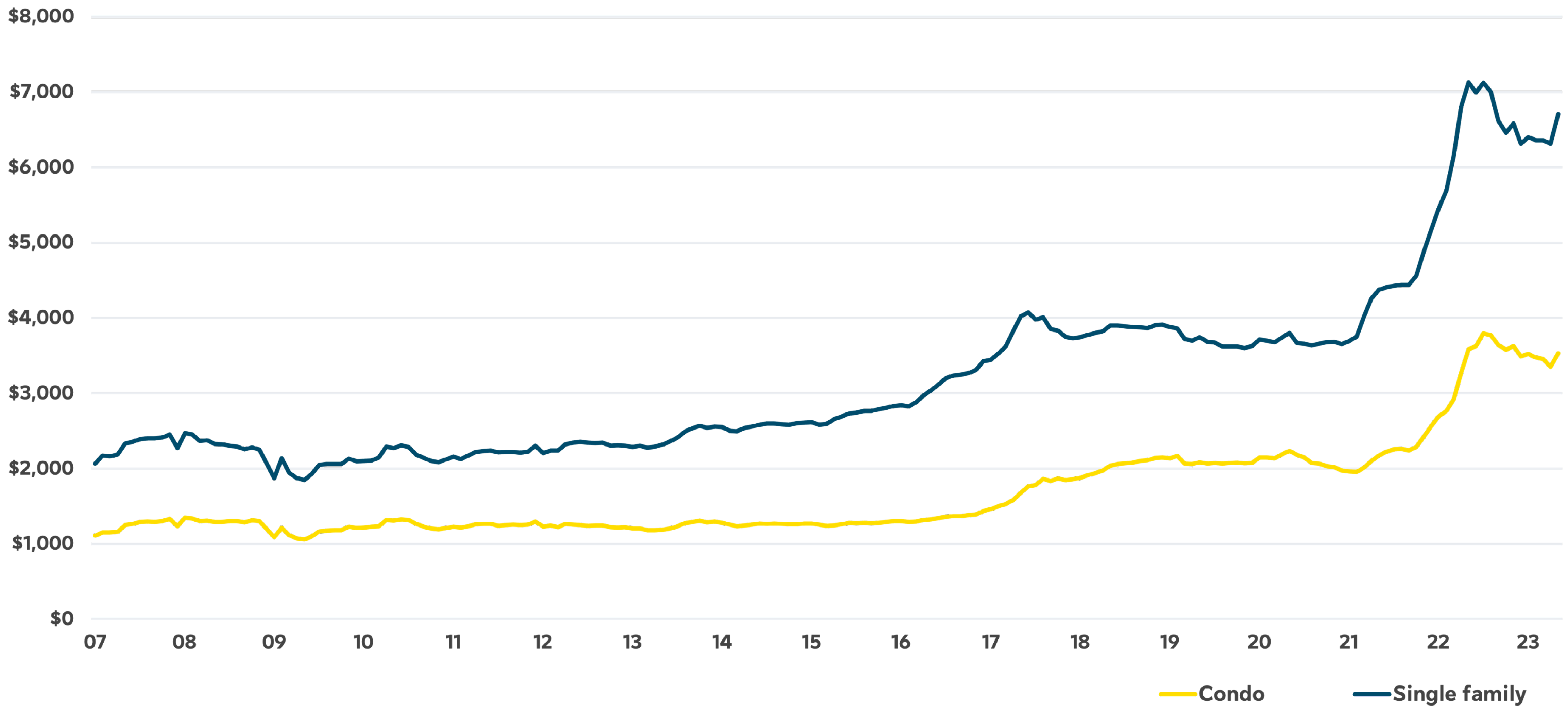
The retail sector has recovered as a result of job growth, wage increases and excess savings, but it is expected to soften as a result of high interest rates. A weakening economy will pose challenges for discretionary retail, just as it does for the logistics sector. Needs-based retail, particularly "value-oriented" retail, should remain strong, however. Suburban retail is benefiting from work-from-home trends and an aging Millennial cohort, whereas urban retail is facing similar challenges from the same factors.

While there has been a recent uptick in office re-entry rates as occupiers entice employees back to the office, weekly physical occupancy in most Canadian markets remains well below pre-COVID levels. Outside of the best-in-class "A" buildings, "commodity office" properties will be challenged by remote work, drag from high capital expenditures, job layoffs and further automation of knowledge work as generative AI advances. We anticipate further performance bifurcation, with value holding up much better for top-tier assets that occupiers want to collaborate in.

Homeownership affordability hasn't materially improved in 2023 as higher interest carrying costs have offset home price declines. This has continued to boost rental demand across all price points and geographies. The recent increase in mortgage rates may further boost demand for rentals as homebuyers delay purchasing decisions. Finally, a decline in housing starts is likely to exacerbate the housing shortage over the next few years. The following exhibit uses the Greater Toronto Area to illustrate affordability through mortgage carrying costs.

Homeownership affordability challenging

New mortgage monthly carrying costs, Greater Toronto Area



Source: CREA, Ratehub.ca, mortgage calculations based on 10% downpayment and 25-year amortization.

Opportunities in the current environment

G7-leading population growth continues to drive solid operating fundamentals in Canada. As a result, we anticipate an increase in investment activity once there is more clarity on inflation, interest rates and the depth and duration of an economic slowdown. In terms of broad investment capital, there is still a significant amount of “dry powder” sitting on the sidelines ready to be deployed into real estate. Opportunities in high-quality debt may be providing attractive risk-adjusted returns in the current environment, in our view. We believe 2023 is shaping up to be a good vintage in value-add equity with opportunities emerging at better entry points as motivated sellers seek liquidity. Meanwhile, core strategies continue to generate strong cash flow with healthy fundamentals, and should prices adjust further there may be opportunities to add to portfolios.

Sources: MSCI, Bank of Canada, Bloomberg, CREA, Ratehub.ca, 2023.

Infrastructure

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Opportunities, risks in the asset class amid sticky inflation and sustainability initiatives

A tighter focus on recurring themes driving infrastructure

Looking toward the second half of 2023, we view the dominant themes affecting infrastructure investing as being largely a continuation with those identified in our previous outlook (elevated interest rates and inflation, sustainability and demand drivers). However, national policy initiatives and market responses to developments so far this year have shifted the landscape somewhat, affecting both the opportunity set in infrastructure as well as potential risks going forward.

Investing for tomorrow's economic development

By 2024, the world will need an estimated **US$94 trillion** in global infrastructure investment to meet growth goals (G20 Global Infrastructure Outlook 2023).

For example, the issue of interest rates has, in our view, moved even more to the forefront in mid-2023, especially with respect to the potential implications of high rates for the valuations of other investment types, such as infrastructure and other real assets. The high-rate environment may be a longer-term reality, as evidenced by some key benchmark bond yields remaining elevated even as short-term market disruptions pass. At the halfway point of 2023, for instance, gilt yields indicated that they would be entrenched in the 4%-plus range for some time, as they increased to those levels during the U.S. debt ceiling debates but continued to linger there even after political leaders reached an agreement.

Inflation readings in certain economies have suggested the upward price pressures have become stickier and more deeply rooted than previously anticipated. Such developments could underpin the case for a higher-for-longer interest rate environment, which would in turn pose a potential challenge to real assets and other investments should the cost of capital remain high.

However, the differentiated nature of infrastructure investing might paint a different picture for the asset class. We expect the effects of central bank policies intended to moderate inflation to increasingly filter into the economy, and the likelihood of a recession has increased as well. Infrastructure investments have historically held up well in recessionary conditions, as demand for long-term infrastructure assets tends to be inelastic and many such investments have defensive characteristics, such as pricing protection through underlying contracts.

The expanding infrastructure market opportunity

By 2035, an average of **US$3.7 trillion** per year in infrastructure investment worldwide will be required to keep pace with growth (McKinsey & Company, 2023).

Shorter- and longer-term growth catalysts from sustainability

We expect sustainability issues to also drive infrastructure investment. A combination of geopolitical developments and longer-term secular themes should support sustainability initiatives and related green infrastructure. On top of its immense human cost, the war in Ukraine has continued to increase concerns about energy security and, consequently, the urgency toward renewable energy development. On the legislative front, 2022's U.S. Inflation Reduction Act (IRA), which directed US$400 billion in federal funding to clean energy, should continue to drive green infrastructure demand as this funding works its way through the economy. Such legislation has incentivized other economies, such as in Europe and Canada, to similarly invest further in clean energy.

Investments needed for sustainability goals

Until 2030, an estimated **US$2.6 trillion** annually in global sustainable infrastructure required investment will be needed to meet UN Sustainable Development Goals and 2050 net-zero emissions (World Bank, 2023).

Immediate-term geopolitical affairs aside, the longer-term global move toward sustainability will continue to act as a catalyst for infrastructure, in our view. Investment themes we are paying particularly close attention to include electrified vehicle infrastructure – such as charging facilities – as well as digitalization and the circular economy.

Sources: Bloomberg, McKinsey Group, World Bank, G20 Global Infrastructure Outlook, 2023.

Insurance asset management

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Higher yields creating opportunities for insurers across the fixed income market

Window of opportunity in fixed income

Relative to last year, expected returns have risen across the universe of asset classes that insurance companies invest in, with the most notable increases coming in fixed income. The higher yields driving the improved forecast are likely here for the duration of 2023, creating a window of potential opportunity to invest across the investment spectrum, including:

1

Traditional core fixed income, to lock in high quality attractive yields in the face of a likely recession

2

Less familiar areas of the investment grade (IG) public bond market, such as U.S. structured securities, which can offer additional spread if you have the expertise and resources to monitor underlying loan collateral and hedge the related foreign exchange exposures

3

Alternative credit, which comes with enhanced yield and diversification potential, in exchange for less liquidity and greater complexity

4

Real estate, which may provide similar potential returns along with higher income generation, plus a lower capital charge than common shares

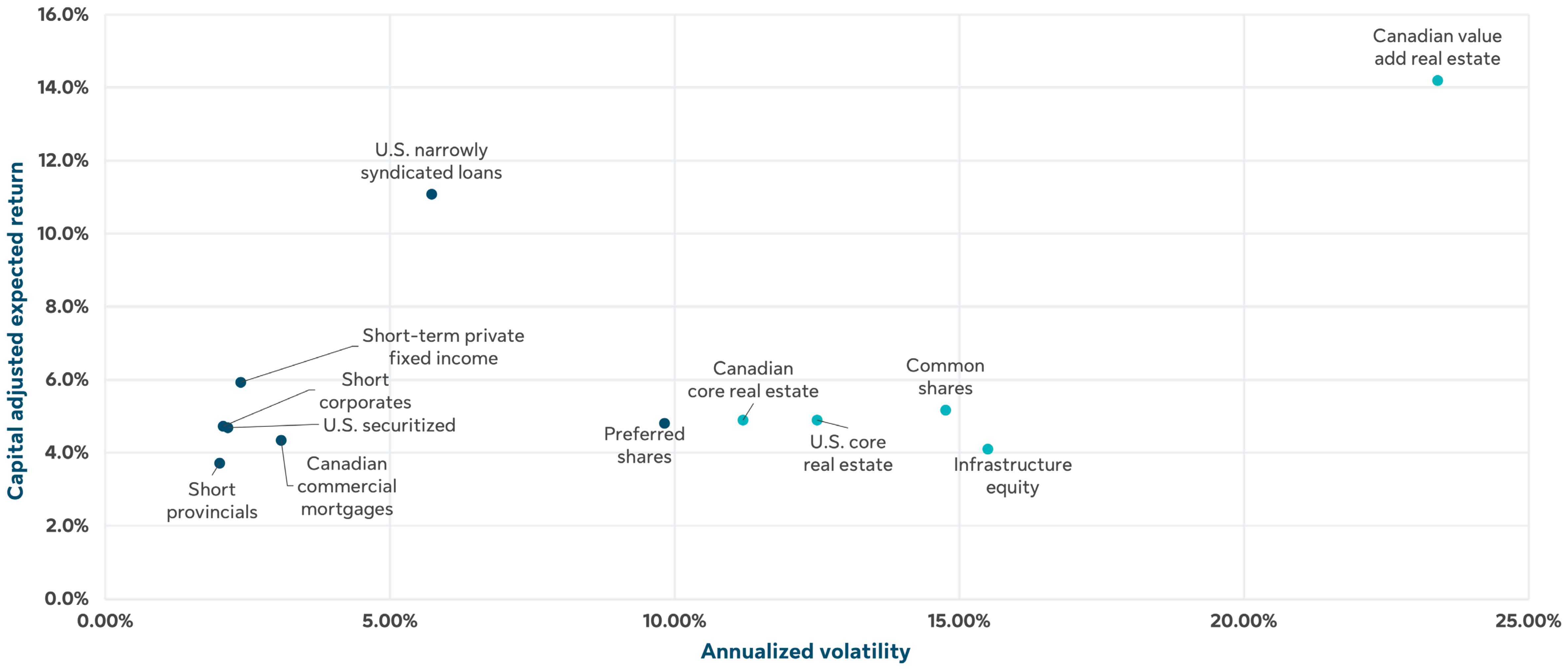
Insurance asset allocation shifting toward bonds

Given the increase in yields, it's no surprise that we're witnessing a shift in insurer asset allocations out of equities and into fixed income, as the move in valuations has driven a divergence in relative value. To illustrate this divergence, we look at the FTSE Short Universe Index, which exhibited a yield of 2.7% in March 2022.

As of May 31, 2023, the yield on the index was approximately 4.5%. Compare that to our forward return forecast for equities, which has barely budged (7.9% last year compared to 8.3% today, using the S&P 500 Index as a proxy benchmark). To put that change into a portfolio context, last year an allocation of 80% core fixed income and 20% equities (using the two previously mentioned benchmarks as proxies) would have resulted in an expected return of 3.7%, annualized. Today, expectations of that same asset mix would be 5.3%.[1]

On a capital-adjusted basis, the change in relative value is even more striking when considering historical volatility, given the favorable capital treatment bestowed on fixed income over common shares. The following exhibit illustrates the historical volatility in short-term fixed income (as represented by short term provincials and corporates) at 3.7%–4.7%, a fraction of the 14.8% historical volatility of equities.

Capital-adjusted expected risk/return profile of asset classes used by insurers



Sources: Office of the Superintendent of Financial Institutions, Bloomberg, FTSE, TMX Group Limited, 2023. All data as at 3/31/2023 unless otherwise stated. Expected return for preferred shares (S&P/TSX Preferred Stock Index) reflects total current yield. Expected returns for S&P/TSX Preferred Stock Index before proposed changes reflects the benefit of not paying taxes, assuming a 27% tax rate. Expected returns and volatility for common shares, real estate and infrastructure based on SLC Management's analysis of the current risk free rate as of the end of Q1 2023 versus spreads characteristic of asset class benchmarks over a 3–5-year economic cycle. Expected return for all other asset classes shown reflects yield to maturity. Short-term private fixed income calculated based on the yield of the FTSE Short Corporate Index plus an assumed illiquidity spread of 157 basis points (bps). U.S. narrowly syndicated bank loans calculated based on the yield of S&P Leveraged Loans index plus an assumed small cap spread of 345 bps. The Estimated MCT Credit/Market Risk Charges have been calculated internally based on OSFI's Minimum Capital Test ("MCT") rules. Capital adjusted return has been calculated by deducting a cost of capital charge of 10% based on the estimated MCT Credit/Market Risk Charge, from the expected return of each asset class. Annualized volatility measured by the annualized historical standard deviation of the asset class since the inception date of its corresponding benchmark. This information is presented for informational purposes only and is not a guarantee of future results. This is not a recommendation of any asset class or activity.

Aftermath of the preferred and common shares tax announcement

The 2023 Federal Budget contained an unexpected new tax measure for dividends that directly impacts financial institutions, including insurance companies. Through the budget, the Canadian government has amended the Income Tax Act to effectively treat dividends received from Canadian shares held by financial institutions as business income. Current responses from insurers seem to vary from a plan to divest from the asset class to a plan to engage in advocacy efforts for a reversal of the move or a grandfathering provision.

As insurers seek to replace lost yield, we expect some to look further out onto the risk–return spectrum into alternative credit, with below IG public, private credit and commercial mortgages as potential beneficiaries. These asset classes can increase the portfolio's overall yield and, oftentimes, expected return. The less obvious possible benefit is the resulting potential improvement to portfolio diversification and reduction in overall portfolio volatility, which can be illustrated by strategic asset allocation (SAA) analysis. That stated, it's important to understand that this type of analysis focuses on maximizing economic value, but insurers may have different portfolio objectives such as generating more investment income, increasing surplus or optimizing capital adjusted returns. Therefore, SAA should be viewed as just one input into a process that aligns asset allocation changes with a company's goals and risk tolerance.

Increasing cash flow generation, reducing volatility through real estate equity

For some insurers, an allocation to return-seeking assets has been a core component of financial success over the years. For those concerned about recent volatility, and the impact a common shares allocation could have on income generation, real estate equity is a potential asset class of interest. This is in part due to the similar return expectations, lower capital charges and the income generation characteristics that core real estate equity can provide relative to other return-seeking assets. In addition, value add real estate equity may provide an investor with a higher return potential for a reduced capital charge when compared to common shares.

Considering stakeholder objectives when making portfolio decisions

With compelling opportunities available today for insurance investors of varying risk appetites, it's important to maintain an understanding of who an insurer's primary stakeholders are – be it shareholders for a publicly traded stock insurer or policyholders for a mutual insurer. Aligning portfolio decisions with stakeholder objectives while keeping an eye on emerging regulatory changes is an important part of the insurance asset allocation process today.

Sources: Bloomberg, Office of the Superintendent of Financial Institutions, SLC Management, 2023.

[1] FTSE and SLC Management. Expected returns for common shares based on SLC Management's analysis of the current risk free rate as of the end of Q1 2023 versus spreads characteristic of asset class benchmarks over a 3–5-year economic cycle. Expected returns for bonds reflects yield to maturity.

Retirement plan solutions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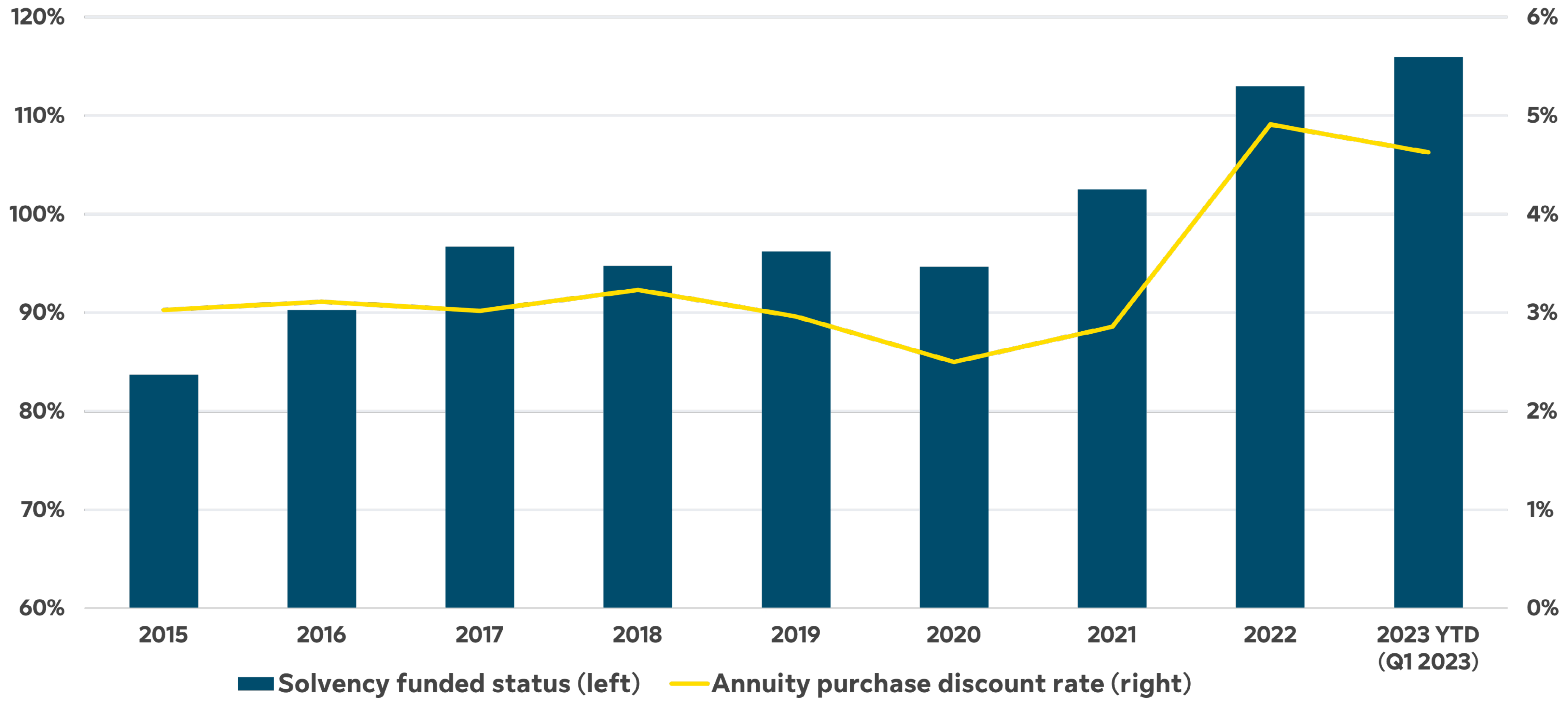
Plan sponsors move to lock in higher rates; diversification key as fixed income allocations begin to grow

As interest rates have stabilized, plan sponsors move to lock in attractive yields

So far, 2023 has provided a semblance of stability in rate markets compared to the turbulence of 2022. Many plan sponsors had experienced increases in funded statuses in 2022 off the back of rate gains, but remained hesitant to act due to fears of further rate moves. **Now that further significant rate rises appear less likely, we have seen plan sponsors come off the sidelines and look to lock in those funded status gains.**

At the mid-year point of 2023, annuity purchase discount rates are approximately 200 basis points higher than at 2021 year end (source: Canadian Institute of Actuaries methodology, medium duration liabilities). Consequently, we believe this is an opportune time for plan sponsors to take risk off the table, as most plan sponsors are still underhedged with respect to interest rate exposure, in our view. The currently attractive yield environment (as well as the uncertainty around how long it might persist), when combined with volatile return expectations for equity markets, means that many defined benefit (DB) plan sponsors are choosing to reallocate to fixed income instruments that increase their interest rate hedge and can better protect their funded status gains from last year.

Improved financial positions, higher discount rates suggest an opportune time to reduce risk



Sources: Solvency funded status based on Mercer Pension Health Pulse (as of Q1 2023), which tracks the median solvency ratio of the DB pension plans in Mercer's pension database. Annuity purchase discount rate based on the Canadian Institute of Actuaries methodology and shown for the medium duration liabilities.

Impact of higher yields, regulatory changes on plan sponsors

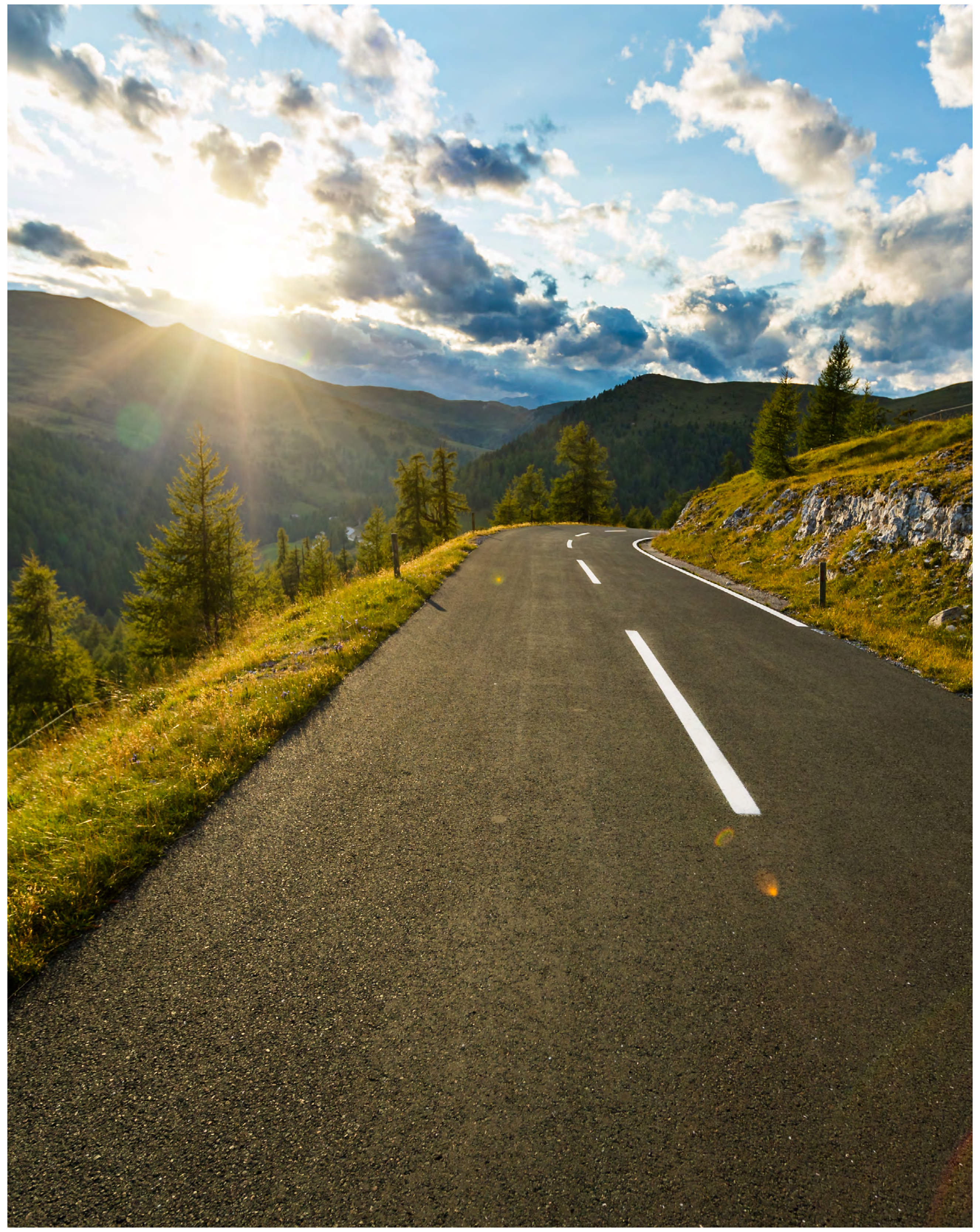
Persistently attractive yields throughout the year, as well as uncertainty in more high-risk asset classes, have led many plan sponsors to revisit their fixed income allocations. Many DB plans are on a pre-designed glidepath that drives a shift toward fixed income as the funded status of their plan improves. For less liability-focused investors like public pension plans, we have seen a similar dynamic as many plan sponsors are now able to hit their expected return targets while utilizing fixed income across the duration spectrum. More broadly, fixed income and real assets are becoming particularly attractive as these plans continue to mature. Many plans have become cash flow negative, increasing the importance of asset classes that provide investment income in the form of stable cash flows.

Diversification a focus for investors amid new fixed income allocations

The key topic in 2023 among fixed income investors has been diversification within fixed income. With increased flows into the asset class, we have seen investors increasingly look at how they can add complementary investment styles or alternative fixed income strategies to their existing lineups. Within public investment grade (IG) fixed income, this has led to an additional focus on how managers within a multi-manager lineup are additive to one another over the long term, as well as how they perform during periods of significant market volatility. Plan sponsors are using metrics like improvements in information ratio (IR) as a measure of the potential benefits of a multi-manager approach.

Outside of traditional credit, two of the main asset strategies to benefit from these actions were U.S. corporate bonds and IG private credit. U.S. corporate bonds provide name and sector diversification outside of the Canadian corporate bond market, as well as significantly improved liquidity, once most of the foreign interest rate and foreign exchange risks are appropriately hedged (using derivatives like cross currency swaps). IG private credit can give plan sponsors access to additional issuers and sectors not found in the publicly traded corporate market, plus the potential for a higher yield due to the additional underwriting required and as compensation for lower liquidity. These trends have been particularly visible in the DB market, where U.S. corporates and IG private credit are increasingly used within liability hedging portfolios.

For plan sponsors that have exhausted their opportunities in the IG fixed income market, we've seen increased interest in below-IG alternatives such as high yield bonds and bank loans, either as standalone sleeves or as part of a broader multi-asset credit solution, as well as increased interest in real estate and infrastructure. For plan sponsors unaccustomed to investing away from traditional asset classes, small incremental changes might be a viable option, as these can still lead to significant improvements in a plan's risk/reward outcomes.



What does the rest of 2023 have in store?

It's hard to predict what will happen as we move toward the end of the year. The consensus appears to be that we will see limited rate rises through the next six months. With this in mind, we see the trend toward fixed income to continue full steam ahead as plan sponsors look to de-risk their plans while conditions remain favorable. The adoption of alternative fixed income assets in both the DB and defined contribution markets still feels like it is in its early stages. We anticipate significant growth for these alternative strategies as more plan sponsors become comfortable with private assets and look to benefit from their favorable risk and return characteristics.

Sources: Bloomberg, Canadian Institute of Actuaries, Mercer Pension Health Pulse, 2023.

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Unless otherwise stated, all figures and estimates provided have been sourced internally and are as of June 30, 2023.

Unless otherwise noted, all references to "$" are in CAD dollars.

All data are subject to change.

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