Why the TSX may outperform in 2022

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Last year at this time we published a somewhat divisive white paper outlining why we thought it was finally time that Canadian equities could outperform their U.S. peers.

[Financial data on a screen. Images of Canadian flags.]

Well, it may be unCanadian to brag, but now it is safe to say that Canada may have finally gotten its groove back, and our confidence is even greater now relative to that 2021 call, that this year 2022 will be another year of outperformance for Canadian Equities.

[The S&P 500 or the TSX?]

Prior to last year, the S&P500 had outperformed the TSX in nine out of the prior 10 years. During that stretch, the TSX had risen a respectable 115%, but that return was completely overshadowed by a monstrous tripling of the S&P 500 over that time. To be fair, 2021 was a little bit of a push. The S&P/TSX did outperform the Dow Jones Industrial Average, the Nasdaq, and the Russell 2000, but it fell a tiny bit short of the S&P 500 on a total return basis. But the arguments we presented last year are much stronger and more supportive today.

[10-year performance - S&P/TSX Composite Index vs. S&P 500]

[S&P/TSX Composite Index (CAD) S&P 500 (CAD)]

[*Source: Bloomberg, in Canadian dollars, cumulative total returns (including reinvestment of dividends) from Jan. 3, 2012 to Jan. 31, 2022]

[A line chart that compares the performance of the S&P/TSX Composite Index vs. S&P 500 from 2012 to 2022.]

Last year at this time, we noticed a decidedly wide deviation between the forward price-to-earnings ratio of the TSX and the S&P 500. The TSX was slightly more expensive than its 20-year average of about 16.2x forward earnings, while the S&P 500 was trading about 5 multiple turns higher than its long-term average 16.7x.

Today, there is a similar five multiple gap between the S&P 500 and the TSX, except today, the TSX is close to one standard deviation below its long-term average, while the S&P 500 still looks expensive at 20x forward P/E.

The second main point in our argument was composition of the indices.

[An aerial view of Google headquarters in San Francisco. Social media icons on a phone screen. An aerial view of downtown San Francisco]

The S&P 500 is dominated by technology companies and technology-like companies such as Meta, Amazon and Google. The FAANGMA stocks as they're essentially known, have powered the past 10 years of growth for the S&P 500, but the law of large numbers and the prospects of rising interest rates may make the prior impressive run difficult to sustain.

[A person scrolls through Facebook on a phone. A person drives a Tesla. Thumbs up icons followed by thumbs down icons on a screen.]

We’ve already seen some of those pillars start to crack with the likes of Facebook and Tesla experiencing 30% drawdowns.

[A split screen image containing stock market data displayed on the side of building, an aerial view of a hydro-electric dam, and a close-up of a steel girder.]

Conversely, The TSX is much more cyclically balanced, with its three main pillars, financials, energy and materials benefiting from rising interest rates and the economic growth we’re expecting post the COVID recovery.

[Energy stocks on the rise?]

One of those sectors, energy, has already had an impressive rebound off its 2020 lows, and we’ve seen oil surge higher in recent weeks.

[An offshore oil derrick at sunset. An aerial view of a hydro-electric dam.]

However, there are many reasons to believe in the sustainability of this energy bull run.

[Oil derricks on the side of the road in Alberta. The exterior of OPEC headquarters. An aerial view of an oil pipeline in Alaska.]

Over the past year, we’ve seen global inventory levels being drawn down, DUCs or drilled and uncompleted wells, as they’re called, are a leading indicator, and they have fallen to cyclical lows. All while producers remain quite disciplined on their production growth even while demand begins to approach pre-COVID highs. More specifically, the Canadian energy producers have already repaired their balance sheets, are generating record free cash and returning that cash to the shareholders, yet still trade close to trough valuations.

[Smoke billows from the chimneys of an oil refinery. An aerial view of a refinery in the Alberta Tar Sands.

And while some people criticize the carbon footprint of oil producers, it is important to point out that our Canadian producers are amongst the least carbon intensive and most ESG conscience producers in the world.

[A windmill located offshore in Prince Edward Island. An aerial view of a field of solar panels.]

As well, providing balance to the energy sector is the relatively high 3% allocation to the renewable companies on the TSX that should benefit from the next few decades of renewable growth.

[Canada's COVID-19 response]

Rounding out some of the tailwinds Canada has over the U.S. in a post-COVID world, is our thoughtfulness through COVID.

[A low angle of a Canadian flag. A row of vials containing COVID vaccines. A needle goes into a vial. An arm is cleaned in preparation for a needle.]

Our population has a much greater vaccination rate, a much lower death rate, and that's contributed to the strong rebound in employment.

[People perform varies jobs, including a factory worker, a lab worker, a waiter and a barber.]

Canada has recovered more than all of its lost jobs during the pandemic and has seen its participation rate get back above 65%, while the U.S. lags a few percentage points behind.

[A plane lands at the Calgary airport. A woman in a mask looks for a taxi at the airport. A man in a mask holds a Canadian flag and looks into camera.]

But really one of Canada's superpowers is its strong immigration policy that will target over 400,000 new Canadians or more than a 1% boost to its population.

[A doctor rights on a patient's chart. A scientist looks into a microscope.]

The highly skilled and educated new Canadians give a boost to growth and stimulate the overall economy making up for the lackluster birth rates problematic in many developed countries.

[Conclusions]

All of the tailwinds just mentioned, plus the higher expected earnings per share growth for the TSX due to its cyclical growth composition, plus the much lower starting valuations positions the TSX extremely well to outperform U.S. equities in 2022. Now, this won't be the case every year, so let's enjoy it while it lasts. Go Canada!

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