

November 1, 2022

Make It Stop!

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Global markets have remained very turbulent over the past several months, which given the prevailing wall of worries for many of us, has only added further to investor nausea. The teacups rides, which are a staple at most theme parks, comes to mind. At first, its all smiles and laughter, but once the spinning gets going and the velocity picks up, it's not too long until riders are begging for it to stop! Similarly, while volatility in markets is normal and in most cases appreciated by investors, who can opportunistically add to new or existing positions at lower prices, the level of volatility in markets this year has been anything but normal. The good news is that you are not alone. Investors across the board from retail to institutional are feeling the pinch and have struggled to allocate capital amid the volatility. The bad news is that the level of volatility won't stop until the ride is over, so hold on for more turbulence along the way.

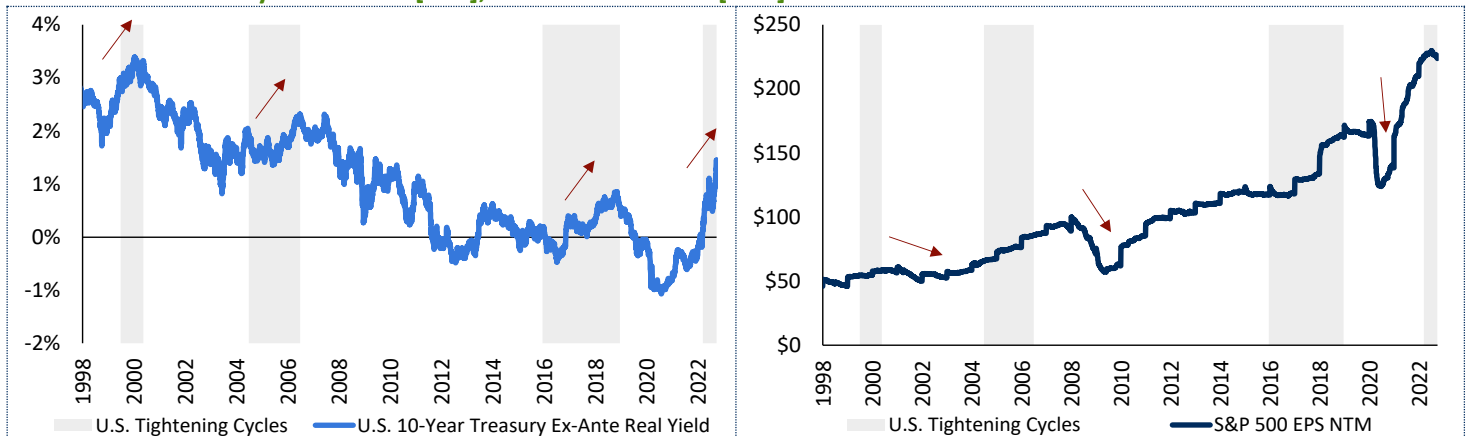
High Inflation leads to Higher Rates, Slower Growth, Lower Valuations and Lower Earnings...

Stubbornly high inflation, rapid increases in interest rates/yields, have caused asset prices including equity valuations to re-rate lower. Elevated inflation, higher rates, a war in Europe and ongoing lockdowns in China have also resulted in a material downside revision to global economic growth for 2023 versus at the start of the year. Additionally, while third quarter corporate earnings in the U.S. have come in better than expected, earnings expectation for 2023E are beginning to be revised lower, with more downside in our view.

When Will it Stop?

Historically speaking over the past 20+ years, each time financial conditions have tightened in the U.S., we have seen a corresponding increase in yields across the curve, including notable increase in U.S. 10-year yields. Corporate earnings, however, have typically weakened with a lag (approx. two years after real yields peak) as rate increases and tighter policy make their way into the real economy. With policy tightening efforts and higher rates only commencing in a material way at the start of this year, we expect earnings to weaken further in the coming quarters even if the pace of policy tightening by central banks moderates from current levels.

U.S. 10-Year Treasury Real Yields [LHS]; S&P 500 EPS NTM [RHS]



Source: BOARD OF GOVERNORS of the FEDERAL RESERVE SYSTEM; FactSet; Bloomberg; Raymond James Ltd.; Data as of September 30, 2022.

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We continue to believe that the sheer pace, magnitude and timing of rate hikes (front-loading vs. gradually throughout the cycle) have raised the probability of a recession in 2023. Below, we take a look at the average change (peak-to-trough) for valuations and earnings for the S&P 1500 index and the S&P/TSX index during past recessions since 2000. Moreover, we highlight in blue, sectors that have already contracted in line with past cycles.

Lower Valuation and Earnings Risks for Two Defensive Sectors (CONS & COMM) on the S&P 1500 Index

From our analysis, **consumer staples (CONS)** and **communication services (COMM)** on the S&P 1500 index have seen their valuation multiples compress in line with the average changes in valuations from peak-to-trough during the past three recessions since 2000. The same goes for earnings. Taken together, we believe these defensive sectors present investors with lower relative valuation and earnings risks, all else equal.

S&P 1500: Historical & Current Drawdown in P/E NTM

	Sector Weight	Total Ret YTD	Average Chg. in P/E NTM*	Chg. in P/E NTM Since 1/4/2022	Difference
S&P 1500		-20.1%	-5.0x	-5.5x	-0.4x
Defensive					
CONS	6.6%	-8.7%	-3.5x	-2.5x	1.0x
UTIL	2.9%	-9.6%	-4.8x	-2.8x	1.9x
HLTH	14.7%	-10.1%	-4.2x	-1.1x	3.0x
COMM	7.6%	-35.9%	-5.3x	-6.6x	-1.4x
Cyclical					
COND	11.4%	-29.6%	-5.5x	-8.3x	-2.8x
ENR	5.3%	61.6%	0.8x	-2.7x	-3.5x
FINL	11.6%	-15.6%	-4.7x	-3.7x	1.0x
INDU	8.9%	-15.3%	-6.5x	-4.7x	1.8x
INFT	25.2%	-28.0%	-8.0x	-8.9x	-0.9x
MATR	2.9%	-17.2%	-4.4x	-2.5x	1.9x
RLST	3.0%	-31.2%	-6.0x	-7.5x	-1.6x

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in P/E NTM during the past three recessions (the dot-com bubble, financial crisis, COVID-19).

S&P 1500: Historical & Current Drawdown in EPS NTM

	Current EPS Grw NTM	3-Mo Rev to EPS NTM	Average Chg. in EPS NTM*	Chg. in EPS NTM Since 1/4/2022	Difference
S&P 1500	7.0%	-2.1%	-24%	6%	30%
Defensive					
CONS	5.0%	-0.5%	-1%	1%	1%
UTIL	6.8%	1.5%	-6%	6%	12%
HLTH	-0.3%	-2.3%	1%	-3%	-3%
COMM	10.1%	2.8%	-19%	-8%	11%
Cyclical					
COND	21.0%	4.8%	-37%	-3%	35%
ENR	22.7%	-37.7%	-58%	83%	140%
FINL	9.5%	6.9%	-29%	7%	36%
INDU	14.6%	-7.6%	-27%	8%	35%
INFT	7.4%	-3.2%	-27%	3%	31%
MATR	-9.7%	-10.3%	-40%	-3%	37%
RLST	6.5%	-2.9%	-25%	6%	31%

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in EPS NTM during the past three recessions (the dot-com bubble, financial crisis, COVID-19).

Two Defensive and One Cyclical Sector Offer Lower Valuation and Earnings Risks on the S&P/TSX Index

There are three sectors on the S&P/TSX index which we view as offering investors lower relative valuation and earnings risk if we are correct in our recession assumption. These sectors include the **consumer staples (CONS)**, **communication services (COMM)** and **real estate (RLST)** sectors.

S&P/TSX: Historical & Current Drawdown in P/E NTM

	Sector Weight	Total Ret YTD	Average Chg. in P/E NTM	Chg. in P/E NTM Since 1/4/2022	Difference
S&P/TSX		-9.0%	-5.6x	-3.3x	2.2x
Defensive					
CONS	4.1%	4.0%	-3.5x	-1.9x	1.6x
UTIL	4.6%	-9.7%	-7.8x	-4.1x	3.6x
COMM	4.8%	-7.3%	-3.3x	-2.3x	1.1x
Cyclical					
COND	3.6%	-9.9%	-4.0x	-2.4x	1.6x
ENR	19.1%	31.7%	-3.8x	-2.4x	1.4x
FINL	30.7%	-12.2%	-3.7x	-2.0x	1.7x
INDU	13.1%	-3.1%	-5.0x	-4.8x	0.2x
INFT	5.3%	-56.1%	-11.6x	-27.5x	-15.9x
MATR	11.8%	-5.5%	-9.0x	-1.4x	7.6x
RLST	2.5%	-26.2%	-7.7x	-5.4x	2.4x

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in P/E NTM during the past two recessions (financial crisis, COVID-19).

S&P/TSX: Historical & Current Drawdown in EPS NTM

	Current EPS Grw NTM	3-Mo Rev to EPS NTM	Average Chg. in EPS NTM*	Chg. in EPS NTM Since 1/4/2022	Difference
S&P/TSX	7.5%	-3.5%	-35%	14%	50%
Defensive					
CONS	8.9%	0.5%	1%	16%	15%
UTIL	7.7%	-1.3%	-10%	10%	20%
COMM	8.5%	1.3%	-10%	2%	12%
Cyclical					
COND	12.9%	-0.2%	-32%	5%	37%
ENR	13.3%	-19.4%	-83%	54%	137%
FINL	6.2%	3.1%	-20%	5%	25%
INDU	35.9%	-2.4%	-29%	19%	48%
INFT	13.5%	5.0%	-3%	-8%	-5%
MATR	-7.7%	-12.3%	-30%	3%	33%
RLST	5.7%	0.0%	-7%	3%	10%

Source: FactSet; Raymond James Ltd.; Data as of October 23, 2022. Average change in EPS NTM during the past two recessions (financial crisis, COVID-19).

Final Thoughts

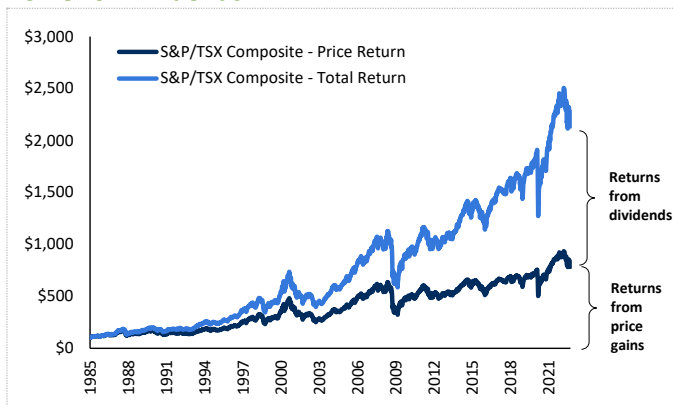
As the market/economy moves closer to the end of this cycle and into an eventual recession, we believe investors should pay greater attention to the names they own/exposures in their portfolios. We suggest investors remain highly selective and be mindful of valuation and earnings risks, especially given the many uncertainties present in today's markets.

Nadeem Kassam, MBA, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

Dividend Treats

There are many reasons we Canadians love the Great White North, including our incredible landscapes, local wildlife and friendly people. When it comes to our portfolios, as stock market investors, one thing we also love is dividends. We love dividends so much that there are 559 Canadian dividend funds/ETFs, almost as much as the Canadian equity category itself, at 816 funds/ETFs. Looking at stock market returns over the years, dividends have significantly contributed to total returns. Since 1985, while the S&P/TSX Composite Index returned a compounded average price return (excluding dividends) of 5.4% per year, the total return, including dividends, was 8.3%. The difference of 2.8% represents the contribution from dividends, meaning re-invested dividends comprised over one-third of the S&P/TSX's total return over the 37-year period.

Power of Dividends



Source: FactSet; Performance from January 4, 1985 to September 30, 2022.

What's Not to Like?

Not only have dividends contributed greatly to total returns over the years, but there are other good reasons to consider, including dividend-paying companies in your portfolio.

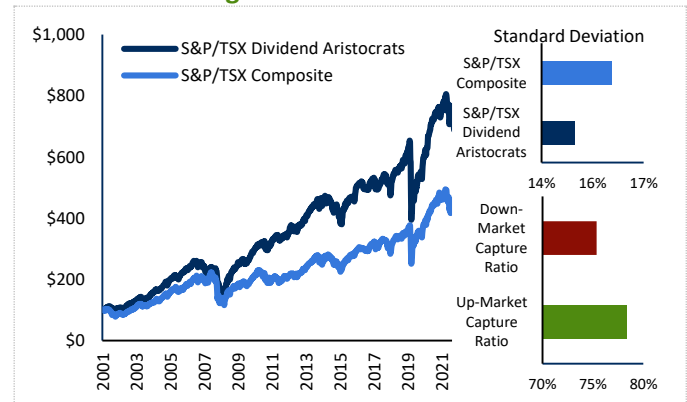
Income. Dividend stocks provide investors with a stream of income from their equity investments. As opposed to most bonds, dividends can be raised if companies believe such distributions can be sustainable in the future, providing investors with inflation protection.

Preferential tax treatment. In Canada, dividend income enjoys preferential tax treatment, benefiting from the federal dividend tax credit, compared to bond interest income, which is taxed at an individual's highest marginal tax rate (just like wage income). This preferential treatment means investors get to keep more after tax.

Performance volatility. Dividend strategies have performed well relative to the overall stock market. In fact, over the past two decades, the S&P/TSX Dividend Aristocrats Index is up 9.7% compounded annually compared to the S&P/TSX up 7.2%, outperforming the market by 250 bps. The dividend index has also exhibited lower volatility than the overall market, having an annual standard deviation of 15.0%, less than that of the S&P/TSX at 16.1%.

Preserving capital during down markets. Dividend strategies have done a good job of preserving capital during market declines, with a down-market capture ratio of 75%, meaning the dividend index declined only 75% as much as the S&P/TSX.

Dividend Investing Over the Past Two Decades



Source: FactSet; Performance from December 28, 2001 to September 30, 2022.

Word of Caution

While there are many positives to investing in dividend stocks for income-seeking investors, readers should also note the inherent volatility that comes with dividend investing. Besides equities being a more volatile asset class than bonds, their dividends are also volatile, as these could be cut should companies need to preserve cash flow. Some may recall in 2015 and 2020 when energy companies had to cut their dividends amid a decline in oil and gas commodity prices.

Stick with Quality

Dividends are a great way to supplement an investor's overall portfolio income, and they have many benefits, including preferential tax treatment and lower volatility over the long term. When picking dividend stocks, we remain focused on quality characteristics, focusing on companies that have good management teams, solid competitive positioning, and can generate strong free cash flow.

Larbi Mounni, CFA
Portfolio Manager and Senior Equity Specialist

Managed Money Fund Flows

To gain a better sense of market sentiment for each asset class and sector, analyzing fund flows can be a great tool. Over the past quarter (July 1, 2022 – September 30, 2022), the top inflows were led by fixed income categories and were fairly aligned for each investment vehicle. For mutual funds, these top categories include Canadian Fixed Income, Canadian Money Market and High Yield Fixed Income. Whereas for ETFs, the top categories include Canadian Money Market, Canadian Long Term Fixed Income and Canadian Short Term Fixed Income.

Mutual Fund Flows

While the Canadian bond market isn't the most extensive category for corporate credit, it is robust in terms of high quality government securities. By looking at the flows in Canadian Fixed Income, we can see that investors continue to leverage domestic active bond strategies to help reduce volatility. While there are many passive ETF strategies one can leverage to construct an appropriate bond sleeve for any given portfolio, it can be valuable to outsource this sleeve to a dedicated fixed income manager to provide a more stable experience. In addition to flows in domestic bond strategies, there has been a rapid increase in flows to Canadian Money Market strategies, suggesting a recent flight to safety.

Leading Categories for 3-Month Mutual Fund Flows vs. Comparable 3-Month ETF Flows

Category	Funds (\$M)	ETFs (\$M)
Canadian Fixed Income	2,565	170
Canadian Money Market	963	3,425
High Yield Fixed Income	822	(1,072)

Source: Morningstar, Raymond James Ltd.; Data as of September 30, 2022.

ETF Flows

Similar to mutual funds, ETFs have also seen a rapid increase in Canadian Money Market strategies over the previous three months. Upon further analysis, the combined mutual fund and ETF flows into the Canadian Money Market category were largely driven by HISA ETFs (as opposed to traditional money market mutual funds). As of September 30, 2022, the category's three-month flows were principally driven by **HISA** (\$1,047M), **CSAV** (\$1,039) and **PSA** (\$721M). Investors appear to be showing a greater interest in HISA strategies as a safe haven as the Bank of Canada continues to increase its policy interest rate.

Leading Categories for 3-Month ETF Flows vs. Comparable 3-Month Mutual Fund Flows

Category	ETFs (\$M)	Funds (\$M)
Canadian Money Market	3,425	963
Canadian Long Term Fixed Income	882	(116)
Canadian Short Term Fixed Income	512	(524)

Source: Morningstar, Raymond James Ltd.; Data as of September 30, 2022.

YTD ETF and Mutual Fund Flows

Category	ETFs (\$M)	Funds (\$M)	Combined (\$M)
US Equity	6,570	1,811	8,382
Canadian Fixed Income	2,140	5,592	7,732
Canadian Money Market	5,265	2,465	7,730
Global Equity	1,728	3,902	5,630
Global Corporate Fixed Income	1,587	1,953	3,541
Global Equity Balanced	960	1,488	2,449
Canadian Dividend & Income Equity	1,289	1,093	2,382
Financial Services Equity	1,573	180	1,753
Energy Equity	1,018	640	1,657
Canadian Long Term Fixed Income	1,232	(63)	1,169
Canadian Neutral Balanced	112	735	846
Canadian Corporate Fixed Income	(115)	764	649
International Equity	884	(244)	640
Canadian Equity	2,580	(1,985)	594
North American Equity	61	500	560
European Equity	176	207	383
Global Infrastructure Equity	175	66	241
US Money Market	507	(346)	161
Greater China Equity	43	(34)	09
Asia Pacific Equity	(06)	(19)	(25)
Global Small/Mid Cap Equity	215	(417)	(201)
Precious Metals Equity	(79)	(138)	(217)
Floating Rate Loans	(396)	160	(237)
Emerging Markets Equity	(218)	(62)	(280)
Natural Resources Equity	(476)	179	(297)
High Yield Fixed Income	(171)	(152)	(323)
Real Estate Equity	(268)	(58)	(326)
Canadian Equity Balanced	189	(723)	(534)
Canadian Small/Mid Cap Equity	(30)	(529)	(559)
US Small/Mid Cap Equity	(461)	(606)	(1,067)
Preferred Share Fixed Income	(1,140)	(247)	(1,387)
Emerging Markets Fixed Income	(236)	(1,355)	(1,591)
Global Neutral Balanced	326	(2,092)	(1,766)
Canadian Short Term Fixed Income	346	(2,354)	(2,008)
Global Fixed Income	(454)	(1,768)	(2,223)
Global Fixed Income Balanced	38	(2,491)	(2,453)
Canadian Fixed Income Balanced	(44)	(6,967)	(7,011)

Source: Morningstar, Raymond James Ltd.; Data as of September 30, 2022.

By reviewing mutual fund and ETF flows, we note that they do not net out equally. The assets redeemed from mutual funds and ETFs could have moved into alternative strategies or GICs or could have been used to help pay down debt. Lastly, portfolio rebalancing and early tax-loss harvesting may be other reasons for recent category outflows.

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

Plaza Hotel Reunion? Don't Count on It!

September saw the Bloomberg Dollar Spot Index hit its highest level on record after rallying nearly 16 per cent year to date at the time, thanks in large part to the most aggressive trajectory of interest rate hikes by the Federal Reserve (Fed) since the 1980s. With the combination of relentless inflationary pressures, a lethargic global growth outlook and aggressive action taken by the Fed, it is not surprising to see why the greenback has become the market's most triumphant winner. The eye-watering run-up in the U.S. dollar has led many to pause and reflect back to the early 1980s when the Fed took similar aggressive monetary policy actions in order to address rampant inflationary pressures, with the resulting effect also being a considerably stronger greenback.

A Trip Down Memory Lane

During the 1980s, the United States found itself in a tough position. An aggressive Fed, coupled with expansionary fiscal policy, sent yields soaring, which naturally led to the U.S. dollar appreciating unencumbered against its major peers at the time, namely the British pound, French franc, Deutsche mark and the Japanese yen. At the time, a strong dollar did align with President Ronald Reagan's administration to combat heightened inflation. However, the United States' trade deficit began to balloon as American exporters were faced with increasing competition from abroad. Japan, on the other hand, was running a sizeable trade surplus, courtesy of a weaker Japanese yen, which made their exports far more competitive on the global stage. It became increasingly evident that a devaluation of the greenback was desperately needed in order to restore balance to international trade dynamics and reduce the United States' trade deficits. In September 1985, finance ministers and central bank governors of the United States, United Kingdom, France, West Germany and Japan met at the Plaza Hotel in New York City and proceeded to sign the famed Plaza Accord. The primary objective was to end the U.S. dollar's rally against its major peers by greenlighting direct intervention in foreign exchange markets, and it worked like a charm, with the DXY U.S. Dollar Index falling by nearly 50 per cent between 1985 and 1987. The slide in the greenback became so relentless that in February 1987, the gang decided to meet again, with the addition of Canada, this time in Paris and signed the Louvre Accord, which was aimed at stabilizing foreign exchange markets and halt the U.S. dollar's decline.

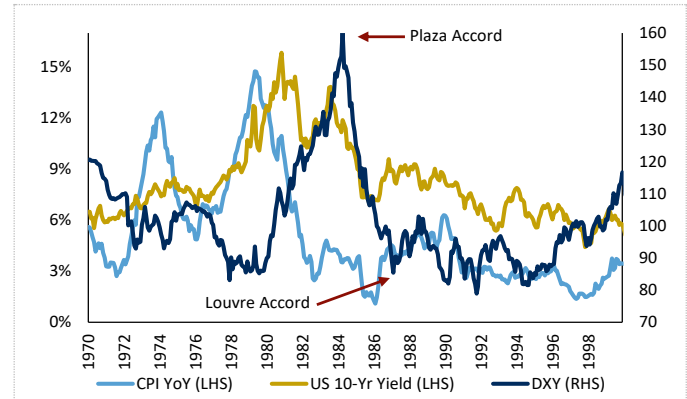
Fast Forward to Today

In a far more globalized world, a stronger U.S. dollar has wide-ranging implications. For example, U.S. multinational corporations have to deal with foreign currency translation headwinds, and emerging market countries with a heavy load of dollar-denominated debt have to face increased servicing

costs. The more problematic issue is when you have a country's currency weaken due to a strong dollar, the prices of imports—especially global commodities, which are denominated in U.S. dollars—rise and put upward pressure on prices (i.e., imported inflation).

It is not surprising to see the Plaza comparison this time around; a strong U.S. dollar has been wreaking havoc around the world. So is it possible that we get a Plaza Accord 2.0? We do not think the situation is nearly severe enough this time around to warrant a global coordinated effort to weaken the U.S. dollar. For one thing, the greenback is just not that strong relatively speaking. Prior to the signing of the Plaza Accord in 1985, the DXY U.S. Dollar Index was up nearly 100 per cent. More importantly, the particular circumstances surrounding the strength of the U.S. dollar are quite different this time around. Global terms of trade dynamics, the fight against inflation being a global macro issue, foreign policies like China's "zero-COVID" mandate and yield curve control in Japan, elevated geopolitical risks and a cloudy global economic growth outlook as well as the varying paces of monetary tightening in the United States relative to other countries are some of the major factors that have contributed to the strength of the U.S. dollar.

Historical Lookback at the DXY U.S. Dollar Index



Source: FactSet, Raymond James Ltd.; Data as of October 27, 2022.

So what can countries do to curb the weakness of their respective currencies? Japan, China, South Korea, the Philippines, India and Chile have all tapped their foreign reserve chests and ramped up interventions into foreign exchange markets to help defend their respective currencies against a surging U.S. dollar. We expect such unilateral interventions to continue for the time being.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Call Me Maybe

In their simplest form, bonds are pretty straightforward. Security holders receive a series of fixed coupon payouts at regular intervals, and then on the known maturity date, the bondholder's principal is returned along with the final coupon. However over time, the fixed income space has had the opportunity to mature and develop, resulting in a variety of optionality and features available on bonds today. Although debt products have become more intricate, we believe investors should not immediately shy away from purchasing corporate bonds with some embedded features such as call provisions. Instead, we hope to provide some information to better educate investors on what a call provision is and discuss their likelihood of affecting you in today's environment.

A callable bond includes an embedded feature that gives the issuer the right to buy back, or call, an outstanding bond prior to maturity. If a bond includes a call provision, the terms would be described in detail within the prospectus of the bond.

If the option is held by the company (the issuer), as it is for callable bonds, the bondholder is almost always provided an incentive as compensation, such as a higher coupon throughout the life of the security or higher payment in the case of the bond being called early. In today's market, a lot of corporate bonds include both a Canada call and a par call three months before the maturity date, so we will focus on those types here.

- **Canada call:** A Canada call allows the issuer to call a bond early at a price calculated using Government of Canada (GoC) bonds. The yield on an equivalent GoC bond (one with the same maturity) is increased by a spread, and this augmented yield is converted to the Canada call price. On the revised maturity date, the bondholder would receive this calculated price or par, whichever is higher. However, since calling a bond through a Canada call is not advantageous for the issuer, they are not used often.
- **Three month par call:** Another feature we see on corporate bonds is an ability to mature a bond at par three months before the original maturity date. This gives the issuer more flexibility on the timing of refinancing (three month window vs. a given day). The company could line up the issue date of the new bond so that it coincides with the maturity of the existing debt rather than having them both outstanding or having to accept the rates available when the company absolutely needs the capital. Three month par calls are exercised more often than

Canada calls, but they are dependent on the company and time in the economic and/or interest rate cycle.

Call features exist on other bonds, such as step-up bonds. These structured bonds are often callable every six months after a certain non-callable term (usually one year), with their coupon increasing periodically, generally annually, if it is extended.

The Interest Rate Environment

Bonds are more likely to be called in a falling interest rate environment, where companies can refinance the debt at a lower cost by providing bond purchasers a lower coupon. Replacing a higher yielding bond with a lower yielding one may make sense purely from a cost perspective, but companies must also consider the reputational risk. When an issuer brings a new security, they have to sell that bond into the market – the prospective buyers may in fact be the holders of the original bond, and if they are unhappy with the original bond being called away, they may choose to pass on the new bond. With a lack of purchasers, the bond new issue may not be successful, leading to potentially more challenges (or a higher yield) to raising capital in future attempts.

Given that today we are experiencing rising rates, issuers are less likely to call outstanding bonds, all things equal. However, unique or changing company needs could result in a bond being called early. Corporations may call bonds early if they are looking to retire debt (rather than refinance it) or if a company is taken over/experiencing a restructuring. Prior to maturing a bond, however, the company must advise bondholders with suitable notice prior to the revised maturity date (often 30 days before).

Although corporate issuers may not exercise their right to such options frequently, it is imperative that investors be aware that they could be included in securities that they purchase and that such a provision could impact the price of the bond over its life as well as its final maturity.

*Charlotte Jakubowicz, CMT
Vice President, Fixed Income and Currencies*

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https://raymondjames.bluematrix.com/sellside/Disclosures.action](https://raymondjames.bluematrix.com/sellside/Disclosures.action)

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