THE REAL ECONOMY

SPRING 2023

CANADA EDITION

ECONOMIC HEADWINDS GAIN STRENGTH

TIGHTER FINANCIAL CONDITIONS THREATEN GROWTH

IS A RECESSION ON THE HORIZON?

QUESTIONS AND ANSWERS: HOW THE MIDDLE MARKET IS REPORTING ON ESG

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QUESTIONS AND ANSWERS: THE STATE OF PRIVATE EQUITY

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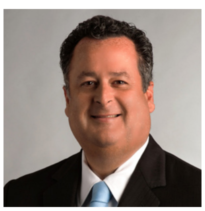

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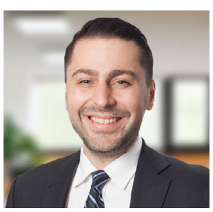

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TIGHTER FINANCIAL CONDITIONS THREATEN CANADA'S GROWTH

BY JOSEPH BRUSUELAS

After two years of whipsaw change, Canada's financial and commodity markets have entered a period of relative calm in recent months.

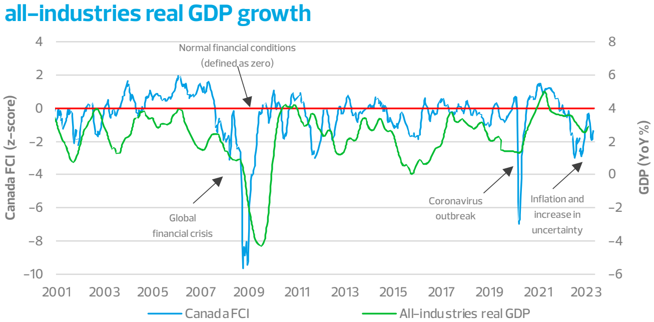
Volatility in the stock market has eased, oil prices have declined and the cost of raw materials has largely held steady. Even the elevated volatility in the bond market has begun to calm.

But lending conditions remain in restrictive territory, despite recent gains. It's a reflection of the uncertainty over a slowing economy and elevated inflation, particularly among Canada's trading partners, as well as other geopolitical tensions.

As a result, our proprietary RSM Canada Financial Conditions Index remains at 1.4 standard deviations below normal, indicating that greater risk than normal is being priced into financial assets.

This heightened risk shows up in the economy in the form of a greater reluctance to borrow or to lend, which ultimately leads to reduced economic activity.

RSM Canada Financial Conditions Index and Canada all-industries real GDP growth



Source: StatCan; Bloomberg; RSM Canada

Economists are now expecting Canadian gross fixed investment to decline by 2.7 per cent this year and for real gross domestic product to grow by less than 1 per cent.

The drop in investment can be attributed to the increase in the cost of capital and operating expenses brought about by higher interest rates around the globe.

Higher interest rates in both Canada and the United States have pushed 10-year government bond yields above the trading range (1 per cent to 2.5 per cent) of the low-inflation era.

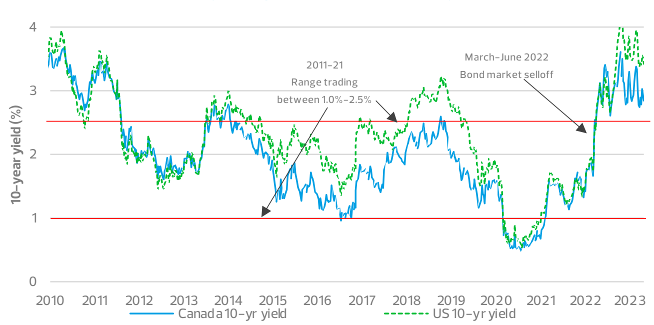
Although Canada's inflation rate dropped from 8.1 per cent last June to 4.1 per cent in March, it is not yet at the Bank of Canada's target range of 1 per cent to 3 per cent.

But with the labour market still tight and wages continuing to increase at a robust 4 per cent to 5 per cent annual rate, that target will remain elusive.

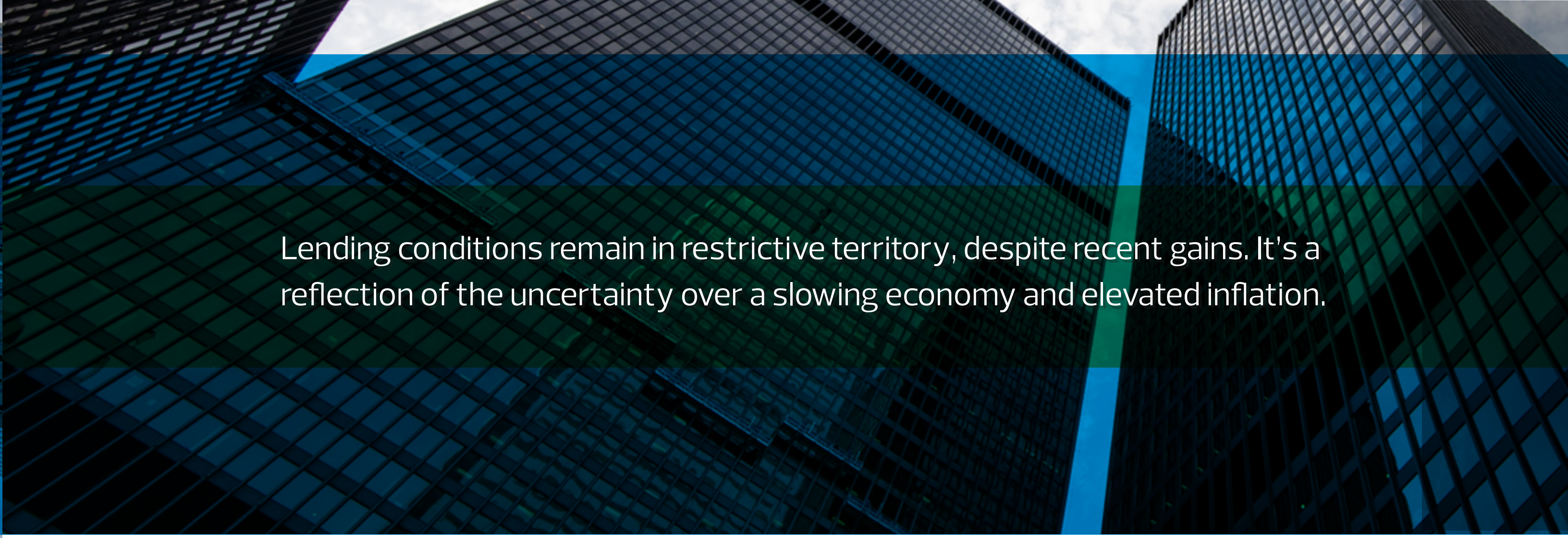
Although the Bank of Canada has left open the possibility that it will raise its policy rate again if inflation proves persistent, the forward markets are pricing in rate cuts by the end of the year.

In the end, it is the bond market that continues to be the main driver of increased risk in the RSM Canada Financial Conditions Index.

Canada and U.S. 10-year government bond yields



Source: Bloomberg; RSM Canada



Monetary policy

The Bank of Canada has held its policy rate at 4.5 per cent since its last rate hike on Jan. 26. There has not been mention of a rate cut by the Bank of Canada, but rather the expected difficulty of reducing inflation from 3 per cent to the central bank's 2 per cent target.

Yet the forward market thinks otherwise, expecting two rate cuts this year, one in September and one at the end of the year. According to the central bank, this could be in reaction to the likelihood of an economic contraction or in a more benign assumption that supply and demand will regain their balance, allowing inflation to soften.

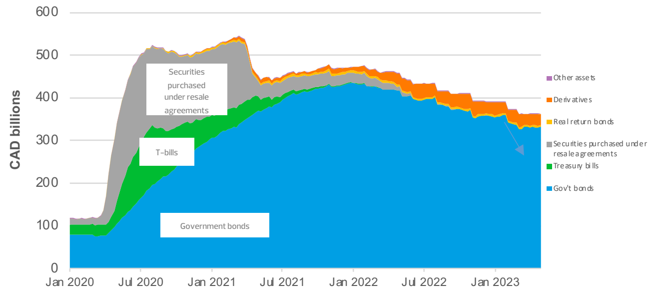
The other half of central bank policy is its quantitative easing program. During a crisis, the bank purchases government securities, flooding the market with liquidity and simultaneously pressuring interest rates lower.

At the peak of its holdings, the bank's balance sheet neared C$550 billion in assets, with outright holdings of government bonds reaching $430 billion by the end of 2021.

But the central bank has switched gears and is reducing its balance sheet. At its April 12 meeting, the central bank continued its current policy of normalizing the balance sheet by allowing maturing bonds to roll off. That is, those bonds are unlikely to have an effect on interest rates.

Bank of Canada holdings of assets

WEEKLY BALANCE SHEET BY TYPE OF SECURITY THROUGH APRIL



Source: StatCan; Bloomberg; RSM US

> The drop in fixed investment can be attributed to the increase in the cost of capital and operating expenses brought about by higher interest rates around the globe.

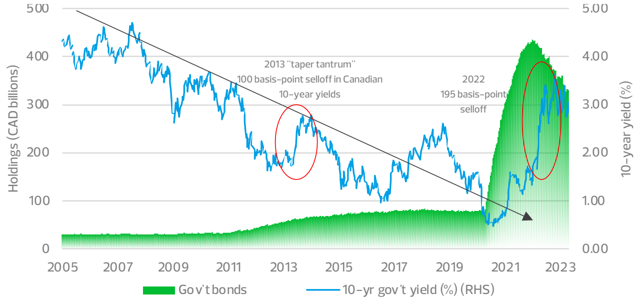
Quantitative tightening's impact

This policy, known as quantitative tightening, began in February 2022, in the weeks before the Bank of Canada started to raise its overnight policy rate. The yield on 10-year bonds rose from 1.9 per cent to 3.2 per cent in less than three months on the realization that inflation was anything but transitory.

By November 2022, 10-year yields were beginning a jagged path to as high as 3.6 per cent, only to fall to less than 3 per cent at the end of April 2023.

There were other factors at play, with the shock of inflation and the possibility of an economic downturn playing bigger roles than the maturing of securities in the determination of bond yields.

Bank of Canada holdings of government bonds and 10-year bond yields



Source: Federal Reserve; Bloomberg; RSM US

Lending conditions

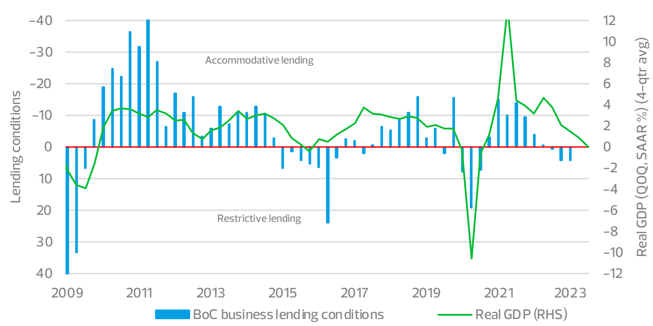
The Bank of Canada's quarterly survey of bank lending conditions offers another view of the transmission of monetary policy to the real economy through financial conditions.

As of the fourth quarter, overall bank lending had become restrictive in response to the increased cost of financing commercial and consumer loans.

The increase in the central bank's overnight interest rate quickly ended the era of minimal risk and cheap financing. Lenders suddenly had a lot more to lose and therefore increased their lending standards.

We expect this trend to continue for as long as the Bank of Canada maintains or raises its policy rate.

Canada lending conditions and real GDP growth by expenditure



Source: Bloomberg; RSM Canada

The Canadian dollar

The Canadian dollar remains a commodity currency, rising and falling with the value of its resources. Its peak in the spring of 2022 coincided with the dramatic shift in monetary policy and the tightening of financial conditions.

It is true that the increased value of the Canadian dollar and commodity prices in 2021 until March of last year coincided with the recovery from the health crisis and the increased demand for commodities, particularly energy.

MIDDLE MARKET INSIGHT

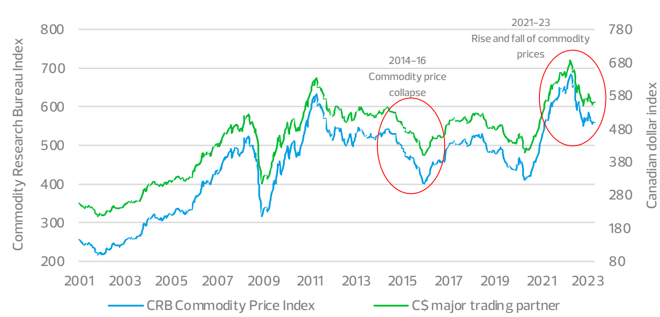
The increase in the central bank's overnight interest rate quickly ended the era of minimal risk and financing on the cheap.

But we would argue that there were other reasons for that increase, including the reduced supply of goods and a surge in shipping costs.

Eventually, shipping costs eased along with the pandemic and its recurring waves. And fears of energy shortages in Europe were averted by a mild winter and a comprehensive effort to find alternative sources.

Now, with commodity prices approaching a normal range and barring another crisis, we can assume that a slowdown in global growth will result in lower demand for raw materials and a moderated value of the Canadian dollar.

Commodity prices and Canadian dollar index



Source: Bloomberg; RSM US

IS A RECESSION ON THE HORIZON?

BY TUAN NGUYEN

As the Bank of Canada tries to tame inflation and simultaneously guide the economy to a soft landing, most market participants are skeptical that it can pull off this feat.

After months of steep interest rate increases, the impact of higher borrowing costs is only beginning to be felt in Canada's real economy.

A recession, albeit mild and brief, is most likely on the horizon. Our forecast puts the chance of a recession at 60 per cent this year , with the downturn hitting the economy unevenly.

We will not be able to determine if a recession has officially begun until the C.D. Howe Institute's Business Cycle Council—an arbiter of business cycle dates in Canada—announces its decision.

Keep in mind it took the council more than a year to officially announce the end of the most recent recession.

However, by replicating the criteria used to identify when a recession begins and ends, we can track the start and end dates much sooner. Here are the top indicators we can monitor, according to the council's past reports: GDP, job growth (from payroll and labour force surveys), and industrial sales.

The past two recessions featured sharp declines in the growth rates of all indicators. Following the same analysis, the Canadian economy has not been in a recession since the pandemic as industrial sales and jobs have remained solid, especially in the first quarter of this year.

But the economy has shown signs of a slowdown as steep interest rate hikes continue to put pressure on borrowing costs and, as a result, investment.

The U.S. economy and other Canadian trading partners will most likely experience some degree of downturn as well, adding more reasons to believe a recession is imminent.

We expect a mild and brief recession that will be spurred by restrictive monetary policies instead of by a problem with the structural foundation of the economy like what happened in 2008.

MIDDLE MARKET INSIGHT

The Canadian economy has shown signs of a slowdown as steep interest rate hikes continue to put pressure on borrowing costs and, as a result, investment.

The Bank of Canada would be in a tougher position compared to 2008 because it would most likely not be able to cut rates aggressively when inflation is expected to remain around 3 per cent by year's end.

But it would still be a much easier job compared to the one faced by the Federal Reserve, which is struggling with higher inflation and more rate hikes to go in the United States.

We still expect 40 per cent of the economy to achieve a soft landing and avoid a recession. The key factor will again depend on the labour market, which can either sink or lift the economy almost single-handedly.

The takeaway

The Canadian economy is preparing for a period when there are likely to be more job losses than gains.

Like almost all other central banks in the world after the pandemic, the Bank of Canada has faced the difficult task of trying to balance economic growth with price stability. While we believe there will be some turbulence during the landing, the economic setbacks will most likely be tempered as the labour market shows residual strength.

> OUR FORECAST PUTS THE CHANCE OF A RECESSION AT 60 PER CENT BY THE MIDDLE OF THE YEAR.

QUESTIONS AND ANSWERS: HOW THE MIDDLE MARKET IS REPORTING ON ESG

WITH ALEX KOTSOPOULOS

Alex Kotsopoulos, a partner and leader of RSM Canada's environmental, social and governance (ESG) advisory practice, focuses on helping companies integrate sustainability factors into their strategy and operation. He recently answered questions about the evolution of reporting on ESG practices. What follows is a conversation that has been edited for brevity and clarity.

Q. Where do Canadian businesses stand when it comes to ESG reporting?

A. Canadian firms have embraced sustainability reporting in a significant way, across industries.

For example, several Canadian mining and energy companies, which can face some more acute ESG-related risks, were early adopters of integrating sustainability into their business models and reporting. Some have developed rather sophisticated approaches.

Canadian pension funds, which are some of the largest in the world, have also played an important role in proliferating sustainability reporting and integration throughout the economy and have actively integrated ESG into their investment mandates. As long-term investors, pension funds are of course highly incented to incorporate ESG and particularly climate risk considerations into their investment and risk management approach.

Q. Is anything holding back Canadian firms in this area?

A. Unlike the European Union, a mandate requiring broad-based ESG disclosures does not exist in Canada. However, large financial institutions are starting to align very closely with the Task Force on Climate-related Financial Disclosures (TCFD).

Canada, too, will be substantially affected by the Securities and Exchange Commission's expected climate disclosure rule, which aligns with the TCFD, given the number of cross-listed companies and degree of integration between the Canadian and U.S. economies.

Q. It seems likely that the International Sustainability Standards Board (ISSB) will become the global gatekeeper of non-financial reporting. Do you welcome this?

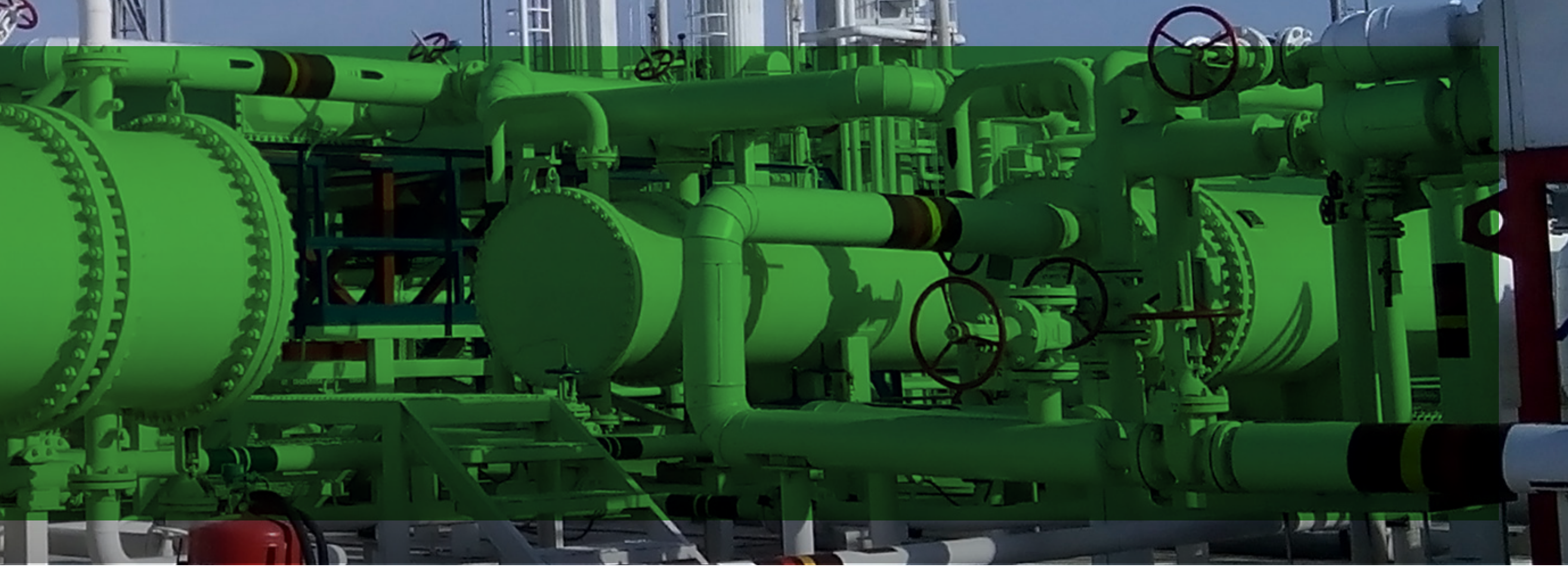
A. A common framework for non-financial reporting will ultimately help address criticisms of greenwashing—falsely promoting environmental soundness—and enable better comparability of ESG disclosures across companies.

However, I think it is important to note that despite incorporating a number of reporting frameworks into a common framework, the standards will be primarily focused on ESG-related risks in relation to enterprise value. In other words, the disclosure of ESG data will be focused on those topics which are viewed as affecting a company's financials. Some ESG ratings and scoring agencies have been criticized for focusing only on ESG risks relating to financial impacts.

I do not necessarily view the ISSB as a gatekeeper as its framework is expected to focus on—in some sense—a narrow definition of materiality.

Q. Are businesses prepared for non-financial reporting?

A. Larger companies have made significant progress regarding non-financial reporting and ESG integration. Middle market firms have also made great strides as noted in RSM's Milddle Market Business Index ESG Special Report. However, as the regulatory environment in Canada and the United States and non-financial reporting are integrated into a company's financial reporting, companies will need to increase the sophistication and controls around their sustainability disclosures. Indeed, we have found that even large companies are struggling to establish the right processes and controls around their ESG disclosures.



Q. How can middle market firms best prepare for non-financial regulations?

A. Companies must understand what is required from a regulatory perspective versus what stakeholders and investors are expecting in terms of ESG disclosures.

If a company has not yet initiated an ESG program, it should get started as soon as possible. In Canada and the United States, regulators are focused on climate disclosures aligned with the TCFD. Accordingly, middle market firms should focus initially on the TCFD, which includes developing a company's carbon inventory.

Q. How are middle market firms currently engaging in non-financial reporting?

A. Middle market firms are generally not prepared to fully adhere to the ISSB framework. Many, particularly smaller, middle market firms are still in the early stages of developing their ESG programs and reporting structures.

It is important to note that as sustainability reporting becomes more institutionalized, even private firms that are suppliers to larger public companies may be required to disclose various ESG-related data to their downstream customers.

Q. As we transition to net zero, how is the auditor's role changing?

A. Auditors will play a critical role in helping companies establish and assess progress against a company's net-zero goal. Investors and other stakeholders will increasingly look at how a company is tracking against its stated target. Auditors will need to understand, and I would suggest at a detailed level, the mechanics of carbon accounting and be comfortable assessing financial results in the context of a company's carbon inventory and other non-financial metrics.

Auditors in many respects will play an important role in protecting against greenwashing and maintaining the integrity of non-financial report standards.

Q. What advice do you have for middle market firms that are initiating or modernizing their ESG programs?

A. I would view ESG and sustainability as an opportunity and I think it is important not to lose sight of that. ESG provides middle market firms with an opportunity to engage with their stakeholders in ways that can generate shared value across their ecosystem thereby lowering business risk, increasing brand loyalty and boosting productivity.

Companies that do this well will be more resilient in the face of what appear to be some significant economic headwinds over the next year.

WHY THE U.S. DOLLAR WILL REMAIN THE RESERVE CURRENCY AND WHY THAT MATTERS TO CANADA

BY JOSEPH BRUSUELAS

Recent talk that China, India and Russia are settling purchases of oil in non-dollar denominations has generated speculation that the U.S. dollar's days as the world's reserve currency are ending.

This is nothing new. There were similar discussions during the financial crisis 15 years ago and, more recently, during the cryptocurrency bubble.

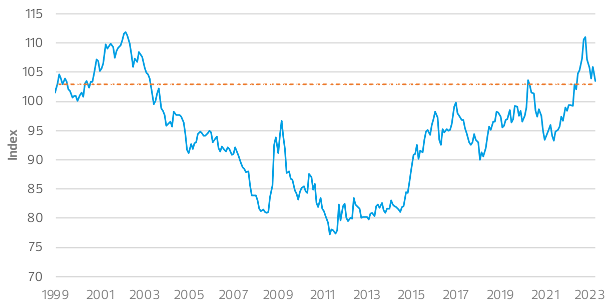
However, most current measures of dollar valuation suggest continued dollar strength.

Its strength is no small matter to the Canadian economy. Canada is the United States' biggest trading partner, shipping nearly all of its energy production, to cite just one industry, south of the border to be consumed, processed or exported.

A U.S. dollar that is the global reserve currency brings stability and predictability to these markets. Without it, Canada and its major industries would pay a premium to find a home for many of its exports.

We find discussion around the end of the dollar's dominance bereft of any linkage to the reality of international finance and understanding of the dollar's role in global economics.

Citi U.S. dollar real effective exchange rate index



Source: Citi; Bloomberg; RSM US

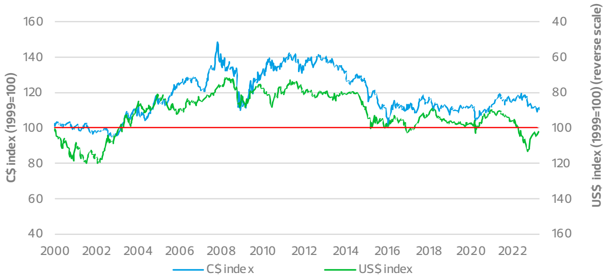
We can see this stability in the U.S. and Canadian trade-weighted currency indices.

Using 1999 as a base period, we show the reverse relationship between the intertwined trading partners. When the U.S. currency appreciates, the Canadian currency depreciates. But after the collapse of oil and commodity prices in 2014, the range of trading for both currencies narrowed as the economies coalesced, allowing monetary policies to move in sync. We expect this relationship to continue.

The biggest diversion between the currency indices since 2012—14 came last year when oil prices spiked and international investors reacted to the rapid response of the Federal Reserve to inflation.

Since then, both currencies appear to be moving back within their narrow trading ranges of the past nine years.

Canadian and U.S. dollar trade-weighted indices



Source: Bloomberg; RSM Canada

Using Citi's real effective exchange rate index, the American dollar in April was below its recent peak of 111.90 in October. Yet 103.81 is well above where it has been for most of the past 20 years. The index measures the value of the dollar, where 100 is neutral.

The dollar accounted for roughly 60 per cent of global currency reserves at the end of last year, down from its recent peak of just above 70 per cent in the first part of this century but well above the 50 per cent of 30 years ago.

We find the recent discussion around the end of the U.S. dollar's dominance bereft of any linkage to the reality of international finance and understanding of the dollar's role as the anchor of the rules-based order that governs global economics.

Rather, the recent conversation is stoked by global grievances about the relative disparity of economic power and the dead end that some economies find themselves in.

While these economies may desire an end to dollar dominance, they are experiencing major challenges on their own. Calling for an end to dollar preeminence is premature at best.

The global financial system rests upon the stability of the dollar and the large trade deficit of the United States.

In essence, the United States exports dollar stability to obtain goods and services at a cheaper price, and in doing so enhances the welfare of its citizens. In return, the major trading economies get to hold a currency that is sounder than their own—think of the Chinese yuan, also known as the renminbi, which relies upon the depth of global liquidity markets based on the dollar to maintain that country's currency regime. That reliance, in turn, reinforces the dollar's hegemony.

The rule of law, foreign direct investment and the dollar's support of the global economy's rules-based order all reinforce U.S. economic and financial power.

In short, the economies that run surpluses need that dollar-based demand from the United States to make up for their own weak consumption and high savings rates.

China, which accounts for 2.7 per cent of global reserves, is a case in point. For the yuan to become a true reserve currency, China would have to liberalize it. Such a loosening would result in a decline in the ability of the regulatory authority to control credit, and in relinquishment of control of its capital account and current account.

China would have to be willing to alter its economic framework so that its economy plays the same role as that of the United States. Given China's current political arrangements, that will not happen. And the dollar will remain dominant.

Moreover, the soft power of the United States is too often discounted. The rule of law, foreign direct investment—with the notable exception of China and Russia—and the dollar's support of the rules-based order all reinforce U.S. economic and financial power.

Global foreign exchange data

The vast majority of international trades, almost 90 per cent, are invoiced in U.S. dollars or euros, according to a recent analysis by the Federal Reserve Bank of New York.

That corresponds to the 80 per cent of total foreign exchange reserves allocated to the dollar and euro held by central banks at the end of last year. The dollar accounted for 60 per cent and the euro 20 per cent.

China, Russia, India and Saudi Arabia are not in any economic shape to support such a change in the rules-based order.

Despite the global economic growth over the past three decades, the current order is simply not going to change at the scale necessary to supplant the American dollar and the global order it supports.

Only three other economies have some of the qualities needed to support a reserve currency: the eurozone area, Japan and the United Kingdom.

But none of those have financial markets with the depth and liquidity to form the backbone of international finance and trade.

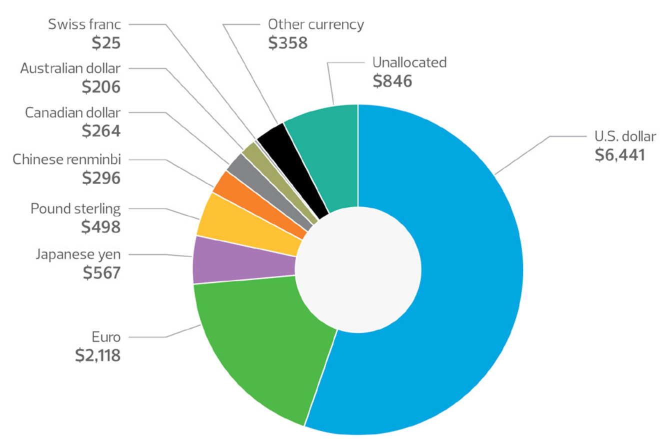
In the early 2000s, the percentage of dollar and euro reserves was as high as 90 per cent, with the gradual decline since then most likely occurring because of increased trade among smaller economies and, more important, their reduced reliance on the foreign issuance of debt.

The International Monetary Fund also notes that as stockpiles of foreign currency reserves grow, so does the case for portfolio diversification.

Currencies of smaller economies that have not traditionally figured prominently in reserve portfolios but offer high returns and stability— like the Australian and Canadian dollars, Swedish krona, and South Korean won—account for three-quarters of the shift from dollars.

Other IMF analysis notes that the dollar is the dominant reserve currency by default. The absence of an alternative to the safety of dollar-trade invoicing, international funding markets and the large supply of guaranteed Treasury bonds suggest that the dollar's role in the global economy is secure.

Currency composition of foreign exchange reserves
IN BILLIONS OF U.S. DOLLARS AS OF DECEMBER 2022



Source: International Monetary Fund; Bloomberg; RSM US

What determines a reserve currency

A reserve currency needs to be stable and safe, a store of value and a medium of exchange, and widely accepted and trusted.

This is according to an analysis by Vivek Joshi in India's Sunday Guardian, which notes additional societal and economic criteria for a global reserve currency, including:

- The stability of the political system of the issuing country
- The size and prospects of the economy
- Global integration of its markets and economy
- A transparent and open economic system
- A credible legal system
- The quality of its sovereign debt
- The ability to bear costs associated with a reserve currency
- The size, depth and liquidity of financial markets

There is good reason for the shared dominance of the dollar and the euro, and, to a lesser extent, the Japanese yen and the British pound.

They represent the major economic centers of the world and operate within the rule of law.

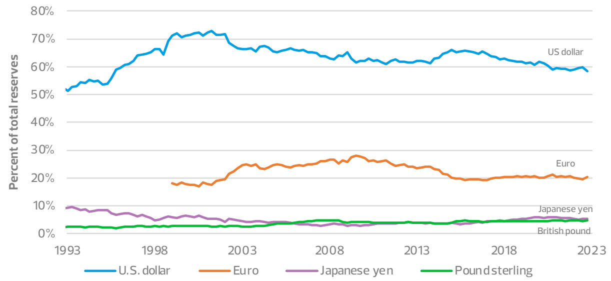
There are good reasons why other currencies do not yet qualify. They are either too small (Switzerland), operate under totalitarian regimes (Russia and China), or allow for protectionism (India).

Finally, a reserve currency needs to be market-based, free-floating and, most important, stable. That rules out cryptocurrencies, which are prone to wild swings and for the most part live outside the regulatory system.

There have been two major reserve currencies in modern times: the British pound until World War II, and the American dollar for the past 75 years.

The euro has gained status since its inception as a single currency in 1999, now bolstered by the increase in transaction demand for it by developing economies in Eastern Europe and Africa.

Foreign exchange reserves by currency as a percentage of total allocated reserves



Source: IMF; Bloomberg; RSM US

Stability of the dollar

The traditional U.S. dollar index is the weighted average of the exchange rates of six developed economies: the eurozone, Japan, the United Kingdom, Canada, Sweden and Switzerland.

The euro has a weight of 58 per cent in the dollar index and a correlation coefficient of 0.98 based on monthly values of the dollar index and the euro since 1980.

Since 1990, the dollar index and the euro have experienced three periods of trading within narrow ranges, interrupted by consequential events that have altered either the demand for U.S. assets or the mix of monetary and fiscal policies.

As we show, the pattern of range trading followed by a breakout of the exchange rates became apparent when advances in desktop computing created the technology boom in the 1990s.

A bust followed, along with a period of the dollar range trading at a lower level from 2005 to 2015 as the sluggish U.S. economic recovery trudged along.

Late 2015 was the next turning point, when the Federal Reserve began to normalize interest rates while the monetary authorities in Europe and Japan kept rates at or below zero.

That shift in monetary policy provided a dramatic boost to the dollar as it quickly moved to a higher trading range that lasted until March 2022.

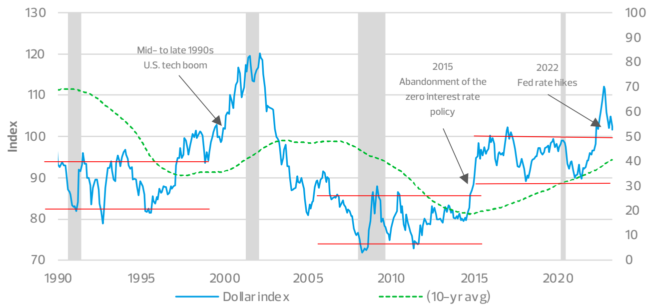
This most recent breakout was the result of the dramatic introduction of a dollar-friendly policy mix last year.

The American government was in the midst of the greatest fiscal response to an economic crisis since the Great Depression when the Federal Reserve rapidly hiked its policy rate. The dollar soared while the European Central Bank (ECB) had a lagging response to inflation and the Bank of Japan maintained its yield-curve control.

The mix of tightening monetary policy and expansive fiscal spending pushed U.S. interest rates higher . With interest rates still near zero in Japan and Europe, the dollar and dollar-denominated assets became that much more attractive.

Global investors looking for higher returns on investments in U.S. securities and business opportunities, augmented by the self-fulfilling higher currency return, flocked into dollar-denominated assets.

Breakouts from range-trading periods in the U.S. dollar index



Source: Bloomberg; RSM US

Where do we go from here?

The differences in monetary policy between the United States and Europe were unlikely to last forever, as evidenced by the dollar's peak most likely occurring last September and the euro now trading back within its 2015-22 range.

We can attribute the strengthening of the euro over the past seven months to the shrinking spread between the Fed's and ECB's policy rates as the ECB continues to respond to its 10 per cent inflation rate.

There is also the newfound ability of Europe to survive the winter with diminished supplies of energy and its efforts to expand NATO. All of this is buffered by the uncertainty surrounding the war in Ukraine.

We do not expect that an economic slowdown will drastically affect the relative policy mixes of the United States and its trading partners.

Instead, the most important factor in exchange rate stability has been the synchronization of economic growth and the coordination of monetary policy among developed nations. This is unlikely to change.

There are bound to be deviations in policy (e.g., Japan's likely end to yield-curve control) that will continue to affect individual currencies.

And there will be differences in the transaction demand for currencies, with the currencies of economies dependent on resource extraction (see Canada and Australia) more affected by trends in economic growth and in particular by the price of energy (see Japan again).

Still, we need to recognize that previous large shifts in the dollar's value were attributable to innovation breakthroughs, financial busts or consequential changes that have affected the demand for U.S. assets.

Since 2015, the range of dollar trading has been between $1.05 and $1.20 against the euro, with a $1.12 center of gravity.

MIDDLE MARKET INSIGHT

Rising interest rates in the United States, and near-zero rates elsewhere, made the dollar and dollar-denominated assets that much more attractive.

By any measure, the dollar at $1.10 is within range of its longer-term average value. Its movements beyond that range will depend on inflation, economic growth and monetary policy, all relative to what happens in the rest of the world.

Whether it breaks out below or above its recent range will depend on the next round of innovation or the next crisis.

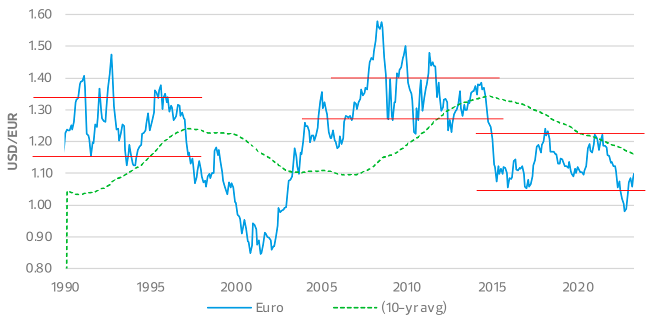
The next crisis could occur as early as June. The [debt ceiling debate] will devolve into an existential crisis only if Congress allows the United States to default on its debts this summer.

There are no viable or readily available alternatives to the U.S. dollar being the world's reserve currency. The result would be chaos in international trade and finance, with the cost borne by American businesses and consumers.

We also expect to hear calls for the abandonment of the regulation provided by central banks and the abandonment of traditional currencies in favour of cryptocurrencies.

Crypto advocates attribute crypto instability to growing pains and argue that, like traditional currencies, crypto fluctuates according to demand. But the demand for any currency is based on economic and societal factors underlying the currency and not purely on speculative behaviour.

Range-trading periods in the U.S. dollar/euro exchange rate



Source: Bloomberg; RSM US

Previous attempts to de-dollarize

The efforts of the United States, the European Union and Japan to use their prodigious financial and economic power to address the Russian invasion of Ukraine have rekindled the ideal of de-dollarization.

This is not exactly a new phenomenon. Latin American and Middle Eastern economies have attempted to exit the dollar-based system.

Since the 1970s, Latin American nations like Chile and Venezuela have tried to exit the dollar-based global financial order. Venezuela has for some time attempted to purchase oil in Chinese yuan.

During the past half-century, Iraq and Libya attempted to move away from the dollar through the euro and a pan-African solution.

And we should all remember the entreaties by Japan in the late 1980s for the United States to consider a broader role for the yen before the bursting of the Japanese financial bubble.

That request was politely rebuffed by the Reagan administration. And one should expect no different from the current and subsequent American governments.

While we recognize that the international economy has been altered by geopolitical tensions, shifting supply chains and the return of industrial policy, we just do not see a major alternative to the rules-based system supported by the American dollar.

In fact, the only thing that would really alter the current international status quo would be for the United States to default on its debt. But that is another story for another day.

QUESTIONS AND ANSWERS: THE STATE OF PRIVATE EQUITY

WITH DIANA DUNLOP

Diana Dunlop is a partner and the transaction advisory services leader for RSM Canada. She is also RSM Canada's private equity leader and has deep insight into the global private equity industry. She shared those insights in a recent conversation.

Q. How has the year started for the Canadian private equity industry?

A. We are coming off a sustained period of strength that began during the COVID-19 pandemic and continued during the recovery. It was very busy, with accelerated growth and a high level of deals during 2021 through 2022. But late last year, deal levels tapered off. While we still see a lot of growth because Canadian private equity funds continue to look for opportunities across the Canadian market and internationally, those deals aren't being reached as quickly or as frequently.

Q. How about the middle market in private equity?

A. The number of deals has tapered off compared to pre-pandemic numbers. With higher interest rates and the potential for a recession, we are seeing a bit of hesitation in the market right now. Deals are taking longer because of negotiations around the right valuation for both parties. Despite this, private equity funds are looking for opportunities and there is still a healthy amount of dry powder in the market.

Q. Are there areas of weakness?

A. With the risk of a recession and rising interest rates, a lot of technology, media and telecom (TMT) companies that relied on low-cost financing are very likely looking to be bought or wanting to transact for additional capital to focus on growth. It's a reflection of the economic times and the pressures they are feeling.

Q. What kind of pressures are these TMT companies feeling?

A. Capital funding has become more difficult with higher interest rates. So early-stage TMT companies, which relied on inexpensive financing to fuel their growth, have become more susceptible to a potential economic downturn. This has caused them to cut costs and extend their run rates for as long as possible. So while activity in TMT may be enhanced, it's not because of growth.

Q. Are there areas of strength?

A. Stable industries in which you will see deal flow and capital invested include infrastructure, industrials and manufacturing, all of which have had a relatively active start to 2023.

Q. What's different compared to a year ago?

A. The easy money is gone. Companies that relied on it are struggling in terms of transactions and financing. We're probably going to see a lot more pressure in the market.

Q. What do you see happening for the rest of the year?

A. While there is still healthy activity in Canadian private equity, some areas are going to be affected more than others. For example, retail and consumer goods could feel the effects of a downturn. But new, innovative industries like energy, renewables and those focused on sustainability are going to see new growth.

For more information on RSM, please visit **rsmcanada.com**.

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