



Quarterly Market Commentary

January 2023

Performance Returns YTD

TSX	-5.84%
DJIA	-8.78%
S&P 500	-18.11%
Nasdaq	-33.10%
Canada Bond Index	-10.55%
US Bond Index	-12.03%

Returns as of Dec 30, 2022 – Morningstar Research

2022 was a difficult year for both stock and bond markets. The accompanying table highlights the fact that no region or market was left unscathed. The combination of unrelenting inflation, the aggressive nature at which central bankers raised interest rates, and the war in Ukraine caused havoc for most investors. There was some relief if you invested in energy as it surged in 2022.

Looking ahead, what can we learn from this past year and how do we position going forward?

What we learned:

1. Central bankers don't always make the best decisions – Central bankers clearly made a mistake in 2021 by underestimating inflation. The question is whether they are making

a mistake today by raising rates as aggressively as they have, and if these actions will cause a severe recession? The participants in the bond market are pricing bonds so that rates on long term bonds are lower than short term bonds. Whenever long-term rates are lower than short-term rates, as they are now, a recession is very likely. What we don't know is how severe the recession will be. As of January 1, the stock market is trading at roughly 18 times estimated earnings. In past recessions, the equity markets have traded at 14-15 times earnings. The stock market is not priced for a recession. Given debt levels are so high, in my opinion, the longer the rates stay high the greater the impact on consumers and the more severe the recession. I also don't have confidence that the central banks can strike the delicate balance by raising rates just enough to bring down inflation and at the same time only cause a mild recession. Their focus is not only on inflation, but also wages and employment. Because we have so few workers relative to job

openings, the central banks may be focused on keeping rates higher for longer in an effort to impact businesses to have less demand for workers. A deep recession would bring about that change in behavior at companies.

How we position:

I still believe that 3-to-5-year bonds offer a good risk/return profile. Rates for these bonds range from 4-5% and I think earning that return will look very attractive if, in fact, we do have a severe recession. If long term rates were higher than they currently are, I would also add to longer term bonds.

2. World events matter – We might think that in North America we are shielded from events that happen around the world however, 2022 certainly taught us that's not the case. We are a global marketplace, and the price of goods is determined by the marginal buyer. When there are supply disruptions in any part of the world, it does eventually translate to higher prices and in effect also impacts our inflation numbers. As I have written about previously, we may be in a less cohesive world than we have been in the past.

How do we position?

I think we need to prepare for less globalization and therefore more volatility. We don't know how long and how severe the Ukraine crisis will be. Currently, it seems to have taken a back seat in the news cycle, but that can change. I believe this will impact how countries view energy and food security. Commodities may have to become a larger portion of portfolio. Supply chains are also being reevaluated. This could take years but could provide opportunities for industrial companies and those focused on automation. I think we also need to be leery of companies with a lot of Chinese exposure if things heat up between China and Taiwan.

3. Earnings and valuations matter – When interest rates are close to zero, there's no inflation and the central banks flood the market with liquidity. It's amazing how investors will look past the valuation of a company. Higher interest rates impact the borrowing rates for companies and therefore also their profits. Suddenly, debt matters. When inflation is low, investors are willing to invest in growth companies that may not have earnings today but will in the future. For example, if a company didn't have earnings today but would earn a \$1/share in 5 years, it matters less when inflation is close to zero. However, if inflation is 6%, that \$1 five years from now is worth a lot less. This might explain why the technology and growth heavy Nasdaq index suffered the steepest losses in 2022. As the central bankers continue to raise rates and at the same time remove liquidity in the markets, the overall financial conditions will become more difficult. Companies that must rely on debt and capital markets may have a difficult time raising money.

How do we position?

We want to focus on companies that have the ability to pay and grow their dividends. They must also have balance sheets that can withstand higher rates, meaning that they have very little debt, or the debt has been fixed at much lower rates. Overlapping that, is looking for industries or sectors that have a long-term positive profile. Healthcare, for example, fits into such a category. Companies that tend to pay a dividend, have reasonable balance sheets, and their product or service has long term demand are definitely companies that we want to allocate capital to. At the same time, I think we must tread carefully with discretionary consumer companies. Those companies may have a lot of difficulties in showing positive earnings growth in a recession.



These are unprecedented times. As stewards of your capital, we are mindful that although we have a plan on how to invest this year, we are prepared to pivot and change as underlying facts change and new issues emerge. As always, we continue to research and understand different viewpoints to ensure that we are not blinded by our own bias, and to ensure we are making decisions that appropriately reflect the global complexities that may impact our financial markets. We look forward to keeping you up to date on our thoughts and our positioning, either through written communication like this one, or through one-on-one meetings and conversations. As always, in the meantime, if you have any questions or concerns, please don't hesitate to contact us.

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