4th Quarter 2022 Commentary

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Schacter Palazzi | Wealth Management

TD Wealth

TD Wealth Private Investment Advice

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How to Sleep with One Eye Shut

If you are a fan of Greek Mythology, you may have heard of the watchman called Argus who, according to legend, had 100 eyes. As the story goes, he kept only some of his eyes closed while sleeping, while others remained open, in this way he was always watching.

This is how we feel as we look out on the investment horizon for the year ahead. Many factors which clouded the investment horizon of 2022 (for example, the war in Ukraine and the sanctions related to it, the ongoing politics around and the restrictions in China) continue to be present as we head into 2023. It is a difficult environment to sleep with one's eyes fully closed!

Through the year-end we received several interesting questions from our clients and while we certainly are not going to predict the outcome of this year so early, we have provided answers to your most popular questions this quarter.

Q: Can you tell us if we are in a bear market and how long does this usually last?

A: With the benefit of hindsight, we now know that we entered a bear market sometime in June of 2022. In a bear market, volatility becomes the new normal and we expect that to continue in 2023 with a possible return to more normal markets (lower volatility and a more positive bias) at some point this year. We suspect the start of the year to continue to be challenging as the Federal Reserve and Bank of Canada (and other central banks around the world) continue to raise interest rates and then hold them at an elevated level for a period of time to quell inflation. The bear market is unlikely to end until the central banks finish their interest rate hiking cycle, and the markets can assess what damage may have been done to the economy.

Having avoided discussion of the Presidential cycle for quite a while in these commentaries, I thought I might touch on it briefly using history as our guide. In general, this cycle suggests that Presidents tend to spend their first two years in office bringing in controversial or unpopular measures culminating at midterm elections that often coincide with equity market volatility and cycle lows. The third and fourth years of the presidency have historically seen a shift to more economically friendly policies in order to put the president in a more favourable light come election time.

This year, 2023, is of course the third year of the Biden presidency. In the table below I have not filled in year 3 or 4 under President Biden as they have not happened yet. There is no similar table with Canadian politics as our country is a much smaller size of world Gross Domestic Product and not quite as influential as the United States.

Presidential Cycle Shifts from Historically Weakest Year to Historically Strongest
Dow Jones Industrial Average Returns:

Presidential Year	Year 1	Year 2	Year 3	Year 4
All Cycles				
Average 1913-2000	3.53%	6.91%	21.88%	11.83%
Average 2001-2022	13.57%	0.61%	11.48%	-0.55%
First Term Only				
Average 1913-2000	5.86%	5.86%	24.37%	12.83%
Average 2001-2022	13.89%	-5.04%	17.73%	5.89%
President Trump	25.08%	-5.63%	22.34%	7.25%
President Biden	18.73%	-8.78%	TBD	TBD

Source: SIA Charts, 2023

Q: Will company dividends be at risk going forward if we are in a recession?

A: We believe that our current roster of companies, with what we feel are great management teams, will be able to maintain their dividends through a mild economic slowdown. We continue to think that consistent dividend growth at a company sends three important signals to investors: 1) the company's balance sheet is strong enough to pay a dividend; 2) management is mindful of shareholder returns, which include dividends; and 3) management believes that the company's near-term outlook is promising. We especially like companies that have grown their dividends at a double-digit pace over the past five years. Some of the companies that are currently in our portfolios that exhibit this kind of growth are: Home Depot (in our US Equity Model) and Magna (held in both our North American model and Canadian Dividend Model). While both these companies underperformed the S&P 500 and TSX respectively in 2022, we believe that this sets the stage for outperformance in the future as their businesses and more importantly cash flows have remained strong.

One thing that would concern us would be a prolonged recession. In that scenario, it is quite possible that companies would slow or pause the rate of dividend growth until such time as the economic outlook improved. Currently, that is not our base case in 2023.

Q: Just curious after a rough ending to the year, how does your team foresee the beginning of 2023?

A: After peaking January 3rd of 2022, the S&P 500 finished with a loss of some 20% for the full year. Since 1980, the S&P 500 has turned in a positive full calendar year performance close to 80% of the time. Given that track record and the historic returns seen in the presidential cycle year three that we noted above, we are biased to the positive for the full year of 2023. That said, we do anticipate a bit of tough sledding through the early months as we noted above.

Another factor that provides a positive bias to 2023 is that many of our investors and a great number of the financial market pundits are expecting very little in the way of good news this year. We see this as a potential contrary indicator. In the December 19th 2022 Argus Research Weekly Economic Commentary, Argus research analysts noted that the general market consensus are for weaker earnings and investment returns in 2023, which could set up the markets for a surprise to the upside.

Q: What can we expect from our bond portfolios this year?

A: There is no doubt that bond returns last year were not much better than stock market returns as rising inflation forced central banks in both Canada and the US to raise interest rates continually, driving down market values of bonds. Based on trends of long-term market interest rates, the signal the bond market seems to be giving is that central bank interest rate hikes are very nearly finished, something which should allow rates at the long end of the curve to drop, improving the returns from our fixed income portfolios in 2023. With Yields to Maturity in the 6%+ range across our fixed income portfolios as of December 31st, we believe investors will have a better experience in fixed income as we head into 2023.

The wild card in the mix for fixed income will be the readings for inflation, as both the Bank of Canada and US Federal Reserve (and central banks globally) have continued to push for a return of inflation to the target range of 2%. This may prove elusive at least in the very near term which could, in turn, hold back some appreciation in bond prices.

Q: Technology really was a weak part of our portfolio last year, will you be sticking with this area or look to add more Canadian content as the year progresses? (This question came from one of our investors that hold our North American Equity model). Can you comment on any other themes you see this year for us or other clients?

A: Technology, through the enablement of greater productivity, is a key driver of economic growth and so, we believe this sector will always have an allocation in our model portfolios despite the obvious weakness in 2022. Occasionally, technology finds new things that have no direct purpose other than fun initially, which over time finds applications never dreamed of by the inventors. An example of that would be virtual reality which seems to be all about games but has real life applications in healthcare and training. Other times technology is all about incremental improvements in production processes that enhance productivity. Either way, technology has become a main ingredient in business, government, and private life globally. While we are cognizant of the challenge that the sector poses for investment in the short-term, we believe it to be an important provider of growth in our portfolios. We don't see material changes to our technology weighting or companies this early in 2023.

Welcome to the Team!

We are pleased to announce the addition of Jessica Molinaro as our latest member to the Schacter Palazzi Wealth Management Team. Please feel free to introduce yourself if you are in our offices and I suspect many of you will get to know Jessica as time marches on.

As always thank you for your questions and feel free to reach out as always to all of us on the team.

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