2022 Fourth Quarter Review

A partial comeback for financial markets in November 2022 on optimism that inflation has peaked was a welcome reprieve from the challenges faced through most of the year. However, December was a reality check for investors as they digested the possibility that a **prolonged period of higher rates** to bring price growth back to the annual target rate of 2% could cause a **significant slowdown in economic activity**. This played “Scrooge” for anyone waiting on a Santa Claus rally in December.

In Canada, while stocks enjoyed a partial rebound in the fourth quarter of 2022, concern over rising debt servicing costs and a potential recession acted as a headwind for markets. Canadian stocks as measured by the S&P/TSX Composite Index returned 6.0% this quarter and -5.8% year to date, outperforming other major financial markets on a year-to-date basis. The Bank of Canada raised its key interest rate seven times in the last year, bringing it from 0.25% to 4.25%, its highest level since January 2008. Subsequently, **rising borrowing costs** have led to a significant decline in housing activity with mortgage rates increasing, contributing to a drop in real estate values. **Inflation peaked** at 8.1% in June and has been **gradually declining** since, largely due to falling energy prices, but food, shelter, and service-related costs remain stubbornly high.

US equities also benefited from a rebound in the year’s final quarter, but a full recovery was not in the cards, as **out-of-favour tech-related companies continued to weigh down the overall market**. The S&P 500 Index, a broad measure of the 500 largest US companies, returned 5.9% (CAD) this quarter and -12.4% (CAD) year to date. It is noteworthy that **value stocks outperformed** more interest-sensitive growth stocks by a meaningful margin this year. For instance, in US dollars, the less tech-heavy Dow Jones Industrial Average returned -8.8% versus -19.4% for the S&P 500. The US Federal Reserve (the Fed) raised interest rates seven times in the past year, pushing the overnight lending rate from a range of 0%-0.25% to 4.25%-4.50%, a 15-year high. Higher rates contributed to the material **appreciation of the US dollar**, creating additional challenges for countries that rely on imports and/or borrow in US currency.

International stocks were down 8.5% (CAD) as **overseas markets faced similar headwinds** to North America. Due to the Russia-Ukraine conflict, surrounding nations now need to import more energy and food and are doing so at high costs as currencies depreciate against the US dollar. Emerging market stocks declined 11.6% (CAD) as countries also struggled with inflation in addition to ongoing COVID-19 lockdowns and rising debt servicing costs, as many of them borrow in US dollars. China more recently abandoned its “zero-COVID” policy and is experiencing a surge in COVID-19 cases and a strain on its health system.

Typically when stocks fall, bonds tend to do well. This wasn’t the case in 2022, as **rising rates caused bond prices to tumble alongside equities**, resulting in a difficult year for balanced investors. Canadian and US government bond yields rose from 1%-2% at the beginning of the year to 3%-4%, whereas corporate issues and GICs began offering coupons of 5%. A basket of short-term Canadian bonds returned -4.1% in 2022. Fortunately, fixed income investors will likely be rewarded with higher yields going forward.

Following are the returns for major indices for the period ended December 31, 2022:

	Q4 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short-Term (FTSE 30-Day T-Bill)	0.9	1.7	1.7	0.8	1.1	0.9
Canadian Bonds (FTSE Short-Term Bond)	0.7	-4.1	-4.1	0.0	1.0	1.4
Canadian Stocks (S&P/TSX Composite)	6.0	-5.8	-5.8	7.5	6.9	7.7
US Stocks (S&P 500)	5.9	-12.4	-12.4	9.2	11.2	16.1
Non-North American Dev. Stocks (EAFE)	15.5	-8.5	-8.5	2.3	3.1	8.0
Emerging Markets Stocks (FTSE / MSCI Emerging)*	6.7	-11.6	-11.6	0.3	1.4	4.6

* Q4, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

As we begin 2023, the Fed, along with the majority of the developed world's central banks, continues its battle against persistent inflation caused by surging demand and supply imbalances from the pandemic, exacerbated by the ongoing conflict between Russia and Ukraine. It appears that both the Fed and Canada's central bank are nearing the top end of their tightening, but a great deal of **uncertainty lingers** as to how long rates will need to remain elevated. It is clear, though, that **squashing inflation is the priority for monetary policy**, with the well-being of the global economy taking a back seat. Therefore, recessionary conditions stoked by higher borrowing costs are likely to continue to weigh on both consumers and businesses in 2023.

Despite the related challenges, the high level of today's interest rates present two silver linings. The first is that unlike this time last year, should the economy slip into a significant recession with inflation also moderating, **central banks have room to drop interest rates** as a policy response the way they have successfully done in the past. The second relates to fixed income, where for the past 10 years returns have been very meagre, in the 1%-2% range. Now the conservative allocation of a portfolio has the **potential to earn a much more respectable yield**, with high-quality bonds currently paying 3%-4% depending on term and credit.

For equities, while past performance is not indicative of the future, it is still encouraging to remember that stocks rarely post two consecutive years of negative performance. Several forecasters have boosted their long-term return expectations for equities, as with prices falling, **current valuation multiples for the broad markets are much closer to their averages** than they were at the beginning of 2022. Going forward, markets will remain especially sensitive to data readings on inflation, labour, the general health of the economy, and central bank announcements/news conferences as they provide colour on where we stand in the interest rate cycle. Important to note is that because the stock market is forward looking, news that is even slightly favourable could spark a meaningful rally.

Investments that rocketed to unsustainable heights during the pandemic (e.g., growth-oriented stocks like tech, fringe assets like cryptocurrencies, meme stocks, residential real estate, collectibles, etc.) lost their shine last year and came crashing to the ground in many cases as interest rates climbed from historic lows and return expectations normalized. According to Bloomberg, US retail investors got caught up in this "hype" and their portfolios suffered, falling 30% on average in 2022, dramatically underperforming more traditional portfolios. We expect "boring" yet dependable and **conservative blue chip and value positions to continue to outpace**, as was the case in 2022, as investors shy away from riskier investment opportunities.

For Canadian stocks, the oligopolistic nature of several of our main industries is helpful in an inflationary environment. Companies here have little competition (e.g., grocers, telcos, and banks) and as a result have the ability to pass higher costs on to their customers. This could help alleviate pressures in other areas of their operations if business slows. In the US, the once-dominant tech-related component of the market is expected to continue to struggle as the aforementioned conservative stocks gain more investor interest. The results of the US midterm elections will likely lead to political gridlock, which has typically been good for markets historically. Overseas, international companies continue to deal with the headwinds related to the Russia-Ukraine conflict and higher import costs due to a very strong US dollar. Emerging markets are facing similar challenges along with the recent ripple effect of China exiting its "zero-COVID" policy.

Portfolio Strategy

Despite weakness in almost all asset classes this past year, we remain cautious in the near term given the ongoing uncertainty about inflation and the impact on interest rates. While most believe that we have seen the peak in inflation, uncertainty remains about how quickly inflation will return to the 2% central bank target. This has a direct impact on how much further rates will need to increase and also on how long they will need to stay at elevated levels. There are well-respected economists and strategists on both sides of this debate, highlighting the difficulty in forecasting. Differences of opinion always exist, but the **uncertainty of dealing with a significant increase in inflation** for the first time in forty years, with elevated debt levels, makes for a much wider range of possible outcomes.

In past cycles, central banks and governments have been able to step in to support the economy and equity markets with lower rates and other policies to stimulate demand during times of weakness, since inflation was not a factor. That is not the environment now, and as long as inflation remains at elevated levels, they will likely need to **keep interest rates higher for longer**, even if it means pushing the economy into a recession. While higher rates today give them room to lower rates, they also need to see meaningful declines in the level of inflation before this will be possible. Weak economic numbers in isolation will not necessarily mean lower interest rates. Inflation will be key.

In our portfolios, while it was a negative year for most asset classes, our **tilt to value stocks helped performance** on a relative basis. Many technology companies are considered growth companies and thus trade at much higher valuations, making them more vulnerable during periods of uncertainty and rising rates. Many of these companies were also huge beneficiaries of COVID-19 lockdowns and working from home, which has subsided as employees return to the office in varying degrees. Many of these stocks were down between 30% and 50% last year.

In equity portfolios, we continue to **focus on dividend stocks** in Canada, but we may be trimming more broad-based Canadian exposure where appropriate given the relative outperformance last year to maintain our policy of disciplined rebalancing. **International markets continue to have more attractive valuations** compared to US stocks, but there are also higher risk factors given the ongoing conflict in Ukraine and rising inflation due to higher energy costs, which may impact consumer and business spending.

In fixed income portfolios, we continue to **rebuild a five-year laddered maturity schedule**. Historically, this was achieved using individual bonds, but GICs now provide a higher return than high-quality bonds, so this remains our focus. We will always maintain some bond exposure to ensure adequate liquidity in portfolios. We may also be **extending term** where appropriate as a hedge against recession risk should central bank policies lead to a possible hard landing and a faster decline in inflation. This is not the consensus outlook now, but it does remain a possibility.

We always believe a disciplined, well-diversified portfolio is the best way to achieve long-term success. While we may miss initial upside in the “hot sector” of the day—whether it be cannabis stocks or, more recently, cryptocurrencies—avoiding these market segments has proved beneficial. Slow and steady wins the investment race, and that will likely continue in the future.