Quarterly Commentary

Year in Review

2022 Market Drivers and our 2023 Outlook

Over my 37-plus years of working in the financial services industry, I have not experienced a year such as 2022. There are myriad factors that both we and market commentators have pointed to to rationalize the various movements observed throughout the year; some being recent effects that follow from our journey through the pandemic, while others resulting from the cumulative effects of policies and market trends that have been in place for many years. There are many theories as to why the markets reacted the way they did, though this may be the topic of a much longer letter to come, once this economic cycle runs its course and we can pontificate—with the benefit of hindsight—about what primarily drove the volatility observed and prompted all major asset classes to experience such significant losses. In a broader sense, I suspect commentary around 2022 will unfold much like it did after the Great Financial Crisis of 2008-2009, when, well after the events, there were seemingly a multitude of pundits who accurately (in their opinion, and in hindsight) predicted the market crash. The truth is, with such a complex global system, we will never be able to definitively outline all the reasons why 2022 was such a tumultuous year for investing. We will, however, continue to analyze the trends and effects observed to help guide both current and future investment decisions.

To this end, we have laid out several of the key drivers that influenced markets this past year in the table below and have also provided some insight into our current outlook for these same factors in 2023. While many of these themes are not historically unique, the magnitude of their collective, negative influence across financial markets has certainly not been seen in such a coordinated manner since the 1970s.

Borger Griffiths
Wealth Management

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2022 Market Drivers	Our 2023 Outlook
Inflation – From transitory to entrenched	– Moving lower, but are we heading to 4% or 2%?
Interest Rates – Global Central Banks hike rates at a historically fast pace to levels not seen in over a decade	– Higher for longer
Economic Indicators – Good news is bad news and bad news is good news	– Once we move past Central Bank interest rate hikes, the focus will shift to economic growth and corporate earnings
Unemployment Rates – Where did all the workers go?	– We do not think they will be showing up in 2023 either
Increasing Geopolitical Risks – Russia's invasion violates Ukraine's sovereignty, destabilizes global trade balances, and drives Europe into an energy crisis – China increases territorial rhetoric and aggression towards Taiwan prompting Western nations to erect trade barriers	– The Russia-Ukraine conflict will not be resolved any time soon, and the impacts to global trade and security will continue well after – China will continue to drive their territorial agenda, though it is likely to be a conflict fought in the forum of words and trade for the time being
Deglobalization – Fallout from the pandemic and increasing geopolitical risks lead Western nations to refocus on security of supply and trade with friendly nations	– Historically we can surmise that globalization was positive for economic growth and improving standards of living; therefore, we suggest that deglobalization will have the opposite affect
China's COVID Zero Policy – Hard-line on lockdowns pummel the economy and eventually lead to political unrest	– As China loosens COVID lock downs, what will be the human and economic toll, both domestically and globally?
Commodities – Tighter oil and gas supply from lack of investment, combined with the Russia-Ukraine crisis and the politicization of supply to Europe, prompt a rapid escalation in price – Current and future supply concerns for metals, and worsening global trade relations, butt up against growth concerns to create highly volatile metal prices	– Oil and natural gas remain a key source of energy; lack of investment and trade barriers are likely to put a floor on prices – Base metals will be heavily influenced by future economic growth in China
Recession Fears – An inverted yield curve, inflation, higher interest rates, and lower growth outlook lead to increasing concern of recession	– This may be a late 2023 or early 2024 story
Volatility and Valuations – Equities and fixed-income valuations reset in response to higher interest rates, driving volatility as markets reprice in the face of a new monetary reality	– More pain on the horizon for high-risk, money-losing corporations – Yields to normalize, but at what levels? What effect will Quantitative Tightening have?

The hand off from 2022 to 2023 looks to be an extension of the same issues, but hopefully their impact will be more muted given the pounding financial markets experienced in 2022. Borger Griffiths Wealth Management's primary investment strategy during 2022 was mitigating risk and financial loss for our clients. Although portfolios still experienced some losses, for the most part, those losses were far from the turmoil evident in the returns of the major indexes. Given our expectation these factors will continue to influence markets over the next year (and longer), we have further expanded on some of these issues below and broadly outlined the investment strategy guiding our portfolio positioning at the current time.

Highlights

Inflation and Interest Rates

It appears that inflation may have peaked in the U.S. in June 2022 with a print of 9.1%, ebbing to 7.1% in November. This is still a high number but heading in the right direction. Currently, the bond market seems to be pricing in a US Federal Reserve (Fed) interest rate policy pivot sometime in mid-2023. Recent Fed policy minutes point to no relief until 2024, continuing their path towards a terminal interest rate of 5.25% (currently at 4.25-4.5%).

We anticipate both the 2-year and 10-year bond yields will move up over the next several months, albeit at a slower pace than short-term rates. This is partly driven by our view that the anticipated recession will be moderate and deferred until late 2023 or early 2024. At the time of writing, the U.S. 2-year treasury yield is 4.35% and the 10-year is at 3.68% (i.e. an inverted, negative-sloping yield curve). That represents a negative spread in yields of 0.67%. If 2-year yields move up in sympathy with the anticipated interest rate hikes in early 2023, and the 10-year yield does not follow, then the 2-to-10-year inversion level will increase significantly, implying market participants expect a substantial recession, or expect a material pivot in the Fed's interest rate policy.

Our view is that inflation is coming down, but will remain sticky at 4% or higher over the next year given the below factors:

- Strong employment and higher wage levels: In the U.S. there remains 1.7 job openings for every person looking for work—Where did all the workers go?
- Geopolitical unrest, reshoring of manufacturing to secure supply chains, labour shortages and wage growth will keep input costs elevated
- Costs of required capital will increase as companies focus on reducing the above inputs by spending on automation and other productivity enhancements

Good News, Bad News Story

Over my many years of managing money, strong employment, solid corporate earnings, and limited volatility were fundamentally positive for asset prices. Good news meant good news for equity markets. Over the past year, good economic news heightened inflation expectations, which in turn translated into higher interest rates, and prompted equity valuations to fall. Bad economic news had the exact opposite effect. Our view is, once we move past the market's laser focus on interest rate hikes stemming from rising inflation, positive economic news will once again be positive for equities, and company performance/earnings will re-emerge as a primary driver of equity performance.

Recession and Equity Valuations

The upcoming recession (assuming we have one) is the most anticipated recession I can remember. The only debate seems to be around when it will actually start, how deep will it be, and how long will it last. These are the three most important questions that no one has the answer to. In September, analysts were forecasting year-over-year growth in corporate earnings of 6.5% in 2023. That has since been ratcheted back to 2.2%. However, taking these forward earnings into account, the S&P500 index is still trading at a forward price-to-earnings (P/E) multiple that appears to be too high if we are truly entering a recession (current forward P/E of 17.3 at the time of writing, down from just under 23 a year ago). If a recession is looming, then we would certainly expect this multiple to contract.

Interest rates have been raised to fight inflation, however, the rate and level of their increase have also been the most significant factor in the equity market pullback. These policy changes have weighed most heavily on technology and consumer discretionary sectors. Although technology likely still has a long future in the sun, the eclipse of higher interest rates is expected to negatively impact these sectors for some time. We don't envision the glory days of 2020 and 2021 for high-risk assets (such as NFTs/meme-stocks/SPACs, etc.) to return any time soon (assuming liquidity continues to be drained from the system via Central Banks' quantitative tightening).

Valuations in the energy sector enjoyed a unique experience this past year. While the benchmark West Texas Intermediate oil price finished the year up only 6% in 2022, the Canadian energy sector rose 30%. Though this relative spread is likely to ebb and flow, it appears we have entered a new phase for energy valuations. This follows from the various factors outlined in the table above with respect to increased geopolitical risks and lower supply expectations stemming from a lack of investment in new production. The latter point has been exacerbated by investors rewarding energy companies (with higher stock prices) for returning excess profits to shareholders in the form of dividends and share buybacks. Further, since oil prices are forecast to move higher by most pundits in 2023, investors are more likely to hold onto energy shares in the face of falling prices, thus supporting the expanded multiples. One potential canary-in-the-coal-mine is a protracted slowdown in China's economy, which will no-doubt be tested as they emerge from strict COVID lockdowns and face the significant waves of higher infection levels that are likely to follow. Combined with the continued implosion of their embattled property developers—which account for almost a third of the country's economic output—and the outlook for the world's second-biggest economy is anything but certain.

Borger Griffiths Wealth Management 2023 Investment Strategy

After reading the above captioned, one might be inclined to sit in cash until the crystal ball becomes less clouded. Unfortunately, investing is about navigating through various storms that never truly go away, but rather evolve in shape, type, severity, or direction. Markets try to anticipate the future and valuations usually reflect these dynamics well in advance.

Although we remain very cautious in the near-term, opportunities continue to present themselves, and we act upon them when they do. When markets are bullish and moving higher, low-quality securities move higher in tandem. When markets are bearish, good companies get taken down with that sentiment. This is where opportunities exist for clients with long-term investment horizons.

Our Key Themes

Keeping in mind our clients' individual financial goals, time horizon and risk tolerance, our key themes are as follows:

- Invest in quality, dividend-paying companies with a bias to North America
- Access and invest with money managers that have proven, long-term track records for generating solid risk-adjusted returns
- Look to increase global exposure if/when valuations and economic outlooks support such investment
- Reduce allocations to growth sectors until such time as inflation and interest rates shift to a downward bias
- Continue to buy individual corporate bonds and GICs for lower-risk fixed income exposure – With interest rates at levels not seen in 10-plus years, there is now an alternative source of income that can be generated at a lower relative risk level than equities

Market Performance

With all major asset classes ending the year in negative territory, suffice to say we have not experienced a storm of this magnitude since the 1970s:

S&P 500	-18.11%
S&P/TSX Composite	-5.84
NASQAQ	-32.54%
Canada Investment Grade Bond Index	-12.47%
U.S. Investment Grade Bond Index	-18.83%

Source: Bloomberg Finance L.P. as of December 31, 2022.
Total returns including dividends and distributions in native currency.

Devon, Maddie, Alejandra, and I thank you for your business. We continue to look forward to working with you and helping your family navigate through the storms with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

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Source:
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