RICHARDSON Wealth

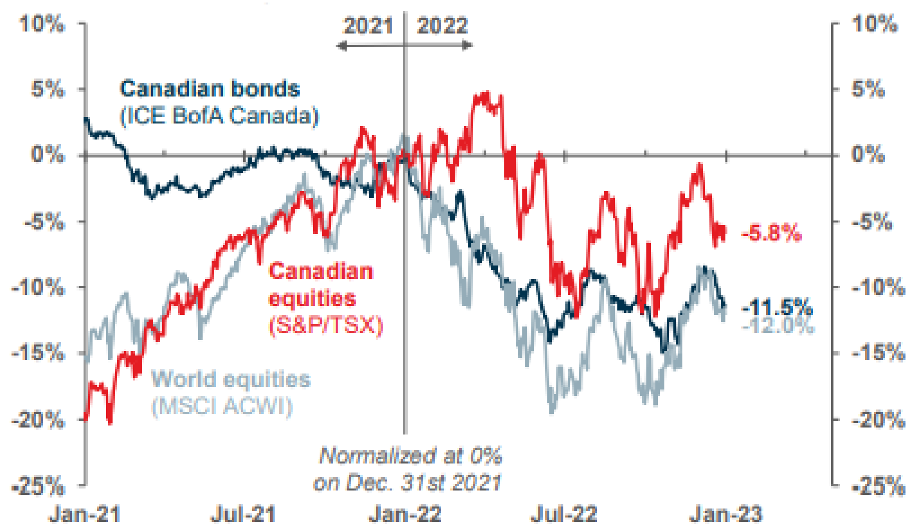
Mackie
Wealth Group

January 2023 market update

2022 in 12 charts and portfolio positioning for 2023

On the whole, 2022 was a tough year for investors. Both the bond and stock markets severely disappointed. This was the first time they have both suffered meaningful losses simultaneously since the late 1960s. US markets posted their largest annual decline since the Financial Crisis almost 15 years ago.

Equities and bonds total return in CAD:



Source: National Bank (data via Refinitiv)

Index	Q4	2022
S&P/TSX Comp TR	6.0%	-5.8%
S&P 500 TR	7.6%	-18.1%
NASDAQ Comp	-1.0%	-33.1%
Europe	14.3%	-11.7%
Japan	0.6%	-9.4%
China	2.1%	-15.1%
Canadian Bonds	0.1%	-11.7%
U.S. Bonds	1.87%	-13.0%

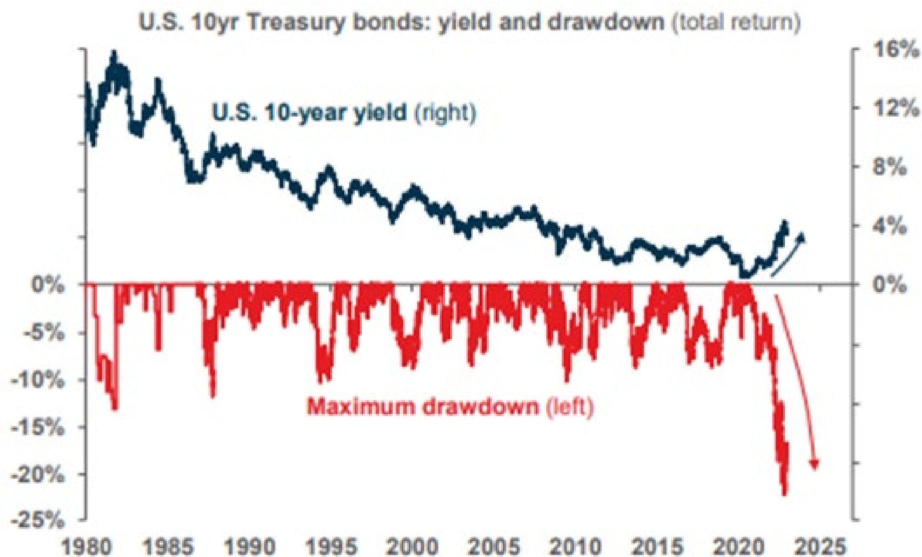
Source: Richardson Wealth (data via Bloomberg)

The biggest losing sectors of 2022 were the old stars of the pandemic years: communication services, technology, and consumer discretionary. These sectors include the largest US companies: Amazon, Netflix, Tesla, Disney, Apple, and Alphabet. These names are just a short sample of companies that dropped between 30% - 70% in value last year. Unprofitable technology or disruptor companies such as Beyond Meat, Doordash, Peloton, and the whole cryptocurrency sector, were even more volatile.

When interest rates go up, bond prices go down

Historically, bonds and stocks have an inverse relationship, and one asset class can protect investors when the other is falling in price. But in 2022, stocks dropped as central banks pulled liquidity from the financial system and aggressively raised interest rates. Less liquidity and higher borrowing costs trigger investors to sell risk assets and increase safety in their portfolios. But this year, there was no offset protection from bonds as quickly rising inflation and yields made older issued bonds with small coupons drop significantly in value. A typical balanced bond portfolio of 40% bonds and 60% equities was down a minimum of 10% at year end.

Interest rate hikes led to unprecedented losses for bonds:

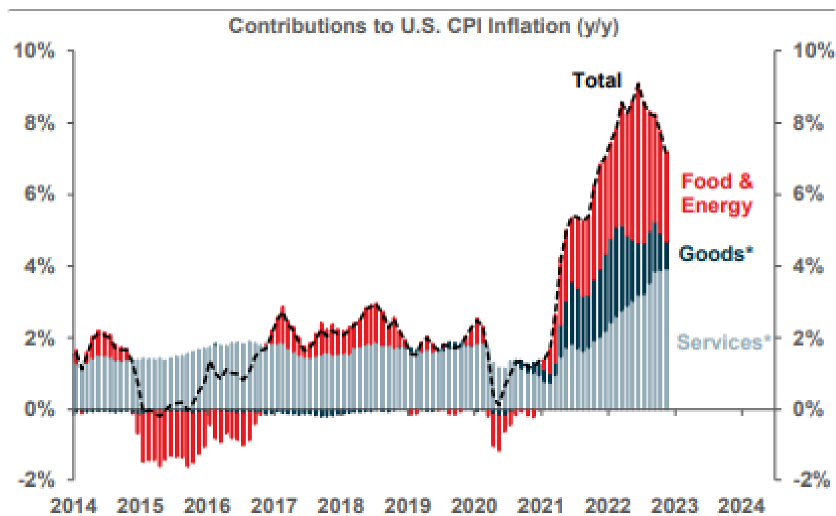


Source: National Bank (Data via Refinitiv)

Inflation was the big story of 2022

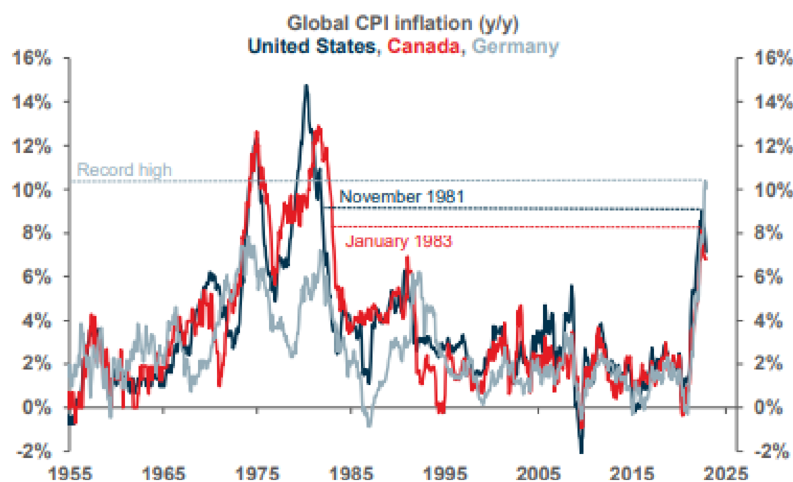
The wave of inflation was building through 2021, when major disruptions in global supply chains led to spiking of prices for certain goods. We also had the effect of near zero borrowing rates, which encouraged consumers to jump into real estate, among other asset classes, causing widespread appreciation in prices. Then, the invasion of Ukraine in early 2022 led to agriculture supply chain issues and food price spikes. Energy was also constrained due to sanctions on Russia, lower than expected OPEC production, and the outcome of 7 years of reduced drilling activity in North America – all while demand for oil was quickly returning to pre-covid levels.

A perfect inflationary storm:



Source: NBF CIO Office (Data via Refinitiv)

…Unparalleled in four decades:

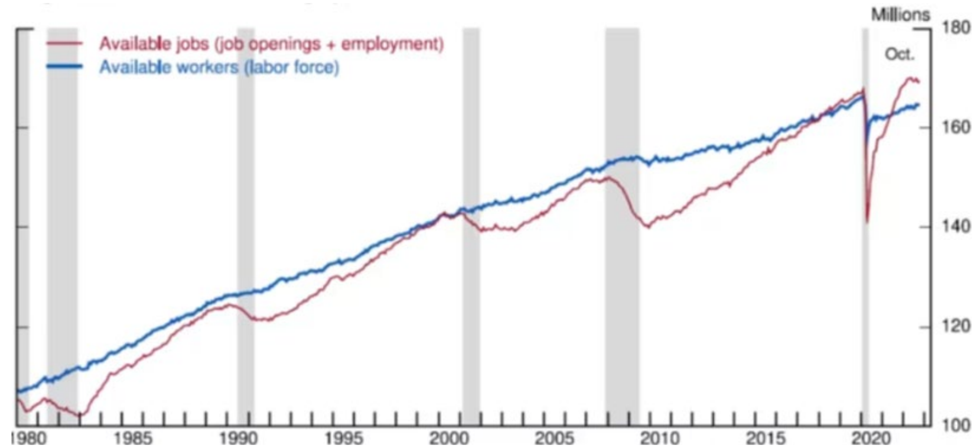


Source: NBF CIO Office (Data via Refinitiv)

Inflation seems to have peaked, except for wage inflation

The one exception to declining inflation remains wage growth, which is an area of concern for bankers. This is the major reason why hospitality services are so expensive. If you have stayed in a hotel or dined out recently, you may have noticed the cost to visit was 20% or more than pre-pandemic. However, the gap between job seekers and jobs available looks like it may be narrowing, as workers that left the workforce during covid start to come back, and some industries like technology, and parts of financial services, are starting to lay off staff they added during the pandemic.

Chart: Jobs-to-worker gap:

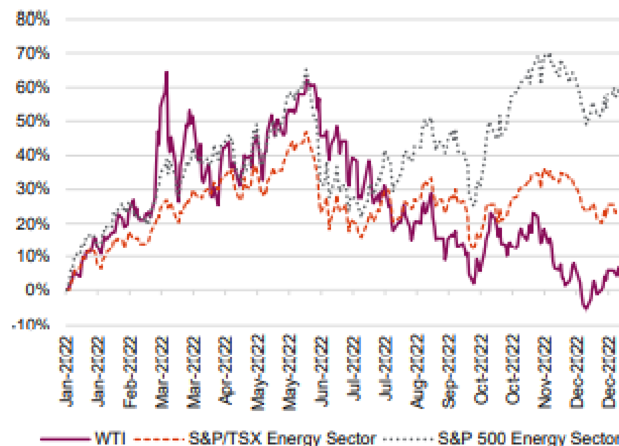


Source: Financial Times

Rising energy costs was the other big story

Energy prices were the next biggest story of 2022. If you were an investor, you were very pleased with the 25% return in 2022 on your oil and gas producer shares. Energy was actually one of the only sectors to have posted positive returns on the year (consumer staples was the other). However, while investors did well if they owned energy stocks, consumers faced a doubling to quadrupling (if you resided in the UK or parts of Europe) of the cost to fill up cars at the pump and on utility bills year over year.

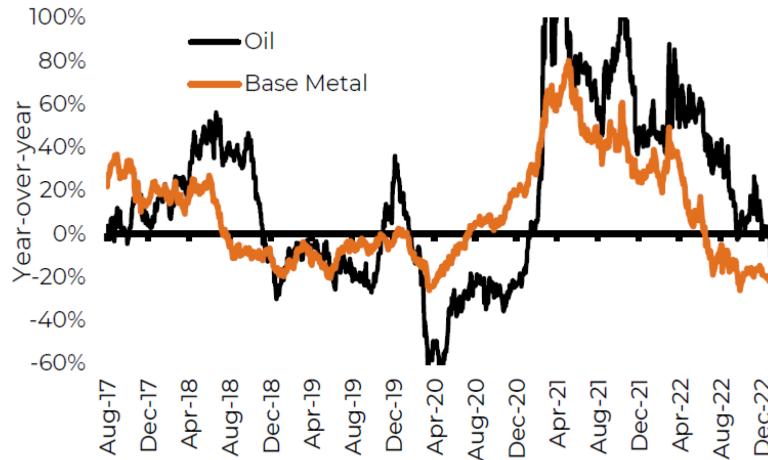
Round trip for oil price, but not the companies:



Source: Richardson Wealth (Data via Bloomberg)

With oil, gas, and metals' prices now well off their peaks of June 2022, there will be a positive downward effect on inflation through the economy in 2023. Lower oil and gas prices benefit agriculture, transportation and shipping costs, manufactured goods, and more.

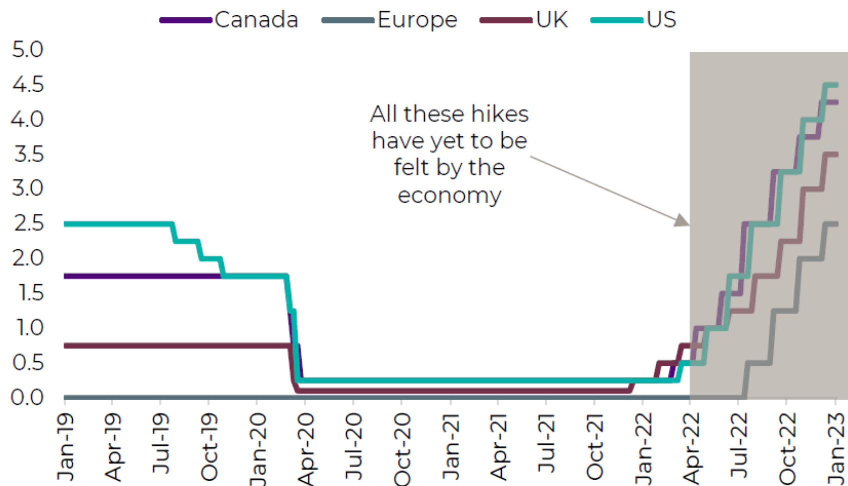
Commodity costs push the direction of inflation:



Source: Purpose Investments (Data via Bloomberg)

As inflation seems to be getting tamed, the new concern for investors is what the lasting impacts of this inflation spike will be, and what sustained higher interest rates will do to the economy. It seems, at best, a slowdown in growth is coming, and possibly a recession in 2023. The big increase in borrowing costs is starting to impact sectors like housing, while the pace of personal spending growth appears to be slowing as well. Central banks are broadcasting that they are watching for inflation to definitively drop to the target 2.5% rate before easing on interest rates or monetary policy, so we don't expect a near-term pause on interest rate hikes or cuts.

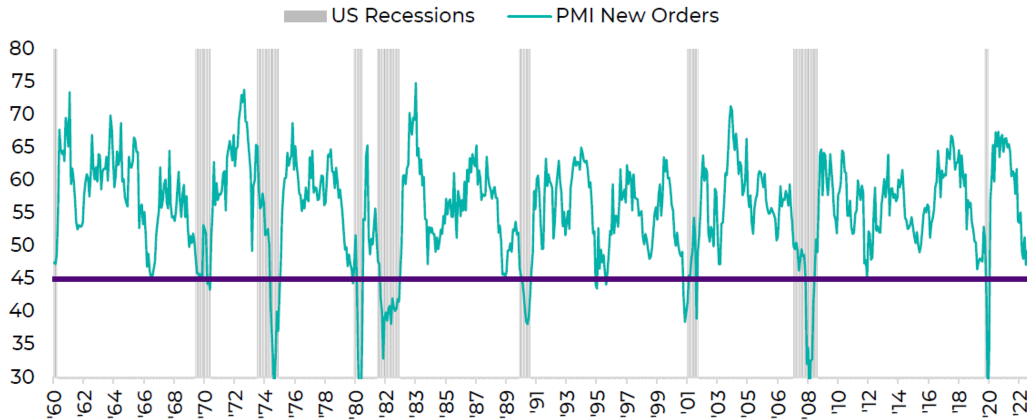
It takes about 9 months for changes in interest rates to hit the broader economy:



Source: Purpose Investments (Data via Bloomberg)

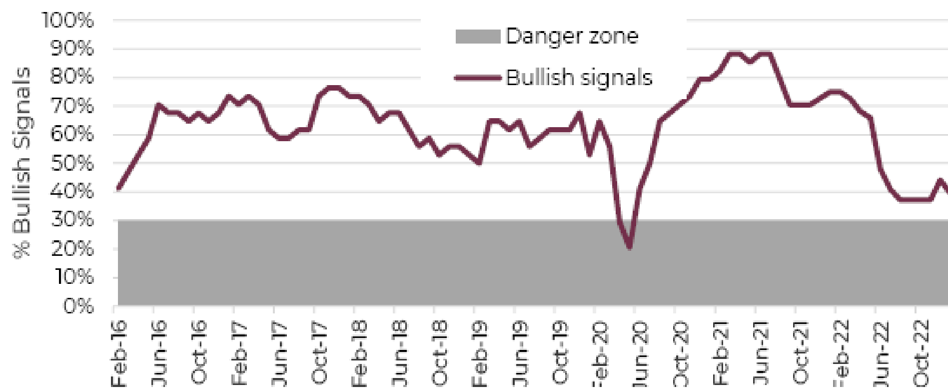
Leading indicators are starting to show stress: the PMI At 50 or below, indicates that confidence among manufacturers and their future plans to build inventories is fading.

It would be rare for PMI New orders to be this low without a recession nearby:



Source: Purpose Investments (Data via Bloomberg)

Market cycle indicators are holding steady but still near precarious levels:



Source: Richardson Wealth (Data via Bloomberg)

Portfolio themes for the start of 2023: Opportunity for returns with a defensive tilt

Central banks now face their next difficult task: when should they stop or reverse the cycle of rate hikes? Their goal is to conquer inflation, while also avoiding an unnecessarily painful recession. While a slowdown seems obvious, a recession and its severity is difficult to predict. A slowdown or mild recession seems to be the consensus at the moment.

In the interim, as economic and inflation data roll in over the coming months, we are investing for economic slowdown. We assume the leaders of growth in the last 10 years, i.e. technology, will not be the leaders for returns going forward, at least in the short-term. The extraordinary rates of growth they enjoyed during the pandemic and via the ability to borrow at near-zero interest rates to grow their businesses and acquire competitors, is over.

Yield is back

For the first time since the financial crisis, we can invest directly in corporate bonds and earn 4-5% on investment grade debt over the next 1-3 years. However, if the bond market predictions for rate cuts are correct, interest rates are peaking now so we won't be able to keep scaling up into higher yielding bonds as the year goes on. If a serious recession were to come, the guaranteed income from them will be very valuable, especially if inflation also recedes back to 2-3%.

For taxable investors, dividends should also be a part of the investment mix. Defensive sectors, like utilities, have strong yields. Specific companies in less defensive and cyclical sectors like banks and telecommunications, and now large E&P companies, are trading at attractive levels and in some cases with 5% to 6% dividend yields. The more tax-effective income from a dividend and the potential for capital gains makes exposure to high-quality stocks arguably better protection from inflation for investors. The Canadian TSX index is weighted to these types of opportunities.

Finally, stock valuations are much more reasonable than they were at the beginning of 2022. A lot of bad news has been priced into equities:

S&P 500 forward price/earnings ratio:

Source: Financial Times (Data via Bloomberg)

We look forward to catching up in the coming weeks on your personal portfolio and investment strategy.

We appreciate the opportunity to work with you in achieving your financial goals.

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