

Reset and Rewind

Equity Commentary

Developed Market (DM) equities moved higher to end the final three months of the year, as hints of moderating inflationary pressure provided the catalyst sparking a broad rally. Domestically, nine of 11 sectors gained ground to collectively spur a 6.0% rise in the S&P/TSX Composite Index. An additional contributor was a 7.9% rise in the price of gold bullion that triggered a strong rally in gold mining stocks, a large constituency that is rather unique to the Canadian market. Internationally, the S&P 500 Index also fared well, rising 7.6% in US dollar terms, again with nine of 11 sectors on the ascent, and led by cyclical groups such as the Materials and Industrials sectors. European and Asian markets, however, performed best of all, aided by the late-breaking decision by Chinese officials to remove longstanding COVID-19 lockdowns, a decision that could potentially remove supply chain bottlenecks and invigorate consumer demand in this critical nation for the global economy. In response, the MSCI EAFE Index rose 17.3% in US dollar terms in the fourth quarter, with all 11 sectors producing robust gains, and cyclical sectors like Consumer Discretionary and Financials notably strong.

Despite this late-year rally, DM equities closed 2022 deeply in the red, with the S&P/TSX Index falling 5.8% over the full 12-month stretch. International markets fared comparably worse, with the S&P 500 down 18.1% and the MSCI EAFE dropping 14.5% in US dollar terms over 2022 — weakness in the Canadian dollar, however, reduced these losses for Canadian investors to 12.2% and 8.2%, respectively. Moreover, the declines came as short-term interest rates rose rapidly to counter surging inflation, prompting a retracement of the gains made in recent years by high-growth companies, which were fueled, in part, by relatively inexpensive capital.

The current complexion of markets entering 2023 reflects a mixture of this high inflation, slowing commercial real estate and residential housing markets, and moderating consumer spending, offset by considerably lower stock market valuations. Equity market performance for the coming year will reflect the interplay between these factors, alongside the evolution of major international considerations, such as the Russian invasion of Ukraine and US relations with China.

Fixed Income Commentary

The final three months of 2022 offered little in terms of a reprieve for fixed income investors as market yields continued to grind higher against indications that global central banks were not yet ready to move to the sidelines despite increasing signs that inflationary pressures were subsiding. Indeed, the still uncomfortably high inflation rates drove further policy tightening by global central banks, with even Japan joining the trend by widening the range for its yield curve control program.

The concurrent shift in the outlook for central bank policy saw markets raise their expectations for the terminal rates for this hiking cycle while also raising expectations that central banks would likely hold rates at higher levels for longer. The result was a rise in yields for all bonds in a bear-flattening manner (the yield on the 2-year Government of Canada note rose 25 basis points in Q4 to finish 2022 at its highest level since July 2007; 10-year yields rose 12 basis points to their highest levels since March 2011) that saw the yield curve invert further (the spread between the 2-year and 10-year yields is its widest since 1990).

Importantly for investors, however, the higher yield on offer in the bond market provided some cushion against the further rise in interest rates in Q4. It kept performance (negligibly) above zero, with the benchmark FTSE Canada Universe Bond Index eking out a 0.1% gain in the quarter even as its yield rose to its highest level since 2008 — less rate-sensitive shorter-term bonds outperformed those with longer-maturities, while corporate credit turned in better performance in Q4 than government bond issues.

While the last two years have been historically bad for bond investors — this is the first time in the 43-year history of the FTSE Canada Universe Index that it has declined in consecutive calendar years and the 2022 drop was by far the largest on record — the outlook for the year ahead appears positive. Inflation appears to be on track to moderate further, and central banks are nearing the end of their hiking cycles, factors that should limit the upward pressure on rates in the months ahead. As well, growing concerns over the durability of the economic expansion, and uncertainty over the outlook in general, could provide support for bonds, especially those of high-quality issuers, that now offer higher income and a far more compelling risk/reward tradeoff than they have in recent history.

Commentary

A year ago, the outlook was positive. The anticipated move back to “normal”/pre-pandemic activity levels would underpin sustained economic growth rates above the past decade’s trends. While inflation was on the rise, it was still being viewed as “transitory”, a by-product of the onset of the pandemic that would be unwound as the broader reopening of the global economy continued. As a result, central banks, while acknowledging that crisis-era levels of policy stimulus were no longer warranted, were in no hurry to raise rates and would move only gradually once they did. Market yields remained near historical lows, with the persistently low costs of borrowing also providing support for the global economic cycle as it transitioned from “recovery” mode into “expansion.”

The anticipated macro backdrop would drive robust profit growth and give a fundamental lift to risk assets — and while valuations for these securities were elevated and represented a potential performance headwind, they were arguably justified by the low-rate environment, which not only raised the values of the output of discounted cash flow models but meant that there was no alternative for investors looking to generate any sort of return. Accordingly, investors were upbeat and willing to continue chasing momentum.

Of course, inflation quickly proved to be anything but transitory. The imbalance between strong demand and constrained supply was exacerbated by the persistence of supply chain pressures due to renewed public health restrictions early in the year (particularly those in China) and the shock to commodity prices brought about by Russia’s invasion of Ukraine. In response to shifting inflation expectations, monetary policymakers felt pressure to move quickly and aggressively to try to get ahead of the curve to prevent price pressures from spiraling ever-higher at significant, longer-run costs.

Suddenly, financial markets, which had largely been permitted to ignore inflation and interest rates over the last decade, were forced to recalibrate — first slowly, then all at once as the breadth and the magnitude of central banks’ responses to firm pricing readings expanded.

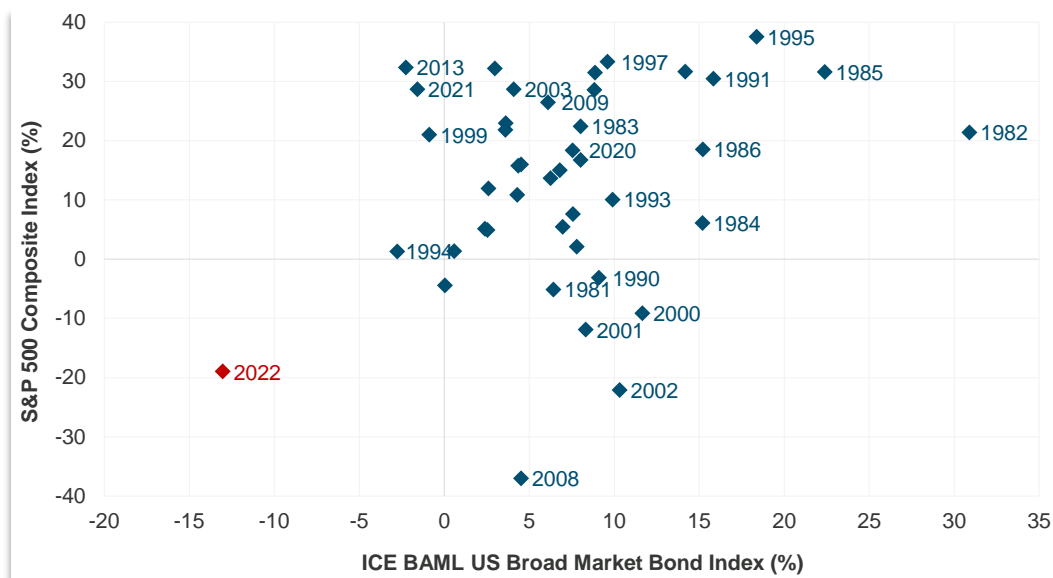
The sharp upward adjustment in rates devastated fixed income securities, as the complete lack of yield on offer meant there was no cushion to soften the blow to total return from the plunge in bond prices (bond prices and yields move inversely).

Equities were on the receiving end of a series of body blows. Just as low rates boosted valuations, higher rates drove multiple compression, particularly among the high-flying growth stocks. As well, central bank-driven tighter financial conditions and geopolitical shocks created clouds over the outlook and increased risks of an economic downturn — the resulting downgrade to economic forecasts weighed on earnings expectations and further eroded valuations, as did the surge in risk aversion that accompanied the increased economic uncertainty.

The end result was a historical outlier of a year — while equities have posted bigger calendar year declines, bonds have not and this is the first time in the last four decades that both have declined at the same time (let alone by similar magnitudes) meaning that there was no cover for balanced investors.

A historical outlier of a year

(calendar year total return; percent, US dollar basis)



Source: Guardian Capital based on data from Bloomberg from January 1980 to December 2022

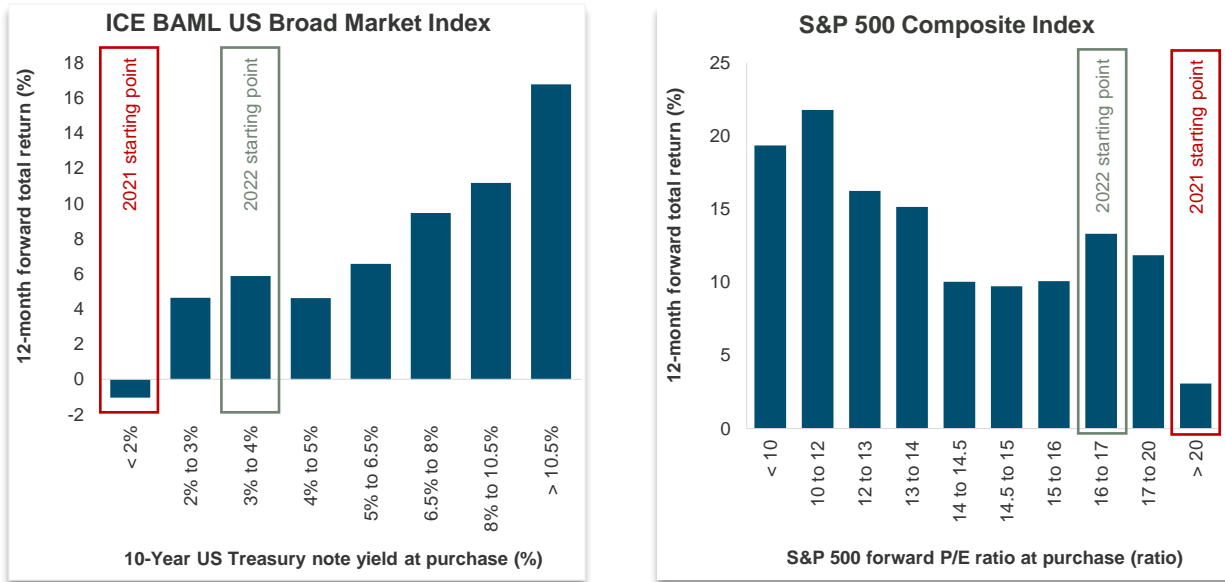
As the focus shifts to the year ahead, what stands out is that the backdrop is almost the polar opposite of what prevailed 12 months ago.

The current consensus is that a recession is all but a certainty in the next 12 months as the now restrictive monetary policy stance restrains demand and accumulated savings get drawn down. Combined with easing supply chain constraints, inflation is anticipated to continue its nascent moderating trend — but it is expected to remain elevated relative to pre-pandemic rates which will keep central banks from unwinding their policy tightening in any sort of earnest manner.

From a market perspective, this backdrop and 2022's hard reset across asset classes means that last year's optimism and expensive assets have been replaced by pervasive pessimism and more moderate asset values, which makes for a more constructive outlook for performance — there is nothing guaranteed when it comes to investing, but history shows that there is more upside to returns when valuations are off their extremes and at more middling levels.

A better value proposition

(average 12-month forward total return by 10-year yields or P/E ratio at purchase; percent)



Source: Guardian Capital based on data from Bloomberg from January 1980 to December 2022

That said, the persistence of risks and uncertainty surrounding the outlook suggests that the heightened volatility is likely to remain for the foreseeable future, and any improvement over the last 12 months dismal performance is unlikely to come in a straight line. Of course, there remains the real prospect of future declines as well. As such, it remains prudent for investors to be disciplined and maintain a long-term focus with respect to investment decisions, selectively adding to positions in high-quality investments rather than aggressively diving into risk in the hopes of unwinding last year’s declines. We welcome a renewed, and perhaps nostalgic, focus on profit, cash flow, and sustainability of companies for their stocks and their bonds. We suspect that the coming years will require a rewind to the metrics and analysis that rewarded successful investors in the past.

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