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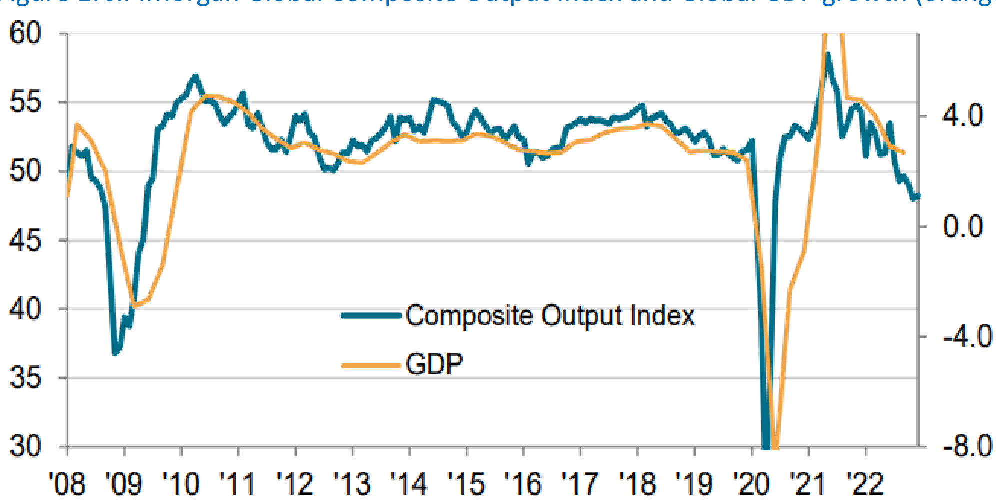
Fourth Quarter 2022 Investment Commentary

Equities bounced back in the fourth quarter of 2022 as the Canada, U.S. and EAFE indexes posted solid gains of 6%, 5.4% and 14.7% respectively (in Canadian dollars). Canadian bonds delivered a modest return of 0.4%. Fully invested client accounts lagged their benchmarks in Q4 but significantly outperformed for the full calendar year.

Economic Overview

Inflation remains elevated, financial conditions are restrictive (high interest rates), and pessimism is widespread. Global growth continued to slide in the fourth quarter against this challenging backdrop. Business activity is on a concerning downward trajectory evidenced by the deterioration among indicators relating to current output, new/future orders, export orders, and capital expenditures. That said, sentiment lifted late in the quarter owing to a handful of positive developments including declining inflation, a re-opening of China's economy, and so far, a better-than-feared winter in Europe (greater energy supply). On balance, however, it appears that growth will moderate further following the latest data tracking global output (Figure 1).

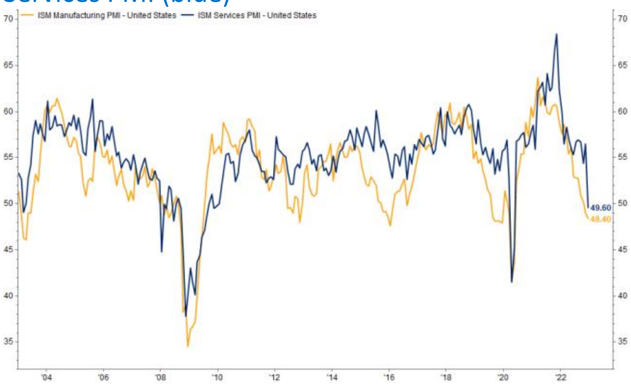
Figure 1: J.P.Morgan Global Composite Output Index and Global GDP growth (orange)



Source: J.P.Morgan, S&P Global

Surveys of business confidence in the United States reveal concerns as well (Figure 2). The ISM Purchasing Managers Indexes for both the manufacturing and services sectors are at levels that indicate negative growth (below 50).

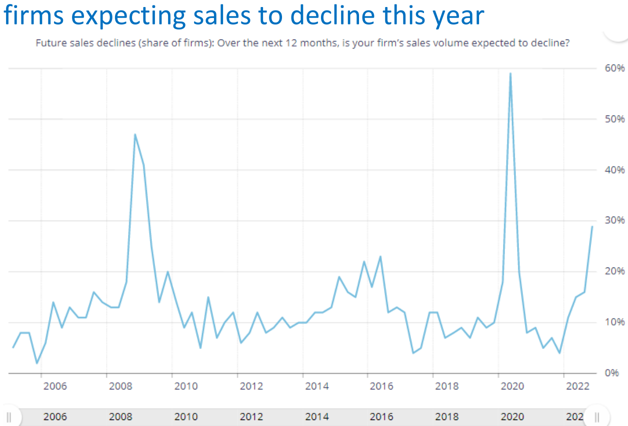
Figure 2: ISM Manufacturing PMI (orange) and ISM Services PMI (blue)



Source: FactSet

The story in Canada is similar. The Bank of Canada's most recent Business Outlook Survey (Q4 2022) revealed slower sales growth expectations among respondents (Figure 3). Rising interest rates and the corresponding impact on consumers' spending power was frequently mentioned.

Figure 3: BOC Business Outlook Survey - number of firms expecting sales to decline this year



Source: Bank of Canada

Households have absorbed higher prices and interest rates remarkably well over the past few quarters but that resilience could be wearing thin. The savings accumulated by individuals early in the pandemic served as a tremendous cushion for consumer spending – something we discussed frequently. That mountain of cash is dwindling and, according to JPMorgan's CEO Jamie Dimon, is estimated to be fully depleted by Q3 of this year.

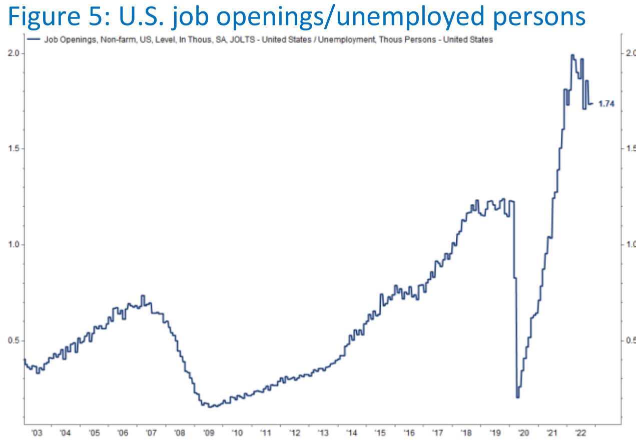
Confirming this idea that consumers are coming under pressure is the decline in the savings rate among individuals in the U.S. The share of personal disposable income that consumers are putting away towards savings is dropping quickly (Figure 4).

Figure 4: U.S. Personal savings rate

Source: U.S. Bureau of Economic Analysis

Despite the difficulties facing households and businesses as well as the widespread pessimism, one part of the economy continues to hold up extraordinarily well: employment. In the U.S., there are roughly 1.74 jobs available for each unemployed person (Figure 5). At 3.5%, the U.S. unemployment rate is near the historical low and there still appears to be strong (albeit declining) demand for labour. The fact that business sentiment readings are at cycle lows (back to Figure 2) and we have yet to see meaningful job cuts is comforting.

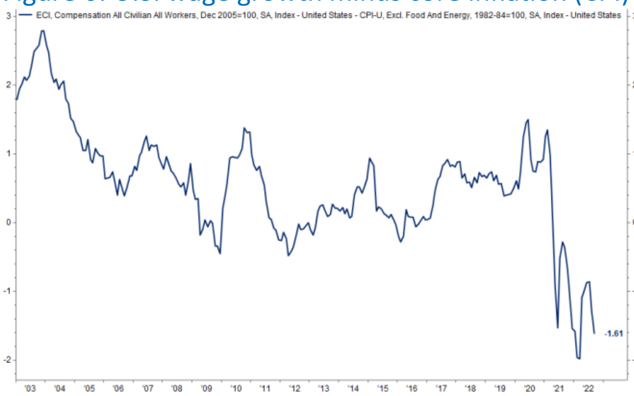
Figure 5: U.S. job openings/unemployed persons



Source: FactSet

Now for the bad news regarding employment – it doesn't get much better than this. Pulling people out of joblessness and providing them with disposable income is perhaps the best form of GDP growth and, of course, with fewer unemployed people this becomes more challenging. We suspect that, in the absence of strong job creation, wage growth will have the do the heavy lifting when it comes to consumer spending. The challenge here is that wages are declining in real terms (adjusted for inflation – Figure 6).

Figure 6: U.S. wage growth minus core inflation (CPI)



Source: FactSet

The inflation picture did improve during the fourth quarter, at least in Canada and the U.S. The rate of price growth has clearly peaked and is on a downward trajectory. Though still elevated, declining inflation will relieve some of the pressure on businesses and households. The uncertainty now is where inflation eventually bottoms and finds a floor (2-3% would be ideal). Regardless, we are of the view that it will take several months, perhaps into 2024, for inflation to reach a level that central banks are comfortable with. Until then, we don't anticipate any central bank interest rate cuts and suspect that monetary conditions (which act with a lag effect) will remain restrictive for some time. One exception to this which could warrant stimulative policy from central banks (cut interest rates) is if we encountered significant negative economic developments. Either way, it is difficult to envision a period of strong GDP expansion over the coming quarters.

Equity Commentary

Equities finished the year off with a stellar quarter and non-U.S. equities led the way amid a weakening dollar (Figure 7).

Figure 7: Benchmark equity returns in $CAD

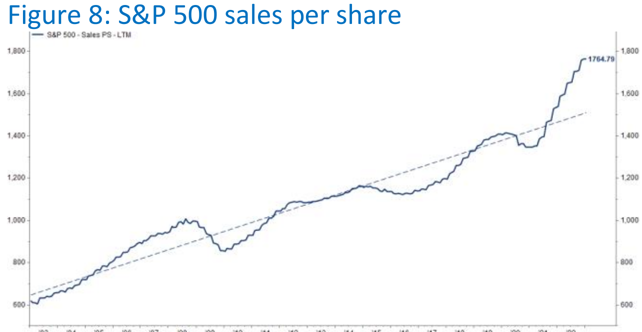
Index	Q1	Q2	Q3	Q4	2022
S&P/TSX	3.8%	-13.2%	-1.4%	6.0%	-5.8%
S&P 500	-5.6%	-13.6%	2.2%	5.4%	-12.2%
MSCI EAFE Index	-7.6%	-12.8%	-3.3%	14.7%	-10.8%

Source: RBC Capital Markets Quant Research

Nevertheless, nearly all asset categories posted steep losses during 2022 and we suspect that some of the driving factors may linger. We continue to maintain an underweight and defensive position in equities and see more compelling opportunities in fixed income.

A company's sales are, to a great degree, a function of industry or GDP growth (assuming stable market share). We already mentioned a number of macroeconomic headwinds that could pressure top line sales for companies, but also consider this: a linear regression of the S&P 500's sales per share going back 20 years suggests that today's point is well above trend (Figure 8). To expect above average or even average growth from this point seems unrealistic.

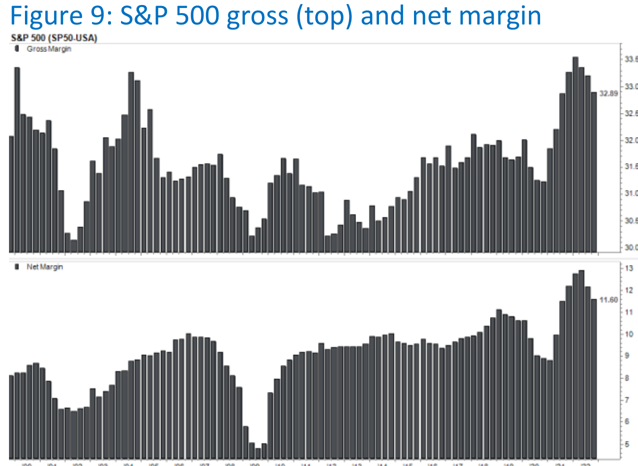
Figure 8: S&P 500 sales per share



Source: FactSet

Adding to our concern is that we see limited capacity for additional operating leverage. Gross and net margins are still near all time highs (Figure 9) and decelerating inflation will inhibit companies' ability to raise output prices (Figure 10).

Figure 9: S&P 500 gross (top) and net margin



Source: FactSet

Figure 10: S&P 500 gross margin (yellow) and U.S. core inflation (CPI)

Source: FactSet

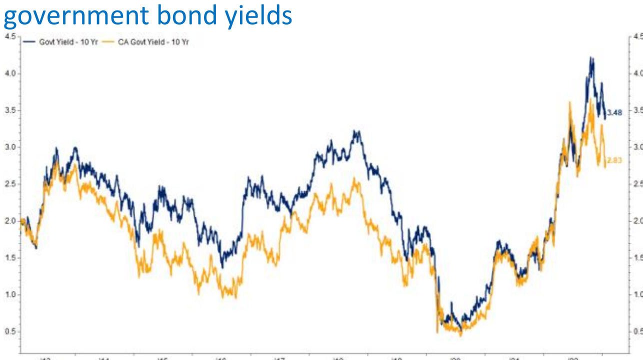
This environment could be challenging for stocks with sub-par returns a real possibility. Our equity focus remains primarily on companies with stable, predictable cash flows and reasonable valuations. We have increased our allocation to fixed income investments with interest rates at decade high levels.

Fixed Income

Interest rates were roughly flat during the fourth quarter with the Canadian Broad Bond Composite posting a modest gain of +0.4%, bringing the bond index’s year-to-date return to -11.4%.

Although below their recent peak, bond yields are still trading near decade-high levels (Figure 11).

Figure 11: U.S. (blue) and Canada 10-year government bond yields



Source: FactSet

Client accounts with a balanced mandate have about 50% in fixed income, above the benchmark weight of 40%. Over the past few quarters we took advantage of the rise in interest rates and purchased a significant amount of discount corporate bonds ranging in maturities of one to ten years and yielding about 4.7% on average. Capital gains form a substantial portion of the return from these bonds making them very attractive for non registered accounts. We also added a number of government guaranteed GICs yielding about 4.5%. Other fixed income investments include preferred shares yielding roughly 6%. Preferred share dividends qualify for the Canadian Dividend Tax Credit which enhances their after tax returns. For the first time in many years, fixed income is offering investors reasonable returns in addition to capital preservation and portfolio diversification.

Trading

Equity trading was light during Q4 as we held to the expectation that our conservative positioning during the year remained the best strategy in the face of decelerating global growth, hawkish central banks and corporate earnings forecasts that appear susceptible to downward revisions. We exited our position in Tricon Residential in October. Tricon is a Canadian company that specializes in mid-market single-family rentals primarily in the U.S. Southeast. We had bought the company as a play on surging residential rents but chose to liquidate our position when data emerged showing significant deterioration in the U.S. rental market.

We were more active in fixed income, adding to our ladder of Guaranteed Investment Certificates (GICs), particularly in non-taxable accounts, as yields exceeded 5% for the first time in years. GICs should provide excellent value over time as we expect interest rates to ultimately decline as inflation moderates from multi-decade highs. We also extended the duration of our bond ladder, selling a Hydro One bond maturing in January 2023 and reinvesting the proceeds in taxable accounts into a combination of discount corporate bonds from Fortis, Telus and Hydro One maturing between 2029 and 2031. This had the dual effect of increasing the taxable equivalent yield of portfolios and extending duration which will benefit from moderating interest rates.

Performance

Client balanced portfolios fully invested to model underperformed their benchmark return of 3.7% in the fourth quarter but significantly outperformed the benchmark's 2022 return of -9.1% after fees.

Fixed income holdings were in line with the 0.4% benchmark return in the final quarter of the year with even contributions from bonds, preferred shares and GICs.

Canadian equity holdings in client portfolios were also in line with the 6.0% total return from the S&P/TSX Index during the quarter. Cyclical companies fared the best with substantial gains being posted by copper-producer Teck Resources (+21.8%), as well as Choice Properties (+17.2%), Air Canada (+16.8%), Manulife (+11.4%) and Suncor (10.4%). Those suffering price setbacks included utility Emera (-7.4%) and TC Energy (-3.0%).

Our U.S. holdings underperformed the benchmark S&P 500 Canadian dollar total return of 5.4% in the year's final quarter. Portfolio holdings in Communication Services disappointed with Walt Disney (-9.7%) and Google-parent Alphabet (-9.5%) leading the downside. Surgical instruments producer Medtronic (-5.7%) and Costco (-5.4%) posted lower-than-expected results and detracted from relative performance. Mitigating these results were a strong quarter from Visa (+14.6%), Home Depot (+12.2%) and Coca-Cola (+11.3%).

We held no international equities in our balanced model during the first quarter, which was a drag on relative performance as the benchmark MSCI EAFE Index, aided by a currency tailwind, returned 14.7% in Canadian dollars.

Wealth Services

Investment research and portfolio management is a top priority, but we appreciate the unique circumstances of each of our clients and recognize the need for a sound financial plan. Over the years we have developed a close relationship with one of RBC's financial planners, Jung-Hee Kim. Jung-Hee has helped many of our clients in situations of varying complexity develop a financial plan. She considers strategies to maximize cash flow, reduce taxes, ensure retirement lifestyle, protect financial security, transfer wealth to the next generation and make the most of philanthropic legacies. Jung-Hee holds her MBA from the Schulich School of Business as well as her Master of Taxation degree from the University of Waterloo. She joined RBC after working at a Big 4 public accounting firm in Toronto as a manager in their High-Net-Worth Tax Services group. This complementary service has received unanimously positive feedback from our clients. We welcome any questions or requests if this is something that may be of interest to you.

Wealth Management
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