2023 New Year Message

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"Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy. Without price stability, the economy does not work for anyone." - Jerome Powell

Happy New Year to you all!

After a 2-year Hiatus on my annual New Year message (due to COVID lockdowns), it gives me great pleasure to be able to get back to writing and putting much of the past year on paper.

2022 Summary:

Well that was fun...
For a number of reasons I will get into, 2022 was the worst year for markets since the 2008 Financial Credit Crisis. A common balanced approach to asset allocation investing, is the 60/40 portfolio balance of stocks/bonds, and it had its worst year since 1937. How on Earth was this possible?

Performance:

S&P 500 US:	**-19.4%**
NASDAQ:	**-33.1%**
Dow Jones:	**-8.9%**
TSX	**-6.2%***
US Core bond	**-12.9%**
CDN Core bond	**-11.8%**

The * next to the Canadian index is to highlight that two of top performing sectors were Energy & Materials ((18 & 12% weight) respectively, so if you were to exclude those sectors, the TSX would look more like the S&P in regards to annual returns.

What Happened?

If I were to explain it in one word, it would be inflation, but that would be short, glib, and unhelpful. We are witnessing the end of the "free money" era, in which, after the 2008 Credit Crisis, Central banks have basically been on a zero-interest rate permanent policy to avoid economic downturns and keep employment numbers high. They were even buying their own bonds with their own printed currency (called Quantitative Easing). Despite all of this, inflation remained stubbornly below, or at, the 2% target rate, and everything seemed great.
As a result, many investors took on too much debt, thinking rates would remain low in perpetuity, while many bought more home than they can afford, or invested heavily in things like crypto currencies, that have zero intrinsic value.

The COVID Effect

When countries around the world went into various forms of lockdown, over an extended time frame, the fuse was lit for this huge bump in inflation. The build-up of pent up demand was extraordinary (I refuse to use the word "unprecedented"), and when economies slowly began to lift restrictions, this was quite inevitable. Supply chain blockages were to be expected.
Aiding all of this, were the generous Government subsidies to those individuals and companies that were forced out of work, or to close their businesses. I'm sure these were all done with the best of intent, but when you borrow trillions of dollars you don't have, to pay people not to work, or businesses to not generate revenue, there on consequences to that, and we are seeing unfold in real time.

Meanwhile...

Inflation had started to spike in all of the major global economies in the fall of 2021, which at the time was dismissed by most Central Bankers as being "temporary" or "transitory", or my favorite, "a blip".
Not only was it not a "blip", but it continued unabated. If your one job is to manage inflation, and you fail on what should have been very obvious signals...

And then Putin decided to invade Ukraine in the early morning of Feb 14th.
With Russia being one of the world's largest producers of oil and natural gas (much of which continental Europe relies on) and along with Belarus, supplying over 50% of the global potash supplies, required for mass agriculture, this sent inflation skyrocketing, as those inputs are required for most of the basic goods humanity relies on.

The Reaction

Most Central Bankers, asleep at the switch until now, had to act and admit they were slow to address inflation (back to the "one job" reference), and then began a very aggressive and sustained increase in interest rates not seen since the early 1980s. The stock and bond market results are fully to blame for this – not inflation per se, but the Central Banks massive mishandling of everything. This should have ended by now, or at least the finish line should be in sight. Instead, it looks like most Central Banks want to make up for their earlier error by raising rates too quickly and too high than what is necessary, thus overdoing things on the tightening side, and forcing a preventable recession.
Jerome Powell, the chair of the US Federal Reserve continues to insist that they will be raising rates well into 2023. This despite economic data is showing current month over month disinflation, not more inflation. We've come to this perverse situation where all positive economic data is seen as a negative by stock markets because it gives Chairman Powell more reasons to continue aggressively raising rates.

For what it's worth, the Bond Market says he is wrong, and just as it predicted he would have to raise rates early this year, it is predicting that the US will be cutting rates in the back half of 2023. Based on their track records, I would rather put my faith in the Bond Markets.

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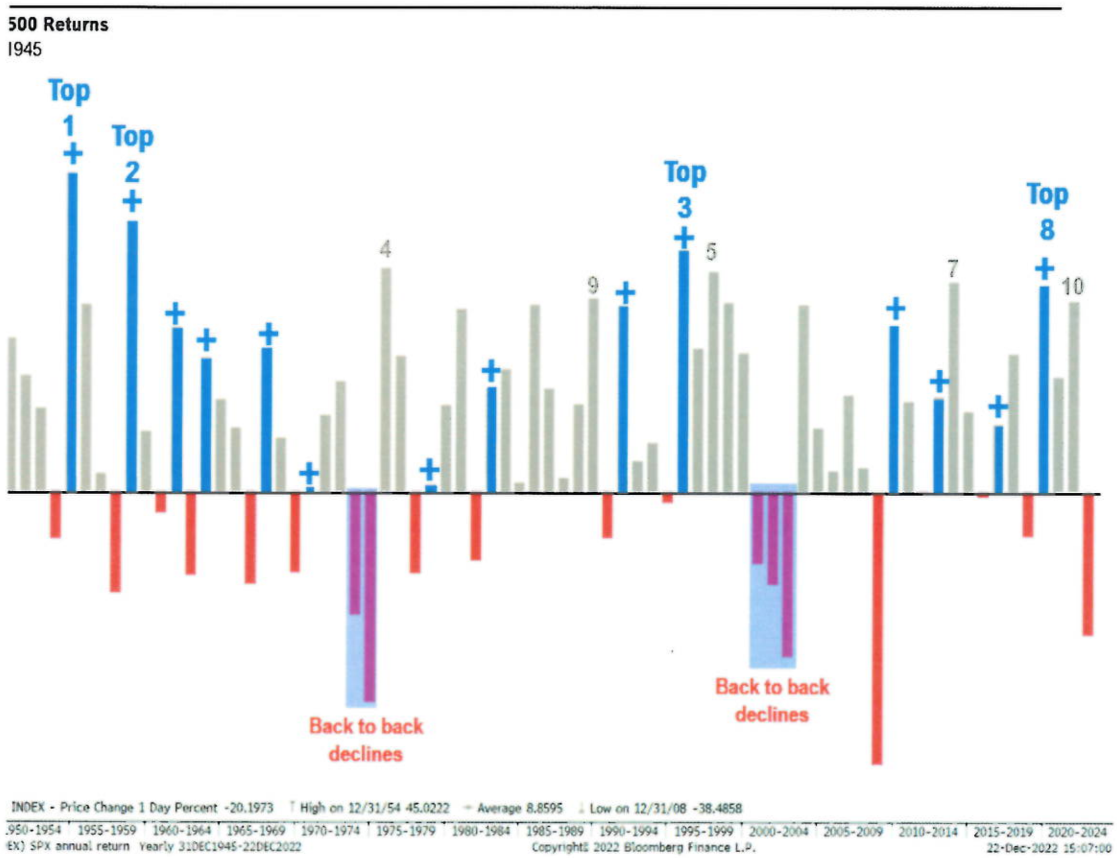
Now the Good News…Maybe

1. **There is plenty of economic data pointing to inflation has already peaked, and is by some metrics even declining. Is it dropping fast enough to satisfy the world's Central Banks remains to be seen. What will help, is that oil, natural gas, wheat, and some other commodities have completed a "round trip" last year. After huge spikes in the price of each, they have now fallen to where they were at the start of 2022.**

2. **There is growing chorus of geopolitical observers and experts predicting an end of the war in Ukraine by the end of spring 2023, and one that will end favorably for the rest of Europe, and democracy in general.**

3. **The number of occurrences in which stock markets had back to back negative years is surprisingly rare. See chart below. In the modern era, it has happened three times. First was the stagflation era of 1973 & 1974. The second was the 2000, 2001, & 2002 most of which is now referred to as the "tech wreck", but the worst of those years was the last, when corporate scandals were everywhere (Enron, Worldcom, Tyco, to name a few) and investors threw in the towel on a system that seemed crooked and rigged against them.**

3 of 5 best ever market gains come after "negative" year
…21 instances, median gain after negative year +17%



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The average return of the S&P 500 after a negative year is +17%. The average.

4. Bearish Sentiment is at an all-time high since this data was first tracked in 1987. Investors are even more negative now than in 2002 and 2008 (Great Financial Crisis), and there is a strong case to be made that things are nowhere near as bad as that now. Depressed sentiment has corresponded with secular lows. When the pendulum moves so far to one side, it will always rebound the other direction.

5. While I say this last one with fingers crossed, it would appear that the COVID-19 pandemic, which is still very much present, is morphing into the endemic stage in much of the world. With China slowly ending lockdowns, it would appear to be the last country to enforce such harsh measures. This would be a great help in alleviating bottleneck orders of semiconductors & telecomm equipment holding back the production of autos, appliances, and pretty much everything else with a computer chip in it.

All this to say, despite some expected continued sloppiness to start the year as this inflation/rate cycle conundrum resolves itself, I am cautiously optimistic for 2023.

We will be starting to book review meetings, New Year conversations in the next few weeks and I would be pleased to know if there any topics or issues that you would like to discuss further.

I welcome your feedback and look forward to 2023

Wishing health & happiness always.
Warm regards,

Rob Chaput

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