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WEALTH MANAGEMENT GROUP
BMO Nesbitt Burns

2023 and The Year Ahead.

To put it mildly 2022 was a brutal year in the markets and one we are all very happy to see behind us. Putting it into perspective, it was the worst year for equities since 2008, and the worst year for a 60/40 'Balanced Portfolio' in 100 years. Bond markets were down well into the double digits with CDN Long Bond Index down -21% and the CDN Universal Bond Index -11.6%. The Nasdaq was down -31%, the S&P 500 -19.6% and the Hong Kong market down over -50% over the course of the year.

One of the aspects that made it particularly difficult was the sustained volatility over the course of the year, opposed to a flare in volatility like we saw in spring 2020. This was highlighted by massive daily and weekly price swings in stocks, bonds and the global indices, which was some of the highest that we have encountered in our careers. Even in 2008, which was a very bad year for the markets (S&P 500: -38.5%) the positive to negative swings were less pervasive and not as sustained as over this last year.

The two major lows of they year for the S&P 500, occurred in June at -23.5% and October at -26%. The rally from the June low was +17%, only to give it all back into the October low. What we have learned from this, is to reduce total percentage exposure to the equity market during periods of sustained high volatility, while continuing to hold our Blue Chip Dividend paying stocks in order to continue collecting the dividend. These Blue Chip Dividend names were still subject to high volatility and downside over last year; (case in point both Bell Canada and Telus were down over -10% in December alone); however with a lower percentage allocation to equity markets we would have been in a better position to ride it out.

With well over 2 decades in this business we have seen many good years, some bad years and have learned a lot along the way. We have always maintained that you learn the most from the bad years, and we have learned a lot this past year.

In building the portfolio we have always maintained a general bias towards the US market for our equity exposure. Our rationale is that the worlds largest and leading companies list on the US markets and these are the Blue Chip companies that we want to own. The US markets have also historically outperformed the CDN markets and so driven strong returns for our clients and portfolios for decades. 2022 ended up being the outlier, as the CDN market outperformed the US market by the largest margin in 17 years.

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The outperformance was driven almost entirely by Energy as it makes up a very large % of the TSX at 17.7 % whereas on the S&P500 it is only 5%. Energy was the #1 performing sector last year globally and essentially the only positive sector in US markets. With our US bias we had very little energy sector exposure and this definitely hurt our performance last year.

With regards our US equity bias this is a more difficult of a comparison, as 2022 was an outlier year and we feel very strongly that the US markets will outperform in 2023 and in the years to come. In order to drive performance and gain exposure to these world leading companies we need the US equity exposure going forward. What we have done is to bring back some funds from US $ for most clients and a little more so for clients that are in Balanced portfolios or require CDN $ Income. These funds have been used to build out our CDN Dividend paying stocks in the portfolio, think Bell, Telus, Fortis, Hydro One, Royal Bank, Manulife, etc.

So now we come to 2023 and the start of the inevitable recovery that follows these severe negative years in the markets. Many of you may not be aware that already, some of the most beaten down global markets are showing strong signs of recovery. Last year we heard about how bad things were in the UK, sky high inflation, recession, political turmoil, etc, well UK markets have had the best start to the year in history and are close to eclipsing almost all of last years losses. The Hang Seng was down -50% and is now up over 40% off it's low. Europe was supposed to freeze this winter due to a natural gas shortage and sky-high energy costs. Well European natural gas storage tanks are over 80% full, Natural gas prices are down -70% from their high and European inflation numbers continue to improve.

Why I draw your attention to these things is that there are numerous indicators out there that are showing that things have started to turn the corner, yet most are not widely reported in the media, which has shifted it's focus from 'Inflation' to 'Recession' rhetoric. This is not me being overly optimistic or overly bullish, this is just what the data is showing.

So let me explain what we are still dealing with in 2023 and then some of the positive catalysts that are happening and likely to happen this coming year.

Last year was all about inflation. What we have seen is the inflation numbers coming down quite rapidly. If we look at the 6-month inflation numbers that back out the spike from the 1st part of last yar then it is running at close to 2.5%; not far off the 2% target of the Fed. The 1 yr number however is still at 6.46%, which includes the high inflation spike from Jan to July of last year. What this shows you, is how fast inflation has come down in the last 6 months of 2022 since the US Federal Reserve and Bank of Canada started raising rates.

The Bank of Canada on Jan 25th just raised by 0.25 bps points and indicated that they are now on hold, which makes them the first major central bank to do so. The bank now expects consumer price index inflation to fall to about **3 per cent** by the middle of this year, and to **2.6 per cent** by the fourth quarter. It sees inflation returning to the 2-per-cent target in 2024. It also reiterated that it expects the economy to "stall" in the first half of the year **but does not foresee a significant recession**.

So if inflation is coming down so quickly what is the issue?
Part of it is a historical worry. The last time we had high inflation was in the 1970s and the US Fed under Paul Volker raised interest rates, saw inflation start to moderate, and then saw it come back and spike higher when they cut interest rates too early. Hence the Central Banks of the world worry that if they start to slow down or stop the rate hikes too soon, then inflation may come back meaningfully as it did in the 70's.

The second main issue is the employment or should I say the unemployment rate.
Wages are a big part of the inflation equation, and though we have seen 'goods' inflation come down rapidly as supply chains get fixed, housing prices come down, etc, the wages component has been very sticky due to the very tight labour market. Workers are still hard to find and so unemployment remains at very low levels in both the US and Canada.

Part of this still the Covid hangover and part of it is also due to the massive cohort of 'Baby-Boomers', that are all in the retirement age bracket. Many of them retired when Covid hit and so there exists this shortage of educated, experienced, skilled workers.

So back to the unemployment numbers, which the US Fed has put increasing emphasis on in the last while. The concern is that for Fed to ensure that high inflation doesn't rear its ugly head again, they would like to see a break in the labor market. This means their restrictive stance could continue through the course of the year despite an inflation number that could at some point this year track even below the Fed target.

The difficulty with the unemployment numbers is that it is a 'lagging indicator' and is one of the slowest and last to move. We are seeing signs of lay-offs already from large Tech companies like Amazon, Salesforce, Microsoft and others like the Bank of America put a freeze on all new hires. The signs are clearly starting to show that the labour market and wage pressures are starting to weaken, but is that going to be enough and or happen fast enough, for the US Fed to scale back and or stop raising rates? A lot depends on which side of inflation they put the most emphasis on.

That remains the multi-trillion dollar question. And for now it remains unresolved. It won't be resolved until either the unemployment rate actually spikes or we see a sustained period of lower prices.

If we see a 'normalization' of the economy, with lower prices and slightly higher unemployment then the stock markets of this world are primed to move markedly higher over the coming year. Arguably the stock markets have already priced in the worst-case scenario and anything short of that will give them the catalyst to move higher. Coming into January we have already see signs of these green shoots of data, as the vast majority of markets and stocks are well off the October lows and showing positive momentum.

The Bond markets are also showing similar positive momentum, as Bond Prices continue to rally off the lows of last year. The Bond market for the 1st time in many years is once again looking appealing as Bonds trade at a discount and for the 1st time, are offering a potential capital gain and interest income to bond investors.

The Bond market is also very important for the housing market. To explain; fixed mortgages are based off the bond market and so a 5 yr 'Fixed Mortgage' is related to the yield on a 5 yr Bond. As we see Bond yields start dropping so will the fixed rate mortgages (with a bit of a time lag). So, if we can see a 5 yr fixed mortgage rate sustain below 5% at some point this year, it will lend support to the housing market in a big way as many sellers and buyers are still on the sidelines. With the Bank of Canada now on hold we have also likely seen the peak in Mortgage rates. One of the positive catalysts that is not widely mentioned.

Our BMO Economics department has been forecasting a -20% to -25% correction in the Canadian housing market from peak to trough and so far some areas in Ontario have already experienced similar price reductions. These were also the areas that experienced the hottest growth in previous years. Our economics department points out that real home prices have grown about 3% per year dating back to the early 1980's.

In the recent episode, even as inflation accelerated to multi decade highs, real estate prices surged more than a third in the span of 2 years opening the widest deviation from its long run trend in 40 years. Toronto prices rose 41% above trend, Ontario markets outside Toronto ran ahead by more than 70%!! They do however see sales volumes bottoming in the spring and prices starting to stabilize by mid year, as they also point to large inflows of new immigrants to support demand more in the 2nd half of the year. Robert Kavic: BMO Capital Markets 2022)
A stable housing market will boost consumer confidence and helps the overall, 'Wealth Affect', which is so important for the economy and the markets.

The China Catalyst.
The re-opening of China after it's Zero COVID Lockdown Policy is a very positive catalyst for global economies and markets that we believe has a long way to go this year. China is experiencing a bit of a V-Shaped recovery much like the western world post the initial COVID lockdowns in 2020. The economy is back in full-swing and the authorities are rolling out stimulus to help the housing sector and industry. When economists look at the overall health of the Chinese economy they look at 8 components of the YiCai index, which is 65% over the last 3 weeks. (Nancy Lazar: Piper Sandler, Jan 10th.)

1. Traffic congestion in the top 30 cities. 2.Commercial housing sales in the top 30 cities
3. Metro flow at the top 8 cities
4. Air pollution at the top 8 cities
5. Coal consumption for power generation
6. Imported dry bulk freight
7. Unemployment index
8. Bankruptcy index

All of these metrics are seeing very sharp recoveries, which bodes well for the economy in the coming months. The recovery in the Chinese economy will greatly help the economies of Asia and their trading partners, think Vietnam, Malaysia, Thailand, South Korea and Singapore. China is also an importer of goods from the EU and Chinese travel demand is exploding once again. These factors cannot be ignored in their positive impact to the global economy. We have already seen the PMI numbers in Japan, Australia and the EU start to tick higher as supply chains are normalized. (The Philadelphia Manufacturing Index tracks flow of industrial goods and when above 50 is in expansionary mode).

Back to the Markets:
Both of our teams of strategists, fundamental and technical are advising us of higher markets this coming year, as they see the markets regaining strength over the coming year. As mentioned above both the Bond and Stock markets have already moved off of the October 2022 low point and look primed to move higher over the coming year.

Of course there are going to be some bumps along the way, think Federal Reserve meetings, unemployment numbers, US Debt Ceilings etc, however what we are seeing is a change in narrative on so many fronts from economic indicators to consumer confidence and just general outlook on the year ahead.

Here are some comments below from our Chief Investment Strategist: Brian Belski. It is interesting to note that he put a target of 4300 on the S&P and as Tuesday 24th January the S&P had breached the 4000 point mark.

Short-Term Price Weakness and Volatility Likely, but High Probability of Solid Calendar-Year Gains: Following severe annual declines, US stocks tend to struggle early on in the subsequent year, which is one of the reasons we expect price weakness in the opening months of 2023, along with the concerns that investors continue to digest related to inflation, the Fed, recession, and earnings. Although this weakness could push the S&P 500 to a new cycle low, we do not believe there would be significant downside left if that occurs given the absence of a crisis within the current market backdrop. Nonetheless, any low (new cycle or 2023) could also come sooner than expected as some of the weakness we initially predicted seemed to be pulled forward in December, leaving ample time for a firm recovery throughout the remainder of the year and setting the index on a path to our 2023 price target of 4,300. Many of our fellow market pundits are less optimistic, however, with some calling for losses resembling prior crisis-level drawdowns. We just do not see this happening. Indeed, consecutive down years are rare, severe annual losses are typically followed by strong gains, unemployment remains low versus history, and the valuation re-rating risk among mega caps has significantly diminished– all reasons that should limit the probability of steep annual losses this year and increase the likelihood of solid gains, in our view.

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Main Points:

- Path to 4,300 by Year End Looks Very Reasonable. A typical bear market drawdown would bring the S&P 500 index price down to about 3,500
- US stocks typically log mid 20% gains in the six months after bear markets and >30% gains nine months post-bear market trough
- On average, it has taken the S&P 500 less than five months to log a 20% gain following its bear market trough

Steep Annual Losses Appear Improbable, While Double-Digit Gains Seem Plausible

- Back-to-back S&P 500 yearly declines are rare
- US stocks tend to struggle early on following severe annual declines, but then finish with notable gains
- Lower levels of unemployment should limit severity of potential recession and provide support to US stocks
- Re-rating risk has diminished for largest stocks

(Brian Belski, Chief Investment Strategist, BMO Capital Markets.)

Portfolio Actions.

The Portfolio team has been hard at work putting funds back to work in the market over the last 8 weeks. As the Bond and Stock markets showed signs of bottoming in October we started stepping in and buying more of the Large Cap stocks on both the US and CDN markets. For our Balanced and more dividend focused clients we continued to add to the dividend paying stocks that were trading at discounts due to the pullback last year.

On the Bond side we picked up some CDN corporate and provincial bonds trading at a discount that will provide some very nice yields upon maturity. Our NinePoint Bond Fund is now yielding over 10% which will provide an excellent income stream for clients this coming year.

On the Equity Side.

What we are very cognizant of is that what led the market last year - think Energy and Consumer Staples - is highly unlikely to lead the market in the recovery. We need to make sure that we do not build a portfolio for yesterday's market. In a recovery we are likely to see Industrial, Consumer Discretionary and Technology lead the recovery in the coming year. We have already seen money flows coming out of both Consumer Staples, Healthcare and Natural Gas stocks and slowly start moving back into some of the large Industrial and Tech Companies. It is incredibly rare to see an index like the Nasdaq down -31% on the year and so when the momentum changes, there are likely to be strong gains in the Tech sector later this year, especially if the market starts to anticipate interest rate cuts.

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We have already seen the semiconductor sector provide some decent returns this year in portfolios and our thesis is that as more money moves off the sidelines and back into the market, large institutional investors will once again be buyers of the names like Google, Apple, Microsoft and others in the large Cap Tech space.

We have also been adding to the industrial names like Trane Technologies, makes of Air-conditioners and HVAC systems and in more growth orientated portfolios, Johnson Controls and Honeywell. Our CDN Financial names continue to improve and we have been buyers of weakness in names like Telus and Bell Canada.

We feel we are well positioned currently for what we see unfolding the rest of this year, however it is also imperative for us to maintain a playbook for alternate scenarios, particularly one where rates remain high for a longer period of time. This involves meticulously evaluating opportunities that are not too sensitive to interest rates and applying our lens of looking for strong and resilient cash flow generating businesses with good dividends.

The other important thing to pursue for 2023, is to actively monitor our sector weights to ensure that we are not taking outsized relative risks in one sector or another. Lastly, it is important that we are more thoughtful and patient with respect to strategic allocation of cash in our portfolios as it can be a drag on performance or prove to be very useful source of capitalizing on opportunities.

The next Federal Reserve meeting occurs on Feb 1st and as such the market is likely to be watching closely the actions and the comments of the US Fed, around inflation and employment numbers. For us, the markets reaction will determine how we deploy or not any residual cash that we have in portfolios.

A Heartfelt Thank You to Our Clients.
We know that 2022 was a difficult and stressful year for all of our clients and we cannot thank you enough for your loyalty and support. We have been touched by your comments and questions asking after our health and the recognition of the hard work that our entire team has put in over the last year.

We have hit the ground running coming into 2023 and look forward to strong and prosperous year as we enter the Year of the Rabbit.
Thank you again from our entire Team.

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Thank you again from our entire Team.

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