QUARTERLY COMMENTARY

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A New Year!

I'm hopeful. As Chauncey Gardiner said in the 1979 movie "Being There" starring Peter Sellers, "there will be growth in the spring". I'm referring to my expectation that life will soon return much closer to normal – it wouldn't surprise me if we've seen our last lockdown and by the end of March most people will be back into the swing of things. Of course, the economy hasn't been affected as much as it might have thanks to all the government intervention and growth but soon we will be seeing a reversal of their work with a rise in interest rates. An increase in rates is not necessarily such a terrible thing unless it is taken too far or happens too quickly. Although equity markets have a history of declining during the first three months after the first of a series of rate hikes, on average after a year of rising rates equities have historically delivered above average returns with particular strength in small cap stocks.

Last year the markets had a terrific move and no-one is expecting anything like that to be repeated in 2022. The first 18 days of this year have not been encouraging with the S+P 500 down 3%, the NASDAQ (where most high tech stocks trade) down 7% and the TSX down by 2% (less than the others - mostly thanks to the financials and energy sectors). But as long as shareholder yields remain high (shareholder yield is a ratio that shows how much a company sends back to shareholders through a combination of dividend payments as well as share repurchases) higher equity valuations can be supported.

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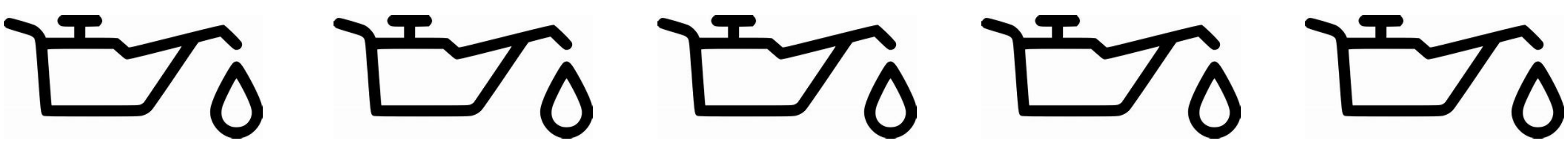
Market strategist Leon Tuey recently wrote the following: while the big techs will likely underperform, financials, and commodity-related issues will shine. This year will likely mark the end of Covid. When that happens, consumer spending and commodities will skyrocket. The small- and mid-cap companies (which have been the primary reason for the "poor breadth" that market commentators have been bemoaning) will surge. The market is already telling us that.

2022 has gotten off to a volatile start, and, unfortunately, I think that may be something to which we will have to get accustomed. Sentimentrader noted this week that 40% of NASDAQ Composite companies are down at least 50% from their 52-week highs and a majority are in “bear market territory” at least 20% below such highs. Right now there’s a struggle going on between growth stocks and value stocks. Many high tech companies are expensive in relation to their earnings and those are the stocks that have come down the most. I expect we’ll see continuing rotation and corrections in certain sectors. These pullbacks can happen though without the market as a whole moving down too much. It’s mainly when the huge mega cap companies like Microsoft, Amazon, Tesla or Google etc… have a downward move that you’ll notice the U.S. stock market average has a big down day. In Canada the largest companies are the banks, Enbridge, CN, TC Energy, BCE, Suncor, Shopify etc… and most of them are not growth stories (Shopify is the exception) so whenever you hear the TSX is down its most likely because the financial, energy or materials stocks are having a bad day.

A pullback of 10% is always possible but with regards to a major drop in the immediate future, I’d be surprised. No rational investor is going to remain in cash or bonds for long when inflation is running hot, rates are rising, and bonds are costing holders money on an inflation-adjusted basis. Interest rates would have to have a fairly substantial move in order for investors to be tempted to go elsewhere. Regarding fixed income, 2021 was a very challenging year as I expected it to be. With yields rising, the average bond fund dropped in value. For example the benchmark 10 year Government of Canada bond dropped 5.3% and the corporate bond index dropped 1.6%. This year will be even more difficult for fixed income investors as rates increase. Bloomberg's survey of US economists show strategists expect 10 year yields to increase an additional 50 bps which would roughly correspond to another negative return of -4.5%. There are places to hide in the fixed income space that won't be affected as much by higher rates but the average bond allocation in traditional investment portfolios has been reduced due to inflation and interest rate concerns.

It's possible that interest rates do not have as big or as many moves as expected. This might be the case if oil prices continue to move higher. Goldman Sachs is saying that $100/barrel oil is a good possibility this year and if that actually happens, I think the Fed will put a pause on higher interest rates because higher oil prices act as a de facto tax on consumers which lowers economic growth. Oil prices have risen to a seven year high amid ongoing supply concerns and escalating tensions in the Middle East. There are conflicting opinions on where oil prices are headed – Exxon's CEO Darren Woods says that the ultimate trend for prices is lower. He also said though that it's hard to predict when the market's supply/demand levels might balance out given the many factors involved. In the meantime, energy sector investors are enjoying a nice move in their oil producers.



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One catalyst that I believe can actually drive markets higher in the face of tapering and higher interest rates is a shift on the part of policy-makers towards treating COVID-19 as an endemic rather than a pandemic. This would mean the move away from the rolling lockdowns and a path towards some semblance of normalcy. The recent shift of hospitals to focus on treatments, such as the anti-viral pills from Merck and Pfizer and potentially other treatments, should be seen as a positive and a move in this direction.

Thank you for your continued trust and confidence and don't get too upset by the market's volatility. Should you have any questions or concerns at any time or if you would like to have a detailed discussion of your personal portfolio please do not hesitate to let me know.

Sincerely,

Richard