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QUARTERLY COMMENTARY

Richard Liss, CFP, CIM®, FCSI®
Portfolio Manager
Private Client Group
(416)777-7041
richard.liss@raymondjames.ca

Gala Petrenko
Financial Advisor Assistant
(416) 777-7154
gala.petrenko@raymondjames.ca

Raymond James Ltd.
Scotia Plaza - Suite 5300, 40 King Street West, Toronto, ON M5H 3Y2
Phone: (416) 777-7041
Fax: (416) 777-7020
www.raymondjames.ca/richardliss

Rockin' Rates

With an extremely challenging 2022 now in the books, a look back reveals a year defined almost entirely by inflation. Financial markets, investors and policymakers alike in many major economies zeroed in on surging prices and what they meant for growth and asset prices. Expect 2023 to be different though—a year of transition. Inflation will still dominate headlines, likely for months to come. However, it looks like inflation pressures are starting to ebb, enabling investors and policymakers to shift focus to the outlook for economic growth and corporate earnings. The transition will herald a return to a more normal environment, though the ride will be uneven. Goods inflation has started to moderate. In the early stages of the COVID-19 pandemic, goods inflation rose sharply as supply-chain disruptions dominated the global landscape. At their peak early in 2022, goods prices were up almost 20% on a year-over-year basis. With supply chains now largely healed though, prices have fallen over the past few months. That hasn't stopped price gouging though. I know from personal experience – last summer I needed to replace my backyard fencing. And although lumber prices had dropped 75% from the year before, back to almost normal levels, the price I was quoted from multiple suppliers was twice the price a neighbour had spent two years before. It's disgusting. Despite what they say, many companies have taken advantage of peoples expectations and acceptance of higher prices. With the news that prices are normalizing somewhat, hopefully this practice will stop.

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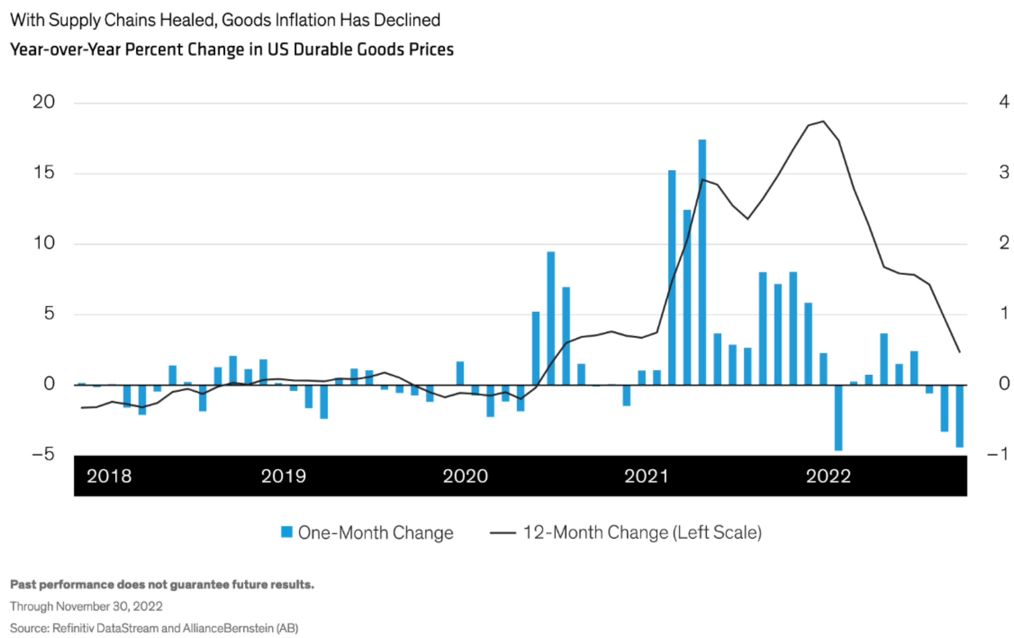
Equity markets were all up the last quarter of 2022 – the TSX rose by 5.3%, S&P was up 7.6% and the NASDAQ bounced 10.2%. That wasn't enough to make up for a terrible year all around though– one of the worst in recent memory. As discussed previously, it was the commodity sector that had a robust year – especially the energy companies. Indeed commodities' propensity to deliver strong returns during inflationary shocks – when stocks and bonds struggle together – suggests they most likely deserve a place in strategic portfolio allocations. Portfolios that incorporate stocks and bonds along with inflation-sensitive assets like commodities, and seek to balance risk between these three legs of the stool, are often called "Risk Parity" or "All-Weather" portfolios. While commodities deserve a place in strategic portfolios, they cannot be relied upon to provide ballast in all market environments. Even during sustained inflationary periods, commodities often produce large and painful drawdowns. Commodities delivered a total return of 650 percent from 1970 through 1980 but endured a 37 percent peak-to-trough loss in the middle that lasted almost three years. Some continuous exposure is helpful for robust long term returns but just like everything else, valuation is key.



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According to Bank of America Corp. strategists expect US stocks are poised for a fresh slide before ultimately rallying in the second half of the year when economic conditions stabilize. Former Treasury Secretary Lawrence Summers said that the US economy is still facing a recession this year, despite encouraging news in recent weeks. Not everyone believes a recession is imminent though despite an inverted yield curve (which is a major indicator of a possible slowdown). A recession could be mild however because even though layoffs are beginning to take place, the overall employment numbers are robust.

“We’ve been in the inflationary bus, which is a fancy way of saying stagflation, and that’s not a great environment for financial assets,” said Jack McIntyre, portfolio manager at Brandywine Global. “Equities don’t like the slowing economic activity and bonds don’t like the inflation part of it. So, we should get resolution this year on how do we break out of that stagflationary environment.”

Another major factor that will affect this year’s world markets is the reopening in China. Recurring outbreaks of the virus are happening as China shifts to living with COVID, and surveys in December suggest that manufacturers have experienced an increase in worker absences. But inventory has been rebuilt along global supply chains and global demand for goods is now weakening so I don’t anticipate a renewed inflationary surge in the rest of the world driven by shifts in China’s supply-side. Demand for goods from China is set to rise but demand from North America and Europe will be constrained (by possible recessions or at least a slowdown). The only thing now that might place some pressure on prices is demand for energy – certainly in China and Europe.




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Economists are divided over whether the Bank of Canada will pause or raise rates by another 25 basis points at the Jan. 25 meeting. The large increases in interest rates in the last six months has allowed me to take advantage of very good yields and purchase one and two year GICs as well as corporate bonds for clients. The Canadian economy added 104,000 jobs in December, surprising economists. Douglas Porter, chief economist with BMO Financial Group, said the economy ended the year with a lot more momentum than anyone expected but most economists are confident that inflation is being tamed. RBC chief economist Craig Wright said he expects the inflation rate to be back within the Bank of Canada's 1% to 3% target range by the end of this year. That might be a little optimistic but it's certainly heading in the right direction.

All successful investors know that patience is key. Thank you for your continued trust and confidence. 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