WHY 2023 OFFERS SOME REASONS FOR OPTIMISM

Lorne Zeiler, CFA, MBA,
VP, Private Client Management

2022 has been a tough year for all investors, but an especially harsh one for balanced and income focused investors. The main reason this year has been so difficult is because both stocks and bonds have declined together. In most other periods of equity market decline, investors have fled to safe assets such as bonds, leading to price increases on government and high-quality corporate bonds as yields came down (bond prices and yields act inversely). In those instances, positive returns on bonds offset some of the losses on equities. This year has not followed that pattern, as Central Banks have been raising interest rates at one of the fastest paces in the past 40 years in an attempt to rein in inflation. In fact, according to research from Bank of America, while there have only been a handful of years where the balanced portfolio of 60% equities and 40% fixed income have generated returns of -10% or poorer, this has been the worst year for a balanced portfolio in 100 years.[1]

While the next few months are likely to be volatile, there are significant reasons to assume that 2023 will be better and likely offer positive returns as well as setting investors up for relatively high medium- to long-term returns.

INFLATION WILL DECLINE

While I am not sure when or if we will reach the central banks' target of 2%, it is highly likely that inflation will decrease substantially from its current high levels of roughly 7% in Canada and 8% in the US. Some of the reasons for the expected decline are:

1. **Inflation Has Likely Peaked.** Inflation rates have declined by roughly 15% in both the US and Canada since peaking in the summer. Inflation rates should decline further in 2023. At the beginning of 2022, we had increases in all of the four main areas of inflation: Commodities, Goods, Services and Wages. After a huge price increase in Q1, commodity prices, particularly oil and metals, have generally flattened and in some areas declined. Price increases on goods have also receded as consumers seem to be cutting back on their purchases and supply-side issues are being resolved. There was massive pent-up demand for services in 2022 due to the Covid-related restrictions in 2020-2021; this demand should likely decline in 2023 as the capital cushions consumers built up from generous government programs decrease. While wages are still increasing, the lower level of unionization today (less than 25% from 40% in the 1970s)[2] and likely tighter labour market conditions from slowing economic growth should limit wage growth in the near future.
2. **Base Effect.** Inflation is calculated by comparing the cost for a basket of goods and services to that same basket (called the Consumer Price Index) 12 months prior. As inflation accelerated in early 2022, this means that the cost comparison in 2023 will be against a higher base rate, likely leading to smaller price increases and a lower inflation rate.
3. **Lag Effect of Interest Rate Increases.** When interest rates rise quickly, consumers have few options but to pay the higher rates. Over a few months, they begin adjusting their consumption patterns to take into account their higher costs on debt. A pullback on spending will likely lead to slower price increases or even declines.

[1] https://www.reuters.com/markets/europe/global-markets-flows-urgent-2022-10-14/;
https://www.investopedia.com/60-40-portfolios-face-worst-returns-in-a-century-6751333
[2] https://www.fraserinstitute.org/blogs/canadians-relearning-hard-economic-lessons-of-70s-and-80s

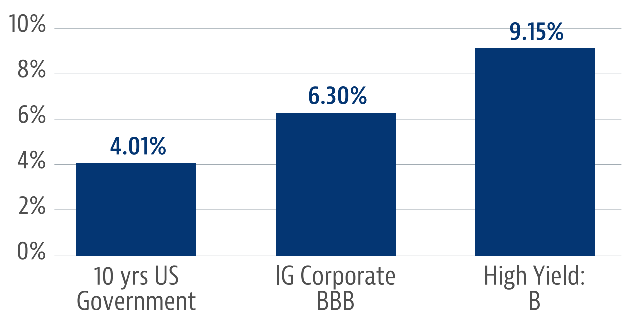
4. **China Possibly Ending its Covid Policy.** With the most recent National Congress completed and Xi Jinping cementing his position as leader, there is greater likelihood that China will rethink its zero Covid policy. This would result in a more stable labour force producing more of the world's goods at a cheaper price, which would help to reduce the inflation rate.

BONDS ARE OFFERING FAVOURABLE YIELDS

While it is still uncertain at what rate the Central Banks will pause their interest rate increases, it is anticipated that the timing of the pause will be in Q1 2023 with terminal rates in Canada at somewhere likely between 4.0% - 4.5% and between 4.75% - 5.25% in the US. Bond market pricing today reflects those expectations. Some reasons why income investors may be happy in 2023 and beyond:

1. **Yields Are Much Higher.** As of November 7th, 5- and 10-Year Government of Canada bonds were offering current yields of 3.75% and 3.6%, respectively. US Government bonds were offering yields of nearly 4.4% and 4.2% on similar maturities. With credit spreads (yield premium from owning a corporate bond over a government bond) slightly above average, US investment grade bonds are offering yields of over 5% to 6.5%. Corporate credit fundamentals are also fairly strong, so while credit yield spreads could widen further in a recessionary scenario in the near-term, corporate bonds should provide mid single-digit returns in the medium- to long-term for investors.

SELECTED US BOND YIELDS[3]



2. **Potential for Capital Gains.** Bond yields reflect the average return a bond should pay over the *entire life* of that bond, i.e. if a 10-year government bond is yielding 4%, this means the average interest rate during that entire 10 year period is expected to be roughly 4%. If the current rate hikes lead to a recession, central banks may actually have to decrease interest rates in the future to spur growth. This means there is a strong possibility that bond yields could actually drop in the future, meaning bond prices would rise.

Given that rates are higher, yield spreads are favourable on a long-term basis, corporate fundamentals look fairly strong, and bonds may offer potential for capital gains, a fixed income portfolio made up of government and high-quality North American corporate bonds should provide above average returns of 4%-6% over the medium-long term at current rates.

VALUATIONS HAVE BECOME REASONABLE TO CHEAP (PARTICULARLY NON-US)

Stock market investing is essentially buying fractional ownership of companies. Buying great companies at low to moderate prices has been and will continue to be one of the best ways to earn high long-term returns. But, even great companies can be bad investments if the price is too high. Equity markets ended 2021 at reasonable levels in some countries, but at high valuations in others. For example, valuations were high in the US, with the S&P 500, the main US market index, trading at 21 times forward earnings. Stock market declines in 2022 have resulted in significant multiple contraction, leading stocks to be priced at much more favourable levels than before, which bodes well for future returns.

US

The US market has declined by as much as 25% on the S&P 500 and by nearly 35% on the tech-focused NASDAQ. Prices have since increased a bit, but valuations have become much more reasonable with the S&P 500 trading at roughly 16.8x 2023 forward earnings estimates[4], which is slightly below its 10-year average. Valuations are cheap in many other regions.

CANADA

The Canadian market is trading at a much cheaper valuation, by comparison. The S&P/TSX is trading at approximately 11.4 times forward projected earnings.[5] While its historical

---

[3] Source: Bloomberg Finance LP, as of October 28, 2022. CI GAM
[4] https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_110422.pdf
[5] https://insight.factset.com/canada-earnings-season-preview-q3-2022

average P/E multiple is lower than the US at about 15 times earnings (vs. closer to 17 for the US), a P/E multiple of 11.4 is a substantial discount, especially with the TSX's two biggest sectors, financials and energy, generating strong profits.

EAFE (EUROPE, ASIA, AND FAR EAST DEVELOPED COUNTRIES)

Europe definitely has its challenges with high inflation, low growth and uncertainty about energy supply, but their markets have priced in a lot of that bad news, with the UK trading at just over 9 times earnings, and the region trading at roughly 11 times earnings. Japan, which has not experienced an inflation surge, is trading at 12.3 times earnings.[6]

EMERGING MARKETS

While China's growth rate has declined substantially, many other Emerging Market countries continue to be engines of growth, yet their equity prices do not reflect this. The Emerging Market index is trading at just 10.5 times.[7]

SELECT P/E RATIOS BY COUNTRY OR REGION

Country / Region	P/E Ratio*
US	16.8
Canada	11.4
UK	9.2
EAFE	12.3
All World ex-US	11.4
Emerging Markets	10.5

*P/E Ratios based on 12 month forward earnings' estimates as at November 8, 2022. Source: Yardeni Research, Inc. yardeni.com/pub/mscipe.pdf

REGRESSION TO THE MEAN

One of the most relevant investment principles that I have learned in the past 30 years is **Regression to the Mean.** Essentially, markets can swing from trading at extremely high valuations, such as prior to the Tech Wreck of the early 2000s, or at substantial discounts, such as market bottoms in 2009 and 2020, but over time investors should expect equity markets to trade at their average multiples. If you buy the market near the average multiple, you should expect to earn the historical average market return and if you can buy cheaper than average, you should earn a *premium return* over time. With the US trading just below average and many markets at a discount, investors should expect to earn high single-digit to low double-digit returns from world equity markets over the medium-long term.

Please note that is not to say that markets can't go lower from here, because they can or that short-term returns can be well above or below the Mean (average) return, but over time, investment managers with disciplined processes, who buy good quality companies at reasonable to low prices should be able to generate returns in the high single- to double-digits. **Equity investments pay a premium to investors for accepting uncertainty and volatility, and having patience.** There is no reason to believe that this time will be any different or that long-term, disciplined investors will not enjoy that premium in the future.

As Peter Lynch, one of the most successful investors of all time, highlights in a famous speech that he gave to the National Press Club in 1994:

"Some event will come out of left field, and the market will go down, or the market will go up. Volatility will occur. Markets will continue to have these ups and downs. ... Basic corporate profits have grown about 8% a year historically. So, corporate profits double about every nine years... So, the market ought to double in the next eight or nine years. They'll double again in eight or nine years after that. Because profits go up 8% a year, and stocks will follow. That's all there is to it."[8]

What is amazing is how accurate that long-term focused comment has been. Lynch was talking about the Dow Jones Industrial Average. On the date of his speech (October 7, 1994), the index was trading at approximately 3,800. 8% growth over the 28 years since that speech would result in the market doubling just over 3 times (3.11 to be exact) and a market value of approximately 33,500 in early November 2022. The Dow Jones Industrial Average closed at 33,747 on Friday, November 11th, 2022.

The volatility that we have experienced over the past year is not over and we will likely see more short-term declines or periods of rapid gains, such as Thursday, November 10th when the S&P/TSX was up over 3%, the S&P 500 was up over 5% and the NASDAQ was up over 7% — all in one day.

[6] https://www.yardeni.com/pub/mscipe.pdf
[7] https://www.yardeni.com/pub/mscipe.pdf
[8] https://finance.yahoo.com/news/legendary-stock-picker-peter-lynch-made-a-remarkably-prescient-market-observation-in-1994-184332355.html

What should an investor do? Build a financial plan that is accurate to your needs and risk profile, then trust in that financial plan. Be patient, have a long-term focus, but ensure that your portfolio also meets your short-term cash flow needs. Trust in earning an equity risk premium over time and trust that markets will Regress to the Mean, which as Peter Lynch highlighted, at current valuations, is a good thing.

CI ASSANTE PRIVATE CLIENT

Published November 18, 2022.

22-11-771964_E_APC (11/22)