January 2023

Investment Commentary

The table below indicates the capital appreciation of the TSX/S&P index over the last one and three year periods and the capital appreciation of the S&P 500 index over the same periods. In the last twelve months the S&P substantially underperformed the TSX. This can largely be explained by the fact that Technology sector of the S&P index has a much larger weighting than the Technology sector of the TSX. The Technology sector of the S&P index declined by 33% in 2022. Further the Energy sector represents a 18% weighting in the TSX index vs. 5% of the S&P index. The Energy sector of the TSX was up 30% in 2022, and the energy sector of the S&P index was up 66% in the same period.

Table 1

Price Performance of the S&P 500 index and the TSX/S&P index

% Change

	S&P/TSX	S&P500 index
One Year	(8.7)	(19.5)
Three Years	12.9	18.5

Source: Factset

The S&P 500 index had its worst return in more than forty years in 2022 with the exception of 2002 and 2008. The decline in the index was entirely the result of the price/earnings multiple of the index compressing. Specifically profits increased by 3% and the price/earnings multiple of the index declined by 21.9% in 2022. There was a dramatic difference in performance between sectors. The heavily weighted Technology sector, at 29% of the Index experienced a decline of almost 34% in 2022. By comparison the much lighter weighted Energy sector at 5%, had a substantial 66% return. Generally, growth stocks performed poorly in 2022. Further, all the loss during the year occurred in the first half of 2022. The S&P 500 index declined 19.6 % in the first half of 2022, and rose by 0.21% in the second half of the year.

As with the S&P index the Energy sector dramatically outperformed all others in the TSX index in 2022. However, given the Energy sector's much larger weighting in the TSX index it had a much greater impact on the performance of the TSX. The largest sector in the TSX index, Financial Services with a 31% weighting ended the year down 10%.

Inflation Expectations – An Inverted Yield Curve Indicates Investors Expect Inflation Will Decline

Yields on longer term U.S. treasuries have fallen further below those on short term bonds than any time in decades. This situation is known as an inverted yield curve. It indicates that investors believe two things: inflation is about to subside, and a recession is imminent.

At the end of 2022 the yield on three month treasury bills was 4.3% and the yield on ten year treasury bonds was 3.8%. The current expectation is that the yield on three month treasury bills will reach slightly more than 5% by March of 2023 while the yield on ten year treasury bonds remains the same.

Arguably the most important economic metric that investors are watching currently is inflation. In June of 2022 inflation peaked at 9.1% annualized. As of December it was 6.5%. Core inflation, which excludes volatile items such as food and energy peaked at 6.6% in September and declined to 5.7% in December. Parsing the numbers in more detail, goods inflation declined substantially from a peak of 12.3% in February 2022 to 3.7% at the end of 2022. Services inflation peaked at 6.8% in September 2022, and fell to 6.4% by the end of the year.

In response to higher inflation interest rates increased substantially during 2022. Table 2 demonstrates the changes in short term and long term bond rates.

Table 2

Change in Interest Rates in 2022

	Dec 31st 2021	Dec 31st 2022
Three month Treasury Bonds	0.12 %	4.4%
Ten-Year Treasury Bonds	1.8%	3.9%

Source: Credit Suisse

The Prospect of an Imminent Recession- Strong Employment and Weak Housing Provide Conflicting Evidence

During 2022 Gross Domestic Product forecasts for the year declined from 3.9% to 1.9%. Further, the Institute of Supply Management manufacturing Index fell from 58.8 to 48.5. A reading of below 50 typically indicates a recession is imminent.

However, jobs continue to grow faster than incoming labour participants. In December employers added 223,000 jobs. The number was consistent with job additions each month since September. These numbers indicate a tight labour market with employment about 500,000 higher than the pre-pandemic level.

There are currently 10.5 million job openings. This compares with 7 million openings in August of 2019 before the pandemic began. Consequently it is a very tight labour market. The unemployment rate ticked down to 3.5% in November, which is back to the level before the pandemic began. It is also the lowest level since 1969. As a result the unemployment rate is well below normal economic cycle lows.

On average at the peak of an economic cycle the unemployment rate bottoms at 4.9%. If the unemployment remains at or near its current level real wages (wages minus the CPI) will turn positive by mid 2023. In November average hourly earnings grew by 4.6% while the Consumer Price index increased by 7.1%. A combination of strong employment and wages catching up to inflation create a very healthy consumer spending environment.

One of the real dampers on the economy has been the decline in housing prices over the last year. The median house price in the U.S. peaked in June of 2022 at $413,000. Since then it has fallen more than 10% to $370,700. The decline has been precipitated by the rise in interest rates, which in turn has caused the affordability index to fall precipitously. The housing affordability Index measures the affordability of a house using a fixed 30 year mortgage, and 20% down payment. An Index of 100 indicates that an individual with a median income has just enough to qualify for a mortgage on a median priced house. In November of 2021 the Index was 142. By November of 2022 it had declined to just over 90. Incredibly this is the first time since 1986 that the affordability index had declined below 100. Housing constitutes a substantial $43 trillion asset to the U.S. economy. Therefore a material decline in value or affordability can have a dramatic impact on U.S. consumers.

Fixed Income - Still an Unattractive Asset Class

The yield on all fixed income, both short and long term increased steadily during 2022. The yield increase was driven the steady increases in the Federal Funds rate. During 2022 the Federal Reserve Board increased the Federal Funds rate seven times. The rate began the year at .25%, and ended the year at 4.5%.

Ten year Treasury bonds began 2022 with a yield of 1.66%. They ended the year with a yield of 3.88 %. Treasury bond prices declined in response to the increase in yield. This development has led some investors to believe that fixed income is now an attractive asset class. However, it is not the case. It is imperative to look at investment returns net of inflation. By way of example if inflation is 6% and the rate of interest on your bond is 4% you are receiving a negative 2% return.

Energy - Notwithstanding Strong Performance in 2022 This Sector Continues To Represents Good Value

The Energy sector has now had two consecutive years of strong performance, for the first time in decades. Given the outlook for oil and gas prices in 2023 it is reasonable to expect another year of outperformance. Valuations remain modest. There is substantial room for the expansion of p/e multiples and cash flow multiples this year. Most importantly oil and gas companies are committed to a rigorous capital discipline. Companies are not chasing production growth anymore. Capital expenditures are strictly for maintenance type programs. It should be noted however that there has been substantial inflation in capital costs in 2023. Specifically the prices of steel, sand, and labour increased more than expected. Consequently capital expenditure budgets for 2023 will be slightly higher than anticipated.

In sum, most companies in the Energy sector have the objective of maximizing free cash flow, and directing this free cash flow to shareholders returns. Companies will be paying down debt, repurchasing shares and increasing dividends in 2023. All of these activities should serve to generate strong returns for this sector.

Crypto- Currency Collapse – There Will Not Be a Spillover Impact on The Wider Economy

It is estimated that the crypto-currency industry which was once valued at $3 trillion is now valued at $900 billion. The $2 trillion collapse occurred with a speed that caught most investors and speculators by surprise. The unravelling really accelerated when stablecoin, a digital currency designed to maintain a 1 to 1 peg with the U.S. dollar became unstable. Stablecoin was supposed to act as a kind of bank for the crypto market and offer a store of value. When the value of stablecoin declined below the $1 mark panic set-in. Abruptly nothing in crypto was safe. During the last year Bitcoin lost 73% of its value, and another major crypto currency ethereum lost 75% of its value.

A concern now is that the collapse of the crypto market will trigger a financial event similar to the financial crisis of 2008. There is no such risk. To begin with although $2 trillion appears to be a large amount it pales in comparison to total U.S. household wealth of $150 trillion. Secondly virtually all crypto currency lending and financing occurred within a closed loop of crypto lenders. Consequently while numerous individual investors lost money on their crypto investments very few traditional financial institutions were involved in crypto lending.

Valuation – The U.S. Market Is Not Expensive

Table 3

Credit Suisse Price target For The S&P 500 Index

S&P 500 Price Level	Price	% Change
Current Price level	3897	
2023 Price Target	4050	

Credit Suisse Operating Earnings Estimates	EPS	YoY Change
2021 Actual	209	47%
2022E	223	6.5
2023E	215	-3.5
2024E	230	7.0

P/E Multiples on Credit Suisse Estimates	P/E
Current on NTM EPS Estimate	18.1

Year-end 2023 on 2024 EPS	17.6

Source: Credit Suisse

The valuation for the S&P 500 Index seem quite reasonable based on the forecast next twelve month (NTM) earnings of the S&P companies. The Index is currently trading at 18x 2023 earnings. By comparison, throughout 2121 the NTM price earnings multiple ranged between 21.2 and 22.5x.

Summary and Assessment:

There has been extensive discussion about the expectation of an imminent recession in the U.S. over the last six months. The S&P Index declined 19% in 2022, with some sectors, notably Technology declining by more than 30%. It is therefore important to ask how much of the imminent recession, and subsequent fall in earnings is already factored into the current valuation of the S&P Index. Further if in fact a material reduction in inflation does occur in 2023 it will serve to increase the valuation of the S&P 500 Index.

Ian Osler, CFA
Portfolio Manager

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