Monthly Market Update - January

2022 IN THE REAR VIEW

As 2022 comes to an end, we are able to look back on the year and see the tremendous value we have provided for clients. Although the markets are still contending with inflation, rising rates, and volatility, this is precisely the type of market where prudent portfolio management and tactical strategies make all the difference. As the page turns on 2022, the forecast is looking bright for the year ahead.

Monthly Market Movements

North American Markets	Last	Change	% Change
S&P/TSX 60	19,384.90	-1,068.40	-5.22%
Dow Jones	33,147.25	-1,442.52	-4.17%
S&P500	3,839.50	-240.61	-5.90%
NASDAQ	10,466.48	-1,001.52	-8.73%
Russell 2000	1,761.25	-125.33	-6.64%

Commodities / FX	Last	Change	% Change
Crude oil WTI	$80.26	-$0.29	-0.36%
Natural Gas	$4.10	-$2.83	-40.78%
Gold	$1,826.20	$66.30	3.77%
CAD / USD	$0.738	$0.00	0.00%
CAD / EUR	€0.690	-€0.02	-3.51%

Overseas Markets	Last	Change	% Change
FTSE 100	7,451.74	-121.31	-1.60%
DAX GERMANY	13,923.59	-473.45	-3.29%
NIKKEI 225 INDEX	26,094.50	-1,874.49	-6.70%
HANG SENG INDEX	19,781.41	1,184.18	6.37%

The Month in Review

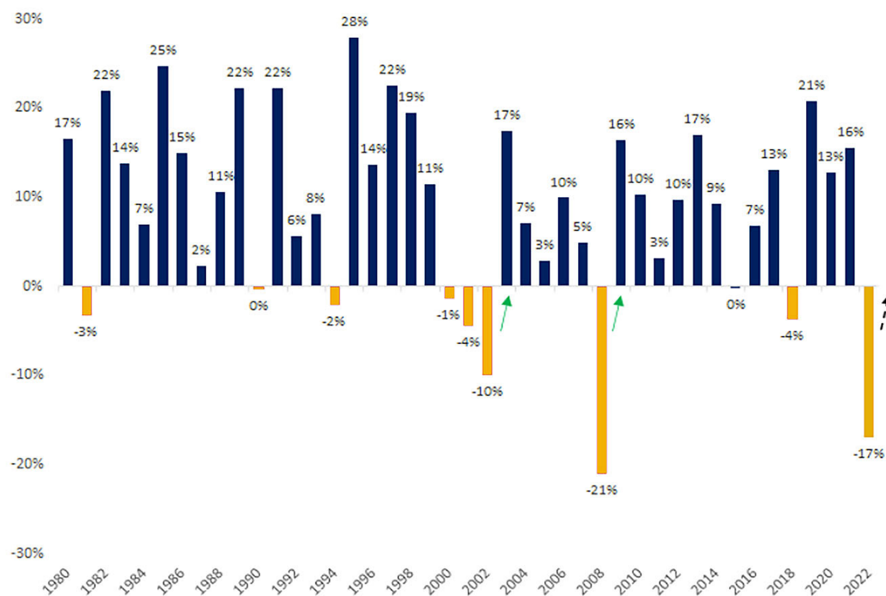
- **Value Beat Growth:** In 2022, value outperformed growth by the largest margin since 2001.
- **Canada Outperformed the U.S.:** The TSX Composite proved to be the most resilient North American index, helped by commodities and more stable, value-focused companies.
- **A Challenging Year for Bonds:** Long-duration debt posted its worst year on record on a risk adjusted basis, ending the year down double-digits.
- **Active Beat Passive:** Active management strategies convincingly beat out most passive investment strategies, and with volatility to remain in 2023, this should continue.

Strong Returns Often Follow Negative Years

The 60/40 portfolio is often used as a representation of the average investor's retirement portfolio. In this case, it consists of 60% equity (S&P500) and 40% bonds (U.S. aggregate bond index). Although client portfolios will vary, this is a good way to track broad performance for a retail investor with a balanced profile.

Over the last several decades, it has held true that years with a drawdown of 10% or more have been followed by strong returns in subsequent years. Even more broadly, with the exception of the dot-com-era, markets have typically performed very well following a negative year.

U.S. 60/40 PORTFOLIO CALENDAR YEAR RETURNS



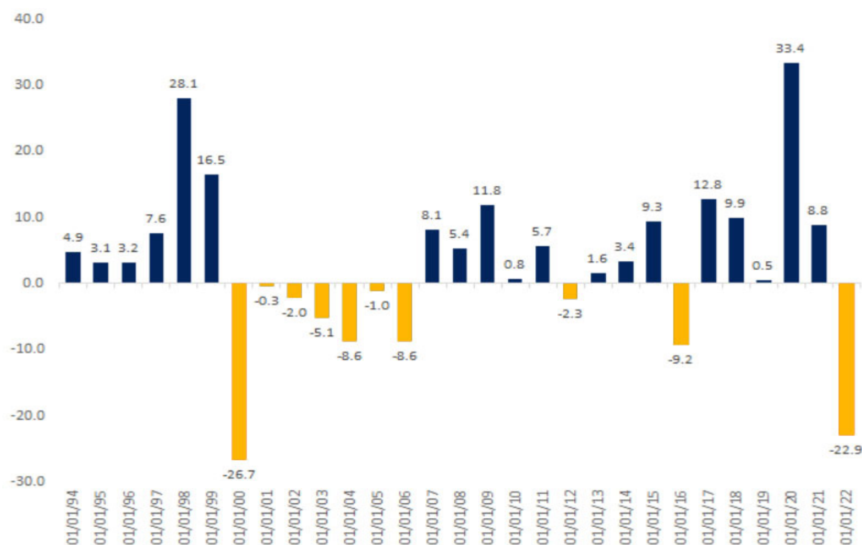
Source: Bloomberg, S&P 500

- This chart shows the annual return of the U.S. 60/40 portfolio. In almost all cases where this portfolio exhibits a negative return, the following year is generally very strong.
- In years where drawdown exceeded 10%, this trend is even stronger, with returns in the mid to high teens.
- **Looking Forward:** The dominant narrative in 2022 was centered around inflation, rising interest rates, geopolitical tension, as well as supply chain issues. Interest rates are approaching the terminal Fed-funds rate, supply chain issues have waned and volatility in commodities due to geopolitical pressure has somewhat normalized. The above bodes well for the broader markets in 2023 and 2024.

Value Outperformed Growth in 2022

One of the most significant trends that emerged in 2022 was the outperformance of value oriented companies, relative to its growth-focused counterparts. Over the past decade, and particularly after the GFC, we have seen growth largely outperform value. This also held true throughout the pandemic as central banks of the world cut rates significantly in an attempt to stimulate the economy and mitigate the effects of lockdowns. As interest rates rose rapidly in 2022, we saw pressure on companies carrying more debt, leading to a flight to safety and quality as investors moved towards more defensive value-based companies.

S&P GROWTH VS. S&P VALUE (ANNUAL INDEX PERFORMANCE, %)



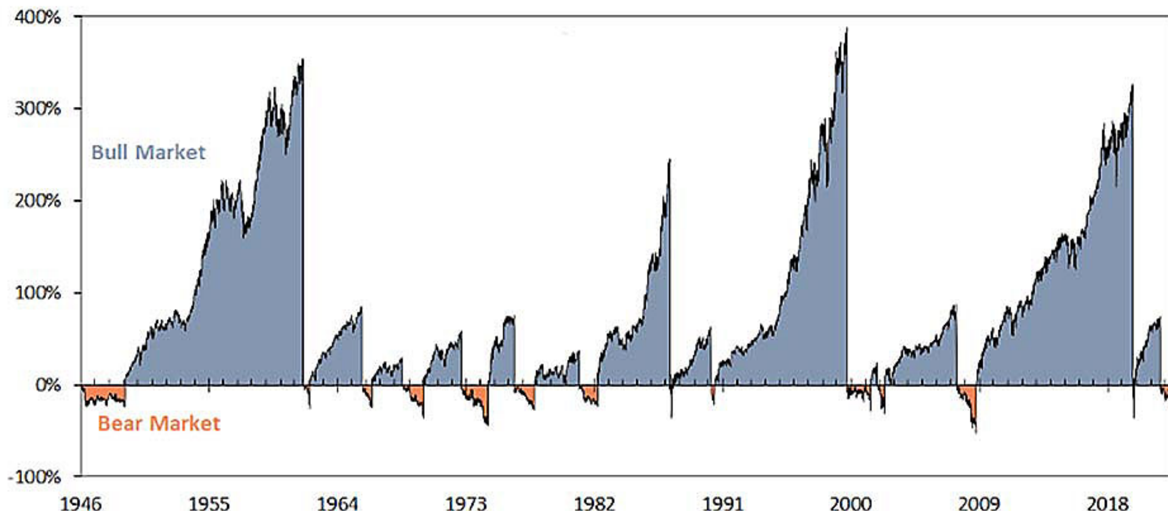
Source: Bloomberg, S&P 500

- The chart above shows the relative performance of value and growth based companies in the S&P500 by calendar year.
- In 2022, value outperformed growth by 22.9%. This was the largest outperformance since the tech crash in 2001.
- Given guidance on the Fed-funds rate, we would expect a more favourable environment for value based companies to continue. Many growth focused companies may face challenges navigating a prolonged period of higher rates, as their multiples are revised downwards.
- **Looking Forward:** Given the current interest rate environment, as well as Fed guidance, we would expect value to continue to outperform growth in the near term. However, as the Fed completes its planned fiscal tightening, and yields move lower, we would expect a rebound in growth. This highlights again why active management will be paramount in 2023 and 2024.

Focus on the Long Term

At any given time, the markets are reflecting investor sentiment of asset prices into the future. Depending on market conditions, this may be focused on the shorter term (3 months ahead), or longer term (12 - 18 months ahead). This past year, with so much volatility, investor focus was certainly on the short term. Given cooling inflation and deflationary markers such as China's reopening and commodities prices moderating, investors should be shifting their focus back towards their long-term goals.

BULL MARKETS IN HISTORY HAVE BEEN LONGER AND STRONGER THAN THE BEAR MARKETS THAT PRECEDED THEM



Source: Bloomberg, Dow Jones

- The chart above displays the size and duration of both bear and bull markets over the last 80 years.
- The average bear market has a -34% return, and lasts about 15 months, whereas the average bull market has a 167% return and lasts about 3.8 years.
- **Looking Forward:** As discussed above, given that so many of the prevailing headwinds have either waned or have been priced in, it is likely that the bear market that began in 2022 concludes this year. The predominant story remains focused on inflation and interest rates, and although some hallmarks of a fresh bull market are yet to emerge, the probability of moving past this bear in the near term is certainly more likely than the opposite.

The Optimize Perspective

Overall, 2022 was a year of high volatility, with inflation data, interest rates, geopolitical uncertainty, and continuing headwinds from the pandemic taking the focus. But over the last year, the U.S. Fed-funds rate has climbed from 0.25% to 4.5%. The spike in commodity prices we saw due to geopolitical tensions have mostly normalized and inflation is beginning to moderate downwards.

Despite volatility, the Optimize Portfolios performed strongly with respect to both equity and income-focused mandates. We saw value-based companies significantly outperform growth in 2022, and we expect this trend to continue for at least the short term, with opportunities for growth and more cyclical sectors emerging. Something we are also monitoring is the movement of the U.S. Dollar; as was observed in Q4, this will have an impact on equity performance of U.S. multinationals that may play into how earnings are perceived and reported.

On the yield-focused side of the ledger, 2022 provided ample opportunity for tactical decision making. In reducing exposure to investment grade debt, as well as other rate-sensitive investments such as real estate, we were able to add significant value by reducing downside risks in a material way. We expect to see some continued challenges in the real estate space, but strategy selection will be the key driver of success. Projects able to better account for, and pass on higher interest rates will be able to shine, where the same factor will play to the detriment of competitive projects. We also expect to see tactical buying opportunities in the investment grade debt space, although we believe broadly that equity continues to carry better risk adjusted returns based on current valuation.

We have seen evidence of wage growth deceleration, while maintaining robust employment figures, suggesting the Fed may successfully engineer a soft landing, potentially avoiding recession. With China's economy gradually beginning to reopen, supply chain issues will continue to abate, which should further fuel deflationary pressures. All this to say, we are optimistic for the year ahead and very much looking forward to the opportunity these markets are presenting us.

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