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INVESTMENT NOTES

DECEMBER 2022

UPCOMING 2023 BNN SHOWS

Christine: January 18 @ 12 pm

Christine: February 17 @ 12 pm

Christine: March 21 @12 pm

Equity markets staged a muted bounce in the last quarter of what can be described as a tumultuous year. Following strong price gains in 2021, global equity indices posted negative returns in 2022. Historically viewed as a safe harbour, bonds offered little respite, as illustrated by the -11.4% return posted by the Canadian Broad Bond Composite Index and -13.0% by the Bloomberg U.S. Aggregate Bond Index. Both asset classes reacted negatively to sharply higher interest rates driven by aggressive monetary tightening by central banks to quell inflation and restore price stability.

While inflation has likely peaked, it remains well above the 2% target range, meaning central banks still have work to do. Policymakers will be faced with trade-offs in 2023, as they juggle elevated inflation and higher interest rates with the possibility of triggering a recession along the way.

Central Bank Policy

Interestingly, there is a difference between market and central bank expectations about where interest rates are headed. The Fed Funds rate is currently 4.4%. Central banks continue to prioritize controlling inflation, pointing to a historically low unemployment rate as an offset to the impact of higher interest rates. The Federal Reserve has publicly observed that nominal wage growth is elevated (4.6% year-over-year in December 2022) and would require some softening in the growth of labour demand to bring the labour market back into better balance. Once again, like price inflation of goods, the ability to influence labour supply is beyond the Fed's reach; however, Fed policy can lower demand to bring the labour market closer to equilibrium.

The U.S. unemployment rate is 3.5% and the Federal Reserve is projecting it to rise to 4.6% in 2023, up 1.1% point from this cycle's low of 3.5%. As David Rosenberg points out, historically, by the time the unemployment rate had risen by 1.1%, the economy was six months into a recession. This suggests a policy shift toward supporting growth as recession conditions unfold at some point later in 2023.

Accordingly, the market's consensus is that the Fed Funds rate will peak mid-year at 5.1%, with rate cuts starting in the back half of 2023, leading to a year-end rate of 4.6%. In contrast, the Fed projects the rate to be 5.1% at the end of 2023 with no rate cuts planned this year. We note that a year ago, the Federal Reserve projected the Federal Funds rate would be 0.9% at the end of 2022 and 1.6% at the end of 2023.

Forecasts, regardless of the source, should be taken with a grain of salt, however, they do set market expectations which in turn drive volatility depending on the actual outcome.

Economic Indicators

Restrictive monetary policy is slowing economic growth. Due to the lagged effect of monetary policy, the impact of higher interest rates and borrowing costs will be more fully felt in 2023. Tighter financial conditions for households and businesses will dampen consumption and investment as well as increase the cost burden of existing debt. The leading indicators we track signal a broadening economic slowdown, although the depth and duration remain to be seen.

The U.S. Treasury yield curve has been inverted since July 2022, with the 10 Year/2 Year spread presently at -65 basis points. The negative spread suggests high short-term interest rates (reflecting current inflation) will inevitably lead to slower economic growth, resulting in rate cuts over the medium-term. Historically, an inverted yield curve is one of the best leading indicators of a recession, and typically inverts an average 11 months prior to a recession's onset.

The ISM Manufacturing and Services indices are gauges of future economic activity; a reading above 50 designates expansion from contraction activity. Both indices have been steadily declining in 2022 and more recently fell below the 50 threshold (charts 1 and 2).

The ISM Services Index plunged into contraction in December, after 30 consecutive months of growth. The ISM Manufacturing Index has been in contraction for the last two months. New orders and production continued to trend lower and were also in contraction territory. That said, there were some silver linings in the December 2022 report: (1) the prices paid component continued to decline, approaching the lows hit amid the height of the pandemic lockdowns (chart 3), suggesting the rapid pace of Fed tightening is being met with a drop in price pressures; (2) weakness in manufacturing activity has yet to meaningfully weigh on manufacturing employment, with hiring in expansionary mode.

The Conference Board Leading Economic Index (LEI) is a predictive indicator that anticipates turning points in the business cycle by about 12 months. The LEI for the U.S. peaked at a record high in February 2022 and has since declined for the nine consecutive months. It continues to signal a recession is on the horizon, with the six-month average change falling to -0.6%, well below the 0.4% threshold decline that has been historically indicative of a coming recession (chart 4).

The Consumer

Given the significance of the consumer sector in many developed economies, the overall features of the consumer debt profile are relevant in assessing the impact of higher interest rates. According to a study by Wells Fargo, Canada stands out as having one of the highest ratios of household debt to disposable income at 184% (chart 5) and interest expense to disposable income at 7.2% (charts 6). These metrics suggest a higher sensitivity to rising interest rates for Canadian households than other countries.

A positive trend for the Canadian consumer sector is the robust immigration targets set by the government. Canada welcomed a record high 437,000 new permanent residents in 2022, with plans to approve 500,000 new immigrants per year through to 2025. Most new spots have been set aside for “economic immigrants”, who either have money to invest, have highly desirable skills, or can demonstrate that they are capable of opening businesses. The influx of new residents is equivalent to 3.8% of Canada’s population, which is supportive for the general economy.

Geopolitics

Geopolitics took center stage in 2022 and is expected to remain so with the Russia/Ukraine war seemingly no closer to ending. China will also remain a focus given a globally coordinated approach to containing China’s rise as a global superpower as evidenced by the U.S. government restricting exports of certain equipment and services to Chinese semiconductor companies. In addition, Chinese hostilities toward Taiwan will need to be monitored.

The geopolitical climate has shifted dramatically over the past year and the longstanding trend of globalization has shifted backwards. Security and proximity of supply are also considerations along with cost in the decision-making process. A possible implication of de-globalization is a generally higher price stability framework in excess of the Fed’s 2% target range, and the end of an era of historically low interest rates (Chart 7).

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On a positive note, re-globalization will promote capital investment as companies build new factories and plants located in "friendly" nations (friend-shoring) or closer to end markets (on-shoring).

China Reopening

The rapid reversal of China's zero-COVID strategy, in the wake of widespread protests across the country in November, will be good news for both the world's second-largest economy and global trade as a whole… eventually. The strict lockdowns imposed upon residents likely resulted in Chinese GDP growing by less than 3% in 2022, versus an official target of 5.5%. These lockdowns hurt nearly every aspect of the Chinese economy: its 1.4 billion residents consumed less as they were stuck at home, its exports fell as factories closed, and its businesses' investments plummeted thanks to the uncertainty about when things would return to normal.

While a return to normal now looks to be occurring sooner than what was expected a few months ago, it's going to be a bumpy ride getting there. The Economist reports that an estimated 37 million people are now catching COVID every day in a reopened China, and the health data firm Airfinity estimates that 9,000 people are dying every day. Chinese officials' refusal to adopt the Western-developed mRNA in favour of domestically developed – yet somewhat ineffective – vaccines is one cause. Another is a low vaccination rate, with 32% of those older than 60 having no protection against COVID. So, while investors can now look forward to China resuming its ravenous demand for commodities, labour, and global goods, the timing of when this demand returns to normal remains uncertain.

Corporate Profits

2022 earnings per share (EPS) projections for S&P 500 Index companies declined just 1.3% from the beginning of 2022 to the end of the year, whereas the price-to earnings (P/E) ratio declined from 20.6x to 16.7x. Thus, the negative return posted by the S&P 500 Index in 2022 was mainly due to a contraction in the valuation multiple.

For S&P/TSX Composite Index companies, 2022 EPS projections rose 14% throughout the year (mainly due to higher earnings from the energy sector), whereas the P/E multiple contracted from 15.7x to 12.7x.

Despite negative revisions for 2023 EPS, corporate profits are expected to be up 4.1% and 5.0% for the for the S&P 500 Index and S&P/TSX Composite Index, respectively. Current consensus estimates are not baking in a recession, which has historically resulted in a 13% median drop in annual EPS. The upcoming earnings season scheduled to start later this month will provide more clarity as senior management teams issue guidance for this year.

Recession and Equity Markets

If you were able to predict now, with 100% certainty, that a recession was coming in 2023, how would that affect your investment decisions? It would likely be tempting to sell everything and wait until the economy is on stable footing again before buying back in. But if history is any guide, the worst of the recession-driven market performance may already be behind us.

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Markets are forward-looking, constantly trying to anticipate events that are in the future. How they attempt to anticipate recessions is no different. Chart 8 shows how equity markets have both anticipated and responded to Canadian recessions over the last 40 years. Since 1982, annual Canadian GDP has decreased year-over-year four times: in 1982, 1991, 2009, and 2020. In three of those four instances, the S&P/TSX Composite Total Return Index fell in the preceding year (the one exception is 2020; it seems equity markets are poor at predicting global pandemics). Furthermore, the Index increased during every one of those four years that actually realized negative GDP growth.

Similar data is applicable to the U.S. stock market. Since 1947 there have been 12 instances of negative GDP years. In the years prior to those 12 instances the S&P 500 Index realized an average return of -7.5%. During the actual years of those GDP decreases the Index was up an average of 13.6%. With both Canadian and U.S. indices realizing negative returns in 2022, time will tell whether 2023 will bring another recession rally.

Conclusion

The decline in broad equity indices in 2022 already reflects many of the concerns we have discussed for 2023. While all market participants are currently making educated guesses about what 2023 has in store, history has shown that nearly all of these guesses will prove to be wrong. Accurate macroeconomic forecasting over the short-term is incredibly difficult (some people would even say it's impossible). That's why we'll continue to focus our efforts where we believe history has shown we can add value: investing for the long-term by forecasting out through full economic cycles. While it can be tempting to voice an opinion about where the economy and markets will take us over the coming weeks and months, we believe it's much more prudent to look past this short-term noise and own companies with strong fundamentals that can withstand any economic shocks we may (or may not) see coming.

Christine Poole, MBA, CFA
Alexander MacDonald, CFA, P.Eng., MBA

CHART 1: ISM Manufacturing Index (Diffusion Index)
- Institute for Supply Management and Wells Fargo Economics

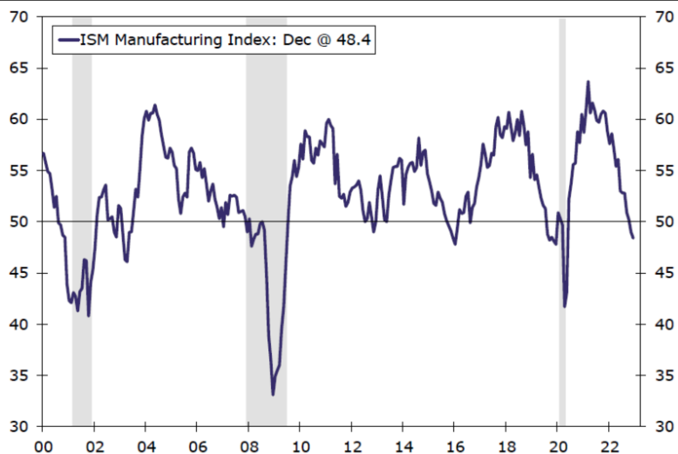

CHART 2: ISM Services (Composite Index)
- Institute for Supply Management and Wells Fargo Economics

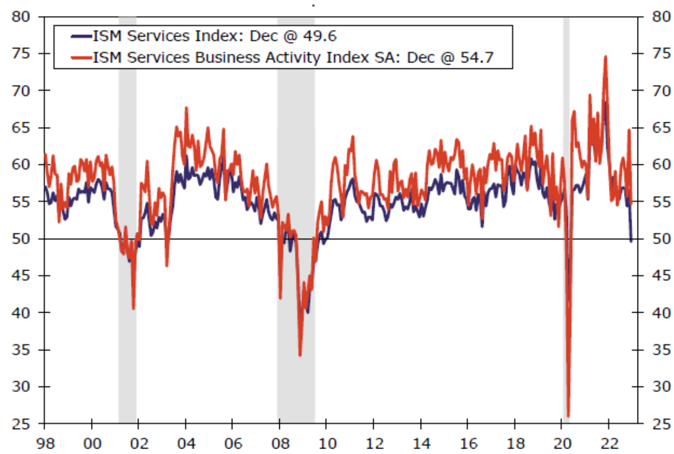

CHART 3: ISM Prices Paid Index (Diffusion Index)
- Institute for Supply Management and Wells Fargo Economics

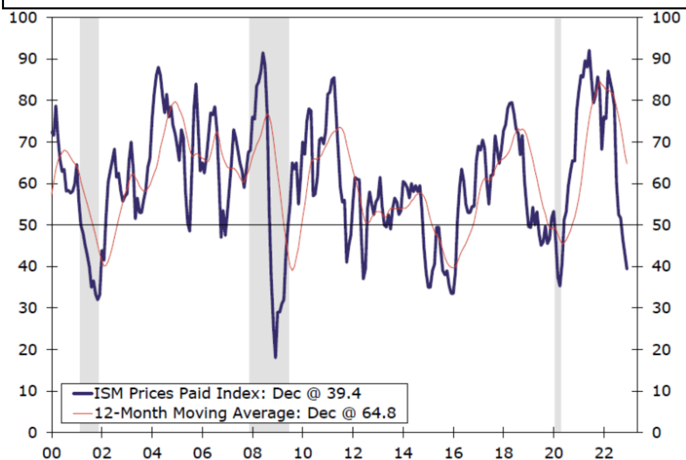

CHART 4: Leading Economic Index (Six-Month Average of Monthly Change)
- The Conference Board and Wells Fargo Economics

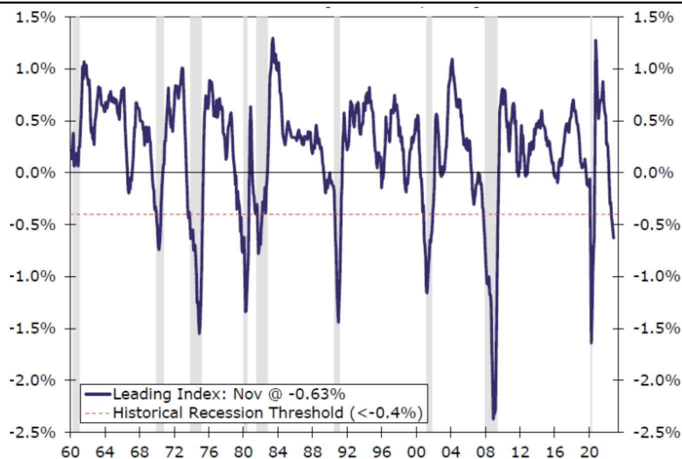

CHART 5: Household Dept to Disposable Income (Percent)
– Datastream and Wells Fargo Economics

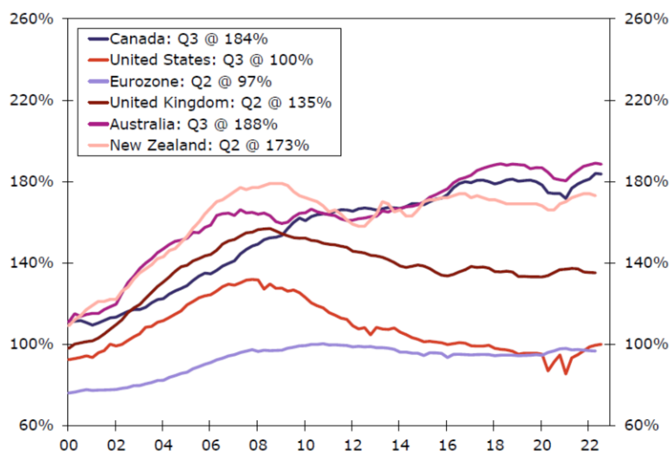

CHART 6: Interest Expense to Disposable Income (Percent)
– Datastream and Wells Fargo Economics

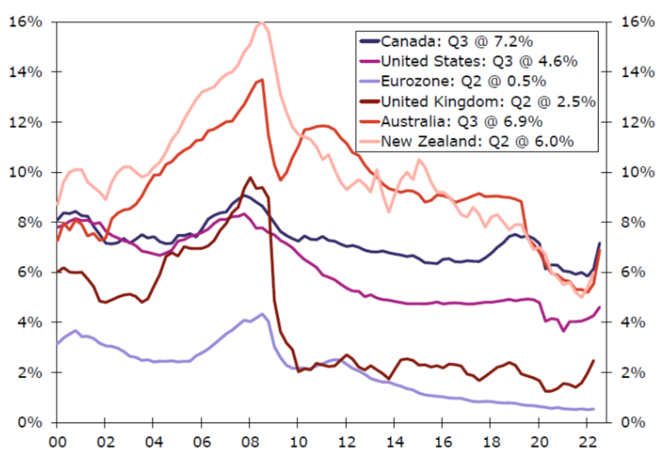

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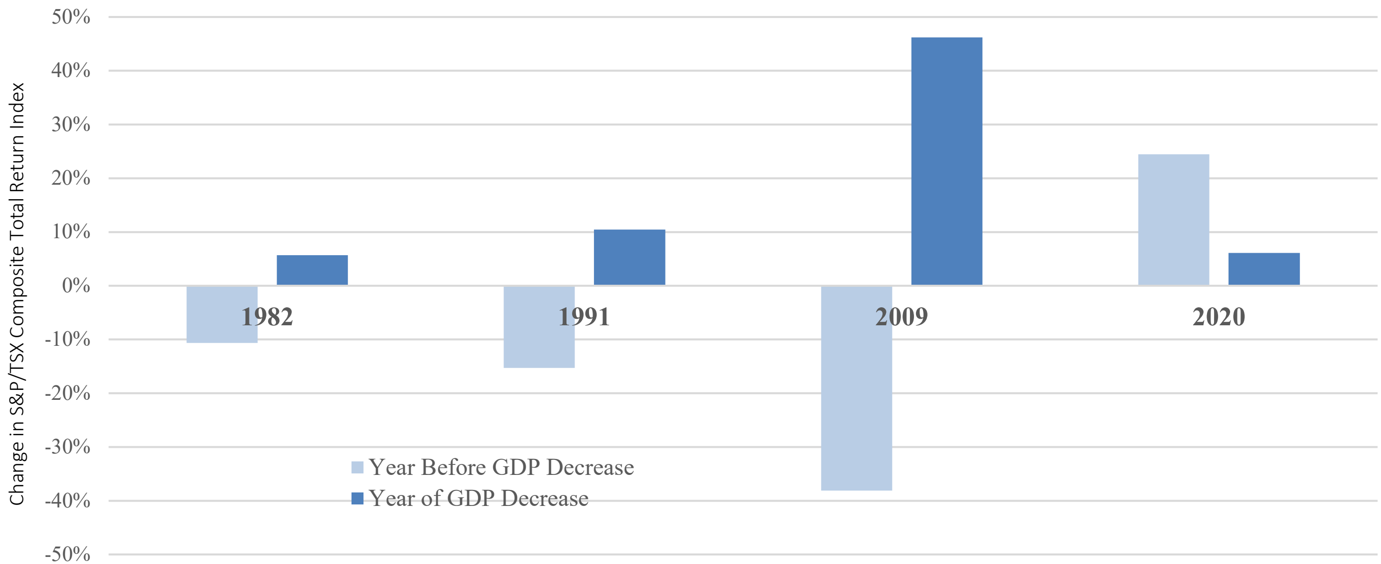
CHART 7: Market yield on U.S. Treasury Securities at 10- Year Constant Maturity, Quoted on an Investment Basis
– Bord of Governors of the Federal Reserve System (US)

Note: Shaded areas indicate U.S. recessions.

CHART 8: What Could a 2023 Recession mean for Equity Makers?
– Statistics Canada, Bloomberg Finance L.P.



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RECENT BNN SHOWS

Christine: December 16, 2022

Christine: November 18, 2022

Christine: October 18, 2022

Christine: September 20, 2022

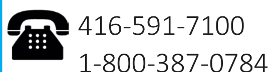
Christine: August 23, 2022

Christine: July 19, 2022

Christine: June 14, 2022

20 Queen St. West, Suite 3308 Toronto, ON M5H 3R3

www.globe-invest.com



416-591-7100
1-800-387-0784

416-591-7133

info@globe-invest.com

DECEMBER 31, 2022 STATISTICAL SUMMARY

STOCK MARKETS	QTD	YTD	3 YEARS*
S&P TSX COMPOSITE TOTAL RETURN (CAD)	6.0 %	-5.8 %	7.5 %
S&P 500 TOTAL RETURN (CAD)	5.4 %	-12.2 %	9.2 %
S&P 500 TOTAL RETURN (USD)	7.6 %	-18.1 %	7.7 %
DJIA TOTAL RETURN (USD)	16.0 %	-6.9 %	7.3 %
NASDAQ COMPOSITE PRICE RETURN (USD)	-1.0 %	-33.1 %	5.3 %
MSCI WORLD INDEX PRICE RETURN (CAD)	7.2 %	-13.6 %	4.8 %
MSCI WORLD INDEX PRICE RETURN (USD)	9.4 %	-19.5 %	3.3 %
CANADIAN UNIVERSE BOND INDEX	0.4 %	-11.4 %	-2.1 %

***ANNUALIZED**

COMMODITIES	QTD	YTD
GOLD	7.9 %	-0.8 %
SILVER	23.6 %	2.0 %
COPPER	8.9 %	-14.1 %
NATURAL GAS (NYMEX)	-33.9 %	20.0 %
WTI	1.0 %	6.7 %
BRENT	-4.3 %	6.8 %

TREASURY BONDS	12/31/22	12/31/21	09/30/22
2 YEAR (CAD)	4.06 %	0.98 %	3.79 %
2 YEAR (US)	4.41 %	0.73 %	4.22 %
5 YEAR (CAD)	3.41 %	1.28 %	3.32 %
5 YEAR (US)	3.99 %	1.26 %	4.06 %
10 YEAR (CAD)	3.30 %	1.45 %	3.16 %
10 YEAR (US)	3.88 %	1.52 %	3.83 %
30 YEAR (CAD)	3.28 %	1.72 %	3.09 %
30 YEAR (US)	3.97 %	1.90 %	3.79 %
CPI (CAD)	6.80 %	4.70 %	7.00 %
CORE CPI (CAD)	5.40 %	3.60 %	5.30 %
CPI (US)	7.10 %	6.80 %	8.30 %
CORE CPI (US)	6.00 %	4.90 %	6.30 %

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