CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

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Welcome to our special year-end review

How were the stock markets in 2022? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2023 and beyond.

We hope you find this review informative and useful. Enjoy!

Stan

Year-End Review

DESPITE HIGH INFLATION, GLIMMERS OF RECOVERY

By Stan Clark and Michael Chu

The main economic themes at the end of 2022 remain similar to those we saw mid-year. Inflation is too high, with most central banks continuing to rapidly drive rates upwards. The slowing economy still threatens to fall into a recession. Fortunately, there have been several positive shifts of late.

The biggest shift is that inflation seems to have peaked. It is unlikely to fall smoothly or quickly, but should be a reduced threat in 2023. Central banks will feel less pressure to raise rates. The banks may soon even "pivot," reversing their policy outlook.

	Q1	Q2	Q3	Q4	2022
Canada (S&P/TSX)	3.8%	-13.2%	-1.4%	6.0%	**-5.8%**
U.S. (S&P 500)	-5.6%	-13.6%	2.2%	5.4%	**-12.2%**
EAFE (Europe, Australasia, Far East)	-6.9%	-12.0%	-2.6%	15.0%	**-8.2%**
Emerging Markets	-7.9%	-8.8%	-5.0%	7.5%	**-14.3%**
World	-6.1%	-13.7%	0.8%	7.6%	**-12.2%**

Source: Bloomberg

For 2022 the World Equity Index, a gauge of stocks around the world, was down 12.2% (in C$). At home, the TSX was down 5.8%. The chart above shows the returns of major stock markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

Valuations

Stock prices were down in 2022, but what happened to valuations? If expected company earnings stay about the same, valuations become cheaper and more compelling going forward.

That's what's happening so far. Top economist Ed Yardeni forecasts higher earnings in 2023, about 5% growth from 2022. The current forward price-to-earnings (P/E) ratio is 16.7 times earnings. This is significantly cheaper than the 22 to 23 range we had just a couple years ago. Of course, if the economy weakens *more* than analysts expect, earnings forecasts could come down. Then forward valuations would not be as good.

You can also compare stocks to *trailing earnings* (last year's earnings) instead of forecasted earnings. Last year, trailing P/E ratios for Canada and the U.S. were 17.1 and 26.1, respectively. This year, trailing P/E ratios are much cheaper at 12.7 and 19.4. Basically, valuations are about 25% better than last year – which bodes well for stocks going forward.

	Trailing P/E	Trailing Eanings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	12.7	7.9%	3.4%	3.1%
U.S. (S&P 500)	19.4	5.2%	1.7%	3.6%
Europe	13.4	7.5%	3.3%	2.5%
Japan	13.8	7.3%	2.6%	0.6%
EAFE (Europe, Australasia, Far East)	13.7	7.3%	3.3%	1.9%
Emerging Markets	12.2	8.2%	3.4%	3.4%
World	17.1	5.9%	2.2%	3.3%

Source: Bloomberg

How did we do?

Our strategies had negative returns for 2022, but outperformed their respective benchmarks – reducing losses for our clients.

Composite	2022 Strategy	2022 Benchmark	10-Year Strategy	10-Year Benchmark
Disciplined Canadian Stock	3.0%	-5.8%	11.6%	7.7%
Disciplined U.S. Stock (in US$)	-14.6%	-18.1%	11.4%	12.6%
Disciplined World Equity	-6.0%	-8.8%	12.4%	10.2%
Dividend Select World Equity	-4.5%	-8.9%	11.9%	9.5%
Disciplined North American Equity	-7.9%	9.6%		

Our Canadian stock strategies (Disciplined Canadian Stock) returned 3.0%; the TSX Index was -5.8%. Our U.S. stock strategies (Disciplined U.S. Stock), returned -14.6%; the S&P 500 was -18.1% (in US$).

We also have two global portfolios made up of our multiple stock strategies. The Disciplined World Equity composite returned -6.0%, compared to a benchmark -8.8%. This portfolio is roughly 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned -4.5%, compared to a benchmark of -8.9%. This portfolio has a slightly higher weighting in Canada and dividend payers.

We also have a North American composite, which returned -7.9%, compared to the benchmark of -9.6%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are for stocks. Clients with less than 100% in stocks would have higher or lower returns. These returns are also before fees.

Bond market blues

Many investors welcomed higher interest rates. Yields on long-term bonds are about three times higher than they were at the end of 2020, rising from about 1% to 3%. The flip side of higher interest rates is that bond prices go down. Those same bonds that were paying three times more in interest are also down 10% in price.

There's usually a beneficial relationship between stock and bond returns. Bonds tend to provide stability when stocks go down. But in 2022 a rarity occurred: Both stocks and bonds were down considerably. Losses in bonds were mainly due to the exceptionally fast pace of monetary tightening, which should abate going forward. Plus, since bonds were starting from such a low yield, the losses were larger than typical. As expectations of rate hikes scale back, the historical relationship of bonds providing protection should reassert itself.

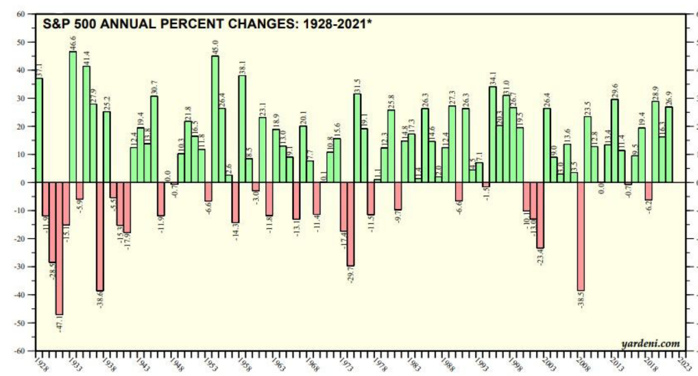
Taking away the punchbowl

For much of the past decade, inflation was little more than an afterthought. Then, for most of 2022, inflation and interest rates captivated investors' attention. There had been an outburst of stimulus to prevent a full-scale economic collapse after the once-in-a-century pandemic. That stimulus fanned inflation's flames.

However, thanks in part to the stimulus, the feared economic collapse never came. Instead the economy roared back to life.

For a time, this seemed like the best of both worlds for investors. Strong demand produced record revenue and earnings, and lower interest rates pushed up valuations, causing stocks to climb ever higher. Despite a clear improvement in the economy, the U.S. Fed kept interest rates low and the government continued to spend trillions on fiscal stimulus.

Today, investors are dealing with the aftermath of fiscal and monetary policy that stayed much looser and much longer than called for. The result is raging inflation that had to be reined in with rapid interest rate hikes. The impact on markets is twofold. Higher interest rates reduce the present value of cash flows, reducing the intrinsic value of stocks. Higher interest rates also slow the economy.



* Annual percent changes based on year-end values except 1928, which uses Jan 3, 1928 for year-end 1927.
Source: Standard & Poor's and Haver Analytics.

Why are investors so worried about inflation? Because, in the short run, it's bad for the bottom line. Inflation increases the cost of doing business. And, if businesses can't push through price increases, inflation reduces margins. It can also destroy demand and reduce revenue if customers are forced to pare back on purchases. Demand has so far been less of an issue, given employment and wage growth remain strong. Investors seem more focused on company profit margins.

Life is full of surprises

2022 was a tough year for investors. The consensus view is that 2023 could be just as tough. With a quick scan of the media, you'll see plenty of headlines like, "Recession is looming" and "Majority of economists say U.S. is heading for a recession in 2023."

The bearish narrative is that inflation may remain too high in 2023, forcing the Fed to raise interest rates even higher until a credit crunch and recession result. Another energy shock, or China's COVID-19 crisis, could worsen and further disrupt global supply chains. The Ukraine war could spread, with unpredictable consequences.

In 2022, falling valuation multiples caused a bear market for stocks, while, as noted above, earnings held up surprisingly well. According to the bears, 2023 will be the year the earnings will fall, driving valuations and stock prices even lower. According to Ed Yardeni, since 1928 there have been 29 down years for the S&P 500, with 20 followed by *rising* stock prices and only eight followed by at least another consecutive down year.

The S&P 500 was down 18.1% in 2022 in US$. Yardeni thinks 2023 will be an up year. He is expecting a 60% chance of a soft landing and 40% chance of a hard landing in 2023. He thinks the economy is much more resilient than it was in the past and less prone to a credit crunch. Yardeni believes the economy is experiencing a "rolling recession," that is, different industries slowing at different times, causing inflation to moderate without the need for an economy-wide drop. So he doesn't expect a hard landing for earnings.

There's no shortage of articles about what could go wrong in 2023. But from a contrarian perspective, that's supportive of what could go *right* for 2023.

Diving deeper into the U.S. presidential cycle

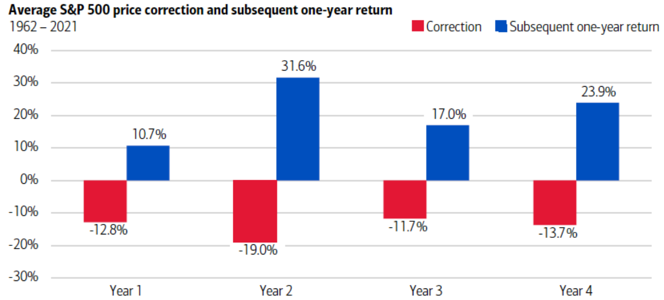
In past articles, we've discussed the relationship between stock market performance and the U.S. presidential cycle. Typically years three and four have higher-than-average returns, while years one and two have lower-than-average returns. That bodes well for 2023, as it is year three. But let's take a deeper dive into the presidential cycle.

Past mid-term election years have featured significant policy-related market volatility. On average they have included the largest corrections of any single year in the presidential cycle. Over the past six decades, the average intra-year decline for the S&P 500 in a mid-term election year has been 19%. This is much worse than the typical drawdown in years one, three and four. One explanation is that lawmakers introduce measures that enjoy popular support but are viewed unfavorably by investors. 2022 was no different, with the S&P 500 down 18%, sanctions imposed on Russia reducing global energy supply, and the Federal Reserve raising interest rates to fight high inflation.

Fortunately, mid-term year volatility has typically been followed by strong recoveries, with markets up an average of 32% one year after the mid-term election-year low. Just as market negative policies may explain periods of weakness in past mid-term years, subsequent strength may be associated with expectations for economic stimulus ahead of the presidential election campaign season. Every cycle is different, but this tendency is worth remembering.

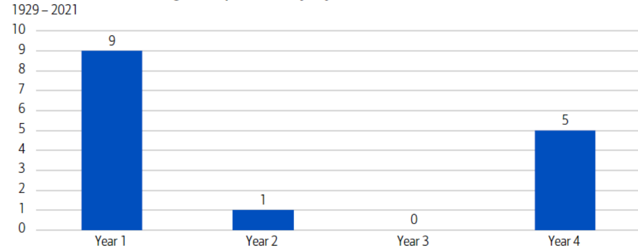
Another reason that stocks are higher in year three is that, since 1929, there has never been a recession in year three. But with today's monetary policy expected to tighten further, recession risks may be higher in the current environment. The no-recession record for year three could be snapped in 2023.

Average S&P 500 price correction and subsequent one-year return
1962 – 2021



Source: Strategas Research Partners, Chief Investment Office. Data as of October 14, 2022. **Past performance is no guarantee of future results.**

Number of recessions starting in each presidential cycle year
1929 – 2021



Source: Strategas Research Partners, Chief Investment Office. Data as of October 14, 2022.

Divided government

As expected, the mid-term elections in the U.S. resulted in a divided government.

But there are two kinds of divided government: 1) where both houses of Congress are held by one party and the White House held by the other, and 2) where the two houses of Congress are held by different parties, i.e., a split Congress. This time, we have the latter. It's interesting to note that short-term investment returns historically have been best under a split Congress. As you can see in the chart, the S&P 500 has risen significantly more in the two-year period after election day with a split Congress:

- Average gain over two-year period: 16.9%
- Average gain during a split Congress: 18.7%
- Average gain with unified control: 17.3%
- Average gain with a unified Congress and president from an opposing party:15.7%.

Stock market drop predicted for 2023

"Stock market drop predicted for 2023." Such a headline is typical and sounds scary, but it's hardly a bold statement. Stocks drop almost every year! Ben Carlson of Ritholtz Wealth Management made the following chart to show the returns every year for the S&P 500, along with the peak-to-trough drawdown.

Year	Return	Drawdown
1928	43.8%	-10.3%
1929	-8.3%	-44.6%
1930	-25.1%	-44.3%
1931	-43.8%	-57.5%
1932	-8.6%	-51.0%
1933	50.0%	-29.4%
1934	-1.2%	-29.3%
1935	46.7%	-15.9%
1936	31.9%	-12.8%
1937	-35.3%	-45.5%
1938	29.3%	-28.9%
1939	-1.1%	-21.2%
1940	-10.7%	-29.6%
1941	-12.8%	-22.9%
1942	19.2%	-17.8%
1943	25.1%	-13.1%
1944	19.0%	-6.9%
1945	35.8%	-6.9%
1946	-8.4%	-26.6%
1947	5.2%	-14.7%
1948	5.7%	-13.5%
1949	18.3%	-13.2%
1950	30.8%	-14.0%
1951	23.7%	-8.1%

Year	Return	Drawdown
1952	18.2%	-6.8%
1953	-1.2%	-14.8%
1954	52.6%	-4.4%
1955	32.6%	-10.6%
1956	7.4%	-10.8%
1957	-10.5%	-20.7%
1958	43.7%	-4.4%
1959	12.1%	-9.2%
1960	0.3%	-13.4%
1961	26.6%	-4.4%
1962	-8.8%	-26.9%
1963	22.6%	-6.5%
1964	16.4%	-3.5%
1965	12.4%	-9.6%
1966	-10.0%	-22.2%
1967	23.8%	-6.6%
1968	10.8%	-9.3%
1969	-8.2%	-16.0%
1970	3.6%	-25.9%
1971	14.2%	-13.9%
1972	18.8%	-5.1%
1973	-14.3%	-23.4%
1974	-25.9%	-37.6%
1975	37.0%	-14.1%

Year	Return	Drawdown
1976	23.8%	-8.4%
1977	-7.0%	-15.6%
1978	6.5%	-13.6%
1979	18.5%	-10.2%
1980	31.7%	-17.1%
1981	-4.7%	-18.4%
1982	20.4%	-16.6%
1983	22.3%	-6.9%
1984	6.2%	-12.7%
1985	31.2%	-7.7%
1986	18.5%	-9.4%
1987	5.8%	-33.5%
1988	16.5%	-7.6%
1989	31.5%	-7.6%
1990	-3.1%	-19.9%
1991	30.2%	-5.7%
1992	7.5%	-6.2%
1993	10.0%	-5.0%
1994	1.3%	-8.9%
1995	37.2%	-2.5%
1996	22.7%	-7.6%
1997	33.1%	-10.8%
1998	28.3%	-19.3%
1999	20.9%	-12.1%

Year	Return	Drawdown
2000	-9.0%	-17.2%
2001	-11.9%	-29.7%
2002	-22.0%	-33.8%
2003	28.4%	-14.1%
2004	10.7%	-8.2%
2005	4.8%	-7.2%
2006	15.6%	-7.7%
2007	5.5%	-10.1%
2008	-36.6%	-48.8%
2009	25.9%	-27.6%
2010	14.8%	-16.0%
2011	2.1%	-19.4%
2012	15.9%	-9.9%
2013	32.2%	-5.8%
2014	13.5%	-7.4%
2015	1.4%	-12.4%
2016	11.8%	-10.5%
2017	21.6%	-2.8%
2018	-4.2%	-19.8%
2019	31.2%	-6.8%
2020	18.0%	-33.9%
2021	28.5%	-5.2%
2022	-18.01%	-25.4%

Data Sources: NYU, Bloomberg (My Calculations)

As you can see, yearly the stock market is up about 75% of the time. But in every year there is also a drawdown. Even when stocks have a positive year, there are hiccups along the way.

No one can predict the stock market in the short term. The key to the above table is that drawdowns will occur, yes. But don't let that dissuade you from believing in the strong long-term performance of the stock market. In order to achieve your long-term goals, make sure you are financially and emotionally prepared for any inevitable bumps along the way.

Inflation

Inflation is still a major issue, peaking in 2022 at almost four times higher than normal. Inflation is very damaging to the economy in the long term, as it results in diminished purchasing power and misallocated resources. In their efforts to restore inflation to normal levels, central banks raise interest rates – which, if taken too far, then threatens short-term economic growth.

Where did all this inflation come from? There were four main sources: supply chain issues, commodity shocks, too much monetary stimulus and too much fiscal stimulus. Fortunately, these supply-and-demand forces have mostly gone into reverse. Inflation trends worldwide seem to be improving. With fewer supply chain problems, these trends are mostly apparent in manufactured goods. Price declines in the service sector seem more tentative, as consumers have pivoted from buying goods to services, and lower commodity prices affect goods producers more than service providers. Wage growth is still elevated but likely decelerating. So in the U.S, signs of both inflation and wages cooling are good news.

Canadian inflation seems less cooperative, with inflation dropping only slightly. However, the same downward forces around the world should eventually apply to Canada: easing supply chain woes, lower commodity prices and tighter monetary policy.

Inflation fighters

The Bank of Canada and the U.S. Federal Reserve have established their reputation as inflation-fighters. They've made it clear that, given the choice between inflation and a recession, they will choose a recession. We're seeing supply-driven inflation diminishing, which means that supply chains are improving and shipping costs are down. This makes it easier for central banks to control the demand-side inflation, as it's more of a domestic issue than something outside the country.

Benjamin Tal, CIBC's chief economist, believes we're at or near the end of the interest-rate-hiking cycle. But Tal feels there will be a lag between the last hike and the first easing move, which we might not see until 2024. This is because central banks must make sure inflation is controlled before they ease monetary policy. The last thing they want is to repeat the mistakes of the 1970s, when a premature easing of monetary policy led to another wave of inflation and the double-dip recession of the 1980s. Of course, you also have to worry about overshooting: Every economic recession was helped, if not caused, by a monetary policy error of raising interest rates too much.

Furthermore, Tal believes that interest rates will settle higher than pre-pandemic levels. He cites new inflationary forces pressuring overall inflation: de-globalization, changing from "just-in-time" to "just-in-case" inventories and tight labour markets. With these at play, the new neutral rate will likely be higher than before.

Recession expectations

Some indicators have historically been triggered before recessions: inverted yield curve, commencement of monetary tightening cycle, and spiking inflation. While none are near-perfect indicators, it's pertinent to take note of them, especially when a few are blinking warning signs at the same time.

Even if a recession does occur, it should be mild. Given the strength of the labour market, a recession could "feel" even milder if there are fewer job losses.

These indicators predict that a recession is more likely than not.

However, with the economy seeming more resilient than expected, the extent of such a recession has arguably shrunk. Even if a recession does occur, it should be mild. Given the strength of the labour market, a recession could "feel" even milder if there are fewer job losses. The job market has been strong in both Canada and the U.S. Canada unemployment is only 5%; U.S. unemployment, 3.5%.

Rising productivity

Worker productivity should increase, due to big advances in the way we work: working and collaborating remotely (saving time and travel expenses), online commerce, greater automation and more services online.

Productivity could increase dramatically over the coming decades due to the above, and especially because productivity growth was so slow in the past decade. Also add in scientific advances in healthcare and artificial intelligence. But there are a few negatives, too: loss of human capital, as children did not learn as much during the pandemic; and a workforce that is aging and therefore less innovative.

Given all these considerations, productivity benefits should emerge. But it could take some time.

Chinese economy

Chinese policymakers continue scrambling to stabilize their economy after a series of bad policy decisions sent it tumbling in 2022. China is currently experiencing a wave of COVID-19 infections. The cause: the government abruptly abandoning its zero-COVID policy. The official numbers suggest oddly few infections and deaths. However, this is widely viewed as a radical underestimation. Leaks from the Chinese Centre for Disease Control estimated 250 million infections for the first 20 days in December.

Hopefully the infection numbers will soon come down. Until then, the Chinese economy continues to suffer, with factories well below capacity and ports starting to back up. There will likely be a temporary deterioration in global supply chains – although the broader trend is toward improvement. China's economy can then revive, providing an important counterweight to economic weakness elsewhere in 2023.

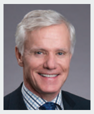
Looking ahead

2022 was a tough year for markets. Fortunately, our stock selection strategies and a stronger U.S. dollar bolstered our returns. Central banks' plans are still up for debate as inflation remains high. Global growth appears to be slowing, while the employment rate remains resilient. Whether we wind up with a soft or hard landing may rest on how persistent inflation will be.

Relative to historical standards, we are experiencing a very rapid pace of interest rate hikes, especially since we're coming out of a prolonged period of low interest rates. Things could become more challenging for more leveraged companies and individuals.

For 2023, as with most years, there will be concerns and challenges. The key is to guard against the temptation to stray from well-established philosophies and processes.

It's worth reminding our readers that the Stan Clark Financial Team doesn't rely on impossible attempts to predict the future. Rather, we aim to build diversified portfolios coupled with resilient financial plans that can adapt and adjust to whatever the future brings. Uncertainty and volatility will always be around: They're just part of investing. But our approach will remain consistent, which includes having a sound plan with an established set of sensible guidelines to help us navigate the future.



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Disclaimer:

Performance results in this document are based on a composite of CIBC Wood Gundy Advisor Managed Account ("AMA") retail accounts with more than $75,000 invested in the "Disciplined Canadian Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined U.S. Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined World Equity (CAD) strategy" (created in November 2008 and includes AMA performance data from January 1, 2009, two months after the Strategy's inception in the AMA program), "Dividend Select World Equity strategy" (created in November 2010 and includes AMA performance data from January 1, 2011, two months after the Strategy's inception in the AMA program), "Disciplined North America Stock strategy" (created in November 2015 and includes AMA performance data from January 1, 2016, two months after the Strategy's inception in the AMA program).

The composite includes open fee-paying discretionary managed accounts where the Strategy has been held for at least two months, through a purchase or a switch from another investment or a different AMA strategy. Also included in the composite are closed accounts that held the Strategy, up to the last full month the Strategy was held.

Composite performance returns are geometrically linked and calculated by weighting each account's monthly performance, including changes in securities' values, and accrued income (i.e., dividends and interest), against its market value at the beginning of each month, as represented by the market value at the opening of the first business day of each month. This Strategy can be purchased either in U.S. or Canadian dollars. Unless specified otherwise, performance returns in this document are expressed in Canadian dollars and are calculated by converting U.S. dollar accounts into Canadian dollars using the month-end Bank of Canada noon rate. Performance returns are gross of AMA investment management fees, and other expenses, if any. Each individual account's performance returns will be reduced by these fees and expenses.

Individual Advisor Managed Account performance results may materially differ from those in this document due to the above and other factors such as an account's size, the length of time an AMA Strategy has been held, cash flows in and out of the individual account, trade execution timing, market conditions and movements, trading prices, foreign exchange rates, specific client constraints, and constraints against purchasing securities of related and connected issuers to CIBC Wood Gundy.

Past performance may not be repeated and is not indicative of future results. This document is prepared for informational purposes only and is subject to change without notice.

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