CIBC PRIVATE WEALTH

Year Ahead Outlook

January 2023

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2023 Year Ahead – Are Superbowl Ads A Contrarian Indicator?

What a year! You made it through. Congratulations and give yourself a pat on the back, you deserve it. We were all promised a fun year coming out of the COVID-19 pandemic but it's becoming apparent that you can't just shut down large parts of the economy and expect to re-start without having a few glitches. While it was a tough year, client accounts held in there well in comparison to market averages.

While 2022 gave us a lot of unforgettable moments, the funniest investment moment of 2022 had to be early in the year with Larry David's Superbowl ad for crypto exchange FTX.

Hold down Ctrl button + Click on the picture below to watch the ad.

We do our best to stay up to date on the latest events in cryptocurrency, however we've definitely 'curbed our enthusiasm' (Larry David fans will get this pun) with respect to doing any investing in this space. Many high-profile investors on the other hand, including the Ontario Teachers' Pension Plan, chose to invest in FTX.

What happened at FTX? On December 13, 2022, Sam Bankman Fried, the founder of FTX, was arrested in the Bahamas for fraud. Lack of regulations and scrutiny allowed Bankman Fried to transfer client money from FTX to his hedge fund, Alameda Research, to cover trading losses. On top of this, massive amounts of leverage were used to cover for Alameda. All while he continued to donate to political campaigns, run Superbowl ads, etc. When a run on the exchange occurred, the house of cards collapsed, and investors and clients lost tens of billions of dollars.

It looks as though on this one, Larry David was right.

What Happened in 2022

In order to understand what happened this past year, we need to look back on the environment in early 2020. Central bankers were worried about a huge economic downturn and deflation, so they resorted to their 2008/2009 playbook by launching one of the most aggressive and stimulative monetary policy programs since World War II. Governments (particularly the U.S. and Canada) pumped a massive amount of fiscal stimulus into the economy - which took off like a rocket ship.

Increasing the money supply and lowering interest rates involved the use of a monetary policy tool called 'quantitative easing' (QE). Use of this method began as an experiment to help revive the economy during 2008/2009. How QE works is still not fully understood (only theorized). Today's serious issue with inflation is largely the result of central bankers misreading the inflationary impact of ultra-low short, medium, and long-term interest rates. Central banks moved short term rates to zero. They also ensured medium and long-term rates declined by printing money electronically and using this money to buy medium and long-term bonds.

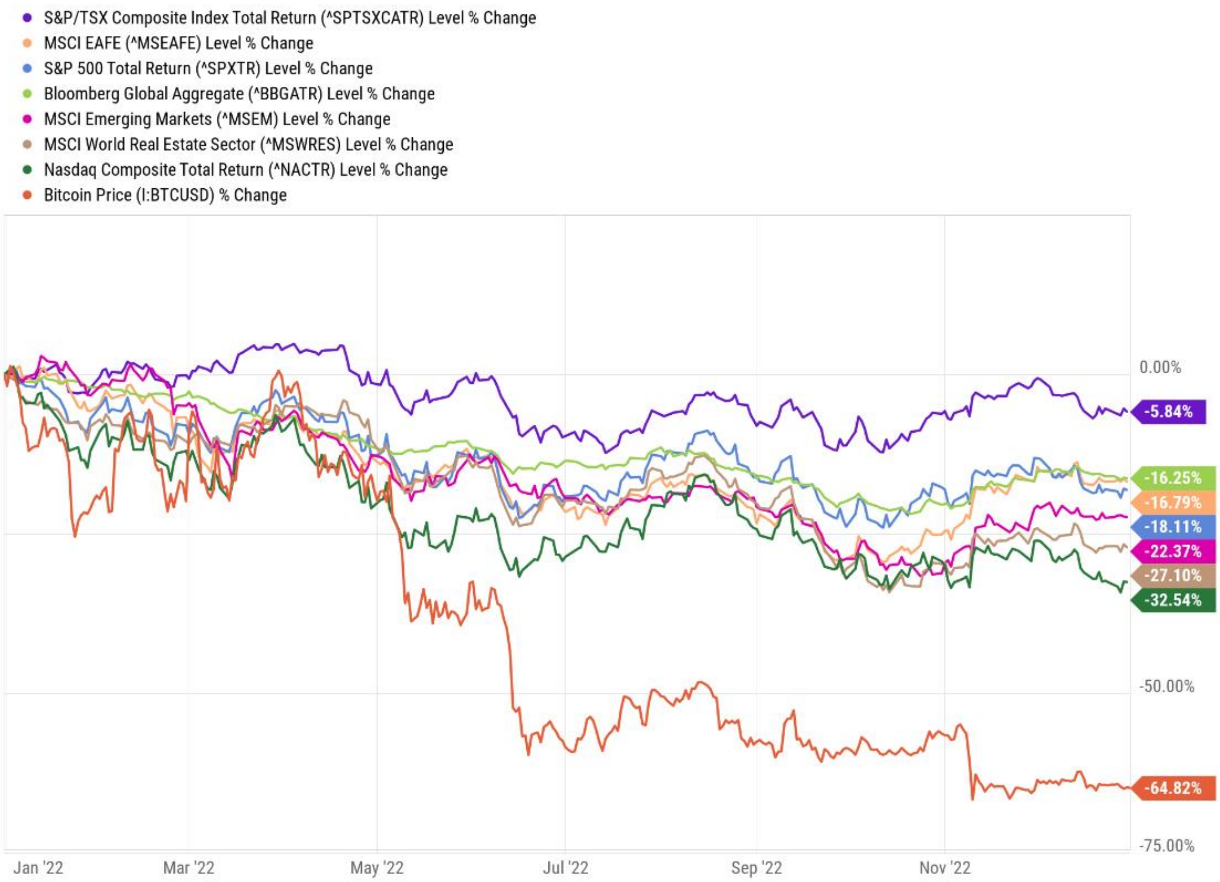
Consumer demand increased almost instantaneously (due to QE and massive government spending) but this stimulus resulted in ‘excess consumer demand’ - creating a problem in the ‘supply side’ of the economy.

You can imagine the turmoil in a business owner’s mind. Employees who were laid off had to be called back months later, but the employer then finds out that their employees don’t want to come back to work at all. Maybe they’ve become dogecoin millionaires or started building virtual properties in the metaverse? Crazier things happened in 2020! Now the employer is struggling to meet all the incoming orders. There’s money in the air and increased consumer spending. It’s all too much! The owner then needs to increase prices (as the prices of his supplies have gone up) and increase wages (to find new good quality workers) to meet the demand for his product. All this chaos led to the resurgence of the central banks most dreaded enemy…inflation.

On February 24, 2022, sadly, Putin invaded Ukraine, causing further disruption to already vulnerable global supply chains. Prices of commodities sky-rocketed and inflation peaked in June 2022 at 9.1% year over year.

This rapid increase in inflation sent central banks into panic mode as out-of-control inflation is incredibly hard to deal with and can wreak havoc on any country. Policy rates were rapidly adjusted upwards. In Canada we went from 0.25% to 4.25%, devastating the bond market and causing a correction in the equity markets.

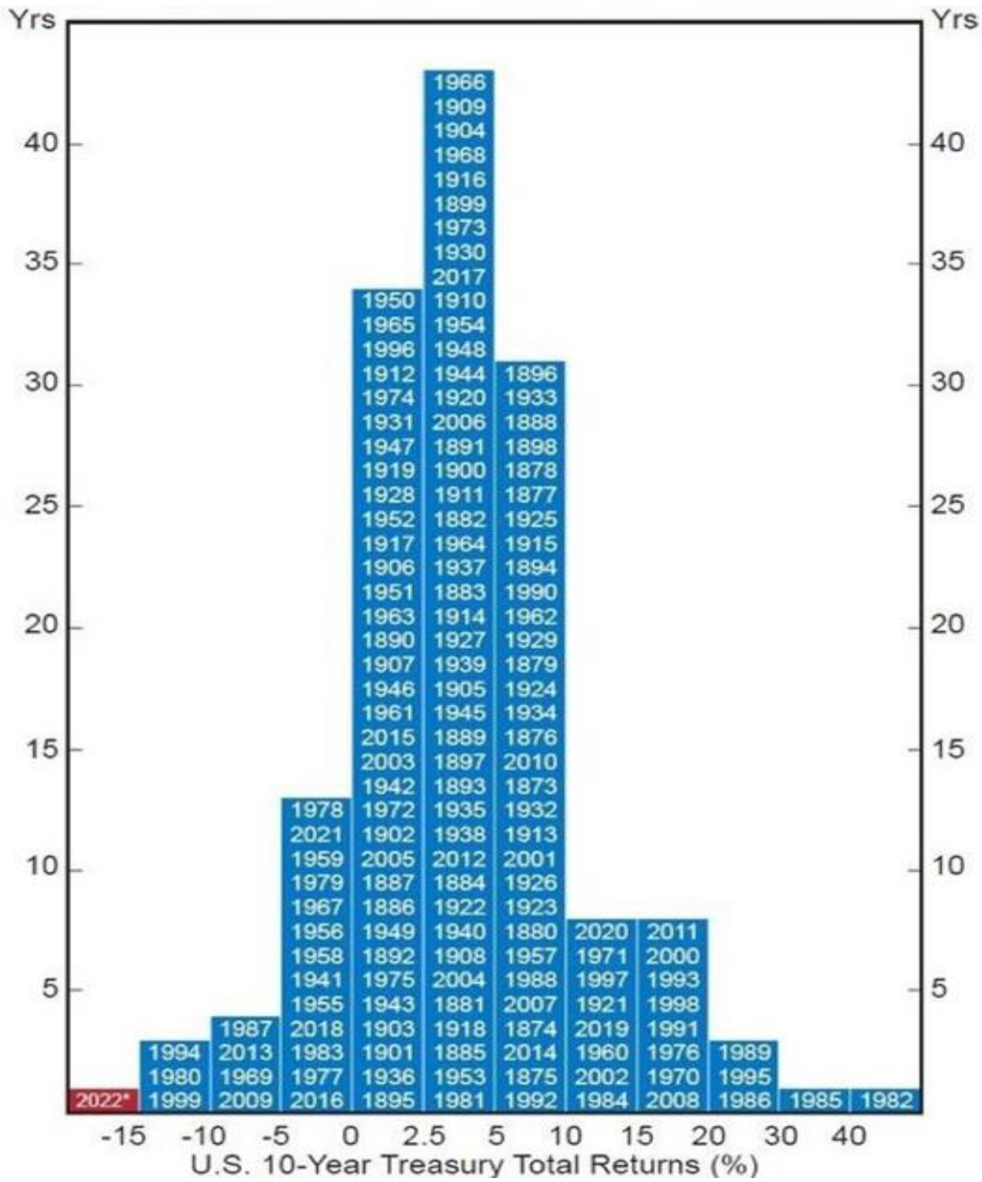
Check out the chart below to see total returns on most asset classes up to December 2022. (The Bloomberg Global Aggregate is the global bond market):



For a decade now, we've enjoyed low interest rates and low inflation. It was thought that supply chains could quickly re-organize and equilibrium between supply and demand would be found. In 2022, reality set in and financial markets responded accordingly – in the red.

What Happened to the Bond Market?

2022 was truly a statistical outlier in the bond market. It was the worst return year on record for fixed income. Wait seriously??? Yes… you read that correctly. We just went through the worst bond market year in history. Check out the chart below with historical annual returns for the U.S. 10-year treasury bond.



What happened? In order to understand what occurred with bonds this year, we need to delve a little deeper with how they behave with respect to interest rate changes. Bond prices move inversely to bond yields. When interest rates increase, bond prices decline - and when rates decline, bond prices rise.

Bond Prices and Yields

When bond yields are low, as was the case until early 2022, bond prices are extra sensitive to changes in interest rates. When yields are high, bond prices are less sensitive to interest rate changes. To explain why, let's do a little math. If rates increase from 2% to 4%, that's a 100% increase, which causes a large fall in the bond's price. But if rates go from 4% to 6%, that's a smaller percentage increase, so the bond price declines less. Thus, the move from 'ultra-low to more normal interest rates' resulted in a huge decrease in bond prices.

We often get asked about the late 1970s and early 1980s when inflation and interest rates skyrocketed. Rates increased much more in absolute terms during that time, so how could the bond market correction be worse this year? The answer is, artificially low rates this past decade produced bonds whose prices were ultra-sensitive to changes in yield (per the math above). When rates rose rapidly this year, the percentage increase in bond yields was greater than anything we've experienced in the past.

On Macro-Economic Predictions

2022 will go down as the year when almost no one's economic predictions came true. This is a good example of why we shouldn't rely too heavily on forecasts when making portfolio decisions. It's better to be prepared for many possible outcomes.

Human brains have evolved over thousands of years to intuitively understand concepts such as momentum, leverage and force. These laws of nature were used to build shelter, avoid danger, and obtain food. This innate way of understanding the world is based on a well understood concept called 'stationarity' which is the idea that historical data can be projected well into the future. Or in other words, we can predict the future based on what has happened in the past.

If you were standing at the bottom of a hill, and you saw a large boulder rolling towards you, your brain would instantly analyze the trajectory of the rock. By projecting forward the boulder's current path and through your intrinsic understanding of momentum, you would likely be able to avoid being crushed to death by realizing you were in the boulders potential path and moving out of the way. When investing in financial markets, we have to re-wire this way of thinking. Buying into the stock market when it's low is akin to staying in front of the falling boulder - in terms of how our brain views it. Our natural reaction is not to buy low as we should, our natural reaction is to get out of the way of the rock (sell!).

When thinking about what might happen in the future to the economy and financial markets, the best way to think about things is as a range of possible outcomes. Therefore, when we are asked about what might happen in the future, we never answer this question with certainty. All we do is weigh the positives and risks - and give an estimate of what we believe are the most probable outcomes. We also need to be humble enough to admit there will be events that we did not see coming. And it is generally these sorts of events that derail financial markets.

When we look at all market history including the last few years, it was the improbable events (e.g., COVID-19 and the Russia/Ukraine war) that have caused the most grief. The likelihood of us predicting the next event that derails financial markets is very low. The world is very complex and there are simply too many variables to consider. Any model we try to make to forecast the future will likely fail to predict extreme outcomes that occur, as the model will only be as good as its inputs. Those inputs will be subjectively biased towards our own experiences and understanding of the world. And our experiences and understanding of the world are all based on what has occurred in the past.

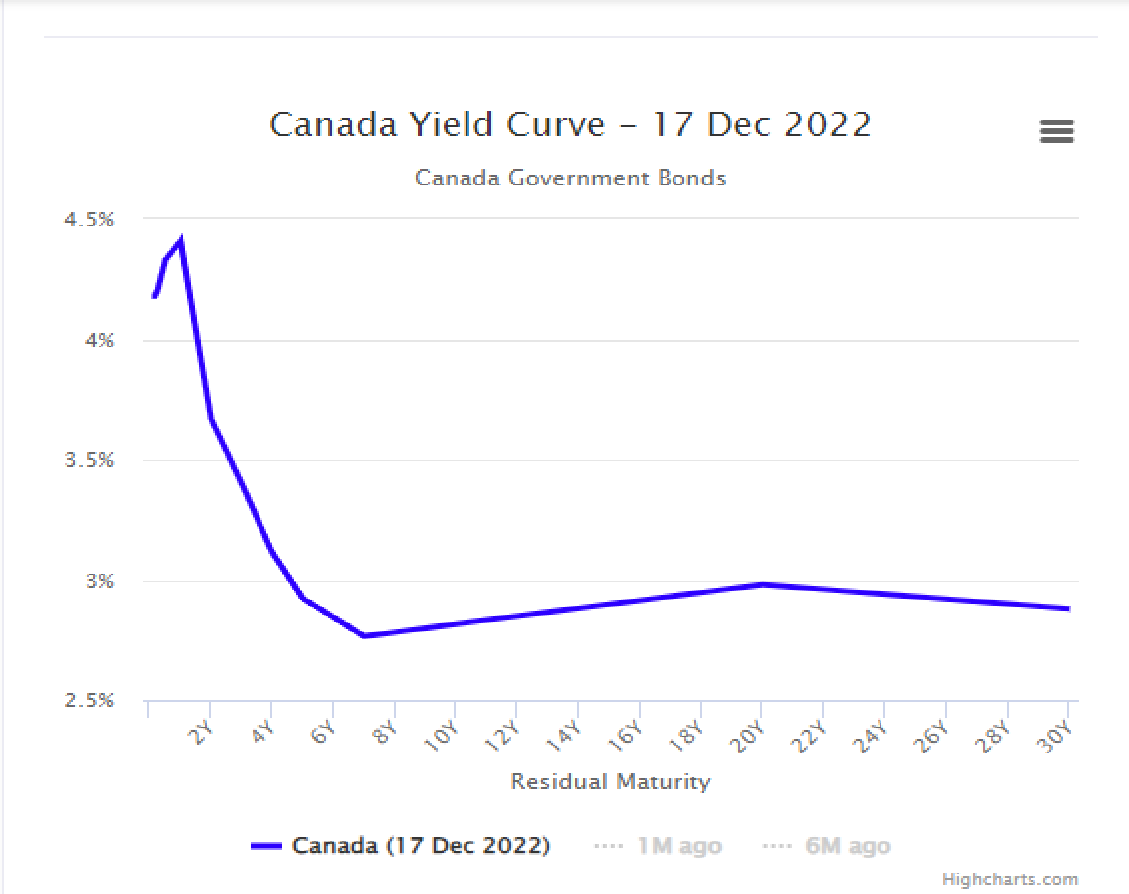
All of this often makes us think that whatever is happening now will continue for a long time. However, most often things will generally change faster than we think.

By buying good quality businesses with good valuations and ensuring significant portfolio diversification, we don't need to be in the business of predicting outcomes of wars, elections, the direction of inflation, or the trajectory of interest rates. Those risks will affect us in the short term but will be unlikely to affect the long-term outcome of a group of strong businesses and a well-constructed portfolio. When it comes to companies in your portfolio, "you own their earnings forever." This certainty gives us the confidence to a have a long-term outlook, which in the past has always led to good investor returns.

This philosophy doesn't preclude us from having opinions. So here is our best guess on the range of possible outcomes, for 2023:

Where Are We Now and Where Are We Going?

We are likely in the final stages of this post-covid economic cycle and most people in our industry would conclude that we are headed for a mild recession. One of the reasons many feel this way is due to the currently *inverted yield curve*, namely short-term interest rates are higher than longer term interest rates. In the past, when the yield curve inverts, a slowing economy or recession follows. The chart below shows government bond yields (from 3 months to 30 years).



One way to interpret the yield chart above is that the bond market is predicting central banks will have to lower rates in the future. Thus, some fixed income investors are buying longer term bonds (more so than shorter term bonds) with the expectation that lower central bank policy rates in the future will cause longer term bonds to rise in price. Longer term bonds are very sensitive to interest rate changes and these bonds will increase in price if long term interest rates decline.

Mitigating factors to the consensus view that we are heading for a recession are that unemployment is still at record lows (5% in Canada and 3.5% in the U.S.) and consumers are still sitting on large amounts of cash savings – albeit savings rates are starting to decline.

Portfolio Asset Allocation

We have been using higher equity portfolios (currently around 70%) the last few years due to extremely low yields on bonds. Now that the bond market has corrected quite substantially, existing bonds in client portfolios have adjusted price wise - and thus now have a higher yield going forward. Should we see strength in the equity market this year, we will look to increase client exposure to fixed income - by decreasing equity. In terms of ‘what type of bonds’, we will concentrate mostly on reasonably safe ‘corporate fixed income’. We will not focus on high yield (below investment grade) bonds as during any downturn in the economy, this type of bond is very sensitive to default risk. The chart below shows that high yield corporate bond yields are not yielding high enough - to incent using them. Note how in recessionary periods, high yield bond spreads can widen quite a bit.

Geographical Equity Allocation

Although U.S equity markets have come off in price a fair amount, U.S. markets (and U.S currency) still look pricey. The U.S is more expensive on both a ‘price to earnings’ and ‘price to book value’ basis - relative to Canadian and international markets.

The United States has just 4% of the world’s population, and produces 25% of the worlds GDP, yet its stock market is valued at a very large 60% of the global market capitalization. This is close to a record high, and further evidence of some overvaluation in U.S Equites. We are therefore maintaining our current geographical allocation (Overweight Canada, Europe, Asia, and Far East and underweight United States). Simply put, we can invest in the remaining 75% of the worlds GDP at a much lower cost.

Technology and Clean Energy Companies

Fortunately, we avoided carnage in this area of the market. We were underweight U.S. technology and avoided unprofitable technology companies based on the reasoning spelled out in our previous newsletter. We felt there was massive overvaluation in the more ‘speculative tech companies’ and a degree of overvaluation in ‘quality’ tech companies (META, Amazon, Netflix, Google et al). This approach cost us a bit of gain when markets were going up but paid off in the past down-market year. Given the large correction in this area of the market, we have been looking for opportunities. We recently took profit on ‘defensive stock’ Diageo and used proceeds to buy Qualcomm. This company looks undervalued, trading at just ten times annual earnings. Qualcomm sells semiconductors, and software - plus owns key patents critical to 5G and autonomous driving.

Although many clean energy companies have come down a lot in price, they are still trading at somewhat expensive valuations. For example, the average conventional oil and gas stock trades at an inexpensive three and a half times cashflow while the average clean energy stock costs over thirteen times cashflow. (i.e., three and a half years to be made whole on our investment vs. thirteen years). Renewables have better growth potential but at current prices, we are still holding off.

Inflation and Interest Rates

Well, we sure got this projection wrong last year, as did most in our industry. We anticipated higher interest rates in 2022, but the multi-decade high inflation of 2022 was “stickier” than we anticipated, causing interest rates to go up a lot.

Higher central bank policy rates are now starting to work. Latest projections are that inflation drops from current levels to about 4%. Achieving a further drop from 4% to 2% will be harder, but long-term bond yields (that are not that high) are betting this will occur. As we move toward a more “normal” post-pandemic economy, we believe that the long-term secular trends that caused inflation to be low in the past will return. Namely an aging population, excess savings, below normal demand, and enhanced productivity.

Higher interest rates affect everything around us, from prices of bonds and stocks to housing and commercial real estate. All these areas have corrected in price due to the substantial rise in interest rates this year.

We think we will eventually see rates slowly decrease from current levels. Given excessive government debt levels and high consumer debt in Canada, central banks will vacillate likely between not wanting to cause a harsh recession (and too much bond and mortgage default risk) while also attempting to bring inflation down.

Volatility will likely be with us for some time until this past year’s runaway inflation is under control - as markets try to anticipate the eventual path forward.

Private Fixed Income and Private Commercial Real Estate

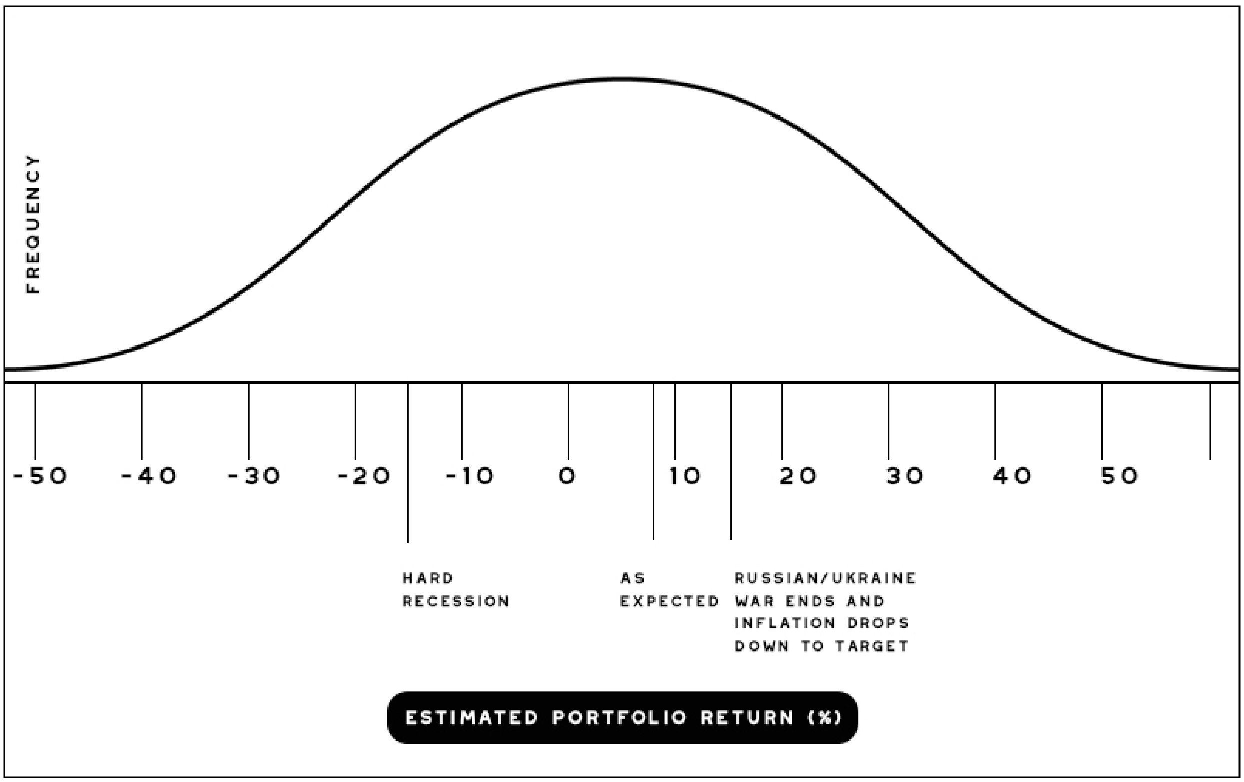
This area of our portfolio has done exactly what we hoped it would this year, namely protect clients’ capital - in a year that has been tough for just about every other asset class. Although we are currently not adding new funds to privately valued assets, it continues to be an important asset class for us. We currently hold about ten percent of portfolio assets in this category and plan on increasing this asset class if stock markets become expensive and publicly traded real estate trades up in price - closer to the true value of their properties.

Currently, our publicly traded REITs (real estate investment trusts) are trading at large discounts to the appraised values of the properties they own. We think this area offers good value to longer term investors as one can now buy real estate in the public market at good discounts, rather than in the private market - at fair value. Higher interest rates are a risk, but leverage inside REIT's is quite reasonable, plus lease renewals rates and occupancy levels are good.

Preferred Shares

We eventually plan to trade out of preferred shares, however with recent rate increases, we are seeing rate-reset "preferreds" offering yields as high as 7%. If held in non-registered or corporate accounts, this provides a solid after-tax return, due to the Canadian dividend tax credit. In the coming years, we will continue to see some of these issues called away (at $25 per share) and will also as said, look for trading opportunities for "preferreds" that are not being redeemed by their issuers.

Potential Risks (and Opportunities)



We thought we would use a 'bell curve' to illustrate how we think about potential outcomes in the stock market. For those not familiar with bell curves, this is a method used in statistics to indicate the probability of a range of possible outcomes. The highest likelihood is the middle of the curve. Less likely outcomes are what we call "tail events", namely the probability we see very good - or very bad - results. We've presented three scenarios to give you a sense of our expectations.

Downside Scenario

On the possible risk side of the ledger (see left hand side of the graph above), let's start with the obvious risks that could produce a hard recession. The first is that inflation does not come down as quickly as markets are currently pricing in. This would cause central banks to raise short term interest rates further (than currently predicted) in order to tame inflationary pressures. Should this occur, we would likely experience a worse economy than markets are currently pricing in.

This scenario is negative for equities and would likely cause medium to long term bond yields to rise, pushing bond prices lower. Shorter term fixed income along with privately valued fixed income/commercial real estate likely hold their value.

In terms of industry exposure, consumer discretionary and technology likely underperform, while consumer staples and quality value-oriented low PE stocks (our preference) should do better than market averages.

What's the probability of this negative scenario happening? Our guess is about 25%. We have left room (in this 25% probability) for always possible 'unexpected' risk(s) which cause markets to fall off. As said earlier in this letter, its often not the 'predicted risk' but the 'unexpected risk' that comes from 'out of the blue' that derails markets.

If this negative scenario occurs, we could take advantage of market weakness by adding to whatever low-priced asset class looks to be best from a risk/return standpoint. We did just that during the covid downturn - which proved to be a very good time to add to equity.

Should we see these tough market conditions in 2023 occur, we likely experience a good year in 2024. Markets have historically performed very well, starting usually about halfway through a hard recession - as stocks begin to 'price in' the eventual recovery.

Expected Scenario

What's our best guess for 2023? (See the ranges along the middle of the bell curve above with say a 50% probability.) Likely a mild recession - or perhaps even minimal GDP growth. In this scenario, interest rates likely increase a bit from here but reach a peak early this year. We do see some encouraging economic signs such as many leading inflation-oriented indicators moderating - and the latest U.S. GDP figure which came in at a healthy 3.2% real growth.

We think that unemployment levels will only increase a bit in 2023. Right now, there is a record 1.75 job openings for every unemployed person in the U.S. (and a heathy one job opening for every unemployed person in Canada). Hence, we think that employment simply returns to a normal 'equilibrium' (helping tame wage price inflation) while also helping cure employment headaches for employers who currently can't find enough workers.

We have never historically experienced a bad recession when unemployment levels were 'low to normal'. Thus, we think we will likely avoid 'the hard recession scenario'. Our expected portfolio returns in an environment such as this would be between six and ten percent.

Upside Scenario

The positive 'tail' outcome, (perhaps a 25% probability) is that inflation comes down faster than markets are predicting, and central banks therefore go back to "being nice to us". Thus, interest rates level off near current levels and then drop a bit going into the second half of this year. This also assumes no further escalations in the Ukraine war, no resurgence of COVID lockdowns (including in China) - and no other material negative surprises.

If all this occurs, corporate earnings will exceed current expectations, and we likely experience a good performance year in equity markets. However, as our portfolios are tilted more towards 'defense than offense', we will likely lag market averages a bit. If markets indeed perform very well in 2023, as said earlier, we intend to begin the process of decreasing equity exposure to further increase the defensive nature of client portfolios (e.g., by adding to fixed income - both publicly traded and privately valued). And we may also bring in some asset classes that can hedge market risk, such as gold and/or long-term U.S treasuries bonds.

No matter how things turn out, we have never felt better about being able to proactively deal with whatever outcome materializes. About 95% of our clientele is now set up in discretionary trading accounts so we can action portfolio moves on a very timely basis. We have seen a lot in our long careers so have a good handle of what we might buy (or lighten up on) depending on what occurs.

Bits and Bites

This year's TFSA limit has been increased to $6,500. For most client situations, we will be investing in a liquid short term (floating rate) government bond ETF yielding 5.3%. We are doing this to slightly increase client exposure to fixed income and to provide liquidity to deploy if we see weakness in a sector that we want exposure to. Most clients have asked us to automatically fund TFSA contributions using proceeds from their non- registered accounts

The 2022 RRSP maximum is $29,210 (deadline is end of February). The 2023 maximum RRSP contribution is $30,780. Please check your CRA notice of assessment for your RRSP limit.

We have employed some tax loss harvesting this year for clients in their taxable accounts. Any net capital loss can be carried back up to three tax years, or forward indefinitely to offset future capital gains.

As we head towards tax season, please look out for your ‘investment management fee report’ which will be mailed to you. The fee for non-registered accounts is tax-deductible.

BC resident children (ages 6 to 9) are eligible for a $1200 grant (fully BC government funded) towards a ‘Registered Educational Savings Plan.’ In RESPs we manage here, we track the children’s age – and help clients apply for the funds when the child turns six. Please talk with Cheryl (or any other team member) regarding how to take advantage of this program.

We’ve been very fortunate to have several new clients join our practice this past year. We would like to wish a warm welcome to everyone that has joined us and thank-you all for mentioning our practice to your family, friends, and colleagues. Our minimum for new clients continues to be $500,000, but as we have always said, any of your children or parents are welcome as clients. And we are more than happy to provide some general advice over the phone to people you care about – regardless of how much money they have available to invest.

Each year, via our firms ‘Children’s Miracle Day’, we give a portion of client revenues from the past year to charity. The Scientists in Residence program which we supported for many years, is fully funded for this upcoming year. Athletics for Kids pairs underprivileged children wanting to participate in sports with high school athletes for support and friendship. They also assist financially with sign-up and equipment costs. Kids Up Front provides access to arts, culture, sports, and recreation for children who otherwise would not have the opportunity.

We also continue to support Richmond’s excellent charity, ‘Pathways’ which supports individuals with mental health challenges by helping them in a variety of ways - including seeking employment.

A big thanks to Graeme who did a lot of the work on this letter. And as he a degree in physics, you know who wrote the innovative section on ‘momentum, leverage and force’.

Thank-you very much for the trust that you have placed in our team. As always, please call or email us with any of your financial needs or questions. All the best in 2023!

Sincerely,

The Pope Team

Neil Pope, MBA, CIM Portfolio Manager, Investment Advisor Tel: 604 207-8578	CIBC Wood Gundy The Pope Team www.thepopeteam.ca 606-5811 Cooney Rd, Richmond, BC V6X3M1	
Rick Aulik, CFP, CIM, FCSI Investment Advisor 604 207-8585 rick.aulik@cibc.ca	Susan Christie, CFP, BA, CIM Associate Portfolio Manager 604 207-8570 susan.christie@cibc.ca	Graeme Schuss, CFP, BSc Associate Investment Advisor 604 207-8582 graeme.schuss@cibc.ca
Cheryl Sy, BSc Client Associate 604 207-8581 cheryl.sy@cibc.ca	Melanie Burns Client Associate 604 207-8583 melanie.burns@cibc.ca	Phoebe Tagaca Administrative Assistant 604 270-6457 phoebe.tagaca@cibc.ca

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Clients are advised to seek advice regarding their circumstances from their personal tax and legal advisors.

Yields/rates are as of January 10th, 2023, and are subject to availability and change without notification. Minimum investment amounts may apply.