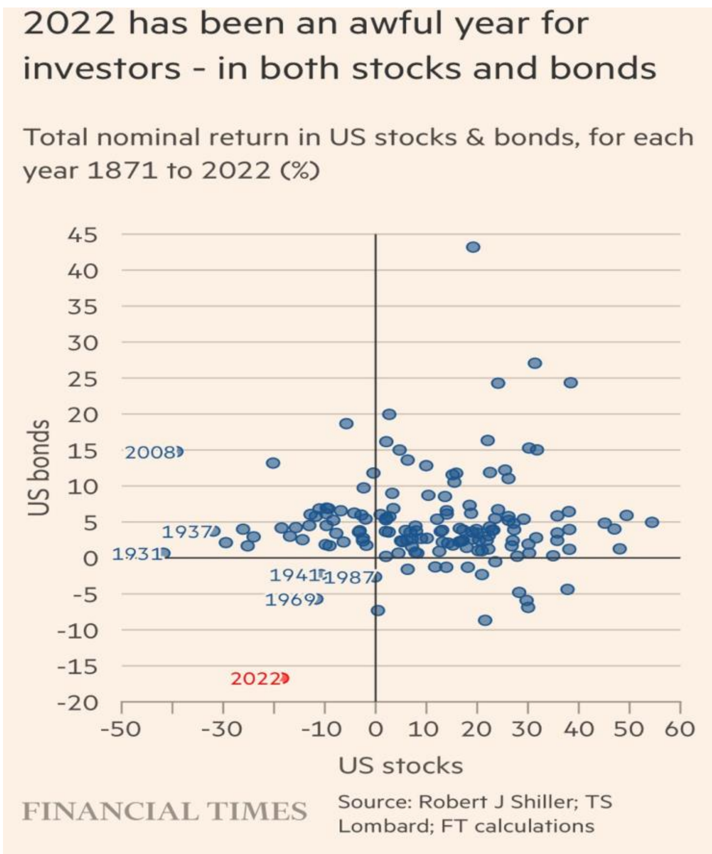
2022 Year-in-Review and 2023 Outlook

In this newsletter, we will briefly review the challenges of 2022, and provide our perspective for 2023.

2022: Outlier

2022 was truly an outliner year as, according to Goldman Sachs, the combination of losses in both the stock and bond market in the same year only happens two percent of the time. Here is a great chart from 2022 that shows the same thing:



Source: Financial Times

The chart above is the U.S. experience, but the same thing happened in Canada. As you can see, it is extremely rare to see a year in which both stocks and bonds lose value, and even rarer to see bonds underperform stocks in that year.

Let’s dig into the numbers. I have outlined the returns by asset class as provided by the Index Return monitor supplied by our Discretionary management oversight committee:

Asset Class	2022 Return in $CAD
Cash	1.44%
Bond Universe	-11.69%
TSX Composite	-5.75%
MSCI World	-11.75%

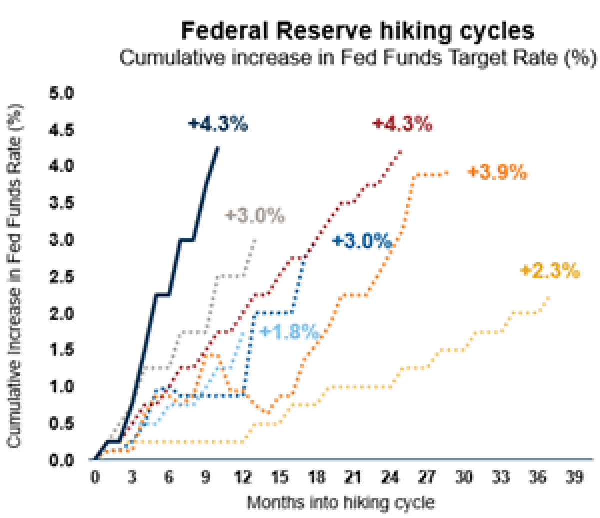
As you can see it was a very difficult market. I would like to breakdown each asset class for more analysis.

Cash

Not much to reveal here other than that, at the end of the year, cash was king for 2022. Not only did it not lose any money, but the return has also risen to close to four percent over the year, something we have not seen for a long time.

Bonds

Canadian bonds had one of the worst years on record. Why might you ask? The chart below shows what happened in the U.S. but Canada was similar.



Period	Starting Rate	Cumulative Increase	Months
1983-1984	8.5%	+3.0%	18
1986-1989	5.9%	+3.9%	29
1994-1995	3.0%	+3.0%	13
1999-2000	4.8%	+1.8%	12
2004-2006	1.0%	+4.3%	25
2015-2018	0.3%	+2.3%	37
2022	0.3%	+4.3%	10

Source: Advisor Analyst: Lance Roberts RIA

We saw one of the biggest, and the *fastest,* rate hike cycle in the past forty years. Rising rates put tremendous pressure on bond values, and since the overnight interest rate was near zero the sensitivity of bonds to rising rates is even more exaggerated when compared to other periods.

TAG started positioning our bond exposure with active managers in 2018, when the Federal Reserve began to hike rates, expecting that at some point in the future interest rates would normalize relative to inflation. The pandemic short circuited this transition but inflation came roaring back to levels not seen in forty years. This forced the central banks around the world, led by the Federal Reserve, to rapidly raise rates to try and get control of inflation.

Most of our portfolio managers were able to substantially outperform the bond universe with the exception of our duration manager and our preferred share allocation.

We had overweighted preferred shares as their rate-reset structure was supposed to insulate us from rising rates. Unfortunately, for a number of technical reasons, they did not behave like we had anticipated and underperformed the index badly.

Now that rates have normalized, with the current bond yields higher than expected inflation, we feel that bonds can not only help with risk management but will provide a substantial contribution to our portfolio returns going forward.

Canadian Equity

The TSX composite generated a modest decline of -5.75%, including dividends, in 2022.

You may be wondering why the TSX outperformed both the S&P 500 and the MSCI world index by such a large market. It has a lot to do with the make-up of our index. The TSX is dominated by financials which currently represent 36% of the index, followed by Energy which is now 18%. The energy sector started the year at 13% of the TSX, and ended the year at 18% of the index thanks to the +30% return. According to Bloomberg, the Energy sector contributed +3.53% to the index return, so if you did not own any energy your 2022 return would have been closer to -9%. According to Reuters, the beta of the energy index, as expressed by the iShares S&P/TSX capped energy index, is 1.46. Put simply, the energy index has almost 50% more volatility than the S&P TSX which makes it a very difficult sector in which to consistently make money.

The biggest sector in the TSX, financials, had a return of -9.38% followed by energy and then real estate -21.54% and utilities -10.56%. We tend to focus on yield for our Canadian equity allocations so you can see it was a difficult space to invest in 2022.

U.S. Equity

U.S. equity is part of our global sleeve, but it is well followed so I thought I would include it in my commentary. For 2022, the S&P 500 total return in $CAD was -12.16% but this only tells half the story. What is not obvious was the substantial performance difference between growth stocks and value stocks.

The S&P 500 Growth index had a 2022 return of -24.27%, while the S&P 500 value index had a 2022 return of 1.67%. We are growth-at-a-reasonable-price (GARP) managers, so we were affected by this underperformance of growth in 2022. Fortunately, we raised some cash in the Spring to help reduce the portfolio volatility so we ended up with index like performance.

Global Equity

As you know, we use professional managers to access the global markets. We tend to use GARP managers so they struggled as well in 2022.

Over the past eighteen months we have been adding to a Global "Green" value manager that performed very well as did our Infrastructure allocation. We also have a relative value manager that outperformed the benchmark so our global allocation was roughly equivalent to the global index.

Alternative Strategy

We actively added to our alternative strategy allocation in late 2021, and early 2022. Our allocation to alternative strategy really helped soften the blow from the equity and bond markets and acted as we expected. The inflation linked index was a positive performer as was our market neutral and multi strategy allocations. Our long-biased funds generated some excellent yield and mostly preserved capital with a small loss in one of our managers.

Summary

As we stated in our last newsletter, we had two portfolio construction research groups drill into our portfolio construction to ensure that we did not have any weaknesses, unintentional biases or risks in the portfolio.

The feedback we received from both companies was excellent. They both felt that our portfolio construction was some of the best they had ever seen, effectively of institutional quality. That being said, there were a few small tweaks that we could make to generate slightly higher returns and less volatility.

So, while 2022 was very difficult, it has not fundamentally altered anyone's financial plan glide path. In fact, the reset in bond yields has increased the probability of us being able to meet our return targets going forward.

2023: Mixed Signals

Anyone that professes that they have a good handle on the current economic condition is not telling the truth or has an overconfidence issue. We are seeing a number of conflicting economic signals, some that indicate we are going into recession and others that would suggest that the global economy is actually improving which might allow us to have a soft landing or no recession at all.

For the first six weeks of the year, the markets have been believing the soft-landing narrative and have rallied aggressively across most asset classes, except commodities. Bond yields had fallen substantially which led to investors flocking to beaten down tech stocks. Many of the most speculative names that got crushed in 2022 have had a big rally in 2023 (although many are still down quite a bit from their highs). This reemergence of the speculative behaviour, that we saw between 2020 to 2022, is a little unsettling for us as we had hoped that 2022 would have extinguished the urge to invest in this way.

The good news is that as we write this in mid-February, we have observed that many of our portfolios have recovered about 40% of the losses incurred in 2022.

No more Fed, more about the fun…damentals

Much of the rally so far this year has been driven by the perceived notion that the Fed will become less aggressive with monetary policy as the year progresses. In some ways that is true as any increase in rates will be modest when compared to 2022, but they will likely remain at a multi-year high for all of 2023.

With the Fed more or less on pause, the focus will start to shift to earnings and margins. We feel this is a good thing as we can add value by buying good companies and not the market. There is likely going to be lots of volatility over 2023 as we get whipsawed between macro-economic concerns and a difficult earnings environment. We are already seeing massive swings in stock prices around earnings announcements that are difficult to fathom.

We believe that a recession in Canada and likely the U.S. is probable in 2023. We definitely believe that earnings growth will be muted and that there will be more dispersion in stock performance based on the individual financial performance of companies. We also believe that new leadership will emerge as we work our way through this recession with themes like the energy transition, energy security, food security, infrastructure rebuild, water and resource scarcity, biotechnology breakthroughs, and now the impact of artificial intelligence.

We can't ignore some of the macro-issues as well including the war in Ukraine, rogue nations, food insecurity in much of the world, migration from failed states and climate change.

All in all, a very complex environment to invest, with likely more volatility than we have been accustomed to over the past decade.

The Good News

As we have said before, the rise of bond yields has allowed us to allocate capital better with greater certainty of achieving our financial planning targets.

What is our plan for the first half of 2023? Here is a brief summary of some of the changes to the portfolios that we are planning.

- Cash has value. We are now getting an attractive yield in Money Market and short term GICs and may continue to carry more cash than usual. We are also laddering maturities with income needs over the next year to 18 months to take advantage of these attractive rates.
- That being said, we are beginning to deploy cash into bonds as there is both attractive yield and an opportunity for potential capital gains if our recession call comes to fruition

- We are reducing our preferred share allocation significantly. The current yield in preferred shares is not that attractive and the volatility of the underlying shares makes it significant source of risk in our portfolios. We will still buy specific preferred shares that offer attractive yields over the next three or four years, but the overall allocation will be less than half our previous amount.
- Our Canadian equity will be focused on dividends and dividend growth. It has been very difficult to consistently make money in the growth space in Canada so we are going to reduce our exposure to these kinds of companies.
- In the U.S., we started migrating away from technology last year and into more industrials and a small sliver of energy. We will continue to focus on companies that are developing technologies that are consistent with the themes outlined earlier.
- We are changing some key managers in our Global equity space to improve the return profile as well as lowering correlation between managers.
- We will also be adding to our alternative strategy space with a rationalization of some of our current managers and a shift to more multi-strategy approaches that invest in strategies that we can’t replicate.

We are excited for 2023. While we know that the economic conditions may deteriorate as the years progress, we view this as an opportunity to add value through careful allocation of capital to opportunities that emerge in difficult times. We also believe that patient investing will allow us to ignore the volatility and focus on the long-term trends that are emerging.

As always, we are happy to provide more detail on our thinking or entertain any ideas that you might have for your portfolio.

Sincerely,

Lisa Applegath	Tom Trimble
Senior Wealth Advisor	Portfolio Manager

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