PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Key Questions for 2023

After a difficult 2022, in which equities and fixed-income investments both had negative years, we may be seeing the beginning of a rebound in January of 2023. Interest rates have been rising for almost a year, and the cycle may now be close to its peak. Some equities may have been oversold in late 2022 due to tax loss selling and excessive pessimism. Even so, we are wary of extrapolating recent positive outcomes too far ahead, given the multiple challenges global economies are facing.

There are several questions we have to ask as we consider investment opportunities in 2023 and beyond. How probable is it that we have a significant recession? Will inflation return to more acceptable levels? Is there good value in technology equities after major declines last year? Finally, will global energy markets stabilize? None of these questions are easy to answer, but addressing them in this fourth quarter (Q4) of 2022 Newsletter could help us inform clients.

How Probable is a Significant Recession?

The global economy appears to be slowing down. Many commodity prices are down from their highs. Some large companies in a variety of industries have recently announced disappointing growth outlooks. There have recently been some high-profile layoff announcements, especially in the technology sector. Residential real estate prices are dropping in many areas. It would surprise no one if a recession were to begin sometime in 2023.

A very mild recession may not be of too much concern. Investors know that higher interest rates are intended to reduce inflation, and economic growth may decline as a side effect. Many equities already experienced significant declines in 2022, suggesting that the market has already anticipated a slowdown.

Could a recession that significantly impacts corporate earnings begin in 2023?

Rapid interest rate hikes by central banks frequently lead to economic recessions after a delay. Tightening of financial conditions takes time to work its way through the economy. It appears that the vast majority of the central bank rate hikes are behind us for this cycle. We must wait to observe how the economy responds. In North America, there are high levels of debt at all levels of society - personal, corporate and government. Clearly, higher interest rates are already impacting the economy, and their full impact probably hasn't been felt.

On the other hand, today's interest rates are not historically that high. Those of us who have been investing for decades have seen these conditions before. Conservatively-financed companies with strong competitive positions in their industries can handle these conditions and potentially even thrive. Some highly-leveraged weaker companies could run into trouble in the next 12-24 months, but that is a normal part of the economic cycle, and one reason why we focus so much on quality when making equity investments.

Looking back at the past recessions, the biggest challenges and opportunities for investors came many months into the process, and the industries affected can vary widely. The investment opportunities can be exceptional, especially in terms of purchasing high-quality assets at discounted prices. This requires good enough risk management to have capital available to take advantage of declines, which we intend to do.

Fixed-income assets are already providing, in our opinion, good opportunities. The prices of many bonds have declined, and newly-issued bonds are paying significantly more interest. Fixed-income investing now appears more attractive than at any point in the past several years. We will likely gradually increase allocations to fixed-income securities in our discretionary portfolios over the coming months.

Will Inflation Return to Acceptable Levels?

Using a very simplistic analysis, a lot of the world's inflation problem was caused by excessive money creation during the pandemic. Now that this money creation has been at least partially reigned in, the inflation problem is starting to recede.

To discuss the issue more intelligently, we also have to include supply chain problems. Demand (excess money) increased prices, but supply (restricted availability of goods) also increased prices. It appears that political leaders in the world's mature democratic economies are preparing us for a world where we trade more with like-minded countries and less with autocratic countries. If this unfolds, some additional price increases will likely occur for manufactured goods, simply because it costs more to make things in mature democratic countries with strong environmental and labor laws.

Overall, there are encouraging signs that inflation is coming down, but we cannot be confident that it will drop in a straight line all the way back to 2% annually. Central banks are indicating that they may hold interest rates near current levels until late 2023 or early 2024. Their reasoning seems to be that they need to ensure that inflation is truly tamed before they ease financial conditions. Will they follow through? Central bankers have lost some credibility with the public in recent years. They called high inflation “transitory” when it first emerged, perhaps out of wishful thinking. They may now need to delay any steps towards easing in order to regain credibility. Investors will probably have to be patient while waiting for a return to acceptable levels of inflation.

Are Technology Companies Now Good Value?

After a terrible year for technology equities and other growth equities in 2022, we are finding some opportunities. One of our largest recent equity purchases has been Amazon.com Inc. (US:AMZN). On January 12, we added to our Amazon holdings in the Balanced Portfolio at a price of US$95.71. On November 29, 2022, we added to Amazon in the Total Return Portfolio at a price of US$92.18. Amazon shares hit US$170 in early 2022, so it has been a long ride down to the current level around US$100. Amazon's near-term growth prospects have slowed along with the overall economy, but it remains a high-quality business with a strong competitive position.

Higher inflation and interest rates have reduced the valuations of many fast-growing companies. Investors began to favor strong near-term cash flows over speculative longer-dated cash flows (money now instead of money later). While this may seem like an obvious trait for investors to favor, in 2020, during the worst of the pandemic, we saw numerous unprofitable technology companies trading up to extreme levels due to a combination of future growth potential and irrational speculation.

Declines in technology and other fast-growing companies have created some buying opportunities, but we have to view these declines in context. For example, some of the worst performing technology equities of 2022 had multiple years of exceptional returns before this year began. This means that we have to be careful about what we consider undervalued. To find real opportunities that fit our strategy, we focus on the highest-quality holdings with good growth potential and strong current profitability. The more speculative companies will not be candidates for our portfolios.

Will Global Energy Markets Stabilize?

Global energy markets have been quite volatile in recent years. A rapid decline in oil demand sent oil futures to negative levels during the pandemic. Reopening drove oil higher again, along with the Russian invasion of Ukraine. Efforts to transition rapidly to cleaner energy ran into trouble as well. The Ukraine invasion threatened to create a serious European energy crisis that has been partially averted by warmer than expected weather this winter.

What comes next? It seems that energy questions will be a key investment theme for the next few decades. Efforts to transition away from fossil fuels for environmental reasons can create short-term winners and losers in the economy.

The oil and gas industry is far from obsolete. 5-10 years ago, investor capital was consistently flowing towards the industry. The abundant capital allowed producers to drill countless new wells and rapidly grow North American energy production, reducing prices for consumers. Today, investor capital is more scarce. In what seems like an industry trend, oil and gas management teams are choosing to return capital to investors over expanding production. For example, on January 25, Chevron Corp. (US:CVX) announced that it would be allocating US$75 billion towards share buybacks. If enough companies follow this path, oil and gas supply growth will be suppressed, and prices could head higher over the coming years.

Electricity markets may also be facing inadequate supply growth. As discussed in our last Newsletter, there is a huge gap between what our politicians are saying and what our energy utilities and their regulators are doing. Canadian electricity consumption will likely surge over the next decade, but our major utilities and their regulators are not preparing to meet that demand.

Looking at the long term for global energy, technology will have to play a large role in solving our problems. A recent U.S. research breakthrough in nuclear fusion may have no near-term practical implications, but could be helpful over the next 25-50 years.

Like most Canadians, we are not energy experts, but it appears to us that we will need diverse energy sources to meet future demand. The capital investment could create immense investment opportunities. As most clients know, we currently have renewable energy holdings and also maintain some holdings in the oil and gas sector. A stable global energy picture would help equities and fixed-income assets achieve better returns in 2023.

Conclusion

Thank you for reading this Q4 Newsletter. Ideally, the positive results we've experienced so far in January will lead to a full year that is far better than 2022. Our philosophy of buying high-quality businesses trading at undervalued prices remains the same through different market environments, but our candidates for purchase are constantly changing. We will continue to look for opportunities that fit that philosophy.

As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORTFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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