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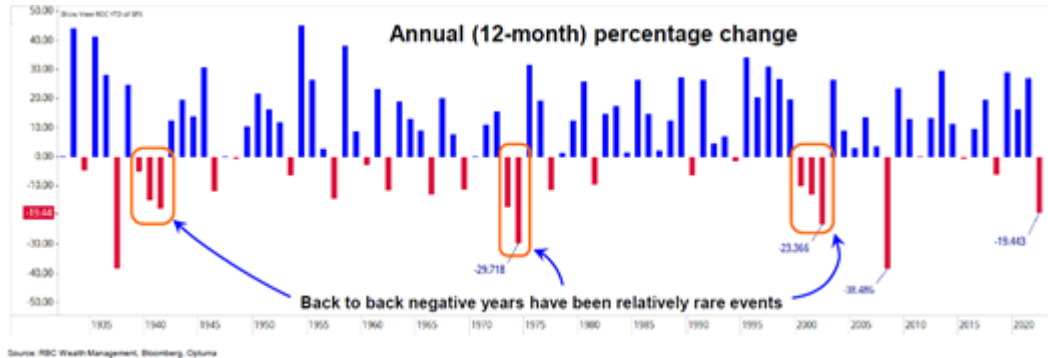
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The Great Unwind – the good, the bad and the ugly

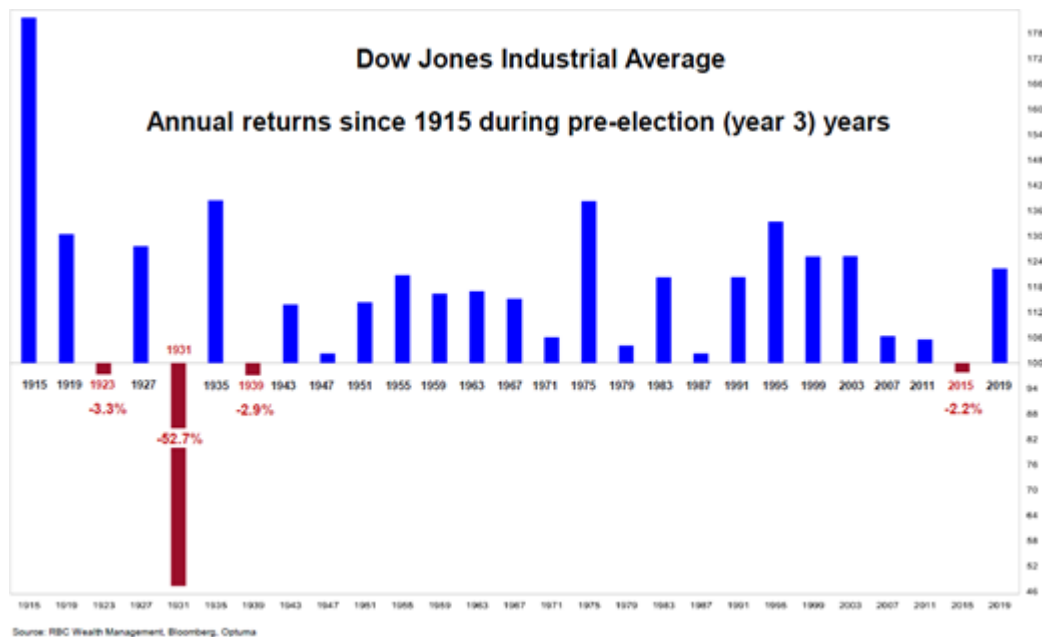
2022 marked one of the worst years for the markets on record which was further amplified by the rare occurrence of the bond market selling off in tandem with stocks, as rising rates and inflation impacted virtually all asset classes in a very negative manner. Sadly, years like this are a part of investing and a cost we must endure on our journey of long-term capital appreciation from the financial markets. I think I can speak for all of us as we wish 2022 'good riddance'.

What can we expect from 2023 as central banks continue to unwind the greatest monetary support of the economy in history, which has been in place for 15 years and climaxed in response to the COVID crisis? Many predict a recession to take hold by late-2023 and while likely it is not yet a certainty. The attempts of Central bankers to buy their way out of the business cycle no longer seem possible, and as it turns out, the trillions of dollars that were thrown at the economy over the last two years really only postponed the recession rather than prevented it. The recession that we expect this year is the one we should have more formally experienced in 2020. In addition to simply pushing out the economic contraction somewhat, all of the stimulus created an inflation problem that we are now being forced to contend with, coinciding with the 2nd sharpest spike in interest rates in history. While all of this sounds rather dour, all is not lost. As we perpetually discuss, markets discount future events well in advance, and the terrible markets of 2022 largely accounted for the issues we face going forward. Further, inflation has peaked and is declining fairly rapidly which should set the stage for central banks to become far less aggressive, and if they are reading the tea leaves correctly, to begin to lower interest rates later this year. Markets love the prospects of lower rates even more than they hate the prospects of higher rates, and should the Fed pause or possibly pivot, it is likely to mark the end of this miserable period for stocks and bonds. Markets are likely to remain challenged in the first half of this year, but as we continue to work through this downturn and consider the return of the business cycle (that was temporarily muted), it may well provide for a strong finish to 2023. Back-to-back negative years are extremely rare, and most importantly this drawn out bear market should spawn a new bull market, which is how these terrible periods typically culminate. The tough medicine associated with the great unwind of easy money has largely been taken, though the implications have yet to fully play out, so keep some Advil on hand for the last remaining headache or two. With the end of this economic reset somewhere on the horizon, a new bull market will emerge, which should last for many years and allow for extraordinary opportunities for ongoing wealth creation and accumulation. In short, while there is more wood to chop as the much anticipated recession ensues, we should spend the coming months keeping our eyes forward in order to prepare for the next cycle, which should be very productive.

For perspective, let us consider some context around 2022 that, as mentioned, was one of the worst years in history for the markets. The S&P 500 had its 7th worst year on record down 19.4%, the NASDAQ was down over 33%, most aggregate bond indices were down between 13 and 15%, and the bright star of the group for the first time in many years was the TSX, down 8.5%. Further, 2022 marked the worst year since 1932 for a typical 60/40 balanced portfolio. Dismal results to be sure as monetary conditions tightened at the fastest pace in history, but there may indeed be a silver lining. Years of back-to-back negative returns are a highly unusual occurrence, with only three instances in the last 100 years, as the chart below depicts:



Further, as we enter the 3rd year of the Presidential cycle in the U.S., negative years are an even greater anomaly, with the notable exception of 1931, the onset of the Great Depression.



Lastly, the Goldman Sachs Financial Conditions index, which tracks the implications of monetary actions by the Fed, also suggests brighter days may be on the horizon. When this index crosses 100 from below, as it has recently (implying a move from loose monetary conditions to restrictive) the average return in the coming 6 and 12 months is 8.8% and 18.6% respectively, contrary to what many would assume.

Market sentiment is yet another profoundly contrarian indicator which is at trough levels close to those seen during the Great Financial Crisis of 2008. I would argue that this environment is far less sinister than it was back then, given at the time we were faced with the potential implosion of the entire global financial system. While I do not believe we are out of the woods yet in terms of fully dealing with the issues that face the markets and the economy, we must keep in mind that markets turn when least expected and always in conjunction with a climax of terrible news and when the

economy feels the worst, as was the case in March of 2009. By the time the backdrop is better and the economy is on the mend, the markets will be well on their way to new highs and the opportunities that are present will be gone. We must always keep in mind that it is the unexpected that drives stock prices, not the expected, as we consider the most anticipated recession in history. It should be noted that the average return for the S&P 500 after a negative year is +13.2% in spite of challenges typically remaining.

I feel it would be useful to consider a recent interview by Robert Huebscher with Professor of Finance Jeremy Siegel of the Wharton Business School, who has been extremely accurate in his market calls and prognostications from as far back as I can recall. While the interview touched on many topics I will focus my attention on the questions around money supply. Money supply (M2) is largely influenced by changes in monetary policy by the Fed and maintains a very high correlation with equity prices. Dr Siegel was very critical of the Fed in 2020 suggesting they had massively overcommitted their response to the pandemic with explosive money supply growth which, in turn, would be very inflationary – no surprises there as most of us felt the same, although the Fed argued otherwise. Fast forward to today and we have seen the largest 7 month decline in money supply since World War II, which in itself should bring inflation to their desired 2% target rate over time. In Siegel's words, and in joining a growing chorus from top economists, "This is too much. The Fed cannot continue that rate of decline. It will cause a recession." In short, if the Fed would read the tea leaves instead of obsessively focusing on very lagging indicators like employment and housing, and consider the impact of declining money supply (and, in fact, get it back to a level of modest growth consistent with 2% inflation), they are likely to accomplish their goal without the need for a painful recession.

The Fed missed the boat significantly as inflation emerged, continually suggesting its transient nature, which was entirely incorrect as I wrote about at the time, ultimately forcing a Fed pivot. They are repeating the same mistake again in the opposite direction remaining steadfastly focused on what is happening in the rearview mirror instead of the road ahead. Many Fed observers are suggesting that Powell is determined to preserve his legacy and not make a second major policy mistake by failing to fully defeat inflation much like Arthur Burns in the 1970's; however, he is playing a dangerous game with the economy which could equally affect the legacy he is trying so hard to protect. It is too soon for the Fed to pivot and some slack in the labour market will be required to get to that point, but a pause would be prudent to allow for the economy to digest the historic rate hikes that require 12-18 months to be felt fully by the economy. Should the Fed maintain their current and projected course, my assumption is once again for the Fed to concede they were wrong and to make a major pivot sooner than expected as recession takes hold. Should they not, the prospect of something fracturing in the credit markets is greatly enhanced which could lead to a fourth instance of two down years in a row. Regardless of whether we get any change in Fed rhetoric, by the March meeting they should be done with their hikes allowing for the fear of ever rising rates to abate and the hope that interest rates and bond yields may ease going forward to reflect lower inflation and economic growth.

There is active and ongoing debate amongst the world's most notable strategists as to whether we do indeed enter recession later this year or if the Fed can pull a rabbit out of its hat and orchestrate a soft economic landing, contrary to the assumption that recession is a given. From my perspective, it is difficult to imagine that the historic monetary tightening coupled with the collapse in money supply we are witnessing will not lead to a recession, unless the Fed steps back from its incredibly stubborn stance, of which thankfully there is ample precedent. The recessionary scorecard that I have referenced on many occasions, as per below, is drifting towards a recessionary outcome.

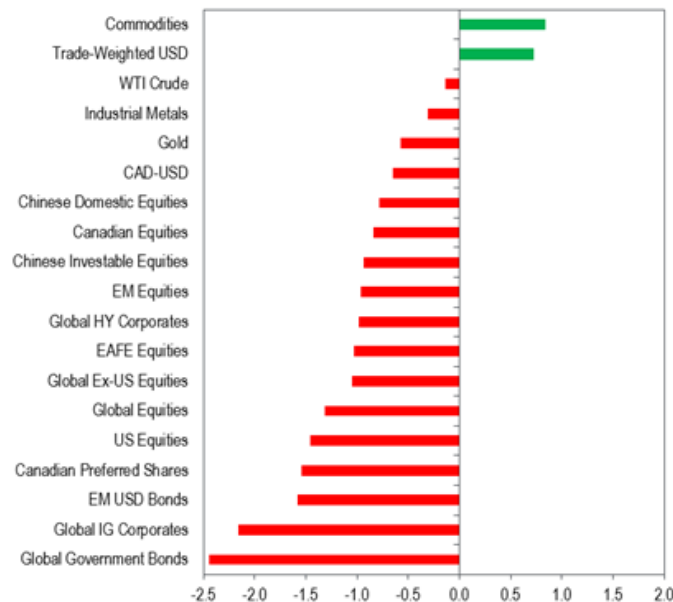
U.S. recession scorecard

Indicator	Status		
	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index			✓
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth	✓		

Source - RBC Wealth Management

With respect to the equity markets stock prices follow earnings, although not in perfectly linear fashion, as stocks discount future outcomes well in advance as was the case in 2022. Earnings are likely to continue to trend lower for another quarter or two as the decline in demand starts to hit corporate bottom lines. This could cause the markets to have one last dip back to the 2022 lows in the coming months which would likely be short lived, should it occur. There are some strategists who suggest that we haven't fully priced in a recession and that may be true, but we have seen a historic \$18 Trillion dollars wiped out of the global stock and bond markets in the last 12 months, which implies we have largely done so. Others suggest we have to assign a market multiple to trough recessionary earnings and as such the markets remain somewhat overvalued. It has never been correct to use trough earnings to value the markets, nor will it be this time. As trough earnings approach in the heart of a recession, the markets begin to look towards an economy coming out the other side. Marked down earnings estimates (which admittedly are far from finished) greatly amplify the ability for companies to beat those estimates going forward, setting the stage for a better backdrop and allowing multiples to begin to expand.

In 2022, virtually every financial asset suffered to make up that \$18 Trillion dollar decline in asset values, so there were few places to hide, as per below:



Source: RBC Wealth Management, Bloomberg

From an economic perspective there is plenty to be concerned about which the media bombards us with each day; however, as Tom Lee from Fundstrat points out below, many of the headwinds facing the economy last year are becoming tailwinds as we enter 2023.

Headwinds for much of 2022...



1. Inflation surges 7% BoY to 9% by mid-year
2. Russia-Ukraine war inflation and uncertainty
3. Crude prices surge \$75 to \$130
4. Food prices soar globally
5. Supply chain leading to higher goods prices
6. 10-yr yield 1.5% BoY to 3.5% mid-year
7. Fed "hurry to get higher"
8. Fed funds too easy: 1.75% vs 9% CPI midyear
9. China pursues zero COVID
10. CEO confidence falls at fastest rate in 50 years
11. Expensive stocks hit by higher rates

...becoming tailwinds starting December 2022



1. Inflation 0.2-0.3% MoM, or -3% next few mos
2. Russia-Ukraine war becoming stasis
3. Crude from \$130 to \$75
4. FAO food price index set to decline YoY
5. Goods prices tanking
6. 10-year from 4.3% to 3.7%
7. Fed set to become "more predictable"
8. Fed funds 4.5% (YE) vs 3% inflation run-rate
9. China possibly easing
10. CEO confidence bottoming
11. Expensive stocks de-rated

Source: Fundstrat, Bloomberg

While we have explored the concept of market timing in prior notes, it is worth revisiting after such a challenging year and the relentless media inspired discussion about raising cash in the face of uncertainty. While taking on a more defensive posture is never a bad idea when the macro environment faces significant risks, it should generally be done at the margin and not in binary fashion. To explore the notion of timing the markets, let us first consider at what point during a market cycle that the very best days tend to occur. Looking back in history since 1930, approximately 50% of the very best days in the markets occur during bear markets and usually the day after a big drop. So you may say I am ok to miss those. Another 28% occur in the first two months of a bull market when consensus most often suggests that it is just another bear market rally, with the news and backdrop still awful. The final 20% or so typically occur right at the top of a bull market when some market timers may be 'getting out' as stocks are getting too expensive and a downturn is looming. Let's assume one said, 'I am fine to miss all of the huge up days if it means missing bad markets and taking profits in good markets'. A study by Bank of America explores the impact on returns of only missing the 10 best market days in each decade since 1930. The results are astounding, albeit over a long period of time. Missing only the 10 best days each decade resulted in a total cumulative return since 1930 of 28% (not a typo), versus remaining fully invested over that time your total cumulative return would have been 17,715% (also not a typo). Still wish to try to time the markets? Consider trying to time the market akin to trying to time jumping on and off one of the high speed trains and not getting hurt. Virtually everyone that has tried ends up hurting themselves financially versus helping. Own great assets long-term and let them evolve and compound over years, and you will find tremendous success.

Our portfolios consist of many of the highest quality companies on earth with an excellent blend of value and the highest quality growth. Dividends will continue to grow pervasively and share buy backs will be on going. I am pleased to report that, in what was a challenging fourth quarter, more than 20 companies in our portfolios raised their dividends yet again. If these outstanding businesses, which possess superior earnings growth and strong free cash flow generation, get re-rated by the market from time to time, as they do, so be it. We want to be there as long-term investors at least until such time that something changes to truly alter their respective narratives. Treat your portfolio like you treat your personal residence. Own it, nurture it and let it compound. We will get through this car crash of a market as we always have with nothing more than a few bruises and scratches and we'll be the better for it as we look forward to a new cycle that I suspect will start a little more slowly than we have become accustomed but will ramp up over time putting this extreme volatility in the rear view mirror.

Sincerely,

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