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## 2022 – A Year Best Forgotten

Financial markets began their descent almost from day one in 2022. By the end of January, the die was cast for what would be an uncharacteristic loss of capital in *both the stock and bond markets*.

The S&P/TSX Composite price index dropped 8.7%. In the U.S. the S&P 500 index gave back almost 20%, while the NASDAQ index plunged 33%. European and Emerging markets fared poorly with the EAFE index down 15% and the EM index down 20%.

The drop in bond prices was historic as interest rates exploded higher. The Universe Bond index in Canada plunged 12.3% as the yield on the 10-year benchmark Government of Canada bond rose almost 2% during the year to 3.3%. In the U.S. the carnage in bonds was similar. The Aggregate Bond Index was down about 13%.

For the commodity sector it was mostly a year of declining prices. Copper, zinc, aluminum, were all down in double digits. Lumber prices collapsed dropping by 67.4%. Oil was up modestly over the twelve-month period peaking in June at U.S. \$120 and falling sharply to exit the year at \$80.

The declines in global stock markets in 2022 are illustrated below. Charted are four major indices, the S&P/TSX Composite index, in Cdn dollars, with the S&P 500, EAFE and EM markets in USD. The Canadian stock market had the best *relative* performance.



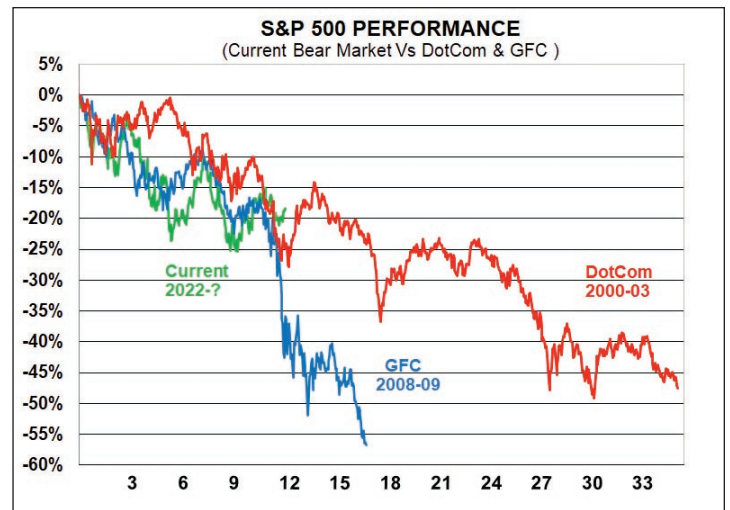
# 2023 – More Of The Same?

The decline in stock prices in 2022 was largely the result of rising interest rates. The root cause was the surge in inflation, which drove Central Bank monetary policy and undermined investor confidence. Stock valuations however remain at high levels in comparison to previous market cycles. They likely have not fully adjusted to the new higher yields available in the bond market. There is usually a lag time between equity valuation levels and interest rates. It takes time for investors to recognize a change in a cyclical trend. Importantly, Chairman Powell, of the U.S. Federal Reserve, keeps confirming he has no plans on cutting short term interest rates.

Still, any significant decline in stock prices in 2023 would need to be fundamentally based, driven by a slowdown in corporate sales and profits. For many economists and market practitioners, it has become obvious a recession is pre-ordained. It is only the duration and magnitude of the economic decline that is being debated.

For those with a more optimistic view, a soft landing is the hopeful scenario. They cite that inflation has peaked and is now trending down. The U.S. CPI registered 9.1% in June with the latest December reading at 6.1%. The “hope” is it will not be necessary for the Federal Reserve to maintain its aggressive policy. Labour markets are also steady with encouraging job openings as there continues to be a dearth of service level jobs. On the surface, it does not appear any serious downturn is right around the corner.

The adjacent chart shows the decline in the S&P 500 in 2022 compared to the declines during the DotCom mania in 2000-2003, and during the Great Financial Crisis (GFC) in 2008-2009. While it may be different this time around, the chart shows the two previous cycles each experienced a plunge of 50% in the major index. The declines ranged from 18 months during the



GFC to almost three years during the DotCom era.

On a positive note, there were profitable sectors to invest in during the long harrowing decline of 2000-2003. The cyclical and resource sectors and many smaller to medium sized companies did well. What sank the major index were the technology stocks, which became extremely overvalued and carried an excessive weighting in the index. This current cycle downturn may be a case of deja-vu as technology and growth stocks were again bid up to excessive valuation levels.

2023 will be a pivotal year and should clarify which sectors are gaining favour and attracting investor capital. Resources, mainly the beneficiaries of higher inflation, are likely to perform well, along with new growth industries in the green energy space. Or maybe Bitcoin will rise from the ashes and become the cryptocurrency of choice and command a safe haven status.

## Debt Ceiling

In the U.S., the debt ceiling has become a concern once again, and threatens to shut down the federal government. The current debt limit is \$31.4 trillion, and it has officially just been reached. Of course, this is really a case of political theatre, which Washington is well known for. In 2011, the last time the two parties engaged in an altruistic battle over the debt ceiling, the debt was a mere \$14.3 trillion. The debt ceiling has been breached multiple times since then only to be continually readjusted higher. The ceiling is obviously constructed of very flexible material.

Still, perhaps this time around global investors will be less forgiving. A short-term panic in financial markets is always possible. In the summer of 2011, the fear of a government shut down triggered a decline in the U.S. dollar and the stock market plunged quickly by about 15%.

It has always been theorized the excessive debt would one day

undermine confidence in the U.S. government and cause a run on the U.S. dollar. However, while the fiscal situation in the U.S. is troublesome, the rest of the developed worlds countries are not exactly upholding puritan standards. Debt is a global dilemma.

According to Janet Yellen, Secretary of the Treasury, the U.S can implement “extraordinary measures” to continue funding government operations until June. She is also considering swapping long-term bonds for short-term bonds, although it is not exactly clear why this is relevant to the debt ceiling. Perhaps it is recognition that there is no appetite in the marketplace for long-term government bonds.

In any event, expect more drama out of Congress. The debt limit debates will make good political theater and when it is all over the debt limit will be raised again and the lights will stay on in Washington.

# Recession - Shallow or Deep

Many leading economists and market pundits are already predicting a shallow recession. The World Bank has forecast global GDP growth at 1.7%, down considerably from earlier growth forecasts of 3+%. Recent surveys put the chances of a recession in 2023 at 60%, while CitiGroup is on record predicting a mild recession. It is therefore reasonable to believe a shallow recession may be "priced in" the financial markets.

Employment trends are mixed with small to medium businesses stating labour markets are tight. The larger technology firms are feeling less confident. Amazon has announced a reduction in their employees by 10% or 17,000 jobs. Microsoft and Google have also trimmed back their workforce indicating underlying economic growth rates are weakening.

Retail sales in the U.S. were down in December. Retail sales for the past several months contracted at an annual rate of about 2.5%. Inventories have piled up. Going forward this will result in less production and detract from GDP. The December Industrial production rate of change data is already slowing. These and many other indicators are signaling recessionary conditions for the U.S. economy.

On the fiscal side the next two years will see far less government spending. It was a raucous start to the year in the U.S. Congress. Electing the Speaker of the House is normally a straightforward political process. In the past 100 years the Speaker has been elected on the very first vote. Not this time. It took Kevin McCarthy a full week and 15 tries to get elected. Quite the spectacle.

Importantly, McCarthy was forced to make several concessions to appease the right wing of the party, including a cap on fiscal spending. This means that any fiscal largess is out of the question for the next two years. This is quite a departure from the fiscal handouts and deep budget deficits of the past two years. The \$1.7 trillion omnibus spending bill signed at the end of the year is likely the last stimulative piece of legislation for the next two years. The Republican controlled House is aiming to balance the budget that will put an end to fiscal support for the economy.

The combination of tighter fiscal policy and a restrictive monetary policy courtesy of the U.S. Federal Reserve means a shallow recession is almost guaranteed. A deep recession is usually the result of a policy error and/or a structural imbalance in the private sector. It is too early to know with any certainty how this cycle will end.

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## The Wealth Effect

The wealth effect is one of those ambiguous economic concepts that surfaces once and awhile. It is rooted in behavioral economics, and it attempts to quantify the impact of a change in wealth on future spending. It is intuitively obvious that a decline in financial asset prices, if significant and prolonged, will bring about a change in the desire to spend. Similarly, a rise in portfolio wealth will encourage spending. The decline in financial markets in 2022 has produced a negative wealth effect which may contribute to a larger than expected decline in consumer spending for 2023, with the obvious impact on the economy.

The "paper loss" in financial markets in 2022 was not extraordinary in percentage terms. However, the loss in dollar terms was staggering since market valuations were at record highs. At the peak, the total market capitalization in fixed income securities in the U.S. was close to \$50 trillion. The decline

of about 15% in the Bloomberg Aggregate Bond Index means that in 2023 the paper loss in bonds equaled about \$7 trillion. The 20% decline in the stock market equates to about \$10 trillion (the Wilshire Index of 5000 companies peaked at almost \$50 trillion). According to the Financial Times, the combined *global* loss in stocks and bonds was over \$30 trillion. These are substantial losses and in dollar terms are *greater than* the losses during the GFC in 2008-09 when the Wilshire 5000 shed almost \$11 trillion. The losses then were limited to stocks *as bonds rose in price*.

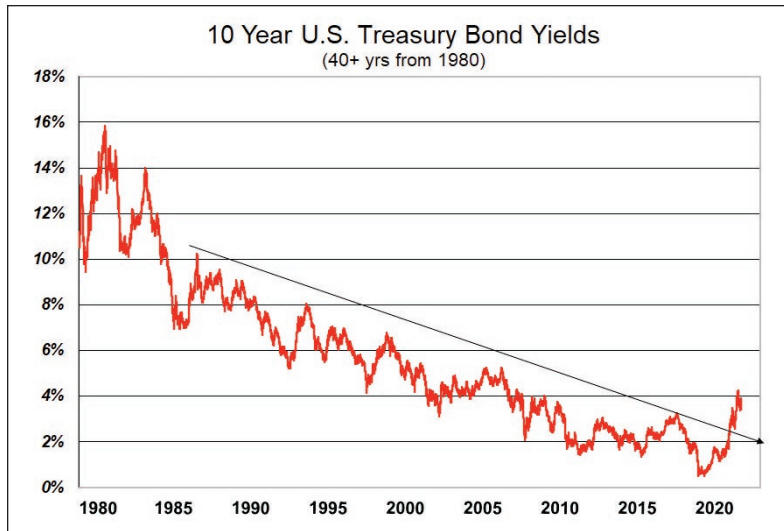
It is uncertain how consumers will respond to the loss in portfolio wealth. There is similar uncertainty in the housing market. Although home prices are declining, they are still well above where they were before the pandemic. At some point, however, consumers are bound to retrench if asset prices keep drifting lower.

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## Bond Market

The bond market had a terrible year in 2022. By some accounts it was the worst decline in bond prices in over 100 years. This has rekindled the debate as to the longer-term outlook for bond yields. The following chart shows the yield on the 10-year U.S. Treasury bond going back to 1980. It has been a long 40 plus year decline in yields. The trend line was finally broken in 2022 lifting yields from practically zero percent.

The consensus is still anticipating a return to low interest rates in the next year or so. While the outlook is uncertain, the probability of a secular change to a higher interest rate environment in the course of the next 10 years is almost a certainty. The beginning of a new shift to higher interest rates is not on investors' radar screens. While this may not matter in the  
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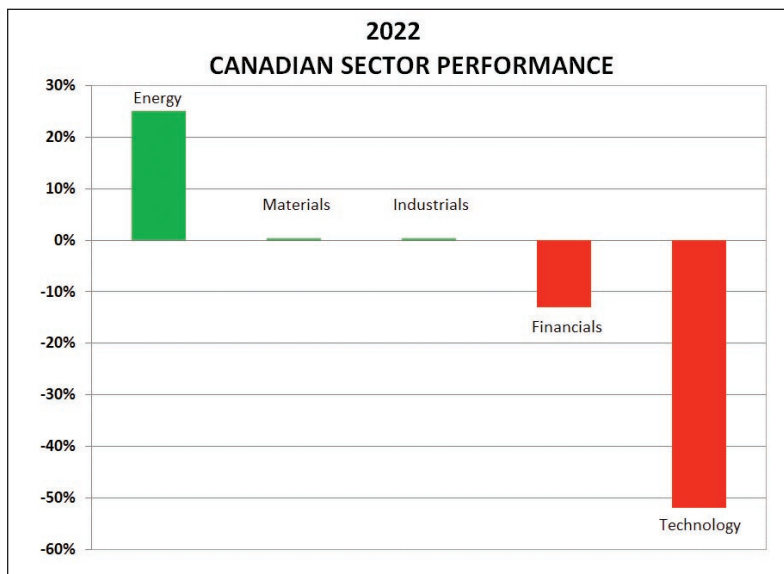
short term, it is an important issue which is bound to be constantly reassessed in the years ahead.

Jerome Powell has consistently stated he intends to get inflation under control and back to the 2% level. He has been described as a modern-day Paul Volcker. Volcker was appointed to the Federal Reserve as chairman back in 1979 to deal with a decade of runaway inflation. Monetary policy under his watch was highly controversial yet he succeeded in taming inflation by raising interest rates to punishing levels. The circumstances are quite different today however Powell is very much aware of the importance of getting inflation under control before expectations build and become ingrained.

Bond yields will likely decline this year in parallel with weaker economic conditions. As such positive returns in both short and longer-term bonds should be expected in 2023.

## Equity Market

The S&P/TSX Composite price index declined by almost 9% in 2022. For the second year in a row, Energy was the best performing sector rising by 26%. The Financial sector, led by the major banks, disappointed with a loss of 12%. The technology sector plunged by over 50%. The bar chart below shows the performance of the top five sectors in the index. Together these five industry groups comprise about 80% of the index weight.



In the U.S. market the Technology sector also performed poorly. The six largest companies, Apple, Microsoft, Alphabet (Google), Nvidia, Amazon and Meta Platforms (Facebook), lost nearly a total of \$4 trillion in market value in 2022.

Companies with higher dividend yields, limited earnings cyclicality and strong balance sheets experienced lower volatility in 2023. We believe these will continue to be important characteristics in 2023.

At this stage corporate earnings have held reasonably well. The consumer discretionary sector has shown some of the sharpest declines as cost pressures mount and profit margins are squeezed. If a mild recession ensues as consensus expects then the outlook for revenues and earnings will continue to soften.

Hoping for interest rates and inflation to decline is not a sound investment strategy. While it could reprice stocks sending valuation levels higher, it would require a recovery in economic growth. Unfortunately, there is a likely a recession in the way.

Furthermore, with short-term deposit instruments yielding well north of 4%, the competition for stocks is now surmountable. Cash outperformed in 2022 and may still manage to do very well both on an absolute and relative basis in 2023. Yields are finally attractive, and it makes sense to wait for some clarity in equity markets.

The reopening of China is bound to be a positive catalyst for the global economy. China has effectively been in a lockdown for almost three years. The reopening will bring relief to supply chains and improve overall demand for goods and services.

Still, the Federal Reserve is dealing with a classic Catch-22. If the stock market strengthens it is just more ammunition for the Fed to maintain their aggressive policy stance.

Maintaining an aggressive stance will eventually short-circuit the economy and accelerate the potential for a financial accident.

We are maintaining a cautious approach. Actively managing risk is still very important considering the uncertainty in financial markets. Opportunities should surface in the year ahead.