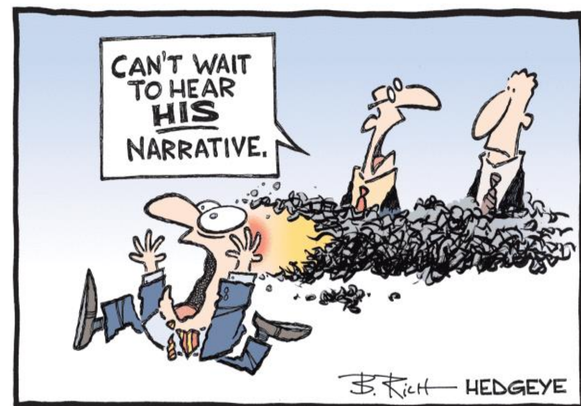
FAIRCOURT
Asset Management Inc.

4th Quarter Commentary – 2021

Summary:

Capital markets finished up strong to end 2021 but have set up quite choppy to begin 2022. The market confusion opening the year is a result of the latest virus mutation, Omicron, and concerns regarding Fed interest rate policy. Omicrom is likely to restrict economies, lockdowns have once again begun in some parts of the world. In Canada and Europe we seem to already have the playbook. Cases go up, politicians panic, economies get locked down and growth begins to slow. In the USA it's a wait and see approach. Market bears are pointing to the Fed and raising rates, yield curve compression and continued rising inflation prints, albeit on lagging data. Market bulls are acknowledging the bears narrative, but continue to point to reopening delays and stability in employment levels needed before a more hawkish Fed policy can take place. These two different narratives seem to be fighting for control and contributing to market choppiness. As a result there is uncertainty with respect to market direction. Needless to say the macro backdrop is getting complicated. Capital markets can adjust to good news and bad news but have no easy way to price in true uncertainty. None of these narratives have anything to do with the economic cycle we are navigating. The economic data is telling us growth and inflation have potentially peaked and are even decelerating. This is the pivot we began making in late December.



Recap & Outlook:

It has been an extraordinarily one sided market for all major equity indices and a struggle for defensive strategies. For the year ended December 31st 2021, the S&P 500 was up +25.6% and the Nasdaq Composite up +27.5%, TSX Composite up +25.4%. Gold reduced by -4.2%. Bonds also generally decreased on the year, with Long-Term U.S. Treasuries decreasing

by -4.7%, and 10-year Tresuries down -3.3%. Inflation came in at 6.71%, printing north of 7% subsequent to year end.

Based on our capital preservation and sustainable income bias, there are several sectors we are underweight in our SMA mandates. We have largely avoided many unproven technology stocks, been underweight traditional energy exposure and have also reduced our exposure to traditional financials. Despite avoiding those frothy volatile sectors, the SMA mandates generated a return of +18.1% in 2021.

Since the end of 2021, equities have struggled to find their footing amid a risk-off sentiment driven by the Omicron variant, the release of minutes from last months's FOMC meeting, and rising geopolitical tensions. Uncertainty has been propagated by lower US growth expectations following doubts that the US administration's Build Back Better spending plans can be resuscitated. The detail contained within the Fed minutes indicated a more widespread belief among FOMC participants that the Fed needed to move sooner and more quickly in reducing the overall size of the Fed balance sheet, signaling possibly 4 rate hikes for 2022 and that has spooked equity markets. This degree of hawkishness had already been communicated by the Fed in several forms, and so it is perhaps surprising that equity investors had a strong reaction to the news. Investors were perhaps caught off guard by the forcefulness and level of consensus shown in the minutes. Chairman Powell did say the Fed is not on a preset path and would adjust if conditions warranted, meaning he has left the door open to delaying, defering or pivoting back to a more accomodative stance, essentially buying them optionality on when to execute further.

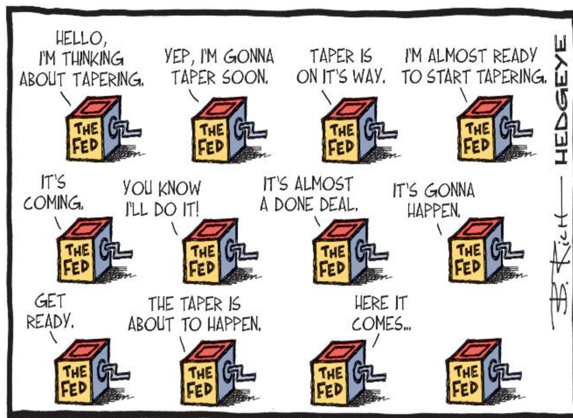
On the point of rate increases market bulls are pointing to the bond market action and suggesting long term rates have peaked or are peaking (peaks, like bottoms, are a process and not points) suggesting the economy is not fully stablized and the Fed will not deliver on everything they said they would. Perhaps the Fed decides to

raise once or twice at best and then allow the economic prints to confirm policy success in fighting inflation and then likely be in a position to stimulate again, when needed. The risk to this view is the Fed does see through its actions ensuring more dry powder in future cycles and we thus witness a prolonged bear market. US markets are a tad spooked right now, looking for direction. And barring a direction it is comfortable with (slow moving rate hikes), the market may overreact to get the Fed's attention.

Globally, the evidence that inflation has peaked or may be peaking is beginning to take shape. We have seen readings so far that multiple countries have reported slowing CPI in December vs November. Data is pointing to disinflation in 2022, but the reality is, certain components of CPI, such as wages and shelter, may not disinflate quick enough to have the Fed not begin raising rates in a material way. In absolute terms inflation will still be elevated but focusing on rate of change we are seeing deceleration.

On the labour front, job reports have been a mixed bag. On the one front the unemployment rate is on or about 4.2pct, good on the surface, but at the same time we are having the smallest number of new jobs created which is a concern. Then we factor in the declining labour force participation rate and concerns about growth resurface. These mixed signals suggest nothing that would likely stop the Fed from changing its mind on the taper trajectory it has set for itself. The Fed has a dual mandate. The Fed's concern on price stability, meaning manageable inflation, suggests they would be willing to let interest rates rise a bit. On the other hand its maximum employment mandate has been driving the main reason why they have been so loose with monetary policy. Given the jobs reports keep disappointing, the Fed's two mandates are now in conflict. But it appears, based on Powell's latest testimony, the inflation debate is in the driver's seat. While a low interest rate environment has sent equities to all time highs, rate hikes and ending easy-money policies more quickly could, however, turn the market into

a bearish direction. Our role as PM's is to recognize the hazzards as this environment will force feed you discipline, or punish you for not showing it.



The bond market action is a leading indicator for us. Bond markets tend to be far less emotional than equity investors. Bond markets attempt to price in future inflation and GDP growth. Equity traders trade narratives, sentiment, earnings, buybacks to name just a few factors. The reality is removal of liquidity and Fed tone hawkishness are negative dynamics for capital markets. The short end of the curve, 2yr, will accelerate as the Fed moves to tighten rates. The long end of the curve, the 10 yr, is suggesting growth is close to peaking. The bond market is smart enough to look through cyclical dynamics and equity market noise. Tightening into a stagflation (inflation rising and growth decelerating) or deflation environment (growth and inflation both decelerating) bonds go up in price (rates fall) because the risk premium assigned to risk assets, equities and commodities, begin to widen. This is the scenario we believe we find ourselves in now. Risk assets will not enjoy this environment.

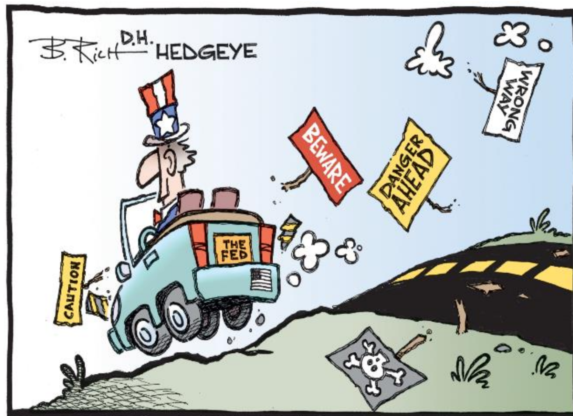
For Q1 the market is pricing in a quantitative tightening policy (reduced Fed Balance Sheet), with a slightly positive growth outlook and elevated inflation prints. Our expectation for Q1 is that bond market volatility will reduce and the yield curve to trade range bound. It is currently acceptable for rates to be rising as we are not in a slowdown, we are still in expansion, albeit slower. Economic growth decelerates slowly, rather than sharply, with strong underlying economic growth characteristics. We see domestic inflation rolling over in the coming months. Inflation will (on an absolute level) remain high for some time, but we see disinflationary pressures proliferating globally in the first half of

this year. With the Fed and most of Wall Street consensus forecasting 4 rate hikes in 2022, the bond market moved in kind to reflect this hawkish tone. Gold price positive performance is confirming peak inflation, peak interest rates and peak Fed hawkishness.

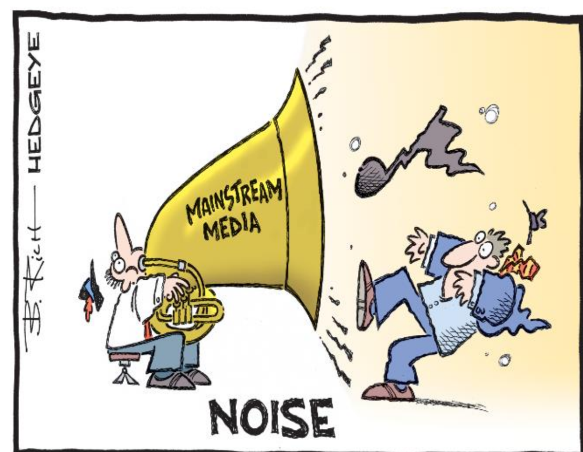
Part of the volatility we are experiencing during these transitions is to allow for market participants to figure out the current cycle and reposition going forward. The biggest risk accumulating in the market is if the Fed does in fact implement aggressive rate hikes (to combat past inflation prints) which would be, in our opinion, a possible policy mistake. The spending drop due to cuts in pandemic aid is in the neighborhood of 1.3Trillion. This is unavoidable. Years 2020 and 2021 were very big years for stimulus cheques and support payments, and rent abatements and child tax credits and now we seem to lack progress on President Biden's 'Build Back Better' infrastructure plan that could offer extensions for some of those programs. The passage or lack there of of this plan by Congress could play a role on both inflation and growth. Raising rates into a slowdown is a very risky move on the part of the Fed. The Fed is looking to taper, talking about raising rates at the same time the consumer is potentially restricing consumption. This could be the worst possible time for the Fed to move to a monetary tightening policy. The catalyst for disinflation is a rate hike, the catalyst for deflation is multiple rate hikes while growth is slowing. This is what a policy mistake looks like.

The more challenging the macro environment the more likely we are to see a flight to safety, slow at first and then suddenly. This would be bullish for certain assets, USD$, treasuries, gold, utilities, REIT's, and consumer staples, and yet bearish for basically everything else. The Fed has made this mistake twice before, Dec 2018 and in 2013. The Fed seems to have the uncanny ability to make moves at the wrong times. Our faith in the Fed has been deeply shaken by its approach to currency debasement, its inability to stay independent and its failed attempt to dismiss 16 months of elevated inflation prints that was evident to anyone paying attention. A

world where both growth and inflation decelerates warrants a differrent asset allocation from the world we are exiting from, which has been elevated growth and inflation. We are gettting to a place where we need to be underweight what we were overweight and overweight what we were underweight. Risk managing a growth and inflation slowdown is tricky, but we think of it from a volatility perspective.



One of the main themes of this quarter's commentary is to block out the noise of the financial press, internet, social media (professional and amateur). The largest oversupply in our profession is in narratives and noise. We look to capitalize on that. We will keep focused on the Fed's commentary behind the decisions and the bond market's reaction. Data for us, outweighs narratives every time. Most of what passes for economic or market news is just noise, distractions that take your focus off what is really important. Our job as PM's is to to fade feelings and execute on our process, investing in the market we have and not the one we want. Financial turbulence is not rare, markets are unpredictable and volatility misbehaves. Never confuse lack of volatility with stability, ever. Even if they cannot be avoided, our role as PM's is to learn how to mitigate the risks associated with volatility.



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If markets are keeping you up at night and you would like a fresh approach, give us a call at 1-800-831-0304 or 416-364-8989.

Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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