FAIRCOURT
Asset Management Inc.

4th Quarter Commentary – 2022

Key Take-aways:

- The S&P500 posted an uncomfortable -19.4% for 2022, Nasdaq was -33.1%, Russell 2K -22%, TSX (ex energy) -8.5%. Since 1940, the only years with a larger decline for the S&P500: 1974, 2002, and 2008.

- We are in a developing global recession; Central Banks are still playing catch-up on inflation and the rapid pace of monetary tightening will be painful. The reality is meaningful disinflation for the FED remains afar, as long as consumer demand remains relatively robust due to a tight labor market.

- FED pivots are defined by rate cuts not sustained periods of elevated rates. Rate hikes are implied to end in March 2023 then remain elevated until Sept 2023.

- The Equity Volatility Index ("VIX") averaged approximately 26 in 2022. With data beginning in 1990, the only years with a higher average VIX: 2002, 2008, 2009, and 2020.

- Equity markets still appear out of sync with Monetary Policy Maker Forecasts as they have yet to fully price in the structural change in rates (higher for much longer).

- The Savings Rate in the US has moved down to 2.3%, the 2nd lowest level on record with data going back to 1959 (lowest was 2.1% in July 2005). We continue to reiterate the consumer has less cash to spend.

Positioning:

- Global growth, inflation, consumer spending, and corporate profits decelerating cementing a global recession. The way forward is risk managing a recession.

- Maintain defensive posture, reducing net market exposure.

- Maintain overweight US dollar.

- Execute on selective shorts on vulnerable sectors/indexes and high yield bonds.

- Beware bear-market bounces and position for weaker corporate earnings.

- Continue to be macro aware, showing discipline, and focusing on investible volatility.

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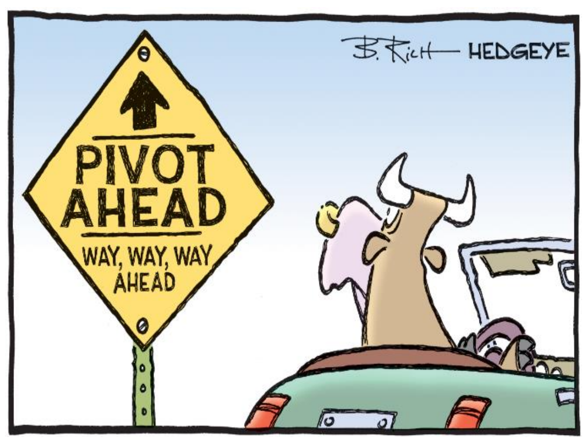
As we close the chapter on 2022 it will be one that many long only investors want to forget as both bond markets and capital markets suffered as Central Banks reacted with delay to inflationary pressures. Since 1950, the only years with more 1%+ declines on the S&P500 were 1974, 2002 and 2008. Absent being long the U.S. dollar, chosen commodities, or having the ability to short it was a challenging year for investors. Brief rallies in the markets were based on hopes that any tick down in inflation prints would convince the FED to pivot away from aggressive liquidity withdrawal measures.

On December 1st Chairman Powell increased rates for the 7th time in 2022 by an additional 50bps for a total of 4.25% in 2022. Chairman Powell wants to get the policy rate to 5.0%+ and hold it there for an extended period. Current market expectations for path of the Fed Funds Rate is Feb 2023: 50 bps hike to 4.75%-5.00%; then pause; then rate cuts begin in Nov 2023, continue in 2024. Whatever the FED decides on future rate hikes, it won't change the fact that inflation remains elevated, financial conditions are tightening, and real growth is decelerating. While some components of inflation have come down, collectively the data remains near 40-year highs. During every major inflation shock since the 1950's it took on average 25 months to go from trough to peak inflation. Looking at the current period, trough inflation being Q1 2020 (0.3%) and peak inflation being Q2 2022 (9.1%) it took almost 26 months. If peak inflation was June of 2022 we are rather early in the deceleration narrative and should be thinking Q2 2024 of getting near FED targets of 2%. Meanwhile in the labor market, the overall employment rate in the economy remains near generational lows and monthly job additions to the economy remain positive. The FED's aggressive path of interest rate hikes have done very little to dent the labor market. The reality is inflation is still a problem and will be so for the foreseeable future.

The bond markets are the biggest and most liquid asset class in the world. Currently the bond markets are discounting a reasonable probability of a long FED pause next year, accompanied by an economic slowdown that will most likely require accommodation in late 2023 and 2024. The largest central bank in the world is actively draining liquidity from the financial system while most economic indicators are pointing towards significant economic deceleration.

The equity markets are pricing in the assumption that the slowdown will be mild and quick. This uninformed narrative has changed in less than a month with the new narrative being inflation peaked combined with a developing recession (rising unemployment too) that forces the FED to turn dovish. Regardless of where near term inflation prints come in, it won't change the facts at hand. Growth is slowing, monetary conditions are tightening, and inflation remains elevated. Recession risks are far important now than rear-view peak inflation prints. Credit risk rises during developing corporate recessions. US 2-10 spread is at -71 bps while global 2-10 spreads continue to further invert with 30 of 33 countries declining month over month and 14 of 33 countries with an inverted yield curve. Once again, this is a leading indicator and pointing to a global recession. If that weren't enough, the spread between 10-year and 1-year Treasury yields moved down to -1.18% in early December, the most inverted curve since September 1981. The last 8 recessions in the US were all preceded by an inversion in this yield curve relationship. In other words, lots of bullish investors continue to misunderstand the FED's true intentions. FED pivots are defined by rate cuts not sustained periods of elevated rates. Recession risks now exceed inflation risks and remains the principal feature defining the current macro trajectory. The way forward is risk managing a recession.



The transition from inflation concerns to recession risks is a narrative we believe will dominate the headlines throughout 2023. Monetary policy has a delayed effect and will have to remain tighter for longer. On the consumer, data is proving to us that the US consumer is not well positioned for this downturn and deteriorating at an accelerating rate. Further rate hikes will only continue to weaken the consumer. As cost of loans becomes more expensive demand for credit should decelerate. The natural deterioration in the credit profile of the consumer had already begun and now looks to worsen. The speed with which the consumer's fundamentals have deteriorated has been remarkable. We remain concerned about the stress being shouldered by increasingly tapped out U.S. consumers.

On the corporates, valuations face a dangerous mix of rising interest rates, slowing economic growth, rising inventories, margins at all time highs, increasing bad debts, and the strong U.S. dollar remains a headwind. Most analysts, economists and market participants expect a linear and predictable bear market and economic slowdown. Analysts' projections remain far too optimistic in our opinion. Double digit EPS growth is not attainable if the private sector is being faced with the sharp tightening in financial conditions and now setting up for tighter for much longer. The rate of change of the US economy continues to slow at a faster pace. Both companies and street analysts are late to revise.

Important signals for our process remains cross asset volatility, USD dollar strength, and the activity coming out of fixed income markets. Being macro aware and data driven, we had pivoted to a more defensive portfolio, adding macro hedges such as being overweight the USD dollar and shorting select indexes and high yield bonds while monitoring trending cross asset volatility. With inflation peaking and the FED tightening (that is negative real rates) this environment also supports an allocation to precious metals. Market participants are still not bearish enough nor grasping the scale of the treasury market volatility.

Our non-consensus view remains, the longer equity markets go without capitulating further and re-evaluating fair value the bigger the problem becomes as the FED continues to aggressively tighten monetary conditions. Equity volatility tends to elevate once a recession commences. Our goal in our portfolios is to be directionally accurate and get allocations correct on a rate of change basis. Yield curves flatten and invert while headed into a recession and steepen while in a recession. For economic growth there needs to be capital available and that currently does not appear to be the case with inflation outpacing wages, cost of mortgage funding spiking, and significant wealth destruction in stocks and bonds. History of bear markets is that there are observable deterioration points across various macro economic variables before we achieve a bottom. The bottoming of the market is a process and not a point and for now the market risk is to the downside.

Investors focus heading into 2023 should turn to the challenge for economic growth rather than the risk of inflation and higher rates that are beginning to show up in an economic recession and weaker corporate data. Global liquidity cycles drive changes in asset prices. They influence the direction of global equity markets. They drive fluctuations in bond yields and credit spreads. A reversal in global liquidity is one of, if not the most, important catalysts for a renewed bull market. The business cycle leads liquidity and, the ISM is forecasting significant economic weakness ahead. The FED has yet to show signs of a liquidity reversal. The problem is that an expansion in global liquidity tends to loosen financial conditions, which is the opposite of what the FED wants right now. For now, Central Banks around the world are expected to continue the tightening path ahead despite the weak economic data. Patience remains our core allocation.

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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