2022 Year in Review

The S&P/TSX Total Return Index declined 5.84% versus the S&P 500 falling 18.10% with dividends included, and the more tech-focused Nasdaq declining approximately 32%. Bond markets provided no ballast in 2022 evidenced by the Bloomberg US Aggregate Bond Index declining 13% over the course of the year.

Volatility in the U.S. benefitted throughout the year, however, the Canadian equity markets significantly outperformed due to the ballast provided by the energy and financial sector.

North American Market Returns	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**35 Year**
S&P 500 Total Return (USD$)	-18.1%	7.5%	9.4%	12.7%	10.4%
S&P 500 Total Return (CAD$)	-12.4%	8.8%	11.1%	16.1%	10.5%
S&P/TSX Composite Total Return (CAD$)	-5.8%	7.5%	6.8%	7.8%	8.1%
Bloomberg Aggregate Bond Index Total Return (USD$)	-13.0%	-2.7%	0.0%	1.0%	5.4%

Source: Bloomberg, Dec 31st 2021

In our 2021 letter – A Warning Sign – we chose to highlight a verse from a Coldplay song. 2022 was certainly a difficult year for segments of the global markets, particularly technology. Despite this worse than average drawdown, the reality remains that the period prior had significantly larger than average appreciation of values. Rarely does the sector that leads the market down subsequently become the sector that leads it back up. Therefore, we think we are still in corrective territory and that the broad excesses of the past several years require further deflation.

A warning sign
I missed the good part then I realised
I started looking and the bubble burst
I started looking for excuses.

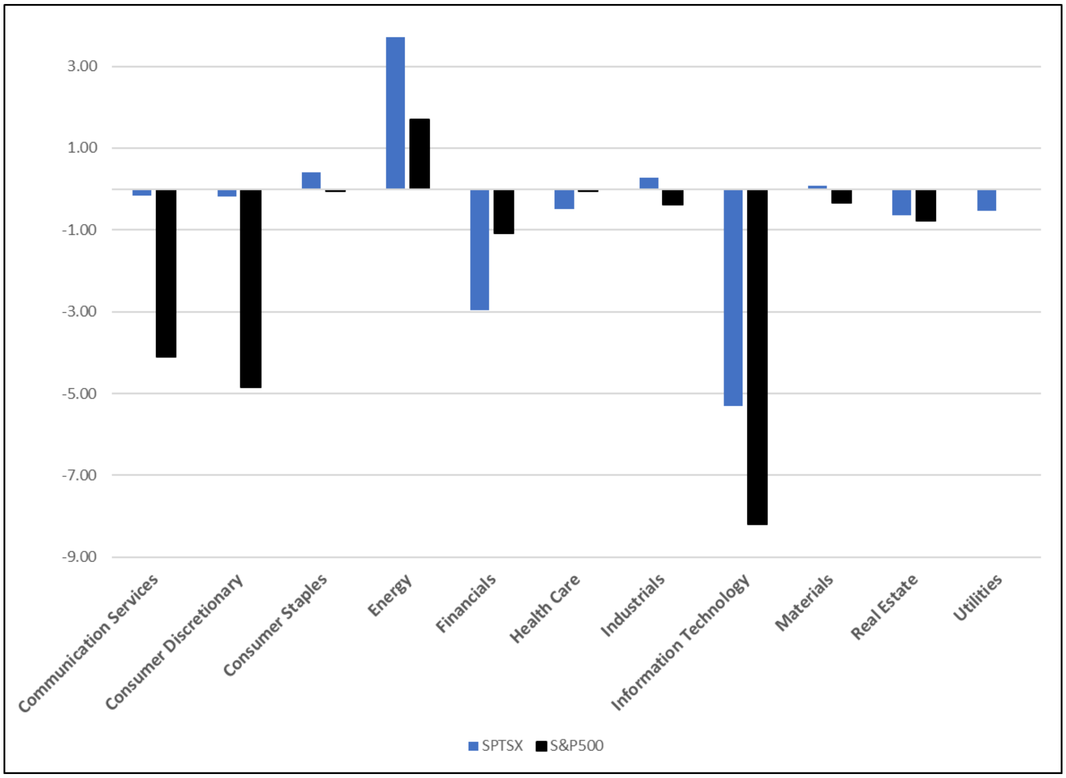
-Coldplay

Correlation and Volatility

Historically, volatile periods in equity markets are associated with rising correlations across the entire equity complex. This is not simply an observation of equity behaviour but rather a mathematical identity whereby volatility is a function of the standard deviation of assets and their corresponding correlation with each other. Therefore, it is uncommon to see rising volatility while at the same time observing low or negative correlations.

In 2022, Canadian equity market volatility was significantly dampened by the positive performance of energy, consumer staples, industrials, and materials relative to the rest of the equity universe. In contrast, US equity market sectors were more correlated resulting in higher volatility.

Chart 1 – Return Contributions by Sector 2022



Source: Bloomberg

Our options strategy looks to purchase exposure to volatility when it is cheap and sell it when it is expensive. One of the factors affecting these opportunities will be the relative correlations between equities and sectors. As a result of the low sector correlation, index volatility was cheap relative to other areas of the market. We therefore are holding a long volatility index position. It is our experience that during significant market drawdowns or rallies, correlations rise resulting in an increase in volatility. Compared to the U.S., we did not see that in the Canadian market in 2022.

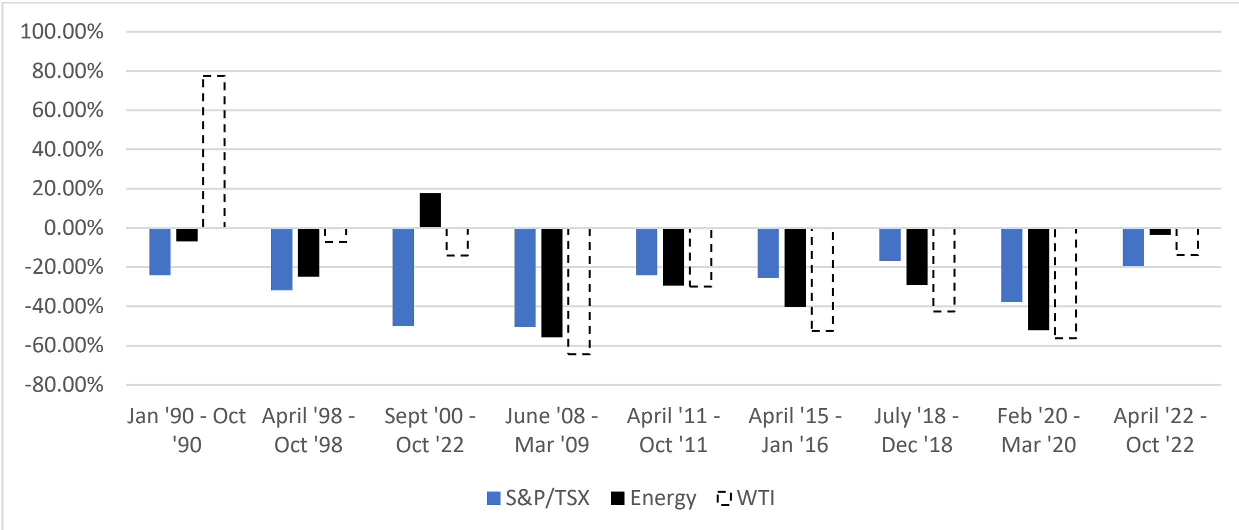
Outlook for Canadian Equity Markets

The positive performance Canada experienced relative to other markets around the world can largely be explained by the country's overweight to Energy and Commodities. Geopolitical pressures are likely the cause of this relative outperformance. However, this exogenous factor impacting the system throughout 2022 remains susceptible, along with all commodity prices, to changes in aggregate demand.

The inflationary pressures impacting the world, brought upon by loose monetary policy, has forced central banks to react. Current monetary policy tightening is expected to impact aggregate demand in 2023. These policy decisions take time to filter through the economy and we are only beginning to see the consequences of these shifts. We are likely to see earnings declines that accompany a fall in aggregate demand along with decreases in consumer spending and higher commercial and consumer defaults. There has never been a hiking cycle in history that has not proceeded a recession. There has never been a recession that didn't negatively impact equity prices.

Canadian investors have benefited from the relative performance of the energy sector in the past year. While the geopolitical environment remains supportive of energy prices, there are few instances where market declines, caused by economic contraction, does not result in rising correlations and price declines across all sectors. We therefore would caution those that believe "this time is different" and suggest recessions are bad for all industries.

Chart 2 – Energy is Positively Correlated During Drawdowns



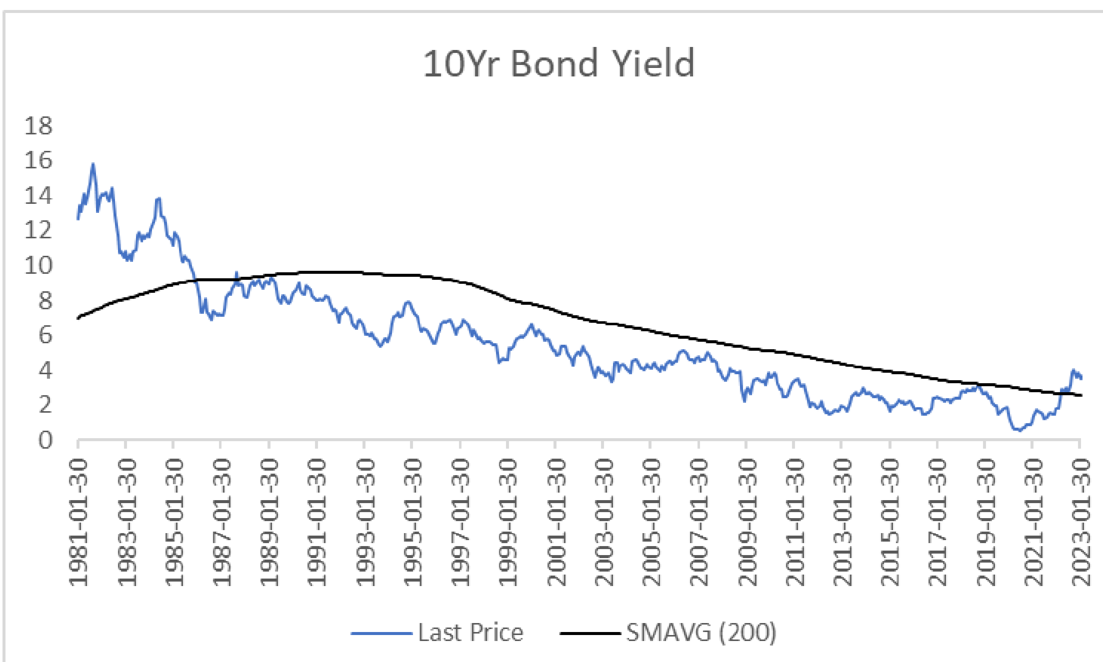
Source: Bloomberg

Where we could be wrong

The behaviour of monetary authorities over the last decade suggest they are quick to pivot at the first sign of economic stress. This time, these same authorities are faced with the hurdle of inflation, making it more difficult to pivot - but not impossible. A premature loosening of financial conditions could result in significantly higher equity prices. Given that this is not our view, we would likely adjust our portfolio positioning in response.

It's all about interest rates

Chart 3 – 10-Year Bond Yield Break-out



Source: Bloomberg

The level of interest rates remains a key variable impacting the direction of financial markets. Interest rates anchor risk expectations and discount rates for all other financial assets. For the last 40 years, North American rates have been in secular decline. Despite efforts to "normalize" interest rates, a comment that central bankers make blindly without much explanation – they have never successfully stabilized at previous levels. We have had a 40-year trend of lower highs and lower lows until we hit zero. An entire generation's financial success is likely the result of this trend.

The trend has broken.

It is hard to predict what this ultimately means for the value of financial assets but if low interest rates were "good" then perhaps higher interest rates are "bad". We find it confusing that there are alternative narratives describing this dynamic. The investment business is overwhelmed by intelligent and thoughtful people who often make economic topics overly complex, however, we simply do not think this is an accurate reflection of reality. When the price of something rises, the demand for it should fall. In effect, that is the source of our monetary authority's interest rate strategy – the cost of money.

There are several examples throughout history dealing with the consequences of higher interest rates following a decline to zero. Like our peers, we have no crystal ball, but we maintain our conviction that there will be better opportunities, at lower prices, to deploy capital. We remain defensive, have concentrated our portfolio into our best ideas and believe investors will be rewarded for their patience.

Sincerely,

Ryan Marr & Max Torokvei