Perspective

2023 Investment Outlook – Inflation Inflection

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LONG-TERM MACRO THEMES

As 2022 unfolded, we expected stagflation to materialize. However, the economy (the first half of the equation) held up well in the face of high inflation and rising interest rates. However, higher interest rates logically depressed equity valuation. High-flying growth stocks with optimistic but uncertain futures experienced significant price declines.

Despite some doomsday scenarios, numerous 2023 economic green shoots suggest it will be a good year for investors. These positive signs are consistent with historical trends – it is very rare for the S&P 500, a leading investment benchmark, to have back-to-back negative years. In fact, since 1950, there have only been two episodes of multiple down calendar years.

MACRO THEMES

1. Interest rate inflection.
2. Aging G8 populations.
3. Nationalism & production onshoring.
4. N.A. infrastructure renewal.
5. Climate change & renewable energy.
   a. Increasing weather intensity.
   b. Increasing food insecurity.
   c. Housing displacement.
   d. Increasing copper demand.

As we look ahead, there are critical macro themes that will help us position portfolios in the years ahead. While most of them are familiar, they offer important investment opportunities that will ebb and flow over time. For example, electrification associated with green energy to combat climate change means the price of copper will benefit from a surge in volume through 2050. Amongst other things, copper is used in electric transmission. Combining this long-term macro theme with a cyclical economic rebound (as we expect later this year) improves probabilities and magnitudes of investment success.

Two of our macro themes – production onshoring and infrastructure renewal – are already evident in public policy. In November 2021, the U.S. Congress passed a massive $1.2 trillion bi-partisan bill to improve American infrastructure (transportation, broadband, power & grid, and water). This generation-defining initiative will have a significant impact on infrastructure businesses and commodities like cement, copper, steel, engineering, construction, internet technology and hardware, etc.

The Creating Helpful Incentives to Produce Semiconductors and Science Act – CHIPS Act – of August 2022 is designed to catalyze investments in domestic semiconductor manufacturing capacity. This onshoring effect is already evident in Apple's December announcement to use made-in-Amercian semiconductor chips when a new multi-billion dollar foundry plant is up and running in Arizona.

Marrying infrastructure rebuilding and made-in-America with a cyclical economic rebound unleashes years of compounding investment opportunities. As discussed below, Thornmark portfolios are being positioned to capitalize on these catalysts. In our assessment, doomsday stagflation protection is no longer necessary; however, the opportunities must be balanced against risks (discussed below).

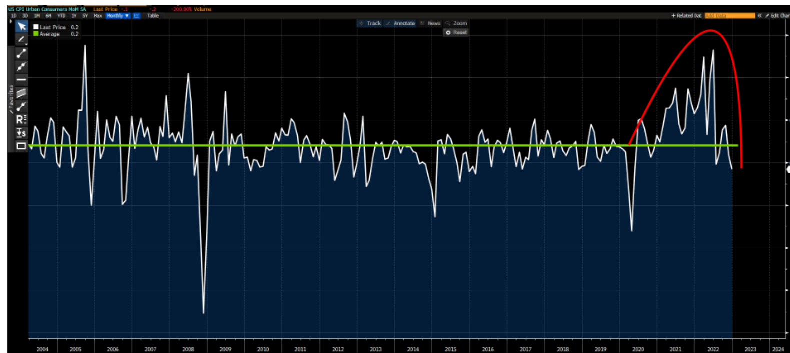
UNIQUE ECONOMIC CYCLE

Equity markets have never troughed before the start of a recession. However, we don't have a good comparison for a pandemic-induced inflation spiral. Therefore we cannot rely on historical examples of market troughs, and this time around, it likely will be different.

After initially denying the global inflation threat, the U.S. Federal Reserve has ratcheted up rates the most since early this century. In less than a year, the central bank increased the Fed Funds Rate seven times, from 0.25% to 4.50%. And there are likely more but less aggressive hikes to come. As a result, the Canadian bond market had a terrible year, declining 11.7% last year and down 17.8% from the August 2020 peak (FTSE Canada Universe Bond Index).

While trailing year-over-year inflation remains high at 6.5% in the U.S. and 6.3% in Canada, the trend is decidedly low. The average of the past five months of U.S. month-over-month CPI is only 0.16%. Annualized, that's equivalent to only 1.5% CPI, compared with 9.1% in June 2022. While there may be some stickiness from services inflation, the trend is definitively lower, and we think is moving quickly toward the Fed's 2.0% target.

While central banks worldwide have normalized rates, economic conditions have remained positive. In North America, employment, consumer spending, and corporate earnings all remain relatively strong. The impact of interest hikes may well push the economy into a recession (the risk); however, that is anything but a certainty at this time. In our opinion, a recession is still a flip of the coin.



INFLATION OPPORTUNITY IS LOWER RATES

We expect inflation will continue its trend toward the Fed's target range. This isn't comfortable while prices remain elevated from prior levels. At least things aren't getting worse. And from an economic perspective, that's good enough.

As shown in the graph on this page, the past 5 month-over-month changes in the U.S. CPI have hovered around the 20-year average (the green line) and are well within tolerance. If this trend continues, it will provide central banks with renewed monetary flexibility. If economic conditions cool, they now have ammunition to resuscitate it with lower interest rates. If the economy continues to expand modestly, the Fed can take a wait-and-see approach. And if the economy accelerates, central banks will have a green light to raise rates. Of course, everything hangs on the balance of inflation. Hence it is the centrepiece of our outlook.

ECONOMIC SCENARIOS

As we see it, the economic outlook boils down to three primary scenarios:

1. Soft landing + moderate inflation.
2. Soft landing + sticky inflation.
3. Hard landing (recession).

The worst of these, in our assessment, is scenario two since it will require the Fed to slam on the brakes again and force a difficult recession this year. Our view is that cooler inflation is sustainable, and therefore this is a low-probability scenario. The risk is it isn't.

The most likely scenario is a soft landing or a very mild recession. Central banks wouldn't need to do much to stimulate growth, which could easily be aided by moderate fiscal policy.

Lastly, a hard landing is also an unlikely scenario for many reasons, not the least because so many expect it. Even uber-bear Jeremy Grantham laments the predicament – it's hard to be correctly contrarian when everyone agrees with him. Further, as he pointed out recently, since FDR's first election, the seven months starting the month before mid-term have been far, far better than the returns in all the other months of the cycle. And low-and-behold, we are roughly in the middle of that part of the election cycle now.

INVESTMENT OUTLOOK

There are two primary drivers of stock market valuation – earnings and multiple. Since markets are forward-looking, a 2023 year-end price target depends on a multiple of 2024 earnings. The impact of higher interest rates may be lower earnings than expected. Conservatively using a 10% discount to consensus '24 S&P EPS is ~ $225. Since interest rates will have stabilized with potential cuts on the horizon, valuation will likely nudge back toward 19x. That generates a roughly 13% total return for U.S. equities in 2023. Canada is likely to follow a similar trajectory with a stock market return above the long-term average, a welcome outcome.

Despite our optimism, we must be mindful of a hard landing risk. Therefore, while we prefer stocks over bonds, with equity portfolios blending a balance of value and growth opportunities, cautious positioning remains prudent in the short term.

David Baird