HEMISPHERE
CAPITAL MANAGEMENT INC.
Reflections
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# VALUATIONS MATTER

*On a relative basis, client portfolios have performed well in 2022 as global financial markets have suffered from a myriad of headwinds.*

The first-half of 2022 proved to be a challenging time for global financial markets. High inflation, rising interest rates, the ongoing conflict in Ukraine and persistent supply-chain challenges have acted as a myriad of headwinds for financial markets. Notable indexes for both risky assets (stocks) and less-risky assets (bonds) have suffered double-digit losses since the start of the year. On a relative basis, client portfolios have performed well and have continued to protect capital during the market weakness.

*Much of the weakness seen thus far has come from valuations being reset. Notable indexes including the Nasdaq, S&P 500 and TSX Composite index have suffered double digit losses since the start of the year.*

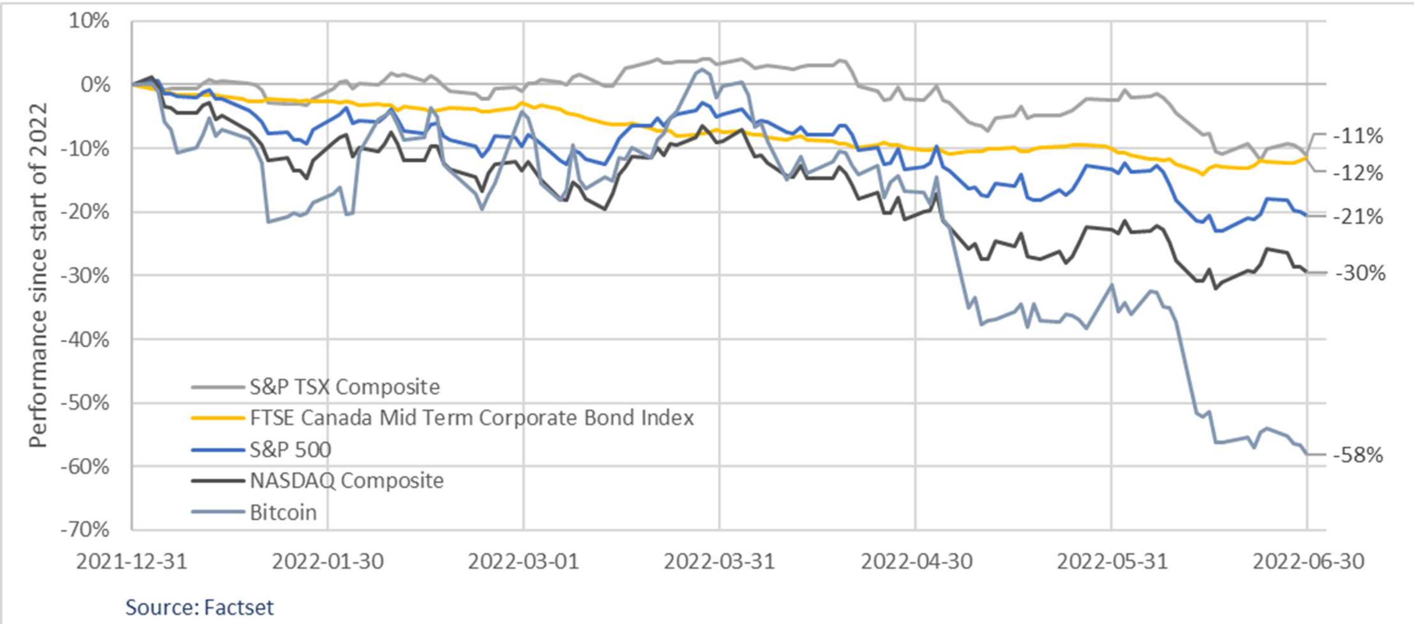
Much of the weakness seen thus far has come from stock market valuations being reset. The high-flying growth (ie. technology) stocks that reached unprecedented valuations during the pandemic were the first to fall near the start of the year. Notable U.S. indexes, including the technology-heavy Nasdaq index and the S&P 500 index (500 largest publicly-traded companies in the U.S.), have seen significant losses, declining 21% and 30% respectively from the start of the year to the end of June. Since the end of March, other sectors have started to follow-suit. The Canadian TSX Composite index (~250 largest publicly-traded companies in Canada), which consists of more financial and commodity stocks, was a standout performer until April but has now declined 11% from the start of the year to the end of June.

*Higher risk and speculative assets including bitcoin and other cryptocurrencies have suffered even larger losses.*

Many higher risk and speculative assets have suffered even larger losses. The euphoria that encapsulated cryptocurrencies for the better part of the past two years has largely faded. The total market value of cryptocurrencies has fallen from over $3 trillion to less than $1 trillion. The price of Bitcoin has declined more than 50% since the start of the year while many other "Altcoins" have suffered even larger losses.

*Bond prices have also suffered with rising bond yields which has created an even more challenging investing environment.*

One of the challenges investors have faced is that this market weakness has come during a period of rising bond yields. Historically, high-quality bonds have tended to perform well during periods of market weakness as many investors would typically undertake a flight-to-safety by buying high-quality bonds, thus raising bond prices. However, bond yields have shifted upwards with rising interest rates. Bond prices fall as bond yields rise and this has created a rare situation where bond prices have fallen alongside stock prices. The FTSE Canada Mid Term Corporate Bond Index™, which consists of Canadian bonds with a maturity of 5 to 10 years, has declined 12% since the start of the year through June 30.




*Now that valuations have been reset, earnings may continue to suffer as rising inflation and higher interest rates continue to take hold.*

Now that stock valuation have reset, we expect that company earnings may continue to suffer as high inflation and rising interest rates continue to take hold. Inflation has a tendency to propagate quickly throughout industries as rising input costs lead to higher prices and pressure household incomes. Workers must then seek higher wages to offset higher household expenses which further drives up labour input costs. This can cause a wage-price spiral to take hold as the cycle repeats and company margins are squeezed. Higher interest rates serve as an attempt to avoid this spiral by reducing consumer demand to drive down prices. With higher interest rates, consumers will need to prioritize core monthly expenses over discretionary spending. This is ultimately a lose-lose situation as rising input costs followed by lower demand leads to lower earnings.

*We continue to emphasis the benefit of a conservative investing approach focused on fundamentals. Over the long-term, valuations have shown to be a reliable indicator of expected returns and are a key component to any investment decision.*

During these uncertain times, we continue to emphasize the benefit of a conservative approach and investing with a margin of safety. Over the long-term, valuations have shown to be a reliable indicator of expected returns and the potential for losses during periods of weakness. They should therefore be considered fundamental to any investment decision. We continue to remain focused on owning good companies with strong pricing power to combat margin compression, but at fair or discounted valuations. We view the current weakness as an opportunity to evaulate some of these companies that did not previously trade at fair valuations. From a fixed income standpoint, although rising yields continue to pressure bond prices, they have presented an opportunity in shorter-term fixed income investments as short-term yields have risen significantly over the past year.