



## THE WAY WE WERE

*North American stock and bond markets suffered double-digit negative returns in 2022. HCM clients were able to avoid the carnage.*

2022 was a very difficult year for the global financial markets. Both North American stock and bond markets suffered double-digit negative returns. As measured by the Nasdaq Index, technology stocks fared the worst, ending the year down over 30%. In Canada, the average return for a Canadian balanced fund was a loss of 12%<sup>1</sup>. Hemisphere Capital Management (“HCM”) clients fared significantly better as we were able to avoid the carnage.

*Inflation was the primary reason for the dismal returns, reaching 45-year highs.*

The primary reason for the dismal investment returns in 2022 was the resurgence of inflation. As seen in Figure 1 below, during 2022, the price of goods and services in North America rose at their fastest rate in almost 45 years. Inflation peaked at over 9% and ended the year around 6.5%. As discussed in our April 2022 newsletter, the causes of higher inflation include the war in Ukraine, supply chain issues and the massive increase in money supply from Covid-19 relief programs.

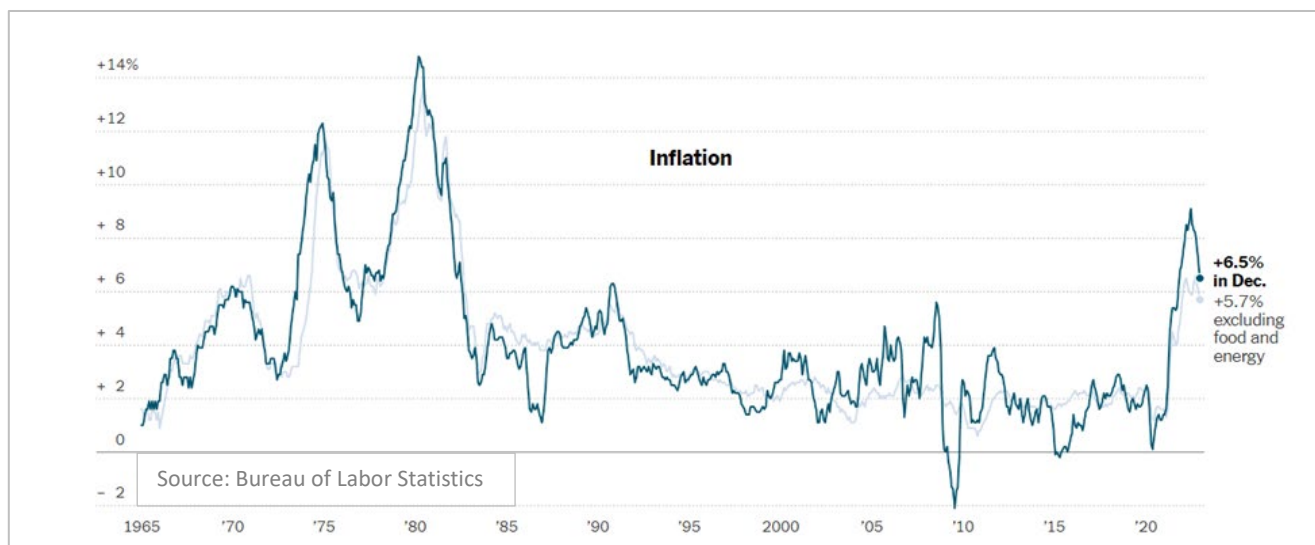


Figure 1: Year-over-year percentage change in the Consumer Price Index

*Central banks have responded with “inflation-fighting” interest rate increases which has impacted corporate earnings and stock valuations.*

Higher inflation caused the world’s central bankers to react with “inflation-fighting” short-term interest rate increases. The Federal Reserve System (the central bank of the U.S.) increased the federal funds rate (the overnight rate at which U.S. banks borrow or lend) by over 4% from 0.25% to 4.25% (see Figure 2). The Bank of Canada increased our bank rate by a similar amount. This dramatic rise in short-term interest rates caused investors to completely re-evaluate their outlook for corporate earnings and stock valuations.

<sup>1</sup>Total annual return of Vanguard Balanced ETF Portfolio as per FactSet

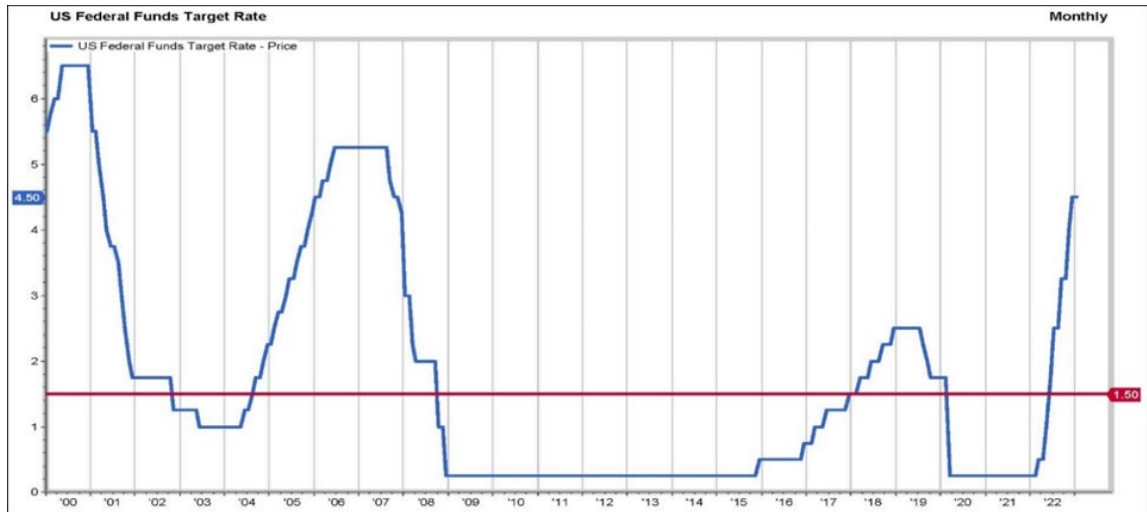


Figure 2: U.S Federal Funds Target Rate

*Many investors have not experienced the economic impacts of inflation and believe that inflation will quickly subside - a return to "the way we were".*

Many investors who have been involved in the financial markets over the past 20 years have had little experience with the economic consequences of inflation. Within their ranks, there appears to be a belief that inflation will quickly subside and financial markets will return to the ultra-low interest rates, high stock valuations and high stock returns of the previous two decades. They have faith in a return to "the way we were", where more and more money was invested in a small number of technology stocks that dominated North America stock indices.

*We expect inflation to remain more stubborn, persisting near mid-single digit levels. This will keep interest rates higher and compress stock valuations.*

We believe these investors are too optimistic. Historically, central banks tend to hold interest rates at their highest level for at least six months before a cut is made. While it is unlikely that North America will see anything close to double digit inflation in the near future, it is also unlikely that we will see inflation at pre-covid levels of less than 2% and an average Federal Funds rate around 1.5%. Inflation will likely trend to mid-single digit levels and remain more stubborn. Companies are only now starting to experience inflation-driven wage increases which is reducing margins and increasing their cost of capital. Furthermore, persistent inflation will result in a compression of valuation multiples.

*Major secular changes including technology decoupling and geoeconomic fragmentation are overshadowing the normal business cycle. These changes are inherently inflationary.*

The world is experiencing major secular changes that appear to be overshadowing the normal business cycle. The "peace dividend" of the last 30 years is over. Likewise, the era of globalization and cheap consumer goods from offshore manufacturing is also over as geopolitical rivalries intensify and technology decoupling takes place. We are reimagining globalization and changing our view of the law of comparative advantage. Onshoring (think computer chips made in America) will promote economic resiliency but also geoeconomic fragmentation. This will be inflationary. Global growth will slow and rising societal polarization in both democracies and autocracies will create a higher level of civil unrest.

*Although more turbulence is expected, this also brings opportunities through more reasonable stock valuations and higher bond yields. The current uncertainty is challenging, but not unwelcome.*

After years of easy money and excessive speculation, North American stock markets will confront more turbulence moving forward. Fundamental stock valuation, the core of HCM's investing approach, is now imperative to success. Fortunately, from an investing perspective, the current environment also offers multiple opportunities. Numerous wide-moat, dividend stocks have been hurt by inflation and are trading at multi-year lows. Additionally, shorter-term, high-quality corporate bonds still yield close to 5%. As long-term investors, the current uncertainty is challenging, but not unwelcome.

*P.S. Coinciding with the initial high inflation period of the 1970's, *The Way We Were* was a popular movie in 1973 starring two high profile acting professionals of the day: Robert Redford and Barbara Streisand. The theme song for the movie, also titled *The Way We Were*, was the most successful recording in North America in 1974.*