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INVESTMENT COUNSEL LTD.

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Investment Commentary

Table 1 below shows the price performance of the TSX and index and the S&P index over the periods indicated. The S&P 500 index declined by almost 21% in the first half of 2022. This compares with a decline of 15.3% for the Dow Jones Industrial index, which consists of the 30 largest companies, and 29.3% for the Nasdaq index which is heavily weighted with technology stocks. It was the worst first half of the year since 1970 for the S&P 500 Index. The index has also fallen for eleven of the last thirteen weeks.

The S&P/TSX index performed substantially better, both over the six month and one year period. This was primarily due to the fact that the energy sector which performed very well. It is a much larger weighting in the TSX at 17.9% vs 4.8% of the S&P 500 index. The energy sector was propelled by a 40% increase in the price of oil in the first half of the year.

Table 1

Price Performance S&P 500 index and S&P/TSX index

% Change

	S&P/TSX	S&P 500 index
6 Months	(11.1)	(20.6)
One Year	(6.5)	(11.9)
Three years	15.7	28.7

Source: Bloomberg

The Canadian Market:

The performance of the Canadian market in the first half of 2022 was impacted by dramatically different results for the two most heavily weighted sectors. The energy sector had price appreciation of 28%, led by the oil producers with a 12% gain and the integrated oils with a 10% gain.

The financial services sector had a loss of 37%. The banks declined by 23%, and the diversified financials by 10%. The largest positive contributor to the TSX index was Suncor, and the largest negative contributor was Shopify.

Table 2

Price Performance of the Sectors of the TSX index First Half 2022

	% Change	Sector Weight
Health Care	(48.9)	0.4
Information Technology	(39.8)	5.7
Real Estate	(22.9)	
Consumer discretionary	(17.9)	3.3
Financials	(12.7)	31.8
Materials	(9.1)	11.4
Communications	(2.2)	5.7
Utilities	(0.6)	5.2
Consumer Staples	0.74	4.2
Energy	39.8	17.9

Source: Globe and Mail

The TSX index is very concentrated, with three sectors accounting for more than 60% of the weight of the entire index. The energy sector was one of the few positive contributors to the TSX in the first half of 2022. While the health care and Information sectors experienced material price declines their weights in the overall index are very small.

The U.S. Market:

Table 3

Price Performance of the Sectors of the S&P 500 index First half 2022

	% Change	Sector Weight
Consumer Discretionary	(31.8)	10.9
Information Technology	(27.1)	27.1
Real Estate	(19.8)	2.8
Communication Services	(19.7)	6.5
Financials	(18.3)	11.2
Materials	(18.1)	2.8
Industrials	(16.7)	7.8
Health Care	(8.0)	14.4
Consumer Staples	(5.4)	6.5
Utilities	0.4	3.0
Energy	31.1	4.8

Source: Barrons

The table above demonstrates that the decline in the S&P index in the first half of the year was broad based. All sectors with the exception of the most defensive, utilities, health care and consumer staples experienced double-digit declines. The only sector with meaningful positive performance was energy.

Grain Shortages – A Material Contributor to Inflation

In 2021 Russia and the Ukraine were the world's first and fifth largest exporters of wheat. They represented 28% of the world market. They also produce grain used to feed animals such as maize and barley. Finally they have an 11.5% share of the vegetable oil market. The war between the Ukraine and Russia has severely restricted Ukrainian exports, and modestly disrupted Russian exports.

The shortfall from these countries is unlikely to be met by other wheat exporters. China has warned that last year's floods means that its winter wheat crop could be the worst in history. Much of the U.S. grain belt is undergoing a drought as bad as the one in 2012-13.

In addition to war and weather related concerns higher input costs are driving higher grain prices. Higher prices for fertilizer, diesel fuel, and labour have pushed input costs up by 20 – 25% this year.

In sum, futures markets expect wheat and maize prices to remain at today's extortionate levels until at least mid-2023. Food prices account for about 1.3 percentage points of America's 8.3% inflation rate, and 1% of the Euro area's 7.4% inflation rate. Consequently they are one of the factors driving tightening monetary policy.

Higher Returns on Fixed Income – Still a Poor Absolute Return

Returns on fixed income assets, bonds, have improved dramatically since the beginning of 2022. High yield bonds, otherwise known as junk bonds are currently yielding more than 8%. Mortgage securities are yielding 5%, and U.S. 10 year treasury bonds now yield 3%. By way of comparison at the beginning of the year 10 year treasury bonds had a yield of 1.5% and mortgage securities had a yield of 3.1%.

Inflation is hopefully headed down from the current level of 9.1%, but how low it gets, and long it takes to get there are major questions. If annual inflation is running at 3% a year from now bonds will be a lot more appealing. However, if inflation is still 5% plus bonds will continue to provide a negative real return.

The Recent Decline in The Price of Equities in the Information Technology Sector:

The Information technology sector of the S&P 500 index has enjoyed substantial price performance over the last five years. The Information Technology index increased from 981 to 3,091 at the end of 2021. This represents a 215% gain in the sector. At the peak of the information technology boom the next twelve month p/e multiple was 28x. Since the peak the next twelve months p/e multiple has declined to 18x. The decline in the p/e multiple of the Information technology sector has largely been explained by rising interest rates. At this point investors must ask whether there is going to be precipitous decline in the earnings of the sector which will cause the prices of the Information Technology companies to decline further. Companies in virtually all sectors face challenges associated with passing along higher input costs to consumers. However, in the case of the information technology sector the EBITDA margins have risen materially, from levels in line with the broader market in the early 2000's to well above the broader market today.

Summary and Assessment:

The overriding concerns for the remainder of the year are stubbornly high inflation and aggressive Federal Reserve Board interest rate increases. There is one group of investors that anticipates these factors will lead to lower consumer confidence, a decline in the housing market, and lower consumer spending. The result will be a deep and drawn out contraction. In this event the U.S. market and to a lesser extent the Canadian market are vulnerable to further declines.

A second group expects more of a mid-cycle slowdown similar to the 1994-95 period. This will be a modest recession. They argue that the impact of such a recession is largely already reflected in the market decline of the last six months.

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