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INVESTMENT COUNSEL LTD.

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Investment Commentary

Table 1 below shows the price performance of the TSX /S&P index and the S&P 500 index over the periods indicated. The S&P index declined by almost 25% in the first nine months of 2022. By comparison the NASDAQ index which is heavily oriented to technology stocks was down 32%. The Dow Jones index which consists of only the thirty largest weighted stocks in the U.S. declined by 22%. At the end of September the S&P had reached the lowest level it had been at since November of 2020. September was a particularly bad month for the S&P index which fell more than 13% in ten days.

The S&P/TSX index performed better over both the year-to-date and one year periods. This was primarily due to the fact that the energy sector performed very well. It is a much larger weighting in the TSX at 17.9% vs. 4.8% for the S&P 500 index.

Table 1

Price performance of the S&P 500 index and the TSX/S&P index

% Change

	S&P/TSX	S&P 500 Index
Year-To-Date	(13)	(24.7)
One Year	(8.5)	(17.7)
Three Years	10.4	21.1

Source: Bloomberg

The Canadian Market:

The performance of the Canadian market was heavily supported by the strength of the oil sector in the first nine months of the year. The energy index appreciated by 20% in the year-to-date period. However in the latest three month period the energy index declined by just under 3%. The recent decline is explained by the fall in the price of West Texas intermediate oil from $104 a barrel on July 1st to $79.55 at the end of September.

The heaviest weighted index, financial services declined by 12% over the same period.

The U.S. Market:

The sub-indices of the S&P 500 index have had dramatically different performances over the course of 2022. At one extreme the Energy index has appreciated by 31%. At the other extreme the Communications Services sector declined by 39%. The heavily weighted Technology sector was down by 32%, and the Consumer Discretionary sector declined by 30%. It is reasonable to expect the majority of the decline in these sectors is now over.

The U.S. Economy – The Unemployment Rate Remains Low

Labour conditions are very strong, with robust payroll growth, weekly claims falling, and abundant job openings. The number of job openings in August of 2022 was 10.1 million. This was down from a record level of 11.9 million in March. It was also the lowest number of job openings since June of 2021. However, in August of 2019 before the pandemic the number of job openings was 7 million. The result is there is no shortage of job openings in the U.S. at present.

The U.S. economy added 263,000 jobs in September 2022. The number was a decline from an average of 439,000 in the first eight months of 2022. The number indicates a tight labour market with employment about 500,000 higher than the pre-pandemic level.

Finally the unemployment rate remained at 3.5%. This is approximately the unemployment rate prior to the pandemic. Further as the baby boom generation ages they are more inclined to leave the labour force. Currently those over sixty-five constitute 16.3% of the population, up from 13% in 2010. As a result the participation rate will continue to decline.

In sum the strong labour force statistics should support consumer spending and keep the economy out of recession.

Monetary Policy and Inflation

The Federal Reserve Board's stance on inflation has evolved over the last year. Initially inflation was not perceived as a problem. Then it became "transitory". The Board is now stating that there will be a soft landing for the economy as it increased interest rates to slow down economic growth. In essence the Federal Reserve Board will do whatever is required to control inflation. As of August the CPI was running at an annual rate of 8.3%, and ex food and energy 6.3% .This is well above the target level of 2%.

High inflation will not slowdown in October. In fact it could be several months before there is an appreciable reduction in inflation. Part of the reason for this is that when the prices of some goods and services go up they tend to stay up. This phenomenon is known as "sticky inflation". The prices of some items such as gas rise and fall on a regular basis. By comparison items such as rent change more slowly, and when they go up they stay up. Other sticky inflation items include education, medical care and transportation.

In sum we do not believe the Federal Reserve Board will be able to manage the economy to a soft landing while reducing inflation. Other than increasing interest rates the only significant monetary policy tool available is quantitative tightening. The Federal Reserve currently has U.S $8.8 trillion in Treasury securities, agency debt, and mortgage backed securities on its balance sheet. The Board has the objective of reducing the size of these holdings. The problem however is that both quantitative tightening and raising interest rates have a lagged effect on the economy. Therefore there is a high risk that monetary policy overshoots in its attempt to manage a soft landing of the economy.

The Bank of Canada has adopted a similar policy with regard to inflation as the U.S. Federal Reserve Board. It will raise interest rates as much as required to reduce inflation. The Bank of Canada has raised interest rates five times since March, moving the policy rate to 3.25% from .25%. It has been one of the fastest rate hike cycles on record. It is now widely expected that the Bank rate will increase to 4% or higher before stopping.

Higher Interest Rates – Longer Than Expected

It is difficult to overstate the dramatic rate of increase in interest rates in the last nine months. In Canada short term interest rates were almost zero nine months ago. They are now close to 4%. The yield on ten year Government of Canada bonds has increased from under 2% to 3.5%. The Canadian yield curve is now inverted which means that short term interest rates are higher than long term interest rates. Typically this situation occurs when investors believe that inflation is going to remain higher than nominal interest rates for an extended period of time. An inverted yield curve can also serve as a predictor of an imminent recession.

The pattern of interest rate increases in the U.S. has been similar to that of Canada. The only difference is that in the U.S. the yield curve is not inverted, but almost flat. This situation indicates that investors have no clear expectation about the future rate of inflation.

In our opinion interest rates have not peaked.

Bond Yields vs. S&P 500 Multiples – The Market is Not Overvalued

Table 2

	Current	February 2003	July 1986
Baa Bond Yields	6.0 %	7.1%	8.4%
Implied P/E Multiple	16.6x	14.1x	11.9x
Actual P/E	15.1	15.1	15.1

Source: Credit Suisse

The table above compares Baa quality bond yields with the implied p/e multiple and the actual p/e multiple of 15.1x at specific times. The implied p/e multiple is the inverse of the bond yield. This means that the higher the bond yield the lower the implied p/e multiple. The table demonstrates that in each of the last two instances in which the actual p/e multiple was 15.1x the implied p/e multiple was lower. Currently however the implied p/e multiple is higher. This indicates that either investors anticipate interest rates are going to increase or that the S&P 500 is undervalued relative to historic levels.

S&P 500 Index Earnings Forecasts

Table 3

Concensus Earnings	**E.P.S.**	**% Change**
2020 Actual	142.38	-13.5
2021 Actual	209.38	47.1
2022Estimate	225.85	7.9
2023 Estimate	240.75	6.6
2024 Estimate	260.35	8.1

Source:Credit Suisse

S&P 500 earnings estimates for 2022 are still higher than they were in 2021. As a result, the year-to-date decline in the S&P 500 Index has been entirely driven by a decline in the p/e multiple of the index. This in turn is a response to the increase in interest rates.

The S&P 500 index is currently valued at 15.1x next twelve months earnings. This indicates the market is fairly to slightly undervalued.

Summary and Assessment:

Each new economic data point that is released one government agency or another results in dramatic swings in the market depending on whether it is above or below expectations. This kind of volatility indicates the market is essentially directionless. The debate appears to be whether or not the earnings of S&P 500 companies are about to decline. It is important to recognize that the market is already down 25% year-to-date. Absent a complete collapse of S&P 500 companies earnings it is difficult to imagine a further decline in the market of more than 10%.

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