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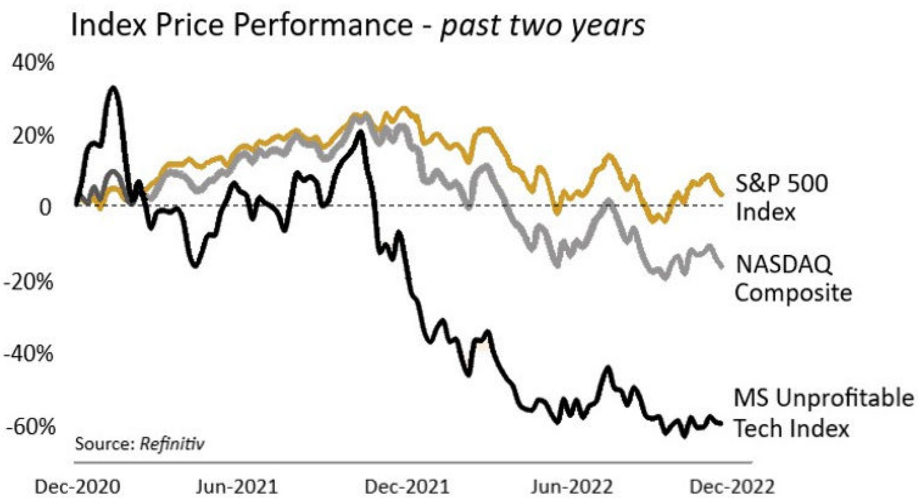
DM PORTFOLIO COMMENTARY
4th Quarter 2022

Searching for Goldilocks

We are not a top-down manager. Through more than two decades of investment stewardship, our success in equity portfolios has been driven by our assessment of individual companies, their prospects, and the valuation at which we can buy their shares. Broad macroeconomic trends have not factored significantly into our day-to-day analytical process and we have no plans to change this approach.

That said, there have been moments in our history when the financial tide has flowed with such force that even the most dependable boats have been unable to escape its pull. The fallout from the dot-com collapse, the damage wrought by the financial crisis, and the economic seizure that accompanied the covid lockdowns all fit this bill. Instead of matching these towering episodes with equally substantial shifts in management strategy, however, we've mostly used them as occasions to make incremental adjustments, either to reflect a new risk/reward backdrop or to seize on opportunities created by the anxiousness of others.



The past year dropped another economic obstacle in front of portfolios, with inflation jumping to levels not seen in a generation and interest rates following in tandem. As the "free money" regime came to a rapid close, valuations readjusted across the investment spectrum and, in the case of the stock market, the largest share of the decline was accounted for by the rise in the rate at which future cash flows are discounted. In fact, even though the consensus earnings estimate for S&P companies made at the start of 2022 was almost spot on by the time we reached the end of the third quarter, none of the investment houses surveyed had predicted that the index would plunge by 25% at any time during the year.

The accompanying graph illustrates how the equity market incrementally revalued risk along the continuum as we crossed into 2022. As you can see, the broadly balanced S&P 500 Index forfeited the lofty gain that it had posted in the prior year and the "growthier" NASDAQ gave back that and more. At the same time, Morgan Stanley's index of unprofitable tech stocks dropped by almost two thirds, indicative of the harsh reckoning visited upon most of the speculative space in recent months.

The DM US Equity Portfolio is not without exposure to senior NASDAQ members and these positions were amongst our biggest sources of performance drag in 2022. We own names like Apple, Amazon, and Alphabet not as bets on ideas which may or may not come to fruition, but because they dominate industries which have be-

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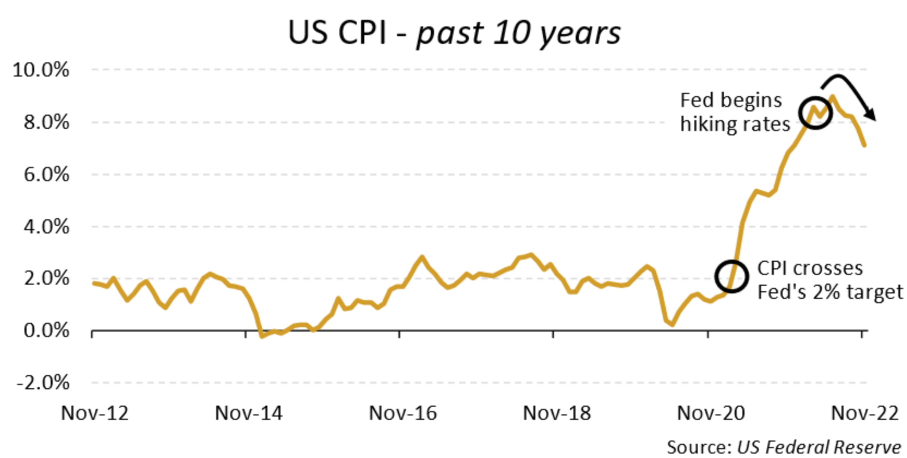
come major components of the world economy. These companies generate prodigious amounts of excess cash, which is used to buy back shares, pay dividends, make acquisitions, and expand market share and business scope, all of which grow intrinsic value over time. For this reason, we are more inclined to regard share price weakness in such names as a long-term opportunity, rather than a reason to relinquish our stake. On the other side of the equity ledger, the DM Canadian Equity Portfolio performed extremely well, significantly exceeding the TSX for the year despite carrying little exposure to the heavily favoured energy sector.

In our third quarter report, written just after the broad market had reached its low for the year, we suggested that some of the underlying drivers of inflation were rolling over and that this could offer some relief at the consumer level. In particular, we noted that most key commodity prices had fallen significantly from highs set earlier in the year and that the tangles which had constricted supply chains were beginning to unwind themselves. Sure enough, US inflation reports released in October, November, and December all came in lower than expected and interest rates fell markedly, with the US 10-year Treasury yield dropping from a summer high of 4.2% to as low as 3.4% in Q4. This news sparked a rebound in equity prices and helped stocks to recover a significant portion of their earlier valuation-related losses.



Source: *US Federal Reserve*

Some of this gain was given back in the year's closing days, however, as inflation and interest relief gave way to concern that relentless monetary tightening would push the world into recession. It's no revelation that central bankers were slow off the mark as economies regained their footing and have since sought to compensate for their tardiness with vigour, raising policy rates at an historic pace. The chart below shows both the point on the inflation path at which the US Federal Reserve finally began raising rates, as well as the subsequent downturn in consumer prices. If forced to make a market prediction for 2023, we'd probably say that equity volatility will remain elevated, as central bankers search for a "not too hot / not too cold" policy tack to balance the competing risks of inflation and recession.

Unfortunately, even though monetary policy is likely to exert an outsized influence on stock price behaviour in the months to come, successfully predicting its path is no more likely than guessing right on a market timing call. In fact, even the Fed can't forecast the Fed: in 2018, for example, minutes from their meetings called for three to four rate hikes the following year (instead they cut rates three times in 2019) and in December 2021, they projected that the policy rate would stay below 1% for 2022 (but, as we now know, it closed the year well above 4%).

So, beyond all the uncertainty surrounding the economy and markets, are there any reasons for equity investors to feel optimistic? First, it's rare stocks to post losses in consecutive calendar years – in the S&P's case, this has happened just twice since the end of the Second World War and so history is on the side of a positive 2023. Below are a few more factors that could help stocks in the near and long term:

Falling USD – since the onset of the pandemic, the US dollar has been on a virtually uninterrupted tear, climbing by as much as 25% against a basket of major global currencies and even more vs. most emerging markets. This has compounded inflation troubles for nations importing goods priced in greenbacks and has doubly imperilled those with US dollar denominated debt; it has also weighed on the reported profits of US companies earning international revenues. In December, however, the USD fell by nearly 10% from its recent high, which should provide some relief to both the world economy and businesses with operations around the globe.

China – after pursuing a "zero-covid" policy long after the rest of the world was well on the road to economic normalization, it appears that the Chinese government may finally be set to loosen its grip. If the world's second largest economy reopens in 2023, pent up demand and delayed business activity could pull a large swath of consumption and growth forward, brightening the outlook for the entire world.

Innovation – some commentators have lamented that the contemporary economy lacks a paradigm shifting breakthrough, such as the internet or mobile telephony, to propel a meaningful leap forward. This complaint ignores several innovations taking place in our midst, however, which could meaningfully alter the way we live and work. From solar to wind to advanced battery storage, we're now experiencing the greatest energy transition since the discovery of fossil fuels and, in December, scientists announced a significant advance in the development nuclear fusion technology. If fully realized, nuclear fusion would be one of the most transformational innovations in human history. As we all know, vaccines were developed at record pace during the pandemic using mRNA technology and, by all accounts, the potential for this novel platform has only just been scratched. Also in the fourth quarter, OpenAI invited the public to experiment with its ChatGPT artificial intelligence interface, which created a notable buzz in tech community. Now Microsoft, which was the largest initial investor in OpenAI and whose Azure supercomputer was used to train ChatGPT, plans to incorporate it into its Bing search engine to provide users with direct answers to search queries, rather than just a list of links. Said Brad Smith, President of Microsoft, "We're going to see advances in 2023 that people two years ago would have expected in 2033. It's going to be extremely important not just for Microsoft's future, but for everyone's future."

Sentiment – perhaps one of the most compelling reasons to own stocks as we enter the new year is the mood of the investing public, which is about as low as it gets. We know this not only from formal surveys of individual and institutional investors, but from the tone of the business media and of the people we encounter every day. Even with respect to the economy, the level of groupthink is uncommonly high, with an imminent recession pretty much the consensus expectation. While we can't say for sure what the stock market or economy will do in 2023, we do know from experience that when the vast majority expects one thing to happen, there's a very good chance that the opposite will occur. If the months ahead bring more relief on the inflation front, additional easing of interest rates, or even some geopolitical good news, we might see pessimists change their tune and stocks recapture some or all of what was lost over the past year.