



Winter 2023

2022 may be the year that saw a fundamental change in the assumptions that have driven global economic and investment thought over the past thirty years. To quote Bloomberg Businessweek:

“Plentiful cheap labour, low energy and transportation costs and a generally peaceful environment for geopolitics all helped turbocharge the globalization of supply chains around the world... Whenever one of those three pillars wobbled, there was cheap money to keep the party going.”

During 2022 each of these three conditions changed. There is a labour shortage in many industrialized countries and wages are rising across the board. Oil prices have been on a steady rise over the past three years and increased by fifty per cent in 2022.

The stable geopolitical landscape has eroded on two fronts. Russia’s invasion of Ukraine has resulted in higher energy costs, disrupted supply chains and made

Europe less secure. In addition, the United States and several other western democracies are starting to push back against China's global ambitions and economic power. Western countries are developing strategies to protect their intellectual capital and technologies against increasing Chinese competition. This Western response is causing new geopolitical and economic tensions translating into more competition for scarce resources and a retrenchment in Western and Chinese trade agreements.

2022 saw the consequence of these changes, a return of inflation. In response, Central bankers increased interest rates quite aggressively for the first time in decades. More worrisome is that there is little room to maneuver. Inflation puts policy makers in a box. To curb inflation interest rates must rise. The higher and more persistent inflation is, the higher and longer rates must rise. This resolve to curb inflation will cause a recession.

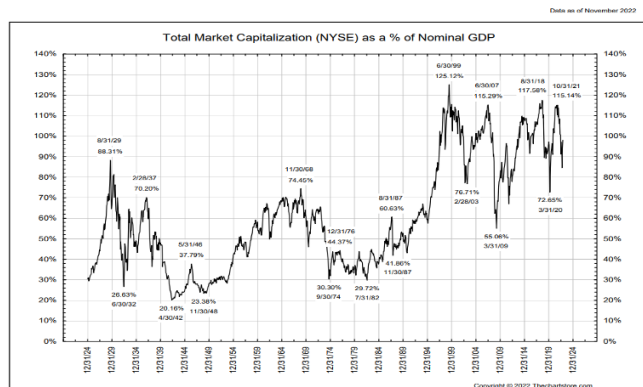
The sharp spike in borrowing costs has started to filter through the economy. The real estate sector is starting to feel the effects of these interest rate increases. Demand has dropped and residential real estate prices are starting to decline. In addition, some homeowners are starting to feel the impact of higher rates and are starting to cut back on discretionary expenditures to meet increased mortgage payments. As well, businesses are starting to lay off employees, reduce expenses and cut back on capital expenditures in anticipation of an economic slowdown.

In response to higher rates, equity markets declined during 2022. The MSCI (USD) World Index, S&P 500 (USD) and S&P/TSX Composite Index declined 18.11%, 23.87% and 5.84% respectively during 2022. The TSX performed better on a relative basis due to its heavier weighting in the oil and gas sector. The Canadian market's energy subsector was up 24.42% during 2022 providing some support to the overall index. During the fourth quarter of 2022 global markets bounced back from their third quarter declines. The MSCI (USD) World Index rose 9.89% while the S&P 500 (USD) posted a positive return of 7.56%. The S&P/TSX Composite Index rose 5.96%.

A significant amount of the decline in equity markets was the result of the rerating of many extraordinarily valued high growth businesses. While some of these businesses are true disrupters and innovators, their valuations exceeded any semblance of rational intrinsic worth. In addition, many of these companies are not profitable and/or generate relatively small cash flows and in some cases their underlying business model is financially unsustainable. Despite the substantial decline in share prices, many of these businesses are still extremely overvalued and, potentially, subject to further declines.

While indices have come down from previous highs, equity markets are still expensive by historical standards as the chart on the next page indicates.

Graph 1
Market Capitalization/GDP



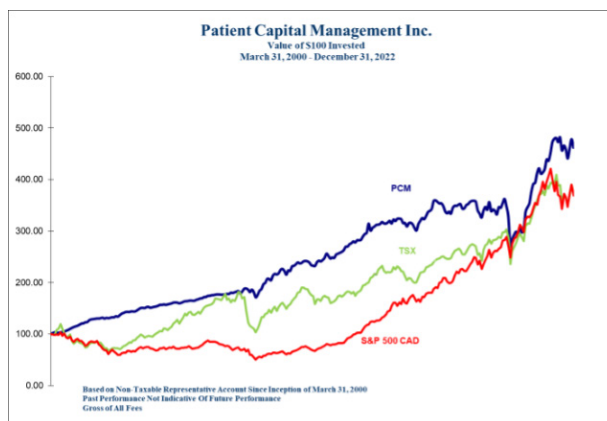
From current valuation levels investors may be facing a “double whammy”. Should interest rates continue to rise, market multiples are likely to come under continued pressure. In addition, the resultant recession will result in lower corporate earnings. A lower market multiple applied to lower corporate earnings implies substantial downside risk from current levels. For example, assuming corporate earnings of \$1.00 and a multiple of 18.5x gives a value of \$18.50. If earnings dropped 20% to \$0.80 and the multiple fell to the long term average of 14.5x the resultant value is \$11.60; a drop of almost 35%.

Our portfolios continue to be well positioned for current market conditions. As of December 31, 2022, the dividend yield on equities was 4.72%. The total portfolio yield was 4.54% at year end. In addition, the portfolio’s overall valuation metrics compare favourably to major benchmarks such as the S&P 500 index and S&P/TSX Composite index. PCM’s value based investment philosophy stood up well during the past year as we outperformed the MSCI World Index, S&P 500, and S&P/TSX Composite Index by substantial margins.

Over the past two years our performance has been quite strong. As a result, our long term performance is now back to outperforming our benchmarks. It is important to note that we have achieved these results with approximately, on average, fifty percent cash balances since inception.

In challenging financial markets and times our time tested philosophy has proven itself once again!

Graph 2
Performance Chart



We thank you for your confidence and support and wish you and yours all the best for 2023.

Vito Maida

