

A Tale of Two Halves



2023 Annual Outlook

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A Tale of Two Halves

Investment industry analysts and experts are debating whether a recession will occur in 2023. If you polled a long list of them, the response would be split down the middle. It’s hard to remember a time when expectations were this divided. This uncertain outlook raises a couple of questions. Does Matco see a recession taking place in 2023? And does it matter to investors if a recession happens or not?

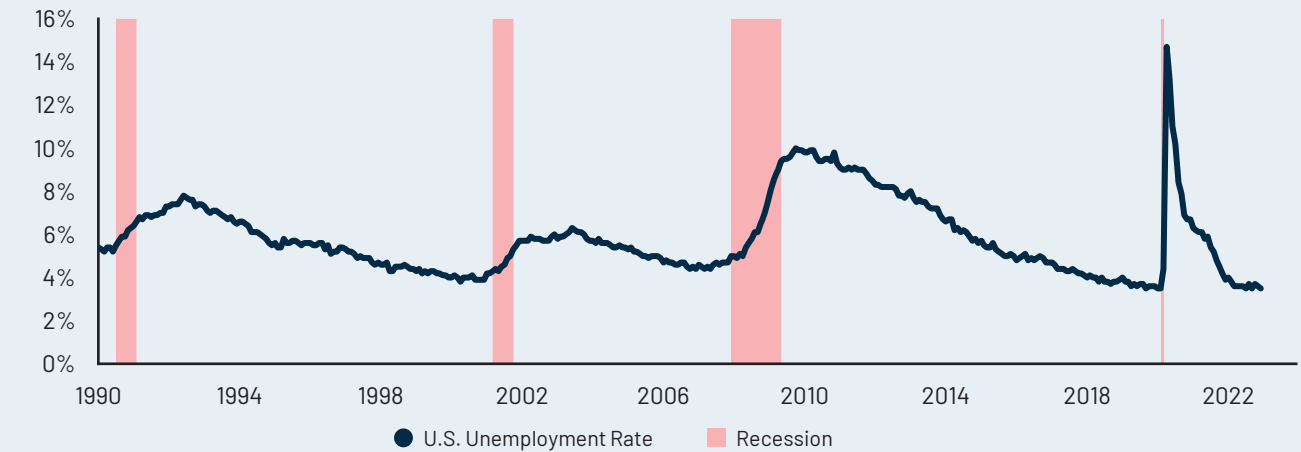
In the event of a recession, a few key developments will occur. Corporate profits will decline, unemployment rates will increase, and interest rates will move lower. There isn’t a recession in history where these three developments have not coincided with a recession. So, let’s start by assessing the current state of these fundamentals.

First, the expectation is for U.S. corporate profits to grow by 2.5% year over year and Canadian corporate profits to grow by 6% year over year. On average, U.S. and Canadian corporate profits have declined by 37% in the last three recessions. Although Matco has a more conservative outlook for earnings growth than consensus estimates, we still believe corporate profit growth will be positive. Consensus estimates and Matco’s expectations are a long cry from the 37% earnings declines experienced during recent recessions.

Second, a landslide of layoffs typically takes place during a recession. Although some layoffs have occurred in the technology sector, the job market has remained stable. Throughout 2022, net monthly job growth averaged 26,000 in Canada and 375,000 in the U.S., indicating a robust labour market. Canada and U.S. job growth in December was 110,000 and 23,000, respectively. The data continues to point towards strong economies in both countries.

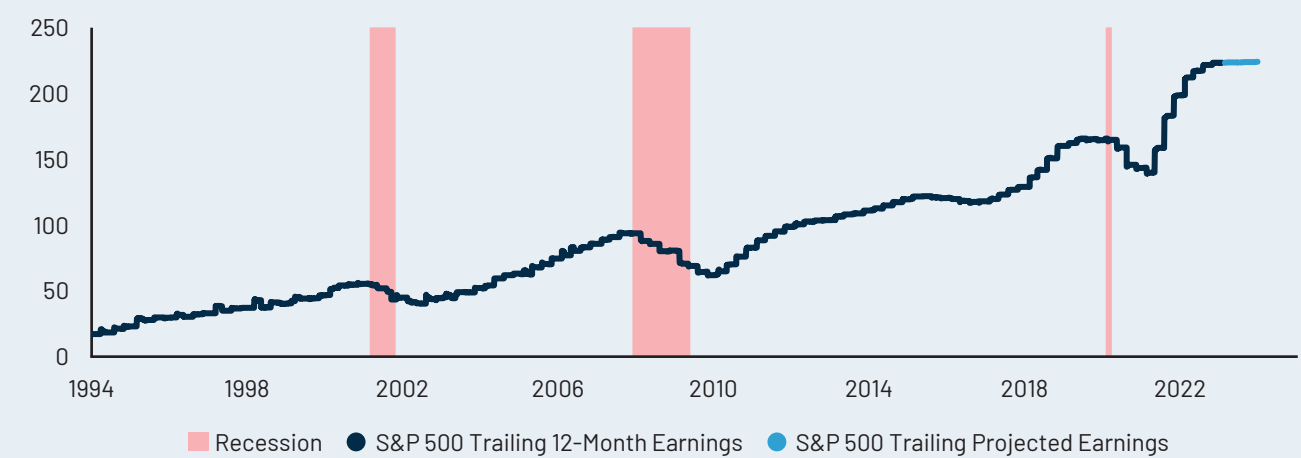
Third, due to elevated inflation, global central banks increased interest rates rapidly throughout 2022. They have also communicated that they will continue to increase interest rates through the first quarter of 2023 and keep them elevated for a period. There has been a clear commitment to fighting inflation.

A Large Number of Layoffs Happen During a Recession
U.S. Unemployment Rate



Source: Bloomberg, Matco Financial Inc. as at December 30, 2022

Recent Recessions Have Influenced Earnings Decline
S&P 500 Trailing 12-Month Earnings



Source: Bloomberg, Matco Financial Inc. as at December 30, 2022

So why does half the investment world expect a recession if these fundamentals are far from recessionary levels?

Industry experts expect a recession due to the significant rise in interest rates over the last 12 months. Within the investment world, there’s an adage: “don’t fight the fed.” This refers to the notion that a tightening of financial conditions orchestrated by central banks is a preminent event that causes an economic slowdown.

Where Does Matco Land in This Debate?

Matco expects that a recession is more likely to occur in 2024. The first half of the year will likely see central banks continuing to increase interest rates, the labour market producing healthy job growth, and corporate profits surprising analysts by remaining positive, all while inflation trends lower. However, given that investment markets are forward-looking and the economy will slow heading into 2024, the second half of this year will be a little more precarious, with corporate profits beginning to wane, resulting in greater market volatility.

Does A Recession Matter?

The reason it matters if a recession happens is not that investors should run from the market and stuff their cash under a mattress. It's well documented that timing the market is incredibly difficult, if not impossible. However, it's critical that investors:

- 1. Ensure their investment mix is consistent with their risk profile.
- 2. Ensure their portfolio has been rebalanced after the volatility experienced in 2022.
- 3. Understand their capital and income requirements over the short and medium term.

Whether the economy is booming, slowing, or trudging through a recession, our commitment is to build portfolios that protect and grow capital over the long term. This involves a disciplined investment process focusing on fundamentals while removing emotion from the equation.

A Year in Short

Matco's Active Portfolio Management

First Half of 2023

Leveraging our Matco M-Factor investment process to select companies with strong and stable earnings growth for our Matco equity funds.

High grading our corporate bond exposure, focusing on A-rated investment grade corporate bonds that enhance yield more than volatility.

Remaining invested in floating rate notes as they provide a healthy income of approximately 5% while protecting against rising overnight interest rates.

Capitalizing on higher interest rates by locking in attractive yields within our Matco Fixed Income Fund.

Second Half of 2023

Remove floating rate note exposure from our Matco Fixed Income Fund while reducing corporate credit exposure.

Increase the weighting of our fixed income allocation within our Matco Balanced Fund.

Transitioning corporate bond holdings to provincial bond holdings, which still offer enhanced yield, but more capital stability.

Leveraging our Matco M-Factor investment process to select recession-resilient companies with low earnings variability.

Theme 1

Deglobalization

Today active money management is more critical than ever due to geopolitics and the integration of the global economy. Although we are an investment firm primarily focused on Canadian investments, what happens in other major economies such as China, India, Europe, and Japan can have significant ripple effects on Canadian companies.

The combination of the impact of COVID on supply chains and rising geopolitical risk is causing globalization to unwind slowly. National governments realize that economic and political interdependency is a thing of the past. The interdependency of supply chains and just-in-time inventory laid bare how dependent the West has become on Asian manufacturing, especially for mission-critical technology such as semiconductors, which are used in everything from cars, computers, phones, buses, trains, etc.

On the Geopolitical Front

Certain trading partners have become foes as national ambitions by authoritative regimes have overtaken economic growth priorities. Russia's invasion of Ukraine has changed the West's tone and urgency regarding how to deal with authoritarian governments. The West's significantly larger combined military firepower and major economic sanctions couldn't deter President Putin's expansionary quest. The invasion also exposed Europe's dependency on Russian energy imports, showing that the norm would be structurally higher energy prices for consumers and businesses.

The closer political and economic alignment between Russia and China also poses a quandary for the West. Since Russia's invasion, China has been buying discounted Russian oil and recently held joint defence exercises with Russia. China's soft endorsement of the Russian invasion aligns nicely with China's ambition to have Taiwan rejoin the country by force if necessary.

Over 20 years ago, the West allowed China (2001) and Russia (1993) into the World Trade Organization on the assumption that helping liberalize their economies would lead to a higher standard of living and more human rights for their citizens. In addition to modernizing their economies, it would reduce the potential for regional military conflicts. Unfortunately, only some of these goals have come to fruition.

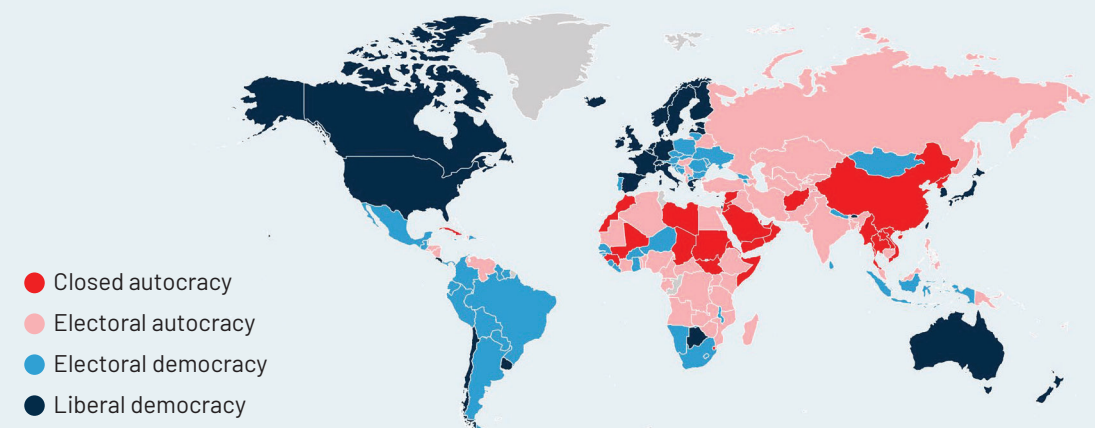
Although re-aligning Western supply chains may take a few years, the geopolitical re-alignment will likely be faster and has already started. Like during the Cold War era, politically aligned countries became more economically aligned and less integrated. We will likely see two distinct geopolitical and trading blocks, one consisting of democratic countries, such as the U.S., Canada, the European Union, Japan, and South Korea. The second block consists of autocratic states such as China, Russia, Iran, North Korea and other smaller countries.

The Bottom Line

Understanding geopolitics is more important than ever for professional investors. The ripple effects of far-away conflicts will no longer be meaningless to the West. Economic growth will be de-synchronized in the future, meaning growth will be more regional-based than global. In the 1980s, economic growth was uneven worldwide, and certain countries were growing while others were in a recession.

Geographic portfolio selection will be a larger driver for returns for investors as economies become less interdependent globally and more integrated regionally. For example, Canada is well positioned since our economy is already well integrated with the U.S. Meanwhile, Mexico provides an opportunity for low-cost manufacturing and the onshoring of jobs to North America from Asia. Active portfolio management will likely be vital in taking advantage of these regional growth discrepancies.

World Political Regimes, 2021



Source: Herre, B. (2021, December 2). *The 'Regimes of the World' data: how do researchers measure democracy?* Our World in Data. <https://ourworldindata.org/regimes-of-the-world-data>

Energy's Transition

After being shunned by institutional investors due to climate change concerns, the energy sector has roared back in the last two years as the best-performing sector globally. With the reopening of the global economy in 2021 and Russia's invasion of Ukraine in 2022, investors awoke to the fact that the world needs more traditional energy supplies, not less. Energy security and independence concerns are now top of mind for most Western governments. Despite the rally in energy shares over the last two years, the sector still has several positive catalysts.

First, global sentiment towards the sector has changed. Once seen as the scapegoat for climate change, companies are leading the charge through better ESG disclosure, investing in technology to reduce carbon emissions, and investing in renewables. Globally the sector is preparing for the decades-long energy transition to fewer fuel fossils and more renewable energy sources.

Second, energy companies have strict capital discipline today. Higher-than-expected commodity prices over the last year are generating excess cash, which is being used to rapidly pay down debt and return cash to shareholders through a combination of dividend increases, special dividends and share buybacks. Annual production growth is being kept at modest levels of 2-5% as cost control and return on invested capital are more important than production growth at any cost. Companies with excess cash and low or no debt will be in a stronger financial position if there is a recession, plus they will no longer be held hostage by their bankers.

Third, institutional investors' portfolios remain underweight in the energy sector. A few years ago, as the anti-energy lobby was growing due to climate change concerns, many large institutional investors publicly shunned the energy sector and stated that they would divest their energy holdings and no longer invest in it. As the energy sector has evolved with better disclosure of emissions risks and finding solutions for the coming energy transition, some but not all of these institutional investors have come back to invest in the sector. In addition, many generalist portfolio managers also remain underweight the sector in their funds. Thus, there is still potential for these investment managers to increase their energy holdings.

Fourth, globally over the last decade, the energy sector has underinvested in capital expenditures to increase production since investors were running away from the sector and share prices were depressed. This past underinvestment and the current capital discipline should ensure that production growth is more modest and that the industry wants to ensure that it doesn't create an oversupply condition, causing energy commodity prices to decline.

Finally, the energy sector trades at a very modest 4 to 6 times free cash flow, with cashflow yields north of 12%. The energy sector today has the highest free cash yield relative to other sectors. Although we have seen some mergers and acquisitions in the last two years, we expect that pace to pick up, given the excess cash being generated. Private energy companies now again have an exit strategy given that making an initial public offering since the oil price crash of late 2014 was nonexistent.

The Bottom Line

Although energy stocks have rallied over the last two years, there is still time to have energy in your portfolio. Only two questions remain: How much is right for you? and can you handle the short-term volatility of investing in a cyclical sector? The answer to these two questions is based on your risk tolerance and investment horizon.

Energy Companies Are Generating Excess Cash

iShares Global Energy ETF Free Cash Flow Yield



Source: FactSet Economics Standardized Database, Matco Financial Inc.

Fixed Income, My Old Friend

Fixed Income, or more simply put, the bond market, has often been a haven for investors. The asset class is intended to provide investors with stability and income. For some, it serves as a source of retirement income. For others, it has smoothed its equity returns over the long term due to its typical characteristic of being less volatile.

Throughout 2022, our old friend fixed income betrayed investors. With inflation rising to 9% in the U.S. and 10% in Canada, central banks were forced to ratchet up interest rates dramatically. Doing so is an action by central banks to dampen growth or tame inflation. Interest rates began the year relatively low, offering investors little income for their capital invested. To make matters worse, increasing interest rates throughout the year, which pushed down the price of bonds, led to capital depreciation of approximately 11%. Bond indexes in North America underperformed their equity siblings in most cases.

This raises the question, are bonds serving as a source of income and stability a thing of the past?

Central banks have communicated that they will continue to increase their overnight interest rates through the first quarter of 2023. They have also communicated that they will continue to re-assess inflation data as it comes and act accordingly. Based on the current central bank “dot-plot” forecasts, a direct communication from those who decide if the overnight rate increases or decreases, they anticipate the overnight rate to increase through the first quarter, remain on hold and then decrease near the end of 2023.

Inflation has been cooperating recently by declining on a smooth trajectory. Digesting this information indicates that the path of least resistance for interest rates overall is sideways through the first half of 2023 and begins to decline in the second half. This is good news for bond investors and investors with fixed income as part of their overall investment mix. Sideways to declining interest rates mean capital losses are behind us, and capital gains are just around the corner.

In addition, bond market indexes in North America had been providing income at rates well below 1.5% through 2020 and 2021. With the increase in interest rates in 2022, bonds are now yielding an income of approximately 3.5%. Of course, lower yields and higher yields are available, dependent on what bonds are selected for investment and how the investors’ appetite for credit risk.

Matco Fixed Income Fund Yield		
	December 31, 2021	December 31, 2022
Yield to Maturity	1.7%	4.5%
Current Yield	2.5%	3.5%

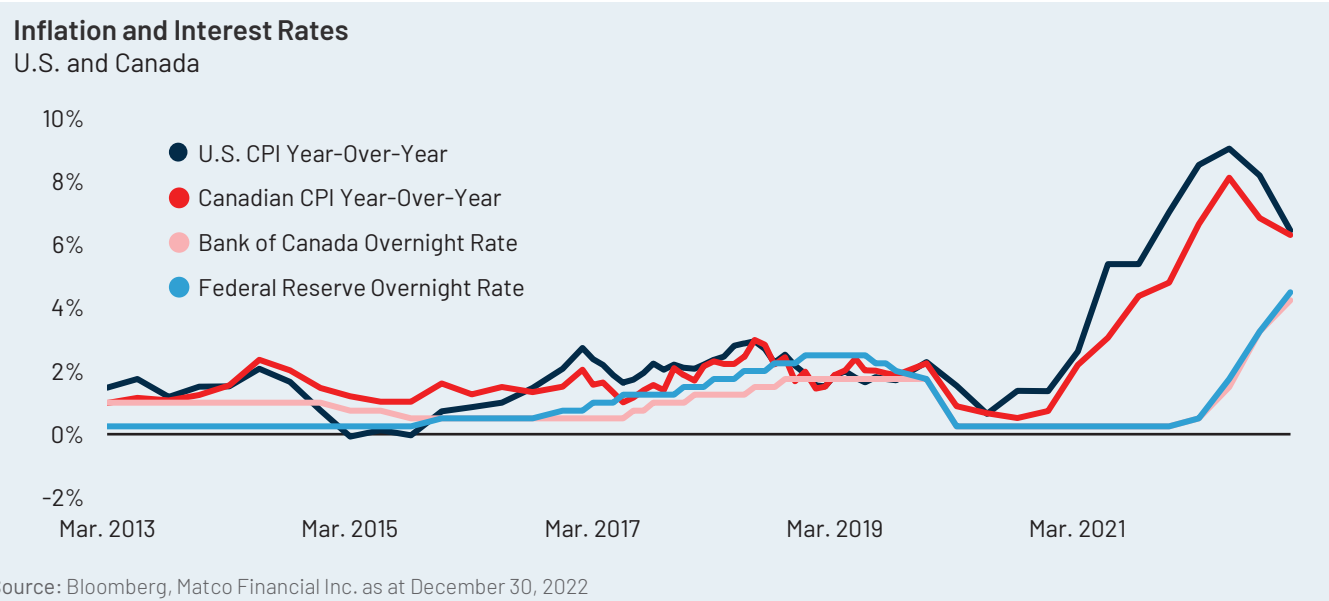
Source: Morningstar CPMS, Matco Financial Inc.

Looking beyond 2023, the path of least resistance for interest rates based on a balance of data, communication from central banks, and educated assumptions is for interest rates to head lower.

The Bottom Line

Matco’s commitment is to make investment decisions based on a balance of risk and return outcomes. In our industry, this is referred to as risk-adjusted portfolio construction. With our old friend fixed income now providing much more reasonable income/yield, and the path of least resistance for interest rates is to trend sideways or lower, the risk-adjusted outlook for the asset class is far improved when comparing its characteristics to most recent years.

Rest assured, the bond world isn’t for every investor. However, for investors seeking stable income or an allocation to provide downside protection against another downdraft in equity markets, our old friend is in a much better position to serve its intended purpose for an investor’s portfolio.



Navigating Market Volatility

Equity investors know that volatility isn't new, that financial markets move up and down, and that this movement is expected. Over 2022, bond investors were also reminded that fixed-income securities are highly sensitive to interest rates. We believe that a well-defined investment process to select securities and deploy capital allows investors to navigate market uncertainty. By incorporating factors contributing to a margin of safety, we believe we are in a solid position to remain convicted in our investments and successfully navigate 2023 and beyond.

In 1934 the book "Security Analysis" was written by Benjamin Graham and Frank Dodd. This book could be easily viewed as one of the first textbooks for investors. In it, the authors describe several topics and lay out a process for investors to follow to determine the value of an equity or bond investment. Security Analysis has since been followed by many more investing books written by academics and portfolio managers, where they continue to expand on many of the concepts within Security Analysis. One of these concepts is the Margin of Safety.

The concept is simple, the margin of safety means that you are making an investment where there is a cushion between what you believe is fair value and the value you paid to initiate your investment. With this cushion, investors hold a higher degree of conviction about their investments, meaning they are not as bothered by short-term volatility. Low conviction investment process causes panic or excessive trading in the face of volatility, which is not optimal for investment success. Higher conviction allows investors to focus on the long-term and dismiss market noise for what it is—noise.

What does a Margin of safety mean to us?

We evaluate a company's Earnings Variability, Price to Earnings, and Return on Invested Capital so we can set guideposts for what we believe to be good businesses at attractive prices.

First, we analyze a company's earnings variability to understand the durability of earnings. This means analyzing the long-term trend in earnings and how much the current reporting period fluctuates around that longer-term trend. Our research shows that the market rewards investors who own companies that consistently produce positive and growing earnings over the long term.

	Earnings Variability	Price to Earnings	Return on Invested Capital
Matco US Equity Strategy	10.7%	20.2x	30.6%
S&P 500	18.0%	23.5x*	21.2%

Source: Bloomberg, Matco Financial Inc.
*5 Year average S&P 500 P/E

Second, we evaluate a company's price-to-earnings to understand how much an investor must pay for their share of a company's earnings. For example, if a company is expected to earn \$10 per share over the next year and its current stock price is \$100, its price-to-earnings ratio is 10 times. Paying a smaller amount relative to higher earnings is the name of the game.

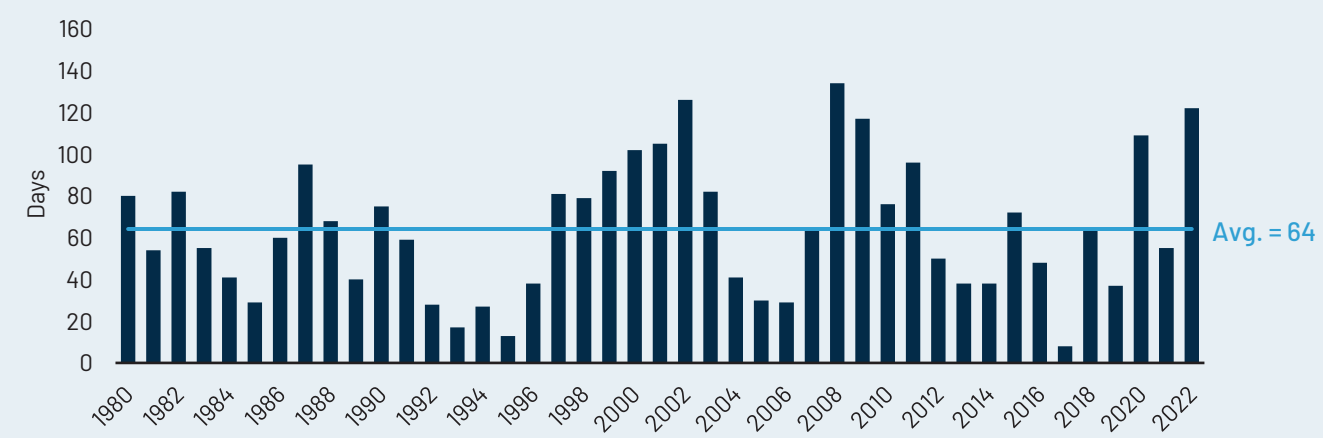
Third is understanding how effectively a company invests its capital. One way of doing this is to rank companies based on their return on invested capital (ROIC). High ROIC means that the company can effectively invest back into its business and grow its earnings. The higher return a company can earn for each dollar of investment directly correlates to the overall earnings of the business.

The Bottom Line

Financial markets are volatile and require a plan. We incorporate concepts like margin of safety in our investment approach to deploying capital effectively over the long term despite short-term uncertainty.

42 Years Of Volatility

Number of days when the S&P 500's value changed by at least 1%



Source: Bloomberg, Matco Financial Inc. as at December 30, 2022

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