AGF FUND INSIGHT

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History Suggests a Positive Year in 2023

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A Constructive View for 2023 for the S&P 500 Index

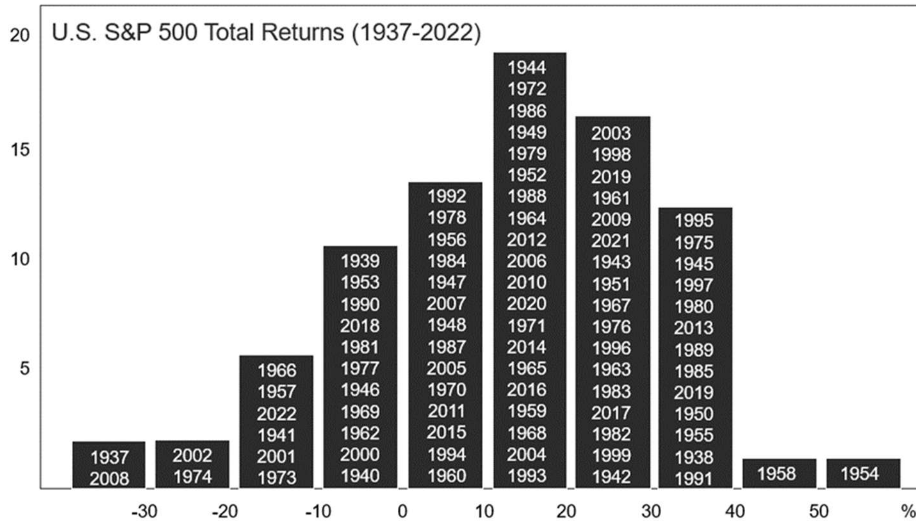
As we enter 2023, our view for equities is a constructive one. We are anticipating the return to a more favourable environment for equity investors with positive returns expected in the year ahead. The last twelve months have demonstrated that volatility is alive and well for both downside and upside moves (e.g. the Dow Jones Industrial Average had its 2nd best quarterly return since 1999 with its Q4 2022 gain). Given all the uncertainty related to inflation rates, U.S. Federal Reserve (Fed) interest rate policy, economic growth prospects, and geopolitical developments, we would expect volatility continue in 2023. Volatility is part of the landscape for equity investors and even with this reality, the annual market return has generally been favourable with approximately 75% of the past 85 calendar years showing a positive return. Notwithstanding a tough start to the decades of the 2020's, the past 10 years has been a rewarding experience for U.S. equity investors. Whether the returns for the S&P 500 in 2023 approach the mean return level of those experienced in the last 10 years (of +13.3%)[1] remains to be seen, but we believe that the odds of this occurring are favourable. Not only does the historical experience provide support for this view, but the fundamental pieces also seem to be falling into place for a constructive outlook.

First, some observations on the historical experience of the stock markets. This year's return is shaping up to be a loss year for equities (S&P 500 Index) with the likelihood it falls into the -10% to -20% range given the year-to-date return is roughly -19%[1]. So this year will likely be one of those one-in-four negative calendar year returns that the market has historically experienced.

[1] Source: Bloomberg, as of December 27, 2022

20221228-2655019

Figure 1 – S&P 500 Calendar Year Return Histogram



Source: AGF Investments Inc., as of December 27, 2022. One cannot invest directly in an index. **Past performance is not indicative of future results.**

If history is any guide, the likelihood of the market experiencing two negative calendar year returns is not very high. In fact, in the last 85 years two consecutive negative return years has only happened 3 times, as illustrated in Figure 1. For two of these experiences, the market decline had commenced from a very high valuation level. This was the case for the consecutive negative years of 1973/1974 with the "nifty fifty" era and it was also the case with negative return years after the technology bubble burst in 2000 when P/Es were at their highest ever. The terrible events of September 11, 2001, was also a factor in the negative return years of the early 2000's. A third occasion of negative return years occurred in 1940 and 1941, in the midst of World War II, which clearly had its own set of uncertainties. In our view, it does not appear that the current cycle has attributes similar to these occasions, though there are rising risks of regional wars, with the ongoing (and potential expansion) of the Russia/Ukraine conflict, or perhaps rising tension with China and Taiwan. On the other hand, strong positive years have tended to follow negative return years. In examining the positive years following a negative return year, 12 out of the 15 years have seen returns exceeding 20%.

Meanwhile, the fundamental backdrop for a more constructive view also appears to be falling into place. The loud drumbeat of concerns over inflation have started to abate. To be sure, inflation is still a concern and will without question take some time to come back down to the lower single digit range but the recent figures do suggest a declining trend for this all important economic variable. This in turn, should allow the Fed to be much closer to ending its aggressively tightening posture. Given that the economy has yet to weaken substantially, the case for a milder recession (should one occur) should gain greater credibility.

Even with the case of the widely anticipated recession actually occurring in the 2023, the stock market has shown remarkable resilience during those calendar years of negative GDP growth. In the 12 calendar years for which GDP recorded a decline, the stock market averaged a return of 14%. Stock market weakness tends to occur ahead of the actual recession – the year before a recession occurs tends to result in negative return years, but returns have averaged double digit positive gains in the year a recession actually occurs. The stock market is, after-all, a leading indicator and is anticipatory.

20221228-2655019

Figure 2 – S&P 500 Returns in Prior and Current Years of Recessions

S&P 500 Returns During Different GDP Environments					
Real GDP Range	# Instances	Average Return (Prior Year)	Median Return (Prior Year)	Average Return (Current Year)	Median Return (Current Year)
< 0%	12	-7.5%	-8.2%	13.6%	19.9%
0 - 2%	8	4.0%	6.0%	0.0%	0.0%
2 - 4 %	28	10.3%	8.7%	9.6%	11.1%
> 4%	27	15.9%	16.5%	9.6%	12.4%
All Years (1947-2021)	*75*	*8.8%*	*10.8%*	*9.2%*	*11.4%*

Source: RBC Capital Markets, as of December 2022. One cannot invest directly in an index. **Past performance is not indicative of future results.**

On the subject leading indicators, the OECD composite leading indicator (CLI) is still in a downtrend. This should come as no surprise since the lagged effects of rising interest rates are still filtering through the economy. A declining CLI is not conducive for corporate profit growth. Most forecasters have been calling for weaker corporate earnings and while estimates have come down for the 4th quarter of this year and for 2023, the actual results have generally not been weaker than consensus expectations. In fact, during the 3rd quarter there were more upward guidance revisions than in the prior two quarters. Our expectation is for the stock market to look beyond the valley of not only from the perspective of a weaker economy but also looking beyond declining earnings estimates. Indeed, stock market returns have tended to be positive amidst an environment of negative earnings growth since the market is forward looking - this phenomenon has occurred in 9 out of 11 calendar years where S&P 500 earnings have declined by 10% or more, as illustrated in Figure 3.

Figure 3 – S&P 500 Returns in -10% Earnings Growth Years

Source: Strategas Research, as of December 2022. One cannot invest directly in an index. **Past performance is not indicative of future results.**

In summary, we believe the set-up for 2023 is attractive. Beyond the historical trends following a negative year and a more constructive fundamental backdrop, other considerations are also showing signs of pointing in the right direction. This includes the potential reopening of the Chinese economy, political gridlock in Washington which will provide more regulatory certainty, a potential easing of global geopolitical tensions, ongoing corporate buybacks, and the eventual return of equity market inflows given the high levels of cash on the sidelines.

A last thought – a favourite line that we heard in 2022 about investing is: **'Looking at market average statistics leads to an average forecast.'** Our belief is that successful investors typically have to resist having a consensus view or at least be front of where the consensus view may be moving. To do this, it is essential, in our view, to be a student of market history and combining that with an evaluation of where the common current thinking is. By starting out each day with a white piece of paper, we have the flexibility to change our views and modify our positioning accordingly in order to hopefully continue to give our investors a good experience.

20221228-2655019

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