

January 20, 2022

Dear clients,

*Genius abhors consensus because when consensus is reached, thinking stops.  
Stop nodding your head.*

- Albert Einstein

*It's tough to make predictions, especially about the future.*

- Yogi Berra

Did you predict that 2022 would go as it did? Be honest!

I didn't.

King Charles III. Twitter sale to Elon Musk. Invasion of Ukraine. Prime Minister-for-two-months Liz Truss. Protests in China and Iran. And let's not forget the Amber Heard v. Johnny Depp trial!

Most of these had little effect on us, it's true. But other things did. I moved into a new home in the Fall of 2021, and delayed installing an air conditioner. Then came the summer heat wave, and I paid the price! I was unprepared.

The best we can do with uncertainty is to prepare. But everyone's sense for what is "reasonable" preparation is different. Some invest thousands of dollars in canned goods and toilet paper for the next natural disaster, and others live day-to-day. It's all about tolerance for risk. (And perhaps wisdom, or lack thereof.)

As your investment manager I take risk management very seriously. Your financial future is too important. Most adverse events, in the stock market and in life, are unpredictable – what Donald Rumsfeld called "unknown unknowns". So it is wise to limit our exposure to things that could hurt us. In investment terms I build portfolios that will not be harmed too much by any one event. This is called diversification, a critical risk management tool.

### **Consensus is always wrong**

In 2021 the talking heads were all saying the same thing about inflation – that it was coming, but would be "transitory" – that is, temporary – as supply chains got back online, people got back to work, and rate increases took effect. This was "consensus" opinion. In reality, inflation proved to be much stickier than expected, as we now know. In fact, throughout history it is rare that consensus predictions turn out to be correct. There is a reason for this – if the crowd likes something, they have already "purchased" it. Its

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value is already at its maximum, and the only direction it can go is down. Yogi Berra famously said, “Nobody goes to that restaurant anymore; it’s too crowded.” In the same (non-)sense, if everyone recognizes the same bargain, it’s not a bargain. Investors make money by identifying bargains before the crowd does. And usually this means investing in opportunities that are temporarily unpopular.

Today’s consensus is that the U.S. and Canada will enter a recession mid-year, inflation will moderate, and markets will fall in the next few months but rally into the second half.

Now you know what *won’t* happen.

### **What worked, and didn’t, in 2022**

In a year when North American stock markets fell<sup>1</sup> by 6% (Canada) and 14% (US), and the Canadian bond market lost 12%, investors did very well to tread water in 2022.

Canadian portfolios under my management benefited from Materials stocks such as Teck Resources (copper, coal), Yamana Gold, and Nutrien (fertilizer), plus a basket of larger oil & gas companies. As these holdings performed well we took profits. Interest rate-sensitive stocks were among the poorer performers, such as TD Bank, Bank of Nova Scotia, Canadian Apartment Properties REIT, and Granite REIT. We remain invested in most of these.

U.S. portfolios benefited from arbitrage situations in VMWare and First Horizon Bank, covid-related demand imbalances in Autozone (retail auto parts) and D.R. Horton (homebuilders), and several oil & gas selections. Traditional “growth” companies Micron, Alphabet, and Microsoft fared poorly, and the first two have been sold. I underestimated the extent to which those companies would be punished in a rising rate environment, despite their reasonable valuations.

### **Where to from here**

We will see if inflation normalizes later this year, and interest rates peak. Materials stocks remain a solid investment opportunity given supply constraints, China’s reopening, and the ongoing threat of war. Gold in particular should perform well as rates peak and the US dollar declines.

It seems counter-intuitive to many, but a recession doesn’t necessarily mean markets will fall. The reality is that markets anticipate – they fall before the recession hits, and they start rising well in advance of the recovery. If markets have been trading on the belief that a recession is coming, it’s possible that markets will not in fact fall in 2023, because the market has already adjusted. It’s equally possible that we will not have a recession at all. The labour shortage at the lower end of the income scale would be proof against one. I think we will see higher white-collar unemployment and an earnings

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<sup>1</sup> Source: FactSet. Performance figures are Total Return, with dividends and interest reinvested. Canadian bonds based on iShares Core Canadian Universe Bond ETF (XBB), an ETF representative of Canada’s bond market. Canada based on S&P/TSX Composite Index, a Canadian equity benchmark representative of Canada’s stock market. US based on S&P 500 Index (\$CAD), a US equity benchmark representative of the United States stock market.

recession, not a broad-based recession. If so, it will remain in the media, but markets may not even notice.

### On mutual funds

Many clients have smaller accounts (under \$80,000), and it is not possible to manage a full stock portfolio in these accounts. So I have invested these smaller accounts in mutual funds. However, one fund I selected (Cap Group Global Equity) did not perform well in 2021-22. I replaced it with a fund I have a high degree of conviction in, and expect future performance to be better.

### Stay the course

It is easy to be made anxious by the consensus views out there about imminent recession and impending doom. Despite the turmoil of 2022, most of my clients' portfolios saw modest gains, for which I am thankful. This will never change: when it comes to investment predictions the best advice is simply to ignore the voices! Instead, have confidence in your discipline, and prepare for contingencies. If you have questions please don't hesitate to reach out, that's what I'm here for.

All the best in 2023,



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