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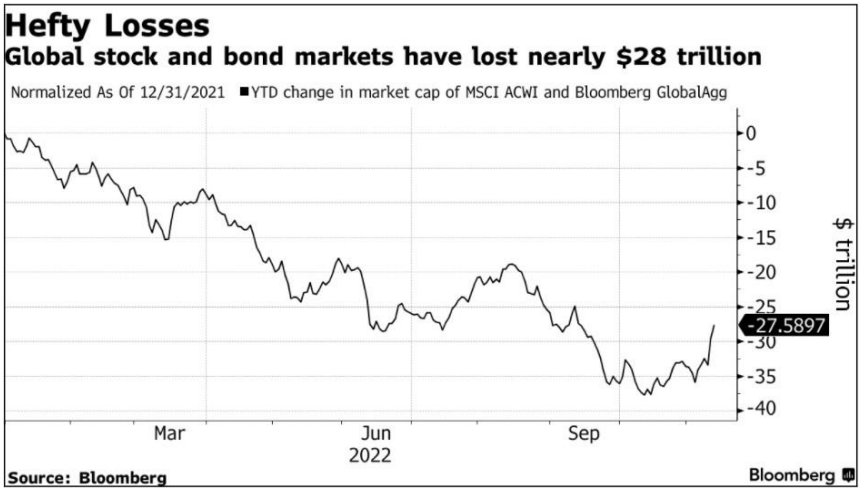
2022 was a volatile year for global economies and markets with inflation the main culprit. While inflation likely peaked for this cycle in 2022, inflationary pressures will remain persistent and remain above central bank target levels for some time. Inflation surged past central bank target levels due to goods inflation based on supply constraints, pent-up post-Covid demand and geo-political tensions. These pressures are now abating and inflationary pressures are transitioning to services. Service inflation is stickier than goods inflation as workers try to recoup spending power loss through higher wages. There is a lag in services inflation compared to goods inflation and therefore we can expect inflation to fall much slower than it ramped up resulting in inflation remaining above target throughout 2023. Sharply higher interest rates orchestrated by central banks will eventually reign in inflation but this will take some time and will slow economic activity. In the interim the risk is that central banks will continue to raise rates through at least the first half of 2023. Economic and policy fundamentals will ultimately have their say in 2023 but in the short run inflation and geo-political tensions will continue to be headline risks. There is a high probability of recessions this year in developed countries.

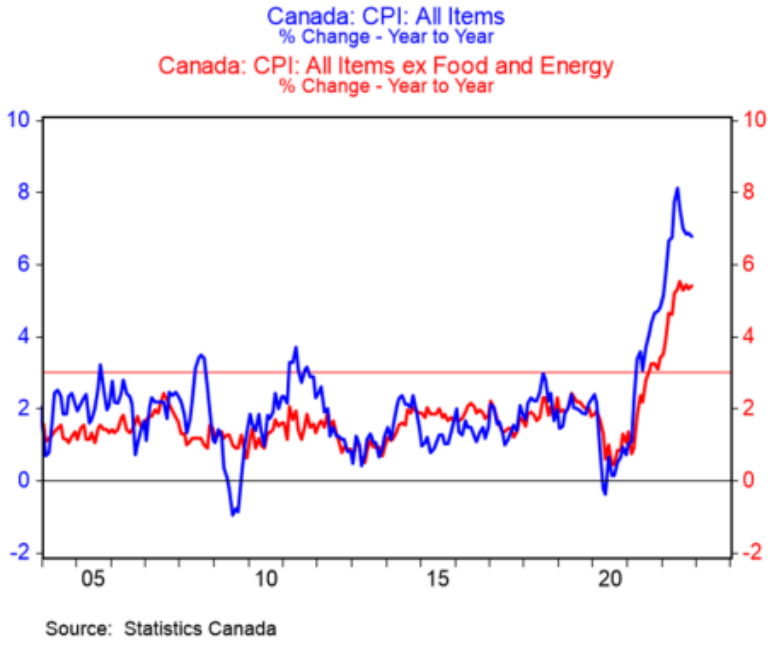
Globally it was not a good year for bond and stock markets. The combined Bloomberg Global Aggregate bond index and the market cap of the MSCI All-Country Index fell a combined US$ 27.5 trillion in 2022, the largest drop on record.



It was also a year in which the US dollar strengthened against major currencies in a flight to safety. Falling stock markets and rising bond yields led to selling and a flight to safety, which in a volatile world typically means that the US dollar and Swiss franc are favoured havens. Emerging markets were particularly hard hit with a trifecta of losses in bonds, stocks and currencies. Crypto currencies were in the news this year as high-profile implosions of crypto exchanges and falling prices were global news. Overall, crypto markets had a dismal year falling some 70%. We continue to fail to see the value in digital currencies and eschew these types of investments.

Canada

Relatively speaking Canada weathered 2022 well. Economic output cooled but was still positive for the year. Employment remains strong with the unemployment rate at 5.1%, which is driving strong wage growth (service inflation) and consumer confidence remains positive. The story for 2022 was inflation, which likely peaked around mid-year, at just over 8% in Canada. But even with a big helping hand from much lower gasoline prices, inflation is still more than 2% above year-ago levels at 6.8%. The annual trend in most underlying measures has been locked in at just above 5% for months now. The story of 2023 may well be just what a tough slog it is to get underlying inflation back down to more comfortable levels. The Bank of Canada focused on capping inflation pressures the Bank will stay the course and raise rates a few more times in 2023.



Higher interest rates are beginning to take their toll and we can expect further economic slowing with a high probability of a recession in 2023 which will lead to higher unemployment. Housing prices have been on a downtrend since their peak in the spring of 2022 and will likely continue this trend in 2023. Canadian bond markets had one their worst years in memory declining 6.1%. Our position in relatively short maturity bonds helped to mitigate the potential losses. The positive side to higher bond yields is that they now offer more attractive yields than they have in years. As a result, we have extended out the bond maturity of our portfolios to take advantage of these more attractive yields. Bond yields will remain elevated, underpinned by higher short rates in the first half of the year. Eventually, slowing economic conditions and lower inflationary pressures will result in stronger bond markets in the second half of the year.

Canadian stocks had a volatile year declining 8.66%. Commodity oriented stocks (energy +22.5%, materials +10.1%) performed well while most other sectors (financials -12.3%, utilities -13.3%, real estate -24.0%, information technology -51.8%, health care -62.1%) had a rather challenging year. Interest sensitive sectors will

continue to be pressured as rates rise in the first half of the year. Slowing economic growth will temper the strong returns in commodities and energy that occurred in 2022 and with higher rates it will be difficult for Canadian stocks to make a significant rally in the short to medium term. The second half of the year looks more promising for Canadian stocks as the outlook for inflation, direction of rates, and the economic outlook becomes clearer.

The Canadian dollar fell against the US dollar, the Euro and the Swiss franc but rose against most other currencies. Higher short-term rates and a flight to safety underpinned the strength of the USD and CHF. Relatively faster interest rate increases coupled with firm energy and commodity prices lent strength to the CAD versus most remaining currencies.

US

Strong consumer price inflation led to an aggressive response from the US Fed in 2022 which led to higher bond yields and lower stock prices. Higher rates to fight inflation has led to slowing economic growth but overall the US economy remained positive in 2022 and employment remained strong. The latest CPI report showed inflation at 7.1% in November, which is below the 40-year high of 9.1% hit in June but still well above the Fed's 2% target and clocks in at 2.4 standard deviations above the 10-year average. The Fed's December 50 basis point rate hike lifted 2022's cumulative rate increases to a towering 425 bps in little more than nine months. In the post-World War II era, there have only been three other periods where rates went up by at least 425 bps in a 12-month period—in 1973, in 1979/80, and in 1981. In each and every case, the U.S. economy was in a recession within a year and fundamentally, this points to the high probability that there will be an economic downturn in 2023. While there are certainly many unique aspects of this cycle, it's going to be incredibly tough to swim against this tide. US Fed Chairman Powell recently stated that the Fed wants to see substantial evidence of a sustained decline in inflation pressure before ending its tightening campaign. A recent survey of economists by Bloomberg indicated a 65% chance of US recession in the next 12 months, with the Fed's rate peaking at 5% in 2023 and falling to 3% by the end of 2024. As such we project that the US Fed will continue to raise rates in the short term and likely cease such moves as the second half of 2023 approaches. In this context we can expect that bond yields will remain elevated with a negative outlook for the short-term. US bonds won't likely strengthen until the second half of the year when the effects of higher rates and a slowing economy take the wind out of inflation.

US stocks had a challenging year with the broader market, as measured by the S&P 500 index, falling 19.4% and the high tech dominated NASDAQ falling 33.1%. These are the worst run of numbers since the 2008 financial crisis. Higher yields led to a compression in P/E's in 2022 which had an outsized negative effect on high growth stocks and led to the decline in the NASDAQ. The only positive sector in the S&P 500 was energy. The remaining 10 sectors all declined with real estate (-28.6%), info tech (-30%), consumer discretionary (-38.4%) and communication services (-40.1%) the worst performers. Higher rates and slowing economic activity will continue to weigh on the overall stock market in the short term. Stocks will have a difficult time rallying until rates stabilize and the depth of the economic slowdown becomes apparent. We foresee US stocks trending sideways at best with the potential for a rally in the second half of the year.

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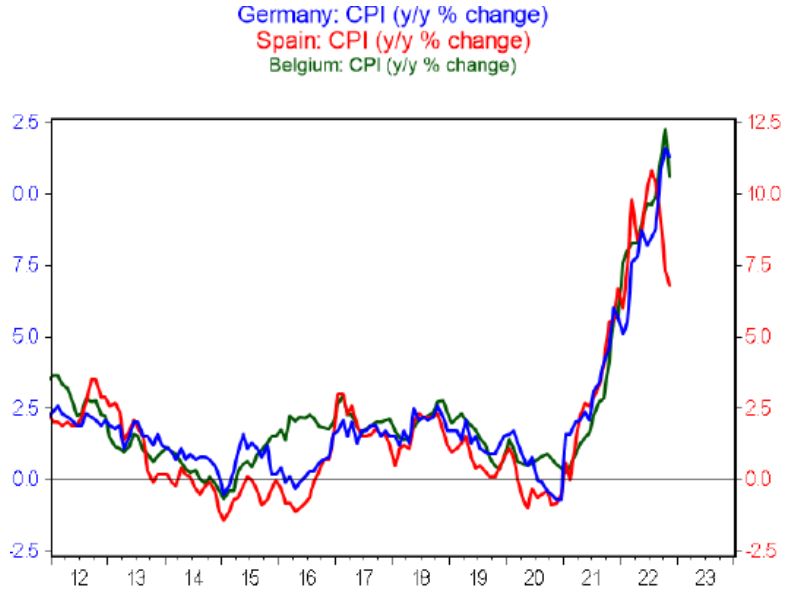
The US dollar was the standout for its strength in 2022. The aggressive stance by the US Fed to fight inflation by ratcheting up interest rates led to a flight to the US dollar. The strength in the USD has likely peaked as the US Fed counterparts catch up with their own rate increases.

Europe

As elsewhere, inflation was a top story in Europe in 2022 (however, the invasion of the Ukraine by Russia must be equal or at least a close second). The better November inflation news coming out of Spain, Belgium, and Germany may portend that the peak of inflation has passed, but we must remember that winter just began and the threat of Russia shutting off its gas supply is still very much alive. In any event, ECB President Christine Lagarde, who has taken a hawkish stand, warned that not only are they "not done" but inflation "still has a way to go". And "I would like to see inflation as having peaked in October, but I'm afraid that I would not go as far as that." Importantly, German inflation slowed more than anticipated in December after the government paid some households' gas bills for the month, offering a temporary respite in the country's cost-of-living crisis. Consumer-price growth for December was 9.6%, the weakest since August and much better than the 11.3% posted in November. At almost five times the European Central Bank's goal, the strength of inflation in the region's largest economy underscores the challenge faced by officials in bringing prices under control. Policymakers including Bundesbank President Joachim Nagel have pledged further forceful action in response. That may mean extending a historic series of ECB interest-rate hikes with at least two more half-point steps early this year. A strong labour market in Germany, where unemployment unexpectedly dropped in December, is supporting the argument that a mild winter recession isn't about to push the economy off a cliff. Germany's inflation rate measured on a national basis at 7.9% last year is by far the strongest on record since the country's reunification in 1990.



European bonds had a very dismal year in 2022 with the sovereign 10-year bond index falling 11.85%. German and Swiss 10-year bonds started 2022 with negative yields while the Netherlands was effectively flat and most other sovereign 10-year bonds well under 1%. The outliers were Italy and Greece at 1.2% and 1.25% respectively.

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Fast forward to the end of 2022 and German 10-year bunds are at 2.38%, Switzerland 10-year governments bonds at 1.19% with outliers Italy at 4.48% and Greece at 4.55%. The carnage in the European bond markets was the worst in over 40 years and was based on the highest inflation numbers in a generation prompting a strong ECB response. The latest inflation numbers appear to show that inflation has peaked but with the ECB indicating that the inflation fight has not been won further interest rate increases will occur. This means that European bonds are not out of the woods yet and we expect yields to trend higher in the first half of 2023. Falling inflation pressures coupled with weakening economic output will prove to be supportive of bonds during the second half of 2023.

European stocks had a challenging year with the broader European stock market falling 12.89%. Higher short term interest rates weighed on stocks as did the uncertainty over the Russian invasion of the Ukraine. With higher short term interest rates still in the cards and the likelihood for an economic slowdown the outlook for European stocks remains mixed for the first part of 2023. As the outlook for economic conditions becomes clearer and the cessation of interest rate increases occur, we expect stocks to perform better into the second half of 2023.

The Euro fell 5.9% against the US dollar in 2022. We expect that the Euro will rebound somewhat as the ECB catches up with its increases in short rates.

Switzerland

On a relative basis Switzerland performed quite well in 2022. Inflation was an issue but not to the same extent as other developed countries. Bond markets declined (10-year sovereign bonds fell 4.8%) but to a lesser extent than other markets as the Swiss National Bank followed its global colleagues and raised short term rates. The Swiss stock market actually declined more than broader Europe, falling 16.7% in 2022. Poor export markets and higher short-term rates weighed on stocks. The Swiss franc fell the least against the USD (-1.25%) in 2022 compared to much higher losses in every other major currency.

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