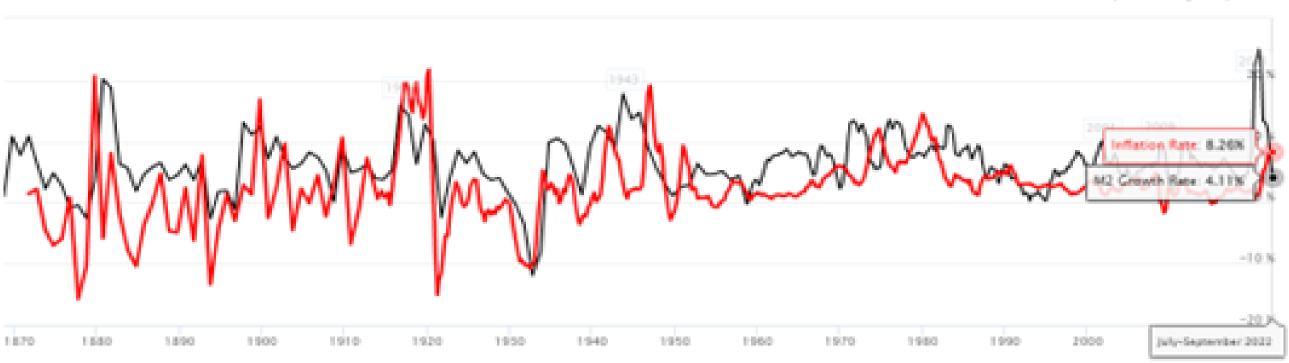
October 2022

Are we there yet?

The year 2022 is shaping up to be one many investors would like to forget, given the volatility and negative performance of equity and fixed income markets. With the declines witnessed to date, many investors are asking, "Are we there yet?". First, let's address the cause, before moving to a few of the consequences and finally addressing the evolving opportunity set.

As we know, the COVID-19 pandemic led to a complete global shut-down followed by cascading, global economic pauses. The world then experienced supply-chain bottlenecks, as pent-up demand took hold in the second half of 2020 and into 2021. These conditions led to extremely accommodative fiscal policy, coupled with global central banks injecting significant stimulus (cheap and abundant money) into the global system to combat the economic slowdown. As illustrated below, the consequences of tight supply with rising demand for goods and services and the availability of cheap money, led to the consequence of inflation outpacing expectations. The typical response from central banks has been the reversal of accommodative conditions, hence rising interest rates. This time around, select central banks are also unraveling prior fixed income purchases or quantitative tightening – recall the Taper Tantrum of 2018?

M2 Yearly Growth vs. Inflation (Oct 1, 1868 – July 31, 2022)



Source: Longtermtrends. Data from Federal Reserve Bank of St. Louis, U.S. Census Bureau, Robert Shiller and the Congressional Budget Office.

Additionally, the world is facing a tightening of energy supplies from numerous sources (oil, natural gas, hydro-electric, nuclear, etc.) caused by an under-investment in fossil fuels, logistical re-routing of Russian supplies and various weather/climate occurrences that are considered "once every 500-year" events. With global growth accelerating in 2021, the vulnerability/reliability of our global energy supply and infrastructure has been called into question. Essentially, without abundant, reliable, and cost-effective energy, global growth has been challenged. Now, discussions of energy rationing, windfall taxes on oil and gas companies and tax rebates/caps on energy bills for consumers are taking center stage. The required discussion on "real world" energy policy solutions needs to be agreed upon, implemented and enacted as energy is economic growth.

Another consequence includes the health of the consumer. Economic growth is tied with the health of the masses, not where financial wealth is concentrated among a small portion of the population. As higher interest

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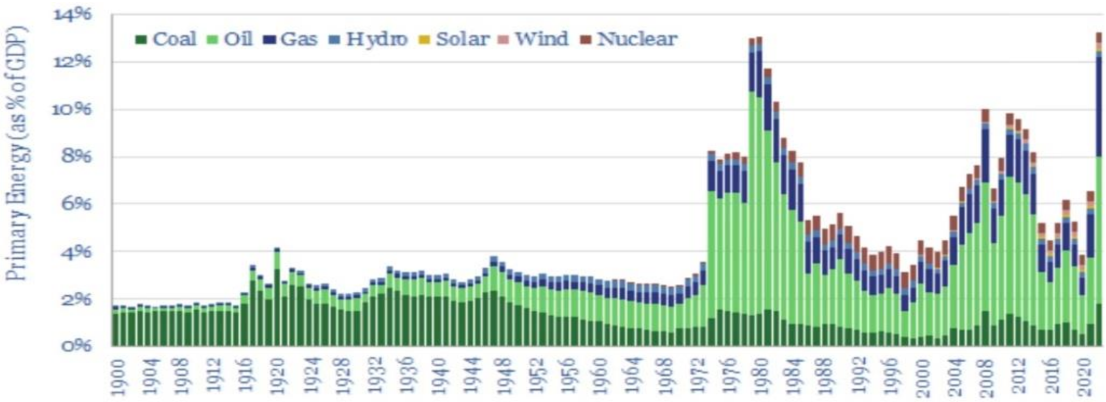
rates and elevated energy prices are essentially a tax on the consumer and businesses, the masses typically grow cautious as a larger portion of their pocketbooks are allocated to these areas. The following chart illustrates various cycles, but we will focus on 1970-1984 and 2000-2016 cycles. A few observations of these cycles: 1) once elevated, prices remained higher for longer; 2) under-investment and reliance on outsourcing were common threads; and 3) oil disproportionately rose, and today, oil and natural gas have risen as coal continues to be phased out. It comes down to a simple re-allocation of available resources and a tightening of budgets in the near term. We have travelled through these types of environments many times and will move through these conditions once again.



Source: Thunder Said Energy.

We know equity markets are forward-looking, discounting various scenarios into valuations. So, the question comes back to, "Are we there yet?". Have the markets fully discounted these "knowns" into prices and valuations? This is where the "Art of Investing" kicks in. The current correction we are witnessing may not be the same as those in the past, but we do have similar road maps we can follow from prior periods. From various measures, we see investors have crowded back into the US$ as in past corrections and times of uncertainty. Valuations have checked back, and as the following charts demonstrate, Canadian markets reflect a significant discount compared to their long-term averages. The questions that most investors need answered right now include: are earning estimates close to being correct?; are we closer to the end of the tightening monetary cycle or the beginning?; is there another unknown waiting around the next corner?; and is inflation now on the cusp of receding? All great questions, which will likely be answered over the coming weeks/quarters ahead.

Source: Bloomberg/Morgan Stanley Research.

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Forward P/E: Global Sector Overview (July 29, 2022)

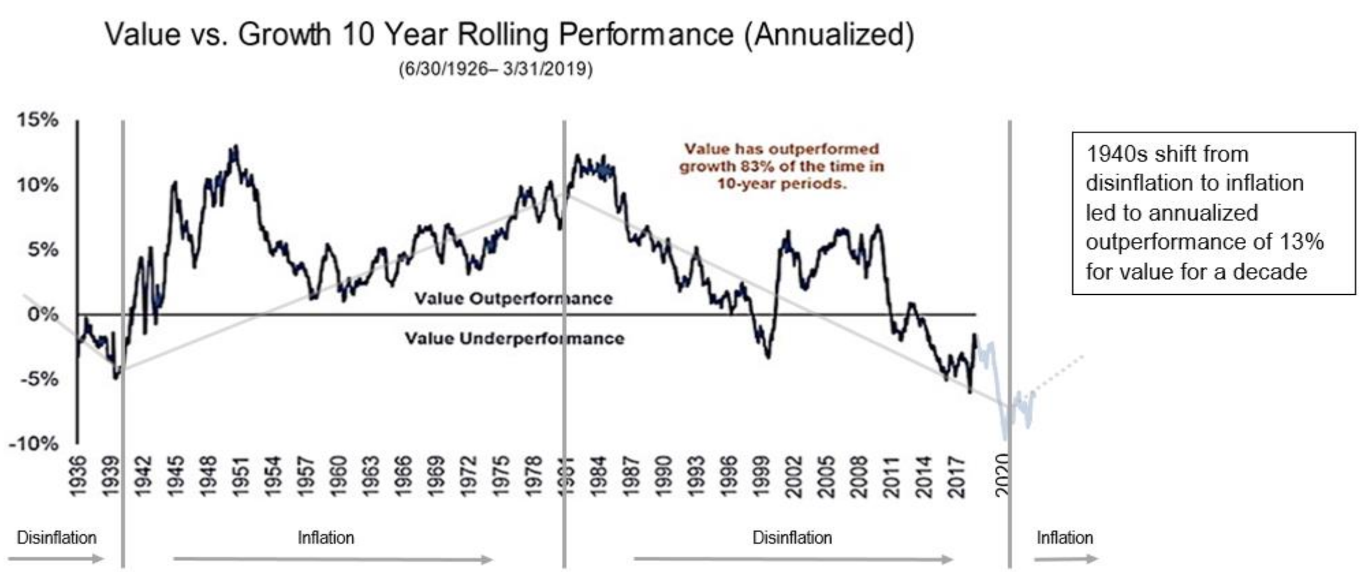
	Canada (TSX)			U.S. (S&P 500)			AC World (ex-USA)			DM World (ex-USA)		
	Current	LT Avg	Premium / Discount (%)	Current	LT Avg	Premium / Discount (%)	Current	LT Avg	Premium / Discount (%)	Current	LT Avg	Premium / Discount (%)
Index	11.9	14.5	-18%	17.4	15.5	12%	12.1	13.5	-11%	12.5	16.2	-23%
Energy	8.7	22.4	-61%	8.7	18.0	-52%	6.5	12.5	-48%	6.3	14.0	-55%
Materials	9.7	16.6	-41%	13.7	15.9	-14%	8.8	13.1	-33%	9.2	14.3	-35%
Industrials	24.8	16.2	53%	17.3	16.8	4%	13.3	15.6	-15%	14.3	16.5	-13%
Discretionary	13.0	17.7	-27%	25.5	19.3	32%	14.2	16.2	-12%	12.8	16.6	-23%
Staples	16.7	16.0	5%	20.7	18.1	15%	19.6	17.9	10%	19.3	17.9	8%
Healthcare	8.2	18.7	-56%	16.2	17.5	-7%	19.1	18.5	3%	18.2	18.3	-1%
Financials	9.8	11.5	-15%	12.2	12.9	-5%	9.0	12.5	-28%	9.6	12.9	-26%
Technology	31.2	31.1	0%	21.7	20.9	4%	14.9	19.9	-25%	20.4	23.8	-14%
Communications	17.9	16.6	8%	15.0	16.6	-10%	17.6	30.8	-43%	16.3	24.6	-34%
Utilities	24.2	17.1	42%	20.6	14.8	39%	15.0	14.3	5%	14.9	15.0	-1%
Real Estate	13.8	20.7	-33%	39.3	37.6	4%	12.0	15.6	-23%	14.3	16.7	-14%

Based on MSCI indices, unless otherwise stated, with data going back to 1995.
Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg.

Source: Scotiabank. Global Strategy Outlook. August 2022.

From our perspective, opportunities are abundant on the surface today and we are diligently selecting the businesses we wish to own in our portfolios going forward. When the markets transition from discounting the worst-case scenario, as they always do, towards the next phase of economic growth, we believe value-oriented businesses will once again outperform. As illustrated below, leadership transitions from growth to value are rarely smooth in nature, but once established are typically long in duration and provide significant returns over the medium- to long-term.

Transition From Growth to Value Beginning



Source: Eugene Fama & Kenneth French. Ronald Blue Trust. 2019. 2019-2022 is an estimate by Sionna based off of S&P 500 Value and S&P 500 Growth Index Data.

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The pandemic has brought about momentous change and with it many questions regarding how the future investment landscape may take shape. Given abundant, secure and cost-effective energy in North America (NA), will it be NA providing this resource to the world? Can an onshoring of industry/manufacturing shift back to NA? With the announcements of electrification, and with reduced emissions, can NA become a global leader in this space? This question is key, as portions of outsourcing to certain nations will likely reverse as security of supply chains continue to gain momentum – we have witnessed part of this already (Inflation Reduction Act in the US, Critical Raw Materials Acts). For instance, Canada recently announced investments of over $13 billion into its electric vehicle industry. These investments are centered within Ontario and Quebec, prime areas given ~70+%/~94+%, respectively, of electricity is generated from low- to no-emission hydro/nuclear/renewable sources. Canada's access to critical minerals and Carbon Capture Storage will also play a crucial role in the future. There are numerous other examples of how Canada is set to thrive in the decades to follow, but we will leave that for another conversation.

The investment landscape can be cloudy at times, but clarity is typically around the next turn. What is becoming abundantly clear is the opportunity set for North America to outperform, with Canada having the potential to lead the way in the decades to come; we look forward to capitalizing on this opportunity in the months, years and decades ahead. Once valuation permits and we commit capital to our new investment holdings, we look forward to discussing these opportunities with you. Once again, we want to thank you for your continued support and wish you a safe, happy autumn – stay warm!

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