Préfontaine Capital Inc.

- FINANCIAL LETTER -
THIRD QUARTER 2022

Economic and Market Outlook

In its *World Economic Outlook* published on October 11th 2022, the International Monetary Fund (IMF) maintains its global growth forecast at 3.2% for 2022 but further lowered its forecast for 2023 to 2.7%, from the 2.9% it expected in July. The IMF sees very low growth for the US (1.0%) and the euro zone (0.5%) in 2023. Canada is expected to grow by 1.5%. The organization also states that the risk of a further downward revision to its forecasts remain high. The IMF sees global inflation at 8.8% in 2022, 6.5% in 2023 and 4.1% in 2024. It further mentions that indicators of systemic financial risk (essentially a liquidity crisis or crisis of confidence, which is always accompanied by a sharp fall in asset prices) are on the rise.

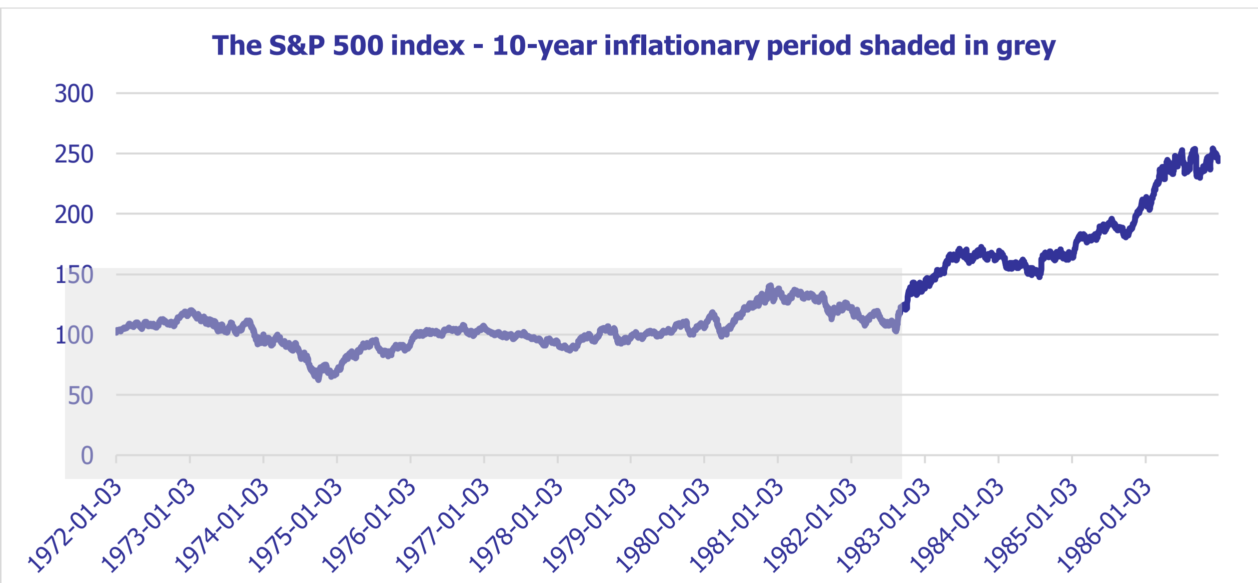
Recently, Russia threatened to use nuclear weapons in Ukraine and Europe responded that in such a scenario, the West would annihilate the Russian army. This is a systemic risk whose extent and scope over time is difficult to assess and it is even more difficult to know whether equity markets have correctly priced in this risk.

Stock markets were particularly volatile during the quarter, reflecting investors' uncertainty about corporate profits in the coming quarters. At the time of writing, the S&P 500 has declined by about 25% in 2022 and is trading at about 16x the earnings that are currently expected in the next 12 months (recall that the S&P 500 rose by 28.7% in 2021). We are satisfied with the ongoing cleanup of the economic excesses caused by interest rates that have been too low for too long and by the massive creation of money by central banks. During a major cleanup, it often happens that the pendulum swings to the opposite extreme. That is why we remain vigilant.

In the '70s, the fight against inflation led the price to earnings ratio of the S&P 500 to fall from about 18x in 1972 (before the inflation surge) to below 9x from 1977 to 1982 (in gray in the chart on the next page). We should be careful about comparisons of different eras and economic environments, but the ‘70s still provide us with some points of reference. Here are some interesting numbers from the last period of high inflation in the U.S.:

	Federal funds rate (monthly average)	10-year US Treasury bill rate (monthly average)	Inflation rate (monthly average)	Last 12 months S&P 500 P/E ratio (monthly average)	S&P 500 Total Return (including dividends)
1972	4.6%	6.2%	3.3%	18.1x	18.8%
1973	9.0%	6.9%	6.2%	14.3x	-14.3%
1974	10.3%	7.6%	11.0%	9.2x	-25.9%
1975	5.6%	8.0%	9.1%	11.0x	37.0%
1976	5.0%	7.6%	5.8%	11.0x	23.8%
1977	5.7%	7.4%	6.5%	9.2x	-7.0%
1978	8.2%	8.4%	7.7%	8.4x	6.5%
1979	11.5%	9.4%	11.3%	7.3x	18.5%
1980	13.8%	11.4%	13.5%	8.1x	31.7%
1981	15.9%	13.9%	10.4%	8.4x	-4.7%
1982	11.9%	13.0%	6.1%	8.9x	20.4%
1983	9.2%	11.1%	3.2%	12.4x	22.3%
Mid-Oct 2022	3.1%	4.1%	8.2%	17.9x	

Sources: Damodaran Online, Wall Street Journal, Nasdaq, Bureau of Labor Statistics, Macrotrends, Federal Reserve Bank of St. Louis.



The Federal Reserve made a mistake in the period between '75 to '77 by cutting rates too quickly for fear of creating too deep a recession and this prolonged the fight against inflation by several years. It is unlikely to make the same mistake this time. Some experts believe that to overcome inflation, interest rates will have to exceed the level of inflation for quite some time, as we saw from 1981 to 1983 (in yellow in the table above). If this is the case, then interest rates (in green) will likely have to rise even higher than currently expected, which would normally put additional downward pressure on the price of all assets. This remains to be seen.

Investment strategy: seeking balance in the face of uncertainty

There are always uncertainties and they always seem worse today than in the past. Our role as an investor is to find the best possible balance in the face of ever-changing uncertainties and opportunities.

We maintain the same view as in our previous letter, namely that we expect to gradually commit fresh liquidity throughout the duration of the current market downturn, favouring the most underinvested portfolios relative to their targets. We will look to buy securities that we believe have a greater margin of safety at the prices paid. At this point, we believe that several of the companies we follow are attractive at current prices and should allow for a healthy compound return if we hold them for 5 to 10 years, even if their prices temporarily fall further. Timing the absolute bottom in price is impossible, so we have to act in increments and accept that we will sometimes see the price fall after our purchases. At the moment, our purchases are very limited. In the event of a liquidity crisis and a stock market panic, and depending on the cause of such a crisis, we will then buy more shares of the companies we follow, always for the purpose of holding them for the long term.

As for our bonds, we have started to extend our maturities somewhat by buying maturities of 12, 18 and 24 months. However, bond portfolios continue to remain very short term.

Our investments

"Simplicity is the ultimate sophistication."

-Leonardo da Vinci

We only had a few purchases during the quarter in portfolios that are the most underinvested in equities (mainly for new clients).

We completed the sale of **Abbvie** (ABBV) in July in the last accounts. We are satisfied with the price obtained and the compounded return (including dividend) since January 2013, which is close to 22% per year in USD and around 25% in Canadian dollars over nearly 10 years. This ranks the investment in Abbvie in the category of exceptional returns.