BMO Private Wealth

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We hope that you are enjoying the summer and the good weather that we have witnessed since Spring. In over 50 years that I have lived out West, I think that I have only witnessed seven or eight perfect July weekends, but this year was one of them! And thankfully, there has been no smoke, but we better touch wood on that issue given how dry our forests are!

The markets in the first 6 months of 2023 have confounded a lot of people, including us. If investors had been able to correctly predict that they would witness ten successive interest rate increases amounting to +5 percentage points of interest and, at the same time that they would experience three major US bank failures, we might expect that they would have been pessimistic and that the markets would have been down. What a surprise to see the US S&P 500 up by over +12% in this period. It is also a surprise to see how Canada's S&P/TSX lagged during this time and returned only slightly more than +1%.

Among other things in this Newsletter, we will explain the undercurrents of the markets that are leading to these returns. We continue to caution investors not to "Fight the FED" (The US Federal Reserve). We explain why we think that investors who are ignoring the FED's warning, are doing so at their peril. Another section of this Newsletter explains how the Fiscal Policies of governments in the US and in Canada are making the Federal Reserve and Canada's Central Bank's job more difficult to the extent that interest rates might need to go even higher and stay there for longer.

As we did in the April Newsletter, we warn of the growing concentration of a few Technology stocks that are propelling the markets to a level of overvaluation and making certain US Indices risky in our opinion.

Once again we would like to remind you that our Team has grown to five people: myself, Ricky Cheung, Wendy Lok, Crystal Au-Yeung and Sara Diaz Cranage. And we are very pleased that Wendy has recently passed all the exams to obtain the Chartered Investment Management (CIM) designation. This designation allows her to become an Associate Portfolio Manager, the same designation that Jim and Ricky have. This will substantially increase the flexibility and security of our team to three Portfolio managers.

We try to keep clients updated with the quarterly Newsletters, but we realize that we could be doing more in contacting clients in between quarters. Now that our team has been working together for over a year and we have become more efficient in assigning responsibilities, we will endeavour to contact you more often. It would be by phone or it could be by Zoom meeting, and don't be surprised if anyone of us calls you, or if three of us join you on a planned Zoom call. We are trying to improve our communications to you.

Along with this newsletter are your Portfolio Report and Performance Report(s). The Newsletter will put the performance results into perspective.

2nd Quarter Trades in MPA Accounts

In the second Quarter we sold one stock: Metro, and we bought one stock: Linamar. Metro is a grocery chain that does well when inflation is rising because it passes on inflationary costs plus an extra margin onto customers. Linamar is an automotive stock that does well when inflation begins to slow. We also added 1% to our current holdings of Thomas Reuters.

Year-to-Date 2023 Portfolio Returns

We are comfortable with the Managed Portfolio Returns in accounts year-to-date. The Registered Retirement Accounts, in Growth mandated accounts, were up between +5.5% and +6% (after fees). Growth mandated Cash Accounts (i.e. Non-Registered Accounts) were up an average by +5.75% and +7%. The equivalent returns for Balanced Accounts were between +3.5% and 3.9% for Registered Accounts and between +4.5% and +4.6% in Balanced Cash Accounts. These returns compare favourably to the year-to-date return for the Canadian S&P/TSX Index which was up +1.04%. They are not as favourable to the +12.7% return posted in the US by the S&P 500 but we offer a few caveats. The Indices in both countries assume a 100% weighting in equities, whereas all of the Managed Portfolio accounts that we oversee have some measure of Fixed Income as a means of reducing risk. In the case of Balanced Portfolios, the level of Fixed Income is 30%. Secondly, as you will read later in this Newsletter, the US S&P 500 has become an undiversified and risky Index like it has never been seen before. Just seven stocks propelled that market to its recent height, and if they had been excluded, the S&P 500 would have been negative for the year ending June 30th. (We go into more detail later).

In Canada, Finance and Energy were negative (Banks down by nearly -4% and Energy down by -6.8%). The Banking and Energy Sectors account for approximately 50% of the Canadian S&P/TSX. Six of eleven Sectors in Canada were negative for the year ending in June.

A similar story was the case in the US with the S&P 500 experiencing seven of eleven sectors in the red year-to-date. The big difference is that the Technology Sector was up by +36.6% in the first six months, and the Communications Sector was up by +32.5%. Combined, those two Sectors account for over 35% of the Index weighting in the US but less than 10% of the Canadian Index weighting.

Fiscal Policy (Government Spending) is Fighting Monetary Policy (Interest Rates)

It is easy to see why investors are confused today. In the same day they can read in various reports that the markets as poised to go way up and that the markets are about to tumble due to overvaluation and rising interest rates. What gives?

Everyone knows that we have an inflation problem. It was caused initially by the effects of Covid which brought commerce to a stop worldwide, causing supply lines to freeze, employees to be laid off and small businesses to flirt with bankruptcy. Governments rushed to the rescue by printing money and sending cheques to the unemployed as well as to failing businesses (Fiscal Policy). This was necessary, and few will argue that it was avoidable, but of course it was inflationary.

Controlling inflation is the job of the US Federal Reverse (FED) and the other Central Banks around the world. Given current world growth, a 2% inflation rate is considered normal and Central Banks regulate the inflation rate by increasing or decreasing interest rates (Monetary Policy). To a certain point Governments and Central Banks (e.g. the FED) want the same thing: a thriving economy with small businesses flourishing and unemployment at acceptable levels. However Governments want to be popular and wish to be re-elected, and often provide too much Fiscal Stimulus to make voters happy. When the global pandemic struck in early 2020, the immediate blow to the US and Canadian economies was said to be a reduction in Gross Domestic Product of over 30%. The policy response by Governments (Fiscal Policy) was equally astronomical, it was necessary, but perhaps in retrospect it was overdone. (That is easy to say in retrospect because it is difficult to achieve the precise amount of extra spending that will be necessary while the world economy is falling apart). One statistic that implies that government spending was overdone, is that by August 2021 Americans had socked away an extra US $2.1 trillion beyond their current needs and beyond the pre-pandemic trend, according to estimates by the Federal Reserve Bank of San Francisco. Much of this money was plowed back into the economy and robust consumer spending padded corporate profits. A good chunk of that money also ended up in financial markets and it is yet to be seen if that has inflated a stock bubble. Another statistic that implies that Fiscal stimulus was overdone is that the San Francisco FED believes that US $500 billion in excess savings still remains in consumer hands and could ignite consumer spending until the end of 2023. This is now the problem of the FED.

If governments erred on the side of providing too much stimulus, the Federal Reserve also had erred by waiting until March of 2022 to begin raising interest rates. To use an analogy, if it was the job of governments to “provide a punch bowl” to liven the party during Covid, it was the FED’s job to remove the “punch bowl” by increasing interest rates at the proper time in order to end the party. But the FED waited too long in order to be sure that Covid had ended and the economy was on the mend. It was March of 2022, with inflation at 8.5%, when the Fed began the first of what has now become ten interest rate increases amounting to 500 basis points of interest, yet the goal of 2% annual inflation is still nowhere in sight. The double errors of: 1) the government providing stimulus cheques that were too generous and 2) the FED waiting too long to raise interest rates have left us with the uncertain market today.

Stock markets tend to be highly sensitive to the direction and magnitude of interest rate increases. So after ten rate increases, one would expect markets to be negative. So again, what gives?

It appears that even though the "punch bowl" is gone, the flow of punch was once so bounteous, and it was left on the table so long, that there is a whole lot of it still in the glasses of consumers. "Last Call", in the form of ten interest rate increases, has been rung, but consumers have not yet left the party, to the chagrin of the Federal Reserve.

Meanwhile recent Fiscal policy stimulus due to US federal bills passed in Congress last year are the gifts that keep on giving and will give the Federal Reserve (Monetary Policy) a headache, before the "partiers" leave and get their hangover. Money continues to be printed due to the Chips and Science Act and the Inflation Reduction Act which have incented the construction of semiconductor and electric vehicle plants in the US. The Infrastructure Investment and Jobs Act is creating more government spending in transportation structures and railways. In Canada, in order to keep up to the US, the government has offered over Cdn $12 billion each to Volkswagen and Stellantis to spur car battery investments here. All of these handouts blunt the effect of interest rate increases pitting Fiscal Policy against Monetary Policy, and working against the FED's goal of restoring price stability. This situation could lead the economy to a harder landing or it could mean that we never attain the goal of 2% annual inflation. No wonder investors are confused!

The Mentality of Inflation and the Labour Market

Central Banks worldwide are spooked. For reasons explained in the last section, after ten interest rate increases, the economy and the markets continue to roll along. Although inflation is coming down, it is not coming down fast enough, and there is considerable doubt that it will ever get back to 2%. The thing about inflation is that it depends largely on what we expect it to be. Businesses have become experts at convincing us that 10% annual price increases are justified. We have been trained by companies to accept unusually high price increases and it is a tough cycle to break, especially if consumers have the money to accept high prices. The road to price stability runs through the labour market and one school of thought believes that only a harsh recession with massive job losses will restore the inflation equilibrium. Currently every industry is trying to hire and "job hoarding" is becoming common. "Job hoarding" is the phenomenon of companies keeping employees when they should be laying them off. Hoarding occurs because the companies know the current difficulty of being able to hire employees and they worry that they won't be able to hire laid off employees back when the economy picks up. Not only is this inefficient, but it is expensive to keep excessive employees, and the costs get passed on to the consumer. The Federal Reserve is focused on dampening the demand for labour in order to slow the growth in wages and eliminate hoarding. Dampening labour demand and causing layoffs inhibits the demand for goods and services because some employees lose their pay cheques while the lucky others who keep their jobs spend more conservatively. This type of slowdown is instrumental in stopping the ability of businesses to pass along their escalating wages and supply costs to customers. Of course the tool to dampen labour demand is increasing interest rates by the FED. But increasing interest rates are a headwind to escalating stock prices. The markets are waiting for the FED to reduce rates, and this will only happen when high inflation has been slayed and there is pain on Main Street. It is ironic that pain on Main Street may be necessary for joy on Wall Street.

It is why we believe the price stability runs through the labour market.

Don’t Fight the FED

If there is one thing that we have learned over the years, it is that investors shouldn’t swim against the tide of the US Federal Reserve. After ten successive interest rate hikes until mid June 2023, the FED paused it’s hiking program, but FED Chairman Jerome Powell did his level best to warn one and all that the rate hike campaign was not finished, and that there was plenty more work to be done. He said that core inflation was too high for comfort and although it was coming down, it wasn’t coming down fast enough. He all but implied that asset prices were too high and that investors should heed his call of caution. The markets simply showed no fear of the FED comments and continued to rise. In effect investors were snubbing their noses at FED policy and in their words. Until very recently the markets have been clinging to a belief that the FED will need to reduce rates by year end. Recently the Wall Street Journal suggested that the current stock rally was the market’s way of telling the FED, “you haven’t done enough”. It appears that the Canadian housing market is sending the Bank of Canada the same message. (Home sales began to rise in February immediately after our Central Bank signalled a pause in rates.) And this is despite that Canadian households are burdened with debt-to-income levels that are above 180%, an all time high.

Not only do we believe that the FED will not reduce rates in 2023, we believe that they will raise interest rates at least twice, and maybe three times again this year. We may be wrong, and we hope that we are, but we currently believe that the Federal Reserve will fight the latest Wall Street advance and that it will raise interest rates until Wall Street falls. We think that the FED has come to the conclusion that a Recession is necessary to bring inflation back to 2% per year.

Of course we may be wrong in this thinking and it may depend on the delayed response in the economy to the ten rate hikes that we have witnessed to date. It has been said that each interest rate increase could take up to 12 months to “bite” the economy. The increases began in March 2022 and continued approximately for every 6 weeks. The optimistic view is that the early increases (ie. the first four or five) have affected the economy already, but that the later increases (for example from six to ten) have yet to be felt. As those later increases kick in, it might be possible that fewer, or no future increases are necessary. This could produce a “soft landing” or only a small recession, and this is the hope of the Federal Reserve and perhaps the optimistic thinking of the market. The word “pivot” has been used frequently to describe the eventual turn by the FED from raising interest rates to reducing them. The last three “pivots” by the FED occurred in 2001, 2008, and 2020. The “Tech Wreck” occurred in 2001, the “Financial Crisis” occurred in 2008 and the “Covid Meltdown” occurred in 2020. In all three cases, the markets were falling and the FED was moved to save the economy by “pivoting” to reduce interest rates. It is why we believe that central banks might continue raising rates until something breaks, causing a Recession and that may be the cue for them to reduce rates. The markets will sense a pending reduction 6 months before the “pivot”, and that will be the ideal time to deploy the cash that we are holding in accounts.

In the meantime we are going to be patient and we are not going to fight the FED. As always, we may be wrong about this and the markets might continue up for the next 6 months just as they have for the last 6 months. This wouldn’t be the end of the world as we are currently still invested with a large portion your money in the markets, just not fully invested. In the meantime the extra cash balances in accounts are making approximately 5%. This is our way of managing risk in a market that isn’t tracking the usual playbook.

US Market Concentration Risk

In our April Newsletter we outlined our growing concern about the concentration of the five biggest companies (including Apple, Microsoft, Alphabet and Meta among others) in the US markets. At the time, the top five stocks accounted for 23% of the S&P 500. Similar concentration was occurring in the NASDAQ Index with these same companies. Technology, (one of eleven Sectors in the S&P 500), was up already 40% year-to-date ending June, and the Telecom Sector (which formerly was included in the Technology Sector) was up by 34%. Six of the eleven Sectors in the S&P 500 were in negative territory for the first six months of the year. In fact if we exclude the top 7 stocks, (Apple, Microsoft, Nvidia, Amazon, Meta, Tesla and Alphabet), the S&P 500 would go from being up by double digits in the first six months of this year to being slightly down for the year. Goldman Sachs has noted that the top 10 stocks have previously accounted for up to 32% of the S&P 500, but the current top 10 stocks now account for approximately 80% of that Index. Our view is that the extreme Tech leadership that we have seen year-to-date is an "echo" of the 2022 Covid related slaughter of Tech stocks, and that the extreme concentration will not last much longer. Although Artificial Intelligences has played a part in the Tech rise this year, it appears overdone, similar to the year 2000 when the "new" internet had driven Tech stocks to overvaluation territory. We all know what happened back then. The current concentration far exceeds the concentration at the peak of the 2000 Tech bubble and is cause for concern.

The US Indices are finally realizing that they have a diversification problem and after the end of the Second Quarter the NASDAQ announced plans to "rebalance" the index. This rebalance will change the weights and the stocks component percentages of the top ten stocks. The NASDAQ has only conducted such a special rebalance twice in the past – in December 1998 before the Tech Meltdown, and in May of 2011 after the Financial Crisis, which indicates that they are concerned about the current concentration within the Index.

Summary

2023 has been a confusing time in the economy and in the markets with successive interest rate increases, US bank failures, Technology stocks increasing, home prices rising and unemployment falling. It is difficult to make sense of the twist and turns we are witnessing today, and as singer Randy Newman crooned: "It's a Jungle Out There". The singer also points out several times in the song, "I may be wrong though"! We feel the same way with our advice and our direction to clients. There is always the risk that we are wrong in our thinking. Our current belief is that although interest rates increases will soon cease, they will not begin to decline until the end of the First Quarter of 2024 at the earliest. Six months prior to this event, or about October 2023, there is a good possibility that the markets could start to rise in our opinion. We believe that a little more patience will pay off.

As we mentioned earlier, one of us, or all of us together in Zoom, look forward to communicating with you soon. Expanding our team has allowed us to increase our research but will soon free up more of our time to touch bases with you. Until then, we wish you an enjoyable summer.

Please call us if you have questions.

Best regards,

Sincerely,

Jim

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