BMO Private Wealth

BMO Nesbitt Burns
2300 – 885 West Georgia Street
Vancouver, BC V6C 3E8

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Dear:

As we begin writing the Newsletter on Oct 2nd, we notice that while the Cdn S&P/TSX is down over 1% year-to-date, the Technology-heavy Nasdaq is up over +26%. The average Cdn bank is down by approximately 8%, while Bank of America is down over -19%! The S&P 500 is up approximately +11%, but shockingly, seven megacap (Technology) stocks, (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta Platforms) have accounted for over 80% of the S&P 500's total return for 2023. Without those stocks, the remaining 493 S&P stocks were only up by approximately +2.2% year-to-date ending September 30th. Fortunately, we own four of the "megacaps" which have helped your portfolio to hold its own.

We offer a caution however. Technology stocks are known as "long duration stocks" that pay out few dividends. Since July of this year, they have been falling, (including the "magnificent seven" listed above). On average, those seven stocks trade at a Price/Earnings ratio of 31.8 compared to the S&P 500 Index trading at a ratio of 18.1 times earnings. Although Apple is up by 32% for 2023, its stock price has fallen 13% since late July. Long duration stocks, such as Technology stocks, which have limited dividends but have significant expected profit growth in the years ahead, tend to be hit particularly hard when interest rates rise. That is because their future projected earnings are discounted back to today more severely than when they are in a low interest rate environment. One explanation for the gain by Technology stocks so far in 2023 is the promise of Artificial Intelligence. However, like the promise of the Internet in the late 1990s, there comes a time when "The New Technology" is fully priced into the Technology stocks. We are not sure if we have reached that point yet with Artificial Intelligence, but we are surely getting closer to it.

In this Newsletter, we outline the returns in Managed Portfolio Accounts in the Third Quarter and year-to-date, and the trades that we have undertaken in the Third Quarter. We analyze the effects of higher interest rates in the case that they will not be coming down soon. Our current strategy reflects that belief.

Attached with this Newsletter is your Portfolio Report and Performance Report(s).

3rd Quarter Trades in MPA accounts

Clients who read this Newsletter know that we turned caution on the markets over a year ago. Since then, we have bought virtually no new equity but we have raised cash throughout the past twelve months. In the Third Quarter of 2023 we sold Enbridge, Johnson and Johnson, Nutrien, Telus, and Pembina Pipeline. We will be opportunistic in re-deploying the cash, but in the meantime, it is currently earning 5% in the Money Market.

3rd Quarter and Year-to-Date Returns

The Third Quarter of 2023 was negative for all North American markets. The S&P/TSX in Canada was down -3.33% while the S&P/500 was down -4.77%. Year-to-date in 2023, the S&P/TSX in Canada has been basically flat, (actually up +0.01%) while the S&P 500 was up +11.6% (led by the seven stocks mentioned earlier. Without those seven stocks, the S&P/500 would have been up by only +2.2%.)

On average, Growth Mandated MPA Accounts were up year-to-date between +7.5 and +8% after fees. Growth Mandated Registered Accounts were also up on average between +7.5 an +8% after fees. Despite that all North American Indices were negative in the Third Quarter, all of our Managed Portfolio Accounts were able to attain gains ranging between +1% and +1.8% in the quarter. (The above performance figures exclude TFSA and smaller accounts. Please refer to the enclosed performance reports for the return figures of your accounts.)

The biggest losing Sectors in the S&P 500 for the Third Quarter were Real Estate (-7.82%), followed by Technology (-6.87%), followed by Utilities and Industrials. In Canada the biggest losers were Technology (-9.95%), followed by Utilities (-6.76%) and Telecom.

The Effects of "Higher for Longer"

Anyone who reads our Newsletters would realize two things:

1) We believe in the mantra "Don't fight the Federal Reserve (FED)"- especially when they're on a mission.
2) The (stock) markets will react positively a full 6 months before any expected interest rate reductions.

With respect to the Federal Reserve, the market appears to have finally taken notice of the FED's resolve. After markets rose sharply in the first half of July, they have deteriorated ever since into the end of the Third Quarter as the markets finally realized that interest rates would not be reduced soon. With regards to when the FED might begin to reduce interest rates, we have changed our tune. We originally believed that the earliest date would be April 2024. We now believe that rates will not come down before the year 2025.

In the first half of this year, it seemed like nothing could stop the 2023 market rally. Then the Third Quarter arrived. Yields on longer-term government bonds soared, blunting the advance of a stock market that had been powered by richly valued technology shares. The U.S. S&P 500, which had been up nearly 20% just two months ago is hanging onto a 12% increase now. The Canadian S&P/TSX is negative on the year at time of writing. Pressured by inflation fears, by large governments deficits and reduced global trade, the era of low interest rates looks to be over, and this should prompt a re-think of the investment strategies that prevailed during years of rock-bottom rates after the 2008 global financial crisis.

For one, the days of real estate being a “sure-fire” investment opportunity are over. Home ownership as a means of increasing wealth for retirement is now a risky bet as prices are unlikely to match the rise of the last 10 or 20 years. At today's interest rates, owning a Toronto condo for investment purposes is no longer profitable. Meanwhile equities are competing with 5% money market funds which are basically a no-risk investment.

The S&P 500 dropped -4.77% in the Third Quarter while the NASDAQ tumbled -4.1%. A retreat by Technology stocks helped cement these declines with shares such as Apple and Microsoft falling -12% and -7.3% respectively. We had trimmed clients’ positions in these two stocks earlier this year and were surprised when excitement about Artificial Intelligence and hopes of decreasing inflation propelled the S&P 500 into a new bull market on the backs of the Magnificent Seven Technology stocks. The biggest reason for optimism was that the FED would soon cut interest rates (Monetary Policy). This view has now changed partially due to a mismatch with Fiscal Policy (which deals with government deficits and taxes as opposed to interest rates). As governments in both Canada and the U.S. continue to spend more money, no party has vowed to increase taxes to pay for the spending. For the first time in U.S. history, a party has fired its own Speaker of the House in the middle of a Term. His offence? He brokered a deal between Republicans and Democrats to keep the U.S. government afloat, but only until November 17th! Markets of any stripe do not like uncertainty like this and many are now questioning the sustainability of deficits at all levels of government.

Market headlines have been going from one extreme to the other: From “we're going to have a recession” to “we’re definitely not going to have a recession.” The truth is probably somewhere in between. Despite the interest rate increases of the past year, the economy has remained strong and unemployment is at historic lows. We, as investors, are confronting a complicated picture as we try to anticipate the markets’ next moves. Will interest rates stay elevated? Will the economy remain strong? Will unemployment rates rise? No one knows for sure, and it is why we have maintained a higher allocation to Money Market funds paying 5%. Currently we hold a lighter than usual allocation to equities.

We have most probably hit peak inflation (back in July of 22). In the 14 months since then, the S&P 500 is up +13%. Here is an interesting statistic from Goldman Sachs Investment Strategy Group:

“Since 1945, the S&P has risen between 21% and 28% on average in the two years after the release of data indicating peak inflation. Generally speaking history has shown us that the market rallies, whether there's a recession or not after inflation peaks.”

In other words, it would be risky to give up on equities at this point.

Summary

Rarely have so many economic and political crossroads occurred at the same time, giving rise to an era of uncertainty. As we continue to write this Newsletter on October 9th, the S&P/TSX in Canada is down by -0.72% on the year while the NASDAQ is up +28.33% and the DJI (Dow Jones Industrial Average) is up by a mere +0.79%, while the S&P 500 is up just over +12%. And as we have mentioned, 80% of this +12% increase is due to only 7 out of 500 stocks in the S&P 500. The remaining 493 S&P/500 stocks are up by just over +2% for the year. With that backdrop we are relieved at MPA returns in the +7.5 to +8.0% year-to-date.

Meanwhile, our growing team of five people are continuing to reach out to all clients via "Microsoft Teams" online meetings. We intend to reach everyone before year end and apologize if we haven't reached you yet. In the meantime, please phone us if you have any questions.

P.S. The attack on Israel, and ensuing war, erupted just as the Newsletter was being printed. It is a good sign when bad news like this cannot bring a market down. For whatever reason, the markets have risen in the first few days of this terrible war.

Best regards,

Sincerely,

J.S. (Jim) Pipe B. Comm, MBA, CMA
Portfolio Manager, Senior Investment Advisor
(604) 443-1520

Ricky Cheung MBA
Portfolio Manager, Senior Investment Advisor
(604) 443-1606

Wendy Lok B. Comm, FMA
Senior Investment Associate
(604) 443-1591

Crystal Au-Yeung B.A.
Senior Associate
(604) 443-1602

Sara Diaz Cranage
Client Service Assistant
(778) 327-5227