Q4 2023 Newsletter

We hope that you and your family enjoyed the Christmas season and our team wishes you a happy and prosperous New Year in 2024. At the end of December, we celebrated Wendy's 20th anniversary with BMO. Two decades of unwavering dedication and hard work defined Wendy's commitments to our clients. Her efficiency, professionalism and a positive attitude has greatly contributed to the success of our team. We look forward to continuing this journey of success together for the years to come.

Despite the gloom that was rampant at the beginning of 2023, the year was very positive as far as the markets were concerned. Leading the pack was the Nasdaq, up +42% (but down -33% the year before) followed by the S&P 500, up +24% (but down -20% in 2022), and the S&P/TSX up +7.5% in 2023 (but down -8.5% the year before). Put in this context, these indices are merely back to where they were at the beginning of 2022. There will doubtless be lots of ups and downs going forward, but we believe that the cyclical Bear Market that has occurred over the past 18 months ended in October, and that we have returned to the Secular Bull Market that initially began in 2013.

On this last point, the views of various analysts differ markedly. In late November, we attended the annual market conference in New York that is hosted by J.P. Morgan, Piper Sandler and BMO Capital Markets on Wall Street for the benefit of Nesbitt Burns. In the sixteen years that we have attended this event, we had never witnessed such negative views for the upcoming year. It was hard to find a single analyst who was positive on their sector for 2024. But this had also been the case at the conference held in November 2022, and of course we know now that 2023 proved to be a very positive market year. Opposing this years' doomsayers were companies with analysts who believe 2024 will be a very positive year. This includes Goldman Sachs, Brian Belski – chief strategist for BMO Capital Markets, as well as the strategy team of BMO Nesbitt Burns in Canada. We had long ago learned to take all this information with a grain of salt and are sticking with what we have been telling clients for the last two years – namely that we believe that the market will go up at least six months before the US Federal Reserve begins lowering interest rates. We believe that that date will be July 1, 2024, and six months before that is about now. The market is betting that the start date for Fed rate reductions will be March 1, 2024 which likely was the reason for the spectacular market returns in November and December of 2023. Of course only time will tell.

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In this Newsletter, we discuss the 4th Quarter trades in Managed Portfolio Accounts and the average returns for 2023 based on representative accounts that did not have large inflows or outflows of cash during the year. We talk about how most analysts missed the mark in their forecasts for 2023 and we make some predictions for 2024. Along with this newsletter are your Portfolio Report and Performance Report(s).

Also new in this Newsletter is a section written by Ricky on Artificial Intelligence, the difference between hard landing, soft landing and no landing. In each of our newsletters going forward, he will highlight an interesting fact on one of our stock holdings. This time, it is Eli Lilly.

4th Quarter Trades in MPA Accounts

After almost eighteen months of raising cash by selling stocks in MPA portfolios, we began putting money to work in October. That month, we bought Finning, CAE Inc. and Cenovus, all Canadian companies. Finning is the largest Caterpillar dealer in the world and operates in Canada, South America and the UK, with its headquarters in Vancouver. CAE, headquartered in Montreal, is one of the largest pilot training companies focusing in civil aviation and defence. With large scale pilot turnover and new technology in today's aircraft, we believe that there is a considerable upside. Cenovus, an oil company based in Alberta was added into order to augment our relatively lean energy holdings.

In early November we added to the current holdings of Thomson Reuters, Royal Bank, Linamar, Altagas, Corteva and Granite Real Estate Trust. In early December, following our trip to New York, we bought Walmart because of its advances in digital shopping and delivery which we believe the market has not rewarded yet. We also bought Merck in Healthcare, in order to augment the holdings of Eli Lilly which has proven very successful. We bought Rogers in Canada believing that reduced interest rates will benefit the telephone companies, and we added Adobe because we believe that this U.S. company will be a big beneficiary of Artificial Intelligence.

Portfolio Returns for 2023[1]

We were expecting very little in 2023, but in the end we were pleased with the returns in the Managed Portfolio Accounts. The Canadian S&P/TSX returned just under 8% for the year which paled in comparison to the S&P 500 return of 24%. However if the S&P 500 didn't contain the "Magnificent Seven" Technology & Discretionary stocks, its 2023 return would have been below the 7.5% return of the Canadian market. With this in mind, we are happy with the average return in the Non-Registered Growth-Mandated Portfolio Accounts of between +13.5% and +14.5% returns for 2023. Registered Accounts that are Growth-Mandated returned on average between 12% and 12.5%, (the difference between returns for Registered versus Non-Registered Account is due to the Fixed Income component of the accounts. In order to take advantage of tax efficiencies, Non-Registered Accounts use Preferred Shares for Fixed Income. Registered Accounts, since they don't pay tax, use coupon bonds. In 2023, preferred shares performed better than bonds. In other past years, the reverse has been true.)

[1] (The performance figures exclude TFSA and smaller accounts. Please refer to the enclosed performance reports for the return figures of your accounts.)

Balanced Accounts require a 30% minimum of Fixed Income and are expected to earn a smaller return than Growth accounts. Balanced Registered MPA accounts on average returned between 8.5% to 9.5% in 2023, while Balanced Non-Registered Accounts returned between 10.5% to 11.5%. Again, it was the positive performance of Preferred Shares in these Non-Registered Accounts that gave them the edge.

How Everyone Missed the Mark in 2023

Almost no one thought 2023 would be a blockbuster year for stocks. They could hardly have been more wrong. At no other time in recent memory has the economy surpassed expectations as much as it did over the past twelve months. At this time last year we were all bracing for at least a mild recession in 2023. After all, the U.S. Federal Reserve (FED) had been raising interest rates at the fastest clip in forty years going back to the 1980’s, inflation was rising to dangerous levels, pandemic savings were depleted and S&P Index had been down by 20% in the prior year. While the Russian War continued, a U.S. regional banking crisis developed in March, with a customer run on Silicon Valley and First Republic Banks. This was the result of soaring interest rates perpetrated by the FED and it had caught these two banks flat-footed. Silicon Valley Bank used it vast deposits, (paying short term interest rates to clients), to buy a long term bonds, which paid much higher interest. However as interest rates rose, it decimated the value of the long bond portfolio that supported those shorter term deposits. Customers (rightly) feared that their deposits were not safe and they triggered a bank run and evoking memories of the global financial crisis in 2008. First Republic and other mid tier banks collapsed and Bank stocks in general swung wildly. At that point the probability of a U.S. Recession rose to over 70%. Oftentimes as interest rates rise precipitously, something in the economy will break. It looked like this could be the shock that would finally trigger the economic downturn that we had all been anticipating. The FED however quickly shored up confidence when it announced that they would guarantee the deposits in these troubled banks. At this point the dark clouds disappeared, the Financial and Credit markets quickly normalized, and almost magically it was as if the crisis had never happened.

In October, an attack on Israel by Hamas launched a war in the Middle East. It was feared that any resulting oil price increase would reverse the declining trend of inflation. Once again however the impact on markets was short term and limited. Even the price of oil had dropped by 10% over the year as of the end of December. Through all of these troubles, American consumers continued to spend on everything from Taylor Swift tickets to airline flights and restaurant meals, causing profits to grow again at the large U.S. companies.

In the end, the professional analysts’ prediction of doom for 2023 proved wrong. Instead, world inflation continued falling throughout the year and the US unemployment rate fell to 3.4% which is the lowest it has been since 1969. The S&P 500 finished the year up 24%, just 0.6% from its all-time high in January 2022. The Dow Jones Industrial Average advanced 14% to its all-time high and setting seven record closes in the final days of 2023. A mania surrounding artificial intelligence and big technology stocks sent the Nasdaq soaring +43% for the year. It was a far cry from the doom and gloom most were bracing for at the start of 2023.

Five Predictions For 2024

Let's start with a fact: the year ahead will be dominated by the U.S. election so newspaper headlines, both true and false, will be more flamboyant, and anxiety levels will be high. Other facts include: inflation is cooling, a soft landing is the new consensus and there are now over 100 basis points of Central Bank interest rate easing priced into market expectations for 2024. All told, the mood heading into the new year is magnitudes better than it was a year ago.
Below are five predictions for 2024.

1) Most major central banks will begin to bring policy rates down near mid year. This is not a brave call given recent official remarks by the FED and the positive market returns of the last two months of 2023. We have been stating in past Newsletters that we believe that the market would respond positively a full six months ahead of any FED rate cut. The market is expecting rate cuts beginning in March, which we believe could be premature, but is no doubt the reason that the markets perked up in November and December. We continue to suspect that central banks will be more cautious than widely anticipated in both timing and pace of rate reductions. Having miscalculated the initial rise of inflation two years ago, we believe the FED will be careful in not reducing rates prematurely in order to preserve the path to a "soft landing" that is now the consensus thinking on Wall Street.

The Canadian economy is in a weaker state than in the U.S., and we could be eventually teetering on the verge of recession. Normally this would give rise to Canada's Central Bank (BOC) lowering interest rates before the FED does. However Canadian Bank Governor Macklem has remained more hawkish than one might expect he should be, and we believe that this is because of the state of our housing market. He wants to keep housing price rises in check.

2) We believe that Canada's housing market is frustrating future interest rate relief in this country. Canadian mortgage rates are based off of the 5-year bond yield which has dropped a huge 115 basis points from its October peak. This was not due to BOC easing, but merely due to expectations about declining inflation. As witnessed last Spring, it doesn't take much to revive Canadian home sales and prices, especially with the population rising a fiery 3% year over year. Contrary to widespread calls for more supply, we expect housing starts to drop in 2024, the third annual decline in a row due to a lack of skilled trades people. (If only the 3% of new immigrants were experienced home builders!)

3) Despite Canada's soft economic outlook, the S&P/TSX will perform well. Going back to 2010, the S&P 500 outclassed the TSX for the 11th time in 13 years in 2023, powered by the surge in the mega cap tech companies. The sustained outperformance by the U.S. market is more a positive story about the Tech sector rather than a strike against Canada's major index. With impending interest rate reductions we think that Canada's big dividend payers (telecoms, utilities, pipelines, alternative energy companies), stand to make up some distance between them and last year's big tech winners. Amid a calmer rate backdrop and a slowing global economy, we think that dividends and dividend stocks will be an important place to be.

4) The U.S. dollar, which has been on a tear the past few years, will lose altitude. A more dovish Fed, a cooler U.S. economy and a drive by many emerging markets to move away from the dollar point to some softening in the year ahead. We believe that the old link between crude oil and the Canadian dollar has all but disappeared, but that our dollar could benefit relative to a sagging U.S. dollar.

5) Canada's unemployment rate will rise by at least 1 percent we believe. BMO's economic group is calling for Gross Domestic Product growth of only 0.5% in 2023. While this does not quite meet the definition of Recession, only twice in the past 30 years has growth been weaker, (in the recession of 2009 and at the beginning of Covid in 2020). Combined with a 3% population growth, we think that this will make for a sustained rise in the jobless rate.

Here is a sixth thought that we are too embarrassed to call a "prediction", because it seems to be too obvious! The massive outperformance of Technology stocks cannot continue at the same pace in 2024. We believe the positive performance in 2023 was due to 1) Tech's very poor returns in 2022, 2) an overhyped belief in Artificial Intelligence, and 3) increasing evidence that central banks will reduce interest rates soon. (Technology stocks are "long duration" stocks that require lower interest rates to "discount" their future earnings growth back to a current stock price). The five biggest stocks in the S&P 500, (Apple, Microsoft, Google, Amazon and Nvidia), now have an aggregate value of over US $10 trillion, and they represent 25% of that stock index. During the tech bubble of 2000, the top five stocks in the S&P 500 accounted for only 18% of the total. It has been said that for the current five large stocks to continue to rise at last year's pace they would need to grow in 2024 at a market cap rate level that would be equivalent to than adding a Pepsi Co., Bank of America, Coca-Cola and a Merck to their collective Balance Sheets. They would also need to grow at that level in subsequent years. Despite the boost of Artificial Intelligence to Tech stocks, we don't believe that the market growth opportunities will be that large, or even possible. That is simple math in our opinion.

Ricky's Corner

Artificial Intelligence (AI)

In 2023, Artificial Intelligence ranked 4th in the 10 most searched words on Google. In simple terms, AI is merely machine learning - the simulation of human intelligence by machines. It has already played many roles in our everyday lives. For instance, Google maps uses AI to monitor traffic and give you real-time traffic condition, the customer service phone lines that use voice recognition to direct or respond caller inquiries, personalized contents on your social media feeds, digital voice assistants such as Google Home, Alexa or Siri, just to name a few.

The AI application ChatGPT (Generative Pre-trained Transformer) caught the world's attention in record time in 2022. It achieved the incredible milestone of reaching 100 million monthly active users in only 2 months; the popular Instagram in comparison took over 2 years to achieve the same milestone. ChatGPT is the next level of AI which takes user input and generate intelligent, human-like responses instead of giving simple answers. It has read nearly everything on the internet and stored it in its massive brain. For instance, you can ask ChatGPT to plan your next trip to Europe and it will give you a detailed itinerary.

From an investment standpoint, there are two key themes: collection of data and processing of data. Companies like Google, Amazon, MasterCard, Microsoft and Thomson Reuter gather vast amount of data from their users and this data serves as valuable input for computer learning. To process the data, we need faster computers; companies like Broadcom, Qualcomm and Nvidia make powerful semi-conductors to increase the speed of computers. We believe AI is an ongoing thesis and our portfolios already have companies that are incorporating AI in their businesses.

Hard landing, Soft landing and No landing

In 2023, these three terms were often mentioned in the media, so what do they actually mean? Seeing the sharp increase in inflation, both Bank of Canada and the Federal Reserve initiated an aggressive rate hike cycle in March 2022. Such increases serve to curb inflation and slow economic growth. However, if the central banks raise interest rates too much, it may cause a recession which is also known as **Hard Landing**. On the flip side, if the central banks manage to raise interest rates just sufficient to slow the economy as well as inflation without triggering a recession, the central bank has done an awesome job to achieve a **Soft Landing**. If, after a series of rate hikes, the economy continues to grow, that is a **No landing** scenario. Theoretically, higher inflation is the consequence of robust economic growth. As such, Central Banks will continue raising rates until inflation drops and therefore the economy slows down. Thus, some economists argue that there is actually no such thing as "No landing." From an investment standpoint, soft landing is the optimal scenario because inflation falls whereas the economy does not fall into a recession.

Stock Feature – Eli Lilly

Eli Lilly achieves a major milestone with its weight loss drug called Mounjaro, which is an injection treatment on a weekly basis. Mounjaro contains an active ingredient called Tirzepatide which treats Type 2 diabetes mellitus and, in some case, obesity. When blood sugar levels start to rise after eating, Tirzepatide stimulates the body to produce more insulin and the extra insulin helps lower blood sugar levels. It also slows down the movement of food from the stomach to intestine so people taking the drug feel full faster and longer. In November 2023, US Food and Drug Administration approved Tirzepatide under the brand name Zepbound for weight loss. In studies Eli Lilly submitted to the FDA, Mounjaro can lower body mass among users at its highest dose by up to 15%. As a reference, the weight reductions of oral form weight loss drugs are between 3 to 7%. Besides obesity, researchers continue to uncover other benefits of Mounjaro in lowering the risk of heart disease (i.e. heart failure), stroke and kidney disease. In early 2023, Goldman Sachs Research forecasted the global market for anti-obesity was about $8 billion for the year and it could grow to $100 billion by 2030. Although Novo Nordisk has a similar drug called Ozempic, so far Eli Lilly is still in a leading position. All MPA clients have owned Lilly for a number of years and the stock is one of the best performers in portfolios.

Summary

It is said that successful investing should not be fun and 2023 is a perfect example! Do you know of anyone who had fun last year? To us it felt like agony! Despite the negativity in the markets due to interest rate increases, bank failures and wars, in the end investments did well. As is always the case, the patient and calm investors become richer over time.

We thank all of our clients for their patience and for the trust that they have put with us and as always we thank those clients who referred their friends to us in 2023. We will take good care of them. In the coming weeks we will continue to reach out to all clients via video conference to go over the results of portfolios, to review strategy, and just to say hello! One final reminder: as of now clients can add an additional $7,000 to their Tax Free Savings Account for 2024.

We look forward to talking with you soon.

Best regards,

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