Q1 2024 Newsletter

As we enter Spring, we hope that all is well with you. Since November, our weather has surprised us with, (except for one week in early January), unseasonably warm temperatures and little rainfall. Unless you're a skier, no doubt you have enjoyed it! Weather wasn't the only thing that was hotter than expected in the past five months and particularly in the Q1 2024. We have been surprised by the hotter than expected growth in the economy; higher than expected (U.S.) inflation; hotter commodity prices; new record highs for crypto currencies as well as semi conductor stocks, not to mention a 10% rise in the S&P 500 during the First Quarter of this year.

That's a good start, but what is perhaps most surprising is that this all occurred despite mostly disappointing inflation results in the U.S. which caused the Federal Reserve (FED) to state that they were in "no rush" to cut interest rates in this environment. The market, for its part, has come to the conclusion that there might be only three rate cuts this year, having originally expected six. Despite this new belief, instead of declining, the markets roared ahead. Who would have thought? Perhaps over cautious optimism going into 2024 may have underestimated the power of momentum.

In this Newsletter we will review the First Quarter economic events and we will outline what we see as potential parallels between the market boost now, with Artificial Intelligence, compared to the 1990's with the advent of the Internet. We will also outline differences in interest rate policy between Canada and the U.S. and the possible implications for Canada. As usual we'll outline trades and results in Managed Portfolio Accounts, and Ricky weighs in with a discussion on FED Chairman Powell's path on fighting inflation. The stock he will highlight in this Newsletter from our portfolio holdings will be Costco.

Your Portfolio Reports and Performance Report(s) are attached.

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First Quarter 2024 Returns[1]

For Growth Mandated Managed Portfolio Accounts (both Cash and Registered Accounts), the First Quarter return on average, after fees, was between +8.5% and +9.0%. This compares with the Canadian S&P/TSX Index which was up by 6.6% and the S&P 500 Index which returned +10.0%.

For the average Balanced Mandated MPA account (which requires a minimum of 30% Fixed Income), the Cash Accounts returned +7.5% on average while Registered Balance Accounts returned +6.0%.

It is interesting to note that all sectors (except Real Estate) in the S&P 500 participated in the 10% return. In Canada, nine of the 11 sectors were positive in the Quarter. The two sectors that were negative were Communications Services (Telephones) and Utilities.

First Quarter Trades in MPA Accounts

During the quarter we made several changes to Managed Portfolio Accounts. We trimmed the holdings of Eli Lilly (which is up over 500% since we bought it) and of Broadcom, (up over 300%). We reduced these two stocks after they both rose to over a 5% weight in portfolios. We sold the 1% holdings of Rogers due to rising competition of telephone companies in Canada as well as the negative press revealing Rogers' poor customer service record. We also sold Bungee after making good money on this soybean producer.

We bought four Canadian companies: Cenovus, Finning, Northland Power and CAE limited. Cenovus is a leading Canadian oil and gas producer while Northland Power is a world leader in alternative energy. Finning is the world's largest Caterpillar Equipment Dealer, while CAE is the biggest aircraft simulator company for training civilian and military pilots.

First Quarter Synopsys

Despite having high hopes going into 2024, the markets' robust First-Quarter rally still managed to surprise most investors. The S&P 500 in the U.S. gained 10% for its best start in five years, and everything from stocks to bitcoin to gold marched to new records. Any weakness in the stock market didn't last for more than a few sessions, with investors buying the dip and sending the index to 22 all-time closing highs. Of the 11 sectors of the S&P 500, all but one (real estate) rose, and finally it wasn't just the "Magnificent Seven" megacap tech stocks that participated in the rally.

The economy continued to defy expectations, and any recession worries mostly disappeared during the quarter. Resilient corporate profits, enthusiasm surrounding artificial-intelligence and a belief that the Federal Reserve is on track to begin cutting interest rates gave investors reasons to continue buying. More than half of the stocks in the S&P 500 notched 52-week highs and, as mentioned, the dominance of the "magnificent seven" faded with pullbacks in Telsa and Apple. The broadening out of positive momentum for companies that are not tech related bodes well for future market returns.

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

A seemingly "Goldilocks" economy underpins investors' current bets. U.S. consumers are spending briskly, employers are still hiring, and U.S. unemployment is still below 4%. U.S. FED Chairman Powell said that he believes that inflation remains on a downward trend, despite a recent spell of hotter-than-expected price reports.

If the market has been wrong about anything over the past two years, it may be that it was trying to be far too precise in trying to determine the timing of the FED's pivot to lower rates. Coming into the year, investors had expected the FED to cut interest rates six times in 2024. That turned out to be overly optimistic and the market now accepts that only three rate cuts are likely. This didn't seem to matter as investors rejoiced the fact that interest rate reductions will likely begin this summer.

According to the Dow Jones Market Data analysis of index performance since 1950, when the S&P 500 adds 8% or more in the First Quarter of a year, it finishes the rest of the year higher 94% of the time, with an average gain of 9.7% over the next three quarters. This history bodes well that the markets are in good shape to keep the good times going. Against this trend is a pattern of pullbacks in the Third Quarter results in the years of Presidential elections, which is something that we will be keeping an eye on.

All in all we are satisfied the way portfolios are positioned and we recently raised some cash to take advantage of the changing opportunities that are sure to come.

Artificial Intelligence and its 1990's Parallel

We have often stated in this Newsletter that markets react approximately six months before the economy reveals its hand. (We have consistently believed that the market would turn positive at least six months before the FED begins reducing interest rates). Given this pattern of equity markets being among the most consistent leading economic indicators, the recent market strength does not portend a global recession within the next year. New "all time highs" are bullish and history tells us that market strength begets more strength. According to our BMO Nesbitt Burns Strategy Team as outlined in a recent report, "Since 1960, after reaching a new all-time high following a bear market (which we had in 2022), the S&P 500 has been positive 88% of the time over the next three, six and 12 month periods."

Aside from the prospects of imminent interest rate reductions, we believe that progress with Artificial Intelligence is related to the markets' recent good fortune, and that this could last for a while. Productivity increases (in this case due to AI) move slowly, and with some lag following investment in it. Recent investments in AI, cloud computing and such advances in autonomous vehicles and robots is bound to have a positive economic impact in the future. A recent article in the Economist stated that AI has already raised the productivity for salespeople and for coders in tech start up companies. This is likely only the beginning, and we witnessed a similar situation in the 1990's. Back then, new investments in personal computers, wireless communication and the Internet were all the rage. But it took time for employers to truly harness the power of these new technology tools and by the mid to late 90's productivity started accelerating. The Federal Reserve later stated that the acceleration of labour productivity growth that began in the mid-1990's was the defining economic event of the decade and was the major contributing factor to the epic bull market we witnessed back then.

We believe that we may now be experiencing a similar situation that may indicate falling inflation pressures that would be consistent with above average stock market gains. If this thesis is correct, there could be more positive market returns yet to come.

The Dilemma of Canadian Interest Rates

It is ironic that just as U.S. leading economic indicators are turning positive, (homes sales and housing starts turning up, GDP increasing, low unemployment), the U.S. is gearing up for interest rate cuts. It is not as if the U.S. economy or financial conditions are crying out for relief! It is possible that there could be fewer U.S. rate cuts in 2024 than expected and that they start later in the year.

Meanwhile the current belief (including our own BMO economists) is that Canada will start cutting interest rates before the U.S. does. There are some compelling reasons for Canada to cut first:

- Underlying inflation in Canada at 2.8% is markedly below the rate in the U.S.
- Growth is suffering much more in Canada. Peak consumer spending in the past year is up just 0.6% here compared to a U.S. rise of 3.4%. Given the 3% population growth in Canada over the past 12 months, consumer spending per capital is actually negative.
- The unemployment rate in Canada is more than one percentage above the U.S. rate of 3.9%. Of course this is partly due the surge in Canada's non-permanent residents.

There are also some negative factors that could surface if Canada reduces interest rates before the U.S.:

- Housing affordability in Canada is at its worst level and shelter costs are currently the main driver of lingering inflation. A snapback of housing sales and prices due to lower interest rates is the last thing that Ottawa wants to see.
- Canada's Central Bank hiked rates less than the FED did through the up cycle such that our rates are currently lower than in the U.S. already.

Our main concern for Canadian markets is the effect on the Canadian dollar. The loonie is already in a soggy state and it has been trending down. Reducing Canadian interest rates will be negative for our dollar, and increasing oil prices are no longer propping up our dollar as it used to. Any gains made by the S&P/TSX could be nullified by a declining Canadian Dollar. This is a change in thinking for us and we have stopped emphasizing the Canadian market until we see how the Canadian dollar reacts to future Bank of Canada rate cuts.

Ricky's Corner

Powell's stance – not as hawkish as he sounds.

Federal Reserve, as the U.S. central bank, has two main mandates: to achieve maximum employment and to maintain price stability. Nevertheless, as the U.S. economy continues to grow, the Federal Reserve has a third hidden mandate, which is to ensure stable financial conditions. While not explicitly supporting the stock market, the FED aims to avoid unsettling surprises.

Financial conditions are gauged through various metrics like credit spreads, financial system leverage, credit risk and volatility. Several indices, including those from the Chicago Reserve Bank, Goldman Sachs, Bloomberg, and the Federal Reserve itself, currently indicate healthy U.S. financial conditions. However, Chairman Powell's remarks on March 22, 2024, suggested that financial conditions are dampening economic activities due to cooling demand indicated by labor market indicators.

Initially, when the FED began raising rates in March 2022, its tone was strongly hawkish. After a total of 5% rate hikes and a 27.5% correction in the S&P500 between January to October 2022, Chairman Powell shifted to a more modestly hawkish stance in October 2023, signaling that rates would remain "higher for longer". This signaled the rate hike cycle was close to finished and the markets took off. However, recent observations suggest Powell's stance may be shifting once again, this time towards a more dovish position. Despite sounding hawkish, the FED's policy has leaned towards a looser stance. The combination of loose financial conditions and expected rate cuts later in the year aligns with our team's anticipation that more positive market returns are yet to come.

Stock Feature – Every member loves Costco

How often do you shop at Costco? Wendy and I visit the mega box about once a month. Regardless of the hour, navigating the aisles, long lines at the cashiers, and finding parking are the constant challenges. Yet, as shareholders, like our clients, as well as ourselves, relish these "hurdles" faced by Costco customers. With a unique business model and a strong management team that is deeply attuned to its clientele, Costco has long dominated the Consumer Staples sector. While one might assume their profits stem primarily from the huge variety of products they sell, the truth is membership fees are their major revenue source. As of 2023, Costco boasted 130 million global members, generating approximately US $4.6 billion in fees – constituting 72% of its income. To sustain its global expansion, Costco opened its first warehouse in Shenzhen, China, on Jan 12th, 2024, boasting 90,000 pre-opening members, and surging to 140,000 on opening day. Costco has been a core Consumer Staples holding in our portfolios and we do not see the need to change anytime soon. Having said that, remember to renew your membership!

Wills and Powers of Attorney

In every conversation with our clients, we ask if they have a Will and Powers of Attorney in place. Keeping your will updated ensures it accurately reflect your current wishes and provides for your loved ones. Powers of Attorney are equally important for managing your property and financial affairs should you become incapacitated. Generally, there are two types of Power of Attorney, medical and legal.

On May 1st, BMO will host a virtual seminar titled "***The Recipe of Will"*** and we encourage you to join us. Two sessions will be held from 12:00 to 1:00pm PST and 4:30 to 5:30pm PST. Invitations have been sent via email. Please RSVP by clicking the link provided in the email if you are interested.

Summary

We've experienced a promising beginning to 2024. While the upcoming Presidential Election in November may render some volatility, history suggests that a robust first quarter often sets a positive tone for the remainder of the year. Our portfolios are well positioned to take advantage of any opportunities that may arise. With regards to interest rates, both the FED and Bank of Canada are trying to keep their options open. Although they have stopped warning about potential rate hikes, they have been non-committal about when the first rate cut might come. As such, we believe the Bank of Canada is likely to cut rates before the FED does.

In the coming months, we will continue to reach out to all clients via video conference. If you have any questions in the meantime, please feel free to reach out to us. We are just a phone call or email away.

Best Regards,

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