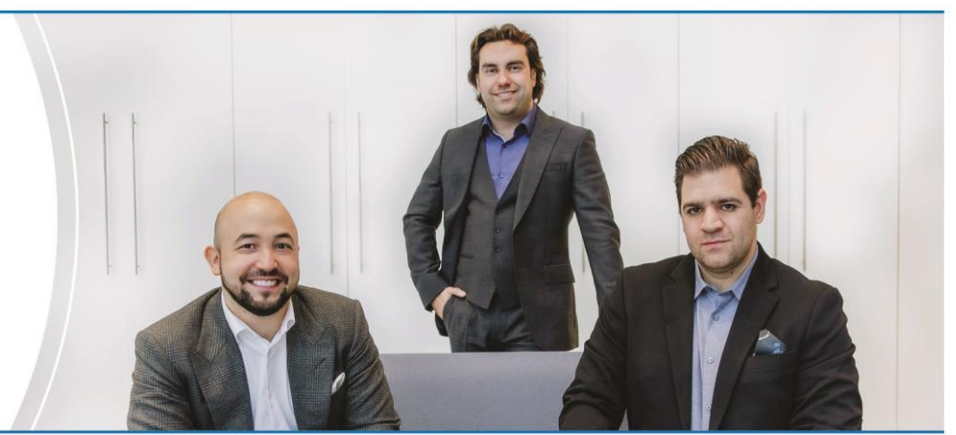
The Wrap Up



Can You Hear Me, Major Powell?

It’s been a tough week and overall bad month for investors as stocks retreated from their July highs. A combination of negative headlines, soft earnings and weak forecasts have all contributed to the recent pullback. This week, we’ll assess the state of everything and provide commentary on how we’re navigating this.

Equity valuations are a product of future expected earnings and/or cashflow generation; the more those future earnings are in doubt, the more negative sentiment becomes. We’ve been reiterating our concern that the valuations we see today are not justified when compared to the macroeconomic backdrop. Labour markets are tight which will impact costs and the timing of projects; elevated interest rates and high debt levels for some consumers and governments will limit future spending as well as future credit growth. Inflation has proven (but not surprisingly) to be stickier; prices rose in July for both Canada and the United States.

The higher than desired inflation suggests that future rate hikes are still possible. While we do believe that significant rate increases are unlikely from here, we would not be surprised to see one or two more rate hikes. For anyone already forecasting rate cuts; the Fed released its July 25-26 meeting minutes and it was evident that there is still an appetite for rate increases from the majority of the participants. This is where we have doubts about the market’s consensus: how can we have rate cuts without a recession in 2024, while central banks do not see inflation getting in line until 2025? Ultimately, the market is going to be wrong about the rate hikes or the recession outlook, either one of which is negative for equities.

If the market prices in a more negative outlook, we would see lower

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equity prices today; again this is more desirable than a market detached from reality that risks bubbling and then popping. It is in investors' best interest that the market reflects the balance of positive and negative outcomes so as not to overshoot one way or another. Looking at GDP and unemployment trends, we understand that there have been more positive surprises than negative ones this year which is why it is perfectly normal that markets have yielded positive returns year to date. The resilience of the US and Canadian economies do not tell us the entire story, however.

Germany and the Netherlands have entered recessions and China's macro-economic data has disappointed most of the year. A slower growing China, the world's second largest economy, will mean slower growth for its trading partners, especially those who have a concentrated exposure to the country. Even investors who have avoided the region as an investment destination can be exposed to the slow down; China represents just over 20% of Apple's sales and just over 30% of Tesla's volumes (23% of revenue). Both these companies have had strong years and both currently trade at above average multiples relative to their peers, which makes us wonder if it would be more appropriate to price in some of the growing uncertainties? Well known economist Mohamed El-Erian highlighted China's reality this morning; their two, long term, fundamental issues are converging in elevated debt and weakening growth, and their government will have to expertly address one without disrupting the other.

Although The United States has bucked the trend and continued to grow faster than expectations, it will have to address its spending issues as well. Just to balance their budget, they would have to raise taxes or cut expenditures by $1.5 trillion; that's almost the equivalent of Canada's entire GDP. At last August's Jackson Hole Economic Symposium, Fed Chair Jerome Powell acknowledged that achieving price stability would yield the greatest collective benefit but would come with some trade-offs and some economic pain; for the most part, that hasn't happened yet. We've been waiting for the other shoe to drop for some time and we still believe that it will. This moment of reflection for equities, as undesirable as it seems, should allow us to price in some of those trade-offs that we will face.

Regardless of the tone of this recap, long term investors should not be intimidated by this reality and should, in fact, embrace it. The future is still extremely bright; unemployment is likely to remain low even if there is a temporary uptick due to recession, revolutions in AI, energy, transportation and entertainment will yield advances in quality of life, productivity and profitability for many firms and a new generation of entrepreneurs will build their wealth off these ideas. The amount of projects that were set off because of the pandemic (and its many, many consequences) will keep global demand elevated for years to come and will create opportunities for new regions to benefit from global trade. As investors, we can see a healthy long term path to meeting return objectives and quality of life goals. In order for that to become a reality, however, we need to address long term risks related to debt levels and asset valuations. Think about it this way: what growth potential exists if the current share price is factoring in the next 10 years of growth, with a high degree of certainty?

For our clients, we have avoided chasing expensive ideas, convinced that we would be able to revisit them at more reasonable prices. We have continued to prioritize defensive yield and proactive profit

taking which has protected some profits. We have also been slow to deploy new funds; we’ve done some buying but are in no rush to use all of our liquidity. Ironically, the more the market deflates and the more it begins to price in negative outcomes, the more interesting it becomes to invest in. Should there be more air let out of this market balloon, we could begin to change our tune and become more constructive on growth oriented ideas.

Healthy Distraction

Walking around the shopping mall recently, we noticed back-to-school marketing in full force. We consider ourselves a fairly young wealth management team, therefore, we don’t have to travel too far down memory lane to remember the feeling of dread as summer was winding down. Those Staples commercials that played “It’s the Most Wonderful Time of the Year”? Yeah, we hated them! It’s funny how the anticipation of something in the future impacts our mood today and, how common that feeling is. Sunday used to be our least favorite day of the week; the thought of going to school or even going to work can weigh us down at times.

Two developments have helped us to better cope with this reality: one, we graduated, so the school season doesn’t really bother us anymore. More importantly, we became NFL fans and now Sunday is too entertaining to be depressing. Actually, sports fans have plenty of reason to celebrate the arrival of August; we are weeks away from the start of a new football, hockey, basketball and international soccer season! It's not only in August but we love Mondays year round! We love the beginning of a new and challenging week, filled with opportunities for personal and professional growth. We consider ourselves lucky to be in a situation where we enjoy the day-to-day progression of our careers. We love to see our clients grow and we love to see our business flourish.

Were those feelings of the past exclusive to LD Wealth or can you, our readers, relate? How about the new generation, are we setting them up to love Mondays? What are your thoughts?

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