The Wrap Up

You May Say I'm a Dreamer but I'm Not the Only One

After two weeks of market turmoil, investors were gifted a relatively calm week. This week also marks the start of earnings season, something that we always look forward to with great anticipation. After spending so much time talking down optimism and highlighting risk, we wanted to show the other side of the coin and talk about what we're getting right.

The efforts to contain inflation are still in full force (at least monetary policy is). With interest rates restrictively elevated, this week's US inflation data came in at 3.7% on a year over year basis. September prices were 0.4% higher; slower than the 0.6% of August, albeit 0.1% higher than forecasted. Core inflation is at 4.1%, slightly higher due to an increase in shelter prices. While inflation is still running at double the central bank's objective, 75% of the job is done which is especially noteworthy as central banks were slow to react to inflation in 2021.

We should expect interest rates to remain elevated until the job is completed and inflation is considered to be under control. Beyond the positive momentum regarding inflation, the market activity of the previous two weeks has replaced the need for a further rate hike in the short term. The FOMC minutes did leave the door open to further action, reminding us that we still live in uncertain times, although the overall interpretation of their September 20th meeting was that it was more dovish than expected.

The elevated interest rates have had a positive effect on one industry: lending. This morning JPMorgan, Citigroup and Wells Fargo all reported above consensus earnings due to a combination of higher net interest income and lower than expected (although still rising) provisions for credit losses. Banks have been underperformers, on both sides of the border, with most large banks' share prices down 8-10% (the extremes being JPMorgan up 8.7% while Bank of America is down 18.7%). This

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morning's strong earnings could signal a bottom for the banking industry, however, it may premature to immediately expect a strong rally as leadership still articulated a cautious tone. Jamie Dimon highlighted the strength of consumers and business while also stating that "persistently tight labor markets as well as extremely high government debt levels with the largest peacetime fiscal deficits ever are increasing the risks that inflation remains elevated and that interest rates rise further from here".

The banking sector is but one of the many sectors suffering this year; unless you have a weight loss (diabetes) drug on the market, your healthcare company has lagged the broader index. Staples have struggled, with a few exceptions (Costco and Walmart), as elevated post pandemic share prices required some moderate selling off. Energy is mixed with large cap producers like Exxon (-3.4%) and Conocco Phillips (up 2.6%) not moving much while there are some standout stories such as Petroleo Brasileiro (up 41%) and Shell (up 16%). Renewables have had an extremely difficult year as the higher interest rates have slowed down adoption in some areas (residential solar) and have severely impacted valuations in currently unprofitable fields (hydrogen). Industries that are defensive but yield sensitive have suffered this year as telecommunication and utility stocks are mostly all negative this year as well. Materials have also had a difficult year; while historically a good place to hide during periods of elevated inflation, China's economic uncertainty has weighed down on this sector. Where we have seen strength is with the large cap tech firms, cybersecurity, digital advertising, alternative asset managers, industrials (for the most part) and that's about it.

This difficult market environment is not necessarily a bad thing; we have argued that the macro environment may weigh on future profit growth. That companies better reflect this risk is a positive development; it leaves less room for future disappointment. As we learned in 2022, market valuations are sensitive to the level of interest rates and, like we've mentioned on countless occasions, they are also sensitive to earnings expectations. In our opinion, the market is still expecting too much, which is why a moderation in these expectations today could yield less negative surprises in the future. It's a difficult moment for forecasters as the consumer has been more resilient than anyone anticipated; on one hand they need to respond to that strength while on the other, they also need to account for the higher interest rates doing their job. As much as we like indefinitely rising stock markets, it is more important for long term investors to have markets that reflect the reality and therefore moderate performance, as opposed to high flying markets that are detached from fundamentals.

Even though we believe that growth in the medium term will be limited by high debt levels and higher interest rates than what we were accustomed to in the previous decade, that does not mean the market cannot have positive cycles and periods of strong performance. A market with modest expectations and lower valuations is a market that can surprise on the upside and reward patient investors. The earnings season is still young and in the upcoming weeks, we will have updated outlooks from both company heads and financial analysts. Our hope is to get a clearer picture on what we own while asking ourselves, have the reasons we bought a company changed? Have new growth opportunities emerged? And in the case of Nvidia, can they squeeze out another 200% return before the end of the year?

Our commitment here is to remain nimble; markets move quickly these days and we want to able to respond to news as soon as we understand it. We are still cautious, we are still looking at equity alternatives but we want to acknowledge positive developments as well. We'll be sharing what we learn

from earnings in the weeks ahead and provide an update on some of our longer term ideas (namely AI and renewable energy).

Healthy Distraction

Our thoughts are with those who have suffered the mass terrorist attack on Israel. Many of our friends, colleagues and clients have been personally impacted; they have experienced loss, they are worried for their family and loved ones and they are concerned about further acts of terror in the region and elsewhere. Terrorism is not a political tool, it is an evil act and it has no place in our world; this unprecedented attack must be condemned.

When tragedies occur, we are often at a loss for what we can say and do to offer comfort and hope. We offer our support to those who have suffered this terrible experience and let them know that they are not alone.

We join the global community in mourning the loss of innocent lives and we stand in solidarity with those affected.

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