Putting the Pieces Together

Economic Resiliency and AI Trade

Last year was a special mix of elevated fears of recession and low global growth expectations coupled with juxtaposing positive narratives of hope of China's reopening, large fiscal stimulus in Developed Markets and a strong US Consumer, which would balance off the higher interest rate scenarios and keep us moving upward. Little did we know at the beginning of 2023 that AI, weight-loss drugs, Fed rate cut expectations and optimism in cryptocurrency would culminate one the biggest "risk on" year end finish that we have seen in a long time!

After finishing 2023 in strong fashion, US stocks have thus far struggled at the start of 2024 and this relatively minor weakness has yet again raised concern amongst investors regarding the sustainability of the market's positive trend. As we have stated in our last webcast, we believed the November through December move in the S&P 500 was probably a little too much, too fast given what we believed were overly optimistic Fed rate cut expectations that essentially drove the rally. Therefore, we are not concerned about recent market weakness and view it as a healthy and necessary break in what had been the longest weekly winning streak for US stocks in 20 years. In other words, we continue to believe that this positive trend will persist. As a result, we continue to advise investors to use any periods of market weakness as a buying opportunity.

We start this newsletter with our investment strategy for 2024:

- As we enter 2024 we remain overweight equities and also find very good value in discount bonds which are quite efficient from a tax perspective.

- The S&P/TSX may outperform the S&P 500 as sector leadership broadens out from "Magnificent 7" type stocks where the U.S. market has a huge advantage. In a nutshell: 1) we see the Canadian market as far cheaper; 2) Canadian sector weights are more favourable in the context of a "soft landing" scenario and eventual upturn in 2024; and 3) we consider the Canadian dollar to currently be substantially undervalued.

- We think high-quality, low-duration stocks (i.e. reasonably valued vs. profitability and growth, and paying growing dividends) remain the place to be.

Let's connect

Roux & Associates
Wealth Management Group
BMO Nesbitt Burns

1501 McGill College Ave.
Suite 3200
Montréal, QC
H3A 3M8

www.christian-roux.com

Christian Roux
514-871-7026
christian.roux@nbpcd.com

Nektarios Pouliezos
514-282-5929
nektarios.pouliezos@nbpcd.com

Nancy Bélanger
514-871-7076
nancy.belanger@nbpcd.com

Elizabeth Le Comte
514-282-5808
elizabeth.lecomte@nbpcd.com

- Defensive/interest rate-sensitive sectors like Pipelines/Utilities, Multi-Family REITs, Financials, and Telecoms should continue their recovery from a difficult 2023 if we are right that interest rates are unlikely to spike up from current levels. In fact, the recently expressed dovish view from the Federal Reserve makes the prospect of short-term interest rate cuts more likely.

The biggest hurdle in 2024 will probably be how the FED will go about cutting the overnight rate. Regardless on when they cut and how they cut rates, the adage of buying the rumors selling the news, would probably apply in either scenario. We've already seen the market go higher on the perspective of a rate cut this year. Moreover, the bond market is pricing-in a rate cut as well. The first scenario is, if the FED waits too long before they start cutting rates and consequently, they need to drastically cut the rate, markets will probably have to price-in the slower economy and hence lower earnings. If this is the case, then the market won't like the uncertainty and would signal that the increases in rates were too much and had a more severe impact on the economy than previously forecasted. The second scenario would be if the FED starts cutting the rate several times before an employment problem emerges. For us, this would be the proverbial soft-landing scenario. Whereby, the ISM rebounds above 50 and unemployment remains low.

Regardless, of which scenario occurs, the market will initially pullback to account for lower earnings and thus will have to reprice for lower valuations. Common sense dictates that costs for companies remain elevated because of wages and cost of capital and demand is softening. Henceforth, we are already witnessing a slower economy and at a certain point in time the FED will have to cut rates.

We do believe that in the first scenario the market will pullback more than in the second scenario because of uncertainty.

However, we don't believe the pullback will be long in nature because once the FED starts cutting the rate the impact of the rate cut is immediate. Rate cuts have an immediate effect on demand whereas interest increases take time to fully have an impact on demand. That is why we stated that in 2024 any pullback is a buying opportunity.

Henceforth in this market environment we remain cautiously optimistic and that is reflected in our investment strategy. As outlined at the beginning of our newsletter, we remain overweight equity with a premium on free cash flow, high profitability, predictable earnings stream and we won't be chasing high beta names nor deep value names.

We are already seeing some optimistic signals. First, far from deteriorating, BMOCM's (BMO Capital Markets) recession probability model has shown some improvement with odds of a recession ticking down to about 40%. As our readers know well, securities markets are primarily influenced not by absolute numbers but by the trajectory of key macro variables. On that front, the situation has already improved massively for inflation and the 2%+ range is now in our sights for 2024. The key missing ingredients have been an improvement in growth and housing momentum, and that's what we think will happen in the new year as rates further stabilize/decline. As always, the stock and bond markets will discount these improvements well before we see the evidence in the "real world".

In 2023, the average North American stock had a middling single-digit positive performance with a few select mega-cap super performers (Tech and Communication stocks along with Tesla). The net result of this bifurcated market was that the S&P 500 Composite gained over 20%, but only 8% on an equal-weighted basis. The TSX, being far less endowed with magnificent Tech stocks, was up a paltry 4% while the TSX High Dividend Index was down slightly.

Sector Performance in 2023

U.S. - S&P 500	
Information Technology	57.4%
Communication Services	56.2%
Consumer Discretionary	44.0%
Industrials	16.8%
Materials	11.9%
Real Estate	11.1%
Financials	11.0%
Healthcare	0.6%
Energy	(0.2%)
Consumer Staples	(1.3%)
Utilities	(8.5%)

We believe the massive outperformance of high-multiple Tech/Communication stocks this year was due to: 1) their very poor returns in 2022, meaning expectations were far lower coming into 2023; and 2) increasing evidence that central banks have gotten the inflation under control thus lowering the odds of another interest rate spike which tends to hurt these high-duration stocks disproportionately.

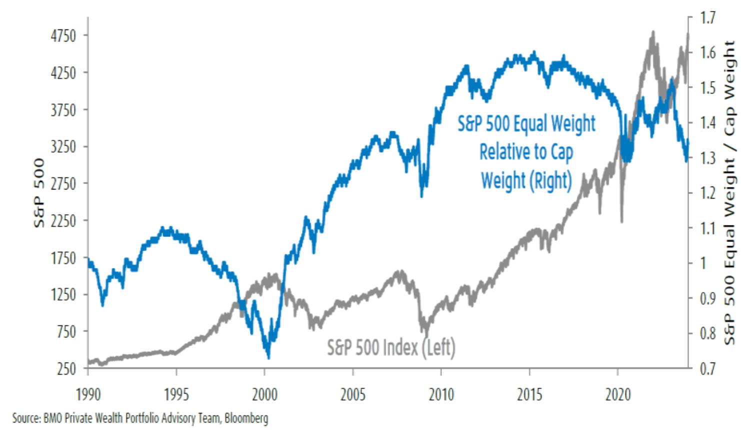
But that was last year's story. History has shown that chasing past performance can be a dangerous endeavour for investors and we believe this time will be no different.

A simplistic argument for this is that 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, representing over 25% of the total value of the biggest stock index in the world. That said, slowing growth will act to compress their very high trading multiples (price to earnings or price to free cash flow).

A numerical example should help illustrate. Investors who are paying 30-40x expected earnings per share for these companies implicitly expect at least a 10% return on their investment as compensation for the risk.

To attain that goal, all things being equal, these 5 companies would have to add the market cap equivalent to PepsiCo, Bank of America, Coca-Cola, and Merck & Co in 2024. To continue that compounding trend, they would then have to add the equivalent of Oracle, Adobe, Costco, and Chevron in 2025, and J.P. Morgan, Wal-Mart and Johnson & Johnson in 2026. Anything is possible, but is that a likely scenario? We think not.

S&P 500 Performance – Comparing Equal Weight & Cap Weight



But as we now are in last few days of January, AI related companies have again moved materially more than the rest of the market since the start of 2024. Therefore, for the rest of this newsletter we will focus more on the AI concept and opportunities. Most of the content of the following are excerpts taken from our Portfolio Advisory Team's "Artificial Intelligence Primer" research.

Artificial intelligence – Humanity's Next Big Leap

Generative AI (gen AI) is creating massive opportunities and disruptions as the global economy embraces its potential to reshape countless functions and processes. Despite having only captured the world's interest in 2023, gen AI is projected to grow at a compounded annual growth rate (CAGR) of 42% to become a U$1.3T market by 2032. Incumbents of numerous tech segments (i.e., inference devices, infrastructure, and software) are likely to see boosts in sales as corporations push towards setting up AI-infrastructure. While the spotlight has mainly been on cloud-based AI technology, edge AI is an area of gen AI that has largely gone under the radar, despite its valuable ability to make real-time decisions without requiring a connection to the cloud.

While the concept of AI has been around for over 50 years, we are at a pivotal point for its adoption today due to the availability of big data, high-powered computing and advances in algorithms – all of which make AI cheaper and faster to implement.

In simple terms, artificial intelligence is the simulation of human intelligence by machines. It is the development of computer systems with the ability to learn, reason, discover meaning, perceive environment, learn from experience, and interact.

In practice, AI is a group of technologies that help facilitate the discovery and analysis of information for the purpose of making predictions and recommendations, support decision making, facilitate interactions and automate certain responses. AI tools will be intimately linked with the overall digital transformation going on now within businesses, and AI is likely to be embedded in numerous technology applications within a few years.

AI is different from traditional software programs in that it extracts knowledge from data and can alter its behavior (or learn) without being specifically programmed. Traditional software pre-defines the logic, whereas AI discovers the patterns and logic.

Investing in AI

There are numerous ways to invest in AI and the avenues of investment are only increasing with the advancement and adoption of AI.

Investing in AI can be narrowed down to an umbrella of three broad topics:

1. **Industry-Specific AI:** Due to its versatility, AI can be leveraged in many industries and their feasibility is easily tailored to meet industry-specific needs. According to PwC, healthcare, automotive, and financial services are the sectors with the greatest potential for product enhancement and disruption.

2. **Hardware:** AI (and in part automation) is heavily reliant on technologically advanced hardware that acts as the brain and eyes of the computer system. Components such as the central processing unit (CPU), graphics processing unit (GPU), and image recognition devices, are vital for the success of the system.

3. **Software:** AI software is a broad topic as it also pertains to industry-specific uses. One common use of AI software is the use of cloud-computing as many industries are moving towards AI integration and digitization.

BMO Capital Market's Ambrish Srivastava published a report on generative AI where he states "The new arms race spurred by generative AI is just getting started as others race to compete after the initial salvo fired by OpenAI.

While it will take time before the list of winners/losers shakes out in different parts of the AI stack, we believe the technology presents a secular growth opportunity for certain semi companies". Furthermore, Ambrish claims that the tech industry could be in an extended phase of training-led AI development for 2-3 years, which especially favors NVIDIA. Other beneficiaries of generative AI driven capital intensity in data centers range from networking/datacenter silicon leaders such as Broadcom, Marvell, and potentially AMD.

One area of gen AI that has largely remained under the radar is Edge AI. However, its value proposition when compared to cloud-based AI technology cannot be understated. To understand edge AI, it is important to first understand what an edge device is. According to HP, an edge device is "an endpoint on the network, the interface between the data center and the real world" (Source). Edge devices collect or communicate information using sensors and systems and at the boundary between digital processes and the physical environment.

Some examples of edge devices include smartphones, automated vehicles, and medical devices. In contrast, data centers or the cloud are examples of non-edge devices. The gen AI that we are all very familiar with, ChatGPT, is a cloud-based technology, and while it can be extremely useful, it is susceptible to high-latency1 (lag from having to connect to the cloud for data and calculations), making it less reliable in scenarios where making real-time decisions quickly is vital. Edge AI moves the data processing to where data is generated (edge device) and this allows for real-time decision-making and cost savings, which is crucial in areas such healthcare, manufacturing, and transportation. Furthermore, the attach rate of edge AI to wearables (smartphones, smartwatches, etc.) is a key driver of adoption. According to Bloomberg, these drivers could potentially lead edge AI to have a larger user base than cloud-based AI. Based on their scenario analysis, the edge AI semiconductor market could be up to 3.37x as large as the cloud-based AI market by the end of 2032 - growing at a 10-year CAGR of 39% (Source).

AI related Stocks

Ticker	Company Name	Price	Market Cap (Millions)	Rating	Revenue (Millions) FY23	Revenue (Millions) FY24E	Price / Earnings 2024E	Price / Earnings 2025E	EV / EBITDA 2024E	EV / EBITDA 2025E
MSFT-US	Microsoft	$ 391	$ 2,887,211	BMO: OP	$ 211,915	$ 243,143	30x	40x	19x	24x
GOOGL-US	Alphabet	142	1,669,977	BMO: OP	280,875	306,166	21x	25x	10x	14x
AMZN-US	Amazon.com	153	1,597,848	BMO: OP	513,983	570,783	42x	57x	13x	16x
NVDA-US	NVIDIA	564	1,351,337	BMO: OP	26,974	58,933	27x	46x	48x	40x
META-US	Meta Platforms	370	831,221	BMO: MP	116,609	133,573	21x	26x	6x	12x
TSLA-US	Tesla	220	695,834	JPM: UW	81,462	97,460	59x	72x	22x	56x
AVGO-US	Broadcom	1,113	518,550	BMO: OP	35,819	49,749	20x	26x	11x	17x
ADBE-US	Adobe	594	271,605	BMO: OP	19,409	21,479	29x	37x	19x	29x
QCOM-US	QUALCOMM	140	156,742	JPM: OW	35,820	37,858	13x	17x	7x	10x
IBM-US	International Business Machines	166	151,395	BMO: MW	60,530	61,734	17x	17x	11x	13x
MRVL-US	Marvell Technology	66	56,780	BMO: OP	5,920	5,502	33x	44x	20x	35x
EPAM-US	EPAM Systems	300	17,756	JPM: OW	4,825	4,669	28x	29x	20x	19x

Your team will remain alert to the developing trends and remain active to keep your short and long-term plans on track.

Hope to talk to you soon,

Team Roux & Associates