April 2024 - Excerpt # 71

AYE, YAI YAI! AI, AI AI!

Private Wealth

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Pierre's comments

AYE, YAI YAI! derives from a Mexican expression meaning someone experiencing dismay or disappointment while AI AI AI could perhaps become a call for the integration and evolution of Artificial Intelligence in a new world about to be discovered.

As of today, March 13, 2024, the S&P 500 has reached new highs 17 times since the beginning of the year. Driven by a great earnings momentum and the expectation of interest rate cuts as well as the perceived rise in productivity with the introduction and implementation of artificial intelligence (AI) and machine learning, markets have discounted lots of future corporate earnings growth.

While interest rates seemed to have peaked, inflation, the main driver of interest rates, seems to have reached a first bottom. Indeed, the first two months of the year have seen inflation move up, albeit by a small percentage, rather than down in the U.S. CHART 1 Inflation CDA-U.S.

Chart 1

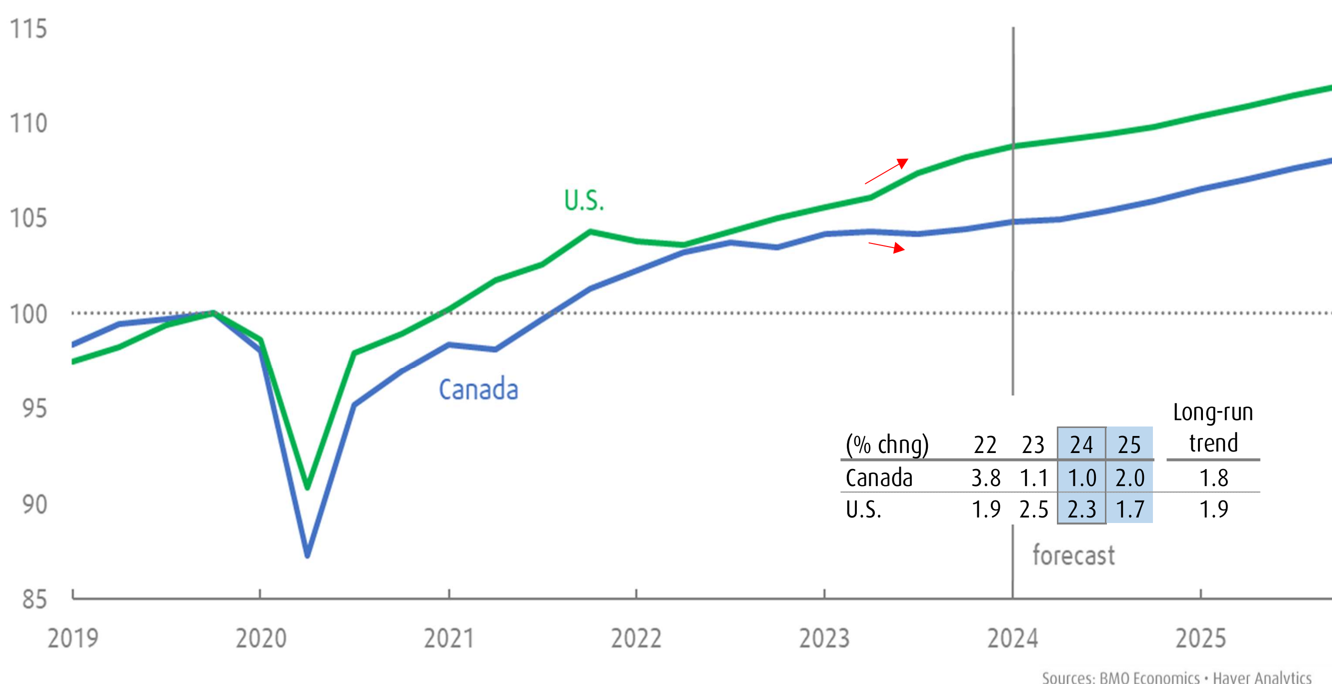
Table 1

		Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24
Canada	Total (%)	3.27	4.00	3.80	3.12	3.12	3.40	2.86	2.78	2.93
	Core[1] (%)	3.75	3.95	3.70	3.50	3.50	3.60	3.35	3.15	3.10
United States	Total (%)	3.18	3.67	3.70	3.24	3.14	3.35	3.09	3.15	3.43
	Core[1] (%)	4.65	4.35	4.15	4.03	4.01	3.93	3.86	3.75	3.75

1. Core inflation exclude food and energy

Inflation remains in a negative trend, which is good news, but it does seem that bridging the last mile from 3% to 2% might be very difficult. The Central Bank's target inflation remains at 2%, but actual inflation is stubbornly sticking at ±3%. Tiff Macklem, the Governor of the Bank of Canada, and Jerome Powell, Chairman of the Federal Reserve Board, are both on pause and both will remain highly data sensitive. The inflation downtrend will have to resume in the U.S., or they will need at least some confirmation of an economic slowdown before they start to think of cutting interest rates. Canada's economic numbers are showing signs of weakness, with the last three quarters relatively flat including one negative quarter (Q2 Sept. 2023). Chart 2, GDP growth us/cdn.

Chart 2



(% chng)	22	23	24	25	Long-run trend
Canada	3.8	1.1	1.0	2.0	1.8
U.S.	1.9	2.5	2.3	1.7	1.9

Meanwhile, according to the Bureau of Economic Analysis (BEA), the U.S. economy grew at the rate of 4.9% and 3.2% in the last two quarters respectively, which does not suggest changes in the monetary policy anytime soon. But things can change rapidly. Holding on to a tight monetary policy for too long could be very disruptive, just like being too accommodative and keeping rates too low for too long caused the recent rise in inflation (2022). Mr. Powell has been firm on the notion that he would not make the same mistake as in the '70s when interest rates were cut too soon and reignited inflation. Paul Volker, chairman of the Fed at the time, raised interest rates to 20% to finally break inflation's back and simultaneously caused a huge economic recession (the worst since the Great Depression) with unemployment reaching all-time highs of 12% in Canada (Statistics Canada) and 11% in the U.S. late in 1982. (federalreservehistory.org).

While the market was expecting no less than six interest rate cuts at the beginning of the year, the consensus is now for only three cuts of a quarter point by the end of the year. Obviously, this can change at any time as central banks are economic data sensitive. But the market might be getting ahead of itself in view of the incredible ride it has been enjoying since last October. I do believe this bull market can last for a long cycle,

but I also believe that this latest uptick has been driven by FOMO – the fear of missing out.

History shows us that markets tend to underperform in the third quarter during an election year in the U.S. Apart from the 2008 election year, when the market collapsed in the third quarter because of the financial crisis, the average pullback in the S&P's performance in the third quarter during an election year in the U.S. is 8.28%. If we include 2008, that number drops to 10.27%. History also shows that when major setbacks occur within a secular bull market, such as the market lows of October 2022, the average performance over the following 30 months was an increase of 86%, which would push the S&P to near 6,500 by mid 2025 (an increase of nearly 13% from this point). The question is: What can drive this bull market into the future?

1) Technology
2) Capital spending (corporate and government)
3) Consumer spending
4) Earnings growth
5) Monetary and fiscal policies

1) Technology

There seems to be a consensus that artificial intelligence (AI) and machine learning will boost productivity significantly. Some projections suggest that their implementation could create an economic boom approaching that of India's and China's combined output by 2030. According to the World Economic Forum, we are at the beginning of a transformative decade, similar to the mid-nineties, when the Internet changed the way we work, live and do business. The access to data changed our behavior as humans. The dictionary was replaced by the Googles of this world, accessible on our smart phones. AI is a derivative born from the compilation of this data and its interaction with human behaviour. For instance, through AI, we could now have access to faster and potentially more accurate health diagnoses. While humans can do average to good work, compiled data banks can crunch all the information, combine it with all the historical experiences, and come up with a faster and better diagnosis. Thus, good work becomes great work, and that could benefit us all. While we are not going to become doctors overnight and prescribe our own medication, huge savings could result providing an accurate diagnosis and earlier treatment. The result of a broadened knowledge base thanks to AI can be used to improve the decision-making process and solve or prevent problems sooner. The biggest hurdle will be to properly regulate, structure and control the sources of data and their use. Manipulating data with false information could lead to catastrophic results, perhaps even change the course of education and history. The European Union introduced its AI Act in October 2023. The Act which prohibits the use of AI that poses unacceptable risks. China has ruled that algorithms must be reviewed in advance by the State and "should adhere to the core Socialist views". The U.S. has yet to propose a regulated structure, while Canada initiated a code of ethics in September 2023, whereby Canadian companies must demonstrate that they are developing and using generative AI systems responsibly until formal regulations are in effect. Is technology evolving faster than humans can adapt and regulate?

The most advanced and powerful microchips will enable supercomputers to compile all the data stored in data centers at unimaginable speeds and will provide more accurate results or solutions. While this perception seems to be obvious to many, the issue may lie in the sources of energy and power needed to propel all these data centers. In a recent Washington Post article, it was suggested that alone, a single data center will consume the energy equivalent of a town of 80,000 inhabitants. In order to meet the exponential demand from AI in the near future, permits for new data centers are being issued every 3 days – that's over 100 per year, and they take two years to build. If my math is correct, we will be building centers requiring the equivalent in energy of a new city of 8 million people per year, for years to come...! Where will this power come from? Is the technology getting ahead of energy sources? Perhaps those who will supply the energy will have the power...

2) Capital spending (Corporate and government)

The theme "Climate Change" is contributing significantly to a spending push across the globe. From the way we manage our garbage to the way we power our tools and vehicles – all require major investments. Electrification and its source are but one example of significant infrastructure changes that commands huge capital. Both the U.S. and Canada have committed extensive funds to help finance and subsidize major infrastructure projects that will contribute to the fight against climate changes. This should boost economic growth notably in North America in the coming years.

3) Consumer spending

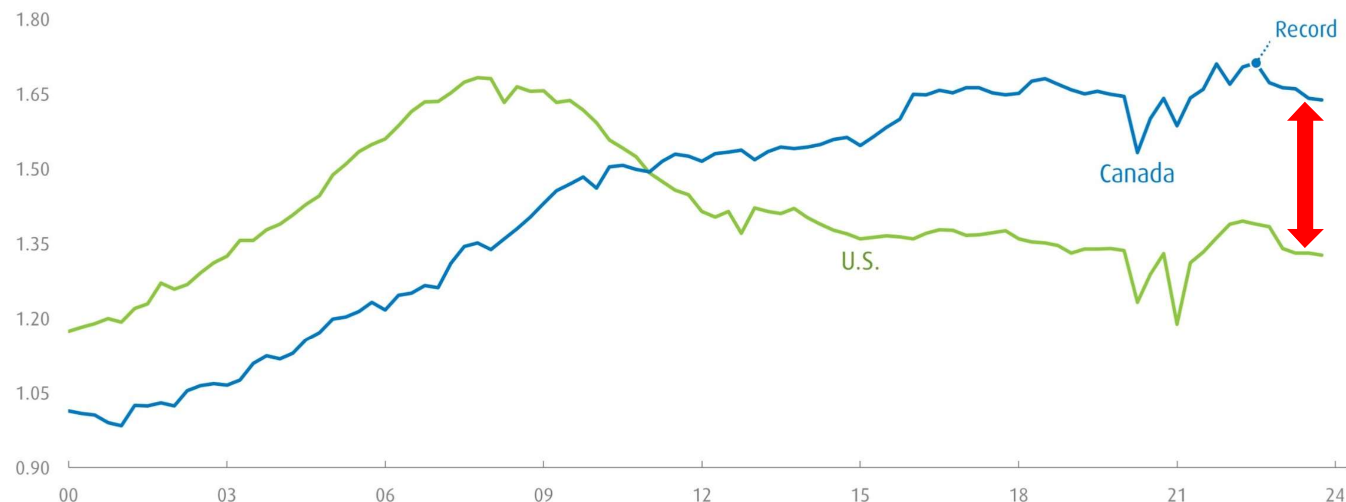
In our last newsletter, we talked about consumer resilience that is more evident in the U.S. given their lower level of indebtedness (Chart 3) Debt/$ of Rev.

Chart 3

Household debt

(ratio to personal disposable income)

Household debt[1]



[1] Households, nonprofits and unincorporated businesses

Sources: BMO Economics • Haver Analytics

Although we have seen signs of easing in consumer spending, it is believed to be for a relatively short period, assuming inflation slows further, and interest rates start their new downward trend. We have also witnessed a rise in unemployment and a slowdown in job vacancies. Charts 4-5. This bodes well for a soft landing of economic activity, empowering central bankers to initiate interest-rate cuts, as long as this softness continues.

Chart 4

Chart 5

Sources: BMO Economics • Haver Analytics

4) Earnings Growth

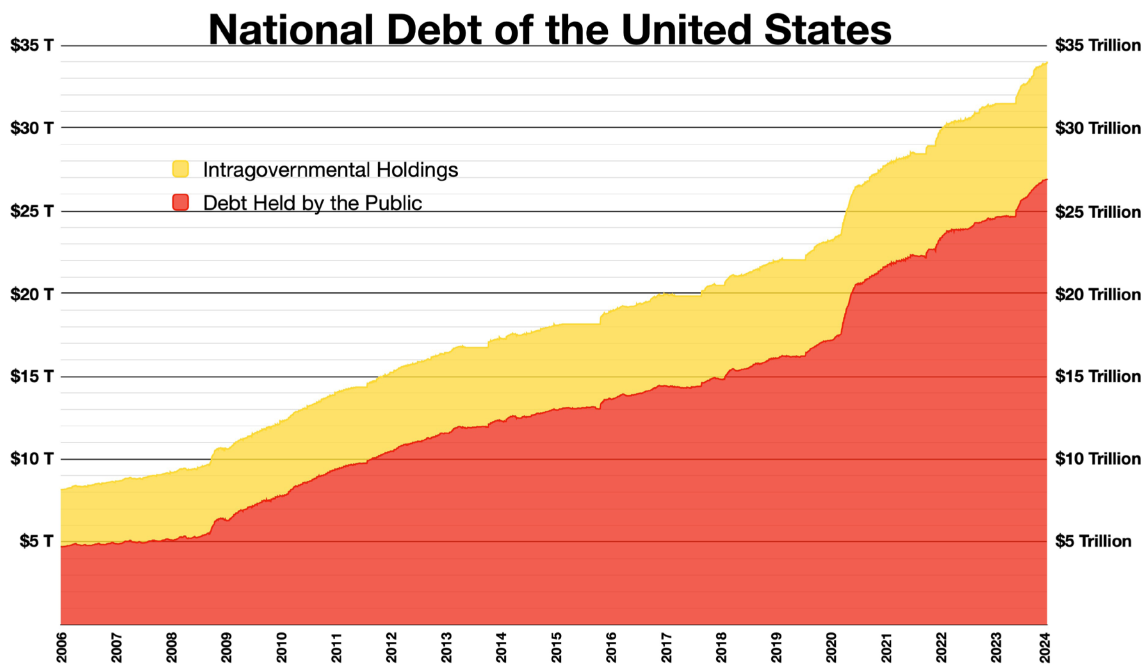
Corporate costs were significantly challenged during the pandemic. Transportation costs multiplied by five, a broken supply chain and raw materials scarcity drove up prices, lack of manpower pushed salaries up, and the cost of debt rose. Many of these pressures have retreated, yet the price of goods not only remains high, but it continues to increase, albeit at a slower pace. Corporate profit margins are benefiting from that, and that explains why stocks have such a great record of offsetting inflation over time! With unemployment edging higher, combined with the advancement in technology, wage pressures should ease moving forward. Debt remains the key element. While the cost of debt should come down somewhat, it is the sheer size of debt that can destroy a company, even though it has all the growth potential one could want. History has seen some of the greatest companies fall under the weight of debt, defying gravity as greed took over the rational (more on debt later).

5) Monetary and fiscal policies

Speaking of defying gravity, both central bankers and politicians seem fearless. Either central banks print more money or governments borrow to pay the interest on their debt!?! How does that work? Perhaps the fact that gold and Bitcoins are at new all-time highs is indicative of something. Are fiat currencies losing their “legal tender” status? There are small countries in South Africa and South America for example, with worthless currencies and where chaos has taken over.

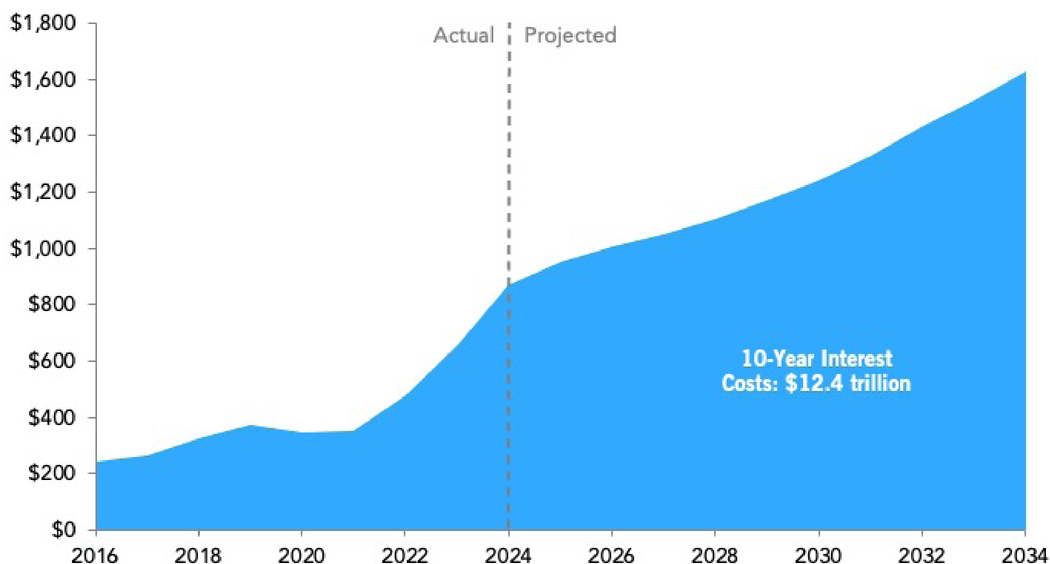
According to the Congressional Budget Office (CBO), the level of U.S. debt will evenly match the highest post World War II level as a percentage of GDP (gross domestic product) in 2025 at 3.2% (recorded in 1991). That ratio is forecasted to reach 3.9% by 2034 according to the CBO. Chart 6 shows the rise of U.S. total debt and Chart 7, the related interest costs alone on that $34 trillion current U.S. total debt.

Chart 6



Sources: National debt of the United States - Wikipedia

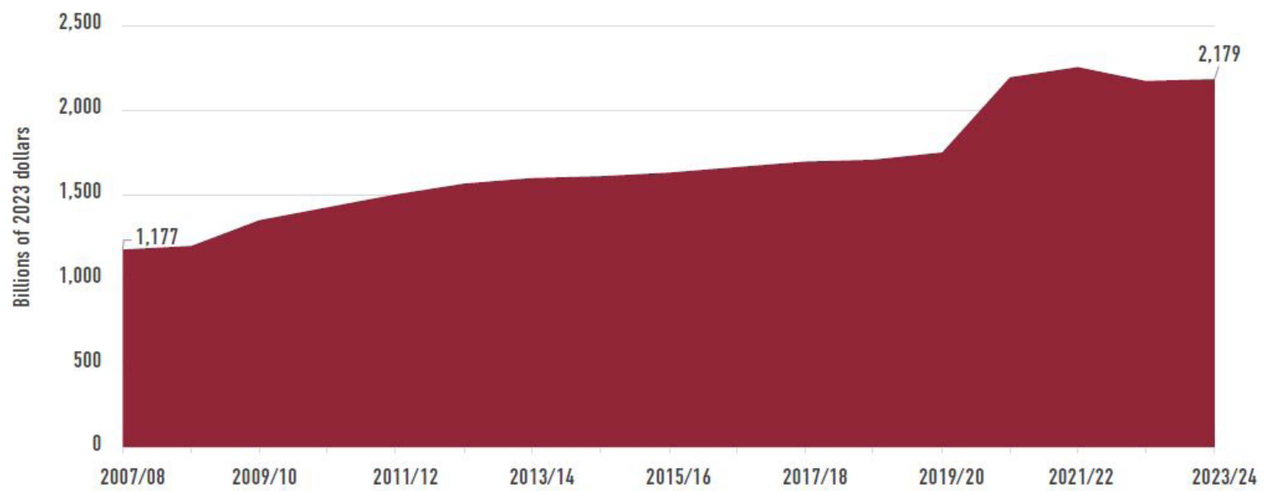
Chart 7



According to the Fraser Institute, Canada isn't faring any better. Including provinces, Canada is expected to spend $81.8 billion on interest payments alone in 2023/24. As shown in chart 8, Canada's total provincial and federal debt in Canada has increased from $1.1 trillion in 2008 to $2.1 trillion in 2023 (therefore the cost of borrowing at roughly 4%).

Chart 8

Figure 1: Combined Federal and Provincial Net Debt (in billions of 2023 dollars), 2007/08 to 2023/24



Notes:

(i) Debt levels for 2023/24 are based on the latest government projections available at the time of writing.

(ii) Net debt is presented on a consolidated basis in each province.

Sources:

Bank of Canada (2023); Canada, Department of Finance (2023a; 2023b); Alberta, Ministry of Finance (2023); British Columbia, Ministry of Finance (2023b); Saskatchewan, Ministry of Finance (2023); Manitoba, Ministry of Finance (2023a; 2023b); Ontario, Ministry of Finance (2023); Québec, Ministère des Finances (2023); Newfoundland & Labrador, Department of Finance (2023a; 2023b); New Brunswick, Department of Finance (2023); Nova Scotia, Department of Finance (2023a; 2023b); Prince Edward Island, Department of Finance (2023a; 2023b); Statistics Canada (2023c).

In other words, it took 140 years after the creation of Canada's confederation in 1867 to accumulate $1.1 trillion in debt, while it took 16 years since 2008 to double it! Thanks to near 0% interest rates! *AYE YAI YAI!*

Meanwhile, the Organization for Economic Cooperation and Development (OECD), which counts 38 member countries worldwide, recently reported similar red flags. Within the OECD region, the government's debt to GDP ratio reached 83%, up from 53% at the time of the 2008 financial crisis. The OECD government bond debt will grow by another $2 trillion this year to reach $56 trillion (including the U.S.'s $34 trillion), up from $30 trillion in 2008 ($17 trillion in the U.S. in 2008). In addition, as part of their quantitative tightening, central banks are now reducing their bond holdings. That means that the supply of bonds will reach record levels, the OECD report states. Who will buy all those bonds, and at what interest rates? Adding to those financing pressures, notably in emerging countries, a substantial share of this debt will be maturing in the next three years, according to the OECD report.

Those trends are reflected in corporations as well. The lowest grade of the so-called "investment-grade bond" is BBB. At the end of 2023, over half (53%) of all the investment-grade corporate bonds of non-financial companies were in the lowest category (BBB). That is more than double where their share stood in 2000. The highly leveraged share of issuers (below BBB rating) went from 11% in 2008 to 42% in 2023. Quality bonds are becoming a scarce commodity or quality needs to be redefined!

Investment Strategy

Debt management remains a key element and a preoccupation for investors and portfolio management. Our role is not to speculate your hard-earned savings. Preserving your capital remains our priority. By the same token we need to participate in innovation that is bound to transform our future. There are similarities between today's AI's implementation and the mid-nineties. Back then, it was the introduction of PCs and laptops, wireless communications and Internet access that drove productivity to new highs.

Similar productivity gains today are necessary to reduce costs, generate more revenue, enhance profit margins, and reduce debt. The win/win combination happens when corporations make more money, and proportionally increase their tax contribution to governments. The expected outcome from our governments would be to cut their non-productive spending habits and pay down debt... *AYE, YAI YAI!* (God help us with that!)

Corporations have been more disciplined in the past six months, as shown in the jobless claims. The restructuring through attrition, together with the introduction of AI tools, bodes well for profit margins in the future. Certain sectors have been more active than others using this strategy, including the financial and communications industries, as well as in health care and technology sectors. In addition, the first two are also interest-sensitive and we would maintain a slightly overweight position.

Canadian banks diversified in the U.S. are favoured over others, but at this juncture, we prefer RBC for its size and depth. Insurers are in a better position than they have been in the last 10 years, taking advantage of higher interest rates. Manulife has substantially reduced its exposure to the long-term care business, which has been dragging their results. Look for continuous improvement on the bottom line going forward.

Stocks such as BCE, Telus and Rogers continue to offer attractive dividend income and should rebound nicely once the cost of cutting jobs is all absorbed in 2025. The latter two sectors, health care and technology are more U.S.-based, but are well accessible in Canadian dollars through our Canadian Depositary Receipts (CDRs). While Pfizer hit rock bottom late last year, it made the very significant acquisition of Seagen in December 2023 for $43 billion. Seagen, a cancer treatment specialized biotech company, will complement well Pfizer's oncology portfolio. Eli Lilly and Company and Novo Nordisk are the leaders of "obesity" drugs which have penetrated a mere 1% of the market. Their potential is huge, and the evolution of their drugs will only get better over time.

In Technology, the key is obviously AI, but also cybersecurity, which will be continuously challenged with the evolution of AI. Here, we continue to believe in Microsoft and Google with their leading AI positions, but we also like the leading Canadian cybersecurity company, OpenText, which is in the midst of transforming itself. We are currently expanding our knowledge in this space with Palo Alto Networks and CrowdStrike Holdings as potential buys.

We also believe that transport companies, such as Canadian Pacific (CP), as well as engineering firms WSP Global and Stantec will continue to benefit from major infrastructure developments which will continue for many more years to come in the industrial sector. The utilities sector is wiping off a very bad year, victim of the huge increase in interest rates and climate change. While the need for electricity is growing exponentially, many of these companies were ill prepared to finance this huge increase in demand at these much higher interest rates. Many companies in this sector are down some 30% to 50% from their highs. With interest rates at their peak, those with the better balance sheets will prevail and benefit from this great opportunity. Here we like Northland Power, Hydro One and Brookfield Infrastructure, as well as Emera for stability.

A change in government in the U.S. this fall could have a notable impact on the energy sector overall. It could cause a delay in the energy transition, encourage mergers and acquisitions, and lead to the rebuilding U.S.'s strategic reserves and the export of more LNG (liquid natural gas) which is desperate for more pipelines...

The real estate sector is suffering from higher interest rates and as we advance deeper in 2024 and 2025, we should see some realignment of valuations and therefore find ourselves in a better position to increase weighting or not. We remain underweight in this sector for now.

Consumer staples have nothing spicy to offer and therefore can't burn you too much... We have been taking some profits in this sector as we rebalance portfolios and remain market weight.

Last but not least, materials which include gold. While gold reached a new all-time high on March 8, 2024, at $2,195.00, it is a far cry from the Bitcoin, which jumped from $25,000 last September to over $73,000 six months later. Does that signal a note of confidence? The latest Bitcoin rally started at the introduction of regulated Bitcoin ETFs in February, from $42,000. This investment instrument (ETF) makes this speculative digital currency available to all. This new accessible way to own fractions of Bitcoin drove up the demand and its price. The only "tangible" currency acceptable in the world remains gold. Gold, however, seems to have become a victim of its greatest advantage i.e., it is tangible, but you cannot deploy it quickly or efficiently. The Bitcoin comes with this technology, able to settle transactions and payments electronically and efficiently. As I've written before, cryptocurrency is here to stay, but what becomes of a central bank if it can no longer control money flows? How will monetary policy work? Who will control the financial system? In my mind, cryptocurrencies must stay within the boundaries of control of the currently accepted and tested monetary system. Better the devil you know than the devil you don't know.

Perhaps the new gold could be found in the transportation of the desperately needed energy (electricity) to propel the data centers of the future i.e., copper... AI, AI, AI...

Conclusion

There is a perception out there that the only way out of this huge debt is by strong economic growth. This is where the danger lies i.e., how to contain inflation in this kind of growth-dependent environment? Tax increases can be another solution, but it comes at the detriment of growth, which could be counterintuitive. There are fiscal policies that ministers, statesman and stateswoman could introduce that could greatly improve the balance sheet of North American countries and others, but some of those measures might be unpopular and may highlight their past abuse and their lack of accountability. The U.S. election race says a lot about the trust Americans have in their politicians - *AYE, YAI YAI!*.

Meanwhile, Americans do have technology in their favor, and should they take full advantage of it, like they historically have done, they could undertake reducing that debt burden by better targeting government spending with an increased focus on investments in areas that drive productivity and sustainable growth. Perhaps the solution can be found in our capacity of efficiently and effectively implementing and integrating the use of AI in all areas of operations, from consumers to suppliers, from corporations to governments. AI, AI, AI!

Recommended Sector Weighting - April 2024

Geographics	Sectors	Income Oriented Portfolio	Growth Oriented Portfolio	Rational
North-American Equities	Communication Services	5.00%	6.00%	Canadian telecoms remain excessively oversold. They are our favourite yield play based on dividend growth history. Use current weakness to add to your positions to reach recommended weight.
	Consumer Discretionary	2.50%	6.00%	Stick with sector leaders and well managed companies.
	Consumer Staples	5.00%	5.25%	Easing inflationary pressure in 2024 will likely be a key headwind within an already expensive sector.
	Energy	7.00%	8.00%	Fundamentally sound = deep value, strong cash generation; possible oil price weakness provides resistance. Stay with vertically integrated names and pipelines, presenting a Growth at a Reasonable Price (GARP) opportunity.
	Financials	14.50%	18.00%	Pessimism is at historic extremes. Currently one of the best value proposition. Steadfastly maintaining holdings, especially those with large US platforms.
	Healthcare	4.00%	5.25%	COVID-19 overhang hurting pharma; focus on value names with steady cash flow, dividends and stable earnings
	Industrials	8.00%	8.25%	Earnings have struggled to meet expectations year to date. Stock valuations are slowly becoming more attractive. Focus on railways and select manufacturers – especially those leveraged to the U.S. Infrastructure stocks should continue to outperform.
	Information Technology	6.50%	10.50%	Technology = Innovation = Long-term Growth - Not just about the "Magnificent Seven" – The A.I megatrend is still a key but cybersecurity will evolve proportionnaly. Higher importance of sharpened selectivity and scrutiny while selecting names in the space.
	Materials	4.50%	3.75%	Our focus is on gold and base metals. We appreciate companies with strong operating efficiency and cash flow generation. Gold represents an attractive hedge against the market and the financial sector in the long term.
	Real Estate	2.00%	2.00%	Good hedge against inflation over the long-term. Leverage is a double-edged sword. In contrast to the Great Recession of 2008-2009, residential real estate is in better shape. Commercial real estate is now the major worry, given the excessive amount of loans to be refinanced at much higher rates over the next year.
	Utilities	6.00%	2.00%	Very oversold, multiples have come back to reality. Focus on free cash flow to provide for growing demand and finance future growth opportunities.
Other	International Equities (EAFE)	0.00%	0.00%	Geopolitical instability and currency risks make international markets less attractive to us. (EAFE - Europe, Asia, Far East)
Total Equities		**65.00%**	**75.00%**	**Average equity weighting**

The suggested weightings for an income-oriented portfolio and a growth-oriented portfolio are appropriate for portfolios comprised of 65% and 75% equities respectively. They should be adjusted based on your investor profile.

Sources:

- Advisor.ca
- Bloomberg
- BMO Capital Markets Equity Research Reports
- BMO Capital Markets North American outlook
- BMO Financial Group Economic Outlook
- BMO Nesbit Burns Part Team, portfolio advisory team
- BMO NB Canadian Equities Guided Portfolio – March 2024
- BMO NB US Equities Guided Portfolio – March 2024
- BMO NB North American Equities Guided Portfolio – March 2024
- BNN
- CIBC Asset Management
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- FACSET
- Fraser Institute
- Globe and Mail
- Goldman Sachs
- Havard Business Review
- JP Morgan
- OECD.org
- Seeking Alpha
- TD Asset Management
- Templeton
- The High Tech Strategist
- The Wall Street Journal
- Trahan Macro Research
- U.S. Bureau of Economic Analysis (BEA)
- World Economic Forum

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Reference Portfolio Return

$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0

Dec '90 Dec '91 Dec '92 Dec '93 Dec '94 Dec '95 Dec '96 Dec '97 Dec '98 Dec '99 Dec '00 Dec '01 Dec '02 Dec '03 Dec '04 Dec '05 Dec '06 Dec '07 Dec '08 Dec '09 Dec '10 Dec '11 Dec '12 Dec '13 Dec '14 Dec '15 Dec '16 Dec '17 Dec '18 Dec '19 Dec '20 Dec '21 Dec '22 Dec '23

Ref Portfolio
S&P TSX*
S&P TSX**
T-Bills

Value as of
March 31, 2024
$ 5,111,720

Average
Return
12.30 %

$100,000 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

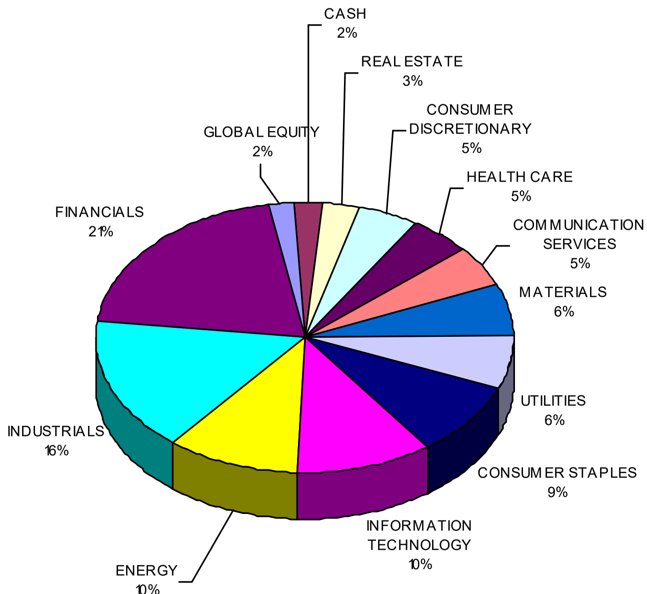
***Does not include income or div*

*****Includes income and div***

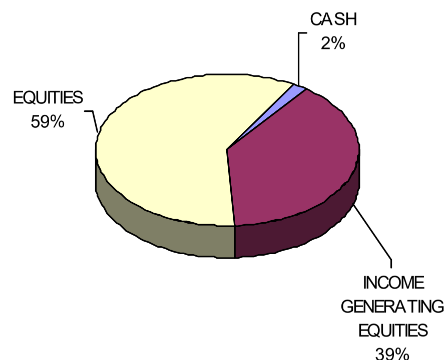
BMO Private Wealth

March 2024

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

Private Wealth

Performance - T-Bills vs SP TSX vs Reference Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	Portfolio(return)
1990	13.20%	-17.96%	-14.80%	**5.94%**
1991	9.35%	7.85%	12.02%	**22.14%**
1992	6.67%	-4.61%	-1.43%	**10.50%**
1993	4.68%	28.98%	32.55%	**34.91%**
1994	5.19%	-2.50%	-0.18%	**6.09%**
1995	6.42%	11.86%	14.53%	**8.09%**
1996	3.93%	25.74%	28.35%	**16.21%**
1997	2.85%	13.03%	14.98%	**21.05%**
1998	4.56%	-3.19%	-1.58%	**1.87%**
1999	4.67%	29.72%	31.71%	**19.96%**
2000	5.23%	6.18%	7.41%	**30.40%**
2001	3.73%	-13.94%	-12.57%	**9.54%**
2002	1.75%	-13.97%	-12.44%	**3.61%**
2003	2.22%	24.29%	26.72%	**22.23%**
2004	1.84%	12.48%	14.48%	**13.87%**
2005	2.53%	21.91%	24.13%	**15.73%**
2006	3.52%	14.51%	17.26%	**14.30%**
2007	3.59%	7.16%	9.83%	**8.06%**
2008	1.50%	-35.03%	-33.00%	**-28.07%**
2009	0.29%	30.69%	35.05%	**29.37%**
2010	0.60%	14.45%	17.61%	**21.05%**
2011	0.92%	-11.07%	-8.71%	**4.18%**
2012	0.97%	4.00%	7.19%	**7.38%**
2013	0.97%	9.55%	12.99%	**18.14%**
2014	0.92%	7.42%	10.55%	**16.43%**
2015	0.50%	-11.09%	-8.32%	**6.36%**
2016	0.50%	17.51%	21.08%	**16.75%**
2017	0.71%	6.03%	9.10%	**13.26%**
2018	1.40%	-11.64%	-8.89%	**-3.26%**
2019	1.67%	19.13%	22.88%	**26.19%**
2020	0.39%	2.17%	5.60%	**8.38%**
2021	0.13%	21.74%	25.09%	**28.72%**
2022	2.35%	-8.66%	-5.84%	**-6.94%**
2023	4.88%	8.12%	11.75%	**12.64%**
*2024	1.26%	5.48%	6.62%	**7.30%**
Return Compounded as of December 31, 2022				
3 years	2.43%	6.33%	9.59%	10.50%
5 years	1.87%	7.91%	11.30%	13.03%
10 years	1.34%	4.40%	7.62%	11.32%
***Average return since inception (YTD) ……………………………………..**				**12.30%**

* (YTD): Year To Date (March 31st, 2024)
$100,000 invested on June 1st, 1990
1: Does not include income or dividend
2: Includes income and dividend

The returns are compounded monthly and revenues are reinvested.

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