The new standard in
personalized asset management.

MDL Group

BMO Nesbitt Burns

35th Anniversary

October 2023 - Excerpt # 70

Resilience vs. Recession

BMO Private Wealth

MDL Group

Table of contents

The Economy and Review of the Markets

- Pierre’s comments 4
- Investment strategy 13

Recommended Sector Weightings (Table) 14

Reference Portfolio Graph and Pie Charts 16

Historical Performance Tables and Benchmark 18

Pierre's comments

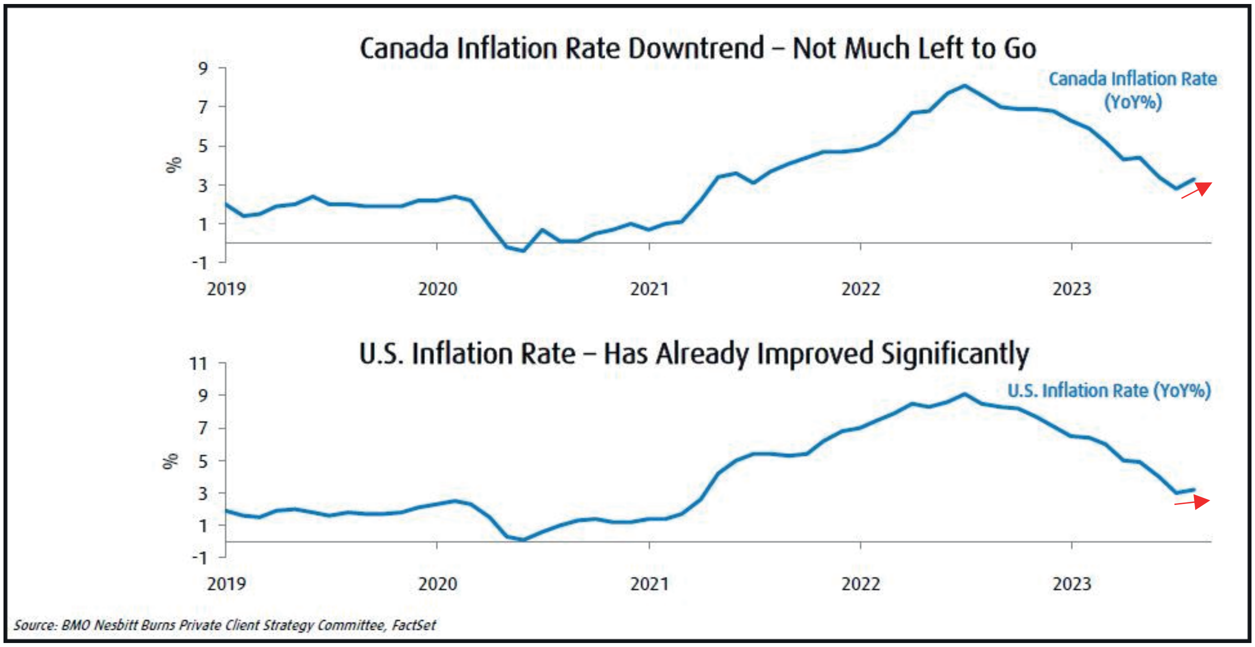
Resilience vs. Recession

Back in March 2023, in newsletter #69, we called for prudence in view of rising interest rates, inflationary pressures and slowing earnings estimates. We stated then that higher unemployment would help drive inflation lower, as slowing demand would stifle pricing power. We were expecting interest rates to rise further in order to regain control over inflation, but that would not happen without having a negative impact on economic growth. Thus, the situation called for cautiousness without being underweight in equities, since equities are the best asset class to offset inflationary pressures over time. Our position was to maintain the target equity exposure respecting individual client investment objectives, without being either over or underweight. It turned out that equity indexes performed better than expected, although interest rates continued to rise, given better than expected corporate earnings. However, expected corporate earnings had been readjusted on the downside twice since the beginning of the year based on the anticipated economic slowdown. The resulting market resiliency is therefore based on lower expected corporate earnings and on the excess cash still in circulation following the extremely accommodative monetary and fiscal policies during the pandemic. Subsequent to the pandemic, government, corporate and personal debt levels skyrocketed, driving markets in the short-term. This also drove inflation and interest rates. The reality of having to pay the accruing interest on that debt is now catching up with everyone. But why is the market so **resilient**?

1) There is still a lot of free money around (over $6 Trillion in money market funds)
2) Labor shortages have delayed layoffs
3) Working from home has freed up more time for consumers
4) The delay in an economic slowdown has strengthened the belief in a soft landing
5) The U.S. remains the best investment choice in the world
6) Recession worries fade over time
7) Inflation is slowing
8) The gap between job openings and unemployment is still positive, although narrowing
9) Unemployment remains stubbornly low despite the rise in interest rates and the economic slowdown
10) Consumption remains strong especially in the US

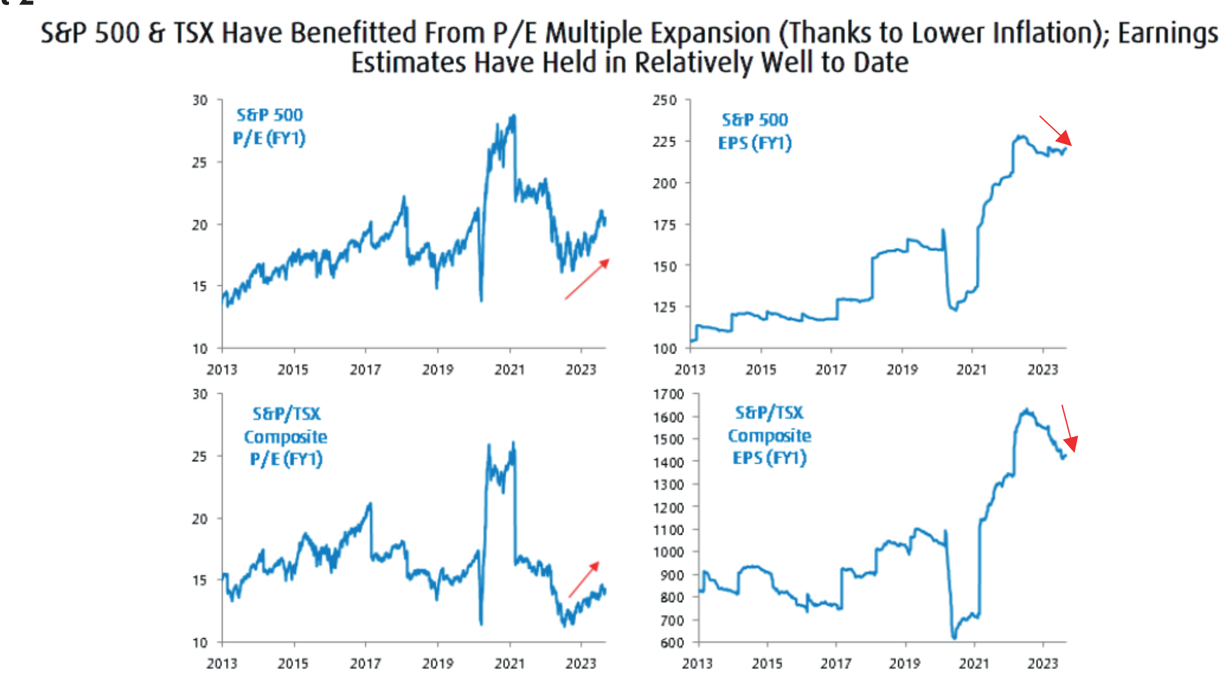
Looking ahead, can we justify the extension of this market resiliency? Can some of these resilient arguments be challenged? Have we been misled by the equity market performance? Will inflation continue to fall? (see **Chart 1**)

Chart 1



Today, as I write this newsletter, (Sep 8th, 2023) seven stocks - Nvidia, Apple, Alphabet, Microsoft, Tesla, Amazon and Meta – are responsible for no less than 73% of the S&P 500's year-to-date performance. Now flip that around. Take out the "Magnificent Seven" and the 493 remaining names on the S&P 500 are responsible for 27% of its year-to-date performance, putting its performance in the 4% to 5% range, similar to the TSX. These levels of performance are consistent with a slowing but still growing economy. The market doesn't seem to be discounting a recession at all, and believes interest rates will drop sometime midway next year. I would say the market is priced to "perfection", leaving little room for surprises at near 19 times next year's earnings. (see **Chart 2**)

Chart 2



Now let's have a look at **recession risks**:

1) U.S. budget turmoil and risk of a government shutdown in mid November

2) Record commercial real estate debt (CRE) refinancing next year

3) Stubborn inflation moving forward

4) Wage inflation and unionized labor strikes (sticky inflation)

5) Risk of one or two additional interest rate hikes

6) Mortgage rates around 7% in the U.S. and over 6% in Canada

7) Consumer momentum showing signs of fatigue especially in Canada

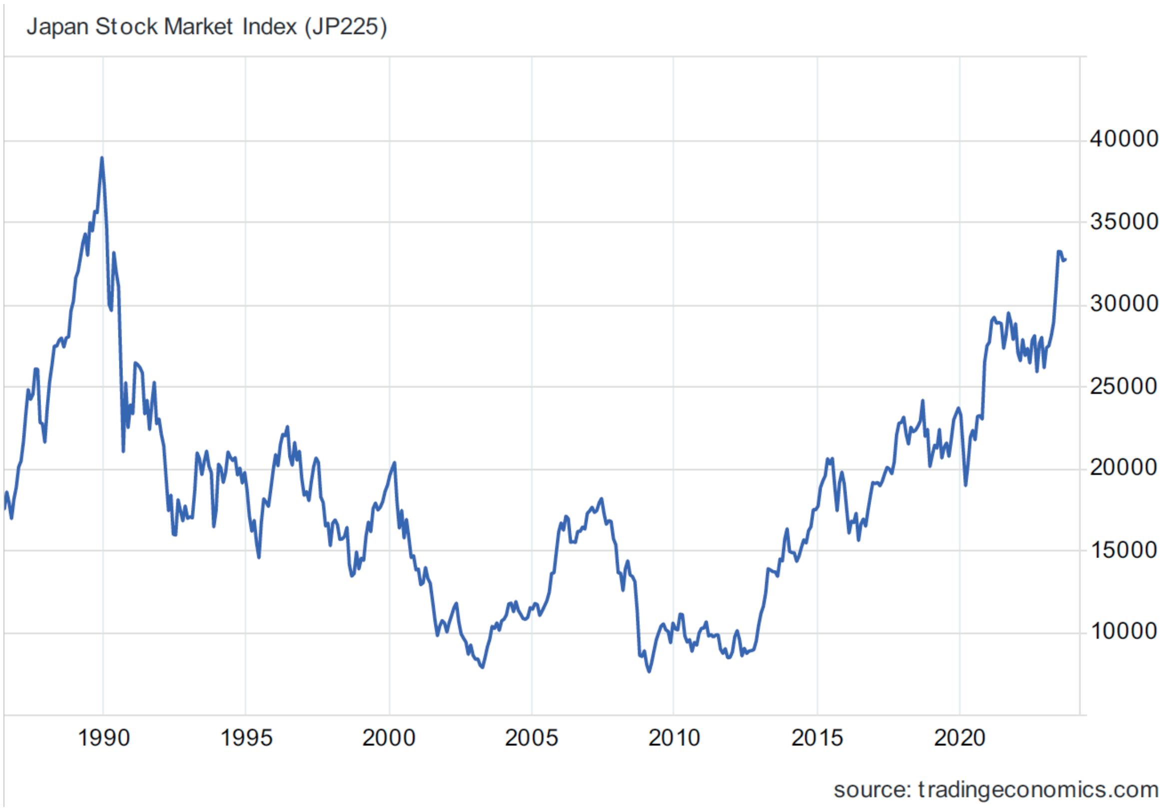
8) Higher unemployment would help counter labor shortages and wage inflation

9) Energy prices pressuring inflation over the short-term

Basically, no big surprises on this list. Although these risks are known, the market has yet to quantify them! As they evolve – maybe positively, maybe negatively – the market will adjust to them accordingly. Given the current market valuation, we feel that very little negative impact is discounted. This is our rational for remaining prudent. However, realizing that there is very little room left for interest rates to rise without squashing the whole economy, we feel market corrections are to be used as buying opportunities to enhance your equity exposure at more attractive entry points. Meanwhile, your cash contributes to your portfolio performance for the first time in 15 years, at a rate of 5% plus. Let's take time to analyze some of those risks that could crush market resilience.

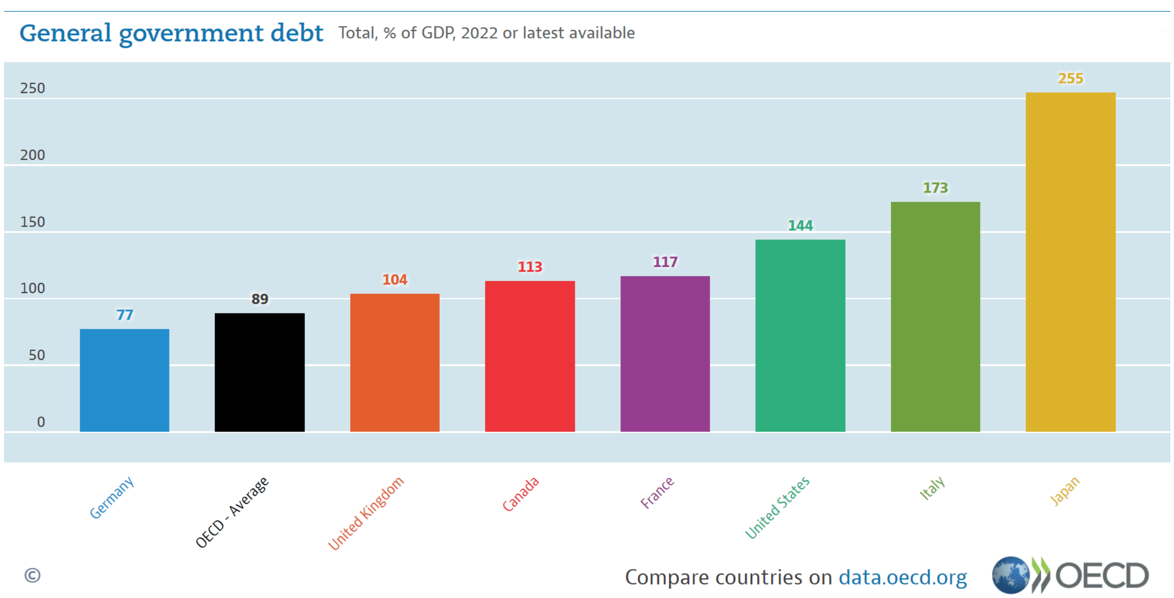
1) In the U.S., the Congressional Budget Office projects a $1.7 trillion deficit for the current year, adding to the country's $32 trillion debt. Consequent to the sharp rise in interest rates, the interest payment alone has risen to $149 billion, approaching what the U.S. spends on national defence annually. This exponential growth in debt means less capital is left for economic growth. The reality of printing money to solve short-term destabilization has its drawbacks, i.e., inflation. Given the cure to control runaway inflation is to raise interest rates, we find ourselves in a Catch-22 situation with rising debt costs. Have we passed the point of no return? Japan's economic bubble burst in October 1989, after amassing excessive debt for decades. (see **Chart 3** – 35 yrs. Nikkei Dow)

Chart 3



The Nikkei Dow collapsed from its 1989 peak of 39,500 to a low of 8,500 13 years later, with an intermediate high of 23,000 in July 1991. Today, the index stands at the 33,000 level, still below its peak of 1989, 34 years ago. Borrowing their way out of trouble led to very low economic growth over the next three decades, and a debt-to-GDP ratio among the highest in the world at 255%, according to the Organisation for Economic Co-operation and Development (OECD). The U.S. debt-to-GDP ratio is at a much lower level, standing at 144% of the country's GDP, but growing exponentially. (see **Chart 4** - debt/GDP – G7 Countries) The total Canadian debt in relation to its GDP is 113% if we include the debt of the provinces and exclude the pension funds.

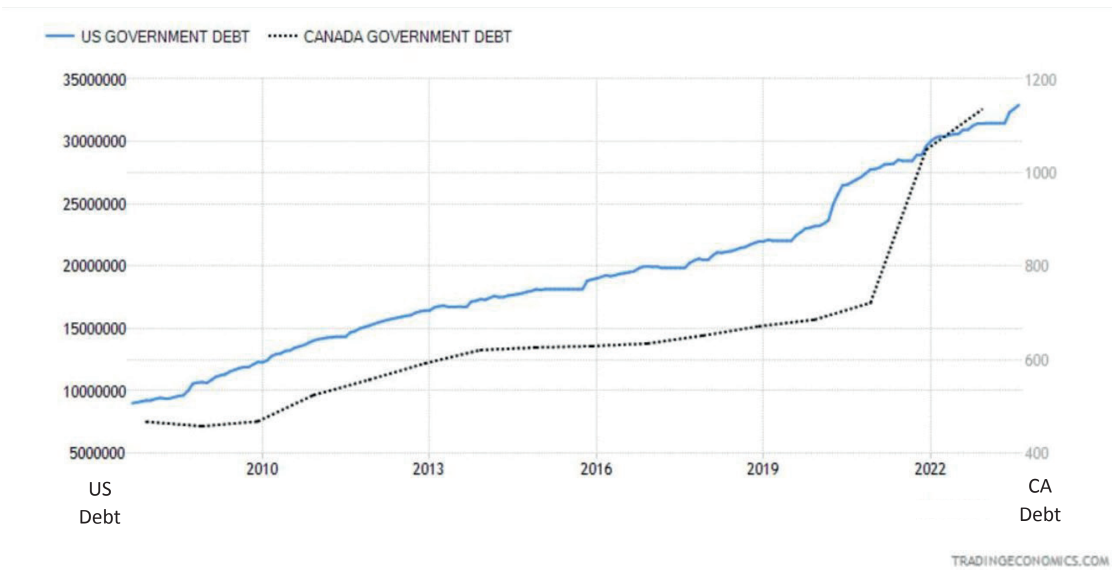
Chart 4



Back in my university days, as a student in the '70s, a nation's debt-to-GDP ratio surpassing 50% was past the point of no return. Interest rates were in the high teens back then, which is self-explanatory. But in 13 of the past 15 years, interest rates have been hovering around 0%, thanks to the financial crisis of 2008 and the pandemic of 2020. Over that relatively short period, the debt of both Canada and the U.S. has doubled, respectively. (see **Chart 5** U.S. National Debt vs CDA)

Chart 5

US vs Canada Government debt



When debt costs nothing thanks to a 0% interest rate, one can have an infinite amount of debt. Ah, but when interest rates rise, too much of a good thing can become overwhelming. The point of no return is when you can no longer pay back even a small portion of capital. And at this point, most G7 countries are borrowing to pay the interest on their debt...!

Since the U.S. is the world's biggest economy and carries the world's international currency status, it remains, shall we say, the best of the worse. The world wants U.S. dollars, and U.S. bonds pay 4% - 5%... so the U.S. dollar (DXY) is up substantially vs basket of currencies since the month of July. (see **Chart 6**)

Chart 6

It should also be noted that in the presence of geopolitical tensions, the U.S. dollar is perceived to be the "safe haven" currency. But that doesn't mean the country is immune to fiscal mismanagement…

2) Record commercial real estate debt refinancing (CRE) in the U.S. is estimated at near $1.5 trillion, according to the Mortgage Bankers Association. The office segment of the real estate debt market is the most vulnerable currently, given extremely low occupancy rates.

TABLE 1

CITY OFFICE OCCUPANCY RATE

Austin	57.6%
Chicago	50.6%
Los Angeles	47.8%
New York	42.5%
San Francisco	40%
Philadelphia	38.5%

Source: Kastle Systems

Many of these buildings have suffered a significant drop in valuations based on much lower revenues, and now loans must be refinanced at much higher interest rates. In fact, similar to the residential real estate crisis of 2008, many of the current valuations are lower than the outstanding debt… As the saying goes, "Houston, we have a problem".

Therefore, those who will put up the capital to avoid bankruptcy will considerably soften their bids to justify the new reality. According to Green Street Real Estate Data, the average office building valuation is down 27%, while apartment buildings and malls are down 21% and 18%, respectively, since March 2022. Obviously, these valuations vary widely depending on the location. San Francisco is among the hardest hit cities, and it has seen major institutional owners starting to default on loans on their downtown, mostly empty, skyscrapers. Although it is true that this situation could be perceived as an investment opportunity, one will need to put down a large amount of cash to minimize the cost of high mortgage rates, and trust people will be returning to the office full time sometime soon. Furthermore, according to a JP Morgan Private Bank report published back in April 2023, small regional banks held an average of 4.4 times more exposure to commercial real estate (CRE) loans than their larger peers. According to the Federal Reserve Bank of St. Louis, nearly 70% of all CRE loans are with community and regional banks. On average, CRE loans make up about 25% of total loans outstanding. But in the regional bank sector, nearly half of loans are CRE loans, and this makes them more vulnerable. The risk of contagion seems manageable, with a moderate devaluation of those CRE assets in the 10 to 15% range, explained the JP Morgan analyst. But a severely adverse and unexpected scenario of a 40% drop in CRE asset values could lead to a liquidity crunch in some banks, which could destabilize the system, according to JP Morgan, although this is not their base case scenario. Which brings me to risks 3,4,5 and 6.

3) Stubborn inflation

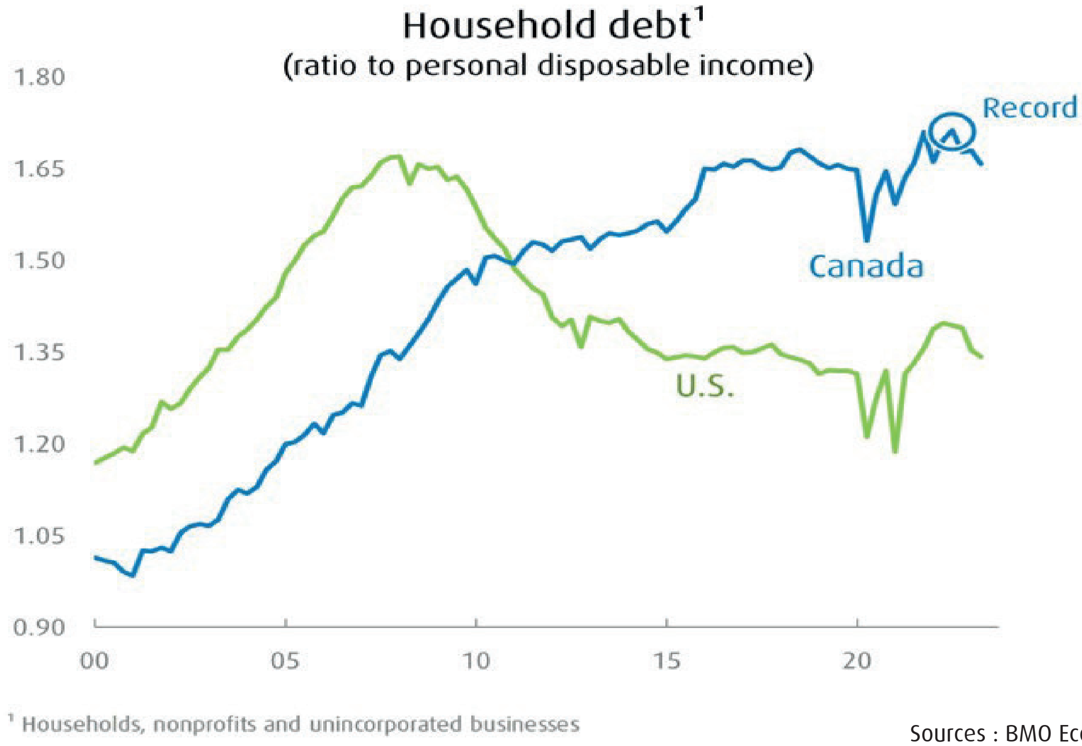
4) Wages inflation

5) Higher interest rates

6) Mortgage rates above 7% in U.S. and 6% in Canada

Stubborn inflation can be a consequence of geopolitical decisions or trends. Take, for instance, deglobalization – the desire to become more self-sufficient, to depend less on others. Perhaps deglobalization compares to the "protectionism" of the early 20th century. This behavioral change pressures our manufacturing, labor and energy sectors and more. These pressures are now embedded in our new higher costs. This movement could feed inflation for the foreseeable future and is very labor dependent. Since inflation reduces one's purchasing power, wages need to be adjusted. And what better time is there to rebalance salaries when there are labor shortages everywhere, right? Strikes have been widespread in 2023 and continue to be a major headache for employers. This leads to higher-than-expected settlements, the costs of which will be passed on to consumers and continue to pressure inflation. Wage inflation is sticky inflation, as salaries don't come back down. Historically, inflation comes in waves until the consumer rationalizes or chokes! Let say that higher indebted Canadians are closer to that point than their U.S. counterparts. (see **Chart 7**) That leaves more room for higher interest rates in the US, to successfully fight inflation, but it could also open the door to a worsening case scenario for the commercial real estate market and regional banks, as mortgages rates are already above 7% in the U.S.

Chart 7

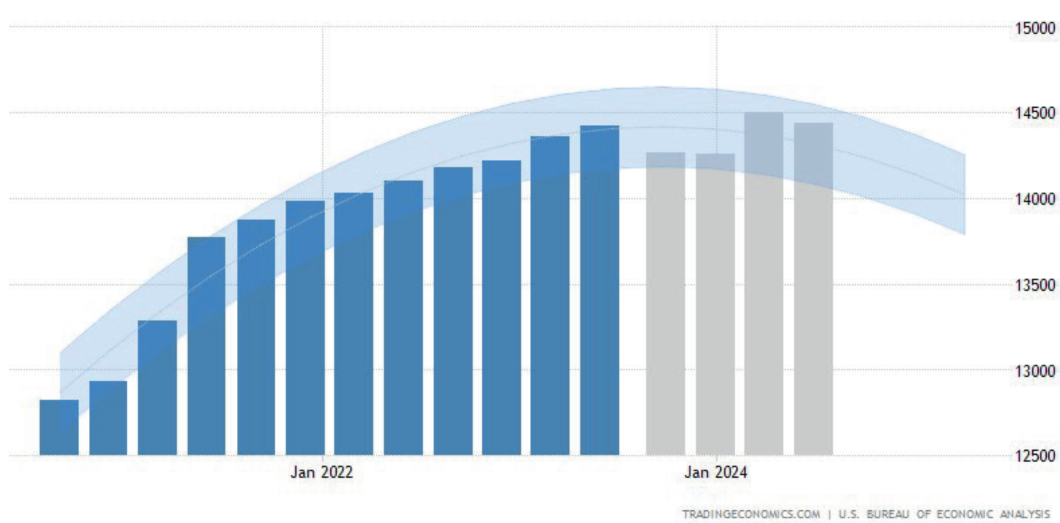


Sources : BMO Economics

7) Consumer momentum showing signs of fatigue. This is more obvious in Canada than in the U.S. Credit card delinquencies have ticked up slightly since June 2023. While this is not a major issue yet as we remain at historically low levels of credit card delinquencies, this new trend may prove to be an early indicator of consumer spending contraction in Canada. In the U.S., consumer spending remains strong, as personal debt levels are lower than that of Canadians (see previous **Chart 7**). Furthermore, in the U.S., you have the popular 30-year mortgages, and those have for the most part been refinanced in recent years at low cost, which provides more leverage power to U.S. consumers. (see **Chart 8** U.S. Consumption)

Chart 8

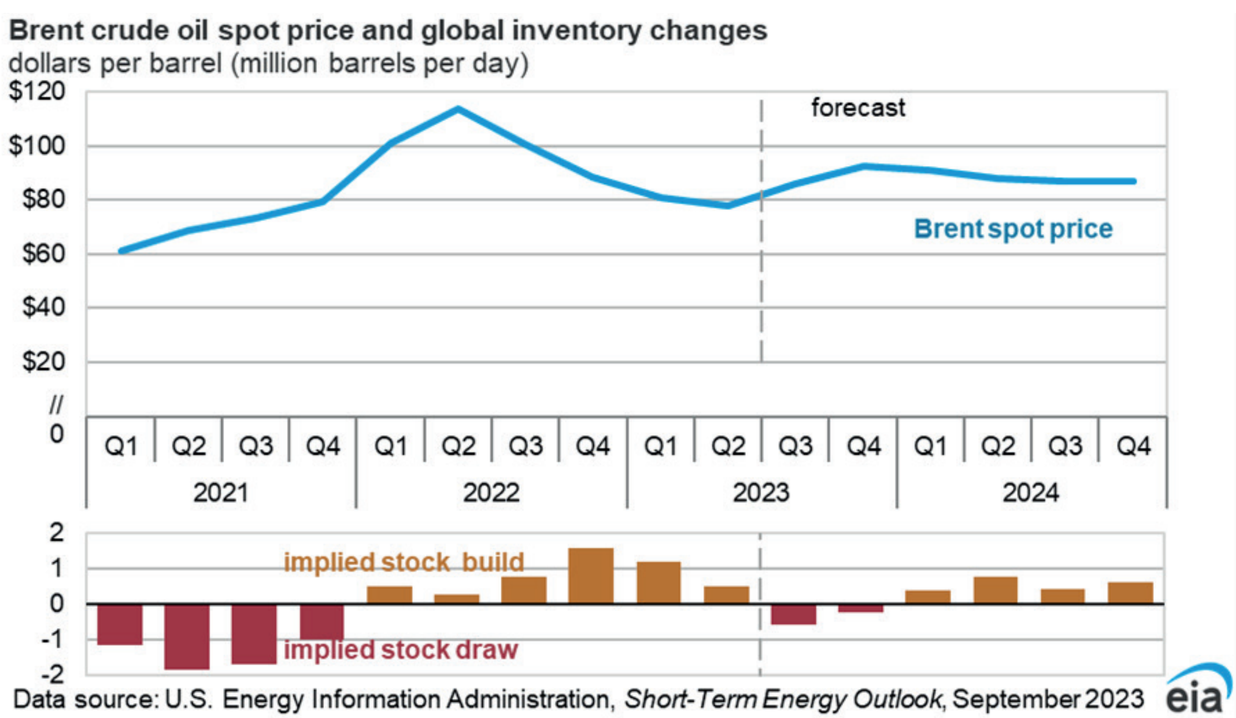
US Consumer Spending Forecast



8) Higher unemployment would ease labor shortages and wage inflation. Back in August 2022, Federal Reserve Board Chairman, Jerome Powell, categorically stated that the U.S. will not repeat the same mistakes as it did the '70s, when the Fed allowed inflation to run away with itself, with its much too accommodating policy. If he maintains his position on inflation, then the odds are on more rate hikes to come, especially given the very real wage pressures exerted by strong unions. Just this last summer in the U.S., the West Coast dock workers, UPS drivers and Airlines pilot unions won 30% to 40% pay increases, while the actors and writers' union has just been joined by United Auto Workers demanding huge pay increases to match their peers. This is why an economic slowdown has some benefits. The UAW strike could cause curtailments in production and force the obvious layoffs. Not reaching a settlement would mean longer strikes, causing economic slowdown. On the other hand, high and costly settlements could force the Fed to squeeze further by raising interest rates, causing an economic slowdown and, consequently, layoffs. Any delay in an economic contraction may make it more difficult for the Fed to fight inflation and could cause a harder fall later.

9) Energy prices pressuring inflation short-term. Currently, the two largest oil producers, Saudi Arabia and Russia, have extended voluntary oil cuts, putting pressure on oil prices worldwide. These initiatives have counter effects on Western economies that are trying to cut inflationary pressures. This puts President Biden, who is facing an election year in 2024, in a delicate position (see **Chart 9** Oil prices and supply / Demand ± 3 yrs). Higher oil prices not only add to growing costs for consumers, but they also help Russia finance its war against Ukraine. This situation could jeopardize the already unstable and shaky geopolitical environment worldwide. Let's hope for another warm winter in Europe...

Chart 9



INVESTMENT STRATEGY

After 16 months of a negative yield curve, the GDP has yet to see a single negative quarter in the U.S. The surprising underlying strength of this economy has been impressive, especially after getting hit by the largest and fastest rate hike in history. It takes a lot of cash to withstand these types of attacks... and boy did we print some!! That newly minted money has now turned into debt, and high interest rates can hurt badly. So, we need a slowdown. However, some of that "preprinted" money has yet to be invested or make its way through the system. That is the case for the US$1.3 trillion budget approved for its infrastructure program... and it is an election year next year. With this in mind, remember that some sectors may benefit more than others, even in a weakening economic environment. We would favor infrastructure, industrial related stocks, even interest-sensitive stocks (such as communications and utilities), as lower interest rates are expected in the second half of 2024.

Energy stocks are generally in a great financial position, with OPEC and Russia cutting supply, putting pressure on prices. Consumer staples and healthcare stocks offer stability and predictability to any portfolio. While I remain cautious with financial services stocks, I favor our industry leaders with strong management team, and have a slight preference for the insurance industry at this time.

Don't forget, it is a market of stocks not a stock market. Fundamentals of each company are an increasingly important factor. Within the same sector, some companies are over-leveraged while others are cash rich. Investing in a sector-based ETF gives you both, while we can point you towards the ones with the strongest fundamentals, helping them make it through tough times. Companies with a strong balance sheet and a dividend growth strategy will carry your portfolio with fewer hiccups along the way.

That is what we call a **resilient** portfolio.

Conclusion

Naturally, we all wish for a positive outcome. The resiliency of this market is quite surprising to most of us. I remain optimistic that we will get at least a "mild recession" to get offer and demand back into balance, to bring inflation back under control and, by the same token, to stabilize interest rates. Reestablishing better spending habits across all levels of governments, corporations as well as individual consumers could also contribute to smoother and more predictable economic growth. Financial discipline is what we should all strive for. A short-term recession will bring about financial discipline sooner... and the sooner the better to ensure longer term resiliency.

Recommended Sector Weighting - October 2023				
Geographics	**Sectors**	**Income Oriented Portfolio**	**Growth Oriented Portfolio**	**Rational**
North-American Equities	Communication Services	4,50%	5,25%	Remains our favourite yield play based on dividend growth, despite challenges of yield strategies. Use current weakness to add to your positions to reach recommended weight.
	Consumer Discretionary	2,50%	4,50%	Caution is warranted in cyclical sectors. Valuations have improved but still too early. Stick with sector leaders.
	Consumer Staples	5,50%	6,00%	Classic defensive sector, can underperform in a recovery scenario.
	Energy	7,00%	10,50%	Fundamentally, we are cautiously positive as Saudi Arabia and Russia are cutting production. Deep value and strong cash generators, we are focused on higher quality large cap Energy stocks. Debt is disappearing in this industry, which should enhance distributions and buy-backs going foreward (it would be best if excess cash flow went to financing environmental R&D and renewable technologies).
	Financials	14,00%	15,25%	U.S. regional bank weakness could continue, given commercial real estate loans default risk. The sector will be under regulatory scrutiny after recent events in the U.S. Therefore, we worry about both slowing loan growth and net interest income affecting future earnings. Longer term, this sector tends to outperform coming out of recession. Stock selection is key.
	Healthcare	4,00%	5,00%	Prefer the U.S. for diversity
	Industrials	8,00%	8,00%	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	6,00%	8,50%	Technology = Innovation = Long-term Growth - **Sector is allergic to high interest rates** and is dependent on easy access to capital. Focus on cash-generating companies with predictable margins. We are reducing weighting based on high cash cost, margin squeeze and high valuations.
	Materials	4,50%	4,00%	We are increasing our weighting in the Materials sector with a focus on gold and base metals, and on companies with strong operating efficiency and cash flow generation. Gold represents an attractive hedge against the market and the financial sector.
	Real Estate	2,00%	3,00%	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 18 months.
	Utilities	7,00%	5,00%	Rising yields, low organic growth and high payout ratios are a tough combination. However, electricity producers offering growth with a strong balance sheet remain attractive.
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.				

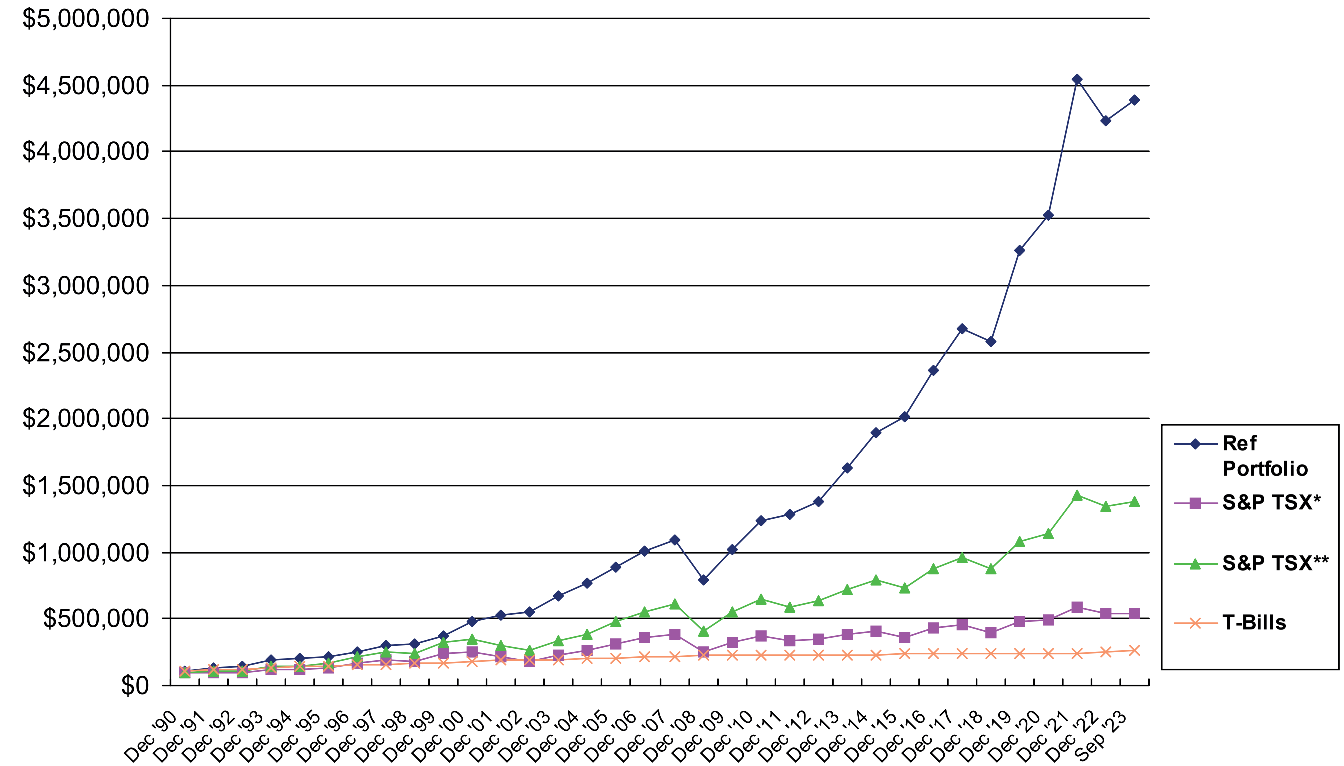
Sources:

- 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 – September 2023
- BMO NB US Equities Guided Portfolio – September 2023
- BMO NB North American Equities Guided Portfolio – September 2023
- BNN
- CNBC
- CNN Business
- Dow Jones Newswires
- FACSET
- Globe and Mail
- Goldman Sachs
- iStock.com
- JP Morgan
- OECD.org
- S&P Global
- Seeking Alpha
- The High Tech Strategist
- The Wall Street Journal
- Trading Economics
- TradingView
- Trahan Macro Research
- U.S. Bureau of Economic Analysis (BEA)
- U.S. Energy Information Administration (EIA)

BMO Private Wealth

Reference Portfolio Return

MDL Group



Value as of September 30,
$ 4,389,437

Average Return
11.98 %

$100,000 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

**Does not include income or div*

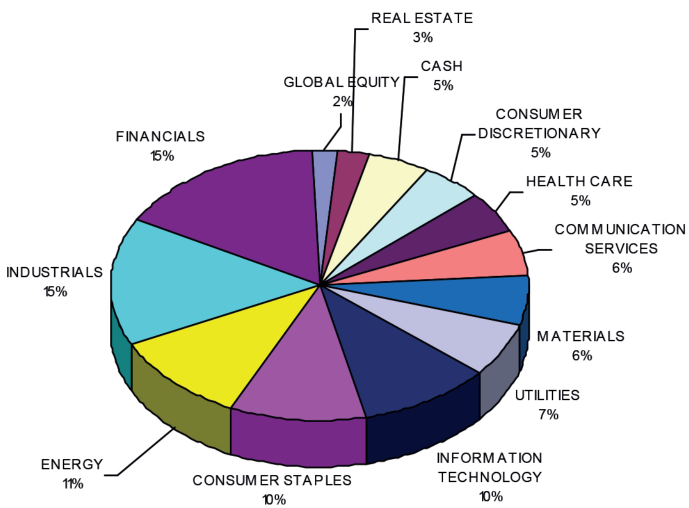
***Includes income and div*

BMO Private Wealth

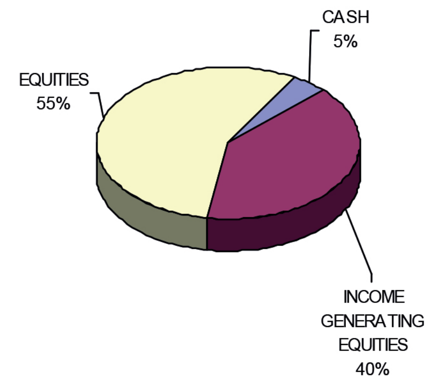
MDL Group

September 2023

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

BMO Private Wealth

MDL Group

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	3.56%	0.81%	3.38%	**3.78%**
Return Compounded as of December 31, 2022				
3 years	0.95%	4.34%	7.54%	9.09%
5 years	1.18%	3.64%	6.85%	9.65%
10 years	0.95%	4.54%	7.74%	11.86%
***Average return since inception (YTD)** …………………………………..				11.98%

* (YTD): Year To Date (September 30th, 2023)
$100,00 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.

The Team

Brenda Walls
Investment Associate
514-282-5887
Brenda.Walls@nbpcd.com

Patrick Delaney
Investment Associate
514-282-5847
Patrick.Delaney@nbpcd.com

Neela Patel
Senior Administration Associate
514-282-5840
Neela.Patel@nbpcd.com

Nancy Landry
Administrative Assistant
514-282-5801
Nancy.Landry@nbpcd.com

Marie Michelle Valade
Administrative Associate
514-282-5835
MarieMichelle.Valade@nbpcd.com

Tanya Bishara
Senior Administration Associate
514-282-5966
Tanya.Bishara@nbpcd.com

Meriem Trabelsi
Administrative Associate
514-282-5848
Meriem.Trabelsi@nbpcd.com

Kayla Piccolo
Administrative Associate
514-282-5845
Kayla.Piccolo@nbpcd.com

Steve Mc Cready
Investment Advisor
Financial Planner
514-282-5886
Steve.McCready@nbpcd.com

Johnny Mazraani
Administrative Assistant
514-282-5803
Johnny.Mazraani@nbpcd.com

Dimitra Paneris
Administrative Assistant
514-282-5839
Dimitra.Paneris@nbpcd.com

Simon Bellemare
Financial Planner
514-282-5816
Simon.Bellemare@nbpcd.com

Pierre Morin, B.Com., Fin. Pl.
Senior Investment Advisor
Portfolio Manager
514-282-5828
Pierre.Morin@nbpcd.com

Josée Dupont, B.Com., Fin. Pl.
Senior Investment Advisor
Portfolio Manager
514-282-5707
Josee.Dupont@nbpcd.com

Daniel Lebeuf, MBA, Fin. Pl.
Senior Investment Advisor
Portfolio Manager
514-282-5884
Daniel.Lebeuf@nbpcd.com

Nicole Dimyan, CPA
Investment Advisor
Financial Planner
514-286-7292
Nicole.Dimyan@nbpcd.com

Hugo Lessard
Investment Advisor
Financial Planner
514-282-5861
Hugo.Lessard@nbpcd.com

Louis Morin
Investment Advisor
Financial Planner
514-282-5955
Louis2.Morin@nbpcd.com

MDL Group

BMO Nesbitt Burns

Feel free to contact us : 1-800-363-6732
1501 McGill College, suite 3000, Montreal, Quebec, H3A 3M8

www.GoupeMDL.com

BMO | Private Wealth