BREZER, VOS, MANDELL, REEMS & HAO
WEALTH MANAGEMENT GROUP
BMO Nesbitt Burns

June 2023 Newsletter

As always it has been an interesting start to the year and as we approach the mid-point, we thought it would be good to review some of the themes and talking points that have impacted the markets both to the positive and to the negative.

The early part of this year was dominated by the Central Banks and raising interest rates in an attempt to fight inflation. The market was obviously intensely focused on this area as it was what had impacted the market the most in 2022. After a series of hikes, the Bank of Canada was the first to go on 'hold' and not raise rates successively, as they saw inflation starting to come down and also saw some cracks in the all-important housing sector in Canada. This 'pause' in hindsight was well timed, as the housing sector has indeed stabilized in Canada and in fact started to recover due to strong demand and low inventory. Many people had locked into low-rate mortgages and were not prepared to move and have to take on a mortgage at much higher rates, resulting in few homes coming up for sale.

In the US, the Federal Reserve continued to raise rates, however the pace of the rate hikes slowed and there is some indication that they may be close to hitting the pause button. The US Fed had a stark warning of the impact of their rate hikes with the failure of Silicon Valley Bank (SVB), First Republic and Signature Bank. The regional banks having often outside exposure to commercial real estate and or a concentrated deposit base like SVB in the Tech sector. This coupled with the failure of Credit Suisse in Europe started a lot of worry in the market about the spread of 'financial contagion'. This lasted a couple of weeks and weighed on the markets. However, a quick acting US Fed had to assure all the deposits were made whole and the fact the large US Banks had none of the same issues that the regional banks were struggling with, was enough to quickly stabilize the markets.

The third major market worry was the US Debt Ceiling, with the US Treasury warning that the US Government would run out of money in early June and risk defaulting on its debt obligations. A default would have had major global impacts and severely impacted the US economy. What many people forget that this 'debt ceiling' issue is nothing new and the US ends up dealing with it every couple of years and is a political quagmire that never really gets resolved. Bottom line though, is that at the 11th hour some compromise is made by the political powers and a new 'debt ceiling' is approved for a couple of years and so the proverbial can is kicked down the road, so that another administration has to deal with it again in the years to come. The Debt Ceiling passed Congress and the Senate this week (June 2nd).

Look, for sure longer term this is an issue, as the US is spending more and more and many of the programs like Social Security, Medicare and Medicaid are drastically underfunded and sucking up more and more money. Realistically at some point taxes will need to be raised to continue to fund these types of programs or the benefits are going to have to be reduced. These problems are not unique to the US, as many countries with aging populations are experiencing the same phenomena. Canada continues to raise marginal tax rates and push out the age when one can claim CPP. France took the unpopular step of raising the retirement age to 65. As a result, President Macron faced massive protests, however he is one of the few politicians willing to take on the issue head on.

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461

The same cannot be said of the US where raising taxes is a key no go issue for Republicans and no politician is willing to take on the task of reducing Social Security and other benefits. So yes, the 'debt ceiling' issue in the US will be an ongoing issue.

Through all of these worries the North American market has started to move slowly higher and in the case of the Nasdaq rapidly higher. We have often spoken of the 'Wall of Worry' and the start of this year has been a perfect example of that saying. The biggest boost to the markets is the fact that the pace of interest rate hikes has been slowing as inflation has come down and at the same time though the economy has slowed it remains pretty robust. This was evident in the latest earnings season for S&P500 companies where over 70% of companies beat analyst expectations and provided decent forward guidance.

In spite of the media fanning the 'Recession' flames constantly in the press there is little signs of a recession in both Canada and the US so far. Consumers have for sure pulled back and large ticket discretionary items are not flying off the shelf like what happened during Covid times. Employment remains strong which is key and the wage pressure which drove inflation pressure has cooled dramatically. Overall though inflation remains sticky and may not coming down as fast as hoped for by the Central Banks. This may be an issue as it may mean that the Bank of Canada and the US Fed may have to raise rates again later this year.

One area where inflation has remained high has been in the cost of food. This may change in the coming months as the prices of wheat and other grains continues to drop dramatically as the world has a glut of wheat at present. This flows into everything from pasta to animal feed and so we should be seeing softening in meat and poultry prices. As farmers make less profit so the demand of fertilizer and agriculture equipment softens as do prices and so we see the back of inflation slowly starting to soften.

The other story that unfolded this year is the progress of Artificial Intelligence. Of course, AI has been top of mind for tech companies for quite some time but with the release of ChatGPT, the access to this technology was significantly broadened opening the door for wider forms of adoption and a strong competition among the big tech players. Competing strategies and approaches have created the expectation that the speed of innovation and adoption will have a step increase resulting in strong positive tailwind for the value chains that feed this process. More on this later.

As always it has been an interesting start to the year and as we approach the mid-point, we thought it would be good to review some of the themes and talking points that have impacted the markets both to the positive and to the negative.

The early part of this year was dominated by the Central Banks and raising interest rates in an attempt to fight inflation. The market was obviously intensely focused on this area as it was what had impacted the market the most in 2022. After a series of hikes, the Bank of Canada was the first to go on 'hold' and not raise rates successively, as they saw inflation starting to come down and also saw some cracks in the all-important housing sector in Canada. This 'pause' in hindsight was well timed, as the housing sector has indeed stabilized in Canada and in fact started to recover due to strong demand and low inventory. Many people had locked into low-rate mortgages and were not prepared to move and have to take on a mortgage at much higher rates, resulting in few homes coming up for sale.

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461

In the US, the Federal Reserve continued to raise rates, however the pace of the rate hikes slowed and there is some indication that they may be close to hitting the pause button. The US Fed had a stark warning of the impact of their rate hikes with the failure of Silicon Valley Bank (SVB), First Republic and Signature Bank. The regional banks having often outside exposure to commercial real estate and or a concentrated deposit base like SVB in the Tech sector. This coupled with the failure of Credit Suisse in Europe started a lot of worry in the market about the spread of 'financial contagion'. This lasted a couple of weeks and weighed on the markets. However, a quick acting US Fed had to assure all the deposits were made whole and the fact the large US Banks had none of the same issues that the regional banks were struggling with, was enough to quickly stabilize the markets.

The third major market worry was the US Debt Ceiling, with the US Treasury warning that the US Government would run out of money in early June and risk defaulting on its debt obligations. A default would have had major global impacts and severely impacted the US economy. What many people forget that this 'debt ceiling' issue is nothing new and the US ends up dealing with it every couple of years and is a political quagmire that never really gets resolved. Bottom line though, is that at the 11th hour some compromise is made by the political powers and a new 'debt ceiling' is approved for a couple of years and so the proverbial can is kicked down the road, so that another administration has to deal with it again in the years to come. The Debt Ceiling passed Congress and the Senate this week (June 2nd).

Look, for sure longer term this is an issue, as the US is spending more and more and many of the programs like Social Security, Medicare and Medicaid are drastically underfunded and sucking up more and more money. Realistically at some point taxes will need to be raised to continue to fund these types of programs or the benefits are going to have to be reduced. These problems are not unique to the US, as many countries with aging populations are experiencing the same phenomena. Canada continues to raise marginal tax rates and push out the age when one can claim CPP. France took the unpopular step of raising the retirement age to 65. As a result, President Macron faced massive protests, however he is one of the few politicians willing to take on the issue head on. The same cannot be said of the US where raising taxes is a key no go issue for Republicans and no politician is willing to take on the task of reducing Social Security and other benefits. So yes, the 'debt ceiling' issue in the US will be an ongoing issue.

Through all of these worries the North American market has started to move slowly higher and in the case of the Nasdaq rapidly higher. We have often spoken of the 'Wall of Worry' and the start of this year has been a perfect example of that saying. The biggest boost to the markets is the fact that the pace of interest rate hikes has been slowing as inflation has come down and at the same time though the economy has slowed it remains pretty robust. This was evident in the latest earnings season for S&P500 companies where over 70% of companies beat analyst expectations and provided decent forward guidance.

In spite of the media fanning the 'Recession' flames constantly in the press there is little signs of a recession in both Canada and the US so far. Consumers have for sure pulled back and large ticket discretionary items are not flying off the shelf like what happened during Covid times.

Employment remains strong which is key and the wage pressure which drove inflation pressure has cooled dramatically. Overall though inflation remains sticky and may not coming down as fast as hoped for by the Central Banks. This may be an issue as it may mean that the Bank of Canada and the US Fed may have to raise rates again later this year.

One area where inflation has remained high has been in the cost of food. This may change in the coming months as the prices of wheat and other grains continues to drop dramatically as the world has a glut of wheat at present. This flows into everything from pasta to animal feed and so we should be seeing softening in meat and poultry prices. As farmers make less profit so the demand of fertilizer and agriculture equipment softens as do prices and so we see the back of inflation slowly starting to soften.

The other story that unfolded this year is the progress of Artificial Intelligence. Of course, AI has been top of mind for tech companies for quite some time but with the release of ChatGPT, the access to this technology was significantly broadened opening the door for wider forms of adoption and a strong competition among the big tech players. Competing strategies and approaches have created the expectation that the speed of innovation and adoption will have a step increase resulting in strong positive tailwind for the value chains that feed this process. More on this later.

Market Update

What we are seeing is a patchy recovery with some areas doing very well and others clearly lagging or moving the other way. Those areas that were hurt the most in 2022 have recovered the most and the areas that were defensive and positive in 2022 are now negative this year. Last year the Nasdaq index was -31%. With the big heavyweights like Apple, Amazon, Meta, Microsoft, Google taking it on the chin as did the entire Tech sector, with many stocks down over -50%. These stocks had the most sensitivity to higher interest rates, higher multiples due to higher future growth rates and consequently were impacted the most.

Fast forward to this year and it is the complete opposite as those same names are leading the recovery as the large Cap Tech stocks outstrip the rest of the market. This has powered the Nasdaq index which is now up over +20% on the year solely on the back of these 'Mega Cap' Tech stocks. What we are not seeing however is the same rate of recovery in all of the other sectors of all the indices.

As of the time of writing the DOW was -1.1% YTD; the Toronto Stock Exchange was +0.87% YTD; the New York Stock Exchange is -2.3% YTD and the S&P 500 was +8% YTD.

To explain, certain indices have different components in their make up and hence their performance is impacted greatly on the weighting of the stocks in the index. So, the greater the weight of Tech stocks like Apple, Google, Microsoft, Amazon etc in each index the better the performance. In the S&P 500, Apple and Microsoft combined represent approximately 14% of the index and in the Nasdaq they represent approx. 25% of the index. If you look at the S&P 500 'equal weight index' which puts all companies in the S&P 500 index at the same weight, then the return this year is -1.5%.

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461

Looking at the Toronto Stock Exchange (TSX) it has a heavy weighting towards Energy, Materials and Financials. Last year Energy was the winner, yet this year Energy is the loser and with the CDN Banks still struggling the index is lagging the US indices like the S&P, as the TSX has very few Tech companies in the index.

Weak breadth dynamics continue to get outsized attention with lowest number of S&P 500 stocks beating the market since March 2020. In addition, Bespoke Investment Group pointed out that the three-month performance spread between S&P 500 and S&P 500 Equal weight is the widest it has been since December 1999. Bank of America noted that an equal-weighted basket of just seven stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla) is up 70% ytd, while the other 493 stocks in the S&P 500 up only 0.1%. Added that in price terms, 228 of S&P 500 companies are up vs 275 down YTD. (Bloomberg, May 31, 2023)

So why the disparity?

There are a couple of factors to consider in that higher interest rates have slowed the consumer as mentioned and so in turn slowed industrial production. This is essentially what the US Fed wanted, to stop inflation, and it has worked. The result for the market is that consumer discretionary sector has been pretty flat, as has the industrial sector. One of the key reasons why the DOW Jones Industrial Index is flat to slightly negative on the year. But then why has some Tech boomed?

There are two elements to this, one as mentioned was that many of these Big Cap Tech names were beaten up last year and valuations were compelling and so investors started to buy these names at low prices. The companies are also market leaders and have very good cash flow and so when money started to move back into the market these were the 1st names where institutional and pension funds began to place money. The second element was the release of ChatGPT and Google's 'Bard' that started the AI revolution. AI has become the 'hot topic' of late and the market has run very hard with it as anything related to AI from semiconductors to software has seen a major increase in valuation. Anything outside of AI, even in the tech space has not received the same attention from investors.

AI has the potential to be ground-breaking in so many areas and people have described it as much as a watershed moment, as the invention of the cell phone and the computer. We have already spoken to clients that are using it in their respective businesses with success and yet like everything there are some pros and cons. There are still some glaring mistakes and false information that it spits out, there are worries about lack of regulation and the potential to make many people unemployed. On the other side there is the potential to work on the advancement of medicine and the cure of diseases like never before.

What these large AI language models need are huge masses of data in order to learn and also a bunch of very smart people with substantial funding behind them to support this research. Once again large companies like Microsoft, Apple, Meta, Google and Amazon have been investing in building these AI models for a very long time, and so once again are the major beneficiaries of this latest surge in interest in AI, as they are leaps and bounds ahead of the rest. Clearly this has benefited their share prices greatly in the last quarter.

Chip and equipment makers like Nvidia, AMAT and AMD to name a few, have also received investors attention as the computing power required to run these AI models is massive and so the demand for sophisticated chips to run these things is huge and growing.

This is clearly the future of things to come and is likely to have momentum and growth for many years to come as it develops further. There will be winners and losers in the race to develop new AI applications however this is likely to be a Technology Growth story for a long time to come.

In portfolios we had established a strong weighting in Tech early on this year and this has been to our benefit, as we owned and bought more of Apple, Microsoft, Amazon and Google. We have also had a strong weighting in semiconductors across all portfolios with names like Broadcom, Taiwan Semiconductor and Applied Materials to name a few.

This position in Tech has been to our benefit, while we wait for the rest of the market to catch up. Many of our dividend names have stagnated of late and the CDN Banks released somewhat underwhelming results recently, which has weighed on the entire financial sector. The regional bank issue in the US as discussed, has weighed on the financial sector in general. As a point of reference, BMO shares are still -8% YTD and -19% below their 52-week high. TD Bank is -12% YTD.

Another factor affecting financials is their exposure to Office Real Estate space. Prior to interest rate hikes, pension funds, endowment funds, family offices and large institutional investors bought large amounts of office real estate due to their long-term stable cash flows. Much of this was financed by the banks. Now with much higher interest rates and office vacancies climbing higher in the post-Covid work from home phenomena, these 'stable cash flows' are fast evaporating and many of these buildings are underwater in their valuations. This means that the banks are having to put more money aside to cover 'loan loss provisions' which is likely to weigh on their earnings in the coming quarters.

At a time when restaurants, planes and concert arenas are packed to the rafters, office buildings remain half full. Thinly populated cubicles and hallways are straining downtown economies and, bosses say, fragmenting corporate cultures as workers lose a sense of engagement. Yet workers say high costs, caregiving duties, long commutes, and days still scheduled full of Zooms are keeping them at home at least part of the time, along with a lingering sense that they're able to do their jobs competently from anywhere. More than a dozen workers interviewed by The Wall Street Journal say they can't envision returning to a five-day office routine, even if they're missing career development or winding up on the company layoff list. (Wall Street Journal May 31st.)

How we see things unfolding the rest of the year?

The debate from last year around soft landing versus hard landing is still very much alive. Data so far has been pointing to a soft landing as so far, we have managed to deal with some of the catalysts for deep recession in a timely manner. That said, the whole point of such structural challenges is that they are easy to miss and therefore, its hard to truly say that we're out of the woods until inflation has tracked down and monetary policy normalizes. We will be closely watching macro economic data points to see how this story unfolds. Unemployment numbers in both Canada and the US remain low, which continues to support the soft-landing thesis.

Our base case view is that rates are almost at their peak and its more a matter of how long to hold the rates at this level than whether to increase rates further. Under our base case, the high rates will slowly trickle through the economy over the next few quarters. We should also expect to have instances where parts of the economy run into trouble (commercial real estate) but we do not see the probability of contagion to the broader economy. As long as that remains contained, our base case will continue to unfold in line with expectations which is an improving economy and global stock markets. We also expect the market participation to broaden out beyond the Tech sector in the coming quarters as things normalize further.

We have more confidence on the AI story. It is truly the beginning of a structural shift, and we are in the first few innings of it. We expect that to continue with its momentum and reshape the way companies operate across multiple industries, creating opportunities for enablers and adaptors of this technology. Our portfolio positioning will continue to attempt capturing the upside associate with this long-term secular tailwind. Expect more from us on this topic.

So far this year the markets have dealt with each, “Wall of Worry” issue and subsequently moved higher, something that we expect to continue in the coming months and expect to see this market and all portfolios higher in the coming months, after a difficult start to this year.
You may also have noticed that we have done some rebalancing in the portfolios this last month as we get our stock and sector weightings back in line. As some stocks move higher and lower, their weighting in the portfolio change, which has prompted us to do some rebalancing where we felt it was necessary to either reduce some positions by a small percentage and increase it in other areas, where we feel we can drive better returns.

If you have any questions, please reach out to any of the team members.

All the best from our team,
Greg, Jed, Dave, Marion, Lili, Samantha, Kenzy, Mahad, Ling, Tracy, Kelly, Sarah and Jennifer

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing Private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. Estate, trust, and custodial services are offered through BMO Trust Company. Insurance services and products are offered through BMO Estate Insurance Advisory Services Inc., a wholly-owned subsidiary of BMO Nesbitt Burns Inc. BMO Private Wealth legal entities do not offer tax advice. BMO Nesbitt Burns Inc. is a member of the Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada. BMO Trust Company and BMO Bank of Montreal are Members of CDIC. ® Registered trademark of Bank of Montreal, used under license.

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461