2nd Quarter North American Market Commentary – 2023

Key Take-aways:

- It took 11 rate hikes and 525 bps in cumulative increases, but the Effective FED Funds Rate is finally above the rate of inflation in the US.
- The Bank of Canada has raised rates again and its key benchmark rate now stands at 5.0%, with 3 more future policy interest decision dates remaining in 2023.
- The principal risk is to the economic outlook, particularly as the Federal Reserve attempts a delicate balancing act of controlling inflation while trying to not harm real economic growth.
- The risks weighted towards full tilt to equities and ignoring downside risk is not supported by fundamentals.
- Despite the lagging labor market data, the U.S. Treasury Yield Curves, bank lending standards, and leading economic indicators have only served to reinforce the recession forecast.
- Do not look at the strength of the S&P500, with its concentration risk, as a signal to the strength of the economy. Confusing short term performance with the realities of the economic cycle can be dangerous.
- The Artificial Intelligence boom narrative has helped propel large cap performance disproportionally but outside of that the performance of others has been lacklustre.

Positioning:

- Monetary policy is still very restrictive and the damages to the economy are still rolling through at a considerable lag. The way forward is risk managing a recession.
- Energy was down dramatically in Q2 with June being the largest contributor to June CPI decelerating. With energy prices rising materially in July (one month lag) expect inflation to accelerate from the low print for June.
- Positioning for stagflation (rising inflation, falling growth) supports allocations to utilities, energy, select REIT's and select growth.
- Canadian equities remain attractive destinations of capital in comparison to US equities.
- With inflation peaking and the FED tightening (that is negative real rates) this environment supports an allocation to precious metals.
- Execute on selective shorts on vulnerable sectors/indexes such as financials, cyclical growth, US consumer, and high yield bonds.
- Current market consensus is as polarized as ever, and that is why volatility will return. Don't confuse lack of volatility with stability.

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2nd Quarter North American Market Commentary – 2023

Federal Reserve Chair Jerome Powell has now been responsible for 11 rate hikes since March 16th 2022. This is now the highest FED Funds' Rate since 2001. It took 11 rate hikes and 525 bps but the Effective FED Funds Rate is finally above the rate of inflation in the US. This strategy of aggressive hikes, paused in June, then resumption of hikes in July tells us the FED is uncertain of the outcomes and knows its strategy is close to causing something to break. The FED has in our opinion been very slow to identify this economic cycle. They had been slow to identify inflation and then slow to raise rates. And on the other side they have been notorious to rush in and raise rates.

Inflation remains above the FED's 2% target. Monetary policy has a delayed effect as inflation stays higher for longer than investors expect, central bankers raise rates for higher and longer than expected, and ultimately the economic data slowing is greater than expected. Energy was down dramatically in June being the largest contributor to June CPI decelerating. Having said that, crude oil prices have risen in July which swings the other way, with one month lag, when August CPI is reported keeping the FED hawkish on rate policy. Short term market behaviour is ignoring this when estimating FED policy. Simply put, we remain in a new inflation volatility regime, skewed to the upside of what was previously considered normal. Our position has been and remains that rates will remain at elevated levels for an extended period of time.

Here at home, the Bank of Canada noted in its July 2023 Monetary Policy Report, that, although inflation had declined from its peak, inflation in Canada remains too high. To combat inflation, the Bank of Canada increased the benchmark interest rate by 500 basis points since the start of 2022, to 5.0%. The Bank of Canada signaled that it intends to assesses the impact of the policy actions already taken but as we have learned there remains, however, the potential for additional rate increases in the near term.

On the surface, this has been a positive year thus far for select equities. Rather than a strong economic backdrop for Corporate America, the vast majority of the gains have been due to rallies largely reflecting a surge in optimism about the prospects of a very small number of mammoth companies (7 megga cap companies to be exact) linked to speculation about recent breakthroughs in artificial intelligence. Market participants find themselves in a conundrum. Other than flow and keeping up with benchmarks, certain equities are melting up with no fundamental rationale behind the multiples, forcing investors to take on higher levels of risks that would have been considered unacceptable years ago. This market action lacks market breadth. The cap weighted index is outpacing the equal weighted index, which would be unusual during the beginning of a new bull market. There have been exceptions, including new bull markets following the 1994 and 1998 declines, but these are outliers. The uncomfortable truth is S&P500 valuations are distorted with an environment where the cost of capital remains on the rise to be followed by an increasing risk of an economic drawdown that looks to surprise most market participants. A recession is likely and data being released is progressively deteriorating and cannot be handwaved away. We have never had a tightening cycle of this magnitude without generating a recession. The consequences of the FED tightening have yet to be completed. Todays' investor base have significantly shortened their investment horizons. Those ignoring the recession signals are ignoring the historical record. The difficulty for investors is to understand a time when valuations will mean revert. Yield curves flatten and invert while headed into a recession and steepen while in a recession.

The 10s/2s spread on the U.S. Treasury yield curve is currently at a -91 bps as the 2 year yield accelerates on expectations of a more hawkish FED and the 10 year is signalling incoming data with a surprise to the downside. This will only continue to put pressure on the global economy with cost of borrowing only showing signs of accelerating further before staying higher for longer. This yield curve is the single best predictor of the US economic cycle with a lag that averages around 18-24 months and one of the best proofs of this is the correlation between the yield curve and bank lending standards. Tighter standards always follow an inverted curve with a lag and slowly starves the economy of easy credit. An inverted yield curve is very problematic for banks, they borrow short and lend long which in the case means they have negative margins. Bank lending drives economic growth. This deepening yield curve inversion is telling us to focus on recession risks as cost of capital continues to increase.

Credit is what drives economic growth and the data is clear, credit has been contracting for some time. This means consumption will decelerate, slow at first and then all of a sudden. The rate of change across the different lending programs for commercial banks are not expanding. For context every 100bps bank lending slows this equates to 25bps contraction in GDP (real economic growth). Latest data tells us total loans and leases in bank credit year over year rate of change is down -6.2% suggesting to us GDP rate of change should come down approximating -1.50% year over year. Slowdowns in credit growth cause slowdowns in economic growth. Improvement in the outlook for lending doesn't happen when the vast majority of U.S. Treasury Yield Curves remains inverted. A bull market does not begin with Financials being a weak link.

On the consumer the year over year rate of change in credit card and debit card spending has reduced significantly. The average interest rate on US credit card balances is around 21%, the highest Americans have ever seen. Credit card delinquency rates are now at Great Financial Crisis (GFC) levels and rising. Excess savings is now below pre-pandemic levels. All those excess savings that had been accumulated during the 2020/21 time frame has been spent. This is problematic, now at a level where we would expect the consumer, regardless of income level, to cut back on consumption spending. When the labour market does worsen combined with the worsening excess savings situation this makes for an uncomfortable situation for both the consumer and corporate profits. Consumer confidence is at levels consistent with the onset of past recessions, and trending lower. The point is consumers are not healthy and the narrative is misleading.

On the labour market, the unemployment rate is sitting at 3.6% down from 3.7% the previous month. The issue is the labour market is a lagging indicator. Looking past lagging labour indicator headlines and focusing on leading indicators (overtime hours, temporary staffing, average hourly work week, job openings) these are moving lower and trending in negative territory. This is in fact what you begin to see when economic growth is slowing. Going back over 70 years this is the classic transition from economic expansion to economic contraction and this is generally what takes place ahead of job cuts as companies realize a recession is unavoidable. To date companies have been shy to cut labour (wanting to avoid the 2020 COVID problem where hiring labour was difficult due to gov't handouts) but this time around they will have no choice but to preserve margins and cash flow by cutting the largest cost component, being labour. The trend is clear, the labour market is deteriorating with the early leading indicators suggesting this strongly. This has all historically coincided with recessionary conditions.

In equity markets we have witnessed the absolute collapse in volatility (VIX - fear index) closing below 13 (lowest since January 2020). By comparison, the 2000-02 and 2007-09 bear markets never saw a VIX below 16. FX volatility, credit spreads, equity volatility also seem to be supressed, especially when considering the upcoming data releases expected to be negative surprises. Current valuations in the USA are excessive and not sustainable. Corporate guidance has been overwhelmingly negative. Mean reversion still exists and we must be careful when it comes to extreme complacency. Corrections are perhaps less frequent but more impactful. We encourage investors to pay attention to the instability of market behaviour. History has taught us there is a phase transition with volatility (upside explosion) between entering a recession and being in a recession. There seems to be embedded optimism by market participants who will now have to juggle the realities of upcoming data releases. Great deal of uncertainty looking out over the balance of this year as macro pressures on the consumer have gradually intensified. With VIX at sub 13 levels and upcoming data releases (economic and corporate profits) there is the increased probability that risk accelerates from these levels. It is difficult to see how the market can continue to ignore economic gravity that is upon us. If you go back in history, not once has it been different. This rate hike cycle has been so severe that many corporate business models and consumer health will break. The back half of the year and into 2024 may be problematic. The longer this divergence continues the larger the drawdown, perhaps.

Investor focus heading into Q3 2023 should turn to the challenge for economic growth. Recent economic releases suggesting lower inflation and modest economic growth coupled with better-than-expected past corporate profit reports have fueled the soft-landing economic narrative. Thus far, the entire move in the S&P500 has been driven by valuation expansion on the expectations that lower inflation should allow for lower interest rates, which has yet to materialize. The bulls keep pointing to the soft landing narrative, suggesting consumer spending is resilient and the yield curve inversion, although significant, will reverse. Ultimately, the only way to disprove the soft-landing view is to actually be in a recession, and that clearly is taking more time than expected, as the continued recovery in services funded by the depletion of excess savings and solid inflation-based wage growth keeps growth positive. Although the downturn in manufacturing, weakness in industrial production, worsening leading labor indicators, and tightening lending standards continue to point to an eventual recession, investors are clearly not going to price one in until it is obvious. The reality is, the FED continues to tighten into weak economic data and this yield curve is deeply inverted. A recession, when it is officially called, may catch many by surprise. We maintain, for the absolute gains to be sustainable, we must disprove the prospect of a recession. Since 1957 the S&P500 has never bottomed before a recession even began. The bears recognize this phenomena, the bulls are ignoring.

This market has been trained into thinking drawdowns rarely take place justifying long only exposure. This whole optimism is we are going to get a FED pivot, the FED tightening cycle is almost complete and investors need to rush in and position for the next bull market. The speed with which the data (GDP, Inflation, profits, cash flow) deteriorates might be dramatic and catch many by surprise. More and more data that gets released is negative and we are getting steeper on the decline part of this cycle . This idea that a FED pivot is bullish is just a narrative. The reason for the pivot is what matters. When the FED pivots it is because things are worse than most thought. We will continue to find a path to preserve investor capital and add to our investor wealth gradually and responsibly. Our goal in our portfolios is to be directionally accurate and get allocations correct on a rate of change basis.

The divergence of the market from economic fundamentals has been remarkable and sobering. It is important to recognize this divergence and come to terms with the data and discontinue pointing to the stock market as an economic indicator when in fact, at best, it’s a momentum indicator. The current trading multiple is at levels where the earnings yield is inferior to what you get on the risk free rate (US Treasuries). One of the most attractive trades right now is earning 5+% in short term Treasuries while the heard invest in risky growth stocks that look to mean revert. This meltup has been based on speculation, momentum, sentiment and not fundamentally sound. The US is a very expensive market when benchmarked against risk free rates and even the Canadian and some Emerging markets. We are basically back to peak multiples in the face of an earnings recession and the FED is still hiking. Core message here is rallies not backed by fundamentals are not sustainable and while they can be exciting to watch they are anxious to own. Patience remains our core allocation.

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Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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