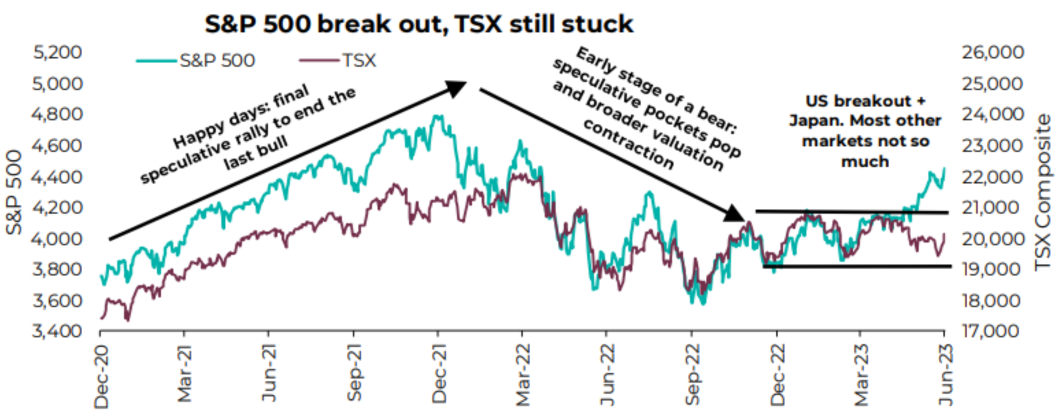
RICHARDSON Wealth

Summer 2023 mid-year outlook

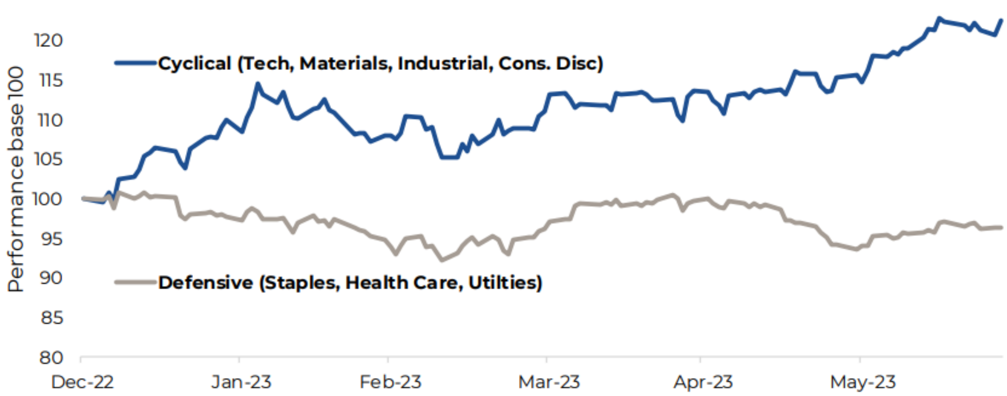
The pandemic recovery market has been quite a dramatic ride:



Source: Bloomberg, Purpose Investments

So far, the expectations that investors had for 2023 have been well off the mark, for both stock market performance and economic health. At the beginning of the year, most economic outlooks predicted a recession in 2023 as a forgone conclusion, which would lead to corresponding decline in share prices. It was expected that both the impacts of extreme inflation and higher interest rates would follow through to reduced consumer spending. As a result, many portfolios were defensively tilted, including ours, with an emphasis on conservative equities that are reliable dividend payers. However, year-to-date, defensive stocks are generally lacklustre, while economically sensitive stocks in Technology (like NVDIA and Microsoft) and Consumer Discretionary (LVMH and Amazon) sectors have soared:

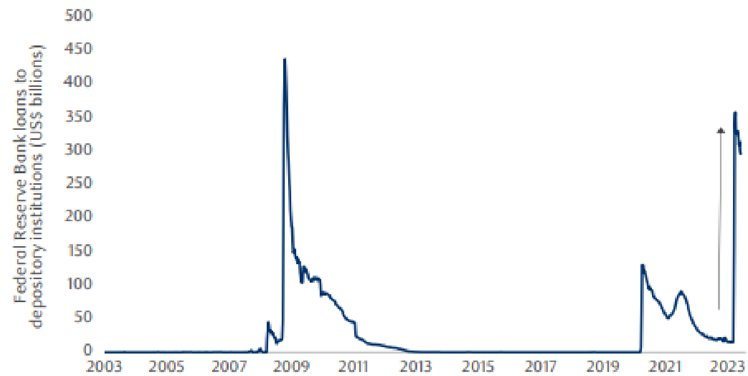
Tale of two markets so far this year:



Source: Bloomberg, Purpose Investments

Markets swooned in the first quarter when Silicon Valley Bank, followed by several other regional banks, failed. However, as larger banks acquired them, supported by the U.S. Treasury and Federal government providing an explicit backstop to risk on depositers, markets quickly regained confidence and moved into “risk-on” mode. It helped that cash flood the markets again in the form of loans to banks from the Federal reserve. Investors turned to buying the technology markets, focusing on the well-capitalized mega-cap companies that now seem to have predictable growth in a time of uncertainty. The craze around generative artificial intelligence has driven some companies to bubble-like valuations.

Emergency lending to banks by Fed soared amid latest bank failures:



Source: Federal Reserve Bank, Macrobond, RBC GAM

In the second quarter of the year, U.S. stock markets pushed higher, with the NASDAQ and S&P500 recovering much of 2022’s losses, and several mega-cap technology comanies making new highs. The defensive/dividend-weighted TSX is up 4% year to date, while the technology-focused S&P500 and NASDAQ are up 16% and 31% respectively.

The extreme outperformance of the U.S. markets is owing to the recently coined “Magnificent 7”: Apple, Alphabet, Microsoft, Amazon, NVIDIA, Tesla and Meta. All have links to the Artificial Intelligence craze.

Performance in 2023 has been extremely concentrated:

Technology mega-cap stocks have dominated U.S. market returns

Source: Refinitiv, Russell Investments

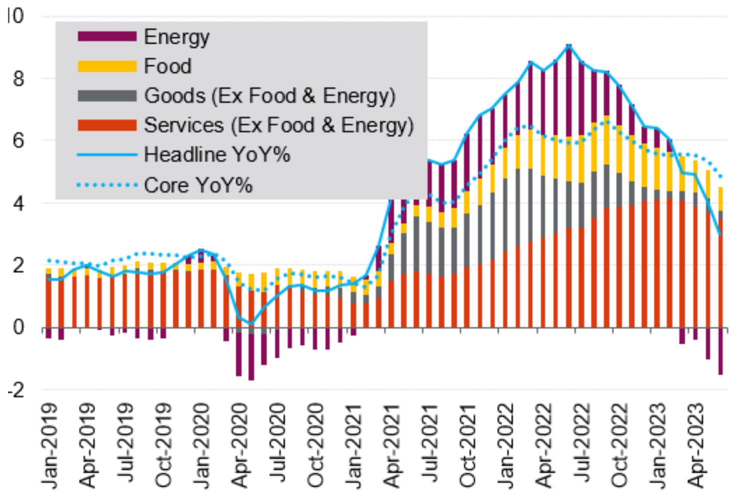
What could lie ahead for the rest of 2023? Staying defensive, warning signs are flashing.

Going forward, the impacts of higher interest rates have yet to play out through the ecnomony, in terms of reduced consumer demand and soft corproate earnings. Interest rates in Canada and the U.S. are at the highest rates since 2007, and are likely to stay at these levels well into 2024. The Prime Rate in Canada today sits at 7.2%.

Inflation is moderating, but still a factor for future consumer spending. After touching 7% - 9% levels last summer, year-over-year inflation is at 3% - 4% today. The over 60% decline in natural gas prices and 33% drop in oil prices over the last year are major factors that helped tame it.

Inflation is moderating, but services, especially wages, are still very sticky.

CPI (y/y) down to 3%. It was 9% a year ago:



Source: Richardson Wealth, Bloomberg

Natural gas prices are at multi-year lows.

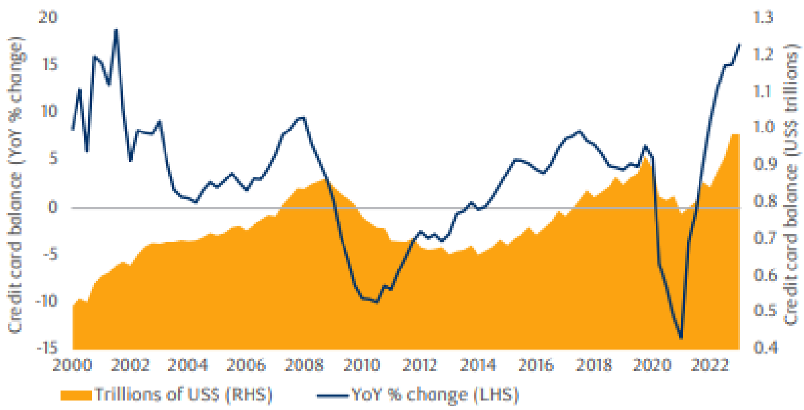
Natural gas spot prices:

Dollars per million British thermal units

Source: Natural Gas Intelligence

However, it is a question whether consumers will continue to spend at the post-covid levels they have been on services like travel, restaurants and entertainment. We note that while the rate of inflation growth may be slowing, this does not mean that prices will go *down* on groceries, rent, airline tickets, technology hardware, etc.. This just means that they will not continue to increase at the rates they did over 2021-2022. We should still assume that the elevated prices as compared to the pandemic years will remain for the foreseeable future, which is a risk to the economy if consumers stop spending on discretionary services and activities.

U.S. consumers leaning on credit cards:



Source: Federal Reserve Bank of New York, Macrobond, RBC GAM

Portfolio stance:

Valuations on equities are not cheap at this juncture, but relatively attractive in Canada with P/E ratios at 13x earnings versus 19x P/E on U.S. stocks. We remain focused on owning relatively value-priced dividend payers and dividend growers with quality balance sheets and businesses that are resilient in the event of economic slowdown. Dividend payers can do better than non-dividend stocks when economic growth is slowing and can provide a hedge against inflation as dividend payouts are increased over time. At the moment, utilities, pipelines, telecoms, and banks are trading near 52-week lows, and in some cases with over 5% dividend yields. Collecting a regular cash flow stream is attractive during this time of uncertainty. Cyclical companies that are benefitting from the demand for traditional and renewable energy sources, like mining and oil producers, also are in the portfolio. Short-term investment grade bonds now have yields at 5%, which are particularly effective to own in non-taxable accounts, such as RRSPs and RRIFs.

We remain cautious but invested as we watch for post-covid economy to adjust to the new normal of higher borrowing costs and higher lifestyle expenses.

I look forward to connecting in the coming weeks.

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