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RICHARDSON
Wealth

Watson Investment Partners

Portfolio Playbook

Interest Rates across the globe - with the exception of Japan - are now falling. Last Friday's speech from U.S. Central Bank's Chairman, Jerome Powell, confirmed a new economic regime is upon us. Falling borrowing costs for businesses and consumers around the globe offers fresh new opportunities, and potential challenges. We are preparing portfolios for this inevitability and increasing exposure to areas that benefit from this new regime such as in MidCaps and dividend-paying companies. We are also decreasing exposure to the U.S. dollar, as the trend of a strengthening dollar over the Loonie has largely been realized in the first 7 months of this year.

Riding the Dollar Wave

We began decreasing U.S. dollar exposure in portfolios this month. The Bank of Canada began cutting interest rates in June, leading the G7. Canada's proactive cuts were a result of falling inflation, increasing unemployment (6.1% unemployment rate today), dismal GDP growth, and a mortgage wall that is weighing on Canadian consumers. The rate cuts were a significant reason for the weakening Canadian dollar this year. The Loonie fell by 4.7% in the first 7 months against the U.S. dollar, a trend our portfolios benefitted from. Going forward, with interest rate cuts in Canada and the U.S. now expected to move in lockstep, the weakening Canadian dollar trend has likely largely been realized. Forecasting currencies is notoriously challenging, and we do not intend to say that the Canadian dollar will not weaken from here, but the majority of the trend does appear to have largely been realized with marginal reward offered at these levels of risk. As a result, we have converted portfolio USD exposure, where possible, to their Canadian dollar-hedged equivalent.

Bigger Isn't Better

We began increasing portfolio exposures to MidCaps in recent weeks. MidCaps - companies with $2Bn to $20Bn in market capitalization - tend to have higher leverage and lower profit margins than their Large and Mega Cap brethren. As a result, MidCaps tend to disproportionately benefit from low borrowing costs, which leads to higher cash flow, reinvestment, and potential growth. Further, the case in the U.S. economy for a 'soft landing' is growing stronger, which also benefits growth-oriented segments of the market like MidCaps. As discussed, in Canada, the news is different and more dire, and we are not considering the MidCap theme domestically.

Compared to their high-flying MegaCap compatriots (NVDA, AAPL, etc.), U.S. MidCaps valuations have suffered during the recent high-interest rate environment. This new rate-cutting regime is poised to reverse this trend. With the certainty of rate cuts and a view to a soft landing, we have initiated adding MidCaps with a bias to high-quality exposure in this space.

Cash Flow is King

Dividend-paying stocks attract capital as interest rates fall. The reasons are simple, retirees, pensions, and other income-sensitive investors have enjoyed an easy period of high rates. As rates fall, these investors look for alternatives to maintain their income levels and, if necessary, take additional risk to do so. This will lead many to convert to dividend solutions, which is supportive of a subsequent rise in these stock prices. The S&P 500's dividend yield has plummeted by 43% since March 2020, but this is largely due to skyrocketing valuations in a narrow band of stocks. There are segments of the market still offering stable, high dividend-yielding alternatives to interest income. Sectors such as Financials, Utilities and Real Estate are poised to benefit in this new regime. We have begun to add diversified high dividend-paying equity exposures to portfolios, with an emphasis on Financials and Utilities.

Private Members Only

We remain bullish on the Canadian multi-residential market with a focus on purpose-built student accommodations. Challenging supply and demand issues persist in this country under crippling regulatory red tape, and it doesn't appear this will change under the current government. The benefit to investors is that this asset class offers exceptional reward for the risk taken, especially in this new regime. In contrast to the Financials and Utilities sectors, for Real Estate we remain focused on private markets. Publicly traded Canadian multi-residential exposure is notoriously volatile, with stock prices falling as much as 68% during the height of the pandemic (TSX: -36%). This was despite the underlying assets having lost little to no value and appreciating aggressively through the pandemic. We remain bullish on the Canadian real estate theme, seeking the benefit of the asset class from the stable, consistent performance of multi-billion-dollar private portfolios.

Regime change is often a rather dramatic affair, but in this case, the world will change by the invisible hand of falling interest rates.

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