Market Update

Q3 2023

In this issue

September lives up to its notorious reputation, bonds are starting to make sense again and interest rates continue to hold the spotlight.

Market Returns

September 30th, 2023 (YTD)

Q2-2023 Returns

S&P/TSX Total Return	**1.10%**
S&P 500 Total Return (USD)	**8.70%**
NASDAQ Comp (US Tech)	**6.60%**
FTSE All-World Index	**5.50%**
FTSE TMX Universe Bond	**-0.69%**
Canadian Spot FX Rate	**-2.03%**

YTD-Total Returns

S&P/TSX Total Return	**5.70%**
S&P 500 Total Return (USD)	**16.90%**
NASDAQ Comp (US Tech)	**31.70%**
FTSE All-World Index	**12.50%**
FTSE TMX Universe Bond	**2.51%**
Canadian Spot FX Rate	**-2.30%**

Higher for Longer

I recently met with a portfolio manager, Noah Blackstein, who made a very interesting point about Jerome Powell's comment "higher for longer". He said it was utter garbage. How did his previous comments about inflation being transitory work out? They didn't start raising rates until it was too late. In a similar fashion, perhaps these comments will end up being the same, simply untrue. There are commentators suggesting that if you place an abandoned police car on the side of the highway most of us will slow down out of instinct. This could be one reason for the Fed to comment higher for longer so we might slow down spending knowing that there could be tougher times ahead. I don't believe we will see rates back to the lows seen recently but with mortgages at 6.5%, I could easily see them come down to 4 or 5%.

In any event, August, September and now October have been challenging months as an investor for both the equity side and the bond side. September is historically one of the worst months to invest and this year it has continued to hold true. However, the good news is that the last quarter of the year typically tends to be one of the better times to invest.

Many of the areas we invest in today will see a lift as soon as rates peak and will do even better if rates start to go down. These allocations include bonds, dividend paying stocks and growth stocks. There are several companies with solid dividends that have been heavily punished as there is now a tradeoff, which is money market funds and GICs for income-oriented investors. I can guarantee you I will not be cancelling my Enbridge services as we head into winter and as of today, you are being paid an 8% dividend per year just to hold the stock. On an after-tax basis you need to earn over 10% in an interest-bearing investment for them to be equal. The major difference is that stocks move and GICs do not.

What is holding up inflation?

Banks, Spending, and Higher Rates

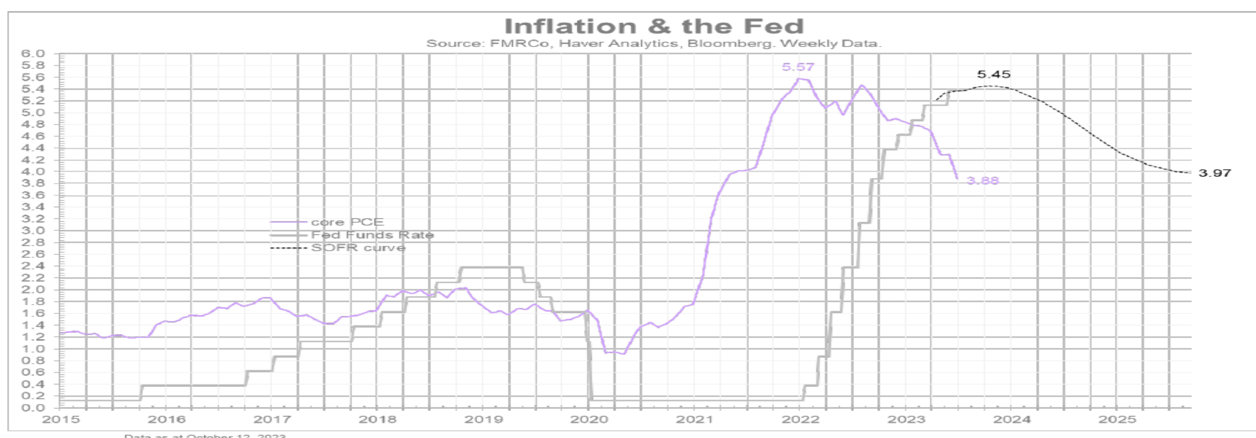
I was recently interviewed by the Globe and Mail about the higher spending by many Canadians. **Click here to read the article.** Banks are trying to manage their loan book to the best of their ability, but this means that many Canadians are refinancing at much longer durations. **Here** you can read that both RBC and TD bank have almost a quarter of all their mortgages amortized over 35 years. It isn't just the percentage of their loans that are longer than 35 years that concerns me, but it is the speed at which banks are changing this. **Royal Bank**, the country's largest lender, disclosed that 43% of its Canadian residential mortgages had an amortization period of longer than 25 years, as of July 2023. As of January 2022, it was only 26%, which has almost doubled.

When central bankers increase rates with the intention of slowing spending and Canadians increase their amortization period significantly, thereby reducing their monthly expenses, it minimizes the impact of rates moving higher. Doing so creates more costs in the long run for families, and in turn, reduces their total net worth when they look at retiring. It is interesting to note that my clients who live in Switzerland informed me that they have intergenerational mortgages. These are mortgages designed to never be paid off and effectively transferred to the next generation. When they retire, the mortgage payment is reduced, likely interest only, and then when they transfer the house to the next generation, the mortgage payments start back up and they continue to pay the higher amount. Is this where Canada is heading? Let's hope not.

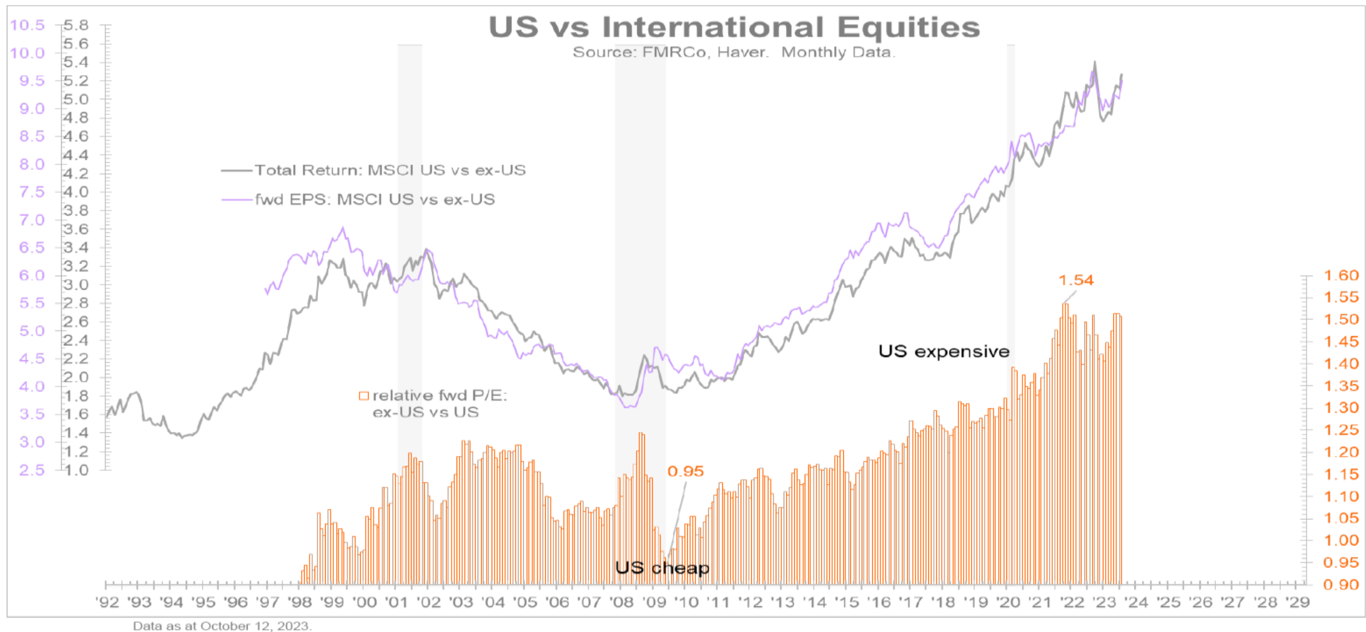
The last comment I will make on inflation is how it is calculated. It is done with many different inputs from our economy and now there are different ways to calculate inflation. One major driver of inflation is housing costs. As rates move higher the goal is to bring inflation down. However, as rates move higher, the cost of housing goes up, which has been a large part of the increase in inflation that we are seeing today. Sometimes you need to scratch your head and ask what is going on here?! You can see why it is easy to get the rate decision wrong and over reactions can occur.

With many conflicting views on where the world is heading, we need to look at earnings which lead stock prices higher. As we enter the Q3 earnings period we are looking for our companies to continue to post higher earnings and revenue than expected. As we know, when companies continue to beat earnings, their stock price will soon follow. Below are a few charts and trends to leave you with.

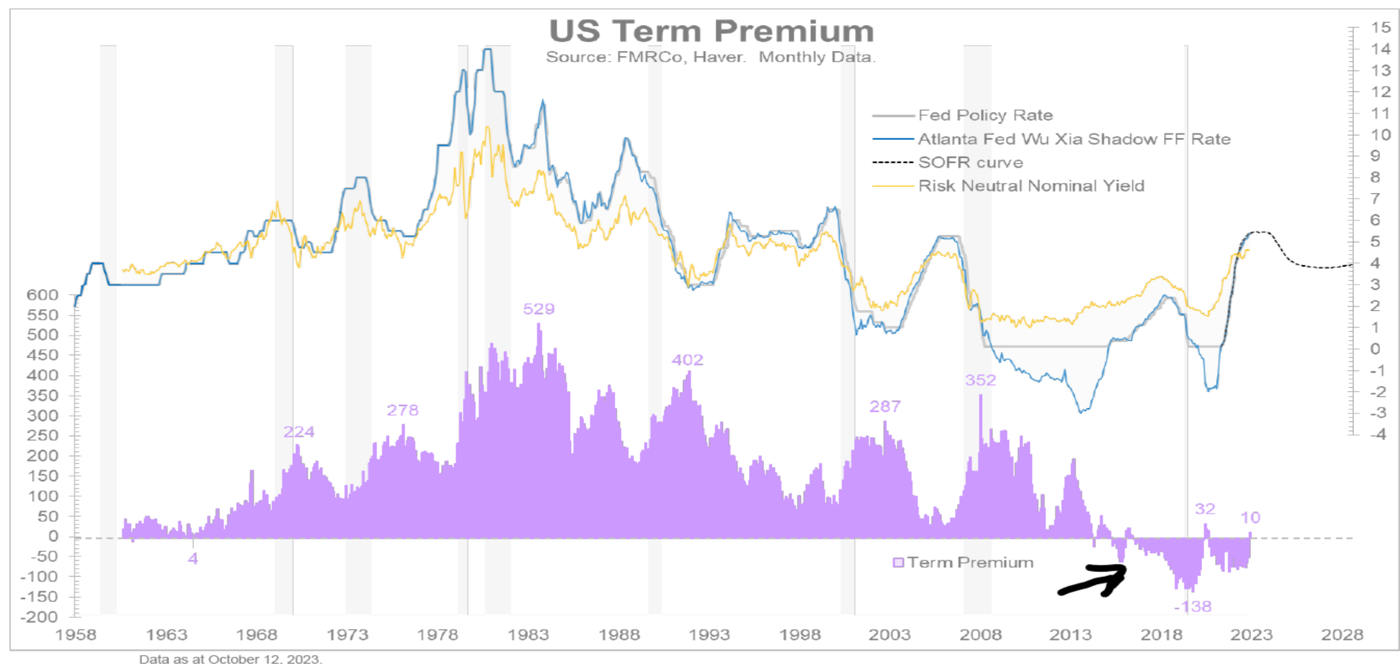
Inflation, when the Fed Funds Rate is greater: over the last 10 years, each time the Fed Funds Rate (black line) crosses over the inflation rate (purple line) we typically know that we have gone far enough, and the Fed should likely stop raising or even begin to cut rates.



International vs. US Equities – The US continues to look overbought at these levels, so we will continue to increase our international exposure or increase our weight in fixed income.



Bonds make sense again – Over the last decade the risk payoff for owning bonds didn't make sense. Bonds didn't pay enough interest for the risk of price decline as interest rates moved higher. We are finally getting back to the place where they do make sense again! Considering an average duration in the Canadian Bond index, a 1% move lower will generate about an 11% return in both price and interest. If rates move up another 1% you are earning 5% interest still and the price of the bond falling will lose 6% so overall, you have lost 1%. It is nice to see an upside of 11% with a downside of only 1%, all else being equal.



Investment Highlights in the Third Quarter

For those of you who enjoy more detail on investments, please see the below comments from myself and Brenan. This commentary provides a more detailed evaluation of our best and worst performing stocks within the models.

As of 09/30/2023	Standouts based on Q3 - 2023 returns	Stocks Under Pressure – Q3 2023
US Stocks (in USD)	Nvidia Corp (NVDA): +2.83% Abbvie (ABBV): +10.64%	Albemarle (ALB): -23.78% United Airlines (UAL): -22.91% (Sold)
Canadian Stocks (in CDN)	Fairfax Financial Holdings (FFH): +11.74% Dollarama Inc. (DOL): +4.30%	Canadian Tire Corp (CTC.A): -19.36% (Sold) Slate Grocery REIT (SGR.UN): -14.74%
Mutual Funds	MMCAP Canadian Fund: +26.64% Rosalind Capital Partners: +10.84%	Dynamic Global Infrastructure Fund: -10.98% Dynamic Power Global Growth Fund: -8.29%

US Stocks

In Q3 2023, the US Asset Growth & Income Model was down -8.40% meanwhile the S&P 500 Total Return Index was down -3.30% resulting in an underperformance of -5.1% over the quarter. On a year-to-date basis, the US Model is up 4.70% relative to the S&P 500 Total Return Index which is up 13.10%. It's been a very challenging quarter with only 2 out of 20 companies we own posting positive returns over this time frame. Although we're lagging in terms of performance, the companies in our portfolio are doing well, with 17 out of the 20 positions beating top line (revenue) and bottom line (earnings) consensus estimates in Q2, and many of them guiding higher for future quarters – typically this would be well received by the market but that hasn't been the case thus far. One thing to note, the S&P 500 Equal Weight Index is up 1.79% year to date as of September 30th so most of the return accounted for the S&P 500 Total Return Index (i.e., a market capitalization weighted index) has been due to the relatively large weights in the Magnificent Seven (NVDA, AMZN, AAPL, MSFT, GOOG, META, and TSLA) who have posted significant returns on the year.

Over the quarter, we sold out of our positions in Devon Energy (DVN) and United Airlines (UAL) and have purchased Amazon (AMZN) and Sherwin Williams (SHW). We decided to exit our position in DVN given the macro uncertainty around natural gas prices and the company's falling dividend yield. Our decision to sell UAL was predominantly due to the rapid increase of jet fuel prices over the quarter which we believed would squeeze margins and weigh on future earnings – recently UAL reported Q3 financials and have forecasted lower earnings and the price has fallen 18% since we exited out of the position. We decided to buy AMZN & SHW as both companies have shown an improving sale and cashflow profile and strong earnings momentum after bottoming in Q4 of 2022 – typically stock price appreciation is correlated to earnings growth, so we'll stick to our process of buying companies beating these metrics.

Canadian Stocks

In Q3 2023, the Canadian Dividend Growth Model was down -5.05% relative to the S&P/TSX Total Return Index which was down -2.19% resulting in an underperformance of -2.86%. On a year-to-year basis, the Canadian Model is up 0.60% compared to the S&P/TSX Total Return Index which was up 3.4%. The underperformance in the Canadian Model can be largely attributed to the dividend growth portion of the portfolio, where there wasn't a single stock that posted a positive return over the quarter. Many dividend paying companies have seen a sharp decline in their stock prices year to date predominantly due to interest rates continuing to trend higher. Most dividend paying companies are

large, mature, companies who have consistent sales and earnings; in Canada, think of utilities, telecommunications, financials, and some pipelines. In the past, these companies were viewed as “safe haven” stocks as they appreciate slowly and pay out great dividends consistently. With GIC’s competing for income many have decided to sell these stable companies and take no risk, meanwhile earning 5% interest income. On an after-tax basis I would rather have Enbridge paying us an 8% dividend with upside potential than the 5% on the GIC. This change in mentality has led to substantial selling pressure over the year but more so over the past quarter as the “higher for longer” narrative has resurfaced.

Over the quarter, we sold Canadian Tire Corporation (CTC.a) and Atco Limited (ACO.x) and have purchased Alimentation Couche-Tard (ATD) and Quebecor Inc (QBR.b). ATD is a Canada-based independent convenience store and road transportation fuel retailer with approximately 14,300 stores around the world. ATD has been flagging well on our Canadian Growth Model for several months and has shown consistent revenue and earnings growth year over year. QBR.b primarily provides telecommunications services in Quebec, where it has roughly 1.7 million internet subscribers and more recently has added 1.5M mobile subscribers in Ontario by closing on the Freedom Mobile acquisition. QBR.b trades at an attractive valuation (9.1x forward P/E) and pays out a 4.2% dividend yield. We believe there is ample long-term upside to a company such as QBR.b as they have a strong history of earnings growth and should be able to generate synergies from the integration of Freedom Mobile assets.

Mutual Funds

In Q3, MMCAP and Rosalind Capital Partners were our top performers and were up 26.64% and 10.84%, respectively. On a year-to-date basis, MMCAP and Rosalind Capital Partners are up 26.56% and 35.10%, respectively. MMCAP uses a variety of strategies including special situations, merger arbitrage, corporate restructuring, short selling, convertible arbitrage, and pairs trading. The fund’s main objective is long-term capital appreciation and has an annualized return of 24%. MMCAP year to date gains can be solely attributed to their performance over the past quarter. In conversations with the portfolio management team, approximately 20% of the fund was invested in uranium companies heading into the quarter. Uranium has moved from a spot price of approximately $50 earlier this year to $70 now, and the fund benefitted from having significant exposure to these uranium companies (CCO, NXE, EFR, etc.) which have traded substantially higher (in some cases doubling in a few months). Rosalind Capital Partners is an event driven long short manager who invests only in the life sciences sector. The fund aims to cushion against extreme downside market volatility with out of the money index ETF puts. Rosalind is a relatively small fund with $150M in AUM and has posted a per annum return of 18% since inception.

Our worst performing funds over the quarter were the Dynamic Global Infrastructure Fund and the Dynamic Power Global Growth Fund which were down 10.98% and 8.29% respectively. Both funds were impacted by an increase in interest rates and the “higher for longer” rhetoric. Dynamic Power Global invests in growth companies and Dynamic Global Infrastructure invests in publicly traded infrastructure assets – both investments are typically inversely correlated with interest rates, so when interest rates move higher (or when the market expects them to move higher), these funds will typically get hit and underperform, which was the case in Q3.

Looking Ahead

Taking into consideration the turmoil we have seen in the markets at the end of this quarter, we will look to use this drawdown to our advantage and begin tax loss harvesting for year-end. As we enter Q4, we also recommend reviewing your 2023 RESP and TFSA contributions to ensure we have maxed out those accounts and taken advantage of the grants and tax-free savings. Please reach out to Mikaela with any questions.

Given a volatile year in the world at large, we look forward to being able to come together to celebrate the Holiday season with you all. This year we will be hosting our **Annual Holiday Party at Stratus Restaurant on Tuesday, December 12th**. You should see Save the Date in your inbox shortly. We hope to see you all there!

As always, should you have any questions or if you are looking to book a portfolio review, please let us know and we will be happy to schedule a time.

With Kind Regards,

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