THOUGHTS ON THE MARKET

Perception vs. Reality in Investing

"It's not what you look at that matters, it's what you see."

- Henry David Thoreau, Author and Philosopher

May was a tough month for stock markets as fear of a U.S. debt ceiling crisis and a small increase in the U.S. Consumer Price Index kept buyers on the sidelines. The overall market perception was that there was potential for a deep sell off in stocks and interest rates were not going lower any time soon, with little consideration to what was actually happening. This month, we will examine the perceptions and realities of the current investment environment to try to best determine what is on the investment horizon.

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The Dow closed down -3.7% on the month and the TSX down -4.98%. The perception of a possible U.S. debt ceiling crisis was increased almost daily by the media. The reality is that House Speaker McCarthy was able to negotiate a deal with President Biden and the bill passed the Republican controlled House of Representatives. Then passed in the Senate where Democrats hold the majority and avoid any potential crisis until January 2025. This should calm the political waters for the moment, until the U.S. election campaign gets into high gear.

On the inflation front, the U.S. Core Personal Consumption Index did rise from 4.63% to 4.7%, which some market participants have attributed to inflation being higher across all sectors. The majority of this increase was a result of higher housing costs due to the Fed's most recent interest rate hike. The reality is several key elements including services, food and energy are trending downward but remain above target levels. The market was looking for the linear decline in inflation to continue and moved lower in disappointment, as hopes for a Fed rate cut this year diminish. When we look at the reality of inflation, the Fed has expressly stated that there will be no rate cuts until at least 2024. We don't see Chairman Powell moving before then, solely not to undermine his credibility. However, we do see companies being able to navigate the current rate environment.

As to interest rates, the U.S. yield curve remains highly inverted with 3 month Treasury bills at 5.38%, 2 yr bonds at 4.35% and 10 yr bonds at 3.6%. We expect U.S. yields to be pressed lower, at least temporarily, in June as the U.S. needs to raise approximately $500 billion to refinance the U.S. Treasury which was nearly out of short term funds due to the debt ceiling. Traditionally, the government's operating cash balance is funded by short term Treasury bills but given the higher cost, they may issue longer maturity debt. The yield curve may somewhat flatten given how much needs to be raised but the perception is that the bond market is still predicting a recession. The reality is we are 15 months into a rising interest rate cycle and economic activity as measured by U.S. Gross Domestic Product has remained stable. Combined with the fact that unemployment levels remain near historic lows throughout North America, we believe the likelihood of a meaningful recession is low.

Individual stocks are always evaluated on their dividend and earnings power but trade on perception. Take the examples of Canopy Growth and Royal Bank. When cannabis was legalized in Canada, Canopy was perceived to be the market leader and saw its stock rise from pennies to over $67 per share in April of 2019. This rise occurred despite the fact that they lost more money with each passing quarter. The perception was they would reach profitability as sales grew but reality has now caught up to them. They continue to lose money and the stock is at $1.02 per share. On the other hand, Royal Bank recently reported earnings and the stock fell from $132 to $123 today. The market was disappointed by higher provisions for loan losses and a lower Net Interest Margin as they had to pay higher rates on deposits. The perception was that a slowing economy with the potential for a recession would continue to be a drag on earnings. There are two points of reality that deserve further consideration here. First, reserves taken for potential losses are a non-cash accounting entry. They haven't actually realized the losses and the cash remains on their balance sheet. Second and even more important, management increased the dividend moving forward. In this investment era where dozens of U.S. law firms are solely focused on suing companies over false or exaggerated statements, you have to be precise in what you disclose to shareholders and increasing the dividend is one of the strongest and most positive messages a company can deliver. While we are temporarily unhappy Royal Bank stock is down, we remain confident the stock will recover and continue growing while Canopy investors have little hope on the immediate horizon unless their reality materially improves.

The rest of the Canadian market was weak along with the banks as oil and base metal stocks also moved lower on recession fears. Pending OPEC production cuts will stabilize oil prices and Canadian oil producers will remain very profitable. Canada's GDP was a healthy 3.1% for the first quarter of 2023 and with the unemployment rate at 5%, only 0.1% above the record low, the perception of a pending recession should fade and the Canadian market would return to a more normal, higher level.

The next major talking point for markets comes in mid June with the next U.S. Fed meeting. The market is hoping for a pause in interest rate increases and words of comfort from Chairman Powell. The market may get their pause but Powell will undoubtedly keep the door open for future increases, depending on inflation data. A positive perception of Powell's comments would definitely help the overall market.

Market sentiment was weak in May but it is interesting to note that the Volatility Index, the market's fear gauge, has dropped to pre-Covid levels and is in bullish territory. One bright spot during May was the strength in technology stocks, particularly portfolio names such as Apple and Microsoft. Traditional investment analysis would suggest this sector be avoided in a rising rate environment but the market's new found enthusiasm for stocks involved in artificial intelligence has led to a strong uptrend in the sector. As these stocks are some of the largest in the Dow and S&P Indexes, they move the index higher but the overall market advance has been limited to a narrow range of stocks as recession fears have kept the broader market from advancing. As recession fears ease, we expect a broader based rally, with the possibility of some profit taking in the technology names given the reality of the more compelling value in many other sectors.

Perception is a driving force in today's financial markets. Stocks can be driven higher by the merest possibility of positive news but the true, sustainable rallies come when the reality of facts reinforce the market's view. At this time, the market's overall perception is of a pending slowdown but the facts we have discussed seem to disagree. We will have to see if either the June Fed meeting or the second quarter earnings season starting in July can help change minds and lead to a broader market advance.

In conclusion, perception can change but facts remain consistent. While the market will always be worried about something, we expect that the resilience of both companies and the economy will eventually be reflected in higher stock prices. Until next month, stay well.

As always, questions, comments, concerns and feedback are always welcome.

Yours truly,
Trevor, Walter and the Cooper Wealth Management team