Markets Made Simple

Chan and Brown Wealth Management

Wealth Management
Dominion Securities

FOURTH QUARTER REPORT – DECEMEBER 31ST, 2023

THE NEXT 10 YEARS

Waiting patiently at the boarding gate, nine days after we arrived in Mexico, my brother Justin and I were happy to be alive. We wanted an exciting Mexican adventure, and we got all that and more! We had driven over 2000 km in a rental car and experienced everything from questionable street tacos, to violating historical Mayan Ruins by parking next to a 1200-year-old hundred-foot pyramid. We avoided Mexican jail by paying a bribe six hours after arriving, almost had my fingers amputated by a snapping turtle, and visited towns where we were the only people who did not have a gun fashionably strapped on our back. We thought our adventures were all done.

Catching up on our emails in the airport lounge was not as much fun as having a python slowly wrap itself around our neck or walking through a cave surrounded by bats likely infected with rabies, but we were glad to be at the end of our Mexican excursion and ready to go home. Boarding call came and we leisurely made our way to the gates as one of the last passengers to board.

At the gate, passengers were checked for a piece of paper with a QR code that we were given when we arrived in Mexico. If you don't have it, you don't leave Mexico. I handed the immigration officer mine, while my brother frantically looked for his. He could not find it anywhere…then he realized during the flight check-in, the attendant took it but did not return it.

We had 10 minutes before the gate closed. Justin had to leave the airport, get his passport stamped by immigration, come back through customs, and then run halfway across the terminal to our gate where our plane will hopefully still be waiting. It was like an episode of Amazing Race. He either completes it in time or it's Hasta La Vista Justin.

2021 – What Do the Next 10 Years Look Like?

A few years ago, I wrote a newsletter in the second quarter of 2021 entitled ***What Do the Next 10 Years Look Like.*** In that letter, I highlighted the expectations for investors over the next decade, basically: Not Good.

There have been five periods over the past 100 years where investors in a balanced portfolio of 40% bonds and 60% stocks[1], made no money over 10 years. Each time, the common theme was that *either stocks or bonds* started with expensive valuations. Investors overpaid and lacklustre returns followed. If you bought your neighbours house for $2 million while your own identical house was valued at $1.2 million, recouping your purchase price would take some time. When investors overpay, their future returns suffer, sometimes for decades.

In 2021, for the first time in history, ***BOTH bond and stock markets were expensive.*** *Bonds were trading at their third highest, and stocks at their second highest valuations in the past 100 years. The outlook for the next decade was not promising.*

Since I wrote that newsletter, a lot has changed. Rates increased from 0.25% to 5.75%, at the fastest pace in over 50 years sending shockwaves through the economy and the markets. Higher rates were the medicine for the massive government spending, artificially suppressed low rates, and record growth in money supply that occurred after COVID and caused inflation to spike to 50-year highs.

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[1] 60% in US stocks - S&P500 and 40% in US bonds - JP Morgan Government Bond Index, rebalanced monthly.

Like Buckley's cough mixture, "…the medicine tastes awful…", mortgage and debt payments ballooned while investors went on an unpleasant roller coaster ride, "…but it works…" as two painful years later the economy is approaching a sustainable equilibrium for the first time in four years.

<u>What Do the Next 10 Years Look Like From 2024?</u>

Bonds

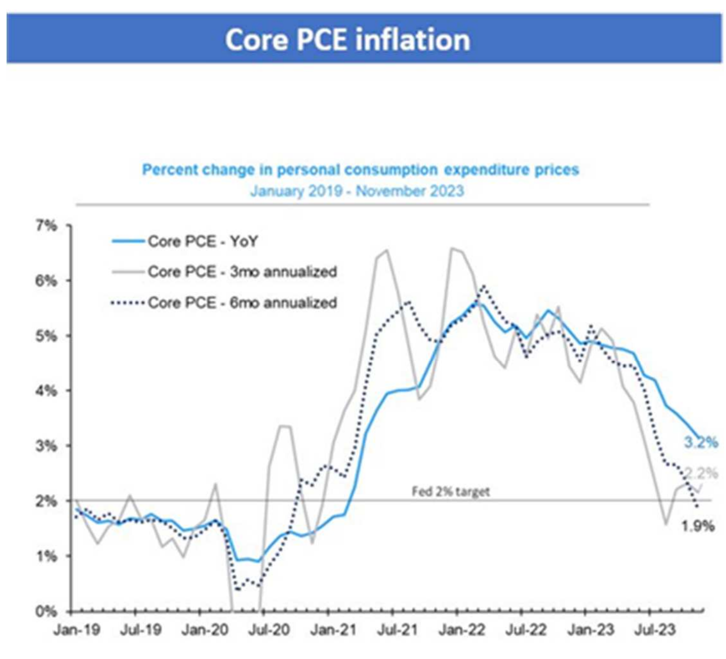
In 2021, US Treasury 10-Year notes yielded 1.3% and corporate bonds 2.1%, not quite as exciting as driving at night in rural Mexico but at least returns were predictable. With bonds paying investors almost nothing for the next decade and representing close to half of a balanced portfolio, it was going to be a challenge for investors to generate meaningful returns. Instead of owning longer term bonds with minimal yields and large downside risks, we focused on ones that matured in the short-term and could be reinvested when rates went up.

Fast forward to today, US 10-Year Treasury yields have reached almost 5% in 2023 and yields on corporate bonds increased over 300%, reaching a high of 6.7% in 2023. The future is looking much brighter for investors as yields reached their highest levels in over 15 years. We are now able to get exposure to corporate bond funds with 6-9% yields as well as individual discount government bonds where most of the return is tax efficient capital gains rather than interest. The equivalent after tax yields for some of these government bonds is over 7%. We are also finding preferred shares that will be resetting their dividends in the next one to two years, paying investors almost double digits yields[2].

It has been a long time since the fixed income market has been this generous, but many investors are still locking their funds away in short term GIC's or leaving them in variable rate high interest saving accounts.

<u>The End of the 5% GIC</u>

In December the US Federal Reserve acknowledged that the economy is slowing, job growth is moderating, and inflation is cooling. The PCE Price Index tracks the prices paid by consumers and is a key method used to monitor inflation by the FED. The annualized growth rate over 6-months dropped below 2% for the first time since late 2020, and below the FED's target range for inflation. The cooling effects of higher rates are filtering through the economy and inflation is falling with it.



Source: BEA; EY-Parthenon

2 Based on the current 5 Year Bank of Canada Rate

After raising interest rates over 10 times in the past two years, the FED is done. As the economy has slowed and returned to normal, the FED now plans to start lowering rates instead of raising them. The FED indicated they expect to cut rates three times in 2024[3], while the markets expect even more, six rate cuts in 2024[4].

This is good news for variable rate mortgage holders and bad news for investors with maturing GIC's. As rates fall, the brief appearance of the 5% GIC will disappear faster than Taylor Swift concert tickets. We have never seen such a large amount of cash being held by investors which now total in the trillions….so the trillion-dollar question is: "What will investors be doing with this cash?"

Stocks

The Shiller Price-to-Earnings ratio (Shiller P/E) is based on average inflation-adjusted earnings of the previous 10 years. It helps smooth out extreme year over year jumps in earnings that can occur throughout a business cycle. A simple way to understand this ratio is that it represents the number of years you are paying for a company's earnings. The long-term average Shiller adjusted Price-to-Earnings Ratio for the S&P 500 since 1872 is 17X[5]. At 17X, for every $1 in earnings, you are paying 17X the amount for shares. If earnings were $1, you would be paying $17 per share. The lower the ratio, the cheaper stocks are and the higher the ratio, the more expensive they are. In 1920, the PE Ratio was around 5X, stocks were incredibly cheap, so if earnings were $1 you would be paying $5 per share.

The chart below shows the Shiller PE Ratio for the S&P500 since 1872.

In 2021, stock market valuations hit their second highest level in the past century at 120% higher than its long-term average. When the Shiller PE ratio becomes too expensive, future returns suffer. In 1929 when the markets reached a Shiller PE ratio of 31X, 85% higher than its long-term average, it took investors almost 30 years[6] for their investment to return to the levels they bought them at[7]. Or in 1999 when the S&P 500 had a Shiller PE ratio of 44X, it took investors over 15 years for their investments to recover. Most recently in 2021, after reaching 38X, the S&P 500 would drop almost 30% and the NASDAQ by 35%.

When history talks, we listen. Our goal is protecting the value of our clients' savings through different business and market cycles. In 2021 we focused on investments in value-oriented companies and segments of the market that were reasonably priced and trading below their long-term averages such as oil companies. These were selling at some of the cheapest valuations in decades and had inflation protection built into their business models. This helped us weather the storm and significantly outperformed the average balanced portfolio in 2022, while also taking advantage of many of the bargains that presented themselves.

[3] https://fortune.com/recommends/banking/fed-rate-change-history-forecast/
[4] https://www.investors.com/news/economy/federal-reserve-tees-up-three-rate-cuts-for-2024-sp-500/
[5] https://www.multpl.com/shiller-pe
[6] Investors Investing in the S&P500 - https://www.macrotrends.net/2324/sp-500-historical-chart-data
[7] Based on the Price Return of the S&P500 https://www.macrotrends.net/2324/sp-500-historical-chart-data

What about valuations today? After falling slightly from their highs in 2022, the Shiller PE ratio is at their fourth highest valuation in the past 150 years at 32X, or 88% higher than its long-term average. With the S&P 500 still expensive, what should investors do? Taking a page from the Boxing Week shopping season, when one store isn't offering us the discounts we want, we go shopping at another store.

<u>The Bargains Today</u>

1. ***<u>Small and Mid-Cap Stocks</u>***

Stocks, sectors, and markets go through different cycles. Technology stocks outperformed in 2023 after dramatically underperforming the previous year. Oil stocks were the highest returning segment of the markets in 2021 and 2022 after underperforming for almost a decade. Like children demanding Barbie Dream House as this Christmas' most wanted toy, investors often get excited about the latest "seasonal" fad such as AI or EV related businesses. However, previously years' hot must have items like Cabbage Patch dolls or Beanie Babies, soon lose their luster and are relegated to the back of the closet to languish beside former investor favorites like cannabis stocks or crypto currencies. Our role as your money manager is to shift through the "popular trends" and find the best opportunities of true value for long-term growth.

After chasing various themes such as work from home (WFH) related stocks during COVID, cryptocurrencies, and now Artificial Intelligence, investors have once again forgotten about a segment of the market that has historically produced the best returns and had the largest potential growth rates over the long-term. Small and mid-sized companies have historically traded at a premium to larger companies because of this potential. It is much easier for a smaller company to double their sales from $100 million to $200 million than a company like Apple to double their sales from $380 billion to $760 billion. As investors have lost interest in these companies their valuations have become more and more attractive.

Mid-Cap P/E Ratio Relative to Large-Cap P/E Ratio

Jan.1997 – Oct. 2023

Source: Bloomberg. Mid-cap represented by the S&P Midcap 400 Index. Large-cap represented by the S&P 500 Index. Index performance is not illustrative of fund performance. It is not possible to invest directly in an index. Past performance is no guarantee of future results. See disclaimers and descriptions at bottom of page.

The chart above shows the valuation difference between mid-cap and large-cap stocks. During the internet boom in 2000, investors pushed the valuations of large cap, internet stocks way up and forgot about small and mid-cap stocks. Over the next 14 years, large cap stocks[8] would return basically zero for investors while small cap stocks would double[9] and mid-cap stocks would increase over 250%[10]. We have seen this valuation gap grow even larger today than in 2000 and have decided to allocate more of our portfolio to these bargains that will not last.

[8] Dow Jones U.S. Large-Cap Price Index from March 20th, 2000, to December 16th, 2023
[9] Russel 2000 Price Index from March 20th, 2000, to December 16th, 2023
[10] S&P 400 Price Index from March 20th, 2000, to December 16th, 2023

2. ***Canadian Equities***

With the strong returns of the US markets over the past decade, investors have been leaving Canada like snowbirds in the winter. Funds have been flowing mostly to the US, causing the valuations in Canadian markets to drop. They currently sit at close to a 15% discount to their 10-year average Price-to-Earnings ratio while our small cap holdings are even cheaper, trading at a 25% discount to the S&P/TSX.

3. ***International Equites***

Our international equities also continue to trade at record discounts to their American counterparts and we remain overweight in this area. After the year 2000, international markets outperformed their US counterparts by 65% over the next eight years[11] when valuations of US markets became expensive and international stocks remained fairly valued. Today the gap is even bigger than in 2000. The chart below shows international stocks are trading at a 30% discount to US stocks.

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of September 30, 2023.

Getting Home

Back at the airport, as my brother set off on his quest feeling like ET trying to get home, I had a job to do: Delay the plane as long as possible! I asked the flight attendant how long until the gates close? Eight minutes. I decided to make that the longest eight minutes since Jack Dawson's death scene in Titanic.

I waited outside the gate as long as I could until I was told it was my last chance to board. With the speed of a tortoise wading through molasses, I fumbled my way through the boarding counter. I then informed the attendant that they had to get my brother's (non-existent) checked luggage off the plane first and the confusion while they conferred, bought us several more precious minutes. Finally, I was told to "Get on the plane now!" or we are leaving without both of you.

Cash

With record amounts of cash earning 4-5% interest, investors were happy to be an NFL back up quarterback, well paid to sit on the sidelines. Unfortunately, the current rates offered by financial institutions will not last. Like my situation at the airport in Mexico, the cost of waiting is getting higher as rates begin to fall.

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[11] MSCI EAFE vs the MSCI USA, JP Morgan Guide to the Markets

After the Financial Crisis in 2009, rates dropped to zero. Large amounts of cash had accumulated from investors who got scared, panicked, and sold their investments. With limited appealing options, funds started flowing back into the markets. Over the next 13 years, the US markets would climb over 400%. Investors who waited, faced the consequences of seeing prices climb higher and higher when they missed their chance to board. The cost to board has already become more expensive as stock and bonds markets moved higher over the past year, and yields have dropped heading into the end of 2023.

End of the Mexican Adventure:

As my litany of excuses to delay the plane ran out and the flight attendant began to walk toward the closing doors, I spied in the distance a racing form at the far end of the terminal. “I see him, he’s coming!!!” I shouted to the attendant. With the music of Chariots of Fire playing in the background, I watched as my brother weaved through half-asleep families, leaped over small children and sidestepped luggage trolleys with the agility of a gazelle being chased by a cheetah and finally arrived at the gate, stamped passport in hand, completely breathless and wheezing like he was on life support.

“Ok, you are lucky, you just made it.” grumbled the attendant.

As we boarded the plane together amidst some dirty looks from the flight crew and passengers, my brother and I sat down and reflected on what might have been. Justin would have eventually gotten home. However, he would have suffered consequences such as missing work, important business and social appointments, and the additional cost of purchasing another flight. Investors who miss opportunities may still eventually achieve their goals, but they may not appreciate the cost and possibly long delay to get there.

All in all, Justin and I are glad we made it.

-Kind regards,

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