Markets Made Simple

Chan and Brown Wealth Management

Wealth Management
Dominion Securities

FIRST QUARTER REPORT – MARCH 31ST, 2024

THE LAST MILE

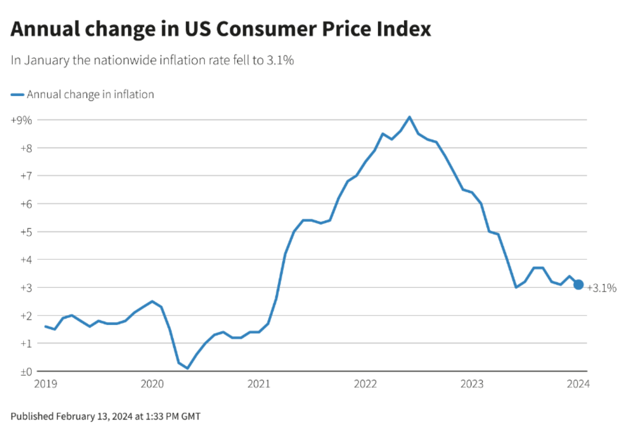
The last rays of sun were starting to fade on the green canopy of treetops dotting the skyline in the distance. We were somewhere in the Rocky Mountains and the temperature was quickly falling while we were still miles from our intended destination. We should have been at home, relaxing by a cozy fireplace, content and pleasantly stuffed from a hefty steak and potato celebratory dinner with my parents and siblings. Instead, we were spending our third night in the wilderness, running low on food and water, and feeling pain in areas of our body we didn't know existed. It had been another long day, up at 5:00 am to catch the sunrise, lugging a 50-pound pack over snow-covered mountains for 14 hours while playing hide and seek with a variety of dangerous and hungry wildlife. We were exhausted and ready to lie down and just let the bears eat us and be done with it. We needed to find a place to camp, and fast.

It was just another Brown family vacation. We were celebrating my dad's 60th birthday and he decided it would be 'fun' to take a helicopter, get dropped off in the wilderness of Banff, Alberta, and hike our way out like an episode of 'Survivor – Amazon'. Why couldn't I have a dad that just enjoys golfing for his birthday?

As darkness descended and we thought about all the horror movies where a naive family goes exploring in the backwoods and is never heard from again, we wondered whether this final stretch of our family journey would ever end.

Taming Inflation

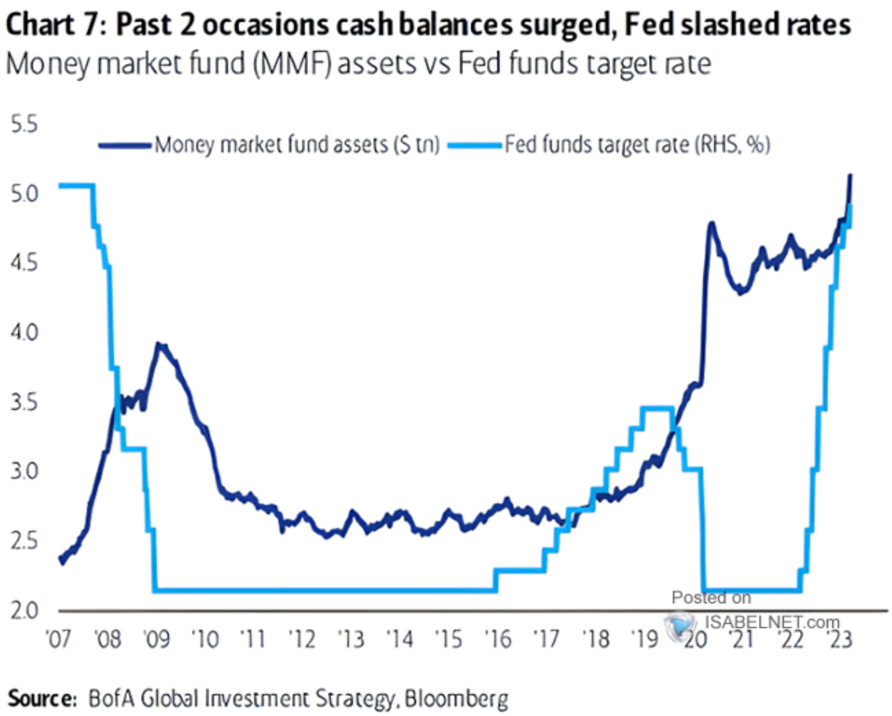
By June inflation had retreated to 3% from a high of 9% and has steadied there for the past 10 months. The large reduction in money supply and the increase in interest rates have succeeded in driving inflation down from their 2022 highs. Now coming up to almost a year, dropping the final level of inflation from 3% to the targeted 2% seems to drag on like our long hike in the dark. As the battle against inflation rages on, mortgage and debt holders are feeling the pain. 80% of mortgages that were outstanding two years ago are renewing this year at two to three times their current rates.[1]



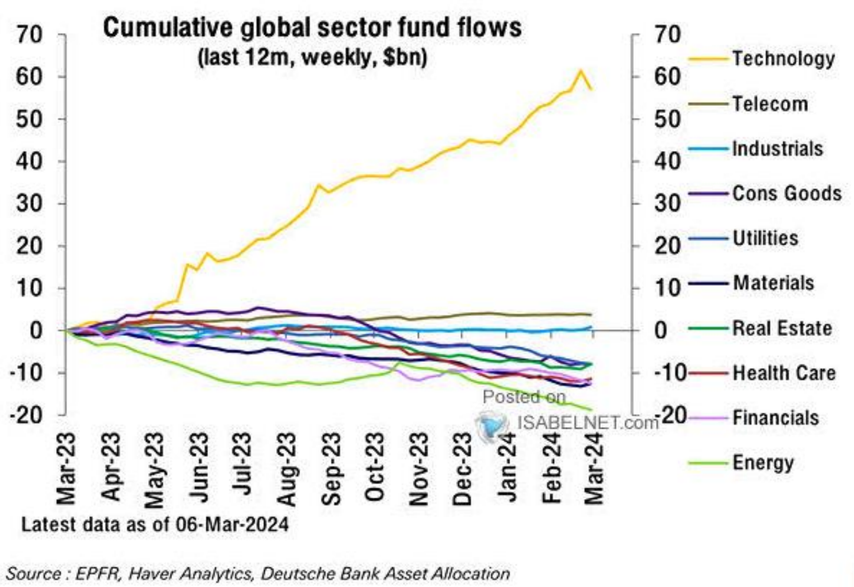
[1] https://www.ratehub.ca/blog/renewing-your-mortgage-in-2024-heres-what-to-expect/

The Shift in Capital

The rapid rise in rates have caused a huge shift in capital as investors were finally able to earn a ***return!!!*** on cash. Money has been moving quickly to savings and money market funds causing balances to reach all-time highs. The chart below shows cash balances since 2007 relative to rates. As interest rates have surged, so have cash balances.



Money has been leaving almost every sector in the market over the past 14 months… except one, technology.



Technology

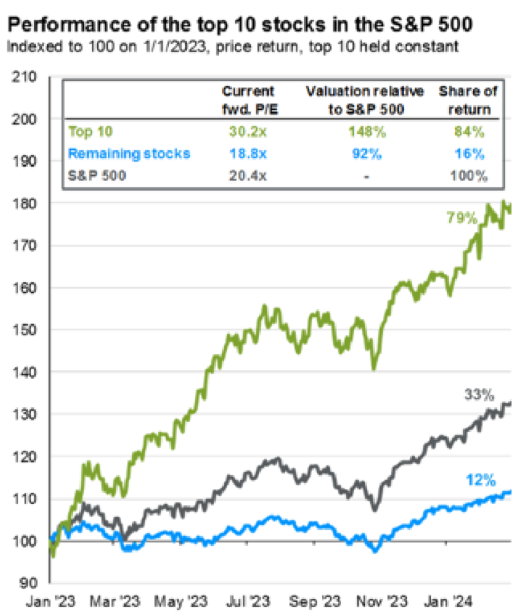
Let's rewind the clock to the 1999 when the World Wide Web was taking over the world. For the first time in history, you could press a button and have almost anything delivered right to your door. No need to line up at the bookstore for the release of JK Rowling's *Harry Potter and the Goblet of Fire* or rush down to Blockbuster to rent the hottest new titles only to see nothing left on the wall but copies of 'Bridges of Madison County'. The internet was changing the world and excitement was in the air. With limitless possibilities dancing in front of investor's eyes, funds poured into internet companies until it came to a crashing halt in 2000 when those same companies watched their share prices freefall into oblivion. Companies like Books-A-Million, a bookstore chain in the US saw their shares "lose-a-million" as they drop from $47 to $3 or Digex one of the first internet service providers in the US who watched their share price plummet to $1 from a high of $184.

Fast forward 25 years and the internet has now completely revolutionized the world. Along the way, *investors* in internet companies lost hundreds of millions of dollars. Today, Artificial Intelligence (AI) is changing the world. It can do many jobs better than we can, drive us all over the city while we watch Netflix movies on our phones, automatically play our favorite music in our house or order from our preferred take-out joint, they even have AI boyfriends and from what I hear, they are better listeners than real boyfriends. The excitement over AI is growing and money is pouring into AI companies faster than my mom runs when she hears the bushes rustling on our hiking trail.

The Divide

Last year we highlighted the divide in the markets. There is technology, and then there is everything else. If we divide the S&P500 into two segments, the 10 largest companies of the index and the other 490 companies, two different stories emerge.

From January 2023 until February 2024, the 10 largest companies in the S&P500 returned 79%. The rest of the 490 companies? *12%. That is a difference of 67%.* Remove the 10 largest companies from the S&P500 and the return for the index would fall 20%. These 10 companies have grown exponentially and now represent over a third of the entire index. This has never happened in the entire history of the market.



*JP Morgan Guide to the Markets, as of February 29th, 2024

In past last year, the term 'The Magnificent Seven' arose which refers to the seven largest companies in the United States: Microsoft, Amazon, Meta, Apple, Alphabet, NVIDIA, and Tesla, all which have AI as part of their business. As funds continue to flow into this sector, they have been exiting other areas of the market. We have seen this before, approximately two and half decades earlier in 1999.

Value

I love finding a bargain, it has been a core value since I was a young child. Our family grew up with one income and my parents spent everything they had on schooling and sports for the three of us kids. When we wanted something that was not essential to our survival, like the newest Red Hot Chili Peppers CD, Nike Pumps, or fashionable baggy jeans, we had to come up with the money for it. From mowing the neighbors' lawns during the hottest days of summer to dodging vicious chihuahuas while delivering newspapers, I worked hard to earn my money and learned the value of finding bargains to stretch every penny.

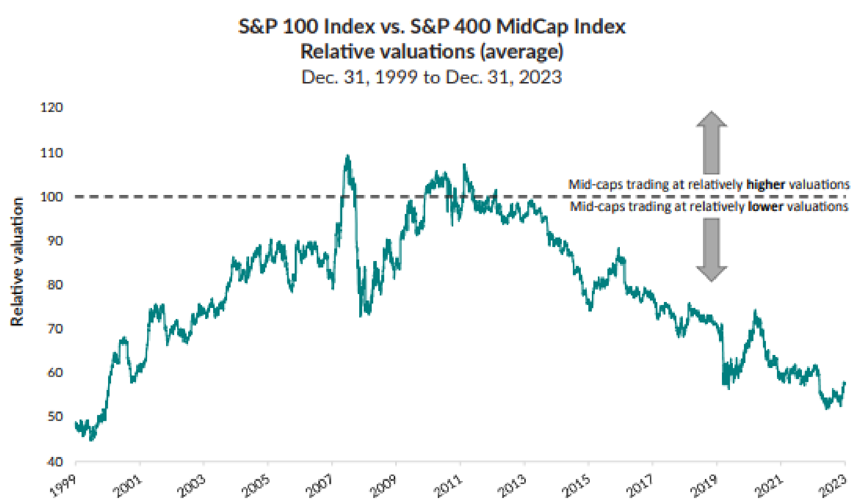
We look at investing the same way. We scour the markets to find the best deals and try to make the most of every dollar of our client's money. Overpaying based on hopes and dreams is a recipe for disaster and history is full of examples of them. From the internet boom in 2000, weed stocks in 2018 and cryptocurrency companies three years ago, most people who were caught up in the hype lost big.

There are a number of ways to look for bargains (other than the weekly Walmart flyer); one is during market volatility when good investments go on sale in the face of investor panic and fear. This can be a great opportunity for us to add to our holdings in quality businesses or attractive fixed income investments. When the markets dropped 25% in 2022 and 10% last November after a strong gain in the summer, we took advantage and went shopping for deals, adding to existing positions and adding some underpriced new ones.

Another way is to pay close attention to where investors are not. Investors may need to sell for a variety of reasons unrelated to markets such as tax loss selling, or the short-term allure of day-trading the latest investment fad. As capital moves around within the markets, it flows from one area to another, leading to great opportunities when investors ditch good investments. With the excitement and potential in AI, investors have been discarding some very attractive investments.

The Forgotten: Small and Mid-Caps

Leading up to the internet peak in 2000, the flow of capital into internet companies became a flood. As funds moved into these companies, investors paid higher and higher prices and neglected segments of the market that were considered 'boring'. Small and mid-cap stocks, like the side of vegetables at a steak dinner, was one area investors ignored even though they have historically produced the highest long-term returns[2]. As funds moved out of these companies, prices got cheaper and the gap in valuations between small and mid-cap stocks vs large cap stocks reached extremes.



Source: FactSet Research Inc. The S&P 100 Index and S&P MidCap 400 Index are shown to compare the relative valuations of large- and medium-capitalization companies. The indexes are not investible. *See Important information – benchmarks and indexes* for additional details. Relative valuations are the daily average of five valuation metrics for the two indexes: price-to-earnings ratio, price-to-book value ratio, price-to-cash flow ratio, price-to-sales ratio and enterprise value-to-earnings before interest, taxes, depreciation and amortization.

[2] https://pictureperfectportfolios.com/invest-in-the-sp-500-if-you-enjoy-losing-in-life-and-want-to-be-in-last-place/

The chart above compares large and mid-cap stocks and their relative valuations since 1999. Mid-cap stocks were trading at about half of the valuations of large cap stocks in 1999. In 2000 that reversed. Funds started flowing out of large cap companies and into small and mid-cap companies propelling small caps up 200% and mid-caps up 250% over the next 15 years. Meanwhile large cap stocks would languish and return *NOTHING* over that same period. Today we are seeing large flows into Artificial Intelligence like the Magnificent Seven while the valuation gap between large vs mid-cap companies reach levels not seen in over two decades.

We took advantage of this disconnect over the past twelve months and have continued to do so this year, selling some of our best performing and expensive large cap names to increase our exposure to smaller, more attractive companies. We have also written extensively about preferred shares, an area of the fixed income market we find attractive. Preferred shares have historically yielded around 1-2% higher than GIC's while many of the rate-resets we own will be see an increase in yields of 3-4% in the next couple of years[3]. Investors are starting to take notice. Over the past 5 months the S&P/TSX Canadian Preferred Share Index rose 20% and over the past month several companies have redeemed their own preferreds.

In the past month, $700 million of preferreds were redeemed by TD, CIBC and Brookfield Renewable Partners. Many companies are sitting on excess cash they need to put work and based on the high rates they are paying to investors who own their preferreds, it makes sense to buy them back. Another other reason companies are redeeming their preferreds is to issue new debt with lower yields that cost the company less to fund. Preferreds have a par value of $25 and almost all the preferreds we own were purchased at a discount to their par. If a company wants to redeem their shares, they must pay investors back the original $25 par value and we are more than happy to oblige and let them buy us as many of our preferreds are trading at discounts of 20% or more. If the company does not call their shares, we will also be quite happy to continue collecting close to double digit yields on them. As rates are forecasted to drop, we expect these redemptions to continue.

The Last Mile

The last four years have been a wild ride for markets, interest rates, inflation, and investors. COVID led the US markets to experiencing the fastest drop in history, falling almost 35% in three weeks. Then investor excitement took over when record amounts of stimulus was injected into the economy causing markets to double from their lows over the next 18 months.

After this period, fear took over again as inflation and interest rates skyrocketed and markets fell 25% in 2022 before rallying 50% in 2023 from their lows. Now, all of us, especially mortgage holders are holding their breath and waiting for inflation to drop to the 2% central bank target so rates can fall again. Forecasters began this year with an anticipation of six rate cuts[4]. Three months later with inflation stuck at current levels, markets have pared back their expectations to just two cuts[5]. When will this journey end?

The End of the Journey?

During the Brown Family "Birthday" Vacation, our family started with excitement as the helicopter first took off and we flew over the majestic Rocky Mountains taking in the beautiful scenery. Then we went through trials as we struggled up and down mountains, wading through several feet of snow and enduring unaccustomed physical pain. We were also rewarded along the way with awesome views of the magnificent untouched landscape surrounding us.

As we neared the end of our journey after 4 short but eventful days, we like felt like investors did after the last 4 years, hoping for an end to the cycles of up and down. Darkness fell around us when we finally stumbled upon our final campsite. We threw down our packs, ate what little food we had left and located a source of water. After setting the world record time for putting up a campsite, we settled into bed. We awoke the next morning to the beautiful sound of birds and the sun shining onto our tent. We didn't know how much longer we had to hike out, but we knew we were closer than the day before.

We also don't know when the current see-saw inflation driven cycle of the market will end but can see we are closer than the day (or year) before.

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[3] Based on the current 5 Year Bank of Canada Rate
[4] https://www.cnbc.com/2024/01/03/fed-minutes-december-2023-.html#:~:text=Fed%20funds%20futures%20trading%20points,range%20between%203.75%25%2D4%25.
[5] https://ca.finance.yahoo.com/news/futures-ease-investors-seek-clues-102557010.html

When we finally arrived at the parking lot, thinking “Yes, Dad will make it to a 61st birthday after all”, we watched him look thoughtfully at the empty lot, “Wait, I think I parked the car in another lot…..”.

The journey continues.

-Kind regards,

Joshua Brown, CFA
Portfolio Manager

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