THOUGHTS ON THE MARKET

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It Takes Two

"It takes two to make an accident."

- F. Scott Fitzgerald, The Great Gatsby

It's a popular start to many quotes and a catchy hook in some popular songs but at this moment in market history, it is notable because 2% is the U.S. Federal Reserve's (Fed) inflation target and

both the stock markets and the global economy are doing their best to avoid the possibility of a recession, despite the Fed's ongoing interest rate policy. This month, we will explore the steps being taken by companies and individuals globally to help reduce inflation, and assess the potential impact on global financial markets.

Inflation is all about supply and demand. If people demand more of an item than what is available, the price of the item will continue to rise until either no one will pay the price or producers make more until the price comes down to a level both parties are satisfied with. From 1973 to 1999, inflation was largely caused by a lack of available money to borrow, sending interest rates to historic highs as the Baby Boom generation set up their households. Post-Covid, inflation was caused by an excessive demand for goods and services. This type of inflation is easier to fight as consumers have more choice of alternatives, including not buying some products. The Fed is using its main tool of raising interest rates to try and combat inflation. This will reduce demand from the most leveraged households and companies, particularly smaller businesses, but it does not have the same impact it used to due to the available liquidity in the economy.

U.S. inflation, as measured by the Consumer Price Index (CPI) which has fallen from 9% to 5% in the last year. It is interesting to note that one of the main components, housing costs, continues to rise due to interest rates increasing. Housing comprises 32.77% of CPI in the U.S. and 44% in Canada and therefore inflation will have a difficult time reaching the Fed's target until interest rates start to fall. However, supply and demand are even helping the housing market. While home prices are down, resale listings have dropped sharply but this has given new home builders a chance to fill demand as prices have stabilized enough that they can make their profit margins. As a result, U.S. new home sales have started to trend higher, which helps the overall economy.

Food inflation has also started to move lower in the last two months. Given the high prices of basic foods such as wheat, corn and soybeans, we expect farmers will be planting all available acreage and food prices later this year will be highly dependent on this year's crop yield. The two wild cards in world food production will be weather and the ongoing Ukrainian invasion. Russia could conceivably again cut off Ukrainian agricultural exports but success on the battlefield for the Ukraine could also lead to further supply and therefore lower prices.

Another critical element of the health of the economy is consumer spending, which accounts for about 70% of U.S. economic activity. Spending remains stable and has shown no signs of a significant slowdown despite the increased interest rates. An even more positive trend is the U.S. personal savings rate has also increased to 4.6% from 4.2%. This means the U.S. consumer is not under enough pressure that they have to spend all their income to make ends meet.

Next, we turn our attention to U.S. corporate earnings. The first quarter earnings reports for most companies exceeded expectations and overall earnings were only down 1.9% versus the 5.1% forecast by analysts. The market was particularly encouraged by the results of some of the largest technology companies such as Microsoft, which not only beat expectations but also forecast continued growth. The biggest area of concern at the moment is the continued weakness among U.S. regional banks,

with First Republic being the third to fall this year. The company was bought by JP Morgan for a bargain basement price and is expected to add to their profit margin immediately. According to the Fed, deposits have stabilized across the U.S. banking sector but the continued problem is caused by market forces. Short sellers are driving down the prices of these securities, which leads to depositors becoming fearful and moving money, with the compound effect of the banks being unable to raise capital due to their low stock price. We believe it will take the failure of at least one more regional bank before the Fed and other regulators might be forced to take action such as stopping short selling on these banks or cutting interest rates. This instability has caused some temporary weakness in Canadian banks. There has been some impact on deposits at U.S. subsidiaries, particularly in TD's 12% holding of the discount brokerage Charles Schwab, but definitely not enough to cause any instability or to greatly affect profits. We expect Canadian bank earnings due later this month once again show their strength. Canadian resource stocks have been weaker as oil dropped below $80 per barrel and base metal prices fell on global recession fears. However, producers remain profitable at current prices so we expect dividends and share buybacks to continue.

The Fed is also watching unemployment to see if the economy is slowing. Here we believe they will be disappointed. The ADP jobs number for April came in well above expectations at 296,000 new private sector jobs. The forces of supply and demand are definitely at work here. Most new hires were service industry and construction jobs, with a notable 80,000 employee reduction in manufacturing, which again highlights the big shift in consumer spending after Covid. The other key factors of the report were that wage inflation is easing and fewer people are switching jobs, as higher paying positions such as in technology have been the largest target of corporate layoffs. Ironically, the Fed will likely achieve their goal of slower wage inflation, just not the way they expected with a higher unemployment rate.

There is no doubt that the Fed's rate policy is slowing the U.S. economy. U.S. Gross Domestic Product (GDP) which measures the total economic output of the country only grew by 1.1% in the first quarter of 2023 versus 2.6% the previous quarter. The technical definition of a recession is two consecutive quarters of negative GDP growth. Given the recent bank failures, it is expected that credit will be less available and definitely more expensive, which will slow the economy further. Economists are predicting the likelihood of what is technically a recession later in 2023 but definitely a mild one without any major surge in unemployment. How U.S. consumers respond will likely dictate how long a recession might last, or if we have one at all.

The Fed has now hiked rates to 5.25% and they have indicated they are done with increases unless inflation continues. They also indicated they expect to cut interest rates next year. Everyone is waiting for further data but we seem closer to the end of this rate cycle than at any time since it began.

We continue to remain defensive with the portfolio but are encouraged by the continued resilience of corporate earnings, particularly among our portfolio names. Our focus remains on dividend income and cash flow generation through our call program. Our expectation for the market is a bumpy road higher as further information is available on such key issues as the U.S. debt ceiling, U.S. banking, this year's crop harvest and very importantly, the Ukrainian invasion.

Market participants, and we as individuals and companies in the economy, are doing well in terms of fighting off a recession. The economy continues to grow, albeit at a slower pace. Employment remains robust and inflation continues to fall. Despite some clouds on the horizon, we expect market conditions to improve as long as an issue or two go as planned. Let's hope for at least two. 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

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