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THOUGHTS ON THE MARKET

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Signs of improvement in Uncertain Times

"It's been an ideal period for investors: A climate of fear is their best friend. Those who invest only when commentators are upbeat end up paying a heavy price for meaningless reassurance."

- Warren Buffett, Berkshire Hathaway Chairman

While market and economic conditions have been improving since October, a vocal majority of analysts and economists have continued to warn anyone who will listen about inflation, recession or higher interest rates. Are their fears justified or are they too focused on last year's results? This month, we will explore recent market and economic developments to determine developing trends and filter out market noise in order to determine the clearest possible path moving forward.

Let's start with an overview of the U.S. economy. Fourth quarter U.S. Gross Domestic Product (GDP) came in at 2.9% versus 2.5% in the previous quarter. In theory, rising interest rates were supposed to slow economic activity but while there was weakness in manufacturing due to softer demand in consumer goods, demand for travel and leisure services remained strong. It has been argued that this is the tail end of Covid savings being spent but so far the economy has remained robust.

The next sign of economic weakness is unemployment. Last month, total non-farm payroll increased by 517,000 jobs, far exceeding expectations. Despite some high profile layoffs in the technology sector, almost two jobs are on offer for every available worker. The U.S. unemployment rate is at a record low 3.4% and has been trending lower. December's new jobs number could be higher because of seasonal hiring but the fact remains that the interest rate increases are having little effect so far.

Next we look at corporate earnings for the fourth quarter. Once again, there was little evidence of recession as many companies exceeded their estimates. One notable exception this quarter was Apple, which missed its sales and profit estimates for the first time since 2016. Due to supply constraints from China, Apple was unable to deliver eight million iPhones. The market was quick to realize that demand and profit margins were still strong and the stock actually ended the day higher.

A further read on the market's recession fears comes from the bond market. In December, the 2 year U.S. Treasury yield was 4.31% and the 10 year at 3.57%. Currently, the 2 year is 4.42% and the 10 year at 3.62%. This slight increase in rates is in response to the Fed's 25 basis point increase. What is interesting to note is that the yield curve inversion has increased to 80 basis points, which is the bond market's way of warning the Fed that if they continue to raise rates, they will indeed cause a recession. The bond market is also signalling that interest rates will move lower as the 10 year and 30 year bond yields remain well below the current Federal Reserve rate.

Inflation remains the Fed's primary concern and recent comments by Fed Chairman Powell acknowledge that inflation is trending lower. The U.S. Core Personal Consumption Index was 4.2% year over year in December, down from 4.68% last month and 5.42% last February. The U.S. Consumer Price Index, the broader measure of inflation which includes food and energy, reached a high of 9.06% in June 2022 but has declined to 6.45% in December. These are both significant percentage declines and clearly show inflation trending downward. However, Chairman Powell stated that if wage inflation starts to create a problem, he will continue to raise rates. We believe much of the wage inflation was caused by the increase in the minimum wage. Otherwise, wage increases have generally remained below the current inflation level but as more people hit age 65 in record numbers over the next two years, it is an area of the economy to watch.

The stock markets had a favourable January as the Dow rallied 2.8%, the S&P 500 up 6.3% and the TSX up 7.1%. The rally was broad based, with the biggest gains being in some of the hardest hit sectors of last year such as technology. In our portfolio, notable gainers included Apple up 11%, Suncor up 7.5% and Royal Bank up 6.8%. This is definitely an improvement over the poor market conditions we saw last year and if earnings continue to meet expectations and there are no further extraordinary events such as the Ukrainian invasion or Covid, we would expect this positive trend to continue.

Another underlying sign of strength has been the pace of corporate stock buybacks. In the U.S. last year, stock buybacks hit a record $1.26 trillion, up from $881 billion in 2021. This was during a year of rising interest rates and growing recession fears. Clearly, S&P 500 CEO's had enough confidence in their companies to buy back stock instead of hoarding cash and this conviction should be kept in mind as we consider the direction of the overall market.

In the Canadian market, we saw a rally in financials, technology and energy. There was also an interesting development in the preferred share market as we saw share prices rise and yields fall despite rising interest rates. This is a significant move as it shows that the market believes rates are going lower sooner rather than later.

Given all these positive developments, why do market analysts and commentators still have a negative outlook for stocks? There are a number of reasons. Firstly, the market has only been recovering since October and that is too short a time frame to change minds. The market also continues to fear the Fed and is worried about them actually forcing a recession. Inflation is coming down quickly but the Fed's 2% inflation target may take longer than expected to reach. Our stance on the market remains a balance between growth and defensive names, with an emphasis on cash flow generation from both dividends and our covered call program where possible. For growth, we remain focused on premier technology names such as Apple and Microsoft. For dividends, we are concentrating on banks, insurance and pipeline companies that have demonstrated their ability to raise dividends over time.

Uncertainty often brings opportunity to the market and the improving conditions suggest better times ahead. We know Warren Buffett is out there looking for opportunities and we will continue to do the same.

On closing, we want to remind those of you with taxable accounts that your tax return information is being sent out at the end of this month. We took available tax losses where possible last year and it is important to remind your accountant that those losses can be used to reduce capital gains tax that you paid over the last three years and can get you a refund. Any losses not used can be carried forward to offset future gains. 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