COOPER WEALTH MANAGEMENT

RBC Dominion Securities

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THOUGHTS ON THE MARKET

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Sell in May? No Way!

"Sell in May and go away."

- The "Halloween" Theory

The Halloween market theory suggests that investors should sell their stocks by May and only reinvest after Halloween. This theory evolved over time as the November to May period has tended to outperform May to October. In contrast, June is statistically one of the strongest months for market performance and was proven again this June. This July, we are awaiting some key economic and earnings data which will confirm or deny this theory. This month, we will explore the economic and equity landscapes and discuss market timing as we determine the best path forward.

Market timing is like dancing - most people think they can do it, but very few are good at it and even professionals make a misstep at some point. For example, the legendary Warren Buffett decided in the early days of Covid that the price of U.S. airline stocks had fallen too far so he took a multi billion dollar position in the major airlines, expecting a quick profit. Covid lasted longer than expected and what was expected to be a quick profit turned into a substantial loss. In the market, if you miss the best five days of performance, you will miss approximately 70% of the return for the year. Missing the top ten days equates to 90%. Neither of these figures considers dividends which would also be missed by sitting in cash. For these and other reasons, we believe in remaining fully invested.

With that in mind, let's consider upcoming market events. All eyes will be on the U.S. Federal Reserve (Fed) as they meet again this month to decide U.S. interest rate policy. It is widely expected they will raise interest rates by 0.25%. Everyone will be looking for signs from Chairman Powell that the rate hikes are almost over. We expect Powell to be consistent with his message that they may have to raise rates further to keep fighting inflation. The Fed expects to cool the economy by tightening credit conditions and reducing the money supply by selling their existing bond inventory into the market. However, by driving short term rates up to 5% on money market funds, they are undermining their own efforts. Since April, the Fed has sold approximately $500 billion of their holdings which the bond market has absorbed. On the other side, approximately $3.2 trillion has moved into the money market and is expected to generate over $150 billion in interest. Total U.S. bank deposits currently sit at $19.2 trillion. The longer U.S. rates remain elevated, the more money is likely to flow to the money market and make this situation worse for the Fed as they can only sell the assets once and then they are out of options.

The good news for Fed watchers is that the U.S. Consumer Price Index for June came in below forecast at 3% which is the lowest it has been for over 2 years and well below the peak of 9%. Inflation is trending aggressively lower but two sticking points remain from the Fed's point of view: housing costs and labour. When the Fed begins to lower rates, housing costs will fall. The employment picture is more difficult given our aging population and the U.S. encouraging manufacturing companies like the computer chip makers to build new plants in the U.S. instead of China. This problem will take years of increased immigration and technology gains to solve but as inflation pressures have eased, so have wage demands. This isn't driving inflation higher at the moment but we will continue to monitor developments.

Global interest rate increases are having a much higher impact in Canada than the U.S.. The majority of U.S. mortgages are locked into 30 year terms and the average rate is 3.8% so U.S. households have felt less impact than here at home. In Canada, between 25 - 33% of all mortgages, depending on the bank, are variable rate and these homeowners are now paying interest only on their home. In many cases some are even adding interest to their existing balance owing. To further complicate matters, an additional 13% of all mortgages are up for renewal this year with a similar amount next year. Mortgage increases take time to be reflected in economic data but until interest rates begin to fall, we anticipate the Canadian economy will lag behind the U.S. for the next few quarters.

Why should we invest in Canada then if the economy is weakening? We principally buy Canadian equities for the higher dividend income and currently dividend yields are as high as they have been in years. The bank stocks will stay relatively flat until interest rates start to fall. As the cost of deposits and size of write offs go down, bank profits will again rise and without the drag of higher costs, as they will be earning more from the higher mortgage rates. Canada does have some strong growth stories as well such as Couche-Tard (Circle K convenience stores) and Dollarama. The energy sector also remains interesting as global oil demand reached a new all time high of 101.89 million barrels per day, despite the surge in electric vehicles and the global push for renewable energy.

The next important element to market success will be corporate earnings as second quarter U.S. corporate earnings will be released this month. Between lower analyst estimates and the length of time companies have had to adjust to the higher rate environment, we expect decent earnings to bring higher stock prices.

Another interesting development during June was the broadening of the market rally. Instead of just large technology companies rising, we have seen other sectors such as consumer discretionary and industrial stocks move higher. This wider market leadership is a good sign that the market believes we will likely avoid a U.S. recession and that better days are ahead.

The one lingering concern in the marketplace is that the Fed will either be too slow in lowering rates once inflation reaches their target or they will leave rates elevated for too long and actually force a recession. Either of these outcomes is too difficult to predict but the Fed will have the ability to act and correct their course of action as required.

As to fixed income investments, returns remain flat and will remain so until the Fed and the Bank of Canada stop raising rates. We have locked in attractive yields and expect to see preferred share prices rise as interest rates begin to fall.

On the portfolio, we have continued to collect call premiums where available and remain balanced between income and growth stocks. As market conditions continue to improve and interest rates begin to move lower, we will be looking to increase growth oriented names.

The Halloween Theory has been around for many years and in quiet markets it has often been statistically true. However, current market conditions seem to be pointing to positive summer and fall sessions. In the meantime, we will keep you updated and adjust the portfolio accordingly. Until next time, stay well.

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

Yours truly,

Trevor, Walter and the Cooper Wealth Management team