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THOUGHTS ON THE MARKET

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Value Investing and the Markets

"Market prices for stocks fluctuate at great amplitudes around intrinsic value but over the long term, intrinsic value is virtually always reflected at some point in market price."
- *Warren Buffett*

When the markets get as choppy as they have this year, investors turn to value investments to be defensive but in a rising interest rate environment, even these investments have shown weakness. By definition, value stocks tend to pay higher dividends and are in stable industries that can weather a recession. However, there is a deeper meaning to value stocks than just the ordinary definition and this month, we will explore the intrinsic value of stocks in the particular context of today's market.

For illustration, let's consider Royal Bank stock. The current market price is the same as it was in April 2021. At first glance, this is a poor outcome and should be sold. When we look below the surface, a different picture emerges. To begin with, shareholders have received $9 in dividends for a return over 4%. This is a good start but the real story lies in the increased intrinsic value of the company itself. In 2022, Royal had net earnings of $14.2 billion and for the first nine months of 2023, they earned $11.9 billion. With 1.7 billion shares outstanding, this translates to $15.35 in earnings per share over 21 months. Taking away the $9 in dividends, the intrinsic value of the stock has increased by $6.35 per share and will likely be higher when Royal reports their year end results after October. This compounding of the intrinsic value of the stock is what Mr. Buffett is referring to in this month's quote. The key question is when will this value be realized. Here's where an analysis of market conditions comes in. We will begin our analysis with a key market factor: interest rates.

Higher interest rates suppress market values, as everything is compared to what you can earn on a risk free asset such as a GIC. At this point, it is important to clarify what is meant by risk free. This definition strictly applies to loss of capital. An asset such as a GIC does carry two significant risks, interest rate risk and opportunity cost. Interest rate risk is primarily a factor at renewal. If rates move lower, as they are predicted to do over the next couple of years, you end up having to reinvest at a lower rate. In the meantime, other interest sensitive investments would move higher and you would miss out on the opportunity to make gains. Forecasts for interest rates are expecting perhaps one more increase in November and then begin to decline some time in 2024 but will be controlled by two factors, inflation and the state of the US economy.

Inflation has been trending lower post Covid as the supply and demand for goods and services comes back into balance. While housing and food prices remain elevated, even these sectors were showing initial signs of easing. On food, the Ukrainian invasion is still hampering global food supply and with housing, only increased supply and lower interest rates can address the affordability issue. The recent 30% surge in oil prices since June to over $90 was due to OPEC production cuts and low US inventory levels but it was temporary and prices are already starting to drop.

Despite interest rate increases, US Gross Domestic Product (GDP) remained steady at 2.1%. The growth in consumer spending was noticeably weaker in the quarter but business investment increased as they are taking advantage of government stimulus measures to build manufacturing capacity in the United States. There are two particular concerns that could slow down US growth next quarter: a widening of the US auto workers strike and a potential US government shutdown as of mid November. The auto workers are asking for substantial wage and benefit increases but talks are continuing. The US government shutdown is possibly more problematic as a group of Republican House representatives are taking a hard line on government spending cuts they want to see moving forward. They even went so far as to fire their own House Speaker for the first time in history. With no clear successor in evidence, this delay could definitely cause a shutdown which would be a drag on the economy but could potentially stop the Fed from an interest rate increase in November. It is too early to predict how this may turn out but we will continue to monitor developments.

In the Canadian market, we have had four significant rallies this year only to see the market decline to where it is slightly down for the year. The rise in energy stocks has been offset by declines in banking and high dividend value stocks. Dividends did help performance as well as growth stocks such as Dollarama and Alimentation Couche-Tard. While the TSX is under performing in a higher interest rate environment, we expect it to be stronger when interest rates start to fall.

By comparison, the Dow Jones is up less than 1% after a disappointing July to September quarter. The S&P 500 is up approximately 10% and the technology focused Nasdaq is up 30%, regaining their 2021 levels after last year's decline. Our portfolio has benefited from positions in Apple, Palo Alto and Microsoft but most of the performance in both the S&P and Nasdaq can be attributed to seven large capitalization technology companies. The broader market has begun to slowly advance on the back of three quarters of positive earnings this year but as per our earlier example of Royal, greater value is being created which we believe will eventually show up as higher stock prices in the future. In the meantime, we continue to evaluate earnings and other corporate developments of our portfolio holdings to continue to ensure they are delivering the results we expect.

Upcoming key events will include third quarter earnings, year end tax loss selling and developments in US politics. Expectations for corporate profits remain solid as the US economy is still growing. The strength of the US dollar may dampen profits for international companies but on the whole, forecasts are positive and we will see what future earnings guidance will be provided.

Going into year end, it is possible we may see some profit taking in technology stocks as portfolio managers may look to rebalance overweight positions using other losses to offset gains.

As to the US political scene, we expect more theatrics related to the budget in mid November but hopefully a new Speaker will be able to get a consensus vote. All eyes are also on the battle for the Republican nominee for president. At the moment, the former president is the runaway leader in all polls, despite an ever growing list of indictments, lawsuits, trials and convictions. Barring a legal blockade, it looks like a rematch of the 2020 election, with the idea logical division between the two parties as wide as it has ever been. While corporate profits are generally unaffected by who is in the White House, with the notable exception of a possible increase in corporate taxes, we do expect a media feeding frenzy with dire predictions about electing either party. It promises to be a lot of sound and fury, with little significance.

In closing, we are definitely in a time that requires patience and a diligent eye on profitability. We continue to focus on generating cash flow from dividends and covered call premiums in the interim. As Mr. Buffett advises, we are monitoring intrinsic values and look forward to realizing higher prices in the days ahead. 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