



**Wealth Management**  
Dominion Securities

Cooper Wealth Management of  
RBC Dominion Securities



# Thoughts on the market

August 21, 2024

RBC Dominion Securities Inc.

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## The Little Things



**“The little things are infinitely the most important.”**  
– Sir Arthur Conan Doyle

Details. Details. In the investment world, as long as the market is moving higher, data points that are deemed irrelevant are ignored until they become relevant. On August 5, we saw a large sell off in US equities after a 12% decline in Japan’s Nikkei stock index, all triggered by a rise in the yen after the Bank of Japan increased their interest rate from 0.1% to 0.25%. How does such a little thing as a 0.15% Japanese rate increase send the US market into a tailspin? The simple answer is that the world financial markets are increasingly interdependent and anxiety in one part of the market can trigger insecurities in other markets, such as fear of a hard landing US recession, creating a domino effect and leading to more selling. This month, we will dig into what happened in the Japanese market and explore some further data points that bear watching moving forward.

For years, a very popular trade among hedge funds has been “the carry trade”. The hedge fund borrows Japanese yen at 0.25%, converts the funds to US dollars and purchases US T-bills at 4%. The interest earned covers the carrying cost of the loan and the hedge fund pockets the difference. This trade has been particularly attractive as the US dollar has appreciated against the yen, making the loan even cheaper. However, when the Bank of Japan raised rates in a surprise move, the yen started to appreciate, causing a brief rush to sell, which sent the Japanese stock market lower, but only for a day.

Another interesting little market fact that emerged while the US was raising interest rates and Japan did not, was that Japanese investors sought to protect their global purchasing power by buying over \$28 trillion in foreign securities, much of it in US dollars. If the Japanese yen continues to appreciate, it could lead to downward pressure on US securities. While this again would likely be short-lived, it does pose a threat of potential volatility as the summer moves on.

Insecurity around the US economy has also dampened trader enthusiasm. Year-to-date, the Dow was up only 4.27%, S&P 500 up 12.67%, NASDAQ up 11.91% and the TSX up 7.3%. When we take a closer look at these numbers, we get an idea of how narrow the markets focus has truly been. The top four stocks of the Dow were responsible for just over 2% or close to half the performance. The top 10 stocks of the S&P 500 index, which represent about 35% of the total weight of the index, produced the entire 12.67% of the return to the second decimal point. In other words, the remaining 490 stocks in the Index produced a net return of zero. This concentration is even more evident for the NASDAQ, where the top 10 stocks represent 46.57% of the index and had a combined return of 16.09%, which means that the remaining 90 stocks representing 53.43% had a combined negative return of 4.18%. A further point we would make is that eight of the top 10 stocks in both indices are the same and all are technology companies. By contrast, the TSX top 10 represents 32.64% of the index and contains only two technology names, with growth spread out among different sectors, including materials, financials, and oil and gas.

Any correction in the technology sector will have an outsized impact on the major US Indices so selective diversification into less economically sensitive stocks such as Waste Connections and Dollarama have helped to reduce portfolio volatility while still providing positive returns.

The possibility of a hard landing US recession is fading with each new data release. Weekly US jobless claims fell by 7000, to a one month low. The US Consumer Price Index for July was down to 2.9% year-over-year, with housing cost remaining as the major sticking point. The market is now predicting that the US Federal Reserve will reduce interest rates by 100 bases points by year end. While we consider this view to be a bit optimistic given the Fed’s previous reluctance to reduce rates, there is a very high degree of conviction that there will be at least a 25-basis point cut at their September meeting. Any actual rate decrease would definitely be a positive for the market and the meeting notes will be more closely monitored than ever.

There has also been good news on the US consumer spending front. US retail sales increased 1% in July versus an expected 0.3% increase. As retail sales count for approximately 70% of US Gross Domestic Product, this is yet another sign of the overall strength of the US economy.

The market will also be watching corporate earnings closely to see if this economic activity translates to higher earnings. JP Morgan is the benchmark for US banks and the market will be looking for fewer write offs and better profitability. Visa and MasterCard will be watched for consumer spending information, Microsoft and Nvidia, if they continue to make the estimates, would continue to provide market leadership.

The Canadian fixed income market has been the beneficiary of the first two interest rate cuts in Canada and we expect preferred share prices to continue to move higher as rates fall further. On the Canadian equity site, we expect to see leadership from the banks, particularly Royal and National, as well as other high dividends stock, such as Pembina Pipelines and Enbridge. In general, the TSX is more interest rate sensitive than its US counterparts due to its much heavier weightings in financials and commodities. Due to the Index’s relatively low weighting in technology, it will likely continue to under perform the S&P 500, but we foresee a

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broader based advance across multiple sectors as the economy avoids recession, which will provide us with further diversification opportunities.

As we saw with the correction of US technology stocks in the last two weeks of July, portfolio diversification remains vital. The market tends to overreact to both positive and negative news and concerns about the US economy midmonth sent technology stocks into a tailspin. Fast forward to today, and we have solid economic numbers and a significant rally in the same technology names. Our goal with portfolio diversification is to limit the downside while still participating in the upside recovery during these volatile moments in the market.

We have written in previous newsletters that we prefer broad market advances to narrow ones. The technology leadership of the US markets has proven to be resilient in August after the July correction. When one sector of the market greatly outperforms the rest, there is often a bout of profit taking and rotation into more undervalued securities. In this case, the correction was short-lived as the fear of missing out on the artificial intelligence phenomenon proved to be too great. However, it is our view that as US inflation and recession concerns continue to fade, we expect the more economically sensitive areas such as financials, industrials, and transport will begin to benefit.

One final small thing we are keeping an eye on is market and economic confidence surveys, particularly consumer, business, and Chief Executive Officer surveys. As long as these three indicators are positive, it tends to be a positive indicator for both economy and the markets. Currently, US business confidence is just below its long-term average but trending upward. The CEO confidence index shows moderate optimism, despite dipping slightly last quarter while consumer confidence also increased but is still showing caution. While corporate earnings eventually drive all these indicators, economic data between earnings periods can reduce confidence temporarily and lead to market volatility. We again expect that as US interest rates actually start to come down, all these indicators will continue to improve.

As we have seen, even small changes in key data points can have a profound effect. A small increase in Japanese interest rates of 0.15% led to a US market sell off which is now a rally, at least partly due to a 0.10% decrease in US inflation. As Conan Doyle's most famous character Sherlock Holmes said in "The Hound of the Baskerville", we will "presume nothing" and continue to be mindful of both the big and little details. Until next month, stay well.

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

Yours truly,

Trevor, Walter, Charles, and the Cooper Wealth Management team



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