Wealth Management
Dominion Securities

Cooper Wealth Management of
RBC Dominion Securities

# Thoughts on the market

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RBC Dominion Securities Inc.

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# So it begins


"So it begins, the great battle of our time."
– Gandalf, *"Lord of the Rings"*

In the movie trilogy, the Lord of the Rings, the forces of good and evil battle over the fate of Middle Earth. In the investing world, the fight has been between inflation and interest rates with higher interest rates slowing the economy and bringing down the overall inflation rate. With inflation now heading towards the US Federal Reserve's target of 2% and international inflation rates moving lower even faster, we have seen the first interest rate cuts from Canada and European Central Bank of 25 basis points. The question that presents itself is: are we finally at the beginning of an interest rate trend towards a normalized economy or will inflation again rear its ugly head as interest rate pressures are eased on consumers? This month, we will explore that question and the implications for markets moving forward.

The US inflation rate for May came in at 3.3%, 2.6% for the Euro zone and 2.7% for Canada, which is a three-year low. Except for the odd spike in the inflation data, the trend has been steadily downward. One of the key remaining inflation problems has been housing. Housing costs rising dramatically as they have over the last several years has been the result of good and bad government policies since the Great Financial Crisis of 2008, depending on when you purchased a home. Post 2008, we had years of zero interest rates for which allowed for much higher mortgage leverage and gave buyers the flexibility to bid house prices higher. This is a positive kind of inflation for existing homeowners as house prices soared, but a definite negative for new buyers. By raising interest rates, governments around the world, calculated the move would lower house prices and thereby make housing more affordable. At the same time, they were trying to slow down their economies and raise unemployment to help bring down inflation. In our opinion, raising interest rates only made the housing situation in North America worse. In the US where the majority of homeowners have 20–30-year mortgages, many people can't afford to give up their attractive long-term mortgages, so the market for starter homes has stagnated as undeveloped land remains too expensive to build starter homes. Strong immigration has also driven the cost of renting higher. In Canada, the situation is further complicated by the much shorter term of our mortgages. Lowering interest rates will allow the starter home market to improve, but it will likely take government intervention for builders to build more affordable housing. Particularly, the construction of multi unit housing is down over 40% this year in the US, as these units tend to have lower profit margins and builders are trying to make up for the twin problems of lower prices and higher costs by focussing on up market single-family homes.

All wars have lost battles on both sides, and we expect the war on inflation to be no different. During the summer months, we tend to see increase in fuel cost as well as travel and leisure spending. On the positive side, retail sales on items such as clothing and appliances, tend to be slower with sale pricing often required to get people back into the stores and online. While we continue to believe that the trend in inflation is clearly lower, the path will not be smooth or straight.

One potential source of US inflation that is currently flying under the radar is the cost of electricity. Everyone is aware of the sharp increase in the number of electric vehicles on the road, but this usage pales in comparison to the current and future demand for electricity from artificial intelligence data centers. A traditional data center requires a lot of power, but with the increased focus on artificial intelligence, the demand for power is set to soar. For example, Google's power usage increased 13% last year, and has doubled since 2019. A typical nuclear reactor can generate one gigawatt of electricity and would cost approximately $5.4 billion to build under normal circumstances. That is enough electricity to power approximately 750,000 homes for a year. The International Energy Agency's Electricity 2024 report estimates that by 2026, AI data centres will be using about 10 GW of power. With the US and global focus on clean energy, we expect future energy production to remain in this vein. Therefore, we need to consider development time frames to see how long it might take to bring future power online. The world's first wind farm was built in New Hampshire in 1980 and the US just passed the 50 GW mark for wind production. More recently, the UK built the first offshore wind Farm in 2003 and by 2012, they had over 3 GW of power online, the most in the world. Nuclear reactors have an average planned construction time of between 42 and 48 months, depending on the type. Given the fact that we see the demand for AI is growing, not slowing, and the long lead times required to build new capacity, the price of electricity could become a major inflation talking point in the near future if oil and gas production is not allowed to continue to develop. This is a trend we will continue to monitor closely.

Despite the continuing inflation battle, the overall stock market has performed well as many global indices have hit new highs. US stock buybacks are expected to hit $934 billion in 2024 and be over $1 trillion in 2025, which equates to about 1.7% of total US market capitalization. This provides some additional tailwinds to an already positive market outlook. One market trend we would like to see improved on is the breadth of the market advance. So far this year, about 60% of the S&P 500 total return of 14.6% has been driven by five companies: Nvidia, Microsoft, Meta, Alphabet and Amazon. Rotation out of these names could send the market lower, but we would expect that decline to be short-lived as no one wants to miss out on where artificial intelligence is expected to take these stocks. Value stocks have largely been left behind with the exceptions of our portfolio holding JP Morgan and the utility sector which is up about 9% year to date. US small capitalization stocks, as represented by the Russell 2000 index, are actually down 0.5%.

By contrast, the TSX is lagging behind it +4.8% year to date. Bright spots include Royal Bank and National Bank, thanks to significant mergers this year, while TD and Bank of Montreal have disappointed. Other portfolio highlights have included Dollarama and Waste Connections which have so far been able to withstand concerns about a slowing Canadian economy, interest rates and inflation. The Energy sector has also continued to steadily build value as portfolio holdings in Suncor, Canadian Natural Resources, Pembina, and Keyera have all performed above the market. Our outlook for Canada remains largely hinged on the key points of interest rates and energy prices.

Our overall portfolio strategy remains focussed on roughly 60% US/40% Canadian equity balance, which we will be likely to maintain until we see more definitive progress on interest rate cuts. On the US side, we continue to focus on growth names while our Canadian stocks focus on dividends.

On the fixed income side, we have seen the beginning of a rally in preferred share prices as the expectation of interest rate cuts has begun to materialize. We expect this rally to continue as the size and scope of future interest rate cuts come into clearer focus.

The US Federal Reserve is leading the global war on inflation, but it may be forced to negotiate a peace treaty with global markets soon by lowering interest rates as a soaring budget deficit and the cost of their debt service now exceeding what is spent on defence annually. The Fed seems to be running out of room to defend its higher interest rate position and global economic pressure could force them to lower rates sooner than they perhaps would like. As we stated earlier, the war is not yet over, but the tide of battle does seem to be favourably turning. Until next month, stay well.

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

Yours truly,

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

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