Bessette Wealth Management of RBC Dominion Securities

Don't Call it a Comeback

Global markets continued their march higher during the second quarter, with global stocks up 7% driven in large part by the U.S. stock market's gain of 8.7%. The tech heavy NASDAQ index, one of the hardest hit in 2022, continued to outperform the broader global stock market up another 13% in Q2. This brought it's year-to-date total return to an almost unprecedented 32%, almost exactly mirroring its decline for the full year in 2022. Canada continued to lag strong performance south of the border and globally, up a modest 1.1% for the second quarter as commodity prices continue to face headwinds.

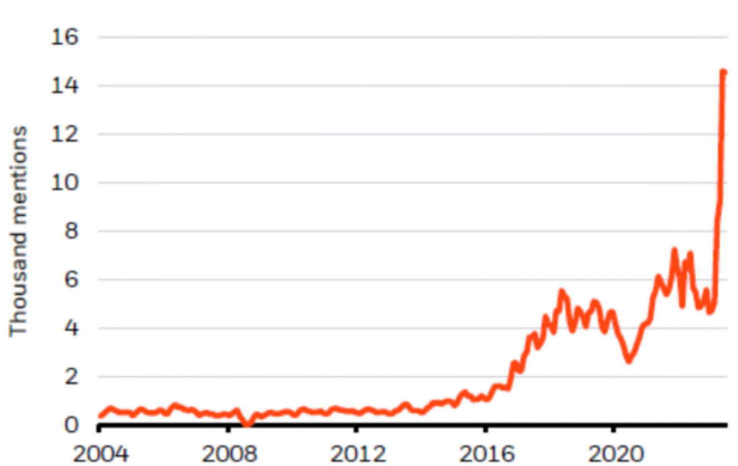
Stocks are a volatile asset class to begin with, but the ride since the end of 2021 has been extraordinary. The U.S. stock market (as represented by the S&P 500 index) peaked on January 3, 2022, proceeded to fall 25% to its low on October 12th, and after rebounding 27% through the time of this writing sits just 5% below the prior peak.

The bond market has not fared so well. Despite inflation continuing to fall with the latest U.S. CPI up just 3% year-over-year in June and Canada up an even lesser 2.8%, the Canadian bond market was down 0.7% in the second quarter, bringing half year performance gains down to just 2.4%. On a global basis, bonds fell 1.5% in Q2, bringing first half performance to 1.4%.

Hiding in Plain Sight

Despite the significant gains for U.S. and global equities, the rally has not been evenly distributed. Market leadership has resided in a narrow list of large cap technology companies with the words Artificial Intelligence or AI hitting headlines like never before.

Artificial intelligence mentions on company earnings calls, 2004-2023



Source: BlackRock

The new “Big 7” stocks (Apple, Microsoft, Nvidia, Amazon, Alphabet/Google, Meta/Facebook and Tesla) have been the difference in gains on the NASDAQ, S&P 500 and MSCI World. Through the end of June, these companies represented over 80% of the gains for the U.S. market. Because big companies make up more of the stock market (they are value weighted indices), gains or losses by larger companies can disproportionately drive the overall market return.

Outperformance in the S&P 500 over an equal weighted index of all ~500 of the index companies (i.e., no one company drives performance more than another) has now surpassed levels from the 2000s tech boom (the last time big tech was at such a valuation premium). So while the headline gains are very strong, the market’s participation has not been broad-based. This is leading to divergent valuation gaps, not just in the Big 7 versus other large U.S. stocks, but between regions and sizes. Currently the valuation premium of the U.S. large caps is near an all-time high compared to the Canadian market and U.S. small caps.

So Far, So Good?

Entering 2023, inflation sat above 6% and the market believed the probability of U.S. and Canadian recessions were over 60% within calendar year 2023. Europe, which was bracing for an energy shortage and resulting economic fall-out (primarily as a result of Russian sanctions), was pricing about an 80% chance of recession within 12 months. Fast forward to today, inflation is 3% and no recession has hit the developed West (albeit Europe is technically in one with back to back -0.1% quarters). Adding fuel to the rally fire has been strong corporate results announced during the current earning season, with ~80% of companies having beaten expected results as of a few days ago. So far, so good.

When pessimism is well founded and bad outcomes more likely, asset prices will partly reflect the bad news. As the future has unfolded and things have not been as bad as expected, global asset prices have rallied on better than expected economic outcomes.

Today, the market is pricing in a still elevated 65% chance of a U.S. recession within the next 12 months. Effectively the timing of a recession in North America has simply been pushed back to 2024. We continue to see the balance of probabilities suggesting challenges remain for global growth. For one, Central Banks have been steadfast that no interest rate cuts are coming in 2023. For context, as recently as May, the market believed five interest rate cuts would occur before year-end. The aim of high interest rates for longer is to reduce consumer demand for goods and services. Central Bankers are in other words pursuing economic weakness. We are seeing it across some important areas.

Firstly, there has been a year-long trend of U.S. banks raising lending standards on almost every category of business and consumer loan. Banks are also reporting reduced demand for these loans. These conditions have historically been witnessed around the time of a recession.

Elsewhere, commodity prices continue to be weak, a direct signal of slack in the physical market resulting from weak demand. Geopolitics also continue to represent a headwind, where just this week Russia pulled out of its grain deal with Ukraine, sending wheat prices soaring.

The largest changing of the tide and what had been the brightest spot in the economic engine, historically low unemployment, has finally begun to show cracks. Despite robust job gains in May, unemployment increased from 3.4% to 3.7% month-over-month which marked the biggest monthly increase of this economic cycle to date. Both temporary employment and job openings are falling on a year-over-year basis which again signals potential weakness in labor markets on the horizon.

If You Can Be Wrong, Choose How Carefully

The likely path forward is still marred by challenges. A soft landing has all but been priced into the market's overall valuation. While we entered 2023 with pessimism abound and resulting low and attractive valuations for a variety of asset classes, we find ourselves in the opposite situation today. There is not a lot of room for bad news to happen when stock valuations are already above long-term averages and there are attractive relative opportunities elsewhere. The unfortunate part of the historical record is that stocks do not do well in rough economic times. However, this same set of circumstances has historically led to strength in bond prices. Potential future strength in bond prices as a positive is before considering where yields sit today.

The yield on global bonds sits close to 4% today, well above the 20-year average of 2.5% and the highest since 2007. Yields above current levels have only been available 15% of the time since 2003. In other words, bond yields are rarely this high.

This has directly impacted recent decisions at BWM across the majority of our client base. We have shifted capital from riskier areas of the markets into ones we perceive as being better positioned for what may lay ahead. Many reading this letter will note that their equity has been reduced while their fixed income exposure has increased recently.

We know stocks have rebounded sharply, valuations are now high (or certainly not low) and yet stock price performance is bad during recessions (-27% price declines since the 1940s on average) which we still see as more likely than not. At the same time, we are looking to take advantage of current elevated bond yields and bond price upside that we have rarely seen in the past 20 years.

If we are going to be wrong about what future economic path unfolds, we believe it is prudent to protect our investors' capital from unnecessary risks when there are attractive relative return opportunities elsewhere. Ultimately, if things keep chugging along, you can be sure we are also positioned to participate in the ongoing rally and given the disparity in performance noted above its not just bonds we are finding value in amidst the current market landscape.

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