Money Never Sleeps

The newsletter for the informed investor

Wealth Management
Dominion Securities

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Vito Finucci, B.Comm., CIM, FCSI
Senior Portfolio Manager
& Investment Advisor
519-675-2011
vito.finucci@rbc.com

Eric Janitis, CIM
Senior Portfolio Manager
& Investment Advisor

Rachelle Allen, CFP, CIM
Associate Portfolio Manager
& Wealth Advisor

Gary Weatherup, CFP
Associate Advisor
& Financial Planner

Jodie Fuller
Associate Advisor

Sarah Smith, CIM, FCSI
Associate Wealth & Investment Advisor

Vann Robson
Associate Advisor

Jessica Basacco
Administrative Assistant

Lindsey Rideout
Associate

Ryan Tanason, CIM
Associate Advisor

Andrea Oliviera
Associate

Fax: 519-675-2020
www.fjwealthgroup.com

RBC Dominion Securities
148 Fullarton St., Suite 1900
London, ON N6A 5P3

Hair of the Dog Solutions

Interest rate cuts are coming, the money-printing presses are warming up and...yes...so is more inflation.

"If you put the federal government in charge of the Sahara Desert, in 5 years there'd be a shortage of sand." – Milton Friedman

Happy New Year! Let's hope 2024 brings health, wealth and prosperity to us all.

2023 was a good year for Wall Street (even though it somehow didn't feel like a good year): The stock market rode out the last of a long line of interest rate hikes from the Federal Reserve; the labour market remained strong and inflation finally appears to be fading...for now.

It was a year of the large-cap tech stocks, namely the Magnificent Seven, which is essentially the former FAANG stocks rebranded to include AMZN, AAPL, GOOG, NVDA, META, MSFT and TSLA. After getting pummelled in 2022, they rebounded on the back of heightened expectations for artificial intelligence (AI). At times, it appeared that the pandemic era's speculative momentum had returned – largely because there had been no capitulation to inflict enough pain to turn people off risk-on assets.

The stock market did well, but returns were very uneven. It was an odd year. About 70% of the stocks in the S&P 500 lagged the index in 2023. Growth outpaced value and, as mentioned above, the large-cap tech sector did especially well: The Nasdaq gained more than 43%, and the Nasdaq 100 was up over 53%, all on the back of seven names. After a correction from August to October, markets have since surged to the strongest finish of any year since the 1990s.

(Source: NY Times https://www.nytimes.com/2023/12/01/business/stock-market-high.html)

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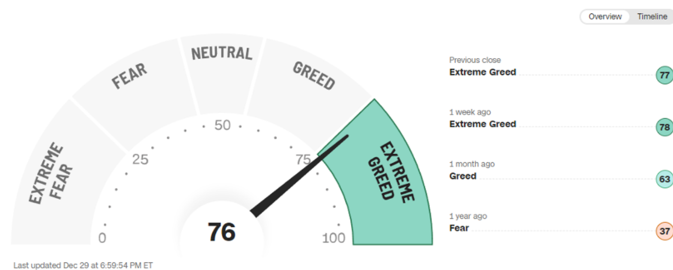
Even sentiment indicators, like the year-ending Fear & Greed Index, show how frothy things have become:

Fear & Greed Index

What emotion is driving the market now?
Learn more about the index



(Source: CNN https://www.cnn.com/markets/fear-and-greed)

"Don't fight the Fed" has been a constant investor mantra, so the pivot toward a more dovish outlook on interest rates at the December Federal Open Market Committee (FOMC) meeting should not be underestimated, particularly in this seasonally strong period for stocks. This liquidity argument may take stocks even higher in the short term. However, the economic and corporate earnings recoveries to justify those moves could come up well short of expectations next year. Also, with valuations at near-record levels, expectations for earnings growth in 2024 seem far too optimistic. In other words, sentiment is at extreme bullish levels, yet many anticipate a sharp deceleration in economic activity over the next few quarters.

Speaking of inflation, what is often lost in the discussion is the nature of its impact.

Inflation is a regressive tax, impacting households regardless of income, yet doing so with varying degrees of relative magnitude. That is, the more vulnerable households (middle and lower class) are disproportionately affected by this hidden tax, the effect of which is gradual and cumulative. As such, disinflation from record-high prices offers little relief.

The inflation effect has manifested in the rocketing credit card delinquency rates, as recently reported by credit card behemoths Capital One and Discover, two of the big US card lenders with outsized exposure to lower-income and less-creditworthy borrowers. Recent reporting indicates that we have overshot normalization, and there's no relief in sight, despite the strong supportive labour backdrop.

Contending with the cumulative effect of 26 consecutive months of real earnings decay, households have turned to credit lines to help bridge the income gap. Unsurprisingly, revolving credit in the USA reached an all-time high of $1.3 trillion. While some will postulate that revolving consumer credit as a share of disposable income is below pre-pandemic levels, the rate-of-change in these balances is what matters: Credit card debt is currently growing at a whopping +9.3% year over year, far exceeding the 20-year average of 3.3%.

The cost of credit is another factor that matters. Did you know that the average credit card APR of 22.77% is +34% or +6 pts above its pre-pandemic level?

We are witnessing the inversing of the recent reality. The pandemic acted as the mother of all bailouts for the most vulnerable of borrowers. Paradoxically, the worse off you were, the better off you became. Now, with pandemic-induced excesses eroded, the most vulnerable are returning to economic reality.

The Great Debate that started in early 2022 between the stock market's bulls and the bears continued in 2023 and is set to continue through 2024. Both sides are basically repeating the same talking points to support the narrative they have used since early 2022, sprinkled with a few new ones.

According to the bears, nothing is different. The Fed raised the federal funds rate by 5.25% between March 2020 and August 2023 – the biggest increase since Fed Chair Paul Volcker tightened monetary policy in late 1979. In addition, the Fed has been paring the size of its balance sheet through quantitative tightening (QT). The bears still expect a recession based on historical precedent: When economic indicators were flashing the signs they are today, recessions occurred. They will argue that surely such a massive swing from easy to tight monetary policy will cause a credit crunch and a recession...and maybe even a severe one.

Indeed, monetary policy tightening cycles have been followed by recessions. In fact, each of the past 10 recessions was preceded by such a cycle, mainly supported by the fact that the yield curve has been inverted since the summer of 2022. Also, an ominous sign for real GDP growth is that money supply (i.e. M2) has been falling year-over-year since December 2022.

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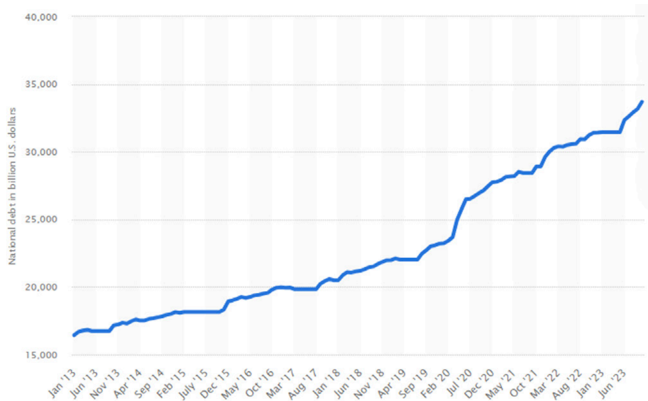
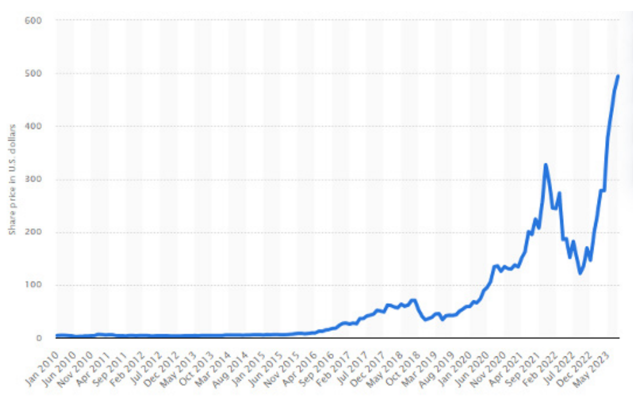
Bears will also cite the level of the USA's national debt, which has gone parabolic:



(Source: Statista https://www.statista.com/statistics/273294/public-debt-of-the-united-states-by-month/)

Recognizing that the U.S. consumer and their spending currently accounts for almost 70% of nominal GDP, the bears have been attributing the resilience of consumer spending to excess saving, which they had expected to run out by now. So now, they believe, whatever is left will be spent in the coming months, forcing consumers to retrench in 2024.

And the bears will say: Some things simply look frothy due to unintended consequences of government policy consequences – organizations often just get in the way and mess things up. Sometimes, it's from exuberance; things run ahead of themselves. And with that, I bring you Nvidia (NVDA) which was the poster child stock of 2023.



(Source: Statista https://www.statista.com/statistics/1331201/nvidia-share-price-development-monthly/)

When something is selling for almost 40X sales, investors expect massive revenue growth. Nvidia total revenue is around $45 billion with a profit margin of over 50%. Those are fabulous numbers. But does anyone really think Nvidia can grow sales to $1 trillion and maintain those margins? Forget about competition. Even at the rates they're compounding, it can't grow fast enough to catch up. So, you end up with lots of problems when the market looks around and thinks, "Okay, this is overvalued." It doesn't mean that Nvidia isn't one of the most important companies in the world. It is. But that doesn't mean it's a good stock to buy today. It brings backs memories of Cisco (CSCO), which in 1999 was the Nvidia of the day. With the internet boom just starting, network boxes were all the rage, and Cisco was the king. In 1999, everyone wanted Cisco – but here's how the stock has done since:

(Source: https://www.macrotrends.net/stocks/charts/CSCO/cisco/stock-price-history#google_vignette)

Last spring, Cisco's stock price just reached its 1999 Dot-Com cycle high. That round trip took about 23 years. I'm not saying that's what's going to happen to Nvidia – it could double in the next 12 months – but I'm skeptical they are going to be the only winner in selling AI chips. But at least for right now they have the leading edge.

Overall, stocks face a tough earnings landscape as profits continue to come under pressure from higher input costs and weaker economic growth. The largest risk for stocks right now is earnings expectations and the guidance for the next few quarters as global economic growth slows further. The S&P 500 Index is expecting 12% profit growth in 2024 over 2023 – but that seems too optimistic for me. Economic growth will most likely continue to slow in 2024 as the lagged impact of higher interest rates are fully absorbed.

From a risk-return trade off, fixed income (i.e. bonds) looked really attractive after the pullback that ended in October, but even they had a 12 to 15% move higher in the last six weeks of 2023. Investors have the most confidence in the idea that interest rates will finish 2024 lower than

(Continued on page 4)

where they started. However, given that the 10-year average in the U.S. has already rallied from almost 5% to less than 4%, we are hesitant to add to more bonds, but would look to do that on any move in yields on the 10-year back toward the 5% zone.

Technology and consumer staples sectors usually do well in periods of falling interest rates. However, the valuations of those sectors are already at the high end of their traditional range, so we don't see much upside from the big names but do see more opportunities in some of the mid-sized and smaller names.

Precious metals should finally get a lift in 2024 as the price of gold seems to be breaking out, and any decline in real rates, along with the ongoing global geopolitical noise, should weaken the U.S. dollar, all while inflation remains stubborn. Weaker economic growth in the U.S. is likely to undermine the U.S. dollar and further lift gold prices.

In terms of the energy sector, the mantra lately is that weaker global growth will cause a fall in global demand, which may also make it more difficult for the OPEC+ group to maintain their production discipline. That doesn't line up with the soft-landing economy scenario compelling all the big moves in the last 60 days of 2023. However, from everything we've researched, valuations in the Canadian producer sector are attractive even with oil in the US$70 range. Our focus is on the larger and mid-sized oil-levered producers, with double-digit free cash flow yields and investor-friendly activity, such as debt reduction, special dividends and share buybacks. As such, our models still have decent energy exposure.

The entire Fed panel seems to be relaying something similar in their talks. They cannot possibly think, with deficits being what they are and the eventual zeroing of reserves from past QE (RRP), that the long end won't react again. At the Fed's last FOMC meeting in December, Chairman Powell indicated that officials were turning their attention to interest rate cuts because inflation has declined much faster than they expected. He noted holding rates steady as inflation falls would lead to real rate rise and restrictive policy. This was taken as a Fed "pivot" by the markets, and the reaction from both the equity and fixed income markets was overwhelmingly positive. As I type, Fed futures are expecting the Fed to start easing interest rates in March 2024, and continue to trim rates (at least three more times) as the year progresses.

Regardless, perhaps indirectly the Fed is proactively telling banks, large and small, to clean it up, after what happened in March to the regional banks (notably SVB and FRC going broke). If you are a bank and you are not using this whole rate reversal that's happened so quickly to set up rate swaps to hedge your balance sheet risk right now, you deserve to go broke next round. The whole "fool me once, fool me twice" thing.

It occurred to me recently that everyone sees Powell's recent pivot the same way: politically motivated. Regardless of motivation, there is something deeper here, maybe he didn't even realize it when he did it.

We need to make a mental note of what happened at that last December 2023 Fed meeting. It may not seem like it, but it could go down as one of the most important macro events of this decade. Why do I say that? Well... any policymaker seriously committed to fighting inflation would NEVER publicly announce their intention to start cutting interest rates before achieving their ambitious price stability target (2%). Note as well, that communique happened on the heels of an announced core CPI at >4%, and top that off with government spending currently exceeding 20% of U.S. GDP (which is inflationary), combined with the deglobalization taking place (also inflationary), widespread labour issues and strikes (you guessed it... inflationary) and an exceptional constrained supply chain in the commodity markets (yep.... inflationary). Follow my logic?

With this in mind, the next time we get a rip higher in rates on the long end, people will prepare, because everybody knows the risk – it's visible – and that takes the risk off the table. *Right?*

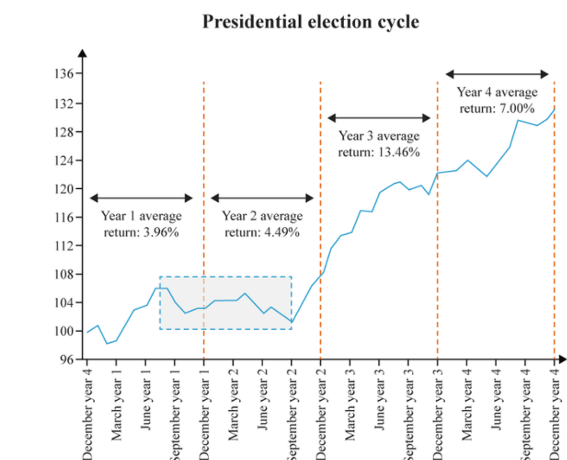
I suspect U.S. and global growth is about to inflect higher again. Manufacturing and inventory drawdown didn't hurt U.S. growth in 2023, but it sure will help if it rebounds into the teeth of a softened Fed...and with wages sticky at 5%, the long end of the treasury curve may not be done hurting players (though it probably won't be banks if they're taking clues from the Fed).

I think it's long equities (by end of the year), short rates and short the USD. But what do I know?

Here is what I do know: Next year is a U.S. Presidential election. It's a Year 4. Here's how they have looked in history:

(Continued on page 5)

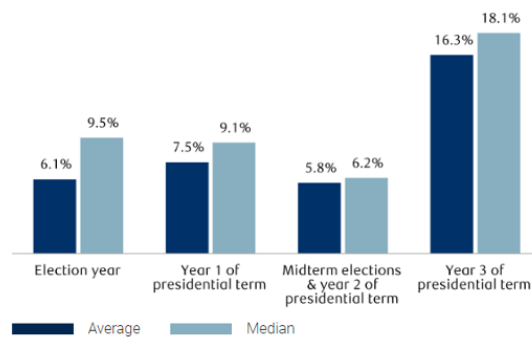
The Presidential Election Cycle



(Source: https://bookmap.com/blog/what-are-market-cycles/)

Midterm election years tend to be weak, but the following year is typically strong

S&P 500 performance during election cycles since 1932



Source – RBC Capital Markets U.S. Equity Strategy, Bloomberg; based on price returns and does not include dividends

(Source: RBC Wealth management https://www.rbcwealthmanagement.com/en-ca/insights/equities-and-the-election-effect)

On only five occasions over the past 90 years, had the U.S. Federal Reserve cut interest rates when core CPI (now 4%) is higher than the unemployment rate (currently standing at 3.70%) (Source: Bank of America Research / Michael Harnett).

Here's what makes me doubt the soft landing narrative being spun:

1. Consumers are maxing their credit cards. Credit card debt rose to over $1 trillion for the first time ever in Q2 of 2023. Which leads us to reason number 2...
2. Credit card defaults are rising. A combination of higher rates and increasing balances are squeezing consumers. The number of Americans now rolling credit card debt from month to month is, for the first time ever, larger than the number of people paying their bills. Defaults and delinquencies are rising on personal and auto loans as well.
3. Excess savings are running out. One of the reasons consumers have been able to keep up with the inflation price increases was that they piled up a lot of excess savings during the pandemic due to "free" money being handed out or at greatly reduced costs. But that's all nearly gone.
4. Student loan payments have resumed. After enjoying a three-year hiatus on payments, student loan borrowers are about to meet reality. Moody's estimated that the repayments will deliver a $75 billion hit to consumption on an annual basis. That's -0.5% of GDP.
5. Credit has tightened. Banks are tightening lending standards.
6. The cost of housing continues to soar and is unaffordable for many.
7. The old Wall Street adage that "there's never just one cockroach." Is there a financial crisis brewing? We had the regional bank scare in the spring, but it sure went away fast...or did it? In August, Moody's cut the credit ratings of 10 small and midsize banks, it also placed six large banks on review for downgrades and revised 11 more from stable to negative, but this was barely reported in financial news.
8. Corporate defaults have surged. By June of 2023, the number of corporate defaults had already exceeded the total in 2022.
9. The Biden Administration has added to the U.S. debt at the fastest pace in history. Interest has to be paid on that debt, and it's going to start biting in 2024.
10. Last but far from least, monetary policy acts with a lag. A lot of people like to believe in the soft landing because rates have already spiked higher and everything seems OK – the economy hasn't cratered yet. As my favourite economist Milton Friedman noted many times, the impact of monetary policy takes at least six to eight months to arrive at the street level. History (and my 40 years in finance) teaches us that it takes a while for the impacts of tighter monetary policy to work their way through an economy. One recent example most readers will recall: The Great recession of 2008-09 didn't kick off until nearly two years after the last Fed rate hike in June of 2006.

(Continued on page 6)

It seems to me the US economy is now a two-speed economy.

There's the "financial economy" that relies on interest rates. That would be Wall Street, Private equity, tech sector, venture capital, hedge funds, some housing, even autos – basically anything that needs lower rates to keep it rolling.

Then there's the "real" economy, which has been pumped on financial steroids via stimulation, with a layer of COLA (Cost of Living Allowance) that kicked in last month for social security and government employees at 8.7% (which works out to about +$140 per month for 70 million Americans).

Here is Powell's dilemma: He can only fight one of the two. If he raises rates and adds QT to target asset inflation and the financial economy, he hits the real economy if CEOs create serious layoffs to keep numbers in line. Wage growth is still ramping higher for the lower and middle class, and there's no direct event the Fed can use to transmit to that person, especially because most of that person's debt (whether housing, auto or student loans) is fixed. So, his wages going up makes him flush with cash and they have built a propensity over the past few decades to buy stuff from overseas. You could actually raise rates to 10% right now and still have wages going up because of the unintended consequences the bureaucrats created during the pandemic. What's worse than the wage increases for inflation is that we are now seeing local governments wanting to step in and "help" with more stimulus with ideas like this from the governor of New York:

Peg minimum wage to inflation? Insanity.

I've proposed a plan to peg the minimum wage to inflation — if costs go up, so will wages.

This would help to put more money in the pockets of nearly 900,000 New Yorkers.

3:31 PM · Feb 18, 2023 · 1.2M Views

(Source: X / Governor Hochul https://twitter.com/GovKathyHochul/status/1627043185611665409?lang=en)

Don't believe me? Here's some real history. You know who's been really good at this type of "indexing"? Latin America. Venezuela comes to mind. Places like Argentina, where inflation is now at 150%. It is a feature of inflationary regimes everywhere, and if this genie got out of the bottle, there's no getting it back in. You think 8 to 9% inflation is bad? The dysfunction of so many governments is that winning the next election at any cost (with a "we can fix it later" approach) takes priority over everything else has taken deficits to historical extremes. There is hardly anyone who stands for fiscal prudence. I think many governments will just continue to run tabs until the bond markets say it's over. Think Greece 2011. Portugal. Ireland. And so on....

This is why I think we're going to have levels of inflation coming and going in waves. The Fed can't fix this problem they helped create with ZIRP (Zero Interest Rate Policy) for over a decade. Inflationary recessions create monetary illusions, and the middle and lower classes will only feel poorer, leading to even greater social unrest. It also means that tax revenues are set to decline as well, leading to substantially more borrowing in order to make up the difference as election-year spending kicks in.

So, if inflation is going to stay hotter for longer with a U.S. presidential election looming, I'm reminded of the periods in the 1970s, right before I began at RBC in 1982.

Look at these charts of the S&P 500 during election years from 1968 and 1972 for context...

(Source: www.macrotrends.net)

And these ones from 1976 and 1980.

(Source: www.macrotrends.net)

(Continued on page 7)

Looking at election years back then with inflation running hot, what do you notice about how the equity markets performed?

If it's Biden vs. Trump in the next general election (God help us either way), Trump is currently leading in the polls and has already promised to replace Powell, who he called "the worst pick ever." If Powell's chairmanship is dependant on Biden (or the Dems) winning next year, that's highly unlikely if the economy is in a tailspin as homes remain unaffordable to all but the top 10% of earners. Much more realistic is lower interest rates (damn the inflation rate) and, more palpable to those deficit-addicted politicians who love to give away "free stuff" in election years: freshly printed money hitting the economy. The Fed has shown repeatedly that they are neither politically independent nor data dependent.

Let me remind readers that when his first term as Fed Chair was ending and inflation alarm bells were already ringing, Powell ignored them until after he was reappointed, keeping rates below 1% as inflation ratcheted them up to 40-year highs. Less than a month after he was confirmed, he cranked areas up an incredible +0.75% after promising that an interest rate hike of that size was "off the table." He then delivered four interest rate hikes in a row. If you ask me, the Fed is setting itself up to repeat the mistakes of the 1970s. They are going to snatch defeat from the jaws of victory. Which means....

"Hair of the dog" solutions are coming.

This sums up the sentiment of many people today, where things are so great on one hand, and yet we feel so awful on the other. It's a confusing time for many. A lot of people's optimism flows around their view of politics, and depending on who's in the White House or controls Congress, one group is happy and other is not. We've had violent shifts over the last 10 years. That makes it hard for people to trust anything. The media just makes it worse. A constant flow of information doesn't help because ironically – and there's a whole world of behavioral psychology focused on this – we become more confident the more we know.

Normally when we think of cycles, we think of a normal 4 to 5 year circle. It just keeps repeating itself. I think that's the wrong way to look at it today. We should view these cycles as spirals. It's not repeating, it's still going up and down, but it's not going up and down like it did in the past. It's in a different time frame. Through time, we're spiraling through these cycles, and we've got multiple spirals all working with each other, or against each other. What I see is a huge thrust, right down the middle, and that's technology.

Technology is pulling all of this forward. And very quickly. It has its own center of gravity, if you will, that shapes and changes how these spiraling cycles play out. A world with instantaneous social media is radically different than 1860s U.S., World War II, the 1930s...or even the 1980s. It's a different framework. The same patterns are there, but with different causes, different gravity through the center.

Pessimists always have problems, but research shows that the best stance for your portfolio has always been cautious optimism. Investors should be thinking, "This is where we're going, but we need to have risk controls. How am I going to deal with risk? What am I going to balance it with?" For over 50 years, the way you balanced stock market risk was with bonds, especially longer-term bonds. And when the stock market was going down, the bonds would go up, offsetting the damage from your stock portfolio. That was the genesis of the 60:40 portfolio. That hasn't worked the past three years.

Since the pandemic, you couldn't count on bonds to balance your equity risk. It was the opposite. Not that we've had much equity risk since the bottom, but certainly bond risk.

Equity markets have historically tended to trend upward over long periods of time as the real economy and profits tend to grow, and price levels rise in concert. We still believe there are many reasons to believe the future is relatively bright: Entrepreneurs are still creating and innovating, and artificial intelligence is no doubt going to have a huge impact. Our natural tendency leans towards bullishness, but there are periods where some caution and less exposure using an asset allocation is warranted.

The macroeconomic forecast is highly unreliable and financial markets may tend to be more volatile and reactive when actual outcomes deviate from recent experience. Therefore, investors should stay invested within a portfolio-asset mix that meets their risk tolerance levels, return objectives and liquidity needs, and allow their wealth to compound over the long term. We have not strayed from that process.

If I am correct and the Fed is going to repeat the 1970s policy error by bowing to political pressure, it will drop rates, fire up the money printers, and restart the inflation race, but if Uncle Milton is right, you won't see the largest impact of that stimulus, ironically, until after the U.S. presidential election and into 2025...

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