Wealth Management
Dominion Securities

George Stedman, CFA
Senior Portfolio Manager

RBC Dominion Securities Inc.
1501 McGIll College, Suite 2150
Montreal, QC, H3A 3M8
Tel: 514-840-7626
Fax: 514-840-7639
george.stedman@rbc.com
www.georgestedman.com

Tuesday, October 17 , 2023

Third Quarter 2023

The frightful news of the Israel-Hamas war has cast a pall over Thanksgiving. With so much sadness, it seems strange to be writing about investing. At this writing, I don't know how markets will react. There is uncertainty about the potential for the conflict spreading. Energy prices have risen. Another big question is how the Federal Reserve's attitude about interest rates might change in response to a shift in consumer sentiment. A drop in bond yields might dampen the blow to stock prices caused by uncertainty.

It is a holiday tradition that I use a gloomy chunk of Thanksgiving Weekend to write my Third Quarter letter. The outbreak of a new war in October adds much anxiety to what has generally been a weak period for stocks. But in any case, it never fails that by Canadian Thanksgiving the days are getting shorter. September has a well-deserved reputation for weakness and this year it certainly lived up to its reputation. Over the last 23 years the average return of the S&P 500 in September has been -1.53% (in U$, RBCDS's Rob Sluymer, Oct. 3). October's reputation is that it kills bear markets, but October has had mixed returns in recent years. Monthly seasonal data varies depending on the start date but generally there is an improvement in the fourth quarter.

It is not just seasonal affective disorder that accounted for September's stock market swoon. There is a long list of worries for the stock market. War and political disfunction count among them but, the 'single issue' that the stock market is 'singularly focused' on is yields. (Tom Lee, Fundstrat, Oct. 4). Rising US interest rates and a rising US dollar have been major headwinds for equities. On Oct. 5 the yield on the 10-year US Treasury was 4.74%, a 16 year high, and up from 3.84% on June 30. Yields have shot up for several reasons: The credit worthiness of the US for one (as dramatized by Fitch's downgrade on August 1). US 10-year bonds now yield significantly more than bonds from Greece and Spain for example.

Strong employment data and a strong economy create a worry that the Federal Reserve might raise short-term interest rates more or, more likely, that they will hold interest rates high for longer than previously expected. This in turn fosters a worry that they will keep interest rates too high for too long and create a recession, not the soft landing for the economy that might spare

corporate profitability. Yet another less reported reason for the surge in bond yields since the summer has been the Federal Reserve's continuing program of 'quantitative tightening' which it started last year. "It is currently allowing up to $60 billion in Treasurys and $35 billion in mortgage-backed and agency securities to mature each month without replacing them, effectively adding to the supply of bonds that other buyers must absorb." (Justin Lahart, WSJ.com, Oct. 5) These were bonds that the Fed bought to reduce supply to keep interest rates artificially low before 2022. As a history buff, I like the chart below of the US 10-year bond yield for the last 100 years. It well illustrates how dramatic the rise in yields over the last year and a half has been.

US 10 Year Yield

The US 10-year yield has pushed above a key level between 4-4.33% negating the view that a cycle peak developed in Q4 2022.

The next key technical hurdle is 5.15%.

Start: 15.840
12.228 76.4%
9.993 61.8%
8.187 50%
6.381 38.2%
5.155
4.146 23.6%
3.830
3.239
3.020
0.31%
4.68

1910's 1920's 1930's 1940's 1950's 1960's 1970's 1980's 1990's 2000's 2010's 2020's 2030's

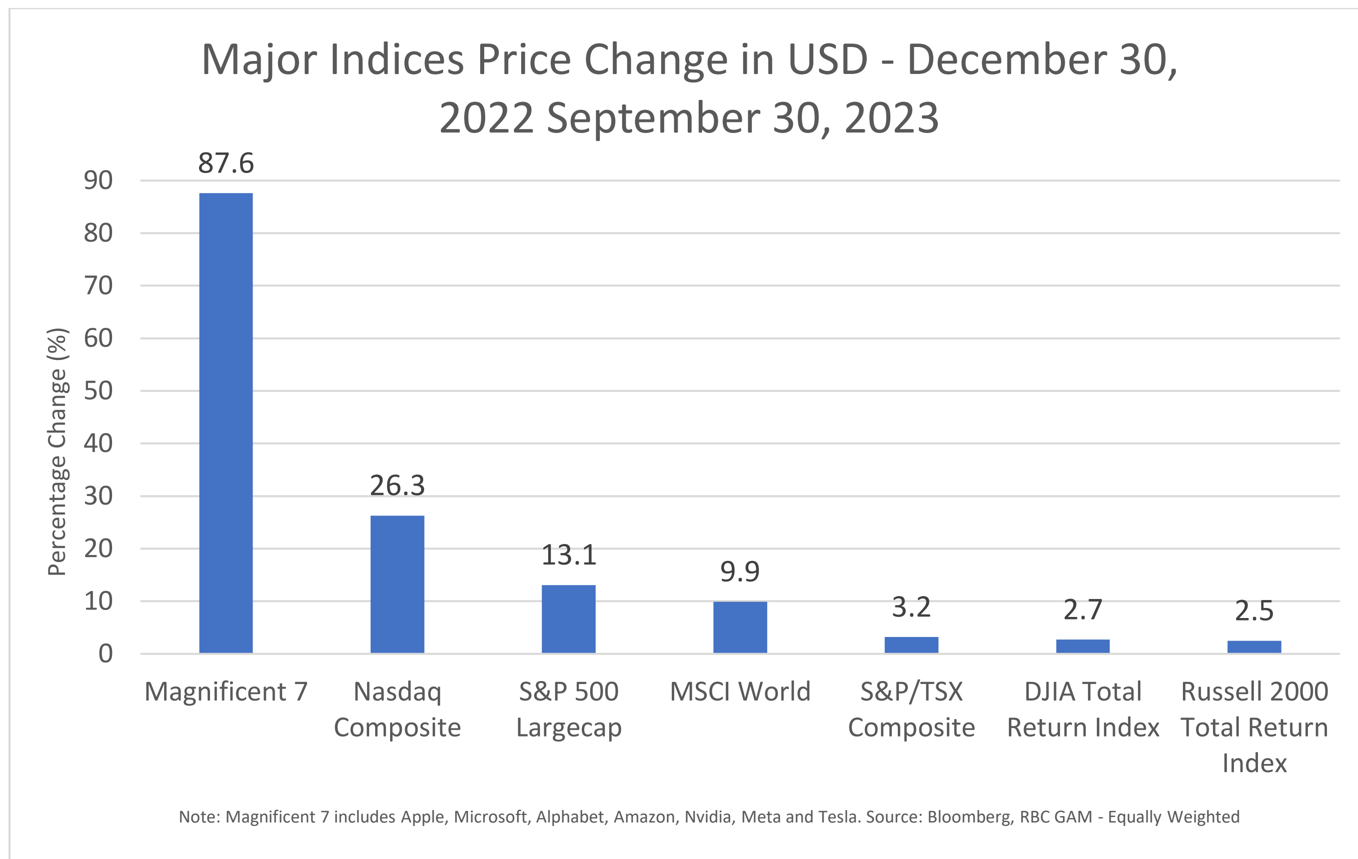
Optuma optuma.com

Source: RBC Wealth Management, Bloomberg, Optuma

October 3, 2023 RBC Wealth Management Portfolio Advisory Group | Robert Sluymer, CFA – robert.sluymer@rbc.com 20

Rising interest rates and the threat of economic weakness impact sectors particularly known for their dividends and for being capital intensive – TSX banks (-2.5% total return), communication services (-10.7%), utilities (-7.4), and real estate (-3.4%). These dividend stalwarts are well represented in our portfolios whereas not half of the 'magnificent seven', the companies seen to be the favoured providers of generative artificial intelligence, are. For now, it is the providers of AI that are benefiting but, in the years to come industries will be able to apply AI. For example, waste companies will use AI to sort garbage. The idea for the table below originated from RBC's Dan

Chornous and has been updated for September's stock market swoon. It illustrates the huge difference between the returns for different types of stocks in the first 9 months of this year.



The good news is that income is back in fixed income, to coin a phrase. As I've said before, I am particularly pleased to be able to buy good quality bonds in a taxable account at substantial discounts to their par value. Many are available with terms to maturity of 2 to 4 years as they were issued at a time when interest rates were much lower. A two-year bond bought at $92 held to maturity at $100 will have much of its return come in the form of a capital gain and only half of a capital gain is taxable in Canada. Let me illustrate with a couple of specific examples. The Government of Canada bond with a coupon rate of 0.50%, due in 1.85 years on Sept. 1, 2025, at a price of $92.06 has a yield to maturity of 4.91%, an after-tax yield of 3.49% (for somebody in the top tax bracket In Ontario) and a taxable equivalent yield 7.50%. By comparison a two-year GIC yields 5.75%. Permit me one more example. A 3-year GIC yields 5.25%. The Bank of Nova Scotia bond with a coupon of 1.85% and a maturity date of Nov. 2026, is available at $89.06 at which price it has a yield to maturity of 5.80%, an after-tax yield of 3.76% and a taxable equivalent yield of 8.09%.

This Thanksgiving I am especially thankful to announce that last week Margarita Martinez Elizondo had a baby girl, Chloe, and both are doing well. I have told Margarita that (and I know I shouldn't have) two children are enough and that I expect her back in the office in 47 weeks from now (but

who's counting 😊). I am also thankful to be able to announce that Matthew Pascale has joined Elena Venneri and me and together we will try to fill in for Margarita. Matthew is a graduate of the John Molson School of Business. He has worked in our branch for over a year, and he spent a few weeks being trained by Margarita before her maternity leave.

Thanks for reading. Happy Thanksgiving.

Sincerely,

George Stedman, CFA

Senior Portfolio Manager
Please visit us at www.georgestedman.com

RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. Used under licence. © RBC Dominion Securities Inc. 2023. All rights reserved.