Gestion de patrimoine
Dominion valeurs mobilières

RBC Dominion valeurs mobilières inc.

Équipe Marchand Filiatrault de RBC Dominion valeurs mobilières

FEBRUARY 2024

Market update

Jean Marchand, CPA, FCSI
Senior Portfolio Manager and Wealth Advisor
jean.marchand@rbc.com
450-686-3325

Patrice Filiatrault, CFA
Senior Portfolio Manager
patrice.filiatrault@rbc.com
450-686-4207

Mario St-Amant, B.B.A.
Associate Wealth Advisor
mario.st-amant@rbc.com
450-686-4204

Philippe Ouellette, B.A.A., CIM, FCSI
Associate Portfolio Manager
philippe.ouellette@rbc.com
450-686-3485

545 Promenade du Centropolis
Suite 200
Laval, Quebec H7T 0A3

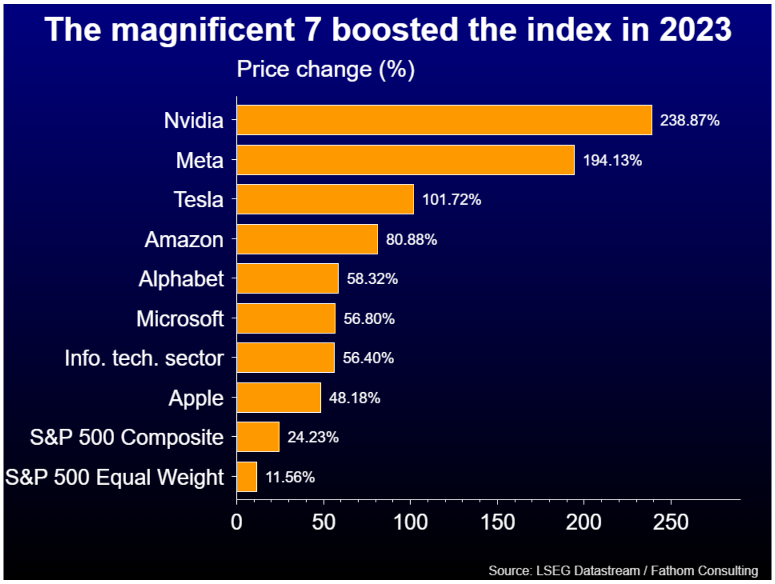
www.equipemarchandfiliatrault.com

Thanks to an exceptional year-end, investors are undoubtedly pleased with the returns generated by the financial markets in 2023. After a very challenging 2022, with the stock market and the bond market both facing major setbacks, 2023's returns have all but erased the previous year's losses.

Investors can thank Jerome Powell for the sharp uptick in enthusiasm that played out especially over the last two months of 2023. Although the level of pessimism was growing in late October and the cumulative returns to date were disappointing, the chair of the U.S. central bank hinted, at a press conference, that the monetary tightening cycle was drawing to a close and that he even foresaw the Federal Reserve undertaking a series of reductions in its key rate in 2024. That was all it took to boost investor confidence and trigger a meteoric rise in the price of stocks, bonds and several other asset classes.

In addition to Powell's comments on the future direction of the U.S. monetary policy, 2023 also gave us a powerful comeback from the technology sector, which posted its second-best year since the tech bubble burst in the early 2000s. With the wider release of ChatGPT, the hope of a promising future for artificial intelligence bumped up share prices for many companies in this sector. In fact, thanks to its strong exposure to tech stocks, the S&P 500 was the index that benefited most from the interest in artificial intelligence, and its gains far exceeded those of all the other main stock indexes in 2023. It is worth noting that seven tech giants, whose collective weight now represents more than 25% of the S&P 500, helped push up the index's performance. As can be seen in Chart 1 on the next page, the increase in the share price of these companies was absolutely staggering, and the performance gap between the S&P 500 and its equal-weight version equally so. Actually, when using an equal-weight approach that attributes a similar weighting to all securities in the benchmark index, the gain for the S&P 500 is significantly less at 11.56%, a level that reflects more accurately the average performance of non-tech securities in 2023.

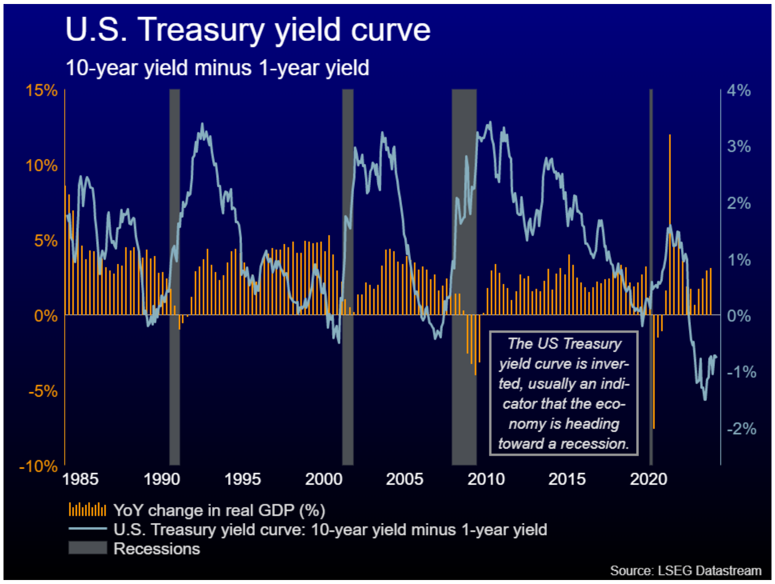
Chart 1



Outlook for the economy and the financial markets

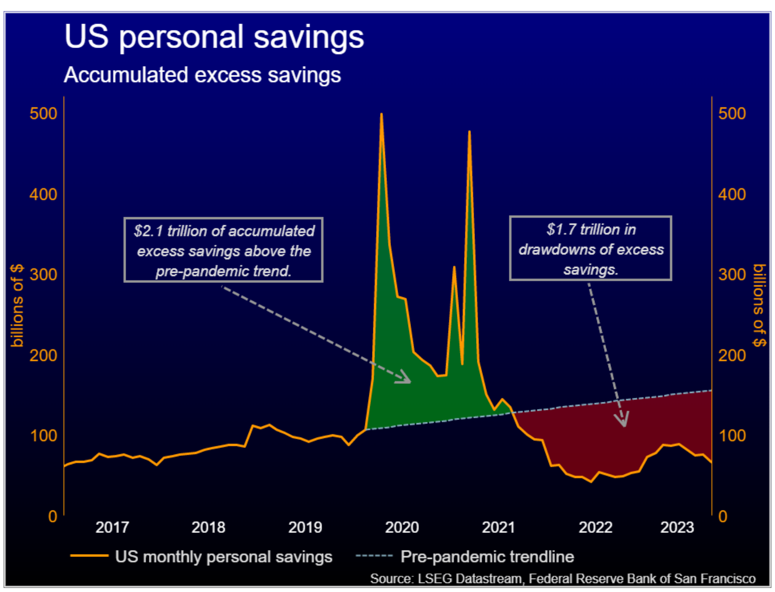
For several quarters now, the U.S. economy has presented a fairly challenging puzzle for economists and investors. Despite the most relentless monetary tightening cycle since 1980 and an inflation rate that remains too high, the U.S. economy continues to surprise most economists with its resilience. Based on several reliable economic indicators, such as the U.S. Treasury bond yield curve, illustrated in Chart 2 on the next page, and the Conference Board's leading economic index, the American economy should already be in recession. It is also of note that, unlike the United States, many economies are struggling to advance in the current climate. For example, the United Kingdom and Japan are officially in recession, and the economies of Europe and Canada have come very close to posting two consecutive quarters of contraction in their gross domestic product, barely avoiding sliding officially into recession for the time being. It should be said that the economists who are clinging to the soft-landing scenario for the American economy have very valid arguments to support their thesis. American consumers are in good financial health, having significantly reduced their debt since the 2008 financial crisis. The job market is still strong, and workers' salaries are increasing at a high enough rate to make up for the rising cost of living, while inflation is gradually returning to its longer-term target. Construction and the manufacturing sector have rebounded, as shown by statistics on housing starts and manufacturing orders. Furthermore, the banking system is well capitalized and well equipped to absorb potential losses on loans, and business profits are doing fine. Finally, new laws passed by congress will foster economic growth in the years ahead by encouraging investment in several areas, including infrastructures, renewable energy and semiconductors.

Chart 2



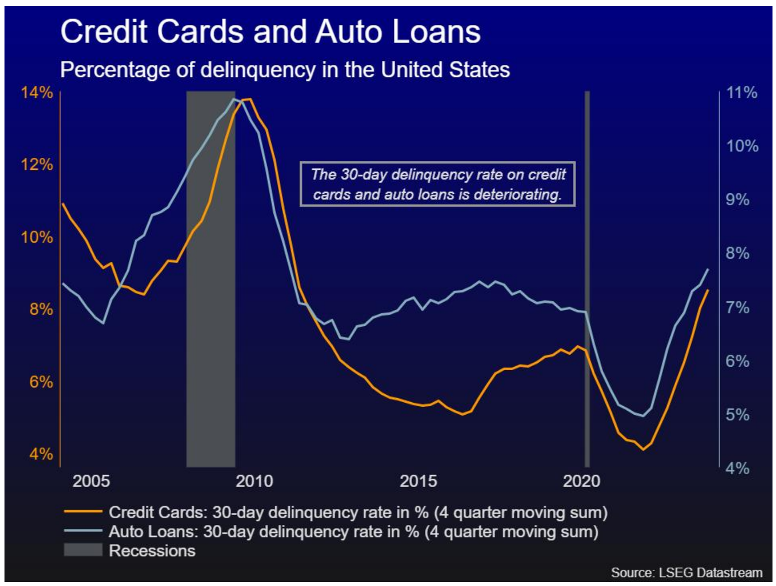
From this perspective, it is hard to deny that the economic situation in the United States appears to be in good shape, and the financial markets are unreservedly reflecting back that optimism. In the last few weeks, U.S. stock market indexes have hit new highs, and the bond market is behaving far better with the recent pullback in long-term interest rates. However, investors seem to have decided to ignore the fact that the current context is not entirely risk-free as several things still look worrisome in our view. First, bear in mind that the U.S. economy greatly benefited from the generous assistance programs set up by the government to support it during the pandemic. Those programs, which came in several waves while the public was in lockdown, meant that American households ended up with significant additional savings. Surplus savings undoubtedly helped keep household consumption at a high level despite the increase in interest rates and the higher cost of living in general. As Chart 3 illustrates, however, a recent study by the Federal Reserve Bank of San Francisco suggests that those surplus savings are rapidly dwindling.

Chart 3



From $2,100 billion at its peak, the study's author estimates that households had just $400 billion in surpluses left in September 2023 and that at the current rate of consumption, the surplus savings would be completely depleted by summer 2024. And since the remaining surplus savings seem to be concentrated in the hands of the wealthiest households, it is highly likely that some American consumers are already feeling the pinch of inflation and higher interest rates. Chart 4 shows that the percentage of unpaid credit card balances and car loans is increasing significantly and now exceeds pre-pandemic levels, a sign that consumption growth among U.S. households may dry up.

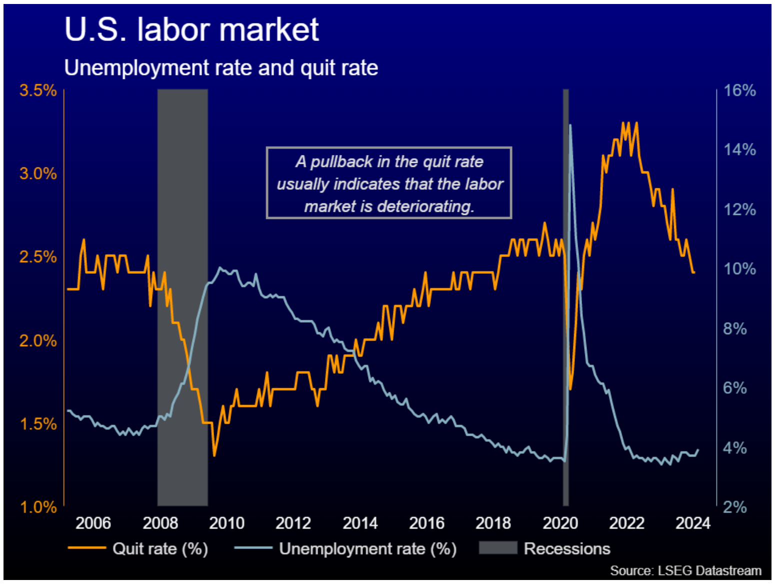
Chart 4



In addition to this deterioration in credit quality for some classes of consumer loans, banks are also facing a sizeable issue in the commercial real estate sector. Many loans will come due in the coming years, and it is clear that the banks will have to absorb considerable losses. Even though several segments of the real estate sector are performing well, many properties have an inadequate capital structure for the current environment, where mortgage rates are much higher. We believe that the banks will continue to be prudent and maintain stricter loan standards in 2024, especially after the banking sector was seriously shaken in 2023 by the liquidity crunch that bankrupted a few regional lenders and forced the U.S. government to intervene. That shock wave was felt all over the world, including in Europe, where the crisis got the better of the financial institution Crédit Suisse. To halt massive withdrawals by the depositors of this major banking institution, the regulatory authorities had no choice but to impose a merger with UBS, the other Swiss financial giant. In response to this crisis, capital and liquidity requirements will likely be tightened, another source of uncertainty for the banking sector in 2024.

Since the end of the pandemic, the job market in the United States has performed remarkably well, with job creation exceeding all expectations and the unemployment rate at historically very low levels. Strong job creation in recent years is clearly an important contributor to the resilience of the U.S. economy, but we are seeing early signs that the job market is losing momentum and that an increase in unemployment may be on the horizon. Employment statistics reveal that the number of lay-offs is continuing to climb while opportunities — that is, the number of vacant positions to be filled — are on the decline. Although current conditions in the job market are still favourable, the trend is less encouraging, and we can see this gradual deterioration in the behaviour of workers who are less and less likely to leave their jobs voluntarily. As Chart 5 on the next page shows, the quit rate is down, a trend which historically coincides with an increase in the unemployment rate. A shrinking quit rate is generally a sign that there are fewer opportunities or that the conditions offered elsewhere are not beneficial enough to justifying quitting voluntarily.

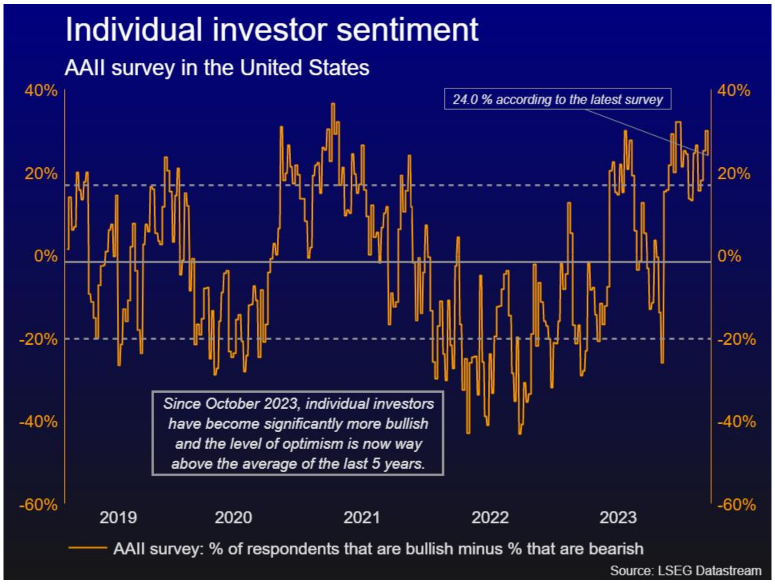
Chart 5



The debate over the U.S. economy's capacity to pull off a soft landing is not new. It has been going on since 2022, and we will still have to wait for several more quarters before the final pieces of the puzzle fall into place. Although the progression of economic activity in the United States is a decisive factor for assessing the potential return on various asset classes, it is not a matter than can be debated in a vacuum without considering what the financial markets are already counting on. The U.S. equity market is especially revealing, as indexes scale new heights and seem to have already concluded that the economy will definitely avoid a recession. Since the Federal Reserve chair's speech in November, the stock markets seem to be counting on a picture-perfect scenario: inflation will quickly return to its target of 2%, the Fed will begin a cycle of significant rate decreases, the economy will achieve a flawless soft landing, and business profits will get back on the growth trail. This upsurge in confidence is clearly visible on the recent results of the AAII investor sentiment survey, which can be seen in Chart 6 on the next page. After reaching a level of extreme pessimism last October, investor sentiment rebounded very briskly. On our side, we think that it is premature to bank exclusively on the most optimistic scenario. We actually believe that the economy should show more significant signs of weakness before the Federal Reserve undertakes a convincing cycle of rate decreases. In other words, bad news may be coming before the next cycle of monetary policy easing, and the stock market does not seem to reflect that possibility. Moreover, the difficult economic context in China, severe geopolitical tensions and the U.S. presidential race are also factors that could drag down investor enthusiasm in the coming months.

Of course, stock market indexes do not tell us everything and may sometimes be misleading. For example, it would be simplistic to conclude that all S&P 500 securities are overpriced. Many securities outside the tech sector still have reasonable valuations, especially those of corporations that pay high dividends. Those securities did suffer a lot with the significant increase in interest rates in recent years, and many of them are now trading at historically more attractive valuations. The utilities, telecommunications and real estate sectors are overflowing with high-dividend corporations whose valuations may benefit from a drop in interest rates. We also believe that certain industries that are less dependent on the level of economic activity and therefore more defensive may perform well in an uncertain economic environment. Finally, with the massive investments generated by U.S. government initiatives in infrastructures, renewable energy and the reindustrialization of the U.S. economy, we believe that the prospects are good for many securities in the industrial sector.

Chart 6



As for technology stocks, the valuations are back at extreme levels and appear to us to be inflated by the excitement generated by artificial intelligence. We are not contesting the long-term potential of this innovation, which may transform many aspects of the economy, but it is still very early to determine with certainty who the winners will be and what impact it will have on the profitability of the players in this emerging industry. As can be seen in Chart 7 on the next page, the price-earnings ratio of the tech sector is well above its average for the last 20 years, and we believe it is preferable to approach this sector with caution at the present time. Naturally, many companies in the sector are incredible businesses, and their long-term growth prospects are still excellent. Some of them generate enormous cashflows, deliver outstanding returns on invested capital and are in great financial shape. But let's not forget the history of the technology sector, which has often enjoyed strong periods of speculation followed by long difficult periods when valuations come back down to earth. For example, in 2022, the sector fell more than 30% during the worst of the correction, and if we go further back, many investors surely remember when the internet bubble burst and the 15 years it took the NASDAQ to recover the lost ground, as shown in Chart 8 on the next page. In Canada, we have also had periods of tech stock speculation that led to significant losses for some investors. The most famous case is no doubt Nortel, but there was also Research in Motion and, more recently, Shopify. While we are not predicting a rout like the one in the 2000s, we believe that there are enough signs of exuberance right now to justify a more cautious approach for this sector.

For fixed-income securities, our opinion has not changed since our last update. After a difficult period in 2021–2022, Canadian bonds have bounced back, with a total return of 6.69% in 2023. Preferred shares generated a return of 5.90% during the same period. We continue to believe that the yields to maturity offered by bonds are currently attractive at levels that we haven't seen in a long time. Furthermore, with inflation continuing to move toward the 2% target, we believe that the central banks will be able to ease their respective monetary policies, which will be beneficial for bond prices. Since a recession scenario is still very real, bonds could be a valuable asset in portfolios in the quarters ahead.

Chart 7

Chart 8

Portfolio management – performance

In 2023, equities were the asset class that generated the best returns in portfolios. Compared to the U.S. benchmark, our U.S. equities portfolio was behind for the year, and the performance gap can be explained by our lower weighting in the technology sector. At over 40% of the S&P 500 index, technology represents an enormous weight in the U.S. benchmark index, and we believe that this concentration is not appropriate for portfolios. With regard to Canadian equities, our portfolio surpassed the Canadian benchmark index.

Our portfolio of fixed-income securities generated positive returns, comparable to the benchmark index in 2023. In 2022, the short duration of our bond portfolio allowed it to outperform the benchmark index by a large margin. In an environment with interest rates at higher levels, our decision to significantly extend the maturities paid off. As for preferred shares, our portfolio outperformed the benchmark index by a good margin over the last year.

For our alternative component, three strategies have been gradually added to certain mandates. After an excellent year in 2022, with a return of 11.87%, the real estate fund generated a performance of -2.44% in 2023. This decline is due to the increase in capitalization rates in the sector, which led to a depreciation in the value of the properties and the market value of the fund. It is important to point out, however, that the fund's financial performance is good and that all the portfolio's asset classes generated profitability growth. Furthermore, with little debt, the fund is in a good position to take advantage of opportunities that may arise in the coming months. With regard to the mortgage fund, the portfolio's performance in 2023 was 6.03%. We anticipate that the fund will continue to generate good returns in 2024, now that it is fully invested and that the mortgages in the portfolio are generating high returns. Finally, the infrastructure fund began its deployment with two initial investments. First, the fund took a position in Highway 407 in Ontario, a well-established toll highway that has been in operation since 1997. Second, the fund acquired an interest in Ports America, the largest port facility operator in North America.

In 2023, our asset allocation was prudent. Compared to their targets, cash and high-quality alternative investments represented a higher proportion of the portfolio, as we had decided to slightly underweight equities. This positioning weighed somewhat on overall performance, but we are still comfortable with our portfolio in the current environment. Finally, it is important to note that the portfolio returns in 2023 were significantly higher than the losses in 2022 and as a result the portfolios rose over the entire 2022–2023 period.

Portfolio management – changes

Over the last year, we continued to reduce the risk and volatility of the portfolios. From the asset allocation angle, we reduced the proportion of equities and increased cash. Despite recent investor enthusiasm for the equity market, we believe that the issues are still very real and that the coming months may be volatile, presenting buying opportunities at more attractive valuations. We are closely tracking inflation, as well as the Federal Reserve's comments because, historically, the beginning of a monetary easing cycle can signal the launch of a new bullish period for the equity market.

We also made changes within each asset class. On the bond side, we continued to extend our duration and took advantage of the significant rise in yields to add high-quality bonds at a discount that benefit from advantageous tax treatment. In a more pessimistic scenario where economic conditions deteriorate beyond expectations, longer-term bonds can act as a counterbalance and thus reduce overall portfolio volatility. We believe, as we did in 2023, that the bond market will be both profitable and less volatile in the year ahead.

On the equity side, we progressively reduced the risk in our portfolio by focusing on quality and opting for stocks that are less sensitive to the pace of economic growth. We also gradually increased our exposure to more defensive securities as we want to reduce the portfolio's downside risk if the economy slides into recession. In order to reduce the portfolios' exposure to the resources sector, we liquidated a portion of our investments in the U.S. Energy index fund and in Teck Resources, a copper and coal producer. Given the attractive valuations and the very high dividend yield in the pipeline industry, we increased our exposure to Enbridge and TC Energy. We replaced TC Energy later in the year with Pembina, because this company has a healthier financial balance sheet and offers better growth prospects for its dividend. In the industrial sector, we reduced our position in Honeywell and eliminated Cargojet, an airline specializing in scheduled cargo flights. We also initiated a position in Roper Technologies, a developer of software and high-tech products, and reduced Microsoft and Apple. Also in the technology sector, we increased our position in Shopify and initiated a new position in Constellation Software. For several years, Shopify shares were trading at stratospheric valuations, to the point that the stock boasted the highest market capitalization in Canada. Since the share price dropped by about 80% in 2022, we have gradually built a position in this corporation. In the financial services sector, we eliminated Berkshire and reduced our banking risk in Canada by replacing our position in the Bank of Montreal with National Bank. We also reduced our position in JP Morgan and Visa and increased our exposure to US Bancorp, whose share price was under pressure during the U.S. regional bank crisis. It should be noted that for tax reasons, and to reduce risk, we replaced US Bancorp at the end of the year with the KBWB financial institution index fund. Finally, still in the financial sector, we sold the shares of Brookfield Asset Management distributed by the parent company Brookfield Corporation following a reorganization of the group. To make the portfolio more defensive, we increased our exposure to Telus in the telecommunications sector and later replaced that security with BCE. We also initiated a new position in NextEra, a company in the utilities sector. NextEra is a major player in the renewable energy sector that offers excellent growth prospects. To fund this purchase, we eliminated our position in Algonquin. In the healthcare sector, we added CVS Health to the portfolio and funded this purchase by reducing our weighting in Johnson & Johnson and Stryker. Finally, turning to the consumer sector, we initiated a position in Home Depot while its stock was trading at attractive valuations.

During the last year, we have directed additional funds into the alternative investments category. Depending on mandates, we added an infrastructure fund that is currently in the deployment phase. We believe that high-quality alternative solutions are interesting given that they bring considerable diversification to the portfolios. The year 2022 provided a good example of the role that some alternative investments can play. Throughout the year, the correlation between stocks and bonds remained high and both asset classes had simultaneous negative returns. On the other hand, with positive returns in 2022, our alternative solutions not only made progress but helped reduce portfolio volatility. Over the next few years, financial markets are likely to experience further episodes of high correlation. With inflation likely to stabilize at a higher level than in the past, the spotlight will be on central bankers' monetary policies, and simultaneous movements among different asset classes could be more frequent. As part of this diversification effort, we are currently exploring the possibility of adding a private loan fund to the portfolios, to add to our current exposure to alternative investments. Of course, the manager's approach will have to align well with our philosophy of focusing on investment quality. We believe that the private loan fund, like the new infrastructure fund, is more of an alternative to equities, and the source of funding for this investment will most likely be this portion of the portfolio. In closing, it should be noted that private alternative investments are not very liquid and require a longer-term commitment, so it is important to balance the weighting of this asset class in portfolios. In our opinion, for an investor with a long-term investment horizon, private investments could represent up to 10% of the total portfolio value.

We hope that this account of our management has been useful to you, and we invite you to contact us for any questions or clarification. We also want to take this opportunity to thank you for your trust in us.