THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

MID-YEAR REVIEW

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Welcome to our 2023 mid-year review issue. Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2023 – and what the major influences were over the last six months. We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course. Enjoy your summer!

Stan

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Mid-Year Review

ECONOMY PROVES MORE RESILIENT THAN EXPECTED

By Stan Clark, Senior Wealth Advisor, and Michael Chu, Senior Wealth Advisor

We trust you are enjoying the warm summer! The midpoint of the year seems a good time to review 2023 so far – and to look ahead.

Stock markets around the world have bounced back from 2022's poor returns. Among the strongest is the U.S. market, driven by a handful of technology companies. In Canada and the U.S., inflation continues to fall while the employment market remains strong. Still, central banks remain vigilant in their commitment to fight inflation.

The World Equity Index, a gauge of stocks around the world, was up 12.4% (in C$) in the first six months of 2023. At home, the TSX was up 5.7%. The chart below shows the returns of major markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

	Q1 2023	Q2 2023	H1 2023
Canada (S&P/TSX)	4.6%	1.1%	5.7%
U.S. (S&P 500)	7.2%	6.5%	14.2%
Europe	10.3%	2.0%	12.6%
Japan	6.8%	6.9%	14.2%
EAFE (Europe, Australia, Far East)	8.2%	0.9%	9.1%
Emerging Markets	3.7%	-1.1%	2.5%
World	7.4%	4.7%	12.4%

Source: Bloomberg

As you can see in the next table, dividends from Canadian stocks are about the same as 10-year bond yields, while trailing earnings yields are nearly twice as much. Although not as good as before, this still indicates decent value when comparing stocks to bonds. In the U.S., dividend yields are much lower than 10-year bond yields, and earnings yields are only marginally higher – indicating not as much value in U.S. stocks, as these have increased in price. Other regions like Europe, Asia and Emerging Markets show good value when compared to the average yield on 10-year bonds.

	Trailing P/E	Trailing Eanings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	14.9	6.7%	3.3%	3.4%
U.S. (S&P 500)	23.6	4.2%	1.5%	3.8%
Europe	14.8	6.8%	3.2%	2.9%
Japan	17.5	5.7%	2.2%	0.5%
EAFE (Europe, Australasia, Far East)	15.4	6.5%	3.1%	2.1%
Emerging Markets	13.6	7.4%	3.3%	3.6%
World	20.3	4.9%	2.0%	3.5%

*Weighted average for regions

Source: Bloomberg

The earnings yield in the table uses reported earnings over the past 12 months. It's also useful to look at estimates of future (or forward) earnings. According to data from top economist Ed Yardeni, the S&P 500 price to earnings ratio (P/E) is about 19 times forward earnings, which equates to a 5.3% earnings yield. At the beginning of the year, the forward earnings yield was 6.3%. This implies that stocks are about 20% more expensive than at the beginning of the year, because stock prices moved 20% higher (in US$ terms) while earnings expectations stayed about the same.

Global equity markets rose to their highest levels in a year, signifying investors' belief that the economy can achieve a soft landing. The full impact of the interest rate hikes will take some time. But the expansion has shown impressive resilience, despite the most aggressive monetary tightening cycle since the 1970s.

Valuations

Wharton Professor Jeremy Siegel says the equity markets as a whole are fairly valued. Siegel has argued that a 20x price-to-earnings is a reasonable multiple for the S&P 500, close to what we have for the broad market now. But tech stocks are about 50% more expensive, while the non-tech stocks in the S&P 500 are about 20% less – right around the median for the last 30 years.

The key point is that not all stocks are the same and that, despite higher valuations overall, there are still many opportunities with much cheaper valuations. For example, mid- and small-sized stocks are about 25% cheaper.

A 70% risk

Jeremy Grantham of GMO recently said there's a 70% risk of stocks crashing in the next few years. This is based on a comparison of today vs. previous big bubbles like 1929 (Great Depression), 2000 (dot-com bust) and 2021 (COVID). At the top of their cycles, those bubbles all exhibited long economic upswings, very strong bull markets, strong earnings and almost perfect economic financial conditions. They then all ended with a sharp descent.

Grantham originally predicted an 85% chance of a crash, but backed off to "only" 70%, due to the complications of the emergence of speculation around artificial intelligence (AI). Grantham recognizes that the final stages of a bubble are usually the longest and most difficult to predict. Also unknown is how severe the aftermath will be. If the economy is handled badly, you might get a 1929; if the economy is handled well, you might get a mild recession as in 2000 or 2021. The stock market significantly fell in 2020 and 2021, but recovered quickly along with the economy.

Note that Grantham has been negative for some time. He might be right eventually, but when is almost as important as if. We place little faith in economic and stock market predictions, no matter how well-credentialed the predictor is. Nevertheless, it's important to consider different perspectives.

Are we there yet?

The Fed appears at or close to the end of this rate hike cycle. Now investors will be concerned with how long the "pause" will be. The focus of the debate could change to the timing and size of potential rate cuts.

In Canada, with recently upwardly revised economic growth estimates in hand, the Bank of Canada has the confidence to overshoot with further rate hikes to further fight inflation. It raised rates by .25% on July 12 and might raise rates again in September.

Contrarian

Despite this year's strong stock market performance, Wall Street strategists are far from irrationally exuberant. Bank of America's Sell Side Indicator, which tracks the average sentiment of Wall Street strategists, was at 53% at the end of June – a six-year low.

As a contrary indicator, the Sell Side Indicator is bullish for stocks when strategists are extremely negative and bearish for stocks when strategists are extremely positive. With strategists remaining largely bearish, that pessimism provides a favourable backdrop for U.S. stocks. Based on historical data, the current reading is close to being extremely negative and corresponds to 16% return for U.S. stocks over the next 12 months. While the indicator isn't anywhere near perfect, it's one of the best timing models for making predictions over the next 12 months.

Exhibit 1: Equity sentiment ticked up in June
Sell Side Indicator, 8/1985-6/2023

Source: BofA US Equity & Quant Strategy. Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviation from the rolling 15-year mean. A reading above the red line indicates a Sell Signal and a reading below the green line indicates a Buy Signal
BofA GLOBAL RESEARCH

Another view

Another contrarian indicator is the Bull/Bear Ratio (BBR). Though similar to the Sell Side Indicator, the BBR is a survey of investment newsletter writers instead of Wall Street strategists. Again, extreme values are important. The BBR jumped to three recently, meaning there are three times more bullish than bearish newsletters. Historically, BBRs of three or higher are not as bearish as readings of one or lower are bullish. So, high bullish sentiment can be a caution flag going forward. This is the opposite reading of the Sell Side Indicator discussed above. Conflicting signals are nothing new. They just remind us that nothing is certain and we should be prepared for a variety of outcomes.

Inverted yield curve

At the end of June, the yield curve reached its steepest level on inversion since 1981. Normally, long-term interest rates are higher than short-term rates – hence an upward sloping curve. An inverted curve is when long-term rates are lower than short-term rates, say, the 10-year rate vs. the two-year rate. The yield curve is important because it's often seen as a sign that a recession is coming. But the curve has been inverted for about a year now, long enough for investors to question if this highly expected recession will actually occur. So far, the economy has been much more resilient than most had expected in the face of aggressive Fed rate hikes.

At a basic level, an inverted yield curve means that bond investors expect rates to fall. Their thinking is that the Fed must slash rates in the future as the economy weakens. But this isn't a forgone conclusion.

Continued tightening of monetary policy could result in a financial crisis, which could result into an economy-wide credit crunch and then a recession. One theory is that these credit crunches cause recessions, not merely that the yield curve anticipates such events.

As discussed previously, the inverted yield curve correctly anticipated a banking crisis that occurred in March. The difference this time was the Fed's quick response: an emergency bank liquidity facility to avert an economy-wide run on banks and a credit crunch. As a result, no real recession so far. But, since the outstanding banking issues could slowly turn into a credit crunch, there are still some worries here.

Recession worries

Maybe there already is a recession, but it's just harder to see.

Economists still forecasting a recession typically have been citing four reasons: inversion of the yield curve; a drop in the money supply; rising interest rates; and depleted savings.

The Index of Leading Economic Indicators (LEI) peaked at a record high in late 2021. To the end of May, it's down about 9%. The LEI correctly anticipated the previous eight recessions with an average lead time of 12 months. But Yardeni says the LEI is biased, giving more weight to the manufacturing sector than the services sector. He believes we are experiencing a rolling recession, with downturns rolling through various goods sectors at different times while the economy as a whole, including the services sectors, keeps growing.

Things take time to work through the economy. We don't necessarily need the "hard landing" of an economy-wide recession to bring down service inflation. Yardeni's probability of a hard landing has decreased from 40% to 20% – citing the resilience of the economy.

The chances of an economy-wide recession rise if the Fed persists in raising rates. But don't forget that more than monetary policy affects the economy. Current fiscal policy (government spending) today is stimulative. Onshoring, that is, moving a business back home from overseas, as well as infrastructure and green spending, have helped offset the effects of rising interest rates. Yardeni argues that the economy has already shifted from a rolling recession to a rolling recovery. Hard-hit sectors in goods, manufacturing and housing are showing signs of recovery.

Shake it off (i.e., recession worries)

Who would have thought that Taylor Swift would be mentioned in a Fed report? The Fed cited the singer/songwriter's impact on local economies, thanks to the supercharged tourism revenue her concerts bring. For example, her current Eras tour, a multi-generational cultural event for all walks of fans. One study estimated that Swifties in the U.S. spend more than $1,300 each – adding billions to the economy and benefitting everything from restaurants to hotels to local attractions. Taylornomics is now going global, with the tour expanding to Asia, Australia, Europe and South America. Although it's a temporary boost, and perhaps takes away from other spending, it's an interesting way to get consumers to spend and help the economy.

New bull market

The current bull market started in October 2022. So far the U.S. market is up 27% (in US$ terms) from its low. With inflation fading and the labour market proving resilient in the face of aggressive rate hikes, Ed Yardeni believes that a soft landing and further market gains are inevitable. Yardeni now expects the S&P 500 to reach a new record high somewhere between 4,800 and 5,400 over the next 18 months. That implies a gain of 6% to 20% by the end of 2024. Keep in mind, though, it might not be a smooth road and there could be corrections along the way.

Inflation transitory, after all

In May, inflation fell to 4% in the U.S. and 3.4% in Canada. So, we're getting closer to the target of 2%. Inflation is cooperating somewhat, but we're not all the way back to normal. Undeniably central banks have come a long way in their fight to dampen inflation. Over the past 18 months, we've seen rates go from near 0% to roughly 5%.

Inflation seems likely to continue to fall. The big four drivers on inflation have all turned: supply chain; commodity prices; monetary policy; and government spending. Service inflation continues to be sticky. To tame that sector you probably need a weaker labour market. This might require a recession, even if it's a mild one.

Goldilocks economy

Jeremy Siegel describes today's economy as a Goldilocks economy, not too hot, not too cold, i.e., good economic growth with falling inflation. The Fed's aggressive interest rate hikes since last March to tame inflation appear to be working. Inflation now stands at 4% and looks to fall more – a far cry from the 9% four-decade high seen at this time a year ago. Many economists have warned that rising interest rates could spark a recession, but Siegel doesn't buy it. He thinks the Fed might actually "stick the landing," meaning a soft landing where inflation is tamed with no job-killing recession.

First-quarter GDP was revised up to 2% and the estimate for the second quarter stands at 2.3% , far from recession territory.

Siegel also recently noted how consumer spending has been resilient due to what he calls YOLO (you only live once) shoppers. He says these summer spenders have been "impervious to the impact of higher borrowing costs" amid a consistently low unemployment rate. The resilience should keep the economy going, as consumer spending represents 70% of the U.S. economy.

Despite the positive news on inflation and growth, Siegel thinks the Fed has already locked in for one more rate hike. Still, he believes the Fed shouldn't raise rates further. Seigel's argument is that inflation has been defeated and more rate hikes would be an attack on rising wages, which are just catching up from falling wages during the pandemic. He sees stability in oil prices, commodities and housing.

Artificial intelligence

One of the big topics this year is the impact of artificial intelligence on the economy and productivity. As we noted in last month's Perspectives, the uptake of AI such as ChatGPT has been extremely fast. There are fears that AI could reduce many jobs, with some extremists predicting up to 40%! But things rarely turn out as extreme as they first seem. There will be pockets where jobs are eliminated. However, this could be offset by AI improving the efficiency of current jobs, plus creating new jobs. And companies may benefit through savings from automation and increased productivity.

For the economy at large, technology is deflationary. Products can be produced more efficiently and companies can use technology to offset their largest input cost: labour. This might help both companies and consumers. Remember that while AI has lots of potential, it will not take over the world overnight. There are always issues with starting new technologies, e.g., people who were initially afraid to ride the elevator without a human operator. Today's equivalent version might be self-driving cars. We won't be napping during a car ride just yet.

Working from home

One concern in the office real estate sector is the high vacancies in office space due to hybrid work seemingly being here to stay. Add higher interest rates to the mix and it could spell trouble for lenders and real estate investors. According to a recent report by McKinsey, office attendance has stabilized at 30% lower today than pre-pandemic, with workers going to the office 3.5 days per week. Attendance varies around the world: U.S. and Europe working at home more; Asian countries, not as much. Office vacancies also affect retail space, as workers aren't around as much for their shopping needs. In its moderate scenario, McKinsey estimates there will be a 13% lower demand in office real estate by 2030 vs. pre-pandemic.

Fortunately, office space is just one segment of the commercial real estate sector. Segments like industrial real estate and hotels are little affected by hybrid work. The same thing applies to loans. Office space is just a part of the overall commercial real estate loans business. Diversification applies to real estate, too!

China reopening fizzles

After much anticipation of its post-zero-COVID reopening, China reported a weak second economic quarter that worked out to only 3% annualized. To help with the growth, it's likely that more government stimulus is coming. At least with China's inflation rate being low, the policy solution should be simple. There was probably too much optimism at the start of 2023 with the reopening. Based on this last quarter, there's now probably too much pessimism.

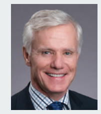
Looking ahead

That yield curves remain inverted in many countries likely signals we are heading towards a continued slowdown and possible recession. But the severity and timing are highly uncertain. The market is still hopeful about a soft landing, but any perceived deviation from this path could result in a volatile stock market. An unwavering fight against inflation by the Fed and Bank of Canada points to interest rates staying high for a bit longer. When the rates fall, they probably won't return to the ultra-low rates of 2020 and 2021.

The banking sector seems stable for now. As noted, one new concern is commercial real estate, part of which is experiencing high vacancies and an uncertain outlook given the work-from-home theme.

Even with recession uncertainty clouding the outlook, our philosophy remains the same. For us, it's all about making sure that we're sticking with our financial plan and investment philosophy, and rigorously following our processes.

We welcome your comments and questions – and wish you the best for the rest of the summer!



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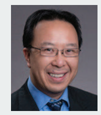

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