CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

YEAR-END REVIEW

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Welcome to our special year-end review

How were the stock markets in 2023? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2024 and beyond.

We hope you find this review informative and useful. Enjoy!

Stan

Year-End Review:

2023 WAS A BETTER YEAR THAN MANY EXPECTED – AND 2024 COULD BE, AS WELL

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

As with most years, a lot happened in 2023. The good news: The likelihood of a *soft landing*, that is, the economy slowing down while avoiding a recession, has gone up significantly.

A recession is still possible, but if it does happen it will likely be mild. The U.S. economy in particular keeps chugging along, defying many expectations. It grew 5% annualized in the third quarter, much stronger than that of any other country. Inflation has fallen out of the danger zone and bond interest rates are lower. This should help the economy continue to grow in 2024.

The U.S. economy is moving forward at a "Goldilocks" pace. The economic data isn't so strong that it will encourage the Fed to tighten interest rates more. But neither is it so weak as to prompt a slowdown in corporate profits.

For 2023, the World Equity Index, a gauge of stocks around the world, was up 20.9% (in C$). At home, the TSX was up 11.8%. The chart below shows the returns of major stock indexes around the world.

	Q1	Q2	Q3	Q4	2023
Canada (S&P/TSX)	4.6%	1.1%	-2.2%	8.1%	**11.8%**
U.S. (S&P 500)	7.2%	6.5%	-0.8%	8.9%	**23.4%**
EAFE (Europe, Australasia, Far East)	8.2%	0.9%	-1.7%	7.7%	**15.5%**
Emerging Markets	3.7%	-1.1%	-0.5%	5.2%	**7.3%**
World	7.4%	4.7%	-1.0%	8.7%	**20.9%**

Source: Bloomberg

Note that these returns are in Canadian dollars, so the effects of currency changes are included.

How did we do?

We're happy to report that all our strategies had positive returns for 2023 and also beat their respective benchmarks.

Composite	2023 Strategy	2023 Benchmark	2023 Outperformance	10-Year Strategy	10-Year Benchmark
Disciplined Canadian Stock	12.7%	11.8%	1.0%	9.7%	7.6%
Disciplined U.S. Stock (in US$)	30.3%	26.3%	4.0%	10.7%	12.0%
Disciplined World Equity	24.3%	15.4%	8.9%	11.5%	9.5%
Dividend Select World Equity	21.1%	15.0%	6.1%	10.7%	9.1%
Disciplined North American Equity	30.6%	18.4%	12.2%		

Our Canadian stock strategies (Disciplined Canadian Stock) returned 12.7%; the TSX Index was 11.8%. Our U.S. stock strategies (Disciplined U.S. Stock), returned 30.3%; the S&P 500 was 26.3% (in US$).

We also have two global portfolios made up of our multiple stock strategies. The Disciplined World Equity composite returned 24.3%, compared to a benchmark 15.4%. This portfolio is roughly 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned 21.1%, compared to a benchmark of 15%. This portfolio has a slightly higher weighting in Canada and dividend payers.

We also have a North American composite, which returned 30.6%, compared to the benchmark of 18.4%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are for stocks. Clients with less than 100% in stocks would have lower returns. These returns are also before fees.

Valuations

Stock prices were up in 2023, so what happened to valuations? Let's look at forward P/E ratios, which use expected earnings over the next 12 months. In the U.S., the S&P 500 was up 24%; earnings expectations were also up, but only by 10%. So, the forward P/E ratio in 2023 was 17.5 and for 2024 it's 19.6. On a forward-looking basis, stocks are more expensive by about 12% since prices rose more than earnings expectations.

A forward P/E ratio around 20 is priced for a 5% real long-term return. Based on today's valuation, this is the annual real return (before inflation) that we can expect over the next 10 years. This is lower than the historical average, but still much higher than the real yield on government bonds.

In 2023 the S&P 500 was dominated by a handful of tech behemoths dubbed "the Magnificent Seven" (more on them later). But what about the other stocks? As mentioned above, the S&P 500 forward P/E ratio is 19.6. Medium- and small-sized stocks are only 14.8 times earnings, or 25% cheaper.

The S&P 500 can also be broken down between growth and value stocks. The forward P/E for growth stocks is 24.8, compared to just 15.5 for value stocks. Plus, this is just in the U.S. As you can see in the chart, stocks are much cheaper in the rest of the world than in the U.S. – meaning there are plenty of opportunities both within the U.S. and around the world, despite higher overall valuations.

You can also compare stocks to *trailing earnings* (last year's earnings) instead of forecasted earnings. A year ago, trailing P/E ratios for Canada and the U.S. were 12.7 and 19.4, respectively. This year, trailing P/E ratios are more expensive at 16.1 and 24.9. Basically, valuations are about 25% higher than a year ago – lowering the prospects for higher returns going forward.

	Trailing P/E	Trailing Eanings Yield	Dividend Yield	10-Year Bonds*
Canada	16.1	6.2%	3.2%	3.2%
U.S.	24.9	4.0%	1.4%	4.0%
Europe	14.2	7.0%	3.2%	2.5%
Japan	15.6	6.4%	2.2%	0.6%
EAFE (Europe, Australasia, Far East)	14.7	6.8%	3.0%	1.9%
Emerging Markets	14.5	6.9%	2.9%	3.6%
World	20.7	4.8%	1.9%	3.7%

*Weighted average for regions

Source: Bloomberg

Roaring '20s

The roaring '20s have been a wild ride so far. Starting in 2020, we endured multiple waves of COVID. Then, in 2022, Russia invaded Ukraine, inflation soared and the most anticipated recession remains, well, anticipated. Those stories continued in 2023 with a few additions, notably the Gaza War and recession in China. In 2023 inflation moderated significantly, raising expectations that the Fed is done tightening interest rates and perhaps pivoting to some easing in 2024.

Yet even during those first dangerous years of the roaring '20s, the S&P 500 advanced 48% from the end of 2019 to the end of 2023.

Reasons not to be bullish

It seems to be the perverse nature of the market to believe that, if there were nothing to worry about, things would probably get worse. (Un)fortunately, there are plenty of worries:

1. Taiwan elections are over, ushering in an unprecedented third term for the pro-independence ruling party. Meanwhile, Chinese President Xi told the world that "The motherland must and will be reunited. ...[We must] resolutely prevent anyone from separating Taiwan from China in any way." This was more of a warning to Taiwanese voters than a sign of imminent invasion. The likelihood of an invasion soon is low, due to China's weak economy, its reliance on international trade and the potential global backlash. However, a build-up of unemployed young males does point towards military solutions over trade as a focus for China's future.
2. Escalation in the Middle East. For months, Iranian proxies have been attacking Israeli and U.S. facilities in the Middle East and cargo ships in the Red Sea. This route is how goods are normally shipped between Asia and Europe. About 12% of global trade and 30% of container traffic go through the Suez Canal. The attacks have escalated tensions and redirected cargo ships, which will likely increase the costs of gas and container goods. Despite the arrival of a U.S. military presence, several shipping companies are avoiding the route, adding as much as 25% more time to trips. Coincidentally, the Panama Canal, the other major oceanic canal, is struggling, too – not because of missiles, but because some water levels are too low due to drought. So, shipping costs are going up, although thankfully not as much as in 2021/22.
3. America's federal debt crossed $34 trillion. As recently as the early 1980s, America crossing its first trillion was supposed to be the end of the world. Weirdly, there have been no major horror stories about hitting the $34 trillion debt benchmark, or even the downgrade of American government's debt ratings in 2023. Perhaps this is the calm before the storm.
4. U.S. presidential elections are this year and there will be plenty of surprises caused by anything from age related health issues to legal cases.
5. The U.S. manufacturing sector has been contracting for more than a year. This an important sector that's suffering, despite the resilience of the overall economy.

That's a lot of negatives! However, if there were no worries, markets would likely be much higher than they are, adding increased risk that prices would then fall. Counter-intuitively, negatives and known worries increase the odds that markets can grow further by helping prevent dangerous excesses from occurring.

Reasons to be bullish

Top economist Ed Yardeni recently raised his 2025 target for the S&P 500 to 6000, as he believes that a roaring '20s scenario is not only possible, but likely. This would mean a gain of about 25%. Yardeni cites these reasons:

1. Interest rates are back to the old normal, that is, back to where they were before the Financial Crisis, when rates were near zero. This also implies that rates might not decline as much as expected either, provided the economy remains resilient and inflation continues to fall closer to the 2% target.
2. Consumers are continuing to buy. Even though excess savings might come down and debt is rising, consumers are likely to continue buying if their job security remains high – which it will, as long as there are plenty of job openings.
3. Households are wealthy and liquid. The net worth of American households is at a record high, including a record high amount in money market funds. These liquid assets could be deployed into the stock market, especially if interest rates start to come down.
4. Corporate cash flow is at a record high, despite pressure on profit margins due to

higher labour costs and interest rates.

5. Inflation is turning out to be transitory. Inflation on goods has plunged as global-supply-chain disruptions have eased. Services inflation is showing signs of easing.
6. The high-tech revolution is boosting productivity. In response to labour shortages, companies are allocating more of their capital spending to technology to boost their productivity.
7. Leading economic indicators have been misleading. There were many leading indicators last year signalling an upcoming recession – for example, the inverted yield curve. These indicators likely misfired their recession signals because their composition is biased towards the goods rather than the services sector of the economy. A rolling recession in goods has been more than offset by strength in services.
8. People are feeling better. The sentiment of feeling better, of thinking a recession is less likely, may indeed make a recession less likely because people behave more confidently.

What's normal

Howard Marks, co-chairman of Oaktree Capital, recently discussed "what's normal" for interest rates and inflation. During the period from 2009-2020, normal for central banks meant working to increase inflation up to the 2% target. Despite near-zero interest rates, central banks couldn't keep inflation at that level.

As we know, inflation surged well above 2% in 2021 and 2022. The Federal Reserve first said this spike was abnormal and would therefore be "transitory," but central banks eventually gave up on that position. The Fed then began to aggressively hike interest rates to combat inflation. Today this seems to be working, but it's important to remember that inflation can be mysterious, unpredictable and challenging to manage.

What does this mean for 2024? Like us, Marks has little faith in forecasts. But let's assume that inflation does come back down to 2%. Does that mean interest rates will come back down to pre-pandemic levels, with interest rates near zero?

Marks says probably not. Interest rates don't decline just because they're not being raised. So, returning to 2% inflation doesn't mean a significant rate cut is imminent. Furthermore, a return to a consistent sub-2% inflation seems unlikely given trends like slowing globalization and rising union influence.

Besides, today's interest rates are much closer to the long-term historical average than what most investors are used to. Marks thinks that when inflation has been fully conquered, rates will be lower than today, but not back to near zero.

Still no recession

Based on the recent U.S. employment report, there's still no sign of an impending recession. The soft-landing scenario (i.e., avoiding recession) remains intact. Diehard hard landers are still expecting a recession, as they have since rates started to go up in 2022 – but they now expect it in 2024. Fortunately, even most of the pessimists think a recession will be mild.

A recession was widely anticipated, mostly because the Fed started to aggressively raise interest rates by over 5%. This shocking pivot, following a long period of ultra-easy monetary policy, would be a terrible shock to the economy – or so the thinking went. The pessimists also pointed to the inverted yield curve and other leading economic indicators. Yet, contrary to these quite plausible arguments, the economy remains resilient and has avoided a recession so far. There's still a decent chance of a recession in 2024 but, as noted above, if one does occur it most likely will be mild.

Canada hasn't fared as well compared to the U.S. Canada's economy contracted slightly in the third quarter of 2023. Consumer spending has been weak perhaps due to higher per capita debt coupled with higher interest rates and a decline in excess savings. So Canada's chance of a recession is probably higher than the U.S. and may prompt a more aggressive rate cut scenario by the Bank of Canada. This may result in a divergence in monetary policy with the Fed, but that's not that uncommon.

Done raising rates

The U.S. Fed seems to be done raising rates, timing this well with the economy doing reasonably well. Now the question is, "What happens next?" At its most recent meeting, in December, the Fed came out fairly dovish – talking explicitly about potentially two to three rate cuts in 2024. The U.S. economy probably doesn't need cuts much, as the economy is still growing and inflation is still somewhat elevated. Rate cuts in the U.S., Canada and the rest of the world will likely be cautious initially – perhaps starting in the spring or summer.

The key message from the Fed is that there's flexibility. If there's reasonable growth the Fed need not cut rates much. And if the economy slows considerably, then the Fed has the ability to lower rates more.

The U.S. economy expanded at an annual rate of 5.2% in the third quarter of 2023. The current expectations for the fourth quarter are only 1 to 2%. According to Jeremy Siegel, Wharton emeritus professor of Finance, "The Fed has to realize that all its tightness is in the pipeline and will continue to press on the economy in 2024. They must start thinking about lowering rates. Inflation is beat."

Siegel's big hope is that "the Fed doesn't get stuck on the downside and delay the way it did on the upside, tightening way too late." 2023 saw the economy more resilient than many experts had predicted — productivity surged, and so did the stock market. "[But] we do have a slowing economy now, so we do have to watch out for 2024." Siegel expects that, if a recession does occur, it won't be severe; that the stock market is poised for continued strength.

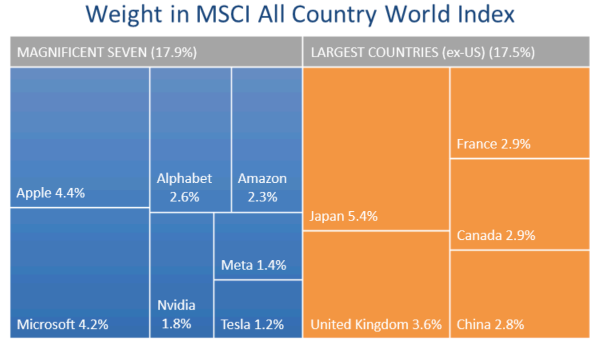
We have little confidence in most economic or stock market predictions. However, it's worth noting that Siegel's outlook for the S&P 500 in 2024 is another good year – around 8 to 10% gains. Value or smaller stocks that trade at lower valuations could be up even more. He cites the combination of progress on inflation while the economy stays robust as the best possible combination for the stock market.

The Magnificent Seven

A review of 2023 wouldn't be complete without mentioning artificial intelligence (AI) as the new investment theme that greatly contributed to the spectacular outperformance of U.S. technology giants. The seven largest companies in the S&P 500 – recently, as noted, dubbed the Magnificent Seven – posted a phenomenal return of 76% in 2023. This contrasts sharply with the remaining 493 companies in the S&P 500 and the Canadian TSX market.

The S&P 500 returned 26.3% (in US$). But the average stock in the S&P 500 was only up

Weight in MSCI All Country World Index



Source: Factset

13.9%. A lot of the discrepancy is due to the Magnificent Seven's strong performance and heavy weighting (about 30% of the index). But it also goes to show that most stocks didn't do nearly as well as the index.

To help put things in perspective, the Magnificent Seven's dominance is such that they are now a similar weighting to the five largest countries (apart from the U.S.) in the MSCI All Country World Index, which represents stocks around the world.

China

Two major factors that usually help the Chinese economy likely won't be as helpful in 2024. Foreign demand for Chinese products will probably be less. And the Chinese housing market, a great source of strength over the past few decades, has stalled. Housing represents about a quarter of the Chinese economy and about 80% of household wealth. If house prices aren't moving, it casts a chill on economic activity. So, 2024 will likely be muted for China's economy. However, slower growth for China, while disappointing for Chinese, could still beat the bulk of the world and be enough to generate about a quarter of global growth. China is still here and still a big deal, even if it's not growing as fast percentage-wise as we're used to.

Emerging markets

China's slowing economy has the potential to drag down other economies with it, whether local trading partners like Korea and Taiwan or big exporters to China like Germany.

While earnings may slow due to softening demand and higher interest rates, fortunately valuations are relatively good. The emerging markets sector has a P/E of 14.5, which is cheaper than Canada (16.1) and especially cheaper than the U.S. (24.9). We can also look at dividends as an measure of value: Emerging markets dividend yield is 2.9%, similar to Canada (3.2%) but much better than the U.S. (1.4%).

Fiscal deficits

Many countries around the world are running large fiscal deficits, to the degree you might normally see during a recession. But these deficits are occurring while their economies are alive and well. Some of this is leftover stimulus from the pandemic. Some is just governments being drawn into more spending and a reluctance to raise taxes. While not the main hot topic these days, these deficits are not a sustainable proposition. Countries will eventually need to exercise some austerity to get things back on side.

This won't be easy because there is so much demand for government money, from aging populations to climate change mitigation to military spending. The cost of debt has gone up, too, with rising interest rates. For countries running the highest deficits, this will be difficult and may involve somewhat slower growth. There's no shortage of such countries. In fact, it's hard to find any major country not running large deficits.

Canadian housing

The Canadian housing market has been on a roller coaster the past few years. There was a boom during the pandemic, with people spending more time at home plus interest rates being low. A bust occurred in 2022 as interest rates started to heat up, while 2023 was a bit of a mixed bag. House prices will probably be flat to down over the next few years. The biggest reason is that affordability is still poor. Plus, upcoming mortgage renewals will be painful – five-year mortgages taken out at ultra-low interest rates in 2020-2022 will not come due until 2025-2027. Population growth and immigration should help to at least partially offset the negatives.

Looking ahead

While 2023 was a cause for celebration, what the markets are discounting for 2024 seems not far from perfection: return of inflation to target; interest rate cuts; strong jobs market; and steady earnings growth. All of this is not impossible and not totally unreasonable, though perhaps allowing little room for error.

We remain wary of some valuations. Even though expectations are pointing to a soft landing, that's not the only possible scenario. Monetary policy often works with a big delay and the full effects of this tightening cycle may not have occurred yet.

We're still comfortable staying invested, but things could become challenging. The key is to guard against temptations to stray from well-established philosophies and processes. It's worth reminding our readers that the Stan Clark Financial Team doesn't rely on impossible attempts to predict the future. Rather, we aim to build diversified portfolios coupled with resilient financial plans. Together, these can adapt and adjust to whatever the future brings.

Uncertainty and volatility will always be around. They're just part of investing. But our approach will remain consistent, which includes having a sound plan with an established set of sensible guidelines to help us responsibly steward our clients' investments through uncertainty.

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Disclaimer:

Performance results in this document are based on a composite of CIBC Wood Gundy Advisor Managed Account ("AMA") retail accounts with more than $75,000 invested in the "Disciplined Canadian Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined U.S. Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined World Equity (CAD) strategy" (created in November 2008 and includes AMA performance data from January 1, 2009, two months after the Strategy's inception in the AMA program), "Dividend Select World Equity strategy" (created in November 2010 and includes AMA performance data from January 1, 2011, two months after the Strategy's inception in the AMA program), "Disciplined North America Stock strategy" (created in November 2015 and includes AMA performance data from January 1, 2016, two months after the Strategy's inception in the AMA program).

The composite includes open fee-paying discretionary managed accounts where the Strategy has been held for at least two months, through a purchase or a switch from another investment or a different AMA strategy. Also included in the composite are closed accounts that held the Strategy, up to the last full month the Strategy was held.

Composite performance returns are geometrically linked and calculated by weighting each account's monthly performance, including changes in securities' values, and accrued income (i.e., dividends and interest), against its market value at the beginning of each month, as represented by the market value at the opening of the first business day of each month. This Strategy can be purchased either in U.S. or Canadian dollars. Unless specified otherwise, performance returns in this document are expressed in Canadian dollars and are calculated by converting U.S. dollar accounts into Canadian dollars using the month-end Bank of Canada noon rate. Performance returns are gross of AMA investment management fees, and other expenses, if any. Each individual account's performance returns will be reduced by these fees and expenses.

Individual Advisor Managed Account performance results may materially differ from those in this document due to the above and other factors such as an account's size, the length of time an AMA Strategy has been held, cash flows in and out of the individual account, trade execution timing, market conditions and movements, trading prices, foreign exchange rates, specific client constraints, and constraints against purchasing securities of related and connected issuers to CIBC Wood Gundy.

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