

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

MID-YEAR REVIEW



Volume 15 – Issue 5 July 2024



STAN CLARK
Senior Wealth Advisor

Welcome to our 2024 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 2024 – 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 Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Mid-Year Review:

AMID CONTINUING UNCERTAINTIES, A CAUTIOUSLY OPTIMISTIC OUTLOOK

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 2024 so far – and to look ahead.

The second quarter of 2024 saw a continuation of key themes, with strength in stock markets being largely led by artificial intelligence-related (AI-related) companies. Due to a slowing Canadian economy, the Bank of Canada diverged from the U.S. Federal Reserve and began reducing interest rates, despite mixed inflation data. In the U.S., despite a growing economy, recent inflation data has been encouraging, so there’s a good chance of a first rate cut in September.

The World Equity Index, a gauge of stocks around the world, was up 15.4% (in C\$) in the first six months of 2024. At home, the TSX was up 6.1%. 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 2024	Q2 2024	H1 2024
Canada (S&P/TSX)	6.6%	-0.5%	6.1%
U.S. (S&P 500)	13.0%	5.4%	19.1%
Europe	9.1%	2.1%	11.3%
Japan	15.8%	-6.7%	8.1%
EAFE (Europe, Australasia, Far East)	8.2%	0.6%	8.8%
Emerging Markets	4.7%	6.1%	11.0%
World	11.3%	3.7%	15.4%

Source: Bloomberg

Valuations

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 double. Although not as cheap as before, this still indicates good value when comparing stocks to bonds in Canada. But in the U.S., dividend yields are much lower than 10-year bond yields, and earnings yields are now marginally lower, too – indicating less value in U.S. stocks, as stocks have increased in price.

Other regions like Europe, Asia and Emerging Markets show good-to-decent value when compared to their average yield on 10-year bonds – but again, not as good value as a year ago. Since then, stocks have become more expensive relative to earnings and dividends.

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds*
Canada (S&P/TSX)	17.4	5.8%	3.1%	3.5%
U.S. (S&P 500)	25.8	3.9%	1.4%	4.3%
Europe	14.9	6.7%	3.2%	2.8%
Japan	16.5	6.1%	2.0%	1.1%
EAFE (Europe, Australasia, Far East)	15.5	6.5%	3.0%	2.2%
Emerging Markets	15.5	6.4%	2.8%	3.6%
World	21.7	4.6%	1.9%	3.9%

*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 21 times forward earnings, which equates to a 4.8% earnings yield. At the beginning of the year, the forward earnings yield was 5%. This implies that stocks are about 6% more expensive than at the beginning of the year, because stock prices moved 14% higher (in US\$ terms) while earnings expectations only rose 8%.

But excluding the dominating eight tech-related companies, otherwise known as the *Megacap* or *Magnificent 8* (whose combined P/E is 31 times), the P/E ratio of the remaining 492 companies is only 18 times. 18x is a lot more palatable valuation than 21x, but it's still considered on the high end historically.

Jeremy Grantham of GMO uses a slightly different version of valuing stocks. According to Grantham, U.S. stocks are valued in the top 1% of history. While valuations are high, Grantham also recognizes that total profits are at record levels. But he sees these as two things that will potentially drop, rather than high profits validating high prices.

Inflation

Inflation data in the U.S. has been encouraging, with key indexes like the Consumer Price Index (CPI) and Producer Price Index (PPI) coming in below expectations. And if you adjust for how shelter costs are calculated, the core inflation comes in at 1.6% over the last 12 months, compared to the official 3.4%. For goods, by the end of 2023 the inflation rate was forecast to be in the 3 to 4% range. By the end of 2024 we should be at around 2 to 3%, close to the target set by the Federal Reserve. Inflation in the services sector has been stickier, but is also coming down.

Year of the election

From Mexico and India to the United Kingdom, France and Taiwan, 2024 has the largest fraction in history of the world's population voting in national elections. However, all eyes are on the U.S. elections, coming up in four months. From what we can tell based on the polls and betting markets, it's still a close race, with Donald Trump in the lead. But much can change especially given recent events surrounding health issues and attempted assassinations.

From an economic perspective, perhaps Trump's policies - characterized by lower business taxes and reduced regulation - would be more favourable for the stock market. However, Trump's approach would bring unpredictability, which can be a double-edged sword for investors plus Trump's habit

of using tariffs won't help with inflation. On the other hand, while Biden's statements may imply a shift towards higher taxes and increased regulation, his policy approach promises more stability and predictability.

There isn't a Canadian election expected this year. But, it will take place by October 2025, which isn't that far away.

So much could change in the world over the next year and a half!

From hikes to cuts

Starting with Canada and the Eurozone, as inflation slows the world's central banks are gradually moving their policy from interest rate hikes to cuts.

The Fed acknowledges that the economy is cooling and inflation is slowing, though it wants to see more data before making any policy changes. For that reason, the Fed will likely have just one rate cut this year, rather than the six originally predicted.

Economist Ed Yardeni thinks the economy looks good and appears to be handling the current higher interest rates. While there are pockets of weakness, inflation is moderating, growth remains good, the labour market is solid and earnings expectations are high. Yardeni suggests the Fed should just stand pat, keeping interest rates where they are for longer, to prevent a risky "melt-up" in stock prices.

Slow motion melt-up

Yardeni originally had a 2024 year-end price target of 5400 for the S&P 500, but this has already been surpassed. He got 5400 by multiplying \$270 expected earnings x 20 multiple = 5400. Analysts are expecting double-digit earnings growth over the next few years: \$270 in earnings by end of this year and \$300 by end of 2025.

Valuations have been expanding as well as forward earnings. If there is a rate cut, valuations may expand even more. Yardeni recently revised his year-end target to 5800.

Yardeni is not expecting a recession, and his Roaring 2020s scenario is still the base case. This scenario is driven by strong productivity growth keeping a lid on inflation, and by improving profit margins keeping real wages growing and consumers consuming.

Profit margins are expected to climb to a record high in 2026 with automation, AI and robotics filling the gap in skilled labour. Companies that are more productive can keep costs down with technology, even if revenue growth is not as strong.

Is there room for yet higher valuations? Maybe. The stock market was 22x recently, and much higher during the dot-com boom. But the market was also as low as 16x in 2022. Yardeni believes that 20x is the higher end of where things should be in the coming years.

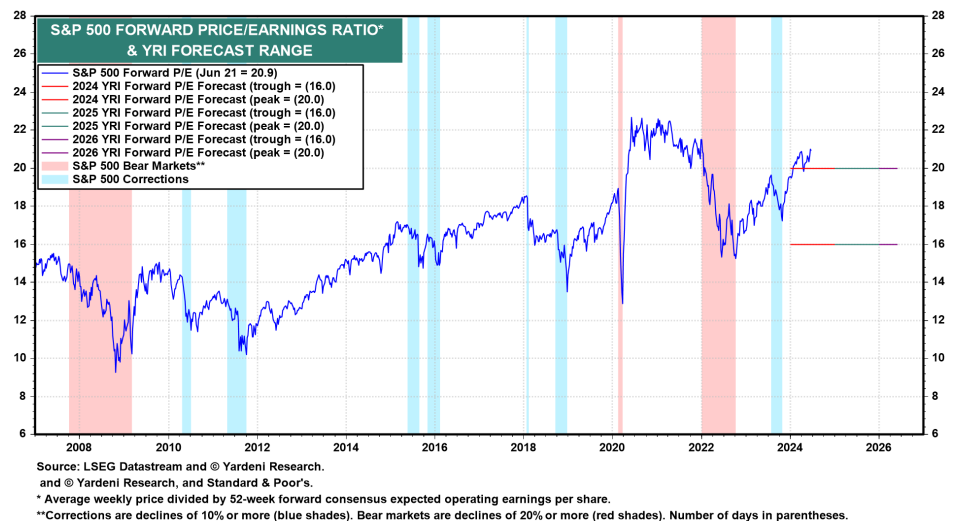
If rates get cut, that could push the current earnings-driven market to a valuation-driven market. This would make it more like the late 1990s... perhaps melting up just to melt down.

Yardeni's end-of-decade price target is 8000 for the S&P 500 (400 earnings x 20). Yardeni puts a 60% chance on this Roaring '20s scenario base case, a 20% chance on a 1990s' style melt-up (due to a rate-cut catalyst) and a 20% chance on a downturn (due to a possible geopolitical supply shock).

Comparing now to the '90s

As we observe the tech-driven market rally, it's natural to make comparisons to the dot-com boom of the '90s.

What's different today vs. the '90s? Forward P/E for the S&P 500 peaked at 24.5x back in 1999; today it's "only" 21x. However, the tech valuation today is nowhere near as high.



Valuations peaked at 48x in 2000 whereas today it is 30x. This comparison makes it either more sensible (or less non-sensible) today vs. the '90s.

the underlying support is narrowing, too. Current geo-political trends of more protectionism, less globalization and more

period of disappointment during which the initial bubble burst. Is the AI boom is a replication of the dot com boom or is it actually a continuation?

Grantham has been negative about the AI boom for some time, recognizing that the final stages of a bubble are usually the longest and most difficult to predict. Also unknown, as he points out, is how severe the aftermath will be. Grantham may be proved right eventually, but *when* is as important as *if*.

On the other hand

Will history repeat with AI? So far the AI boom has been mostly limited to a handful of extremely large companies. These companies have huge profits, strong balance sheets, tons of cash and tremendous economies of scale. That's very different from the 1990s, when some of the biggest gains were made by companies with little or no earnings, history of success or financial strength.

Ed Yardeni believes the current rally isn't close to being over. While the concerns above are legitimate, Yardeni is less concerned than Grantham.

Forward earnings expectations have risen to a record high. Second-quarter earnings will be reported soon (as this newsletter goes to print) and are expected to go well. The percentage of S&P 500 companies with positive three-month changes in earnings expectations is 83%. More companies with improving earnings should help with the market breadth.

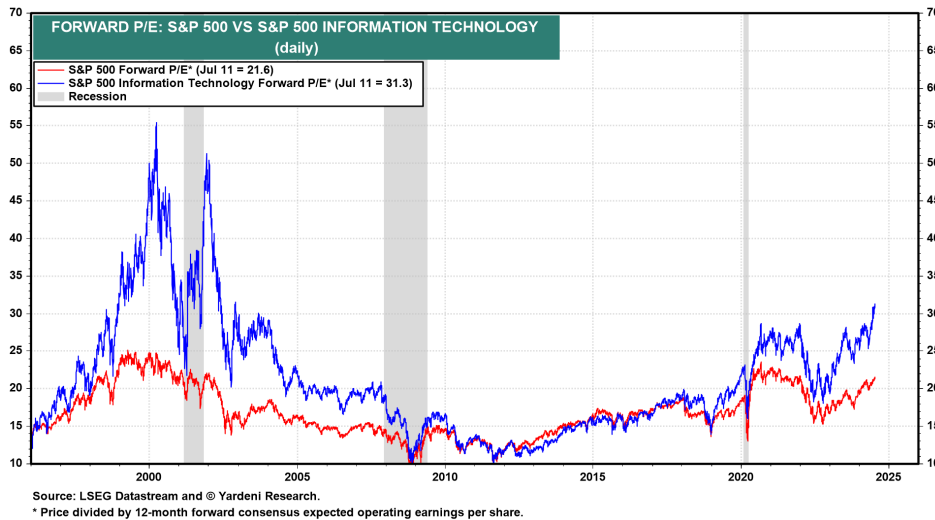
Excluding the Magnificent 8, the broad market is not overvalued and, based on better earnings and higher valuations, could go up.

There are indeed similarities today compared to the 1990s. The good news is that, if things go south, the Fed has plenty of room to lower interest rates.

Mixed signals

As mentioned, the Bank of Canada recently cut rates and may make one more cut this year. Other countries have also cut rates. Their economies have slowed but are not tumbling into recession, so there's no emergency - and central banks recognize that. But the pressures to cut rates come from the pain of higher rates, especially in a rate-sensitive countries like Canada. As inflation becomes less of an issue, rates can become less restrictive without being so low as to become stimulative.

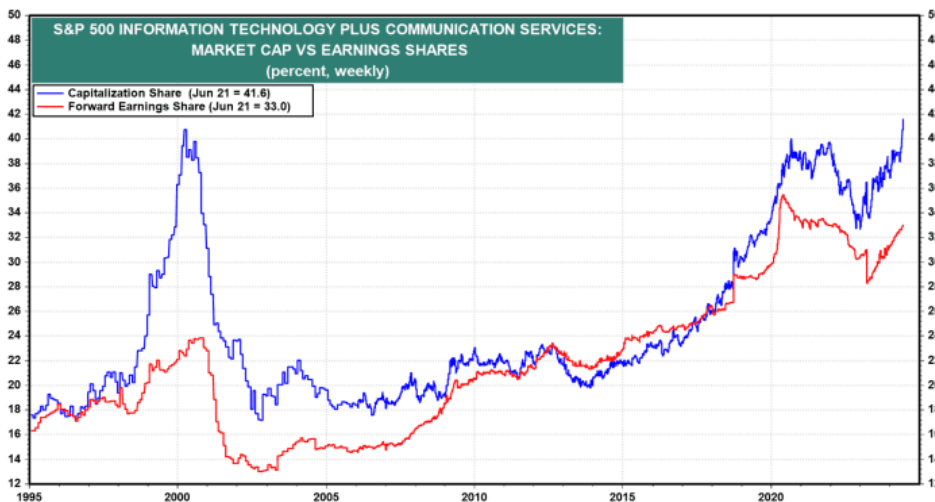
In the U.S., consumers seem resilient, but also more cautious as they feel the burden of higher rates and inflation. Business conditions are mixed, too. Measured by the



The tech sector today has about the same share of market cap as in the '90s, at around 40%. But one big difference is that the share of tech companies' forward earnings today is about a third vs. about a quarter in the '90s.

conflict, along with higher interest rates lasting longer, may lower returns going forward.

People tend to overestimate the effect



While earnings can collapse, there seems to be lots of room for valuations to expand, as earnings are much more supportive. Today's tech companies are the most profitable: highest profit margins, highest free cash flows and highest return on equity. That's a significant difference compared to tech companies in the '90s.

Vulnerabilities

The U.S. stock market's bull run since October 2022 has caused concerns. Earnings expectations may be too high if signs of an economic slowdown lead to a recession. A narrowing market rally concentrated in megacap technology stocks may show that

of technology in the short run and underestimate its effect in the long run. There's a risk of over-exuberance in markets extrapolating today's pace of AI-related demand, especially as companies hastily deploy their AI strategies.

According to Jeremy Grantham, every technological revolution goes like this. From railroads to electricity to the Internet, each has come with early massive hype and a stock market bubble as investors focus on the ultimate possibilities and then pricing most of the long-term potential immediately into stock prices. To be sure, many such revolutions end up being as transformative as early investors envisioned - and sometimes much more so - but only after a substantial

ISM (Institute for Supply Management) manufacturing index, services continue to grow, but manufacturing is shrinking and has been for the past year and a half. Overall, the economy is still growing, but it's not the perfect environment. Maybe it's just part of the process for a soft landing.

Less inverted yield curve

The yield curve is still inverted but much less so than it was a year ago, when it was at the steepest level of 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 since early 2023, long enough for investors to question if this highly expected recession will 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 short-term rates to fall. They think the Fed must slash rates as the economy weakens. But this isn't a foregone conclusion. Regardless, both Yardeni and we on the Stan Clark Financial Team believe that credit crunches cause recessions, not merely the yield curve, which only signals such events.

Recession still possible

While Professor Jeremy Siegel doesn't predict a recession, he acknowledges some recent troublesome economic data. Unemployment has ticked up from a low in January 2023 to a three-year high of 4.1%. Normally that level is not worrisome, but the big change of half a percent does concern Siegel.

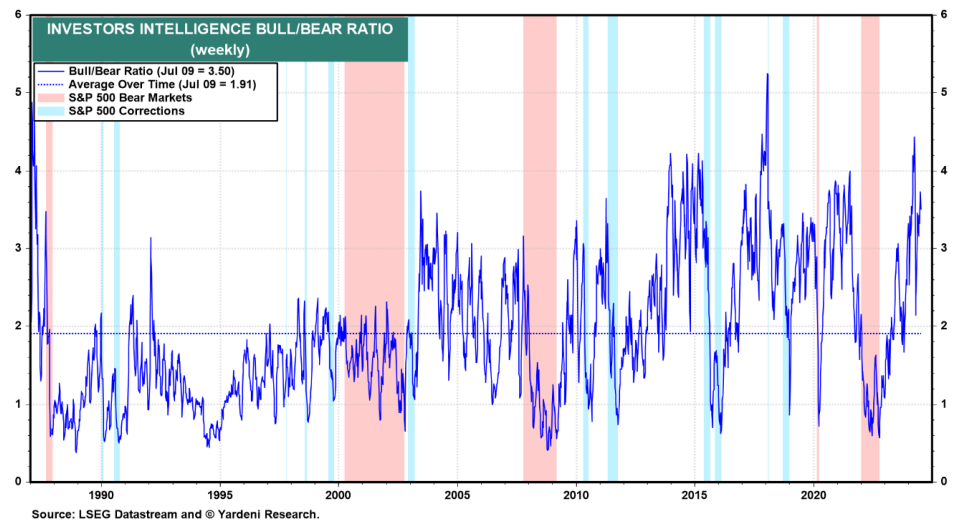
He is also concerned about the slippage in economic growth. Last year, the U.S. gross domestic product (GDP) far exceeded 2023 expectations, but this year growth is falling short. At the beginning of the year, the Fed predicted 2.1% growth, yet the first quarter was only 1.5% and the second quarter is running under 2%. Siegel says if the economy continues to slip, the Fed should contemplate a rate cut. Another concern he cites is the narrowness of the stock market.

Running out of breadth

Stock performance has indeed been lopsided. This is measured by *market breadth*. If more stocks go up than down, it means the market is stronger and more sustainable. A broad-

based rally is preferable, being evidence of widespread growth across most industries. The concern today is that growth is occurring in just one or two sectors and in a handful of megacap stocks, and that this growth is responsible for most of the market gains.

So far this year in the U.S., only two of the 11 sectors, information technology and communication services, are beating the S&P 500. These sectors are home to six of the



Magnificent 8 companies.

But if you dig deeper, almost half of the industries in the S&P 500 are up over 10%. While it's true a few stocks have greatly outperformed, many of the laggards have done pretty well – just not as well. So the market performance is broader than it appears.

Minsky moment

In the early 1990s, economist Hyman Minsky wrote, "Over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system." Stability leads to instability as investors and businesses throw caution to the wind in good times and take on more risk. Expectations keep getting revised upwards and investors get overly optimistic.

This inevitably leads to the bad times. You don't need bad news for things to end; sometimes just less good news. During downturns, expectations keep getting revised lower and lower amid bad news. Markets fall and investors get overly pessimistic. This eventually ends and leads to another upturn.

So far this year, for the S&P 500, there have been 34 new all-time highs. Volatility has been relatively low. We haven't had a 2% down day in the S&P 500 in 340 days to the

end of June. That's close to the record 351 days in the past 10 years. It doesn't mean something bad is imminent, but suggests a correction is well overdue and should not be surprising.

We believe you should always be prepared for corrections, as these can occur at any time and without warning. A long streak without a correction does not reduce this risk, and likely does the opposite.

Need more bears to keep the bull market going

The Investor Intelligence Bull/Bear Ratio (BBR) was at 3.73 at the mid-point of the year, with the percentage of bulls rising to 63.1% and bears falling to 16.9%.

The BBR averaged about 1.9 over the last 37 years, but it's been higher in the last 20 years – around 2.5 with several readings above 4.0. Interestingly, the BBR remained just above 2.0 during 1999, just before the tech bust.

BBRs below 1.0 work better as a contrary buy signal than readings of more than 3.0 work as sell signals. But, if the bulls are mostly invested, the concern is there may not be enough bears flipping to keep the bull market going.

Looking ahead

While global economic growth remains positive, it has slowed. We note that the word "deflation" has started to occasionally creep into conversations, a shift relative to the last few years.

U.S. markets seem expensive, and this comes with a higher chance of a correction. We're a little cautious about that. But the U.S. also presents the greatest opportunities from AI advances. So, while we are cautious we are not outright negative. We think it's important to remain diversified and also to remember

there are better valuations in Canada and other parts of the world that we invest in.

Stocks might fall in the short term, but we remain comfortable holding stocks for the long term. Even with recession uncertainty clouding the outlook, our philosophy remains constant. 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!



Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.



Michael Chu is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

CIBC WOOD GUNDY

The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: 604 641-4361 | Toll-free: 1 800 661-9442 | Fax: 604 608-5211 | Email: stanclarkfinancialteam@cibc.ca | www.stanclark.ca

Stan Clark is an Investment Advisor with CIBC Wood Gundy in Vancouver. The views of the Stan Clark and third-party commentators, do not necessarily reflect those of CIBC World Markets Inc. CIBC Private Wealth consists of services provided by CIBC and certain of its subsidiaries, including CIBC Wood Gundy, a division of CIBC World Markets Inc. The CIBC logo and "CIBC Private Wealth" are trademarks of CIBC, used under license. "Wood Gundy" is a registered trademark of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed. The commentary is for informational purposes only and is not being provided in the context of an offering of any security, sector, or financial instrument, and is not a recommendation or solicitation to buy, hold or sell any security. If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2024.