CIBC PRIVATE WEALTH

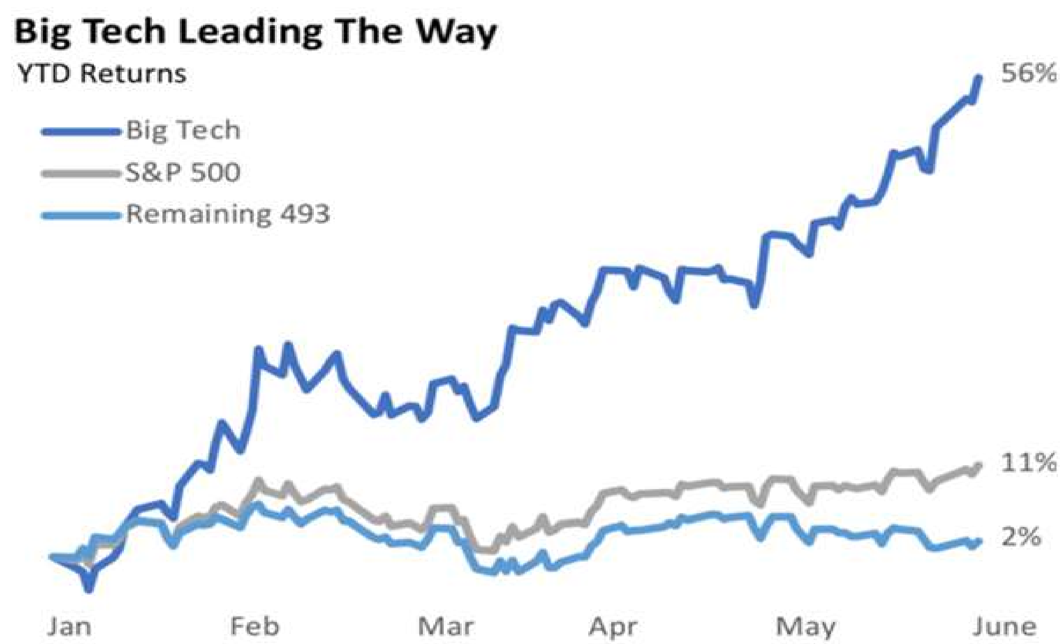
July 2023

Portfolio Update

As we enter the summer months, markets as a whole and our portfolio remain below the all-time highs set in 2022. The Toronto Stock Exchange peaked in March of 2022. The S&P 500 and the Nasdaq reached their all-time highs in December 2021 and November 2021 respectively. International markets excluding North America peaked in September 2021 and Emerging markets reached their market zenith in February 2021. The Canadian bond market index is still below its peak set in July 2020.

Central banks continue to work through all the complications of our post-COVID economy by raising rates to quell persistent inflation. Most positive returns in the U.S. market this year are concentrated amongst 7 or 8 technology companies as the launch and popularity of large language models such as ChatGPT has created immense excitement around prospects for Artificial Intelligence.

As of June 2nd 2023:



Big Tech: Apple, Microsoft, Amazon, NVIDIA, Google, Meta, and Tesla. Data from YCharts as of 6/1/23. Past performance is no guarantee of future results. Chart from @ChicagoAdvisor.

International markets have also provided a bit of a lift to client portfolios this year from their very depressed levels in October of 2022.

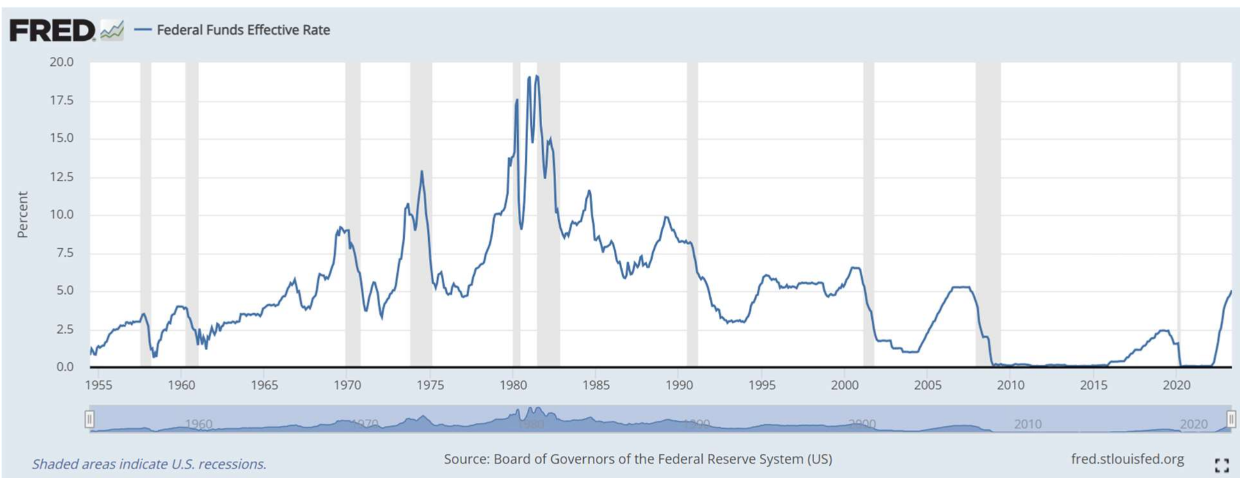
We wish we could tell you exactly when markets will begin a new ascendance however, we'll leave this to the market pundits at CNBC. We will put a lot of effort into ensuring we are positioned appropriately to maximize longer term client returns while doing our best to minimize risk.

Below is our perspective on events effecting markets today and an outline of what we're doing to ensure your portfolio is positioned appropriately for the current environment.

Rising Rates

As we discussed in our year ahead newsletter, skyrocketing inflation during 2022 has caused central banks to rapidly raise interest rates across the world. For most economies, this increase in percentage terms is the largest in recorded history - given how low rates were previously.

This is in stark contrast to what has been a thirty plus year trend of declining rates. The chart below shows the steady decline in interest rates via the Fed Funds rate set by the United States central bank. Canadian rates have followed a similar trend. Notice the peak in the early 1980's and the steady decline since.



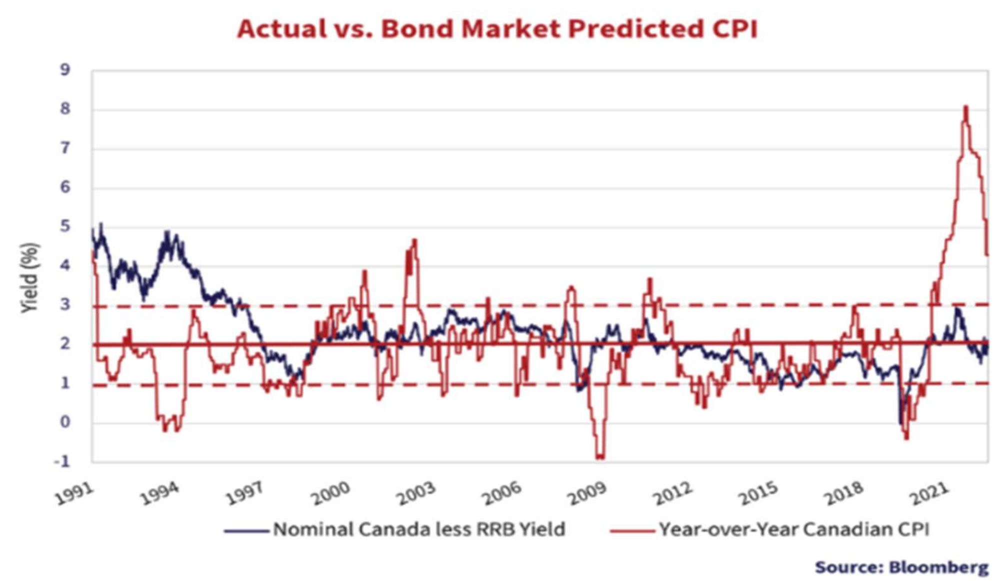
Most asset classes are heavily influenced by interest rates. Someone who bought a home in the 1980's has likely seen their mortgage amortization shrink during every renewal period. This meant either increased savings and or an increased ability to borrow and purchase more assets. Companies issuing bonds have for a long time been able to 'roll over' their debt at maturity at decreasingly lower interest costs - which increases profit margins. A steady decline in interest rates also favours "growth" investing over "value" based investments.

Most analysts/market participants value stocks by taking the present value of future cash flows or dividends (think of cash flow as how much cash a company takes in after expenses). Thus, a fast-growing company or "growth" stock, even if it's not producing a lot of cash flow currently, becomes much more attractive in a lower rate environment. In a higher rate environment, a company that's giving you more cash presently (commonly termed a "value" investment) gets a higher total worth.

What are the implications of higher interest rates? In today's higher rate regime, we are already experiencing some key changes. Instead of the macro environment favouring the borrower, it now favours the lender. Many homeowners for the first time have seen or will see at renewal, their mortgage amortizations increase due to higher rates. This will decrease both their savings and consumption rates. As investors can earn a high risk-free rate of return on their cash, some will think twice before investing in stocks (and real estate). We believe as well that with valuations on reasonably safe "value" oriented dividend stocks favourable at present, investor interest will shift towards this area of the market.

The market, interestingly, is pricing a lower inflation and interest rate regime, about a year from now. The yield curve is still heavily inverted (which means shorter term interest rates are higher than medium- and long-term rates.) This generally means the bond market is expecting slower economic growth or a recession.

Real return bonds -which we can use to gain some insight into future inflation expectations- are pricing in an eventual return to a 2% inflation rate. See the chart below which shows current CPI (Consumer Price Index) vs. what the bond market is predicting (As of today's date, Canadian inflation has decelerated even further to 2.8%):



We would expect rates and inflation to settle in a bit higher than they were pre-COVID. Longer term, we think expectations of lower inflation and lower rates will prove correct. This is due to trends we've discussed in previous newsletters - such as an ageing population, shrinking fiscal deficits, decreasing central bank asset levels and de-globalization.

Should we remain in a higher rate environment than pre-covid, we would expect our current portfolio positioning and value-based investment style to perform very well relative to markets. Should rates drop back down to the near zero levels we experienced for much of the past decade, we would expect some underperformance vs. a "growthier" portfolio - although still decent returns.

Fixed Income

The good news about higher interest rates is the fixed income portion of client portfolios is now producing a very attractive yield. For much of the past decade, near zero rates left government bonds yielding next to nothing and riskier high yield bonds yielding in the 5% range. As we discussed in previous newsletters, very low rates produced excessive amounts of risk in some areas of the corporate bond market and in all forms of longer term bonds. Investors were not adequately compensated for the risk they were taking. Most of this risk, we foresaw, so we ensured reasonably good fixed income quality, and emphasized shorter term bonds to minimize the bond price declines that occur due to increased interest rates.

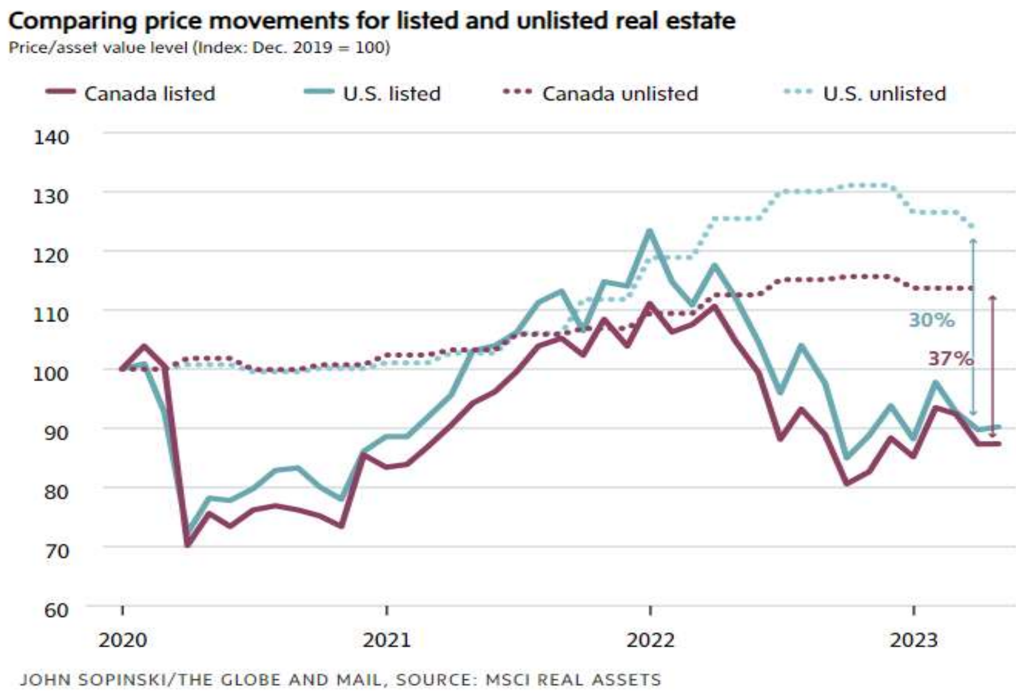
Today, we are being compensated much better on bonds (relative to risk) than was the case a couple of years back. Very short-term government bonds are yielding close to 5%. Across our portfolios, investment grade corporate bonds are yielding over 5.5% and riskier high yield bonds are giving yields in the 7% to 10% range. This bodes well for our expected returns on bonds over the next three to five years. We can reasonably expect a 5% to 6% return on our fixed income portfolio without having to take on a lot of risk.

Real Estate

Commercial real estate (other than low quality office buildings) has been remarkably resilient price wise. However, the market has also become very bifurcated as we're seeing large discrepancies between public and private real estate valuations.

From the covid lows of early 2020, publicly traded REITs performed quite well until prices began declining in 2022 and thus far in 2023.

The latest data shows an almost 37% gap in private vs. public real estate valuations. We expect privately valued commercial real estate to drop a bit from here as higher interest rates begin to cause a bit of a sell off. We don't expect a material decline due to high land values in Canada and very high replacement (construction) costs. Regarding publicly traded REITs, after seeing how this asset class has traded for well over 30 years now, we are quite confident that the large gap between today's low trading prices and actual value of real estate will narrow. Total return potential (including income via net rent) looks quite attractive going forward.



For this reason, we are concentrating mostly on publicly traded real estate investments and will not add any funds to the small amount of privately valued real estate clients own through Hazelview. Current market value is very good at present in industrial space, unenclosed retail centers, well located enclosed malls, medical facilities and apartments. This is where we have the bulk of our exposure. We have almost no exposure to lower quality office properties.

The office market is complex as there are many kinds of office properties. The type and quality of office space very much matters. The 'work from home trend' is here to stay (in different forms) so properties will have to be attractive to encourage workers to come into the office environment.

The bulk of our exposure to office property remains through Allied Properties REIT. Allied owns high-quality class A office properties in downtown city cores. Allied generates a healthy 8% yield, has very low leverage and trades at a 27% discount to the current market value of its properties.

Artificial Intelligence

The launch of ChatGPT and other large language models (LLM's) has created immense excitement around the potential for Artificial Intelligence. LLM's are machine learning models that try and predict the next most appropriate word to fill in a sentence or phrase based on the context of the given text. AI Algorithms are also able to successfully write computer code - and connect to other website plugins. Thus, they can assist in performing activities such as booking restaurants, flights, hotels etc. The responses based on general search cues provide conversational like dialogue in a way that seems very "life-like".

There seems to be little doubt that this very powerful technology will create a lot of change amongst the tech landscape. For the first time in a long while, Google, (which previously had almost a monopoly on search) is in a race to protect its dominance by developing its own LLM called “BARD,” - which it hopes will provide competition to ChatGPT.

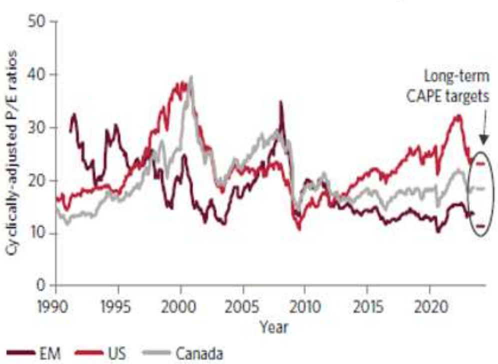
Nvidia, the world’s leading chipmaker has seen its share price rise almost 400% from its October lows. The company recently reported strong expected future revenue growth due to surging demand for it’s A.I. chips. At a very expensive 50 times forward projected earnings, there’s no “margin of safety” for an investor buying at todays prices. Of course we wish we had bought this stock at its previous low point, but at todays price, we see a very expensive valuation. The same can be said of many other companies in this space. Some have promising business opportunities but the entire space is ‘priced for perfection’ at todays levels.

Predicting a new ‘exciting industry to come’ is possible. We discussed a few year back in this letter how A.I would eventually assist businesses greatly from an efficiency standpoint . However predicting when investors will jump in, and which companies will actually be winners in any new industry is more challenging. We have some A.I investment exposure through companies which are reasonably valued - IBM and Qualcomm. Over-time as said, most businesses will benefit indirectly through increased profitability and efficiency.

Portfolio Allocation

How are we positioned portfolio wise? In general, we are always going to have a ‘value-based philosophy’ in our portfolio construction. We believe that over time, fundamentals will dictate long term client returns. Warren Buffett is famous for saying that “in the short term, the market is a voting machine, in the long term, its a weighing machine” . We do our best to echo this philosophy.

This means that we always going to do our best to overweight companies and markets that look attractive to us on a fundamental valuation basis. To give you a sense of this, look at the chart below that shows long term P/E ratios. The CAPE ratio or cyclically adjusted P/E ratio is the current price of a market divided by its ten-year earnings average. Taking the inverse of this gives you your earnings yield which is how the returns under the “long term expected returns” chart is derived.



Sources: Refinitiv-Datastream, CIBC Asset Management calculations. Long-Term CAPE Targets are projections based on data available as of January 31, 2023.

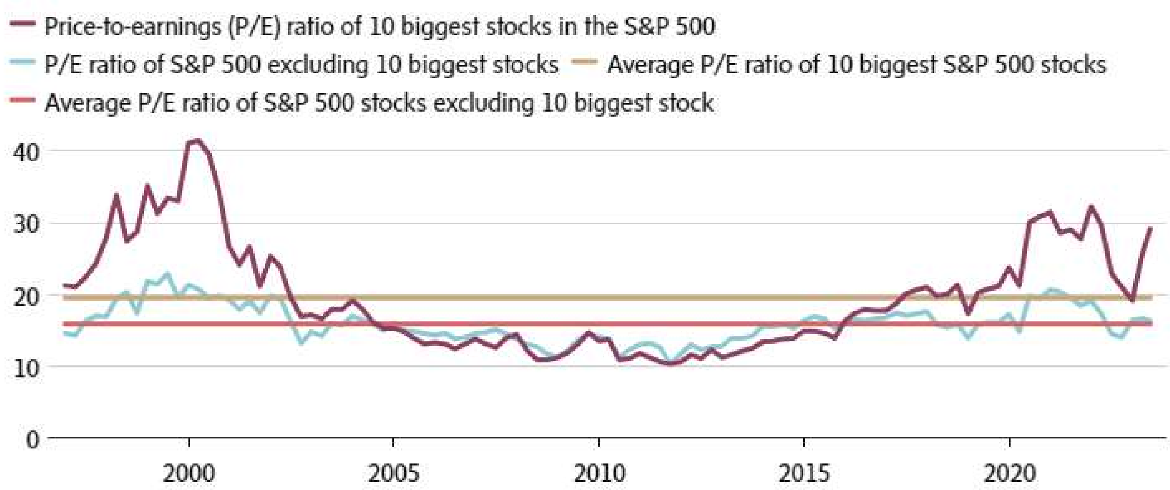
Long Term Expected Returns (%)

Asset classes	Dividend yield	Earnings growth	Valuation	Expected return (LC)	Currency impact	Expected return (CAD)
Canada S&P/TSX	3.0	4.0	-0.2	6.8	--	6.8
US S&P 500	1.8	4.3	-0.8	5.2	-1.1	4.1
MSCI EAFE	3.1	2.9	0.2	6.3	0.3	6.6
MSCI Europe	3.2	3.0	-0.1	6.0	-0.2	5.8
MSCI Japan	2.3	1.8	1.8	5.9	2.1	8.1
MSCI All Country World	2.3	4.2	-0.6	5.9	-0.4	5.5
MSCI Emerging	3.1	6.6	-1.0	8.7	1.9	10.6
MSCI Emerging Asia	2.7	6.7	-1.1	8.4	2.6	10.9
MSCI Emerging Europe	3.4	6.9	-0.6	9.6	-1.6	8.0
MSCI Emerging LATAM	6.7	5.8	-0.9	11.6	-1.9	9.7

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2023).

Relative to long term earnings, U.S. markets remain expensive relative to the rest of the world. We thus, maintain our overweight positions in Canadian and International markets while maintaining some measured exposure to U.S. markets. The S&P 500 returns for 2023 have all been driven by large cap technology companies which have and continue to look very expensive relative to other companies in the index on a historical basis.

The chart below shows the top ten companies by market cap in the S&P 500 have an average P/E of thirty which is well above their longer term average of twenty. The rest of the companies in the S&P 500 are trading in line with their longer term averages.



JOHN SOPINSKI / THE GLOBE AND MAIL, SOURCE: CIBC WORLD MARKETS

We will maintain our reasonable but not excessive exposure to publicly traded real estate due to the large discounts on price relative to the properties they own. When the REITs begin trading closer to the appraised value of their properties, we will again look to sell off some of our REIT exposure. Depending on our views at the time, we will look to position these funds into bonds and other asset classes that can generate good income without too much risk.

Private credit will likely be providing some opportunities in the future as increased regulation of regional banks in the U.S. creates a lending void for institutions to fill. We are currently vetting some private debt pools to have available if needed.

Enjoy summer! And please call in anytime for any help whatsoever.

Cheers!

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