CIBC PRIVATE WEALTH

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November 2023

Good afternoon.

Please find attached our firm's monthly markets report which touches on the importance of good quality dividend paying stocks and provides further information on the corporate bond market. Please read on for our own update on markets and portfolio activity.

Portfolio and Market Update

So far in 2023, despite all the negative commentary with which the year began, the Canadian and U.S. economies have held up better than expected. CIBC's Economics team expects real GDP growth of 1.2% for 2023 in Canada, declining to 0.7% in 2024; and 2.0% in the U.S., this year, declining to 0.8% in 2024.

In the U.S., consumer spending, which accounts for approximately 70% of their economy, has shown resilience as spending levels have held up well; and the job market has remained strong. In Canada, the unemployment rate is currently 5.7% and, in the U.S., it is 3.9%. These figures compare well to the level of 5%, which is generally accepted as the unemployment level of an economy running at full capacity.

Good news on the economy is bad news for the market right now though as investors are fixated on what will happen with interest rates going forward. The better the economy performs, the harder it is to get inflation down from its approximate 4% level to the central bank's target of close to 2%. And it is clear now that central banks are more than willing to inflict some sort of short-term economic pain, to decrease both consumer demand and wage growth expectations, which in turn will decrease inflation.

The continued increase this year in interest rates is hurting both stock and bond prices. The Canadian stock market is barely positive so far this year and is still lower than earlier highs in 2022. So far this year, the U.S. stock market, as represented by the S&P 500 index is doing well, but it is still down from its earlier high reached in late 2021. The more value-oriented Dow Jones Index, which more reflects the type of US equities we own, is showing a tiny profit year to date.

Market Valuations and Performance

Valuations on Canadian stocks are quite reasonable. The TSX index trades at a forward price to earnings ratio (P/E) of twelve, while the (40% weighted tech heavy) U.S. S&P 500 index trades at a more expensive forward P/E of eighteen. Taking out currently expensive U.S tech company stock prices, the balance of the US stock market is trading at very reasonable levels.

With respect to the Canadian bond market, returns are a bit negative so far this year (due to continued higher interest rates pushing down bond prices).

Our European and Asian market exposure (through a well-diversified exchange traded fund (Vanguard Developed Markets Index)) has done reasonably well this year while our privately valued income-oriented investments are generating returns that meet our expectations.

Cash Rates and GICs

Higher short-term interest rates have created some serious competition for equities as investors can now earn upwards of 5% on short-term guaranteed investments. Today's higher rates have sent many high-quality dividend paying companies to prices they were trading at five years ago, despite significantly higher corporate earnings now vs. then. Our best guess is that when the market gets a sense that interest rates are poised to start declining, we will see fund flows back into inexpensive and high yielding dividend payers (which make up a lot of our equity exposure).

We sometimes are asked if we should move some of our stock exposure into now higher yielding cash, or GICs. For the past 15 years, short-term rates paid little, but today they are indeed competitive. The reason we are not selling equity and buying fixed income (on across the board basis for clients) is that while shorter term yields look good at present, within a year or so, we will likely see rates coming down. In addition, with respect to non-registered accounts (where we have most of client's stock exposure) interest income is highly taxed. Also, we do our best to "buy low and sell high." And right now, except for a few of our stocks, most of our stock exposure 'ain't high.' One last reason is that in the longer term, equity market returns have always outperformed short term market rates.

Having said above, we are always here to discuss your personal objectives, portfolio wise. Should a client wish to decrease risk, we will look for a way to do so that involves increasing bond investments inside registered accounts, so that the income is sheltered from tax.

We have also had some clients of late ask about safe interest-bearing alternatives for new money investments. If liquidity is needed, we use money market investments. If your timeframe is a bit longer term, we are locking in good rates, using GICs (mostly). We broker for twenty-five different banks and trust companies, so we can always provide clients with very competitive rates; and at renewal time, again shop the market for the best possible rates.

Portfolio Positioning and Trades

What are we doing in client portfolios to position well for the longer term? We recently traded out of our short-term bond ETF called "Enhanced Short Duration Bond Fund" and bought a corporate bond ETF maturing in 2027 to lock in a higher and longer-term yield. And we are sweeping cash that comes into client's portfolio's each month into investments we feel are undervalued. We have also increased bond credit quality (by selling our high yield bond ETF and moving the proceeds into a higher quality corporate bond ETF).

Regarding real estate, our REIT positions are now trading at crisis levels but without the crisis! Almost all our REIT exposure is in areas of real estate that are fundamentally very strong (industrial, apartments, and high-quality retail with good land value that is available for condominium developments). With regards to office space, some properties are indeed challenged by the ‘work from home trend’ which is here to stay. We are examining our very small amount of office exposure with a view to decreasing that area down to almost no exposure.

New supply of commercial real estate going forward will be very much constrained by high land cost as well as high construction cost - now 45% greater than pre-pandemic. Despite the quality of their real estate, our average REIT currently trades for close to 40% below what the properties can be sold for today. The only times when we have seen such a high discount to true value (in over thirty years of using REITs) was the market low during the financial crisis March 2009 and at the market low late March 2020 (during the covid downturn). Both those times, REIT prices rebounded significantly.

Higher interest rates have continued to weigh heavily on REIT prices in the short term. Longer term though, high occupancy levels and long-term leases that increase with inflation should eventually cause these positions to trade closer to appraised value.

We continue to not add any additional dollars to privately valued fixed income and commercial real estate as publicly traded bonds and REIT’s trade at discounted levels relative to their private counterparts.

We have also made the decision to collectively move our ten ‘Dogs of the Dow’ stocks into a very low-cost ETF which invests in the same manner. As a reminder, the Dogs of the Dow is a collection of the ten highest dividend paying stocks in the Dow Jones Industrial Average. Using an ETF rather than individual stocks will isolate this strategy from our other fundamental U.S. picks. And in future, when this trading method is ‘in favor,’ we will be better positioned to take profits.

Think Long Term

Psychologically, enduring long periods of flat markets can be tiring. It is quite easy (even sometimes for us advisors) to lose sight of the big picture. Day-to-day news can of course be compelling, and it is easy to focus on things that are happening presently. We have learned in our long careers managing portfolios, that with respect to long term portfolio returns, they are a lot more predictable than many think. However, we have also learned that markets are also a lot less predictable in the short-term than many think. The market is always trying to price in all known information, so it is not what we know now that will drive short-term returns, but whether things will turn out better (or worse) than what the market is currently pricing in. Thus, it is the surprises (a geopolitical event, or more commonly, does the economy and/or interest rates surprise on the upside or downside) that drive short term returns. And no one ever has done a good job at consistently predicting whether future events over the months ahead (or say the next year or two) will surprise on either ‘the good or bad side.’

Given we have little control over the short term, the question of where we will be five years from now becomes much more relevant to investment success. We must manage for the highest degree of probability, which means that we manage based on financial market history (and the mathematical certainty that profitable companies will be worth more in the future than they are today). And in the longer term, economic growth will continue due to increases in both productivity and population. These truisms can guide us well.

Thank-you for your trust in our team. Please call in at any time for anything whatsoever.

Cheers!

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