CIBC PRIVATE WEALTH

June 2023 update: Range bound, for now

As summer approaches, we thought we would give everyone a brief update on our portfolios and what we see for the remainder of 2023.

In this update, we would like to address the following subjects:

- The investors conundrum. Mixed signals makes for a difficult decision making environment.
- The technology that has captured every investors' imagination: artificial intelligence.
- Tom's reflections on the Investment and Wealth Institutes Annual Conference
- Asset allocation and portfolio changes we are making.

Let's start with an overview of the confounding economic signals.

Economic signals: Mixed at best

We do not envy Central Bankers around the world trying to discern the impact of their interest rate increases on economies and inflation. I have likened Chairman Powell's task of engineering a "soft landing" in 2023, as the equivalent of trying to land a Boeing 747 on an aircraft carrier. It is theoretically possible, but it has never been done before. Depending on your perspective, you could reasonably argue that we are slipping into recession or are emerging into a stronger economy. This macro tug-of-war has led to most markets being stuck in a trading range since last October.

The bearish view is that there are lots of signals that would suggest we are about to slip into a long-anticipated recession. Recessions usually result in higher unemployment and lower consumer demand which will have a profound impact on earnings and thus stock valuations.

The bullish view is that the Central Bank has finished with their rate hikes, inflation continues to drop, the economy and employment remain very resilient and thus earnings will pick up as the year progresses. Investors will want to position their portfolios for this recovery in earnings.

Over the past few weeks, we have seen the European Central Bank hike rates and hint at more hikes, the Federal reserve paused, but indicated that two more rate hikes are

likely in 2023 and both Canada and Australia. This is a far cry from the expected rate cuts later this year that the market thought would happen only a few months ago Meanwhile, Q2 earnings for the S&P 500 came in below the same quarter in 2022, but significantly higher than what was expected. According to Factset, earnings for Q3 are expected to be flat year-over-year, and then accelerate starting in Q4 and into 2024. The S&P 500 P/E multiple is trading at roughly the five-year average but interest rates are double what they have been for the past five years. This would imply that the market is anticipating a rapid rise in earnings in the not do distant future to support this valuation.

As of June 16, it would appear that the S&P 500 has broken out of the trading range as it trades around 4400. This occurred despite the hawkish tone of the Federal Reserve. It appears that the markets don't believe that the Fed will raise rates again this year.

The move in the stock and bond markets make the valuation less attractive at the moment. The risk premium for stocks, relative to bonds, is almost zero. The risk premium for Investment Grade bonds, relative to treasuries, is at a very low level as well. According to Canso, one of our bond managers, this often occurs just before a recession.

As you can see, there are a number of different perspectives to consider. We maintain a balanced approach so that we will have assets that will benefit if the various market choose to make a sudden shift in direction.

The Market Fiddles While the Country Burns

Whether you believe in climate change or not, there is no denying that we are experiencing more profound "weather" events each year. While the market is agog with AI, most of Canada and the eastern seaboard of the U.S. is cloaked in a thick ball of wildfire smoke.

We believe that the long-term investment theme of a world of scarcity will begin to emerge in 2024. We mean a scarcity of labour, water, food, housing, critical materials, energy, healthcare, cyber security, productivity, and a rapidly changing climate. Technology needs to be harnessed to solve these critical issues, not just to create avatars in the metaverse and to make you buy more stuff.

We have been pivoting our portfolios toward companies that are using technology, including AI, to develop solutions to these problems.

AI : Game Changer or Another Shiny Object?

The investment world is aflutter with the latest incarnation of Artificial Intelligence, generative AI. Is it a boon to mankind or the seeds of our destruction? I feel that most of the advanced thinkers in the space believe it represents potentially both of these outcomes.

We are no experts on AI, but we do have some observations. AI has been and will continue to be profound influencer on human behaviour and our relationship with technology. Notice that we used the term "relationship," which implies a human-like quality.

AI has long been the domain of large organizations with access to vast quantities of data, usually proprietary data. Every social media application, or shopping application, has been using AI to maximize the utility of their algorithms for years.

AI is used extensively in the investment world as well. One example is where algorithms examine press releases and earnings calls and make trades based on the language used in the calls and releases.

The launch of Chat GPT has suddenly opened up the power of AI to the just about anyone with a computer or cell phone. This generative AI is quite different and user-friendly. A user can pose a question to the AI engine and it will craft a very, knowledgeable, human-like response in a matter of seconds. The quality of the answers, combined with the speed that it is compiled has taken the world by a storm. Need an essay on Shakespeare? GPT can fire one up that could have been written by a professor in English Lit in an instant. Need some code written? Done. Want to show the Pope in a massive puffy jacket? Easy as 1-2-3.

The impact on the stock market has been profound. Mega-Cap-Tech, which everyone assumed would have a post-COVID slowdown of earnings has stormed back based on the assumption that they are well positioned for the coming AI investment cycle. We have seen the same effect in the semiconductor space with the leading AI chip-maker up almost 200% this year, reaching a $1,000,0000,000,000 valuation on $40,000,000,000 in sales.

Much like the .com era, or even the blockchain/crypto hype of a few years back, we see companies that are somehow related to AI going parabolic. Even soup companies are talking about AI in their earnings calls! Really?

AI will likely dominate the narrative for many years to come. But as we stated before, we will gravitate to the companies that utilize the power of AI to design solutions for the looming global issues.

Notes from the Investment and Wealth Institute Annual Conference

After a few years hiatus, for obvious reasons, Tom decided to attend the annual conference of the Investment and Wealth Institute in San Diego. As a U.S. based organization, he has always found that views that are presented at the conference are a few years ahead of what happens in Canada. Here are some of his key takeaways:

- There was a real focus on adding more alternative strategy to the traditional stock and bond portfolio. This was a function of the changing investment conditions in the U.S. where banks are lending less and private lenders have filled the gap. The same can be said about the public versus private equity markets as more and more companies take longer to go public or public companies go private. The other reason is that bonds may not offer the same level of risk management in the future so, you need to find other investments that offer good risk adjusted returns and add diversification. We continue to look more closely in this space as a way to smooth out returns.

- From a planning perspective, there were many presentations on modelling retirement income to ensure that clients don't outlive their capital. This is a bit of a reflexive move after 2022, but is also consistent with the idea of bond's not offering as much protection (although much better yields) and the idea that the future may be more volatile with higher inflation. There has been a lot of research in this area over the years to highlight the impact of large drawdowns as one begins retirement and how it can compromise the success of your plan. We have always been sensitive to this situation and structure our portfolios well in advance of retirement to limit the possibility of a drawdown.

- His final observation was that many of the presentations for advisors focused on a complete Wealth Management offering. The advisory market in the U.S., is a little different than in Canada as there are many more independent advisors that are responsible for every aspect of the business. Much of what was discussed in these presentations was using technology to enhance the client experience. At CIBC we recently launched Salesforce to help us do exactly this for our clients. Maddie Tanzola, who we introduced as the newest member of T.A.G. will work with all of us to help us learn the many tools that Salesforce has available for us to deliver better service.

Action Plan for the remainder of 2023

We continue to believe in our asset allocation and portfolio construction process that will enable our portfolios to navigate whatever the world throws at us. As we write this, we have fully weighted our bond and equity portfolio managers. We have held on to a little bit of cash in our stock portfolios to try and take advantage of any sudden downdraft in the market as I still feel that it is too expensive.

For 2023, we have been slowly introducing a new Global Equity Manager, GQG. They offer a unique investment approach that is different than our traditional growth at a reasonable price (GARP) global managers. They will be replacing Mackenzie Ivy Foreign Equity as the longtime manager, Paul Musson, has retired.

The recent tragic death of Paul Sandhu has put his bond funds, FSB and CMDO on review. We need to better understand the impact of his loss.

You will also see more stock positions of a smaller size as we try and add attractive names but avoid some of the volatility that can plague stock positions.

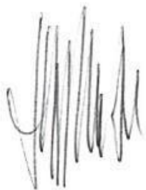
The Case for Alternatives

Over the next few months, we will be moving some of our bond and equity allocations into Alternative Strategies. Some of our allocation in Canadian equity will be moving to managers that have unique skills in that space where they have been able to deliver much better risk-adjusted returns than the underlying index and provide some current income.

We are exiting our preferred share allocation and are moving it to an alternative multi strategy. These managers use a variety of investment strategies that are different than the ones we currently employ to help manage risk, and generate a different return stream. From a portfolio construction perspective, it is designed to help us generate the return we need to meet your financial objectives and add diversification beyond stocks and bonds.

In order to accommodate the increased exposure to these managers, we may need to update our Investment Policy Statements which we will review with you the next time we touch base.

Sincerely,
CIBC Wood Gundy



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