PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Seven Themes Moving Markets in 2023

Looking back on the first half of 2023, we can make several observations. Many of the best performing equities in North America have been large U.S.-based technology companies. This contrasts strongly with the declines in many of these same equities throughout 2022. Fortunately, we were able to purchase some of them during 2022 and early 2023 at attractive levels, so we have had exposure to them in our Total Return Portfolio and Balanced Portfolio this year.

Interest rates have surged higher, which is creating more opportunities in the fixed-income markets. Low-risk short-term fixed-income securities, for example, are now paying far more interest than they did a couple of years ago. Reacting to higher rates, many high-quality dividend equities have lagged the technology sector and are now offering very attractive dividends. We seem to be entering a relatively good time for income investments, which are especially relevant to retirees.

In this first half of 2023 Newsletter, we will discuss these issues and also examine several related themes that could move markets for years to come.

North American Economies Surprisingly Resilient

Early in 2023, many believed U.S. GDP growth would come in well under 2% for the year, and that a slowing economy and falling inflation could allow for the U.S. Federal Reserve to cut interest rates this fall.

We are now in the third quarter of 2023, and year-over-year estimates of U.S. GDP growth for Q3 are in some cases above 3% annually.[i] In Canada, the data appears weaker, with second quarter GDP growth around zero.[ii]

Of course there are many pockets of weakness in both economies if you look below the surface, but the fact that both economies have broadly held up better than expected has helped some equities produce gains and has allowed interest rates to rise a bit further than some expected.

Government Spending Still Elevated

Federal governments in the U.S. and Canada are arguably overspending in this economic environment. The battle against inflation is not yet finished. Government overspending is probably making this battle more difficult than it has to be. While probably set to rise in the next six months, unemployment remains relatively low. Government spending and deficits are at levels suggesting that we are in a crisis, not a decent economy. In general, governments in Canada and the U.S. have left the central banks alone to fight inflation through interest rate increases and have not provided much support.

The negative consequences of this government overspending keep being pushed out into the future, except that now the future is much closer at hand. With higher interest rates on government debt, interest costs are going to make up a larger portion of government expenditures. The average citizen will feel no benefit from taxes going to pay interest on debt, and government policy choices will start to be restricted.

In early August, bond rating agency Fitch downgraded the U.S. government's credit rating to AA+ from AAA. Canada could conceivably face downgrades in the coming years, depending on fiscal policy adjustments.

Interest Rates Staying Higher for Longer

Equity markets weakened a bit recently, in part because investors are facing the prospect of interest rates staying higher for longer than was originally expected. As mentioned above, some economists thought that rate cuts could begin in the fall of this year. That now seems unlikely, as current projections see rate cuts beginning sometime around mid-2024. While inflation has come down significantly from its highs, it appears we are not yet sustainably around the 2% level targeted by central banks.

Higher rates for a longer time have consequences. Some fixed-income securities are providing significantly better yields. For example, the U.S. 10 year government bond is yielding around 4.3% as of September 8. To put that in context, in early January of 2022, the yield was only 1.5%.[iii] That is a major change on such an important and widely-held security.

U.S. and Canadian mortgage rates have continued to trend higher. In the U.S., the benchmark 30 year fixed-term mortgage rate has recently hit 7.5%. Many Americans are choosing to stay put in their existing homes rather than sell, as they have fixed rates far below that level. U.S. existing home sales are at lows not seen since the years around the 2008-2009 financial crisis.[iv] All other types of loans, including lines of credit, credit card rates, and auto loans have also been affected. For many people, homes, cars and other big-ticket items are now unaffordable due to today's interest rates, and this will slow the overall economy.

Recent interest rate trends arguably benefit investors who have large cash balances and minimal debts, and also investors who rely on passive income for living expenses. It was a long wait for people in the latter category, as borrowers paid minimal interest from around 2009 until 2022. Meanwhile, investors often had to either accept higher risk to receive good yields or had to sit patiently in low-return holdings, waiting for higher rates that never seemed to arrive until now.

Technology Sector Gains Follow a Rough 2022

After a very rough ride for large U.S. technology equities in 2022, we were able to find some good entry points and increase our overall technology sector weightings for clients in our Total Return Portfolio and Balanced Portfolio. (Many technology equities are not suitable for our High Yield Portfolio because they lack significant dividends.)

Excitement about artificial intelligence has contributed to the 2023 rebound in this sector, but realistically the profit and revenue growth reported by these companies has been the primary factor. While there is a lot of excitement about AI today, the actual profits likely to result from AI adoption are mostly several years into the future. Our approach to AI is simply to own some high-quality technology companies at attractive valuations that are both profitable today and are developing AI.

It is fortunate for our investment style that many of the early leaders in AI are large-capitalization high-quality companies that we are comfortable owning for clients.

Oil Prices Strengthening Again

The pandemic-related 2020 oil price collapse is now very old news, but oil is, in theory, very sensitive to economic weakness. Also, any large oil price increases can be very unwelcome during an inflationary time. Oil prices (U.S. West Texas Intermediate) have actually been trending up towards US$90 again lately.

In 2022, the current U.S. administration made a somewhat surprising decision to withdraw a significant portion of the U.S. strategic petroleum reserve (SPR) for the purpose of suppressing oil prices. While this action may have been of short-term benefit to U.S. consumers, it created a vulnerability, as the SPR has not been refilled, and it may have negatively impacted U.S. - Saudi Arabia relations.

On the other hand, the relationship between Saudi Arabia and China seems to have strengthened in recent years, particularly in the energy sector. China is the world's largest importer of crude oil, and Saudi Arabia has emerged as its top supplier. Saudi Aramco, the largest Saudi oil company, has at least two massive petrochemical complexes underway within China in the form of joint ventures.[v] The two sides have clear and compelling motives as producer and customer. For the rest of the world, we may find that there is less spare oil capacity available during future price surges.

In other oil sector news, some U.S. oil companies attracted criticism from the current U.S. administration by announcing share repurchases instead of investments to increase production. For example, Chevron Corp. (US:CVX) intends to triple its spending on share repurchases to US$75 billion over the next five years.[vi]

North American politicians are now in a difficult position on this issue, as many constantly criticize oil and gas producers and advocate for their long-term demise. For the same politicians to demand that these companies think long-term about energy supply and reasonable pricing for consumers appears disingenuous. A political message that acknowledges the continuing relevance of oil and gas for a few more decades while advocating for more renewables would be more pragmatic. It would not surprise us if we see another uncomfortably high move in oil prices in the next few years, as government policy sometimes disincentivizes investment in new supply.

China's Fast-Growth Phase May Be Over

Recent economic news out of China includes declining rates of GDP growth, hesitancy by foreign companies to invest, rising youth unemployment and possible bankruptcies of more real estate developers. It is often difficult to get a clear picture of what is going on in China, but it is safe to say that the current picture appears significantly weaker.

Potential implications include weaker commodity demand, disappointing corporate profits for many multinational companies present in that market, weaker global demand for luxury items, and possibly even more geopolitical friction.

As noted in our last Newsletter, it appears that political leaders in the world's mature democratic economies are preparing to trade more with like-minded countries and less with autocratic countries. If this unfolds, some additional price increases will likely occur for manufactured goods, simply because it costs more to make things in mature democratic countries with strong environmental and labor laws.

Office Real Estate is Still in Trouble

It has been a very rough three years for office landlords. Initially, many office workers were required to stay away from the office during the pandemic. Then, many workers reorganized their lives, in some cases by purchasing real estate far from the office due to the extra space and better affordability. Now, many workers prefer to permanently work from home, or have adopted a hybrid model involving fewer days at the office.

Because office rents are so high in many major cities, creditworthy tenants now have a lot of bargaining power, and some are pushing for rent reductions or other concessions. Lower-quality office space is now facing unsustainable vacancies, and building values have plummeted. There is talk of converting some office space to residential, but realistically this is incredibly expensive and time consuming. There are not that many examples of successful conversion projects in North America.

We do not own any real estate investment trusts (REITs) for clients that are dedicated only to office properties. We tend to focus on conservatively-financed REITs with long-track records of paying their distribution. It is probably too early to shop for bargains in the world of office real estate. At some point in the next two years, the best office REITs will distinguish themselves with comparatively strong financial performance, and we might consider them for portfolios at that time.

Real estate across the board is going to face trials in the coming months as mortgages come up for renewal in this higher interest rate environment. Office real estate especially will see many defaults, where buildings are taken back by lenders who do not really want them. It is a good reason to avoid many of the smaller, lower-quality banks in the U.S., and therefore we are not currently shopping in that area of the equities markets.

Conclusion

Thank you for reading this first half of 2023 Newsletter. We are adjusting client portfolios as the fundamentals change, and the rapid increase in interest rates has brought new opportunities. Rapid interest rate hikes tend to have significant economic impacts after some delay. Looking at recent GDP estimates, we may not be facing an imminent recession, but we believe we have not yet felt the full impact of interest rate hikes.

As noted above, there are currently increasing opportunities in the areas of fixed-income investing and also dividend investing in the highest-quality companies. It is a good time to be an investor in search of cash flow.

Ideally, the positive results we've experienced so far in 2023 will lead to a solid full year. Our philosophy of buying high-quality businesses trading at undervalued prices remains the same through different market environments, but our candidates for purchase are constantly changing. We will continue to look for opportunities that fit that philosophy. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORTFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[i] https://www.axios.com/2023/08/23/fed-rates-growth

[ii] https://www.theglobeandmail.com/business/commentary/article-tiff-macklem-says-we-arent-entering-a-recession-but-he-cant-know-that
[iii] https://www.cnbc.com/quotes/US10Y
[iv] https://tradingeconomics.com/united-states/existing-home-sales
[v] https://energy.economictimes.indiatimes.com/news/oil-and-gas/saudi-aramco-plans-10-billion-china-oil-refinery-complex
[vi] https://www.reuters.com/business/energy/white-house-blasts-big-oil-stock-buybacks-again-chevron-profits-double-2023-01-27/