QUARTERLY COMMENTARY

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"You can't predict but you can prepare"
Howard Marks, billionaire investor, author, and co-founder of Oaktree Capital

What Recession?

Our Moderate Risk Equity and Balanced portfolios did very well this quarter on an absolute basis and relative to their benchmarks (see chart below). In fact, most portfolios are at fresh new highs. As you may recall, I mentioned last year that a recession was probable due to much higher interest rates, lower leading economic indicators and a severely inverted yield curve. Many economists at the time agreed that a recession was probable. Fortunately, a major global recession did not occur. However, global growth has slowed down. Japan, UK, Finland and Ireland are currently in recession, and Canada just barely avoided one. The U.S. showed unexpected strength and grew its economy by 2.5% in 2023 and China grew by 5.2%. I mentioned last year that even if I thought a recession was imminent, I would not sell everything and move it all into cash. I would instead reduce some risk and look for quality companies with consistent earnings and rising dividends and quality bonds if they were trading at a good price. These types of assets fare relatively well in recessions. That is what I did over the last year. As a result, your portfolios were able to outperform the Canadian equity and bond markets in the last year with less risk and capture most of the returns of the hotter-than-expected U.S. market as well. It's not hurting us to be prepared for a possible slowdown or recession considering safe short-term bonds, cash funds and quality dividend stocks continue to offer great risk-adjusted returns. If any of the recent market enthusiasm is overdone, we'll be happy we have some investments like this.

Moderate Risk Equity Portfolio vs. Canadian and U.S. markets over the last five years:

	Three Month	One Year	Three Year	Five Year
TSX	+5.8%	+10.3%	+18.5% (5.8%/yr)	+37.8% (+6.6%/yr)
Dow Jones (in CDN$)	+7.2%	+19.6%	+29.3% (8.9%/yr)	+47.0% (+8.0%/yr)
Moderate Risk Equity Portfolio	+9.4%	+12.2%	+36.4 (+10.9%/yr)	+54.6% (+9.1%/yr)

Balanced Portfolio Returns vs. Benchmark over last three years:

	Three Month	One Year	Three Year	Five Year
Benchmark*	+1.8%	+4.6%	+6.0% (2.0%/yr)	+25.6% (+4.7%/yr)
Balanced Portfolio	+6.3%	+8.5%	+12.4% (+4.0%/yr)	+33.7% (+6.0%/yr)

**50% TSX/50% Canadian Bond Universe Index ETF (XBB)*

Great Expectations

The U.S. economy is by far the largest in the world and its stock market has been one of the best performers since the end of the financial crisis in 2009. This momentum continued over the last year with the Dow Jones up 19.6%. The expectations for technology companies due to artificial intelligence (AI) is sky high. Computers with AI capabilities require far more processing power than what is available now, so real money is already being spent on upgrades to the latest microchip technology. This trend is expected to continue for years, and the U.S. has a very high share of the companies involved in this area. At the same time interest rates seem to have peaked and, according to the U.S. Federal Reserve Chair Jerome Powell, are expected to be cut three times in 2024 starting in June. This would also be good for stock prices and especially stocks that are priced mostly on expected growth such as the expensive technology companies that have done so well recently and who did so poorly in 2022 when rates rose. The expectations of AI spending and lower interest rates have caused the valuation of the U.S. market go from 17 – 21.4 times earnings or a 26% jump in the last year despite only a 4% increase in actual earnings. The 25-year average is around 17 times, so the U.S. market looks quite expensive and will require some significant earnings growth or a rapid decrease in interest rates to justify their current prices. If we get disappointing news on either of these fronts, stocks could easily drop back down from here.

What Else Could Go Wrong?

Energy and commodity prices were in decline for most of 2023, but they are now starting to rise quickly. The lower prices last year helped to bring inflation down from over 10% in the summer of 2022 to around 3.8% currently in the U.S. Great progress has been made by the Federal Reserve to reduce inflation and, so far, avoid a recession. However, inflation remains higher than the Federal Reserve's 2% target rate, and now that energy and commodity prices are rising again, it appears rates may not be able to be cut three times this year as expected by the markets. In fact, many members of the Federal Reserve have indicated that it may still be too early to cut rates, given inflation continues to stay stubbornly high. Another risk is that U.S. consumer spending continues to slow. Consumer spending is a large part of the U.S. economy, and it was stronger than expected in 2023, but is showing signs of slowing. During the pandemic, the U.S. government spent $5 trillion in financial aid, which is far more than other countries. This put lots of cash in the hands of the U.S. consumer. Initially, this money was saved but then spending ramped up after the pandemic. There are now signs that consumers have spent most of their pandemic savings and the strong consumer spending is coming to an end. Also, U.S. government spending made up 25% of GDP in 2023 due to Biden's $1 trillion infrastructure spending bill and his $2 trillion inflation reduction bill. Spending from these initiatives are also expected to slow going forward and it is not likely that any other fiscal spending will occur until after the next election.

China

China's economy has been the envy of the world for decades and is now the second largest economy in the world. It is responsible for bringing hundreds of millions of people out of poverty as its citizens moved from rural areas into the cities. This huge supply of workers kept labour costs low and attracted foreign investment. China built more and more infrastructure, which created more jobs, attracted more workers and foreign investment. China's economy grew at 5.2% in 2023, so it appears this impressive economy continues to dominate. However, its stock market dropped by 14% over the last year. Investors clearly are not as enthusiastic about China as they are about the U.S., despite China posting double the growth. Something doesn't add up. Many of China's large corporations are state owned. Historically, when the economy slowed down these state-owned enterprises ramped up spending on infrastructure. They would build roads and bridges and entire cities betting that people would continue to move to those cities, get jobs in factories and stimulate the economy in the future. This worked for decades. However, in recent years the return on investment of infrastructure spending has been in decline. A higher and higher percentage of China's GDP is now simply government spending via state-owned enterprises and that spending has had less impact on real economic growth. The result is government debt has expanded rapidly to 287% of GDP, which indicates a real problem. Part of the problem is Chinese labour is not nearly as cheap as it once was relative to other countries such as the U.S. The U.S. has also been investing in renewable energy, so some companies have recently built manufacturing facilities in the

U.S. Despite the higher labour costs to build the facilities, it is often still worth the extra cost given lower energy costs. Micron Technology Inc.'s $100 billion memory chip facility proposed for New York is an example of this. Also, China's population has reached a peak and is now expected to decline. That is generally a bad sign for future economic growth. This is concerning because China's economy is huge, and any major slowdown could have negative economic consequences for the rest of the global economy.

U.S. Election Update

During the quarter both Joe Biden and Donald Trump won enough votes in the primary elections to secure their nominations. This year will be a rematch of the 2020 election, but this time Biden has far more money available for his campaign with $192 million vs. Trump's $93 million. Trump is also in real jeopardy of being convicted of a criminal offence. He has already lost two civil cases this year. One for defamation and the other for fraud. He was ordered to pay $91 million and $464 million in fines for these rulings, and he has appealed both. He still faces four criminal indictments with the first criminal trial scheduled to start on April 15th. The last time I wrote about this, Trump had a slight edge in the polls against Biden. However, Biden now leads 48-50% in at least one poll. If inflation continues to stay low and the economy in the U.S. stays strong, it is likely Biden will continue to gain momentum. If inflation picks up, the war in the Middle East worsens or U.S. border tensions get worse, then Trump may regain momentum. It is difficult to know how the markets will react depending on who wins. In 2020, after Biden won, the markets rallied. In 2016, after Trump won, the markets also rallied. Markets hate uncertainty so they usually do well after the winner is known regardless of who wins. This year might be different if Trump wins. He has claimed he would become a dictator on day one if elected and that if NATO countries did not pay their fair share, he would let Russia do whatever they want to them. He has also said he would try and pardon those convicted in the January 6, 2021, riots on the U.S. Capitol. These statements may be seen as destabilizing, and if he won it could create lots of uncertainty.

Going Forward

In his latest newsletter, Jamie Dimon, CEO of JP Morgan wrote "Equity values, by most measures, are at the high end of the valuation range, and credit spreads are extremely tight. These markets seem to be pricing in a 70-80% chance of a soft landing – modest growth along with declining inflation and interest rates. I believe the odds are a lot lower than that." He went on to mention "the trillions needed each year for the green economy, the remilitarization of the world, and the restructuring of global trade" are contributors to future inflation. So, he is saying that the battle against inflation is not yet over, and the war in Ukraine and the Middle East and other geopolitical tensions are not appropriately factored into current stock and bond prices. This is just one opinion, but it is a highly educated and well respected one. Warren Buffett, another well respected CEO, is also proceeding with caution lately. His company, Berkshire Hathaway, was a net seller of publicly traded stocks for 2023 and has a record level of safe U.S. T-bill holdings. I believe our current global problems will eventually be overcome. However, current market conditions warrant a cautious approach. It's always okay to err on the side of caution when investing hard-earned money.

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