QUARTERLY MARKET COMMENTARY

2ND QUARTER 2024

SHAWN DUNBAR
Portfolio Manager
shawn.dunbar@raymondjames.ca

Dunbar Wealth Management of Raymond James Ltd.

1000 - 1175 Douglas Street
Victoria, British Columbia
Canada V8W 2E1

250-405-2464
https://www.raymondjames.ca/shawndunbar/

"Companies that achieve a high return on capital are likely to have a special advantage of some kind. That special advantage keeps competitors from destroying the ability to earn above-average profits."

Joel Greenblatt, founder of Gotham Capital, Value Investing professor at Columbia and author

Holding Strong

After two consecutive strong quarters of new highs, the markets stabilized in the second quarter. Historically, the fourth quarter is by far the best for markets, followed by the first quarter. There is often enthusiasm in January as CEOs, investors and analysts look towards the New Year. As time goes on and reality sets in, corporate earnings expectations usually drop over the rest of the year. This year has been different. Earnings for the first quarter were very strong and expectations for earnings over the rest of 2024 have remained high. This has helped keep markets trading near their all-time highs and is a reflection that the economy has weathered the storm of much higher interest rates. Below are the performance numbers for the Moderate Risk Equity and Balanced portfolios in which many of you invest.

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

	Three Month	One Year	Three Year	Five Year
TSX	-1.3%	+8.5%	+8.4% (2.8%/yr)	+33.5% (+6.0%/yr)
Dow Jones (in CDN$)	-0.01%	+17.3%	+25.2% (7.8%/yr)	+53.8% (+9.0%/yr)
Moderate Risk Equity Portfolio	-0.26%	+12.5%	+27.80% (+8.5/yr)	+57.7% (+9.5/yr)

Balanced Portfolio Returns vs. Benchmark over the last three years:

	Three Month	One Year	Three Year	Five Year
Benchmark*	-0.24%	+6.05%	+1.5% (0.47%/yr)	+16.4% (+2.9%/yr)
Balanced Portfolio	+2.37%	+11.86%	+11.4% (+3.7%/yr)	+36.0% (+6.3%/yr)

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

Interest Rate Cut

The Bank of Canada cut their interest rate by 0.25% to 4.75% in June. This was the first rate cut in Canada since the early days of the pandemic in 2020. It was widely anticipated, so it did not have much of an effect on the market. It is positive, however, as it indicates inflation is back under control. There has been concern that lower interest rates would fuel demand for an already unaffordable housing sector. This is not likely, as this move is relatively small compared to the huge move up in Canadian rates in 2022 and 2023, when rates went from 0.25% to 5.0%. There are still many people renewing their mortgages at much higher rates than they were before, and this will continue for several years. This should keep the real estate market from getting over-heated again. In the U.S., the Federal Reserve has held rates steady, and according to the markets, there is an 80% chance of a rate cut in September. At the beginning of the year, some economists predicted six rate cuts by the end of 2024. The expectation is now only one or two 0.25% rate cuts. The U.S. economy has been stronger than Canada's recently, so their inflation hasn't subsided as much as ours.

Gain in Capital Gains

Also in the quarter, the capital gains inclusion rate was increased from 50% to 66.67% for capital gains tax in Canada, effective June 25th this year. For individuals, this new rate only kicks in for capital gains above $250,000, but for corporations and trusts, the new rate applies to any gains. The Liberals claim that this will only result in higher taxes for 0.13% of the population, however, this measure has been criticized by many including small business owners, medical professionals and farmers. Many doctors have personal corporations that will now pay higher taxes. This will not be helpful for attracting doctors to Canada where we already have a crisis-level shortage. Farmers will also be hurt by this, as farms passed on to the next generation will be taxed at the higher rate. The Liberals claim that only the rich will pay most of this extra tax, but Royal LePage did a study showing that 10% of Canadians own a rental property. When these are sold, they will likely elicit at least $250k in capital gains, considering the big rise in the price of real estate in recent years. Also, when someone dies, any investments are deemed as sold on the date of death and many of these estates will incur capital gains tax well over the $250k threshold. Therefore, it seems unlikely that only 0.13% of Canadians will be affected over their lifetime. An article by Jack Mintz from Deep Dive analyzed tax returns for the last 10 years and concluded that 4.3% of Canadian taxpayers would have paid more tax on capital gains at the new inclusion rate. This higher tax is not helping Justin Trudeau's approval ratings, which are at their lowest point since he became Prime Minister in 2015. This is almost certain to be an election issue, as Conservative leader Pierre Poilievre has described the new tax as "job-killing" and has promised to set up a tax reform taskforce made up of inventors, farmers, entrepreneurs and workers dedicated to make a tax system that is lower, simpler and safer. The next Canadian federal election is October 20, 2025.

U.S. Election: Trump Convicted…and More Likely To Win

Near the end of May, Donald Trump was convicted of 34 counts of falsifying business records to cover up his hush money payment to former adult film star Stormy Daniels and became the first former president to be convicted of a felony in the U.S. His sentencing was originally scheduled for July 11, but has now been moved to September due to his lawyer's appeal of the case. Jail time is possible but not likely. His other three indictments, which are more severe, are not likely to be dealt with until well after the election in November. One would think that his conviction would decrease Trump's chances of winning, but he is currently ahead in the polls by one percentage point 43% - 42%. Earlier in the year, Biden was polling higher, but then, he had a disastrous debate against Trump a couple weeks ago. In the debate, Biden seemed to have trouble recalling important statistics and articulating the accomplishments of his administration. It was such a bad performance that some high-profile Democratics stated they would prefer him to drop out of the race. In a recent poll of those who watched the debate, 61% of respondents said he does not have the mental capacity and physical stamina to serve another four-year term. Currently, Kamala Harris and Hilary Clinton are polling slightly higher than Biden in a hypothetical race against Trump. This is remarkable, considering Clinton is not even being seriously discussed as a candidate.

The stock market response to the election, thus far, has been modest. Typically, election years are positive for the markets and similar or slightly better than other years, with the biggest gains after the election. When Trump won in 2016, there was a stock market rally

shortly after and the same was true when Biden won in 2020. Leading up to elections, markets tend to be affected if there is a major change in a candidate's popularity or a potential sweep of the house and senate. Right now, there is a close battle between the incumbent and a former president, and the Senate and House are expected to remain divided. The market knows these candidates well and does not anticipate any major changes to legislation that would be significant for stock valuations. Therefore, despite the unusual nature of this election, there is no reason to think markets won't remain indifferent until after a new president is named.

Concentration

The S&P 500 index is often quoted as "the market" as it reflects prices of the largest 500 stocks in the U.S., which is still, by far, the largest economy in the world. However, its returns recently are a little misleading. The largest 10 stocks in the S&P 500 now represent 34% of the total value of the stocks in the S&P 500. This is the highest concentration ever, beating the previous concentration high of 33% in 1963. So far this year, these top 10 stocks have contributed 75% of the S&P 500 return. The market value of these top 10 also equals 60% of the GDP of the U.S., which is double the level of the top 10 stocks in the 2000 technology bubble. The second quarter returns were also a little misleading as the S&P 500 index was up 4.3% in the quarter, but the average S&P 500 stock was in fact down 2.6%. That is a huge difference. Some of these top companies have phenomenal profit margins and unlimited scalability and are far superior to their 2000 tech bubble peers. However, investors would be wise to avoid too much capital in these companies, as their valuations are stretched. Plus, their sheer collective size will make it difficult to sustain growth levels the market currently expects. Investors will likely achieve far better returns from the other 490 stocks in the S&P 500 which have much better valuations and will still benefit from a relatively strong U.S. economy.

Investment Style

One such company outside of the top 10 is Lululemon. This is a company that was recently purchased in many of my clients' portfolios in the second quarter. I thought I would share some details about this company to outline what I look for in a new investment.

Lululemon Data over the last 10 years:

Earnings per share: $1.66, $1.89, $2.21, $2.34, $3.67, $4.93, $4.50, $7.48, $6.68, $12.20

Return on Capital: 21.6%, 25.3%, 22.3%, 19.8%, 33.2%, 32.9%, 22.9%, 35.1%, 27.0%, 36.4%

Other Data:

Debt: Zero, Free cash flow: $12.94/share, Use of retained earnings: Management has generated a 22.2% return on retained earnings over the last 10 years, Share buybacks: Bought back 7.9% of shares over the last five years, Revenue/square foot: $1,650 U.S., Earnings yield: 4.8%

Lululemon is a retailer of athletic apparel, footwear and accessories. They are a leader in their industry and have grown revenues by over 10% each year since 2003 and earnings by over 20% per year over the last 10 years. This consistent growth is even more impressive, considering they have expanded with no debt. They have also maintained very high and consistent return on capital. It is difficult to maintain high returns like this over the long-term unless you have some sort of competitive advantage. Lululemon clearly has this. It is also shown in their revenue per square foot shown above. The average retailer in the U.S. earns around $350 U.S./sq ft and Lululemon averages $1,650 U.S./sq ft., which is way ahead of the competition. It's always difficult to pinpoint why one company does better than others but in this case, it is clearly reflected in the numbers. Management's ability to use its retained earnings to add shareholder value without taking on debt is also impressive. Perhaps it is their stylish, comfortable and quality products that can be sold at a premium or maybe it is the overall customer experience at their stores. Perhaps my wife is single-handedly keeping the company profitable. Either way, they have something that their competitors have not been able to replicate. Lulu's growth, consistency, efficiency and pristine balance sheet has historically resulted in a very high stock price compared to the market, but right now, Lulu is trading right around the price of the average stock and near its lowest valuation in the last five years. Therefore, this looks like an opportunity to buy a tremendous

company at a fair price. These investment criteria have been used by many famous investors such as Warren Buffett, Charlie Munger and Joel Greenblatt. It's a type of value investing meant to identify businesses with enduring competitive advantages who are leaders in their respective industries. They are worthy of and usually trade at very high prices, so in the rare occasion they trade at a discount, they should be bought. The investors mentioned above are among the best investors the world has known and made their careers by investing in this fashion. In fact, if you look at all the best long-term track records of investors over time, the common theme is that they use some form of fundamental analysis like this, where company financial statements are examined to determine the value of a company.

Investment Style

I mentioned in my last newsletter that much of China's GDP was fueled by government spending. Any substantial future growth will likely require government stimulus as well. They are facing declining population and adverse demographics, lower productivity, higher national debt and real estate debt and more competition from other countries such as Japan, India, the U.S. and Mexico. I attended a presentation from one of our Raymond James analysts a few weeks ago and he mentioned Japan and Mexico as major benefactors of this more muted China growth profile. As the U.S. market becomes more expensive, there could be some better investment opportunities in these countries. I will keep them on my radar, as some companies in these countries are bound to meet my investment criteria and will provide diversity to portfolios which tend to have higher concentrations of Canadian and U.S. investments.

Final Thoughts

Global events, politics, new technologies and internet trends are covered well in the media and often grab the attention of investors. They should never replace thorough fundamental analysis when looking for the best long-term performance with the lowest risk. The best investors have always known this and act accordingly. I will try and do the same with your hard-earned money.

Hope all of you enjoy your summer!

Shawn Dunbar, BSc., CIM®
Portfolio Manager

Raymond James Ltd.
250-405-2464
shawn.dunbar@raymondjames.ca

RAYMOND JAMES®

This e-newsletter has been prepared by Shawn Dunbar and expresses the opinions of the author and not necessarily those of Raymond James Ltd. (RJL). Statistics, factual data and other information are from sources RJL believes to be reliable, but their accuracy cannot be guaranteed. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. This newsletter is intended for distribution only in those jurisdictions where RJL and the author are registered. This newsletter may provide links to other Internet sites for the convenience of users. Raymond James Ltd. is not responsible for the availability or content of these external sites, nor does Raymond James Ltd endorse, warrant or guarantee the products, services or information described or offered at these other Internet sites. Users cannot assume that the external sites will abide by the same privacy policy which Raymond James Ltd adheres to. Securities-related products and services are offered through Raymond James Ltd., member-Canadian Investor Protection Fund. Insurance products and services are offered through Raymond James Financial Planning Ltd., which is not a member-Canadian Investor Protection Fund.