Wealth for Life

Wealth Management
Dominion Securities

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The second quarter of 2023 presented a conundrum of diverse and sometimes conflicting market developments. Equity markets began the quarter on a positive note in Canada, on the heels of an interest rate "pause" by the Bank of Canada (BOC). In the US after a 0.25% interest rate increase in May by the Federal Reserve (Fed) and talk of a June pause, US equity markets were moved to the upside as well. Then as April progressed both the BOC and the Fed both started talking hawkish about "sticky" inflation and the need to raise rates further. Equity markets in Canada pulled back but finished the quarter up 1.1% and 5.7% for the YTD. US equity markets continued its Q1 uptrend through the quarter with an 8.7% $USD return (6.5% $CAD).

As central banks continued discussion of their "hawkish" position, the reasoning offered to financial markets was the prospect that inflation was "sticky". Now you may not remember that in 2021 central banks and in particular the Fed justified – Not raising interest rates on the notion that inflation was......... "transitory". So now 2 years later we are set to endure higher interest rates for longer because inflation is "sticky". In addition, the implied central bank strategy, now that they know inflation is not transitory, is to engineer a "soft landing" (shallow recession) hopefully with – higher interest rates for longer. History tells us that the track record of central banks' success at navigating "soft landings" is very limited, while central banks' record of excessive tightening or easing is quite common. To be fair, fine tuning any economy is a daunting challenge.

Inflation, as measured by CPI, peaked in June 2022 at 9.1% in the US and at 8.1% in Canada. The latest readings for CPI are now 3% in the US and 3.4% in Canada. On the basis that "Transitory" means of short duration or – temporary, one can surely consider inflation of the last 12 months just that. Furthermore, the US Producers Price Index (PPI) has declined from 11.1% in June 22 to 1.1% currently. Keep in mind the PPI is a leading indicator for CPI and includes prices of all goods, as well as being 66% weighted to the service sector, which central banks are so fixated on. In the face of unprecedented increasing interest rates – of which the full impact is has yet to be felt by the economy – inflation, has in fact, been transitory and is declining at a breakneck pace.

It's noteworthy, that while equity markets moved to the upside in Q2 and inflation declined more quickly than expected, interest rates as measured by the 2 year and 10 years bonds increased and approached the prior Q1 highs. The increasing interest rates seem to foretell higher rates for longer as per the Fed's message, however rising equity markets would suggest economic conditions may be improving. At the time of writing and early in Q3, the US CPI came in at 3%, lower than expected and confirming the war on inflation was in fact progressing. Interest rates took the que from the CPI and turned

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down, falling in line with the view that we may in fact experience a shallow recession – manageable economic slowdown – equity markets responded positively to the new data.

If we pull back the curtain to reveal the future economic outlook, we will see it is always uncertain. The degree of uncertainty will vary, the data will often be conflicting, and everyone will have an opinion or view, and that includes central banks. With so many casting views and opinions, some will be deemed correct in hindsight, but no one - not even central banks, have any consistency with forecasting the future of the economy or markets, except the market itself. The challenge of course is interpreting what the markets are communicating about the outlook.

The outcomes for the balance of 2023 are many. The USD$ has broken to a low dating back to the level of March 2022, before the Fed started raising rate. This move is significant and indicative that financial markets are suggesting interest rates are at a peak level. Equity markets and bond markets have reinforced the move in the $USD, providing support for a recovery from the March 2023 low continuing. The probability that central banks will succeed in stamping out inflation is building. Future inflationary data will offer insight into whether the BOC & Fed have gone too far and need to reduce rates or keep rates higher for longer.

Bay Street and Wall Street have been fixated with the probability, timing and nature of a recession. With GDP in Canada and the US trending at 1.5% - 2% recently, some have floated the idea that we are in a rolling recession. The housing market was stopped in its tracks in the US at the outset of higher interest rates – Canada's housing market slowed but less so and commercial real estate has been clearly affected by higher interest rates and the remote work hangover. Similarly, demand for goods – for example retail & consumer discretionary were hard hit at the outset of higher interest rates as well. In Q2 both US housing starts staged a strong recovery and Canadian housing prices began to firm, while consumer discretionary also staged a rebound.

After the route in 2022, technology & communications have continued their robust recovery notwithstanding higher interest rates. Although the rally centered on and was dominated by a few (7) mega cap global companies – tagged as the "magnificent seven", the Nasdaq index has recovered two-thirds of its losses from the peak of 2021. During this recovery, technology and communication sectors have accounted for over 75% of the S&P 500 16.9% return YTD, while the magnificent seven have accounted for 58% of the Nasdaq YTD return. Remember it's a market of stocks, so in the rush to join the crowd in the magnificent seven, many companies remain attractive based on growth at a reasonable price.

Investor sentiment varies greatly by sector for equity markets. On the one hand, technology and communications look richly priced as the fear of missing out has many piling in. On the other hand, financials and health care have born a disproportionate amount of the recessionary pessimism. Canadian banks are split – trading at a 20% discount to "average price to book value" or virtually at trough price to book value levels and offer a compelling opportunity. US banks vary greatly, but many are at book value or lower. Yes, financials could go lower in a recessionary scenario, but with a 2–5-year time frame the opportunity going forward is very attractive.

Like the financial sector, health care also provides compelling opportunity. After a strong 2022, health care has been left behind by the recent "risk – on" trade. With aging "Boomers" and the growing wealth of millennials, there is much to like about the future of some of the highest quality companies with very sustainable business strategies, trading at discounted valuations.

Central banks may indeed go too far. We will likely experience a recession or at least an economic slowdown. A correction can reasonably be expected as financial markets are constantly experiencing cycles of growth and slowdown. However, we know that over the last 80 decades the US economy has spent nearly 90% of the time in growth mode, long run corporate profits have trended upwards and equity markets have generated positive returns roughly 70% of the time. We are confident our positioning in high quality and resilient companies will allow us to successfully navigate any future economic challenges that may develop, just as we've done for over 25 years.

> "When all the experts and forecasts agree – something else is going to happen."
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> - **Bob Farrell,** a Wall Street veteran of some 50 years. Launched his career with Merrill Lynch in 1957. Masters graduate, Columbia Business School.

Steve Lester

The freedom to live the life you want

If you desire greater freedom to focus on what's really important to you, and the confidence of knowing that your portfolio is in the care of trusted professionals, we invite you to consider Private Investment Management, our premium level of advisor-managed portfolios.

Our first step in developing your portfolio is to understand your investment needs.

Busy professionals and executives, travellers, retirees and snowbirds often find that the greater their wealth, the more time they require every day to manage it. If you are responsible for investing for a not-for-profit organization, foundation or endowment, you may also find that the expertise required to make investment decisions according to specific guidelines can be time-consuming and complex.

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How it works

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A dedicated portfolio manager to serve you

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The Investment Policy Statement is your specific mandate that details all your objectives, goals and constraints in managing your portfolio. You can think of it as the charter or master plan that we create to manage your portfolio.

Essential standards for quality and oversight

Every portfolio we build is based on core asset quality requirements that set the standards for security concentration, industry and sector diversification, market capitalization and credit quality. An additional Portfolio Implementation and Risk Monitoring Group monitors the portfolio for alignment with our investment management guidelines and the preferences, constraints and other unique directives set out in your customized Investment Policy Statement.

An additional compliance team ensures that your portfolio meets industry regulations and legal standards. By auditing our work, as well as the portfolios we manage, this team can help provide you with even greater peace of mind.

> Our careful process involving robust investment management guidelines, regular review and formal oversight helps to ensure that your portfolio is managed to high standards of ethics and professionalism.

The framework for success

1. Create your investment policy

Our first step in developing your portfolio is to understand your investment needs – the return you need to earn on your investments, your income requirements, comfort with market risk, time to invest and other preferences.

Based on your needs, we'll draft your Investment Policy Statement, the document that guides us in making day-to-day investment decisions for your portfolio. Taking all these factors into account, we recommend an appropriate asset-allocation model for your portfolio. How your portfolio is allocated among the three main asset classes – cash, fixed income and equities – is the single most important factor in determining the balance between managing risk and providing higher returns.

2. Construct your portfolio

Based on your asset-allocation model, we will select an appropriate combination of investments for your portfolio. In selecting your investments, we combine an understanding of the "big picture" – overall global economic and market trends – with fundamental research of individual investment opportunities. Senior economists, portfolio strategists and research analysts from various parts of RBC augment our insights in these key areas.

3. Manage your portfolio

Market and economic conditions change. As needed, we make appropriate adjustments to your portfolio to respond to and anticipate the changing market and economic landscape. If the outlook for a certain sector of the economy changes, we may adjust your holdings in that sector. Similarly, if the outlook for a certain region of the world changes, your portfolio will be adjusted accordingly, within the guidelines established in your Investment Policy Statement.

4. Review and monitor your portfolio

Your portfolio is regularly monitored by our Portfolio Implementation and Risk Monitoring Group to help ensure your portfolio is managed according to the terms of your Investment Policy Statement, as well as core Private Investment Management guidelines designed to ensure you hold a mix of investments that align with your situation.

5. Adjust your investment strategy

We will also meet with you on a regular basis to review your portfolio and get an update on your personal and financial situation. Your goals are likely to change over time, and both your Investment Policy Statement and portfolio will need to reflect these changes.

6. Keep you informed of your progress

You will receive a regular account statement that details the activity in your portfolio and provides the current market value of all your positions. In addition, you can receive a quarterly rate-of-return calculation. You also have access to your custody statement and timely market information through our secure private client website, DS Online.

Please contact us for more information about Private Investment Management at RBC Dominion Securities.

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