QUARTERLY COMMENTARY

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Smokescreen

Investors went into the second quarter on high alert for a recession and thinking the Fed could soon be cutting rates. At the quarter's end, however, there is still no economic downturn in sight and the Fed is expected to raise rates once again. There were significant divergences in performance in the markets. Fixed income values dropped slightly as interest rates continued to climb and the Canadian equity market essentially went sideways along with most of the S&P500 while the "Magnificent Seven" tech companies continued their huge run. Amazingly, the top seven US stocks by market capitalization have accounted for almost all of this year's gains and eight of the market's largest stocks—Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia and Tesla—now account for 30 per cent of the S&P 500's market capitalization. Said another way, market breadth has been extremely narrow. The large tech companies have become such a large part of the US markets, the Nasdaq 100 index is going to undergo a rare "special rebalance" later this month which will decrease the weighting of most of the above mentioned companies and increase the weighting of companies outside of the sector. That comes as these tech stocks now make up more than 50% of that particular index while Apple and Microsoft alone represent about 25% of it with their $3 trillion valuations. Their strong stock rallies this year helped push the Nasdaq 100 up nearly 40% in the first half of 2023. Don't forget though that this amazing recovery has taken place after a brutal 2022 bear market where it was down over 32%!

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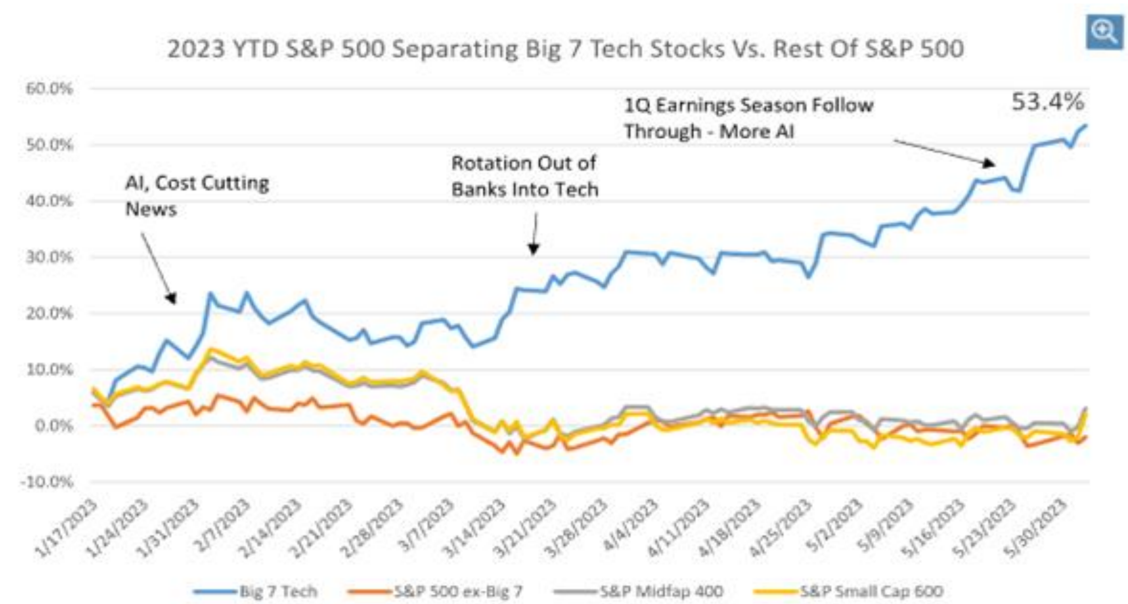
The collective weight of the large tech companies will be down-sized to 40% of the Nasdaq 100. Last Monday, investors sold the mega-cap tech stocks down as much as 2% in anticipation of the reweighting. Meanwhile, some stocks gained on the expectation that what's mega-cap tech stocks' pain will be their gain. According to Wells Fargo equity analyst Chris Harvey, potential winners of the index shake-up that could see an increased allocation include Starbucks, Mondelez, Booking Holdings, Gilead Sciences, Intuitive Surgical, Analog Devices, and Automatic Data Processing.



Source: FactSet, Raymond James research

So would it make sense to hop on the train and join the party? Typically what happens after such a big move by a few select stocks, is the rest of the market catches up. According to BMO Capital, **the S&P has returned an average of 6.7 per cent in the subsequent six months after outperformance by the market's largest five stocks.** Out of 12 periods of similarly narrow breadth, BMO found that the index has only gone on to produce negative returns only one time.

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The Bank of Canada just raised rates again by 0.25% because the economy has been stronger than expected, with more momentum in demand. Consumption growth has been surprisingly strong at 5.8% in the first quarter. As higher interest rates continue to work their way through the economy, the Bank expects economic growth to slow, averaging around 1% through the second half of this year and the first half of next year. Their projection for inflation is for it to hover around 3% for the next year before gradually declining more in the middle of 2025. With the prospect of rates soon topping and eventually then going lower (probably after 1 or 2 more increases at the most) I'm starting to get more excited about bonds again. Most bond prices are down year to date with rates increasing, but as we near the peak in rates they are beginning to look really attractive. Other than last November, the last time a 5 year GIC yield was above 5% was in the early 2000s.

Source: Investing.com ; Bloomberg

Considering bonds are offering an attractive yield again and inflation is beginning to fade in the rear-view mirror, with an anticipated further economic slowdown it's possible that fixed income will outperform equities in the latter half of the year. When interest rates drop, the sectors that tend to outperform in the equity markets are real estate, utilities, pipelines and consumer discretionary.

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You've probably gathered by now the reason for choosing "Smokescreen" as the title of this quarter's newsletter - it's not just an allusion to the disastrous forest fires across the country. We need to dig down in order to see what the underlying factors are that drive the performance of a particular market that we're investing in (its attribution). Does one really want to buy an investment after it's gone up and the risk is skewed to the downside? Although the mere fact that a stock has had a big move is not enough of a reason to take a pass, it's when it is expensive by all measures that the risk-reward becomes skewed. Most active investors can relate if they bought into the tech craze of the late 90s or more recently the marijuana haze five years ago.

Regarding the economy, we've never seen a full employment recession before and that's why if we do have a recession, as previously discussed, it could be a reasonably shallow one. I think it is fair to ask whether the October 2022 market lows were the lows for this cycle and it's very possible that they were. That doesn't mean we are off to the races, but we may have already been through the period of maximum pessimism.

Richard

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