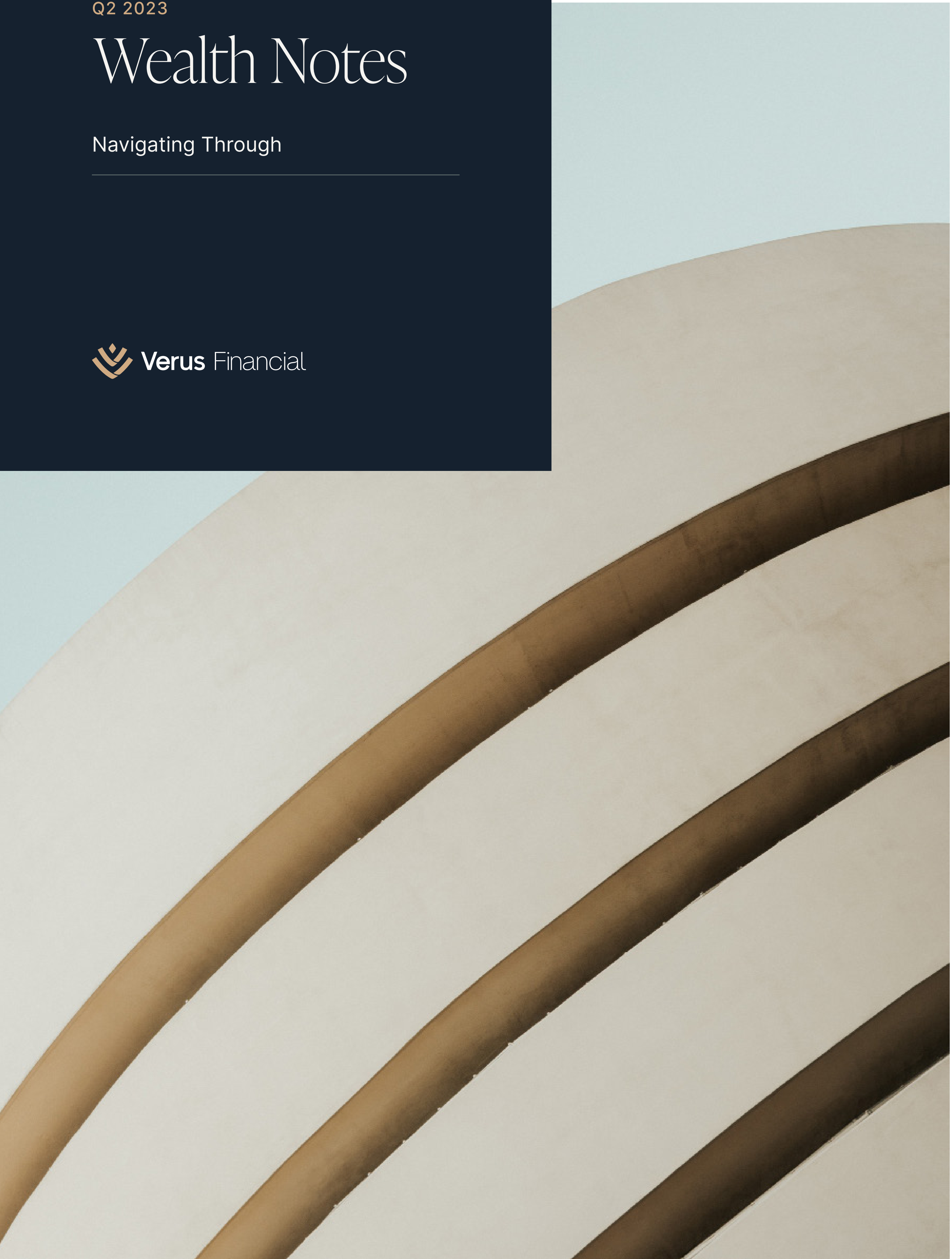
Q2 2023

Wealth Notes

Navigating Through

Verus Financial



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INTRODUCTION

What a great first half of the year for the Contrarians. What a devastating first half for the Bears.

For June: The S&P 500 gained 6.5% for its best monthly performance since October. The Nasdaq advanced 6.6%. Both indexes notched a fourth consecutive postive month. The Dow climbed 4.6%, for its best month since November.

For the second quarter: The S&P 500 rose 8.3% for a third straight quarter of gains and its biggest quarterly advance since the fourth quarter of 2021. The Nasdaq jumped 12.8% for back-to-back postive quarters. The Dow added 3.4% for a third winning quarter.

For year to date and the first half: The S&P 500 popped 15.9% for its best first half since 2019. The Nasdaq surged 31.7%, for its best first half since 1983. The 30-stock Dow added a modest gain of 3.8%.

The three major averages also notched winning weeks, gaining more than 2% each.

Wall Street also got another hint of encouraging inflation news as the core personal consumption expenditures price index, a closely watched gauge by the Federal Reserve, rose less than expected in May.

On the year, core PCE inflation increased 4.6% though the headline number was up just 3.8%. Spending rose just 0.1% for the month of May, below the 0.2% estimate and a sharp drop from the 0.6% increase in April. Personal income accelerated 0.4% ahead of the 0.3% estimate.

On the international front, the MSCI EAFE had a solid first half of the year, rising 9.63%. On the homefront, the S&P/TSX Composite did not fair as well with the return of just 3.97%. The energy sector was down -1.24% YTD and the Financials were up a mere 0.61% YTD.

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Navigating Through

Spotting a bear while driving through Manning Park is a very rare occurrence. Spotting an economist or stock analyst’s bearish views on Wall Street has never been easier. The overwhelming consensus view of these so-called experts has been dead wrong so far this year. The market pundits are saying the same regurgitated information that the economy is going to go into a deep recession with their beliefs that corporate profits are going to come under extreme pressure, with profits dropping anywhere from 10 – 20% or greater.

After a year in which Wall Street and its professional observers have said a US recession was coming, looming, pending, and guaranteed, it still hasn’t happened. Despite these long-standing predictions from the bear camp of a forthcoming recession, recent data underscored the US economy’s surprising resilience. Consumer spending, which drives most of the US economy, has been bolstered by solid job gains and wage increases.

Wall Streets’ analysts, economists, and individual investors are so bearish with the most predicted recession in the last 40 years that we at Verus Financial continue to believe it’s a contrarian buy signal that bodes well for the stock market going forward. Investors are still sitting on a record $5.43 trillion in money market funds, as of the week ending June 21st according to the Investment Company Institute. With the inevitable drop in interest rates, where do you think a good portion of that money is going to go?

Keeping their conviction with their bearish views must keep these people awake at night, with the S&P 500, as of June 3rd, 2023, up 11.48% and the Nasdaq Composite, which hit a new 52-week high up 26.51% YTD. Combining that with the first quarter earnings data is yet another clear example of why the consensus view is usually wrong. As of June 1st, 99% of the S&P 500 comapnies have reported Q1 2023 earnings. 78% of the S&P 500 companies have reported positive earnings per share surprises, which surpasses the prior fourth quarter average of 73.5% and well above the long-term average of 66.63%.

To add further context on why the consensus view is usually wrong, I will share with you our insights from the beginning of 2023. As we entered the new year, we at Verus Financial were

The year began with faith that inflation would fade and the Fed would hold rates low. Then came the brutal awakening.

more optimistic for 2023 as the vast amount of economists, analysts, and market pundits are overwhelmingly bearish, and as we have repeatedly said over and over again – the consensus view is usually wrong. While we were taking risk off the table in the third and fourth quarters of 2021, we also had a very cautious outlook going into 2022.

The sense of optimism on Bay Street and Wall Street at the start of 2022 was staggering. As it turned out, Wall Street's top stars got blindsided by the 2022 market collapse. The year began with faith that inflation would fade and the Fed would hold rates low. Then came the brutal awakening.

Marko Kolanovic, Co-head of Global Research at JP Morgan Chase and John Stoltzfus, Managing Director and Chief Market Strategist at Oppenheimer Asset Management Inc, two of the loudest stock bulls on all of Wall Street, were convinced of one thing at the outset of 2022: The Federal Reserve would go slow, very slow, with its plan to raise interest rates. It didn't matter to them that inflation had already soared to the highest level in four decades. The rate increases, they said, would come in increments so small that financial markets would barely feel them.

Kolanovic predicted a broad rally and had a target for the S&P 500 at 5,050 by the end of 2022. Stoltzfus was even bolder, with a target of 5,330.

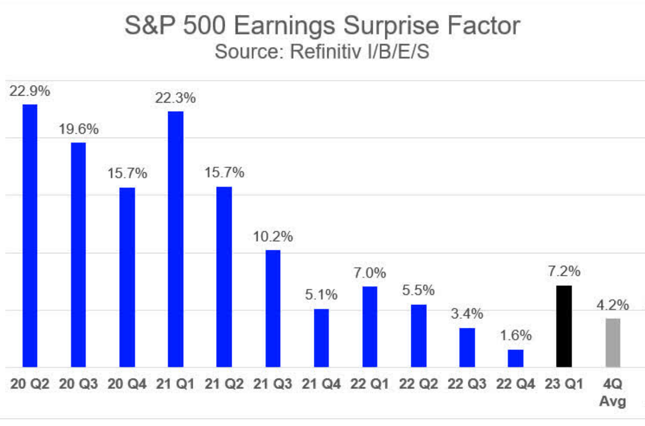
Both men were miserably wrong, as the S&P 500 closed out the year at 3,839.56. Kolanovic missed the mark by 1211 points or 24%, and Stoltzfus missed by an astounding 1491 points or 28%.

With very few expectations, the best and the brightest in equities and bond markets failed to appreciate how the inflation outbreak would flip the investing world in 2022. They completely failed to anticipate how the Fed would react. The rate increases came at a blazing pace, so not measured. They failed to see how that, in turn, would trigger the worst simultaneous rout in stocks and bonds since at least the 1970s.

The Bears are still currently out in full force, sticking with their predictions of doom and gloom despite being dead wrong. On February 20th, 2023, Morgan Stanley's top strategist, Michael Wilson, who is among the most predominant bearish voices on US equities, warns the rally and tech stocks that exceeded 20% aren't sustainable and that the sector will return to new lows. He believes that the S&P 500 could drop 26% in the first half of this year. So far, he has only mispredicted by almost 37.5%. When you're dead wrong, why not double down. On Monday, June 26th, 2023, Wilson said, "US equities are facing a wall of worry, which could fuel a sharp sell-off in the near future." Obviously, his prediction for 2023 has yet to materialize. He expects the S&P 500 to end this year at 3,900, about 10% below Friday, June 23rd close. He also said, "the headwinds significantly outweigh the tailwinds, and we believe risks for a major correction have rarely been higher." With the S&P 500 currently standing at 4,384 on June 29th, he continues to miss the boat by an increasingly large margin. His predictions continue to be one of the most bearish among those tracked by Bloomberg as he believes earnings-per-share for the S&P 500 are set to drop 16% this year.

Individual investors are notorious for employing investment strategies at the exact wrong time. According to the Investment Funds Institute of Canada (IFIC), mutual funds saw $44 billion in net redemptions in 2022. With all the bearish predictions, it was easy for retail investors to flock to money market mutual funds that were paying 4.5-5%. We are sure many of those investors are rethinking their logic. At Verus Financial, we have said many times that to successfully deliver superior risk-adjusted returns, you must be proactive rather than reactive. To take a quote from the great one, Wayne Gretzky, "skate to where the puck is going to be, not where it has been."

Here is what unfolded for earnings in Q1 2023



S&P 500 Earnings Surprise Factor

Source: Refinitiv I/B/E/S

According to the Investment Funds Institute of Canada (IFIC), mutual funds saw $44 billion in net redemptions in 2022.

After almost 40 years of managing money, I find it amazing how few market pundits can ever reverse their predictions and come clean and say they got it wrong. In mid-April 2023, a group of five Wall Street veterans who all worked at Merrill Lynch and have a combined experience of more than 230 years are mostly bearish about the stock market in the coming months. The so-called experts are as follows:

1. Economist David Rosenberg sees the coming bear market sinking the S&P 500 to 3,300. As of June 3rd, 2023, the S&P 500 stands at 4,278. His forecast represents a drop of approximately 950 points, which translates into an astounding 28% fallout.

2. Richard Bernstein, chief executive at Richard Bernstein Advisors, says the rally and risk asset so far this year is "not a fundamental one." He sees a considerable downside to the overall markets
3. Wall Street legend, Bob Farrell, points out that the stock market rally so far this year is led by growth stocks instead of value stocks, which he implies that the bounce may be more of a result of growth stocks getting oversold last year. As a result, he believes the rally is likely to be temporary, "we haven't had the market discounting and economy going into recession."

4. Gary Shilling, president of A. Gary Shilling & Co., recently said, "We've been very definitely in a risk-off investment stance since May last year." Shilling said he thinks the stock market is only halfway to the bottom. "I've been forecasting somewhere around a 40% peak-to-trough decline. We are not quite halfway down there." In his view, that means the S&P 500 could reach a low of 2,877 from its peak at 4,796 on January 3rd, 2022.

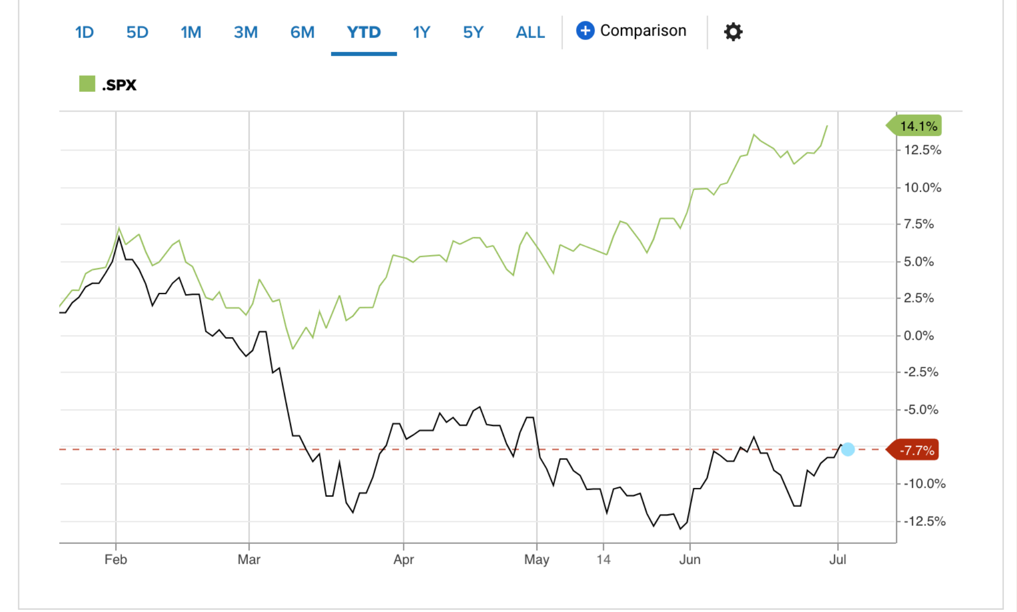
5. Chuck Clough, Chairman and Chief Investment Officer at Clough Capital Partners, thinks the S&P 500 will be flat for a long period of time. "I don't buy the narrative that the S&P 500 will fall to 3,300. I don't think there is enough rebalancing the economy to get us down that far." However, he thinks the bulls will be equally disappointed, and there will be a long but shallow recession.

For years I've been subscribing to Jonathan Baird's Global Investment Letter. Although he has had some very accurate predictions over the years, his current edition of the Global Investment Letter is ridiculed with bearish tones. He still believes that in the second half of 2023, there will be a significant economic recession, and his most current probable scenario is a market low sometime this fall that coincides with investors recognizing that a (soft economic landing) is not in the cards.

Thane Stenner of Stenner Wealth Partners at CG Wealth Management, acclaimed advisor to the ultra-rich, has now moved his clients to a 58% cash weighting. Mr. Stenner believes that we are likely headed into a recession or will soon be in one, and it's probably going to be a hard landing.

Two other highly touted predictions for 2023 were that value stocks that pay dividends would outperform growth stocks and that any new bull market would start with new leadership from different sectors. Both of those predictions have not materialized in the first half of 2023. The following chart clearly depicts the huge outperformance of growth stocks versus value stocks.

Large-cap huge outperformance has overshadowed dividend paying stocks in the first half of this year.



SPDR Portfolio S&P 500 High Dividend ETF versus the S&P 500 in 2023

Dividend payers are on track for the worst half against stocks that don’t pay dividends since 2009.

Look no further than the Bank of Nova Scotia. It currently has a dividend yield of 6.48%; however, its share performance is down over 12% in the last five years.

2023 was supposed to be all about the energy, material, healthcare, and financial sectors, which did well in 2022. The chart below depicts that that didn’t happen either.

Sector Performance

S&P/TSX (In CAD)	YTD
Energy	-5.99%
Materials	-0.15%
Industrials	3.77%
Consumer Discretionary	2.04%
Consumer Staples	3.50%
Healthcare	3.36%
Financials	-0.49%
Information Technology	41.36%
Communication Services	0.97%
Utilities	7.62%
Real Estate	2.12%

S&P500 (In USD)	YTD
Energy	-11.40%
Materials	-2.99%
Industrials	-0.99%
Consumer Discretionary	18.73%
Consumer Staples	-1.89%
Healthcare	-5.60%
Financials	-6.77%
Information Technology	33.95%
Communication Services	32.81%
Utilities	-7.22%
Real Estate	-1.70%

The bears continue to believe that the market leadership is far too narrow, as the bulk of the move has come from the Megacap-8.

Returns

As of Date: June 20, 2023 **Data Point**: Return

	YTD
S&P 500	14.30%
Amazon.com Inc	49.74%
NVIDIA Corp	199.85%
Meta Platforms Inc Class A	136.27%
Netflix Inc	47.42%
Alphabet Inc Class A	39.52%
Tesla Inc	122.80%
Apple Inc	42.81%
Microsoft Corp	41.62%

They believe the huge move in these stocks is all about the AI crave, and they are completely overvalued.

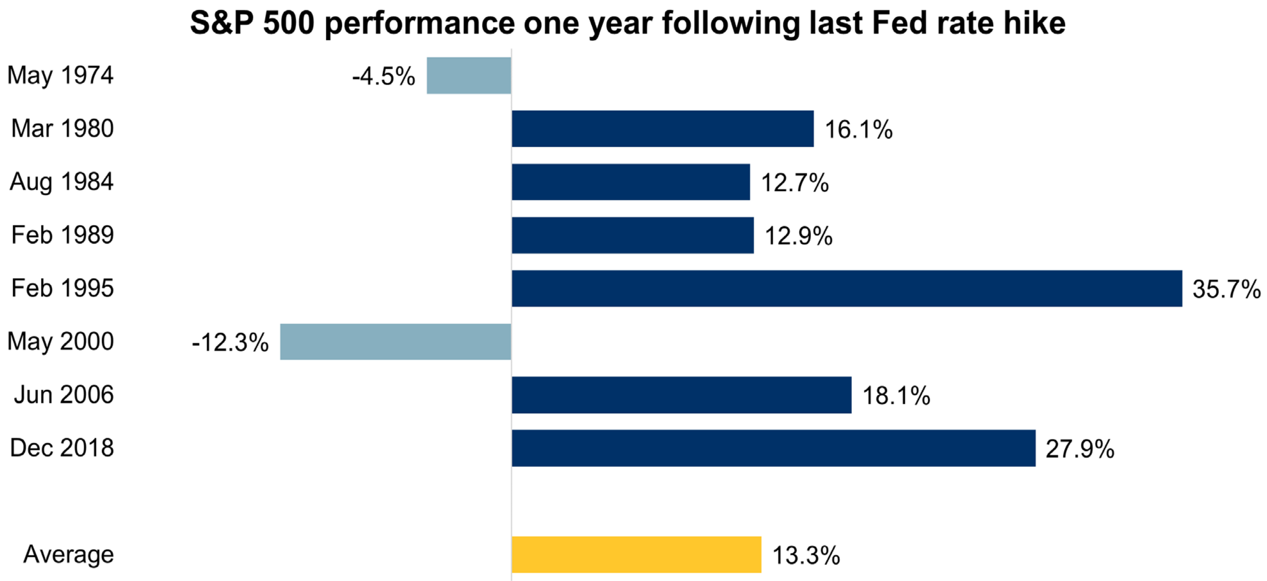
Again, our view is a contrarian one to the street as we believe these Megacap stocks have performed very well in 2023 for the following reasons.

1. They dropped significantly in 2022
2. After the regional bank crisis, investors were looking for companies that had the following criteria: Excellent balance sheets with enormous amounts of cash on their balance sheets.
3. Their growth potential justifies their PE ratio.
4. If a recession does come, we believe that these stocks will hold up better than the broader market.

Our US Focus Growth owns four of the eight companies. Amazon, Netflix, Alphabet, and Microsoft. That is why our US Focus Growth Strategy finished up 26.40% in the first 6 months of the year. We also believe that it would be healthy for the market to take a pause. One negative scenario for growth stocks would be if the Fed continued to raise rates further from their pause in June. We believe that the other performing sectors could catch up so that the market performance will be broader based on the resilience of the economy.

The title wave of negative sentiment may be changing as the recent data compiled by Venda research shows retail investors recently bought $1.48 billion in US-listed stocks. After sitting on the sidelines since the end of February, retail investors appear to have more conviction as their most recent purchases hit a 3-month high.

We at Verus will continue our cautious yet optimistic outlook even though we expect that volatility will remain high. The bulk of the rate hikes are most definitely in the rear-view mirror. We believe that inflation in both Canada and the US will continue its downward trajectory in the last half of the year. In Canada, the inflation rate fell to 3.4% in May of 2023 from 4.4% in the previous month, which is the lowest level since June 2021. Our cautious optimistic outlook is supported by the following chart on the equity returns of the S&P 500, one year following the last Fed hike.



Source: Strategas Research, RBC GAM. S&P 500 Price Return Index performance in US dollars. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

I will leave you with two final thoughts to ponder; how do you have a deep and meaningful recession when you have some of the lowest unemployment rates since 1969? On Friday, June 3rd, 2023, it was announced that the US economy added 339,000 jobs in May, much better than the 190,000 Dow Jones estimates, which marked 29 straight months of positive job growth. And finally, a quote from Benjamin Disraeli, British Prime Minister, “what we anticipate seldom occurs: but what we least expect generally happens.”

Yours in Investing Strategies,
Ken Gordon

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