# Wealth Notes

January 2024

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# Introduction

In 2023, markets ended dramatically, with the S&P 500 rallying 8.9% in November and closing December up 4.42%, leading to a 24.2% annual return. The Nasdaq Composite soared 43%, driven by the "Magnificent 7" tech giants and AI enthusiasm. The Dow Jones also grew nearly 14%. In contrast, the S&P/TSX Composite Index had a modest year with a return of 8.2%, influenced by rising interest rates affecting dividend-heavy sectors.

U.S. equity markets were dominated by mega-cap tech stocks, with the Magnificent 7 (Apple, Microsoft, Google parent Alphabet, Amazon.com, Nvidia, Meta Platforms and Tesla) contributing significantly to the S&P 500's gains. Looking ahead to 2024, there's cautious optimism for these stocks, though valuations hinge on meeting growth expectations.

In Canada, there was muted PE expansion compared to the US. Meaning that investors were not willing to pay more for each dollar of earnings, showing scepticism about the future prospects in Canada.The S&P/TSX now trades at a near-record discount to the S&P 500. Our view remains that the Bank of Canada is setting itself up for a policy mistake as they continue to maintain their over restrictive stance with clear evidence of a suffering economy.

Global inflation rates have significantly decelerated, with the CPI dropping from 10.4% to 5.5%, hinting at a cooling economy. Consumer resilience averted a 2023 recession but rising financial strains in North America and China's deepening real estate crisis signal emerging challenges in maintaining global economic stability.

Ken Gordon, PFP, CDFA
Senior Wealth Advisor

Cody Gordon, CFA, CIM
Portfolio Manager and Wealth Advisor

# Economics

## Inflation and interest rates headed south

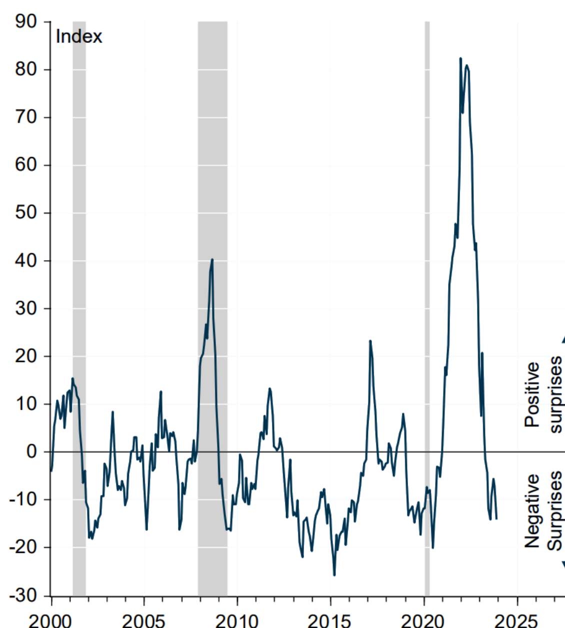
The significant deceleration in global inflation rates has been one of the most closely watched trends in recent weeks, and rightfully so. The latest data regarding price increases have not only been unexpectedly low, but there's also been a drastic reduction in the global Consumer Price Index (CPI), as reported by Bloomberg. This index fell from 10.4% to around 5.5% in the most recent evaluation.

A noteworthy aspect of this decline is the substantial decrease in oil prices, about 40% since March. While economists often exclude such volatile factors in their analyses to assess core price pressures, the drop in oil prices, despite OPEC+'s significant cuts in production quotas, should not be overlooked. It mirrors another key driver behind the recent slowdown in price growth: the cooling of global economic momentum.
Domestically, the reduction in inflation has sparked expectations of interest rate cuts in the coming year for Canada and the United States. This anticipation is reflected in the alterations observed in the 10-year yield curves for both countries, particularly the sharp decline in the latter part of 2023.

Two questions remain: will the downward trend in inflation continue? And are interest rates hike behind us?

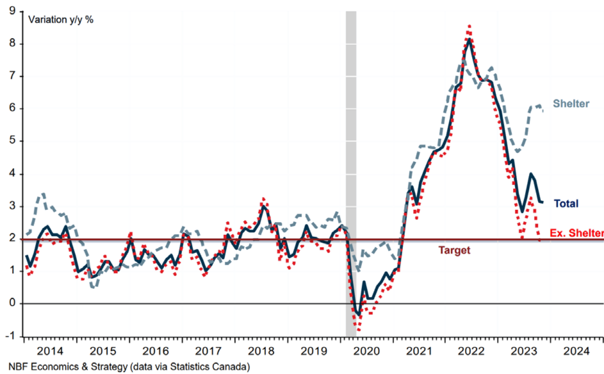
At Verus, we believe inflation will recede to the central bankers' targets, prompting no further rate hikes. There are two key reasons for our conviction. First, real rates in the US (current interest rate minus inflation) are at their highest since 2007. The long-term transmission of monetary policy will continue to put pressure on the already declining inflation picture and potentially cause some headaches to individuals and corporations. These headaches would lead to a reduction in aggregate demand, which was the intended result at the start of the hiking cycle. It has just taken longer than most analysts predicted.

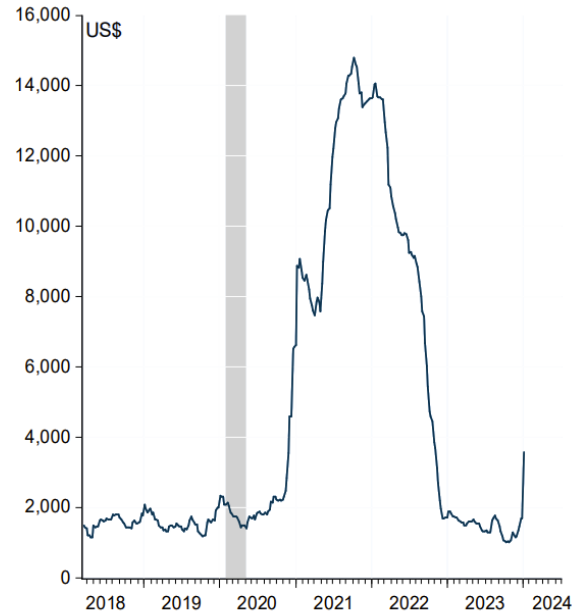
World: Inflation has eased materially




Secondly, annual inflation for Canada is currently at 3.1%, but excluding the shelter component, which has risen by 6.0% year-on-year due to higher mortgage interest costs and a surge in rental prices from population growth, inflation stands at just 1.9%. This suggests that the central bank's tighter monetary policy is effectively impacting a major portion of household consumption.

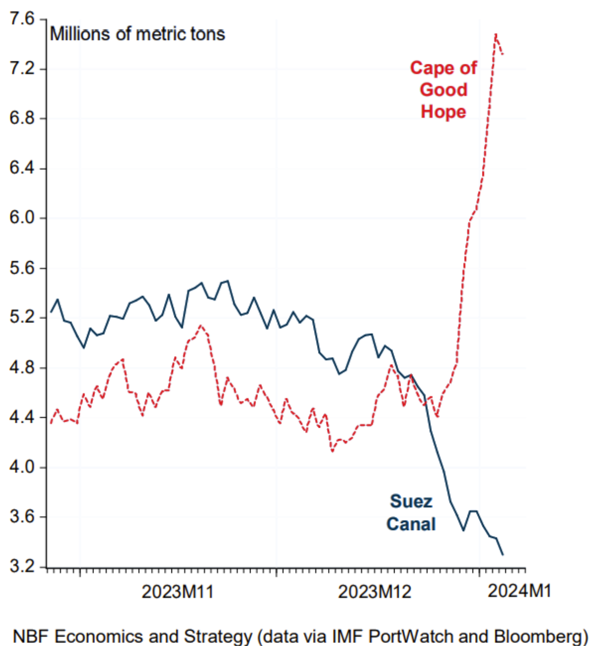
Canada: Without shelter inflation is on target




Although we expect inflation and policy rates to decline, there is one risk that could prompt a resurgence. The conflicts occurring in the Middle East have forced freighters to boycott the shortcut through the Suez Canal and take the long route down the Cape of Good Hope. This extended trip has bolstered the price of shipping goods over recent weeks and could become worse if military interventions continue.

World: Global conflict casts some doubts on goods disinflation




# Consumer resilience to be tested yet again. Will they hold up?

One of the main reasons the consensus view of a 2023 recession did not unfold was the resiliency of the consumer. Many market pundits underestimated both the extended lag times of monetary policy and the behavioral aspects of consumers coming out of the COVID lockdown.

Although we did believe in a strong consumer through 2023, there are signs that a spending hangover might eat into the economy, and the extended lag of monetary policy might start to have its intended effect on employment and aggregate demand.

Consumers in the U.S., who were previously somewhat shielded from the impact of rate

increases due to the prevalence of fixed-rate mortgages, are now starting to feel the strain. This is due to the escalating expenses associated with servicing non-mortgage debt. In recent months, there has been a significant uptick in total interest payment expenditures, and auto and credit card loan delinquencies have reached their highest point in over a decade.

With policy rates at decade highs, the intended effect on employment is starting to show its effect on both sides of the border. This is shown as an uptick in unemployment, a decrease in wage growth, and a severe loss in business confidence by employers.

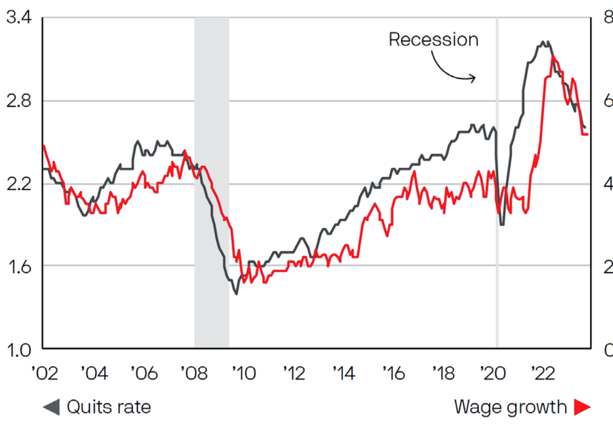
In Canada, the unemployment rate rose sharply to 5.8% in November, marking a substantial increase of 0.8% in just seven months. This magnitude of increase has only been seen once outside of a Canadian recession since the early 1980s, which occurred during the burst of the tech bubble in 2001. Also, an increasing number of individuals who had employment in the past year are now unemployed due to decisions made by their employers, as opposed to leaving their jobs voluntarily.

In the US, there are now signs of the labor market cooling and wage growth and quit rates both are starting to fall dramatically. If this trend continues, the consumer resiliency story may fade out in 2024. No job, no income, no spending.

The U.S. labour market is cooling.

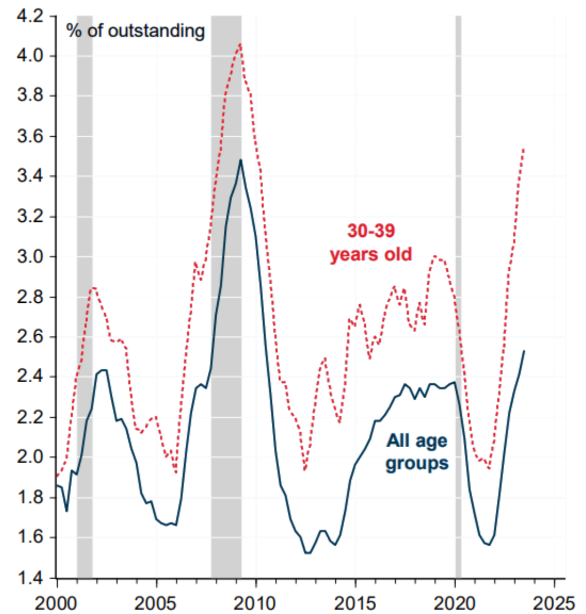
**US job quits and wage growth**

%, three-month moving averages, wage growth is year on year



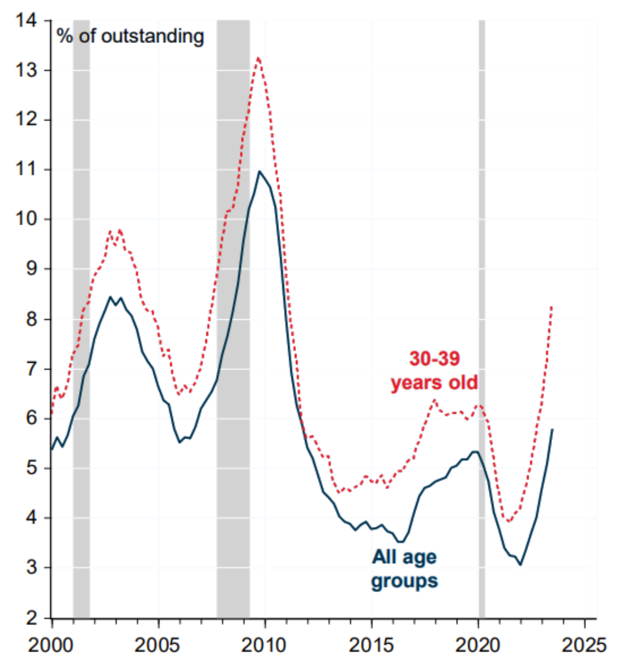

U.S.: Consumers finding it increasingly difficult to service their debt.

**Percentage of auto loans transitioning into serious delinquency (90+ days)**




NBF Economics and Strategy (data via Bloomberg)

**Percentage of credit card loans transitioning into serious delinquency (90+ days)**

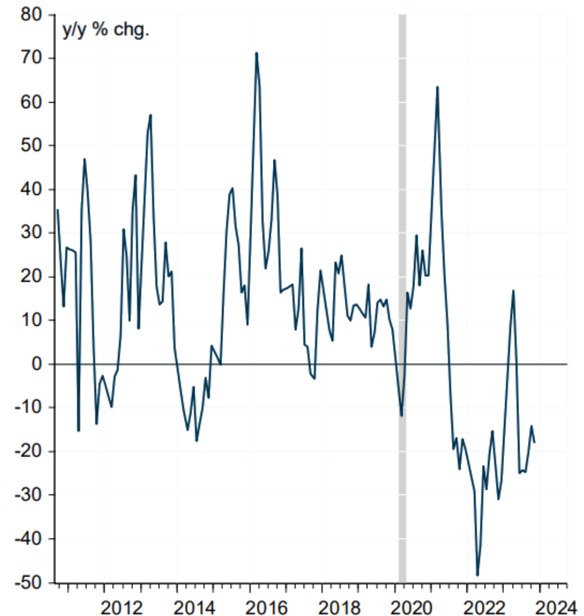


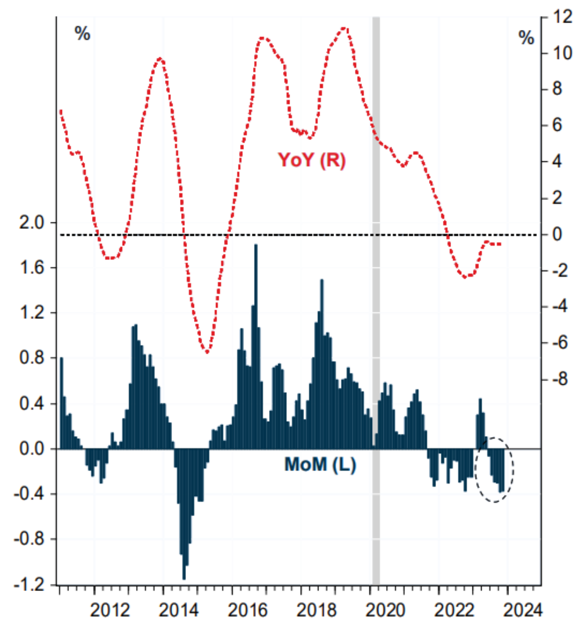
# China's Real Estate Problem.

The core issue with the Chinese economy is its struggling real estate sector. Despite government interventions, residential sales and new home prices are still falling. The government is now urging banks to finance developers likely to survive, hoping they'll absorb weaker ones. This short-term solution risks exacerbating banks' declining margins, already under pressure from supporting low-profit sectors. Bailing out the massive real estate sector could further harm bank profitability, potentially reducing credit for more profitable sectors and negatively impacting long-term economic growth.

Last month, Moody's assigned a negative outlook to China's credit rating, citing the heightened risks associated with structurally and sustainably weaker economic growth in the medium term and problems in the real estate sector.

China: Real estate sector remains a major factor.



# Markets

## Performance Update

As of December 31st, 2023

| Indices | Monthly Return | Year to Date Return |
|---|---|---|
| S&P/TSX Composite Index | 3.57% | 8.12% |
| S&P500 Index | 4.42% | 24.23% |
| DJ Industrial Average | 4.84% | 13.70% |
| NASDAQ Composite | 5.52% | 43.42% |
| Russell 2000 Index | 12.05% | 15.09% |
| MSCI EAFE | 5.24% | 15.03% |
| S&P Global Infrastructure | 3.91% | 2.50% |
| FTSE Canada Universe Bond | 3.43% | 6.69% |

The markets ended 2023 in dramatic fashion. After the S&P 500 historic 8.9% rally in November, which completely blindsided the sceptics on Wall Street the Christmas rally came to fruition just as we predicted. The S&P 500 closed up 4.42% in the month of December and finished the year with a return of 24.2% for 2023. The S&P 500 close 2023 with nine straight up weeks surging over $8 trillion in market capitalization.

Fuelled by the Magnificent 7 (Mag 7), artificial-intelligence (AI) and the "fear of missing out" (FOMO) the Nasdaq Composite soared 43% in 2023. It's best one-year gain since 2020. The NASDAQ 100 had its best year since 1999.

The Dow Jones Industrial Average ended up nearly 14% in 2023 reaching record. The combined net worth of the 500 richest people surged by $1.5 trillion in 2023, fully rebounding from the $1.4 trillion lost the year prior. As we always say, the patient investor always gets rewarded.

The S&P/TSX composite index didn't fare as well in 2023 as other major global markets. Canadian dividend payers like utilities, energy and banks came under pressure as interest rates rose in 2023. The bulk of the composite index return happened in the month of November when the index closed up 7.2%, its biggest monthly advance since November 2020.

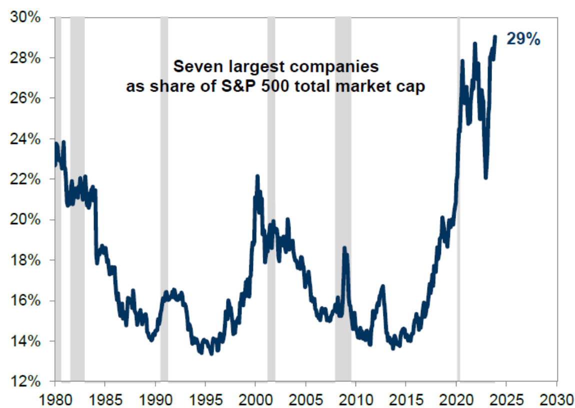
The bond market had a year of massive swings and numerous head fakes, as the 10-year US treasury yield ended 2023 pretty much where it began. It was a farcical conclusion to 12 months of trading that saw it tumble to a low of 3.25% in the week of March's banking crisis, only to surpass 5% just a few months later.

## U.S. Markets

In 2023, the U.S. equity market was dominated by

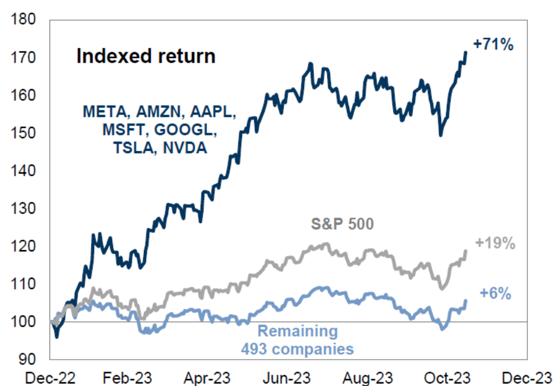
the exceptional performance of mega-cap tech stocks, particularly the "Magnificent 7" (AAPL, MSFT, GOOGL, AMZN, NVDA, META, TSLA), which contributed significantly to the S&P 500's gains. These seven stocks, comprising 29% of the S&P 500's market cap, returned 71% YTD, in contrast to the modest 6% return from the other 493 stocks. This rebound follows their notable underperformance in 2022.

**Exhibit 22: Share of largest seven companies' market cap in S&P 500 is at an all-time high**




Source: Compustat, Goldman Sachs Global Investment Research

**Exhibit 23: The Magnificent 7 have led the index higher in 2023**




Source: FactSet, Goldman Sachs Global Investment Research

As we look ahead to 2024, we at Verus Financial believe the mega-cap tech stocks will continue their outperformance over the rest of the S&P500, although the risk/reward profile appears less attractive due to high expectations.

The Magnificent 7 stocks (Apple, Microsoft, Google parent Alphabet, Amazon.com, Nvidia, Meta Platforms and Tesla) have faster expected 2023-2025 compounded annual growth rate (CAGR) sales growth (11% vs. 3%), higher 2023 margins (22% vs. 10%), and a greater re-investment ratio (61% vs. 18%) than the other 493 stocks and trade at a relative valuation in line with recent averages after accounting for expected growth (0.9x relative PEG ratio).

The primary factor influencing whether mega-cap stocks will maintain their superior performance in 2024 hinges less on interest rate movements and more on whether their actual sales and earnings growth aligns with or surpasses current expectations. If the mega-cap stocks disappoint expectations or there is a severe deterioration in AI enthusiasm in 2024, those stocks' valuations will likely "catch down" towards the remainder of the index and underperform. But P/E multiple expansion is possible if their sales growth expectations accelerate due to faster-than-anticipated adoption of AI.

To decipher which companies will meet expectations and which will not require a deep fundamental understanding of each business. Active management will play a crucial role from a bottom-up perspective in 2024.
Erroring on the side of caution, we have decided to take some profits from our Verus US Focus Growth (VUFG) mandate, which was up 40.37% in 2023. We have brought the mandates exposure in line with our long-term allocation weight. We continue to have immense faith in the sub-manager's ability to select competitively advantaged businesses with superior earnings growth.

# Canadian Market

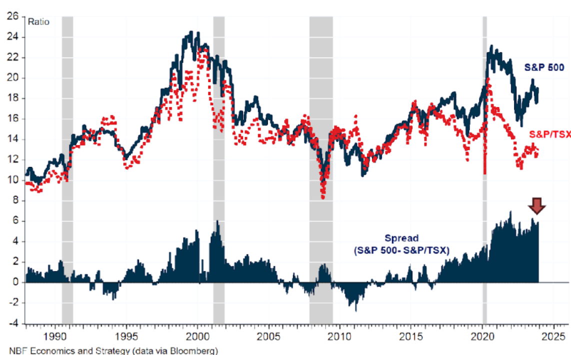
Despite a modest 4.42% rally in December, the S&P/TSX had a lackluster year in 2023, returning

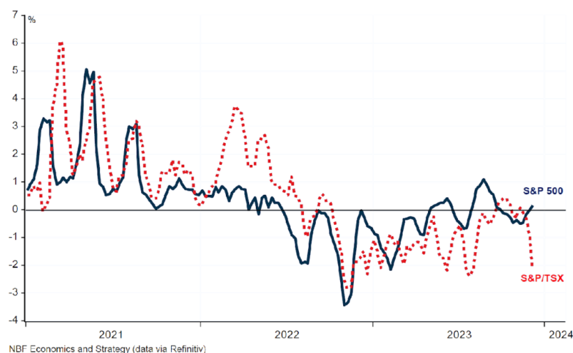
8.12%. Shopify alone accounted for close to 2.4% of the total return for 2023.

In contrast to the US, PE expansion on this side of the border has been much more muted. While the S&P 500 trades at more than 19 times forward earnings, the forward PE on the S&P/TSX is no more than 13 times. This is a near-record discount to the S&P 500.

Interestingly, this discount is not largely due to the higher IT weighting of the S&P 500 relative to the S&P/TSX. In fact, the discount is widespread, with forward P/Es for 9 of the 11 major S&P/TSX industries currently trading below their 20-year average differential with the S&P 500.

This reflects skepticism about Canada's economic prospects amid tight monetary policy and less optimistic Bank of Canada guidance compared to the U.S., alongside a significant drop in S&P/TSX earnings expectations.




Despite our concerns for the Canadian economy, we believe a lot of the negativity has been priced in, as shown by the tables above. With the underperformance of the Canadian market in 2023, we have decided to increase Verus High Income (VHIN) back to its original long-term weight. This comes from profit taking on our US and International mandates (VUFG & VING).

# International Market

European stock valuations appear fair on their own but are particularly attractive compared to the U.S., showing a 30% discount to the S&P 500, a gap similar to post-financial crisis levels. This discount extends beyond sector composition, with many European companies trading at above-average discounts across various sectors. Despite a weaker macro environment in Europe compared to the U.S. in 2023, current prices seem to incorporate much of this pessimism, especially considering that European indices derive only 40% of their revenue from domestic sources.

Our Verus International Growth (VING) strategy delivered a whopping 30.17% return in 2023 versus its benchmark (MSCI EAFE) at 15.09%. Although we see attractive valuations on an international front, we still wish to take profits after an amazing year. It's never a profit till it's realized.

# Fixed Income

In the economic section of this report, we spent some time talking about how we expect policy rates to decline on both sides of the border. The Bank of Canada (BOC), compared to the Federal Reverse, has been more cautious in providing guidance on future rate cuts and still maintains a very hawkish stance.

Ironically, compared to the Federal Reserve, the BOC seems to have a stronger argument for softening its stance. Q3 2023 data indicates that while U.S. GDP grew by 5% in the same period, Canada's GDP contracted in the third quarter, with the decline primarily in the private sector.

Put this on top of an inflation figure in Canada that is only being bolstered by the shelter component CPI, and you have all the right elements for a large policy mistake.

It is our opinion at Verus Financial that the BOC is too far into restrictive territory. If they do not change their stance quickly, the risk to the economy and real estate market is high.

From a fixed income position standpoint, although yields may be volatile at the start of 2024, we believe that once the BOC realizes their mistake, they will be forced to cut rates at an extremely fast pace to save the economy and, more importantly, the housing market. The benefactor of this will be core Canadian bonds as yields drop, giving investors large capital gains.

As the saying goes – the higher you climb, the harder you fall.

# Alternatives

Looking ahead to 2024, the outlook for private markets is cautiously optimistic yet uncertain. Hedge funds are expected to capitalize on market dislocations, while private equity may see a slowdown in deal activity as investors become more selective amidst economic uncertainties. Private real estate could face headwinds for higher real rates, although certain sectors like logistics and data centers might continue to thrive. Private credit is likely to remain a popular choice for investors seeking increased yield, although due diligence will be key in navigating credit risks as defaults could pick up quickly.

We continue to be large advocates of alternative investments and believe their addition to a traditional investment portfolio helps increase the overall risk/reward prospects.

# Commentary

As we step into 2024, Verus Financial sees a clear distinction: the likelihood of the US markets replicating their 2023 performance is highly improbable. What remains consistent, in our view, is the persistent presence of volatility, with central bankers globally once again influencing the trajectory of 2024. The pivotal questions revolve around predicting the timing and extent of the initial cuts, along with the frequency and depth of subsequent cuts. These factors will significantly shape the year ahead.

Although our expatiation is lower policy rates in 2024, the current expectations surrounding rate decreases might be excessively optimistic, specifically in the US. The anticipation of rate cuts may have already influenced market movements to some extent, both in stocks and bonds. If these cuts, as anticipated by investors, fail to materialize, we anticipate witnessing further volatility.

While we view a mild recession in Canada as the most probable outcome and perceive a potential soft landing in the US, it's crucial to note the latter is not guaranteed. Evading a recession would amplify corporate profits and bolster consumer resilience, as seen in 2023.

Throughout the past year, many market analysts and pundits steadfastly maintained bearish predictions, only to be proven incorrect for two consecutive years. As of December 6th, 2023, there is a record high of 5.9 trillion in money market funds, which could positively impact both the stock and bond market if these funds are invested.

Geopolitical risks may escalate in 2024 compared to their current level. The uncertainty surrounding the November 2024 presidential election could very well increase volatility. A win by Trump will more than likely be globally disruptive.

This isn't investing,
its *family-invested*

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