

Markets Made Simple

Chan and Brown Wealth Management



Wealth Management
Dominion Securities

FOURTH QUARTER REPORT – DECEMBER 31ST, 2024

RISING DEBT AND FALLING ROCKS

My family is competitive. Well...that is an understatement, we like to win, especially against each other. Our family road hockey games can be intense and have included crying, bleeding, cracked teeth and broken bones, and not far removed from the definition of felony assault.

Growing up, one thing I wanted to do more than anything is to beat my dad at sports. From basketball to boxing, my dad routinely beat me no matter how much I pushed my 5-year-old body to compete. He (literally) pounded me in everything. However, as I got older (and taller) I have been able to claim victory more often in such physical sports as hockey and the 100-meter dash while he continues to dominate on skill and experience activities like tennis, shooting pool and crossword puzzles.

One activity we love doing together is hiking and have done so all around the world, from our backyard in Vancouver and Whistler to different Provinces and States around the Rocky Mountains. My dad is in great shape and we regularly tradeoff who is the first to reach the peak first or first to get back down to the car or most mosquito bites.

To slow him down, I learned to take advantage of his weakness.... rocks. No, not the one which I wrote about in my last newsletter that rolled off the mountain and almost killed him, I mean all rocks in general. My dad loves rocks and loves collecting them. The more unique it is, the more he wants it. After an eight-hour grueling hike up a mountain, he will stumble across an unusual rock at the peak and he will stop to pick it up. Even if it weighs 30 pounds and is bigger than his head, he will lug it down the mountain for his collection. He is the only person I know who finishes a hike with a backpack heavier than he started. You might say he has rocks in his head...err, I mean on his mind. If I want to slow him down, I simply point to a rock... "look dad, ever seen one that shade of grey?", "unusual spots on that one", or "wow, a real Jurassic rock". Then I sit back to watch him stop and add another 10 pounds to his pack.

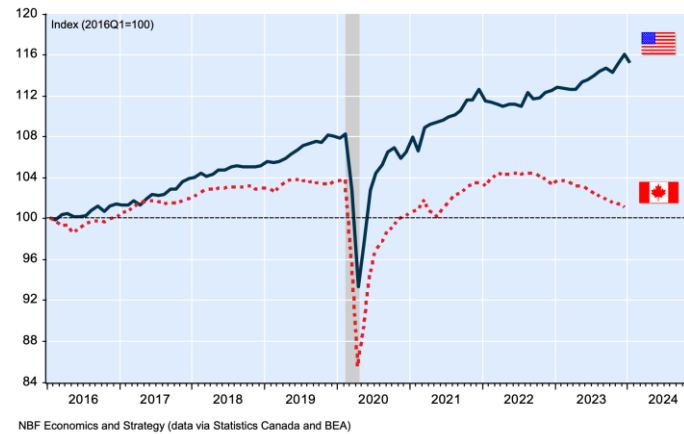
It is not easy for him to move forward when he is loaded down by 50 pounds of "collectables". Similarly, Canadians and our economy will be hard pressed to move ahead with the heavy load of debt that is weighing them down today.

The Canadian Consumer

The Canadian consumer is in rough shape. Over the last two years, real Gross Domestic Product (GDP) per person in Canada has been falling and sits at the same level it was at seven years ago. In the US, real GDP per person has been moving opposite to us. Rising real GDP per person means individual output is increasing causing the economy to expand, employment to stay strong and bringing an increase in the overall standard of living. In Canada, the opposite is happening, output and GDP per person is decreasing, unemployment is rising and the gap between our standard of living and our neighbor continues to grow.

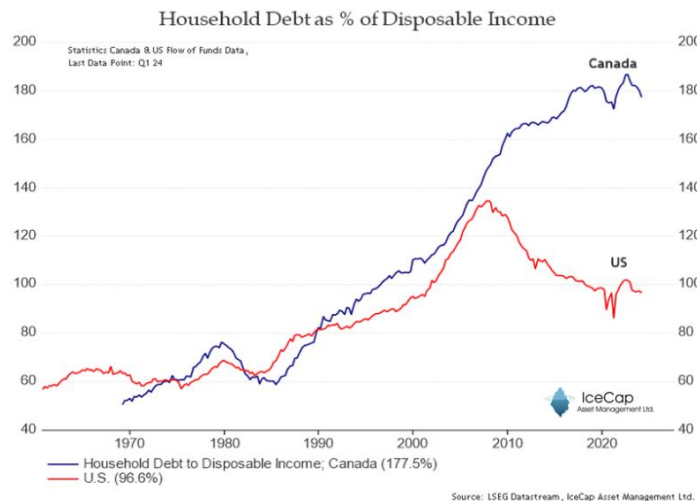
Canada: Standard of living is declining

Real GDP per capita: Canada vs. the U.S.



Why the divergence?

Since the US housing bubble burst in 2008, household finances between our countries have moved in opposite directions. Americans paid down debt, Canadians took on more. Our mortgages, home equity line of credits, and credit card balances have all expanded like my waistline during the holiday season and like my belt, Canadians’ household finances are tighter than ever.



Just as hard as it is to climb a mountain carrying a heavy knapsack of rocks, our extra debt is dragging us down and as interest rates have risen, the carrying costs of our debt have become progressive heavier. Each month many Canadians are dealing with mortgages that have come up for renewal and for most, at much higher rates. In the US they enjoy the luxury of mortgages that are locked-in for the entire term, typically 30-years and do not experience our pain. Close to half of Canadian households are \$200 away from an inability to cover their bills and 30% are not able to meet their current obligations now.¹. The only alternative left to Canadian consumers is a massive cut back in their spending which would be devastating to the main driver of our economy, consumer spending.

Falling Rates

The mission for central banks in 2022 and 2023 was to tame inflation. After reaching 50-year highs, central banks responded by increasing rates and they went way up, and fast. Some countries felt the pain much more than others and as one of the

¹ <https://www.sudbury.com/beyond-local/two-thirds-of-canadians-desperately-need-interest-rates-to-go-down-mnp-survey-9255210>

most indebted countries in the world², Canada was one of the worst impacted. With inflation slowing in 2024, central banks can now focus on the battered consumer, and in Canada they are more in desperate need of help than our local hockey team.

The Rate Cuts

With the precarious situation for Canadian consumers, the Bank of Canada (BOC) has been *the most aggressive central bank in the world in reducing rates*. In the past seven months they have reduced rates by a total 175 basis points and their last two interest rate reductions have been, HUGE **50 basis point interest rate cuts**. This is a bigger deal than trading both Elias Petterson and JT Miller from the Canucks. The Bank of Canada has only ever used back-to-back interest rate cuts of 50 basis points during times of extreme financial stress such as in early stages of COVID in 2020, and in the Financial Crisis in 2008. It is obvious that the BOC believes that if they do not take action to help consumers, there would be severe consequences for our economy. Unfortunately, their drastic rate cut campaign has the negative side effect of causing our dollar to collapse against other currencies, with the Canadian dollar dropping to five-year lows against the USD.

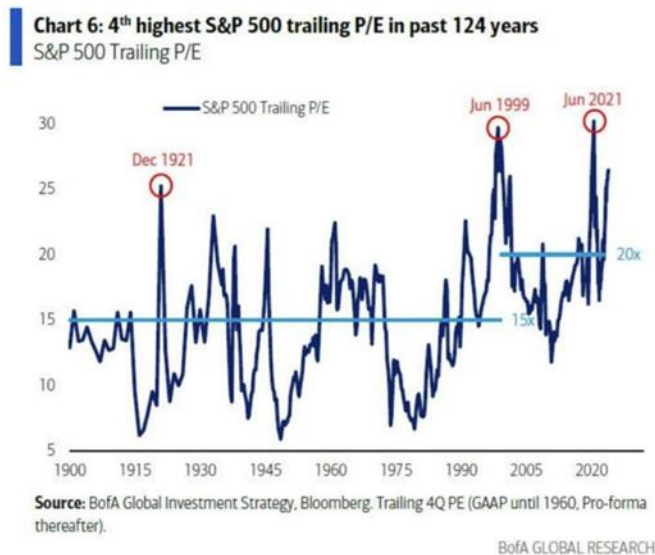
A Year in Review for Markets

Markets look a lot different at the end of 2024 than they did at the beginning of the year. Market expectations are changing from predicting how fast and high interest rates will rise, to now guessing how far and fast they will fall, resulting in equity markets rebounding to the point where valuations in some countries have become troublingly expensive.

	01-Jan-24	31-Dec-24
	Trailing P/E Ratio	Trailing P/E Ratio
US - S&P 500	23.9	27.8
Canada - S&P/TSX	14.2	18.4
Europe - FTSE Developed Europe	14.5	16.1
Government of Canada Overnight Rate	5.00%	3.25%
Prime Rate	5.50%	4.50%

*Current P/E Ratio - <https://worldperatio.com/>

A Look into the Future

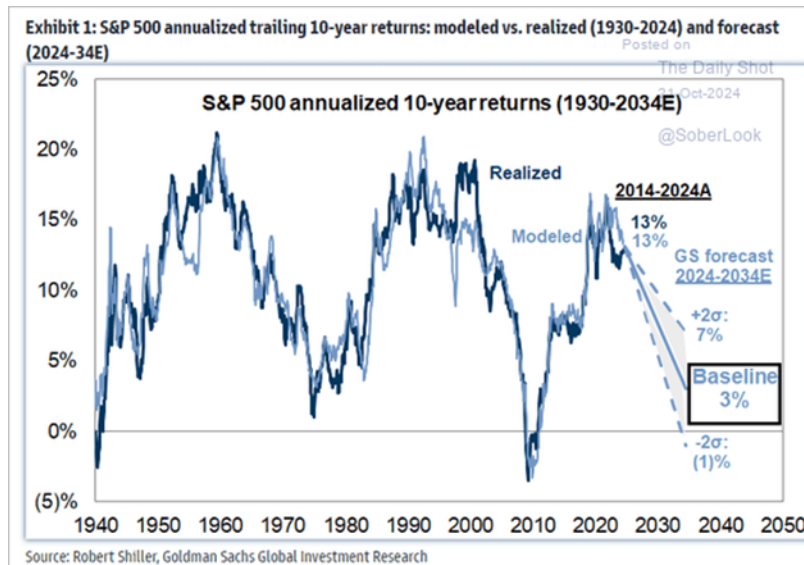


One of most widely used metrics to analyze markets and investments is the Price to Earnings (or P/E) Ratio. It tells us how much we pay for each dollar of a company’s earnings. For example, a P/E Ratio of 15X means we are paying \$15 for every one dollar of earnings a business generates and 15X is right around where the average P/E ratio was for US markets from 1900-

² <https://betterdwelling.com/canadian-households-now-the-third-most-indebted-in-the-world/>

2005³. Today the P/E Ratio for the S&P 500 is around 27X, and from the chart above it currently sits at the fourth highest valuation in the last 124 years. That's as pricy as the \$12 beers at Roger's Arena.

Goldman Sachs recently came out with their predictions for the S&P 500 for the next decade. Based on current valuations they expect the S&P 500 to return around 3% per year⁴. Investors buying into the S&P 500 today who think they will get the 13% annual returns of the last decade will be more disappointed than the kids who hoped for a white Christmas this year. Future returns in the world's largest stock market look as promising as the text you received telling you that you have a massive tax refund and if you just fill in your banking information....



The US Election

President Trump emerged as the winner of the 2024 US Presidential Election, and he continues to build on his agenda from his last term. He wants deregulation to make it easier for businesses, reduction of the size of government, lower taxes, secure the border, and protect strategically important US industries through tariffs and/or other means as well as have all the pending charges to be dropped against him.

To stop the flow of illegal drugs and immigrants Trump has threatened 25% tariffs on imports from both Canada and Mexico unless they secure their borders. A 25% tariff on our exports would be the death blow to Canada. Almost 80% of our exports go to the US⁵ and a 25% tariff could shave another 2.4% off our already weak GDP⁶.

Putting It All Together

Investors have a lot to worry about. A weak and faltering Canadian economy, a tapped-out consumer, potential tariffs, high stock market valuations and political uncertainty in Canada...as a quote from Wizard of Oz goes: "Lions and Tigers and Bears...Oh My!" What should investors do?

Over the past year we "followed the yellow brick road" of disciplined portfolio management and have taken many steps to adjust portfolios to minimize these risks and set our clients on the right path for the next decade.

Fixed Income

In our fixed income we have made large reductions to our preferred share exposure over the past year. During the turmoil in 2022, preferred shares had represented one of the best bargains. Yields were the most compelling they had been in decades,

³ https://en.wikipedia.org/wiki/Price%E2%80%93earnings_ratio

⁴ <https://www.msn.com/en-us/money/markets/goldman-predicts-a-paltry-3-return-for-s-p-over-the-next-decade/ar-AA1sAZ2B>

⁵ <https://www.fasken.com/en/knowledge/2024/12/les-impacts-de-la-victoire-de-donald-trump-sur-le-canada>

⁶ <https://economics.td.com/ca-trump-tariffs>

and it was a great time to take advantage by increasing our exposure to them, gaining dividends of 10% or more for our clients.

However, we were not the only ones to recognize this opportunity, the companies who issued them did as well. They were paying investors super expensive yields and realized they could lower their borrowing cost by buying back their shares at a premium and replacing it with cheaper forms of debt. That is exactly what they did. In 2024, \$7 billion of the \$70 billion preferred market was redeemed. As a flurry of redemptions occurred, prices for preferreds moved higher with many trading near their issue price so they no longer offered much more upside. Preferreds have been one of the best performing fixed income assets in 2024 providing investors with over a 24% return⁷, now with less upside and more downside at the end of the year, we are taking profits and reducing our position.

ICE BofA U.S. High Yield Index



Source: ICE BofA Indices

Another area in our fixed income positions where we have been taking profits are in high yield bonds. There has been tremendous demand from institutional investors for bonds in the past 12 months and limited new supply to meet it. Investors had to accept smaller and smaller yields for their bonds as their prices rose. The chart above shows high yield spreads over the past 3 decades. The best opportunities and yields occur when spreads expand or peak like they did in 2002, 2009, 2011, 2015, 2020 and 2022. During these times companies needed to offer more attractive terms and higher yields to encourage investors to lend to them. Today investors lining up to buy bonds have caused yields to compress to the point where interest rate spreads for corporate bonds now sit at the lowest they have been since 1998 and in high yield bonds, the lowest since 2007⁸.

Last quarter we highlighted the threat of long-term inflation. Government spending and deficits have continued to grow. Canada blew past their promise to finish the 2023-2024 fiscal year with a deficit of \$40.1 billion, instead closing with a final bill for \$61.9 billion or 50% higher. Governments today are happy to write cheques and leave future generations to pay. Over the next decade, under President Trump the US is expecting to add another \$7.5 trillion to their deficit⁹. Higher long-inflation is an increasing risk as government debt continues to grow and there are significant risks in some areas of the bond market. During the last inflation surprise in 2022, long-term US treasury bonds with maturities of 20 years and more, fell by 35%¹⁰.

To protect against the risks of long-term inflation we avoided bonds carrying the most risk such as long-dated bonds. Instead, we have been focusing on short-term bonds with higher yields and have been adding US Treasury Inflation Protected Securities (US TIPS) to portfolios in the form of an ETF symbol QTIP, not to be confused with the multiuse cotton swab of the same name. US TIPS do not have fixed interest payments like most bonds but adjust their interest rates to inflation on a regular basis. If inflation climbs to 10%, our return also adjusts by the same amount.

These changes have positioned the fixed income portion of our portfolio to take advantage of the run up in certain areas of the bond market, be more conservative in the face of tighter corporate bond spreads, protect against long-term inflation and retain the flexibility to be proactive and take advantage of future volatility and opportunities.

⁷ Based on iShares S&P/TSX Canadian Preferred Share Index ETF <https://www.blackrock.com/ca/investors/en/products/239836/ishares-sptsx-canadian-preferred-share-index-fund>

⁸ <https://www.reuters.com/markets/us/us-high-grade-corporate-bond-spreads-lowest-since-1998-after-trump-election-2024-11-08/>

⁹ <https://www.wsj.com/politics/elections/trump-plan-boosts-budget-deficits-by-7-5-trillion-double-harris-proposal-526efd2>

¹⁰ <https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf>

Equities

We made several changes in our equity holdings over the year. Some areas of the market are very expensive while others are surprisingly cheap, kind of like walking through Best Buy on Boxing Day. Opportunities have arisen in areas of the market where no one is looking, "...yes Dad, I am sure you will find a unique rock if you climb out over that 1000-foot ravine, but I don't think anyone has tried it... ". We have been reducing our exposure to the most expensive areas of the market such as the overvalued mega-cap stocks and have been shifting into sectors which are better valued, specially the small and mid-cap space. These sectors, like our preferred shares on the fixed income side or like the vegetable options at All-You-Can-Eat buffets, have largely been ignored over the past several years. But like the preferreds in 2022, the small and mid-cap stocks are offering bargains as the valuation gap between large cap stocks and the small and mid-cap space have expanded to the widest we have seen in 25 years. Another point in their favour is that small caps have historically outperformed when central banks start cutting rates¹¹.

President Trump's agenda of pro-growth, domestic-focused policies, and tax cuts supports American small and mid-sized firms much more than larger US companies. Smaller and mid-sized companies have 70-80% of their revenues and sales generated from within the US while larger companies have only about half their sales from the US¹². During US election in November, small cap stocks surged 11%¹³, trouncing the 6% return of the S&P 500 as investors started to turn their eyes to these companies with the election of Trump. These companies are cheap and are well positioned for the future.

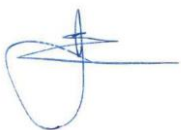
Canadian and International companies also look quite compelling. For years we have been avoiding companies that are tied to the health of the Canadian consumer due to their mounting debts. Instead, we have been overweight areas such as energy and insurance. International markets are also quite attractive trading at much more modest valuations, especially relative to their US counterparts.

In our equities, we plan to continue to rebalance and move out of the areas with limited upside and add to positions that have much more potential over the long term.

Canadians are drowning in debt. This will be a huge headwind for the Canadian economy and has already suppressed growth. Consumer spending is collapsing, employment is weak, and it will be difficult for Canada to grow at the same pace as other economies. The average Canadian has a backpack full of rocks and they need to shed the weight so they can continue climbing. It will be a long and likely painful process.

My dad has the same problem, he has too many rocks. He is now running out of places to store them, but he is considering building a rock wall between his house and his neighbour (who happens to be American). However, I think he has come up with another plan. I received a rock from my dad for Christmas. Apparently, my brother, my sister and my nephew and niece also got rocks. I thanked him and plan to regift it to my mom next year.

-Kind regards,



Joshua Brown, CFA
Portfolio Manager



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¹¹ <https://www.mackenzieinvestments.com/en/institute/insights/monthly-economic-update-november-2024>

¹² <https://www.hermes-investment.com/uk/en/institutions/insights/macro/us-small-caps-surge-on-trump-rally/>

¹³ Total November Return of the Russell 2000