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Skeat Private Wealth

The Bobb Report

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Major Paradigm Shift Creates a New Normal

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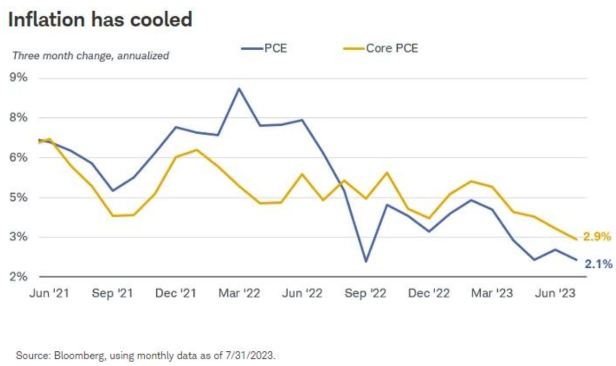
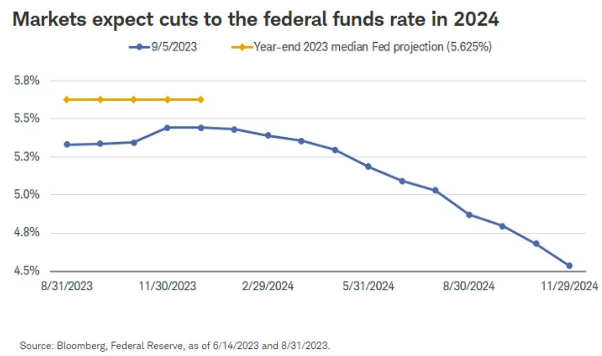
A historic spike in interest rates, 'Quantitative Tightening', surging oil prices, economic softness in China and a U.S. consumer that appears poised to buckle, certainly paints the picture of an economic slowdown. Can this slowdown be aptly offset by a shockingly resilient economy, inflation on a slow path to the Federal Reserve's target, interest rates on the verge of peaking, and the sudden emergence of Artificial Intelligence adding fuel to the early stages of a productivity boom? It is very difficult to reconcile the opportunities and challenges we are evidently facing as it feels much like we are balancing at the center of a teeter totter which will fall one way or the other. The pervasive view has suddenly shifted away from the 'no recession' scenario, but we must be mindful not to extrapolate too much from the fears that grip the market every October like clockwork, as they usually lead to a short-term low with a powerful rally into year end. The end of the third quarter brought with it the typical September setback largely on the back of suddenly much higher longer-term bond yields, which may yet to have finished their assent and could lead to a final leg of this correction over the coming weeks. It does feel like we are nearing a capitulatory bottom as tremendous long-term opportunities abound. While all of this is important short-term, perhaps we are focusing our attention on the wrong things. Our obsessive consideration for short-term macro factors may not be the best use of our time as they rarely drive the market narrative beyond enhancing short-term volatility. If we shift our focus to the notion that the economy always has and will evolve over time regardless of macro concerns, would it not be more productive to dedicate our attention to finding the strongest and most consistently growing companies that will persevere in times of economic weakness and thrive as economic evolution transpires over time? For those with a longer-term view the short answer seemingly has to be yes. Having said that, there is a major paradigm shift underway in the markets that cannot be ignored as the era of free money, near zero interest rates and government stimulus has come to an end and we must consider the implications carefully.

Let's focus our attention on what is currently driving the market action which is no longer inflation and short-term interest rates, as it has been for some time. What is driving the market now is the rapid spike in longer-term rates over the last couple of months. The recent spike in long rates validates the overly opined 'higher for longer' narrative; however, the market is now extrapolating this to mean higher for much longer. One thing that appears certain is the era of free money and ultra low interest rates is over, and for those hoping rates are not going back to where they were. This does not mean they won't start to decline next year and settle somewhere in between where they are and where they came from. In fact, US Treasuries are on pace to record a third year in a row of declines, something that has never happened in the history of the US Republic, as per Bank of America, using data back to 1787. Inflation is moderating quickly across all fronts, in spite of a few year-over-year data points that imply the contrary. Short rates should come down but will long rates remain stubbornly high? To solve for this, we need to understand why longer rates have pushed so much higher. The reasons for this move are both systemic and profound and unlikely to fully reverse course for quite some time. A recent article from strategist Larry Swedroe describes these various factors in a thoughtful way. For the sake of brevity, I will list them without providing too much context:

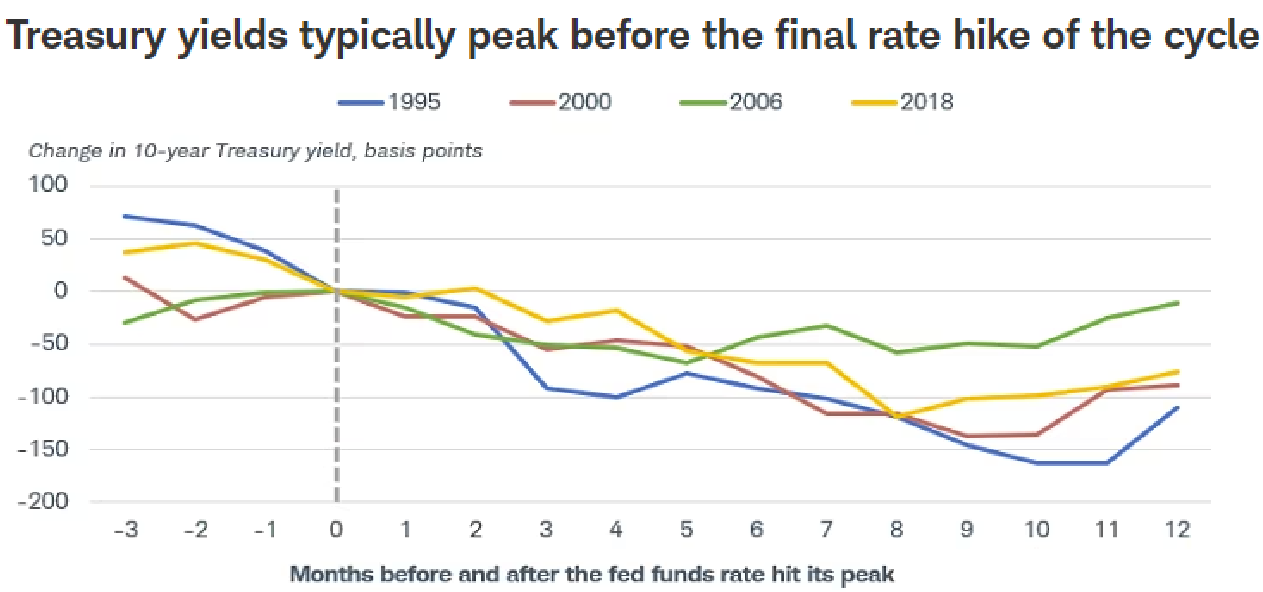
1) The move from Quantitative Easing (QE) to Quantitative Tightening (QT) is allowing the Fed to repair and reduce its swollen balance sheet, which is a good thing, but is draining liquidity from the system thereby pushing yields higher.
2) The 'BRICS" countries are actively reducing their holdings in U$'s as a reserve currency. To do so they are selling Treasuries which pushes yields higher.
3) US banks are very large holders of Treasury Securities, and the commercial real estate crisis is causing capital issues for these banks causing them to be forced sellers of Treasuries to raise capital, pushing yields higher.
4) Despite QT, the US government is engaging in massive fiscal stimulus with the CHIPS and Inflation Reduction Act, during a time of economic strength and full employment, leading to a massive budget deficit that in short must be financed by higher rate debt issuance.
5) The fiscal deficit has led to a downgrading of US credit rating which again pushes yields higher.

6) Japanese Yield Curve Control is ending, which had previously suppressed bond yields in Japan and created significant demand for higher-yielding US Treasuries.





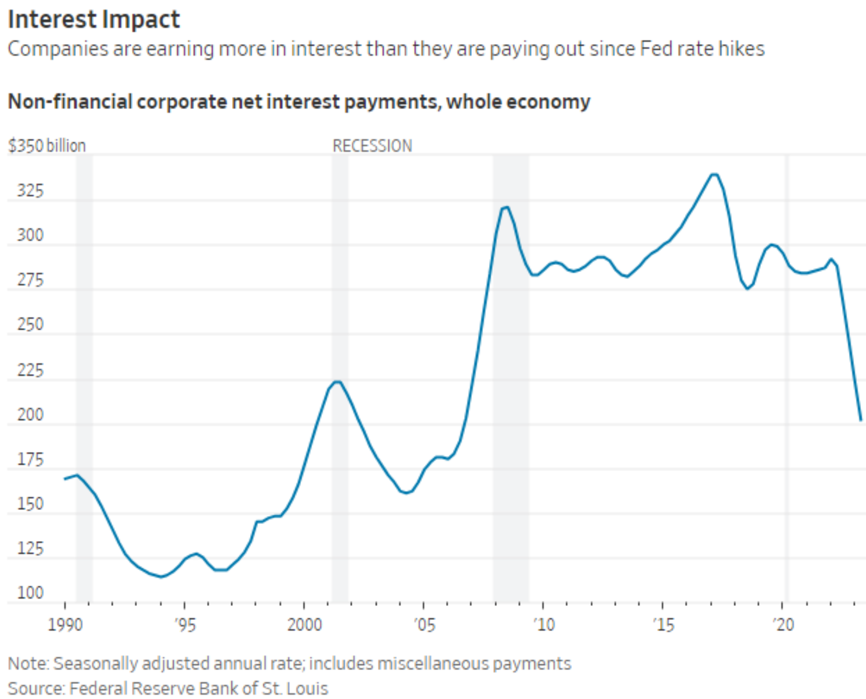
OK, that was a lot, so what does it all mean? This paradigm shift is real and interest rates are going to remain higher for longer as discussed, though perhaps not as high as the ever-panicky October markets are pricing in. 10-year yields tend to peak just prior to the last interest rate hike and then trend lower. Should this occur the expectation is for a 15% return for 10-year Treasuries in the coming 12 months. Thus, if we are to embrace this new normal, how then do we position our portfolios?



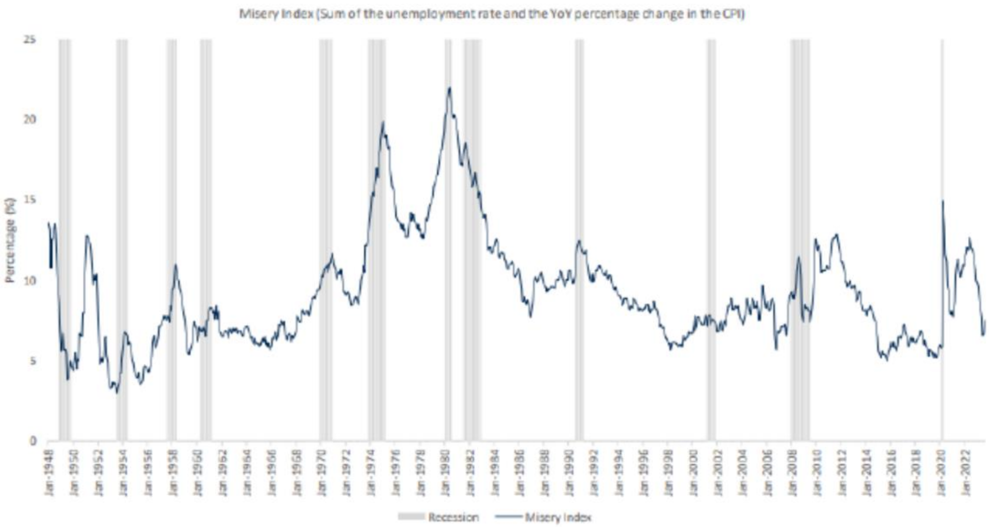
Source: Schwab Center for Financial Research, Bloomberg, as of 9/6/2023.

While focusing our attention long-term is all well and good, we must consider this profound shift in the market backdrop that may alter our expectations going forward, that of a broader normalization phase after years of free money driving all asset prices higher. Over the last 18 months we have seen the end of QE, which provided a support function to asset prices when volatility did arise. Not only has QE ended but the Fed has moved in the opposite direction towards Quantitative Tightening (QT) in an effort to repair its balance sheet, after first supporting the economy during the financial crisis and more recently during Covid. Over the last 12 months the Fed has reduced its balance sheet by $1Trillion. The Fed still has a long way to go to get back to square, which does lead to enhanced volatility in the market, but overall this should be seen as a good thing, as the Fed recharges its coffers for the next time they are required to intervene due to crisis. This return to long-term normalcy for the economy, interest rates, earnings, valuations, and Fed policy does imply a more muted return profile for most asset classes. Once the current extremes abate and a new equilibrium is found, I would expect equity returns in the 8-10% range and bonds in the mid-single digits along with a moderately enhanced volatility framework. We should set our expectations accordingly.

For the moment, consider the competing economic narratives given that this is top of mind for most investors. There is no question that while surprisingly resilient, the US economy is starting to slow and there are no shortage of recessionary indicators flashing yellow and red. While these indicators generally imply the long-awaited recession is on the horizon, this outcome is not a certainty. The economy has massively outperformed expectations, the US consumer should keep spending as long as employment remains robust and believe it or not, due to the strongest balance sheets in history, corporate net interest payments have actually declined as interest rates have risen – the opposite of what would typically be expected.



While RBC expects a short, shallow recession (not the end of the world by any means), Jan Hanzius, Chief Economist at Goldman Sachs says 'no recession' taking his odds of one down to 15% which is consistent with a normal environment, from 35% last March. As a reminder, GDP is primarily made up of government spending + business investment + consumer spending, along with net exports. While many things to consider economically, the biggest piece of the puzzle hinges around the US consumer which, as mentioned previously, represents more than 70% of the US economy. Americans love to spend and that isn't going to change. What is changing is the depletion of $3 trillion of excess savings from Covid relief plans, rising costs of living, and surging oil prices. To put a cherry on a not-so great sundae, the resumption of student loan payments, which were put on hold during covid, will clearly impact the consumer. Government spending is also challenged with higher interest rates causing the need to direct substantially more of their budget towards servicing the debt. Businesses are also cutting back on spending and layoff announcements are gaining steam. The one bright spot here is a loosening of the incredibly tight labour market which is a critical inflation indicator for the Fed. This has led to a reprieve in the economic misery index, for the moment, which has rolled over aggressively as per the chart below. It seems hard to fathom, mind you, that we will not have a meaningful slowdown over the next couple of quarters and into early 2024, but with any hope a recession can be avoided.

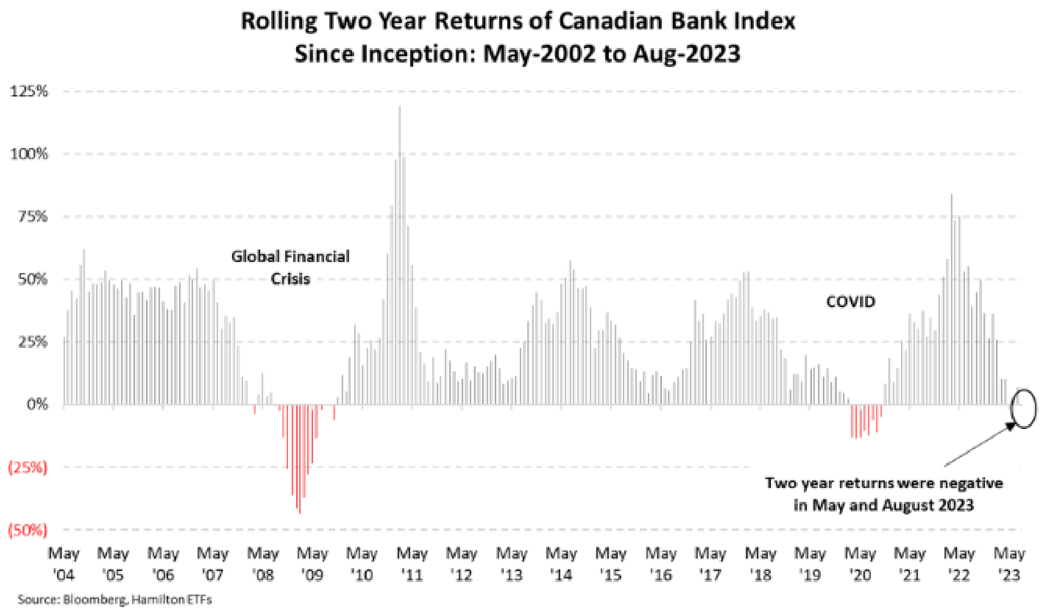


Source: PAG

The Fed may still hike rates one last time in November although consensus is building to the contrary and rightly so. The good news is rates are at or near a peak, they will then flatten and eventually start to decline and that is when the real fun begins for the market. There is little the markets like more than declining interest rates and for the first time in years meaningful declines from current rates are a possibility. In the very short-term the indicator to watch is the yield on the 10-year US Treasury which has rallied aggressively leading to the market softness over the last few weeks. Quite simply, it is at a dangerous level and needs to stop going up. Should it push up near the 5% level, which is not far from here, it could trigger a significant, short-term October selloff which is not uncommon and won't feel very good. Whether this arises or not, if we believe the Fed is finished raising rates which I suspect is the case, history suggests that stocks will bottom imminently, implying that we should be accumulating stocks and not selling them. Prepare yourself for some difficult days this month, but keep in mind that if a final setback in this already very oversold market does transpire, it is very likely to be short-lived. From a seasonal perspective, the best period of the year is typically from the October low into springtime so we are getting there, and the world will look much better in the coming weeks and months.

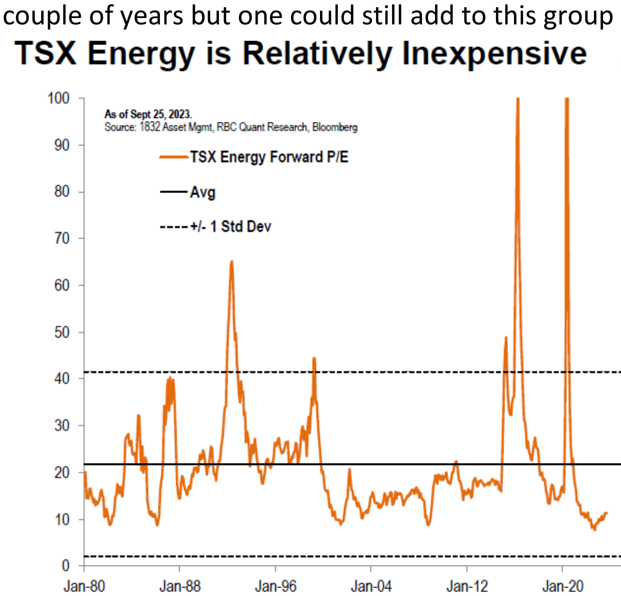
By way of a base case, the US economy looks reasonably stable for the balance of this year with growth expectations for the next two quarters in the 3-4% range. Slowing but still surprisingly strong underlying economic growth, declining inflation and monetary tightening nearing its climax should help to offset some of the expected spending declines noted above. A meaningful rebound in productivity, even without help from AI, from multi-decade low levels in 2022 should also allow for a balanced narrative. For the time being this is a reasonably favorable backdrop for risk assets such as equities and fixed income. Strong businesses with low debt levels, high profit margins, above-average earnings growth and ideally rising dividends should be the order of the day. This is not a new theme but rather one that appears particularly poignant in this environment. While not nearly as flashy as the AI and tech stocks, it should be noted that our beloved Canadian, blue chip dividend stocks have been absolutely pounded by this recent spike in interest rates making them look particularly attractive, though the 10-year yield will likely dictate the bottom, which may not be in just yet. There have been few times in my 30 years in the investment business in which the valuation and yield profile of these excellent companies look as compelling from a longer-term investment perspective as they do at present.

Take the Canadian banks for example, there is no question that they are facing a challenging environment on many fronts, but this has largely been reflected in their depressed prices. The historic trading range is 10-14x earnings, and they are currently below 9x; and are at or below the low end of other metrics like price to book. Over the last 20 years, when our banks are down for two consecutive years, they were up on average 40% over the subsequent 12 months, with the 3 instances of major crises still providing a +15% return over the following year.



The Utilities sector, while not exciting, is particularly interesting at present. Defensive utilities tend to be a safe haven in times of volatility but they are interest rate sensitive so this has not been the case of late. In fact, this is the first time in history in which the S&P has corrected 6% and the utility sector has underperformed that index by an additional 10%. Consider building positions in the better companies in this group.

Despite the recent runup in Energy, from incredibly oversold levels, the energy sector is sitting at the low end of its historic range, boasting rapidly rising cash flows and dividend yields which are averaging north of 5% for the group, and rising. We have had exposure here for the last couple of years but one could still add to this group quite comfortably.



Source: Dynamic Funds 09/29/2023

Lastly, the high quality, 'profitable' Technology and Communications companies, in spite of all of the chatter about overvaluation and bubbles (they are nowhere near bubble territory for the record), possess ideal businesses and balance sheet structures for this environment. These companies, for the most part, do not need to borrow money which is a major strain for others at present. Further, most have massive cash hoards which they are now earning substantial returns on post the spike in rates. Couple this with falling valuations, improving fundamentals, and with the secular trend in AI still in its infancy and you have a very solid macro backdrop. The recent setback in these companies at least provides a decent entry point for those that need incremental exposure. There may be a little more volatility for this group but add on any weakness.

In short, as Confucius says, 'life is very simple, but we insist on making it complicated'. Sentiment is near trough levels, there is $5 Trillion of cash on the sidelines which is growing by the day, inflation is falling fast, interest rates should reverse course some time next year, stocks are very oversold and earnings estimates are actually ticking higher for the moment. Most importantly, our oft referenced M2 Money Supply has seen its rate of change bottom over the last few months which historically has always led to a multi-year rally in stocks. We may have a little more to go in this tightening cycle, but we are much closer to the end than the beginning. Increasing exposure to Canadian banks and energy stocks, pair this with large-cap, 'profitable' tech and communication services, nibble at a bit of fixed income at current yields to add some ballast, and you have the makings of a very productive portfolio going forward. An overall, tax-efficient portfolio yield north of 5% as we wait for the resilient economy to work through its challenges, for stocks to recover significantly, and interest rates to find their new equilibrium, and this is quite simply not a bad place to be. In fact from current levels, it is an excellent place to be for investors looking out a year or two. I should note that it is unfortunate that this historic spike in interest rates has had the greatest impact on the most conservative, yield driven portfolios for those who are less comfortable with volatility, but as rates finally stop going up these portfolios should experience a slingshot effect that will surprise most in a positive way. Investing in the markets takes patience, persistence, perseverance and at times courage and this is one of those times. We have all experienced many of these difficult periods before and we always come out the other end much stronger than we went in, and this time will be no different. Further, we have always been rewarded for owning the highest quality businesses long-term and leaving them alone such that their consistently growing earnings drive the stock prices ever higher over time, regardless of the noise. We are experiencing an aggressive and challenging bump in the road that we must endure but that is all that it is. The proprietary process we use at Skeat Private Wealth has led us through all types of markets, good and bad, with excellent results and it will again. We may have to draw on our patience and perseverance over the coming weeks and perhaps months, but we are getting paid handsomely while we wait for the markets ascent to resume.

Sincerely,

Bob Skeat, CIM, FCSI, FEA

Skeat Private Wealth

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