

Robert Wm. Skeat, CIM, FCSI,  
FEA

Senior Portfolio Manager and  
Wealth Advisor  
416-842-7075  
[robert.skeat@rbc.com](mailto:robert.skeat@rbc.com)

Angel Tang, CFP, CIM, FCSI  
Associate Portfolio Manager &  
Associate Wealth Advisor  
416-842-7032  
[angel.tang@rbc.com](mailto:angel.tang@rbc.com)

Adelle S. Léger, CA, CPA, CFP  
Wealth Planning Specialist  
[Adelle.leger@rbc.com](mailto:Adelle.leger@rbc.com)

Lindsey McLaughlin, CIM  
Senior Associate Advisor  
416-842-3394  
[lindsey.mclaughlin@rbc.com](mailto:lindsey.mclaughlin@rbc.com)

Daria Kazhdan  
Associate  
416-842-7030  
[daria.kazhdan@rbc.com](mailto:daria.kazhdan@rbc.com)

Ksenia Naboka, CFP  
Wealth Associate & Financial  
Planner  
416-842-2110  
[ksenia.naboka@rbc.com](mailto:ksenia.naboka@rbc.com)

RBC Dominion Securities Inc.  
181 Bay Street, Suite 2200  
Toronto, Ontario M5J 2T3

Toll-free: 1-800-561-4468  
Fax: 416-842-7799  
Website:  
[www.skeatprivatewealth.com](http://www.skeatprivatewealth.com)

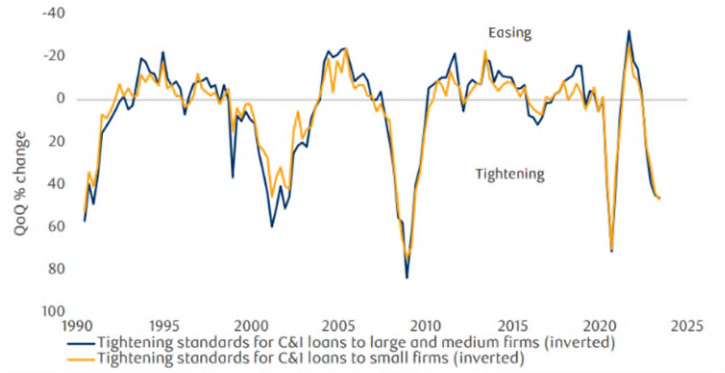
## 50 Shades of Grey

The markets, or parts thereof, have been surprisingly strong over the first half of 2023 defying near-record skepticism and cash levels that have been in place over the last few months, providing a stern reminder not to try to time the markets. While we continue to await the most anticipated recession in history the economy has held up surprisingly well thus far in the face of historic monetary tightening. Conflicting economic data, corporate earnings, market narratives and opinions abound no matter where you look. How do we reconcile this non-binary environment to create a plan and position ourselves for such a variety of potential outcomes? The answer may not be as difficult as it sounds for a host of reasons. The short-term is murky as we await the full economic impact that always lags changes in interest rates, let alone the unprecedented series of hikes over the last 18 months. It is very difficult to consider such tightening without some period of economic contraction which I suspect we will see in the coming quarters. The resiliency of the economy however seemingly suggests the looming recession may be of the short shallow variety, with some touting the possibility of a 'soft landing', meaning no recession at all. With so much uncertainty remaining and a surprisingly strong first half of the year market wise, I have little doubt that some downside volatility will present itself between now and the fall which should provide excellent opportunities for long-term portfolio positioning. Further, delving deeper into the history of market behavior after two quarters of negative GDP growth (i.e., Recession), you may be surprised at just how positively and profoundly the markets respond to interest rates declining and recessions coming to an end. Further, post-recessionary markets tend to embrace a more balanced, less narrow subset of market drivers providing opportunities across many markets, styles, sectors, and companies. While a bit of pain may lie ahead as we rip off the Band-aid from these rate hikes, the frustrating sideways market of the last two years has provided for a major market reset in which a compelling, broader set of opportunities will present as we commence the next economic cycle. We have already started to position portfolios for this outcome and will continue to as we work through the remaining bumps in the road.

So why the confusion? Leading economic indicators (LEI's) have been declining steadily since late 2022, the ISM manufacturing index ticked below 50 which is consistent with recession, significantly tighter bank lending standards are pressuring businesses and consumers alike, demand for home loans has collapsed and even the incredibly tight labor market is showing signs of weakness with jobless claims on the rise. Further, the new order component of the ISM manufacturing survey has declined for 9 consecutive months, its longest streak of declines since the Great Financial Crisis (GFC). Couple this with 13 straight months of money supply contraction (M2), a widely watched indicator for the future direction of the economy and inflation, and a twenty-fold increase in interest rates which the world is not set up for, particularly as mortgages mature, and it is rather difficult to paint a rosy picture for the macro backdrop.



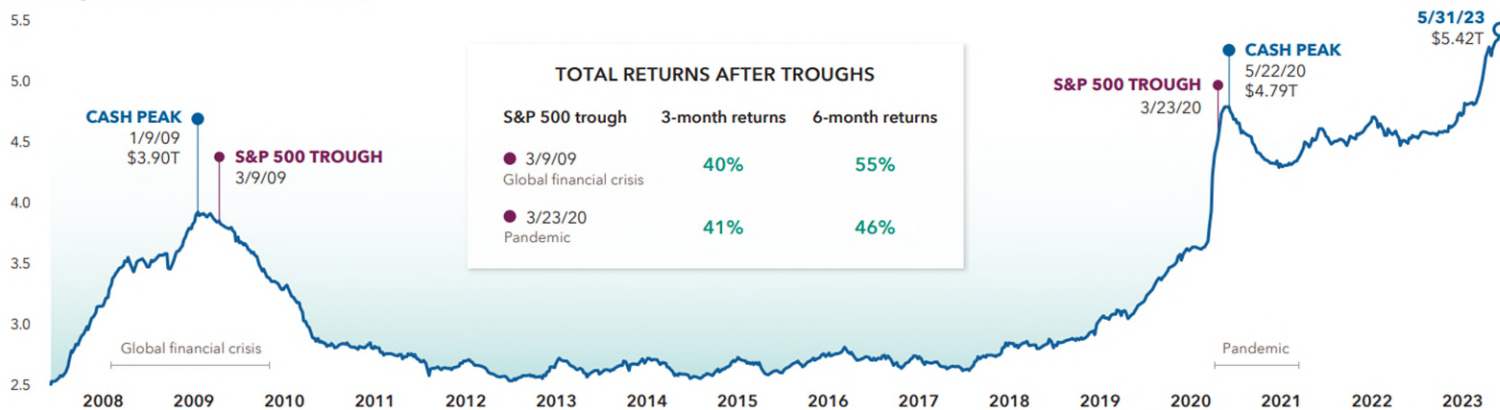
**Exhibit 4: Senior loan officer survey on bank lending practices – Number of banks reporting tightening standards for C & I loans**



Note: As of Q2 2023. Source: Federal Reserve, Macrobond

Perhaps there are a few things on the other side of the ledger that might provide some hope. Declines in Money Supply lead inflation by about 16 months so while inflation has already come down from almost 9% to 4%, the path to 2-2.5% appears to be in place. Wage inflation is moving back to more normal levels, down 50% from its peak, as the labor market begins to soften, taking pressure off the Fed. Consumer spending remains robust, although the covid-induced excess savings is dwindling rapidly. Both household debt (ex-Canada) and corporate interest coverage ratios are in far better shape than is customary at the onset of a recession. In March, investor sentiment hit levels of pessimism not seen since the GFC which is truly a contrarian indicator, although it is reversing quickly. This has led to record cash on the sidelines to the tune of \$5.5 trillion. If you strip out the ‘magnificent 7’ stocks from the S&P which have almost solely combined to provide the market’s gain year-to-date, stocks around the world are cheap and well below long-term fair value metrics. This is consistent with return expectations in the high single digits for the years ahead. Further, stock markets love the prospect of inflation and interest rates declining, which is on the horizon for early 2024, as these declines reignite economic activity allowing for price/earnings multiples to expand. Market breadth is starting to broaden globally, and by sector, which is critical to sustain this advance. Corporate dividends are on the rise globally with around \$2 trillion dollars distributed in the last year and an expected dividend growth rate averaging 7-9% for the next few years. In short, looking past the expected economic weakness that is largely priced in, a very constructive backdrop awaits as a new cycle emerges which it inevitably will.

ICI Money Market Fund Assets (USD trillions)

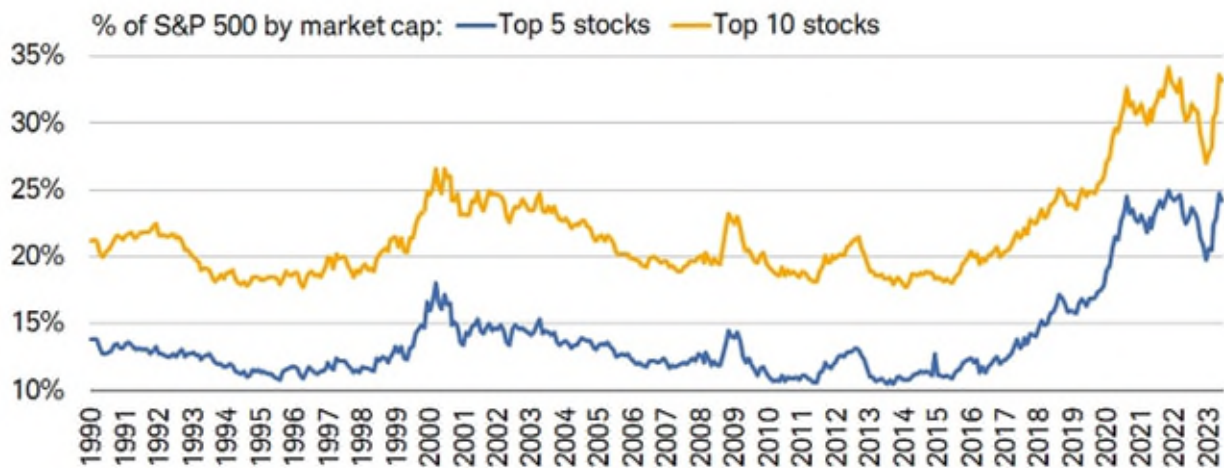


Sources: Capital Group, Bloomberg Index Services Ltd., Investment Company Institute (ICI), Standard & Poor’s.

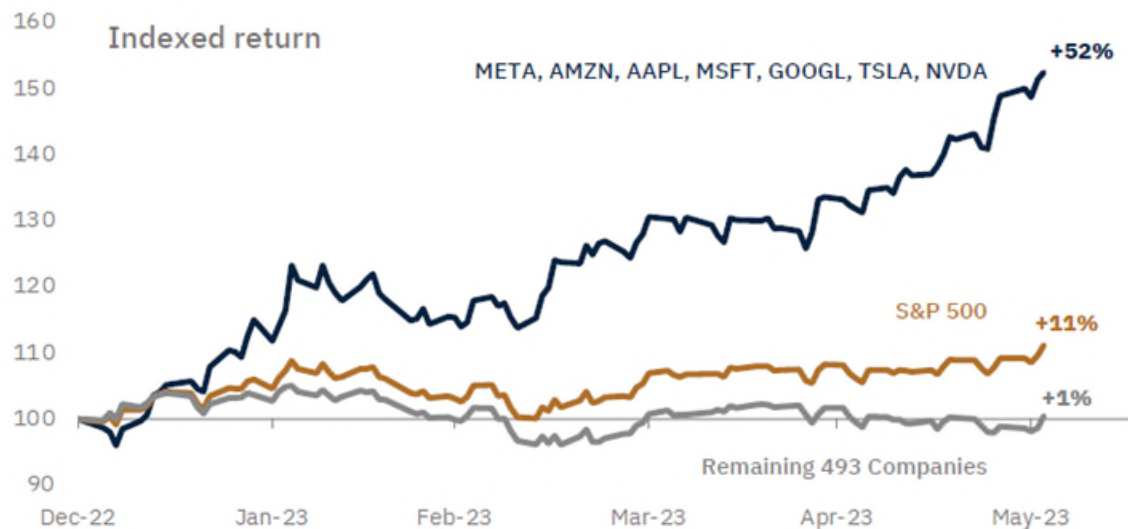
Any discussion around dividends would be incomplete without considering our home market in Canada, which has been a dreadful performer year-to-date, save for a bounce into quarter end. With the TSX dominated by financials (reacting to the uncertainty around SVB et al) and energy (the worst performing sector of 2023 after leading the markets last year), it has most certainly been a drag on overall portfolio performance. That said, the pressure on these sectors and others has pushed dividend yields of many extraordinary companies to levels not seen in quite

some time. To take this one step further, not only are yields compelling on many of Canada's best companies, in the 4-7% range, but most of these dividend payments grow every year, compounding at mid-to-high single-digit growth rates. Take our beloved Canadian banks as an example, which are trading at a forward price/earnings ratio of approximately 9.5 times and boasting yields between 4.25% and 6.5%, which will rise from current levels, and you have a pretty good recipe for success. In fact, even if purchased at much higher valuations this group has outperformed the MSCI world index over the last 35 years by a large margin. The few instances in history when we have seen our banks trade at these levels always represent a compelling entry point and fit perfectly with our 'conservatively opportunistic' approach. Fear not, we have considerable exposure, which we always do, as we wait for these shares to return to more normal valuations.

With respect to the US stock market, concentration in a small number of companies is a major issue which will likely shape the return profile for the S&P index going forward. Our portfolios have unquestionably benefitted from our exposure to world-class franchises like Apple, Google, and Microsoft; however, there is a 'but' that we must consider. The top 10 stocks in the S&P 500 represent over 30% of the index market capitalization, which is even higher than it was at the peak of the dot com bubble, with the remaining 490 companies making up the balance. More importantly, virtually all the impressive advance year-to-date for the S&P index can be attributed to these names (Apple, Google, Microsoft, Amazon, Meta, Tesla, Nvidia) as the key drivers, with the remaining 490+ names providing almost no return at all as a collective. A look back at the history of such narrow outperformance generally leads to a long period of underperformance by the 'leaders' with the followers experiencing mean reversion and driving returns for years to come. It is difficult for our minds to reconcile the notion that a company like Microsoft, one of the best companies on the planet, took nearly 14 years from its peak in 1999 to make a new high in 2013, despite earnings growing impressively and steadily each year in between. Valuations matter no matter how good a company is, and we must always be mindful of this in our equity selections.



Source: Charles Schwab, Bloomberg, as of 6/9/2023.



Source: Bloomberg, Canoe Financial as at 06/02/2023 using market cap weighted returns.

In nearly every instance of such market cap concentration, it seems near impossible that these most extraordinary companies could somehow stop delivering the spectacular returns we have come to expect, but this is precisely what tends to occur. I am not referring to the demise of these companies but rather a major shift in performance drivers going forward. It may be premature to consider this, and market enthusiasm can always take trends much further than we can logically assume, but based on all accounts historically we should at least keep this concept top of mind. At the time of writing this note, we are finally seeing a broadening of market breadth to other stocks and sectors which is a very healthy sign for both the sustainability of this advance and to slowly alleviate some of the noted concentration. So, while we have no intention of abandoning our investments in these leading companies, where can we turn to position around them and take advantage of some of the less robustly valued segments of the market and find additional opportunities for growth?

Drivers of portfolio performance often come from unexpected places. Think back to April of 2020 when the price of a barrel of oil shockingly and briefly turned negative and nearly everyone on earth had abandoned anything oil related including all the energy stocks. In keeping with Murphy's law, maximum pessimism and market leadership often coming from the strangest of places, oil and oil stocks staged a massive resurgence representing the number one sector in the market for two consecutive years and the only positive sector in 2022, far outpacing technology stocks as interest rates soared. We must always be on the lookout for changes in trends and this was a prime example of a group left for dead. Looking forward, with interest rates having broken out of a 30+ year downtrend the macro landscape looks quite different. While interest rates should decline over time, as inflation continues to moderate, it seems unlikely that they will return to where they were, particularly with the economy holding up as well as it is, thus far anyway. Somewhat 'higher for longer' seems to be the prevailing interest rate theme at present and these trends tend to be longer-term in nature.

In terms of exploring new themes, the end of interest rate hikes (still pending) is expected to also bring to an end the incredible strength of the US dollar. Dollar trends are also typically very long-term and significant in nature with broad implications globally. The massive underperformance, until recently, of international equities over the last 10-15 years has seemingly come to an end and this is yet another trend that is most often measured in years not quarters, more commonly known as 'supercycle'. Dividend paying stocks and more importantly, dividend 'growers', always a core focus, should continue to see a significant resurgence both in Canada and around the globe. Fixed income and credit also represent interesting opportunities that have not been seen in well over a decade, so we are slowly, carefully adding exposure to these areas. As Howard Marks recently opined, and he is someone to listen to on the credit side, 'for the first time in many, many years the environment favors lenders over borrowers'. In short, under-the-radar opportunities abound and should act as a meaningful complement to our core holdings to drive portfolio performance through the next cycle.

**U.S. dollar index**

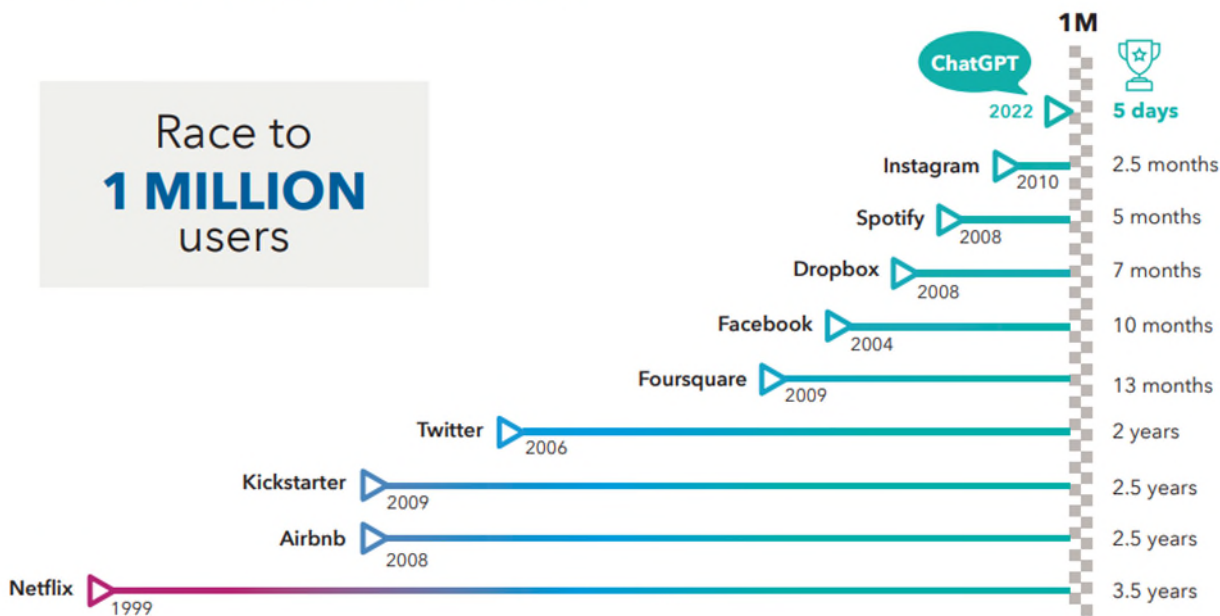


Source: Capital Group, J.P. Morgan, MSCI, Refinitiv Datastream, Standard & Poor's.

By way of a broad introduction to the recent phenomenon of Artificial Intelligence (AI), which we will undoubtedly be discussing and writing about for many years to come and with far greater clarity than today, this seemingly represents a major sea change in how we will live our lives and how business is done. AI is a 'general purpose technology' much like the internet, with broad-based applications and implications across the spectrum of life and business. Further still, the adoption of these new technologies such as ChatGPT, of which Microsoft has recently made a major investment, is exponentially faster than ever. ChatGPT set a new record passing one million users in the first 5 days of its existence, and approximately 100 million in the first 60 days.

**The adoption rate of new technologies is accelerating**

**Time for selected online services to reach one million users**



Source: Statista. As of May 31, 2023.

With applications that should span all industries and with an incredibly fast rate of adoption, this emerging technology is expected over time to lead to a major productivity boom which should help to spur economic and earnings growth globally. Technological advancements such as AI are deflationary in nature which should further help moderate inflation longer-term. For all the excitement over AI and the good that can come from it, it is not without its respective risks as the possibility for negative outcomes reside in the minds of those with nefarious intentions and with AI itself using logic to solve problems with no consideration for the repercussions of a given suggestion. The notion of trying to

regulate and govern a technology this profound is of great debate presently which will only ramp up as AI infiltrates our daily lives.

The recent excitement around AI has led to a major surge in technology stocks that have exposure, and many that are trying to portray exposure, leading some to suggest the tech-dominated Nasdaq is approaching 'bubble' territory, a term that is now thrown around with reckless abandon. While there is reason for optimism around this profound technology, I can say with conviction that these stocks will not go straight up and corrections will be vicious, typically arriving as enthusiasm climaxes. To date, the reaction which albeit has been lightning fast is not anywhere near the excessive nature of prior bubbles. For perspective, the Nasdaq trades at 30 times earnings today versus 100 times in 1999. While I too would have called the reaction in March and April premature, the profoundly rapid nature of adoption was at least partially validated when Nvidia reported a shocking \$5 billion earnings beat attributed solely to their industry-leading AI chips. The beat was so extraordinary that it led to the largest one-day market cap gain for any stock in history, while simultaneously allowing for a decline in the valuation of Nvidia, which is hard to fathom. My suggestion at present, which we are embracing, is to stick with the leading companies and avoid the newcomers that are jumping on the bandwagon and have little in the way of earning prospects. A look back to the late 90s when the internet came to prominence and many of the 'new' companies that were fueling this revelation are no longer in existence. Final thought for the moment, the US is the major driver of capital investment in AI at 54% of the total, with China a distant second at approximately 15%. Hmmmm...

In spite of so much excitement and optimism around AI, a surprisingly resilient economy and better than expected earnings; there is no shortage of things to concern ourselves with after a twenty-fold increase in interest rates that is yet to be fully felt. The prospect of recession remains a dark cloud on the horizon, and it is not uncommon for recessions to arise quickly and often out of nowhere. On the plus side, recently expanding breadth in the market provides a reason for hope with those in the 'bullish' camp suggesting the new bull market has commenced, and boy do I hope they are right. Since 1929, cyclical bull markets on average last 33 months and deliver a 141% total return, with 'secular bulls', which we may still be in, lasting far longer and providing dramatically higher total returns. For this advance to continue and confirm a new bull cycle we need economic growth to provide for renewed and sustained upward earnings revisions which seems like a tall order in the near term. It seems absolutely counter to the myriad of factors I would typically consider that we can escape the fastest, largest increase in interest rates in history without some meaningful economic pain; the jury is still out on this. Only time will tell how this narrative plays out and the resiliency of the economy thus far may have pushed out the final outcome further, but I can't help but question the notion that the Federal Reserve and their counterparts globally have perfectly negotiated a 'soft landing' for the economy as their track record of doing so is abysmal. The good news is, after such a strong first half of 2023, the odds that the market finishes this year meaningfully higher is very high based on precedent regardless of any potholes in the interim. In fact, when the index makes a new 52-week high after not doing so for 12 months (which occurred recently), the market has been up 15 out of 15 times for an average gain of 20% over the following 12 months. Further, should recession emerge all is not lost as some suggest. The history of the S&P 500 after two consecutive quarters of negative GDP growth, i.e., recession, is up 30% one year hence. There are indeed many shades of grey as we try to reconcile the current macro backdrop and how it will impact our investments short term, but it truly is not the short term that we should concern ourselves with. We know from history that the best course of action is to have exposure to equities and other quality assets and not overthink short-term challenges. Focus on owning the best companies in the world, which in most cases pay us ever-growing streams of income, while we wait for further evidence of the sun poking through the grey skies and a new bull market to emerge, if it hasn't already. Let the passage of time take care of the rest.

Sincerely,

Bob Skeat, CIM, FCSI, FEA

**Skeat Private Wealth**

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.\* and Royal Bank of Canada are separate corporate entities which are affiliated. \*Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. © 2018 RBC Dominion Securities Inc. All rights reserved.