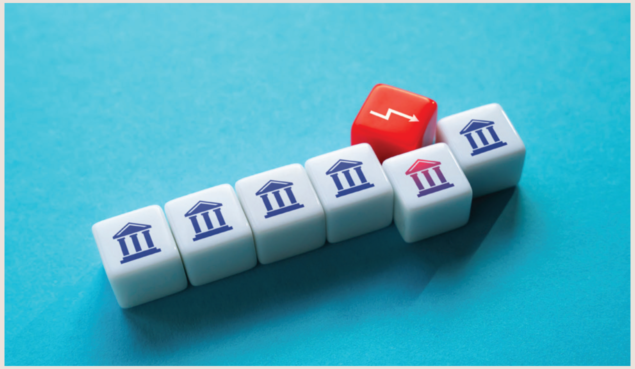
QUARTERLY LETTER | Q3.2023

Are rising interest rates finally putting a dent in this bull market?

October, 2023

After the second best yearly first half of this century, the third quarter of 2023 has not been too friendly to the bulls of this market: the S & P 500 lost 3.27% in the 3 months ending September 30th, 2023. Market pundits blamed the rise of interest rates resulting from the Federal Reserve policy to reign in inflation. The Canadian market did fare slightly better, having lost only 2.7% in the quarter.



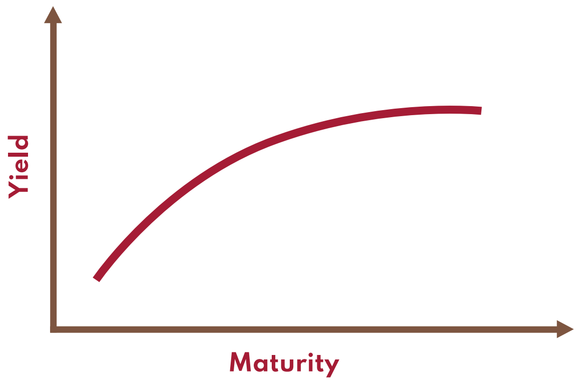
Recession or not recession, that is the question…

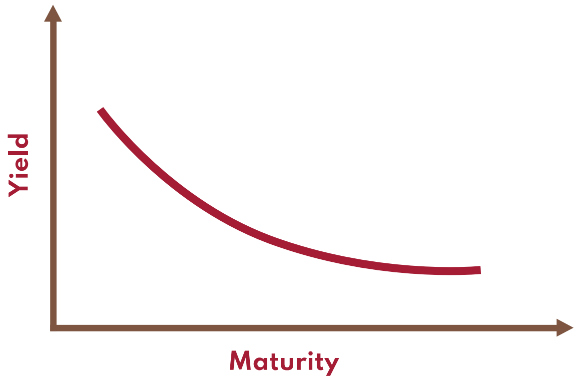
With so many indicators contradicting one another, investors are caught in this windmill of predictions that make astrologists, fortune tellers and meteorologists respectable.

Let us go through some of these indicators and add our grain of salt into what you have been reading in the news.

Inverted Yield Curve – what is a yield curve again?

A yield curve is essentially a line graph that indicates the level of interest rates for different maturities. Most of the time, short term rates are lower than longer term rates causing the curve to be upward-sloping (normal shape). The curve can also be flat (i.e. rates are approximately the same whatever the maturity), or downward-sloping (defined as inverted), when short term interest rates are higher than long term rates.





Economists believe that yield curves have predicting power on the economy, especially the inverted yield curve being one of the most reliable leading indicators for economic recession during the post-World War II era. Proponents of this position maintain that inversion tends to predate a recession by several months. Others are skeptical, for example stating that the inverted yield curve is "not necessarily" a reliable metric for predicting recession. Let's not forget economists have predicted "nine of the past five" recessions…

Nevertheless, we should be aware that, of the last 10 recessions, eight were preceded by an inverted yield curve…

Currently, the yield curve has been inverted since July 2022. Going back to 1978, it takes about 15 months on average (in reality, it could be anywhere from six to 18 months) for the economy to enter a recession after the yield curve inverts. It has been 15 months…

Inflation – with the trillions of dollars printed and distributed during Covid 19, is anyone surprised by the rising inflation?

While we agree that the money printing remedy was the right thing to do during the pandemic, the ensuing inflation is the direct consequence of too much money (lots of people receive monthly cheques or free loans) chasing too few goods (the goods and services sector shut down because of lack of staff due to Covid). Central banks therefore have no choice but to raise interest rates to reign in the inflation beast (i.e., make money more expensive so as to force people to spend less). It sometimes takes many more interest rate hikes than economists anticipate before we have a slowdown of spending. Well, we are still waiting for the slowdown… hopefully, the slowdown does not turn into a big downturn.

Oil prices – is USD 100 a barrel too expensive?

From the pandemic low of $10 US a barrel in March 2020 (the intraday low was actually less than $2.00 US a barrel), oil reached a high of $123 US, came back down to $70 US and hovers around $85 US as of this writing. According to the International Energy Agency, *"growth in the world's demand for oil is set to slow almost to a halt in the coming years, with the high prices and security of supply concerns highlighted by the global energy crisis hastening the shift towards cleaner energy technologies"*.

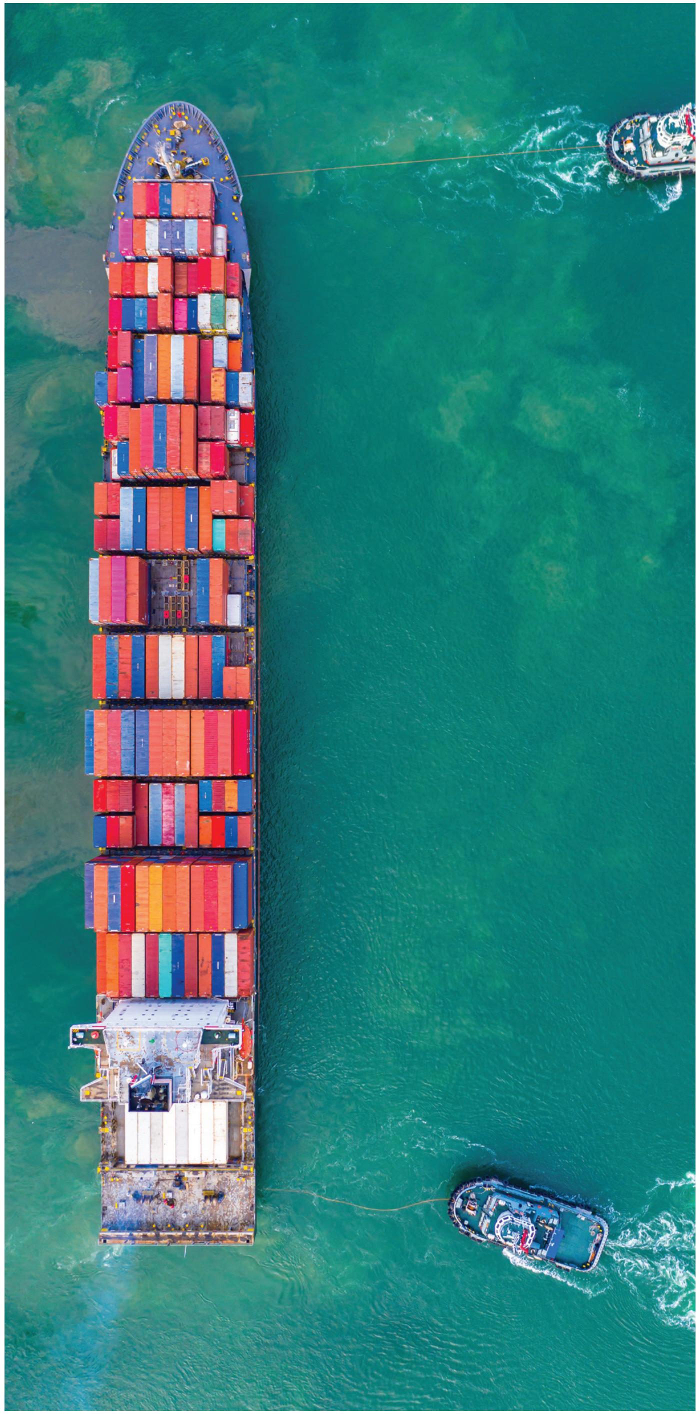
To put some perspective on oil price, let us draw your attention to the fact that oil price hit its peak in 2008 at $145 US a barrel. Back then, world oil consumption was 3.96 billion metric tons. Fast forward to 2022, global consumption stands at 4.39 billion metric tons. It does seem that the growth rate of oil consumption has slowed down somewhat over the last 25 years: it grew by close to 18% from 1996 to 2008 but by only 11% from 2008 to 2022.

Maybe OPEC+ is right in cutting production steadily so as to not flood the market with too much oil. Besides, Saudi needs a $100 US oil to balance their budget and Russia needs it to finance the war in Ukraine...

The war in Ukraine – is it a prelude of bad things to come for the world economy?

Not only do we deplore the Russian invasion of Ukraine regardless of the reasons Putin can come up with, we also applaud the determined resistance of the Ukrainian people to Russian aggression. It has shown the folly of Putin's vision of renewed imperial grandeur. Having found independence from Moscow in the years since 1991, Ukrainians have no desire to return to their previous colonial status. Despite Russia's superior military might, the Ukrainian people have made a stand for their sovereignty and their freedom, earning support and respect around the world.

But how do wars affect the economy and stock markets? Only time will tell, but historical data have shown that past wars didn't push U.S. equities lower over the long term:



Markets Often Shrug It Off

Research notes that stocks have largely shrugged off past geopolitical conflicts. As serious as this escalation is, previous experiences have indicated it may be unlikely to have a material impact on U.S. economic fundamentals or corporate profits.

"From the start of World War II in 1939 until it ended in late 1945, the Dow was up a total of 50%, more than 7% per year. So, during two of the worst wars in modern history, the U.S. stock market was up a combined 115%," wrote Ben Carlson, director of institutional asset management at Ritholtz Wealth Management, in an article about counterintuitive market outcomes. "The relationship between geopolitical crises and market outcomes isn't as simple as it seems."

When Markets Can Suffer

History tells us periods of uncertainty like we're seeing now are usually when stocks suffer the most. In 2015, researchers at the Swiss Finance Institute looked at U.S. military conflicts after World War II and found that in cases when there is a prewar phase, an increase in the war likelihood tends to decrease stock prices, but the ultimate outbreak of a war increases them. However, in cases when a war starts as a surprise, the outbreak of a war decreases stock prices. They called this phenomenon "the war puzzle" and said there is no clear explanation why stocks increase significantly when war breaks out after a prelude.

As you can see, we really do not have any more enlightening thoughts regarding macroeconomics and geopolitics than anyone else in the business of forecasting. We are pretty sure that our batting average will not be much worse than, well, average. So instead of wasting our time in predicting the unpredictable, we believe time is much better spent in analysis of different businesses and to invest in the ones with industry tailwinds that have reasonable profit margins.

A few comments on markets in general:

- We have mentioned in the last letter that the "magnificent seven" -- Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla -- dominated the performance of the S&P 500. We might have left you with the feeling that we are bearish because we don't find the Magnificent 7 attractive. Let us make it clear: we are just not so pessimistic as to believe there are only 7 growth opportunities in the entire global equity market. In fact, we are optimists and think opportunity is abundant. Just not in everyone's current 7 favorite stocks.

- Also in the last letter, we discussed quite extensively the math between housing prices, interest rates and mortgage payments. As are most things in finance, it is never straightforward and it always takes longer to unfold: we are in 2023 and assuming most mortgages in Canada are of 5-year term, homeowners who had bought houses in 2018 are renewing their mortgage now and rates are quite similar to those in 2018. However, rates were at their lowest in 2020 - 2021, years of the pandemic, **where the 5-year fixed mortgage reached 1.44% and the 5-year variable mortgage rate dropped to as low as 0.88%.** Those who bought houses then will only renew their mortgages in 2025 – 2026... and it may significantly change their discretionary spending power.

- We often say that there are lies, damn lies and statistics. We can also say there are lies, damn lies and valuations. As an example, let's look at the Initial Public Offering (IPO) of a company called Vinfast. According to Bloomberg News, this is a *Vietnamese company that operates an electric vehicle intelligent platform. The Company offers a full-scale mobility platform focused primarily on designing and manufacturing premium EVs, electric scooters, and electric buses. Vinfast Auto serves customers worldwide.* In plain English, it is an electric car manufacturing company in Viet Nam. According to their own financials, they delivered 9,600 vehicles in the second quarter of 2023 with revenues of $333M US, with an operating loss of over $370M US. Yet, none of these facts seemed to have been mentioned to the gullible investors who jumped in and bought the shares at prices ranging from $20.00 US to $93.00 US. It closed at $8.50 US on October 5th, 2023. At its peak, this company had a market capitalization of over $200 billion US. However, out of the 2.3 billion shares outstanding, only 32 million shares are freely trading (the float). Extreme demand created by investment bankers hype and promotion, combined with limited supply can do magic to the stock price, and gullible investors turned speculators get taken for a ride. Even Tesla looks cheap compared to Vinfast...

- Most investors are familiar with equity markets, commonly known collectively as the stock market. Very few know that the bond market is actually 3 times the size of the stock market. Without the bond market, most long-term infrastructure projects would never have been built. We recently came across a very interesting article by Robin Wigglesworth in the Financial Times of London on the long history of the bond market. It puts into perspective how capitalism has financed itself since the Middle Ages through to the evolution of the bond market as we know it today. For those who are interested in the topic, let us know and we will send you a copy.

We hope you have all had a wonderful Thanksgiving, we all have a lot to be grateful for. One of the things we are most grateful for is your ongoing confidence and support.

- Alain Chung, CFA, Chairman and CIO, on behalf of the Claret team.