Tulett, Matthews & Associates

Mid-year investment review: inflation down, resilient economy, stocks up!

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you?

Marcelo: I'm doing extremely well, all suited up today. We have three prospects today in the company, so it's an exciting day, and we're doing this great podcast, which is going to be informative. I think there's a lot of good stuff to talk about.

Keith: Yeah. Today's podcast is a mid-year review, specifically on investments and what we're seeing in portfolios and asset classes. So Marcelo, let's go back in time. Let's go back six months ago, or maybe even to the fourth quarter of last year. What are some of the narratives that were bouncing around in the media, in the press, in financial journals? What were people talking about?

Marcelo: As 2022 was a challenging year for a lot of things. There was a big drawdown in markets, a lot of economic turmoil, and a lot of talk about what was going to happen in 2023. So we've identified four themes, so to speak. The first one we heard a lot about was that we are heading for a tough recession in 2023. I think that hasn't panned out yet. There was a lot of talk about that. I think the Wall Street Journal was predicting a 50 percent chance of going into a recession. Big economists like Larry Summers were talking about us getting into a recession. I think he was all over the news.

Keith: He said it is absolutely inevitable that we have a recession in early 2023. So you're right. Why are we doing this? We're looking at some of the previous narratives and we want to see how things have evolved in the last six months. That was a big discussion point in the media and among economists. What were some of the other things that people were talking about in terms of what was going to happen or what they were worried about?

Marcelo: Obviously the war in Ukraine and people were expecting European economies to struggle depending on the winter and how bad it was going to be. The energy situation was going to spread across European markets. That didn't pan out. High inflation here to stay was another theme that we heard a lot about in 2022. It hasn't panned out yet. We're going to talk about the inflation numbers, but we've seen a massive trend downward in inflation. We're still not where we want to be, but it was a big topic.

Keith: Yeah. There was a lot of discussion, especially among Main Street individuals. It's the first time they'd seen inflation and they were seeing it everywhere. Everything they did had higher prices and there was a worry that this would stick around for a lot longer than ever thought.

Marcelo: The last one was hard not to think about. To put a timestamp on this, we're July 13th. The central bank in Canada raised rates again yesterday. Now the overnight rate is at 5%. So a lot of the predictions in 2022 were that high interest rates would absolutely crush the economy in 2023. It hasn't happened yet. I think it relates to the first point that we talked about. They were expecting it to go into a recession because of those high interest rates, trying to slow down the economy. But it is a new reality for a lot of people that we have high interest rates, and we'll definitely get into that.

Keith: What I think we're raising here is these were the big concerns and worries in the second half of last year, 2022. The economy has been extremely resilient, and none of these things have transpired as of yet. The irony is even in yesterday's Bank of Canada report, they're predicting still no recession and positive, albeit small, growth in GDP. What are the implications from an investment perspective? If you would have been more on the agitated side and made major portfolio moves six months ago trying to be super defensive, you would have missed out on what has turned out to be a pretty reasonable first half of the year. Let's slide into returns, Marcelo. How have returns looked from Jan 1st to June 30th? Let's go over fixed income, general equity returns, and then we'll add global REITs in there.

Marcelo: Canadian bonds are up 2.5%. Canadian stocks are up 5.7%. U.S. stocks are leading the way at 14.3%. International stocks are up 9.2%. Emerging market stocks are up 2.6%, and we have global REITs essentially flat.

Keith: The number that really surprises me, but surprises a lot of individuals, is how Europe can be up so much. In fact, if you go back to September of last year, European stocks are probably one of the best-performing stocks in the last nine months. You would have never thought that would be the case given all of the difficulties that are going on and the devastating war in Ukraine. It hasn't necessarily been a smooth trajectory. We went up for the first few months, January, February, March, and then I believe we sagged down for a month or two. Then we've had a big push forward in the last two months. Let's unpack some of these returns a little bit. Let's start with general portfolios and then we'll migrate into more specific sub-asset classes. Generally speaking, if you're in a 50/50 portfolio or 60/40 portfolio, what are the kind of returns that you might likely see if you had good diversification in Canada, U.S., and international?

Marcelo: Portfolios at 50/50 came in at 4.5%. If you look at a 65/35, so that's closer to the 60/40 you were talking about, it was up 5.2. Now if you go to the other extreme, which is 100% equities, our equity portfolio was up 6.9%. So hovering around that.

Keith: We'll talk about these returns relative to other returns as we go through the show. Our portfolios are tilted towards value companies and include small company stocks. Essentially, what we're seeing here in the first half of the year are positive returns across

most asset classes: fixed income and stocks around the world, with the United States and Europe leading the way. Let's go into sub-asset class. We'll start with the U.S. because it's the biggest market in the world, and there are some fascinating things going on in that stock market. Then we'll have some general comments for more global stocks. What's going on within the U.S. stock market?

Marcelo: Within the U.S., it's clear that the big tech companies related to AI—the Facebooks, the Amazons, the Microsoft's, the NVIDIAs—they are absolutely crushing the market right now. When you look at the U.S. market, growth companies are doing better than value. Small-cap companies are up but not as high as large-cap companies.

Keith: I remember when somebody in the office came to me and said, "Let's just use Chat GPT." I always say GDP or I always said GPT. I still can't even pronounce it right. Chat GPT. And I'm like, "What the hell?" This was like January, and I think it was launched in November. We're like, "What is that?" Then all of a sudden, you fast forward the last six months and everybody's talking about AI and what AI can possibly do to change the world and change the way we work. A little side tangent: my sister-in-law wrote a poem for my brother-in-law and shared it with 10 people in an email. She sends this poem out, and it was beautiful. We sat back and I said, "Oh my God, I didn't spend five hours. I feel guilty." Because it looked like she would have spent an entire day. I'm sitting back saying, "You are so gifted. This is incredible." An hour after she released it, she acknowledged that she got the help of Chat GPT. Afterwards, I said, "What exactly did you do?" She said, "I loaded up 10 words. I told the person the age, and that's it." It spat out this absolutely beautiful poem. I could never think that this was possible. This is what everybody's excited about.

Marcelo: That example is perfect because I think that's exactly what artificial intelligence has done. These types of things have captured people's imagination now. When you think about investors at large, everybody's buying into this. We're back into this idea that AI is going to take over the future. It reminds me a little bit, I'm not saying it will happen the same way, but it reminds me a little bit of the dot-com crisis where people were completely captivated by the idea of the internet and just changing the future, changing the way we live and work, and the way we relate to people. I think we're seeing that theme right now with AI companies and artificial intelligence at large. I think it's capturing people's imagination.

Keith: It'll be interesting to see if we go out 10 years from now and look back to see who the actual winners are. Is it the manufacturers of this software, or is it the live companies? Is it small companies, medium companies, or companies around the world that will benefit by introducing this by making themselves more productive? It's a fascinating evolution. It's eight months old, but it is affecting five to 10 companies. When we looked at attribution of the S&P 500 and we boiled down, you've got some stats up until May 31st. I think it was like five companies were producing 80 percent of the returns of the S&P 500.

Marcelo: If you look at the S&P 500, the top five companies right now as of May 31st were Apple, Microsoft, NVIDIA, Meta, and Amazon. If you look at year to date, so from January 1st to May 31st, those five companies returned 56.2%. When you look at the index of the S&P 500 as a whole, it returned 8.9%. So most of the return came from those five stocks. If

we push down that to, let's say, the top 20 stocks, we have data on the top 20 stocks in the S&P 500. Their return was 7.05%. When you look at the total return of the S&P 500, it was 7.55%. Ninety percent or so of the returns came from the top 20 companies.

Keith: When you actually look at the top five companies, they produced, in that same report, five out of the 7%. So five companies produced 80% of the return of the S&P 500. When I look at that, part of me says that's an interesting observation. I also know that the other 480 that have not appreciated that much are still, and we know this, at more reasonable valuations. In our case, our portfolios are broadly diversified and have tilts towards these areas that aren't necessarily pushing forward as fast as some of these AI companies because we know that the valuations are better and that will produce stronger returns long term.

Marcelo: Yeah, and make no mistake. Our portfolios do have those stocks in the portfolio. They just won't have an overweight or a big quantity to drive those types of returns. But we do have those companies still in the portfolio, right?

Keith: Absolutely. When we look at things back in the U.S. small value, you're looking at returns that are close to zero, but these are companies that areas of the market have a great long-term return. They're having a bit of a pause right now, and that bodes well for the future of those stocks and bodes well for expected returns. Is all technology booming right now, Marcelo? Remember we spoke about this in the last quarter and in late 2022 when a lot of these tech companies got crushed. Have those crushed technologies, the ARKs of this world, the Zooms of this world, have they come back to anything close to where they were before?

Marcelo: No, they're rallying. Technology is being driven by AI or artificial intelligence. It hasn't panned out for the other companies. You look at Zoom, Peloton, ARK, which is a bundle of all these types of securities. They're not even close to what the peak was in 2020-2021.

Keith: So those investors that were chasing those securities unfortunately aren't seeing the return of their capital and might likely never see the return of their capital, which bodes well back to broadly diversified security. So that's a little bit about the U.S. market. Marcelo, what's going on thematically around the world, whether it's Canada, international, or emerging? What are some of the themes that we're seeing inside of asset class returns right now?

Marcelo: The theme remains the same. You look at Canada, international, emerging, you see the same theme. Growth is doing better than value, maybe not as extreme as in the U.S. small-cap is still up but not as good as large-cap. So you're seeing that difference in both of them. It boils down to valuations. It boils down to how much are you paying for that extra level of growth or revenue. Yeah, you see it across the themes. That's the thing with these types of factors or when you're trying to look at growth versus value, small-cap versus large-cap. Just because the factors or small-cap has done better than large-cap over the long term, it doesn't mean it's going to happen every year. It just goes through cycles.

Keith: Sure. And the last growth was doing better than value from 2015-2016 until about 2021. Then value did better for two or three years. Now it's the year of growth again. However, when economies open up, like if we don't go into recessions and we don't tank, it bodes well for all asset classes, fixed income as well as equities. Even if we do hit a recession, it just means a readjustment of pricing, which is a great time to be buying into equities. Let's talk a little bit about interest rates and inflation. Then we're going to wrap up and talk about how we think investors should position portfolios for the long term. Marcelo, where's prime today?

Marcelo: At 7.2.

Keith: We got a chart up on the screen right in front of us right now. We're looking at 21 years of prime rate versus Bank of Canada target and overnight rate. We're right back to where we were in 2001. I'm going to tell you an entire generation of either investors or homeowners have never seen rates as high as this. There are a few implications here. First of all, I think as we alluded to at the beginning, everybody thought that these higher interest rates would crush the economy, and it hasn't happened yet. But when you speak to your friends and people, it almost appears that we're back to these days that I am very familiar with as an individual who's in my late 50s. What I'm speaking to is this concept of people now all of a sudden realizing how expensive debt is. If you're a borrower, it's expensive. Whether you're borrowing for a house in a mortgage, whether you're borrowing for a car, whether you're borrowing interest on a line of credit, debt is expensive. This is the first time people have seen this in 20 years. This last increase that's come through, it's almost like a rocket ship going up to the moon here. The flip side to that would be if you're an investor, finally you feel like you're getting a rate of return. I was golfing yesterday, and a bunch of guys that were my age were joking, saying, "I guess I should move everything to GICs now because I can get 6%." We haven't seen that in 20 years. Obviously, they're not going to do that. They were chuckling as they went through. Finally, the tide has shifted so that the investor is going to get a decent rate of return. But the borrower, it's going to be hard. What are your thoughts on that and how things stand?

Marcelo: I think it's tough. You're seeing it in people my generation who maybe took variable rates. I'm seeing it in people who maybe took out equity from a property to buy another one on variable rates. I'm seeing the stress. People who bought cars, they have to finance that at 7-8% instead of 1 or 2%. It makes a difference on your budget. I'm starting to see in my circle at least people acting with more caution. Now you will still see people who are acting recklessly. I guess that's part of life, but I am seeing people now being more careful and saying, "You know what, maybe I'll hold on to that project. Maybe I won't take that trip. Maybe I'll start eating at home a bit more." Just to give you a personal example, I have to renew my mortgage next year, and it's going to be quite a shock because I bought my house in 2019. We were still at lower interest rates. Now of course I do this for a living. I have planned for this and I have started to look at it, but it is definitely changing my behavior. I sit down with my wife and we have a finance conversation and we're talking about, "Okay, come next year we have to renew. Our mortgage payments are probably going to go up 500-600." How do we adjust for that? It's definitely changing the way people behave and it has implications.

Keith: But you are fortunate enough that you bought your property in 2019 before the big jump, right? I'd sit back and say, "Okay, your property probably went up 40%. Now there's a payment that has to occur." The individuals that are really going to be squeezed are people that bought properties and levered themselves in 2021-2022 at super low interest rates. This is what economists are concerned about: the individuals that have to renew rates because, my understanding after reading some articles that came out in the Globe and Mail, only one third of homeowners have had to readjust their mortgages so far.

Marcelo: The other thing that banks are doing is if you have a variable, I don't want to get into a rabbit hole, but the variable rates they're pushing the amortization so people don't have to increase their payments. They're telling people, "You keep your payments. You'll just pay more interest and we'll adjust the amortization." But at some point, they can't do that anymore and the payments do shoot up, and that's going to be a shock.

Keith: Sure. I think there's a little bit more adjustment coming, probably a year or two of adjustments for individuals who indebted themselves. There's going to be a new set of interest rates that will be introduced, and that is going to be an adjustment. Savings rates also went from very low 2%. Individuals' personal savings rates went from 2% and then during the pandemic went up to as high as 9 and 10%. But the stats show that it's right back down to 2%.

Marcelo: You're seeing delinquency rates go up in debt, and you're seeing credit card usage going up. People are going to get squeezed. It's going to be interesting to see how it plays out.

Keith: We've always spoken about being prudent, doing a variety of what we call prudent financial planning concepts. Don't put yourself into too much debt, be reasonable. But I will say that this timeframe when I look at the historical numbers is reminding me of the old days a little bit. The old days being the person who had the cash who could invest. For our clients, we're in an investment show here. This is a good time to be a bondholder. This is a good time to own assets and not such a great time to be indebted, especially with high levels of debt. Let's now move to how we always recommend individuals go forward with portfolios. Where are we at now? Let's spend a couple of minutes and do a wrap-up on general themes here. Marcelo, equities, we always talk about international equities. Make sure you're diversified: Canada, U.S., international. Anything changing in that concept?

Marcelo: No, I think it was just reassuring that we saw a report from Vanguard suggesting that there's always been a problem in Canada that we have this thing called the home bias, which is when people invest mostly in Canadian stocks. If you look at Canada, the percentage of people who invest in the stock market is about 52%. Of those people, they invest in Canadian markets. So if you have a portfolio, the average Canadian is allocating 52% of his stock allocation into Canadian markets just because of that home bias idea of familiarity: "Those are the stocks that I know and I'm going to buy."

Keith: So what you're saying is they put 52% of their money in the Canadian stock market, but of course, we know the Canadian stock market only represents 3-4% of the global stock market. So why would you overweight?

Marcelo: Yeah, there's a problem with that. You have an overweight to energy and banks and things like that. Maybe for another discussion, but the Vanguard report says that Canadians should allocate 30% of their stock allocation to Canada and the rest to international markets, including the U.S., Europe, and emerging markets. So that was validating. That's what we do. We believe in broad diversification: a third in each of the markets and just rebalance that. And we've been doing that for 20 plus years.

Keith: So it's nice to see that Vanguard is making that a recommendation. Our clients have experienced that for a long time. I remember one of the things about these diversification concepts is you hear individuals say, "When the markets go down, everything goes down." And I think that's a valid point. Everything goes down. Everything gets affected by a shock or a moment of crisis.

Marcelo: Yeah, but I think that's more in the short term. In the first two or three months, then after that, you see differences.

Keith: One of the things that was interesting is, and this is a report we're going to allude to with Cliff Asness, he says that any kind of diversification away from your home country doesn't necessarily protect you when there's a moment of crisis. What it does is it protects you from long periods of underperformance. You could be stuck in an asset class that has a lost decade. People are very quick to say the only place to invest is the U.S. because of the great returns. Investors have a very short memory because in 2010, which is only 13 years ago, you couldn't find a lot of people that wanted to invest in the U.S. market. We just finished a credit crisis. The U.S. market had spent 10 years in the lost decade. You couldn't find anybody who was bullish on the U.S. Then obviously, they just went through one of the best 13-year bull markets we've seen in a long term. So now we're here today. How do you think about the future? This gets back to making sure you invest globally.

Marcelo: That report was interesting because it pretty much said that in the last 30 years, the stock market in the U.S. has done better than international markets, but international companies have been as good and as profitable as the U.S. companies. They just haven't been loved. So that was interesting.

Keith: Yeah, the AQR report highlighted essentially, this is a report written primarily to U.S. investors. Do not give up on international investing. This is not the time to do that because international stocks are well valued. In other words, they're not super expensive. U.S. stocks are super expensive, and there's a segment of U.S. stocks that are expensive, making the entire market look more expensive. But there are lots of areas of the U.S. market that are reasonable. The point of that was that when they looked at the last 20 years, the vast amount of extra return that U.S. stocks got relative to international stocks came from multiple expansion. In other words, investors loving those securities more and bidding up their prices, as opposed to better profits. They concluded there's still lots of profits that

these international companies are generating. You're able to get them at better prices, and that's how you generate good future returns. It was just another report that really supported the idea of making sure you build international and global portfolios.

Marcelo: It makes me think about our portfolios. We're diversified, valuations look very attractive for us to get an extra level of earnings or return. It's cheaper than to get, let's say, a top-five company in the S&P 500. So at the end of the day, it's how much you're paying for that extra level of growth, that extra level of revenue. When we think about that in our portfolios relative to the market, we're looking quite well. People in diversified portfolios shouldn't give up on that idea just yet.

Keith: They shouldn't give up on it ever.

Marcelo: Exactly. Yeah. You may have the temptation of people chirping in your ear, "Oh, these stocks are doing amazing," and the tech stocks. It's a story as old as time. So I think my takeaway is to just stay the course. I know we sound like broken records, but it's perfect advice.

Keith: It is. I'll go back to 2008-2009, and everybody thought the only place to invest was Canada. If you look at the investment shows, it was all about resources. It was all about buying Canada, Australia, South Africa. Just three years ago, people would say there's never going to be higher interest rates ever. Here we are, three years in, and now you get a car loan and it's 9%. We have to be able to adjust. I think back to the future, how we build portfolios on an ongoing basis, I think our asset makes are really well diversified between Canada, U.S., international, and emerging markets. Have the right amount of fixed income. Include global REITs as a very small portion. Stay the course and rebalance. Marcelo, it's been a great mid-year review. Any final takeaways?

Marcelo: No, I think that's it. Diversification for me and then stick to your plan. I'm seeing it with my clients. I'm sure you see it as well, where when you're focusing on the plan and you're reiterating the strong points of the person's plan and staying the course, you remove the stress from the whole thing. I just think about my situation with my mortgage. I was very stressed, but then I sat down and started doing the planning and revised my plan, how it relates to the long term. It reduces the stress. I see that with clients when we're talking about why they're not getting those extra returns in the market. You know what, let's just go back to the plan, how you're doing, what your level of spending will be in retirement, are you going to be okay? I think that whole element of planning removes the stress of having to deal with this stuff day-to-day.

Keith: I agree with you a hundred percent. The only thing I'll add is not even investment-related. I sometimes find myself in the last few weeks reflecting and saying it was two years ago that we were all stuck in our homes. I personally am back in a gym. My wife and I are traveling. We're not in that same moment of anxiety that society was in then. We feel like that's gone and that's behind us. Sure, there are things to worry about now. Everybody's worried about other things. So I like to try to remind myself to keep perspective. Things are good. Live within your means. Keep diversified portfolios. Have the plan, and things will

work out. Work hard. A little bit less investment-oriented, but I can't help thinking of where we all were two years ago and how much better a spot we are in now. Marcelo, thank you so much for a really informative mid-year review. To our listeners and clients, thank you for tuning in and we will see you at the next show.

Marcelo: See you next time.

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