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INVESTMENT COUNSEL LTD.

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Investment Commentary

Table one below shows the price performance of the S&P/TSX Index and the S&P 500 Index over the periods indicated. The TSX experienced only a modest gain in the first half of 2023 and over the last twelve months. This was the result of weak performance by the financial services equities and a decline in many oil and gas stocks. The S&P 500 Index performed much better in both these periods. For the second quarter the S&P was up 8.3% which makes three consecutive quarters of positive performance. It was largely due to the strong performance of the heavily weighted technology sub-index and the communications sub-index. It is worth noting that the technology heavy NASDAQ Index was up 32% in the first half of 2023, the best performance for this index since 1983.

Table 1

Price Performance of the S&P 500 index and the S&P/TSX index

% Change

	S&P/TSX	S&P 500 index
1st Half 2023	3.9	15.9
One Year	6.8	16.2
Three years	29.9	36.0

Source: Factset

The Canadian Market in The First Half of 2023 – Very Modest Gain

The weak performance by the TSX in the first half of 2023 can largely be explained by the weak performance of both the Financial Services and Energy sectors. These are the two largest sectors in the TSX index, and therefore are very influential in its performance.

The performance of the Energy sector is largely driven by the price of oil. Since the beginning of the year WTI oil has declined in price from $80 a barrel to its current level of $69. This is a

decline of almost 14%. The weakness in the price of oil two primary contributing factors. The prospect of further interest rates increases that could restrict global growth and energy demand is foremost. The second major factor is economic uncertainty in China, which is the world's largest importer of crude oil.

For the year-to-date period the financial services sector has generated roughly flat returns. From the peak on February 13th the sector is down 9%. The financial services sector in Canada was affected by the fallout from the bankruptcy of two mid-size U.S. banks in the spring. There are concerns about greater regulatory oversight as a result of these bankruptcies. Further the commercial real estate market in Canada is weak and there are quite legitimate concerns that that it will remain weak for several years. This situation will lead to loan defaults by property owners and ultimately loan write-offs by the banking system. It is too early at this time to have a sense of how material the commercial real estate market decline will be on the banks. However, the market has reacted to the prospects of major loan write-offs by reducing the valuations of the Canadian banks.

The U.S. Market in The First Half of 2023 – Dominated By Large Capitalization Technology Stocks

The past few years have been periodically driven by U.S. technology stock dominance. Recently that situation has become more pronounced. Eight of the largest technology and growth companies in the U.S. – Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla, and Nvidia – now account for 30% of the S&P 500's market capitalization. It is up from 22% at the beginning of the year. This lack of market breadth, which reflects how many stocks participate in a rally has narrowed.

The narrowing of the breadth of the S&P 500 this year can be seen in how the index has fared compared with its equally weighted counterpart, which gives equal weight to every company in the index. Compared with the S&P's 16% gain, the equally weighted index has added 7%. This is the largest ever outperformance by the S&P 500 on a year-to-date basis, based on data starting in 1990. Other indicators of poor market breadth have also provided warning indications. The share of S&P 500 stocks closing above 200 day moving averages fell as low as 38% at the end of May.

Additionally, the technology sub-index, and the communications services sub-index dramatically outperformed the S&P 500 Index since last October. In October of 2022 the S&P 500 Index reached a two year low point. Since then the index has experienced a 20% gain. During the same period the technology sub-index and the communications sub-index increased by 40% and 42% respectively.

Is The US Economy In a Recession or is The Economy Strong – Divergent Economic Indicators

The Federal Reserve Board increased interest rates from .10% to 5.06% between February of 2022 and May of 2023 in an attempt to slow the economy and reduce inflation. The Federal Funds rate reached a sixteen year high in May of 2023. Two pieces of economic data were released in mid June that suggest the economy is still strong. The May jobs data indicated that employers added 339,000 jobs bringing the total number of jobs added in 2023 to nearly 1.6 million. May of 2023 was the twenty-eighth consecutive month of increases in non-farm payroll employment. The unemployment rate was essentially unchanged from the month before at 3.7%. Secondly, retail sales rose a seasonally adjusted 0.3% in May from April. Many economists had expected a decline.

Employers are hiring aggressively, and consumers are spending freely, the most recent evidence that the Federal Reserve Board's efforts have yet to significantly weaken the economy. Instead, the effects of the pandemic have left consumers and employers still catching-up. Job openings increased to 10.1 million in April from 9.7 million in March, far exceeding the 5.7 million unemployed Americans that month. The mismatch between job opportunities and job seekers continues to drive wage growth. Further, the job market could stay tight as millions of workers near retirement age could continue to drop out of the labour force.

At the same time that the labour force was expanding real gross domestic income, a measure of total economic activity shrank in the fourth quarter of 2022 and the first quarter of 2023. The economy has gone through periods where output expanded faster than employment but seldom the other way around. What explains these inconsistent signals is productivity or output per hour worked. It is in decline. Labour productivity fell 2.1% in the first quarter from the fourth quarter at an annual rate, and was down 0.8% in the first quarter from a year earlier according to the Labour Department. This represents the fifth straight quarter of negative year-over-year productivity growth, the longest run since records began in 1948.

Productivity growth is important in the long run, because it is one of two engines of economic growth, the other being an expanding workforce.

Table 2

Household Holdings of Cash Equivalent as a Percentage of GDP

Q2 of Each Year Except Q1 in 2023

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
54.3	54.4	55.5	57.1	57.1	56.5	56.1	74.9	71.8	69	63.8

Source: Federal Reserve Board

Table 2 above indicates that individuals still have a lot of the money they saved during the pandemic. Cash and cash equivalents held by U.S. households in the first quarter equaled 64% of GDP. While it was below the 75% reached in the first quarter of 2020 it was well above the level of 56% in 2019.

Americans aggregate personal savings averaged approximately $100 billion in six years leading up to the pandemic. By the end of 2020 aggregate personal savings had increased to $2.1 trillion. Between early 2022 and the beginning of 2023 there was a drawdown of this excess saving in the amount of approximately $1.6 trillion. As a result in early 2023 Americans still held $500 billion in excess savings. This allows consumers to continue to pay for goods and services despite rising prices, which in turn allows companies to keep raising prices.

Asset Mix – In Spite of The Increase in Interest Rates Fixed Income is Still Not Attractive

At the June Federal Open Market Committee meeting the Federal Reserve Board decided not to increase the Federal Funds rate. However the Chairman of the Federal Reserve Board indicated clearly that this was a pause and not the end of interest rate increases. It is now widely anticipated that there will be another rate increase in July. This will increase the Federal Funds rate to approximately 5.5%.

Long term bond rates (ten year treasury bonds) have also increased substantially since their low point in 2020. Yields on these bonds are now 3.75%, the highest they have been since September of 2008. As of June 27th the yield on two year treasury bonds was 4.5% the highest level it has been since July 2007.

The dramatic increase in interest rates has led some strategists to suggest that fixed income is now an attractive asset class. We do not share that opinion.

On June 13th the Consumer Price Index was released for May of 2023. Over the last twelve months the all-items index increased by 4%. This was the smallest 12 month increase since March of 2021. The core consumer price index – excluding food and energy – increased by 5.3% over the last twelve months. This is down from a high of 6.6% in September of 2022.

Based on the current rate of inflation neither two year treasury yields nor ten year treasury yields are at or above the level of core inflation. Therefore investing in fixed income will result in an erosion in an individual's wealth at present levels of inflation. In order to justify investing bonds you have to be convinced that inflation will continue to decline.

Valuation – Stocks Are Not as Overvalued as They Appear

Since the start of the year price earnings multiples have jumped from 16.7x to 18.7x. The vast majority of the increase in valuations can be explained by the performance of the large

capitalization technology stocks. By contrast the median (50th percentile) stock is trading at 17x earnings only modestly above its historical average of 16.2x. In addition, bond yields imply that stocks are fairly valued at present. The S&P 500 Index has an earnings yield of 5.3%. This number is the inverse of the p/e multiple. For example, if the S&P 500 p/e multiple is 20x then the earnings yield is its inverse, or 5%. Currently corporate bonds have a yield of 5.7% and the S&P 500 Index has an earnings yield of 5.3%. They are roughly in line. Over the last twenty-five years the spread between corporate bond yields and the earnings yield has been much larger when the earnings yield was 5.3%, as the table below indicates.

Table 3

Bond Yields vs. S&P 500 Earnings Yield

	Current	May 2002	July 1997
Corporate Bond Yield	6.7	8.1	7.8
S&P 500 Index Earnings Yield	5.3	5.3	5.3

Source:Credit Suisse

Summary and Assessment:

There was a widespread expectation at the beginning of 2023 that the increase in interest rates that occurred in 2022 would result in a recession in 2023. To date that expectation has not been met. Many economists believe it just a matter of time before higher interest rates have the desired effect of slowing the economy. Interest rate increases do work with a lag. There are indications the economy is cooling. From the start of the year through May of 2023 286 U.S. companies filed for bankruptcy protection according to S&P Global Market Intelligence. This is the highest number for the first five months of the year since 2010. There appears to be agreement that the U.S. economy is slowing. What investors cannot agree on is when the much anticipated downturn will begin the weigh on markets.

The greater risk in our opinion is that of a secular rather than transitory increase in interest rates.

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