Monthly Newsletter
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In this Issue

Executive Summary

If you've been following my publications through the first half of the year you would know that we've been a little skeptical of the strength in the stock market and in this month's publication I want to provide an update on the following important topics:

- **What is market breadth and how has it influenced 2023 market performance?**
- **Understanding the negative narrative that could drive markets lower**
- **Comparing the positive narrative that could drive markets higher**
- **The 2 important economic indicators to monitor now**
- **How to think about portfolio positioning**

What's Happened Lately

There's nothing more rewarding in my life these days than seeing my son get interested in doing something that I also enjoy. With the sun finally shining it's that time of year where we can get outside and get active. Urban planning is one of those things that I believe Vancouver got right because you don't have to venture too far from home to find a park and/or some green space. Coming from an active background myself I have of course tried to expose our boy to all sports to see if he gravitates to anything specific. So far it seems that running around in circles with any other child, or dog, willing to chase him is his favourite pastime. I don't know if that's going to earn him any scholarships but hey, maybe the game of tag or capture the flag will eventually become an Olympic sport.

At one of our recent park visits we came across an outdoor kid's camp. Interested as he is in any loud crowds, we gazed from afar as it appeared the kids were lining up for a good old fashion game of tug of war against the camp leaders. As we watched the first battle where the 6 camp leaders were able to wrestle a handful of kids across the line to a victory. In the second battle, all the kids in the camp lined up against the camp leaders and with all the extra people power they were easily able to drag the line the other direction for a victory of their own. Lastly, the teams were divided equally which resulted in a long and exhausting battle. One team seemed to quickly organize a strategy and in unison on a two-count they were able to achieve the final triumph. Then (failing miserably in my attempt to get my mind off work) I started to compare what we were watching on this long weekend to what I watch on a day-to-day basis in the stock market.

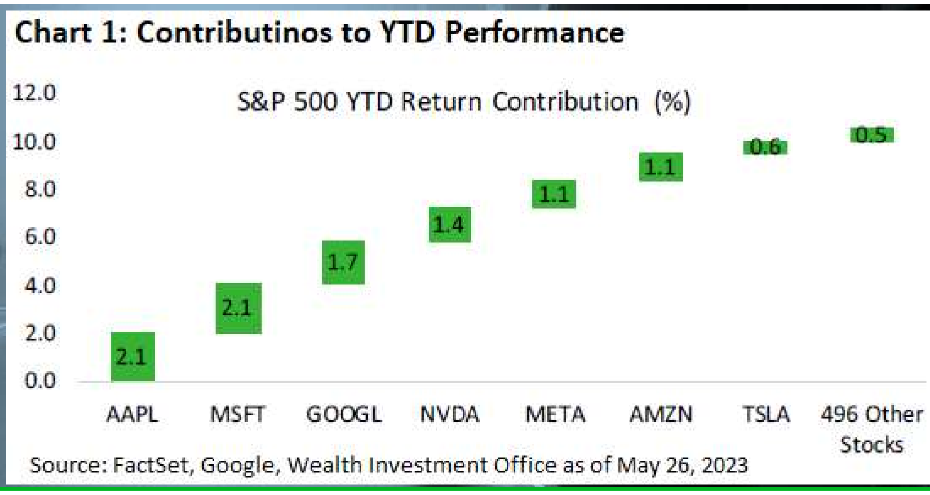
You see, the stock market has performed surprisingly well this year and continues to climb a proverbial wall of worry. It's great to see some gains after a challenging 2022 but it's worrisome as the rally has been driven by only a handful of mega-cap technology stocks akin to the camp leaders being able to pull the rope to the first victory, with a lot of the rest of the market trading sideways or down. Market breadth is a term used by financial pundits which refers to the number of stocks advancing relative to those that are declining in a given index. The breadth so far this year has been weak with the narrowest stock market leadership in an up-market since the 1990's. In fact, the 10 largest US traded stocks have accumulated more in market value than the increase in the entire remaining S&P 500 index, according to Dow Jones Market Data. As you can see by Figure 1, there has been clear sector leadership with the top 3 sectors accounting for most of the positive performance this year.

Figure 1: S&P 500 Sector Performance YTD

Year To Date	
Sector	**Performance**
Communication Services	30.77%
Information Technology	27.45%
Consumer Discretionary	17.93%
Consumer Staples	1.42%
Industrials	1.33%
Materials	1.06%
Real Estate	-2.37%
Health Care	-3.60%
Financials	-5.02%
Utilities	-6.79%
Energy	-9.38%

Source: Bloomberg Finanace L.P., as at May 19, 2023

If we dig a little deeper below the surface the performance within each sector has been driven by only a couple stocks. The Communications Services sector is up significantly driven by its over 50% weighted to Facebook and Google, the Information Technology sector is up on the back of its over 55% weighted to Apple, Microsoft and Nvidia and the same story with the Consumer Discretionary sector which is over 39% weighted to Amazon and Tesla. These 7 stocks combined have contributed almost 100% of the S&P 500 gains year-to-date, while 496 other stocks contributed to only 0.5% of the rise, chart 1, next page.



What's Happened Lately – *con't*

Where we go from here is the million-dollar question. The negative narrative suggests markets could see another significant sell-off with the clear fact that only a handful of stocks are dragging the overall index upward at the moment. Shaky economic data could result in a recession that would surely drive earnings down and given the importance of earnings on stock prices, the overall markets would likely have to fall from here. The positive narrative would suggest that markets could continue higher if the stocks outside of the current leadership join the rally. This could become evident if the economic weakness that economists are waiting for was already priced in last year at the October market lows suggesting more upside from here. There's plenty of evidence to support both narratives which I've summarized below:

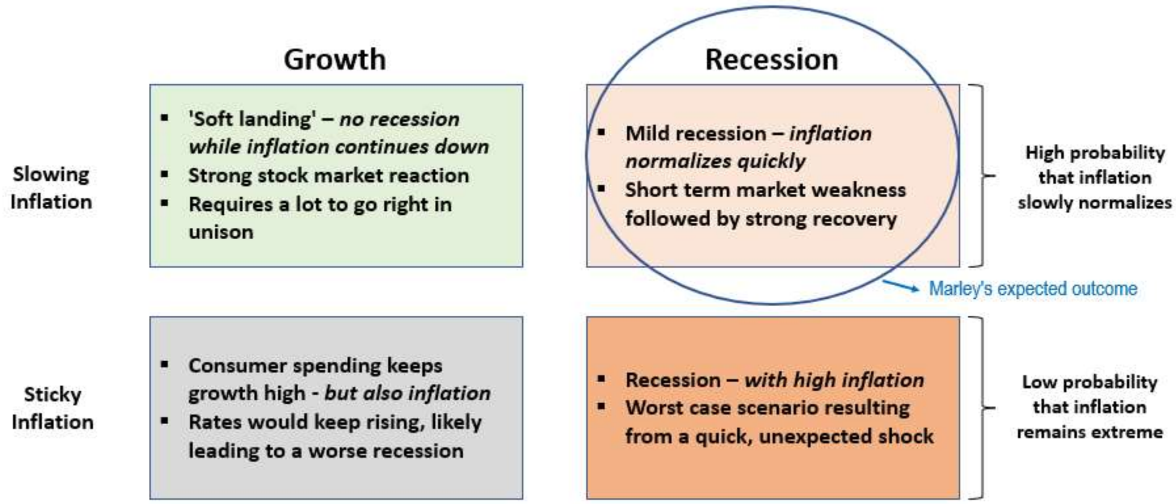
Negative Narrative:

- Weakening market breadth
- Sustained yield-curve inversion
- Inflation decline slowing
- Money supply decline
- High interest rates and their delayed impact
- Tightening lending standards due to the banking crisis
- Corporate earnings heading lower
- Slowing housing starts
- Investors becoming complacent about risks

Positive Narrative:

- Lots of room for an improvement in market breadth
- Economic slowdown priced into the 2022 October lows
- Strong labour market and supporting pent up consumer spending
- Inflation still declining
- A pause, or close to a pause, in interest rate increases
- Chinese economy reopening
- Positive earnings will cure high multiples
- Early stages of a commodities super cycle
- Elevated cash on the sidelines could limit downside and lead to weaker sectors joining the rally

Could strength across the rest of the market, like all of the camp kids overpowering their leaders, mean that the weakness was left in 2022 and the strength continues, or will the leaders be dragged down by underwhelming breadth taking the whole market down with them? As my publications and positioning would suggest, we would give a higher probability to the latter, but ultimately in the long term, a well-balanced strategy will overcome any short-term gyrations. We also need to be cognizant that there is a ton of cash mounting on the sidelines which could come back into the markets propelling them higher especially if/when interest rates decline to make that cash much less attractive to hold.



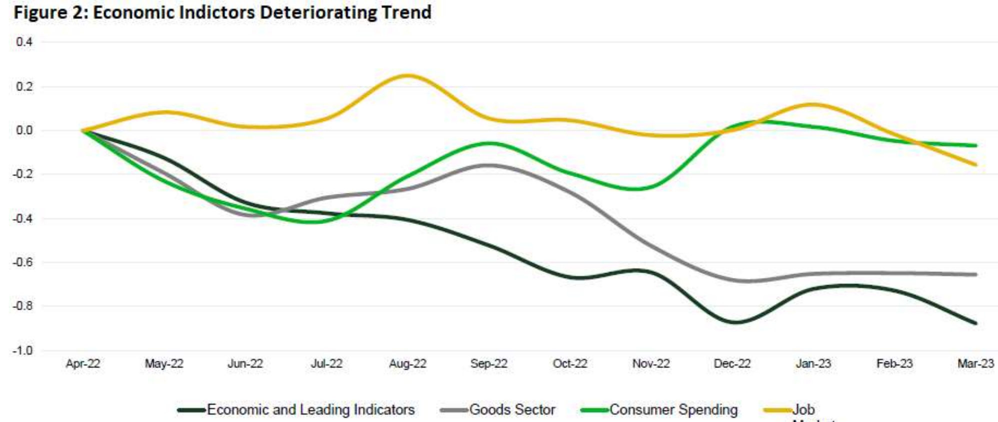
Why Should We Care

Given the tug of war between positive and negative influences I would argue that this is one of the more challenging times to invest in my career outside of the Global Financial Crisis (GFC) of 2008. Strategy is again of upmost importance after a few post COVID years where everything worked then an extremely high inflation year where nothing worked. My summary above suggests four possible outcomes with the top two having the highest probability in my mind. You'll notice a common theme with inflation as the driving force across all scenarios. Abnormally high inflation was what got us into this mess and the path out of it will ultimately be determined by how and when it normalizes.

I'll first briefly describe the outcomes that I am not expecting. The best outcome is undeniably a soft landing where inflation comes down to target without the economy suffering a recession which would mean the path for stocks would be back to record highs. Although not impossible, many factors would have to go right for this to come to fruition. The reason I challenge this outcome is because if growth remains strong, inflation likely remains high and lands us in the bottom left quadrant where rates would need to go higher for longer which would likely just delay or exacerbate the recession scenario. The one scenario we cannot plan for is some sort of an unexpected shock. Could the calming regional banking crisis somehow worsen into a more systemic problem or is there something else lurking underneath the surface? Given the strength of the financial system since the GFC I'm not overly concerned but there are definitely a few moving parts like commercial real estate and some private markets that we'll need to continue to monitor.

As you can see above, I believe the most likely outcome is a mild recession. Given the delayed impact of rate hikes and tightening credit conditions, my best guess would suggest a recession commences late this year or early next. At times likes these we always revert to our recessionary indicators dashboard which has been signaling caution since late last year. The only indicators still giving us positive signs are the labour market and credit performance (low bankruptcies and businesses access to credit).

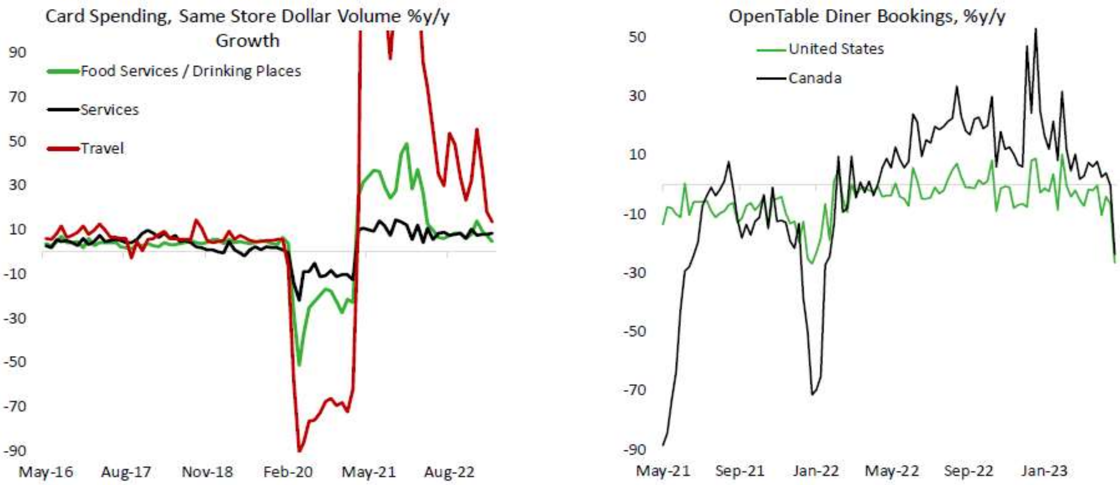
Figure 2: Economic Indictors Deteriorating Trend

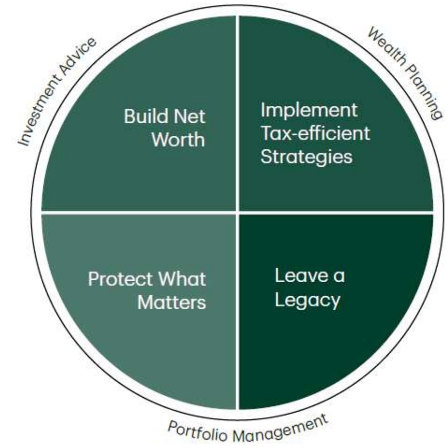


Source: Bloomberg L.P., Wealth Investment Office, as of May 5, 2023

The challenge comes down to timing as no indicator gives us an immediate green or red light for the economy. For instance, the commonly quoted inverted yield curve is a leading indicator that can help tell us a recession is on the horizon but that it could happen anywhere in the next 6 to 18 months. Whereas the labour market is a lagging indicator and sometimes a recession can already be upon us before this indicator signals trouble. In figure 2, we can see that a summary of these indicators and the trajectory of the economy isn't overwhelming good. As always, having a well diversified portfolio can calm the ebbs and flows as we transition through the business/economic cycle.

Graphics 1 & 2: Consumer Spending





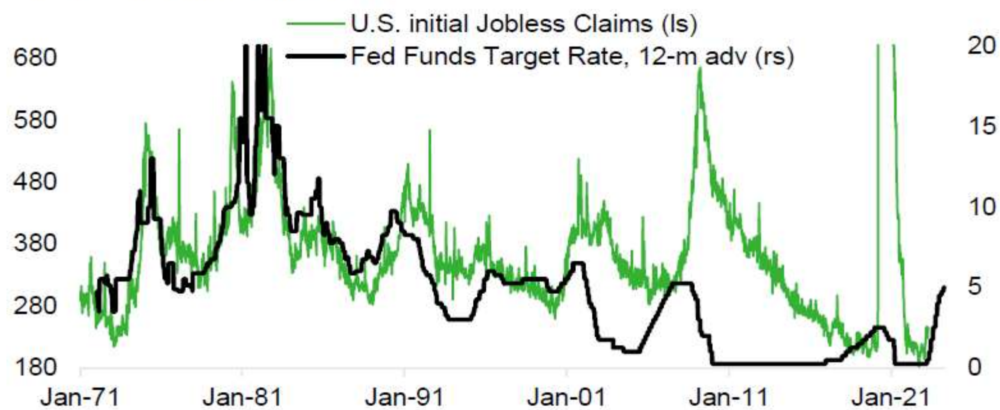
Source: OpenTable, Bloomberg L.P., Wealth Investment Office, as of May 22, 2023

Why Should We Care *Con't*

While unemployment remains extremely low and consumer spending has been resilient, we are starting to see signs that consumers may be using some caution in their discretionary spending decisions. We can peel the onion back a little further to see that there's been a recent flattening in airline passenger numbers, hotel occupancy and restaurant spending, graphics 1 & 2. Maybe the revenge spending on experiences since reopening is starting to slow. There's also a strong correlation between rising interest rates (12 months lagged) and initial jobless claims in the U.S. We haven't yet seen the spike in jobless claims that would follow such aggressive rate hikes, but history would suggest it shouldn't be too far off, figure 3.

We know how important the consumer is to the North American economy so if the consumer stops spending, the economy will likely falter. Any recession would largely depend on the labour market and if we start to get signs that unemployment is trending up, further caution should be warranted. I would caveat this all by saying a mild recession could be a reasonable outcome. Yes, some would lose their jobs, but inflation would likely fall rapidly, businesses would likely become more productive with the right people in the right jobs at the right price.

Figure 3: Unemployement & Interest Rates



Source: FactSet as of April 24, 2023

This would mean that stocks probably see the last of their negative volatility in the next quarter or two as stock markets typically bottom, pricing in the recession, 4-6 months before the economy bottoms. A relatively quick sell-off, to make stock prices more reasonable, followed by realization of a recession would set markets up for a strong recovery in the not-too-distant future. I can even see a path to a positive outcome this year albeit with some volatility between now and then. That would bring about one of those periods that can provide above average returns and set portfolios up to realize very strong long-term performance.

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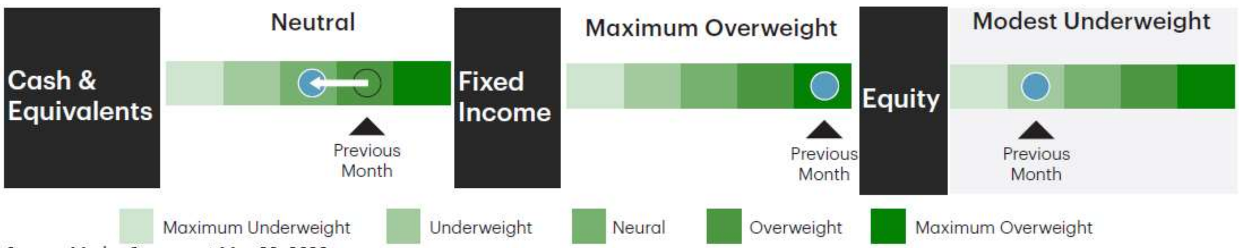
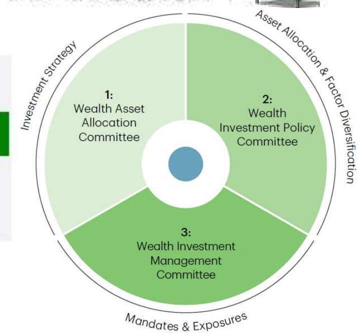
Figure 4: Broad Asset Allocations



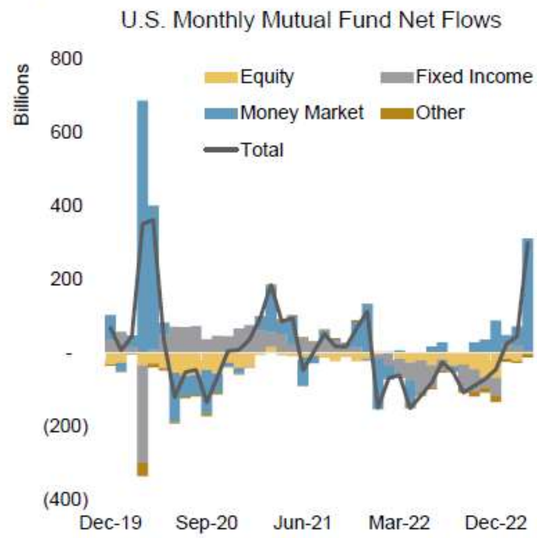


Source: Marley Snow as at May 22, 2023

What Should We Do – *Investment Strategy*

As outlined above, I believe the most probable outcome is either a soft landing or a mild recession, with my conviction leaning towards the latter. I think investors should consider both as possible outcomes therefore having no equity exposure would be a great risk to long-term returns. Something else to keep in mind is the massive inflows into cash most recently, figure 5. The cash stampeding into money markets (cash equivalents) during the first quarter was in historical terms a considerable outlier, if you exclude what happened at the beginning of the COVID pandemic. I believe this could provide support if we get the stock market weakness that typically accompanies a recession and I'm sure it's still fresh in our minds how quickly markets recovered when that cash on the sidelines started coming back into stocks in 2020. Given our outlook, we followed suit and used the strength early in the year to raise our cash weighting since you can get paid around 5% to wait. Now that we believe we are at, or close to, a peak in interest rates, we've subsequently lowered cash to lock in yields in fixed income, bonds, which we believe will have better 12-month performance than cash, if rates go down and possibly equities, if recession.

Figure 5: Cash on the Sidelines



Source: Bloomberg Finance L.P., as of May 5, 2023

Figure 6: Equity Positioning Through the Economic Cycle

	Stage of the Economic Cycle			
Equity Portfolio Considerations	Early Stage	Mid Stage	Late Stage	Recession
Style	Growth	Growth	Value	Value & Income
Business Cycle Positioning	Cyclical	Cyclical	Defensive	Defensive
Sectors	• Financials • Technology • Discretionary	• Technology • Comm. Services • Industrials • Discretionary	• Energy • Materials • Staples • Health Care • Utilities	• Health Care • Utilities • Real Estate

Source: Wealth Investment Office, April 12, 2023

As such, we remain cautious on the stock market as we haven't yet seen corporate earnings face the headwinds that would surely come if we ended up in recession. Within our equities, we expect higher quality companies to outperform with a bias towards those sectors that do well in the late, and possibly recession, stage of the economic cycle, figure 6.

To help identify these companies we focus on above average return-on-equity (RoE) and operating margins, strong earnings per share growth (EPS), and low debt-to-equity for any new additions or changes in portfolios. It's not a time for highfliers, unprofitable companies or those with a lot of debt. Free cash flow is king.

I will conclude our strategy section with a reminder that all the moving parts, the proverbial tug of war and these financial ratios is our job to monitor. Investors need to remember why they are investing. What are your objectives, how long is your timeline, and how do you feel about risk/volatility? Within portfolios our goal is to protect on the downside where possible when we believe it's time to play defense so that we can be in the best position possible when we believe it's time to play offence.

As always, please don't hesitate to contact me directly should you have any questions or want any clarification. Now would also be good time to remind readers that if you, or anyone you know, is struggling with the challenging period we've been going through, I would love to chat. You'd be surprised how much help a sounding board can be, and of course no obligations.

Personal Note

Over the last two months, inspiration from the Golden Gate Park resulted in my digging five large holes in my yard, I've learned what the term mal de debarquement means firsthand and watched a 43-foot dinosaur roam the earth again. Let me explain.

Recently, close friends of ours tied the knot in San Francisco. As this was where the groom was born, they had a small ceremony at city hall and the rest of the festivities were carried out aboard a short repositioning cruise to Vancouver. We had some free time to re-explore the Golden Gate City ahead of boarding the ship and neither my wife or I had ever been to the San Francisco Botanical Garden. It's creatively designed with a series of very toddler friend walking trails taking you through 10 geographically inspired zones. You can follow the feather shaped fronds of New Zealand Nikau Palm to the massive trunks of the Chilean Wind Palms. After a few hours of frolicking amongst the trees we collectively decided that our yard at home needs some more natural canopy. As such, after a brief bout of mal de debarquement, the lasting unpleasant feeling of still being on a boat, I began my 2nd career as a horticulturally inspired paleontologist. You see, I spent most of the rainy April evenings and weekends unearthing ancient treasures as I dug up my yard to plant a number large trees and bushes. One of my colleagues had a good laugh when we ran into each other at the garden center while I was literally stuffing my little SUV with plants.

My imaginary paleontology career came to a climax when I took my son to his first live event, Jurassic World Live Tour. Some of you may have noticed the performance listed on our last Seasonal Events Calendar. The Live performance included massive animatronic dinosaurs set in the famous Jurassic Park, a converted hockey rink at the Pacific Coliseum. I'm sure it was designed for the younger crowd and/or the Jurassic park enthusiasts, but we had a great time! I shouldn't have paid for my son's whole seat because he barely used the edge.

With summer upon us, it's time to get out in the yard and enjoy the fruits of our labour, if my pear or apricot trees yield that is. Let's not forget how beautiful this place is that we call home and don't forget to stop and smell the flowers.

Best,

Marley

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