# Quarterly Commentary

2023

Year-in-Review

As we entered 2023, you could scroll to any financial-reporting website, newspaper, or research publisher, and you'd almost certainly be greeted by a gloomy economic outlook for the year ahead. Market 'forecasters' and prognosticators alike nearly all predicted a recession in North America, ushered in by high interest rates, slowing economic growth, and high inflation—all of which were sure to crush the engine of the economy (the consumer). The turning point would likely come as a result the U.S. Federal Reserve (the Fed) maintaining high interest rates for too long, eventually causing something of systemic importance to 'break'.

Indeed, this prediction appeared to be playing out in March, as several U.S. regional banks succumbed to a run on deposits. Banks scrambled to fund those withdrawals, which forced them to liquidate U.S. Treasury assets held on their balance sheet at substantial losses. This temporary crisis prompted a collapse in long-term U.S. bond yields, as economists and investors were confident the much-predicted recession was underway. Central banks would start cutting rates by late summer, unemployment rates would rise, and the prognosticators could comfortably bask in the praise that would surely befall them for having enlightened the world. However, thanks to significant short-term funding backstops brought in by the Fed and other U.S. regulators, the U.S. Regional Bank Crisis (as it came to be known) proved to be short-lived. Markets quickly moved on, and 10-year U.S. Treasury yields eventually marched to levels not seen since before the financial crisis.

Looking for some sunshine through the dark clouds hanging over the North American market, forecasters pinned their hopes on a consumer-driven comeback for the world's second-biggest economy. The Chinese government had finally announced the long-anticipated end to their draconian COVID-Zero policy. Enthusiasm for an explosion of pent-up demand (à la the western world) reigned supreme. The expectation was their economy would return to pre-COVID form, posting world-leading growth, and equity markets would follow suit. Unfortunately, anemic consumer demand and the overhang of their severely indebted property developers weighed heavily on growth. Combined with a lack of significant government stimulus, their economy continues to struggle, and the much-anticipated boom has failed to take hold.

While we look back judgingly upon the forecasts of last year (even with tongue-in-cheek), we know it is easy to find holes where they've already been dug. One might, quite reasonably, question the value of such forecasts, particularly within the context of the last several years.

The reality of 2023 is yet another reminder that, despite anyone's best efforts, markets are a never-ending source of humility; they will always surprise in one way or another. Beyond that though, these forecasts do serve a purpose: They help us identify and evaluate potential risks in the marketplace; they force us to think about the potential impacts of such risks on different investments and asset classes; and they help guide our investment philosophy as we endeavour to mitigate risk and build resilient investment portfolios for our clients.

With that in mind, we discuss some of the key market themes of 2023 below and briefly address how we view these same trends heading into 2024.

| 2023 Market Drivers | Our 2024 Outlook |
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| **The Magnificent 7**<br>– Seven 'technology' stocks that accounted for two-thirds of the S&P500 index's total gain | – Given the significant multiple expansion, and P/E ratios trading above 35x, we expect the onus to be on earnings to justify the lofty price targets, and overall performance may be subdued |
| **Artificial Intelligence**<br>– ChatGPT was released and the future of our technological lives (and apparently any and all other parts of our lives, too) seemingly changed overnight<br>– NVIDIA revenue growth and Microsoft's interest in OpenAI (the developer of ChatGPT) set this sector ablaze | – Definitively disruptive technology that has significant productivity-enhancement capabilities (and some potentially troubling societal implications over the long-term), but not all in a few months' time |
| **Federal Reserve Pivot**<br>– In December, Jerome Powell finally revealed the possibility of three rate cuts in 2024, spurring a year-end, broad-based rally across equity and bond markets | – We still expect the Fed will be cautious when it comes to rate cuts, leaning more in the direction higher-for-longer at the risk of reigniting inflation if cut too quickly<br>– The expectation of interest rate cuts is likely baked into equity valuations to a large degree; corporate earnings will therefore be the key driver of equity prices this year, with close attention being paid to economic and employment numbers |
| **Recession Expectations**<br>– As 2023 rolled on, and economic data continued to surprise to the upside, recession expectations evolved from hard-landing, to soft-landing, to no-landing (i.e. no recession) | – As 2023 highlighted, recessions are very difficult to predict. Even if the U.S. skirts a recession, which it may well do, we expect Canada to fall victim to elevated debt-to-income ratios and rising housing (i.e. mortgage) costs by late 2024 or 2025 |

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| **Increasing Geopolitical Risks**<br>– The Russia-Ukraine war drags on with no end in sight<br>– Hamas provokes Israel and another needless conflict erupts, with concern it may spread to the broader region<br>– China continues to make noise regarding their intentions for Taiwan | – This year may be a year where geopolitical risks materially influence financial markets<br>– In addition to the existing conflicts, 40 countries—representing 41% of the world's population and 42% global GDP—have elections this year, and a rise in populous candidates winning could increase internal tensions and negatively affect global trade<br>– As we move closer to U.S. election day, we expect market volatility to increase, and election results could prove to be a seminal risk to equity markets if voting results are contested |
| **U.S. Treasury Auctions**<br>– Government spending spirals higher and the Federal Reserve enters quantitative-tightening mode; questions start to emerge regarding the massive level of Treasury bonds scheduled to be issued and the impact this may have on corporate bonds<br>– Moody's and Fitch downgrade their respective outlooks for U.S. federal debt, which markets promptly shrug off | – U.S. long-bond yields may be anchored higher to attract foreign buyers of their debt<br>– Japan may continue to pull investors away as they move closer to the end of decades of yield-curve control |
| **Inflation**<br>– Inflation fell from the eyewatering values seen in 2022, offering some assurance of progress; however, core inflation proved to be stubborn, and inflation continued to trend above central banks' targets | – Reaching 2% will be a slog as the easy gains are behind us<br>– Canada may get there sooner than the U.S. |

## Magnificent 7

The equity-market drubbing experienced in 2022 was somewhat laid at the feet of the U.S. Federal Reserve as they rapidly hiked interest rates to levels not seen for many years. In response, equity valuation models called for higher discount rates to be applied to future cash flows, which had the effect of lowering the present value of these cashflows and decreasing current estimates of fair value. Prices for long-duration assets, like non-dividend paying technology stocks, are more negatively impacted by these adjustments. This all sounded like a reasonable (if a little technical explanation) for the pain the tech sector endured in 2022. That is until 2023, when interest rates marched even higher, and technology stocks, led by the Magnificent 7, powered higher. By the end of November, the Mag 7 were up 80% and the remaining 493 stocks in the S&P 500 were essentially flat. These seven companies now make up approximately 30% of the S&P 500 Index. That level of concentration brings risk to U.S. market performance in 2024.

## Artificial Intelligence

Although the Massachusetts Institute of Technology (MIT) began experimenting with developing artificial intelligence (AI) in the 70s, this acronym came blazing into your news sources with the release of OpenAI's ChatGPT.

This prompted the world to contemplate the future of technology as we know it, and the wave of productivity AI is poised to unleash. Microsoft, via its financial interest in OpenAI, and NVIDIA had blowout quarters, with NVIDIA being the leading supplier of microchips needed for AI infrastructure. Earnings releases by companies across sectors soon started referencing the utilization of AI in their own operations, and how it would surely help drive efficiencies and improve productivity.

There is little doubt this technology is disruptive. It will be a game-changer for labour and industry. It will upend the way companies, governments, societies, and individuals, operate and interact in the world. These changes will likely manifest in ways none of us can currently contemplate, not even AI's developers. How we adapt to these changes, and how we control the utility of this tool (rather than have it control us), will be interesting to watch over the next decades.

With all the euphoria surrounding AI this past year, one would think AI is entirely new technology that's seemingly been dropped from the heavens. However, as indicated above, the framework for this technology has been in development for many years. The tipping point with respect to its progress and application and application, however, has recently come as a result of two major factors:

1. The amount of digital data being obtained and stored, and
2. The immense computing power now available to source, manage, interpret, and effectively manipulate this data into functional AI

One of the more concerning outlooks for AI is its potential use in developing ever more convincing fraud schemes. Human voices and nearly perfect video representations of real people are now possible. Those fraudulent texts and e-mails you receive, that sometimes appear to be written by a 4th grader, will be generated by AI and practically impossible to detect. This will invoke a need for some sort of "CAI" force— that is, Counter Artificial Intelligence—to detect and suppress such nefarious uses.

## Federal Reserve Pivot

Going into 2023, rate cuts by the Federal reserve were expected to begin by mid-year, at the latest. As the year progressed, this was pushed further and further into 2024. Finally, Jerome Powell announced in mid-December that three rate cuts were on the table for 2024. The equity and bond markets promptly seized the news and rallied through year-end. Following this rally, it is likely that the bulk of rate-cut expectations are baked into current equity valuations. If, for some reason, there is a resurgence in inflation, rate cuts could be deferred once again. Such an outcome would surely have negative impacts on equity and bond markets alike.

## Recession Expectations

Our position has not changed on this topic since our 2022 year-end letter. At that time, we indicated we did not envision any recessions until 2024. Our current view is that the U.S. may well be able to avoid recession, or at least experience only a shallow one one. Our outlook for Canada, however, is not as bright, as recent economic data continues to point to an economy that is faltering. Combined with a wave of mortgage renewals over the next several years, and a consumer that will inevitably feel the pain of higher interest rates, we see the Canadian economy entering recession in late 2024 or early 2025.

## Increasing Geopolitical Risks

The financial markets continued to shrug off the Russia-Ukraine war in 2023. Quite possibly, its most significant effect on financial markets, was the debate over funding for Ukraine being used as a wedge issue between republicans and democrats over national debt-ceiling negotiations.

In the same vein, except for a brief blip in oil prices, the recent Israel-Hamas conflict has been largely overlooked. Beyond the needless human suffering these conflicts have caused—which is both appalling and disturbing—such conflicts continue to destabilize global trade relationships, which are already frayed, and further polarize relationships between western and developing nations as they align themselves to either side

Will China be next to bring conflict? Depending on who wins the U.S. election later this year, there may be an opportunistic moment for China to launch their attempt at 'reunification' while the developed nations are too busy occupying themselves with concerns of their own.

## U.S. Treasury Auctions

Although we have highlighted the U.S. on this issue, it is a significant issue for Canada as well, albeit on a lesser scale and with minimal impact on global financial markets. As the governments continue to roll forward significant debt maturities and refinance through the issuance of new bonds, they will have to pay higher interest rates to attract buyers. Finding buyers for the immense amount of maturities coming due raises the prospect for bond yields to remain elevated for longer than many might expect. This is to say nothing of the burden these higher interest rates will impose on governments long into the future.

## Inflation

Undoubtable progress was made in the fight to bring down inflation in 2023. Dropping from the eyewatering heights of 9% in June of 2022 (in the U.S.), both Canada and the U.S. finished off 2023 with year-over-year inflation prints of 3.4% (as gauged by Consumer Price Index reports for December 2023). That said, core inflation continues to remain sticky, and we believe the easy gains on the inflation front are in the past. With higher debt-servicing costs expected to pressure Canadian consumer spending in a more significant way, Canada may get closer to the 2% target sooner than the U.S.

## Borger Griffiths 2023 Investment Strategy

Every year new risks appear; some change, and some are resolved. We consistently stay abreast of these evolving risks—we research them, analyze how they may affect markets and asset classes, and then formulate our investment strategy to mitigate those risks as much as possible. All while being cognizant of our clients' individual financial goals and risk tolerances.

We believe that interest rates are at or near their peak, with a downside bias as global economies weaken. We anticipate corporate earnings to be stable, with potential pressure coming from slowing economies and/or weakening employment numbers. The primary concerns, that we continue to monitor closely, are as follows:

- Escalation of current wars that expand to periphery countries
- A hard-landing recession driven by higher rates for longer
- A resurgence in inflation which negatively impacts fixed-income and equity valuations alike (especially richly valued technology companies), and finally kills consumer spending
- Major cracks in the labour and/or housing market
- The potential for stagflation (high inflation and low economic growth)
- U.S. election results that are inconclusive, prompting a protracted period of uncertainty

## Our Key Themes

- We are currently cautious on equities and remain underweight overall
- Shift to Increasing global equity exposure with valuations of primary importance
- Limit Canadian equity investments to quality, dividend-paying companies with a long track record of raising dividends

- Continue to take advantage of fixed-income yields at levels not seen for many years, where appropriate

## Market Performance

Although 2023 was a great year for a few growth stocks, the S&P 500 and S&P/TSX Composite indexes only just got back to the levels they had reached at the end of 2021. Despite the impressive percentage increase posted by the NASDAQ, it is still short of its November 2021 peak. Investment-grade fixed income in North America has yet to climb back to previous multi-year highs.

| Index | Total 2023 Return (%) |
|---|---|
| S&P 500 | 26.3% |
| S&P/TSX Composite | 11.8% |
| NASQAQ | 44.6% |
| Canada Investment Grade Bond Index | 8.5% |
| U.S. Investment Grade Bond Index | 8.2% |

Source: FactSet as of December 31, 2023. Total returns including dividends and distributions in native currency.

## Market Commentary

All major global indices had a positive year in 2023, except for the MSCI China index which, fell by 14.1%. Japan's Nikkei was number one with a positive 31% return. The S&P/TSX was near the bottom of the global performance list, as large-cap dividend-paying companies were muted by rising interest rates. These higher rates opened the door to lower-risk fixed-income investments that provided a comparable fixed rate of return.

Enthusiasm was driven primarily by positive sentiment and momentum around artificial intelligence, the U.S. economy's resilient growth, slowing inflation despite low unemployment rates, resilient house prices, as well as expectations the Fed's rate-hiking cycle was coming to an end.

After 2 years of negative returns for the FTSE Canada Universe Bond Index, a positive return was finally realized in 2023. Even with a rally through the final quarter of 2023, the 3-year compounded rate of return for this index has been negative 2.8%.

## TFSA and RSP

The 2024 TFSA contribution limit has increased to $7,000 and the cumulative contribution limit is now $95,000.

For those of you who make annual RRSP contributions, the deadline for inclusion in the 2023 tax year is February 29th, 2024. The limit for 2023 contributions is 18% of earned income up to a maximum of $30,780 (subject to pension adjustments). The 2024 maximum limit is $31,560.

The Borger Griffiths Wealth Management team thanks you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

Sources: Bloomberg, Bloomberg Economics, TD Wealth Investment Office, FactSet, US Bureau of Labour and Statistics, Statistics Canada

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