HIGGINS
INVESTMENT
GROUP INC.

December Market Analysis

Views of Gordon Higgins CPA CA, MBA, CFA

This and prior newsletters are available at www.Higginsinvestment.com

The Markets

	December	Change in Month	Year –To-Date
S&P TSX	20958	3.6%	8.1%
S&P 500	4768	4.4%	24.2%
Dow 30	37689	4.8%	13.7%
Oil	$71.65	−5.2%	−10.8%
Gold	2072	0.8%	14.8%

Head of the US Federal Reserve, Powel, indicated rates may not need to increase which caused the market to rally. Other bank governors tried to clarify there is a difference between no more rate increases and future rate declines. The major equity markets were virtually unchanged for the month until the Federal Reserve's announcement. As you can see in the table at the top of the page, the markets surged 4% in the second half of the month.

The ever-volatile Health Care sector led the market upwards. The Health Care sector, in Canada, is dominated by the cannabis stocks which are really more like liquor stocks which are in the Consumer Discretionary sector. As an aside, some people say they have a drink for medicinal purposes. The prospect of lower interest rates led to a recovery in the bank stocks, the income trust subsector and the REITs. The prospect of lower rates led to expectations that a recession may be avoided so the economically sensitive Metal stocks were the second strongest sector. At the other end of the spectrum were the Oil and Gas stocks that declined in line with the underlying commodity. A 5.2% decline in the price of oil contributed to a 5.6% decline in the Energy sector. One factor contributing to the decline in the price of oil was the prospect that the war in the Middle East would be confined to Gaza and Israel. The reduced global risk contributed to a decline in the gold stocks despite a small increase in the price of gold. Otherwise, every other sector had a positive performance in the month.

The chart on the next page presents the performance of the S&P 500 and the S&P TSX over the past 6 months.

6 Month Performance S&P 500 and TSX

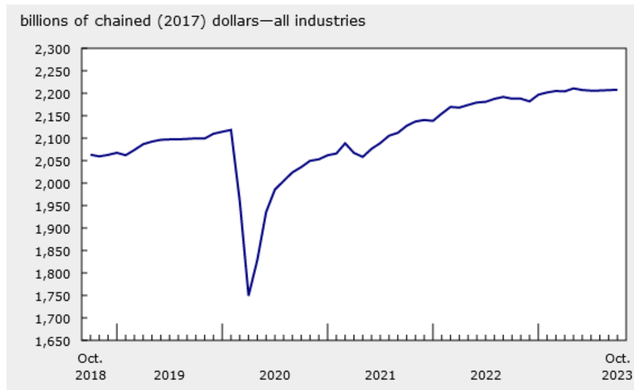
TSX Index S&P 500

Economic Indicators

1. Canadian Gross Domestic Product (GDP)

After significant increase in interest rates in the past 18 months many analysts forecast a decline in economic activity or a recession. One definition of a recession is when your neighbour loses his job and a depression is when you lose your job.

So far, the economy had only minor changes and has not entered a recession. The data for the whole economy takes awhile to compile so the October GDP statistics were only released near the end of the year. GDP was flat for a third consecutive month. The chart on the next page clearly shows a Covid related collapse followed by a sharp recovery and more recently only moderate growth.



Source Statistics Canada

Although the general economy continued to grow, manufacturing declined. Manufacturing activity fell in three of the past four months. The subsector of machinery manufacturing decreased by 4% in October and metalwork machinery declined by more than 7%. All but one subsector of Wholesale trade contracted. The completion of major projects in the third quarter was offered as an explanation for the decline in October.

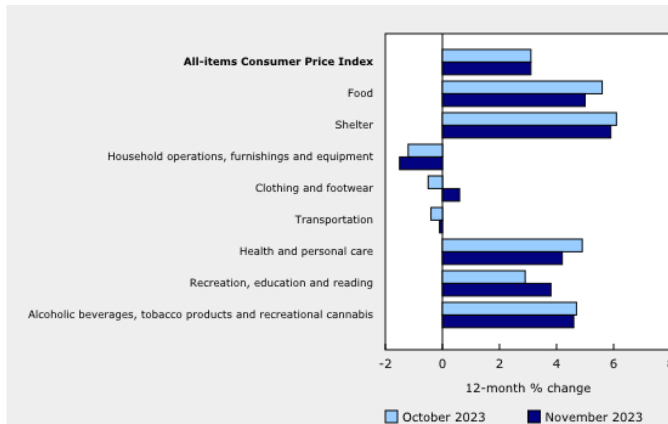
The consumer continues to spend despite higher mortgage payments. Retail sales grew 1.2% in October. Online retailers showed a modest decline. Clothing stores had a 3% increase in sales. It might be a different story in December as mild weather might impact sales of winter coats and boots. Mining and Energy also exhibited solid growth.

2. Canada Consumer Price Index (Inflation)

Everyone is focused on the rate of inflation. We know the Bank of Canada has a target rate of 2% and will do what it takes to get there. Inflation is down from its recent peak but is still above the target rate. Based on this release the question is similar to a hair dye commercial, does he or doesn’t he (lower rates).

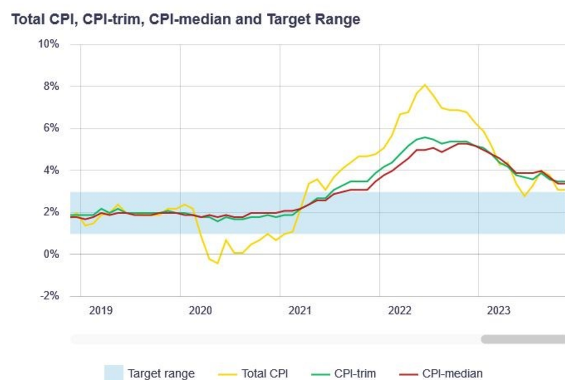
CPI was unchanged from October to November. Inflation remained at 3.1%. The chart on the next page shows the change in prices of the components of CPI. Lower prices for energy and gasoline partially offset increases in the price of food. In an odd twist, higher interest rates used to calm inflation can cause inflation in certain sectors. Mortgage interest costs were up almost 30% year-over-year. Rent rose 7.4% so it did not matter if you owned or rented it cost you more for shelter.

Food prices are still rising faster than the average consumer good but they grew at a slower pace last month. This is the fifth consecutive month with a month-over-month decrease in the rate of food price increases. The price of services continued to put pressure on the overall rate of price increases. Energy prices declined by almost 6% versus the same month last year.



Source Statistics Canada

The chart below shows CPI under three different definitions along with the target range for the bank of Canada. CPI, using the broad definition usually used for inflation, as depicted in the yellow line can be very volatile. In 2020 at the beginning of Covid closures, CPI went negative partially due to a collapse in the price of oil. Then there was a massive spike in 2022 when Russia invaded Ukraine and the price of several commodities surged. The Bank of Canada prefers to use the CPI-trim. It is essentially CPI with outlying data points excluded. For instance, if a commodity price rose 100% it would be excluded from Trim as it is not representative of most items. We have seen CPI decline but CPI-trim has been steady around 3% for the past few months. If this is the metric the Bank is using to set interest rates then future decreases may not be around the corner but be several months away.



Source Bank of Canada

Reflection

Another Year Over

Another year over and time for a forecast. As I write every year, I think it is very arbitrary that people choose the beginning of January to make annual forecasts. A 12-month forecast made in January is no more relevant than a 12-month forecast made in July, in each case you are forecasting for a one-year period.

As you read this the S&P 500 is close to the same level as January 3rd 2022. Yes, the index hit an all-time high 2 years ago. In other words, the market is unchanged over the past 24 months. When you read the S&P has hit an all-time high it takes on a different meaning when you realize it is only slightly higher than 2 years ago. When I first got into the investment business my boss had a cartoon cut out of the paper, before the internet, taped to his monochrome computer screen. The picture showed a man watching the news with the newsreader saying "the stock market opened today at 1000 shot to 2000 at noon, fell to zero at 2 and closed unchanged at 1000". The market may fluctuate but people focus on month end statements.

The other day I was sitting in a food court while a person at the next table was providing sales and investment advice to someone on the phone. They were loud enough that most of us at neighbouring tables were able to glean some not so useful advice. He pushed the people on the other end of the phone to get investors to keep putting money into the market; there was no talk about client needs or ability to take risks. It was interesting to see he was working on his retirement plan at the same time as he was providing investment advice to others. He had several lottery tickets with multiple lines on each. He continued with his sales pitch as none of his numbers came in. Some people mistake the stock market and investing for a casino. If you want it to be you can make it like gambling but we prefer investing with controlled risks. This is less exciting but more likely to lead to sustained returns.

We can safely assume that the major central banks will lower interest rates in 2024. Unfortunately, the stock market rallied in December of 2023 when the central banks indicated rates may have peaked. Therefore, much of the gain you expect from lower rates may already be reflected in the stock market. The stock market is a discounting mechanism. It does not matter what a company earns today but what they are expected to earn in the coming years. It is for that reason people pay more for companies with rapid growth. If two companies earn $1 per share this year and one has no growth in earnings for the next 2 years but the other grows at 50% each year. In 2 years, company one will still earn a dollar a share while the second company will earn $2.25 ($1*1.5*1.5) per share. Fifty percent growth for 2 years will result in $2.25 in earnings . If you assume both

companies grow at the same rate of the 2 years of different growth then they should trade at the same price earnings ration. But in 2 years one company will be earning $2.25 per share and the other $1 per share. If both companies do not grow after that one should be worth 2.25 times the other in 2 years. Knowing this, investors will pay more today for this prospect of growth. There is a big IF, these are expected earnings. Often fast-growing companies have minor hiccups and have slower growth than expected which results in big drops in the price of the shares. Growth can offer higher returns and higher risks.

Back to the discussion of interest rates. A friend who follows short-term deposit rates told me one of the trust companies lowered the rate they pay by .2% and then 2 weeks later dropped rates by another .2% for a combined 0.4% or almost half a percent less. For those who are looking for mortgages from this issuer they would have seen a .4% drop in the posted mortgage rate. The banks have a choice to finance mortgages from GICs or from the bond market, so when the yield on bonds decrease, mortgage rates will decline. Most variable rate mortgages at the banks are based on their prime interest rate. The bank prime rate moves in line with the Bank of Canada prime rate. This means that until the Bank of Canada lowers its prime rate, most mortgage holders will not get any relief. This will continue to put pressure on the housing market.

At this point some interest sensitive stocks such as the Banks look attractive. They have near-term earnings weakness but their core operations are strong. If you look beyond the earnings profile for the next few months, they seem attractive. We also like the juicy yields north of 5%. If the price of the stock rises by 5% the total return would be 10%. A 10% return is more than acceptable. Plus, the banks have a history of increasing their dividends. I cannot predict the entire market or whether one bank will be up or down in the next 12 month but I can see good opportunities that will position a portfolio for future years.

Asset Mix: We expect the equity markets to continue to be volatile but provide positive returns over the coming year.

Summary

"Your Future Is Whatever You Make It. So Make It A Good One." Back to the Future

(borrowed from last year's commentary**)**

It is somewhat arbitrary to make a forecast about markets at the beginning of a year. It is said a portfolio manager buys their portfolio every morning. What that means is that you have to look at every stock and say would I buy it today or should I sell it. Over the holidays people have more time to examine their portfolios and ask if they are structured properly for the next year. Our view is the markets will remain volatile over the next few months until there is greater clarity on when the central banks have finished their inflation fight. There is a bit of irony that the markets will recover when it appears the economy is slowing as it will be one step closer to a recovery.

When we look at the stocks in our client portfolios, we like many of the attributes including the average dividend, the history of dividend increases and the underlying earnings potential. We focus on the combination of the price we pay for the stock in relation to the future earnings stream and the degree of certainty of the earnings.

Disclaimer: This material is for information purposes only and is not an offer to sell or the solicitation of an offer to buy any security. The opinions reflect those of the author and are not to be relied on for investment decisions. The comments are provided to give the reader something to think about and are not investment advice.