HIGGINS
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February Market Analysis

Views of Gordon Higgins CPA CA, MBA, CFA,

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The Markets

	February	Change in Month	Year –To-Date
S&P TSX	21363	1.6%	1.9%
S&P 500	5096	5.2%	6.9%
Dow 30	39996	4.8%	6.1%
Oil	$78.32	3.3%	9.3%
Gold	$2052	−0.7%	−1.0%

Technology and optimism ruled the markets this month. The markets got off to a slow start as investors realized economic strength would likely delay expected interest rate cuts by the Federal Reserve. Some expected a rate cut at the next Fed meeting but it looks like it will be the summer before we see a rate cut. Higher interest rates put pressure on the market. Artificial Intelligence (AI) dominated the markets this month, and even the past few months. Nvidia announced their earnings and raised their expected earnings forecast. This was enough for a rally in most large technology stocks that can even claim a modicum of relationship with AI. These stocks helped propel the S&P 500 to a record high.

The fact the US economy was stronger than expected led investors to retract their hopes for a quick decline in rates controlled by the Federal Reserve. This led to weakness in the interest sensitive REITs, Utilities and Communications services. All three sectors were down more than 4%. Gold is also interest sensitive and the stocks declined by close to 7% despite a less than 1% decline in the underlying commodity. A strong economy combined with uncertainty in the Middle East led the Energy stocks to lead all the sectors in the TSX. The Energy stocks were much stronger than the underlying commodity. Industrials, Consumer Staples and Health Care all had returns greater than 3% in the month.

The graph on the next page presents the performance of the S&P 500 and the S&P TSX for year-to-date.

Year-to-Date Performance S&P 500 and TSX

TSX, S&P 500 source google.com/finance

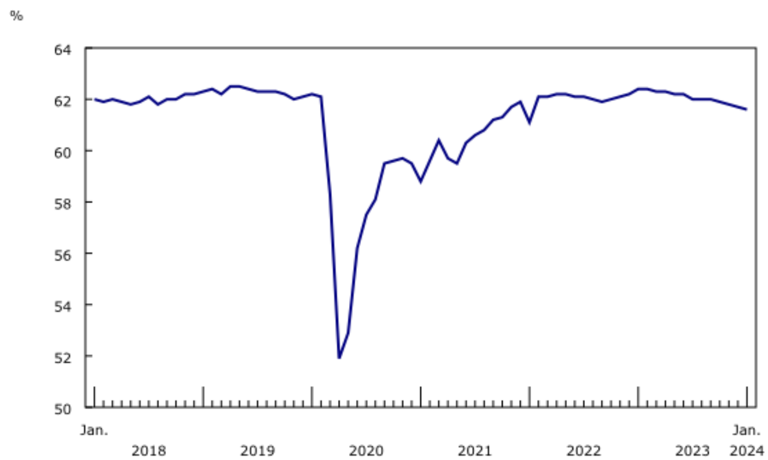
Economic Indicators

1. Canadian Labour Force

This month's release will satisfy the optimist and the pessimist, it just depends on which number you want to focus. First the good news, the number of people employed increased by 37,000 in January. The bad new is the percentage of the population employed decreased by 0.1%. The growth in the population in percentage terms was greater than the percentage increase in people employed. If you have watched the news, Canada has a significant influx of students and immigrants of working age. This increase led to Millennials now out numbering Baby Boomers. This is skewing the labour market. One commentator said these programs are almost a recruitment pool for Uber and other delivery companies.

Most of the employment gains were in Ontario, 24,000 of the 37,000 jobs were in Ontario. The number of people employed in Newfoundland spiked up 3.2%. Most of the job creation was in the service sector. Strength was evident in retail trade and finance. Gains in those sectors more than offset a decline in accommodation and food services. Average hourly wages rose more than 5% year-over-year. The total hours worked rose more than 1%.

If you dig deeper, you will see that part-time work was almost solely responsible for the increase in employment. The proportion of working age population that was employed declined for the fourth consecutive month. As mentioned earlier, an influx of employment age immigrants caused the number of working age population to grow faster than the number of jobs available. The working-age population grew by 1,000,000 in the past 12 months. The chart below from Statistics Canada shows the employment rate peaking and gradually declining in the past year.



2. Canadian Manufacturing survey

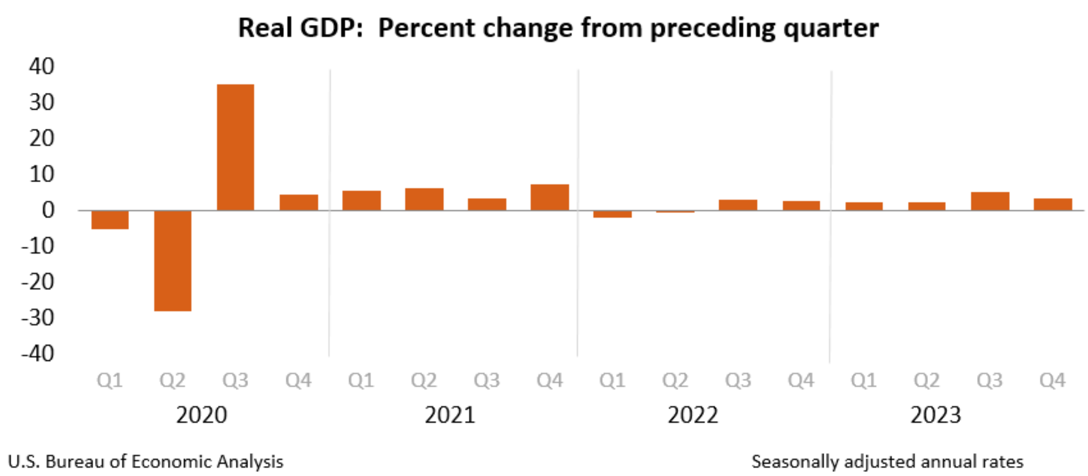
The survey of manufacturers by Statistics Canada has some interesting statistics. Here are a few of them.

- More than half of businesses expect rising inflation to be a problem. Almost 75% of businesses in accommodation or food services view this as an issue.
- 40% of businesses expect rising interest rates to be an issue over the next 3 months.
- 72% of businesses indicate interest rates had an impact on their business.
- Almost a quarter of the businesses expect shortage of labour to be an obstacle in the next 3 months.
- 14% of business are using generative AI or plan to use it.
- More than quarter of retail business still view supply chain issues as an obstacle.

3. US GDP

There is a play “Waiting for Godot”. The key point of the, I would say boring play, is that the two main characters spend the entire play waiting for Godot who never comes. This made me think of the long-awaited US recession. Analysts have been forecasting various versions of the coming slow down but so far, they have been wrong. Not to say one is not coming but as of now there is little evidence of a significant economic slow down. People expect the increase in interest rates to have a negative impact on the US economy. Changes in interest rates have a lagged response. Typically, it takes about 18 months for the rate increase to impact the economy. It has almost been 2 years. One of the more dangerous phases in investing is, it is different this time. Interest rates will have an impact we just can’t know when and how much of an impact.

The chart below shows the Covid related decline in early 2020 and the recovery shortly thereafter. Since then, there has been slow and steady growth. The preliminary estimate of GDP was released in January and revised in February as the bureau has more data and more time to compile the data.



Fourth quarter GDP was revised from 3.3% to 3.2% in the most recent update. The main contributor of the change was a reduction in inventory levels. A quirk of accounting is an increase in inventory is considered an investment but it can also mean sales were lower than expected. An increase in inventory could be bad for future production. That said, inventories were revised downward – a potential positive. GDP grew in the quarter due to increases in consumer spending, exports and government spending.

The economy was slower in the first two quarters than in the third and fourth. Definitely not a trend indicating a slowing economy. For the full year US GDP grew at a 2.5% rate while it grew at a 3.2% rate in the fourth quarter. By some measures, the rate of inflation decreased in the second half of the year. The GDP price increase for the year was 2.4% but was 1.9% in the fourth quarter. If we use another price index, the PCE index rose 2.8% for the year but 1.8% in the fourth quarter.

Economic growth with lower inflation is optimal for the economy. Let’s see what happens in the next couple of quarters.

Reflection

Physician heal thyself.

The title of this section refers to the need for a physician, or any person, to heal their self before worrying about other problems. In this section we will discuss the concept of knowing yourself and making sure you have the right portfolio for yourself. In the end, it is your money and your money manager should follow your needs. However, you should look at yourself and take advice from those with more knowledge in their specialty.

We tend to work with model portfolios. We have models that were built with Exchange Traded Funds, ETFs, similar to a robo-advisor. We rebalance periodically to bring the portfolios back to the target weights. The portfolios are assigned to investors based on a risk questionnaire. For most of our clients we have list of stocks we prefer and use them to build individual portfolios. We adjust the stocks and their weights in the portfolios based on the client's risk tolerance.

In the last week we talked or had email chats with some clients.

One client wanted to generate monthly income from their portfolio. Each month we have the cash generated from the portfolio transferred to their bank account. This portfolio is entirely composed of dividend paying stocks with a yield above 4%. The value of the portfolio will fluctuate but we expect the income to grow over time as many of the companies have a history of increasing their dividends. Another client with a similar mandate has seen an increase in the monthly income in each of the past 3 years. The client contacted us and asked if they had made the right decision.

Over the past few years an acronym FOMO has been used to explain why the stock market has been so strong. FOMO stands for Fear Of Missing Out. If everyone else is enjoying the rise in the stock market, you don't want to be the only one sitting in low yielding GICs. The rise in interest rates put some pressure on FOMO as TINA became less relevant. TINA is There Is No Alternative. When bonds and GIC paid less than 1 percent there was no real alternative to putting money in the stock market. Since rate began rising in 2022 there was an alternative to the stock market – the GIC that paid 5%.

The client asked if they should have been in some of the hot technology stocks. My answer was "not if you want steady income". There is a choice a higher POTENTIAL return with higher volatility or higher yielding portfolio with a smaller expected total return. A second consideration was the client had on occasion requested an additional funds to be withdrawn from their account. I looked at Apple as one of the lost opportunities. The stock was $175 at the beginning of 2022 and decline to $125 at the beginning of 2023. If you needed cash and had to sell Apple you would have locked in a loss. If you look at the beginning of 2023 to the present you missed a significant rally. Apple soared from $125 to close to $190. This was an increase of more than 50%. Your decision can depend on when you made your investment. Apple may have been cheap at $125 but there was no assurance that it would recover in a year or when you needed to make a withdrawal.

A second client called and said that their portfolio was down at the time they looked at their last statement. They were correct as many Canadian dividend-oriented stocks had a rough January. Like we discussed in our November commentary, no one likes to lose money. The key is whether the decline in the stocks is permanent or due to the vagaries of market fluctuations. A quote from Warren Buffet helps put this in perspective "A wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses". The Canadian banks are increasing their provisions for potential loan losses but the core business is still good. I think getting the banks with yields approaching 5% and price earnings of close to 10 times puts the investor in a good position for the next few years. In any given month the stocks will fluctuate and that makes some investors nervous. The fixed income portion of the client who does not like to see market fluctuations is in GIC's that yield 5%. There is some price fluctuation in bonds but not in GIC's this is how we adjust a portfolio to meet the clients risk tolerance.

When you build a portfolio, you have to consider the risk tolerance, need for income and the time horizon. One size does not fit all.

Summary

"A wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses.". Warren Buffet

In this month's reflection section, we looked at the intersection of expected return and an investor's ability to handle market volatility. Some investors have objectives such as generating monthly income. This skews their portfolio toward stocks with above average dividend yields. This means they are likely to miss out on some growth stocks or commodity-based stocks. Both growth stocks and commodity stocks can be more volatile than dividend-oriented stocks. You give up potentially higher returns but gain lower volatility and higher income. Other investors do not like to see a decline in their portfolios, no matter how short-term. When they get their statement, it tells them they have lost money. The key point to consider is whether the portfolio is down because the companies in the portfolio have a problem or is it just there is a temporary price decline where a good business is under priced. If you are saving for years ahead then a few weak months may not have any impact on the value of your portfolio when you need the funds years later.

We continue to focus on purchasing companies with, what we believe to be solid long-term prospects. We tend to prefer dividend paying stocks that continue to pay income despite the market fluctuations. The past year of rising interest rates has put pressure on the price of many dividend paying stocks such as the banks and pipeline companies. One factor we like is not just the yield, but the potential for the company to increase its dividend over time. Over the past year we have seen the beaten-up banks and pipelines increase their dividends. This gives us confidence in the long-term investment returns on these stocks.