HIGGINS INVESTMENT GROUP INC.

June Market Analysis

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The Markets

	June	Change in Month	Year –To-Date
S&P TSX	20155	3.0%	4.0%
S&P 500	4451	6.5%	15.9%
Dow 30	34414	4.6%	3.8%
Oil	$70.59	3.7%	−12.1%
Gold	$1928	−2.7%	6.8%

We have said it before and we will say it again. “The stock market climbs a wall of worry.” This means the market can go up in the face of bad news. Let’s look at June. China announced weaker than expected economic activity. There was an armed insurrection in Russia. Interest rates continued to rise. Economic growth and employment continued at levels that would lead the Federal reserve to raise interest rates. After all that gloom and doom all the major markets rose, even oil prices increased after several months of weaker prices.

The US markets were pushed upward by a select group of seven technology companies. Despite rising interest rates, consumers continued to spend. The consumer discretionary stocks on the TSX led the market with a double-digit return. Since the economy did not show signs of slowing, investors took a more positive view of the base metal stocks. As you would expect, the Canadian technology stocks exhibited strong performance. Subdued inflation combined with higher interest rates and quickly ended insurrection in Russia led to weaker gold prices. The worst performing subsector in the TSX was the Gold index. The belief that rates may stay higher for longer led to weakness in the interest sensitive Utilities and REITs. The stocks with a past track record of low volatility a negative return for the month. Obviously, investors were willing to accept risk this month.

The chart on the next page presents the performance of the S&P 500 and the S&P TSX for the Year-to-Date.

YTD Performance S&P 500 and TSX

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

Economic Indicators

1. Canada Inflation

In short, inflation is moderating but maybe not enough to satisfy the Bank of Canada. One problem with statistics is theY are pure math and if you do not understand the assumptions, you do not understand the results. I remember being told that in the early days of spreadsheets there was an acronym GIGO. This stood for Garbage In, Garbage Out. You might have a wonderful spreadsheet but if you start with inaccurate data then you end up with inaccurate results.

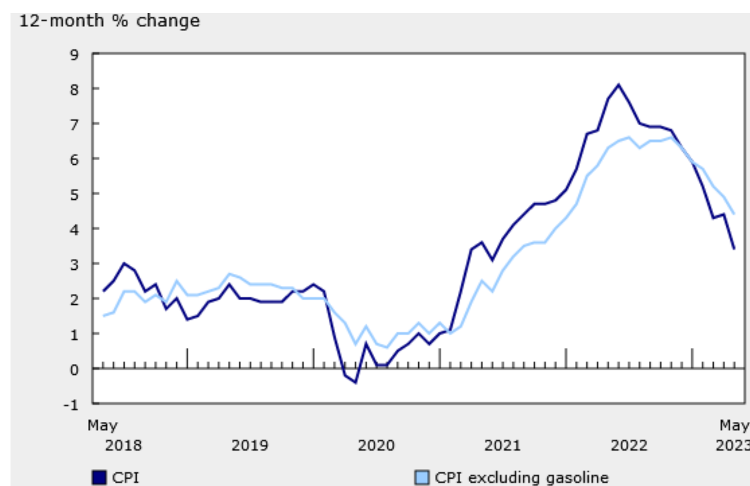
We will start with a short example. If a can of beans costs a dollar on January 1 but is on sale from February to June then the price increases to $1.40 for July to November at the end of the year the bean market returns to normal and the price of the beans ends at $1.20 per can. Inflation for the year on the can of beans is 20%, from $1 to $1.20. It does not matter what the price of the beans are on any other date other than the date Statistics Canada surveys prices to calculate the cost of goods and the rate of inflation. It the can of beans fluctuates in the second year but finishes the year at $1.20 then the inflation rate in the second year is 0.0%. You might feel the impact of inflation from the first year but the reported rate in the second year is still zero. The inflation rate is a comparison between two fixed points and not a motion picture. The one-year rate of inflation is based on a comparison to the prices in the same month a year ago. We are now comparing prices to levels that were above trend due to the war in Ukraine.

Why that long preamble? Many commentators mentioned inflation had declined from more than 7% a year ago to less than 4% last month because prices were higher last year. Last year prices were higher as there was great uncertainty after Russia's invasion of Ukraine. Yes, it is a snap shot, but using the same logic inflation was transitory as last year's high inflation rate was only because prices had spiked. You see that rising prices are the definition of inflation so if the decline is not real then last year's spike was not real and none of the unions are correct in asking for raises to compensate for inflation. (I even quote V. Lenin later in this commentary).

The chart below shows the dramatic rise in inflation and the subsequent decline. The lighter coloured line shows inflation if you exclude the price of gasoline. You can clearly see the rate of inflation was much higher a year ago due to the price of energy and is much lower today for the same reason. One problem with that analysis is I cannot heat my house or drive a car with an internal combustion engine without using energy. Higher gasoline and diesel prices worked their way into the cost of almost everything you buy. Trucking companies and airlines charged customers fuel surcharges to cover their extra costs. This worked its way into many goods that must be shipped. One public trucking company commented their revenues declined as their fuel surcharges declined in line with the price of fuel.

The Consumer Price Index rose 3.4% in May, this is the lowest increase since the summer of 2021. Gasoline prices were 18% lower than a year ago. If you exclude gasoline then the CPI rose 4.4% year-over-year.

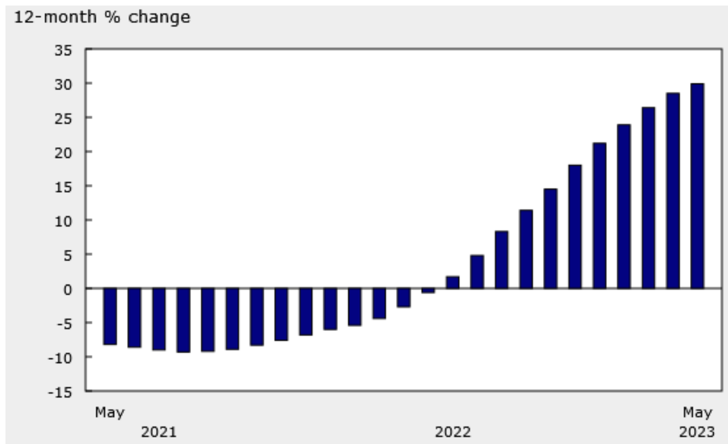
As we discussed earlier, inflation is usually analyzed as year-over-year rate. Month-over-month trends are also useful. CPI was up 0.4% from April to May. If you use simple math .4 times 12 months would be approximately 5%. If you seasonally adjust the inflation number for historic seasonal movements, the rate of increase was 0.1% or less than 2%. You must be wary of politicians and economists espousing their views on inflation.



Source: Statistics Canada

In order to fight inflation the central bank increased interest rates, in a perverse way higher interest rates are inflationary. Higher interest rates lead to higher mortgage rates and this adds to the inflation rate for

the housing portion of the CPI. The chart below shows the dramatic increase in mortgage interest costs. The chart below highlights the year-over-year change in the interest charges in the mortgage market.

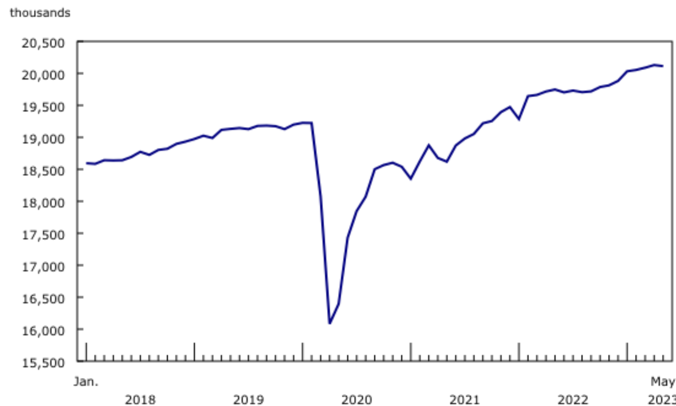


Source: Statistics Canada

2. Canadian Labour

The status of Canada's employment can be described as steady. The chart below shows Canada's labour force in thousands. In a country that just surpassed a population of 40 million we have just over 20 million in the labour force. Employment levels exceed the precovid levels. In 2018 the labour force was 18.5 million and today we are at 20.1 million. I would say we have recovered from the depths of the Covid lockdowns. The chart has been relatively flat for the past few months with the labour force around 20 million. The aggregate number has had minor changes but the composition constantly changes.

Employment for youth under 24 declined by 77 thousand while employment for the 24 to 54 age bracket improved by 63 thousand In May. Employment fell by 24 thousand in Ontario while expanding by 8 thousand in Manitoba. Employment declined in support services but increased in manufacturing. In a country as large as Canada it is possible there are inefficiencies. There might be a need for youth workers in one province while another needs more support workers but they are available in another province. In aggregate things may be fine but if you have the wrong skill in the wrong province there can be problems.



Source: Statistics Canada

Since Covid, the concept of work from home and hybrid work have become acceptable norms for many office workers. Currently 10% of the work force have a hybrid work arrangement, part-time at home and part-time in the office. This is similar to the levels when the survey was last taken in December 2022. More than 14% of workers work solely from home. The percentage who are permitted to solely work from home continues to decline. As you would expect professional services have the highest percentage of those allowed to either work from home or have a hybrid arrangement.

Reflection

And so it begins?

For months every economic publication has reported a recession was around the corner. It must be a long street with no corners. Many analysts expect the Federal Reserve to stop raising rates and even move to decreases by the end of the year. They base this forecast on the fact interest rates are up more than 4% in the past year. Typically, such a sharp increase in rates leads to an economic slowdown or worse. So far, the employment picture has remained a picture of health.

In Canada we might start to see some evidence the employment picture is going to deteriorate. This has a slight tinge of the 80s where there was inflation and rising unemployment. This was known as stagflation.

So far, the employment picture has been very positive. Jobs have been plentiful and the unemployment rate has remained low. Maybe, just maybe, a few cracks are starting to form.

First some stories about the current tight labour market. A coffee shop owner told me that they have a hard time filling positions. Once someone worked for one day and said the job was not what they expected. I am not sure how the owner described the job but on one side of the counter was baked goods and a coffee machine on the other people looking to buy baked goods and coffee. It is hard to

misrepresent that job. They told me people ask for an interview then did not show up or even call to cancel. There are enough jobs out there you do not have to show any courtesy when you decide not to show up for an interview. Another person told me of a pizza restaurant in cottage country that will only do takeout for the summer. You would expect the summer to be the busiest time but they cannot get enough staff to server the customers so will just serve pizza to go. This is like a toy store closing for Christmas because they could get too busy.

Now for the other side of the coin,

Some big financial institutions have, in their view, too many employees.

In the last quarterly earnings release RBC explained one cause for their earnings decline was excess staff. During the growth in technology phase of many technology companies the bank found it hard to attract and keep IT workers as they were being snapped up by companies like Shopify. RBC had to pay more and to hire more people as they knew they would constantly have to hire to replace those lured away by the tech companies. Then many tech companies, such as Shopify, announced layoffs. The tech workers at RBC did not have all those juicy stock options offered by the upstart tech companies so they stayed. But RBC staffing levels were predicated on people leaving. I would assume RBC will likely have to cut some staff.

I saw a small announcement from one of the major mutual fund companies outlined the departure of a couple of department heads and 2 portfolio managers. A week later I read a research comment from one of the major brokerage firms that Great West Life, that owns Mackenzie Funds, was going to right size the portfolio teams. Did I mention the rest of the comments from Great West Life were about other efforts to cut costs? This means more analysts and PMs will be looking for a new place to call home.

Both the cuts at RBC and Great West do not involve many people but do involve those with above average incomes and likely above average spending habits. This is just the thin edge of the wedge. Another bank released an organization chart with one of the boxes that previously had someone’s job no longer in the chart. Another financial institution is beginning a staffing review.

Mergers meant layoffs, or in polite circles, the elimination of overlap. After Rogers’ merger with Shaw was approved Rogers announced a small percentage of staff would be cut. I am not sure what a few percentage is but it matters to those who will be cut. One guest on BNN indicated he expected a “massacre”. By the end of the year RBC hopes to close their purchase of HSBC and they will eliminate any overlap.

Due to lower deal flow Bank of Montreal cut 100 positions in its capital markets division, Ford is laying off 1000 engineers as they feel they are overstaffed by 25%. Some are even in the growing electronic car division. Nordstrom just closed their Canadian operations in June. A colleague told me they used a job website for jobs requiring a certain skill 2 months ago and found several companies look for skilled white collared workers. They executed the same search last week and there were only a handful of positions open and the companies had raised the minimum requirements.

As I write this the weather is mirroring the economy. Like the economy it is sunny days and feel-good times. The forecast and the clouds to the West indicate stormy weather or a less than sunny outlook. That said a recession has been forecast for months and the nice weather lady told all who would listen that today was going to be a rainy day. I leave it to you to decide what the future may bring.

Summary

The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation. Vladimir Lenin

Inflation used to be viewed as transitory and now has become sticky. To beat the inflation demon central banks have raised rates by more than 4%. Investors have become fixated on the risk of the next recession. People are focused on GDP growth and employment as two gauges of the economy. The problem with many economic statistics is they are delayed by a month or two. The question that must be answered is, have interest rates risen enough to tame inflation without too much damage to the economy? Hard to say but I agree with Lenin, inflation is a grind as wages often lag inflation.

We still see many stocks with attractive valuations. The problem is good stocks can still decline if investors believe earnings will decline. In a previous commentary I mentioned how I was able to purchase a Canadian bank stock with a 10% yield in 2009. Today the banks look attractive with 5% yields and single digit price earnings multiplies but this does not mean the prices will not continue to drift lower. Our clients continue to enjoy the dividends they receive from their holdings of banks, pipelines and telecom stocks. They are being paid to be patient. When there is greater clarity, we will likely add to those stocks. Many crypto currencies have also declined but I have no clear way of establishing a value on those currencies so we do not pass opinions on whether they are attractive or not. We like sticking to what we know has worked and will likely work over time.

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