HIGGINS INVESTMENT GROUP INC.

November Market Analysis

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The Markets

	November	Change in Month	Year –To-Date
S&P TSX	20236	7.2%	4.4%
S&P 500	4568	8.9%	19.0%
Dow 30	35951	8.8%	8.5%
Oil	$75.56	−6.7%	−5.9%
Gold	$2055	3.1%	13.9%

After declining for 3 consecutive months the markets almost recovered the entire decline in one month. There was no particular good news this month, just the situation was better than in late October. The catalyst was the expectation that the Federal Reserve was finished raising rates. The market declined in October as the yield on the 10-year US Treasury bond was close to 5%. The yield on the 10-year Treasury was closer to 4.25% at the end of November. This allowed interest sensitive stocks and growth stocks to rally. In October the world feared the war between Hamas and Israel might spread, by the middle of November it appeared the conflict was going to be limited. The US made another deal to extend the debt limit, not fully resolved but better than was originally expected. Less bad was definitely good for the bond and equity markets in November.

In September the Energy sector was the only sector with a positive performance and in November the Energy sector was the only sector with a negative performance. The decline in the price of oil led to a 3% decline in the Energy sector. The prospect of lower inflation leading to lower interest rates cause a reversal of fortunes for some sectors. After significant declines in recent month the Information Technology sector surged ahead by 21%. Lower rates helped the Financial Services sector to a 10% rally in November. Ironically the prospect of tame inflation allowed the Gold sector to rally. It is interesting that Gold is supposed to be a hedge against rising inflation and political uncertainty had it best month when inflation declined and the situation in the Middle East remained stable.

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

6 Month Performance S&P 500 and TSX

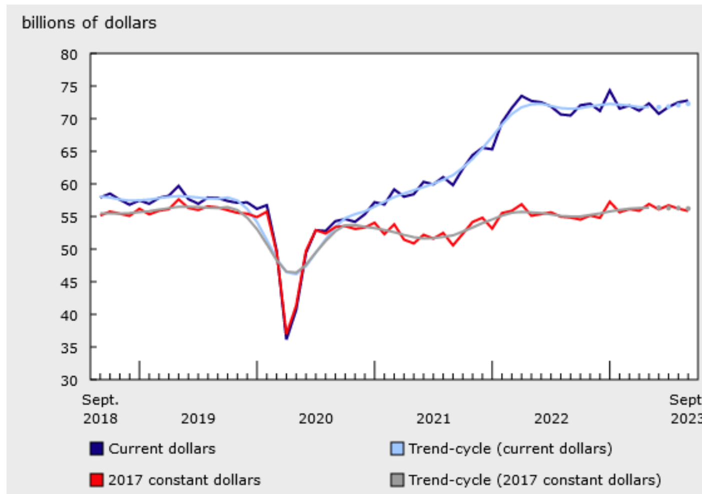
TSX, S&P 500 source google.com/finance

Economic Indicators

1. Canadian Manufacturing

In the reflection section we reference a quote about the dangers of driving while looking in the rearview mirror. This month's manufacturing data is definitely proof of this adage.

The graph on the next page shows Manufacturing sales in billions of dollars. You can see the steady improvement in manufacturing activity in the past few months.



Source: Statistics Canada

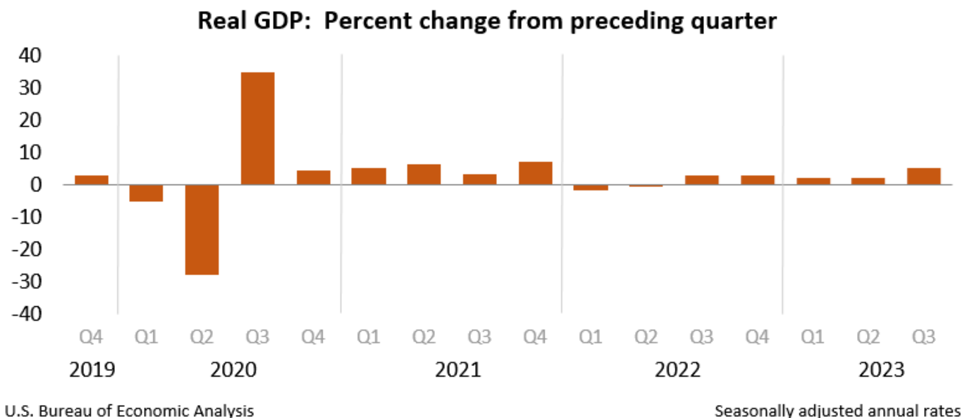
Manufacturing sales rose 0.4% in the month of September. Approximately half the sectors showed improved sales in September. Growth was led by petroleum and coal products which increased by more than 6%. Another commodity related sector, wood/lumber, was the second-best performer. There was weakness in chemicals and motor vehicle parts. Sales of petroleum and coal hit their best levels since January this year. Energy prices rose 10% in the month due to production cuts by OPEC. Prices were up for the commodities but volumes were muted. Now we are in November oil prices are significantly lower than September, so the caveat of driving in the rearview mirror. September sales was strong based on prices that have now reversed, so we can anticipate lower manufacturing sales when they report the numbers for November in 2 months.

There are some other factors that could lead to lower manufacturing activity in coming months. Inventory rose by 1.5% in September which means companies can meet demand without producing more goods. The ratio of inventories to sales increased, also an indicator that inventories can be used to meet future demand. Unfilled orders declined by 1.2%, meaning there is less demand. Only time will tell but we cannot rely on the September data given these other indicators.

2. US GDP

Contrary to what you would expect, the US economy had its strongest quarterly growth rate since the fourth quarter of 2021. All the talk of a US recession is just that, talk. Despite significant increases in interest rates over the past 18 months the US is still experiencing strong growth. Some estimate that it takes about 18 months for rising rates to have an impact on the economy so we could be looking in the beginning of an economic slowdown. However, for the third quarter it was full speed ahead.

The chart below shows the Covid related decline in early 2022 and the recovery shortly thereafter. Since then, there has been slow and steady growth.



The US economy grew at annual rate of 5.2% in the third quarter. This follows 2.1% growth in the second quarter. Growth was driven by increased consumer spending, increased exports and increased inventory level. Rising interest rates led to decline in non-residential fixed investments. Personal income adjusted for inflation increase by $218 billion in the third quarter. Income grew as both wages and interest income increased. This led to a $144 billion increase in disposable personal income. Even after paying increased wages corporate profits increased by $106 billion in the quarter.

Reflection

Dude, where's my money?

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I recently received a call from an investor who had recently opened his investment statement. It made me think of the phrase related to what I thought was an unfunny comedy "Dude, where's my car?" The investor wanted to know why their portfolio was down. So the heading dude where's my money.

There are a couple of phases that contradict each other but help define looking at your statement and worrying. The first phrase is you are likely to bump into another car if you drive by looking in the rearview mirror. The second phrase is those who fail to study history are destined to repeat it.

To use the first phrase first. Your statement is in the past. It was interesting to note that the investor was concerned that their portfolio had declined 3 months in a row. This is a very legitimate concern. At the same time, the market declined more than their portfolio in the past 3 months. The portfolio was a victim of market movements. That is little comfort. There are many would have/ could have. We could have sold the banks before their decline but we still believed in them, with 20/20 hindsight you can always sell before a decline and buy back cheaper but you have to be right twice. The banks were cheap before they declined but headlines warned us about a coming recession so it was timely to sell. We definitely want to avoid declines in client portfolios but short-term fluctuations will always occur.

One client asked about purchasing a stock that had declined in his portfolio and suggested we add to it at the new low price. I still liked the stock but the gains in it looked less certain as they planned to sell some assets over the next year. The market does not like uncertainty so the stock price fell. Less certain than the dividends of the banks. Shortly after the call the stock dropped 10%. This was the volatility I feared. Having a small weight in a stock with high potential is good but it isnot always good to add to it even after a decline. However, after the 10% decline the stock spiked up 25% on no real news. Do I regret not purchasing the stock despite the price gain? No. I like the stock but the weight in the portfolio is equally important to control the risk.

The second phase is more important to the portfolio manager than the first. “Those who fail to study history are destined to repeat it”. The portfolio manager must look at what is driving the performance of the portfolio and determine if it is something that requires action or just requires time. No one is perfect and you should learn from your mistakes and the mistakes of others. I have learned not to buy stocks at lofty valuations or to purchase things I do not understand. Just think of stocks in the end of 1999, also known as the tech bubble. I remember selling Nortel at $17 per share as it was trading at 40 times earnings and even if you gave them 50% growth for 5 years and gave them a healthy earnings multiple you could only justify a price a bit higher. The stock hit over $130 per share. I was asked how I missed it and I told them my logic but I was told I did not understand the true value. A few years later Nortel was worth a few pennies a share. This is a permanent loss not a market fluctuation. As we came out of Covid lockdowns a transportation company traded at $200 with analysts’ price targets of $300, I could not understand the value for a shipping company. Today it trades around $100 per share. I missed the upside but more importantly missed the decline. The stock is fairly valued at today’s prices. We not only look at the stocks in the portfolio to see if I missed anything but we look at other opportunities.

There is always a stock that can decline and stay down for a while after a negative earnings surprise. As the name indicates it was a surprise. We have to look and see if the impairment is permanent and whether at the new price is the stock still worth holding.

Let's take a look at the Canadian banks. Most of the banks are down 10% plus year to date. This is not a performance anyone wants. This would imply things are bad for the banks. The banks just reported earnings for their year end of October. Earnings were down. But if you take a closer look, it may not be as bad as you think. The banks took a hit to earnings to cover expected costs to reduce staffing. TD announced it was going to reduce staffing by 3,000. The Bank of Nova Scotia had previously announced staffing reductions. This hits this year's earnings but should lead to lower costs in coming years. The banks are preparing for the risk of rising defaults due to the impact of higher interest rates on their clients. They are preparing. These are provisions against future losses and not related to actual write-offs in 2023. So far 3 of the 4 Canadian banks to report also reported an increase to their dividends. Companies pay dividends from earnings. If a company believes earnings are going to stay weak, they would not increase their dividend. This only makes the banks more attractive. A dividend that provides a 5% yield gives the investor 5.15% if it increases by 3%, which is a typical increase. Are you happy the banks in your portfolio are down 10% this year? Obviously, NO. What if the banks are likely to recover to their old price levels while providing a yield over 5%, based on today's price? You are looking at a healthy return in the coming years.

Another interest sensitive area, the pipelines, has a negative price movement this year-to-date. The pipelines currently offer yields of around 7%. Just like the banks, some of the pipeline companies increased their dividends. If the price of the stock only increases 3% then you will have a 10% return on this part of your portfolio. The stocks can continue to fluctuate but if the dividend continues to be paid and continues to increase your portfolio will do well over time.

One key question you have to ask about a decline in a portfolio is, is the decline permanent or just a fluctuation. If you purchase a speculative stock and it does not work as intended the loss is likely permanent. If you purchase a solid large and liquid stock that is reasonably priced the loss is not likely permanent. Most of the banks are trading at 8 to 10 times earnings with dividend yields of 5% or better. In better times the banks trade closer to 12 times earnings. If you assume good times are a year or 2 away and the banks do not have a significant increase in their earnings you could see the banks increase in price by 50% to 25% if they trade at historic 12 times earnings multiples.

Summary

You can't grow long-term if you can't eat short-term. Anybody can manage short. Anybody can manage long. Balancing those two things is what management is. Jack Welch

In this month's reflection section, we looked at short-term fluctuations in a portfolio. It hurts to look at a statement and see a decline in your assets. The statement is a snapshot of your financial assets at one point of time, you cannot see the potential in the portfolio. A case in point was a portfolio that declined for 3 consecutive months. Before the next statement arrived, the portfolio had fully recovered the losses from the previous months. If you need the funds near term then a short-term decline can be devastating. 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.

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.

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