HIGGINS INVESTMENT GROUP INC.

October Market Analysis

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

The Markets

	October	Change in Month	Year –To-Date
S&P TSX	35620	1.1%	12.3%
S&P 500	7580	−0.9%	10.7%
Dow 30	51770	1.7%	7.7%
Oil	$104.12	15.0%	81.2%
Gold	$3898	−6.9%	−9.8%

The market was going along fine and then some cracks began to form. Companies began to report third quarter earnings. Earnings were good but analysts did not like the details provided in the earnings announcements. Concerns resurfaced about the capital required to sustain the hot AI sector. The big tech stocks fell, including NVIDIA which is no longer the world's largest company based on market capitalization. Concerns about the midterm elections also rose. Inflation remained above target, but the Federal Reserve held rates steady. This was probably the best move as they did not want to become a political issue. The cost of holding gold, interest rates, started wearing on the price then technical pressures enhanced the decline.

We can start from the bottom. Gold stocks suffered double digit declines. The price of gold declined which precipitated the decline in the stocks, but when the companies reported earnings, it became evident that the cost of mining had surged as many of the mines run their equipment on diesel. The more volatile small cap stocks had negative returns. Since the Canadian technology sector is dominated by software stocks so it was unscathed by the decline in the AI stocks in the US. Despite rising shipments from the Middle East, oil prices spiked upward. The higher commodity price took the energy stocks up double digits in October. As investors sold US technology there was a rotation into perceived safe sectors including Consumer Staples and Consumer Discretionary.

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

6-Month Performance S&P 500 and TSX



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

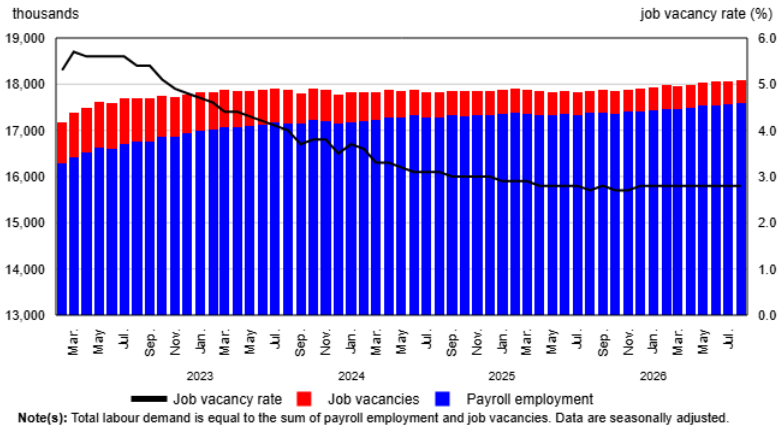
Economic Indicators

1. Economic announcements

Payroll employment dropped by 49,600 jobs or -0.3% in August. This followed a smaller decline in July. Total employment is higher than it was last year. The downturn hit half of all industries, with public administration taking the biggest hit. The decline in public admin was due to loss of temporary census jobs at the end of the census. The decline was fully expected. Other sectors like restaurants, construction, retail, and entertainment also saw fewer people on payrolls. Despite the recent decline there was a net gain of more than 10 thousand jobs in those sectors over the past four months. On the bright side, workers who kept their jobs saw average weekly earnings grow by 0.5% over the month to $1,355, which is a 3.7% increase compared to last August. This increase is higher than the rate of inflation.

The number of available job openings held steady at around 507 thousand, marking eight straight months of very little change. Finding a job has become slightly less competitive compared to last year, with 2.9 unemployed people competing for every open position which is a decrease from last August's 3.3. Job openings surged in the finance and insurance sectors but dropped in arts and entertainment. Restaurants and hotels continue to have the highest shortage of workers, boasting the highest job vacancy rate of any industry. The job shortage in minimum wage jobs can be a result in a decrease in foreign students.

The chart on the next page clearly shows the steady level of employment and declining job vacancies.



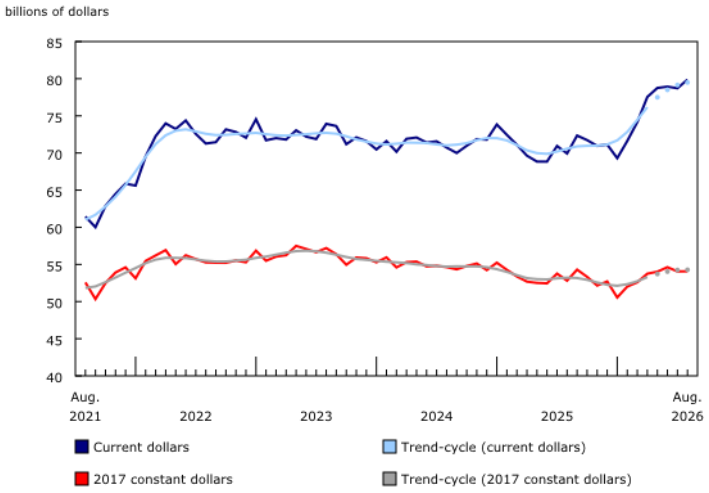
Source Statistics Canada

2. Canadian Manufacturing

One problem with economic releases is that you are looking at the past. A trend is very important, but when the numbers fluctuate and are often revised it is difficult to make any decisions based on the data. Manufacturing activity recently reported is for the end of August, we are 2 months away from that date. That said, some information is better than operating in an information vacuum.

Manufacturing sales rose 1.5% in August which more than offset the 0.2% decline in July. It is more impressive when you look at the fact manufacturing sales were up 14.2% on a year-over-year basis. The annual increase is very evident in the chart on the next page.

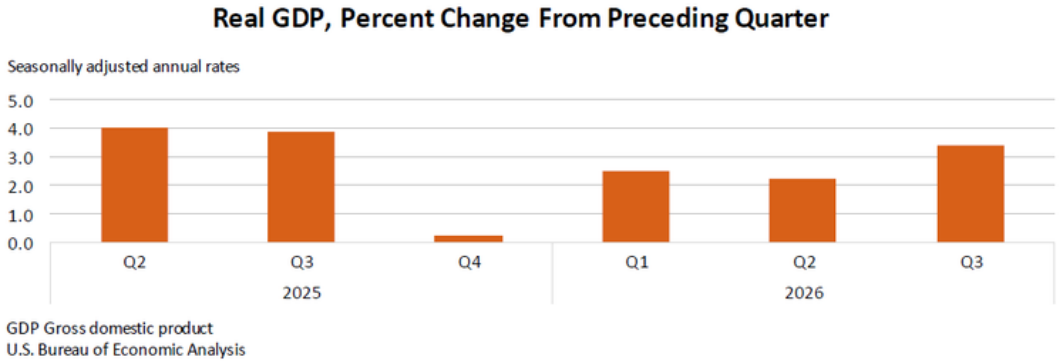
Areas of strength included Primary Metal and Chemicals. Weakness was evident in transportation equipment. Sales of transportation equipment can be lumpy so this may not be the beginning of a trend. The primary metals sales grew by14% in the month with a 9.3% increase in volume with the rest resulting from price increases. Transportation equipment includes automobiles, that are being negatively impacted by tariffs, and aircraft. To put this in perspective, one Bombardier jet would cost as much as 85,000 cars. It is easy to see how volatile this component of manufacturing sales can fluctuate.



Source: Statistics Canada

3. US GDP

The first estimate of US GDP showed amazing growth. Despite tariffs and rising energy prices the US economy grew at an annual rate of 3.4%. As we have mentioned in other commentaries, this is just the first estimate and very often it is revised when more data is collected. That said, 3.4% is impressive. The chart below shows the US GDP for the past few quarters.



The tariffs might not be working as imports rose and exports declined. Lower imports are positive when calculating GDP. We know some Canadian companies increased their shipments to the US to get the goods into the US before an increase in tariffs. This could mean the increase in imports is only a blip that will be reversed. Both consumer

spending and government spending were positive contributors to GDP. Higher energy prices could have contributed to higher spending by consumers.

When they release the GDP, they release some inflation indexes. Inflation declined from the previous quarter but remained above the target of 2%. The GDP price index rose 3% which is significantly lower than the 5.6% rate reported in the second quarter. The Person Consumption Expenditures (PCE), the index preferred by the central banks, fell to 2.1% however if you removed volatile food and energy the index rose by 2.5%.

Reflection

Talking out of both sides of their mouth

I had a hearty discussion with another investor about the risk of a market decline. They offered the idea that the market was supported by rising earnings. A good thesis but not always right.

One example is Seagate Technologies. They manufacture hard disc drives that used to be primarily deployed in desktop computers. The shares have rocketed in the past 18 months as hard drives are an essential part of data centres. The AI computers don't just need computer chips they need somewhere to store their calculations. The company recently announced quarterly earnings that exceeded analysts estimates. The company also raised guidance for next year's earnings. You could describe this as a win-win. If you knew what would be announced in advance you would have purchased shares. Well, you would have been wrong. The stock declined by more than 5% on the earnings release. Some analysts reduced their estimates as they think the AI inspired growth could slow. I am not sure how that was news and why the company raising guidance would lead to that response. The company indicated they continued to have strong pricing power but that exabyte shipments were lower than their internal models. Others argued that the stock had a good run and people were taking profits. So much for rising earnings supporting this stock.

Meta Platforms, aka Facebook, beat on quarterly profit and revenues but fell 3% on the news. Tesla beat expectations and declined by 4%. Here is a bit of irony. Meta declined because they did not cut capital expenditures creating balance sheet risk. Telsa cut capital expenditures which caused investors to worry about lower growth. Obviously, there were other factors.

A key factor to look at when examining the market is the valuation. In previous commentaries we noted the market was expensive when you look at the price earnings level based on historic averages.

Let's start with NVIDIA. The stock is trading at a trailing price earnings ratio of 28. The forward PE ratio is close to 15. The trailing PE is the current price divided by the earnings from the past 12 months. The forward PE is the current price divided by the estimated earnings for the next 12 month. The key point to note is that is based on estimates. The analysts make certain assumptions about earnings, which may or may not be accurate. To put this in perspective NVIDIA's PE at the end of 2025 was 46, at the end of 2023 was 65 and was 89 times at the end of 2021. Who would have purchased NVIDIA at the lofty 50 times earnings at the beginning of this year? I guess those that looked beyond near-term PE ratios.

At the other end of the spectrum is a screaming bargain, if you believe earnings estimates and you believe current earnings are sustainable. Samsung, yes, the company that makes TVs, phones etc. has a price earnings ratio of 8 times. Samsung has seen earnings surge based on chip sales. Sometimes less than 10 times earnings is still not cheap enough.

Shortly after getting into the investment industry, I was told to analyze companies in a commodity-based industry. I took a quick look and told my boss that the companies were all losing money and that maybe my time could be better spent on companies with earnings. I was told to have another look. Due to low commodity prices mills had been closed and would not likely reopen. The price of the commodity had begun to move up. Within a year the companies were breaking even and a year later were profitable. They became so profitable they traded at 5 times earnings. The companies had cash flow and announced expansion of their mills. Expanding production combined with high commodity prices led to increase supply and lower demand. One of my first lessons was that the stocks were cheap when they were losing money and were expensive at 5 times earnings.

Summary

"The four most expensive words in investing are 'This time it's different.'"- John Tempton

In the reflection section we looked at the concept the market was being supported by earnings. This reminds me of the thought that an investment thesis works until it doesn't. Companies have reported solid earnings, but investors have shrugged them off. Some companies declined because they increased their spending on technology and others declined when they announced they were reducing their spending. The market depends on spending on technology. The market may look attractive when you consider NVIDIA is trading at 14 times next year's earnings and traded at more than 50 times earnings for years. Interest rates have risen in the past year and other times this happened the market pulled back. The market will eventually decline the question is when and why.

We try to look past short-term events. We still have near-term uncertainty due to events in Iran and US midterm elections. We cannot foretell what may happen. Client accounts have benefited from holdings in the energy sector. Those stocks may decline if there is a quick settlement between the US and Iran or they could surge if the situation gets worse. The energy stocks are only one piece of a portfolio and movements in that sector may be offset by movements in stocks in other sectors. We continue to like dividend paying stocks that will keep paying even during periods of market volatility.

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