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July Market Analysis

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The Markets

	July	Change in Month	Year –To-Date
S&P TSX	20626	2.3%	6.4%
S&P 500	4588	3.1%	19.5%
Dow 30	35559	3.3%	7.3%
Oil	$81.87	16.0%	2.0%
Gold	$2004	4.0%	11.0%

Markets continued to power forward. In July the European Central Bank, the US Federal Reserve and the Bank of Canada all increased benchmark interest rates by a quarter of a percent. The Dow Jones index rose 13 days in a row, a feat that has not been seen since 1987. A caveat is late that year the market crashed 25% in one day. The US markets have been up in each of the past 5 months. You have heard it before, elsewhere, but the US market has been led almost entirely by 7 technology names known as the magnificent 7. The seven are Microsoft, Amazon, Meta, Alphabet, Apple, Nvidia and Tesla. The TSX hit a 3-month high. The markets were almost as hot as the record global temperatures.

Investors believed it was game on and shunned safety and sought stocks that would thrive in a growing economy. The Health Care sector leapt more than 21% this month. Investors looked though the smoke and purchased some of the beaten-up marijuana stocks. Stocks defined as high beta outperformed all sectors except the Health Care sector. The hope for an economic recovery led the commodity-based stocks to lead the market. The Metals and Energy stocks both had returns of more than 9%. The Energy stocks lagged the double-digit gains in the price of Oil. As the high volatility stocks led the market up, the stocks classified as low volatility had negative returns. Three sectors had negative returns. The stocks generally perceived as safe were laggards. The Telecom stocks were down 5% while the Consumer Staples and Utilities indexes both had negative performance for the month of July.

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. Inflation or Disinflation.

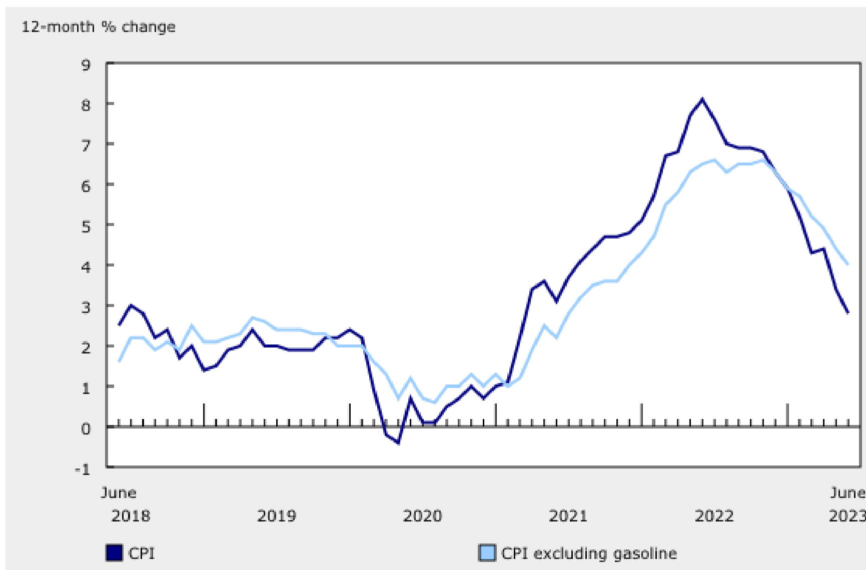
Everyone is watching the Bank of Canada and the Bank of Canada is watching inflation. The central bank has a policy goal to bring inflation down to 2%. The central bank began increasing the interest rates it can control when they realized inflation was not transitory. They took the policy rate from 0.5% in early 2022 to 5% currently. The bank paused their interest rate increases in March and April. The BofC clearly stated their interest policy will be data dependent, needless to say the CPI measure of inflation is a one of the rates on which they will be focused.

There are many ways to measure inflation. Some look at the Producer Price Index which is the price increases received by domestic manufacturers for their products. Just listen to Loblaws tell you they are only passing on price increases, so a rising PPI is likely to lead to higher prices for consumers. Then you have the Consumer Price Index. The CPI is the definition most analyst use to define inflation. Within the CPI there are various ways to define inflation. Some like to look at the core rate that excludes volatile energy and food prices. This avoids reacting to what could be short term movements in oil prices due to a war or the $11 price for lettuce that happened during a bad crop in California. Since your spending includes these volatile items the inflation your experience may not be the one they are looking at. There are some anomalies in the calculation, as they assume a basket of goods, not necessarily the ones you purchase. I don't care about the price of computers each month. only in the month I have to purchase one. The cost of home ownership is included in the CPI so rising interest rates that are used to tame inflation technically increase the reported level of inflation as the cost of a mortgage increases.

We still have inflation but the rate of inflation is decreasing, this is known as disinflation. This is totally different than deflation. Deflation is when prices are actually dropping. Inflation is when the price of your coffee rises 10%, disinflation is when the price of coffee after rising 10% “only” increases at half that rate, 5%. Deflation is when the price of coffee drops by in price, not a sale but a sustained price decrease. Deflation actually occurred in the price of gasoline in the past year. If it is one item deflation is not an issue. If it spreads to the rest of the economy it can be a problem. At first it seems to be good that when you can buy items cheaper than you paid last year, but….Deflation can be much worse for the economy than inflation. If you know the price of something is going to drop, you will wait to buy it. If you wait, the manufacturer ends up with more inventory, so he lays off workers. Workers have less money to spend and therefore even fewer goods are sold. This was one of the impacts that led to the Great Depression in the 30s when prices collapsed.

The Consumer Price Index for the past year ending in June rose 2.8%. This is not too far from the Bank of Canada’s target rate of 2%. This is a significant decline from 3.4% recorded in May. As we mentioned earlier, there are many ways to look at the inflation data. The Debbie downers point out that inflation is only down due to the decrease in the price of gasoline. If you exclude gasoline inflation would come in at 4%, a good bit away from the Bank of Canada’s target rate. The flaw in that analysis is when inflation peaked last year very few said the inflation number was overstated because so large part of the increase was attributable to gasoline. Look at the chart below and you can clearly see inflation peaked almost 2% lower if gasoline were excluded. Ask the unions asking for increased wages to catch up for inflation if they want to accept a 2% smaller raise as the inflation number was overstated, didn’t think so.

Food prices, some thing we all consume, rose more than 9% over the year and mortgage interest costs rose more than 30%. Thanks to new plans from Freedom Mobile and a response from the larger telcos, costs for cellphone plans fell 14%.



Source: Statistics Canada

2. CHINA Economy

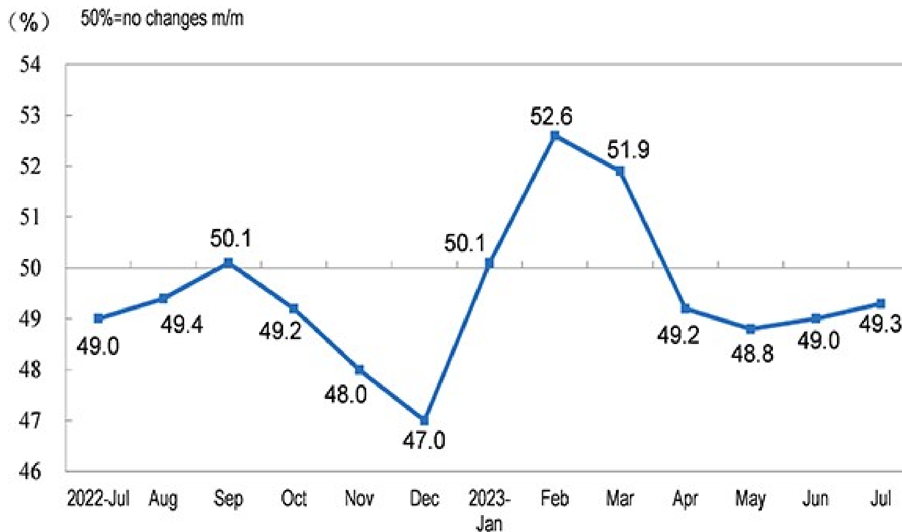
China's GDP disappointed analysts. Given China's historic growth rate, the recent growth in GDP was a disappointment. The Chinese economy grew 4.5% year-over-year in the first quarter and 6.3% in the second. These comparisons are made against last year when portions of the economy were shut down to prevent the spread of Covid. In other words, the economy grew from a low base.

The National Bureau of Statistics of China reported Industrial production grew at a 3.8% rate on a year-over-year basis. Although growth was under 4% year-over-year, production grew close to 1% if you compare June to May of this year. The Bureau breaks the data into 3 categories. The year-over-year growth in Mining was 1.7%, Manufacturing 4.2% and utilities 4.2%. In one-way, utilities are a good indicator of the general health of the economy as power consumption is directly related to industrial activity. The rate of growth was relatively consistent between state-owned companies, private enterprises and companies operating in Hong Kong, Macao and Taiwan. As an aside, I do not know how they collect information on activity in Taiwan.

While our central bank worries about above trend inflation, China has to be concerned about low inflation. Their inflation rate is getting close to zero and zero is close to negative and we have discussed the risks of deflation. Inflation was recently reported at 0.7% on an annual basis. Both housing and transportation had negative price moves in the past year. The core CPI which excludes volatile food and inflation, was identical to the broader measure of inflation with a 0.7% level. CPI was negative if measured on a month-over-month basis.

The Producer Price Index was down 3.1% for the first half over the same period last year. PPI declined by 5.4% year-over-year. PPI declined by 0.8% in the last month alone. Goods produced eventually get to the consumer so this might be a harbinger of even lower CPI readings.

The chart on the next page shows the Chinese manufacturing Purchasing Managers Index. This measures sentiment and changes in earnings and orders of manufacturing companies. When the index is above 50 it is an indicator that the economy is likely to grow. When it is below 50 it is an indicator that the economy is likely to contract. The index was negative during Covid related shutdowns but has been negative in each of the past 4 months. Since China is the world's second largest economy any slowdown will have global implications.



Reflection

I have a plan

What if you knew what was going to happen would it help you make investment decisions?

Probably not.

Let's look beyond our borders. Take Israel for example. This month the government passed what they called the Reasonableness law. Essentially the government wrestled the right to appoint judges to the supreme court from the members of the supreme court. Supporters of the government said it is about time. Many thousands of others took to the streets in protest. Not just one day but for several days. Some members of the army reserve indicated they did not want to serve. The government brought out the riot squad and used water cannons to attempt to disperse the crowds. With perfect knowledge you would have sold your Israeli stocks at the beginning of the month and waited for the market crash to get back in. Wrong answer! The Tel Aviv 35 stock index surged up by 7% this month.

The Economist magazine has presented statistics **for years** that the Toronto housing market is in a bubble and it should burst. Since 2000 the average house price more than tripled while in the US the price is up 60%. A BMO economist reported house prices are 38% above their trend which is the widest difference in four decades. Household debt is 185% of disposable income. This looks like an accident waiting to happen. With these facts it is easy to see housing prices in Canada, and more specifically Toronto, will crash or should have crashed.

If you knew that there would be a virus that would shut down the economy for months and that people would have to rely of government support that was only a fraction of their income before Covid you would "know" that housing prices would collapse. Here is what the Canada Mortgage and Housing Corporation, the government sponsored mortgage insurance company predicted.

"Sales are likely to register a decline in the range of 19% to 29% from their pre-COVID level before beginning a slow, gradual recovery in 2021. Our forecasts indicate that sales are not likely to recover to pre-COVID-19 levels by the end of the forecast horizon. Our forecasts indicate that the average MLS® price will decline by 9% to 18% from its pre-COVID-19 level."

As you saw earlier in this commentary, housing prices more than tripled. Oh yes, I forgot to factor in that we didn't know that interest rates would collapse and governments would inject liquidity to keep the economy growing, with this additional knowledge we could have predicted house prices would not decline. But…

What if you knew that interest rates would go from 0.25% to almost 5% in a little bit more than a year and the central banks would reduce liquidity provided to the economy. A set of factors that will crush the housing market and the economy. If I had only known these facts, I could have sold my house and all my stocks and waited for the end of times. Wrong again.

More recently, what if you knew that a major pipeline company would make 2 major announcements that they had met some goals and were moving closer to ESG objectives in the same month. Two potentially positive developments in one month, get me in. TC Energy indicated they would sell $5 Billion in assets to reduce their debt levels. Previously investors expressed concerns about TC's debt level. TC announced they had sold $5 billion of assets in one transaction and earlier than expected. A reason to buy the shares, except they sold the assets for less than people had expected. Some investors prefer not to invest in companies involved in transporting so called dirty oil vs. cleaner natural gas. TC announced they were going to split into 2 companies. One entity comprising 88% of the company would include the non-oil related business and 12% would the legacy oil pipeline. Investors sold the stock as they viewed this as a distraction.

Summary

"It is difficult to make predictions, especially about the future."– Niels Bohr

Investors began to see daylight in the clouds of inflation. In the reflection section we examined what you should do if you knew what a key economic indicator would be. Even if you knew in advance that a country would experience rioting in the streets you would likely have made the wrong decision. In Israel there is massive political uncertainty but the stock market surged 7% last month. The Economist magazine has pointed out for years that the Canadian housing market is grossly overvalued. At the same time, we were told it was supported by unreasonably low interest rates created by a central bank trying to avoid a Covid induced closure. Then higher rates did not bring the prices back to the pre-Covid so called over valuation.

We have missed the recent increase in the price of the US technology stocks. Some are trading at high double-digit multiples to sales, not to earnings. We avoided the collapse in many technology stocks last year. Just like we missed the Cannabis stocks in their early days, we will miss out when stocks trade above prices justified by their fundamentals. Sometimes this can go on for years. We believe in the earnings potential and income we get from stocks, such as the Canadian banks. They might lag near term but their valuation gives us comfort that our clients will benefit over the longer term. We focus on companies that have a history of paying and increasing their dividends. We are not myopic and create portfolios that also capture stock that do not pay dividends. It is a portfolio and not a collection of stocks with the same attributes.

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