THE WEEKLY BEACON JULY 21, 2023

We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

MacNicol & Associates
Asset Management

Contact us today if you would like to meet about your investment future. info@macnicolasset.com

BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Bengtskär Lighthouse,

Bengtskär, Dragsfjärd, Kimitoön, Finland

Bengtskär Lighthouse is in the Archipelago Sea about 25 kilometers southwest of Hanko, Finland. The lighthouse was built in 1906. Today the lighthouse is a popular tourist destination and is visited by 15,000 people annually.

Harmaja, Helsinki, Finland

Harmaja is an island lighthouse outside of Helsinki. The island has functioned as a landmark since the 16th century and the lighthouse was built in 1883. The lighthouse was first lit in 1900.

**Feel free to send us your photos of Lighthouses to be featured in our weekly market observations. **

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ESG Pushback

ESG is a modern-day acronym that many investors are familiar with. The acronym stands for Environmental, Social and Governance. ESG investing not only focuses on returns but also on holding companies that have good environmental, social, and governance scores. These scores are typically graded out of 100 - the higher the better. Think about it this way, the more eco-friendly your company is, the higher your environmental score is. There are now ESG-focused funds that hold the stocks of companies that grade well on an ESG basis. You might ask, who grades a company's ESG score? Numerous institutions operate across the capital markets industry. The major issue is that there is no ultimate consensus between investors as numerous agencies operate in this field and grade companies. Investors or institutions can simply pluck the rating that they want their holdings to have. The scores are completely subjective and sometimes extremely inconsistent. These scores also seem to be far from perfect as many companies that you would assume would have a high ESG score, grade quite poorly, while some companies that you would assume would score very low, have high grades.

These inconsistencies are major reasons why we have trouble using ESG as one of our investing principles. The scores from these rating agencies make no sense and are completely subjective. We think the ESG phenomenon does not make sense and is being pushed by large corporations that can profit from the launch of new ESG-focused funds. When institutions sell retail clients ESG funds, they are ecstatic, little do they know that the scores are subjective and that they are extremely flawed.

Some of the agencies that grade companies on ESG include Refinitiv, S&P Global Intelligence, Bloomberg, Dow Jones, and many others.

We did not bring this up this week because we woke up on July 16th and realized these inconsistencies, we have critiqued ESG for quite some time. We bring it up this week because of an article we came across last week. An article that compares the ESG scores of electric vehicle maker, Tesla to Phillip-Morris, a tobacco producer that is best known for producing cigarettes.

Now through our knowledge of ESG and what it should score, we would presume that Tesla scores higher. After all, Tesla is the world's largest producer of non-fossil fuel automobiles, and Phillip-Morris’s products cause lung cancer.

Elon Musk saw this online and ripped the ESG system – comparing the scoring system to the devil. Although that might be hyperbolic, the brash CEO might have a point.

This is not the first time that Musk has ripped ESG.

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Elon Musk
@elonmusk

Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list!

ESG is a scam. It has been weaponized by phony social justice warriors.

11:09 AM · May 18, 2022 · Twitter for iPhone

Both S&P Global and the London Stock Exchange score multiple tobacco companies ahead of Tesla in terms of ESG. S&P Global gave Tesla a grade of 37 out of 100 while giving Phillip Morris an 84. The London Stock Exchange scored British American Tobacco an ESG rating of 94 and Tesla a 65. These subjective scores impact what ESG-focused funds buy. Ironically, tobacco producers score better than Tesla when one produces cigarettes which kill 8 million people a year and one produces electric vehicles to decrease fossil fuel emissions.

Critiques of the ESG framework have coined ESG investing as greenwashing.

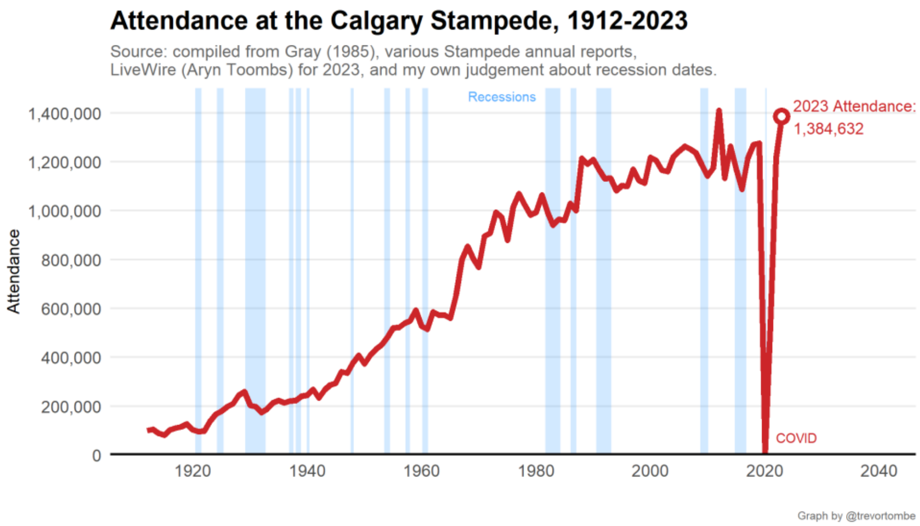
Perhaps this issue is an anomaly or perhaps it's the best example of how flawed ESG is. We also cannot overlook the fact that Elon Musk is brash and anti-establishment which could also be a reason Tesla scores poorly in terms of ESG.

By nature, we usually rip on Tesla due to the companies' multiples but in this issue, we defend it against the ESG overlords. This does not mean we recommend buying Tesla at this very point. We would recommend looking at the components of the ESG funds that are pushed on you by large institutions and see if their high ESG scores make sense.

<u>What recession?</u>

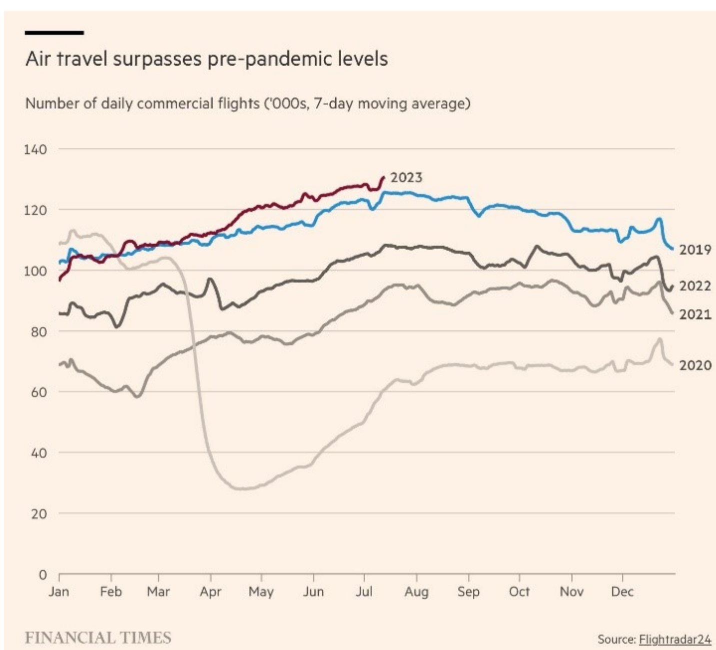
Are we really in a recession? We think we could be but that is not stopping consumers from spending. Consumers are simply adding on debt and digging into their savings to splurge. When we say splurge, we are not talking about a new iPhone, TV, clothing, or any other consumer goods, we are talking about experiences, trips, and services. We have talked about the rotation from goods to services for quite some time and continue to believe service inflation will tick higher purely from consumer demand. We think this trend will be even stronger amongst Canadian consumers. Covid-19 restrictions remained in place for most of last summer, so this summer is the first in almost 4 years with no restrictions. Consumers have flocked to airports this summer to experience what they have missed over the last few years.

If you do not believe us, look at this chart which tracks attendance at the Calgary Stampede. This year close to 1.4 million people attended the Stampede, the highest number since 2012:



During tough times, people historically spend less on experiences and trips, but this year is quite the opposite due to the restrictions that were in place for three consecutive summers across the Western world. Expect airlines to continue to report record travel numbers and expect hotels to be booked out for most of the summer. We continue to believe that consumers will stretch their budgets to travel and experience things with friends and family even if it's not the best financial decision for them.

Air travel has already surpassed pre-pandemic levels and will only increase through the end of this summer.



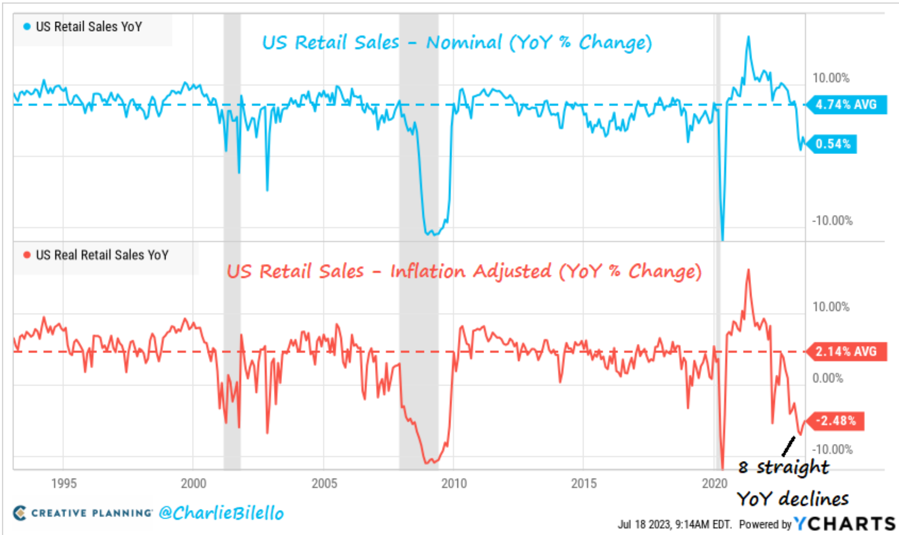
Stock returns for companies operating in this space have been extremely strong over the last few months after their rebound from years of struggling.

Air Canada and many airlines are trading at 52-week highs:

Hotel and cruise line stocks have also surged after being battered over the last 2.5 years. Who would have thought Carnival Corp and Nvidia were two of the best-performing stocks in 2023?

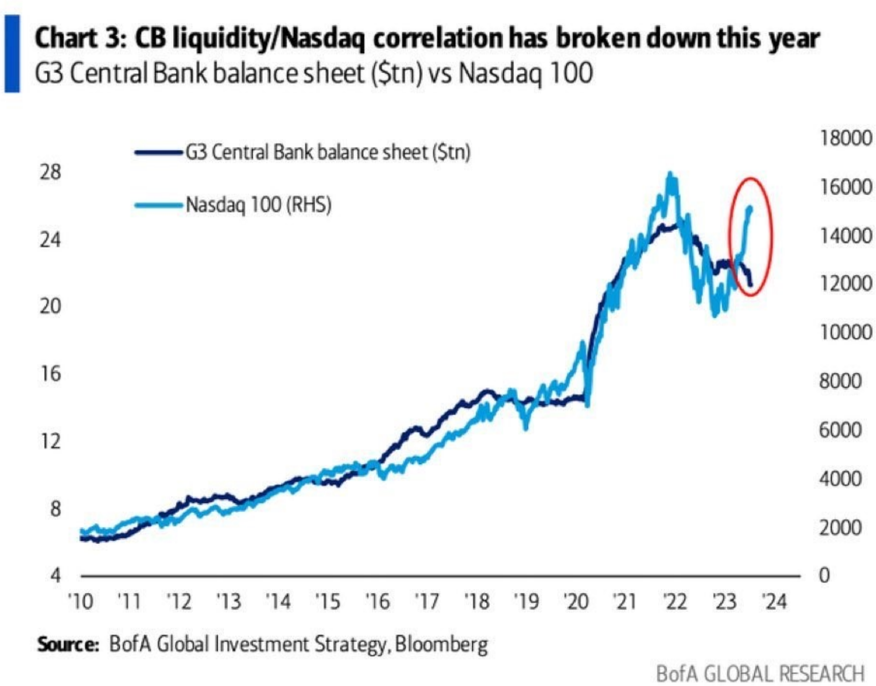
The rotation that we have seen by consumers is absolute (goods to services). We expect this to continue moving forward and expect retail sales as well as earnings for non-necessity good-producing companies to be softer than usual over the next two quarters. Do not be surprised if these stocks lag indices and other benchmarks.

Retail sales have already started to crack and after adjusting for inflation, they are down 2.5% over the last year. This is the 8th month in a row that retail sales have declined year over year, the longest down streak since 2009.



When correlation breaks

Global Central Bank liquidity has decreased in 2023 as Central Bankers shrink their balance sheets to slow inflation. A decrease in global liquidity usually slows financial markets down as there is less capital available in capital markets. If you do not believe us, look at the chart below which tracks the Nasdaq 100 and the G3 Central Banks (Japan, United Kingdom, and United States of America) balance sheet size, the correlation from 2010-2022 was extremely high but this year that trend has broken.



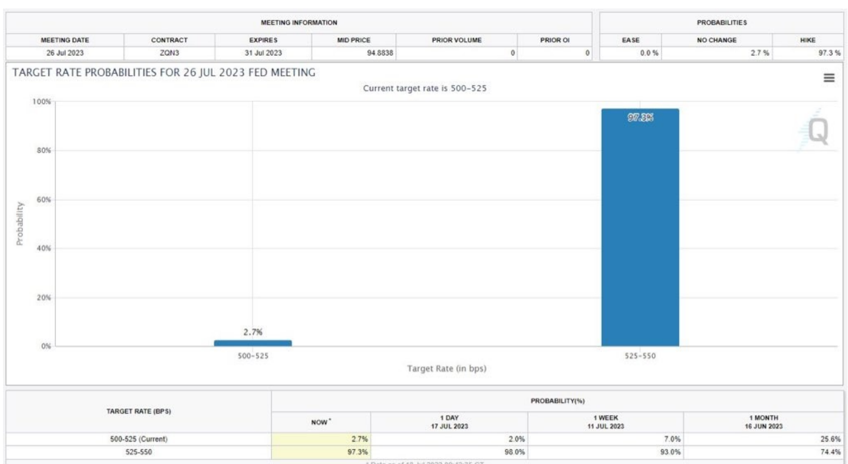
We think this divergence is purely due to the magnificent seven and their outsized returns in 2023. Those outsized returns are mainly not due to fundamentals, they are due to artificial intelligence, investor optimism, and fear of missing out by retail investors. (We will not bore you with details as we have shared these opinions over the last few months.)

We also believe the Nasdaq-100 will return to its historical trendline which matches the G3 Central Bank's balance sheet size. If these two trends are highly correlated and they have diverged, something needs to happen - either the Nasdaq-100 needs to drop, or global liquidity needs to rapidly increase. We know one thing for sure, global liquidity will not increase in the short term and it will not change in the mid-term unless the world tips into a recession. This means there could be some downside in the short term for the Nasdaq-100. We are not saying this will 100% happen but believe it is very likely after looking at the correlation between these two things over the last 12 years.

After all, more money equals higher prices, larger balance sheets, and cheaper money results in higher stock prices.

FED watch tool

The probability for a 25-basis point rate hike is now 97% for the Fed's next meeting which is next week.



MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
26 Jul 2023	ZQN3	31 Jul 2023	94.8838	0	0	0.0 %	2.7 %	97.3 %

TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 17 JUL 2023	1 WEEK 11 JUL 2023	1 MONTH 16 JUN 2023
500-525 (Current)	2.7%	2.0%	7.0%	25.6%
525-550	97.3%	98.0%	93.0%	74.4%

* Data as of 18 Jul 2023 09:42:35 CT

Many believe that this could be the last rate hike from the Fed during this cycle. Last week inflation numbers came in lower than expected. The Fed's monetary policy looks like it is now impacting prices in a way that is slowing the rate of inflation.

This is not major news but we wanted to share this with you, so you are not surprised when rates rise by another 0.25% next week.

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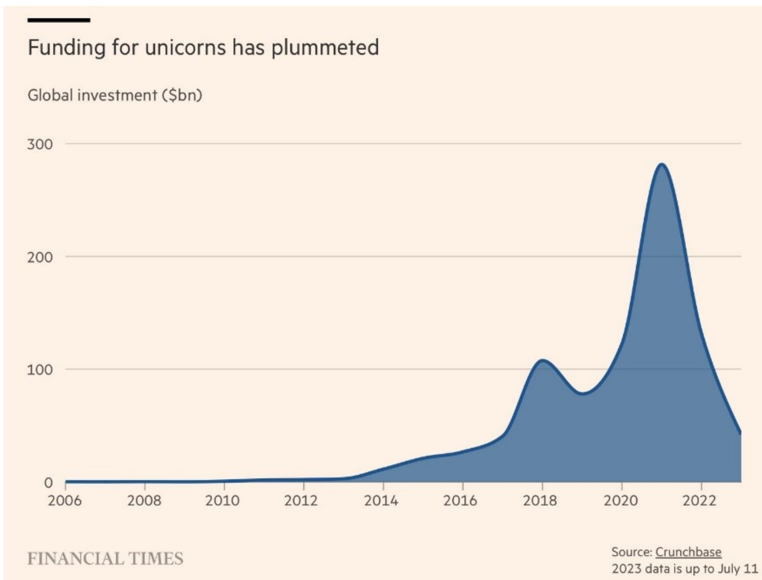
Lack of liquidity

Funding for Unicorns has completely dried up over the last 18 months. In 2022, Unicorns attracted $132 billion of funding. This might seem like a lot, but it is significantly down from the $281 billion raised in 2021. The trend has continued this year with unicorns only raising $42.1 billion so far this year. When interest rates rise, money becomes more expensive, and investors deploy less capital. The depressed funding that we have seen in private markets has also happened in public markets over the last 18 months. IPOs, secondaries, and even M&A activity are well below their recent historical averages. No company wants to raise money at a reduced valuation and investors are less likely to deploy capital in periods when interest rates are rising.

*In business, a Unicorn is a privately held Startup company valued at over US$1 billion. *



The acceleration in funding that Unicorns saw from 2016-2021 directly correlates with Central Banks injecting the global financial system with trillions of dollars.

However, the lack of funding over the last 18 months might be a warning to investors. Startups are burning through their cash reserves and might be forced to raise capital at lower valuations to keep the lights on.

Silicon Valley heavyweights expect many Unicorns to do "down rounds", where they raise funding at a lower valuation than their previous capital injection, or go out of business entirely.

Currently, there are approximately 1,400 Unicorns worldwide. In 2013, when the term Unicorn originated and there were only 39 worldwide and by 2018 that number was 119. Since 2018 the number of Unicorns worldwide has multiplied by ten. The advancement of modern technology is a major driver of the growing technology industry, but global liquidity has also been a major reason for this trend.

Testing the reverse Cramer index

Our friend (ya right!) Jim Cramer is an all-time personality in finance. He is notoriously wrong on his calls. When he is bullish on a stock, they miss earnings, when he's bearish, they break earning records. At this point, many people online call this the Cramer curse.

It appears Cramer is really testing the luck of the U.S. economy as he made a bold call on Tuesday.

MAD MONEY

Jim Cramer doesn't see a recession on the horizon, says recent conjecture "just doesn't hold up under close scrutiny"

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KEY POINTS

- CNBC's Jim Cramer said on Tuesday he doesn't think recent recession discourse holds much weight.

If Cramer is calling for no recession, then we probably will get one.

For now, we will have to wait and see if Cramer is right.

MacNicol & Associates Asset Management
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