MacNicol & Associates Asset Management Inc.

August 2023

The Monthly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snapshots of metrics, a section on behavioral investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the marketplace.

"Education is something no one can take away from you…"

- Elin Nordegren, *Tiger Woods' ex-wife*

The Numbers:

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Index:		**2023 YTD:**
S&P/TSX:		6.41%
NASDAQ:		37.1%
Dow Jones:		7.28%
S&P500:		19.5%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	5.10%	5.44%
5-Year Bond:	4.02%	4.34%
10-Year Bond:	3.70%	4.18%
30-Year Bond:	3.51%	4.28%

Economic Data:

- Eurozone inflation drops to 5.3% in July
- Several emerging market central banks poised to begin easing policy rates
- Commodities higher in July
- China's July economic reports miss consensus estimates, Beijing to stop releasing youth unemployment stats
- Canada lost 6,500 jobs in July; jobless rate now set at 5.5%
- Stocks ex-Japan higher globally in July

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	25	21
P/B: Price-to-Book	4.2	3.6
P/S: Price-to-Sales	2.7	2.6
Yield: Dividend Yield	1.6%	1.5%

2023 Year to Date Performance, by Sector: July31st, 2023

S&P/TSX Composite	6.41%
NASDAQ	37.1%
Dow Jones Industrials	7.28%
S&P 500	19.5%
Russel 2000 (Small Caps)	13.7%
MSCI EAFE	14.3%
Crude Oil Spot (WTI)	0.61%
Gold Bullion ($US/Troy Ounce)	4.97%
SOX Semiconductor Index	42.8%
VIX Volatility Index	-60.4%

Source: Canaccord Genuity Capital Markets & Thomson Reuters

Foreign Exchange - FX

As of August 21, 2023 09:00 AM EST	$5,000	Cdn		
Banks	Rate	Buy USD	Cost	% Difference from Spot Rate
CIBC	No Public Rate Posted Online			
Interactive Brokers	1.35	$3,704	$1	0.0%
Laurentian Bank	No Public Rate Posted Online			
National Bank	1.3880	$3,602	$(101)	-2.8%
Raymond James	1.3610	$3,674	$(29)	-0.8%
Royal Bank	1.3772	$3,631	$(73)	-2.0%
Scotia	1.3902	$3,597	$(107)	-3.0%
TD	1.3859	$3,608	$(95)	-2.6%
Canadian Snowbird	1.3390	$3,734	$31	0.8%
Spot Rate	1.3502	$3,703	$-	0.0%

An education you can bank on…

2022 saw most balanced investors schooled in the main constituents of a balanced portfolio (stocks and bonds). Even educated investors had to quickly remind themselves that fixed income securities can lose value and that stocks aren't the only asset class that can fluctuate every now and again. Interest rate risk is common to all bonds, even US treasuries, and bonds with fixed coupon rates are especially prone to losses when rates around them move up. The mathematics are extremely simple: bonds that pay a fixed rate of interest become less attractive as interest rates around those bonds rise subsequently squishing prices. Of course, this sort of volatility only happens in the secondary market and only prior to maturity. A bond's yield to maturity on the other hand shows what you *will* make if the bond is held until it matures. But the simple fact of the matter is this: neither the Canadian nor US Government explicitly guarantee the value of their bonds if they are sold prior to maturity.

Education can be at times frustrating and expensive, so occasionally, taking a break is a very good thing. Most financial market media outlets having been talking about the potentially steep valuations in technologynology stocks and so I figured that it would be a good opportunity to see what is going on in the wonderful world of Canadian banks. Compared to sectors like energy or technologynology, financials get very little press coverage and in some ways, I like that.

Most of the Canadian banks haven't been in style with investors that much of late. That's despite generally good dividends and share buybacks. This year's stand out in the group, Laurentien Bank, soared in July but that was due to take over speculation following 2 years of largely lousy performance. But Canadian bank stocks are starting to look attractive for long-term income seeking investors. The relative valuation gap that exists between many bank stocks and technologynology stocks is now glaringly obvious and the gap expands even more if you look at the performance of the S&P500 in a different way. If you consider the S&P 500 index's performance thus far in 2023 (nearly 20%) but then strip out the performance of the top 10 names (all technologynology giants) the return figure left behind is a more pedestrian single-digit gain. This suggests that whereas valuations in technologynology are high, the same cannot be said for the rest of the market. We are not piling into the banks just yet. But we have been consistent with our view that the odds of a recession were more of a coin toss and less of a foregone conclusion. In June, the housing market in North America gave off signs that it had entered a bottoming process, and this is a very good thing for not just our big banks but all big banks. Big banks have wholesale and asset management divisions, but their exposure to the consumer and to housing is about as high as you can get.

Bloomberg ran a very good piece on the relative valuation gap between bank and technology stocks, and the chart they used to illustrate the said gap was excellent. But what Bloomberg said investors should do about the gap was a bit of a stretch for me: bank stocks (not technology stocks) are the superior value here, especially for long-term investors. Let's take a moment to consider why. Inflation is beginning to roll over and this will not only reduce the likelihood of rate increases in the future, but it will also boost big bank profitability as the yield curve re-establishes an upward slope in the coming years. On a seasonally adjusted basis, CPI rose just 0.1% in June, and this is the smallest increase so far this year. In the United States, American 12-month forward inflation expectations dipped for the third consecutive month in June, a catastrophic failure in the US economy seems unlikely even if recent scars from bank failures or debt ceiling debacles still exists.

A more likely near-term problem with the banks however is loan losses. The losses will be higher but credit risk and reserve levels as at the end of the second quarter were appropriate for dealing with provisions for credit loss. RBC earned $3.65 billion during the quarter ended April 30 and that was down from $4.25 billion during the same quarter last year. Revenue for the quarter was $13.52 billion, up from $11.22 billion in the second quarter last year, while its provisions for credit losses amounted to $600 million compared with a recovery of $342 million a year earlier.

Cautiously intrepid…

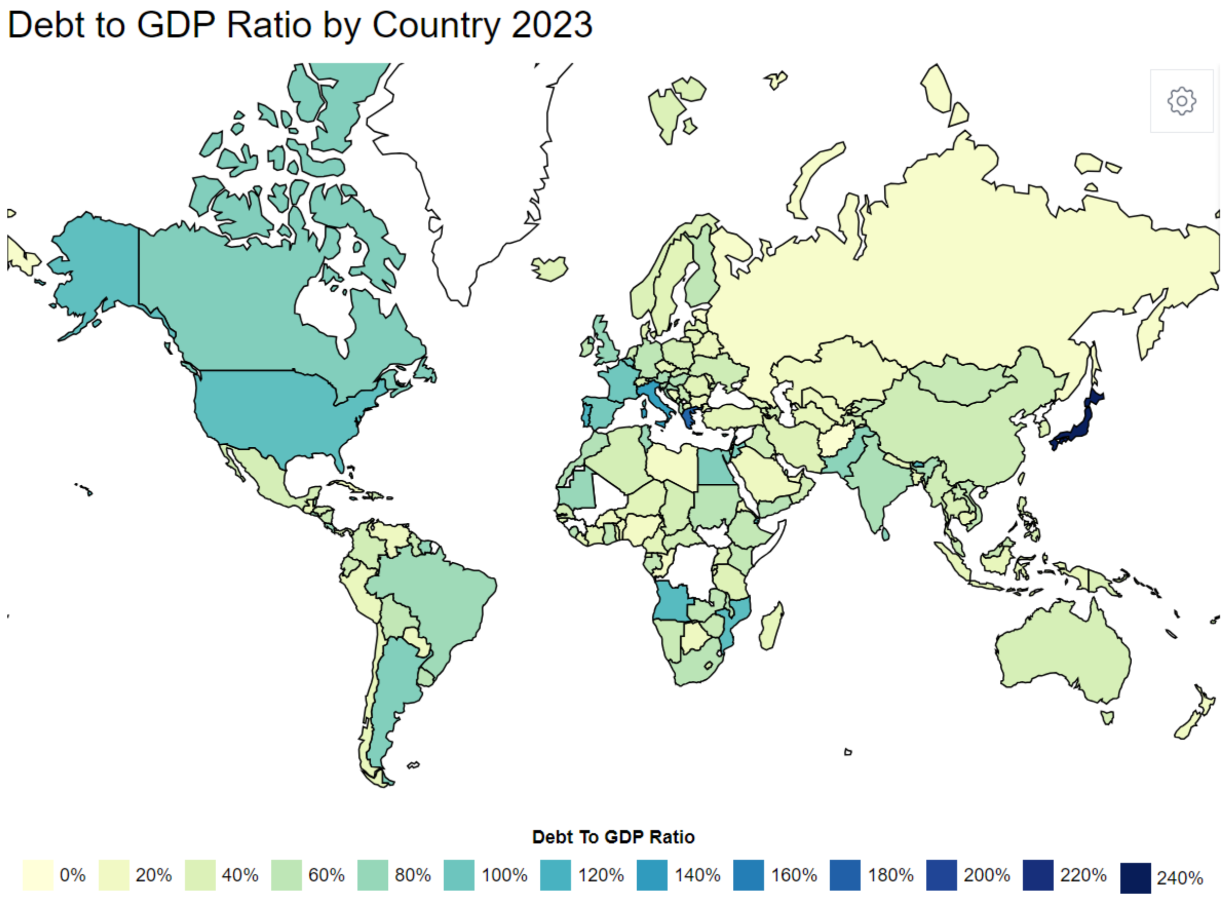
You should exercise caution when chasing big bank dividends, provisions for loan losses "seem" appropriate but there could always be surprises (remember CIBC) so start with the cheapest banks since buying the pricier names will raise the main risk with buying banks now: poorly telegraphing loan losses to investors. Now a days, Canadian banks have excess reserves, part of this is frankly good corporate governance but a lot of it is regulatory. I certainly hope that is the case, but the simple fact remains that most Managers my age see a CIBC sign and immediately think a) the loan loss debacle and b) the $3 billion fine for getting involved with Enron. So, you'll certainly have to choose wisely in your hunt for juicy dividends.

With inflation beginning to look like it has come off peak levels, economic momentum stable and an improvement in housing in the neighborhood, revenues at most banks should accelerate over the next years and we truly do mean years. Therefore, an investment in the big banks is a lot like an investment in a good education: both can be difficult and take years to bear fruit, but ultimately worth making.

Emerging opportunities?

Many investors might not know that in certain ways the emerging markets have a superior credit rating when compared to their developed market peers. If this does not seem to make a lot of sense, then let me explain what I mean. The map of the world on the following page comes from the World Population Review. The World Population Review is a Lancaster Pennsylvania based not-for-profit organization dedicated to making important statistics about the world a little bit easier to use. Most demographic data is hidden in spreadsheets, behind complex APIs, or inside cumbersome tools.

World Population Review's goal is to make this data more accessible through graphs, charts, analysis and visualizations. The visualization below demonstrates the Debt-to-GDP ratio for the entire planet and lighter colors are “better” in the sense that they represent economies with a little more breathing room. Indeed, many emerging market economies have far lower Debt-to-GDP ratios than developed economies such as Italy, France or even the United States. And who can forget that when it comes to Debt-to-GDP no major country is encumbered as heavily as Japan.



Developed economies generally produce more than emerging economies do, and this is the main reason why credit tends to flow so freely to these nations. But a high debt overhang also makes these countries vulnerable to inflation expectations and interest rates. While there is still some uncertainty around the future path of rate hikes by the US Federal Reserve, many emerging market central banks have communicated that rate cuts are now only a matter of time. Inflation tends to roil emerging markets more than the bigger, more voluminous markets of the developed world so central bankers in those places must act fast and act hard. However, because emerging markets quite simply carry less debt, interest rate shocks can puncture built up inflation more quickly and allow opportunistic investors the chance to dabble outside of their homelands. The MacNicol Investment Team feels that rates in emerging markets have been held at restrictive, double-digit levels for a sufficient period of time, and inflation is now trending downward. That downward trend is raising the odds that central banks in those countries will soon begin to cut interest rates as dramatically as they raised them. In some cases, interest rate cuts have already begun.

As July concluded, the Central Bank of Chile cut rates by 100bps from 11.25% to 10.25%. Brazil, Columbia, Mexico and Peru are expected to start easing in the coming months. And the elevated levels of interest rates in those countries [Brazil (13.75%), Colombia (13.25%), Mexico (11.25%) and Peru (7.75%)] offer bankers the opportunity to ease rates materially over the coming year. Brazil's 13.75% policy rate implies a real yield of 10% given that annualized inflation in the country has dropped to 3.2%.

The opportunity?

Developed capital markets have provided a larger share of financing to emerging market companies over the past decade and an easing of tight credit conditions should allow for improved growth in the second half of 2023 and into 2024. What's more, the growth outlook for many emerging markets (not including China) remains positive. The International Monetary Fund (IMF) in their latest forecast projected emerging market growth to remain stable at 4.0% in 2023 and 4.1% in 2024. Developed economies, on the other hand, are expected to see their growth slow from 1.5% in 2023 and 1.4% in 2024. Of course, very low valuations in both emerging market stocks and credit related to an uncertain outlook: 4% is more than 1.5% but there is greater variability in the dispersion of outcomes around the 4% than the 1.5% so this opportunity isn't for everyone. Yet despite strong corporate credit fundamentals, with emerging market leverage for the most part at decade lows and the ability to make payments on debt substantially better than developed market peers, emerging market corporate and sovereign yields have remained elevated, shutting many issuers out of capital markets.

Nearly 20 emerging market countries have spreads at distressed levels (over 1000 basis points) and these high spreads have made new hard-currency debt issuance very challenging. Emerging markets are issuing about a fifth to a quarter of the amount of debt that they usually do ($30 billion per year from 2017 to 2021versus $7 billion in 2022 and $5 billion so far in 2023).

If anything, the lack of credit issuance has created a healthier setup for emerging market asset prices as the lack of bond supply due to depressed valuations has removed sellers from the market. We know this is a highly optimistic way of looking at things, but emerging market credit has rallied since the start of the summer, and we think it has a good chance of continuing. So, is this an opportunity and if so, is it a better opportunity than 2008 and 2020? I think it is fair to say that is indeed starting to look like an opportunity. If the central banks of Brazil, Columbia, Mexico and Peru (and the rest of the emerging markets ex-China) follow Chile's lead, then this won't just look like an opportunity, it will at that point be one. As far as whether it will be "better" than the opportunity presented to investors during the fallout of Lehman Brothers or COVID, I am not sure. During those debt dislocations the period of market bottom-to-recovery was generally 6 to 12 months. The current period of drawdown has already been over 12 months, and some emerging market equity benchmarks are trading at 2007 levels. I intentionally distance myself from telling you what is "better" in this publication. "Better" really depends on your situation and overall ability to handle volatile investments. But my goodness you must admit that a 10% *real* rate of return on some emerging market sovereigns has created a very attractive environment for investors with a bit of brains and a lot of patience.

Behavioral investing: confirmation bias

My sister recently purchased a new car from an established manufacturer. Unfortunately, the experience for Liz could not have been more frustrating. The car, nearly twice the price of the one I drive, is very nice to look at, very nice to be in…but almost a complete piece of junk. In just 6,000 short kilometers, Liz has sadly encountered problems ranging from minor irritants (a strange "electrical" noise emanating from the vehicle's underside) to major safety concerns (the vehicle "deciding" to shift into neutral from drive) and more recently (the vehicle's side view mirrors "deciding" to tuck themselves in for parking whilst Liz was still driving). Absolutely unacceptable, I said. Both my sister and I enjoy driving but whereas Liz enjoys confirming what she already knows about a car, I take a very draconian view towards crappy engineering, build quality or electronics. Rather than confirming what I already know about a vehicle (for example that I like the way it looks on the road) I am more prefer to thoroughly research all of a vehicle's known or potential defects.

Confirmation bias…

Confirmation bias is when investors seek information that supports what they already believe (Rogers must be a good investment because I just received my latest bill from them, and it was $300) and ignore information that contradicts these beliefs (such as the costs of bringing all that information technology into your home). Confirmation bias operates in many areas of our lives such as Liz with vehicles, some of my personal friends who consume only media that supports their view of the world, and in pessimists who focus on negatives (like how you can lose a fortune in the stock market very quickly) while ignoring the positives (like how you can make a fortune in the stock market over the long term if you are just careful and apply a little basic common sense). It's that last part, the investing world, where confirmation bias can be a costly behavioral investing bias to have. Confirmation bias may lead people to cling to preconceived notions about their investments, while discounting information that contradicts these ideas. For example, an investor whose portfolio is concentrated in a specific sector or group of stocks (technology stocks are an easy recent example but you could alternatively insert any sector here) may only absorb good news and ignore bad news regarding these investments.

In one more current study, Cerulli Associates found that investment advisors saw confirmation bias as one of the top behavioral biases affecting their clients' investment decisions, and it is very easy to understand why. No one likes being presented with data or information that contradicts pre-existing views. It is quite simply not a pleasant experience and much like being told by your doctor that you should lose weight or quit smoking. But in the same way that you should listen to your Doctor, you should probably also listen to your financial advisor. Confirmation bias usually leads investors to concentrate on their portfolios in a particular stock or sector. I would suggest that lack of overall portfolio diversity is perhaps the single most common error we see on the part of prospective investors that we meet each week. Focusing too myopically on a particular type of stock or sector or investment generally makes investors vulnerable to downturns, which can leave their portfolios misaligned with their long-term investment goals and create unpleasant "statement shock" come reporting season. Confirmation bias can also keep investors from viewing market conditions objectively. For instance, investors may focus on some expert opinions while ignoring others simply because they happen to like the way one investment strategist looks or speaks. The issue here is that investors risk making decisions based on incomplete information.

What we can do to help…

Dealing with confirmation bias requires independence but it also requires open and effective communication. At MacNicol & Associates Asset Management, you will find that we start off by asking you where you would like to begin. We want to know your story and what's important to you. Your experience with investments, your current portfolio of holdings, these queries give us a better sense of your overall perspective thoroughly so that we can set up a framework that helps override the frankly understandable cognitive impulses around investing. This may include establishing formal buy and sell criteria as we do here at the firm. Establishing formal goal posts around your investments helps take the element of "feelings" out of the equation and can help you avoid making sudden investment decisions catalyzed by confirmation bias.

Buy Criteria

VALUE INVESTING

- Low price-to-earnings (P/E) multiples
- Low price-to-cash-flow multiples
- Discount to book/net asset value
- Hidden Assets
- Discounted valuations compared to peers
- Contrary opinion and under-followed by investment analysts

GROWTH INVESTING

- Growth at a reasonable price (G.A.R.P)
- Predictable and sustainable earnings growth.
- Focused and committed management.
- Conservative yet innovative culture.
- Reasonable valuation, financial strength, liquidity.

Sell Criteria

- Excessive valuation.
- Size of holding exceeds parameter.
- Loss of confidence in management.
- More attractive opportunities elsewhere.

[At MacNicol & Associates Asset Management, we have a highly structured and disciplined set of buy/sell criteria for our holdings, and this means the only thing we are biased towards is helping you and your family become more successful investors.]

The only thing we ever want our investors to confirm is that they believe we have their best interests in mind and that those interests are carefully and methodically reflected in their portfolios. Together, we can ensure that your next investment purchase isn't just a nice-looking piece of junk.

The MacNicol Investment Team

Firm Wide News

The First Home Savings Account (FHSA) has launched in Canada and financial institutions are launching accounts as we speak. Stay tuned over the next month to open a FHSA for yourself, or a loved one as soon as possible. The account is tax deductible like an RRSP, and individuals can contribute $8,000 per year to the account (for 5 years).

The MAAM Investment team did a webinar in July on the FHSA. Click here to watch the webinar.