Let's talk investing: 2Q23 review with Scotia's Multi-Asset Management team

July 10, 2023

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GS Welcome again to our listeners. I'm your host, Greg Sweet. Today we'd like to bring you a new podcast to help empower our customers when making important financial decisions. The second quarter of 2023 has finished, and, once again, on balance, it provided solid financial returns. As always, we had some ups and downs, but at the halfway point of the calendar year, we're in good shape year-to-date in both equity and fixed-income markets.

Right around now, Canadians are receiving their second quarterly statement. This is once again a natural time to reflect on recent events, as well as look ahead. We know our customers love to hear what's going on directly from the portfolio managers. Today our special guest is Craig Maddock, Senior Portfolio Manager and Head of Multi-Asset Management Team, as well as Mark Fairbank, a Portfolio Manager on Craig's team. Let's get started.

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Performance was solid in Q2, but some significant questions remain about where we're going for the rest of the year and into 2024. What are the key drivers of this quarter's performance?

CM Good to chat with you again, Greg, especially when performance has been so strong. Year-to-date returns across both stocks and bonds have been very positive, and our quality growth strategies across most of our portfolios was an added boost to performance. Of course, that means the portfolios we manage were off to a great start, and that makes me and the team very pleased.

Year-to-date performance on conservative portfolios are up around 3% and longer-term growth portfolios up around 6%. And, of course, some are a little higher, some are a little lower, depending on the specific portfolio you're invested in, but it gives you a pretty good flavour for what's happened so far this year.

Now, as you mentioned, we're only halfway through the year. And while most of our portfolios are approaching our long-term annual return expectations, that's a pretty good outcome. Now, of course, most conservative portfolios have a higher allocation to bonds, and Canadian bond investments were up around 3% this year, and that's with midterm bonds outpacing short-term bonds as interest rates have started to moderate this year in anticipation of a reduction of the very aggressive Central Bank tightening that will hopefully come to an end.

And the reason the year-to-date results are so impressive is because the same strong drivers of return we spoke about in the first quarter continued throughout the second quarter. Now, this first half of the year is the strongest start to the Nasdaq-100 index in history, up a staggering 36%.

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Now, this, of course, has been fuelled by the craze over AI pushing growth stocks back to excessive multiples in hopes of picking up the winner. For instance, the chipmaker Nvidia has emerged as the frontrunner to monetise the potential success of AI, and time will tell if this excessive runup in stock prices of the growthiest AI-linked companies is truly artificial intelligence or perhaps just natural stupidity.

Now, similarly, the S&P 500 also had its best start since the year 2000. Now, this time it's been driven by Apple, which now has a market cap of over $3 trillion. That is larger than all of the companies in the Russell 2000, the smaller-cap companies in the US, combined. It's also larger than the entire size of the Canadian stock market. That's just one company. Wow. That does seem a little bit crazy.

Now, outside of these speculative gains we've seen in IT, telecoms and consumer discretionary, the real economy continues to slow. It was in this quarter that Bed Bath and Beyond filed for bankruptcy, suggesting that the global slowdown is truly having impact on companies. Traditional bricks-and-mortar businesses are feeling the pressure. Think of the global real estate sector. It's down 7% year-to-date. That's a huge contrast to the Information Technology sector, up over 30%.

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And real estate was not alone. Aside from the strength of the top three sectors globally, nothing else was really positive, with most sectors delivering a near-zero return, and utilities and energies firmly in negative territory, alongside real estate. Most of the global stock market seems to be feeling the impact of monetary tightening.

If you're looking at specific markets, the Canadian Stock Market was up about 5.7% year-to-date. However, that paled in comparison to the S&P 500 in the US, which was up over 14%. Growth stocks in the US, represented by the Russell 1000 Growth index, was up 26%, while its value counterpart was up a measly 2.7%.

And then around the world, we saw strength coming from Europe and, surprisingly, Japan, which propelled non-North American markets up over 9% so far this year. The weak spot in global equities was in emerging markets, with China down almost 8% year-to-date.

Now, with three strong quarters of market returns, the next 12 months' price earnings multiple on the S&P 500 is back to 19.3 times, which is, quite frankly, where it was before the Fed started hiking interest rates back in March of 2022. And most of the market return can therefore be attributed to multiple expansion, which, I have to say, feels quite optimistic against the backdrop of higher interest rates and slowing growth.

GS Craig, those are some pretty compelling and interesting stats. Can you tell us a little bit more about these market-driving events?

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CM We sometimes see investors really key-in on a particular topic of concern, whether it's a geopolitical event, an election, or something of that nature. And maybe, Greg, just for interest, in this last quarter, we saw the US Government run up against the debt ceiling limit, which was a political obstacle that we've seen come up every few years now lately. And the most likely outcome was always going to be that it always got worked out.

And in this case, there was a small chance, very small chance, that the parties and the Government wouldn't be able to negotiate a resolution, in which case, we could have seen some pretty unusual outcomes. The US defaulting on debt obligations, a shutdown of the government services, things of that nature.

And in the quarter, investors were really keyed in on this one event over the past few months and how the markets moved up and down on reports of how negotiations were going. I don't want to say investors were wrong to focus on this, because it was an important event. But, as is usually the case, clear heads prevailed, and a reasonable outcome was achieved. And once that happened, US stocks rallied again, and the negotiations are now just a footnote.

To me, the key takeaway is, as much as we can focus on what the drivers were in the short-term, like in a quarter, and this certainly was one of those events, the key takeaway is that while short-term events matter, long-term investors shouldn't get too focussed on them. We really should be spending time thinking about the long-term fundamentals and try to ignore these short-term distractions.

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GS That's good advice, Craig. Mark, what about the shifts in monetary policy expectations? What do you make of that?

MF That was one of the biggest events in the quarter. Elevated inflation has generally been declining around the world after a significant series of interest rate hikes from most major central banks. A few months ago, most would've guessed that the majority of the heavy lifting had been done, and it was mostly a matter of letting those rate hikes flow through economy over time, which would bring inflation down around the level targeted by central banks.

In fact, most investors believe that not only had most of the rate hikes already occurred, but there were likely to be rate cuts later this year as the economy slowed down. As it turns out, the economy has proven to be pretty resilient, and with inflation, particularly core inflation, coming down slower than central bankers would like, we saw continued monetary tightening in Q2 and indications from central bankers that we may see even more tightening in the second half of the year.

GS Mark, that seems like a pretty notable shift in expectations.

MF It's certainly notable. And that kind of thing can move the market in the short-term. Of course, over the longer-term, it's not such a big deal. It just moves things in line with our longer-term expectations.

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But in terms of what happened in Q2, we saw bond yields rise and bond prices pulling back a little bit. Equity investors were also building these updated interest rate expectations into their view on stocks. While higher interest rates are negative for equities, some evidence of a resilient global economy also factored in here, with a likelihood of a near-term recession a little lower now, an increasing possibility of a soft landing.

GS That's fascinating stuff, Mark. Do you see any other big macro events that are of note for Q2?

CM I mentioned it earlier, Greg, but China's economy showed an impressive rebound when things opened up after COVID lockdowns a while back. But the pace of growth has now slowed in the second quarter, and the manufacturing performance is underwhelming. And services growth, while still positive, is also slowing.

And since China's such a big market for Canadian exports, and particularly for commodities, this has implications for the Canadian economy but as well the rest of the world. And we're already seeing recent interest rate cuts in China. We're going to likely see some more stimulus to get the Chinese economy back on track.

GS How should we think about markets and the economy in the context of the Q2 performance?

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MF Q2 performance was pretty good. But, more importantly, year-to-date performance has been excellent. In fact, as Craig mentioned, we've now seen three solid quarters in a row after a rough patch last year. This is a bit of a reminder that we sometimes see volatility in short periods, but it's important for us to focus on long-term fundamentals.

In the short-term, anything can happen. But in the long-term, fundamentals prevail. In fact, last fall, as part of our annual process, we updated our long-term capital market assumptions, raising our expectations for future returns from where they were previously.

Notably, a big part of that was raising our fixed-income return expectations, which is related to bond yields that are much higher than we've seen in recent years. We think the future remains bright and will provide nice returns to meet the goals of long-term investors.

GS Given the strong performance in stocks and the growing enthusiasm for sustained economic strength, are you getting more aggressive in terms of your investments?

CM Greg, certainly, some of what we've seen is encouraging. Inflation is declining. Most of the monetary policy tightening has likely already occurred. And while we've seen some indications of a slowing global economy, there's some data that's showing resilience. It's certainly not collapsing.

But with that said, we're trying not to get caught up in the excitement of rising markets. We still remain a bit cautious, try to keep a prudent view. All those rate hikes we've seen in the past five quarters are eventually going to make an impact. It just takes a little bit of time for that to show through the economy.

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Therefore, we do expect the economy will continue to slow. And while we believe it will be hard to escape a recession with all of the policy tightening that's in the system, it's, of course, difficult to know exactly when that's going to show up. We are confident that it will come at some point in time because that is part of the normal business cycle.

Now, as always, we've said this a few times already, investors will be rewarded for focussing on the fundamentals. Our active management strategies have worked, particularly in fixed income recently, as, of course, we can add or subtract from portfolio credit and duration.

And, as always, we try to keep our portfolios positioned to perform very well in a variety of different circumstances. Greg, what are advisors hearing from customers these days?

GS Yes, customers are telling us that they're pretty happy with the returns so far in 2023, although they're still a little bit nervous after seeing such a negative year in markets from 2022. One thing that's grabbing their attention is higher interest rates, and this has led to some pretty appealing GIC rates, which have been a little more attractive for many of our customers.

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CM What do you tell them when you hear this response from them?

GS We've been reminding customers that GICs are a good solution for certain types of investors and certain types of goals. But, for many, they're not the ideal solution for a long-term investor saving for retirement. As always, long-term goals are best achieved with long-term solutions.

CM I think that's really good advice, Greg, especially since rising interest rates over the past several quarters have created a compelling environment for our fixed-income portfolios.

As I mentioned, our active managers are choosing from a variety of government and corporate bonds to find really appealing investment opportunities. In fact, we have a more optimistic forward-looking return expectations in this area than we've had in recent years, primarily because of these higher interest rates. And since our portfolios are generally designed for longer-term investments, our products are more likely, more appropriate for long-term retirement-focussed investors.

GS That's a really good point, Craig. How did the events of the year-to-date inform your views of investing throughout the rest of the year? Has anything changed for you?

CM Greg, we continue to closely follow the path of the global economy. And we've touched on some of the interesting macroeconomic trends that we're going to keep an eye on. Some of the news that we see will inform the long-term fundamentals, some of it will be short-term in nature and just be noise that won't affect the long-term.

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And, of course, as always, we know stocks and bonds will fluctuate in value. And we also know that, generally, they go up over time. So while we still think there's good investment opportunities available, we believe volatility will likely continue for the foreseeable future. And there may be some economic ups and downs ahead. And, as a result, we're planning for that by managing our portfolios a little bit more defensively than normal.

GS Thanks for that context, Craig. Mark, has anything changed in your view on the market?

MF As we've said over the past couple of quarters, we're now expecting higher investment returns in the coming years than what we were expecting a year ago. This is particularly true for bonds, due to the more compelling bond yields. But it's also true for equities. There are some sectors where we continue to see attractive valuations.

The economy may experience some challenges along the way, but some cheaper entry-points now continue to provide wiggle room since a fair amount of negativity is already priced into some parts of the market. And any positive economic performance may be a bit of a surprise.

GS Sounds like a lot of your team's views on the state of the market continue to align with what our advisors have been telling our customers. We've been telling them to stay invested, think long-term. We really want them to focus on their investment plans, not to worry too much about the day-to-day fluctuations in their portfolios, and to talk to their advisor about making sure that their plans are optimised to meet their investment needs.

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I'd like to thank you both from me but also from our customers that learned a great deal from our conversation today. This kind of conversation can help provide our customers with the knowledge and the confidence to tackle these issues, leading them to make smart decisions with their long-term investments, and, ultimately, helping them maintain the health of their long-term financial plans.

And to all listeners of this podcast, I want to thank you for investing your time in this discussion today. Our goal is to lead with advice and help our customers for every future. Thanks so much for spending your time with us today.

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