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NO RECESSION – YET

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By Gordon Pape, Editor and Publisher

Last December, the head of the International Monetary Fund warned to buckle up for a rough ride. Kristalina Georgieva said 2023 would be “a tough year, tougher than the one we leave behind”. At least one-third of the global economy would be in recession by year-end, she forecast.

That was a worrisome prediction as 2022 was no picnic. Soaring inflation forced central banks to raise interest rates at a pace not seen in decades. That resulted in stocks sliding and the worst bond market retreat since the early 1980s. Who needed more of that?

Well, it hasn’t happened, at least so far. The first half of 2023 is behind us, and it has turned out better than expected. Inflation has declined and while rates look poised to move a little higher, it appears the worst is behind us. As for the long-predicted recession, it may still happen, but it’s coming in slow motion and the consensus now is that it will be mild.

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Recession—continued from page 1...

Stocks have had a mixed response to these developments. The better-than-expected economic news has raised concerns that the Federal Reserve Board and the Bank of Canada may push rates higher than originally anticipated. It's the old "good news is bad news" stock market story.

That's had a deflating affect on most stocks, except for tech giants. Nasdaq ended June with a first half gain of 32%, far and away outpacing all other North American indexes. The S&P 500 was a distant second at 15.9%. Our own TSX managed a 4% gain, slightly ahead of the Dow Jones Industrial Average.

It was a better outcome than many analysts had predicted at the start of the year, but it was narrowly based. Technology stocks, which were hammered in 2022, rebounded strongly. Since Nasdaq is tech heavy, it was the main beneficiary.

It was the same with the S&P. The S&P 500 Information Technology Index was ahead about 40% in the first half. According to a report on CNBC, the seven largest companies in the S&P, all tech, were up 86% in the first half. The other 493 stocks more or less broke even.

That's left some tech valuations looking uncomfortably high, especially in the context of what happened last year. Amazon's p/e ratio is now 309. Nvidia is at 214. Tesla is at 74. Stocks like Alphabet (p/e of 26), Apple (32), Meta Platforms (35), and Microsoft (36) look cheap by comparison. They're not. They're just less unreasonable.

The upsurge in tech has been fueled almost entirely by the surge of artificial intelligence (AI). Companies like Alphabet and Microsoft have been working in this area for years, and AI is central to Tesla's self-driving cars. But until recently most investors saw AI as an interesting idea for a future time. Suddenly, with ChatGPT, here and accessible, everyone wants in.

In that sense, we're back in 1999-2000 territory, where any company that had a credible internet story could make millions on an IPO. Except that this time around, we're not dealing with start-ups but giant international corporations with market caps north of a trillion dollars in many cases.

The sheer size of these giants makes the current situation less risky in the sense that none are liable to crash and burn. But if AI turns out to be just another bubble, the losses will still sting.

Exciting as AI might be, anyone allocating new money right now is probably better to look at sectors that have been beaten down over the past year.

One sector to consider is energy. After surging last year, the big oil companies have been market pariahs in 2023. The S&P/TSX Capped Energy Index down about 7% since the end of December and some oil stocks have posted double-digit losses this year. That's left some great companies looking very attractive.

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Recession—continued from page 2...

Consider Canadian Natural Resources (TSX, NYSE: CNQ), one of the country's best managed and productive businesses. It has posted a small gain so far in 2023. You can now buy the stock at about 9x earnings and enjoy a dividend of 4.85%. CNQ has raised the dividend twice in the past year. The shares were first recommended here in 2019 by contributing editor Gavin Graham.

ARC Resources (TSX: ARC) is another energy stock to consider. It's about at break-even for the year and trades at a multiple of 4.11x. The yield is 3.8%. More on ARC below.

Interest sensitive stocks look attractive now and will be more so as rate increases wind down.

REITs are one example. The S&P/TSX Capped REIT Index took a big tumble in 2022 when the central banks began aggressively raising rates. After hitting a low in October of that year, the sector staged a modest rally. It's now bumping along, going nowhere, with a year-to-date loss of about 1%.

One of our recommendations, Boardwalk REIT (TSX: BEI.UN), has gained 25% so far this year but still only shows a p/e ratio of 7.27. Minto Apartment REIT, an Income Investor recommendation, is even cheaper at 3.59x. It has gained about 6% year-to-date and yields 3.2%.

Other interest-sensitive sectors to watch include pipelines, telecoms, and utilities. All should start to turn higher when the rate tightening cycle ends, which should happen by year-end.

If we have a recession, stocks will take a temporary hit – how much will depend on the severity of the downturn. That's when the cycle will turn. Central banks will start to cut rates again and the out-of-favour sectors I've mentioned will rebound.

YOUR QUESTIONS ETF volume

Q – I am a long-time subscriber and follower of yours and I want to tell you how much I enjoy your Canadian content on investing. I enjoy the Canadian perspective and Canadian content from both The Income Investor and Internet Wealth Builder.

You discussed the iShares Core S&P US Total Market ETF (TSX: XUU) in your latest edition of the IWB newsletter. I have not invested in it because I find the daily volume is too low. Do you follow a similar ETF that trades on the TSX with a higher daily volume? Thanks for your time. – Pat H., Renfrew ON

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ARC LOOKS ATTRACTIVE

By Gordon Pape

The energy sector is out of favour this year as oil prices have eased and there are concerns a recession would cut demand.

However, a few companies have held their ground during the pull-back. One is ARC Resources (TSX: ARC) and we're adding it to our recommended list. Here are the details.

Background: Calgary-based ARC was founded in 1996. It is the largest pure-play Montney producer, and Canada's third-largest natural gas producer and largest producer of condensate.

Performance: It's been a choppy year, but the stock has been trending higher, in contrast to the broad sector.

Recent developments: The company reported first quarter average production of 338,377 boe (barrels of oil equivalent) per day, of which 62% was natural gas and 38% crude oil and liquids. ARC drilled 46 wells and completed 34 across its Alberta and British Columbia assets.

Net income was $741 million ($1.18 per share), compared to $574.9 million ($0.93 a share) in the same period last year.

ARC entered into a non-binding memorandum of understanding for a 20-year agreement to supply and liquefy approximately 200 MMcf per day of natural gas with the Cedar LNG Project in BC. This represents the equivalent of 1.5 million tonnes per annum of LNG or approximately one half of the facility's total production capacity. Work is proceeding on a binding agreement.

The company is pursuing more LNG arrangements with the goal of increasing its exposure to internationally linked natural gas pricing.

Dividend and buybacks: The board of directors approved a 13% increase to the quarterly dividend, from $0.15 per share to $0.17 ($0.68 per year). It's the second dividend increase in the past 12 months. The yield is 3.7% at the current price. The company's policy is to increase the dividend with the underlying profitability of the business, and on a per share basis as the share count is reduced.

ARC repurchased 10 million shares during the first quarter. Since renewing its normal course issuer bid on Sept. 1, 2022, ARC has repurchased 44 million shares, representing 16% of total outstanding shares.

Outlook: ARC increased production guidance for the year to average between 350,000 and 355,000 boe per day (previously 345,000 to 350,000 boe per day). The increase reflects stronger than forecast production from its base assets.

Action now: Buy. The shares closed Friday at $18.33.

BUY HUMILIATION, SELL HUBRIS

By Gavin Graham, Contributing Editor

Regular readers will remember that I previously recommended buying the UK stock market, using the UK iShares MSCI ETF (NYSE: EWU). It invests in the 100 largest UK listed shares by market capitalization.

This ETF has been a volatile performaner over the past few years. The UK economy faced difficult challenges, first from Brexit, and then from the Covid-19 pandemic.

The situation was worsened by turmoil at the top of the ruling Conservative party. Charismatic but flawed Boris Johnson, who won an 80-seat majority in the December 2019 election, was forced to resign in June of last year over breaches of lockdown rules during the pandemic. He was succeeded (very briefly) by former trade and foreign secretary Liz Truss, whose dash for growth through unfunded tax cuts was torpedoed by a collapse in the UK bond market. The Conservatives are now led by ex-Goldman Sachs partner Rishi Sunak, who is Britain's first prime minister of Asian extraction. As Chancellor of the Exchequer (finance minister) under Mr. Johnson, Mr. Sunak had dealt with the explosion in government borrowing caused by the pandemic and the attempt to raise revenues and cut spending to deal with it.

With an election due by the end of next year, and the Conservatives trailing the opposition Labour Party by 20% in the opinion polls, foreign investors have been happy to write off the UK. As a result, stocks are selling at the lowest level since the devaluation of the pound on Black Friday in October 1992.

The persistently high level of inflation, with the May reading at over 8%, has forced the Bank of England (BoE) to raise interest rates by a higher than expected 0.5% last month to 5%. That's the highest level since before the Great Financial Crisis of 2008, and this has reinforced the general view that the government is losing control.

The weakness of the pound has aggravated inflationary pressures. Meanwhile, mortgage rates are back over 6%, the same level as during Liz Truss's disastrous tenure. The wave of strikes affecting industries such as the railways, healthcare, and teaching, combined with legal challenges to the government's attempts to clamp down on illegal immigration, has added to the general malaise.

To some observers, this pessimism is providing investors with a buying opportunity. Michael Hartnett, strategist at Banc of America/Merrill described the UK as the "stagflationary sick man of Europe" as he urged investors to tuck away cheap and unloved UK companies for the next

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Humiliation & hubris—continued from page 5...

few years. “Heard anyone say anything good about the UK recently? Nor have we,” he wrote in a recent research note. He went on to comment that UK assets were cheap and reviled. Compared to global stocks, the UK market hasn’t been this inexpensive since 2003, he said.

Buy humiliation

The FTSE 100 index sells at a p/e ratio of 14 and a dividend yield of 3.8%. This compares to a p/e of 16 times for the MSCI Europe Index and over 22 times for the S&P 500. A low p/e is not necessarily a reason for buying, as cheap assets may be cheap for a good reason. The composition of the UK’s market is heavily weighted to so-called old economy sectors (19% in financials, 13% in energy, and 8.7% in materials). Less than 1% is in technology, almost the exact opposite of the tech heavy S&P 500, let alone Nasdaq.

Of course, the same could be said of the S&P/TSX 60 Index, with its heavy exposure to financials and natural resources. The interesting point for investors to consider is that both the UK and Canada actually outperformed substantially in 2022, ending the year flat compared to a 20% fall for the S&P 500.

The run-up in the so-called Magnificent Seven large capitalization technology stocks (Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta, and Tesla) has seen the S&P gain 15% so far this year and the Nasdaq is up 30%. The UK market, as represented by the EWU ETF, is actually up 8% despite all of the bad news!

Financials and consumer staples dominate UK

The rebound in Britain may be attributed to the large number of multinational companies with global operations listed in the UK. The largest weights at 19% in EWU are financials (HSBC, London Stock Exchange, Lloyds Bank, Prudential) and consumer staples (Unilever, Diageo, BAT, Reckitt Benckiser). Healthcare is at 13% (AstraZeneca, GSK). All are larger than energy (Shell, BP). Defensive sectors such as consumer discretionary and utilities comprise 6% and 4% respectively.

Over two-thirds of the FTSE 100’s revenues and earnings are from outside the UK, either as exports or from international operations. A weaker currency is a benefit to these companies as their numbers are reported in sterling. In fact, the pound has appreciated by over 15% from the thirty-five-year lows hit last October, when the sell-off in gilts drove the pound down to £1=US$1.05 and £1=€1.10.

EWU has delivered an 11.2% annual compound return in US dollars over the three years to the end of May, despite all of the political and economic uncertainties. The ETF gives investors a chance to buy world class multinationals at a discounted price compared to their US or even continental European rivals. Should

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sentiment on the UK become even slightly less negative, investors would benefit from an improvement in p/e multiples, while the dividend yield on EWU is 3.3%, nearly double that on the S&P 500.

Sell hubris

It's worth noting that all of the Magnificent Seven technology mega caps have appreciated at least 35% so far this year. Apple now has a market capitalization of US$3 trillion, the same as its previous high reached in January 2022. Microsoft has a $2.5 trillion market cap while Alphabet and Amazon are worth $1.5 trillion and $1.3 trillion respectively. AI darling Nvidia is up 190% year to date, to a market cap of over $1 trillion.

The "Sell Hubris" part of Michael Hartnett's recommendation refers to taking some profits on these outperformers. All of them sell at record equalling valuations for companies whose very size makes it difficult for them to deliver the earnings growth expected by enthusiastic investors.

Some of the proceeds should be reinvested in markets selling at more reasonable valuations with exposure to defensive sectors that should prove resilient in an economic slowdown. These include healthcare and consumer stocks, as well as materials and energy. Focus on companies benefiting from the transition to green energy and the need for greater energy security. Of course, Canada has exposure to the latter sectors, but lacks global leaders in the former areas. While the TSX is cheaper than the US, it is not as cheap as the unloved and disregarded UK market.

More information on EWU follows.

Gavin Graham has had a long and successful career in money management and is a specialist in international securities. He held senior positions in financial organizations in London, Hong Kong, and Toronto. He is a Trustee of the Royal Medical Foundation Investment Committee and Chief Strategy Officer SmartBe Investments (www.smartbeinvestments.com). H e divides his time between Canada and the UK.

Questions?

Our team of experts have the answers!

Send your questions to
gordonpape@hotmail.com

Selected Q&A will be published in an upcoming issue!

GAVIN GRAHAM'S UPDATES

Recommendations are colour-coded:
Green indicates Buy
Yellow indicates Hold
Red indicates Sell

iShares MSCI UK ETF NYSE: EWU

BUY

Originally recommended on Dec. 16/19 (#21944) at $34.10. Closed Friday at $31.44. (Prices in US dollars.)

Background: This ETF invests in the largest UK companies listed on the FTSE 100.

Performance: It's been a rocky year, but the units are up about 8% so far in 2023. The compound average annual return over the last five and ten years is a very disappointing 1.4% and 2.4% respectively. But we're now seeing signs of a turnaround.

Key metrics: The fund was launched in March 1996. It has assets of $2.8 billion, and a management fee is 0.5%.

Portfolio: The largest weights are in financials and consumer staples (19% each). Healthcare and energy are at 13% each, with materials 9%, consumer discretionary 6%, and utilities 4%.

Distributions: Payments are semi-annual, and at present are equivalent to a yield of 3.3%.

Comments: Selling at its lowest valuations in two decades and the cheapest by comparison with Europe and the US since the Financial Crisis, this ETF offers a good opportunity to buy world class companies at a sizeable discount.

Action now: Buy EWU at present levels.

ETF volume—continued from page 3...

A – XUU has an average daily volume of 17,887. That's low but not unreasonable. For more trading activity, look at the Vanguard US Total Market Index ETF which trades on the TSX under the symbol VUN. Its mandate is much the same as that of XUU and the average daily volume is 45,225. This version of the fund is unhedged (there is also a hedged version). However, VUN has a management expense ratio (MER) of 0.17%, compared to 0.08% for XUU. That contributes to slightly higher returns for the iShares entry. Over the five years to May 31, it averaged 10.71% annually compared to 10.57% for VUN. Not a lot, but over time it can add up.

So, take your pick. More volume or a slightly better return. – G.P.

Fairfax Financial Holdings TSX: FFH, FFH.U

Originally recommended on Nov. 30/20 (#22110) at C$445.20, US$340.41. Closed Friday at C$962.57, US$734.31. (All numbers in US dollars except per share amounts.)

Background: Fairfax Financial is one of the largest property/casualty insurers and reinsurers in North America. Its CEO, Prem Watsa, is often called the "Warren Buffett of Canada" because of his value-based investment approach. Apart from its insurance operations, Fairfax owns stakes in a number of non-insurance businesses, such as Stelco, BlackBerry, Resolute Forest Products, and Golf Town.

Performance: Fairfax has risen sharply over the last year, virtually doubling to reach an all-time high near $1,000. The stock is up 116% since it was recommended.

Recent developments: For the year ending Dec. 31, 2022, underwriting profit was a record at $1.1 billion. This was despite $1.3 billion in catastrophic losses, largely due to Hurricane Ian hitting Florida.

Gross premiums written were up 15.8% to $27.6 billion. Net profit fell by two-thirds to $1.15 billion ($43.49 per share) from $3.4 billion ($122.25) in 2021. This reflected a markdown on Fairfax's bond portfolio on the sharp rise in interest rates. Mr. Watsa expects these unrealized losses to be reversed once interest rates stabilize. Fairfax also booked a $1.2 billion gain on the sale of its pet insurance business to German private investment company JAB Holdings.

For the first quarter to March 31, Fairfax reported net earnings of $1.25 billion ($49.38 per share) versus $588.7 million ($22.67) the year before. Operating income from its insurance business was $1.31 billion, due to growth in net premiums of 6.1%. Operating profit was $313.8 million. The company reported an operating ratio (costs as a percentage of revenues) of 94%.

Book value per share, which Warren Buffett and Mr. Watsa consider the best measure of an insurance company's progress, was C$803.49, a 6.8% increase from $762.28 as of Dec. 31.

Fairfax sold its interest in Brit Insurance's MGA Ambridge to insurance services group Amynta for $400 million in May, booking a pre-tax gain of $255 million.

In June, Fairfax announced the acquisition of a $2.3 billion portfolio of real estate construction loans from troubled Pacific Western Bank, in partnership with real estate investor Kennedy Wilson. The portfolio is being acquired for $2.1 billion, of which Fairfax

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iA Financial Group TSX: IAG

Originally recommended by Tom Slee on April1/13 (#21313) at $37.36. Closed Friday at $91.01.

Background: iA Financial was founded in Quebec City in 1892. It is the fourth largest life insurance company in Canada and its acquisition of Hollis Wealth from Scotiabank in 2017 made it the largest non-bank financial advisory firm in Canada. It also has sizeable operations in the US.

Performance: The shares have almost tripled since being recommended by former contributing editor Tom Slee in 2013, and have risen over 20% since the last update in November. They reached an all-time high of $93.40 recently.

Recent developments: iA reported net income of $842 million ($7.65 per share) for the year ending Dec. 31. That was down 1% from 2021. Assets under management (AUM) was down 9.5% to $200.2 billion due the bear markets in equities and bonds.

Core earnings per share were actually up 6% to $8.85. Return on shareholders' equity was unchanged at 14.2% and book value per share rose 1.7% to $63.06.

For the quarter ended March 31, net income was $273 million, compared to a loss of $19 million in 2022. Core earnings per share rose 7% to $2.08 versus $1.94 the year before. Core return on shareholders' equity rose slightly to 14.6%. Book value per share rose 1.5% to $64.69.

Dividend: The company raised its quarterly dividend 13% to $0.765 per share ($3.06 per year), giving iA a yield of 3.4%.

Action now: iA remains a Buy for its strong operating performance, conservative investment portfolio, consistent dividend increases, and industry best share price performance since its IPO in 2000.

Fairfax—continued from page 9...

will provide 95% ($2 billion). Some 70% of the portfolio is in multifamily or student housing developments, with a loan to value of 51%, and an average interest rate of 8.6%. Fairfax is also investing $200 million in a 6% preferred from Kennedy Wilson and receiving seven-year warrants over 12.3 million Kennedy Wilson shares.

Dividend: The stock pays an annual dividend, in January. This year's payment was $13.59.

Action now: Fairfax, despite its recent strong share price performance, remains a Buy for its strong growth in operating income, ability to create value from its non-insurance investments, and continued repurchase of shares.

iShares Core US Aggregate Bond ETF

HOLD

NYSE: AGG *Originally recommended on Jan. 31/15 (#21505) at $111.97. Closed Friday at $96.53. (All figures in US dollars.)*

Background: This is the US equivalent of the iShares Core Canadian Universe Bond Index ETF (TSX: XBB). It tracks the performance of the entire US investment-grade bond sector.

Performance: The long string of interest rate increases by the Federal Reserve Board has been rough on bond prices. There are likely to be two more hikes, but the end is in sight. This ETF lost 13% last year and is about at breakeven so far in 2023.

Key metrics: The fund was launched in September 2003 and has about $92 billion in assets under management (AUM). The net expense ratio is a rock -bottom 0.3%.

Portfolio: This is a huge fund, with 11,063 positions. The credit quality of this fund is excellent, with about 72% of the portfolio invested in AAA bonds. US Treasury bonds are the largest sector at about 42%.

Distributions: Payments are made monthly and are currently about $0.25 per unit ($3 per year) for an implied yield of 3.1%. However, the distributions fluctuate so an accurate forward projection isn't possible.

Outlook: With interest rates poised to rise probably twice more, bond prices are still facing headwinds. But the worst should be behind us.

Action now: If you want a long-term investment in quality US bonds, Hold. The yield is decent and there is some capital gains potential when rates start to fall again, which will happen when (if) the long-awaited recession arrives.

BMO Low Volatility US Equity Hedged to CAD ETF TSX: ZLH

HOLD

Originally recommended on Aug. 8/22 (#22229) at $32.41. Closed Friday at $31.28.

Background: This ETF has a similar mandate to XMS, reviewed above. However, it takes a different approach to portfolio construction – it's actively managed by BMO Global Asset Management whereas XMS is a passive, index-based fund.

Performance: This ETF actually managed a small gain of about half a percent in 2022, a standout performance when compared to the overall indexes. By contrast, XMS was down 10.89% for the year. Going back to 2018, that's the largest calendar year discrepancy between the funds. Normally, their returns are similar.

Key metrics: The fund was launched in February 2016 and has assets under management of $95.3 billion. The MER is 0.33%.

Portfolio: This is also an equal-weighted fund but the stocks at the top of the list are quite different from XMS. They include Johnson & Johnson, Merck & Co., Becton Dickenson & Co., Campbell Soup, and Quest Diagnostics.

Almost one-quarter of the fund is in consumer staples stocks, followed by health care and utilities. Information technology accounts for only 2.35% of the portfolio. In contrast, XMS has almost 23% of its assets in the tech sector. This explains why the iShares fund performed so badly in 2022 compared to this one.

Distributions: Payments are made quarterly and are currently set at $0.19 per unit ($0.76 per year). The yield is 2.4% at Friday's closing price, although that is not guaranteed.

Tax implications: Last year, most of the distribution was treated as foreign income, meaning it was fully taxable outside a registered plan. Unitholders also received a foreign tax credit.

Outlook: The comments relating to XMS apply here. Based on 2022 and the difference in portfolio composition, this ETF should fare better than XMS in a down market where tech stocks are especially hard hit, like last year. Of course, the next bear market might see a different group of stocks get wacked.

Action now: Hold. Both funds are useful for asset protection. Rather than choose between them and which sectors will outperform, consider dividing the money between them that you wish to allocate to this type of security.

iShares Edge MSCI Minimum Volatility USA Index ETF (CAD-Hedged) TSX: XMS

HOLD

Originally recommended on Aug. 17/20 (#22030) at $27.80. Closed Friday at $31.10.

Background: This ETF tracks an index which measures the performance of US stocks that have low volatility in the MSCI USA Index. The fund is hedged back to the Canadian dollar.

Performance: This type of fund is designed to protect assets during times when markets are falling. It delivered in 2022, dropping 10.9% while the broader indexes fell much more. The fund is modestly higher this year.

Key metrics: The ETF was launched in April 2016 and has $49 million in AUM. The MER is 0.33%.

Portfolio: Most of the assets are held in its sister fund, the iShares MSCI MV USA Index ETF (TSX: XMU), which is unhedged. Holdings are equal weighted, with none comprising more than 1.69% of total assets. Top stocks include Oracle, Microsoft, Eli Lilly, Cisco Systems, and IBM.

Distributions: Payments are made quarterly. They are not consistent but usually in the range of $0.09-$0.11 per unit. Trailing 12-month distributions were $0.4073 per unit, for a yield of 1.3% at the current price.

Outlook: This is a defensive security. It will limit losses if the stock market retreats but gains will be below average in the event the market continues to rise.

Action now: Hold.

HOUSEKEEPING

The following listings have been deleted from our website. Sell advisories were previously given in this newsletter, so this notice is for record keeping purposes only.

Alcanna Inc. (TSX: CLIQ). Originally recommended by Shawn Allen on Oct. 5/20 at $4.19. Sold Oct.18/21 at $9.16.

Badger Infrastructure (TSX: BDGI). Originally recommended by Gordon Pape on Nov. 24/14 at $32.77. Sold Oct. 4/21 at $34.33.

CRH Medical Corporation (TSX: CRH). Originally recommended by Shawn Allen on Oct. 24/16 at $6.19. Sold Feb. 15/21 at $4.88.

Espial Group (TSX: ESP). Originally recommended by Ryan Irvine on Feb. 2/15 at $2.52. Sold Feb. 21/22 at $1.54.