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INVESTMENT MANAGEMENT

January 17th, 2024

Equity markets finished the year on a positive note with strong fourth quarter returns. The S&P/TSX Composite Total Return Index (TSX) rose 8.1% in Q4 bringing the total return to 11.8% for the year. The U.S. S&P 500 Index rose 9.0% in Q4, resulting in a 23.5% total return for the year. The MSCI EAFE Index Price Return, representing 21 developed markets excluding the U.S. and Canada, returned 7.4% for the quarter and 12.5% for the year.

The positive equity returns in 2023 do not reflect the higher-than-normal volatility that most equity markets experienced during the year. Concerns about rising interest rates and the possibility of a recession contributed to the unease experienced by investors.

Market Forecasting is, on Average, Not Very Accurate

During this time of year, many economists and strategists are making forecasts and providing an outlook for the year ahead. As is the case year after year, a significant number of these forecasts will turn out to be wrong. Take last year, in January 2023 pessimism was high as the world came to accept that the inflation was not transitory. Commodity prices were rising and economists believed consumers would surely feel the pain of interest rates and cut back spending. Geopolitical tensions and a recession in 2023 seemed to be a consensus point of view. Yet, commodity prices came down; consumer savings that were built up during the pandemic endured; geopolitical tensions erupted but not where forecasted; China's recovery was all but absent; and the global GDP grew by approximately 3%.

The median Wall Street forecast from 2000 through 2023 missed its target by an average 13.8 percentage points

A recent NY Times article looked back on the median Wall Street forecast vs. the actual return of the S&P 500. In 2022, the forecast called for an annual increase of 3.9%, but the stock market lost 19.4%. The forecasters were wrong by a margin of more than 23 percentage points. For 2023, they called for a 6.2% gain vs a 23.5% return. Taking gaps like these into account, the median Wall Street forecast from 2000 through 2023 missed its target by an average 13.8 percentage points annually — more than double the actual average annual performance of the stock market.

The Optimistic U.S. Market Forecast

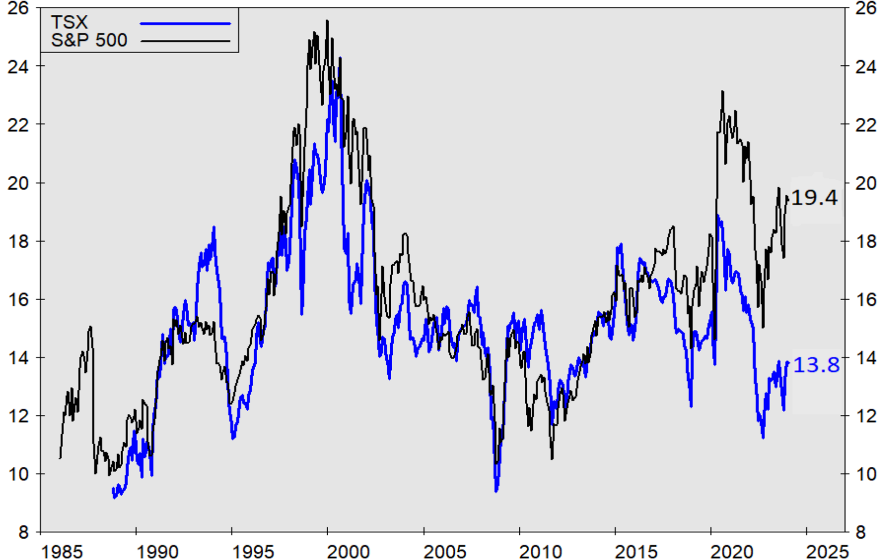
The market itself is an aggregate forecaster, with every new piece of information being quickly priced in and extrapolated out. Markets are forward looking and endeavor to predict what the world, the economy, and the companies will be doing in the years ahead. As with predictions made by

economists, the market, in the short term, is just as frequently incorrect. For example, many economists are currently predicting a slowdown in nominal GDP in 2024 in Canada, the US, and around the world. However, many forecasts for S&P earnings suggest a powerful earnings re-acceleration into 2024. One or both of these predictions will turn out to be incorrect.

Expansion in the Price to Earnings valuation multiple has contributed around two thirds of the gain in the S&P 500 index since 1982, when the multiple sat below 8x, until the end of 2019. More than 1/3rd of the gain since 1994, when the multiple was around 14x, is attributed to valuation expansion.

The U.S. equity market is currently expensive, trading at more than 19x forward earnings, markedly above its historical average of 14.7x over the past four decades. In contrast, other equity markets including Canada, are trading near, or below their historical average. Historically, the TSX in Canada has traded around 15x earnings and today the earnings multiple sits at 13.8x forward earnings, a near-record discount to the S&P 500.

Exhibit 1: Unlike the S&P 500 Index, the TSX is Below Its Historical Valuation Range



Source: TD, Aitkens Strategy

In the absence of increasing valuation multiples, market gains will depend on the growth in earnings. For many companies, the question remains, will the growth in earnings match expectations.

When Do Advances in Technology Lead to Earnings Acceleration

Advances in technology have been moving the economy, and life as we know it, forward for centuries. From harnessing steam power and later electricity to developing internal combustion engines, leaps forward in productivity have been a hallmark of human existence. More recently, a major leap forward in the information technology revolution, which started with computers and microprocessors, was achieved with the introduction of the internet. Even more recently, the adoption of generative artificial intelligence (A.I.) has begun to reshape economies.

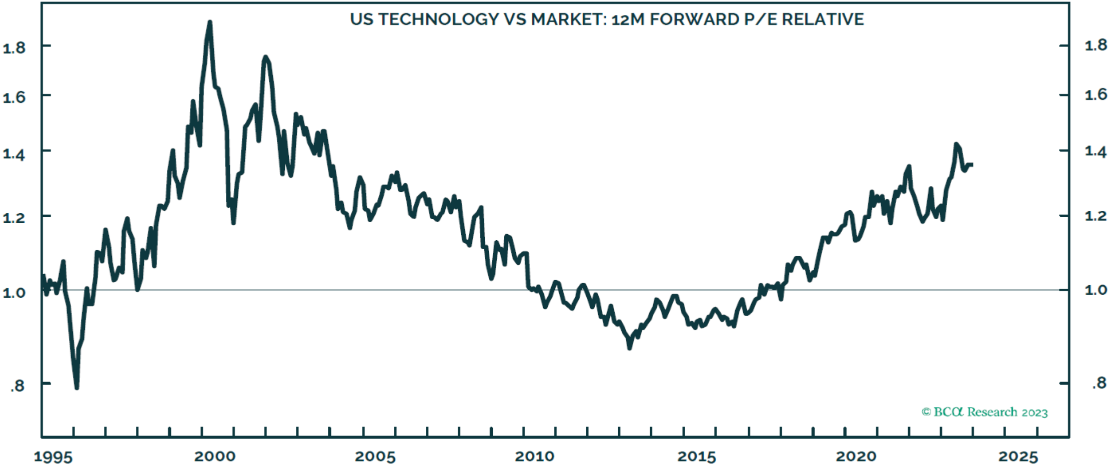
With much hype surrounding the radical impact AI is projected to have on earnings, we ask the question of when does innovation excitement give way to outsized profits. Companies that have been the darlings of technological advancements of years past are not always the beneficiary of long term economic profits. Technology does not always benefit the inventor. Looking back at the Personal Computer (PC) excitement for example, HP, Dell, Compaq, IBM and NEC were the darlings at the time. While the vision of every person having a computer (or three) came true, today, many of those companies are no longer the illustrious names they once were.

Major innovations such as the PC, the Internet and A.I., does not guarantee that technology profits will generate sustained outperformance. As with all industries and companies, innovation alone is not enough, you also need some protective moat to keep the potential profits from being competed away. Sustainable competitive advantages, the key word being sustainable, are a lynch pin in long-term successful companies.

Technology companies are trading at a significant premium, not too far off the levels seen in the late 90s internet frenzy

Currently, technology companies are trading at a significant premium to the market, as demonstrated in the graph below, not too far off the levels seen in the late 90s internet frenzy. Previously, when profits did not live up to the lofty expectations set for them, valuations came down. The current premium is warranted, only assuming that the spread between technology profits and the market profits continues to widen from where it already currently sits.

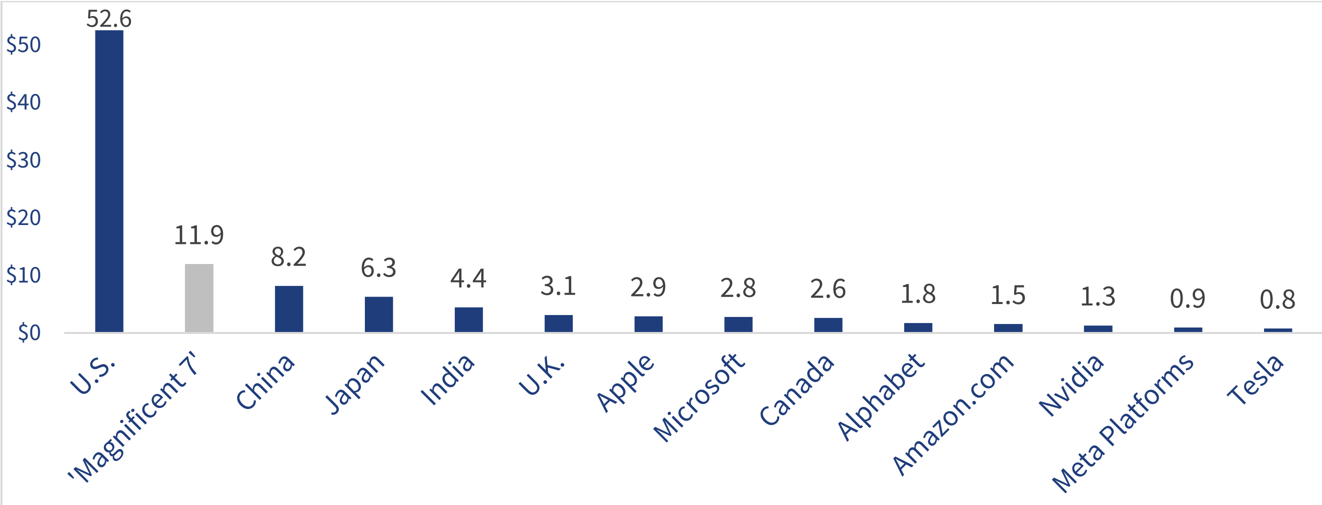
Exhibit 2: Technology Valuation Premiums During the Internet and A.I. Excitement



Source: Bank Credit Analyst

This A.I. excitement and valuation expansion has led to a small number of technology names making up a large part of the S&P 500. As we wrote about in our second quarter letter, these 'Magnificent Seven' companies (Amazon, Apple, Alphabet, Microsoft, Meta Platforms, Tesla, and Nvidia) account for just under 30% of the entire S&P 500 Index. For reference, these seven companies have a combined market cap that eclipses all other countries' stock markets, except the U.S. They are larger than China's $8.7 trillion dollar stock market, four times as large as the entire Russel 2000 Index which represents small-cap companies in the U.S., and larger than the Japanese, U.K. and Canadian stock markets combined.

Exhibit 3: The Magnificent Seven has a Larger Market Capitalization Than Entire Country's Stock Markets (in Trillions of USD)



Source: Barron's, Fact Set

The sheer size and price of these mega-cap, technology names will influence the market returns. The excitement and application of a new information technology revolution will influence how companies and people do business. As for predicting how the market and the economy will respond, as with all forecasting, that is a precarious endeavor. Only in hindsight will we be able to see the results of structural changes, adoption of technology, and earnings potential.

Notwithstanding the difficulty predicting the market, we believe predicting where the underlying companies are going to be a much more worthwhile and fruitful venture. Companies with strong and predictable free cash flow, barriers to entry that protect their profitable position, and stable leadership will be well positioned to navigate the advancements and challenges that lay ahead. Despite short term dislocations, over time, the share price converges with the earnings of the business.

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And so, when it comes to us making a prediction for 2024, you will hear our same answer – in the short term, we don't know. Longer term, we think the fundamental outlook for our companies will improve as positive economic growth, falling cost pressures and lower interest rates drive earnings growth. Our portfolio companies are well managed companies with attractive long-term growth opportunities that are trading at reasonable, or in some cases compelling, valuations. With Canadian equity valuations near the low band of their historic range, there is an attractive investment opportunity for our portfolio of companies over a multi-year period.

As always, we thank you for your support and invite you to connect with any member of our team.

Sincerely,
Seymour Team