NCM

Pension Portfolios Monthly Update

Pension Style Investing for All Canadians

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January 2023 Comments

While writing our last comments of 2022, we decided that playing a little offense as we begin 2023 might make sense. Our reasoning was that much of what had roiled markets though the year had been baked into the market's prices. We also noted that a lot of the characteristics that we did not like about major stock markets had become more constructive. Quite simply, we have calculated that many indices are now at valuation levels we can understand.

Our allocations were adjusted to reflect our views and there were three major outcomes. The first was a shift from low beta Canada (defensive stocks) to higher beta Canada (higher price appreciation stocks) and importantly, leaving Canada's overall allocation unchanged.

The second was our shift in allocations away from major markets outside of North America and toward a more global positioning with a goal to bump up our U.S. allocation. Prior to this shift and in relative terms, the U.S. was an underweighted region in the NCM Pension Portfolios when compared to global indices like the MSCI World.

Finally, within our fixed income holdings, we made a shift toward short-term corporate issues, focusing on discounted bond prices and away from lower yielding provincial ETFs. The following comments revisit our views that specifically favour the U.S. and also what we are seeing in the corporate bond market in Canada.

Equities: Growth Is On Sale

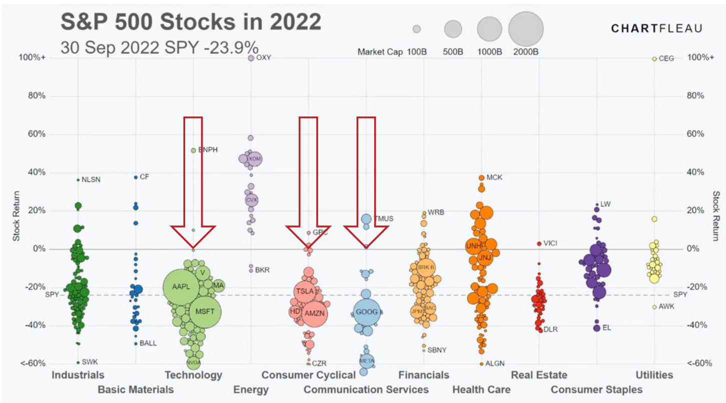
Our outlook for the S&P 500 has a lot to do with our view that many of the risks that we started with in 2022 have been priced out of the market. Many portfolio managers have their email inboxes full of strategy write-ups that will be using history to forecast what will happen during this coming year. Much will focus on the experiences with past bear markets. Some may look back as far as 100 years. I think that's too far.

A bear market has been defined as a 20% decline from a recent peak and the S&P 500 went through -20% a couple of times last year. While that's a reasonable performance bogie to define a bear, I think it falls short as a full definition. I think the definition would be improved by looking at the number of companies experiencing significant declines, in a given year, for a given index. For example, indices with top-heavy companies can experience bear price declines with only a handful of companies truly being punished.

The 2022 S&P 500 decline was broadly based. At the close of last year, 342, or well over half, of the companies had seen lower prices during the year. Only three sectors saw positive total returns: Energy (+59%), Consumer Staples (+3.3%), and Utilities (+3%). So that's a snapshot of the breadth of the bear, but what's not evident is the extent of the price declines and this is what will determine where we look for rebound potential.

The average decline was approximately 10% but the weighted decline was almost double that, meaning the damage was uneven. The arrows in Chart 1 highlight three sectors that accounted for over 80% of the weighted decline. Mega cap companies define the sectors with arrows and almost 100% of the companies in Technology, Communications and Consumer Discretionary were lower. A true bear for these three sectors but not as clear a bear for the others. Importantly, the hardest hit is where we need to be selectively looking for "rebounders". For many of these companies, growth is on sale.

CHART 1



Source: Chartfleau, https://www.chartfleau.com/

While running my forensics on 2022, I noticed a couple of important statistics that I think we should pay attention to as we move into 2023. These include the new P/E ratios (prices divided by earnings) for many companies post price melt-down, the sustainability and level of future longer-term earnings growth and, related to those two, the quotient of P/E dividend by growth (aka: PEG ratio). Lower PEG ratios suggest better prices associated with future earnings growth. I think this might be a price driver this year as a lot of higher-growth companies, in my view, were over-sold through 2022.

At the beginning of last year, the forward P/E for the S&P 500 was almost 28X. This is an expensive index P/E ratio and defined risk. Today, that P/E is around 21X, which by historic standards does not define value, but it does represent a significant amount of P/E compression.

Interestingly, the P/E compression has not been even across all sectors. This means that some sectors have seen significant relative value improvements while others have not. For example, the P/E compression for the Financial sector was only 2 P/E points (17X decreasing to 15X). In contrast, Technology is lower by 8 points (32X lower to 24X) which, by this measure, means Tech has much better value today relative to where it was.

The PEG ratios have also changed. The PEG ratio for financial companies is modestly lower to 1.9 versus 2.0 last year, whereas Technology is recording a PEG ratio of 2.0 versus 2.4 a year ago. Based on forward earnings growth potential, P/E compression and similar PEG ratios, I would favour Technology versus Financials in today's S&P 500. Discrepancies like these, between value and growth, exist across the whole sector spectrum and can help with where we look for opportunities.

2023 S&P 500 Outlook: Divergent Opinions

There is a wide range of opinion concerning overall value, risk and outlook for the S&P 500. Many strategists think we are in for another year of pain. However, this is not an expectation that I would agree with. The bear forecasts are typically backstopped with comparisons of current valuation and whether long-term expectations for earnings growth will support the valuations in today's market.

The market bears often use decades of history to create the backdrop for future market loses. While this might be true for some sectors, I'd argue that the general profile of the S&P 500 has changed, and it is a higher earnings growth vehicle today than it has been in the past. I'd also argue that higher growth will likely be with us for some time.

The S&P 500 evolves over time. In 1969, the index held over 160 companies in the Industrials sector and, at that time, there were fewer than 20 companies considered Technology. Industrial and Technology now account for 70 and 76 companies respectively. That difference alone would make comparisons to ancient history questionable.

CHART 2

S&P 500 Sectors Weights and Growth

	Today	1990
Communication Services	8.4%	8.70%
Consumer Discretionary	10.4%	12.80%
Consumer Staples	7.4%	14%
Energy	5.1%	13.40%
Financials	11.8%	7.50%
Health Care	14.6%	10.40%
Industrials	8.3%	13.60%
Information Technology	25.9%	6.30%
Materials	2.7%	7.20%
Real Estate	2.7%	0.00%
Utilities	2.8%	6.20%

	Today	1990
Lower Growth Sectors	17.9%	40.8%
Medium Growth Sectors	37.4%	53.0%
High Growth Sectors	44.7%	6.3%

Red is High Growth Green Medium Growth Yellow Lower Growth

Source: S&P Capital IQ

The fact is that the evolution of the S&P 500 over the past few years has been profound as "New Economy" industries change the way we consume goods and services. In most developed nations, the boom-bust nature of metal bending and widget production has given way to a steadier service economy. Furthermore, many of these service companies exhibit higher earnings growth. Chart 2 and Chart 3 show the weight differences among today's sectors' earnings growth prospects versus the growth prospects in 1990. I have taken some liberty to impose my view of sector growth categorization, but I don't think my view is too far off the mark. For example, in Chart 2, the sectors I would characterize as low growth (yellow) include the Resource sectors, Consumer Staples and Utilities. Medium growth (green) includes Industrial, Health Care and Financials, and few would argue that today's S&P 500 high growth (red) is found in Communications, Consumer Discretionary and Technology.

In 1990, only Technology would be considered higher growth. Even if others disagree with my silos, it would be hard to argue Technology alone moving from 6.3% to over 25% changes the complexion of the index.

The term structure of interest rates has also changed and it will also be a different factor in valuation levels and growth. Comparing today's value to a history that was created in a much higher interest rate environment has flaws.

Theoretically, P/Es and long-term interest rates have an inverse relationship. The longer term history of P/Es, averaging

CHART 3

Source: S&P Capital IQ

in the mid-teens, could well be a thing of the past. Recently, earnings yields (the inverse of P/E) being compared to long term bond yields around the 1% mark might have led to stocks getting ahead of themselves. Given that, last year's reaction to elevated rates shouldn't be too surprising.

It is possible that the current cycle in yields may lead to a recalibration of P/Es relative to sustainable yield levels. The average yields above 6% through the 1990s and into the 2000s were too high and the sub-1% yields recently recorded were too low. A real yield of 100 basis points above inflation is what I believe is sustainable. In my opinion, that means yields should settle around 3.5%.

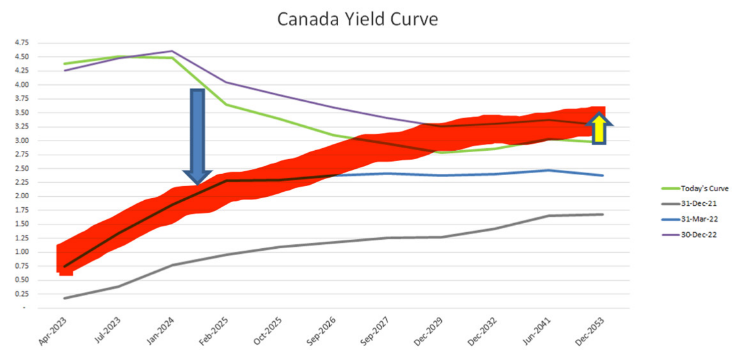
I expect rates to begin to normalize earlier than many other strategists. Further to this, I believe that my outlook for rates, once they finally settle, are reasonably constructive for stocks in general. My view of where the yield curve should settle is presented in the next section. Lastly, I wouldn't look at 2023 earnings as a yard stick for value. Many investors and analysts are already factoring in expectations for a recession and 2023 forward EPS cuts will likely accompany those expectations. The P/Es I look at will increasingly be based on 2024 forecasts.

Stock price performance for the start of 2023 has been strong. It seems that investors are paying attention to a lot of companies that were over-sold when investors rushed to get out of the way last year. I also think growth is playing a big part in investors' new interests.

Bond Markets: The discount trade

Chart 4 shows my expectation (thick red line) of where interest rates are going. It also defines where I see risk in the current market (yellow arrow). The risk is noted because it is forecasting a modest increase in rates from below 3% today to somewhere between 3.25% - 3.75%. It also shows where I see opportunity in the near term (blue arrow). A move to lower yields in shorter-dated maturities could happen with prices moving higher and yields moving toward the thick red line OR given the short-term nature of the bonds at this end of the curve, prices simply move to par, meaning gains will be realised as principle is paid back.

CHART 4



Source: Bloomberg

This graph shows where interest rates have moved over several different periods over the last year. The green line, called "Todays Curve" shows where rates were during the week of January 17th. The lowest line is where rates were about a year ago. The thick red line is where I think rates will be going as the tightening cycle plays itself out.

The pain endured by the bond market has been felt by all bond investors. The whole yield curve shifted higher as prices dropped. What is very noticeable is the degree to which the shorter-term interest rates have moved higher due to their close relationship to what our central banks have been doing. For money that had already been invested, this has been no fun, as bond prices have traded lower with each notch higher in central bank policy. On the other hand, for new money, this has presented a near-term opportunity.

Above, I noted of two scenarios that see higher bond prices. One relies on policy adjustments and the other is simply principle pay back. We are attempting to harness this opportunity by focusing on bonds that have traded to a discount, as central bank policy tightened.

CHART 5

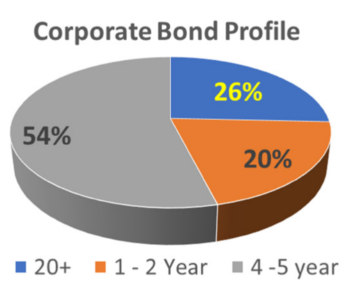


CHART 6

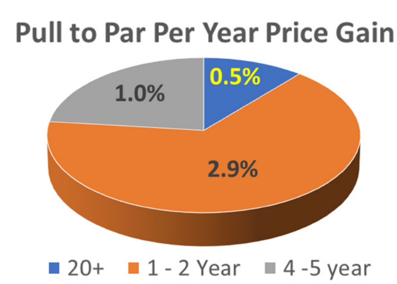


Chart 5 and 6: Bond profile of the NCM Balanced Income Portfolio

We have purchased a bundle of corporate issues that all trade at discounts to par and have decent coupon yields. We are confident that we will see a dependable pull to par as time moves forward. When we began this trade last year, the average price of this bundle was $93.72 (Sept 30th 2022). The average price today is $95.64. The strategy, so far, is working out.

Chart 5 shows our corporate bond distribution by maturities today and Chart 6 shows our estimated pull to par, per year. The percentages indicated are based on the prices of the bonds today and the expectation of principle payout at 100 over the term. For example, we have 20% of the discount bonds in 1-to-2-year maturity and they will show a price appreciation on average of 2.9% annualized and this is in addition to the stated coupons, which on average are over 3%. This discount pricing will not remain forever but taking advantage of it is a silver lining to a cloudy bond market today.

We Are Positioned For 2023

The year has only begun but so far, we are seeing value from our allocation strategies. As we begin the year, we are seeing three bright spots in the NCM Pension Portfolios. Canadian allocations continue to show relative value. Our growth-oriented "New Economy" themes are showing very encouraging rebounds after a tough 2022. Finally, as mentioned above, the "Discount Bond" trade is also working.

We worked very hard through the last quarter of 2022 to adjust our portfolios to reflect our outlook for 2023. We are happy with our positioning and are expecting a solid year for our NCM Pension Portfolios as we move through 2023.

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