Manulife Investment Management

Investments Unplugged Ep 85

Macan Nia:

Commentary is for general information purposes only clients should seek professional advice for their particular situation. But you remember I C Q Kev back in the day,

Kevin Headland:

I was like I C Q I was like msn, you know I'm going to aid myself. I use I C Q all the time in university.

Macan Nia:

Just when you think that you understand its sentiment, the market does a wonderful job of sending you back to your thinking chair. Look no further than the market dynamics. Over the past couple of weeks around artificial intelligence and central bank policy. In our 2023 outlook, we laid out our framework in which we believe markets would have average like returns with risk to the upside specifically for US equities, yet less than halfway through the year, markets have already reached those levels. The rally has been very top heavy and the companies leading the way have been associated with artificial intelligence euphoria that has captured the hearts of investors. As a timer recording the S&P index year to date was up roughly 12% as of the end of May. But if you remove the top 10 holdings, the return is roughly flat or slightly positive. For the S&P 500, no one is questioning the immense potential of artificial intelligence and it's likely to impact on economies, industries, and our own personal lives. However, similar to the early stages of the integration of the internet into society, it's far too early to understand how it will unfold with any reasonable amount of confidence. But we'll try and we'll try to answer the following questions. Are there signs of fraud? Is there a replay of the dotcom era? What are the investment implications? Listen on as we discuss these topics and whether central banks are back to hiking or whether pausing or cuts are more likely in the cards ahead. Listen on this is Investments Unplugged.

Welcome back to Investments Unplugged. My name is Macan Nia, co-Chief Investment strategist at Main Life Investment Management. And as always I'm joined here with my partner in crime. Kevin Headland

Kevin Headland:

Going on, Macan

Macan Nia:

Not much. How are you?

Kevin Headland:

I'm good man. I don't say we're partners in crime. Geez. Come on. Are we criminals here?

Macan Nia:

Sure, that will be canceled by compliance as well. But anyways, we are recording this on June 12th and we thought that we would take this podcast to talk about two recent topical discussions, Kev, one being the Bank of Canada's surprise interest rate hiking announcement. Last week I was personally cursing underneath my breath as my variable rate mortgage keeps trending higher and my disposable income keeps trending lower. And then obviously the other one is the AI boom, artificial intelligence and how it's going to change our lives and change economies and change industries and markets. And we've seen quite a sizable rally in this theme. So we thought we'd spend a little bit of time on both of those because they will have implications from an investment perspective. Since it's Monday, I'm in a giving mood. Kev, why don't you decide which topic we'll lead with AI or Bank of Canada.

Kevin Headland:

Which one's more exciting at this? Depends on what I see it. Let's go with ai cause I think that's really what a lot of people are talking about right now.

Macan Nia:

So where to even begin, right? This has become a topic, the s and p, not to the really surprise of us because we thought the s and p would do well this year. However, we have got a lot of the rally in a very short period of time in a very concentrated select group of stocks. So regardless of how you look at it, Kev, whether you want to look at it from the top 10 or whether you want to look at it from the AI concentrated names as a timer writing the s and p's up roughly 12%. You take out these top tens, whether it's in the eye, whether it's in tech name, the s and p performance is either negative two to plus two. So a lot of the rally year to date has been concentrated in these select few. Now we're fielding a lot of questions about this, the implications for ai, how do we invest in it? And I think for this perspective before we get lost in the weeds, because I think it's very easy to Kev, is let's just really talk to three things. Questions. Is there signs of froth? Question number two, is this a replay of.com? Because that's the second question we always get. And last but not least is okay, what's the investment implications moving forward? How do I invest along this theme for my clients? So when it comes to signs of fraud, Kev, how are you looking at it?

Kevin Headland:

I think when I look at leadership and it's so contrary in not necessarily sectors but perhaps companies that have a similar attribute. And when I look at the fact that it's not a broad based rally, I tend to believe that means it's a bit frothy and it means a bit of a FOMO or fear missing out by investors chasing some of these companies that are somehow aligned with artificial intelligence or could benefit from artificial intelligence. And when I look at that, I worry that perhaps this is not the starting of a broad based rally in that those that are chasing this market right now might be on the wrong end of it. And that's seen it before. One of the ones I looked at in some research, and you might not remember this, but do you remember the Long Island Brewing Company or beverage company? Long, long Island. The Long, long Island iced tea beverage

Macan Nia:

Company. I'm going to say no, but I feel yes. But anyways,

Kevin Headland:

So they changed their name to the Long Island iced Tea crypto company and they actually, when they changed crypto their name crypto, the stock was up 183% in one day and they had nothing to do with crypto. It was just they changed the name and because it went to blockchain, the stock price jumped right? And this was a during the crypto craze, remember that. And we've known what happened since then that perhaps some companies that you think are attached to this or you think might benefit aren't always the winners, right? We've seen 'em before. We've seen a.com where the companies out of the gate are often not the winners in the long run. It's a marathon. Mark's our marathon, not a sprint. And we don't want to try and capture that too early for me.

Macan Nia:

Yeah, I think for me the signs of Frothiness is everything around Nvidia. There is no doubt Nvidia is a very profitable company. It is positioned uniquely to take advantage of artificial intelligence when it comes from semiconductors, but just the price movement over the last month is staggering. As of right now. I checked this morning, I think it's a 950 billion market cap company. So Nvidia at 30 times sales at 200 pe, if it hits a trillion market cap will be the first trillion market cap company to have valuations of that magnitude ever. So that's one. Also, when looking at Nvidia, they had that blowout earnings on May 25th or 25th. Yeah, I think it was 25th, the stock was up 25% on that day. But because of its earnings expectations, it's PE actually dropped from 60 times to 50 times and it added roughly I think 185 billion in market cap in one day, which was equivalent to the market cap, total market cap of Texas instrument, total market cap of Qualcomm, total market cap of intel combined. I could keep going.

Kevin Headland:

Pardon? Combined?

Macan Nia:

No, no, no. Not combined individually but still. Oh

Kevin Headland:

Yeah, sorry. The 185 billion was better. That one day was bigger than

Macan Nia:

Those three companies individually. Now I find this funny, I think they obviously do it through an AI algorithm, but it essentially analyze all these S&P 500 earnings call and look for keywords and just last quarter, last quarter, only 10% of MA management was referring to AI in their earnings call. Three months later it's 20% now. So in a span of three months, an increase of 10% of S&P 500 executives are now talking about AI in their earnings calls. So it just speaks to the attractiveness of ai, but just the eu, a bit of the euphoria surrounding it. So are there signs of froth? Yes. Is it all encompassing? No. So I think that's goes leads into the second discussion. Kev is replay of.com and I think the biggest difference here is it's basically concentrated in these 10 names first off and then second, these names that have rallied are still very profitable companies. These are very solid businesses, very solid fundamentals. Unlike what we saw in.com where these market casts are being driven higher based on no fundamentals

Kevin Headland:

For the most part. I would agree with you, I think some of the euphoria around a new technology is similar to.com, but at the same time, again going back to.com, going back to that era, there's companies that did well and have survived and actually thrived as a result of the link to the internet. And of course some companies that didn't survive and the leaders out of the gate were not the long winners. We could be seeing a simmer aspect. Now, not saying again that companies will go bankrupt because that there's a lot of fly by night type of companies that just showed up in the internet. And then of course no business models, no fundamentals, you said no earnings, pre-revenue, all kinds of issues of course that weren't longstanding. Majority of these companies now, especially because they're the biggest companies for the most part in the SP 500 that are leading the way right now.

Hard to argue again that these aren't solid businesses. Perhaps it's more about is it the right price to pay Right now the decision really is what are they worth, what should we pay for them as investors long term? Not necessarily that these are companies that will disappear in the coming months and artificial intelligence just like.com, just like the internet is definitely here to stay. It's transformational and this is going to be perhaps the next productivity boom that we haven't seen again since the advent of the internet. It's something to be excited about. But from an investment perspective, investors need to be careful and just be mindful about what they're investing at and what price they're investing at.

Macan Nia:

And I think you said it really well, Kev, is the investment implications. And I'm going to be honest, I have no idea. I have no idea which of these AI companies, I think we can say with a high degree of confidence that the any chip manufacturer, anyone that, and I'm getting into the weeds where I don't even understand it, but creating the actual chips in terms of etching them and putting in these transistors, so on and so forth, those companies will benefit. But which companies that we will be using from a, you're right Kev, it's it's going to be a productivity boost. Look at something like chat G P T, not that we use it, but I can see how individuals can use it very effectively for a one page review of markets. It saves a couple hours out of the advisor's time. They can use that using something else, but I don't know which companies are going to be around as a result. So I'm going to go through some names because the reality is the first mover is very rarely the one that survives. Give me the equivalent of what we used today, but I'm going to give you the original and back then it was like okay, this is going to be the platform and clearly it's not going to be the case today I C Q, it could be any one of these messaging apps that we use today, WhatsApp, telegram, see

Kevin Headland:

What you're,

Macan Nia:

But you remember I C Q Kev back in the day,

Kevin Headland:

I was like I C Q I was like msn, you know I'm going to age myself. I use I C Q all the time in university. Yeah, I guess WhatsApp or any direct messaging system,

Macan Nia:

Right? I remember I broke up with a girlfriend over I C Q I never, never heard it that for my sister or my mom. Wow. They never let me forget. Exactly.

Kevin Headland:

Wow.

Macan Nia:

It was a lot more immature back then, Kev.

Kevin Headland:

Oh my gosh.

Macan Nia:

Okay, so let's go to another one. Friendster- Friendster was the original Facebook.

Kevin Headland:

Yeah, Facebook exactly. So I think anybody younger than us uses Facebook anymore.

Macan Nia:

How about the original? It wasn't even a smartphone but the original phone, do you remember what it was?

Kevin Headland:

Well I know that because we talked about this earlier, so it's

Macan Nia:

Remember the Palm, right? And people would think Blackberry, that's what I typically hear, but it was Palm, the original and how it was going to transform the way we communicate Netscape, right? The advent of the internet, how are we going to search it from a browsing perspective? Thin Netscape, remember that end with that globe it was the primary. I can go on Atari. My point here is who you may assume or think is going to be the leader in three to five, 10 years is probably not going to be the case and the investment implications, how do we deal with that? I think the big investment implication today, Kev, is the concentration because of the rally in these big names. So I'm going to go through the top 10. The top 10 today for the S&P 500 and we know who their culprits are, right?

Apple, Microsoft, Google, go through the list. It's 30% of the S&P 500 today. Back a couple years ago in 2020 was that 25%, which was the second highest and then tied back in 1980 was also 25%. So the S&P 500 has never been this concentrated within the top 10. And when you look at the names, apples 7% weight, Microsoft 7% weight Google four. The reason I bring this up, Kev, I think this is the implication too is not so much how do I take advantage of the ai? Because I think if you invest in a broad-based index, we will take advantage of that. But for me, Kevin, we've talked about it, how much tech do I really own in my US equity weight today? Assuming I own and we know advisors own or investors generally own a passive ETF. Okay, well you're concentrated 30% in these tech heavy names primarily.

You may have an active manager, I'm going to assume that they own these tech names as well. You probably do your own stock picking when it comes to the Canadian equity market and US equity market and the data suggests us equity. We know if you're going to pick a stock it's easier to pick a Tesla or an Apple or Microsoft or Google. So how much US equity tech weight do you actually own? And I think that's the investment implication today it's too hard to try to figure out the winners and losers today, but I think how we can protect our clients in an environment where we're seeing that the path from let's say 9% to where we are today, that was the easy move. The next lifting from four-ish to two-ish is going to be tougher and there's going to be ebbs and flows along the way. We saw and regret to the next topic, the Bank of Canada surprise increase last week is if these central banks start not materially Kev, but increasing rates instead of cutting them these interest rates sensitive sectors, i e tech are going to be vulnerable. So how vulnerable is your equities to a potential, not pause, but a slight pivot higher?

Kevin Headland:

Yeah, I think the key is diversification wins over time. We know that. We got to be very mindful about that. You were talking about returns earlier and I just ran quickly while we're talking this data here, this is some macro bond. So the top 10 names, the S&P 500 are up 12%, the rest of the four 90 stocks are up 1%, that's as a Friday's close. Again, it's important to realize that and a lot of these charts out there have talked about, oh these are the only companies that have been positive and that's a fallacy. Of course they've just driven the market higher because they're larger weights. There are other companies in the S&P 500 who are positive year date, many have underperformed the index but some have actually outperformed the index. So it's not just the top weights, but when you see an index is top heavy and not just in names, like you said in 1980, I think it was 25%, the top 10 names, I bet you the industries or the businesses amongst those top 10 names were much more diversified.

Although the top 10 was similarly concentrated, the actual types of companies were still very diversified. And I think that's something else to understand is to pay attention to. And I think that's, we're not saying don't own the S&P 500 and we're not saying not own these companies, but perhaps we want to be mindful about if we are in a choppy environment or perhaps as rally as too quick, too fast, too soon, perhaps there's some downside risk here. We want to be very mindful of diversification over time that wins out over time. I talked about Marathon before. This is all exciting to win the first a hundred meters, but if your race is much longer than that, the first hundred meters doesn't matter in the long run. And it's important to make sure that we win the marathon, the full race, not just the sprint out of the gates.

Macan Nia:

Well you're wrong Kev. Actually I'm looking at it right now in terms of 1980. Actually I was, I'm kind of actually kind of surprised by this is the makeup. So IBM number one at four, I'm going to use right numbers at and t different, but you know what, she's a lot. I would've never thought oil. So number three, I'm going to go in oil, Exxon, standard Oil, Schlumberger, shell, Mobil, standard Oil Atlantic, Richfield. Wow. So basically from three to nine is all oil. So back in, so there was concentration risk but to your point, is those names, you know what I mean, diversification,

Kevin Headland:

How many of those companies don't exist anymore?

Macan Nia:

Standard oil does it. I don't think. Yeah, well General Electric going through the years has really been all over the place

Kevin Headland:

That, and that's a good timing. That's like end of the seventies. That was the oil was big boom there in oil prices 1980 that could have driven those up. It was more, it wasn't because of the great companies necessarily. It was because of the underlying business they're in and just timing I guess, which is very similar to perhaps today.

Macan Nia:

So let's transition Kev to the recent Bank of Canada surprise hike. So now they've hiked I think 450 beeps in the last basically year and a half. One of the most aggressive central bank hiking cycles in recent Canadian history. And I don't want to just talk to Canada specifically. I think there's a lot of themes that we can apply globally when it comes to the US Central Bank. I think the first one is central banks are going to likely continue raising rates may not at the degree or pace they did last year, but unlike previous tightening cycles going into a recession, that's not going to be the reason that they stop or pause. Because even if we get a recession, I think more importantly that's not going to be a reason that they cut because inflation still is four to five, 4%, let's just say that's well above the target. And until we're at two, I don't think they're going to be as quick to, and we talked about this at nauseum as quick to cut as they may have been historically.

Kevin Headland:

Yeah, I was less surprised the Bank Canada announcement than perhaps some were. We discussed this many times. We talk about the balance of risks and when we look at where inflation is right now, there is a stickiness and the several banks know they have to raise rates to kind of get rid of that excess inflation that lasts 2%, which is the hardest part I would say of the reduction of inflation. It's kind of the consumption inflation, that sticky part where people are still spending money and perhaps rates have to move higher to finally break them out of that consumption habits. But the bar to cut rates is much higher than the bar to perhaps raise rates again or at least be on pause for much longer than they expect. And I think that is the key is we're likely going to see at least a longer pause or perhaps additional rate cuts in all day dependent.

One thing that it was surprising the bank had did not do at their announcement was talk about four guidance, right? Talk about where they see things. I think this is probably a good news story because the market tends to react on the four guidance when the federal reserve announces rate hikes, the market reacts to the dot plots that suggest rate cuts in 12 or 18 months. And that's counterintuitive what the Fed is trying to do by raising rates. This four guidance is great on when you have a dovish tone and trying to stimulate the economy. You can talk about potential rate cuts that'll help the economy and help the markets. But in a hawkish perspective, the market's almost too forward looking and certain pricing future rate cuts. And I still think we're a ways away from that. And it seems that timeframe has been pushed out.

Not too long ago the markets were pricing in four rate cuts by the Fed, at least two by the Bank of Canada and now we're at the point where there's no rate cuts before the end of this year priced in the market for Bank of Canada, perhaps another rate hike priced in and in the US we're looking at perhaps another rate hike combined between the next two meetings at some point and then maybe one rate cut by the end of this year and maybe and that numbers are changing dramatically over the last little while, so it'll be quite interesting to see. But ultimately again, the bias is probably to a longer pause or further rate hikes before you see any rate cuts.

Macan Nia:

Yeah, I'm not, I'm in the camp where I think they're probably going to pause at some point. You're in either one or two camps, you're in camp one where you think that we can absorb these higher rates even a little bit more or you're at the camp where we are getting to the point where at these levels, even an additional 50 beeps or 1% is going to really have an impact on the consumer despite all the increases we've seen since last year, specifically since the summer. And it takes time for these to be absorbed by the broader economy, but the consumer's been resilient. When you look at retail, there's cracks emerging now, but to my surprise, they had excess savings and all that, but they like that story I feel like has been gone for the past couple months. But still they're spending, they've been resilient.

But I think we're getting to the point now where credit availability, the excess savings is not as much there. And I just think that if we keep going at this space, we will be cutting at some point at the end of the year because it is going to trigger recession probably sooner. But I think as of right now, consumers are resilient and that's more likely to be a pause than at the actual cut. And then the challenge is for these central banks is they're at a point now too is if what inflation or the contributors of inflation was something that they could manipulate by monetary policy, that's one thing. But when you look at the inflation breakdown, so a third in Canada anyways, and I'm sure it's the same in the us a third of it of headline inflation is attributed to food prices. The Bank of Canada or Federal Reserve, it doesn't matter.

Central banks cannot control that. So that's kind of out of sight of their control. Energy costs is another one. Also labor costs, it's kind of outside of the control. They're saying actually San Francisco Fed came out with basically a paper saying that crushing labor simplistically is not the way to deter businesses from borrowing and spending and so on and so forth to bring down in inflation. I think at the margin they can impact elements of inflation, demand being a big one, but there's other aspect of headline that they can't control. So I think they're also mindful of that. Why raise rates to crush the economy into a hard landing if the things you're trying to control you can't control through monetary policy in itself.

Kevin Headland:

Yeah, no, I agree with you, but we all know that I think it seems like the Fed makes mistakes on both sides. They cut rates too far and they raise rates too high and eventually we get the recession. They're looking for this idea of cutting spending. People talk about shelter for example, and shelter right now I'm justly at CPI and overall CPI looking at almost 30%. But interest costs are actually surprisingly small. Interest costs are only about 2%. So people are saying, well, interest rates are going up, they could be inflationary. But the idea here I think is the ability to spend by a Canadian is reduced by higher interest costs. The idea of if I'm spending more for my mortgage, I have a less propensity to consume elsewhere and discretionary spending is slow. So maybe that results in at some point some lower food prices or other discretionary spending.

We're seeing a lot of kind of inflation or this is consumption move from goods to services and you're seeing restaurants and travel and ideally that will slow and that'll help a little bit reduce some of this pressure there. I often joke in some of my presentations I say everyone knows at least one person is complaining about higher interest costs for their mortgage. And during that conversation you ask them, are we still on to go to the restaurant on Friday night? And they're like, yeah, sure, no problem. And that will tend to slow eventually. Eventually as you said, excess savings slow down. We're seeing savings rates much lower than expected, near long-term lows. We're seeing credit usage increase eventually credit cards are maxed down, you have to pay those credit cards off. So it will come, it's being patient. I think inflation will eventually slow but don't, definitely don't expect just because inflation is slowed from call seven to five, that it naturally goes from five down to three. I think that's the key is it doesn't slow in a linear fashion. There is some stickiness there. So don't be surprised in the next couple months the inflation is kind of almost flat lined I would say. I think we should not be surprised about that wraps the central bank's reaction to that sticky inflation again, could be more hawkish than the market perhaps expects. So let's

Macan Nia:

Finish off with the investment implications of this. So you might hear again, if we had a dollar to spend today, and this is such a difficult question, depends on what the client is, I'm not even going to ask it.

Kevin Headland:

I hate that question.

Macan Nia:

I was going to ask like, well your next dollar, where would it go? But it depends on what your current weighting is. Are you overweight equities? Are you underweight, fixed income, so on and so forth. But the idea where central banks may not be as quick to cut or even maybe pause now, although I think we are still going towards the pause that will have investment implications and especially let's talk about it from a bond perspective. Oh, the higher rates are going to impact bonds. And I think the first response to that is these central banks, they control the overnight rate. They don't control the long end five years plus. The long end is much more of function of economic activity. So one would assume as central banks keep raising or if they potentially keep raising the overnight rate, the long end would actually probably go down because of the very same thing that we have talked about.

Pause, but not necessarily keep going up materially. But the idea is, okay, central banks are raising rates too quickly. They're likely going to cause a recession maybe sooner. And the long end is a function of the economic environment. So yields could fall from that level. So just because the overnight rate at the margin might be going up another 0.25 or 0.5 doesn't necessarily put the bond investment opportunity or make it vulnerable because you're also starting off with 5% yields, right? Yield to worse for investment grade credit in Canada and the US is at 5%. So your starting base, you have a lot bigger cushion today than what you did last year. So I think even in your worst case scenario, and maybe I should rephrase that worst case, you never know, right? But with the odds, even if the Bank of Canada or US Federal Reserve, they go one more percent. What's the down? Yeah, I know Kevs face like shot up. I don't agree. I don't think that's going to happen, but that's a very aggressive central bank. What's your downside for bonds, right? Maybe flat to negative, but like it just said, I think if they go 1% the long it actually comes down because people will have Kevin's face like, oh my goodness, we're going to cause a hard landing. So despite at the margin now that they are still going a little bit up, the bond investment opportunity which we've covered at nauseum is still intact.

Kevin Headland:

Yeah, I think the question we get most often I see almost in the last 12 to 18 months is kind of should we be short duration or long duration? And the answer is not as simple as that. But because of the volatility that's seen in specifically the treasury market and you cross the treasury market, there's an index that measures the volatility called the move index. And that is actually one of the highest we've seen since the financial crisis. And that means that the market's been volatile and the treasury market's been volatile and the curve has been volatile. And I think this shows you the need to be flexible and not be just long duration or short duration, but be flexible. For example, the tenure treasury in the last month has moved roughly 37 basis points in the last month, 37 basis points. That is material upwards.

It moved higher. Yeah, it moved higher. 30% base points after coming down almost 60 basis points. So going down 60, going up in our 35 or 37. And this is not, you go back to the beginning of the year, you saw even more moves like that. You saw a lot of vault here, there. And these are material moves. These are 20 plus percent moves. And this is where active management I think really takes advantage of these gyrations, gyrations of the market. An equity manager would really enjoy these moves because if you have a good quality company that sells off and rallies, you can buy low and trim profits and you can move around. It's rare to see this volatility in a fixed income, especially on the US treasury market. And again, this really adds value to an active manager that can take advantage of this. And I think that's important. It's not just short duration, long duration or where should we be, but really about the individual security selection and the opportunity set that exists that can really do well from outperformance perspective right now.

Macan Nia:

You know what Kevin? I think that's a really good area to stop. You're at the 30 minute mark. People's attention spans are actually, do you know what the average attention span of a human is? Kev?

Kevin Headland:

It's got to be like five minutes.

Macan Nia:

It's actually 12 minutes. So you after 12 minutes have to remind your brain to focus. So if you've been listening throughout the entirety of this at some point at the 15 minute mark, you have to remind yourself to keep listening to us because you started, your brain started drifting elsewhere. But I think that's a good area to a lot going on. A lot is always going on. It's as long as we've been in the business, there's always something to talk about. Right now it just so happens to be central banks that may not be as quick to be cutting, which we've been talking about this year, probably increase at the margin, but most likely going to be pausing soon. And then keeping the pause longer. And then also from the AI perspective, which I think is interesting and will always be something right in terms of technology, but investment in implications involved. But I thought it was a very good discussion and I'll stop there unless you wanted to add anything.

Kevin Headland:

No, it's all good. I just got to remember to set an alarm for 12 minutes during my presentations to remind the audience to keep paying attention.

Macan Nia:

Yeah, exactly. So with that, I'm Ma Nia and Kevin Headland and thank you for listening to Investments Unplugged. If you find this podcast useful, please rate it. Hi. It allows the podcast to be reached by other like-minded individuals like yourselves. And again, we always appreciate your support and we always enjoy the positive feedback we hear on the road and just wanted to thank everyone on the call for that. So thank you again and until next time. Goodbye.

Kevin Headland:

Take care.

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