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CAPITAL MANAGEMENT INC.

INVESTMENT NOTES

JUNE 2023

UPCOMING 2023 BNN SHOWS

Christine: July 13 @ 12 pm

Alexander: August 14 @ 12 pm

Christine: August 25 @12 pm

Christine: September 21 @12pm

Since mid-March, the NASDAQ Composite Index skyrocketed, driven by fervor around artificial intelligence (AI). For the entire second quarter it was up 12.8%. Aided by the healthy price gains from the technology heavyweights, the S&P 500 Composite Index advanced 8.7% in the quarter. In contrast, the S&P/TSX Composite Index barely eked out a gain, up 1.1%, dragged down by economically sensitive sectors, including energy, materials, and banks.

The enthusiasm surrounding AI has propelled the broader stock market indices higher this year. The much-anticipated recession has yet to arrive, and the anticipated timing continues to be pushed out by economic forecasters. So far, higher interest rates have not slowed the economy to the point where dampened demand has led to significantly weaker prices and a contraction in economic growth.

More on AI and Market Breadth

So far in 2023, major markets have had a nice rebound after their negative returns in 2022. The S&P 500 Index, for example, is up 16.9% on a total return basis, versus a -18.1% return last year. But looking at the headline index returns masks what's really going on under the surface.

The index's seven largest technology stocks – Apple, Microsoft, Alphabet, Amazon, Meta, Tesla, and Nvidia – have generated a 58% year-to-date return. Meanwhile, the other 493 stocks in the S&P 500 are up just 5%. This means that those seven tech stocks are responsible for 12% of the S&P 500's 15% return (excluding dividends) this year.

This lack of breadth in returns isn't a new phenomenon. Since 1995 the top-10 performing stocks in the S&P 500 have generated 32% of the index's return in the median year. What's new this year, however, is what many of these high-flying technology stocks have in common: AI.

ChatGPT took the world by storm when it was released to the public in November of last year. Users (us included) were amazed that a computer could have such a human-like conversation about a seemingly endless list of topics. By January of this year, ChatGPT had collected 100 million monthly active users, leading to investment bank UBS crowning it the fastest-growing consumer software application in history. This hype caused its parent company's private market valuation to jump to $29 billion, versus $14 billion in 2021. Suddenly, AI was the next big thing, and public market valuations of AI-related tech companies followed suit: at their highs, both Microsoft and Alphabet were up 44% from their autumn lows, while Nvidia was up 290%.

Fortunately, we owned both Microsoft and Alphabet in client portfolios prior to the AI hype gaining steam this year. With respect to Microsoft, we liked the company for its exposure to cloud computing and dominance in business software and operating systems. For Alphabet, its search business has been an incredible generator of free cash flow for a long time. And while we are certainly happy that these stocks have been rewarded for their exposure to AI, we won't be doubling down on our positions anytime soon.

If history is any guide, successfully identifying the winners during the early days of a technological revolution is easier said than done. While the term "first mover advantage" is often used to justify an investment thesis, history has shown that these advantages are often proven to be quite fleeting as industries mature. Think of IBM dominating the PC market in the 1980s, only to steadily lose market share to the likes of Compaq, Dell, and HP. Or in the smartphone market, Blackberry's dominance vanished in just a couple of years thanks to the emergence of the iPhone. Or in the social media space, with Myspace losing out to Facebook.

This isn't to say that Microsoft, Alphabet, and Nvidia won't be major players in the revolutionary AI space for years to come, rather, we believe it is just too early to call. Other equity investors, however, don't seem as restrained in their analysis. Take Nvidia for example. While it is currently the dominant provider of chips for AI data centres, that dominance comes at a price. It is currently trading at over 20x revenues and almost 50x earnings. For comparison, Alphabet looks like a steal at just 4.5x revenues and 20x earnings.

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In other words, some AI stocks look like they are priced for perfection, while others appear to have a significant margin for error built into their valuations. We will continue to watch the space with a close eye and won't hesitate to act if we gain more conviction about who the winners and losers will ultimately prove to be.

Inflation

Since March of 2022, central banks around the world adopted an aggressive interest rate tightening cycle to dampen demand and bring inflation back down. The pandemic-induced inflation spike has resulted in one of the most rapid tightening cycles by the U.S. Federal Reserve. In the current cycle, the Fed funds rate has risen 500 bps over a span of 14 months (Chart 1).

Headline inflation is coming down at a much faster pace than core inflation, which excludes food and energy prices (Chart 2 and 3). Central banks focus on core inflation and view it as a better predictor of future inflation. The "stickiness" of high core inflation above the target range concerns central bankers and has kept them on a restrictive monetary path. Rent inflation has been a large contributor to the sticky factor.

Rent inflation accounts for about 32% of U.S. CPI and has steadily been rising since late 2021 (Charts 4 and 5). Rent inflation dipped during the pandemic when many cities and states placed limits on rent increases and some cases, froze prices altogether. As those measures expired, landlords factored in foregone increases into sharply higher rents on renewal. At the same time, demand for rentals rose as people exited from pandemic lockdowns looking for their own living space while many existing renters were priced out of the housing market due to robust home prices and dreams of home ownership were pushed out. Over the past year, rising mortgage rates have also reduced home ownership affordability. Strong demand has spurred a supply response where starts in the multi-family housing sector have boomed 33% over the past year and units under construction have accelerated by 17% over the same period. David Rosenberg opines that the onslaught of new supply to come on stream in the next year will swamp demand, thereby significantly dampening not only rent inflation, but core inflation over this period. Thus, he is adamant that further interest rates are not necessary to quell inflation – it's already a done deal.

The supply/demand dynamics in the rental market, in conjunction with the lagged impact of monetary policy has on the economy, magnifies the risk that the U.S. Federal Reserve raises interest rates beyond what is necessary to lower inflation and causes a recession.

Economic Indicators

The stalwart leading economic indicators continue to signal a recession on the horizon. Historically, an inverted U.S. Treasury yield curve is reliable recession indicator, and typically inverts an average 12 months prior to a recession beginning (since 1955 the actual time periods span from six to 24 months before each recession). The US Treasury yield curve has been inverted since July 2022, with the current spread between the 10-year and 2-year treasury bond at negative 100 bps (Chart 6).

The Conference Board Leading Economic Index (LEI), a trusted composite of multiple leading indicators, is released monthly. The LEI anticipates turning points in the business cycle by about 12 months and peaked in March 2022. The index has since declined for 14 consecutive months and is signaling an economic contraction (Chart 7).

The U.S. Consumer

Household expenditures are a major driver of economic growth since consumer spending accounts for about 70% of U.S. GDP. The resilience of U.S. consumer spending in the face of multi-decade high inflation can be attributed to the amount of wealth that was accumulated over the pandemic.

The amount of U.S. household savings initially spiked to $4.8 trillion in Q2/2020 when full lockdowns were implemented and then settled in around $4 trillion in Q1/2021 (Chart 8). The accumulation of household savings was attributable to government assistance programs and a sharp increase in the savings rate to over 25% during the pandemic (Chart 9). The amount of personal savings is now back to pre-pandemic levels, and the savings rate has declined to 4.6% in May 2023, in-line with historical levels.

The tailwinds bolstering consumer spending capacity may be fizzling out as the stockpile of excess savings accumulated during the pandemic has eroded and banks are tightening lending standards for consumer credit. Going forward, consumer spending will be more reliant on traditional drivers such as wage growth and employment levels.

The recent decision by the Supreme Court blocking President Biden's s student loan forgiveness plan is a potential headwind for consumer spending. Most student loan borrowers have not been required to make payments on their student loans since March 2020, when Congress passed a sweeping aid program to help people struggling financially because of the pandemic. Student debt payments are scheduled to resume in October and will weigh on consumer spending later this year.

Potential Green Shoots

Housing is among the most interest-rate sensitive sectors in the economy and tends to weaken first when the Fed is raising interest rates. The U.S. single-family housing market has been declining since early 2022. Weakness in residential construction, however, has been offset by rising non-residential and public construction (chart 10). Within non-residential, construction of manufacturing facilities has roughly doubled over the past year, driven by the onshoring of new semiconductor and electric vehicle manufacturing plants. The single-family housing market is showing early signs of a bottom, reporting a month-over-month increase in construction spending in May, the first monthly increase since April 2022.

Conclusion

While there are numerous risks that continue to weigh on the economic outlook, one thing remains quite clear: we certainly aren't yet in a recession. The number of jobs being added in both Canada and the U.S. continues to suggest that the North American economy is still sound, despite central banks trying to cool things off for over a year now. Economists' prior predictions about job losses, rate cuts, and an imminent recession have, so far, been proven wrong. This underscores just how difficult predicting macroeconomic trends has been and will continue to be. That is one of the reasons why we will continue to look through any potential short-term economic weakness by continuing to invest in companies that we believe have a foundation strong enough to not only survive but thrive coming out of the next recession.

Christine Poole, MBA, CFA
Alexander MacDonald, CFA, P.Eng., MBA

CHART 1: Changes in the federal funds target rate in past tightening cycles (in percentage points)
- U.S. Federal Reserve

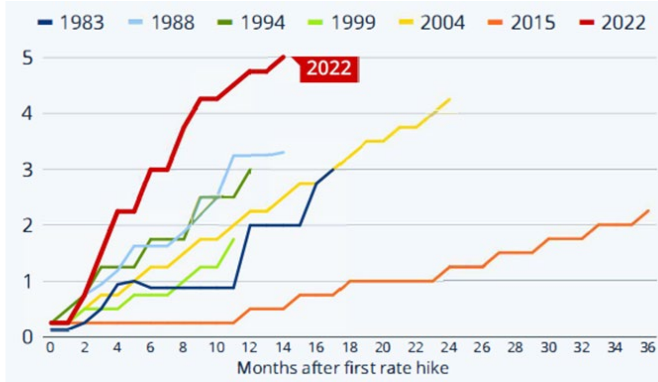
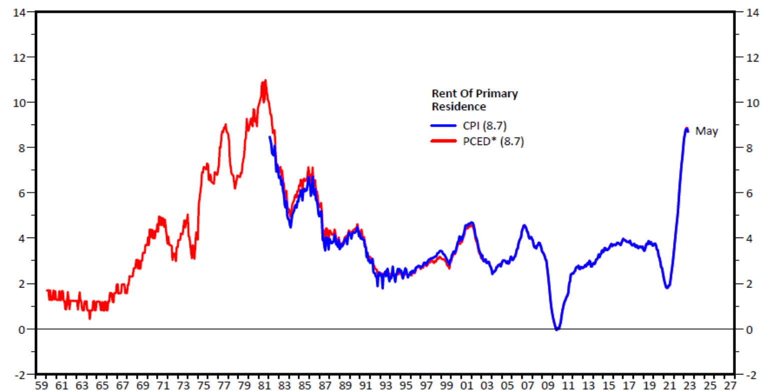
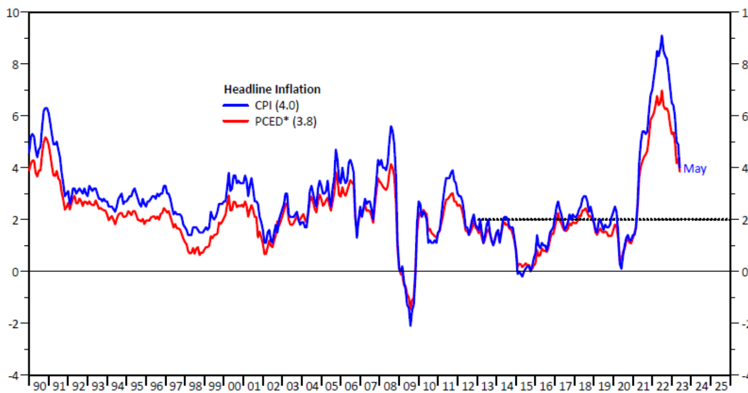


CHART 4: Consumer Prices (yearly percent change)
- Bureau of Economic Analysis and Bureau of Labor Statistics



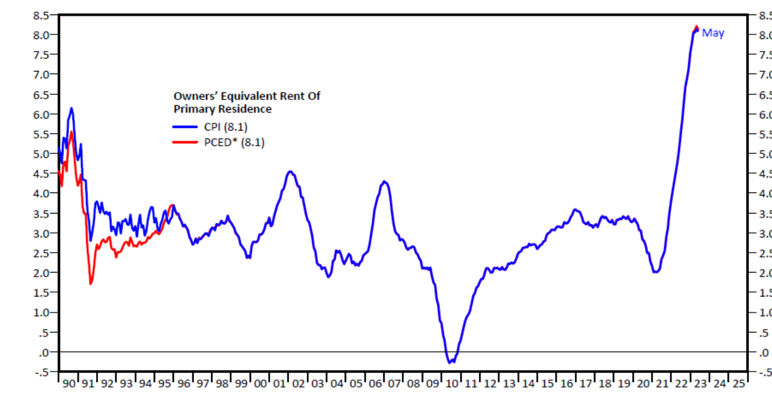
* Personal consumption expenditures deflator

CHART 2: Consumer Prices (yearly percent change)
- Bureau of Economic Analysis and Bureau of Labor Statistics



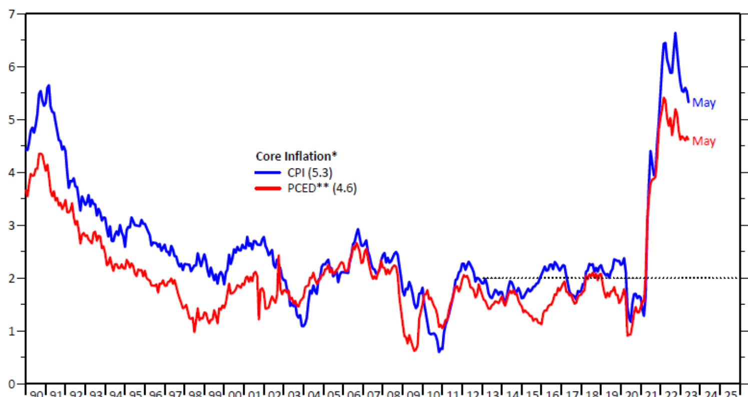
* Personal consumption expenditures deflator

CHART 5: Consumer Prices (yearly percent change)
- Bureau of Economic Analysis and Bureau of Labor Statistics



* Personal consumption expenditures deflator

CHART 3: Consumer Prices (yearly percent change)
- Bureau of Economic Analysis and Bureau of Labor Statistics



* Excluding food and energy
** Personal consumption expenditures deflator.

CHART 6: 10- Year Note yield less 2-Year T-Bill Yield
- Haver Analytics, Rosenberg Research

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CHART 7: Leading Economic Index (Six-Month Average of Monthly Change)
- The Conference Board and Wells Fargo Economics

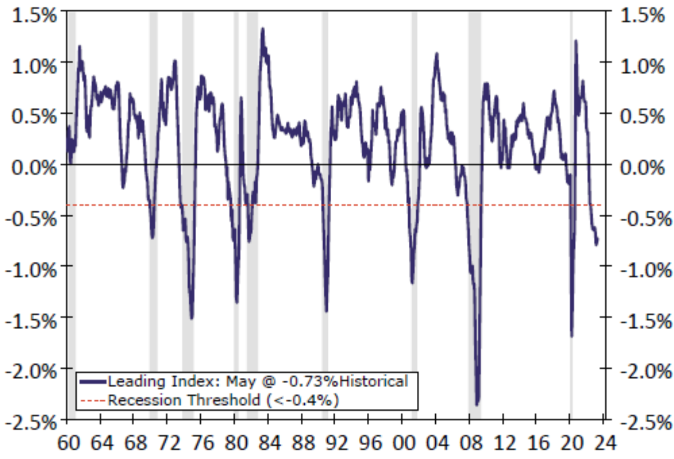


CHART 8: Personal Saving
- U.S. Bureau of Economic Analysis

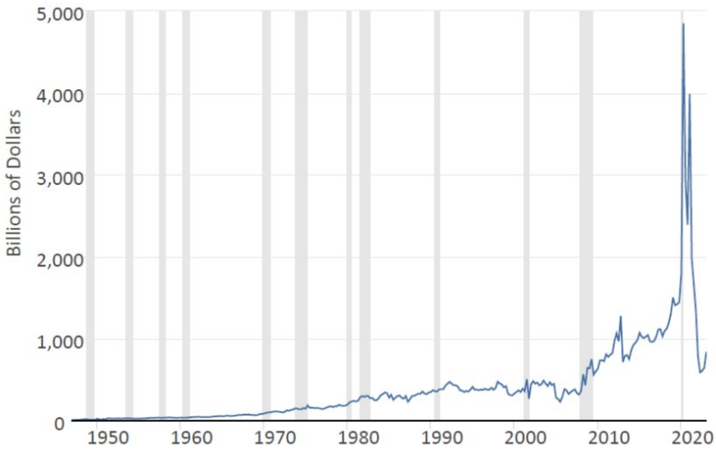


CHART 9: Personal Saving Rate
- U.S. Bureau of Economic Analysis

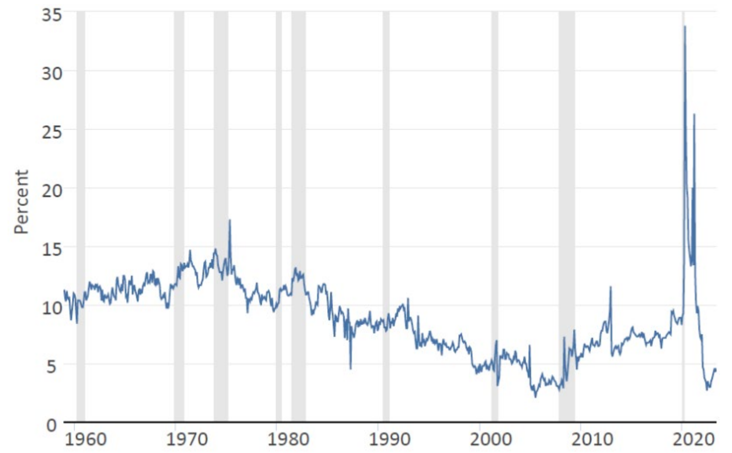
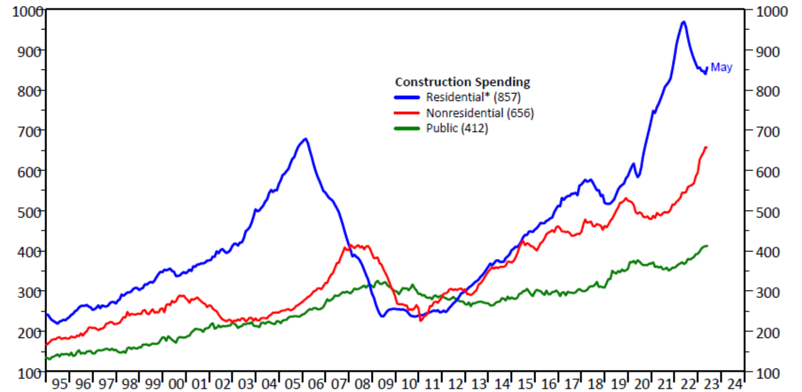


CHART 10: Value of Construction put in Place (billion dollars, saar)
- Census Bureau



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RECENT BNN SHOWS

Christine: June 13, 2023

Christine: May 17, 2023

Christine: April 18, 2023

Christine: March 21, 2023

Christine: February 17, 2023

Christine: January 18, 2023

Christine: December 16, 2022

JUNE 30, 2023 STATISTICAL SUMMARY

STOCK MARKETS	QTD	YTD	1 YEAR
S&P TSX COMPOSITE TOTAL RETURN (CAD)	1.1 %	5.7 %	10.4 %
S&P 500 TOTAL RETURN (CAD)	6.5 %	14.2 %	23.0 %
S&P 500 TOTAL RETURN (USD)	8.7 %	16.9 %	19.6 %
DJIA TOTAL RETURN (USD)	4.0 %	4.9 %	14.2 %
NASDAQ COMPOSITE PRICE RETURN (USD)	12.8 %	31.7 %	25.0 %
MSCI WORLD INDEX PRICE RETURN (CAD)	4.1 %	11.4 %	19.8 %
MSCI WORLD INDEX PRICE RETURN (USD)	6.3 %	14.0 %	16.5 %

COMMODITIES	QTD	YTD	1 YEAR
GOLD	-3.8 %	5.0 %	5.0 %
SILVER	-5.8 %	-4.2 %	11.1 %
COPPER	-7.6 %	-0.5 %	0.8 %
NATURAL GAS (NYMEX)	26.3 %	-37.5 %	-48.4 %
WTI	-6.7 %	-12.6 %	-33.2 %
BRENT	-6.4 %	-13.3 %	-32.7 %

20 Queen St. West, Suite 3308 Toronto, ON M5H 3R3

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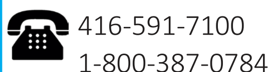

416-591-7100
1-800-387-0784

416-591-7133

info@globe-invest.com

TREASURY BONDS	06/30/23	12/31/22	06/30/22
2 YEAR (CAD)	4.58 %	4.06 %	3.10 %
2 YEAR (US)	4.87 %	4.41 %	2.92 %
5 YEAR (CAD)	3.68 %	3.41 %	3.10 %
5 YEAR (US)	4.13 %	3.99 %	3.01 %
10 YEAR (CAD)	3.26 %	3.30 %	3.23 %
10 YEAR (US)	3.81 %	3.88 %	2.98 %
30 YEAR (CAD)	3.09 %	3.28 %	3.14 %
30 YEAR (US)	3.85 %	3.97 %	3.14 %
CPI (CAD)	3.40 %	6.30 %	8.10 %
CORE CPI (CAD)	4.40 %	5.30 %	6.50 %
CPI (US)	4.00 %	6.50 %	9.10 %
CORE CPI (US)	5.30 %	5.70 %	5.90 %

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