Fall 2023

"Rising rates have been momentum-sapping kryptonite for the higher growth stocks."
Value Line November 3, 2023

As we steer through the third quarter of 2023 and into the year end, our navigation charts are marked by the rough seas of geopolitical tensions, particularly the escalating crisis in the Middle East, alongside the persistent currents of rising interest rates and inflation. These factors are exerting a significant influence on global markets.

During the third quarter, equity markets gave back some of the gains experienced in the first half of 2023. The S&P/TSX Composite, the S&P 500 and the MSCI had negative returns of 2.20%, 3.27% and 3.36%, respectively. Despite these third quarter losses, the one-year returns were positive. Canadian, U.S. and global equity markets had gains of 9.54%, 21.62% and 22.58%, respectively. The annual returns in the S&P 500 and MSCI World Index were driven by large-cap technology companies. Energy stocks were the best

performers in the third quarter thanks to a rise in oil prices driven by strong demand and supply constraints. Technology stocks, which had led the market rally in the first half of the year, lost momentum as higher interest rates reduced their valuation appeal.

Economic reports for Canada in the third quarter of 2023 depict a challenging scenario, with several indicators hinting at a looming recession. The Canadian economy experienced stagnation in August 2023, and data suggests a likelihood of a shallow recession in the third quarter of 2023. This is attributed to the central bank's ten interest rate hikes since the previous year, which are perceived to be affecting growth adversely.

There was a preliminary estimate from Statistics Canada indicating that the economy shrank at an annualized rate of 0.1% in the third quarter, following a contraction in the second quarter. In contrast, the American economy showed robust growth. The US economy expanded at a strong 4.9% annual rate during the third quarter, marking the fastest pace of growth in more than two years. This growth was propelled by consumer spending, government spending, and inventory accumulation by businesses. Also, the labour market exhibited resilience with 336,000 jobs added in September 2023, and the unemployment rate remained steady at 3.8%.

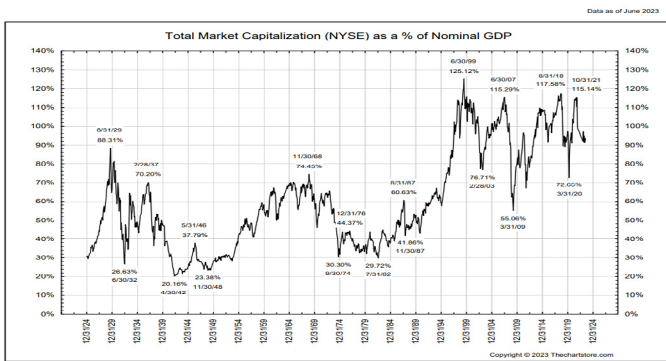
Inflation remains a major concern in North America as it hovers in the four to five per cent range; well above central banker's 2% target. A resilient U.S. economy, continued supply chain constraints and rising food and oil prices are keeping inflation high. As a result, financial markets were impacted by the fear of "higher rates for longer". The prospect of stagflation also looms as aggressive monetary tightening slows economic growth while inflation remains stubbornly high.

The Middle East, often the crucible of geopolitical volatility, has once again captured the world's anxious attention. The recent crisis has not only political implications but also profound economic repercussions. Energy markets have been the first to respond, with oil prices exhibiting heightened volatility. As well, supply chains may be impacted further, adding to the aforementioned inflationary and supply chain concerns.

The specter of inflation has continued its unyielding march, prompting central banks around the globe to persist with their monetary tightening policies. Rising interest rates are a double-edged sword; while they aim to curb inflation, they also increase borrowing costs, potentially slowing economic growth and corporate earnings.

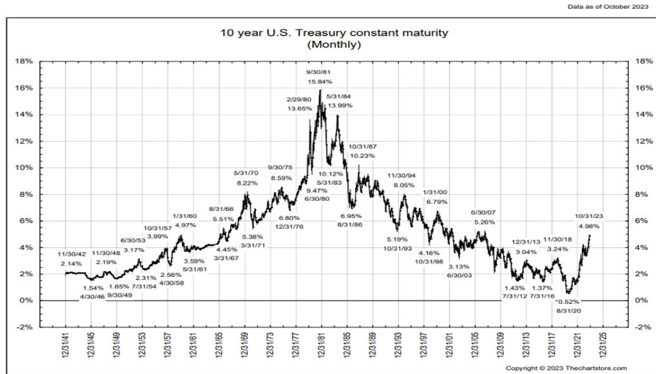
Equities have traditionally been viewed as a hedge against inflation. However, as Chart 1 below indicates, valuations are stretched by historical standards. As we argue in the following commentary, equity markets could face a downward revaluation from higher interest rates.

Chart 1



As evidenced in Chart 2 interest rates have risen dramatically from near zero to approximately five per cent today. This rapid rise in rates over such a short period is unprecedented. Furthermore, interest rates are now close to their long term historical averages.

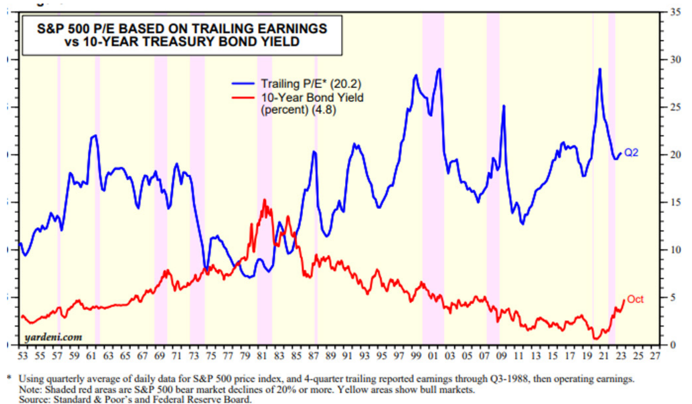
Chart 2



Historically, equity valuations and interest rates have been intrinsically tied together. As the risk free premium rises or falls the market P/E multiples follow. For example, assuming an interest rate of 1%, an equity risk premium of 4% and a long term growth rate of 3% gives us a market P/E multiple of 50x (calculated as follows: 1/ (0.01+0.4-0.03). Today's interest rate is approximately 5%. Thus, using the same logic, the market P/E should be 16.67x. (1/ (0.05+0.4-0.03). The current P/E on the S&P 500 is approximately 23x. This dichotomy indicates that market participants believe that interest rates are poised to fall back in the near future, to the unusually low levels of the past few years.

However, central banks are signaling that rates may stay higher for longer. If central bankers are true to their word, leaving rates at current rates or higher for an extended period, equity valuations face a steep drop. Should rates remain at their current levels a decline of 25% is warranted. Another one per cent increase in rates implies a P/E multiple of 14.3x. This revaluation results in a fall of nearly 40% from current levels!

The graph below prepared by the Yardini Research Group elegantly highlights the relationship between interest rates and P/E ratios. As is clearly illustrated, P/E multiples fall when rates rise and vice versa. The graph also highlights that at current interest rates the P/E ratio should be much lower than it is today.

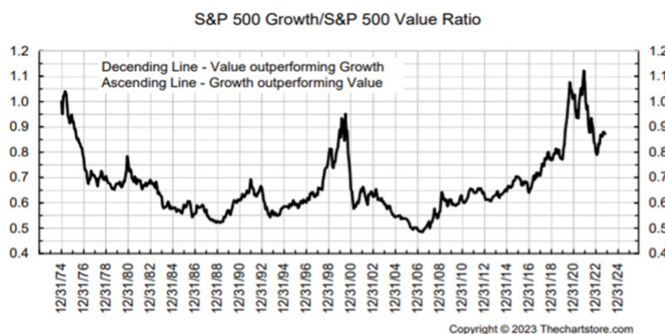


* Using quarterly average of daily data for S&P 500 price index, and 4-quarter trailing reported earnings through Q3-1988, then operating earnings.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: Standard & Poor's and Federal Reserve Board.

Rising interest rates benefit our investment strategies and your portfolios

for several reasons. As discussed above, as rates rise equity valuations should come down. As a result, investment opportunities that meet both our criteria for quality and value may present themselves in greater numbers than they have in the past. We are now earning over five per cent on our fixed income securities as we patiently wait to deploy our “store of wealth”. Finally, as Chart 3 indicates, value investing outperforms growth investing during times of rising interest rates.

Chart 3



Your portfolios continue to be well positioned. As of September 30th, 2023, the total model portfolio yield was 5.3%. The dividend yield on the portfolio’s equity component was 5.40%. This dividend yield not only provides an excellent source of income but provides a growing and inflation protected income stream as our investee companies regularly increase their dividend payouts. In addition, the portfolio’s overall characteristics compare favourably to major benchmarks such as the S&P 500 index and S&P/TSX Composite index. During the quarter, we added to several of our holdings and reduced our T-Bill position to 35%. The fund’s investments in T-Bills and lack of exposure to the volatile technology sector helped returns relative to the market in the third quarter. The wind is finally in our sails!

As noted in the accompanying table, our performance is now above our benchmarks across every time frame except for the one year period relative to the S&P 500 CAD and the five year period.

Patient Capital Management
Compound Annual Rates of Return
as of October 31st, 2023

	PCM	TSX	S&P CAD
Since Inception	6.75%	5.71%	6.25%
Five Years	6.57	7.96	12.21
Three Years	15.92	9.85	11.87
Two Years	3.18	2.26	2.64
One Year	1.64	0.42	11.94

Inception Date March 31, 2000
Before Fees and Expenses
Based on Representative Account
Past Returns not Indicative of Future Returns

As always, we appreciate your trust and partnership. Please do not hesitate to contact us if you have any questions or would like to discuss your portfolio.

Vito Maida