HILBERRY GROUP
WEALTH MANAGEMENT

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"Why does the TSX Suck?"

A client emailed us a great question this week. She wanted know why Canada's TSX has underperformed the US S&P500. To protect her privacy, we're calling her Susan.

Morning Steve,

Why is the Canadian market sucking so much at the moment? Is it this capital gains stuff, or is that too simplistic?

Curious investor ;)

Susan

Sent from my iPhone

Susan,

It's a great question. Thanks for asking it! We've been discussing Canada's underperformance in recent Weekend Readings. I'm going to feature your question in this week's commentary.

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Why the TSX sucks:

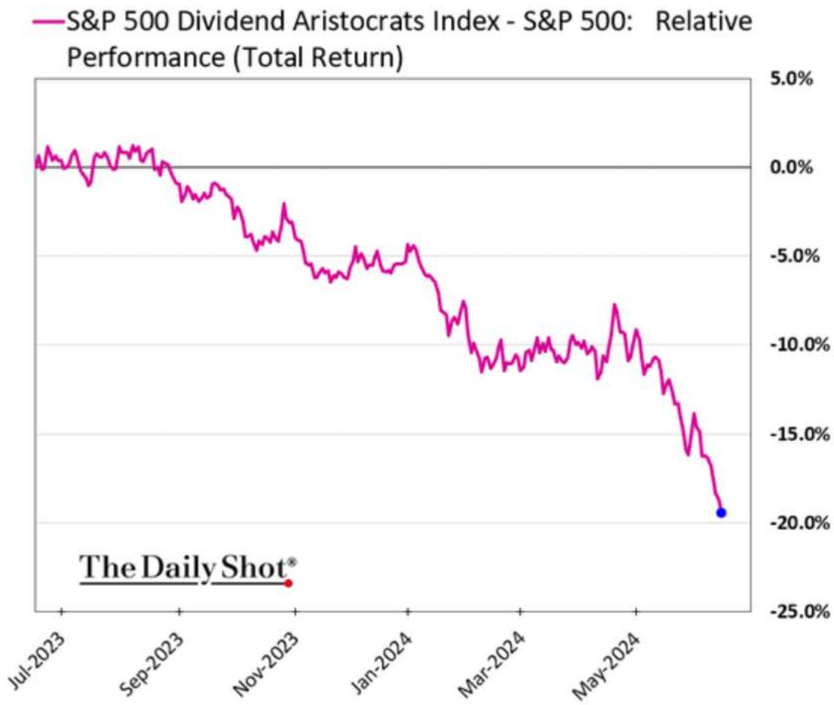
- US growth stocks (Magnificent-7, etc.) have captured investor enthusiasm.
    - The S&P500 Dividend Aristocrats index (all S&P500 constituents) has underperformed the S&P500, pushed up by Mag-7.
    - This rampant enthusiasm for growth stocks is beyond Canada's control.

S&P500 Momentum index (buying what's hot) vs the S&P500

Source: WSJ Daily Shot

US Momentum stocks are up close to 60% pushing up the S&P500 by roughly 27%

S&P500 Dividend Aristocrats Index to the S&P500



The Dividend Aristocrats have underperformed the S&P500 by close to 20%. Over the past 12 months, Momentum stocks are up 59.2%, pushing up the S&P500 close to 27.2% while the top US dividend paying stocks provided a total return of 7.6%. Extracting re-invested dividends from the Aristocrats total return, leaves roughly 4% price return. Yawn.

Canada's TSX Composite generated +13% while Canada's Dividend Index showed a total return of 3.5% (Source Thomson ONE). Extracting the dividends from the Cdn Div Index result implies a small price-loss over the past 12 months for Canadian dividend paying stocks (blame the banks). So yes, Canada has sucked but so has everyone else not engaged in Mag-7 business models. This is beyond Canada's control.

More reasons:

- Political tensions with China and Russia's desperation to sell commodities, has reduced Canada's commodities trade with China and India.
  - Geopolitics are mostly beyond Canada's control.
- Canada's economy remains focused on things not ideas (commodities, vs. Big Tech).
  - Refocusing Canada's economy away from commodities has been a popular Canadian political narrative. We noted some of the challenges. Do we really want to Mexico's or China's manufacturing advantages (low regulations, cheap labor, heavy government intervention)?
- The areas of Canada's economy that normally see expansion during commodity bull markets (oil & gas, mining, etc.) have been suppressed by recent made-in Canada policies.

- The Loonie typically matches commodity price rises. Oil-up/Loonie up. Oil is up while the Loonie is down. Doubts about Canadian future production has broken this pattern.
  - This is within Canada's control.
- Canadian regulations make commodity production financially challenging:
  - Example: BC's TransMountain Pipeline Expansion (TMX) is 10's of billions over budget and more than a decade past original build projections.
  - The original proponent, Kinder-Morgan Canada gave up and returned to Texas selling the TMX assets to the only buyer, the Fed Government.
  - A Fed Government sale of TMX to various Canadian groups looks to be loaded with political agendas.
  - As the Federal Govt is hunts for politically acceptable buyers, they appear ready to shield such buyers from financial risk, burying the huge cost overruns at taxpayers expense
  - This is within Canada's control.
- International investment dominates Canada's economy.
  - Our tax policies historically were designed to reward retaining the capital in Canada (capital gains treatment competitive with US policies) while enabling cash-flow from profits (dividends) to be paid to the international owners.
  - Dividend income plays a larger role in Canadian corporate structures than in the US.
  - Dividends tend to derive from mature corporations, in later stages of their growth cycles.
  - Dividend paying stocks have been out of favor vs. high growth stories (see the first bullet point).
- Canada's economy represents less than 2.9% of global GDP.
  - Despite political dreams to the contrary, Canada doesn't matter much on the global financial stage. International money has many other options.
  - Canadian polices dissuading even a small portion of international investment flows have little effect in New York, but a significant impact in Canada.
  - The most likely investment flows into Canada will be towards what we're <u>really</u> good at, being commodities, currently out of favor in Ottawa and Victoria.
  - It would be great to diversify our economy – and our markets. Raising questions about our future commitment to capital intensive projects won't help.
  - This is within Canada's control.
- Income Tax policies in Canada are dissuading high income earners from locating here.
  - Look up the difference in taxation between a resident of Whiterock, BC and Blaine Washington.
  - This is within Canada's control.
- International investors appear reluctant to invest in long-term, captured assets inside Canada, if those projects may become a target for populist politicians pointing figures at 'Big Business'.
  - Rampant deficits lead to declining governments revenue after debt payments.
  - Where are they going to get the money? Not from the 'progressive' voters.

- Money flowing out of Canada has pushed the Loonie to near-record lows.
    - This makes Canadian assets attractive…if one doesn't have to worry about being a target (see above).
    - The declining Loonie has amplified US dollar returns for Canadian investors.
- Even Canadians wonder why own Canada stocks.

The above has led to both international and domestic money flowing out of Canada. Canada's largest pension funds are under-weight Canada. Given Canada's small footprint within global retained wealth, this isn't entirely crazy, but it's a statement of Canadian's view of their own economy.

That's the bad news.

We've repeatedly advised this can't last. Canada's small economy is too closely tied to the US to deviate widely for long periods. Recalling Canada's small footprint, history says once ta catalyst arrives, a small change in US/International investment flows means a dramatic change in Canadian dollar results. We don't see the catalyst for change…yet.

We suspect the irrational exuberance for super-growth stories inside the US will prove disappointing for investors. We think investors will turn away from the Bold and New, returning the Tried and True. The Loonie's decline means Canadian assets are cheap compared to US and European equivalents. Canada's major corporations stock prices are lower than average vs their business fundamentals, meaning their cash dividends are priced higher than average.

We must clarify dividends are derived from corporate earnings, are not guaranteed, and may be reduced or eliminated at any time by corporate Boards of Directors. Holding common shares can result in loss of capital. Investors must carefully review their risk tolerance in consultation with professional advice.

EXAMPLE:
A $1 dividend received from a stock originally priced at $25 gives a 4% income yield on cost (close to average for Canadian large caps). Typically, Canadian large cap dividends have grown around 7% (not in a straight line and not for all corporations).

Assume 24-months later the stock price has declined to $15.00 while the dividend grew by 7% per year over 2 years ending at $1.145 per share. The new lower market price yield for a new buyer is now 7.6%. That's likely to dissuade sellers and attract buyers…eventually. If the price has 'only' declined 15% to $21.25, the market yield is 5.4%. It's 4.6% to the original $25 price and growing so not a disaster either.

An investor who pays $15.00, receiving a $1.145 dividend growing at 7% per year <u>might</u> receive $3.68 in quarterly cash dividends per share over the next three years = 24.5% on their $15 purchase cost (not guaranteed!). To achieve a 3-year average return of 10% per year, the stock price must increase by 5.5% over three years for an average annual price gain of roughly 1.85% per year.

If the stock price gains 5% per year, the ending 3-year total return is 39% or roughly 13% per year (Source Thomson ONE). A very boring 2% to 5% annual price gain won't attract much media attention, particularly if high-growth narrative stocks have increased 300% in 12-months. Boring works.

This is broadly what we've seen in Canada's large caps. We think owning them makes sense. But it's likely to be boring. If we're right, Canada's equity markets stand at a cusp of value, that could – eventually – generate outsized returns.

A rising Loonie reduces US dollar denominated returns. Getting the Loonie right has been a major factor for Canadian investors considering US stocks. This hasn't been important lately.

We're seeing 6-8% plus dividend yields (Source Thomson ONE). A 7% dividend yield doubles one's investment in 10 years from the cash income alone. Even a small increase in price can translate into very satisfactory returns that will mostly be invisible to casual observers. Given the high Canadian yields, if we're early, we're getting well paid to wait.

We think Canadians will make internal changes and international investment flows will return to Canada.

Have a Great Weekend

Steve & Anna Hilberry

<u>FOR THE RECORD Intraday: June 21, 2024</u>

DOW INDUSTRIALS:	39,128
S&P 500:	5,461
S&P/TSX COMP:	21,543
WTI:	$80.48
LOONIE IN $USD:	$0.7295 $US

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