WATERMARK PRIVATE PORTFOLIOS MAY 2023 COMMENTARY

We saw a large difference in performance amongst different sectors of the economy in May. The S&P 500 was up 0.7% (in CAD), once again led by mega-cap technology companies, whereas the TSX Composite Index fell 4.9% as oil and financial companies had poor performance. The bond market also had a downward-trending month, with interest rates rising and the Canadian Universe Bond Index falling 1.6%.

Markets

With interest rates rising in the month of May, from purely a macroeconomic perspective, these sector movements were counterintuitive:

1. Typically, higher interest rates are associated with higher oil prices, as oil moves goods and workers, resulting in higher inflation.
2. Longer-duration assets such as technology companies usually underperform when interest rates rise.

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The likely explanation for the divergence was a strong earnings report and very strong guidance on future earnings (due to Artificial Intelligence revenue) from a technology company and chip leader NVIDIA Corporation, moving that company higher and taking technology stocks higher with it.

The gain on the day for NVIDIA was the largest increase in market capitalization for a single company in history. As impressive as the gain was (NVIDIA was up 25% on the earnings report), we are still in the early innings of the Artificial Intelligence (AI) race, with a lack of clarity on how AI will fully impact society and how companies will monetize it. With the massive run-up in the price of NVIDIA's stock, the valuation of the company and other technology companies have moved significantly higher, leaving technology companies looking overvalued for the time being (see the two charts below for historical comparisons to 1999).

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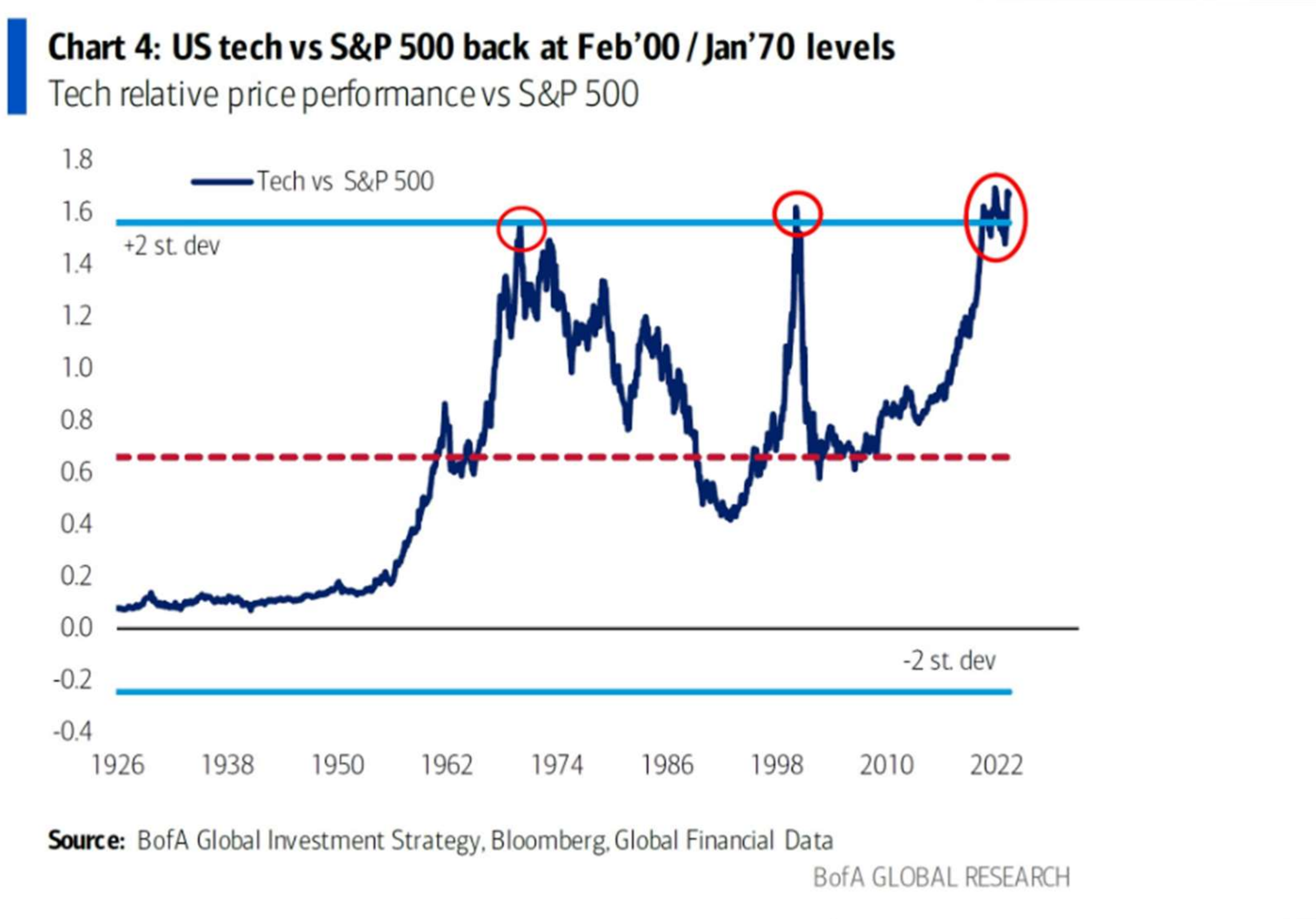

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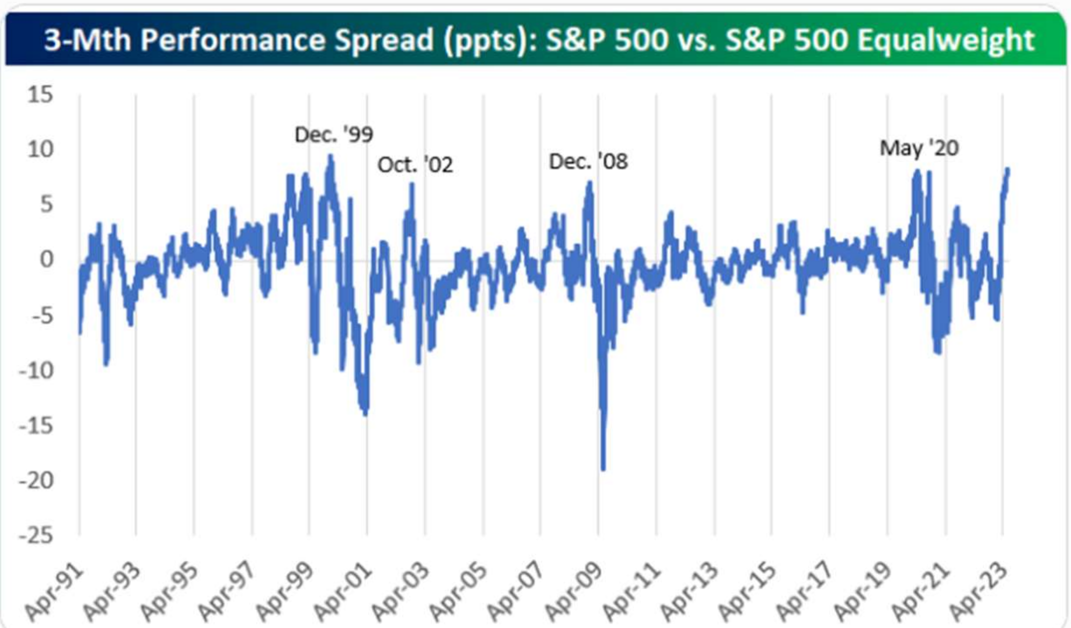
The 3-month performance spread between the S&P 500 and the S&P 500 Equalweight is the widest it has been since December 1999.



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While AI is exciting and cutting-edge, valuations in technology companies appear to be on the high side, so we'll continue to monitor the space and wait for a better entry point. In the short run, investors and speculators may continue to pile into technology companies driving valuations even higher, leading to opportunities in other sectors as money leaves and chases technology companies.

Lastly, it's important to note that inflation seems to be persisting at a higher rate, with core inflation remaining higher than expected in April. In addition, the US will need to issue a large number of bonds in the coming months to top up its Treasury Account and finance its spending. Likewise, interest rates will presumably remain elevated to attract buyers of US debt as the US debt to GDP ratio is high. This will likely result in continued volatility in bond and interest rate markets, which may spill over to stocks.

Our portfolios continue to be positioned defensively going into June, as we're at the high end of the trading range we've been in over the past 13 months. Furthermore, with the US expected to issue a large amount of debt in the next two months to top up their General Treasury Account and taking into consideration the resolution of the Debt Ceiling, we expect this will remove liquidity from the market as money goes into these newly-issued bonds. This may likely result in a pull-back in stocks, at which point we'll be able to strategically redeploy cash back into companies with a proven track record of growing their earnings and dividends.

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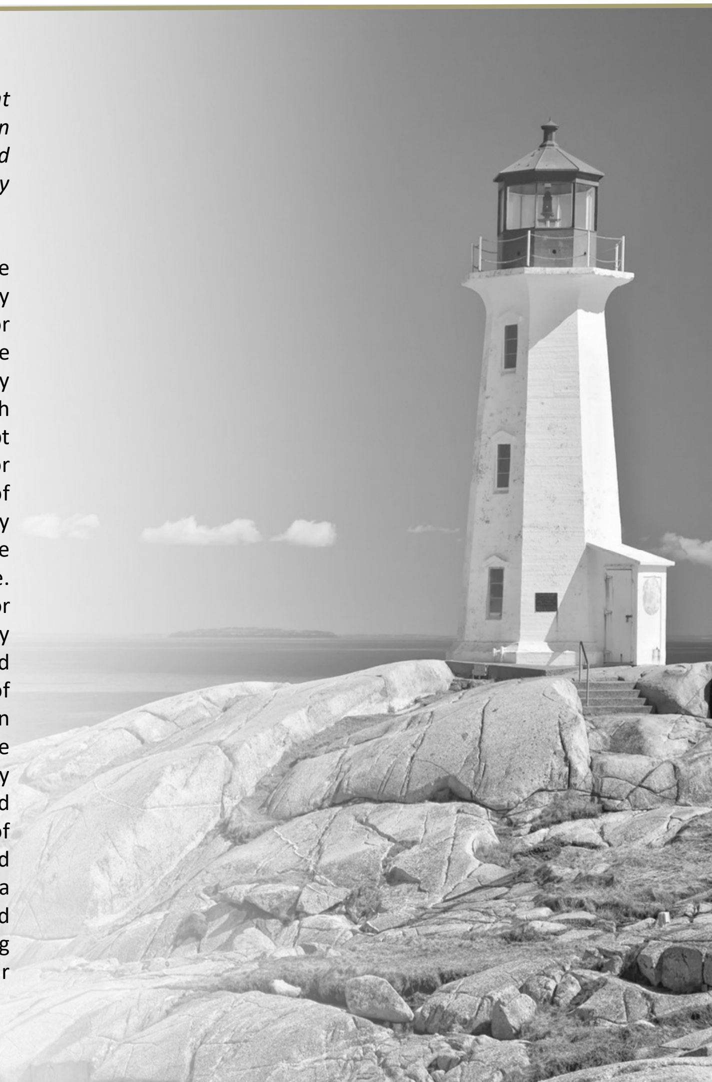

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