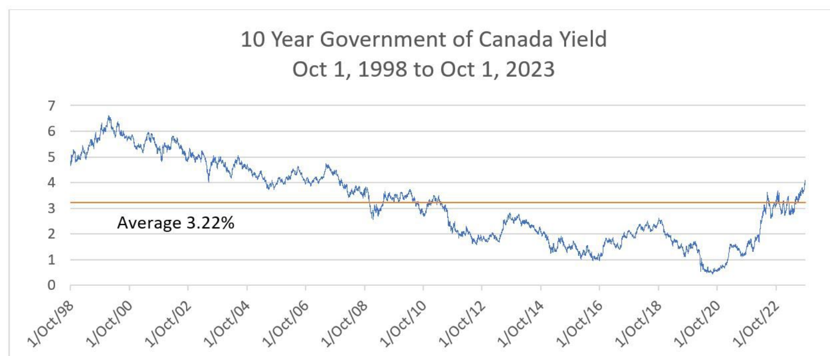
Q3 2023 Review

After reasonably strong performance in the first half of the year, the third quarter of 2023 saw equity markets pull back modestly across the globe. The Canadian market was down 2.2%[1] on the quarter but remains up 3.4% on the year. In the third quarter, the U.S. and Developed Markets outside of North America were down 0.8%[2] and 2.3%[3] respectively, but remain up 13.1% and 7.6% for the year. Emerging Market equities were down 0.8%[4] on the quarter, and are now up just 1.6% on the year. All numbers are reported in Canadian dollars.

Interest rates continue to be the key consideration across all geographies and asset classes. Interest rates continued to move higher during the quarter which negatively impacts the valuation of most asset classes. As can be seen below, rates are now higher than they have been in over 15 years. The overall rate is not particularly high, what is unusual is the speed of the change. Higher rates can negatively impact equity valuations but can also make fixed income investing a more attractive option; something we discuss in more detail below.

It is worth noting that while rates have come up a long way in a short period of time, the absolute rate is only modestly above the 25-year average. In the broader historical context, current interest rates are more 'normal' than the sub-2% rates the market has seen for much of the past decade.



Source: Bloomberg

[1] S&P TSX Composite
[2] S&P 500 (C$)
[3] MSCI EAFE (C$)
[4] MSCI Emerging Markets (C$)

Where have we come from?

Looking back 10 years

The past two years have been tough for investors in most asset classes. 2022 was particularly notable as it was the first time both the broad bond and equity markets were down more than 10% in the same year. We understand that a couple of years of poor returns in the markets can make it hard for investors to focus on the long-term; but focus on the long we must. Having a long time horizon is one of the keys to investing success. Long time horizons allow investors to weather the short-term storms of market volatility, which, ultimately, translates into higher long-term returns. So, thinking long-term we thought it worthwhile to revisit the markets from 10 years ago with the goal of putting past performance into context and providing some guidance about how an investor should allocate capital today.

Rolling back the calendar to October 1, 2013, an investor would have observed the following broad equity market valuations.

October 1, 2013	Price/ Earnings	Dividend Yield (%)
TSX (Canadian Market)	17.4	3.3
S&P 500 (U.S. Market)	15.5	2.1
MSCI EAFE (Developed Markets ex-North America)	17.1	3.2

Source: Bloomberg

The Price to Earnings (P/E) ratio is a simple valuation metric that divides the price of stock by the earnings per share. It is the most basic method of evaluating how cheap or expensive a given stock is. When discussing the P/E or yield for the overall market we are simply referring to the weighted average of the given metric.

October 1, 2013, saw the following rates for fixed income:

	October 1, 2013 (%)
10-Year Canada Bond	2.423
1-Year Canada Bond	1.050
10-Year U.S. Treasury	1.720
1-Year U.S Treasury	0.180

Source: Bloomberg, Bank of Canada

Valuation metrics such as Price/Earnings or Dividend Yield are poor predictors of short-term market performance but have been shown to have some predictive power for medium and long-term market performance. So, while there is certainly more nuance to the market conditions, these numbers do give an overall sense of where the market was 10 years ago.

To demonstrate what Cypress was thinking 10 years ago the following is from the Outlook section of our fourth quarter client letter from 2013.

> *Current valuations suggest that investors can expect returns in the range of 7% over the next decade on a broad portfolio of equities. Government long bonds, on the other hand, are very likely to provide negative returns....*
>
> *..., given the significant discrepancy in valuation between government fixed-income and equities, the biggest driver of performance over the next decade will be the allocation between equities and bonds, not the individual securities held in a portfolio.*

For the past 10 years, returns from the various assets classes and markets have been as follows:

Annualized Oct 1, 2013, to September 30, 2023 (%)	
TSX (Canadian Market) $CDN	7.5
S&P 500 (U.S. Market) $US	11.9
MSCI EAFE (Developed Markets ex-North America) $US	3.8
Canadian Broad Composite Bond Index $CDN	1.6

Source: RBC

Looking back at our long-term expectations for asset returns, our decade-long prediction has largely been proven correct. Equites have performed much better than bonds, in fact U.S. equities have performed much better than we had anticipated. The path of equity returns was volatile, but we always knew it would be. Bonds have been, as expected, a poor investment. Recent bond returns have been so poor that we have seen it reported that if bonds generate negative returns in 2023 it will be the first time ever that bonds have been down 3 years in a row.

The purpose of this trip down memory lane is not to demonstrate our skill as long-term market prognosticators, far from it. Rather, we wanted to highlight that occasionally there are some obvious valuation disconnections in the markets which create asset allocation opportunities. 10 years ago, it seemed obvious that bonds would underperform equities by a wide margin over the next decade.

Looking back 20 years

Going even further back the paragraph below is from the Outlook section from the oldest Cypress Client letter we can find. It is from the second quarter of 2001. The investing themes and concerns from over two decades ago remain as relevant today as they did back in 2001.

> *It is the volatile nature of the stock market that makes investing difficult. The key to a successful investment program is to maintain a disciplined approach to investing and not let emotions corrode this discipline. The past year has been a difficult one; but our focus on value stocks helped us avoid the most severe consequences of the collapsed hi-tech market. Looking forward, we are optimistic about the overall trend of the market. We continue to find good companies at reasonable valuations that we expect will do well in a positive economic environment.*

Where are we going?

Taking the same metrics we saw 10 years ago and putting them alongside the numbers as of October 1, 2023; the broad market valuations are as follows for both the equity and bond market.

	October 1, 2013		**October 1, 2023**	
	P/E	**Yield (%)**	**P/E**	**Yield (%)**
TSX	17.4	3.3	14.8	3.6
S&P 500	15.5	2.1	21.0	1.7
MSCI EAFE	17.1	3.2	13.4	3.4

Source: Bloomberg

CYPRESS CAPITAL MANAGEMENT

	October 1, 2013	October 1, 2023
10-Year Government of Canada Rate	2.423	4.026
1-Year Government of Canada Rate	1.050	5.470
10-Year U.S Treasury Rate	1.720	4.685
1-Year U.S. Treasury Rate	0.180	5.287

Source: Bloomberg, Bank of Canada

The obvious change between 2013 and 2023 is interest rates. One doesn't need a degree in finance or mathematics to understand that the current interest rate environment is considerably different than a decade ago, especially for shorter term bonds. The other clear difference is the valuation expansion in the U.S., which has been led by a handful of extremely large companies.

Outlook and Strategy

The fact is that fixed income has become a viable option for investors, especially those investors who are beyond the accumulation phase of their investment lives and are potentially looking to draw on portfolios to fund expenses. As investors, we have to take what the market gives us, and the market is now giving us reasonable options in the fixed-income space.

Current valuations suggest to us that equities will continue to outperform bonds in the medium and long-term, but the gap going forward is reduced compared to the recent past. For those investors with little, or no, short-term income or cash-flow needs, our advice from 10 and 20 years ago has not changed; allocate as much as possible to equites as your circumstances allow.

The mix within equities may shift compared to a decade ago to account for valuation changes, specifically the expansion of valuation in the U.S. market. However, the expansion in valuation for the U.S. market is entirely concentrated in a small number of stocks so the adjustments may be more nuanced than simply reducing overall U.S. exposure.

Finally, we close with the same reminder we finish every letter with. If there have been any changes in circumstances that we should be aware or if you have any questions or concerns regarding your portfolio do not hesitate to reach out. The most important update being any changes to short-term cash-flow needs. We do not want to be forced sellers of equities in a down market, so short-term cash needs should be set aside in an asset not subject to the volatility of the equity markets.

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Please see our website www.cypresscap.com for our most current disclosure document.