CYPRESS CAPITAL MANAGEMENT

2024 Third quarter review

Equity markets around the world moved materially higher in the third quarter, though, as is typical, the performance varied across geographies. The Canadian market was up 10.5%[1] in the quarter and is now up 17.2% year to date (YTD). The U.S. market was up 4.7%[2] in the quarter and is now up 24.7% YTD. Developed Markets were up 6.3%[3] in the quarter and are up 15.5% YTD. Finally, Emerging Markets were up 6.3%[4] in the quarter and are up 17.4% YTD.

Benchmark interest rates across most geographies were down during the quarter. The 10-year government of Canada yield moved from 3.42% to 3.0%. In the past 12-months, interest rates in Canada have dropped a full percentage point, which may not appear significant, but does have a material impact on long-term valuations.

History has taught us to never be surprised by the short-term moves of the equity markets. However, had we been asked at the start of the year to put a probability of global markets returning close to 20% in the first nine months of the year, that probability would have been low.

So, the question becomes; after such a strong move in equity markets, do they continue to offer good value?

On Value

On value generally

Determining value may seem like a straightforward question, but as we will argue below, making broad conclusions is not straightforward. The discussion below focuses first on value broadly, which hopefully gives some insight into how we believe investors should think about value as it pertains to investable assets. We will focus on valuing investable assets towards the end of the letter.

Value is abstract, meaning what constitutes value can be endlessly discussed and debated. Value is a function of cost and utility, both of which are subjective. $100 is not the same 'cost' for a wealthy individual as it is for a poor one, similarly one person might derive a great deal of joy (utility) from a musical performance, whereas another person might think it is just noise. What is valuable to one person may seem completely worthless to another.

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

To demonstrate the abstract nature of value generally, we can look at an asset that many Cypress clients have some experience with (and an opinion on), Vancouver real estate. We will compare Vancouver to the rest of Canada and Vancouver to the rest of the world.

Compared to the rest of Canada, based on simple high-level metrics, Vancouver housing appears to be poor value.

	Vancouver	**Canada**
Average Home Price	1,184,000	718,400
Price to Income Ratio	11.6x	7.7x
Mortgage as a % of income	72.0%	47.9%

Source: CMHC, NUMBEO

Looking at the average home price of other, arguably similar, global cities, prices in Vancouver appear to be reasonable, so compared to other global cities, Vancouver housing appears to be good value.

	Auckland	**Seattle**	**Vancouver**	**Munich**	**Sydney**	**Hong Kong**	**San Fran**
Average Home ($C)	1,061,707	1,175,114	1,184,000	1,351,351	1,481,139	1,695,165	1,756,269

Source: Various sites, Cypress Capital Management

Is Vancouver real estate good or bad value? The question depends on whether it is appropriate to compare Vancouver to the rest of Canada, to rest of the Globe, or some other benchmark. The data in the tables above have been deliberately picked to show that the appropriate comparison will depend on the priorities of the individual or group making the valuation judgement.

For example, take a Canadian bilingual software engineer looking for a home, who can work remotely and is indifferent to the Vancouver lifestyle. That person would likely compare Vancouver to the rest of Canada and conclude that Vancouver is ridiculously overvalued and choose to live in Quebec City where housing costs are less than one-third of Vancouver.

Another example would be a wealthy individual looking to diversify land holdings globally. For that individual a global comparison is more appropriate, and the conclusion may be that Vancouver is good value since it is much cheaper than Sydney or San Francisco.

Depending on the benchmark one chooses, it is possible to make almost any asset appear good value or poor value. We see this phenomenon often in the financial markets. Financial markets produce endless quantities of data that can be evaluated and manipulated in any manner. Quite often, how the data are evaluated and presented will depend on the motivations and incentives of the presenter. A media outlet selling doom-and-gloom will focus on the relative metrics that make the market or an asset appear overvalued, while a broker looking to encourage someone to invest will focus on the relative metrics that make the market or an asset look undervalued.

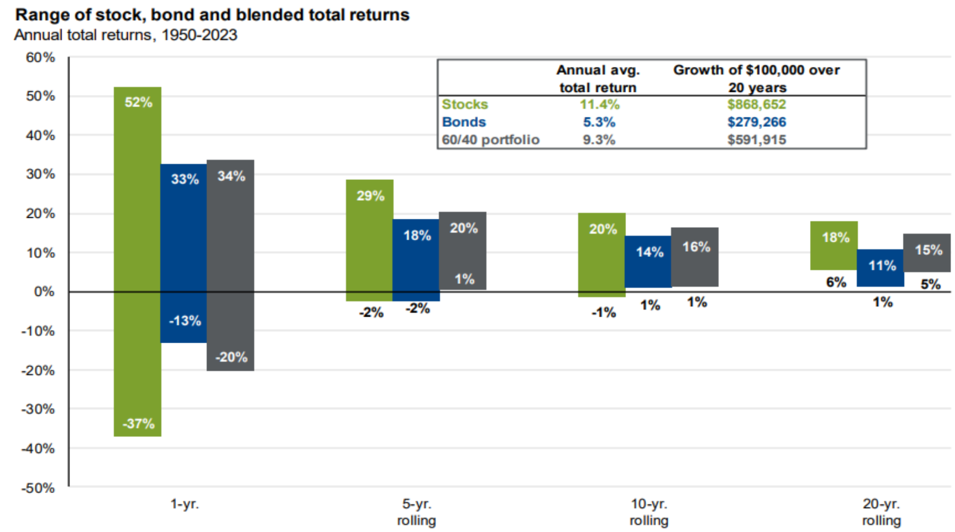
So, determining value requires an understanding of circumstances to determine the appropriate valuation comparisons.

Valuation benchmarks for investable assets

With the understanding that value is a function of circumstances, we will shift our attention to investable assets, which is what Cypress is primarily concerned with. A key characteristic of an investable asset is that an investor should be largely indifferent to the non-quantifiable characteristics, unlike art or music, where personal preference is a key driver of value. Determining the appropriate valuation metrics for investable assets is therefore, in theory, straightforward since personal preferences should not be a factor. However, one still needs to determine the best valuation metrics to make the appropriate investment decisions.

What is the appropriate metric for determining the value of investable assets? ***Our view is that investors should evaluate the value of investable assets through the lens of what offers the best expected rate of return over the contemplated holding period.***

Some may ask how risk is factored into this analysis. Assuming a diversified portfolio (which is crucial), the primary risk of owning investable assets is selling at a loss during periods of negative volatility. This is why the notion of holding periods or time horizons is so important. As time horizons are extended, the volatility becomes less and less. Focusing on equities, historically, once we look beyond a five-year holding period, the probability of a negative outcome from owning equities is low, and even the losses during those periods are modest (see below). If we look out twenty years, the range of outcomes is very tight considering the level of short-term volatility. Even investors in their 80s and 90s likely have a long-term time horizon for at least a portion of their portfolio. The risk in owning equities is being a forced or panicked seller when the market is down. If an investor has the appropriate time horizons and manages emotions, this should hopefully never happen. The graph below is likely one of the five best we have seen about investing. Investors that can internalize the lessons from this graph are all likely to be successful investors.



Source: JP Morgan Guide to Markets

Current valuation of investable assets

We will focus our attention on the primary assets that make up an investment portfolio, which are equities and fixed income, but the analysis could extend to other assets such as real estate or commodities.

Are the equity markets good value? Below we look at some high-level market valuations compared to history and compared to fixed income; we also look across geographies.

For over a decade the primary driver of the global equity markets has been the U.S. market. Given this strong performance, it is not surprising to see that compared to historical valuation measures the U.S. equity market looks expensive.

S&P 500 (U.S. Market)			
Valuation Measure	**Description**	**Value Sept 30, 2024**	**30-Year Average**
P/E	Forward Price to Earnings	21.5x	16.7x
CAPE	Cyclically Adjusted Price to Earnings	35.2x	28.0x
Div Yield	Dividend Yield	1.35%	1.99%
P/B	Price to Book Value	4.5x	3.2x
P/CF	Price to Cash Flow	16.5x	11.3x

Source: JP Morgan Guide Markets

However, this does not necessarily mean that the U.S. market is currently *bad value*. Recall investors should be looking at value as a function of expected returns. High valuation means that expected returns should be lower going forward, but returns have been over 13% annualized for over a decade (see table below). Even if returns in the U.S. are lower over the next decade, which seems highly likely, the U.S. markets may still offer good or reasonable value when compared to other investable assets.

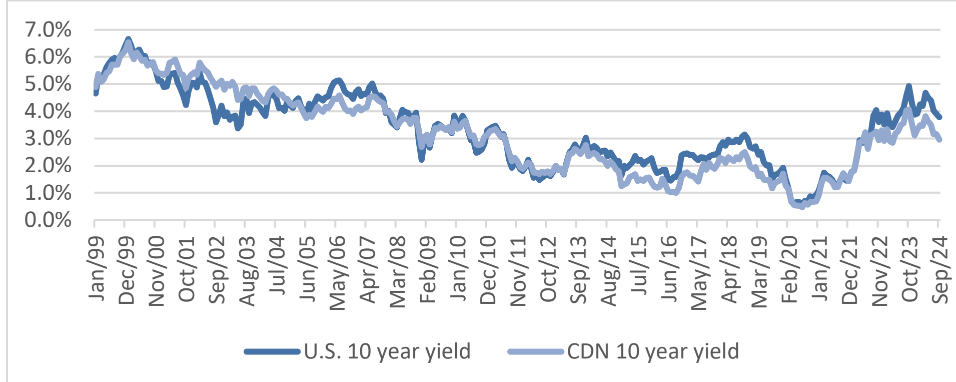
Looking across the globe, the valuation situation is more nuanced. Global equity valuations, based on a simple forward price to earnings, are largely in line with the 25-year averages.

	Current Forward P/E	25 Year Average Forward P/E	10-year return*
U.S.	21.5x	16.7x	13.4%
Japan	14.7x	17.8x	8.0%
Europe ex-UK	14.5x	14.4x	8.9%
Emerging Markets	12.7x	11.2x	3.5%
China	10.5x	11.0x	2.1%
Canada	13.8x	14.2x	8.6%
All World - ex-U.S.	13.8x	13.1x**	5.0%

Source: JPM Morgan Guide to Markets, RBC, iShares, *US$ returns except for Canada **20-year average

Forward price-to-earnings multiples are a simple metric, and we could certainly add more nuance to the analysis, but from a high level, given that valuations for much of the global market have not changed much over the last quarter century, it is reasonable to expect that long-term returns going forward will look similar to the past. This assumes earnings growth going forward is similar to past, which may not be the case, but we have not seen a compelling argument that future growth should be materially different than the past. The obvious outlier is the U.S., where return expectations relative to recent history should be scaled back to reflect higher valuation. By how much is a source of much debate across the investment industry.

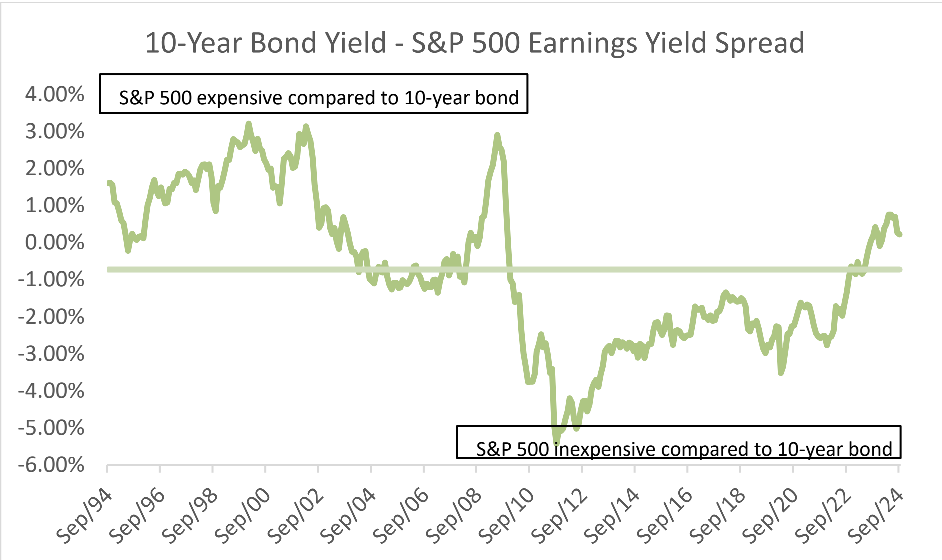
Shifting our focus to fixed income, below is a chart of the10-year yield for both Canadian and U.S. government 10-year bonds. While rates have come up significantly in the last 4 years, current rates are not an outlier when compared to longer periods, in fact, rates in Canada remain low compared to history. When looking at return expectations for fixed income, the current 10-year rates are a reasonable return expectation for long-term bonds. Investment grade corporate bonds will yield somewhat more than government bonds, for example, a 10-year Hydro One bond has a yield of 4.2% So, in our view, a reasonable expected return on broad long-term fixed income holdings is in the range of 4%.



	Current Yield	25-year average	10-year return
10-year CDN Govt	2.96%	3.19%	1.7%
10-year U.S. Govt	3.79%	3.31%	1.2%

Source: Bloomberg, RBC

Finally, we compare historical valuations between fixed income and equities. This is a more nuanced analysis than simple price to earnings and compares the relative value of bonds to equities over time. Below is a graph that plots the spread between earnings yield on the S&P 500 and the U.S. government10-year bond yield. The earnings yield is simply the inverse of the price to earnings multiple and allows for more ‘like-for-like’ comparison to bond yields. Over the past 30 years there have been periods of large spreads during the 2000 Dot-Com Bubble and the 2008 Financial Crisis. However, the current spreads are unremarkable compared to history. There is an argument that the S&P 500 is expensive compared to the 10-year bond yield, but given the strong run in U.S. equity prices, and the move up in bond yields over the last few years, this is not surprising. Our takeaway from this analysis is that it is wise to temper expectations for U.S. equity returns compared to the last decade.



Source: www.econ.yale.edu/~shiller/data.htm, Bloomberg

There is a great deal of debate and discussion in the investment industry about what are the most predictive and relevant valuation measures. Over the short-term, valuation measures like price to earnings or yield spreads have shown to have no predictive power. Market movements are essentially random in the short term. Over the longer term, valuation does have some predictive power and allows us to develop some reasonable expectations about return potential.

Pulling it all together

While there are more charts and tables in this letter than is typical, there are a few key takeaways:

- Value is a function of circumstances.
- Individual investors should be primarily concerned with the expected return over the investor's contemplated holding period.
- *Best Long Term-Value = Highest Long-Term Expected Return*
- Higher than average U.S. equity market valuations mean future returns in the U.S. market will likely be lower than what has been seen over the past decade, by how much, is a source of great debate.
- Global equity markets outside the U.S. have not seen the valuation expansion of the U.S., so it is reasonable to expect long-term returns to look similar to the past, assuming no material change in the earnings growth rate.
- Despite the rise in bond yields over the 4 years, long-term expected returns for equities continue to be much higher than bonds.

The conclusion is that equities, even U.S. equities, continue to offer good 'value' to the individual investor over the long-term since equities offer the highest expected return. Return expectations should be recalibrated to reflect the realities of valuation, so the returns expected for the U.S. market over the next decade must be lower than what has been earned over the last decade.

Outlook and Strategy

The key points laid out above essentially outline our strategy. Where appropriate, we will continue to shift the geographical allocation of portfolios to reflect the return expectations of the various markets. As always, it is important that short-term liquidity needs be set aside and that clients keep us posted on any changes to their individual circumstances.

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