MacNicol & Associates Asset Management Inc.

October 2023

The Quarterly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snapshots of metrics, a section on behavioral investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the marketplace.

"My powers are ordinary…only my application brings me success."

- Isaac Newton

The Numbers:

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Index:		**2023 YTD:**
S&P/TSX:		0.81%
NASDAQ:		26.3%
Dow Jones:		1.09%
S&P500:		11.7%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	5.16%	5.53%
5-Year Bond:	4.31%	4.86%
10-Year Bond:	4.07%	4.84%
30-Year Bond:	3.75%	4.93%

Economic Data:

- Equities broadly lower in September
- Oil and Gas higher during the month, basic and precious materials lower
- BITCOIN lower during September but sharply higher overall in 2023 thus far
- US 30-year mortgage now well over 7%
- CAD/USD higher by 60 basis points in September
- Protracted property crisis adds to Asia's economic woes

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	22	21
P/B: Price-to-Book	4.1	4.5
P/S: Price-to-Sales	2.4	2.8
Yield: Dividend Yield	1.7%	1.4%

2023 Year to Date Performance, by Sector: Sept 30th, 2023

S&P/TSX Composite	0.81%
NASDAQ	26.3%
Dow Jones Industrials	1.09%
S&P 500	11.7%
Russel 2000 (Small Caps)	0.4%
MSCI ACWI ex USA	5.02%
Crude Oil Spot (WTI)	13.29%
Gold Bullion ($US/Troy Ounce)	-2.51%
SOX Semiconductor Index	42.8%
VIX Volatility Index	-63.2%

Source: Canaccord Genuity Capital Markets & Thomson Reuters

Foreign Exchange - FX

As of October 19, 2023 10:00 AM EST	$5,000	Cdn		
Banks	**Rate**	**Buy USD**	**Cost**	**% Difference from Spot Rate**
CIBC	No Public Rate Posted Online			
Interactive Brokers	1.371	$3,647	$0	0.0%
Laurentian Bank	No Public Rate Posted Online			
National Bank	1.4080	$3,551	$(96)	-2.7%
Raymond James	1.3714	$3,646	$(1)	0.0%
Royal Bank	1.4002	$3,571	$(76)	-2.1%
Scotia	1.4008	$3,569	$(77)	-2.2%
TD	1.4075	$3,552	$(94)	-2.7%
Canadian Snowbird	1.3800	$3,623	$(24)	-0.6%
Spot Rate	1.3711	$3,647	$-	0.0%

Lead times, lag times, good times, bad times…

In *Comparison of Experienced and Novice Drivers' Visual and Driving Behaviors during Warned or Unwarned Near–Forward Collisions,* researchers: Jordan Navarro, Emmanuelle Raynaud Marie, Claude-Ouimet and Damien Schnebelen used forward collision warning system (FCWS) data to elucidate the difference between braking reaction times in experienced drivers and inexperienced drivers. In this classic example of what artificial intelligence and real intelligence can do when androids and humans join forces, the researchers provided an analogue to show inexperienced drivers **substantially** lag their seasoned counterparts when it came to stopping a car safely. Specifically, inexperienced drivers had more cases in which the vehicle's own FCWS became activated, and a much higher percentage of "value added braking events" (i.e., situations where the FCWS had to kick in to actually stop the car rather than just tweak breaking amplitude. Indeed, even in situations where FCWS activation was triggered, experienced drivers were already applying force to the brake pedal and adapting to their environment whereas inexperienced drivers had not even transitioned their feet from the accelerator pedal to the brake pedal, which indicated they were not even aware of the need to hit the brakes. This is all very important, and if you are wondering what the tie in to investing is, you won't have to wonder much longer.

The velocities below represent the distance a car travels at various speeds. For example, at 50 km/h, a car travelling eastbound on Bloor Street West would traverse 14 meters or just over 45 feet in a single second. The researchers found that inexperienced drivers took 3 seconds longer to: a) determine that braking was needed and b) successfully transition their feet from the gas pedal to the brake pedal with c) sufficient amplitude to trigger enough deceleration to cancel the activation of the FCWS. Thus, even with a lead of over 100 feet, you may not have enough time to cross Bloor Street if approached by an inexperienced driver doing 50 km/h.

10 km/h ≈ 3 m/s	**60 km/h** ≈ 17 m/s
20 km/h ≈ 6 m/s	**70 km/h** ≈ 19 m/s
30 km/h ≈ 8 m/s	**80 km/h** ≈ 22 m/s
40 km/h ≈ 11 m/s	**90 km/h** ≈ 25 m/s
50 km/h ≈ 14 m/s	**100 km/h** ≈ 28 m/s

Suffice it to say, pedestrians and other drivers alike are much safer when in the presence of experienced drivers than inexperienced drivers.

Investors are much safer in the hands of experienced managers and though this should be common sense let us take a moment to explain what we mean by that. Back in 2022, when the yield curve first inverted, the media seemed to suggest that impending doom was just around the corner. The coverage was exciting, but shallow and simplistic. The basic premise reporters used was that whatever the status of the economy was yield curve inversion immediately equaled a recession. Perhaps it is for that reason that not long after the media found something else to talk about investors began to become skeptical about a recession happening.

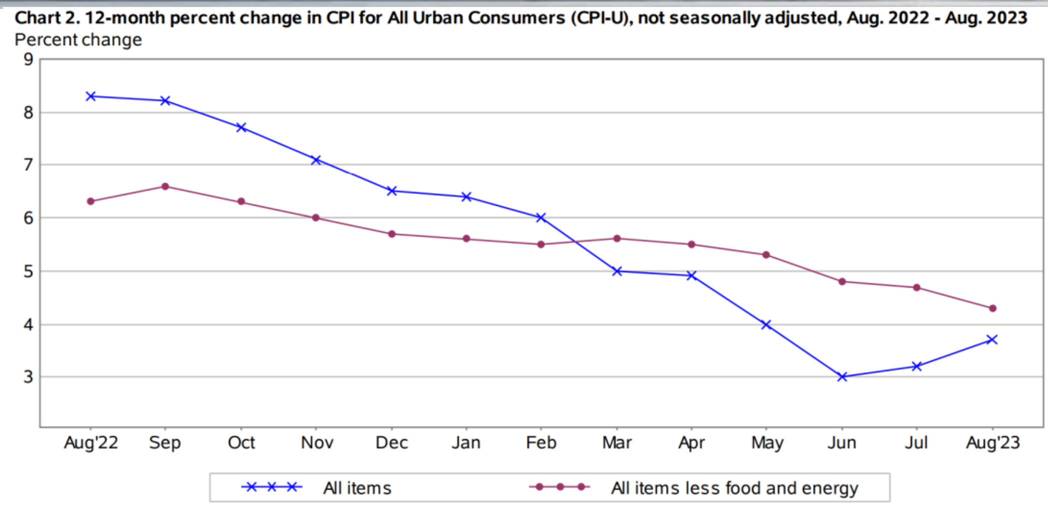
Those that had recession on the table had a soft landing as their base case and I will admit that after a while I too began to accept that view. I also noticed that investors were selling off longer-dated government bonds as skepticism about a coming recession grew. The yield curve inverted in April of 2022 or bit later depending on your preferred term structure[1]. But in any case, the current ~ 16-month lag is longer than the average lead time between inversion and recession though not quite the longest lead time ever. So why is that? Well one factor we believe is adding to the delayed arrival of a not-so-soft recession is fiscal spending. Governments are running large deficits as they spend more than they take in. Emergency fiscal measures during COVID quickly became fiscal profligacy that distorted the impact that the consumer has had on the economy (Central Bankers *can* take the punch bowl away, Politicians have a much harder time doing so). Last year was the first full year after the pandemic and consumer spending was high. Latent consumer demand in 2021 resulted in accelerated spending in 2022 because people were prevented from spending and mostly locked up at home with various government handouts that they could not use. 2022 then was effectively a blowing off steam that gave the economy liquidity and made it appear livelier than perhaps it ought to have been. Consumer spending is forecast to decline heading into 2024 because all the COVID loans have run out and people are yet again maxed out or feeling the pinch of higher rates and higher prices. And although consumer spending is a most important econometric variable that goes hand in hand with inventory levels and manufacturing activity it is (at best) a coincident economic indicator. When sales improve, companies can hire more employees to sell and manufacture more products, which in turn puts more money back in the pockets of consumers but it doesn't account for how people pay for their purchases. Racking up debt to acquire things results in strong consumer data but becoming over levered in a rising rate environment is bad, not good, and could signal a recession more strongly than it signals prosperity.

1 The term structure of interest rates refers to the market interest rates (spot rates) on bonds with different lengths of time to maturity but with the same credit rating. It measures the relationship among yields on bonds that differ only in their term to maturity. In a healthy economy, long-term interest rates are higher than short-term rates, which I suspect many of you know. But what isn't as well known in the investing community is that inflation *also* has a term structure. If inflation is running at 3% annualized, then the 90-day rate of inflation is only 75 basis points (0.75%), and this means your money will only be worth 99.25% of its current value. However, over a decade, assuming the same 3% rate of annualized inflation means your money will be worth 61.3% of its current value, a dramatic decline if there ever was one.

A much less subjective leading economic indicator is Duke University's CFO survey, which was released on September 23rd, 2023. For the past several quarters, CFOs ranked difficulty in hiring and retaining workers as their top business concern. This quarter, concerns about monetary policy jumped to the top, and this is the first time in at least a decade of this survey that monetary policy concerns ranked so highly to CFOs. To expand on the significance of this survey, assume you are the CFO of a major corporation. As CFO your job is to allocate millions or even billions of dollars to capital projects. If you must finance one of those projects with debt, say an advanced facility that manufactures cooling equipment for computer chips, and you get that decision wrong because demand for chips tappers off due to a recession at the same time as your debt load has ballooned, your company could be forced to let go of hundreds of workers or worse go bankrupt. Maybe that is why 40% of CFOs in the survey say that the current level of interest rates (September 2023) has caused their companies to pull back on capital spending and non-capital spending alike. The share of firms curtailing spending would grow closer to half if rates were to remain at their current level for another year. If rates were to increase another percentage point, half of the companies would dampen spending.

Purely domestic factors are not solely to blame for US treasury yields. China has experienced slower growth for cyclical (real estate bubble) and structural (peak population in the rearview mirror) reasons, and Chinese exports to the U.S. are lower. As a result, China does not need as many US treasuries as it once did. Politically, the United States and China seem as far apart as they have in years and so a reduction in Chinese appetite for US treasuries is a no brainer.

If long-term US treasuries are not attractive to investors irrespective of geography, then perhaps the US Federal Reserve and other central banks should soldier forward with their existing course of monetary action and not take into consideration the dangers of a policy error. Jerome Powell opened the door to a further rate hike at some point later this year in his most recent post FOMC meeting scrum with the media. Fellow hawk Loretta Mester who presides over the central bank of Cleveland (who does not vote) conducted interviews supporting Powell's comments. Powell and Mester both tabled, as an aggravating inflationary factor, the August CPI print. That report is very easily accessed through The Bureau of Labor Statistics (BLS) website or by e-mailing PressOffice@bls.gov and asking the Bureau to simply e-mail you the 38-page PDF report. August CPI rose by 0.6% percent on a seasonally adjusted basis, after increasing 0.2 percent in July, and this took the 12-month rolling CPI window of CPI to 3.7% which is above the Fed's target rate. But overall inflation has been in decline as demonstrated in Chart 2 below, which is taken from the BLS report.



Until 1983, the CPI measure of homeowner cost was based largely on housing prices. The long recognized flaw of that approach was that owner-occupied housing combines both consumption and investment elements, and the CPI is designed to exclude investment items. The approach now used in the CPI, called rental equivalence, measures the value of shelter to owner-occupants as the amount they forgo by not renting out their homes. The rental equivalence approach is grounded in economic theory, receives broad support from academic economists and each of the prominent panels, and agencies that have reviewed the CPI, and is the most used method by countries in the Organization for Economic Cooperation and Development (OECD). Critics often assume that the BLS adopted rental equivalence to lower the measured rate of inflation. It is certainly true that an index based on home prices would be more volatile and might move differently from other CPI indexes over any given period. However, when it was first introduced, rental equivalence increased the rate of change of the CPI shelter index, and in the long run there is no evidence that the CPI method yields lower inflation rates than some other alternatives. For example, according to the National Association of Realtors, between 1983 and 2007 the monthly principal and interest payment required to purchase a median-priced existing home in the United States rose by 79 percent, much less than the rental equivalence increase of 140 percent over that same period. It is as though policy makers have opted for figures, they know will support their sluggish, inflation combating campaigns.

Business Cycle			***5-Year Yield Spread***				
NBER Peak	**NBER Trough**	**Length of Cycle**	**Inversion**	**Lead**	**Normal**	**Lead**	**Length of Inversion**
Dec-69	Nov-70	12	Oct-68	15	Feb-70	10	17
Nov-73	Mar-75	17	Jun-73	6	Jan-75	3	20
Jan-80	Jul-80	7	Nov-78	15	May-80	3	19
Jul-81	Nov-82	17	Oct-80	10	Oct-81	14	13
Jul-90	Mar-91	9	May-89	15	Feb-90	14	10
Mar-01	Nov-01	9	Jul-00	9	Mar-01	9	9
Average last six		12		12		9	15

[If you are going to follow just one economic indicator, make it the yield curve. And, if you are going to follow just one person's interpretation of the yield curve, make it Duke University Business School Professor Campbell Harvey.]

Duke University Business School Professor Campbell Harvey pioneered a recession prediction model linked to the term structure of interest rates. Harvey notes that a substantial lag between the time a yield curve first inverts (March 2022 in this most recent cycle) and the onset of an economic recession. The table above is from Harvey's *Yield Curve Inversions and Future Economic Growth*. Harvey also notes that there is informational alpha in the *extent* to which a yield curve inverts. The current lag is entirely consistent with Harvey's work generally and (well) within the 15-month average if the post pandemic consumer is factored into the equation.

Since July, the degree of inversion has lessened, but there is still concern of a slowdown and we fear it may be driven by unintended consequences of tight monetary policy that was in place for too long. As the economic window rolls forward, the white-hot inflation prints from the summer of 2022 roll off the 12-month annualized inflation tracker.

CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS (CPI-U)
(not seasonally adjusted)

ALL ITEMS (1982-84=100)	U.S. City Average											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Consumer Price Index												
2013	230.280	232.166	232.773	232.531	232.945	233.504	233.596	233.877	234.149	233.546	233.069	233.049
2014	233.916	234.781	236.293	237.072	237.900	238.343	238.250	237.852	238.031	237.433	236.151	234.812
2015	233.707	234.722	236.119	236.599	237.805	238.638	238.654	238.316	237.945	237.838	237.336	236.525
2016	236.916	237.111	238.132	239.261	240.229	241.018	240.628	240.849	241.428	241.729	241.353	241.432
2017	242.839	243.603	243.801	244.524	244.733	244.955	244.786	245.519	246.819	246.663	246.669	246.524
2018	247.867	248.991	249.554	250.546	251.588	251.989	252.006	252.146	252.439	252.885	252.038	251.233
2019	251.712	252.776	254.202	255.548	256.092	256.143	256.571	256.558	256.759	257.346	257.208	256.974
2020	257.971	258.678	258.115	256.389	256.394	257.797	259.101	259.918	260.280	260.388	260.229	260.474
2021	261.582	263.014	264.877	267.054	269.195	271.696	273.003	273.567	274.310	276.589	277.948	278.802
2022	281.148	283.716	287.504	289.109	292.296	296.311	296.276	296.171	296.808	298.012	297.711	296.797
2023	299.170	300.840	301.836	303.363	304.127	305.109	305.691	307.026	307.789			

[US CPI Data from the Bureau of Labor Statistics.]

Let's look at the current CPI (consumer price index) numbers. In September 2022, the index was 296.808. In August 2022, the index was 296.171, and in September of 2021, the index was 274.310. The annual inflation rate calculation is the value of today's index (307.789) less last September's index value (296.808) divided by last year's index value of (274.310). The result is 4.003% which is starting to look a lot more normal than the rate of 7, 8 and 9 percent seen last June, July and August. Why is that? Well, it is a mathematical fact that rolling forward the 12-month inflation window results in blistering hot readings from last summer to "drop off" the calculation. Therefore, annual inflation readings can "spike" up quickly but take time to come back down because of the lag in calculating inflation. Without question this is our main fear: that Central Banks are still in full blown attack mode when it comes to inflation when they should instead be in full blown hold mode and not even hinting or suggesting that further rate hikes are a possibility. In fact, we believe that developed world Central Banks should *immediately* leap into action and give interviews with the media stating that they are not just on hold but on hold and in preparations to begin cutting rates sooner rather than later.

Unfortunately, there are no FCWS when it comes to investing, there are only experienced managers and inexperienced managers. If you are thinking about crossing Bloor Street be sure to look both ways, leave ample distance and make your final portfolio destination our offices at 130. We will be sure to tell you what we think of today's current investment environment without any delays!

Das-a-problem…

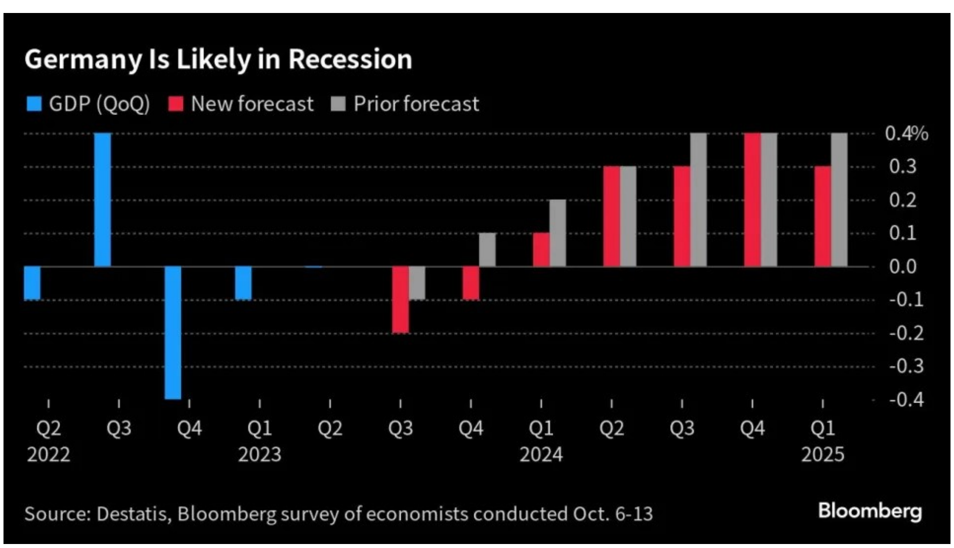
In pretty much every automotive circle, the mere suggestion of an invasion of the German auto market by the Chinese or a guy named Elon would be towed away with non-stop laughter. So deep and so strong are Germany's ties to the auto world that in just about any automotive magazine "*the Germans*" is synonymous with the five brands pictured above. Audi, BMW, Mercedes-Benz, Porsche, and Volkswagen are not just car companies, they are automotive legends. Even people who don't know anything about cars know what a Porsche is, think car first and insect second when you say Beetle and may even know that *Mercedes*-Benz was a little girl whose father named his car company after her. For decades, German cars were quite simply regarded as the best and drivers from around the world and Deutschland itself paid handsomely for the privilege of parking one of these magnificent machines on their property in LA, or confidently soaring down the Autobahn outside of Munich or sitting motionless in Toronto's soul crushing traffic.

So, what's the problem?

The crown jewel of the German auto industry has always been amazing engines. Whether powered by gasoline or diesel, German engines were powerful and efficient but electrically unadulterated. All German automakers now have electric or hybrid divisions, Volkswagen's being the biggest, but they are scrambling to deal with a major problem from China at the same time as Elon Musk is stealing away market share up top. Tesla is the superior product in many ways, but speed and handling prowess have little to do with it. These days car buyers are as plugged in as most EVs (Electric Vehicles) themselves. Their connected lives mean that to be successful today's cars must frequently do battle through apps on the metaverse rather than drag strips on the ground. Horsepower and torque are not meaningful to modern car buyers because they care more about hooking up their vehicles to the latest gen smart phones. As with other industries, the product itself is not the main selling feature, it's how seamlessly the product can park itself into the myriad of other interconnected products and services the consumer already uses. In this respect, the Germans are very definitely playing catch up. For the Germans to regain the lead, they'll have to look to their storied past.

[Though Mercedes (Jellinek) Benz and Elon Musk will never pass each other on the Autobahn, their enigmas and vehicles are today parked closer together than either unintended automotive icon would have ever thought.]

Right now, only the priciest of Audi and Porsche's electric models are more electrifying than the best Elon Musk can offer. Perhaps more importantly is that Chinese offerings in the lower cost EV segment are literally being dumped not just in Germany's traditional markets but Germany's own backyard. This is creating a huge problem, in a huge industry, for a huge economy. Auswirkungen auf investitionen? Well Germany's stock market is not exclusively comprised of car companies, but it is very definitely auto heavy. BMW, Mercedes-Benz, Porsche, and Volkswagen all rank among Germany's largest companies by market cap. Other benchmarks such as the various MSCI EAFE or ACWI indices we feature in various publications make it harder to notice the heft of Germany's auto industry. But that doesn't mean some weren't paying attention. Years ago, Germany's Chancellor expressed his angst about exporting German car-building know how to China and the attendant domestic economic challenges that doing so might create. Either for reasons of confidence, arrogance, or sheer stupidity the German auto industry believed that only dabbling in EVs was good enough. German carmakers invested in Chinese joint ventures and continued to expect that their stranglehold of their stalwart markets would continue but it didn't. Chinese drivers certainly paid big bucks for German brands during periods of strong growth in China's enormous economy, but it backfired badly over the last five years. Every business owner knows that if you aren't innovating you aren't doing anything. Germany still makes excellent vehicles; they just don't make the sort of vehicles people want.



As shown in the Bloomberg chart on page 8, Germany's economy is in trouble. Large scale layoffs in any industry would be a problem and large-scale layoff in Germany's auto sector would be a gargantuan problem. Germany's government announced just after the 3rd quarter that it expects the country's economy to shrink by 0.4% this year, joining a string of other forecasters in revising sharply downward its outlook for Europe's biggest economy.

This article is more than **5 years old**

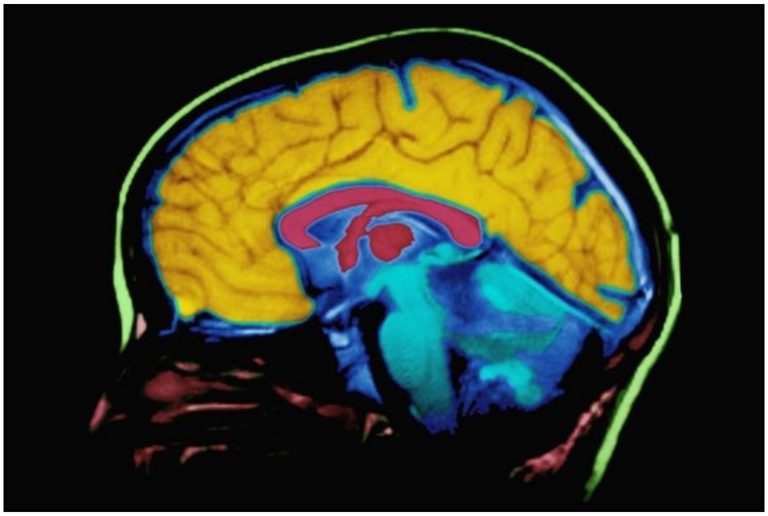
Tesla halts Model 3 production as firm scrambles to improve automation

Firm struggles to hit targets for mass-market electric car after reeling from excessive automation and mounting pressure

CEO Elon Musk said Tesla was making 2,000 Model 3s a week, but failed to assuage doubts about the company reaching its 5,000-a-week target in three months time. Photograph: Bloomberg/Bloomberg via Getty Images

Five years ago, Elon Musk was struggling to produce Tesla's, period. You do not hear that much these days. Five years ago, the Chinese were net *buyers* of German vehicles, you don't hear that much these days. And five years ago, we might have contemplated an investment in the German stock market, but you won't hear that much today. Cars are cool, fun looking and for a lot of people necessary, but they are a horrible investment. We fear that it is precisely a lack of investment on the part of the German auto sector that has compounded the problems of an economy already in peril. Inflation and higher interests remain challenges, but they are broad based. A client of ours recently informed us that the Porsche 911 has computers today that are more advanced than many of the world's super computers from just 20 years ago and we completely believe him. Yet in the end it isn't computers or the electrification of everything that has led Germany's once storied auto sector down the dead-end street it now finds itself. In our opinion, it is something much more basic: Germany's once brilliant track record of innovation slid off the track and into a ditch as the Chinese and Elon Musk moved into the passing lane.

Behavioral investing: cognitive dissonance



Cognitive dissonance is that weird feeling we get when we try to maintain two or more inconsistent beliefs at the same time or when you believe one thing but act in a contradictory way. For example, let’s say you decide to quite smoking but sneak in a few puffs each day along the side of your house. The incongruity can be unnerving, and that’s why we will often try to eliminate the dissonance by changing our interpretation of the situation. For example, to feel better about sneaking in the odd cigarette here and there, we may tell ourselves that a particular smoking tryst did not count because of some other variable [the stock market being down, a tough day at work, an argument with one’s spouse or one’s generally lazy and underachieving pet being disobedient to an extent bordering on outright defiant] beyond one’s control. The inability to control or manage cognitive dissonance can result in irrational decision-making as a person contradicts their own self in their beliefs or actions. However, conflicting beliefs can be held at the same time, often without a person realizing it.

An example of cognitive dissonance is when an investor purchase shares in a company believing the shares will return 12% per year. However, if during a five-year period this does not happen, and instead shares in other companies do provide the 12% per year return the investor may face mental discomfort. On the one hand, the investor may “believe” in the shares they initially purchased even though they may want to liquidate and buy shares in the other company to achieve their immediate investment goals. Investors often go to great lengths to convince themselves that their initial decision was right. They do so because they are predisposed to maintaining their old beliefs. Generally, the cognitive dissonance becomes difficult to manage resulting in rash decisions. These decisions may not be rational and taken only to achieve cognitive stability.

At MacNicol & Associates Asset Management our independence and objectivity allows us to approach your investing goals in complete comfort and control. We will work to understand your goals and objectives and then implement a suitable asset mix that requires no convincing. Then, we will meet with you periodically to ensure your portfolio stays right for you, eliminating any weird or contradictory feelings.

The MacNicol Investment Team

Firm Wide News

Ken Reid, our research associate passed his CSC this quarter, and is working towards his CIM at the moment. Ken also visited Nashville this month, taking in the sights and live music, including at a University of Vanderbilt football game when they played the number one team in the country, the University of Georgia.