SV Wealth - Newsletter

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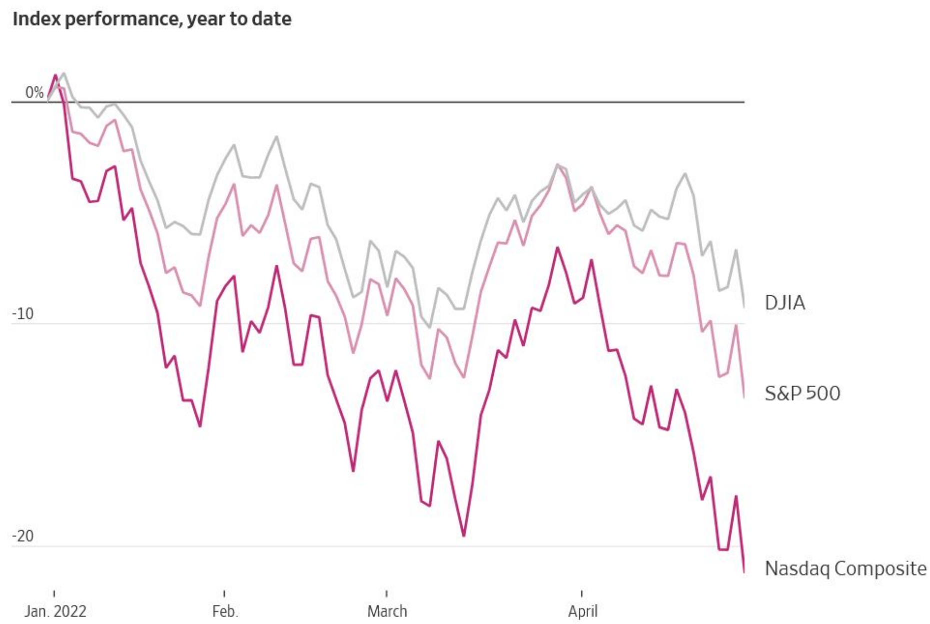
April Showers... May Flowers?

With spring finally underway, we are reminded of the old adage "April showers bring May flowers." For the markets, it was a very rainy April filled with thunderstorms and turbulence, exacerbating an already weak start to the year.

April emerged as the worst month for stocks since March 2020, when the coronavirus pandemic spurred widespread lockdowns. The pain was pretty widespread for the month, with the Canadian TSX index losing 5.4% for April while the broader S&P 500 lost 8.8%. The technology-heavy Nasdaq index had its worst month since October 2008, dropping more than 13% for April and having its worst ever start to a year, down 21%.



Source: Wall Street Journal, FactSet

Why so Stormy?

Among the themes driving the volatility was a central bank increasingly concerned about rampant inflation, the war in Ukraine entering its third month and aggravating inflationary pressures in food and energy, and fresh lockdowns in China that are snarling supply chains that haven't yet recovered from the pandemic.

American inflation, up 8.7% year-over-year in March, is at levels not seen since the early 1980s. In Canada, which pumped out less Coronavirus stimulus than our southern neighbors, inflation hit 6% in March, the highest level since the early 1990s.

When inflation gets higher than the central bank's desired 2-3% target range, they will raise interest rates to slow down the economy. As inflation is currently far outside of the banks' acceptable range, the market expects the central bank to raise rates at every quarterly meeting this year and most of next.

Shades of Tech Stocks

Conventional wisdom say that rising interest rates are bad for technology stocks, the idea being that technology stocks are often more focused on growth than profitability, and usually require cheap financing to expand their business. If interest rates increase, it makes growing the business a slower process since costs are higher.

However, technology has been around for a long and has matured into a central part of our daily lives. As a result, there are now many different types of technology stocks. The two clearest distinctions to make are between large cap tech versus speculative tech.

Case Study: Microsoft vs Netflix

To illustrate the distinction, consider two tech companies: Microsoft and Netflix. Both companies are large but Microsoft is a "large cap" in the sense that its market capitalization is over $2 trillion whereas Netflix is only about $90 billion.

Microsoft may be famous for its Windows operating systems but it is involved in many other businesses. This diversification within the company helps it weather turbulence in any one sector (among Microsoft's many businesses: the Azure cloud service, X-box gaming, Bing search, LinkedIn, etc.).

On the other hand, like many similar speculative tech stocks, Netflix is predominantly focused on one area: internet streaming. This means the company must continue investing money into the business in order to avoid losing market share.

When interest rates begin to rise, technology stocks like Netflix suffer because it's likely they won't be able to grow as fast or as far as they would with lower rates. For a large company like Microsoft (or Apple), rising interest rates will have a smaller impact since the company typically has the option to internally finance its own growth projects from other profitable parts of the business.

Portfolio Positioning

We anticipate an environment of rising interest rates will cause difficulty for speculative tech stocks but believe that large cap technology will continue to perform well on account of how integrated technology has become in our lives. For this reason, we remain invested in mature technology companies that will outperform when the market recovers.

Focus on Dividend Yield

Our portfolios are also increasingly focused on boosting our dividend yield by choosing high-quality dividend paying names. As the risk in the market remains elevated for the near-term, we remain invested but are positioned defensively to capture more income from dividends in lieu of capital growth.