Investing Wisely

A Newsletter from Mike Wise

May 2023

Spring is Sprung! What a joy to be able to go outside in shorts and T-shirt once again!

Our robin has once again built her nest on the light above our patio door, and is sitting patiently, waiting for her eggs to hatch. She keeps an eye on us as we pass by, but doesn't seem disturbed by our presence within arms-reach of her. We wonder if it is always the same bird, and also marvel how a robin can fly thousands of miles each fall and spring, and return to exactly the same nesting place.

Carmen and Mike at Kananaskis Village

Carmen had a relapse in her recovery from her broken femur, and the surgeon decided to remove all the hardware that he had installed last August and start all over again, this time with more robust hardware and bone marrow in the break. This seems to be working, and the latest x-rays show that healing is taking place. She still has to use her walker to get around, but the physiotherapist will be increasing the level of exercise. We continue to hope for a full recovery.

Our summer plans are uncertain. Carmen's mobility issues might slow us down, but won't stop us. We expect to enjoy Stampede, and afterwards relax at Fairmont during our timeshare week. We had planned a trip to Ottawa in August to celebrate my cousin's 85th birthday, but unfortunately she passed away unexpectedly last month. The 3 surviving cousins are still trying to determine when we can reunite to have a celebration of her life.

And finally, Carmen and I will be going on a Grand Tour of BC in September. Portfolio Strategies will be having its annual conference in Kelowna, and I'll be meeting with all my BC clients before and after the conference.

Where We Are

Table 1 shows how stocks, bonds and commodities are performing so far this year.

It is a good year for both stocks and bonds. As shown in Table 1, the Government of Canada 10-year bond has declined by almost ½% in the first 4 months of the year (from 3.316% to 2.858%), causing the DEX Universe Bond Index to rise by 3.9%. (Bond prices move inversely to bond yields). At the same time, the Bank of Canada is still raising short term interest rates, such that the interest paid on bank deposits and GICs is rising. Scotiabank is offering a special rate of 4.25% on their High Interest Savings Accounts; these are available only through participating financial advisors (of which I am one).

The Canadian Prime Rate is now 6.70%. The Prime Rate serves as the benchmark for GICs and other insured savings instruments. On the other side, it also serves as the base rate for variable rate mortgages and consumer loans. My friendly Big Bank

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Table 1
2023 Returns - Year to 30 April

	31 December Price	30 April Price	YTD Change
Equities			
TSX (CAD)	19384.92	20636.54	6.5%
S&P500 (USD)	3839.50	4169.48	8.6%
NASDAQ 100 (USD)	10466.48	12226.58	16.8%
Commodities			
Oil (WTI; USD)	$80.51	$76.63	-4.8%
Gold (Comex; USD)	$1830.10	$1999.20	9.2%
Fixed Income			
DEX Universe Bond Index (CAD) - Total Return	1054.5	1095.6	3.9%
Govt of Canada 10-Yr Bond Interest Rate	3.316%	2.858%	-0.458%
Best 5-yr GIC Rate (rate as of May 8)	4.10%	4.20%	0.10%
High Interest Savings Account (rate as of May 8)		4.25%	
Exchange Rates			
USD/CAD	$0.7378	$0.7372	-$0.0006
EURO/CAD	$0.6894	$0.6701	-$0.0193

is offering me a 5-year non-redeemable GIC at 3.85%, and an unsecured line of credit floating at "only" Prime + 4.1%, or 11.8%! What a deal!

The US Federal Reserve is continuing to raise the Fed Funds Rate this year, albeit by only ¼% increments. The rate is now up to 5.25%. The US Prime Rate tends to be 3% higher than the Fed Funds Rate, so the US Prime is now 8.25%. More on US interest policy in a later section.

Everything is rosy over on the stock side. As you can see on Table 1, the tech-heavy NASDAQ is already up almost 17% so far this year as traders have fallen in love with the growth prospects of Technology once again.

The Canadian TSX Index is considered to be more of a value index due to its heavy weighting in resources and financials. Oil is down on the year, so the TSX is lagging the US indexes but is still up on the year overall. Interestingly, TD Bank has become the most-shorted stock in the world on a dollar basis! This is apparently due to the bank's substantial exposure to the US regional banks.

Most of my clients have a balanced portfolio. My Canadian Neutral Balanced Benchmark is up 5.1% so far in 2023.

Taking Advantage of the "Just Transition"

The federal government has introduced a couple of changes to Canadian tax laws in order to stimulate private sector investment in the Green Economy. You might find these applicable to your own circumstances.

Canadian Renewable and Conservation Expenses ↑

We'll start this discussion by referring to Canadian tax law. It has always been the case that companies can deduct their expenses from income before calculating tax owed. However, many junior companies don't have any revenue against which to deduct their expenses; hence the creation of a provision in Canadian tax law that allows certain companies, traditionally in the resource sector, to "flow through" their Canadian Exploration Expenses (CEE) to their investors, who can deduct those expenses against their other income. This deduction is just like an RRSP contribution, and is nothing extraordinary.

However, recently the federal government expanded the concept of Canadian Exploration Expense (CEE) to include "Canadian Renewable and Conservation Expenses" (CRCE). Companies whose activities would have CRCE can "flow through" their CRCE to their investors, who can deduct those expenses against their other income. Activities eligible for CRCE include:

- co-generation and specified waste-fuelled electrical and heat generation systems;
- wind turbines;
- electrical generating equipment that uses only geothermal energy;

- small hydroelectric facilities;
- stationary fuel cells;
- photovoltaics and "active" solar equipment used to heat a liquid or gas;
- equipment powered by certain waste fuels (e.g. wood waste, municipal waste, biogas from a sewage treatment facility);
- equipment that recovers biogas from a landfill; and
- equipment used to convert biomass into bio-oil.

This is so new that I don't currently have any offerings in this space, but no doubt they are coming soon.

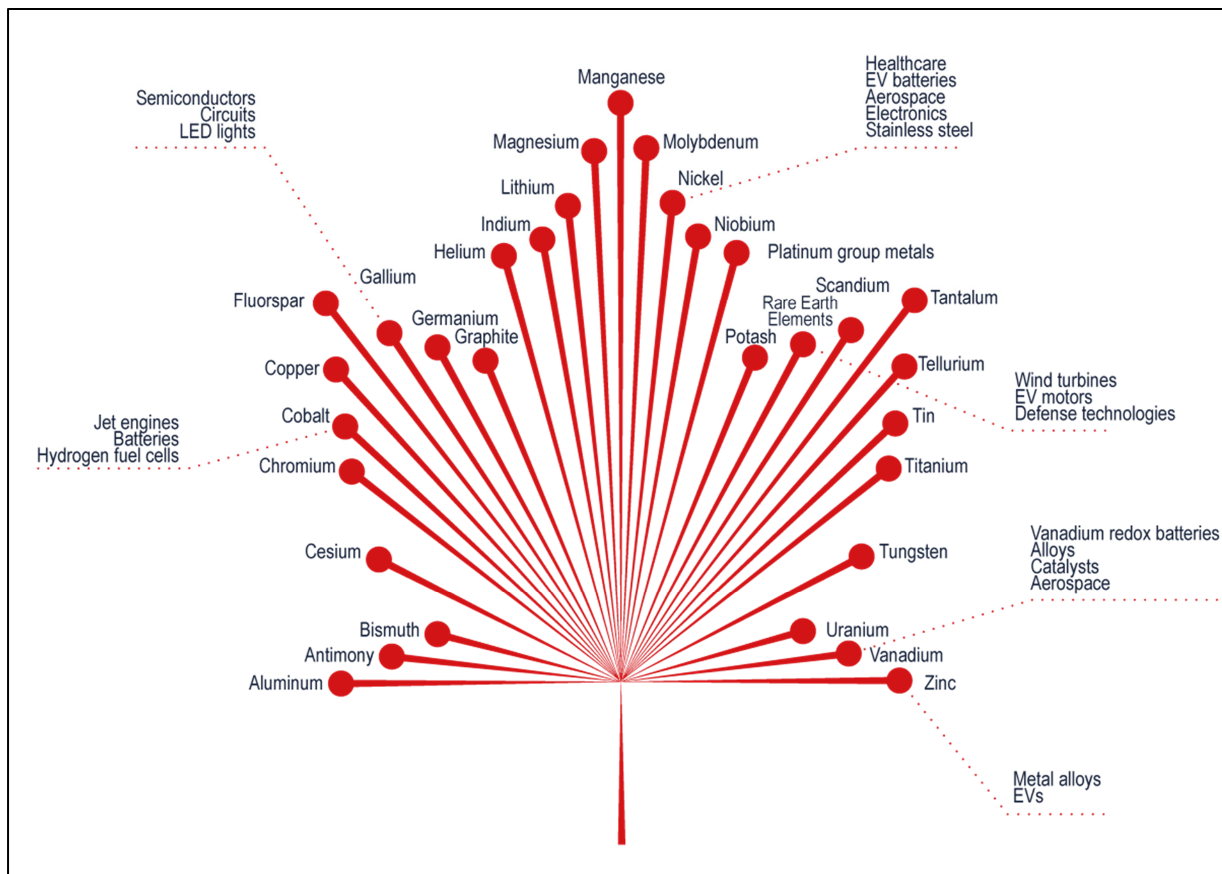
Perhaps you, or someone who you know, has a project idea in this area who could utilize CRCE as part of their project financing.

Critical Minerals Exploration Tax Credit

I've been offering flow-through limited partnerships to my clients for a number of years. The Critical Minerals Exploration Tax Credit provides a significant upgrade to their potential benefits.

What makes flow-throughs interesting are the additional tax credits that the federal government and some provincial governments provide to investors. A tax credit comes directly from your taxes otherwise payable. The federal government offers a 15% Minerals Exploration Tax Credit (METC) for investors in qualified mining exploration projects in Canada. The governments of British Columbia, Saskatchewan, Manitoba and Ontario also offer tax credits for exploration done in their province. Quebec offers a tax deduction as an incentive, rather than a tax credit.

Figure 1
Critical Minerals List



Source: https://www.canada.ca/en/campaign/critical-minerals-in-canada/critical-minerals-an-opportunity-for-canada.html

The biggie, though, is a new Critical Minerals Exploration Tax Credit (CMETC) that the federal government announced in the 2022 budget. This provides a 30% tax credit to flow-through investors who support exploration projects for 31 minerals deemed critical to the new Green Economy (see Figure 1).

Here's a hypothetical example.

The XYZ Critical Minerals Flow-Through Limited Partnership has the following characteristics:

- It has 10% administrative costs, so that 90% of your investment will be eligible for CEE.
- The promoters plan to spend 2/3 of their exploration dollars on critical minerals projects, with the other 1/3 on non-critical minerals (for example gold, silver or iron ore).
- 2/3 of the CEE will be eligible for the CMETC of 30%, and the other third will be eligible for the METC of 15%.
- All junior mining shares purchased by the partnership must be with companies listed on the TSX or TSX Venture exchange, providing liquidity and transparency.
- The promoters plan to dissolve the partnership in 18 months, at which time the partnership units will be automatically rolled over into a mutual fund.
- Partnership units cost $100 each, and the minimum purchase is 100 units.

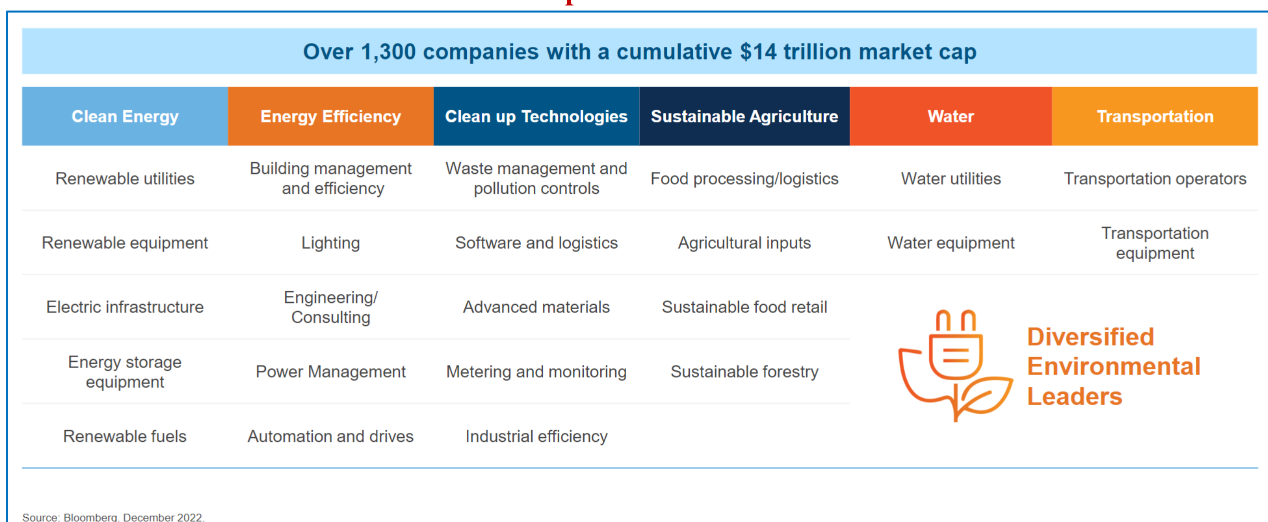
Say you live in Alberta and have taxable income of $150,000. Your combined federal and provincial marginal tax rate is 38%. You place $10,000 into the XYZ Critical Minerals Flow-Through Limited Partnership, so you receive $9,000 of CEE and your taxable income gets reduced to $141,000. This lowers your tax bill $3,420. The 15% METC on 33% of the CEE provides additional tax relief of $446, and the 30% CMETC on 67% of the CEE gives you another $1,809 in tax savings. Your total tax savings will be $5,675 on your investment of $10,000. Your "at-risk" money is only $4,325, yet you also still have $10,000 worth of junior mining shares that have the potential to rise in value.

We might be entering a decade in which "mining" is no longer a dirty word. Give me a call if you are interested in lowering your tax bill through an investment in flow through shares.

Mackenzie Greenchip Global Environmental All-Cap Fund

I've written about this fund in a couple of newsletters already. It remains one of my favourite recommendations. It is a global equity fund, but it is different from all the others. I recently attended a talk by the Greenchip people, and it reinforced my belief that they have a concept whose time is ripe.

Figure 2
Greenchip Investible Universe



Over 1,300 companies with a cumulative $14 trillion market cap

Clean Energy	Energy Efficiency	Clean up Technologies	Sustainable Agriculture	Water	Transportation
Renewable utilities	Building management and efficiency	Waste management and pollution controls	Food processing/logistics	Water utilities	Transportation operators
Renewable equipment	Lighting	Software and logistics	Agricultural inputs	Water equipment	Transportation equipment
Electric infrastructure	Engineering/ Consulting	Advanced materials	Sustainable food retail	Diversified Environmental Leaders	
Energy storage equipment	Power Management	Metering and monitoring	Sustainable forestry		
Renewable fuels	Automation and drives	Industrial efficiency			

Source: Bloomberg. December 2022.

Software vs Hardware

Their basic premise is that if we are going to go through the transition towards a Green Economy, there has to be a massive investment in real things – hardware, not software. Solar cells and windmills are just a small part of the required investment in hardware. Greenchip concentrates on the companies that make and operate real things. (see Figure 2). Their investible universe is 1300 companies, but only about 130 of those have the financial profile and share price that make them interesting as an investment.

The Greenchip fund only has a 17.6% exposure to the US, versus 60.5% US exposure in its benchmark (the MSCI All-Country World Index (MSCI ACWI)). The main sector weightings are Industrials at 26.5% and Utilities at 23.2%. This is also far different from the MSCI ACWI, in which Technology dominates.

Carmen and Mike at the Opera

As far as performance is concerned, the *Mackenzie Greenchip Global Environmental All-cap Fund* ranks as 1st quartile in 3 out of 4 years of its existence, and is up 7.3% to the end of April in 2023. I rate it as an excellent complement to a more mainstream global equity fund, meriting up to 50% of your allocation to Global Equities.

The *Mackenzie Greenchip Global Environmental All-cap Fund* is available to clients who have a Portfolio Strategies nominee account, or who have a Mackenzie client name account. T-SWP class is available for those who need tax-efficient income. Dollar-cost averaging is available for those who prefer to tip-toe into the market.

Flexible Tax-Efficient Income

Many investors are looking for regular income from their non-registered accounts, without having to pay brokerage fees on the sale of securities, capital gains taxes, or complicated income tax filings.

The fund industry has responded with an innovation commonly known as T-SWPs. Essentially, the fund companies return regular income to their investors that is classified as Return of Capital (ROC), rather than dividends, interest income or capital gains. ROC is return of the investor's own invested capital, so is not taxable. If ROC equals the investment gains within the fund, there is no actual decrease in the value of the investment. Call me if you want a more detailed explanation.

Most T-SWPs offer a 5% annual distribution, payable in equal monthly installments. Mackenzie has recently introduced a flexible payments option, in which the investor can select a T-SWP distribution that can range anywhere between 1% and 8%. (Reinvestment of the entire distribution has always been allowed.) Another option would be to select a fixed dollar amount of distribution. Furthermore, Mackenzie allows investors to change the level of distribution as their circumstances change.

Of course, as with regular T-SWPs, if the amount of distribution exceeds the investment gain within the fund, the value of the account will decrease.

Where We're Heading

As usual, I'll be focusing more on the US than on Canada, because as the old saying goes, "whenever the United States sneezes, Canada catches a cold".

United States

Politics is a blood sport in the US. Why else would elections cost in the billions of dollars? There have to be under-the-table favours asked for and granted when such large amounts of money are involved. A politician's first priority is to satisfy his/her donor!

Right now, one of the big controversies is something called the debt ceiling. There is a legislated limit to how much the US government can borrow, and since the US government always runs at a deficit, the debt ceiling has to be periodically raised by amending the legislation. It is all kabuki theatre: everyone knows that there will eventually be agreement, and the ceiling will get raised at the last second. Personally, I'm not following it at all.

Whether the debt ceiling or some other issue, turmoil in Washington is likely to continue. In the real world, life goes on.

Interest Rates

I'd be considered a monetarist in economic terms. I believe that the policies of the US Federal Reserve (the Fed) are extremely important in the economic life of not only the US, but around the world. The US runs on debt. Even mortgage interest is a tax-deductible expense; there is no incentive for ordinary homeowners to pay off their mortgage and live debt-free. Since debt, and living beyond one's means, is an American tradition, it follows that the nation is very sensitive to the Fed's interest rate policy.

The Fed raised its Federal Funds Rate by ¼% at its meeting on May 3, bringing this benchmark rate up to 5.25%. Future rate rises are likely to be in the ¼% range, until the Fed is happy that inflation is down to the 2% level (I think that is wishful thinking!). Markets think that rate hikes might be over because the Fed softened its language about future increases. They might be over-optimistic: the labour market is still tight and inflation, though declining, is still a concern.

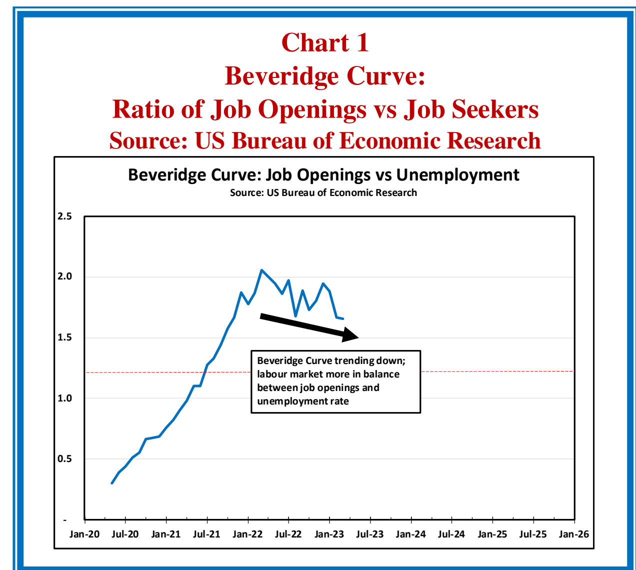


Chart 1
Beveridge Curve:
Ratio of Job Openings vs Job Seekers
Source: US Bureau of Economic Research

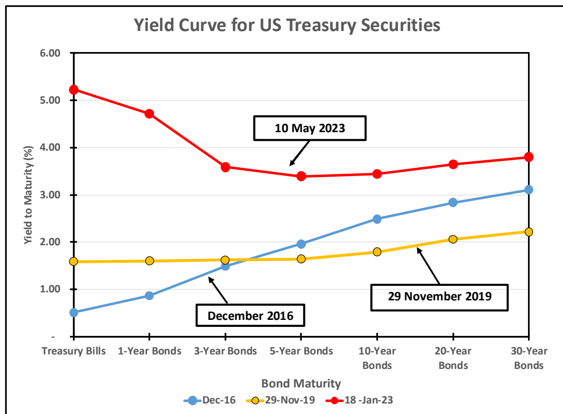
Chart 1 shows something called the Beveridge Curve, which is the ratio between job openings and the unemployment rate. In a "balanced" job market, the Beveridge ratio is in the order of 1.2, meaning there are 1.2 job openings for every person on the unemployment roles. In the US, someone has to be actively seeking employment to be considered as unemployed. Chart 1 shows that the ratio is slowly declining, but with the current Beveridge value standing at 1.7, the labour market is still considered to be tight.

The Consumer Price Index for April was only 4.9%. Things people actually buy, like groceries, were up twice that on an annual basis.

Wages of ordinary Americans are not keeping up with inflation. This is not good news for Democrats. As President Clinton once said, "It's the economy, stupid!"

The interest rate yield curve is the single best predictor of future economic activity and recessions. Recession typically starts 12-18 months after the interest rate charged by 90-day Treasury Bills becomes higher than the rate charged by 10-year US Government Bonds. Banks make their money by playing the spread between lending at long-term rates and paying depositors based upon short-term

Chart 2
US Treasuries Yield Curve as of 18 Jan 2023
Source: Barron's

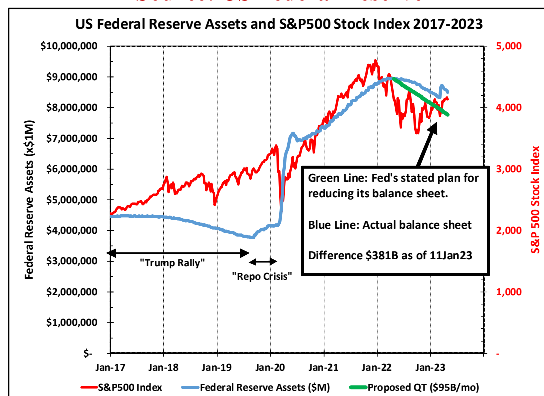


rates. They can't make money when the rates are inverted, so they stop lending. Chart 2 shows 3 curves: a strong positively-sloped yield curve at the end of 2016; the curve just before the outbreak of Covid in November 2019, and the current negative-sloped yield curve for US Treasuries. As of May 10, the 10-year yield is 3.444%, while the 3-month yield is 5.225%.

Problems in the US Banking System

The Fed can control short term interest rates by periodically adjusting the Fed Funds Rate. The other arrow in the Fed's quiver is whether it is a net buyer or seller of government and agency-backed debt. It holds a massive amount of debt (remember, another entity's debt is an asset to a bank, not a liability!) that it purchased during the Pandemic. Its much-repeated intention has been to be a net seller of this debt, thereby pulling excess cash out of the economy. Chart 3 shows its intention (green line), and actual performance (blue line). It has been somewhat slower in action than advertised; it doesn't look like much on Chart 3, but the difference between those 2 lines has now grown to a stunning $727B.

Chart 3
US Federal Reserve Assets
Source: US Federal Reserve



If you look carefully at the blue line in Chart 3, you'll see a big jump in the Fed's assets in March. That was the bailout of the Silicon Valley Bank. The Federal Deposit Insurance Corporation (FDIC) insures bank deposits up to a $250,000 limit, but the government chose to reimburse all depositors for the full amount of their deposits, irrespective of their size. SVB had massive deposits from tech companies that had made public financings and were holding the proceeds at SVB prior to investing the funds in their business. I heard a rumour that Roku had $40M deposited at SVB. It wouldn't have been alone. This was a bailout of Big Tech by Big Government.

The US has a few very large banks (Bank of America; JP Morgan-Chase; Wells Fargo to name a few), and something like 1300 smaller regional banks. Canada is much different; we have 5 Big Banks, and the only significant regional bank that I can think of is ATB Financial.

The regional banks don't amount to much on a country-wide level, but they are big players within the communities in which they operate. According to economists at Goldman Sachs, regional banks with less than $250B in assets account for 80% of commercial real estate lending, 60% of residential real estate mortgages, and 50% of commercial and industrial loans.

The regional banks get their deposits from the people and small businesses in the area that they serve.

SVB's problems started when a large depositor made a withdrawal, and this induced other large depositors to follow suit. There was an old-fashioned run on the bank, much like the scene in *It's a Wondeful Life*, with depositors scrambling to get out their money. The bank literally ran out of money!

It didn't take long before other major depositors at other regional banks looked where they had their deposits, and decided to move their money to a Big Bank for safety's sake. Signature Bank was next to fail, followed by First Republic Bank last week.

So far, 3 of the 4 largest bank failures in the past 50 years have occurred this year. Investors are dreaming if they think that this can happen without any follow-on repercussions.

"3 of the 4 largest bank failures in in the past 50 years have occurred this year. Investors are dreaming if they think that this can happen without any follow-on repercussions."

Other regional banks are fighting their way through deposit flight, but there is an even-larger threat out there, this time on the loans side of the ledger. According to BNN Bloomberg, "Many money managers fear that nearly $1.5T of commercial real estate debt is due to mature by the end of 2025, and refinancing some of it could be difficult".

The winners from all this will be the Big Banks. They are getting unprecedented levels of deposits as transfers from the regional banks, and are scooping up the assets of the failed banks at fire sale prices.

The losers will be the American public. There is a substantial gap between what the Big Bank is paying for a failed bank's assets, and what those assets (the book of loans and mortgages) are worth. The public will make up the difference, and for First Republic that gap is in the tens of billions. Secondly, the FDIC is having to increase the premium that it charges to banks for deposit insurance. A bank, being a sensible business, will recover that money by lowering interest paid on deposits, and/or increasing the interest rate on loans it grants. (Interestingly, Treasury Secretary Yellen has made it clear that not all regional banks will benefit from the now-unlimited deposit insurance, but all will have to pay the additional premium).

US Economy

I can't see that the Fed will stop its program of raising interest rates while the US economy remains strong and inflation remains a problem. Let's look at a few economic indicators to see how the rest of the year might unfold.

Let's start with employment. I've already talked about the Beveridge curve, which measures the ratio between job openings and the unemployment rate. Job openings are drifting downwards, while the unemployment rate, at 3.6%, is steady. According to the Bureau of Labor Statistics, the US economy added 1.1 million jobs so far in 2023, of which 900,000 were in the private sector. The preliminary April numbers were also encouraging.

There doesn't seem to be any looming problem there, at least when looking at the big picture.

Burrowing deeper into the employment data gives the first look at a couple of leading economic indicators that might point towards future trouble.

Manufacturing overtime gives me a glimpse of the demand for blue-collar workers, while employment at temporary agencies does much the same for white-collar workers. In both cases, they act as surge capacity: when times are good employers will ask employees to work overtime (or hire temp workers) rather than hire new employees; in hard times they will reduce or eliminate overtime (or lay off the temp workers) rather than let their core employees go.

Manufacturing overtime is a leading indicator for the health of the manufacturing sector. See Chart 4. Overtime in the manufacturing sector has fallen substantially over the past few months, to a level seen only rarely and in the midst of major downturns.

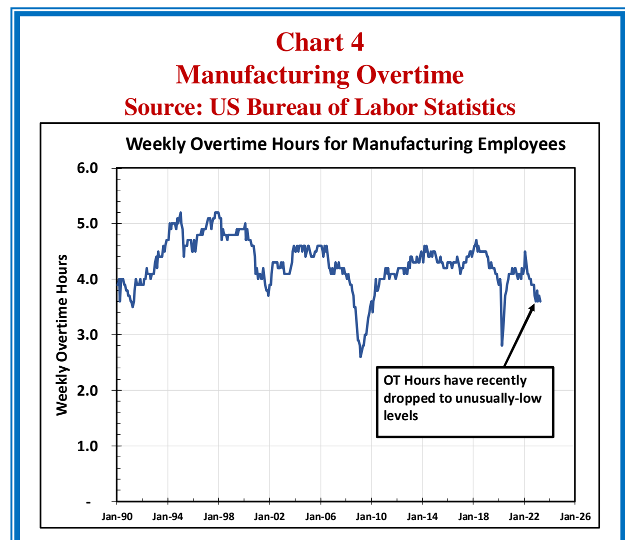
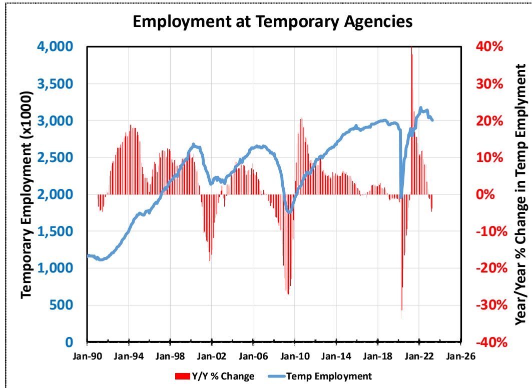


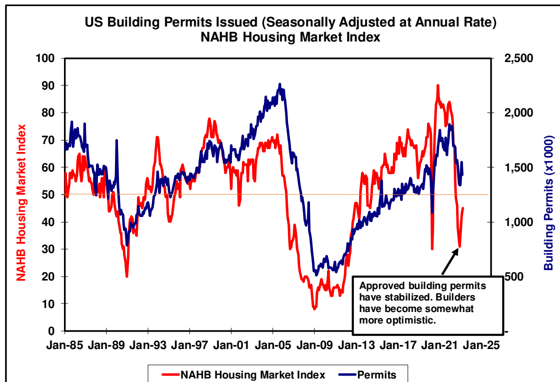
Chart 5
Employment at Temp Agencies
Source: US Bureau of Labor Statistics



Employment through temporary agencies looks at mainly white-collar jobs. See Chart 5. The blue line shows that employment at temp agencies has started to fall recently from a record high in 2022. It is hard to see in Chart 6, but the year-over-year change in temp employment (red bars) is also negative now. That doesn't happen very often, and is often a precursor to much greater job losses in the sector.

Housing is a sector of the economy that is very sensitive to interest rates. Higher mortgage costs and more stringent lending terms can really hamper the sector. New housing construction is an important component of the overall economy. The actual construction is one thing; then there are all the extras that go into a new house, like carpeting and window furnishings, furniture, appliances, and landscaping.

Chart 6
Building Permits & NAHB Confidence Indicator
Source: Nat'l Assoc of Home Builders; US Census Bureau



A couple of leading indicators for the health of the residential construction industry are the builder's confidence survey that is conducted monthly by the National Association of Home Builders (NAHB), and the number of new building permits issued. A builder needs a permit before construction can begin.

See Chart 6. I'm surprised that the number of building permits issued for residential construction has stabilized (blue line), and that builders are becoming more optimistic about the prospects for their industry (red line).

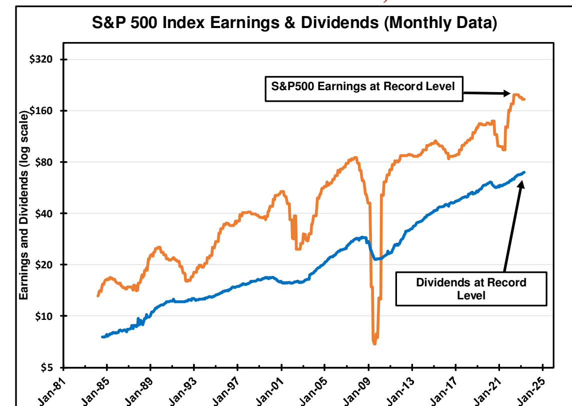
I've already shown that the regional banks are responsible for 80% of commercial real estate lending, and 60% of residential mortgages. It will be interesting to see whether the regional banks will stop issuing new mortgages in light of their difficulties on their deposit base and their existing loan book. That will have quite an impact on the housing sector!

Finally, let's look at corporate earnings and dividends. See Chart 7. These are the things that drive the stock market over the long term. Chart 7 shows that the large corporations that are listed on the S&P500 Index continue to increase their dividends. Their earnings have fallen slightly this year, by roughly 2%, from the record earnings posted last year. It is too early to say if there's a slowdown there!

Summary

In summary, then, we have a mixed bag of signals. Consumer spending is an important part of the US

Chart 7
US Corporate Earnings & Dividends
Source: Standard & Poors; Barrons



economy. Wages have not kept up with inflation. The US Prime Rate is already at 8.25%. How much higher does it have to go before the consumer has to stop spending?

In the meantime, large corporations are doing well, with near-record earnings that are supporting increased dividends from already-record levels. The employment data still looks very good, with a tight labour market and low unemployment.

The Fed seems to think that the economy is doing too good. The tight labour market is causing wages to rise, and that's a bad thing as far as the Fed is concerned.

On the other hand, the yield curve is negative, and the leading indicators of manufacturing overtime and employment at temporary agencies are both troubling. High interest rates have slowed the construction sector. Problems at the regional banks have got to ripple through the US economy. **I remain a believer in "Don't Fight the Fed!"**

Canada

This newsletter is already too long, so I won't spend much time on Canada. I'll let the Bank of Canada's *Monetary Policy Report* for April 2023 tell the Canadian story from their point of view:

In Canada, consumer price index (CPI) inflation is expected to come down quickly to around 3% in the middle of 2023 and then decline more gradually, reaching the 2% target by the end of 2024.

Goods price inflation is easing quickly, reflecting lower energy prices, improved global supply chains and the effects of restrictive monetary policy on sectors sensitive to interest rates. Inflation is then forecast to return the rest of the way to the 2% target more gradually because services price inflation is responding more slowly to the effects of restrictive monetary policy.

Demand in Canada still exceeds supply, and the labour market remains tight.

Although the slowing economy and increasing labour supply are helping relieve some of this tightness, the labour market is still above maximum sustainable employment.

Economic growth is expected to be subdued through the remainder of this year, with the economy moving into excess supply in the second half, and then to pick up gradually through 2024.

Strong population growth is supporting aggregate consumption and employment growth. Household spending is being restrained by higher interest rates. At current interest rates, the share of income spent on interest payments will continue to rise as homeowners renew their mortgages.

Growth in business investment and exports is also expected to soften, reflecting increased borrowing costs and weaker foreign demand.

With slow growth in Canada for the next several quarters, the Bank of Canada anticipates near-term inflation expectations to decline, services price inflation and wage growth to moderate, and the pricing behaviour of businesses to normalize. As these things happen, domestic price pressures will ease further, returning inflation gradually to the 2% target.

On an annual average basis, growth in gross domestic product (GDP) in Canada is projected to be 1.4% this year and 1.3% in 2024. As the economy adjusts to higher interest rates and inflation returns to the 2% target, GDP growth is projected to pick back up in 2025, reaching 2.5%.

Prairie Crocus in Early April