Investing Wisely

A Newsletter from Mike Wise

September 2022

I hope that this letter finds you and your loved ones safe and healthy. After a slow start, our August in Calgary was certainly a beautiful month to be out and about!

Our August was very different. Carmen fell and broke her leg in early August, and has spent the last month first at Foothills Hospital and now at the Carewest Glenmore Park rehab center. The doctors expect a full recovery by the end of October, and she is on schedule; she'll be coming home in just a few days.

It feels great to be back to "normal" socially. My sister visited us in early July, and a bit later in the month we went Stampeding at breakfasts and the grandstand show. I've also been to 3 Stampeder football games. No doubt we'll rejoin the more refined circuit of symphony concerts once Carmen is able to get out easily.

Looking ahead, we'll be spending our Christmas at Fairmont Hot Springs for the first time. The big news is that both our kids, and family, are likely to be joining us! We're really excited over that!

In other family news, our son David received a significant promotion, and is now Director of Long-Term Planning for the City of Ottawa. Liz also changed titles, and moved from Current Production to Vice President, Creative, and now is responsible for discovering concepts, ideas, and scripts that might have potential to go on to the pilot stage, and finally on-air at CWTV.

Queen Elizabeth II
1926 – 2022

Grandson Eshan will be performing in *The Music Man* with a local repertoire company in mid-October. We had planned to go down to LA to see the show, but Carmen's leg put an end to that plan. Over the summer, he appeared in an advertisement for a soft drink. His big event, as far as we are concerned, was that he was chosen to represent Canada at the opening ceremony of the head-of-states meeting of

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Eshan with US Vice-President Kamala Harris

the Organization of American States. He met US Vice-President Kamala Harris, and while he didn't meet President Biden, he did say that the President circulated backstage afterwards, and seemed like a sociable and likeable guy.

Service Improvements

This is a repeat from my May newsletter. Some of my clients have taken advantage, but I recommend that more – or even most – of my clients should make the switch. The service improvements have the potential to improve your investment returns by increasing flexibility and lowering costs.

Fee-Based Accounts

This change is optional. Clients with smaller accounts may prefer to maintain the status quo.

The primary change is a move away from embedded fees to negotiated fees in a nominee account. Ordinary A-series mutual funds have 2 layers of embedded fees: one layer is the management fee assessed by the fund company, and is expressed by the Management Expense Ratio (MER). The other layer consists of the advisor service fee, which is the primary way that advisors get paid for the services that they provide to clients. The advisor fee is 1% annually for most equity and balanced funds, and is non-negotiable.

Table 1

Advisor Fee Discounts for Fee Based Accounts (Advisor Fees are generally 1% for Equity and Balanced Funds in Embedded-Fee Accounts)

Tier	Annual Advisor Fee	
<$250K	1.20%	($1.00/$1000/mo)
$250K - $500K	1.08%	($0.90/$1000/mo)
$500K - $1M	0.96%	($0.80/$1000/mo)
$1M - $2M	0.84%	($0.70/$1000/mo)
$2M - $4M	0.72%	($0.60/$1000/mo)
$4M - $10M	0.60%	($0.50/$1000/mo)
>$10M	0.48%	($0.40/$1000/mo)

Note 1: Tiers include Assets Under Management for all related accounts

Note 2: Funds qualifying for discount include F-Class (Fee-based) funds and ETFs

In a fee-based account, the 2 layers are separated and the advisor service fee is negotiable. Table 1 indicates my fee schedule. The fund companies also typically lower their MER for a fee-based account, and the advisor fee is tax-deductible in a non-registered account.

There's a bit of paperwork involved in the change-over, as it is necessary to switch from a client-name plan at the fund company to a nominee plan at Portfolio Strategies. But switching from A-series at the fund company to F-series in the nominee account is NOT considered a disposition for tax purposes.

Increased Flexibility

The switch to a Portfolio Strategies nominee account opens up a new world of investment opportunities.

I discussed Exchange Traded Funds (ETFs) in a previous newsletter. Conceptually, ETFs aren't that much different from mutual funds, with the exception that they are free from much of the regulatory baggage (and resulting costs) that hamper mutual funds. An index ETF, designed to follow a stock market index like the TSX or S&P500, has a *very* low MER compared to a mutual fund with a similar investment objective. A lower cost can potentially translate to a higher after-fees return. (Note – not always true; some active managers seem to be able to consistently beat the market index on an after-fees basis.)

PSC is aiming to allow direct investing in ETFs, GICs and government bonds. However, there are various obstacles in the way, and we're not yet in position to offer these to clients.

We've found a way around this difficulty, though. One large financial institution is offering mutual fund equivalents of their ETFs with MERs not much different from the underlying ETFs! We are therefore able to offer you something like an S&P500 Index ETF, at near-ETF prices, but in a mutual fund wrapper. The breadth of available offerings is restricted to core stock and bond index ETFs.

I'm excited by this new opportunity to help my clients! Call or email me if you'd like to explore how a fee-based nominee account might fit in with your investment objectives.

Where We Are

Table 2 shows how stocks, bonds and commodities performed in the first 8 months of this year.

Table 2
2022 Returns - Year to 31 August

	31 August Price	YTD Change
Equities		
TSX (CAD)	19270.85	-9.2%
S&P500 (USD)	3924.26	-17.7%
NASDAQ 100 (USD)	11630.86	-25.7%
Commodities		
Oil (WTI; USD)	$87.25	15.6%
Gold (Comex; USD)	$1722.60	-5.9%
Fixed Income		
DEX Universe Bond Index (CAD) - Total Return	1056.8	-11.2%
Govt of Canada 10-Yr Bond Interest Rate	3.116%	1.682%
Best 5-yr GIC Rate (rate as of Sept 6)	4.450%	2.15%
Exchange Rates		
USD/CAD	$0.7616	-$0.0296
EURO/CAD	$0.7652	$0.0694

It has been a rough start for stocks, but especially for bonds. As shown in Table 2, the Government of Canada 10-year bond has more than doubled in yield (from 1.434% to 3.116%), causing the DEX Universe Bond Index to fall by 11.2%. (Bond prices move inversely to bond yields). Long term bonds did even worse: the DEX Long-Term Bond Index is down a stunning -19.9% just this year!

So much for the theory that bonds add stability to a portfolio. I fear that this is a permanent loss of capital, as it is unlikely that interest rates will get back down to the 1% range in my lifetime.

The Governor of the Bank of Canada has made it clear that he is going to continue to aggressively raise rates throughout the year, so the carnage may be far from over. The Bank increased its Target Interest Rate by another ¾% last week. This increases all mortgage rates by a similar amount, and the Prime Rate is now up to 5.45%. The Prime Rate is the basis for variable rate mortgages and all consumer loans.

On the stock side, there has been a massive switch in investor sentiment from "growth" to "value". Tech stocks are the poster child for growth stocks, and the NASDAQ index in the US is weighted towards Tech. It is already in bear territory, being down more than 20% this year. The S&P500 index is in corrections territory (a correction being down -10% from a previous high). This major market index is weighted towards the Tech giants like Facebook (Meta), Google (Alphabet), Amazon and Apple.

The Canadian TSX Index is considered to be more of a value index due to its heavy weighting in resources and financials. The TSX only fell into negative territory during the last week of April.

Doug, Wanda & Carmen at the Stampede

Most of my clients have a mixture of stocks and bonds in a balanced portfolio. My Canadian Neutral Balanced Benchmark was down -10.3% for the year, at the end of August.

The underlying cause of all the angst in stock and bond markets is of course inflation. Canada's official inflation rate in July was 7.6%, down slightly from 8.1% the month before. The US was even worse, with the August number coming in at 8.3%, greatly exceeding market expectations. Both are measured on a year-over-year basis.

We're now seeing today's prices being compared to a time during the great run-up in energy prices last year. I think that we may see the inflation numbers cool off as the year-over-year change in energy prices works its way through the economy.

The headline inflation numbers might go down as the year unfolds, but I don't think that we'll be seeing inflation heading back towards zero anytime soon. And we're certainly not going to see prices in the store going down! The great economist Milton Friedman wrote that inflation is the result of too much money chasing too few goods (see sidebar), and we have seen an unprecedented gusher of money printed by central banks during the Covid pandemic.

> ***"Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."***
> ***Milton Friedman***

Where We're Heading

I wrote in my January newsletter that I thought that 2022 was going to be an uncertain, and maybe a difficult, year for both stocks and bonds. That is certainly proving to be the case!

I'll start with a quick look at currencies. but I'm going to be focusing on the US in this section, and particularly the US Federal Reserve because its interest rate policy will, to a great extent, influence

> ***"Expansions don't die of old age; they are murdered by central bank policy action"***
> ***Jeremy Warner, London Daily Telegraph***

whether the current economic expansion continues or comes to a screeching halt. As Jeremy Warner wrote, in the *London Daily Telegraph*, "Expansions don't die of old age; they are murdered by central bank policy action".

Currencies

The US greenback has traditionally been viewed as a safe-haven currency. Investors flee to the US dollar whenever global tensions and uncertainty rise. Today is no exception. The Euro has fallen to the extent that it is now on par with the greenback, while the British pound is not far behind. The main reason why the looney can't break the 80c mark is because of the strength of the greenback. Sure, the US has its problems, but it is still a mighty economic engine and the greatest force ever to be unleashed on the world. (The political system is another story, but let's not get into that!)

Right now, the #2 economy (China) is in lockdown with a zero-Covid policy that is doomed to fail. The #3 economy (Japan) insists on a low-interest-rate policy and is still mired in a zero-immigration mindset. Europe (Eurozone) is caught up in the middle of the Russia-Ukraine war and may well freeze to death this winter.

The US dollar is already at multi-decade highs relative to its major trading partners, and is

Morning Visitor – Bobcat in our Backyard

aggressively raising interest rates. We can expect further strengthening of the greenback, and because of this, weakening of the looney.

There is one big caveat to the above. Thanks to the sanctions imposed on Russia (the #2 oil exporter, after Saudi Arabia; Canada is #4) due to its invasion of Ukraine, Russia has turned to China, India and other Asian countries as its major export markets. The country is now accepting payments in rubles or Chinese Yuan, rather than US dollars.

Similarly, sanctions caused Russia to be locked out of the SWIFT foreign currency exchange system, so Russia and China have set up their own competing system.

We may be looking at the end of an era in which the greenback was the world's de facto reserve currency.

United States

2022 is a mid-term election year in the United States, so we can expect the level of anguish and rhetoric coming out of that country to be even louder than usual. The pundits expect that the Republicans will retake the House and Senate, and make it impossible for President Biden to implement his agenda.

Market participants had hoped that declining inflation rate numbers might cause the US Federal Reserve to be less aggressive in raising interest rates than they had previously expected. Those hopes were dashed by Fed members, who without exception have stated that their goal is to bring price rises in goods and services back in line with their target of 2%.

It is now expected that the Fed will raise its Federal Funds Rate by ¾% at its meeting on September 20, bringing it up to 3.0%. This is bad news for borrowers, as the US Prime Rate will jump up to 6.25%, but for savers it also means an increase in the rates paid on GICs and other interest-bearing investments.

"… there is a substantial delay between when the Fed raises interest rates and a slowdown in the economy. The delay between stimulus and response is in the order of 12 months, and almost always has caused the Fed to overshoot …"

Fed watchers are now predicting that the Fed Policy Rate will peak at around 4%, or another 1% more than the post-Sept 20 Federal Funds Rate.

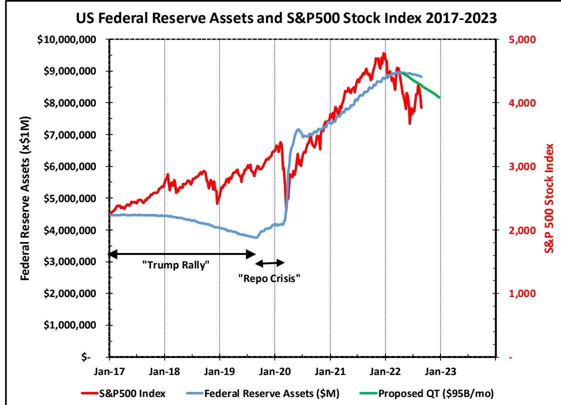
The US economy is still doing well (more on that later), but the problem is that there is a substantial delay between when the Fed raises interest rates and a slowdown in the economy. The delay between stimulus and response is in the order of 12 months, and almost always has caused the Fed to overshoot, thereby making the downturn more severe than perhaps was necessary.

Given this path of future interest rate increases, I can't be optimistic about any bond holdings, with the exception, perhaps, of ultra-short-term money market funds. A fund like the CI Enhanced Short Duration Bond Fund might be a suitable place for capital preservation.

In addition to the rate increases, the Fed is getting serious about reducing its balance sheet. Its publicized intention has been to sell off $95B of bonds each month for the foreseeable future. This quantitative tightening (QT) would have the effect of

Robins

Chart 1
Source: US Federal Reserve; Standard & Poors



pulling money out of circulation. However, there is a substantial difference between what the Fed says they are going to do, and what they have actually done. If you look closely at Chart 1, there is already a large gap between intention (green line) and reality (blue line). That gap is already $280B!

While the Fed is busily trying to slow down inflation with rate increases and (to a lesser extent) QT, the Democrats have an election to be won in just a few months. Voters like free stuff, so the next goodie is forgiveness of student loans. The plan has an upper limit of $10,000 ($20,000 for certain students). The cost is uncertain, but estimates range from a low of $450B to a high of $600B over 10 years. This will all be borrowed money, ultimately financed by the US Federal Reserve, that will get injected into the economy, or about the same amount as the Fed is trying to remove!

I've written previously that in my view the Fed's money-printing has sustained the stock market (see Chart 1). I watch the Fed's balance sheet like a hawk, watching if there has been any slowdown or reversal of their bond-buying policy. It doesn't look to me that the Fed's assets on its balance sheet are going to go down any time soon.

If my theory is correct, we might not see much in the way of new money flowing into the stock market, but we also won't see much money being sucked out of the economy through Quantitative Tightening (QT). On balance, we are likely to see very unstable financial markets because it will be more difficult for

Lundbreck Falls

valuations to increase across the broad market. Individual company valuations (earnings and dividends, for example) might start to matter!

While on the subject of earnings and dividends, let's see how they are doing in the US. Chart 2 shows that they are at record levels. No sign of a slowdown there!

The US employment numbers are looking good. The Bureau of Labor Statistics job report showed net gain of 3.5 million jobs so far this year, almost all of whom were in the private sector. (NB: in Canada, almost all

Chart 2
Source: Standard & Poors; Barrons

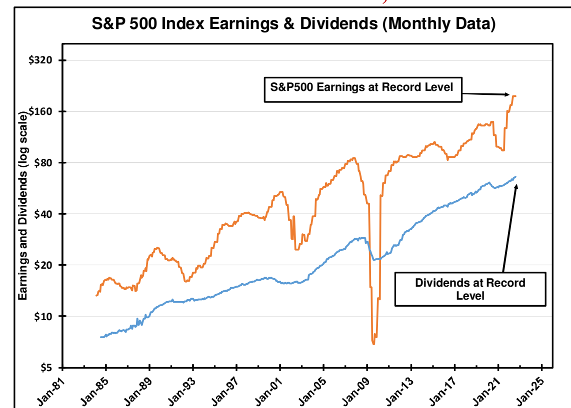
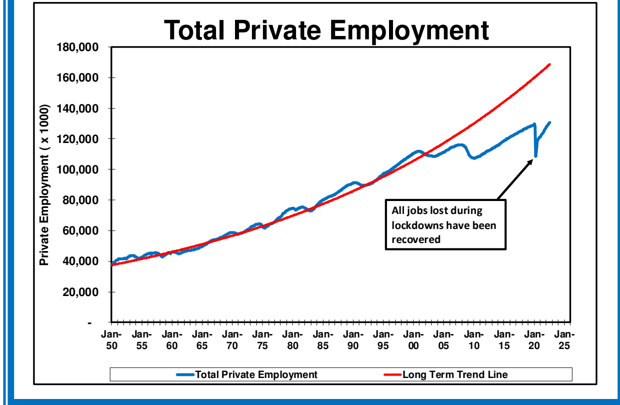


Chart 3
Source: US Bureau of Labor Statistics



job growth has been in government!). As shown in Chart 3 (blue line), all of the jobs lost during the lockdowns have been recovered. I'm not going to show the charts this time, but the leading economic indicators that I follow, manufacturing overtime hours and employment through temporary agencies, are both looking good.

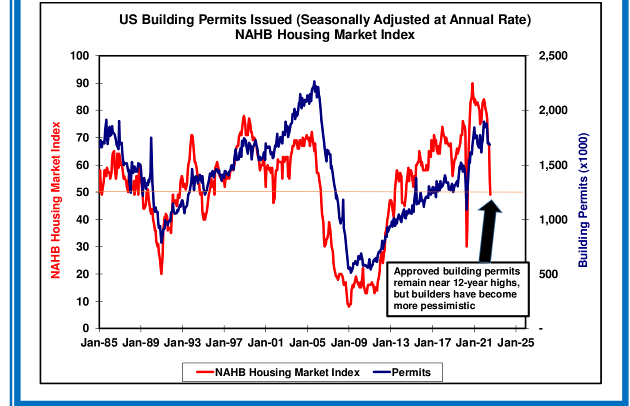
Residential housing construction is very sensitive to mortgage rates, which in turn are dependent upon Fed interest rate policy. Chart 4 shows that builders' confidence, as expressed by the National Association of Home Builders Housing Market Index, has turned pessimistic. Meanwhile, approved building permits remain strong, but of course having a permit does not necessarily mean that construction follows.

To summarize, right now US corporations are doing very well. Corporate earnings and dividends are at record highs. Employment is very strong, with 3.5 million new jobs created this year, mostly in the private sector. Residential construction is not as robust; increased mortgage rates are having an effect. All-in-all, the Fed likely sees no reason to slow down its policy of raising interest rates to fight inflation. Whether their policy will drive the US into recession a year from now is anyone's guess.

Europe

The great investor Sir John Templeton is reported to have said that the best time to invest is when there is "blood in the streets".

Chart 4
Source: Nat'l Assoc of Home Builders; US Census Bureau



If you are the type of investor who is looking for bargains, as was Sir John, Europe may well be the best place in the world to look right now. Great companies with a global reach are currently selling at bargain prices.

The Canadian media are strangely silent about all the turbulence going on in western Europe, but the continent might be getting pretty close to the point where there literally is "blood in the streets". There are demonstrations numbering in the tens of thousands in almost every capital, and Dutch farmers continue their protest over the government's plan to force the culling of up to 70% of livestock herds because their waste is harming the country's natural areas. French President Macron must be mindful that his countrymen once stormed the Bastille!

As far as I can figure out, the only sensible politician in the European Union is Hungarian Prime Minister Viktor Orban, who has tried to keep his country out of the Russia-Ukraine war, and in a recent speech

Glenmore Reservoir from Carewest Glenmore Park Rehab Hospital

Miners Push Tourist's Dead Electric Car to Charge Up at a Coal Mine

said that "Europe needs to fight the fundamentalist greens" to enable energy sources such as coal, nuclear and gas to be properly deployed. Orban stands virtually alone among European political leaders, for whom the green agenda remains paramount. Most leaders are now mandating rationing of energy supplies as the EU finds itself unable to replace now-unavailable Russian gas at any price.

Europe *will* have "blood in the streets" if this winter is a cold one.

Canada

The story in Canada is much like that of the US, minus the frenzied political atmosphere. The economy is currently doing well, but there's a danger that high inflation, and the Bank of Canada's resolve to fight it through interest rate increases, could crush it and drive Canada into recession. There's an old saying that whenever the US sneezes, Canada catches a cold.

I mentioned earlier that the Bank of Canada raised its benchmark interest rate by ¾% last month. This raised the Prime Rate, which is the rate charged by banks for loans to their best customers, up to 5.45%. It also meant that savers can get a better rate on savings accounts and GICs. Table 1 showed that on Sept 6 an investor could buy a 5-year GIC yielding 4.45%. The Bank has made clear that the rate increases will continue until inflation falls to its target range of 2%.

Housing is more sensitive to interest rises in Canada than in the US, because in Canada we typically have 5-year terms, meaning that our mortgage comes up for renewal, at then-current mortgage rates, every 5 years. It is possible to get a mortgage with a 30-year term in the US. According to www.ratehub.ca, a home buyer 5 years ago could get a 5-year fixed mortgage at an interest rate of 2.64%; the same homeowner would have to renew currently at 4.49%. The difference in monthly payment (for a $500K mortgage and a 25-year amortization period) is $500/mo.

The extra $500/mo could sink many over-stretched homebuyers, particularly in places like Toronto or Vancouver. TD Bank estimates that Toronto house prices could fall by as much as 25% if interest rates (and mortgage rates) continue to rise.

Employment is also a bit of a concern. Statistics Canada reported on Sept 9 that employment fell by 39,700 jobs in August, greatly surprising economists who had expected a small rise in employment. This was the 3rd month in a row with declining employment, something that seldom happens outside of a recession. The unemployment rate rose to 5.4% from 4.9%.

According to *The Financial Post*: "The job losses were mostly concentrated in the public sector, particularly education, which lost 50,000 jobs. Some of those drops in schools and educational institutions could reverse when data for September comes out, reflecting the back-to-school season. The public sector has borne the brunt of the jobs decline over the summer, losing 79,000 positions of the 114,000 overall in the past three months. But, it could be

Elbow River Canyon

Waldron Ranch, South of Calgary

overstating broader weakness since it reflects a reversal in the hiring surge during the pandemic, Stephen Brown, senior economist at Capital Economics, said in a note."

Statistics Canada also reported that hourly wages increased by 5.4% from August 2021. While encouraging for workers, it is still less than what workers lost to inflation. For the Bank, though, this is considered bad news as it indicates that inflation expectations are creeping into the labour market.

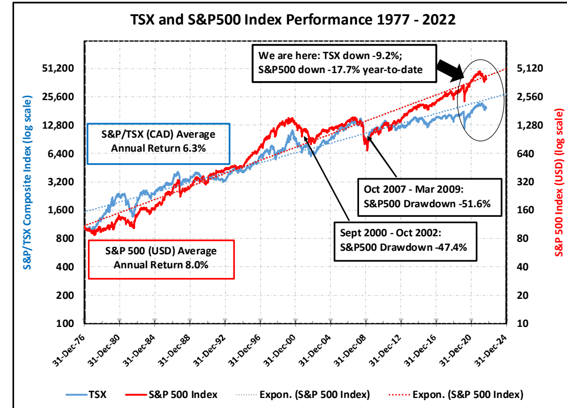
Action Plan

Since the Federal Reserve in the US and the Bank of Canada in Canada are determined to wrestle inflation into the ground through a policy of rising interest rates, I can't get very excited about the immediate prospects for either the bond or stock markets. However, we all like to "buy low; sell high", and the opportunity of the decade is fast approaching. We just don't know when that will be! I think, though, we have a clue from Sir John Templeton: the time to buy will be when the news is full of gloom and doom. The nightly news will be talking about mass layoffs and hardship everywhere.

People are emotional beings. I am; you are. Psychologists say that fear is 3 times more powerful than greed. It is extremely difficult for us to put aside our fears and not only make the decision to buy, but to actually make the phone call.

We can make that easier through **Dollar-cost Averaging**. This works by putting a small amount into the market each week; generally 2% of the total amount that you ultimately want to be in the market.

Chart 5
TSX and S&P500 Index, 1977 – 2022
Source: Toronto Stock Exchange; Standard & Poors



For example, if you have $10,000 that you want to invest, say into your RRSP, we can put the entire amount in a dollar-cost averaging fund, where it is initially invested in an interest-bearing money market account. Each week the fund company will automatically move $200 from the money market account into the equity fund of your choice, so that at the end of 50 weeks you'll be fully invested in the equity fund.

If the market continues to fall, you'll be buying each week at lower and lower prices: BUY LOW! And when the market finally turns around – which is usually at the point of maximum pessimism - you'll have the bulk of your funds invested at low prices, and ready to take advantage of the new bull market.

I've shown the current value of the TSX and S&P500 indexes way over on the right side of Chart 5. Both indexes reached their most recent all-time high just before last Christmas. This year, the TSX is down -9.2% year-to-date, while the S&P500 is down -17.7% year-to-date. Both downturns are minor blips on the chart.

The chart also shows the 2 most recent grizzly-bear markets, in which the S&P500 fell around 50% from peak to trough. I have no idea whether our current downturn is going to be anything like these events, but what I want to show in this chart is that the 2000-2002 bear market lasted 25 months, while the 2007-2009 bear market lasted 17 months. We are now 9 months into our current downturn, so odds are that

the “point of maximum pessimism” will be roughly a year from now, plus or minus a few months.

You’ll want to be fully invested by the time we reach that point of maximum pessimism! Dollar-Cost Averaging is the way to go!

By the way, this is consistent with the forecasts of many economists: they forecast that the Fed will stop raising rates in early 2023, and the US (and Canada) will fall into recession by mid-2023.

Hollyhock

A Building in Downtown Calgary