Wealth Management
Dominion Securities

2023 Commentary Vol I

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Jon Mitchell, Portfolio Manager

If I were free to speak my mind,
I'd tell a tale to all mankind
Of how the flowers do bloom and fade
Of how we've fought and how we've paid.

This weary world has had its fill
Of words of war on every hill
The time has come for peaceful days
And peaceful men of peaceful ways.

If I were free to speak my mind,
I'd tell a tale to all mankind
Of how the flowers do bloom and fade
Of how we've fought and how we've paid.

When all mankind has ceased to fight
I'll raise my head in thanks each night
For this rich Earth and all it means
For golden days and peaceful dreams.

If I were free to speak my mind,
I'd tell a tale to all mankind
Of how the flowers do bloom and fade
Of how we've fought and how we've paid.

Peter, Paul and Mary, released in 1965 on the *See What Tomorrow Brings* album.

Freedom is not free

For many Canadians, the notion that we are losing our right to free speech many seem preposterous. Or our mobility rights to travel wherever and whenever we want, our freedom of association or religion, our right to peaceful protest or what is referred to as bodily autonomy. Yet, if we look back over the last few years, we may see examples of where each of these freedoms have been eroded or diminished in some way or form. Are we able to voice an opinion that runs contrary to the narrative that is being put forth by government, medical or education officials? If we do, will we be faced with losing our job, our place in university, or our ability to access health care because we espouse a perspective that is at odds with that of those in power?

Having just come through the Alberta provincial election, it has been a case in point of how one's views can be challenged and, in some cases, derided and attacked. It was an interesting experience for me going door-to-door in my constituency to ask people what their major concerns were for the upcoming election. I heard a broad spectrum of replies and, in a few cases, no reply at all except the door shutting quickly in my face. I have a sense that Premier Smith and the government will face the difficult task of representing the views of Albertans and standing up for our provincial resources in the next four years.

I think the greatest concern I am hearing is the stress individuals and families are under with the increasing impact of higher borrowing rates and rising cost of everything, which is contrasted by fairly constant monthly income. With each interest rate hike, the average person's budget is tightened that much more, and the pressure to try and make ends meet weighs heavier on the family unit. We will get into some specific examples a bit later in the commentary.

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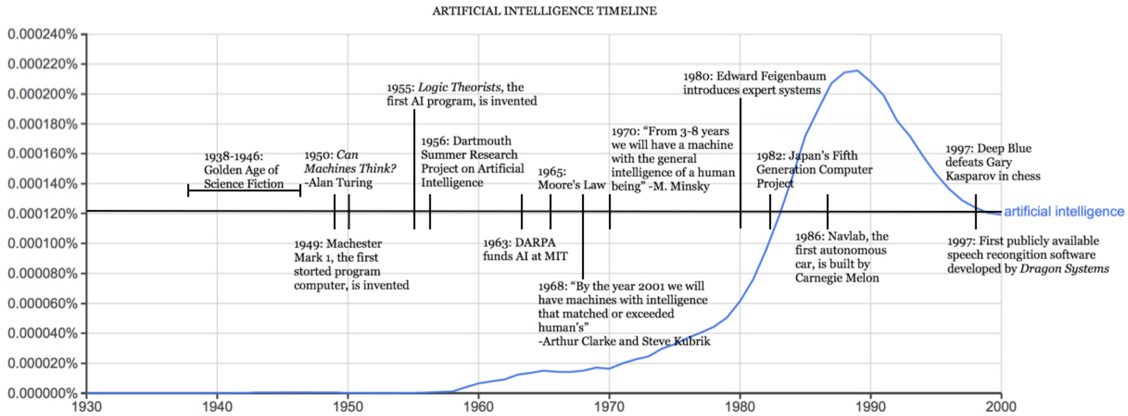


Source: Harvard University : The Graduate Students of Arts and Sciences August 2007

Artificial Intelligence is here to stay

Artificial Intelligence (AI) is not new, it has been growing for over 50 years as evidenced by the graph above, but its fixation by the equity markets in 2023 has been remarkable. The launch of ChatGPT 2.0 (GPT stands for Generative Pre-Trained Transformer) on November 30, 2022, has caused a frenzy of activity in the shares of Nvidia and AMD (producer of mircochips for data storage), Microsoft (major investor in ChatGPT 2.0) and other related large technology firms such as Apple, Meta, Amazon, or others poised to benefit from greater use of AI.

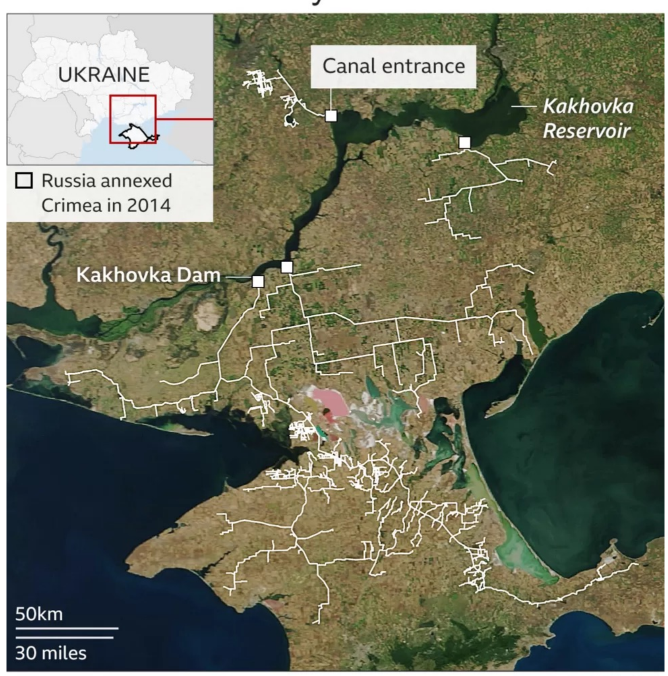
A colleague of mine gave me an example of how he asked ChatGPT for a workout routine, related diet and weekly grocery list – all of which were responded to in seconds by ChatGPT. We are all familiar with the telephone matrix that we are given when we call one of our service providers (bank, insurer, government, utility, telephone company) with a question. When we are on a website, there is often a chat box that appears that asks if we have a question – these are all AI tools that businesses are using today. In time, we will not even be certain whether we are actually speaking to a human being, because the voice software will be so advanced, and the response time and answer so accurate, that we may believe we are speaking with a person when we are actually conversing with an AI software robot.

Ukraine – Russia War

The conflict in Ukraine continues and it appears that both sides have set up defensive positions after the initial territories in eastern and southern Ukraine had been entered into by Russian forces. There seems to be no urgency by NATO officials for ceasefire talks given the view that no post-invasion land (or even Crimea, which was annexed by Russia in 2014) should become Russian territory. There appears to be a growing number of developing countries who have either moved to a more neutral stance on Russia or who are openly leaning to support Russia. A recent publication by the Economist Intelligence Unit showed that 33% of the world's population were now sided with Russia, versus 36% of the world's population supportive of Ukraine.[1]

The most devastating event in the conflict in the past quarter was the early June 2023 destruction of the Kakhovka Dam in southern Ukraine. The breech of the dam resulted in flooding and the loss of fresh water supply to much of the region, including Crimea.[2] The map below shows the extensive canal system that relied on the water being diverted by the dam. Both sides are accusing the other of destroying this critical infrastructure, but the consequences are being felt by the civilian population of the region.[3]

Canal networks fed by Kakhovka Reservoir



Source: Open Street Map, Nasa Modis

Investment observations

This year has been a tale of two markets. In Canada, one of the largest companies by market capitalization, Shopify, is up over 70% so far in 2023, while the entire index is up only 2.3% (as of July 7, 2023), while in the U.S., the entire gain in 2023 of the S&P 500 can be attributed to the gains of seven stocks: Alphabet,

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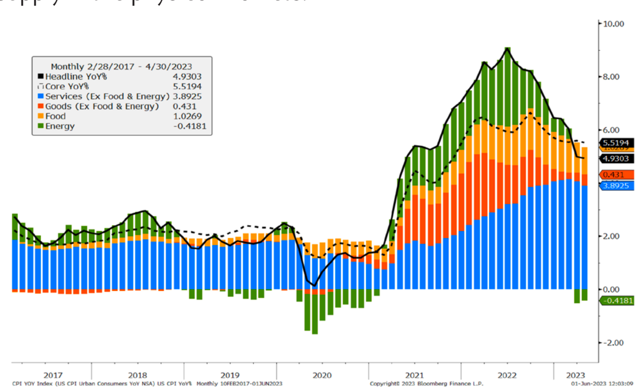
Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla. Only Apple and Microsoft pay dividends (both less than 1%). The common theme here is largely associated with the AI topic that we reviewed earlier on.

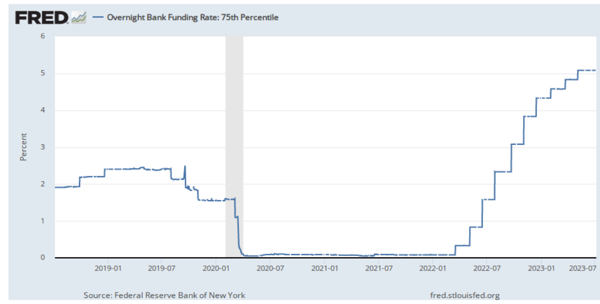
Another possible theme for many of the companies (Alphabet, Apple, Meta, Microsoft) would be the fact that they have significant cash balances and relatively low debt holdings, rendering them less impacted by the large increase in interest/ borrowing costs. On the side of caution, the valuations of these companies is very close to all-time levels in terms of their price-to-earnings or cash flow.

The rest of the market seems pre-occupied with the same concerns of Main Street: Much higher interest rates and costs through higher inflation. As set out in the chart below, the increase of the overnight rate by the U.S. Federal Reserve (the Fed) has been unrelenting (save for the very last meeting in June 2023, where they held the rate instead of increasing it).

The impact of higher rates is filtering through all families and businesses as interest costs become a larger and larger part of overall costs. Moreover, the impact on inflation on other components (wages, materials, services) is also squeezing corporate earnings. As noted on the bar chart below, services and food inflation remain persistently high, while it remains to be seen whether energy costs will start to creep higher given the tight supply in the physical markets.

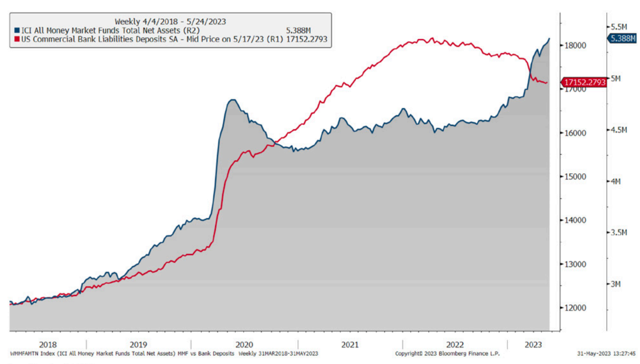


These two headwinds are proving to be a significant obstacle to resuming any meaningful kind of growth trajectory.

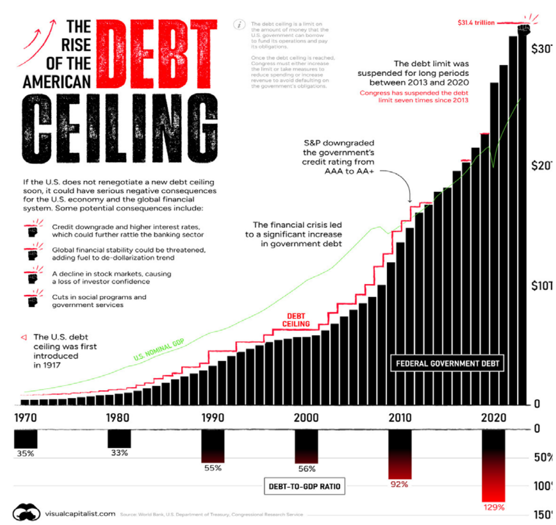


As we discussed in the last commentary, one of the contributing factors in the failure of a number of U.S. banks in March 2023 related to the mismatch of assets with liabilities (demand deposits/ liabilities earning less than 0.5% were being withdrawn to buy U.S. Treasury Bills and Money Market funds paying more than 4% (now closer to 5.25%), while the banks' assets were invested in longer term U.S. Treasury bonds that had declined by 15% in value with the increase in rates).

More and more money continues to flow into short-term deposits, which are now becoming serious competition for the marginal dollar. Today, well over US$5 trillion is now held in these short-term interest bearing investments.



One of the toughest challenges is to forecast just how high interest rates will go. One of the factors that could limit the increase is the enormous level of all debts, led by government debt.



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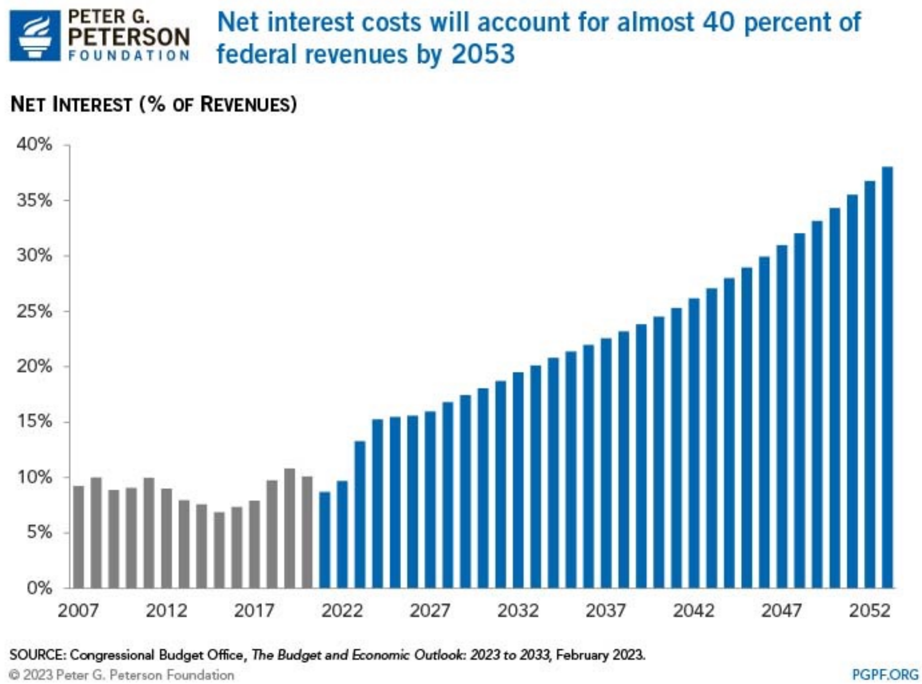
One of the major contributors to instability in the markets this year was the ongoing issue of the U.S. debt ceiling, which has been agreed upon by the House of Representatives, the Senate and the Oval Office (Canada has no such legislative requirement to approve any increase to our federal debt). The chart below depicts the scale of the U.S. national debt over the years. It has quadrupled since 2000, which was about the last time the U.S. had a balanced budget.

Related to the size of the debt is the annual cost of servicing it, which has been severely impacted by the skyrocketing rise of interest rates (up 21-fold since March 2022). With borrowing rates now over 5%, the percentage of interest costs will begin to rise dramatically as a percentage of the overall budget, as evidenced in the graph below. How will other components of a government's budget (health care, social security, defense, government pensions) be affected if, indeed, the debt servicing costs reach 40% of the budget?

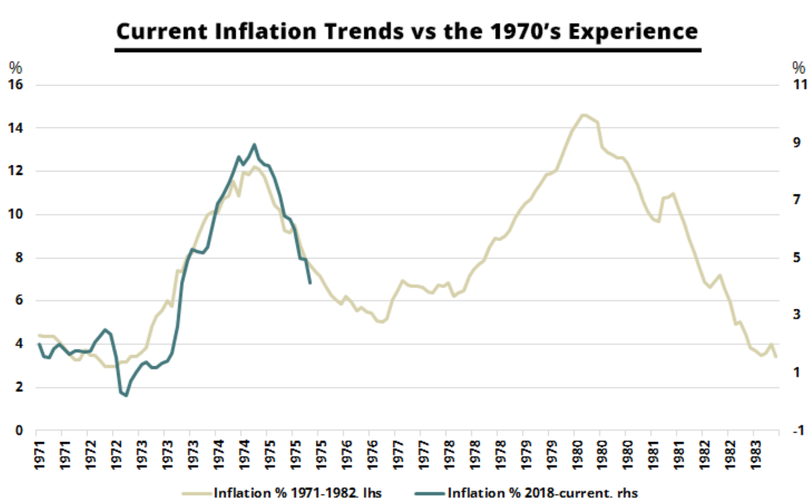


Inflation: Down but not out?

Our guest commentary this issue features QV Investors Chief Investment Officer Mathew Hermary. QV is one of the investment firms connected with iA Clarington, and they provide me with a weekly update. Mathew has some interesting views on inflation, which I have read about this year, comparing what is happening today with what many of our clients experienced in the 1970s, which was the last time we had a surge in inflation.

He notes: *"While inflation should drift lower in the near-term, have the forces of inflation truly been conquered? Surges in inflation have historically been accompanied by commodity price shocks. Little has been done to address underinvestment in supply in recent years and geopolitical instability remains an ever-present risk to price stability. After decades of disinflationary benefit from the hollowing out of American manufacturing, the gears of globalization have begun to reverse as companies look to onshore production in a less stable world. At the margin, onshoring is inflationary. Finally, labour markets remain very tight and wage growth has remained persistent. The longer this remains the case, the more entrenched inflation could ultimately become.*

If inflation is not dead but instead retreating into temporary dormancy, how is the Fed likely to respond if inflation either remains above target or even begins to re-accelerate in 12 to 18 months? The Fed's credibility is already at stake in a way it hasn't been in decades. Both bond and equity markets are convinced the Fed will lower rates sooner than they have signaled. What are the implications if markets are wrong about the Fed's conviction either to fight inflation or its ability to lower rates as expected if inflation begins to rise again at some point?



Mortgage resets will be a reality check

My RBC colleague, Mortgage Specialist Sarah Macsymic, sent me some data of what homeowners are facing when their mortgages reset this year. Sarah recalls that the most favourable variable rate mortgages several years ago were at the Bank Prime lending rate minus 1%. In 2021, Bank Prime lending was only 2.45%, so the variable rate mortgage interest rate was priced at 1.45%. On a $350,000 mortgage taken out three years ago (for a starter home here in Alberta), the mortgage payment would have been set at $1,391.

With the rise in the Bank Prime lending rate, the mortgage holder would now be paying $1,550, with 100% of the payment

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Notable Quotes

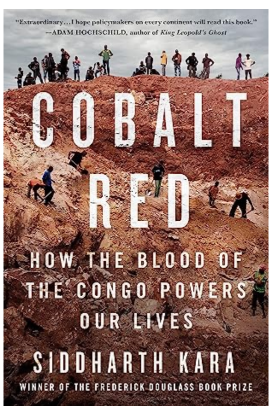
"Few men are willing to brave the disapproval of their fellows, the censure of their colleagues, the wrath of their society. Moral courage is a rarer commodity than bravery in battle or great intelligence. Yet it is the one essential, vital quality for those who seek to change the world, which yields most painfully to change."

– Former Attorney General Robert F. Kennedy, whose son Robert Jr. has announced that he is seeking the Democratic nomination for the 2024 Presidential election.

"Canada is free and freedom is its nationality."

– Former Prime Minister Wilfrid Laurier

Books I've recently finished reading:

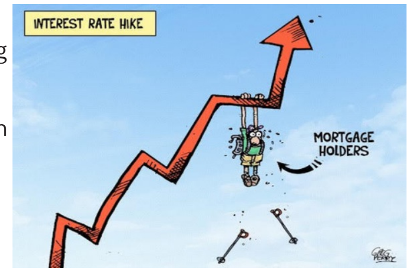


Cobalt Red: How the Blood of the Congo Powers our Lives
Siddharth Kara (2023).

This is a first-person exposé of the immense toll taken on the people and environment of the Democratic Republic of the Congo by cobalt mining – many of the miners being children, who work for about a $1 a day in wages. Cobalt is one of the critical elements needed for electric vehicles, cell phones and other widely used electronics. A must-read for those considering the ethical issues surrounding these products.

just paying the revised interest rate (now 5.95%). If the mortgage was renewing today into a five-year fixed rate at 5.04%, the mortgage payment would be about $2,036, and the mortgage balance would still be $326,000.

For fixed-rate mortgages, three years ago, the rock bottom rate was 1.45% and a corresponding mortgage payment of $1,397. Today, the balance owing on the mortgage would be $314,500 and a five-year fixed mortgage at 5.04% would result in a monthly payment of $1,965. So, in either case, the monthly mortgage payment is increasing between 41% and 46%, which is a significant impact to the monthly budget. This cartoon pretty much sums it up.



Source: Greg Perry, The Toronto Star

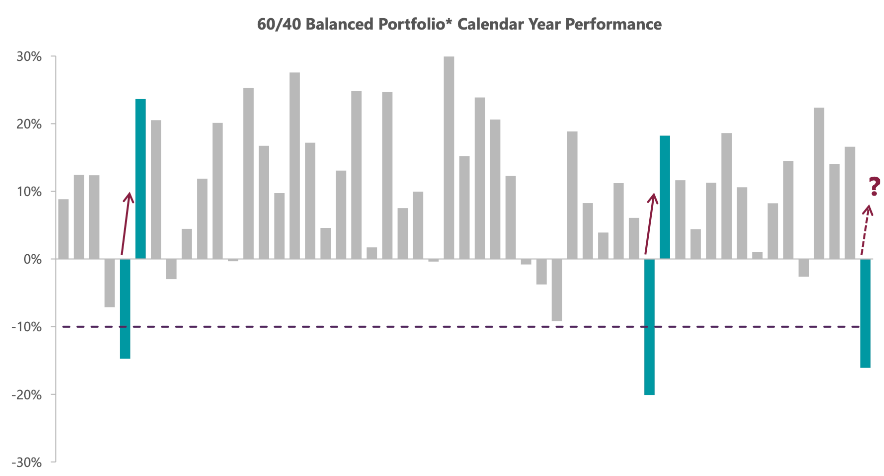
Here are a few charts that I clipped in the past few months that illustrate some of the market issues and changing trends. The first one reflects the remaining Bank of Canada and Federal Reserve meetings this year. For Canada, the market is now forecasting at least one more interest rate hike, possibly two, with no cuts priced in until 2024. For the U.S., the forecast is for one more 0.25% increase in July, with no implied cuts in 2024. Inflation data will be a key determinant along with employment levels and general economic conditions.

Current Implied Government Overnight Rates

Canada			US		
Meeting	Implied Rate	#Hikes	Meeting	Implied Rate	#Hikes
07/12/2023	4.92	0.66	07/26/2023	5.30	0.91
09/06/2023	5.05	1.19	09/20/2023	5.37	1.18
10/25/2023	5.15	1.61	11/01/2023	5.44	1.46
12/06/2023	5.15	1.61	12/13/2023	5.41	1.35
			01/31/2024	5.36	1.14
Target:	**4.75**		Target:	**5.25**	
Effective:	4.75		Effective:	5.08	

Source: Bloomberg

Lastly, looking ahead, there is general support for a recovery in a balanced portfolio (which is what most clients are invested in) following a year after a significant negative return, which is what most investors experienced in 2022.



Source: Bloomberg, FactSet, NYU Stern School of Business, S&P

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Team Updates

- Here in Alberta, our work arrangements are four days in office / one day work from home. Either Pauline or James are here each day, though. It has been good to see clients face-to-face for office meetings again.
- Jon has made a few trips to Saskatchewan to take in the growth of the crops, Canada Day celebrations and the annual rodeo. He and his wife, Debbie, look forward to their daughter's wedding on August 26.
- Pauline is looking forward to some time off for a road trip in September.
- James and Nicole had a great trip to Japan in May.
- Finally, we would like to recommend that you circle back to our website from time to time, as we are using that as one of our primary points of contact to post salient articles on our firm's views, along with details on relevant government programs and announcements. You can access it here: ca.rbcwealthmanagement.com/jon.mitchell/

Again, we have so much to be thankful for, living here in Canada. Do your best to enjoy the positive moments each day, and please support your local businesses whenever you can.

Sector Performance

Below is a table of the performance of various sectors for the 2023 Q1 results / Year-to-Date and three-year rolling periods.

Investment index	Q1 2023 return	Year-to-Date 2023 (June 2023)	3-year compound return (June 2023)
S&P/ TSX composite index	4.6%	5.7%	12.4%
S&P 500 (C$)	7.2%	14.2%	13.6%
NASDAQ Comp (C$)	16.5%	28.7%	10.2%
Short-term comp bond index	1.7%	0.9%	-1.0%
iShares U.S. High Yield Bond Index ETF (XHY, C$ Hedged)	3.3%	4.2%	1.6%
US$ / C$	-0.3%	-2.3%	-0.8%
Gold bullion (C$)	8.5%	3.2%	1.6%
Global gold mining index (XGD – C$)	11.2%	1.0%	-5.6%
iShares Energy Index (XEG – C$)	-4.3%	-5.2%	47.7%

Source: RBC Capital Markets Quantitative Research, Benchmarks, Monthly March/ May 2023

Sources

1. "Russia's pockets of support are growing in the developing world," Economist Intelligence, March 7, 2023. https://www.eiu.com/n/russias-pockets-of-support-are-growing-in-the-developing-world/
2. "Ukraine dam: Satellite images reveal Kakhovka canals drying up," BBC News, June 22, 2023. https://www.bbc.com/news/world-europe-65963403
3. "What we know about Nova Kakhovka incident," June 8, 2023. https://www.bbc.com/news/world-europe-65818705

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