



Wealth Management  
Dominion Securities

# 2022 Q3 commentary



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## Jon Mitchell, Portfolio Manager

### Hammer to Fall

Here we stand or here we fall  
History won't care at all  
Make the bed light the light  
Lady mercy won't be home tonight yeah  
You don't waste no time at all  
Don't hear the bell but you answer the call  
It comes to you as to us all  
We're just waiting  
For the Hammer To Fall

Oh ev'ry night and every day  
A little piece of you is falling away  
But lift your face the western way  
Build your muscles as your body decays  
yeah  
Toe your line and play their game yeah  
Let the anaesthetic cover it all  
Till one day they call your name  
You know it's time for the Hammer To Fall

Rich or poor or famous  
For your truth it's all the same (oh no oh no)  
Lock your door the rain is pouring  
Through your window pane (oh no)  
Baby now your struggle's all in vain  
For we who grew up tall and proud  
In the shadow of the mushroom cloud  
Convinced our voices can't be heard

We just wanna scream it louder and louder  
louder  
What the hell we fighting for?  
Just surrender and it won't hurt at all  
You just got time to say your prayers  
While your waiting for the hammer to  
Hammer To Fall  
It's gonna fall  
Hammer, you know, Hammer To Fall  
While you're waiting for the Hammer To Fall  
Give it to me one more time

"Hammer to Fall" Written by Brian May,  
released in 1984 on *The Works* album by  
British band *Queen*

### War and peace

As we approach the holiday season, we are reminded of classic movies like "It's a Wonderful Life" or "White Christmas" which reference the impact of World War II on the lives of everyday Americans and the lives of the US soldiers that were affected by the conflict so far away from their homes. As the war in Ukraine does not appear to be at a point where talks of peace are being contemplated, the soldiers from both sides and Ukrainian civilians are facing a difficult winter after 10 months of chaos and destruction.

With the rhetoric that both President Putin and President Biden are espousing are we inching ever closer to the possibility of nuclear combat in the Ukrainian war theatre? Is there any hope for peace now or are the two sides firmly entrenched in a

war that guarantees only destruction of a country, death and dismemberment to tens of thousands, another refugee crisis and billions of dollars to the Western military industrial complex? Are we all waiting for the Hammer to Fall? We will elaborate on the demise and bankruptcy of Crypto exchange firm FTX and their relationship to Ukraine in the next commentary.

### Nord Stream 1 and 2 sabotage

On September 26<sup>th</sup>, there was a major escalation in the war beyond the borders of Ukraine as two natural gas pipelines which traverse the Baltic Sea between Russia and Germany were sabotaged. Like 9-11, we were confused about the report of the first aircraft hitting the World Trade Center tower, but when the second plane crashed within an hour later, we knew this was no accident. Sometimes a leak can develop in

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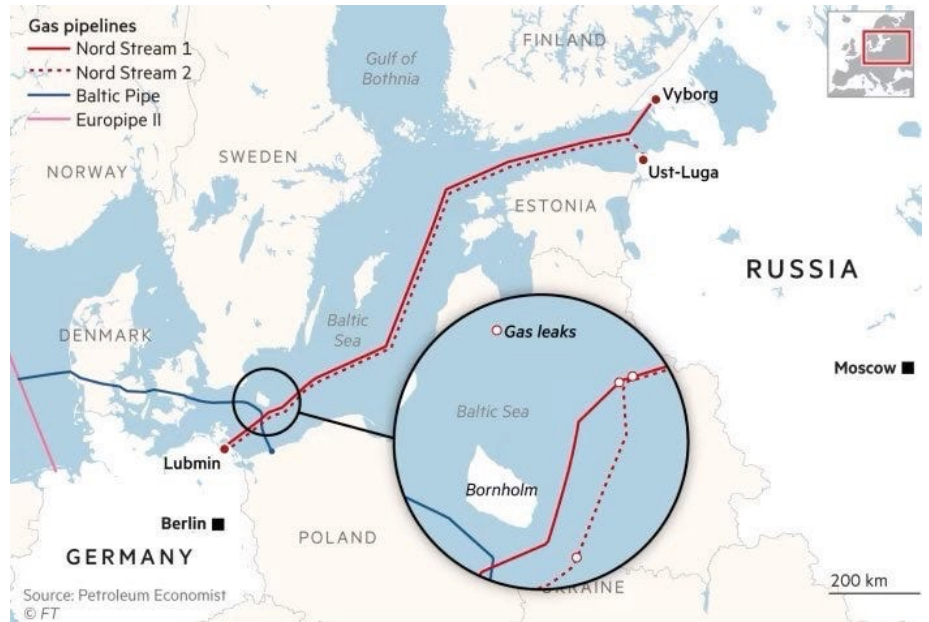
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a pipeline for some odd reason, but when both pipelines are impacted within minutes, we realized that this was not an accident but rather it was an act of sabotage. So the obvious question to ask is who benefits from the inability to transport natural gas to Germany? Immediately after the attack, Russia denied that they had anything to do with the explosions that badly damaged the pipelines. The second line (Nord Stream 2) had just completed its commissioning. With 55% of Germany's natural gas needs being imported from Russia, Europe is struggling to cobble together a path to getting through the next few winters using a combination of reduced energy use, substitution of Russian gas with liquefied natural gas (LNG) imports, and re-starting of coal and nuclear power facilities.

Late in October, the same day that unmanned naval drones attacked the Russian fleet near Crimea, Russia confronted a special unit of the British Navy that they bore responsibility for both the drone attack in Crimea and the Nord Stream pipeline sabotage four weeks earlier.

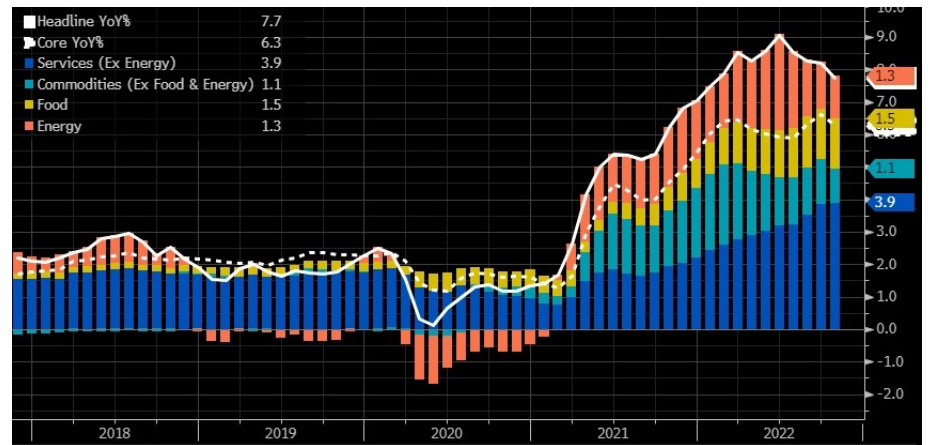
The U.K. denied that they had anything to do with the sabotage. Regardless of who is ultimately held responsible, the people of Europe are going to have a harsh winter with much higher heating and electricity costs.

- <https://www.nytimes.com/2022/10/06/world/europe/biden-armed-armed-nuclear-war-risk.html>
- <https://www.reuters.com/world/europe/russia-says-british-navy-personnel-blew-up-nord-stream-gas-pipelines-2022-10-29/>
- <https://thebulletin.org/2022/09/war-and-peace-imagining-a-way-from-one-to-the-other-in-ukraine/#post-heading>
- <https://www.aljazeera.com/news/2022/10/25/russia-tells-un-that-ukraine-is-preparing-to-use-a-dirty-bomb>
- <https://www.gisreportsonline.com/r/germany-gas/>



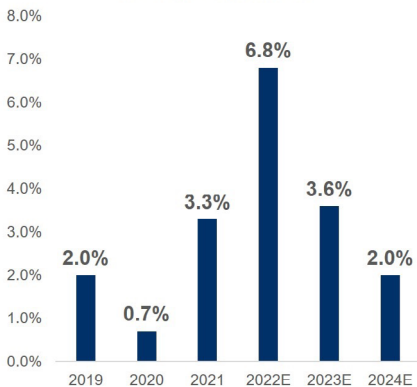
Source: Financial Times Maps

**Inflation: Moving into your basement, your fridge and the services economy**



Source: Bloomberg, November 24, 2022

**Headline Inflation**



Source: FactSet as of November 9th 2022

We had a couple members of our Portfolio Advisory Group into our offices recently for an update on equity and fixed income markets. The chart above was one of the most interesting ones in their presentation. It depicts the fact that Services inflation component (excluding energy) now accounts for 3.9% of the 7.7% headline U.S. inflation figure or a contribution of just over 50%. The largest component of services is rent (housing) which is remaining stubbornly high here in Canada. Rents in Toronto for a 2 bedroom house have increased 24% in a year to \$3,319 a month. Food inflation remains stubbornly high, with an current

rate of 1.5% or nearly 20% of the headline number. Every one of us knows the reality of much higher food prices and the stress it is putting on budgets. Visually, only commodity and energy inflation rates are on the decline, and this may be temporary given the under-investment of capital into both of these sectors over the last decade.

To the left is a bar chart of the historical and projection headline inflation figures for Canada. It will be very interesting to see if the headline inflation rate can actually decline back to 2% in the next 14 months. I follow the 2 and 3 year US Treasury bond yields closely which are in the 4.5% and

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4.3% range (as of November 22<sup>nd</sup>). In my opinion, these elevated rates are suggesting that inflation rates will likely not decline much lower than 4% over the next few years, given the fact that real interest yields (the nominal interest rate minus the inflation rate) have been predominantly negative over the course of the last 20 years.

[Average rent in Canada up nearly 12% year-over-year: report | CTV News](#)

<https://www.longtermtrends.net/real-interest-rate/>

[China thought to be stockpiling gold to cut greenback dependence - Nikkei Asia](#)

## Pandemic update

In many respects, most Americans and Canadians have returned to their pre-pandemic lives. People are travelling again, dining out, going to the movies (despite the dearth of good movies it seems), hanging out at the hockey or curling rinks, partying it up in Regina for the Grey Cup (which turned out to be an awesome nail biter game). More people seem to be getting the flu these days and there is a limited supply of cough and cold medications, especially for children. Kids are having an especially difficult time with colds and flus, which was likely aggravated by the lack of child doses of over-the-counter flu medicines.

Here in Alberta, our new Premier, Danielle Smith, used her first press conference to indicate that the government's position was that Covid-19 was to be treated as an endemic so no special measures are planned to prevent illness. She has indicated that the government has no intention of mandating mask use in public spaces or schools.

The level of Covid-19 boosters has been strongest in the senior segment of the population, but overall it the uptake is nowhere near the initial vaccine recommendations. In Quebec at the beginning of December, 12% of Quebecers had received their most recent booster shot (5 doses) while 88% had received the initial two doses which were required by most government and corporate mandates.

The number of Canadians getting their flu shot seems to be stubbornly low. At the end of November only 20% of Alberta had received a flu shot, which is down from 37% in 2020/21 which was the last year before the launch of the Covid-19 vaccinations. 2020/21 was the highest flu immunization rate in Alberta in the last 12 years.



Source: Bloomberg and Sprout Asset Management. Data as of 9/30/2022.

<https://vaccintrackerqc.ca/en/>

<https://www.cbc.ca/news/canada/calgary/low-flu-shot-rates-alberta-1.6664759>

<https://www.alberta.ca/influenza-the-flu.aspx>

Finally, the Government of Canada announced on October 1, 2022 that arrival into Canada by land, air or sea would not require any proof of vaccination or quarantine. The U.S. meanwhile, extended their vaccination requirements for entry into the U.S. by non U.S. citizens until at least January 8<sup>th</sup> 2023.

<https://www.cbc.ca/news/canada/edmonton/premier-danielle-smith-rules-out-mask-mandates-despite-widespread-school-illness-1.6651417#:~:text=Smith%20said%20the%20government%20is,times%20at%20Alberta's%20children's%20hospitals.>

<https://irshadgul.com/why-quebec-is-lagging-behind-in-covid-boosters-and-why-it-matters-ig-news/>

<https://www.msn.com/en-in/health/nutrition/pfizer-admits-it-did-not-know-its-covid-vaccine-prevented-transmission-of-virus-when-rollout-began/ar-AA12UVUUp>

<https://nypost.com/2021/04/02/cdc-walks-back-claim-that-vaccinated-people-cant-carry-covid/>

<https://www.canada.ca/en/public-health/news/2022/09/government-of-canada-to-remove-covid-19-border-and-travel-measures-effective-october-1.html#:~:text=Today%20the%20Government%20of%20Canada,%20effective%20October%201%2C%202022.>

## Investment observations

2022 (as of October 22, 2022) has been the worst year on record for US Treasury bond returns with losses in excess of 15%. The speed at which rates have increased in 2022 has caused a myriad of carnage in the debt universe. In the last 3 years, the percentage of Canadians with variable rate mortgages have increased from 20% to about 33%. The Bank of Canada recently reported that nearly 50% of variable rate mortgages had reached their "trigger rate" which is the point where additional payments may be needed.

As set out above, apart from holding US Dollars and a basket of commodities (anchored by energy commodities),

all other investment classes ended the quarter down double digits.

I had one of my RBC colleagues give me some data on the impact of the rise in variable rate mortgages so far in 2022. On a \$500,000 mortgage with a 25-year amortization period, the monthly payment has risen from \$2,203 a month at the end of 2021 to \$3,145 for a variable rate mortgage today, an increase of 43%. Assuming interest rates do not change, the total interest paid on the \$500,000 mortgage would increase from \$107,000 to \$443,000 due to the massive increase in the underlying variable rate from 1.60% to 5.75% in 11 short months.

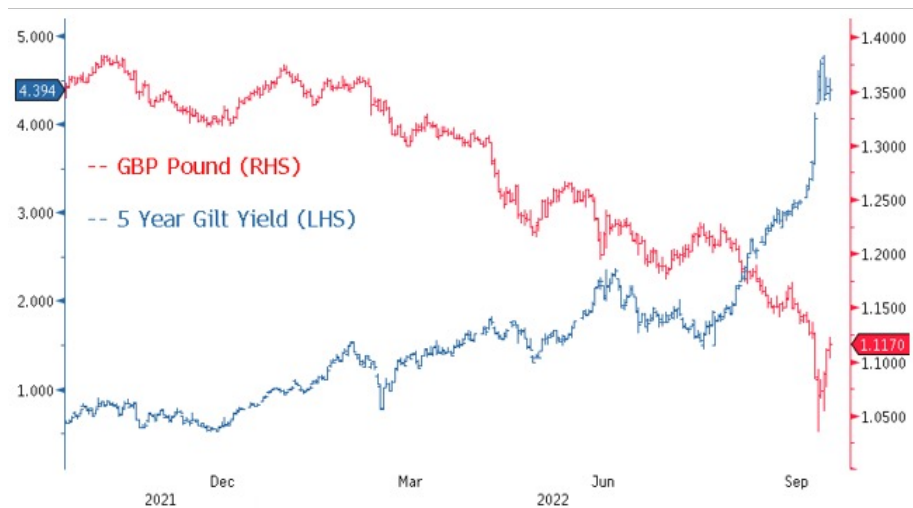
<https://financialpost.com/real-estate/mortgages/bank-of-canada-mortgage-variable-rate-trigger>

The U.K. was the epicentre recently of massive volatility in their government bond yields fueled by a serious liquidity problem incurred with their pension industry. With the recent trend of low long term government bond yields, pension funds who had long term liabilities were using leverage in which to bolster their fixed income returns, under a structured term as "liability-driven investment" or LDI for short. As long term government yields shot up as a response to the dramatic increase in short term rates by central banks, the pensions were forced to put up significant amounts of collateral. In a dramatic move, the Bank of England announced on September 28<sup>th</sup> that they would embark on a two week emergency purchase program for long dated U.K. government bonds to protect LDI funds from imminent collapse. As you can see in the graph below, U.K. 5 Year Gilt yields have risen from 0.60% to 4.50% this year, while the value of the GBP Pound has declined from US\$1.35 to US\$1.05, nearly a 30% depreciation of their currency.

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Source: Bloomberg and Sprout Asset Management.  
Data as of 10/1/2022

<https://www.bnnbloomberg.ca/the-uk-pension-problem-that-threatened-to-wreck-the-gilt-market-1.1824934>

<https://www.cbc.com/2022/10/10/bank-of-england-announces-liquidity-measures-to-help-ease-pension-fund-issues.html>

One of the developments associated with the Russia-Ukraine war has been a growing number of countries that have applied to join the BRICS Block (Brazil Russia India China and South Africa). They include Argentina, Iran (a major oil producer and Russia ally), Turkey, Egypt and perhaps most importantly Saudi Arabia whose intention to apply for membership was announced in late October. This is a very critical announcement given the fact that Saudi Arabia is the world's largest oil producer and essentially settles most of its oil sales in US dollars. Another development this year has been a significant purchase of gold bullion by eastern nations, with speculation that China is the largest purchaser. More gold bullion has been purchased by central banks in 2022 than in any year since 1967 according to the World Gold Council. As I noted a few commentaries ago, Russia did allow full convertibility of Russian roubles for their citizens into gold bullion back in March 2022. There has been discussion as to whether the BRICS Block will announce some kind of gold or commodities backed currency as an alternative currency for this Block to settle transactions in a currency other than the reserve US dollar currency.

<https://www.financialexpress.com/defence/brics-to-expand-soon-saudi-arabia-keen-to-join/2737102/>

[China thought to be stockpiling gold to cut greenback dependence - Nikkei Asia](#)

<https://www.usgoldbureau.com/news/is-brics-a-threat-to-the-dollar> (this reference was not in Draft 1)

I get a lot of commentaries from various investment firms every day it seems. One recent commentary came in from Robert Cohen who manages several precious metals funds for Dynamic Funds. Robert is what I call a straight-shooter, one who is quite willing to give his honest opinion, so here it is: "Long and short, if you double the money supply, you double the price level. You expand the money supply 30% over two years, prices will go up 30%. Killing the economy to "slow" inflation is causing more harm than good."

Here are a few charts that I clipped in the past few months that illustrate some of the market issues and changing trends.

So the 2.7 figure below implies nearly three 0.25% interest rate hikes by March 2023, which would bring the overnight rate of the Bank of Canada to 4.44%. Meanwhile the market is expecting US rates to move from the current 4.0% level to 5.0% by March 2023. Again, this does not necessarily mean that the central banks will stop raising interest rates once this level is achieved.

| Canada     |              |        | US         |              |        |
|------------|--------------|--------|------------|--------------|--------|
| Meeting    | Implied Rate | #Hikes | Meeting    | Implied Rate | #Hikes |
| 12/07/2022 | 4.09         | 1.3    | 12/14/2022 | 4.40         | 2.2    |
| 01/25/2023 | 4.27         | 2.0    | 02/01/2023 | 4.79         | 3.8    |
| 03/08/2023 | 4.44         | 2.7    | 03/22/2023 | 4.99         | 4.6    |
| 04/12/2023 | 4.43         | 2.7    | 05/03/2023 | 5.08         | 4.9    |
| 06/07/2023 | 4.47         | 2.8    | 06/14/2023 | 5.07         | 4.9    |
| 07/12/2023 | 4.42         | 2.7    | 07/26/2023 | 5.01         | 4.7    |
| Target:    | <b>3.75</b>  |        | Target:    | <b>4.00</b>  |        |
| Effective: | 3.76         |        | Effective: | 3.83         |        |

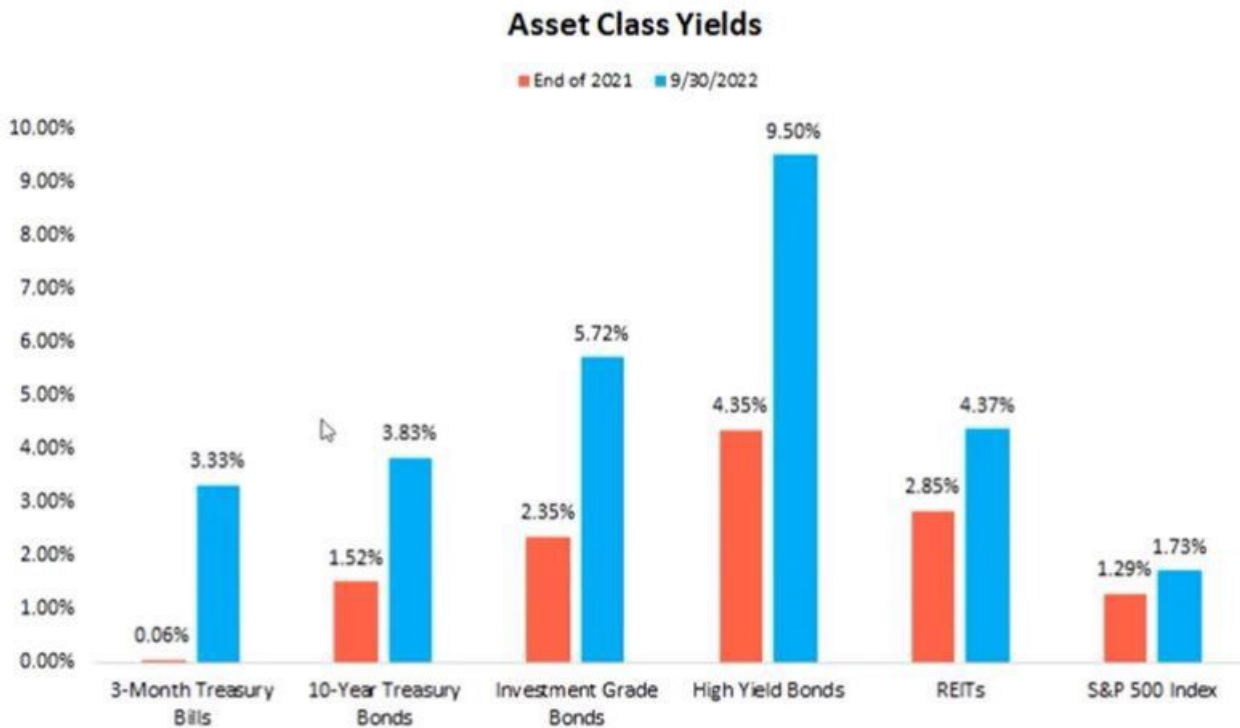
Source: Bloomberg

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The chart below, courtesy of Nathan Ma from Russell Investments, shows the various changes in yields of different asset classes from the end of 2021 to the end of Q3 2022. The investment grade bond segment (which has moved from 2.35% to 5.72%) looks attractive, especially compared to equities as depicted by the yield

on the S&P 500 (which increased from 1.29% to 1.73%). In other words, the investment grade bonds of the companies typical of the S&P 500 index now offer over 3 times the yield of the dividend yield of the same company.



Source: Chart courtesy of Nathan Ma, Russell Investments.

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## Notable quotes

“Let us prepare our minds as if we’d come to the very end of life. Let us postpone nothing. Let us balance life’s books each day. The one who puts the finishing touches on their life each day is never short of time.”

- Seneca the Younger (4 BCE to 65 CE)

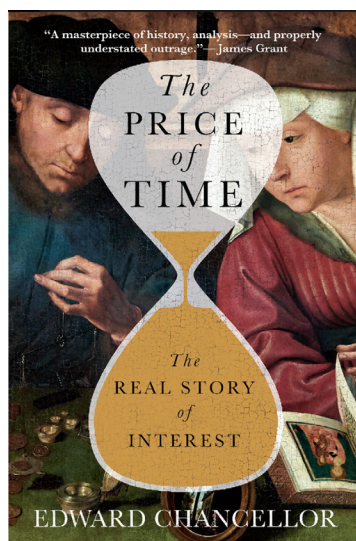
“I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth – one shred of evidence.”

- Paul Volcker  
Former U.S. Federal Reserve Chair

“Without freedom of thought there can be no such thing as wisdom; and no such thing as public liberty, without freedom of speech.”

- Benjamin Franklin

## Books I’ve recently finished reading



**The Price of Time: The Real Story of Interest**, by Edward Chancellor (2022)

(this is one of the Best financial books I have read in my career)

## Sector performance

Below is a table of the performance of various sectors for the 2022 Q3 results / Year-to-Date and three-year rolling periods.

| Investment index   | Q3 2022 return | Year to Date 2022 return | 3-year compound return |
|--|----------------|--------------------------|------------------------|
| S&P/ TSX composite index                                 | -1.4%          | -11.4%                   | 6.6%                   |
| S&P 500 (C\$)  | 2.2%           | -16.7%                   | 9.7%                   |
| NASDAQ comp (C\$)  | 3.0%           | -26.0%                   | 11.4%                  |
| Short-term comp bond index                               | -0.3%          | -4.7%                    | -0.1%                  |
| iShares U.S. High Yield Bond Index ETF (XHY, C\$ Hedged) | -1.1%          | -15.0%                   | -2.3%                  |
| US\$ / C\$   | 7.4%           | 9.4%                     | 1.5%                   |
| Gold bullion (C\$)                                       | -0.9%          | -0.3%                    | 8.1%                   |
| Global gold mining index (XGD – C\$)                     | -7.1%          | -15.9%                   | 2.1%                   |

Source: RBC Capital Markets Quantitative Research, Benchmarks, Monthly – Sept 2022. Oct 4, 2022.



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