Wealth Management
Dominion Securities

2022 Q2 commentary

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Rough road ahead

Jon Mitchell, Portfolio Manager

The wall on which the prophets wrote
Is cracking at the seams.
Upon the instruments of death
The sunlight brightly gleams.
When every man is torn apart
With nightmares and with dreams,
Will no one lay the laurel wreath
When silence drowns the screams.

Confusion will be my epitaph.
As I crawl a cracked and broken path
If we make it we can all sit back
And laugh.
But I fear tomorrow I'll be crying,
Yes I fear tomorrow I'll be crying.

Between the iron gates of fate,
The seeds of time were sown,
And watered by the deeds of those
Who know and who are known;
Knowledge is a deadly friend
If no one sets the rules.
The fate of all mankind I see
Is in the hands of fools.

"Epitaph" by King Crimson (from the 1969 album In the Court of the Crimson King).

When you look at the table of performance that I always place at the end of the commentary, a more fitting tune could have been "Nowhere to run to baby, Nowhere to hide," by Martha and the Vandellas. When I looked through the lyrics, however, I realized that it was more of a love song than a tragedy, which may be more close to what we are living through these days.

I have always admired the scathing lyrics and searing guitar solos of "Epitaph" with special emphasis on the lyrics, "The fate of all mankind I see is in the hands of fools."

Prime Minister Boris Johnson lasted about 10 days after joking with Prime Minister Trudeau that the G7 leaders should not only take off their jackets and get down to business, but that they should "show them our pecs," while Trudeau mentioned "bare-chested horseback riding" (in reference to the famous photograph of Russia's president, Vladimir Putin, riding a horse bare-chested).[1]

Also, despite having more than 400 economists working at the U.S. Federal Reserve, the best advice they could give the world late last year was that inflation was "transitory" and used this as their primary reason for not raising interest rates from 0.25% until March 16, 2022.[2] It is possible that rates will be 2.50% by July 27, 2023, or 10 times the level from the beginning of the year.

Meanwhile, we had seen one of the worst half-year performances to both stock and bond markets in decades after a relatively unremarkable first quarter. Inflation is seemingly spiralling out of control with the latest U.S. print at 9.1% for the year ended June 30, 2022. This means that the "real interest rate" (nominal yield less inflation) is somewhere around minus 7%, give or take a percentage point. Fed Reserve Chairman Jerome Powell inherited more than a half dozen years of negative real interest rates. Are we resigned to continuing with many more years of negative real rates? In a recent article by Rob Arnott,[3] Chair Powell faces the same

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problem as Iain MacDougall, lost in the Scottish countryside. MacDougall asks a local, "How do I gae to Dundee?" The local replies, "Well, I would nae start from here."

The current narrative around inflation is that the Central Banks can simply raise interest rates steadily and then inflation will undoubtedly subside. However, the major elements in the U.S. Consumer Price index are Housing (42%), Transportation (15%) and Food and Beverages (15%).[4] Instead of actually using housing prices as the marker for inflation, the U.S. Bureau of Labor Statistics uses a homeowner's equivalent rent.[4]

In the last two years ended March 31, 2022, U.S. home prices have increased by 37% while the owners' equivalent rent is up only 7.3%.[5] This is supported by a recent article stating that rents in the Greater Toronto Area (GTA) rose by "the fastest pace on record" where the year-over-year increase was over 16%.[6] Does anyone see a noticeable decrease in either food prices or energy prices? Anyone?? So, if housing (rent) costs are increasing and food and energy prices remain stubbornly high, inflation may be higher for longer despite the steady or abrupt increases to short term interest rates.

Energy becoming a weapon

In the heart of Europe, the most powerful European nation is in the midst of an epic battle to keep the lights on. Before the start of Russia's invasion of Ukraine, about 55% of Germany's natural gas was imported from Russia.[7]

Natural gas is not only used to generate electricity, like much of Alberta's electricity but, equally as important, natural gas is a feedstock for the great German industrial complex.[7] Companies like BASF use huge volumes of natural gas to produce specialty chemicals and consume significant amounts just in the energy used in the manufacturing and pharmaceutical industries.[8] The EU has already agreed to a 15% reduction in natural gas use.[9]

Meanwhile the price of natural gas in Europe remains at an extreme level, nearly 10 times the level of January 2021,[10] which will put pressure on the prices of the products using natural gas feedstocks. We are starting to see countries like the U.K. and Germany announce significant programs to their citizens to try and defray the burden of excessively high electricity and energy costs.[11]

Greenflation takes a breather

Greenflation is the term coined for the added inflationary costs associated with the transition from non-renewable energy sources (primary coal, oil and gas) to renewable energy sources (primarily wind and solar). This transition requires vast amount of base metals such as lithium, copper, nickel and cobalt, to name a few of the key building components for renewable energy systems. Like oil and gas exploration, capital expenditures in the base metals has been underwhelming in the last decade. This means that additional supply is lacking at a time when demand increases.[12]

Germany, as the nation that has spent \$300 billion euros on building out its renewable energy system in the past 20 years[13] is now faced with the grim possibility of rationing natural gas and being forced to restart some of its coal and oil burning plants to generate electricity.[14] In reality, it is much cheaper to burn oil at current prices (US\$94/barrel Brent) than Euro-priced natural gas (estimated US\$58/mcf), which is about eight times higher than the North American price.[15] As well, oil is much easier to transport in tankers and pipelines than liquid natural gas, which requires complex port facilities.[16] It may take years for Europe to find alternative sources to Russian oil and natural gas so the renewables transition could also be set back for a period of years. A recent report from the International Energy Association (IEA) cited "soaring oil use for power generation and gas-to-oil switching are boosting [oil] demand."[15]

Conflict update

Russian forces invaded Ukraine nearly six months ago. It appears that Russia has largely re-taken control of the two disputed provinces (Donetsk and Luhansk), and consolidated most of the southern coast, with the exception of Odessa, which is the primary sea terminal for Ukrainian grain and commodity exports. However, with the financial and military aid from many NATO countries (with the U.S. leading in this support), Ukraine has been trying to launch some significant counteroffensives. This Financial Times map gives you some perspective on where the forces are, about six months into the conflict.[17]

It is very difficult to gauge how long the conflict will last and what will be the critical elements that may push the parties to try and arrange a cease fire or settlement to the conflict. The spectre of a winter with rolling blackouts and potential shutdown of European industries due to lack of Russian gas is a real factor as is the possibility of notable Ukrainian counter offensives.

Pandemic update

As we begin to try and resume our lives, after over two years of disruption from both the virus and the federal and provincial government's response, I would make the following comments:

The level of restrictions vary depending on where you live, or who you work for and not because the virus is different in various geographic regions. Even within the federal government, only the military and the RCMP have not allowed their unvaccinated staff to return to work, while most provincial and large municipal police forces have reversed their policies for mandatory vaccination.[18]

All Canadians, whether vaccinated or not, were allowed to board an airplane or train for a domestic trip within Canada starting on June 29, 2022.[19] Major events – such as outdoor concerts, sporting events, large civic events like the Canadian National Exhibition and the Calgary Stampede – were attended by large crowds, on the whole.

The number of Canadians who have experienced the virus first hand is quite high as well. A study by the British Columbia Centre for Disease Control – that analyzed thousands of blood samples in the Lower Mainland throughout the pandemic – estimated that, of the population between age 10 to 40, nearly 60% have been infected with COVID-19, and just under 50% between the age of 40 and 60.[20] This could explain the willingness of many Canadians to return to pre-pandemic activities, while also explaining why the seniors among us are still cautious of too much activity with younger generations.

Public Health Ontario recently announced the Ontario COVID-19 Science Advisory Table and its working groups would be dissolved as of September 6, 2022.[21] Meanwhile the U.S. Center for Disease Control recently updated their guidelines, effectively making no differentiation in measures for whether an individual was vaccinated or unvaccinated in terms of quarantining or testing.[22]

Investment observations

While it is not officially a recession, which is often denoted by two consecutive negative quarters of GDP, in a lot of ways it feels like we are in a recession. Toronto real estate prices have dropped 15% from their peak prices already, while mortgage rates are likely headed higher with the market pricing in another 1.25% to 1.50% of interest rate increases by the Bank of Canada following the latest 0.75% increase on September 7, 2022.[23]

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Canadians are borrowing more on their credit cards and lines of credit in order to pay for higher food, energy and most other components of spending.[24] Canadians are also being pulled in different directions. With asset prices falling (real estate, equity markets), the natural response is to delay purchases with the expectation that if one waits three to six months, the prices may be lower still than today. However, with some consumer goods such as food, building supplies or appliances, there may be a tendency to buy today if one believes that the trend of rising prices is going to remain in place.

The last two years were a very different experience depending on who you worked for, outside of hiring by the federal and provincial governments, while few new jobs were created in the public sector. I have a chart of the percentage growth in jobs in these two sectors in the next segment.

Only energy, some industrials and technology, consumer staples, and utilities sectors have managed to show a positive return in 2022 so far this year. The U.S. dollar has also gained ground on the Canadian dollar and most other major currencies this year.[25]

We are seeing some reasonable levels in Guaranteed Investment Certificates (GICs), which are at the highest level since 2006, corporate bonds and preferred shares. With good quality fixed income rates yielding between 4% and 5%, this is historically a decent entry level.

We remain constructive on sectors that are experiencing higher prices such as the energy, fertilizer and uranium commodities. Sometimes just avoiding the high flyers whose share prices plummet after soaring to close to the sun feels a bit like a win in evaluating one's portfolio.

2022 will go down as one of the toughest years for both equity and fixed income managers alike.

Given the concerns that we are hearing from a number of clients, I thought it would be useful to add a few tried and tested investment axioms:

- Do not use a short time frame to define success or failure (this is true of life as well). Investing is a marathon not a 100 yard dash.
- Quell your emotions before making investment decisions.
- Invest in quality (sort of like location in real estate).
- Be fearful when others are greedy, and greedy when others are fearful (Warren Buffet)

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

So stay strapped in and hang on for the ride in 2022. Good businesses will figure inflation out just as they had to adapt to what happened during the COVID-19 era. The cream always rises to the top!

So 1.8 figure below implies two 0.25% interest rate hikes by December 2022, which would bring the overnight rate of the Bank of Canada to 3.75% with about an 80% probability that the full 0.50% increase will occur on the October 26, 2022, meeting. Again, this does not necessarily mean that the Bank of Canada will stop raising interest rates once this level is achieved.

Current Implied Government Overnight Rates

Canada			US		
Meeting	Implied Rate	#Hikes	Meeting	Implied Rate	#Hikes
10/26/2022	3.66	1.7	09/21/2022	3.04	2.8
12/07/2022	3.79	2.2	11/02/2022	3.54	4.8
01/25/2023	3.77	2.1	12/14/2022	3.78	5.8
03/08/2023	3.86	2.4	02/01/2023	3.86	6.1
04/12/2023	3.76	2.1	03/22/2023	3.88	6.2
06/07/2023	3.70	1.8	05/03/2023	3.85	6.1
Target:	**3.25**		Target:	**2.50**	
Effective:	2.50		Effective:	2.33	

Source: Bloomberg

www.fraserinstitute.org/file/comparing-government-private-sector-job-growth-covid-era-infographicjpg

Resisting Medical Tyranny, by Professor Francis A. Boyle (2022)

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)

Notable quotes

"Markets are never wrong – opinions often are."

- Jesse Livermore

"The first panacea for a mismanaged nation is inflation of the currency, the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."

- Ernest Hemingway

"All tyranny needs to gain a foothold is for people of good conscious to remain silent."

- Thomas Jefferson

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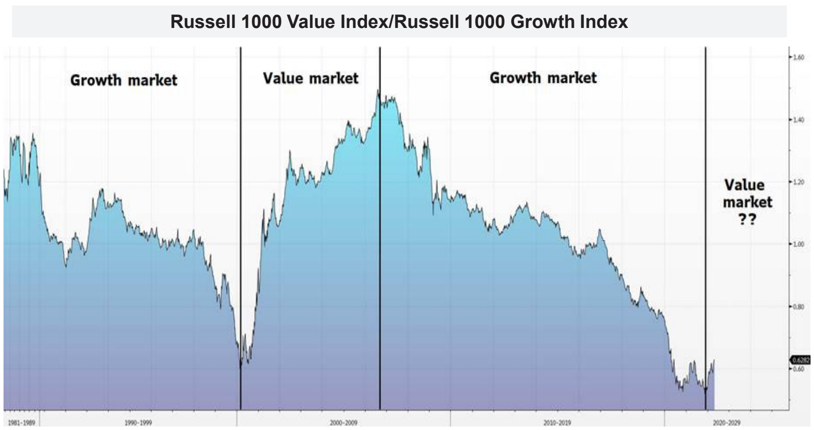
Rotation: early innings

Canoe FINANCIAL

Are value strategies beginning to assert themselves again ?



Source: Bloomberg, as of 05/06/2022.

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Energy sector representation

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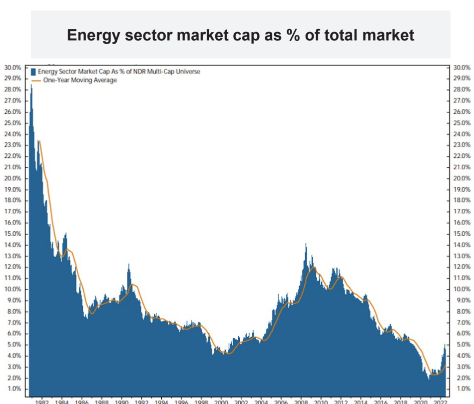
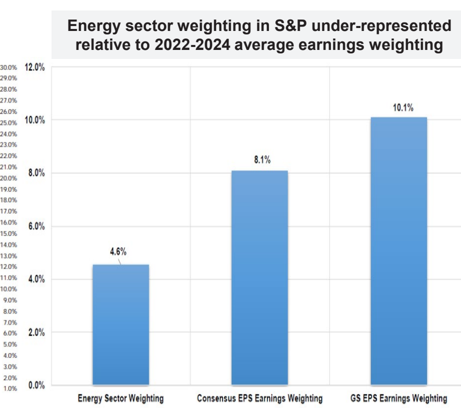
The S&P energy sector represents only 4 % of the market index by capitalization but contributes at least 8 % of the total earnings of the index.





Source: Ned Davis Research, as of 06/23/2022, Goldman Sachs, as of 06/01/2022.

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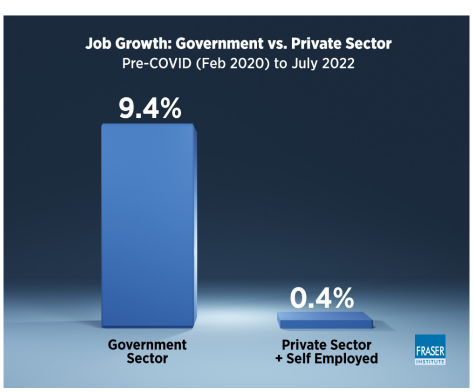

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Team updates

- Here in Alberta, we are generally back to normal with the office life, as most staff are working at least four days in the office out of five.
- We continue to use Webex for our client meetings as an option. Our clients are getting pretty adept with the e-signature forms that James and Pauline are using.
- Jon (and family) got a short trip to Ottawa this August, where he had a tour of the Royal Canadian Mint and took in a sights and sound show on Parliament Hill. He spent much of the summer weekends in and around Unity, SK, with his farm and rancher friends. He went through some minor surgery in North Battleford in late August but is recovering steadily.
- James and Nicole were married this summer and incorporated traditional Korean elements into the ceremony.
- Pauline is planning on a short driving holiday in September with hubby Frank.
- As always, we are open to speaking to any of your friends that may benefit from a second opinion on their investments or current wealth plan.
- 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, stay safe and take care. We have a lot to be thankful for, living in Canada. Do your best to enjoy the positive moments each day, and please support your local businesses whenever you can.

Investment index	Q2 2022 return	Year to Date 2022 return	3-year compound return
S&P/ TSX composite index	-13.2 %	-9.9 %	8.0 %
S&P 500 (C$)	-13.6 %	-18.5 %	10.0 %
NASDAQ comp (C$)	-20.1 %	-28.2 %	10.6 %
Short-term comp bond index	-1.5 %	-4.4 %	0.0 %
iShares U.S. High Yield Bond Index ETF (XHY, C$ Hedged)	-10.0 %	-14.0 %	-1.6 %
US$ / C$	3.0 %	1.9 %	-0.6 %
Gold bullion (C$)	-4.5 %	0.9 %	8.1 %
Global gold mining index (XGD – C$)	-24.5 %	-9.5 %	6.9 %

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