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Markets Made Simple

Wealth Management
Dominion Securities

FOURTH QUARTER REPORT – DECEMBER 31ST, 2021

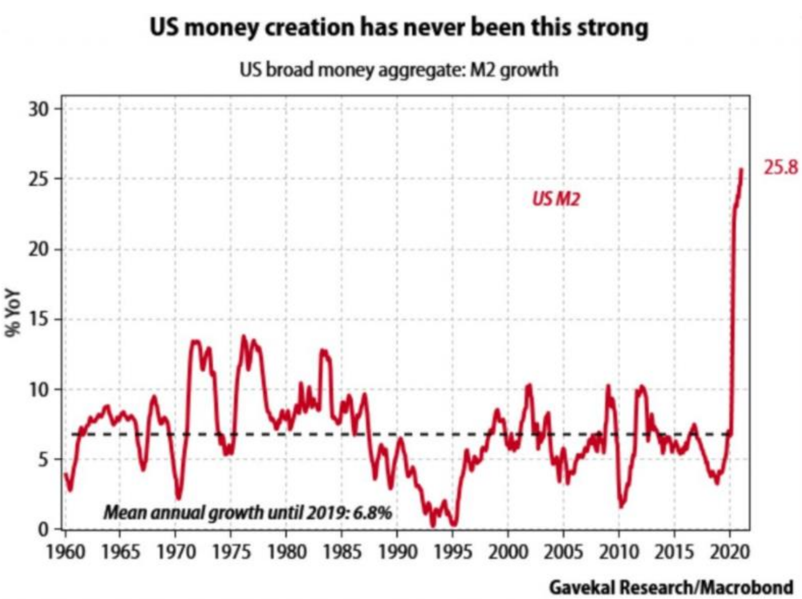
Canada has borrowed more money under our current Prime Minister than all previous Prime Ministers of this country in the last 154 years… combined.

SUPER SIZE ME

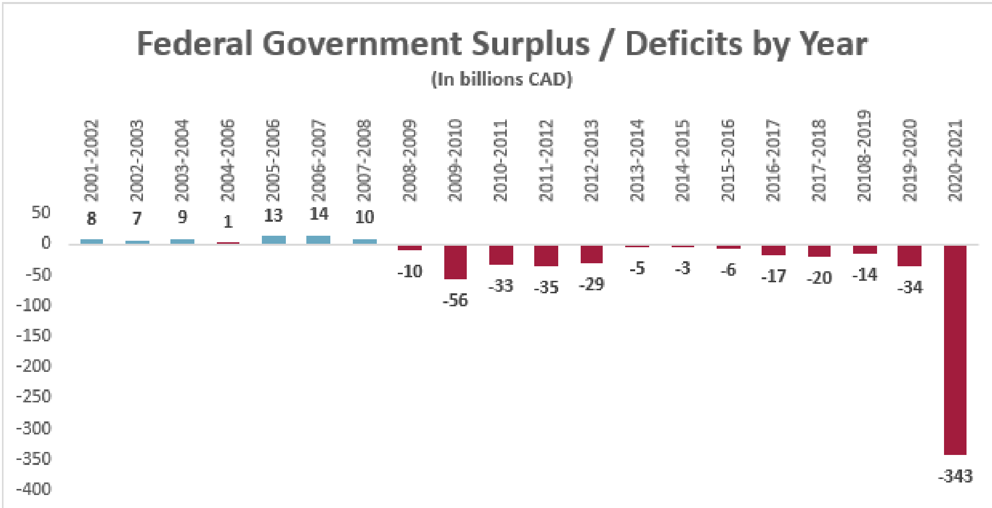
McDonald's. As a kid just thinking about it made my mouth water. It was my favourite restaurant. Ingrained in my DNA. When a baby turtle hatches on the beach, its animal instinct is to make a run for the water. Predators are everywhere and seconds mean the difference between life and death. My animal instinct was drawing me to McDonald's. If you had asked me to choose between a top international Michelin Star restaurant and McDonald's, I would have chosen McDonald's, every time.

When the movie 'Super Size Me' came out about eating only McDonald's, it sounded like a fantasy to the kid in me. Morgan Spurlock decides to indulge in the fantasy I had when I was 10. His Super Size diet consisted of over 5000 calories a day and it doesn't take long for side effects to show up. He gains 24 pounds in 30 days, his cholesterol skyrockets, and even manages to accumulate fat in his liver. His doctor urges him to stop, telling him he is like an alcoholic drinking himself to death.

Governments and central banks have our economy on the Super Size diet. US money supply grew by 40% from February 2020 to December 2021. Never in US history had the money supply grown so quickly. Thirty cents out of every dollar in circulation has been created in less than 2 years.



Governments have also handed out massive amounts of money. *For every $1 dollar lost during the pandemic, our government gave out $20 in 2020*[1]*. Canada has borrowed more money under our current Prime Minister than all previous Prime Ministers of this country in the last 154 years… combined.* The independent Parliamentary Budget Office predicted our deficits will last until 2070, the time our current high school students are retiring.

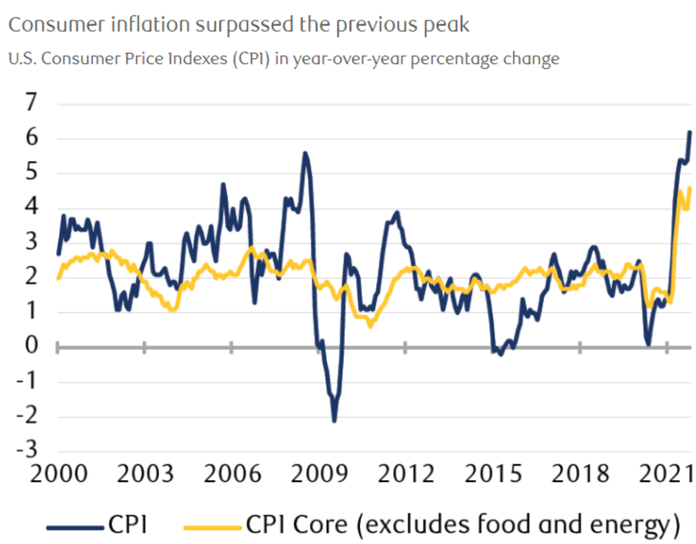


Source: Department of Finance, Canada

Short-Term Side Effects

Being on a 5000 calorie a day diet will have short and long-term side effects. The short-term side effects from our economic diet are already showing up. Every day I walk past the same Falafel shop. In early 2021, their daily special, a Falafel, pop and side was $9.99. It increased to $10.99. Then again to $11.99. And now to $12.49, increasing 25% in a year. From gas, groceries, houses, and rents, everything is increasing. Since the start of the pandemic, the average house price in Abbotsford increased from $800,000 to $1.2 million, gas prices from $1.20/litre to $1.70/litre, and the Tuna Poke Bowl from Cactus Club, my favorite dish (which I would highly recommend), from $19.50 to over $23.

The Consumer Price Index (CPI) measures the average cost of living. It includes things such as food, housing, clothing and transportation. In November, it rose to 6.8%, the highest yearly increase since 1982, when the world was dancing to Michael Jackson's 'Thriller'.



Source - RBC Wealth Management, Bloomberg; monthly data through 10/31/21

[1] https://www.bnnbloomberg.ca/trudeau-s-debt-binge-shows-limits-in-canada-s-sharp-contraction-1.1571174

Producers are seeing the prices they pay increase even more, rising 12.5% over the past year, the largest yearly increase since 1980. Inflation is at the highest level in over 40 years and it happening all around us. It is no surprise that the massive increases in money supply and government deficits are pushing prices higher everywhere and in everything.

Where Are All the Workers?

The biggest challenge for companies are finding qualified workers. From entry-level to highly specialized positions, from farm workers to marketing executives, we have millions of unfilled jobs and no one to fill them. At the start of October 2021, Canada had a record 1 million[2] unfilled positions while the US had 11 million[3]. This is the tightest job market since 1950.

One of my clients is hiring for their company. They had 45 applications for a position a few years ago. For the same position recently, they had one.

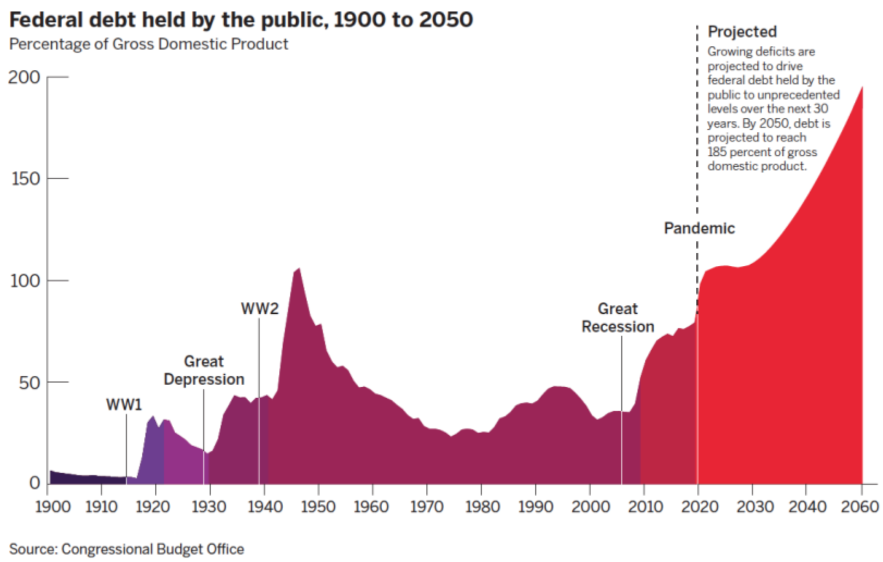
As companies compete to find workers, they are having to increase wages and incentives. Ascension Health Alliance is offering a $100,000 signing bonus, Raytheon Technologies is offering $50,000, and Banfield Pet Hospital is offering $60,000.

Labour costs account for up to 70% of a company's total costs. As labour costs skyrocket, businesses have to raise prices to maintain profit margins. This leads to even more inflation.

The short-term side effects of our Super Size diet have been a roaring economy, with the US GDP growing at the fastest rate since 1984[4], inflation at the highest levels since 1982, and the tightest job markets since 1950. Just like Morgan gaining 24 pounds in 30 days, some side effects showed right away and others later on. If he maintained his McDonald's diet over time, it would lead to narrowing and hardening of his arteries causing high blood pressure, heart disease, diabetes, and quite possibly cutting his life short. The long-term effects from our economic binge have not yet been fully realized.

World War II and Deja-Vu

At the end of World War II in 1945, interest rates climbed from 0.375%, to 20% in 1981. Interest rates rising to 20% didn't just happen overnight, the factors that lead to them started 40 years prior, from World War II. World War II started in 1939 and ended in 1945. The war was costly and to finance it, governments borrowed record amounts of money. The US Government Federal Debt to GDP ratio hit a high of 106% in 1946. Essentially borrowing more than the economy was producing. The US again is borrowing the same amounts relative to GDP and projections are expected to go considerably higher than the records set in 1945.



[2] https://www150.statcan.gc.ca/n1/daily-quotidien/211220/dq211220a-eng.htm
[3] https://www.thebalance.com/current-u-s-unemployment-rate-statistics-and-news-3305733
[4] https://www.macrotrends.net/countries/USA/united-states/gdp-growth-rate, https://economics.td.com/ca-quarterly-economic-forecast

During the war, 1/3 of the entire economy was producing items for the war. When the war ended in 1945, government officials were worried. The war was done and with millions of soldiers returning home, how would the economy have enough work to support everyone? To help stimulate the economy, the US Federal Reserve held interest rates artificially low at 0.375%. Interest rates today are 0.25%.

At the start of the war in 1939, the unemployment rate was at 14.6% and fell to an all-time record low of 1.2% in 1945. When the war ended, tremendous amounts of pent-up demand that was built up during the war was unleashed as soldiers came home, started families, bought new houses, filled those houses with new appliances and furniture, and then new vehicles to go along with everything else. The economy easily transitioned from the jobs needed for war, to jobs needed for the economy. The labour shortage continued after the war ended, pushing wages higher, and caused inflation to reach 20% two years after the war. Today there is massive pent-up demand from being stuck at home, and our bank accounts are flush with cash from governments and savings during the pandemic. We are ready to spend. And similar to labour shortages after the war, we have the same labour shortages today.

Our economic climate today is looking very similar to the 1940's.

Long-Term Side Effects

The long-term side effects from World War II lasted for over 35 years and came to an end in 1981. After Morgan gained 24 pounds, he had to lose it. What took a month to gain, took 14 months of dieting and exercise to lose. I think most of us can relate. It is always a lot easier to gain weight than lose it. An extreme in one direction requires an extreme reaction in the opposite direction to achieve equilibrium. The long-term effects from World War II included soaring wages, 20% interest rates, and out of control inflation. Paul Volcker, the US Federal Reserve chairmen had to raise interest rates to 20% in 1981 to put the economy on a painful diet to gain control of inflation that threatened economic growth. He was successful in stopping inflation and bringing the economy back to equilibrium that paved the way for a new cycle, one of falling interest rates and low inflation. We have benefited from the stable economic growth from this new cycle over the past 40 years.

Inflation and Investing

With prices soaring around us and our cash being worth less every day, how can investors protect themselves? Investors that left funds in cash last year saw it lose 7% to inflation. And if you are on the Falafel diet, your cash is worth 25% less. After World War II, investors who left their money in cash saw it lose 25% after 5 years, 33% after 10 years and 80% after 40 years. Losing 80% of your money in 40 years would harm even the best laid out retirement plans. Investors today can either protect their money or leave it in cash and have inflation slowly eat away at it.

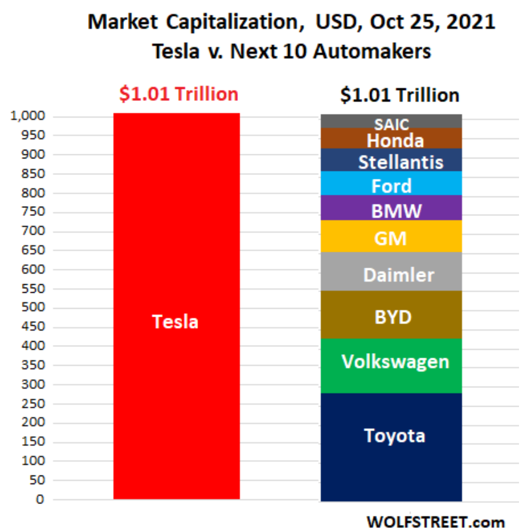
Increasing costs of living are one of the biggest risks to investors. Having a steady income stream that grows with and above inflation is one of the best ways to protect yourself. Just like a rental property, as the cost of living goes up, rents also go up offsetting increasing living costs. In the businesses we own, they have historically grown their dividends and cash flows at twice the rate of inflation. As the cost of living increases, so does the cash flows these businesses generate, protecting investors from the rising costs around them. In the last 90 years, dividends have accounted for close to ½ of the total returns of the markets. We are focusing on finding the best value in companies around the world, with strong and increasing cash flows and dividends that we can buy at prices below their intrinsic value.

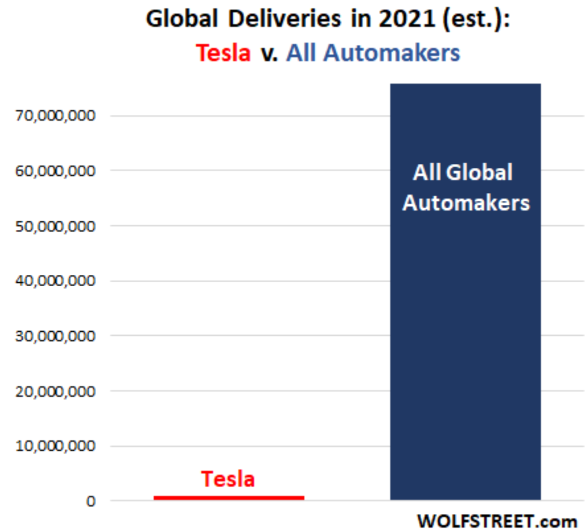
Opportunities Today

What are the best opportunities for investors today? For patient investors, the opportunities are plentiful. The average investor has lost patience and wants to make the highest return as quickly as possible. Investors' attention spans have substantially decreased. Who wants to wait a few years for a return when they can make 20% in a week with Bitcoin? As investor's attention spans have decreased, so has the time they hold onto their investments. In 1960 the average time an investor held a stock was 8 years[5], today that time frame has shrunk by 95%, to less than 5 months. Investors are speculating on short-term increases in price. The wealthiest individuals and investors in the world achieved their success by patiently growing and compounding their businesses over years and decades, not days or months. This has led to tremendous

[5] https://www.visualcapitalist.com/the-decline-of-long-term-investing

opportunities as many investors are more interested in the most exciting, sexiest and fastest growing names. Tesla is one of those companies. It is now the 4th largest company in the United States, worth over a trillion dollars. Tesla is worth more than the top 10 car companies in the world, combined. Tesla sells 900,000 car a year. The other top 10 car companies in the world sell 75,000,000[6]. If you had the choice to own a company that sells 75 million cars a year, or one that sells less than a million, a company that sells close to 99% of all cars, or one that sells 1%, for the same price, which would you choose?





As investors have been chasing these stocks and paying increasingly higher valuations for them, parts of the market have been pushed to extremes. Investors have ignored the incredibly good value, 'boring' names. Names we own such as Kimberly Clark that produce Kleenex or Telus that many of us use for our cell phone or internet services. Similar to how investors can either own Tesla or the entire car universe, many investors today have chosen to own the 'Tesla's' of the market.

The kid version of me would love to try the Super Size diet. The adult version gets queasy just thinking about it. Kids don't realize the consequences. As an adult, I do now. I remember being super excited to grow up. I could eat whatever I wanted, whenever I wanted, go to bed anytime I chose, and play video games all day long. Living out this fantasy as an adult I know I would be 400 pounds and unemployed. As our economic climate has drastically changed, investors need to adapt to protect what they have and to reach their long-term goals. Many investors have not made any change to their portfolio to reflect this new economic landscape. They own bonds that pay nothing and lose value as rates go higher, are exposed to companies with some of the highest valuations since the tech bubble in 2000, and have very little protection against inflation. We understand the consequences of our economic binge and how to properly position clients over the next 5, 10, 15 years, to protect and grow their capital, while finding opportunities as they arise. In 2020, that was buying more equities when markets fell by 30%, in 2021 that included global real estate at the start of the year which ended up 32% for the year, and in 2022 that is continuing to be overweight to Canadian and International markets which have the best value in today's markets. We continue to watch the economic environment, interest rates, and other economic indicators to make sure we are properly positioned now and for the future. If you had any questions on your portfolio, please don't hesitate to let us know.

-Kind regards,

Joshua Brown, CFA
Portfolio Manager

[6] https://wolfstreet.com/2021/10/26/teslas-market-cap-gigantic-v-next-10-automakers-v-teslas-global-market-share-minuscule/