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Markets Made Simple

Wealth Management
Dominion Securities

FIRST QUARTER REPORT – MARCH 31ST, 2022

On January 1st 2021, the 5 Year Government of Canada bond rate was 0.4%. Less than a year and half later on March 31st, 2022 it was 2.49%, an increase of over 500%.

THE WINDS OF CHANGE

I hate the cold. I am just not built for it. The 'harsh' Vancouver wet winters are enough for me. When I go to Canuck games I suit up with wool socks, extra layers of marina wool, winter gloves and I'm still frozen during the game. I get back home feeling like I survived an Artic expedition. My unprofessional medical diagnostic, I am allergic to the cold.

Northern Canada is a place I would love to visit but not when temperatures drop to -40°C during the winter. 150 years ago only the bravest attempted to journey there. There were no roads, maps, or trails. It was a treacherous trip that cost many their lives.

People flocked from all over the world to British Columbia in the 1800's in search of a better life with big dreams of striking it rich and finding gold. Two rough, tested, and bonded friends, Scotty and Cass were among those. They ventured deep into Northern BC with no idea of what was out there. They found a magical place of untouched beauty that they never imagined. They also stumbled upon a massive gold find, with gold nuggets, some the size of hazelnuts laying in just a few feet beneath gravel and bedrock. Excitement overtook them and in over a month they found 60 pounds of gold worth over $2.3 million dollars today. And close-by was the mother lode…they had just scratched the surface.

In their excitement they didn't notice the subtle changes around them, the days growing shorter, the weather getting colder, and the trees changing colors. Winter was coming but their minds were on the gold.

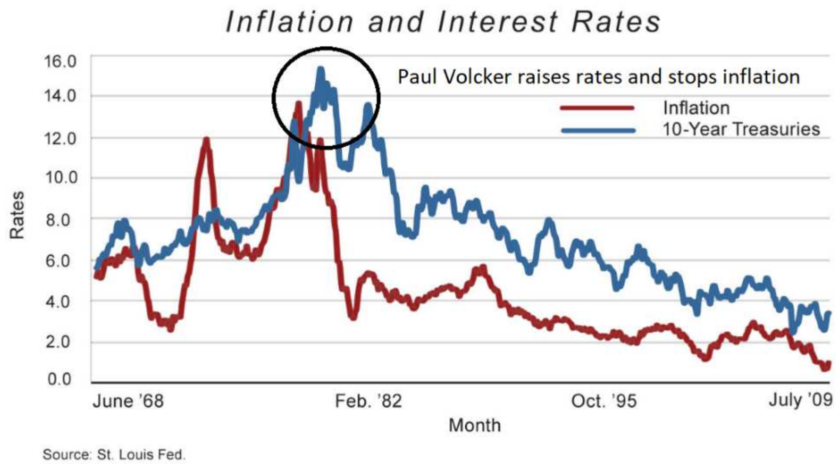
And just like Scotty and Cass, many investors today haven't been noticing the subtle shifting economic landscape around them.

The Winds of Change

1980 was a turning point in history. Inflation was out of control. It rose from 2% in the 60's, to 12% in 70's, to 14% in 80's. Getting inflation under control was not going to be easy. It was a big task that needed someone big. Meet Paul Volcker, the 6 foot, 7 inch giant from New Jersey who hated inflation. When he started college his mother provided him with an allowance of $25 a month. The problem was, just like today, everything was going up in price but his mother would not acknowledge inflation. He received the same allowance when he started college until he finished, and each month he could afford less.

Paul became the Chairman of the Federal Reserve in 1979 and vowed to stop the inflation that ruined his college years. As Paul stepped into his new office, inflation was 11% and interest rates were 10.5%. Seven months later Paul raised interest rates to 20%, putting the economy into a severe recession. Auto dealers mailed him the keys of the cars they couldn't sell, house builders sent him 2X4's of the houses that stood empty, and farmers on tractors circled the Federal Reserve calling for his head.

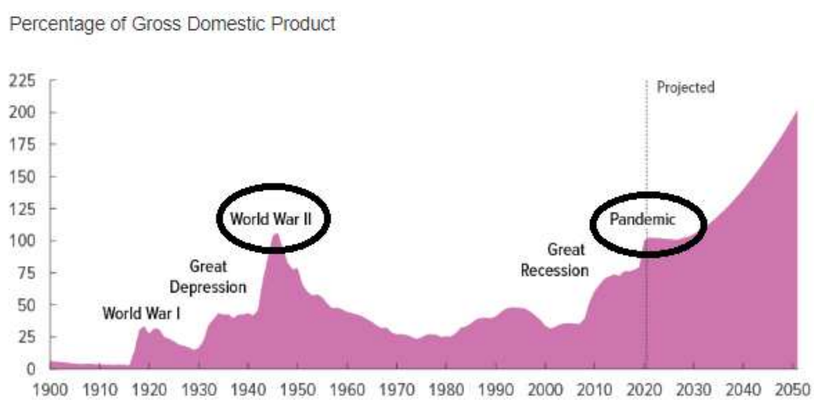
But Paul was successful in stopping inflation. After administrating his painful medicine to the economy, by 1983 inflation fell back to 3%. Thanks to Paul, the US then enjoyed 40 years of stable prices, leading to strong economic growth and prosperity for generations to come.



Time and time again history has shown us that rapid increases in money supply + large government deficits = inflation. To finance World War II, 35 years before Paul took office, governments ran high government deficits and central banks kept interest rates artificially low. What followed was high, uncontrollable inflation that peaked in the 1980's. We needed Paul to come and save the day with the economic pain of high interest rates to put us back on the right path.

Inflation erodes our purchasing power and creates a vicious feedback loop as high inflation leads to higher inflation. With everything around us going up in price, we start spending our money faster and faster. The longer we wait, the less it's worth and the inflation cycle quickly gets out of control. Just ask the Germans in the 1920's. As soon as they got paid they ran to the store because prices would be higher an hour later. Prices doubled every four days. A loaf of bread cost $160 Marks in 1922, a year later it cost $200 Billion Marks. Paul knew he needed to stop inflation before it got completely out of control.

Our friends Scotty and Cass were so focused on what was right in front of them they didn't notice that the environment was changing. The window to make it home before winter was quickly closing. Over the past two years we have been watching and noticing the signs that change was on the horizon, the rapid increases in money supply and large government deficits. *US money supply increased by 40% during the past two years, the largest increase in US history[1]. US federal debt exceeded 100% of GDP for the first time in 80 years[2]. Canada has created more government debt under our current Prime Minster than during the entire history of our country, and our National Debt grows by $400 million dollars, a day[3].*



The Russia/Ukraine War

On February 24th, 2022, Russia invaded Ukraine. It is incredibly sad to see millions of Ukraine citizens uprooted from their homes and fleeing for their lives. The world responded swiftly to Russia with harsh economic sanctions cutting them off from global trade and the rest of the world. Russia is the third largest producer of oil in the world, behind the US and Saudi Arabia. The war plus the sanctions have sent oil prices sky rocking. Crude Oil Western Texas Intermediate (WTI) prices started the

[1] https://fred.stlouisfed.org/series/M2SL
[2] https://www.cbo.gov/publication/57038
[3] https://torontosun.com/news/local-news/canadas-national-debt-1-1-trillion-growing-by-nearly-400-million-daily

year at $75 US/barrel and rose over 65% to $125 US/barrel on March 8th. Skyrocketing oil prices and sanctions are also causing additional shipping bottlenecks and supply chain issues, adding more inflation pressures to current inflation issues.

The Fight against Inflation

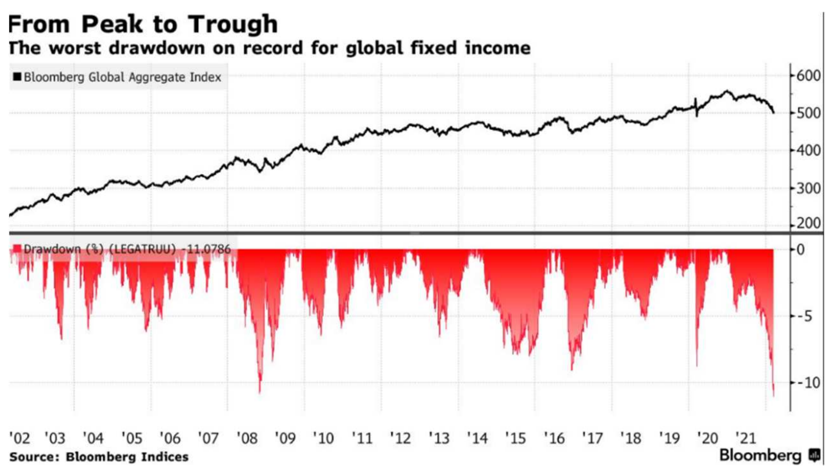
At the start of 2021, inflation in the United States was 1.4%. In March 2022, it was at 8.5%, a 40-year high[4]. The side effects from our economic binge have arrived.

Central bankers realize that inflation is not going away and they cannot wait any longer to address it. Now is the time to take our painful economic medicine. The scariest movie a central banker can imagine is uncontrollable and runaway inflation. On March 16th this year, the US FED announced the first interest rate hike in four years and are planning to raise rates six more times in 2022[5]. On April 13th Canada announced their first 0.5% rate increase in 22 years. Canada will be following in the footsteps of our neighbours next door and aggressively raising rates.

The Changing Seasons

Investors consider the bond section of their portfolio safe. Bonds provide portfolios with stability and diversification during times of turbulence. The average investor's balanced portfolio today consists of 40% bonds. The problem is these bonds were paying record low yields last year. *Over the past year with the winds of change on the horizon, we highlighted the risks that high inflation and rising rates are not friendly to bonds. The average bond holder in Canada today will see their bond portfolio fall by 8% with every 1% rise in interest rates, and bond yields have been moving a lot higher recently. On January 1st 2021, the 5 Year Government of Canada bond rate was 0.4%. Less than a year and half later, on March 31st 2022 it was 2.49%, an increase of over 500%.*

Scotty and Cass quickly realized that winter was fast approaching when a nearby stream was covered in ice. A few days later they saw snow. The subtle changes that winter was coming were no longer subtle. Winter was coming, and they suddenly realized they had waited too long. Like Scotty and Cass many of us have waited too long[6]. Some investors now find themselves in the middle of a changing season. Over the past year, rising rates have not been kind to bond holders. The Canadian Universe Bond Index is a good proxy for the average bond. It was down almost 3% in 2021 and then down another 7% during the first three months of this year. Global bonds saw their worst sell off ever falling more than 10% from their peak from last year.



Last year we also warned about risks in some of the areas of the US markets where investors bid up stocks to extreme valuations during COVID. The NASDAQ stock exchange, which mostly consists of these concerning stocks has not done well. On February 28th, the median stock in the NASDAQ was down by 40% from its peak.[7]

[4] https://ca.news.yahoo.com/us-inflation-jumps-fresh-4-124608280.html?msclkid=a783f78cbce611ecacd4fdcb2ac11825
[5] https://www.forbes.com/advisor/investing/fomc-meeting-federal-reserve/
[6] Cassiar's Elusive Gold by Francis E. Caldwell - https://www.amazon.ca/Cassiars-Elusive-Gold-Francis-Caldwell/dp/1552123375
[7] https://privatebank.jpmorgan.com/gl/en/insights/investing/eotm/growth-trade-aftermath

Rising Rates and Stocks

With rates rising, how have stocks historically done? Since 1960 there have been 14 periods of time when interest rates rose with the S&P500 producing an average return of 17% over the next two years[8].

1 HIGHER RATES ARE USUALLY BULLISH FOR STOCKS

S&P 500 Index Returns Under A Higher 10-Year Yield

Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-Year Treasury Yield	S&P 500 Gain/Loss
12/26/62	8/29/66	44.7	1.7%	18.3%
3/16/67	12/29/69	34.0	3.6%	1.3%
3/23/71	9/16/75	54.6	3.2%	-18.1%
12/30/76	9/30/81	57.8	9.0%	8.7%
5/4/83	5/30/84	13.1	3.9%	-7.9%
8/29/86	10/16/87	13.8	3.3%	11.8%
10/15/93	11/7/94	12.9	2.9%	-1.4%
1/19/96	7/8/96	5.7	1.5%	6.7%
10/5/98	1/21/00	15.8	2.6%	45.8%
6/13/03	6/28/06	37.0	2.1%	26.0%
12/30/08	4/5/10	15.4	1.9%	33.3%
7/24/12	12/31/13	17.5	1.6%	38.1%
7/8/16	10/5/18	27.3	1.9%	35.5%
3/9/20	2/25/21	11.8	1.0%	39.4%
	Average	25.8	2.9%	17.0%
	Median	16.6	2.4%	15.0%
	% Positive			78.6%

Source: LPL Research, FactSet 03/03/21

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

What are investors' options today? Since banks have raised rates, some savings accounts are now paying 2%. With inflation well above that, 2% doesn't go very far.

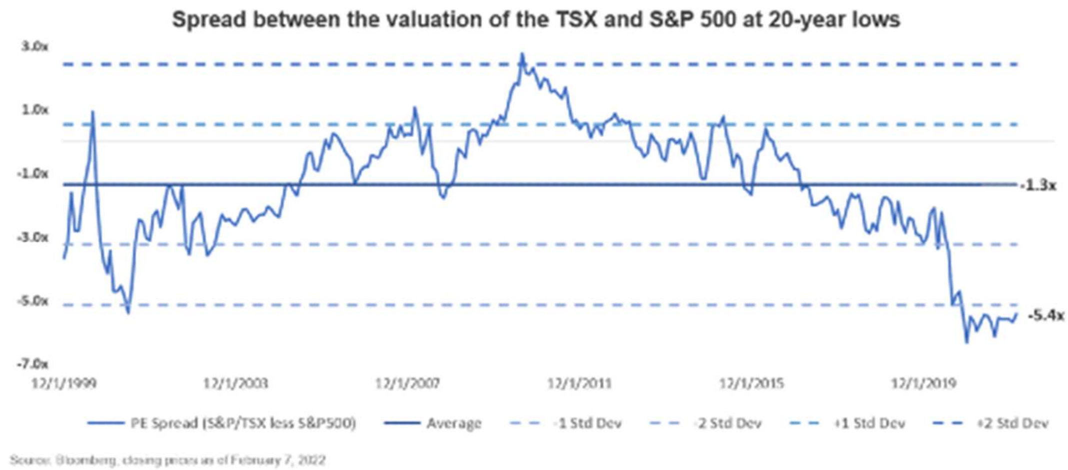
Our stock market in Canada is trading at an earnings yield of 6.84% (as of January 2022). If the stock market was like a real estate investment, we would be collecting $68,400 in net profits every year on a $1,000,000 investment, after all expenses. That is pretty attractive considering the same $1,000,000 investments at the bank only provides only $20,000 a year and buying actual real estate in Vancouver provides even less. A recent property in Point Grey on 4425 and West 12th sold last year[9] for $4,000,000. The yearly rent is $88,000. After all expenses such as maintenance, insurance and property taxes, investors would be left with less than 2% on their investment. I can walk into the bank and receive a higher return. Stocks are still the best and highest paying employer in town.

However, not all stocks are created the same. Under a high inflationary environment the key is to be selective with the companies that will protect you. We are finding incredible bargains in those types of investments today, such as companies with strong and growing cash flows that act as an inflation hedge by growing their earnings above inflation. One example is George Weston who owns Shoppers Drug Market and Real Canadian Superstore who has grown their earnings by 90% over the past 10 years. Or American Express that have grown their earnings by almost 150% in the past 10 years.

The best opportunities we are finding today are in Canada and internationally. Over the past 10 years the Canadian stock markets have significantly lagged the US in performance. Investors love chasing past performance which is why most investors don't do very well over the long-term. *DALBAR tracks investor returns, and in their latest survey on Investor Behaviour the average equity fund investor has underperformed the S&P500 by 4.5% per year, over the past 30 years!*[10] As investors follow the best past returns they have forgotten about the gold right in their back yard.

The discount between the Canadian and the US markets are at record levels not seen since the tech bubble over 20 years ago when the Canadian markets would go on to dramatically outperform the US over the next decade. From 2000 to 2010 the S&P500 had a total return of 6.13% vs the S&P/TSX that had a total return of 85.60%.

[8] https://www.northoaksfs.com/blog/rising-rates-and-stock-market-performance
[9] https://www.redfin.ca/bc/vancouver/4425-W-12th-Ave-V6R-2R3/home/155300872
[10] DALBAR



Over the past year we have been focusing on protecting clients from rising rates and inflation. We are focusing on high quality, low interest rate sensitive bond investments such as floating rate bonds that helped our overall bond portfolios generate positive returns in 2021 and have outperformed during the sell-off in the bonds this year. Our equity holdings are well diversified, in companies with growing earning streams that protect against rising inflation. We are overweight to the opportunities we are finding in our back yard and around the world. Over the past year we have been aware of the changing economic climate and have made our way back well in advance of the upcoming winter storms. More recently things have been changing quickly around us and we are ready.

Scotty and Cass knew they needed to make their way home quickly with winter almost upon them. The beautiful mountains and bare ground they saw when they arrived, now looked completely foreign all covered in snow. In this unrecognizable landscape they prayed they were heading in the right direction. Supplies were running low and the animals that had been a plentiful food source had disappeared. With the excitement of their gold find, they worked day and night and had both lost considerable weight. They were also carrying an extra $2.3 million dollars' worth of gold. They quickly realized they couldn't carry it all back so they hid most of it, planning on returning later. Then, when crossing a frozen lake Cass fell through the ice into the freezing water, losing the valuable supplies and remaining gold he was carrying. Winter quickly engulfed them and temperatures continued to drop. The days grew shorter and they found themselves fighting their way through snowstorms and blizzards.

After falling through the ice, sickness quickly overtook Cass and he could no longer continue in his weakened state. Though Scotty did not want to abandon his best friend, Cass was insistent he must. It was a miracle Scotty made it back. Scotty ended up losing his leg and several fingers and toes. With only one leg, he was never able to return to find his hidden gold or the mother lode. Only a few ounces of gold made it back with Scotty and he was forced to work any job he could until the last of his days. Unfortunately Scotty and Cass didn't pay close attention to the changing seasons around them. Many advisors have not either, leaving them and their clients out in the cold.

We are ready for the change of seasons and are well positioned to navigate and protect our clients.

I think that if I had been with Scotty and Cass we would have made it back safely. With my hyper sensitivity superpower to the cold, at the slightest drop in temperature I would have hightailed it out of there!

-Kind regards,

Joshua Brown, CFA
Portfolio Manager