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Markets Made Simple

Wealth Management
Dominion Securities

SECOND QUARTER REPORT – JUNE 30TH, 2022

Half of the NASDAQ Index consists of technology stocks that reached extreme valuations last year. The average stock in the NASDAQ Index has fallen 50%.

BOOMS AND BUSTS

Markets move in cycles. Up, down, high, low, from one extreme to the other. Similar to life.

When I graduated university my parents gave me a graduation gift. The best gift you can give any poor student…cash. During university I managed to go from a poor to a very poor student. I took a course on losing your savings by investing at the peak of a market cycle. It was my first lesson in cycles, costing me $9000 and taught me that investing at the top of a bubble is an easy way to lose money.

My parents suggested I take a trip with my gift. As a very poor student I was good at stretching my limited funds and I found a great deal at an all-inclusive, four star Cuba resort. I also learned another lesson. Cuba does not have the same worldwide standards for their resorts. Deduct two stars to get to the real rating. However, I was young, excited and wanted to be in the sun and I would have been happy with only a sleeping bag on the beach. It was my first time at an all-inclusive resort. Unlimited food, anytime, all day, for a week! I may have gone a little overboard. Three meals a day turned into four, then five, and by the end of the week, six. After my week in Cuba, I arrived back in Vancouver and stepped on the scale. I had gained 10 pounds. It was my second lesson in cycles. The up phase is a lot more fun than the down phase. Unlimited food in Cuba and 10 pounds later, my favourite jeans no longer fit.

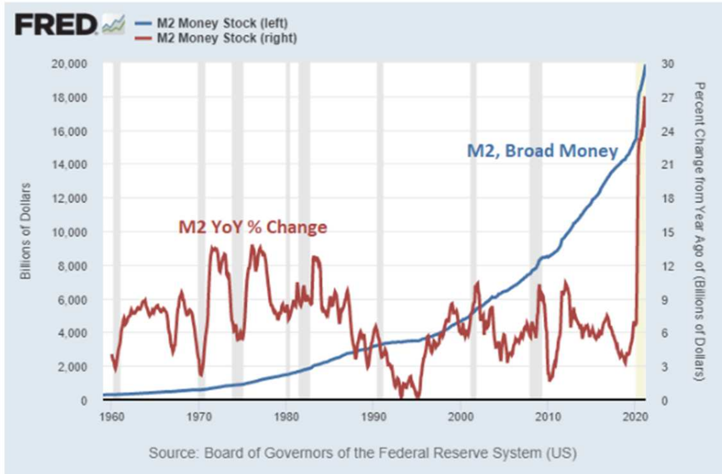
History is filled with cycles, ups and downs, booms and busts. The bigger the boom, the bigger the bust, and I don't think I would have any more clothes that would fit if I stayed at an all-inclusive resort for a month.

Two Years Ago

March 2020, the world shut-down. Governments spent record amounts of money and central banks responded by cutting interest rates to zero, flooding the economy with liquidity. *US money supply grew at levels never seen in history. To fight previous slowdowns the US FED grew their money supply by 10% during the 2008 Financial Crisis, 18% during World War II in 1943, and 10% during Great Depression in 1935[1].* ***In 2020 they grew by 27%[2].***

[1] https://www.wheaton.edu/academics/academic-centers/wheaton-center-for-faith-politics-and-economics/resource-center/articles/2021/understanding-the-money-supply/

[2] https://www.lynalden.com/inflation/



In 2020 the Canadian government spent more federally per person...ever. It was more than double what was spent per person in WWII and double the Financial Crisis in 2008.[3] *Just like my visit at an all-inclusive resort, we went a little overboard.*

Investors now faced an environment of low interest rates, and record amounts of monetary and fiscal stimulus. With the market sell-off, there were tons of bargains. As we referenced in our commentary at the time, it would be wise for investors to not bet against the record stimulus and low interest rates. We were taking advantage of the opportunities. The record stimulus and liquidity in the economy created a giant boom.

<u>One Year Ago</u>

Money flowed like free drinks at an all-inclusive resort, from bank accounts into stocks, real estate, bonds, and even areas such as Dogecoin, a cryptocurrency made as a joke by two roommates. It went from being virtually worthless to $40 billion in 2021. Some of the areas that saw the most money flow into them from this stimulus included technology stocks, rural real estate, and cryptocurrencies. Partying and having fun in the sun like their vacation would never end, investors started investing more and more in speculative ideas, pushing prices and valuations higher and higher.

In the summer of last year, we highlighted the extreme valuations the market had now reached. US stocks and bond were at the valuations seen only twice in the past 100 years.

[3] https://www.fraserinstitute.org/sites/default/files/prime-ministers-and-government-spending-updated-2021-edition.pdf

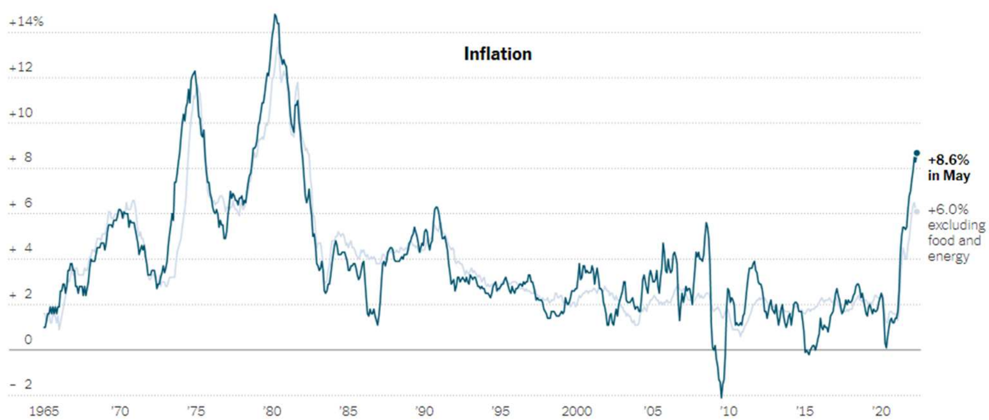
History has not been kind to investors when valuations have reached these levels in the past. The Shiller PE Ratio of the S&P500 was at 37X, close to the same levels as at the top of the tech bubble when it would then lose 50% of its value over the next several years. Real yields on bonds were -2.5%, one of the lowest yields on record. Bond investors were guaranteed to lose money after accounting for inflation. Previously when valuations had reached these levels, a balanced portfolio of 40% bonds and 60% stocks made no money over the next 10 years. This was the first time in 100 years where investors faced a situation where both stocks and bonds were extremely expensive. It was a difficult investment environment.

Investors needed to properly position themselves as not all investments were trading at extreme valuations. We were finding the best bargains in Canada. The Canadian markets were trading at a record discount to our friends in the US. The last time this happened was 22 years ago when the Canadian markets would go on to dramatically outperform our US friends over the next 10 years. From 2000 to 2010 the US markets (S&P500) would have a total return of 6.13%, while the Canadian markets (S&P/TSX) would have a total return of 85.60%. Many companies where trading at attractive prices with strong, stable and growing cash flows such Element Fleet or Telus in Canada. In the US you could still find good value in companies like Merck and Verizon.

Investors were too busy working on their tans and dreaming about all the money they were going to make in Dogecoin to worry about the upcoming hangover. The hangover from the massive governmental and monetary stimulus was fast approaching. Inflation was on the horizon and things were going to change, fast.

The Present

Inflation rose from 1.2% at the start of 2021, to 40 year highs of 8.6% at the end of May[4]. ***The 5 year Government of Canada Bond increased from under 0.5% at the start of 2021 to 3.1% at the end of June[5], an increase of over 5X!***



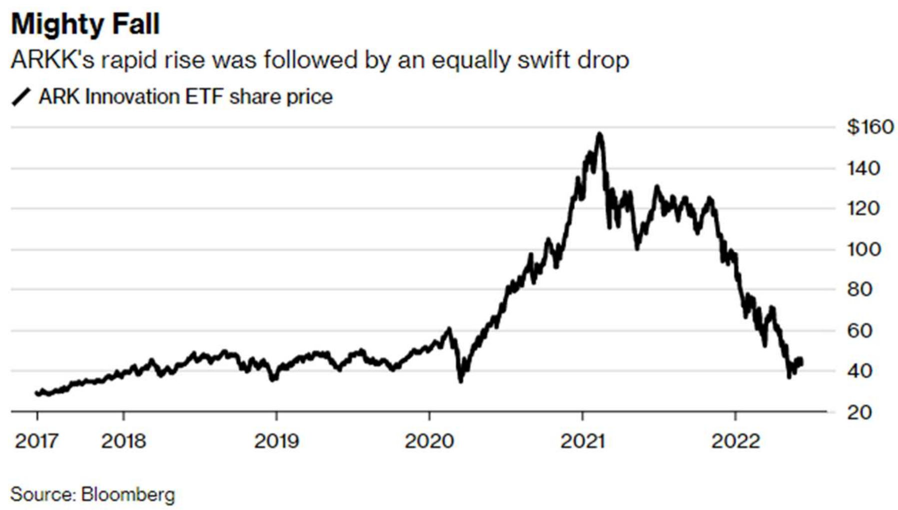
After a week binge in Cuba, many cardio sessions and lots of veggies and plain boiled chicken breasts were needed to fit back in my pants. An excess in one direction requires a large action in the opposite direction to get back to where we started.

With the huge excess government spending, record low interest rates and massive increases in money supply from central banks over the past two years, the time for our diet has arrived. Annual growth in money supply decreased from 27% to 4%. Interest rates are rising at the fastest pace in almost 30 years[6] with the US overnight rates increasing from 0% to 1.50-1.75% in the last five months[7] and is expected to climb to 3.40% by year-end. Central banks are putting the economy on a crash diet in order to gain control over inflation before none of us can fit in our pants.

With rising interest rates, banks are offering attractive rates again. Advertisements for 1 year terms at 4% are being seen on billboards for the first time since 2008 when Heath Ledger was the Joker. Higher rates are now attracting money back into saving accounts. Funds that went into Dogecoin, rural real estate and technology stocks that pushed them up to extreme valuations are now going elsewhere and causing them to fall back to earth in a hurry. The fun partying in the sun last year is over as the beaches are empty and investors are back to reality. Half of the NASDAQ Index consists of technology stocks that

[4] https://ycharts.com/indicators/us_inflation_rate_hcpi
[5] https://www.marketwatch.com/investing/bond/tmbmkca-05y?countrycode=bx
[6] https://www.cnbc.com/2022/06/15/real-time-updates-of-the-feds-big-rate-decision-and-powells-press-conference.html
[7] https://www.cbc.ca/news/business/us-rate-hike-1.6489696

reached extreme valuations last year, such as Zoom and Peloton. Zoom is down 80%, Peloton by 90%. The average stock in the NASDAQ Index has fallen 50%. Dogecoin is down almost 90%, and Canadian real estate is starting to turn. Suburbs that saw massive price increases with a rush to leave the city during COVID such as Brampton, Burlington, and Oshawa are seeing a turnaround in prices. Values are down 15% in the last three months with the average property $250,000 cheaper than in February. Vancouver real estate offering 2% rental yields is not looking very attractive when GIC's are now paying twice that. Below is a chart showing ARKK Innovation ETF which saw massive inflows of cash after COVID into new, exciting, mostly unprofitable innovative companies and had some of the most stretched valuations in the markets in 2021. It has fallen 75%.



Bonds that hit record low yields in 2021 are also seeing large price declines due to rising rates. As interest rates go up, it causes existing bonds to fall in price. The Canadian bond index fell 3% last year and another 13% during the first six months of the year. The start of 2022 has seen the worst 6 month sell-off for 10-Year US treasury bonds since 1788[8]. Focusing on bonds that are better protected in a rising rate environment, our bonds are down less than a third of the corresponding drop in the broad bond market since the start of 2021.

The global stock markets have seen the worst sell-off since 1990 for the first six months of the year, with the S&P 500 down -20% and the NASDAQ down -30%. However the largest sell-off has occurred in the most expensive regions of the markets where investors got the most excited and had pushed prices and valuations to extreme levels after COVID. We have been focusing on protecting clients against those risks.

The Biggest Risks Today

Like last year, investors are facing a tough environment. A potential recession, rising interest rates, inflation, and extreme market movements, both up and down make it difficult for investors to know where to put their money.

The biggest risk right now is inflation. Even with a recession and large market movements, not having cash keep up with the increasing prices around us can derail even the best retirement plans or other goals we have. With 8% inflation, cash will buy half of what it does today in 10 years and 20% of what it does today in 20 years. Inflation has not been kind to us. In the 1970's, annual inflation rose from 6% to almost 14% by 1980. A can of Campbell's Soup increased from $0.10 to $0.24, a box of Oreos from $0.45 to $0.99, a McDonald's hamburger from $0.20 to $0.40 and a Hersey's Chocolate from $0.10 to $0.25[9]. From 1970 to 1980, a dollar invested in the S&P500 grew to $2.30, allowing investors with $0.20 in cash to still be able to afford a McDonald's hamburger a decade later. During that decade, the markets went up, and down, there were two recessions, wars, rising interest rates and high inflation, but the alternative of keeping investments in cash did not keep up with the growing costs of everything else. The right companies, with strong growing cash flows at attractive valuations allowed investors to maintain their purchasing power. Staying in cash makes us feel good, but does not help us afford our Hersey Chocolates.

[8] https://financialpost.com/investing/markets-in-h1-the-almost-perfect-storm
[9] https://www.foodtimeline.org/foodfaq5.html#usaprices

So how do we protect against inflation? GIC's of 4%, isn't keeping up with inflation. The earnings yield on the average Canadian stock we own is 8.5% and has been growing with increasing earnings as these companies have been raising prices to counter higher inflation.

Many investors are worried with the uncertainty in the economy today. However the valuations we are seeing now are very attractive. The valuations in the companies in our portfolio are trading at the lower end of their historical ranges and below the markets. The valuations today already has much of the current negativity reflected in them. The S&P 500 has experienced an average decline of 26% during the 11 prior recessions[10] and this year it is already down 20%.

Investors need to make sure they are properly positioned, not only in the right asset classes, but also the right companies. We are well positioned with the attractive valuations of the companies that we own with strong and growing cash flows and able to protect against the rising cost of living from groceries to haircuts.

Would I still book a 4-star resort in Cuba? Yes. Would I still fit in my pants after? Probably not. History has a way of repeating itself. Our history books are full of booms and busts that have been happening again and again over the past hundreds of years. They always end the same… well most the time. Sometimes we go overboard at an all-inclusive resort and can't fit in our jeans. The next all-inclusive vacation I book, I will budget for new pants.

If you had any questions or would like to discuss your portfolio in more detail, please do not hesitate to reach out.

-Kind regards,

Joshua Brown, CFA
Portfolio Manager

Wealth Management
Dominion Securities

[10] https://markets.businessinsider.com/news/stocks/economy-outlook-stock-market-implies-recession-gloomy-self-fulling-jpmorgan-2022-6