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Markets Made Simple

Wealth Management
Dominion Securities

FIRST QUARTER REPORT – MARCH 31ST, 2021

I became a millionaire at age 23. It was a lot easier than I thought.

INFLATION

I'm being modest, I was a trillionarie. All it took was a click of a button to trade one dollar for $10 trillion Zimbabwe dollars.

The Zimbabwean dollar (ZWD) was introduced in 1980. At first, $1 ZWD was worth $1.50 USD. To finance the Congo War (1982 – 2002), Zimbabwe printed money…a lot of money. The long-term effect was inflation. Massive devaluations followed for the Zimbabwean dollar and citizens lost faith in their currency. The exchange rate for $1.50 USD went from $1 ZWD, to eventually a trillion ZWD. When grocery shopping, prices soared so rapidly that by the time they reached the checkout the prices were higher than when they started. Grocery shopping became a sport in Zimbabwe, the fastest person wins, and as the winner they pay the lowest price.

Buying that ten trillion dollar note is a reminder to myself the effects of inflation over the long-term. *This is more relevant now than ever.*

Interest Rates

Over the past 40 years, interest rates have been declining. This February, a 5 year fixed-mortgage rate was 1.40%. *A Dutch bank was recently offering clients a negative 0.50% interest rate for a 10 year mortgage*[1]. Yes, you read that right, the bank was paying customers to take out mortgages.

Low interest rates are great for borrowers. However, with an average annual Inflation rate of 2% since 2000[2], lenders are losing money after inflation, and that's the best case scenario. What happens if the best case scenario doesn't happen and house prices go down? Can borrowers afford to pay back their mortgages? Maybe not, and then lenders are looking at losing

[1] https://www.cnbc.com/2019/08/12/danish-bank-is-offering-10-year-mortgages-with-negative-interest-rates.html
[2] https://www.inflation.eu/en/inflation-rates/canada/historic-inflation/cpi-inflation-canada.aspx

10, 25, 50%, or even their initial investment. Best case scenario lenders get their money back and it's worth less, worst case they do not get it back.

Lenders are taking on these types of risks based on the options in today's economy. Central banks have brought interest rates to almost zero, forcing people to take risks and accept yields on bonds they never would have dreamed of. When compared to getting 0% in a bank account, a 1.40% return looks pretty good. As I referenced in past newsletters, this pushes investors into stocks, real estate, and other investments.

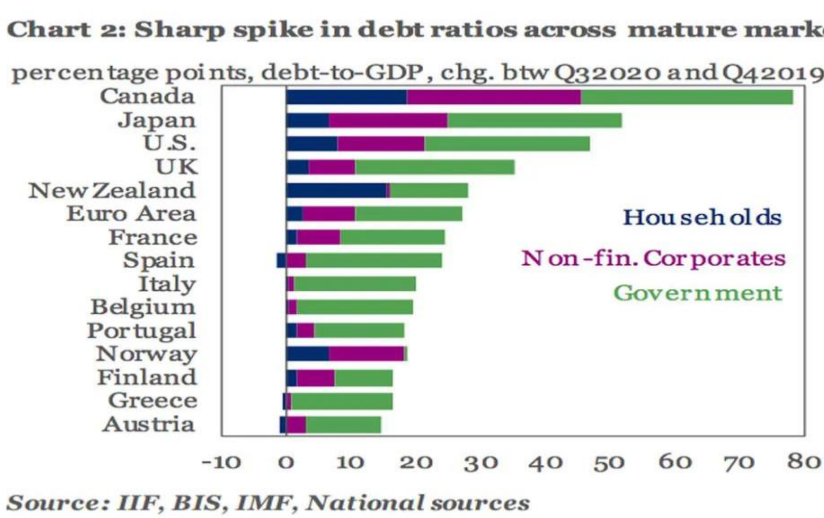
Government Stimulus

To fill the economic gap left from the global pandemic, governments continue to take on massive levels of debt. How massive? It pales in comparison to the debt taken to get out of the Great Financial Crisis of 2009.

During that Financial Crisis, governments came to the rescue with stimulus. Businesses closed, borrowers defaulted and unemployment soared causing the US economy to have a shortfall between where it was, and when it was operating at full capacity. After the Financial Crisis, had the US been at full capacity, they would be producing $80 billion more a month of goods and services. To partially bridge this gap, the Obama administration provided stimulus programs of about $40 billion a month. Even though a gap still existed, this stimulus helped to bring the economy roaring back to full employment.

Today, the current gap in the US (if they were operating at full capacity) is a shortfall of around $50 billion per month. Proposed stimulus programs will provide around $150 billion a month[3]. This would not only close the gap, but it would be $100 billion more than when the economy is already at full strength! In 2009, the bathtub was empty and stimulus helped fill it half way. Today the bathtub is filled to the brim, the tap still running at full blast, and A LOT more stimulus on the way!

In Canada, our stimulus packages have been on an even larger scale than in the US relative to our population. *For every dollar that has been lost in Canada over the past year due to the pandemic, the Canadian government has given out $20. Our total public and private debt rose about 50% to 353% of Gross Domestic Product as of Q3 2020[4].*



Central Bank Stimulus

In addition to governments taking on massive deficits, central banks are also printing enormous amounts of money. The increase in money supply over the past year is staggering and on a scale we have never seen. From August 2007 to early 2015, the FED increased their balance sheet by $3.6 trillion, or roughly $40 billion a month to get the US through the worst financial crisis since the Depression. With all this liquidity in the markets and interest rates at zero, cash flowed into stocks and fueled a 440% return from the market bottom in 2009 to 2020 for the S&P500.

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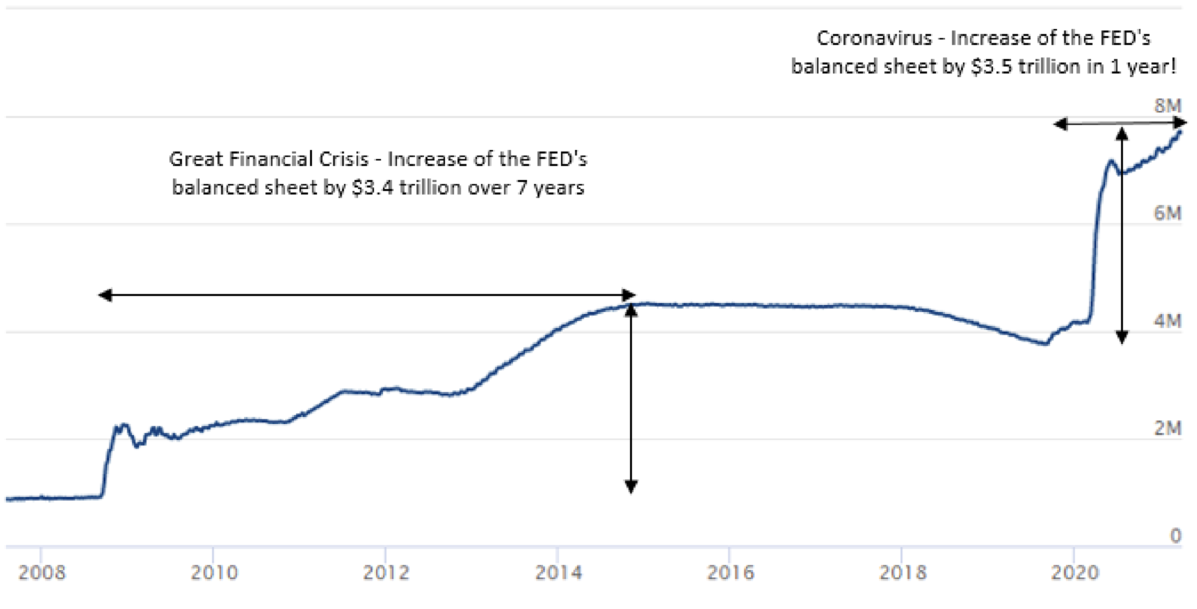
[3] https://www.oaktreecapital.com/insights/howard-marks-memos
[4] https://www.bnnbloomberg.ca/trudeau-s-debt-binge-shows-limits-in-canada-s-sharp-contraction-1.1571174

In the past year the FED has increased their balance sheet by $3.5 trillion, or roughly $300 billion a month, an increase of 650% from the Financial Crisis! The total growth of the FED's balance sheet to fight the Financial Crisis in 7 years, was done in 1 year in 2020. The scale of this intervention cannot be understated.

The S&P500 has returned over 80% since the market bottom on March 23rd, 2020. Many investors have been wondering how the market can produce a positive return during the worst worldwide pandemic in 100 years.

From my newsletter exactly a year ago in April: *'There is a saying, 'Don't fight the FED'. Meaning that if the central banks are trying to stimulate the economy, don't bet against them. The amount of monetary stimulus from central banks is the most aggressive we have ever witnessed.' Since 1982, from when the FED cut interest rates, to when they finally raised rates, the average annualized return for the S&P500 has been 20%[5].'*

The FED has a lot more to do with the markets than we think. The amount of support the FED provided during the Financial Crisis has been minuscule compared to the amount of support over the past year. It appears instead of bringing a grenade launcher to fight the crisis, the FED brought the entire army. Below the chart shows the Total Assets of the US Federal Reserve[6].

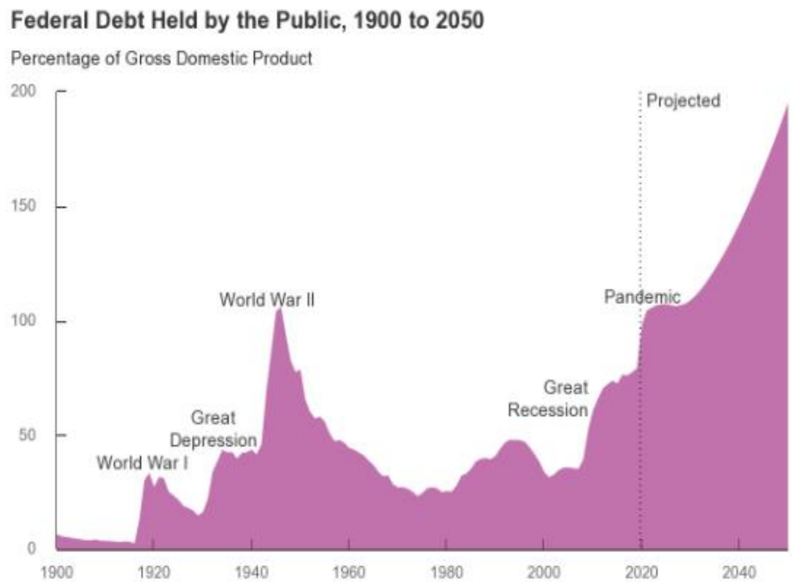


How can we possibly pay back all this debt?

We can't.

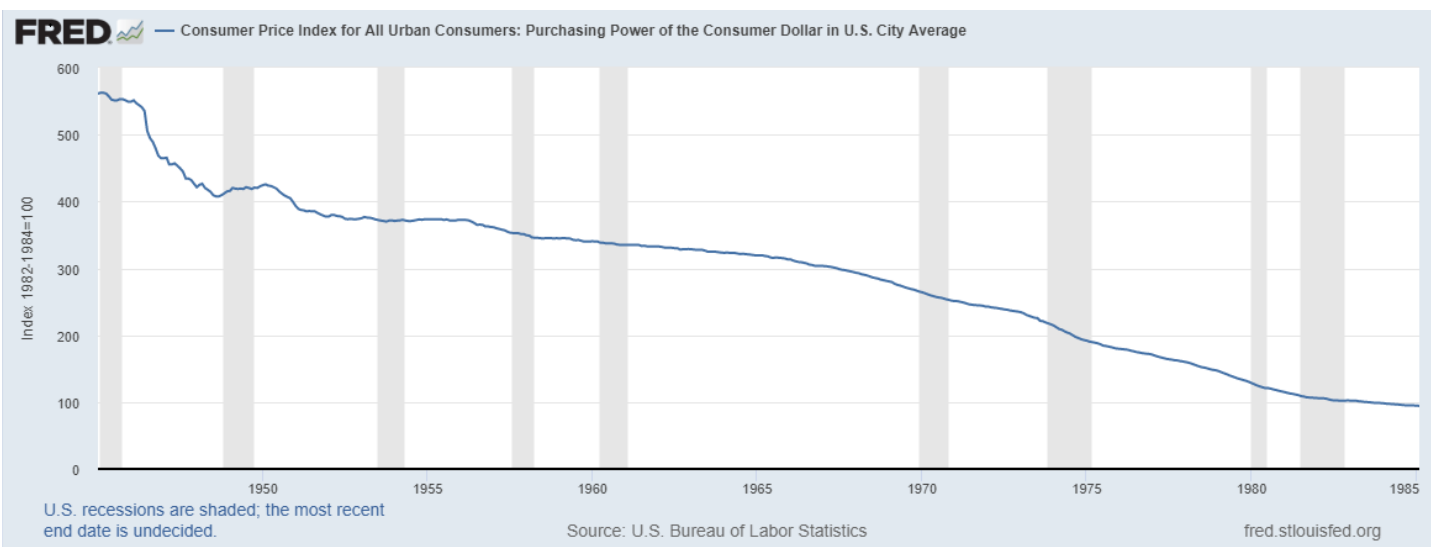
To finance the Second World War, governments around the world took on massive debts. It was similar to Zimbabwe trying to pay for the Congo War, they just inflated the debt away. A dollar that is worth $0.70 in 10 years, or $0.20 in 40 years is a much easier to pay back. Currently, government debt levels are hitting the same levels they did to finance World War II, and are expected to get even worst. On the following page is the federal debt held by the public in the US[7].

5 https://www.cnbc.com/2019/07/30/this-chart-shows-why-stock-investors-say-dont-fight-the-fed.html
6 https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
7 https://www.cbo.gov/publication/56516



After World War II, investors owning bonds got paid back with dollars' worth less and less each year. Those that sat in cash fared even worse. They still had the same amount of dollars, while everything around them went up in price. Interest rates rose from 1% in War World II to almost 20% in the 80's as inflation spiralled out of control.

Below shows the purchasing power of a USD after the World War II. Notice how quickly cash lost its value. 5 years after the war, cash lost about 25% of its value. After 10 years, it lost 33%. 40 years later, it had lost 80%.



The Hangover

All this money has to go somewhere, and so far it has gone right into our bank accounts. Being at home and spending little, along with government support programs, bank accounts have grown larger and larger and sit at record highs.

As the economy slowly re-opens and we get back to a new normal, more money is chasing the same amount of goods, causing prices to rise. As you have gone grocery shopping, picked up gas, and got a haircut you probably noticed it costs more. We are starting to spend the cash we have accumulated, and goods and services will get even more expensive.

How can you protect against inflation?

Own assets that hedge and protect against it. Companies that sell goods where they can raise prices and pass those costs onto buyers. Also owning hard assets such as commodities, and real estate that has inflation protection. Cash and bonds are the worst assets to hold as inflation literally eats them away. Just ask those grocery shoppers in Zimbabwe taking too long to decide between which brand of milk to buy. Avoid bonds that are paying rates that are less than inflation.

The biggest risk now facing investors is rising inflation and interest rates

Over the past 40 years, bonds have benefited from falling interest rates and falling inflation. The average balanced portfolio is roughly 40% in bonds and 60% in stocks. These portfolios were built in the 1980's when times were much different. Bonds were paying 20% in interest. Things have changed; a 10 year Government of Canada bonds now pays 1.5% in interest. With 40% of a portfolio in bonds making 1.5%, expect future returns to be much lower.

Not only that, but the risk to many bond portfolios is staggering. So far this year, many bond portfolios have dropped by 6-7% as interest rates went up from 0.5 to 1.5%. What happens if interest rates go up by 2 or 3%? Losses could be as high as 20% for some bonds, which accounts for 40% or more in some portfolios. *Many investors and advisors are not paying close enough attention to these risks.*

What are we doing?

As I reference last quarter, expect to see more volatility in the markets. We have seen the most loved and best performing asset classes of last year underperform, with many down significantly from their highs.

Over the past year, there are a number of different opportunities we took advantage of. As I referenced in previous newsletters, during the sell-off in March 2020, we bought more equities at very cheap valuations. Opportunities also arose to increase yields on fixed income providing more protection against rising rates. At the end of the year, we took advantage of companies that would benefit as the economy re-opens.

I also referenced in my September 2020 newsletter that we were avoiding many of the segments that have gotten ahead of themselves, such as technology stocks. Being very expensive with more downside risk, we have seen investors rotate out of them and focus on higher quality companies at better valuations. The largest technology stocks in the US significantly unperformed since then.

Recently we are seeing the best value in public real estate, commodities and specific equities. Going forward, with all this liquidity in the markets from governments and central banks it is very important to be selective with what we own. Future returns depend on it. Many of the most popular and best investments over the past decade benefited from low interest rates and will perform very differently in an environment with rising interest rates.

Investing is about securing, and growing wealth over the long term while minimizing the risks along the way. Each person has a unique situation. The risks for investors who own large amounts of fixed income and cash has significantly tilted, and represents a large risk for anyone that needs to protect their wealth over the long-term, in retirement or maintain their wealth.

In Zimbabwe, over the period of a year, they went from printing $10 notes to printing $100 billion dollar notes. Unfortunately the cost of a meal also went up to a billion. Everyone became a billionaire, and then a trillionaire. Myself included.

-Kind regards,

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