Wealth Management
Dominion Securities

THIRD QUARTER REPORT – SEPTEMBER 30TH, 2022

The FED has pivoted this year from zero interest rates to the fastest pace of interest rate hikes in 50 years.[1]

THE PIVOT

A few years ago I was in Chile. All I knew about Chile is they have llamas, so I consulted the smartest person I know… Google. Google gave me more insights and also showed me the most amazing place ever, the eighth wonder of the world, Patagonia. I had no choice but to go. After a little more research, my plan was to do the W-Trail. Spanning 80 KM, it goes past bright blue glaciers, jaw dropping waterfalls, and scenery from a Disney movie. The trail is usually done over five days and is rated one of the best hikes in the world. My plan was to do it in four days and alone.

I had never done an overnight hike…actually, I had never even camped before. I didn't know how to set-up a tent, turn on a portable stove or even what supplies to bring, but hey, how hard could it be?

I arrived in Patagonia and timed the weather perfectly. The first three days of the hike were clear skies and sun. I started the trek and quickly realized I over packed. I was carrying an extra 20 pounds of stuff I didn't need and forgot the things I needed, like warm clothes.

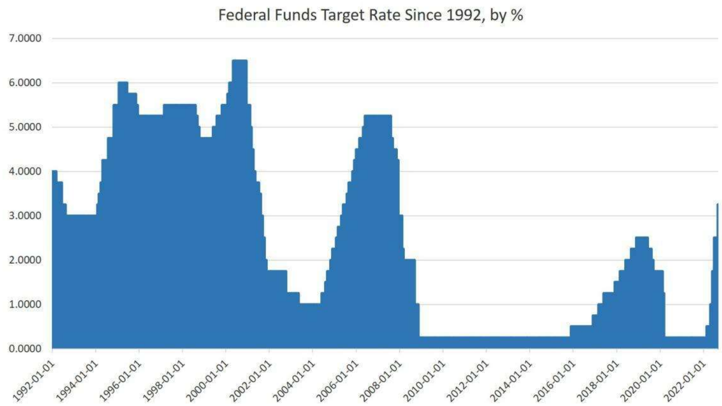
I quickly established my daily morning routine. Wake up shivering from the cold after too few hours of sleep, lie in my tent dreaming of warm sunny beaches until my chattering teeth got me fully awake and then start hiking to warm up. I continued my new routine on the second night. Up at 2:00AM, hiking by 4:30AM, arriving at my next camp site in the early afternoon. After two nights of little sleep and three full days of hiking, I hurt everywhere. My back was sore from the poorly positioned pack putting pressure on all the wrong spots, I was exhausted from lack of sleep, I wasn't eating enough to replenish the 6000+ calories a day I was burning, and I was tired of being cold all the time. The weather forecast posted at the camping ground said that after three full days of sun, it was forecasted straight rain. I had travelled almost half way around the world to see the Torres del Paine, the crown jewel of Patagonia and it would be covered by a sea of clouds.

I had a decision to make, I could continue on, making it a 16 hour day of hiking with my 50 pound overstuffed pack, condensing a five day hiking trip to three to beat the rain, or resting and hoping for a miracle.

The Pivot

The US Federal Reserve quickly changed course this year. Starting the year with interest rates at zero to raising them to 3.25% in the first 9 months of 2022, and with the expectation to raise them to 4.50% by year-end. Record government spending, years of low interest rates, record money growth and supply chain issues have brought inflation to 40 year highs causing central banks to pivot fast and take up the fight against inflation. *They began with the fastest series of interest rate hikes in 50 years.*[1]

[1] https://www.cbc.ca/news/business/powell-fed-speech-interest-rate-hikes-1.6563183



[2]

Interest Rates and Inflation

After World War II ended in 1945, record government deficits and low interest rates led to inflation being unleashed and taking off in the 1970's, reaching a high of 13%. At first, governments and central banks took the easy route hoping inflation would go away. Nope, instead it continued to climb, and a dangerous cycle took hold. A cycle that has caused economic collapses from Germany in the 1920's and recently in Venezuela. As inflation climbs we spend faster in anticipation of higher prices. This causes prices to rise more, so we spend even faster to get ahead of the future increasing prices. We get stuck in a spiral of rising prices fueled by increasing spending. *The inflation cycle.* It becomes ingrained in society that inflation and prices will continue to rise which creates an even bigger problem: not just dealing with inflation but changing our mindset which is not an easy task, ask any couple still waiting for their partner 'to change'.

In the 1970's, central banks let inflation go on for too long and it became ingrained in society. The chart below shows investors' inflation expectations going back to 1960. The light blue line is expectations for future falling prices and the dark blue line is expectations for future rising prices. Inflation expectations continued to increase from the 60's to the 80's and by the early 80's the majority of society believed that prices would continue to rise higher.

The FED faced a big uphill battle to end inflation once and for all after World War II and had to take extreme measures to change the minds of a nation. They accomplished their mission, it only took 10 years, interest rates at 20%, and putting the economy through two recessions. Central banks do not want to repeat the same mistakes. They are dealing with inflation now! The longer they wait, the higher the risk of getting caught in the inflation cycle. In the chart above, society doesn't believe inflation and prices will continue to rise. However that will change if left too long. Time is on our side and the FED is taking advantage of that brief window and "ripping off the Band-Aid" by increasing interest rates…NOW!

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[2] https://cms.zerohedge.com/s3/files/inline-images/ffr_4.jpg?itok=sliU4WcQ

How High Are Rates Going?

As the FED embarks on their mission to stop inflation, how high will rates go? The FED wants to see inflation peak and start falling before they can take their foot off the gas pedal. On the horizon it looks like the clouds are parting and the sun is peaking out.

Real estate and consumer spending are slowing, companies are starting to reduce their work force, inventory levels are rapidly rising, and commodity prices are falling. Supply chain issues around COVID are resolving. Shipping costs for containers from everything from toothbrushes to cars increased over 600% during COVID going from $1500 to over $10,000 to ship a container. Shipping rates have now fallen 60% from their highs down to around $4000.

[3]

The interest rate hikes this year are not felt instantly in the economy. They take around 12-18 months for the full effects to be evident. As the economy continues to slow, inflation will also slow. The FED can relax, take their foot off the gas and bring rates back to a level that promote future growth and long-term prosperity. After the FED's extreme actions in the 1980's, it set the economy on course for the next 40 years of low inflation, stable interest rates, growth, and economic prosperity.

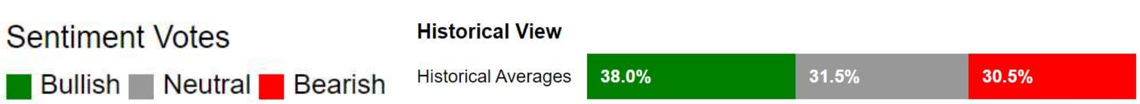
The economy is huge, with many moving parts. In golf, a shot too far to the right means overcompensating by snap hooking the next shot to the left. The ball doesn't make a straight line to the hole unless you are Tiger Woods. Instead it zigs and zags, but moves in the general direction of the green. My golfing buddies call this "Army Golf", left, right, left… eventually getting to the hole. COVID was like a squirrel that ran onto the course and carried the ball into the woods and the FED is now trying to get us back on the fairway but overcompensating since we're so far away and behind a tree.

The FED's attempt to maneuver the economy back 'on course' has created a lot of uncertainty for investors.

Pessimism

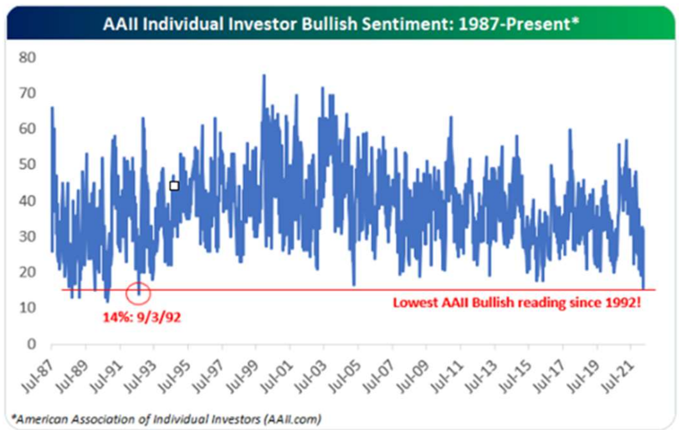
Everyone is worried right now. Business owners, employees, homeowners, retirees, my mom…especially my mom! The list of worries is long: inflation, climbing mortgage payments, government deficits, war, the economic outlook, if the Canucks will make the play-offs.

Investors are nervous and the AAII Sentiment Survey reflects that. Each week the American Association of Individual Investors surveys investors about how they feel about the stock markets over the next 6 months. Are they positive, negative, or neutral? The long-term results from their weekly surveys are shown below. On any given week, an average of 38% of investors are bullish or optimistic about the future, 31.5% are neutral, and 30.5% are bearish or negative.



[3] https://fbx.freightos.com/

Investors are negative today. This is the most negative investors have been in 30 years. Over 60% of investors are bearish and only 17% of investors are bullish, the least amount of bullish investors since 1992. Investors are more negative than during the middle of the Financial Crisis with the possibility of a depression and more negative during the middle of the pandemic panic during COVID when we thought the world was ending so we all went out and bought toilet paper.



These results are important because it provides a window into how the average investor is feeling. The feelings of investors are reflected in stock prices and valuations. When investors are bullish, they bid up prices and valuations causing them to become expensive. When they are bearish, they sell investments pushing prices down and causing them to become cheap. Right now markets look to investors like socks to a 5 year-old on Christmas day, they don't want anything to do with them.

Valuations

Since the beginning of the year, the S&P500 is down 23%. During the past ten US recessions, the median market decline for the S&P500 is 24%. For investors worried about a recession, markets have already priced it in.

The best buying opportunities occur when things look bleak. The more worried investors are, the cheaper they part with their investments. Investors want to wait until the sun comes out before buying. Unfortunately, the markets don't work like that. In 2009 during the financial crisis, markets bottomed on March 9th, 2009. Unemployment and economic data continued to worsen over the next 8 months. The markets were not paying attention to the worsening economic data, instead they were looking at the sun coming out on the horizon. During the next 8 months while economic data continued to decline, the Dow Jones increased 60%.

Investors are scared and worried and are preparing to, or already selling. The Canadian markets are trading at 11X forward earnings, and 33% below their 10 year average. Many of the companies that we own today have earning yields of 8-10%, growing earnings and are trading well below their historical valuations. Stocks are on sale.

The Outlook

The markets saw one of the worst sell-offs for the second quarter this year. US markets were down 16% in 3 months. After previous large market sell-offs, future returns have been quite strong. Below shows the largest quarterly sell-offs in the past 80 years. The average market return the following year after the largest quarterly market sell-offs? ***…26.1%.***[4]

Quarter	Return	1 Month	3 Month	6 Month	12 Month
30-Sep-1974	-26.1%	16.3%	7.9%	31.2%	32.0%
31-Dec-1987	-23.2%	4.0%	4.8%	10.7%	12.4%
31-Dec-2008	-22.6%	-8.6%	-11.7%	1.8%	23.5%
29-Jun-1962	-21.3%	6.4%	2.8%	15.3%	26.7%
31-Mar-2020	-20.0%	12.7%	20.0%	30.1%	53.7%
30-Jun-1970	-18.9%	7.3%	15.8%	26.7%	37.1%
30-Sep-1946	-18.8%	-0.8%	2.3%	1.4%	1.0%
30-Sep-2002	-17.6%	8.6%	7.9%	4.0%	22.2%
30-Jun-2022	-16.4%	9.1%	?	?	?
	Average	6.1%	6.2%	15.2%	26.1%
	% Positive	77.8%	87.5%	100.0%	100.0%

Investors, along with my mom, are the most negative they have been in the past 30 years. And when investors are overly negative, they sell their investments, depressing prices and causing them to become cheap. With extreme negativity, the markets reach a point when stocks are so cheap, there is no one left to sell and prices move higher. In March 2009 investors were incredibly negative and reached extremes with over 70% of investors bearish, and only 19% of investors bullish. The markets returned 70% over the next 12 months. During COVID lock-downs in 2020, 50% of investors were bearish and only 23% were bullish. Markets would return 30% in the next 12 months. In mid-September, 61% of investors were bearish and only 17.7% were bullish, the lowest number of bullish investors in 30 years and there have only been four other times when the number of bearish investors have reached over 60%. The average one year return when the number of bearish investors reached over 60%? ***…30.0%.***[5]

The number of stocks trading above their 50-day moving averages (meaning they are in a positive uptrend) is only 5%. This has also only occurred 8 times in the past 25 years. The average return a year later? ***…31.7%***[6]

The average earnings yield in the Canadian markets today is just over 9%. Many of the companies that we own are earning even more than that, but instead of a fixed rate for a GIC, are growing their earnings, protecting against inflation and have excellent upside based on current valuations.

What Have We Been Doing?

We recognized the expensive valuations in various asset classes last year. The excessive stimulus pushed many investments to ridiculous prices with large downside risks. A change of seasons was on the horizon and we needed to make sure clients were properly prepared. We focused on decreasing our exposure to rising interest rates, avoiding areas of the market that got too expensive and protecting against the inflation tidal wave that we could see building on the horizon.

All these changes helped clients and portfolios weather the market carnage this year. In the first 9 months of the year, the average balanced portfolio is down by 13%, US investments grade bonds are down 23%[7] for their worst sell-off ever and US stocks are down by 23%. Being proactive has helped our portfolios avoid those big draw-downs. However there are still risks remaining, a rapidly changing economic environment, high inflation, and areas of the market that still have elevated risks. Inflation is still here, but stock market valuations are incredibly cheap with excellent upside and investors are willing to part with their investments for bargain prices. Now is the time to be aggressive. Boxing Day sales only occur for a short while. Many companies are extremely cheap, have growing cash flows and earnings, and good long-term upside from current levels.

[4] RBC Global Asset Management: Bloomberg, S&P 500 USD

[5, 6] SentimenTrader.com

[7] U.S. IG Corporate Bond Index https://www.blackrock.com/ca/investors/en/products/239859/ishares-us-ig-corporate-bond-index-etf-cadhedged-fund

Pivot

In Patagonia, I had a choice. Should I push myself to the mental and physical limits to see Torres del Paine? I have played hockey games with a broken hand, trained alongside some of the best NHL hockey players in the world and pushed my body to extreme limits so I am no stranger to pain and perseverance. But the past three days on the hike put such a toll on me that I felt I had aged 10 years. I had nothing left.

I thought back to inspiration stories of Rick Hanson, Terry Fox and others that have overcome much more difficult challenges than me and it inspired me to try. Mentally I had won the first battle, physically was a different story. Focusing on the next step in front of me, eight more hours of pure agony and eventually I finally made it. The sun was just setting, giving the mountains a beautiful bright orange hue. It was one of the biggest mental challenges I had ever overcome, and one of the biggest rewards and memorable moments of my life. I felt a rush of energy like I had never experienced. I was ready to hike the whole 80 KM again.

The next morning the clouds rolled in and I looked up. The view was completely gone. The opportunity was there for only a brief moment in time… and then it was gone.

The economy looks bleak. We feel like giving up and letting our money relax, it has worked hard and things look bad, but investing isn't always easy. Following our natural instincts like selling when things look bad is one of the reasons investors dramatically underperform and limit their financial goals. In the past 30 years, the average equity investor has underperformed the US markets by 3.5% per year. Investing $100,000 in the S&P500 would have turned in over $2.0 million over the past 30 years. The average investor would have $1.3 million less[8]. When things get negative, investors give up. They sell their investments, pause their plans, and wait for things to get better. Very few investors achieve market returns and even fewer outperform the markets.

To experience and witness the grand vistas waiting for us ahead, these are the times to push ahead and continue on course.

Markets and sentiment can change quickly. They can go from optimistic to pessimistic overnight. It happened to me during my hike. When things look the bleakest, those that stay the course are rewarded.

As always, if you have any questions on your portfolio, please do not hesitate to reach out.

-Kind regards,

Joshua Brown, CFA
Portfolio Manager

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[8] DALBAR - https://www.ifa.com/articles/dalbar_2016_qaib_investors_still_their_worst_enemy/