Wealth Management
Dominion Securities

SECOND QUARTER REPORT – JUNE 30TH, 2023

FREE FALLING

I woke up and I am falling…floating high amongst the clouds and looking down at a river flowing peacefully through the sloping hills of the canyon below. Am I am dreaming? I hear a voice calling my name, 'Joshua...Joshua' and I realize I am being shaken back and forth like a bobble head and suddenly remember where I am…in a plane…hanging upside down.

Getting Home to Vancouver

The key mandates for our central banks are to maintain stable prices, maximize sustainable employment, and provide economic stability. In our past, there have been many periods with both high and low inflation. When inflation is too low, we risk deflation where consumers hold off making purchases because prices will be cheaper in the future. If inflation is too high, we start spending our money as quickly as possible to avoid the loss of purchasing power. Prices rise, we front load our purchases and push prices even higher, propagating the dangerous cycle of ever-increasing levels of inflation. Through experience with different economic policies in the past we have found the optimal inflation rate for long-term sustainable growth should be around 2%.

The central banks have the task of flying a plane as close to our economic targets as possible: inflation at 2% and full employment. When economic winds and storms come along that knock us off our path, our central banks need to maneuver us back on track. We are often just passengers on their plane, along for the ride.

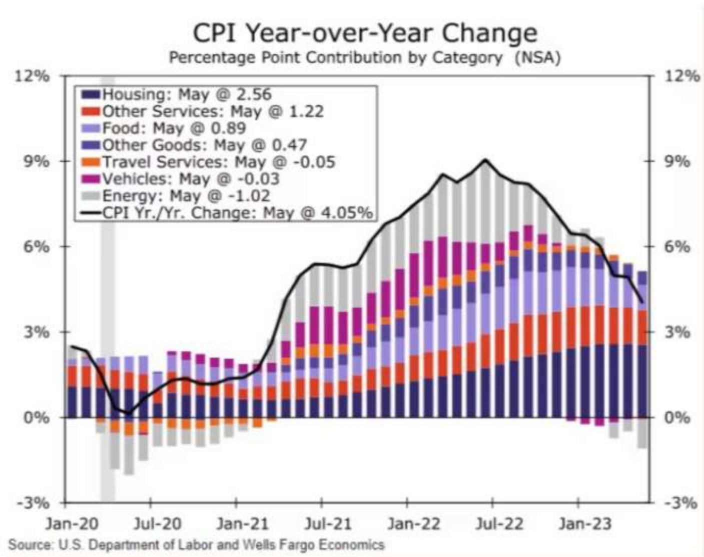
Our plane was on track at the start of 2020 and then a tornado named COVID hit us. It pushed us so far off course that instead of flying towards our original destination of Vancouver, we were upside-down and heading in the opposite direction and towards Tijuana. To get us back on course involved drastic maneuvering by central banks. This included dropping interest rates to zero and printing record amounts of money which eventually pushed our economy to the limit.

Our plane (the economy) did turn back around and upright, but not without some bumps and bruises along the way. Although we were once again on track, we were approaching our destination too fast and overshot. With all the fuel that central banks poured into the economy in 2020 and 2021, we went well past our 2% inflation target and inflation rose to almost 10%, reaching 40-year highs. We were well beyond our destination of Vancouver and heading towards Whitehorse.

In the fastest reversal ever in monetary policy, we raised interest rates at the fastest pace in 50 years and at the start of the year reduced the money supply for the first time since the Great Depression. The economy was effectively put into a flight stall out to try to get us back on track.

Our stall out is working as inflation has since fallen to 4%. However, all those extreme actions and gyrations caused additional problems to emerge. Rapidly changing the direction of our economy in such a short period of time caused several US banks to become insolvent with ripple effects throughout the credit markets. The availability of credit is the lifeline to our economy and limiting access to it can have devastating consequences. Putting the brakes on money supply and liquidity, like stalling a plane for too long can cause our economy to go into free fall.

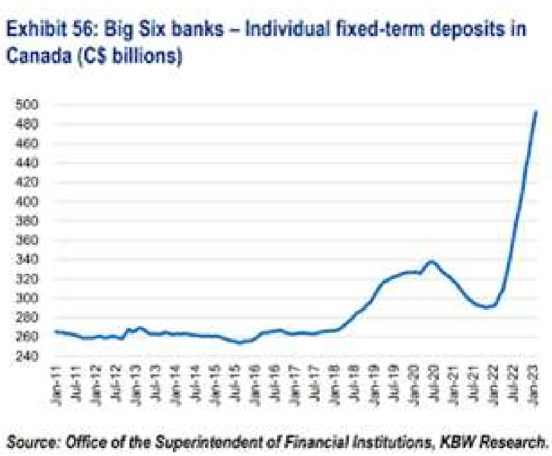
Central banks modified their approach in 2023 slowing rate increases from a fast sprint, to cautiously tiptoeing past a sleeping lion. Central banks are now raising rates by 1/4% increments, a 50% reduction from the 1/2% rate hikes in 2022 and are taking pauses after each hike to make sure the economy is not seriously impacted.



As you can see from the chart above, it has been a wild ride over the past two and half years and many of us want to get off!

<u>A Special Guest Appearance: The 5% GIC!</u>

In early 2023, investors seeking safety and refuge from the turmoil stumbled onto the holy grail. For the first time in decades banks were offering a 5% interest rate for 1-year deposits! With the recent uncertainty investors stampeded to lock their funds into savings and bank deposits which have grown to record levels.



I-NEED-A-RAISE!

WestJet pilots recently negotiated a 24% raise over the next 4 years to deal with the higher costs of living. What about our savings, can we get a raise for them as well?

The erosive effects of inflation makes it more important than ever that we earn clients a rate of return that can mitigate the impact of rising costs. Like WestJet pilots, we may now have the opportunity to get some of the biggest raises in decades.

Interest rates on fixed income in the past decade have been as exciting as watching coffee drip into a pot. For almost 20 years, we watched rates drip-drip-drip lower, and we wondered when the bank would start charging us to hold our money. In 2020, you could give the US government your money for 30 years (in a US Treasury Bond) and get the incredible sum of 1% per year. A freshly baked cinnamon bun would get more attention from me.

Long-term US treasury yields reached all-time lows after the COVID tornado hit and there was no place for yields to go but up. In June of 2021 we highlighted that the 20 largest bond funds in Canada, managing trillions of dollars of investors' money, would lose 8% for every 1% increase in interest rates, and lose 11.5% for every 1.5% increase. In 2022, over a period of less than 9 months, rates went up from virtually zero to almost 4.5%. Bonds dropped in price due to rising yields and 2022 marked the worst year for US bonds in 250 years, with long-term US bonds dropping almost 40% and the carnage being felt throughout the bond markets[1]. Many investors incurred massive losses in the supposedly 'safe' part of their portfolio.

We protected clients from these risks by keeping our bond exposure in short to medium bonds last year that were less impacted by rising rates. Now, with higher yields and bonds prices falling, bonds that were as exciting as watching coffee drip are looking as attractive as freshly baked cinnamon buns. High-grade, short-term, corporate bonds now yield 6-8% when less than a year and half ago investors received less than half of that. That is a 100% raise, and we believe there may be even more "tasty" opportunities on the horizon.

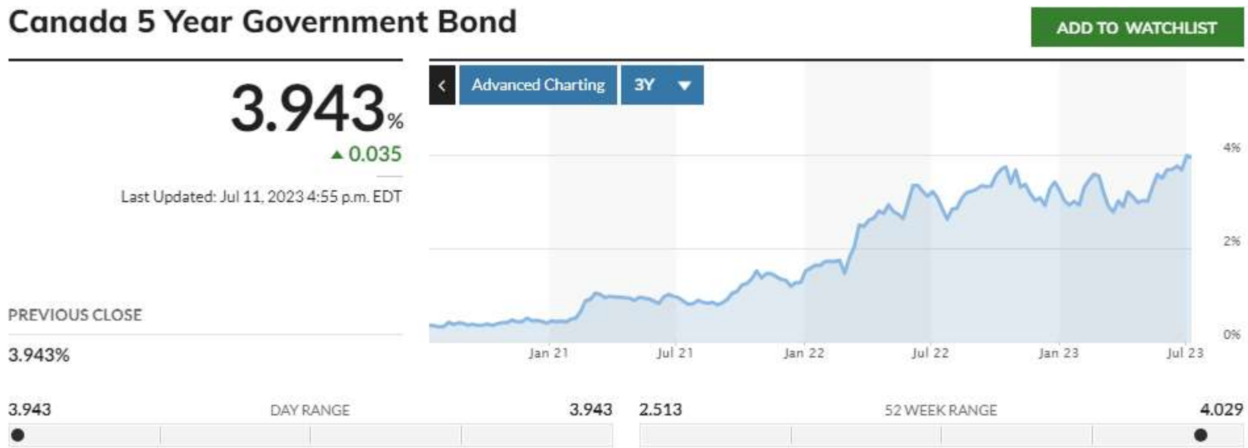
Many Canadians had taken out mortgages with record low rates over the past 5 years. These mortgages are now maturing and being renewed at huge increases. A record number of businesses also borrowed at low rates and their loans are coming up for renewal, also at higher rates. In 2009 and again in 2020, lenders became very cautious and companies needing to borrow had to pay high interest rates to entice lenders to lend to them. Recently with the US bank failures, banks have become much more conservative in their lending, worried they could be the next casualty. As the amount of available capital dries up, corporate borrowers are needing a record amount of funds that simply may not be there. Borrowers will have to offer higher and higher rates to attract lenders and we are seeing that occur in the private lending market. Private borrowers are now having to pay high rates to attract lenders. Any funding that companies can access are going to get snapped up faster than that last sweet, spicy, cream cheese covered pastry, at least when I am in the vicinity.

In 2009 and 2020 there were generational opportunities in fixed income. We are ready if it happens again.

Another area of opportunity is preferred shares. Preferreds, like Ikea furniture assembly instructions, are one of the most difficult to understand areas of the Canadian markets. With hundreds of different shares, each one has specific terms and conditions, their rate that can be fixed, floating, or reset, and that amount of information can be overwhelming. For example, Enbridge has 18 different issues of preferreds currently trading on the TSX. The main difference when you try to buy them is one or more letters after the stock symbol. Telling them apart is like knowing the difference between a Bjoksta or a Jarvfjallet bookcase.

With RBC Capital markets resources, we can easily sort through the best options for clients and are seeing tremendous value in rate reset preferreds as their dividends are reset every 5 years and right now, they are and will be resetting at very attractive rates. Their resets are pegged to 5-year Government of Canada (GOC) bond rate and as you can see from the chart on the next page GOC bond rates have been moving much higher. From 0.5% in 2021 to almost 4.0% in July. That is an 800% increase!

[1] https://www.cnbc.com/2023/01/07/2022-was-the-worst-ever-year-for-us-bonds-how-to-position-for-2023.html



This year a number of preferreds have reset their dividends. Manulife preferreds reset their dividend 30% higher, Enbridge 26% higher, CIBC by 30% more and BCE increased the dividend by 50%. The yields on various preferreds we hold are yielding 7-8%, with some having resets coming up providing even larger increases. In the next few years, some of the preferreds we own will be resetting with yields as high as 10% based on yields today. Also attractive for investors are the dividend tax credit they receive which is not available with GIC's. To have the same after-tax yield as these preferreds you would need to find a GIC that is paying double what the best are paying today[2]. With climbing rates this year, upcoming rate reset preferreds will deliver even higher increases for investors.

The Markets

Today the popular option is to *RUN* to GIC's and come back to investing when it's safe! Last September, the S&P500 was down 24% from its highs. We had just gone through one of the worst quarterly sell offs in the US market over the past 60 years and you could smell the fear from investors. The AAII sentiment survey measures how investors feel about the markets, investors were the most negative in the past 30 years. 'Popular opinion' is where the smart money goes right?

Nope. Time and time again investors sell when they are scared at market bottoms, then buy at market tops. In the past when the number of negative investors in the AAII survey has reached 60%, the subsequent one-year return was over 30%. On September 21st the number of bearish investors reached 60.9%.[3]

After the worst eight quarterly selloffs over the past 50 years, the average one-year return was 26.1%. In the fall of last year, we witnessed the 9th worst quarterly sell off. Investors were pricing in much more negative news than they should, and markets have rebounded off their lows in September 2022.

The first quarter of 2023 saw strong performance in the US markets. What happens next? Historically, strong performance has been proceeded with additional outperformance. In the past 50 years, looking at the 21 strongest quarters for the S&P500, the average subsequent three-year return has been more than 12% annually, shown in the chart on the following page.

[2] Assuming the highest marginal tax rate for investors on income at 53.50%
[3] https://www.aaii.com/sentimentsurvey

Date	First quarter return	6mo	1yr	2yr	3yr
1971	9.7%	3.5%	10.2%	8.6%	0.9%
1972	5.8%	4.6%	7.0%	-3.4%	-4.6%
1975	23.0%	5.3%	28.2%	13.1%	6.9%
1976	15.0%	7.9%	-0.2%	-2.5%	4.5%
1979	7.1%	10.6%	6.2%	21.9%	8.9%
1983	10.0%	15.1%	8.7%	13.7%	21.2%
1985	9.2%	2.9%	37.7%	31.8%	16.8%
1986	14.1%	4.0%	26.2%	7.5%	11.0%
1987	21.4%	15.2%	-8.3%	4.1%	8.9%
1988	5.7%	7.4%	18.1%	18.7%	17.3%
1989	7.1%	21.5%	19.3%	16.8%	14.8%
1991	14.5%	5.1%	11.0%	13.1%	9.1%
1995	9.7%	17.9%	32.0%	25.8%	32.8%
1996	5.4%	7.7%	19.8%	33.2%	28.1%
1998	13.9%	-6.3%	18.5%	18.2%	3.0%
2010	5.4%	-1.7%	15.6%	12.0%	12.7%
2011	5.9%	-13.9%	8.5%	11.2%	14.6%
2012	12.6%	3.4%	14.0%	17.8%	16.1%
2013	10.6%	8.3%	21.9%	17.2%	11.8%
2017	6.1%	7.5%	14.0%	11.7%	5.1%
2019	13.6%	6.1%	-7.0%	20.6%	18.9%
2021	6.2%	9.6%	15.6%	3.3%	?
2023	7.5%	?	?	?	?
	Average	*6.4%*	*14.4%*	*14.3%*	*12.3%*
	Median	*6.4%*	*14.4%*	*13.7%*	*12.1%*
	% Time higher	*86%*	*86%*	*91%*	*95%*

Source: RBC GAM, Morningstar. S&P 500 TR USD, annualized returns for periods greater than 1 year.

Although recent months have provided some mixed results, markets continue to show good value in specific areas. Our focus is finding the best opportunities in the markets to generate the returns needed to offset inflation. We continue to look for companies with growing earnings, cash flows and growth potential that are trading at prices below their business value. Cisco, one of the companies we own, is the leading provider of Internet Protocol-based networking and if you work in an office, you probably use one of their products. They have grown their earnings by over 80% in the past decade and their dividend has more than doubled while the stock is trading below its historical valuation. Cisco has been an excellent allocator of capital and we continue to see long-term growth in their earnings and dividend, exactly the type of company we want to own.

In the past nine months, we took advantage of many of the opportunities for clients that have occurred. We rebalanced portfolios, added to positions that had dropped, and put extra cash to work. Our disciplined investment approach will continue to look for and uncover opportunities as they present themselves.

Joshua, Joshua

As I regained consciousness back on the Extra 330LC, the highest performance certified aerobatic aircraft in the world, I remembered where I was and why I was there. I had signed up for an extreme flying experience in El Cajon, California and I recalled telling “Tex”, the veteran F-16 pilot who was flying, ‘To go as crazy as he wants.’ As my mushy thought process began to clear, I realized that “Tex” regularly breaks the sound barrier and flies at over 2000 kph in high-performance fighter jets, so his definition of crazy is a tad different from mine. We had just pulled close to 10G’s, and a gravitational force of 10 times our body weight was applied to us, kind of like being sat on by a T-Rex. My body could not pump enough blood to my brain, and I had passed out.

Tex has been flying and training for decades. He’s used to putting planes and his body through some of the most extreme situations in flight. Tex has prepared for any contingency, expected, or unexpected and knows exactly what to do under pressure. My training prior to flying with Tex was watching the new Top Gun movie from a theatre chair. I am grateful he was flying and not me as the flight would have ended much different.

That is how many investors approach one of the most critical areas of their lives…their finances. They are not prepared and think they can handle anything that comes along. They read a few books or articles on investing, listen to their friend's brag about all the money they made, (and of course never about the money they lost), but reality is much different. Like trying to fly a plane by watching Top Gun, they are not ready for the real thing. When the unexpected happens, they realize they are not prepared, like me experiencing 10G's for the first time.

During certain times, investors may change their long-term investment plans such as in 2009 when they sold a record amount of stocks on March 9th, 2009, a level that pushed the S&P500 below where it had traded 14 years prior. A year later the S&P500 was 70% higher and today it is over 600% higher. Or during COVID when close to 1/3rd of all investors over the age of 65 sold all their stocks[4]. A year later the S&P500 was 80% higher and it is now double. Making changes to long-term plans due to our fear or greed can have significant, and sometime non-recoverable impacts to our financial future.

From 2001 – 2020, the S&P500 returned 7.5% per year, bonds returned 4.8%... the average investor 2.9%[5], underperforming the same assets they were investing in. In 2022, the US markets sold off by 18.11% and the average equity investor lost 21.17%, an additional 3.06%[6]. Investors and their long-term returns are barley keeping pace with inflation.

History is a guide for helping us navigate the sometimes-crazy ride we are on. We see events and situations we have never seen before, like COVID and a complete shutdown of the economy. It is said that "History doesn't repeat itself, but it often rhymes". Looking at the nature of markets has helped us navigate the pandemic and the ups and downs that followed. There have been 26 recessions since 1900, the Great Depression in the 20's, the high inflation era of the 80's, and many other unique events from wars to pandemics. If we study and use these events and history as a guide, they can provide insights and a playbook for us for the future.

Although the ride central banks have us on has been rough, it has never paid to bet against them. They tend to get the job done. Every plane ride can have some turbulence and bumps along the way, but having a professional pilot navigate for you will help you arrive safely to your destination. When we are flying the plane and are not experienced, our ride will be much bumpier and we may not get to where we wanted to go.

One word of wisdom, I have learned is if you are going to go flying with an F-16 pilot and pull 10G's, fly backwards with the engine stalled and perform the same stunts they did in Top Gun Maverick, it is best to tell your mom after, not before.

-Kind regards,

Joshua Brown, CFA
Portfolio Manager

Wealth Management
Dominion Securities

[4] Fidelity Investments
[5] https://darnallsikeswealth.com/wp-content/uploads/2022/07/DSWP-The-Behavioral-Effect-on-Investor-Returns-2022.pdf
[6] https://www.businesswire.com/news/home/20230330005218/en/Investors-Panic-in-2022-and-Lose-More-than-Indices-Suggest