

Markets Made Simple

Chan and Brown Wealth Management



Wealth Management
Dominion Securities

THIRD QUARTER REPORT – SEPTEMBER 30TH, 2023

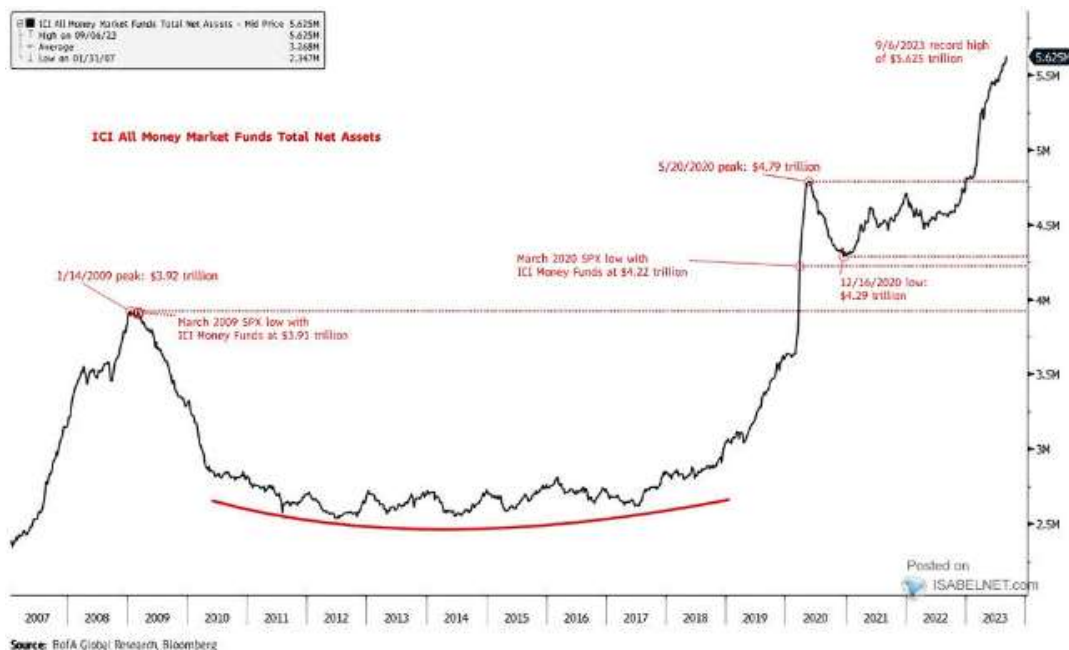
PUPPY LOVE

Friends of ours were heading out of town for the weekend and needed help with their little ball of energy, cute, six-month-old puppy, Cheesy. I had not taken care of a dog before and thought it would be a fun and an interesting experience. How hard could it be?

As usual I was dead wrong, like how I also thought my first ever overnight, multi-day hike in Patagonia for someone with zero camping experience would be easy. We started our first walk with the goal of getting around the seawall in two hours and being home in time for dinner. Fifteen minutes later we had gone a block. Making it home for dinner on time seemed as likely as the Canucks making the playoffs. Cheesy should have been named Chase-y because she ran after anything that moved like squirrels, birds, other dogs, or anything that didn't move like a leaf, a bone, a fire hydrant, or a pole. The walk was feeling like the march of Xenophon and the Ten Thousand (you can check your Greek history).

The Flow of Funds and Our Investments

For the first time in decades investors collected yields of 5% or more on cash and they dumped their investments quicker than Cheesy switches what she's chasing. A massive shift occurred in investment accounts with money leaving stocks, bonds, and other securities to move into cash vehicles like money market funds and GIC's. Cash accumulated and reached the highest levels in history.



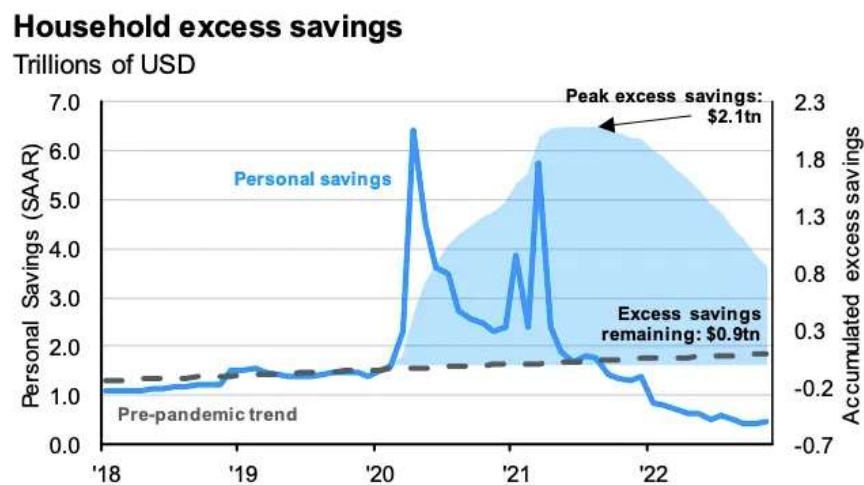
Borrowing

In contrast, our expenses have also increased because of higher interest rates. Canadian’s largest monthly expense is, (no, not our children) our mortgage payments and they have been steadily rising. The mortgage to buy a home based on the average prices, with a 20% down payment and current rates in 2020 would have been around \$1700/month. Buying the average home at today’s prices and rates the mortgage would be \$3600/month¹.

Our Balance Sheets

The most important driver of the economy is consumer spending, accounting for close to 2/3rds of our economy so any cut back by consumers will have a large impact. How has rising interest rates been affecting consumers?

After the initial outbreak of COVID most of us sat around in our pajamas, became experts at crochet and jigsaw puzzles and transitioned to working from home in our kitchens. As we became prisoners in our homes lounging around in the revitalized fashion statement of sweatpants and hoodies, our expenses dropped. Governments gave out record amounts of money and our bank accounts swelled like our waistlines, reaching record levels. Our savings rate went from around 8% in early 2020 to a record of 34% in a matter of months during COVID² and our extra savings has come in handy to help cover today’s rising costs. But now our extra savings are evaporating.



Consumer savings accumulated during the COVID-19 pandemic have been more than cut in half. (Source: JPMorgan Asset Management)

Banks have provided help with our increasing debt payments. Approximately 1/3rd of Canadians have variable mortgages. Prime rates went from 2.45% to 7.20% in the past 20 months, causing the payments on a \$1,000,000 variable, 25-year amortization mortgage to go from \$4500/month to \$7100/month. Most Canadians don’t have an extra \$2600/month laying around, so banks have been allowing customers to increase the term of their mortgage to maintain their payments at the same level. 25-year mortgages are growing to 50, 75 or even 100-year mortgages. Almost 50% of Canadians now have a mortgage that is 25 years or longer³ and with the Canadian median age being 41⁴ many Canadians will be paying their mortgages well into retirement.

The Slow Down

When we started our walk Cheesy was full of energy. Every squirrel was worth chasing, every piece of goose dropping was worth sniffing, she had an endless supply of energy like me after a Lee’s Donut. At our current meandering pace, I decided to modify our original plan of walking the seawall and took the side route and cut through Stanley Park so we could make it home before the winter solstice set in. We still needed to tire Cheesy out or it would be a long night with no sleep with an energetic puppy.

¹Based on the MLS HPI Benchmark Price, 80% LTV, 30 Year Amortizations and the Average 5 Year Mortgage Rate at the Time of Purchase

² FRED St. Louis FED - <https://fred.stlouisfed.org/series/PSAVERT>

³ <https://www.bnnbloomberg.ca/homeowners-brace-for-mortgage-payment-shock-amid-higher-for-longer-rate-outlook-1.1979028>

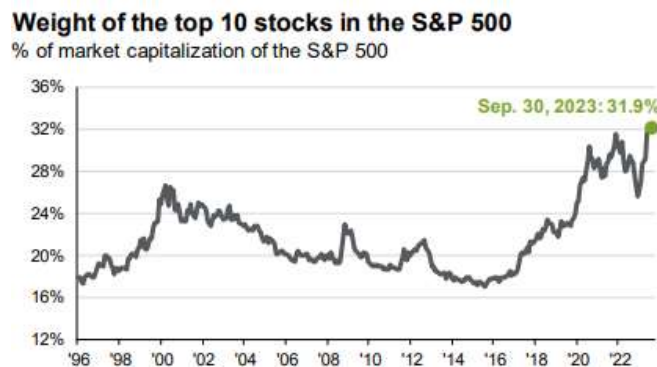
⁴ Statscan - <https://www150.statcan.gc.ca/n1/daily-quotidien/220928/dq220928c-eng.htm>

We started our walk in Coal Harbor. By the time we got to English Bay Cheesy had started to fade. She switched from chasing something new every 30 seconds to flopping down on the seawall every 30 seconds. Getting her back up was harder than trying to get me to go see the new Barbie movie. Like a tired puppy, Canadian's are running out of gas. Our extra savings and our banks have allowed us to continue to "roam" with higher rates, but as those balances shrink, some of us feel like laying down in exhaustion.

Regulators have taken notice that mortgages are being extended past many of our best before dates. At renewal, banks are being required to set mortgages to a maximum 30-year term. Roughly 2% of Canadian's mortgages come due every month and the average mortgage payment is increasing by 45% at renewal. Canadians are having to cut back to make ends meet and are worried about the future. Nearly half of Canadians have never been more stressed about money based on a recent RBC survey⁵. This cut back has caused consumer spending, the biggest driver of our economy, to fall. GDP growth has gone from almost 5% in 2022, down to 1%⁶ and is expected to continue dropping. Our record bank account balances are being quickly drawn down, while inflation has also dropped from almost 10% to 4%. Many economists think we will have used up the extra savings we accumulated during COVID⁷ by the end of this year.

A Tale of Two Markets

The S&P500 is the most referenced index in the world, tracking the largest 500 companies in the US. For the first 9 months of the year, the S&P500 was up 13% and the seven largest stocks, Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta were each up an average of 88%. Investors have become very excited about the potential of Artificial Intelligence and have lined up to buy these names like they were Taylor Swift concert tickets. Since these stocks have continued to grow larger, for the first time ever the top 10 companies in the S&P500 now make up 32% of the index.⁸ Over the past 35 years, the top 10 largest companies have represented around 20% of the S&P500. We have blown past that mark and the index is now more concentrated than during the tech bubble in 2000⁹.



History has not been kind to investors who own the biggest stocks when markets become highly concentrated, like in 2000, the top four companies of the S&P500 were Microsoft, Cisco, GE, and Intel. Over the next three years these stocks would fall on average of 63%, or almost 25% more than the S&P500. The top four companies in the index in 2021, lost an average 42% during 2022, or 25% more than the S&P500. Now investors are chasing these seven stocks like Cheesy chases pigeons.

How are the other 98% companies in the S&P500 doing? The average return of all the companies in the S&P500 from the start of the year to September 30th has been less than 2%. In the Canadian markets, the S&P/TSX was up 3% for the year. Aside from the seven largest companies in the S&P500 this year, the average stock is essentially flat and investors that have piled into the largest and most expensive companies in the S&P500 may be ignoring the downside risks.

The Allure of GIC's

With the uncertainty around us, high interest rates, stubborn inflation, shrinking bank accounts and poor prospects for the Canucks, investors are happy locking their funds in GIC's or parking their funds into money market funds. Is that really the best option today?

⁵ <https://nationalpost.com/news/canada/canadians-financial-stress>

⁶ <https://tradingeconomics.com/canada/gdp-growth-annual#:~:text=GDP%20Annual%20Growth%20Rate%20in,the%20second%20quarter%20of%202020>

⁷ <https://www.marketplace.org/2023/09/28/all-those-pandemic-savings-they-might-already-be-gone/>

⁸ JP Morgan – Guide to the Markets September 2023

⁹ <https://www.fool.com/investing/2023/09/28/wall-street-magnificent-seven-stock-market/>

The Dilemma

A common theme you have heard from us repeatedly, is that cash will flow to where it can earn the best return. It is important to not only follow the flow of money but also stay ahead of it. Similar to the famous Wayne Gretzky quote, “I try to go where the puck *is going to be...*”. In early 2020, one of the most uncertain times in our generation, many thought it was the end of the world, so we stocked up on toilet paper and sold our investments. One third of investors over the age of 65 sold all their stocks in the first stages of COVID¹⁰. Stock markets had their fastest drop in history and central banks responded by dropping interest rates to zero. Even with all the uncertainty, money went where it could earn the best return. With saving accounts paying nothing, funds started moving into stocks and bonds and with the cheap valuations we saw where the flow of funds were heading and took advantage of the generational bargains. The S&P500 would return 90% to investors within two years.

As cash continued to flow into markets and prices of investments rose, risks mounted for stocks and bonds in 2021. On June 30th, 2021, we warned investors about the risks in our newsletter. *The S&P500 was trading at a valuation 120% higher than it had historically traded over the past 100 years and the only other time in history it had traded at that level was in 2000 during the internet bubble. After that time, the NASDAQ would go on to lose almost 80% of its value and the S&P500 would lose almost 60%. The risk in many of the most popular bond funds was also staggering. For every 1% rise in interest rates, the average bond fund would lose 8% and lose 11.5% for every 1.5% increase in interest rates. (2021 – Q2 – What Do the Next 10 Years Look Like?)* We focused on insulating portfolios from these risks with bonds that were better protected in a rising rate environment and high-quality stocks trading at attractive valuations with built-in inflation protection. The following year in 2022, global bonds fell 20%, the NASDAQ dropped 40%, and the S&P500 was worth 25% less.

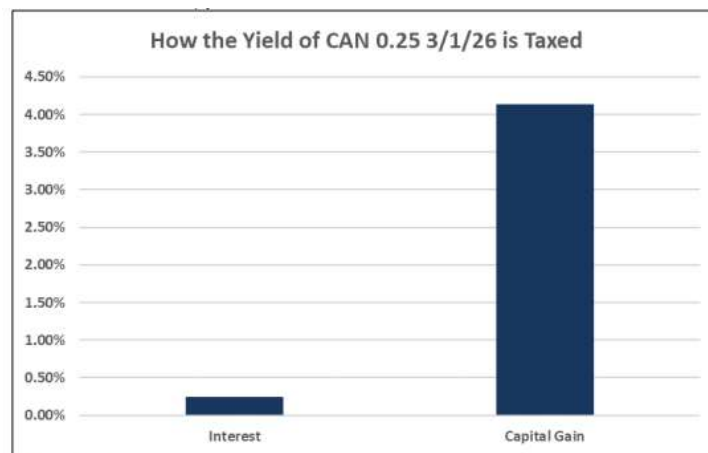
Today, investors are again wondering what to do. Should they continue to walk into the local bank and buy GIC’s?

The Options for Cash

Discount Bonds:

The current yield on an investment does not matter as much as how much money is left after taxes. If you purchase a GIC at 5% but the tax man takes half of that leaving you with a 2.5% return, would you prefer to receive only 4% but you keep 3% of it? After-tax returns are important for investors and there are some unique opportunities today.

With interest rates being so low after COVID, the Government of Canada issued bonds with yields as little as 0.25%. Now that rates are much higher no one wants these bonds and they have to be sold at a discount. A government bond that was issued in 2021 at \$100 paying 0.25% in annual interest maturing in 2026 is now trading at \$90. In March 2026, two and half years from now, the Government of Canada will pay back bond holders \$100. Investors buying these today will make a capital gain of \$10 plus an interest rate of 0.25%. With the favorable tax treatment of capital gains (50% tax free), these bonds are equivalent to buying 7% GIC’s.¹¹



Source: RBC DS

¹⁰ Fidelity Investments – Data collected from February 20th to May 15th 2020

¹¹ Based on the highest marginal tax rate in BC of 53.5%

Corporate Bonds:

We are finding good opportunities in corporate bonds. High quality, investment grade bonds in our portfolios are yielding between 6-8%, maturing over the next 3-5 years which includes bonds from companies like TD and BNS.

Preferred Shares:

Even more compelling for investors are preferred shares with yields being the most attractive we have ever seen. A Partners REIT preferred share we own will pay shareholders cash for their preferred shares in one year. That preferred is currently yielding 8%. An Enbridge preferred that we purchased earlier this year has a yield of 9%. Rate-reset preferreds reset their dividend every 5 years based on the current rates. As interest rates have skyrocketed, many of these preferred shares are resetting their dividends at much higher levels, some at or close to double digits. Similar to how a bank is collecting higher interest from their customers renewing their 5-year mortgage, we are collecting larger dividends for clients as our preferred shares reset at higher rates.

Being Paid to Wait

Unlike the line up at Lee’s Donuts, we are being paid to wait, paid very well indeed. In our stock holdings, many of them are providing double digit earning yields, twice as much as the best GIC rates today. That is in addition to an ability to a substantial capital gain as cash on the sidelines eventually flow back to markets. Something worth being paid to wait for.

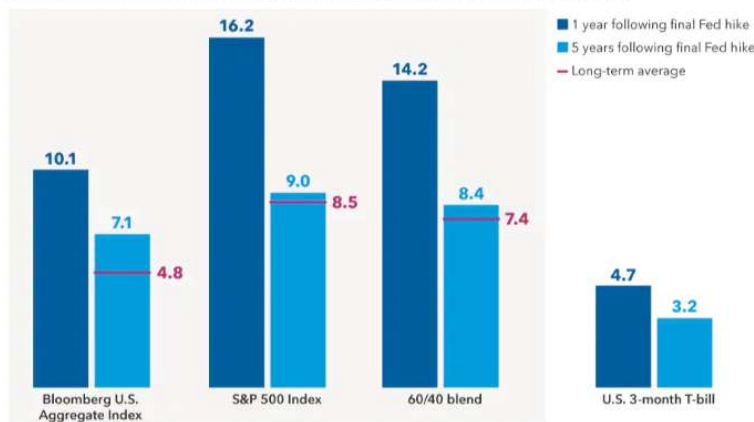
One thing many GIC investors forget to consider is the future. What happens when they need to renew their GIC in a year or two? What will rates be then? Rates have jumped because inflation rose to 10%. Now inflation is at 4% and as the economy slows and we run out of savings, consumer demand and inflation will continue to drop. Will banks still be offering 5% GIC’s when inflation falls back to 2% and central banks no longer want rates to be high? Where will the record amounts of cash in GIC’s go?

The End of Rising Rates

When central banks are done raising rates, cash has historically poured back into the markets causing strong, above average returns for investors.

After Fed hikes ended, long-term results outpaced cash, with the first year contributing most

Results have been front-loaded following the final Federal Reserve hike in the last four cycles (%)



Sources: Capital Group, Morningstar. Chart represents the average returns across respective sector proxies in a forward extending window starting in the month of the last Fed hike in the last four transition cycles from 1995 to 2018 with data through 6/30/23. The 60/40 blend represents 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index, rebalanced monthly. Long-term averages represented by the average five-year annualized rolling returns from 1995. Past results are not predictive of results in future periods. Returns are in USD.

Portfolios

Over the past year our portfolios have continued to outperform, and we have been taking advantage of the incredible opportunities we see in the markets, from discount bonds, corporate bonds, preferreds shares, and high-quality companies

like Manulife. This company has doubled its dividend over the past decade, and we expect to grow its payout by another 10% this year.

Back to our journey with Cheesy. It was getting dark as we weaved, backtracked, zigged, zagged, and sat on the ground and it was obvious that she was petering out. Her energy tank was depleted but we still needed to get home. We had made it to English Bay with the final stretch in sight, but Cheesy was quite content laying on the ground. Thinking of coyotes that may be possibly emerging at dusk and how'd they love to make a quick meal of Brown and Cheesy, I needed to get her up and home for dinner before we became dinner. Thankfully, I remembered the dog treats and quickly fed her one, and then another and another. Like Popeye with spinach, Cheesy was alive and up again and we were on the move. A few blocks later and after almost an entire bag of treats, we were home.

The sun had set, it was dark, it was past our bedtime, but we had accomplished our mission, a walk and tiring Cheesy out. In fact, she was so tired, she barely moved the next day and when we gave Cheesy back to our friends, she just slept for the next two days.

Many investors are like Cheesy. Easily distracted by the environment and losing sight of their goals. High rates being offered on GIC's, the daily news, market fluctuations, and what their family or friends are doing all serve to keep us from considering what our objectives are. Like Cheesy chasing squirrels, investors are chasing returns and the whims and fads of the moment and similarly never ever catching them but tiring themselves out along the way.

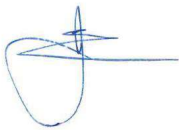
During COVID I remember walking down Robson Street and seeing store signs with sales of 50, 60, and 70% off... so I took the opportunity to replace my entire wardrobe. I figured deals like that do not come around often. When things are on sale, buy what's on sale! You can find us shopping the deals right now.

Focusing on your long-term investment goals are the best way to achieve them and the best way to avoid getting tired from chasing things that cannot be caught. After chasing the most expensive, non-profitable stocks in 2021, investors sold their investments for losses in 2022 while markets tumbled, and today they are tired like Cheesy. Falling asleep as an investor for a year of two is as dangerous to your future goal as Cheesy falling asleep in coyote filled Stanley Park.

We are focused on finding the best value for clients, determining the best place funds should go to before everyone else goes there and avoiding risks so we can get our clients home in time for dinner and into their warm, cozy bed.

If you had any questions on your portfolio, please do not hesitate to reach out.

-Kind regards,



Joshua Brown, CFA
Portfolio Manager



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