THE RISK OF LOWER RATES

Omaha, Nebraska. Population 500,000. Notable landmarks and attractions include the Henry Doorly Zoo, the Strategic Air Command Museum, a 3000-step pedestrian foot bridge and the headquarters of Mutual of Omaha, sponsor of the vintage Mutual of Omaha's Wild Kingdom television show hosted by Marlin Perkins which enthralled small children and animal lovers Sunday afternoons between the 1960's to the 1980's. If you remember that show, you are definitely a 'Boomer'.

This sleepy mid-west town may not be on most people's list of 'places to visit before I die', but for me it was at the top of my dream destinations.

Every May, Omaha is overrun by tens of thousands of visitors from all over the world coming in by commercial air, by car, by bus and by the most private jets anyone has ever seen outside of Beverly Hills. All are here to attend the Berkshire Hathaway annual shareholder's meeting and see the Oracle of Omaha, Warren Buffet, Berkshire's Chairman and CEO. As 40,000 shareholders and their entourage descend on the city, hotel rooms triple in price and are booked out months in advance, rental car selection evaporates (how about a Kia Rio), and you will need blackmail material on the owner to get a reservation at Gorat's, Warren's favourite steakhouse. For one weekend, Omaha has the atmosphere and enthusiasm of a Taylor Swift concert. And then on May 4th, 2024, I too was there!

Warren started managing Berkshire Hathaway in 1965 and is considered the world's most successful investor. Since he headed Berkshire, he has returned shareholders an average of 19.8% per year for close to 60 years[1], almost doubling the return of the S&P500. $1000 invested in the S&P500 in 1965 would be worth $280,000 in 2023. The same $1000 invested with Warren would be worth $35 million[1]. He didn't just beat the S&P500, he pretty much body slammed it.

Warren loves bargains, whether it is buying a multi-billion-dollar company or buying lunch at a fast-food joint, he is always looking to pay less than what it is worth. One time, he was in Hong Kong with his best friend, Bill Gates, Warren offered to take Bill to lunch. Buffett, the 10th richest person in the world and worth $125 billion, took Bill to McDonalds and when it came time to pay, he pulled out a coupon.

It has always been my dream to go to Omaha and attend Berkshire's annual meeting, considered the Coachella (or Woodstock depending on your age), for us finance nerds. This year it became a reality, and I was as excited as a 'Swifty' for the Eras tour.

[1] From 1965 until the end of 2023 - https://www.bankrate.com/investing/warren-buffett-top-stock-picks-of-all-time/

My dream weekend unfolded. I lined up at 6am in the rain and freezing cold to get a good seat in the CHI Health Centre, watched the corporate video with a special tribute to Warren's long-time partner Charlie Munger who died last year at age 99 and listened with rapt attention as Warren answered questions from shareholders and dispensed his wisdom for 6 hours. Then it was off to drive by the office of Berkshire Hathaway, an unimposing building on Farnam Street, midtown Omaha, and on to visit his house which he bought for $31,500 in 1958 and still lives in today, also on Farnam Street. I guess if you are one of the richest men in the world, you don't have to move close to your office, just move the office building close to you. To end my perfect day, we had dinner at Gorats Steakhouse, reservations secured months in advance. May 4th, 2024, there was nowhere else on earth I'd rather be.

What was my takeaway from the day? Like using a coupon to get two Big Macs for the price of one, I was reminded that Warren is astute at using opportunities like market selloffs and out of favour sectors to get more for his investors' money. This same attribute was instilled in me at a young age as my mom avoided paying full price for a meal. I remember going to A&W, her favourite place to take us kids and watching her select a coupon from the stack she pulled out and talking the cashier into accepting it even though it had expired five years earlier. My mom got value out of every opportunity, even expired ones!

<u>The Big Picture</u>

Today's investors are often enticed to focus on short-term news events or fluctuating stock prices by the streams of conflicting information constantly bombarding them. Warren takes a different approach. He steps back and looks at the big picture. For the same reason that movie goers in the front row tend to miss a lot of the story (and get a stiff neck), focusing too closely on the wrong factors make investors miss out on how the market is developing and where the opportunities are. By taking a broad approach as well as sticking to simple investment principles such as buying great companies like Coca Cola and American Express at good prices, Warren has done exceptionally well for shareholders for over six decades.

<u>Looking back at the Big Picture</u>

Heading into 2022 the biggest risk for investors were high interest rates. We warned that the move from record low rates to higher rates was going to be ugly and there would be carnage, not unlike telling a bunch of waiting WestJet travellers that the mechanics strike was going ahead despite government arbitration.

As central banks raised rates at the start of 2022 from 0.25% to 5% a blood bath ensued. The S&P500 dropped 25%, the NASDAQ suffered its worst sell-off since the 2009 Financial Crisis plunging almost 40%, the S&P/TSX fell 16%, global bonds had their worst sell-off ever collapsing 20%[2] and even the typical 'safe' balanced portfolio consisting of 60% bonds and 40% equities had its worst drop since 1937, falling 17%[3]. We protected portfolios by shifting into investments that had better downside protection in a rising rate environment allowing us to outperform a very challenging market.

<u>As rates rose to 5%, we have recently been sounding another alarm… the risk of lower rates.</u>

<u>Lower Rates?</u>

Aren't lower rates a good thing?

They are. Lower rates help stimulate the economy. Consumers spending is the biggest driver of the economy and accounts for 60-70% of our Gross Domestic Product. Lower interest rates encourage consumers to borrow and spend more. As rates fall, consumers increase their purchases of houses, cars, appliances, vacations, and concert tickets. To keep up with increased demand, businesses hire more workers, invest and expand into new factories, and all this causes the economy to grow.

Higher rates have the opposite effect. As rates go up, spending and borrowing by consumers drop, businesses cut back and the economy slows, something we have all witnessed over the past two years.

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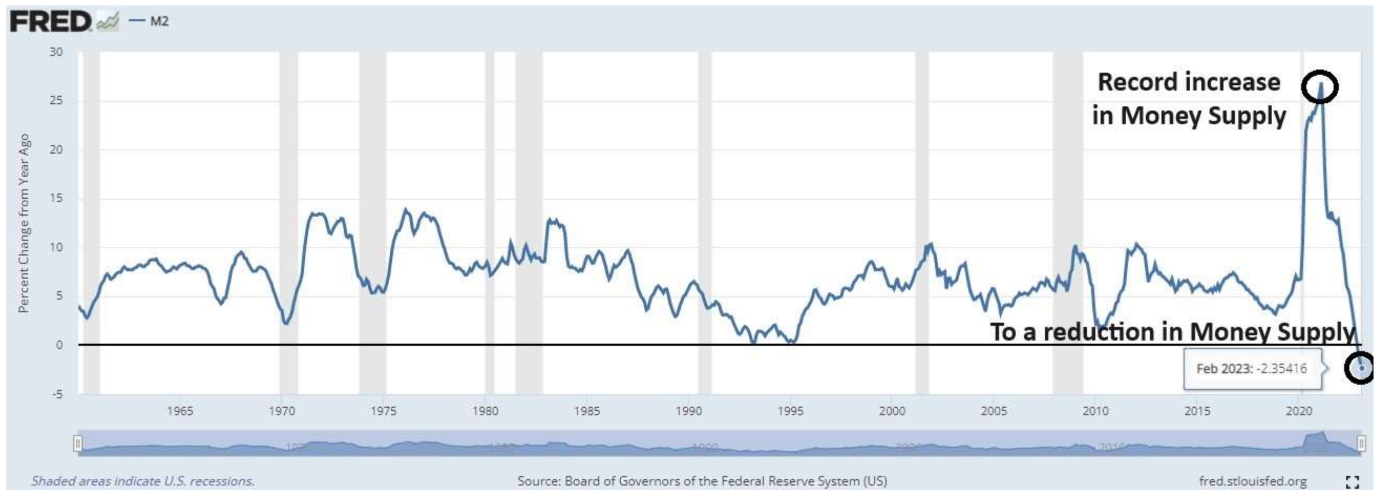
[2] Bloomberg Barclays Global Bond Aggregate

[3] https://www.morganstanley.com/im/publication/insights/articles/article_bigpicturereturnofthe6040_ltr.pdf

The Economic Reverse

As inflation approached double digits in 2022, central banks slammed the breaks on the economy. Interest rates rose from 0.25% to 5% at the fastest pace in 50 years and money supply fell at the quickest pace since the 1930's[4]. In the chart below, money supply went from growing by an astonishing 27% per year, to shrinking by 5% per year[5].



From one extreme to the other, like pulling the brake line on a runaway train at full speed, the economy was grinding to a halt. Changes to monetary policy such as increasing rates or reducing our money supply can take a year and half or more for the full impacts to be felt. Just like a runaway train does not come to an instant stop when the brakes are applied, there are loud squeals and lots of sparks as the train slows and we are likely going to see the same squealing and sparks from consumers as our economy begins to slow and inflation falls.

The Risk of Falling Rates

At the start of 2023, we started warning investors about the risk of lower yields and the concept of 'reinvestment risk'.

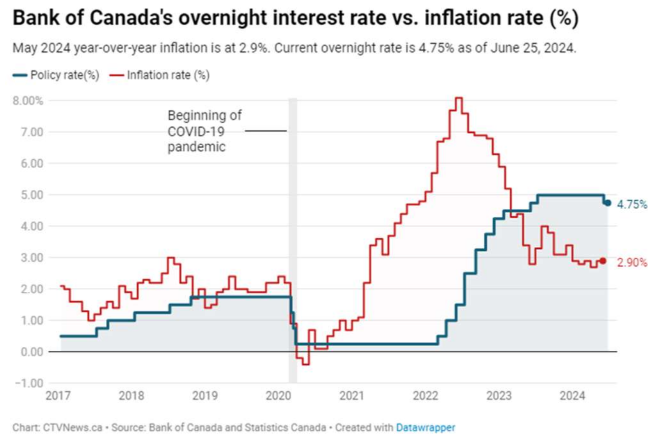
Soaring inflation, high interest rates and a large sell-off in their 'safe', balanced portfolios drove investors to flee to the 'safety' of GIC's and cash. Money market balances and funds in GIC's reached record highs and continue to grow today.

Like Warren, we love market volatility, and the big picture indicates that high rates were not going to last. As the effects of a restrictive monetary policy took hold on the economy, the growth slowed and inflation dropped, rates would soon follow. In the meantime, we were getting bargains not seen in several decades in both fixed income and equities. Yields were more attractive than the best GIC rates, with corporate bonds yields of 6-8%, preferred shares with almost double digits yields and equities with earning yields of 8–12%. The opportunities we were buying also had one key feature GIC's and cash did not…upside.

[4] https://mishtalk.com/economics/the-biggest-collapse-in-m2-money-supply-since-the-great-depression/
[5] https://ycharts.com/indicators/us_m2_money_supply_yoy

The Rate Cuts Start

With the brakes applied to the economy, the restrictive monetary policies have worked their way through the economy stalling economic growth and inflation. Unemployment in Canada and the US is starting to rise. The unemployment rate increased to a 29-month high of 6.3% in Canada and in the US, the highest levels since October 2021 at 4.1%. They are still low from historical standards but with a weakening job market we are seeing less pressure on wages, one of the key drivers of inflation. As the effects of higher rates filter through the economy, inflation has dropped significantly and is back to around our target range. Central banks have started rate cuts, on June 5th the Bank of Canada stopped their rate hiking cycle and cut rates from 5.0% to 4.75% for their first rate cut since 2020. The next day, the European Central Bank cut rates from 4% to 3.75% and the US is expected to follow. As economic data continues to confirm that the economy is slowing, markets are predicting more rate cuts later this year.



With the first-rate cuts, GIC rates are now lower than what they were a year ago.

Facing Lower Yields

Cash is facing a tough situation. It is now making less and less while investments have moved higher. Over the past year, the S&P/TSX is up 12%, the S&P500 is up 23%, the Canadian Corporate Bond Index is up 6.5% with some of our bond investments up double digits, and S&P/TSX Canadian Preferred Share Index is up 21%. Investors that had fled to cash are starting to witness the risk of lower yields. Their formerly hard-working cash assets paying over target inflation, has now like our Gen Z's decided on prioritizing work-life balance and is not delivering the returns they were last year.

If the Economy is Slowing, Why Are Markets Moving Higher?

The economy and the markets can be on two very different trajectories. The markets can have some of their strongest returns while the economy deteriorates. From March 2009 to October 2009, the economy contracted, unemployment increased and the S&P500 rose almost 60%. In 2020 the markets hit a bottom on March 23rd, US GDP continued to shrink for the next nine months while the S&P500 increased by 75%. *The markets look to the future and reflect what the economy is going to do, not what it is doing now*. In both 2009 and 2020 the markets anticipated an economy recovery and the stock market rose to reflect that well before the economy had recovered. Investors who waited for the economic data to confirm an economic recovery missed out on strong market returns like watching the last WestJet flight out of Calgary before the strike.

The economic slowdown over the past few years has occurred because of a restrictive monetary policy. Companies and consumers are still in relatively good shape but have cut back from the pressures of higher rates. The brakes that have been applied are bringing our economy to a halt and causing inflation to fall. To avoid putting the economy in a prolonged recession, central banks have begun to cut rates and are starting to alleviate the pressure of higher rates on consumers. As more economic data confirm that inflation is under control, central banks can take their foot off the gas with high rates, and instead continue with additional rate cuts.

Don't Fight the FED

The S&P 500 performance during every rate cut cycle

Date of rate cut	Date of rate hike	Days in between	S&P 500 annualized return
10/1/1982	3/31/1983	181	57.90%
8/17/1983	3/29/1984	225	-5.60%
9/20/1984	1/24/1985	126	16.80%
4/25/1985	7/25/1985	91	20.30%
12/18/1985	4/2/1986	105	49.90%
4/21/1986	5/22/1986	31	-20.10%
7/11/1986	1/5/1987	178	8.60%
7/2/1987	8/27/1987	56	69.40%
11/4/1987	3/30/1988	147	9.30%
7/7/1989	2/4/1994	1,673	8.40%
7/6/1995	3/25/1997	628	22.80%
9/29/1998	6/30/1999	274	43.10%
1/3/2001	6/30/2004	1,274	-4.70%
9/18/2007	12/16/2015	3,011	3.80%
	Average	571	20%
	Median	180	13%

Source: Strategas CNBC

Interest rates have a huge effect on stock markets. High rates drive funds from the markets into other areas, such as saving accounts and bonds. Low rates do the opposite and make markets more attractive which is the reason we so closely focus our attention on the actions of central banks. When the Federal Reserve (FED) embarked on rate cutting cycles in the past, markets have produced strong, above average returns. In the table above, focusing on only the time frames of past cycles of rate cuts from 1982 to 2015, the average return of the S&P500 has been 20%, almost double the total annualized return for the S&P500 during all cycles, of 11%[6]. It doesn't pay to fight the FED… or Mike Tyson, you just get hurt.

The Big Picture Today

The past four years have been one wild ride, like driving a Tesla on autonomous mode – yikes! We went from the most accommodative monetary environment in history in 2020, to the most restrictive monetary environment since the Great Depression a few years after. This has caused markets to roar ahead when central banks were accommodative, to a large sell-off when they became restrictive. As central banks have already started cutting rates or plan to later this year. It is important for investors to be positioned for the next leg in of our journey. Many investors were caught unprepared when central banks made the move from a restrictive or accommodative policy.

With the first-rate cuts, great opportunities begin to emerge. Preferred shares, our favourite opportunity in fixed income over the past few years, has outperformed most asset classes and we have recently seen a huge rush of companies redeeming their existing preferred shares. For some companies it has been more advantageous to issue other cheaper forms of debt instead of paying investors the current rich yields. Over the next two months over 5% of the entire preferred share market will be redeemed as companies such as CIBC and Royal Bank are paying investors $25 per share for preferreds that were trading at $17 a year ago. As investors receive cash for their shares, funds are recycled back into the existing preferred shares market putting a strong floor of buying pressure.

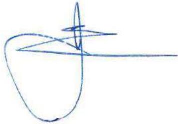
We have also increased our weightings in small and mid-cap stocks which are trading at the largest valuation gap with the rest of the market since 2000. This segment of the market is the cheapest they have been for over two decades. It's like we got into a Delorian time machine that sent us 'Back to the Future' and allows us to buy companies at the same cheap valuations they had at the start of 2000. From that time, they would return over 250% over the following decade and a half. As investors have clamoured to the hottest and most exciting Artificial Intelligence names, they have neglected many companies with strong and improving fundamentals over the past several years. These sectors temporarily out of favour to investors are great places for finding bargains, as Warren Buffet has shown.

Over the past few years, we focused on investing portfolios to the most attractive opportunities, setting our clients up for success over the next five to ten years, exiting the areas we see with the most risk and preparing for the next transition by central banks. After the Great Financial Crisis in 2009, investors facing low interest rates and accommodative central banks and monetary policies, poured cash into the markets pushing the S&P500 up over 600% over the next thirteen years.

[6] https://www.officialdata.org/us/stocks/s-p-500/1982?amount=100&endYear=2015

I feel so fortunate to have had the opportunity to have attended the Berkshire Hathaway meeting this year. There is a reason Warren Buffett is the world's most successful investor, his investment principles have stood the test of time. There are many investment managers who come and go with great short-term performance that don't last over the long-term. Recently it was Catherine Wood and her ARKK Innovation Fund which was the hottest and most exciting fund around. Investors poured billions into it as the fund returned 87% in 2017, 3% in 2018, 36% in 2019 and 152% in 2020. After investors rushed in, her ARKK fund (which should better be renamed the ARRGH fund) lost 62% over the past three years[7]. We believe the best strategy is to stick to the tried and tested principles of sound investing such as focusing on the big picture and finding a bargain when we can, something I learned from our friend, Warren…and my mom.

-Kind regards,



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[7] As of June 30th, 2024