Markets Made Simple

Chan and Brown Wealth Management

Wealth Management
Dominion Securities

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A ROCKY FUTURE

Like many marriages, it didn't last, it was officially done. It lasted two years before they called it quits. Jagmeet Singh, leader of the NDP announced on September 4th that their party would no longer support and prop up Justin Trudeau and his minority Liberal party. They were "too weak, too selfish", and "had let Canadians down". With Justin Trudeau's popularity falling faster than that of Megan Markle and Prince Harry, the NDP are distancing themselves from Justin and Canadians may be heading to the polls sooner than next fall.

On the other side of the border the US elections are also heating up. It is shaping up to be one of the closest Presidential races ever with the odds for either party winning the electoral vote the same as Jennifer Lopez's fourth marriage working out, about 50/50.

Two elections fast approaching. Each party with very different visions. Potential changes to our way of living, economy, and future. As each candidate lays out their plans, none have addressed the large pink elephant in the room, a risk that is slowly lumbering towards us.

Where has the Year Gone?

When I sat down to write this newsletter I could not believe where the time has gone. Fall is in the air, the Canucks are back on the ice, and Costco is selling Christmas decorations. Soon it will be Thanksgiving, Christmas, and then time for New Year's resolutions. I still have not started mine from 2023 which was to stop procrastinating.

The older we get the faster time seems to go by. Events like birthdays, anniversaries, and 5-Year colonoscopy exams seem to sneak up on us. Many risks in life are the same, suddenly appearing, and surprising us like our pet cat. Unlike a change of seasons, or birthdays and holidays, risks do not always provide the same luxury of giving us notice before they happen.

A lot of the risks in our lives start off as small and insignificant like staring at a distant light at the end of a long tunnel that grows larger and large until you realize too late that you are face-to-face with a CN train.

On a recent trip to the Grand Canyon with my dad, a risk which had been building for possibly thousands, even millions of years suddenly came to fruition. In a matter of seconds, we were faced with a life-or-death situation.

The Boulder

Walking behind my dad on a hike in the Grand Canyon, I saw movement from up the cliff and a boulder the size of a Chinese made EV come crashing out of the trees like a scene from Indiana Jones. I had heard some rustling from the hill earlier but thought it was something innocuous like a squirrel or friendly bear cubs playing. Instead, before I could think "Danger Will Robinson…Danger", the rock was flying in a trajectory that would intersect with my dad's head.

We thought we had prepared for everything for our hike. Extra food, water, proper hiking gear, enough caffeine to keep us awake for a week and the latest Rolling Stones album on our iPod's (a big upgrade from our Sony Walkman). With all our planning there was one risk we had not thought of, a boulder sitting harmlessly at the top of the canyon that would become dislodged the moment we walked below humming along (ironically) to "Miss You".

The risk of that boulder tumbling down the Grand Canyon had grown over time. Erosion and weather increased that risk until one day, that risk suddenly materialized…not unlike the risks which are quietly building today that political leaders are choosing to ignore. On our hike, that risk had simmered for eons. We were unaware of the risk until suddenly, it erupted…full force into our lives.

Going Back to WWII

World War II ended on September 2nd, 1945. Wars are not cheap, they cost a lot of pain and loss of life as well as money. When we got the final bill, it was like my plate at Thanksgiving dinner, huge and overflowing. This bill took decades to pay down and caused taxes to skyrocket. The highest marginal tax rate in the US reached 92%. It eventually dropped back to 70%...36 years later. Inflation was a byproduct that wiped out the value of cash. Cash was worth 25% less five years after the war, 10 years later it lost a third and after 40 years it had depreciated by 80%.

As pleasant as talking about politics at the Thanksgiving dinner table, paying the final bill for WWII was uncomfortable to say the least. The litany of uncomfortable results included higher taxes, loss of purchasing power and fiscal restraint by governments, but the enduring economic and fiscal pain was a lot better than ignoring the bill. When we don't pay our debts our credit scores fall, and lenders become nervous and stop lending money. The same happens with governments, as they excessively borrow, they reach a point where they owe too much and finally get cut off from lenders. History is full of these examples and the results are not pleasant. Countries like Germany after WWI, Mexico in 1994, Russia in 1998 and Argentina all have dealt with unmanageable government debts, suffered economic collapses, and had to deal with the long painful road to recovery, sometimes taking several decades.

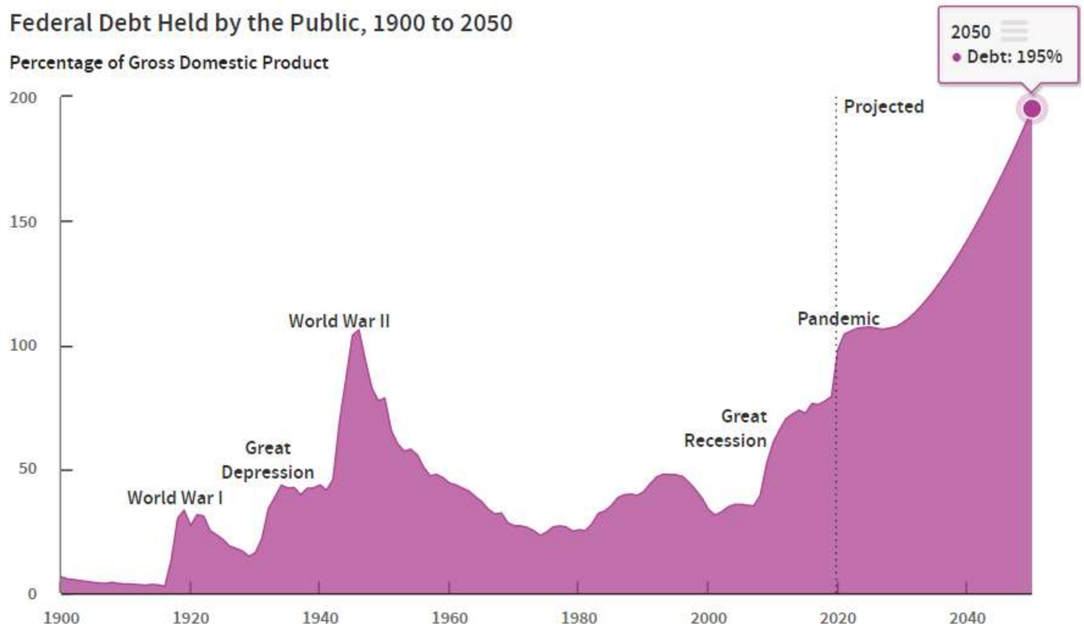
If the US had been cut off from credit after WWII due to mounting deficits and poor fiscal restraint, the history books would read much differently. The US would not have had the ability to have the strong economic growth they witnessed after WWII or remain as the dominant financial superpower they are today. To grow, countries need easy access to credit at favorable rates, this is a key component and the backbone to a strong and growing economy. No access to credit equals no growth.

Governments that borrow too much also find themselves in a tough position when the next crisis occurs. Canada and the US were able to recover quickly from the 2008 Financial Crisis and from the 2020 worldwide pandemic by accessing and tapping into their lines of credit. Paying down debt when times are good allows you to borrow when times are bad. If we could not respond to these crises by borrowing, the outcome would have been much worse. During the Great Depression in 1930's, policymakers made several errors. They responded too slowly to providing stimulus to the economy to bridge the gap from the slowdown. A recession turned into a Depression and the US downturn spilled over to the rest of the world causing a global financial crisis. It took over a decade of pain and suffering for the US to recover and for other countries, it took even longer.

Post WWII, we did not get our fiscal house back in order until the 1980's. This then set the stage for the next generation of unprecedented economic growth over the next 40 years as well as the ability to deal with setbacks along the way such as the Financial Crisis in 2008 and COVID in 2020.

Deficits Today

The graph below shows the United States Federal Debt to GDP since 1900. WWII caused the ratio of Federal Debt to GDP to spike over 100%. By 2008 this ratio had fallen back to 39% and then increased again to 100% during COVID as we had to bridge the gap in the economy from the pandemic. On our current trajectory, deficits are expected to reach 200% of GDP by 2050, however that will not be our problem, Gen Z or Z1 or Z2 will have to deal with it.



Canada has increased their debt by 83% since 2008. From that time, we have also accumulated twice the amount of debt we worked so hard to pay down between the mid-1990's to 2008. Under Prime Minster Justin Trudeau, federal spending has reached the highest inflation adjusted spending per person in Canada[1]. Basically, he is like Elon Musk's ex-girlfriend, Grimes, spending more of our money each year because "there is always more where that came from".

The plan from politicians for deficits is to ignore them and push them into the future. Politicians today are too busy trying to get elected or re-elected to worry about the future and there are no plans on either side of the border to address this quietly growing risk.

Under Kamala Harris's plan, the US total deficit will increase by $1.7 trillion over the next decade[2] and under Donald Trump it is forecasted to increase by $4 trillion[3] or as the Donald would say "Billions and Billions". In Canada, recent estimates show deficits will continue to grow with no plans for a balanced budget. When the Liberals first came to power, they at least pretended the budget would balance one day. Now they don't even pretend, "No son, there is no Santa Claus". Like a homeowner who borrows more and more from the equity in their home until one day they reach their limit and there is nothing left to borrow. Instead of being house rich and cash poor, they will be house AND cash poor.

The Downgrades

There are three primary credit rating agencies that rate government and corporate bonds. This is important because when investors lend their money, they want to know how likely they will be repaid. The higher the credit rating, the higher the chance they will get their money back. Borrowers in a strong fiscal situation will get lower interest rates and borrowers who are more questionable will receive higher rates.

[1] https://www.fraserinstitute.org/sites/default/files/growing-debt-burden-for-canadians-2024.pdf
[2] https://thehill.com/business/budget/4831977-harris-economic-pitch-cost-analysis/
[3] https://thehill.com/business/budget/4849727-trump-economic-proposals-deficit-analysis/

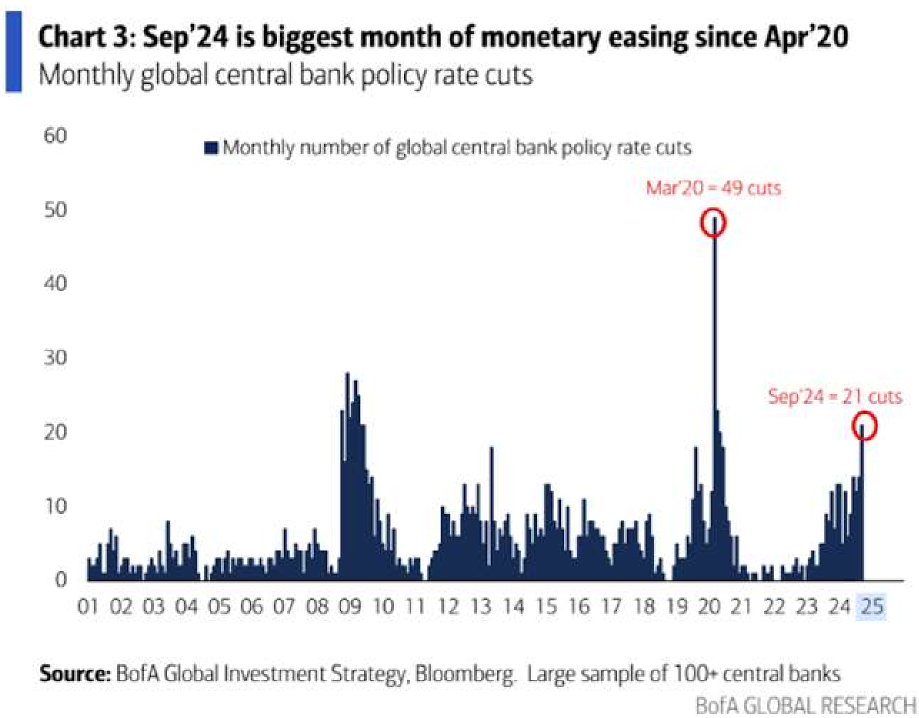
When a borrower's credit is downgraded their cost to finance initiatives gets a lot more expensive until their rating improves. Canada and the US have historically enjoyed the highest possible credit rating, AAA, from all three of the rating agencies. AAA is the gold standard and provides the best access to rates and credit. For the first time in the history, the United States was downgraded by one of the rating agencies in 2011, and then again in 2023, a second rating agency downgraded them[4]. Canada saw their first rating reduction in 2020 and based on our current spending, we are at risk for future downgrades[5]. Credit rating agencies have noted the deteriorating financial situation for both Canada and the US. As time passes, the hole is getting deeper and deeper with no signs that our political leaders will stop digging anytime soon.

<u>How do you Protect Yourself?</u>

With deteriorating fiscal positions in both Canada and US, the long-term outlook for the countries are looking more uncertain. Therefore, we are avoiding long-term government bonds. As we witnessed after WWII, large government deficits wiped out the value of cash. Investors need to protect against that risk with the appropriate investments. Areas to consider include real assets such as gold and gold equities at large discounts to their net asset values, energy companies with record cash flows, real estate companies with inflation protection through increasing rents, and global stocks with growing revenues from multiple sources.

<u>The Shift to Lower Rates</u>

Higher rates over the past few years have worked to slow the economy and caused inflation to fall. In Canada inflation has dropped from over 8% to 2%[6] and in the US it is back to 2.5% after reaching 9%. As inflation has returned to target ranges, central banks are now shifting their attention to the economy and stimulating it with rate cuts. September saw the largest month of monetary easing by central banks around the world since April 2020 and aside from the record stimulus during COVID, the highest month of easing since the Financial Crisis 15 years ago.



As we open the next chapter in monetary policy, with an environment of falling rates, are investors ready? Observing the record amount of cash and GIC's on the sidelines, we do not believe so.

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[4] https://budget.house.gov/resources/staff-working-papers/us-debt-credit-rating-downgraded-only-second-time-in-nations-history
[5] https://financialpost.com/news/economy/canada-credit-rating-at-risk-if-deficit-deepens-rbc
[6] https://www.ctvnews.ca/business/canada-s-inflation-cools-to-2-in-august-the-smallest-gain-since-early-2021-1.7040815#:~:text=August%202024%20year%2Dover%2Dyear,as%20of%20August%2020%2C%202024

New Risks Today

New risks have emerged over the past year including sky-high valuations in technology and Artificial Intelligence, an economic slowdown and increasing government deficits. Our focus is on positioning portfolios for the growth opportunities while managing sudden, unexpected risks, as well as risks that have been building over the long term. This brings me back to the story of my dad and the big rock.

The Grand Canyon

Watching the boulder speed towards a messy collision with my dad and with only a fleeting thought of how this could literally 'rock his world', I yelled:

"RRRRRUUUUNNN!!!!"

My voice had a tone of panic that my dad had only heard once before when I was being chased by the neighbour's rottweiler and he instantly knew something was wrong. Fortunately, my dad is a rare breed. Humans in general are genetically programmed to avoid speeding objects but as a seasoned hockey goalie, my dad uses his lightning-fast reflexes to throw himself in front of them. That ability also allows him to avoid speeding objects such as flailing hockey sticks or opponents on a breakaway that lose their balance and slide headfirst towards him. At the sound of my voice, he sprang forward like Usain Bolt at the blocks and dodged the boulder as it went flying past within inches of his head.

The boulder continued on, crashing down into the Grand Canyon below. Avoiding the boulder was not without consequences as the sudden jarring caused a tear and searing pain in his shoulder, aggravating an injury from hockey a few weeks prior. However, that is a small price to pay considering the alternative of suddenly travelling to the bottom of the Grand Canyon in seconds instead of days.

There are risks in life you can plan for and risks you may need to just react to. As much as possible, we prepare portfolios for the risks that we can see on the horizon but also ensure we are nimble enough (like my dad) to react to risks that appear suddenly and without warning.

By preparing ourselves for these risks, we can also profit for our clients and take advantage of opportunities in the aftermath of risk events. Investors who are not prepared can be surprised by the unexpected quietly building risk, and suddenly find themselves facing a rocky situation.

Later, as my dad and I watched the most magnificent sunset atop of the Grand Canyon eating the gourmet dinner that I prepared, tuna from the can, cheese, and crackers, and for dessert, Original Werther's butterscotch candy, we reflected that being on top of the canyon with a sore shoulder is a lot better than being at the bottom smashed to a pulp.

-Kind regards,

Joshua Brown, CFA
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