Money Never Sleeps

The newsletter for the informed investor

Wealth Management
Dominion Securities

Fall 2024

Vito Finucci, B.Comm., CIM, FCSI
Senior Portfolio Manager
& Investment Advisor
519-675-2011
vito.finucci@rbc.com

Eric Janitis, CIM
Senior Portfolio Manager
& Investment Advisor

Rachelle Allen, CFP, CIM
Portfolio Manager
& Wealth Advisor

Gary Weatherup, CFP
Associate Advisor
& Financial Planner

Jodie Fuller
Associate Advisor

Sarah Smith, CIM, FCSI
Associate Wealth & Investment Advisor

Vann Robson
Associate Advisor

Jessica Basacco
Administrative Assistant

Lindsey Rideout
Associate

Ryan Tanason, CIM
Associate Advisor

Andrea Oliviera
Associate

Fax: 519-675-2020
www.fjawealth.com

RBC Dominion Securities
148 Fullarton St., Suite 1900
London, ON N6A 5P3

Predictions are hard, especially about the future

Do politics affect the markets?

"I think more inflation over the next 100 years is inevitable with – given the nature of democratic politics – politics in a democracy. So, I think we'll have more inflation." – Billionaire businessman Charlie Munger, 2023

With a nod in the title to Yankee great Yogi Berra, this issue of *Money Never Sleeps*, which was intentionally delayed until after the U.S. election, will look at several issues facing investors in this ever more complicated world. All the pundits made bold predictions about what should happen if this person won, or what would happen if the other person won, but markets are a lot more nuanced than that. The answer to the question of whether politics affect markets is definitely not "zero". Political policies can have a huge effect on economies, and by extension, markets. One perfect example of that unfolding right in front of us now is the nation of Argentina.

Here is a very short list of some things that can affect markets:

- Taxation
- Trade policies
- Regulation
- Monetary policy

Wait, monetary policy? But monetary policy is not supposed to be political? In this election, it was absolutely political because Mr. Trump has said on the campaign trail that he wants a voice in setting interest rates ... lower. One would then assume monetary policy would be unquestionably easier in a second Trump term, which is going to make stocks go up – right? Maybe. But odds are, it would also make the yield curve steepen, perhaps like never before.

The recent U.S. election, combined with the U.S. Federal Reserve (the Fed) rate cut, have provided another boost for the markets. The still inverted yield curve in the U.S. suggests further easing coming, as (supposedly) inflation is under control. Right now, it appears the Fed has achieved a soft landing – slowing growth, but no recession.

For now.

This is usually a perfect backdrop for equities as rate relief benefits consumers, and economic growth helps corporate profits. The biggest question for investors now is: "How much of this is already built in to stock prices?"

Trump's victory was largely won on the economy, now he will have to offer details on all of the tax cut proposals he floated on the campaign trail.

(Continued on page 2)

Washington, D.C., lobbyists will be busy in 2025. Another question is foreign policy. Can Trump quickly end the Ukraine War? And how about Gaza? Many Trump supporters are calling for diminished military spending. In Canada's case, we know there are no Christmas cards being exchanged between the President and our Prime Minister.

Another theory making rounds is that now that President Trump was re-elected, inflation is going to surge. The premise is that he will raise tariffs, reduce immigration, and jawbone the Federal Reserve to cut rates aggressively, all of which could push inflation higher. Remember, Trump raised tariffs during his first term and yet inflation remained subdued until the Fed ignited it during the COVID-19 lockdown. The same applies for immigration, which was much slower in Trump's administration than under President Obama's terms, without causing any inflation spikes. By contrast, immigration soared under Biden, while CPI inflation has averaged 5.60%. If immigration was some sort of secret elixir that kept inflation lower, why wasn't inflation much higher under Trump than Biden or Obama?

Ultimately, as the great Milton Friedman told us many times, it's monetary policy that determines inflation, not tariffs or immigration. While it may be true President Trump will put loyalists in charge at the Fed, overall, Fed committee policymakers turn over gradually and every nominee has to be confirmed by the Senate. Politically, no one would want to leave a legacy of causing a surge in inflation. The Fed is a political animal, and there are a lot of politics tied up in the job market. When people start losing their jobs, politicians panic, and then they blame the Fed. In 2021 and 2022, the Fed cared about inflation. Now, according to them, inflation has been tamed, so they now care about growth. My two cents: They should still care about inflation. If they believe their economic data, why are they even cutting rates at all?

What does gold know? If you look at the action of gold, it's been going up since it broke out above $2,530 an ounce. Until the election, and the U.S. dollar rallied, it went straight up. Gold is discounting a highly inflationary period ahead. Gold historically simply discounts the probability of future debt monetization. No matter who won the U.S. election, odds are even higher deficits are coming. The odds that the Fed will someday have to peg the yield curve – printing a virtually unlimited amount of dollars to buy government bonds to keep interest rates low – have gone up ... a lot. If gold continues a lot higher, it probably will mean the world economies are not in a happy place. The odds of a Fed policy error have risen.

Inflation...inflation...inflation...

The purchasing power of money will always decline and that's the nature of it. The only way to keep pace with inflation has been to invest money into "hard assets" – real estate, stocks, commodities, collectibles. The people who always get left behind are those without means to invest, with stagnant wages barely keeping pace with the rise in prices. Check out this almost 400-year chart of the purchasing power of the U.S. dollar. If you look at the chart closely, you will see a huge slide starting in 1933:

(Source: Statista https://www.statista.com/statistics/1032048/value-us-dollar-since-1640)

What happened in 1933 you ask?

Upon taking office in March 1933, U.S. President Franklin D. Roosevelt departed from the gold standard. By the end of 1932, the gold standard had been abandoned as a global monetary system. Czechoslovakia, Belgium, France, the Netherlands and Switzerland abandoned the gold standard in the mid-1930s.

I hear people talk about solutions to this problem and pretending that Trump, somehow, will be able to fix it. He cannot.

The only way to reduce the price of things is through massive deflation. In order to achieve deflation, we'd need a Great Depression-style collapse in the banks and employment markets, creating a scarcity of money, which in turn would increase the value of your money. The problem with periods of deflation is that people don't have incomes to enjoy the cheap prices – akin to not having anywhere to go or drive to during the COVID-19 lockdowns to take advantage of the negative $36 crude prices at the time.

If you want to fix the inflation problem, the entire monetary system needs to be uprooted and changed. The Fed would need to cease to exist and the dollar would need to be restructured, and the ability to print money greatly limited, via backing it by assets and/or gold. Currently, the dollar is a debenture, not really backed by anything other than the "full faith and credit" of a malfunctioning government. One with a basic understanding of economics and basic critical thinking can see where this will eventually go, but we're not going to willingly swallow these pain pills. The way prices will come down, eventually, will be through the destruction

(Continued on page 3)

of some markets, the global monetary system, and some governments.

Speaking of inflation, what is often lost in the discussion is the nature of inflation and its impact.

Inflation is a regressive tax, impacting households regardless of income, yet doing so with varying degrees of relative magnitude. That is, the more vulnerable household segments are disproportionately affected by this hidden tax, the effect of which is gradual and cumulative. As such, disinflation from record-high price levels offers little relief.

The inflation effect has manifested in the rocketing credit card delinquency rates we see as reported by Capital One and Discover, two of the big card lenders with outsized exposure to lower-income and less creditworthy borrowers. From the latest recent numbers, it is readily apparent that we have overshot normalization and there doesn't seem to be abatement in sight, notwithstanding the supportive labour backdrop.

Contending with the cumulative effect of 26 consecutive months of real earnings decay, households turned to credit lines in bridging the income gap. Unsurprisingly, revolving credit has reached an all-time high of $1.3 trillion. While some argue that revolving consumer credit as a share of disposable income is below pre-pandemic levels, the rate-of-change in these balances is what matters: Credit card debt is currently growing at +9.3% y/y, far exceeding the 20-year average of 3.3%.

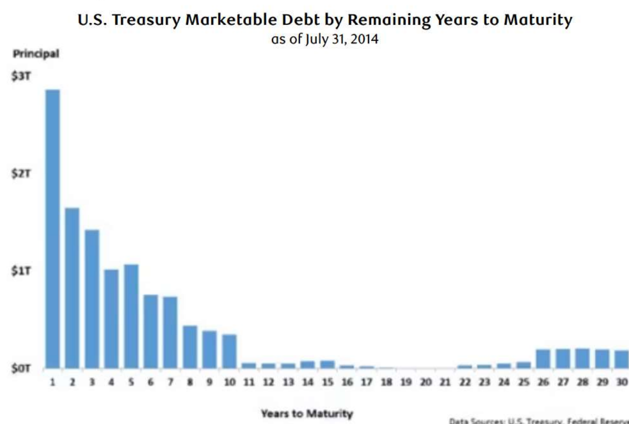
Another significant factor contributing to the observed credit deterioration is the "catch-up" or "credit boomerang" effect. Historically, periods of credit underperformance are often succeeded by periods of outperformance and vice versa. The aftermath of the Great Financial Crisis (GFC) of 2008-09 exemplifies this phenomenon, with net charge-offs and bad credit being pulled forward and washed out by a severe economic downturn and leading to credit outperformance in its wake.

We are currently experiencing the inverse of that reality: The pandemic acted as the mother of all bailouts for the most vulnerable of borrowers. Paradoxically, the worse off you were, the better off you became. Now, with pandemic-induced excesses having been eroded, this ever-present, most vulnerable household segment is returning to economic reality. There are people who say the worst of credit is behind us and, based on how some of the card lenders have performed recently, one may think that; however, the data, and the sanity it lends us, does not seem to be turning that way.

I challenged you earlier to think about why the Fed was cutting rates earlier because on paper thing are good:

- Unemployment is low.
- Sales are strong.
- Profit margins are good.
- Stocks are near record highs.

It's a curious thing to need to cut rates when at record highs. But beneath the veneer is a categorically odious facade. There's a debt maturity wall looming in the literal sense, as you can see in this chart:



(Source: The Financial Times https://www.ft.com/content/f034fa9c-e1f7-39e3-ae3e-f2f643350f21)

Globally, things aren't much better, as these tables show:

(Source: S & P Global https://www.spglobal.com/ratings/en/research/articles/240205-credit-trends-global-refinancing-maturity-wall-looms-higher-for-speculative-grade-debt-12991317)

Refinancing demands loom
Speculative-grade represents a growing share of upcoming maturities

Debt maturing in the next:	12 months	24 months	36 months
Total debt maturing	$2.00 tril.	$4.52 tril.	$7.30 tril.
Percentage of total debt	8.5%	19.3%	31.1%
Speculative-grade share	12%	17%	20%
Amount rated 'B-' and lower	$60.4 bil.	$214.0 bil.	$441.4 bil.
Regional breakout (U.S. / Europe / Rest of world)	41% / 38% / 21%	42% / 38% / 21%	44% / 38% / 18%

(Source: S & P Global https://www.spglobal.com/ratings/en/research/articles/240205-credit-trends-global-refinancing-maturity-wall-looms-higher-for-speculative-grade-debt-12991317)

If the Fed doesn't start cutting rates more aggressively, soon and fast, then a wide swath of companies might go bust, facing quadruple the amount of debt maturities from now till 2028. That's all this is, "financial engineering," and the Fed, for once, getting ahead of the

(Continued on page 4)

curve. If done right, we might all benefit from this and perhaps create another giant bubble to worry about by the 2028 U.S. election.

Before you say, “the first cut by the Federal Reserve is bullish”, make sure you have a view that a recession isn’t imminent. In the case of a recession, 50 days after the first cut, the S&P 500 was down on average 5%. Whereas, no recession, it was up 5%. Heck, we gained 5% just three days after the election results came in.

What about other segments of the market? Unfortunately, the Nasdaq didn’t exist in the 1980s, so we don’t have a complete data set of its behaviour after the first rate cut, but there were small-caps.

Yes, Trump won, and consensus seems to be he will be better for the economy and markets. But let me ask readers a question: What are the odds that Trump’s next four-year term won’t have a recession and, with it, some form of a bear market throughout his entire second term?

Historically, bear markets have occurred once every four to five years in terms of market cycles. The average duration of a bear market is 12 to 24 months, though this can vary. On average, the stock market experiences a bear market every 3.5 years. Given the above, over any four-year period, the probability of a bear market is somewhat high. Considering we haven’t had one in 16 years (I am excluding the 30-day COVID-19 bear market), I will ask again, if we haven’t had a recession in more than four years now, is the probability higher or lower we will have one under Trump?

The point I’m trying to make is: Given the way investors have been behaving since the election, it’s as if many believe that stocks and the economy will be up and up non-stop over the next four years, as we experience the biggest boom in history. Now, don’t get me wrong, I hope that happens, but four decades of experience with these sorts of things tells me to be wary. Economic policies (like the ones of the past *four* years), tend to work with a long lag. Yes, Trump will have pro-growth policies, but you might not feel the effects of them for a while.

We will also probably see some sort of collision coming between the Trump administration and the Fed and, odds are, it won’t be pretty – probably market moving as well. I remind you, this is the same Fed who waited until a month before the election to cut a “surprise” 0.50 basis points. The same Fed who, for almost eight years, sat on their hands, and immediately raised rates for the first time last cycle a month *after* Trump was elected. But please, don’t believe in coincidences.

There will be a lot of good (and probably bad too) that will come with a second Trump term, but perhaps the best thing that will come out of it will be the complete dismantling of the regulatory state, which has grown exponentially since 2008 when Obama began pouring resources into regulators on top of regulators. It’s now like a bad condo homeowners’ association.

The 60/40 portfolio

After its worst year on record in 2022, the 60/40 balanced portfolio has rebounded. Its death was greatly exaggerated.

(Source: AXIOS Markets 4-12-24 https://www.axios.com/2024/04/12/60-40-portfolio-stocks-bonds)

Despite the fact markets are at, or close to, all-time highs, the reality, as we’ve mentioned so many times in the past, is that a small number of stocks have driven the performance over the past several years, while much of the rest of the markets have treaded water. This may mean there is more opportunities in those names/sectors as they play catch up. Discipline is the key at this point in the cycle. We’ve been trimming winners when it makes sense where prices no longer offer adequate risk/reward upside and trying to replace them with names that offer more compelling value. Patience will important for investors as we go forward.

Wealth Management
Dominion Securities

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The strategies and advice in this report are provided for general guidance. Readers should consult their own Investment Advisor when planning to implement a strategy. Interest rates, market conditions, special offers, tax rulings, and other investment factors are subject to change. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. © 2024 RBC Dominion Securities Inc. All rights reserved. 24_90641_NF8_005