Manulife Securities

ROYDS REPORT

April 2022

Statements Aren't Pretty this Quarter

If you've been our client for very long, you'll had had a comment or two written on your mailed out Portfolio Reviews in the past that said something like "just hold on when the market is down to give it a chance to recover and go on to long-term gains." And there have been lots of corrections (1998, 2001, 2007-2009, 2015-2016, 2018, and 2020, and even more 5% dips and 10% pullbacks, including now. And each time markets did indeed recover and go on to new highs. Now we have another market pullback, with only the NASDAQ index falling to the correction level (-20%) at one point. Again, we need to stick with the long-term plan of holding quality, well-researched and growing companies that weren't purchased at outrageous prices and ride out the ups and downs of the market to get long-term growth. If anything, we should invest more in market down periods, like our favourite role model, Warren Buffett. He just bought Alleghany, an insurance company, for about $11.6 Billion, which "adds to its [Berkshire Hathaway's] 2022 acquisition run" and Buffett "hinted earlier this year that he may be tempted to put his [Berkshire's] $146.7 billion cash pile to work in finding more companies to buy".
(Source: thestreet.com Mar 21, 2022 post)

So, as bad as statements look (they looked worse a few weeks ago and they will look worse periodically in the future too), remind yourself that your funds' managers are holding strong, growing companies that the managers' analysis showed weren't overpriced before the market drop. Then trust that the market will eventually value the stock logically and will reward profit increases with increased stock prices. So it certainly not time to sell out of the market. And, if you haven't topped up your TFSA or want to make a 2022 RRSP contribution, why not do it now while the market is on sale. (And "Way to Go", all of you who have already taken this opportunity to "buy low".)

The Latest on Interest Rates, Canadian GDP and Resources

In an attempt to help Canadians continue to be able to afford their outsized debt by keeping interest rates low, the Bank of Canada's low interest rate policy allowed Canadians to borrow even more, cheaply, especially for mortgages to buy houses at prices the borrowers wouldn't normally be able to afford. Now the Bank of Canada has to be careful when it raises interest rates not to raise them too fast or too much, because it could tip the economy into a recession. At the same time, the Bank of Canada is very motivated to increase interest rates to try to control inflation, which has ballooned up to about 5.7%. The Bank of Canada's inflation target is 1-3%. Higher interest rates are how central banks tame inflation. The Bank of Canada could increase interest rates by 2% this year, according to CIBC Economics. The next rate increase in Canada is expected on Apr 13 and could be .5%. Prime interest rates could increase to about 5%.

If you have a line of credit on which you currently only pay interest or a HELOC (Home Equity Line of Credit), the interest rate rises could impact your monthly cash flow a lot. The average HELOC in Canada is about $52,000. For a loan at prime plus .5%, monthly interest payments could increase about $100. If you have a $500,000 mortgage and your interest rate on renewal increased only 1.5% (less than interest rates might go up) and went from 3.5% to 5%, your monthly payment, assuming a 20 yr amortization, would go up almost $400. Many mortgage holders won't be able to afford such greatly increased payments. (Source: Globe & Mail Mar 31, 2022)

Be very careful of taking on any new debt and it you have a lot of debt now, think about what you can do to lower it as quickly as you can before rates get much higher.

The UK increased interest rates before Canada and the US started their interest rate increases, but interest rates in the West pale compared to Russia's doubling of interest rates this winter to 20%, and this at a time that the ruble is at an all-time low compared to the US dollar. (Source: NBC.com Feb 28 22) And apparently, Russia is headed towards a $150 Billion debt default (on debt taken out at pre-invasion interest rates). So high rates are all relative! (Source: AGF email Mar 31 22)

Russian's situation makes Canada look pretty good, but Canada doesn't look so favourably positioned when it comes to GDP (Gross Domestic Product) growth however. The Organisation for Economic Co-operation and Development (OECD) predicted in December that Canada would have the lowest GDP growth of any advanced economy for the next 40 years!! The OECD says Canada is failing to 'raise workers' productivity and real wage growth through higher business investment per worker, faster innovation adoption, and getting the average company to operate at scale". (Source: https://bcbc.com/insights-and-opinions/oecd-predicts-canada-will-be-the-worst-performing-advanced-economy-over-the-next-decade-and-the-three-decades-after-that)

One thing the OECD isn't factoring in is that, "since 2016, Canada's population has been growing faster than that of any other G7 nation, according to Statistics Canada data released in February this year… one could reasonably expect its consumer base – and, correspondingly, domestic consumption – to grow faster than in counterpart economies. Countries with sustained population growth are attractive landing spots for foreign capital looking to invest." (Source: Mar 22, 2022 Commentary by Mike Archibald, a VP at AGF) While we (and other developed nations) need immigration, because the we don't have enough native born people entering the labour force to replace all the retiring ones, we seem to be missing out on the other ways to grow our GDP.

Canada's stock exchange has been a star so far in 2022 on the back of higher resource prices, like oil and potash, due to the disruption of supply from Russia, Ukraine and Belarus. So why aren't our portfolios loaded up with Canadian stocks? It might be a good short-term play, if you are nimble enough to get in in time and out before supply increases and resource stocks fall back. That timing is something we leave to our fund managers, especially since short-term moves like that can be very tax inefficient. Basically we don't want to be too exposed to the Canadian market, because, "average returns in the United States have outpaced Canadian returns over the past 30-plus years (8.5% U.S. return vs. 5.4% Canadian return, both in local currency terms). … the resource dependency of the Canadian economy (and stock market) has led to more sectoral volatility over time." (Source: Mar 22, 2022 Commentary by Mike Archibald, a VP at AGF) If this long-term outperformance of the US market persists, and US stock market returns are less volatile than Canadian market returns, portfolios that are overweight US equities should make more money without being as much of a rollercoaster ride.

High Risk Investing, or Gambling?

In the last couple weeks of March, some of the "meme-stocks", like GameStop Corp and AMC Entertainment Holdings, that went on wild rides last year, because of internet chat by influencers who wanted to show that they could control the market, doubled in value. ARK Innovations, an ETF filled with high growth stocks, is up 26%. Bitcoin is up 19%. Meanwhile the S&P 500 index is still down about 3.4% after being down 12.5% earlier in the quarter. Before you wish that you held those "investments", we should mention that GameStop and AMC, despite doubling, are still down 52 & 59% from last year. ARK is still down 56% and Bitcoin 30%. Some people win putting their money into these things, IF they time it right. Many people lose a ton of money on these volatile holdings. If you can read the market's emotional state and accurately assess popularity levels on an ongoing basis, you can make a fortune with these kinds of purchases. But if you read the market's emotions incorrectly, you can lose big-time and in possibly non-recoverable ways. If you want to invest with a more predictable outcome over the long-term and without risking permanent losses of capital, you should buy stocks that have tangible assets, recurring and growing income streams, and try to get them at bargain prices. Remember that your retirement and other financial objectives are riding on your actions.

We can expect more craziness like this in the markets ahead. Goldman Sachs predicts that more of the $15 Trillion US dollars that Americans are holding in cash will be moved into equity markets. "Retail is seeing that speculative trading still works and is still trying to catch the high-flyers of the day" according to the chief executive of TradeZero, a retail brokerage. In other words, non-institutional (and mostly younger) investors have reduced their large-cap stock holdings in favour of more speculative stocks, apparently to make up for earlier losses. (Source: Globe & Mail Apr 1, 2022)

In summary, we'll be sticking with funds that concentrate on fundamental analysis to determine what a company's future profits are worth and which try to buy those stocks at favourable prices. And if those stocks and funds fall to even cheaper prices, while their future profits still seem to warrant a higher price, we'll hold on for the market to realize their worth. In other words, we'll stick with long-term investing and not speculating on the latest fads or whims of the market.

Analysts' Bets on Outcomes of Today's Risks

Since the Ukraine Invasion, a 40 yr veteran of Washington politics and economic markets has been writing an almost daily newsletter that we've found very insightful. On Apr 4, 2022, he listed some of the risks of the day (a larger number that the world seems to normally be facing) and what he judges economists, political analysts etc feel currently is the likelihood of certain scenarios. Here are the ones that we thought you'd be most interested in:

- Chance of Ukraine winning the war against Russia 70%
- Chance of Ukraine and Russia making a deal before month end 60%
- Chances of a Depression in Russia due to the war and sanctions 70%
- Chance that Putin will be ousted 60%

- Chance of Putin's replacements being even more strident 70%
- Chance of China moving to takeover Taiwan any time soon 30%
- Chance of a .5% U.S. interest rate hike on May 4 60%
- Chance of Trump being indicted over Jan 6 riot 60%
- Chance of the western US drought worsening 60%
- Chance of climate change legislation coming soon 0%
- Chance of a serious global food shortage 80%
- Chance of inflation not just moderating, but subsiding 30%
- Chance of an increased defense budget 100%
- Chances of tax hikes on highly profitable companies 55%
- Chance of a meaningful deficit reduction 20%
- Chance of a recession this year 30%

(Source: AGF Insights and Market Perspectives Apr 4, 2022)

Opportunity in Markets Today?

Over the last 3 months (ending Mar 29, 2022), 10 out of 11 stock market sectors fell, with only the Energy sector rising and it soared. The Consumer Cyclicals, Communications and Technology sectors fell the worst, between 11.6 and 14%. Some technology companies are now cheaper, in terms of price compared to earnings, than they have been in a couple of years. That is partly because of earnings growth and partly because of stock price drops. Per a previous newsletter, the absolute value of Price to Earnings Ratios can be inaccurate because of problems with financial statements based on Generally Accepted Accounting Principles (GAAP), but relative changes in them are still meaningful. Here's a chart from Morningstar as of Mar 16, 2022 (courtesy of Loomis) that shows how much cheaper some major companies that our funds hold are:

	Price/Earnings 2020	Price/Earnings Mar 16, 2022
Alphabet (Google)	34	23
Amazon	95	45
MasterCard	54	38
Meta (Facebook)	31	14
Nvidia	86	60

Why should these companies have gotten cheaper, relative to their earnings, when their year over year earnings growth and their 10 year average earnings growth rates are spectacular, as follows:

	Year Over Year Growth	10 Year Average Growth
Alphabet (Google)	91%	22%
Amazon	55%	47%

MasterCard	38%	19%
Meta (Facebook)	36%	41%
Nvidia	53%	32%

If we weren't worried about having these funds in our portfolios in 2020, it seems there should be even less worry about holding them today. When oil production ramps up to meet increased demand and potential lower supply from Russia, oil prices could fall back precipitously. Resource exposure might be one of the riskier areas of the market over the next couple of years. Source: Loomis Global Equity Teams Mar 30, 2022 email)

Russian Oil and Gas Exposure

On Mar 22, 2022, the Globe & Mail wrote that thanks to Western sanctions the price of the 4 largest Russian energy stocks had fallen an average of 85% and that ESG (Environmental, Social and Governance focused) funds in Canada had over $600 Million invested in those four oil and gas companies, approximately twice as much as those funds had invested in the Canada's four largest oil and gas companies. Some fund managers preferred the Russian companies because didn't have the stigma of the oil sands reputation [unfounded?] for being dirty energy.

While most of the fund companies we use perform ESG screening on stocks they might purchase (like Manulife, Fidelity, RBC etc), we have been using Mackenzie and Desjardins ESG focused funds, funds where ESG is the first consideration rather than the last. You will be pleased to know that Mackenzie's and Desjardins' ESG funds had zero exposure to any Russian stocks. These funds had negligible, if any, exposure to oil and gas, since they are supporting renewable energy companies. While you may be happy about this, there is another consequence. Since Canadian energy stocks are up about 35%, since the start of the year, funds not focusing on reducing carbon emissions will have outperformed funds that have been trying to promote their versions of ethical investments. So, you may see others profiting from energy investments, for the time being. However, oil and gas investments are cyclical and the long term track record is poor. The TSX Oil and Gas EW Index shows a 10.9% **total** return (not annual) from May 1, 2017 to Mar 23, 2022 (Source: theglobeandmail.com). So for about 5 yrs, that sector made about 2%/yr, falling by more than half from 2017 to early 2020. That's a lot of volatility for negligible returns. It's not a sector we'd like to sit around in waiting for a rebound, or one we'd like to be holding when the sector goes out of favour.

So far, we haven't found any of our funds had any significant exposure to Russian stocks. Inflation, exacerbated by the Ukraine Invasion, the loss of much of Ukraine's grain crop for 2022, embargos on Russian oil, together with the reduction of business conducted in Russia by international companies will have an impact on company profitability, stock prices and market returns however. Still we aren't hearing of any devastating impact or slowing down of long-term profit growth trends.

Cybersecurity

Cyber attacks have been a big problem in the Western world. "According to the U.S. Cybersecurity * Infrastructure Security Agency, North Korea's state-backed "malicious cyberactivities" target banks around the world, steal defense secrets, extort money through ransomware, hijack digitally mined currency, and launder ill-gotten gains through cryptocurrency exchanges. Kim's [Kim Jong Un's] regime has already taken in as much as $2.3 billion through cybercrimes and is geared to rake in even more , U.S. and United Nations investigators have said." There are over 6000 members in Korea's cyber attack unit. (Source: Bloomberg Businessweek Dec 27, 2021) China and Russia are also believed to have state-backed cyber attackers.

With the increased threat of cyber attacks from Russia, people have been asking what this could mean. Governments are advising big organizations and individuals to take greater measures to keep their data and operating systems safe. Of course Manulife has always gone to great length to keep client data and systems safe. For example, increasingly we are using two factor identification, where in addition to a regular password, you might need to supply a one-time password sent to your cell phone, when you log in. And there are all sorts of rules about locking up data, where and how it can be stored, how to safeguard passwords etc. You need to take increased precautions with your passwords and data storage too.

One of the Security Commission's regulations that impacts you is a rule that says we cannot accept any instructions from you by email. You can imagine how dangerous that would be, if your email and bank account were both hacked, and the hacker asked us to send money to your bank account from your investments. When you speak to us in person, we can recognize your voice or even ask questions to confirm your identity. This is much safer for you, even if it can be inconvenient. It doesn't hurt to give us a heads-up by email about a change you want to make to your portfolio, so we can think about how to best do it in advance of talking to you. But we cannot take action on your accounts, until you verbally give us your instructions. So don't expect us to react to an email you send us with trading or redemption instructions.

Remember to change your passwords regularly and make them hard to guess with special characters (like !@#$), capitals and lowercase letters and numbers, not in a sequence. Use antivirus software on your computer. Don't open or click on links or attachments in emails that look suspicious or which you aren't expecting. Check the source email address and any web address. Royal Bank, for example, is never going to send you an email from an address that say JoeBlow@ro**u**yalbnk.com. Sometimes the addresses resemble the real thing, but sometimes they are obviously phony. If you want to follow up on something claiming to be from a company, look up the company's phone online and internet address online, rather than trusting what's written in a suspicious email. Then contact the company to verify that they sent the email.

Here is a link to a Government of Canada website https://www.getcybersafe.gc.ca/en which has tips on staying safe on-line. You can google "Government of Canada cyber tips?" to find the same link. If you ever aren't sure if something we sent you is real, call us to confirm before you open it. When we've told you we are sending a document for an electronic signature, you can expect it to come from Docusign.

One of the unintended consequences of our computers trying to protect themselves is that sometimes emails you send us get sent to our "junk folder". Or, we may see an email you sent, but the email address doesn't give us a clue who you are, so we may not open the email, thinking that it's more spam or something dangerous. If you don't hear back from us in a day or two after emailing us, please call to ensure we saw your e-mail. We don't want to miss a legitimate email from you.

Stay Covid and Cyber safe!

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