Manulife Securities

ROYDS REPORT

October 2022

Statements

If you only looked at the S&P500 market index on June 30th and September 30th of this year, you might have thought that the market stood still for three months. In fact though, in July and the first part of August, the S&P500 had noticeable recovery. Then, the end of September took us right back down to just below its end of June values (3,785.38 on June 30th and 3,585.62 on Sept 30th). There was an attempt at a market rally or recovery, but inflation has been more persistent than first expected, so conditions weren't right to sustain a recovery yet. On the bright side, the market didn't keep going down all quarter.

We'll have to stay patient waiting for the recovery awhile longer, and our fund managers will keep positioning their stock holdings to get the best gains they can when the market turns around. **No matter how many downturns you've lived through, it's never comfortable (although it does get a bit easier with experience).** The **secret to coming out of a bear market unscathed has always been, to not panic and sell while the market is down, but to hold on for the recovery**. That seems like the right course of action this time too.

This Time the Economy and Stock Market Troubles are Different

"While most of us wince when we pull up to the gas pump, wonder about the sudden decline in the market values of our houses, and worry over the looming eco-catastrophe, these realities don't seem to hamper the lifestyles of the 0.00000002 percent" of the population who are the most powerful and richest. Do those realities have you worried and wincing too? Terrible gas prices, falling home values, and worries about climate change? Surprise! That quote wasn't about 2022. It comes from the October 2008 Vanity Fair magazine, yes, a 14 year old magazine. It sounds like what we are living through now is very similar to what people experienced in 2008.

Some of our clients have been worrying that "this time the economic problems are more serious than they've been in the past, so how the world and economy have behaved in the past aren't relevant to today". In our experience, every time there's an economic crisis, people think it's unique and more painful than the past, because with time people's memory of the last pain and worries fades. Legendary investor, Sir John Templeton, said ***"The four most expensive words in the English language are, 'This time it's different. '"*** Those words gave people the excuse to ignore the ridiculous stock valuations of new tech companies with no profits, which led to the Tech Wreck market crash. In the end, it turned out that what people would pay for stocks compared to their profits and growth rates wasn't radically different than it had been in the past. Certainly the causes and magnitudes of each market downturn are different, but economic cycles follow very similar patterns and human nature, as it impacts the stock market, doesn't really change. That's why legions of economists, central bankers, analysts and investors study past cycles. Mankind is still resourceful, and with each crisis, resolutions are found, and economic growth eventually continues. So we need to have faith that this time will be no different from the past and that an economic and a stock market recovery will happen. We just don't know quite when, although there are clues we'll talk about further on as to what it will take to have a recovery.

Lessons about the Stocks from Buffett and about the Market from Dogs!

"Be Fearful when others are Greedy and be Greedy when other are Fearful" is a famous quote from the master investor, Warren Buffett. He's saying that when fear overtakes people, they often sell investments at bargain prices. But when no one has any fear and is irrationally exuberant, then prices will be too high, and you should watch out. It seems like all the fear around markets, inflation, interest rates and Russia's war have made some people sell indiscriminately (a common phenomena in market downturns). Investment company GQG Partners shared examples of stock pricing that doesn't make much sense. They cited a major pharmaceutical (who just had a blockbuster product approved in the US and Canada) that was trading 6 months ago at 7 times the value of its sales and is now trading at 3 times sales (a drop of 57%), even though earnings are forecast to increase by 2%. Another example was of a popular business in the dental industry whose price dropped 43%, while its sales are forecast to drop only 3%. They had other less extreme examples too. Our fund managers love it when the market misprices companies, because it gives them opportunities to buy some companies cheaply. Eventually the market should recognize the true value of the companies and the fund managers make money for us. The following story of Warren Buffett's investment in Coca Cola demonstrates this concept. Buffett first invested in Coca Cola in 1988 and 1989 at an average price of under $44 per share (actual share price at the time, not split adjusted). He has famously advised investors to focus on the "playing field" (company performance), not the "scoreboard" (stock price), and in the years that Buffett was buying Coca Cola, it had been increasing gross profits at a rate of about 10-15% per year but the stock price didn't keep up. Then, by 1994, the stock quadrupled in value—a handsome profit. In other words, the market eventually reflected Coca Cola's profit growth, but until then, Buffett was able to buy the company at a price reflecting its old lower profitability level.

We love our office dogs, Holly and Piper, but they can be a distraction (sometimes welcome, sometimes not). Our experience with taking them for walks really makes the following analogy about the total stock market resonate with us. "Ralph Wanger, a portfolio manager … likens the market to an excitable dog on a very long leash in New York City, darting randomly in every direction. The dog's owner is walking from Columbus Circle, through Central Park, to the Metropolitan Museum. At any one moment, there is no predicting which way the pooch will lurch. But in the long run, you know he's heading northeast at an average speed of three miles per hour. ***What is astonishing is that almost all of the market players, big and small, seem to have their eye on the dog, and not the owner. "*** Source: https://awealthofcommonsense.com/2022/09/were-still-in-a-bear-market-you-know/ *Needless to say,* ***if we watch the hour to hour, or day to day, fluctuations of the market, we can lose sight of the big picture, that over the long-term the corporate profit and the economy grows.*** *This has driven the main US stock market, reflecting the aggregate price of most of the largest public companies in the country, to rise at a rate of about 10% compounded annually. The next decade or even 50 years may not be as good, but the long-term trend is nonetheless upwards, and has been despite the thousands of down days and lots of extended down periods it has gone through. If we try to react to each market gyration, we'll lose sight of where the market is most likely to go over the long-term (following the economy). And if we aren't interested in where the market will take our investments over the long-term, because we're only interested in the short-term, then we shouldn't be invested in the equity or stock market.*

Interest Rates and Inflation

A Sept 22, 2022 article on Bloomberg.com described the current situation with respect to interest rates quite succinctly, so we'll just quote it. Around the world, "many policy makers lifted their benchmark borrowing costs in a three-day window that made clear their chief worry is the strongest run of inflation since the 1980s. That marks a dramatic step change from a year ago when officials were publicly predicting the pandemic-era spike in prices would soon fade. … Inflation has probably peaked with easing commodity prices, but wage cost pressures have not subsided which could mean more persistent and sticky core services inflation. … After taking their key rate to a range of 3% to 3.25%, Fed officials sent a more hawkish signal than previously expected by forecasting a further 1.25 percentage points of tightening [increase] before yearend. … Chair Jerome Powell indicated officials are increasingly willing to tolerate a recession as the price for controlling inflation." So, ***we can expect more interest rate rises in the US, and the Bank of Canada often acts similarly to the Fed in the US. This may lead to a recession, but that is less dangerous in our countries' chief economists and central bankers' eyes than continued high inflation.*** *While this isn't good for bonds, or the stock market, or real estate, it may be good for the long-term economy, and it certainly means higher savings account and GIC returns (still not high enough to keep up with inflation though). So, it may be a while before the stock market recovers, but we want to stay invested, so we don't miss the start of that recovery.* *Source:* https://www.wealthprofessional.ca/business-news/more-rate-hikes-to-come-after-marathon-week-for-central-banks/370073?utm_source=GA&e=ZWxhaW5lLnJveWRzQG1hbnVsaWZlc2VjdXJpdGllcy5jYQ&utm_medium=20220922&utm_campaign=WPCW-Breaking-2-20220922&utm_content=FF17E427-FCF0-4EFB-8BE3-4AF60D315279&tu=FF17E427-FCF0-4EFB-8BE3-4AF60D315279

Also on Sept 22, 2022, NEI published a bulletin about the US interest rate increase of ¾% the day before. In it they cited that Canada has had 2 consecutive months of shrinking inflation rates which bodes well, because the sooner inflation cools off, the sooner the Bank of Canada and the Federal Reserve might stop increasing interest rates.

Another National Bank publication on Sept 22, 2022, the long-term expectations report, pointed out an inflationary pressure that could lead to extra business for North American companies. For decades companies have been offshoring business to emerging markets where labour is cheaper. Clothes are rarely made in North America anymore, but more likely in Vietnam, China etc. But through Covid, companies realized how vulnerable supply chains are, and that transportation can be a major bottleneck. So there is "growing interest amongst U.S. manufacturing companies in reshoring foreign operations to the United States" … protectionist trade interventions and the reshoring of supply chains are inflationary measures. Imposing tariffs and quotas has a direct impact on the price of imported goods, while repatriating foreign operations incurs relocation costs in the short run and higher labour costs in the long run. Environmental considerations could exacerbate these effects." There are other factors though that could be deflationary, like "Technological innovation, demographics [older people tend not to buy as much], … the propensity of households to save". With all these factors at play, who can say whether inflationary pressures will outweigh deflationary pressures. But while inflation is high, "the stock-bond correlation increases and even becomes positive." This means that both stocks and bonds tend to increase in value or fall in value at the same time, in contrast to the 2000s and 2010s, when inflation was low and bonds might increase in value when stocks fell and holding the two asset classes could decrease total volatility. … "positive stock-bond correlation suggests that good years will be even better, but bad years will be even worse than what they [investors] have been used to in recent history." This won't be comfortable. But if we want equity returns, this is something we will have to get used to. We may have to find alternatives to balanced funds with their mixture of stocks and bonds in order to find something with low to medium volatility going forward, if high inflation persists. If you want to read the whole report, you can go to https://www.nbinvestments.ca/content/dam/bni/publication/long-term-market-expectations.pdf

What do Bad (Bear) Markets Usually Look Like?

Another National Bank report (found at https://www.nbinvestments.ca/content/dam/bni/publication/cio-office/strategic-report.pdf) listed all 10 of the other S&P 500 (U.S.) bear markets since 1950. Here's the highlights of that report. **On average the market took 14 months to hit the bottom**. The S&P 500's last peak was at the very beginning of this year. So we are just over 9 months into it (the National Bank report was written before the most recent drop, so it showed June as the market bottom). The average recovery is 25 months, but it included the 70 month recovery from the oil shock in the 70s, the 56 month long recovery of the dot-com bubble and the 49 month long recovery of the Great Financial Crisis. In those 3 crises the market fell over 48%, so almost double the current market drop. **The other less severe bear markets had recoveries which took between 3 and 21 months**. It doesn't look like there is a real "norm", but economically we are not in the same position as the 3 crises that took so long to recover. Bear markets' drops and duration are very much tied to the magnitude and length of the economy's decline. Generally the start of a recovery is governed by 3 things: valuations declining, manufacturing pulling back and the central banks easing off on interest rates. We have seen valuations decline fairly significantly, as measured by Price to Earnings ratios. We have not seen a manufacturing pullback of the same magnitude yet. So we may need to see more of that (more layoffs?). As for the third factor, the central banks aren't expected to reduce interest rates till partway into next year (by which time they hope to see that inflation is heading towards government targets (for both the US and Canada). So it's unlikely a sustained recovery is about to begin in the next few months, but no one has a clear crystal ball to know for sure.

US Government May Issue a Digital Currency

Central Banks have been talking about issuing their own cryptocurrency to supplement paper money. The talk is that anonymity would be maintained for cryptocurrency owners/spenders. The feasibility of a widespread cryptocurrency is improved by the fact that there is now a way to process transactions using a fraction of the energy that early cryptocurrencies used/use. Could existing cryptocurrencies compete with one backed by the US government? It's not a bet we'd want to take. Source: https://www.nbinvestments.ca/content/dam/bni/publication/cio-office/cio-strategic-report-cryptocurrencies-portfolio.pdf

Which Generation Spends the Most?

According to recent American data, the oldest and youngest generations spend the least of the 5 commonly named generations. The youngest probably don't have more to spend. For the oldest generation, it may be a combination of some people not having more to spend and others just not having the desire to spend more. Here's a chart comparing each generation's expenditures compared to the average American's expenditures. It also shows how much of each generation's income is spend on housing. The percent spent on housing is similar across all generations, but the actual dollars aren't, because the different generations expenditures vary hugely.

	Silent Generation	Boomers	Gen X	Millenials	Gen Z
	Born 1945 or earlier	Born 1946-1964	Born 1965-1980	Born 1981 - 1996	Born 1997 or later
% Expenditure vs Average	74%	104%	139%	115%	69%
% of Expenditure spent on Housing	37.30%	34.20%	31.70%	34.80%	37.10%

Source: https://www.visualcapitalist.com/cp/how-americans-spend-their-money-2022/

Reminders: The RESP contribution deadline is December each year. The RRSP contribution deadline is March 1. If you want to trigger a loss for tax purposes, it has to be done no later than market close on December 28.

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