Manulife Securities

ROYDS REPORT

Late Sept 2022

Are You Feeling Emotionally Fatigued?

We've all been through a lot in the last 2 ½ years. First there was the Covid shutdown with some losing their employment or businesses, others having to adjust to work and kids' schooling being done from home, the fear of getting sick/dying, and for many the loss of friends or family to Covid. When the Covid shutdowns started in North America, the stock markets tanked. The market drop was one of the fastest in history and was deeper than had been seen since the Great Financial Crisis of 2007-2009. At least people could understand markets dropping then, and the market drop was relatively short-lived (it was a V shaped recovery, not a U or L shaped recovery). But life didn't quite resume after the lockdowns ended in Canada, because Covid just won't quit. We keep hearing about it. People are still getting sick from it. Sometimes we have to/want to wear masks and certainly we have to jump through extra hoops if we want to travel. Then the Ukraine invasion happened, and that heartbreaking war continues on, with the threat of similar trouble with Taiwan. As if that wasn't bad enough, the supply shortages from Covid shutdowns, the increase in demand that came with people trying to resume a more normal life or even to catch up on what the missed, people quitting the workforce (perhaps permanently retiring if their job was disrupted by Covid, or not wanting to continue what they had been doing because of new risks or strains caused by Covid), together with the food and gas shortages resulting from Russia's devastation of Ukrainian crops, and the embargoes on Russian oil together caused a huge worldwide imbalance between supply and demand of both materials and labour. When demand outstrips supply, prices spike up, and this time we ended up with the worst inflation in 5 decades. So now, as a world, we face a more expensive existence (at least for the time being). To combat this, central banks like the Bank of Canada and the Federal Reserve in the US, have raised interest rates (5 times in Canada for a total of 3% so far this year, with more increases expected). The idea is to make it more expensive for anyone or companies to borrow to spend more, so that individuals and businesses end up spending less and bringing supply and demand back in balance. There have been widespread consequences of higher interest rates. People with variable rate debt are paying substantially more interest, and people who have had to renew fixed rate mortgages saw their payments balloon. We haven't started to see bankruptcies and foreclosures yet, but they are expected. Banks have socked away money to cover loans they expect when people default on their loans. Some expect more people will have to sell their houses, because they are not affordable with higher interest rates. (More on that later.) And to add insult to injury, housing prices have fallen off a cliff. Where people had been feeling rich on the basis of their home values, which on average in Canada doubled between 2010 and 2022, people don't feel as rich now that the value of their homes have fallen. And inflation and higher interest rates (along with the Russian Invasion) have caused stock (and bond) markets to fall again, so soon after the last time, and with no speedy recovery this time. There's even talk of a recession coming, as a result of this inflation and higher interest rates (central banks around the world seem more fearful of runaway inflation than they do of a recession, perhaps rightfully so after the experience of the world in the early 1980s). According to the Globe & Mail on Sept 13, 2022, "Household net worth fell by $900-billion in the second quarter to $15.2-trillion, a decline of 6.1 per cent from the first quarter, Statistic Canada said Monday in a report. That was the largest decrease since at least 1990, and eclipsed a 5-per cent fall in the third quarter of 2008, coinciding with the global financial crisis." This is a whole lot to have endured in the last 2 ½ years. The financial worry of higher expenses due to inflation, less home equity value and fallen stock and bond portfolio values is really weighing on people emotionally, after all the other stress they've been under. No wonder people feel emotionally exhausted. If that's how you feel, you sure aren't alone. The thing is, we can't let our fatigue induce us to make poor financial decisions.

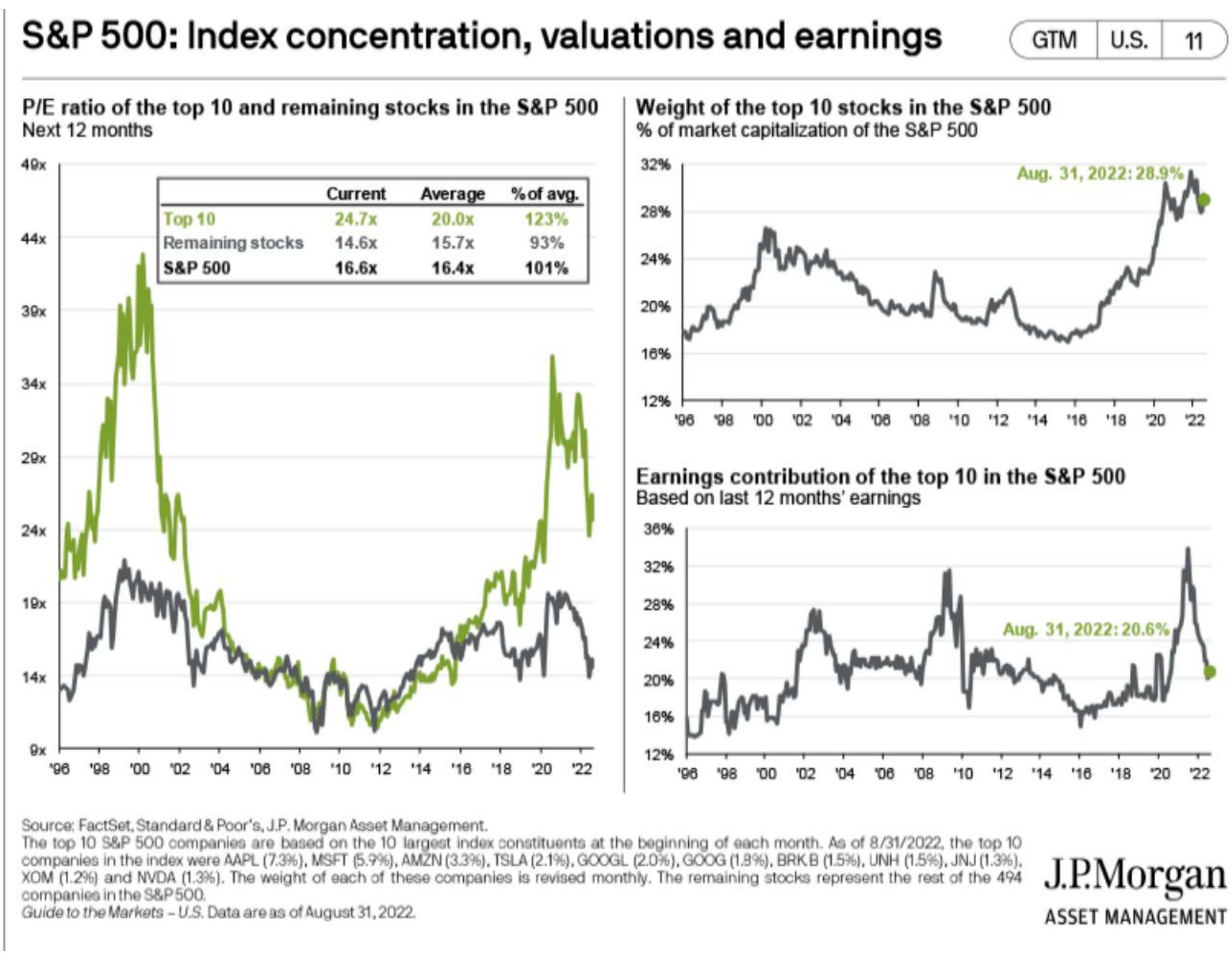
We can't succumb to the human tendency to think that whatever has happened recently is going to continue on forever. Thinking that the market will keep falling, just because if did fall, would be like driving down from the Rockies into the foothills and thinking that you'll keep driving downhill forever. Even in 2009, after the S&P had fallen about 50%, the right thing to do was to patiently hold on and wait for the rebound and the long-term growth that has characterized stock markets. If we listen to the master stock investor, Warren Buffett, we would never panic sell, if we were holding quality. Here's an except from Investopedia.com on Buffett's investing philosophy:

"How long should you hold a stock? Buffett says ***if you don't feel comfortable owning a stock for 10 years, you shouldn't own it for 10 minutes****. Even during the time period, he referred to as the "Financial Pearl Harbor," Buffett loyally held on to the bulk of his portfolio.*

Unless a company has suffered a sea change in prospects, such as impossible labor problems or product obsolescence, a long holding period will keep an investor from acting too human. ***Being too fearful or too greedy can cause investors to sell stocks at the bottom or buy at the peak and destroy portfolio appreciation for the long run****."*

We love his point about owning stock. If you aren't prepared to own it for 10 years, don't ever buy it. Investing is a long-term process, because you are really owning companies, and you have to ignore the stock price ups and downs, except for watching for good buying opportunities! This is in stark contrast to deciding based on the daily news whether you should be in the market today or not. As we write this, last week was the best week in the US stock market in months. And yesterday we were buoyed by news that Ukraine had pushed Russian troops almost to the Russian border, creating hope that there could be an end to the war in the next few months, which would help with world oil and gas supply and possibly reduce inflation. Then today, the reported inflation as of August exceeded expectations in the US. While inflation dropped a bit, it is being more persistent than expected and some speculate that this will lead the Federal Reserve to increase interest rates more than expected. This has led to a massive market selloff – again. (We should add that we did not change what how we were investing on any of this news.) One day or one week markets are strong, and on a dime they turn around sharply. We cannot predict this and it's next to impossible to win by trying to time market reactions to daily news. So we stick with Warren Buffett's GARP philosophy (Growth At a Reasonable Price) of buying great companies with strong growth prospects over the long term and buying only when the value of their future earnings (discounted to present value) is significantly greater than the market price of their stock. We don't know whether the market will be up or down tomorrow, or next month, or even next year, but over the long-term economies have expanded and stock markets have risen, more than other asset classes. Investing for the long-term makes sense. Investing for the short-term isn't investing; it's gambling.

Below is a chart on where the US market stands in terms of being expensive compared to earnings compared to the last 16 years. It's interesting that the 10 biggest stocks in the S&P 500 index are still trading above their long-term average Price to Earnings (P/E) multiples, even though they have fallen in price a lot. The other 490 or so stocks in the index are trading below their long-term P/E average. The 10 biggest companies used to represent almost 32% of the total value of all 500 companies, while bringing in over 33% of the income of all 500 companies. Now those 10 companies are worth 29% of the total value of the 500 companies in the index, while only bringing in 21% of the earnings. Perhaps those companies' stocks haven't fallen enough, or perhaps it is fair that they are expensive compared to their earnings. If the top 10 companies have more growth potential, perhaps they should be trading at a higher price, since they may bring in a larger share of earnings as they grow. However, it's harder for companies worth trillions to keep growing quickly compared to small companies which may have new disruptive technology that's gaining them market share. The top 10 companies as of June were: Apple Inc., Microsoft Corp., Alphabet Inc. (now trading as Google), Amazon.com Inc., Tesla Inc., Berkshire Hathaway Inc., Meta Platforms Inc. (Facebook), Johnson & Johnson, UnitedHealth Group Inc., and Exxon Mobil Corp. Can you imagine Exxon (Esso), Johnson & Johnson and UnitedHealth (which sells private health insurance) being among the fastest growing companies in the US? The above questions are why we have fund managers with teams of analysts to determine a fair price to pay for a business.



More on Housing

For almost 2 decades, young people have been saying to Elaine, “house prices can’t go down” or “real estate is the best investment”, because these people had only ever experienced extraordinary growth in home prices. In 2008/2009, there was a little drop in prices in Canada (a larger drop in the US), but that price drop was small compared to the stock market fall. The chart below shows you just how exceptional the real estate market growth has been over the last 20 years. From 1970 to about 2002 (a period of 32 years), real estate rose approximately 50% in value, nothing close to stock market gains over that time period. But in the next 20 years, real estate rose in value close to 250%. Many feel the exceptional rise was fuelled by historic low interest rates, with the cost of borrowing money being close to zero, at least in historic terms. What a difference in growth rates over those 2 time periods! The real estate market drop since March 2022, triggered by increasing interest rates from nearly zero to something more like historic rates, may just be a correction of inflated real estate prices. It’s a shock to those who thought real estate only went up in price, and paying more normal interest rates is another big shock. Just as the rise in real estate prices made homeowners feel wealthier, the fall in prices is making people feel poorer. The Globe & Mail reported on Sept 13, 2020, that July data showed that nationally resale home prices had fallen almost 23% since the peak in February 2022, and that RBC Economics recently said that **a peak to trough drop in housing prices could hit 42% sometime next year (*only* 38% in Ontario**, more in BC.) The country has been calling for more affordable housing, and this is a step in that direction.

Let’s look more at recent interest rate trends which really help make sense of the changes in real estate values. To put the 5 rate increases this year in historical perspective, interest rates are just getting to more average or normal levels. They are no where near the 8, 12, 14% or higher levels that many seniors remember having to pay for their mortgages in the 80’s and 90’s. It’s just been that interest rates have been at the lowest levels in history in recent years, and people got used to them, and young people thought such low rates were normal and spent accordingly. Below is a chart of interest rates since 1975 (check out 1982!), to show you how abnormally cheap it has been to borrow in recent years.

Year	Variable Rate	5 Year Rate
1975	8.70%	11.50%
1976	9.95%	12.00%
1977	7.95%	10.25%
1978	8.95%	10.25%
1979	11.70%	11.25%
1980	13.45%	14.50%
1981	19.20%	18.13%
1982	16.20%	19.25%
1983	10.70%	13.50%
1984	11.70%	13.50%
1985	10.20%	11.75%
1986	9.95%	11.25%
1987	9.20%	11.25%
1988	10.45%	11.75%
1989	13.20%	12.00%
1990	13.95%	13.25%
1991	9.45%	11.25%
1992	7.20%	9.63%
1993	5.70%	8.85%
1994	6.70%	9.90%
1995	7.95%	8.95%
1996	6.20%	7.95%
1997	4.45%	7.00%

Year	Variable Rate	5 Year Rate
1998	6.20%	6.95%
1999	5.95%	7.50%
2000	7.20%	8.30%
2001	5.95%	7.50%
2002	3.95%	6.85%
2003	4.45%	6.45%
2004	3.70%	6.30%
2005	3.95%	6.05%
2006	5.70%	6.60%
2007	5.70%	7.19%
2008	4.45%	7.15%
2009	1.95%	5.79%
2010	2.20%	5.42%
2011	2.70%	5.39%
2012	2.70%	5.24%
2013	2.70%	5.24%
2014	2.70%	4.79%
2015	2.55%	4.64%
2016	2.40%	4.64%
2017	2.40%	4.64%
2018	3.15%	5.34%
2019	3.65%	5.34%
2020	2.15%	4.94%
2021	2.15%	4.79%

Source: https://www.superbrokers.ca/tools/mortgage-rate-history

Cryptocurrency

About 16% of Americans, or 53 million people, have used, owned or own cryptocurrencies. Those who got in on the craze may still be in a profit position. Last November, when Bitcoin was trading at about $69,000 (as opposed to $20,300 on Sept 14, 2022), the value of all crypto was about $3 Trillion. (Source: Bloomberg Businessweek, Aug 29, 2022, a drop of over 70%) Now, the value of all crypto is about $1 Trillion. What is its true value? Who knows. And if you don't know how to value something, how do you know what a fair value is to pay for it, especially if you hope to make money on it. This is why we don't regard crypto as something in the realm of investments, of flavour of the day stocks like Pelaton. At the close of business on September 13, 2022, it sold for $9.91 USD. It had been as high as $114.50 USD in the previous 52 weeks. One can't value a company using Buffett's discounted free cash flow (net profits) method, if a company doesn't have profits, which is why GARP managers only invest in profitable companies, not unprofitable start ups, no matter how much promise they might have. There's no way to tell for those of us who judge what to pay based on expected profits, based on a record of profitability and researched growth projections to estimate future profits.

We hope you had an enjoyable summer and didn't stress too much over markets. Investing is a long-term process and nothing that has happened this past year has changed our views of the long-term prospects. If it helps you, just don't open your statements (or only look at the comments we write on them). Call us if you want to talk, or to set up a review meeting.

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