BMO Nesbitt Burns

ISSUE #100: SPRING 2021

The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

COMMODITY SUPER-CYCLE?

When we talk about cyclical industries there are no companies more sensitive to the economic cycle than raw commodity producers. Apart from the often dominant effect of the economic cycle, individual commodities prices can also be greatly affected by short term forces, such as weather, in the case of agricultural commodities, as well as secular forces, such as tighter regulation. When more than one of these forces come together, an extended cycle is possible: the big carrot that lures investors.

A Love-Hate Relationship

Any investor that's been in the market for two or more cycles and has participated in the sector, likely knows the joy of well timed purchases. Share prices that quickly rise off of depressed valuations, as we saw in 2020 with energy stocks. Or having participated in an extended cycle as we saw from 2000-2011 when copper ran from under $1/lb to $4/lb turning companies such as Phelps Dodge and Freeport McMoran into cash gushing machines. However, arrive to the party too late and/or extend your stay a little too long and you risk getting severely punished. The long sideways patterns of the share price of commodity producers certainly does not make these stocks, one-stop, buy & hold type of investments, timing is so often critical, and large outsized gains are their siren song. However, an extended cycle can offer investors much more latitude with their entry and exit points along the way, as well as the potential for increased total returns. Keep in mind, that volatility will not be reduced by an extended cycle and will test the metal of most investors. A willingness to tolerate added volatility in such deeply cyclical names often determines whether investors lose money, make okay money or make a lot of money, during the up part of the cycle. Gut wrenching corrections along the way often trigger fears of an early end to the cycle, leading investors to bail-out prematurely. Despite these challenges, I believe the coming cycle will be an extended one and will also offer specific secular tailwinds for investors willing to participate.

Electrifying Global Transportation

It seems clear that the electrification of the transportation system or at least the category that is classified as light duty passenger vehicles is well under way. The average age of the passenger vehicle fleet is roughly 12 years, thus if 100% of new vehicles sold going forward are EVs, it will take 12 years to replace all current ICE (internal combustion engine) vehicles. The more realistic time line is something in the 15-25 year range. Fleet conversion is a one time event that will underpin the next cycle's base demand for many metals, in particular copper, nickel, cobalt and silver. While all the talk tends to focus around lithium, which is an important component of EV batteries, there is no shortage of lithium to be found in the earth's crust. Furthermore, lithium's other uses, and thus demand, are somewhat limited. On the other hand, copper and nickel are critically

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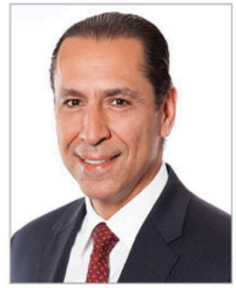

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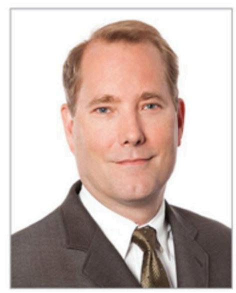

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FIXED INCOME: Rising From The Dead

Tough Times
Over the past decade preferred share investors have been thoroughly disappointed. Despite seemingly attractive yields, quoted prices were down substantially resulting in net negative returns over many periods. Depending on the timing of purchase, returns varied from awful to ho-hum. In fact, the total return over the last ten years on this asset class has been 2.4%. However, in the last 12 months, signs of life have emerged in this left for dead sector.

A Little Background
Preferred shares are a type of stock issued by companies that pay a dividend. Typically issuers are required to pay dividends due on any outstanding preferred shares before any dividend can be paid to common shareholders. This priority to dividend payments is how this class of security got is name. However, unlike common shareholders, preferred owners do not have voting rights. In a sense, a preferred share is a hybrid security, sharing some of the attributes of both common shares and corporate bonds. Within the corporate capital structure, preferreds are senior to common shares, but rank below bonds with respect to any claims on capital in the event of a corporate restructuring or liquidation.

There are several types of preferred shares in the over 60 billion dollar Canadian preferred share market. The two main types are perpetual preferreds and rate reset preferreds. Perpetuals have no set maturity date, pay a fixed dividend amount and because of their long duration, tend to be quite sensitive to changes in long-term interests. Resets pay a fixed dividend until the next reset date, typically set at five year intervals, the reset rate is determined by adding a stipulated fixed spread above the then prevailing rate on five year Government of Canada bonds.

For more than a decade now, essentially since the 2008-09 financial crisis, the Bank of Canada has kept rates exceptionally low. In fact, rates were kept much lower, for much longer, than most market participants expected, myself included. Many of the rate resets issued over that period had relatively low spreads above the benchmark government bonds. Investors fearing unacceptably low resets based off of Canada five year bonds yielding a paltry 0.5%, dumped the shares. In addition, talk of negative interest rates further stoked investor fears of the securities. How much would you potentially pay for a security yielding one half of one percent above a negative one percent benchmark? Short answer: not much!

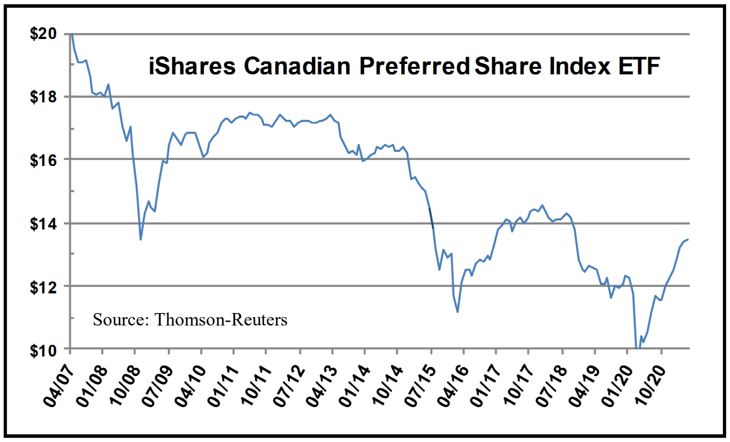
Capitulation
During the COVID led market decline last year the sector fell with stocks. As interest rates plummeted, panic gripped investors imagining a world where depression, deflation and permanently negative rates would render these securities practically worthless. This was perhaps the moment of ultimate pessimism, a classic set up for a market bottom!

As optimism related to vaccines and glimmers of hope related to economic recovery began, the sector started to recover. Rate resets have led on the upside, yet most of them still trade well below their $25 issuance price. While the reset typically happens every five years, the market is expecting interest rates to stay on an upward trajectory, making future reset rates look more attractive.

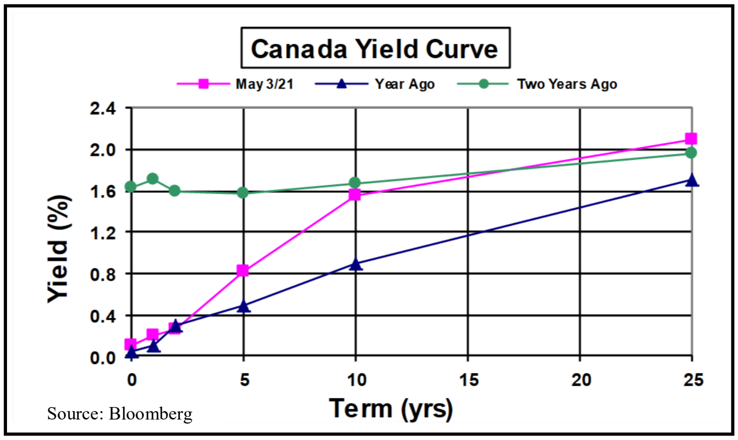
From a portfolio construction perspective, especially in non-registered accounts, a position in the sector may be appropriate. As interest rates gradually recover off of historic lows, most investors are seeing declines in the value of their bond portfolio. A typical balanced portfolio for example might hold 30 to 40% in bonds, therefore balanced investors who benefited from holding bonds during the historic decline in rates (rise in bond prices) in the past, might be able to soften the blow of any reversal in this trend, by holding some preferred shares which can potentially appreciate in a rising rate environment.

From a taxation perspective preferreds offer advantages when held in non-registered accounts: the distributions are considered dividend income and hence benefit from the dividend tax credit.

Every dog has its day!….Al.



Source: Thomson-Reuters



Source: Bloomberg

STOCK TALK: Part Of The Solution

Disaster

In March of 2011 a massive earthquake and Tsunami off the coast of Japan resulted in a nuclear meltdown and the release of radioactive material at the Fukushima nuclear power plant. This resulted in the evacuation of 150,000 residents and a public relations disaster for the nuclear industry. Understandably, since that time, the world has shunned nuclear energy. Prices for uranium, used to fuel nuclear power plants, fell from around $70 a pound to less than $30 and have remained there for a decade. Japanese utilities not only stopped buying the metal, but also sold the uranium fuel they had on hand into an already over-supplied market, further depressing prices for the heavy metal. These low prices have discouraged new investment, as it is widely accepted that a price of $50 or more per pound, on a sustained basis, is required to encourage new capital projects.

The pandemic forced the curtailment of production at several important mining properties. In addition to COVID related production issues, the world's two largest and lowest cost uranium producers, Canada's Cameco and Kazakstan's National Atomic Company Kazatomprom have for several years now maintained output discipline; actually reducing their production voluntarily in order to help remove the overhang of supply in the spot market.

While the supply-demand picture appears relatively balanced for the moment, BMO Economics believe a quarter of 2025 and 80% of 2035 demand is currently uncovered. It would appear that the market is structurally undersupplied for the next decade.

Change of Heart

Recently investor interest in the nuclear space has been percolating due to its low carbon footprint. The conversation around Environmental, Social and Governance (ESG) investing is top of mind for both market participants and business leaders. Many believe that a major transition towards carbon neutrality will require a significant contribution from nuclear. President Biden has included nuclear energy in his Nuclear Energy Program and the U.S. nuclear regulatory commission is looking into extending the license for nuclear power plants to 100 years.

Currently the United States is getting roughly 20% of its electricity from nuclear and for now that level is projected to remain stable. However, this winter's storms and resulting power shortages in the Southwestern U.S. highlighted the vulnerability of the electric grid and the need for improvement.

China is slowly moving away from coal, its motivation is strongly related to the air pollution caused by coal fired plants. Beijing would like to reach peak emissions by 2030 and become carbon neutral by 2060. Currently there are 49 operating reactors in the People's Republic with six to eight new reactors to be commissioned each year for the foreseeable future. Additionally according to The World Nuclear Association, there are 16 nuclear reactors currently being built in 16 countries, ex-China.

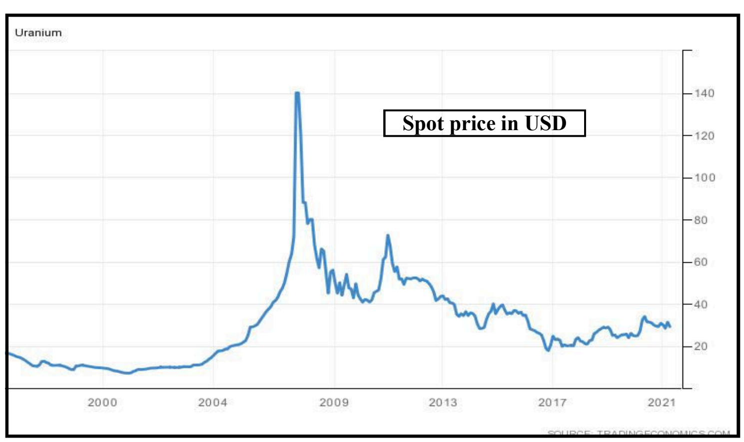
In my opinion, we need not make the case for uranium miners based on future expectations of reactor builds and Chinese demand. There is an old saying, "The cure for low prices, is low prices". The inference is that when prices are low, producers have little incentive to spend money on new exploration and production. As time passes, the depletion of existing mines and a lack of new projects begins to gradually squeeze supply, eventually creating shortages, driving prices higher, which incentivizes new production to be brought on stream.

At this stage, it would appear that we are at or near an inflection point. Due to a prolonged lack of investment and new production, we are close to depleting existing stockpiles. The precise timing of this inflection is clouded by the uncertainty around just how much uranium has been stockpiled by the various utilities. Additionally some utilities employ the practice of reprocessing fuel rods as a supplement to buying newly mined metal.

Uranium is sold to utilities using long-term agreements, so far we have not seen an urgency from the utilities to ink deals, however I believe it is only a matter of time. The already functioning reactors need uranium just to keep the lights on for the next decade. At some point they'll have to come to market and *BUY*. In addition, if we begin to see greater adoption of nuclear energy for the reasons mentioned above along with increased demand from China, then prices could easily head back to the $70 range and potentially even higher.

If we are correct in our analysis, shares of the uranium producers should do well. The two big players in the space, Cameco and Kazatomprom are the go to names in my opinion. Commodity investing is precarious enough as it is, thus owning the largest, best capitalized, lowest cost producers, makes sense. Share prices in these kinds of companies are inherently volatile, however, patient investors with a 3-5 year horizon should be well rewarded.

As Mark would say, go green, go nuclear...Al.



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important to many other industries within the broader economy—think electrical wiring and stainless steel. At the same time charging all those EVs literally means a need to double our electricity production and distribution capacity. I've done the math, converting America's annual gasoline consumption of 142B gallons into an increased need for K-watt hours is a monumental project of its own. This involves trillions of dollars of new investment and huge amounts of metals. Besides the cost of doubling its transmission capacity, estimated at 2-3T dollars, America would also have to bring roughly one new giga-watt sized power plant on-line, every week, for the next decade at roughly a billion dollars per unit. This would be in addition to completely replacing America's existing, decrepit transmission system. Also keep in mind the rest of the world will, more or less, have to do the same.

A Decade of Under Investment
Similar to the underinvestment by the oil patch over the last five years, we have an even more extreme situation in the metals space. After the last commodity super-cycle peaked in 2011 with $137 oil, $4 copper, $140 uranium and strong agricultural prices, its been all down hill for the entire commodity complex, until the recent bump based on enthusiasm for the post-pandemic re-opening trade.

At the moment many metals are in a tenuous supply-demand balance and that's with a weak global economy. As COVID passes and the economy picks up modest momentum many analysts are projecting shortages for tin, zinc, copper, nickel and a host of other important commodities in the years ahead. The underinvestment of the last decade means there's been a dearth of new discoveries and few new projects permitted to commence production.

The tightness of supply-demand is evidenced by record low inventories at both the London Metals Exchange and the Shanghai Metals Exchange, the world's two largest metals warehousing and trading companies.

The Embedded Irony of the ESG Movement
The Greens have done a good job of moving forward the de-carbonization agenda. In their enthusiasm the Greens have driven the share prices of battery producers, EV manufacturers and anything that even smells a little green to outrageous price levels, while continuing to pooh-pooh the extractive industries, such as base metal miners. Ironically enough, the Greens can't seem to make the important connection between the need to mine vast amounts of metals in the years ahead and realizing their EV dreams.

Thus, not only is there a growing scarcity of new deposits to be found, as we've already picked all the low hanging fruit over the last 100 years, but regulation of all types advanced by the greens has resulted in the average time from discovery to production of new deposits to climb from 6-7 years, a couple decades ago, to 10+ years today. While higher prices for metals are likely to cause all parties to move somewhat faster in the future, the delay hurdle from discovery to production is unlikely to move much, allowing producers to enjoy an elongated period of high prices during the next cycle.

Inflationary Defense-Currency Tailwind
Since most commodities are priced in US dollars, a weaker dollar tends to cause both financial markets and producers to rapidly adjust commodity prices. In such a way that their real, inflation-currency adjusted price, remains fairly constant, outside of supply-demand influences. The 10 year long strength in the US dollar versus most other currencies seems to be ebbing somewhat and those that are concerned about skyrocketing US debt obligations and debt monetization by the Federal Reserve may find a natural hedge built into their portfolios against a falling dollar through exposure to commodities and commodity producers. This too could prove to be anther secular tailwind at the back of commodity investors as a new cycle gets underway.

Final Thoughts
I'm going to have to truncate the commodity discussion here due to space limitations, but I do hope to follow-up with further discussions on the growing silver shortage, a metal so critical to our high-tech driven world and the hopes of the greens for more solar power. Also, see Al's discussion in *Stock Talk* on the uranium shortage which seems to be gaining steam, whose risk-reward payoff appears hugely asymmetric at the moment.

Hard assets, such as commodities offer exposure to a turn in the economic cycle; a secular tailwind due to a decade of underinvestment by the sector; secular supply constraints due to greatly expanded regulation; a natural hedge to a secular decline in the dollar and the potential for renewed inflation pressures.

Go hard, go green, go commodities. Sincerely, Mark.