BMO Nesbitt Burns

ISSUE #99: WINTER 2021

The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

POWERFUL FORCES

Hard to believe it's been a year since we started avoiding our friends and disinfecting our groceries. Who can forget the historic plunge in markets in those early days as fear and uncertainty ruled. Today, despite no longer being obsessed with disinfecting, many of the day-to-day realities have not changed much for many people. However, undeniably powerful forces have investors in a decidedly bullish mood.

No force is more powerful or more influential to the psyche of market participants as the unwavering support of central bankers. Since the beginning of the crisis, their support in effect put a floor under equity prices. While some critics may ridicule the money printing, endless quantitative easing and hyper dovish stance, the fact is: it's what was needed. Today, central bankers are signaling that they do not intend to take away the punch bowl until at least the middle of 2022.

Day of Reckoning

Some investors are concerned that all the easy money is creating a "bubble" in asset prices. Recent activity in stocks like GameStop, Blackberry, as well as battery and hydrogen related names certainly appear bubbly in my view, however those names are not representative of the stock market as a whole. In fact, I believe the valuation of many solid companies whose business models are sustainable and whose fortunes are related to the economy re-opening are quite reasonable indeed. In addition, over the last decade, growth stocks have outperformed value names by a wide margin. I think it would be pretty tough to make the case that these value names are in a bubble, quite the contrary! In fact, many of these companies have favorable metrics and pay sustainable dividends that are as much as 4 to 5 times what you can earn on a 10 year government bond. Cryptocurrencies have made a parabolic move up, which is quite likely an unsustainable pattern. Their behavior appears like a speculative frenzy that may potentially end quite badly. If they are intended to be an alternative method of payment, their volatility alone should give users second thoughts. Imagine agreeing to buy a house with Bitcoin one day only to see the coin price move by 10% the next!

Another powerful force is hope. In this case, hope related to the vaccine. The thinking is that as people get vaccinated and life slowly goes back to normal, economic activity will pick up: some pundits have coined the phrase "growth bomb". With hundreds of millions of people having felt like they just wasted a year of their lives, some investors believe economic activity will explode

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FIXED INCOME: A Truly Broken Asset Class

When the 10 year US Treasury bond hit an all-time low yield of 1.6% in August of 2016 and started to gradually rise back towards 3.1% in mid 2018, I was convinced that the 40 year bond bull was dead. But the arrival of COVID and unprecedented central bank action, would prove me wrong. In March of 2020, the 10 year bond yield would plunge to a new all-time record low of 0.55%. My guess, is that COVID has triggered this one last hurrah for the 40 year old bond bull. While it is still possible that higher bond prices (lower yields) might materialize, this would require the US to follow Europe and Japan down the negative rate rabbit hole. A place, that thankfully so far, Fed officials have said they are reluctant to go. But let's be honest, this possibility has not been completely taken off the table and despite anything they might have said in the past, they could change their minds. Nonetheless, it is one thing for countries such as Japan, Holland, Denmark, Switzerland and Germany to manipulate rates into negative territory, it is quite another thing for the guardian of the world's reserve currency (the Fed) and the world's largest debtor (the USA) to go negative. Remember, the US decades ago convinced everyone (central banks) around the globe that they were better off holding treasury bonds rather than gold as a reserve asset: after all gold paid them no interest, while treasuries paid them 5-10%, hence their trading partners could recycle their trade surpluses into treasury bonds and earn a return on their money. Today, with US Treasury bonds yielding a scant 1% this relative return advantage over gold is all but gone, and should the US decide to push rates into negative territory, there would be no incentive for foreign central banks to hold US government debt, indeed 0% yielding gold bullion would actually provide a yield pick up for them, while reducing their risk to the US economy and currency.

The Biggest Bubble in the Bubble Multi-verse

Without calling the beginning of a new bond bear market, I'm pretty confident that we've seen the secular lows for global bond yields given that 5 year Greek bonds yield 0% (rated BB- by Standard & Poor's, a junk rating) and German 10 year bunds pay -0.5% —-(that is for the privilege of loaning $1,000 of your hard earned money to the German government they will give you back $950 in ten years)! I've highlighted before how even a modest move to normalize rates would produce massive losses for longer term bond investors rivaling that of any stock market bear. For example, if the 10 year US treasury yield moved from 1% to 4%, bond prices would fall roughly 25%. Even a 5 year bond going from 0.5% to 3.5% would result in a 15% loss! While most asset classes around the globe look expensive, I'm confident the most bubblelicious of all asset classes is the bond market.

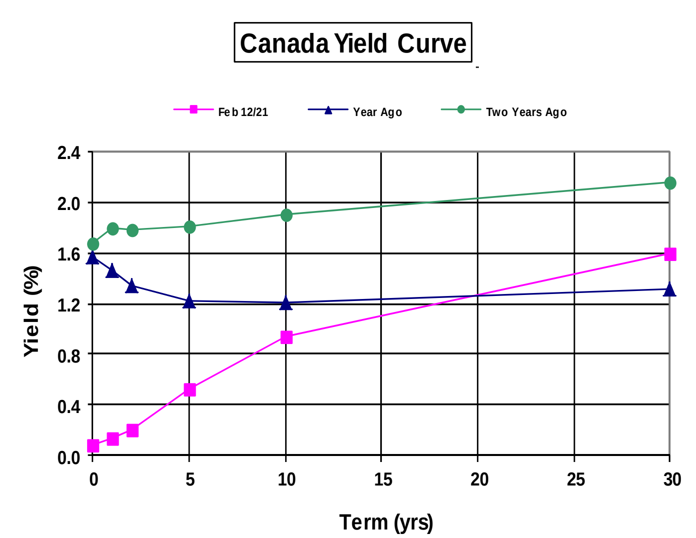
Financial Repression and Gov.'s Optimal Outcome

The Fed has told us that they are not even *'thinking about, thinking about, raising rates'*, and that they plan to keep short rates pinned at the zero bound until at least 2023, if not out to 2025. While at the same time, they (central bankers) continue to promote the ludicrous idea that our cost of living is rising too slowly: that we need more inflation, at least 2% in their view. Assuming that central banks don't loose control of the bond market at some point and can keep rates all along the curve well below the inflation rate, I have no doubt that their plan is to slowly steal our purchasing power in order to deal with their massive sovereign debt loads (and increase taxes along the way of course). This is exactly what they did for the a decade+ following WWll, after US debt hit 130% of GDP. If you are terrified of the volatility of the stock market and want to hide in government guaranteed bonds or bank term deposits for the coming decade and central bankers are successful in their efforts to suppress rates and pump up inflation, then you could expect the following loss of purchasing power over the coming decade.

Nominal Bond Yield	Inv. Mgt. Fees	Taxes on Int. Income @50%	Inflation Rate	Net Annual Real Yield	Cpd. 10yr Purchasing Power Loss
1.50%	0.0%	0.75%	1.50%	-0.75%	-7%
1.50%	0.0%	0.75%	2.00%	-1.25%	-12%
1.50%	0.0%	0.75%	2.50%	-1.75%	-16%
1.50%	0.0%	0.75%	3.00%	-2.25%	-20%

The only way bonds win, is if we have a multi-year bout of meaningful deflation (negative inflation). However, with central bankers and policy makers hell bent on generating inflation through QE, asset purchases, checks in the mail, colossal budget deficits, yield curve control and zero interest rates, I wouldn't count on deflation to save your bond portfolio's purchasing power. Even during one of the worst economic downturns of our lifetimes, inflation still clocked-in at 0.7% for 2020, and looks set to keep climbing in 2021. All investors should be re-thinking the role bonds might play in their portfolios over the coming years, if any.

Central bankers are not your friend. Sincerely, Mark.



Source: Bloomberg

STOCK TALK: The Coming Energy Crisis

The current narrative that the Greens would have us believe is that we will all be driving EVs by next Christmas and that we don't need oil anymore. What I want to highlight here, is that I believe this current narrative to be false and that a tremendous value opportunity has been created in the oil patch, in a market that otherwise offers a dearth of quality, large cap, value opportunities.

Don't get me wrong, I do believe the EV revolution is upon us and that we will electrify the globe, I just don't think it's going to happen as fast as the current narrative expounds. Proponents of the current narrative appear solely focused on the demand side of the oil equation, without considering what's happening on the supply side and therein lies the opportunity.

The Rise and Fall of Fracking

As a result of two drilling innovations, horizontal drilling and fracking, previously inaccessible shale oil deposits began to bare fruit. Coupled with access to cheap capital from banks eager to capitalize on this new frontier, US daily oil production grew from a low of 5M b/d in 2005 to 10M b/d by 2015. But when a global growth scare materialized in 2015, oil prices had already started to slide from over $100/b in 2014, before finally bottoming-out in early 2016 at $26. The frackers whose breakeven point was in the $75-80/b range began to fail, even while crude prices recovered into the mid $50s over the course of 2016. However, it wasn't enough, the banks once burnt refused to lend new capital to the sector, even as oil prices continued to recover. In 2017 with oil in the mid $60s, in walked yield hunger private equity investors (think central bank zero interest rate policy, and rock bottom bond yields). The private equity guys scooped up assets at 30 cents on the dollar in bankruptcy auctions and recapitalized the frackers with new debt, hoping to make money where the banks had failed. Meanwhile, all the players in the sector moved to the lowest cost area, the Permian Basin and found ways to do more with less, managing to get their breakeven point into the low $60s.

Enter COVID and $20 oil, the frackers began to fail again, despite crude's recovery over the course of 2020 into the low $50s, while US production continues to edge lower. After peaking in late 2019 at nearly 13M b/d, US daily production currently stands at roughly 10.7M b/d. The US drill rig count is still down 50% from pre-COVID levels despite a bounce off of mid 2020 lows. This bodes ill for US production as shale wells have a horrendous production decline profile. Typically production falls about 80% within a year and 90% with two years, meaning that just to keep production levels steady requires an absolutely frenetic pace of drilling. Given these dynamics in the shale patch, I expect US shale production to continue declining in 2021. Looking to the future, it's hard to imagine what large investor group might step up to lend the frackers new capital to drill, even if oil recovers above $70/b. In my view investors in the shale space have done nothing but subsidize consumers for the better part of 15 years. Cumulatively since the birth of shale oil production, the industry has produced nothing but losses for investors and has been a serial destroyers of capital, despite a record low interest rate environment. It'll probably take oil persistently above $80 to even begin attracting new capital.

And What of the Super Majors?

Besides having to deal with COVID and rock bottom oil prices, the executives of the super majors are being told they are the spawn of Satan incarnate, that their product is no longer needed, effective immediately and that new capital from investors is never, ever coming their way again, all due to a big trend in ESG (Environmental, Social & Governance) investing.

Following the first plunge in oil prices in early 2016, all of the majors slashed their capex budgets dramatically, only loosening the purse strings a bit starting in 2018 as oil worked its way back up into the mid $70s. But less than 18 months before exploration and development (E&P) budgets could really start ramping back up, budgets were slash again in 2020, even more dramatically this time. Given the 5 to 6 year lead times needed for the majors to bring new production of conventional oil on-line and how little capital has been spent on E&P in the last 5 years, I fully expect their production to be flat at best, if not declining slightly over the next few years.

Executives in the sector have been clubbed by plunging oil prices that have fallen well below the cost of production twice in the last five years, publicly flogged by the ESG movement and are witnessing the rise of EVs. Until they get a signal from oil prices and a green light from society, these companies with decades of reserves will likely spend as little money as possible on E&P. And unlike their shale counterparts, the super majors can cover their maintenance capex and dividends at $55 oil. At $75 oil they make great money, but I fully expect to see $100+ oil in the near future, maybe not in 2021, but likely in 2022-23. Supply is falling and will continue to fall as a result of a lack of investment. Saudi may have a few extra million barrels per day of spare capacity, but my feeling is it simply wont be enough: The supply crunch is coming.

Meanwhile you can buy BP, Chevron, Exxon and Royal Dutch at prices not seen since the early 2000s. Those that have already cut their dividends in half, such as BP and Royal Dutch still pay 4-5%, Chevron with the strongest balance sheet in the business and Exxon with the most efficient business model pay 5.8% and 7.0% respectively.

Time to back up the truck for black gold. Sincerely, Mark.

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as pent up demand for capital investment, travel and leisure, in addition to general consumption, are unleashed.

This view is confirmed by the yield curve. The currently strongly upward sloping curve, in particular the closely watched gap between 2 and 10 year yields, is signaling strong economic growth ahead.

This hope is largely dependent on functioning vaccines. The never ending emergence of new variants is forcing portfolio managers to take a keen interest in virology. Thankfully it appears that while some vaccines may be less effective against certain strains, their protective qualities would appear to be sufficient.

It seems likely that the Biden administration will secure the $1.9 trillion COVID-19 relief package it is seeking. More money in people's pockets ultimately means more spending and hence economic growth. Newly appointed Treasury Secretary, Janet Yellen, has been lobbying for passage. Markets see this as enhancing the case for higher equity prices, yet lower bond prices as the massive package can lead to inflationary pressures down the road.

This trifecta of easy money from central bankers, strong economic expectations and fiscal stimulus from governments is driving asset prices higher. I expect it will continue to do so for some time. Of course the logical questions are: how much of this has already been factored into current prices? What is a reasonable price to pay for a given asset under current conditions? The honest answer to both these questions is: nobody knows for sure. However, once again this is why owning real sustainable businesses with profits and dividends reduces downside risk.

In the last issue of the TFI (*Keep Calm, Carry On*), I wrote about the shift away from the U.S. dollar and assets. I believe current conditions are accelerating this trend. We have seen the TSX and emerging markets begin to outperform U.S. markets. Commodity prices, a direct beneficiary of stronger economic growth expectations, have been rallying. Even left for dead oil and energy stocks are the top performing market group albeit from a low base.

The one exception to the commodity bull, so far at least, has been gold. After a strong rally during the darkest days of the pandemic, it seems to have cooled off. However, I am not ready to throw in the towel on the yellow metal, as I believe the weak U.S. dollar, money printing and potential inflation with depressed interest rates should put a floor under its price.

> *"There are known knowns, known unknowns and unknown unknowns." Donald Rumsfeld*

Since the market has been rallying on the assumption of continuity of the forces discussed above, it is logical to assume that if one of these was to be taken away, we could have a violent reality check. The first is the easy monetary policy. If central bankers were to signal they are going to be less accommodative (i.e. reduce quantitative easing and/or raise rates) perhaps due to mounting inflationary pressures unleashed by today's monetary and fiscal policies, we could expect a market temper tantrum.

Secondly, the expectations of economic recovery are highly dependent on a functioning vaccine. If we wake up one day to learn that a new strain is resistant to our current batch of vaccines, we'd have a serious problem. Third, if governments around the world decide it's more important to be "fiscally responsible" than to help working families during a difficult time, this would also be disruptive.

Bond yields have already begun to rise on the expectation of future inflation. This has implications for certain market sectors. The higher yields, upward sloping yield curve and brighter economic prospects are a positive for financial, industrial and cyclical areas of the market. Even so, they may be seen as marginally negative for growth stock valuation metrics as the present value of future cash flows are worth less under a higher interest rate scenario.

Just as COVID came out of nowhere to be the biggest story of 2020, some other issue not currently on our radar can easily become the next driver of markets. Making decisions without absolute certainty is one of the most challenging aspects of managing money. However, if you own great businesses purchased at reasonable prices, you'll be fine.

Spring is coming….Al.