BMO Nesbitt Burns

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The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

KING DOLLAR

Seems like every time there is a panic in financial markets, investors run to the U.S. dollar. Doesn't seem to matter if the epicenter of the crisis is the U.S. itself as in the Great Financial Crisis. This time around has been no different. Since the beginning of the year the U.S. Dollar Index (DXY) has rallied strongly. The Federal Reserve has been raising interest rates to combat inflation. The higher interest rate paid on dollar deposits has attracted money into the currency. In fact, the Greenback it is now at a 20 year high. The strong dollar may be nice for Americans vacationing in Europe (if they can get over the frustrations at the airport), however, it has reeked havoc on financial markets due to the effect on companies and countries who are dependent on the currency.

Our Currency, Your Problem

Take for example companies who issue debt in dollars, but whose businesses are run in local currency (euro, yen, lira, etc.). The rising dollar means they now need to earn more in local currency to service that debt. In addition, American companies who do business around the globe but report their earnings in dollars earn less.

Commodities trade in U.S. dollars, so all else being equal, a strong dollar, means weaker commodity prices. Recent declines in prices for raw materials are a result of a double whammy: recession fear plus a strong Greenback.

Of course there is a logical argument that can be made for the currencies' strength. The euro, which is by far the largest component of the DXY at 57% has major challenges. While the European Central Bank has recently raised its benchmark rate, it's far behind the Federal Reserve. Furthermore, Europe is a large net energy importer, further exacerbated by currently high oil prices and is at the mercy of Vladimir Putin. If Mr. Putin decides to turn off the gas supply this winter, not only will they freeze, but a deep recession could be at hand. Despite the sanctions, angry rhetoric, the Europeans remain in a very vulnerable position. Hence, their currency is reflecting this reality.

Japan (the yen is the second largest component of the DXY) is in a tough spot as well. They too are big energy importers plus they are in no position to raise interest rates. Their demographic challenges and uber loose monetary policies have them in no position to compete with a hawkish Federal Reserve.

It's Good to be the Reserve Issuer

The Americans by contrast are in a better position. First, their economy while weakening is still far stronger than Europe's or Japan's. They can "more" easily afford to raise rates. Furthermore, as the world's second largest producer of oil, they do not have the burden of massive net imports at current prices.

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FIXED INCOME: Red Hot CPI

June CPI numbers on both sides of the border indicate a relentless march higher in consumer prices. Indeed, both year-over-year numbers hit multi-decade highs of 9.1% in the USA and 8.1% in Canada.

Central Bankers Still Way Behind the Curve
It's clear that central bankers are terrified of *The Kraken* that they themselves are largely responsible for releasing and are now rushing to play catch-up. Of course being late as a result of having drunk their own *transitory narrative* cool-aid and now having to move much more aggressively, virtually guarantees a *'policy mistake'* that will push us into recession.

Basic math indicates that it is impossible for policy makers to raise rates high enough to actually slay the inflation dragon. However, given the enormous debt loads carried by our society, I have no doubt they can raise rates high enough to kill the economy. Because central bankers know this, I am convinced that their goal is to induce a recession in the hope that it (the recession) will do the job for them, of bringing down inflation.

The Problem with Soft Landings
Economic soft landings are the equivalent of unicorns, lovely mythical creatures that don't actually exist. Inducing a mild recession in order to bring inflation down is like trying to stay dry during a category 5 hurricane, good luck with that!

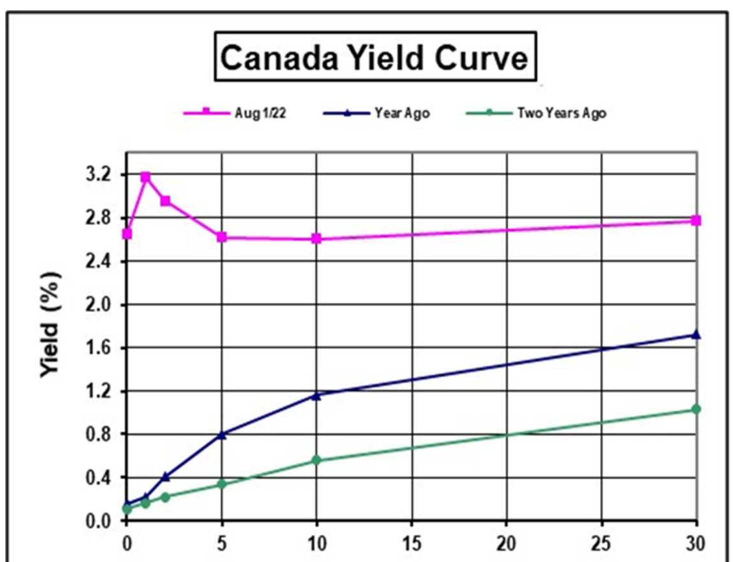
The Problem with CPI
I fully expect CPI readings to come down meaningfully in H2'22. However, the biggest drops will likely be in consumer discretionary items such as airfares, restaurants, hotels, used cars and RVs. But the reality is nobody *needs* these items, which is why they are referred to as discretionary, but I suspect the items we all *must have* will prove much stickier from an inflationary perspective. We all need food, energy to fill our cars and heat our homes and we all need shelter. These items seem likely to come down more slowly and thus workers who continue to suffer real wage declines (i.e. wages that are rising more slowly than the rate of inflation) forcing them to cut back on discretionary items and spend more on basic necessities. In a nutshell, the prices of the things we must have will continue to go up, while the things we can do without will fall, resulting in a CPI reading that masks the true pain that consumers are suffering.

Deflationary Forces Still in Play, But Less So
Central bankers would still like us to believe that inflation will come back down to pre-pandemic levels of 1-2% in the near future and that they are doing everything possible to make that happen. The Millennials, our largest cohort, bigger than the Boomers, are now in their prime spending years: family formation and home buying. While the Boomers, well into their retirement years, are likely to consume less as aging people do. Furthermore, over the coming decade we will continue to move from *just-in-time* to *just-in-case* inventory management. This means less efficiency and higher carrying costs for corporations. Costs that they will be forced to pass on to consumers. Also, it is important to appreciate that moving from energy dense fossil fuels to other less dense energy sources will by definition be inflationary: an important point that politicians have repeatedly failed to highlight to the electorate. Furthermore, we will continue to need lots of fossil fuels during the transition and have failed to make the necessary investments over the last decade to assure ourselves of adequate supplies. This is also true of the metals needed to transition to EVs and upgrade the grid to support much higher electricity use.

Energy Crisis 2.0 Coming Soon to a Theatre Near You
I expect the relatively inelastic demand curves for the above increasingly scarce resources will dominate the deflationary forces we have so enjoyed for more than two decades plus. A recession can certainly kill, at least temporarily, aggregate demand, but what it can't do is fix supply side issues. Unless the Fed figures out how to print wheat, oil and copper, I fully expect to see $100-200/bbl oil and $6/lb copper coming out the other side of the next recession.

Central Bankers Must Choose
Rapidly rising inflation is a global phenomenon and thus central bankers, as I have always maintained, will be faced with the difficult decision as to whether they want to save their currencies by letting rates rise or save their bonds markets—suppressing rates with QE and yield curve control—-and let their currencies depreciate. Already we've seen Europe and Japan, whose central banks have failed to follow the Fed with higher rates, pay the price. Both the Yen and Euro have fallen precipitously vs the dollar so far in 2022. The dollar will be the 2nd to last man standing and gold will be the last man standing, when all is said and done. Protect yourself accordingly.

Central bankers are not your friend. Sincerely, Mark.



Source: Bloomberg

PORTFOLIO MANAGER: Hedge Hog

It has always been a challenge for long only managers to hedge (protect against the downside) their retail clients' portfolios. Historically, the tools to do so have been non-existent or accessible to institutional investors only. For example, a hedge fund manager might hedge his/her long stock positions by shorting a number of S&P500 Index futures contracts.

The Going to Cash Option
Raising cash has long been the default option for long only managers such as myself and Al. Of course any tactical strategy has it pros and cons. For one, in taxable accounts this might mean selling long held positions with a low cost basis, thus triggering taxable capital gains. It might also mean selling some of your value stocks or strong dividend payers that you rely on for steady retirement income. Furthermore, sitting on cash in a highly inflationary environment like we have now comes with its own problems.

Consider your portfolio, what would you sell, some of your high dividend paying, defensive names in pharma, telecom, consumer staples or utility sectors? Or would you sell names that should help protect you against persistent inflation such as base metals, energy and/or real estate, many of which also pay good dividends? Perhaps selling some of your precious metals which are there to provide you with insurance in the event of systemic failure and/or rapid currency debasement? It's a tough call. One solution, might be to do an across the board trim of all names held. This has tax implications too of course and requires a ridiculous number of very small impractical trades. Consider that if you wanted to reduce your equity exposure from 80% to 70%, you'll have to trim all your names by a 1/4 percentage point (i.e. 2.50% to 2.25%).

Quite frankly I think all of the stocks we own, with the exception of our tech holdings in Microsoft and Google, are either fairly valued or undervalued and all have unique characteristics that play an important role in our portfolio under various economic scenarios, which are impossible to predict.

Wall Street Occasionally Creates a Useful Product
I've spent 30 years watching Wall Street bring so called new and innovative products to market most of which pander to retail's desire to participate in what is hot right now and generally at the top. But as long as there are big fees to be made in bringing money losing IPOs to market or incomprehensible packaged products that make all kinds of wonderful guarantees, I wouldn't expect their behavior to change any time soon. However, one product that didn't really exist heading into the last protracted bear market in 2007-08 were these bear ETFs. These products were just making their debut, there wasn't much selection to choose from, liquidity was poor, there was no track record to speak of and most had generally higher fees than today. Fast forward 15 years and we have public track records to examine, generally lower fees, decent liquidity and lots of product choice.

So What Exactly is a Bear ETF
These are index products that are designed to be perfectly negatively correlated with an index. So, instead of selling 10% of your stocks and triggering taxable gains or selling things you like longer term, you buy a 10% position in an index bear ETF which is essentially the same as reducing your equity allocation. I think it's potentially better, because cash will earn little as the market slides. By contrast, your bear ETF will gain in value, providing you with something that has appreciated that you can sell at a profit in order to buy new bargains or add to your existing names with strong balance sheets and good dividends.

The Direxion S&P500 Bear 1x ETF (SPDN)
This fund is meant to inversely track the S&P500 one for one. Indeed at mid-year the S&P500 was -20.6% while the SPDN was +21.3%. That is pretty good tracking in my book with little error. The other thing I like about this product is you are essentially short an index that is 30% overvalued tech stocks and 13% consumer discretionary stocks heading into a recesssion while maintaining a portfolio of individual stocks that are mostly dividend paying, value stocks. Stocks which hopefully will fall less than the market as a whole, thus potentially providing your with extra return should the gap between growth and value tighten, as it has done so far in 2022. Despite narrowing, this gap remains historically wide. Thus there are two ways to win potentially as a value investor.

My Expectations for the Balance of 2022
I remain convinced that the correction we've seen so far is simply the first leg down in this bear market. So far the market's decline has been about multiple contraction. As a result P/Es (price to earnings multiple) have come down closer to historical norms, from 21x to 17x. However, in a recession, surging input costs, rising labour costs and a surging US dollar, etc. are likely to force analysts to revise corporate earnings estimates down in a meaningful way. This will push valuations back up to 20x, creating room for another down leg of 10-20% later in the year. I've added an initial 4% SPDN position simply to reduce equity exposure.

So far, so good in 2022, lets see how it all plays out and if we can whether the storm for the full year. Sincerely, Mark.

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The bottom line: The difference between the rates paid on deposits of dollar vs euro and dollar vs yen alone could explain the rise in the Greenback. When we add in other factors such as energy security, the trade becomes a slam dunk.

Petro Dollar Strength
The Canadian dollar has largely escaped the decline other currencies have suffered. This is likely due both to our own central bank's hawkishness in addition to Canada's oil production capabilities. In past episodes of economic turbulence we have seen the Loonie fall into the 60-70 cent range. This time around the economic tailwind from still relatively elevated commodity prices, along with a better than most economy, has spared our currency.

More recently fears of recession have increased and the TSX which held up relatively well earlier in the year, is now firmly in correction territory. From an investment management perspective, the current challenges should be put into context relating to time horizon, diversification and fundamental value.

It's Not The Currency, But The Business
We have always maintained a large position in American companies not because of a currency bet against the Loonie, but rather because there are great companies in America in sectors that simply do not exist here in Canada. Sometimes the exchange rate is a tailwind to returns, at other times it is a drag on performance. However, there are simply no equivalents in Canada for great companies such as Microsoft, Johnson & Johnson or Coca Cola.

The energy sector, while giving up some gains recently, has held up quite well and is one of the only areas of the market still in the green for the year. Other commodities and their producers have been under tremendous pressure of late. Nonetheless, under a scenario where the dollar begins to fall, gold bullion, commodity producers and miners can rally. This situation could occur if the market perceives the Federal Reserve will begin to back off from further rate hikes. In fact the futures market is already beginning to predict the Fed will loosen (cut rates) at some point in 2023.

The Lesser Of Two Evils
The incoming economic data over the next weeks and months will no doubt be a push and pull between inflation readings and economic data. Markets will attempt to discount every incoming data point to decipher Mr. Powell's next move. Stronger inflation data would keep the pressure on the Chairman to maintain his foot on the accelerator, pumping up interest rates and hence keeping the Greenback on an upward trajectory. However, if inflation numbers begin to moderate, then we will likely see a softening in stance and a turn down for the dollar. The fly in the ointment could well be economic data that begins to show recessionary tendencies at the same time that inflation remains strong. The Federal Reserve may have no choice but to moderate its policy in this scenario to save the economy at the cost of a hotter than desired inflation.

As Clear As Mud
It is often said that markets overreact in both directions. That is, in good times, market participants can be wildly optimistic about a company's future prospects (i.e. Netflix, Shopify). Conversely, in bad times (recession or other shocks) markets often assume overly dire outcomes.

The current macro environment is extremely difficult to gauge. Many corporate leaders, while acknowledging a slowing economy, reiterate that the consumer is healthy and they see no recession . Others claim that an economic storm is on the horizon.

Since nobody knows the future, diversification helps reduce overall portfolio volatility. Not all stocks in a portfolio will work at the same time. Defensive sectors such as pharmaceuticals, consumer staples tend to hold up better in times of economic turbulence. However, more cyclical or economically sensitive names can jump when indicators bottom out and markets sniff out recovery on the horizon.

Ultimately, what we try to do is to buy great businesses at reasonable prices and let time and the power of compounding take care of the rest. This strategy has done well over the years. It has helped protect our portfolios from some of the disasters many market participants have experienced either from buying bad businesses or for overpaying. This crisis will pass as others have before it; the dollar will not always be king; and the economy will not always be in recession. Our great businesses will prevail, their share price will increase and so will the value of our investments in them.

Be super careful out there….Al