April 2022 - Excerpt # 67

BMO Private Wealth

MDL Associates
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Pierre's comments

RISK OFF?

March 21, 2022. The title of this newsletter, number 67 in the series, is not the family name of a famous Russian portfolio strategist but rather the most obvious question that comes to mind in the midst of Russia's invasion of Ukraine.

Inflationary pressures had been present long before the developing conflict became reality as we illustrated in our October newsletter. We then considered the return of inflation as something more permanent in nature, rather than temporary. Rising inflation can be a good thing, as long as it is kept under control, which can be achieved by adjusting the cost of money i.e., interest rates, commonly known as monetary policy. However, the state of the economy can be more vulnerable to an unpredictable event when it is already weakened by a growing concern such as inflation. The timing of the Russian invasion added fuel to the pre-existing supply chain disruptions and excess money supply in a post-COVID pandemic world. Transitory inflation hopes have become obsolete. Runaway inflation can be disastrous for any economy, and therefore I strongly believe the Federal Reserve Board (Fed) will not hesitate to raise interest rates by at least a full percentage point between now and July 2022, regardless of the ongoing geopolitical situation. As mentioned in the past, inflation feeds on itself, as the rising cost of raw materials and labor as well as cost of financing are mostly passed on to consumers until consumer demand abates. At that point consumer prices lose their elasticity i.e., when companies exceed the upper limit in pricing, demand falls and so does production and manufacturing. Corporate layoffs eventually intensify, further shrinking demand, leading to an economic slowdown or recession. In my 40-year career, I do not remember anytime when I thought that a recession was either needed or a good thing! Coincidentally, those 40 years mirror all of the disinflationary era that started in 1982. None of the recessions since then were accompanied by overextending inflation. Perhaps globalization and its disinflationary pressures allowed for longer cycles with fewer and shorter recessions. During the inflationary era, post WWII, the average economic cycle lasted 3 ½ to 4 ½ years, moving interest rates higher every time to control growing inflationary pressures. We used to say that the last upward leg of a bull market was the steepest and shortest one of all, and was commodity driven(inflation). We then needed higher interest rates to smooth out demand and simultaneously stimulate savings. Today, while the U.S. savings rate is back to pre-pandemic levels, Canadians seem more cautions, perhaps a consequence of their much higher debt levels (Chart 1-2).

Chart 1: Consumer Saving

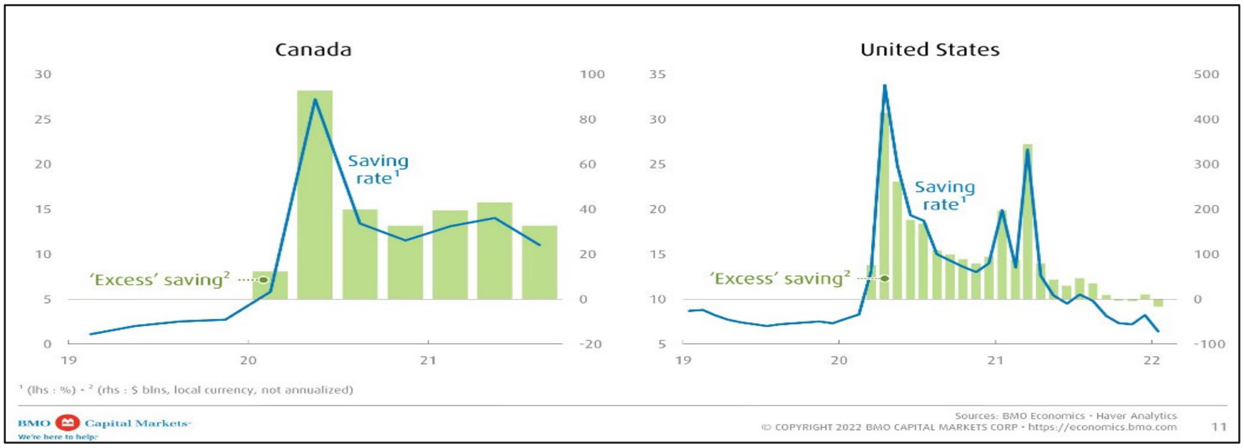
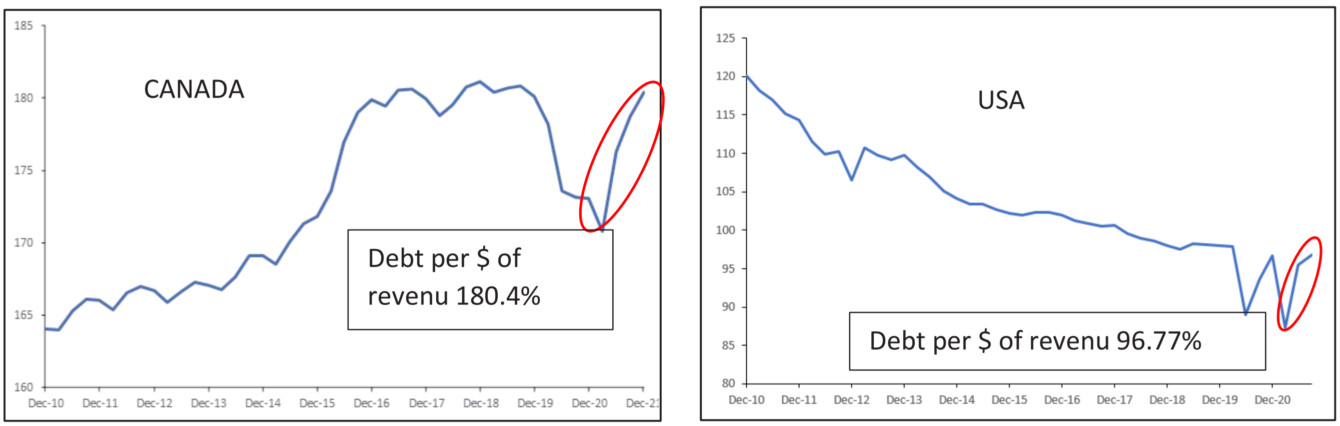


Chart 2: % debt/ $ of revenue



Source: BMO Private Client Division research   Source: BMO Private Client Division research

Canadians' higher personal debt levels may also mean that the Bank of Canada may not have to raise rates significantly to cause an economic slowdown while the U.S. Federal Reserve Board may have more room to maneuver. During the post-WWII recovery – the last time interest rates were as low as today – the U.S. 10-year Treasury notes peaked after a 1.25% increase that caused an economic slowdown. Personal debt levels were much lower back then, as people couldn't spend during a war that lasted much longer than the pandemic. A higher debt level may hurt consumption capacity and slow economic growth sooner!

So, the question is, how much wiggle room does the Central Bank have on the short end of the curve (i.e., the bank rate) before it squeezes the consumer and chokes the economy? Will it be enough to dampen inflation? This is why it is much more difficult for central bankers to engineer a soft landing of the economy in a reflationary environment. Our current economic state could be summarized as follows:

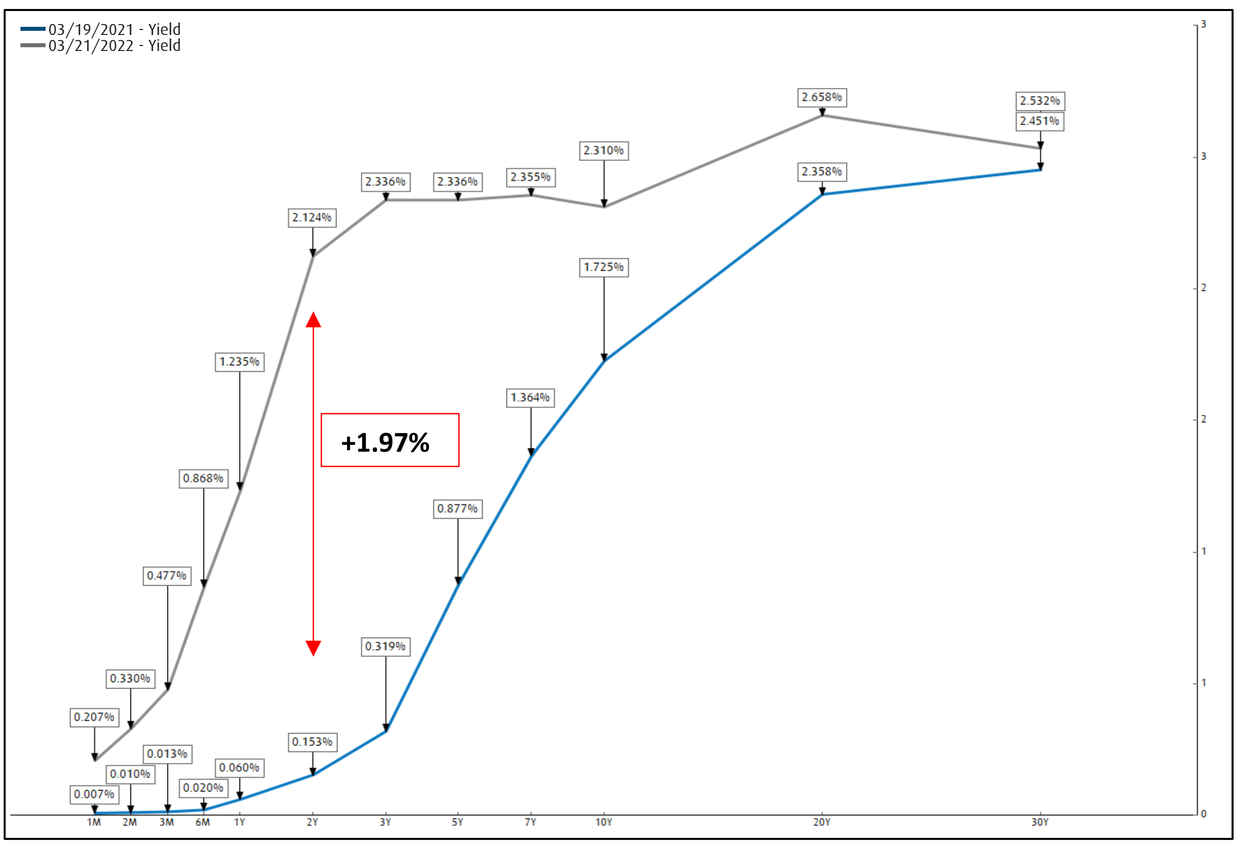
1) High Canadian personal debt to revenue ratio
2) Rising interest rates and flattening yield curve
3) Unemployment at or near all-time lows
4) Labor shortages and wage pressures
5) Disrupted supply chain
6) Commodity prices at or near all-time highs
7) Real estate prices at or near all-time highs

In view of these facts, in my mind, a recession would resolve many of these issues and would also have a compressing effect on price/earnings ratios, providing investors a better entry point. In anticipation of a post-pandemic economic rebound, stock markets have been on a tear for the past two years, extending P/E ratios to 24 times at the end of 2021. Higher interest rates would cause a market correction, slow consumer spending, reduce wage pressures and buy us some time to re-stabilize the supply chain. As of January 25th, according to a BBC report, there were hundreds of container ships anchored near international ports waiting to be unloaded and reloaded. While it normally takes 3 to 4 days to complete the rollover, the shortage of truckers and COVID-related delays have caused a logistics nightmare, resulting in doubling the rollover time to 7 to 8 days. While there were, respectively, 82 and 61 container ships anchored in Shanghai and Hong Kong Ports in late January, there were 68 delayed ships in Los Angeles Port and 19 at a standstill in Rotterdam. Meanwhile the cost of shipping containers overseas has increased fivefold, further contributing to inflationary pressures, in addition to inventory shortages at the retail level.

Higher interest rates may also dampen the demand for real estate as mortgage rates follow suit. Real estate prices are already out of reach for too many Canadians, and a slowdown could be welcome news for many. Perhaps a little inventory buildup as demand slows may lead to a more balanced real estate market.

As explained in the past (letter #57, graph 3, p. 4), a negative yield curve is the most accurate leading indicator of a recession to come, with an 80% correlation. Although the yield curve has yet to turn negative, as of March 21st, note its progression year-over-year (chart 3) March 2021 vs. March 2022.

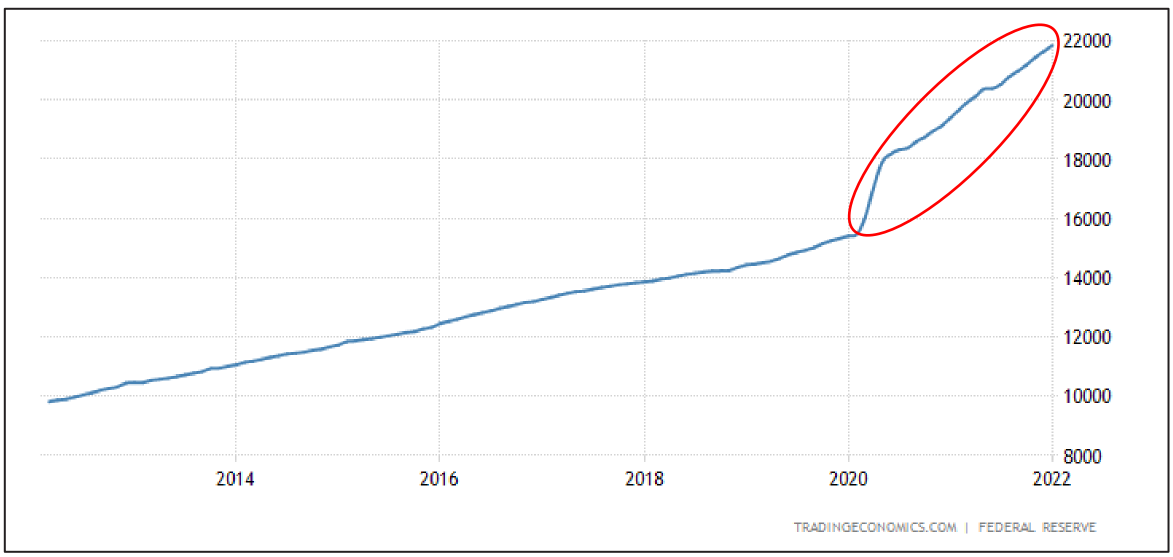
Chart 3: United States Treasury Yield Curve



Source: BMO Private Client Division research

The sharp increase in the 2-year bond yield reflects the widely known intent of the Fed to raise interest rates to fight inflationary pressures. The idea is to raise the cost of money in order to slow consumer spending and stimulate savings. As bonds trade freely, their prices adjust themselves to reflect ahead of time what investors expect. Therefore, the current 2-year bond yields are already discounting something close to seven quarter-point increases, or 1.75%, over the next several months. Although these hikes are expected, they could come sooner and faster than expected, which could further enhance volatility. Evidently, Russia's invasion makes things even more complicated for the Fed, as war is like a moving target – you never know when and where it will come to an end. If the Fed moves too aggressively or too fast and the war drags on, then an economic slowdown may turn into a recession or stagflation. The latter, less desired outcome would be a consequence of resilient inflation, driven by commodities, energy and materials, combined with an inefficient supply chain and a stagnant economy. Sanctions against Russia are further destabilizing the supply chain at the worst possible time. Disentangling the supply chain is imperative and time-sensitive given the additional pressures caused by the war. While a soft landing of the economy would be great, a short recession may be more beneficial in the longer run, leading to more control over inflationary pressures. The Fed is also aware of all the liquidity in the system generated to stimulate a post-pandemic recovery. This money supply is expressed as M2, which includes savings account deposits and retail money market accounts (Chart 4).

Chart 4: M2 U.S. money supply (last 10 years)

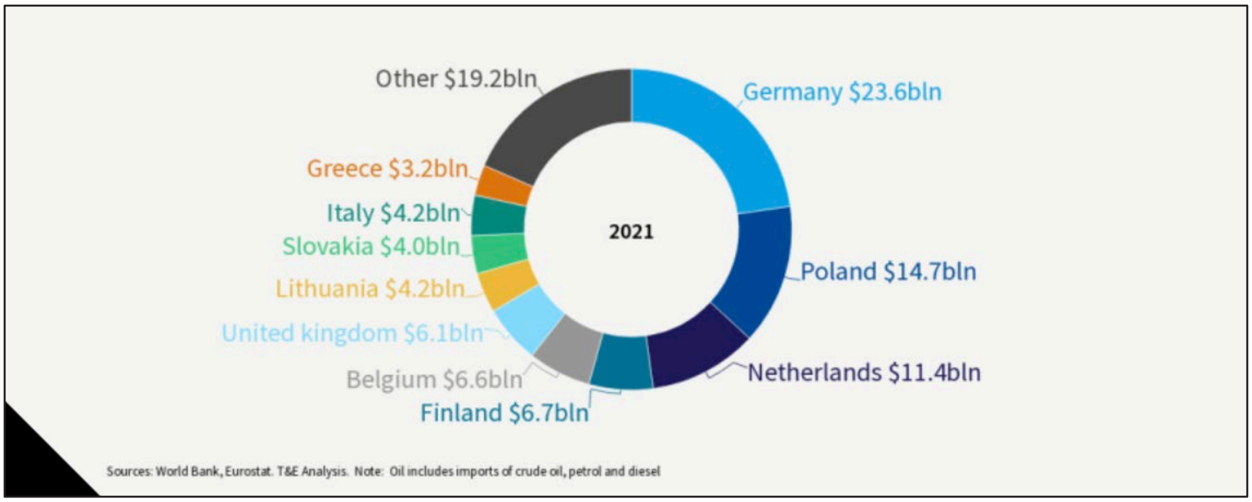


Source: BMO Private Client Division research

The sharp increase in money supply during the pandemic was the main driver of pent-up demand given the lockdown and other restrictions implemented because of the pandemic. People were paid to stay home. Excess cash was invested, pumping up markets, or spent, which boosted demand while the supply chain got disrupted. The loss of this supply/demand equilibrium will cause pricing inefficiencies, as we all learned in Economics 101.

As we come out of the pandemic, most of the G20 countries have adopted plans unlocking trillions to boost much needed infrastructure spending. The good news is that this will stimulate the economy. The bad news, however, is that it might cost much more than expected and it may hinder the effort to curb inflation. Russia's invasion of Ukraine is certainly not welcome for humanitarian reasons, but also completes the conditions required to form a perfect storm by further disrupting the supply chain and using energy against most of Europe as a weapon. Europe depends on Russia for 40% of its natural gas requirements and 25% of its oil needs. According to a Transport and Environment (T&E) analysis for Eurostat, Europe, including the UK, puts $285 million a day in Russia's coffers from its oil imports or $104 Billion per year, dwarfing its gas contributions to Russia of $43.4 billion per year (Chart 5).

Chart 5: Europe's biggest importers of Russian oil



William Todts, the Executive Director of T&E, argues that Europe is financing a war in its own backyard and that "the time has come to greatly improve transport efficiency and turbocharge the electrification of transport to drive down oil consumption", and our dependency, I might add!

Europe's short squeeze for energy creates an opportunity, but most of all, it makes us all realize the importance and the urgency of investing heavily in renewable energy and using the available raised capital for infrastructure to this end. Many fossil-energy companies have already adopted plans to massively invest in new technologies and renewables as they have struggled to find financing for traditional fossil-energy development projects in the past several years. They now know they need to clean up their carbon footprint drastically to get investor support. We should all applaud those traditional oil and gas companies that are using their skyrocketing cash flows caused by the war to reduce and perhaps eventually eliminate the need for fossil fuels, which in turn would put a very significant dent in Russia's economy going forward.

Meanwhile in America, the economy is still going strong but, as mentioned, facing significant headwinds (Table 1).

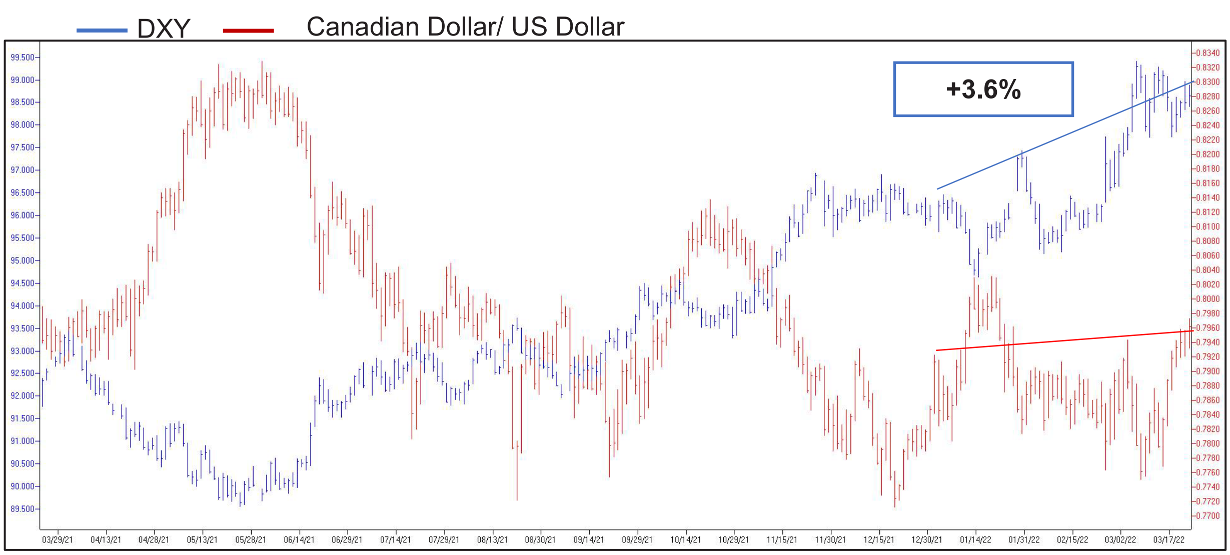
Table 1: Key Indicators (March 4, 2022)

	2020 (actual)	2021 (estimated)	2022 (projected)	2023 (projected)
Canada				
Real GDP % change	-5.2	4.6	4.0	3.5
Unemployment rate	9.6	7.4	5.7	5.5
Canadian dollar (US cents)	74.6	79.8	80.0	80.5
CPI % change	0.7	3.4	4.7	3.0
Overnight rate (year-end)	0.25	0.25	1.50	2.00
United States				
Real GDP % change	-3.4	5.7	3.5	2.5
Unemployment rate	8.1	5.4	3.6	3.4
CPI % change	1.2	4.7	6.5	2.8
Fed Funds rate (year-end)	0.13	0.13	1.38	2.38

Source: BMO Economics, Haver Economics

Most of these figures probably peaked in Q4 2021, except perhaps for the unemployment rate, which typically tends to lag. The one thing that I find odd is the correlation between the oil and commodity price surge and the relatively stable Canadian dollar... The loonie has always been perceived as a commodity currency, along with the Australian dollar and the Brazilian real. Again, the Russia/Ukraine conflict may be a large part of the explanation, as the U.S. dollar is the safe haven currency.

Chart 6: US Dollar Index (DXY) vs Canadian Dollar/US Dollar



Source: Thompson one

Chart 6 shows the U.S. dollar itself has gained 3.6%, going from $0.955 to $0.99 in the past two months, while our Canadian counterpart was resilient as it barely budged during the same period.
Chart 7 shows the strength of the CAD $ during inflationary periods namely post WWII and past oil shocks of 1974, 1990 and 2008... If you believe in a world synchronized growth post-pandemic and post-war, the loonie should realign itself with its old trends.

Chart 7: History of Canadian-Us Exchange rates

Investment Strategy

The 40-year high inflation rate of 7.9% reached in February in the US, is expected to peak in March as the year-over-year comparison starting in April 2022 vs. April 2021 will be less dramatic. Still, given this inflationary momentum, combined with the predictable interest rate hikes to come, we may not have seen the bottom of this market yet. Moreover, Putin's unpredictable behavior will continue to enhance volatility in the markets. Meanwhile, S&P valuations have been compressed, from 24 times earnings at the end of 2021 to 19 times today (March 10, 2022). It is quite possible that the resiliency of corporate earnings will be a function of the length of the war and the recalibration of the supply chain. In this kind of environment, value prevails. Stick with companies with predictable sources of revenue and cash flow, with high barriers to entry and a commitment to grow dividend distributions over time. One last key valuation credential is the level of indebtedness or debt to equity ratio, especially in a rising interest rate environment. There is a natural sector pivot from growth to value, from sales to earnings focus, from interest- to inflation-sensitive and from overleveraged to underleveraged companies.

Our investment philosophy has always been a more conservative and somewhat passive approach in the face of a less competitive Canadian marketplace. As consumers, we can be unamused and outright upset at this Canadian corporate landscape, which lacks competitiveness, but it can surely be used to the investor's favor. There is a saying, "if you can't beat them, join them," and that's what all Canadians should somewhat capitalize on. We do have phone companies (3), banks (6), gasoline providers (3), grocery chains (3), pipelines (3), railways (2) and a nationalized electric power grid. We surely can protect good cash flows and good dividend growth for investors.

Meanwhile our government can surely protect great tax revenues through this oligopolistic structure. So, throughout such unstable periods, our focus should be what your portfolio is earning in the form of income and not its short-term performance. If, as and when we fall into recession, we can live on our investment income and cash. In due course, when confidence is back, the first stocks people will buy will fit the definition of those you already own. Therefore, you will benefit by being in on the ground floor and staying in throughout tougher period collecting your growing dividend!

Ask yourself what your "optimal" asset mix is given your risk tolerance and anxiety level. Is an equity reduction appropriate in inflationary times? What is your alternative investment? What "real income" does it generate (after inflation)? How much cash, bonds and GICs can I afford to hold in "real" terms?

One thing for sure is that any excessive concentration in a single asset class is pure speculation! Depending on your status, your age, your needs and your objectives, your asset mix will vary.

Conclusion

Inflation may bring with it a new sense of thought and perspective about the future. First, the golden era of the **FAANG** group of companies (**F**acebook, **A**pple, **A**mazon, **N**etflix, **G**oogle) is being challenged for the first time in two decades by a new inflation sensitive **FAANG** namely **F**uel, **A**gri, **A**erospace, **N**uclear & Renewables, **G**old & Minerals...Second, we might have passed the peak of globalization. Countries will now tend towards self-sufficiency any way they can and avoid being dependent on unique suppliers. That trend may have an internal inflationary twist to it, as consumers may be willing to pay more to support their local economy. Third may relate to the consciousness of indebtedness and excess leverage in a reflationary era. Profitability protects the value of any asset as it is the source of debt repayment.

Stay invested and invest wisely, as we know that time is always on your side if your portfolio is well balanced, naturally hedged and income driven!

"Risk off" in the short term, and long live the balance approach!

Recommended Asset Mix				
Income Portfolio			Balanced Portfolio	
Oct 2021	Apr 2022		Oct 2021	Apr 2022
10%	15%	CASH (maturities ≤ 12 months)	5%	10%
40%	45%	Fixed income (Bonds & GICs)	30%	35%
15%	15%	Convertible Debs. And, Income, Generating, Securities	10%	15%
27.5%	20%	Equities	45%	35%
7.5%	5%	Foreign	10%	5%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Recommended sector weighting April 2022			
Sectors	Rec'd weighting	Trend	Rational
Communication Services	4.75%		Remains our favourite yield play, despite challenges of yield strategies; given secular dividend growth, recent underperformance provides timely longer-term opportunity.
Consumer Discretionary	2.00%	⬇	Cyclical with long outperformance tail suggests persistent outperformance, overweight names with strong U.S. growth exposure. Interest sensitive
Consumer Staples	4.50%		Food inflation is near-term tactical advantage, but sector is a classic defensive sector.
Energy	6.00%		Deep value sector, strong cash generation, risk of commodity price running its course is high. Continue to favour large cap Energy Stocks that have shown operational resilience in a range bound oil price environment.
Financials	14.00%		Steadfastly maintaining holdings in the broader sector. However we prefer those companies with strong U.S. platforms – especially within banks (commercial banking + wealth management).
Healthcare	4.00%	⬇	Significant price correction and regulatory tailwinds within cannabis suggest neutralized position. Prefer the U.S. for diversity
Industrials	7.00%		Well positioned for cyclical recovery. Focus on rails, select manufacturers, waste companies and engineering firms – especially those leveraged to the U.S.
Information Technology	6.50%		No denying the fundamental momentum, but rate of change in terms of performance is under way; remain increasingly selective.
Materials	4.25%		We like this sector with a focus on base metals, and companies with strong operating efficiency and cash flow generation. Gold is a good market hedge.
Real Estate	3.00%		Stronger-than-expected earnings environment, also our work shows Real Estate to be less interest-sensitive than other high-yield sectors, particularly since 2002.
Utilities	7.00%		Rising yields, low organic growth and high payout ratios are a tough combination. However, electricity producers offering growth with a strong balance sheet remain attractive.
International Equities	2.00%		Be aware of exchange rates. We like Canadian Depository Receipts for U.S. stocks in sectors that are under-represented in the Canadian Market.
Total Equities	**65.00%**		Average equity weighting.

• The suggested weightings are appropriate for a 65/35 equity/fixed income portfolio and should be adjusted based on your investor profile.

Sources:

- Bank of Canada
- BBC
- Bloomberg
- BMO Capital Markets Equity Research Reports
- BMO Capital Markets North American outlook
- BMO Financial Group Economic Outlook
- BMO Nesbit Burns
- BMO Nesbit Burns Part Team, portfolio advisory team
- BMO NB Canadian Equities Guided Portfolio – March 2022
- BMO NB US Equities Guided Portfolio – March 2022
- BMO NB North American Equities Guided Portfolio – March 2022
- BNN
- CNBC
- Dow Jones Newswires
- Globe and Mail
- Goldman Sachs
- Standard & Poor's Capital IQ Equity Research
- The Barons
- The Economist
- The high-tech Strategist
- The Wall Street Journal
- Transport and Environnement Eurostat

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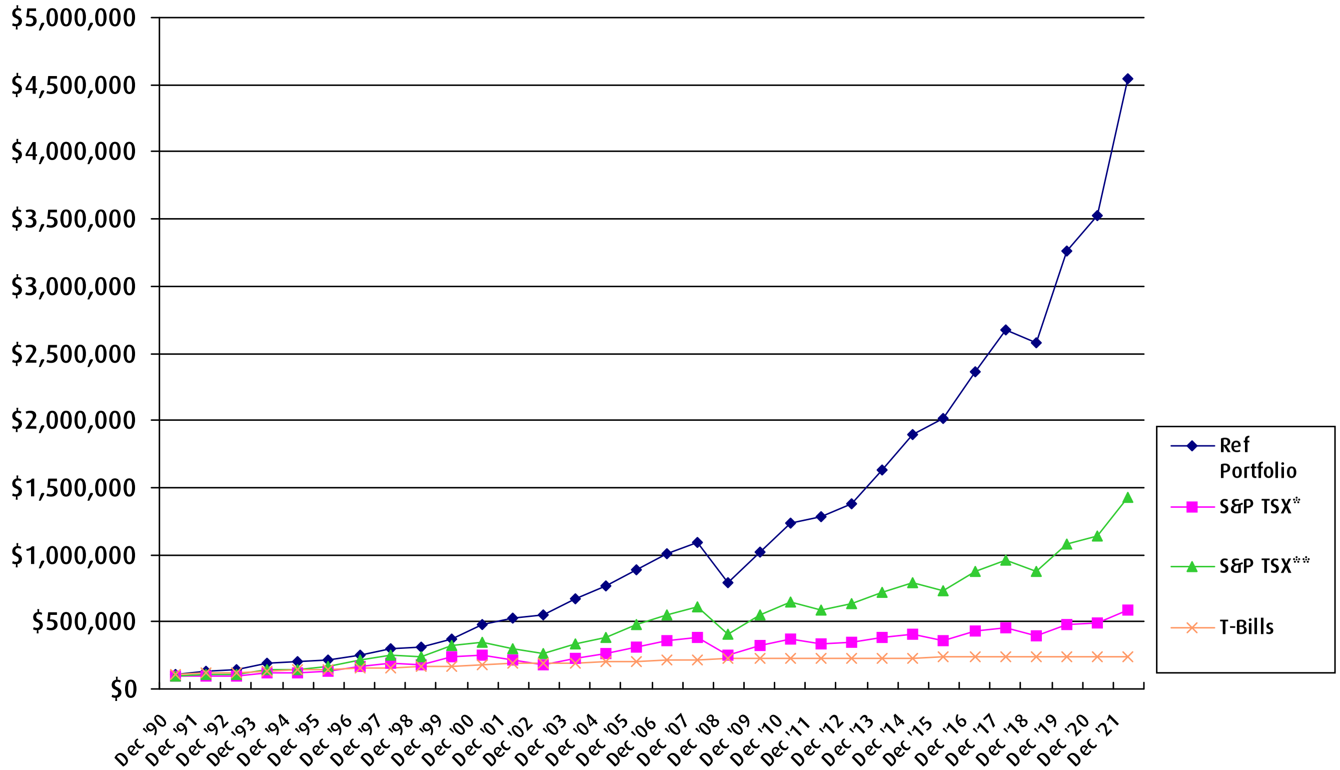
Reference Portfolio Return

MDL Associates
BMO Nesbitt Burns



Value as of
March 31, 2022
$ 4,566,435

Average
Return
12.72 %

$100,000 invested on June 1st 1990

*Does not include income or div

**Includes income and div

The returns are compounded monthly and revenues are reinvested.

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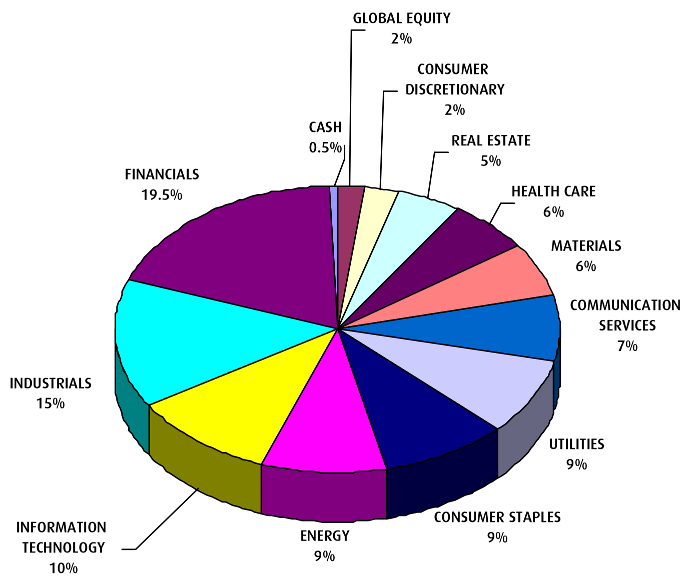
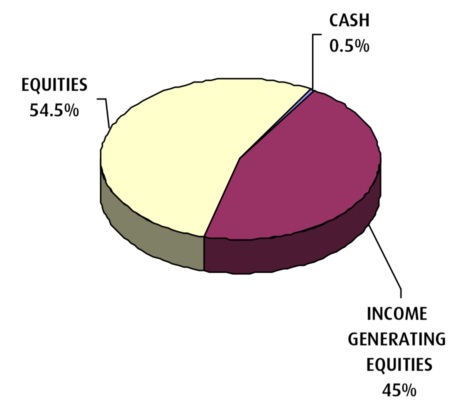
March 2022

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

Performance - T-Bills vs SP TSX vs Reference Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	Portfolio(return)
1990	13.20%	-17.96%	-14.80%	**5.94%**
1991	9.35%	7.85%	12.02%	**22.14%**
1992	6.67%	-4.61%	-1.43%	**10.50%**
1993	4.68%	28.98%	32.55%	**34.91%**
1994	5.19%	-2.50%	-0.18%	**6.09%**
1995	6.42%	11.86%	14.53%	**8.09%**
1996	3.93%	25.74%	28.35%	**16.21%**
1997	2.85%	13.03%	14.98%	**21.05%**
1998	4.56%	-3.19%	-1.58%	**1.87%**
1999	4.67%	29.72%	31.71%	**19.96%**
2000	5.23%	6.18%	7.41%	**30.40%**
2001	3.73%	-13.94%	-12.57%	**9.54%**
2002	1.75%	-13.97%	-12.44%	**3.61%**
2003	2.22%	24.29%	26.72%	**22.23%**
2004	1.84%	12.48%	14.48%	**13.87%**
2005	2.53%	21.91%	24.13%	**15.73%**
2006	3.52%	14.51%	17.26%	**14.30%**
2007	3.59%	7.16%	9.83%	**8.06%**
2008	1.50%	-35.03%	-33.00%	**-28.07%**
2009	0.29%	30.69%	35.05%	**29.37%**
2010	0.60%	14.45%	17.61%	**21.05%**
2011	0.92%	-11.07%	-8.71%	**4.18%**
2012	0.97%	4.00%	7.19%	**7.38%**
2013	0.97%	9.55%	12.99%	**18.14%**
2014	0.92%	7.42%	10.55%	**16.43%**
2015	0.50%	-11.09%	-8.32%	**6.36%**
2016	0.50%	17.51%	21.08%	**16.75%**
2017	0.71%	6.03%	9.10%	**13.26%**
2018	1.40%	-11.64%	-8.89%	**-3.26%**
2019	1.67%	19.13%	22.88%	**26.19%**
2020	0.39%	2.17%	5.60%	**8.38%**
2021	0.19%	21.74%	25.09%	**28.68%**
* 2022	0.03%	3.14%	3.82%	**0.51%**
Return Compounded as of December 31, 2021				
3 years	0.73%	14.01%	17.52%	20.73%
5 years	0.86%	6.78%	10.04%	14.04%
10 years	0.82%	5.91%	9.14%	13.47%
***Average return since inception (YTD)** ………………………………..				**12.72%**

* (YTD): Year To Date (March 31st 2022)
$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

1: Does not include income or dividend
2: Includes income and dividend

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