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September Market Update Volatility

September has proven to be a difficult month for the markets due to a host of different factors and so we thought it a good time to look at some of reasons and try provide some insight to our readers. We have of late almost a, 'perfect storm', with continuing supply chain disruptions, rising inflation, an Energy crisis in China (lack of coal=electricity), soaring natural gas prices in Europe, shortage of gasoline in the UK, China's massive property developer 'Evergrande' on the edge collapse, rising bond yields, slowing growth, the US bumping up against it's $28.4 trillion debt limits and threats to shut government down and oh yes in case we all forgot…rising COVID cases with Delta. No wonder the markets have been volatile.

So to explain a little more…COVID and Supply Chains.

Unfortunately, almost every conversation these days ends up incorporating some discussion around COVID and the impact that the Delta variant continues to have on the economic recovery. With the rise of the Delta variant over the course of the summer, we started to see the economic recovery start to slow, with the first signs of a slowdown occurring in Asia. Chinese economic expansion started to slow in August as shutdowns in 3 of the major shipping ports due to outbreaks of the Delta variant, literally put the breaks on global container shipping.

Supply chain disruptions are something that we have all become accustomed to over the last year and something that I assumed would recover quickly as the global economy started back up after the COVID shutdown. Unfortunately, the recovery in the supply chain has taken a lot longer than many predicted as getting goods to market remains a constant challenge. When 3 of the worlds largest container ports get shut down the ripple affect globally is massive. Containers full of goods get stuck in port unable to be loaded on a vessel, manufacturers with goods to ship cannot get empty containers to load their goods into. Container ships normally are on a very tight schedule with a ship being fully unloaded and reloaded often within 24 hours of arriving at a port.

However now we have the situation of ships arriving on the West coast at the Port of Long Beach and having to wait 2 weeks at anchor in order to get a berth to unload. Why? Well primarily due to a shortage of truck drivers in the US, which is estimated to be short in the region of 250,000 truckers. So no trucks, so no containers get moved, which also complicates the backhaul issue as you need truckers to pick up empty containers to get them back to port and back to Asia to be reloaded at the factories. Even a small delay starts a chain of events that are still being felt globally.

Of course, the cost of shipping goods also soared with the cost of moving a 40 ft container from Shanghai to the US West coast rising to over $15,000 at its peak. Prior to the pandemic the cost averaged around $1500. This is a massive increase. This week it fell again to around $8000. So large swings and all feeding into the inflationary pressure that the world is facing.

BMO Private Wealth
Brezer, Vos, Mandell, Reems & Hao
Wealth Management Group
BMO Nesbitt Burns

1800 - 885 W. Georgia Street, Vancouver BC V6C 3E8 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 631 2658

Different industries are facing different supply chain disruptions which also affect them in different ways. A good example is the shortage of semiconductors. As our usage of technology has expanded so has our usage and reliance on semiconductors in almost everything we buy. Most of the major 'chip' manufacturers are located in Asia and so once again, getting the 'chips' from factory to the end user has been problematic. Car manufacturers have probably been hit one of the hardest, with fleets of finished cars sitting in lots unable to be delivered, due to a shortage in just one or two crucial semiconductors. Net result we see General Motors and others shutting down plants and reducing production. Not good for corporate profits.

What is becoming more apparent and maybe something that we forget in the Western world, as to how hard COVID hit some of the developing countries in Asia like Indonesia, Thailand, Vietnam etc where many of these crucial goods are made.

This last month we have seen companies from Nike to Costco warn customers that they may be facing a shortage of goods in their stores. In the UK we have seen a shortage of gasoline in many areas as once again a shortage of truck drivers impacts deliveries and many UK merchants warning of Xmas shortages of many goods. (Note to self: Shop early for Xmas this year..)

Supply Chain & Inflation.

Disruptions in the supply chain have also impacted inflation, forcing the prices of goods higher across the board. This is classic economics, where you have a large demand and a shortage of supply, you get an increase in price. When you cannot buy a new car, then the price of 2nd hand cars rises with supposedly the price of a two year old car now higher than the original price paid 2 years previously. Inflationary pressure is something that worries the stock markets of the world as high inflation is not good for company profits and generally not good for stock markets. The debate this last year has been whether the inflation we are feeling is temporary and dissipates once the supply chain is rebuilt or more long term in nature. The jury is still out at this point.

The market fears long term inflation, as Central Banks have historically combated inflation by raising interest rates. Higher interest rates make the cost of borrowing that much more expensive and can throttle business and economic growth if interest rates go too high too quickly. So what the market is starting to worry about is that we are seeing the economic growth and recovery slowing again, yet at the same time inflationary pressure is strong and rising. The worst case scenario is a slowing economy, lower corporate profits and a Central Bank raising interest rates to try combat inflation.
The longer the supply chain disruptions continue, the more difficult it becomes to reduce inflationary pressure and this is what the market is currently worrying about, which feeds into increased volatility in equity markets.

Doug Porter, BMO's Chief Economist writes: This year's economic and global developments hint that it carried a few important messages. To wit, **growth can be limited**—or at least challenged—**by real-world resource constraints, and/or pollution** (i.e., carbon emissions, updated for current conditions). Bringing it a bit closer to recent market action, bond yields are grinding higher and inflation forecasts keep pushing upward, even as real growth estimates are slowly climbing down the mountain. Simply, the trade-off between volumes (real GDP) and prices (inflation) has been much less favourable than expected this year. And a big part of that is due to the fact that **physical supply can not keep pace with raging demand**, whether due to the chip shortage, bottlenecks, a lack of workers, or natural disasters.

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Essentially, soaring spending butted up against true limits to growth in 2021. At the height of optimism around mid-year, GDP growth was expected to rise nearly 7% in 2021, and 4.5% in 2022.
For perspective, a 'normal' year for the U.S. economy would be nominal growth of about 3.5% (with both real GDP and inflation just under 2%). Instead of that upbeat view earlier this year, the **consensus on real growth has now faded** to below 6% (we're at 5.8%) in 2021 and just over 4% (we're at 3.5%) in 2022. But at the same time, **inflation estimates have jumped**. (BMO Talking Points, Oct 1st, 2021)

Labour and Inflation.

Everywhere you look there seems to be a shortage of workers. Every CEO is citing a shortage of labour as their number one issue. Without workers you cannot operate at 100% and the shortage of labour is impacting almost every industry from restaurant and hotel staff to high paying Tech jobs and all levels of management and not just the entry level jobs. So where did all the workers go?? Some have blamed government subsidies but in my opinion the problem seems more pervasive than that. Sure subsidies affected low paying poor quality jobs, however that is just a small segment. Why the shortage of people in high paying jobs? Are we seeing more of the Baby Boom generation retiring causing a vacuum of experienced workers?

Whatever the reason, the net affect is that it is hard to find people and those applying for jobs are expecting and getting higher wages because of it. Senior staff are getting pay hikes and incentives to stop them moving to competitors and entry level jobs are having to pay a lot more to attract any applicants. This causes wage inflation and also feeds into the higher cost of goods and the overall inflationary pressure that the economy is facing.

Higher wages are not necessarily a bad thing as it creates more consumers and that money is then spent back in the economy. Wages in North America have been stagnant for going on 40 years and have been one of the factors leading to the increased income disparity that we are seeing globally. Higher wages would go a long way to correcting this, however coupled with the current COVID situation, the higher wage pressure has given the stock markets of this world one more thing to worry about, as higher wages affect corporate profitability in the short term or until those costs can get passed onto the consumer. Which leads to higher inflation…Ahh the negative feedback loop.

Debt and Interest Rates.

So when COVID hit every Central Bank slashed interest rates. Net result was borrowing suddenly become very inexpensive and so what did everyone do but go out and buy more real estate. Property prices soared globally and every homeowner felt pretty good about their brilliance in purchasing real estate. Higher housing prices also feed into the whole inflationary pressure loop and pour more gasoline on the housing affordability debate.

During this period the debt levels continued to rise on both an individual basis and on a Federal level and now we sit at debt levels to GDP that have never been seen before. On a Federal level, the last couple of financial crisis have been met with the governments of this world supplying increased amounts of stimulus and lowering interest rates to combat the crisis. The difficulty now, is how do you cool the property markets? You can try and blame 'foreign buyers' (Never mind the borders have been closed for the past 1.5 years, during which time property prices soared.) or you can try and raise interest rates. The problem with that, is that if you destabilize the property market then you will put the entire economy at risk, so a very slippery slope.

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The other problem that exists is all of the Federal Debt which needs to be serviced. Higher interest rates make servicing this debt more expensive and so no government can really afford to have interest rates go up by very much.

So when the Central Banks start talking about having to raise interest rates to counter inflation, then you start to uncork a whole host of other problems. If interest rates rise then the cost of borrowing for corporations rises and once again impacts their profitability.

Bottom line here markets are acutely aware of interest rates and movements in the interest rate are likely to cause the market to become more volatile. Even the talk of higher rates unsettles the markets and this last week when the bond markets started to move in anticipation of higher rates, it was enough to see the DOW peel off -600 pts.

The levels of Government Debt in the US have also started to once again trigger political discord with many politicians balking at raising the US Debt Ceiling again, currently sitting at $28.4 Trillion. Many of the initiatives proposed by President Biden come with steep price tags which would involve taking on more debt. Many are asking at what point does the debt overwhelm the economy and this is not just a US problem but a Canadian, European and Japanese problem too. The political in-fighting in the US and the threat of the US Government shutting down has also led to market volatility the last week of September. The bickering generally gets resolved at the 11th hour and the debt ceiling gets raised and probably will again this time, as no politician is willing to risk their ‘careers’ by causing the US to shutdown and default on their debt.

The other problem that has started to be realized is that the increased levels of debt seem to be having less and less of a positive impact on improving the economy. Previously every $ of stimulus had a meaningful impact on GDP and now we see that same $1 of stimulus having very little affect on improving economic growth. Previously that $1 stimulus was used to build new factories, increase production etc, where now more of that stimulus goes to paying interest on the ever expanding debt and less and less is used to improve economic capacity. This is a long term problem and is not going away any time soon.

Bottom Line.

All of the above factors feed into the economy and the market and explain the recent spate of volatility. The one thing the market worries about more than anything is the prospect of ‘Stagflation’. Basically a situation where you have rising inflation, rising costs and stagnant growth. The worry is that the Central Banks would be forced to raise interest rates to fight the inflationary pressure, yet in an environment where growth is already slipping, it would lead to slowing the economy even further and pushing the economy possibly back into a recession.

This gets fixed pretty quickly if you fix the supply chain issues. If not, we will be facing some pretty slow economic growth for this coming year with increased risk of inflationary pressure. Consumer demand remains incredibly strong and household wealth has increased dramatically this last year and so the ability and willingness to spend is there, if you can just get the goods to the consumer. If the consumer is in good shape then generally the economy is in good shape. Remember that roughly 72% of US GDP is consumer driven. Happy consumer leads to a strong economy which leads to strong market returns.
U.S. household net worth rose $5.8 trillion in 2021Q2.

The gains were driven by equities (60%) and real estate assets (21%). While those lofty levels seem par for the course these days, it's almost quadruple the typical increase from 2015 to 2019. That's one of the key reasons why consumer demand has been so strong since the recession ended. Households have much healthier balance sheets to fund current and future consumption.

Now it's worth pointing out that stock holdings are more heavily concentrated in the upper portion of the wealth distribution, but let's take a look instead at a more broadly held asset class: housing. Over the past four quarters, household mortgage debt increased by roughly $645 billion while homeowners' equity has risen by nearly $3 trillion. The surge in home prices has led to significant aggregate deleveraging—yet another difference compared to the last time house prices soared. It also highlights that existing homeowners are likely much better off than first-time buyers.
BMO Capital Markets Factet Oct 1. 2021.

I think it is worth remembering that all of these current issues are just par for the course as the market climbs the endless wall of worry. Yes economic growth and market returns may be a little more muted over the next quarter or so, however the supply chain issues do eventually get fixed and this economy and market booms all over again or until the next issue raises it's head.

We do expect increased volatility in the markets in the coming year around interest rate announcements by the US Federal reserve as inflationary pressure, unemployment rates and economic numbers feed into the interest rate debate.

ESG Investing: What is it?

The term 'ESG' stands for **Environmental, Social and Corporate Governance and** has become a widely used term with regards investing in the past year. Basically 'ESG is an evaluation of a company's collective conscientiousness for social and environmental factors. ESG has become an increasingly important part of the investment process as investors are incorporating ESG data to gain a fuller understanding of the companies in which they invest.

With Global Warming and Climate Change we are seeing more and more extreme weather events that are impacting and threatening our way of life on this planet in so many different ways. Governments, Companies, Boards of Directors, Pension Funds, large Institutional and individual investors are fast realizing, that the way to encourage awareness and compliance is through the financial system. In other words; 'follow the money'. Those companies and their boards of directors that fail to incorporate ESG compliance into their corporate culture risk being left behind, as their access to capital evaporates as banks refuse to lend them money, Institutional investors and pension funds refuse to invest in their company shares, investors bring class action lawsuits against them and they suffer reputational and financial loss.

Like it or not, most CEO's and the directors are compensated based on share price performance and more and more we see companies that are not ESG compliant share prices struggling, which in turn motivates management to get on board with the ESG mandate.
As your advisors we are extremely happy with the current awareness of ESG, as we have always adopted the approach when investing in your portfolios.
Understanding and Interpreting ESG

Almost daily we are seeing announcements and headlines supporting the divestiture from Fossil Fuels and re-investment in to renewable/sustainable sectors and ideas. Immediately following the most recent Federal election Canadians polled that the Environment and COVID-19 are tied for their top overall concerns, according to Nanos Research. Government policies are starting to shape a more environmentally sensitive landscape and simultaneously corporations and pension funds are willingly taking big steps to transition to a 'greener' profile. Criteria was needed to assess the sustainability of a company's business model and to measure the contribution to sustainable development, hence the emergence of Environmental, Social and Governance (ESG) standards. Applying ESG criteria to a company provides a model where we can measure data to interpret relative and real rankings on several different spectrums. Environmental measures include energy usage, carbon footprint, wildlife impact, compliance with regulations; the Social criteria includes employee engagement and compensation, workplace policy, diversity/inclusion, training, and stances on human rights issues; Governance encompasses executive management compensation, shareholder rights, financial reporting and accounting.

It is important to note that ESG is not to be confused with Socially Responsible Investing (SRI), where the latter can have formal constraints most commonly sub-sectors such as Tobacco, Defence, Oil and Pipelines. ESG mandates can in fact include the sub-sectors just mentioned but it is the responsibility of the portfolio manager to incorporate the ESG criteria with a minimum standard which is not universal. ESG rankings can be considered as a modern 'Corporate Social Credit Score' and while we have chosen to not invest in areas that raise environmental concern, we look forward to going further by incorporating the ESG screening more and more into our stock selection. Several studies have been done to support that investment performance is not sacrificed when comparing ESG mandates to regular investment mandates, and with increased awareness comes increased investment and money flows. We do believe that this is a permanent trend in the evolution of portfolio management and we strive to make our investment decisions with full integrity.

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Larry Fink, the CEO of Blackrock which is the world largest investment firm stated the following in his 2021 letter to shareholders: “More and more people do understand that climate risk is investment risk. ...When finance really understands a problem, we take that future problem and bring it forward. That’s what we saw in 2020, and what we’re seeing now. No issue ranks higher than climate change on our clients’ lists of priorities. They ask us about it nearly every day.”

We echo his sentiments and realize that environmental concerns are having a greater and greater impact on the economy and how we invest. So stay tuned for more on this subject.

Sincerely,

All the best from our team members.

Greg, Marion, Kenzy, Jed, Lili, Samantha, Dave, Tracy and Kelly.

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