Markets Made Simple

Chan and Brown Wealth Management

Wealth Management
Dominion Securities

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CASUALTIES OF RATES

While most kids were dreaming about being whisked away by prince charming, travelling through space, or walking with the dinosaurs, I was busy worrying about my financial future, kind of like Alex P. Keaton (played by Michael J Fox) from the classic sitcom Family Ties. By age eight my net worth consisted of Lego, Hot Wheels, and hockey cards. These illiquid assets were not going to fund my retirement and it was time to get serious. Unfortunately, there were limited employment opportunities for eight-year-olds and my Grade 3 diploma was not in high demand, so I started my first entrepreneurial venture...collecting and returning cans and pop bottles. Bottle collecting became the focus of my world. We would be out for a family drive and my eagle eyes, sensitized to glass and plastic objects would zoom in on a bottle 50 feet away. My dad would slam on the breaks, pull over, and I would dash out to add another nickel to my retirement.

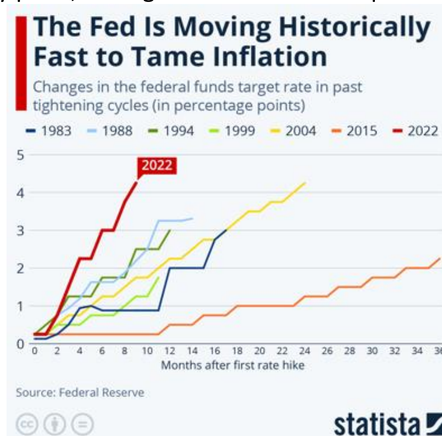
Early in my recycling career, I hit the jackpot. On a hot, humid summer day at my grandpa's family reunion, several garbage bags full of bottles piled up and they were mine to take. Suddenly I was rich, having just made $21.15 in a single day. As the Notorious B.I.G. song goes, 'More Money, More Problems'. What do I do with my new wealth?

My parents took me to the bank and I opened my first account. The bank was offering 8% in interest to just leave my money there. I couldn't believe it. They would pay me a $1.70 a year to borrow my money? I could kick my feet back, let my money work, and wait for retirement to roll around.

Sadly, as rates fell to 35 year lows my money worked less and less until one day, it stopped working completely. Eventually, I expected the bank to ask me to start paying to keep my money there. That all changed in 2022.

Interest Rates

Money supply in the US grew a record 40% from 2020 - 2021[1], and inflation followed. Inflation then rose to the highest level since 1982 causing central banks to quickly pivot, raising rates at the fastest pace in 50 years.



[1] US Money Supply - http://surl.li/geigd

Rates and Investments

Higher rates make investments look less favorable. For example, real estate with a 2.5% rental yield looks attractive when the bank is only offering 0.5% on a savings account. When savings accounts offer 5.0%, a 2.5% real estate yield does not look attractive anymore. Money flows out of investments into savings accounts, causing investments to fall.

Rising rates have a dark side, they expose the dirty financial secrets amongst us. We all know someone living beyond their means. They borrow more than they earn to finance new cars, lavish vacations, and ongoing home renovations. This strategy is sustainable for a while when rates are low or dropping and there is easy access to credit. But when rates rise and credit dries up, the party is over and their problems start.

Past Casualties

In every rising rate environment, there are graveyards littered with casualties. Long-Term Capital Management was a large, very successful and highly leveraged, hedge fund. When rates rose in 1998 and at the same time their investments went against them, the losses piled up and wiped out the company and their investors.

Leading up to the new millennium, money flowed into internet companies, pushing up the valuations and prices of companies that had no prospects of making money to valuations never seen before. Webvan was a company 20 years ahead of their time who delivered groceries to their customer's door. They had sold less than $400,000 worth of groceries, incurred losses of $50 million, but were valued at $4.8 billion in 1999. The FED was concerned about the overheating economy and decided to cool it down by raising rates. This time tech companies were the casualties. One year later, Webvan was worthless and tech investors lost virtually everything.

A recession ensued after the tech bubble burst and rates fell. Investors, cautious on stocks, put funds into housing and pushed prices higher and higher. Homeowners and lenders took on more leverage, along with more risk. As inflation started rising in 2006, the FED had to act again and raise rates. Homeowners could not handle the higher rates and started defaulting. Investors and companies who had also too much leverage were exposed and kickstarted the Financial Crisis in 2008.

New Casualties

"Those who do not learn from the past are doomed to repeat it." George Santayana

A new group of casualties emerged in 2022. After COVID, funds flowed into technology stocks and other 'exciting new investments' such as crypto currencies. Investors took big risks, added more leverage, and bid up pockets of the markets, such as companies like Tesla to record high valuations that we had not seen since the internet bubble in 2000. Is this starting to sound familiar? Interest rates rose in 2022, Tesla was down 72% in the year, FAANG stocks (Facebook 'Meta', Amazon, Apple, Netflix and Google 'Alphabet') were down 46%, Bitcoin was down 65% and many cryptocurrencies went to zero.

The list of casualties has continued to grow in 2023. First was Silicon Valley Bank (SVB), a large regional bank in the US who specializes in banking for technology start-ups. They decided to put client deposits (short term money) into long term bonds to get higher rates in the low interest environment in 2020 and 2021. When rates rose in 2022, SVB took heavy losses on the bonds they bought as prices fell and clients, concerned about the bank demanded their money back. A bank run ensued, and SVB was taken over by regulators.

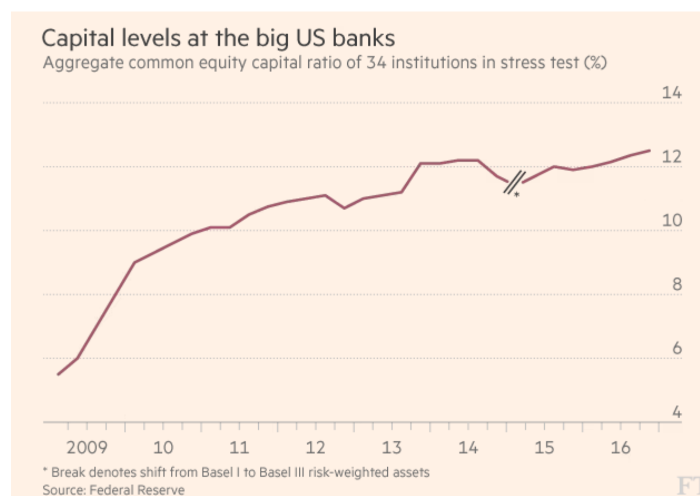
Finally, there is Credit Suisse which used to be one of the world's largest banks. Plagued by scandals, large fines, management turnover, and multi-billion-dollar losses, clients pulled $119 billion of their funds out in the last three months of 2022. Years of mismanagement, loss of confidence, and rising rates led to Credit Suisse suffering their largest annual loss in 2022 and put their survival at risk. UBS bank had to acquire them and they were buried in the growing cemetery of casualties.

Fresh in investors' minds is the 2008 Financial Crisis.

Another Crisis in the Making?

Leading up to 2008, banks were having fun printing money. It was easy. Underwrite mortgages, package them up, and sell them to investors. Investors couldn't get enough and banks dedicated more and more resources to their new profit centers and took on more and more risk, and debt.

As banks added more debt to finance their mortgage underwriting, the margin of safety shrank. It doesn't take much to wipe out a homeowner who has only 5% equity. The chart below highlights the capital levels at the bank over time. In 2008, the largest banks in the US had about 5% in equity. Not much of a buffer.

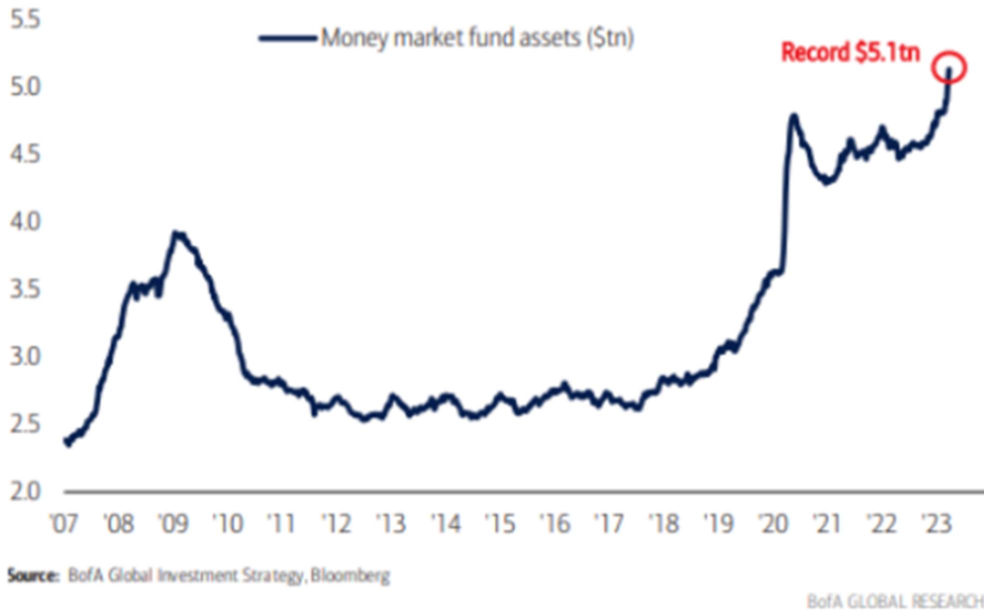


After that, things have changed. Regulators stepped in and required banks to be better prepared to withstand a crisis by increasing their equity and having additional safeguards in place. Large US banks have increased their equity to more than double the level of 2008. The failures of SVB and Credit Suisse were isolated incidents stemming from poor management and

unnecessary risk taking. They are not systemic issues throughout the banking sector. The large US banks now have a much bigger buffer to handle the unexpected.

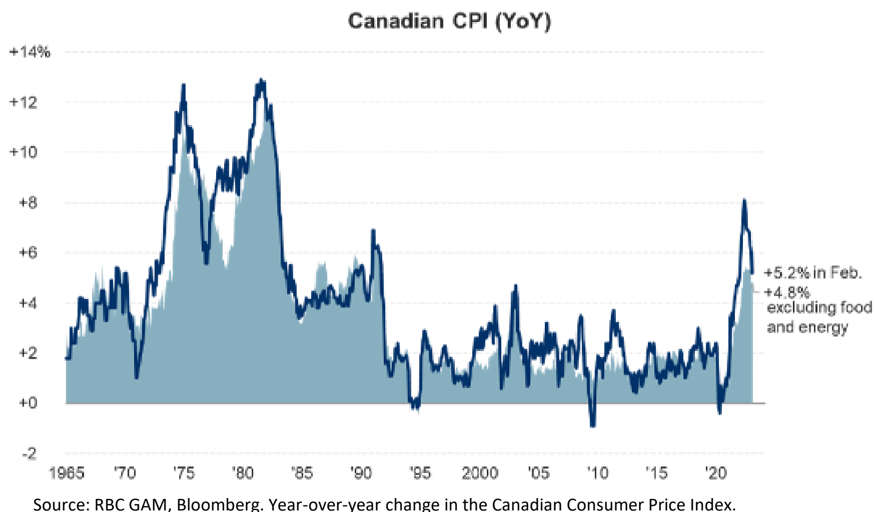
Our Growing Pile of Cash

As the FED raised rates from zero to 5% last year, investors have taken their money from stocks, bonds, and real estate and parked them in savings accounts. Cash balances hit record highs and continue to grow.



The Million-Dollar Question. Where are Rates Going?

Last quarter we highlighted that our new economic diet of high interest rates and tighter money supply is working. The factors leading to inflation are reversing. We no longer have low rates, growth in our money supply has turned negative for the first time since The Great Depression[2], and many of the supply chain issues from COVID are being resolved. Many components of inflation have peaked and are falling while the economy is also slowing, helping to bring down inflation. We don't lose 10 pounds overnight, it takes time to work off the extra weight we came home with from our recent cruise vacation. Stopping inflation will also take time.



Source: RBC GAM, Bloomberg. Year-over-year change in the Canadian Consumer Price Index.

[2] https://mishtalk.com/economics/the-biggest-collapse-in-m2-money-supply-since-the-great-depression

Freeze

Ever see a small child freeze when they break something? The FED does the same. In past hiking cycles the FED freezes when things start breaking. Like a small boy looking at mom's favorite vase shattered on the floor (that I will forever hear about), the Fed stopped raising rates when Long-Term Capital Management imploded in 1998, they stopped when the tech bubble burst in 2000 and they stopped when the housing market collapsed in 2008.

Silicon Valley Bank and Credit Suisse both failed this year after the Fed raised rates at the most aggressive pace in 50 years. They have now slowed the pace to a crawl. The FED raised rates four times in 2022 by oversized hikes of 75 bps. The last time the FED did a single 75 bps rate hike was in 1994, and they only did it once. Their recent rate hikes have dropped from 75 bps to 25 bps and FED's tone and forward guidance has become more cautious. They are moving much more slowly now that a few things have started breaking.

Cash

As I grew up, I continued to add to my retirement fund from employment that doesn't require me hauling around bags of pop cans and bottles. I needed to find better places for my money to work outside of paltry savings accounts. Lending the bank my money and letting them make more on it than they pay me doesn't seem like a good deal.

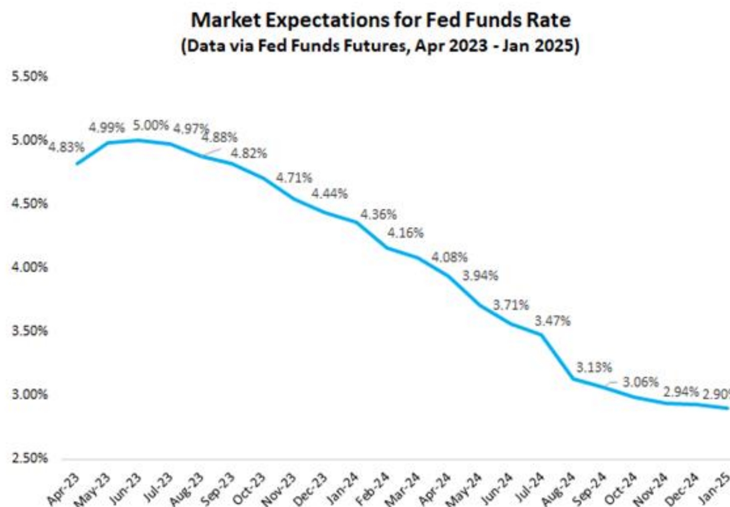
Last quarter we highlighted the investments we were buying for clients. Enbridge preferreds are currently paying 7.4% over the next 5 years. To receive the same after-tax return from a GIC, we would need to find a GIC paying over 10%.

We recently added Telus to our portfolios. Telus is the best-in-class wireless provider in Canada with a current dividend yield of 5.10%, better than most GIC's and has grown their dividend by over 7% per year over the past 10 years. Telus has invested heavily into their fiber optics network and we believe it will continue to pay off for the company in the future, translating into continued, strong, long-term earnings growth.

We also added global real estate. Caution is still warranted in real estate, however there are pockets with tremendous value. For example, Canada added more new immigrants last year than in the US, which has a population almost 10X that of Canada. This is translating into strong rent growth and multifamily residential real estate is at very compelling valuations, seen only a few times as low over the past decade.

Funds

Money flows to where it earns the best return. The 5% GIC's investors were clamoring to last year are disappearing faster than grandma's pie at Easter dinner. Rates have been falling and bond markets tell us they think they will continue to fall. Below is a chart showing the market expectations for future yields. Rates are expected to fall back below 3% over the next two years as inflation continues to fall from the effects of the FED's actions.



After the large market selloffs in 2009 and 2020, investors were scared. They sat on the sidelines and accumulated cash, however as rates fell to record lows savings accounts looked less and less appealing. Investors got fed up and started deploying their cash into the markets pushing the S&P 500 up 440% from 2009 to 2020, and up over 100% after COVID.

A portfolio of quality companies with strong, stable cash flows and earnings that looks good now will look even better in 12 months when those 5%, one-year GIC's are maturing and investors are facing lower rates. What will investors do with their record cash balances?

Compounding

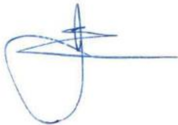
Short-term current yields look promising to some investors but there are much better long-term options for funds designated for future needs. The power of compounding is astonishing over time. My $21.15 earning 8% per year would grow to $1780 by retirement. If I had saved $20,000, it would be worth $1.6 million at retirement[3]. Since 1928, cash has returned 3.3% per year[4]. At a 3.3% rate of return, $1.6 million drops to $127,000. That is a lot of pop bottles I would need to collect to make up that difference.

It is our job is to protect clients and ensure their funds are secure when they need them. For whichever purpose our clients have for their hard-earned savings, we match it with investments that meet their needs and time frame. It could be for the purchase of a new house, retirement, or an upcoming vacation. We carefully assess and manage the risks we see to avoid the dangers to investors such as the record high valuations in stocks and bonds in 2021, and inflation. We continue to assess the current economic landscape and are quite excited about the new opportunities being presented today.

When I went to the bank and proudly deposited my dollars and pennies from collecting bottles, my money was working. Over time things changed and it stopped working. Money at the banks started working a little harder in the past year, but it is still not working hard enough for me and my money. Savings accounts do not keep pace with inflation and current GIC rates that are dropping are not good long-term options for my financial future. As I outgrew collecting bottles, I also outgrew how I invested my money. I learned better ways to get my money working for me, and I highly recommend you do the same.

I continued collecting bottles until I moved onto my next big career opportunity…a paperboy, but that is a story for another day with dogs, rollerblades and broken bones.

-Kind regards,



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[3] Compounded annually for 57 years at 8%
[4] https://awealthofcommonsense.com/2023/01/stock-bond-cash-returns-over-the-past-95-years/