

Harmony Wealth Partners of RBC Dominion Securities

2024 Letter to Clients

To the Clients of Harmony Wealth Partners,

The world of investment management is synonymous with forecasting. Prognostication is the name of the game. Whoever can read the proverbial 'tea leaves' best wins. We are going to take a different approach this year, our letter is focused on nowcasting rather than forecasting. The rationale for this pivot: **society writ large is under processing the facts**. Perhaps this is because the facts are uncomfortable. Perhaps this is because governments or special interests want to control the narrative. Perhaps it is a little of both.

If our analysis of the current global situation makes us uncomfortable, we want to have the courage to take bold action to protect your portfolio, as well as take advantage of opportunities that may be missed by others. Often these risks or opportunities appear self evident with hindsight (re: inflation risks circa 2021).

We make decisions for you grounded on the principle of independence. **This concept of independence is multifaceted**. The first relates to the independence we exercise in decision making on your portfolio. Our preference for localized decision making on your portfolio (not hiring sub managers) and an aversion to purchasing financial products with embedded fees.

The second relates to helping you build your own financial independence giving you and your family agency over your financial lives. We wish to provide you with a sense of control that you can feel in your life and an improved ability to handle a wide range of economic situations. During these times of tumult, we do this by deploying your capital in a way that hedges uncertainty. If the tomato prices are rising at the grocery store, we can help mitigate this increase by directly owning a company that benefits from that same higher price. If the government is running massive deficits and printing money, we help you directly own physical gold bullion in lieu of the sovereign currency that is being inflated.

The third concept of independence relates to our ability to convey our market analysis, including our thoughts and opinions, in a direct manner without interference. **This is perhaps the most important ingredient in our privileged position of trust with you**.

The news events of today are shocking, but framing has normalized them. For instance, why is the constant risk of nuclear war being wholly ignored? **This is the definition of an existential risk**. Global leaders worldwide are using threats of nuclear attacks as political and strategic wedges. You do not get to take back launching a Satan II or Minuteman III missile. This should not be normalized, and the public should not accept posturing from politicians on either side of the conflict zone. That said, normalcy bias today is near universal. Our minds are hard wired to ignore nebulous threat warnings. Regardless of the extent of your country's jingoism, **no-one wins global thermonuclear war**. Yet, nearly every week, European leaders are announcing the expansion of nuclear arsenals and Putin is threatening to use nuclear weapons against the West. In conclusion, the risks are no longer far off on the horizon.

A few nowcasting items:

1. The Former President and front runner of the Republican party, Donald J. Trump, **was found guilty of 34 felony charges by a New York jury on May 30, 2024.** Frank Luntz, a well know US pollster, stated on May 31, 2024 on CNBC, 'I don't believe this case is going to change the outcome [of the election.]' What greater indictment is there on the social circumstance of America than a former President being found guilty of 34 felonies and that verdict does not change the election outcome?! **This is prima facie evidence that half the country thinks the candidate is corrupt and the other half thinks the government and the justice system is corrupt.**
2. The United States Treasury is having to issue ½ Trillion \$USD in new debt issuance every three months to fund ever increasing deficits. By all accounts, this issuance is only expected to rise exponentially with increasing costs in medicare, pension, interest, and defense spending.
3. We have German manufactured Leopard tanks, British manufactured Challenger tanks and American M1A1 Abrams tanks engaging Russian T-90 tanks in a European theatre of war.

With regards to item[s] 1 and 2, if you removed the actors from the storyline, the script would read exactly like your meat and potatoes vanilla bean banana republic. These are uncomfortable truths. Unfortunately, this is not prognostication. This is our world today that we must navigate. We do not wish to be pollyannish about the world we live in, nor do we want to be hyperbolic. **Our objective is pure pragmatism.** We would like to see the world for what it is, not what we want it to be.

TOPICS FOR DISCUSSION

1) The Age of Consequence

- i. *Prelude – Not Worth a Continental*
- ii. *Fiscal Dominance*
 - *Why Canada is Redeemable*
 - *Why the US fiscal circumstance is Irredeemable*
- iii. *The End of History's Largest Ponzi / The United States Dollar*
- iv. *Inflation Champagne Supernova*
 - *How Conflict is a Symptom of What's to Come*

2) A Frog in Water

- i. *Normalcy Bias*
- ii. *Silent Depression*
- iii. *The Canadian Social ~~Class~~ Caste*

3) Solutions for a Prudent Investor

- i. *Passing the Buck*
- ii. *Diversified Portfolio – Hedging Inflation for the Long Run*
- iii. *Bargain Hunting while Swimming Downstream*

AGE OF CONSEQUENCE

Prelude – Not Worth a Continental

The newly formed United States of America had an issue in the early 1780s. Many citizens were burdened with war debts. Moreover, the fiat money issued by the Continental Congress (Continental bills), quickly lost value. Having suffered hyperinflation, by 1785 citizens of the United States of America stopped accepting Continental bills as payment for goods or services. Many everyday Americans struggled to make ends meet during this time. Individuals who had saved in the Continental currency witnessed their investments become essentially worthless.

By 1787, the founding fathers of the United States held a Constitutional Convention to remove the power of Congress to issue fiat money. As Farley Grubb wrote, “George Read captured the depth of the Convention’s conviction when he noted that if the power to emit paper money was not removed from Congress it [would be] as alarming as the mark of the Beast in Revelations.” (*The Continental Dollar: Initial Design, Ideal Performance, and the Credibility of Congressional Commitment*, 2011, p.2).

Grubb then goes on to highlight comments by Alexander Hamilton, US Treasury Secretary on page 3:

“Paper emissions...are of a nature so liable to abuse, ...so certain of being abused, that the wisdom of the Government will be shewn in never trusting itself with the use of so seducing and dangerous an expedient...In great and trying emergencies, there is almost a moral certainty of its becoming mischievous. The stamping of paper is an operation so much easier than the laying of taxes, that a government, in the practice of paper emissions, would rarely fail in any such emergency to indulge itself too far...to avoid as much as possible one less auspicious to present popularity.”

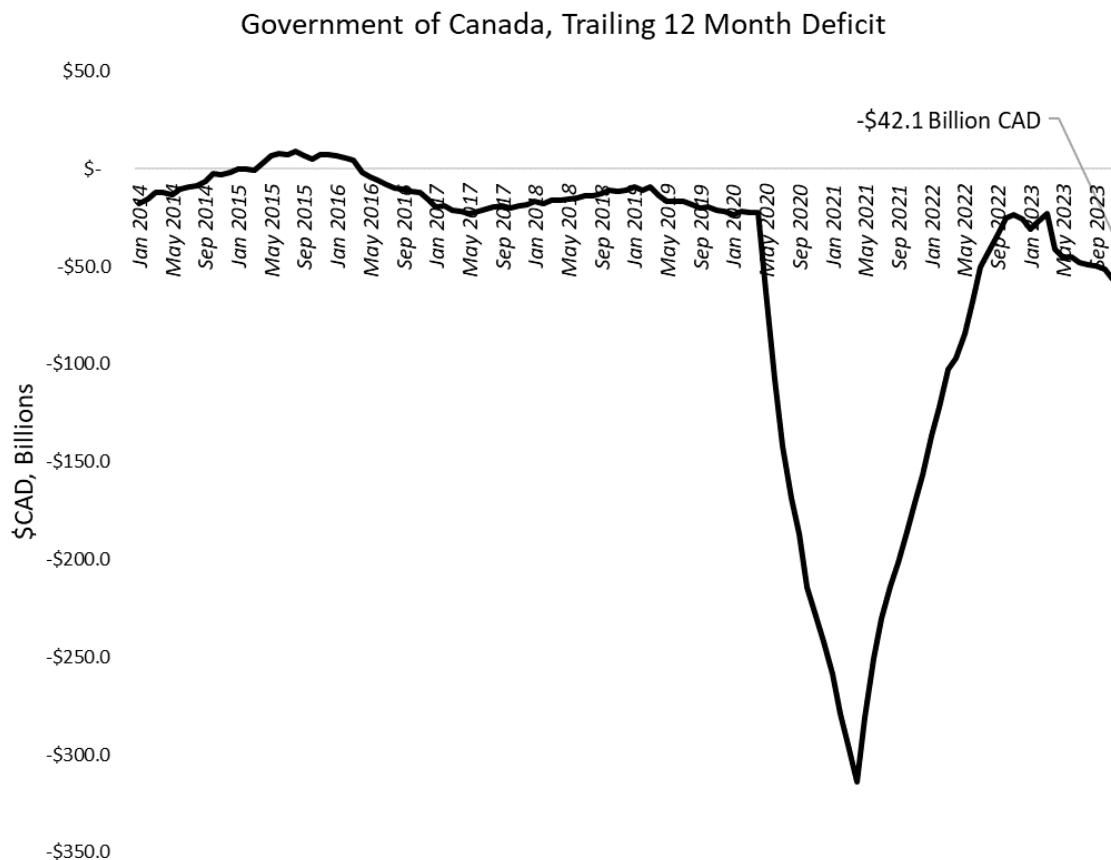
The Bank of the United States or First Bank of the United States was established in 1791. Prior to the establishment of this financial institution, gold and silver operated as a stable medium of exchange in the United States. According to the US Federal Reserve, the bank did not set monetary policy, regulate private banks, hold excess reserves or act as a lender of last resort. Conversely, Alexander Hamilton established the First Bank to ameliorate revolutionary war debt and establish a common stable currency for the fledging nation. According to the Federal Reserve history, the Bank acted as “the federal government’s fiscal agent, collecting tax revenues, securing the government’s funds, making loans to the government, transferring government deposits through the bank’s branch network, and paying the government’s bills...**to avoid inflation and the appearance of impropriety, the Bank was forbidden from buying U.S. government bonds.**”

The currency issued by the First Bank of the United States, the US Dollar, was backed by substantial gold reserves. This provided the new country a stable national currency. This is relevant in a contemporary context for two reasons:

1. The medium of exchange and storage of value in the United States has precedence of collapse. This is not well known, even by those in the financial industry. Knowledge helps to mitigate our own optimism bias: a belief that bad things can’t happen in America.
2. The currency collapsed on the same pre-text that we have going on today. Unfettered growth in the money supply coupled with large fiscal deficits.

Fiscal Dominance

The Canadian Constitution Acts (1867 to 1982) underscores the promise of peace, order and good government as the cornerstone of Canada's democracy. **A balanced budget is germane to the substantive execution to the good government promise in Canada's constitution.** As highlighted in the chart below, the Government of Canada has been operating in a perennial deficit since 2016.



Source: Refinitiv Eikon, June 2024

The impact of ever rising government spending has the potential to cause a **crowding out** of private capital, a phenomenon aptly labelled the Crowding Out Effect. This economic theory purports that rising public sector spending drives down private sector spending (notwithstanding increases interest rates as government competes for capital).

Fiscal dominance occurs when government spending exercises undo influence over monetary policy. In other words, government deficits reduce the independence of central banks, thus undermining efforts of central banks to achieve price stability. Famous examples of fiscal dominance were the post World War II period and the stagflation era of the 1970s. We believe the current era is much more unstable and nuanced than these periods and requires a wider lens of history to understand what is really going on.

Post World War Two Fiscal Dominance – Western Governments in the post World War II period had accumulated huge war debts necessary for the War effort. The United States was tasked with rebuilding the institutions and infrastructure of Europe. In 1948, the US Congress passed the Economic Cooperation Act (Marshall Plan) in which Congress appropriated funds for European recovery. The US Federal Reserve, albeit indirectly, contributed to funding the Marshall plan by conducting open market operations in the US treasury market.

Fiscal Dominance in the 1970s – The United States experienced a period of high inflation, high unemployment and falling economic growth during this period. Arthur Burns was the US Federal Reserve Chair for the majority of 1970s. He has been accused of helping to underwrite the economy and spending plans of the Nixon government. The late 1970s inflation had pernicious impacts on society as it eroded purchasing power and led to a substantial decrease in the standard of living for many families. Moreover, it exacerbated the wealth gap as those on nominal fixed incomes saw their wealth decline while those with real assets (gold, farmland, energy) fared better.

Fiscal Dominance – Why Canada is Redeemable

When measured on a gross government debt to GDP, the Canadian Government’s fiscal strength has deteriorated meaningfully over the previous decade. On a roughly \$2.952 Trillion GDP, Canada today has gross Federal and Provincial Government debt outstanding of nearly \$3 Trillion as highlighted in the table below.

Gross Government Debt in Canada, Source: Refinitiv Eikon	\$CAD, Billions
CDN Federal Government***	\$1,925
BC	\$92
AB	\$93
AK	\$29
MB*	\$33
ON	\$447
QC**	\$223
NB	\$23
NS	\$17
PE	\$3
NL	\$23
Total Provincial and Federal Gross Debt	\$2,907

Source: *Taxpayer Supported Debt., Manitoba F/S 2023, **QC Gross Debt as at March 31 2023, The Quebec Government Debt F/S, ***Dept of Finance, Canada, Debt Management Report P. 42, Outstanding Market Debt and Debt Charges (Gross)

Canada does have a pathway back to redemption for the middleclass. **Axiomatic to fiscal redemption is running balanced budgets achieved by smaller governments with less tax and regulation.** Given the changes to the capital gains tax recently (2/3rd inclusion), Canada is seemingly becoming an all stick and no carrot nation for entrepreneurship and innovation. Anecdotally, many businesspeople have realized pregnant capital gains now for fear of paying tax at the new inclusion rates. The new rules incentivize the tax base (i.e. capital), to leave Canada for warmer pastures given the cost base is bumped up and the disincentives to leave are concurrently reduced. Once the capital base leaves a country, even if it is fungible, it is extremely difficult to induce it to return. Countries have a habit of trapping capital internally. As such, it would take an extremely lucrative tax system coupled with a focus on property rights to induce a repatriation of this capital over time.

The net result of the higher capital gains tax rate will likely be:

- *An immediate 'surprise' tax windfall as businesses leave the country or bump up cost base on assets to pay tax at the 50% inclusion rate*
- *A reduction in economic activity and a smaller tax base in the medium and long term, resulting in lower government tax receipts and less productivity*

Canada has been running a budget deficit for eight years. Inflation has been sticky due to a combination of:

- *Pass through inflation related to the Carbon Tax*
- *Continued deficit spending of the Federal government*
- *High housing costs as a result of higher interest rates (not unrelated to deficit spending of Government; this is the real-world impact of fiscal dominance)*

Former Canadian finance minister John Manley stated in 2022, 'If you're driving your car, fiscal measures are the gas pedal. Monetary policy run by the Bank of Canada is the brake. We've got a situation now where we've got our foot on the gas and the brake at the same time. Let's call that sub-optimal.' John was referring to higher interest rates as the brake and the deficit spending by government as the gas pedal.

We prefer the gross debt measure because we do not deduct pension assets such as the Canada Pension Plan (CPP) to arrive at net debt. Assuming a rolling 12 month \$2.952 trillion GDP, Canada's gross Government debt to GDP is roughly 100%. On its face, this seems an insurmountable level of national debt, we would argue that fiscally Canada is redeemable. There are examples of countries working through levels of national debt more than 100% of GDP including the United States in the post World War Two period. The ability of Canada to navigate its significant increase in debt depends on action by policy makers over the coming years. The path back for financial redemption is to be paved with a combination of fiscal constraint and private sector productivity growth.

The debt bomb in Canada resides not at the sovereign level but at the household. To ensure a path back to fiscal redemption, the **Federal Government of Canada must not bail out over levered households should a Canadian made household debt crisis arise.** A bailout would exacerbate the wealth gap and become an anathema to the long-term prosperity of the middle class. Moreover, a bailout would burden the Federal apparatus with an irredeemable debt load, setting in motion a similar set of events in Canada that the United States is currently experiencing.

Fiscal Dominance – Why the US fiscal circumstance is irredeemable

The Australian rock band Midnight Oil released their album *Diesel and Dust* in 1987. Their hit song Beds are Burning hit No. 1 Canada and No. 6 on US Charts. While written for completely different reasons, we can't help but find allegory between the US fiscal circumstance and the pre-chorus lyrics from Beds are Burning:

'The time has come to say fair's fair

To pay the rent, to pay our share

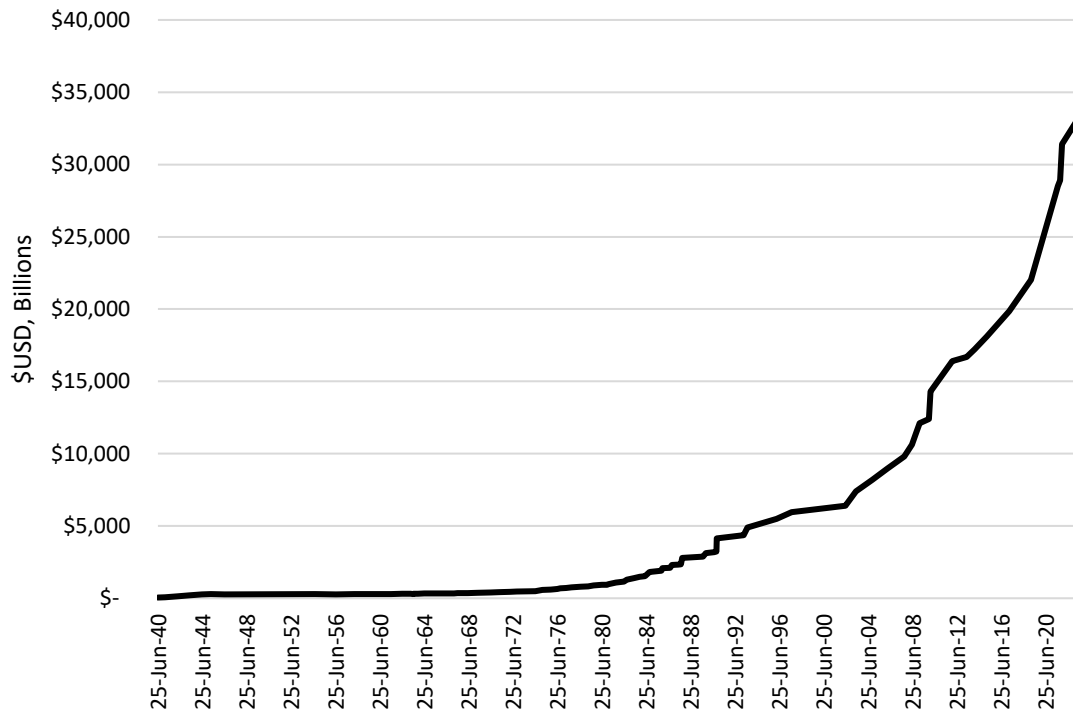
The time has come, a fact's a fact [']

America at all social strata, will atone for its deficits and unfunded commitments. Because social commitments (eg. knees, hips, groceries, EKG machines) cannot be printed at a central bank, deficit spending underwritten by central banks will create structural inflation. **Inflation is a tax on society.** It disproportionately impacts the working and middle class as wages do not have the pricing power that the means of production do. Real world negative outcomes are homelessness and food insecurity. The US Department of Agriculture observed year over year increases in both low food security and very low food security households. The numbers of Americans in either of these categories increased from an already unacceptable 13.5 million in 2021 to 17 million in 2022. According to the US Department of Urban Planning and Development, homelessness increased by more than 12% year over year in 2023. We acknowledge that Canada also faces severe homelessness and food insecurity exacerbated by central bank debt monetization. That said, our contention is that Canada is redeemable because our fiscal situation federally is fixable.

Sustained pernicious inflation has a destabilizing impact on society that can lead to a potential violent reallocation of capital from a plutocracy to the populace. We can see many examples of this throughout history, from the execution by firing squad of Tsar Nicholas in 1918 (after the 304-year rule of the Romanov dynasty), the rise of Hugo Chavez to President in Venezuela in 1998 to the more recent collapse of the Sri Lankan government in 2022 and *de facto* asylum of the then President Gotabaya Rajapaksa to Singapore and his subsequent resignation.

While the growth in the US debt ceiling as highlighted below is shocking, it will only accelerate.

Historical US Debt Ceiling



Sources: Office of Management and Budget, "Meet the New Debt Ceiling: \$22.03 Trillion," Washington Examiner, "Treasury Dept to Invoke 'Extraordinary Measures' as Congress Misses Debt-Ceiling Deadline" NBC News

“The United States can pay any debt it has because we can always print money to do that.”

~ Alan Greenspan

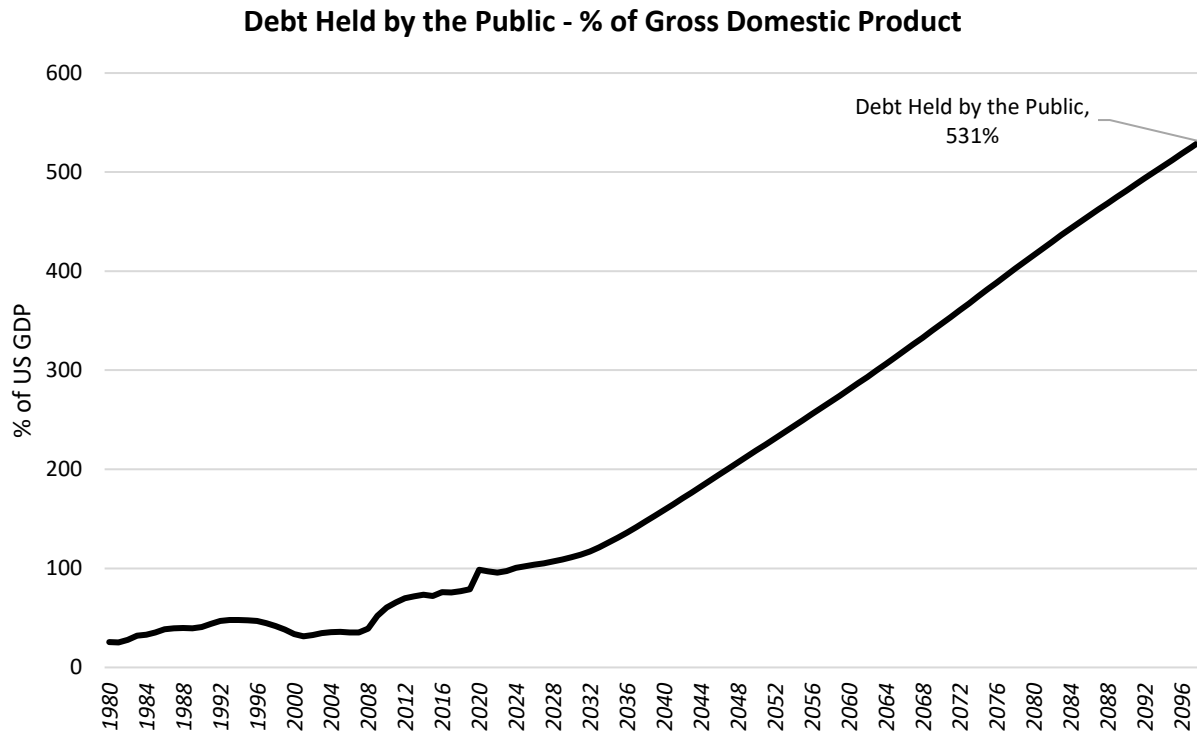
America is hitting escape velocity on its national debt and off-balance sheet liabilities. In other words, the consequences of compounding fiscal immorality are here and now. **The following highlights (in \$USD billions) the off-balance sheet liabilities for Medicare and Social Security liability:**

Unfunded Liabilities	
Medicare	\$41,696
Social Security	\$27,177

Source(s): US Treasury

According to the financial reports of the US Treasury, social insurance expenditures [Social Security (OASDI) and Medicare (Parts A, B, & D)] increased from 2022 to 2023 by \$2.5 trillion. The official budget deficit during 2023 was \$1.695 trillion (Source: executive summary to the 2023 financial report of the U.S. Government). A proper accounting of the budget deficit would include the increase in off balance sheet entitlement liability. In other words, the US government ran a \$4.2 trillion (rounded) deficit in 2023 or roughly \$350 billion a month, (calculated as \$1.695 + \$2.5). This is unsustainable and is projected by the US Treasury to worsen.

The chart below highlights the projected debt to GDP held by the general public:



Source: Bureau of the Fiscal Service, *Financial Report of the United States Government, Executive Summary – An Unsustainable Fiscal Path*

The presupposition of the US Treasury report, ‘An Unsustainable Fiscal Path,’ is the public’s willingness to underwrite the enormous projected future US deficits. There are not enough US dollars in existence to finance upcoming deficits, even if one hundred percent of the public’s cash was deployed to finance said deficits. This is a case of the emperor having no clothes. Our prognostication is that a treasury auction will in effect fail with a massive tail (the price spread between the average competitive bid on treasuries and the stop out price). Illiquidity in the treasury market can cause chaos in other financial markets, which may be the impetus for the Federal Reserve to resume some form of debt monetization (i.e. quantitative easing by another name). It is important to note, this new debt monetization may occur in a clandestine manner executed through rule changes in the banking reserves system which could ameliorate a potential market liquidity crisis both in public markets and at the sovereign level in the short term.

Whatever form new money printing takes, this is only a short-term solution. Because the entitlement liability is so unimaginably large, as Social Security and Medicare trusts run out of money, the only plausible way to create enough liquidity to make promised payments would be to print more money. The truth is: **The US Government is going to print tens of trillions of dollars to finance the entitlement tsunami.**

The End of History's Largest Ponzi | The United States Dollar

Empires come and go. The bureaucratic class of successful empires inevitably succumb to their own hubris. Grandiose visions for their nations led them to subvert the financial law of nature: scarcity. In other words, resources (spices, bronze, copper, pottery, iron, silver, gold) are finite and cannot be created via central bank printing money or adding base metals to currency. The Carthaginian, Abbasid and Turkish Empires all succumbed to lose fiscal and monetary policy that was employed to underwrite military and territorial expansion (notwithstanding burgeoning bureaucracies). In other words, all these empires failed due to the negative consequences of running deficits or currency dilution to fund their growing state apparatus. The United States has set in motion the foundations to a collapse in its currency. We will explore foundational monetary missteps undertaken by dominant empires through time that parallel the mistakes which have been made by the United States.

Carthage had an incredibly successful trade network that helped to fund the expansion of commerce throughout the Mediterranean. This empire lasted from roughly 800 BC to 150 BC (eventually being destroyed by the expanding Roman Empire in the Third Punic War). What had caused the failure of an incredibly successful empire that lasted the better part of six hundred years? Carthage relied on mercenary armies to exert its hegemony in modern day North Africa and southern Spain. This strained the fiscal resources of Carthage which led to much of the coinage produced in North Africa during the period between the first and second Punic Wars being Bronze. (*Coinage and Money Under the Roman Republic*, Michael Hewson, 1985). Unlike gold and silver, bronze was plentiful. Shifting coinage production from silver and gold to bronze at first would have seemed a miracle cure. Bronze was the paper money of antiquity. This created domestic inflation as the Carthaginians' currency lost value making their hired mercenaries more expensive.

The seeds of defeat were sown as a result of Carthage's loss of the Iberian Peninsula to Rome in the Second Punic War. According to Pliny the Elder in his book *The Natural History*, written between 77 and 79 AD, the mines of "Asturia, Gallaecia and Lusitania annually produced 20,000 pounds weight...of gold." Subsequent to the Roman seizure of the gold mines, Carthage stopped minting gold or silver coinage. In leading up to the downfall of Carthage, Carthage became a closed currency system minting purely in bronze. In other words, if you visited Carthage in 170 BC with gold and silver coinage, you were required to exchange your coinage to civic authorities for local bronze coinage. This is not dissimilar to the unwitting exchange of gold certificates in the form of redeemable certificates (i.e. USD) for paper USD when the gold window closed in 1971.

The Abbasid Caliphate peaked in influence in the 8th and 9th century. The empire was centered in Baghdad Iraq extended north into the Caucasus, east and south into the Arabian Peninsula and west into North Africa. The Caliphate was geographically at a crossroads of trade between Europe, Asia, North Africa and the Middle East. Cities like Cairo and Mecca became prosperous and attracted merchants and scholars. Famous theologians of the period, such as Averroes (Ibn Rushd) who introduced Greek texts (Plato and Aristotle) to the Islamic world came out of this golden age (from the Almohad Caliphate directly west of the Abbasid). Over the centuries, the empire began to reduce the metallic content in its coinage, resulting in inflation and decreasing trust in the monetary system. The best source for identifying the deliberate debasement of currency without informing the users of the coinage is not textual sources recording protests over debasements, but the coinage itself (*Islamic History through Coins*, Jere L. Bacharach, 2006). The currency debasement in the Abbasid Caliphate occurred concurrently with increasing corruption and bureaucracy, reducing efficiency and productivity. Eventually, the grandson of Genghis Khan, Mongol prince Hulegu, sieged Baghdad and ended the roughly four hundred year rule of the Abbasid empire. Persian historian Hamd Allah Mustawfi Qazwini estimates the death toll at 800,000, however, letters from Hulegu to Louis IX of France written in 1262 indicate that the death toll was closer to 200,000 (*The Mongols*, David Morgan, 1985).

Turkish (Ottoman) Empire spanned a period of almost 600 years from the late 13th century to the early 20th century. It was one of the most dominant and enduring empires in history. According to Metin M. Cosgel in *Agricultural Productivity in the Early Ottoman Empire*, “By mid-sixteenth century the Ottomans had built a vast Empire that controlled the lands between the Crimea in the north to Egypt and the Arabian Peninsula in the south, and between the Persian Gulf in the east to central Europe and North Africa in the west.” (2004, p.1) Cosgel goes on to detail tax and government data collected during the period to provide estimates of labour productivity. He highlights, “...results suggest that grain output per worker in Ottoman provinces in the fifteenth and sixteenth centuries was higher than even some countries in northwestern Europe in mid-nineteenth century.”

Increases in labour and capital productivity are vital for any society. Notwithstanding territorial conquests, the Ottomans had many achievements in art, science and medicine. Istanbul was both a hub for commerce and culture. Not all great things last forever. Sultan Suleiman the Magnificent (1520-1566) had his chief architect, Mimar Sinan, build over three hundred monuments throughout the empire, including the Suleymaniye and Selimiye mosques. While magnificent, these construction programs along with the military conquest of the empire began to place financial strain on the empire. Suleiman initiated a series of debasements of the empire’s silver coinage, the akce. Predictively, this created inflation by reducing purchasing power of the population. This inflation disproportionately affected the lower and middle classes, who saw their savings reduce in value. In 1585, the Ottoman Monetary Crisis occurred, where the Akce officially devalued by 100% vis-à-vis the Venetian gold ducat and foreign silver currencies (*Journal of the Economic and Social History of the Orient, The Ottoman Monetary Crisis of 1585 Revisited*). Eventually, merchants and traders became wary of accepting Ottoman currency, which impeded efficient economic transactions. The resulting debasement inflation, corruption and fiscal instability created an economic tumor that the Ottoman rulers were unable to overcome. The decline of the Ottoman Empire accelerated over the period 1798 to 1913, where it aptly earned the title, ‘Sick Man of Europe.’

The choice to use these three empires as examples was random. The impact of spending deficits and debasement on the great empires of history is always the same, from debased copper-alloy coins during the Ming Dynasty to the 16th century silver content reduction in Spain’s “Piece of Eight.” The DNA these empires share is:

- Growth in the bureaucratic apparatus underwritten and enabled by successful trade and productivity
- That apparatus becomes too cumbersome
- Eventually the power players resort to debasement as a solution to maintain or grow the state

The subsequent debasement yields predictable results:

- *Inflation*
- *Goods scarcity*
- *Revaluation of real assets vis-à-vis the currency being debased*
- *Expansion of the wealth gap*

In our 2020 Annual Letter to Clients, we forecasted *ex ante* a coming inflation by drawing on the cause and effects of more modern examples: French Inflation (1795-1796), Confederate States Dollar (1861-1865), Austria (1919-1923), Germany (1921-1923), Israel (1970-1999), and New Zealand (1984). We are by no means prescient. With hindsight, it is simply the application of history and common sense. **What is probably more surprising to us is the *status quo bias* exhibited by contemporary economic experts prior to each inflation.** The 2020 period was no different. Many mainstream economists were forecasting deflation. After early shoots of inflation data began percolating in, David Rosenberg stated on an episode of CNBC November 4, 2021, “based on my view, I think that when the long bond gets to 2 or above 2% I think you want to be adding duration to your bond portfolio...inflation is going to dissipate, I think that these fed futures contracts and swaps curves that are pricing in two rate hikes next year, I’d want to buy those and take the opposite side of the inflation and rates bet.”

As we now know, near-term US CPI inflation peaked at an annualized rate of 9.1% in June 2022, the highest in forty years. Wholesale or producer inflation peaked at 11.7% in March 2022. The long bond ETF TLT was trading at roughly \$149 USD a share during this interview with Rosenberg. It bottomed at roughly \$83 a share late 2023, a capital loss of ~ 44% on an asset class that many historically would have viewed as conservative. During 2020, we began using physical gold in lieu of more traditional fix rate ‘safe havens’ such as treasuries do to the above-mentioned issues related to US dollar hegemony and sustainability.

The following excerpt is from our 2020 Letter (p. 16 of 25):

When the central bank of a government becomes weaponized for political or social reasons – as noted above – it comes with a plethora of unintended consequences. The central bank in Canada has been creating cash to purchase bonds on the secondary market. The Bank of Canada buying secondary market bonds rather than participating in the primary market only serves to obfuscate what is really going on: The Bank of Canada is electronically printing cash to *de facto* finance massive government deficits. The Bank of Canada has become a political extension of the government.

The government in this clandestine approach steals resources from:

- Fixed dollar pensioners without cost-of-living adjustments
- Retirees with cash savings
- Labour with fixed dollar employee contracts

This debt monetization is so attractive for politicians because it does not require a pragmatic and unpopular framework for the nation’s finances. You can avoid unpopular deflation resulting in:

- Lower asset prices
- Lower wages
- Lower inflation

This strategy of government stealing from savers can go on in perpetuity, but the real effectiveness becomes diminished as society’s trust in the currency as even a short-term value storage diminishes. At the limit, individuals begin transacting in a barter system or begin to hold real assets in lieu of cash.

Some argue that deflation is more of a risk than inflation caused by currency printing coupled with deficits. Technology, artificial intelligence (automation), significant debts and aging demographics are all deflationary factors that exist. For instance, technology: a simple four function calculator (Teal LC811) would have cost \$24.95 US in 1977 (\$107.16 in today's dollars!). A more advanced calculator today can be had for \$5 US at Walmart. This simple example is a greater than ninety percent reduction in cost. Similar examples can be found for computers, televisions or other electronics. While these deflationary forces are very real, we believe in the medium term they will be overwhelmed by weakness in the currency.

The power of the printing press to overwhelm these factors is limitless. Governments globally can run infinite deficits in nominal terms. In that scenario, it is not *if*, it is *when* the currency collapses. Moreover, under those conditions prices rise, not because the economy is good – but because the currency is being devalued by way of excessive printing.

“A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury with the result that a democracy always collapses over loose fiscal policy.”

~ Alexander Fraser Tytler

Inflation Champagne Supernova – How Conflict is a Symptom of What’s to Come

The Winnipeg Manitoba founded Bachman Turner Overdrive released its hit song, “You Ain’t Seen Nothing Yet” in 1974. It reached the number one position on the US Billboard Hot 100 singles chart. Not dissimilar to Midnight Oil’s “Beds are Burning” allegory, the juxtaposition between our inflation prognostication and the recent inflation experienced post Covid-19 is summarized in the chorus:

*You ain’t seen nothin’ yet
B-b-b-baby, you just ain’t seen n-n-n-nothin’ yet
Here’s something that you’re never gonna forget
B-b-b-baby, you just ain’t seen n-n-n-nothin’ yet
Nothin’ yet, you ain’t been around*

To better understand the world as a powder keg *writ large*, we look at a small region with a very complicated and troubled history: The Balkans. Kosovo is a small Balkan nation, once part of Yugoslavia. It has been troubled by ethnic tensions and bitterness for centuries. Kosovo is constituted primarily by two ethnic groups that historically have lamented one another: Serbians and Albanians. For more than one hundred years, Serbs and Albanians have been at conflict off and on in the region. During the 1990s, NATO and Russia nearly went to war due to conflict in Kosovo. During the conflict, the Serbian military shot down a Lockheed F-117 Nighthawk and two General Dynamics F-16s. Conversely, the Serbian military lost six MiG-29s, mostly in air-to-air combat. The Serbians who had the sympathy from Russia due to their historically close ties, were implored by Putin and Yeltsin to leave Kosovo. Russia had been in its modern state at that time for less than a decade as the fall of the Soviet Union was a not-so-distant memory. You could contrast the modern-day conflict in Ukraine with the conflict war in Kosovo, with one difference, the power position of the belligerents. During the late 1990s, US global hegemony was unrivalled. The US dollar was king, and the country was running budget surpluses. **Today, the United States is weakened, and the conflict in Ukraine is a symptom of the disease.**

Rome peaked in the 2nd century AD. At the time, the Roman Empire controlled or influenced territory that spanned from the beaches of Western Spain, north to the Southern Border of Scotland, East to the shores of the Persian Gulf and South towards the border of modern-day Sudan. Rome’s Empire was vast and expansive. Roughly three hundred years after the peak of the Roman Empire, Germanic Visigoths sacked Rome. Germanic tribes had been attacking Roman lands on the periphery of the Empire for hundreds of years, but it did not matter because Rome was a strong and healthy empire. Rome fell because it rotted internally, not because the Visigoths own power strengthened. Much like Rome, the United States is failing, not because its enemies are necessarily stronger (although they are) it is failing because the US is weakening. It is as if the United States is immune compromised, and opportunistic infections (Russia) are taking advantage of the situation.

In June 2024, Aleksandar Vučić the President of Serbia was quoted: “I spoke to President Xi [President of China] as well...and he has the same view on this issue as I do. We are very far away from reaching the [Minsk] agreement...A big confrontation, I believe we are not far away from it. Not more than three or four months.”

When discussing a de-escalation, Vučić goes on to state:

You have totally different interests; you have conflicting interests of big powers. There is a big power on the rise, which is China, which has a lot of conflicting interests with the United States of America. US and Europe, let me call it the collective West would like to preserve everything they worked for, everything they had in last 300 years and the other people are seeking, from their point of view, more justice, [a] more equal world. With the wish for preservation, and the desire of change, you have conflict and totally different economic interests. The world is changing although we don't want to accept it and we don't want to admit it, it is changing on a daily basis and much faster than ever before. When you have this kind of conflicting interests, contradicting interests, then you get close to big clashes and big wars. I don't see the way anyone can stop it. I'd like to see that more than anything else to tell you the truth. Today I was checking the data about our reserves on oil, flour, sugar, salt because I don't know what tomorrow will bring to all of us.

The comments from Vučić regarding a potential World War Three are ironic for a few of reasons:

1. Gavrilo Princip, a member of Young Bosnia, or conversely, the Black Hand (depending on your politics), was a primarily Serbian group responsible for the death of Archduke Franz Ferdinand. This was the ember that started World War One. Many historians have argued that the consequences of World War I led to World War II. For example, the social suffering and runaway inflation caused by the onerous Treaty of Versailles reparations (Weimer Germany) allowed a monster like Hitler to assume power.
2. Belgrade, the modern-day capital of the country Vučić leads, was where the Great War became kinetic. The bombardment of Belgrade, carried out by Austria-Hungary, began hours after the declaration of war on Serbia the night of 28 July 1914.
3. The modern-day recognition of Kosovo's independence is roughly the dividing lines of the new powers. The Western powers (Australia, Austria, Belgium, Canada, Denmark, USA, etc.) recognize the independence of Kosovo. Conversely, the powers challenging Western hegemony that Vučić is referring to above are the same powers that do not recognize Kosovo as separate from Serbia (Brazil, China, Russia, Syria, Iran, India, etc.)

The dividing line for the recognition of Kosovo provides an *ex-ante* contemporary axis and allies. These battle lines also align with members of the BRIC nations (Brazil, Russia, India, China), or even how UN members voted in condemning Russia due to its invasion of Ukraine. The table below highlights UN member voting post Ukraine invasion.

Countries who Voted Neutral or Marginally in Russia’s Favor on UN Resolutions

Countries Abstained in all, Against or Abstained, or Against all UN Resolutions					
Sudan	China	Uganda	Vietnam	Central African Republic	Bolivia
Algeria	Kazakhstan	Tanzania	Laos	Arunachal Pradesh	Nicaragua
Mali	Uzbekistan	Mozambique	Belarus	Kyrgyzstan	eSwatini
Guinea	Iran	South Africa	Republic of the Congo	Tajikistan	El Salvador
Ethiopia	India	Namibia	Cameroon	Syria	Cuba
Eritrea	Pakistan	Mongolia	Sri Lanka	Burundi	

Source: UN, ES1 – Demand that Russia withdraw its military forces from Ukraine, ES2 – Humanitarian consequences of the aggression against Ukraine, ES3 – Suspending Russia from the UN Human Rights Council, ES4 – Territorial integrity of Ukraine, condemning Russia’s move to annex parts of Ukraine

While some of these countries are economically nominal vis-à-vis global GDP (eSwatini’s GDP is roughly \$5 billion USD), there are some heavy hitters, such as China or India. Interestingly, the BRICS (Brazil, Russia, India, China, South Africa, Iran, Egypt, Ethiopia) predominately voted either neutral or marginally in Russia’s favor.

Normalcy Bias

Normalcy Bias - Our Tendency to Minimize or Ignore Threat Warnings and to Believe that Nothing Can Seriously Disrupt our Everyday Life

Normalcy bias is a form of cognitive dissonance. Esther Inglis-Arkell highlights in her article, “The Frozen Calm of Normalcy Bias,” that, “people seeking shelter during tornadoes and cyclones are often called back, or delayed, by people doing normal activities, who refuse to believe the emergency is happening.” This impacts the majority of the population, or approximately 70-80%. Another inter-related cognitive bias is the ostrich effect, originally coined by Galai & Sade (2003). The Ostrich Effect purports that people “bury their head in the sand” to avoid potentially negative but useful information to avoid psychological discomfort. As an example, Karlsson et al. in 2005 found that investors look at their portfolios more when the stock market was increasing and less when the stock market was decreasing. (*The ‘Ostrich Effect’: Selective Attention to Information about Investments*).

World War One was not in our lexicon until the term was coined by Time magazine on page 28 of its June 12, 1939 issue. Up until that point, the conflict was ubiquitously known as The Great War. The first eight months of World War Two was a time of limited conflict. This period was colloquially known as the Phoney War. It occurred from September 1, 1939 until the German invasion of France and the Low Countries in May of 1940.

Hindsight bias is the tendency to overestimate the accuracy of our predictions after knowing the outcome of an event.

The seeds for both World Wars were planted years or even decades prior. Jingoism coupled with the arms race characterized the early 20th century dreadnought era could be reasoned as the seed crop for World War One. This period was characterized by alliances, nationalism, imperial ambitions, and militarization. It only took the actions of the young Gavrilo Princip killing the Archduke of Austro Hungary Franz Ferdinand to unleash a geopolitical, economic, and humanitarian catastrophe that was World War One. Princip was not a black swan. Conversely, he was a match in a forest of dry timber. Today, **we are seeing the world bifurcate with Ukraine being a kinetic flash point of a broader economic and cultural conflict. We are witnessing what appears to be a 21st Century World War.**

Our idea of what a World War is supposed to be is a paradigm that has been superimposed on our beliefs by the past World Wars. In other words, for us to spot the next World War, we need to have a certain set of circumstances that we collectively approve of before it triggers our emotive response and cultural agreement that the current period is that of a global conflict. The future is stochastic or random. The next global conflict will involve different belligerents. It will have a different pretext. It will be caused by different motives. What’s more, our interaction or participation in the next war will also be varied. In North America, the next Great War may have a greater economic impact on our way of life than it has on our loss of life.

Moreover, the polarization of today’s Western world makes mass conscription implausible. Having diverse opinions can be a strength as homogeneous societies can make abhorrent mistakes. For example, creating internment camps for minority groups such as the Japanese during World War II was likely a popular policy at the time, but a horrendous mistake with hindsight. That said, a population with heterogeneous values is challenging if you are trying to win a war. In other words, it is hard to have a common cause if you don’t have common values.

Mission creep is defined as the gradual expansion of objectives or scope beyond initial intentions. World War One began as a localized conflict between Austria-Hungary and Serbia. The harsh terms of the Treaty of Versailles, which created a massive debt overhang in the interwar period for Germany, contributed to hyperinflation during the Weimar years. The seeds of World War Two were planted during this period. The interwar German economic hardship created the ecosystem where the rise of a tyrant such as Adolf Hitler was possible. Mission creep also characterized the latter half of the interwar period. The remilitarization of the Ruhr and the Annexation of Austria, the Sudetenland or subsequently the remainder of Czechoslovakia were prime examples of this creep towards full scale global conflict.

This period today may be characterized as World War Three in the future. Many geopolitical experts have characterized Ukraine as a proxy war. In our estimation, this may be a form of the previously discussed Ostrich Effect. When we contrast the conflict in Ukraine with historical examples of proxy wars: Spanish Civil War, Soviet-Afghan War, Second Indochina War (Vietnam War), we can see stark differences between these conflicts. Notwithstanding the Korean War, generally proxy wars have a limited number of belligerents (ten or less on either side). Moreover, if there was involvement, many times it was via economic involvement and often did not include the direct supply of arms.

Non-exhaustive List of Countries Sending Military Equipment to Ukraine:

Country	Examples of Equipment
Australia	56 M113A4 Armoured Personnel Carrier, 120 Bushmaster Protected Mobility Vehicles, 14 Supacat HMT Extenda MK2
Belgium	80 Iveco LMVs
Canada	1 NASAMS, 12 AIM-120 AMRAAMS, 43 Aim-9s, 250 AIM-7, 4+ 155mm M777s, 8 Leopard Main Battle Tanks
Denmark	19 F-16 Fighting Falcon Jets
France	38 AMX-10 RC Light Tanks, several hundred 12.7mm machine guns, 30 CAESAR 155mm howitzer, much more
Italy	100+ 155mm M109Ls howitzers, FIM-92 Stingers, Milans, Panzerfaust 3 RPGs
Norway	F-16A/Bs, 23 155mm M109A3GNs, 5 155mm ShKH Zuzana 2s, 8 Leopard 2A4s Main Battle Tanks, Hellfire shore defense system, 4,000 M72 LAW
Poland	14 MiG-29s, 12 Mi-24 "Hind" helicopters, 250 T-72M and T-72M1, 14 Leopard 2A4 Main Battle Tanks, 60 PT-91s
Spain	10 Leopard 2A4 Main Battle Tanks, 60 M113 armored personal carriers
Sweden	10 Leopard 2A5s, 50 CV9040s, 90 Barrett M82A1s, KSP-58 machine guns
United Kingdom	14 Challenger 2 tanks, AGM-84 Harpoon missiles, storm shadow air to surface missiles, 5,361 NLAW anti-armour weapons
United States	31 M1A1 Abrams Main Battle Tank, 186 M2A2 ODS Bradleys, 10,000 Javelin anti-tank missiles

Silent Depression

In our 2023 Annual Letter, we highlighted the rise in food bank usage:

As a result, any tax on agricultural production, directly or indirectly, will be passed onto the consumer. Those consumers who can afford the higher price for food will of course pay and those who can not will not. We are beginning to see what we believe is just the tip of the iceberg at even Canadian food banks. Food Banks Canada (FBC) reported that in March 2022 “there were nearly 1.5 million visits to food banks in Canada, the highest March usage on record” (Hunger Count, 2022). According to FBC, 485,041 of the nearly 1.5 million were children. In Canada, year over year food bank usage is up 15% from 2021. Ironically, the unemployment rate in Canada is historically low during this time, highlighting that wages are not keeping up with the cost of living. It is modern day financial repression. The working and middle class spend a disproportionate percentage of their incomes on food and energy, the precise goods we anticipate higher costs on over the coming decade. We expect further carbon tax increases and potential restrictions in ammonia-based fertilizers will only exacerbate this issue.”

In May 2024, Food Banks Canada CEO Kirstin Beardsley noted, “Food Bank Canada’s 2024 Poverty Report Cards show that people in Canada, from coast to coast to coast, are struggling to keep up with the rising cost of living. Though deeply concerning, these results are sadly unsurprising to the thousands of food banks across the country who have seen a **50 per cent increase in visits since 2021.**” Since the release of our Annual Letter in 2023, food bank usage has skyrocketed. We fundamentally disagree with many of the solutions proposed to ameliorate the food insecurity crisis by Kirstin Beardsley, which generally revolve around larger government and more social assistance. While the outcomes for Canadians have never been worse, we have never spent more money on government or government programs. The solution to the food crisis is simple: **make energy and input costs lower for the producers of food.**

The Canadian Social Class Caste

A caste system is a class structure that is determined by your birth. One of the most well-known caste systems still exists in India today. The Dalit (previously known as the untouchables) is the lowest stratum of the castes in India. Canada was a country which hard work and a rules based social contract allowed immigrants and young Canadians the opportunity, if they play by the rules, to improve their financial and personal welfare. In other words, Canada was a place of social mobility. If you studied medicine and opened a practice as a general practitioner, you could eventually buy a home in Oakville or Kitsilano. Conversely, your social/economic caste today is increasingly based on your familial endowment. What intergenerational inheritance will you receive? The data is stark and supports this economic reality for many Canadians trying to improve their circumstances.

According to the Government of Canada, (Job Bank), the median annual wages for a General Practitioner (GP) in British Columbia (BC) in 2021/2022 was \$178,810. After federal, provincial taxes and CPP/EI Premiums, your average GP in BC took home roughly \$120,000 in 2022. According to the MLS ® home price index for Greater Vancouver, the average detached home price in Greater Vancouver for April 2024 was \$2,040,000. Assuming you inherited a down payment of 20% of the purchase price and factoring in roughly \$45,000 in closing costs and property transfer tax, your mortgage would be ~\$1,680,000. **At a current market interest rate of roughly five and a half percent, your annual mortgage and interest costs on this property would be \$123,054.96!** This is over 100% of the 2022 median take home salary of your BC GP! This does not factor in any student loan debt required for the almost decade of school/training (pre-med, medical school and then residency)!

SOLUTIONS FOR A PRUDENT INVESTOR

Passing the Buck

We are in a new paradigm characterized by deficit spending and monetary manipulation (notwithstanding an entitlement tsunami). We need to own businesses that can pass through inflation. In other words, companies that can raise prices to offset increasing costs. In a perfect world, these price hikes would occur without a corresponding decrease in the quantity of the product demanded. That said, different businesses produce products with different price elasticities. A company that sells food such as potatoes or table salt will have a very low-price elasticity. If the spot price of the commodity rises, consumers are forced to pay the higher price. That said, these businesses generally have low barriers to entry in which excess returns (or excess 'rents') are ground away through competition.

Thus, the Holy Grail businesses are those that can:

1. *Pass through inflation*
2. *Maintain volumes*
3. *Control costs*

Diversified Portfolio – Hedging Inflation for the Long Run

Our Current Diversification Focus

Portfolios are currently constructed of eight different asset allocation baskets. We do not add more baskets because we feel it would negatively impact the portfolios long run risk/reward.

We believe a portfolio of these assets will have a unique ability to protect capital from inflation and economic shocks. We would like to focus on businesses with strong current cash flows and an ability to grow these cash flows over time. Our current portfolio construction is more focused on how the macro world drives the fundamentals of each business rather than a traditional Pavlovian asset allocation decision, (i.e. equities or bonds). The global themes and their existential consequences will mean that businesses on the wrong side of the future will have often insurmountable headwinds. These headwinds will make medium- and long-term profitability growth challenging. For instance, the Canadian banks face an overleveraged consumer and rising costs.

This creates two potential pain points:

- *Higher provisions for credit losses (PCLs)*
- *Weakening bank efficiency ratios*

Rather than a bull-headed approach to Canadian banks, (which the top six are in aggregate roughly a quarter of the TSX 60 Index), we would rather underweight this sector and overweight an asset class with tailwinds. This idiosyncratic asset allocation decision comes with risks. If Canadian banks surprisingly outperform, you will underperform.

That said, we are willing to take this risk given our analysis has its foundations in data, and in our opinion, economic reality.

This system of analysis was a core rationale for the underweighting of long-term sovereign debt in 2020 as noted previously. Given current interest rates, this asset basket should be expected to generate roughly \$40,000 of income annually for each \$1,000,000 invested, notwithstanding potential growth. Higher interest rates are a boon for wealthy investors with capital invested in a tax prudent structure. Current rates are de facto CERB for the wealthy.

Energy Infrastructure
Pipelines
Upstream
Refineries
Real Estate and Essential Logistics
Grocery-Anchored Property
Railways
Ports
Defence Manufacturers
Civilian Small Arms
Government Arms
Agriculture
Fertilizer Producers
Equipment Manufacturers
SIN Companies
Alcohol
Tobacco
Social Media Companies
Misc Stocks
UHNW Luxury Brands
Power Generation / Home and Business Standby
Communication Services
Precious Metals
Physical Gold
Physical Silver
Fixed Income
Preferred Shares
GICs
Sovereign Debt

Bargain Hunting while Swimming Downstream

As prudent investors, we are incredibly demand elastic when deploying capital. In plain language, we want to buy a high-quality company or asset at the cheapest price possible. In fact, **the long-term return function is mathematically related to the price you pay for the asset.** This is a commonsense approach to capital allocation. The late Jack Bogle was an early pioneer of passive investing. It too, initially, was a commonsense approach to asset management.

The Coles Notes of Jack Bogles approach was:

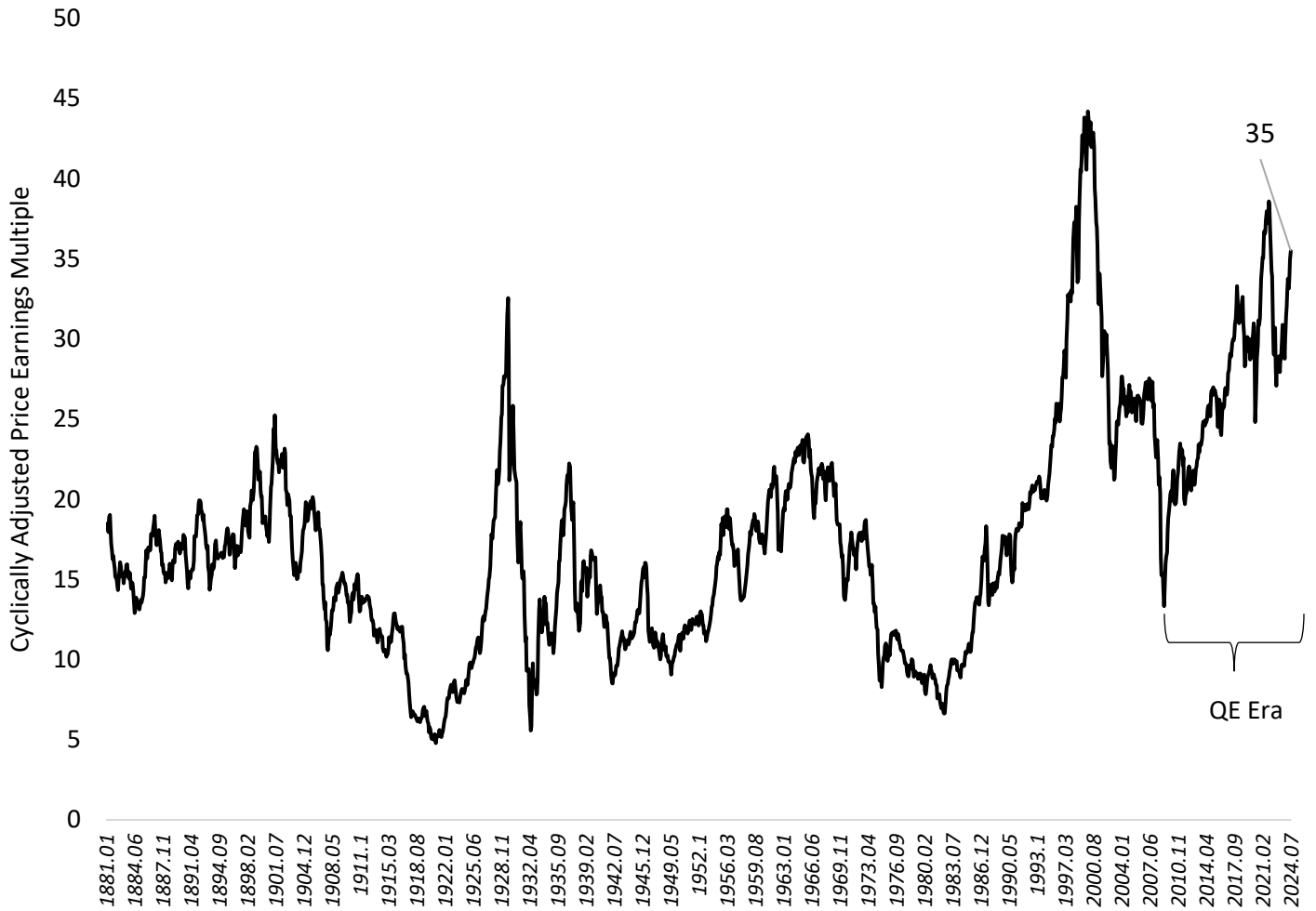
- *Smart and prudent investors are spending money to price assets*
- *Assets prices reflect fair values because smart investors are pricing them efficiently*
- *Free ride on the work of others by buying the efficiently priced index basket*

Uniquely, part of what is responsible for our success was founded on the concept that an attention to cost matters in two facets:

1. Paying a reasonable price for your investment management
2. Paying reasonable prices for the underlying investments themselves

We have created a business model advocating that these two concepts do not need to be mutually exclusive. That said, the active investment management crowd forgot about #1, often charging unwitting investors 250 basis points annually for mediocre results. This cohort has atoned for its sins over the past decade. We would also contend, that the passive investment crowd is making another, quite possibly as critical, mistake on #2. The Shiller p/e ratio on the following page highlights the nosebleed valuation premium on S&P 500 as at July 2024. The Shiller P/E ratio looks at stock multiples and adjusts earnings for a business cycle. Its creator, Robert Shiller won a Nobel Prize in Economics. The ratio has been shown to demonstrate predictive power over longer periods of time. The deductive reasoning here: **If you overpay for a company, your returns will be lower in the future.**

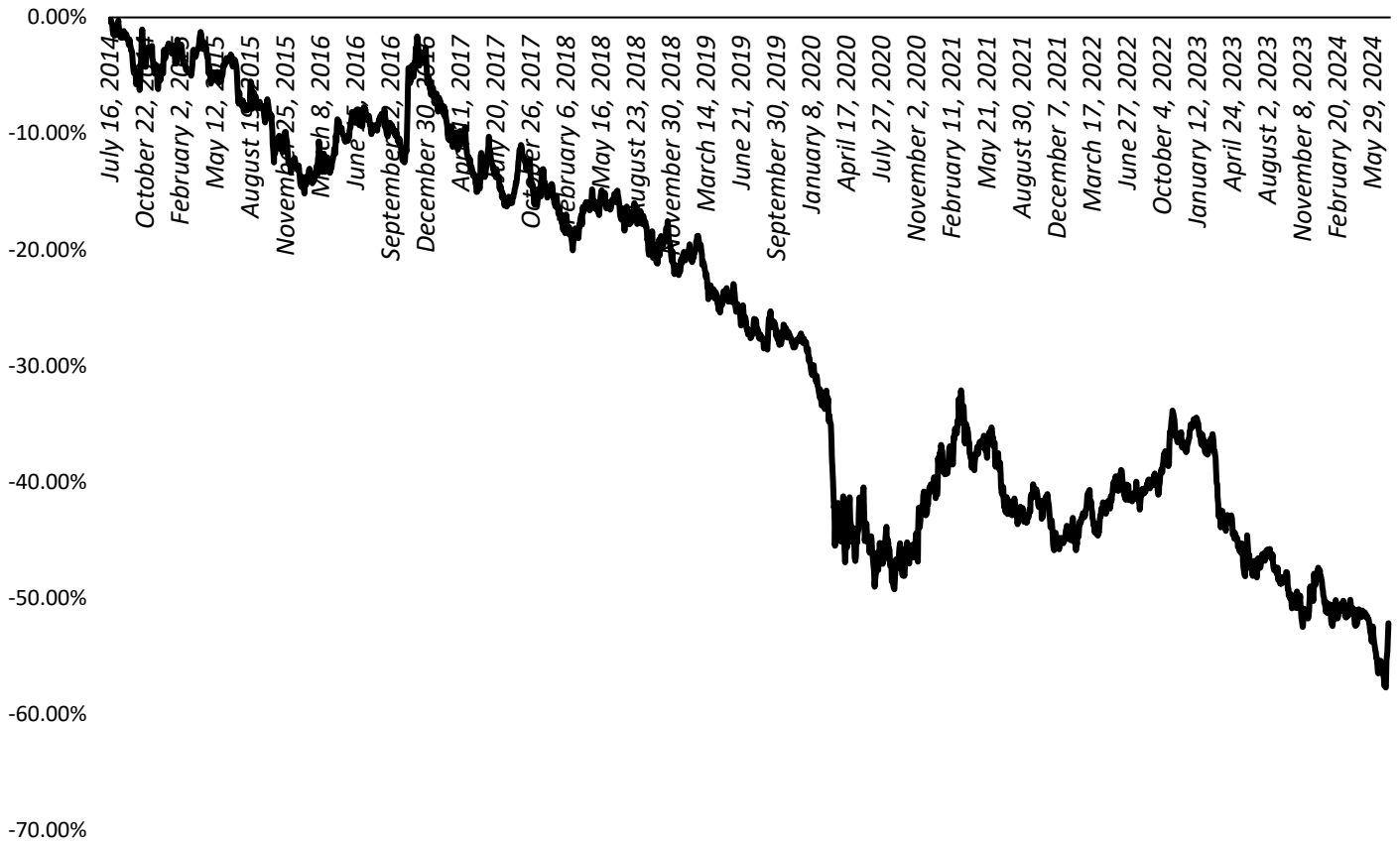
Shiller PE Ratio - US Stocks



Source: Robert Shiller, Yale University, June 2024

The price insensitive bid from the passive investment buyer, coupled with the Federal Reserve’s liquidity injections, have created a very risky situation for investors. These structural phenomenon in the market are causing distortions within equities. If we explore the return of the Russell 2000, vis-à-vis, the NASDAQ, we can see that megacap technology stocks (beneficiaries of a market cap weighted index inflow) has outperformed the small capitalization stocks over the past decade by roughly 5,200 basis points. This is a dramatic delta in outperformance of the NASDAQ given these indexes would be expected to earn a similar equity risk premia over the long term. To be sure, some of this is based on fundamentals: earnings growth, revenue growth, balance sheet strength. Some of this may even have a reflective component: The NASDAQ receives passive allocations not based on the underlying merit of the business. Said capital lowers the cost of capital for the companies in the NASDAQ and as a result improves profitability.

Total Return of Russell 2000 vis à vis NASDAQ



Source: Refinitiv Eikon, July 16, 2024, Russel 2000 Vs. Nasdaq, Total Return USD

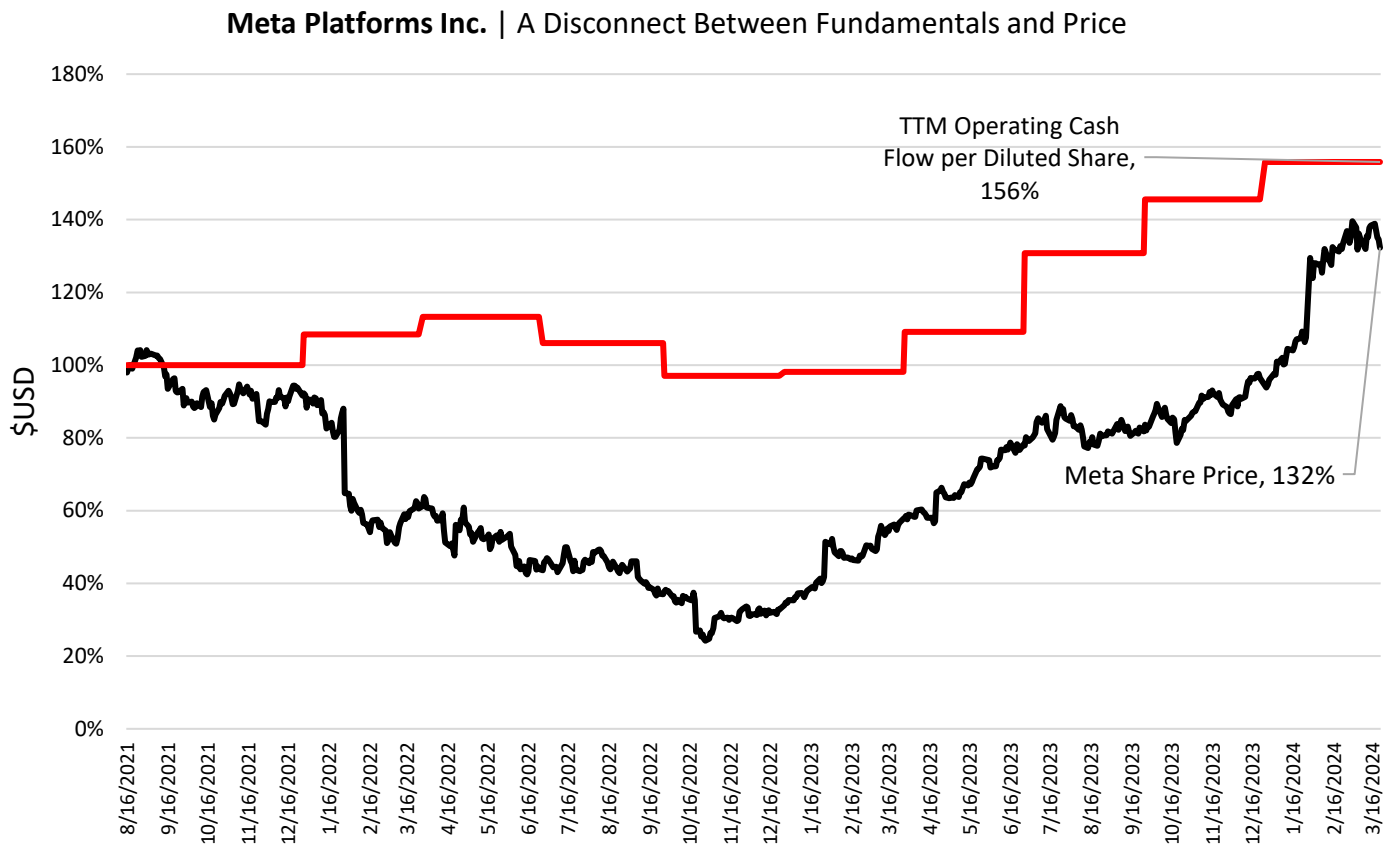
This market structure creates a risky environment for investors. One successful strategy under a certain paradigm might lead to financial disaster in another. What we believe the current market structure discussed above causes is instability.

Nassim Taleb describes instability in a different way in *Antifragile*:

Some can be more intelligent than others in a structured environment—in fact school has a selection bias as it favors those quicker in such an environment, and like anything competitive, at the expense of performance outside it. Although I was not yet familiar with gyms, my idea of knowledge was as follows. People who build their strength using these modern expensive gym machines can lift extremely large weights, show great numbers and develop impressive-looking muscles, but fail to lift a stone; they get completely hammered in a street fight by someone trained in more disorderly settings. Their strength is extremely domain-specific and their domain doesn't exist outside of ludic—extremely organized—constructs. In fact their strength, as with over-specialized athletes, is the result of a deformity. I thought it was the same with people who were selected for trying to get high grades in a small number of subjects rather than follow their curiosity: try taking them slightly away from what they studied and watch their decomposition, loss of confidence, and denial. (Just like corporate executives are selected for their ability to put up with the boredom of meetings, many of these people were selected for their ability to concentrate on boring material.) I've debated many economists who claim to specialize in risk and probability: when one takes them slightly outside their narrow focus, but within the discipline of probability, they fall apart, with the disconsolate face of a gym rat in front of a gangster hit man.

Nassim Nicholas Taleb, *Antifragile: Things That Gain from Disorder*, 2012

The chart regarding Meta in 2022 highlights this fragility. How on Earth can a company with zero net debt, whose operating cash flow dropped 2%, see its equity value drop 76%!?



Source: Refinitiv Eikon, July 16, 2024, Meta Platforms \$USD, Base TTM OCFPDS of \$18.62 USD, Base Share Price of \$366.56 USD

We do not think either passive or active investing is wholly going away. Conversely, just the ebb and flow of capital to either strategy may not be one directional as it has been in the past decade. Today, the true capital allocators (the kinds passive investing rely on for market integrity), are a rare breed. **Sometimes good things come to an end.** In this section, we are going to review some of the structural challenges faced by purely passive investors today regarding market dynamics.

Lasse Heje Pedersen highlights in his paper, ‘*Sharpening the Arithmetic of Active Management – Financial Analysts Journal 2018*’ the hara-kiri inevitability of purely passive management:

To level the playing field for passive investors, can’t we simply ban active management from IPOs? Well, even if we could, this would not work. To see why, suppose that only passive investors could participate in IPOs. Then they would get 100% of the shares and, as discussed above, they would lose to active investors if the passive needed to sell part of the shares in the secondary market. What if we ensured that everyone was passive in both the primary and secondary markets? In this case, all shares would be bought in every IPO at whatever the offer price because no investor would perform security analysis and every investor would simply request his fraction of shares (the same fraction that he or she owned of the rest of the market). This indiscriminate buying might initially lead to a fantastic IPO boom at high prices as most anybody could take a company public at any price.

Ultimately, when many of these new, “opportunistic” companies go bankrupt, the confidence in the financial system would quickly vanish as investors would exit from the market, leading to a collapse in security prices, a complete halt in new issues, even for good companies. The economy would then come to a grinding halt. In summary, in order for investors to be willing to buy new securities, these securities need to be sold at fair prices. To set fair prices, some investors must be active and collect information about the securities. Hence, when we take into account that capital markets are also about raising capital, we see that informational efficiency, which requires active investors, can have a significant positive impact on the real economy.”

Passive markets rely on active participants to price securities. **Small changes in market dynamics can have significant impacts in the resulting price.** Anecdotally, the Greater Vancouver and Toronto real estate markets have had outside price influence from a relatively small percentage of price agnostic foreign buyers. Xavier Gabaix and Ralph Koijen discovered in their research, “In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis,” that, “Investing \$1 in the stock market increases the market’s aggregate value by about \$5.” Gabaix and Koijen conclude that, “this paper finds, both theoretically and empirically, that the aggregate stock market is surprisingly price-inelastic, so that flows in and out of the market have a significant impact on prices and risk premia.”

So we can deduce two items:

1. *Passive investments are price agnostic*
2. *New capital flows have had pronounced impacts on financial prices*

As practitioners, we can attest to item #2. Selling one percent of the outstanding shares (float) can disproportionately impact on the price of a security. **In conclusion, we have gone through a structural period over the past fifteen years where an increasingly enormous block of price agnostic buyers is influencing the price action of securities.** According to Adam Sabban of Morningstar Research, US passive equity fund values closed above active at the end of 2023 for the first time ever (both at roughly thirteen trillion USD). This theme is something we celebrate and are fully expecting to exploit the dogmas pernicious impact for the average investor over the coming decades.

The presupposition of passive management, as noted previously, is the efficient market pricing provided by informed buyer and sellers. What happens if the service provided by the active community no longer exists *en masse*? We expect this to cause mispricing. While passive investing fund flow growth has been self reinforcing, the 2nd derivative (rate of change of the rate of change) we expect has gone negative. What happens when a positive feedback loop turns negative? A disconnect between the price of a business and its underlying fundamental intrinsic value. For an active investor, this is truly manna from heaven.

PORTFOLIO CONSIDERATIONS AND FINAL THOUGHTS

The world has entered the Age of Consequence. Rather than see the world for what we want it to be, we recognize the need to see the world for what it is. As described, we are entering a period of both financial and armed conflict. These conflicts have been brewing for decades and policy makers have been using financial, social and monetary policies to mask symptoms of the underlying issues. Armed with pragmatism and data, we can mitigate cognitive mistakes, such as normalcy bias.

We recognize it is uncomfortable to even discuss objectively what is really happening. That said, we are committed to the truth because it matters. This commitment has helped us to protect your net worth from the confiscatory impacts of inflation. Moreover, this commitment has helped us to avoid crisis such as the significant sell off in sovereign debt in the previous two years. A real-world example of this is our pivot into physical gold bullion which was a watershed moment for our asset allocation process. While uncomfortable at the time, it was our willingness to follow the data that allowed us to act for your best interests. Working at the intersection of data and history, we will continue to seek the truth to protect and preserve your wealth.

Thank you to our Harmony Wealth Team:

Michelle, Meagen, Niki, Shelby, Veronika, Anne, Ghada, Amy, Eleanor, and Natalia.

We could not be prouder of this passionate group that is tirelessly committed to serving our clients.

A special thanks to our partners: the analysts, commercial and private bankers, planners, lawyers and accountants that help serve our clients every day. We know that good financial management is a continuous and consistent process. We could not do it without you. Thank you for your flexibility, diligence, and the amazing work you do.

Despite the challenges we see in the world today, the focus of our team remains unchanged. We will continue to build and champion an ethical practice focused on:

- 1. Understanding each client*
- 2. Having an attention to cost and eliminating perceived or potential conflicts of interest*
- 3. Executing on our wealth management promise to provide personalized tax, estate and financial planning*

Most importantly, we thank you, our clients, for allowing us to be the financial stewards of your monetized life's work. Your long-term orientation will allow us to help you achieve those goals most important to you.

Grounded by a strong sense of ethics and responsibility, we work every day to preserve your wealth. Thank you for your continued confidence.

Please do not hesitate to reach out if you have questions.

Yours Truly,



James K. Law, CFA



Jason Gifford, CPA, CMA



Kinny Dhaliwal, CFA



Chris Weiers, CPA, CMA

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