PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Stronger Trends Emerging in Q1

In our last quarterly Newsletter, we explored whether we were entering a new market environment due to inflation concerns, higher interest rates, and downward pressure on asset prices. These trends persisted in the first quarter of 2022 (Q1), and significantly impacted bond and equity market performance. We will therefore comment further on these trends, as well as discuss a selection of recent transactions in our three discretionary portfolios – the Balanced Portfolio, Total Return Portfolio and High Yield Portfolio. We must reflect on the potential duration of these trends and what might come next.

Invasion of Ukraine

It seems foolish to attempt to predict the outcome of Russia's Ukraine invasion when the whole event seems largely driven by the motivations of one man - the Russian President. This invasion has pushed energy and fertilizer prices significantly higher and has had a significant impact on the global economy. Russia is an important exporter of these commodities and is now facing sanctions. We have made some minor portfolio adjustments in response to the invasion, which are discussed further below under "Selected Transactions".

Uncomfortably High Inflation

Inflation is now a regular topic in the media, as it has begun to noticeably impact daily life. While politicians and central bankers have attempted to speak reassuringly about it, inflation is uncomfortably high. It causes great harm to the many people living on moderate or fixed incomes. It can also reduce overall prosperity and harm savers and investors the longer it persists. We will need to think from multiple perspectives to successfully navigate this period of inflation. It is helpful to notice which assets are inflation beneficiaries, but reflexively buying them is too simplistic. We are also evaluating the assets being harmed by inflation to determine when they might become a bargain for a longer-term investor.

Causes of Inflation

The primary cause of high inflation in North America has been the massive amount of money printing and government spending during the pandemic. An important secondary cause is the continuing problems with the global supply chain. Recent patchy lockdowns in China have extended the disruption. Also, the Ukraine invasion is causing commodity price surges on top of the other problems. Finally, worker preferences are also contributing. The North American workforce is aging and there is an ongoing wave of retirements. With shortages of workers in some sectors, wages are rising, and these wage increases will not be reversed.

Fighting Inflation with Higher Rates

While supply chain issues and worker shortages are likely to persist in the coming months, the primary cause of inflation – the money printing and overspending – is slowly being reined in. For example, on April 13, the Bank of Canada raised its key overnight interest rate by 50 basis points (half a percent), and many expect another 50 basis point increase in June. To understand the significance of these developments, consider that the Bank of Canada last raised rates by 50 basis points in May of 2000, almost 22 years ago. Every other rate hike since then was only 25 basis points (a quarter of a percent). The Bank of Canada also intends to begin quantitative tightening soon, meaning that the government bonds it had purchased to provide economic support will no longer be replaced when they mature.

Central bankers were perhaps engaging in wishful thinking about this period of inflation, stating that they expected it to be transitory. They are now admitting that it seems to require significant monetary tightening. They may be losing credibility with investors and the general public for being “behind the curve” – slow to act in the face of inflation. If they overreact and tighten too far, we could eventually face recession, as typically the effect of rate hikes is only seen after a lag time of several months.

When will Inflation Subside?

It is too early to say when this period of high inflation will subside. Looking at structural factors in the North American economy provides guidance. Generally Canada and the U.S. have aging workforces and households are highly indebted. There is already anecdotal evidence in our business of individuals changing their decision process regarding investments, real estate purchasing and auto financing. In other words, a series of large interest rate hikes (combined with quantitative tightening) will likely have a major impact on reducing inflation and potentially economic growth in North America. Investors are now all wondering how high rates will go, and how fast they will get there. Looking at equity and bond market reactions in April, high inflation and higher rates have started to become bigger issues than anticipated at the start of 2022.

Impact on Equities

Recent shifts in equity prices suggest a growing investor preference for near-term profits. This is not a bad thing for our style of investing. We aim to purchase high-quality companies at undervalued prices, and many of our holdings are expected to generate substantial near-term profits.

On the other hand, many fast-growing and highly-valued companies that are positioned for large profits many years from now have declined substantially in recent months. The logic of this shift in investor preferences is somewhat sound, as inflation reduces the value of profits to be realized many years from now, and higher interest rates give investors alternatives for excess cash.

Being somewhat contrarian, and attempting to think multiple steps ahead, we are increasingly reviewing opportunities among higher-growth companies, including in the technology sector, without making any major commitments to date. Logically, as innovative faster-growth companies get cheaper, and well-established slower-growth companies become more richly valued, at some point there will be minimal advantage to favoring the latter.

Advancements in technology will proceed despite fluctuations in inflation and interest rates. The hard part is finding a good entry point in a fast-growing company that is declining rapidly in value. We will have to add to these types of opportunities in stages and focus on long-term value, as the short-term results will be volatile.

Selected Transactions

Fertilizer producer Nutrien has been a large winner in our Total Return Portfolio and High Yield Portfolio, partially due to the Ukraine invasion, and partially because we bought an improving company at a low valuation. On March 22, we trimmed the position in both portfolios at $130.67 per share, representing a large gain over our cost bases in the $50-$60 range. Nutrien remains a 1.4% position in each portfolio following these transactions. The company is the one of the largest fertilizer producers in the world. Its customers are agriculture businesses such as farmers. In addition to producing potash, nitrogen and phosphate fertilizers, Nutrien has numerous retail locations, mainly in North America. While fertilizer producers outside of Russia may be able to expand production in the coming months and years, it will not happen instantly, and it will require capital investment.

It has been an interesting few years for Pfizer Inc. (US:PFE). We became interested in the company around the time it announced its plan to spin off its generic drugs into a separate corporation now called Viatris (US:VTRS). We believed this transaction would refocus the company on innovation and result in faster growth. Our purchase prices from a couple years ago were in the US$30 range. Recently we have sold out of Pfizer entirely in the Balanced Portfolio and High Yield Portfolio, with sale prices around US$50. The enormous revenues from Pfizer’s Covid vaccine brought a lot of gains in the shares forward, while also creating a new risk – the unsustainability of vaccine cash flows. We would potentially consider owning Pfizer again if it traded

at a lower level that does not assume an endless income stream from a vaccine against an ever-mutating virus that is now far less deadly than it was in early 2020.

Starbucks Corp. (US:SBUX) is an example of a faster-growth high-quality business that has been affected by the pandemic, and also the prospect of higher rates. At US$120, Starbucks looked a bit pricy as a long-term hold, despite its industry-leading digital loyalty program and exceptional profitability. As the stock has declined, we have been purchasing small stakes in our Balanced and Total Return Portfolios. With the stock currently around US$78, we are down on our initial purchases, but may have the opportunity to build a larger position if it continues to decline towards undervaluation.

Salesforce.com Inc. (US:CRM) is another faster-growing business that we have been accumulating in the Total Return and Balanced Portfolios as its shares come down in the current market. Salesforce has become a dominant cloud-based provider of customer relationship management software. The company's software is an integral part of operations for numerous large customers. We expect earnings and revenues to grow at 10% or more per year for the next several years. Although Salesforce shares have been quite volatile lately, we view the company as a much safer investment than many fast-growing technology companies with less market dominance and no near-term earnings.

We have accumulated a small weighting in Intel Corp. (US:INTC) in both the Total Return Portfolio and the High Yield Portfolio. This semiconductor maker pays a significant dividend and has been trading at a fairly low valuation in recent months, in part due to the company's lack of leadership in cutting-edge chip development. The history of the semiconductor industry has involved frequent shifts in industry leaders. We believe Intel will remain a formidable competitor, and has an opportunity to gain back a competitive advantage with its planned construction of new semiconductor fabrication plants in North America.

Finally we will mention a couple of precious metals sector transactions. In our Total Return Portfolio, we purchased shares of Barrick Gold Corp. (TSX:ABX) at a price of $25.10 per share on February 8 and sold the entire position on March 8 at $33.07. The gain of 32% in a month was large enough to convince us to move on far faster than we had expected. Barrick has recently been engaging in debt reduction and has improved its dividend policy, making it more attractive to investors. We may have an opportunity to repurchase the shares in the coming months.

In our High Yield Portfolio we reduced our position in Newmont Corp. (US:NEM) on April 12 at a price of US$82.45. Newmont remains a small position in the High Yield Portfolio and is the only precious metals company in that portfolio, in part due to its substantial dividend. The harsh reality of investments in the mining industry is that many of them are not "buy and hold forever" investments due to the incredibly wide swings in commodity prices and the depleting nature of their assets. Therefore, our hold period in this sector has tended to be shorter than our hold period in other sectors like healthcare or financial services.

Conclusion

This Q1 edition of our Newsletter provides our updated views on various key trends impacting markets in 2022, including higher inflation and increasing interest rates. Our philosophy of buying high-quality businesses trading at undervalued prices remains the same through different market environments, but our candidates for purchase are constantly changing. We will continue to look for opportunities that fit our philosophy. Perhaps this year will offer more opportunities in fast growing businesses, as those have been driven way lower by investors in recent months. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Newsletter, and thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORTFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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