PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Three Essential Themes

Three themes have been essential to understanding the financial markets in recent months. The first is high inflation and rising interest rates. This theme has weighed heavily on markets but has also created opportunities, which we will discuss below. The second theme is the global energy transition. While Europeans are already facing this issue as part of their daily lives, investors around the world will need to understand the basics. Finally, globalization appears to be receding. Mainly for political reasons, global trade and investment patterns will be realigned in the coming years. We will devote this third quarter of 2022 (Q3) edition of our Newsletter to discussing these three themes, and some of opportunities and risks they create.

Inflation and Rising Rates

Uncomfortably high inflation is mainly a negative for investors, but it also can create opportunities. Central bankers around the world have now been raising interest rates for many months in an attempt to reduce demand, slow economies, and ultimately bring inflation down to more comfortable levels.

On October 26, the Bank of Canada raised rates by another 50 basis points (half of a percent) and indicated that more rate hikes are still likely. The majority of the necessary rate hikes may now be complete for this cycle, but further rate hikes will be consequential. Clients should understand that the rate hikes are part of a cycle which typically peaks when the economy wavers. Many investors are attempting to predict when rates will peak and central banks will "pivot" towards cutting rates again.

We do not have precise views on when a pivot will occur. This rapid rate hike cycle will have a large economic impact on mature economies globally, as there are large debts at every level of society, and many borrowers became accustomed to extremely low rates. For example, U.S. 30 year fixed rate mortgages are above 7%, which will force some to back away from home purchases. In Canada, 5 year fixed mortgage rates are hovering around 5.5%, and various bank research departments are projecting significant home prices declines. Housing is an important part of the North American economy, especially since home price performance affects consumer spending.

So far, there are no clear indications in North America that central bank rate hikes are substantially reducing inflation. This lack of clarity has fueled the current risk aversion among investors. Some investors fear that the central banks could go "too far too fast" with the rate hikes and cause a significant recession.

This possibility has to be considered now that central bankers have lost some credibility with the public. They called high inflation "transitory" when it first emerged, perhaps out of wishful thinking. It now seems that the peak for rates will have to be significantly higher than most expected in the Spring of this year. We could easily see further rate hikes in early 2023, and a more significant economic slowdown or recession than previously anticipated.

The rate hike cycle has created some opportunities for investors. For example, investors who need income can now get higher interest on bonds and, in many cases, higher dividends on beaten-down equities. An especially attractive opportunity may arise around the time of a central bank pivot, as investors may be able to purchase higher yielding investments that continue to pay good income while interest rates start to fall. The timing will be tricky, but we may add these types of holdings in stages, especially in our High Yield Portfolio.

For growth investors, there have been massive declines in technology and consumer discretionary equities partially caused by inflation and higher interest rates. In general, investors are now favoring strong near-term cash flows over speculative longer-dated cash flows (money now vs. money later), and this shift has disproportionately hit growth equities. While this may seem like an obvious trait for investors to favor, in 2020, during the worst of the pandemic, we saw numerous unprofitable technology companies trading up to extreme levels due to a combination of future growth potential and irrational speculation.

Declines in technology and consumer discretionary equities have created some buying opportunities, but we have to view these declines in context. For example, some of the worst performing technology equities of 2022 had multiple years of exceptional returns before this year began. This means that we have to be careful about what we consider undervalued. To find real opportunities that fit our strategy, we focus on the highest-quality holdings with good growth potential and strong current profitability. The more speculative companies will not be candidates for our portfolios.

Looking at the theme of inflation and interest rates generally, we do believe that central bank rate hikes will help tame inflation, largely because a highly-indebted society probably cannot maintain high demand in the face of such rapid rate increases. We are unsure of exactly how soon the inflation readings will head significantly lower, but we believe we can make adjustments to take advantage of the opportunities that emerge.

The Global Energy Transition

There are global efforts to achieve a multi-decade transition towards renewable energy. We can only briefly touch upon the topic in this Newsletter. The Russian invasion of Ukraine has exposed vulnerabilities in the transition, and has, at least in Europe, created an energy crisis. These difficult times may lead to more realistic energy policies, a positive outcome.

There are several factors that created the current European energy crisis. One was the decision by countries like Germany to trust Russia to be a reliable energy supplier. That trust was misplaced, and it is not easy to rapidly switch large-scale natural gas suppliers. For example, a country cannot build additional liquified natural gas import infrastructure in a matter of months.

Secondly, some political forces in Europe (and in other countries) have demanded a rapid transition to cleaner energy sources including a reduction in fossil fuel use and the closure of aging nuclear facilities. The harsh current reality is forcing reconsideration of the speed and details of this transition. Outside of Europe, other countries must now clarify their energy policies. For example, decisions to restrict highly-regulated energy production in North America are now under more scrutiny. Some are arguing that North American natural gas is a cleaner energy source in the medium term than, for example, coal, which will be burned on a larger scale in Asia if our natural gas production cannot reach global markets.

Lately, Canadians seem to be having more realistic conversations about our own long-term energy needs. According to a recent Globe and Mail article, "a recent report from Royal Bank of Canada predicted Canadian electricity consumption will rise by 50 per cent over the next decade alone. Earlier this year, one by the Canadian Climate Institute said the nation's electricity generation capacity will need to grow between 2.2 and 3.4 times larger by mid-century than it is today. Last year, another report by the Institut de l'énergie Trottier – Polytechnique Montréal said electricity production from variable sources such as wind and solar must grow dramatically to achieve net-zero objectives. The investment required to build all that capacity has been likened to wartime spending. But Canada's major utilities aren't preparing for anything of the sort. Nor are major planning bodies… telling them to."[i]

It appears that we have not been following through on our good intentions. Assuming that we do some of the capital investment necessary to transition towards renewable energy, this will create immense investment opportunities, and we already own some of the companies that we believe will play important roles.

Receding Globalization

Ever-increasing globalization of trade was a strong trend for many decades, but it has stalled or started to recede in recent years. The deterioration of the relationships between western democracies and both China and Russia has been the primary source of deglobalization sentiment. The political winds have now definitively shifted. North American and many European countries have decided to direct more trade to countries with shared democratic values. Even so, political intentions do not translate immediately into economic results, as demonstrated by energy transition difficulties.

At this point, low-cost Chinese manufacturing is essential to supply chains for many products. It is foolish to think other suppliers could replace China overnight, especially at current prices for goods. If globalization breaks down in a disorderly fashion, inflation could soar, or at least stay stubbornly high. Therefore, the theme of receding globalization will be important to watch. Recent examples would include the U.S. placing restrictions on the sale of certain cutting-edge semiconductor equipment to China, and Saudi Arabia being unsympathetic to the current U.S. administration's requests for lower oil prices. The partial destruction of the Nord Stream pipelines bringing Russian natural gas to Europe is also arguably an example.

If globalization continues to recede, there could certainly be investment opportunities in the rebuilding of supply chains in more friendly countries. We may not fully understand the implications of this theme for several years.

Conclusion

Thank you for reading this Q3 edition of our Newsletter. It appears that the coming months could be volatile and also full of opportunities. 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 that philosophy.

Regarding the essential investment themes discussed above, there are no simplistic strategies to address them all. We will need to think from multiple perspectives to successfully navigate this period. We will remain fully engaged in the search for high-quality opportunities of all kinds.

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.

[i] https://www.theglobeandmail.com/business/article-canada-electricity-expansion/