PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Are We Entering a New Market Environment?

North American equity markets performed well during 2021, despite facing numerous risks. We are pleased with the 2021 performance of our three discretionary portfolios, and we believe that our holdings are still promising for the coming years. That said, we have to remain vigilant, as we may be entering a new economic and equity market environment.

During the past decade, inflation was often moderate or disregarded. Interest rates held relatively steady or even trended lower. Equities frequently benefitted from multiple expansion (investor willingness to pay higher and higher amounts per dollar of revenue and earnings). Capable employees were often abundant, and global supply chains functioned efficiently. Recently, all of these factors have changed.

We will therefore devote this fourth quarter (Q4) edition of our Newsletter to discussing the broader economic picture and the implications for our investments.

Inflation

The financial media is full of articles about inflation and interest rates. Many clients experienced the 1970s and early 1980s economy and need no reminder of the importance of these issues. For younger clients, we will note that sustained high inflation is incredibly destructive, and can even lead to extreme wealth inequality and political instability, such has occurred many times in Latin America.

The current high inflation rates in North America have several root causes. The primary cause is the massive amount of money printing and government spending during the pandemic. This appears to have been overdone, since the North American economy adjusted rapidly to any pandemic restrictions. The second root cause is the fractured supply chain for manufactured goods. Damage to the supply chain included Asian factory closures, disorderly container shipping, clogged ports, and trucking limitations. These problems have not been fully resolved.

Worker preferences are also contributing to high inflation. Some workers opted to retire rather than deal with pandemic hassles. Some workers moved away from large urban centers for lower housing costs. Many workers chose to receive government payments rather than look for alternative work. With shortages of workers in some sectors, wages are rising, and these increases will not be reversed.

Overall, the Covid pandemic has been an inflationary, rather than deflationary event. We believe the pandemic is almost over, with the weaker Omicron strain now dominant. For example, on January 19th, the U.K. announced a removal of most of its Covid restrictions. Had Omicron had been the initial strain of the pandemic, it is possible that many of the Covid policies would have been unnecessary.

Regardless of the causes, the unfortunate reality is that inflation is harmful to Canadian's household budgets and investments.

Interest Rates

Many policy makers view higher inflation levels as a tool to reduce government debt burdens. They are playing a potentially dangerous game, as bond investors must willingly play along. If enough bond investors refuse to lend at low rates to governments like Canada, there will be trouble. Central banks are therefore being pressured to raise interest rates significantly to maintain price stability. The effect of high interest rates on asset prices, such as equities, real estate and longer-term bonds, could be quite negative.

Recent shifts in equity prices, which have largely been to our advantage, suggest a growing investor preference for near-term profits. Investors, in other words, are favoring companies with higher earnings right away, and selling down many fast-growing and highly-valued companies where large earnings are expected many years down the road. This has benefitted sectors like banking, where higher interest rates can lead to higher returns on loans. Sectors harmed include fast growth technology, where high market valuations rely on distant future projections, as today' revenues and profits aren't very impressive. Of course, this "rotation" in the market, like the many recent trends towards "work-from-home" equities and Covid beneficiary equities, may not last.

The consensus belief is that we will face multiple rate hikes in both Canada and the U.S. within 2022. Some economists believe our central banks are "behind the curve," meaning that they should have started raising rates earlier, and they are now risking an even worse inflation problem. We tend to agree. Will this year's rate hikes successfully tame inflation?

We cannot offer a clear answer to that question, as there are other factors at play. We are living in an aging and highly-indebted society that depends more than ever on high asset prices for its sense of prosperity. A few interest rate hikes may have a larger than expected effect on real estate and equity prices this time around. Healing of the supply chain can also restrain prices. It therefore seems unwise to fully commit our portfolios to the theory that inflation will stay high indefinitely. It is hard for us to imagine Canada and the U.S. becoming fast growth economies post-pandemic. If a recession occurs in the next couple years, we may even hear talk of deflation again.

Wages could easily become a stubborn component of inflation in the coming years, but deservedly so. Many workers' income has lagged the cost of living for decades, so their discontent is unsurprising. Energy prices are another important variable in the inflation and interest rate discussion. Oil prices are now flirting with levels that could both raise the cost of goods and slow global economic growth.

Energy Sector

US$100 oil prices are easily possible in 2022 as the global economy gets back on track. Energy sector equities have therefore been trending higher for good fundamental reasons.

According to research firm Rystad Energy, 2021 global oil and gas discoveries were the lowest since 1946.[i] 2021 discoveries of 4.7 billion barrels of oil equivalent (boe) are also far lower than 2020 discoveries of 12.5 billion boe. Why are we finding so little oil?

Oil prices were so low during the worst of the pandemic that there was a disincentive for companies to spend on exploration. Also, large institutional investors are increasingly focused on environmentally sustainable investing. This is diverting capital away from the oil and gas sector. Capital may grudgingly return, but only if the near-term profit potential seems exceptionally high. The oil and gas industry is also losing the war for talent. Many talented people are now seeking careers in alternative energy or other fields, instead of risking a 40-year career in a potentially shrinking industry.

Oil and gas equities have been a conundrum for us. As we discussed in one of our recent newsletters, we intend to slowly shift client investments towards renewable energy, but we want the shift to be profitable for clients, not an ideological decision. Many of the best renewable energy companies already look fully valued, meaning that future shareholder returns could be mediocre. It also appears that oil and natural gas will remain critical to the global economy for decades. We currently have investments in both fossil fuels and renewables. If we had already shifted completely to renewables, clients would have missed out on the large recent gains in energy equities. If we invest aggressively into oil and gas equities now, we risk holding securities with questionable long-term economic value. So we will have to balance these considerations and make reasonable decisions.

Strategy

Even if we are entering a different economic environment, our strategy of buying high-quality businesses trading at undervalued prices will remain the same. The quality of a business can easily change over time. So can the attractiveness of an entire industry. Valuation can change much faster than quality, depending on market sentiment.

As mentioned above, in recent months, investors are favoring companies with higher near-term earnings and penalizing faster-growth companies with high valuations and unimpressive near-term revenues and profits. This has favored our strategy, but it may not continue for long.

We will consider purchasing faster-growth beaten-down technology equities if we can gain confidence that the 3-5 year returns are likely to be satisfactory to clients. We have not made any major decisions yet.

Regarding inflation, it is a serious issue for investors, but should not become an obsession. There are always investors who put inflation first by focusing portfolios on “inflation hedges” or “hard assets,” which can result in a lack of diversification.

A high-quality regular business can typically deal with inflation by passing on price increases to customers. The 100 year performance of high-quality equities demonstrates this, as returns have been incredibly high, far outpacing the massive devaluation of the U.S. and Canadian dollars. Clients should understand that we already have some “inflation hedges” and “hard assets” in portfolios, including real estate investment trusts, gold bullion, precious metals equities, and oil and gas equities. So we can shift weightings as needed, while maintaining diversification among various industries.

Conclusion

This Q4 edition of our Newsletter provides our views on a complex time in the North American economy. We could be entering into a significantly different environment. Our philosophy of buying high-quality businesses trading at undervalued prices will remain the same, but our candidates for purchase are constantly changing. We will continue to look for opportunities that fit our philosophy.

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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[i] https://www.offshore-energy.biz/oil-gas-discoveries-in-2021-to-hit-lowest-level-in-75-years-rystad-says/