MacNicol & Associates Asset Management Inc.

March 2023

The Monthly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snapshots of metrics, a section on behavioral investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the marketplace.

"Nature always tends to act in the simplest way…"

- Daniel Bernoulli, Swiss mathematician and physicist

The Numbers:

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Index:		**2023 YTD:**
S&P/TSX:		4.3%
NASDAQ:		9.4%
Dow Jones:		-1.5%
S&P500:		- 3.4%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	4.53%	4.99%
5-Year Bond:	3.60%	4.32%
10-Year Bond:	3.33%	3.97%
30-Year Bond:	3.18%	3.87%

Economic Data:

- North American yield curves invert
- US nonfarm payrolls and retail sales for January stronger than expected
- Bank of Canada pauses rate tightening
- Kazuo Euda widely expected to be the next Bank of Japan Governor
- Gold lower by $100 per ounce in February to $1828
- A broad basket of commodities also lower in February
- Canadian dollar lower by 1% in February

Valuation Measures: S&P 500 Index

Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	21	20
P/B: Price-to-Book	4.0	4.5
P/S: Price-to-Sales	2.3	2.8
Yield: Dividend Yield	1.7%	1.4%

2022 Year to Date Performance, by Sector: Feb 28th, 2023

S&P/TSX Composite	4.3%
NASDAQ	9.4%
Dow Jones Industrials	-1.5%
S&P 500	3.4%
Russel 2000 (Small Caps)	7.7%
MSCI EAFE	5.6%
Crude Oil Spot (WTI)	-4.1%
Gold Bullion ($US/Troy Ounce)	0.6%
SOX Semiconductor Index	16.7%
VIX Volatility Index	-5.0%

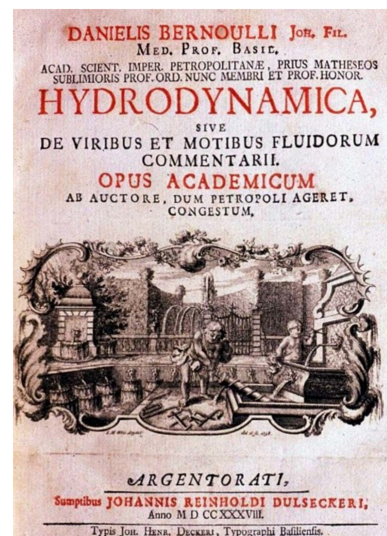
Source: Canaccord Genuity Capital Markets & Thomson Reuters

Foreign Exchange - FX

As of March 14, 2023 11:00 AM EST	$5,000	Cdn		
Banks	Rate	Buy USD	Cost	% Difference from Spot Rate
CIBC	No Public Rate Posted Online			
Interactive Brokers	1.366	$3,660	$2	0.1%
Laurentian Bank	No Public Rate Posted Online			
National Bank	1.4070	$3,554	$(105)	-2.9%
Raymond James	1.3663	$3,660	$1	0.0%
Royal Bank	1.3938	$3,587	$(71)	-2.0%
Scotia	1.4039	$3,562	$(97)	-2.7%
TD	1.4043	$3,560	$(98)	-2.8%
Canadian Snowbird	1.3735	$3,640	$(18)	-0.5%
Spot Rate	1.3667	$3,658	$-	0.0%

So simple, so *fluid*…

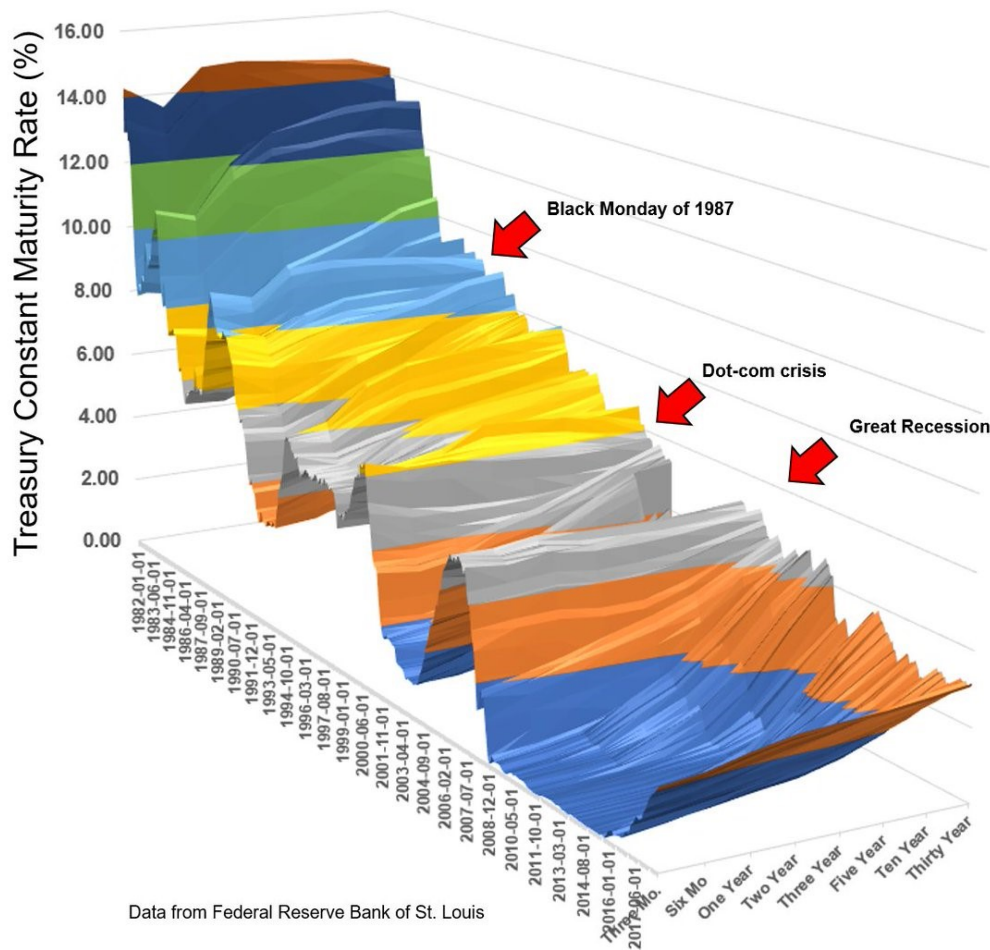
Daniel Bernoulli was a renowned Swiss mathematician and physicist, and the main architect of what most engineers today know as **fluid mechanics**. A member of the famous Bernoulli academic family: if it involved science, chances are, Daniel was quite good at it. His father Johann was one of the founders of modern Calculus and Calculus co-contributor Leonard Euler was actually Bernoulli Senior's pupil. And Daniel's uncle Jacob was a major contributor to probability theory and the discoverer of *e*, the mathematical constant known as epsilon $(1+1/n)^n$ or 2.71828. By the late 1720s, Daniel was already a household name in the academic world, but it wasn't until 1738 that Daniel's reservoir of fame changed from a drip to a deluge. *Hydromechanica*, Daniel's masterpiece on how the laws of physics can be applied to the study of fluids using the world's most perfect language – mathematics - was published in 1738 and it didn't just cement Daniel's legacy as a giant in the world of modern science, it demonstrated how traditional hardcore subjects like mathematics and physics could be applied to solve problems in the real world.


DANIELIS BERNOULLI Joh. Fil.
Med. Prof. Basil.
ACAD. SCIENT. IMPER. PETROPOLITANÆ, PRIUS MATHESEOS SUBLIMIORIS PROF. ORD. NUNC MEMBRI ET PROF. HONOR.
HYDRODYNAMICA,
SIVE
DE VIRIBUS ET MOTIBUS FLUIDORUM COMMENTARII.
OPUS ACADEMICUM
AB AUCTORE, DUM PETROPOLI AGERET, CONGESTUM.

ARGENTORATI,
Sumptibus JOHANNIS REINHOLDI DULSECKERI,
Anno M D CCXXXVIII.
Typis Joh. Henr. Deckeri, Typographi Basiliensis.

[With his preposterous 18th century hair and complicated, Latin-inspired fluid mechanics book, Daniel Bernoulli was one smart fellow.]

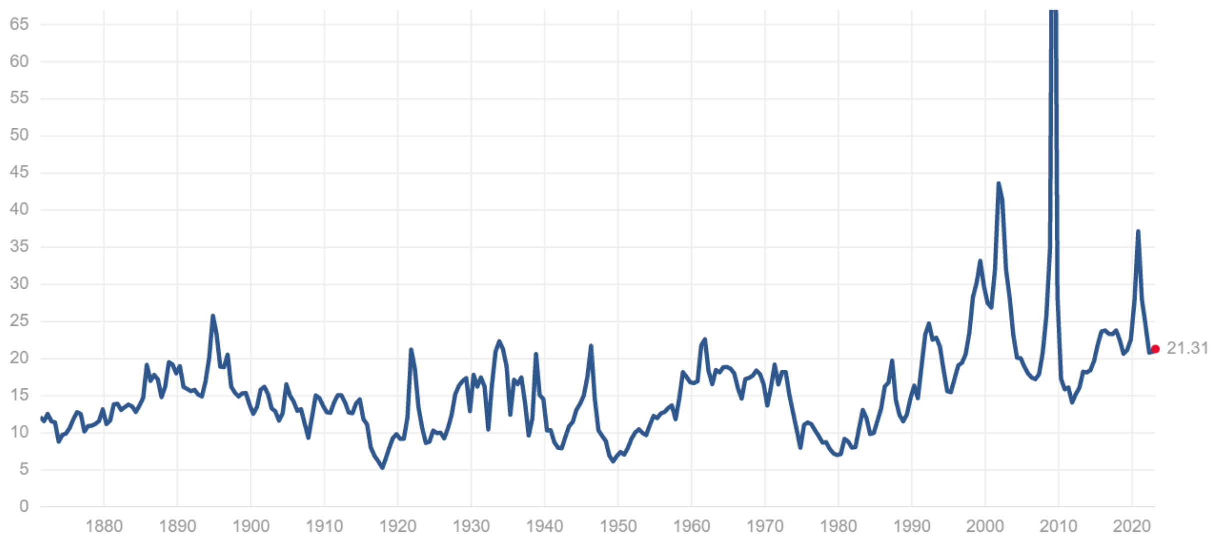
Today's central investing problems are something we have spoken about for years. And, we have prepared for this inevitability for just as long. Inflation and the higher and higher interest rates need to tame it are no longer just academic theory, they are modern investing reality. We believe that this new (investing) world order is coaxing investors into making choices they wouldn't have made just a few years prior. So why don't we tackle inflation and rates first. Roughly a year ago, most professional economists would have opined that inflation would quickly and gently "flow" back down to the 3% level that had, on average, run since the Ming Dynasty as supply chains normalized following the pandemic.



[Speaking of masterpieces check out this 3-dimensional term-structure chart of US treasuries from the St. Louis Fed. I really don't think there is a more perfect depiction of just how important changes in the slope of the yield curve can be to investors, and if I was the head of a prominent business school, meticulous study of this chart would be compulsory for all of my pupils.]

For whatever reason, we never quite accepted that inflation could simply "drain" back down to 3% in a world of *accelerating* wage pressures. In fact, we think that it will easily take all of 2023 and perhaps into 2024 to achieve a rate of inflation judged as acceptable by the majority of the world's major central banks. However, and we discussed this in a previous edition of *The Monthly*, we strongly believe that inflation has peaked. This view continues to be reinforced by data showing that price increases in things like food, fuel and materials (wood, brick, concrete and steel) have begun to moderate. Household inflation expectations continue to decline in Canada and the United States, and this has been a big positive for equity valuation multiples historically and will be again.

But just like the flow of water or any fluid for that matter, it will not happen in a straight line and may take longer than some investors might like, which could encourage hasty departures from time-tested investment strategies. Indeed, with short-term rates materially higher than they were just a year ago, there exists an undeniable temptation to abandon risk assets (stocks, private equity, hedge funds, distressed debt or commodities) for the perceived safety of bonds. Perceived because despite being off its highs, inflation continues to present a challenge to owners of investment capital. Perceived also because we never believed that either Mr. Powell or Mr. Macklem would cut rates this year, a view that many have simply rushed to accept. But it isn't actually that simple. Indeed the Bank of Canada is officially on hold while expectations for rate hikes in the United States gyrate between 50 and 100 basis points. Fundamentally we are closer to what Winston Churchill would call the end of the beginning of monetary tightening. The risk of phrases like *higher-for-longer* or terms such as *forceful* as they pertain to interest rates matters to equity valuations clearly, and bond prices. The trouncing bonds took in 2022 has certainly created significant amounts of value for fixed income investors, but a strategy predicated exclusively on bonds sounds more like dangerous pretense and less like strategy. With equities, we recommend a selective approach to stock sectors given the massive gap in performance and valuations we have seen over the last few years.



[At 21x next year's earnings, the S&P500 is neither dirt cheap nor outrageously expensive.]

Categorizing stocks into growth & value buckets is overly simplistic since earnings growth is the actual thing that increases a stock's value, and yet some sectors and stocks remain flagrantly overvalued such as technology and telecommunications businesses. On the other hand, several non-bank financials, industrials, consumer, energy, and basic material stocks are on our radar and in our portfolios. Those whose earnings power remains strong, and which are attractively valued both fundamentally and technically are places we go to first in our conservative investment strategy. Assuming we aren't wrong about technology and other areas, we think the Canadian stock market will outperform the S&P500 in 2023. A more optimal mix of industrials, financials and basic materials and energy names in this country compliments our mostly American private equity exposure in our Alternative Asset Trust. We are quite bullish on metals and energy because we think the trend of demand outstripping supply growth with Chinese manufacturing data reaccelerating and no end in sight to the Russian invasion of Ukraine along with a fundamentally undervalued Canadian dollar represent a variety of better options for investors to consider.

Stronger U.S. economic data (retail sales and non-farm payrolls) and grinding progress on American and European inflation fronts certainly drove a significant shift in the bond market in February. Investors came to the realization that inflation will be slower to trend back toward 3%, and a rate cut is almost totally out-of-the-question in 2023. With upside pressure on short-term rates now more noticeable, yield curve inversion reached a new cycle low not seen since the 1980s. The rising bond yields, however, led to a stark performance reversal that we feel is not fully appreciated by investors. January's gains were almost entirely lost during February. Do not for a moment allow January's movements in the bond market to lure you into thinking that the mechanics of investment strategy flow easily and fluidly from one month to the next. A typical fixed income portfolio yielding 4% should return 25 bps per month and even that is using textbooks dating back years. Last year's numbers for the bond market were so atrocious you'd not even want to include them in any textbook. January's 300 basis point punt.

Daniel Bernoulli said that nature always tends to act in the simplest way. But financial markets, and the mere mortals who study them, don't. In the same way that Bernoulli pioneered ways to think about fluids using mathematical equations, we believe we pioneered a way in which investors can safely and effectively incorporate conventional and alternative assets in a way that cements your financial legacy.

A serum for the mortgage industry

Occasionally, and only after the conclusion of a highly productive work week here at the firm, I sample high quality craft beer. My favorite craft is the IPA, which stands for "India Pale Ale", one of the more flavorful beer varieties. Ontario is arguably the epicenter of beer's renaissance and home to a vibrant and thriving craft beer industry. If you look carefully enough, you will find beers here that rival anything the world has to offer. One delectable IPA that makes my taste buds very "hoppy" is **Truth Serum**, a double-dry hopped IPA that packs a succulent, citrusy taste and which is quite rightfully the flagship of Toronto based Rorschach Brewing Company located on Eastern Avenue just west of Coxwell. Even in a land blessed with fantastic beer, Truth Serum really is a knockout. Rorschach's own website describes Truth Serum as "a nuanced bitterness with a hint of sweetness", and the tropical, grapefruit flavor is bite-the-back-of-your-hand good…especially on a hot, muggy Toronto day.

But with a name like *Truth Serum*, the inescapable question some of you might have is: will it actually make you tell the truth? Frankly, I am not entirely sure. But don't worry, my answer won't change if you ask me whether the quantity of Truth Serum consumed has any impact on one's honesty: IPAs like all alcohol should be consumed judiciously and this brings me to the Canadian mortgage industry. I suspect they have been drinking for quite a while now, and I worry the hangover might be pretty bad.

[Ratehub.ca tracks movements in Canadian mortgage rates and the movements seen in 2022 speak for themselves.]

In an effort to "keep the party going" lenders and realtors are actually encouraging prospective home buyers to throw caution to the wind by committing to their "dream" home even as most 5-year rates are now (deep) into the 5 percent range. Sure, 5.9% seems like a steep price to pay on an enormous principal balance that for many numbers in the *several* hundreds of thousands of dollars. But you can always refinance when rates come down…

Can't you?

Perhaps, but that certainly doesn't sound like prudent advice to me. First-time homeowners, especially people 12-15 years younger than me, may come to find that the strategy of: "But we can always refinance when rates come back down wink-wink, nudge-nudge" is a costly one.

My own sister, Elizabeth, is a long-time mortgage insurance pro, and she told me that over the past 10-years - meaning just prior to 2022's rate surge, rates averaged 3.7%. And if you have stellar credit, a level of income that gets you on the CRA's annual mailing list or assets by the barrel, your rate might have been much less than that. But that certainly doesn't imply that mortgage rates will plunge back down to earth anytime soon. As a matter of fact, and as alluded to in our opening piece, the bond market is beginning to price in higher (not lower) trend setting interest rates following stronger economic data, particularly in the areas of consumer spending and the labour market. Refinancing is also more complicated these days, and most mortgage brokers and real estate salespeople will only sell you on the upside of a refinancing (your rate going down) while leaving out the finer aspects of the closing costs charged to refinance. Closing costs typically include fees for origination, appraisal and title, and unless you yourself precisely model out how these and other costs impact your overall rate, you might find that the first several months of your new, "lower" rate mortgage, are actually spent 1st paying off those added costs. Promotions whereby a lender will pay for a percentage of your refinancing fees should rates fall within a certain time to me sound sketchy. Unless the lender making the promotion is deeply skilled in economics, particularly inflation, or has a very senior contact at either the Federal Reserve or the Bank of Canada (doubtful) they should not be relied upon.

We know some extremely good economists here at MacNicol & Associates, and in some cases even subscribe to their research services for asset managers. Yet, what we can tell you is that despite the walls of prestigious degrees or books written, few of the economists we use offer predictions on where mortgage rates might be even 12 months from now. There is simply too much going on at the present moment that could force the hand of central bankers and ultimately impact borrowing rates. One data point we can direct you to is Fannie Mae. Fannie provides liquidity to the market for single-family homes by purchasing and guaranteeing mortgage loans made by lenders and issuing debt securities and mortgage-backed securities that investors globally can buy, and they reckon that the average 30-year fixed rate will remain comfortably over 5% next year. Of course, Fannie Mae is an American organization for American home owners, but the simple mathematics of my point extend up here too: 5 is certainly less than 7, but only marginally less than 6 once other costs are tacked on. And another facet of refinancing that people do not give much consideration too, and which takes its cues from the auto industry is duration. When you refinance, you are effectively in a whole new mortgage, so enjoy.

[Single 20-something year old office worker just starting out, of course you should be driving a vehicle at least as expensive as the 60-year-old CEO of the company you work for. Besides do not trouble yourself about your first 3 lease payments, they're "on us".]

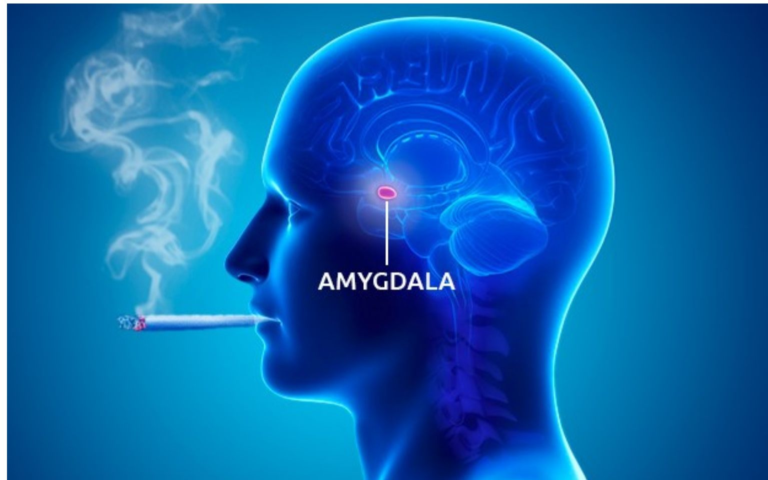
Mortgages of course are much more flexible these days and you can play around with the product's term from your desk. Choosing a shorter amortization period can help if you can swing it, but let's be realistic: do you really think that's a feasible strategy if the original mortgage was already putting the screws to your monthly budget? And what about the all-important equity piece? You certainly do not need to hit 20% in equity to qualify for "a rate" these days, but to get the **very best rate** you sure will. Buyers who purchased homes just prior to COVID might very well have a decent chunk of equity in their homes. Unfortunately, many buyers purchasing homes now will need significant discipline in their budgets to eventually hit the key 20% milestone. And even the stingiest borrowers might find hitting 20% challenging given the decline in home prices.

["Yosemite Sam" once pointed his guns at "Bugs Bunny" and said: *keep reaching for the sky until you reach it rabbit*. For many new home buyers, the dream of actually owning their own home is sadly up in the sky.]

The rouse in refinancing was for years a way of bringing back from the dead discussions lenders and realtors would have with their clients. But is the refinancing revenant finally dead? That we don't know. But what we can tell you is this: during the apex of the refinancing boom 3 years ago, homeowners who refinanced were able to lower their mortgage rates by well over one percent. Enough to absorb fees and expenses, and enough to take some of the pressure off. I really wonder whether we will see that sort of mass refinancing lending event again during my career. The mortgage industry seems to think so and that is why I wonder whether they could stand to benefit from a glass of Truth Serum or whether they have been overindulging for some time…

At MacNicol & Associates, we certainly appreciate that everyone's got to make a living. But we are also accountable to you, so that is why we believe that today's crop of homebuyers should be prepared for the sobering reality that they will most likely have to maintain the present higher rates on their mortgages for an extended period of time without bitterness. In some cases, ignorance is bliss, but in other cases it's just plan ignorance.

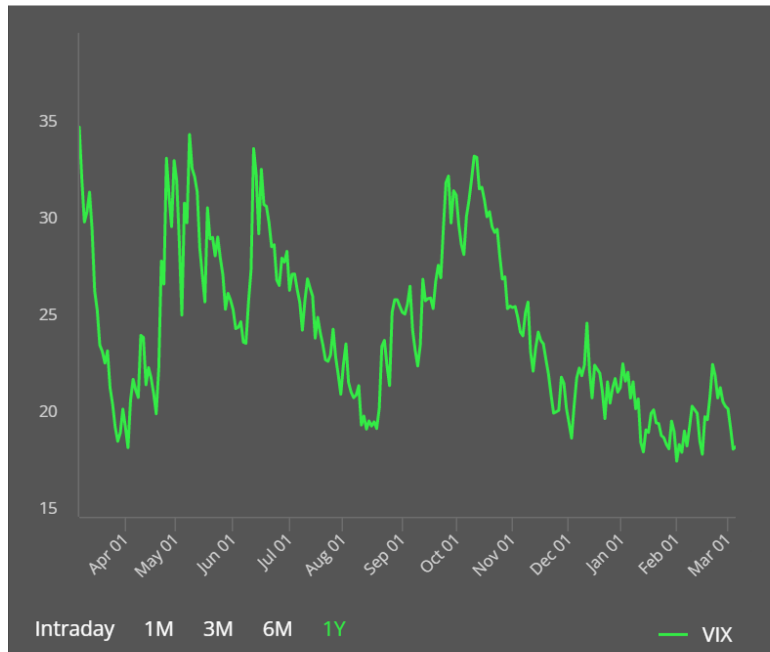
Behavioral Investing: The fallacy of forecasting



Investors these days can be forgiven for feeling paranoid about their savings. The Dot.com bubble burst, the global financial crisis, inflation, and geopolitical risk were all significant negative events that investors have had to endure over the past 22 years. Paranoia is associated with elevated levels of neurological activity in an area of the brain called the amygdala. Investment paranoia is often counteracted not buy drugs or therapy, but by investors attempting to forecast or guess which hemisphere of financial markets to park their capital. It's as though the act of doing "something" makes them feel better about their finances purely because they aren't just standing idly by and doing nothing. And the investment industry I feel is partially to blame for creating the fear that functions as fodder for forecasting. Most large investment banks have entire floors full of analysts and strategists whose full-time jobs are to forecast the future rates of return on pretty much any asset you can think of. It is unfortunate because sometimes, the absence of having a forecast and therefore an action plan fuels investment paranoia even further. Sixth Century philosopher Lao Tzu once said that "those who have knowledge don't predict and those who predict don't have knowledge".

[Lao Tzu, is generally regarded as the founder of Taoism. Taoism or Daoism refers to a set of Chinese traditions and religions which emphasize living in harmony with the Dao. The Dao is generally defined as the source of everything and the ultimate principle underlying reality.]

Often, investors tend to overestimate the significance of data that they receive, or cherry pick the data that best supports their desire to do anything but stay disciplined and stay focused on their existing investment strategy. Financial media is unfortunately the enemy of these sorts of investors. We all know fear sells more subscriptions than facts. If you are in a position where memories of Lehman Brothers or 2022 have gotten the better of you, then speak with us first. We will *reduce* the activity in your amygdala to help you keep your investing head on straight.



[The CBOE Volatility Index or "VIX" is Wall Street's fear index and while the world continues to juggle multiple problems, the stock market doesn't seem to be concerned about any of them.]

Wall Street and Bay Street are filled with promoters, and the A-B-Cs of sales stand for "Always, Be, Closing…". But before some smooth-talking soothsayer siphons your savings off into something that sounds like it might be a good idea, be sure to exercise two other parts of your brain: the prefrontal cortex and hippocampus. Both play pivotal roles in judgement, which more than the latest forecast is something we feel will help investors live in better harmony.

The MacNicol Investment Team

Firm Wide News

MacNicol & Associates Asset Management would like to congratulate Portfolio Manager Joe Pochodyniak on the progress he is making with anger management therapy. This month, Joe only got mad at his lazy, grossly underachieving dog "Oreo" three times on a net basis, and 5 times on a gross of an apology after the fact basis. Way to go Joe! We never thought such a boorish goon like you could change.