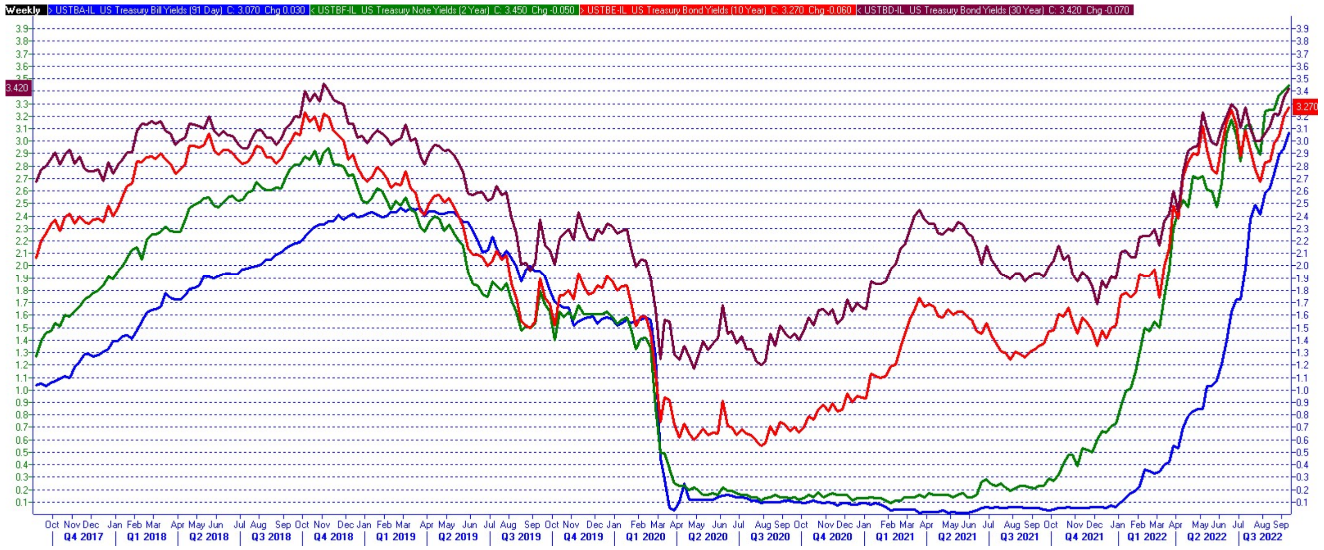
September 9, 2022

The Yield Curve is steepening…maybe.



We continue to follow bond yields. We noted the narrowing in mid August. A decline in the long end matched with hikes on the short means trouble for the economy. In August we advised all rates were more likely to continue their upward trend signaling demand, stronger economy, not weaker = BUY stocks don't SELL. We expected to see longer term rates (red and burgundy) swing above short term (blue and green). This appears to be happening. We still think stocks are where it's at.

Note the Mr. Putin

"There is no greater danger than underestimating your opponent" Lao Tzu

Russia's invasion of Ukraine has been a huge mistake with no winning outcomes. Territorial gains in Ukraine, if they occur, will be more than offset by significant contraction in Russia's future. Triumph motorcycles are built in Thailand. Thais are learning excellence in manufacturing, quality control and inventory management. A home-grown industry will improve. The world buys quality motorcycles at lower cost, Thailand gets jobs, knowledge, and foreign currency. Technology and inventions should follow. Russia has invented…what? All growth in the economy came from resource extraction that favored the state. Even that model is flawed. Russian oil company executives have a distressing habit of falling out of hospital windows. As quality control matters little to a barrel of oil, corruption runs rife. I had a hard time imagining why Russia would bother with Ukraine. The notion of a land-bridge to Romania seemed far fetched. Peter Zeihan explains the importance of water to Crimea. Hint: It originates in a canal from Ukraine. Now I get it.

'In Kherson, Ukraine and Russia Vie Over the Dnieper' - Peter Zeihan

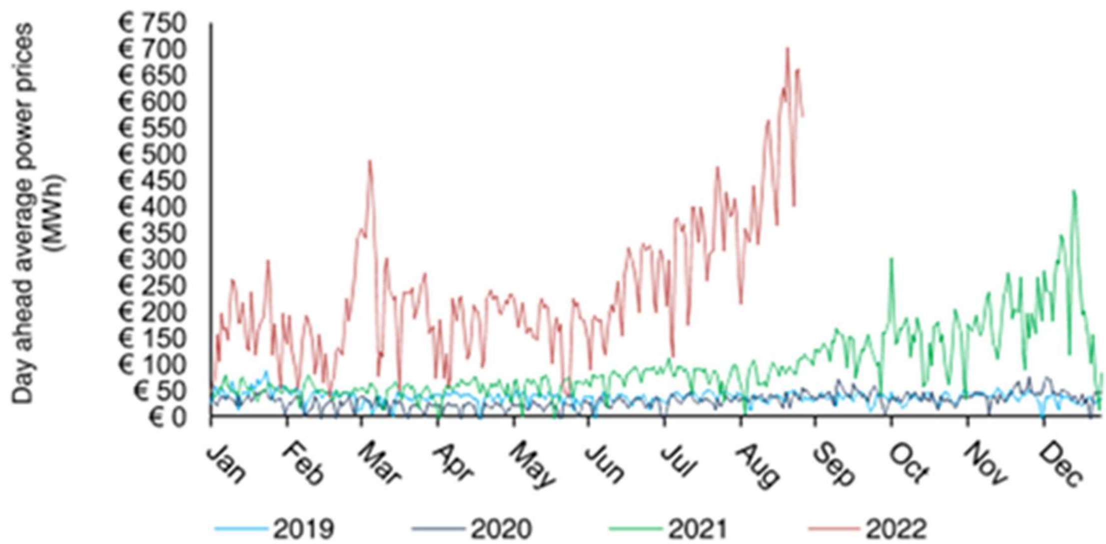
https://www.youtube.com/watch?v=Tb3U9Ydiw64

'Europe's Natural Gas Challenge' – Peter Zeihan

https://www.youtube.com/watch?v=7E1xGQTHTZQ

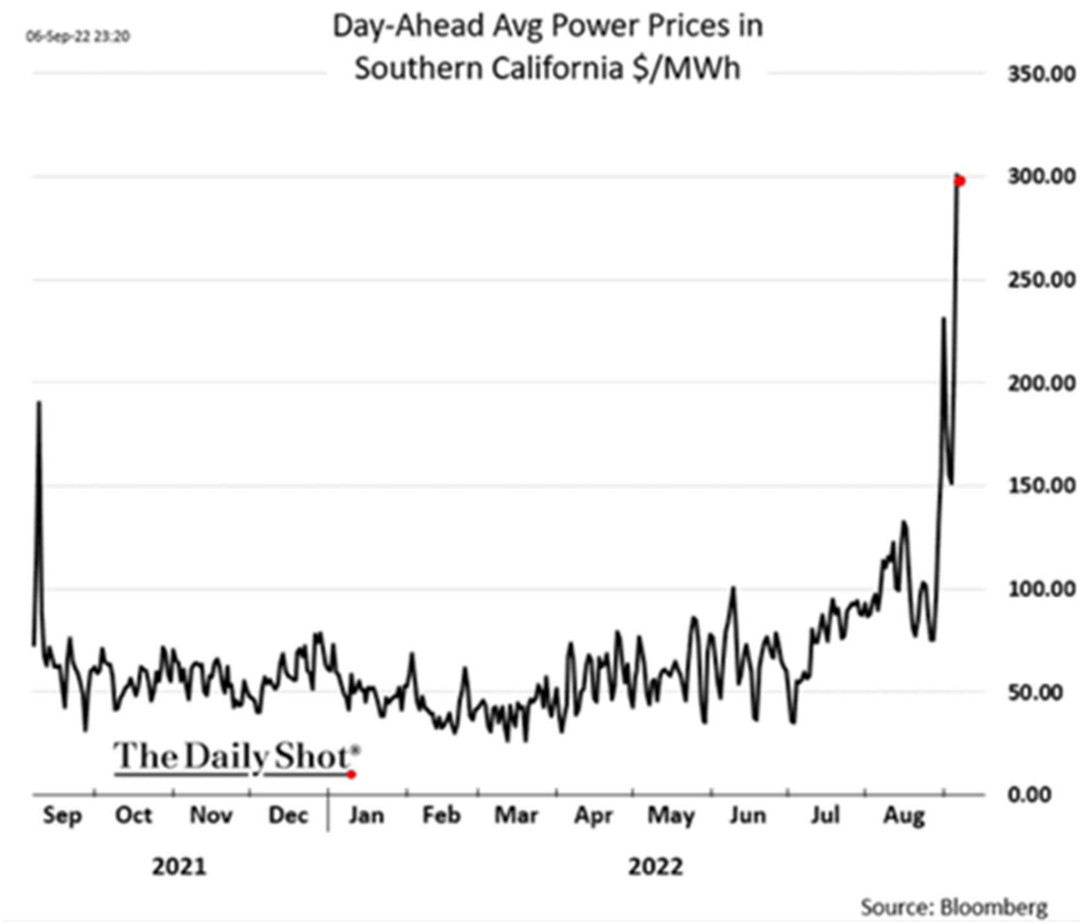
…and Europe is clearly in an energy crisis. Day ahead power prices:

Figure 1: Power prices in Germany reach record high at >€500/MWh



Source: Bloomberg, as of August 31st

California is getting pricey too.



40 CEOs from European metal groups sent a letter to European policy makers warning of the "worsening energy crisis" and its "existential threat" to their future.

"50% of the EU's aluminium and zinc capacity has already been forced offline due to the power crisis, as well as significant curtailments in silicon and ferroalloys production and further impacts felt across copper and nickel sectors. In the last month, several companies have had to announce indefinite closures and many more are on the brink ahead of a life-or-death winter for many operations. Producers face electricity and gas costs over ten times higher than last year, far exceeding the sales price for their products. We know from experience that once a plant is closed it very often becomes a permanent situation, as re-opening implies significant uncertainty and cost."

Eurometaux — METALS: AT THE HEART OF EUROPE

To: President of the European Commission Ursula Von der Leyen, President of the European Parliament Roberta Metsola, President of the European Council Charles Michel

Cc: Executive Vice Presidents Frans Timmermans, Margrethe Vestager, Valdis Dombrovskis; Commissioners Thierry Breton, Paolo Gentiloni, Ms. Kadri Simson, European Commissioner for Energy

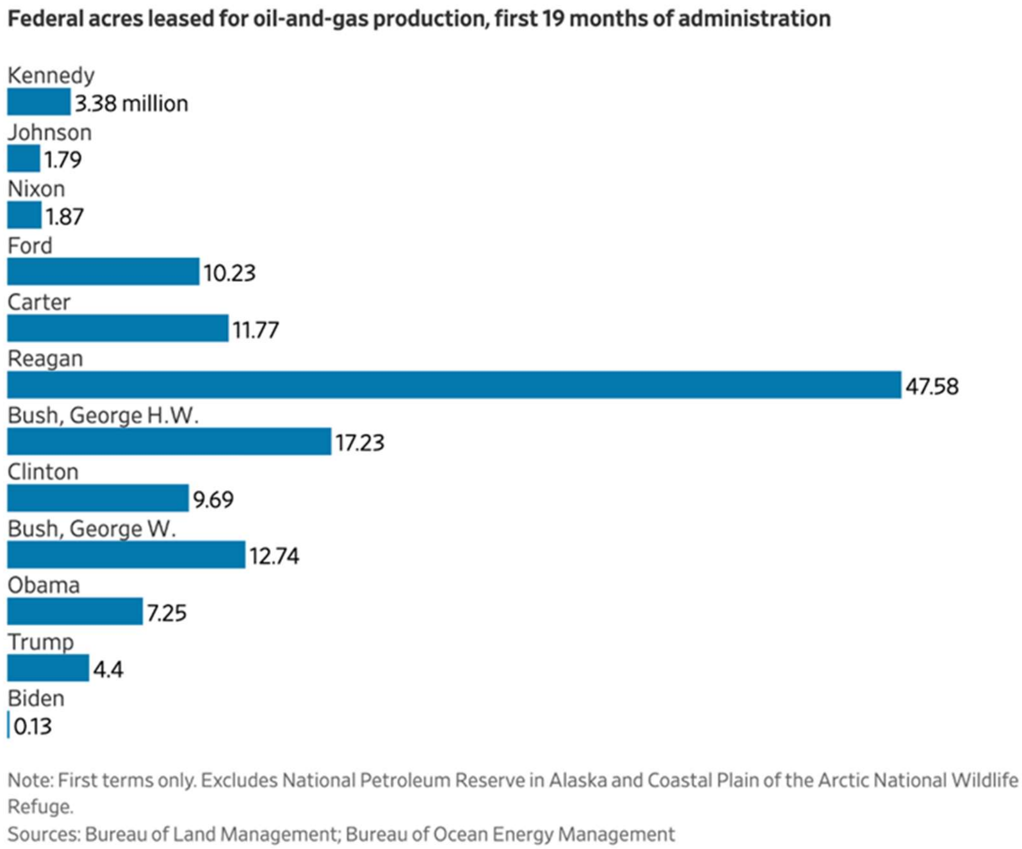
September 2022

RE: Europe's non-ferrous metals producers call for emergency EU action to prevent permanent deindustrialisation from spiralling electricity and gas prices

EURO carbon credit prices have flopped. Not because there's less carbon.

Underinvestment in oil exploration and development = contracted supply.

The oil price result of no exploration was delayed until demand recovered from the COVID-19 pandemic. Eventually, supply down/demand up = prices up. Historically, flush with high priced oil cash, the oil industry's response was to explore and Drill Baby Drill. The surge in eventual production caught up to and surpassed demand. Prices bust. Rinse and repeat. But…to explore you need permission. The following chart contrasts US federal acres leased by past presidents compared to the Biden administration – in the past, (see Reagan and both Bush's) when supply was short, the U.S. fostered more production on federal land. Supporting anything related to fossil fuels is not something that Biden appears willing to do, making supply side gains more challenging. An oil well is a declining asset. No exploration, no new oil to replace it. Period. Not a complicated formula.



This takes us to the blame game for Europe's energy crises.

'Three myths about the global energy crisis' – Fatih Birol

Dr Birol has this to say about the source of Europe's current energy woes.

"The second fallacy is that today's global energy crisis is a clean energy crisis. This is an absurd claim. I talk to energy policymakers all the time and none of them complains of relying too much on clean energy. On the contrary, they wish they had more. They regret not moving faster to build solar and wind plants, to improve the energy efficiency of buildings and vehicles or to extend the lifetime of nuclear plants. More low-carbon energy would have helped ease the crisis — and a faster transition from fossil fuels towards clean energy represents the best way out of it."

Dr Birol has been an executive directive of Paris based **Intl Energy Agency (IEA**) since 2015, being…ahem…the period leading to the current mess. The IEA has been cheerleading the move away from fossil fuels to renewable energy, shuttering nuclear power. The policymakers he mentions are European ones. His contention these policymakers want to 'extend the lifetime of nuclear power plants' is at odds with the previous stated goals of Germany shuttering their 3 remaining nuclear plants. The desire to delay has only come after a severe energy crises that hasn't seen winter yet.

https://financialpost.com/commodities/energy/oil-gas/three-myths-global-energy-crisis

Others aren't as forgiving of EURO government policies.

Europe's Energy Crisis Was Created by Political Interventionism – Daniel Lacalle

https://www.dlacalle.com/en/europes-energy-crisis-was-created-by-political-interventionism/

So clearly there's an opportunity in LNG. While Canada dithers …

Kinder Morgan Mulls Expansion at LNG Terminal in Georgia

By Gerson Freitas Jr.

(Bloomberg) -- Pipeline giant is weighing an opportunity to expand capacity at its Elba LNG facility by 3-5 million tonnes per annum, CEO Steve Kean said during the Barclays CEO Energy-Power Conference in New York Wednesday.

At current capacity of 2.5 million tons, KM's Elba facility is one of the smaller US terminals. KM plans to more than double it.

Canada's only new LNG export terminal coming online is **Canada LNG's** terminal in Kitimat. Nearing completion, the Kitimat terminal will have annual capacity of 14 million tons. Kinder Morgan's potential expansion at one existing smaller terminal equals up to 35% of Canada's national capacity. The US has 13 operating export terminals with 6 coming on stream recently and is actively building another 16. The US certainly thinks there's a business case for LNG.

We may have a new industry of biblical origins.

'Sheep Are the Solar Industry's Lawn Mowers of Choice'

Are we about to see a bull market in sheep?

https://www.wsj.com/articles/sheep-solar-industry-panel-fields-11662390795

In our experience on the farm, sheep attract predators. On Vancouver Island that means mostly wolves and occasionally cougars. An effective defense is a pair of Great Pyrenees sheep dogs.

We had one on the farm. He would protect anything in the barnyard he was raised with. Chickens, horses, ducks, goats, he did his duty 24-7, rarely wanting to leave his 'flock', dying of old age in the barn. Be warned, Great Pyrenees like to dig holes to keep cool in summer. You could park a Fiat 500 in one.

From the 'There is no free lunch' file.

"Spend Now, Deal with The Consequences Later" Is the Worst Policy – Daniel Lacalle

I just had to include one of Mr. Lacalle's previous notes.

https://www.dlacalle.com/en/spend-now-deal-with-the-consequences-later-is-the-worst-policy/

U.S. Recession Risk - Weekly Monitor National Bank Sept 6, 2022

Given the growing fears of a recession in the U.S., we have decided to resurrect our tracking table for recession indicators. The table below shows the current reading and recent momentum of several indicators compared to the ones observed three months before the eight previous recessions. Red indicates that the current reading is worse than any historical episodes while green is better. Both yellow and orange are in the historical range, the former indicating a better situation compared to the median while the latter shows the opposite.

In terms of the economic indicators tracked in this dashboard, the main events were August's employment situation and a host of both soft and hard data indicators. Data released over the past week did not send a more alarming signal than their previous reading, but financial markets showed signs of weakening

U.S.: Economic and financial indicators 3 months before recessions
As of September 2, 2022

		Last reading	Prior reading*	Value 3 months before U.S. Recessions: 2020	2007-09	2001	1990-91	1981-82	1980	1973-75	1970	Median
Financial	S&P 500 (% drawdown from past year max)	-18.2%	-15.4%	-1%	0%	-14%	-8%	-6%	-8%	-13%	-15%	-8%
Financial	BBB spread (increase from past year min, bps)	62.7	53.3	2	46	134	6	0	41	43	23	32
Financial	Copper price (% drawdown from past year max)	-32%	-28%	-11%	-2%	-10%	-12%	-16%	-1%	0%	-2%	-6%
Financial	Oil price (% drawdown from past year max)	-30%	-25%	-16%	-4%	-31%	-21%	-4%	0%	0%	0%	-4%
Financial	U.S. Dollar (% increase from past year min)	9.5%	9.2%	3%	0%	7%	11%	12%	6%	NA	NA	7%
Financial	Yield curve (10-year minus 3-month, bps)	28	20	26	77	-76	98	-62	-127	-157	35	-18
Financial	3 month treasury - core PCE (percentage points)	-1.7	-1.8	0.0	1.6	3.9	4.2	5.6	4.5	4.5	2.5	4.0
Soft data	Consumer sentiment (Michigan)	58.2	51.5	99.3	80.9	94.7	90.6	76.3	63.3	72.0	86.4	83.7
Soft data	SME optimism	89.9	89.5	102.7	96.1	96.4	99.4	97.4	93.3	NA	NA	96.9
Soft data	CEO confidence (quarterly data)	34.0	42.0	43.0	44.0	31.0	48.0	61.0	32.0	NA	NA	43.5
Soft data	ISM manufacturing	52.8	52.8	47.9	52.8	42.3	49.5	53.5	48.0	63.5	54.6	51.2
Soft data	ISM services	56.7	55.3	55.7	53.5	52	NA	NA	NA	NA	NA	53.5
Hard data	UI Claims 4-week ave. (% increase from past year min)	41.6%	44.0%	6%	8%	26%	6%	2%	20%	12%	10%	9%
Hard data	Temp. help services jobs (% drawdown from past year max)	0.0%	0.00%	0.0%	-3.2%	-4.3%	NA	NA	NA	NA	NA	-3.2%
Hard data	Average hours worked (% drawdown from past year max)	-1.2%	-0.9%	-0.9%	-0.3%	-0.6%	-0.9%	-0.3%	-0.6%	-0.5%	-0.8%	-0.6%
Hard data	Building permits (% drawdown from past year max)	-11.1%	-10.5%	-5%	-27%	-2%	-39%	-21%	-30%	-30%	-19%	-24%
Hard data	Real consumption (3-month, % ann)	0.7%	0.7%	1.3%	2.4%	2.3%	1.8%	-0.1%	0.7%	4.1%	6.4%	2.1%

*Previous Friday for financial data, previous month for hard and soft data (quarter for CEO confidence)
NBF Economics and Strategy (data via Refinitiv, Bloomberg)

"The signal sent by financial market slightly worsened compared to a week ago. The S&P 500 declined 2.8% further from its 12-month peak and remains the worst drawdown observed a quarter prior to a recession. Meanwhile, the yield curve steepened 8 bps, and remains steeper than the median reading 3 months ahead of a recession. The price of oil fell by 5% and BBB spreads widened 9.4 bps, but their signal as defined by the colours of the dashboard remained unchanged. The price of copper declined a bit further while the U.S. dollar and real policy rates, for their part, were essentially unchanged. ***In short, equities, corporate bond market, commodities and the U.S. dollar are still at risk-off levels, while the still accommodative real rates suggest a pro-growth environment."*** (emphasis mine)

National Bank's research team confirms our comments over the past few weeks that financial markets have already priced in a recession. My take is unless a recession is much deeper than we expect stock prices are unlikely to decline significantly. While that doesn't mean stock prices won't go down, it also doesn't mean they won't go up!

On media bears:

We see the media's favorite bear pundits getting air-time as a broadly contrarian BUY signal. I usually pay little attention to these folks, but our clients have been reading these gems and are understandable anxious about the predictions of perdition from 'legendary' pundits. Let's have a look.

An example:

'Entering the Superbubble's Final Act' Jeremy Grantham Sept 2, 2022

https://advisoranalyst.com/2022/09/02/entering-the-superbubbles-final-act.html/

Mr. Grantham is described regularly by media interviewers as 'the legendary Jeremy Grantham' due to his 'foresight' calling previous market selloffs. This narrative has Mr. Grantham calling market tops in 2000 and 2007. Mr. Grantham has also predicted market tops, and has been spectacularly wrong, nearly every year before and since. A walk through his 'legendary' record. The **S&P500 now stands at 4053** (Sept 9, 2022 mid-session).

In his 1st quarter 2014 quarterly newsletter, Mr. Grantham predicted *'Big Stock Bubble will end badly in 2016'*. March/2014 S&P500 close: **1872**. The S&P is up 116%

https://www.thinkadvisor.com/2014/05/04/grantham-big-stock-bubble-will-end-badly-in-2016/

In August 2015 he predicted markets will be *"ripe for a major decline" some time in 2016, potentially triggering government bankruptcies.'*. Aug 2015 S&P500 close: **1972**. The S&P is up 105.5%.

https://www.ft.com/content/82737cca-39f2-11e5-bbd1-b37bc06f590c

Feb/2018 he predicted the US stock market would decline 50%. Feb/2018 S&P500 close: **2713**. The S&P is up 49.4%.

https://www.institutionalinvestor.com/article/b1743d0x0ms3yx/why-is-no-one-listening-to-jeremy-grantham.

In March/2019 he advised *'This bull market will* ***not end with a massive pullback****, investor Jeremy Grantham says'*. March 2019 the S&P 500 closed at 2834.

https://www.cnbc.com/2019/03/07/this-bull-market-will-not-end-with-a-massive-pullback-grantham-says.html

Summer of 2019 we were selling stocks. Feb-March/2020 saw the S&P 500 decline to losses of 2191 -22.7% from Mr. Grantham's sanguine statement March/2019. Peak to trough decline was -36%. Wrong again.

In January 2021, Mr Grantham claimed the market was in a *"fully-fledged epic bubble" featuring "extreme overvaluation, explosive price increases, frenzied issuance and hysterically speculative investor behaviour". "I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929 and 2000,"*

While we also noted the nuttiness in the 2021 meme-stock/crypto silliness as signs of excess and warned FAANG stocks were due for a come-uppance, we did not associate that craziness with delusional prices for our dividend payers. We didn't believe our stalwart dividend payers were likely to decline much from Jan/2021. Since Jan/2021 Canada's Select Dividend Index is up 24.3% before dividends. Today the S&P is up 5.8%. Not quite 1929.

This takes us to 2022…

'Is the Plunge in the Nasdaq and Bitcoin the End of a "Superbubble"?' the New Yorker Jan 24, 2022

https://www.newyorker.com/news/our-columnists/is-the-plunge-in-the-nasdaq-and-bitcoin-the-end-of-a-superbubble

Jan 24, 2022 S&P 500 close 4410. The S&P sold off to intraday low of 3639 in June for a decline of -17.5%. He was finally partially correct. June month end the S&P was still down 15%. To call a decline is half the battle. You then must buy. Mr. Grantham was at it again in July.

'Legendary investor Jeremy Grantham says stocks could plunge another 25% as the 'superbubble' continues to pop' **Fortune July 20, 2022**

https://fortune.com/2022/07/20/jeremy-grantham-stocks-plunge-another-25-percent-superbubble/

July 20 the S&P close 3854. -12.5% from Jan 24. He could have reversed course. Nope. He doubled down, calling for further 25% decline IE S&P500 **2,890**. Today the S&P is 40.2% above his predicted price and 5% above the July 20th prediction date.

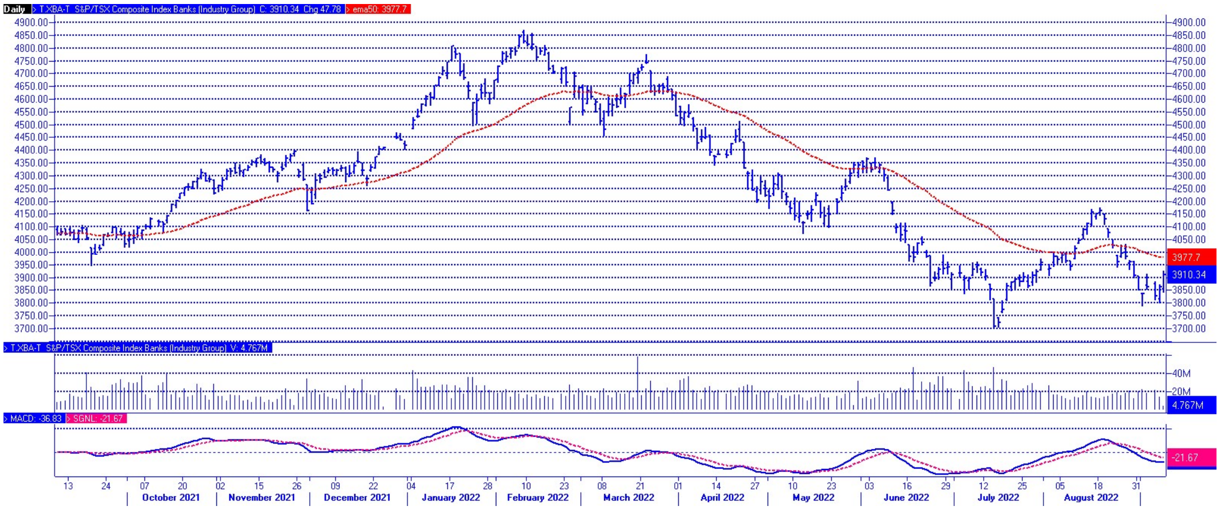
A stopped clock is right twice per day. Eventually Mr. Grantham will be proved correct in calling for a decline. He will then become legendary yet again. Wonder why the media trots him out so often? Because they sell advertising, not portfolio results. They really don't care if you make or lose money.

We benefit from his prognostications of purgatory. A careful review of when the media features Grantham reveals stocks have often declined before they get the call for an interview. He fulfills the media need to give their viewers what they want to hear about. Grantham receives gratis airtime to attract clients who favor a dire worldview, and the media gets a gratis appearance by a 'legendary investor'. So there is value to his predictions. They are a contrary indicator of investor sentiment.

Staying with Doom –

The Canadian financial media and blogsphere has been rife with predictions of a devastating collapse in Canadian house prices. They say this will 'crush' consumers and cause 'massive' losses to the Canadian Banks. Hyperbole sells. Share prices for the Canadian Banks declined 24% from the Feb/2022 highs into mid-July. Prices have since rebounded but remain 20% from the highs. We're seeing dividend yields north of 4% across the board. Yes, that yield is lower than the current trailing 12-month posted inflation rate in BC of 8%. Stocks historically are the best hedge against inflation.

TSX Banks sub-index 12 months



Some say the Canadian property markets are already 'crashing'. While we've warned that house prices are unlikely to reward leveraged risk taking, we've also said we don't believe prices will collapse a la the US 2007 Sub-Prime Mortgage bust. We've walked clients through a typical home-owner's equity vs. mortgage payment over time. Want a copy? Let us know. 2020-21 we urged our clients with floating rate mortgages to lock in their rates. We've advised that in a rising interest rate environment, house prices struggle while rents rise. This theory is being tested. We see a prolonged flat spell for Canadian house prices. In certain markets (looking at you Toronto and Vancouver) the average price may decline. That doesn't mean the average house will be cheaper. This is due to the way Canadian real estate data is compiled. The Financial Post explains.

Canada's housing market isn't melting down as you've been led to think

https://financialpost.com/real-estate/housing-market-not-melting-down-statistics

We don't think US house prices will collapse either. First Trust explains.

Home Prices Plateauing, Rents Catching Up – First Trust

https://www.ftportfolios.com/Commentary/EconomicResearch/2022/9/6/home-prices-plateauing,-rents-catching-up

Note First Trust's comments on rising rents. Our past Readings predicted when rates go up, rents rise. This is not necessarily all roses for landlords. Rates follow behind inflation. Inflation eats more of the rent. Rental increases lag and rarely fully match inflation. Landlords are also at the whim of Government rent controls. Here in BC, despite inflation running at 8%, the Prov NDP is enforcing a 2% rent increase cap, forcing landlords to eat a 6% loss. Recall that 8% inflation reduces not only the rental income but the equivalent purchasing power of the building itself. If the building is sold for a capital gain, that gain is taxed at the actual dollar sale price, not the 'real' inflation-adjusted sale price.

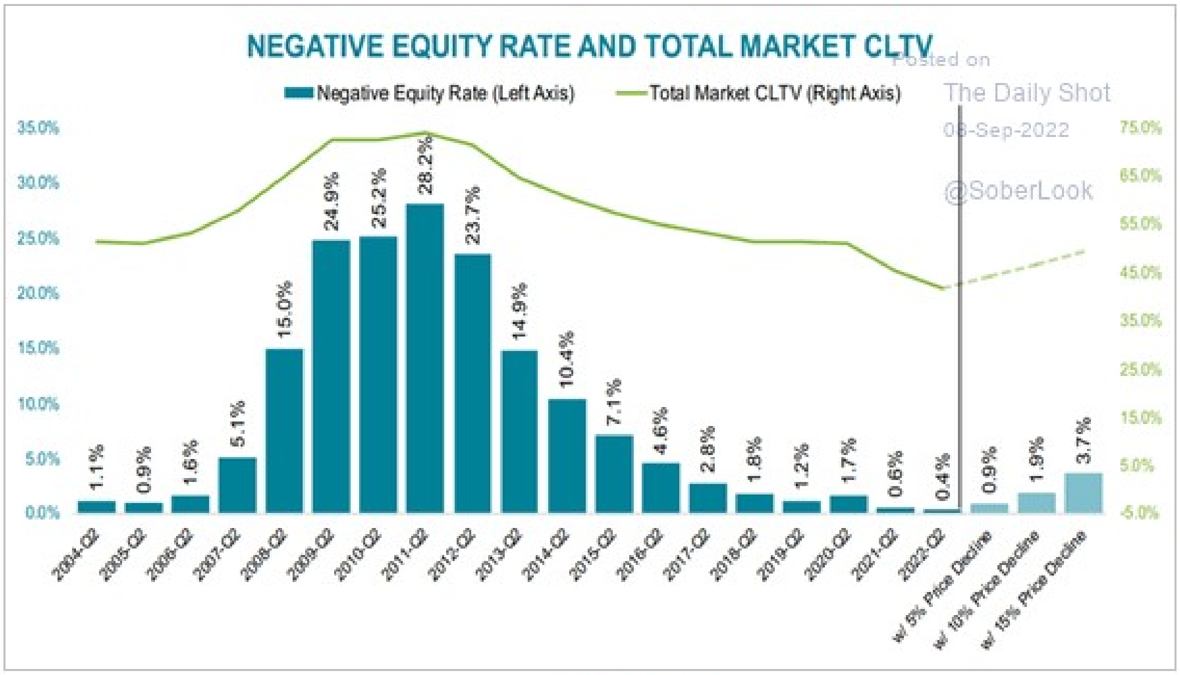
Scenario: An investor buys a multi-family building for $1,000,000 and holds it for 10 years. Inflation averages 4% per year. In 10 years, the investor needs a market value of $1,480,000 to maintain purchasing power. Let's say they don't like the tone and direction of Govt regulations on rentals. They sell the building for $1.48 million. 1/2 the $480,000 gain is taxable. In BC the rate is 53% or roughly $112,800 in tax. Our investor's net after-tax proceeds is $1,367,200. They've lost $112,8000 in real purchasing power over 10 years. If inflation averages 6%, they need $1.8 million to breakeven. This scenario has some likely results.

1) The investor demands a higher selling price to compensate AND will be reluctant to take on another project. Supply won't increase.
2) As rents are squeezed by both inflation and regulations the landlord's only option is to increase rents to the maximum permitted, defer/avoid maintenance and cut staffing expenses. No maintenance means the building declines over time. Why do slum landlords exist? Now you know.

Still staying with doom…

We don't think house prices will crash. If we're wrong? What does it mean for lenders?

The United States: In the housing market, very few homeowners should end up with negative equity in the case of a significant decline in home prices.



Source: Black Knight

PROPERTY PRICE DECLINE SCENARIO SUMMARY:

For owner occupants, no biggy. For leveraged landlords, different story as inflation eats their earning power and Governments enact populist rent control measures.

Which takes us to…

Canadian Banks & Life Insurance Companies – NBF Research

Conference Questions: September 2022 Edition

NBF Research Gabriel Dechaine updates his view on the Canadian Financial sector.

https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=6d8f95af-743d-42fb-9905-cb59019c4999&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail

Canadian mortgage rates

NBC's Vancouver Island mortgage broker provides the following current rates.

- Five year variable: P – 0.6% (effectively 4.85% right now
- One year fixed: 5.09%
- Two year fixed: 5.21%
- Three year fixed: 5.25%
- Four year fixed: 5.21%
- Five year fixed: 5.20%

We'll close with a reading assignment

Much of the broader inflation cause debate has focused on energy inputs. This narrative blames inflation on rising energy costs. Partly true. Recently the debate is *'Are rising energy costs the result of government policies or due to geopolitical events* (conveniently) *beyond those governments control?'* See above.

While we have repeatedly warned energy policies would be inflationary (they are) this misses the point. We do lay the inflation blame game at the feet of governments, but believe the real culprit is tax, fiscal and monetary policy regulations not just energy. If a government increases taxes, the cost of living rises while purchasing power declines. Focusing on one tax paying cohort IE The Rich, does not shield remaining taxpayers. If a high earning business owner sees less net income, they will raise their prices and reduce their costs. Consumers pay more and employees get less pay or have fewer fellow workers. The BC Provincial Govt has capped rents at 2%. Rolling 12-month inflation in BC is 8%. If a 'rich' landlord sees their rents capped, they will reduce maintenance and staffing and defer or exit any future property development. Housing availability contracts = inflation. If Governments increase regulations, costs increase, supply contracts = inflation. If the governments send cheques to their population to 'shield' them from the predictable effects of those same policies, more dollars chasing fewer goods = inflation. If Central banks then force rates down to slash borrowing costs, debt is incentivized. Party on = inflation. History says the longer governments attempt to put off the day of reckoning, the worse the outcome.

Weekend Reading assignment:

The Ascent of Money: A Financial History of the World – Niall Ferguson

https://www.amazon.ca/Ascent-Money-Financial-History-World/dp/0143116177

Keep a copy on your bookshelf. Hand it to your college-student nephew touting ***Modern Monetary Theory***

We close with a salute to Queen Elizabeth. Britain's longest reigning monarch left us on Thursday. As promised, she did her duty until her last breath. You've earned your rest your majesty.

As she advised…

Life is short. We're gone for a long time.

Have a Great Weekend

[Anna Hilberry's YouTube Page]

[NBF – Hilberry Group website]

Steve & Anna Hilberry

FOR THE RECORD Sept 9, 2022

DOW INDUSTRIALS:	32,110
S&P 500:	4,056
S&P/TSX COMP:	19725
WTI:	$87.10
LOONIE IN $USD:	$0.7673 $US

Sent by

Montreal office
National Bank Financial
Wealth Management
1155 Metcalfe 5th Floor
Montreal, Quebec H3B 4S9
Phone: 514 879-2222

Toronto office
National Bank Financial
Wealth Management
130 King Street West Suite 3200
Toronto, Ontario M5X 1J9
Phone: 416 869-3707