A Clue to a Brighter Future | Odlum Brown's 29th Annual Address

By Murray Leith, BComm, CFA, Executive Vice President, Director, Investment Research

A colleague recently asked me why I love my job. The answer is easy. I love making sense of the world and figuring out what makes one company or stock better than another. I think of the economy, markets and human nature as a big, complicated puzzle, and I love working on it. I know I'm never going to solve it, but if I understand it better than others, our clients will have an advantage. I'm naturally curious, and what I love most is that my job is always changing. I'm always learning, and that makes it incredibly interesting.

I've worked in the investment industry for 35 years, and next year will mark my 30th year at Odlum Brown. That's almost a third of the firm's 100-year history, and I'm very grateful to hang my hat here. We are proudly independent. We put clients first and don't have the conflicts of interest that exist at a lot of other firms, and that gives me and my team the freedom to call it like we see it.

I also feel lucky because markets have generally performed very well during my time in the business. That, of course, has a lot to do with the 40-year decline in inflation and interest rates that ended in 2022. Howard Marks, an expert manager of corporate debt and someone I admire, likened the impact of falling interest rates to the people-mover conveyor belts at airports. You cover ground a lot faster on a moving sidewalk. In similar fashion, when interest rates are falling, asset prices tend to rise faster than underlying fundamentals. Over the last few decades, we've had a lot of help from the conveyor belt. But not last year.

Last year, we experienced the worst inflation in four decades, which caused the U.S. Federal Reserve and the Bank of Canada to raise administered short-term interest rates by 4.25% and 4.50%, respectively. That was the most aggressive tightening of monetary policy since the early 1980s, and while the Bank of Canada may be finished raising interest rates, the U.S. Federal Reserve has indicated more tightening is needed to get annual inflation back to the 2% target.

Higher inflation and interest rates are the enemy of stocks and bonds, and 2022 ended up being a really tough year for both asset classes. The only equity sector that did well last year was Energy.

Investors are worried that the significant increase in interest rates will cause a recession, and they are right to worry.

Central banks' administered interest rates are the building blocks for all other interest rates. Across the board, interest rates on government debt, corporate debt, mortgages, auto loans and credit cards have gone up dramatically. It's not just in North America. They have gone up around the world, as inflation is a universal problem. It can take up to two years for changes in interest rates to fully work their way through the economy. And global growth has already slowed meaningfully from roughly 6% in 2021 to 3% last year.

In addition to inflation, the world is facing a lot of other challenges: record debt, inequality, unaffordable housing, tremendous social unrest, war and climate change, to name a few. Despite all the doom and gloom, markets have had a pretty good start to the year. The reasons are threefold: (1) China's economy has reopened; (2) Europe has thus far had a mild winter, which has taken a lot of pressure off energy prices and softened their energy crisis; and (3) the U.S. economy is holding up as inflation trends down.

Investors are starting to believe the Fed won't raise interest rates much more and that we might not have a recession. While that is certainly possible, we don't think it is probable. We also don't think a recession is a bad thing. It's the

tough medicine that will curb inflation and put the economy on a much healthier footing. In fact, I'm increasingly optimistic because the normalization of interest rates not only fights inflation, it also helps alleviate some of those other problems I mentioned.

Investors naturally think a recession is bad for the stock market, and they are both right and wrong. Timing is the issue. The stock market is forward looking, and it rises and falls in anticipation of what is going to happen in the future. In fact, stocks tend to drop the year before a recession and rise in the year of a recession. That doesn't always happen, but it is what happens most often.

In the spirt of thinking about the outlook as a puzzle, I'm going to use the board game Clue in an attempt to simplify a complicated situation and explain why I see a brighter future. As with many of my presentations, the inspiration came from playing the game with my boys over the holidays. As many of you know, the objective of Clue is to solve a murder mystery by deducing the weapon, location and perpetrator of the crime.

I initially thought the crime we'd solve was "Who killed the economy?" But that crime hasn't occurred yet. The economy is still growing, jobs are plentiful, incomes are rising, corporate profit margins are good and government finances are actually improving.

"Who killed the economy?" is not the crime. If we do have a recession, it will be because central banks raised interest rates. We all know that.

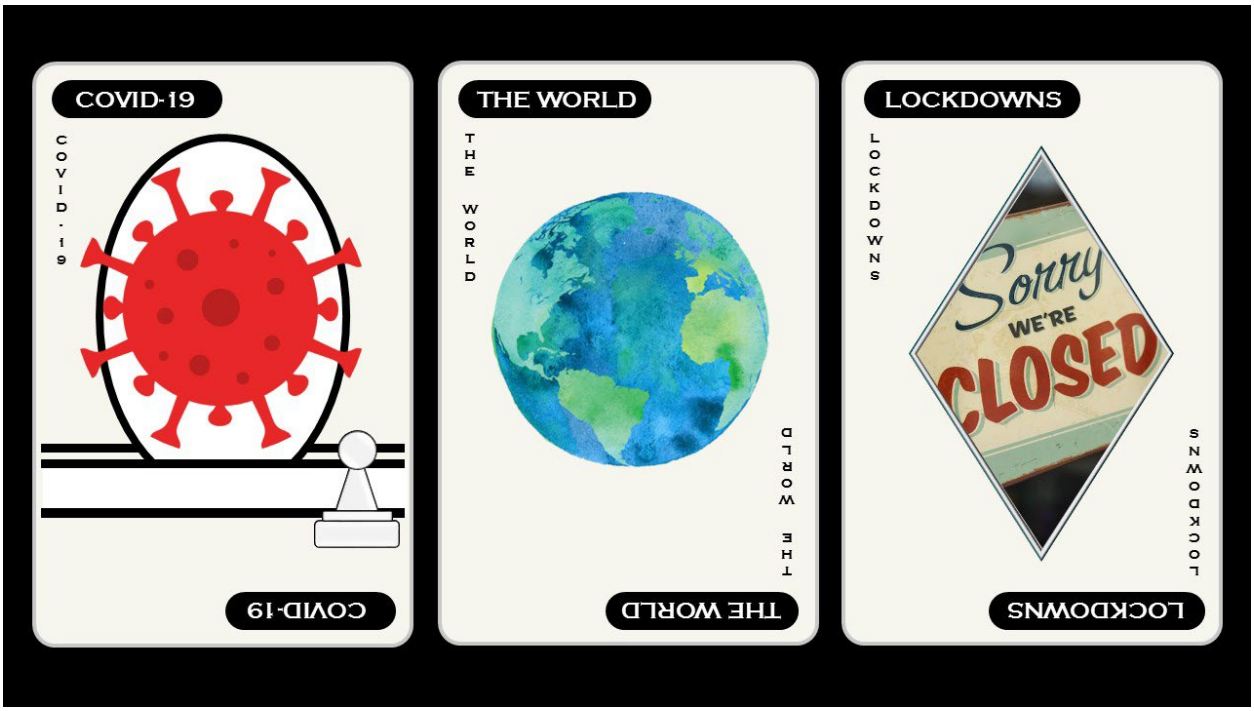
Inflation is the crime. Without inflation, central banks wouldn't be raising interest rates. Without higher interest rates, asset prices wouldn't have fallen, and we wouldn't be worried about a recession.

What we need to understand is who or what caused inflation and, more importantly, where it is headed.

There are many suspects, but I'm going to focus on six: (1) Covid; (2) President Biden; (3) Jay Powell, the Chair of the U.S. Federal Reserve; (4) the disgraced crypto king, Sam Bankman-Fried; (5) President Putin; and (6) China's President Xi.

Before we dig in, I want to explain why we are going to play the American version of Economic Clue and not the Canadian version. There are two reasons: (1) The U.S. is the largest economy in the world, and our biggest trading partner, and as such it has a dominating effect on our economy; and (2) the U.S. dollar is the world's reserve currency, and, because of that, their central bank has an overwhelming influence on both domestic and international interest rates.

In almost all cases, our observations about the U.S. apply to Canada and most of the developed world.



So, let's start with Covid and worldwide lockdowns.

I have to give a shout out to Maggie Chan on our Marketing and Communications team. She put these amazing graphics together from a very limited description of my vision. She is brilliant!

Covid lockdowns exposed the limitations of global trade and just-in-time inventory systems. We learnt very quickly that many products would have long delays and/or not be available at all.

Authorities and economists have consistently pointed to the supply challenges as the reason for the surge in inflation, and that is part of the story. But inflation is a function of supply and demand, and we need to consider the demand side of the equation as well.

The price of many goods escalated dramatically during the pandemic because more of our spending was directed towards the goods sector rather than services when we were locked down and unable to go to restaurants, travel and consume a whole host of other services.

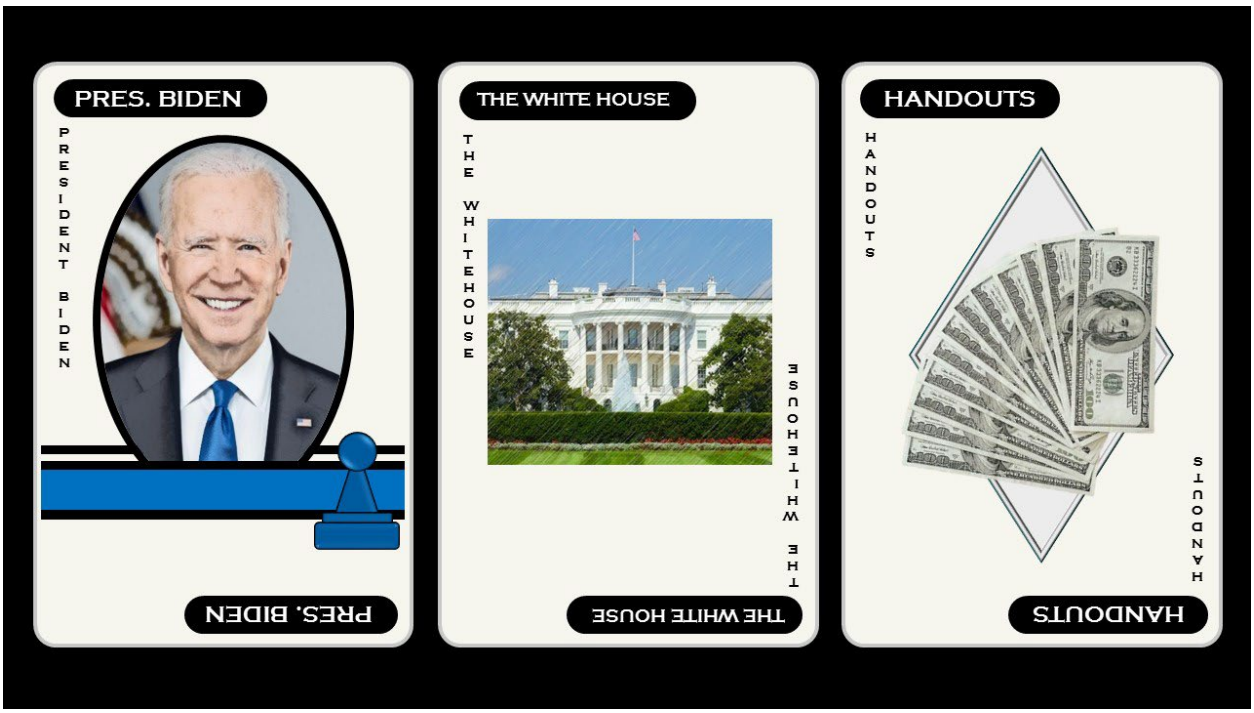
Do you remember how bare grocery store shelves were in the early days of the pandemic? Sure, there were supply issues, and hoarding of products like toilet paper, but a big reason was that a ton of people were suddenly eating at home instead of dining out. Grocery stores didn't have the supply to meet that surge in demand.

Something similar happened with used cars, which saw some of the biggest price increases during the pandemic. There was a shortage of new cars because manufacturers couldn't get semiconductors, so consumers were forced to buy used cars instead. Demand also rose because people didn't want to expose themselves to Covid on public transit.

The good news is that much of the demand and supply imbalances in the goods sector have proven to be temporary. Prices of many goods have stopped rising, and some have even fallen as (1) economies have reopened, (2) supply

bottlenecks have resolved and (3) people have shifted spending from goods to services. In fact, used car prices are falling at their fastest rate ever!

Unfortunately, as goods inflation has abated, price pressures in the services sector have heated up. That's worrisome because North Americans spend roughly three times as much on services as they do on goods. Service sector inflation is being driven by two things: (1) wage inflation, which is a consequence of the tight labour market; and (2) the high cost of owning and renting real estate, which is a byproduct of asset inflation. We'll talk about these again in a little bit.



The authorities deserve full credit for saving us from a brutal recession when the world locked down and millions of people were put out of work, but I'm going to make the case that they are also guilty of over-stimulating demand.

Government handouts are a smoking gun in the inflation crime, and we submit President Biden as a prime suspect. To be fair, Trump was also in the White House during the pandemic. Both presidents pumped up demand when the world had a supply problem, as did Prime Minister Trudeau here in Canada.

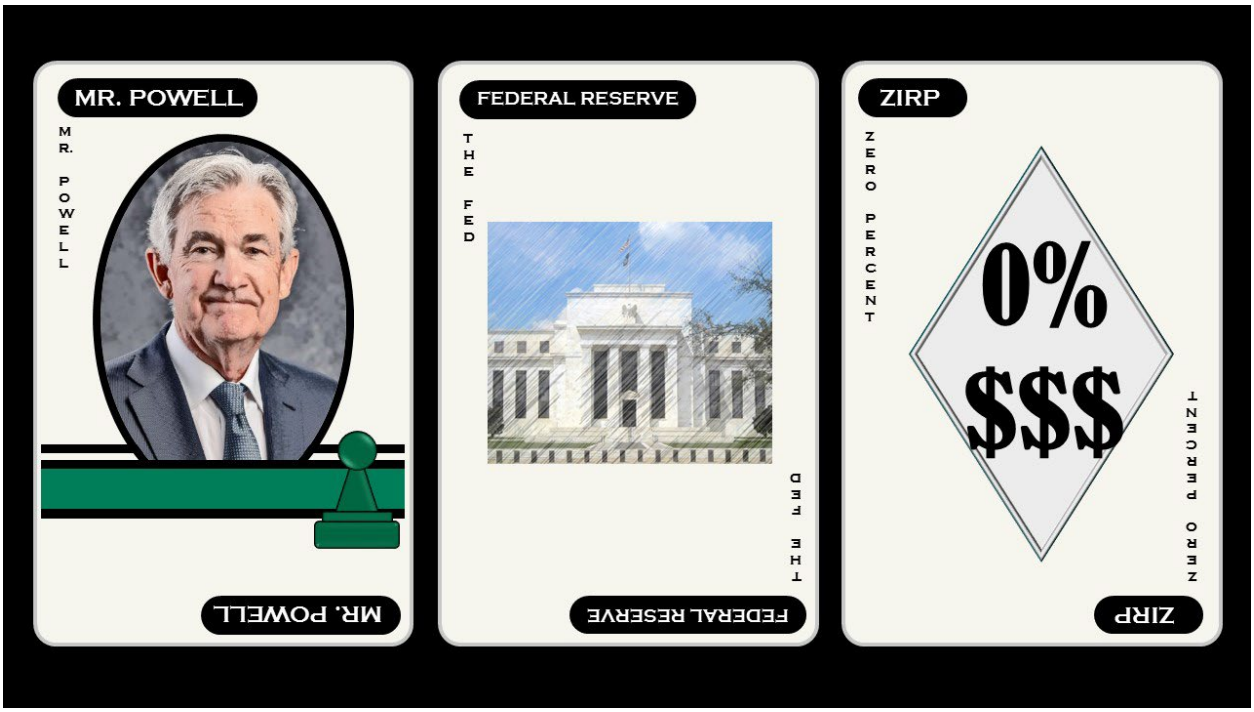
In the first year of the pandemic, laws were passed in the United States authorizing more than $5 trillion worth of support. In a $20 trillion dollar economy, that is a ton of money. In fact, it's more than four times the amount of support the U.S. government provided during the financial crisis in 2008 and 2009.

Not only did governments replace lost incomes during the pandemic, they also significantly augmented them. I don't want to suggest that there wasn't tremendous suffering. There was. But in aggregate, U.S. and Canadian consumers had more money to spend than they did before the pandemic.

Therein lies one of the worrisome things about inflation. It can be self-fulfilling. If people can afford to pay more, then companies can increase prices. And if companies can raise prices, they can afford to pay workers more when they demand higher wages to pay for the higher cost of living. And when our incomes go up, we can afford to pay more,

and so on and so on. It becomes a wage-price spiral. It's what took hold in the 1970s and what we want to avoid at all costs.

Governments weren't the only ones driving up consumer demand with unprecedented stimulus. Central banks were as well.



Chairman Jay Powell at the U.S. Federal Reserve is the next suspect to consider.

The U.S. central bank has a dual mandate: price stability and full employment. The two tools it uses to achieve those objectives are interest rates, which is the price of money, and the supply of money.

Let's start with interest rates. For nine of the last 14 years since the financial crisis, the U.S. Federal Reserve has had a zero interest rate policy (ZIRP). That's right, the federal funds rate was pegged at zero from 2009 to 2015, and again in 2020 and 2021 in response to the pandemic. Never in U.S. history has the cost of money been so cheap for so long. The Bank of Canada also lowered interest rates to zero during the pandemic.

Aside from making money cheap, the Fed also supported the economy by making sure money was abundant. They did so by buying government bonds and mortgages. A lot of them! The technical term is quantitative easing, but it's money printing for all intents and purposes.

During the financial crisis, the Federal Reserve spent $1 trillion buying bonds and mortgages, an enormous amount of money at the time. During the pandemic, they spent $5 trillion – five times as much!

Do you know what happens when money is ridiculously cheap and abundant? I'll give you a hint: it's the same thing that happens when I give my boys my credit card without strings attached. Governments, businesses and consumers borrow and spend. And they have done plenty of that in an era of cheap and easy money.

As a society, we ignored the damaging long-term consequence of cheap and easy monetary policies mainly because voters and politicians prefer instant gratification. But we were also able to do so because inflation wasn't a threat. Globalization in general, and China's economic boom in particular, has been a huge deflationary force for the last two decades. Making stuff in countries like China with abundant cheap labour has kept wage inflation and the price of goods low.

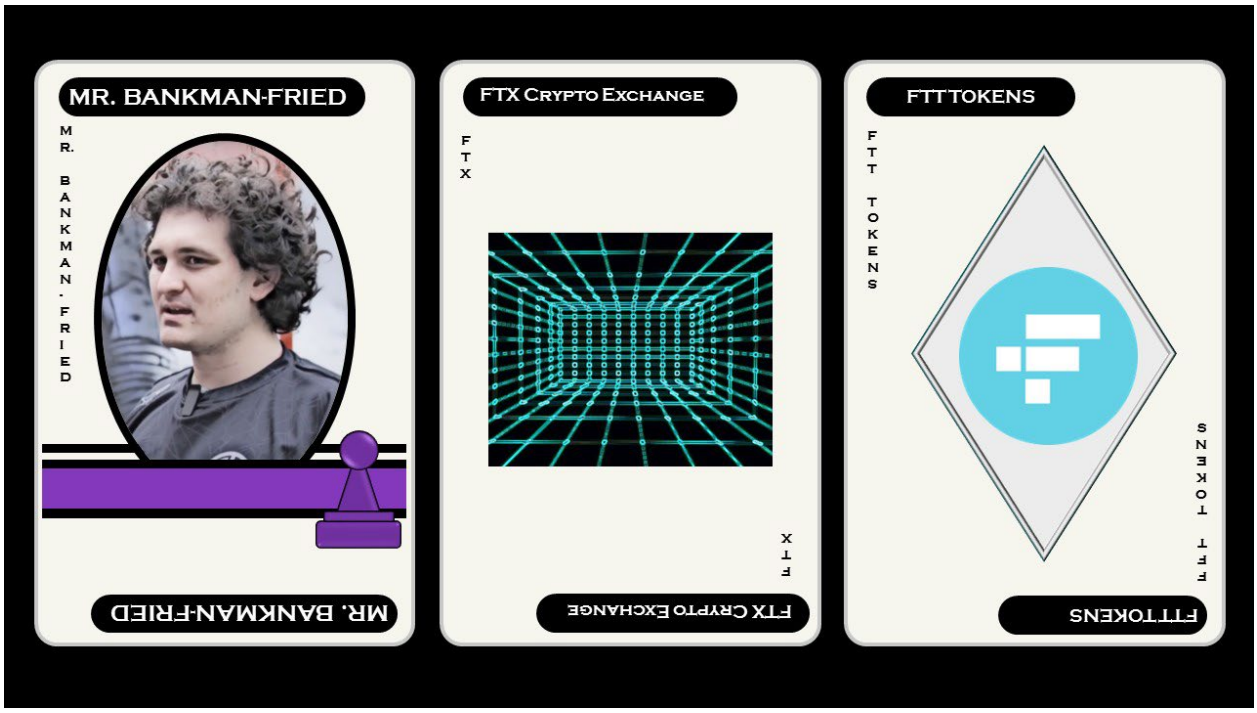
Printing money and zero interest rates most definitely saved us from a brutal recession. But the Fed maintained those policies long after the inflation horse had left the barn. All central bankers did, including the Governor of the Bank of Canada, Tiff Macklem.

You might be wondering why I'm putting so much energy into my case against central banks. It's because inflation isn't the only negative byproduct of cheap and easy money. There are other harmful, unintended consequences that have been building up for years, ones that undermine our financial stability, productivity and social fabric.

To understand these, we first have to appreciate how lower interest rates stimulate the economy and create new jobs: (1) they encourage consumers to borrow and spend; (2) they motivate business leaders to expand businesses and launch new ones; and (3) they inflate asset values, magnifying wealth, which leads to greater spending.

Unfortunately, there are three damaging effects of low interest rates that fester: (1) they encourage excessive risk taking and debt, and we have unprecedented debt in the world today; (2) they promote a misallocation of capital toward unproductive activities; and (3) they cause inequality, as wealthy people own a disproportionate amount of the assets that are inflated by low interest rates.

If we fix the inflation problem, and more importantly learn from our mistakes, then we begin to quell these negative consequences. We get off an unsustainable path, and we start building a stronger economic foundation.



Let's turn to someone who illustrates all three negative consequences: Sam Bankman-Fried, who was operating a cryptocurrency exchange with made-up money. He allegedly stole billions from millions of clients. Now Sam didn't cause inflation, but he is the poster child for the speculative excesses we just described.

They say "turkeys fly when the wind blows," and, boy, did a lot of turkeys fly during the pandemic. People are greedy by nature, and when they hear others are making money in Bitcoin and meme stocks, they pile in. Similarly, venture capitalists have raised billions of dollars for companies with questionable business plans and little or no profits.

It wasn't just speculative investments that benefited from cheap and easy money. The average home price in North America increased by more than 40% during the pandemic. Some of that was due to people buying bigger homes so they could work remotely, but most of it was stimulated by ultra-low interest rates.

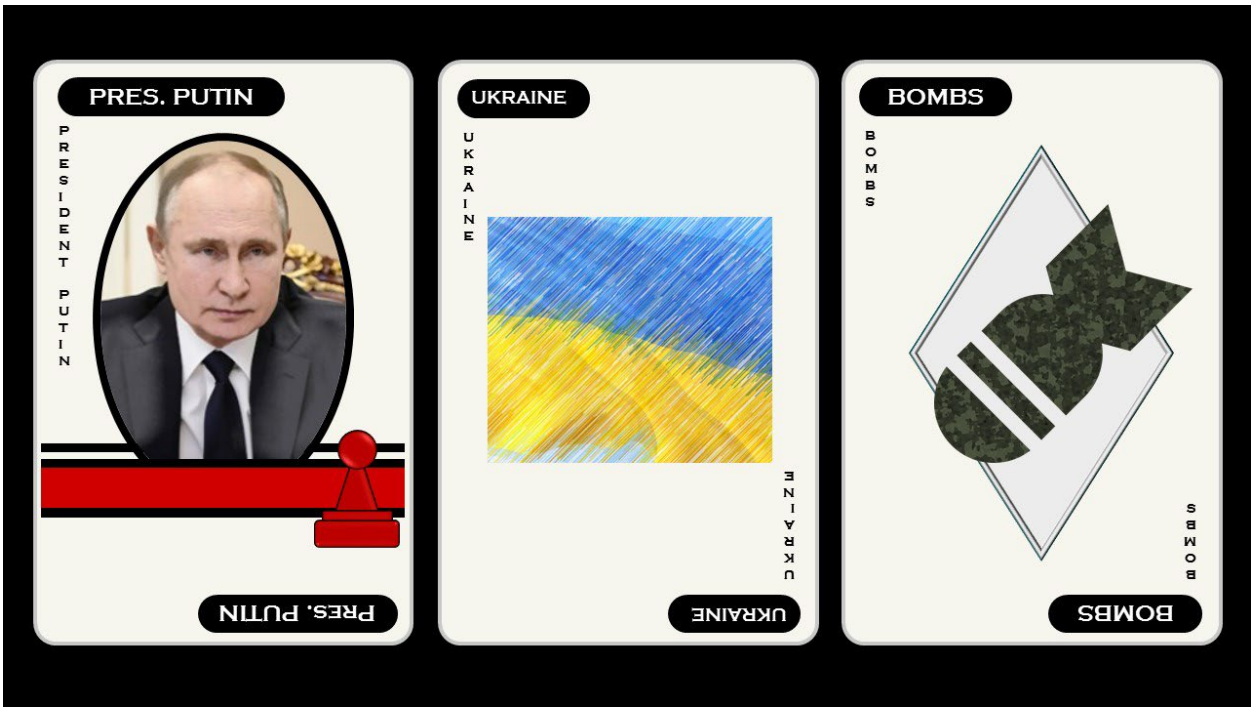
Low interest rates have created enormous wealth, which has been wonderful for your portfolio and for our business, but they aren't sustainable.

Do you know why Starbucks closed so many stores in Vancouver? It's because they couldn't meet their return targets. Rent is too expensive, and they're struggling to find employees.

The boom in speculation has contributed to a shortage of workers and wage inflation. Don't get me wrong, I want my children to have better-paying jobs. But prices and the cost of owning a home have gone up faster than wages. The average person's real income, adjusted for the cost of living, has actually declined. That is why so many people are angry and why we're seeing greater political polarization.

Sam Bankman-Fried employed a lot of people. He controlled 135 businesses that filed for bankruptcy when his empire blew up. In fact, a lot of companies raised billions of dollars and hired thousands, if not millions, of workers. Many are now having to lay people off because the easy money has ended, and the businesses don't generate enough cash flow to pay their employees.

While I feel badly for those workers, it's a positive step for our economic foundation. Many of those jobs were unproductive. Every business owner in the audience knows how tight the labour market has been. The good news is that it will get better as laid-off workers find productive jobs elsewhere.



Let's move away from North America and talk about Russia and China.

Putin's invasion of Ukraine is a humanitarian tragedy, and our thoughts are with all those who are impacted. Wars are awful.

Wars are also inflationary, and there is no doubt this one is adding to existing price pressures.

Russia's economy is relatively small at roughly 3% of global GDP. Consequently, cutting it off didn't hurt the rest of the world much from a demand perspective. But Russia is a major supplier of energy and other important commodities. Disruptions and curtailments have had a huge influence on the price of oil, natural gas and other commodities.

Still, this war is a reminder of our collective resiliency. Not only are Ukrainians defending their country and culture better than anyone expected, but the rest of the world, particularly Europe, has adjusted to supply disruptions remarkably well.

Russia used to provide 40% of Europe's natural gas, which is critical to heat homes, run businesses and generate electricity. Not surprisingly, the price of natural gas went through the roof when Putin turned off the tap, yet it has since fallen below pre-invasions levels.

So why is that? Well, luckily a mild winter has helped reduce heating demand. There was also time for Europe to top up its storage reserves before curtailments came into effect. Other countries pitched in, too, by bringing in new supplies of gas. Europe also dipped into alternative energy sources, including dirty ones like coal, which helped fill the void.

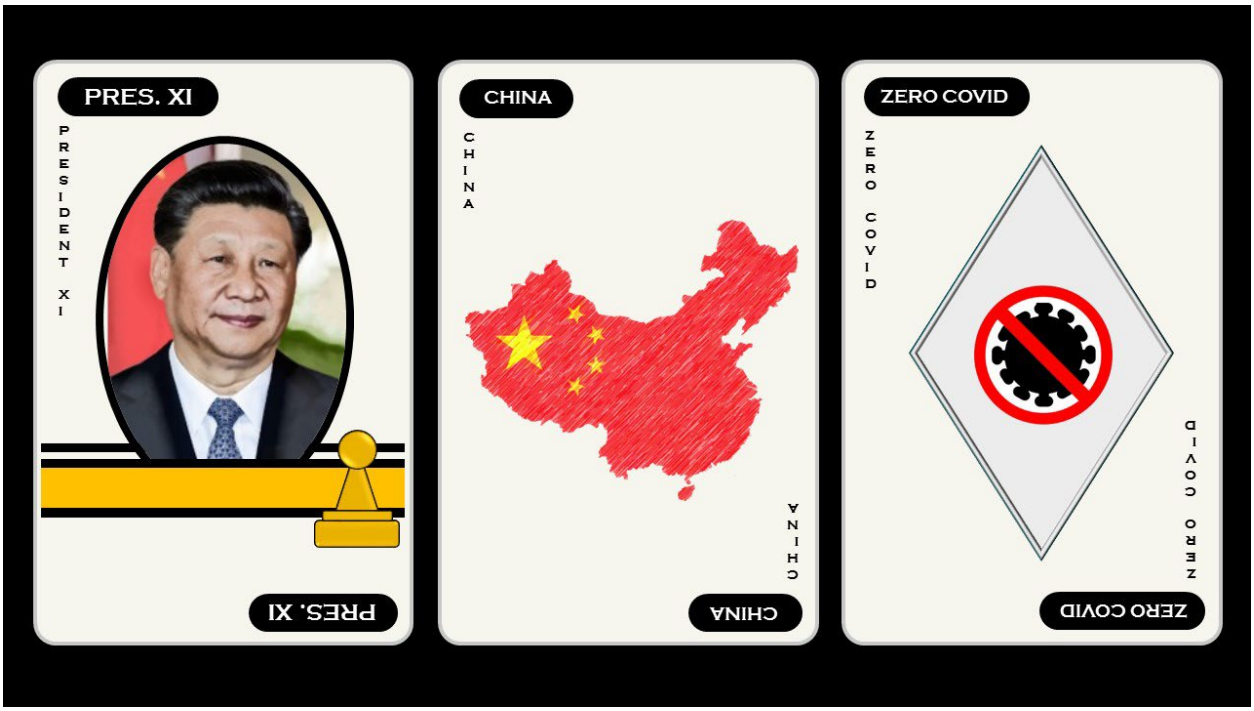
The energy crisis in Europe isn't over, and it is a stark warning that the world isn't managing climate change and the transition to green energy very well. The European price of natural gas may be below pre-invasion levels, but that's not much consolation. It was sky-high before the war, and it is currently nine times what it is in North America. That is a huge weight on the European economy, and it has a lot to do with how Europeans are managing the energy transition.

Oil and gas prices are high because it's been unpopular to reinvest in those businesses in an ESG-focused era. Chevron recently announced huge profits and plans to buy back $75 billion of stock. Some are frustrated that the company is returning money to shareholders instead of investing in greater production when gasoline prices are high. But companies like Chevron have faced intense pushback to stem drilling and not grow production for environmental reasons.

ESG issues are complex. The war has been a wakeup call for everyone, which is good news because governments and industry are accelerating their efforts in the green transition. But we can't turn the lights out on traditional fossil fuels overnight. The huge investments in the energy transition will create a lot of good jobs, but it is going to be expensive and inflationary in the near term. Longer term, technological advancements will make energy cleaner and hopefully cheaper.

Another byproduct of Russia's invasion, and China's saber-rattling around Taiwan, is a growing emphasis on supply chain security and military defense. The world is going to be less cooperative. "Friendshoring" is the new buzzword, which *The New York Times* defined as the practice of relocating critical supply chains to politically stable and friendly countries. The process will no doubt create a lot of good jobs, but it, too, is likely to be inflationary.

A case in point is the CHIPS and Science Act, which President Biden signed into law in August. It will provide $280 billion dollars in funding for domestic semiconductor research and manufacturing. Taiwan Semiconductor, the world's dominant producer of advanced chips, will be part of the effort, and to that end it is building a massive new facility in Arizona. However, producing those chips in the United States will cost 50% more than doing so in Taiwan.



Let's talk about China and President Xi's zero-Covid policy. China is the world's second-largest economy, with 1.4 billion people, so it matters a lot. The country is also governed very differently than we are, and its policies and economic data are often opaque.

Has President Xi's zero-Covid policy been inflationary? It's frankly hard to know. On the one hand, factory and port closures caused significant supply problems, which were definitely inflationary. But China is also a huge consumer of oil and other commodities, and they consumed less while in lockdown. Prices for these resources surely would have been higher without the zero-Covid policy.

What we do know is investors are really excited about the end of this policy. They think the country's reopening will do wonders for global growth and lessen the risk of recession. While there is merit to that view, we think investors could be disappointed.

China was the engine of global growth following the financial crisis, as the country was in the early stages of a debt-driven real estate boom. Real estate accounts for a massive 25% of China's economy versus less than 10% in North America. Some call it "the mother of all real estate bubbles," which they are presently trying to deflate.

Consumer spending is only 40% of the Chinese economy versus 70% in Canada and the U.S. Chinese consumers didn't get stimulus checks like we did. Furthermore, real estate is their largest asset, and it's going down in value.

There are other conflicting considerations. Demographically, China's population is shrinking due to the one-child policy, yet there is still plenty of cheap labour to tap in rural areas.

Companies like Starbucks want to grow in China and take advantage of the expanding middle class, while others like Apple are diversifying production elsewhere to reduce their economic concentration in a country that is seen as less friendly.

At the end of the day, China's overall influence on inflation has been mixed, and it's unclear whether it will be a deflationary or inflationary force in the world.

I'm sure you realize by now that all six suspects are guilty to a certain extent. While that's important to understand, my real motivation in using this framework was to give you a "clue" to a brighter future.

The prerequisite for enjoying what I do has always been believing that the future will be brighter. I'll be honest, that notion has been challenged in recent years.

What's exciting to me now is that I once again see a path to a brighter world. We start making the world better when we stop doing the things that make it worse. Raising interest rates to combat inflation means the end of an era of monetary mismanagement. It means we stop instigating negative unintended consequences. We stop encouraging more and more debt. We stop inflating bubbles and the misallocation of resources. And we stop fueling inequality.

It also means that savers can once again earn a decent return on bonds, and as portfolio managers, we can utilize fixed income to better balance portfolios.

The authorities used the lessons from the Great Depression to avert disaster during the financial crisis and, more recently, the pandemic. They overdid it this time, but they are determined to set the world straight, and we are confident they will.

There is a short-term cost to putting the world on a firmer foundation. We will probably have a recession, and that will come with higher unemployment and lower corporate profits.

We make a difference at Odlum Brown by being the voice of caution in highly speculative markets, and by staying the course when headlines are scary and markets are turbulent. We made a few mistakes during the boom times, holding

stocks like Netflix too long, but for the most part our portfolios have held up reasonably well. I know people are worried that stocks will perform poorly if we have a recession. Further downside is possible, and you may be inclined to sell. I'll leave you with four reasons not to:

First, the market is forward-looking; it discounts bad news in advance. When the bad news finally arrives, investors are normally focused on the recovery ahead.

Second, a ton of froth has already been expunged from the stock market. Most of the speculative turkeys that flew to the moon in 2020 and 2021 have dropped 70%, 80% or 90%-plus. Even the huge and profitable so-called FAANGM stocks – Facebook (Meta), Apple, Amazon, Netflix, Google (Alphabet) and Microsoft – were down an average of 40% last year. Valuations of the great businesses we own range from outstanding to reasonable. We believe they will be bigger, more profitable and more valuable three to five years from now.

Third, and perhaps you've heard me say this before, we believe investors would be wealthier if they treated their stocks like their home. For most people, their home is their most valuable asset because they hold it through thick and thin. They don't make the mistake of selling it when headlines are negative. At the beginning of the pandemic, I thought we were in for a long and nasty recession. If we had made a wholesale shift out of the market at that time, our Model Portfolio wouldn't be up more than 35% since the end of 2019 – and that is despite last year's drawdown.

One final consideration: Odlum Brown and our clients have prospered over the last 100 years despite World War II, the Great Depression, the inflationary 1970s, the 1987 crash, the bursting of the dot-com bubble, the financial crisis and the pandemic.

Preserving and growing wealth is not about the economy. It's about building a trusted relationship with your advisor, having a sensible long-term plan and, most of all, sticking to it. That's what we're here to help you do.

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