



## Presentation Transcript | Odium Brown's 28<sup>th</sup> Annual Address

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I'd been working on this presentation for what felt like a few long weeks and it was almost complete when Russia invaded Ukraine.

As tragic as the war is, it doesn't change our outlook or strategy. But, it has changed how I want to frame the discussion today.

Frankly, I don't think I have ever struggled more trying to figure out how best to explain our views. I think that is because the world and the investment markets are more complex and uncertain than they have been in my 30 years in the business.

We have a lot of important thoughts on the state of the world and the risks and opportunities in the investment markets. Many of these thoughts are connected or dependant on each other, and many are in conflict with each other.

Let me add some colour to that. Debt and social unrest in the world are the worst I've seen in my career and yet stocks are generally expensive. That doesn't seem right; stocks shouldn't be expensive when the world is fragile.

Ordinarily, one would favour bonds or cash when the risk and reward equation for stocks is unexciting. But one can argue that bonds are even more expensive and riskier than stocks today. Holding cash isn't without risk either, because inflation is eroding purchasing power at its fastest rate since the early 1980s.

That doesn't mean there isn't a place for cash and bonds in a portfolio – there absolutely is. But the right amount is different for everyone as it depends on your age, time horizon, income needs and your ability or desire to withstand volatility. There isn't a one-size-fits-all answer for the correct asset mix. I'm all-in on stocks and what I think is outrageously-priced BC real estate, although I've also carried a modest cash buffer ever since the Great Financial Crisis in 2008.

There are virtuous and vicious cycles operating simultaneously in the world. They have self-fulfilling feedback loops that sustain or even accelerate the cycles, and they are fuelled by economics, politics and human nature. There are desirable outcomes as well as negative and unintended consequences. Some are short term and some are long term.

Think about energy and climate change. Abundant and cheap fossil fuels powered the Industrial Revolution and have been fundamental drivers of human progress ever since. A virtuous cycle, for sure. But I think most of us would agree that it's a vicious cycle as well, with really negative long-term consequences. We definitely need to transition to cleaner forms of energy, but we have to manage the transition well.

Europeans pay roughly four times what we do to heat their homes with natural gas, in part because they haven't managed the transition well. The West wants to impose tough sanctions on Russia, and the way to hit them hardest would be to refuse to buy their oil and gas. However, those commodities, and others, have thus far been excluded from sanctions because including them would cause prices to soar. Understandably, many European countries don't want to cut off the hand that feeds them. Being tougher with Russia would cause painful economic consequences at home, and make politicians unpopular.

The human race is not naturally wired to endure short-term pain for long-term gain. We tend to favour instant gratification, the path of least resistance and what is politically expedient.

North American stocks were having a rough start to the year, after an absolutely amazing run last year, and they gapped even lower the morning after Russian tanks rolled into Ukraine. But, they abruptly reversed course midday and ended the trading day up a lot, and are up even more since then.

The best explanation for the market's big reversal on the first day of the war is that Wall Street was relieved that sanctions were watered down and wouldn't have a big economic bite. No short-term pain for investors to worry about!

My industry is amazing at looking at history to understand how markets react to various events, and statistics on wars are encouraging. The draw-downs tend to be shallow and short, and the recoveries are generally quick and rewarding.

That is comforting for sure, but there is more going on in the world and other things to consider.

Before the situation in Ukraine escalated, investors worried about inflation and how much central banks would have to raise interest rates to tame it.

# Goldilocks and the Federal Reserve



The original title of my presentation was "Goldilocks and the Federal Reserve." I was going to tell you a story about the confidence investors have in central banks – a belief that they will always have investors' backs and do "whatever it takes" to save the day and make things just right in the face of a crisis or big market correction.

It was a story about short-term gratification versus long-term consequences. It was about the trade-offs society has made and the possibility that our choices will be narrower as the short term catches up to the long term.

The debate and uncertainty about inflation – whether it will stay high or abate – was centre stage in the presentation. How the Federal Reserve and other central banks handle the situation was and still is critical. The pandemic has distorted so much in the global economy, and it's unclear if those distortions will be fleeting or longer lasting. The outcome for inflation has huge implications for the future of interest rates and asset prices, and whether we should favour growth stocks like Apple and Amazon that have treated us so well for more than a decade, or value stocks like banks and energy firms that are leading the market this year, after years of being out of favour.

With so many considerations and crosscurrents, my presentation was becoming convoluted. The Goldilocks fairy tale was becoming a nightmare. I needed to either simplify the story or come up with a different theme. I wondered if “Outlook Nuanced: Don't Put All Your Eggs in the Same Basket” would be a better title.

I worry that sharing a lot of conflicting thoughts will give you the impression that we are confused. We are not confused. The conclusions from all our work is that quality and diversification are paramount in a risky and uncertain world. It's the same message we have been repeating in recent years. We have tons of confidence in the mix of businesses we own and recommend, and we are convinced that they will collectively survive and thrive through good times and bad. They won't all go up or down at once, and we have purposely structured portfolios for that outcome. There are too many moving variables in our world, and too many possible scenarios to bet boldly on one outcome over another.

In any event, I needed a break. It was a beautiful day last Friday, so I called it quits early and asked my boys to go for a bike ride to UBC to have a drink and a bite.

At the restaurant, Patrick, my 18-year old who was back from the University of Victoria for reading break, shared that it was going to cost his friend \$3,800 to insure his motor bike, up from \$1,800 last year, just because he got one speeding ticket! That caused my older son Michael to exclaim in a bitter tone that “Everything in this city is ridiculously expensive. I'm never going to be able to afford to live here.”

I told my boys that I empathize with them. I also told them that I actually talk about their predicament in my presentation, and how the policies of the U.S. Federal Reserve, the Bank of Canada and other central banks have fuelled inequality and made it tough on the younger generation.

Patrick said, "How so?"

I said, "Let me give you a crash course in central banking 101. The central banks control interest rates and the amount of money in our economy. When we have a crisis, or an economic slump, the central bank lowers interest rates to help jump start the economy. Low interest rates do three positive things for the economy: 1) they encourage people to borrow and spend; 2) they encourage entrepreneurs and businesses to invest; and 3) they cause the value of homes, stocks and other assets to go up in price, which in turn makes the owners of those assets richer and feel like spending money. All three things help create jobs, which is one of the Federal Reserve's main mandates. Most central banks have a singular purpose of controlling inflation, but the Fed has a dual mandate of maximizing employment and price stability."

Creating jobs and getting the economy going when it is in a slump is absolutely a good thing and the right thing for central banks to do. However, it's when they keep interest rates low after the economy is back on its feet that undermines the long-term health of our society. It fuels asset inflation that drives a growing wedge between the "haves" and the "have nots," those who own assets and those who don't.

We went through a little exercise on the mechanics of how low interest rates fuel home price inflation. I used simple numbers to make it easy. Suppose you make \$100k a year and that you can spend half of that or \$50,000 a year paying interest on a loan, which you use to buy a house. How big a loan can you get if the interest rate is 10%?

Michael said, "\$500,000."

I said, "Correct:  $\$500,000 \times 10\% = \$50,000$ . And, if interest rate were to fall in half from 10% to 5%, you could afford a \$1 million loan. And if the rate falls in half again to 2.5%, \$50,000 would cover the interest on a \$2 million loan."

I told my boys the reason home ownership keeps getting more and more expensive is because people can borrow more money when interest rates go down, and they use those bigger loans, or mortgages, to bid up house prices. The average five-year mortgage rate has declined from 20%, 40 years ago in the early 1980s, to 2.5% recently, and it's that big drop that has caused home prices to go through the roof. Think of interest rates and home prices on the opposite end of a teeter-totter. When interest rates go down, home prices go up. All assets are affected by interest rates in the same way. Stocks, bonds, art – you name it – are expensive because interest rates are low.

Because home prices have gone up so much faster than wages, it's understandable that the younger generation and those who don't own homes are frustrated and feel the system isn't fair.

That's when Patrick sarcastically said, "I'm just going to buy NFTs."

"Ha," I laughed. Do you know what has fuelled the crazy speculation in NFTs, or non-fungible tokens? Money printing has! That's the part of the central bank story I haven't explained yet, and what has supercharged the economic recovery and asset inflation during the pandemic.

Before I do, let me explain what non-fungible tokens are. They are unique digital assets, with much of the current market centered on collectibles, such as digital artwork, sports cards and rarities. The speculation has been absolutely crazy! In early March 2021, a group of NFTs by digital artist Beeple sold for over \$69 million. It reminds me of the 17<sup>th</sup> century tulip mania in Holland, when tulip bulbs sold for upwards of 10 times a skilled labourers' annual wages at the height of the speculative craze.

In any event, back to money printing.

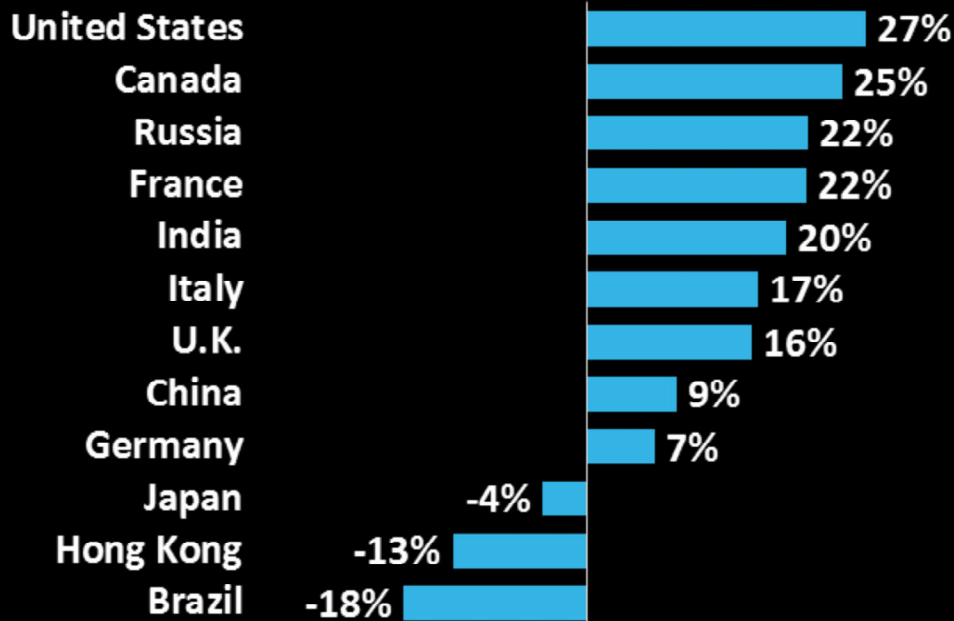


When the economy and financial markets are in really bad shape, the central banks print money and add it to the economy, in addition to lowering interest rates. They don't actually say they are printing money. They call it quantitative easing, probably because they don't want us to know that they are diluting and depreciating the value of our money. In any event, the way they add new money to the economy is to buy bonds out of the public market, in exchange for cash that they create. They take the bonds out and add cash back. That new money either gets spent in the economy, or it gets used to buy another bond or stock or some other asset. That added flow of money puts added upward pressure on asset prices. It's like throwing gas on a fire!

The U.S. Federal Reserve and other central banks played a huge role in supporting the economy during the pandemic by lowering interest rates and by buying massive amounts of bonds. In other words, they threw a lot of gas on the economic fire. Governments played a big role too, with enormous support payments to individuals and businesses. The deficits that governments produced to make those payments were largely financed by the central banks.

From an investor's perspective, one would have to say that the central banks were wildly successful. After contracting in 2020, the world economy grew by 5.6% in 2021.

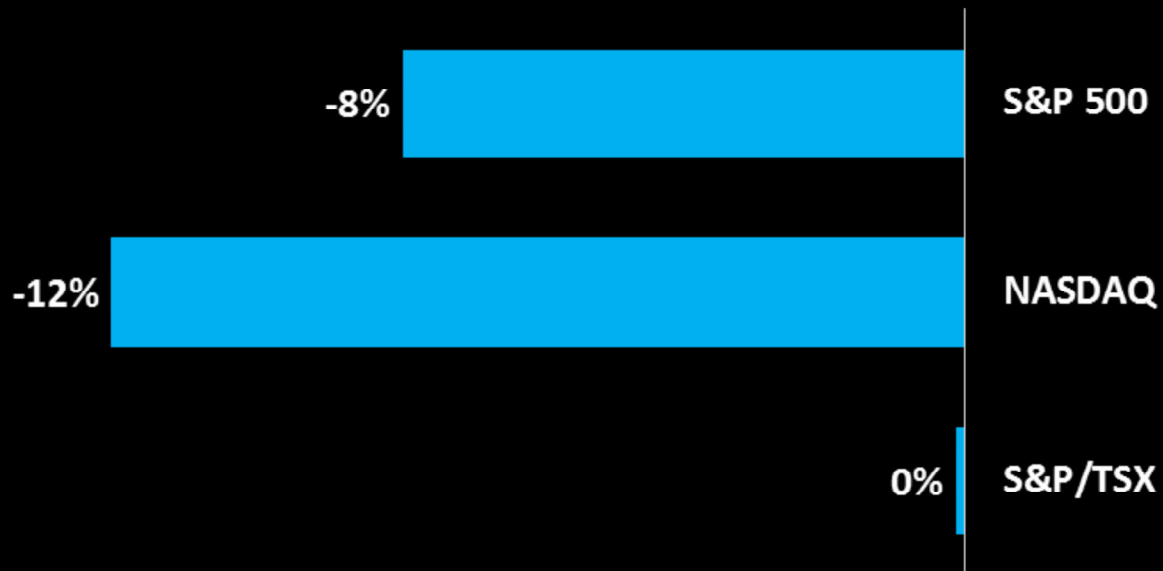
# 2021 Total Returns (\$CDN)



And you might say that the U.S. Federal Reserve was the most successful of all, as the U.S. S&P 500 Index led the world's major markets with a return of 27% last year. Canada wasn't far behind with a return of 25%.

The Goldilocks story has always had a happy ending, but investors are starting to wonder if the Fed and other central banks are losing control of inflation, and that has caused a lot of volatility in the stock market lately. In fact, the equity markets have had a rough start in 2022, as I mentioned earlier and I'm sure you are aware.

# 2022 YTD Total Returns (\$CDN)\*



\*As of February 28, 2022

In the U.S. market, the broadly based S&P 500 Index is down almost 8% for the YTD, and the technology-heavy NASDAQ is down 12%. And those returns mask more significant turbulence below the surface. There have been notable shifts in which stocks are leading and considerable drawdowns in parts of the market. Many of the growth-type stocks, which were popular in 2020, have been pummelled, while many value-type stocks, which were laggards in the early part of the pandemic, are doing well.

The Canadian market has held up much better than the U.S. market this year, and is roughly flat for the year-to-date, helped by good performance from Energy and Bank stocks, which have a big weighting in our benchmark Index. Nonetheless, like the U.S. market, we also have many stocks that are down significantly.

Concerns about inflation and uncertainty about central bank policy is creating the turbulence. I'm going to talk about the U.S. because it's the world's largest economy and our biggest trading partner. What happens in the U.S. has a huge influence on what happens in Canada, and because of that, our inflation trends and central bank policies follow what happens south of the border. Although the Bank of Canada raised interest rates today, and the U.S. Federal Reserve will likely raise interest rates in a couple of weeks at their regular meeting.



# CPI Inflation Highest in 40 Years

## Consumer Price Index (CPI) Y/Y % Change



Source: Bureau of Labour Statistics

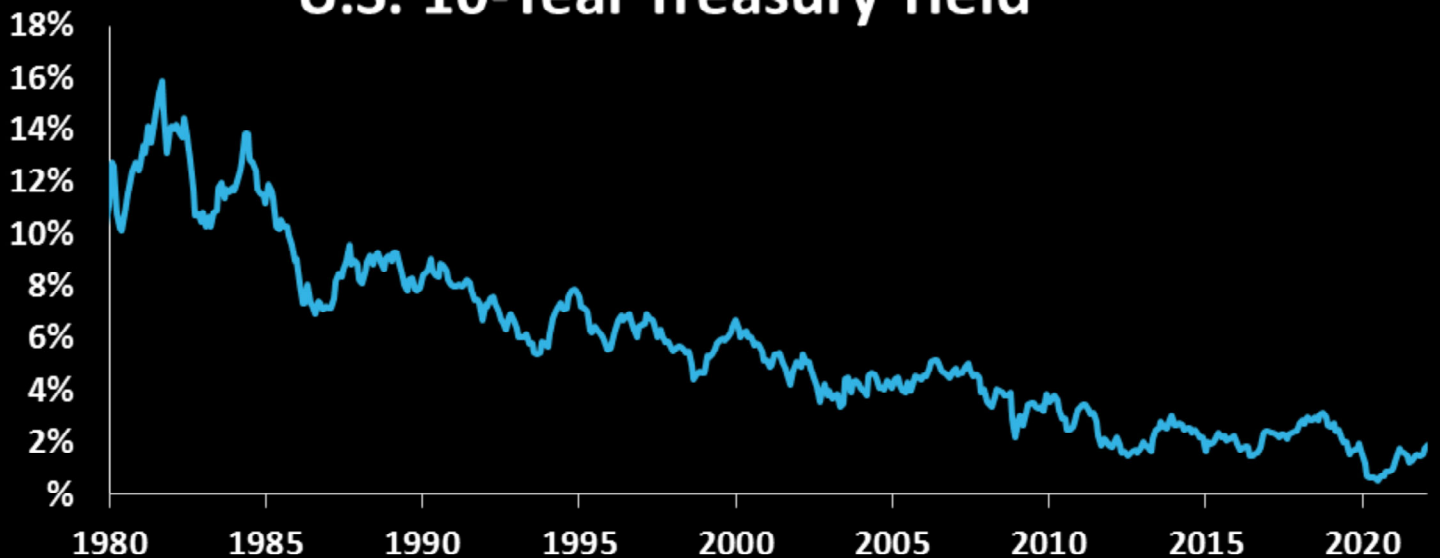
U.S. consumer price inflation hit 7.5% last month, its highest level since the early 1980s. Interest rates are normally higher than inflation because investors expect to get a real return on top of inflation, and interest rates were certainly high for that reason in the early 1980s. Back then, the Federal Reserve broke the back of inflation by jacking up short-term interest rates to 20%, and that in turn killed the economy and housing market and drove stock valuation multiples to record lows. Nobody wants a repeat of that experience, which is why there is so much talk about whether central banks are falling behind in their fight against inflation.

It's important to have some historical context to appreciate what is at risk.

Since the early 1980s, we have been in a disinflationary environment, which means that inflation has trended lower and lower. Globalization and technology are the primary reasons for the trend.

# 40 Years of Falling Interest Rates

## U.S. 10-Year Treasury Yield

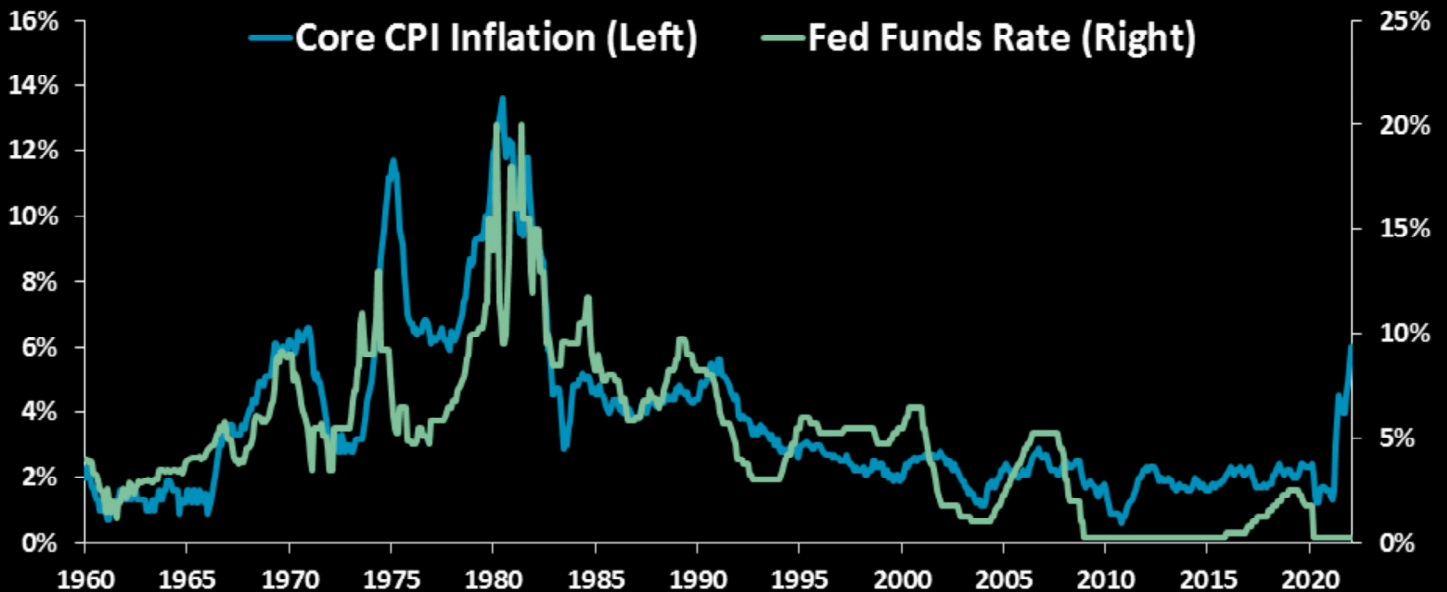


Interest rates have steadily fallen with inflation over the last four decades, as illustrated by the chart of the U.S. 10-year Treasury bond yield. As I explained earlier, the drop in interest rates has had the wonderful effect of pushing asset valuations higher over time. If interest rates reverse course and trend meaningfully higher because consumer price inflation remains persistently high, the value of our homes and stocks will be at risk. That's why getting inflation under control is critically important.

The big debate these days is about whether high inflation is due to the pandemic-related economic dislocations or if it is due to ultra-low interest rates and excessive money printing during the pandemic. There are strong arguments on both sides, and we suspect reality lies somewhere in between.

It seems crazy that the authorities have kept administered interest rates pegged near zero, and continued to inject new money into the financial system, as inflation has tracked higher and higher, month after month.

# Federal Reserve Slow to React



Never before has the Fed sat idly by in the face of a significant increase in inflation. In fact, you have to go all the way back to the oil crisis of 1973 to find a time when the spread between the inflation rate and the Fed Funds rate was wider than it is today. The blue line on the chart is Core CPI Inflation, which excludes the volatile components of food and energy, and the green line is the Fed Funds Rate, the short-term interest rate, which is essentially the building block for all other interest rates.

The Fed's lack of action seems especially out of touch, given how much businesses are struggling to find workers. Worker wages are rising at an accelerating rate, and the worry is that we will get into a self-fulfilling wage-price spiral similar to what happened in the 1970s. When one person's wages increase, their spending increases as well. That increased spending becomes someone else's increased wages, which drives higher spending and so on and so forth.

You might think it is good that wages are rising, but the problem is that prices are rising at a faster rate. Workers are falling further behind. In effect, the pandemic and central banks' cheap and easy money policies have exacerbated the inequality trends that were already well-established. It's what keeps happening every time there is a crisis. It's one of those vicious cycles that isn't sustainable in the long run.

In the near term, the Fed knows that it's behind the curve and that it needs to play catch up. They have telegraphed to the market that they will end their bond buying program and start raising interest rates later this month. They have also said they will likely start unwinding some of their quantitative easing later in the year, and start quantitative tightening. That means they will start selling some of the \$9 trillion worth of bonds they own, which will take cash out of the financial system. It's the opposite of money printing.

Investors are on edge. There is an inordinate amount of debate about how quickly and by how much the Fed will raise interest rates, and whether they will be successful in bringing inflation down.



# Once upon a time... Everything was perfect.

What's interesting is that the bond market is pricing in a Goldilocks scenario, whereby the economy slows and inflation recedes to 2% without the Fed having to raise interest rates much beyond 2%. That would be a great outcome and we hope bond investors are right.

But, we are not banking on it. There is a risk that the economy runs too hot, that inflation is a persistent problem and that central banks will have to raise interest rates more than expected. There is also a risk that the economy will cool too much and tip into recession, and cause investors to worry about falling asset prices and deflation.

There was a whole section in my presentation about the rotation going on between growth-type and value-type stocks and how we thought the tug-of-war between the two groups would evolve depending on the temperature of the economy. It was a nuanced discussion that rightfully ended up on the cutting room floor.

We own both types of stocks because that is what is sensible in a complex and uncertain world.

By owning reasonably priced high-quality businesses and diversifying our holdings, we believe we limit our downside risks and ensure we generate relatively good performance irrespective of what happens.

I've covered a lot of ground. There is a lot of uncertainty in the world and volatility in investment markets. While that is daunting, it also presents opportunities.

At the beginning of the presentation, I said stocks were generally expensive. But that doesn't mean they are all pricey.

In my career, the North American stock markets were most expensive at the turn of the century. That was during the technology mania and it was also a time when the big U.S. Blue Chip companies were very expensive. But outside of those areas, there were a lot of cheap stocks. It was the best time in my 30 years in the business to be a stock picker, and we did very well despite the market looking very expensive on a top-down basis. The opportunities are not as exciting today, but they still exist.

We strongly believe that a well-diversified portfolio of high-quality businesses will continue to serve us well, despite the uncertainty in the world.

Thank you for joining us today. We really look forward to seeing you in person soon.

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