# Investing Wisely

## A Newsletter from Mike Wise

# September 2023

Every year it seems that summer gets shorter and shorter. However, on the bright side, we are having a beautiful Indian Summer, and no frost yet!

We feel sorry for the good folks in BC and the Northwest Territories who lost their homes or had to evacuate from all the forest fires this summer. The smoke that we endured in Calgary was a minor inconvenience compared to what they went through!

Our robin raised 3 sets of babies over the summer! They've all grown up and have departed our back yard, presumably making their leisurely trip down south to a more temperate climate for the winter.

Fall Colours
Photo courtesy of T. Vanzelm

We don't have any travel plans. Carmen's leg is making progress, but she is still not ready for the long trip down to our house in Costa Rica.

We travelled to Ottawa over the summer for our family reunion. It was a great success, with 3 generations of Wises in attendance. Charles, the patriarch of the family, held the youngsters in rapt attention with his tales from the past. Some of them might even have been true!

We also just returned from our Grand Tour of BC. Portfolio Strategies held its annual conference in Kelowna, and I met with my BC clients before and after the conference. Carmen and I also enjoyed a pleasant reunion with our long-time friends who now live in BC.

### Where We Are

Table 1 shows how stocks, bonds and commodities are performing so far this year. The numbers shown are as of September 22 rather than the end of August, because my tour of BC delayed when I could put this newsletter together.

Bonds had a good start to the year, propelled by declining interest rates (and therefore rising bond prices). However, sentiment changed as the summer progressed, and now Mr Market seems to think that higher rates are here to stay. The Universe Bond Index is down -1.2% on the year, and High Interest Savings Accounts, 5-year GICs, and the Canada 10-year Bond are all offering higher interest rates than at the start of the year. Scotiabank is offering a rate of 4.75% on their High Interest Savings Accounts; these are CDIC-insured and have 1-day liquidity. They are available only through participating financial advisors (of which I am one).

The Bank of Canada chose to hold interest rates steady at its last meeting. The Canadian Prime Rate is now 7.20%. The Prime Rate serves as the benchmark for GICs and other insured savings instruments. On the other side, it also serves as the

PORTFOLIO STRATEGIES

11 Lenton Place SW
Calgary AB T3E 5C7
Tel: 403-616-3434
mikewise@wiseword.ca
www.wiseword.ca

**Table 1**
**2023 Returns - Year to 22 September**

| | 31 December Price | 22 Sept Price | YTD Change |
|---|---|---|---|
| **Equities** | | | |
| TSX (CAD) | 19384.92 | 19779.97 | 2.0% |
| S&P500 (USD) | 3839.50 | 4320.06 | 12.5% |
| NASDAQ 100 (USD) | 10466.48 | 13211.81 | 26.2% |
| | | | |
| **Commodities** | | | |
| Oil (WTI; USD) | $80.51 | $90.33 | 12.2% |
| Gold (Comex; USD) | $1830.10 | $1944.90 | 6.3% |
| | | | |
| **Fixed Income** | | | |
| DEX Universe Bond Index (CAD) - Total Return | 1054.5 | 1042.0 | -1.2% |
| Govt of Canada 10-Yr Bond Interest Rate | 3.316% | 3.950% | 0.634% |
| Best 5-yr GIC Rate (rate as of Sept 22) | 4.10% | 5.01% | 0.91% |
| High Interest Savings Account (rate as of Sept 22) | | 4.75% | |
| | | | |
| **Exchange Rates** | | | |
| USD/CAD | $0.7378 | $0.7411 | $0.0033 |
| EURO/CAD | $0.6894 | $0.6962 | $0.0068 |

base rate for variable rate mortgages and consumer loans.

The US Federal Reserve also chose to hold its Fed Funds Rate steady at its last meeting. The rate is now up to 5.50%. The US Prime Rate tends to be 3% higher than the Fed Funds Rate, so the US Prime is now 8.50%. More on US interest policy in a later section.

September is often a bad month for the stock market, and this year is no exception. The Canadian TSX Composite Index is down -3.7% in the first 3 weeks of this month, dragging gains for the year down to a paltry 2.0%. On the US side, the S&P500 Index of the 500 largest stocks is down -4.3% so far in September. Even so, the S&P500 is up 12.5% on the year, while the tech-heavy NASDAQ Index is up a whopping 26.2%.

Just 7 stocks represent 88% of the gains of the S&P500; the other 493 stocks have essentially done nothing. The Big 7 are: Alphabet (Google), Apple, Meta (Facebook), Nvidia, Amazon, Microsoft and Tesla. Collectively they have gained $2.1 Trillion in market capitalization. Apple alone gained more than $0.5T in market cap.

I'm not going to predict when the market's love affair with Big Tech will end, but past history does indicate that it is always dangerous when the stock market is so concentrated.

The Canadian TSX Index is considered to be more of a value index due to its heavy weighting in resources and financials. Oil has rebounded after a tough start and is back above $90/bbl on the back of geopolitical maneuvering. Gold seems unable to break the $2000/oz barrier.

Most of my clients have a balanced portfolio. Falling bond prices and an anemic Canadian stock market have hurt overall returns. My Canadian Neutral Balanced Benchmark is up only 2.01% so far in 2023.

## Alberta Pension Plan Proposal

The big news on the investment front for Albertans is the proposed Alberta Pension Plan. The Alberta government had commissioned a study by pension consultant Lifeworks (formenly Morneau Shepell – yes, father of the Morneau that was Liberal Finance Minister), concerning the viability of transferring assets from the Canada Pension plan to a brand-new Alberta Pension Plan. Lifeworks delivered its report to the government about a week ago, and it has certainly generated lots of comment.

Whether that comment was informed is another question; when I downloaded the report (it is available online at www.albertapensionplan.ca), only 4771 people had accessed it. Fewer than 1 in 1000 Albertans have actually seen the document, let alone read it!

I've attached the Lifeworks report to the emailed version of this newsletter, and have posted it on my website www.wiseword.ca.

To start at the beginning, the Canada Pension Plan Act (1966) has a provision that a province may leave the Canada Pension Plan upon 3 years' notice. Lifeworks made the assumption in its analysis that notice would be given on 1 January 2024, with termination on 1 January 2027. These dates are arbitrary and don't affect the analysis. Certain caveats apply:

- An Alberta Pension Plan (APP) must provide comparable (or better) benefits as CPP;
- The APP must assume all obligations and liabilities accrued to members up to the date of withdrawal from CPP.

As you likely know, Quebec has never participated in the Canada Pension Plan, but its benefits are essentially the same as CPP.

Furthermore, to quote from the Lifeworks report: "*The other provinces are not legally entitled to a formal role in the withdrawal process or a veto over the withdrawal.*"

The Lifeworks report made the rather startling assessment that the new APP would be entitled to receive assets totaling $334B from the CPP as startup capital. This is, according to Lifeworks, the accrued net contributions from Albertans since 1966. This sum represents more than half of CPP assets, so the question naturally arises as to how a province with only 15% of the country's population could lay claim to 53% of the assets.

The answer, according to Lifeworks, is that throughout the history of CPP, Alberta has always had a younger population with higher labour participation and a higher income than the rest of the country. It has had fewer retired people making withdrawals from CPP than other provinces, and has been a net contributor almost every year*. Some other provinces – think the 4 Maritime provinces, Saskatchewan and Manitoba – are the exact

**Nuthatch at our Garden Fountain**

opposite, and have had net withdrawals (negative equity, if you will) from CPP.

According to the Canada Pension Plan Act, the withdrawing province is entitled to the net contributions of the residents of the province (payments into the CPP, less retirement and death benefits), plus the accrued earnings from those net contributions. For example, if Albertans contributed $100,000,000 (net) to CPP in 1966, this sum would be compounded by the investment returns of CPP over 56 years. If CPP had achieved a compound 7% return over those 56 years, that would amount to $4.42B "owed" to the new Alberta Pension Plan. If you do this type of calculation each year for 56 years, it doesn't take long to come up with a number measured in the 100s of billions.

Others have disputed this approach. Fair enough, but the formula is laid out in the Act and the discussion has to be based upon the law as it currently exists. Net contributions and the investment returns of the CPP from 1966 to 2023 are not easily disputed. Appendix B of the Lifeworks report shows net contributions and investment returns by year from 1966 to 2021.

And to repeat what I wrote earlier: "*The other provinces are not legally entitled to a formal role in*

* Alberta had net outflows from 1992 to 1997, along with every other province. CPP changed from a "pay-as-you-go" funding system to a fully-funded model in 1997 with the establishment of the Canada Pension Plan Investment Board (CPPIB).

*the withdrawal process or a veto over the withdrawal."*

The amount to be transferred from CPP to APP is a key component to any discussion of future contribution rates and/or improved benefits to Albertans. Everything else deals with assumptions about the future, and as Yogi Berra once said, "it's tough to make predictions, especially about the future."

Lifework's base estimate is that the new APP could support a contribution rate of 5.91%, versus the current CPP contribution rate of 9.9%. This would save every Albertan (and every employer) who has earnings at or above YMPE over $1425/yr, adding more than $5B annually into the Alberta economy.

In this regard, Lifeworks made the assumption that Alberta's advantage of youth and high earnings will gradually disappear, such that the demographics and earnings potential of Albertans will be same as the rest of Canada by 2050.

Most other assumptions in the report are the same as made for the Canada Pension Plan: future returns will be 5.9% to 2030, then 6.0% thereafter, and participation rates will be the same as they are today. And so on, with assumptions that only an actuary could love (see Appendix C).

One key bone of contention has been who would manage the money in a future APP. The main contender is Alberta Investment Management Corporation (AIMCo), which already manages the pension funds of almost all Alberta public sector workers. However, the Lifeworks report seems to lean towards making an agreement with CPPIB (the investment arm of CPP) to continue managing the assets. This is an interesting choice. A lot of CPPIB's investments are in "private equity", which by its very nature is illiquid and hard to divide between CPP and a new APP. Also, CPPIB has had better returns over the last 10 years than has AIMCo. On the negative side, CPPIB is fully committed to ESG (Environment, Social, Governance) and DIE (Diversity, Inclusion, Equity) so favoured by the current federal Liberal government. CPPIB does not like investment in

**Our Baby About to Leave the Nest**

Alberta's energy industry. An APP that had funds managed by CPPIB could not have an independent investment policy, unlike the Quebec Pension Plan that has the mandate of promoting Quebec's economic development.

Anyway, read the report for yourself so that you can form an informed opinion. Feel free to pass it on to others. The Executive Summary is short, and does a good job of summarizing the body of the report. As always with this type of study, the useful details are in the Appendices.

## *Flexible* Tax-Efficient Income

Many investors are looking for regular income from their non-registered accounts, without having to pay brokerage fees on the sale of securities, capital gains taxes, or complicated income tax filings.

The fund industry has responded with an innovation commonly known as T-SWPs. Essentially, the fund companies return regular income to their investors that is classified as Return of Capital (ROC), rather than dividends, interest income or capital gains. ROC is return of the investor's own invested capital, so is not taxable. If ROC equals the investment gains within the fund, there is no actual decrease in the value of the investment. Call me if you want a more detailed explanation.

Most T-SWPs offer a 5% annual distribution, payable in equal monthly installments. Mackenzie has recently introduced a flexible payments option, in

Charles Telling a Tale at the Family Reunion

which the investor can select a T-SWP distribution that can range anywhere between 1% and 8%. (Reinvestment of the entire distribution has always been allowed.) Another option would be to select a fixed dollar amount of distribution. Furthermore, Mackenzie allows investors to change the level of distribution as their circumstances change.

Of course, as with regular T-SWPs, if the amount of distribution exceeds the investment gain within the fund, the value of the account will decrease.

## Where We're Heading

As usual, I'll be focusing more on the US than on Canada, because as the old saying goes, "whenever the United States sneezes, Canada catches a cold".

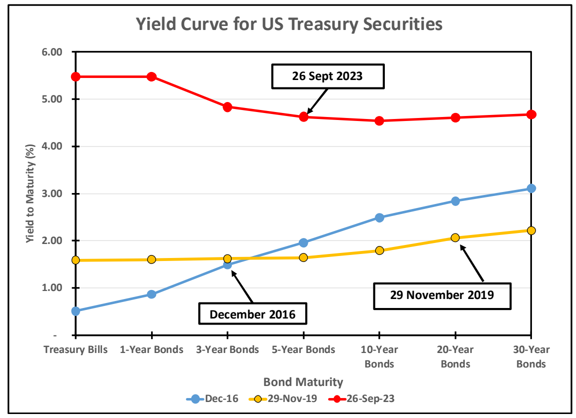
## United States

### Interest Rates

I'd be considered a monetarist in economic terms. I believe that the policies of the US Federal Reserve (the Fed) are extremely important in the economic life of not only the US, but around the world. The US runs on debt. Even mortgage interest is a tax-deductible expense; there is no incentive for ordinary homeowners to pay off their mortgage and live debt-free. Since debt, and living beyond one's means, is an American tradition, it follows that the nation is very sensitive to the Fed's interest rate policy.

The Fed held its Federal Funds Rate steady at its most recent meeting. This benchmark rate remains at 5.50%. Mackenzie Investments summarized the Fed's comments as follows:

**Chart 1**
**US Treasuries Yield Curve as of 26 Sept 2023**
**Source: Barron's**




- Higher for longer was the key takeaway from the US Federal Reserve's (Fed) policy decision last week.
- The updated Summary of Economic Projections and Chairman Powell's tone were hawkish, resulting in bond yields taking another leg higher.
- The Open Market Committee notably raised its Fed Funds Rate (FFR) forecast for the next two years to 5.1% for 2024 (prev. 4.6%) and 3.9% (prev. 3.4%) for 2025.
- Meanwhile, members kept their expectations for another 25-bps hike by the end of the year.
- The Committee largely held its projections for its preferred measure of inflation, Core PCE inflation, over the next few years. With inflation still expected to moderate and an increase in its rate projections, this likely means that they might no longer be fixated on a 2% inflation target, but might be looking at 2.5%.
- The other takeaway from this month's meeting was a reaffirmation that policy would need to remain restrictive for some time due to a more resilient US economy.
- The Fed significantly revised its 2023 real GDP estimate to 2.1% (prev. 1.5%), while the forecasts for the unemployment rate downshifted materially over the next two years.
- Markets have pushed out their expectations for the first rate cut to September of next year, a stark contrast to expectations earlier this year, where markets were anticipating cuts to begin in the second half of this year.

The Consumer Price Index for August was up 3.7% compared to August 2022. Things people actually buy, like groceries, were up twice that on an annual basis.

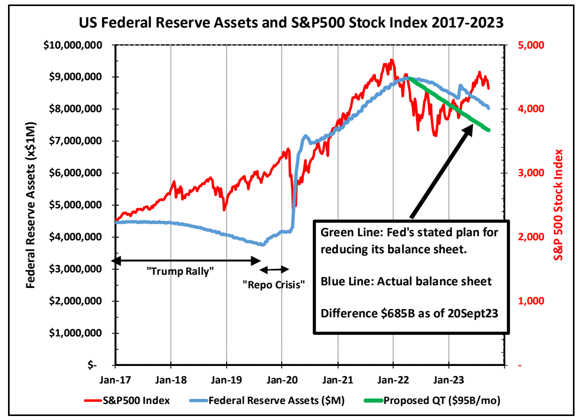
Wages rose 4.8% year-over-year. Although this is higher than the posted CPI, the incomes of ordinary Americans are not keeping up with inflation of the things that they actually buy. Americans are unhappy. This is not good news for Democrats. As President Clinton once said, “It’s the economy, stupid!”

The interest rate yield curve is the single best predictor of future economic activity and recessions. Recession typically starts 12-18 months after the interest rate charged by 90-day Treasury Bills becomes higher than the rate charged by 10-year US Government Bonds. Banks make their money by playing the spread between lending at long-term rates and paying depositors based upon short-term rates. They can’t make money when the rates are inverted, so they stop lending. Chart 1 (previous page) shows 3 curves: a strong positively-sloped yield curve at the end of 2016; the curve just before the outbreak of Covid in November 2019, and the current negative-sloped yield curve for US Treasuries. The 10yr/3mo curve turned negative in October 2022, or 11 months ago. As of September 26, the 10-year yield is 4.542%, while the 3-month yield is 5.476%.

The Fed can control short term interest rates by periodically adjusting the Fed Funds Rate. The other arrow in the Fed’s quiver is whether it is a net buyer or seller of government and agency-backed debt. It

**Carmen at Invermere Beach**

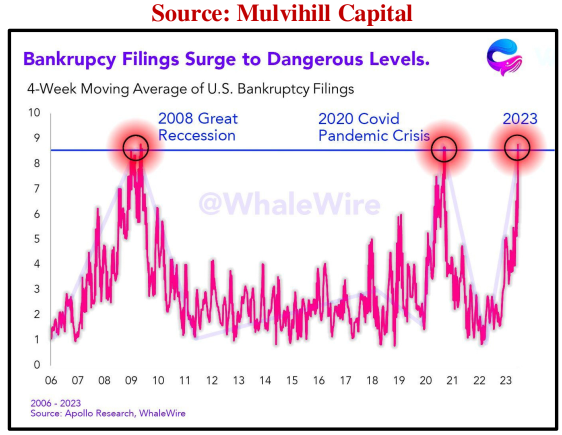
**Chart 2**
**US Federal Reserve Assets**
**Source: US Federal Reserve**




holds a massive amount of debt (remember, another entity’s debt is an asset to a bank, not a liability!) that it purchased during the Pandemic. Its much-repeated intention has been to be a net seller of this debt, thereby pulling excess cash out of the economy. Chart 2 shows its intention (green line), and actual performance (blue line). It has been somewhat slower in action than advertised; it doesn’t look like much on Chart 2, but the difference between those 2 lines has now grown to a stunning $685B.

If you look carefully at the blue line in Chart 2, you’ll see a big jump in the Fed’s assets in March. That was the bailout of the Silicon Valley Bank. Since then, the Fed has resumed its course of asset sales. This pulls cash out of the economy. Perhaps this accounts for at least some of the stock market’s recent

**Chart 3**
**US Bankruptcy Filings**
**Source: Mulvihill Capital**



performance. The Big Tech darlings are now down more than 10% from their mid-July highs.

## US Economy

I can't see that the Fed will stop its tight money policy of raising interest rates and selling assets while the US economy remains strong and inflation remains a problem. Let's look at a few economic indicators to see how the rest of the year might unfold.

An interesting chart arrived in my email inbox this morning. Apparently, bankruptcies are nearing an all-time high! See Chart 3 (previous page). Does this mean there's a serious discrepancy between Wall Street and Main Street?

Let's start with employment. The Beveridge Curve (Chart 4) measures the ratio between job openings and the unemployment rate. Job openings are drifting downwards, while the unemployment rate, at 3.8%, remains range-bound between 3.4% and 3.8%. According to the Bureau of Labor Statistics, the US economy added 1.9 million jobs to the end of August, of which 1.6 million were in the private sector.

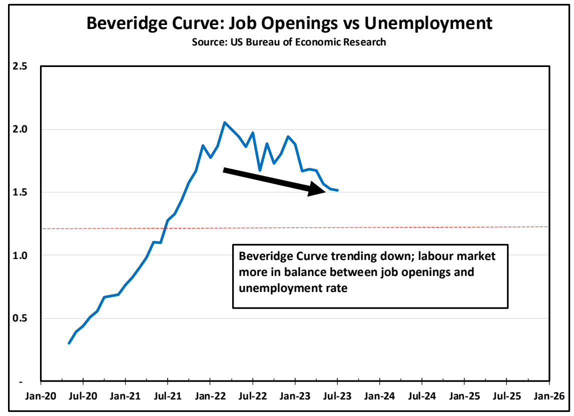
There doesn't seem to be any looming problem there, at least when looking at the big picture. Main Street seems fine.

Burrowing deeper into the employment data gives the first look at a couple of leading economic indicators that might point towards future trouble.

I'm not going to show the charts this time, but the BLS labour statistics data shows that employment in the goods-producing sector has barely changed so far this year, while manufacturing employment has not changed at all. It makes me wonder where all those 1.6 million new jobs came from: all in the service sector?

Manufacturing overtime gives me a glimpse of the demand for blue-collar workers, while employment at temporary agencies does much the same for white-collar workers. In both cases, they act as surge capacity: when times are good employers will ask employees to work overtime (or hire temp workers) rather than hire new employees; in hard times they will reduce or eliminate overtime (or lay off the temp workers) rather than let their core employees go.

**Chart 4**
**Beveridge Curve**
**(Job Openings vs Unemployment Rate)**
**Source: US Bureau of Labor Statistics**




The BLS data shows that overtime in the manufacturing sector remains substantially lower than normal, to a level seen only rarely and in the midst of major downturns.

Employment through temporary agencies looks at mainly white-collar jobs. The BLS survey shows a continuing trend of lower employment at temp agencies from the record high in 2022. The year-over-year change in temp employment is down by -5.9%. That doesn't happen very often, and is often a precursor to much greater job losses in the sector.

**Joyce, Carmen, Wanda, Steve & Mike**

**Chart 5**
**Building Permits & NAHB Confidence Indicator**
**Source: Nat'l Assoc of Home Builders; US Census Bureau**

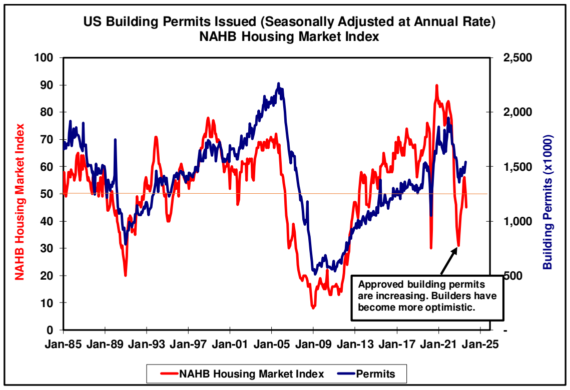
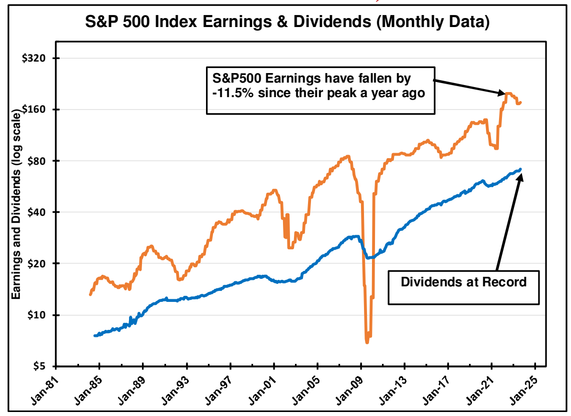



**Chart 6**
**US Corporate Earnings & Dividends**
**Source: Standard & Poors; Barrons**




Housing is a sector of the economy that is very sensitive to interest rates. Higher mortgage costs and more stringent lending terms can really hamper the sector. New housing construction is an important component of the overall economy. The actual construction is one thing; then there are all the extras that go into a new house, like carpeting and window furnishings, furniture, appliances, and landscaping.

A couple of leading indicators for the health of the residential construction industry are the builder's confidence survey that is conducted monthly by the National Association of Home Builders (NAHB), and the number of new building permits issued. A builder needs a permit before construction can begin.

See Chart 5. This chart surprised me. Builders have become more optimistic (red line) recently (although there was a pullback in the September survey) despite increasing interest rates and mortgage rates and inflation in the cost of building materials. Optimistic builders are applying for and obtaining more building permits (blue line).

Finally, let's look at corporate earnings and dividends. See Chart 6. These are the things that drive the stock market over the long term. Chart 6 shows that the large corporations that are listed on the S&P500 Index continue to increase their dividends. Dividends are at an all-time high. Earnings have fallen by -11.5% over the past year, and the path is downwards. That's not a good sign!

**Lakeview Golf Course, Hole #8**

September in Kelowna

## Summary

In summary, then, we have a mixed bag of signals. Consumer spending is an important part of the US economy. Wages have not kept up with inflation in the prices of things that people actually buy. The US Prime Rate is already at 8.50%. How much higher does it have to go before the consumer has to stop spending?

In the meantime, large corporations are doing well. Earnings over the past year have fallen slightly, but are still at healthy levels. The earnings are supporting increased dividends from already-record levels. The employment data still looks very good, with a tight labour market and low unemployment.

The Fed continues to think that the economy is doing too good. The tight labour market is causing wages to rise, and that's a bad thing as far as the Fed is concerned.

On the other hand, the yield curve is negative, and the leading indicators of manufacturing overtime and employment at temporary agencies are both troubling. High interest rates have slowed the construction sector. Problems at the regional banks have got to ripple through the US economy. **I remain a believer in "Don't Fight the Fed!"**

## Canada & the World

There's lots that I could be talking about in this section, but this newsletter is already too long, so I'll stop here.

We'll end with just a couple of headlines in today's *Calgary Sun*:

September in Calgary

- Poll shows Canadians see through Trudeau's carbon tax claims: majority want carbon tax reduced or cut altogether, small minority want it to go up.
- Statistics Canada says real gross domestic product was essentially unchanged in July, following a 0.2 per cent decline in June.