A Tale of Two Cities

By John Nicola, CFP, CLU, CHFC

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."

Charles Dickens – A Tale of Two Cities

We have just finished a tumultuous and challenging 2021 which provided good results financially for many investors while being a significant drain emotionally and psychologically as the Fourth Covid wave became a part of our existence. As I was thinking about how we might want to look at 2022 and beyond I remembered these first lines from Charles Dickens classic about the French Revolution. To me it is asking the question "is the glass half full or half empty?" And the answer seems to be both. Let's separate his quote into the positive and the negative and consider how they may apply to our environment today

Glass Half Full:

• Best of Times • Age of Wisdom • Epoch of Belief • Season of Light • Spring of Hope	• Public markets and residential real estate at all-time highs in several markets • Covid Vaccines developed in record time. Fourth Wave of Omicron may have much lower levels of serious illness or death • The move to ESG investment options in light of major environment issues such as climate change is accelerating rapidly. The cost and evolution of renewable energy is improving exponentially • Significant drops in levels of global poverty, hunger and illiteracy (Marian Tupy – 10 Global Trends) • Global population increases are slowing rapidly and likely to peak within 30 years at about 8.9 Billion • Any rises in interest rates are likely to be measured and spread out over time. Impact on asset prices will be modest

Glass Half Empty:

• Worst of times • Age of foolishness • Epoch of Incredulity	• Huge increases in corporate and government debt to finance the pandemic and acquisition of assets (Evergrande as an example). The end results a

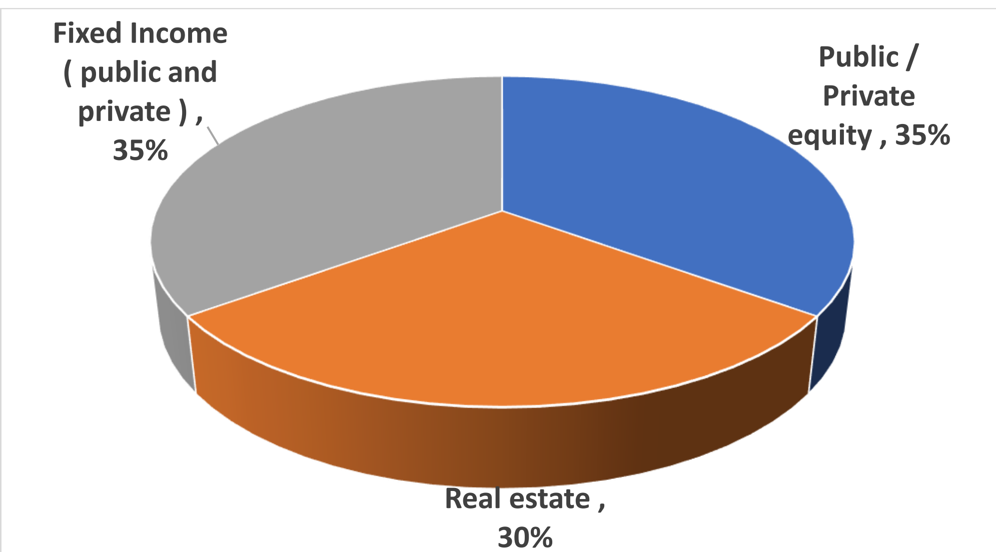
• Season of darkness • Winter of despair	combination of higher inflation and corporate defaults • Geo-political tensions such as China/ US and Russia/Nato • Dysfunctional politics and the rise of populism (US in particular) • Equity prices (especially the US) at near record valuation levels • Faster infectious rates for Omicron lead to new lockdowns globally • Higher interest rates and inflation (major impact on residential housing)

Our first objective in this newsletter is to describe the current investment and economic environment as we see it and then review how we feel that will impact major asset classes.

As many of you know our asset allocation is roughly divided into three major asset classes

- Public/Private equities
- Real estate (income and development)
- Fixed Income (private and public)

Depending on our views of both opportunities and valuation levels each of these asset groups could change plus or minus by 5%



Interest Rates rising:

It is virtually a given that interest rates will rise globally as central banks start increase their base lending rates in 2022 (some central banks such as the UK and Chile have already announced increases) central banks are also winding down their purchases of government debt (quantitative easing). Inflation has increased to levels not seen in more than a decade. Under these circumstances, at least in theory, bond yields should be rising. On a YOY basis they are with Canadian 10-year bonds up almost 80bps since January 1st, 2021 and US 10-year treasuries up almost 60 bps. US 10-year rates are almost 120 bps higher than their nadir reached in July of 2020. However, they are also the same as they were in March of last year. No net change in long-term rates over the last nine months

Is the bond market trying to tell us something about future expectations for inflation? As of now it seems messages are mixed. If central banks follow through on their commitment to increase rates while bond yields stay flat or drop we would end up with an inverted yield curve (short-term rates higher than long-term). This has often been a precursor to a recession.

If bond rates rise, they would likely negatively impact public markets and real estate cap rates.

The chart below shows a high correlation between bond yields and the earnings yield (the inverse of the PE ratio for the S& P 500). To use a simple example, the fictitious issuer Pubco is trading at $20 and in 2021 has earnings of $1 per share. That means the earnings yield is 1/20 or 5%; for stocks the earnings are after tax. Some of those earnings may get paid out as dividends and the rest retained to grow the company.

Source: Macrotrends.net

This chart also reveals a lot of other information. As of now the earnings yield for the S&P 500 is about 1.8% higher than the 10-year bonds. In 2009 the earnings yield at 5.76% was only 1% higher than the then 10-year bond yield of 4.77%. At the beginning of 2009 (near the nadir of the 2008 financial crisis) the earnings yield was 1.4% vs 2.65% for 10-year treasuries. It was negative, so in theory investing in bonds would have been more logical and safer than investing in equities. As we all know, 2009 was the beginning of a major bull market (mildly interrupted by Covid in 2020). As of now, we feel that the earnings yield spread between the S&P 500 and bonds is quite reasonable.

Furthermore, the S&P 500 is somewhat inflated by very large cap technology stocks, FAANG (although I guess with Facebook's new name of Meta this is now MAANG). Other markets and indices are not so expensive. The TSX for example has a current PE ratio of about 22.5 and that means it has an earnings yield of 4.5% or three times the level of 10-year Canadian government bonds.

Lastly, when it comes to interest rates it is always good to look at rates for other countries and currencies.

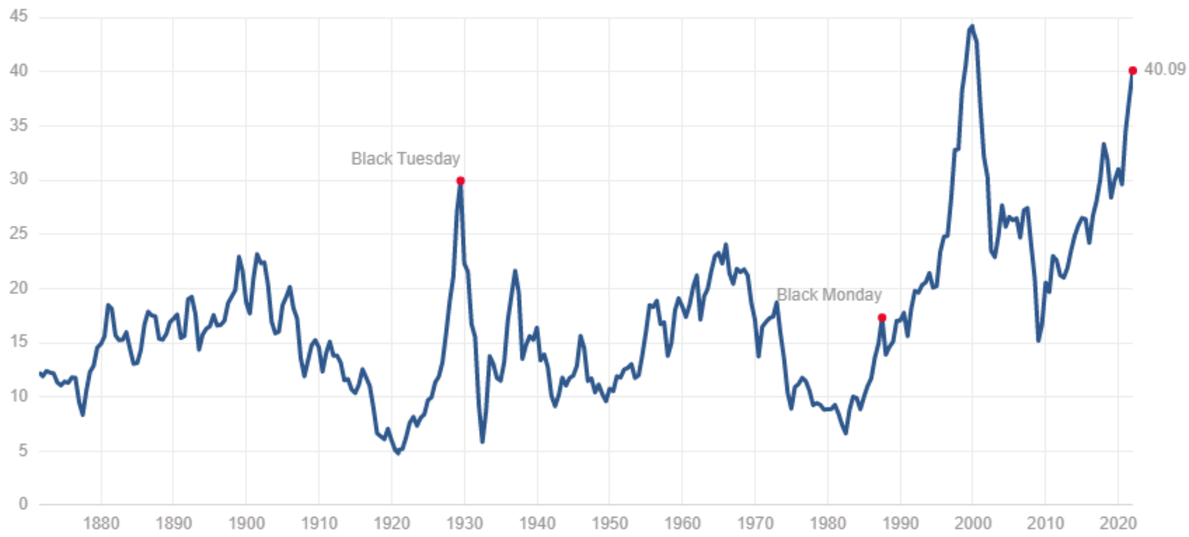
Country	10-year bond yield (January/7th/2022 (Bloomberg)
US	1.76%
Canada	1.72%
Greece	1.52%
UK	1.18%
Japan	.14%
Switzerland	-.16%
Germany	-.05%

If investors do not like the yields on US government bonds, they can get better rates with Developing country bonds but with the added risk of possible default and currency depreciation. Besides the list above US rates are higher than, Italy, France, Croatia, Slovenia, Ireland, Israel, Finland, Belgium, Spain, and Sweden (Trading Economics January 1, 2022).

<u>Stocks are expensive????</u>

Robert Shiller is a Yale University Economics professor who is both well-known and well regarded. He won the Nobel Prize in 2013 with Eugene Fama and Lars Peter Hansen. In 2000 his book *Irrational Exuberance* effectively predicted the dotcom crash that began later that year and prior to the 2008 sub-prime crisis he has written about excessive valuations in housing price.

A number of years ago he developed a different way of evaluating the price of publicly traded shares using a 10-year weighted model called CAPE (Cyclically adjusted price earnings). The graph below outlines this ratio.



Source: Multpl.com

As of the end of 2021 this ratio is the highest it has ever been except for dotcom crash of 2000.

Higher than 1929 and higher than the levels reached before the Great Financial Crisis of 2008. It would appear that this graph is telling you to get out of equities now and stay out until sane valuations return.

However, there are a number of factors to take into account. First let's look at the chart below which measures the PE ratio of the S&P 500 on a current basis (not averaged over 10 years).

Source: Multpl.com

This chart is telling a somewhat different story. First the current level of 30 is almost 20% lower than it was in January of 2021. That has mainly been driven by earnings rising faster than share prices (even though rose about 20% in 2021). Furthermore, ratios were considerably higher in 2000 and 2008 then they are now.

Finally, as noted above the S&P 500 is more expensive because of the impact of large cap tech stocks in it. Canadian, European, and Emerging market equities all have notably lower PE ratios than the S&P 500.

Nevertheless, stock returns are typically mean reverting over time (years of high returns are followed by years of low or negative returns so that over a long cycle the inflation adjusted return for equities should be in the 6-8% range). In April of 2021 we displayed the chart below that outlined what several major asset management groups expectations were for different asset classes. Note their collective real rate of return (net of fees) for US stocks is under 1% for the next decade. There are a number of large Canadian pension plans with similar views.

Return expectations 10 years equities and US bonds (nominal and before fees)

Company	US equities	Developed market equities	Emerging market equities	US Bonds
Blackrock	5.00%	7.00%	6.20%	0.80%
JP Morgan	4.10%	5.50%	7.20%	2.50%
Morningstar	-0.10%	4.80%	4.50%	1.00%
Research AffiLiates	2.00%	6.30%	7.90%	1.10%
Average	3.14%	6.32%	6.76%	1.33%
Fees/ Trading Costs	0.50%	0.60%	1.00%	0.25%
Infaltion assumption	2.00%	2.00%	2.00%	2.00%
After inflation/ Fee retur	0.64%	3.72%	3.76%	-0.92%
Asset Allocation	25.00%	25.00%	10.00%	40.00%
Fure value of $1000(after inflation and fees	$1,065.88	$1,440.87	$1,446.44	$911.72
Future Value Balanced portfolio (net of fees	$1,136.02		After inflation / fee IRR (10 years)	1.28%

As of Dec 31, 2021

Hypothetical performance results have many inherent limitations, only some of which are described below. No representation is being made that any account will or is likely to produce profits or losses similar to those shown. In fact, there are frequent sharp differences between hypothetical performance results and the actual results subsequently produced by any particular trading approach.

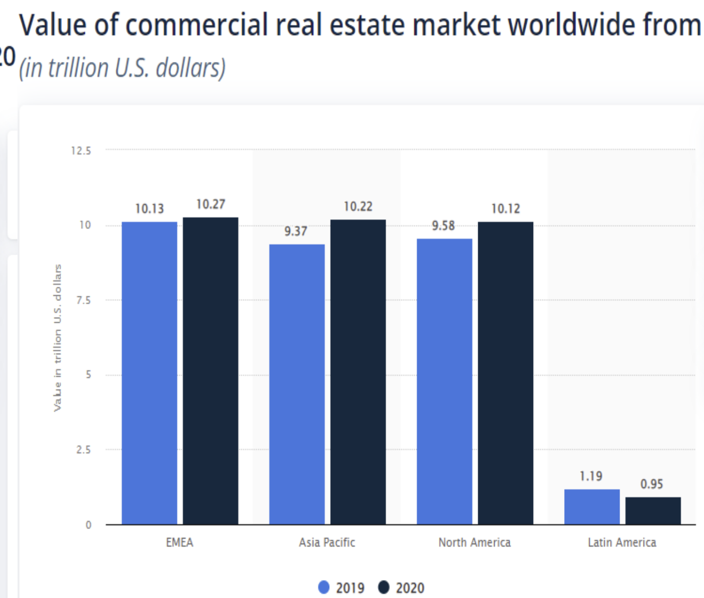
1) Hypothetical performance results are limited in that they are generally prepared with the benefit of hindsight.

2) Hypothetical trading does not involve financial risk and no hypothetical trading record can completely account for the impact of financial risk in actual trading. The ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can adversely affect actual trading results.

3) Numerous other limiting factors related to the behavior and performance of markets in general and/or to the implementation of any specific trading approach cannot be fully accounted for in the preparation of hypothetical performance results all of which can adversely affect actual trading results when compared to the hypothetical model.

<u>Other Asset Classes:</u>

Well over half of the world's wealth is invested in real estate and private assets (private companies) if we take away from that wealth tied up in personal use homes (almost 80% of total real estate) and assets such as art and jewelry what's left looks like this.



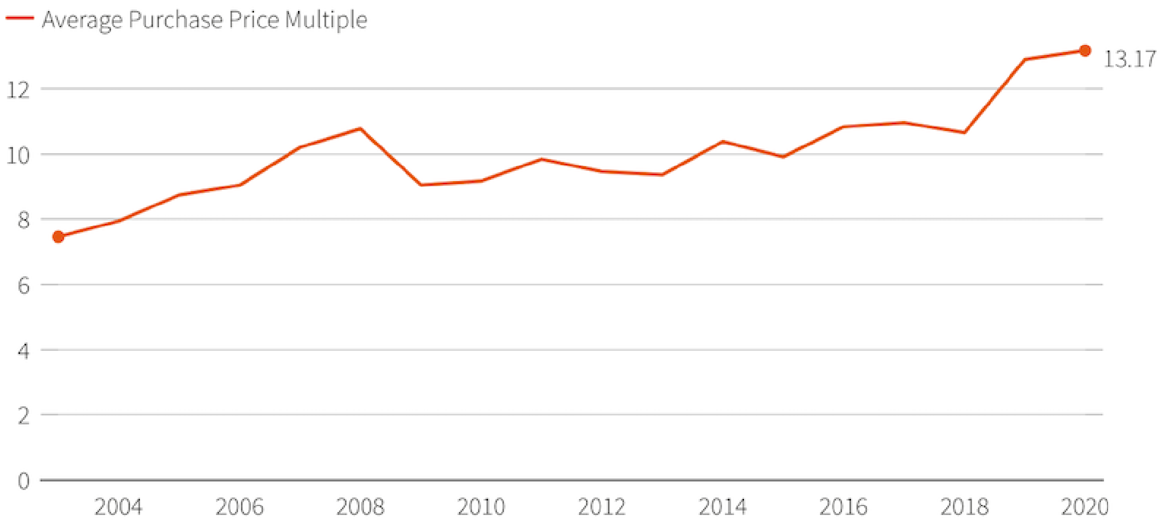
Source: Statista

Current values for private companies are hard to locate but Statista analysis shows that the number of private companies globally is a staggering 213 million up more than 90 million since 2000 (there are only 41,000 publicly traded companies globally with a current market value of about $100 trillion USD).

With respect to commercial real estate, the best estimate of a global value of $32.5 Trillion (not including farmland which is another $35 Trillion in its own right). Given low interest rates have inflated the value of all asset classes how have they impacted private equity and real estate?

The chart below from Refintiv shows that price multiples have indeed risen to an average of 13.2 in 2020. That is equivalent to a PE ratio for public stocks of about 18 (the S&P 500 had a PE ratio of 36 at the end of 2020).

U.S. leverage buyout multiples



Note: Average purchase price multiples for large corporates

Source: [Reuters]

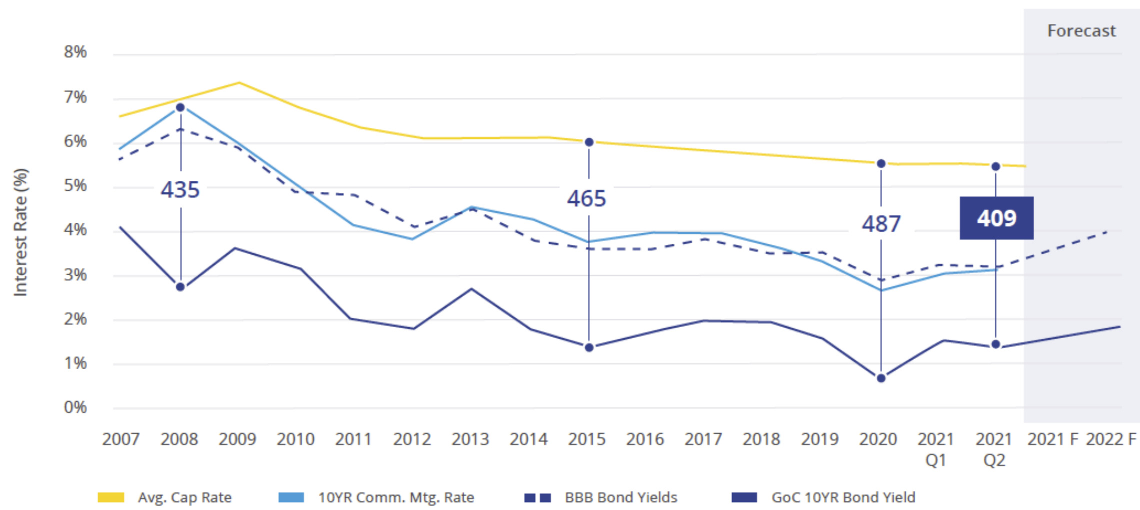
Private equity can most closely be compared to small cap public companies. As of November 2021, the MSCI Global Small cap index fund was trading at a current PE ratio of over 26 or almost 50% higher than the PE multiple the Refinitiv chart is indicating. For private equity to be as expensive as Global small cap companies the purchase prices would need to move to about 20 from 13.

Real estate:

Colliers recently published an analysis of current commercial real estate markets in Canada. One interesting chart is the one below comparing the cap rate (net income yield) to both mortgage rates and 10-year bond rates.

Interest Rates vs Cap Rates

Spread between bonds & cap rates is now only 15 bps above the 15-yr avg. of 388 bps!

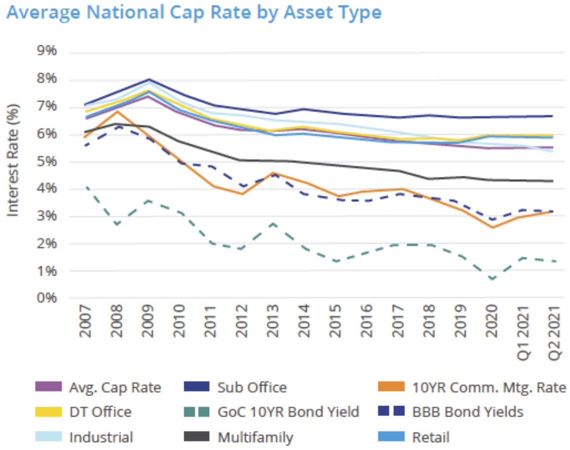


Source: Colliers International

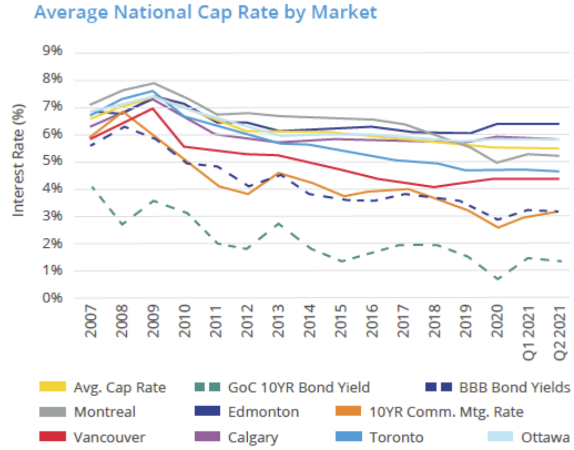
The key number to look at is the difference between 10-year bonds and the cap rates (the spread). It is still over 4%. If bond rates do rise, then cap rates would also rise, and prices would fall unless incomes on commercial real estate rose sufficiently to offset the impact of higher rates. This report was done as of mid-2021 and expected rates to rise through the end of the year and into 2022. As noted above 10-year Bond rates are now 1.72% (about the same as they were in March 2021).

Real estate is also about location and type as the report goes onto show with the results comparing cap rates based on these factors alone in Canada. Toronto and Vancouver maintain most favoured status and within those markets industrial and multi-family residential have offered the best risk adjusted returns.

Average National Cap Rate by Asset Type



Average National Cap Rate by Market



Source: Colliers Q2 2021, Bank of Canada.

Source: Colliers International

So far, we have made a good case that all asset classes are more expensive than they were a few years ago and in some cases by big margins primarily driven by ultra-low interest rates supported by accommodative central banks.

If this period of cheap money is over then would a good investment strategy be to sell everything, go to cash, buy some gold, and consider building a moat around your home?

Later in January we will be presenting our strategy for 2022. Rob Edel our CIO along with Mark Hannah (managing director of our real estate group) and Bijal Patel (managing director of our private capital group) and I will share our thoughts for the upcoming year and beyond that.

The major themes we will look at will include:

- We believe this a time when active management will outperform passive investing
- Value investing may be a better and more defensive approach. Dividends and dividend growth will matter
- Value add in terms of real estate may make the difference in total returns. Industrial and multi -family will continue to be a major focus for us
- “Build to Own” may be one of the best ways to capture better long term returns in real estate while creating assets that have much lower requirements for Capex over the next decade
- Private capital may allow us to buy $1 of profits at lower levels than public markets and with the right partners help improve the growth strategies of portfolio companies
- Private debt may allow us to return good inflation adjusted returns in the fixed income space.

We will explore all of these in some detail and then allow for an extended Q&A for our clients and followers.

We see markets and asset classes being expensive AND the opportunity to continue to invest and earn strong risk adjusted returns after inflation.

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