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This and prior newsletters are available at www.Higginsinvestment.com

The Markets

	September	Change in Month	Year –To-Date
S&P TSX	35236	–2.9%	11.1%
S&P 500	4651	–0.5%	11.8%
Dow 30	50906	–4.3%	5.9%
Oil	\$90.56	5.4%	57.7%
Gold	\$4187	–7.0%	–3.1%

Rising interest rates put pressure on US equities early in the month. The market rallied but did not fully recover the earlier losses. The 10-year Treasury bond hit rates not seen in almost two decades. Rates rose along the full-term curve. US mortgage rates hit 7%. In the US mortgages are based on the rate of the 30-year Treasury. The on again off again war in Iran continued to impact the market. A major pipeline that was used to avoid the shuttered Strait of Hormuz was bombed by allies of Iran. This caused the price of oil to rise. As the month ended it appeared that some ships were getting through the strait and the pipeline was repaired which led to lower oil prices. Higher interest rates put pressure on the price of Gold. Like we mentioned last month, forecasters have warned that higher rates should lead to weaker equities. Another month has passed and they seem to be like the boy who cried wolf. Remember in the end the wolf did come.

Although the Canadian equity market was not down by a significant amount in September the losses were broadly based. Only the Industrial and Information Technology sectors had positive returns in the month. Even then, both sectors were up less than 4%. A resurgence of Tech stocks in the US support the positive returns in the Canadian technology sector. The tech stocks kept the S&P closer to break even compared to the TSX and Dow. The Gold stocks were the the weakest performing subsector as they were pulled down by the underlying commodity. They are only one component of the Materials sectors that had a negative 9% return in the month. Higher interest rates and lower population growth drove the phone/cable companies down as much as the Material stocks. Some of the Telecom stocks have yields greater than 5% which is significant as this is AFTER they lowered their dividend payouts. Real Estate stocks, considered interest rate sensitive, were down close to 5% in the month.

The chart on the next page presents the performance of the S&P 500 and the S&P TSX for the last 6 months.

6-Month Performance S&P 500 and TSX

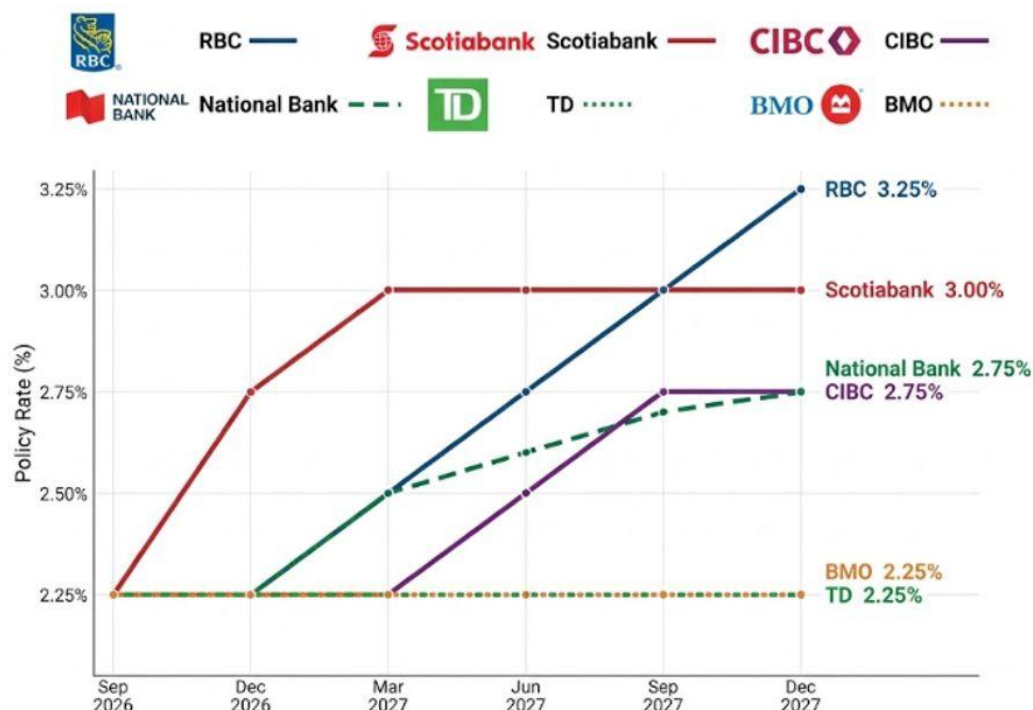


TSX, S&P 500 source google.com/finance

Economic Indicators

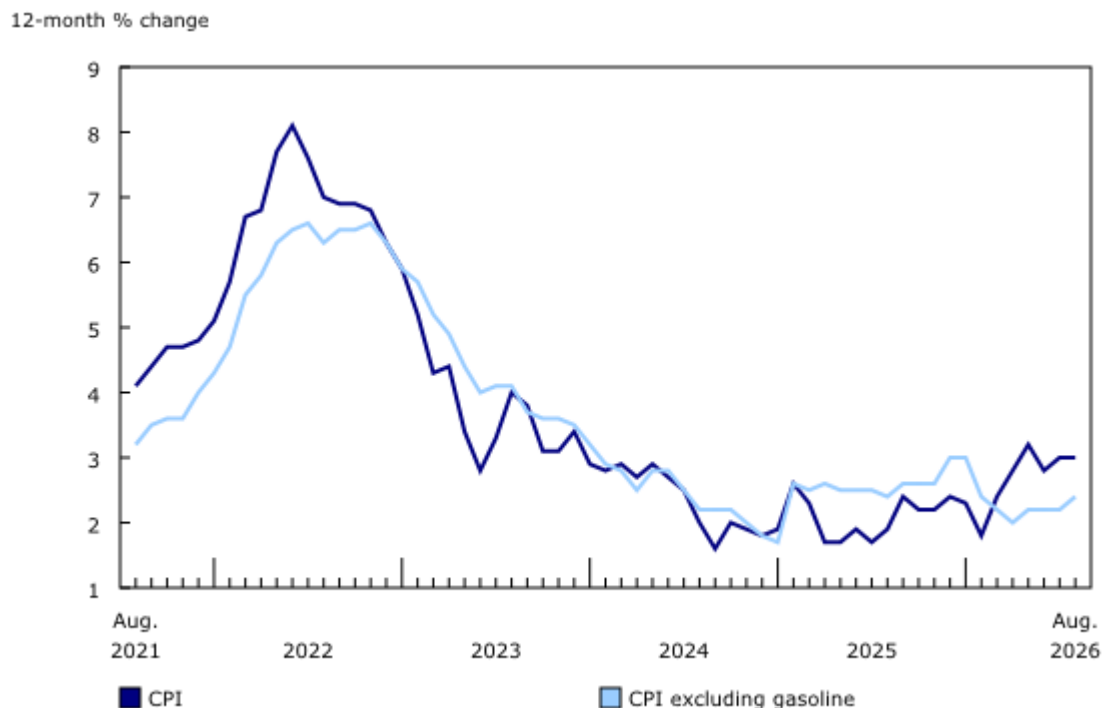
1. Where are interest rates going?

I borrowed this chart from someone's LinkedIn post. This was posted by Elliot Higgins of Largo Capital. He asked, "Where do the major banks see the Bank of Canada policy rate going?" I was surprised at the lack of group think at the various banks. There is a full percentage difference in the expectations for the end of 2027. I found it interesting that many of those who commented suggested rates were already too high. When planning how you position your portfolio these expectations can have a major impact. I leave it to the reader to decide where they think rates might be heading. In one way it is good to see that the economists are putting some thought into their estimates and not just drawing a straight line, unless of course that is where they expect rates to go. I can't knock TD's forecast since I have another family member who works there.



2. Canadian Inflation

Canada's inflation rate picked up in July, with the Consumer Price Index (CPI) rising 3.0% year over year, up from 2.8% in June. Much of the acceleration came from higher gasoline prices and travel costs, which were impacted by higher fuel costs. Gasoline prices rose 25.7% from a year earlier. Travel tours rose 15.2%, while airfares increased 12.0%. On a more encouraging note, inflation excluding gasoline remained at 2.2%, suggesting that some of the headline increase was being driven by energy rather than broad-based price pressures. The chart on the next page shows difference in inflation including and excluding gasoline. One concern is that higher fuel prices will work their way into the rest of the economy.

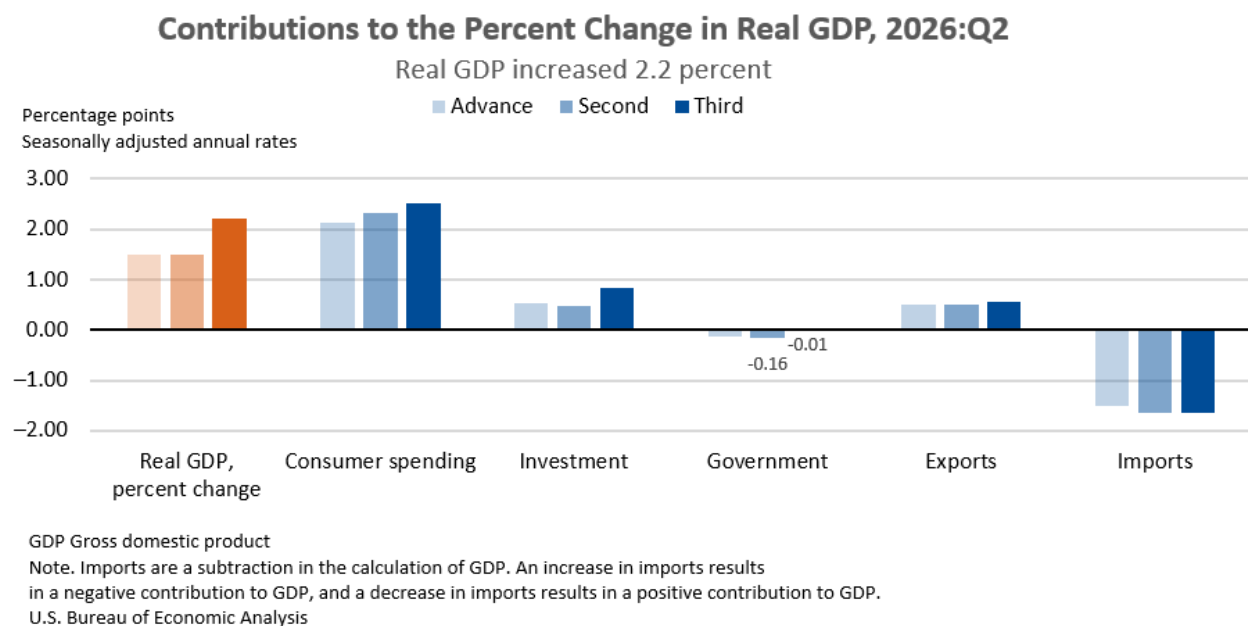


Source: Statistics Canada

Grocery inflation eased but still remained above the general inflation rate. Food purchased from stores rose 3.1% which is lower than the 3.9% rate in June. This still marked the 18th consecutive month in which grocery prices increased faster than overall CPI. Consumers continue to feel relatively strong pressure at the grocery store. Regionally, inflation accelerated in every province except Ontario, where it remained at 2.0. Overall, the July numbers suggest that inflation is still relatively contained beneath the headline 3.0% rate, but higher gasoline, travel and food costs continue to put pressure on household budgets.

3. US GDP

You often read in our commentaries that economic releases are frequently revised. It is for this reason it is not wise to change your investment strategy based on the most recent economic data. If you remember, there was a hew and cry that Canada was in a technical recession as we had 2 quarters of negative GDP growth. Then the prior quarter was revised upward so we did not have a technical recession, that did not make the daily news. Think of going trough a yellow light in your car. Then a month later you get a ticket for running a red light. This happened because the officer tells you he revised his previous view of the traffic light. You were driving based on the information you had at the time, this is the same as reacting to preliminary economic data. The chart below shows the factors contributing two the changes over the 3 estimates.



The US GDP is announced in stages as the government collects the data. The third estimate of the second quarter that ended in June was just released, essentially a full quarter ago. In the most recent announcement GDP was revied up by 0.7% to 2.5%. To say the least that is a significant change. The factors contributing to the change were higher levels of consumer spending, government spending and investment.

Included in the GDP is the PCE, Personal Consumer Expenditure price index. The PCE is the key metric the Federal Reserve uses to track inflation, The PCE remained above 3% but was revised downward by 0.4%. This should reduce pressure of the Fed to increase rates. The odds of a rate increase dropped from greater than 60% to lower than 50%.

Reflection

Unintended Consequences

It seems like a simple solution, If the price of diesel is too high you can increase the supply or reduce the amount you can export. The President suggested the US stop exporting diesel.

Refineries are making higher margins than historic levels. The higher price of diesel is translating into higher profits. There is a phrase in the commodity world that the solution for high prices is high prices. It sounds a bit illogical, but it is very logical. If natural gas prices are high, then energy companies will choose to drill for natural gas vs oil to reap the benefits of high prices. If everyone increases production, then the increased supply will lead to lower prices. Conversely, if prices drop below the cost of production companies will shut in natural gas and the reduced supply will fix the low prices. It reminds me of a concept I learned in introductory economics. It is called the fallacy of composition. The theory works as follows. If you go to a concert and stand up, you will see better. Then the people behind you will stand up to see better, you will get a better view if you stand on your toes and so will everyone else, At the end no one sees better and everyone is uncomfortable.

The solution is to increase production and take advantage of the higher prices for diesel. Unfortunately, the price of diesel is set by the world market. First the higher price of oil impacts the input cost of diesel, As Trump said, "it is a small price to pay to ensure Iran does not develop nuclear weapons". He also has been quoted saying "most people do not know that dumb is spelled with a B, no judgement here. The profit a refiner makes is known as the crack spread. They typically have a 3-2-1 ratio; 3 barrels of oil will produce 2 gallons of gas and one barrel of diesel or heating oil. Refineries produce more than gasoline and diesel as jet fuel and lubricants are derived from the same process. To keep the calculations easy, it is best to assume the 3-2-1 ratio is what matters. Usually, diesel is cheaper than gasoline in the summer due to additives to summer gasoline. In the winter some of the heavier oil normally used to make diesel is used to produce heating oil. In the winter diesel is usually slightly more expensive than gasoline. This has not been the case this year as diesel is now 60 cents a litre more than gasoline.

What happened? Iran has bombed some refineries in the middle east and restricted the export of refined product through the strait of Hormuz. Then Ukraine strategically bombed Russian refineries to limit production. Russia was short of diesel and stopped all exports. Russian not only needs diesel for normal commerce, but they need it for the trucks and tanks involved in the war with Ukraine. This probably should not have been a big issue since I thought there were restrictions on Russian exports. This tells you that no one was enforcing the export restrictions. This reduction only reinforces the shortage of diesel.

There are other problems. One is that countries that typically purchase diesel from the US could run into shortages or be forced to buy new supplies at higher prices. If you restrict diesel exports to lower the price of diesel in the US it is only logical to assume then the lower supply to the rest of the world would lead to higher prices elsewhere. Higher diesel prices outside of the US would be create inflation in those countries. The bigger risk is the other countries could retaliate with restrictions on shipments of other goods to the US. For instance. Canada purchases diesel from the US. It does not make sense for Canada to export oil to the US that is used to make diesel if the US will not ship the finished product back to Canada. This would not be popular in Alberta. Alternatively, Canada could restrict shipments of strategic metals. This would only amplify the trade war to the point where even the US would have to say it was a war.

Another issue is geography. The US has refineries in many regions. The ones on the gulf coast are the refineries that produce diesel that is exported, diesel produced in the central US does not get exported. The refineries on the coast would have to put the diesel in storage until their tanks are full. The pipelines to the coast only work in one direction, shipping oil to the coast for refineries or export., The pipelines cannot ship the excess diesel from the refineries. It is not efficient to ship it by truck plus the US limits ships that move goods between US coastal cities to ships owned by Americans. There are no idle US ships to move the diesel.

It sounds like good politics to say you want lower prices in your country, ask Trump, Carney or Polievre, but implementation can be an issue.

Summary

“Two hundred gallons from LA, the engines thumpin’ like a disco” Diesel, the band

In this month’s reflection section, we discussed the idea the US should ban exports of diesel. This is not the most exciting topic, but it definitely highlights the concept of a simple idea with unintended consequences. It seems like you can solve the high price of diesel by keeping more diesel in the US and detach from the higher prices in the rest of the world. There are several problems with this. Some of the refineries that produce diesel for export are on the coast and do not have an easy way to ship the diesel inland for domestic consumption. A big issue is how will the rest of the world handle the export ban? Will they retaliate? Canada ships oil to the US and US ships some diesel to Canada. This might be a big issue, why ship oil if they won’t ship us the diesel they made with the oil? It seems easy until you dig deeper. That may be why we have only heard it as an idea and not as a plan. This is just one example of knee jerk solutions to any problem.

We have stressed in other commentaries how we believe in creating portfolios and not just a collection of stocks. Our portfolios primarily are concentrated on dividend paying stocks such as banks and pipelines. We like the history of dividend increases that help grow returns over time. We include stocks with other attributes. For instance, gold stocks provide some diversification from the interest sensitive sectors. We understand the market will fluctuate and a diversified portfolio is the best defence to changing markets.

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