HIGGINS INVESTMENT GROUP INC.

September Market Analysis

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The Markets

	September	Change in Month	Year –To-Date
S&P TSX	19541	−3.7%	0.8%
S&P 500	4297	−4.7%	11.9%
Dow 30	33557	−3.4%	1.2%
Oil	$90.96	8.9%	13.3%
Gold	$1865	−5.1%	3.3%

No safe place to hide. This month even the magnificent 7 technology stocks that supported the S&P 500 or the NASDQ could not provide positive returns. Fears that inflation might still be a risk led to a cascading decline in the markets. Bond yields rose as investors demanded higher rates to compensate for inflation risk. The US central bank released its forecast for rates and there were fewer declines than investors had hoped. Higher rates increase the discount rate for stocks and led to a decline of 5% in the S&P 500. The markets had a similar decline last September. Even gold, a presumed safe haven, declined as the cost of holding it went up with interest rates. Problems in the Chinese property market only added fuel to the pyre of declining prices. The month closed with 3 positive days, not quite a rally.

Declines were widespread. The Oil and Gas sector was the only sector of the TSX with a positive performance in September. Investors only partially believe in increase in the underlying commodity. Oil prices rose 9% in the month but the Energy shares rose 3%. The next best sectors, albeit with negative performance, were Consumer Staples and Health Care. Consumer Stapes were viewed as less economically sensitive, as the name indicates they are staples. At the other end of the spectrum was the Gold subsector. Higher interest rates put pressure on the price of gold and caused the Gold subsector to suffer a double digit decline. The prospect of interest rates staying higher for longer caused the Utility sector and the Real Estate sector to decline more than 8%.

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

6 Month Performance S&P 500 and TSX

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

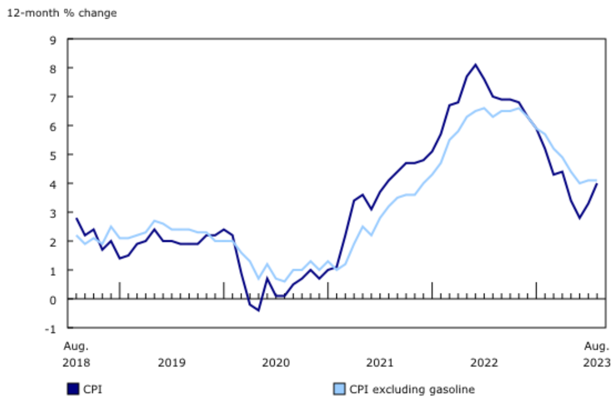
Economic Indicators

1. **Consumer Price Index.**

The Consumer Price Index is the most common measure of price increases experienced by consumers, known as the inflation rate. We all know the central bank's stated objective is to wrestle inflation back to 2% from its current 4% level. There are different measures of CPI including the total rate and the core rate that removes volatile food and energy. We have mentioned in previous commentaries it is hard to avoid consuming food or heating your home, so this might not be the best measure of inflation.

CPI rose from June to July due to the increase in the price of gasoline. The rate of inflation was unchanged at 4.1% if you exclude the price of gasoline. Higher rents contributed to inflation. Shelter prices rose 6% year-over-year. Mortgage interest costs rose 30.9% in August. Interest costs on mortgages are up as a direct result of the series of rate increases announced by the central bank. Higher mortgage costs have induced some landlords to increase the rent charged on their units. In this way the central bank does contribute to inflation but it is wrong to say higher rates cause inflation as higher rates slow the economy and lead to lower rates.

The chart below show the CPI and the CPI excuding gasoline. One key point to note is inflation was more than 8% at the outset of the Russian invasion of Ukraine. The central bank stated inflation was transitory. It was to an extent but 4% is a long way from a 2% target.



Source: Statistics Canada

2. Canadian GDP

Gross Domestic Product (GDP) is often used to measure the size and growth of an economy. GDP as defined by Statistics Canada is:

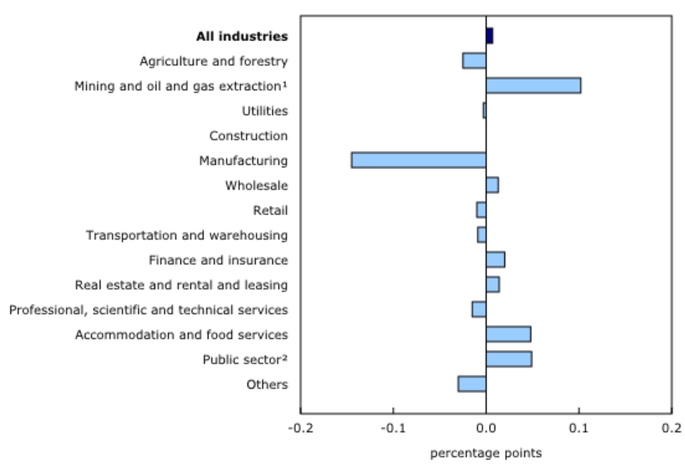
GDP lies at the centre of the National Economic Accounts. GDP is the unduplicated value of goods and services produced during a period that is available for final domestic consumption, investment or export. The National Economic Accounts record the value of GDP from two perspectives, as income arising from production and ***as final expenditure*** *on goods and services produced. In real terms (that is, adjusted for price change), GDP is representative of the volume of economic activity in a given period. The national production account provides a measure of gross value added by industry—total output (or sales)* ***less intermediate consumption.***

GDP measures the increase in goods produced and sold. To avoid duplicate counting they have to back out intermediate goods. For instance, wheat sold by a farmer is counted in GDP but must be backed out of the value of the flour it is used to produce. The value added by the miller is the value above the value of the wheat. The same is true for the baker that makes bread with the flour, you have to back out the value of the flour. Don't even think about the restaurant that sells toasted sandwiches. Due to this type of adjustment, there are often significant revisions to GDP.

GDP was essentially unchanged from the previous month. Gains in the services industries were fully offset by declines in goods producing industries. As you would expect, when the economy is showing no growth approximately half the sectors grew and half did not.

There are long term trends in GDP and there are one-time events that have an impact. In June oil production and mining activity had a significant decline due to forest fires in BC and Quebec. In the month-over-month comparison the restart of activity in July is recorded as monthly growth. Manufacturing declined by 1.5% in July. This is the largest decline since April 2021. GDP is measured based on production and not sales. If a company builds 100 items and sells zero GDP grew by the value of 100 items. Building inventories is positive for GDP but may lead to slower grow if it takes time to sell the items in inventory. A positive point is a portion of the decline was related to a decline in inventories. The strike induced closure of the BC ports caused a reduction in the production of goods, especially in the chemicals sector. Exports are a positive contributor to GDP and when the ports are closed then there are fewer exports.

You can see clearly in this chart from Statistics Canada the recovery in the mining & energy industries was offset by a decline in manufacturing.



Reflection

Random Thoughts

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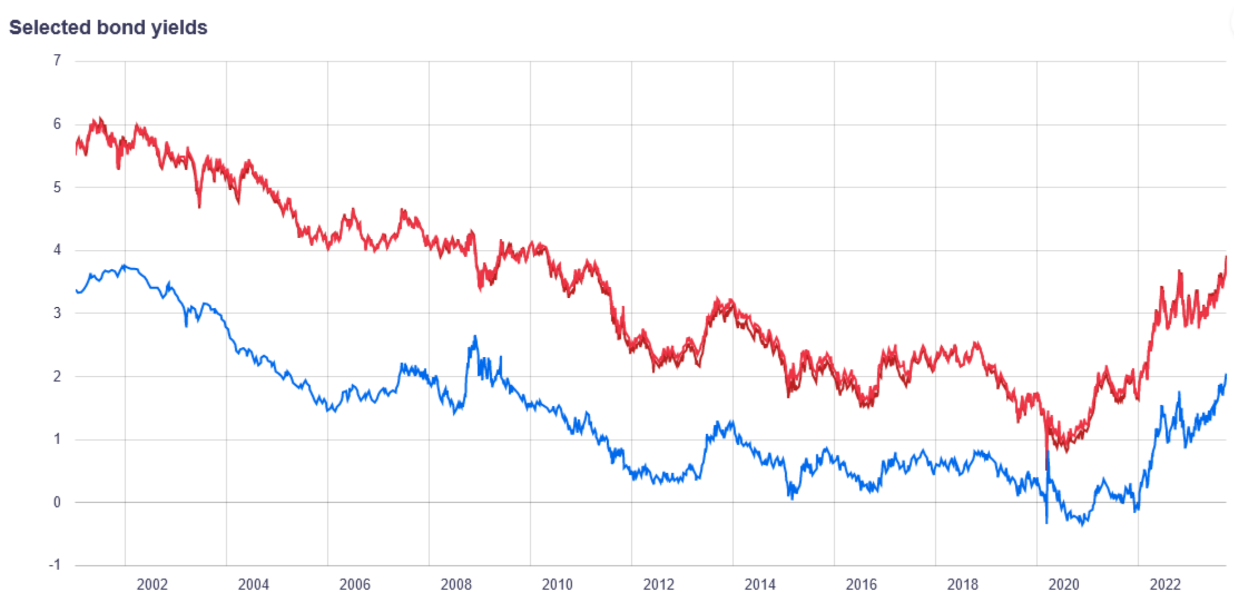
First, I typically do not make predictions. Or as one person advised make a prediction but not a date. For the last few years, I have read many predictions of an imminent market decline. Not like the 5% we experienced this month but a real market decline. Each month they are proven wrong but they make the prediction almost every month and when the market pulls back, they will be proven right. This despite the fact they had the market declining from much lower levels.

I can safely predict that interest rates will decline from the current levels. Invest accordingly. I did not say when rates would decline.

A more important prediction is rates will end up higher than many expect. We can start with some simple math and expected returns. We all agree the central banks have an objective to bring inflation down to their target rate of 2%. We do not know how high rates will have to go for the banks to reach their objectives. At the moment both the Canadian and US central banks have indicated their moves will be data dependent. The recent rise in oil prices may lead to higher inflation, hence, higher interest rates.

The simple math part of the equation is…. Investors want to earn more than the rate of inflation or you lose purchasing power. A dollar today will buy a dollar's worth of pizza. If pizza prices rise by 10% and your cash deposit earns zero, the slice will cost $1.10 but you only have $1 in the bank, therefore less pizza. If you earned 10% on your deposit you have a dollar plus 10 cents and can still afford a slice of pizza. If the central bank expects 2% inflation you should expect interest rates to be at least 2%. The average investor expects to get a premium for the risk of investing their money. Interest rates typically are higher for longer terms than for short-term investments. You want to be compensated for the risk that inflation could rise over the term of the loan. Add another 1%. If you are looking at mortgages you can expect rates to be higher again, as the banks like to make money from lending money. Therefore, you can expect mortgages to be around 3% or higher. Three percent is lower than today but much higher than in the past 3 years. There is a reason old people talk about the good old days.

The chart below shows the government bond yield from the Bank of Canada. The blue line is the real return bond and the red line is the yield on the government bond. Note rates were much higher a decade ago. You can decide where you think rates might end up. My forecast of 3% looks a tad bit high but we should not expect 1% rates either.



Does the US government closure have an impact on the fate of interest rates. A brief explanation of the difference between the US and Canadian model. In the US they have a limit on the debt issuance by the government. The limit may only be raised if the House and the Senate approve the increase. Partisan politics cause prolonged debates that take the talks to the limit or beyond. To get the lending limit raised the parties either want an increase in spending on their pet project, say defense or green energy, while others want a reduction in spending to raise the limit. What happens is government workers are put on leave, essential workers continue to work unpaid with the understanding that the government will pay them when they can. Defense contractors will continue to build the equipment just not be able to invoice for their work. Yes, thousands of workers will be laid off and this can cause a minor economic slow down. The real test is how long this last. For a couple of weeks, it will not have a lasting impact..

The US Federal Reserve indicated the future of interest rate movements will be data dependant. If the Fed does not get the data, they are working blind. The Federal government departments calculate the Consumer Price Index, Gross Domestic Product and Employment levels. There are private data providers but they do not have the extensive data bases as the government. The government shut down could impact the timing of interest rate moves.

The other day I met with a person that shared a conspiracy theory. They indicated the Bank of Canada's ownership is hidden from the public. The argument is that someone is making money from us. I decided to use the power of the internet and discovered the Bank of Canada was a private company in the 1930's but was nationalized and is now an arms length crown corporation, just like the Canada Mortgage and Housing Corporation. The Bank sets short-term rates by setting the prime rate and actively trading short-term T-bills. The bank can provide or remove monetary stimulus. Since the bank is the entity that creates cash, the mint prints it. In the depths of Covid the Bank of Canada aggressively purchased bonds. Their purchases put cash into the hands of those who sold the bonds. By outbidding others for bonds they drove the prices of bonds up which led to lower bond yields. The bank is now in the process of winding down some of their bond holdings. They let some bonds mature and do not reinvest all the proceeds in other bonds. This can lead to higher rates. The injection of liquidity via bond purchases can lead to inflation as people have more cash than they want and are not earning much on their deposits and are inclined to spend their cash. Higher demand for goods can lead to inflation. As an aside, when the bank purchases bonds it earns interest on the bonds. All the income other than what is needed to cover the operating costs is returned to the government.

Summary

"Prediction is very difficult, especially if it's about the future!" ***– N. Bohr***

In this month's reflection section, we had some random thoughts. One was our prediction for interest rates. As the quote above indicates, it is difficult to make a worthwhile prediction. If you assume inflation will settle at 2% and people want to be compensated for taking risks you can safely predict interest rates should settle above 2%, say 3%. This is lower than current rates but much higher than in 2019, 2020 or 2021. Other interest rate thoughts include the risk of a government shutdown in the US is not merely the increase in the unemployed but the fact the Federal Reserve will have much less information to make their interest rate decisions. Higher uncertainty is never a good thing.

The prospect that interest rates might be higher for longer than anticipated by analysts led to weakness in the interest sensitive sectors. These sectors contain companies with above average dividends. We continue to think these stocks are attractive long-term investments. I look at the Canadian banks and can get 5% dividend yields. The banks have solid core earnings but negative returns so far this year. Once rates begin to decline, even the US Federal Reserve expects lower rates next year, these stocks will get back in favour and you will have collected a handsome dividend in the interim. We remain focused on stocks for the long-term.