

The Good, The Bad, and The Ugly

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RICHARDSON
Wealth

**GUSTAFSON
& ASSOCIATES**

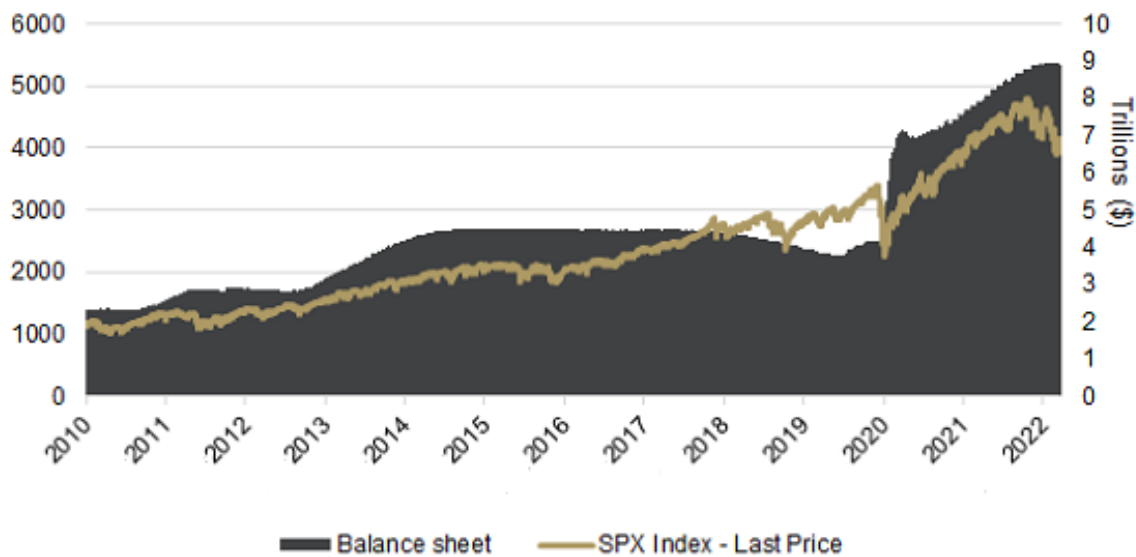
Hello, my friends and subscribers,

I have seen more recessions in my 6 decades than I can count. This is the first one that everyone unanimously agrees is on its way. Events that everyone agrees on seldom happen as it is difficult to get run over by a train you can see coming. In that light I wanted to reach out and share my 2 cents with you. Have you ever noticed that people ask you to “put your 2 cents in” but only give “a penny for your thoughts”? I could never figure out where the extra penny went until I filed my first tax return. Yes, I always find it fitting to start with a dad joke so Charles, Cam, Jenna, Alex, Brett, and James can make fun of me all day.

Speaking of taxes, on behalf of our ever-growing governments I want to wish you all a “happy belated Tax Freedom Day”. Whoop Whoop. This is the day up until which the average Canadian works to pay their taxes. The rest of the year you get to work for your family. In 2022, Tax Freedom Day was June 15 which is 4 days later than 2021. So, folks, you work 165 days to pay your taxes. This year it is forecasted that there will be \$86 billion of new government debt created. So, in case you are planning your family camping trip around this event, Tax Freedom Day will most assuredly be later in 2023 and will continue as long as we elect tax and spend governments. The good news is that Alberta’s Tax Freedom Day is June 9 and B.C. is June 5. The Alberta advantage has indeed dissolved although it is an incredible place to live. Quebec has the latest Tax Freedom Day on July 1.

I am proud to pay taxes and feel blessed to be able to do so as they provide things like great roads and healthcare and help for people who are unable to care for themselves. However even the greatest parties can get too large and damaging if they go on too long. So, I remain vocal in areas like lowering taxes through downsizing government, free enterprise, the government getting out of the way so businesses can create jobs and letting the stock market function freely without government interference. As a stock market with no artificial stimulus is more stable and its cycles are more predictable. Well, I am finally getting my wish as the government is stepping aside and ending almost 16 years of stimulus (printing money), helicopter money (sending money to voters) and letting the stock market correct to cleanse it of unprofitable companies (zombie companies), incompetent business owners, and return the ownership of the great companies of the world to long term investors (you) while the gamblers run with their tails between their legs back to their bag of popcorn at the race track or their free highball at the casino. The free money party is almost over.

S&P 500 & Fed balance sheet Easy money era helped fuel market advance



(Source: Richardson Wealth Research, 2022)

With views like the above some friends call me a “red neck” as I want to see the government move out of areas of our life where they do not belong. That label always makes me laugh as it reminds me of the great American philosopher, Jeff Foxworthy, who tossed several jewels on the table like, “you know you are a red neck if you have made change in the collection plate at church” (guilty) or, “you know you are a red neck if you have ever financed a tattoo” (not guilty). My personal favorite was, “you know you are a redneck if you are in a bar fight and you, and your mom are the last ones standing” (Not guilty, my mom was only 100 pounds with an Eat-More bar in her pocket). I apologize to all you moms for that joke.

For all you trivial pursuit buffs, the term “red neck” was originated in New York in the 1800’s. At the time, it was a very derogatory term applied to immigrant farmers and construction workers who worked so hard all day digging in the soil that the back or their neck became sunburnt and red. So, if you use “red neck”, you are using an adjective that refers to a very hard-working immigrant who is trying to create a life for their family. I am proud to be associated with people with that work ethic in any way I can. I have never met a new Canadian who is not a hard worker. Without them we will be doomed to watch Canada collapse in years to come due to an aging population. A society that has a birth rate of less than 2 children per family will experience economic decline for decades as the country becomes an aging senior’s home like Japan. Our present birth rate hovers between 1.2 to 1.4 children per family. Without new Canadians, this great country will end in tears within our children’s lifetime.

Aside from politics, the other most volatile area recently is resource shares. For most of my career when oil rose, the stock market dropped. This makes sense as oil and natural gas represent the input costs for manufacturing, air travel, cosmetics, clothing, food production, fertilizer, making your cell phone, powering the main frame to store your Facebook page, and is virtually a part of everything around you. This makes sense since if it costs more to manufacture and ship goods due to rising energy prices the earnings of the companies selling those goods will drop. In turn the value of their company as reflected in their share price will drop. However, today when oil rises, so does the stock market. That makes no sense and is one of those great mysteries in life right up there with... “Why does Donald Duck never wear pants but when he gets out of the shower, he wraps a towel around his waist?” The answer is negative news cycles pulling on the fears and emotions of investors. This is causing the present volatility in today’s resource shares as the news cycle is switching from, “oil is rising which means the economy is going to boom and burn more resources” to, “oil is rising which will cause higher inflation which in turn will cause a recession

lowering the demand for oil and gas and in turn will lower the price of those commodities". People trying to out-guess what is next are now fleeing the stock market en masse into bonds which my clients already owned (because we did not leave them with the herd earlier). It is easy to leave but my goodness how will they decide when to re-enter the stock market? Will they come back and invest when all is clear in the economy? That will for sure be too late as the economy lags the stock market by about 8 to 16 months.

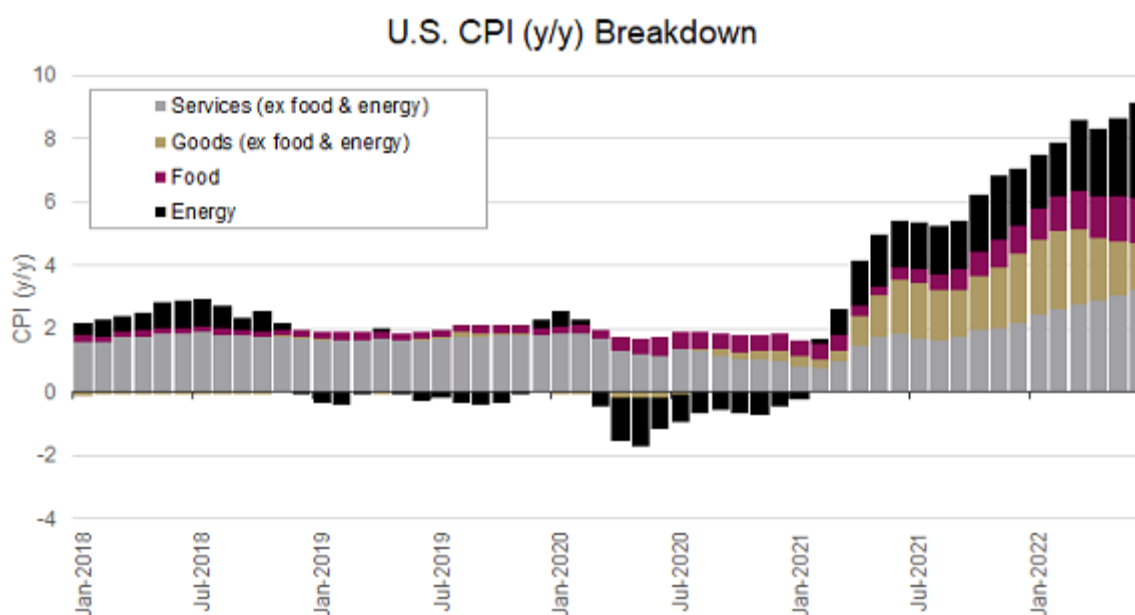
"If you wait to hear the Robins sing you will have missed spring"

- **Warren Buffett**

I respect all of you deeply as your families have achieved so much in just one generation with that old-fashioned thing called hard work. Also, you cannot reach your level of success without being extremely erudite. Yes, that is my new word of the day. I thought it was cool when I heard it. So, as always, I am not going to tell you how to think or feel. That would be beyond condescending. I am simply going to give you a tiny sample of the graphs and research we do each day as we choose your investments. Some of the data below is good news. Some is bad news. All of them are being presented so you can formulate your own thoughts on what is next.

The Bad News:

Inflation is rampant in the world. There are no signs of relief. The yield curve has inverted (long bond interest rates paying lower than short bonds). These are all signs of a recession looming. As you can see, the supply chain issues which were causing some of the inflation has eased. However, inflation has moved to the services sector (hotels, travel, restaurants, etc.) as we all come out of hibernation from our COVID caves. The restrictive government policy environment that hindered lending to resource companies, foreign investment, and approvals of any new infrastructure are now coming home to roost, increasing global resource and food prices. In Holland farmers are now being attacked by government. The Western governments may join in. Declining energy and good security will most likely be the end result. We are blessed to live in a country rich in both. Many fellow earthlings are not and will and are suffering.



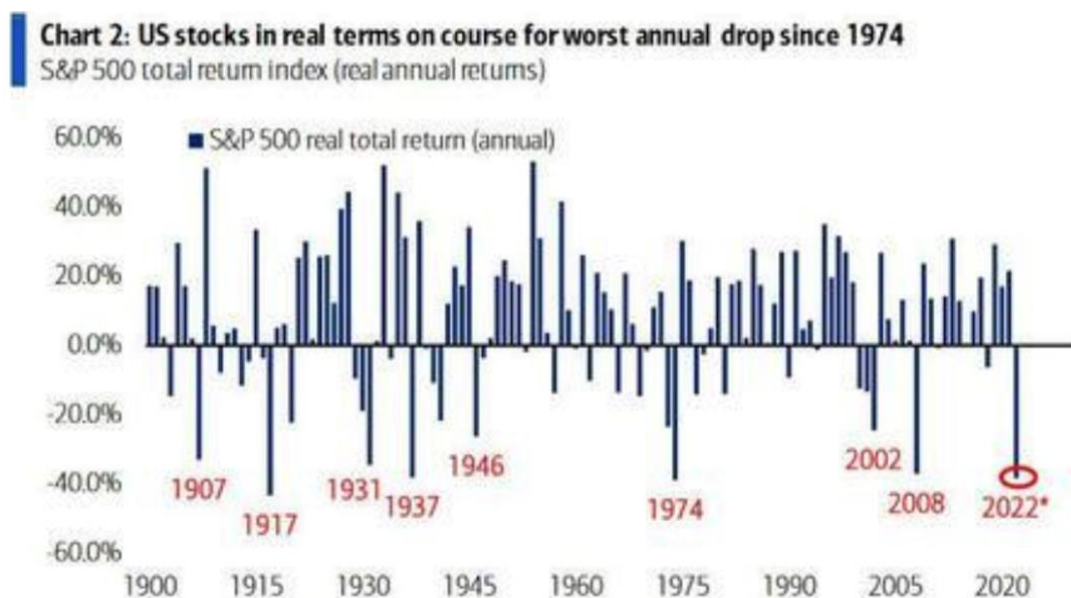
(Source: Richardson Wealth Research, 2022)

As a result, this year was the third worst start for stock market performance in the last 100 years. The only years that were worse than the 2022 start were 1932 and 1939 during the Great Depression.

S&P 500: Worst Performance through 82 Trading Days (1928 - 2022)				
Rank	Year	Price Return: First 82 Trading Days	Price Return: Day 83 to Year- End	Price Return: Full Year
1	1932	-28.2%	18.7%	-14.8%
2	1939	-17.4%	14.7%	-5.2%
3	2022	-13.3%	?	?
4	1942	-11.9%	27.5%	12.4%
5	1970	-11.1%	12.6%	0.0%
6	1941	-10.8%	-7.9%	-17.9%
7	1973	-9.4%	-8.8%	-17.4%
8	2020	-9.0%	27.8%	16.3%
9	1960	-8.9%	6.5%	-3.0%
10	1977	-8.6%	-3.2%	-11.5%
11	1974	-7.7%	-23.8%	-29.7%
12	1938	-7.4%	34.5%	24.5%
13	1953	-7.3%	0.8%	-6.6%
14	1962	-7.3%	-4.8%	-11.8%
15	1990	-6.9%	-0.1%	-7.0%

(Source: Charlie Bilello, 2022)

The stock market is on course for the worst annual drop since 1974.

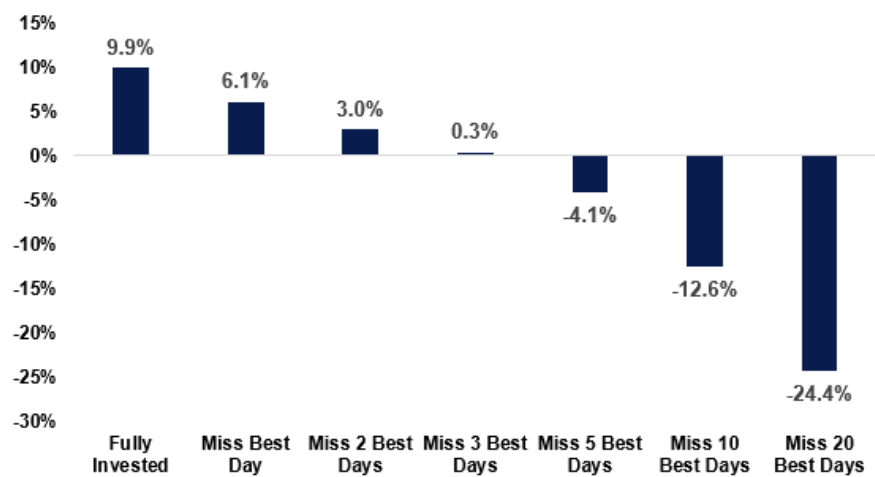


(Source: BofA Global Investment Strategy, GFD, Bloomberg, 2022)

That is a lot of really bad news. However, during such times please burn the below graph into your brain case as it explains why we have not taken you to cash like many other investors have done by following the herd:

Market Timing Can Be Costly

S&P 500 Index Annualized Performance (1990-2021)



(Source: LPL Research, FactSet, 2022)



There Is Actually Some Good News:

There are several studies and commentators predicting the collapse of Canadian real estate if inflation and interest rates continue to rise as that one-two punch will most certainly cause massive mortgage defaults and Canadians losing their homes.

The below graphs certainly back up that thesis. As you can see, they show:

- (1) Inflation is now over 8%. That is causing the Bank of Canada to raise interest rates to slow rising prices.
- (2) The average Canadian household has total debt that is 180% higher than their take home pay. That amount is the highest I have seen of any country and is a staggering 2 times higher than American households.
- (3) The average Canadian household debt is 80% higher than American households were at when their real estate collapsed in 2008.
- (4) Mortgage debt divided by income (debt service ratio) is at nosebleed levels.

Chart 6 Canada: The Boom Lasted Until Interest Rates Rose



* Sources: Statistics Canada, U.S. Federal Reserve

** Source: Statistics Canada

(Source: MRB Research, 2022)

Also:

- (1) House prices divided by disposable income are at extreme record levels in Canada.
- (2) The housing affordability graph is heading in a dangerous direction only rivalled by the early 90's.



* Composite MLS Home Price Index joined with Teranet index and the new house price index; deflated by headline CPI; rebased; sources: The Canadian Real Estate Association, Teranet/National Bank of Canada, and Statistics Canada

** Rebased; sources: Canadian Real Estate Association, Teranet/National Bank of Canada, and Statistics Canada

*** A decline in the ratio indicates an improvement in affordability; source: Bank of Canada

**** MRB Estimate

(Source: MRB Research, 2022)

In fact, an Angus Reid survey completed in June of 2022 reported:

- 45% of Canadians are worse off than a year ago. That is a 12-year high.
- 1/4 of Canadians are struggling, while an additional 25% are “uncomfortable”.
- 1/3 of homeowners say it is tough to make their mortgage payments.
- 35% say they could not handle a \$150 rise in their mortgage payment.
- 4/10^{ths} of Canadians has credit card debt and 58% are struggling to make payments.

There is a fine line, however, between a numerator and denominator. Only a fraction of people will find that sentence funny. If you rolled your eyes after the bad jokes in the last 2 sentences, thank you for paying attention and not skimming.

As I used to say when I was a banker in the '80's, “If you think nobody cares whether you're alive, try missing a couple of payments.”

So, with this kind of massive household and government debt, it makes sense that real estate would collapse with rising mortgage rates, dragging the Canadian economy into the gutter with housing. This theory is so universally accepted that even bank stocks are dropping as they hold a lot of mortgages that are predicted by wall street to default.

So why the heck is all of this in the good news section of my newsletter? Well, I always get nervous when everyone is thinking the same thing as it usually means that no one is thinking as they predict the demise of the Canadian bank oligopoly. This was bothering me, so, I dug a lot deeper than the talking heads echo chamber. I discovered some positive facts that no one is telling you regarding this predicted apocalypse:

- 1) 63% of Canadians own a home, while 37% rent.
- 2) 71% of mortgages have a fixed rate for 5 years, 29% are variable rate. So, interest rates rising will take a long time to affect most homeowners.
- 3) Only 56% of homeowners even have a mortgage. How is that a massive risk?
- 4) Over 70% of mortgages have 20% down payment so they have home equity to weather a drop.
- 5) If you have a down payment less than 20% your mortgage is backed by the government. \$700 billion worth of mortgage debt is CMHC insured. So how are banks hurt if the government pays them defaulting mortgages.
- 6) For new home buyers there is a mortgage stress test of the greater of the lending rate +2%, or 5.25%. That also builds in protection against rising rates.
- 7) The average household net worth has increased \$250,000 since before the pandemic.
- 8) Ratio of debt-to-net worth is at 16%, which is a 20-year low.
- 9) Mortgage delinquencies are 8%, which is a 30-year low. Is this the boogie man that is causing bank stock to drop? Seriously?
- 10) 44% of homeowners do not even have a mortgage!

- 11) For those that have a mortgage, it is, on average, only 43% of the value of the property.
- 12) So, on average, Canadian's mortgages represent only 23% of Canada's property values. So, there is lots of room here for dropping prices before homeowners are handing their keys to their banker like we saw in the '80's when some of us had massive mortgages at 20% or more.
- 13) Canada is short 1.8 million homes.
- 14) We are immigrating 400,000 people per year.
- 15) We only build 200,000 homes per year.

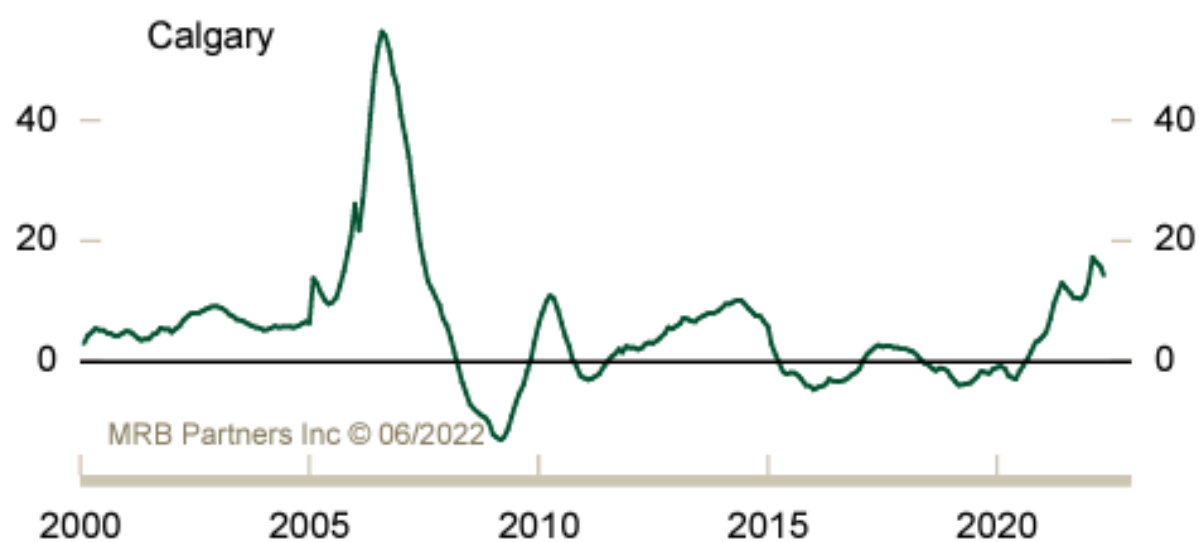
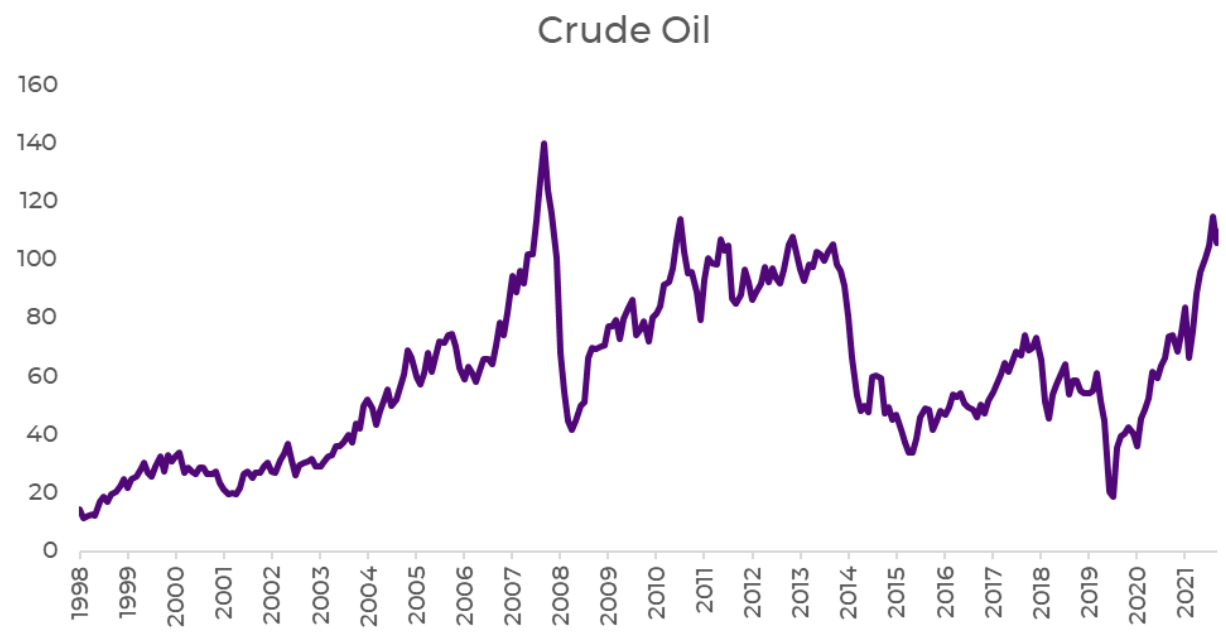
(Source: Bank of Canada Financial Review System, OECD, CMHC, UNESA)

So, I don't understand how a mortgage situation like the above can hurt banks. Their stocks today are dropping due to the *perception* that they will be hurt, not actual facts. I suspect it is also the effect of the baby (stocks or great companies) getting thrown out with the bathwater (stocks of bad companies) So, if you don't think that I am sleeping with one eye open to eventually buy more bank stock you do not know me very well.

Could real estate drop? Sure, it is now. Will it pause and grow more slowly? Perhaps. Will it crash like it did in the early 80's. I would not bet the farm on that one.

In reality, if you want to predict Calgary real estate prices or prices of houses in some British Columbian towns (inhabited mostly by Albertans), you may need to pull out your oil price crystal ball. I learned this from the below graphs that were put together by one of the smart members of my investment board...Brett Gustafson, who is an investment analyst working on Bay Street (Canada's Wall Street). Yes, he is my son and yes, I am proud.

These 2 graphs were an eye opener for me as the student becomes the teacher:



* Composite MLS Home Price Index joined with Teranet index; source:
The Canadian Real Estate Association, Teranet / National Bank of Canada

(Source: Brett Gustafson, Purpose Investments, MRB Research, 2022)

Many of the research papers I have read show that the leading indicators are not calling for a recession. In fact, based on historical statistics, if the recession does not show up, we may be close to bottom now. If the recession does come to fruition, based on historical averages, the market is not at bottom. No one truly knows.

Stocks Near A Bottom If Recession Is Avoided

Correction & Bear Market Historical Performance (Peak-Trough % Decline)			
	Mean Decline	Median Decline	Days Peak-Trough (mean)
Global*	-19	-12	220
Non-Recessions	-13	-11	101
Recession	-36	-33	418
U.S.**	-20	-15	205
Non-Recessions	-15	-14	98
Recession	-36	-35	406

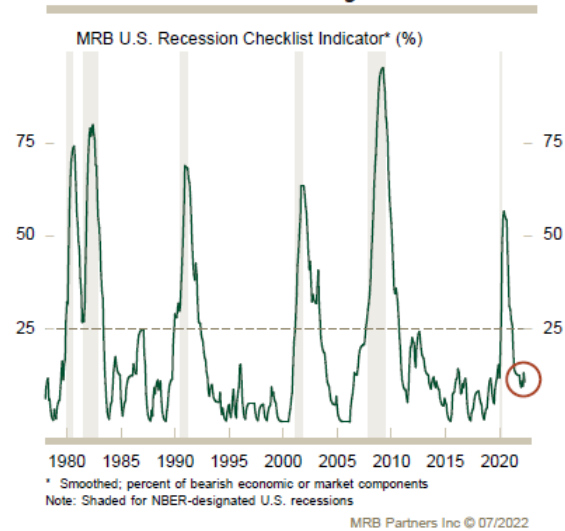
* Local currency, since 1970; source: MSCI

** S&P 500 since 1966; source: Bloomberg

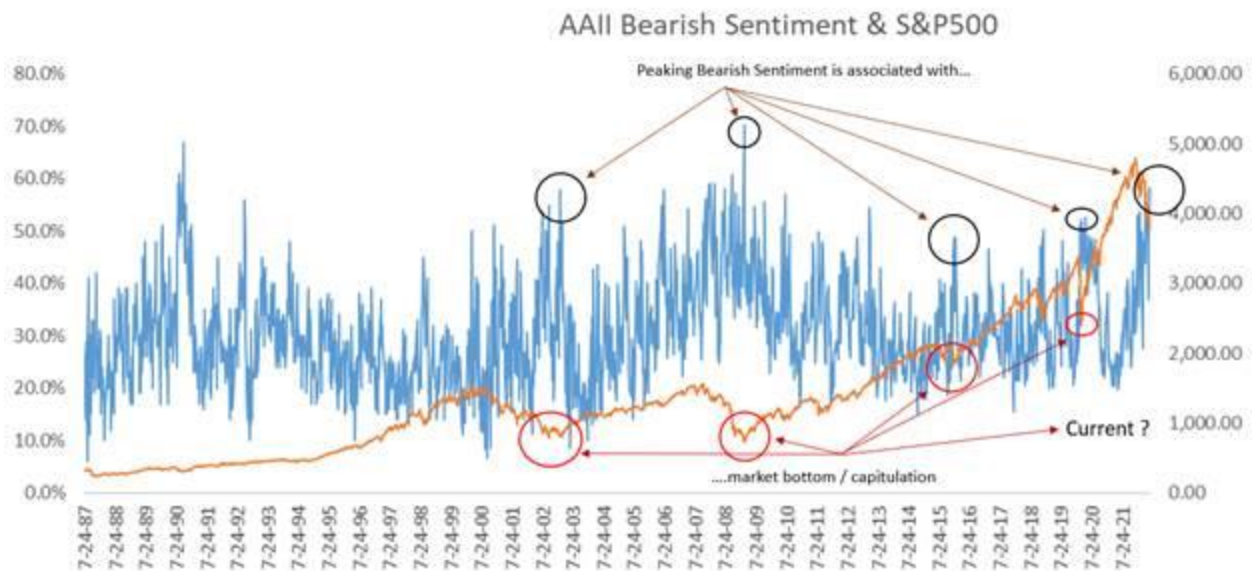
MRB Partners Inc © 07/2022

(Source: MRB Research, 2022)

So Far, No Recession Warning For The U.S.



The bearish sentiment graph (number of people who think the stock market will crash farther) is at a level as high as the market bottom of the 2000 and 2008 crashes. This is a contrarian indicator and could mean that the market is about to have some great upside growth.



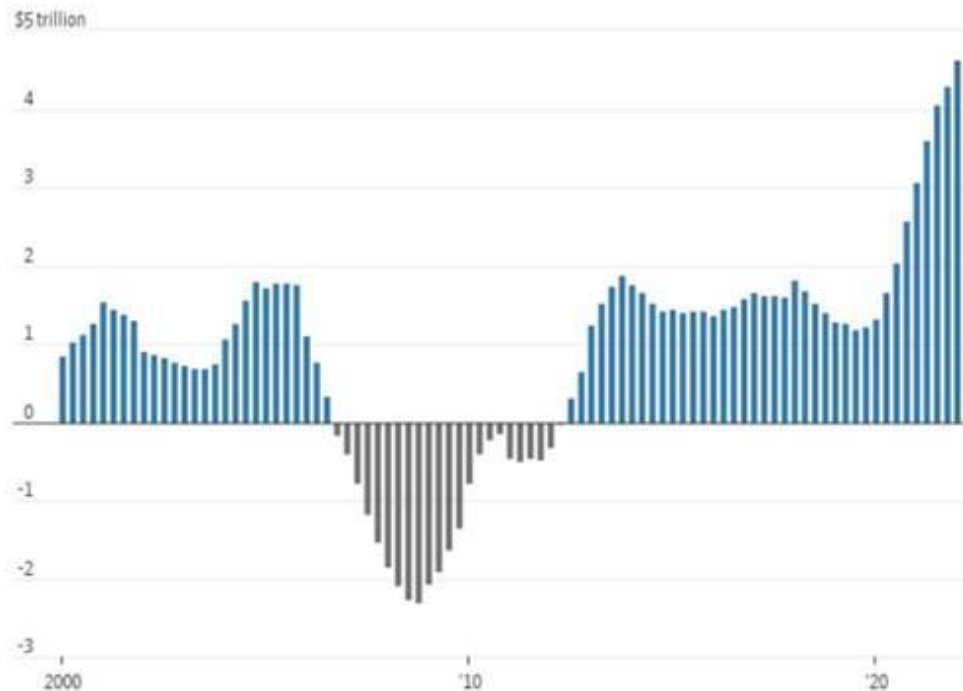
(Source: Purpose Investments, 2022)

The United States consumer is the fuel for 45% of the global economy as they buy the globe's stuff. The balance sheets of these global consumers have never been healthier. In fact, the average American's home equity has doubled in just 3 years. This produces a phenomenon called the "wealth effect". If home equity rises consumers buy more stuff. When you combine that information with a 3.6% unemployment rate and the fact that "full employment" is considered to be 6% I find it impossible to be pessimistic at this juncture.

U.S. Home Equity Hits Highest Level on Record— \$27.8 Trillion

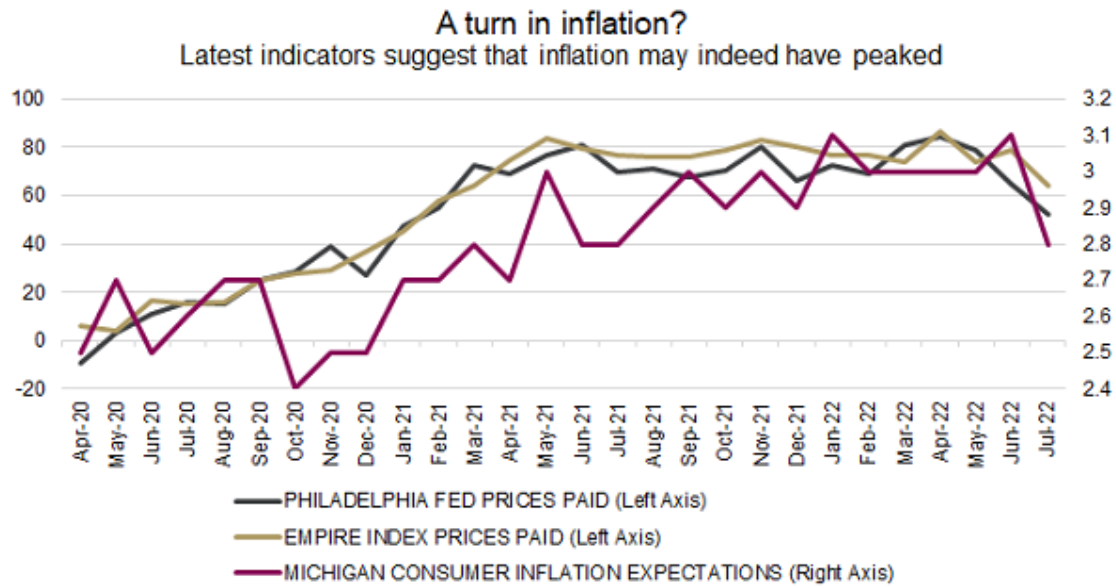
By Orla McCaffrey

Home equity, quarterly



(Source: Federal Reserve, 2022)

Now, I know what you're thinking, with a healthy consumer spending, we are dealing with the big "I" word, inflation. There is talk everywhere regarding inflation causing interest rates and in turn a recession. Even the IMF (International Monetary Fund) press releases are saying as such... The good news is that we ARE starting to see signs that inflation may be peaking and rolling over a bit.

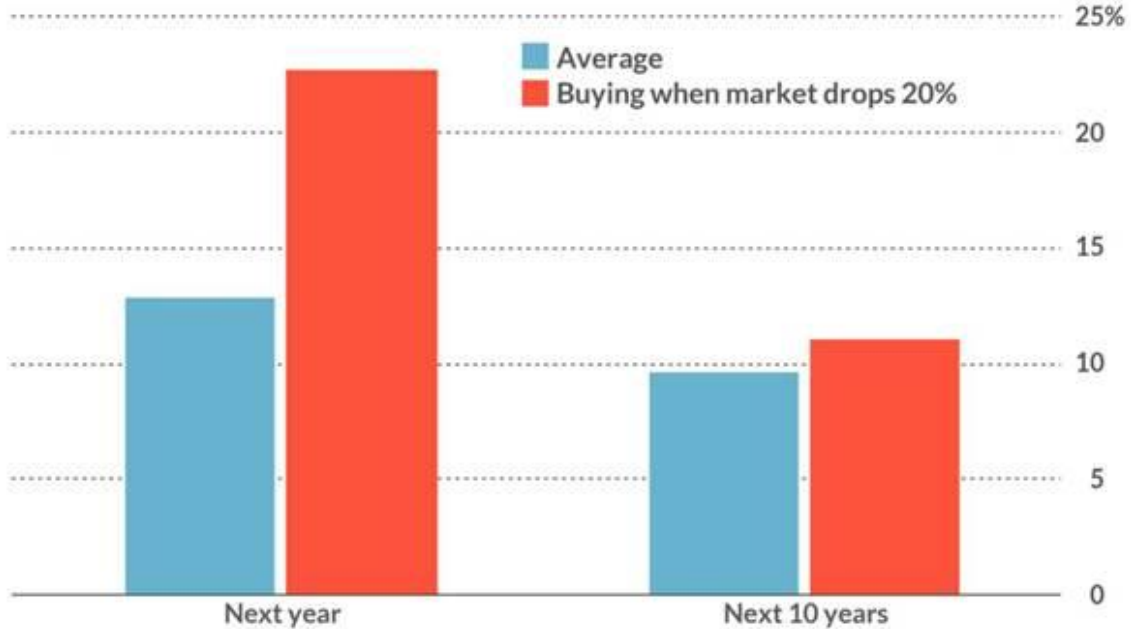


(Source: Connected Wealth)

As you know, for decades I always have signed off on these newsletters with, "It is always a great day to be alive and invest". This may sound like some sort of self-serving tag line; however, the below graph proves the accuracy of those words. On average, since World War 2, if you invest after a 20% stock market drop like today, your return the next year was 25% on average. Over the next 10 years, it was around 12% per year. The pessimist complains about the wind. The optimist expects it to change. The realist adjusts his sails. That is why we are taking advantage of this drop to capitalize on the only thing that I can promise will be constant the rest of our lives, which is that little thing called "change".

Buying when market drops 20%

S&P 500's annualized total return since World War II



(Source: Hulbert Ratings, 2022)

I think of you all every day and in everything my team does together to care for you. Great health and many capital gains to you and your families. Have a great summer!

As always, it's a great day to be alive and invest!

Sincerely,

Brad Gustafson, B.Sc., CFP®, CIM®

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