



**Review**

Two years after it was initially diagnosed as “transitory”, inflation remains, despite interest rates rising, quickly, to meet it. Meanwhile, we find ourselves with the almost Herculean task of trying to find a new metaphor to describe the dynamic. Global economies remain stuck trying to negotiate dangerous waters, caught between the threat of untamed inflation and the costly medicine of higher interest rates. Canadian inflation rate was 4.4% and 3.4% in April and May respectively while the Bank of Canada raised rates a further 0.25% to 4.75%, after a four-month pause in June. A year ago, the rate was 1.5%. More importantly, we are, officially, in a new regime as we have topped the pre-Financial Crisis high of 4.5% recorded in July 2007.

**Bank of Canada Policy Rate**  
June 2003 - June 2023



Source: Bank of Canada, Federal Reserve Bank of St. Louis

Markets reacted to all of the above, as well as various wrangles in geopolitics in Russia and China, with optimism that inflation had neared its peak and rates, surely now, would not continue to climb. TSX grew by 1.1% including

dividends (0.3% without), with sectors benefiting from inflation, Materials and Energy, declining while Consumer Discretionary and Information Technology climbed. Financials, the largest portion of the index at 30%, grew by 0.9%. By contrast, the American markets threw all caution to the wind with the S&P 500 and Nasdaq posting 8.3% and 12.8% during the quarter. The Dow Jones, predisposed to more “value” companies rather than “growth”, delivered a passable 3.4%. The Canadian bond market meanwhile declined 0.69% despite bond yields rising quickly near the end of June.

**Forecast**

When inflation first reared its monstrous head in 2021, it was naturally despised. But (to borrow from Alexander Pope) with its constant presence, some economists find themselves transitioning from enduring it, to pitying it, and we suspect eventually to a point of embracing its existence. While we've yet to see mainstream publications tell us that inflation is actually good for us, during the last quarter we saw a number of publications firmly in the “pity” phase. “Why is 2 percent the target anyway?” opined the New York Times on the shared target of most developed central banks. The truth is that for some, above target but not high inflation (let's say around 4-5%) would be a boon. The debtor's debts grow smaller, the lender (with prime above 5%) can still lend at rates that generate a real return, and the homeowner retains a real asset which should appreciate with inflation (emphasis on “should”). The worker, however, where wage growth has only just begun to catch up to inflation, is unconvinced. While these distinct



categories are artificial, (workers own homes, retirees rent, etc.) we believe many economists and market participants are discounting just how much power has swung back to labor.

Central banks on the other hand, have not entirely discounted labor, reiterating a commitment to maintaining and/or raising rates amid increasing strikes and union negotiations. We expect this tug of war between central banks and labor to continue, with wage inflation testing policy maker resolve even while other inflation indicators come down. Barring a catastrophe, we believe the era of low interest rates is behind us. Yes, we fully expect a recession will materialize in the next few couple years that will bring rates down but, now that rates have lapped their former cycle high at 4.75%, we do not expect them to return to the near-zero bound nor do we expect them to stay low for very long. The forces that set the low interest rate world into motion—China growth, globalization, tech optimism, etc—have begun to unwind with increasing speed.

### **Strategy**

After last quarter's banking scare, and with central banks so far refusing to blink, bonds have returned to looking at the edge of favorable without quite tipping over into attractive yet. Equity, for now, remains the only real game in town for our long-term focused strategy, bumpy though the ride has been in Canada since the start of the year. Among the equity hybrids, preferred shares have, confusingly for us, been quite a rough ride, particularly where the security will reset soon. As a refresher, rate reset preferred shares use the Canadian 5-year bond as a starting point and then add a premium, with the rate resetting (hence the name) every five years. Some of these resets will be resetting with a 5-year bond yielding nearly 4% and will then be adding 2% on top, for nice 6% dividend. However, that's if the security was trading at par of \$25. Instead, many of these securities are trading well below par with premiums often closer to 3%, implying dividend yields of nearly 10%.

With such favorable resets, what is driving the poor performance? We believe it is likely a combination of factors (institutional demand changes, small market size, ETF selling by retail investors, etc.) but chief among them is the competition with government bonds as many buy-and-hold investors chose preferreds over the past decade to deal with the low interest rate environment. For now, we still think the risk/reward and taxation tradeoffs favor preferreds, particularly those resetting soon, but it is an area we have spent and will continue to spend much time on.

### **Our communication with you**

We would like to take this opportunity to address a compliance examination conducted by the securities regulator in 2020, which highlighted some processes where we fell short, mainly in areas of documentation. While this outcome is disappointing, we want to assure you that we have taken the necessary actions over the last three years to address our internal procedures and systems.

The audit results serve as a reminder of the importance of maintaining rigorous standards in all aspects of our operations. We thank you in advance for your understanding and kindly request your support in completing forms and documents when requested. Should you have any questions or require any further information, please do not hesitate to reach out to us directly.

If you would like to opt for emailed quarterly packages and discontinue mailed quarterly packages, please email [trevor@lee-turner.com](mailto:trevor@lee-turner.com) and let us know. Thank you.