July 13, 2022.

What now?

Being faced with a “blank’ Word-document was less intimidating and alarming than the ‘blank glares’ so many financial experts are wearing lately.

Recently witnessed zero or negative interest rates were the anomaly. Current ratcheting up of rates, a movement towards realistic Long Term capital costs, is more desirable than a prolonged, ‘free’ money type economic stimulus. Pandemic stopped the Globe. The Governments’ instigated economic restart and the destabilizing, pent-up pandemic-demand effects, have caused a short-term ‘*wicked’* inflation which should abate soon. The increasing interest rates and the negative wealth effects on capital markets should tame inflationary expectations. [that is the objective]

The Covid pandemic and the Ukraine War have disrupted the capital markets and instigated a disorderly reallocation of funds within asset classes & industries; however, the recent pace of rising interest rates is causing much more damage to valuations and to investor psychology. An excerpt from a previous communique to you [still valid] may outline the current dynamic we are all facing in International Capital markets.

> “Asset values which have improved notably beyond pre-crash highs, have done so helped materially by Governments’ seemingly endless, ‘charmed’ liquidities and fiscal accommodation. Europe, Japan, China, and USA have been relentless in their monetary easing, all trying to stimulate the world economy, to a point where massive QE will not be required and that the world would gyrate economically on its own dynamic…
>
> Many professionals, policy makers, academics, and the public too often base their expectations and forecasts on untenable assumptions: that all-things-remain-equal. However, ‘things mostly don’t remain equal.’ So, when rates increase, and we all know they will, valuations of all asset classes will be negatively affected. Magnitude of ensuing wealth destruction will depend in part on the speed of rate increases; on the riskiness of asset allocations; on the absence [or not] of undesirable systemic effects.
>
> When Financial markets bid up the yield curve, and they will irrespective of the FED’s administered rates, this bond (*Austrian 100-yr* and other ultra-long bonds) will suffer massive paper-losses” – ***VV 15Jul2019***

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Only a few months ago [April 2020], Oil was trading at an anomalous price of **minus** $37 per barrel. Similarly, some interest rates [in the West] offered negative yields. Do you recall the commentaries then, by so many, that "There is no inflation?

What happened since? Inflation, now has a 'panic-mode' attention from central bankers everywhere. Stock markets 'corrected' massively to now represent more reasonable valuation levels; bond markets did the same but were more rudely affected as many investors were unprepared for such a rapid increase in interest rates.

What will happen? The answer is unknowable but there is a reasonable mechanism to monitor and trace possible future changes & valuations. As interest rates *stabilize*, the revised cost-of-capital will be imputed into valuation models [includes inflation expectations] that will more accurately reflect the new investment environment. This process contributes materially to vicious, market-price changes.

Why do increasing rates reduce the value of equities [& bonds for that matter]? A previously shared illustration may add clarity:

John Evdokias
@VisavisInvest

What is the difference between a 2% #yield & a 4% yield?

(Those who think it's 2%, pls read on)

Actually, on #Perpetual #preferred shares, the difference is 50%.

~50% would be the drop in price of the perpetual preferred, if 'interest rates' increased from 2% to 4%.

Got some?

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"Often Assets are valued based on the income stream they generate over time. However, this income stream is one determinant of asset value; another, is the discount rate used [i.e. interest rate] to value the income stream. So as interest rates change, so will the 'intrinsic' value of the asset. Evaluation metrics for perpetual-preferred-shares may provide needed context and a fair and helpful example. In a 6% interest discount rate environment, how much would you pay for an annual

> $1 perpetual income stream? Answer: 1/6%= $16.67
>
> At a 2% interest discount rate environment, the same income stream would be valued at $50.
>
> At a 3% interest discount rate environment, the same income stream would be valued at $33.

Basically, your perpetual-preferred share which was worth $50 in a 2% interest environment, would be worth only $33 at a 3% discount rate. Interest rates went up only 1% [from 2 to 3%] but your asset lost value from $50 to $33 for a loss of 34%.
The future direction of interest rates is one important variable that can ultimately influence and determine the financial performance of your investment portfolios." ***-VV Feb 2018***

Portfolio dynamics:

Current, short term GIC [Bond] rates pay about 4.0-5.0%. At these rates, the fixed income component of your savings will again contribute more notably and positively to your total portfolio return. The high inflation rate now witnessed in the West, will be much lower we think, over the next few quarters. Why? An economic slowdown is being 'maneuvered' by Central banks who intend to reduce [contain] this anomalous, rapid inflation increase which has taken hold recently. Pandemic and Ukraine dynamics have directly affected both demand and supply economic metrics and contributed much to the undesirable inflation pressures. [i.e. shortages in energy, commodities, labour, 'transport' alternatives]

> "We still expect difficult markets and more volatility; same reasons we have discussed in the past: abuses in leverage, fiscal and monetary policies, alarming geopolitical degradations, pandemics effects on health, society, world economies. Increasing interest rates accelerate the asset re[de]valuation process and are likely to create many more mispriced and undervalued securities"- *VV 30Apr22*

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The market rout has created some worthwhile investment opportunities. Your patience, by having maintained high 'Cash' liquidities [what many in the past called 'Trash'] over the past while, now provides & permits you the financial-flexibility to notably benefit financially.

Of course, uncertainty is always there, especially for those who are more alert. Surely, we have all entertained some dark thoughts recently about the possibility of expanded & extended wars, other pandemic health hazards, Mother Nature's anguish, harpoon-inflation-spikes, social unrest, food insecurity… Somehow, these risks seem inescapable. Even nimbly navigating through uncertainty has imperfect results, especially for our behemoth institutions & Governments who are often less timely to respond to material, adverse changes.

> "Striving **not** to be 100% wrong in our asset-allocations decisions [diversification], maintains the integrity of your savings. The cost of attempting to be 100% correct in investment decisions, over time, often destroys most investment portfolios. That is why maintaining a balance within your investment portfolio is so important. Because the future is unknowable, there is a risk and a cost of being 100% wrong which is irrecoverable in most cases. [unless you are a bank, insurance company, pension fund or a country]." *-VV 15Jul2019*

Until recently, both stock markets and bond markets suffered notable losses: Average stock indexes were down 20% & Bonds were down about 15%. This wealth-destruction-event that befell the world this year, was epic. In this environment, a <u>diversified</u> portfolio should have been **down** about 18% this year to 30 June 2022. [60% stocks @ **-**20% & 40% Bonds @ **-**15%= -18%].

In most cases, the diversified portfolios we manage, performed much better because of the high 'Cash' component maintained, almost NIL in Bonds, and some decent, aggregate stock selections].

Some say: 'the future holds promise.' We are also hopeful.

As always, it will be our pleasure to discuss these matters further or any other financial considerations you may have.

John Evdokias

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