The Market in Review

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This week's articles and insights

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"But I don't want to go among mad people," Alice remarked.

"Oh, you can't help that," said the Cat. "We're all mad here. I'm mad. You're mad."

"How do you know I'm mad?" said Alice.

"You must be," said the Cat, "or you wouldn't have come here."

— Lewis Carroll, *Alice in Wonderland*

Your Index Report

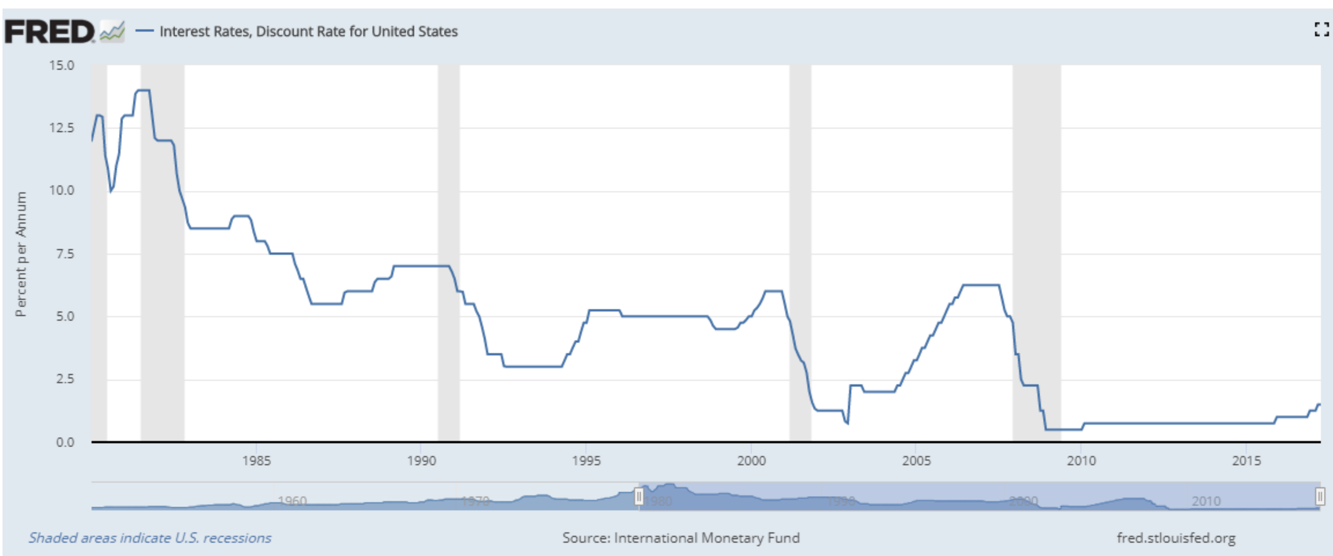
	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,753	+ 2.48%	+ 14.69%
S&P 500	2,954	+ 2.16%	+ 17.84% (+13.92% in $CDN)
TSX	16,575	+ 2.07%	+ 15.72%

Negative Thoughts

Declining interest rates are nothing new for today's generation. Rates have been falling since late 1981 after being pushed to ridiculous levels to stop the inflation of the 1970s.

My first consumer loan was in 1982 and the rate was 23.5%. My father almost wept as he co-signed the loan, which I used to buy a water bed and a couch to start my first job.

Higher rates worked, but at a cost of two recessions. By late 1982, rates were dropping 1% every few months and the economy was turning up. Inflation's back had been broken and there was no need to keep rates as high as they were. Stocks and bonds soared, and real estate soon followed.



The boom that lasted from 1983 through 1990 demonstrated to central bankers what a powerful weapon interest rates were. They could stop an economy in its tracks or jump start one dead in the water.

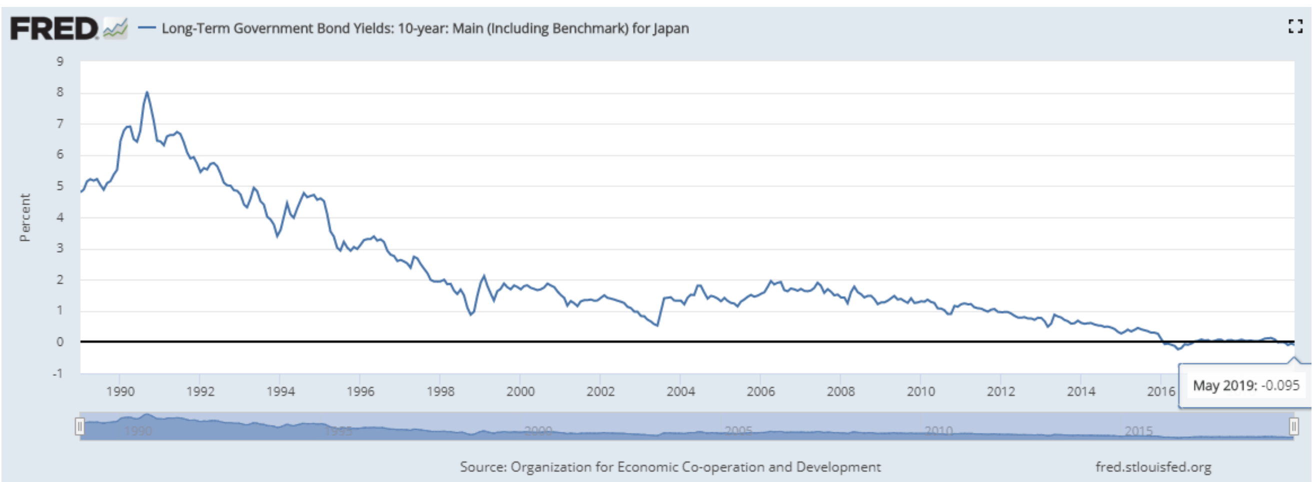
In 1987, Alan Greenspan was the head of the US Federal Reserve. Mr. Greenspan was determined to stop any recession before it even started, so when stocks plummeted in October, 1987, he forced rates lower to slam the door on any slowdown or problem that might show up. This came to be known as "the

Greenspan Put", which is a reference to a form of insurance used in the stock market. He wielded lower interest rates like a shining sword every time the world got into trouble, from the Russian devaluation of 1998 to the recession of 2000-2002.

He even talked of permanently banishing recessions through perfectly-timed interest rate cuts.

The problem was, no one really understood when to stop. Or how far we could go down this path. US T-Bill rates had fallen from 14% in 1981 to 0.75% in 2002. They rose to 6.25% in 2007 but were back to 0.50% by 2009. Not quite 0% but close enough.

The Japanese were the first to push their interest rates to zero.



Low interest rates encourage people to save less and borrow more. It is as simple as that. When rates are 10%, for example, people will run to put their money into a savings account. But when rates are 1% or less? They run to the store.

Also, it encourages larger purchases. A $500,000 house with a 5% mortgage has the same interest bill as a $250,000 house with a 10% mortgage – both accrue $25,000 in annual interest. Banks love to lend you more if you can afford the payments. Why not get the extra bedroom, bathroom, and garage a larger home offers? Governments have taken advantage of ultra-low rates even more. There are few countries in the world today with surplus budgets.

Over time, as more people have larger and larger mortgages, car loans, and lines-of-credit, it becomes difficult to stimulate more borrowing. Growth stagnates at high levels of debt because people can only stomach so much. This has come to be known as “pushing on a string” when lower interest rates help no further.

After the crisis of 2008, central governments around the world panicked. If low interest rates didn’t increase growth, what if they tried something even more extreme: 0% rates. Or even negative rates. Charge people for saving their money and you could potentially force them to invest in real estate, bonds, and stocks. Japan was the first country to test the waters of negative interest rates. In 2016, their rates went below 0% and today, their 10-year bond yields -0.095%.

They are no longer alone. Switzerland, Germany, Netherlands, Denmark, Austria, Sweden, France, Belgium, Slovakia, Ireland, Slovenia, Spain, Portugal, Malta, Bulgaria, and even Italy are now experiencing negative rates. If it seems like an impossible concept, it truly is.

“*Why, sometimes I've believed as many as six impossible things before breakfast*.”

— Lewis Carroll, Alice in Wonderland

Enter the world of negative interest rates, where everything is backward. The borrower gets paid and the lender loses.

In Spain, for example, one bank tied its mortgages to government bond rates. When Spanish bonds fell to negative yields, the banks were forced to start paying borrowers by deducting a little principal from their loans every month. Then, it charged savings accounts interest instead of paying them.

Stuffing money under the mattress suddenly became financially prudent – at least your bed doesn’t charge you for storing cash.

“*If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?”*

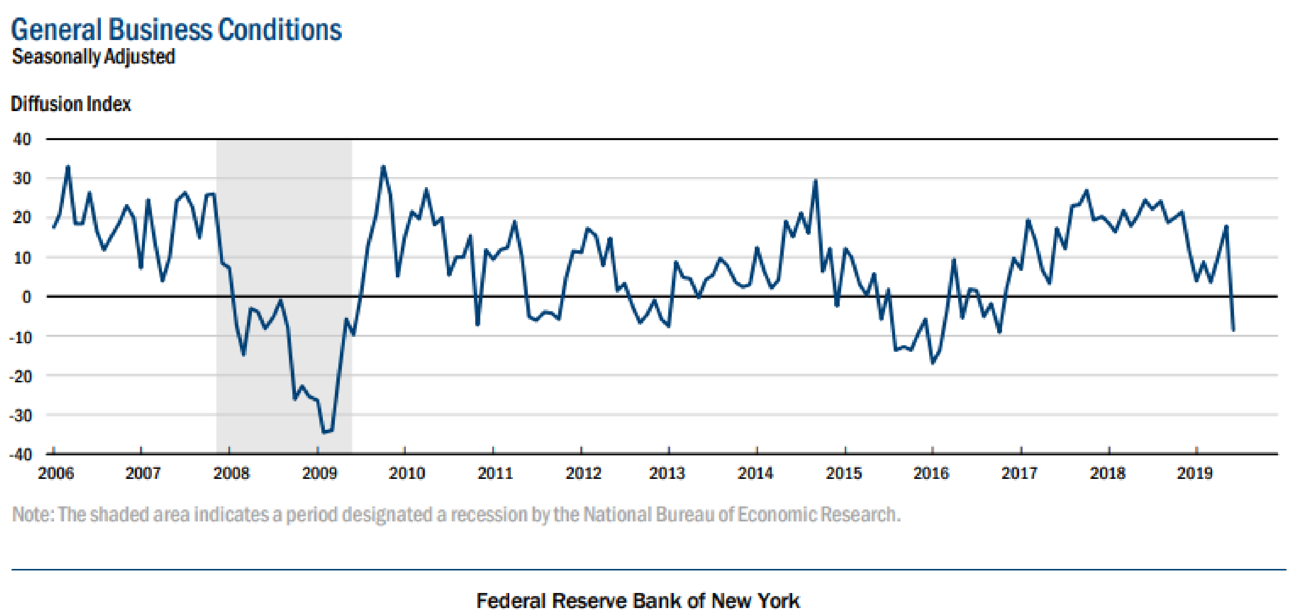
— Lewis Carroll

European banks have been hit hard by negative rates, since they are required by law to hold government bonds as reserves. Since these bonds charge you for holding them, banks in the Eurozone now pay approximately €7 billion annually to their central governments for the “privilege” of owning safe bonds.

“*I am convinced that we will at some point return to positive interest rates*,” Swiss National Bank Chairman Thomas Jordan said. “*I cannot tell you when exactly that will be*.”

Fast forward to 2019, and we see the impact of negative interest rates on asset prices. Stocks, bonds, and real estate everywhere have risen in value in this world of ultra-low rates. In fact, one could even argue that most of the real estate inflation in British Columbia (and Seattle, and New York, and Sydney, and London) is due to low interest rates, rather than the foreign buying we like to point fingers at.

In 2017 and 2018, the US Federal Reserve began raising interest rates to get back to some form of normalcy. It didn’t last long – rates have been on hold since December because growth is sputtering again. Thanks to the US-China trade war and other geopolitical tensions, global manufacturing is falling. US business conditions experienced a record drop last month:



Federal Reserve Bank of New York

Bad News is Good News, for now…

Stocks and bonds rallied this week because the US Federal Reserve indicated it could lower interest rates at its next meeting in July. In the short-term, this is a positive. Markets are hopeful the “Greenspan Put” is back in play - any threat of recession will be stopped before it starts.

Longer-term, however, recessions are very hard to stop. And, how far will interest rates have to fall to accomplish this?

In Canada, our 5-year bond paid 2.5% last October. Today? It is 1.31% - almost cut in half. Do we follow Japan to 0% rates, or even lower? It used to be unthinkable. Now, we definitely think about it.

In the meantime, dividend-paying stocks, income-producing real estate, and quality corporate bonds still make a great deal of sense. Any form of safe, or relatively safe income, is increasingly valuable.

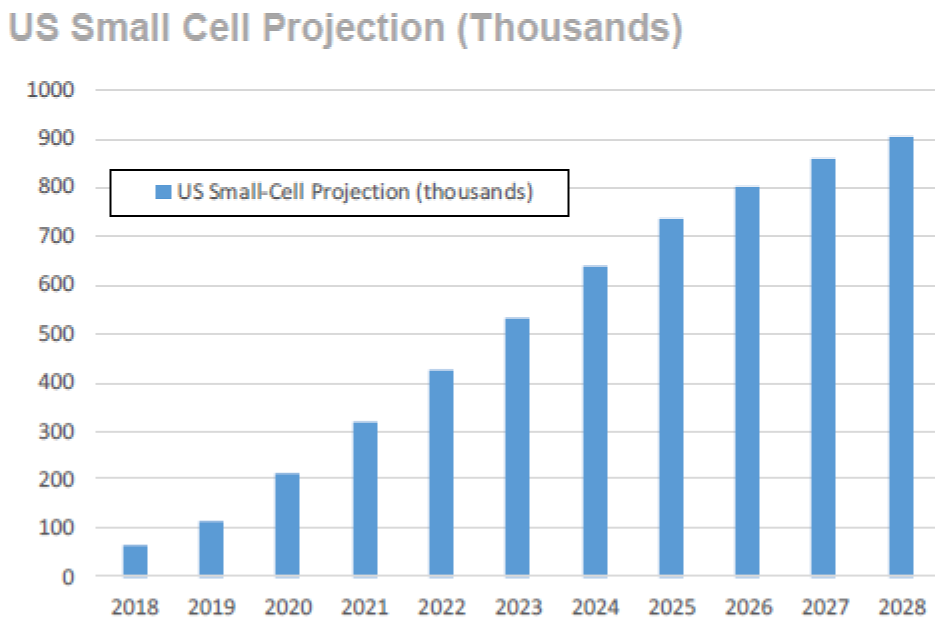
Meanwhile, there are still pockets of growth in the world.

5th Generation

Your smartphone is about to get even smarter. And faster.

You may not know it, but your current device is the 4th generation of wireless technology, known as 4G. This has enabled most modern phones to connect to the internet and download everything from text messages to movies.

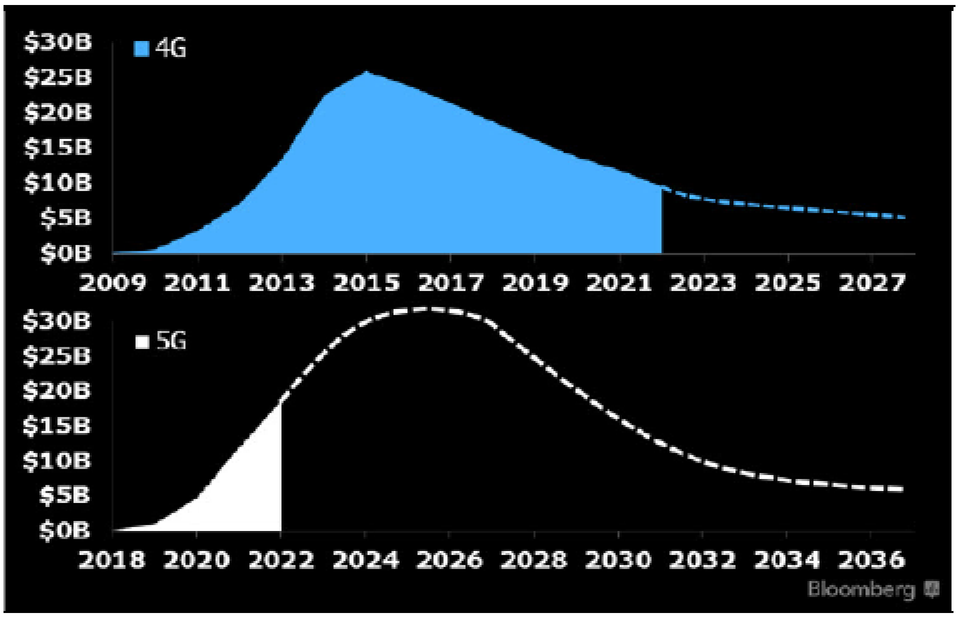
The 5th generation, or 5G, will soon be upon us. The antennas will be smaller and far more numerous, allowing autonomous cars to “talk” to the world around them and your device to work up to 300 times faster. By 2028, these little antennas will be everywhere:



Source: Bloomberg Intelligence, Raymond James Ltd.

Homes, cities, factories, cars, and even clothing will be wired for instant data. To accomplish this, a lot of new equipment will be needed by our telecommunications companies. Equipment spending is expected to quadruple to $3.2 billion in 2019 from around $750 million in 2018, growing to $19.3 billion in 2022.

Wireless Equipment Revenue Forecast



Source: IHS, Bloomberg Intelligence

Our Dividend Value portfolios currently hold Nokia shares (**NYSE NOK**). Nokia makes the base stations that process these 5G signals and should be one of the earliest beneficiaries of the exploding 5G trend. Nokia should also benefit from any orders lost by China’s Huawei in the current trade spat with the US. The shares have not benefitted yet, but we believe it is just a matter of time.

The 5G tide is coming in and it will be large.

Trash Talk

The Canadian government recently proposed a ban on single-use plastics by 2021, including such nefarious items as plastic straws. This follows on the heels of the “Garbage War” with the Philippines, where Canadian plastic sent for recycling was actually just containers of garbage.

Both issues highlight two major issues of the modern era:

1. What is trash and what is recycling?
2. What do we do with them?

For years, Canada has shipped its recycling off to countries like the Philippines and China to be reprocessed. All of Canada's recyclable mixed paper went to China and about 36% of our plastic was shipped there, as well.

And then China stopped taking it. After fighting with grease-soiled cardboard for years, and often forced to burn hard-to-recycle plastics, China closed its borders to the recycling trade. Prices plummeted for all forms of recycled material, and some cities have even had to start paying companies to take our recyclables. This has turned the entire blue-box industry upside down. With fewer and fewer companies willing to pay, municipalities may have to start charging to recycle. Canada only recycles 9% of our plastic waste now (source: Deloitte) – will more and more end up in the dump because it is too expensive to recycle? Toronto is now paying $40 per tonne to have plastic hauled away that recyclers once paid a nice price for. No one wants the stuff.

"It's a Canada-wide problem. There's no place in Canada that's not feeling the effects of the China ban," says Linda Andrushkoff, manager of a recycling facility in North Glengarry, Ontario. Some Canadian recycling has found a market in Vietnam, Thailand and Taiwan, says the Globe & Mail, but these places are also clamping down. Plastics are hard to reprocess and Asia already has too much of their own.

One of the problems with plastic is that is it just so darn cheap to make. And, it lasts forever and is practically indestructible. Paper and cotton substitutes can take far more energy to make, which makes them expensive substitutes.

The reality is, this has been a global problem years in the making. It is a crisis now, but in crisis there is opportunity. Someone, somewhere, is going to make a lot of money when they figure out a solution.

The obvious solution is to use less plastic in our everyday packaging. Many things, like food, will be difficult to ship and sell without plastic, so there is only so far we can go. Stricter recycling separation rules are likely coming as well. Most of us don't know the difference between the different grades of plastic. I expect that to change as domestic recycling gets serious.

We often wished we had bought a waste management company years ago. They are almost immune to economic cycles (garbage is forever, it seems) and they are at the "tip of the spear" when it comes to dealing with trash. Some waste companies operate incinerators to generate power from burning waste, and plastic is an ideal candidate, if burned efficiently. Sweden burns plastic to generate energy, and does so with a process that emits few harmful emissions.

Perhaps that is the future for hard-to-recycle plastics: burn them like we do oil and natural gas to create power.

The Chinese ban on imports of recyclables will soon be felt here at home. For decades, local governments have subsidized local waste management and recycling programs with subsidies, which were then offset when these products were sold overseas. Now that the price for these is zero or less, expect blue box services to start costing more, and to be more stringent.

But, someone will find a way to solve this, and solve it profitably. Our job is to find out who that will be.

Thank you for your referrals this month! They are always handled with great care and discretion.

http://www.dividendvaluepartners.com

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