The Market in Review

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This week's articles and insights

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"If you are possessed by an idea, you find it expressed everywhere, you even smell it."

- *Thomas Mann*

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	34,197	+ 1.10%	+ 11.73%
S&P 500	4,266	+ 1.06%	+ 13.59%
TSX	20,215	+ 0.35%	+ 15.96%

The Smell Test

One of the aspects of the pandemic that upsets libertarians most is the facemask. By hiding facial expressions, we become nameless and uniform. For a person who needs expressions and smiles, I can't wait for masks to vanish.

Another sense that is dulled by the mask is our sense of smell. Unlike sight and hearing, smell is one of the most underappreciated senses in that there are many things about how humans smell that we are still discovering. Take, for example, what we smell like to other people.

Long before religion and formal marriage came along, humans avoided marrying close relatives. It makes sense from a genetic point of view, in that DNA that is too similar risks generating offspring that carry recessive genes. Therefore, smell plays a part in how we choose a favourable mate.

How do we do this?

Every one of us carries a set of proteins that help our immune systems identify cells that are from something, or someone, else. Our bodies use this "surveillance" to identify how *different* someone else is by their odour, and scientific studies have shown that both women and men are more attracted to the smell of people who are genetically *unlike* them. An immune profile that is opposite yours can mean added protection from pathogens and less risk of genetic defects surfacing.

So, we like the smell of people who are genetically different from us. And it is all subconscious. Unlike dogs, we don't actively start smelling other people when we meet them. And yet, our noses are doing exactly that.

Of course, humans are complex, thinking creatures. We don't just base marriage on what someone smells like. Many other aspects – facial attraction, manners, economics – play a significant role. But, our sense of smell is active at the subconscious level, moving us in ways we are barely aware of.

The full article can be read here:

https://www.bbc.com/future/article/20210621-why-single-people-smell-different

The Scent of Change

The human nose can often smell a change in the weather, as well. We detect rain through a fragrant chemical compound called petrichor that is released from soil when the first raindrops hit. We can smell the sweetness of ozone that precedes storms when thunderclouds bring it down from the lightning above.

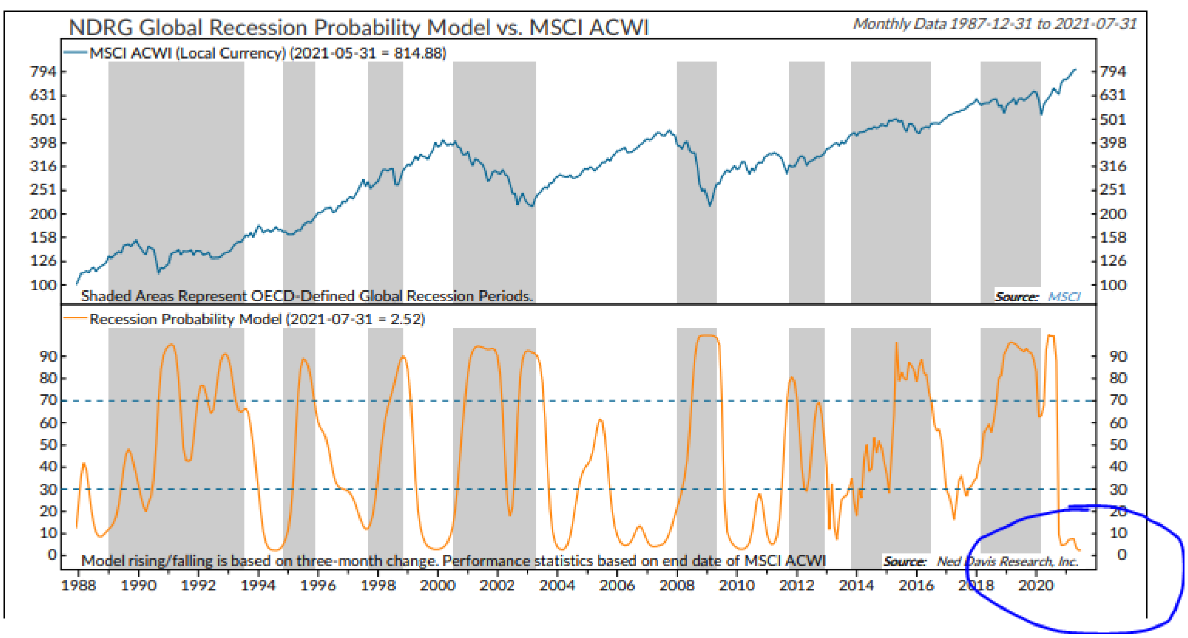
Markets also have a sense of smell, and they did not like what was emanating from the Federal Reserve last week. U.S. Federal Reserve chairman Jerome Powell hinted that they may have to hike interest rates twice in 2023 to slow an overheating economy. He had stated earlier there would be no hikes until 2024.

“Slow the economy” is not what investors want to hear this early in the recovery. A storm of selling hit commodity and “re-opening” stocks, smacking sectors from airlines to hotels to chemical producers. Gold, a barometer of inflation, fell $100 per ounce as fears of higher rates sunk in.

So investors smelled the ozone, but does that mean a thunderstorm is necessarily brewing?

The Global Recession Probability Indicator sits at its lowest point since 1994, suggesting almost no chance of a recession in the next 12 months. That doesn’t mean we can’t get bumps and scares along the way, but with the world re-opening everywhere, a major decline is very unlikely.

Global recession probability at rock-bottom level



Rising interest rates are the biggest thing that could derail today’s recovery. How likely is this, though?

As much as the Fed may want higher interest rates, the market's reaction tells us they are very constrained in what they can do. In fact, we've seen versions of this horror movie before. In 2021, the threat of higher interest rates is less credible today than ever before.

- U.S. interest rates reached almost 7% in 2000 before the 2000-2002 recession hit. Rates fell to 1% in 2002 before things picked up.
- The Fed hiked rates only back to 5% by 2008 to "get back to normal", but this was enough to cause the Great Recession of 2008-2009. Rates then fell to 0.25% until 2015.
- The Fed tried hiking again through 2018, getting only as high as 2 ½% by late 2018 before the market seized up. Rates were already on the way back down by the time the pandemic hit, and are now back at 0.25%.

How high can they go this time before markets react violently? To 1%?

The reality is that all central banks have painted themselves into a corner. Debt loads are so high that even small interest rate hikes will choke off any recovery. So, the U.S. Fed – and the Bank of Canada – are walking a fine line between low interest rates forever and small rate hikes to hold back inflation.

The Smell of Inflation

"I love the smell of napalm in the morning."

- *Colonel Bill Kilgore," Apocalypse Now"*

"Have you seen the price of food lately? How high will gasoline prices go? How can I protect my portfolio?"

Inflation is the biggest question we get from clients these days.

As we have said in previous weeks, some of this inflation will pass. Supplies of lumber, computer chips, steel and food – just a few of the commodities seeing price increases - will increase as people get back to work, sending prices lower. In fact, prices for most of these are already declining. High lumber prices have helped push intentions to build or buy a house in the U.S. down - mortgage applications to purchase a home dropped to the lowest level in 13 months. After a pause, though, we have to remember that we underinvested in building new homes for a decade even as millions of Millennials are now forming families and need homes.

Once sellers and buyers catch their breath, the housing boom is likely to continue, albeit at a more measured pace.

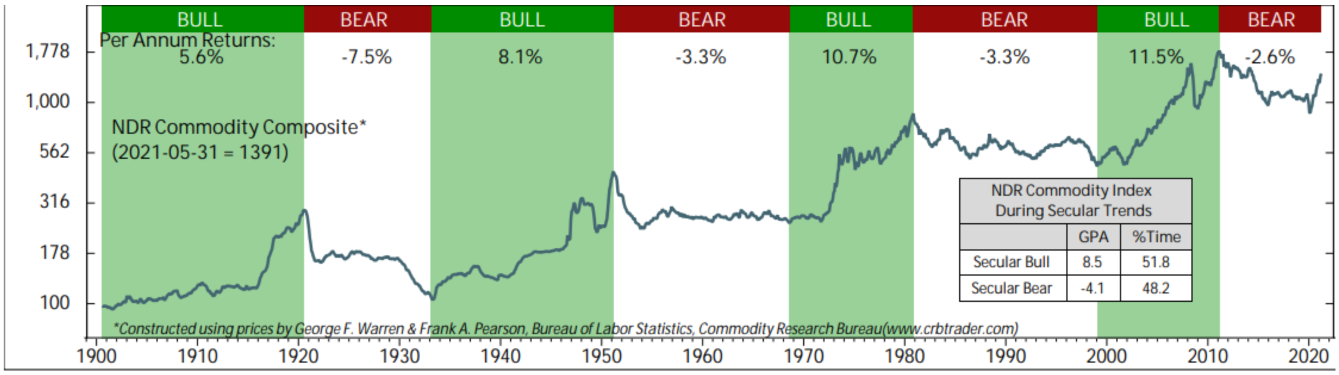
But will prices of everything drop back to last year's levels? Not likely. Costs are likely to stay higher for longer as inflation creeps up over the decade. It is part of the new cycle the pandemic ushered in.

Meanwhile, the global recovery is very uneven. While the UK, the U.S. and Canada are enjoying high vaccination levels, most other countries are well behind us even as they race to catch up.

And, many countries, such as Chile, Indonesia, and the UAE relied on Chinese vaccines. Covid infections have surged because those vaccines, which were never properly tested, work poorly against the new variants of Covid-19. China itself is having to lock down cities and regions as new outbreaks flare up. The world could experience a fourth wave if inoculation programs are too slow. And, there is talk about a new Delta Plus variant emerging in India.

In summary:

- Interest rate hikes are still far off. Central banks may talk about raising rates, but it will just be that – talk – for a few years. There are still *millions* of unemployed workers who need an economic recovery to get back to work.
- Slower vaccinations worldwide – and setbacks for those countries using the Chinese vaccines – mean a global recovery will be in fits and starts. And take longer to accomplish.
- There will be more inflation, but it won't be in a straight line. There may well be a mini-recession that sees prices fall for a short time. In the long-term, however, we have spent far too little opening up new farmland, mines, and commodity production. Canadian stocks in these industries could do quite well in the next decade. This chart shows the 10-20 year commodity cycles since 1900. We are near the end of this bear market cycle.



Stumbles in the markets are to be expected, but no storm coming yet.

Show Me The Money!

There are many ways to find value in the market. Day traders look at promising chart pictures while fundamentalists scour the balance sheet for hidden underappreciated assets.

Dividends are another way to look at companies. The famous quote “Show me the money!” from the movie Jerry Maguire encapsulates this form of analysis best, because quarterly cash dividends are the most dependable form of return.

There may be significant opportunities building today. Why? Because so many companies delayed, deferred, or decreased their dividends during the pandemic in preparation for the worst. With all the government support and the rapid success of vaccines, the war chests they built up were never needed. Many companies paid off debt in 2020 rather than increase dividends, but now we could see outsized dividend increases to make up for lost time.

Here’s a quick summary of the dividend landscape:

The Steady-Eddies:

Utilities: This group never missed a beat. And why would they? With so many people working from home, any power and natural gas demand decline at factories and offices was made up for in the home. Companies like Fortis (**TSX FTS**) routinely raise their dividends at a 7-8% increase every year. Smaller utilities like Algonquin Power & Utilities (**TSX AQN**) has raised its dividend by 10% repeatedly for several years.

The Hesitant:

Companies like Visa (**NYSE V**) grew their annual dividends by over 20% for years until the pandemic. Visa cautiously raised its payout by just 6% in 2020 – no surprise, really, because they saw payments for restaurants and travel plummet. Then suddenly, on-line buying surged and cash payments nosedived. Cash had already been on the decline in favour of electronic payments and the pandemic-induced fear of germs only sped this up. Expect a resumption of bigger increases ahead.

Nutrien (**TSX NTR**), the fertilizer company, could be another company on the verge of larger hikes. After several years of steady 5-7% annual raises, Nutrien paused for 6 quarters during the pandemic. Farmers had been deferring their fertilization cycle due to weather, tariffs, and weak crop prices. Nutrien was also forced to defer any hikes to its dividend during 2020, then raised it by a small 2% recently. Surging fertilizer sales due to bumper crops suggest better times – and faster dividend hikes – lie ahead.

Finning (**TSX FTT**) is another example of a company forced to pause. Their dividend, now 2.5%, has been frozen for over two years as its customers – mining, energy, forestry, and construction – struggled. Now? Conditions have flipped and these industries are booming. Finning has paid out between 30% and 50% of its earnings as dividends in the past and has focused on paying down debt in the last few years. If Finning makes what analysts expect this year, the company could be in a position to raise their dividend by over 20%, with even more in the year after that. Now, companies in cyclical industries tend to be very careful in what they promise. Finning may do what some other companies have done recently, which is pay one-time large dividends so as not to commit themselves long-term. No promises, but with less debt and improved profits, good things could happen.

The Newly Emerging:

It may surprise people to hear that gold companies have been some of the biggest dividend hikers in recent years. Forced to pay down debts for years as gold prices fell, many cut their dividends over the last decade. Now carrying far less debt and operating on a 'lean and mean' model, gold companies like Barrick Gold (**TSX GOLD**) have tripled their payouts and are even paying special dividends. Old favourite Kirkland Lake Gold (**TSX KL**) raised its dividend by 50% this year.

The most reliable gold company of them all – Franco-Nevada (**TSX FNV**) – has raised its dividend by 4% a year for the past few years while most gold companies couldn't or wouldn't. With gold prices higher in 2021, Franco-Nevada felt confident enough to hike by 15% this year.

The Forcibly Restrained:

The biggest dividend opportunity may be in the banking and insurance stocks. These companies have to undergo annual stress tests to demonstrate how well they could safeguard depositors' money in the event of a crash. These tests were toughened during the pandemic, which forced banks and insurance companies to halt any dividend increases in order to build up vaults of cash as extra reserves.

We know now that the worst never happened. And yet, that cash is still sitting there. In the U.S., investment firm Piper Sandler expects bank dividends to rise 7.6% from current levels. In Canada, the increases could be even higher and faster.

For example, Bank of Montreal (**TSX BMO**). Since 2012, BMO has increased its dividend twice per year, with increases in the 5-7% range annually. Since the pandemic, it has been frozen at $1.06 since December 2019 – seven full quarters. It is overdue for a big hike. Same for TD (**TSX TD**), Royal Bank (**TSX RY**) and CIBC (**TSX CM**) – frozen for 6 quarters. The biggest laggard is Bank of Nova Scotia (**TSX BNS**), which has seen its dividend hikes halted for a full two years.

This giant pause affects other financials, like Manulife (**TSX MFC**) which yields 4.7% and has been flat for 6 quarters. Sun Life (**TSX SLF**) yields 3.5% and has been the same for 7 quarters. If current profit estimates hold up for Manulife, and its historic dividend payout ratio is maintained, it could be in line for a 9% dividend hike sometime in the next year. Sun Life could be even higher.

And the banks? Thanks to cash being freed up from unused loan loss reserves, Bank of Montreal could have the capacity to raise its dividend by 29%! They likely won't be this generous, but it does show how much surplus cash has been building up on their balance sheet. We expect above-normal dividend hikes to begin soon, or at least accelerated steps to distribute this cash.

Another sector possibly poised for hikes is the energy companies. Suncor (**TSX SU**) is an example of a former *dividend machine* that regularly raised its dividend. It even managed to raise its payout by 3% when oil was cut in half in 2015, demonstrating the resilience of its diversified business model that encompasses production at the well all the way to its national gas stations.

However, when the pandemic hit and oil prices actually went negative briefly, Suncor cut its dividend in half, and now yields 2.75%. In case you hadn't noticed, oil prices are now over U.S. $70 per barrel. Suncor is very profitable once again. At current estimates and using its historic payout ratio, Suncor could afford a 49% dividend increase this year (based on its paying out 50% of its earnings as dividends). Will it? Not likely – the industry is still too shell-shocked to overpromise anything. But every company in the oil patch has learned to scrimp and save even as profits grow. They have focused on buying back stock while other energy companies have paid down debt.

At some point, investors should see dividends increase.

Father's Day Run

For the 4th straight year, Raymond James Victoria partnered with the Island Prostate Centre to sponsor the Father's Day Run for Dad. The Centre provides information and support to men with prostate cancer and is an invaluable resource for those with this condition.

Unfortunately, the pandemic threw a wrench into the works for this event for the second time. We were unable to host the live race, breakfast, and band that we have enjoyed for years in the past and instead had to rely on a virtual run (your course, your pace) which is way less fun.

Charities have been hit doubly hard by Covid-19. They don't qualify for much financial support from governments, and their fundraising venues have all but disappeared. Because I am a prostate cancer survivor, my wife Sue and I decided to match all donations raised through us, which was a rather painful decision! In the end, we raised about $7,000, meaning we had to cough up a similar amount.

Hey, I survived prostate cancer. I am the lucky one.

Meanwhile, for the race, I coerced seven of my fastest running friends to run a 5km course with me. I ran in a pair of Nike Vaporfly shoes, which are shoes with a carbon plate that flexes like a spring when you land, and then gives your foot a tiny push with each step forward. They are a technological marvel! Estimates suggest a 1% to 4% improvement in speed, which I am not ashamed to take at my age.

Source: Nike.com

At the end, one of the fellows confided to me that he needs a biopsy to determine if he has prostate cancer, so I was able to point him to the Island Prostate Centre, as well as give him some comforting advice of my own experience. It is a disease that will strike one in three men over our lifetimes, so be vigilant.

I managed to beat all my younger friends in the race with my new shoes. Maybe I should buy some Nike (**NYSE NKE**) stock…

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http://www.dividendvaluepartners.com

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