The Market in Review

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This week's articles and insights

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"The greatest problem about old age is the fear that it may go on too long."

- *A. J. P. Taylor*

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	35,603	+1.98%	+ 16.33%
S&P 500	4,550	+2.51%	+ 21.13%
TSX	21,212	+1.88%	+ 21.68%

Welcoming the Seasonal Best Months

Despite many reasons for the market to decline – rising interest rates, high oil prices, labour tensions, shipping log jams – stocks have continued their relentless climb since mid-October. Less noticed are that earnings and employment have also been rising, which are bigger influences on stock prices. U.S. stocks are up approximately 6% since July, when the 3rd quarter began. But earnings are up 10% in the same time, so stocks have responded positively.

Stocks move in the *direction* of profits more than the *amount*. The question to ask is not if things are 'good' or 'bad', but rather are things 'better' or 'worse'. Since July, profits are clearly 'better'. Almost all companies in the S&P 500 have now reported Q3 results, according to FactSet. Of that group, 82% have exceeded Wall Street's estimates versus the usual 79%. Reported earnings were +10.3% above expectations.

Some of this is 'bounce back' from the horrid earnings during the pandemic, so we can't count on 10% increases in earnings every quarter. 2021 looks abnormally good compared to 2020, in other words. Ned Davis Research thinks earnings will continue to accelerate until next spring when comparisons should become less rosy. 2022 won't look as good compared to 2021 as 2021 looked versus 2020. We are experiencing the biggest catch-up in earnings right now.

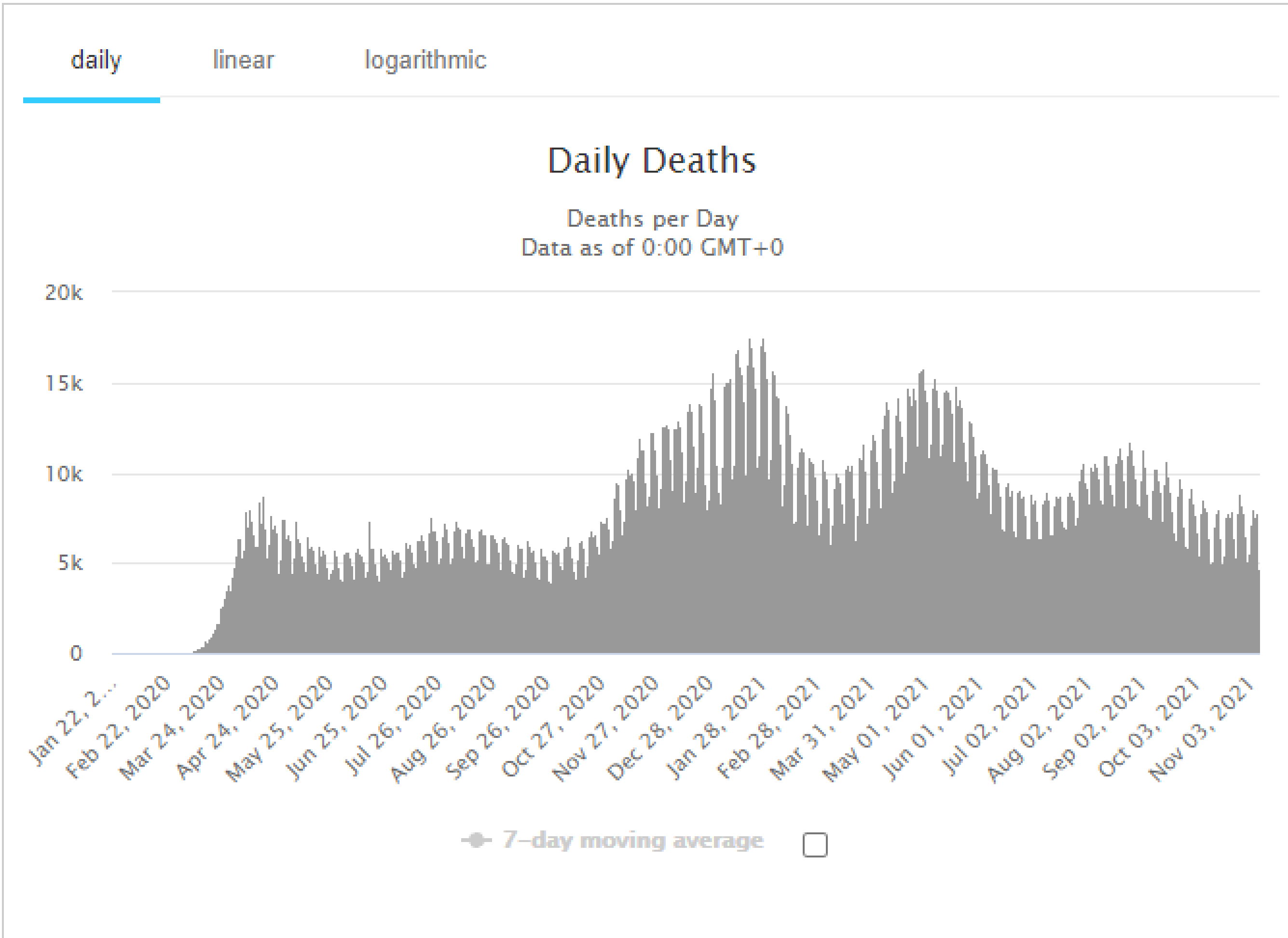
Welcome to the seasonal best months for stocks.

Rate Hikes and Road Building

The two largest financial stories of the last month have been rising interest rates and the new Infrastructure Bill being approved in the U.S.

What, *not* the pandemic? Even as new cases continue to climb in China and Russia, the global death rate has been declining with each new peak in cases. 96% of the world's population is now out of lockdown and two new antiviral drugs are on the way to stop Covid-19 once you already have it.

This means the world is moving on. Note the trend of fewer deaths with each surge in new cases.



Source: Worldometers

On the interest rate front, 40% of global central banks are now raising interest rates. The U.S. and Canada have not yet raised rates, but both have either stopped their bond-buying programs (Canada) or started 'tapering' their purchases (U.S.).

Historically, cutting back on bond buying does not negatively affect the stock market until the final taper, which would be mid-2022. (*Note to self to circle that date.)*

Offsetting the decline in money-printing stimulus is spending by governments. The U.S. Infrastructure Bill, worth about $1.2 trillion, is close to being passed. This will help engineering and industrial companies involved in road building, electrification, and other infrastructure projects.

Image from Unsplash

Both countries need serious upgrades to their rails, roads, and sewers, but much of this will end up spread out over many years, and some will be wasted. So, the new bill will mean a lot of headlines but not a lot of market impact.

Cogitation About Inflation

I've been thinking about inflation recently. I mean, who hasn't been thinking about inflation recently? Costs for everything are up across the board, including the cost to rent an apartment, food, wages, lumber, and gasoline. And now we hear the price of milk is expected to rise in Canada next year by 8% and butter by 12%.

Not all of these increases are happening because of demand. Are you drinking more milk? Most of these price hikes are due to shortages, both temporary and long-term in nature.

Take lumber, as one of the temporary examples. Lowest-in-a-century interest rates prompted home building on a massive scale last year, pushing lumber prices up by 500% at their peak. This has subsided, so lumber prices are now only 200% above their pre-pandemic levels.

But lumber prices also have a long-term component. Canadian supplies have shrunk due to the mountain pine beetle devastation in the last decade, and the recent decision to ban harvesting of more old growth forests. And less of anything, assuming constant demand, means higher prices.

It will be difficult to push the prices of other things lower. Beef prices are high because of poor hay crops this year, which increased feed prices and forced many farmers to reduce their herds. Fewer cows = more expensive beef. It only takes a season or two to grow a herd back, but the pace of adding cows will depend on feed prices, which are still high. So, higher beef prices for longer.

And oil prices? Oil producers are under siege at the World Climate Forum in Glasgow right now, and Canada's newly-announced emissions cap means there will be few new energy projects launched in Canada ever again. This is fine if demand is also in decline, but it isn't. At one point last year, over 60% of the world's population was under lockdown. Not travelling, not driving, not doing anything.

Now? Only 4% of the world's population remains in lockdown, thanks to a 50% global vaccination rate. Transportation, manufacturing, and travel are jumping, which means more energy use.

At $84 per barrel, oil is now at its highest price since 2014:

But, here is the true question.

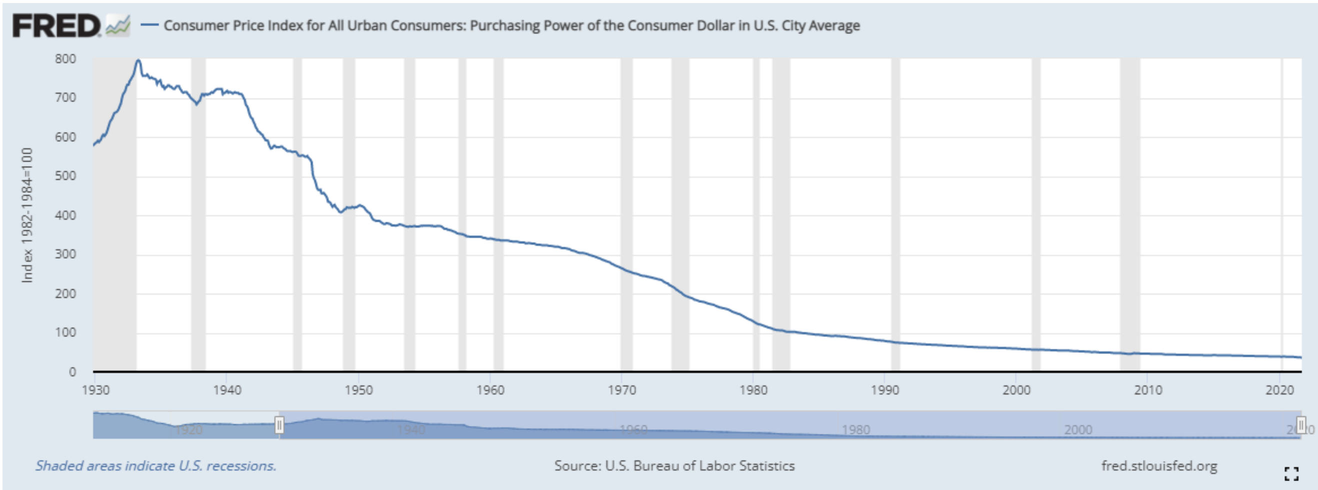
Are things really more expensive, or is the value of our money shrinking? In other words, is our elevator going up, or is the floor around us falling?

It is a pertinent question today, because many historians have begun to look back on past empires to see how their monetary systems evolved. Or devolved, as the case may be.

The Roman Empire had a remarkably stable gold coin called the aureus, which later became the solidus. It retained its value for close to 300 years until the empire was low on gold and high on debts, leading emperors to cut the amount of gold in each coin ("clipping") by decreasing the weight . Sometimes, they added in silver or copper, which were worth less but had the same volume. One theory is that this debasing led to Rome's decline. Soldiers, seeing their real wages fall as their coins became worth less, rebelled or simply fought less ardently.

Today, we no longer mint gold coins for daily use, but we have certainly become experts on printing money, even if it is digital. Ever since the U.S. Federal Reserve was created in 1913, the value of a dollar has decreased steadily through overspending.

For example, here is a graph of the purchasing power of a U.S. dollar from 1930. $1 in 1930 is worth about $0.06 today, which is a reduction of about 16x. Because inflation calculations changed in 1980 and again in 1990 to lower the impact of inflation, some say it is higher than has been reported. This would put the reduction at closer to 18x since 1913 (source: Shadowstats).



How does this square with the value of items? Pretty close, as it turns out.

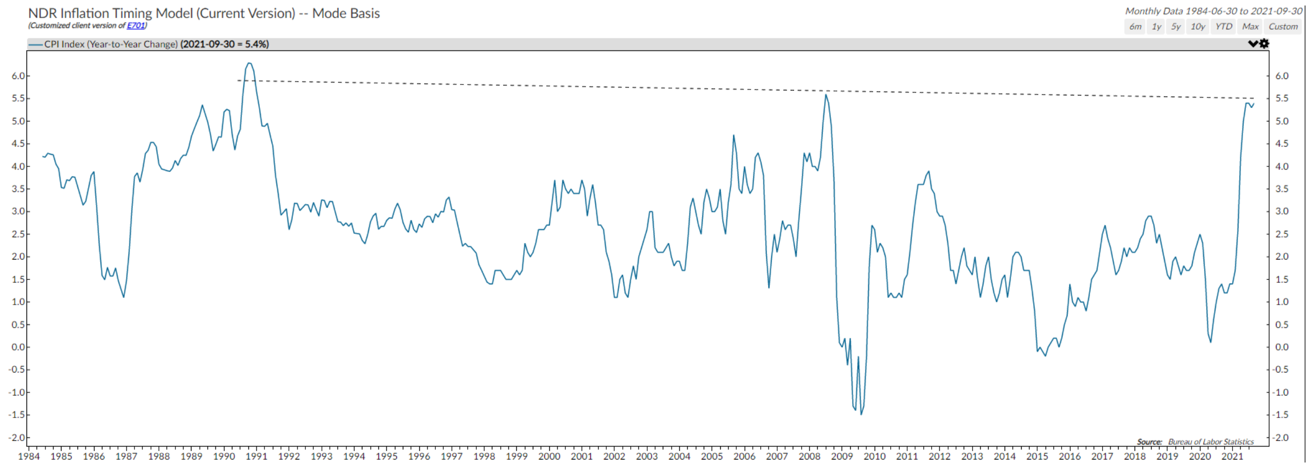
Costs of everything rose in lockstep from 1930 to today (all prices from ThePeoplesHistory.com):

23x Bread ($0.09 per loaf to $2.12 today)
33x Hamburger
28x Gasoline
26x Wages

We can say that we are making far more today than in 1930 in dollar terms, but since costs have risen almost exactly in-line with our wages, things cost about the same as they did 91 years ago. The difference? Our dollars are worth less. Notice that wages have increased at a faster rate than the dollar depreciating, which is why we can actually buy more "stuff" today than we could 90 years ago. But not 26 times more.

The faster inflation rises, the faster a currency is devalued. Past periods when this happened were the post war years of 1946 -1950 and the inflationary 1970s. The faster inflation rises, the less that currency buys. Are we seeing that happen today? We may be.

Inflation today is rising at the highest rate since 2008 and 1991 before that:



We can argue about what caused inflation to rise, but the reality today is that every country in the world has printed money *with abandon* to battle Covid-19. With costs rising, expect to see more demands for higher wages through strikes (Kellogg's and Deere are now on strike, for example) or government increases to the minimum wage. Ontario just raised its minimum wage to $15 per hour.

Looking back at the 1930 data again, several items stand out as exceeding the rate of inflation: gold, real estate, and stocks. To no one's surprise, these are the largest areas of investment for most people. Why? As shown below, they have not only held their value in real terms but exceeded the devaluation of money (18x):

87x Gold since 1930
100x Average house price increase since 1930
143x Dow Jones Industrial Average rise since 1930

Returns on gold, stocks, and real estate have exceeded inflation – or deflation of our currency – since 1930. Yes, they can be more volatile, but over the long haul, there has been no other place to grow long-term wealth.

Growth stocks, like Amazon (**NASDAQ AMZN**) and Facebook (**NASDAQ FB**), have outperformed value stocks, like Exxon Mobil (**NYSE XOM**) and Boeing (**NYSE BA**) as interest rates fell over the last decade. Traditionally, however, the opposite tends to happen when inflation and interest rates are rising. Value stocks and those tied to real assets (oil, minerals, real estate) outperform growth stocks.

Canada's stock market is much more tilted to value stocks and real assets, which could mean Canada outperforms in 2022 over the more growth-oriented U.S. market.

Dividend Jubilee

A dramatic number of companies have been raising their dividends recently. Some are special dividends, which are paid once, although most are permanent hikes. Since almost 40% of stock market returns since 1926 have been due to dividends, rising dividends are vital to future returns. And boy, are they rising.

The biggest hikes are coming from the energy companies. This group is in a very virtuous place right now, in terms of dividends. Blessed with $80 oil and little appetite for new drilling, companies are using the newfound profits to pay down debt and lift dividends. Suncor (**TSX SU**) and Cenovus (**TSX CVE**) both doubled their annual dividends this month while Arc Resources (**TSX ARX**) raised its dividend a mere 52%. Some smaller energy companies are starting new dividends when they have never paid one before.

The banks have been prevented from raising dividends for two years now, and have built up enormous cash hoards. The insurance companies, too. Manulife (**TSX MFC**) hiked its annual payout by 11% and Sun Life (**TSX SLF**) by 20%. Some of Canada's big banks could see up to 25% increases to their annual payouts.

For some people, maturing term deposit and guaranteed investment certificate money could be placed in one of these dividend giants. Some are now yielding above 4%.

Diamonds Are (Not) Forever

Years ago, we wrote of a company that had managed to manufacture diamonds. They were small and full of impurities, and were yellow in colour. Expensive to make, "lab-grown diamonds" were not competitive with mined diamonds. We pontificated that someday they would be.

Well, here we are at 'someday'.

Today, lab-grown diamonds are much higher quality and can be manufactured in multi-carat sizes. And they look and act the same as mined diamonds because they are the same chemically. Their prices are no longer comparable, however. Lab-grown diamonds are now about half the price of mined diamonds, according to the Diamond Producer's Association, and they continue to fall.

When we wrote the article years ago, it was to warn people that investing in diamonds might not work out as well as it had in the past. A thing is expensive because it is rare, so when it is no longer rare, it is no longer expensive. Today, diamonds are still expensive to buy, but try selling one back to a jeweller. Be prepared for a big surprise – the true value is a lot less than you think.

What we did not foresee was the new era of diamond manufacturing for use in many industries. Of all lab-grown diamonds manufactured today, only about 10% are used in jewellery. The rest are used in drill bits, scalpels, lenses for lasers, and glass screens for cellphones. And because diamond has a lower coefficient of friction than metal (as much as 25% lower), diamond-coated parts are increasingly seen in cars, planes and turbines.

Even your next knee replacement may have a diamond coating. Diamonds have low friction, are biologically inert, and last a very long time. One trial underway is using lab-grown diamond in spinal disk replacements.

Finally, diamonds are made of carbon, which has similar – but superior – insulation characteristics compared to silicon, which is used in almost all modern computer chips. Diamond could replace silicon in electronics and computer processors one day, especially those requiring high power (think of all those Tesla's) and extreme temperatures (i.e. in space).

"Diamond-based computers are significantly more efficient and better than silicon in handling high voltages and high frequency. Electrons move more freely through diamond than silicon and diamond is far more thermally conductive than any other known material. We are reaching the end of the road for silicon. Starting with power transformers, electric vehicles, satellites, and cell phone towers, diamond will gradually replace silicon in the decades ahead."

- Jason Payne, CEO of Ada Diamonds (a lab-grown diamond company)

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