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> *"I do not like debt and do not like to invest in companies that have too much debt, particularly long-term debt. With long-term debt, increases in interest rates can drastically affect company profits and make future cash flows less predictable.*
>
> *- Warren Buffett*

Lorne Steinberg,
MBA CFA
PRESIDENT

Low Interest Rates: End of an Era, but Not the End of the World

Dear Investor,

As we write this letter, Ukraine is at the forefront of everyone's thoughts.

The markets have experienced some weakness, which is to be expected, but have actually held up reasonably well.

From an economic perspective, this is not surprising. Russia's economy is heavily based on commodities, such as oil, gas, metals and fertilizers, and prices for each of these is up sharply. However, Russia's economy is relatively small.

Despite its population size (145 million), its GDP is smaller than Canada's, accounting for about 2% of global GDP. The recent economic sanctions, if they remain in place, will have a major negative impact on the Russian economy and its citizens. For most companies domiciled outside of Russia, the economic impact will not be very significant.

However, the elevated inflation rate has brought about a rapid rise in bond yields, which signals the end of the zero-interest-rate era.

Interest Rates

The Federal Reserve raised rates 1/4 of 1% in Q1 but indicated that this is just the start. Markets are now pricing in an additional 150-200 basis points of rate increases (a basis point is 1/100 of 1%) by the end of 2022, and the yield curve looks very different today versus one year ago, as indicated in the chart below:

U.S. Treasury Yields

	March 31, 2022	March 31, 2021
2-year	2.28%	0.16%
5-year	2.42%	0.92%
10-year	2.32%	1.74%
30-year	2.44%	2.41%

Source: Board of Governors of the Federal Reserve System (US)

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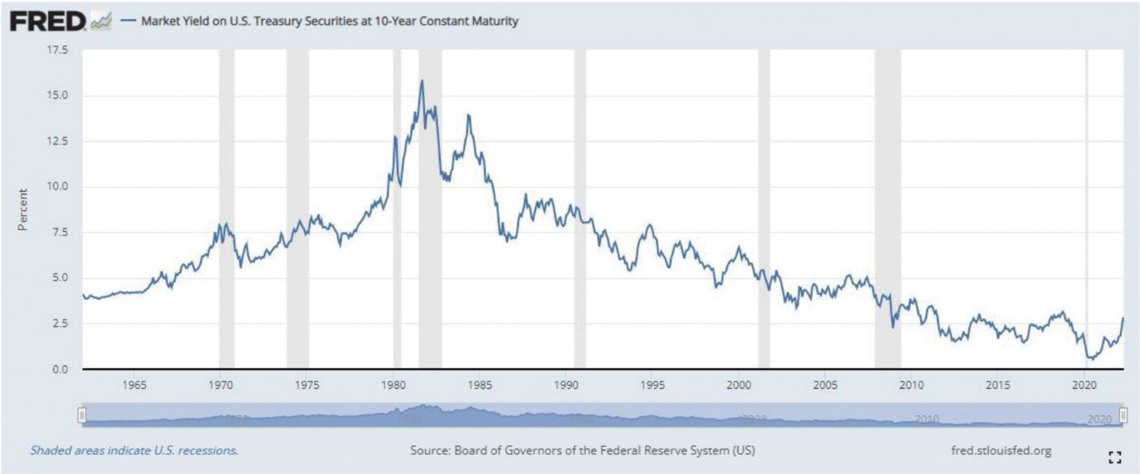
Shorter-term bond yields have risen substantially due to the high inflation rate. However, longer-term yields have risen much less, indicating that investors assume the current high level of inflation will ultimately prove to be transitory.

The sudden increase in yields has caused those "safe" government bond funds to suffer their worst performance in many years, and has investors concerned about the impact on markets.

However, it is important to note that for most of the past half-century yields were significantly higher than today, as can be seen in the graph below.



Given its shorter duration and other attributes, high yield bonds have been outperforming regular fixed income in 2022, as they did in 2021. This is not surprising, as high yield bonds have historically generated positive returns over a rising interest rate cycle.

Inflation

The U.S. inflation rate (CPI) reached 8.5% in March, the highest level in 40 years. "Core" inflation (excluding food and energy) was 6.5%. The impact of higher energy and food prices is that consumers have less money to spend on other goods, and therefore economic growth will be lower than originally forecast.

However, looking forward, there are already signs that the inflation rate may be peaking. Last month GM and Ford stated that they expect to be operating at full capacity by year-end, as the semiconductor shortage is abating. Used car prices, which reached record highs, have started to decline. Other indicators, such as the Baltic Dry Index (shipping), are also showing signs of moderating.

The primary mandate of most central banks is to keep inflation under control. This explains the hawkish comments by the Bank of Canada and the Fed over the past few weeks. Higher rates will incentivize consumers to pay down debt and/or save vs. spend, which should have a cooling effect on the economy.

How will all of this impact equities?

When input costs rise, companies raise their prices to maintain their profit margins. This usually results in increased earnings, dividends and share prices. This pricing power is why equities remain among the best hedges against inflation. From 1978-1988, the decade with the highest inflation rate, the annualized return of the S&P 500 was 14.8%, well above the annualized inflation rate of 6%.

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RECENT ACTIVITY

There were several new purchases, as well as additions to existing positions over the past few months. Here, we highlight three of them.

ADOBE invented the PDF, and has become a leading provider of creative content (their Creative Cloud division) and document management software (Document Cloud), along with a suite of customer relationship management and data analytics products (Experience Cloud).

Key products include Photoshop, Illustrator, Acrobat, and PDF Editor, all of which serve long-term secular growth markets. The company generates significant free cash flow, much of which is reinvested back into the business through R&D spending, product development as well as strategic acquisitions. Revenues have more than doubled over the past five years, and we anticipate years of continued growth in the years ahead. With the recent stock market turbulence causing some wild swings in individual share prices, we were able to acquire the shares at a valuation level very close to historic lows.

AMAZON is one of the great success stories of the past 20 years, and we regret not having purchased the shares years earlier. That being said, the recent technology sell-off offered an excellent entry price, and we took advantage of the opportunity.

The company has two major divisions: e-commerce and cloud services, and is the dominant player in both markets.

The e-commerce division accounts for about 80% of revenues, while the cloud division (AWS), with its higher margins, accounts for about 75% of the profits.

The company should continue to deliver strong revenue growth, but it is the opportunity for margin expansion that should result in significant earnings growth.

PET VALU - In our Canadian Dividend Growth portfolio, we added Pet Valu – Canada's largest specialty pet food and pet-related retailer with nearly 700 stores across the country.

Canadians adopted three million new pets during the pandemic and, as the market leader with two million loyalty members, we anticipate continued strong sales growth for many more years to come. This will be as a result of opening a number of new stores each year (management targets 30-45 annually) as well as broadening their offering to include services such as nutritional advice, grooming, self-service bays for dog washing, etc. Running a hybrid store structure (one third owned, two thirds franchised) means they can test and experiment new offerings within their owned stores while also growing in a relatively capital light / high return fashion through their franchisees. As a result, the business is very cash generative and we anticipate Pet Valu to deliver one of the highest compound dividend growth rates of our portfolio of holdings.

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High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

The quote at the beginning of this letter summarizes an important part of our investment approach. We own a portfolio of companies in many different industries, some more cyclical than others. However, the common theme is that all of them are financially sound and will be able to withstand whatever near-term challenges they will face.

With a humanitarian crisis and war in the Ukraine, inflation at its highest level since 1981, supply chain bottlenecks, ongoing COVID disruptions, and interest rates on the rise, there are many challenges facing investors. While the resolution of these issues is inherently unknowable, we remain focused on the quality of what we own, and will continue to act when great opportunities arise.

Sincerely,

Lorne Steinberg

Lorne Steinberg
President

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