LIBERTY
International Investment Management

MARKET UPDATE

Q4 | January 1 to December 31, 2022

IN THIS ISSUE:

The Markets

After considerable market over-speculation such as we saw in 2020 and 2021, there comes a period of recession caused by a need to restore harmony to economies and financial markets. This is a time of "cleansing" or "purging" to reset values. I believe that such an earnings recession may occur in 2023.

Over-investment in money-losing ideas such as cryptocurrency, profitless companies up 100% in value in one year, over-paying for investments by private equity companies and silly day trading in meme stocks led the market to peak in January, 2022.

Quarterly Equity Index Returns for 2022 (in native currency)

QUARTERLY RETURNS	Q1	Q2	Q3	Q4	2022
STOCK INDEXES	RETURN	RETURN	RETURN	RETURN	RETURN
TSX 300 Composite (Canada)	3.14%	-14.69%	-2.21%	5.10%	-8.66%
Stoxx600 Index (Europe)	-6.55%	-11.15%	-4.75%	9.55%	-12.90%
S&P 500 Index (United States)	-4.95%	-16.45%	-5.28%	7.23%	-19.45%
MSCI Global Index (World)	-5.53%	-16.77%	-6.58%	9.42%	-19.46%
Russell 2000 Index (U.S. Small-Caps)	-7.80%	-17.02%	-2.53%	5.80%	-21.55%
MXEF Index (Emerging Markets)	-7.32%	-12.45%	-11.80%	9.20%	-22.37%
Nasdaq Index (U.S. Technology)	-8.10%	-20.44%	-3.53%	-1.03%	-33.10%

Data Courtesy of Bloomberg L.P.

During the past year, there were two major bear market rallies in July and October / November based on the hopes by investors that we were going to get a "soft landing" and either no recession or a mild one.

U.S. Federal Reserve Chairman Jerome Powell squashed those hopes twice when he reiterated at Jackson Hole in August and in the last Fed meeting in December that fighting inflation was the top priority and that the Fed wouldn't stop raising rates until inflation, per their policy goal, returned to the 2% to 3% range. Rate expectations are now for the Fed Funds rate, currently at 4.32%, to rise over five per cent in 2023.

After Powell spoke in December, the markets fell between five and nine per cent and wiped out any hopes for a Santa Claus rally.

From the fixed income chart below, bonds rallied in December as the U.S. yield curve inverted further, with short-term rates rising while long-term bond yields fell slightly, causing bond prices to rise, especially among U.S. 30-year maturities.

We still believe that a bond rally should occur before stocks recover and why we're currently bond buyers and not stock purchasers.

We've already seen a drop in equity values based on higher interest rates, but we haven't yet seen the next leg down if profits weaken or disappear. A Price-Earnings multiple contraction based on weaker earnings could drive the markets another 10% to 30% lower. If so, this would be a duplication of the years 2000 to 2003 when the tech bubble burst, America was then attacked by terrorists on September 11, 2001, and then a two-year recession began.

Here's how U.S. markets performed during the 2000 to 2003 recession:

INDEX	2000 PERFORMANCE	2001 PERFORMANCE	2002 PERFORMANCE	2003 PERFORMANCE
S&P 500	-10.14%	-13.04%	-23.36%	+26.38%
Nasdaq	-39.29%	-21.05%	-31.52%	+50.01%

Data Courtesy of Bloomberg L.P.

And just for fun, here's how the U.S. markets performed during the 2008-09 Financial Crisis:

INDEX	2007 PERFORMANCE	2008 PERFORMANCE	2009 PERFORMANCE
S&P 500	+3.53%	-38.48%	+23.45%
Nasdaq	+9.81%	-40.54%	+43.88%

Data Courtesy of Bloomberg L.P.

Quarterly Fixed Income Returns for 2022 (in native currency)

QUARTERLY RETURNS	Q1	Q2	Q3	Q4	2022
BOND INDEXES	**RETURN**	**RETURN**	**RETURN**	**RETURN**	**RETURN**
Canadian 1-5 Year Bond Index (ZCS)	-4.04%	-2.52%	-0.99%	0.31%	-7.24%
Canadian 6-10 Year Bond Index (ZCM)	-8.12%	-5.44%	-0.90%	0.91%	-13.55%
Canadian 10-30+ Year Bond Index (ZLC)	-10.45%	-12.35%	0.75%	-0.27%	-22.32%
Canadian Real Return Bond Index (ZRR)	-10.31%	-9.85%	-1.16%	0.97%	-20.35%
U.S. 30+ YEAR BOND INDEX (VCLT)	-10.62%	-11.52%	-9.70%	3.37%	-28.47%
PREFERRED SHARE INDEXES					
Canadian Rate Reset Index (ZPR)	-3.41%	-8.91%	-6.18%	-3.26%	-21.76%
U.S. Perpetual Index (ZUP)	-7.46%	-5.09%	2.29%	-8.27%	-18.53%

Data Courtesy of Bloomberg L.P.

The market direction in 2023 will be dictated by how quickly:

- → The Federal Reserve successfully tackles inflation
- → The Federal Reserve stops raising rates
- → The depth of the recession

The difference between the two recessions is that the 2007-09 period was a shallow one. The U.S. Federal Reserve cut interest rates and began its Quantitative Easing program, essentially propping up the markets and planting the seeds that the Fed would bail out Wall Street at every turn. That's what caused the bull market of the last decade.

In 2022, however, the Fed pulled the security blanket out from under Wall Street by raising interest rates and invoking Quantitative Tightening (more on that below).

Here's what Liberty believes could occur in 2023 based on our tea leaves:

1. **We may see a flow of funds from growth stocks to value stocks due to higher interest rates**. Some Liberty names that offer yields above 4% and with lower-than-average Price-Earnings multiples are Jardine Matheson, Svenska Handelsbanken, TD Bank, TC Energy and Great West Lifeco.

2. **The U.S. dollar could begin a precipitous drop.** This would be helpful to emerging market economies. In 2022, the U.S. dollar rose 8%, while Emerging Market stock indexes fell 22%.

   That's because emerging market debt is mostly valued in US dollars. As the US dollar rose in 2022, emerging market currencies fell. Those countries allocated more of their tax income to U.S. debt repayment instead of capital projects such as the construction of hospitals and schools. The drop in emerging market currencies caused higher inflation in those countries as imported goods cost more.

   This may be a 2023 story or one that occurs in 2024, depending on when the U.S. Federal Reserve stops raising interest rates.

3. **If the U.S. dollar falls, U.S. stock markets could underperform other countries for the next five or ten years**. As shown below, they're currently more expensive than other bourses.

Index	Current P/E Multiple
Emerging Market	10.7
Canada – TSX	12.8
Stoxx600 - Europe	14.6
MSCI Index – Global	16.7
S&P 500 – US	18.5
Dow Jones Industrial - US	18.7
Nasdaq - US	43.4
Russell 2000 Small-Cap US	48.8

Data Courtesy of Bloomberg L.P.

4. **If the U.S. dollar drops, the only American benefactors would be U.S. multi-national firms.** Those companies earn revenues in currencies other than the U.S. dollar. Domestic U.S. firms would suffer more.

5. **If we fall into an earnings recession, the favoured sectors would be consumer staples, healthcare (medical devices & pharmaceuticals) and financials, mostly insurance companies.** Many of those stocks rose in 2022 while the rest of the market sectors lost money.

6. **Commodities may do better because most are valued in U.S. dollars.** If commodity prices rise, inflation will become "stickier" and harder to counter with interest rate increases.

However, investing in commodities is a highly risky strategy, as are the underlying equities. Investors need to take this with a grain of salt.

For example, small-cap oil stocks in Canada have betas greater than 1.75; many are closer to 2.00. This means that for every $1 the TSX 300 Composite goes up or down, the junior oils go up or down $1.75 to $2.00. When a stock trades at a 2.00 beta, it's time to short the stock, not buy it. As a result, risk-adjusted returns are currently not attractive.

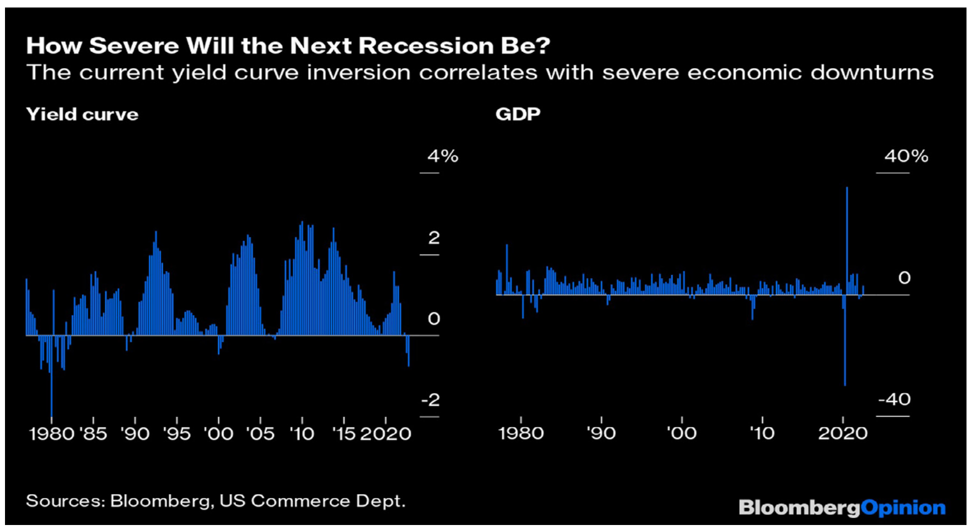
7. **These past three months, the bond market has been in rally mode. This could slow if the yield curve inverts further.** Short-duration bond portfolios could be hurt, especially since the U.S. Federal Reserve continues its "Quantitative Tightening", the opposite of "Quantitative Easing", the strategy it has followed since 2008's Financial Crisis.

   Quantitative Tightening is a process that lets proceeds from maturing bonds roll off the Federal Reserve's balance sheet each month rather than reinvesting them. A capped total of $95 billion is allowed to run off each month, resulting in a $332 billion decline in the Fed's balance sheet since early June. It now stands at $8.63 trillion.

   This, in turn, could hurt the 2-year bond market, causing liquidity to disappear and send yields up more than the Fed would like. This would steepen the yield curve and make corporate borrowing costs difficult, making the recession run longer and deeper than many equity investors expect.

   In a December 6, 2022 *Bloomberg* article by Aaron Brown, "Although inverted yield curves aren't nearly as scary as ancient zombie illnesses, they instill plenty of fear in markets. The inversion of the 2-to-10-year Treasury spread has deepened to levels not seen since the Iran hostage crisis — years before the yield curve was even considered a recession indicator."

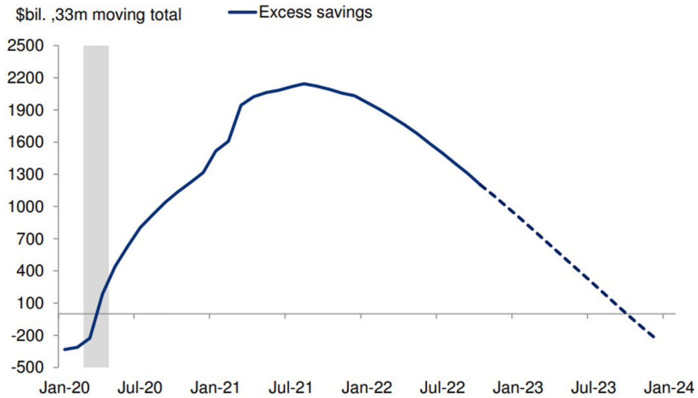
   "An inversion this deep is more abnormal than that weird-looking mole on your foot you've been meaning to get checked out. It has economists and investors wondering whether the next economic downturn will be longer and deeper than any of the previous 40 years."



8. **Consumer spending may dry up, creating a deeper recession than anticipated.** Two-thirds of U.S. Gross Domestic Product (GDP) growth comes from consumer spending. With higher interest rates, most consumers must set aside more of their take-home pay and allocate it to debt repayment.

   This means they have less money to buy "stuff". And if one of those household incomes is lost to job layoffs, the situation could deteriorate quickly, especially given that household savings have fallen – see the chart below.

Figure 1: Excess savings still elevated but will be depleted by Q3 2023



Source : BEA & Deutsche Bank

Other Concerns

- Paychex (PAYX US), a payroll processing company for firms of 50 employees or less, announced in its recent earnings report that they expect lower future revenue growth from 9% to 7%. Since two-thirds of U.S. businesses are small in nature, this is a sign that these corporations are cutting back spending or reducing their workforce.
- Eighty percent of stocks in both the Russell 2000 Small-Cap Index and the Nasdaq Composite have either no profits or are companies with poor financials. Both indexes, however, finished the year down only 21.6% and 33.1%, respectively.

Because they are the most sensitive indexes to rising interest rates, they should have fallen closer to 30% to 50%, similar to past recessions.

INVESTING FOR MILLENIALS: FOUR COMMON MISTAKES OF DO-IT- YOURSELF INVESTORS

By Alice Park

Shortly after the Covid lockdown began, investing videos on YouTube abounded. Every Tom, Dick and Harry doled out investment advice and tips, fueling the naïve general public to recklessly jump into the stock market for fear of missing out (FOMO).

These first-time traders, many in their 20s and 30s, blindly followed the stock picks on the news and social media, believing it to be a shortcut to great wealth. Some of them saw big gains until interest rates rose and things got ugly.

In the first half of 2022, this investing frenzy died as fast as it began, nursing 30% to 70% losses. It was evident that these self-directed investors were in over their heads.

Here are five common mistakes that Do-it-Yourself (DIY) stock investors make. Avoid these mistakes and you increase your odds for success in the stock market.

Hindsight bias: Sober up from past glories

Also known as “confirmation bias”, this behavior is very common in our investment decision process. Our view of how the market will change in the future is greatly influenced by the information we choose to focus on and the choices we made in the past.

Because of this bias, investors tend to stick with their original investment decisions long after circumstances have changed.

During the last couple of years, investments in cryptocurrency and mega-cap tech stocks reached unprecedented market price highs as investors bought them with little regard to the true valuations.

Investors failed to see the market shift as the U.S. Federal Reserve attempted to quell inflation with interest rate hikes and those “hot investments” were the first to be crushed.

Confirmation bias clouds judgments about turning points in the market. Investors should periodically review their investment decisions dispassionately and recognize the types of information they consume to avoid these biased behavioral constraints.

Learn to avoid putting all your eggs in one basket through diversification

This is a widespread investing mantra that investors have heard of but find hard to implement. Many DIY investors try and buy different names but fail to reduce portfolio risk. This is because they did not grasp the full meaning of “don’t put your eggs all in one basket”.

A study from UBC’s Sauder School of Business showed that investors with low financial literacy find a portfolio with stocks within the same or similar industries (a positively correlated portfolio) to be “more familiar, simple and more predictable” and thus “erroneously perceive it as less risky”.

It is common for companies in the same industry to be influenced by similar market variables, causing their prices to move in tandem. Correlation risk can be better managed by diversifying your portfolio by size of company (large-caps, mid-caps and small-caps), by owning stocks in different industries and in different countries.

Avoid Blind Faith in Concept Stocks

Investors are drawn to concept stocks like moths to the flame as they are perceived to have the ability to double or triple their value in a short timeframe. Unfortunately, concept stocks are just that: An idea that a company has invented a new mousetrap and, therefore, should enjoy future riches above all others. This couldn’t be further from the truth because companies grow based on a solid business model, not a “concept”.

Recent concept stocks included names from the cannabis and cryptocurrency industries, along with firms that were deemed to be “disruptive” (such as Cathie Wood’s ARK Innovation Fund – down 67% in 2022) or were a “hot commodity” during the Covid lockdown period like Zoom Video Communications.

Historically, many concept stocks underperform significantly. Almost 80% of all concept stocks go bankrupt, leaving investors with capital losses and stock certificates that sit in their portfolio forever - a reminder of a foolish endeavour.

Instead, investors should focus on companies that exhibit tangible growth in the form of rising free cash flows. Also, the portfolio risk should be managed by setting rules such as taking profits when the stock doubles so that you get your original investment back. This lets you make money and preserve capital over time.

Avoid Buying at the Highs

A final error comes from misunderstanding “a fair price”. All things considered, does the price I pay for this name justify what it is worth?

This is something most investors often overlook and ignore. At the beginning of the year, the share prices of Amazon, Meta and Netflix traded at an average Price / Earnings multiple of 38.

Since then, the prices of these mega cap stocks have plummeted. In 2022, Nvidia and Amazon lost 50% and both Meta Platforms (the parent company of Facebook) and Tesla shed a whopping 65% of their value.

If you buy a name with decent fundamentals but is overpriced, future price growth may be limited. When the market corrects, these types of companies will be the first to crash. And once down, it may take a long time for the company to return to the original purchase price.

For example, on December 31, 1999, Microsoft traded at $58.38 a share, reached a low of $15.15 on March 9, 2009 and didn't return to the $58 level until August 11, 2016, sixteen and a half years later. Do you have 16 years to wait to make back your money?

It's imperative, therefore, that investors always ask themselves these four things before buying:

- → Is it a good price?
- → Why did I buy it?
- → How does it fit in the portfolio?
- → What are the risks?

To avoid being a money-losing investor, heed the above mistakes and give yourself a chance to actually make money.

FUN WITH MATH: THE INVESTMENT OPPORTUNITY IN RATE-RESET PREFERRED SHARES

By David Driscoll

> "Investors should understand that for preferred shares, it's all about the income, nothing more."

Are you interested in making a 9% pre-tax yield on an investment? If so, that's the current opportunity in Canadian rate-reset preferred shares.

In 2022, the Canadian Rate-Reset Preferred Share ETF dropped 21.7%, a reason for many investors to avoid putting money into these types of investments. However, rather than avoid these instruments, it may be a reason to buy.

Preferred shares came to be as a company alternative to issue capital when the market wasn't receptive for issuing bonds (interest rates were too high) or equity (the share price was too low). The sweetener with preferred shares is that they pay dividends, not interest, and are attractive for income-seeking investors who want greater income than stock dividends currently pay.

The added security owning these instruments is that they are mostly issued by the banks, insurance companies, pipeline firms and utilities. Many of these companies carry investment grade credit ratings.

Types of Preferred Shares

There are two types of preferred shares: Perpetual and Rate-Reset.

Perpetual preferred shares are issued with a stated coupon that pays that rate in perpetuity or as long as the company stays in business. One example would be the Brookfield Corp. Series 17 preferred share. It pays an annual coupon of 4.75% every year, forever, or in perpetuity. Perpetual preferred shares do well when interest rates fall or stay steady for a period of time.

Rate-Reset preferred shares begin with a stated coupon for five years in length and then reset at the Government of Canada 5-year interest rate plus a premium. They do well when rates rise as the reset amount should be higher than the original coupon – as we're seeing today.

Recent changes for preferred shares

What's changed in the last few years is that financial institutions have eschewed the retail preferred share market in favour of Limited Recourse Capital Notes (LRCN).

From the perspective of a bank, issuing preferred shares was attractive because they were attributed to the bank's Tier-One Capital and were a cheaper form of raising capital than issuing common stock. From the perspective of an investor, buying preferred shares was attractive because they provided a predictable income stream with attractive yields that were also tax efficient.

There are two reasons that LRCNs have changed the preferred share landscape:

- They let the banks satisfy their Tier-One Capital requirements with regulators.
- By shifting from issuing preferred shares to LRCNs, bank issuers improve their net income via the tax deductibility of LRCN interest payments and, in effect, claim the tax benefit that had typically gone to preferred share investors.

What's happening today

As institutional money has moved toward LRCN purchases, the preferred share market has been squeezed. In 2022, liquidity dried up and preferred share prices fell because they mimicked the stock market (they are quasi-equity) and because of the sale by retail investors of the aforementioned ETF. There were more sellers than buyers and no liquidity to support prices.

Instead of avoiding investing in this category, there is an opportunity to make money.

Here are some rate-reset preferred shares that reset in 2023:

Company	Coupon	Annual Dividend	Price	Yield	Gross-Up Yield	5-year GOC	Reset Premium	Reset Coupon	Reset Date
Algonquin Power	5.162%	$ 1.29	$ 18.50	6.98%	9.77%	3.26%	2.94%	6.20%	Dec. 21, 2023
Capital Power	5.453%	$ 1.36	$ 21.40	6.37%	8.92%	3.26%	3.23%	6.49%	Dec. 31, 2023
Fortis Inc.	4.393%	$ 1.10	$ 17.30	6.35%	8.89%	3.26%	2.13%	5.39%	Sep. 1, 2023
Emera Inc.	4.721%	$ 1.18	$ 18.75	6.29%	8.81%	3.26%	2.65%	5.91%	Aug. 15, 2023
Intact Financial	4.900%	$ 1.23	$ 19.71	6.22%	8.70%	3.26%	2.55%	5.81%	Jun. 30, 2023
Manulife Financial	4.700%	$ 1.18	$ 18.95	6.20%	8.68%	3.26%	2.55%	5.81%	Jun. 19, 2023

Data Courtesy of Bloomberg L.P.

As you can see, the gross-up yield because of the dividend (40% in Ontario), ranges from 9.77% (Algonquin Power) to 8.68% (Manulife). This compares to the 5-year Government of Canada (GOC) bond rate of 3.26%.

In addition to the higher yield, investors also benefit from the potential capital gain. If any of the companies don't want to pay the higher reset coupon, they can "call" or buy back the preferred share at its $25 par value.

Therefore, three things can happen and two of them are good:

- → An investor receives a higher yield (a gross-up yield north of 8%) that would last for the next five years and is greater than the current inflation rate. This means faster income into the portfolio than stocks or bonds, money that can be re-invested to support faster long-term compounding.
- → Compared to today's $17.30 price, if Fortis calls its preferred share at its $25 par value, there's an inherent capital gain of 45%.
- → If interest rates fall, the preferred share price would drop as the expected reset rate would be lower.

For the first two reasons above, this is a buying opportunity where the rewards outweigh the risks. The 21% price drop this year is irrelevant to us as it's not lost unless it's sold. Instead, investors should understand that for preferred shares, it's all about the income, nothing more.

UNDERSTANDING BONDS

By David Driscoll

Many investors find that understanding bonds is a difficult, if not impossible task. In fact, it's quite the opposite. It's the same as owning a GIC except that bonds trade over-the-counter and their prices vary based on the movement of interest rates over the life of the bond.

Simply put, a bond is issued by a government agency or a corporation to raise capital for some kind of project. For the government, it could involve building a highway; for a corporation, it could be to build a factory.

To receive that capital from investors, the company enters into a contract to pay a stipulated amount of interest each year to the investor until the bond matures. Bonds can range in maturity from three years to 100 years, depending on the use of the funds.

The bond shown on the right is an old Government of Canada Savings bond, Series 16. On the left is the face value of the bond ($50). At right are the annual coupons that the government paid to the investor from 1962 to 1971. Since there are 10 coupons, the duration of the bond is 10 years.

The annual coupon paid an original $2.13 in the first year, $2.25 for the next 6 years, then $2.50 for the final 3 years. The total income over the life of the bond was $23.13.

Each November 1st, the investor would clip the coupon for that year and deposit the funds into their bank account. When all the coupons were clipped, the bond would mature. All that's left would be the $50 face value and it would be cashed in at the bank and deposited into the investor's bank account.

Government of Canada Savings Bond Series 16

Courtesy of The Bank of Canada

This is the same for all bonds, except the payments are semi-annual. As the coupons are paid, the bond value migrates toward the face value of the bond. Within two years of maturity, the price of the bond is close to its $100 par value because that's essentially all that's left to be paid.

If there are more than 2 years to maturity, the bond price will fluctuate on the movement in interest rates. This volatility is known as duration.

How duration affects the bond price

In the chart below, we see the impact of a bond's price based on its duration.

Chart courtesy of Blackrock

If a bond has a duration of five years and interest rates increase by 1%, the bond's price will decline by approximately 5%. Conversely, if interest rates fall by 1%, the bond's price will increase by approximately 5%.

Understanding duration is only important for those who plan to sell their bonds prior to maturity. At Liberty, we hold our bonds to maturity so duration is irrelevant. You still get paid bond interest each year and, at maturity, you get paid back the face value of the bond, just like the Canada Savings bond shown above.

This year, short-term bonds (maturing in 1-5 years) were down 7% in price, medium-term bonds (5-10 years) fell 13% and long-term bonds (10-30 years) dropped 22%.

While price movement affects client performance in any one year, those numbers are irrelevant. Again, we hold our bonds to maturity so changes in price don't mean anything.

Yield-to-Maturity

In the Liberty quarterly statements, the far-right column shows a bond's yield-to-maturity (YTM).

The yield to maturity is the percentage rate of return for a bond assuming that the investor holds the asset until its maturity date. It is the sum of all of its remaining coupon payments. A bond's yield to maturity rises or falls depending on its market value and how many payments remain.

For example, a 4% coupon bond could have a yield-to-maturity of 5% or greater because the price trades below $100 and all the coupons paid during the duration of the bond can be re-invested at current interest rates. This is another way to understand time and compounding.

If interest rates rise during the duration of the bond, those coupons can be re-invested at higher rates. Today, we see yields-to-maturity in the 5% to 7% range, making bonds attractive. If we go into recession and inflation falls, the real return on bonds, after inflation, will be positive. And if the central banks reduce interest rates during a recession to kickstart the economy, bond prices will rise.

This is why we're more bullish on bonds than stocks. Similar to the rate-reset preferred shares, four things can happen with bonds and three of them are good:

- → Earning 5% to 7% in yield-to-maturity provides future real returns (yield minus inflation) that are positive.
- → If the economy falls into recession, demand should fall, thus bringing inflation down,

making the real return even more attractive.

- If the central banks start cutting rates because of a recession, bond prices will rise.
- Only continued inflation would have negative effects from owning bonds.

Over the long-term, owning bonds provides capital protection during most economic downturns and a reasonable return. Bonds are half as risky as stocks because they have a stated maturity date when investors get all their capital back. Stock prices can trade at any level for any specified time period.

It's important to ignore bond price movements because we don't trade them and, therefore, don't suffer losses. You only lose money if you sell.

CLIENT QUESTIONS

Why do growth stocks suffer when interest rates rise?

Interest rate increases can have a profound effect on stock valuations because most professional investors use the present value of future cash flows over a 10-20-year time horizon to determine a range of prices where the stock should trade.

Without going into the calculation criteria, valuations are based on the present value of a premium to the risk-free rate, often 30-day Treasury Bills. Usually, large-cap, blue chip stocks which are mature companies, have a discount rate of 2.50% over the risk-free rate. Small-cap stocks, because of the higher risk, may have a discount rate of 5.00%.

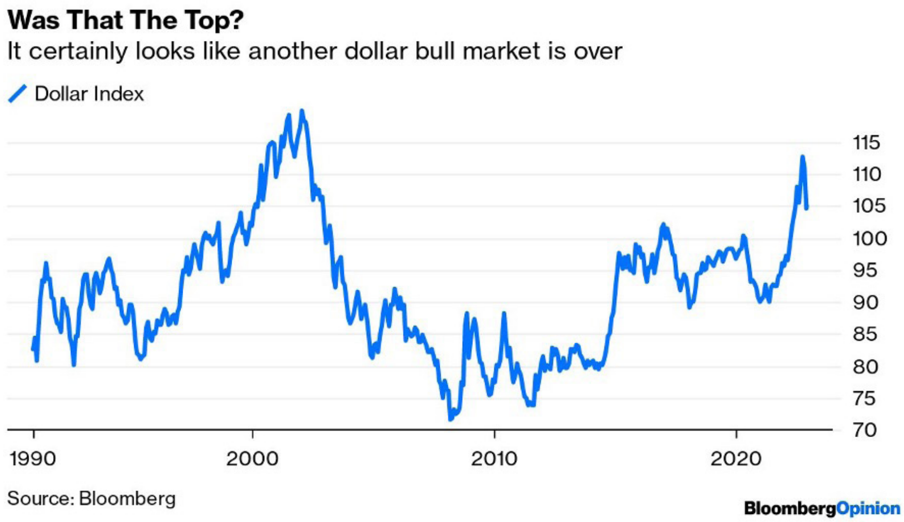
In 2020, the risk-free rate was zero, meaning the discount rate ranged between 2.50% and 5.00%. When calculating the present value, the lower discount rate provided a larger cash flow number per share and, therefore, a higher share value. That's why growth stocks such as technology names saw their share prices skyrocket.

Today, the risk-free rate is now 4.50% in the United States, meaning the discounted rate to calculate the present value of stocks is higher, ranging from 7% for large-caps to 9.50% for small-caps. This creates a cash flow number that is smaller, thus reducing the perceived stock value.

As a result, growth stocks during 2022 plummeted in price as their expected cash flows fell and resulted in lower share price valuations. That's why investors should never forget the old axiom, "Don't Fight The Fed." When the U.S. Federal Reserve raises interest rates, stock values drop. When rates are cut, cash flow expectations rise and the markets often go higher.

What's your outlook on the U.S. dollar?

In a *Bloomberg* article by Isabelle Lee on December 8, 2022, she stated that, "The dollar bull market appears to be over as investors stop being quite so freaked out about everything." During market upheavals, investors tend to hide in the major currencies like the U.S. Dollar, the Japanese Yen, the Euro and the Swiss Franc where there's liquidity and eschew the minor currencies, like the Canadian dollar, which are more illiquid.



U.S. Dollar performance against a basket of other global currencies

PRICE MOVEMENT IN 2022	VERSUS THE U.S. DOLLAR
Japanese Yen	-12.2%
British Pound	-10.7%
Indian Rupee	-9.9%
Chinese Yuan	-8.1%
South Korean Won	-5.7%
New Zealand Dollar	-7.0%
Canadian Dollar	-6.7%
Australian Dollar	-6.2%
Euro	-5.8%
Swiss Franc	-1.3%

Data Courtesy of Bloomberg L.P.

At right is how some global currencies fared against the U.S. dollar in 2022.

Note that the biggest drops were mostly from emerging market countries where a rise in U.S. interest rates and better U.S. Gross Domestic Product (GDP) helped strengthen the U.S. dollar. With higher interest rates, foreign investors buy U.S. bonds for the higher yield and have to buy U.S. dollars to pay for them, sending the U.S. dollar higher and the domestic currency lower.

When the U.S. Federal Reserve stops raising interest rates, the U.S. dollar should begin to fall, if not sooner. During this past November, on the expectation of slower rate increases, the U.S. dollar fell 4.91% against a basket of those currencies noted above. Naturally, the emerging market equity index (MXEF) rose 11.66% and provided the best stock market return of all the major indexes.

Based on these facts, what should an investor do?

Instead of worrying about the movement of the U.S. dollar on existing portfolio holdings, I want to use cash to go hunting for investments where the currency is weak.

For example, when the New Zealand dollar traded near a 52-week low around 79 cents to the Canadian dollar, we purchased a New Zealand Local Government Fund Agency bond (rated AAA) with a 4.50% coupon maturing April 15, 2027 that traded at $97.624 for a 5.16% yield.

At the time, the New Zealand dollar traded at $0.79 to the Canadian dollar. Currently, the currency trades at $0.86, up 8.8%. The currency rose because the New Zealand central bank raised rates recently by another 0.75%.

If the currency holds at these levels until maturity, we stand to make the small capital gain by purchasing the bond at a discount and a potentially bigger capital gain from the currency increase. If the currency goes the opposite way, we'll just roll over the maturing proceeds and buy another Kiwi bond.

We always look to take advantage of the short-term weakness of a currency for potential long-term profits.

With all the geopolitical turmoil in Europe, should we reduce our exposure there?

I consider this backward thinking and a common mistake of Do-It-Yourself investors as they often let their emotions get the best of them. Instead of looking for opportunity, they're more inclined to react to headlines and sell when it's actually time to buy.

In our last newsletter, we explained why it's more important to pay attention to where the revenue streams come from, not where the company is domiciled.

Based on the Price-Earnings table shown above, Europe is the third-cheapest place to invest but with greater earnings growth potential in 2023 than other indexes. This fact was noticed by professional investors. During October and November, the Euro600 stock index was up 14.4%, well ahead of the other indexes (the next highest was the TSX 300 Composite Index – up 8.8%). Instead of selling European stocks, investors should be buying more of them.

We will invest our client dollars in a diversified manner globally. Among stocks, it's all about investing in companies that generate consistently growing free cash flow, no matter where that firm has its headquarters.

My daughter and her husband have very different incomes. Would you suggest a Spousal RRSP to level their income at retirement?

A Spousal RRSP lets you "split" your retirement income and pay less tax as a couple over your lifetimes. If one spouse earns income at the highest taxable rate and the other spouse is in the middle-income tax bracket, there's an opportunity to minimize RRIF income tax in retirement through the use of a spousal RRSP.

How a Spousal RRSP works

Here's an example: A wife works her whole life and earns a great salary. The husband is a stay-at-home dad. When the wife turns 72 and draws down her RRIF, say $100,000, she is taxed on that money at the highest income bracket rate.

With a Spousal RRSP, the wife makes annual contributions to her husband's account. When they turn 72 the RRIF withdrawal for each spouse is $50,000. It's the same total (2 x $50,000) as the paragraph above but because each spouse is in a lower tax bracket, they pay less total tax than in the first case.

Pros and cons of a Spousal RRSP

The biggest advantage of having a Spousal RRSP is to reduce family taxes owing in retirement. Also, if the larger income earner is over 72 and still working, they may continue to contribute to a Spousal RRSP if their spouse is younger than 72.

A disadvantage of a Spousal RRSP is the three-year attribution rule. Spousal contributions cannot be withdrawn from the Spousal RRSP for three years. Otherwise, the income is attributed back to the spouse that made the contribution and taxed to them.

In divorce situations, spousal and regular RRSPs are generally considered family assets, and amounts accumulated while together are often divided. Whether married or living common-law, you can transfer RRSPs between former spouses without tax, if you have proper documentation.

You need to take into account pension income before deciding to use a Spousal RRSP. Pension income is taxed as ordinary income much like RRSP/RRIF withdrawals. If either partner has a defined benefit pension, this will need to be considered before using a Spousal RRSP.

What are your thoughts on reverse mortgages?

We're not fans of reverse mortgages. They are anathema to the way to create the proper financial plan for individuals or families. I consider them a "last-resort' product used by people who didn't save appropriately during their working years to provide enough capital to live on during retirement.

During our working years, the first focus should be on debt-repayment exclusively to reduce loans or mortgages quickly. Once the debt is paid off, investors can then focus on saving for their retirement through the use of retirement savings plans (RRSPs) and Tax-Free Savings Accounts (TFSAs) with any residue directed toward non-registered (taxable) savings accounts.

If you build a portfolio that can cover your expenses in retirement, a reverse-mortgage should never come into consideration. That's why I spent most of my time in 2022 with the second-generation of clients to teach them how to save the right way during their working years.

What is a reverse mortgage?

A reverse mortgage is a loan that allows senior homeowners (55+) to borrow up to 55% of the value of their home. A reverse mortgage is secured by the equity in your home and, unlike a home equity line of credit (HELOC), it does not require any income verification.

Because they are secured by your home, reverse mortgages are considered mortgage products, as opposed to other lines of credit. If you take out a reverse mortgage, you can use the money to pay for anything you want, including day-to-day spending, home repairs, bills, or travel.

You won't have to pay back the loan or interest until you either sell your home or if you die. Of course, you or your family will rely on the value of your home to pay back the reverse mortgage, which will often mean that you won't be able to leave your house as part of your inheritance.

However, there are pros and cons to getting a reverse mortgage. Here's everything you need to know about reverse mortgages in Canada.

The pros of a reverse mortgage

- → You don't have to make any regular mortgage payments
- → You don't have to prove your income in order to qualify
- → The money you borrow is tax-free and does not affect your Old-Age Security or Guaranteed Income Supplement
- → You can decide how you want to receive the money – you can take it as a lump sum, a regular payment, or a combination of the two
- → The money can be spent on whatever you want
- → You get to maintain ownership of your property
- → You don't have to pay back the loan or interest costs until you either sell the home or until you die

What are the cons of a reverse mortgage?

- → Reverse mortgages can significantly increase the amount of debt you carry, which can result in you having less to leave your family or other beneficiaries
- → Reverse mortgage interest rates are much higher than typical mortgage loans
- → As you borrow more against the equity in the home, interest accumulates faster
- → Additional setup costs (home appraisal fees, application fees, closing costs) add up and are deducted from the amount you'll receive

- The only way to get out of a reverse mortgage is if you sell your home or die
- You'll be subject to a penalty if you sell the home or pass away within three years of taking out the reverse mortgage
- If you die, the amount you borrowed plus interest must be repaid within a limited period of time

Based on the above, I view reverse mortgages as "products" that benefit the lenders, not the homeowners or their families. It essentially preys on people who didn't plan correctly during their working years. That's why it's important for people to do financial planning in their 20s to prepare for the future and avoid institutions that don't have your best interests at heart.

If you have any questions, let us know.

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