Update Edition

THE INCOME INVESTOR

Volume 20, Number 17 **Issue #2217** **September 15, 2022**

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Next issue:
September 29

INFLATION PROTECTION

By Gordon Pape, Publisher and Editor

The Bank of Canada did what everyone expected last week and raised the overnight rate by 0.75%. It now sits at 3.25%, up three full percentage points since the start of the year. That's the highest level since early 2008.

And it's not over yet. In the statement accompanying the announcement, the Bank said the Governing Council "still judges that the policy interest rate will need to rise further". How much further is anyone's guess.

What's clear is that the Governors are not impressed by the slight easing of inflation in July because it was narrowly based on gasoline prices.

"Inflation excluding gasoline increased and data indicate a further broadening of price pressures, particularly in services," the statement said. "The Bank's core measures of inflation continued to move up, ranging from 5% to 5.5% in July. Surveys suggest that short-term inflation expectations remain high. The longer this continues, the greater the risk that elevated inflation becomes entrenched."

That's as clear an indication as we can expect that the target rate will move even higher at the next announcement on Oct. 26.

The announcement, and the clear indication of more hikes to come, was bad news for bonds, which are already suffering their worst bear market since the early 1980s. As of Sept. 9, the FTSE Canadian Universe Bond Index was down 11.55% year to date. Government bonds fared even worse, losing 12.1%.

It's also bad news for the housing market, which has seen sales and prices fall since the Bank began raising rates earlier this year. Some economists are suggesting house values could drop 20% before this cycle is over.

Among the few beneficiaries are conservative investors who gravitate to low risk guaranteed investment certificates (GICs). Their rates have been slowly moving higher, but it's a case of two steps forward, one step back. The expectation was that GIC yields would rise after last week's move by the central bank. They didn't, at least not across the board. Some five-year rates actually declined.

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At the time of writing, the best rate on a one-year GIC was 4.5% from EQ Bank, according to ratehub.ca. Last week, there were some 5% rates available on five-year terms. As I write, the best I can find is 4.75%. No wonder people are confused.

If you want to look at other options, there are a few fixed income ETFs that are bucking the interest rate trend. One is the iShares 0-5 Years TIPS Bond Index ETF (TSX: XSTP). This is a new ETF that invests in short-term US Government inflation protected notes. They pay a low rate of return, but both the face value and the interest increase as inflation rises. The fund is ahead 2% so far in 2022 (to Sept. 8). That's not a lot but it's much better than the double-digit losses most bond funds are recording.

This ETF is included in the RRSP Portfolio of our companion Internet Wealth Builder newsletter. We've added it as a low-risk option to our Income Investor recommended list. See the Top Picks section for details.

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TOP PICK

Here is our Top Pick for this month. Prices are as of the close of trading on Sept. 9 unless otherwise indicated.

iShares 0-5 Years TIPS Bond Index ETF (TSX: XSTP)

Type: Exchange-traded fund (ETF)
Current price: $39.44
Entry level: Current price
Annual payout: $2.31 (trailing 12 months)
Yield: 5.9%
Risk Rating: Lower risk
Recommended by: Gordon Pape
Website: www.ishares.ca

The security: This is a short-term ETF that invests in a portfolio of inflation protected bonds issued by the United States Treasury, which are known as TIPS.

Performance: As of Aug. 31, the fund was showing a one-year rate of return of 3.5%.

Why we like it: Safety. This is about as good as it gets if you're looking for a bond fund in these inflationary times. You would get a better return from a GIC, but that involves locking in your money for a fixed period. This ETF offers flexibility – you can sell any time.

Key metrics: The fund has only been in existence for slightly over a year (it was launched on July 6, 2021). Assets under management are about $46 million. The management expense ratio is 0.16%.

Risks: Nothing is risk-free, but this comes close. The bonds it holds are issued by the US Treasury. Nothing is safer than that. The securities in the portfolio mature within five years. The effective duration is 2.56 years.

Distribution policy: The fund makes monthly distributions, which can vary significantly. For example, the July payment was $0.408 per unit but that dropped to $0.164 in August. If you need steady income, this isn't a good choice.

Tax implications: Most of the distributions will be in the form of foreign income, which are fully taxable unless the units are held in a registered plan.

Who it's for: This fund is best suited for conservative investors who want some short-term inflation protection at minimal risk.

How to buy: The fund trades on the TSX but volume is very light – an average of only 1,285 units per day. So, place a price limit on your offer and be patient.

Summing up: This is one of the few bond funds that is in the black this year.

Action now: XSTP is a Buy for conservative investors.

GORDON PAPE'S UPDATES

Note: Prices are as of the close on Sept. 9.

BMO Group (TSX, NYSE: BMO)

Type: Common stock
Current price: C$127.44, US$97.84
Originally recommended: Sept. 24/15 at C$71.39, US$53.87
Annual payout: $5.56
Yield: 4.4%
Risk: Low
Website: www.bmo.com

Comments: Periods of rising interest rates are normally good news for bank stocks because it increases the spread between the amount they charge on loans and the interest rate paid to depositors (called the net interest margin or NIM).

This time it's different. Although the NIM is improving, investors are worried about the threat of a recession and the impact that would have on loan losses, new loan generations, investment portfolios, and business in general.

As a result, bank stocks have been selling off all summer. BMO is down 13.4% from $147.11 at the time of our last review in March, although it's still up 78% since being recommended. It's not just Bank of Montreal stock that's taking a beating. The S&P/TSX Capped Financials Index was down 9.2% year to date as of Sept. 9.

BMO's third quarter financial results (to July 31) clearly indicated the problem areas. Predictably, NIM was up five basis points from the previous quarter, to 1.76%. But adjusted net income was $2.2 billion ($3.09 per share), down from $2.3 billion ($3.44 a share) in the previous fiscal year.

One reason for the decline in earnings was a swing of $206 million in credit loss provisions. A year ago, BMO reported a $70 million gain from a recovery of previous loan loss provisions. This year, the company booked $136 million against potential future losses, which amounts to 10 basis points as a percentage of average net loans and acceptances.

Another contributor to the downside was BMO Capital Markets, which reported adjusted net income of $266 million, compared with $559 million last year. Global Markets and Investment and Corporate Banking had reduced revenue.

Adjusted return on equity was 13.8%, down from 17.6% last year. Common Equity Tier 1 Ratio was 15.8%, compared with 13.4% in the same period of 2021.

The decline in the share price has created one advantage for new investors: the yield on the shares has jumped to 4.4%, which is very attractive for a bank stock.

Action now: Buy. The stock price is close to its 52-week low, and the p/e ratio is only 7.64. There may be a little more downside, but the shares appear to be good value at the current price.

Innergex Renewable Energy (TSX: INE, OTC: INGXF)

Type: Common stock
Current price: C$19.77, US$15.20
Originally recommended: July 14/16 at C$14.59, US$11.34
Annual payout: $0.72
Yield: 3.6%
Risk: Moderate
Website: www.innergex.com

Comments: After a rebound at the start of the year, the green energy sector has stalled. The share price of Innergex is virtually flat from my last review in April.

Mixed second quarter results contributed to investors' wariness. Production and revenues were up over last year but the company reported a loss of $24.6 million (-$0.13 a share) compared to a profit of $50.2 million ($0.23 a share) in the same period last year.

The loss was mainly due to a $45.2 million decrease in recovery of income tax, an unfavourable $25.6 million unrealized change in the fair value of financial instruments, and an unfavourable change in foreign exchange.

The company also noted a 40% increase in operating, general, administrative, and prospective projects expenses to $66.9 million as contributing to the loss. Expenses were pushed up by higher maintenance costs at some of the hydro facilities in British Columbia, the commissioning of the Griffin Trail wind facility and the Hillcrest solar facility, and the cost of several acquisitions.

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Other numbers were somewhat encouraging. Production was 2.9 million MWh, up 19% from the year-ago period. However, that number was below the company's long-term average. Revenue was $220 million, ahead 29% from a year ago. Adjusted EBITDA was $153 million, up from $122.7 million. Free cash flow was $149 million, compared $76.7 million in last year's second quarter.

Subsequent to the release of the quarterly report, the company announced the signing of a 30-year, 320 MW power purchase agreement with PacifiCorp, a Berkshire Hathaway subsidiary, for the electricity to be produced by the Boswell Springs wind project located in eastern Wyoming. The commercial operation date is scheduled during the fourth quarter of 2024.

Action now: Hold.

The North West Company Inc. (TSX: NWC, OTC: NNWWF)

Type: Common stock
Current price: C$33.60, US$25.73
Originally recommended: April 25/07 at C$18.83, US$16.65
Annual payout: $1.52
Yield: 4.5%
Risk: Moderate
Website: www.northwest.ca

Comments: This is a descendant of the original North West Company of Canada's fur-trading days. The main focus is on operating general stores in the Canadian north and Alaska, but the company also has operations in the South Pacific and the Caribbean as well as in some urban areas. It has a total of 244 stores. The stock touched a five-year high of $40.08 in April but has been in a slump since. It's trading about $3 above its 52-week low.

On Sept. 7, the company reported second quarter results (to July 31). Consolidated sales increased 2.4% to $578.9 million, led by sales gains in International Operations and the impact of foreign exchange. An increase in other sales in Canadian Operations, which includes airline revenue, financial services, fuel and pharmacy, and the impact of new stores were also factors.

Excluding the foreign exchange impact, consolidated sales increased 0.4%, with food sales increasing 0.7% and general merchandise sales decreasing 14.9% compared to last year. The company said the impact of higher merchandise and freight cost inflation has resulted in changes in the product sales blend, as consumers allocated more of their spending to food and reduced purchases of general merchandise.

On a same store basis, sales decreased 4.1% compared to the second quarter last year, with both food and general merchandise same store sales decreasing 1.3% and 18.8% respectively. The company said the decrease in same store sales was primarily due to the impact of COVID-19-related factors. Although same store sales this year have decreased, they were up 16.3% compared to pre-COVID levels in 2019, with food same store sales up 16.2% and general merchandise same store sales up 17.1%.

Net earnings decreased to $32.4 million ($0.64 a share) compared to $42.4 million ($0.86 per share) last year.

Despite the decline in earnings, the company increased its quarterly dividend by a penny a share, to $0.38 ($1.52 a year). The increase bumps the yield to 4.5%.

Action now: Hold.

YOUR QUESTIONS

Interest rates and the BoC

Q - When the Bank of Canada increases their target rate, can we expect that, subsequent to the announcement, there would be a comparable increase to GIC rates? Or are there other factors involved in determining GIC rates? It seems to me that when the last increase of 75 basis points was announced, there wasn't a comparable increase to GIC rates. I ask as I am on the cusp of retiring and want to ladder some GIC investments out over five years and of course am looking for what might eventually be the top end of GIC rates. - Harry S.

A - There is a correlation between the Bank of Canada rates and market interest rates, such as prime, mortgage rates, and GICs. But it's not a direct relationship by any means. GIC rates didn't go up 75 bp when the Bank moved; in fact some surprisingly went down. Financial institutions make their own decisions as to how much they'll pay depositors or charge for loans. As for how high rates will go, everything depends on how successful the central banks are in taming inflation. They don't want a repeat of the 1970s, so they'll keep raising aggressively until they see positive results. The extent to which GIC issuers will follow is the big question mark. - G.P.