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# WEALTH *builder*

## PREDICTIONS AND PROBABILITIES

***By Gordon Pape, Editor and Publisher***

By the end of the year, the economy will be in a full-blown recession and stocks will be tumbling.

By the end of the year, the central banks will have ended their rate-hiking cycle, inflation will continue to trend down, and stocks will be staging a strong rally.

By the end of the year, inflation will still not be tamed, the Fed and the Bank of Canada will be warning of more rate hikes, and the stock market will be struggling to find direction.

You could make a plausible case for any of these scenarios, which is why predicting the future direction of bond and stock markets is almost impossible. Of course, that doesn't stop people from trying.

Last week, some commentators were taking an optimistic tone. The Wall Street Journal published a column on the improving odds of a so-called soft landing. I tuned into an interview on CNN in which the focus was on how the

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public was ignoring the success of President Biden's economic program. I received an analysis from one of my brokers that said current conditions are "creating the fundamental foundation for the upcoming secular bull market".

Meantime, The Bureau of Labor Statistics announced that the US unemployment rate for June was 3.6%, not far off its record low. It's no wonder there's a sense of optimism in the air.

Of course, not everyone feels bullish. But there seems to be a subtle change in tone.

So, should we listen to the optimists? What data should we be considering when making our financial decisions at this point in time?

Noah Solomon, president of Toronto-based Outcome Metric Asset Management LP, said in a recent note to clients that his company had modelled some of the most commonly used macroeconomic variables that influence stock market returns. The objective was to determine whether and how these factors have historically influenced markets and what they are signaling now. Here are the results.

**Fed policy.** Investors have been told for years: "Don't fight the Fed." It's good advice, Outcome's modelling concluded. The results showed one-year real returns for the S&P 500 of 6.6% following a period of Fed tightening. That

compared to 10.6% following periods when the Fed was in stimulus mode.

"As of the end of June, the Fed (had) increased its policy rate by 3.5% over the past 12 months," the client note said. "From a historical perspective, this change in stance lies within the top 5% of one-year policy moves since 1960 and is the single largest 12-month increase since the early 1980s. Given the historical tendency for stocks to struggle following such developments, this dramatic increase in rates is cause for concern."

**Valuations.** Over the past several decades, valuations have shown an inverse relationship to future equity market returns. When stocks are cheap on a p/e basis, gains follow. When they're expensive, future profits will be reduced or investors may suffer losses.

Outcome's research shows when p/e valuations are in the top quintile (most expensive) of their historical range, gains in the following year are 6.9%. When they are in the lowest quintile, the next year's gains average 9.4%. When valuations are sky-high, as they were in 1999 and early 2000, the result is usually a crash.

Right now, the S&P p/e is 23.46, which is in the top quintile historically. This is "at the very least not a ringing endorsement for strong equity market returns," writes Mr. Solomon.

**Yield curve.** It's been widely accepted

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that an inverted yield curve (short-term rates higher than long-term ones) signals a recession. Is it true? To what extent?

Outcome studied the difference between the 10-year US Treasury yields and the Fed Funds rate. It found that inverted yield curves have predicted every recession since 1955, with only one false signal.

When the yield curve is normal (long-term rates are higher), stocks perform better. The steeper the curve in favour of long maturities, the better. The S&P 500 averaged gains of 9.3% in the year following a positive yield curve in the top quintile. It lost 0.4% in the year after a steep inverted yield curve.

The Fed Funds rate is currently more than 100 basis points higher than the yield on the 10-year US Treasury Bond. That's one of the largest gaps in history, says Mr. Solomon. "Given the strong historical connection between inverted curves and subsequent recessions, it follows that there is a distinct possibility of a recession occurring in the near term," he wrote.

Note he said "possibility". Not probability.

"There are no flawless, silver bullet indicators for stocks, which means I am not suggesting that investors should run for the hills based on the preceding analysis," Mr. Solomon concluded.

"Although the macroeconomic indicators discussed in this missive represent some of the more powerful historical drivers of stock prices, the fact remains that there are thousands of variables and millions of interactions that have and can influence markets...

"This being said, if the past proves to be prologue the odds argue for tepid returns from stock portfolios over the near to medium term, and that investors may want to resist the temptation to add exposure and chase 2023's rebound in stocks."

## Questions?

Our team of experts  
have the answers!

Send your questions to  
[gordonpape@hotmail.com](mailto:gordonpape@hotmail.com)

Selected Q&A will be published in  
an upcoming issue!

## CORRECTION

In last week's issue I gave the wrong trading symbol for ARC Resources. The correct symbol on the TSX is ARX. I apologize for any inconvenience. — G.P.

# ADJUST YOUR FIXED INCOME ALLOCATIONS

**By Shawn Allen, Contributing Editor**

The recent massive increase in interest rates has changed the entire fixed income market. This means you need to review your asset mix because it's probably out of line with the new reality.

Fixed income investments include all interest-bearing accounts, GICs, and bonds. Preferred shares are also generally included in this category. Dividend-paying equity stocks are not included, nor are REITS and royalty income units.

Many or most do-it-yourself investors are guilty of not targeting and sticking to any specific allocation to fixed income. In recent years, with interest rates near zero, there has been a sense that there was no alternative to equities, even for income-seeking investors, with interest-bearing fixed income yields so low. As a result, many readers are likely underweight fixed income.

Now that the interest rate environment has changed radically, it's time to make some adjustments.

## Two categories

Fixed income investments can be divided into two broad categories.

The first category is essentially risk-free investments such as savings accounts, money market accounts, and GICs that provide an income stream without putting

the capital value at risk. This category of fixed income is also fixed value.

The second category includes bonds and preferred shares. This category provides an income stream, but the capital value fluctuates. This is fixed income but not fixed value.

It's the risk-free category that has changed most dramatically. The interest rate paid on cash savings accounts available within self-directed investment accounts has risen from as low as 0.05% in 2020 to 4.3% or more today. In early 2021, GICs were paying as low as 0.15% for the shortest terms, about 0.5% for one year, and about 1.5% for a five-year term. Faced with those extremely low yields, many investors abandoned these products in favor of preferred shares, dividend stocks, and REITs.

The yields available on bonds have also changed noticeably. For example, the yield on the five-year government of Canada bond has increased sharply from lows around 0.3% in 2020 to about 4.0% at the time of writing. The ten-year bond yield has increased from 0.5% to about 3.5%. Looking at commercial bonds, in early 2021 a Telus Communications bond with 9.7 years to maturity was yielding 2.4%. Today a Telus bond with a similar 9.4 years to maturity is yielding 5.4%.

Preferred share yields have also

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**Income allocations—continued from page 4...**

increased. For example, Royal Bank's rate reset preferred share RY.PR.S was yielding 5.2% two years ago. Today it yields 6.0%. Preferred shares also offer a tax advantage in the form of the dividend tax credit if they are held in a non-registered account.

So, the yields available on bonds and preferred shares are significantly higher and are now reasonably attractive. And, equally important, the risk of a capital loss on bonds is arguably far lower today given that interest rates have already risen dramatically and are forecast to decline somewhat within a year or two. In that case, bonds and perpetual preferred shares should provide capital gains.

## Conclusion

Today's interest rates have made all categories of fixed income far more attractive than they have been in years.

Shorter-term fixed income investments, in particular, are now radically more attractive. Investors would be wise to take advantage of this and in most cases should probably increase their allocation to fixed income. They should also target a specific allocation to cash and GICs, where capital is not at risk, and a separate allocation to the categories that provide fixed income but which also include volatility of the capital value.

The following table provides the yields available on the main categories of fixed income and may assist investors in choosing their allocations.

Much more discussion of income investment opportunities is available in our sister publication, *The Income Investor*.

**Contributing editor Shawn Allen provides stock picks and investment education on his website at [www.investorsfriend.com](http://www.investorsfriend.com).**

Category	Approximate Yield	Comment
Cash	4.3% to 5%	Risk-free but floating yields
GICs	3% to 5.3%	Risk-free and locked in for up to 5 years
Preferred shares	6.5%	Based on high quality rate reset and perpetual preferred shares
Short bond ETF	3.0%	Based on Vanguard's VSC
Long bond ETF	3.85%	Based on iShares XLB
Commercial bond ETF	3.4%	Based on Vanguard's VCB



# SHAWN ALLEN'S UPDATES

Recommendations are colour-coded:  
**Green indicates Buy**  
**Yellow indicates Hold**  
**Red indicates Sell**

## Ceapro Inc. TSX-V: CZO, OTC: CRPOF

*Originally recommended on Feb 27/17 (#21708) at C\$1.57. Closed Friday at C\$0.45, US\$0.33.*

**HOLD**

**Background:** Ceapro Inc. is a small Edmonton-based biotechnology company. For many years it has produced beta glucan and avenanthramides, which it extracts from oats. These products are used as ingredients in the cosmetics industry, including in some popular brand-name anti-aging and skin conditioner creams. Geographically, sales of these existing products are 59% in the US, 32% in Germany, and 9% in China, with essentially no sales in Canada.

Management indicates that the future value of the company will be driven by its various research efforts rather than its existing two products. The existing products are profitable and provide cash flow to fund its research efforts, which management hopes will transform Ceapro into a high-value life sciences company.

**Performance:** Since it started trading over 20 years ago, Ceapro's stock price has been very disappointing. The stock is down 24% this year to date.

**Recent developments:** The company indicates that it is investigating two new

nutraceutical products, Alginate (an immune system booster) and Yeast Beta Glucan (for treating certain lung diseases). And it will soon start a Phase 1 (safety) trial using a pill form of its avenanthramides product to treat exercise-induced inflammation.

It also hopes to license out what it describes as its game changing PGX Technology. It is currently working on plans for a small commercial-scale pilot plant to further establish the viability of this technology.

**Recent earnings:** In 2022, revenues per share were up 7% and earnings per share were up 31%. However, the trend turned quite negative over the last half of 2022 and the first quarter of 2023 as revenue declined and the company reported a modest loss.

**Valuation:** Analyzed at a share price of \$0.44. The p/e ratio is not excessive at 15.5 and that's despite the expenditures on research and development initiatives which obscure the profitability of the

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**Ceapro—continued from page 6...**

existing products. The price to book value ratio is attractive at 1.1. The return on equity in 2022 was strong at 15% but has a volatile history. Overall, the value ratios are reasonable and would support a rating of Buy and that is without taking account of the potential for its research to pay off.

**Balance sheet:** Given the sharp increases in interest rates it's fortunate that the company has no debt. Its existing cash and its positive cash flows from operations will support its investment plans for the foreseeable future. As a result, this company has staying power and is in no financial danger even if its research efforts do not produce revenues for several more years.

**Outlook:** The existing products will likely

continue to generate positive cash flows and earnings to support its research efforts. While it could announce a deal to license out its technology and patents at any time, it is probably safer to assume that any pay-off from its various research efforts will not occur before 2025.

**Conclusion:** While this has been a disappointing investment, its earnings have done better than the stock price would suggest. It's now trading at about as low a multiple of book value as it ever has, and it continues to build up cash and to increase its book value. Its existing products are profitable enough to justify the current share price and it's likely that some of its patents and research will eventually pay off.

**Action now:** Continue to Hold.

## MEMBERS' CORNER **Trading volume**

**Member comment:** I disagree with your response to the reader's concern about the trading volume of iShares Core S&P US Total Market ETF (TSX: XUU). As you are aware, the company behind an ETF can optionally create or redeem ETF units. This means the number of ETF units can go up and down based on demand, unlike traditional stocks which are fixed. Readers can search "etf share creation and redemption" to understand the details of how this works. The bottom line is the trading volume does not materially affect the ability to trade the ETF. As long as you are willing to go with the bid or ask price at the time, the block will go through since the market maker steps in. From experience, I have routinely traded blocks well beyond the current buy/sell quantities. It would be interesting to know if your readers have had the same experience or, in fact, had trading order fill issues. My feeling is that it is more important to select the ETF that is right for your needs then to worry about the trading volume. – Paul W.

**Response:** I agree. But for whatever reason the person who posed the question seemed hung up on the volume issue. If anyone has trouble trading ETFs, please let me know. – G.P.

# West Fraser Timber Co. Ltd. TSX, NYSE: WFG



*Originally recommended on Feb. 7/21 (#22106) at C\$88.11, US\$68.94. Closed Friday at C\$115.72, US\$87.59.*

**Background:** West Fraser Timber is a diversified producer of lumber, Oriented Strand Board (OSB), other engineered wood products, and pulp and paper. Its plants include 34 lumber mills, 14 OSB mills, 11 other engineered wood products mills, five pulp and newsprint mills, and six renewable energy plants. Its plants are primarily located in Alberta, BC, and the southeastern United States. It has 11,000 employees.

In 2022 its revenues were US\$9.7 billion, and the United States accounted for 68% of its sales. Canada was 16% and the remaining 16% was sold in Asia and Europe. A total of 57% of its plant assets are located in Canada, 36% in the US, and the remaining 6% are in Europe. Although it's a Canadian company, it now reports in US dollars.

**Performance:** West Fraser Timber has been a strong but very volatile stock over the past decade. In 2021 the stock was up 47%. In 2022 it was down 19% and in 2023 to date, it's up 18.4%. It's up 31% since the original recommendation.

**Recent earnings:** Earnings growth has recently been volatile. Earnings had soared with the extremely high lumber prices during the pandemic but have declined sharply in the past year and the company reported losses in the latest two quarters.

**Recent developments:** Last week the company reported that it is selling its Hinton Alberta pulp mill to Mondi Group but will continue to supply the mill with "fibre" under a long-term contract. That mill had been permanently reduced in capacity in April 2022. The sale price was only US\$5 million and WFG will face a write-off of about \$110 million. Mondi, which specializes in packaging and paper, plans to expand the pulp mill with an investment of €400 million.

In the past two years WFG has reduced its share count by over 30% through buybacks including through two substantial issuer bids completed in 2022 and 2021.

Lumber futures on Nasdaq (LSB) have been extremely volatile. They peaked at an extraordinary record high of \$1,733 in May 2021 but quickly declined to under \$500 in August of that year. They then recovered to over \$1,300 in early 2022 but have averaged about \$550 in the past year.

**Dividend:** The company pays a modest dividend of US\$0.30 per quarter (US\$1.20) per year. The yield at the time of writing is just 1.4%.

**Valuation:** Analyzed at its recent price of C\$111. The price to book value ratio is attractive at 1.1. The p/e ratio appears to be attractive at 8.8 times trailing earnings.

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# GORDON PAPE'S UPDATES

Recommendations are colour-coded:  
**Green indicates Buy**  
**Yellow indicates Hold**  
**Red indicates Sell**

## EQB Inc. TSX: EQB, OTC: EQGPF

**SELL HALF**

*Originally recommended by Irwin Michael on Aug. 10/08 (#2828) at C\$10.52 (split-adjusted). Closed Friday at C\$74.38, US\$55.80.*

**Background:** This company provides mortgage lending services to individuals and businesses in Canadian urban markets, with a focus on entrepreneurs and new Canadians. It carries on operations through its wholly owned subsidiary, Equitable Bank, which is Canada's eighth-largest Schedule 1 bank by market capitalization. Equitable Bank serves 360,000 Canadians and employs about 900 people. It also has a digital banking operation, EQ Bank, with its flagship product being the EQ Bank Savings Plus Account.

**Performance:** After a dip in March, the shares have been on a steady uptrend and are currently trading near their 52-week high. The stock is up more than 600% since it was first recommended.

**Recent developments:** EQB reported a strong first quarter. Revenue was \$267.8 million, up 47.9% from the same period last year. Net income was \$99.5 million (\$2.56 per diluted share), an improvement from last year's \$86.9

million (\$2.51 per share). The results reflect the acquisition of Concentra Bank, which closed on Nov. 1, 2022.

EQ Bank continues to attract new business. Customers were up 26% year-over-year while deposits were ahead 12%.

"It's no surprise that EQ Bank was just crowned Canada's best bank for the third year running, the verdict of tens of thousands of customers surveyed by Forbes," said CEO Andrew Moor.

**Dividend:** EQB increased its quarterly dividend by 6%, to \$0.37 a share (\$1.48 a year). It was the fourth increase in the last 12 months. The pay-out is up 28% from the same period a year ago, with the stock yielding 2%.

**Outlook:** EQB is on a roll, but the shares have a long history of volatility.

**Action now:** Sell half for a capital gain of 603%. Hold the balance.



# GAVIN GRAHAM'S UPDATES

Recommendations are  
colour-coded:  
Green indicates Buy  
Yellow indicates Hold  
Red indicates Sell

## Manulife Financial TSX, NYSE: MFC

**BUY**

*Originally recommended by Tom Slee on Feb. 6/12 (#21205)  
at C\$12.34, US\$12.42. Closed Friday at C\$24.92, US\$18.86.*

**Background:** Manulife is Canada's largest life and health insurance company by market capitalization. It operates in the US under the John Hancock brand and has a large and growing business in Asia servicing the growing middle class. It employed 38,000 people in 2022, had 98,000 sales agents, and distribution relationships with major Asian financial institutions. As of March 31, it had \$779 billion in AUM.

**Performance:** Manulife has recovered from halving its dividend during the Great Financial Crisis in 2009, and the share price has more than doubled since being recommended by former contributing editor Tom Slee in 2012.

**Recent developments:** For the 2022 fiscal year, Manulife reported net income of \$7.3 billion and core earnings of \$6.2 billion, down 7% at constant exchange rates. Per share earnings were \$3.10, down 4.7% after repurchasing 79 million shares, which represents 4.1% of outstanding shares.

Return on shareholders' equity was 11.9% for 2022, and 14.3% in the fourth quarter. Flows into global wealth management fell from \$27.9 billion to \$3.3 billion, reflecting the bear markets in equities and bonds. AUM was down from \$885.9 billion to \$779 billion. Book value per share rose 9.8% to \$26.50.

Manulife completed two transactions to reinsure over 80% of its legacy US variable annuity business, releasing \$2.5 billion of capital and significantly reducing risk.

For the quarter ended March 31, Manulife reported net income of \$1.4 billion, up 6%. Core earnings were \$1.5 billion (\$0.79 per share) up 6%. Core earnings per share gained 11% due to share buybacks.

Core return on shareholders' equity was 14.8%, while net inflows to asset management were \$4.4 billion, larger than the entire year of 2022. Its book value increased 9.1% to \$30.04.

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# Jefferies Financial Group NYSE: JEF

**HOLD**

*Originally recommended on May 7/12 (#21217) at \$24.61. Closed Friday at \$35.31. (All figures in US dollars.)*

**Background:** Jefferies (formerly Leucadia) is a leading investment bank, now sixth in global M&A and IPO business (ex-China). It is the largest independent mid-market investment bank in the US, with major positions in equities, convertibles, and corporate debt. It also had investments in other non-banking assets which it has been gradually reducing over the last few years. It sold its Idaho Timber business last year for \$239 million, producing a \$140 million gain. It also spun off Vitesse Energy (book value \$427 million) to shareholders earlier this year.

**Performance:** The shares of Jefferies rose very sharply in 2021, as investors finally recognized the strength of its investment banking franchise. We recommended taking half profits in November 2021 at \$43.34 for a 75% gain. Since then, the bear market in 2022, especially the 95% collapse in the IPO market, hit Jefferies hard. The shares halved to \$26.45 in June last year. They have since recovered somewhat, up 33% from the low to \$35.31, despite a disappointing second quarter report.

**Recent developments:** Jefferies reported revenues of \$5.98 billion for the year ended Nov. 30, 2022. That was down 25% from the prior year. Net income was \$781.7 million, down 53%. On a per share basis earnings were \$3.06, down 50% due to repurchases of 25.6 million shares. Tangible book value was \$33.78.

For the quarter ending May 31, Jefferies reported net income of \$12 million (\$0.05 per share) after \$72 million in losses from its investment in Italian wireless telecom business OpNet, formerly Linkem.

Revenue of \$1.1 billion was comprised of investment banking revenues of \$510 million, down 26% from the same quarter in 2022. Capital markets revenue was \$543 million, down 15% from the prior quarter but up 30% from the same period last year. Tangible book value fell to \$31.51.

CEO Rich Handler noted the regional banking crisis, the forced merger of Credit Suisse and UBS, and the debt ceiling face-off in Washington contributed to the uncharacteristically low volumes of capital markets and mergers and acquisitions activity. However, “the month of June has brought green shoots in our investment banking and capital markets business, and we are growing increasingly optimistic about the return of a more normal environment,” he said.

**Dividend:** Jefferies pays a quarterly dividend of \$0.30 (\$1.20 a year), equivalent to a yield of 3.4%.

**Action now:** We locked in a substantial profit by selling half our position in 2021. At the current price, Jefferies is a Hold until it's apparent more normal conditions have returned to the financial markets.

FINANCIAL FACTOIDS:

## ELON MUSK



We're introducing a new feature that will appear periodically in the Internet Wealth Builder. It's called Financial Factoids and it will offer little-known bits of information about the people, companies, and markets that drive the investment world. Our topic for today is a person who is dominating the business pages these days, Elon Musk.

### Elon Reeve Musk

**The Canadian connection.** Musk was born in Pretoria, South Africa, and briefly attended the University of Pretoria. He moved to Canada at age 18, and acquired citizenship through his Canadian-born mother, famed supermodel Maye Musk.

His first job in Canada was at his cousin's farm in Waldeck, SK (a village of less than 300 people), tending to vegetables and shoveling grain bins. He later moved to BC.

Still a teenager, Musk visited the local employment office to figure out which jobs in the area paid the most. The answer, he learned, was boiler room cleaner. Starting at \$18 an hour, Musk would don a hazmat suit, squeeze

through a narrow tunnel into the boiler room, and shovel hot boiler-room muck back through the tunnel into a wheelbarrow. According to Musk, only he and three others, out of the original crew of 30, outlasted their first week on the job. The Tesla founder was originally enrolled at Queen's University, but then transferred to the University of Pennsylvania in Philadelphia, where he received bachelor's degrees in physics and economics in 1997.

**Family.** Musk's father, Errol, shot and killed three men who broke into his house. Errol told the Daily Mail that he was tried for manslaughter, pleaded self-defence, and was ultimately acquitted. Musk is currently estranged from his father.

Musk's first marriage was to Canadian author Justine Wilson. She wrote the novels *BloodAngel*, *Uninvited*, and *Lord of Bones*. Their first child died of AIDS. She subsequently gave birth to twins and then triplets. They divorced in 2008.

Musk has a lot of kids, and he sure gave them some funky names. Most famously,

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**Musk—continued from page 12...**

Musk's son with the indie singer Grimes, who was born in 2020, is called X Æ A-XII. They named their second child, a girl born in 2021, something slightly less weird: Exa Dark Sideræl. His children with Justine Wilson have comparatively normal names: Griffin, Xavier, Kai, Saxon, and Damian. Still, it's not like there are any Michaels or Davids in the bunch.

**Latest project:** Musk is plunging into artificial intelligence with the announced formation last week of xAI. His objective is typical Musk hyperbole: "Understand the true nature of the universe". Good luck with that.

**Benevolence:** Musk tweeted that he would donate US\$6 billion to end world hunger, but then didn't do so. Enough said.

**West Fraser Timber—continued from page 8...**

The p/e based on analyst forward earnings, according to Yahoo Finance is very unattractive 435 – although all six analysts covering it rate it a Buy. The dividend yield is modest at 1.4% due to its low payout ratio, which amounts to only 12% of trailing year earnings. The return on equity is very volatile and was recently 10.4%. Due to its earnings volatility linked to lumber prices, the value ratios are also highly volatile and therefore very difficult to interpret.

**Outlook:** The near-term outlook is for substantially lower year-over-year earnings to be reported for the quarter just ended due to lower commodity prices and slowing home construction.

**Conclusion:** West Fraser is a well-managed company that prides itself on being a low-cost producer and on its environment efforts. Its value ratios are difficult to interpret because its earnings are very volatile and are currently declining. Given the unpredictability of earnings and the weak near-term outlook it is probably best to take advantage of the recent price recovery and sell this position.

**Action now:** Sell for a gain of 31% versus the original recommended price.

**Manulife—continued from page 10...**

**Dividend:** The quarterly dividend was increased last quarter by 11% to \$0.365 (\$1.46 per year), equivalent to a 5.86% yield.

**Action now:** Manulife has continued to demonstrate growth in its Asian business despite challenging markets, and with the recovery in equity and bond markets, remains a Buy for its low valuation, sustainable and growing dividend yield, and strong position in Asian markets.