SV Wealth - Newsletter

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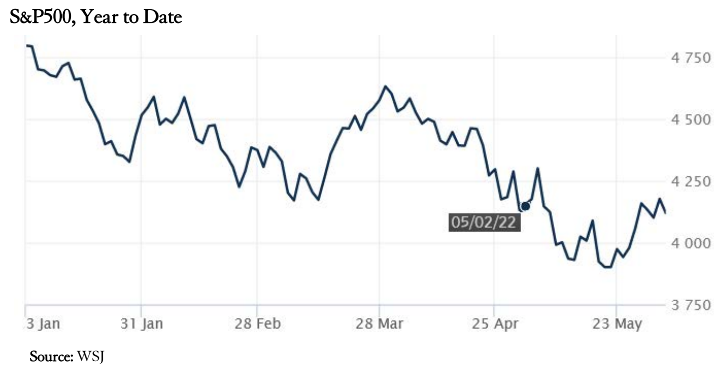
Being Wild While Standing Still

The S&P 500 started May at a level of 4132 and managed to finish the month at that exact same spot. Despite the appearance of standing still, it was a wild month that saw the index almost touch bear market territory before rapidly recovering in the last week of May.



Concerns about economic growth in the face of rising interest rates and softening economic data have kept the markets nervous all year, and fears seemed to escalate in May. The continuing conflict in Ukraine and the lockdowns in China added to the negative environment, with those events continuing to wreak havoc on global supply chains and aggravating inflation that is already at 40-year highs.

Stocks started recovering in the later half of the month as opportunistic buying helped many stocks that had been beaten down too far, too fast. The Federal Reserve also helped ease market concerns about rates rising too high when Chairman Jay Powell said the pace of increases is not on auto-pilot and could slow if inflation starts softening. The new founded optimism is welcome as the S&P 500 ended the month down 14% from its January high.

Looking Ahead

With the markets unstable this year, our focus continues to be on dividend-paying stocks from high-quality companies. As interest rates rise in the short-term and the stocks of technology and growth companies come under pressure, mature companies with steady cash flows will be one of the best havens of safety in an inflationary environment.

We believe we are late in the economic cycle and that higher interest rates are now filtering to real estate, softening housing prices and reducing the volume of sales. Given the prominent role of real estate in Canada, the pain may just be starting on that front.

Scaling the Chinese Wall of Worries

Chinese stocks have been mired in a deep depression since the Xi government cracked down on technology companies in March. Coupled with slowing economic growth from China's stringent zero-Covid lockdowns, most analysts had been slashing their expectations of Chinese growth.

With the punishing lockdowns in Shanghai finishing as of June 1st, we suspect the worst is over for Chinese stocks, at least for now. As valuations there have been beaten down aggressively, we see a good opportunity in terms of risk versus reward for the China story.

We're also expecting to see stimulus come back in China, with the Shanghai government recently announcing tax cuts for businesses and subsidies to buyers in order to help the city get back to growth. Since Shanghai composes 4% of China's GDP and is its' most important city economically, the stimulus is likely to be material.

A Better Fixed Income: Preferred Shares

The market has been falling and all asset classes are falling with it, including fixed income. Despite this, the 10-year and 30-year interest rate curves haven't yet shifted much. As a result, we believe preferred shares present us an opportunity to substitute prefs for fixed income in exchange for picking up yield. Let's take a look at an example of how a pref works.

PRODUCT SPOTLIGHT	
Canadian Western Bank 5-year Rate Reset First Preferred Shares Series 9	
ISSUER	Canadian Western Bank
COUPON	6.00%
MATURITY	30-Apr-24
PRICE	$25.45
ANNUAL DIVIDEND	$0.750
DIVIDEND YIELD	5.89%
RATING	Pfd-3 (Stable)
RESET TERM	5yr GoC + 4.04%

The Canadian Western Bank preferred shares are currently paying 6% per year until the rate resets on April 30, 2024. On that date, the shares will either be called back, or the coupon rate will be reset at the Government of Canada 5-year yield plus 4.04%.

For example, the current 5-year GoC yield is 2.75%; if the GoC yield was to stay constant, this preferred share will reset in 2024 at a coupon of 6.79% for the next five years. If the shares are called back, then we'll receive the par value of $25 per share.

With the way interest rates are, it is quite likely that most, if not all, preferred shares will be called back over the next two years. Even if that happens, we'll be earning 5.98% annually for the next two years holding this security, a very attractive yield compared to options in the bond market. We will essentially be getting a 2-year note that pays 6%, which is strong.