We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

MacNicol & Associates
Asset Management

Contact us today if you would like to meet about your investment future. info@macnicol.com

BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Cape Agulhas Lighthouse,

L'Agulhas, Western Cape, South Africa

The Cape Agulhas Lighthouse is situated at Cape Agulhas, the southernmost tip of Africa. The lighthouse was first built in 1849 and stands at 89 feet tall.

Pinda Lighthouse,

Mozambique

The 31 meter (102 ft) tower rises through the center of a 1-story keeper's house. Completed in 1923, it remains in service today, still bearing its black and white banded daymark.

Feel free to send us your photos of Lighthouses to be featured in our weekly market observations.

Thoughts to Israel

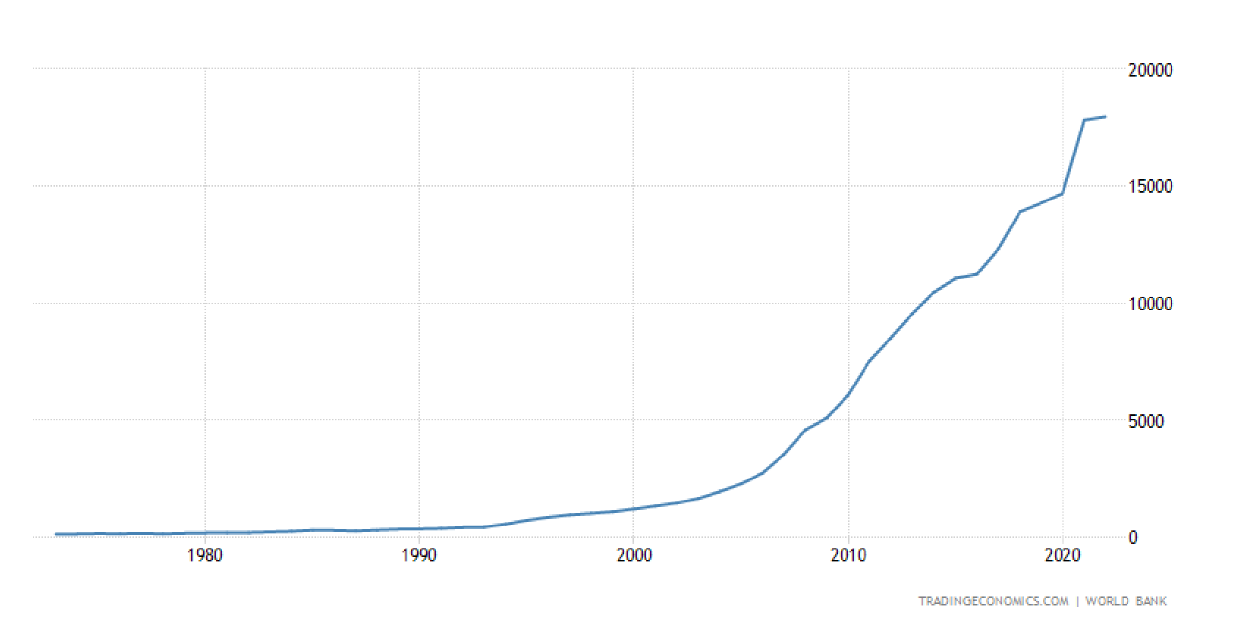
Our thoughts go out to the people of Israel and the entire Jewish community after what went on last weekend. We are people before investors and were astounded by what we woke up to last Saturday. We strongly condemn all forms of terrorism and mourn the loss of innocent lives.

The events that have occurred over the last week have had financial and geopolitical impacts and will continue to. We will not be commenting on those impacts this week as we fully digest the horrific acts that have occurred.

Changing tides

China, once looked at as an up-and-coming, success story with a roaring economy has quietly gotten itself into trouble. The world's second-largest economy has exponentially grown over the last 30 years. The country has improved its economy through a system that has both communist and market attributes. China's economy has accelerated in size through the growth of the manufacturing sector, where China has become the world's largest manufacturer of goods and largest exporter in the world. However, recently other sectors like real estate and technology have added to China's economic growth, diversifying the country's economy.

Here is China's GDP since 1960, note the acceleration in the 1990s to now. The numbers are in trillions of U.S. dollars.

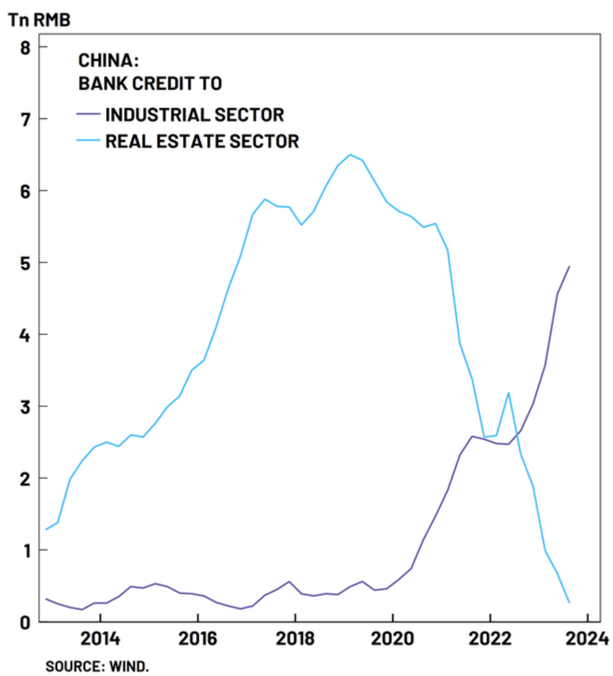


However, even though China's economy has rapidly grown and gives emerging countries a blueprint for success, we think their growth rate is about to slow down. We think the Chinese economic growth rate will slow down substantially moving forward as their population declines and increases in age. China's demographics reflect a problem that many are overlooking. The country has an extremely low birth rate and an aging population. We are not here to say we are long China by any means. The Chinese one-child policy will have a lasting impact that could negatively impact the country for decades. China's economy also has major debt and real estate problems which has negatively impacted equity markets, and the Chinese Yuan over the last 1-2 years. We will not go on about this theme this week as we have talked about this in past issues of this publication but…. (To learn more about these issues simply Google the two terms 1. Chinese ghost cities, and 2. Evergrande Group debt crisis).

With that being said, we are not long or short in China for various reasons.

We are simply going to be talking about a trend that has occurred over the last few months (to year) that has resulted in industrial commodity prices remaining elevated (especially in recent months).

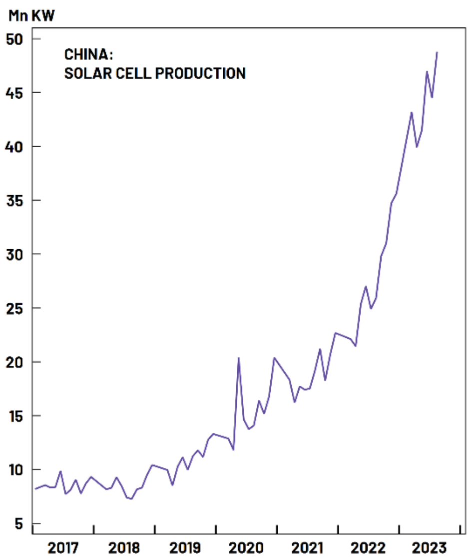
A few years back people realized that China's real estate sector had some serious issues, this included China's banks that issue credit. As banks realized the sector was over-leveraged and developers would have issues selling properties or units, decreasing cash flows, and increasing delinquencies, they rotated their focus onto the industrial sector. Bank credit to the real estate sector has almost disappeared over the last 3.5 years while credit to the industrial sector has increased by 600% over the same period.



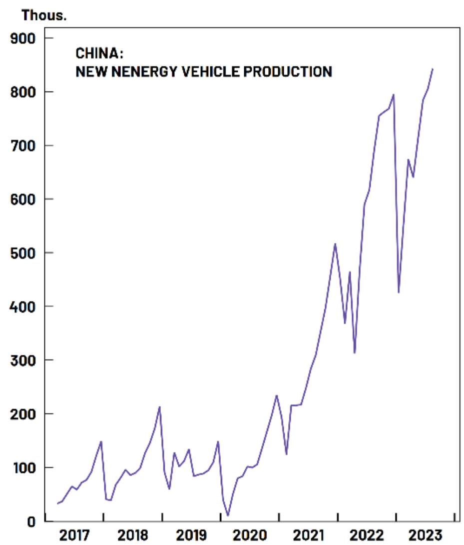
This credit in the industrial sector has helped prevent a total collapse of domestic credit growth and demand in China.

The chart can help explain why China has continued to import industrial metals even though they have gone through numerous COVID-19 lockdowns, a recession, and a major property crisis. China's demand for industrial metals has continued to grow as the country continues to embrace renewable energy. The country is a hotbed for renewable energy manufacturing and has capitalized on the global trend to go green.

For example, fuel cell and electric vehicle production in China has accelerated over the last 3 years.



SOURCE: CHINA ASSOCIATION OF AUTOMOBILE MANUFACTURERS, MACROBOND.



SOURCE: CHINA ASSOCIATION OF AUTOMOBILE MANUFACTURERS, MACROBOND.

The global green wave has filled a major void in the Chinese economy. It has also provided credit providers with a new sector with growing demand. The green wave has also inflated the demand for certain industrial metals allowing prices to remain elevated even as economic conditions have worsened across the world. Our points are quite straightforward but make us ask a few questions, is the industrial sector the next sector to have cash flow issues in China (just like the real estate sector has had)? How exposed are Chinese banks? Would China suffer the most if the demand for green energy slowed down and did not meet analyst expectations?

We think they are fair questions to ask. Investors need to know who could be the biggest winner in certain situations and who has the most to lose in those same situations.

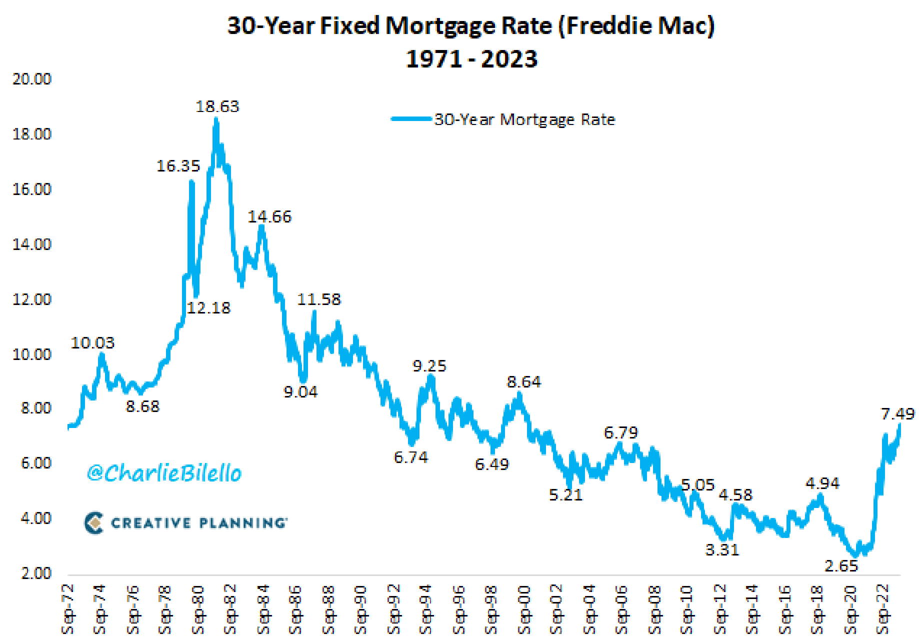
We are certainly not saying the green wave is a fad. We are simply asking if demand for these products slows down due to price, or consumer preferences, what happens to the Chinese economy?

<u>Quality of investment matters</u>

Today's economic environment across North America shows why investment quality matters. As yields have surged and sales have declined, quality has become the most important attribute in the real estate sector. In zero percent interest rate environments almost, anybody can make money especially when housing demand outstrips supply. Think about it almost any home is appreciated by a large amount even during COVID-19, no matter the quality of the property. As rates have risen, it has become more evident that quality matters. Our Investment Team focuses on quality when investing in real estate partnerships in the Alternative Asset Trust. The Investment Team has various criteria when we talk about the quality of assets. For an inside look at our criteria, our Associate Portfolio Manager, Cesar Cossio, authored an article that will be published in the next edition of The Association of Canadian Pension Management (ACPM) publication which we will link upon its release.

Back to quality, why does quality matter now more than ever?

For one, the 30-year mortgage rate hit its highest rate since December 2000 last week.



Two, sales volumes in the sector have slowed down due to affordability issues.

Finally, new builds have plummeted as builders and developers hit the brakes due to higher rates. New construction of apartment buildings has declined by 41% over the last year - the largest decline since 2010. The average financing rate for land development, land acquisition, and single-family construction has doubled over the last 3.5 years from 4% to over 8%. Vacancy rates have also risen recently in the U.S. as demand slows on the consumer side (in certain markets).

All these issues in the real estate sector have made quality matter yet again as developers and landlords are forced to offer the best products in the best places to consumers to keep occupancy rates high, and sale prices increasing. We believe high-quality properties can create large cash flows which will yield high returns even in a high interest rate environment.

Market resilience or trouble ahead

Birkenstock, the German sandal maker is planning to IPO this Wednesday, and many believe after a few weeks of rocky markets that this IPO could foreshadow what is coming in equity markets. The IPO comes a few weeks after the IPOs of Arm Holdings, Klayvio, and Instacart. All three IPOs were initially successful in surging in price, but the surges eventually faded.

Birkenstock is reportedly offering 32.3 million shares at an offering price between $44-49. The company has requested to be listed on the New York Stock Exchange under the ticker symbol “BIRK”. Goldman Sachs, JPMorgan, and Morgan Stanley are the lead underwriters in a team of 22 banks working on the deal. L Catterton, a U.S. Private Equity firm purchased Birkenstock for $4.3 billion in 2021, the post-IPO valuation of Birkenstock is expected to push close to $10 billion.

Birkenstock is pitching its profitability, growth, and notoriety among consumers to investors. Birkenstock's revenue has rapidly grown in recent years as has its profitability. Birkenstock revenue grew by 71% between the 2020 and 2022 fiscal years.

Some believe that Birkenstock’s public market debut could break open the gates on a fashion company log jam of companies waiting to go public. Arc’teryx and Salomon owner Amer Sports have filed for an IPO, while Golden Goose, Skims, Shein, and others are rumored to be planning public listings in the coming months.

Will investors dive all in on this profitable shoemaker with extremely loyal customers or will investors look the other way and not want this added-on risk while markets remain volatile and illiquid?

Developer joins Evergrande

We talked about Evergrande and the Chinese debt crisis that has occurred over the last two years earlier in this issue. Many Chinese real estate firms have defaulted on debt obligations since a liquidity crisis hit the sector in 2021, leaving many homes unfinished. As liquidity dried up, home sales decreased resulting in many companies including Evergrande filing for bankruptcy. Evergrande was revealed to have over $300 billion in liabilities in 2021 while realizing net losses ($81 billion combined loss in 2021 & 2022) resulting in investors rushing to sell their equity and debt securities across the Chinese real estate sector. This week another Chinese developer announced that it cannot meet its debt payments highlighting how serious the real estate crisis is in China and how the issue is widespread. The recent warning further confirms that the issues in the sector are not behind us, and they remain a major issue that needs to be addressed.

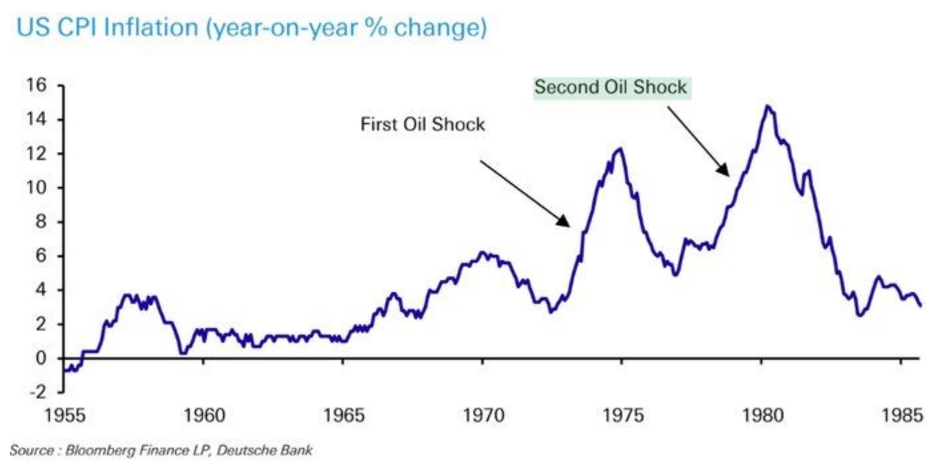
Country Garden warned on Tuesday about its inability to meet offshore debt obligations. Country Garden is China's largest private property developer and has not defaulted so far but has missed coupon payments on some dollar bonds since last month and faces the end of a 30-day grace period for making payments next week.
To address the issues across the real estate sector, the Chinese government attempted to loosen home-buying criteria to increase consumer demand and free up some liquidity. Beijing has rolled out a raft of measures in recent months, including reducing deposit requirements and cutting existing mortgage rates, to help renew homebuyers' confidence, but growing debt woes of developers were unlikely to help achieve that goal. Slashing rates and cutting down payments for homes seems like a good way to make consumers buy homes that they cannot afford.

We do not have any exposure to Chinese real estate and think there will be much more hurt across the sector before it improves. We also think that investors will hesitate when buying Chinese securities in the short to mid-term due to the contagion affects from this debt and real estate crisis that continues to be a major problem for China.

Stagflation warning

A major investment bank has warned that the U.S. could slip into 1970s-style stagflation. Deutsche Bank has put out a note to clients that says the risks of stagflation are higher than many believe. The investment bank highlighted Russia's invasion of Ukraine, Hamas's attack on Israel and growing instability in the Middle East, COVID-19, and energy shortages as reasons for potential stagflation through the next few years. It is important to note inflation rates have been elevated for 2 years now.

For those who do not know or forget, stagflation is defined as the torturous concurrence of both a stagnant economy and high inflation, the term started circulating in the 1970s when the U.S. underwent 10 years of stagflation.



Deutsche Bank highlighted that inflation rates remain well above Central bank targets in each of the G7 countries and pointed to the 1970s for some foreshadowing. History indicates that the last mile of inflation is often the hardest, a mile that could not be conquered for over a decade during the 1970s. We have often talked about the resurgence of inflation in this publication like what we saw in the 1970s.

We are not sure if we will 100% be correct in our prediction but think it's worth looking at as product shortages remain and companies have underinvested in expanding production which will lead to higher prices for longer periods.

Now that inflation has been above target for the last two years, “a fresh inflationary spike could well lead expectations to become unanchored”, according to the Deutsche Bank note.

We say this not to scare investors but to remind them that this is a possibility and it is a possibility they should be accounting for.

MacNicol & Associates Asset Management
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