Gold Investment
Portfolio Manager

Investment Letter

Q3-23 Investment Letter (No. 65)

October 27, 2023

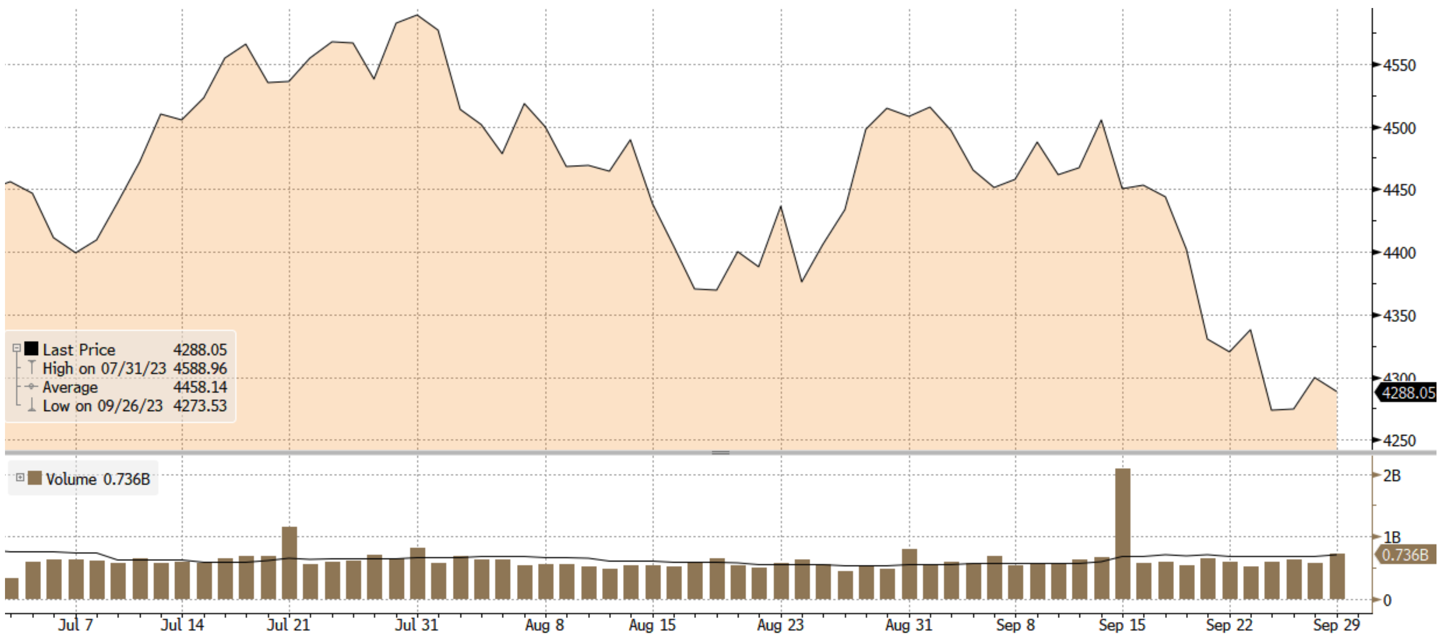
OVERVIEW

Dear Clients and Friends,

We are pleased to provide this quarterly report for the period ended September 30, 2023. This report will be divided into two sections: (1) Market Recap and (2) Commentary.

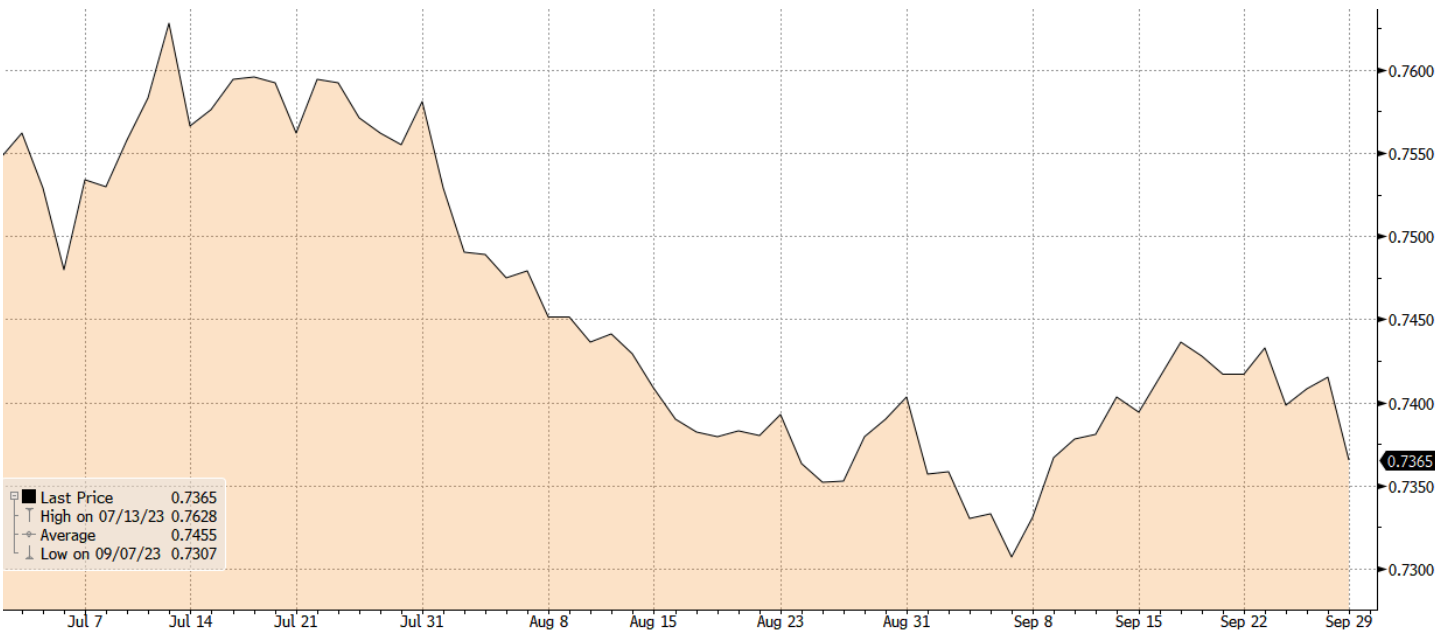
MARKET RECAP

The S&P 500 Index (in USD) lost 3.65% for the three-month period ending September 30, 2023.



The S&P/TSX Composite Index fell 3.17% the three-month period ending September 30, 2023.

The Canadian Dollar quoted in USD (CADUSD) decreased by 1.79% for the three-month period ending September 30, 2023.

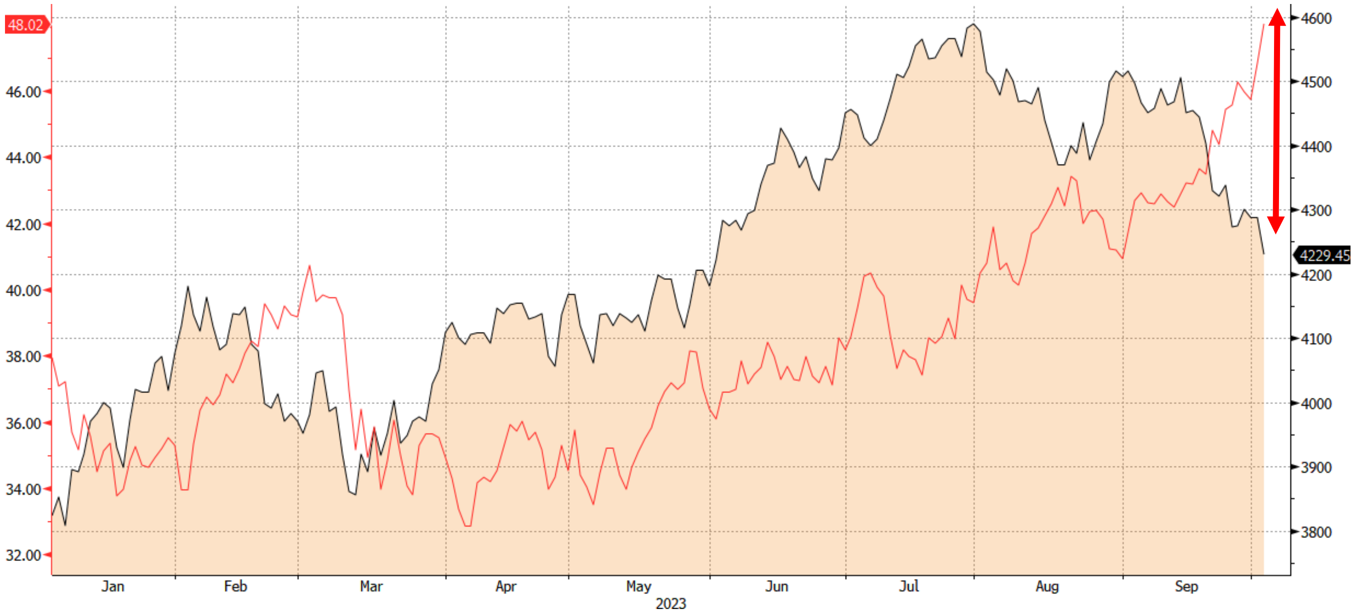


COMMENTARY

Part 1 – Debt Traps

Our recent letter to clients, dated October 5, 2023, described September's bond market sell-off. This coincided with a sharp retreat of the stock markets, represented by the S&P500 on the following page. Bonds go down in price when yields go up. Both the bond and stock markets were battered.

Chart 1 – 10 Yr. Treasury bond yields (red line) vs S&P 500 Index (black line) Jan 1/23 to Oct. 3/23



Source: Bloomberg

We're going to expand on our October 5th comments and here is the punch line. *Rising bond yields are a problem for countries that are trying to get inflation under control.*

Inflation is caused by "running the printing presses". First we should explain how this works. The best way is to think of a purchase and a simultaneous deposit. Governments issue debt (called bonds) regularly and if the Government of Canada (GoC) is short $1 billion to fund its programs, the Bank of Canada (BoC) will purchase $1 billion of bonds being issued and immediately deposit it in an account that the Government of Canada has at the BoC. Table 1, below, shows that the purchase of GoC securities (bonds) is an asset for the BoC but the deposit to the Government of Canada's account is an equal and offsetting liability. Furthermore, the Government of Canada's deposit at the BoC is Government's asset but it's offset by the bonds they've issued.[1]

Table 1 – Money Creation Through the Bank of Canada's Purchases of Government of Canada Securities

Balance Sheet	Type of Entry	
	Asset	Liability
Bank of Canada	New Government of Canada securities purchased	New deposit from the Government of Canada
Government of Canada	New deposit at the Bank of Canada	New Government of Canada securities issued

Note: When the Bank of Canada purchases new Government of Canada securities, it simultaneously records the value of the securities as a new asset on its balance sheet and records the new deposit from the Government of Canada as a liability on its balance sheet. On the balance sheet of the Government of Canada, the new deposit at the Bank of Canada is recorded as an asset and the new securities issued are recorded as a liability.

Source: Table prepared by the Library of Parliament.

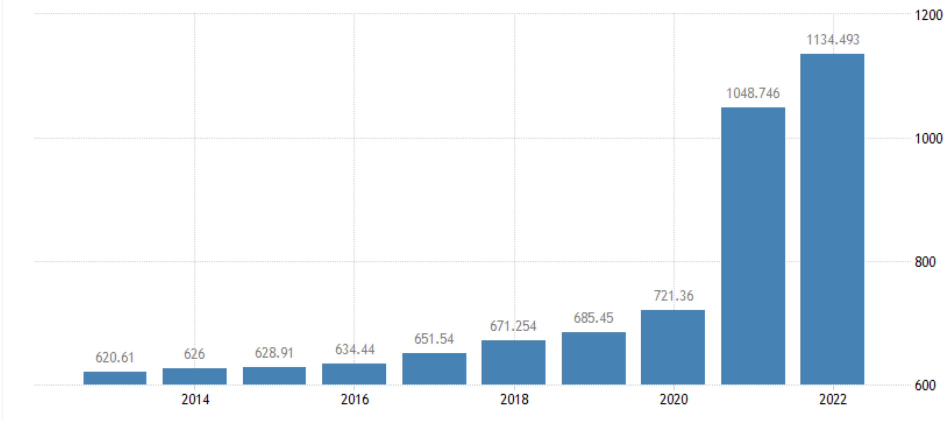
[1] *https://www.investopedia.com/articles/investing/081415/understanding-how-federal-reserve-creates-money.asp#*
https://lop.parl.ca/sites/PublicWebsite/default/en_CA/ResearchPublications/201551E#

Countries with high inflation are in deficit positions, meaning that they spend more than they take in from taxes and other revenues. The problem is that funding deficits is becoming more and more expensive because bond yields (interest rates) are going up – please see Chart 2 below. This means more money is needed to pay interest instead of being used to fund government operations.

Additionally, when debt matures, it can't be readily paid off if the government is in deficit. So the matured debt needs to be refinanced at a higher rate. This creates a vicious cycle where more and more is needed each time to pay interest instead of being used for program spending. If the deficit spending continues, then even more money needs to be "printed" for program spending to offset the rising interest rate expense.

Total debt issued by all levels of Canadian governments stood at $1,134.49 billion in 2022, this is an all time high and has never been higher in Canadian history. [2]

Chart 2 – Government debt, all levels



Conclusion. *Inflation and high interest rates are a toxic combination.* The Bank of Canada and the Government of Canada have 2 critical challenges. Firstly, inflation needs to be brought under control and, secondly, deficit spending needs to be managed so as to not have the country caught in a death spiral of growing interest on the national debt.

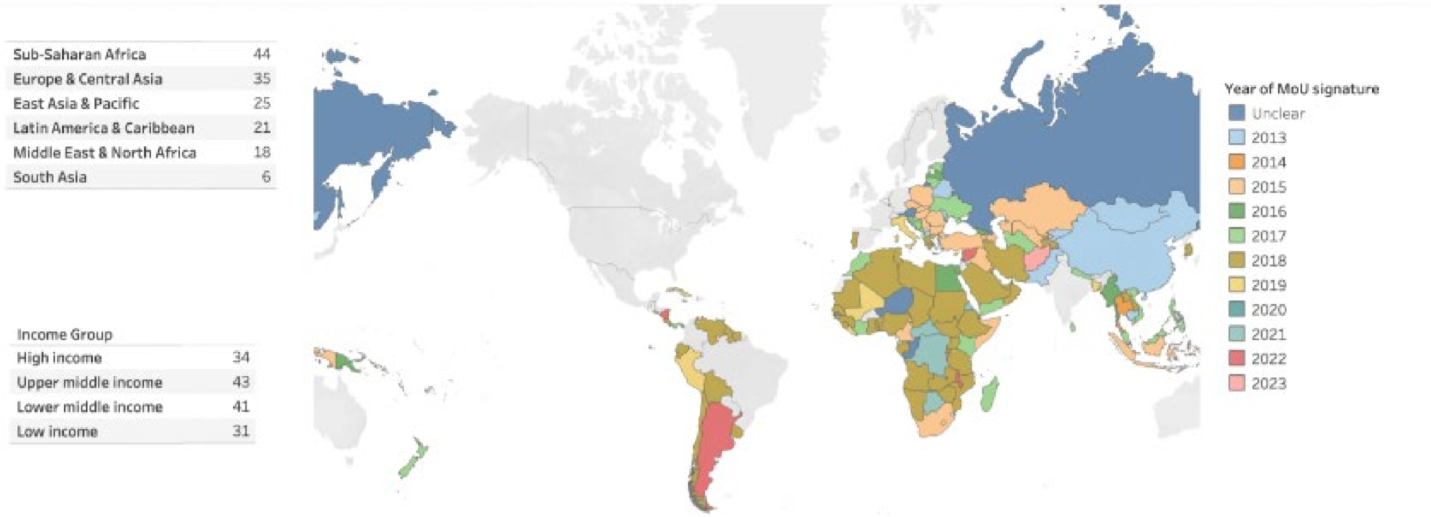
Part 2 – More Debt Traps

We are going to pivot into geopolitics and discuss China's Belt & Road Initiative (BRI). This is a global effort underwritten by China in 2013 to establish trade and secure economic resources around the world. This is President Xi Jinping's signature foreign policy piece. The goal is to provide the rest of the world with modern infrastructure and reliable resources, including energy, and advance China's economic interests and political stature. *Funding for these projects comes solely from the Chinese government and the local country pays nothing.* [3]

BRI's name is inspired by the Silk Road, an ancient trade route that connected China to Europe. The BRI is actually a land component and a maritime piece. The Silk Road Economic Belt is overland pipelines, transportation, and infrastructure projects in Asia, Russia and Europe. A Maritime Silk Road aims to create port and infrastructure projects around the world. As shown on the chart on the following page, as of April 2023, 148 separate countries have signed agreements for BRI projects with China. [4,5]

[2] *https://tradingeconomics.com/canada/government-debt*
[3] *https://www.cfr.org/blog/countries-chinas-belt-and-road-initiative-whos-and-whos-out*
[4] *https://www.ebrd.com/what-we-do/belt-and-road/overview.html*
[5] *https://greenfdc.org/countries-of-the-belt-and-road-initiative-bri/*

Chart 3 – Countries with BRI projects



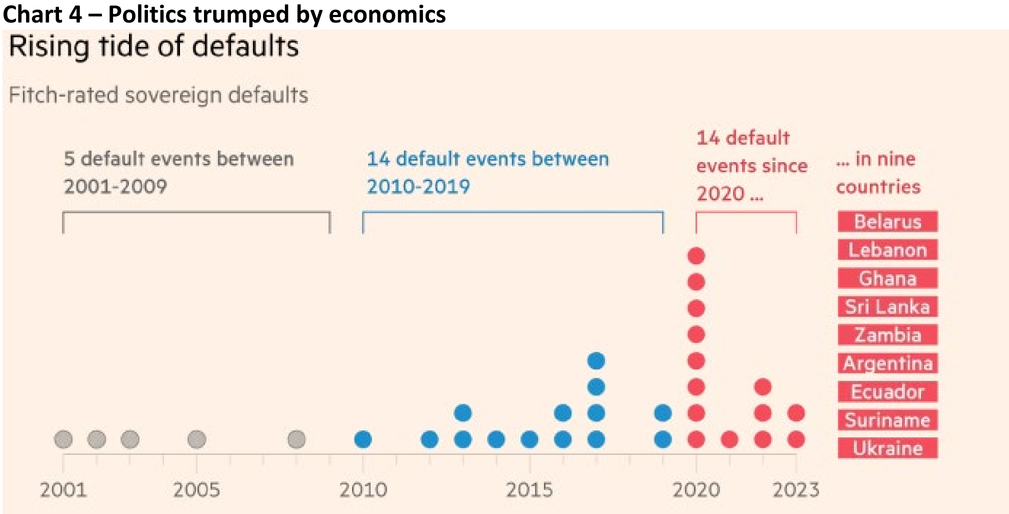
https://greenfdc.org/countries-of-the-belt-and-road-initiative-bri/

Researchers have put together a map of known countries. The participants are quite extensive. There are African, Middle Eastern, Asian, Pacific and South American countries, and Russia. Eagle-eyed readers will notice that participants include wealthy and western allied countries like South Korea, Italy, Greece, Austria, Kuwait, Poland, New Zealand, Saudi Arabia, and the United Arab Emirates. There is an element of politics in BRI as well.

So how has the BRI performed? Things were going great until 4 or 5 years ago. There is a big catch to the Belt & Road. The money given is in a form of a loan from a Chinese bank and usually the money is given to a Chinese contractor who builds the project in the foreign country, using imported Chinese labor, so a lot of that debt goes right back into Chinese companies or the Chinese economy. Of the BRI deals, there have been complaints of unfinished projects, shoddy construction, environmental damage and an excessive debt burden. If a country fails to pay, China tries to take over ownership; when Sri Lanka fell into default, China took a 99 year lease on a port as compensation. [6]

<u>The perils of sovereign debt</u>. BRI is turning out to be a poisoned chalice for China. Of the estimated US$1 trillion in BRI projects, an estimated 60% of this is in financial difficulty or in default. That is something on the order of US$600 billion of bad debt. This number is astounding. If a Canadian or U.S. bank had just 10% of its loans go bad, the regulators would be all over it. The problem is that all of this bad debt is *sovereign* debt, meaning that it is a national government that owes China the money and if they don't want to pay back or allow China to seize on any collateral, then it isn't going to happen. China is believed to have already restructured or made additional emergency loans of US$250 billion – 25% of outstanding BRI debt.

Chart 4 – Politics trumped by economics



https://www.ft.com/content/da01c562-ad29-4c34-ae5e-a0aafddd377c

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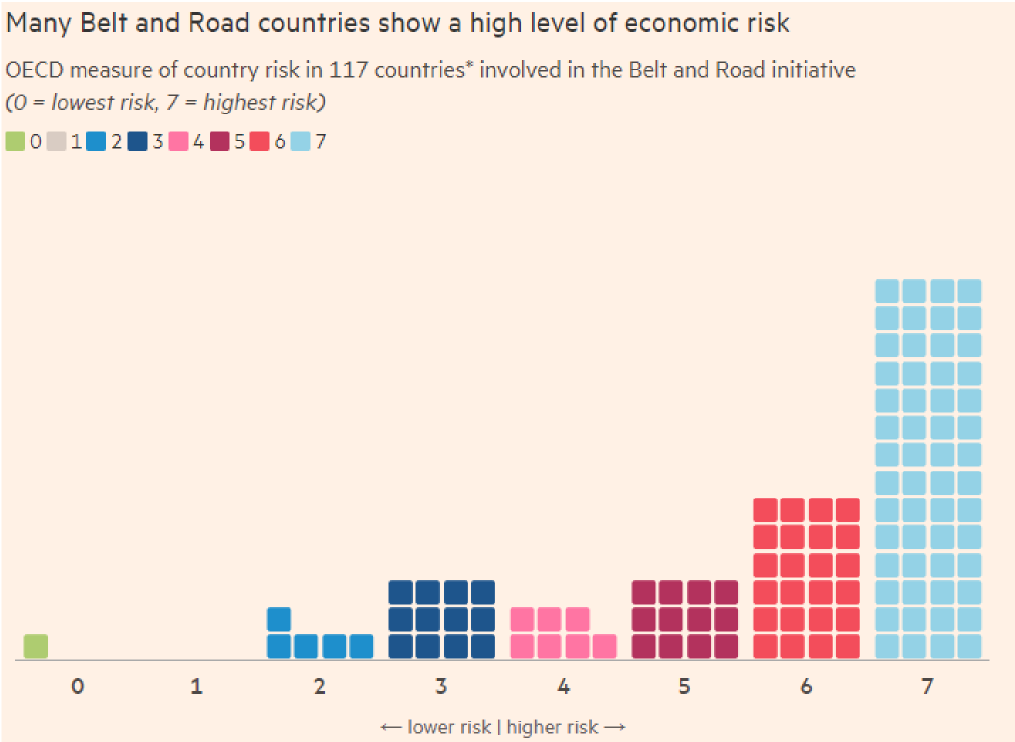
[6] *https://www.forbes.com/sites/wadeshepard/2020/01/29/how-chinas-belt-and-road-became-a-global-trail-of-trouble/?sh=1c7e9219443d*
https://www.forbes.com/sites/miltonezrati/2022/11/21/chinas-vaunted-belt-and-road-initiative-seems-to-have-come-a-cropper/?sh=4952f2241e21

The worst is not over. The next chart shows that by Organisation for Economic Co-operation and Development (OECD) measurements, there are a large number of countries in precarious financial condition in the BRI loan book, the number of "highest risk" countries is astounding and is a sign that problems with loan repayments may continue.

Chart 5 – BRI Countries still risky



https://www.ft.com/content/da01c562-ad29-4c34-ae5e-a0aafddd377c

What China got wrong was not understanding basic economic principles. Many of the countries that willingly took Belt & Road money did so because that country itself was not in good financial condition. Even if the money were in form of a loan, there was a high risk the debt could not be repaid under its original terms. Short of declaring war, there is nothing that China can do about it since the borrower is a sovereign country, so there is no appeal to a higher court. Taking the project as collateral also requires consent of the country in question, and Chart 5 shows that many of these countries are in dire economic condition or do not always follow international rule of law. Just a few such high risk names are Afghanistan, Argentina, Belarus, Cuba, Eritrea, Lebanon, Pakistan, Russia, Sudan, Syria, Ukraine, Venezuela, Zimbabwe. [7]

US $1 trillion in BRI may be sustainable during good times, but the Chinese economy is now under pressure. There is a troubled domestic real estate market, which accounts for 25-30% of GDP; a slower than expected economic rebound from Covid; youth unemployment problem so bad the government has stopped reporting on it; a rapidly aging population; and, ongoing tensions over China's threat to invade Taiwan and its support of Russia in the Ukraine war. The outlook for China's economic growth is probably not as good as it was in the past 30 years.

Chart 6 – 25-year trend China's GDP growth

https://tradingeconomics.com/china/gdp-growth-annual

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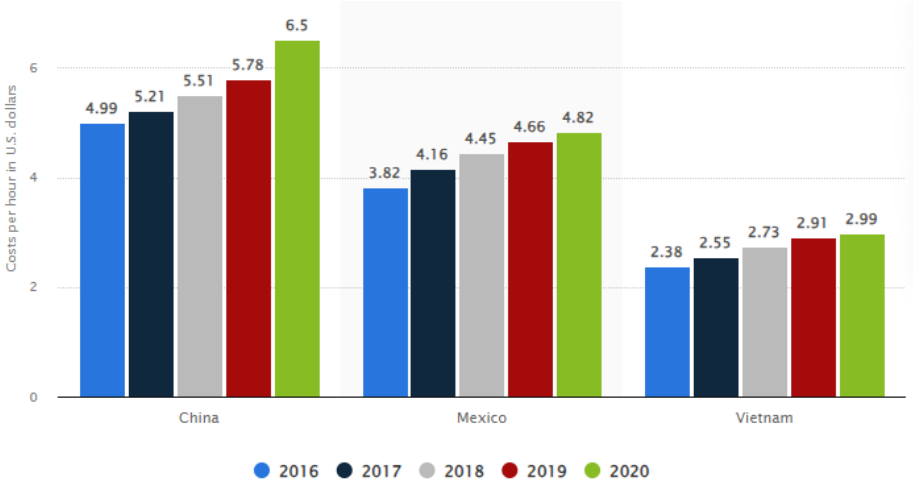
[7] *https://greenfdc.org/countries-of-the-belt-and-road-initiative-bri/*

Conclusion. We are analysts. We use different pieces of data and try to piece a coherent argument for or against owning an investment. When we start looking at the jigsaw puzzle that is China, the problems with BRI get tallied with the positives and negatives.

Into this mix we add one further consideration. We believe there will be a re-onshoring of industrial production in the next 10-20 years and Mexico will be the big beneficiary. Companies will trade lower costs with long supply chains to higher costs but shorter supply chains. Covid demonstrated the weakness of long supply chains, plus China's unit labor costs are now higher than Mexico's.

Chart 7 – Chinese vs. Mexico vs. Vietnam labor costs



https://www.statista.com/statistics/744071/manufacturing-labor-costs-per-hour-china-vietnam-mexico/

China is in the emerging markets category, but it is without doubt one of the main emerging market countries. If China goes up, the rest of the emerging markets will follow – and vice versa.

Therefore, over the past quarter, GIM has been gradually reducing all client's emerging markets exposure. We have been doing this by selling into any emerging markets rallies and the proceeds put into developed markets. The developed markets have weakened (Part 1 of this newsletter) which gives us a good switching opportunity.

Part 3. Summary

The first half of October has seen a continued spike in bond yields and a concurrent fall in stock markets. This is a continuation of late September as the stock and bond markets try to understand when the end of the interest rate cycle is. We remind clients that all assets go through up and down cycles, whether it is a stamp collection or classic cars. We continue to be using this volatility to purchase high quality securities that are on sale. As already noted, we have been lightening up on lower quality securities (emerging markets) and buying higher quality developed markets.

We have been through these types of volatile periods before, and we will again in the future. We continue to like blue chip names with reliable dividend increases. These companies are offering high yields after the recent price decline, which is a rare buying opportunity.

"There's only one reason a share goes to a bargain price: Because other people are selling. There is no other reason. To get a bargain price, you've got to look for where the public is most frightened and pessimistic." – Sir John Templeton

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Thank you for entrusting us with your investments. As always, we welcome your questions and comments. You can contact GIM by telephone: 1.888.436.9955, fax: 1.866.541.7947 or email: invest@gold-im.com

Yours truly,

GOLD INVESTMENT MANAGEMENT LTD.

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