The Weekly Beacon

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.

*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.*

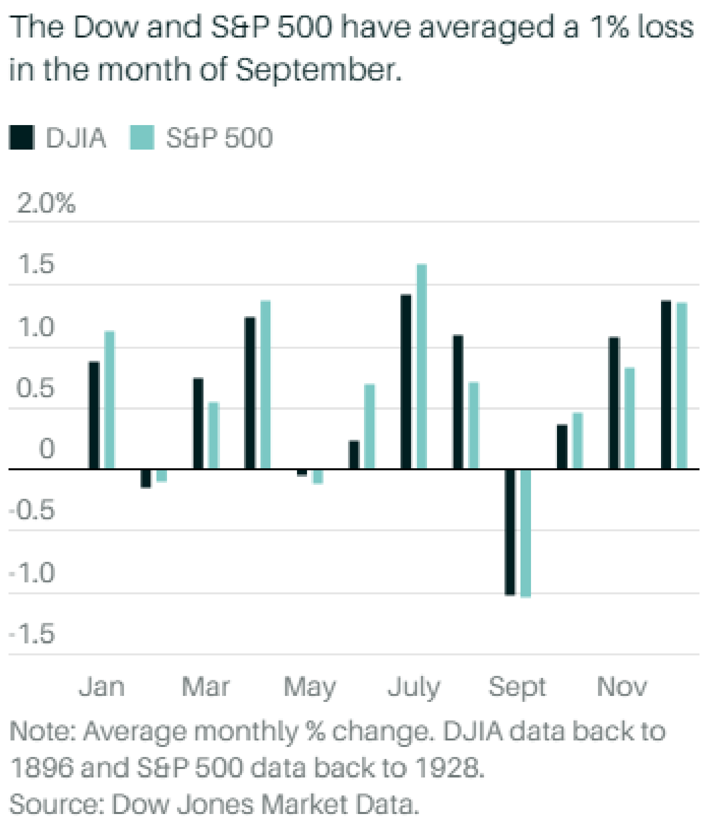
Chania Lighthouse, Greece

Cape Espichel Lighthouse, Setubal Peninsular, Portugal

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

Dog Days of September?

Seasonality tells us that September is the worst month for both the Dow Jones and S&P 500 and it's not even close. Since 1928, the two indexes have averaged a return of -1% for the month. Perhaps, as traders return from their summer adventures and kids go back to school, they tend to raise cash to pay off summer debt, or perhaps it is something else. Either way, we are warning you as September starts next Thursday, and if trends continue it could be rocky.



There is one piece of good news, though: Some of that selling may have already begun. The Dow and S&P 500 were both down Friday and Monday. Maybe September has come early this year.

China on The Brink?

China's economy and financial markets have gone through a whirlwind over the last 12 to 18 months. The Chinese stock market peaked in February-March of 2021 and has yet to recover. Chinese markets have been plagued by scandal, default worries, and even antitrust laws within technology. Investors ran away from China as the risk outweighed the reward. There were safer markets with more trustworthy and stable governments. We warned investors, but were not invested in China directly so we did not sweat what could come.

It appears after all that turmoil in equity markets, the Chinese real estate market could be on the brink of disaster after months of issues. China's property market is about to collapse, and it will arguably have a larger impact than the 2008 Financial Crisis in the U.S. had.

So how did this happen?

What started as trouble with the Evergrande Group (one company) is snowballing into a crisis that risks engulfing some of the biggest developers across China. The sector and developers were extremely levered and most developers' credit ratings have plummeted. Some have defaulted and developers have become desperate.

Developers in China continued to build homes over the last few years even though demand was cooling. The government continued to promote home sales as a smart and safe investment for consumers. Developers continued to throw billions into home development even though there were millions of homes in China that are and were empty. The Chinese real estate market has been described as the wild west by many economists when describing the debt levels that they reached.

HOME > REAL ESTATE

China has at least 65 million empty homes — enough to house the population of France. It offers a glimpse into the country's massive housing-market problem.

Lina Batarags Oct 14, 2021, 3:44 AM

Why did the Chinese government continue to promote home sales as a safe investment and why were they worried about their population's investments? Trudeau and Biden do not give us investment advice so why does Xi give the Chinese advice?

Well for one, China is a communist country and Xi's rules trump all.

In China the land belongs to the state and the government earns billions of dollars from land sales, as well as from the earnings of the real estate market. If the bubble pops, the concentration of wealth in real estate will be a major liability in China. About 70% of the country's household wealth is stored in their property, along with 30-40% of bank loan books, while land sales account for 30-40% of local government revenue according to Pantheon Macroeconomics. The middle class who depends on the value of their homes for retirement and other major expenses will be hurt the most from a real estate collapse.

The fundamental issues that China face can be simply explained by comparing Chinese prices to the U.S. At the peak of the Chinese real estate market, people in Beijing and Shanghai were paying house prices like those in San Francisco and New York, despite having just a quarter the income of American buyers.

It's no surprise that home sales have collapsed by nearly 60% compared to a year ago and the current constant decline in sales (12 months) is pegged to be the worst in China's history. Consumers have stopped paying mortgages and Chinese developers are even taking payments on food and agriculture products. (Imagine, going to TD with a watermelon and a few T-Bones to pay your mortgage this month).

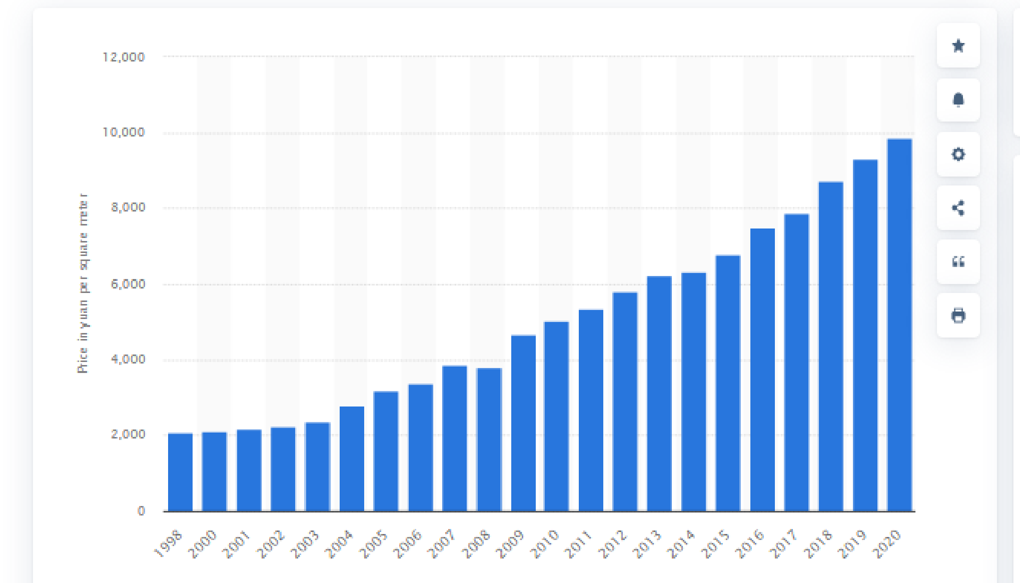
So, will this be worse than in 2008? Not in the west but it could be for China.

China was not affected by the 2008 Credit Crisis. Real estate prices increased in the following year in China.

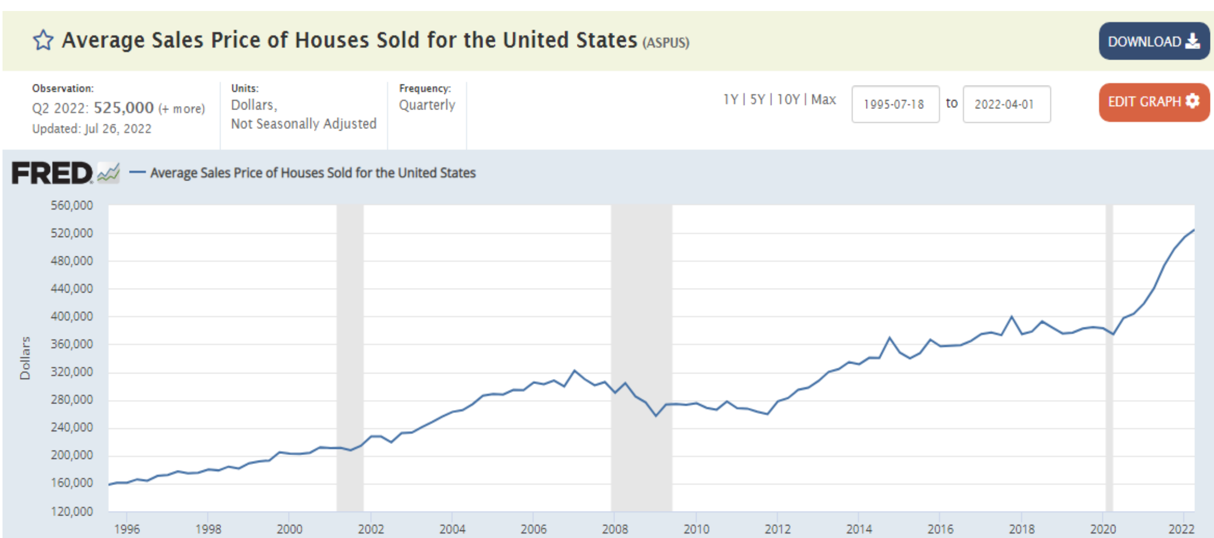
Real Estate

Average real estate sale price in China between 1998 and 2020

(in yuan per square meter)



Meanwhile we know what happened on this side of the world in the real estate world:



China was not hit by the recent housing crisis, but arguably has a much worse problem than the U.S. did in 2008. This screams disaster. Many believe if the government can rein in the problem, the population could handle higher mortgage payments due to a higher savings rate than western nations have. We doubt they can rein in this problem.

Going Forward there are multiple implications……

The Chinese banks are heavily involved in real estate. It is estimated that 25% of each bank's assets are in real estate. But even though they are levered to faltering real estate, these banks will not fail (like they did in 2008 in the U.S.) because they are state-owned.

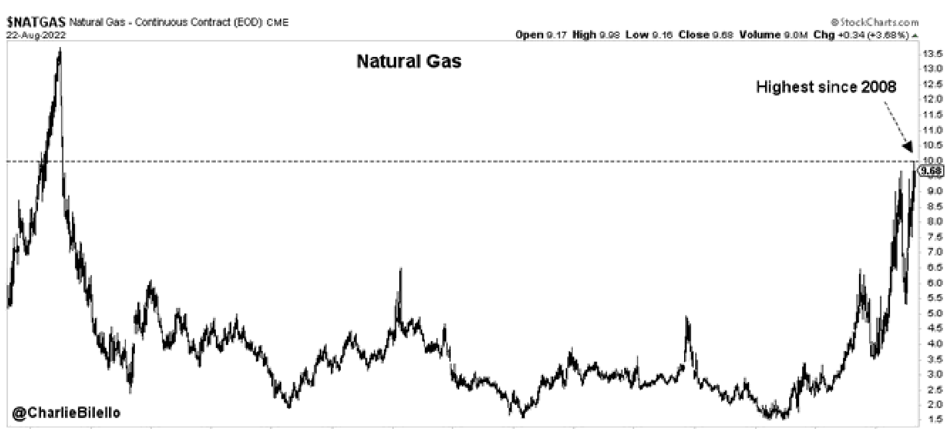
This will impact the world in many ways. Many global investors still own Chinese real estate and Chinese stocks, all of which will drop in value upon the eventual Chinese real estate collapse. China is still the manufacturing hub of the world and if its economy falters, countries around the globe would suffer from slower and more expensive exports.

Either way, steer clear of Chinese equities, real estate, and companies that are heavily reliant on Chinese sales. The fundamental issue could get much worse.

Build Back Better Consequences

The Build Back Better Platform is a plan based on how the economy should work in tomorrow's economy, post Covid-19. One of the cornerstones of the Build Back Better program that has been talked about in the West has been decreasing fossil fuel usage. Companies have divested from traditional energy producers and energy producers have minimized expansion and production. We have long stated that today's energy crisis has been years in the making. We still think that but do believe Build Back Better partially accelerated the crisis.

On Tuesday Natural Gas prices in the U.S. reached their highest price since 2008. For a brief period, the price was above $10 before retreating to $9.25. Even though oil prices are $30 lower than their peak price in June, natural gas prices continue to accelerate higher. This should matter to you. Natural gas is the most common source of energy that creates electricity in North America.



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Natural gas is also the cleanest fossil fuel so ESG and green activists are sometimes okay with using it. Although U.S. prices continue to lag Europe's (which somehow got worse again this week), we expect the spread to close a bit and U.S. prices to get worse as colder weather is welcomed across the U.S.

Perhaps those who preach clean energy, and no fossil fuel use should go without fossil fuels this winter as an experiment to show the rest of us it is possible. We think after a few days of no power, and limited heat, they will realize their thesis is a pipedream in its current form.

We hope recent market volatility in energy did not scare you away. The energy sector has slowly retraced some of its June and July losses in recent weeks.

Natural gas is winning, Canada is not

Canada is one of the world's largest natural gas producers.

Rank	Country	2021 Production (bcm)	Share %
#1	United States	934.2	23.1%
#2	Russia	701.7	17.4%
#3	Iran	256.7	6.4%
#4	China	209.2	5.2%
#5	Qatar	177.0	4.4%
#6	Canada	172.3	4.3%
#7	Australia	147.2	3.6%
#8	Saudi Arabia	117.3	2.9%
#9	Norway	114.3	2.8%
#10	Algeria	100.8	2.5%
	Global Total	**4,036.9**	**100.0%**

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One would think the major run-up in natural gas prices would be good for Canada's economy. One problem: in Canada, it's trading at a MAJOR discount.

News

Why the Canadian dollar is undervalued: Natural gas in US $10, Europe $90, Canada 26-cents

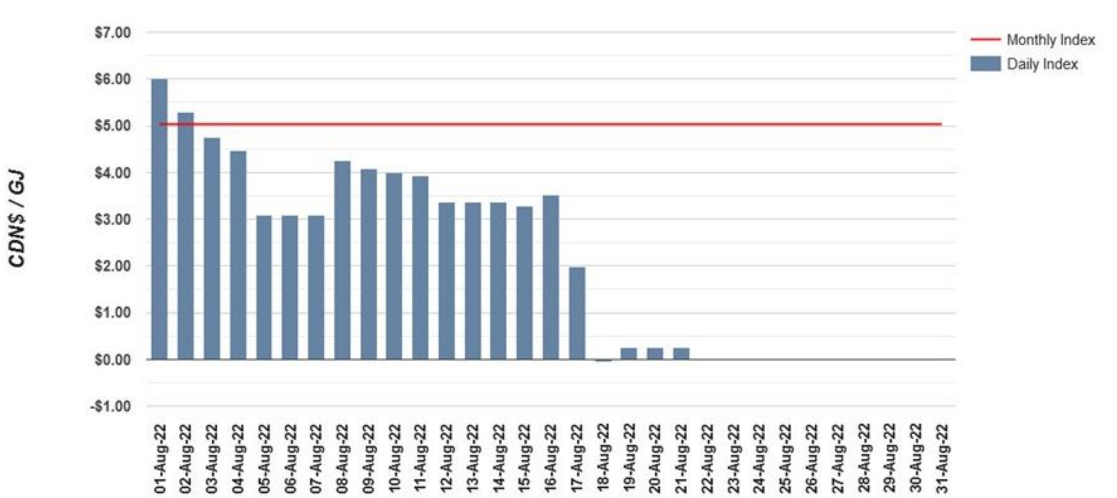
Why is that? We cannot ship it. The whole world wants it and we screwed up so badly over the years we cannot fill the gap in the global energy market. Canada was set up to thrive in times like today. Today's economy should be creating jobs, increasing productivity, and thriving through growth. Instead, we are tripping on our own feet. It is also important to note that the Canadian Dollar would be trading higher if this was not a problem in Canada.

The unfortunate solution to this problem: the solution is something the current Canadian government has shot down.

Pipelines.

Canada has had 20 years to build its LNG industry and has completed exactly nothing. At one point there were nearly 30 projects at some stage of planning, but virtually all of them have been abandoned.

Canadian natural gas prices have trended downward in recent days even while U.S. and European prices have reached multi-year highs.



The LNG Canada project -- which is the only significant one to get off the ground -- is on schedule for completion in 2025.

Trudeau met with the German Chancellor this week and the two agreed on hydrogen energy investments to speed up the transition in energy. There are two issues; it's not fully ready and it's expensive now. The German Chancellor also said he would welcome Canadian Natural Gas as a solution.

August 23, 2022
8:25 PM EDT
Last Updated 12 hours ago

LNG | Fuel Oil | Gas | Transport Fuels | Hydrogen

Germany touts possible 'major role' for Canadian LNG in shift away from Russia

By Andreas Rinke and Steve Scherer

Well, unfortunately, we cannot get it to the east coast to ship it across the Atlantic. Canada could help Germany solve its Russian energy problems but instead, Trudeau is recommending the shipment of Canadian gas through U.S. pipelines. Yes, we know we do not have the infrastructure now but why does he not pledge the money to build it? The energy problem is not going anywhere.

Trudeau douses excitement over East Coast gas exports, calling business case weak

Trudeau said Canada's best chance of helping its allies may be to supply natural gas via existing pipelines to the U.S.

Meghan Potkins
Aug 22, 2022 • 1 day ago • 4 minute read • 61 Comments

Prime Minister Justin Trudeau said there has "never been a strong business case" for liquified natural gas exports from Canada's East Coast to Europe, dealing a blow to those in the energy industry. The business case would promote more jobs, a stronger Canadian dollar, increased productivity, and greater economic growth, but who's counting?

General Electric Wins

A few weeks back we mentioned the split of General Electric and how the company will be split up. It seems one of the three companies that will evolve from the tear down of the titan was a big winner from the Inflation Reduction Act. General Electric energy should get a big boost from the new law's production tax credit, or PTC, for wind-power generation.

In the year's first two quarters, GE's renewable business generated less than $6 billion in sales, down almost 20% from the $7.3 billion in 2021's first two quarters 2021.

Wall Street 2022 earnings estimates for GE have gone from roughly $4 a share to $2.80 over this year. "This is why the restoration of the PTC in the Inflation Reduction Act, with project visibility over the next 10 years, is such an important catalyst for recovery," Nigel Coe, Wolfe Research. "We also note that there are significant manufacturing credits worth up to $100m per [gigawatt] of turbine capacity that could provide additional support."

The analyst called the legislation a "key catalyst" for the stock.

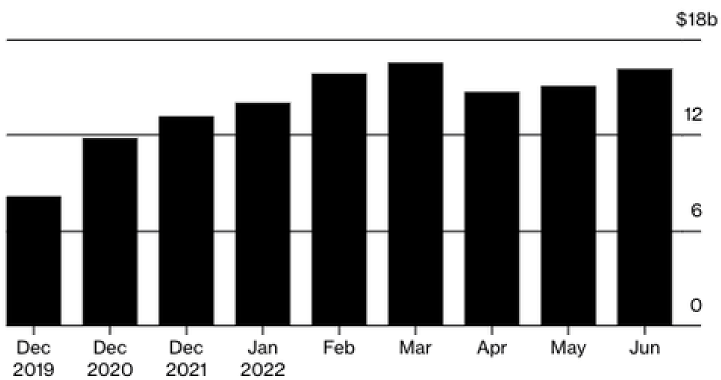
We are not massive wind energy bulls, but this Bill could have some value going forward, especially for the eventual General Electric Energy company.

<u>**Problems at the Pump AND on Utility Bills**</u>

For months consumers have been getting hit hard at the pumps due to high oil prices. It's been headline news every week. Unfortunately, rising power bill prices are seemingly being reported less. Outlets talk about European power bills rising but never mention rising bill prices in the domestic market.

It seems we are at a breaking point in terms of utility bills. At least 20 million households (1 in 6 American homes) are behind on their power bills as soaring electricity prices spark what is said to be the worst-ever crisis in late utility payments, according to Bloomberg. Yes, we know part of being behind on bills is due to the overall economic backdrop in the U.S., but part of the problem is also higher prices.

Total US Overdue Utility Balance



Source: National Energy Assistance Directors Association

Electricity prices are at multi-year highs in the U.S. and it's no surprise why. Natural gas is at its highest price since 2008 and natural gas powers almost 40% of the U.S. electricity grid.

MacNicol & Associates Asset Management Inc.
August 26, 2022