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THE SCHOONER

The official newsletter of the Dalhousie Investment Society (DALIS)

DALIS is Back.

After two years of restrictions, zoom calls, and missing the buzzing classroom, we are back! This September, the Dalhousie Investment Society saw the return of unrestricted in-person events and we could not be more excited to welcome everyone to DALIS 2022/2023.

Our goal this year is to continue to provide members with knowledge and experience that will result in bridging the gap from the classroom to the financial services industry. We will be building on the speaker series from previous years, hosting professionals from industries including Sales & Trading, Investment Banking, Private Equity, Wealth Management and more. Our members receive real trading experience through the Maritime Fund, a mock hedge fund intended to achieve strong returns by employing a multi-pronged strategy on global markets. A diversified set of sub-funds include EIR (Energy, Industrials, and Real-Estate), FCT (Financial, Consumers, and Technology), Commodities, and Global Macro.

DALIS will be run this year by Co-Presidents Nick Francis and Noah Hitzig who previously served as Portfolio Managers throughout the 2021/2022 year. Having completed his summer internship in Wealth Management at Scotiabank, Nick has been inspired to pursue Private Wealth Advisory upon graduation. Noah completed two internships at CIBC Capital Markets, recently on the Debt Capital Markets desk and previously their Prime Services desk. The DALIS executive team is also made up of Vice President Abby Desveaux, and executives Jackie Clegg and Tac Chatterson. Abby has completed two work terms at TD Securities in Sales & Trading which she hopes to continue post graduation. Jackie has worked in asset management at Mackenzie Investments as well as working this past summer at RBC Capital Markets. Tac holds work experience in buy-side corporate development as well as investment banking which he is looking to pursue full time. The Maritime Fund is managed by eight portfolio managers and twelve analysts, all with relative industry experience.

Our executive team is proud of this year's participation and looking forward to an eventful year ahead with many more Schooner issues and Rick's rants to come!

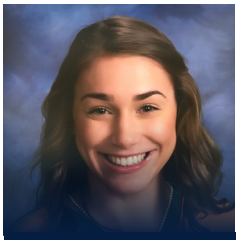
Nick Francis and Noah Hitzig, Co-Presidents

A glimpse of what's inside:

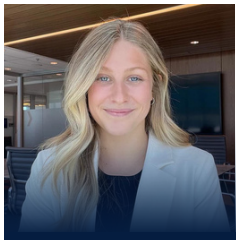
Executive Team

Nick Francis
Co-President

Noah Hitzig
Co-President



Abby Desveaux
Vice-President



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Vice-President, Finance

Tac Chatterson
Executive

Jackie Clegg
Executive

Commodities

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Portfolio Manager

Emmerson McNamara
Portfolio Manager

Ian McKee
Senior Portfolio Analyst

Saeid Rafiei
Junior Portfolio Analyst

Adbel-Rahman Selim
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Portfolio Manager

Kyle Grabke
Portfolio Manager

Tait Carlson
Senior Portfolio Analyst

Lauren Tigert
Junior Portfolio Analyst

Michael Caissie
Junior Portfolio Analyst

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Portfolio Manager

Chris Lauer
Portfolio Manager

Jack Durno
Senior Portfolio Analyst

Alexandra Nichols
Junior Portfolio Analyst

Hoang Quach
Junior Portfolio Analyst

Global Macro

Shashank Mukundan
Portfolio Manager

Arsh Merchant
Portfolio Manager

Thomas Fallows
Senior Portfolio Analyst

Monica Conohan
Junior Portfolio Analyst

Aidan Spencer
Junior Portfolio Analyst

Alumni Spotlight: Blake Newell

Director, CIBC Debt Capital Markets

Portfolio Manager, 2017/18 DALIS

Can you tell us a little bit about your career to date?

I started my career in Scotiabank's Sales & Trading Rotation Program in 2018 after finishing my final co-op on the structured notes team at the end of my 3rd year. I rotated across desks for about 8 months, including 3 months on the rates trading desk in the UK, before landing in Debt Capital Markets full time in 2019. I primarily covered financials, real estate, and power & utilities before joining CIBC's DCM team in October 2021. At CIBC I initially joined to cover energy and telecommunications but have since transitioned back to the financial and real estate sectors.

What was the most valuable experience you received from DALIS?

DALIS pushed me to follow the markets daily which while in university lends credence to you in job interviews by validating your interest. It also lets you speak to trends and historical events as opposed to a single item - it's a lot more impactful to talk about an M&A story you've followed for 8 months in an interview as opposed to reciting a day-of newspaper headline (though you should do this too).

DALIS also taught me how to present ideas clearly and with enough detail. Pitching a trade to your industry group can be tough but it's a space for you to get better, and the questions you get prepare you for tougher ones you might get down the road. Plus, if you can credibly justify your orange juice futures trade in an interview you'll stand out a lot more than someone who pitches a blue chip stock.

What is one piece of advice that you have for current students trying to enter the Capital Markets industry?

Networking is an obvious one, but if you're going to be talking to industry professionals make sure that you've prepared. If you have a coffee chat, do research on the person's role/firm and come ready with questions to ask. If a student clearly doesn't understand your business at all, I can tell you the coffee chat will be short! Asking about market trends or big events makes for a much more interesting discussion and helps you stand out vs those who ask more generic questions.

For interviews – practice, practice, practice. It's clear when a student has practiced interview questions and they come across as much more polished. You know that every interview is going to involve some version of "tell me about yourself" and "what's your biggest weaknesses" so make sure you're ready with answers. Mock interviews with friends, even if they're not in finance, can make a big difference. Practice will also keep you sounding professional and avoid saying things such as "rates are like, super high right now" (actual interview quote).

What is one opinion that you have that most people disagree with?

Contrary to popular belief, it is possible to put too much cheese on something.

If you were not on the DCM desk, where would you want to work and why?

I've always thought a corporate fixer would be interesting – being parachuted into struggling businesses to turn them around. I've always had an entrepreneurial streak and I think it'd be fun to be pushed into unfamiliar situations and try to solve them.

Can Investors Trust Truss?

Nick Francis, Co-President
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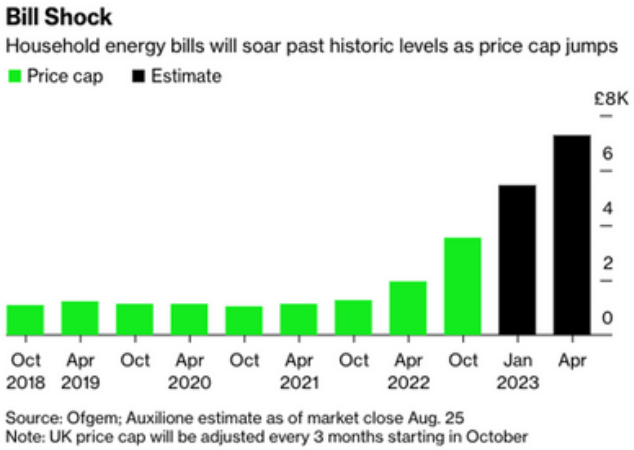
It is evident that recent headwinds such as inflation, supply chain disruptions, and labour shortages have created global economic uncertainty. However, what may be less evident to the general population is the immediate loss of credibility of the United Kingdom's new government by planning to implement a neoliberal fiscal policy without considering the current struggling economy.

Before we get too deep into the chaos, let's take a step back and consider the past. Three apparent economic disruptors in the United Kingdom have been Brexit, Covid-19, and the invasion of Ukraine. The economic turmoil began in 2016 following Britain's vote to exit the European Union and worsened in 2020 when they officially separated. At that time, UK Foreign Direct Investment and trade with the EU plummeted to levels worse than the 1980s recession. Lockdowns took an unprecedented toll on the labour market, causing the UK government to subsidize £70bn in wages throughout the pandemic. Remarkably, that is not even the worst of it. In late February 2022, Russia forced a war upon Ukraine, which sparked an energy crisis across the globe and left families fighting to survive. Particularly in the United Kingdom, citizens are questioning how they will afford to heat poorly insulated homes.



We now understand that the United Kingdom is earning less on trade and foreign investment; simultaneously being forced into large spending, so let's dive into the new government structure. Former Prime Minister Boris Johnson's time is up as he recently passed the torch to Liz Truss and appointed Kwasi Kwarteng as Chancellor of the Exchequer.

The new duo also made the executive decision to terminate the most senior civil servant of the British Treasury, Tom Scholar. They have, without a doubt, disrupted the current state of the UK's economy by throwing stability out the window and focusing exclusively on economic growth.

With the support of Prime Minister Truss, the Chancellor publicized his plans to cut the current 45% tax rate on those in the highest bracket earning £150,000, cancel the 2023 6% corporate tax increase, and mitigate the basic income tax rate from 20% to 19% in 2023. Investors lost confidence in Kwarteng following the announcement that government debt will fund the £45bn deficit. Astonishingly enough, the spending doesn't stop here. In response to the energy crisis, Prime Minister Truss implemented a price cap on annual household energy bills and has committed to subsidizing £100bn over the coming year.

The UK financial markets have watched £500bn of market capitalization disappear since Truss entered office. Following the policy announcements, the yield on 10-year gilts (UK government bonds) skyrocketed briefly from 3.5% to 4.3% by market open. The immediate market sell-off was caused by investor assumptions that the Bank of England will be forced to intervene to avoid a systemic collapse. The sterling pound crashed to 1.03 against the US dollar, a historic low, and remains weaker than we have seen since 1985. Unless the BoE acts fast and aggressively, a weak currency will likely increase import costs, a burden that will pass on to the consumer. Considering the UK is dependent on importing roughly 50% of food and energy, inflation is at risk of exponentially increasing. This market decline will have a large impact on pension funds, and future interest rates will continue to hurt highly leveraged organizations.

The recent trends have caught the attention of economists around the globe. Some are traders capitalizing on the exchange volatility, and others are politicians using it to distract the public from their own issues. One example is the recent remarks from Turkish President Tayyip Erdogan stating that the pound has "blown up." The Turkish lira is down 28% YTD and 80% over half a decade, while the country currently obtains the highest rate of inflation in the G20 at 80.21% in August. Despite the central bank implementing back-to-back 100bps rate cuts, President Erdogan has neglected inflation and stated interest rates "need to come down further." Although Turkey's monetary policy and UK's fiscal policy are not parallel, there is a similar trend in counterintuitive approaches to combat economic turmoil.

The UK is suffering a financial crisis that many argue was self-inflicted by Liz Truss and Kwasi Kwarteng immediately upon acquiring political leadership. In an attempt to keep the UK afloat, The Bank of England has now begun purchasing long-term gilts in a £65bn commitment to protect liability driven investment funds from the risk of collapse. The near future shall determine the success of the UKs attempt at economic growth as the Bank of England pumps the brakes while the UK government steps on the gas.

So, You Failed a Test? Let it Go.

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Failing a test does not mean you're stupid, and it certainly does not give you an excuse to give up. Think of it this way: if you messed up at work, would you quit? Of course not. So why do you assume you're doomed in a course after one bad test?

Listen, I'm no exception. I've failed three tests at university. I know the feeling – it sucks. If it happens to you, it's natural to want to pull away. It's human instinct to avoid things that have hurt us in the past. This instinct serves an important role in keeping us safe. Although it may be helpful to recognize that "tequila = hangover", and consequently decline another shot, the same logic does not apply to school. If you disassociate from a course you are struggling in, it will only come back to bite you in the butt. Instead, as a student, I encourage you to pull the brakes on this feeling and turn your car in the other direction.

The best thing you can do when you fail is lean in. Take control of your fear and use it as fuel to push you forward.

I'd argue there are four key steps to do so: 1) take accountability, 2) determine why, 3) plan, and 4) act.

1. Take Accountability

- Making excuses will get you nowhere. There will be professors you don't like, and there will be hard tests. Welcome to university. You need to focus on what you CAN control. Accepting that you could have prevented the failure is not accepting that you are stupid. Instead, it's acknowledging that there is a viable path to do better in the future. Accepting accountability makes failure a learning experience, setting you up for future success.

2. Determine Why

- It's ignorant to assume that intelligence is the only factor in test performance. This misconception wrongly equates failure to stupidity, often deterring us from moving forward. Poor performance can have absolutely nothing to do with your level of intelligence or your preparation. Broadly speaking, I'd argue that there are three main categories of questions to help explain why you may have 'shit the bed'.

  a. Headspace

  - Did you get enough sleep? Did you eat properly? Are you fighting with your boyfriend/girlfriend? Did you go a little too hard on the weekend? Were your roommates laughing in the other room and distracting you? Was your room a mess?

  b. Ability

  - Did you study enough? Did you study the right material? Did you not understand the material? Did you go to class? Did you pay attention and ask questions in class?

  c. Approach

  - Did you get hung up on one question? Did you go through it too quickly?

Understanding the factors that led you to your present failure is critical in preventing it from happening in the future.

3. Plan

Once you understand why you've failed, it's time to make a plan to ensure it doesn't happen again. The examples above are all valid reasons for not performing your best, but they are not valid excuses. For each, there are practical solutions. Need extra help? Get a tutor. Didn't eat before? Eat. Roommates in another room were distracting you? Find a quiet place to write. It's not rocket science!

4. Act

As with anything, a plan can only get you so far. For it to work, you need to act. For example, if you determine your 'why' was that you prioritized re-writing notes rather than attempting practice problems, a logical plan would be to spend more time on practice problems and less time on notes. As a first step, you could ask your professor for help finding more practice questions or suggesting a focus area. If you wait until the night before to hit your professor with that "you up?"- type email, it's going to be too late. You need to proactively follow your plan in the weeks leading up to the next test. For instance, sending your professor a message the week following your failed test and committing a couple of hours a week to practice problems thereafter.

My hope in writing this article is to offer support to those who may be struggling to accept failures in university and offer advice on how to move forward. As I mentioned in the beginning, I have failed three tests in university. I feel comfortable discussing my shortcomings because I have not let them define who I am. Despite my failures, I still have my academic scholarship, honours status, and most importantly, a signed contract for a post-graduate job at my dream firm. What more could I want? I encourage anyone who may be struggling or has comments/feedback, to reach out. My ears are always open.

Opinion: The Ride Ahead

Please keep arms and legs inside at all times

Max Barrow, FCT Portfolio Manager
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Well... here we are, almost five months since the last schooner was published featuring my article, "Recession Warning!", on recession indicators and defensive portfolio structure. I hate to say it, but we are still very much riding the emotional economic rollercoaster we were back in April of this year. Through the pandemic, with the help of (over) inflationary spending, quantitative easing, and elevated asset prices, we crept up the initial incline preceding what has become and will continue to be, an exhilarating ride ahead.

In my last article, I covered the infamous yield curve, a term that most retail investors are now all too familiar with (and not for good reasons). An inverted curve often preludes a recession, which resulted in it being recognized as a recession indicator in 1986 in a thesis written by a financial economist at Duke University.

These spreads have a proven track record, inverting before each of the 7 major U.S. recessions since 1960, with only one false alarm.

What's Happening Now?

At the time of the April Schooner, five-year and thirty-year yields were inverted, and I wish that were still the severity of the situation.

Six-month and thirty-year yields have now inverted with the two-year yield the highest on the curve - yikes. The Federal Reserve tends to focus on the spread between three-month and ten-year yields, which have not yet inverted. The negative spread comes as the Federal Reserve lifts rates from the near-zero level maintained throughout the pandemic. This aggressive pace is an effort to fight high inflation since COVID-19's inauguration. Inflation rates are sitting at approximately 8.3% and 7.0% in the US and Canada, respectively, continuing to sit well above the 2% target.

These circumstances often precede a recessionary period - contradicting the Federal Reserve's alleged "soft-landing". How do you feel your portfolio's "soft-landing" going so far?

Further, target rates for both the United States and Canada sit at 3.25%, following the most recent hike of seventy-five basis points (0.75%) at the start of September. Central Banks must act in such an inflationary environment to maintain their credibility as the keepers of the economy. But when can we consider their policies to be overdone? Ray Dalio, a billionaire investor, calculated that a hike in rates to four-and-a-half percent (which is likely) could spark a twenty percent decline in stocks; that may hurt. Central bankers are having issues with their 'economy device' and they are now poking a needle into the itsy-bitsy reset button. The only problem: there's no manual, no guidance on how long to hold down the button or how long the reboot process takes.

What Next?

I am not a negative person, but it seems that each day, the pessimist outlook moves closer to that of a realist. The self-fulfilling prophecy of a recession seems inevitable, and the central banks are not helping. Although Wall Street asset prices are down shy of 25% year-to-date, and Bay Street down over 12%, the Federal Reserve and the Bank of Canada continue to increase rates to pummel inflation. Investors feel their portfolios are being punished in the process, and it's not over yet. Stanley Druckenmiller, famed for never having a down year in the markets (yet), appeared at CNBC's Delivering Alpha Investor Summit, where he said he would be "stunned if we don't have a recession in '23 and would be surprised if it's not larger than average."

This article is not written to confirm that we are in the preliminary stages of recession; instead, it aims to inform investors of the current macroeconomic situation and the likelihood of further financial market decline.

What Should you do?

Well, first things first, you could always go back and read my article in the April Schooner, which covers recession-proofing a portfolio. Else, the 'Cole's notes' version would suggest diversifying, rebalancing, and arguably most of all: being patient.

Certain sectors tend to be a haven during recessions and often incorporate an income-generating capability. Consumer staples, such as food and beverages, healthcare, and household goods, are necessities and will experience continuous demand regardless of economic conditions. Such investments could be considered a solid foundation in gloomy times.

Professor Rick Nason has three rules, two of which I will emphasize below:

1. Cash is king
2. When you finally realize its a trend, it's a cycle

Having cash in your portfolio is not necessarily something to avoid. First, many strategic investors will preserve a certain percentage of their portfolio in cash. This not only allows for ultimate liquidity in times of emergency but also allows one to take advantage of buying opportunities in down markets. Second, since the inception of the financial markets, there have been swings in asset prices and the health of the overall economy. However, Professor Nason suggests that by the time you can recognize and anticipate the trend, the cycle will grab hold, and there will be a change in direction.

Final Thoughts

This may all sound quite alarming (a contradiction to my optimistic self) given the current state of the economy and the communications coming from big wigs and billionaire investors. However, fear can drive an individual to make decisions one would not otherwise act upon. Napoleon Bonaparte believed that it is important to stick to the task at hand, regardless of the acts of others. He defined a military genius as "The person who can do the average thing when all those around them are going crazy." This concept can be carried into the financial markets. When the stock market is crashing, buy stocks on the 'end of cycle' clearance sale, no different than how you would shop for new shoes. Most importantly, I will restate the conclusion from my previous article: DO NOT PANIC!

Are the Dollar Days Numbered?

Monica Connohan, Global Marco Junior Analyst
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As a consequence of invading Ukraine, Russia suffered crippling sanctions at the hands of the United States government. These sanctions showcased the immense power the US holds thanks to its dollar, the dominating global currency. Following recent news, the USD hegemony has prompted many countries to reconsider the global status quo under the dollar and develop potential alternatives. The threat of a weaponized US dollar sparks especially large concerns in countries like China, who not only may find themselves in a similar geopolitical situation as Russia (with Taiwan) but also holds frustration with economic dependence on the US.

The USD holds this impressive power thanks to its role as the world's primary reserve currency, a position it has held since WW2. The dollar essentially acts as a vehicle for cross-border operations, making it incredibly important for international trade and central bank reserves. As of 2022, the dollar makes up about 60% of the world's reserves, with the next closest contender barely reaching 20%. In market share of global trade, the USD accounts for 87%. However, there have been talks of replacing the dollar, especially with recent developments of the digital yuan.

SPOILER ALERT: the dollar is not about to be dethroned. Not today, not tomorrow, and not anytime soon. The doom and demise of the dollar have been projected for decades, beginning most notably with Nixon's end of USD-Gold convertibility. And yet, the dollar remains king. However, if world history and a global pandemic have taught us anything, it is that nothing is impossible. Thus, the concept of a replaced dollar remains an intriguing topic to explore. This article explores the yuan's potential as an alternative to the USD.

It has been no secret that Chinese officials have made a case for the yuan over the past couple of years. As China's economic strength continues to grow, they seek Yuan domination for its many benefits and release from the macroeconomic whim of the US.

The digital yuan experiment, or the "E-CNY," began in Late 2020 and has since been adopted by 260m people, 4.5m stores, and used in $12bn USD worth of transactions. No, this is NOT a cryptocurrency. Unlike anonymous, decentralized cryptocurrencies, the digital yuan is backed by the PBOC and considered a legal tender.

Therefore, aside from concerns of Chinese citizens about privacy, this new form of money stands to help the internationalization of China's currency, as it is a cheaper and easier medium for cross-border payments. Chinese officials push this convenient currency to trading partners and developing economies. However, despite all the efforts and attempts made by the Chinese government to provide this alternative to the USD, it cannot compare to the USD in scale. The dollar makes up the majority share of the world transactions and reserves, whereas the yuan barely cracks 3%. Additionally, China lacks desirable traits such as liquidity and free capital markets, characteristics that would require a political trade-off from a government that is most likely not very willing. Overall, the context under which the yuan exists makes it less desirable than the USD to both private and public investors.

As previously stated, we should not expect to see the demise of the dollar soon. Current alternatives can't generate the "steam" to overtake as a dominating world currency. Perhaps under some future conditions the dollar will fail. Maybe the future will see a more diverse international ecosystem, with the yuan, euro and dollar sharing more equal parts of the pie. It's possible that none of these things happen, and about a million different other scenarios could occur instead.

Monetary Policy

Where is it going?

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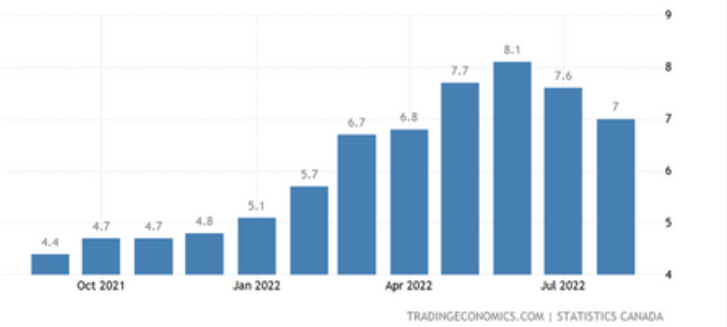
Since 2020, the world has faced many unique challenges, including but not limited to: a global pandemic, changing of geopolitical affiliations, wars, and supply chain disruptions. As a result, the word "uncertainty" has become prominent in everyone's vocabulary. Undoubtedly, much of this uncertainty within the market has arisen from the record high inflation rates we are experiencing in today's economy. As a result, the Bank of Canada has been aggressive in its use of conventional monetary policy tools in an effort to lower inflation. But the question remains as to what interest rate will return inflation to target while preventing the economy from falling into a recession.

The Economy Today

To forecast the future of monetary policy, it is essential to understand how the economy is performing today, and the actions taken thus far by the Bank of Canada.



Graph depicts Canada's inflation (%) over the last year.

Since January 2022, inflation has grown exponentially, dramatically impacting debt and equity markets, as well as consumers' purchasing power. Despite the Bank of Canada initially claiming that inflation was transitory, they have since responded to the inflationary environment through interest rate hikes. In March, the bank announced its decision to raise interest rates from the zero lower bound, ending over a decade of extremely low interest rates. On September 7th, the central bank announced its fifth rate hike this year, bringing the overnight lending rate to 3.25%. The actions taken by the Bank of Canada have been very aggressive as they currently have the highest policy interest rate among the G7 countries. Through published reports and policy decisions made by the central bank, it is unmistakable that they are reaffirming their 2% inflation target mandate.

Forecast of Canadian Interest Rates

While no one can say for certain what the actions of the Bank of Canada will be, there is a strong consensus within the market that we have not seen the end of rate hikes. Moreover, while the cycle of interest rate increases has cooled down the economy as inflation fell from 8.1% in June to 7% in August, it remains too high to assume that rate hikes are in the rear-view mirror.

The unprecedented nature of the post-pandemic world has made it increasingly challenging to predict the exact neutralizing interest rate. Economists vary in their projections of rate hikes, as some have predicted the Bank of Canada will continue to be aggressive with policy decisions bringing interest rates as high as 5%, and others have predicted interest rates will go to only a mere 3.5%. Personally, I believe that rates will rise to 4.25% before the end of 2023. Based on its actions in the past, I am confident in the bank's ability to execute its singular mandate. Therefore, I think they will continue aggressive policy actions to curb inflationary pressure. I do not think that rates will rise significantly higher than 4% as I believe this may create instability within the economy and could cause an overcorrection. The central bank has claimed that a main cause of this high inflation is the rise of commodity prices, increases in real estate costs and supply chain disruptions.

Nevertheless, over the last few months commodity prices have fallen significantly, the real estate market has begun to settle down, and there have been fewer economic lockdowns, lessening disruptions to supply chains. Considering this, it is unlikely that the bank will need to make significantly more rate hikes in order to get inflation under control. Policy lag is an important caveat to this prediction, as it is important to note that any decision made by the Bank of Canada takes some time to take full effect. Since it is difficult to project the length of these lags, it may be uncertain as to when they have taken full effect.

Overall, in the short term, it is expected that inflation will remain above target likely until 2024. However, I believe we are nearing the end of aggressive policy decisions and rate hikes. The next interest rate announcement is expected on October 26th.

An Oil and Gas Opinion Piece

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An unorthodox and controversial statement from a studentin 2022: I believe that oil & gas companies should be honoured for their service and relieved from the pressures of today's government. In support of this controversial statement, I will share some facts, arguments, and thoughts defending the oil and gas industry against society's intense criticism.

According to the Environmental and Energy Study Institute, 80% of the world's energy is produced with fossil fuels, and around 81% of that energy is composed of oil and natural gas. For over 150 years, the globe has reaped the benefits of oil & gas to power technological innovation. Simply put, there is no denying that our world is built on petroleum.

Transformation of the LA oil field from 1902 to 2022

I'll begin by listing a few reasons why we should reconsider our discrimination toward the oil industry:

- ·Any and every product you own is made with petroleum,
- ·Advancements in the medical field wouldn't have been possible,
- ·Convenient travelling, and transport of goods,
- ·Heat (50% of Nova Scotia still runs on heating oil),
- ·The industry's consistent effort to remunerate and reclaim the damage from their operations.

I believe that the government should rethink its approach to regulating the industry. In reflecting on past years, it is not hard to see companies' difficulties in staying afloat. Many declared bankruptcy when prices were low leading to orphaned wells and damage left unfixed.

From my perspective, I believe that instead of phasing out oil at an unsustainable rate, we should encourage companies to continue growing, innovating, and designing cleaner solutions. It's important that Canadian companies sell their oil to other countries, but that isn't possible without sufficient egress. We must support pipelines.

Overlooked and the recipients of public contempt, oil & gas companies are beginning to transition to alternative energy sources faster than other industries. I firmly believe the transition is possible, but we can't accomplish it without our oil industry.

Why don't we start from the bottom and work toward a cleaner Earth? Start by eliminating coal energy which, by the way, produces ~67 more pounds of Co2 per million Btu than heating oil and ~112 more pounds than natural gas. Additionally, we could work to replace costs in government to subsidize well-capping efforts for the estimated 10,000 orphan wells in Canada (81,000 in the US) that release toxic chemicals and greenhouse gases. Furthermore, the construction of pipelines improves environmental conditions, since they are cleaner and less risky than trains and trucks.

With all that in mind, I can reaffirm the statement that focuses on rewarding the oil industry and relieving some regulatory pressure. After all, energy companies really do have our best interests in mind.

Rare Earth Elements and Lockheed Martin: An M&A Report

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Why Lockheed Martin should acquire MP Materials

The new F-35 fighter jet developed by Lockheed Martin (LMT) has orders stretching over the coming decade. Earlier this year, Finland announced the purchase of 64 LMT F-35s. The jets are expected to be delivered to Finland before 2030. On the other hand, the U.S. military has ordered roughly 2,400 F-35s; NATO allies have ordered another 900 jets. With such a large number of backlog orders, there is a piece of the supply chain that is particularly at risk. Rare Earth Elements (REE) are particularly fundamental for the production of critical components such as power systems and magnets for the F-35, with an estimated 400kg of REE required to produce each jet. The risk is due to China's dominance over the production and supply of REE. In Feb. 2021, the Chinese government signaled that it may restrict the export of REE to secure domestic production needs. Despite long-term contracts in place to purchase these elements, if China intends to disrupt the U.S. defense industry, they could easily restrict the export of REE to the U.S.

LMT has been gradually ramping up production and deliveries of the F-35. In 2021, the company delivered 133-139 jets, 151 in 2022, and anticipates delivering 156 jets per year thereafter. 156 jets per year is the full-rate production and is set to remain the same till all orders are fulfilled over the next decade. Any disruption of REE supply from China poses a serious and immediate risk to the continuity of the F-35 production process. This has become a real concern in recent years with China's increasing aggression towards Taiwan and the renewed commitment from the U.S. under president Joe Biden to defend Taiwan. Historically, LMT has played a crucial role in supplying fighter jets to Taiwan, which has led the Chinese government to ban LMT from selling weapons in China. Moreover, the director of the CIA has publicly stated that U.S. lack of REE mining poses a serious risk to national security.

MP Materials is the largest producer of REE in the U.S. The acquisition of MP Materials, in our view, ensures the stability and continuity of the production process at the predicted full-rate of 156 jets per year. In case of Chinese export restrictions on REE, acquiring MP becomes fundamental to LMT's ability to produce and fulfill orders of the F-35 on time. If LMT gains partial control over MP Materials, they may be only able to secure a limited supply of REE as supply is split between U.S. companies desperate to keep producing their products including other defence companies directly competing with LMT. Conversely, if LMT owns MP Materials, they can ensure their supply chain needs of REE are fully met.

Why Debt Financing Makes the Most Sense

At first, you may think in current market conditions with interest rates on the rise that debt financing would be less ideal than in the past. However, as the economy slows, LMT has a distinct advantage over many companies due to their stable long-term government contracts that should not be affected by an economic slowdown. This makes their debt attractive as they are highly unlikely to default given this structure and increasing demand from allies for their top-of-the-line F-35s. Moreover, we are back into a high inflationary environment with inflation rates at 8.6%, meaning even with higher interest rates, LMT's real cost of borrowing when accounting for inflation will be minimal. Securing this financing will allow LMT to do a share purchase of MP Materials. In my view, share purchase is the best option as it is more likely to be approved by the board due to tax benefits for long-term shareholders as well as the ability to keep current government contract aimed at constructing a new processing plant near MP's mining site, which will further allow MP to be fully independent from China. An asset purchase deal would offer better tax advantages for LMT as they would be allowed to revalue the assets and depreciate them accordingly. However, I do not believe this outweighs the benefits of a share purchase, in this case allowing the business to operate as a fairly independent subsidiary.

Overview of MP Materials

MP Materials currently has a market cap of $6.17B. MP is the largest producer of REE in the Western Hemisphere, currently delivering approximately 15% of the global supply of REE. Concerning the production process, the company currently ships mined REE over to China to be processed. However, the U.S. government has awarded MP a $35M contract to design and build a new processing plant near their California mine.

This will not only deliver substantial cost savings related to shipping mined materials to China for processing but also solidify their independence from China. The company's operating cash flow was up over 30% for the year ended 2021. Revenues were also up nearly 150% in the same time frame as the price of REE has been rising dramatically. The company has a quick ratio of 24.76, indicating they are in great financial health. They also boost a debt to equity ratio of 0.62, indicating their growth has not been overly reliant on the issuance of debt. MP currently trades at 32.87 times earnings which is difficult to compare as they have a virtual monopoly in the U.S. Some competitors in Australia such as LYC have a market cap of 7.73B AUS and trades at a P/E of 28.43. In comparison, this makes MP slightly more expensive, but given the strategic advantage of this investment and the faster growth in revenues (up 150% in March from the same quarter last year vs LYC's increase of just 55%) this difference is to be expected.

Risk

If the relationship between the U.S. and China improves, this acquisition could be minimally beneficial to the business if they could more easily (and cheaply) import the needed REE. I believe that the risk with China is substantial as they have been increasing pressure on Taiwan, and they understand that the world is reliant on them for these rare materials. Even with long-term contracts in place, if China restricts the global supply of REE, prices will skyrocket and timelines for production will be pushed back making it impossible to meet contract requirements. The acquisition of MP Materials, in our view, ensures the stability and continuity of the production process at the predicted full-rate of 156 jets per year. In case of Chinese export restrictions on REE, acquiring MP becomes fundamental to Lockheed's ability to produce and fulfill orders of the F-35 on time.

Rick's Rant: Laughing at Fiona

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Fiona sure made a mess of things last week. Fiona was the third hurricane that I have experienced first-hand. My family and I moved to Halifax the year that Juan hit. We are very fortunate to live in the suburbs on a heavily treed lot, but after Juan, things were a mess in our entire neighbourhood. After Juan, I lost count at 200 of the number of trees that had fallen on my lot. In particular there was a massive tree that was pushed over by Juan such that it was leaning on our house. Fortunately, it was so close to our house that it leaned rather than fell (which would have destroyed the side of our house). It required a special crane and a team of specialists to remove it. This tree was so massive that your traditional bucket truck and chain saw crew was useless.

With all the trees that were strewn around our lot, there was a particularly curious one. This tree is a very tall, yet very scrawny one that leans over in an arc that looks like it is suffering from a serious case of arthritis. For the slightest of breezes this crippled tree looks like it is finally going to snap. In fact, it looks like one of those blow-up flapping characters that you see at used car dealerships. With its awkward arc, the physics of it seem that surely it is going to pull itself out of the ground, but it just keeps on swaying like it is connected to the ground by nothing more than a thin piece of string. Each year I think that I should just cut it down, but as it has lasted this long, I figure that I may as well leave it (although I am concerned that it will fall on guests at one of our backyard get-togethers, BYOBM&Cs).

The tree in question:

After Fiona this week, I like many others, took a walk around the neighborhood looking at the damage. While Fiona was much less damaging than Juan for our area, there were still several trees down. (My heart really goes out to those in Cape Breton and Newfoundland who had it so much worse.) The interesting thing is that my crippled tree was still standing (and still flopping with the lightest of breezes), while virtually all of the downed trees in our area were the strong massive ones that one would have thought could have withstood a direct nuclear strike.

Enough about trees you are thinking. What the heck does this have to do with financial markets. I think everything. Let me explain.

When a storm happens – and storms will happen – those who are firmly rooted in a philosophy, a paradigm, a set of facts, a thorough data analysis, a dogma, a closely held delusion, whatever, are like the trees that are firmly rooted. With their thick trunks, and their deep roots, they have no flexibility, no adaptability. When the storm hits, all they can do is break – and the bigger they are, the bigger – and more dramatic – the break. Meanwhile my crippled tree is flexible. While it always wavers, it also always survives.

DALIS is like my surviving tree. While other university student funds run on very (extremely) well defined investment rules and restrictions, the reality is that they are like the large firmly rooted trees in my neighbourhood. They do not have the adaptability, the flexibility, the ability to change as conditions and contexts change. DALIS meanwhile is student investors trying things – different things and novel ideas. It is adaptability and learning at its best.

While I am not saying that you want to be whimsical and undisciplined in your approach to the financial markets, the reality is that flexibility and adaptability are very useful characteristics. Meanwhile I am going to go admire my crippled tree as it laughs at Fiona.

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