Q1 2020 Investment Commentary

April 23, 2020

Q1 2020 AT A GLANCE

OUR FAMILY OFFICE

"It is wonderful what great strides can be made when there is a resolute purpose behind them." - Winston Churchill

Irreverent and unconventional as he was, Winston Churchill's unbending will to overcome the perils of his time became emblematic of society's collective mind to defeat a common enemy. In somewhat of a parallel, many Prime Ministers and Presidents around the world have adopted a wartime footing against Covid-19. Unfortunately, the economic consequences of defeating the two are markedly different and global GDP has been ravaged by the deafening silence of social distancing and self-isolation.

The IMF recently released their April 2020 World Economic Outlook, noting "The Great Lockdown" was likely to cause global growth to decline -3% in 2020. While not an explicitly shocking figure, global growth only contracted -0.9% at the worst point following the Global Financial Crisis. It thus comes as little surprise that most global markets were brutalized in the quarter as awareness of the breadth and depth of the crisis unfolded (Charts Right).

Unsurprisingly, we've witnessed unprecedented policy responses in support of families and businesses, with central banks and governments around the world launching everything from enhanced unemployment benefits to liquidity and credit funding vehicles to full scale bailouts. Without question, the global coordination of these resolute and purposeful efforts buffered the immediate fallout and kept the global economic wheels turning, if slowly.

Meanwhile, emergency social distancing measures appear to have slowed the spread of the virus at the same time as pharma companies devote significant resources to vaccine development. Indeed, a Covid-19 vaccine trial by University of Oxford researchers aims to get efficacy results by September. So notwithstanding today's clouds, we see hope and light on the horizon.

Chart 1: S&P 500 Index

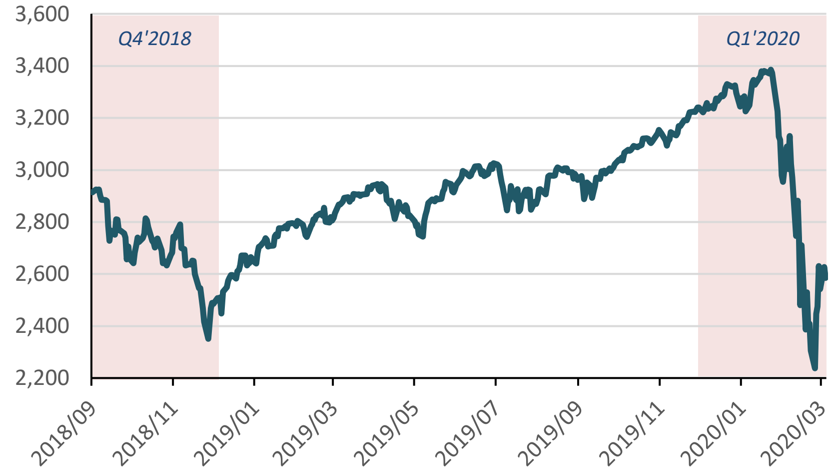


Table 1: Summary of 2019 Investment Returns

	2018	2019	Q1 2020
Canadian Large Cap: TSX Comp	-8.9%	22.9%	-20.9%
US Large Cap: S&P 500	-4.4%	31.5%	-19.6%
US Small Cap: Russell 2000	-11.0%	25.5%	-30.6%
US REITs	-3.6%	28.5%	-22.9%
International: MSCI EAFE	-10.5%	22.3%	-20.4%
Japan: TOPIX	-16.0%	18.1%	-17.5%
UK: FTSE 100	-8.7%	17.3%	-23.8%
Eurozone: Euro Stoxx 50	-11.3%	29.3%	-25.3%
Emerging Markets: MSCI EM	-9.7%	18.5%	-19.0%

OUR FAMILY OFFICE

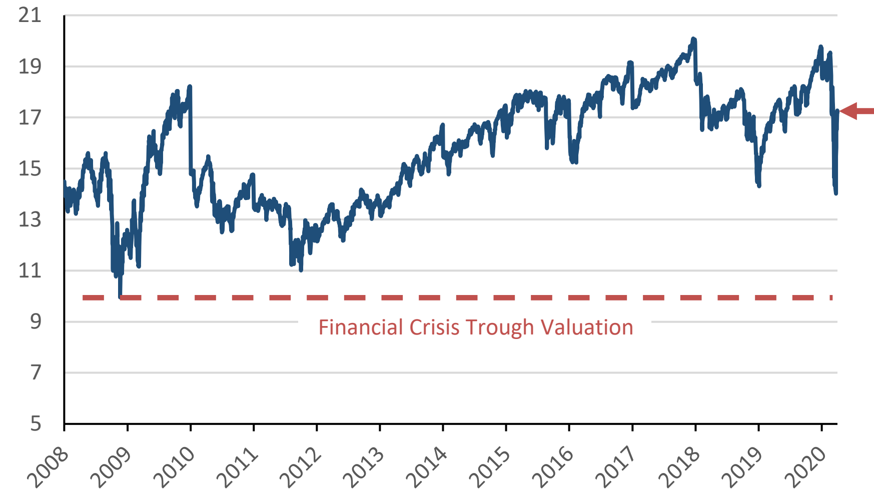
Accordingly, our efforts have been directed towards understanding how the economy will look as we emerge from the depths of the crisis. Though shocking to suggest, 2020 looks like a write-off at this point. But if this, too, shall pass, then it pays to focus on prospects for 2021. Indeed, the IMF forecast for global growth next year jumped to +5.8% on rebounding consumer and business spending, adding to our confidence there is light at the end of the tunnel.

Looking across the 2020 earnings valley to a resurgent 2021 caused stocks to rally in early April. As of April 17th, the TSX Composite had declined -20% from its peak on February 20th, significant but much less than the -37% decline at the March 23rd low. While this price decline is important, it's critical to view it in the context of estimated future earnings, the trajectory of which has undoubtedly declined. Many small businesses won't survive and some whole industries will be permanently reshaped, e.g. tourism and entertainment. Of those companies that survive relatively unscathed, many will face reduced demand even after we emerge from mass quarantine owing to higher unemployment and lower aggregate spending.

With earnings estimates declining at the same time as prices, albeit not as precipitously, next-year valuations have improved less than investors might be hoping for (Chart 2). While this bear market will inevitably create longer-term opportunities, we caution against thinking it's as easy as "quick, buy it now".

Stepping back our perspective further still, we would be remiss to not highlight the success of our non-traditional investment managers during Q1. Our Canadian long-short equities manager was down only -4.2% YTD through the end of March. Our direct lending and short-term private debt managers produced stellar year-to-date returns ranging from -0.9% to +1.3%. Indeed, we are pleased with the enhanced protection of capital our all-weather portfolios provided for clients through an incredibly challenging period.

Chart 2: S&P 500 Index Valuation (Fwd P/E Multiple)



Global Equities

Building off the spectacular gains in 2019, equity prices continued their steady march higher in January and early February, confident that the modest but steady progress in the global economy would continue. U.S. stock prices set an all-time high on February 19 with Canada following suit the next day.

Skip forward to the present, not even 40 days later, and the picture is so dramatically different, people are forgiven for their regular bouts of disbelief. Canadian and U.S. job losses and unemployment claims, indeed in other countries as well, set records in March and early April as a result of emergency mass quarantining measures. The resulting economic damage was swift and severe, reflected decisively in equities (Chart 3).

Stocks and lower-grade bonds (HYG) responded as one would expect when confronted with a near-halt in business activity. North American equities dropped about -20% in the quarter, their worst start to a year ever. Overseas markets fared slightly worse, with losses in the low-20% range.

Energy fared well worse than the broad market (Chart 4) owing to possibly the worst-timed price war in history, discussed further in Currencies & Commodities. Outside of gold and long-term U.S. government bonds (TLT), few hiding places were safe. When this type of broad-based selling pressure occurs, typically-defensive asset classes get sold to pay for losses in other areas of a portfolio, leading to higher correlations and deeper overall losses.

This painful “sell everything” process, a hallmark of meaningful bear market pullbacks, is necessary to set the table for the next bull market. Accordingly, the investment team at Our Family Office is watching valuations and reviewing the capital market assumptions employed in portfolio construction. At some point the case for significantly increasing allocations to public equities will emerge, although we do not yet believe the time has arrived.

Chart 3: Q1 Global Equity Markets (Indexed to 100)

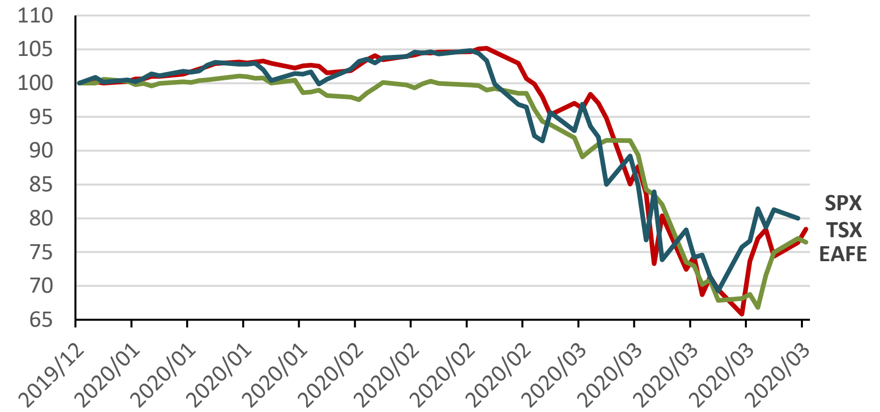
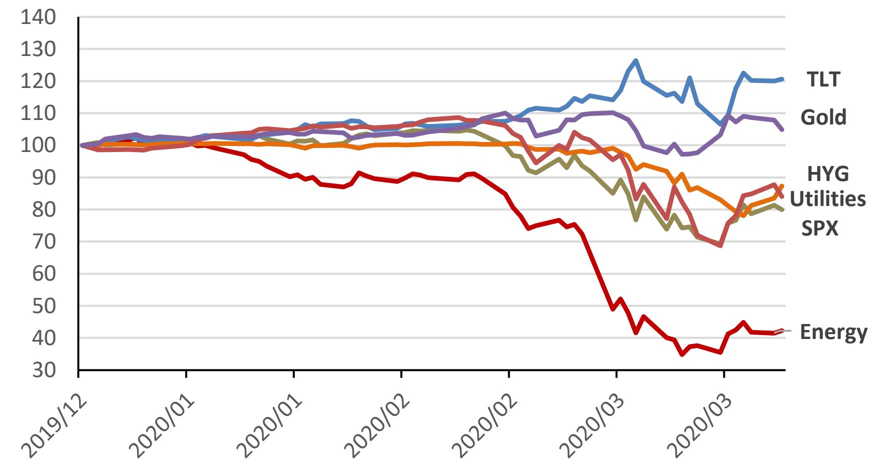


Chart 4: Q1 Asset Class Performance (Indexed to 100)



Global Fixed Income

While not immune from volatility or losses, fixed income as an asset class offers greater opportunity for diversification and capital protection during periods of market stress. Accordingly, such investments factor prominently in Our Family Office all-weather portfolios, both in terms of traditional debt and non-traditional investment exposures.

To be sure, the quarter was as wild in fixed income as it was in all other asset classes. Closing out 2019, the U.S. 10yr Treasury yield appeared poised to break up through 2%, propelled higher by tightening monetary policy on the back of strong global growth. Yet now, with the 10yr yield less than a third of that level (Chart 5), we wonder if negative yields will soon migrate from Europe to North America.

In March, the Fed and BoC shifted policy with admirable, if dizzying speed, dropping policy rates to near zero and fully engaging unconventional monetary policy to support both credit and liquidity markets. The idea was to underpin the economy with liquidity, i.e. credit availability, and low borrowing costs. Positively, central banks' considerable efforts bridged severe and unexpected cash crunches, enabling economies to continue functioning in an orderly, if strained and socially-distant fashion. Beneath the surface, however, such aggressive shifts in policy, risk appetite and economic activity caused credit spreads to blow out to decade highs (Chart 6) and asset pricing dislocations to crop up everywhere.

With markets now calming somewhat, most unjustified credit dislocations are reversing. For example, spreads between U.S. Treasury bonds and U.S. Agency bonds, both explicitly backed by the U.S. government, continue to tighten from wides not seen since before both had the same guarantee. Indeed, this demonstrates the benefit of investing with fixed income managers that know when, where and how to invest in these deep and complicated markets.

Chart 5: Ten Year U.S. Treasury Yield (%)

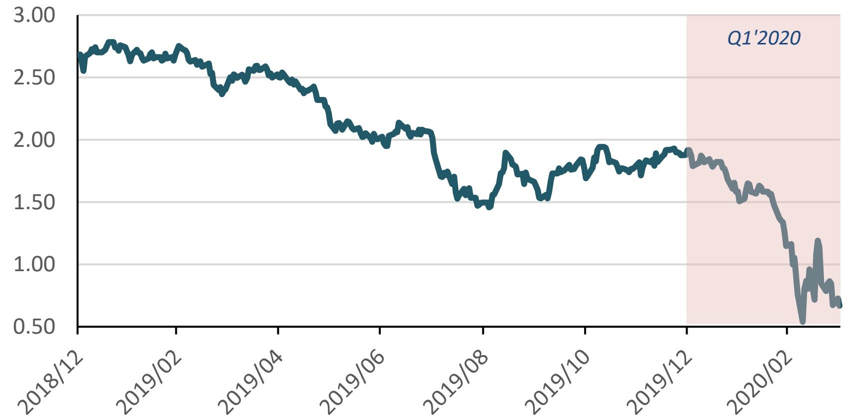


Chart 6: U.S. IG Corporate Credit Spread to (bps)

Currencies & Commodities

By far the worst amongst a bad lot, crude oil experienced a truly disastrous series of negative catalysts this quarter (Table 2). Optimism from trade war resolutions (remember that?) and hopes for incremental global demand on the back of receding tariffs were shattered in spectacular fashion. WTI was already down -25% from Dec 31, 2019 to March 5, 2020, primarily related to Covid-19 demand destruction. Then on March 6th Russia rejected an OPEC request to reduce oil production in-line with the Vienna Summit agreement, triggering a full-scale price war with Saudi Arabia, driving oil down to -66%.

While this geopolitical stand-off badly affects U.S. shale and other global players, it's impossible to overstate the depth of crisis in Canada's oil patch. Canadian Western Select (CWS) spot prices fell below $10 per barrel and futures declined into the abstract territory of negative prices. With global supply still badly outstripping demand and storage facilities around the world nearly full, one side should soon blink. Unfortunately, the tremendous economic damage done to Canadian oil producers cannot easily be reversed.

In stark contrast, gold ranked among the best asset classes during a troubled period, returning a positive 4.8% this quarter. With a few factors propelling it, we view the metal's relative safety during a downturn in addition to its quality as a store of value in the context of ever-lower real rates as most responsible for the strong performance.

Lastly on currencies, after a solid rally in 2019 against the U.S. Dollar, CAD fell a quick -7.5% over the quarter under the double weight of oil patch pain and Covid-19 shutdowns. Moreover, the domestic economic backdrop, discussed next, suggests weak underpinnings for CAD. Irrespective of Canada's present and likely continuing malaise, however, it should be noted that safety currencies, namely USD, Japanese Yen (JPY) and Swiss Franc (CHF) were sources of stability and superior stores of value in global markets (Table 3).

Table 2: Commodities (USD)

	2018	2019	Q1 2020
Commodities	-11.2%	7.7%	-23.3%
Agriculture	-8.0%	-0.3%	-9.4%
Copper	-17.5%	3.4%	-19.8%
Natural Gas	4.8%	-32.3%	-27.1%
Crude Oil	-25.3%	35.4%	-66.5%
Gold	-2.1%	18.9%	4.8%

Table 3: Global Currencies vs. USD

	2019	Q1 2020	Q1 USD Direction
EUR	-2.40%	-1.73%	USD Stronger
JPY	0.91%	1.05%	USD Weaker
GBP	4.11%	-6.45%	USD Stronger
AUD	-0.61%	-12.30%	USD Stronger
CAD	4.61%	-7.53%	USD Stronger
CHF	1.71%	0.62%	USD Weaker

The impact of Covid-19 has been felt far and wide, but not always equally. Export-driven and resource-centric economies, regrettably like Canada, suffered a double hit over the last two months. As discussed in Currencies & Commodities, Canada's oil patch suffered mightily from falling prices (Chart 7) and curtailed production. In turn, Alberta's historical boom–bust–boom economy now faces the reality of no recovery and once unthinkable forecasts like 33% office vacancy in Calgary by next year. This relationship between price of oil and strength of the Canadian economy explains the traditionally high correlation between oil and the Canadian Dollar.

For the last couple years, CIBC's economic research team flagged Canada's elevated debt levels as a potential problem, though consistently noting low interest rates and strong employment make carrying it possible. OK on the low rates: since March 2, 2020 the Bank of Canada aggressively dropped its policy rate from 1.75% to 0.25% to support consumers and businesses alike. However, nearly 1 million people lost their job in March (Chart 8) and 6 million Canadians have applied for the government's emergency income support program since mid-March. Unfortunately, low interest rates don't help much if you don't have an income to pay your loan interest.

In the best scenario, Canada and the rest of the world emerge from The Great Lockdown quickly and with a viable vaccine to prevent a double dip. That said, not all countries face the array of challenges presently encumbering Canadians, not least one of the highest consumer debt loads in the developed world.

In short, there will be a time to over-allocate to Canada, just as there was a time to load up on U.S. equities coming out of the Great Financial Crisis. Unfortunately today is not that day, with myriad headwinds facing the Canadian economy for the foreseeable future, some of which other countries simply do not have to contend with.

Chart 7: WTI (USD) & CWS (CAD) Oil Prices Per Barrel

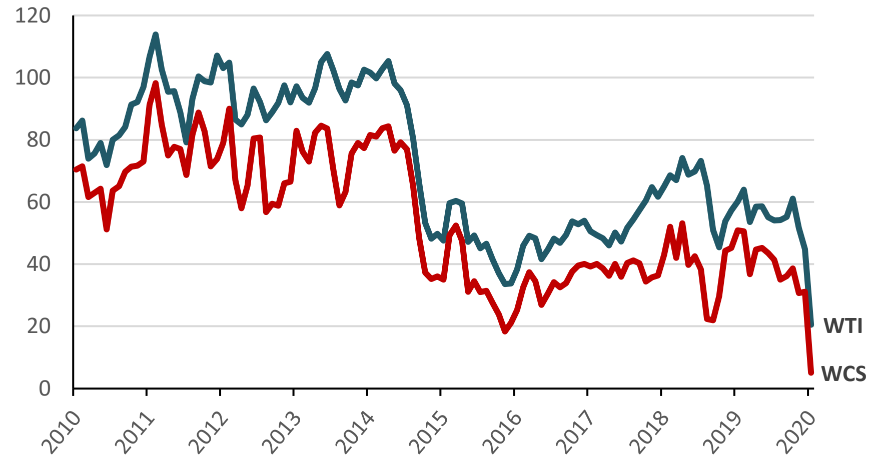
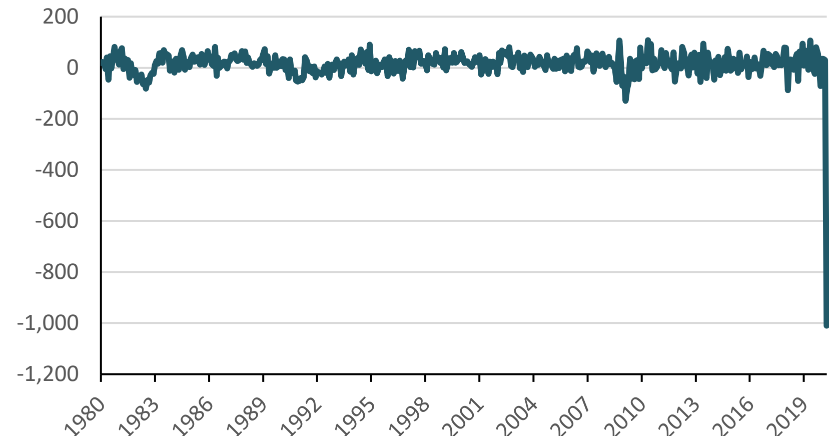


Chart 8: Canadian Employment Change (Monthly, 000s)



Contact Us

161 Bay Street
Suite 4040
Toronto, Ontario
M5J 2S1

t 416.304.9800
f 416.583.1845

www.ourfamilyoffice.ca

Neil Nisker
Co-Founder & Executive Chairman
t 416.304.9870
e neil@ourfamilyoffice.ca

Tim Cestnick
Co-Founder & CEO
t 416.304.9877
e tim@ourfamilyoffice.ca

Cameron Hurst
Managing Director
Global Investment Strategy
t 416.304.9360
e cameron@ourfamilyoffice.ca

Data sources for charts and tables: Morningstar, Bloomberg, Bureau for Economic Analysis, and StatsCan.