



Q2 2020 INVESTMENT COMMENTARY

July 31, 2020



Q2 2020 AT A GLANCE

“It is not the most intellectual of the species that survives; it is not the strongest that survives; but the species that survives is the one that is able to adapt to and adjust best to the changing environment in which it finds itself.”
 - Prof. Leon C. Megginson referring to Darwin’s “On the Origin of Species”

Megginson’s paraphrased take on Darwin’s seminal work describes precisely the investing environment of today. Modern Monetary Theory (MMT) is the new basis upon which virtually every monetary authority around the world is approaching crisis management. Love it or hate it (most pundits the latter), MMT has fundamentally changed investing for the foreseeable future.

At its core, MMT is a macroeconomic theory that describes currency as a public monopoly and unemployment as evidence that a currency monopolist, i.e. government or a central bank, is overly restricting the supply money needed to pay taxes and satisfy savings desires. In short, it is the monetary cousin of populism and proposes that during crisis governments and central bankers need only print enough new money, injecting it broadly across the economy, to inflate everyone’s way out of the problem. Naturally, this should cause inflation to rise once full employment is reached, but the theory states that can be handled by raising taxes and “returning” excess money.

Faced with a pandemic that could not be vaccinated away or contained within borders, most governments abruptly shut down their economies and implemented quarantine policies, forcing mass layoffs and job terminations. Central banks and treasury departments stepped in, interest rates went to zero, effectively sidelining them as a tool, and the printing presses started rolling 24hrs a day to support the economy; enter MMT in full force (Chart 1).

This tidal wave of money has, to-date, succeeded in supporting individuals and families, buoying economies and decisively lifting financial assets (Table 1).

Chart 1: G7+ Stimulating with Money Supply Expansion

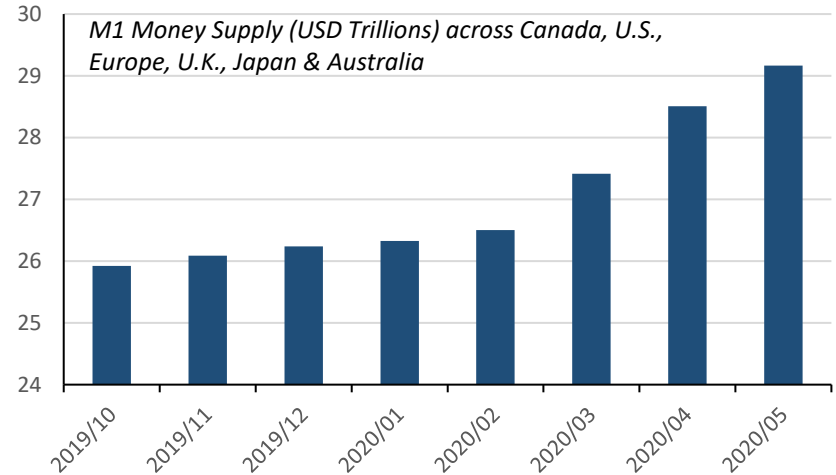


Table 1: Summary of Global Equity Returns

	2019	Q2 2020	YTD 2020
Canadian Large Cap: TSX Comp	22.9%	17.0%	-7.5%
US Large Cap: S&P 500	31.5%	20.5%	-3.1%
US Small Cap: Russell 2000	25.5%	25.4%	-13.0%
US REITs	28.5%	13.2%	-12.7%
International: MSCI EAFE	22.3%	12.8%	-10.3%
Japan: TOPIX	18.1%	11.3%	-8.2%
UK: FTSE 100	17.3%	9.2%	-16.9%
Eurozone: Euro Stoxx 50	29.3%	17.8%	-12.0%
Emerging Markets: MSCI EM	18.5%	16.9%	-5.4%

Q2 2020 AT A GLANCE

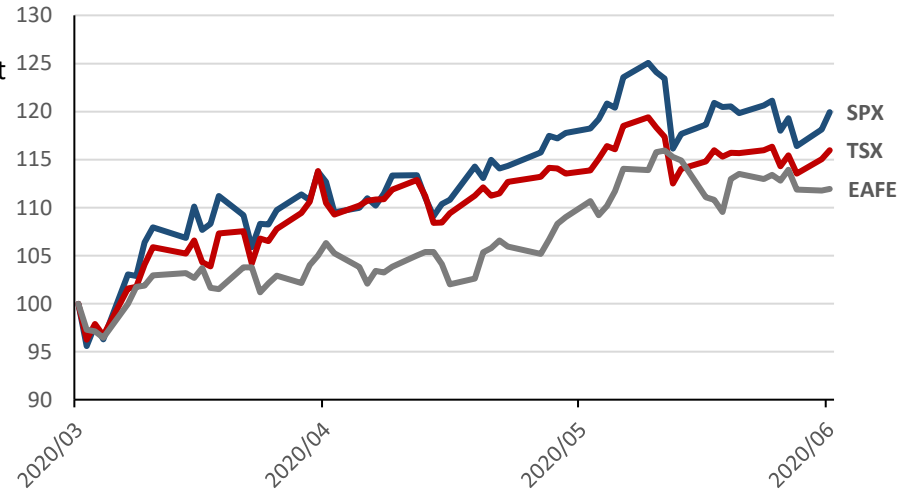
While clearly not the primary motivation for this unprecedented monetary and fiscal stimulus, it's near impossible to prevent significant risk asset inflation when broadly stimulating an economy with a blunt instrument like money supply (Chart 2). Monetary authorities might think of this as an unintended but unavoidable consequence of preventing the next great depression, but it's not without its risks.

Monetary and fiscal stimulus has, in many cases, artificially raised incomes and asset prices to levels in-line with non-pandemic times. If a vaccine is just around the corner and economies around the world soon resume previous levels of activity, then employment and business fundamentals should rapidly catch up to incomes and asset valuations. If, however, global aid packages cannot successfully bridge the entire economic gap because consumer nervousness, or worse an actual second wave of infections keeps economies from reopening and employment from returning, we have a large problem.

So where does this leave us and how should portfolios adapt and evolve to survive these changing and highly uncertain times? For starters, this is no time to reinvent an investment philosophy just because markets are experiencing elevated volatility and heightened uncertainty. The particulars of the story may have changed, as they often do, but the themes and melody are familiar.

Maintaining a prudent balance of income vs. capital appreciation and of traditional vs. non-traditional investment strategies led to resilient capital protection throughout the downturn while also allowing for appreciation as markets recovered. Indeed, we always favour opportunistic portfolio tweaks over wholesale tactical shifts, e.g. modestly adding to traditional equity exposure in March. This time is no different and alongside traditional investment exposure we continue to emphasize low-volatility non-traditional strategies in client portfolios, much to their benefit in good times and bad.

Chart 2: Q2 Global Equity Rally (Indexed to 100)



GLOBAL EQUITIES

A sense of dread confronted investors near the end of March, as the extent of the economic damage caused by the coronavirus pandemic came into sharper relief. The S&P 500 and TSX Composite fell approximately 34% and 37%, respectively, from their highs in mid-February to their lows on March 23. As the Federal Reserve and other central banks and governments stepped in to “do whatever it takes” to minimize the blow to local and global economies, markets began a dramatic rally that lasted nearly the entire quarter.

In Q2, the S&P 500 rose more than 20 percent, its best quarterly performance since 1998. On the heels of a similar loss in the first quarter, at the halfway point, the widely followed index of U.S. stocks remained about 4 percent below its starting level for the year. The two-quarter mirror image represented the largest quarter-to-quarter swing in more than 80 years.

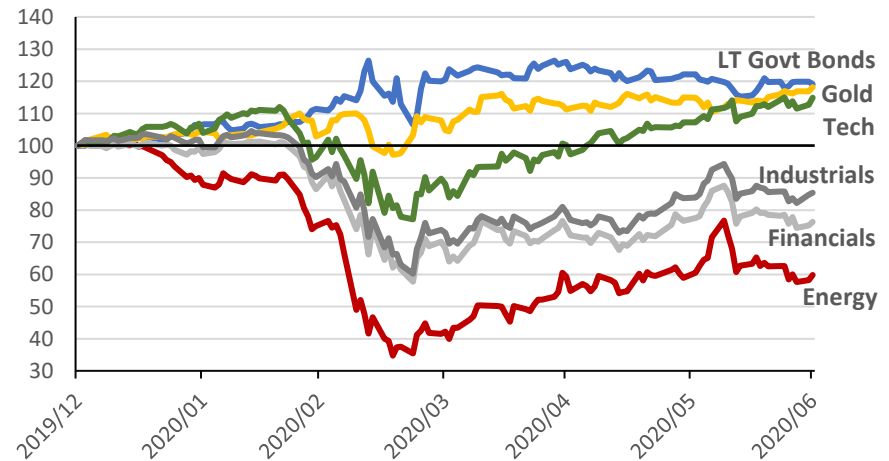
Canadian equities, while much improved and +38% from the low, rallied about 5%pts less than U.S. equities in the quarter and remain behind on a year-to-date basis. Oil has a greater economic influence in Canada, a significant challenge at present, and the over-leveraged consumer base is not well positioned to withstand economic hardship absent massive (and unsustainable) government support. Regrettably, these negative influences are not short-term in nature and appear likely to continue constraining Canadian markets for the foreseeable future.

Price action in Canadian equities this quarter also serves to highlight the importance of capital preservation, a point we never grow tired of making. Top to bottom, the TSX fell -37% and then rallied +38% off the bottom to June 30; however, this leaves the index 13% below the high because an index has to rally back *more* than it drops to stay flat. Accordingly, we remain emphatically focused on protecting client capital during periods of market weakness.

Chart 3: YTD Performance of S&P 500, S&P/TSX Indexes



Chart 4: Divergent Asset Class Returns (YTD Indexed to 100)



GLOBAL FIXED INCOME

The extreme turmoil in the fixed income markets in March was alleviated by the Fed's aggressive efforts to pump liquidity into the system by acquiring (or promising to acquire) treasury and corporate bonds, including some below investment-grade. The massive buying power of the Fed and its move to reduce short-term interest rates to near-zero helped calm the nerves of jittery bondholders and resulted in a decline in interest rates across the yield curve. The move to support corporate bonds, particularly those below investment grade, was principally responsible for relief rallies across the risk asset spectrum.

The Fed's broad and swift support of the fixed income market, in lock-step with central banks around the world, drove solid gains in the second quarter. The broadest measure of U.S. investment grade bonds, Bloomberg Barclays U.S. Aggregate Index, gained +3.7% in the quarter, only slightly ahead of the comparable global index at +3.3%. As an indication of fixed income risk assets, U.S. high yield bonds rose a whopping 10.2% in the quarter, nearing flat on the year as of mid-July.

With rates now near or even below one percent for most developed country government and high-quality corporate bonds (Chart 5), investment-grade fixed income securities hold little interest for those investors seeking returns above the rate of inflation.

More firmly on the cautionary side, we note U.S. corporate credit spreads have yet to return to lows (Chart 6). The optimist might suggest this only reflects investor skittishness as things return to normal; however, our predilection for capital preservation inclines us to remain cautious until we see a clear path to *self-sustaining* economic recovery.

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



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





CURRENCIES & COMMODITIES

After an atrocious Q1, crude oil attempted to bounce back against the tide of reduced consumption and demand. Notwithstanding a pronounced 92% gain in the quarter, oil remains hamstrung by the tempered global recovery and priced well below levels seen at the start of the year. We don't expect crude – or natural gas, for that matter – to experience a quick recovery.

Gold, on the other hand, maintained its luster for yet another quarter, continuing to gain on its "store of value" qualities in spite of the sharp rally in equities (Table 2). As discussed earlier, with Modern Monetary Theory in full swing we expect any rise in inflation expectations to benefit gold. Moreover, with interest rates pinned at or near zero, real rates appear likely to fall farther into negative territory, further supporting gold. While the metal can be notoriously difficult to call, not least because it can quickly flip flop between acting as a commodity and as a currency, the odds are stacking up in its favour.

Lastly on currencies, the Loonie rallied off its Q1 lows and rose against most major global currencies throughout Q2. Although the economic backdrop suggests weak underpinnings for CAD, currencies adhere to different drivers at different times. Oil and other factors remain headwinds just the same this quarter, but the lessening of pressure on Canada from weak oil prices allowed for some recovery that other economies felt less. We view these as temporal issues and not long-term trend changes.

Ominously, the USD lost relative value against most major currencies owing to the pandemic disproportionately impacting U.S. economic recovery prospects. At present, it is unclear whether this will be anything more than a short-term divergence because similar negative trends are now emerging in other countries as well.

Table 2: Commodities (USD)

	2019	Q2 2020	YTD 2020
Commodity Index	7.7%	5.1%	-19.4%
Agriculture	-0.3%	-4.3%	-13.3%
Copper	3.4%	21.6%	-2.5%
Natural Gas	-32.3%	-17.3%	-39.7%
Crude Oil	35.4%	91.5%	-35.8%
Gold	18.9%	12.8%	18.2%

Table 3: Global Currencies vs. USD

	2019	Q2 2020	Q2 USD Direction
EUR	-2.40%	1.89%	USD Weaker
JPY	0.91%	-0.35%	USD Stronger
GBP	4.11%	-0.15%	USD Stronger
AUD	-0.61%	12.41%	USD Weaker
CAD	4.61%	3.65%	USD Weaker
CHF	1.71%	1.50%	USD Weaker

ECONOMIC OVERVIEW

What caused the sharp rally in asset prices? Investors became convinced the impact of the enormous fiscal and monetary stimulus engineered by governments and central banks would stave off the worst economic collapse since the Great Depression. Further, promising signs of therapeutic advances led some to believe that a treatment breakthrough to combat Covid-19 could be coming earlier than was originally envisioned.

At the same time, individual investors stuck at home with few diversions opened record amounts of online brokerage accounts, riding the momentum of the rally. As the economy began to reopen, investors were encouraged by the improving trend in economic data, undaunted by the yawning gap that would be necessary to fill just to get back to even. A V-shaped economic recovery looked more likely early on, although more recently infections in the U.S. and elsewhere have spiked and economic data appears to be stalling.

From our perspective, forward-looking economic indicators, service and manufacturing alike, have indeed improved off levels seen earlier this year. Given the range of possibilities in March as the pandemic worsened daily, today's situation must be seen as an unequivocal positive. Objectively, however, unemployment rates remain in double digits (Chart 7) and debt levels in many developed nations leave little room for consumer spending to drive the recovery, most notably in Canada (Chart 8). Consequently, we would hardly call the economy robust – and that's even before fiscal and monetary stimulus starts to wind down.

Credit market indicators, far from sanguine, parallel what we see in economic data and strike a marked contrast with the optimism evident in equity valuations. A strong alignment of credit and economic signals traditionally offers a reliable gauge of broad market risk and we further note the array of challenges on the horizon, not least the U.S. election, that keep us cautious.

Chart 7: Canadian & U.S. Unemployment

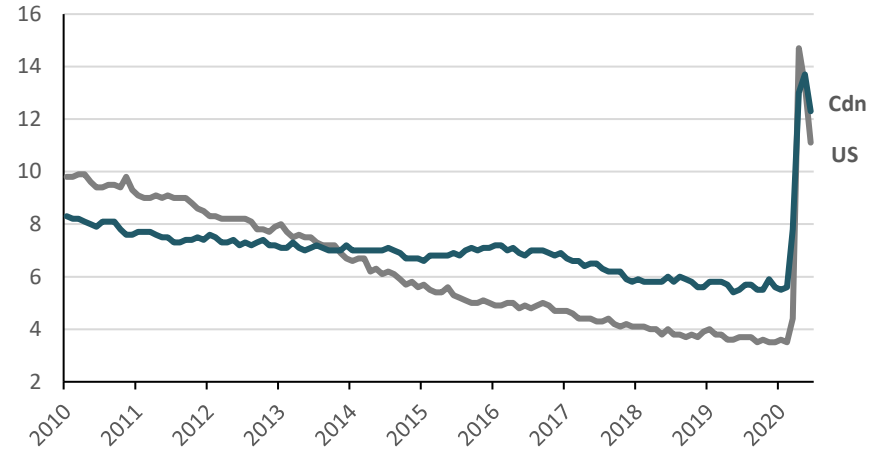
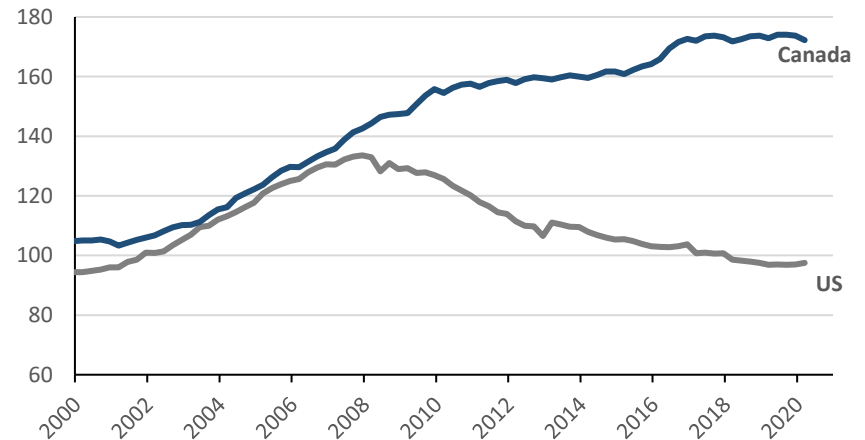


Chart 8: Household Debt to Disposable Income (%)



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