Q3 2020 Investment Commentary

October 30, 2020

Q3 2020 AT A GLANCE

OUR FAMILY OFFICE

"Some stories don't have a beginning, middle and end. Life is about not knowing, having to change, taking the moment and making the best of it, without knowing what's going to happen next. Delicious ambiguity…"
- Gilda Radner, Comedian & Original Saturday Night Live Cast Member

Oddly, the entire third quarter turned out to be a "filler" period, bookended by periods of profound uncertainty that unavoidably draw the eye. Investors experienced unprecedented volatility in the first two quarters owing to the global pandemic and subsequent monetary and fiscal remedies. Indeed, in modern market history there has never been a V-shaped decline and recovery like that of the first 6 months of 2020.

Following the Great Bounce of 2020, for all the shock and awe that involved, this quarter was marked by consistent, if modest risk asset appreciation and stable bond yields. Investor sentiment calmed right down, perhaps even approached complacency, as equity markets again took political and economic noise in stride.

Relaxed equity markets, however, shouldn't be confused with reasonable valuations. Global markets are floating on a sea of stimulus spending and financial support, not strong underlying earnings. In fact, forward S&P 500 earnings have fallen dramatically over the last 6 months due to the pandemic. Yet the index is still near all time highs, meaning valuation, or the price people are willing to pay for exposure to the index, has risen significantly. While we understand valuations rise and fall, paying more for less introduces additional risk and just doesn't make sense at a time like this (Chart 1).

For better or worse, the market recovery in Q2 and modest further appreciation in Q3 set the stage precariously ahead of a period that looks highly uncertain. Much of North America and Europe are setting new daily

Chart 1: S&P 500 Valuation Up with Earnings Down

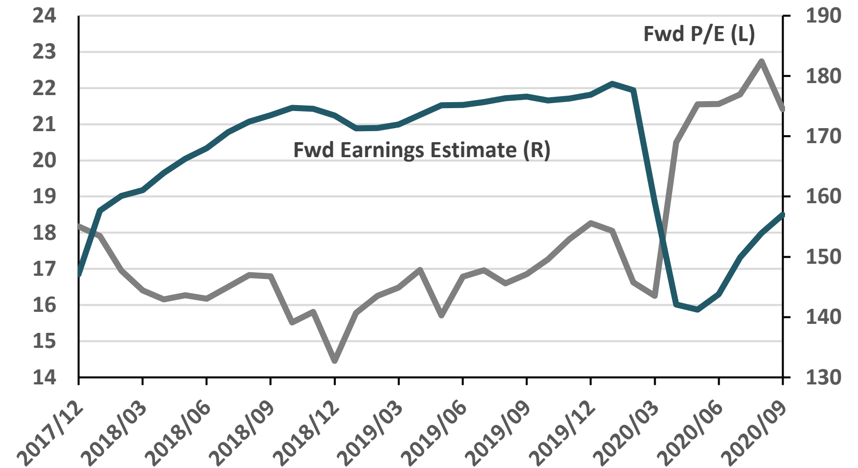
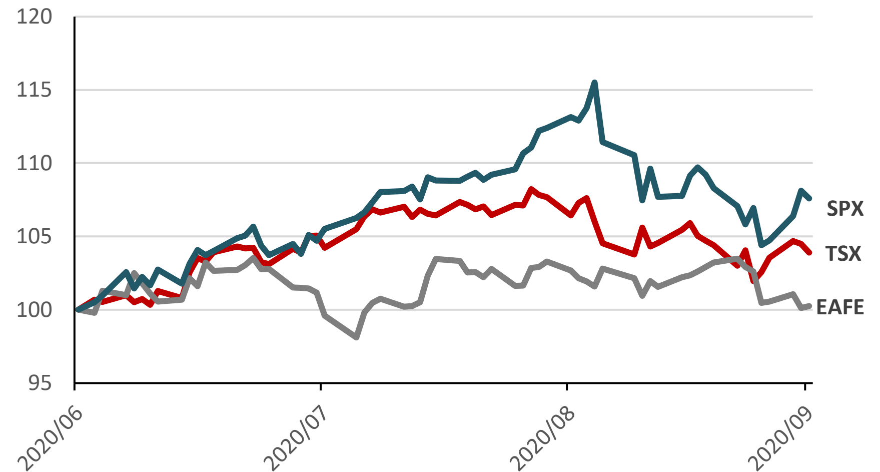


Table 1: Summary of Global Equity Returns

	2019	Q3 2020	YTD 2020
Canadian Large Cap: TSX Comp	22.9%	4.7%	-3.1%
US Large Cap: S&P 500	31.5%	8.9%	5.6%
US Small Cap: Russell 2000	25.5%	4.9%	-8.7%
US REITs	28.5%	0.8%	-21.4%
International: MSCI EAFE	22.3%	4.9%	-6.7%
Japan: TOPIX	18.1%	4.3%	-5.6%
UK: FTSE 100	17.3%	-4.0%	-20.2%
Eurozone: Euro Stoxx 50	29.3%	-0.7%	-12.6%
Emerging Markets: MSCI EM	18.5%	8.8%	2.9%



records for Covid-19 infections, prompting regional authorities to revisit the idea of lockdowns. Further, the U.S. Presidential election seems likely to be decided by a thin margin, opening the possibility of a prolonged and contentious period of determination.

If the small pullback in September is any indication, global equity markets noticed what autumn may bring (Chart 2). That said, this is not to suggest all the market optimism is for naught. Continued stimulus spending in Canada is on the way and another round of support appears most likely by a new or returning U.S. administration. Interest rates around the world remain low and supportive. Perhaps most importantly, Covid-19 mortality rates are significantly lower than just 6 months ago as scientists and doctors figure out the virus and advance treatment protocols rapidly.

Sorting through all the complimentary and contradictory signals, our job at Our Family Office remains the same: protect capital first, then earn a reasonable return. Among the many benefits of our All-Weather Portfolio approach, families experience a smoother ride through periods of uncertainty and market volatility, a safer ride resulting in good long-term investment returns.

Heading into just such a period of uncertainty, this risk reduction is critical. While we can’t say we find the present ambiguity “delicious”, uncertainty is unavoidable when investing; there is no excess return without additional risk. The best antidote, we find, is a well-balanced portfolio, incorporating traditional and non-traditional strategies, delivering both income and capital growth.

The investment team will actively monitor the evolving investment landscape into year-end, carefully shepherding family capital on your behalf so you can spend precious time with family and enjoy the more delicious moments of life!

Global Equities

The first two quarters of 2020 witnessed a mirror image crash and recovery representing the largest quarter-to-quarter swing in more than 80 years. Just about anything would seem tame following such high drama and Q3 didn't disappoint with much more modest returns and volatility (Chart 3). Investor sentiment normalized and policy makers had a chance to catch their collective breath. In short, it was the calm that investors desperately needed to collect themselves after the storm.

U.S. equities, with their much higher weight in global tech and ecommerce industry leaders, continued to outpace other developed markets, rising 9% in the period, notably widening the performance gap versus Canada, which turned in a more modest 5% gain. The Energy sector, the year's worst performer, weighed down the TSX Composite as it continued to languish on reduced demand and increased pressure from the transition to renewable energy sources (Chart 4).

The investment team continues to highlight heightened risks for Canadian equities, powerfully underscored by Fitch Ratings' reduction of the long-term debt rating in late June. Noting "a much expanded general government deficit" was likely in 2020 due to significant stimulative monetary and fiscal policies required to counter-act reduced demand effects of the pandemic. Beyond the report, we've noted elevated consumer debt levels constrain spending in the best of times, much less during periods of weak employment.

All told, we continue to see superior opportunities in both emerging and developed markets outside Canada. Valuations, politics and policy, as ever, present challenges in various proportions across geographies; however, our ability to direct client capital towards non-traditional investment strategies with enhanced downside protection characteristics widens the field considerably, enabling consistent capital deployment over time.

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

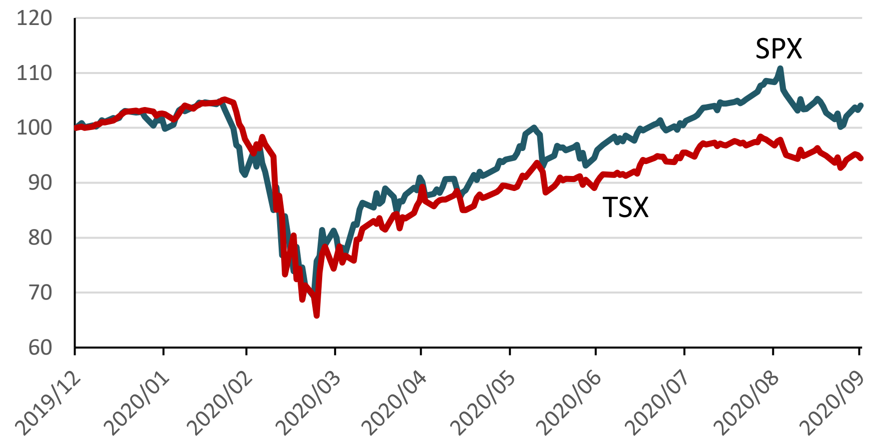
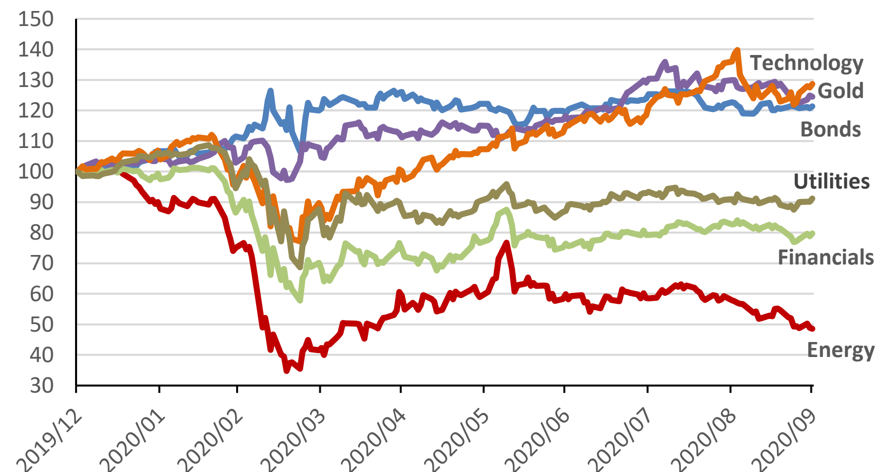


Chart 4: Divergent Asset Class Returns (YTD Indexed to 100)



Global Fixed Income

Investors could be forgiven for thinking it was an uneventful quarter in fixed income. Government bonds saw little yield movement, start to finish in the quarter. Short-term rates remain pinned at or very near zero. Monetary authorities the world over continued to print money, without apparent repercussions, supporting public debt markets, corporations and consumers.

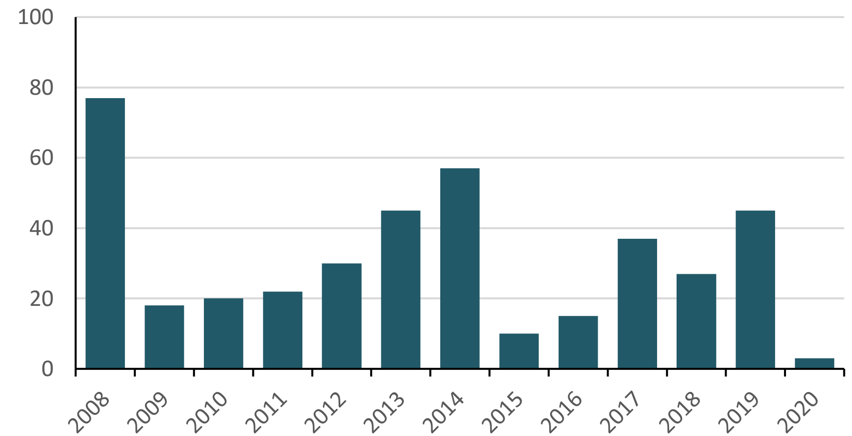
Some corporate debt, however, has fared quite poorly, most notably apparel retail. The fairly grim reality is that notable recent bankruptcies, such as J.C. Penney and Neiman Marcus both last May, are likely just the tip of the iceberg created by a decade of easy money and weak lending standards.

As global central banks took rates to zero, borrowing became a more attractive option for companies short of capital. On the lending side, aggressive money managers trying maintain returns consistent with higher rates of years past continued putting capital to work with higher risk, e.g. with more aggressive underwriting assumptions and foregoing legal protections. This particularly toxic combination worked for everyone involved while economic growth was robust and rates kept falling; however, when the music abruptly stopped in Q1 the weakest and most indebted started falling first, with more likely to come.

For example, credit default swaps, representing insurance policies on corporate debt, are now trading in auction below the level seen in 2009, the aftermath of the Great Financial Crisis (Chart 6). Auction prices of CDS provide a good indication of how debt situations will resolve and what recoveries are likely to be. Unfortunately, with all the foregone legal protections on currently souring debt, many of the insurance policies will be rendered worthless and recoveries are likely to be very low. In fact, debt issued by the owner of Men's Warehouse, which filed for court protection in August, traded this month for less than 2 cents on the dollar. That's a 98% loss and all the motivation we need to keep waiting patiently for the storm to properly and fully clear.

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

Chart 6: U.S. CDS Auction Prices (% of full value)



Currencies & Commodities

Signs of continued economic recovery throughout the quarter were broadly supportive for commodities (Table 2). Outside of a few well-noted industries, global economic growth turned decisively positive on the back of resurgent spending and investment trends, in turn driving positive international trade.

The combination of declining infections, reflecting a better-than-worst case scenario, and broadly rising economic indicators suggested there was much to be positive about through the summer. Notwithstanding the lift in sentiment from lockdowns easing and life resuming something that felt more normal, absolute levels of demand have yet to fully recover to previous highs. In other words, employment, consumption and investment are improving but still appreciably lower than pre-pandemic levels.

This is most apparent in energy markets, where global demand forecasts continue to be slashed in both present and future periods. The International Energy Agency (IEA) recently published downward revisions to total global energy demand, now estimating 2020 to decline more than 5% from 2019 with oil leading the charge at -8.5% decline. Moreover, the Agency now suggests a delayed recovery scenario could mean it takes until 2025 for global energy demand to recover to 2019 levels. Accordingly, the energy sector and crude oil continue to perform very poorly year-to-date.

While manufacturing has lifted nicely it has brought momentum back to copper and other industrial metals. Similarly, gold maintains its lustre and continues to reflect a premium as a store of value against negative real yields.

The confluence of factors weakening the U.S. Dollar ought to see some relief after the election, with related uncertainty traditionally proving a temporary detractor from the currency. The CAD has headwinds of its own that we believe will last longer, not least of which is our serious over-indebtedness.

Table 2: Commodities (USD)

	2019	Q3 2020	YTD 2020
Commodity Index	7.7%	9.1%	-12.1%
Agriculture	-0.3%	11.2%	-3.6%
Copper	3.4%	11.0%	8.2%
Natural Gas	-32.3%	10.1%	-33.6%
Crude Oil	35.4%	2.0%	-34.5%
Gold	18.9%	5.3%	24.5%

Table 3: Global Currencies vs. USD

	2019	Q3 2020	Q3 USD Direction
EUR	-2.40%	4.36%	USD Weaker
JPY	0.91%	2.36%	USD Weaker
GBP	4.11%	4.28%	USD Weaker
AUD	-0.61%	3.88%	USD Weaker
CAD	4.61%	2.01%	USD Weaker
CHF	1.71%	2.90%	USD Weaker

Economic Overview

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Drawing inferences from economic data is a tricky business, accounting for the frequent surplus of qualifiers and caveats. One of the principal challenges is timeliness; getting information out quickly is difficult owing to the expansive data and rigorous analysis involved. For this reason, economists use short cuts, for example releasing an "advanced" reading which is later followed by revisions. These advanced releases are intended to give a sense of magnitude and direction; however, the price of this speediness is inaccuracy of the first release, particularly during rapidly evolving periods. Like this one.

Another tool is a diffusion index, typically used for some of the most widely followed data series. A Purchasing Managers' Index (PMI), used the world over to measure economic activity, is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. Again, a helpful indicator but lacking the detail that should support investment decisions.

Forgive us the academic background, but the construction of economic data sets is of heightened importance at present. For example, if one were to find solace in the recent expansionary data points, it could be sufficient to motivate additional investment in equities. And while things are undoubtedly improving vis-à-vis the start of the year, employment (Chart 7) and overall economic activity (Chart 8) remain well short of prior robust readings.

Equities, which supposedly discount future corporate earnings, have gone on to set new highs, *notwithstanding weaker underlying data*. This is the kind of meaningful contradiction we unearth in the process of monitoring markets and cross-checking investment manager activity. Moreover, similar to the deteriorating undercurrents in fixed income, details like this keep us firmly focused on preserving capital and waiting before putting new capital to work.

Chart 7: Canadian & U.S. Unemployment (%)

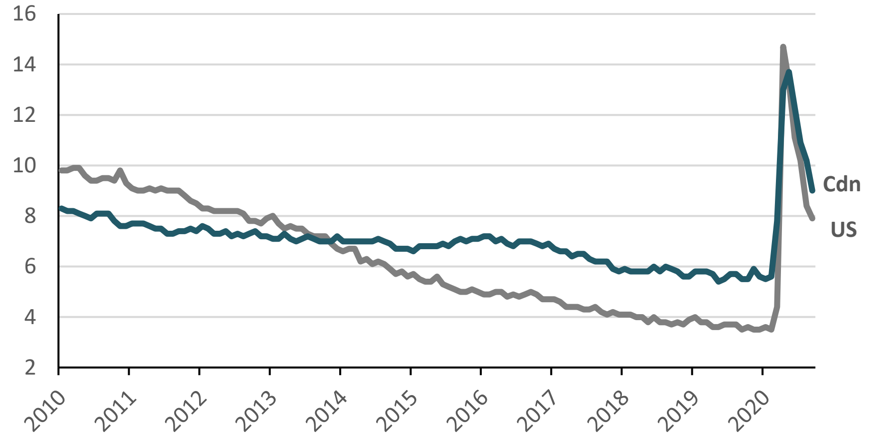
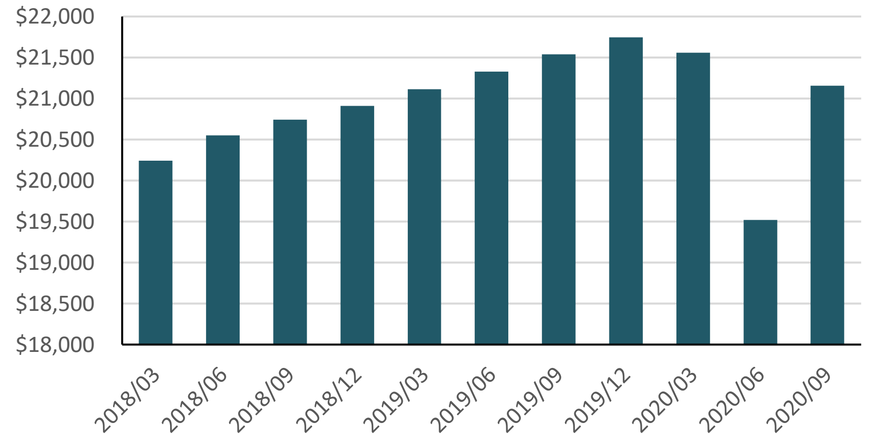


Chart 8: U.S. GDP ($ Billions)



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*

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

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

Charlie Scharfe
Wealth Associate
t 416.304.9866
e *charlie@ourfamilyoffice.ca*

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