Q4 2020 Investment Commentary

February 1, 2020

Q4 2020 & 2021 AT A GLANCE

OUR FAMILY OFFICE

"All the great things are simple, and many can be expressed in a single word: freedom, justice, honor, duty, mercy, hope."

- Sir Winston Churchill

In the midst of the world's first Covid Winter, it's that last word that resonates so deeply, that we're in greatest need of. Change is most certainly upon us and there is ample reason for hope. New vaccines to fight the pandemic are quickly making their way around the globe, opening the possibility of greater normalcy on the horizon. U.S. politics appear to be calming down, taking a more conciliatory path both internally and with foreign allies. And many of the world's largest, most developed equity markets are making new highs alongside their emerging market counterparts (Table 1), driving dramatic wealth creation out of a period of catastrophic economic turmoil. All this lends a decidedly more hopefully hue to the future.

At the risk of sounding perennially pessimistic, however, we still worry about the period between now and then. To our cautiously mindful eye, it seems that markets are baking in the best possible outcome for the economy and corporate earnings, largely on the back of unsustainable stimulus. Plainly, that worries us.

Every cycle has its nuance. In a more typical cycle, stock pickers often screen for quality by checking a company's liquidity, i.e. cash flow and other short-term capital available to pay bills. However, this cycle's stimulus, lending programs and income transfers have completely changed that. The game is now about distinguishing solvent companies with ample capital and bright futures from zombie companies appearing to be cash-rich and stable, but which have dim prospects post-stimulus. Money printing by central banks and governments on a scale hitherto unseen has made this a much more difficult exercise (Chart 1).

Chart 1: Central Bank Balance Sheet Explosion (US$Bln)

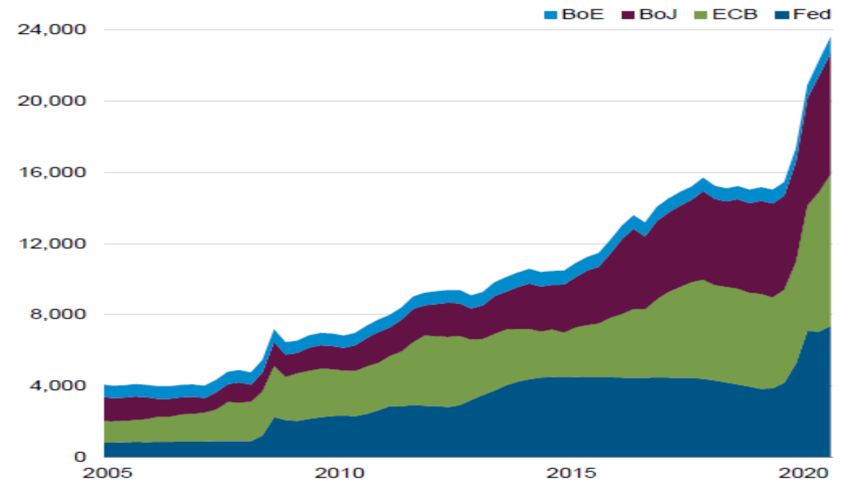


Table 1: Summary of Global Equity Returns

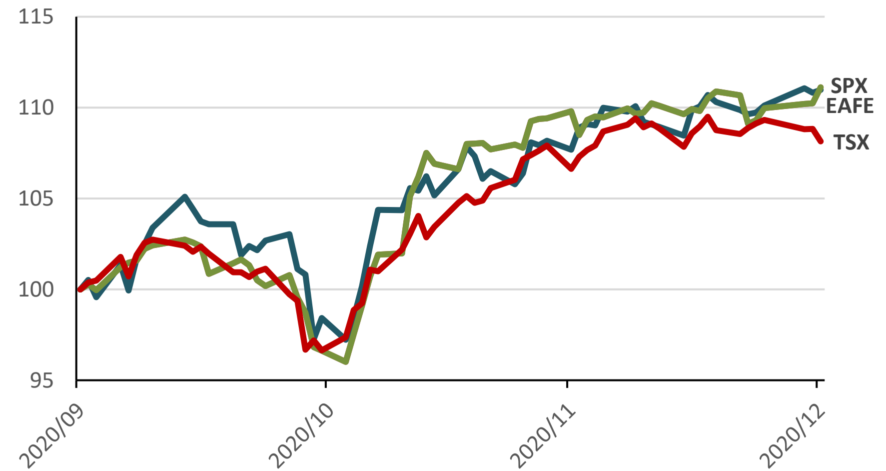
	2019	Q4 2020	2020
Canadian Large Cap: TSX Comp	22.9%	9.0%	5.6%
US Large Cap: S&P 500	31.5%	12.2%	18.4%
US Small Cap: Russell 2000	25.5%	31.4%	20.0%
US REITs	28.5%	7.5%	-4.7%
International: MSCI EAFE	22.3%	11.4%	1.3%
Japan: TOPIX	18.1%	11.2%	7.4%
UK: FTSE 100	17.3%	10.9%	-11.6%
Eurozone: Euro Stoxx 50	29.3%	11.4%	-2.6%
Emerging Markets: MSCI EM	18.5%	16.1%	19.5%

Our Family Office holds the view that stimulus needs to evolve such that it creates *sustainable* economic growth. Simply pumping cheques out to families, acknowledging the immediate need, cannot continue indefinitely. Stimulus must evolve away from income transfers to job-creating investment programs, continuing education, and long-term infrastructure projects. This will combine to create a sustainable economic expansion, lifting the fortunes of all constituents and providing the greatest boost to GDP. And to the extent government programs can "fill the gap" until sustainable growth emerges, we will feel incrementally better about valuation risks in the market.

Risk assets are certainly sniffing out policy makers' intent to deliver on this requirement, notably starting with President Biden's win on November 4th (Chart 2). The increasing likelihood of additional stimulus and longer-term infrastructure investment adds critical fundamental support to the market's lofty valuation. Indeed, the combination of vaccine rollout and supportive long-term programs led to a near-universal global equity rally while fixed income markets remained unbothered by elevated issuance; it was a decidedly positive conclusion to a very challenging year.

As 2021 kicks off, it's hard not to read about spectacular gains in various asset classes, but above all the SPAC industry. Positively, our clients continue to benefit from judicious exposure to a top North American SPAC manager. We frequently note it's rare to find a strategy capable of generating outsized returns without risking losses of a similar magnitude. The SPAC industry previously offered just such an opportunity, although those days may be numbered with broader investor attention turning toward it. More to the point, our dutiful monitoring confirms this manager – and all others – continue to invest with an abundance of caution and keen focus on risk. This, in turn, gives us the ability to steward client capital safely, as though it were our own, and offer families the greatest thing of all, peace of mind.

Chart 2: Q4 Global Equity Relief Rally (Indexed to 100)



GLOBAL EQUITIES

The recovery in global equity markets following March's historic drawdown was nothing short of remarkable, with the U.S. and other markets closing out the year at all-time highs (Chart 3). The fourth quarter witnessed a modest pullback into the U.S. election; however, that was rapidly followed by a strong rebound on the promise of additional economic support following President Biden's win. Other notable markets, including Canada, rebounded well but were governed somewhat by the extent of fiscal support and by the underlying fundamentals of each economy.

2020 was an unusual year in many ways, not least because gold performed nearly as well as cyclical stocks (Chart 4). Indeed, investment professionals would call it an "active management" year, wherein prudent capital allocation to (and away from) specific sectors enabled some managers to outperform the broader index. The key questions now facing investors are whether this outperformance can be repeated and whether equities are now over-valued.

Starting with the former, we note the S&P 500 returned >18% with less risk than active strategies owing to the benefits of broad-based diversification. We feel quite comfortable with the trade-off. Moreover, on the latter, statistics clearly show the odds of active management strategies *consistently* outperforming over the long-term growing ever smaller, further supporting our passive approach to public equity markets.

In the U.S., there are 5 instances since 1950 when the market dropped more than 30%, after which the ensuing 5yr period produced moderately better than historical returns. While only a small sample size, the odds are clearly tilted toward success in equity investing after such a plunge. Again, we await greater clarity on stimulus programs that will underpin sustainable economic growth. With that clarity, however, it may be time to start judiciously, modestly raising equity exposure later this year.

Chart 3: 2YR Performance of S&P 500, S&P/TSX Indexes

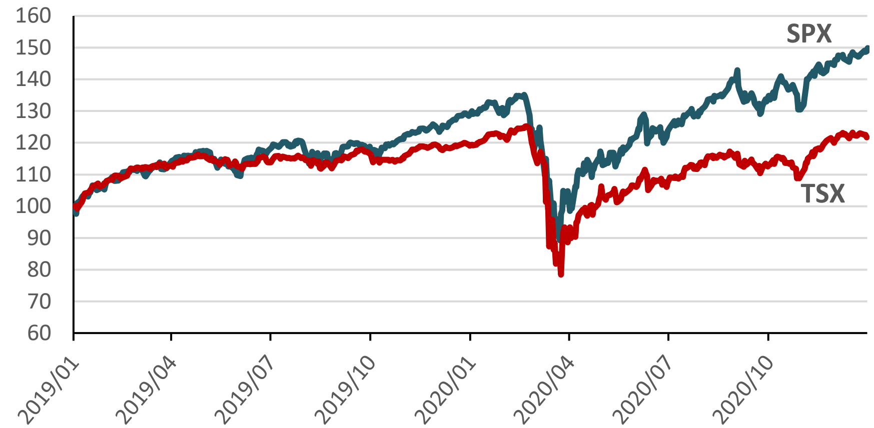
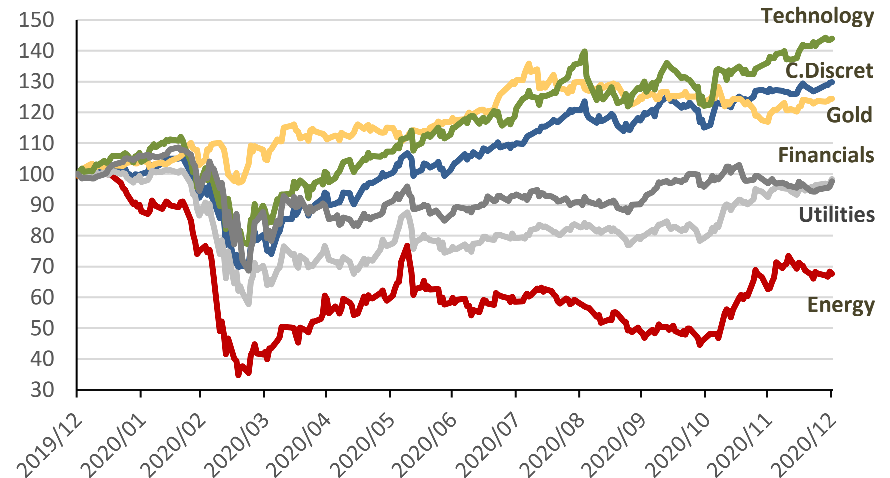


Chart 4: Divergent Asset Class Returns (YTD Indexed to 100)



Global Fixed Income

Every year it seems financial pundits suggest rates just can't go any lower and yet every year they continue sliding lower still (Chart 5). In fairness, no one forecasted a global pandemic and staggering debt issuance, but here we are. Positively, the sheer scale of the potential economic fallout and global nature of it commanded a massive coordinated response. In other words, everyone fired up the printing presses and bailed out their respective economies.

Countries that pumped out the most cash, reset credit to the greatest extent. For example, in March 2020 the U.S. unleashed a massive US$2.2 trillion in direct stimulus to individuals as well as small and large businesses. This was a larger fiscal support than was injected during the Great Financial Crisis and was delivered much faster. The result was higher personal income versus 2019, even despite the job losses in 2020, driving a higher savings rate, plummeting credit delinquencies and strongly accelerating retail sales. Consequently, U.S. consumers will emerge in a better credit position than they were in when the pandemic started, setting the stage for an economic boom when/if jobs return.

This is not to say there aren't credit losses on the horizon. We noted earlier the present twist to stock picking is ferreting out zombie companies, which most assuredly will float to the surface before the crisis is over. For example, business models requiring high volumes of tightly packed people clearly require rethinking and likely will not survive. That said, fixed income markets are more resilient now, reinforced by fiscal and monetary stimulus, and head into the next phase ready to absorb predictable write-downs (Chart 6).

Looking forward, non-traditional fixed income strategies continue to offer much more compelling risk/return profiles, especially when considering 10-year government bond yields range from -0.5% in Germany to about +1.0% in the U.S. Accordingly, portfolio allocations remain focused in strategies offering still-low volatility but far superior returns in the 4% to 7% range.

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

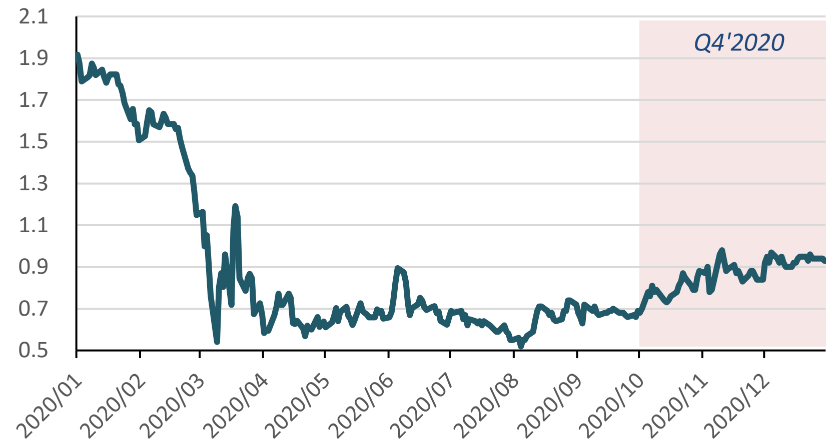
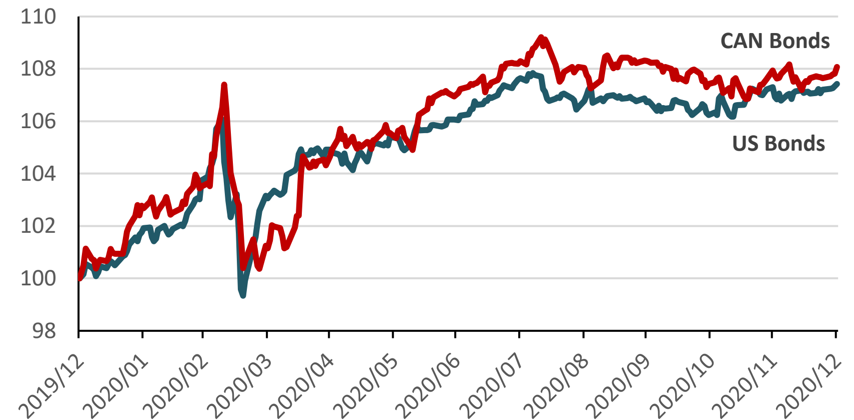


Chart 6: 2020 Cdn & U.S. Bond Market Performance



Currencies & Commodities

As it became clear the massive scale of global stimulus was likely to circumvent the next great depression, attention quickly turned to identifying areas of weakness and strength. The former was easy to spot; small businesses with local markets and limited online sales were suffering mightily from lockdowns, making recovery painful and slow. Fixed asset investment, however, was accelerating strongly driving a boom in commodity markets that looked sustainable (Table 2). Energy markets aside, industrial metals like copper and steel as well as lumber and other input commodities ended the year strongly and look primed for continued strength in 2021.

Oil and gas have had an entirely different experience, with only the former seeing some recovery in the fourth quarter as OPEC+ continued to constrain supply. The challenge of dramatically reduced demand is unlikely to change in the foreseeable future as any budding recovery for transport fuel ground to a halt recently with infections spiking and lockdowns back in force. Everything from reduced travel to a mild winter to ramped-up action on climate change is acting against oil and gas. Accordingly, we continue to view energy markets cautiously, instead focusing attention on industries that benefit from cheaper input costs, e.g. manufacturing in emerging markets.

Precious metals were broadly flat in the quarter to cap a strong year. While gold has reasonable fundamentals and a strong technical setup going for it, we continue to think it will trade most strongly as a store of value. If inflation continues to rise, the USD holds or declines and we see increasingly negative real rates, investors should expect to see gold appreciate further.

Owing principally to increasing confidence we'll manage through Covid-19 in the near future, revived risk appetites broadly reduced demand for the safety of USD (Table 3). The CAD has headwinds of its own that we believe will persist, not least of which is weakness in oil and consumer indebtedness.

Table 2: Commodities (USD)

	2019	Q4 2020	2020
Commodities	7.7%	10.2%	-3.1%
Agriculture	-0.3%	19.2%	14.9%
Copper	3.4%	16.3%	25.8%
Natural Gas	-32.3%	-18.5%	-45.9%
Crude Oil	35.4%	20.7%	-20.9%
Gold	18.9%	0.0%	24.4%

Table 3: Global Currencies vs. USD

	2019	Q4 2020	Q4 USD Direction
EUR	-2.40%	2.24%	USD Weaker
JPY	0.91%	1.80%	USD Weaker
GBP	4.11%	5.74%	USD Weaker
AUD	-0.61%	7.45%	USD Weaker
CAD	4.61%	4.54%	USD Weaker
CHF	1.71%	2.47%	USD Weaker

Economic Overview

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Stepping back, we see an abundance of investment opportunities across various asset classes and geographies offering attractive risk/reward balances. Fiscal and monetary authorities are acting decisively and at such a scale that we believe many negative potential outcomes have been avoided. This leaves us with an over-arching positive view of the investing landscape. That said, we are constantly aware that you can't earn a positive return without taking risk.

Plainly, the economy has a long way to go and much healing to do. Developed nations are still not operating – even with stimulus – at pre-pandemic levels (Chart 7) and some industries are nowhere near recovering, e.g. airlines and tourism (Chart 8). This clearly evidences the need for stimulus to evolve to create long-term sustainable economic expansion, i.e. job creation.

We hear the right language coming from governments around the world. They're aware of the need and working on long-term programs, which admittedly take time to develop. In the meantime, societies reshape themselves to accommodate the "new normal" and vaccine deployment lumbers on. Some industries are struggling, some recovering, some even thriving, and therein lies the opportunity.

Among the bright spots, many emerging markets fall into the "thriving" category as a result of their gearing toward commodities, manufacturing and fabrication. This nuance was not lost on us and we raised portfolio allocations to our emerging market equities manager at the end of 2020. We're pleased to report the strategy had an exceedingly strong year, returning approximately 35%, and appears well positioned going forward into 2021.

No doubt the new year will present continued challenges, both anticipated and unforeseen. 2020 was a very strong year for our investment platform and our continued vigilance should position us well for the year to come.

Chart 7: U.S. GDP ($ Billions)

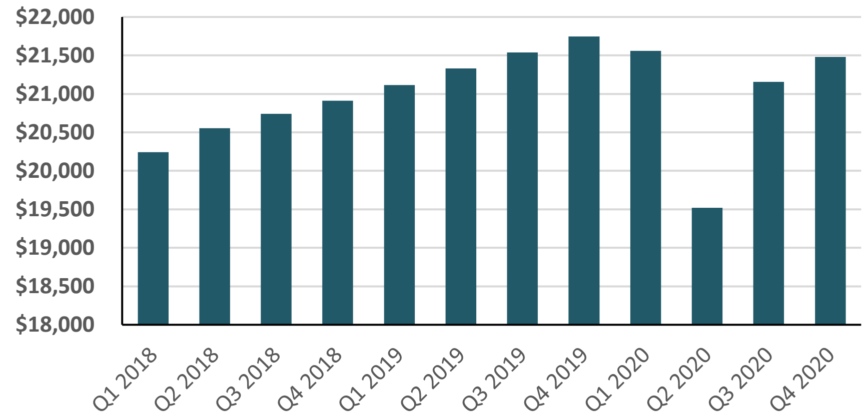
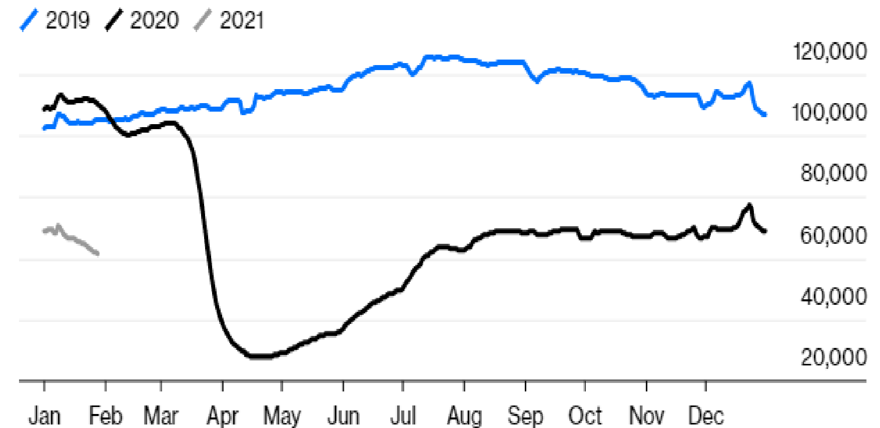


Chart 8: Commercial Flights >60% lower than 2019



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