OUR FAMILY OFFICE

Q1 2021 Investment Commentary

May 3, 2021

Q1 2021 AT A GLANCE

"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."

- Sam Ewing

In stark contrast to the Q1 experience a year ago, the first three months of 2021 saw risk assets rally to new highs around the world (Table 1). This strong performance, while not as spectacular as the preceding three months, was similarly underpinned by massive on-going stimulus from governments and central banks aiming to achieve break-away economic velocity.

Global leaders contemplating an eventual emergence from the pandemic-induced malaise continue to face near-impossible choices about the correct quantity, manner and duration of stimulus. The prevailing theory seems to be that greater risk lies in undershooting economic support, risking a Japan-style deflation spiral, compared to overshooting stimulus and driving inflation higher than long-term targets. Much of the rationale for favouring the latter appears to rest on the view that fighting inflation is simpler, cheaper and requires only well-practiced traditional policy measures. Notably, the narrative frequently omits the benefit to governments of inflating their way out of increased debt burdens.

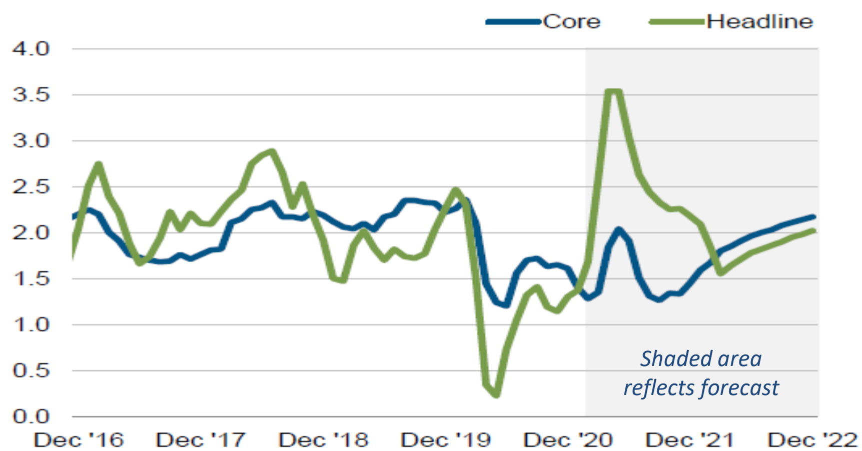
Aside from the political hot potato this decision tree represents, leaders throughout history have struggled with correctly calibrating short-term measures to achieve long-term targets. Notwithstanding, literally trillions of dollars in direct and indirect support have been pumped into the global economy, so naturally all anyone can talk about now is inflation and how quickly it's rising (Chart 1).

As is always our way, we note the importance of differentiating between signal and noise when observing economic and market developments. In this

Table 1: Summary of Global Equity Returns

	2019	2020	Q1 2021
Canadian Large Cap: TSX Comp	22.9%	5.6%	8.1%
US Large Cap: S&P 500	31.5%	18.4%	6.2%
US Small Cap: Russell 2000	25.5%	20.0%	12.7%
US REITs	28.5%	-4.7%	7.7%
International: MSCI EAFE	22.3%	1.3%	7.7%
Japan: TOPIX	18.1%	7.4%	9.3%
UK: FTSE 100	17.3%	-11.6%	5.0%
Eurozone: Euro Stoxx 50	29.3%	-2.6%	10.8%
Emerging Markets: MSCI EM	18.5%	19.5%	4.0%

Chart 1: U.S. CPI Inflation Forecast



Source: PIMCO

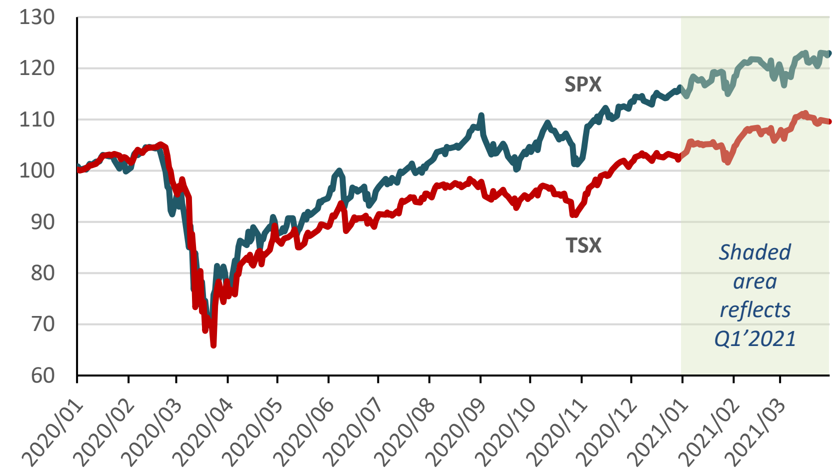
instance and particularly since it involves inherently volatile inflation data, we humbly suggest it's best to focus on long-term objectives to avoid getting whipsawed by high-risk short-term tactical repositioning. Moreover, we highlight that indicators for longer-term core inflation are decidedly mixed (more on this in the commodity section) and most economists forecast it settling into a historical and very manageable range of 2% to 2.5% (Chart 1), despite headline data trending up recently.

On a related note, bond yields also rose in dramatic fashion this quarter, producing negative returns in many corners of the traditional fixed income market. Indeed, money printing can only persist so long before investors start to reprice risk and seek higher yields. Add strengthening global demand to increased debt issuance and bonds quickly lose their appeal as "safe" portfolio allocations.

This demonstrates well one of the pitfalls of traditional 60/40 portfolios. It's easy to overlook the embedded risk of rising yields after they've done nothing but fall for a number of years; however, there's significant evidence to suggest we've seen the cycle low in yields, meaning bonds – that 40% part of a portfolio people forgot to pay attention to – could struggle to produce positive returns for years to come.

Our focus on capital preservation necessarily involves safer asset classes and strategies. That said, our awareness of risk is aptly demonstrated by the fact that our platform does not presently include a single benchmark-following fixed income strategy. Indeed, capital protection characteristics permeate every aspect of our line-up, including both income and growth managers. This helps our All-Weather Portfolios benefit from rallying risk assets (Chart 2) without sacrificing low volatility. Indeed, we can't predict the future, but this approach helps us ensure it remains bright for our families in any environment.

Chart 2: Risk Asset Rally Continues (Indexed to 100)



Global Equities

After the gut-wrenching start to 2020, the volatility we experienced over the last 3 months felt comparatively minor, especially given the overall upward trajectory and broadly positive international returns (Chart 3).

We recall expectations were set very low last year when all manor of forecaster pointed to a low and slow recovery. With the U.S. particularly hard hit at the time, the Congressional Budget Office made a dire prediction that the U.S. unemployment would remain higher than 10% until the end of 2021. There's admittedly a little noise in the data, but we would suggest equities and other risk assets responded correctly and very positively to unemployment already falling to 6.0% by the end of the first quarter.

In the period, the All Country World Index gained 4.6%, with non-North American equities up +7.7% and Emerging Markets rising another +4.0%. Canada, not to be left out, found its footing on strength in resources and rose +8.1%, while U.S. small cap stocks continued their surge, up +12.7%.

Equally, if not more important than seeing good market breadth, i.e. broad-based participation across market cap, sector and geography, we were pleased to see some gains in the value segments of the market, notably energy and financials (Chart 4). TLT, representing long-dated gov't bonds, and high yield were both pressured by rising yields, but overall there was clear continued rotation into risk assets from those deemed "safety".

Looking forward, the stage is set for equities to continue running on the back of ultra-low rates and over-supplied liquidity. While central banks appear to be dialing back their support, fiscal stimulus continues, e.g. Canadian airline bailouts and U.S. infrastructure spending. While valuation in some areas of the market appears speculative, public equities continue to represent an attractive and important component of our All-Weather Portfolios.

Chart 3: Global Equities Performance (YTD)

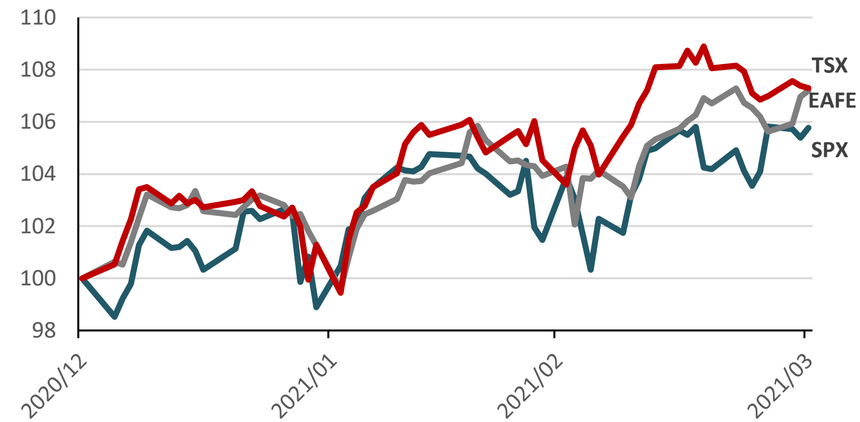
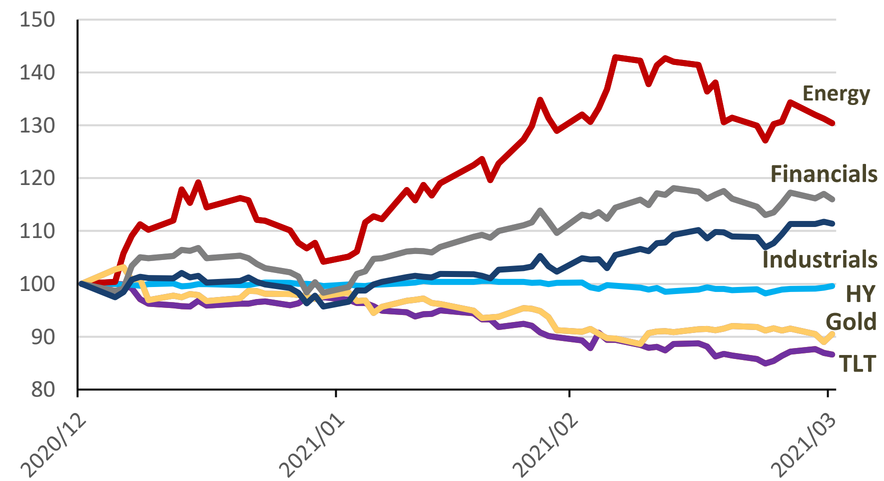


Chart 4: Divergent Asset Class Returns (YTD Indexed to 100)



There's a laughable yet oddly pervasive paradox in the investment industry: change is constant but always surprises forecasters. This was one of those quarters that probably shouldn't have caught as many people off-guard as it did.

Further to our opening comments on embedded risk in traditional fixed income exposure, Chart 5 illustrates the pronounced reversal in the benchmark 10yr Treasury yield in Q1, moving from roughly 90bps all the way up to about 170bps. While the absolute change in yield earned may seem almost trivial, in proportionate terms it represent a monumental near-doubling of the yield. In such environments, fixed income managers beholden to a benchmark struggle to get out of harms way as the broad bond market sells off (Chart 6).

Fortunately, the pace of change appeared to slow by the end of the quarter as Japan and other international buyers stepped in to buy the U.S. curve, leading to a broader calming of debt markets. Owing to inexpensive FX hedging costs on U.S. Treasuries, sovereign wealth funds and large institutional investors were satiated with the relatively modest incremental yield they could earn.

This demonstrates how traditional fixed income managers work to produce returns. They essentially have two levers to pull in order to earn better returns, duration and credit quality, and both are typically scaled relative to a benchmark. For example, a fund manager could run a portfolio with an average maturity of 6 years compared to 7.5 years in the benchmark; however, against a backdrop of rapidly rising bond yields this will do little to mitigate losses.

In contrast to this inflexible approach, our only traditional manager spent most of the period close to 2 years average maturity, avoiding almost all losses and significantly reducing volatility. Their focus on strong fundamental ideas instead of relative benchmark positioning continues to produce great results.

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

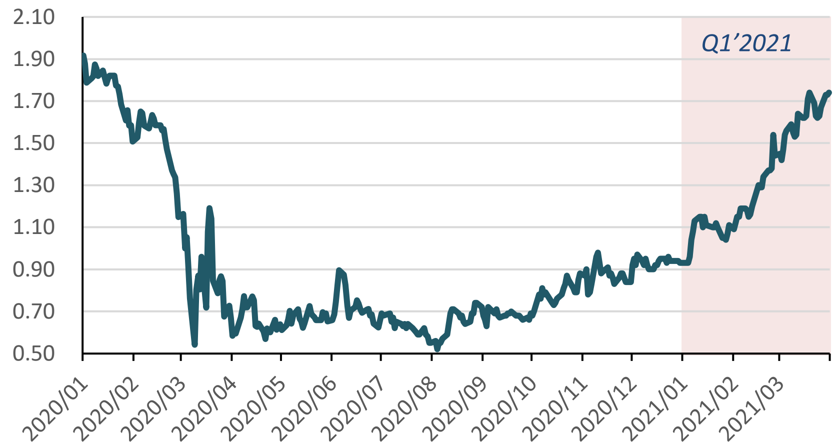
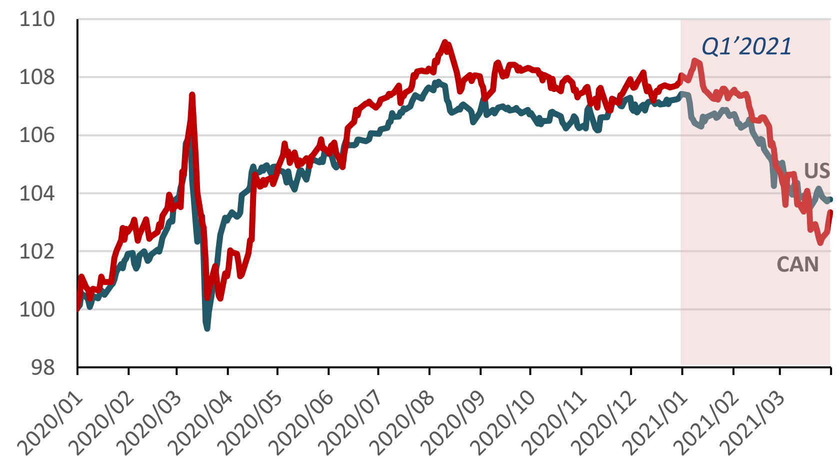


Chart 6: Cdn & U.S. Bond Market Performance



Currencies & Commodities

The greatest driver of commodity returns this quarter was improving global demand, although in energy markets the catch up to the rest of the complex was aided by continued supply constraints (Table 2). Agriculture and industrial metals saw continued momentum from demand and pricing power. All in all, the trends were broadly positive for Canada and risk assets rallied accordingly.

The staggering copper, lumber and food price increases over the last 6 months, which represent input cost inflation to producers and direct spending increases to consumers, make it easy to worry hyper-inflation is around the corner. Importantly, we note gold is not buying into the hype despite real rates remaining negative. Without a doubt, short-term inflation measures reflect significant energy price increases; however, that was off a very low base and amid unprecedented stimulus, so it would be a mistake to extrapolate into a longer-term trend just yet.

In terms of currencies, the USD found its footing in the period after a tough Q4 when the world seemed to accept the pandemic wouldn't last forever and eschewed safety. More notably this period, cryptocurrencies hit everyone's radar as bitcoin reached eye-popping levels, doubling in just 3 months. Call us old fashioned, but we get nervous when we see the combination of short, sharp price increases with extreme volatility, a rising inflow of questions from investors seeking to join the party at any cost and an equally impressive stream of new investment options from enterprising fund managers. Historically, this pattern suggests some measure of mania may be taking hold and buyers need still beware.

Don't forget, this is still very early stage of the industry's development. We're closely following progress at the central banks with eCurrency research and testing. Ultimately, the banks will determine much of how the industry shapes up long-term and which coin remains relevant, if any of those that exist today.

Table 2: Commodities (USD)

	2019	2020	Q1 2021
Commodities	7.7%	-3.1%	6.9%
Agriculture	-0.3%	14.9%	6.0%
Copper	3.4%	25.8%	13.2%
Natural Gas	-32.3%	-45.9%	3.8%
Crude Oil	35.4%	-20.9%	22.4%
Gold	18.9%	24.4%	-9.5%

Table 3: Global Currencies vs. USD

	2020	Q1 2021	Q1 USD Direction
EUR	6.84%	-2.18%	USD Stronger
JPY	4.93%	-6.51%	USD Stronger
GBP	2.99%	0.93%	USD Weaker
AUD	10.04%	-1.39%	USD Stronger
CAD	2.21%	1.33%	USD Weaker
CHF	7.68%	-4.83%	USD Stronger

Economic Overview

As we run out of superlatives to describe the fiscal and monetary response to the pandemic, maybe the only investment-related observation that matters is this, it worked. Whether you like how they did it or not, GDP in the U.S. made a new high in Q1 (Chart 7) and Canada is getting close to surpassing its prior peak. The debt burden is extraordinary and the distribution of wealth wildly uneven, but people are consuming again (if shopping differently), companies are producing goods again (if selling differently) and consequently risk assets are making new highs. So, too, are our client portfolios.

Economic ripples of the pandemic continue to be felt and implications for the workforce have yet to be fully understood, but capital market liquidity and broad-based economic growth are reasonably healthy again. To this end, the Bank of Canada recently indicated they would begin reducing stimulus by winding down several emergency buying and lending programs. However, fiscal support from the government remains firmly in place, supporting those still displaced or forced out of work by the pandemic. Bottom line, capital markets are clearly functioning well and require diminishing support.

At this point, we remain hopeful that all this fiscal stimulus (Chart 9) will create long-term sustainable economic expansion driven by employment growth and leading to more evenly distributed wealth accumulation. Vaccine deployment will surely aid the process and open more of the economy where people pay for a service instead of a good. That said, it's clear society has experienced a step-function change in retail and service disintermediation. This will take time to resolve and we believe it's still too early to "buy value."

Fortunately, incorporating all of this into portfolios is relatively straight-forward because we already focus allocations with managers engaged in asset classes and industry groups facing attractive risk-adjusted investment opportunities, such as SPACs, private credit, and private equity.

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

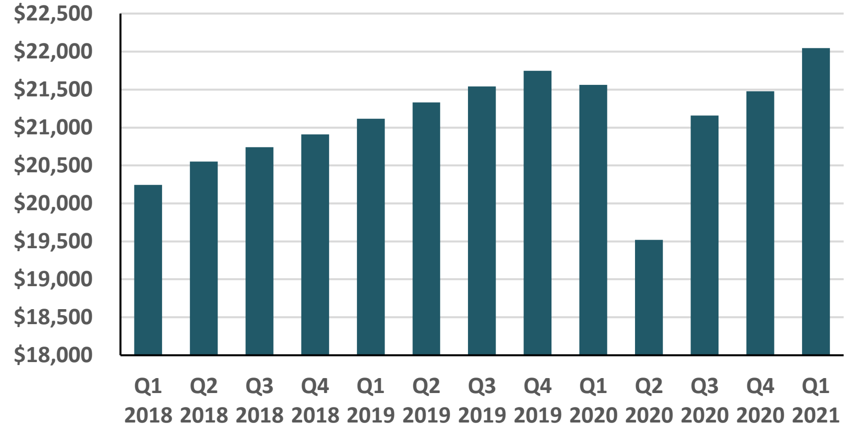
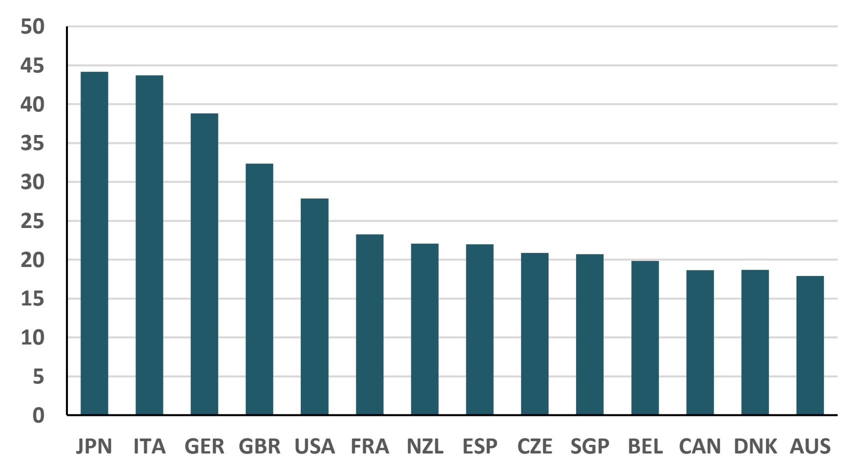


Chart 9: Fiscal Stimulus Response to COVID-19 (% of GDP)



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