



Investment Commentary Second Quarter 2021

23 July 2021

“There is an objective reality out there, but we view it through the spectacles of our beliefs, attitudes and values. Success requires enough optimism to provide hope and enough pessimism to prevent complacency.”

- Prof. David Myers, Ph.D.

We were all due for a quieter quarter and, mercifully, that’s exactly what Q2 brought us. Panic over ripping inflation eased into benign interest. Spiking 10-year yields moderated evenly throughout the period. Central banks soothed concerns of a rapid withdrawal of support. Equities rallied on the goldilocks scenario (Table 1). In essence, everyone just took a breath and let their shoulders drop.

Specifically on inflation, some commodities moderated this quarter while others continued to build on a strong Q1. U.S. Lumber prices, for example, ended June approximately where they began in January after skyrocketing more than 140% at their peak. Crude oil, however, tacked on another 24% in Q2, bringing the YTD gain to over 52%.

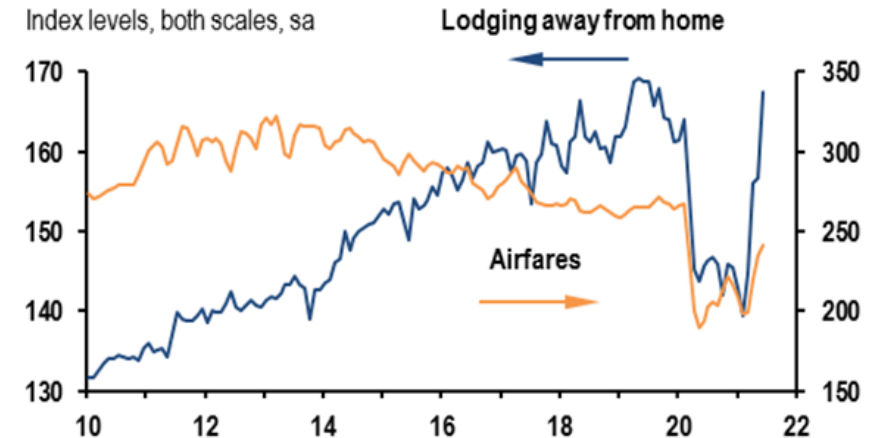
Indeed, prices are rising dramatically in many corners of the economy. What is critical to understand is where they stand relative to long-term history, not just 12 months ago, the measurement period for standard inflation indices. Chart 1 shows astronomical lodging price inflation so far in 2021, but note prices are only just approaching pre-pandemic levels. Airfares have certainly risen recently yet remain well below historical levels, so all may not be as it seems in headlines.

Context is everything in investing, which makes it paramount for market participants to get information from the source instead of media quick takes. In short, we remain unphased by the inflation data reported to date. We are, as always, watching very carefully and in constant communication with

Table 1: Summary of Global Equity Returns

	2020	YTD 2021	Q2 2021
Canadian Large Cap: TSX Comp	5.6%	17.3%	8.5%
US Large Cap: S&P 500	18.4%	15.3%	8.6%
US Small Cap: Russell 2000	20.0%	17.5%	4.3%
US REITs	-4.7%	20.7%	12.2%
International: MSCI EAFE	1.3%	13.1%	5.0%
Japan: TOPIX	7.4%	8.9%	-0.3%
UK: FTSE 100	-11.6%	10.9%	5.7%
Eurozone: Euro Stoxx 50	-2.6%	16.6%	5.3%
Emerging Markets: MSCI EM	19.5%	8.1%	3.9%

Chart 1: Price Level vs. Price Change



Source: JPMorgan

investment managers on this and other topics. It's not an accident that our client portfolios weather market turbulence and long-term cycles without requiring major retooling, hence the All-Weather Portfolio descriptor.

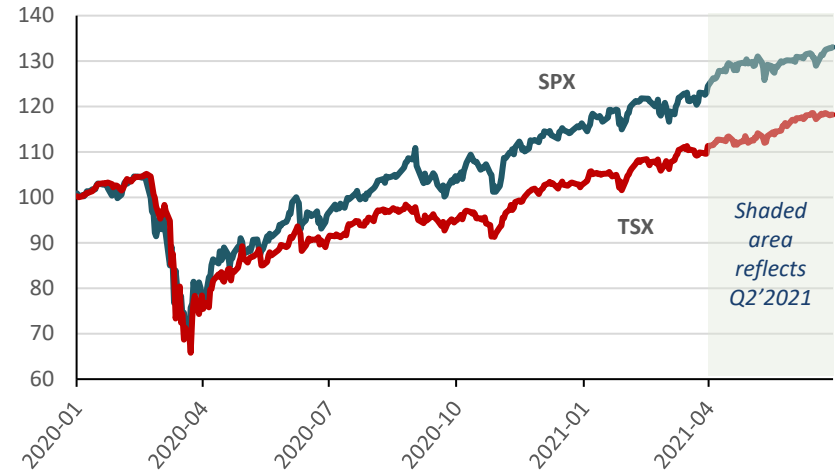
Instead, we look to put client capital to work opportunistically, always considering capital preservation first and modestly tweaking asset architecture to better achieve long-term investment goals.

This quarter saw Canada play catch-up to other global equity markets, finally performing in-line with the world-leading U.S. equity market (Chart2). Largely on the back of resurgent energy and financial stocks, the TSX Composite rallied a decisive 8.5%, making YTD returns more than 3x that of 2020's paltry mid-single digit gain.

Owing partly to the long-running disconnect between Canadian and U.S. equities and partly to the opportunity for that disconnect to mean-revert as global growth gained traction, the Investment Committee approved and allocated capital to a new non-traditional Canadian equity manager during the period. Running a hedged North-American equity portfolio that heavily skews to Canadian stocks, our new manager historically runs about 1/3 less volatility than the index benchmark yet annualized returns come in consistently better. This addition is an excellent example of how we aim to constantly enhance the platform's ability to increase exposure to risk assets while still minding and mitigating risk.

As the world decrypts the best way to defend and counter against Covid-19, economies slowly reopen, people breathe a little easier and so, too, do markets. Risks remain, stretched valuations to name just one, but opportunities do exist across asset classes and we feel cautiously more positive about the foreseeable future.

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



The good times of Q1 largely continued in Q2 as investors gained greater comfort that central banks and governments weren't likely to pull the stimulus rug out any time soon. Global demand recovered as the weather warmed and covid infections rates cooled, driving equities higher the world over (Chart 3).

S&P 500 earnings for Q1, reported throughout Q2, underpinned the market and kept the rally going, with revenues up +11% and earnings per share higher by +35%. Granted, the skeptic could say these results came against decidedly challenged year-over-year comparables; however, the continued building of global economic momentum combined with sharply stronger corporate results overwhelmed the bearish perspective.

Nowhere was this more evident than in resurgent energy stocks (Chart 4), though strong rallies in financials and industrials contributed a healthier sector mix and improved breadth to the overall market.

In the period, the All Country World Index gained a little more than +6%, with non-North American equities up +5% and Emerging Markets rising just shy of +4%. Canada, not to be left out, found its footing on strength in resources and rose +8.5%, approximately in line with the U.S.

Looking forward, the stage is set for equities to consolidate gains and possibly continue higher in the second half of the year. While central banks appear to be dialing back their support and fiscal stimulus must inevitably come to an end, authorities are clear on the notion that overshooting an economic expansion is vastly superior to falling short and slipping back into economic malaise. 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)

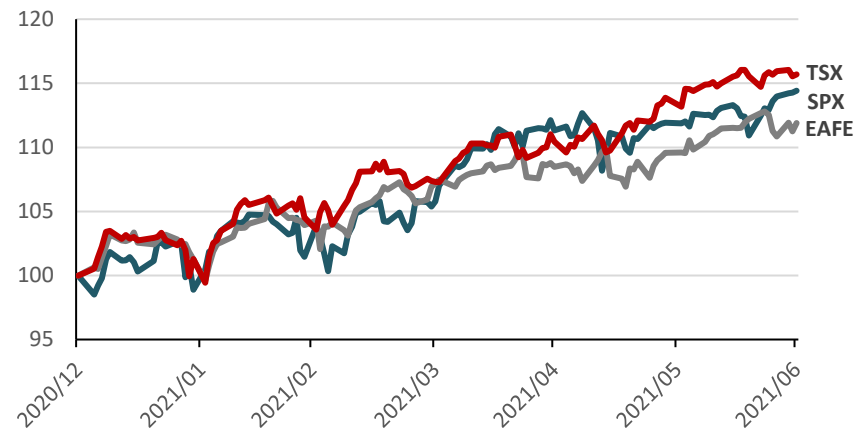
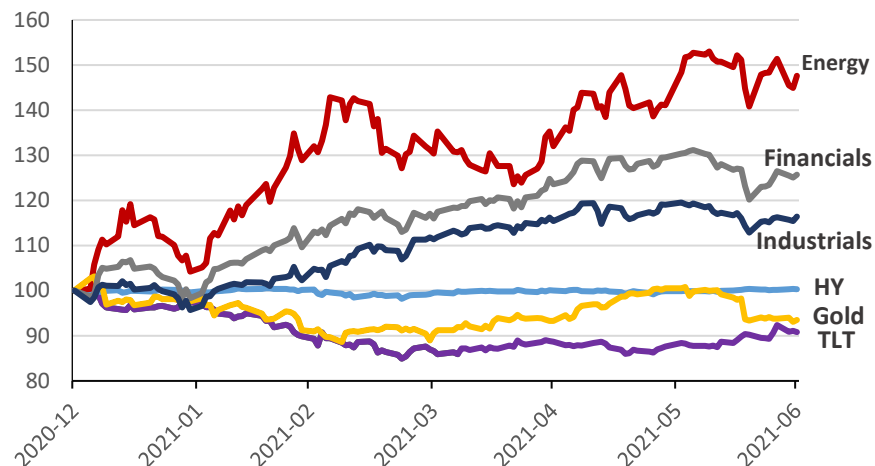


Chart 4: Divergent Asset Class Returns (YTD Indexed to 100)



The very end of last quarter marked the near-term high in long-dated yields (Chart 5), which coincided with increased international U.S. Treasury buying and slightly preceded broader inflation expectations turning more benign. The quarter played out relatively calmly from there, with North American and other bond indices experiencing reduced volatility and moderate gains.

Over the last year-plus, credit losses have been remarkably low owing to unprecedented fiscal and monetary support. Consequently, corporate credit spreads tightened, meaning there was a decline in the incremental price demanded for the added risk over similar-duration Treasury bonds. Indeed, corporate credit spreads today remain exceedingly narrow and anticipate very little in the way of losses looking forward.

In our view, the risk in traditional fixed income is substantial. Gains seen in the quarter across Canada, the U.S. and other markets (Chart 6) were a pleasant reprieve, but don't truly represent an inflection point in the respective markets. Scratch the surface and you'll see institutional investors are betting heavily that bond yields will start rising again soon, reflecting strong historical relationships between rates and economic growth. That means a return to losses from duration in the fixed income indices.

Moreover, fiscal stimulus measures, designed to underpin weaker parts of the economy during the pandemic, will eventually have to be withdrawn. Taking away life support will most assuredly expose those businesses that haven't experienced a full return of business volumes to potential bankruptcy. That means credit losses and a subsequent repricing of risk, i.e. wider corporate credit spreads and lower prices for corporate bonds.

Bottom line, we believe short-duration, benchmark-agnostic and non-traditional debt managers remain the best way to mitigate these risks.

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

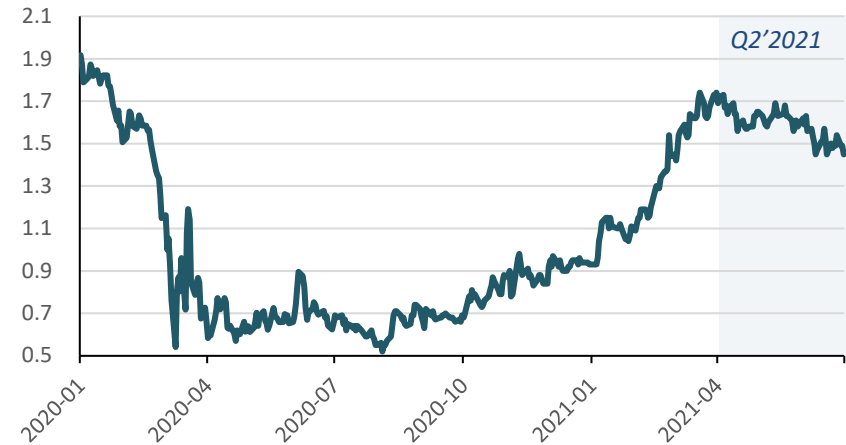
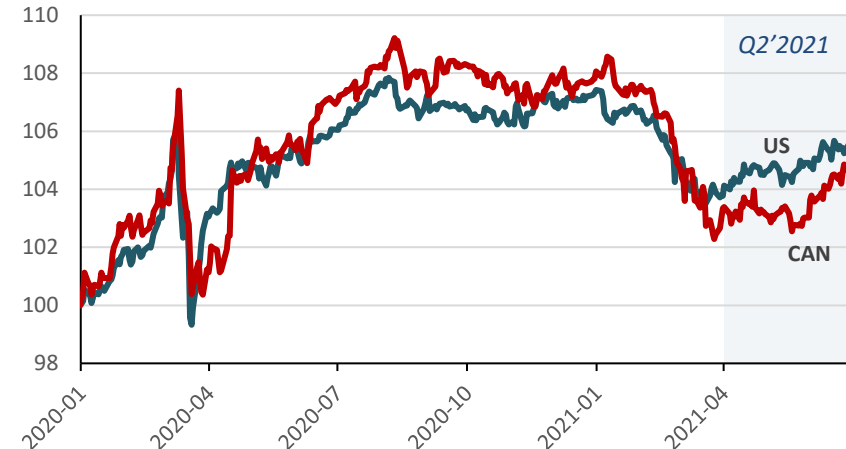


Chart 6: Cdn & U.S. Bond Market Performance



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.

It is impossible not to notice the swelling cost of groceries each week or the rising hit from filling the car with gas, now that we're doing that again. Without question some areas of consumer spending are inflating at alarming rates, so why isn't inflation in the double digits? There's a complex answer underpinning that, involving everything from ever-falling prices of technology to less travel and vacation spending to more cost-efficient online procurement. Bottom line, spending dollars are being allocated differently and commodity supply-demand dynamics are reacting accordingly, although there will most certainly be short-term and long-term impacts.

Gold, insofar as it can be an indicator of inflation expectations, rose early in the quarter only to give most of it back when inflation forecasts came off the boil. While there isn't one indicator that's always right, it's nice to see gold calmly consolidating last years gains.

Currency markets remained sanguine throughout the period. Risk asset rallies were appropriately reflected in USD strength against traditional safe havens of Swiss Franc (CHF) and Japanese Yen (JPY). While we do not attempt to trade or time currency swings, having learned the hard way it's the most complex and challenging of all investment arenas, we do look to cross-check our investment views across asset classes and particularly in currency movements. So far, so good.

Table 2: Commodities (USD)

	2020	YTD 2021	Q2 2021
Commodities	-3.1%	21.2%	13.3%
Agriculture	14.9%	19.1%	12.4%
Copper	25.8%	20.7%	6.6%
Natural Gas	-45.9%	38.0%	33.0%
Crude Oil	-20.9%	52.1%	24.2%
Gold	24.4%	-6.5%	3.3%

Table 3: Global Currencies vs. USD

	2020	Q2 2021	Q2 USD Direction
EUR	6.84%	1.11%	USD Weaker
JPY	4.93%	-0.31%	USD Stronger
GBP	2.99%	0.31%	USD Weaker
AUD	10.04%	-1.26%	USD Stronger
CAD	2.21%	1.38%	USD Weaker
CHF	7.68%	-0.34%	USD Stronger

Economic ripples of the pandemic continue to be felt and implications for the workforce won't be fully understood until fiscal support measures are withdrawn. That said, business activity around the world is improving, albeit unevenly, and job markets are strengthening in response (Chart 7). Jobs are key to self-sustaining economic momentum, the virtuous circle of earning and spending, so this is a significant positive for the overall recovery.

As discussed, the recovery is spawning inflation, but which appears, so far, more transitory than entrenched. Monetary authorities are steadfast in their view that it's better to risk running the economy too hot than too cold. Clearly they recall the Taper Tantrum of 2013, having learned the hard way that a sloth-like pace of stimulus reduction wrapped in a stridently transparent communication policy is best for markets and the economy broadly.

At this point, it seems business has made great strides in operating within the parameters of a global pandemic, which makes every successive wave easier to weather. Jobs are coming back, families are starting to travel and spend again, and the economy is strengthening. Vaccinations, though regrettably politicized, remain a key pillar of continued recovery (Chart 8) and Canada is making great strides in this area. There will always be a business cycle and markets will move accordingly, but the backdrop is better.

After everything we've endured, it's impossible to overstate the relief of feeling some normalcy – in markets and in everyday life. Time with friends and family, holding a new grandchild for the first time, or feeling more at ease walking into a store. These simple moments are critical to the human experience and to improving everyone's mental health. Rest assured, the team at Our Family Office has your investment and planning needs well in hand, leaving you to relax into a calmer and very fulfilling summer.

Chart 7: Improving Unemployment (%)

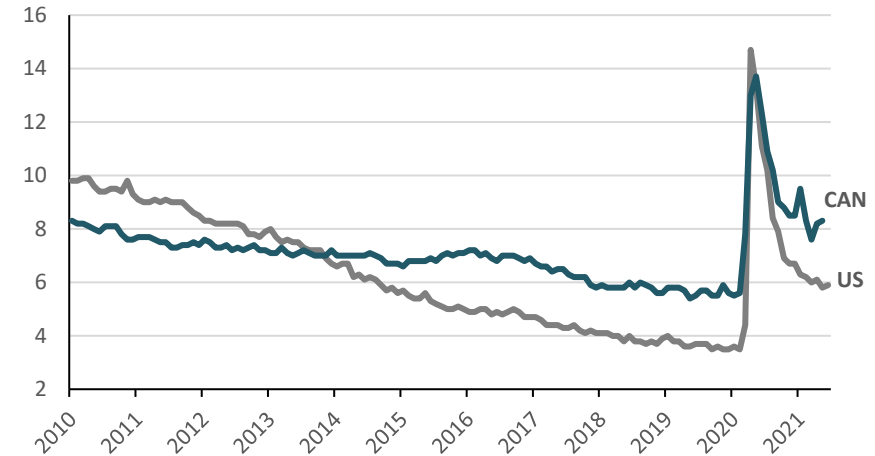
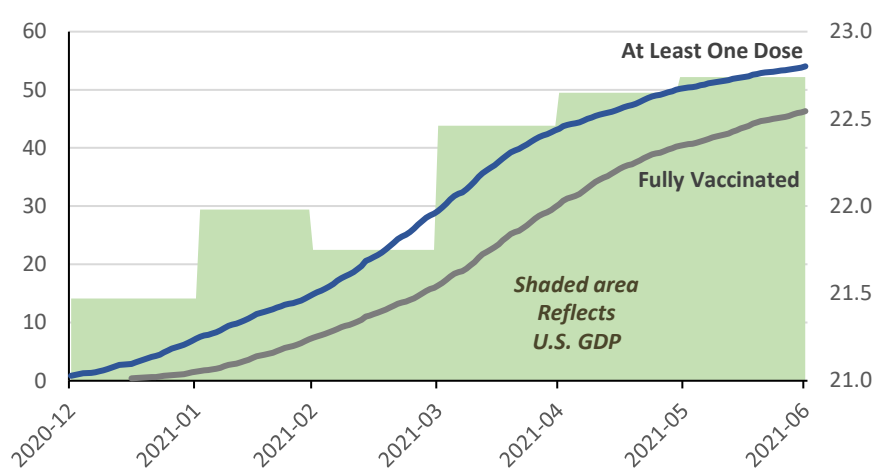


Chart 8: U.S. Vaccinations (Left, %) vs. GDP (Right, US\$Trl)



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