Monthly Newsletter
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Wise Investor – June 2020

'The ultimate measure of a *-human-* ***is not where they stand in moments of comfort and convenience, but where they stand at times of challenge and controversy.'***

Martin Luther King Jr.

What's Happened?

This inspiring quote from Martin Luther King Jr is something that I've turned back to a few times in my life when the world gets challenging. I would say that now, more than ever, it can be connected to our current environment. It's no surprise to anyone that we are in the midst of a global pandemic that has negatively impacted us all in some way. The virus was the impetus that started a downward spiral around the world with great social and economic consequences. In this month's article I will summarize where we've come over the past few months avoiding a political or social conversation to focus more on the stock markets and my outlook.

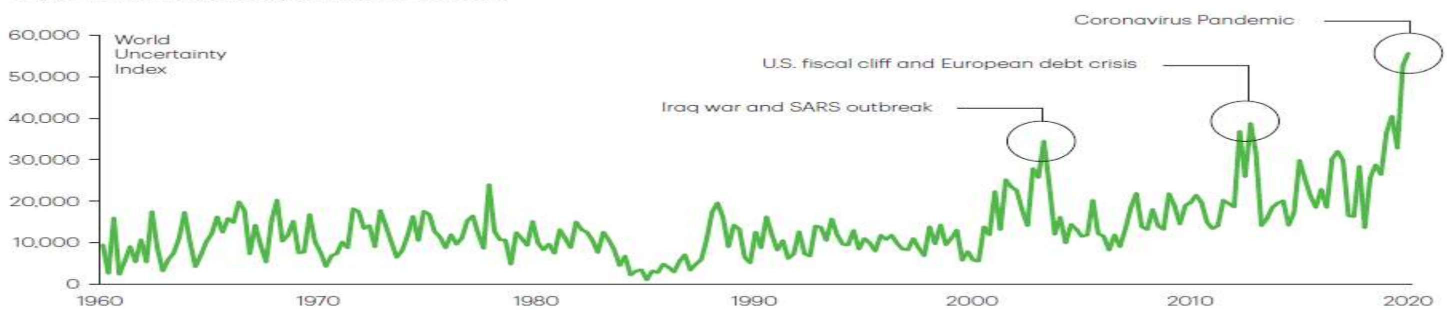
Although not enough time has elapsed to technically call this a recession, I am pretty confident that with the economy on a self-induced coma, we are currently in one. Through the last few months we have witnessed the S&P 500 fall 34% in a record 23 trading days through March. The S&P 500 marked a low of -34% and S&P/TSX down -37% with volatility reaching levels higher than 2008 and 1929! Since then, we have seen strong optimism causing a multi-month rally in stocks with some even surpassing record highs. I continue to explain that the market is the collective wisdom of every investor in the world at any given time. The market usually has it right. Markets are what I call a forecasting mechanism in that they use all relevant information at any given moment to predict what is coming in the future (6-12 months ahead). Although markets often go too far down in bad times and too far up in good times, investors would be wise to ask what the market is telling them rather than proclaim that the market has it wrong. The market appeared to have been pricing in a global depression in the depths of March which could well have been correct if federal governments didn’t step in with trillions of dollars of stimulus. Now markets appear to be pricing in only a mild decline in corporate earnings over the next 2 years and a V-shaped recover. A V-Shaped recovery suggests a quick recovery with the worst long behind us. Again, the markets could have it right provided we avoid a 2nd wave and come up with some sort of a vaccine by early next year allowing life to return to some sense of normality.

As a result of this quick market recovery, those with investment portfolios that were able to avoid any health problems are close to the same position they were in to start the year. This has created a great disparity between Wall Street and Bay Street vs main street or what I like to call the have's vs the have-nots. Those with the ability to invest and maintain employment have been rewarded and those that could not and did not are likely in the worst shape they've ever been. Permanent job losses, impairments in asset values in less desirable neighborhoods and an outsized health impact have penalized the have-not's and increased the social disparity across the world. This can be extrapolated in the heartbreaking examples of racism finally getting the notoriety they deserve. With the have-not's being the most impacted and growing in numbers their voices appear to finally be getting heard. Perhaps history will not repeat itself and possibly centuries of injustice and inequality will finally be reversed. I suspect this movement won't go away any time soon and I can only hope it leads to a change in power. But this is all a topic for another article on another day.

What's the Impact?

One impact that we can be certain of is extreme uncertainty. Believe it or not, this can be tracked as shown on the World Uncertainty Index, Figure 1. This index tracks the frequency of the word 'uncertainty' in the 143 country reports of the Economist Intelligence Unit. As confirmed by the World Pandemic Uncertainty Index and a World Trade Uncertainty Index, it will come as no surprise this has skyrocketed to record levels as of late (figures 2 & 3).

Figure 1: The Most Uncertain Time in 60 Years



Source: Ahir, H, N Bloom, and D Furceri (2018), TD Economics. Note: A higher number means higher uncertainty and vice versa. The Index is constructed by counting the frequency of the word "uncertain" (or its variant) in Economist Intelligence Unit country reports. The Index is then normalized by total number of words and rescaled by multiplying by 1,000.

Figure 2: Pandemic Induced Uncertainty

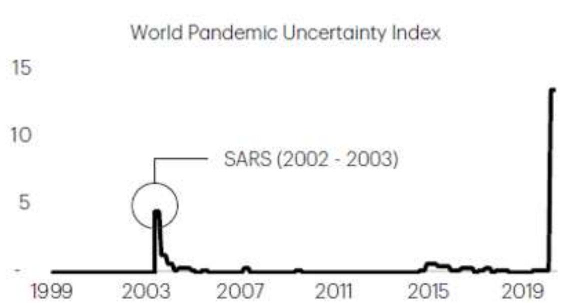
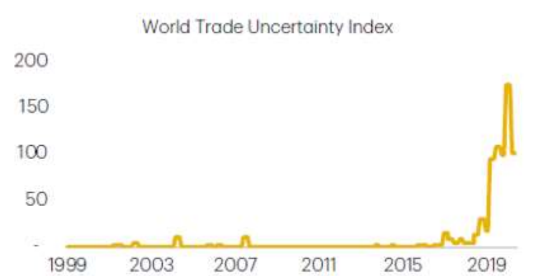
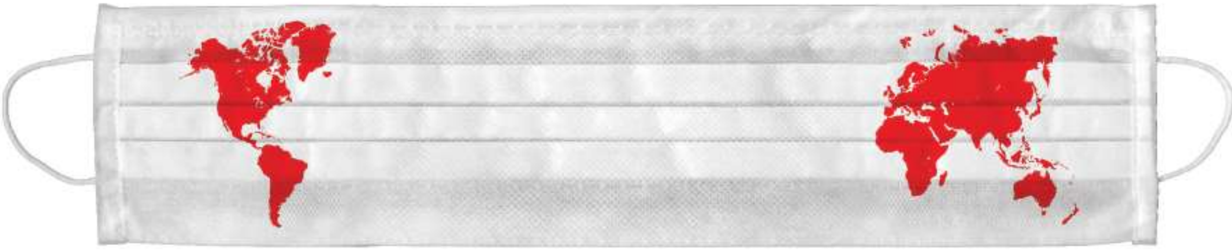


Figure 3: Trade Tension Uncertainty



Source (Figure 2 & 3): Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index", Stanford mimeo.



I expect this pandemic to drastically change all aspects of our lives and leave deep scars on the global economy in years to come. I would expect that many jobs may never return specifically in the lower wage, lower-skilled, face-to-face services. TD Economics predicts that about 42% of job losses in the U.S. may be permanent which would mean at least 17 million will have no job to return to. This will add fuel to the fire of the have's vs the have-nots and likely exacerbate social unrest and populism. This will likely be reverberated on a global scale with the have-not countries like those in the emerging markets getting pushed further into poverty.

It should come as no surprise that the trillions that have already been unleashed with the outlook for many more will significantly increase future debt burdens. Debt-to-GDP levels are expected to surpass the highs recorded after World War II leaving only two options: tax or inflation. One would expect a hefty part of the burden to fall on large corporations and the wealthy for generations to come. I expect interest rates will have to stay very low for a very long-time as any increase would directly increase the costs of the debt burden. This will also allow inflation to run its natural course which will help lower the cost of said debt burden. The negative impact of lower interests rates for longer is there will be less ammunition for central banks for inevitable future financial crisis'. This will also have an unintended consequence for the banking sectors whose profitability relies heavily on higher interest rates. This is because a large share of bank earnings comes from the incremental interest that they earn on a mortgage vs what they pay out on investments like GICs/term deposits. This will disincentivize banks to provide loans which is the backbone of a growing economy.

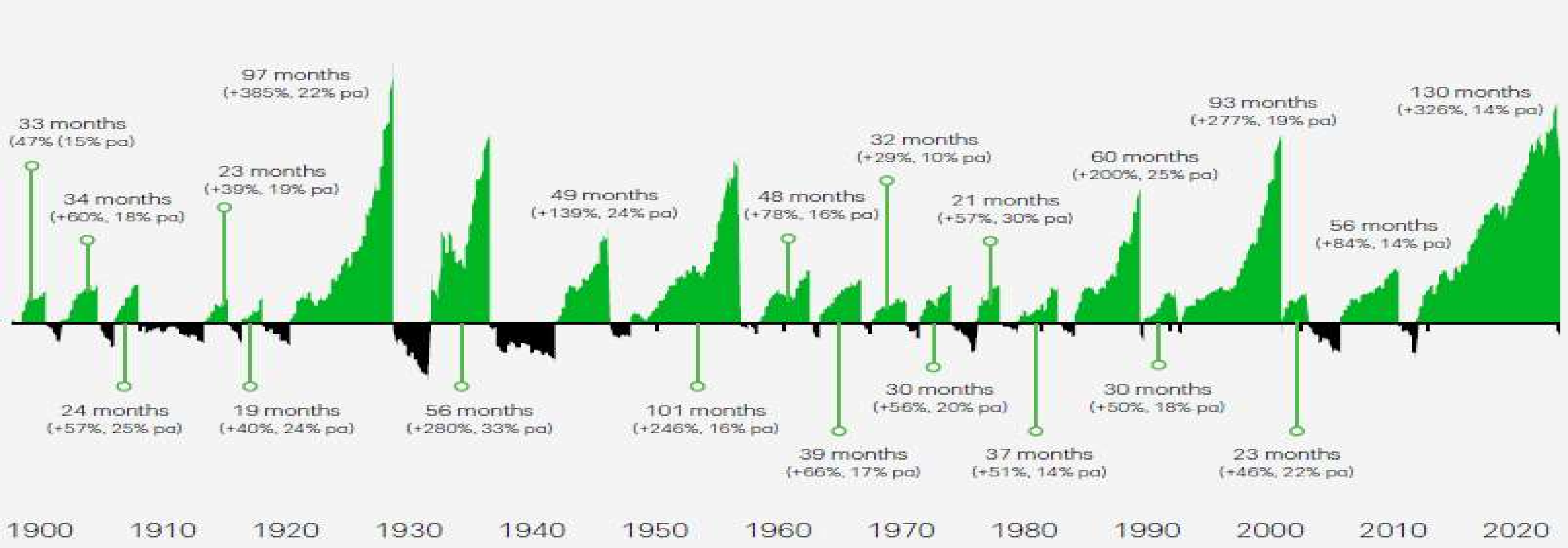
The pandemic also exposed the vulnerabilities of companies or nations relying too much on supply chains abroad. If for instance your company relied on microchips manufactured in China, then you experienced several months where you could not access any. This is one example of thousands that rely on foreign production to complete their products. This has prompted countries to focus more domestically and has increased deglobalization. This has the benefit of keeping more jobs at home but comes with the cost of reduced profits and lower productivity. This will exponentially impact the have-not nations with Large US companies ditching their workers and factories abroad to bring them home. It's also no secret that relations and business between China and the U.S. continue diverge. China's direct investment in the U.S. in the first quarter fell from $2 billion to $200 million vs last year. Whether good or bad, this will reduce business investment and decrease potential growth.

Last but certainly not least, one of the most impactful outcomes of this pandemic has been, and I believe will continue to be, the acceleration of technological change. This has been punctuated by the spectacular performance of the FAANG (Facebook, Amazon, Apple, Netflix and Google) companies of which, if you didn’t own in your portfolio you have significantly underperformed the index. In this case the haves continue to thrive but will lead to less competition, higher consumer prices and give these companies more control in a capitalist world.

Why Should I care?

As I hoped you've learned from above, I do not believe we will be going back to business as usual and we should prepare ourselves for a bumpy ride. The future, in my opinion, will likely include weaker growth, massive debt burdens, less ability for governments to intervene 'next time', extremely low interest rates, further social unrest, populism and deglobalization. In the most recent decade following the financial crisis you could pretty much own anything and make a decent return. When the dust settles from this crisis, I believe it's important to understand the implications on a business sense and focus, where possible, on investing in the haves and avoiding the have-nots. Downside protection strategies will also be more important than ever. In my next section I will walk through my current approach and provide some examples to help explain

Figure 4: S&P 500 Total Returns from January 1900 – April 2020



Source: Yale University Department of Economics, Goldman Sachs, as of April 30, 2020

Investment Strategy

I had the benefit of being a trusted Investment Advisor for affluent families through the 2008 financial crisis and I'm taking what I learned then to structure portfolios now. I believe looking back on this in the future, it will show up as a minor dip in a great period of growth as per figure 4 but things can be done now to be better positioned for the future.

What caused the experience we're facing today is quite different than 2008 but I expect the resulting recession to be similar. I look at our current strategy for the stock market as a 3-bucket approach, complimented by a higher than usual cash balance, bonds and for the first time since 2008, gold. My 3-bucket approach takes into consideration where we are now, where we expect we could be in a year while protecting capital in case we fall back to where we were a few months ago. It goes a little something like this:

- **Bucket # 1 – Long-Term Growth**: those companies that have done well through this pandemic, showing clear market leadership and I expect to come out of this all stronger.
    - Examples include mainly U.S. technology stocks that have proven their worth, taken massive market share and continue to grow like Microsoft, Google or Amazon.

- **Bucket # 2 – Consistent Income**: those companies that weathered the storm, pay a reliable dividend and still work well in a lockdown environment just in case there is a 2nd wave.
    - Examples include blue chip utilities and telecommunications as people still need to turn on the lights and I don't believe anyone is cutting their cable or cell phones any time soon like a Fortis, Algonquin Power or Shaw Communications.

- **Bucket # 3 –Short-Term Growth**: those companies that are still trading at discounts in the areas of the market that will benefit from a reopening of the economy and we always make sure their balance sheets can sustain their dividend in case we have to wait longer than expected.
    - Examples would include the retail sector, industrials and commodities which will all benefit as consumers leave their homes and businesses restart like Canadian Tire, CN Rail or Enbridge.

The markets have had a strong run and are in my opinion probably due for a little backing and filling. Our portfolios have well established positions in all three buckets, and we will be using any weakness through the summer to continue adding to Bucket # 3 as we track COVID cases, social unrest and the economy slowly reopening.

Personal Note

Like many of you I'm sure, my household is starting to go a little stir crazy. I could categorize humans into three buckets as well. Those that probably aren't cautious enough throwing social distancing to the wind, those that abide by the rules but go about their routines and those that are probably a little too cautious. With an infant at home, we definitely fall into the overly-cautious bucket for the most part staying at home with even our groceries being delivered to avoid large groups. The one shining light through the chaos has been seeing my young son grow and develop every day. The Mrs' hasn't thrown me out yet so I must be doing something right around the house. But in all honesty, we've used this time to really connect as a family and the extra caution on exposing ourselves to very little, has given us the ability to visit those higher risk family members whom otherwise may not have been able to see anyone at all.

Travelling has always been of outmost importance to our little family and once a year we strive to go somewhere that we've never been before. As we don't see ourselves getting on an airplane any time soon we have decided to rent an RV and we are taking our quarantine on a road trip. We are heading north up the sunshine coast followed by a trip across the strait of Georgia for some gulf island hopping.

As we all wish for a quick transition back to normalcy the reality is that probably doesn't come until there is a vaccine. As we live in this new normal, I hope that you and your family stay safe, stay healthy and get out there to take advantage of the summer sunshine months outside.

Best,

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