Market Update

July 2020

Important Topic: Inflation

When evaluating any investment it is always critical to consider the after-tax and after-inflation return as the resulting figure is more accurate. Last month I addressed taxation so let's take a look at inflation.

Simply put, inflation is a measure of how quickly the value of our money is decreasing. If inflation is 3% then a $100 item today will cost $103 next year. Therefore, next year, $100 will not be able to buy this item unless you get a return on investment that at least matches the rate of inflation. Consider a bond bought for $100 that will pay annual interest and then return your $100 in ten years' time. When the $100 is returned in ten years it will only buy 66% of what it could have bought today. We describe this as $100 in ten years' time will only be worth $66 in today's dollars.

Therefore finding investments that will, at the very least, match inflation (after-tax) is critical. If not, the dollar value of the account may go up but the "value" (how much you can buy) will actually be going down.

Expectations:

Importantly, one's return expectations should rise and fall with inflation. With the inflation rate in Canada in 2020 at 0.61% (Source: Statista), significantly below the long term average, one should expect lower returns than average but understanding that one's net worth is still increasing at the same pace. In other words, a total return of 6% when inflation is 3% is the same as a total return of 4% when inflation is 1%. Our focus and expectations should be on the net return.

After Tax and Inflation:

Consider the early 1980s when one could get 18% interest at the bank (and I have heard people pine for those days). Now consider the after tax and after inflation return! For certain individuals, 18% interest was taxed at over 50% so they ended up with less than 9%. Rates were 18% only because inflation was at 12%. Getting an after tax return of 9% when inflation is 12% meant a REAL annual return of negative 3%. Today, assume that a person buys a 0.8% GIC with and pays a tax rate of 50% and inflation at .61% means that the REAL return is 0.8% * 50% = 0.4% - 0.61% = a negative annual 0.21%. Today's 0.8% GICs are better than the 18% return of the early 1980s.

Conclusion

Always remember to consider the effects of Inflation. It can have a significant effect on your net worth over time and therefore on your ability to meet your goals.

Market Update:

July 2020 - The Rally Continues .. what's next?

The market has continued its rally, now in its 19th week.

The underpinnings of the rally – government stimulus, low interest rates and better economic data than expected – remain.

As long as these remain in place, I expect that the rally will continue … with its high volatility and with periods of sideway movements .. until the US elections and likely beyond.

At this time governments remain focused on providing assistance (the US Government is considering additional stimulus this weekend) and low interest rates are likely to be with of for some time.

The focus becomes economic data … and the question becomes what's next?

Before I provide my opinion, and that is all it can be when speculating about the future, let me first reiterate two beliefs that underlie all that my team does:

1. No one knows the future and so no one can answer this question with certainty, and

2. Given this unknown, the best strategy remains finding strong, financially sound, competitively advantaged, profitable companies that should survive and even thrive in whatever future lies ahead. Then hold until one of these characteristics are no longer true.

I believe what's next will depend on profitability. Profitability is key. When profitable, companies grow, provide for their stakeholders (employees, communities and shareholders) and increase in value.

Profitability in turn depends on a company being able to sell what it produces for more than it costs. And here is the rub. Sales and costs are undergoing great changes but which changes faster and which are temporary as opposed to permanent?

Are sales going to be able to increase if consumer spending falls given high unemployment, increasing bankruptcies and entire industries shut down?

At the same time will costs continue to fall … with everything from energy to raw materials from technology and labour to overhead becoming cheaper?

This leaves us with a division:

A. Some companies are experiencing increased sales while costs continue to fall thereby driving increasing profitability.

B. Other companies are fighting to balance these two and while expecting a rough time over the coming year, see their way through.

C. Yet other companies are facing a collapse in sales and cannot cut costs fast enough. They will not make it or at least require many years to reposition and recover.

Therefore, the conclusion with respect to our investments, is, again, as always, dependent on the company. Continuously reevaluating investments and repositioning them as events dictate, is a key component to what active managers do. There remains many opportunities.

The conclusion with respect to the economy and the market indices differs. They will depend on how many companies fit into which of the three categories outlined above and how big they are.

The stock market indices are heavily weighted in a few top performers and their future will depend more and more on how these few names fare. But do not be surprised if the market appears disconnected from the economy.

The economy includes all companies (hundreds of thousands of small companies that are not on the stock exchange) and as such will have the hardest time rebounding.

Looking Forward

The markets are likely to remain quite volatile. There is still so much that we do not know and cannot predict. Moving higher on talk of a vaccine and moving lower on poor economic data will likely continue and likely be unsettling for some.

As for our investments, we like the positions we hold. We are continuing to buy, though very selectively.

While US Growth and Large Cap stocks continue to lead the way higher (NASDAQ setting a new all-time high), almost every other asset class (any non-US, or non-Growth, or non-large cap) has not rebounded fully. Many stocks and bonds are still inexpensive, and we remain convinced that superior companies and investments will rebound in time, providing attractive long-term returns. We remain focused, selective and patient.

For the month, the bond market was up 1.5%, the Canadian market was up 4.4%, the US market was up 4.4%, International markets were up 1.9%, the Emerging markets were up 6.7%, the Real Estate market was up 2.9% and the preferred market was up 6.3. (Source: Reuters, as of 7/31/2020)

Year-to-date, the bond market was up 8.8%, the Canadian market was down 2.3%, the US market was up 1.1%, International markets were down 10.8%, the Emerging markets were up 1.5%, the Real Estate market was down 20.0% and the preferred market was down 6.2%. (Source: Reuters, as of 7/31/2020)

Have a great month and let us know if there is anything we can do for you,

- Meir

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