Quarterly Commentary

Craig Fairborn | April 2020

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2020: Q1 Market Commentary

We hope this letter finds you and your families safe and well during these challenging times. Around the globe, people are experiencing a range of emotions, with fear over their own health and that of their loved ones at the top of the list.

These are concerning times, and these emotions are normal. The profound effects of this pandemic on the global economy and the human suffering it has caused cannot be overstated. The good news is that the medical community continues to work tirelessly to keep us safe and the scientific community continues to learn more about COVID-19, all with the hopes of finally producing a treatment or an outright vaccine for the virus. In addition, people working in other essential services continue to work hard to meet the needs of the population, including first responders (police, fire, ambulance), those involved in the supply chain, those stocking shelves at our local grocery/drug stores, and many others who quietly go about their business to help their fellow citizens. It has been reassuring to hear of so many acts of kindness and heroism in a time of great need.

Our Chilliwack office and our firm have also adapted to our current environment and have changed the way we operate to ensure the safety of our clients and our team members. At this time, our offices are being staffed by a small contingent of employees (95% are working remotely from home), and we have restricted access to our offices to these team members only. While the impacts of this pandemic may feel overwhelming at times, this too shall pass. We are all in this together, and we will get through this and move forward together. Please stay safe, maintain social distance and keep washing your hands.

Exogenous Shock and Awe

Following the longest economic expansion on record, the global economy has plunged into a recession. COVID-19 is the black swan event of 2020, and the economic fallout from the pandemic has been extreme. The result has been renewed volatility in global stock markets and international credit markets. In the wake of its rapid spread around the world over the past several weeks, this pandemic has started to reveal its potential economic impact on global growth in the short run, in addition to the obvious devastation for those directly touched by this illness.

Markets reacted swiftly to the calamity, with the broadly based U.S. S&P 500 Index experiencing its steepest and fastest decline on record – down 35% in just 33 days (yes, even faster than the crash of 1929). Fortunately, governments and central banks reacted in record time as well. The massive monetary and fiscal support programs they enacted brought new meaning to "whatever it takes" and have virtually eliminated the risk of a depression. Between the efforts of global central banks and the International Monetary Fund, and the fiscal stimulus of various governments around the world, we have seen about $16 trillion on offer (approximately $8 trillion from central banks and $8 trillion in fiscal stimulus) to help overcome the deflationary impacts of the efforts to contain the health crisis.

The U.S. Federal Reserve has also taken unprecedented action by once again expanding their balance sheet and broadening the collateral they are willing to take on to ease the market panic by preventing highly levered and illiquid markets from seizing up. Meanwhile, the U.S. Congress passed the largest emergency aid package in U.S. history, an amount relative to GDP not seen since World War II. Canada has also acted swiftly on the fiscal and monetary fronts, and the Bank of Canada has now undertaken quantitative easing to help the functioning of credit markets and provide a much-needed backstop for fiscal policy during this period of elevated economic stress.

This is the first-ever recession by government decree, whereby most of the world's governments focused on the need for a temporary partial shutdown of their respective economies to prevent an even larger humanitarian crisis. Given this backdrop, many questions remain on the minds of investors in this highly uncertain environment.

How Does the Medicine Take?

Since the March lows, U.S. markets have rallied just over 30%, as of April 20, given the unprecedented actions taken by governments and major central banks. It would appear that the idea of the central bank "put" is still alive and well given the various monetary bazookas that have helped equity markets over several "crises" since the Great Financial Crisis of 2008. The amount of stimulus this time around is simply unprecedented in the post-war era. As a result of this, the first two weeks of April have seen the biggest bounce in equities since the 1930s.

By mid-April, the S&P 500 Index was down just 13% for the year to date (less than 6% in Canadian-dollar terms). Over the same timeframe, Canada's equity benchmark, the S&P/TSX Composite Index, was down 17% year-to-date. Meanwhile, the broader economy continues to hemorrhage jobs at an unprecedented pace, and Canadian economic activity is expected to contract by about 15-30% in the second quarter of 2020 as compared to the final quarter of 2019. Overall, Canadian economic activity is expected to contract 5-8% in 2020, mainly depending on how long it takes to re-open the economy.

This current level of economic contraction exceeds the Great Financial Crisis of 2008 and can only be compared to some of the data from the Great Depression. As of early April, over six million Canadians had applied for the Canada Emergency Response Benefit (CERB). This dramatic situation will only begin to dissipate as furloughed workers slowly return to work in the coming months. Hopefully, global economies can achieve a higher baseline level of economic activity than the critics assume as global commerce picks up from the re-opening of the economy.

Is it a V, a U or an L?

Market pundits and some members of the media continue to debate the shape of the eventual recovery. To be honest, I think that trying to predict the economic outcomes of a highly unpredictable health crisis seems somewhat disingenuous, as none of us can know for certain how the situation will evolve. Nonetheless, the nature of our business demands that the probability of outcomes be examined.

The recovery from this economic crisis will depend on the severity and duration of the COVID-19 outbreak. While it appears that some nations are handling the outbreak better than others, there is still much work to be done. Most nations globally have been woefully unprepared for a pandemic of this nature despite previous warnings from earlier outbreaks like SARS, MERS and the 2009 H1N1 influenza. From a lack of protective equipment for frontline workers to worries about medical supply chains and, at times, a lack of appreciation for science and common sense, this has cost lives and created more anxiety for everyone. In particular, the response from the United States has been inadequate, to say the least, and has forced them to reevaluate and play catch-up to the rest of the world in terms of flattening the curve.

The good news is that the outbreak curve has started to bend in many nations due to the practice of social distancing, good hygiene, testing/quarantines and case monitoring. In addition, the fiscal stimulus (while costly) should continue to build out the bridge to the eventual recovery as various nations re-open their economies. One also has to be optimistic that modern day science and technology will make us better equipped to deal with the challenges of this virus than we were roughly 100 years ago when the world struggled with the Spanish flu pandemic.

For perspective, the historical record of the 1918-19 Spanish flu (which is the most similar pandemic event in the modern age) shows that the stock market experienced a 33% correction followed by a muted rebound until 1920. The main issue holding back the economy was the psychological resistance to venturing out while the pandemic affected the broader community. In fact, areas that were not as hard hit by the flu tended to have a higher degree of economic activity than those harder hit areas (for obvious reasons). As the outbreak dissipated, confidence returned, and the pent-up demand from the war years drove the economy forward into the Roaring Twenties.

Going into this pandemic, there were a lot more structural issues at play. As outlined in previous quarterly newsletters over the years, the developed world has struggled for growth given the debt overhang of the past several decades, poor demographics and technological shifts that are disrupting labour markets and creating wider economic inequality. These factors will likely continue to weigh on economic growth given the further increase of debt levels brought about by governments' fiscal measures and corporations tapping bond markets to access capital to tide them over until the lockdowns end.

Individuals, corporations and governments will have to undergo some degree of eventual deleveraging, which, while painful in the short term, will be beneficial in the long term. The main concern, similar to the 2008/09 financial crisis, could be the "paradox of thrift" as people's higher savings rate hurts another person's/business's income. This could lead to deflationary forces that further exacerbate the high debt levels, thereby making debt servicing all the more difficult. On the other hand, if the amount of money printing is too excessive, inflation could pick up.

At this point, it is too early to tell what the lasting economic effects of this pandemic will be. However, given some of the issues outlined, it is reasonable to assume that the recovery will be long and bumpy as some areas of the economy (i.e., tourism, airlines, hospitality) continue to struggle in the interim, while other areas likely continue to benefit (i.e., online shopping and technology, grocery, home improvement).

Given the level of uncertainty at play, investors should prepare for a variety of potential outcomes. Remember, investing is often about trade-off scenarios, so one must measure the cost of being aggressive and wrong versus being too conservative and wrong. In the end, investors also need to understand the math behind investment losses.

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Strategy in an Uncertain World and Watching the Data Unfold

Investment advice often does not lend itself to a boilerplate solution as everyone has their own unique goals and levels of risk tolerance. In an uncertain world, investors should continue to focus on things that they can control. From an investment standpoint, these things include one's expectations of a reasonable return over time, the amount of money saved for long-term investing, the amount of risk one wishes to take to achieve returns and, finally, one's own behaviour during the economic cycle.

The main thing to focus on is the resiliency of one's portfolio to weather economic shocks by holding higher-quality assets. Having some liquidity would also provide some optionality given a variety of potential outcomes and timelines.

Investors should also more closely examine their personal balance sheets. Canadian household debt continues to be an area of great debate as it pertains to real estate and consumer discretionary spending. Canada has not seen a major contraction in credit since the recession of the early 1990s, as Canadian households on the whole skated through the recession of the early 2000s and the Great Financial Crisis of 2008/09 in reasonably good shape. Despite repeated warnings from economists and the Bank of Canada, Canadian household debt has now risen to the highest levels within the G7. Perhaps a positive coming out of this pandemic will be a more conservative attitude toward debt.

Lastly, we must pay attention to the actual economic data as the situation evolves. Earnings guidance has largely been abandoned by big business given uncertainty around how their businesses will progress for the remainder of 2020. This is where the bulls and the bears will have their biggest arguments.

The bears will argue that the recovery will be more complicated than a simple re-opening of the economy. They will argue that the risk resides in the duration of the crisis, higher unemployment after the furloughs end and the possibility of reinfection from an end to the lockdowns and/or a second potential wave in the fall, or if testing is inadequate.

The bulls will argue that the markets are simply starting to see through or discount the bad news given the historic intervention, and that science and human strength and ingenuity will be quick to stem the tide against this exogenous shock.

Given this backdrop, I believe it is important to think positively, but also appreciate both sides of the argument. Longer term, the markets and broader economies will push through, but this may entail more hardship and significant volatility along the way.

Over the coming weeks and months, we will be getting our first glimpse of how the economic re-openings are progressing in real time. Given the impact of data in our modern world, it will be interesting to see what sort of baseline economic growth we witness around the globe. Some countries, like China, Germany, France and parts of the U.S., that have re-opened will be able to provide valuable insights regarding traffic congestion, electricity demand and retail foot traffic.

Odlum Brown's Client Focus

Since the escalation of COVID-19, we have been working hard to ensure that we continue to look after our clients throughout this difficult time. Given our firm is approaching our 100th anniversary, you can take comfort that we have guided our clients though several other difficult periods over the past century. We have also invested in technology to build out a robust business continuity plan to stay connected and meet clients' needs.

In the end, we will all get through this just like any other crisis; we just have to be diligent, work hard and remember that "our calm is contagious."

In the meantime, if you have any questions or concerns about your investments, I am always here for you. Please feel free to contact me at **604-858-2455** or toll-free at **1-800-663-5251**. Stay well, and remember to continue helping those most in need in our community at this difficult time.

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