Quarterly Commentary

Craig Fairborn | July 2020

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2020: Q2 Market Commentary

It appears summer has finally arrived and I hope this letter finds you and your families safe and well.

Odlum Brown's plan for returning to the office in the wake of COVID-19 will be gradual and conservative, prioritizing the safety of our clients and our team members. Team members, including myself, are currently working from both our Chilliwack and Langley locations at a reduced capacity, as well as from our home offices. For the time being, we are still not having client meetings in our offices, but if you are interested, I would be happy to arrange a virtual review of your portfolio through online video conferencing, when convenient.

Around the globe, people continue to experience a range of emotions about the current situation, with fear about their own health and that of their loved ones at the top of the list. Economic concerns also continue to linger, given the uncertain nature of pandemics and their overall impacts on the global population. The good news is that through the constant efforts of the global medical community, we have continued to learn more about the epidemiology of COVID-19; in particular, how to mitigate the spread, while focusing on better treatment options and a possible vaccine to combat the virus. In addition, our efforts as Canadians (especially in BC) have allowed us to "bend the curve" on the virus, which has led to better medical outcomes than those originally feared back in March or April. However, we should not become complacent and must continue to remain disciplined in our social distancing efforts, use common sense and continue to wash our hands in order to limit the broader impacts of the virus within our communities.

We have all been personally touched by this pandemic to some extent and many people wonder how the future will unfold amidst the ongoing uncertainty. Faced with this reality, it is important to build a sense of resiliency into our investment portfolio planning. Resilience is defined as "an ability to recover from or adjust easily to misfortune or change."[1] It also helps maintain a sense of balance in our lives during difficult or stressful periods.

Economic Shock Treatment

As global economies shuttered and financial markets cratered in March, governments and central banks responded on a massive scale. The combined fiscal and monetary stimulus from the U.S. Treasury and Federal Reserve currently exceeds over 25% of U.S. Gross Domestic Product (GDP). To put this into perspective, investors should know that it took the U.S Federal Reserve approximately five years to expand their balance sheet to US$2.5 trillion from the lingering effects of the 2008 Financial Crisis. This year, they nearly doubled that amount over a seven-week period in March and April after they broadened the type and amount of assets brought onto their balance sheet. The speed and size of these operations are simply unprecedented. More fiscal stimulus is likely on its way following the troubled re-opening of the U.S. economy and the fact that Americans go to the polls in November.

The U.S. health response to this pandemic has also been one of the biggest self-inflicted wounds in recent memory. The lack of a cohesive federal health agenda backed by science and fact has resulted in an outrageous number of infections, and the death toll continues to move higher. Confusion across state borders, and in some cases within same-state municipalities, has only amplified the situation. The result is that the Canada-U.S. border will remain closed until late August at least, with reasonable odds that it may stay closed for the remainder of the year.

Meanwhile in Canada, the government has announced a federal deficit of over $340 billion from the pandemic, which is the largest on record, as measured as a share of GDP. The Bank of Canada has also launched a quantitative easing program in an attempt to keep borrowing costs low and help keep liquidity ample within credit markets. The end result of these unprecedented initiatives is that credit markets have slowly recovered as spreads have narrowed, but bond yields for government and investment-

[1] https://www.merriam-webster.com/dictionary/resilience

grade credits have hit new all-time lows, with the overnight borrowing rates approaching zero. The fiscal stimulus has been a crucial support to the economy, while the public has continued to maintain social distancing efforts to contain the virus and scientists have endeavoured to learn more about the nature of its epidemiology.

It goes without saying that there is an unusual degree of forecast risk in the back half of this year, and many critical variables could move in several directions. Overall, we will no doubt get through this period, but it may be a long and bumpy road at times. We will continue to diligently monitor how events play out and remain cognizant that we are only a few months into this situation.

Market Performance this Quarter

After a historic drop in financial markets in Q1, the second quarter witnessed its best quarterly performance in decades. The S&P/TSX Composite Index had its best quarter since 2009, with Shopify Inc. contributing about 20% of the recovery in the index. The S&P/TSX is a capitalization-weighted index, and recent behaviours remind me of the wild days when Nortel Networks dominated our exchange. Gold shares also contributed a fair amount, as investors grew more concerned about the potentially inflationary amount of stimulus being offered by governments and central banks alike.

Meanwhile in the United States, the S&P 500 Index registered its best quarter since 1998, rising 20.5% in U.S. dollar terms. One of the interesting things about this market recovery has been the strength of large-cap Technology names leading the indices higher. We have witnessed a somewhat bifurcated market recovery that has benefited some sectors and market areas in a huge way (Technology, home improvement and select Healthcare stocks, for example) whereas other areas have lagged (Financials, REITS, agriculture and commodities like Oil and Gas).

Markets also simultaneously saw deep recession-era levels of unemployment and obvious pockets of late-1990s market excess. This can be summarized by a record amount of discount brokerage accounts being opened, new all-time highs in quite speculative Technology stocks and a game of "the greater fool," where crazed investors bid up stocks of bankrupt and soon to be de-listed companies (Hertz Car Rental serving as the best example).

Bonds also continued their strong performance, with the FTSE TSX Canada Bond Universe adding 5.87% for the quarter, bringing the year-to-date returns to 7.53% in the first six months of 2020. Once again, high-quality bonds have served their purpose as a safe harbour in troubled seas by providing stable income for investors.

Given the facts and figures outlined above, no one is disputing that the first half of 2020 has certainly been memorable.

Evaluating the Economic Medicine

While we are ecstatic and feel grateful regarding the remarkable improvement in stock prices this quarter, we remain somewhat apprehensive given the disconnect between the health of the stock market and the potential state of the economy as some of the fiscal policy support winds down. This economic downturn is not your typical recession. It is still apparent that government stimulus is clouding the visibility of the true economic damage to the economy.

The U.S. unemployment rate stood at 11.1% in June, down from its peak level of 14.7% back in April (it is worth noting that it was only 3.5% in February, pre-COVID). Many people have returned to the labour force following weeks of coronavirus-induced restrictions, but 17.8 million Americans are still unemployed, and others have seen their hours cut back or incomes reduced.

The unemployment rate in Canada stood at 12.3% at the end of June, which is down from the peak of 13.7% in May. Hopefully, most of those affected by these shutdowns can regain meaningful employment and move forward with their lives. However, conditions may remain challenging over the short term while government, businesses and consumers seek to balance the desire for normalization against the still-considerable health threat.

The trajectory of the recovery is likely going to remain choppy, with some industries experiencing a rapid snapback or an outright boom, while others (travel/tourism and leisure, for example) will continue to be faced with existential uncertainty. COVID-19 has also exposed weaknesses in our economy, including income inequality, how we manage the most vulnerable members of our society through quality child care or long-term care homes, and our reliance on sourcing labour and materials from overseas. Perhaps the de-globalization theme may be the biggest potential change resulting from the pandemic, and many companies may focus on sourcing more materials and resources domestically following the supply shocks, closed borders and tariff concerns they have experienced this year.

The pandemic has also acted as an accelerant to some existing investment themes from the past decade. The virtual world has exploded as people shun public spaces and go online for everything from online banking, grocery and retail shopping, and video conferencing in order to work from home. The technological changes and online adaptation have happened at record speed and come with major potential long-term implications for how our world operates. It will be interesting to see how our society is re-structured as we emerge from this pandemic, which will no doubt bring about challenges and opportunities on the economic front.

The history of pandemics also typically reveals that they are deflationary events, because low demand tempers prices until the health crisis fades. Faced with the current crisis, the response of central banks has once again been to expand the money supply and the availability of credit. This act is historically inflationary, but has had less of an impact this time around because debt levels have already continued to climb over the past few decades. Will this level of monetary expansion lead to higher inflation or simply keep deflation at bay?

The other debate is when will the monetary authorities be able to unwind some of this stimulus, and can they slowly extricate themselves without causing market disruption? However, that is a question for another day, as the task at hand continues to be focusing on mitigating the global health impact and keeping the economy on the path to recovery.

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For the moment, investors continue to remain optimistic about the recovery going into the back half of this year and into 2021. No doubt, the next six months are going to be interesting on many levels, and hopefully we will continue to see advances on the medical front to combat and contain the virus. If we have a relatively short timeline in terms of treatment and/or a vaccine, this recession could indeed be the sharpest and shortest on record.

Focus on Balance and Resiliency

Given the current backdrop, we continue to remind clients about our adherence to owning high-quality assets in a slow-growth world. Many of the companies in our coverage universe have a high degree of resiliency in their balance sheets, economic moats and the management teams running them. This process has served us well through difficult periods over the past few decades.

Investors should also prepare for a variety of potential outcomes by remaining diversified across asset classes. Being prudent with your financial goals and open minded to various potential outcomes will continue to serve you well. This can be achieved by maintaining a balanced approach to your investments.

The goal isn't to argue about which way the elephant in the room will break out. Ask yourself, "What sort of an impact will a move in either direction have on my portfolio or financial goals, if any?" Remember, investing is often about trade-off scenarios, so one must measure the cost of being too aggressive and wrong versus being too conservative and wrong. In the end, investors also need to understand the math behind investment losses.

The bulls will continue to argue that the markets are simply starting to see through or discount the bad news based on the historic intervention along the way, and that science and human strength and ingenuity will be quick to stem the tide against this exogenous shock. The bears will continue to argue that investors are underappreciating the second derivative events of surging U.S. infections and/or the potential complications of this pandemic when the normal cold and flu season develops in the fall. They will also continue to worry about the slow withdrawal of government support and another potential economic income shock to households from a slow-growth world.

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

In an uncertain world, investors should definitely continue to focus on things that they can control, rather than things they can't. From an investment standpoint, these things include one's expectations of a reasonable return over time, remaining diversified, consistently setting money aside for long-term investing, understanding the amount of risk one wishes to take to achieve returns and, finally, one's own behaviour during the economic cycle.

If the market drop in the first quarter caused you anxiety or worry, perhaps now would be a good time to make some adjustments to your investments.

If you have any questions or concerns about your investments, I am always here to answer your questions. Please feel free to contact me at **(604) 858-2455** or toll-free at **1-800-663-5251**.

Stay well, stay connected and let's all do our part to continue helping those most in need in our community throughout this difficult time.

CONTACT

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