Quarterly Commentary

Craig Fairborn | October 2020

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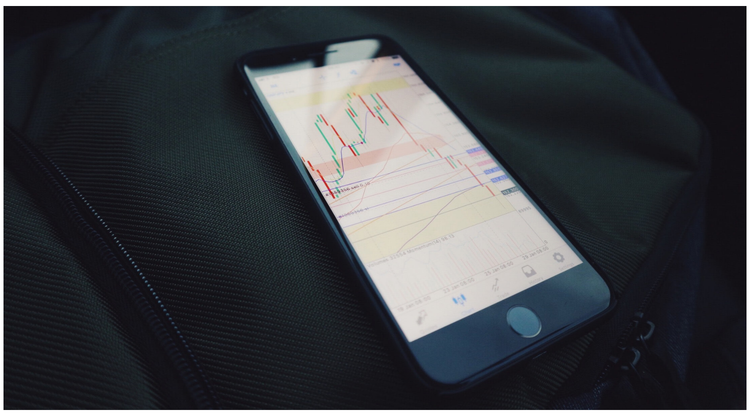
Craig Fairborn, BA, CIM, FCSI - **Portfolio Manager** | **T 604 824 3373 Toll Free 1 800 663 5251** | **cfairborn@odlumbrown.com** | **odlumbrown.com**
Deborah Edwards - **Investment Assistant** | **T 604 824 3375** | **dedwards@odlumbrown.com**
Odlum Brown Limited | **Suite 103 – 45425 Luckakuck Way** | **Chilliwack, BC V2R 2T7** | Member-Canadian Investor Protection Fund

2020: Q3 Market Commentary



We hope this letter finds you and your families safe and well. With the arrival of fall, our plan for returning to the office has begun gradually and conservatively, prioritizing the safety of our clients and our team members. We are now working from both our Chilliwack and Langley locations at a reduced capacity, as well as from our home offices.

Around the globe, people continue to grapple with the COVID-19 pandemic. Over the past several weeks, the world has seen a renewed uptick in the number of COVID-19 cases, as the traditional cold and flu season starts to ramp up. In the U.S., Canada, Europe and other parts of the world, deaths and hospitalizations are once again rising, but at a much more reduced rate compared to the overall rate of reported cases. The epidemiological data continues to expand as time passes, which will allow for ongoing improvements in terms of mitigating the spread of the virus, better treatment options for patients and ultimately a vaccine. In the meantime, we must remain disciplined in our social distancing efforts, use common sense and continue to wash our hands as we attempt to limit the overall impacts of the virus within our communities.

The historical record of pandemics provides a stark reminder that Mother Nature can bring home some heavy lessons for the human race from time to time. As Nigerian philosopher Bayo Akomolafe wisely stated, "This crisis strips away all delusional confidence in the modern notions of history, progress, humanity, knowledge, time, secularism and our tendency to take life itself for granted."[1]

We all continue to be personally touched by this pandemic to some extent, and many people wonder how the future will unfold given the current uncertainty. This is the reality that we are dealing with as the end of 2020 approaches, and the leading outlook suggests that maintaining a balanced and flexible view will provide the best peace of mind.

Rethink and Adapt

This year will go down as one of the most disruptive years in the past century, as COVID-19 exposes the fundamental realities of how our society is structured in terms of social relationships, economic challenges, healthcare delivery and our relationship with government, to name just a few. Pandemics from a historical perspective tend to do that. From our industry perspective, the equity selloff that we witnessed in the spring was easily one of the top five market shocks of the last century, including the Wall Street Crash of 1929, Black Monday in 1987 and the 2008 Financial Crisis.

In fact, U.S. investors witnessed the fastest and steepest drop on record as the S&P 500 Index went from an all-time high on February 19 to its bottom on March 23, recording a 34% bear market decline. The global fiscal and monetary response has been unprecedented in many cases, with governments in Europe, North America and China continuing to provide economic stimulus to boost their respective economies.

The good news is that these efforts have provided a much-needed backstop while the global economies gradually re-opened over the summer months. Economic activity has picked up and in some cases has exceeded the most optimistic scenario. In particular, few people forecasted that we would see this degree of activity in the real estate market in the middle of a global pandemic. Meanwhile, the S&P 500 Index managed to take back its all-time highs on September 2, which is an amazing accomplishment in itself. However, a quick look under the hood reveals that "The Big Five" (the largest companies in the index: Apple Inc., Microsoft Corporation, Amazon.com Inc., Google [Alphabet Inc.] and Facebook, Inc.) have been powering the index higher due to their 23% weight. Many of the other 495 stocks have continued to see mixed results during this environment of diverse economic outcomes.

[1]The Ecologist, March 2020. https://theecologist.org/2020/mar/27/coronavirus-and-crisis-anthropocene

Based on our current economic charts, the global economy is recovering, but the pace of the recovery and its durability as we head into 2021 remain big issues for investors. Some of the upcoming events to monitor include a contentious U.S. election that is now merely a week away, a growing resurgence of COVID-19 cases sparking concerns about further partial economic shutdowns and/or restrictions and, finally, the unknown timing and efficacy of a vaccine or treatment breakthrough.

Market Performance this Quarter

After a historical snapback in Q2, financial markets experienced a more modest recovery in the third quarter. The S&P/TSX Composite Index returned 4.7% for the quarter as it tries to fully recover from the events of 2020. Energy markets have continued to struggle as demand concerns have grown along with the COVID-19 case count, while the price of oil itself is down about 30% for the year. It has been an amazing ride for the sector, dating back to the fallacy of "peak oil" when the price of oil hit over $160/barrel in early 2008. The Alberta oil boom that created countless oil millionaires has now turned into a bust once again.

Meanwhile in the United States, the S&P 500 Index registered a gain of 8.9% in U.S. dollar terms. Large-cap technology and work-from-home stocks continued to see heavy action, but sold off somewhat in the month of September. Overall, we continue to witness a bifurcated market recovery that has benefited some sectors in a huge way (technology, home improvement and some select healthcare) where others have lagged (financials, REITS, commodities like oil and gas and agriculture). This bifurcated market has been described by economists as a "K-shaped" recovery, where fortunes are told by whether the industry is participating in the top half of the letter K or the bottom part of the letter.

Bonds were essentially flat for the quarter, with the FTSE TSX Canada Bond Universe adding 0.44% for the quarter. However, returns from high-quality bonds have been fairly strong this year given the flight to safety due to the pandemic. The vigorous debate about the future path of inflation also continues to intensify based on the growing state of government finances and the huge monetary stimulus that we have witnessed. Typically, pandemics are disinflationary or outright deflationary events, but the wartime-like measures being taken by the authorities in 2020 cloud this assessment. Some positive news on the vaccine front in the months ahead could see longer-term bonds sell off as economic activity would likely pick up further on this news.

Out of Intensive Care

Six months after the global pandemic declaration, data compiled by the AFP news agency found that roughly one half of the world's population – approximately 3.9 billion people – had experienced some level of lockdown measure in their country. That is a truly remarkable once-in-a-lifetime event, and something that we will all remember, united globally by those early days of the pandemic and the shutdowns.

While we continue to be grateful that some of the worst fears have not come to pass, we continue to keep a guarded eye toward some issues in the months ahead (including a second wave of infections, an uncertain U.S. election outcome and some of the longer-term structural issues in the economy that we have discussed in the past). We are only seven months into this pandemic and much is still unknown about the virus itself and some of the longer-term health outcomes for society at large. However, we will have to adapt to the new realities as the pandemic evolves.

As the restrictions were slowly lifted over the past several months, economic activity has moved the unemployment level lower. The U.S. unemployment rate stood at 7.9% in September, down from its peak level of 14.7% back in April (it's important to note that it was only 3.5% back in February). In September, notable job gains occurred in leisure and hospitality, retail trade, health care and social assistance, as well as in professional and business services. Employment in government declined over the month, mainly in state and local government education.

The unemployment rate in Canada stood at 9.0% at the end of September, which is down from the peak of 13.7% in May. There are still 1.8 million Canadians unemployed, which is down from the peak of 2.6 million back in May. In addition, the number of Canadians who perform some of their work from home edged down to 25.6%. Given the current work-from-home dynamic, it will be interesting to see the overall impact on some office real estate if this trend becomes more permanent.

In addition, the Government of Canada also announced the total cost of the Canada Emergency Response Benefit (CERB) program, which saw a total of 8.9 million Canadians use the program and cost approximately $81.64 billion. The official number of Canadians collecting CERB (or those who transitioned to the new enhanced unemployment insurance program) fell to 13.5% in September from 16.1% in August. Clearly, the fiscal cost of the pandemic will be felt for years to come.

Slow Recovery

As expected, the path of the recovery has been very choppy and uneven, with many industries experiencing a rapid snapback or an outright boom, while others will continue to be faced with existential uncertainty (hence the description of a "K-shaped" economic recovery).

Against a mixed bag of global economic news, investors have become eager to see how corporate earnings are going to hold up into 2021. While we remain in an earnings recession, forward estimates have continued to improve. Business leaders have also been much more confident in their general outlook since the end of the second quarter, as some sentiment indicators have climbed back to near or above pre-COVID levels.

In particular, investors will be watching for the potential of permanent layoffs from large corporations. Further cost-cutting measures may be needed, including making decisions over abundant liquidity due to some companies having suspended or eliminated their dividend during the early stages of the pandemic. Finally, companies will have to provide some guidance to the fourth quarter and beyond. The last component is a big ask, as investors have to realize the ongoing potential impact of the virus to surprise us and disrupt expectations, particularly as cases continue to grow.

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It is likely that most developed economies will need some additional fiscal stimulus measures to carry them through into the first half of 2021 in order to ensure that their respective economies do not lose momentum and damage confidence. One of the lessons from the Great Depression was not undertaking enough stimulus to keep the tax base afloat at a time of crisis, which exacerbated the economic damage and resulted in a longer period of recovery.

Keep It Simple

The economic outlook continues to operate under a fog of war against COVID-19. Given a wide range of potential outcomes, we will continue to advocate for patience, flexibility and an adherence to a balanced outlook. Perhaps the biggest risk at this point is overconfidence on any one particular outcome. The rigidity of adhering to one particular view could result in disappointment from either missing out on the recovery (perhaps too defensive) or over-estimating that we have turned the tables on the virus and a smooth recovery is at hand (perhaps too aggressive).

Regardless, we continue to believe that we are living in a world where growth will remain hard to achieve and interest rates are likely going to remain low for a longer period of time. This dynamic brings its own set of challenges pertaining to an appropriate asset mix to achieve one's goals, especially with interest rates hitting all-time lows. We also think that investors are more likely to pay up for more reliable growth companies, which is why we have a bias in favour of large, established companies with solid balance sheets and wide economic moats that offer some defensive characteristics.

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

In an uncertain world, investors should 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.

Odlum Brown's Client Focus

Our firm is approaching its 100th anniversary, and over the last nearly a century, we have guided our clients though several crises and other difficult periods.

Like many businesses, we have adapted to an increasingly online world due to COVID-19. Thankfully, Odlum Brown was well-prepared and we have invested in technology and have a robust business continuity plan in order to continue to meet our clients' needs, stay in contact and help alleviate some of the stress during this difficult time.

We trust that we will get through this together, just as we did through other crises, by staying diligent, working hard and remembering the words of Dr. Bonnie Henry, "Our calm is contagious."

CONTACT

CRAIG FAIRBORN, BA, CIM, FCSI | Portfolio Manager
Tel 604-824-3373 | Toll Free 1-800-663-5251
cfairborn@odlumbrown.com

DEBORAH EDWARDS | Investment Assistant
Tel 604-824-3375
dedwards@odlumbrown.com