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Q3 MARKET AND ECONOMIC UPDATE

PREPARED BY ENCASA FINANCIAL

INTRODUCTION

Capital Market Returns Q3 2020 (%)

	Q3	6 MNTH	YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS	Q12020	Q22020
FTSE Cda 91 day T-Bill Index	0.1	0.2	0.8	1.3	1.4	1.0	1.0	0.7	0.1
FTSE Cda Short Term Index	0.7	2.9	2.9	4.9	3.4	2.3	2.5	1.8	2.2
FTSE Universe Bond Index	0.4	6.3	8.0	7.1	6.1	4.3	4.4	1.6	5.9
S&P/TSX Index	4.7	22.5	(3.1)	(0.0)	4.3	7.2	5.8	(20.9)	17.0
S&P 500 Index ($CAD)	6.8	23.2	8.8	16.2	14.8	14.1	16.7	(11.8)	15.4
S&P 500 Index ($USD)	8.9	31.3	5.6	15.2	12.3	14.2	13.7	(19.6)	20.5
MSCI World Index ($CAD)	5.9	20.9	4.8	11.4	10.1	10.4	12.3	(13.3)	14.2
MSCI EAFE Index ($CAD)	2.8	13.0	(4.3)	1.4	2.8	5.2	7.4	(15.3)	9.9
Russell 1000 Growth ($CAD)	*11.0*	*35.8*	*28.1*	*38.8*	*24.4*	*20.0*	*20.3*	*(5.7)*	*22.3*
Russell 1000 Value ($CAD)	*3.6*	*13.3*	*(8.9)*	*(4.2)*	*4.9*	*7.6*	*12.8*	*(19.6)*	*9.4*
MSCI EAFE Growth ($CAD)	*6.4*	*1.6*	*8.1*	*14.8*	*9.8*	*9.6*	*10.2*	*(9.4)*	*12.1*
MSCI EAFE Value ($CAD)	*(0.7)*	*7.1*	*(15.4)*	*(10.9)*	*(3.2)*	*1.7*	*5.4*	*(21.1)*	*7.8*

2020 has been a year of challenge and surprise.

AUDREY ROBINSON
PORTFOLIO MANAGER

The first three quarters have seen it all – the year started with very constructive outlooks for global economic growth and equity markets, tanked on the pandemic, snapped back in an almost unprecedented way in the second quarter and maintained a reasonably steady rise in the third quarter. It is hard to fathom how the last quarter of 2020 will fare.

Markets stabilized in the third quarter albeit not without days of volatility (especially in September) that tested investors' patience and stamina. Fixed income markets were not immune with yields moving higher in August on the back of the US Federal Reserve Bank's "lower for longer" arising from its new resolve to target average inflation (maintaining low interest rates even if inflation rises above 2%). And corporate spreads widened in September offsetting the small decline in yields in the month.

On a Year to Date (YTD) basis the only red ink in the table above rests with Canadian Equities, EAFE (International) Equities (in $CAD) and the two Value indices – a testament to the sharp rebound experienced by most global equity markets in Q2. Canada continues to be bedeviled by the energy industry with oil prices still struggling in the wake of both supply and demand constraints. And, significantly, by being a market with little exposure to the high flying tech growth stocks that have propelled the US market.

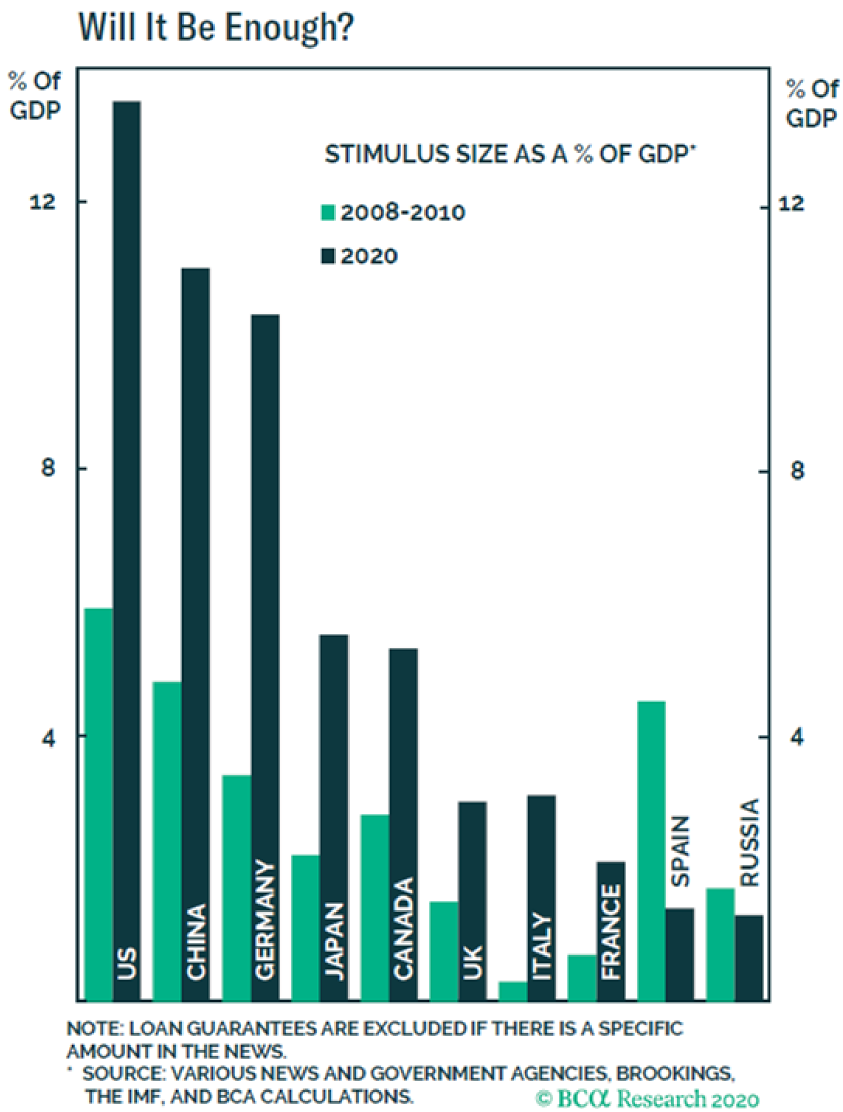
In the quarter, Canadians investing outside Canada continued to lose the currency advantage which we have come to expect over time as the norm – in other words, the Canadian dollar appreciated rather than depreciated against the USD. But Canada is not alone in this reversal. In 2020, the USD has been declining against most major currencies leading some analysts to assert that we could be at the beginning of a USD bear market – a situation which last occurred in the early 2000's when the Canadian dollar not only went to par but for a brief period was above par.

Fixed income returns were flat over the third quarter barely covering the coupon/yield of the two indices. As noted above, interest rates backed up in August especially at the long end of the yield curve as a result of the Federal Reserve Board's shift to targeting average inflation rather than a fixed 2% rate of inflation – a change that economists quickly dubbed Average Inflation Targeting (AIT).

Why the change to AIT?

The Fed (and by implication, the major central banks including the Bank of Canada) have conceded that they have failed at achieving the 2% inflation target that has been in place since the back of inflation was broken in the 1990's[1]. And in the face of strong disinflationary (if not deflationary) forces from advances in technology, stagnant wages and sustained economic pressures from the pandemic, they are prepared to allow inflation to exceed 2% by some unexpressed margin in an effort to support economic growth and deal with rising levels of government debt.

GOVERNMENT DEBT



1. Recall that inflation averaged over 7% annually during the 1970's arising from spikes in oil prices due to the 1973 OPEC-led oil embargo which in turn caused wage increases leading to a wage/price spiral that was only broken by painful increases in interest rates that finally began to decline in the early 1980s. But it took into the 1990's before inflation and interest rates were normalized.

As we highlighted last quarter and as the chart above outlines, the global fiscal response to the global pandemic has been unprecedented in modern times – with some economists likening it to a "wartime" response. It was quickly apparent in late February and early March by many governments that the endogenous shock of shutting down whole economies virtually overnight to deal with the pandemic would have incalculably negative effects on employment and spending; that monetary policy alone (keeping interest rates low) would not be sufficient. Hence governments put in place financial support programs for both businesses and consumers that were designed to shelter both from the economic consequences of the lockdowns. And it has been abundantly clear over the last several months that, without these fiscal supports, the economic and personal impacts of the pandemic would have been almost unfathomable.

Yet despite the surges in new cases through the fall, and despite talk of continuing the fiscal stimulus programs into 2021, attention is turning to the long term economic impact of this fiscal spending on government debt levels. As government deficits have soared with the fiscal stimulus programs, not surprisingly, so have government debt levels.

Canadians are not immune to concerns about levels of government debt – the pain inflicted in the mid 90s when Paul Martin was Finance Minister are easily remembered by those of a "certain age". The Liberal Government of Jean Chretien worked tirelessly to bring Canada's very elevated Debt to GDP ratio down to a more acceptable level through extensive fiscal austerity measures.[2]

Hence there is a growing concern not just in Canada but globally that similar measures will be required, which would have a dampening effect, if not inflict a shock onto the global economies (including Canada's) – and ultimately on the markets. Consensus is, however, that governments including in Canada will maintain their financial support measures until we are back on a more solid economic footing.

And significantly, many governments are unconcerned by their increasing debt levels because of the lower for longer interest rate environment. Why?

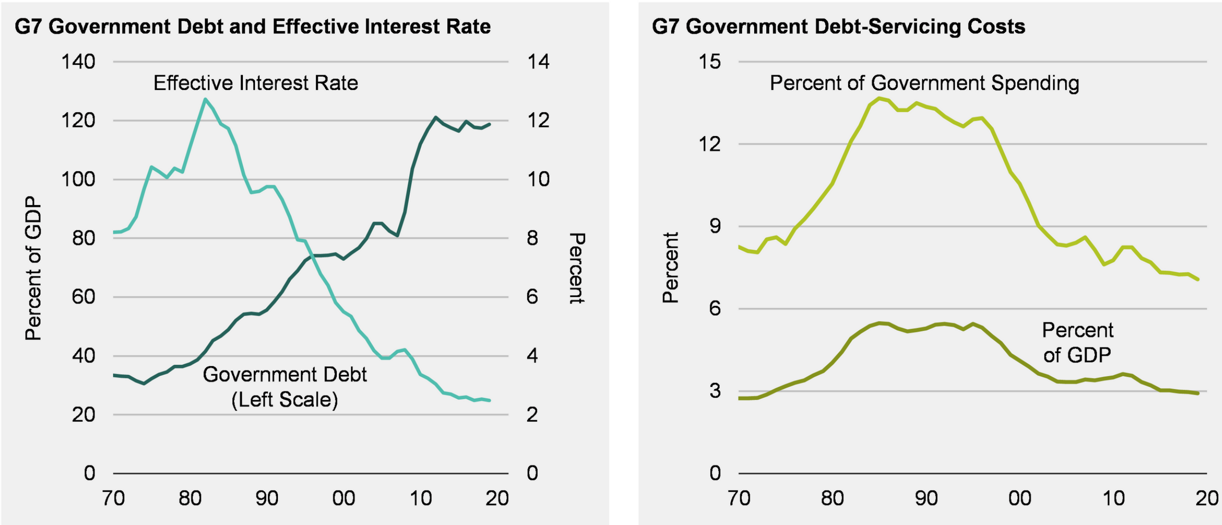
Low interest rates keep the debt servicing burden in check as demonstrated in the charts below. In fact, because of the current level of interest rates, the debt servicing burden for the G7[3] is less than it has been since the 1980's and virtually on par with the early 1970's.

Of equal consideration is the fact that as long as interest rates stay below the growth rate of an economy, debt as a percent of GDP will actually decline. In other words, in the current interest rate environment, governments don't need to do anything (let alone impose fiscal austerity measures) and the debt burden will decline. And with the central banks, in particular the Federal Reserve Bank but also the Bank of Canada, committed to a "lower for longer" interest rate policy servicing the debt should not prove burdensome for governments for the foreseeable future.

2. Fiscal austerity measures generally include some combination of cuts in government spending (program cuts) and tax increases.
3. G7 (Group of Seven) countries include Canada, the U.S., the U.K., France, Germany, Italy and Japan.

Low Rates Keep Debt-Servicing Costs Manageable[4]

But Is this Part of the Problem?



Past performance does not guarantee future results.
As of September 30, 2020
Source: Haver Analytics

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Despite these seemingly favourable conditions, it is nonetheless generally agreed that extreme government debt levels are not desirable over the long term. Therefore, it is worth reviewing the debt reduction options in a government's tool kit.

Alliance Bernstein in their September 2020 paper (referenced above) offered five key debt-reduction options:

- Economic Growth - unlikely in the short to medium term given the pandemic.
- Fiscal Austerity - unlikely, and the wrong move given the pandemic's employment impact and the rise in populism (see chart below).
- Financial Repression (Low Interest Rates) - lower for longer has been the norm since the GFC
- Inflation - AIT
- Write-off (Default/Jubilee/Forgiveness) - unprecedented and an historical anomaly

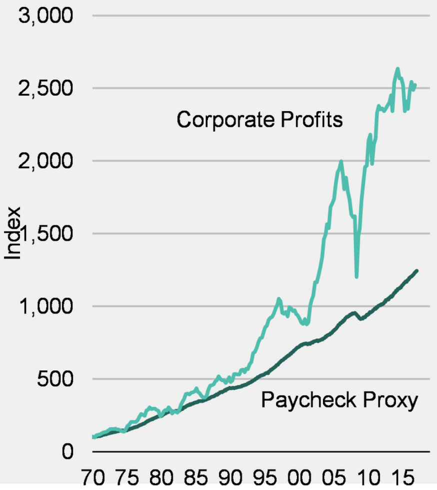
The potential for strong economic growth needs little comment at least for the short to medium term given the economic uncertainties wrought by the pandemic. Governments are wary of managing debt through fiscal austerity given the global rise in populism fuelled by income inequality.[5]

4. Darren Williams, Guy Bruten, Alliance Bernstein Investments, "Pushing On An Open Door – COVID-19 is intensifying long-term macro trends …especially debt overhangs" September 2020.
5. Even though the divided US congress seems willing to push against that envelope in its inability to pass another stimulus bill the expectation is that neither the House nor the Senate would actually allow austerity.

As the charts below succinctly outline for the US (although it is not much different globally), the spoils of economic growth since the 1980's have gone primarily to corporations and the wealthy and not the working classes. Fiscal austerity would do nothing but exacerbate this inequality.

Shift to Populism Fueled by Income Inequality[6]

Corporate Profits and Household Paycheck



Growth in National Income in the US (Postwar Period)

Income Group	Real Income Growth 1946–1980	Real Income Growth 1980–2014
Bottom 50%	102%	1%
Middle 40%	105%	42%
Top 10%	79%	121%
Top 1%	47%	205%
Top 0.1%	54%	321%

Past performance does not guarantee future results.
Middle table: Displays the cumulative real growth rates of pretax national income per adult over two 34-year periods: 1946 to 1980 and 1980 to 2014. The unit is the adult individual (aged 20 or above). Fractiles are defined relative to the total number of adults in the population. Income is split equally among spouses. Pretax national income fractiles are ranked by pre-tax national income, while post-tax national income fractiles are ranked by post-tax national income.
Source: Piketty, Refinitiv Datastream, Saez and Zucman, "*Distributional National Accounts: Methods and Estimates for the United States,*" NBER WP22945, CRS estimates using Current Population Survey Outgoing Rotation Group data for 1979–2018, AllianceBernstein (AB)

And writing off debt is never a good option.

Therefore, increasingly, the prevailing view is that the most effective way to deal with the debt overhang from these unprecedented levels of fiscal stimulus is a combination of financial repression (low interest rates) and inflation. As noted earlier, central banks have been singularly unsuccessful in getting inflation above 2% not just in this decade but for the past 30 years. We have been living in a period of disinflation/low inflation since the early 1980's when inflation and interest rates reached post WWII highs and when high (not anemic) inflation was the focus of central bankers. To the extent that they can achieve a measure of success through AIT, it will allow governments to repay debt with cheaper "dollars".

In other words, financial repression and rising inflation appear to be the only palatable alternative politically and economically – at least for the foreseeable future.

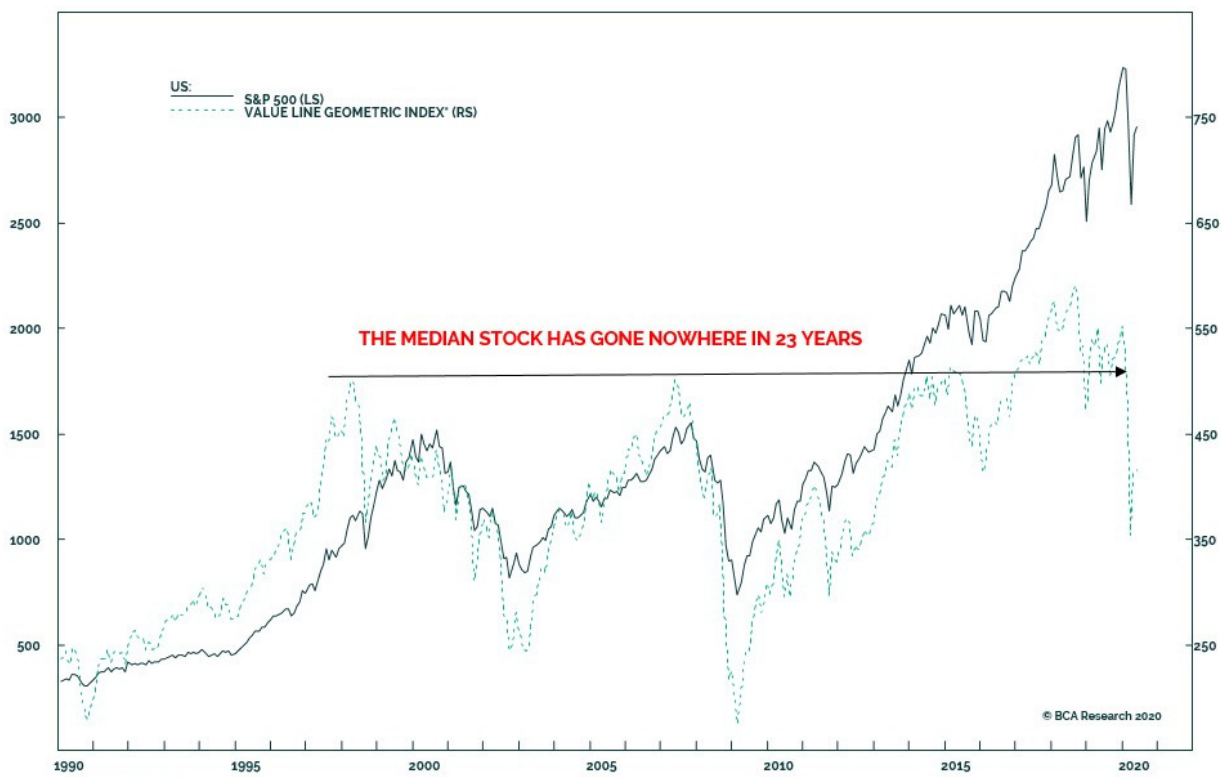
6. Richard Brink, Walt Czaicki, Alliance Bernstein, Do US Elections Matter for Equity Investors? October 19, 2020.

TINA – THERE IS NO ALTERNATIVE

The investment industry is known for its creative development and use of new acronyms; acronyms designed to articulate (?) recent phenomenon. In the late 90's, early 2000's we had the relatively benign TMT (Technology, Media, Telecom) Bubble. Post 2008, we had the GFC (Great Financial Crisis). Today we have AIT (defined above) and for equity investors, TINA – There Is No Alternative.

With bonds yielding little (and in countries with negative interest rates, investors paying, not being paid, to own government bonds), the push to have investors invest in risk assets has been unrelenting since the GFC. Hence, TINA. With anemic returns from bonds, investors are forced to look to invest their capital in equities thereby providing the necessary support for equity markets to continue the bull market that began over 11 years ago (March 2009)! Even the global economic shutdown earlier this year caused only a brief pause (albeit a bear market pause) in the upward march of equity markets. And with no end in sight to "lower for longer" interest rates, it feels like there is little that can curtail the continued upward march of equity markets that began in March 2009 – a march that is aptly outlined in the chart below.

The Median Stock Lies Far Behind



* SOURCE: VALUE LINE.

This chart and the one following also demonstrate that equity markets, especially in the US, have been bifurcated with the result that the median stock has gone nowhere over the past 20-odd years.

And as we noted last quarter that bifurcation has been exacerbated during and by the pandemic.

Awesome 8 Propelling Tech Stocks To New Highs

* MARKET CAP-WEIGHTED INDEX CONSISTING OF AMAZON, APPLE, FACEBOOK, GOOGLE, MICROSOFT, NETFLIX, NVIDIA, AND TESLA.
** INDEX TRACKS THE MEDIAN MOVE OF STOCKS USING EQUALLY-WEIGHTED VALUES AND IS CALCULATED GEOMETRICALLY RATHER THAN ARITHMETICALLY.
NOTE: ALL SERIES SHOWN REBASED TO JAN. 2020 = 100.

From FAAMG (referenced in previous commentaries) the industry has now progressed to referring to the "Awesome 8" – Amazon, Apple, Facebook, Google, Microsoft, Netflix, NVIDIA, and Tesla. The chart above courtesy of BCA Research shows how pronounced has been the outperformance of these eight companies' stocks to the broad markets since the pandemic shut down countries and economies. But the question bedevilling investors is "how long can this party continue?"

Unfortunately, in investing the party can continue long past the point when rationality would suggest it must come to an end. But with many of the "Awesome 8" approaching levels of market penetration that would suggest their ability to expand market share (and hence earnings and stock prices) is increasingly constrained, the answer to the question could be "sooner than one might think."

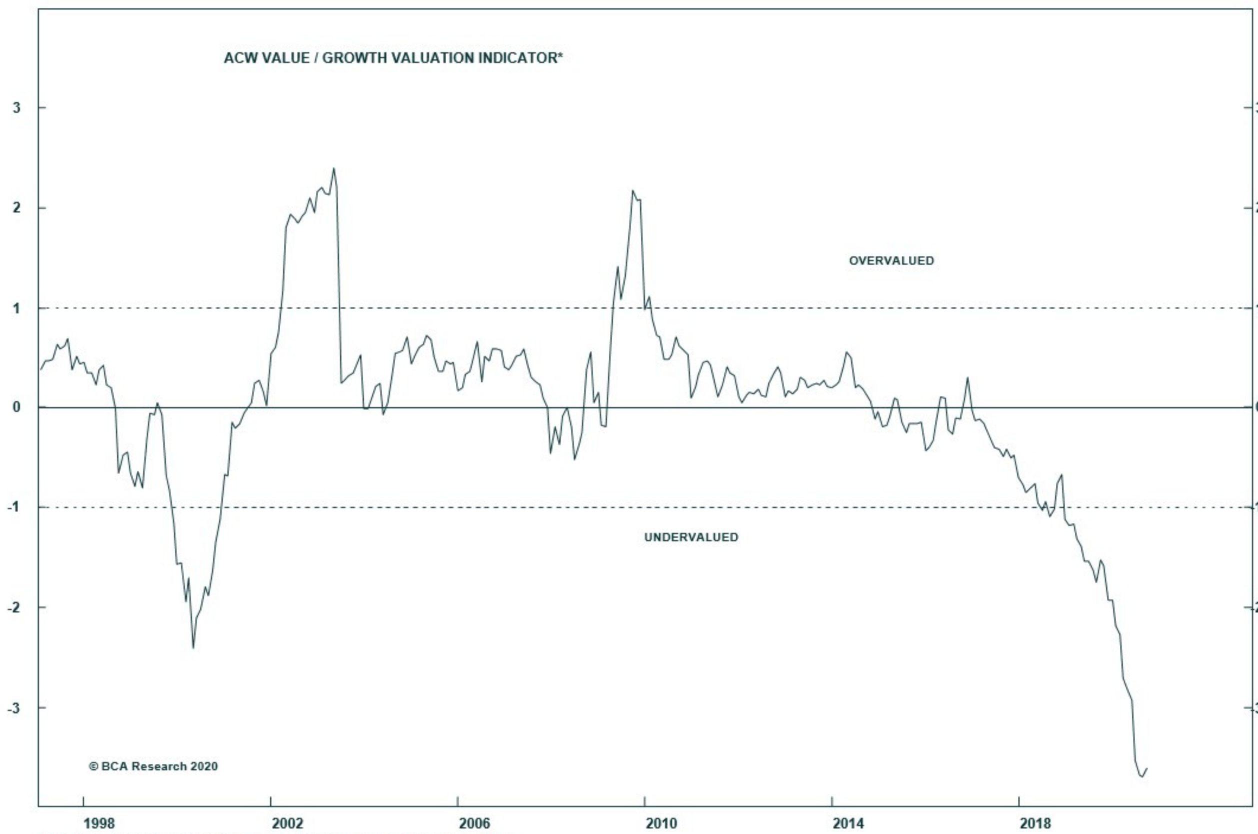
Walking hand in hand with the predominance of these tech growth companies in this rising market has been the underperformance of value stocks - an underperformance which continued into the third quarter. Value investors continue to be asked whether this underperformance is a secular or cyclical issue. Again, there is no definitive answer except to note that over time value stocks do better than growth stocks, and particularly in periods when the US dollar is weakening and global growth is on the upswing.

While global growth is definitely challenged today, as noted earlier, there is a belief that the USD is at the beginning of a new bear market. Hence some of the conditions for a reversal are in place.

And value continues to be extremely undervalued as it has been since 2015. As the chart below demonstrates – it is not the first time value stocks have been extremely undervalued – the last being during the TMT Bubble.

Therefore, in answering the question of secular vs cyclical, value investors will tell you that now is not the time to throw in the towel; that the answer is cyclical and mean reversion does occur in investing.

Value Stocks Are Extremely Cheap Relative To Growth Stocks



* BASED ON RELATIVE PRICE/BOOK, PRICE/EARNINGS, AND DIVIDEND YIELDS.
SOURCE: IBES / THOMSON REUTERS AND MSCI INC. (SEE COPYRIGHT DECLARATION).

DO POLITICS MATTER?

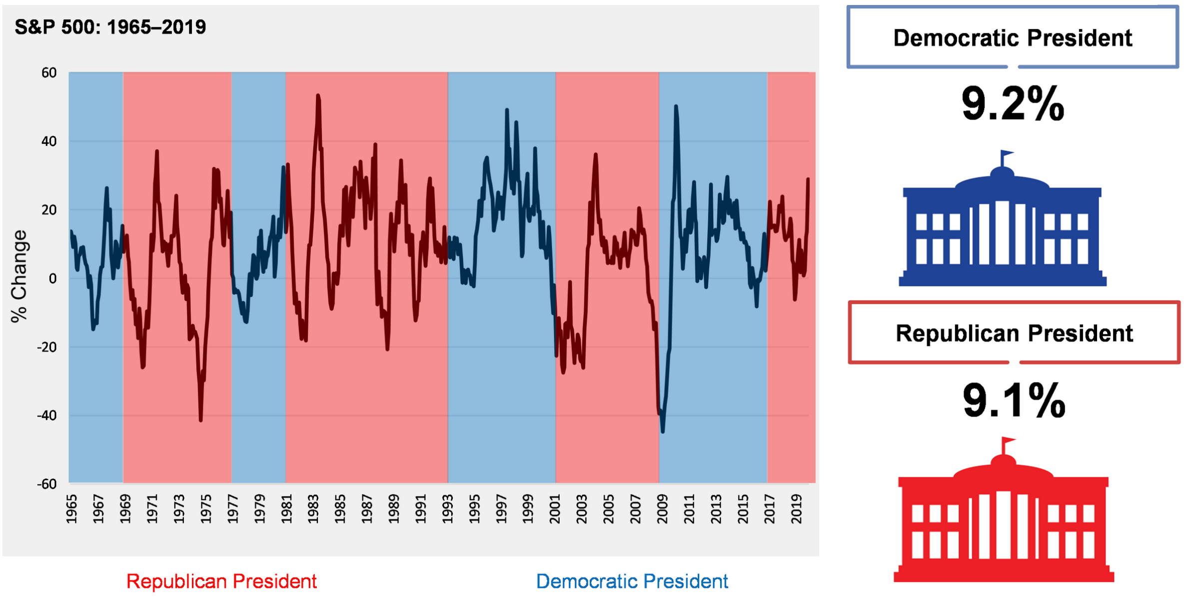
We would be remiss to not address the second biggest issue confronting investors going into the fourth quarter (the first arguably being the availability of a vaccine to bring an end to the pandemic) – the US Election. By the time this commentary is being read the outcome will, in all likelihood, be known[7]

And while it is compelling to conjecture on the impact the outcome will have on capital markets, equity markets in particular, the chart below shows the party affiliation of the US president has had little bearing on US equity returns going back as far as 1965! Irrespective of which party inhabits the White House, returns for the S&P 500 have averaged around 9% under both parties.

7. Providing there are no court challenges in the face of a close race and outcome.

There is certainly noise around an election, but elections do not have a sustained impact either positive or negative on the markets. Markets climb their wall of worry irrespective of who is in the White House.

Does the Market Care Who Is in the White House?[8]

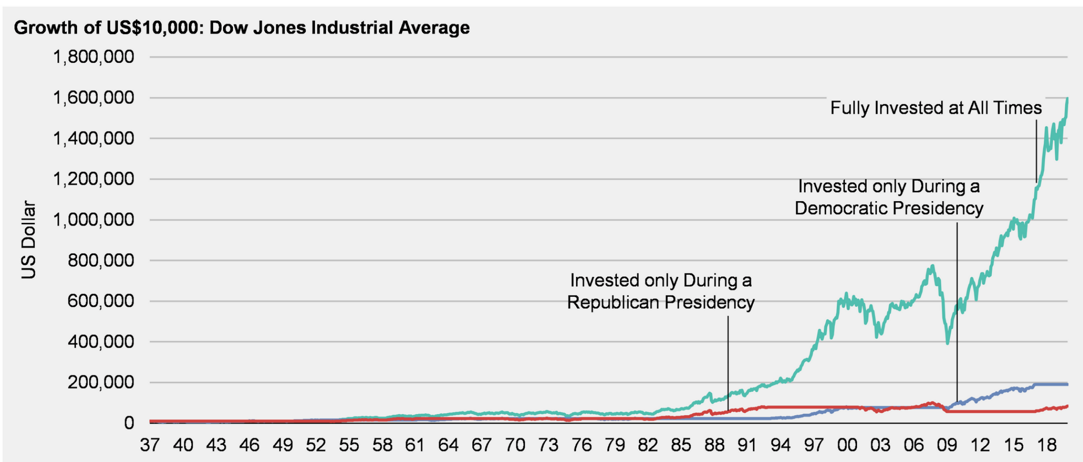


Past performance does not guarantee future results. An investor cannot invest in an index.
As of December 31, 2019
Returns shown on the right reflect annualized returns for each presidential term dating back to 1937, based off the Dow Jones Industrial Average.
Source: Thomson Reuters, Bloomberg and AB

Accordingly, what is important is that investors not let "the tail wag the dog". In other words, do not let your investment strategy be blindsided by the political narrative. Having a defined investment strategy and sticking to that strategy will provide one with greater opportunity for investment success than timing markets based on potential political outcomes.

While the chart below is US focused, its message is equally applicable to Canadian investors… and in fact, to investors everywhere. Staying the course with a thoughtful, articulated investment strategy is the best "sleep at night" approach.

Don't Let Politics Dominate Strategic Investing Plans[9]



Past performance does not guarantee future results.
As of December 31, 2019
Monthly performance of the Dow Jones Industrial Average, dating back to 1937.
Source: Bloomberg, Invesco and AllianceBernstein (AB)

8. Richard Brink, Walt Czaicki, Alliance Bernstein, Do US Elections Matter for Equity Investors? October 19, 2020.
9. Richard Brink, Walt Czaicki, Alliance Bernstein, Do US Elections Matter for Equity Investors? October 19, 2020.

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