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Q4 2020 MARKET AND ECONOMIC REVIEW

PREPARED BY ENCASA FINANCIAL

INTRODUCTION

Capital Market Returns Q4 2020 (%)

	Q3	6 MTH	YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS	Q1	Q2	Q3	Q4
FTSE Cda 91 day T-Bill Index	0.5	0.1	0.9	0.9	1.3	1.0	1.0	0.7	0.1	0.1	0.0
FTSE Cda Short Term Index	0.5	1.2	5.3	5.3	3.4	2.3	2.5	1.8	2.2	0.7	0.5
FTSE Universe Bond Index	0.6	1.1	8.7	8.7	5.6	4.2	4.5	1.6	5.9	0.4	0.6
S&P/TSX Index	9.0	14.1	5.6	5.6	5.7	9.3	5.8	(20.9)	17.0	4.7	9.0
S&P 500 Index ($CAD)	7.0	14.3	16.3	16.3	14.9	13.3	16.7	(11.8)	15.4	6.8	7.0
S&P 500 Index ($USD)	12.2	22.2	18.4	18.4	14.2	15.2	13.9	(19.6)	20.5	8.9	12.2
MSCI World Index ($CAD)	8.7	15.1	13.9	13.9	11.2	10.4	12.6	(13.3)	14.2	5.9	8.7
MSCI EAFE Index ($CAD)	10.7	13.8	5.9	5.9	4.9	5.7	8.2	(15.3)	9.9	2.8	10.7
Russell 1000 Growth ($CAD)	*6.2*	*18.0*	*36.1*	*36.1*	*23.7*	*19.0*	*20.2*	*(5.7)*	*22.3*	*11.0*	*6.2*
Russell 1000 Value ($CAD)	*10.9*	*14.8*	*1.0*	*1.0*	*6.7*	*7.9*	*13.3*	*(19.6)*	*9.4*	*3.6*	*10.9*
MSCI EAFE Growth ($CAD)	*7.9*	*14.8*	*16.6*	*16.6*	*10.7*	*9.1*	*10.6*	*(9.4)*	*12.1*	*6.4*	*7.9*
MSCI EAFE Value ($CAD)	*13.7*	*13.0*	*(3.8)*	*(3.8)*	*(0.1)*	*3.1*	*6.6*	*(21.1)*	*7.8*	*(0.7)*	*13.7*

2020 was a year for the record books!

Encompassing the shortest equity bear market in history (33 days) followed by a sharp reversal, 2020 not only gave investors in Canada a roller coaster ride for the ages, but also positive returns across both stocks and bonds. Who would have predicated that rollercoaster on January 1, 2020 or even at the end of the first quarter?

AUDREY L. ROBINSON
PORTFOLIO MANAGER

2020 opened with very constructive outlooks for global economic growth and equity markets, (albeit with concern that bond yields would rise giving way to losses in bond markets), tanked on the exogenous shock of the global pandemic as governments shut down virtually whole economies (exacerbated by tumbling oil prices especially in Canada), snapped back in an almost unprecedented way in the second quarter and then maintained a steady rise in the third and fourth quarters.

For the year, Canadian bond investors actually earned a higher return than Canadian equity investors as yields over the course of the year eased and corporate spreads over government bonds compressed. In fact, over the past ten years, Canadian bond holders earned a very competitive return of 4.5% compared to the 5.8% earned by Canadian stockholders.

Canada took longer than other global equity markets to recover from the bear market, not regaining its Feb 20, 2020 high until January 7, 2021. By way of comparison, the S&P500 regained its Feb 20 high on August 12. Canada continued to be bedevilled by the dominance of the energy industry in our capital markets, and our comparative lack of tech companies and strong health care companies – the two sectors that dominated US stock returns resulting in a strong 18.4% return for the year for the S&P500 in USD.

But, as noted last quarter, the Canadian dollar continued its appreciation over the US dollar with the result that over the last quarter and for the year, Canadian dollar returns for the US market were lower than the US dollar returns.[1]

Over the full year, value stocks underperformed growth stocks to the continued consternation of value-focused investment managers. However, there was light in the last quarter when the rotation to value that had been anticipated throughout the year finally began. Both Russell 1000 Value and MSCI EAFE Value produced returns that handily exceeded their respective Growth indices. In Canada, the rotation played out with the bounce back in the energy and financial sectors (both of which are considered value) in the fourth quarter as outlined in the table below. And the same rotation took hold in the US.

Industry Sector Returns 2020

	S&P/TSX		S&P 500	
	Q4	**1 Year**	**Q4**	**1 Year**
Consumer Discretionary	21.0	17.1	8.0	33.3
Consumer Staples	(5.6)	4.3	6.4	10.8
Energy	**14.7**	**(26.6)**	**27.8**	**(33.7)**
Financials	**16.7**	**1.6**	**23.2**	**(1.7)**
Health Care	**30.1**	**(23.0)**	8.0	13.5
Industrials	7.1	17.0	15.7	11.1
Information Technology	**7.6**	**80.7**	11.8	43.9
Materials	(3,7)	21.2	14.5	20.7
Real Estate	9.7	(8.7)	4.9	(2.2)
Communication Services	3.7	(3.7)	13.8	(23.6)
Utilities	5.6	18.3	6.5	0.5

International markets marched in lock step with North American markets posting healthy positive returns over the quarter and the full year. International markets as represented by MSCI EAFE have lagged the US markets, but as noted below, with the US dollar depreciating and cyclical sectors outperforming the conditions are being set for international markets to outperform the US.

While fixed income returns were flat over the third and fourth quarters of the year, the strong returns generated in the second quarter when the yields declined and corporate spreads came in, pushed returns for Universe bonds to a robust 8.7% for the year. Bonds continue to be expensive (as they were at the beginning of 2020) and while the central banks control the short end of the yield curve, early in 2021 we have begun to see interest rates at the long end of the yield curve begin to back up or increase.[2] This back up reflects a view that economic growth will continue to be positive for the foreseeable future.

1.It should be noted that the CAD appreciation is not a made-in-Canada phenomenon; rather it has been caused by the depreciation of the USD globally. The US dollar generally depreciates when global growth is accelerating, and cyclical stocks are outperforming defensives – the situation currently. It also bears noting that in this environment, value stocks generally perform better than growth stocks.

2. As we have noted in previous commentaries, there is an inverse relationship between bond yields and bond prices. When yields increase, the price of the bond declines and when yields drop, the price increases.

Review of Major Factors Impacting Markets and Economies in 2020

Given the roller coaster in 2020, it seems pertinent to review the factors that most influenced capital market and global economies over the year.

Economic Contraction

When the true extent of the global pandemic was finally understood, governments around the world moved with extraordinary speed to implement public health measures that also had the effect of shutting down their economies. This action (referred to as an exogenous shock, meaning that it comes from external factors) caused massive contractions in GDP globally. In Canada, GDP contracted 11% in the second quarter and is forecast to be down 3% for the calendar year (chart below from Alliance Bernstein (AB)). However, the silver lining of exogenous shocks, as recently noted by Citibank, is that global economies tend to recover more quickly from exogenous shock than from endogenous ones.

This is confirmed in the AB chart where the forecast for Canadian GDP in 2021 is a very robust 4% before settling back to a forecasted 2.5% in 2022. Similarly, US GDP is forecast to have dropped 3.6% in 2020 with a strong rebound to 4.7% in 2021 and 2.9% in 2022.

By way of contrast, the UK has been hit harder (GDP down 10.7% in 2020), and recovery is expected to be slower (2.3% growth in GDP in 2021) due to the combination of Brexit and the pandemic.

What Do We Mean By Global Reflation: GDP Path Relative to Pre-Crisis Trend

Calendar-Year GDP Growth Forecasts	2020E	2021F	2022F
US	-3.6	4.7	2.9
Canada	-3.0	4.0	2.5
Euro Area	-7.2	2.4	5.6
China	2.0	8.2	5.5
UK	-10.7	2.3	8.8
Global	**-3.8**	**4.9**	**4.5**

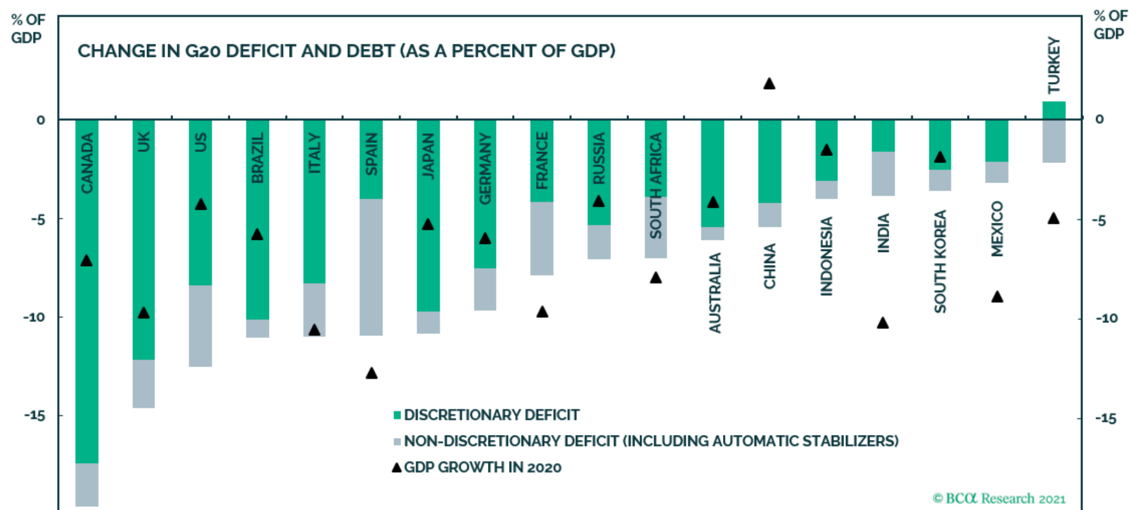
Source: Haver Analytics and AB

Fiscal Stimulus

The collective response by global governments to the pandemic was to hurriedly turn on the spigots of government spending.[3] Without financially supporting both individuals and businesses, employment would have been decimated, and demand for goods and services would have collapsed; a combination which governments collectively feared would set the stage for depression, not the recession we experienced. As it was, unemployment rose to 13.7% in Canada and continues to be at elevated levels 10 months after the pandemic first hit Canada.

The chart below is a reminder of the almost unprecedented fiscal response by major countries to the pandemic.

Fiscal Policy In 2020: Governments Eased Significantly In Response To The Unfolding Crisis



SOURCE: IMF, WORLD ECONOMIC OUTLOOK DATABASE; AND IMF STAFF ESTIMATES.
NOTE: THE IMF DEFINES DISCRETIONARY FISCAL SUPPORT AS THE CHANGE IN THE CYCLICALLY-ADJUSTED PRIMARY BALANCE (CAPB); NON-DISCRETIONARY FISCAL SUPPORT IS THE RESIDUAL

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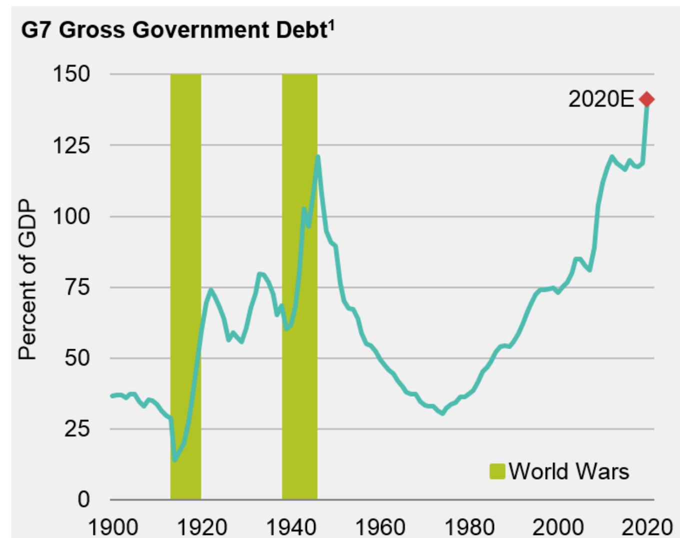
Many economists likened the level of fiscal injection to a "wartime" response – a characterization that is supported by the chart below. In fact, the collective response by the G7[4] governments to the pandemic produced debt levels that exceeded those following the two world wars.

3. Referred to as fiscal stimulus. In Canada, it included broad fiscal measures as well as significant income support measures for persons whose employment was directly affected by the pandemic.

4. G7 countries include Canada, the United States, Britain, Japan, France, Germany and Italy.

Debt, Interest Rates & Inflation: The Unholy Trinity

"To Infinity & Beyond"[1]



[1]Buzz Lightyear. [2]Shaded periods represent wartime
Source: Haver Analytics, Jordà-Schularick-Taylor Macrohistory Database, IMF and AB estimates

But two questions linger into 2021 regarding the economic contraction and the fiscal stimulus:

Is there continued justification for fiscal stimulus?

What is the potential longer term economic and fiscal impact of these levels of public debt?

In the US (where the Horatio Alger myth of bootstraps and self reliance still resonates), the answer to the first question is a resounding yes – not only is fiscal stimulus still viewed as necessary, but it has strong bi-partisan support – something which eluded the US Congress over much of the last four years.

In Canada, the fragility of the economic recovery has motivated both federal and provincial governments to continue to provide financial support to individuals and businesses, especially in the service sector. While the service sector only accounts for 10% of Canadian GDP, it represents approximately 25% of the working population. Without fiscal support, the economic impact of the pandemic would have devastated large numbers of Canadian households and communities.

If there is one thing governments have learned (generally the hard way!) it is that introducing fiscal austerity measures too early can be disastrous – both on economic output and employment. It is generally recognized that the last depression (1930's) could have been avoided if governments had not put on the economic brakes as soon as they did. Consequently, one can expect governments and central banks to move slowly in unwinding the fiscal and monetary support.

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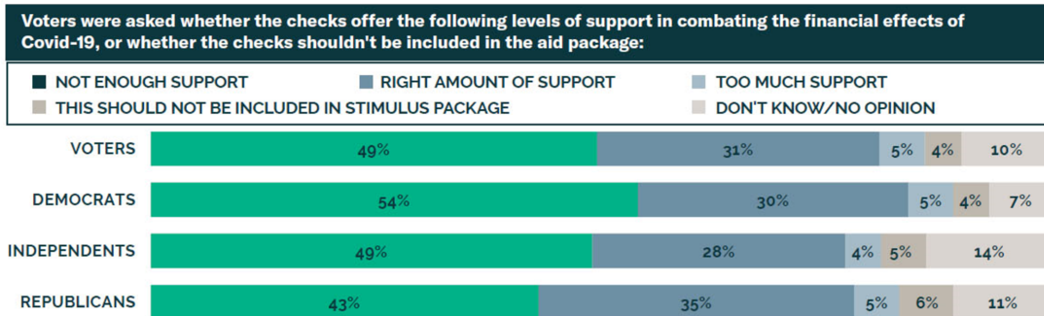
Strong Support For Stimulus

Shape Your Conviction™



SOURCE: "NEARLY HALF OF VOTERS SAY $600 IN STIMULUS CHECKS ISN'T ENOUGH TO COUNTER FINANCIAL TURMOIL FROM COVID-19," MORNING CONSULT, DATED DECEMBER 22, 2020.
NOTE: POLL CONDUCTED DECEMBER 18-20, 2020, AMONG 1,995 REGISTERED VOTERS, WITH A MARGIN OF ERROR OF +/-2%.

Do You Support Or Oppose:

		Total	Democrat	Republican	Independent
A new $2 trillion stimulus package to extend increased UI, send stimulus checks & provide financial support to state & local governments.	Support	72%	91%	56%	67%
	Oppose	21%	6%	34%	27%

SOURCE: NEW YORK TIMES/SIENA COLLEGE SURVEY CONDUCTED OCTOBER 15-18, 2020 (MARGIN OF ERROR OF +/- 3.4%).

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What then of the question of elevated debt levels?

There are two issues that trouble many economists with the levels of public debt that governments have accepted to deal with the pandemic – the impact on inflation and the long term impact on servicing that debt to government finances. Let's begin with the latter.

Financial Repression (aka lower for longer)

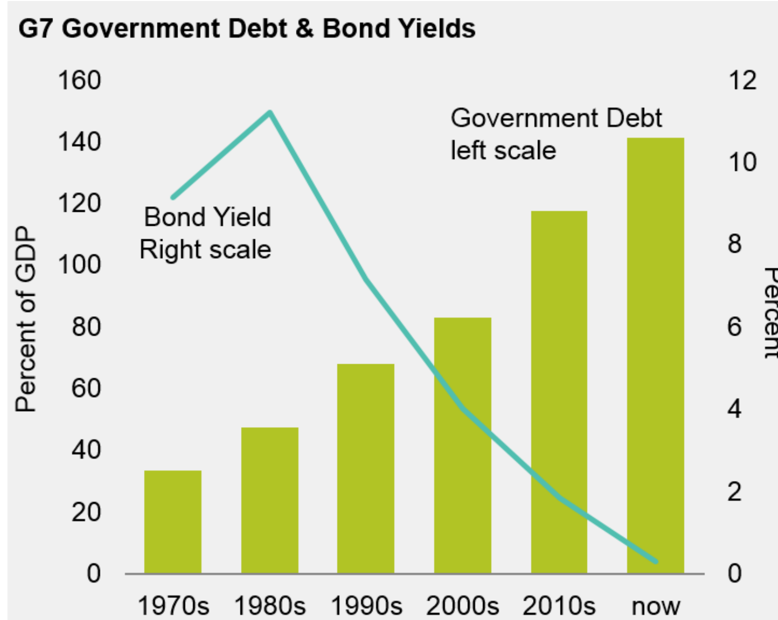
As we noted last quarter, a critical factor in considering the ability of governments to manage their cumulative debt is the interest rate at which they are repaying that debt. And today, nominal rates around the world are either just above zero or just below zero.[5]

As the first chart below highlights, interest rates have been in a secular decline since the early 1980's when central banks hiked interest rates to combat runaway inflation. The end of the 1970's witnessed a wage/price spiral that saw inflation accelerate to unprecedented levels accompanied by painful levels of unemployment. A period described as "stagflation." To put the brakes on inflation, central banks hiked short term rates to the mid-teens. Their efforts were rewarded with the secular decline of rates and inflation over the subsequent 30 years.

5. An interesting fact on negative interest rates – in Japan, which has had negative rates for longer than most countries, the government receives more interest than it pays.

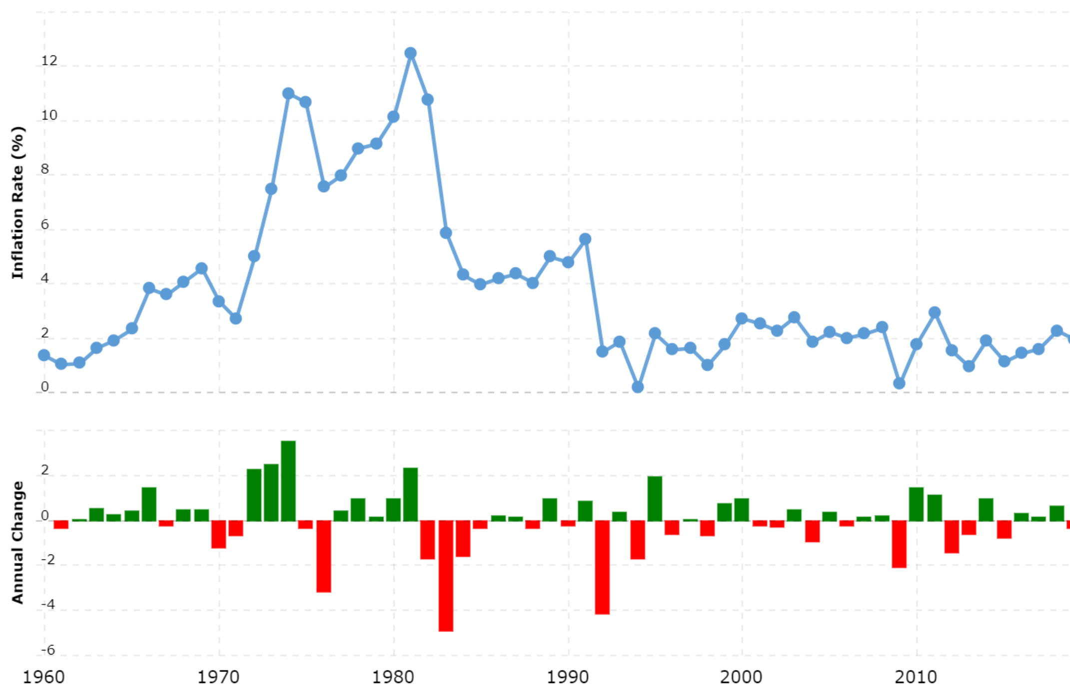
Debt, Interest Rates & Inflation: How Did We Get Here?

"Debt accumulation over successive business and financial cycles becomes the decisive factor."[1]



[1]BIS Annual Report, 2014. [2]COVID-19 and the Global Economy, Larry Summers (Princeton Economics Interview, May 2020). [3]Can "It" Happen Again?, Hyman Minsky.
Source: Haver Analytics and AB

Canada Inflation Rate 1960 - 2019[6]



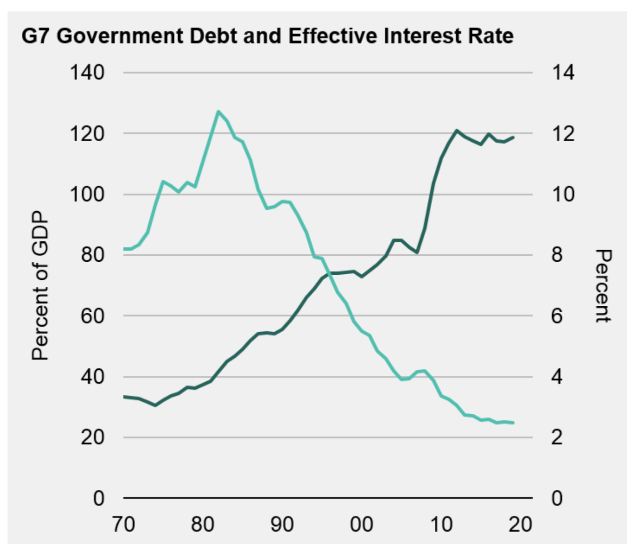
6. Source: www.macrotrends.net

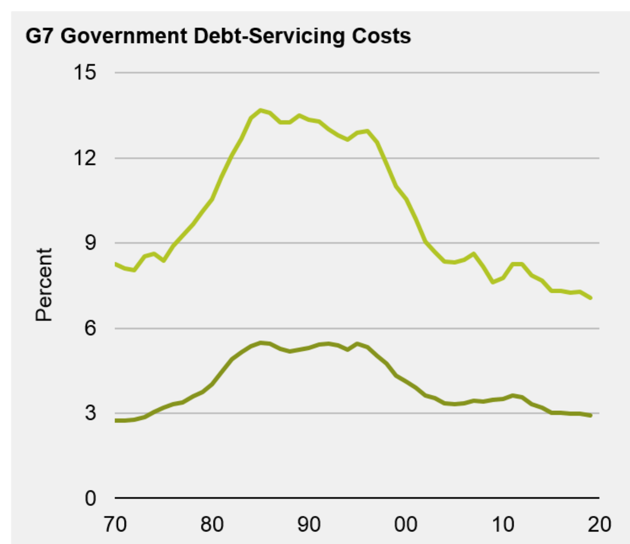
A key consideration for governments in managing their debt to GDP is the debt servicing costs. Today, those costs that are inherently manageable because of the "lower for longer" interest rate policy that central banks have maintained post GFC to deal with the pandemic.[7]

Put another way, as long as interest rates stay below the growth rate of an economy (which they are today), debt as a percent of GDP will 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.

Low Rates Keep Debt-Servicing Costs Manageable[8]

But Is this Part of the Problem?





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

Inflation

Coming out of the period of stagflation in the late 70's and early 80's, central bank monetary policy was focused on price stability – central banks would use monetary policy tools to target inflation (referred to as price stability) at the 2% level. Unfortunately, it has proved to be an elusive target.

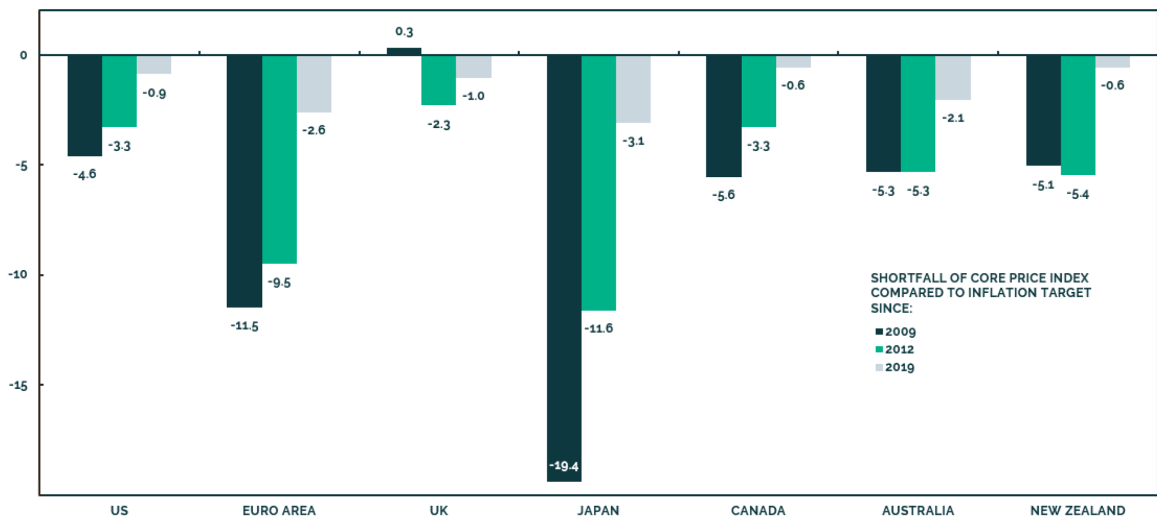
Post the GFC, it was expected that keeping interest rates near zero would be a sufficient lever to jump start inflation. It has been unsuccessful. As a result, towards the end of 2020, central banks led by the US Federal Reserve announced that they were prepared to let economies overheat in order to move inflation meaningfully above 2%. (Referred to as Average Inflation Targeting).

7. Monetary policy post-2008 was anchored to maintaining interest rates at very low levels to cope with the economic impacts of the Great Financial Crisis and to motivate investors into risk assets such as equities.

8. 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.

It is early days for a policy experiment that has many economists concerned that central banks will be unable to control rising inflation once it is unleashed. And more worryingly, that the inability to control inflation could result in another period of stagflation. Admittedly, the concern is not for the near term given we are still struggling with the economic impact of the pandemic but more for mid-decade by which time it is expected that economic stability will have returned.

Central Bank Have Missed Their Inflation Targets



BARS SHOW THE PERCENTAGE DIFFERENCE BETWEEN AN INDEX OF CORE CONSUMER PRICES AND AN INDEX THAT GROWS AT THE RATE OF THE CENTRAL BANK'S INFLATION TARGET SINCE THE BEGINNING OF 2009, 2012, AND 2019. A 2% INFLATION TARGET IS USED FOR ALL COUNTRIES EXCEPT AUSTRALIA, WHERE 2.5% IS USED. THE LATEST DATA POINT FOR THE CONSUMER PRICES INDICES IS SEPTEMBER FOR AUSTRALIA AND NEW ZEALAND; OCTOBER FOR THE US, UK, JAPAN, AND CANADA; AND NOVEMBER FOR THE EURO AREA. THE FOLLOWING CORE PRICE INDICES ARE USED IN THE CALCULATIONS: PCE EXCLUDING FOOD AND ENERGY FOR THE US; CPI EXCLUDING FOOD AND ENERGY FOR CANADA, JAPAN, AND NEW ZEALAND; CPI EXCLUDING FOOD, ENERGY, ALCOHOL, AND TOBACCO FOR THE EURO AREA AND THE UK; AND CPI EXCLUDING VOLATILE ITEMS (FRESH FRUIT, VEGETABLES, AND AUTOMOTIVE FUEL) FOR AUSTRALIA.

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Inequality and Populism

We would be remiss not to address an issue which has caused considerable angst and anxiety - most particularly in the US but not exclusively – growing income inequality and rising populism. While Donald Trump no doubt fanned the flames of populism, its genesis rests in the growing disparity between the wealthy and the rest of the working population. The BCA chart below shows that almost all the gain in real incomes in the US has occurred at the very top while those below the 99th percentile have been experienced flat to negative growth in real income – a phenomenon that is not confined to the US.

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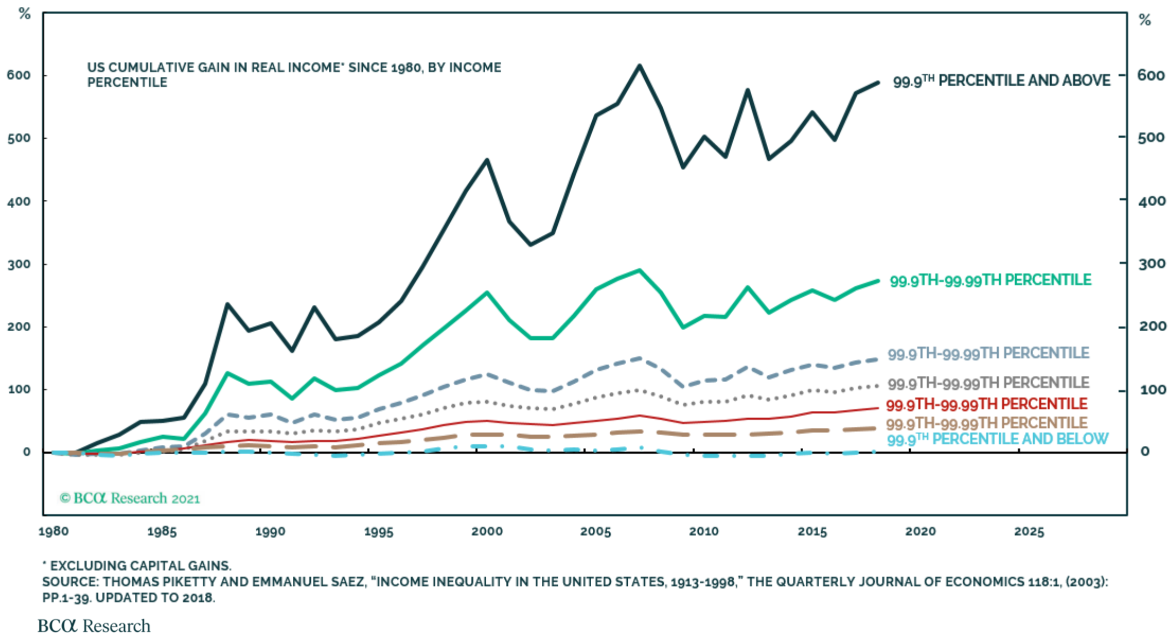
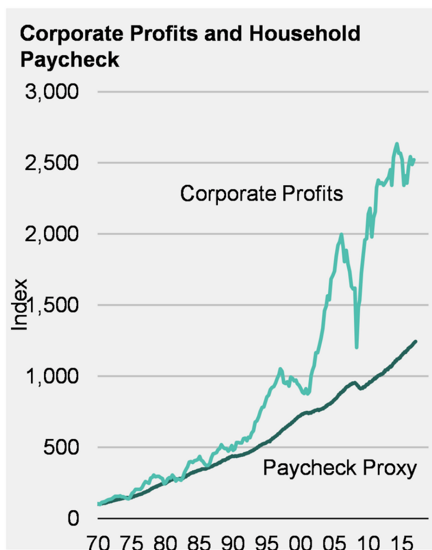
The (Really) Rich Got Richer



Income inequality has been on the rise since the 1980's and corresponds with the growing integration of global economies – in other words, with globalization. However, as the AB chart highlights, globalization may well be ebbing. For example, while Donald Trump was a very vocal advocate for "Buy American", the Biden administration in its early days has indicated that it is supportive of similar policies in an effort to support the US economy and US workers, and to quell populism.

Shift to Populism Fueled by Income Inequality



Growth in National Income in the US (Postwar Period)

Income Group	Real Income Growth 1946–1980	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.

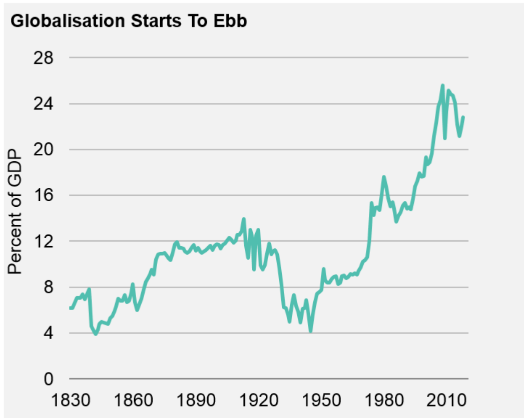
Middle table: Displays the cumulative real growth rates of pretax national income per adult over two 34-year periods: 1946 to 1980 and 1980 to 2014. The unit is the adult individual (aged 20 or above). Fractiles are defined relative to the total number of adults in the population. Income is split equally 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.

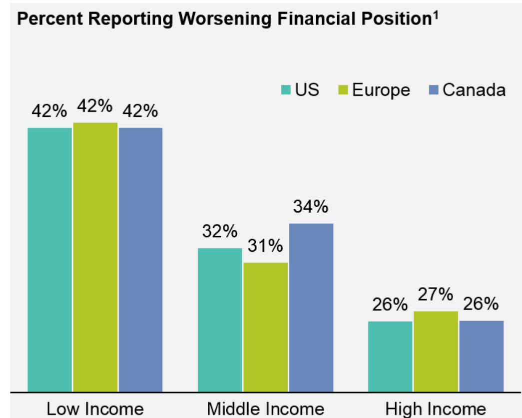
Source: Piketty, Refinitiv Datastream, Saez and Zucman, "*Distributional National Accounts: Methods and Estimates for the United States,*" NBER WP22945, CRS estimates using Current Population Survey Outgoing Rotation Group data for 1979–2018, AllianceBernstein (AB)

AB

COVID-19 & The Secular Outlook: Pushing On An Open Door

Populism Pressures Building



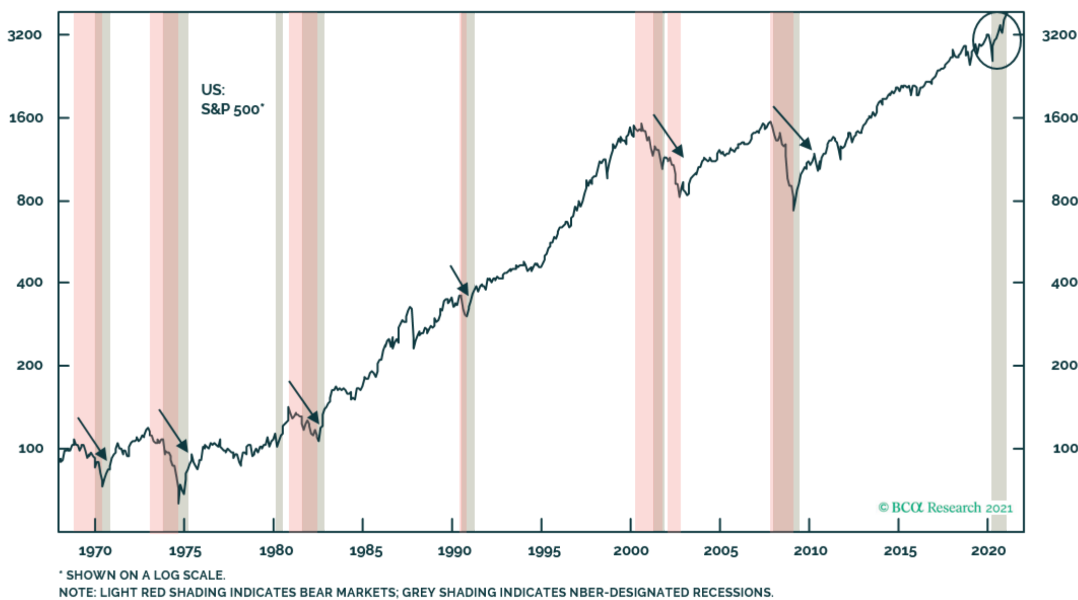


[1]Fouquin and Hugot (CEPII 2016) 1830 to 1959; World Bank data from 1960.
Source: Haver Analytic and Our World In Data

What's Next?

While this chart below shows that bear markets and recessions walk in lock step[9], it also shows an interesting cyclical pattern to markets - that rising markets tend to expand over twenty year cycles (and can include a recession and a bear market) while sideways markets (which can also include recessions and bear markets) tend to play out over ten year cycles. And, if this holds, the current market is only halfway through the standard rising cycle, having begun in March 2009.

Recession And Bear Markets Travel Together



Nonetheless, there continues to be concern that both bond and stock markets are expensive by historical standards. And for equity markets, there are divergent opinions on whether these markets (especially the US) are in bubble territory. As with all things capital markets, the answer on whether the equity markets are in bubble territory will only become known when the bubble bursts. And even those with diverging opinions agree that the crystal ball has a very big crack when it comes to predictions on timing.

9. And 2020 was no exception although its brevity means it is impossible to see its light red shading!

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