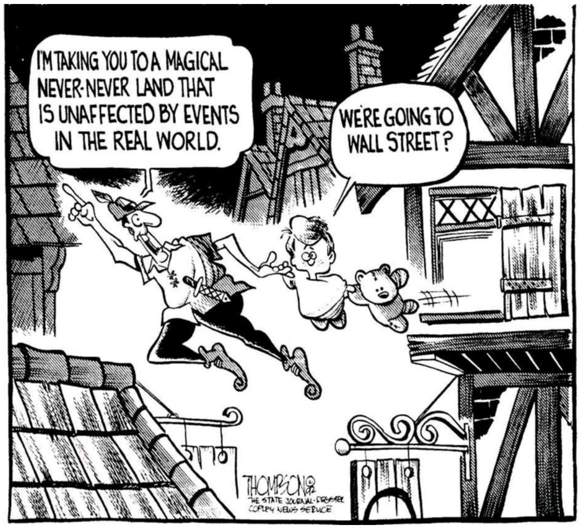
4th Quarter Commentary

The word unprecedented was used repeatedly in 2020 in an attempt to explain the pandemic, pandemic responses around the world and various political events in 2020 and into January of 2021. Governments across the world have engaged in various forms of stimulus, $10Trillion+ has been issued. We have witnessed massive increases in money supply and sovereign debt while all major US stock indices have risen to all-time highs. Here at home Canada's GDP continued to improve with consumer spending, business investment, service sector activity and manufacturing output all improving from the lows of Q2. The Bank of Canada left its policy rate and quantitative easing program unchanged and restated plans to hold interest rates near zero.

Pandemic related restrictions continue to cause havoc in the global economies. Christmas was cancelled in Europe, the UK is in full lockdown, Germany is going to full lockdown, Spain and others are using a more tiered approach. In North America more severe lockdowns and curfews are being considered. The rationale for these lockdowns is that it would buy time to create and distribute a vaccine at whatever costs. Rising virus cases continue from Russia and Asia meanwhile in the US the trajectory of infections and deaths keep rising. As we have said in past commentaries, we can look to the UK and Europe as a leading indicator for what awaits us. Expectations are Europe is slipping into a 2nd recession as a result of the surge COVID and by a mutation in the virus. The threat of more wide ranging lockdowns could lead us to shift to a global recession, at least technically. This form of closing and then reopening and then closing the economy as a form of pandemic control has consequences far beyond the economy. Human behavior is affected and suggests we will continue to take evasive action for the time being further suggesting poor economic data may lie ahead. This situation will only become normalized after people feel no fear of contracting COVID.

With respect to the United States, the real economy and capital markets continue to move in opposite directions. Markets are divorced from reality, unhurt by the millons of unemployed Americans and the negative impacts on small businesses. Capital markets just seem to want to power forward and look for a positive narrative. US capital markets overlook the potential of severe economic weakness. Markets seem to be telling us there does not appear to be any other way to deal with these health and economic issues other than to continue with massive fiscal and monetary support. Whatever you may believe regarding the performance of the capital markets versus main street, it is clear that the difference is a symptom of widespread confusion.


I'M TAKING YOU TO A MAGICAL NEVER-NEVER LAND THAT IS UNAFFECTED BY EVENTS IN THE REAL WORLD.
WE'RE GOING TO WALL STREET?
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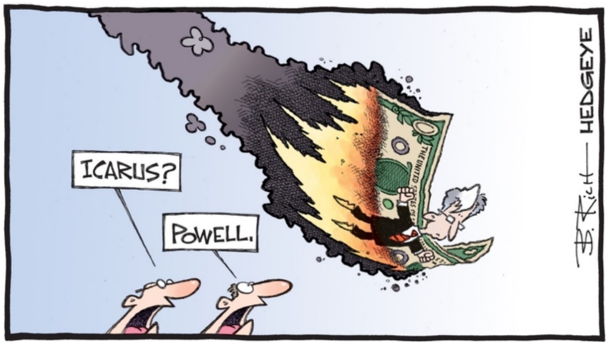
There are no signs that borrowing will let up anytime soon. Public debt levels in the US now sit at greater than 130% of GDP and climbing. This figure may understate the situation when you factor in off balance sheet debts, such as Social Security and Medicare, but to say it mildly, US national debt is off the rails. Persistent debt accumulation will likely be one more reason that will keep central banks suppressing interest rates over a much longer period of time. There is suggestion that the one thing that makes these debt burdens tolerable for the time being is that debt service costs are relatively low and manageable due to prevailing ultralow interest rates. While this is true, the purchasing power of the dollar continues to be eroded and that is what Main Street feels. The US dollar continues to be devalued and is in a bearish trend.



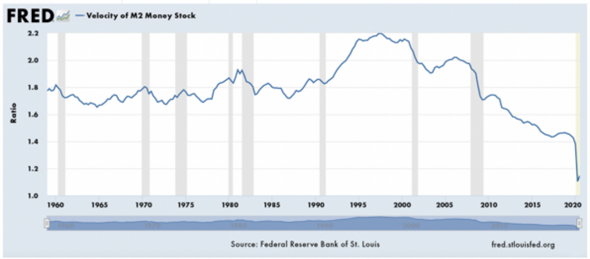
As Presdient Biden transitions into office, his administration will lack the incentive to address the issue of debt levels. Given the ease to finance itself with ultralow interest rates, the path of least resistance seems to be pointing toward increasing fiscal spending, not restraint. The primary economic policy of the Biden presidency is straightforward. They will print money, borrow money, spend money and handout money. Additional trillions in expansion of the money supply is what is expected in 2021. Democrats now control the Senate in a 50-50 split with Republicans, with Vice President-elect Kamala Harris serving as the tie-breaker. Biden will be motivated to front load the legislative agenda during the first two years in office to get motions passed. The Fed will be expanding its balance sheet to support asset prices while the government deficit deteriorates further as it continues to support its citizens. If there is one takeaway at all, it is that monetary expansion is likely to continue, perpetuating dollar based inflation.

Most people tend to look at the performance of the stock market to gauge their view of the economy. Wall Street suggests stock market resiliency is proof that the economy is returning to pre-pandemic performance. In other words a positive narrative justifies a new bull market. The truth of the matter is, there is a significant gap between narrative and reality. The problem is that the stock market is a poor macro variable as it has a reputation for looking into the future and perhaps trading on a narrative it wants to see, discounting bad news and thus removed from reality. We have erased the March lows from our collective minds and we have traded up to all-time highs. Rallies though tell us nothing about the long term trend which is driven by larger forces than momentum. The bond market is suggesting rates, while rising on vaccine distribution news, could be soon topping out. Looking at yields, 10 yr rates in the U.S. are around 1.10%. In Germany they are negative 50bps, in the UK around 25 bps, Australia is close to 0, and New Zealand is negative. Rates are close to zero or negative in all parts of the world except in the U.S. Rates in the US may be far too high considering the macro environment. This will just attract capital if it continues to rise and then lead to US$ strength, potentially unwinding the reflation/reopening trade. In the US there seems to be this inherent belief that rates cannot go negative being the world reserve currency. There are record amounts of short positions on the 10yr and the 30yr U.S. Treasuries. The market narrative is that it does not believe that in this period of time there cannot be reflation. The take on this is if the reflation trade unwinds or comes apart, rates are headed lower quickly as markets get spooked.

Retail sales figures released in January showed the 3rd consecutive month of declines. From a jobs perspective payroll gains continue to slow as a result of permanent job losses in more vulnerable sectors. Job losses that were thought to be temporary have become permanent. The December ADP report demonstrated the first decline in private employment. This is the first time payroll has been negative since April of last year and was well below what economists had expected. Leisure and hospitality continue to lag. Since last February the leisure and hospitality sector has shed 3.9 million jobs. Private payrolls are 10 million jobs below pre pandemic levels. The problem with long term unemployment and permanent job losses moving higher is they may end up being stickier for longer than many people expect. Small business are crumbling and large business are feeling the pain. America's job crisis clearly isn't over especially with additional lockdowns expected. Claims remain well above pre-pandemic levels, 4x higher than this time last year. The stock market is suggesting a jobless recovery that may not have the stamina to keep rising.

Another economic indicator we follow is that personal savings rate is rising. Individuals have the propensity to save and pay down existing debt when they feel their economic situation might be restrictive or deteriorating. Savings rates as a percentage of disposable income skyrocketed to 33% in mid 2020. This will be maintained and expanded if lockdowns continue and behavior continues to be cautious. As a result of the savings rate expansion by consumers and hesitation of banks to lend, the velocity of money is reducing. It is expected that velocity will continue to slide lower as lockdowns continue. Ideally velocity of M2 (money supply) should run north of 2x to support expansion of GDP. Current measure sits around 1.3x and falling. Sustained healthy economic expansion cannot exist without healthy rising velocity of M2. Velocity is something that cannot be controlled by the Fed unless they continue to expand money supply, and forcefully encourage banks to lend and in someway encourage consumer spending at the expense of consumer savings. Neither are inclined to participate at the moment. We acknowledge that banks in North America are in better capital positions and ample liquidity offers comfort but the intermediate term remains fraught with uncertainty. These banks, traditional levered plays on economies, have been reluctant to offer loans and are still struggling with provision adequacy for loans still on their books. JP Morgan was the first bank to release its quarterly results in mid-January and it basically reversed prior provisions suggesting they had over-estimated the severity because fiscal policy essentially bailed out the consumer. This is a slippery narrative. This announcement does not say its reflation, it says we were supported for the time being by government bailouts.

Chart: Velocity of M2 Money Supply



Source: Federal Reserve Bank of St. Louis

fred.stlouisfed.org

The consumer is generally under-employed over levered and over extended. A recovery will come, but in due course. The economic reality is that labour markets remain stressed, consumption capacity is falling, personal savings rates remain elevated, bankruptcies are rising, banks are reluctant to lend, and corporate earnings risk is rising relative to buoyant wall street expectations. Asset prices still do not reflect the economic reality because they have been so heavily inflated by both fiscal and monetary stimulus.

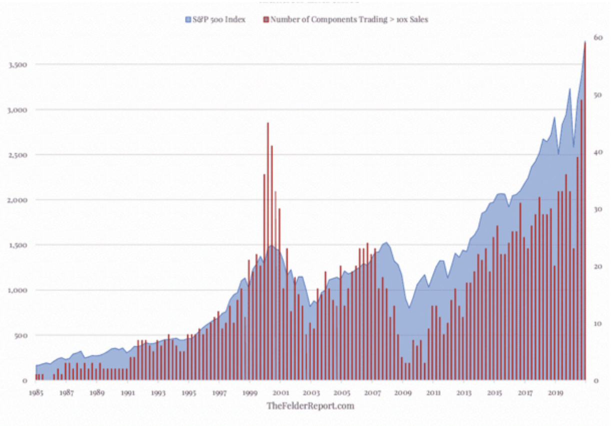
Unemployment levels will improve but they will improve from horrific high levels. Economic expansion will return but it will return at much lower levels than expected.

The narrative from March up to November was to focus on companies that would benefit from travel restrictions and the shift to e-commerce. Since November the narrative and market action all speaks to the reopening/reflation trade, that is, short dollars, short treasuries (yields rising), short volatility, long equities, long commodities, long oil and short gold and gold equities. It is one of the most crowded one-sided narratives we have seen considering we remain vulnerable to the risk of shutdowns or a spike in the US dollar that would unwind this trade very quickly. The point of narratives and bubbles of course is to be aware of them and take risk appropriately when the signs are there. The market has pulled forward recovery by many months leaving 2021 potentially exposed to disappointment. There seems to be an overall belief that central banks and governments are in full control and failure is not an option. By practically every traditional measure it shows speculative excess taking place. Rising yields, while suggesting the economy is rebounding, is also unproductive given corporate and government debt levels are at the highest rate on record. Concern is the Fed may have to intervene and take on yield control as well which would be a headwind for equity markets. This is a fascinating position to be as there appears to be an overwhelming consensus as to how the upcoming year may trade.

In a nutshell, buy risk assets. This can be a logical position to take as there is further fiscal stimulus coming, the Fed continues to shower the market with support and vaccines are being rolled out. As a narrative this is nerve racking as markets may overreach. Also some of the indicators for the reflation trade are a bit weak. A vaccine coming only means productivity takes us back to where we were this time last year, not higher but at the same time the issues surrounding the economy we have been speaking of are still in existence, which should cause stress in the second half of the year as government pulls support away. Fiscal and Monetary support is just that, not stimulus. Stimulus packages allocated to people should be looked at as cash and not cash flow and viewed as injections for a finite period of months to provide assistance but not necessarily drive consumption. The current handouts are not a source of jobs or growth. Growth is not being stimulated, we are protecting the economy from not falling further. The key to this reflation narrative is that it is all on the back of a weaker dollar and not pent up demand. That is what makes current consensus concerning.

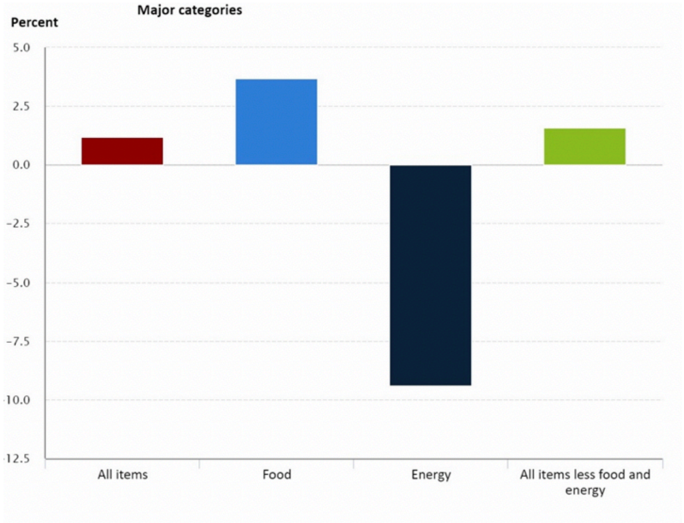
Biden will inherit a difficult situation and has gone on record that his focus will be battling rising infections and deaths suggesting a more restrictive approach in America. The concern here is capital markets continue to look past economic data to when mobility resumes. We see this time as an extremely risky period for capital markets. Risk comes gradually and then suddenly. There is a reasonable case to be made that there is a high probability of a reversal. We will continue to pay attention to market volatility. We will continue to monitor yields and market positioning data. Hedges we have in place are to preserve capital and these hedges will need to be traded and monetized like any other asset price. Markets are in fact not efficient and assets in the same asset class (equities) will move together at signs of trouble as leveraged investors and funds rush to raise capital. The assumption in capital markets is any significant drawdown in equity markets will be supported by central banks to return them to levels pre drawdown. This is a very unhealthy view but has been the view that has existed since 2009.

Chart: Valuation Extremes



The near term bullish case relies on the premise that political uncertainty in the US appears to be clearing, historic monetary stimulus and fiscal support will continue to expand, and countries appear to be reopening as vaccinations accelerate. Robust consumer demand for goods exists until we peak most likely later this year. Consumption growth is outpacing production growth so all this is suggesting we will see corporate profits grow but also goods inflation will be part of it as well. We are likely to see impressive year-over-year economic growth in Q1 and to some extent in Q2 of 2021. While this growth comes on the back of easy pandemic comparables, that acceleration is still real and buoyed by generous monetary expansion of central banks. Outlook for Q1 is bullish in that GDP growth and rate of change should be positive allowing for alpha to be generated. And this is not just happening in the US as we should see similar story lines globally. The generous fiscal support and monetary policy in the US is explicitly bearish for the US dollar and bullish for assets priced in US dollars, globally. Volatility has broken down to the low 20s and ranging from 20-27 the past little while suggesting while choppy trading will not go away the near term forward return outlook for equities is likely positive. Volatility is a leading indicator of price. The current market volatility and volume tells us there is a bit more room to run. It would appear for the time being, we want to be long reflation trade and short duration and rate sensitive securities as real rates keep rising. Also, according to the CFTC non-commercial net long positioning, institutional sentiment position is still bearish, or put another way, not bullish enough for the upcoming trade. Institutions are selling into dips and buying protection on corrections on the narrative the market has in fact topped. This should be another tailwind to capital markets in the near term. However we emphasize that quality, not quantity is the most important factor right now when selecting individual securities.

Chart: 12 Mo. % Change, CPI
11/20 (not seasonally adjusted)



Source: U.S. Bureau of Labor Statistics.

In summary, as long as the Fed continues with its generous support of the markets we will continue to accumulate risk if it continues to be in our favor and divest from risk when we think it goes against us, supported with hedges we can monetize on the irrational speculative behavior or market participants. If we see the Fed trying to cap yields or buying more long dated securities this would be our signal to tilt to a more defensive stance. The Fed minutes released in early Jan showed no intention of changing course so we continue to invest in the environment we are in, one of weak dollar, reflation tilt, underweight yield sensitive securities. Some US equities are crowded trades so we are cautious of that. In the near term we have lower conviction on the strength of this market but not the direction. We will stay invested by navigating the economic cycle we are in, preserving our capital, looking for opportunities in the options market, making decisions based on our risk tolerance and return expectations and compounding our returns on a risk adjusted basis. The real economy impacts may eventually arrive, and could be fierce, however with the Fed continuing to meddle in the price action and discovery as a result of providing support there doesn't appear to be enough negative or surprising upcoming news, near term, to derail the surprising gains seen in the markets.

Our strategy continues to focus on consumer needs relative to wants; and movement of goods and services over unsustainable fads. We believe that companies that exhibit core strengths in providing goods and services will prove beneficial in this environment and after this period. While we cannot ignore the headlines around the world that will surely generate continued volatility in global equities and currencies, we will continue to focus on holding a diversified, but focused portfolio of leading companies, many of which generate stable and growing distributions. Criteria we look for are sound business models focusing on cash flow generation; long term steady demand for their products or services; growing cash flow; disciplined in its need to raise capital; as well as having a lower dividend payout ratio. Core positions in our portfolios include VISA, Microsoft, CN Rail, CDN Apartment REIT and Dollar Tree. These companies meet our criteria and are expected to continue to make up a healthy weighting in our portfolio going forward.

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Sincerely,

The Portfolio Management Team

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