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Asset Management Inc.

1st Quarter Commentary - 2021

This first quarter of 2021 witnessed significant equity volatility as investors reacted to various headlines. Narratives grabbing the attention of investors included fears from rising yields and rising inflation; COVID case counts and vaccine scares; the Suez Canal shipping blockage; high short interest stocks and hedge fund collapses. On top of that, there was significant political discussion with proposals for higher taxes on corporate and individual earnings; further fiscal stimulus and monetary expansion, and increased likelihood of infrastructure spending.

Beyond the headlines, the breadth of the current recovery continues to be challenged. The consumer remains under-employed, over levered and over extended. The labour markets remain stressed, personal savings rates remain elevated, bankruptcies are continuing, and banks are reluctant to lend. Asset prices still do not reflect economic reality because they have been so heavily inflated by both fiscal and monetary stimulus. We anticipate that economic expansion will return but it will return at much lower levels than expected and it likely wont be a straight line.

During the quarter, the S&P 500 was +6.43%; the NASDAQ +2.92%, and the S&P/TSX +7.27%. Capital markets just seem to want to power forward and look for a positive narrative.

Canada's economic recovery has been disappointing as it's vaccine programme has been plagued with problems since its lacklustre procurement attempts, which put Ottawa on the defensive when it came to securing vaccine supplies. This has since been compounded by the country's latest surge in cases in various provinces, driven by more virulent strains of the virus, combined with a relaxation of public health measures and increased mobility. The third wave of COVID-19 means that the restrictions on activity will be in place for longer than Canadians had assumed. The economy is poised to recover once vaccinations reach a critical mass, especially with the help of additional investment-focused stimulus. In its 1st budget released in almost two years, a total of $101 Billion, or 4.4% of GDP, in fresh spending measures were announced by the Trudeau government to help support an economic recovery. Similar to the US Federal Reserve, the Bank of Canada has stated its desire to wait

longer before raising interest rates despite rising inflationary fears.

With respect to the United States, the efforts from Washington, the Federal Reserve and the country's vaccination rollout has been impressive. Since November of last year, there have been two stimulus plans enacted - $900 Billion in December and $1.9 Trillion in March and approximately 124.8 million adults have received at least one dose of a vaccine, representing 48.3% of the US adult population. Investors are becoming more optimistic about economic growth. Consumer spending has powered forward and with the vaccination rollout proceeding at a rapid pace and household finances improving, we expect overall consumption growth to continue rebounding in the second quarter on a rate of change basis.

In capital markets there a few narratives at play, one being rising rates, two being the inflation/deflation debate, and lastly the strength of the re-opening and Federal Reserve involvement. All three are somewhat linked in capital markets and we will see whether this recovery since November of 2020 continues to gain traction or begins to unwind in the second half of the year.

On the aspect on interest rates, we are in a financial world of confusing levels. For a long period of time the Fed policy was seen as a dial, that is dial it up when needed and dial it down when not needed. In our opinion it has become a switch that cannot be turned off. The markets are too dependent and addicted. The longer this goes and the deeper the debt levels get, the riskier we are to the overall system becoming unhinged. Regardless of their communication efforts, the U.S. Fed is aware of this. We believe that the Fed's involvement in capital markets has breached their historical mandate. The extent of Fed meddling can be seen in the high yield debt market where a few years ago, debt yields were in double digits whereas now high yield debt is paying 3%. This is concerning when you factor in default risk of the underlying asset. Those calling for the need to normalize interest rates (meaning higher rates) need to be careful as that means we also need to normalize trading multiples (lower asset prices). Near term talk of central bank tapering, with such incredible debt levels outstanding and more debt

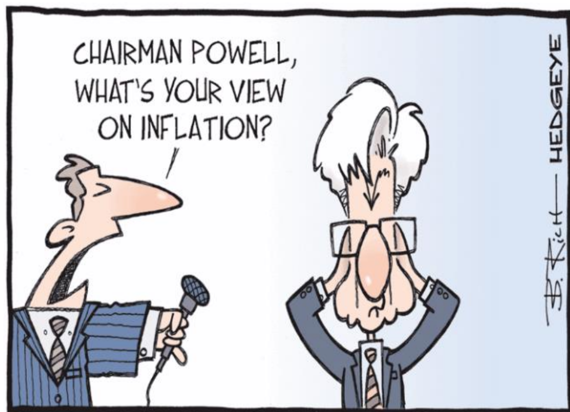
issuance planned, seems like a low probability event.

The yield on the 10-year Treasury began the year at 0.93%, rising 81 bps to 1.74% by March 31st. Yields rising on US Treasuries in a heavy indebted world is crippling for the US economy. Debt service costs will rise significantly and may lead to financial conditions tightening. There is very little margin for error. The system is so over levered that small moves have dramatic effects. Rates rising is a clear indication to us the bond market no longer approves of unlimited money printing. We as investors must understand we are exiting every past financial crisis with more debt and less growth than the previous one.

This is a fascinating period of time. The Fed has to keep yields at politically acceptable rates and by virtue of US debt levels that means continued low rates. This means low rates can go on for longer than people think. They have the means, motive and opportunity to keep them low for a long time. The Fed made clear recently that it still has no plans to raise interest rates within the next three years as the economy reopens and fiscal stimulus feeds through. It is understood that Chairman Powel will do whatever it takes to intervene if the bond market becomes disorderly or constrains the economic recovery.

On the issue of inflation, the path of CPI has been upward since Q3 of 2020. Those calling for rising inflation suggest it was inevitable and will not be temporary and keep speaking to money printing, debt levels and uncertain economic conditions. Those calling for muted inflation or possibly even deflation are pointing to history and money velocity. In previous cycles deflationary forces have been able to keep inflation in check and this has been one of the things that has bothered central banks. Households are deleveraging choosing to pay down existing debt levels and increase savings. It is very difficult to get sustainable inflation when there is no credit creation or where there is no significant wage growth or when people are choosing to pay down

existing debt over spending (reduced money velocity). Currently the inflation scare we are witnessing is the result of three things; one being the disruption of the supply chain as a result of the lockdowns; two being the rise of commodities prices (oil, lumber, wheat, corn, soyabeans, cocoa, cotton etc..) and three being the continued US dollar debasement. It is hard to see habits changing rapidly from savings to spending, regardless of how much pent up demand is said to exist. It is also important to note the US remains a services based economy. By definition, services are affected by deflationary forces (competition / demographics / productivity / technology / income inequality).



Our role as portfolio managers is to determine if rising inflation is sustainable and whether capital markets are mispriced on this narrative. Historically speaking, commodity prices are volatile and their effect on inflation tends to be short-lived. It does not mean we won't have scares. We see CPI rising to unpleasant levels but the data and weightings of CPI suggests the heavily weighted components are still in deflation mode.

And finally there is the narrative that central banks must continue to support markets and governments must continue to provide ongoing income support to its citizens. These safety nets are extremely risky. Government policy of money creation is never neutral and has always been implemented with disastrous effects. Money creation disproportionately benefits government as the first recipient of money and it disproportionately affects real wages as you dilute savings. Trading multiples have expanded rapidly as a result of Fed meddling. And yes this will likely continue. The US Fed is on record saying they will keep accommodative financial conditions. Assets will continue to stay inflated, especially where interest rates and inflation are concerned but our view on equities is not a freefall but rather

too much exuberance is priced in and the 2nd half of this year could see some weakness. We believe earnings expectations may have to be revised with a downward bias. In terms of portfolio construction, after the second quarter of this year, the data suggests that we will likely be on the side of moderate inflation, low growth and low interest rates.

Investors are clear with their expectations. Many expect and are hopeful to returning to pre-pandemic levels. The most over used expression since November is pent up demand. And while we will agree people are excited to get back outdoors and be mobile again we have to be cautious on this exuberance. Increasing savings rate and reduced money velocity also tells us we are not going back to the pre pandemic days. Pent up demand in vacations, outdoor dining, theme parks, musicals, haircuts, manicures, movies for instance is only 6% of consumer spending and 4% of GDP. This is a small fraction of true economic activity. The items we were spending money on such as home improvements and autos are worth twice as much as these other pent up demand items. Looking ahead near term to the second quarter the recovery story here is straightforward. Vaccinations will catalyze a multi-month stretch of large-scale hiring. Improvement in consumption capacity will be amplified by a temporary drawdown in the savings rate, further juiced by ongoing Fed-fiscal support.

The near-term bullish case relies on the premise that 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. We have come to see impressive year-over-year economic growth in Q1 and will likely see more of this into 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 Q2 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 15-25 the past little while suggesting choppy trading will not go away and the near term forward return outlook for equities is likely still positive. The current market volatility range and decreasing volumes tell us there is a bit more room to run. Also, according to the CFTC non-commercial net long positioning, institutional sentiment position is still bearish and long the USD, or put another way, not bullish enough for the continuing recovery 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 our view for the 2nd half of the year will be more cautious as we enter into more difficult company comparables.

Investors focused and worried about day to day volatility (equity VIX) are likely to miss another opportunity in the second quarter in the US. We monitor cross asset volatility (treasury, bond, equity, high yield etc…) and daily trading volume to determine if equity volatility spikes are trending. From our day to day monitoring, this appears to not be the case. Our current interpretation of cross asset volatility indicators and daily trading volume metrics indicate to us to re-gross (buy) while hedge funds and over levered funds are forced to cover their large drawdowns. For the time being, we will be active buyers on significant drawdowns, especially on deaccelerating volume.

In summary, we will continue to accumulate equities if they continue to be in our favor and we will divest from risk when we think its going against us. We believe there will be more stimulus, some in terms of money printing and some in terms of fiscal stimulus. The equity market has learned to manipulate the Fed. If it shows cracks it will invite further measures. The Fed minutes released in early March showed no intention of changing course so we continue to

invest in the environment we are in. Some US equities are crowded consensus 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.

The temptation to chase while markets keep hitting all time highs is not without risk. The challenge is to manage expectations as we look forward. The all time highs on the S&P have resulted with the help of Janet Yellen and Jerome Powell having been successful at supressing market volatility. The law of diminishing returns tells us to be cautious. 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.

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Sincerely,

The Portfolio Management Team

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