FAIRCOURT
Asset Management Inc.

2nd Quarter Commentary - 2021

Since the second half of 2020 global economies have been in reflation, that is where both growth and inflation are accelerating on a trending basis. Propelled by exuberance around reopening and mass vaccinations, the second quarter of 2021 did not disappoint. From the pandemic low in March last year, global equities have risen over 85%, making the rally one of the quickest and stronger post-recession market recoveries on record. During the 2nd quarter, the S&P 500 was up a further +7.21%; the NASDAQ +7.78%, and the S&P/TSX +6.90%.

Narratives grabbing the attention of investors included fears from slowing growth and trending inflation; Delta COVID variant and vaccine heistancy; the US Federal Reserve finally acknowledging they were caught off guard by the recent bout of inflation; the tightening labour market and the expiring government led social assistance payouts. On top of that, we continue to have ongoing discussion in Washington around 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 economic 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. At present, roughly 16 months after the pandemic began, there are still 16 million workers collecting unemployment insurance in America. For reference, at the peak of the Great Financial Crisis ("GFC"), in May of

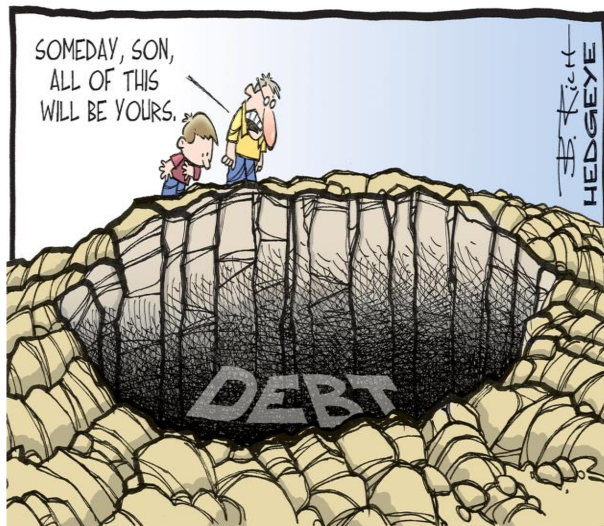
2009, there were 6.5 million workers collecting unemployment insurance. So, we are still at 2.5x the peak of the GFC in terms of the number of insured unemployed.

Canada's economic recovery had been trailing that of the USA and other advanced nations although with it's vaccine programme trending aggressively we should be in the beginning stages of positive economic growth. The near-term bullish case in Canada relies on the premise that historic monetary stimulus and fiscal support will continue to expand, and it appears 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. While this growth comes on the back of easy pandemic comparables, that acceleration is still real and buoyed by generous fiscal transfers by the Federal government. Our one concern points to Ottawa's intention for a fall election which could slow the pace of growth as policy makers focus more on retaining their jobs then on economic expansion. In terms of monetary policy, 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.

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

On the aspect on interest rates and debt levels, we are in uncharted territory. Since the GFC, America's appetite for debt has become extremely concerning, with the U.S Federal Reserve the primary buyer of Treasury issuance. The private sector and foreign governments are no longer the largest buyers especially since they are yielding below the inflation rate. Since the GFC the U.S. has grown it's Federal Debt to $28 Trillion—$7 Trillion of which (~40%) sits on the Federal Reserve's balance sheet. Meanwhile, Annual U.S. GDP has only risen by $7.4 Trillion to $22

Trillion. US Debt to GDP stood at 62% at the end of 2007. At the end of Q1 2021, it stood at 127%. That is a remarkable increase in 13 years. For further perspective, at 127% Debt to GDP the U.S. is tied for the 7th most heavily indebted country in the world. Ahead of America stand these 6 countries: Japan (237%), Venezuela (214%), Sudan (177%), Greece (174%), Lebanon (157%) and Italy (133%). In other words, the markets and government are too dependent and addicted to money printing. The longer this goes and the deeper the debt levels get, the riskier we are to the overall system becoming unhinged. We as investors must understand we are exiting every past financial crisis with more debt and less growth than the previous one.

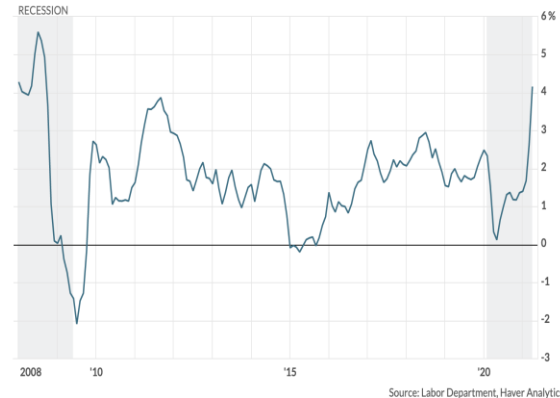


The Fed has to keep yields at politically acceptable rates and by virtue of US debt levels that means continued low rates. This means low rates can go on for longer than people think. The Federal Reserve has the means, motive and opportunity to keep them low for a long time. The Fed made clear recently that it still has no plans to raise interest rates within the next three years as the economy reopens and fiscal stimulus feeds through. 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.

On the issue of inflation investors remain divided, with the outlook for inflation falling into two schools of thought: those that believe the inflation effects are more transitory in nature, and those that see inflation rising to a point where it threatens economic stability. During June, America hit a 13 year high inflation rate. This was unexpected by policymakers and most economists. At

the June 16th Federal Reserve meeting the Fed raised its expectations for inflation considerably and also changed its language on inflation, replacing its 2% inflation target commitment with "seeking to achieve inflation that averages 2% over time." Prior to 2020 inflation prints were below 2%, now we are expecting north of 3% or even 4% which averages on or about 2%. This change is a substantial departure from the previous flexible inflation targeting method. Average inflation targeting means that policymakers would consider those deviations and allow inflation to modestly and temporarily run above target to make up for past shortfalls, or vice versa.

Some layers of the inflation are transitory (high due to the comparison being a year ago when everything was shut down) while other layers are sticky, and represent actual inflation. As we go into the 2nd half of the year and accounting for the base effect the inflation print will likely be lower than the 5% print we just witnessed but nonetheless it will be higher than we have seen for a while. The long term target for the Fed is 2% so by almost all measures inflation is running above the Fed's target. Also there are multiple factors at play that could result in a pro inflation environment. More fiscal stimulus, such as the infrastructure plan, is inflationary. And let us not ignore the higher energy prices we have been witnessing since mid 2020. Also, deglobalization is inflationary and that seems the route most countries are taking. So we should likely get used to the idea of inflationary spikes or scares without the corresponding interest rate increase to defend against. The Fed simply does not have the room to maneuver that way. So with debts levels where they are and the Fed already being the largest buyer of US Treasuries it will be extremely difficult for the Fed to normalize interest rates (raise them) without causing equity markets falling and falling significantly. We must remember that a significant fall in equity markets would then once again lead to the Fed having to further ease conditions. So we would be back to square one again. Their policy options seem limited.



Our role as portfolio managers is to determine if rising inflation is sustainable and whether capital markets are mispriced on this narrative. Inflation seems harmless when under control, however, it becomes painful and uncomfortable when unmanaged. History has consistently shown that too much inflation is detrimental to an economy. Currencies fall, consumers stockpile goods in anticipation of higher prices, consumer spending trends lower, and less consumer and business spending forces governments to run budget deficits and limit social services. Inflation may well be decelerating over the next several quarters from cycle highs, that said, it is stubbornly sticking at a much higher level than any modern-day U.S. central banker has ever had to contend with. By understanding the ins & outs of inflation and reckless monetary policies, we can better protect wealth. Therefore, we believe it remains too difficult to say exactly what will happen to inflation, although we acknowledge that the issue lies directly in the hands of central bankers, and history suggests they will be more reactive rather than proactive. Risk happens slowly at first and then all of a sudden. To protect against inflation-driven loss of purchasing power, our mandates will continue to own assets that appreciate with inflation continuing to add assets as a prudent measure to protect portfolios from the tail-risk that inflation runs out of control or the financial system becomes unhinged. These assets include gold, real estate, utilities, NASDAQ large cap equities and, select commodities. Needless to say, there is no telling what lies ahead, but the best way to take advantage of sticky elevated inflation is by owing it.

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 to ensure the sustained strength of the re-opening. 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.

People are clear with their expectations. Many expect and are hopeful to returning to pre-pandemic levels. For investors the path from here is much more challenging. The economic outlook is not necessarily the problem. The problem will be the extent of disappointments. The first half of year we had economic growth accelerating, inflation accelerating, corporate earnings growth accelerating, monetary easing, and fiscal easing. Now in the back half of the year we will likely see growth and inflation decelerating, earning disappointments, monetary policy tightening and fiscal measures disappointing. An additional risk here is what causes the Fed to pivot from its generous monetary approach and take elevated inflation more seriously. Job number surprises for July and August could be the catalyst. The August Jackson Hole Fed retreat, which has historically served as a turning point for monetary policy, could be the pivot date where they initiate less bond buying leading to yields beginning to fall and Treasuries rising. Capital markets will spasm when loose monetary policy takes place so it will be important the Fed modify its language where it indicates easy money policy is not being taken away but rather it is being dialed down. The new normal going forward could see easy money policy for some time along with the dollar falling drastically as a new era of fiscal policymaking begins. Our role as PM’s is to guage when the market begins to price all these disappointments. This process of economic transition does carry with it changes to portfolio construction. The higher probability is we see both nominal and real interest

rates drift lower during the market cycle. For one, allocation to risky assets need to be tightened and consideration be given to treasuries and gold (b/c rates falling), quality, low beta, defensives like utilities and mega cap growth. This is not a scenario of fear, it is a scenario or risk management/allocate effectively amidst the deflation move. The period of July to Sept could be a very choppy period of time. Risk happens slowly at first and then all of a sudden.

In summary, we will continue to accumulate equities only if they continue to be in our favor and we will divest from risk when we think its going against us. As we continue into the third quarter the US dollar will continue to be the key macro variable as assets are priced in dollars and its moves must be understood to allocate investment money. We have been tilting our mandate to a more defensive stance, in a calm, emotionless, data-driven manner. Cross asset volatility, collectively, currencies, fixed income, high yield, and treasuries have remained relatively benign. Equity volatility remains in bearish trend. Our current interpretation of cross asset volatility indicators and daily trading volume metrics indicate to us, for the time being, we will be active buyers of our preferred sectors on drawdowns, especially on decelerating volume. 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 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 capital, looking for opportunities in the options market, making decisions based on risk tolerance and return expectations and compounding returns on a risk adjusted basis. In the near term we have lower conviction on the strength of this market but not the direction.

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Sincerely,

The Portfolio Management Team

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