The Stan Clark Financial Team's

PERSPECTIVES

Mid-Year REVIEW

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Welcome to our 2020 mid-year review issue

Michael Chu and I have collaborated on a mid-year review of how Canadian, U.S. and international markets performed in the first half of 2020 – and what the major influences were over the last six months.

We hope you find this review both informative and useful in understanding the current economic context – and how we're keeping your portfolio firmly on course.

Enjoy your summer!

Stan

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Mid-Year Review: Uncertain time brings volatility – and surprising market strength

By Stan Clark - Senior Investment Advisor and Michael Chu - Investment Advisor

We trust you are enjoying the summer, while staying strong and safe. Being the midpoint of the year, it's also a good time to review 2020 so far – and discuss what we might expect in the future.

So much has happened already this year. We started 2020 with a presidential impeachment, then the pandemic – followed, especially in the United States, by national protests and urban riots.

The stock market experienced unprecedented volatility. Following the market's quick plunge into bear territory and ultimate low at the end of March, the second quarter of 2020 saw an exuberant rebound. Most major markets around the world ended the half still down, but much less so than after the first quarter. The World Equity Index, a gauge of stocks around the world, was down 1.5% (in C$). At home, the TSX was down 7.5%. The chart below shows the returns of major markets around the world. Note these returns are in Canadian dollars, so the effects of currency changes are included.

	Q1 2020	Q2 2020	H1 2020
Canada (S&P/TSX)	-22.9%	20.0%	-7.5%
U.S. (S&P 500)	-11.6%	14.5%	1.3%
Europe	-16.4%	9.5%	-8.4%
Japan	-11.7%	13.5%	0.2%
EAFE (Europe, Australia, Far East)	-16.5%	11.0%	-7.3%
Emerging Markets	-17.3%	14.0%	-5.7%
World	-14.5%	15.2%	-1.5%

Source: Bloomberg

Now that many governments around the world have reduced COVID-19 restrictions, investors appear to be betting heavily that economies will recover quickly from the coronavirus crisis. Their confidence has also been fuelled by low interest rates and huge monetary and fiscal stimulus.

Going forward, the economy remains murky, as is the path toward a full reopening. So far, in the tug of war between the virus, stimulus and economic fundamentals, optimism has prevailed.

From meltdown to melt-up

The last three U.S. Federal Reserve chairs (Greenspan, Bernanke and Yellen) all took action to boost stock prices when it seemed necessary to avert a meltdown. Current Chair Jerome Powell did the same in late 2018 when the Fed pivoted away from raising interest rates by lowering them three times instead. Then the S&P 500 U.S. stock index soared to a record high in February 2020.

In March, the COVID-19 outbreak was declared a global pandemic. Panic hit the stock and bond markets. Within days, the Fed cut interest rates to zero and announced a $700 billion QE4 program of buying bonds to improve credit liquidity and interest rates. But the bond market continued to worsen, threatening to freeze the economy. As a result. the Fed announced "QE4ever." This involved many of the facilities used to combat the Global Financial Crisis in 2008 and more. The Fed's bold action boosted both stock and bond prices greatly. The 33.9% meltdown in the S&P 500 lasted only 23 trading days – followed by a stock *melt-up* of 38.6% in the next few months. By the end of June, the market was only down only 8.4% (in US$).

How can the market be up during a pandemic?

We are experiencing the greatest pandemic in 100 years and the worst economic contraction since the Great Depression. Yet the stock market has had an astonishing recovery and has nearly recaptured the all-time highs. How can this be?

On one hand, investor sentiment has played a huge role in driving markets up in the last few months. The road to recovery is rarely a straight line and emotions can be fickle, so it's very possible this could reverse. On the other hand, many areas are making headway in flattening the pandemic curve and much effort is being applied to developing treatments and vaccines. And many companies have succeeded at finding creative ways to operate in these difficult conditions.

Importantly, there's a strong case that low interest rates are here to stay for quite some time. In theory, lower interest rates mean higher asset prices for a given level of earnings. These low rates could offset reduced earnings over the next few quarters/years. Now, this assumes that companies can survive, the effects of the virus don't last more than a couple years and growth rates are not materially affected after the virus shock is complete.

Anatomy of a rally

Howard Marks of Oaktree Capital recently put out a memo, "The anatomy of a rally," that sets the current stock rally in perspective. The world is enduring the greatest pandemic in a century and the worst economic contraction in 80+ years. And yet the stock market – supposedly a gauge of the current and future economic prospects – has had a record advance, nearly recapturing the all-time high previously achieved when the economy was humming along, had a rosy outlook and no pandemic.

Marks discusses the possible reasons for the recovery. He notes that the more the market recovers, the easier it is for people to rationalize an even greater recovery:

1. Investors place great confidence in the U.S. Fed and Treasury to bring about economic recovery
2. The worst fears from the pandemic weren't realized
3. Optimism is rising about vaccines and treatments
4. Investors are looking past this year's and perhaps next year's earnings and GDP dip, anticipating what should have happened in 2020
5. Everyone is anticipating low interest rates, which have a positive impact on asset prices.

But Marks also points out many negatives to consider:

1. The reopening of the economy may trigger a second wave of the disease
2. A new shutdown may be "a cure worse than the disease." Less enthusiasm for a new shutdown would put significant stress on the healthcare system
3. A vaccine won't be available as fast or effective as anticipated
4. The full impact of permanent changes to business models could negatively impact industries like physical retail, travel and office space.

There's no way to know for sure what will happen. The market seems ahead of itself, but that doesn't mean it has to go down soon. It may appear as if there is too much optimism incorporating the positives listed above, while overlooking the negatives. In conclusion, Marks thinks that the fundamental outlook on the economy is positive, but prices at current levels aren't in the investors' favour.

Taking the forward view

Investors know the challenges corporate earnings will face this year. Earnings will be down significantly from 2019. But stock markets are forward-looking. They focus on what's going to happen next.

Despite the resurgence of coronavirus cases in the U.S., the stock market applauded positive data on home sales, consumer confidence and unemployment. Just as some people are ignoring the risks of virus exposure, some investors seem to be ignoring a bad earnings quarter. Markets seem to be looking ahead one to two years, factoring in what the recovery will look like and how long will it take.

You've probably heard a lot about the shape of the economic recovery, whether it's V-shaped, U-shaped or what have you. No one knows what the recovery will be, but the support of low interest rates is most important.

Just because the market is looking forward a couple years, doesn't mean there won't be big bumps along the way. More volatility would seem likely, given the ebb and flow of the pandemic and people's emotions.

Valuations

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds
Canada (S&P/TSX)	17.7	5.7%	3.4%	0.5%
U.S. (S&P 500)	24.3	4.1%	1.8%	0.7%
Europe	15.9	6.3%	2.7%	
Japan	15.9	6.3%	2.5%	
EAFE (Europe, Australia, Far East)	15.8	6.3%	2.8%	
Emerging Markets	15.9	6.3%	3.1%	
World	20.6	4.9%	2.2%	

Source: Bloomberg

As you can see, dividends from stocks in Canada are much higher than 10-year bonds. Dividends are almost seven times higher than bonds! In the U.S., dividends are higher too, but not by as much. Historically this is a rare occurrence. So, based on this, stocks look very attractive when compared to bonds.

The earnings yield in the table uses reported earnings over the last 12 months. It's also useful to look at estimates of future (or forward) earnings. According to Standard and Poors, reported earnings are expected to drop by 35% in 2020, then fully recover in 2021, even lightly exceeding the peak in 2019.

Is there a correct valuation? We can always make comparisons to history. Looking at that, valuations today are above average. But interest rates are ultra-low, and the earnings depression should be just temporary. That doesn't mean valuations can't go higher or lower in the meantime.

According to Wharton Professor Jeremy Siegel, the average real return (above inflation) on stocks is 7% per year over the last two centuries. Going forward, because of higher valuations, Siegel expects returns to be less than the historical average. But higher valuations might be somewhat justified as it is much easier and cheaper for people to invest in stocks these days, so net returns going forward might be similar to what they were in the past. Overall, Siegel expects the average real return to be about 5.5% per year. While these expectations are lower, they are still superior to expectations for bonds. That said, even though bond rates are so low, they still have a purpose as a hedge and to offset volatility.

It all depends...

Stock market valuations don't always make sense, especially in the short term. Anything can happen. Ben Carlson of Ritholtz Wealth Management looked at the average one-year returns of the S&P 500 from various CAPE (cyclically adjusted price-to-earnings) valuation ratios going back to 1926.

S&P 500 Valuations & Returns

CAPE Ratio	1 year Avg Annual Return
Less than 10	25.3%
10 to 15	17.8%
15 to 20	7.2%
20 to 25	7.8%
Higher than 25	7.3%

Source: Robert Shiller

You would expect that if stocks are cheaper, future returns should be higher. That's consistent with the table for very low valuations. But for mid- and higher valuations, the returns were about the same regardless of valuations. Part of this is just the randomness of one-year returns.

Carlson quotes Benjamin Graham: "In the short term the stock market is a voting machine while in the long term it's a weighing machine." If you look at long-term returns, you see the weighing machine take over.

S&P 500 Valuations & Returns

CAPE Ratio	10 year Avg Annual Return
Less than 10	15.5%
10 to 15	13.9%
15 to 20	9.9%
20 to 25	6.1%
Higher than 25	4.2%

Source: Robert Shiller

Now the relationship becomes clearer. Higher valuations lead to lower long-term returns. And lower valuations lead to higher long-term returns.

Today's CAPE ratio is high, near 30 times. So, should we expect lower returns in the future? That's reasonable and makes sense to us. But remember, averages are just averages. That is, averages tend to mask the individual outcomes. For example, the height of the average Canadian male is 174cm. But there are many taller and shorter Canadian males, too. So, looking at the average is important, but it's also important to consider the range of outcomes.

S&P 500 Valuations & Returns

CAPE Ratio	10 year Avg Annual Return	High	Low
Less than 10	15.5%	21.4%	5.3%
10 to 15	13.9%	20.1%	2.7%
15 to 20	9.9%	19.5%	-0.4%
20 to 25	6.1%	13.6%	-4.2%
Higher than 25	4.2%	9.3%	-4.9%

Source: Robert Shiller

You can see that for higher CAPE ratios, returns have historically ranged from a low of -4.9% to a high of 9.3%, even though the average is 4.2%.

Then why don't we just wait for better valuations, like "less than 10"? Well, that is possible, but we could be waiting a long time. It's better to get some returns – even if they are lower – while you "wait" than nothing. In the last 30 years, valuations have only been lower than the middle group only 1.1% of the time. Most of the time, it's been on the more expensive side of valuations.

S&P 500 Valuations

CAPE Ratio	% of the time since 1990
Less than 10	0.0%
10 to 15	1.1%
15 to 20	13.9%
20 to 25	31.7%
Higher than 25	53.3%

Source: Robert Shiller

Jeremy Siegel questions CAPE as a useful prediction tool. Siegel argues that for several reasons, including accounting changes, more stock buybacks and lower costs of investing, the current CAPE ratio is distorted. He expects higher returns going forward than were produced with similar high ratios in the past. He believes that even at today's elevated levels, stocks will outperform bonds by a greater degree than they have in the past. Further, Siegel suggests that retiring investors should have a higher percentage of their portfolio in stocks than has normally been recommended.

A world with no yield

Interest rates around the world are now at record lows. Around 90% of developed countries have government bond yields at less than 1%. Almost 40% of these countries have negative interest rates. The 10-year rates in Canada and U.S. are 0.5% and 0.7%, respectively.

Why are rates so low? In a recession, central banks try their hardest to keep rates low to fund all the government spending and also to keep rates low for borrowers. No one knows when or how much rates will change. However, we do know a few things. Savers won't be as happy, but government bonds still have a place as they provide stability and guaranteed income. However, borrowers will be happy with the lower rates. Low interest rates also encourage investors to seek riskier alternatives, which may explain the continued strength in the stock market.

This may make traditional valuation tools less reliable as interest rates are so low compared to historical norms. For example, if we made comparisons to the dot-com bubble, interest rates then were in the 5-6% range: totally different from today. Not saying that valuations aren't important; they are, but they require context.

Inflation

Jeremy Siegel is not only an expert on stocks. His PhD was in economic monetary theory; an early mentor of his was Milton Friedman. Therefore, Siegel is also a savvy expert on monetary and fiscal policy.

Siegel notes that the emergency monetary policy used for the great financial crisis in 2008 did not lead to inflation, as many expected. This is because the reserves generated by the quantitative easing asset purchases went to the bank's excess reserves. The money was not lent out or circulated, so there was no post-financial-crisis inflation.

But 2020 is different. Much of the stimulus this time is being provided directly to individuals and businesses. With savings rates up due to the lockdown, and nowhere to spend money, pent-up spending demand is building. Once there is a treatment and vaccine, Siegel expects a surge in consumer spending, resulting in a moderate – but temporary – increase in inflation of 3-5% per year for next two or three years.

This is consistent with the views of top economist Ed Yardeni. Due to store closings while most people were still working, plus the government stimulus, consumers in the U.S. are overflowing with savings. The personal savings rate was previously 8.2%; it skyrocketed to 33% in April. Accordingly, the national piggybank soared from $1.4 trillion to $6.1 trillion in April. This amount of cash has helped fuel the V-shaped recovery. Yardeni observes, "When Americans are happy, they spend money. But when they are depressed, they spend even more money." Goldman Sachs estimates that consumer spending is now 90% of pre-pandemic levels, resulting in a big boost to the recovering economy.

The pandemic has also exposed vulnerabilities in global supply chains. Countries will be looking to secure their critical supply chains. That doesn't mean the end of globalization, but some areas, such as healthcare and food, will move back to local production. Higher costs may put some slight pressure on inflation.

Siegel also thinks that the 40-year bond bull market is over and that we've seen generational lows on interest rates. Given the low yields and the likely capital losses in bonds, he is bearish on longer-term bonds.

Case for a little gold?

We're not normally supporters of gold, as it produces no income and is therefore more of a speculation than an investment. Based on historical long-term returns, stocks are superior to gold. But gold can be thought of as a money alternative, with its value linked to inflation and fear.

As noted in the previous section, there is a reasonable chance that we will see a bump-up in inflation over the next two to three years. With central banks around the world now aggressively fighting deflation, they might be fine accepting a few years of inflation moderately above their 2% targets. A modest increase in inflation might cause concern about even greater inflation to come, which should help gold prices. Gold should also benefit from geopolitical conflicts, particularly those involving China and Iran. Also, political turmoil in the U.S. could cause investors to lean towards safe-haven assets like gold.

Stocks can provide good protection against moderate inflation because company earnings tend rise with inflation. We don't view physical gold as an alternative to stocks. But having some gold-producing stocks or having some physical gold as an alternative to some cash seems to make some sense.

Bigger is better in 2020

If we had one sentence to summarize the U.S. stock market so far this year it would be: *The bigger, more expensive companies are performing better than the smaller, less expensive companies*. At the end of June, the S&P 500 was down 3.1% (in US$). But does this represent the average stock? Not this year. The median stock is down about 12%. This can be explained as the largest 10 companies in the market having more than made up for the losses in the rest of the market.

So the biggest companies, which happen to be growth companies, are the most expensive but have had the best returns. The smallest companies, which have the best valuations, have had the worst returns this year.

Overall, growth stocks continue to beat value stocks in 2020. So far this year, according to the Russell indexes, growth stocks in the U.S. are up 9% while value stocks are down 17%. Historically, value stocks do better because they beat the low expectations while growth stocks often miss their lofty expectations. The extreme underperformance of value stocks since the start of 2018 has been mostly due to value stocks becoming better value, rather than due to deteriorating fundamentals. Hence, value stocks remain at very attractive levels and are poised to outperform once the sentiment eventually shifts.

Almost election time

The U.S. election grows ever nearer – now less than four months away. As yet, with so much focus on the pandemic, there has been little election discussion. COVID-19 has had an influence on politics globally, depending on how the incumbents have dealt with the virus. In the U.S., both the Republican Party and President Trump have become less popular in the polls and in the betting markets. It now seems plausible that the Democrats could win the presidency and majorities in both the Senate and House of Representatives.

Stock markets have generally preferred a pro-business, less-tax, less-regulation type of regime. A Democrat sweep could cause concerns in these regards, although less so with a moderate Democrat like Joe Biden as president. Given Biden's age, his vice-president would likely be more powerful than normal. For this reason, his upcoming VP selection will be important – and hopefully, like him, a moderate.

However, much can still happen between now and the November election. And with the controversy and delays associated with mail-in voting, it might take extra-long for the voting results to be tallied and confirmed.

Higher taxes not a certainty

Countries around the world are running huge deficits. Canada's 2020 deficit is projected to be an unprecedented $343 billion. This was significant enough for one credit agency to downgrade our credit rating from the treasured AAA to AA+. To be fair, Canada still effectively maintains its AAA status with the other two agencies. Also, many other countries have long lost their AAA status and without this becoming an issue.

Eventually we will have to pay for all this extra fiscal spending. Tax policy is always up in the air because of politics, but it would seem there's an extra risk of higher taxes because of the higher deficits. To justify higher taxes, we would need:

1. A special government stimulus program to become permanent. Current programs are designed to be temporary; the need for them would naturally shrink as the virus shock subsides.
2. There would need to be a serious will to pay down the additional debt. This is unlikely as it's not popular among governments.
3. Debt costs would have to be unmanageable. This, too, is unlikely given we are in what seems to be a structurally low-interest-rate environment around the world.
4. The economy to materially underperform for many years.

It's unusual to hike taxes while emerging from a recession. There will be enough headwinds as stimulus programs shrink, and as politicians become anxious about restoring the economy to its full capacity. Tax cuts could even be possible!

Tax hikes, therefore, aren't automatic. It's more politically palatable to reduce the debt burden by growing the tax base and keeping interest rates at or below the inflation rate. But Canada's current minority government skews to the left, so higher taxes are conceivable, though not directly related to the pandemic.

Looking ahead

Only halfway through 2020 so much has happened. As the year progresses, we should expect continued volatility and uncertainty related to COVID-19, the U.S. election, heightened global trade tensions and yet-to-be-seen surprises we will undoubtedly face. As always, it is important to ensure that money you need for your spending needs in the next few years is safe and protected from major fluctuation.

At the same time, there seems to be an increased risk of inflation and increased rates of changes in politics and business practices over the longer term. Owning a carefully selected diversified portfolio of proven businesses that can adjust to an unknowable future, protects capital and purchasing power for money you will be needing in the longer term. Along with an asset mix customized to your personal financial plan, this will help you stay resilient – and help secure your future. ■

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