The Stan Clark Financial Team's

PERSPECTIVES

Year-End REVIEW

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Welcome to our special year-end review

How were the stock markets in 2020? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2021 and beyond.

We hope you find this review informative and useful.

Enjoy!

Stan

Year-End Review: Despite the pandemic, stocks kept rising

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

Looking back at 2020, we see a year dominated by the pandemic. However, another standout is the stock market's incredible comeback following the March lows induced by COVID-19. This comeback is especially remarkable given that economies were left reeling by the severe blow of lockdowns. Meanwhile millions of people are still relying on government support to make it through this precarious period. Yet, counter-intuitively, despite restrictions and rising infections, investors have propelled the stock market to record highs.

So, while the economy may be slow and unemployment high, markets seem to be looking beyond that into what happens next. Three very positive conditions have given investors optimism going forward: positive vaccine developments; central banks vowing to maintain ultra-low interest rates; and households sitting on excess cash ready to release pent-up demand once restrictions are lifted.

While 2020 was a very volatile year, most major markets ended the year in positive territory. The World Equity Index, a gauge of stocks around the world, was up 13.5% (in C$). At home, the TSX was up 5.6%. The chart below shows the returns of markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

Valuations

Buying when stocks are most loved and highly valued can be hazardous to your wealth. For example, at the height of the dot-com boom, investors scrambled to buy tech stocks. The S&P 500 tech sector made up 24% of the market cap, but only 18% of the earnings. The forward price-to-earnings (P/E) ratio for tech companies was 48.3 before the bubble burst, resulting in significant losses for investors. To compare, today the tech sector P/E is "only" about 26, as the E in P/E is much higher than 21 years ago. Based on P/E, today's tech companies are 46% cheaper than they were when the dot-com bubble burst.

Determining whether something is over- or undervalued can be very tricky. While we can use various models and rules-of-thumb, some parts are just not that predictable. Some aspects, such as future earnings estimates, are by nature subjective. Others are relative. For example, stocks now might look expensive compared to stocks

	Q1	Q2	Q3	Q4	2020
Canada (S&P/TSX)	-22.9%	20.0%	4.7%	9.0%	5.6%
U.S. (S&P 500)	-11.6%	14.5%	6.9%	7.1%	16.0%
EAFE (Europe, Australasia, Far East)	-16.5%	11.0%	2.8%	10.9%	5.6%
Emerging Markets	-17.3%	14.0%	7.5%	14.4%	15.9%
World	-14.5%	15.2%	5.9%	8.9%	13.5%

Source: Bloomberg

CIBC Wood Gundy

in the past, but they look very cheap when compared to bonds. This is especially true in Canada. We can see this in the table below. Earnings yields and dividend yields are far higher than bond yields. This difference makes stocks look much more *undervalued relative to bonds* than at most times in the past. And remember: When you buy a 10-year bond, that interest rate is fixed for the 10-year term. With stocks, both earnings and dividends tend to grow. For example, dividends in the U.S. have been growing 6% per year since 1946.

Whatever the method, it's generally better to buy when valuations are low and sell when valuations are high. With higher prices, all else being equal, it means that returns going forward will be lower. Some experts swear by a *reversion-to-the-mean* approach to timing the market. That is, if valuations get higher than the historical mean (or average), you sell; if they get lower than the historical mean, you buy. This makes intuitive sense, but these simple models can be wrong for several reasons. First, the mean in mean reversion can change over time. Second, the models also can't predict how far things can go before they revert, and exactly when such a reversion might begin. History has shown that valuations can be stretched for a long time. As John Maynard Keynes famously remarked, "The markets can remain irrational longer than you can remain solvent." And third, future earnings can grow faster than in the past, allowing company earnings to catch up with prices. So, trying to time the market using mean reversion is not as easy as it sounds.

Stan Clark Financial Team Strategy Returns

Composite	2020 Strategy	2020 Benchmark	10 year Strategy	10 year Benchmark
Disciplined Canadian Stock	3.9%	5.6%	9.6%	5.8%
Disciplined U.S. Stock (in US$)	19.2%	18.4%	12.6%	13.9%
Disciplined World Equity	11.4%	10.3%	11.6%	9.8%
Dividend Select World Equity	11.0%	10.4%	10.5%	8.8%
Disciplined North America Equity	15.4%	12.1%		

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds
Canada	23.5	4.2%	3.0%	0.7%
U.S.	32.1	3.1%	1.5%	0.9%
EAFE (Europe, Australasia, Far East)	23.1	4.3%	2.4%	
Emerging Markets	21.7	4.6%	2.0%	
World	28.4	3.5%	1.8%	

Source: Bloomberg

Past vs. future

The earnings used in P/E ratios can be trailing or forward earnings. Trailing earnings are those over the last 12 months. Forward earnings are what analysts expect over the *next* 12 months, after considering all the factors that might affect earnings.

Corporate earnings were unusually depressed in 2020 due to the pandemic and are expected to increase by about 20% in 2021. This makes P/E ratios and earnings yields on a forward basis look much more reasonable than trailing.

We show these for Canada and the U.S. in the table below. We also included the measures for the stocks we own in our strategies. They are better value than the markets on both a trailing and forward basis. (Note the below table is operating earnings which does not include extraordinary items like write-offs. This is different from the earlier table which uses reported earnings which does include extraordinary items. Both are commonly used, but just need to make sure we are comparing apples to apples.)

	P/E ratios		Earnings Yield	
	Trailing Earnings	Forward Earnings	Trailing Earnings	Forward Earnings
S&P 500	27.5	22.7	3.6%	4.4%
U.S. Strategy	24	20.4	4.2%	4.9%
TSX	22.2	17.1	4.5%	5.8%
Candian Strategy	19.6	16.6	5.1%	6.0%

Source: Yardeni, CPMS

How did we do?

Our strategies had fairly good returns in 2020, but roughly in line with the benchmarks.

Our Canadian stock strategies (Disciplined Canadian Stock) returned 3.9%; the TSX Index was 5.6%. Our U.S. stock strategies (Disciplined U.S. Stock), returned 19.2%; the S&P 500 was 18.4% (in US$).

We also have two global portfolios made up of our multiple stock strategies. The Disciplined World Equity composite returned 11.4%, compared to a benchmark 10.3%. This portfolio is roughly 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned 11.0%, compared to a benchmark of 10.4%. This portfolio has a slightly higher weighting in Canada and dividend payers.

We also have a North American composite, which returned 15.4%, compared to the benchmark of 12.1%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are just for stocks. Clients with less than 100% in stocks will have proportionately lower returns. These returns are also before fees.

Shrugging off bad news

The stock market has shrugged off so many recent negative events. Take, for example, the blue sweep of the White House and Congress. Stocks rallied strongly against the notion of one party having monopoly power, especially the Democratic Party, which favours tax increases and more regulations. The Democrats have now prevailed, winning both the White House and majorities in Congress. This would seem to be negative for companies – yet it didn't bother the stock market. Other events such as the Capitol intrusion and massive cyberattack on U.S. assets didn't seem to matter, either. Not only that, but the market continues to chug happily along despite high stock valuations, a weak jobs report and a slow vaccination rollout.

Instead, markets focused on the likelihood that vaccines will still ultimately reopen the economy, and that necessary fiscal stimulus is more likely to be forthcoming. These factors, along with a Federal Reserve committed to aggressive quantitative easing for as long as it takes, should all help push 2021 earnings higher. Higher taxes are probably coming in the U.S., but the extent of these are not certain, nor do they appear imminent.

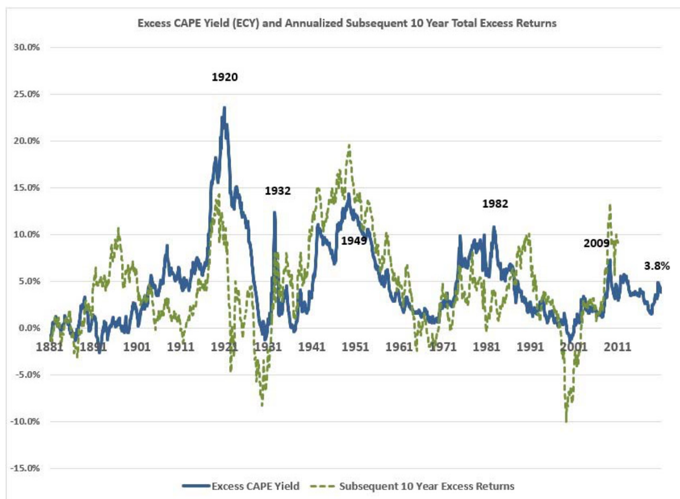
Not a bubble?

The U.S. stock market looks very expensive when compared to trailing 12 months' earnings, but does that mean it's a bubble waiting to burst? The big counter-argument is rock-bottom interest rates. While the market may be in the grips of exuberance, when compared to interest rates it's quite possibly rational exuberance as opposed to irrational exuberance.

Nobel Prize-winning economist and Yale professor Robert J. Shiller, who built a reputation by predicting the market bubbles that burst in 2000 and 2008, writes, "Many have been puzzled that the world's stock markets haven't collapsed in the face of the COVID-19 pandemic and the economic downturn it has wrought. But with interest rates low and likely to stay there, equities will continue to look attractive, particularly when compared to bonds."

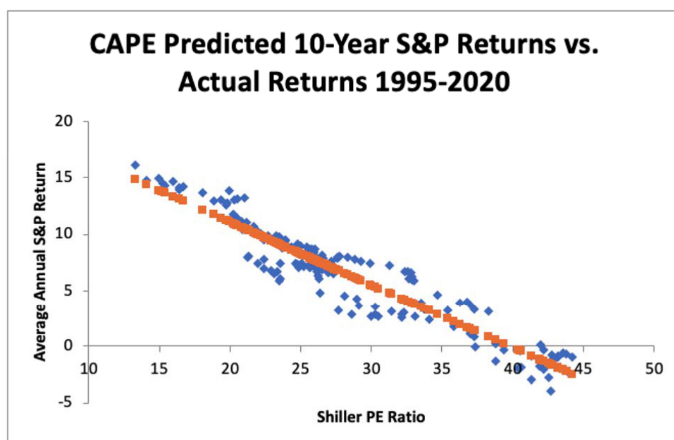
Shiller's famous CAPE (cyclically adjusted price earnings) ratio compares share prices to average inflation-adjusted earnings over the previous 10 years (to even out the effects of the economic cycle). The current CAPE ratio is around 34 times. The only time it was more expensive was near the top of the dot-com bubble. That might seem frightening – until you compare it to interest rates. At the end of 1999, 10-year bonds were yielding about 6%. That was twice as high as the 3% earnings yield on stocks. Today, 10-year bonds are yielding only around 1%. So, bonds are now yielding a third as much as stocks. Viewed this way, it makes stocks seem super cheap in comparison.

By combining CAPE and interest rates into a new factor he calls the "Excess Cape Yield," Shiller shows that this measure has done a great job of predicting subsequent returns over the next 10 years. This suggests that the U.S. market should be in line for real annual returns (i.e., returns above inflation) of about 5% per year for the next decade. If inflation is 2% per year, that would mean stocks would return 7% per year. That doesn't seem so bad. By comparison, bonds yielding 1% per year would be losing 1% per year in real terms.



Source: Robert Shiller

We've pointed out before that the original CAPE ratio on its own has done a reasonable job of predicting long-term returns. The original CAPE is predicting real returns of around 3% per year for the next decade. Combining the two theories, perhaps we should be looking at somewhere between 3% and 5% real returns for stocks, which would equate to 5% to 7% per year if we assume 2% annual inflation.



The key takeaway from the CAPE and the Excess CAPE Yield models is that U.S. stocks, while not cheap, are still very attractive when compared to the low interest rates that may be with us for a while. Down the line, interest rates may rise and equity valuations may be reset. But with high government and private debt levels in almost every corner of the world, there is a limit on how high interest rates can rise. And with the slack that exists in most economies, it will likely be some time before they do rise. So, for the time being, valuations don't look that bad. Shiller made his name by publicly denouncing the dot-com bubble and then the housing bubble, but he isn't prepared to call the current situation a bubble.

On the other hand...

On the other hand, read what Jeremy Grantham, the 82-year-old legendary market seer, has to say: "The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000." These are scary claims! Grantham defines a successful bear market call as simply that "sooner or later there will become a time when an investor is pleased to have been out of the market." His definition of success has nothing to do with precise timing. He further states that overvaluation is a necessary but not sufficient condition for a bubble-bursting, and that precisely calling a market top is all but impossible.

Grantham made a good call by exiting and re-entering the stock market around the Great Financial Crisis, but he was early in calling an exit to the dot-com boom. Grantham says that "valuations aren't the best indicator of a top, it's crazy investor behavior." And he sees a lot of that today, whether it's Bitcoin, higher volumes of small retail purchases, or special purpose acquisition companies (SPACs). SPACs own and do nothing, but hope to buy another business to skip the initial public offering (IPO) process – which kind of reminds you of companies that IPO'd without profits or even revenues in 1999. Grantham also calls out Shiller, one of the few economists he respects. He says Shiller is hedging his bets. Grantham makes the point that Shiller's revised CAPE ratio shows less overvaluation when compared to bonds:

"The one reality that you can never change is that a higher-priced asset will produce a lower return than a lower-priced asset. You can't have your cake and eat it. You can enjoy it now, or you can enjoy it steadily in the distant future, but not both – and the price we pay for having this market go higher and higher is a lower 10-year return from the peak."

Grantham's suggestion is not to avoid stocks altogether. Rather, he notes, there are cheaper stocks such as value stocks around the world, as well as emerging markets. Just avoid U.S. growth stocks, he advises.

Growth vs. value

Growth stocks have meaningfully outperformed value stocks for the last 13 years. Again, we find ourselves asking whether this is a permanent condition. According to investor and writer Howard Marks, most types of investments go through periods of outperformance and underperformance. Marks believes there are many arguments for a resurgence in value investing and also arguments for its permanent impairment. But his key point is that value investing isn't just about finding low-priced stocks. Marks says the goal is to find out what companies are worth and then buy them if they're available for less. The difference, he says, is that value investors shouldn't necessarily shy away from a higher valuation if it can be justified.

At the Stan Clark Financial Team, our stock strategies have a value bias – and they also include a growth/momentum component that has strongly helped their performance, compared to simple value investing. But they have still been negatively affected with value underperforming. We believe the strong trend against value

Even if inflation rises, we're still at very low levels, and many central bankers continue to be more worried about deflation than inflation. Indeed, the Fed has been trying hard to get inflation off the ground since the Great Financial Crisis, but it hasn't succeeded yet. Therefore, while we might be at some risk of higher inflation, it cannot be guaranteed. We believe inflation might rise modestly above the 2% targets for a period of two to three years. But given high global debt levels, we see little risk of it rising dramatically.

Looking ahead

The script for 2021 will depend a lot on the speed and success rates of the vaccination programs. This is especially important considering the increased speed with which the virus seems to spread due to mutation. If vaccination goes well, it should help economies recover after such a destructive year for workers and businesses. But a brighter economic future should still be accompanied with caution as valuations are lofty, driven by low interest rates and investor optimism. Most of the good news we've had may already be embedded in today's prices, which is a cause for concern. But low interest rates can justify valuations that otherwise would appear stretched. Remember that rates can change and so can investor emotions. Inflation is also a concern, but more likely a longer-term risk than something just around the corner.

Uncertainty and volatility will always be around. They're just part of investing. But at the Stan Clark Financial Team, our approach will remain consistent – and this includes having a financial plan with an established equity target to help us navigate the future. ■

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The Stan Clark Financial Team

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Performance results in this document are based on a composite of CIBC Wood Gundy Advisor Managed Account ("AMA") retail accounts with more than $75,000 invested in the "Disciplined Canadian Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined U.S. Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined World Equity (CAD) strategy" (created in November 2008 and includes AMA performance data from January 1, 2009, two months after the Strategy's inception in the AMA program), "Dividend Select World Equity strategy" (created in November 2010 and includes AMA performance data from January 1, 2011, two months after the Strategy's inception in the AMA program), "Disciplined North America Stock strategy" (created in November 2015 and includes AMA performance data from January 1, 2016, two months after the Strategy's inception in the AMA program).

The composite includes open fee-paying discretionary managed accounts where the Strategy has been held for at least two months, through a purchase or a switch from another investment or a different AMA strategy. Also included in the composite are closed accounts that held the Strategy, up to the last full month the Strategy was held.

Composite performance returns are geometrically linked and calculated by weighting each account's monthly performance, including changes in securities' values, and accrued income (i.e., dividends and interest), against its market value at the beginning of each month, as represented by the market value at the opening of the first business day of each month. This Strategy can be purchased either in U.S. or Canadian dollars. Unless specified otherwise, performance returns in this document are expressed in Canadian dollars and are calculated by converting U.S. dollar accounts into Canadian dollars using the month-end Bank of Canada noon rate. Performance returns are gross of AMA investment management fees, and other expenses, if any. Each individual account's performance returns will be reduced by these fees and expenses.

Individual Advisor Managed Account performance results may materially differ from those in this document due to the above and other factors such as an account's size, the length of time an AMA Strategy has been held, cash flows in and out of the individual account, trade execution timing, market conditions and movements, trading prices, foreign exchange rates, specific client constraints, and constraints against purchasing securities of related and connected issuers to CIBC Wood Gundy.

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