PRIVATE WEALTH MANAGEMENT

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MARKET UPDATE

Over the past month, we have all experienced an event that we have never experienced before - a global pandemic that not only affects all our lives personally, but also has had a big impact on financial markets (both stocks and bonds).

Everyone is having to adapt to a 'new normal' in terms of social distancing plus being very careful to minimize the chance of catching/spreading this virus. Some clients are further impacted as they may own a business that is directly affected by the shutdown, while others have family members that have lost their jobs and may need financial assistance. In addition, we have clients living in senior homes which adds risk and concern for both them and family members.

We are trying to communicate personally and via email with as many clients as we can while also spending time to understand as much as we can about Covid-19, and its economic impact. In addition, we are reviewing all our existing investments, plus looking for new opportunities.

At times like this (as we've seen in some previous downturns), some clients may feel concerned enough to consider selling some or all equities. We are also assisting other clients who wish to take advantage of lower prices - in order to try and maximize longer-term returns. We will do our best to help any client with any objective, but our preference is not selling at today's lower levels.

While we have experienced one downturn (2008 financial crisis) worse than the current one, that event (12 years ago) played out over a 6-month period. As of close of markets on March 23 2020, the extent of the drop was about two thirds of the 2008 downturn...with the same pattern repeating in that the fall in equity prices spilled over into corporate bonds, preferred shares and real estate investments trusts (REITs). What is unique to this current event was the speed of the downturn and the massive day-to-day volatility (mostly down but including some big up days). Since the lows of March 23rd, markets experienced a good rally, but we are still a fair degree away from previous highs.

Prior to this downturn, we have been commenting to clients about how we were trying to ensure portfolios had a good degree of defensiveness built into them (to withstand the inevitability of a recession at some point and/or some kind exogenous shock). Covid-19 certainly qualifies as an 'exogenous shock'. In the very low interest rate environment we were in, we did not do too much (of what we have traditionally done to dampen risk) namely decrease stocks and buy safe but low-yielding quality bonds. Instead, we made sure that our equity exposure was tilted towards larger well capitalized dividend paying companies in industries that were not too sensitive to an economic downturn, while also dialing back risk in terms of corporate bond exposure. In addition, for our discretionary accounts, we have added 'privately valued investments' which are holding up well.

Has our strategy worked? It has in various ways although if we could turn back the clock a month or so and decrease risk further, we would certainly do so. What has worked is that we have very little direct exposure to the areas most affected namely 'consumer discretionary stocks' (e.g. travel, entertainment, luxury goods, casinos, automobiles). Also, regarding our corporate fixed income investments, we believe that we dampened risk enough to say that default risk on our corporate bond and preferred shares is minimal (in terms of individual investments); and also reasonably low in terms of well diversified fixed income ETF pools we use (for exposure to below investment grade rated high yield bonds and corporate loans).

There has however been a net decline in the value of some of our bond and loan prices, which contributes a bit towards the decline in statement valuation. Going forward though, your 'yield to maturity' (as bonds and loans mature at 100 cents on the dollar) is now higher. The big increase of late in interest rates in certain areas of the corporate

bond and loan market (e.g. high yield bonds that were paying 3% above the risk-free yield last month, now pay a whopping 9% above the risk-free yield) in turn causes lower fixed income prices. We have some (but low) exposure to high yield bonds and corporate loans.

Having said above, most companies are affected to some degree by the economic shutdown and clients also own stock ETFs that give broad based exposure to stock indexes -which are trading well below previous highs.

Where do we think markets will trade from here?

There is certainly some justification for lower equity and corporate bond prices due to this severe short-term downturn - which in turn has a negative affect on corporate earnings. A short one month back, corporate earnings were predicted to increase by about 8% in 2020 (not anymore). In addition, while the massive fiscal response by governments around the world (close to 10% of GDP) is necessary, big deficit financing means governments (ie. taxpayers) incur a cost.

Everyone is wondering whether markets have sold off enough to properly discount this downturn; and will Covid-19 get a lot worse and be with us for a longer time than any of us wants to see. We believe stock prices have fallen below true value in the sense that when one owns equity in a company, one is entitled to all future earnings 'in perpetuity'. Even if average company earnings go to zero or negative for say three to six months, that does not justify companies trading for 'far less'. Having said that in the short-term, markets (ie. investors) do not like uncertainty and the length of time of this economic shutdown is not known at this point - and the strength of the economic recovery has yet to be seen. Historically, stocks (and corporate fixed income) have often fallen well below true value in situations like this; and following same, subsequent returns have generally been strong.

As this sell-off has had a lot of the same characteristics as the 2008 financial crisis, we are pleased to see the speed and magnitude of government fiscal and central bank monetary response, which is far greater and far faster- than was the case in 2008. Measures announced by the U.S. Federal Reserve (and other central banks) in terms of providing liquidity to the banking system and buying fixed income investments (not just government bonds, but also corporate bonds and mortgage backed securities) have calmed the fixed-income markets enough where we have started to see a rebound in prices.

Financial markets will continue to trade off Covid-19 information for a while yet. In order to try and make some degree of educated guess as to how long this will last, we have listened to health experts and smart people such as Bill Gates (whose charitable foundation is a major supporter of infectious disease research); and we have looked at how Covid-19 has played out thus far in China, South Korea, Taiwan, Singapore and Hong Kong – places where the virus is for the moment, under control. Perhaps we are looking at about couple of months more of significant economic shutdown followed by a partial re-opening that includes social distancing measures for a while longer. Clearly the consensus is that it is better to shut things down hard and fast for a short period of time rather that opening things up too soon.

The initial lack of a well-organized approach by Federal leadership in the United states is an additional risk and concern; but with the benefit of seeing how Covid-19 is playing out in other countries, it appears the U.S. is now belatedly moving in the right direction (at least we hope!). The stock market will no doubt fixate on what happens in the U.S. over the next while.

Market performance going forward

As always, there are various possible outcomes as to how financial markets will trade from here. The optimistic outcome is that one or more of 60 or so research projects into an anti-viral solution will work, perhaps soon. Success with one or more of these drugs (that help the body create antibodies to stop the virus from replicating) and/or discovery of an anti-inflammatory drug (that can help with lung recovery) will certainly help decrease mortality risk; and this will assist with some degree of re-opening of economies.

A vaccine appears at least a year away but it's amazing to see how fast 'possible vaccines' have been created. Firstly, the genetic code to Covid-19 was quickly made public. Then, with the with the help of an A.I. based computer system, a possible vaccine was developed by a company in the U.S. in a matter of hours...while another U.S. company took only 3 weeks. Johnson & Johnson just announced another good potential vaccine; however, doing clinical trials for any vaccine (to ensure safety) is a long process.

The pessimistic scenario is that no anti-virals are discovered soon, and economies are re-opened too quickly resulting in a resurgence of cases in Europe, North America and Asia, etc.

There is another unpredictable element though to how this market trades over the short-term, namely 'market sentiment' which has always and will always be an element to consider. Fast declining markets can create a sense of panic where waves of selling pressure forces prices lower. We experienced elements of this up to the lows of March 23rd, when lower prices then started to attract large amounts of buying. The consensus of many analysts is that we will re-test the lows of March 23rd and then form a bottom. From our experience though when industry professionals try to guesstimate the short-term, their accuracy is a coin-flip at best. Sometimes though 'bear markets' (such as we are in now) do have that type of trading pattern. If we see prices drop again from here, we are prepared to utilize a bit more of our liquid fixed income to try and take advantage of same. While we don't know the end date of Covid-19, we at least know 'there is an end date'…and markets often turn upwards 'on a dime', well before the 'all clear signal'.

What are we doing and what we are suggesting clients do:

1. For our discretionary clientele (about 85% of our practice), we have always said that if markets sell off by a wide margin (and we see above average long-term return potential as a result) we are prepared to 'step on the gas' so to speak and add equities that we see as undervalued. On March 24th, we therefore added about 2% to equity (and sold fixed income). The investment we bought was based on the TSX 60 index. We had our firm create what is called a 'structured note' which (on a 5-year basis) gives clients 235% of upside return on that index (60 of Canada's largest publicly traded companies). It also has partial 'principal protection'. In order to get these enhanced features, the 3.6% per year dividend is given up. We would only use an investment like this after a large market sell-off (where we see above average long-term upside) as we normally would not want to give up the dividend. Tax-wise, we need to buy this in registered accounts as any gain is treated as (fully taxed) interest income.

2. If markets decline further from here and therefore provide even better long-term value (and provided we get a bit better sense of the length of this economic shutdown), we are prepared to add a bit more to equities (and/or commercial real estate trusts where we have seen many trading values decline to well below net asset value).

3. As we see good long-term value at these prices, we do not suggest going to cash, and then trying to get back in before a rebound. The huge sell-off to March 23rd - and the subsequent quick rebound in prices since illustrates how difficult it is to try and time what is the most volatile markets we have ever seen. We fully understand though when some clients see accounts falling (as much as they have) call and ask the question, 'should we sell'. Our standard answer is that our process and investment philosophy is to not sell in a time like this, but we always add that markets may continue to drop in the short-term but getting back in just prior to a rebound is statistically improbable. And we might throw in the Warren Buffett saying: 'be greedy when others are fearful and be fearful when other are greedy!'

4. For clients with cash on the sidelines available for long-term investment, we are now suggesting buying mostly Canadian dollar-based stocks, real estate trusts, and high yielding preferred shares (where prices are so low that most yield 7% or more). The Canadian dollar is low enough now where we prefer to concentrate on this side of portfolios and tax-efficiency is better on Canadian dividends vs. foreign dividends.

5. Preferred shares have been our only disappointing asset class. Historically, preferred shares were very steady 'price wise' but in recent years they have been just as volatile as stocks. In future, we plan on decreasing preferreds, when they get back to any normality in pricing.

We believe that significant overall stock (and corporate bond) volatility will likely last until investors have a bit better handle on how long this shutdown will last; but as said, we are very comfortable with the longer-term value we now see in pricing. Eventually we will be past this situation where Covid-19 is factored into equity and fixed income prices as much as we see today. At some point down the road, when we come out of this, interest rates on safe bonds will still be paying next to nothing and investors will inevitably look for better yields. Today's high yields in dividend paying stocks, REITs and preferred shares will almost surely attract buying interest.

On the positive side, the world now knows better how important vaccine and anti-viral research is, along with the importance of disaster preparedness. And wouldn't it be nice if governments built inventories of life saving ventilators, gloves, masks, and I guess, toilet paper! Many new technological innovations will also come in terms of heath care, working from home, etc. This won't be the last pandemic, but surely the next one won't catch so much of the world off guard as this one has.

Our office remains open although we are not permitted to meet with clients right now personally. For annual reviews that were scheduled, we can email you the reports and we are pleased to do the review by phone if you like. Our team's efficiency and communication are a lot better in our office so for the moment we will continue to mostly work from here - although we have just started rotating a bit (in terms of home and office).

We want to thank all you amazing clients for the support you are giving us during these challenging times.

All the best!

Sincerely,

CIBC Wood Gundy

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