2020 in Review: An Unprecedented *Annus Horribilus*

Where do I begin when looking back at 2020? Clearly, we all grew weary of hearing the term "unprecedented," as it seemed each week, we would encounter something that qualified for this descriptor.

Where do we begin to discuss the events of 2020? We could spend pages recounting the many twists and turns of this surreal year. However, all of us have lived through the ups and downs of 2020 and, as many people have expressed, would like to move on to 2021 (although that has started out where 2020 left off). With this in mind, and in an effort to be brief, we thought we would just review the impact of 2020 on your financial wellbeing.

Amazingly, we are still on track!

If you had asked us in early April if we would generate a positive return in 2020, I would have said, "not a chance." To Matt and Lisa's credit, they reached out to everyone to see how they were doing and if they were concerned. The most common question on these calls was, "are we still on track?"

Despite the *unprecedented* volatility, our portfolios proved to be very resilient and behaved just like we thought they would during the crisis. In general, our portfolios had half the drawdown of the equity markets. When we did go back and check a client's portfolio against their financial plan we found out that the impact was limited. Looking forward it was very difficult to determine what the potential impact that COVID could have both economically and socially. What we did know is our portfolios were well positioned to weather the storm, and they did.

So, are you on track? Yes, you are. In fact, many of you are ahead of schedule!

Here are the numbers for 2020 ($CAD):

Cash	0.6%
Canadian Bond universe	8.68%
Preferred shares	6.16%
Canadian Equity	5.60%
Global Equity ($CAD)	14.76%
Emerging Markets ($CAD)	16.60%
Gold	22.40%

Source: CIBC Index Monthly Index File

If we looked back on 2020 and only focused on the headlines in the paper or on the evening news, you would assume that it would have been a terrible year of financial assets. *Unprecedented* declines in GDP, earnings, stock markets, interest rates, employment, combined with mounting sickness and death, global trade friction, heighted racial tensions and unseemly political discourse made for very depressing reading.

So, how is it that the markets were able to turn around and post such positive returns?

Don't Fight the Fed

In March, the bond market ground to a halt which threatened the financial system. Once again, the Federal Reserve in the U.S rode to the rescue. We watched as it not only bought government debt and mortgages but also indicated that it was prepared to buy corporate debt, which it had never done before. The Federal Reserve's balance sheet ballooned from just under $4 trillion to $7 trillion in a matter of months as it purchased all of this debt. Just for context, this expansion of the balance sheet was equal to roughly 15% of the U.S. GDP! Most importantly, it freed up the corporate bond market which allowed companies to refinance debt and liquidly to return to this most important market.

The result was the 10-year U.S. treasury went from a yield of 1.588% to a low of 0.536% in August. Lower interest rates support increased valuations for all asset classes, especially higher growth stocks like the large cap tech stocks. The price/earnings multiple has subsequently reached a multi-decade high.

Money for Nothing

As the first ever Government mandated shutdown of the economy, it was easy to find the motivation to support those workers affected by this "unprecedented" event. In a matter of months, cheques were sent out to those most affected, as well as many people that were still employed. More money was sent out to support employers to continue to pay staff and to help pay rent and other business expenses. In all, we saw fiscal stimulus that exceeded 15% of GDP in Canada and the U.S. *If you combined this fiscal stimulus with the Federal Reserve's monetary stimulus, you saw 30% of GDP injected into the economy over a matter of months. This is the greatest stimulus seen since WWII.*

So what happened to the money? <u>This was the first recession where personal income actually rose.</u> The savings rate in the U.S. jumped to 33%. Consumers paid off their credit card balances and other debts, people started buying "stuff" instead of "experiences." A new generation of retail investors were suddenly active in the market (more about this later), there were record issuances of corporate debt as companies borrowed money (just in case the lockdown persisted) and debt to GDP skyrocketed.

<u>And when I say money for nothing, I really mean it!</u> As it stands now, the real yield (interest rate less inflation expectations) is negative across the U.S. treasury market. When this relationship exists, it is financially prudent to borrow as much as you can because effectively the cost to borrow is free. It also forces investors to change their allocation as you can't generate real return in safe, secure bonds.

Earnings proved to be resilient

As I said before, in the depths of the recession and facing a "unprecedented" Q2 GDP decline of 33%, FactSet's summary of analysts suggested that earnings would decline by 22% in 2020. We are now entering earnings season for Q4 2020 and the expectation for the year is a decline of -12.8%, a significant improvement from March.

That being said, expectation for 2021 are for earnings to grow 22% to 168. This sounds impressive but when you factor in that 2018 earnings were 161 that is 4.3% earnings growth over three years. That is annual growth of 1.4% or roughly the rate of inflation. If we assume the current price of the S&P 500 reflects the 2021 expectations, we see that is has risen 55% over the past two years.

Which leads me to my next point.

Liquidity and low rates drive asset prices higher

With the money supply growing by 25%, and the velocity (how many times the dollar of money supply is circulated through the economy) of money plumbing new lows, there is a huge amount of savings in bank accounts and on company balance sheets. This is the fastest growth of money supply since WWII and is even faster than China's, for the first time ever. **Source: Doubline**

Investors, faced with negative yields on U.S. treasuries, have been forced to move out the risk curve to generate yield and capital appreciation. This tsunami of demand has forced up the value of bonds, stocks, commodities, real estate, gold, bitcoin, effectively all assets. The current Shiller CAPE Price Earnings multiple is at the second highest reading, going back to 1880. Bonds are close to the highest valuation ever, and are more richly valued, even over stocks.

A vaccine in record time

When Pfizer announced that their vaccine was 80% effective in early November, it effectively changed everyone's outlook. While the pandemic gathered speed and the election results continued to be contested, one could look to 2021 as an opportunity to return to a normal life.

After doing the heavy lifting during the pandemic, the large cap tech companies stepped back and shared the limelight with the broader market, in particular the stocks beaten down by the pandemic.

Most of the positive return for the year occurred in November and December. Rising rates also helped the preferred share market and the Canadian financials, both of whom had lagged the broader market quite badly. Energy suddenly had some activity as did the materials sector.

2020 Summary

So, what did we learn in 2020,

- Asset allocation works and makes our portfolio's resilient. Having a diversified portfolio is especially important when volatility spikes.
- Fiscal stimulus and monetary policy trumps (get it) the headlines that make us anxious every day. Liquidity drives the market so it is essential to monitor these conditions.
- Companies can pivot very quickly in times of crisis. Work-from-home and investments in technology helped blunt the impact from lockdowns.
- Trends that were in place have accelerated rapidly and will continue to so.
- The pace of things continue to speed up, or put another way, timelines compress. What used to take years, now takes months, and what used to take months, now takes weeks. We must adjust our thinking to this new timeframe.
- There are times when momentum overwhelms valuations. It is important to participate, as this condition can persist, but you must remain vigilant as eventually valuations always matters.

We look forward to widespread vaccinations leading to a return to a more normal life, a more stable administration in the U.S., and hopefully a return to a more civil society in 2021.

2021 Outlook

As we have described before, it is almost impossible to predict what will occur in 2021 and which asset will outperform. That is why we own well diversified portfolios! Here are our reflections on what might make a difference in 2021.

The 46th President

There is a lot riding on the new President. For now, the market is ignoring the potential for tax increases and is focused on the massive $1.9 trillion stimulus package and the likelihood of additional infrastructure spend. The market also appreciates a return to normalcy and a degree of predictability coming from the White House.

The massive stimulus package that seems to have fuelled the market most recently is by no means a done deal. President Biden will need his many years of experience working the aisle to try and get his bill through the Senate. He will need 60 Senators of the 100 to agree to the bill for it to pass.

If he is unable to convince the Senate to pass the larger stimulus, you could see a more sizable pullback in the market. This would also be a bad signal to investors that the ability of President Biden will be compromised going forward as the ghost of the previous President still haunts some of the Republican senators.

COVID

In the midst of a lockdown, it would be foolish to ignore the ongoing pandemic. Investors are looking through 2021 and focused on a return to growing earnings in 2022. Based on FactSet, earnings are expected to grow by over 16% in 2022. Some of this growth is already priced in stocks.

So, what could potentially throw a wrench into this optimism?

If the vaccine roll out continues to stumble and be delayed, this will affect the ability of the economy to recover and businesses to grow. It may also weigh heavily on investor confidence as they see the vaccine as a false dawn. We will continue to monitor both the roll out and investor/ business confidence.

The economic indicators have weakened as more countries impose stricter lockdown measures. It is hard to believe that in less than a year the U.S. has lost more people to COVID than G.I.'s in four years of war in WWII. It is possible that the news that comes out over the next few months will make investors question the trajectory of the recovery.

Our biggest concern is the emergence of new variants of the virus. The UK variant is much more contagious but appears to respond to the vaccines. The South African variant is similar, but they are not sure how it responds to vaccines. These variants spread through travel so expect travel restrictions to increase as well as other more testing for new variants. At the moment it appears that science has a good handle on the virus, but we must remain vigilant.

"Pays you money, takes your chances"

The COVID lockdown has created a whole new generation of investors discovering the thrill of victory and the agony of defeat when one tries to make "fast money." What is unique for this generation is the on-line and mobile trading tools and social media feedback loops that are free. But as someone said “If you don’t have to pay for a product or service, YOU are the product or service.” What never changes, regardless of the generation., is the behaviour we see around investing for new generations.

<u>“Double, double toil and trouble; fire burn and caldron bubble” Shakespeare</u>

The term “bubble” is used all-to-frequently and is often a reflection of valuation. In reality, the great bubbles, from the South Sea, the Tulip, the Tech and Housing are a behavioural phenomenon.

It is no coincidence that the “bubble” commentary is focused around the “new” economy names and industries like Electric Vehicles, Work from Home, exercise at home, crafts at home, space travel, renewable energy, artificial intelligence, Fintech, etc. These industries are at the early stages of adoption, show tremendous promise (some benefited from COVID, or at least the growth rate), and are dear to the heart of the new generation of investors. What many of them lack are profits and in some cases, revenue

What tends to motivate the actions of these “investors” is the news flow, whether it is an online chat room, company statements, or a tweet from the founder of one of biggest EV company. What we see are many examples of sudden, unexplainable jumps in stock prices. It could be a bankrupt car company, a pre-revenue EV truck company, or a moribund photographic company. Valuation is irrelevant to these investors; it is the narrative and the opportunity to make fast money.

<u>Exhibit A</u>

The most recent example was in relation to the change in the terms of service for WhatsApp. Elon Musk tweeted out that users should switch from WhatsApp to Signal. Some intrepid investors googled Signal and found a company called Signal Advance. This company has little or no revenue, no employees and was traded over the-counter at around $0.60. The day after the tweet it rose to $3.76. the next day to $7.19, and then on the Monday, after everyone knew it was the wrong company, it reached a peak of $70.85. It still trades today, 11 days after the initial purchase at $6.88.

Wow. It is clear that most of these speculators had no idea of what the company did, or what it was worth, or what the future prospects are for the company.

Greater Fool

What it the Greater Fool theory? It is a condition where someone will invest with no knowledge of the underlying company but with a belief that they will be able to sell it to somebody at a higher price. (see the Signal example above). This results in retail traders, trading against themselves hoping to out trade the other as the underlying company is worthless.

Party like it is 1999

If we were to compare the current speculative "bubble" to other periods of irrational exuberance, I feel it is most like the 2000 "bubble." There is a legitimate story to the move to EV and some of the other technological changes, but like 2000 valuations are divorced from reality.

For that reason, we will stick to tried and true companies and let others gamble on these high fliers. The one thing we learned in all the other events like these, is that eventually it all comes back to fundamentals and profits. Many of the companies from 2000 never survived but what emerged were the leaders for the next generation.

Volatility

Volatility doubled in 2020. We feel that the period of ultra low volatility that we have experienced for the last few years is over. It seems that fund flows are driven as much by news as earnings and valuation has become secondary to growth. Ultra low interest rates also don't help.

So, be prepared to accept periods where your portfolio will suddenly drop in value. Also know that we are expecting these events and are prepared to take corrective action if necessary. Our portfolio construction is robust but will endeavour to manage the volatility.

The Profits Cycle

You hear a lot of talk about value and growth. Growth has outperformed value for over ten years so, value should come back. 2020 marked the greatest outperformance of growth over value on record.

As Richard Bernstein of RBA has pointed out, it is not really growth versus value, it is where we are in the earnings cycle. It is no wonder that the consistent earnings and revenue growth of big tech has outperformed over the last few years by a significant margin because if you excluded the FANNG names, the rest of the companies where experiencing a profit decline. In these circumstances, investors are willing to pay up for growth.

When the vaccine was announced on November 9, we saw the biggest one-day reversal in fortune with growth underperforming value. In Q4, we saw value substantially outperform growth but still lagged growth by a healthy margin for the year.

So, where are we now in the profit cycle? The market believes that we are at the beginning of a new upward trajectory for profits. The jury is still out as many of the other issued we have previously outlined (stimulus, COVID) are unresolved and my result in further delay of the recovery.

That being said, when the recovery comes, it could unleash a wave of animal spirits as people begin to LIVE again.

In this scenario, the large cap tech companies represent safety, and we are well positioned in these names. Over the past few months, we have been selectively adding to more economically sensitive names with good valuations. We may need to be patient to allow these stories to play out as we expect the remainder of the winter to be fraught with risk, but we expect the arrival of spring to coincide with ramped up vaccine deployment and better, less virus friendly weather.

Our thesis right now, is that the profit cycle will turn upwards in the short to medium-term, but we will continue to monitor the current earnings season and the company guidance for indications that it might be delayed.

The Federal Reserve, interest rates, and inflation

The Federal Reserve has indicated that they are committed to keeping the short-term interest rates low for now and for the foreseeable future, even if we see a rise in inflation. There is no doubt that they want inflation as it is much easier to manage than deflation. We are already seeing rising prices across the commodity complex, but what they really want is wage inflation.

At the moment, valuation of most assets is based on the thesis that rates may rise a little but will be contained by the Fed and, inflation will also be controlled. We have seen the 10-year treasury rise from a low of 0.54% in August to 1.1% today. The thirty-year treasury has risen from 1.2% to 1.86% over the same period. According to Bloomberg, inflation expectations have risen from 1.4% in August to 2.14% today.

If the combination of new fiscal stimulus and economic recovery starts to really fuel inflation it may force the Federal Reserve to move rates up. If they don't the market may act on their behalf, primarily on the longer dates bonds where the Fed has less control.

Summary

We know that this newsletter has been longer than normal, but there was a lot to cover. In 2021, there were a lot of moving parts to consider and makes portfolio construction especially important. We continue to fine tune our systems to make us more nimble and responsive to sudden changes in the investing environment.

For the moment, we remain positive on risk assets as the continued stimulus and massive liquidity continues to support valuations. That being said, the conditions that have led to sell offs in the past continue to build.

We will continue to balance the tug-of-war between risk and reward and look forward to another fruitful year.

Regards,
CIBC Wood Gundy

Lisa Applegath
Investment Advisor, Portfolio Manager

Tom Trimble
Portfolio Manager