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COVID #5: What is next?

Summer has arrived and we are off on holidays the first two week of July, so, we thought we would send off a brief note before we left. We must admit, we are both looking forward to spending a couple of weeks at the farm, out of the trenches, to recharge our rather depleted batteries.

It has been awhile since we gave you our perspective on what is going on. So much has happened over the last few months that it is difficult to keep up. We will assume that most of you are keeping abreast of the progress against COVID-19, the dramatic events that have led to widespread protests for social justice, the increasing tension between the U.S. and China, the growing economic costs of trying to mitigate the economic shut down, and the looming election south of the border.

This newsletter will try and focus on our perspective on what is going on, how it affects our decision making, and what we see going forward.

Living with COVID-19

We are now entering the fourth month of COVID-19 in Canada and things appear to be slowly returning to something resembling "normal." We feel that many people have adapted to COVID-19 with the mindset that it will soon be over, and we will get back to our old lives very soon. While we recognize that there is a massive global effort to find a vaccine, we feel that we must accept that COVID-19 is likely to be with us for many months or possibly years. We will need to learn to live with COVID-19. So, what does that mean?

Existing Trends have Accelerated

Some trends, like working from home, adoption of cloud computing, on-line shopping, and video conferencing that were already in place have accelerated at warp speed. It will have a profound impact on many businesses both on how they deliver their products and services and how they will need to adapt to changing demand. It will also affect every place we would normally gather; work, school, leisure. Those that can look into the future and rapidly adapt will survive and thrive. Innovation will be the key and it will be through technology. Our job is to try and identify the primary trends (which we are currently well positioned) but also the secondary and tertiary trends that will emerge.

Existing Inequalities Have Been Ruthlessly Exposed

It is easy to ignore problems if it is just a few voices crying in the woods. It is impossible to ignore them when peoples' lives are at risk and/or lost. Issues with long-term care facilities, education, the health care system, food security, income inequality, social justice, poverty and housing have all been exposed through COVID-19. These issues have been building for decades, but COVID-19 may finally force governments, and hopefully the private sector, to reexamine their priorities and make meaningful change. Serious rethinks around Universal basic income, child care, education, policing, mental health, and health care will need to be done.

This Does Not Come Free

The government forced the economy closed so it was obligated to try and mitigate the damage by providing some financial support to those affected by the shutdown. The global debt that has been accumulated to fight the pandemic has been staggering, and it is far from over. This debt is not free and will likely be paid for by higher taxes and slower economic growth in the future. It may also force governments to rethink their spending priorities with a view to the future versus supporting programs that have long lost their effectiveness.

Capitalism 2.0

Could it be that the notion of maximizing shareholder value is up for a rethink? I am convinced that a company's behavior during the COVID-19 crisis will be remembered and the individuals will allocate both capital and their discretionary dollars to those company's that exhibit good behavior. Hopefully, the future will see companies balance the interests of both their shareholders and the communities they serve.

Globalization is Done

This trend had already begun with the election of Donald Trump and the rise of China. COVID-19 revealed the true character of many of the great trading nations/blocs and it became clear that it was every country for themselves. The global Humpty Dumpty won't be put together again, at least from a government perspective, for a while.

Difficult Decisions are Ahead

We now have a much better understanding of the effects of COVID-19 and who is most at risk. The economic cost of shutting down the economy has been enormous and continues to grow. We believe that policy makers will have to start making difficult choices between those at risk, the economy, and the willingness of people to undergo future shut downs. These decisions will dramatically affect many of our clients and may require a rethink of their plan for the next few years.

The Ying and the Yang

There is an old saying, "don't waste a good crisis". There is no doubt that COVID-19 has had a profound financial, emotional, mental, and physical impact on every one of us. Many of us have reflected on what is most important to us and our society. Maybe it will motive each of us to reconsider our life approach and embrace the changes we need to make. We must remain resilient during this crisis with the idea that maybe the meaningful change will occur once we are through this crisis.

Back to the Markets

The good news is that the rally in equities, and as important bonds, has moved our portfolio to within a few percentage points of where we started the year. So, what do we think of the markets now?

Pavlov's Dog

Back on April 15, we wrote about "new bull market for false dawn" and at the time we suggested that the rally to that point was more probably a false dawn. This thesis was based on the historical performance of markets after 30+% declines and the fact that we were (and still are) facing the worst economic decline in history. Clearly, we were wrong.

What we failed to appreciate was just how forceful the Federal Reserve was going to act, and just how conditioned the markets are to responding to the stimulus. The S&P 500 has roared back in record time.

So, what happened?

Many people feel like they missed this 35% rally, so we want to spend a few moments deconstructing what happened using the S&P 500. On February 19, the market closed at an all time high of 3386. On March 23, 23 trading days later, it closed at 2237 or just under -34%. The VIX (a measure of volatility) went from 13.68 on Feb. 14 to 82.69 on March 16. We were seeing daily market moves of 5% to 10%.

It should be noted that four trading days before the March 23rd low the S&P 500 was trading at 2529 and three days after March 23 it was trading at 2630 or 18% above the lows. Needless to say, that timing the bottom was impossible. This is especially true when you consider the daily volatility was the equivalent to the fall of 2008. Between March 26 and May 14, the market bounced around between 2630 and the intra day level of 2766 or roughly 5% higher. So, having missed the first 18% bounce in the three days after the low, there was no clear signal on which way the market was going to go, and the volatility remained highly elevated. In fact, on May 14th it appeared that the idea that we would test the March lows was about to unfold.

In the meantime, earnings estimates, for 2020 and 2021 continued to drop and over 30% of S&P 500 companies dropped their 2020 guidance. So, as a fundamental investor or analyst you were effectively flying blind. Oh, by the way, 40 million people in the U.S. lost their job or over 20% of workforce.

Is That a Bell We Hear Ringing?

From May 15 to June 8, the S&P 500 took off. It went from 2766 to 3232 or 16.85%. We believe the key component was the Fed chairman Powell doing his "60 Minutes" interview on May 17, and the large number of new retail investors that opened accounts and got very active following the interview. Chairman Powell effectively said that he would continue to print money and do "whatever it takes" to keep the economy afloat. He also reinforced his commitment to buy corporate credit, something no Fed has done in the past, and for many is considered illegal (taking on credit risk)

We did not watch the interview as we assumed that he would not be saying anything different that his monthly briefing and senate hearing. What we failed to grasp was the audience, which was much of middle America. We believe that his statement gave many of these investors confidence to dive in. Thus, our reference to Pavlov's dog.

So, what did we observe after this interview? We saw the absolute junk companies (as determined by their credit default swap spread) go up 160% vs the market 16% (source: Mar Group). JETS, a global ETF related to aircraft and airlines had tested its all-time low of $11.25 on May 14 (having fallen -65% since Feb. 12) only to suddenly go up to $21.94 or 95% by June 8. There is a now a famous, or infamous, quote from a "day trader" about how he showed up Warren Buffett with airlines as it had been recently announced that Berkshire at exited their airline positions with massive losses.

What is the Lesson?

This story is not over. Since June 8th, we have steadily lost ground. Currently the valuation of the markets are extremely high and the future remains a bit cloudy with recent upticks in cases. Earnings downgrades have stabilized for the moment, but this could change rapidly over the summer.

On the other hand, the old adage "don't fight the Fed" continues to have merit. While this saying has been proven out many times over the last 25 years, we have always wondered why people want to invest when the Fed feels it necessary to intervene to stabilize the economy. This is especially true this time as the scope of the intervention is unprecedented. What is Chairman Powell so worried about? In the long run, avoiding a loss of capital is far more beneficial than trying to time guess if the market will go up based on sentiment.

We think it is important to understand that we were invested in the market throughout the current cycle. Any cash that accumulated was a result of company specific decisions. If you want to avoid the downside, sometimes you miss some of the upside. Did we miss some upside? On the margin yes. Will it matter twenty years from now? We doubt it.

Our Plan

If we tried to imagine a more challenging environment for investing then we would struggle to find one that is worse than, a pandemic, massive protests against social injustice, a presidential election, trade tensions, and the worst economic collapse since the Depression (or ever).

We are **fundamentally** driven so we will make investment decisions company by company. We also need to imagine the potential impacts of the lock down on future earnings make decisions without much guidance from the companies. We have added a few small positions this month but recognize that conditions could change so may pull back our commitment.

We expect the summer to be very volatile, but we have plenty of liquidity should we get a sizable pull back. We also allocated and upgraded our bond managers so that the yield on our bonds is much improved.

So, stay safe everyone, we will be back in two weeks.

CIBC Wood Gundy
The Applegath Group

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T.A.G…On a Personal Note

Summertime and the living is easy!

From Lisa and Tom:
Lisa's new summer drink!

In summer we love our Gin and Tonic. We usually add a splash of Limeade and seasonal fruit but Wil, our son, recently introduced us to a new version:

- Add a pour of Empress 1908 gin out of Victoria (LCBO #557470). It has an unusual violet colour
- Add ice.
- Pour in your favourite tonic. Stir
- Here is the interesting part, add an orange peel. And enjoy.

Canadian Bubbly
I know it is not Christmas but there is an excellent Canadian sparkling wine made in the traditional Champagne method. I am a big fan of Canadian wine maker and this one is excellent and quite reasonable for "Champagne"

- Blue Mountain Gold Label Brut (LCBO #206326 so you can search online)

From Susy:
There is nothing I love more than seeing and tasting (…and ultimately preparing) all the wonderful seasonal fruits and vegetables. Last weekend, the family and I made a trip out to the St. Jacob's Farmers Market – how beautiful!!! We bought a few goodies and picnicked right outside the market. Simple but fun!

For something closer to home, this weekend we drove out to Robintide Farms in Vaughan for strawberry picking – the smallest, sweetest strawberries ever!!! Summer is in the air!

From Matt:
With great weather and nowhere to go I have been honing my lackluster barbeque skills. Aside from the obvious grilling foods, I've learned sweet potato and cauliflower are especially delicious. Happy to swap a few BBQ tips and recipes on our next chat

From Jenn:
My favourite TV show over the past couple weeks has been: Little Fires Everywhere and 100 Humans on Netflix. Has anyone seen either of these??? On the literature side, I can't recommend
Neil Pasricha's, *The Happiness Equation* enough. The perfect patio reading…

From one of our clients (…and feel free to share yours as well!!)
Using an online program – sponsored by ArmourAll: MyFitnessPal | MyFitnessPal.com
It's a program that helps you measure your calories and encourages you to work out daily based on your weight loss goal
He's has lost 16 lbs. in just over a month and loves it.