PRIVATE WEALTH MANAGEMENT

CIBC WOOD GUNDY

CIBC World Markets Inc.
333 Bay Street. 28th Floor.
Toronto, ON M5H 2R2

Tel: 416-594-7971
Fax: 416-594-7951
Toll Free: 1-800-263-3803

Mid-2021 Update: So Far, So Good

Summer has finally arrived, and we think many of us are preparing to take a long-awaited break. Let's keep our fingers crossed that the world will remain a calmer, more open place for the summer so we can enjoy friends and family.

So far in 2021, we pick up where we left off in 2020 so, our portfolio has benefitted from being very invested.

We thought for this newsletter that we would briefly review what has happened over the first six months of 2021, and then outline our plan for the next quarter.

So, what has been going on?

Equities: The gift that keeps on giving

Canadian equities have performed well in 2021 as the "value" trade benefits energy, materials and financials. The TSX is up around 15% driven by a significant rebound in energy. What little energy we own is mostly through pipelines as we are not convinced that the supply/demand dynamic is sustainable over the medium-term. We do have positions in some material stocks as we are more comfortable with the fundamental changes in these areas.

With the most aggressive vaccine roll out on the globe, we have seen U.S. equities be the beneficiaries. While the value-trade has been leading since last November recently we have seen a move back to the "quality" trade. While the indexes have quietly marched higher there has been a lot of churn below the surface as the growth/value tug of war continues. We have positions in both camps, and are confident in the underlying companies so are not inclined to try and chase these swings. The strength of the $CAD has been a headwind for returns from U.S. positions.

Global equities are trying to catch up to both Canada and the U.S. They do represent better value but many of the countries are still dealing with COVID related lockdowns or slow vaccine roll outs. With bond yields currently below the expected rate of inflation we have fully allocated to equities across both value and growth, but with focus on quality.

Bonds: Taking a breather as rates rise

Rising rates are not great for bonds in the short-term. This is especially true if the yield is already low as we have seen around the world. With U.S. 10-year treasury yield almost doubling between January and March, we saw bond performance suffer. For our longer duration and investment grade bond managers this represents a small loss year to date. Our more aggressive bond managers have been able to seek out a small gain.

Our overweight position in preferred shares has really paid dividends (get it!). The combination of rising five-year bond yields and shrinking supply has resulted in our preferred share ETF showing a 20% return so far this year.

Interest rates have moderated since March which is something of a mixed signal for those in the stronger GDP growth and higher inflation camp. We have seen the central bank in the U.S. begin to signal that they may start reducing their bond purchase, while in Canada our central bank has already reduced their bonds holdings by 20%. This normalization process could/should result in higher long-term rates, but we shall see over the summer if they start to move higher.

We continue to hold actively managed portfolios for our bond allocation to ensure that you have enough liquidity and to manage volatility in our portfolios.

Commodities: Ouch

We have a close friend who is in the process of rebuilding his house near our farm. He has had a couple of uncomfortable discussion with his builder about lumber prices and other construction materials. It has been a wild ride for commodities in 2020/2021. Here are few examples:

- On March 31, 2020 lumber was priced at $278.50 for 1000 board feet. On May 07, 2021, it was priced at $1670 (that is if you could find any), and it now priced at $774.
- On March 31, 2020 copper was priced at $2.23, it hit a high of $4.75 in early May and now trades at $4.25
- Corn was priced at $334 on March 31, 2020, hit a high of $732 on in early May and now trades at $562
- WTI crude hit a low of $11.57 in April 2020 and now trades at $72.66.

The list can go on across the commodity complex and has been a major contributor to the current inflation readings. It is interesting to note that the commodity pricing peaked close to when interest rates peaked, which is another indicator that the market is pricing in a potential slowdown.

Earnings: Way better than expected

It has been tough to be an analyst throughout this pandemic as trying to model a company's profitability is close to impossible. Add in unprecedented government stimulus and it makes it especially difficult. So, it should come as no surprise that company earnings in the first quarter of 2021 blew past expectations. According to FactSet, as of March 31st analysts expected 2021 S&P 500 earnings to grow by 25.6%, but as of today their expectation is for earnings to grow an astounding 35.2%.

To be fair, earnings needed to be fantastic to justify the valuation of the market and they did not disappoint. For Q2 the expectations are for an astounding 60%+ growth year over year. As the year progresses however the year over year comparisons will get increasingly difficult. In fact, the expectation for 2022 has already been lowered from 15% growth at the end of March to 11.7% today.

What will be important for the rest of year will be the guidance that companies will provide and if margins will come under pressure from input costs.

The supply chain: The end of Globalization?

I don't know if you have tried to buy a new bike, car, computer, or bar bell but you will find it to be a challenge. As Canada found out, it also helps to have a domestic vaccine manufacturing facility. With global inventories at record lows, small things like a ship getting stuck in the Suez Canal shows just how tight things have become.

What started a few years ago with trade friction has blown up into a complete rethink of the global supply chain. Companies are having to factor in the possibility that parts manufactured around the globe might not arrive "just in time" and that having suppliers closer to the final manufacturing location might make sense.

COVID also revealed just how thin the veneer of global cooperation is when it came to the production and distribution of vaccines. This has also become a bit of an issue for scares commodities like computer chips, metals, and other higher tech components. It is not a surprise that the U.S. government is trying to build domestic computer chip manufacturing capacity as they see it as a national security issue.

The transition from an integrated global supply chain won't be easy and will likely take years and initially require some expense. It may be heralded as a new dawn for local manufacturing, but it may contribute to lower employment as new factories will likely be automated. We will be watching over the next few quarters to see if the disruption has affected the margins of companies and reduced earnings. We will also be looking to see what guidance they have on the easing of supply chain retractions as this could have a profound impact on the expected economic recovery.

The economy, rates and inflation: mixed signals:

As lockdowns decline and the world opens up, we will see a sudden surge of economic activity. Consumer, flush with cheques from the government and/or savings that have built up due to a lack of discretionary spending have bought a lot of "stuff" over the past fifteen months. It is anticipated that people will start to spend money on "experiences" like travel, eating out, going to events, etc. The saving rate remains higher than normal so, it is reasonable to expect this surplus saving to be spent which is good for the economy and jobs.

With the potential growth in the economy you would expect that interest rates would likely grind higher. We have also seen evidence of labour shortages and anecdotal evidence of company's having to raise wages to attract workers. The Federal Reserve and other economists feel that these effects will be transitory, and it would appear that the bond market would agree as yields are currently below the expected inflation and have fallen steadily for about two months.

Should the Federal reserve start to reduce the $120 billion of bonds it purchases each month, or if inflation ends up persisting longer than expected, we could see the longer dated bond yield start to rise. This would be problematic for most asset prices, so we continue to monitor yields and do own some assets that benefit from rising inflation and rates.

Other: Cyber, climate, variants, crypto, Meme stocks, stimulus

We have added a category of "other" that reflects the many things we need to pay attention to in order to navigate the investment horizon.

Not long ago, we had expressed that there were really two things that concerned us, a pandemic, and a cyber-attack on critical infrastructure. It both cases the potential for a societal breakdown is real, and scary. Well we have lived through one of the two but recently we have seen ransomware attacks on gasoline pipelines, hospitals, and meat packing plants. It is clear that a few nation-states are involved in industrial espionage and disinformation campaigns, and I suspect are monitoring or participating in these cyber-attacks. We will closely monitor the ongoing evolution of these attacks.

As western Canada bakes under record heat we know that something needs to be done on the climate. We believe that COVID may be the spark that finally gets this change in full gear. We recently added an allocation to an environmental fund because, in the words of the Great One, "I want to go to where the puck is going."

Cryptocurrency, meme stocks, and speculative behaviour continues to flourish in 2021. It took a bit of breather for a few months but seems to be coming back, although with less intensity. Is there a connection between people going back to work, going out with friends and less activity? It is hard to say. We are not involved in these speculative games, but we do watch the activity in case an unwinding of the speculative froth begins to transmit to the broader markets.

Finally, you have to give it to President Biden. It looks like he will be able to bring a bipartisan infrastructure deal into effect over the summer. This will be the second large stimulus package,

only with infrastructure it is an investment instead of income support. They still need to figure out how to pay for it, but it will be good for the economy and for pay cheques.

Going Forward

Our plan has not changed much since earlier in the year.

- We are fully weighted to our equity allocation. We like the companies we own and feel they will hold up well if we have a pull back.
- We have added some economically sensitive names and have kept our large cap tech exposure.
- We have shortened the duration of our bonds and have allocated more to the economically sensitive part of the bond market. You may see more cash at periods instead of bonds.
- We have added an allocation to companies that produce “things” that help the environment.
- We bought and sold our copper exposure, and have repositioned into an inflation linked ETF.
- We continue to assess if our base case for opening up and growth will be compromised by new COVID variants, rising rates, supply chain disruption, and generally slower economic growth. If our base case changes, we will course correct to manage the risk in the portfolio.

We are hoping that the summer will be quiet as everyone on the team could use a little recharge. For the fall newsletter I plan on looking at our future themes:

- Decarbonization
- Deglobalization
- Digitization

Have a great summer.

Best Regards,
CIBC Wood Gundy

Lisa Applegath
Investment Advisor, Portfolio Manager

Tom Trimble
Portfolio Manager

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