CIBC PRIVATE WEALTH

Q3, 2021: The pause that refreshes, or a fundamental shift?

I hope that everyone enjoyed their summer. We certainly enjoyed spending time at the farm, working on our garden, cycling and golfing. We were also able to spend a couple of stretches at the family cottage, which was nice. Fall has arrived, as I write this letter so we can start to look forward to spending time with our families for the upcoming holidays.

Life was also good for our portfolios in July and August as they continued to tick higher. Then September came, and we saw a significant drawdown in the equity markets, and to a lesser extent the bond market. After ten months of steadily rising portfolio values, this negative month came as a bit of a shock for many of you. Needless to say, we have had many conversations over the last few weeks about the sudden drop in the portfolio.

While September was a bit of a surprise, it was not unusual as we should expect at least one 5% - 10% correction each year! It should also be pointed out that, according to Schwab, over 80% of the S&P 500 stocks have experienced a decline of over 10% in September. So, while the surface looked calm, there was a lot of churn happening below.

Here is a summary of things that changed over Q3 and what we are looking at for Q4:

Value in Q1, Growth for most of Q2

Value stocks performed very well in Q1 as bond yields rose on the expectation of a rapid economic recovery fueled by widespread vaccine roll outs. In Q2, this optimism was tempered by the spread of the Delta variant which looked like it would impact economic growth. We saw the bond yield for the U.S. 10-year treasury fall from 1.7% to 1.2% (-29%). We saw a dramatic shift away from the recovery stocks that are more value-oriented back to the large cap growth stocks, especially the big tech names. As we have positions in both styles, we saw continued appreciation in our portfolios until the last week of September.

This decline in bond yields also helped our bond portfolios as the spread between high-yield bonds and Government bonds hit an all-time low.

In that last week of September, the Federal Reserve indicated that they were considering the idea of reducing their monetary stimulus by reducing their bond purchases (currently at $120 billion a month) sooner that most expected. This made the 10-year yield shoot from 1.3% to 1.6% in a matter of days. This was bad for all stocks, but especially the higher valued large cap tech names.

In the final week of September, the markets gave back all that work that had been done in July and August so, we ended up with little or no gain for the quarter as both stocks and bonds lost value.

The driving force behind the equity market's performance so far has been the recovery in earnings combined with negative real yields in bonds. (current 10-year inflation expectations are 2.5% but the 10-year U.S. treasury only yields 1.6% so the real yield is -0.9%). A sudden change in either, or both, of these conditions could have a significant impact on our portfolios

What is the current investment landscape? There are number of things that we are watching at the moment:

Earnings

In Q2, we saw earnings for the S&P increase 90% (Source: Factset) over 2020. This certainly helped support the market valuation as virtually every company seemed to beat expectation. For the Q3 season the expectation is that earnings will rise 25% over 2020. Overall, expectations for 2021 are for record S&P 500 earnings with 43% growth over a suppressed 2020, but still 24% above 2019 earnings.
It should be noted that forward earnings expectations have remained relatively flat since July, which coincides with a flat market overall. We are eagerly waiting to see the Q3 earnings reports and, most importantly, the guidance the companies provide for Q4 of 2021 and fiscal 2022.

We like the companies that we currently own, but we may make changes as the quarterly earnings roll in over the next month.

Inflation and the Labour Shortage

Inflation is on everyone's radar because it can have a dramatic impact on bond yields. Currently, the trailing inflation rate, i.e., food and energy, is just under 5% which is more than double the Fed's target of 2%. The Fed insists that this inflation is transitory because of supply chain disruptions, fiscal stimulus and other issues that are often resolved over time.

The one conundrum that most economists can't explain is why so many jobs remain open despite a large number of unemployed people. In earnings calls, we often hear about the inability of companies to find employees to fill vacancies, even with offers of higher wages and signing bonuses. We are seeing the average hourly income rising faster than in years past as companies forced to raise wages. We are also beginning to see unions going on strike for higher wage and benefits as the balance of power seems to be shifting to workers over companies for the first time in many years. Unlike commodity driven inflation, wage inflation is an important indicator as it is almost impossible to roll back wage increases.

If this wage inflation persists, it will force the Fed to reduce their monetary stimulus to fight inflation which will likely lead to higher interest rates. Many investors are listening to the earnings calls for Q3 to see the impact that inflation, especially wages and labour shortages, on the future profit expectations on companies. We will also keep an eye on bond yields. If they start to creep up, we will reduce our exposure to high value tech companies and add to more cyclical companies with cheap valuations.

China

We have seen a tidal wave of reforms in China in 2021. I will not go into too much detail, but it is a concerted effort by the Chinese Communist Party to assert its supremacy in the political, economic, and societal realm, domestically and economically, and militarily on the international arena.

This is a ground shift away from being the "factory to the world" as they try and pivot from low value manufacturing to high value computing, A.I., clean technology, and space/military tech. There are several consequences to this shift. One will be a dislocation of the workforce that might create some social unrest, and the other may be a significant slowdown in their economic growth for the short to medium term.

Why is this important? China has represented 30% of global growth so if it were to slow down it would have a significant impact on growth. It is also a leading trading partner with many economies so if domestic consumption declines it will impact importers to China. Finally, and most importantly, if China moves into these new areas of the economy it will become a very powerful global competitor to companies currently working in the developed world. This state sponsored capitalism could be the model, and the pursuant Chinese technologies, that developing nations adopt versus democracy and laissez-faire capitalism.

China is a rising superpower and seems bent on usurping the U.S. as the dominant force in the world. In order to do this, they need to be able to design and manufacture

advanced chips to support A.I., and the next generations of computers. While they may be able to design the chips, there are only two manufactures capable of producing them at the moment. One is in Korea, and the other is in Taiwan. China views Taiwan as part of China and has recently been flexing their muscles both rhetorically and militarily. A potential black swan event would be if China perceives that the U.S. is not in a position to respond to a Chinese invasion of Taiwan and decides to take over the country.

We continue to not hold companies that are domiciled in China and limit our exposure to companies that rely on growth in China.

The Biden Presidency and the Threat to Democracy in the U.S.

It is my opinion that the current social/political environment in the U.S. represents the greatest threat to American democracy since the civil war. With the legitimacy of the Biden administration not being recognized by a significant number of Americans and many democratic institutions under attack it has become especially important that he be able to deliver on his legislative priorities. With a razor thin majority in the Senate and a weak majority in the House, this is no easy task.

If they are unable to pass the bipartisan infrastructure bill and/or the larger build back America bill it would be stunning defeat for a president that was elected on the basis of bringing normalcy back to the office and to work on bipartisanship. It would signal that not only can he not manage putting the two parties together to work on the common problems in the U.S. but also that he can’t even corral his own party. This would not bode well for the Democrats in the midterm elections and possibly the 2024 Presidential election.

Ove the next two months we will see what happens with the two “infrastructure” bills as well as more wrangling with the debt ceiling. The defeat of the infrastructure bill(s) would also remove a massive stimulus package for the U.S. economy just when the Fed may be about to tighten interest rates. This could have profoundly negative affect on asset values as markets digest these sudden changes in course.

We own some companies that will benefit from this large-scale infrastructure package so we will continue to monitor the progress of these bills.

Summary

It has been a good year so far which has allowed our portfolios to compound well ahead of plan for a number of years. We continue to hold well-diversified portfolios as the

layers of uncertainty build into 2022. This provides us with lots of liquidity to meet income needs and dry powder should the equity markets have a hiccup.

More recently we have been adding an inflation hedge and have allocated to alternative strategies that offer better returns than bonds, robust risk controls and added diversification.

As always, we would be happy to discuss any of the items above in further detail, plus others like crypto, the energy market, the infodemic, the parallels of today and the end of the 19th century.

Kind regards,
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