CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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# Mid-Year Update

North American financial markets have performed well during the first half of 2021. These results have come despite elevated valuations for many equities. Massive policy intervention from central banks and governments and a trend towards global economic reopening have contributed to equity price gains.

We continue to execute our strategy of owning high-quality companies at attractive valuations. After an active first quarter of 2021 (Q1), we made minimal changes to our three discretionary portfolios during the second quarter (Q2), as they have continued to perform well. Rather than discuss individual holdings, we will devote this Q2 edition of our Newsletter to factors that influence our broader strategy.

## Policy Intervention

Policy intervention has been enormous since the pandemic started. That intervention, in the form of both monetary policy (low rates) and fiscal policy (government spending), has had a major positive effect on asset prices, including equities and real estate. In the next 12-18 months, at least some of this intervention will likely end, and the world economy will have to stand on its own legs.

National economies and corporate earnings will have to be able to grow unaided. There will also likely be headwinds in the form of higher inflation and higher taxation. Policy makers are now walking a bit of a tightrope. They seem to welcome higher inflation in the short-term, but are not confessing to any long-term inflation concerns.

Slightly higher inflation may be desirable to help reduce enormous public debt burdens. On the other hand, inflation cannot run so hot that bond investors will demand significantly higher interest rates. It is hard for us to imagine Canada and the U.S. becoming fast growth economies post-pandemic, given demographic challenges and a potentially slower reopening in some areas. If reopening progresses as planned and policy intervention winds down in the next 18 months, we are likely going back to a moderate growth environment.

## Reopening Progress

Economic reopening in the United States has run ahead of countries such as Canada, Britain and Australia. It appears that travel has mostly recovered in many areas of the U.S., and many states have been fully open for months. While we are optimistic that most major economies will remain open during the fall and winter this year, there is still a possibility of regional travel restrictions and other measures if the pandemic persists.

The path forward depends in part on whether major governments decide they will have to learn to live with some level of Covid, such as most parts of the U.S., or whether they lean towards a zero-Covid strategy, such as Australia and New Zealand. We think the former is more practical and likely. It seems far too late to eradicate a virus that has impacted every corner of the globe, and that can even be contracted in some instances by vaccinated people. Canada is slowly being pulled in the same direction as the U.S.

## Corporate Earnings

Many companies in North America will report large percentage gains in year-over-year earnings. Clearly there will be some easy comparisons, given how far earnings fell during the worst of the pandemic. In most cases the percentage growth rate will not be sustainable in the coming years.

For equities to continue to appreciate rapidly, we will need a strong growth outlook for 2022. Realistically, this outlook will not be present for many companies, and they will guide for moderate growth instead. Some of the best investment opportunities, in our view, will continue to be high-quality companies that continue to benefit from economic reopening around the world, but are not trading at elevated valuations that require outsized future growth. These opportunities are becoming more difficult to find.

## Equity Valuation

Valuation matters to us. When we evaluate equities for our discretionary portfolios, we always examine business quality and the valuation we are being asked to pay. When other investors get too optimistic and are willing to pay ever-higher prices for business without much improvement in their long-term outlook, we get cautious.

While we have added numerous new holdings since mid-2020, when prices were depressed, at today's prices we have to look hard to find good value. The prevalence of high valuations does not mean that the equity markets will immediately decline, as valuations are not helpful for short-term market timing. High (or low) valuations can persist for months or years, despite good reasons for them to change. We simply want clients to understand that unless we see a very strong 2022 outlook, or we have a correction making equity prices more attractive, we currently have to carefully scrutinize the valuation of most equities before purchasing.

## Conclusion

This Q2 edition of our Newsletter has been a mid-year update regarding the big picture issues facing equity markets. Our philosophy of buying high-quality businesses trading at undervalued prices requires varying degrees of action, depending on the availability of bargains in equity markets. Prior to Q2, we were quite active buying individual companies, but at current prices, we have started to become more cautious. We will continue to look for opportunities that fit our philosophy.

As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Q2 Newsletter, and thank you for your business.

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## APPENDIX "A"

## DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.