Raymond Sawicki, MBA, CFA
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MANDEVILLE MARKET PERSPECTIVE – WINTER Q4 2020

MARKET SUMMARY

As the return of colder weather across the northern hemisphere has forced activities and people indoors, in less ventilated environments and in closer proximity to one another, a resurgent second wave of COVID-19 infections has accelerated with ferocity both here in Canada and particularly in the United States and across Europe, as well as in other global hot spots. As of early December, we have recorded over 72 million confirmed cases of COVID-19 globally and over 1.6 million deaths from the virus worldwide[1]. The ongoing trajectory projected among health experts is that the situation will continue to worsen well into the near year, before it has the hope of improving or eventually reversing course. The economic consequences of the pandemic, which has ravaged the global economy through crippling closures and mandated business shutdowns through late Q1 and Q2 of this year, again appears poised to pull a feebly recovering global economy back into the quagmire of social and economic distress.

Against this unenviable backdrop however, financial markets have been remarkably resilient. Global equities, which experienced a 20-30% drawdown in February/March have since directionally reversed, and in several cases, indices have surpassed their pre-COVID highs, riding a shot of adrenaline supplied by unprecedented monetary and fiscal stimulus. Coordinated government and central bank action, coupled with a shimmering beacon of hope – a light at the end of the tunnel in the form of effective COVID vaccines, have provided support for positive market sentiment over the past 8 months of the global equity reversal.

Through the fourth quarter of 2020 to date (to early December), Canadian equities have risen almost +9% as measured by the S&P/TSX Composite Index, bringing the year-to-date performance for the Canadian benchmark index (inclusive of the massive drawdowns of late February/March) to almost +3% for the year. Despite this seemingly respectable overall result, results by individual sector have been decidedly more mixed, with certain industries including energy, financials and real estate struggling through most of 2020. This bifurcation of "have" vs. "have-not" sector performers has been a natural consequence of how each has been individually affected by the COVID-19 environment. While most industries have experienced decidedly negative repercussions—some even decimated (i.e. travel, tourism, hospitality), other industries have benefited and even capitalized from the pandemic—among these, e-commerce, technology, and many healthcare businesses.

In the United States, the broad-based S&P 500 equity index has similarly advanced just over +9% quarter-to-date, but has increased a more impressive +13.7% since the start of the year (after also having experienced the sharp and deep drawdowns of late February/March). The more progressive and technology centric NASDAQ index has advanced a spectacular +37% since the start of the year, while the traditional, blue chip bellwether Dow Jones Industrial Average has only risen a more modest +5.4% year-to date.

The current endpoint, in any other context would be considered generally a "normal" year for equities. But 2020 has been anything but normal—an experience borne out by the equity market's varied path—largely a white knuckled ride for investors, with levels of volatility exceeding even those seen during the financial crisis of 2008, and a peak-to-trough, and return-to-peak range of returns more varied than in any other year in recent financial history.

As we prepare to enter 2021, two key financial themes rest heavily on markets and our minds; (1) the gradual return to normalcy and more prescribed economic certainty that vaccinations will provide (albeit likely well into Q2 or beyond before this becomes meaningful enough among the general population), and (2) the broader economic consequences and lasting effects of what the pandemic has brought and will continue to exact on the global economy.

[1] https://www.worldometers.info/coronavirus/

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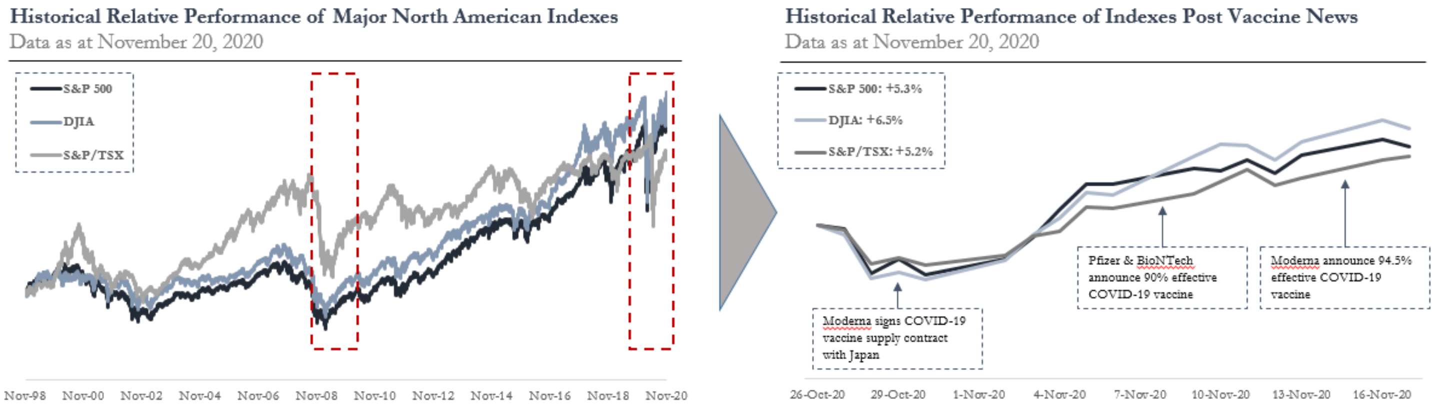
GRADUAL PATH TO ECONOMIC RECOVERY

The economy rebounded quickly after COVID shutdown measures began to ease, but the recovery has since slowed as the easiest of gains have already occurred. A sharp increase in economic activity in Q3, coupled with unprecedented liquidity backstops from global central banks has led major North American equity indices back to record highs.

Vaccine Developments a Catalyst for a Recovery in Equity Markets



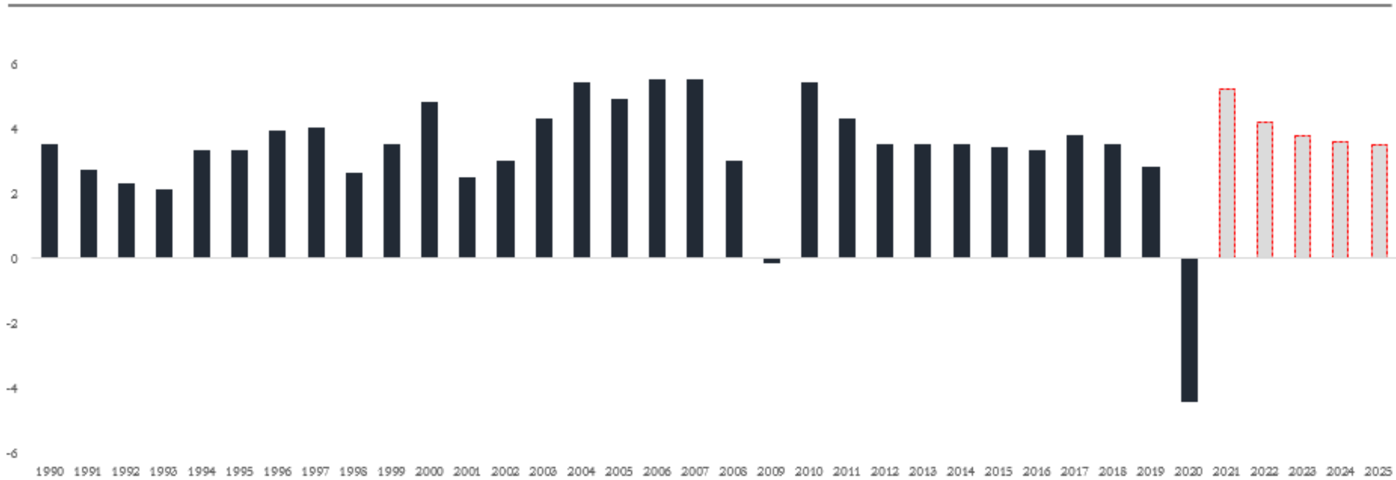
Source: Eikon

Economic activity to post sharp reversal in 2021

With the encouraging vaccine news in mind, investors are now counting on a quicker economic recovery and ultimate return to normalcy than previously expected. In the United States, real GDP increased at an annualized rate of 33.1% in Q3 and is poised to continue on an upward trajectory through 2021.

Many developed economies have reclaimed more than half of their lost output., however consensus expectations still point to global GDP growth to be weak for FY2020 given the magnitude of economic disruption through most of the year. The Organization of Economic Co-operation and Development (OECD) is forecasting a contraction in global GDP of -4.4% in 2020 before rebounding to +5.2% and +4.2% in 2021 and 2022 respectively.

Global Annual GDP Growth (%)
OECD Global GDP Forecast

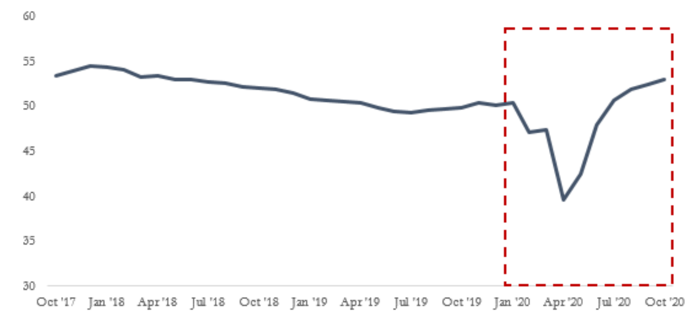


Source: OECD

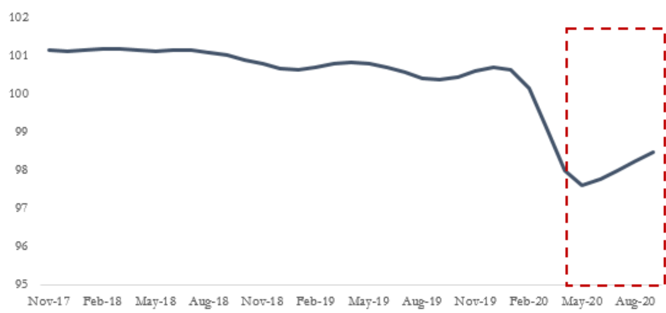
A look at both backward-looking and forward-looking economic indicators paints a more encouraging picture – economists and investors expect pent-up demand following the COVID-19 lockdowns will drive global growth higher in 2021. The backward-looking Purchasing Managers Index, a widely tracked indicator of activity in the manufacturing sector has shown resiliency throughout the pandemic and currently sits at levels last reached in 2018. In addition, the forward-looking Consumer Confidence Index, a gauge of consumer optimism/pessimism for their expected financial situation, has also shown a significant up-tick since April.

Indicators Point to Rebound in Economic Activity

Global Manufacturing PMI
Global PMI has demonstrated a V-shaped recovery throughout Q2 and Q3 2020



Global Consumer Confidence
Consumer confidence remains depressed relative to pre-COVID

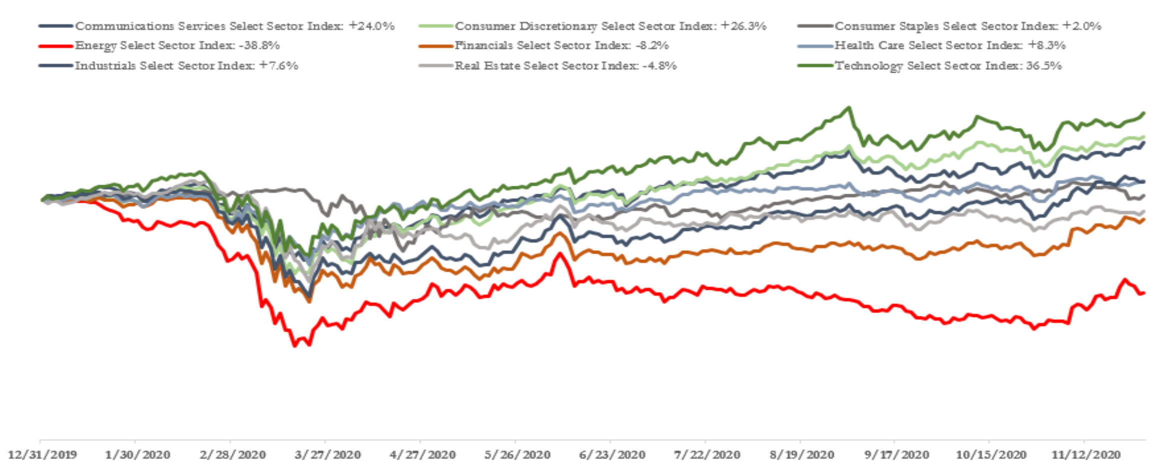


Source: Statista, OECD

Recovery expected to remain uneven across sectors and geographies

Although broader economic indicators appear to be staging a recovery, we note that recovery rates have varied widely among geographies and industry sectors. Despite the recent rally in cyclical market sectors (driven by promising developments on the COVID-19 vaccine front), the bifurcation between the "have" and "have-not" sectors that we've seen in 2020 is significant. For example, the relative difference in price performance between the Energy and Technology sectors year-to-date is roughly 75%, as the two groups returned -38.8% and +36.5% respectively (technology companies continue to reap the benefits of prolonged shelter-in-place measures, while reduced consumer and industrial activity have reduced energy sector demand).

Relative Performance of S&P Sector Indices (YTD)

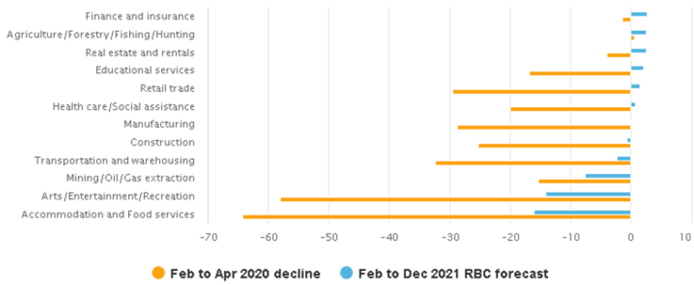


Source: Eikon

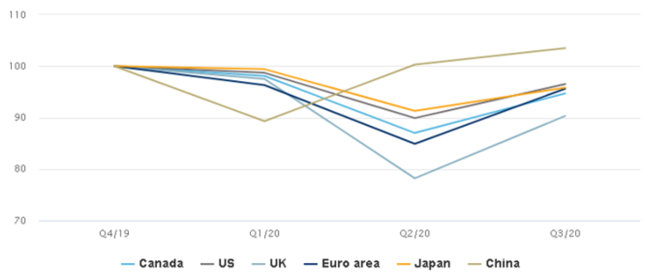
For investors, it is important to note that this bifurcation also exists significantly across geographies. Different countries have experienced widely varying levels of economic recovery, which can largely be traced back to the severity of lockdown measures imposed by their respective governments. China, for example, is leading the global recovery from a GDP perspective, almost certainly due to the stringency of lockdowns that were implemented by the Chinese Communist Party in the first quarter of 2020.

Global Recovery Varies Widely Among Sectors and Countries Across the Globe

Uneven GDP Recovery Across Sectors Globally
Percentage change in GDP by industry (%)



China Leads Global GDP Recovery
Real GDP index from Q4, 2019, indexed to 100



Source: RBC Economics

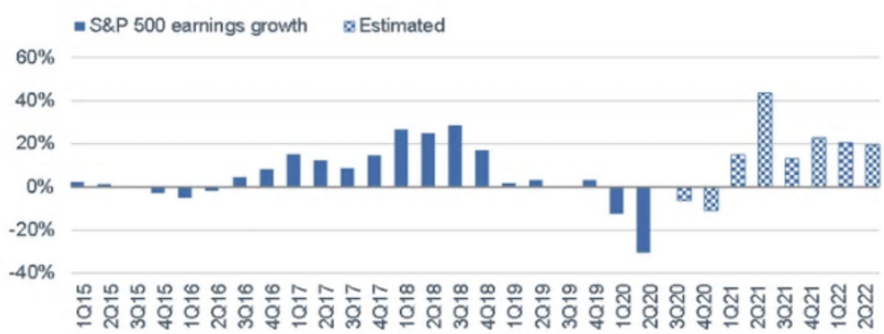
With that in mind, we expect both sectoral and geographical recovery rates will continue to be non-uniform until an effective vaccine is distributed globally.

Equities rally on expectations of 2021 earnings recovery

While uncertainty undoubtedly remains elevated, equity markets have looked beyond the 2020 corporate earnings recession and are pricing a sharp recovery for corporate profits in 2021.

Despite what appears to be a dramatic run-up in equity valuations over the past number of months, we believe that the outlook for corporate earnings in 2021 generally supports recent valuation expansion. The trajectory of analyst earnings revisions into 2021 is significant, and it is expected that earnings for the S&P 500 constituents will rise nearly 40% from Q2 2020 to Q2 2021.

Earnings to Recover in 2021



Source: Charles Schwab

An improving earnings backdrop also helps to lower the market's forward Price-to-Earnings (P/E) ratio (a widely tracked measure of corporate valuations) although this metric remains elevated at levels not experienced since the dot-com build-up of 2000. Despite the market appearing "expensive" on a P/E basis, we would argue that today's constituents of the S&P 500 are much more fundamentally sound than they were during the dotcom tech bubble of 2000. In fact, the largest stocks' forward P/E ratios in 2000 were approximately 60x, whereas today this figure is far lower at approximately 32x. While we agree that froth exists in certain areas of the market, we believe investors should find solace in the fact that underlying business fundamentals are generally stronger despite the economic headwinds of the COVID-19 environment.

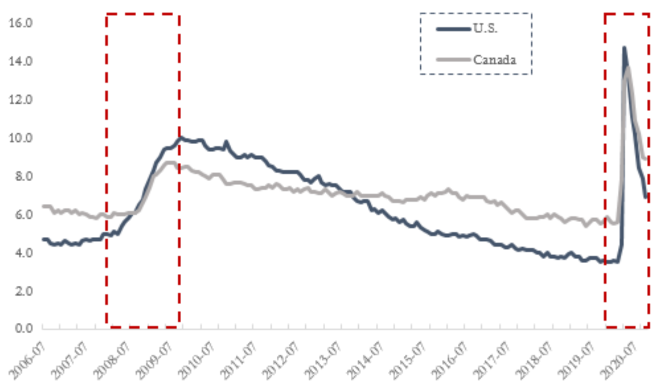
On balance, we don't believe that the current S&P 500 P/E ratio is a cause for investor concern, as the historically low interest rate environment leaves few viable alternatives for investors to allocate capital. In our opinion, the TINA effect (i.e. "there is no alternative"), should continue to support equity momentum into 2021 as investors look beyond COVID-19's near-term economic strain.

ECONOMIC SCARRING EXPECTED TO LAST

New headwinds emerge and the pace of recovery is slowing

The economy continues to face a variety of challenges on the path back to normal. Many of the industry sectors that remain depressed are likely to be structurally limited until virus worries abate. Despite significant gains from the Q2 bottom, unemployment remains elevated and those who are still jobless may have difficulty finding work until their industries return to normal operation, which could be months or possibly even years out.

Unemployment Rate – U.S. vs. Canada



Source: Bureau of Labor Statistics, Statistics Canada

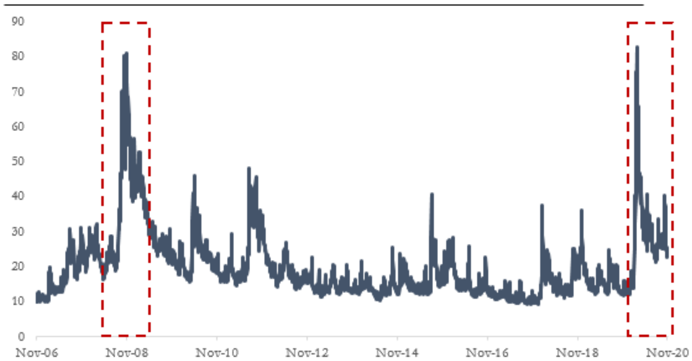
For corporations, credit problems usually occur with a lag, meaning the 2020 recession could result in increased defaults in 2021, should central banks begin to taper the current level of monetary stimulus. The latest survey of senior U.S. loan officers indicates that a moderate tightening in credit conditions is occurring and that fiscal headwinds are beginning to mount. The U.S. has already scaled back its support for the unemployed which could further limit consumer spending. And bipartisan efforts to pass a new economic stimulus package through Congress before the Christmas break and before inauguration day on January 20 appear to have reached an impasse and all but died. That said, it is unlikely these challenges will derail the economic recovery, but they do suggest that it will occur at a slower pace than what may be already priced into financial markets.

While the major North American equity indices may indicate otherwise, evidence of investor caution can be clearly seen in the elevated levels of high-yield corporate bond spreads as well as the VIX (volatility index). The VIX is a popular measure of the stock market's expectation of future price volatility and is often referred to as Wall Street "Fear Gauge". Additionally, corporate bond spreads, which have widened, are also a meaningful indicator of investors' risk appetite.

A VIX reading above 20 is generally considered high, and at the time of writing, remains above 23. Simultaneously, spreads between investment grade and high yield corporate bonds are widening. Wider spreads indicate that debt investors remain cautious, forecasting an increased level of corporate loan defaults in 2021.

Investors Still Cautious on the Timing of Global Recovery

Historical Volatility Index
VIX



Historical High-Yield Corporate Bond Spreads
Investment Grade vs. Non-Investment Grade

Source: Eikon, Federal Reserve Bank of St. Louis

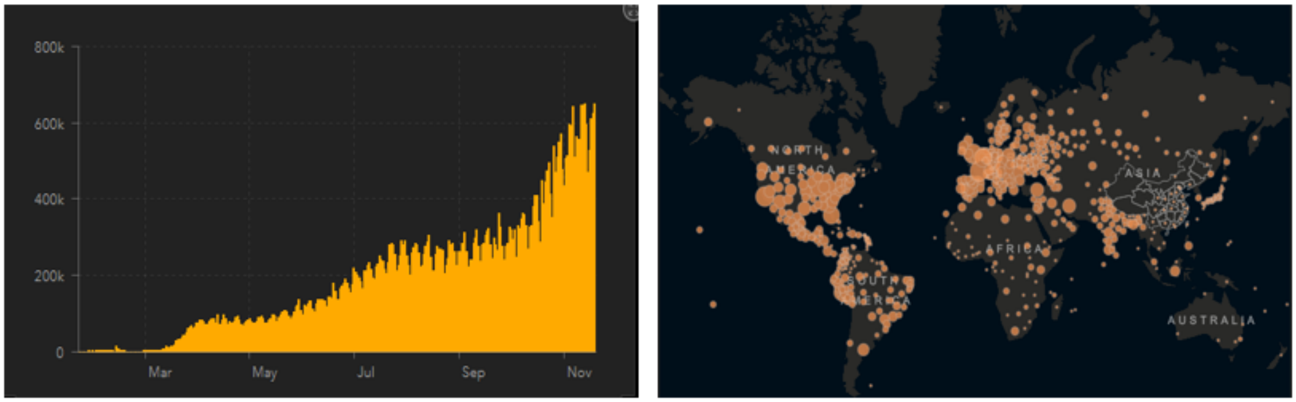
Uptick in global COVID-19 cases suggests longer path to recovery

A key reason to support heighted investor skepticism is certainly the large and quickly rising number of COVID-19 cases globally. As cases increase, many regions have reintroduced mandatory lockdown measures, thereby creating a second-wave of economic deterioration. Such measures have already been implemented widely across Europe, including in France, Germany, and the U.K.

In Canada, despite a more aggressive approach to COVID-19 protocols, new cases in certain regions have increased significantly. Ontario and B.C. in particular have seen a resurgence in cases—mandating regional lockdowns which has affected Toronto, Peel and York regions, with potentially other areas to follow.

South of the border, where COVID-19 restrictions and protocols have been more lax, new daily cases and hospitalizations have grown exponentially as American policymakers have chosen to favour social and economic flexibility over virus containment. At the time of writing, new daily cases in the U.S. have reached over 217,000, while daily hospitalizations approach 100,000.

Growth of Daily COVID-19 Cases



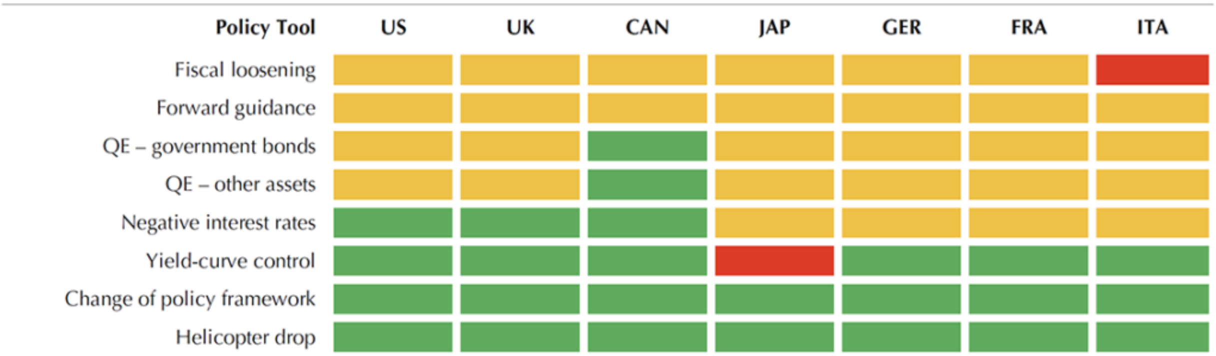
Source: John Hopkins University

Stimulus frenzy carries lasting economic implications

With financial markets having survived and generally reversed the initial shock of the pandemic (thus far) on the back of unprecedented, decisive and substantive monetary and fiscal stimulus efforts, the question remains – what policy tools are still available to effectively deal with further virus-related economic disruptions? Particularly with interest rates having already been driven down to zero or near zero, fears abound that little effective ammunition remains. However, there remain a number of options, from printing and distributing large sums of money (i.e. "helicopter drops"), to fundamental changes in central bank policy framework.

The primary constraint on any of these further monetary tactics is the discomfort with the potential adverse side effects of their long-term implementation. With prolonged exposure, equality distortions could lead to asset price bubbles, or give rise to systemic problems in parts of the financial sector. While the table below illustrates that sufficient monetary levers remain available to central banks, it more likely however that fiscal policy would be used to do the heavy lifting should further stimulus be needed, but this raises the political and economic consequences of rising government deficits and national debt levels.

Table: Heat Map of Policy Tools



Green = Not tried at all yet. Amber = Tried and could do more. Red = Tried, but now at the limit.

Source: Capital Economics

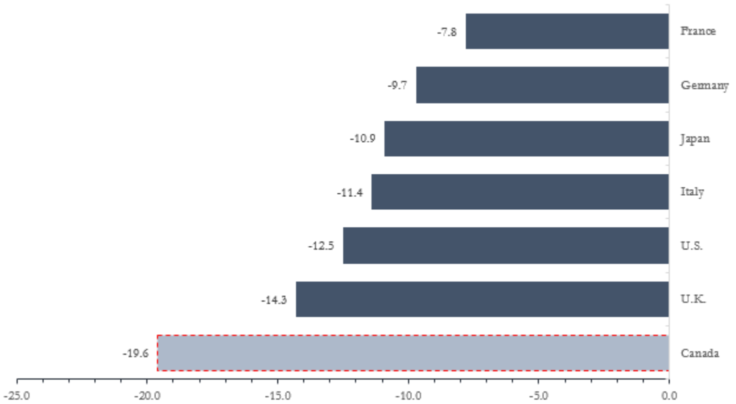
Canadian Fiscal Spending

One needn't look much further than Canada to see the effects of narrow fiscal discipline. Canada introduced an aggressive fiscal spending program in efforts to cap the country's economic fall-out from COVID-19—the country's pandemic-related spending alone has totaled roughly CAD $382 billion and accounts for almost 19% of Canada's total economic output.

Data from the International Monetary Fund (IMF) show that Canada's deficit is growing at the fastest rate among developed nations as the global pandemic continues.

As a result, Fitch Ratings, one of the three major credit agencies, downgraded Canada's "AAA" credit rating to "AA+" in June, citing a steep rise in the country's total government debt. Canada's current total Debt-to-GDP ratio of 350% is on-par with Italy's at 360%, and Greece's at 340%; coincidentally, these countries have debt ratings of BBB- and BB- respectively.

YTD Change in Net Government Borrowing as % of GDP (at Oct. 31, 2020)



Source: International Monetary Fund

Although some level of pandemic-related fiscal relief may be necessary, there is no free lunch when it comes to government spending – the burden of repaying fiscal deficits ultimately rests on the shoulders of Canadian taxpayers and businesses, the implications of which are larger national debt levels, and likely, higher future corporate and personal income tax rates.

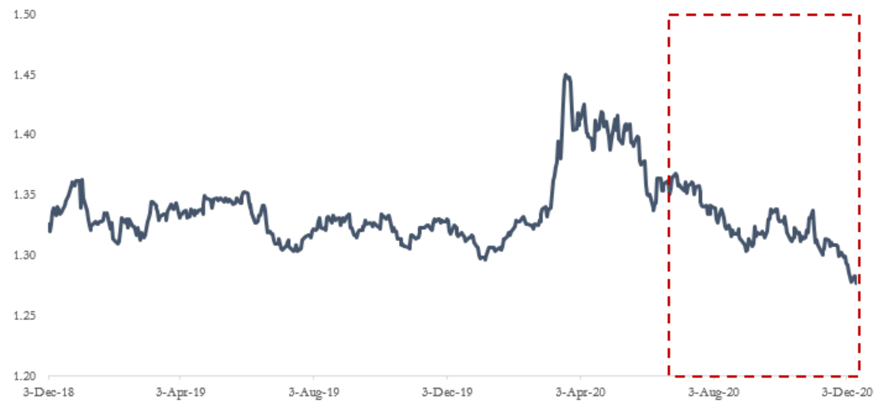
Conditions favour U.S. equities in the near-to-midterm – but USD currency weakness to persist

On March 27th, 2020, President Trump signed the largest fiscal spending bill in American history – a $2 trillion Coronavirus relief package, also known as the CARES Act. Despite these unprecedented measures, the need for another round of large-scale relief spending appears necessary. A stalemate between Republican and the Democratic lawmakers has effectively nullified the chances of President-elect Biden's preferred $1.2 trillion stimulus package from being passed, however investors are hopeful that both sides may reach an interim compromise before the New Year.

In recent weeks, President-elect Biden has also formally introduced his picks for key economic posts. The most notable was former Federal Reserve Chair Janet Yellen as Treasury Secretary Nominee. If confirmed by the Senate, Ms. Yellen would become the first woman to hold the post as the head of the U.S. Treasury. Ms. Yellen has been widely regarded as one of the more dovish Federal Reserve Chairs in recent history and will likely incorporate a similar accommodative stance in her role as Treasury Secretary – which may include implementing policies aimed at increased spending and easier access to credit. The nomination of Janet Yellen was celebrated by equity markets as investors cheer heighted levels of economic support from the U.S. government.

Since Biden was declared President-elect, the USD has fallen to its lowest level since early 2019. And Yellen's accommodative policy stance likely means continued headwinds for the U.S. dollar, as large-scale deficit spending, coupled with sustained low interest rates, are likely to weigh on the U.S. currency in the near-to-mid-term.

Historical USD/CAD Exchange Rate



Source: Eikon

ASSET MIX – INCREASING EQUITY ALLOCATION WITH BIAS TOWARD THE UNITED STATES

Monetary policy is expected to remain highly accommodative in order to support the global economy and financial markets, and price-insensitive asset purchases by central banks will likely keep bond yields from rising. In this environment, markets expect government bonds to deliver low-single-digit to slightly negative total returns. Critically, at these low yields, bonds generally offer less cushion in a balanced portfolio against any deterioration in the macroeconomic outlook.

We recognize that elevated equity-market valuations and optimistic investor sentiment leave stocks potentially vulnerable to short-term correction, and that style exposures should be managed given the massive valuation gap between growth and value stocks. However, despite these possible short-term risks, stocks offer superior return potential versus bonds, a view supported by the still significant equity-risk premium that exists in today's low-interest-rate environment. For these reasons, we are maintaining our tactical overweight to equities. And with elevated debt-to-GDP levels in Canada relative to G8 and other developed countries, Canadian equity returns likely have more significant headwinds to price appreciation and can be expected to produce lower long-term returns relative to their global and U.S. peers. As such, we will continue to tactically overweight the United States and to a lesser degree international equities.

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