First Quarter 2020

COVID-19 Attacks and the World Bolsters its Defenses

The Global COVID-19 Pandemic Causes the Fastest Bear Market (i.e. 20% Drop) in History and Pushes Governments to Initiate Wartime Spending

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Quarterly Summary and How We're Positioning for Q2

It should be noted that our Q4 2019 commentary was titled 'Government Stimulus to the Rescue!' alluding to the massive budget deficits governments ran in 2018 and 2019 to stave off recession. Please keep this in mind while reading the following.

In the first quarter of 2020, governments around the world have approved and started deploy over US$12 trillion in stimulus – ~US$7 trillion monetary and ~US$5 trillion fiscal. Monetary stimulus is when central banks buy securities to boost asset prices and stabilize financial markets while fiscal stimulus is when governments issue bonds and give money to businesses and households to support overall demand. In addition to this US$12 trillion in stimulus is 65 interest rate cuts around the world, which also act as stimulus. For reference, global GDP in 2019 was approximately $86 trillion so this stimulus represents nearly 14% of global GDP.

While in Q4 we mused about how economic growth in 2018 and 2019 was unsustainable as much of this growth was the direct result of historically unprecedented government budget deficits, governments now have to maintain those massive budget deficits plus add another layer of budget deficits to keep the economy afloat. How much is ultimately necessary to keep the economy going is a work-in-progress. US policymakers are already discussing the potential for another $2 trillion for infrastructure spending in the coming months. Investors have begun to show a lack of confidence in some governments' ability to service these debts, as seen in rising interest rates. While government finances are an important story, it is likely a story for another day, similar to how the 2011 European sovereign debt crisis shortly followed the 2008 global financial crisis.

COVID-19

Let's delve into why governments have deployed unprecedented quantities of economic stimulus. The world has stopped. You know that, we know that, my cat knows that (I'm encroaching on her "me-ow time" as I type). We won't get into the specific and rapidly changing COVID-19 statistics here but instead will explore what COVID-19 means for the economy.

Throughout March, governments around the world have gone from intentionally limiting travel between countries, to limiting movement within countries, to issuing stay-at-home orders, all in an effort to limit the spread of the highly contagious and potentially fatal COVID-19. The result of all this limitation of movement and confinement to our homes is that many individuals earn less income and spend less. Even those that are able to maintain their income have few places to spend that income – cinemas, restaurants and venues are closed for business. In addition to the harms at the household level, any business that is closed, faces an unprecedented cash crunch as revenue stops, yet overhead remains. Smaller tenants may be able to negotiate rent deferrals with some landlords, but in the end, someone loses. Further, employers face unprecedented legal issues, as many have "temporarily laid off" employees to avoid business closure but "temporary layoffs" are not something that is defensible in employment law. Famed Toronto employment lawyer Howard Levitt outlined how this could raise the cost of re-opening a business and therefore result in the closure of some businesses. Feel free to look deeper into this issue using the link below.

https://business.financialpost.com/executive/careers/howard-levitt-can-i-refuse-to-go-to-work-because-of-covid-19-concerns-will-i-be-paid

Stimulus will certainly soothe some of the economic pains experienced by some businesses and households during and after the COVID-19 outbreak, but like any stimulus program, many will slip

through the cracks and are the ones that result in a rising unemployment rate, GDP decline and recession. Some northern European nations have opted for payroll guarantees of 75%-90% for three months in addition to covering some overhead costs like rent in order to prevent mass layoffs. While these policies do not mean these economies will avoid economic contraction, it does remove a lot of economic friction between employer and employee. Canada attempted to mimic the European strategy, but so far, it appears to have fallen short, if unemployment rolls are any indication. Many Canadian households and businesses will face financial insecurity in the coming months and are in the legal "temporary unemployment" conundrum described above. The US is not providing these types of guarantees to businesses and is fully exposing its economy to the legal uncertainty and lack of business and household confidence that often coincides with economic recessions.

This exposure to uncertainty in North America, and various other places, drives us to conclude that this is likely the beginning of a long period of subpar economic growth.

Three other concerns related to the COVID-19 outbreak solidify this conclusion.

1) There are hundreds of hotspots around the world, all at different stages of the infection curve, so concerns will linger about reimporting the virus and the prospect of rolling quarantines. Consumers and businesses will remain mindful of social distancing and be cautious about spending for an extended period of time, irrespective of how quickly we get "back to normal".

2) A solution to COVID-19 appears to be well into the future. A treatment has yet to be identified, though some antibody related treatments look promising. There is optimism that using antibodies to prevent individuals from contracting the disease could be effective as well. A traditional vaccine appears to be a year or two away. With some luck, we may find a solution to the problem in the next few months but it will take time to produce, distribute and administer whatever that solution may be.

3) The US$12 trillion in fiscal and monetary support for financial markets and the economy is designed to help the largest and least risky businesses avoid financial hardship. Most recessions are caused by a culling of the weak, not the strong. Nothing is currently in place to prevent a natural recessionary culling of small businesses and higher risk corporations and the rising unemployment that brings. Debt levels for higher risk corporations were already at pre-recessionary levels so a trigger like COVID-19 is likely only the start of this process.

There is already a broad consensus that the global economy will suffer a significant decline in GDP resulting from COVID-19 related shutdowns. Goldman Sachs is now estimating that US GDP will decline by 9% annualized in Q1 and 34% annualized in Q2. Others are forecasting similarly deep economic decline for these two quarters. The consensus is that the economy will rebound strongly in the second half of 2020 and thereafter. We are less concerned about trying to gauge just how bad Q1 and Q2 will be and have greater concern that the consensus is far too optimistic about economic rebound in Q3 and beyond. If we do face a natural recession, wherein higher risk corporations and small businesses fail over a one or two year period, how can the economy be rebounding strongly? Further, if consumers are still concerned about contracting the virus, will the hospitality and travel industries recover to 2019 levels soon? We are skeptical.

Saudi-Russia Relations and Oil Prices

Shortly before COVID-19 went full pandemic, Saudi Arabia and Russia could not agree to keep the 2016 OPEC+ supply agreement in place and instead vowed to maximize oil production. If this comes to fruition it would result in an additional ~4 million barrels per day in oil production at a time when the oil market is already oversupplied. Now that COVID-19 has pushed governments to curtail economic activity, the oil market is that much more oversupplied. As a result, benchmark oil prices fell below US$20/bbl in Q1, their lowest in eighteen years. Western Canadian Select (WCS), the benchmark for Canadian heavy crude, fell below US$4/bbl, reflecting extreme oil oversupply and limited Canadian pipeline capacity. Some oil analysts, including Raymond James analyst Chris Cox, predict that the WCS oil price will actually go negative, as Canadian producers will opt to sell their oil almost at any price.

If the significant oil oversupply exists for an extended period of time, it is likely that many smaller Canadian oil producers will have difficulty surviving in their current form. There is little that the Alberta or federal government can do for companies that produce a wholly uneconomic product.

Positioning Before COVID-19 and Now

Following the inversion of the US yield curve in early 2019, we started preparing portfolios for a recessionary market environment. This meant reducing exposure to the financial sector, which tends to do poorly following a US yield curve inversion, and boosting exposure to value, quality and low volatility stocks which tend to outperform during recessions. Where appropriate, we also added some high quality fixed income securities to provide ballast to equity allocations.

Due to the speed of the equity market decline, our favoured traditional recession indicator, *US Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices*, was not effective this time around. As a result, we were unable to go forward with our final, preemptive de-risking leading up to recession. That said, we had conviction that a recession was underway early in the selloff and we were able to sell several stocks at inflated prices that are expected to do poorly in recession including Sleep Country Canada (ZZZ), CVS Health (CVS) and Enbridge (ENB). We also sold our position in Fortis (FTS) due to its high relative valuation following the market decline as well as the risk to its future earnings due to its above average exposure to Alberta.

As of March 31, North American equity markets are down ~30% from their highs. We believe most of the equity market damage is done but that there is still potential for equity markets to fall further if economic activity remains curtailed, either by government mandates or lack of consumer and business confidence. The vast majority of portfolios are already in defense mode and should perform relatively well going forward. The key going forward will be to identify and sell securities that are overpriced relative to their future opportunities, like Fortis (FTS), and identify and buy securities that have been sold excessively regardless of their future opportunities. There is currently plenty of value in Canadian preferred shares, real estate investment trusts (REITs), US large cap cyclical and industrial companies and some small- and mid-cap growth-oriented health care and technology stocks. These are the areas we will likely be adding to over the next few months.

Sincerely,

Steele Wealth Management

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