Second Quarter 2020

Stimulus Saves the Markets but Has It Saved The Economy?

Unprecedented Stimulus Unleashed in Response to an Unprecedented Viral Outbreak, Causing an Unprecedented Market Rally and Unprecedented Stock Prices

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Quarterly Summary and How We're Positioning for Q3

Using the word unprecedented four times in our subheading pretty much sums it up. Throughout history, there have not been many opportunities to make people sick of the word unprecedented. I guess you could call such an opportunity unprecedented too! We'll try to not use the word again for the remainder of this commentary but believe us, great effort will be required.

In last quarter's commentary, we noted that governments were set to deploy over US$12 trillion in stimulus as of March 31, 2020. The total stimulus number is now almost unquantifiable as stimulus grows day after day to keep the economy afloat, and is now all mixed up with unsustainable state/provincial and municipal spending necessary to fight localized COVID-19 outbreaks. Estimates show cumulative global stimulus at US$20 trillion as of the end of April and US$40+ trillion by 2023. These numbers are mind-melting and represent ~23% and 46%+ of global GDP.

The consequences of such extreme stimulus are completely unknown and will likely not be minor. Unless we collectively try debt monetization (i.e. cancellation) which has unknown and probably major negative consequences, tax rates will need to rise substantially to offset current deficits and make current government debt levels sustainable. For example, a May 26 research paper from the Fraser Institute indicated that the Canadian federal government would need to raise HST from 5% to 9% to erase just the federal budget deficit going forward; that would be a permanent 4% increase in the price of nearly everything just to prevent federal debt levels from going ever higher. This example is a bit daunting when almost every level of government around the world – municipal, provincial, federal – is in a similar position with respect to budget deficits.

It is also important to note that most nations have limited ability to raise debt capital in global markets. Emerging and frontier markets are the drivers of global growth so their economic health and ability to grow their economies are vital to all. If these nations rack up unsustainable budget deficits and they are not able to finance these deficits in global markets, they may instead need to undertake extreme austerity measures or potentially face drastically devalued currencies that will hurt them either way. This spells a major economic and political crisis in the months and years ahead but we'll leave that discussion for later as it unfolds.

The Virus

Many countries and regions around the world have had success in containing the virus and are well on the way to returning to business as usual, both socially and economically. On the other hand, there are still many localized hotspots around the globe. As of the end of June, new confirmed daily COVID-19 cases worldwide are at an all-time high, driven by rampant outbreaks in Brazil, India, Russia and Mexico and new outbreaks in many US states. Localized outbreaks are also beginning to occur in China and South Korea where the virus had previously been contained.

One thing is clear, as we open our economies and attempt to normalize: COVID-19 infection rates are expected to rise, and this poses an ongoing risk to those vulnerable individuals in our communities. Policymakers around the world appear to be willing to allow a certain level of infection in their communities but it is likely that new lockdowns and restrictions will be

implemented in areas where hospitals become overwhelmed with new COVID-19 patients. No region wants their health workers to have to make the tough life and death decisions that were required in Wuhan, Italy and New York City earlier in the year.

From an economic point of view, the high probability of rolling lockdowns and mobility restrictions points to a “U- or W-shaped” economic recovery. It will be nearly impossible to return to the level of economic activity reached in 2019 when government policy prevents the status quo, and consumer and business confidence are hindered by a weak and uncertain economic outlook.

This brings us to the hopeful anticipation of a COVID-19 vaccine. It sounds good. Sign me up for a vaccine tomorrow if possible. But never has a vaccine for any coronavirus been developed, even for the much deadlier SARS and MERS which have always been good candidates for vaccine development. The timeline for a COVID-19 vaccine could possibly be a year or two but it could also possibly be several years or never. While we are not keen to make any predictions here, we are skeptical that a vaccine will be developed in 12-18 months, which would be one of the shortest timeframes for vaccine development ever.

So if near-term vaccine development is unlikely, what about “herd immunity”? This term has been thrown around as the natural end to the COVID-19 outbreak if we cannot develop a vaccine in time. The problem with any expectation of “herd immunity” is that it assumes little or no reinfection. The question of COVID-19 reinfection is still officially up in the air but, from what we know about all other coronaviruses, reinfection is likely for asymptomatic cases or cases with mild symptoms after only a few months to a year. Studies show that long-lasting antibodies have only ever been developed from severe cases of the much deadlier and serious SARS and MERS. For lesser coronaviruses, and for milder cases of SARS and MERS, antibody duration is quite short. What this means is that we may all be susceptible to COVID-19 infection even if we have been infected before. This is our “Debbie Downer” moment but it had to be said because it materially impacts the economic outlook.

To sum up this section, the outlook for the virus is not great. The expectation earlier in the year was that Western societies would tame new COVID-19 cases in a similar fashion as the Chinese after the Wuhan outbreak and that new COVID-19 infections would be negligible until a second wave appeared sometime in the fall. It is now clear that the virus will be endemic in Western society for the foreseeable future unless we fully lockdown and that even in places like China, where the virus was completely under control for a period of time, localized lockdowns will be necessary, just as Beijing is partially locked down now. This new view of the virus will likely result in an extended period of suboptimal global economic activity.

The Economy

The global economy is expected to have suffered the greatest quarterly GDP decline in history in Q2. The total GDP decline in the first half of 2020 has only ever been rivaled by the Great Depression but, even then, the decline in GDP was not globally coordinated and was over a number of years. Plainly, the speed of the decline in economic activity is what makes the economic outlook

so uncertain. There is no economic environment in history that resembles the current economic environment so we cannot look to for guidance.

In early April, the International Monetary Fund (IMF) forecasted a global GDP decline of 3% in 2020 and global GDP growth of 4.7% in 2021. In June, the IMF revised their GDP forecast to a 4.9% global GDP decline in 2020 and global GDP growth of 4.5% in 2021. This revision is in reaction to many of the changes in COVID-19 expectations we discussed above. To put that revision in perspective, the IMF now expects global GDP to be ~US$2 trillion lower over the next 18 months than it was just three months ago. That is not an insignificant number. It is also important to remember that these GDP estimates INCLUDE all of the economic stimulus we detailed above so there really is not much more policymakers can do to boost economic growth further.

The global employment picture remains in flux as government assistance for those not able to work or who are getting less work than desired due to the government mandated COVID-19 lockdowns is still in force. We will not have a good picture of what the unemployment rate will look like until the temporary government assistance ends and we see how well the economy stands on its own.

The path of overall economic revival following the end of the lockdowns is also unclear. We saw gauges of economic activity bounce back after lockdowns ended in some regions but it is difficult to tell how much is simply pent up demand during a high government stimulus period. Importantly, overall economic activity continues to contract and continued business failures in the retail, hospitality and travel sectors will dampen business confidence. If you read the newspaper or watch TV, you hear people talk about economic recovery. A key distinction worth making is that the word "recovery" is different this time around. Recovery in the past meant that the recession was effectively over. In this case, it can mean going from a severe lockdown-induced recession to a more typical recession. We think investors may have misinterpreted the word recovery this time around.

In June, we got a rare candid statement by the IMF about the financial markets akin to the "irrational exuberance" of the late 90s and early 2000s.

> *"financial market sentiment appears <u>disconnected</u> from shifts in underlying economic prospects raising the possibility that financial conditions may tighten more than assumed in the baseline."*

What this means is that the IMF's already gloomy outlook could be negatively impacted further by the unraveling of what appears to be "disconnected financial market sentiment" which is economist-speak for market bubble.

The Markets

Despite the negative outlooks for the virus and economy relative to nearly everyone's initial expectations, equity markets rallied significantly in Q2, likely in reaction to stimulus measures.

US markets have led the way with the Nasdaq hitting all-time highs and the S&P 500 trading within 4% of its all-time highs. Alternately, Canada's stock market, the TSX composite index, is still well

off its all-time highs due to its high weighting in the energy, materials and financial sectors which have not rebounded nearly as much as the technology and health care sectors.

US equity markets are at their highest valuation ever relative to long-term expected growth rates as measured by the S&P 500's PEG (price/earnings to growth) ratio. Previously, when US stocks were valued as richly as they are today or higher, such as 1929 or 2000, long-term expected growth rates were much higher. Today's below average long-term expected earnings growth is the result of two key factors:

- ***US corporate tax rates are at the lowest level since WWII*** so earnings are likely to be negatively affected by future changes to corporate taxation. Add the massive budget deficits accumulated fighting COVID-19, and near-term corporate tax hikes are likely. US presidential hopeful Joe Biden has stated that he would raise the US corporate tax rate from 21% to 28% if elected in November.
- ***Declining US benchmark interest rates have benefitted corporate earnings growth for 40 years*** as falling interest costs went straight to corporations' bottom-lines. Now that US benchmark interest rate is at 0%, the historical boost of falling interest expenses to earnings no longer exists and interest cost on corporate debt can only go up from here, causing a long-term impediment to earnings growth.

Current market behaviour and the market's disconnect from the economy is not unlike the late 1990s. In 1998, following the Asian financial crisis, the US Federal Reserve cut interest rates and helped lead the bailout of a "too-big-to-fail" hedge fund named Long-Term Capital Management (LTCM). These interest rate cuts and the bailout of LTCM are often cited as key reasons for the size and extremity of the dotcom bubble of the late 1990s. Beginning in 1998, lending conditions had begun to deteriorate and qualifying for a loan became harder for large corporations, as indicated by the US Federal Reserve's Senior Loan Officer Opinion Survey. As corporations that rely on debt financing began to be shunned by investors, corporations that rely on equity financing (i.e. technology startups and the like) began to be favoured by investors. The rotation from longstanding but indebted corporations to upstart technology companies was a key driver of that bubble.

We are beginning to see a similar situation play out in today's markets. Investors have shunned corporations that rely on debt financing, at a time when the US Federal Reserve's Senior Loan Officer Opinion Survey indicates that qualifying for a loan is about as hard as it was in 1998. Investors are in turn crowding into stocks that do not rely on debt financing and are bidding up their shares to all-time highs and levels which are difficult to justify. While there are not as many cash burning, venture capital businesses as there were in 2000, valuations of large companies, based on earnings and sales, relative to long-term expected earnings growth, are higher on average.

The combination of an investor rotation from debt-heavy companies to equity-heavy companies as well as historically high average valuations raises concern about some market segments. But to be clear, this does not necessarily dictate overall market direction, especially in the near-term.

Positioning In Light of a Weak Economic Outlook and Pricey Equity Markets

In our last commentary, when North American equity markets were down ~30% from their highs, we stated that we believed most of the equity market damage was done but further downside was still possible. Most of the damage was done as North American markets fell about 35% from peak-to-trough before rampaging higher throughout Q2. Many markets are now within reach of, if not at, all-time highs as of the end of Q2.

How are we positioning portfolios? We are unsure of the near-term direction of equity markets so we have taken a defensive stance in positioning portfolios. We have further focused on buying quality businesses at valuations that are close to historical norms and avoided businesses that trade well above historical valuations. Where appropriate, we have reduced equity exposure and allocated to fixed income or cash to protect against losses and/or to satisfy future withdrawal needs.

We continue to believe that certain pockets of the investment landscape offer attractive long-term returns, including:

- Many telecom, utilities and consumer staples stocks which offer stable return and below average downside. Low volatility funds capture these sectors well.
- Canadian preferred shares, particularly fixed reset preferred shares, for high, predictable yield.
- Real estate investment trusts (REITs) are undervalued as a group, some are riskier than others.
- Alternative investments with low equity market correlation – mortgages, merger arbitrage.
- Gold, which tends to do well in periods following extreme economic stimulus.
- Maintain US dollar exposure where possible which should help offset equity downside.

These are the areas we added to in Q2 and will likely continue to add to selectively throughout Q3.

There are always good investment opportunities somewhere and we are always surveying markets to find these opportunities. During this unprecedented time, we are working constantly to ensure your portfolio is positioned appropriately, providing you with the utmost ability to meet your financial goals. We appreciate the confidence you have placed in us.

Sincerely,

Steele Wealth Management

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