Third Quarter 2020

Is The Market Ready To Face Reality?

Economic Stagnation Caused by Waning Government Stimulus and the Malfunctioning Service Sector Is Starting to Drain Investors' Exuberance

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Quarterly Summary and How We're Positioning for Q4

The Markets

The roaring equity market rally that began in mid-March continued throughout July and August, with the S&P 500, Nasdaq and TSX composite rising as much as 17%, 23% and 9%, respectively, during the third quarter. Total returns from the March lows to the August-September highs were 66%, 84% and 52% for these indices respectively.

These blockbuster returns were largely due to big gains for a handful of technology, health care and precious metals stocks. Stocks hard hit by COVID are largely still much closer to their March lows than new highs. Stocks in between these two groups have rallied but are mostly below the levels seen pre-COVID. So to end the third quarter, we are looking at a market where the:

- ***'strong third'*** of the market (technology, health care) is trading at valuations comparable only to 1929 and 2000 and could see well below average returns over a long period of time,
- ***'middle third'*** of the market (mining, staples, utilities, telecom, banks, most industrials) is trading at fair valuations historically but many stocks in this third would likely see some downside during a recessionary market downturn, and the
- ***'weak third'*** of the market (retail, hospitality, travel, energy, some real estate) is trading at low valuations but rightfully so given the unique COVID-related headwinds facing these stocks/sectors. Many companies/stocks in this third are at risk of failure without government assistance in this environment.

US equity markets were at all-time high valuations, relative to expected long-term earnings growth, at the end of Q2 and are even more expensive at the end of Q3 as the long-term earnings outlook has not changed. Other equity markets remain highly valued relative to expected long-term earnings growth and could be seen as expensive if COVID continues to impair economic growth.

The relentless equity market rally ended in early September as governments became a little more timid in providing economic stimulus. US policymakers have failed to agree on how much stimulus is required and where stimulus is needed. In mid-summer, it was expected that US policymakers would inject another $1-$3 trillion in stimulus by now. This disappointment is a key reason for the loss of enthusiasm in the stock market. Other governments around the world have also become a bit more timid with spending as they are now having to think about how to balance government budgets and how to finance budget deficits going forward. Most governments have limited resources at their disposal and more government support could result in economic turmoil in future.

The US dollar declined relative to most currencies throughout Q3 as investors tend to sell the US in 'risk-on' environments. Similarly, most economically sensitive commodities, particularly those used in housing (e.g. copper, lumber) and infrastructure (e.g. iron ore, nickel) rallied strongly throughout the quarter. Oil on the other hand was roughly flat throughout Q3. While oil is sensitive to changes in the economic outlook and investor risk-taking, it is also directly affected by the reduced travel and changes in social behaviour caused by COVID and COVID restrictions. Economic activity and economic mobility remain well below pre-COVID levels.

The Economy

The global economy snapped back in Q3 from a very low base in Q2. The "growth" in Q3 was mostly just a reversal of the COVID lockdown related "decline" in Q2 though some major new investments in technology and logistics also provided a boost to Q3 growth. Most economies around the world exhibit economic activity (i.e. GDP) that is 5%-10% lower than pre-COVID levels.

So what makes this recession any different than past recessions?

Malinvestment. n. Economics defines malinvestment as business investment that has low or negative returns, effectively a misallocation of capital, which hurts future economic productivity and impedes future economic growth. Virtually all economic and market bubbles in history, including periods of war, involve significant malinvestment.

All of the spending on personal protective equipment (PPE) and other spending to combat COVID has no virtually <u>economic</u> return other than the hope that it allows us to operate as we did before. While this spending is necessary to save lives, and therefore justified, it acts as a drag on economic resources. Further, spending on technology and logistics may not pay off for many as continued economic stress may result in business failure anyway (e.g. a retail company adjusting to the COVID world spends a lot to 'go online' but fails anyway). The rush for schools to digitize and provide online courses for the 2020-2021 school year also involves additional investment in data capacity and computer hardware/software that will likely not continue past 2021. This widespread rush to boost technology and logistics spending could soon result in a glut of technology and logistics capacity that is akin to past boom-bust cycles. The dotcom recession occurred, not because investment to build out the internet was misplaced but because the investment to build out the internet was too great relative to demand when many dotcom businesses failed. Similarly, there was plenty of economic and equity market weakness following the two world wars as production had to shift from war mode to peace mode.

From a societal point of view, this recession couldn't be much worse. Recessions typically disadvantage lower income households, as these households experience higher rates of unemployment and longer stretches of unemployment, than higher income households. Conversely, economic stimulus typically advantages higher income households, who are able to maintain access to credit and therefore retain assets during recession and potentially even acquire new assets at low prices. So far, the COVID recession has resulted in outsized income and job loss for lower income households because these households are more represented in COVID affected sectors. The extreme quantity of stimulus deployed, while targeted at those in COVID affected sectors, still benefits higher income households more due to their continued access to credit and rising/elevated asset values. The bailouts and stimulus throughout the 2008 financial crisis enhanced the divide between rich and poor which led to a decade of polarized politics across the globe. We should all be concerned about future political, social and economic stability following the COVID crisis. **This outlook of instability will be a factor for stock valuations far into the 2020s.**

The US Fed's Senior Loan Officer Survey (SLOOS), which we have referenced in past commentaries, is our favoured recession indicator due to its reliable and logical prediction of a slowdown in economic activity. The survey captures lending intentions from the senior lending officers at US banks. Historically, when ***corporations demand fewer loans*** and senior loan officers as a group start to reel in lending for major corporations by ***raising the credits standards*** required to obtain a loan as well as ***the cost of loans***, this indicates that the business cycle is over and a recession begins within a short period of time. Fewer loans in general results in a greater number of business failures, which in turn results in less business spending on things (e.g. computers, furniture, and equipment) and greater unemployment.

The SLOOS first triggered a recession warning in August 2020. Over the past two market cycles, a US recession began within two months of a SLOOS recession warning and equity markets peaked a few weeks prior or a few weeks following a SLOOS recession warning. The fact that equity markets experienced significant declines just four weeks after the first SLOOS recession warning in just under 13 years increases the odds that the September market peak may be a market peak worth noting. No indicator is perfectly reliable and therefore no investor should use a single signal to wholly "get in" or "get out" of the equity markets but the SLOOS's warning certainly warrants a defensive stance toward equity markets, both in terms of overall allocation to equities and the types of equities one holds. This indicator makes us more confident in our stance that this is likely to be a 'W' shaped recovery with a second round of economic weakness or stagnation ahead.

What do other economic indicators point to? As a group, they all over the place due to the rapid COVID lockdown inspired economic slowdown followed by the rapid semi-recovery. The vast majority of economic indicators today support a bullish stance towards equity markets. That said, the combination of the lockdown inspired economic decline, the stimulus inspired economic recovery and the fact that corporations have far more debt now than before COVID make most indicators useless in our opinion. GDP growth is typically driven by steady corporate debt growth as corporations adding debt reflects investment in new projects. With corporate debt now at an all-time high relative to GDP globally, and with bankruptcies just starting to pick up steam, we highly doubt we are at the beginning of a durable economic expansion.

How will a Republican or Democratic win affect equity markets? The US presidential election is set to occur in November and based on recent polls, Joe Biden is the likely winner. A Biden presidency would likely be seen as negative for equity markets but not necessarily for the economy. A Biden administration would raise taxes on corporations and the rich and increase spending on health care, social services and green infrastructure. Higher corporate taxes would reduce US corporate earnings and potentially cause US equities to slump a little and US corporations may begin to 'offshore' their businesses again after a brief period of 'reshoring' under 'Tariff Man' Trump. In these volatile times, equity markets are yearning for some policy certainty and clarity out of Washington and one party, either party, controlling all branches of government could be seen as a positive. Alternately, a contested election and a split government would likely be seen very negatively by equity markets.

The Virus

Sadly, we are experiencing second waves abound as the school year is in full swing in the western hemisphere. In Canada, daily new confirmed COVID cases are making new highs and many regions and countries around the world are also seeing new daily highs. Thankfully, at this point the number of deaths caused by COVID is much lower than it was at this point in the first wave of the virus as we now have a better understanding of the virus and society has prepared to better protect the more vulnerable. The much lower rate death rate despite record daily new confirmed COVID cases is also likely the result of much more effective COVID case detection and significant underreporting of infection during the first wave.

While record COVID cases isn't resulting in mass hospitalization and deaths at this time, the risk of rising hospitalizations and deaths remains. It is now clear that attempts to normalize the economy are met with higher COVID case counts which then results in pressure to slow economic activity once again. It appears most governments around the world are now willing to let COVID case counts rise until hospitals face capacity issues. This balance between economic stability and COVID outbreaks will remain until we find a solution.

Last quarter we discussed reinfection, something that media outlets had yet to discuss in depth. Since then, reinfection has been detected in many countries and it was discovered that COVID antibodies do not last long for most people. What this confirms is that herd immunity will be difficult to achieve, even with a vaccine.

Speaking of vaccines, as we suspected last quarter, most viable vaccines in development today will have low efficacy rates of 50%-75%, if a vaccine is even possible. Recent polls show that about half of Americans and about one-third of Canadians are unwilling to get a COVID vaccine. A combination of the possibility of reinfection, low vaccine efficacy and low willingness to get a vaccine make attaining herd immunity quite difficult.

The last remaining solution is treatment. There are various treatments that have shown to be effective in reducing the rate of death for serious COVID cases but there does not appear to be a surefire solution yet.

Like last quarter, the virus outlook doesn't look very good and this poor outlook will likely mean a stagnating or shrinking economy for the foreseeable future.

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

US equity markets remain near all-time high valuations and other equity markets are also quite expensive despite a large contingent of businesses still destined for bankruptcy without government bailouts and massive debt accrual that will eventually have significant economic consequences. To say the least, we are not particularly optimistic about the next few years being good years for the economy nor most stocks. This is especially true now that the market's momentum has reversed and investor sentiment is likely to fade.

We remain defensively positioned, both from an asset allocation point of view and in terms of the types of companies that we are interested in owning. Owning companies that perform well in all economic environments and owning a meaningful percentage of 'safer stuff' will limit our participation in future equity market downside.

The areas that are most attractive at the current time haven't changed much since last quarter. Telecom, utilities and consumer staples remain attractive in the face of an extended recessionary environment. Gold, US dollar investments and alternative investments have good return outlooks and should help sidestep losses if equity markets experience material downside. Preferred shares have rallied substantially and many are no longer attractive. Many REITs are less attractive than before as extended rent relief measures and work-from-home policies have put significant pressure on some areas of real estate. The recent equity market weakness has created some opportunities in growth stocks but we remain very picky in this area of the market and prefer companies that have monopolistic and therefore durable long-term growth outlooks. We have also begun to add securities that adjust equity market exposure in response to changes in economic and market momentum thereby allowing us to participate in equity market upside during market rallies and limit downside during market downturns.

Risk management is our number one priority, now and always. The degree by which you participate in a potential recessionary market downturn could make or break your ability to reach your financial goals. We are working constantly to ensure your portfolio is positioned appropriately during the COVID crisis to maximize return while limiting your risk exposure.

We'll get through this together.

Sincerely,

Steele Wealth Management

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