Fourth Quarter 2020

Equity Markets ≠ The Economy?

Record Rally Continues Into Year End on Vaccine Optimism and Trillions More in Stimulus, and More to Come, but Warning Signs Aplenty

The Team:

Brian Steele, CA, CPA, CFA®
Laura Prust, CIM®, CPCA
Jeannine Campbell
Kelly Edmonds
Elizabeth Kernohan
Nudrat Ahsan
Sam Ryder, CFA®
Matthew Bell, CFA®

Quarterly Summary and How We're Positioning for 2021

What an absolutely crazy year! In February and March, we saw one of the fastest and deepest stock market downturns in history, catching investors off-guard. Subsequently we saw one of the fastest and strongest market rallies in history, also catching investors off-guard. Stock market valuations, especially in the US, appear detached from the underlying economy. Many commentators say this is reasonable and can be permanent. Whether we agree or not, we need to remain vigilant.

Despite the rabid stock market recovery throughout 2020, the economy is still weak. Following massive declines in March and April, employment recovered consistently month after month but **this progress reversed in December in Canada**. The US and many other countries also experienced a similar reversal in employment gains amidst a second wave of COVID-19. A double-dip recession is possible in the first half of 2021 in these countries and this could dictate stock performance in 2021. A key reason for strong equity market performance amidst a weak economy can be attributed to an unequal, or "K-shaped", recovery in most countries. **Higher income jobs were much more insulated from the negative effects of the COVID-19 pandemic and the government responses**. While this is not irregular during recessions, the degree of inequality is. These higher income individuals, who are core investors in the equity markets, continued to push equities higher despite an ailing economy.

Still, it almost feels like we are living in bizarro world. One in which this exuberance can exist:

- **An elevated percentage of bulls versus bears in Q4; this is often negative for stocks**
- **US margin debt hitting a record high in November 2020; a reliable market top indicator**
- **A frenzy for Special Purpose Acquisition Companies (SPACs); highlights investor mania**
- **S&P 500 trailing price-to-earnings ratio at 39x; a level that is unlikely to be sustained**
- **S&P 500 forward price-to-earnings ratio at 23x; highest level since all-time high in 2000**
- **US Total Market Cap to GDP at 193%, almost 40% higher than previous high in 2000**

While this gloom exists:

- **US jobless claims at recessionary levels, more than 2x average and flat-to-rising**
- **US and Canadian unemployment still well above pre-COVID levels and rising**
- **Corporate debt rising to all-time high almost everywhere; hardly a bullish signal**
- **Trillions in fiscal stimulus needed to simply keep economies treading water**

Globally coordinated government stimulus is the obvious reason why this disconnect can exist. Legendary hedge fund investor Seth Klarman said it best,

"With so much stimulus being deployed, trying to figure out if the economy is in recession is like trying to assess if you had a fever after you just took a large dose of aspirin"

While government spending around the world was unprecedented in 2020, it may be the more subtle government actions that end up shaping the economy of the future. Actions like a moratorium on eviction makes non-payment of rent practically unenforceable until the moratorium is lifted. The

eviction process plays a key role in housing market stability as it ensures that landlords receive fair compensation for their investment. It will be difficult for governments to remove these moratoriums and other deferment policies without inciting shocks to the real estate markets and potentially the financial system as a whole. It will be interesting to see how governments unwind these policies.

Given the somewhat unnatural environment we are currently in and considering end-of-cycle stock market valuations, particularly in the more growth-oriented US equity market, it is useful to look at long-term return expectations of major asset managers. Below are long-term (10-15 year) annual return expectations for some of the world's largest asset managers in late 2020.

Firm	Date	U.S. Equities	Developed-Markets Equities	Emerging-Markets Equities	U.S. Bonds
BlackRock	Sep 2020	5%	7%[a]	6.40%	0.80%
JPMorgan[b]	Dec 2020	4.10%	5%-6%	7.20%	2.5%[c]
Morningstar Inv. Mgmt.	Dec 2020	-0.10%	4.80%	4.50%	1%
Research Affiliates	Dec 2020	2%[d]	6.30%	7.90%	1.10%
Vanguard	Dec 2020	3.7%–5.7%	7%–9%[e]	7%–9%[e]	0.75%–1.75%

Long-term nominal return expectations are firmly positive on average but below historical levels. It is important to note that the key difference between 'US equities' return expectations, which appear quite low, and 'developed-markets equities' return expectations, which are not far from historical returns, is that the return outlook for many megacap US growth equities is profoundly weak. It is also important to note that while US megacap growth equities comprise a large part of overall US equity market cap and therefore drag down overall long-term return expectations, they are only a handful of stocks. What this table tells us is that we must be especially selective about which securities we buy and ensure there is a strong fundamental basis for everything we buy and hold. This is something we do on a continuous basis.

With respect to COVID and the potential for COVID vaccines and treatment, we are excited about the potential of life and the economy returning to some semblance of normal but we do not see a COVID vaccine or treatment as a way for economies and equity markets to escape high equity valuations and recessionary levels of corporate debt around the world. While many investors are currently discussing the possibility of endless budget deficits or "debt monetization" to support the US and global economy, government stimulus can only ever be counted on as a temporary salve on the wounds of the economy as endless budget deficits are not sustainable in the majority of countries due to US dollar funding and currency issues. This US-centric viewpoint blatantly disregards ongoing economic issues faced by non-US economies. In fact, we already seeing **a rapid spike in food prices and prices of other necessities**, which will pressure the most vulnerable economies, which also are some of the fastest growing. Endless government spending is likely not the way out of the current situation.

One other major factor to watch in 2021 is regime change in the largest economy in the world – the US of A. The Biden administration practically has full government control but not quite enough to pass its more ambitious proposals easily. Still, the stock market likely won't love what the Biden administration has in store for corporate America – higher labour costs, higher corporate taxes and taxes on higher income households, and more regulation of the financial sector and big tech. If the stock market rallied strongly following the election of low tax, light regulation Donald Trump, it seems hard to believe the market will do extraordinarily well with high tax, heavy regulation Biden. That said, what Biden and Trump have in common is **a willingness to run historically high budget deficits, which will likely keep corporate America chugging along**.

How To Position Portfolios Going Forward?

We acknowledge that equity valuations, ***on average***, are at the high end of historical ranges and that ***broad*** equity returns will likely be below average for the next decade or so. Taking note of the "investment menu" on offer is an important first step in building an ideal portfolio as well as guiding client return expectations. That said, we highlight that there are still pockets of equity markets – utilities, consumer staples, telecom, health care, energy, materials, some financials – that are likely to provide better than average returns. Further, there are still individual stocks within the expensive sectors that we believe can provide superior returns. This means that a combination of tilting portfolios toward sectors that offer more stable returns over time as well as disciplined stock and/or factor selection will be key to portfolio success going forward. We see country exposure as being an indirect factor ultimately driven by sector exposure, factor exposure and individual stock selection.

In addition to disciplined equity selection, building diverse portfolios with assets that are negatively correlated or uncorrelated to equity markets is important. In our **January issue of Taking Stock with Steele**, we review the usefulness of incorporating long-term US Treasuries in portfolios to protect against equity market downside. As early as a few months ago, the usefulness of long-term US Treasuries as a risk mitigation tool was limited, but now that long-term US Treasury yields have risen 1% from their March 2020 lows, their ability to offset equity downside has grown significantly. Long-term US Treasuries remain the only liquid asset consistently negatively correlated to equities and will likely remain that way in the next one or two equity market downturns.

Alternative investments are generally uncorrelated to equity markets and can therefore help preserve portfolio value during potential equity market downturns. We have begun to incorporate these investments broadly across portfolios. Credit/merger arbitrage and mortgage funds have some of the best risk adjusted returns over time and have some of the lowest correlations to equities over time. Incorporating these assets into portfolios should help smooth portfolio returns over time while limiting portfolio downside.

Risk management is our number one priority, now and always. It is now more than ever important to resist the siren song of rampant speculation that has captured the minds of many investors. The stock market is not a get-rich quick scheme and most who participate in get-rich quick behaviour tend to lose.

We are working constantly to position your portfolio appropriately to maximize return, while limiting your risk exposure.

Sincerely,

Steele Wealth Management

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