Third Quarter 2021

Easily Spreadable Delta, Debt Ceiling Upheld-a
Red China Evermore, What's Ida Got in Store?
♪*We Didn't Start the Fire*♪

After a Few Quarters of Relative Calm, Markets are Met with a Cluster of Economic Growth Hindering Events All at Once

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Quarterly Summary and How We're Positioning for Q4

Our apologies to Billy Joel. Trust us, our rendition makes Dwight Schrute's sound like 'Stairway to Heaven'. Please note that no typists were injured in the writing of this commentary.

Since mid-2020, it seems that the only market moving news we received was related to new COVID variants and related economic and monetary policy responses. While Chinese policymakers did outwardly state their intention to reel in commodity prices, which has generally proven to be successful, the impact of such price control has not affected much else beyond base metals prices. Further, China's crackdown on Chinese private companies, which began in late 2020, also had limited effect on overall investor sentiment and some posit that this crackdown actually pushed investors to pull money from Chinese tech companies and put it to work in tech companies outside China. The lack of other market-moving catalysts, positive or negative, allowed equity markets to gradually nudge higher as investors' willingness to accept risk and the associated returns remained unhindered by fear. It appears this goldilocks period has ended as numerous exogenous events have surfaced all at once.

China has continued its crusade to limit the activities of many Chinese tech companies and appears to have broadened its data privacy and control restrictions to some financial institutions as well. Further, Chinese real estate sales activity has been much weaker than expected this year and the stock and bond prices of numerous highly indebted Chinese property developers, Evergrande Group in particular, has added to the risk aversion in China and the fears that debt defaults in China could spread beyond China's borders. As China's economy is still largely driven by capital investments in real estate and the associated commodity processing and consumption, the price of many raw commodities used in construction, specifically iron and lumber have fallen significantly from the highs achieved earlier in the year.

There is growing risk that China's economy may finally have to deal with its high overall debt levels and US dollar dependence and this could have a considerable short-term effect on global GDP growth going forward. Specifically, Chinese population growth appears to have peaked, much sooner than many anticipated and this may result in lower than expected Chinese GDP growth over the long-term. The situation in China is quite opaque, as it typically is, and as a result it is difficult to assess if and how financial contagion beyond China would manifest itself. We believe Chinese officials have sufficient power to prevent a short-term financial market event, though managing longer term issues of population growth and the Chinese economy's dependence on building things for a growing population may prove quite difficult.

The ***COVID-19 Delta variant*** negatively impacted global growth in July and August as many economies around the world enacted further restrictions to limit its spread. The economic recovery was impeded during these months and could continue to be, but the effect is likely to be temporary, similar to previous waves of the virus. Early indications show that highly vaccinated regions are having success in suppressing the current wave and this could provide a faster rebound in economic activity relative to previous waves of the virus.

In late August, ***Hurricane Ida*** made landfall in the southern US, causing loss of life and extensive damage to property and energy infrastructure. Damages are believed to be at least US$50 billion and could go as high as US$100 billion, making Ida the third to sixth costliest hurricane in history. Ida's damage caused many affected businesses to halt production, causing a dip in employment in affected areas. While economic activity is expected to rebound, as it has following previous natural disasters, Ida will likely make a full economic recovery more difficult because many business owners are already in dire straits due to COVID's impacts.

Passage of the US stimulus bill is ever more important with post-pandemic government stimulus waning around the world and the three catalysts above potentially pushing economic growth expectations lower. Political infighting within the Democratic Party has stalled passage of stimulus bills. Conservative-to-moderate Democrats have balked at the size of the $3.5 trillion package. Progressives on the other hand see this as a rare chance to pass more radical policy without conceding to Republican interests and Democrats can only count on full control of US government until the midterms in 2022. There is a high likelihood the US government passes a spending bill, which will act to support economic activity, though the ultimate size of the bill could be somewhat lower than the $3.5 trillion price tag favoured by progressives.

Last quarter, we discussed ***inflation*** and how it might be less of a concern than many have feared. Inflation in North America hit the highest level in decades in the summer of 2021 so concern about runaway inflation was high. The reason we believe inflation would come back down to normal levels was the fact that China, the "factory of the world", was shifting into lower gear. China's "credit impulse" (i.e. a measure of debt/credit growth in China) as well as its campaign against high commodity prices hinted at a return to normal global GDP growth rates and inflation by mid-2022. We believe the factors above, as well as the declining pace of economic activity around the world, indicates that inflation remains on the path toward normalcy.

Equities performed well for most of Q3 but the events above put pressure on stocks in September. That said, the S&P 500 and TSX composite indices still provided positive returns in Q3, finishing up 0.6% and 0.2%, respectively.

How To Position Portfolios Going Forward?

You can never know what news or event is going to shake up markets but you always know something will eventually arrive to do so. This is the whole basis for portfolio diversification. When return opportunities appear limited, the best course of action is to diversify across many asset classes and rebalance your portfolio to take advantage of opportunities when they arrive.

With a number of market headwinds arriving all at once, it is no wonder that the market rally stalled in September as investors started to scrutinize their holdings and asset allocation more closely. While we have not made any major changes to asset allocations, having gradually become more defensive throughout 2021, we did begin to pare down some of our bigger winners – GOOG, SONVY, CSCO and PFE, depending on their allocation in individual portfolios – reallocating the funds to stocks with better risk-reward tradeoffs like Smith+Nephew (SNN) and Corby Spirit & Wine (CSW.A) or tactical equity exposure like Purpose Tactical Asset Allocation ETF (RTA).

Global equity market valuations remain near all-time highs. History shows that it is advantageous for investors to maintain an average or below average allocation to equities in response. With fixed income yields near all-time lows and limited upside during future equity market downturns, the age-old strategy of reducing equity exposure and boosting fixed income exposure is much less attractive in today's market.

The best way to de-risk portfolios at the current juncture is to maintain equity exposure as is but build an equity portfolio of high quality businesses whose valuation is much less extreme than average. At the same time, owning only fixed income that provides an attractive yield and upside in any future equity market downturn (e.g. long-term US treasury bonds and highly active but defensive corporate bond funds) and alternative investments that provide high, stable yields with little correlation to equities and bonds, help limit portfolio volatility and offset potential equity downside. As a result, optimally diversified portfolios at this time look very different from those of the past. In the past, equities and alternative investments generated most of their returns from capital gains while fixed income generated the majority of its return from interest income. At the current time, a well-diversified portfolio should derive most portfolio income from high quality dividend paying equities and alternative investments while the "growth" will be generated by all securities almost equally, most often generated from capturing capital gains as part of portfolio rebalancing. We believe investors as a whole will learn first-hand the true value of active portfolio management over the coming years.

As always, we are working constantly to position your portfolio appropriately to maximize return, while managing your overall portfolio risk exposure. Please feel free to reach out if you have any questions or concerns.

Sincerely,

Steele Wealth Management

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