Quarterly Commentary

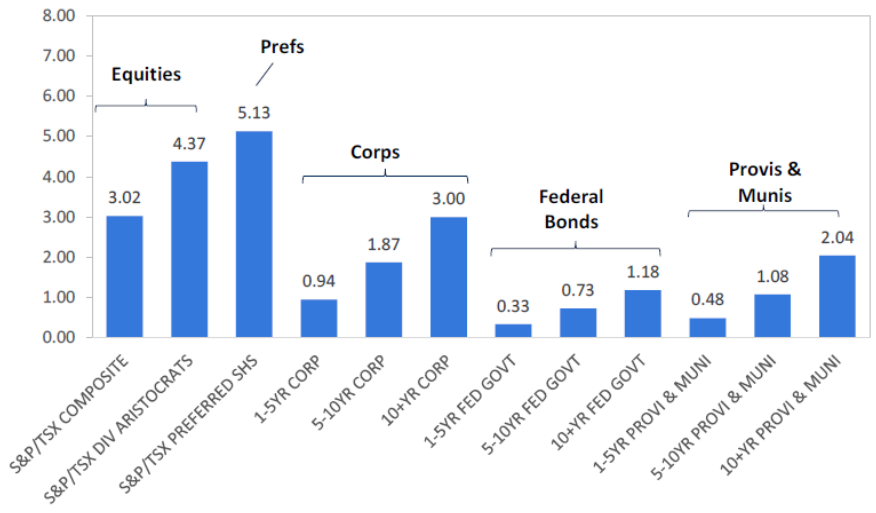
January | 2021

New President, same Fed

COVID-19 has taken a big toll, both from a health and an economic perspective. At the conclusion of 2020, there were 84 million confirmed cases and 1.8 million lives lost globally, due to this virus. The mandated shutdown of many businesses in early spring led to the onset of one of the fastest economic recessions in modern history, as economic activity plummeted. The impact was most pronounced in the services sector: restaurants, hotels, air travel, sports and entertainment, traditional retail stores. With demand cratering, the job losses that ensued made necessary such programs as the Canada Emergency Response Benefit (CERB) which provided financial support to individuals and families in need. Many other countries launched similar financial support programs to lessen the blow of this crisis. Despite this, global stock markets recovered strongly and quickly from the step selloff in March. Technology stocks led the way since they benefited from activities and behaviour that increased due to the pandemic.

With the U.S. Federal Reserve leading the way, central banks (the Bank of Canada, Bank of Japan, European Central bank etc.) throughout the world have done their part by cutting interest rates. The goal of this action is to stimulate the economy by driving down the cost of loans, mortgages and debt, essentially putting more money in the hands of people. Plain and simple, low interests are a relief valve for borrowers. But for investors, low interest rates have big implications for asset allocation, how much money is allocated into stocks, bonds or cash. Conservative or moderately conservative investors in particular are forced to re-think their once higher allocation to cash and bonds given negligible yields (Chart 1), and to contemplate increasing exposure to stocks. For investors looking for returns that exceed the rate of inflation in the coming years, there is no alternative, they need to add stocks to their portfolios. The conviction to increase stock ownership becomes stronger with the explicit promise of low interest rates for "quite an extended time" by the U.S. Fed. This has boosted stock valuations. We have used this phrase many times before, "don't fight the Fed". When the most influential central bank in the world is on a path of lowering rates, and keeping them low for years, stock markets and other risk assets

Chart 1: Bond yields versus Equity yields – ultra low bond yields (%)



Source: FactSet, Raymond James Ltd.

typically do well, regardless of valuation.

The arrival of the COVID-19 vaccines is a game changer. While getting to herd immunity might take some time yet, it's highly likely that it will be reached at some point in 2021. This is a very important development from an investment perspective. Throughout 2020, we discussed the so called beneficiaries of the pandemic, particularly the companies that provide technologies to work from home, or that facilitate e-commerce transactions. The shares of these companies far outperformed those of most other stocks. This stock market leadership is likely to change in the coming year. As we get back to some sort of a pre-pandemic environment, we expect that companies that were hit hardest by the onset of COVID-19 will be the ones that are poised for the biggest gains in the coming year. Some have already staged an impressive recovery, and this is likely to continue, as investors focus on the general improvement of the economy and a return to normalcy. Throughout much of the developed world, expectations are for 2021 GDP growth to be strong, in the 4 to 6% range, following a horrendous 2020.

We are often asked how much of that optimism for recovery is already priced in to markets. Pandemic winners have seen strong earnings growth, yet their share price increases have far outstripped the pace of that growth. Conversely, companies that were hardest hit saw earnings cut to a fraction of pre-pandemic levels and many, particularly in the travel related industries, lost money. Yet share prices have also staged a partial rebound on hopes of a brightening outlook. Stocks are expensive based on any historical measure. This is not unreasonable however, given the level of interest rates and the yields on bonds and cash. So long as central banks continue to support economic recovery and expansion by remaining on the sidelines and not hiking rates prematurely, we see no change to this investing environment. Whereas the bias for positioning was in the stay-at-home growth winners in 2020, the coming year should favour the previously "out of favour" economically sensitive value stocks. The valuation gap between growth and value is the largest it has been in the past two decades (Chart 2). Given the outlook for stronger economic growth, portfolios should benefit

Chart 2: Undervaluation of Value versus Growth is at extremes

Source: BCA Research

from a move into foreign markets, and in sectors and regions that have lagged this recovery. Regardless, we advocate a continuation of a barbell approach, owning core long term positions in secular growth names, but in 2021 a greater exposure to these recovery stories. Central bank policy should be very supportive in the coming year, and stocks should outperform bonds well into 2022.

The biggest risk to the stock market is ironically an economic environment that is too strong, prompting the return of inflation. Sustained levels of higher inflation will eventually prompt the Fed and other central banks to move from their current near zero interest rate stance. This will also lead to an increase in cash and bond yields, which at some point will once again compete for the same investment dollars that are flooding into stocks. We do not see this as a risk to the markets in 2021, possibly not even 2022. In this backdrop, we are tilted towards risk assets (stocks, corporate bonds, high yield debt) to benefit from the continuing recovery.

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