Investment Notes

June 30, 2020

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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Overview

"Unprecedented" – a widely used word to describe the present economic situation, the monetary & fiscal policies in place, the sharp sell-off in stock markets in March and the subsequent rebound. By its very definition, comparing this recession to prior recessions may prove to be a futile analytical exercise due to the uniqueness of this global pandemic which triggered the onset of the current global recession. Nonetheless, with some market pundits speculating the possibility of a depression, we compare key data points from the Great Depression in the 1930s and the present situation to assess the likelihood of a similar outcome.

Stock markets around the world posted double-digit gains in the second quarter, belying abysmal reported economic data. The S&P 500 Index has led in the recovery from the March 23rd low, up 20.5% in the quarter albeit still 8.4% from its prior high on February 19th. Its leadership can largely be attributed to the six large cap technology stocks, which collectively represent 25% of the Index. The more cyclical sectors, including Energy, Materials and Consumer Discretionary, also led in the second quarter rebound.

While there are numerous factors that will influence market direction, the path of the pandemic will continue to be the primary driver.

Commentary

At his press conference on June 10th, U.S. Federal Reserve Jerome Powell stated, "At the Federal Reserve, we are strongly committed to using our tools to do whatever we can and for as long as it takes to provide some relief and stability, to ensure that the recovery will be as strong as possible, and to limit lasting damage to the economy." This statement characterizes the "Powell Put".

Along with cutting the Federal funds rate by 100 basis points to near zero, Powell has activated various credit facilities to purchase corporate bonds, including non-investment grade bonds that were downgraded after March 22, 2020, and asset-backed securities and established lending programs to small and medium-sized businesses and state & municipal governments. The objective was to serve as a backstop to key credit markets and increase the willingness of private lenders to extend credit. Objective accomplished – as of the end of May, U.S. corporations have raised $1 trillion in the bond market amid the Fed backstop, double the pace of last year! Companies are using the proceeds to restructure existing debt, pay down bank lines or just raise cash to weather the recession.

The Bank of Canada has acted in a similar fashion, lowering interest rates to near zero and initiating bond purchasing programs for both government and corporate bonds to inject liquidity in financial markets. According to former Bank head, Stephen Poloz, the economic situation today is more akin to a natural disaster than a depression with fiscal policy in place to essentially stop the clock and later restart the economy. Tiff Macklem, the new Bank of Canada governor, has reiterated commitment to these programs.

We highlighted the substantial fiscal policy responses by governments globally in our last quarterly note, collectively 90% higher than the stimulus packages announced in the 2008/2009 financial crisis. Additional relief packages and/or extensions of existing ones are likely until the economies more fully recover. That is the backdrop of this current recession.

Now a review of the conditions during the Great Depression, the longest and deepest economic downturn in the history of the United States, beginning in 1929 and lasting more than a decade:

Government Aid: Prior to Roosevelt's New Deal, introduced in 1932, there was no government safety net. The first state unemployment insurance system was legislated by Wisconsin in 1932. The Social Security Act was not signed until 1935. This time, the U.S. Congress acted quickly and aggressively with government social benefits accounting for a third of personal income in April, up from 19% before the pandemic, according to the Bureau of Economic Analysis. In some states, the combination of regular state-level unemployment benefits and the extra $600 per week from the federal government has more than offset the loss in average wages & salaries.

Unemployment: The U.S. Conference Board estimated the monthly unemployment rate peaked at 25.6% in May 1933. In the current recession, it appears U.S. unemployment peaked at 14.7% in April, spiking from 3.5% in February. While the peak rate is lower this time, it is the highest on record since the Great Depression. The U.S. unemployment rate in June was 11.1% with 18 million currently classified as unemployed. In Canada, the unemployment rate in May was 13.7%.

Length of Unemployment: The longer joblessness lasts, the more damage it does. It is estimated that the monthly unemployment rate was 20% for most of 1932 and 1933. So far, we are only a few months into this recession, but the recovery has started. The unemployment rate will decline as economies reopen.

Interest Rates: Between January and July 1928, the Federal Reserve raised the discount rate interest rate from 3.5% to 6.0% to stop speculation in stocks, leading to the stock market crash of October 1929, which triggered the Depression. In 1932, it raised rates again to defend the U.S. dollar within a deflationary environment, so real rates were about 15%. In contrast, recall that the Fed had been cutting interest rates in 2019 and quickly went to near zero in March. At its June meeting, the Fed sees the discount rate staying at the current level through to 2022.

Banking System: More than a third of the banks in the U.S. failed in the three years following 1929 and many citizens lost their life savings when banks failed. As part of the New Deal, the Federal Deposit Insurance Corporation (FDIC) was established in 1933. Following the Great Financial Crisis in 2008/2009, regulatory oversight by the Federal Reserve over the banking system increased. The major U.S. banks entered this recession in a relatively robust capital position, built up over the years to comply with stringent capital requirements. In addition to its normal annual stress test, the Fed conducted a sensitivity analysis to assess the strength of banks under various recovery scenarios due to the coronavirus crisis. In June, the Fed said the country's 33 largest financial institutions are strong enough to withstand the crisis and restricted dividend payouts and buybacks to ensure they stay that way.
Similarly, Canada's banking regulator, OSFI, has reaffirmed the resilience of the major Canadian banks and stated that dividend increases and share buybacks should be halted.

This recession is different from the Great Depression and from others in history. It was not the result of built up excesses but rather a global health crisis. The synchronized policy responses by all governments and central banks were necessary and have successfully so far, circumvented another depression. First quarter GDP in the U.S. was down 4.8% and in Canada down 8.2%. Second quarter is expected to be down significantly, about negative 37% in the U.S., and will mark the trough with positive GDP growth expected to resume in the third quarter.

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It is encouraging to see the stabilization and rise in U.S. consumer confidence since its collapse in April to the lowest level in nearly six years. Decreased expenditures due to shelter-in-place restrictions and an increase in government transfer payments have contributed to a jump in the U.S. consumer savings rate to 23% of May disposable income from below 10% in February. The strength in retail sales, up 17.7% in May from the prior month, suggests there is pent up demand. The higher savings rate should help make up for potential lost income as transfer payments abate and help underpin consumer spending in the months ahead. The resurgence of COVID-19 cases in regions that led in reopening with lax adherence to social distancing is unwelcome, however, the positive takeaway is that the social aspect of the consumer psyche has not been permanently altered and the desire for interaction remains innate.

As alluded to in last quarter's note, to bolster the crude oil price, OPEC and Russia announced a coordinated cut in crude oil production on April 12th to reduce global supply by about 10% through to the end of June. In early June, the parties agreed to extend oil production cuts to the end of July. Crude oil is now near the $40 per barrel needed for Russia to balance its budget making further extensions unlikely.

The longevity of this recession and the shape of its recovery will be dictated by the path of the virus and medical progress. We are encouraged by the advancements in therapeutics to treat COVID-19 and the global effort to develop a vaccine. According to the World Health Organization, some 17 vaccines are in human testing and more than 130 are in development. Meanwhile, governments and health authorities must work together to strike the right and reasonable balance between economic policy and health policy.

Other uncertainties in the second half include ongoing trade tensions between the U.S. and China, the impact of long-lived social injustices on business practices and the November U.S. election. Biden has recently emerged as the front runner and odds are rising for the Democrats taking control of the Senate. Regardless of which party gets into the Oval office, stimulus measures will be ongoing until sustainable economic growth is achieved.

Our adherence to investing in companies with sound balance sheets and capable management in attractive industries at reasonable prices remains unchanged. The health crisis has accelerated some trends and practices that had been underway such as e-commerce, streaming services and work from home. The adoption curve and permanency of these trends will be assessed to see if any portfolio shifts are necessary.

One practice we are formally incorporating in our investment process is Environmental, Social and Governance (ESG) factors. Some of the themes include clean energy, water management, quality of life, health and well-being, diversity and board structure. We believe in the principals behind Responsible Investing and that inclusion of ESG factors should enhance portfolio returns over the long term.

Lastly, due to the health crisis, we were unable to host our 7th annual client appreciation night which is usually held in early June. If there is sufficient interest, we are proposing to host a virtual meeting or webinar where clients could either dial-in or participate via webcast. Please let us know if this format would be of interest.

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June 30, 2020 Statistical Summary

STOCK MARKETS	**QTD**	**YTD**	**1 Year**
S&P TSX Composite Total Return (CAD)	17.0%	-7.5%	-2.2%
S&P 500 Total Return (CAD)	16.4%	1.3%	11.5%
S&P 500 Total Return (USD)	20.5%	-3.1%	7.5%
DJIA Total Return (USD)	18.5%	-8.4%	-0.5%
NASDAQ Composite Price Return (USD)	30.6%	12.1%	25.6%
MSCI World Index Price Return (USD)	18.8%	-6.6%	1.1%
CANADIAN UNIVERSE BOND INDEX	5.9%	7.5%	7.9%
COMMODITIES			
GOLD	10.4%	16.3%	25.3%
SILVER	27.7%	1.5%	18.8%
COPPER	21.6%	-2.4%	0.4%
NATURAL GAS	6.8%	-20.0%	-24.1%
WTI	91.8%	-35.7%	-32.8%
BRENT	59.4%	-36.9%	-37.1%

TREASURY BONDS	**06/30/20**	**12/31/19**	**06/30/19**
2 Year (CAD)	0.28%	1.68%	1.47%
(US)	0.16%	1.58%	1.75%
5 Year (CAD)	0.36%	1.66%	1.39%
(US)	0.29%	1.69%	1.76%
10 Year (CAD)	0.52%	1.64%	1.46%
(US)	0.66%	1.92%	2.00%
30 Year (CAD)	0.99%	1.71%	1.68%
(US)	1.41%	2.39%	2.52%
Inflation			
CPI (CAD)	0.7%	2.2%	2.4%
(US)	1.2%	2.1%	2.0%

Upcoming 2020 BNN Dates

Christopher: July 8 @ 12:00pm
Christine: July 16 @12:00pm
Christine: August 11 @ 12:00pm
Christine: September 14 @ 6:00pm
Christine: October 14 @ 12:00pm
Christine: November 9 @ 6:00pm
Christine: December 14 @ 12:00pm

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