# Investment Notes

September 30, 2020

GLOBEINVEST
CAPITAL MANAGEMENT INC.

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**Overview**

The major stock market indices continued to move higher this quarter underpinned by a stronger than expected economic rebound from the second quarter and continued policy support. Output has surged as lockdown restrictions have eased and pent up demand took hold. Fiscal stimulus has sustained household incomes despite a markedly weaker employment situation. Numerous countries have extended government support programs as many industries are still unable to operate anywhere near capacity due to social distancing restrictions.

The V-shaped bounce off the economic low is moderating and growth will inevitably slow in the quarters ahead. The longevity of the ongoing health crisis is leading to businesses adjusting their staffing needs. A second wave of coronavirus infections has resulted in tougher containment measures and targeted lockdowns which may further dampen the pace of the recovery.

The adoption of average inflation targeting framework by the U.S. central bank reinforces a "lower for longer" interest rate path. Signs are emerging that a prolonged period of near zero interest rates in conjunction with the accommodative programs already announced to provide liquidity in the financial system are prompting investors to take more risk.

Over the near-term, COVID-19 will share the headlines with the U.S. presidential election. The likelihood of a contested ballot is high with Election Day evolving to Election Weeks.

**Commentary**

It has been more than six months since COVID-19 was declared a global pandemic and draconian government mandated shutdown measures were implemented to slow the virus's spread. In Canada, first quarter GDP contracted 8.2% (annualized) followed by a 39% decline in the second quarter. Similarly, in the U.S., first quarter was down 4.8% and down 31% in the second. The recovery off the bottom has been surprisingly strong, with third quarter GDP in Canada expected to be up 40% and up 35% in the U.S. Thereafter, GDP growth is expected to continue at a much more reduced rate albeit still positive.

The remarkably swift rebound, particularly in consumer goods spending, can be attributed to the cash windfall many households received in the form of transfer payments from the federal government. In the U.S., the generous $600 weekly federal top-up to jobless benefits resulted in people on unemployment earning above average income in 36 states. Likewise, in Canada, despite a spike in the unemployment rate to 13% in Q2/20 from 6.3% in Q1/20, household disposable incomes rose almost 11% in the second quarter helped by government assistance programs.

Unable to spend money on many services amid lockdowns and phased re-openings, the U.S. personal savings rate spiked to a record high 33.6% in May and while it has since been declining (to 14.1% in August), the savings rate remains significantly above the 7.6% average rate in 2019. The elevated savings rate, especially amongst higher income employed households, represents a source of future liquidity to fund pent-up demand when economies can fully reopen.

In ordinary times, services comprise about 65% of U.S. household spending with 35% to goods. Typically, during a recession, spending on durable goods or big-ticket items such as appliances and home furnishings is the first thing to get cut. However, in this recession, spending on durable goods has surged to replace the inability to spend on services like travel and entertainment. The rebound in goods spending may be largely complete as these items do not need to be replaced frequently. Services outlays will remain muted until the healthcare crisis passes with some economists forecasting that it may not get back to pre-pandemic levels until 2022.

Numerous countries, including Canada, have extended government income support programs with many sectors such as travel, leisure and hospitality remaining under duress. The inability in the U.S. to reach a mutually agreed upon fiscal stimulus package to replace the CARES Act is troubling especially given the prominent role the services industries represent in its economy. The passing of Justice Ginsburg and the increase in partisan tension over the resulting vacancy could be another impediment to getting a deal done before the November elections.

The consequences of near zero interest rates and ample liquidity are starting to emerge in the financial markets. Signs of elevated investor risk appetites include rising equity valuation multiples, the resurgence of special purpose acquisition companies or SPACs and distorted pricing in the U.S. high yield bond market.

U.S. large capitalization technology growth stocks have led in the market rebound this year and deservedly so to an extent, as they have benefitted from societal changes forced by the pandemic. Year-to-date, the FAANGM (Facebook, Amazon, Apple, Netflix, Google, Microsoft) stocks are up on average 44% and represent about 20% of the S&P500 Index (SPX), thereby providing a weighted return of 9%. The overall SPX is up 5.6% so far this year which means the balance of the companies in the SPX are on average down 4%! The forward price to earnings multiples for the group of six range from 25.7x to 70.6x compared to the SPX at 21.6x. Bullish analysts justify their high valuation metrics in a low interest rate world that amplifies the value of their faster growing cash flow stream. In a low growth world, investors are also willing to pay a premium for companies that can offer superior growth. The question, of course, remains how much of a premium is justified. We continue to follow a valuation discipline of growth at a reasonable price, not any price. These technology behemoths are COVID winners and at some point, when the pandemic is nearing resolution, growth from the lagging COVID survivors may gain momentum.

SPACs, first conceived in the 1990s, are blank cheque companies whose investors are essentially betting on the sponsor of the SPAC. After initial investments by the sponsors, the SPAC raises money in an initial public offering (IPO). Investors typically receive a combination of equity and warrants to purchase shares in the future. SPACs go public as just cash shells with no operations. The goal of the SPAC is to merge with a separate private company, effectively taking that private company public. There is typically a two-year window to deploy the capital, otherwise the money is returned to the investors. So far this year, SPAC IPOs have raised US$47 billion compared to US$13 billion last year and more than in the past 10 years combined. Companies taken public through SPACs this year include DraftKings and Nikola. Criticisms of SPACs include share prices that trade at a premium to cash, hefty compensation paid to sponsors, and the pressure to make deals before the window expires.

The average rate in the U.S. high yield bond market is 5.7% against a long-run norm of 8.0% and the spread relative to the 10 year Treasury bond yield is 505 basis points (or 5.05%) again significantly below the historical norm and during recessionary periods (see charts below). The default rate in the high yield market has been rising and just rose above 8% for the first time in a decade. In the past, investors were compensated for this with a 10.0% yield, not 5.0% - 6.0% which is typically equated with a 3.5% default rate. The distortion in the corporate bond market is reflective of the near zero interest rate policy, Fed bond purchasing programs and investor appetite for yield.

President Trump's contraction of the coronavirus adds to the drama in the weeks leading up to the U.S. presidential election. The likelihood the results on November 3rd will be hotly contested and delayed is rising given President Trump's rhetoric against mail-in voting and reluctance to a peaceful transition. The last time a contested election occurred was in 2000, Bush versus Gore. In a very tight race, Al Gore initially conceded to George W. Bush but when Bush's margin of victory was revised down to 300 votes, that concession was rescinded with the Democrats suing for a recount in Florida. After five weeks of partisan bickering and lawsuits, the U.S. Supreme Court ultimately voted 7-2 in favour of Bush on December 12, 2000. Over this time period of political turmoil, the S&P500 Index contracted 5.0% with relative outperformance from the defensives like consumer staples, utilities and healthcare. A contested election this November may trigger a similar reaction.

As managers of your portfolios, our mandate is to preserve and grow your capital over the long term. Many of the events discussed may cause short-term market price reactions. Any that cause a long-term shift in our investment outlook will be reflected accordingly in your portfolios. The elevated volatility that has persisted through most of this year reinforces our philosophy to construct diversified portfolios consisting of income and growth stocks across various sectors and adhering to our process of investing in financially sound, well-run companies at reasonable prices.

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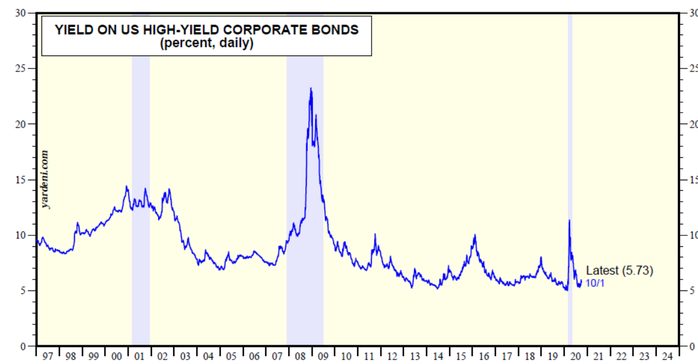
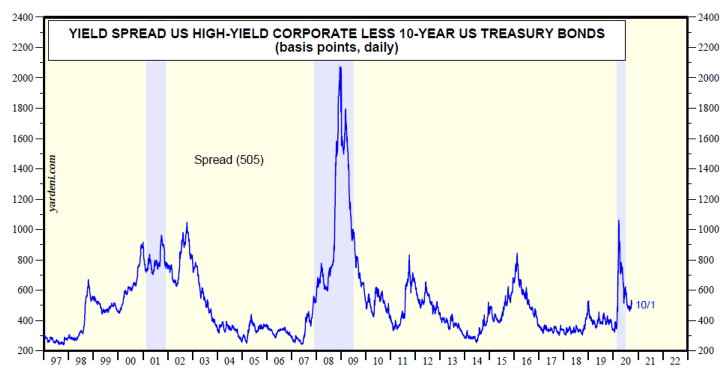
**US High-Yield Corporate Bond Yield and Spread**




Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Bank of America Merrill Lynch.




Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Bank of America Merrill Lynch and Federal Reserve Board.

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## September 30, 2020 Statistical Summary

| **STOCK MARKETS** | **QTD** | **YTD** | **1 Year** |
|---|---|---|---|
| S&P TSX Composite Total Return (CAD) | 4.7% | -3.1% | 0.0% |
| S&P 500 Total Return (CAD) | 6.9% | 8.3% | 15.8% |
| S&P 500 Total Return (USD) | 8.9% | 5.6% | 15.1% |
| DJIA Total Return (USD) | 8.2% | -0.9% | 5.7% |
| NASDAQ Composite Price Return (USD) | 11.0% | 24.5% | 39.6% |
| MSCI World Index Price Return (USD) | 7.5% | 0.4% | 8.6% |
| **CANADIAN UNIVERSE BOND INDEX** | 0.4% | 8.0% | 7.1% |
| **COMMODITIES** | | | |
| GOLD | 6.4% | 23.7% | 26.6% |
| SILVER | 30.9% | 32.9% | 39.5% |
| COPPER | 11.1% | 8.4% | 17.1% |
| NATURAL GAS | 44.3% | 15.4% | 8.5% |
| WTI | 0.1% | -36.9% | -31.0% |
| BRENT | 0.5% | -38.2% | -32.6% |

| **TREASURY BONDS** | **09/30/20** | **12/31/19** | **09/30/19** |
|---|---|---|---|
| 2 Year (CAD) | 0.25% | 1.68% | 1.58% |
| (US) | 0.13% | 1.58% | 1.63% |
| 5 Year (CAD) | 0.37% | 1.66% | 1.40% |
| (US) | 0.28% | 1.69% | 1.55% |
| 10 Year (CAD) | 0.56% | 1.64% | 1.37% |
| (US) | 0.69% | 1.92% | 1.68% |
| 30 Year (CAD) | 1.13% | 1.71% | 1.53% |
| (US) | 1.46% | 2.39% | 2.12% |
| **Inflation** | | | |
| CPI (CAD) | 0.1% | 2.2% | 1.9% |
| (US) | 1.3% | 2.1% | 1.7% |



### Upcoming 2020 BNN Dates

Christine: October 14 @ 12:00pm
Christine: November 12 @ 12:00pm
Christopher: November 19 @12:00pm
Christine: December 14 @ 12:00pm

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