Portfolio Management
Monthly update

May 2020

Is the Market Rally Sustainable?

Highlights

- **Stock prices are discounting a decent economic recovery**
- **Global economies cannot afford to lock down again**
- **More rotation from Growth to Value & Larger to Smaller**
- **Corporate bonds improving**

Chart of the S&P 500
Source: Thomson Reuters, June 02, 2020

We understand that investors are nervous given the unprecedented drop in economic activity & uncertainty about recovery. Market pundits are all over the place, with David Rosenberg consistently bearish, Brian Belski typically bullish and every in-between view published daily. We find that focusing on fundamentals & your financial situation to be most useful. Clients who need income should keep a good portion of funds in a combination of safe yielding stocks & bonds. The growth portion of your portfolio is what we want to focus on here.

The V shaped recovery in the stock market since March 23rd has led many investors to question the sustainability of the advance. The fastest market collapse in history was quickly followed by unprecedented fiscal and monetary stimulus. The huge increase in money supply and “dry powder” on sidelines, along with some optimism about reopening the economy has given equities a strong lift. The market usually attempts to discount what is happening 6 months ahead.

Historically after a hit & bounce like we just experienced, a fairly dramatic sell off occurs as part of the bottoming process. The rally after the late 2018 pullback shows that this doesn’t always happen however.
We do expect some pullbacks & volatility since earnings are going to be hard to predict, with many companies suspending guidance. Many are worried that we shut down again if the number of cases escalates upon reopening. Although this might be the humane thing to do, we believe that it will be ***nearly impossible to re-shut economies since virtually no country can afford this economically.*** Our Chief equity strategist, Stephon Rochon points out in his June 1st strategy report that, the European Commission just proposed a €750B recovery with €500B in grants and €250B in loans, while Japan announced a new $1.1T stimulus that brings total fiscal support to ~40% of GDP. While stimulus was badly needed to prevent a short recession

from turning into something much more sinister, deficits will hit double digits in Canada and the U.S. this year which is not a tenable long term position.

Our research partners at JP Morgan share this view. One of their strategists notes that "virtually everywhere", infection rates have declined (NOT INCREASED) after reopening even after allowing for an appropriate measurement lag. This means that the pandemic and COVID-19 likely have its own dynamics unrelated to lockdown measures that were being implemented. (JP Morgan Strategy May 28)

Goldman Sachs, who was noticeably bearish, became more optimistic in their May 27th economic outlook. They noted that with many states reopening, the number of new cases was increasing at a 5-6% rate, below the 10% ceiling recommended by the World Health Organization. They also noted that unemployment appears to have peaked at about 22% in April. Goldman reported that mortgage applications, which were down 35% in the March-April period have risen to near February levels lately.

Doug Porter, head economist at BMO notes in his May 29th talking points that the 3-month recession from March to the end of May is the shortest on record, since most recessions average 11 months. The 2008-09 recession lasted 18 months. That is the good news, the bad is that this one resulted in a 13% decline in GDP in the U.S. & and 18% decline in Canada vs a 4% average decline. France had the worst decline in the G7 at almost 20%, Japan the least at -3.4%

Sector Rotation and Value vs Growth

Clearly technology has been the biggest beneficiary of the lockdown. Important trends of online shopping, working from home & internet security are here to stay. For those who own these sectors we would keep them. Generally these stocks are too expensive to buy now. The S&P 500 is now down only about 4.5% year to date vs over 11% for the Toronto stock exchange. The much higher weighting in technology and lower weight in cyclical stocks is why the S&P is doing much better. The big 5 "FAANG" stocks Facebook, Apple, Amazon, Netflix & Alphabet (Google) are down only about 1.4% and they now make up about 12.6% of the whole S&P 500.

Small & value stocks have done much worse than larger companies. We expect this to be reversed somewhat, helping funds such Pender Value, Edgepoint & Mackenzie US midcap. Dave Burrows of Barometer Capital noted in their May 29th market update that stocks that were outliers to downside, small caps & value had a 4 standard deviation of up move 2 days last week. This broadening of the rally is good news.

Healthcare has held up reasonably well in the slowdown, although some areas, such as drugs have done much better than those exposed to elective surgery, for example. The long term trends of an aging population & advances in science are making healthcare an increasingly large sector. We recommend adding selected stocks, such as Stryker or buying the best manager in the health - T Rowe Price- via TD Health Sciences Fund.

Financial stocks were particularly hit hard with lower interest rates being bad for banks & insurance companies. Fears of bad debts really hit the banks. Banks have recently rallied as earnings, although weak, have not been as bad as feared. Improving liquidity in corporate bonds has also reduced the fear of insolvency for bank's more indebted customers. Spreads between government & corporate bonds narrowed, partially due to significant liquidity from Central banks. According to the June 4th Barrons, US corporations have issued over $1 Trillion of debt year to date, above issuance in 2019. Bond markets are open for business, a good sign!

Payment processors such as Visa & PayPal have been the stand out as online purchases offset slower economic activity.

Cyclical stocks are bouncing back. Home building looks to be improving in the US, giving Canfor & West Fraser a lift after the big sell off. With rising mortgage applications & low interest rates, we like this area. Commodities are improving, with biggest bounce being oil prices, as US shale production is finally falling. We expect a good rally in energy stocks. Unfortunately the long term outlook for energy is not great, with supply likely to ramp up again if oil gets back up above $60.

Industrial stocks have also risen. Some analysts believe that declining globalization is moving some production back to North America & Mexico from China will help longer term.

Consumer stocks have been a very mixed group, with staples like Loblaw, Costco & Walmart doing well and discretionary areas like tourism & restaurants a disaster.

Consumer discretionary stocks which don't have social distancing issues, such as recreational vehicles, camping goods & pool supplies have been rising. Along this theme in the transportation stocks, rails are doing much better than airlines. Some our current holdings have bounced well and have further to go such as, QSR- Tim Hortons as drive through does well and Boyd Group as auto-body repair volumes rise with more driving.

Our comments are longer than usual, but given how much is going on, certainly not exhaustive. Please call Don, Scott or Rob if you would like more information or to discuss your portfolio. Here is to a better second ½ half of 2020!

Best Regards,

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