An Economy **Gone Viral**

BMO Wealth Management
BMO Nesbitt Burns

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Philip's Comments

Has it only been six months? It feels like a lifetime ago since the publication of our 14th newsletter, *Ever Higher?,* when we wondered, tongue-in-cheek, if markets would forever maintain their upward momentum. The image of the roller-coaster car slowly being dragged up to the pinnacle of the track (and its aftermath) has felt all-too-real in the months that have followed.

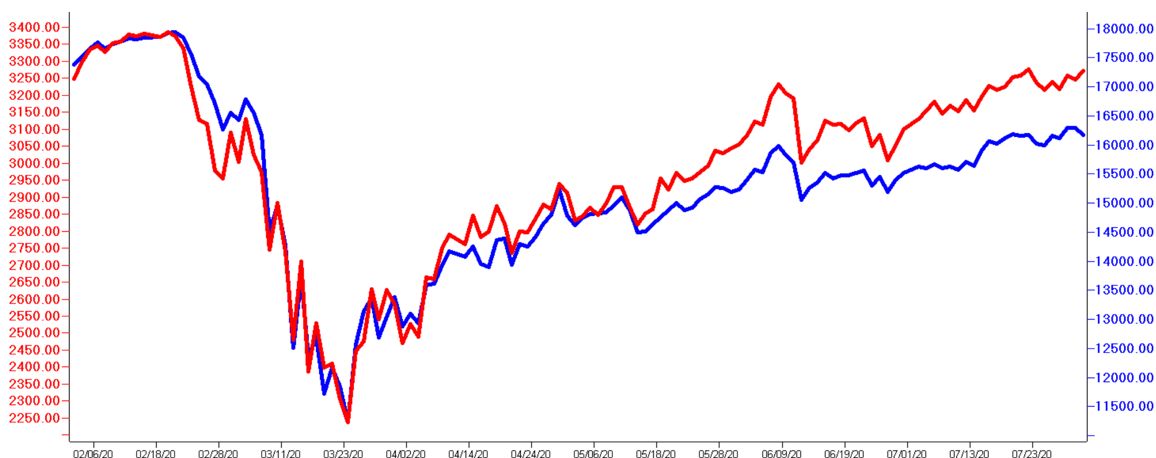
More than ever I hope that this newsletter finds you well in both body and spirit. These last six months have been difficult for everyone, and our team stands ready to help in any way we can. The global COVID-19 pandemic has had a greater effect than simply dominating headlines: it has dominated our lives.

The raw market data does not do justice to the dizzying trajectory that financial markets and broader economic indicators have taken since our last publication in early February. From February 1st to July 31st, the S&P/TSX Composite Index fell by 6.8% - but from the high-water-mark of 17,971 points on February 20th to the low of 11,173 on March 23rd, Canadian markets careened lower by 37.8%[1] - a stark reminder of how jarring stock market movements can be.

US equities fared better, with the S&P 500 actually rising marginally by 1.1% between February 1st and July 31st, but not without subjecting investors to a 35.4% decline from the peak to the trough, also reached on March 23rd (see Figure 1)[2].

Our loonie followed a similar path since February 1st – a precipitous decline, striking a low of $0.682 US on March 19th, but closing-in on $0.745 US[3] at the time of writing this Newsletter in late July – only slightly lower than where we were last winter.

*Figure 1: **S&P500** & **S&P/TSX Composite Index** (February 1 2020 – July 31 2020)*

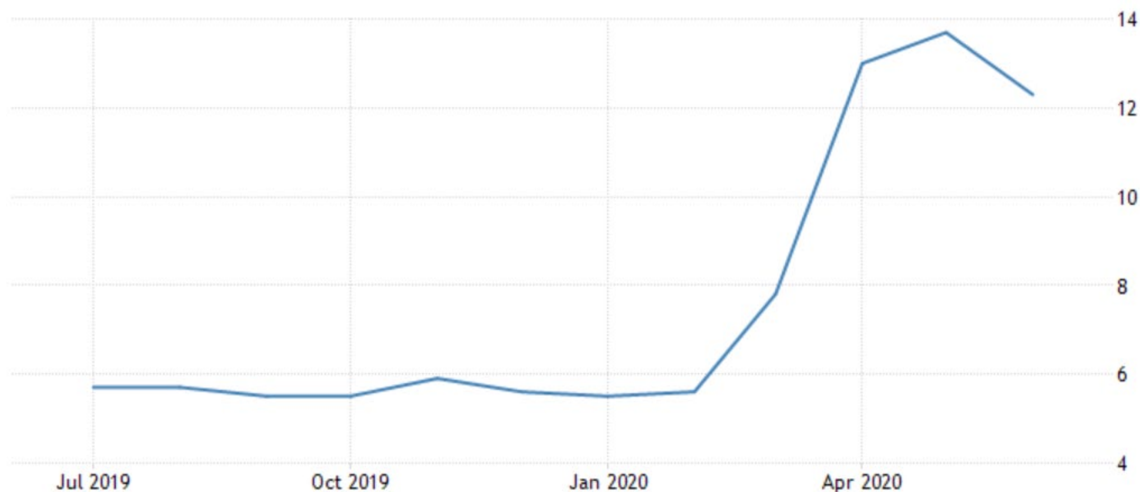


Source: Thomson ONE

The volatility investors have endured during this recent economic contraction has been historic. For example, in March, we saw the largest single-day percentage drop on the S&P/TSX Composite Index since the Second World War (12%), greater even than the crash of Monday, October 19th, 1987 – also known as Black Monday[4]. Despite the hard days of market lows, the robust growth we have seen in markets since March has reminded us of the resilience of financial markets, as well as their capacity to price themselves not on present conditions but on a forward-looking view of what is to come.

The strong resurgence of markets does not change the fact that real economic damage has been done. Before recovering somewhat in June, the Canadian unemployment rate reached a post-war record in May of 13.7% - representing the destruction of 3 million jobs due to economic shutdowns in March and April. While a significant number of these jobs have come back and the unemployment rate is now meaningfully lower at 12.3%[5] (see Figure 2), this kind of labour-market pain does permanent economic damage, not to mention the human cost caused by a sudden loss of financial security.

Figure 2: Canada's Unemployment Rate (July 2019 – June 2020)



Source: TradingEconomics.com, Statistics Canada

Sadly, the human cost of this virus has gone far beyond the harsh effects of unforeseen unemployment. Almost 9,000 Canadians have succumbed to this virus at the time of writing. Worldwide, the death toll represents 674,000 so far[6]. By the time you read this commentary, these numbers will have grown further.

These statistics are sobering, and represent real human tragedy, but there is also reason to be hopeful about what comes next. Since the scale of the pandemic became apparent, the response to COVID-19 by the medical community has been swift. The race to develop a safe and effective vaccine is on, with scientists from around the world sharing data and coordinating efforts through the World Health Organization's pandemic vaccine network. Currently, over 100 teams of experts are working on the development of a vaccine, and clinical trials have been accelerated given the nature of the crisis – including running different phases of these trials simultaneously. At time of writing, six vaccine candidates have begun phase 3 trials – the last step before a vaccine is approved for use[7]. Early indications of some of the vaccine candidates are encouraging, and while it would be irresponsible to speculate on when a vaccine could be approved, manufactured, and

distributed, there is ample evidence that this is being regarded as an "all hands on deck" scenario by researchers, scientists, and governments around the world. It seems as if this crisis will have an end-point. Every day that goes by is a day that brings us closer to that hopeful outcome.

If the market impacts of this crisis have been remarkable in their swiftness, just-as-remarkable are the economic measures that have been put in place in support of the economy. Interest rates around the world have fallen in an attempt to keep the global economy liquid and stimulated, and central banks – the US Federal Reserve chief among them – have brought back many of the same emergency measures that were instituted in response to the financial crisis of 2008. Governments worldwide have incurred massive budget deficits in an effort to support their national economies. Corporations have implemented business-continuity contingencies that are transforming the way work is done.

In this, our 15th newsletter, I will speak to the strategy that has guided our advice and actions, managing our clients' portfolios in *An Economy Gone Viral*, and how we should position ourselves for the troubled times in which we live. I will also touch on the next big story, likely to unfold in parallel to the continuation of the pandemic: the trip to the polls – or to the post-office – that our neighbours to the south will be making this fall. First, though, I want to address a question that has been posed to me many times as we have witnessed the rebound of markets subsequent to the March lows: *how can it be that markets have recovered as much as they have, while the economic news remains so discouraging?*

"Discounting" the Virus

It would be reasonable to interpret the current levels of equity markets (down by only 6.8% in Canada since February 1st, and actually *up* in the United States) as the result of greedy stock market participants ignoring the economic impacts of COVID-19 – discounting its effect on the health of the global economy. After all, the negative economic news we have witnessed in 2020 is not a fiction: real jobs have been lost, real businesses have closed.

I view this interpretation of the markets' recent strength as overly simplistic. What follows are a few arguments that help explain, if not justify, the current valuation of equity markets:

1. The impact of COVID-19 to businesses has been disproportionately focused on small and medium-sized enterprises[8] – these are generally privately held companies that do not trade on the stock market. I am not claiming that no private businesses are growing, or that no publicly-traded companies are suffering, but it is likely that the disproportionate impact that the pandemic has had on smaller firms has contributed to the disconnect we perceive when we compare the shuttered store-fronts and empty restaurants that surround us to the stubborn resilience of larger publicly-traded companies who can benefit from greater reserves of cash and sources of financing that a small-business cannot compete with.

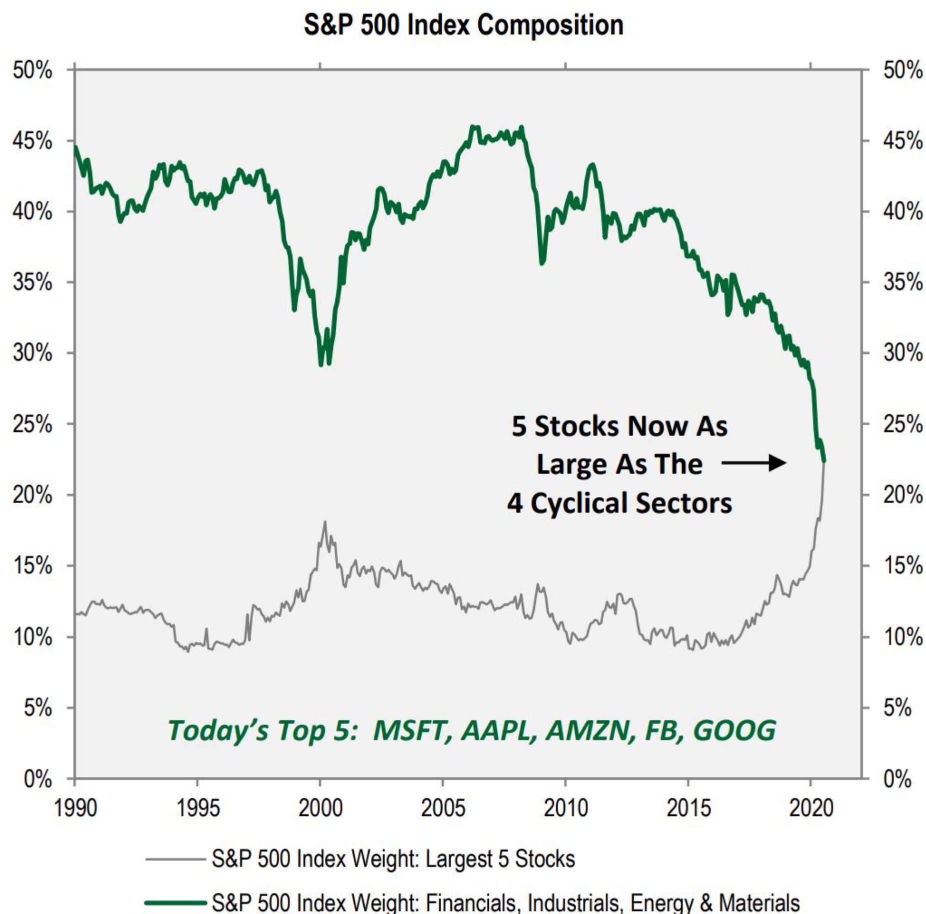
2. In anticipation of the economic devastation that would be caused by a global pandemic, central banks around the world lowered interest rates to the floor. This was not a surprising move, but it does help explain the subsequent rally that took place in the equity markets. Financial theory tells us that the value of a stock is simply the sum of all of its future cash flows, discounted back to today's dollars based on a "discount rate". As the discount rate is the denominator in this equation, a lower number produces a higher value for any given security. There are many ways to determine a discount rate for a company, but one of the major components to consider is the firm's cost of capital, and that is where low interest rates come in, driving down the discount rate for the market, therefore raising its valuation.

   In last winter's newsletter, I lingered on the concept of valuation – the idea that we can determine the "expensiveness" of stocks relative to their earnings, sales, or book value, and then compare their "expensiveness" to historical norms. An added component to this kind of determination is that a lower cost of capital – a lower "discount rate" – causes a structural step-up in valuations. We may be witnessing this phenomenon in markets today.

   Boiled down to its most basic level, think of a stock paying you a $3 annual dividend, compared to a bond, paying you a $2 annual interest coupon. The stock looks pretty good, right? Now, if the bond's coupon were to fall to $1 overnight, (just as interest rates have recently fallen sharply) that $3 dividend would look even more attractive, and you would be justified in paying even more for that stock to get the $3 dividend that it promises. It is logical to assume that at least a portion of the rally in equities since March can be explained by this effect.

3. Most commonly-followed stock indices have been victims at one time or another of the valuation of their constituents. Canadians know this well, having learned the lesson harshly through the rise and fall of Nortel Networks. At its peak at the turn of the millennium, Nortel represented over a third of the value of the TSE 300 Index[9]. A good day for Nortel was a good day for the TSE 300… and vice versa. Today, a similar phenomenon is emerging in the United States, a market that has historically shown much less concentration in the constituents of its indices. At the time of writing, 5 of the best-known "tech giants": Apple, Amazon, Alphabet (a.k.a. Google), Microsoft, and Facebook represent more than 20% of the entire value of the S&P 500 Index – and remarkably, at that valuation, they represent a larger piece of the US stock market than do all the companies that form the Financial, Industrial, Energy and Materials sectors combined (see Figure 3)[10].

Figure 3: Comparison of the S&P 500 Index weight of the largest 5 stocks, to the weight of the financials, industrials, energy, and materials sectors (1990 - 2020)



Source: M. Kantrowitz, Cornerstone Macro

Our Model Portfolio has been a beneficiary of this phenomenon: Amazon and Google were added to the model in January of 2019, and Microsoft was one of the founding securities in the model – a component of the portfolio when it was established in August of 2013. I will speak more about these securities in the next section of this discussion, but suffice it to say that their strong performance in 2020 has been justified, buoyed by an acceleration of well-established consumer and enterprise trends of e-commerce and cloud computing: trends that were jump-started by the sudden requirement for a huge segment of the economy to work from home. The result has been the strong performance of stock-market indices, in no small part due to the outperformance of these hefty few.

While these arguments are credible ways to explain the swift recovery that we have seen in markets since March 23rd, they do not diminish the fact that significant uncertainty remains in markets at this time, and that caution is justified. It is also true that the lofty valuations of high-tech companies are not consistent across all industrial sectors – there remain opportunities to invest in parts of the economy that have not yet fully recovered from this crisis.

Opportunism *and* Caution

The actions that we have taken since the emergence of COVID-19, and the actions that we will need to take in the coming months, blend elements of opportunism – seizing the opportunities that are only present during periods of great economic and financial instability – and caution – recognizing that the market is facing more uncertainty than at almost any other time in its long history.

In many ways the Model Portfolio was ready for this crisis. I would never claim to have predicted that the world would be ravaged by a pandemic, or that we would see anything close to the economic devastation that has resulted from COVID-19, but elements of our strategic positioning have helped ensure resiliency in client accounts:

- Our consistent recommendation to clients since January of 2018, documented then in our 10th newsletter *Pushing the Limits*, had been to maintain equity holdings at about 90% of what would be typically held given the investor's risk profile. This recommendation had been put in place as a safeguard against the end of what was already at that point a long bull market. The result was that many of our clients entered into this crisis with a significant amount of "dry gunpowder": cash ready to be deployed in case of a significant market decline.

- This recommendation has shifted in the last few months, moving from 90% of recommended equity exposure, based on investor profile, to 100% of recommended equity exposure. For many of our clients invested in our discretionary asset management program, also known as "MPA", a portion of that dry gunpowder was put to use in two stages through equity purchases that were designed to bring stock exposures closer to long-term targets. These stages were executed on March 9th (at that point the S&P 500 had fallen by 19% from its peak) and March 17th (with the S&P 500 off its peak by 25%).

- The last security substitution executed in our Model Portfolio before the emergence of the pandemic occurred on Friday December 20th 2019, when we replaced Carnival Cruise Lines with Walmart. This was done primarily due to our fundamental view of those two firms, but also as a way to increase the resiliency of the portfolio in case of an economic slowdown – decreasing our exposure to the more economically-sensitive consumer discretionary sector, and increasing our exposure to the more stable consumer staples sector. With the proximity of this portfolio change to the holiday season, once again our discretionary management program proved to be the best vehicle for execution of timely portfolio adjustments.

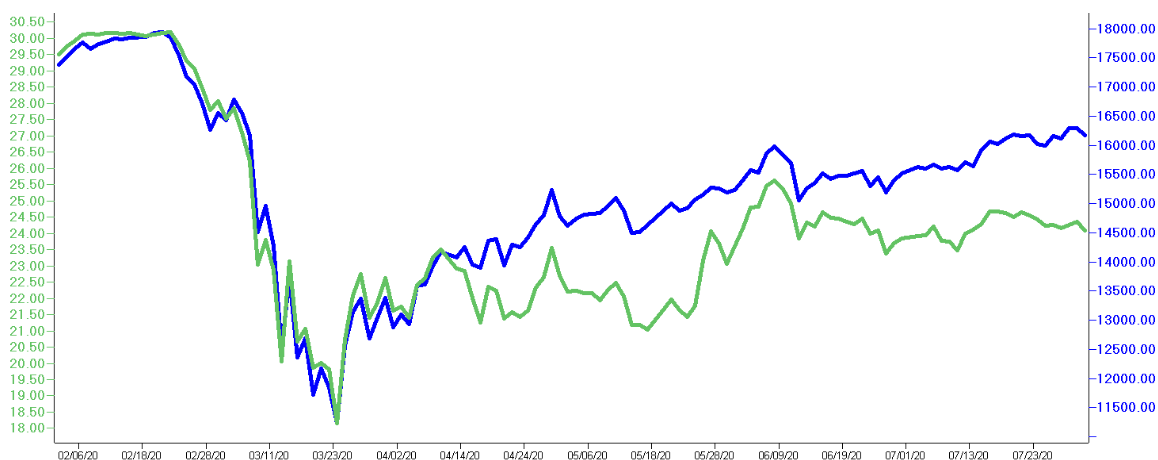
- In the summer of 2015, we reduced the exposure of our Model Portfolio to the energy sector from 10% to 5% - a significant underweight to the sector as compared to the S&P/TSX Composite Index. This lowered exposure to oil has been very helpful, as energy has continued to be under significant pressure since then. This was never truer than in the midst of the pandemic, when in April the price of oil, as determined by oil futures contracts, actually turned negative[11] – a price below $0. Essentially, the concern over limited storage capacity, high production due to arm-wrestling between Saudi Arabia and Russia, and greatly weakened global oil demand due to economic shut-downs, drove oil producers to

pay buyers so as to be relieved of their obligation to store the commodity. While our exposure to the sector is modest, the three components of our Model Portfolio in this sector (Suncor, Vermillion, and Husky) struggled during this most recent period and have not contributed meaningfully to the recovery of portfolio values since March.

- As referenced in the previous section, some of the greatest beneficiaries of the "work-from-home" / "shop-from-home" trends have helped our portfolio navigate this crisis: Amazon, Alphabet, and Microsoft first among them. These three companies have not only recovered from their March lows, but have advanced to new heights.

Despite these encouraging points, our record is not perfect. Certain holdings in the portfolio, beyond the aforementioned energy sector, did not fare as well through this crisis – chief among them Chartwell Retirement Residences – which has had to face the human side of this pandemic head-on, as well as Chemtrade Logistics, which saw its monthly distribution cut in half in March. Concerns over consumer and commercial credit also weighed heavily on our holdings in Canadian bank stocks, which underperformed the S&P/TSX Composite Index since February 1st (see Figure 4).

Figure 4: ***S&P/TSX Composite Index*** *vs.* ***BMO Equal Weight Banks Index (ZEB)***
(February 1 2020 – July 31 2020)



Source: Thomson ONE

As always, the most important question is: "What's next?"

It is very likely that the coming months will deliver significant market volatility, and it will be vital to stick to the conservative portfolio management fundamentals that have been our north star for so long. Without knowing exactly what lies ahead, here are a few themes that may give you an idea of what you can expect from us:

- We currently have no intention to remove from the portfolio any of the "high-flying" US technology stocks that have consistently outperformed over the course of this crisis. On July 30th, Amazon and Alphabet both released encouraging second quarter earnings, helping to justify the lofty valuations at which these companies trade. While they are likely to remain in our Model Portfolio for some time, do not be surprised if you see us trimming positions, so as to rebalance them

back to more reasonable portfolio weights within client accounts. This will help control portfolio risk related to these companies.

- Opportunity remains in certain sectors that have yet to fully recover from the March declines. Canadian banks, insurance companies, residential real-estate investment trusts (REITs), certain industrial companies, grocers, utilities and telecommunications companies all present compelling opportunities as we seek to rebalance the portfolio.

- Our focus will remain on stocks with quality management teams and strong balance sheets. This focus is demonstrated by the most recent addition to our Model Portfolio: Waste Connections Inc., added to the model on July 28th 2020.

- With governments worldwide incurring record-setting national deficits, there is a legitimate concern over currency devaluation – and the US dollar is not insulated from this phenomenon. We have long recommended, but have not consistently implemented, a modest portfolio weighting towards gold. Now may be the time to ensure that each portfolio has some exposure (in moderation, of course) to gold as a hedge against geo-political risk and a weaker US dollar.

As we continue to navigate these strange times, and make the best investment decisions we can, it will be important to keep our eye on the next big story. November may seem like a long way away – but it is not, and this US election is likely to have economic and market implications just as the last one did.

Election, Infection, Confusion

The election of Donald Trump to the presidency in 2016 coincided with a multi-year increase in the value of the S&P 500. With his presidency came significant instability and uncertainty, on more than one occasion moving the market with the power of his Twitter account, but his presidency also trumpeted a consistent agenda of deregulation and the implementation, effective January 1st 2018, of significant tax reductions which benefited corporate America. Think what you will about the man himself (and there is certainly a lot to ponder), but these policies were viewed as pro-business, and almost certainly contributed in part to the strength of markets since his election.

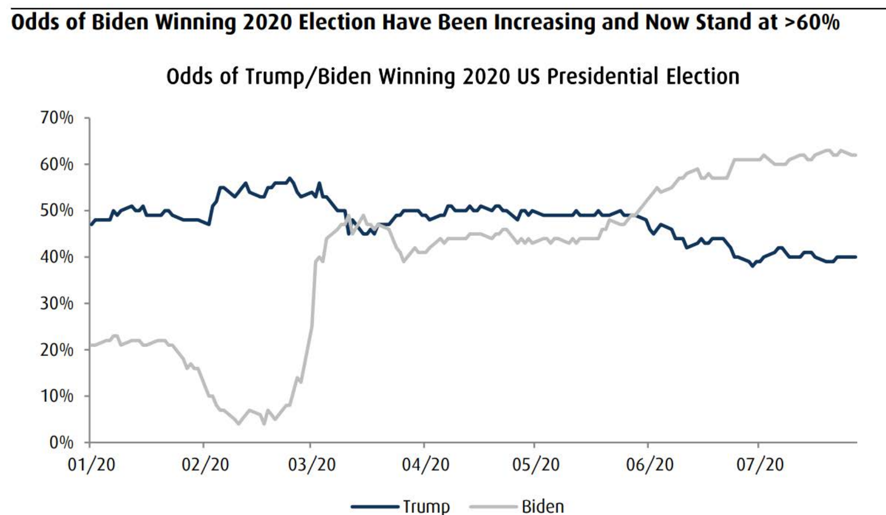
The agenda of the American president matters to markets, but it is not the primary driver of market performance. Corporate profitability, demographic shifts and consumer trends are all just as influential on the market. To quote BMO Capital Markets Chief Investment Strategist, Brian Belski[12], *"...politics neither drive nor define stock market performance – the economy and fundamentals do."*

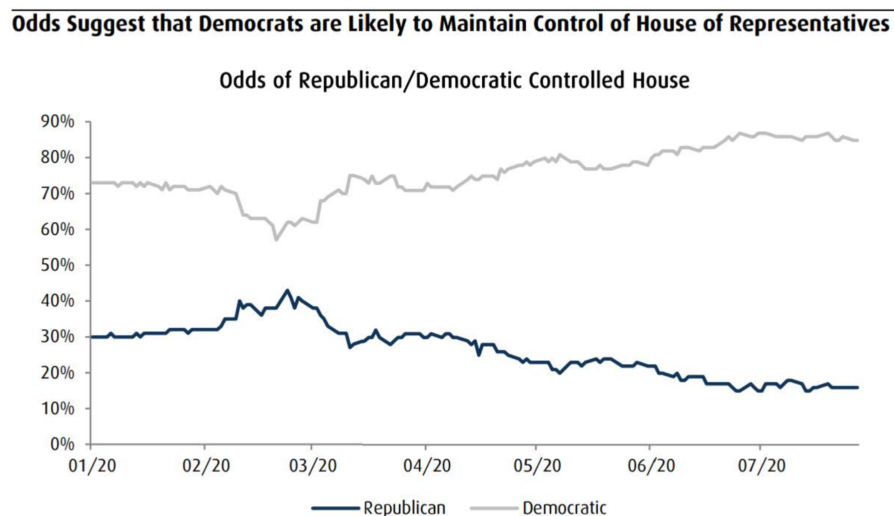
Nevertheless, this will not be a typical election. At the time this commentary is being composed, President Trump has publically mused about delaying the vote, an idea quickly panned by congressional leaders, including those in his own party. He is already laying the groundwork for the questioning of the validity of the election results, given the difficulties in holding a national election during a pandemic, and the likely increase in mail-in voting that will result. Uncertainty and instability are negatives for markets, and

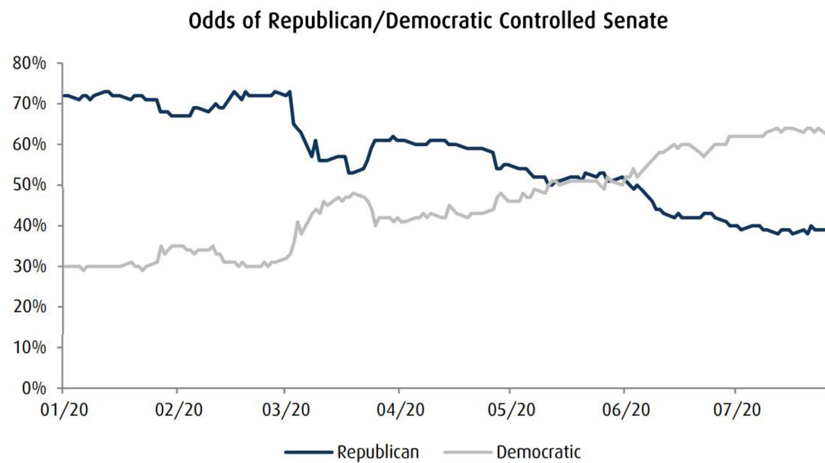
this November's election may be infected with enough confusion to produce heightened market volatility.

As for the expected result, it is too early yet to speak of a possible outcome with any degree of certainty: global events are moving quickly, and the Presidential election of 2016 reminds us how suddenly voting patterns can shift. But as things stand currently, odds point to a real possibility of a sweep by democrats of the presidency and both houses of Congress (see Figure 5).

Figure 5: US Electoral odds for the presidency, the senate, and the house







Source: BMO Capital Markets

While such a result could be music to the ears of those who have found the rhetoric and antics of the last four years to be exhausting, there are policy implications that could impact our investment choices:

- The reversal of the cuts to the corporate tax rate instituted in 2018 could be a significant headwind to corporate profitability.

- Increased regulation of drug prices could result in downward pressure on profit margins of large pharmaceutical companies.

- The regulation of "big-tech", even as far as possible anti-trust challenges to the largest of these companies, would have a significant impact on share prices – though this outcome is not probable, and would not happen quickly.

- Democratic policies would not necessarily be less protectionist than the trade policies espoused by the Trump administration – and the relationship with China could remain at the centre of the conversation.

Of course, there is something to be said for the possible market benefits of a more "traditional" occupant in the White House. It is hard to imagine that fewer 2 a.m. tweets, leading to less day-to-day uncertainty, would be harmful to financial markets.

Again, it is too early to predict the outcome of the election, and the greatest driver of voter behavior is likely to be the evolution of the pandemic in the United States. As things stand, COVID-19 cases are rising rapidly in many states, especially Arizona, California, Texas and Florida. Politics and pandemics… There will be plenty for us to focus on in the coming months as this story continues to unfold.

Conclusion

The events of the last six months have challenged all aspects of our lives, and have led to historic levels of volatility in financial markets. The resiliency of markets since the lows of March has been heartening and was not without justification. However, with the ongoing pandemic and a US presidential election on the horizon, it is likely that volatility will continue to be an important theme for 2020.

- Governments and central banks around the world reacted swiftly to put in place policies to bolster the economy during the pandemic. Some of these policies, including a deep reduction in interest rates, have been very supportive of stock market valuations. The shutting down of economies and rapid transition of large segments of the workforce to "work from home" has accelerated certain trends already in place: online shopping and cloud computing just to name two. Companies at the head of these trends have out-performed, and their rise has helped support markets during the crisis.

- The outperformance of these "tech-giants" has underscored the importance of rebalancing portfolio holdings, which will also help us take advantage of certain sectors of the market that have yet to recover to their former strength. With governments around the world running record deficits, it will be increasingly important to consider the addition of gold in a well-balanced portfolio, as a hedge against currency weakness and geopolitical risk. This must be done in a measured way.

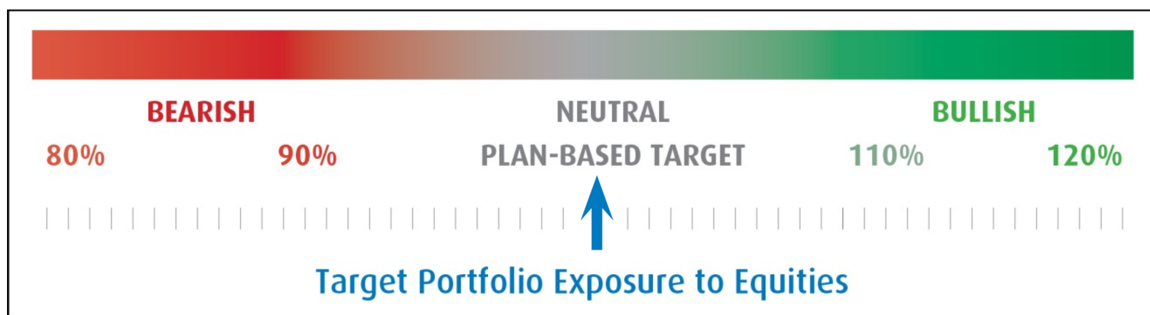
- In addition to the continued evolution of the COVID-19 pandemic, the uncertainty created by the pending presidential election, as well as its eventual result will have implications on certain industrial sectors and possibly market valuations more broadly. This will need to be monitored, though political considerations are rarely the primary driver of market movements – economic fundamentals are.

Above all else, our team wishes you and your family health, security, and all the very best in these trying times.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):



For example, a portfolio with a long term strategic target of 60% equity should currently be targeting an equity weight fully in line (100%) with this target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index[13]
Yield*	3.12%	2.17%
Portfolio Beta*	0.93	1.00
Number of Holdings	28	1603
Sector Allocation (Core Portfolio)		
Financial Services	25.0%	12.7%
Communication Services	7.5%	8.8%
Real Estate	5.0%	3.0%
Utilities	7.5%	3.3%
Consumer Staples	14.5%	8.1%
Consumer Discretionary	7.5%	11.0%
Healthcare	6.0%	14.1%
Information Tech.	6.0%	21.3%
Industrials	11.0%	10.1%
Energy	5.0%	3.2%
Materials	5.0%	4.3%

*As at 2020-07-31; source: Thomson ONE

Meet Our Team

Philip Brock, CFA, CFP, F.Pl., B.Com
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Philip made his entry in the financial industry in 2004, and joined BMO Nesbitt Burns as an Investment Advisor in March of 2006. Since then, Philip has advised many families on retirement planning, personal credit, and investment management. In addition to his work with clients, Philip served as Assistant Branch Manager for the Ottawa Dalhousie/Lansdowne branch of BMO Nesbitt Burns between 2014 and 2019.

Philip holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007, and has held the *Institut Québécois de planification financière*'s F.Pl. designation since 2015. Philip is happy to offer his services in English, French, or Spanish.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He calls Orléans home along with his wife Kathleen and their young sons, David, Jonathan and Nicolas. When he's not providing financial advice to his clients, he and his family can usually be found on the ski hill or off in the woods on a canoe/camping trip.

Patricia Butler, B.A.
Associate Investment Advisor
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Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing soccer and golf and spending time with her husband and two children.

Clara Augustine, BBA
Administrative Assistant
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Clara has over 13 years of experience in Business Administration and Sales Management. She received her BBA from the University of New Brunswick in 2009, subsequently beginning her career in the financial services industry. Clara worked with several BMO Bank of Montreal branches in a management capacity, joining BMO Nesbitt Burns in 2018. She works closely with each member of the Cosgrove-Brock Group to ensure your administrative needs are met seamlessly in the pursuit of your investment goals, and is pleased to offer her assistance in either English or French.

Clara was raised on the East Coast, and now calls Kingston, Nova Scotia home, where she lives with her husband and their young children. In her spare time, she is passionate about fitness, and enjoys cooking, writing, playing music and travelling with her family.

[1, 2, 3] Thomson One

[4] Bellusci, Michael, *Investors Flee Canada's Stock Market on Worst Day in 80 Years*, Bloomberg, March 12 2020

[5] Porter, Douglas, *BMO Economics EconoFacts: Canadian Jobs Climbing out of the Canyon*, BMO Capital Markets Economics, July 10 2020

[6] WHO Coronavirus Disease (COVID-19) Dashboard, July 31 2020, covid19.who.int

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[8] Dua, André, Jain, Neha, Mahajan, Deepa, Velasco, Yohann, *COVID-19's effect on jobs at small businesses in the United States*, McKinsey & Company, May 5 2020.

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[10] Kantrowitz, Michael, *2nd Half 2020 Outlook: Stick with Quality, Growth & a Little Bit of Defense*, Cornerstone Macro, July 14 2020.

[11] Walker, Andrew, *US oil prices turn negative as demand dries up*, BBC News, April 21 2020.

[12] Belski, Brian, *US Strategy Snapshot: US Presidential Elections and Stock Market Performance*, BMO Capital Markets, July 30 2020.

[13] MSCI World Index, MSCI Inc, www.msci.com

[14] Profiles for GOOGL, AMZN, BCE, CP, WN, INE, IFC, MFC, MCD, MSFT, BNS, SU, TRP, WMT and WCN replicated from the BMO Capital Markets RED Sheet, August 2 2020

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