Achieving **Liftoff**

BMO Private Wealth

BROCK & PAPUTSAKIS Wealth Management

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Philip's Comments

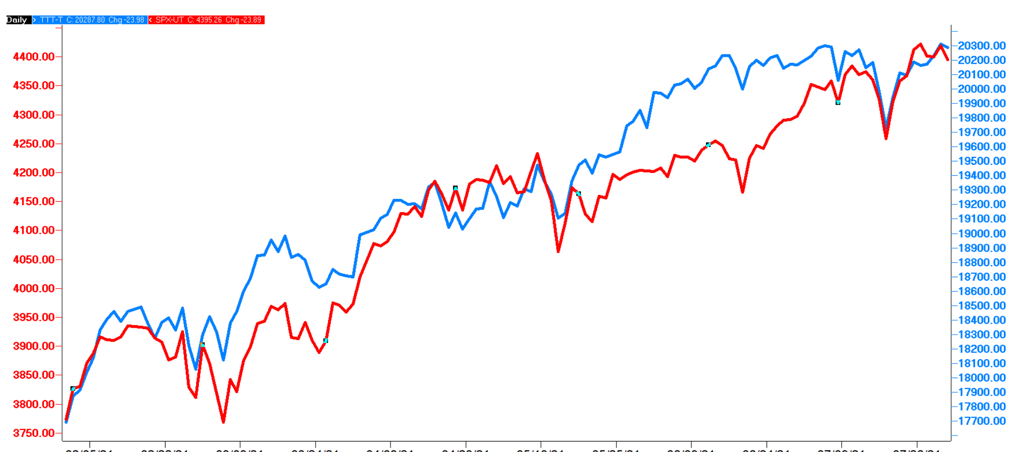
One of my most vivid memories of the COVID-19 pandemic (so far) was watching, with my three young sons, the May 2020 SpaceX demonstration flight of Bob Behnken and Doug Hurley, propelled into space atop the Falcon 9 rocket. It marked the first time in almost a decade that humans have made it to orbit from a launch location in the western hemisphere, a feat not achieved since the end of NASA's Space Shuttle Program in 2011.

We did not know the length of the road before us at the time – May 2020 marked only the beginning of the road to economic recovery after the lows that had been achieved barely two months prior – but I recall that the combination of spring weather, improving market conditions, and the spectacle of this significant human achievement filled me with hope after a long winter, and the excitement on my sons' faces made the feeling all the more poignant.

Since then, there have been many other launches – not only from SpaceX, but also originating from China's Shenzhou space program, as well as the more recent space-tourism efforts from Virgin Galactic and Blue Origin. While I think that it is perfectly normal for the images of Richard Branson and Jeff Bezos floating around aboard their billionaire pet-projects to lead to at least as many pangs of cynicism as they do to feelings of wonder, there is no debating that all throughout this pandemic period, the renewed push towards orbit has been a steady counterpoint to the virus' progression.

Since the publication of our last newsletter, titled *On Balance*, the market's trajectory has been clear, and almost as vertical as the launch of a spacecraft. For the period from February 1st to July 30th, the US market advanced by a staggering 17.8%, followed closely by the Canadian stock market's own remarkable increase of 15.7% - both markets achieving all-time highs during the period (see Figure 1)[1].

*Figure 1: **S&P 500** & **S&P/TSX Composite Index** (February 1 2021 – July 31 2021)*



Source: Thomson ONE

Our Loonie has certainly not been stagnant in the last six months, despite its modest 2.5% gain over the period, which at one point registered as a 6.2% gain when, in early June, the Canadian Dollar closed above 83 cents USD. Unsurprisingly, part of the upward pressure on our dollar has been the surging price of oil, with light crude oil currently priced 42.2% higher than its opening price on February 1st (see Figure 2)[2]. The dollar's recent retracement can be linked to shifting projections around the relative timing of Canadian and US interest rate increases[3].

*Figure 2: **Oil (Light Crude)** & **Canadian Dollar (CAD/USD)** (February 1 2021 – July 31 2021)*

Source: Thomson ONE

In *Achieving Liftoff*, our seventeenth semi-annual newsletter, we will comment on the recent upward trajectory of markets as well as the various elements that have provided markets their thrust. These elements should continue to fuel the markets' ascent, and include continued strength in the corporate sector and a robust and increasingly healthy consumer continuing to support global economic growth. To continue our metaphor, spaceflight (and the market) is not without its risks, and when dealing with large amounts of rocket fuel (or ultra-low interest rates, bond-purchase programs, and fiscal stimulus), the risk of overheating (inflation) is very real, and could still complicate our expected course.

The Market's "Boosters"

Booster #1: Corporations

Generally, the stock market is viewed by the public as an intangible reflection of the state of the economy, or more specifically a reflection of investors' view of what is to come in terms of economic growth and stability. There is truth in this: the market – not too far off from the over-simplified analogy of a local farmer's market – is simply a gathering of individuals – buyers and sellers – looking to exchange goods (stocks) for a price, and establishing that price through the dynamic process of supply and demand.

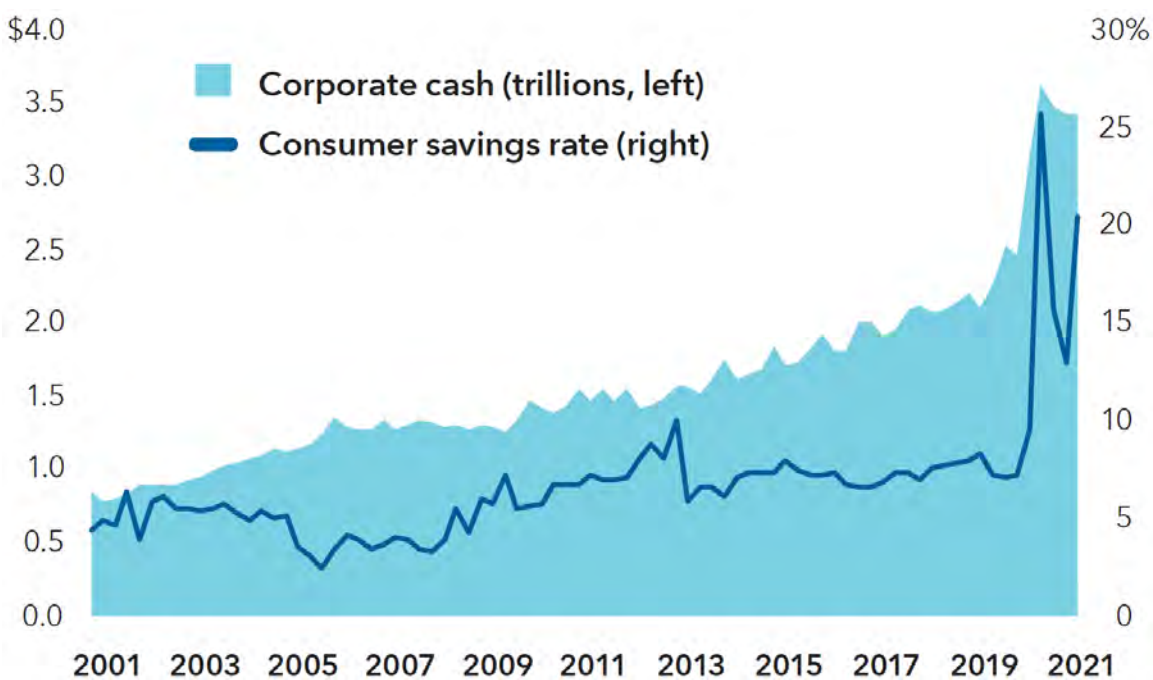
However, this view of the stock market tends to bypass the most important aspect of its nature: the market is simply a collection of corporations – actual companies – selling actual products and services to consumers. When corporations are in good health and are reporting strong earnings, we tend to see greater stability and an upward trajectory to the market itself. This is currently the case: the strength of the corporate sector is one element helping to boost the market higher.

At the time of the writing of this newsletter, corporations are in the process of releasing second quarter earnings results. The bar for this earnings season was atmospheric, with analysts expecting that earnings would beat last year's results for the same quarter by a vertigo-inducing 64%[4]. Granted, the second quarter of last year was amid the forced shut down of many economies.

So far, Model Portfolio constituents Alphabet (GOOGL)[5], McDonalds (MCD)[6], and Microsoft (MSFT)[7], have all declared profits surpassing analysts' expectations.

Beyond earnings, it is the strength of corporate balance sheets (and consumers' balance sheets as well!) that have allowed them to navigate the turbulence of the pandemic. Here, too, the news is positive, with both corporate cash holdings and consumer savings rates continuing to swell during the pandemic period (see Figure 3)[8].

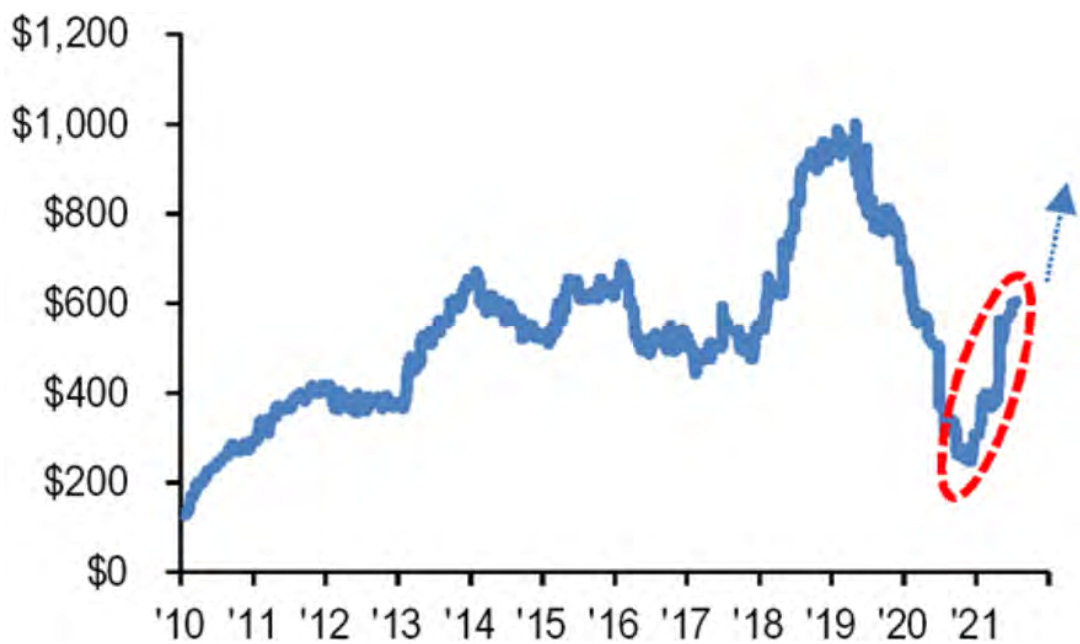
Figure 3: ***Corporate Cash (December 31 2020)*** *&* ***US Consumer Savings Rate (March 31 2021)***



Source: Capital Group, Mid-Year Outlook 2021, with files from the U.S. Bureau of Economic Analysis, U.S. Federal Reserve, & Refinitiv Datastream

In addition to the mere existence of these cash reserves on corporate balance sheets, it is the use of this cash by boards of directors that helps affirm our confidence in the current strength of the market. Boards are feeling optimistic enough to move away from pandemic-era cash hoarding and redistribute these accumulated profits to shareholders by way of dividends and share buybacks, with announcements of share buyback programs recovering significantly from the lows seen in the midst of the pandemic, when companies were using their war chests as rainy-day funds (see Figure 4)[9].

Figure 4: Rolling 12M Buyback Announcements (since 2010)



Source: J.P. Morgan US Equity Strategy & Global Quantitative Research, Bloomberg Finance L.P.

Dividend payments (which our clients tend to prefer, but which are economically equivalent to share buybacks) are also seeing a rebound with over 30% of companies that cut their dividends during 2020 already having reinstated them, as of May 31st of this year[10].

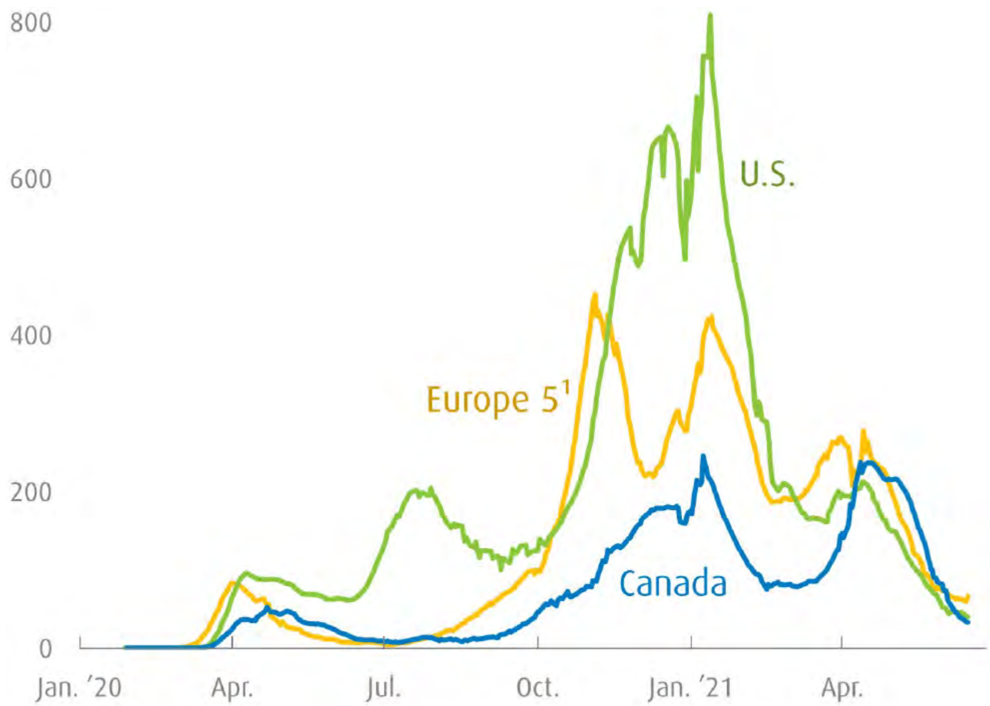
Beyond the stuffiness of virtual corporate boardrooms, on-the-ground company managers are also demonstrating optimism, with the June survey of US purchasing managers landing at a score of 60.6[11] – well above the mark of 50, which typically characterises healthy and growing commercial activity. This metric is considered a leading indicator and is thought to be predictive of future economic growth. In fact, most of the commentary in the most recent survey referenced the challenges that purchasing managers were facing in acquiring enough supply to meet demand – a phenomenon we will reference again later in this text.

<u>Booster #2: Consumers</u>

If we were not still in the midst of a global pandemic, commenting on the health of consumers would typically be referring to their confidence in the economy and in their ability to meet their financial obligations and aspirations. It still means all that, of course, but in addition to these factors we must consider another: their actual physical health.

This summer has brought some relief on the pandemic front, though not unmitigated. COVID-19 infection rates in Canada, the U.S., and Europe have declined after the perilous third wave that we encountered in the spring (see Figure 5)[12].

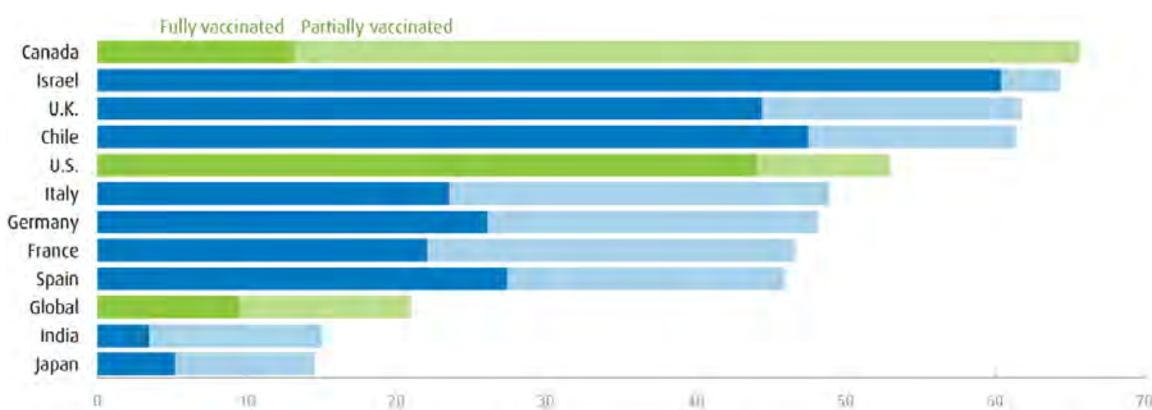
Figure 5: COVID-19 Infection Rates: Canada, the US, and Europe (France, Germany, Italy, Spain, & the U.K.) [new cases per million, 7-day moving average as at June 15th, 2021]



Source: BMO Economics, with notes from Haver Analytics & Johns Hopkins University

With moderating infection rates comes the reopening of economies around the world, and more opportunity for consumers to start spending the cash accumulated due to the elevated savings rates we saw in Figure 3. Consumers will only make use of that opportunity if they feel confident enough in the public health situation to spend their savings. Here too there are signs of hope, with vaccination rates around the world continuing to progress (though in some corners encountering challenges around vaccine hesitancy), and with Canada finally progressing at a rapid pace down the road to a vaccinated population (see Figure 6)[13].

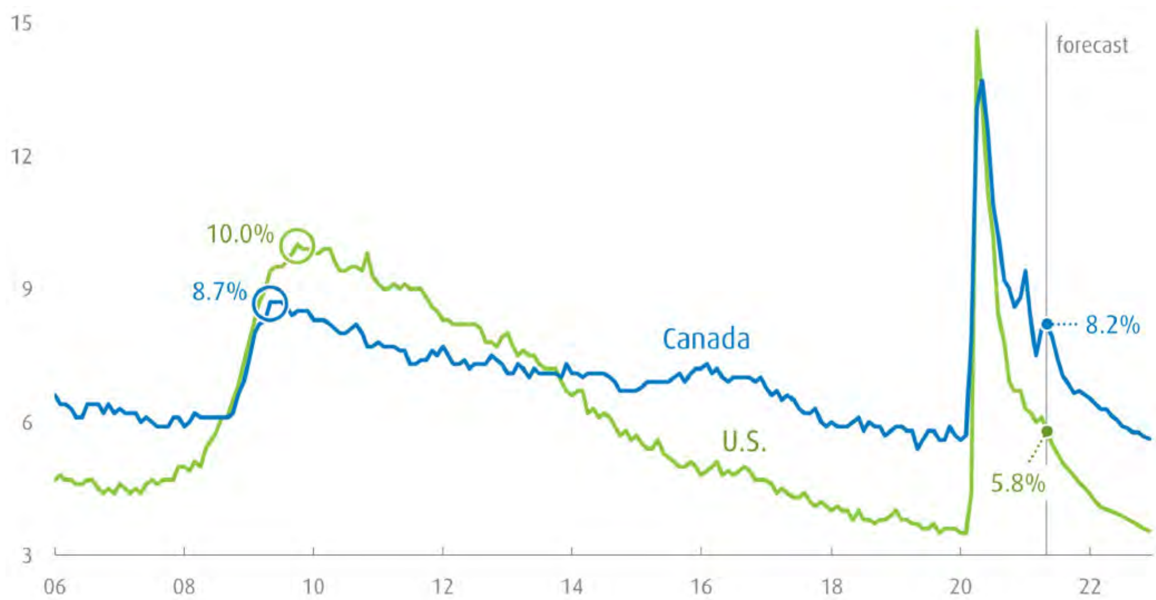
Figure 6: COVID-19 Vaccination Rates (% of population, as at June 14th, 2021)



Source: BMO Economics, with notes from the United Nations – Our World in Data

It has been our view that a vaccinated population is a confident population, and recent consumer confidence numbers tend to support this. The July reading of the Conference Board's consumer confidence index was the sixth in a series of ever-improving reports and measured at the highest level since before the pandemic[14]. On employment in particular, this report is characterized by the highest percentage of respondents in over 20 years indicating that "jobs remain plentiful", even though steadily improving unemployment rates have more ground to cover in order to achieve their pre-pandemic levels (see Figure 7)[15].

Figure 7: Unemployment rates (percent) for Canada and the U.S.



Source: BMO Economics, with notes from Haver Analytics

The upward thrust to corporate earnings caused by a confident, employed, and cash-rich consumer is a very powerful force, and one that should help break-through the gravitational pull of the virus. The progress we have seen in recent months against the pandemic has been fueled no doubt by seasonal effects (let's remember that the summer of 2020 was also a time of low case-counts in Canada) as well as a population willing to embrace vaccination as our best weapon against the virus, but it has not been without caveats. At the time of the writing of this newsletter there are serious concerns about the spread of the delta variant of the disease. If these concerns lead to a drop in consumer confidence or, even worse, a slowing or a reversal of the economic reopening process, markets will undoubtedly respond poorly.

"Houston, we have a problem"

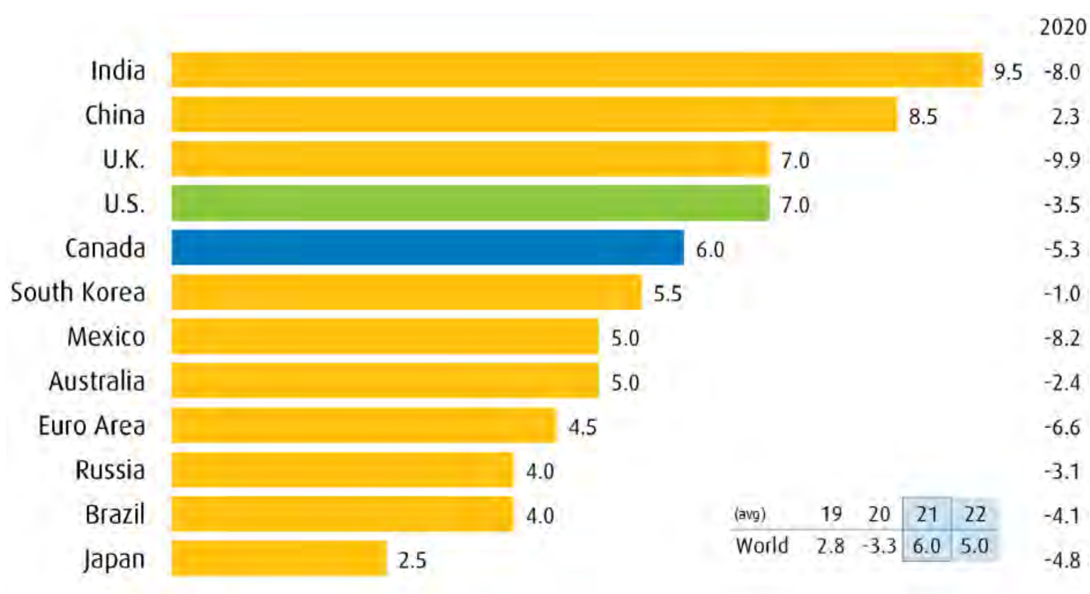
- *Paraphrased from Jack Swigert, Apollo 13 astronaut, NASA*

As the crew of Apollo 13 quickly learned, when in space, not all goes according to plan. It should not be surprising to anyone that the historic experiment that was the complete shutdown of the economy, followed by its gradual reopening, should be accompanied by significant market volatility. The delta variant, mentioned above, is but one of many potential sources of volatility.

Maintaining enough economic rocket-fuel in the form of fiscal and monetary stimulus to achieve a full recovery without overheating the economy and causing inflation is a delicate balancing act that central bankers and policymakers are contending with day-by-day.

As we know the policy response to the pandemic was swift, prompting central banks to use two main elements of their toolkit in reaction to the unfolding economic chaos caused by the economic shutdowns: lower interest rates and quantitative easing, taking the form of bond purchase programs in many ways similar to those that were implemented in the aftermath of the 2008 financial crisis. In coordination with central banks, governments around the world brought their own solutions to the table: using fiscal policy in the form of tax cuts and deferrals, direct payments, and other spending programs. These policies have been credited with at least maintaining the stability of the financial system over this period, and likely contributing to the swift recovery in economic growth that most countries have seen over the last 16 months (see Figure 8)[16].

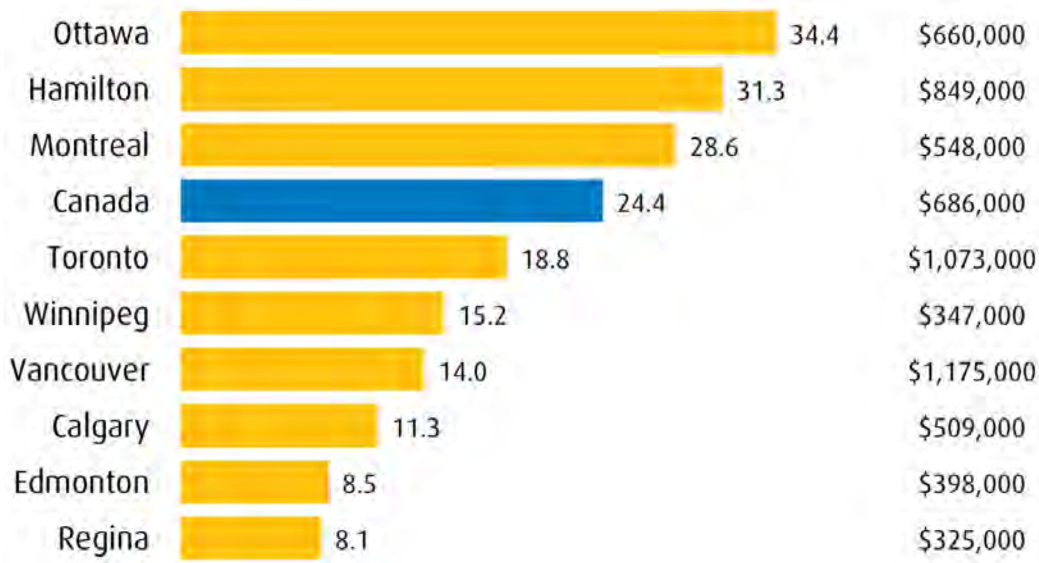
Figure 8: 2021 Forecasted real GDP rates (% change)



Source: BMO Economics, with notes from Haver Analytics

Along with the impressive levels of global economic growth we have seen since the COVID recovery began, we have also seen price levels increase. Central banks have been admirably patient in the face of the onset of inflation; the US Federal Reserve went as far as adjusting its policy framework to allow inflation to track well above its traditional target of 2% for an extended period[17]. The general view is that the inflation that we have been subjected to has been of a "transitory" nature and is not necessarily indicative of a longer-term problem. There is no denying that in certain sectors we have seen increased prices due to disruptions in supply chains, some of which were related to the pandemic. This is the case with the current global shortage in semi-conductors[18], causing supply issues and increased prices in all manner of end-use products, from graphics cards and computer processors to automobiles and even some home appliances. We have also seen inflation of a different sort with the upward pressure on asset prices comingling with an increasingly mobile and home-based workforce to cause very rapid increases in house prices all over the world – Canada included (see Figure 9)[19].

Figure 9: Existing home prices year-over-year change & average home prices – Canada (May 2021)



Source: BMO Economics, with notes from Haver Analytics

These effects have also been seen in the markets for lumber (as anyone who has tried to buy a 2 x 4 knows all too well) and used cars.

Inflation brings a double risk for financial markets:

1. Inflation itself cheapens the future cashflows that corporations hope to earn. From a pure-finance perspective, the value of a stock is simply the present-value of its future cashflows, discounted at an appropriate rate to account for the riskiness of these cashflows. Higher inflation devalues these future cashflows and should therefore have a directly negative impact on the price of securities. It also has the very real effect of gradually eroding our standard of living.

2. Inflation's natural antidote – interest rate increases – carries its own negative side effect, as by definition rising rates lead to slower economic growth and higher unemployment. From the investor's standpoint, rate increases will also have the effect of wreaking havoc on the fixed income side of the portfolio, with bonds being susceptible to devaluation as rates gradually rise.

So, what are policy makers to do? Move too quickly to curtail bond purchase programs and increase interest rates, and they run the risk of stopping the economic recovery in its tracks, before unemployment rates have had a chance to fully recover. Ignore the detrimental effects of inflation for too long and it can become an engrained aspect of our economic reality, negatively impacting our lives in ways well-remembered by those who lived through the turbulent economies of the 1970s and 1980s.

The inflation we have seen is likely a classic disequilibrium in supply and demand: with the damaged post-COVID supply-chain meeting up with strong demand fuelled by cash-laden, economically stimulated consumers. There is good reason to believe that as the supply chain corrects itself, which suppliers will want to ensure, and as the extra stimulus measures begin to expire or wear off, which is already occurring, prices will find their equilibrium point once more. Chair Powell feels the same way, stating to reporters in June that "Our expectation is that these high inflation readings that we are seeing now will start to abate."[20]

Portfolio Strategy: It isn't rocket science

Now that we have reviewed the 30,000 foot-view, it may be useful to bring things back down to Earth, and to comment on the more tangible elements of portfolio strategy.

In our last newsletter, *On Balance*, we emphasised that in the current environment, sticking closely to one's target asset allocation is appropriate, as the risks that exist in the market currently (inflation, new waves of virus) seem fairly balanced against the momentum generated by the global economic reopening.

From a fixed-income standpoint, we remain convinced that a strategy centred on active bond management remains effective: ensuring that we have a qualified pilot guiding us through this very difficult market for bonds. Pairing this central, active approach with passively built short-term and floating rate elements helps ensure a defensive posture against the inevitable increase in interest rates that will result from the higher-inflation backdrop.

For equities, the goal is to reduce volatility by focusing on proper diversification of industrial sectors and ensuring that every company carrying the flag for their sector is a quality business which is a leader in its field. Diversification and quality – really it isn't rocket science! With this in mind, we have made some changes to our model portfolio, parting ways with companies that we no longer felt met this criteria, such as Vermilion Energy (VET) and Chemtrade (CHE.UN), and replacing them with holdings which we feel have stronger winds at their backs: Boralex (BLX) and Air Products & Chemicals (APD). We have also made a more lateral move in the Canadian grocery space which we feel can yield better growth: substituting our holdings in George Weston (WN) with a new position in Metro Inc (MRU).

All systems are nominal and indicator lights are green; the post-COVID economy is taking off. For the sake of everyone onboard, let us hope for a smooth voyage.

Conclusion

The characteristics of the post-COVID economy are beginning to take shape, even though the pandemic may not be quite done with us yet. As always, vigilance and investment discipline will be the keys to success.

- The strength of corporate earnings and balance sheets, and the optimistic behaviour of corporates boards (dividend increases, share buybacks) is helping to fuel the current ascent of the market.

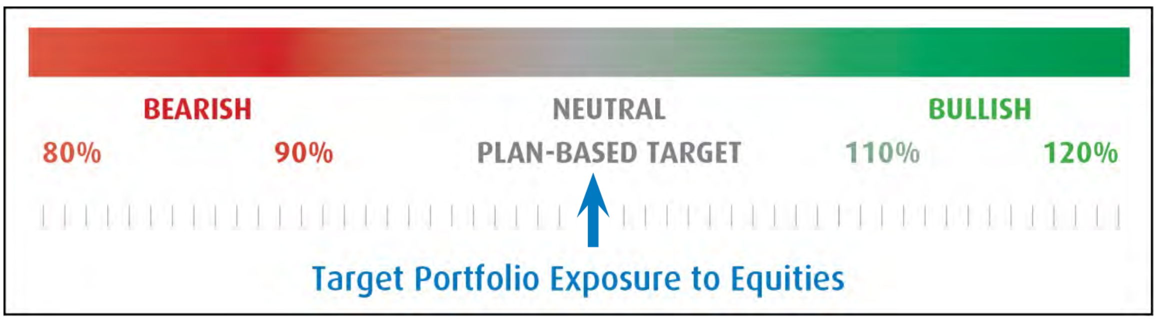
- An increasingly healthy, vaccinated, confident and employed consumer is helping to provide the market with a robust second stage to the ongoing recovery and is helping provide lift to the market.

- Disciplined portfolio management, both in terms of equity selection and fixed income strategy, will be needed if we are to avoid some of the potential problems on the horizon, including new waves and variants of the virus, and the inflationary pressures caused by monetary and fiscal stimulus and continued supply-chain disruptions.

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[21]
Yield*	2.43%	1.65%
Portfolio Beta*	0.90	1.00
Number of Holdings	27	1563

Sector Allocation (Core Portfolio)		
Financial Services	25.0%	13.6%
Real Estate	5.0%	2.7%
Communication Services	7.5%	9.1%
Utilities	8.3%	2.7%
Consumer Staples	14.5%	7.1%
Consumer Discretionary	7.5%	12.0%
Healthcare	6.0%	12.5%
Information Tech.	6.0%	22.1%
Industrials	11.0%	10.6%
Energy	4.3%	3.2%
Materials	5.0%	4.4%

*As at 2021-07-31; 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 and French.

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.

Pierre Paputsakis, PFP
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Pierre has been an investment advisor with BMO Nesbitt Burns since 1999. During his career, Pierre has developed a well-deserved reputation for honesty, integrity and professionalism while working with his clients. Pierre brings a high level of energy to the team as well a genuine desire to help clients effectively manage their wealth. His keen analysis and disciplined approach keep him abreast of relevant issues. Fluently bilingual, Pierre is happy to serve his clients in both official languages.

Born in Montreal, Pierre has lived in the National Capital Region since 1999. Pierre currently resides in Rockland along with his wife Mindy and their son Zachary and daughter Trista. In his spare time, he can usually be found on the golf course or in hockey rinks.

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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 golf and spending time with her husband and two children.

Clara Augustine, BBA
Investment Representative
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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 team 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.

Diane Clark
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Originally from Montreal, Diane has over 30 years of experience in the financial service industry. In 2015 she rejoined BMO Nesbitt Burns following a tour overseas with her military spouse. She brings excellent organizational and communication skills to the team. Diane is responsible for administration and provides superior customer service to our clients. She is pleased to offer her assistance in English and French.

Having lived in a number of countries, Diane currently resides in Ottawa with her husband and has two grown children. In her spare time, she enjoys travelling, kayaking and hiking.

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Megan entered the financial services industry in 2016, completing her Canadian Securities Course (CSC) and Conduct and Practices Handbook course (CPH) to become a licensed investment representative. Megan earned her DEC from CEGEP Heritage College in 2013 and was a Dean's List graduate of St. Francis Xavier University's BBA degree with a focus in Leadership in Management. Before BMO Nesbitt Burns, Megan's career was in hospitality with five years of experience in front office operations in hotels of varying size – this positioned Megan to excel in providing a high level of client service and professional communication. She is dedicated to fostering strong client relationships and trust, as well as careful attention to detail – she is pleased to offer assistance in English and French.

Megan was born and raised in Gatineau, lived in Nova Scotia for University, and is now settled in Ottawa. In her spare time, she enjoys walking her Chihuahua by the Rideau River, reading, playing the ukulele, and has a passion for cooking.

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