On Balance

BMO Private Wealth

BROCK & PAPUTSAKIS Wealth Management

Table of Contents

- The Economy and Review of the Markets
  - Philip's Comments
  - Conclusion
- Recommendations
  - Asset Allocation
  - Model Portfolio
  - Model Portfolio Metrics
  - Changes Since Last Issue
- Selected Portfolio Component Profiles

Philip’s Comments

I would like to take a moment before providing our usual commentary to say “welcome” to a new group of readers. As most of you know by now, in early December my long-time colleague, Pierre Paputsakis, and I announced to our respective clients the creation of “Brock & Paputsakis Wealth Management”, combining our practices within BMO Nesbitt Burns and pooling our resources in the hopes of providing the very best client experience possible.

As this will be the first time that many of Pierre’s clients receive this publication, I thought it would be best to take a moment to provide some context.

This is the sixteenth edition of a newsletter that I began writing every six months, starting in the summer of 2013. At that time, this newsletter was also written as a collaboration of two Investment Advisors: myself and Elizabeth Cosgrove, who retired one year ago after a long and successful career. It was meant as a way for us to regularly express our viewpoint on the markets, the economy, and world events, and to translate that viewpoint into advice on the management of an investment portfolio for clients.

For new readers, allow me to give you a brief tour of this document, and what you can expect:

- This first section is meant to provide you with broad commentary on current market-related events, and our view on what we may expect going forward. These are the thoughts of your advisors, researched and inspired from many different sources, including some internal resources like BMO Capital Markets and BMO Nesbitt Burns’ Portfolio Advisory Team, but also outside sources, all of which we appropriately cite at the end of the document.

- At the heart of the newsletter, after this commentary, you will find a recommendation on what asset allocation we feel is appropriate given the current context. Every investor’s target asset allocation is personal, and should be established on the basis of a financial planning exercise, or at least a thorough analysis of their risk tolerance. But once the target is established, markets may provide us with increased risks or increased opportunities, and from time to time it may be appropriate to nudge our asset allocation a little more towards equities, or a little more towards cash and fixed income investments. As such, the sliding scale on the page titled “Asset Allocation” provides our view as to whether one should currently be right on target, slightly more aggressive, or slightly more conservative.

- Following the asset allocation section, readers will find our Model Portfolio, followed by some metrics pertaining to the Model and a summary of changes we have instituted since the publication of the last Newsletter. This Model is meant to represent what we feel the “equities” side of a client’s portfolio should look like. For example, if a client’s target asset allocation is 60% stocks and 40%

fixed income, we would suggest that 60% of the client's assets be aligned as closely as possible to the Model.

- The final section of this newsletter provides more in-depth information on some (but usually not all) of the stocks held in the Model Portfolio. This section is sourced directly from research provided by BMO Capital Markets.

I hope you enjoy the contents of this newsletter, and that you find this information helpful. As always, we welcome any questions you may have, and Pierre and I look forward to discussing with you various ways to practically apply the information in this newsletter in the coming weeks and months.

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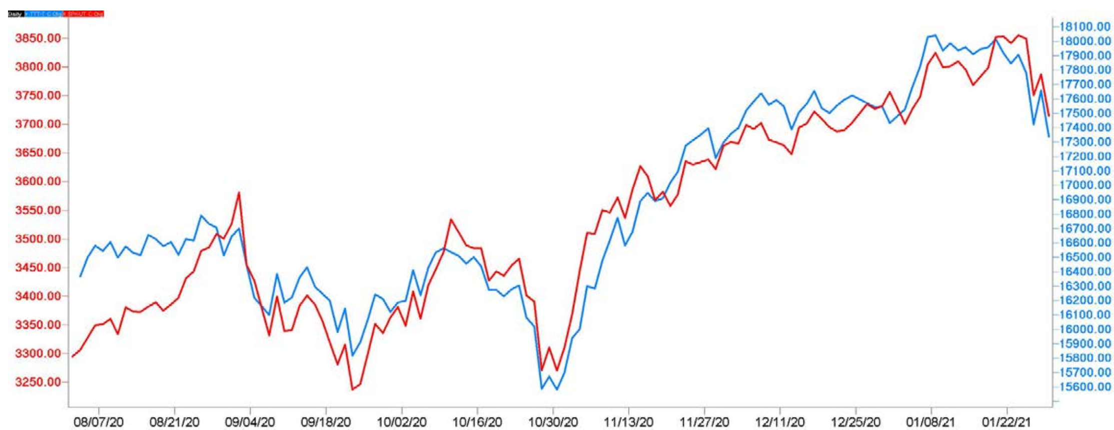
In the time that has passed since the publication of our last newsletter, titled *An Economy Gone Viral*, stocks have continued their recovery from the lows set in March of 2020. Between the 1st of August 2020 and the end of January 2021, the S&P/TSX Composite Index advanced by over 7%, whereas the S&P500, buoyed by its exposure to the explosive technology-related sectors, advanced by 13% (see Figure 1)[1]. Both indices hit all-time highs in January before retreating in the last week of the month.

Figure 1: ***S&P500*** *&* ***S&P/TSX Composite Index*** *(August 1 2020 – January 29 2021)*

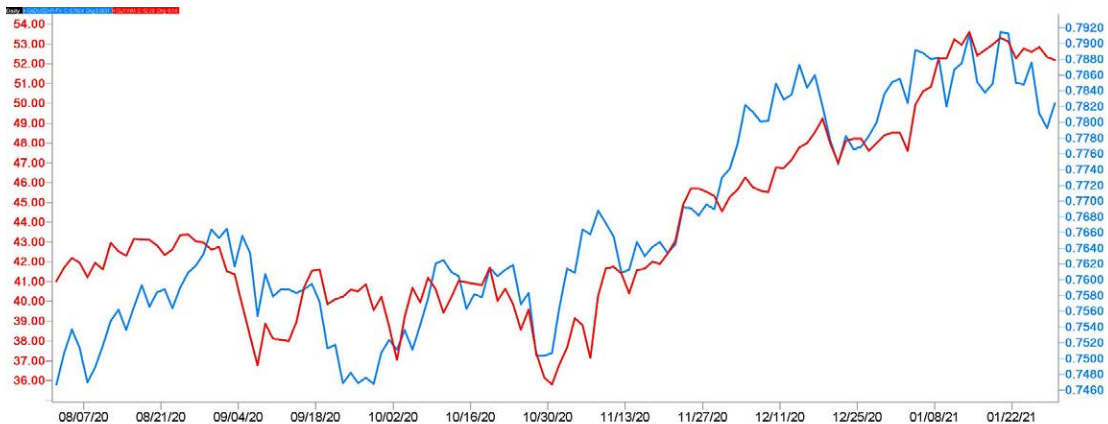


Source: Thomson ONE

Despite the impressive milestone of temporarily achieving a new all-time high, Canadian markets still closed the month at levels below their pre-pandemic highs from February of last year, whereas US markets have risen about 10% higher than pre-pandemic levels. The ascent has seemed greater because we had to climb out from the March 23rd low point.

The Canadian dollar has also gained some ground since August, rising 5% in six months, causing a headwind for any USD deposits held when evaluated in Canadian dollar terms. Our dollar is known for its link to the price of oil and that relationship has held firm over the last six months, with even stronger gains in the price of the light crude contract (see Figure 2)[2].

*Figure 2: **Oil (Light Crude)** & **Canadian Dollar (CAD/USD)** (August 1 2020 – January 29 2021)*



Source: Thomson ONE

Of course, this is also earnings season, with companies reporting their fourth quarter, and therefore final, full-year 2020 results. BMO Capital Markets entered into earnings season expecting a 7% decline from Q4 results from a year ago[3] (which only sounds bad until you remember that Q4 a year ago ended on December 31st 2019, when we were all blissfully ignorant of COVID-19). At the time of writing this newsletter, a number of model portfolio constituents had reported earnings, including Proctor & Gamble[4], Johnson & Johnson[5], and Microsoft[6] – all three of them beating analyst estimates. It is too early to draw any final conclusions on this earnings season but so far there is no evidence of corporate profitability weakening.

On Balance, our winter 2021 newsletter, will make the case that equities should still provide investors with the best outcomes. There are, however, "pockets" of market overvaluation (bubble behavior) that concern us. In the following sections, we will illustrate the opportunity for equity holdings overall, as well as highlight the risks that these "pockets of irrational exuberance" represent. Avoiding herd behavior when selecting our investments is, in a market like this one, one way to ensure that our portfolio remains properly balanced.

The Right Conditions

Our assessment leads us to the conclusion that current conditions are still very supportive of strong equity markets, overall. We recognize that the state of society these days, with populations under lockdown, unemployment high, and private enterprise suffering, seems to contradict this sense of optimism, but we must remember that markets don't live in the past, or even the present. The market looks ahead; focused on conditions it expects to see months from now.

Condition #1: Fiscal and monetary "overdrive"

It is well known that as the COVID-19 pandemic was emerging and in the midst of the violent market reaction that followed, policy-makers intervened in an attempt to avoid the starkest potential economic outcomes. In Canada, this took the form of coordinated

action from the Bank of Canada and the Department of Finance. A series of joint appearances[7] with then-Finance Minister Morneau, and then-Bank of Canada Governor Poloz, announced various measures to ensure the deferral of taxes, to support small businesses, to lower the Bank of Canada's key lending rate to 0.25%, to launch a commercial paper purchase program, and other forms of "quantitative easing" to ensure that short-term lending markets remained healthy. Put another way, Canadian policy-makers took an "all-hands-on-deck" approach to combating the economic fallout of the pandemic.

In the United States, we saw similar actions taken, including a $2-trillion USD fiscal stimulus package[8], which provided for direct payments to individuals (called "helicopter money" because it is the fiscal policy equivalent of dropping money from the sky), enhancement of existing unemployment programs, and a sizable package of loans to small businesses and directly-impacted industries. The US Federal Reserve was also active, with a series of actions on March 15th, including cutting the Fed Funds Rate to zero, and restarting a $700 billion USD quantitative easing program similar to the one that had been used to great effect during the financial crisis of 2008[9].

These measures helped ensure that what was clearly a public health crisis, and would almost unavoidably be an economic crisis, did not also devolve into a financial crisis and risk the very stability of the global financial system as had been seen in 2008.

So it is clear that when we think about what conditions are supportive of further growth in the stock market, the fact that all fiscal and monetary levers are set to "overdrive" is high on the list. But it is the announcement[10] by the US Federal Reserve in August of last year that they would change their way of perceiving the inflation target that really underscores just how supportive these conditions are. The US Federal Reserve has long seen itself as having two mandates; for over forty years, it has been the twin objectives of full employment and price stability that have guided it. By price stability, this meant making sure inflation didn't surpass 2%. In August, the Federal Reserve amended that target to "an average" of 2%. This meant that, when appropriate, the US Fed would delay raising interest rates even if inflation was running hotter than 2%, in support of its full employment mandate, so long as the longer-term average inflation rate stayed around 2%. The bottom line is that there is very strong evidence to believe that we can expect interest rates to remain low for a long time – longer than if the 2% inflation target was still seen as a ceiling.

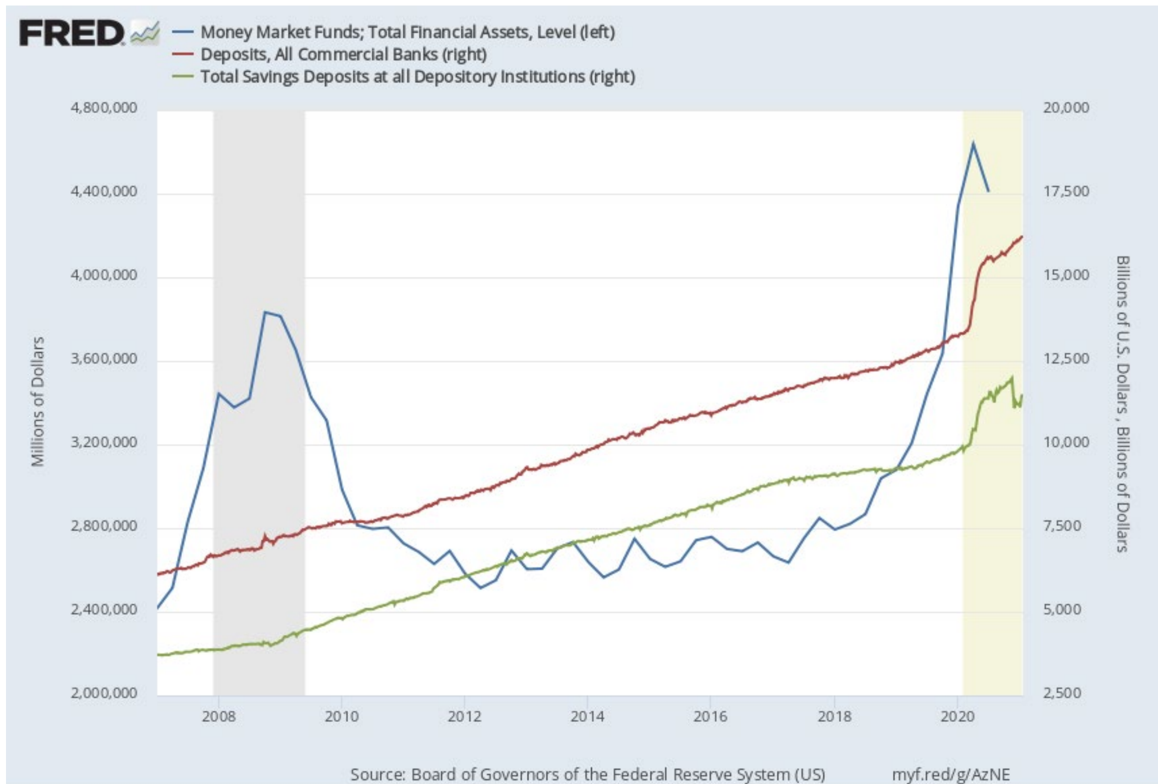
Couple this "lower for longer" stance by the US central bank with the current negotiations in Washington over a second round of fiscal stimulus[11], proposed at $1.9 trillion USD and now made more likely by the Democratic sweep of the presidency and both chambers of Congress, and the conditions are right for a period of strong economic growth – so long as the pandemic can be brought under control.

<u>Condition #2: Dry gunpowder</u>

The second condition that we judge to be supportive of strong equity markets is the sheer quantity of funds that are ready to either bolster future consumption once the pandemic is over (and therefore fuel economic growth), or be invested in equity markets along the way. While the pandemic has certainly caused high rates of unemployment worldwide, those consumers that are employed have seen their options for spending money forcibly

reduced, with travel, dining, and leisure options all curtailed by sensible health restrictions like social distancing, border-closures, and isolating at home. Coupled with a rush in March to build up cash reserves for the pandemic that was to come, this change in consumption patterns has led to a significant jump in bank deposits and money market investments (see Figure 3). The chart below shows two interesting points in particular – first, the "jump" in bank and depository institutions' balances starting in March of 2020 and second, the fact that money market balances haven't been this high since the financial crisis of 2008, which was followed by the longest bull market for stocks in the history of the world between March of 2009 and February of 2020.

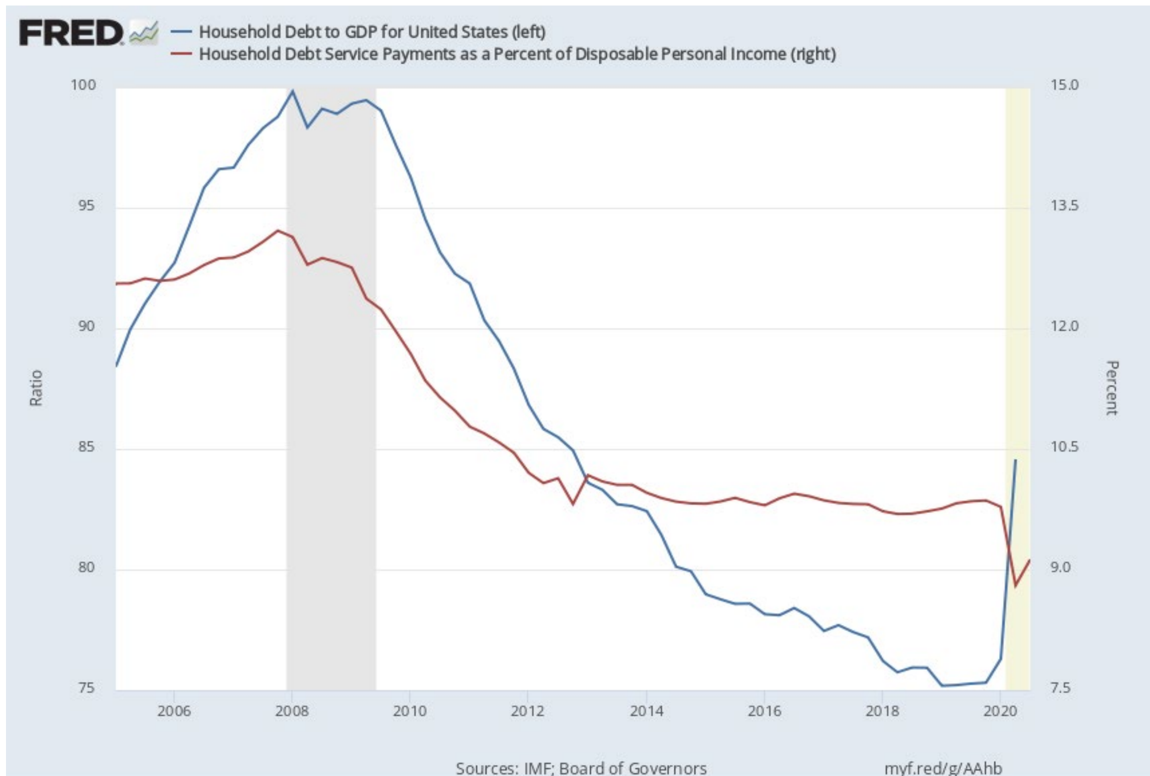
*Figure 3: **US Bank Deposits & Money Market Fund Balances** (January 1 2007 – December 31 2020)*



Source: Board of Governors of the Federal Reserve System (St. Louis Fed)

It is true that high bank deposits and money market instruments could be used for consumer debt repayment but this is not likely to be the case so long as interest rates stay as low as they are, and we've already spoken about the likelihood of the Federal Reserve maintaining the current low-rate setup for some time to come, given its increased tolerance of inflation. In fact, US households are paying only very little in debt-service given the modest rates of interest; the jump last year in the US Debt-to-GDP ratio is more likely due to artificially-low GDP caused by the shutdown of the US economy than an increase in consumer debt (see Figure 4).

Figure 4: ***US Household Debt to GDP* & *Household Debt Service Payments as a % of Disposable Income*** *(January 1 2005 – July 1 2020)*



Source: Board of Governors of the Federal Reserve System (St. Louis Fed)

Put another way: investors already have cash; fixed income investments are paying very little due to lower interest rates; and indebtedness doesn't seem to be a problem for the moment. It is only logical that over time, and with the gradual resolution of the pandemic, this cash is the "dry gunpowder" that will either be spent – which is positive for stocks as it will support corporate earnings growth – or invested – which is positive for stocks as funds flow into the market.

Once again, just like condition #1, the resolution of the pandemic is critical.

Condition #3: Confidence vs. contagion

One common thread of the two conditions mentioned above is that we need to gradually emerge from this pandemic. Monetary policy and fiscal policy can help, and consumers can be flush with cash and ready to spend, but that consumption and the positive market effects that would follow cannot happen if we are still restrained in our spending choices and our mobility.

Many experts believe that COVID-19 and its variants are here to stay[12], and that society will need to adapt to a certain low-hum of cases on a chronic basis. But epidemiologists also believe that if we can ensure that a sufficiently high proportion of the population is vaccinated, and that the vaccines are sufficiently effective against most strains of the disease, then we can return to a version of our lives that very much resembles how we lived before the pandemic.

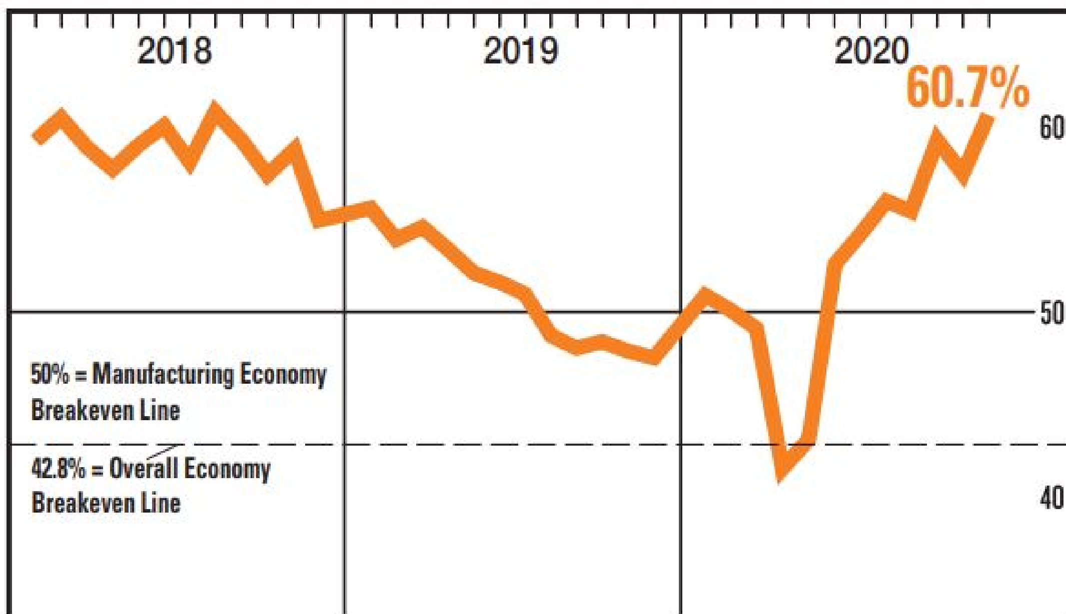
This leads to the conclusion that the supply of vaccines and the rate of distribution of the vaccines are now economic metrics as well as public heath metrics.

There are challenges in supply and distribution, but the news we have received on the vaccine front in the last six months is generally positive. Two vaccines, one by Pfizer, and one by Moderna, are currently being used extensively and have been proven to be very effective against the virus. A third vaccine, from Johnson & Johnson, is close to being the next weapon in this fight. Some indications point to a slightly lower rate of effectiveness compared to the two other vaccines. However, given its lack of need for special refrigeration, and the fact that it is administered in one dose instead of two, it may also play a key role in the end of the pandemic. All agree that the speed of the development of these vaccines has been record-setting. The actual rate of inoculation, but also our *expectations* of inoculation will be factors in how fast the economy recovers from the pandemic.

We have been seeing evidence of this in consumer sentiment, as measured by the Conference Board's consumer confidence index, which posted in January its first increase since October[13], and notably which posted strong "future expectation" figures – basically an acknowledgement that consumers feel their present situation is difficult (I hear you!) but that the future is likely to improve as populations are inoculated.

Another measure of confidence in the future and a good leading indicator of economic activity is the Institute for Supply Management's Manufacturing Purchasing Manager's Index (PMI)[14]. In this measure of confidence among manufacturers, upward movement is good, and an overall level above 50 is also good. Manufacturing PMIs had been falling as the last bull market grew long-in-the-tooth in late 2019 and early 2020, and of course it cratered in March of 2020. But as economic activity has begun anew, we've been seeing positive numbers from this indicator (see Figure 5).

Figure 5: ***Institute for Supply Management Manufacturing PMI*** *(January 1 2018 – December 31 2020)*



Source: Institute for Supply Management, Report on Business, Timothy R. Fiore

In summary, confidence among consumers is low but improving, and confidence is steadily gaining ground among manufacturers. This, in combination with the fiscal and monetary policy efforts underway (Condition #1) and the financial strength of the consumer (Condition #2) leads us to the conclusion that, *On Balance*, corporate earnings and equity prices are likely to stay on an upward path for now.

Pockets of "Irrational Exuberance"

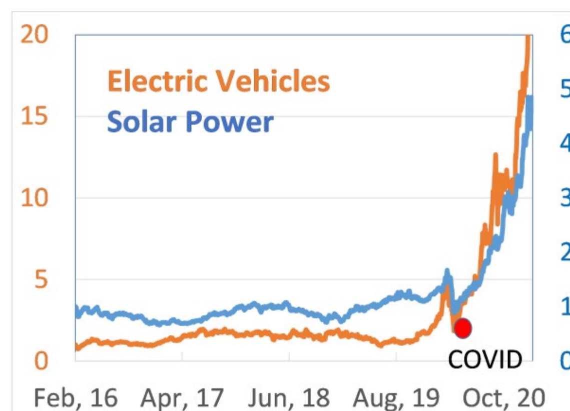
> *"There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again."*
>
> \- Attributed to Jesse Lauriston Livermore, prior to 1923

> *"But how do we know when irrational exuberance has unduly escalated asset values [...]?"*
>
> \- Alan Greenspan, 1996

While we continue to feel generally positive about the prospects for investments in stocks, this optimism is tempered by a need, now more than ever before, to ensure that individual holdings and industrial sectors are held in the proper balance.

Livermore's quote above reminds us that we are working with the benefit of hindsight; we don't need to re-learn the lessons of the past. There are sectors in today's market that are displaying very familiar characteristics of drastic overvaluation. These pockets of "irrational exuberance" – a phrase coined by the former Chairman of the US Federal Reserve, Alan Greenspan, in the years leading up to the bursting of the first tech bubble – should be avoided. We can find them these days in certain parts of the ever-expanding information technology sector, as well as in certain future-forward industries such as electric vehicles and renewable energy (see Figure 6)[15].

Figure 6: ***Electric Vehicles*** ***and*** ***Solar Power*** ***stock performance fits the historical profile of a bubble*** *(2016 –2020)*



Source: J.P. Morgan Quantitative and Derivatives Strategy

These are themes (technology, green energy, innovation) that we believe will dominate economic growth for years to come. But that belief is not sufficient to justify investing in companies in these fields at any price. Indeed, the visionary investors in "internet-based" companies in the late 1990's accurately believed that the internet would take over the world (look at us now!). They were right, but by the year 2001 only a small handful of them had anything concrete to show for their accurate futurism. The bursting of the "dot-com" bubble had much to do with the fact that valuations in these companies became completely unhinged with reality.

The recovery in stocks since the pandemic lows of March 2020 has not been even-handed. In our last newsletter, *An Economy Gone Viral*, we pointed to the fact that a handful of stocks had grown to become significant pieces of the overall S&P 500. This phenomenon has continued, but in recent months has intensified among smaller, less established, less profitable (or completely unprofitable) companies.

Separate from this phenomenon, but equally concerning, are the recent social-media-fueled short-covering rallies in stocks of smaller, and generally considered "lower quality" companies.

The increased use of app-based trading, and a kind of populist fervour found in some social-media groups, has fueled some of these market distortions. We will keep our eye on these situations, but we shouldn't let them distract us from our larger view – that the conditions are right for a continued broad-based recovery in stocks. We also know that the velocity of the stock market seems to be quickening. Last March's fall in stock prices happened historically quickly, but the first leg of the recovery was just as swift. It is unlikely that the road we will walk will be a perfectly smooth one: the signs say caution, bumps ahead.

Given the existence of these pockets of over-valuation, the timely rebalancing of our holdings becomes a critical tool in our arsenal. We need to ensure that overall equity holdings match the investor's target in order to avoid the pitfalls of over-exposure in a volatile time. We also need to ensure that industrial sector diversification is being respected in order to avoid over-concentration in a specific industry that might be richly valued, or in a specific company that might be growing quickly. If you doubt our belief in the need to maintain balance in our portfolios, especially now, please refer to the cover of this newsletter.

In sum, the time between now and the economic recovery that will follow the end of the pandemic will likely be a good time for investors in equity markets. But there are signs of silliness in the market already, and therefore pitfalls to be avoided. Some of these market distortions will cause volatility, and some may indeed cause the market to correct. However, unless the underlying conditions supporting equities have changed, a correction between now and the end of the pandemic should be seen as an opportunity for us to strengthen our exposure to the types of high-quality "leaders in their fields" companies that we favor in our Model Portfolio.

Conclusion

The recovery in stocks since the lows of March 2020 has sustained itself over the last six months, and has led investors to question whether equity markets have behaved in an overly optimistic manner.

- Fiscal and monetary policy, significant free deposits in money market funds and financial institutions, reasonable rates of consumer indebtedness, and strengthening consumer and corporate confidence all point to continued strength in equities, contingent on the continued inoculation of the world's population against COVID-19.

- There are clearly parts of the market exhibiting signs of "irrational exuberance" and those market segments should be avoided, or at the very least underweighted in a well-balanced investment portfolio.

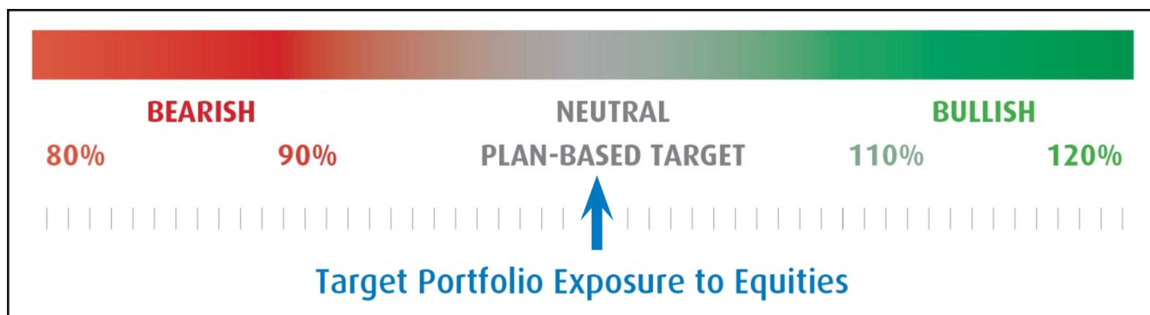
- The importance of keeping individual holdings and exposure to market sectors in proper balance cannot be overstated given the pockets of overvaluation we are seeing in the market. But should current market conditions persist, we remain convinced that pull-backs and corrections should be seen as opportunities to strengthen our positions in high-quality equities.

As always, our team wishes you good health, comfort and prosperity as we continue to navigate these trying times. Let us hope that 2021 brings this situation to a close.

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[16]
Yield*	2.80%	1.78%
Portfolio Beta*	0.93	1.00
Number of Holdings	27	1585

Sector Allocation (Core Portfolio)

	Model Portfolio	MSCI World Index
Financial Services	25.0%	12.8%
Real Estate	5.0%	2.7%
Communication Services	7.5%	8.9%
Utilities	6.3%	3.1%
Consumer Staples	14.5%	7.6%
Consumer Discretionary	7.5%	12.2%
Healthcare	6.0%	13.0%
Information Tech.	6.0%	22.1%
Industrials	11.0%	10.5%
Energy	6.3%	2.7%
Materials	5.0%	4.5%

*As at 2021-01-31; source: Thomson ONE

Meet Our Team

Philip Brock, CFA, CFP, F.Pl., B.Com
Portfolio Manager and Financial Planner
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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
Investment Advisor, Wealth Advisor
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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.

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 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. She is passionate about fitness, and enjoys cooking, writing, playing music and travelling with her family.

Diane Clark
Investment Representative
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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.

Megan Labelle, DEC, BBA
Investment Representative
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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.

[1, 2] Thomson One

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

[17] Profiles for GOOGL, AMZN, BCE, CP, WN, INE, IFC, MFC, MCD, MSFT, BNS, SU, TRP, TD, WMT and WCN replicated from the BMO Capital Markets RED Sheet, February 1 2021

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