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KEEP CALM, CARRY ON

Investors are having quite the wild ride so far in 2020. After a solid 2019, we started the year in an uptrend, until the Covid-19 induced market volatility and recession hit everyone like a ton of bricks. After a sharp drop in March and April, market indices have rebounded sharply and in some cases to new all time highs. All this despite the economy still in recession. What the hell is going on?

Don't Fight the Fed

The unprecedented lock downs and shut downs that took place in the spring had a massive effect on the real economy and the stock market reacted by attempting to discount the effect of the pandemic on future earnings and cash flows. However, central bankers and in particular the U.S. Federal Reserve acted quickly to back stop the system. They eased monetary policy (lowered interest rates), injected tremendous amounts of liquidity (printed money) and have signaled a new and more relaxed policy framework in the future. Thus they insured the financial system could still function and signaled to investors that they had a very powerful ally.

One of the most difficult aspects of determining what is a fair price for a given asset, is the fact that investors seem willing to pay more or less for assets at any given time. However, the return on risk free assets certainly has a large role to play in this calculation. By lowering rates, central bankers are helping to lift asset prices. Investors are hence bidding prices for risk assets higher since risk free assets pay close to nothing. In effect central bankers are "forcing" investors to take risk. There is no doubt that these moves were the greatest catalyst for the market rally from the spring lows. Of course, medical breakthroughs, vaccines, etc., contributed to the rebound, but as they say on Wall Street. Don't fight the Fed!

Winners & Losers

Despite the headline indices recovering to near pre-Covid levels, many companies and entire sectors have lagged badly. In fact, the market has been led by a few mega-cap names. One need look no further than the energy or financial sectors to see that the market rally has not been indiscriminant. The fact is: the pandemic has created winners and losers. The digital transformation that was taking place before the pandemic has been accelerated. Working remotely and more online shopping has consequences and depending on the company, the results can vary greatly. Microsoft executives were quoted as saying they had seen two years of transformation take place in two months.

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FIXED INCOME: Hijacked

The COVID-19 induced financial crisis galvanized central bankers around the world into the most aggressive actions we've seen yet.

Focusing on the Federal Reserve, the world's most important central bank and supposed guardian of the world's reserve currency; it should be clear to all now, that these policies are nothing more than monetary roach motels: they can never be reversed and in fact necessitate ever larger doses of the same just to keep all the plates spinning.

The scale and speed with which the Fed responded was unprecedented. The Fed Funds Rate was cut in a matter of two weeks from 1.75% to 0.25%. Such moves in the past were generally limited to 0.25% increments and would have taken months to execute an adjustment of that magnitude. Outside of rate cuts, the printing presses were also fired up, to the tune of several trillion dollars, to purchase mortgage backed securities and government bonds. Ultimately this prevented corporate bond speads from rising and allowed the funding of exploding government deficits. The end result is that the Fed's balance sheet was quickly expanded from 4 trillion to 7 trillion. The government's funding needs in Q3 & Q4 will be massive and I suspect Fed support will be needed to absorb these new bond issuances in order to prevent rates from rising too much, likely expanding its balance sheet by several more trillion before year end. Furthermore, the Fed in conjunction with the Treasury Department circumvented its congressional charter (broke the law) by setting up special purpose entities (SPEs, think Enron) to purchase corporate bonds and even junk rated bonds to stabilize interest rates in non-government markets. Finally, the Fed announced that it would do whatever it takes, print as much money as required to execute its plan...welcome to QE infinity!

Bond Markets Hijacked, Broken and Useless

In doing all of the above, the Fed has helped push rates to new all time lows across the yield curve. The one saving grace for fixed income investors, at least for now, is that inflation has been falling equally fast. However, I don't expect that to last: so the game of financial repression continues resulting in a slow, but steady transfer of wealth from savers to debtors.

What used to be considered the safe asset class of choice, government guaranteed debt obligations, are now essentially certificates of confiscation. Current rates in both the government and corporate space offer neither compensation for longer term inflation or default risk. Both of these risks are rising with central bank money printing and ballooning debt levels.

It's a Hell of Thing

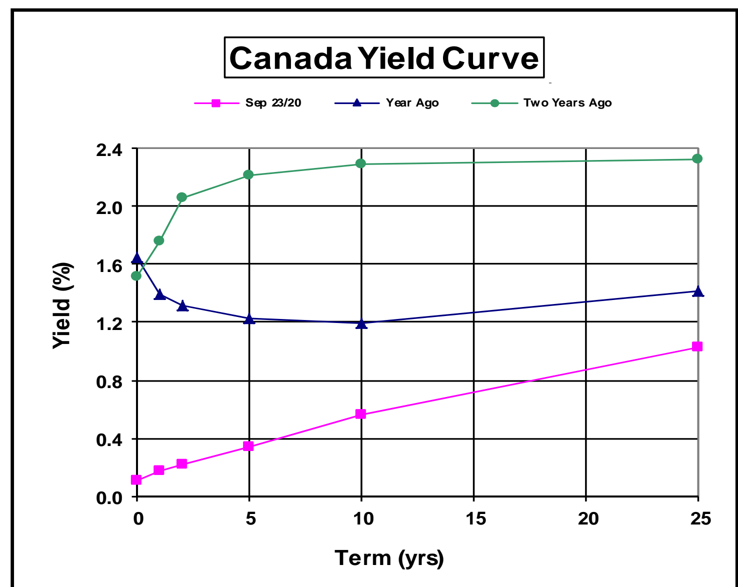
Consider that 10-year federal bonds on both sides of the border currently yield about 0.60% to maturity. Once an investor adjusts this gross return for taxes, investment management fees and inflation, they have locked-in a decade long loss of purchasing power. Certainly those GICs we bought in 2018/19 yielding 2.5 - 3.25% now look positively sumptuous.

Should rates back up, the potential losses over the coming decade, from what I see as the single most overvalued asset class, are truly stunning. Of course this would take a serious revolt from the bond vigilantes given that the Fed has openly stated their intention to keep rates pinned at zero to at least the end of 2022, with recent intimations that this policy may be extended into 2025. It's important to understand, that collectively, bond markets are much, much bigger than central banks, and I have no doubt that they can run over central bankers should they choose to act in unison. But for now market participants seem content with the status quo. I do think that this complacency could change rapidly should inflation trends start moving against bond investors. At that point we could have some fireworks in the bond markets and a titanic battle between free-market forces and the long arm of government.

As we wait for things to unfold, I am forced to acknowledge that this asset class no longer serves any real purpose for investors. Stealing a quote from Jim Grant, *"Government bonds used to offer risk-free returns, however, today they only offer return-free risk."*

Very short-term bonds may be purchased simply to earn something, rather than nothing, which is okay while we pass through the current deflationary period, otherwise investors should avoid this asset class like the plague, there is nothing for us there. Cash pays nothing, and bonds pay almost nothing, so may as well sit on cash at the ready.

There's been a death in our financial family and we will morn the loss of fixed income markets. Sadly, Mark.



PORTFOLIO MANAGER: The Passive Phenomenon

In past articles, I have talked about the liquidity illusion which affects the downside response of markets. Passive investment vehicles play a role in this regards.

What is Passive Investing?
Passive investing is based on the notion that markets are, at all times, efficient (see *Efficient Market Hypothesis* on Wikipedia). Thus, efforts to beat the market are a fools errand and the best returns are earned by owning the market as a whole, at the lowest cost possible: enter the index fund, circa 1975. However, the one big flaw in this approach is its complete reliance on so called efficient markets and the free–rider effect.

> *"In the short run markets a popularity contest, a voting machine, but in the long run they are a weighing machine."* *Warren Buffett*

Markets are only efficient because of research, price discovery and clearing mechanics. None of which can happen without the effort of active managers. Indeed, it is solely because of the research efforts of firms like Nesbitt Burns and JP Morgan that markets are as efficient as they are. So when passive starts to crowd out active managers, an indiscriminant approach that does no research, makes no rational judgements, the markets by definition become less and less efficient. The only question then becomes at what point do markets start to lose their efficiency. The late John Vogel, founder of Vanguard Funds and often referred to as the father of index investing, was once asked this question and he initially assured us that it wouldn't be a problem until the markets reached 50% passive. As passive grew rapidly, he later revised his view to 70%. A revision which seems a little self-serving to me.

Growth of Passive
In 2002, passive products represented about 10% of assets under management (AUM), thus whatever unintended consequences there might be on the markets as a result of these products, they were marginal at worst. Fast forward 18 years and passive now represents about 46% of AUM. Clearly this method of investing, if not yet dominant, is a force to be reckoned with, and its adverse impacts can no longer be dismissed as marginal.

Nothing More Than a Momentum Trade
Active market participants definitely contribute to the misallocation and momentum phenomenon that is passive. Consider that if active participants irrationally bid up a stock significantly, then passive vehicles must adjust their weighting accordingly. So at the very least passive is adding fuel to the fire of active speculators and to the long term detriment of their investors. If you think about how passive money is allocated, its really pretty simple. If you have a dollar, you buy, if you need a dollar to meet redemptions, you sell: remember passive vehicles hold no cash. Furthermore, if a stock has been driven up to rich valuations by the enthusiasm of market participants, then more passive dollars will be allocated to those stocks by default. If the market favors growth over value, then passive will allocate more dollars to growth, helping to drive their prices up even more, regardless of valuation. There is a momentum driven, self fulfilling mechanic at work here, one that has no relation to any fundamentals such as return-on-equity or price-to-earnings. Hence, when to buy, what to buy and how much to buy is irrelevant. For passive investors, today is the right price to buy, tomorrow is the right price to buy, basically everyday is the right price to buy. Intuitively we know this cannot be true. But it is how the markets work now. This seems unsustainable and dangerous to me.

It's Really About Flows Now, Not Fundamentals
Mike Green, a brilliant researcher and partner at Logica Capital has been studying the passive phenomenon for several years now. He concludes that passive is already having a big impact on markets and that it will continue to grow. But he believes that dollar flows are actually more important that AUM. He observes that older generations, who largely work with active managers are in the dissaving stage of their lives, consuming their interest, dividends and gains, hence they represent outflows, while inflows represented by younger generations, who are in the accumulation phase of their lives, have whole heartedly embraced passive. The end result he says, is that 90% of net inflows are into passive. Thus he fully expects the influence of passive on markets to continue growing in the years a head.

Don't Worry About Valuation, Markets Only Go Up
If you start to view the markets through the lens of passive, you can start to make sense of how cash flow negative companies like Netflix, Tesla and Uber can garner massive valuations. You can also start to believe that the above caption, as ridiculous as it obviously is, might seem true. If valuation doesn't matter anymore and it's just about flows, then the sky is the limit, there is nothing stopping the S&P 500 from climbing to 4,000, 5,000, or even 6,000 over the next few years, as long as nothing interrupts the flows of money. That's a big 'if' of course.

More to Come
I've just scratched the surface on this complex topic and I'll have more to say in future issues of TFI. But as Al would point out, with bonds yields at new historic lows TINA (There Is No Alternative—to stocks) remains in full force. Coupled with the passive phenomenon discussed herein, it may be dangerous to disengage from this market. Although, that statement should not be construed as an endorsement to run out and buy Tesla and Netflix. Just be aware of what's driving markets these days.

Participate cautiously, with eyes wide open. Mark.

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Due to the incredible halt in global travel, the recession and increased telecommuting, energy demand has plummeted, oil prices have fallen sharply and oil stocks are down substantially. Financials also continue to struggle as a result of low interest rates and rising loan losses. However, in terms of indices like the S&P 500, the weight of a Microsoft or an Apple, at roughly 7% is larger than the entire energy, materials and utilities sectors combined!

All Roads Lead to Gold

Another beneficiary of the current situation in my opinion are precious metals. They benefit from a number of factors and possible outcomes. First, low interest rates make holding them, instead of bonds for example, seem like a good bet. Furthermore, anyone who asks themselves: “How can central bankers just create trillions of dollars out of thin air, without adverse consequences?” has to conclude that gold is a hedge against this type of out of control money printing. In addition, if the economy recovers, all that extra money that has been injected into the global economy will likely cause inflation (i.e. good for gold). If the economy doesn’t recover and the world is in a bad situation (good for gold as a hedge against disaster!).

Game Plan

Early in 2020, while the market was still rising, we began to raise cash in accounts as were concerned by the news out of China regarding the virus. At that time, North American markets seemed to shrug the virus off. In retrospect, we should have raised more cash and sold more energy! However, having some cash allowed us to buy into the weakness in following months.

During the correction, I increased my exposure to large cap technology names and added gold bullion as well as some exposure to gold miners, while reducing my allocation to financials.

Looking ahead, I believe that a barbell approach is warranted at this time. On one side, the Covid winners, albeit expensive, have strong balance sheets, ideal business models to grow stronger and take market share during these times. The problem with them, is they are expensive and they have had a tremendous run. For this reason I have recently trimmed those names and locked in some profits. On the other side of the barbell, I remain committed to companies whose fortunes will improve with a reopening and an economic recovery. It has been painful to watch energy, pipelines, financials and other value names get hammered. Nonetheless, I believe that we own the best names and they will recover. In some cases, they may not recover to pre-pandemic levels in the near term, but their sustainable dividends and strong capital position make holding them worthwhile. Patience on these names is the best course in my view.

Over the last decade, U.S. assets and the Greenback have been the place to be. Despite the fact that the American economy is the most dynamic on the planet, I believe it makes sense to begin to move some funds away from the U.S. in search of value and better future returns. In fact, the difference in valuation between the U.S. and other markets is at or near all time highs. This will not lead to changes in our long held core holdings in names such as Johnson & Johnson, Walmart and Microsoft. However, I believe increasing exposure to emerging markets may be beneficial to future returns.

Glass Half Full

I believe there are still plenty of opportunities in the market, many quoted shares are still off 30 to 50%+. I suspect we will look back at these prices years from now and wish we would have bought more at these depressed levels. Central bankers are telling market participants they will keep rates lower for a long time. Furthermore, if the economy runs into more trouble, I believe they are going to print more money and bail out the system once again. What is an investor to do but stay the course, look for bargains and keep accounts hedged with a healthy dose of gold? No doubt, we still have to get through the upcoming U.S. elections, the ongoing friction with China and, oh yes, the virus. We will get past these issues as we have always done.

Keep calm and carry on. Al

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