Putting the Pieces Together

Take a deep breath and breathe

Admittedly, we are living in unprecedented times. Most of us are in our homes quietly battling the Covid-19 virus and some of us are heroically on the front lines saving lives or supporting our basic needs and services. Hence, we start this quarter's newsletter by **thanking you all** and wishing you and your family good health.

In this current newsletter, we will outline our action plan, certain key indicators to follow in this crisis and how governments' and central banks' interventions have reshaped the different markets. Before we start, it is important to highlight, **that what is common in all moments of panic and crisis is that financial behavior and money flows within the same manner.**

At this point, we have to take a **step back and evaluate** how this pandemic, the governments' response to it with massive debt creation, the global decrease of interest rates – even lower for longer term interest rate - and the oil price shock, will affect the different aspects of life and economic reality. On the medical front, the first line of defense was - and still is - social distancing and quarantine measures, resulting in the **disintegration of our demand for products and services**. On the opposite, due to exponential medical supply needs, our economies are currently facing **supply chain issues**. A positive element was the unprecedented reaction of central banks and governments, which have reacted swiftly and decisively to maintain the economy. For its part, the price war between OPEC and Russia will undoubtedly have an effect on the **corporate default rates**, even if the world's major producers have reached an historic agreement over the Easter weekend. We also expect the sheer magnitude of the demand reduction in oil will indirectly create more **volatility in the fixed income markets**. Ultimately, there will certainly be more repercussions on our economy than what we have just listed; like for example, which industries will be bailed out? Or, will the infrastructure bill pass as proposed by the White House? **And the two big questions remain, <u>when and how</u> can the global workforce safely return to work**? The answers to these questions will unfold one day at a time. Whatever the case may be, our action plan is routed in what we know and not solely on assumptions.

Let's connect

Roux & Associates
Wealth Management Group
BMO Nesbitt Burns

1501 McGill College Ave.
Suite 3200
Montréal, QC
H3A 3M8

www.christian-roux.com

Christian Roux
(514)871-7026
Christian.roux@nbpcd.com

Nektarios Pouliezos
(514)282-5929
Nektarios.pouliezos@nbpcd.com

Nancy Belanger
(514)871-7076
Nancy.belanger@nbpcd.com

Elizabeth Le Comte
(514)282-5808
Elizabeth.lecomte@nbpcd.com

With all these elements in mind, our action plan can be summarized in three steps

1. In a moment where panic takes over the market, massive selling becomes prevalent amongst all asset classes and it doesn't discriminate any sector. Henceforth, we first **re-balanced our equity positions with an onus on companies that have a high percentage of cash over assets**. This latter factor demonstrates a capacity to relatively perform better under duress. Obviously, we are over simplifying our screening methodology, but the essential point that we want to convey is that we overweight companies that have a healthy balance sheet.

2. After the first initial wave of panic eased off, bond values bounced back off their lows. That is when our second step was initiated and we **re-balanced the fixed income component of our portfolios**. Remember that when the price of oil dropped drastically, that created important ripple effects within the corporate credit markets. This point will be discussed in more detail below.

3. Finally, our plan of action was and will continuously be to **tactically reposition our portfolios** in accordance to the known variables or consequences of this pandemic. In other words, how our economies and markets will behave after this crisis will have passed us. As stated previously, we will probably continue to face some supply-chain issues. Hence, this might cause some price increases, thus we must take a deeper look within the discretionary sector. Further, there is the loss of wages that we must take into consideration. Unemployment will certainly remain higher for a longer period of time. Moreover, interest rates are at historic lows, which will undoubtedly have some effects on the financial sector, especially within the insurance industry. Narrow interest rate spreads and high loan losses will take some time to dissipate.

The point is that, there are certain sectors we must underweight and others like technology and communications services that will probably outperform on the other side of this pandemic.

The important indicators to watch for during this pandemic

On March 28 2020, the *Globe and Mail* published an excellent article - by Ian McGugan - that outlined some important indicators to watch for during this pandemic. We agree with the author and found the article compelling enough to share a summary of his key points:

1. Unlike any other crisis in recent history, the world is currently facing a global viral threat. **This battle is being followed daily** and mapped by the **Johns Hopkins University** on *www.coronavirus.jhu.edu*. The government of Canada shares its own update on *www.canada.ca*. Once we see the virus receding in our favor, the lockdowns can ease and the economic rebound will take hold.

2. When finally **investors will start parting** with the safety of the **10 year government bonds**, this will naturally push interest rates higher, thus leading to **money flows back into riskier assets** and finally signal that some "normality" is coming back in the markets.

3. Oil prices have started retracing some of the losses caused by the effects of lower demand and geopolitical issues between Russia and Saudi Arabia. The **historical OPEC+ announcement**, over the Easter weekend, to reduce his global production, will support world prices or at the very least offer a relief to oversupply. As inventories will eventually diminish and demand for oil starts trending back to pre-crisis levels, we should see the **WTI and Brent crude both go back above 40$ USD**. Prices above that level will also indicate that the global balance is tending back to normal.

4. The world economies are slowing dramatically. The **sign of economic strain** will show up in the **global insolvency** statistics. Here in Canada, we will follow the monthly *Superintendent of Bankruptcy* numbers of consumer insolvencies on *www.tgam.ca/39uFEa4*. Once the numbers start plateauing, we will know that the worst is behind us.

5. **China is slowly coming back** from the worst of Covid-19 effects. A good way to track the progress of its comeback is by following the Shanghai and Shenzhen market with the ***CSI 300 index***. This index tracks the 300 largest stocks of the region. After falling at the very beginning of the crisis, it has now started what looks like a bottoming process within 10% of its 2020 starting level. **We could be soon following the same trajectory in North America**.

Of course, there are many other indicators that one could monitor to suggest that the crisis is dissipating, but these represent to us an excellent start.

Covid-19's impact on the North American equity markets

Prior to a very sharp rally in the last few weeks, the one month U.S. stock market performance was in dubious company indeed. Looking at the worst pullbacks in the last century, the Dow Jones Industrial Average in March 2020 had the second worst performance ever, only slightly trailing September 1931, at the height of the Great Depression**. In fact, BMO's Risk Appetite Index attained a level of panic GREATER than at the height of the financial crisis of 2008/09.** And yet, aside from equity market performance figures, the bearish narrative that we are headed toward another great depression completely misses the mark in our opinion.

In particular, the great depression's policy responses were allowing a contraction in the money supply in part because of the gold standard, trying to balance the budget instead of stimulating the economy, protectionist policies, allowing businesses and banks to fail in alarming numbers etc. Having learned several lessons from history, central banks and governments are thankfully reacting quickly and aggressively to the unprecedented shock we are facing. This is because, in the late 1920s/early 1930s, the policy response was exactly the opposite of what was needed to re-instill confidence for individuals and businesses.

Since the market is a leading indicator of the real economy (typically by 3 to 6 months), this was a prelude to the type of dismal economic data we have started seeing in most countries (i.e. the surge in U.S. initial jobless claims to 3.28 million, almost five times as large as the worst week in 2009 and this followed last week's flash estimate that half a million Canadians applied for EI over the same time). The fact that we have entered a global recession is now a foregone conclusion with many countries on full or severe lockdown. This has crushed economic activity and **the stock and fixed income markets are already discounting a severe downturn. The crucial question at this point is how long the downturn will last**. And this, in turn, will depend on when new COVID-19 infections peak and life returns to some aspect of normalcy. Encouragingly, this is already starting to happen in Asia.

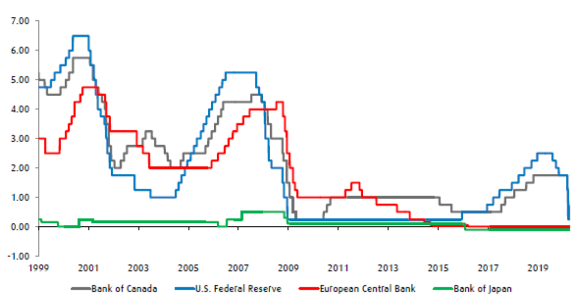
There are early signs that aggressive – and early – social distancing guidelines are having a positive impact in terms of the numbers of infections in Washington State and perhaps in Canada as well. As we have noted before – and this is critical for equity investors – **the stock market will begin to rebound well before the economic data or even as the news flow improves**. From that perspective, the powerful rally since March 23th could be the beginning of the rebuilding process. We hasten to add, however, that we fully expect elevated volatility to persist for a while longer.

Low Interest Rates for Longer than Expected

Because of the unprecedented world wide shutdowns and confinements needs to fight the virus, the world economies have experienced one of the most dramatic slowdown in modern history. Governments across the world have responded by creating massive rescue plans, and in so are creating enormous amounts of debt, literally Trillions**.**

To help repay those loans, low interest rates will be needed to provide financial flexibility and they will be needed for a longer period than initially forecasted. Both the Bank of Canada and the Federal Reserve responded aggressively in less than a month cutting policy rates by 150 bps to a low of 0.25%, the lowest since the Great Financial Crisis. While these cuts are pale in comparison to prior crises, clearly central bank officials have limited appetite for negative interest rates at this juncture.

Monetary Policy changes



Source: FactSet; as of April 01, 2020

In the short-term however, low interest rates are not the solution. The flight-to-safety that initially led longer term yields to record lows and then the flight-to-cash that ensued exposed a greater problem: limited market liquidity.

Reduced liquidity in time of crisis is normal but regulatory changes imposed on financial institutions and securities dealers following the 2008-2009 crisis exacerbated the issue.

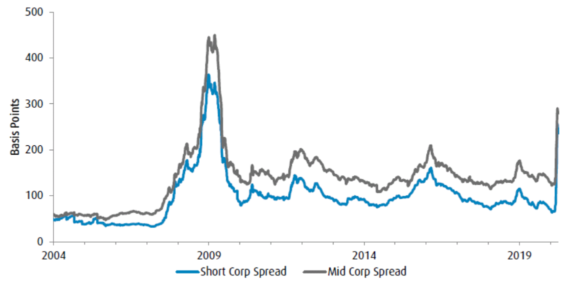
As a result, fixed income markets experienced much higher volatility with extreme daily variation in prices, yields and yield spreads. **More concerning was the corporate bond market freezing-up with limited issuances and secondary market trading.** For example, speaking with one of our traders on our bond desk, there were a few days where if one would only have $10M in US Treasuries to sell, you could have moved the price lower as if you had $100 billion of Treasuries to offer. A very rare panic-driven event, that coincided with a record low level in our BMO Risk Appetite Index.

Canada and U.S. 10-Year Government Yields Print New Record Lows

Source: FactSet; as of April 01, 2020

Early indications confirm that the introduction or extension of new liquidity measures from central banks, including lending facilities and broad fixed income asset purchases contributed to calming markets. **The effort by the Federal Reserve to preserve liquidity, stepped up their asset purchases to average $75 Billion per day… Again unprecedented if you compare it to the support they gave in 2008, with $85 Billion per month!** It helped stabilize and provide much needed support to risk assets in general and as a result lower market volatility. Corporations are issuing debt again with investor demand strengthening and yield spreads tightening from relatively wide levels.

Canadian Investment Grade Bond Spreads



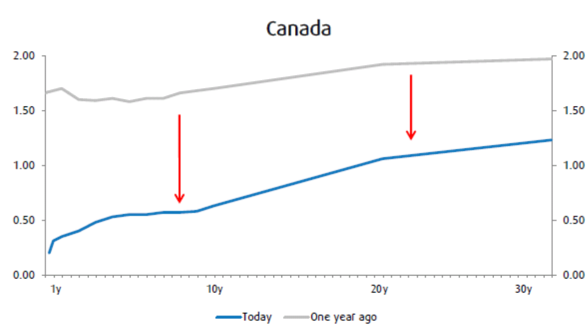
Source: Bloomberg; as of April 01, 2020

As the crisis evolves, low interest rates will become more important in the relief effort and the recovery process. Not only financial institutions, but other businesses and households will benefit from accessibility to inexpensive funding. This will greatly contribute to the speed and strength of the economic recovery. **Understandably, as balance sheet leverage increases to weather the storm, low interest will need to remain in place for a prolonged period to help with the increased financial obligations.** This will ultimately limit the flexibility for the Bank of Canada and other central banks in raising policy rates anytime soon

Governments and corporations will also need access to long term funding. We suspect that sooner rather than later, the initial fiscal response will need to be topped up as relief measures will give way to stimulus aimed at the recovery. Again in talking with our fixed income strategist, it would not be a surprise if Central Banks across the world aim to keep the whole interest rate curve, in a very low, much defined range for several quarters, well into 2021. We could even see Corona Virus Bond issuances worldwide for very long term maturities, possibly even 50 year issues. This fiscal spending with expected lower tax revenues will lead to a significant increase in budget deficits. Fixed income markets will need to absorb the oversupply of debt to help finance these ever increasing deficits. In normal time, this would pressure interest rates higher and steepen the yield curve (meaning that long term rates rise faster than short term rates).

This is where asset purchase programs become even more important. **Central Banks are becoming the lender of last resort.** By not only maintaining rates low in the short-term, central banks will pressure longer term rates lower with targeted purchases of fixed income products to better control the yield curve and effectively monetizing some government debt. Without these purchases, we suspect longer term interest rates would be much higher and would risk becoming an impediment when the recovery comes. This is very reminiscent to a few years back when the Federal Reserve slowed down and stopped their asset purchasing program. This caused longer term rates to creep up and consequently created a repricing of assets which caused some market volatility. That being said, in today's crisis, the Federal Reserve just printed 10% of the US GDP. It goes without saying that when it will be time to unwind the entire stimulus, the Federal Reserve must act diligently. Will this create inflation or will we experience deflation as we have been experiencing in the last decade**.** Again, a situation we will be following closely.

Canada Yield curve shifts in 2020



Source: FactSet; as of April 01, 2020

This pandemic is ever fluid and there are still uncertainties that we must deal with in our everyday life. Obviously things will normalize somewhat with good news from the early stages of positive vaccine results or when the number of cases infected start diminishing. This will give us a bit more clarity in the timeline of our economic recovery.

In terms of the markets recovery, we had our first catalyst with fiscal and monetary responses. **We will probably see more interventions in the future as we experienced during the financial crisis.** However the first catalyst did trigger the beginnings of the bottoming process. That's not to say that the volatility won't persist in the following weeks or months but the latter catalyst did add the much needed liquidity to the credit markets which in turn fuels the equity markets.

Other catalysts are in the form of contrarian signals. Firstly, with the peak of infected cases or because of the effects of social distancing, the plateauing of cases will give some certainty to the markets. Secondly, we are still dealing with the sudden drop in oil prices and as stated above, this will create insolvencies within the high yield space of the credit markets as it did in 2015. **Henceforth, we will monitor credit spreads which is a measure of how risky assets are.**

As we are completing this quarterly newsletter, we have just heard of an additional $2.3 Trillion dollar support by the US Federal Reserve, not only adding to the municipal and small business support already announced, but also a support to lower quality (junk) bond market to avoid having liquidity (or lack of) driven effect. Our sense is that the Fed can clearly see the downgrades that are about to be announced by the rating agencies. It wanted to get ahead of potential forced selling that certain funds may have to do, as ratings go down. We'll have to see how that works out because we are still not sure that everybody can be saved.

The fight against Covid-19 is not over, and as so, your team will stay alert to the trends developing and will be active so that your short and long term plans remain on track.

Safe regards,

Team Roux