Putting the Pieces Together

Stay the course

2020 was a year that will go down in the history books. Periods of heightened emotion, fear and overreaction clearly impacted decision making helping to define one of the most unprecedented stock market periods in history. Granted, a once-in-a-century global pandemic, a month-long cyclical “bungee-jump” bear market, massive amounts of fiscal stimulus, the Fed intervention, a compressed recession and a contentious US presidential election, tend to rattle all cages. All these successions of events only fuelled the preponderance of negativity that has surrounded Wall Street for most part of the last 12 years, following The Great Financial Recession of 2008-2009. In fact, we believe this “pre-destined negativity” has never been more evident than during the depths of the global pandemic chaos in Q1, leading up to a “pessimistic crescendo” and a “reset “of the financial markets, as our Chief Strategist Brian Belski characterized it, on March 23th 2020.

Despite all the turbulence, we never wavered and continuously adhered to our investment discipline and trusted our process. Short term market fluctuations are rooted in an emotional bias but at the end of the day, fundamental drivers like earnings and interest rates shape long-term returns. Consequently, the majority of our families and their portfolios yielded positive results for 2020. Even in a year filled such as 2020, maintaining an investment discipline helps keep your financial strategy (plan) on track.

Before we begin with our newsletter, we thought it would be a good exercise to review certain principles we outlined in last years’ newsletters. In our April 2020 edition, we outlined our action plan in order to navigate through the crisis. Looking back at the plan we laid out, it served our clients well to **stay the course** and remain focused in order to come out of the depths of the selloff. Further, principles such as “analysis paralysis”, whereby too many investors are focused on quant investing rather than company specifics, is a principle that still holds true. In addition, we stated last year, that too many investors “lack perspective”, whereby we believe momentum and “short-termism” has taken over basic longer-term patience and process, as many investors guard against being wrong or FOMO “fear of missing out”. All the latter principles will probably still apply in 2021.

Let’s connect

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For our first newsletter in 2021, we will outline certain investment themes that are still prevalent for this year. Obviously, politics will be discussed, as it seems to be top of mind for many investors. We will continue with a look at our currency and some fundamental backdrops that are supportive for equity markets. Lastly, in the appendix section, we will comment on bitcoin.

We begin by highlighting an interesting statistic that holds the test of time. Whereby, a $1,000 investment made in the Canadian market back in 1935 would now worth over 2.2 Million dollars or 10 Million, if it was invested in the US markets. As Warren Buffet said, investors that lose money do so mainly from “dancing in and out” of the market. This also resume well the old saying “you can’t time the market**”.** Following a market correction stocks often surge, therefore leaving these investors on the sidelines. In fact, **holders of a balanced diversified portfolio, over any 5-year period since 1935, have experienced a positive return 100% of the time**. By contrast, an investor holding a balanced portfolio for only one year since 1935 has made money only 86% of the time. Despite multiple wars, 15 recessions, periods of rampant inflation, double digit interest rates, terrorist attacks and let’s not forget a pandemic… **investors who have stayed the course have been rewarded with persistent and consistent returns.**

The need to make “the call”, to buy, to sell (everything even!) or to short stocks by investors and pundits alike, was never more prevalent than in 2020. As well, the calls for the next great depression, negative interest rates, value over growth, cyclicals and small cap revival, just to name a few. In our view, such assessments have led many investors to make excessively binary decisions, tactics that lacked process, discipline and most of the time, facts and analysis. Unfortunately, such behaviours are hard to unwind and will likely continue to define stock market trends for several more quarters. As such, we believe the exuberance factor of the bull market will once again be in question in 2021, while sharp price moves will undoubtedly be defined by continued investor indecision and lack of commitment. We also think most of the apprehension will eventually center on the validity of unprecedented earnings growth as fundamentals more broadly recover from the depths of 2020.

The recovery in risk assets has been spurred by massive fiscal and monetary stimulus, which in turn, revived confidence. Stock markets were given an additional boost from impressive efficacy data from the clinical trials for first few COVID-19 vaccine candidates. This positive data has revived buying interest in beaten down groups (i.e. retail, restaurants, travel, energy, banks and other credit sensitive financial companies), on the hope that mass vaccination will happen in 2021 and some form of normalcy will return to daily life and in turn, the economy.

Clearly, the trend toward large cap growth stocks (technology in particular) accelerated for most of the year as investors viewed many of these companies as “COVID-beneficiaries”. From our perspective, this has created a historically wide valuation disconnect between sectors (e.g. Technology versus Financials) and investment styles (Growth versus Value). It follows that positioning for 2021 should be far more selective and the focus should be on stocks that still offer a margin of safety (i.e. trading below their fair value combined with decent earnings visibility), irrespective of their official sector classification.

Despite the optimism for a return to our pre-pandemic lives, we believe some investment themes will sustain in 2021:

- ✓ 5G communication investments;
- ✓ Distributed workforce;
- ✓ Domestic travel versus international travel;
- ✓ Nesting phenomenon and demand for housing;
- ✓ Onshoring or domestic manufacturing.

Democrats in Control

Democrats officially “control” the Senate, the House, and the Presidency, so what will be the impact on the market? So far, stocks and other risky assets are taking the outcome in stride. This fits with the view we have expressed for years: the economic cycle is always far more important than politics in driving returns and the news is generally positive from that perspective. In fact, since March of last year, manufacturing, housing, employment and corporate profitability data are all on steep uptrends with more expected good news to come over the next few months.

Our political research partners, Cornerstone Macro, based in New York, state that Democrats controlling the Senate means modest individual top income bracket and corporate tax hikes are likely. They estimate that the top tax rate goes up to 39.6%, corporate rate goes to 25%, capital gain and dividend rate goes up to 25-28%.

Further near-term fiscal stimulus of around US$1 trillion is Cornerstone Macro's estimate. President Biden just released a US$1.9 trillion plan which needs to be passed in Congress. Cornerstone Macro states, there are two dozen House Representative Democrats from affluent GOP-leaning districts in which would be a constraint to both higher taxes and to a greater stimulus package.

To that end, there will be some impacts for certain sectors. This is clearly an incremental positive for commodities, infrastructure and clean energy companies. While higher taxes are a slight risk, we do not think it will be a game changer relative to the kind of corporate earnings momentum we will get from the recovery we are experiencing. Also, President Biden and many of his allies have shown themselves to be centrist (rather than hard left) so we think the potential negative impact to Technology (stronger anti-trust enforcement and higher taxes) and Pharma (pressure to curb drug price inflation) will be relatively limited.

Recall that health care stocks and big Pharma/Biotech in particular, actually benefitted from "Obamacare" through higher volumes (for previously uninsured people).

Foreign Exchange

The other big story for 2020 has been the depreciation of the US dollar in the wake of its Corona crisis spike. The USD had depreciated roughly 5% in 2020 and BMO Economics believes that the fundamentals underneath that trend will not change much with the roll of the calendar, although there are a variety of risks that could cause a USD spike.

The easiest direction for the USD is down for a variety of reasons. First is a widening current account deficit that must be financed. Second is a historically small yield pickup from being long-USD against other currencies. Third is the Foreign Exchange (FX) market's strong belief in mean reversion with the real USD index still about 5% above its long-run average. Fourth on the list is an expectation for global economic recovery, but not at a pace that would raise the spectre of monetary policy tightening. Lastly, there is the issue of the Fed's massive ongoing Quantitative Easing (QE) program. Putting it all together, BMO Economics believes that the case for another 4% down year in the USD is fairly compelling. However, there will almost certainly be risk-off moments in financial markets that will likely bring the USD higher. Further, if the US recovery advances to the point that the Fed tapers its QE program ahead of other central banks, then the USD downtrend could outright reverse.

Further recovery in oil and gains in equities should lift the Canadian dollar (CAD) by a few percent but seeing as though we have a current account deficit, the BoC (Bank of Canada) will likely do what it can to limit CAD gains. BMO Economics' one-year outlook for the USD/CAD is 1.24 (currently 1.28). Our economics' team views that most currency fundamentals as being so similar between Canada and the US that it's hard to envision a move to 1.20 or lower. One potential catalyst would be a full recovery in oil whereby historically the exchange rate was at the 1.20 level in USD/CAD, however we have a hard time seeing oil making that big of a recovery with so much supply capacity. With regard to the monetary policy fundamentals, we don't expect any substantial movement from the BoC all year. However, if the Fed were to alter its policy stance in a major way, we suspect the BoC would mirror it--particularly if the Fed were to ease further.

Bottom line: we do see a good opportunity for those who wish to increase their USD exposure to be able to do so in the next few quarters.

Unprecedented Ingredients for Unrivalled Results Again in 2021

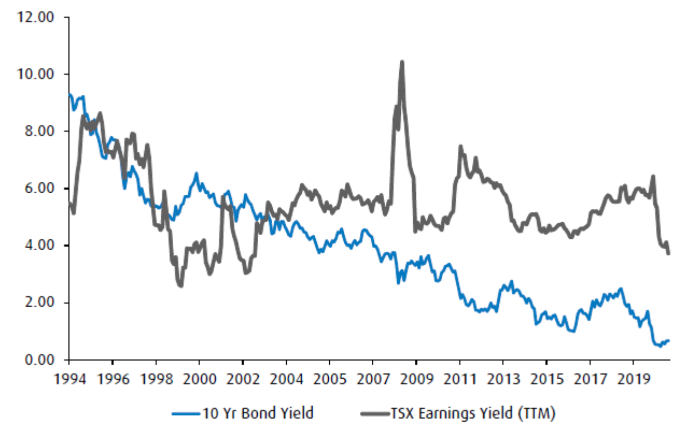
Even with recent positive vaccine and treatment developments, the global pandemic and its unprecedented impact are unlikely to fade in coming months. As such, the massive fiscal and monetary response in the US and around the world (also unprecedented) will likely remain in place to combat its negative economic impact for the foreseeable future. Such environments have historically supported continued stock market gains and we see no reason why 2021 will be any different. Yes, valuations appear stretched at first glance, but they also need to be considered within the context of historically low interest rates and little inflation, ingredients that are likely to persist throughout 2021 and beyond, in our view. When viewed through this lens, we believe it is not unreasonable for market valuation to sustain (or even expand slightly) from its current level.

In addition, we believe corporate earnings growth is poised to recover sharply (+35%) from pandemic lows, particularly during the second half of the year, since much of the damage was lockdown specific and not necessarily related to companies themselves. In fact, aside from the global financial crisis, 2020 represented the swiftest quarter-over-quarter earnings collapse for the S&P 500 where index EPS plummeted nearly 50% during Q1. Thus, we anticipate that 2021 has the potential to be one of the best years ever in terms of earnings growth, something we believe will also help to push stock prices higher.

Fundamental Backdrop: Positive for Stocks

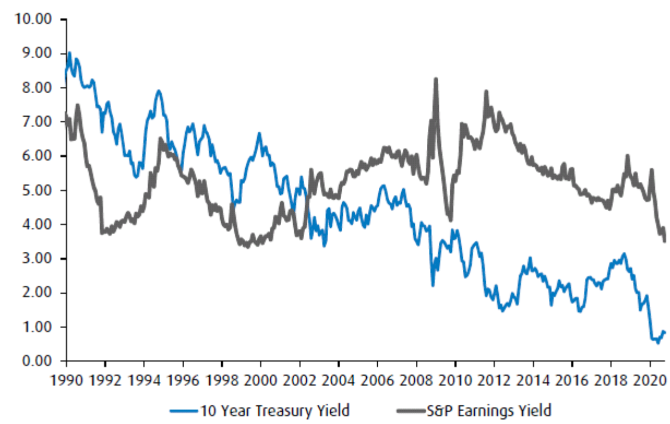
BMO Capital's work, which includes over fifty years of data, has shown that environments with stable or declining interest rates and positive economic momentum have been associated with very positive stock market returns. Interest rates have declined considerably in the last year and are likely to stay at or near historically low levels for years to come. This has very positive implications for the huge real estate market (approximately 20% of the Canadian and U.S. economies), for the cost of financing for companies and governments, and for the relative value of stocks.
Therefore, despite major indices hitting all-time highs, we remain steadfast in our belief that equities offer superior relative value to bonds and therefore retain our overweight stance on stocks in our Strategic Asset Allocation recommendation. The two charts below show that the average dividend yield on North American indices remains very attractive versus interest rates from a historical perspective.

S&P/TSX Composite Earnings Yield vs 10-Year GoC Yield



Source: Bloomberg; as of November 30, 2020

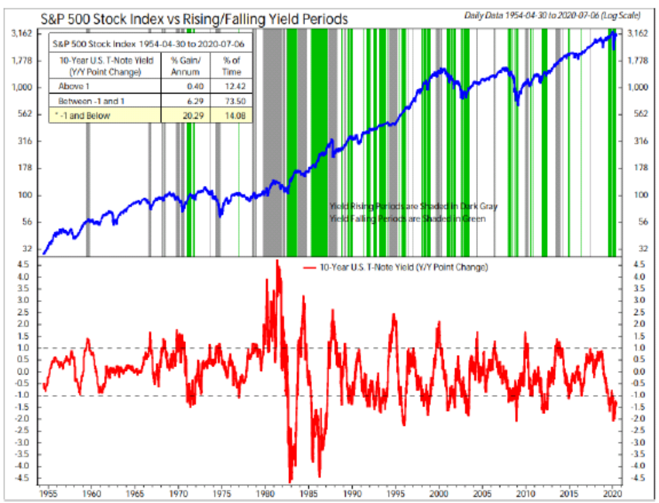
S&P 500 Composite Earnings Yield vs 10-Yr Treasury Yield



We examined market performance going back to 1959 with the help of Ned Davis Research. The results are summarized in the tables below. What we notice immediately is that the current 1% interest rate environment, while quite rare, has historically been associated with excellent stock returns (almost 23% annually for the S&P 500) and that substantial year over year declines in rates (i.e. a downward trend in rates) tend to turbocharge equity returns. This is consistent with the prevailing environment.

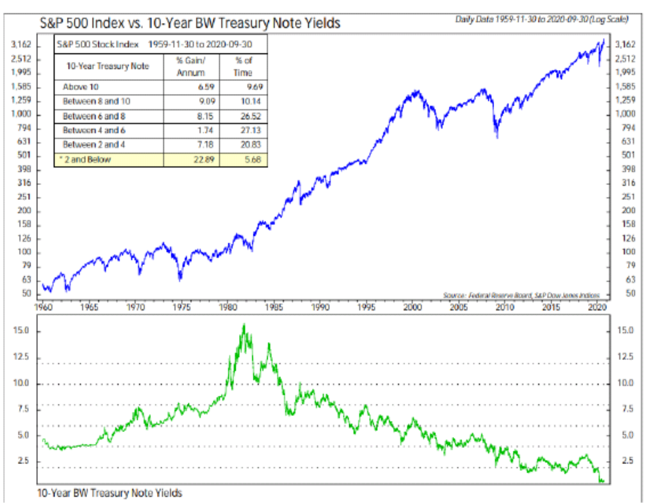
The best performing U.S. sectors when rates decline by 1% or more, going back to 1959, have been Consumer Discretionary (+32%), Technology (+27%), Health Care (+24%) and Industrials (+23%). The market appears to be largely following this playbook, but we note that we have not seen such massive technology outperformance since the technology bubble 20 years ago which makes us worried about certain overvalued stocks in this sector.

S&P 500 Stock Index vs Rising/Falling Yields Periods



Source: Ned Davis Research

S&P 500 Index vs 10-Year Treasury Note Yields

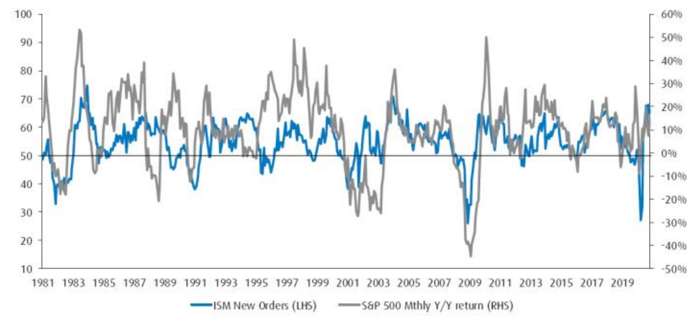


Source: Ned Davis Research

Economic Momentum is Clear

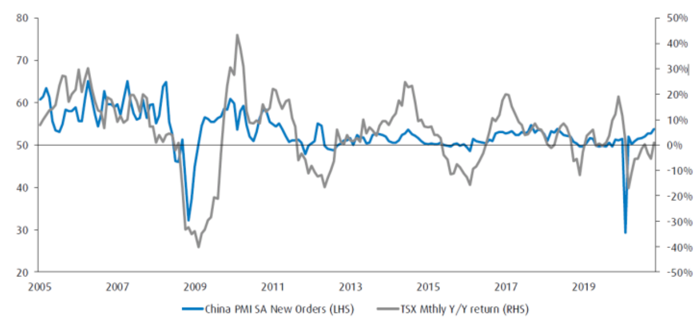
The figures below show the impressive recovery in New Orders in the U.S. and China, overlaid with index performance. Looking at New Orders is very important in our view since today's orders are tomorrow's sales and profits. We can clearly see that the equity market rebound since March is linked to this positive trend, which is consistent with history.

S&P 500 Monthly Returns (Y/Y) vs ISM New Orders Index



Source: BMO Private Wealth; Bloomberg

S&P/TSX Composite Monthly Returns (Y/Y) vs China PMI New Orders



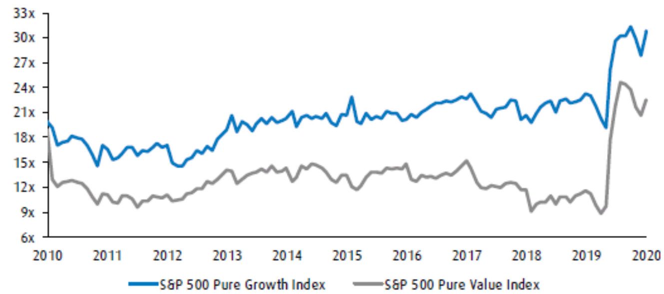
Source: BMO Private Wealth; Bloomberg

Value versus Growth

The figures are compelling in our view as they show that Value stocks are still trading at one of the widest discounts to Growth in over a decade, both in the U.S. and in Canada. After many years in the wilderness, Value stocks started catching a bid a few months back.
We believe the reason for this is global economic momentum turning positive, which historically has made reasonable earnings growth less "scarce". Put another way, Growth stocks (like Shopify, Microsoft, Amazon) have consistently outperformed when economic momentum is

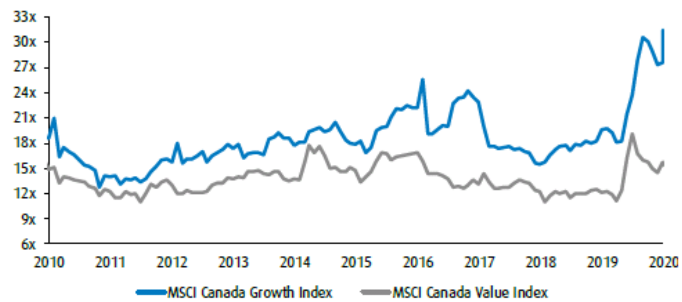
slowing since money flows to those few sub-sectors and companies capable of delivering the highest relative sales and EPS growth.

S&P 500 Pure Growth and S&P 500 Pure Value Forward P/E Ratio



Source: Bloomberg

MSCI Canada Growth and MSCI Canada Value Forward P/E Ratio



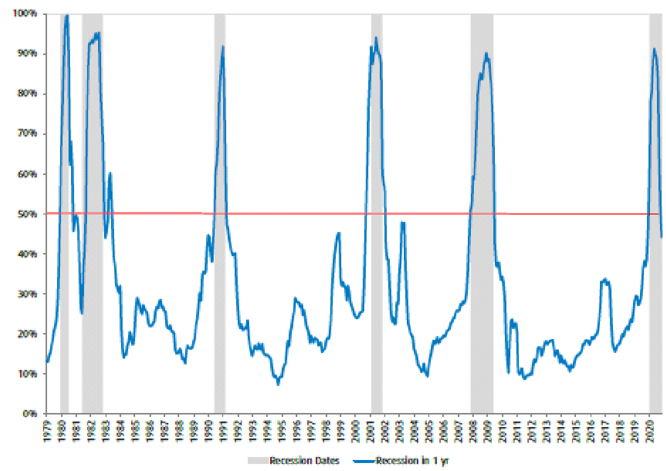
Source: Bloomberg

Recession Model Showing Declining Probabilities

After peaking in March 2020, because of the Coronavirus induced shutdowns, BMO's Recession Model is showing that the chances of a recession in the next year have come down significantly. This is largely due to improvements in the ISM New Orders Index, Real Manufacturing & Trade Sales and the Chicago National Activity Index (CFNAI).

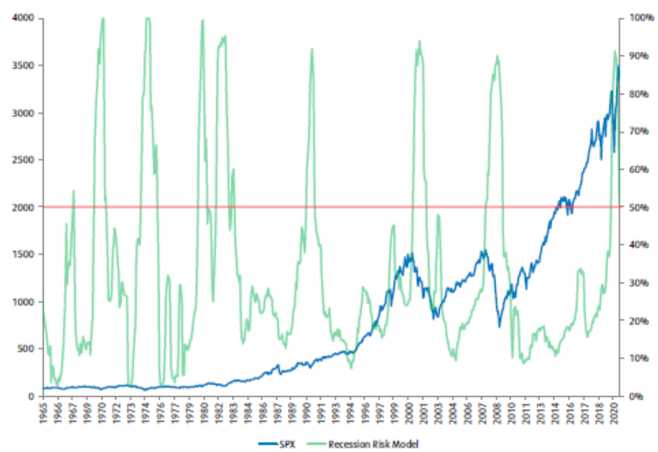
BMO's model has provided an important warning on every upcoming U.S. recession (and most Canadian recessions) since 1950 with a lead of two to three quarters. This is important since the stock market is a leading indicator and discounts improving and worsening business cycles in advance. In practical terms, back testing shows that adding equity exposure when the probability of recession declines (the current situation) would have added substantial value to U.S. and Canadian portfolios. In fact, since the late 90s, both the S&P/TSX and S&P 500 started steep declines almost exactly when the model's probability hit 50% and started recovering as probabilities declined. In other words, the stock market anticipates the recovery and starts rising well before the recession is officially declared to be over.

BMO Nesbitt Burns U.S. Recession Probability Model and Historical Recessions Going Back to 1977



Source: BMO Private Wealth, Bloomberg

BMO Nesbitt Burns Recession Probability Model with S&P 500 Overlay



Source: BMO Private Wealth, Bloomberg

Sector Overweight
We would like to highlight a couple of sectors that we believe we should overweigh in 2021.

Consumer discretionary

BMO Capital Markets state, that when examining recessions since 1973, the Consumer Discretionary sector has exhibited an average gain of 26% in the 12 months following recessions, compared to an 8.8% price return registered by the S&P 500 index. In addition, price strength typically carries through to the following year with the sector outpacing the overall market by more than seven percentage points.

When factoring in long-term EPS growth expectations, the sector has one of the lowest PEG (Price Earnings Growth) ratios. Furthermore, the sector easily has the highest long-term EPS growth forecast among S&P 500 sectors with Amazon being a major driver of that feat.

Financials

Financials are likely to be one of the largest beneficiaries if yield curve steepening persists, and the economic recovery matures and broadens. This is especially magnified given the significant underperformance of the sector relative to the overall market for the past few years. The US 10Y/2Y Treasury Constant Maturity yield spread has been widening over the past several months and recently reached its highest level since early 2018 amid improving US economic growth prospects and vaccine optimism.

Industrials

BMO Capital upgraded Industrials to overweight from underweight and believes the continued improvement in macro conditions could provide significant tailwinds for the sector's relative performance for several more months.

Two of the sector's largest industries - Machinery and Road & Rail - have exhibited fairly strong cash flow generation despite the hurdles faced last year and have helped to offset declines seen elsewhere in the sector such as Aerospace & Defence and Airlines. The potential for stronger than expected global economic growth, could further increase the pace of cash flow growth for these industries and thereby further tailwinds for Industrials overall.

The Backyard Boom in North America

We stole this catchy title from our colleague Rob Kavcic of BMO Economics. The team notes that low mortgage rates and the necessity of remote working has led to accelerating demand for detached homes, cottages and a nascent move to smaller cities (i.e. the job may officially be in Toronto or Montreal but can be done from Stratford, ON or Sherbrooke, QC).

As Rob notes, "Very limited supply in areas that are seeing an influx of demand is still lifting prices and, in some cases, the growth is historic. The national MLS HPI rose 11.6% y/y in November, the strongest pace since July 2017 (when localized mini-bubbles were deflating). Every major market tracked by CREA on this basis is up from a year ago, ranging from very modest gains of 1.3%-to-1.9% in Calgary and Edmonton (which is actually a relief in those markets), to almost 30% y/y in some smaller markets around. The average transactions price was up 13.8% y/y. By the way, most cottage-country regions of Ontario are up about 30% annualized just since February 2020.
Also, interesting, is the fracturing of the market for single-detached homes and condos. This is not new (we've been covering it since the pandemic first broke out), but it is becoming even more stark.

For example, the benchmark of a single detached home price in Toronto increased 15% y/y in December, while condo prices were down again month-over-month, and up just 2.4% from a year ago. That is the widest performance gap on record going back 20 years in favour of single-family homes."

In conclusion, we remain positive on nearly all front for 2021.

Wishing all our clients and friends a healthy and prosperous New Year! To the pleasure of talking to you soon.

Team Roux & Associates

Appendix

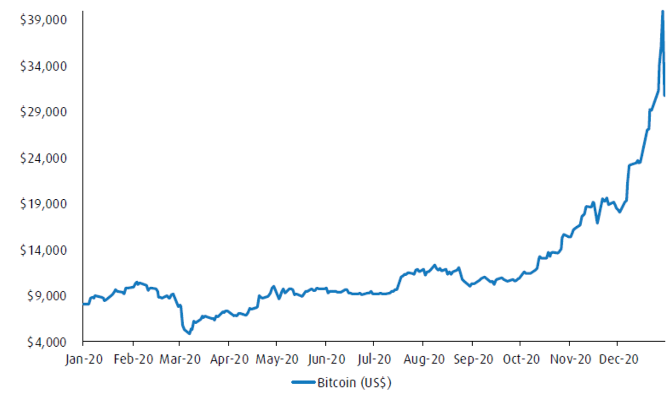
Bitcoin

No contemporary market commentary would be complete without at least a passing reference to Bitcoin, which has come to embody the risk-on attitude pervasive in the market currently.

Having eclipsed previous records at over US$40,000 for a single Bitcoin tells us that this “crypto-currency” has graduated from the fringe to the mainstream with increasing institutional investor interest. While such extreme price moves always make us worried about a potential bubble brewing, we find the derivative implications of the move more interesting. Gold comes to mind immediately. While Bitcoin was only created a little more than a decade ago, gold has been a reliable store of value for thousands of years. Also, with increasing concerns about an eventual return of inflation, we think the yellow metal could regain much of its lustre over the next few years. Call us old fashioned but we would place our bet there or in gold mining stocks, particularly given the much better execution, balance sheets and attractive valuations found in many of these companies.

That said, for those investors with an investment objective of growth coupled with a higher risk tolerance, exposure to Bitcoin through PayPal is an alternative because they accept payment via Bitcoin.

Bitcoin – 1 Year



Source: FactSet