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WEALTH MANAGEMENT GROUP

BMO Nesbitt Burns

First Quarter Recap

This quarter has been a somewhat more difficult quarter than what we experienced for the better part of last year. The initial COVID collapse in February and March 2020 was followed by a market that rallied solidly into January 2021 with barely a hiccup. With the 2021 New Year came a somewhat different set of challenges which has led to increased market volatility and some larger daily, weekly and monthly swings. In my humble opinion, this is going to be the new norm for the rest of this year and the years ahead, as we enter more of a normal market cycle.

In a 'normal' market cycle we expect to see at least x3 pullbacks of -5% to -9% over the course of the year. We will have negative returns that may last a couple of months and maybe even a quarter. While 2020 was a well-performing year for us in hindsight, we would also say that one needs to temper one's return expectations in this environment as we are likely to see more 'normalised' returns over the course of the year.

So let us explain what is happening in the markets and some of the forces both positive and negative that are likely to come into play over the coming quarters. I want to point out that through all of this, we are still bullish on the market and the economy and expect a multi-year expansion, where things continue to improve and get stronger as we enter into a post-COVID world. It just bears remembering that this process will not be a straight line and as always the market will climb the inevitable; 'Wall of worry' along the way.

Sector Rotation

Sector Rotation is something that we saw starting to unfold late last year and gain steam coming into the New Year. Last year during the COVID pandemic we saw certain areas of the market that benefitted from the 'Work from Home' phenomena do exceptionally well. One of the main beneficiaries of this was the Tech sector whose income for the most part was not affected and in many instanced increased dramatically. People shopped more online, made more online payment transaction, streamed more Netflix, played more video games and companies invested copious amounts on software and hardware to keep their employees and operations running smoothly.

As news of successful vaccines became a reality the market started to pivot and look for the next sectors to benefit from the economy being eventually reopened. Many of these companies were ones that had suffered the most during COVID, think airlines, retail, hospitality etc. and so the market started to take profit from the Tech names and move into many of the companies that had lagged in the recovery. We saw hotel stocks and airlines catch a solid bid, while money started to move out of names like Amazon for example. Amazon's stock has not appreciated in value since October last year, as many of these large Tech companies valuations had become fairly stretched and the market looked for better value. We also saw some of the more traditional industries start to rally, like Industrials, Manufacturing, Insurance and Banks.

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This rotation was in many ways a good thing as the rally in the market started to broaden out and expand to a greater number of sectors and companies. When this occurred, we saw money coming out of Tech and in many cases the Nasdaq index which is where many of the major Tech companies list their shares. The net result of all of this is that the Nasdaq index pulled back from peak to trough by -11%, whereas some of the other indices were less affected due to a lower exposure to the large Technology names.

This rotation from one sector to another is a constantly occurring and will continue as this year evolves and as the global economy gets back up to full speed in a post-COVID world.

Interest Rates

One of the elements that triggered the volatility in February and March of this year in the stock markets were movements in the Bond market. To explain in the 'Coles Notes' version: COVID hit; Central Banks of this world threw everything they could at the problem and one of the tools available to them was to lower interest rates. Interest rates came down to in many cases ZERO and in some cases below ZERO. We all looked at this and said 'This is wonderful as we can get a mortgage for 1.6%! Let's go buy some real estate' and so the real estate market globally started to boom and guess what; housing prices went up by leaps and bounds. Once again, a good thing as it stabilized the real estate market. Not so good in that housing prices inflated rapidly.

As housing demand boomed so did the demand for raw materials and commodities, like lumber, copper, steel, zinc, nickel, plastic piping, etc. etc. as basically the demand for all these raw materials came booming back. This demand was made even greater because of when all the factories shut down during COVID, however the consumer kept on shopping, buying cars, RV's, bicycles and so on. Therefore, factories and suppliers ran down inventory levels and in many cases, out of all of their inventory and still needed more. Factories reopened but the back log in orders was huge and so they go on a shopping spree to buy raw materials.

One of the latest shortages is of semiconductor chips, which is starting to affect the production of everything from cars to cell phones, with many auto companies having to shut down their production lines as the shortages worsen and demand remains high.

From a corporate side of things, borrowing money to expand your business or buy another company also became dirt cheap and so companies went on a shopping spree and the value of businesses climbed nicely along with their share prices in the market.

Bottom line is that the price of everything started to climb as demand was high and supply was limited. We started to see a spike in inflation. Initially these higher prices are not passed on to the consumer but at some point they are and inflationary pressure starts to build.

The Bond market looks at the higher prices and the inflationary pressure and realizes that interest rates cannot stay at Zero or at their current level for much longer. So the Bond market starts to move to adjust Bond prices to build into the fact that they see Interest Rates as having to be higher in the near term.

The stock market looked at the Bond market moving interest rates and did not like it one bit. Higher interest rates transfer into high costs of borrowing and inflationary pressure erodes corporate earnings.

Net result is that the stock market took a fright and pulled back quite sharply over the last month or so. The companies that had negative earnings, or high leverage get hit the hardest of course and so we see some additional pressure on some of the high flying Tech names.

Central Banks of the World

They of course came to our rescue during COVID, pumping trillions of money into the market and individual bank accounts to get this thing stabilized. As a consequence, they loaded up on debt and most governments like Canada, are now running massive deficits. These same institutions have at some point to pay back this debt and so higher interest rates would not be well received, as the cost of paying the interest just went up.

The Central Banks have in the past also tried to manage inflationary pressure and keep it in around 2% per year, which is what they perceive as healthy. When inflation rises, their historical way of reducing it was to raise interest rates to cool things down. This time however it could be more difficult in that you have these massive amounts of debt owing and to raise interest rates would be like shooting yourself in the foot, as it costs you more.

Bottom line here is that the Central Banks of this world have a difficult path to follow as they need to keep inflation in check and at the same time keep interest rates low to continue to help and stimulate the economy until things are back to normal.

The stock markets of course look at this Balancing Act and it makes them nervous. The stock markets know that they need the 'cheap money', to keep the economy recovering but at the same time are scared of inflation and the Bond market is telling them rates must go up…

Bottom line: The Central Banks come out and say that in their eyes, that the spike in inflation is temporary and not a longer term phenomena. Once factories and supply chains are back up to full speed, they see inflationary pressure subsiding and returning to the 'normal' sub 2% range. If you look at the past 20 years they are dead right in that inflation has not been an issue over the longer term.

The stock markets go backwards and forwards worrying about it and then not worrying about it and this leads to increased volatility. The unfortunate part of this is that we are likely to be dealing with this for years to come. The same thing happened after the 2008 Financial Crisis. The economy and markets recovered strongly through 2010 to 2014 and every time the Central Banks spoke of raising interest rates or removing stimulus, the stock market had a 'Taper Tantrum'.

The exact same thing will likely occur this time, as the economy recovers from COVID, things return to normal, business and the economy is booming and the Central Banks start to talk about raising interest rates and pulling back on some of the stimulus they have pumped in and the stock market will take fright leading to further periods of volatility.

Remember though that this will occur all within an improving and strengthening global economy, which inevitably will drive corporate profits and stock markets higher over the course of the year, as they climb the proverbial: Wall of Worry.
Volatility is to be expected.

CDN and US Dollar Movements

Of late the CDN dollar has appreciated against the US dollar in spite of Canada running record deficits. This is more due to a decline of the US dollar in relation to other currencies, as currency traders took a negative view of the stimulus packages that the US released to boost the US Economy. This has meant that we have seen the CAD dollar go from $0.76 in November last year to $0.795 in March of 2021. This is approximately a 4.6% change in value versus the US dollar and is important, as on paper it represents as a negative headwind for our US dollar investments, when we convert the holdings back into CAD $ for reporting purposes. As you all know our philosophy is to hold and invest the US dollar in US dollar denominated stocks and we do not convert US dollar back into CAD dollar. Longer term the US dollar is the stronger market and offers way more diversification than the very concentrated Canadian Index.

Our expectation longer term is that CAD dollar will settle into range here of around $0.78 to $0.80 in the coming year and so there may still be a little bit of pain for us on the conversion for reporting purposes. We may see some movement on the CAD dollar once the new budget is announced later this month and we see how large the deficit has become, but that remains to be seen.

Our Perspective

We have remained active as always over this period and had rotated out of many of the Tech names that drove returns last year. Along the way we have added more to the financial sector, insurance and industrials. For more 'Growth' orientated clients we have also added some airlines and leisure stocks and though we were a little early in our purchase, they are starting to pay off. We are also starting to see a bounce in consumer staples and so recently added Costco to all client portfolios. Through all of this we continue to have a strong belief that Technology will continue to drive business and flourish in the years to come. Technology is also a driver of deflation and so is likely to moderate inflationary pressure in the months and years to come. Our investments in this sector will change over time and it may not be the large names like Amazon and others that drive returns for us in the coming years.

We are also a believer that the current inflation is but a temporary phenomena and that longer term inflation will slip below 2% again. However we also believe that interest rates have to go up slightly from where they are today, as ZERO does not make sense to anybody. So even if interest rates creep up slowly over the coming years it is going to be VERY difficult to generate positive returns with any Fixed Income Investments in portfolios. Remember as interest rate rise, Fixed Income (Bonds) prices fall. This is a difficult scenario, as all 'Balanced Investors', have to have a certain % of Fixed Income, Bonds etc in the portfolio in order to be classified as 'Balanced'. We are therefore facing the reality that 25% or more of a Balanced Account is likely to provide negative returns or at best flat returns in the coming years. We have already felt the effects of this in the last 2 months on client portfolios as interest rates climbed.

We have done everything we can to mitigate this, by buying the shortest bonds possible and adding in a larger portion of preferred shares. All of this, in an effort to mitigate the negative attribution that higher interest rates are creating in portfolios. We DO NOT see much in the way of positive returns from Fixed Income in the years to come and it will likely dampen your overall returns in the portfolio.

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To clarify, we are not advocating everybody dump the Fixed Income and put all money into the Equity side of the market, as that can increase the risk profile, however we need to make sure that you are aware of what is likely to occur. Please, if you have further questions, reach out to us and we will be sure to explain in more detail and present other possible options if suitable for your individual situation.

For sure every Pension Fund and retired individual is facing the same question at present, as all need a certain amount of income to enjoy retirement and with interest rates so low and fixed income producing negative returns, investors of all stripes are looking more to the equity market and dividends from stocks to provide the necessary cash flow and income for retirement.

Our Team

We would like to welcome our new team member Penelope Mallea, who will be joining us on the administrative side. Penelope is originally from Chile (Si ella habla Espanol!) and has been with the BMO Nesbitt family for a number of years. She will be working closely with Samantha, Kenzy and Tracy. I am sure you will be talking to her in the months to come.

Thanks again from all of us.

Greg, Jed, Marion, Lili, Dave, Samantha, Kenzy, Tracy and Penelope

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