INVESTMENT OUTLOOK Q2 2020

HIGHLIGHTS

Economic Review

- While financial markets recouped the majority of the losses suffered in March, economic activity is nowhere near normal levels.
- The corporate bond markets in Canada and the U.S. rallied substantially on the back of actions from central bankers, with the announcement of their respective bond purchasing programs.
- Equity markets bounced back sharply with growth-focused markets and those with more cyclical constituents tending to fare well.

Investment Outlook

- In the short run, there is likely to be an upward bias to inflation as income levels have been supported by government programs while the supply of goods and services is still constrained.
- Although financial markets are clearly anticipating a "V-shaped" economic recovery, much will come down to the size and impact of the expected second wave of infections expected in the autumn months.
- While the ability to weather the storm caused by the pandemic is important in the near-term, we continue to keep a long-term perspective, investing in solid companies that can both sustain the current period of economic uncertainty and excel competitively in a post COVID-19 world.

ECONOMIC REVIEW

By the end of the second quarter, financial markets recouped the majority of the losses suffered in March, in what can best be described as a triumph of the optimists. Economic activity is nowhere near normal levels, yet the direction has shifted from bad to good, which is enough for investors (and certainly some speculators) laden with cash. Central banks did not offer any resistance and, if anything, were extremely careful to assure investors that they are willing and able to offset any setbacks in the economic recovery and financial markets —although they have repeatedly downplayed the potential for the latter. Fiscal policy efforts were more of a mixed bag as the inevitable political realities make additional stimulus more contentious, particularly with the upcoming U.S. national election. U.S. economic growth is expected to contract anywhere from 5-10% in 2020 and core inflation recorded its worst three-month annualized rate (-2.4%).

In our first quarter comments, we suggested that the recession would be "serious" and "with some caveats, we can say it will be short-lived". Those caveats reflect the level of uncertainty that remains today. There are multiple unknowns, particularly as it relates to the intensity and path of the pandemic. We do not yet know when a vaccine or effective treatments will be made widely available; we do not yet know the full impact of political decision making on the spread of the virus or of human behavioral responses such as wearing masks and social distancing or refusing to do so. Nor do we yet know the extent of political and social unrest and their implications. What we can be somewhat confident of is the willingness of central bankers to ensure that asset markets function properly and that their prices have a chance to support the economic recovery. At this point, one could argue that valuations have moved ahead of the economic recovery, but this is not unusual as markets discount the future. What is unusual is the clarity with which central banks, and in particular the US Federal Reserve, have reinforced their commitment to sustain the recovery, leading to more support for asset prices than in the past. The one real risk to asset prices relying on that support is that it could be withdrawn, with the main impetus for that change in policy being a significant rise in inflation expectations.

BOND MARKETS

The corporate bond market rallied substantially in the second quarter on the back of actions by central bankers. In mid-April, the Bank of Canada announced its intention to introduce a $10-billion corporate bond purchase program to purchase eligible Canadian investment grade corporate bonds in the secondary market. With this unprecedented direct support, corporate bond spreads rallied strongly—a situation that is not typical during a very weak economic environment. Canadian corporate bonds posted strong gains with their yields declining by 88 bps on average while 10-year federal government bond yields declined by only 24 bps. Likewise, in April, the U.S. Federal Reserve also announced its support for high-yield credit markets, leading to a significant rally in high-yield corporate bonds (rated below investment grade or BBB) despite the likelihood of a substantial rise in default rates.

EQUITY MARKETS

The second quarter provided an extremely sharp bounce back in equity markets, encouraged by unprecedented coordinated monetary and fiscal stimuli globally along with signs of improvement of the COVID-19 pandemic within certain regions. The MSCI All Countries World Net Index, a broad proxy for global market indexes, posted a return of 19.2% (in USD) for the second quarter, its strongest quarter since 2009. Primarily cyclical sectors led the recovery (Materials, Information Technology, Consumer Discretionary, Industrials) while more defensive areas lagged (Consumer Staples, Utilities, Real Estate).

From a sector standpoint, Information Technology continued to lead the way in most markets. The combination of recurring cash flows, wide-ranging capital deployment opportunities in a more digitized world, and the potential for continued "work from home" recommendations propelled many shares to all-time highs. Also notable was the Consumer Discretionary sector, as the prospects for a gradual reopening of the global economy buoyed hopes of the return to consumer spending. Materials stocks also performed well in many markets, with gold companies notably continuing to contribute to Canadian index returns.

Several areas that provided resiliency in the first quarter failed to keep up with the rebound during the second quarter. Consumer Staples, which benefitted from outsized in-home purchases at the onset of the pandemic, posted more modest gains with the expectation of some de-stocking. Banks also posted fairly tepid returns with the prospect of lower rates for the foreseeable future, increasing credit cycle risk and heightened regulatory scrutiny weighing on sentiment.

Regionally, growth-focused markets and those with more cyclical constituents tended to fare well. The U.S. market continued to be a strong performer, with the technology heavyweights propelling benchmarks forward despite ongoing social unrest and a resurgence of COVID-19 cases in many states that relaxed guidelines too soon. Several commodity-linked markets, such as Australia and South Africa, also showed gains, as commodity prices rebounded from their lows and their respective currencies recovered. Conversely, more conservative areas with lower currency beta failed to keep pace. Canadian market returns were broadly in line with most other global indexes in the quarter.

Market Returns (as at June 30, 2020)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	17.0	-2.2	4.5	6.3	6.0
S&P 500 (C$)	15.3	12.1	12.7	16.9	9.6
S&P 500 (US$)	20.5	7.5	10.7	14.0	8.8
Russell 2000 (US$)	25.4	-6.6	4.3	10.5	7.0
DJIA (C$)	12.7	1.1	9.8	13.0	7.1
DJIA (US$)	17.8	-3.0	7.9	10.2	6.3
MSCI EAFE Net (C$)	9.9	-1.1	3.8	8.4	4.8
MSCI EAFE Net (US$)	14.9	-5.1	2.1	5.7	4.1
MSCI Emerging Mkts Net (US$	18.2	-3.0	3.2	3.6	6.7
FTSE Canada Universe Bond	5.9	7.9	4.2	4.6	4.7
FTSE Canada 91 Day T-Bills	0.1	1.6	1.0	1.0	1.6
C$/US$	4.5	-4.1	-1.7	-2.5	-0.7

Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

OUTLOOK

In the short run, there is likely to be an upward bias to inflation as income levels have been supported by government programs while the supply of goods and services is still constrained. Think of your neighborhood restaurant trying to turn a profit at 50% capacity without changing prices. There are still long-term disinflationary influences such as the extreme level of debt obligations, but the economic shutdown has accelerated the marriage of monetary and fiscal policy actions. So far, the U.K. is the only developed economy that has used the central bank to directly fund federal government spending (on a temporary basis). Should other countries see fit to follow their path, our concerns of an imminent rise in inflation will be justified. Needless to say, we are extremely vigilant in our analysis of such a trajectory as the implications for financial markets would be significant.

Financial markets are clearly anticipating a “V-shaped” economic recovery. Indeed, there are certain parts of the economy which can recover quicker, and signs of that have been seen in above-consensus job gains in the past two months. Yet there are other areas, such as travel and leisure, which will surely take much longer to return to normal, if that is even possible.

Taking all of this into consideration, much will come down to the size and impact of the expected second wave of infections expected in the autumn months, and what further measures will be taken by governments and central banks as a response. Given this uncertainty, having a deep understanding of the companies we invest in is as important as ever. Not only do we continuously analyze the quality of their balance sheets and the sustainability of their earnings, our focus on assessing the strength of management teams is equally as important. While the ability to weather the storm caused by the pandemic is important in the near-term, we continue to keep a long-term perspective, investing in solid companies that can both sustain the current period of economic uncertainty and excel competitively in a post COVID-19 world.

All returns are expressed in Canadian dollars unless otherwise indicated.