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Wealth Management
Dominion Securities

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Quarterly Update

The world changes fast, probably faster than we ever want it to. Even though we are coming off one of the strongest equity years in history, that seems like an afterthought with everything that is going on in the world today. While this may be a scary time, governments and citizens are all doing their part to combat this global crisis. It can be quite difficult to see the light at the end of the tunnel, but the one point we are very confident in is that there is always a light at the end of the tunnel. How long it takes to get to that point is unknown, but history has shown us that time and time again, we do come out the other side, and oftentimes, stronger.

The market vs. the economy – the two don't always move in tandem

While the recovery in the stock market has been comforting since its low point of March 23, there are still some lingering issues going on in the economy. That is a tough concept to comprehend, as the world is continuing to move differently than it was five months ago, but the markets continue to rise. It is important to remember that the two are very different from each other. While they both affect each other, they tend to act radically different in the short term. The stock market is forward-looking, and by contrast, economic data often looks backward at what's already occurred. This disconnect produces a notable lag between the economic cycle and that of the market. Until the arrival of COVID-19, the U.S. economy was considered in the "late cycle" stage – enjoying growth while approaching the peak of the cycle. Now, a recession has clearly struck, albeit in a way that is entirely outside the parameters of a normal business cycle. This recession wasn't the classic result of too much risk-taking or an expansion simply becoming fragile as it aged, it was the result of a black swan event.

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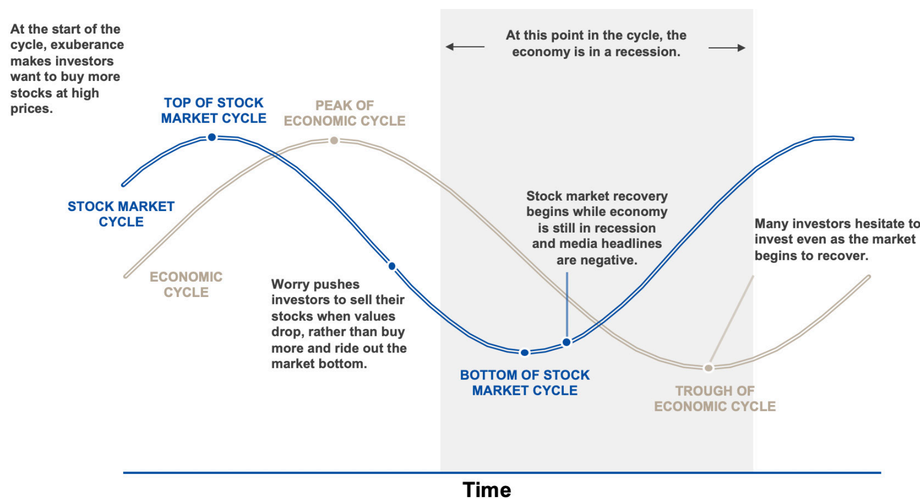
Figure 1: The stock market and the economy: How the two cycles are related



Source: RBC GAM. For illustrative purposes only.

If you look at Figure 1, we find ourselves in this shaded area. The stock market recovery has begun, while alarming headlines continue to swirl regarding the economy. This disconnect can be puzzling. A number of factors have come together to help investors look over the valley – pricing in a narrative that suggests the challenges stemming from the COVID-19 pandemic will be temporary. These factors include:

- Massive stimulus from governments.
- Extraordinary support from central banks
- Optimism surrounding a COVID-19 vaccine

Support and optimism

With no definitive time horizon, governments and scientists around the world are collectively working together to overcome the fallout that COVID-19 has caused. On a monetary front, the Federal Reserve's efforts to soothe financial markets since March have proven successful. Volatility in the treasury market remains at the lowest levels of the year, with the Fed's balance sheet having expanded beyond $7 trillion. While easy monetary policies from global central banks will support the growth outlook, the robustness of the recovery and further yield curve steepening will also depend on strong fiscal support. As of May 29, the U.S. government had already provided the equivalent of 11.3% of its GDP (over $2 trillion) via direct fiscal stimulus. Though the road to economic recovery will be rocky, we look for further curve steepening to confirm that the rebound is taking hold, just as it has in past cycles.

The Fed's unorthodox tools, such as quantitative easing (which allows it to purchase federal government, state and municipal government and corporate bonds), have helped shape not just economic cycles but also short- and medium-term financial market returns. We doubt the S&P 500 would be up nearly 40% (as of June 30) from its COVID-19 shutdown low in March had the Fed not stepped in to keep financial markets functioning, especially the corporate bond market. While bipartisan fiscal stimulus from the White House and Congress mattered a lot, the Fed's interventions and "money printing" abilities were imperative to kickstarting the recovery in the U.S. markets and economy.

This is all in accordance with the further development and optimism around an effective vaccine. Scientists, medical professionals and healthcare companies are working around the clock to get a working vaccine out to the masses. Currently, there are at least 135 vaccine candidates under development, of which seven are in Phase 1 trials, seven in Phase 2 and one in Phase 3.[1] In the business of developing a vaccine, Phase 2 has typically proven to be the largest hurdle. History suggests there is only a 30% chance that a prospective vaccine that makes it to Phase 2 will go on to become an approved effective therapy.[2] While that number is low, there is some solace in the fact that these clinical phases are done in protection of the masses' health and even with the high obstacles, some developments are continuing onto Phase 3. Global governments are doing everything in their power to support the science

[1] RBC Wealth Management Global Portfolio Advisory Committee, "Global Insight," July 2020.
[2] "

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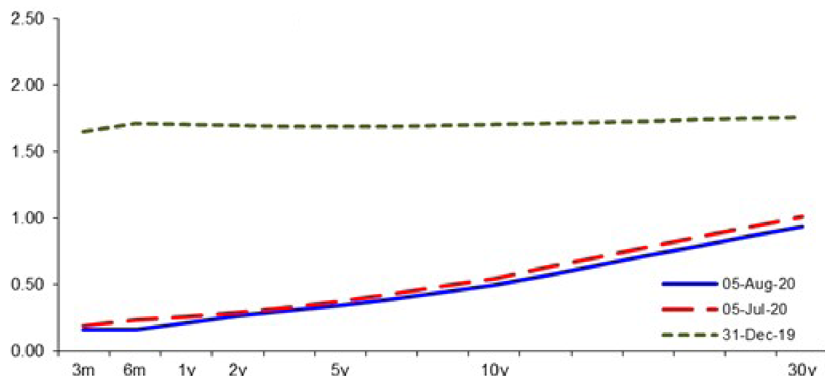
Figure 2: Government of Canada Yield Curve



and companies in their attempts to find a proven vaccine. Along with the monetary and fiscal support, the optimism around the developments of a working vaccine is one of the supporting reasons in the strong recovery of the stock market.

What are we doing

While every economic cycle is different from the rest in the short term, they do tend to follow the same pattern in the long term. Although this is a "black swan" event, the recovery in the stock market thus far is showing a lot of correlation to historical recessions. While we would all prefer a smooth and comfortable recovery, that is unlikely to be the case and as we mentioned in our last quarterly note, we believe a disciplined and strategic plan will prevail in the long run. With our larger-than-normal cash balances coming into 2020, we have been able to take advantage of this downfall in the markets and continue our process of increasing equities towards our longer-term targets. On the fixed income front, the whole world seems to have changed in the last quarter. Everything from simple liquidity vanishing in late March, to a decrease in the overnight lending rates across the board and yield curves shifting down across the whole curve (see Figure 2). Our overall strategy has not changed with respect to our fixed income holdings; we want to keep good-quality credit with low duration, as we feel you are not getting rewarded to take on more risk from the credit and term to maturity perspectives.

Thank you for your continued trust and support.

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