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Wealth Management
Dominion Securities

Winter 2021

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Quarterly report

Last year was one for the record books, and affected the world in a multitude of ways. From rising COVID-19 cases, to lockdowns and a technical recession, I think we're all pretty happy it's now 2021. While 2020 was a struggle for countless reasons, we must remember that it is always the darkest before the dawn, and it appears that dawn may soon be upon us. We are now seeing a rollout of vaccines, lockdowns will hopefully be reduced in the coming months and the economic recovery from all statistical data points is moving in a positive direction. By and large, this recession came upon us through non-conventional circumstances in comparison to other recessions, but it has continued to follow the same trends thus far, and should continue to do so moving forward. Furthermore, between consumers and companies adapting to new trends and governments attempting to help across the board, we believe we will experience a few years of continued growth in economic recovery that extends to pre-recessionary levels and higher.

Adapt or get left behind

The seismic shift in 2020 highlighted the necessity of adapting to the current climate. Companies have been adjusting their businesses and increasing their digital presence, while consumers are finding ways to succeed in this new normal. This has led to another stage in the technological revolution. Fierce competition for market share tends to drive up companies' capital spending. Increasingly, that spending has become technology-focused (see figure 1). Firms need diverse capabilities if they intend to stay ahead or catch up: to reach customers and anticipate their needs; to rapidly develop new products and get them to market; to manage inventories, replenish, and reprice; to manage supply chains and working capital; etc. The digital economy is now thought to be approaching 10% of U.S. GDP, and is growing. That would make it larger than the financial sector. The pandemic has revealed that businesses without a viable, functioning digital presence are at an enormous competitive disadvantage, and the race is on to acquire that capability. This growth in capital spending is good for profits, employment and productivity when considered across the total economy. But within an individual sector or industry group, the willingness and capability to spend what is required to compete digitally – maybe

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more than is required – becomes a differentiating factor that can separate dominant industry leaders from the rest.

Will the liquidity stop?

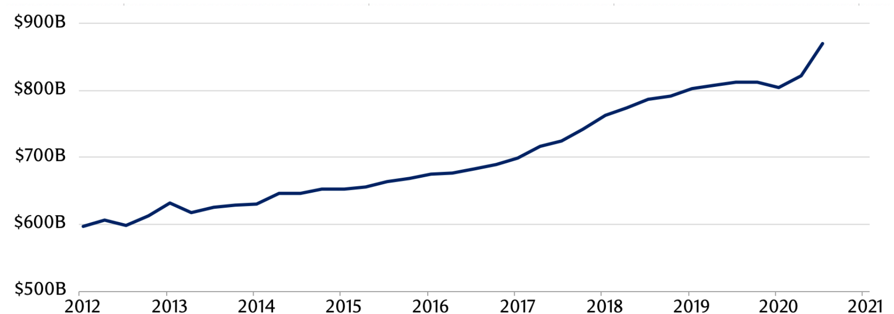
The pandemic has marked the start of a new economic era – one in which old rules are swept away. Global governments are racking up massive debt, increasing their use of fiscal stimulus, and their role as capital allocator has grown markedly. We expect encouraging equity returns and strong earnings growth as COVID-19 economic headwinds diminish. The persistence of ultra-low interest rates should support increasing valuations and make equities the asset class of choice in 2021. One of the common concerns we often hear is the impact of ballooning government debt and the prospect of surging inflation in the years to come, as well as their implications for investment strategy. We surmise that high debt levels do not necessarily represent a systemic risk in the near term and that debt servicing costs will remain manageable even in the medium term, though they will likely restrict governments' budgets in the future.

We expect inflation to stay within acceptable bounds so long as major economies are approaching full capacity. Our forecasts for inflation in the short term point to slightly higher inflation, as the outperformance of the U.S. economy may support faster price increases in the U.S. versus elsewhere. Over the longer term, potential upside risks to inflation exist. Massive monetary stimulus, higher inflation targeting by the U.S. Federal Reserve (Fed), elevated government-debt loads and a push to support sales of American-made products are all elements that could push inflation higher than we would have thought before the pandemic. That said, we don't think inflation will rise to problematic levels, as a number of structural forces such as demographics will continue to weigh on inflation pressures. All in all, any faster inflation that we do encounter is likely to be simply a return to more normal readings after decades of subdued price increases.

Our current exposures and expectations

Earnings, already in recovery, could surprise to the upside in 2021 and 2022, as some sectors and groups, crippled by the pandemic, return to life. To start the year, we have positioned equity portfolios with a larger mix of cyclical (economically sensitive) companies. We expect equity prices will appreciate further from today's levels through 2021, although not as much as earnings advance, bringing price-to-earnings ratios down modestly. There is usually very rapid catch-up growth for both GDP and corporate profits in the 12–18 months following the end of a recession. Thereafter, the GDP expansion settles into a trajectory more closely aligned with the economy's longer-term potential growth rate. Our overweight (above-benchmark) recommended exposure to equities reflects our view that the driving force behind earnings growth and equity valuations is rapidly shifting away from the outsized volatility risks presented by the pandemic, and is moving back toward the long-term expectations for sustainable economic growth. On the fixed income front, we think monetary policy will again be relied upon to support the economic recovery, and that will likely mean lower rates for longer and increased reliance on other policy tools such as quantitative easing. With high debt levels and low inflation enabling central banks to keep interest rates lower for much longer, what worked in the past for fixed income investors may not work in the future. This ultra-low rate environment presents great risk for long-duration bonds, and thus we have positioned our fixed income portfolio with high-quality credit, short duration along with an overall underweight allocation vs. equity.

Figure 1: Tech-related capital expenditure is soaring



Source: RBC GAM, "Global Insight Weekly," Nov. 25, 2020

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