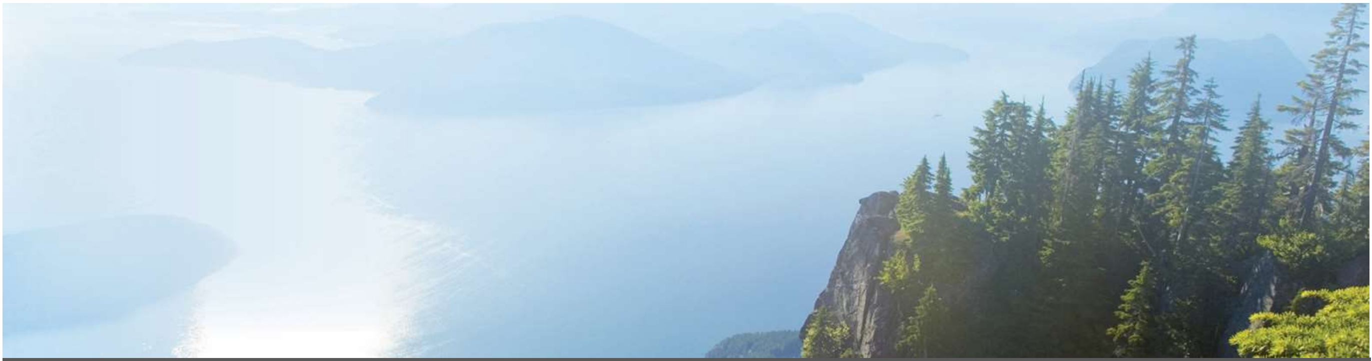


FIRST QUARTER REPORT – MARCH 31ST, 2020

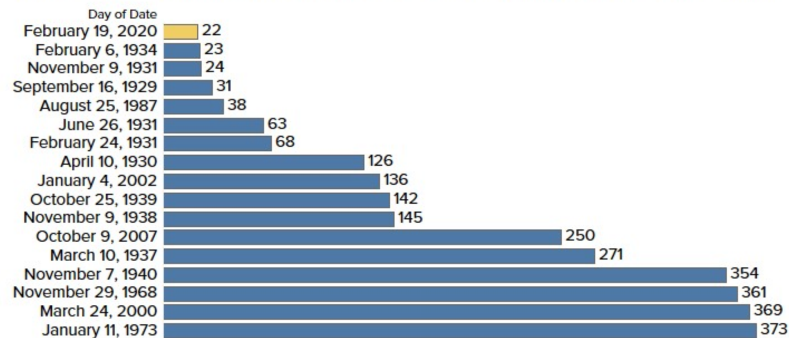
Churches, Schools, Shows Closed. Epidemic Puts Ban on all Public Assemblies. - The Seattle Times, October 5TH, 1918
New York City Schools, Restaurants and Bars Are Shut Down Over Coronavirus - The New York Times, March 15TH, 2020

WHERE DO WE GO FROM HERE?

The spread of the coronavirus from first discovery to worldwide spread has been incredibly fast. On December 31ST, the first cases of an unknown virus were reported by China to the World Health Organization. A few days later cases were reported in Japan, South Korea, Thailand, and the United States. By March 11TH World Health Organization had declared the new coronavirus a pandemic.

The market reaction has been even swifter. The US S&P500 hit a high on February 19TH, 2020. One month later it was 32% lower. Two days later on February 21ST, 2020, the Canadian S&P/TSX hit a high. A one month later it was 37% lower. As more negative news came out about the spread of the virus, bond markets and Exchange Traded Funds (ETFs) also seized up. The iShares Canadian Corporate Bond index ETF (Canadian Investment Grade bonds) fell 23% from February highs, iShares iBoxx $ Investment Grade Corporate Bond ETF (US Investment Grade bonds) fell 22%, and the SPDR Barclays High Yield Bond Index ETF (US Junk Bonds) fell 24%. Even gold, which does well during periods of uncertainty, dropped by 15%.

The spread of the virus and the decline in the markets took everyone by surprise. *The sell-off in markets this quarter was the quickest US markets have dropped 30%, ever*.[1] It took the S&P500 22 trading days to drop 30%. The sell-off was faster than in 2008, 1987 and even during the Great Depression in the 1930's.



[1] https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html

Warren Buffett: 'Only when the tide goes out do you find out who's swimming naked'.

As markets fell, many large investors and investment funds found themselves in extremely unfavorable positions. Low interest rates have enticed many investors to increase borrowing to magnify returns. As markets dropped faster than anyone expected, investors were forced to sell investments to cover their losses. Lenders demanded additional collateral from investors as losses mounted. The problem for many investors who had borrowed was they were not able to come up with additional funds. They had to sell their investments to post additional collateral. You can imagine the problem when markets are falling 10% a day and many investors are forced to sell, all at the same time. A mass liquidation of everything occurred, with not enough buyers to provide price stability. This caused a rapid sell-off across all asset classes.

WHAT'S NEXT?

The slowdown and recession we're in, is very different from a regular recession. In the past, recessions have occurred because of a tightening of credit, or an adverse external shock such as a quick rise in oil prices. This causes inflation to pick up, forcing central banks to counter it by raising rates. Credit is restricted in the economy, and the economy slows and goes through a painful, deleveraging process. The 2008 US housing bubble is a perfect example. This current slowdown is because governments around the world have pressed 'Pause' on the economy: business have been forced to close, workers to remain home, and complete mandatory lockdowns in some cities.

The response by both governments and central banks has been unprecedented. This March, the US Federal Reserve (FED) cut short-term interest rates from 1.50% to essentially zero. The response has been faster and more aggressive than ever before, including the FED's response to the financial crisis of 2008. To put this in perspective, in 2010, the US FED started the second leg of Quantitative Easing. This involves the FED buying financial assets from institutions, creating more funds for the financial system to encourage consumers and businesses to borrow, helping to stimulate the economy. *In 2010, it took the FED eight months to purchase $600 billion of US treasuries and mortgage backed securities. This time, in late March of this year, the FED bought $622 billion of US treasuries and mortgage backed securities*[2]*, roughly the same amount as they did in 2010, (or the equivalent of 2.9% of the US GDP)…all in a week!* There is a saying, 'Don't fight the FED'. Meaning that if the central banks are trying to stimulate the economy, don't bet against them. The amount of monetary stimulus from central banks is the most aggressive we have ever witnessed. Since 1982, from the when the FED cut interest rates, to when they finally raised rates, the average annualized return for the S&P500 has been 20%[3].

In Canada, we've seen the same aggressiveness from our central bank. Rates were reduced from 1.75% to 0.25% in March. And for the first time, the Bank of Canada started their own Quantitative Easing program. This follows other countries such as the United States, United Kingdom, and Europe to drive down borrowing rates, maintain liquidity, and create more funds for the financial system. Other central banks around the world have followed suit, lowering interest rates and using unconventional means to keep borrowing rates down enticing individuals and businesses to borrow.

The amount of fiscal stimulus by governments has also been larger than anything we've previously seen.

Estimates for the deficit this year in Canada are around $180 billion for 2020 (and growing), which is already twice as large as the deficit during the financial crisis in 2009. We've seen governments and corporations take unprecedented actions. Such as mortgage deferrals, the Canadian government providing up to 75% of wages for small and mid-sized businesses, access to interest free loans for a year (with a portion being forgiven), and special benefits provided for those not covered by Employment Insurance (small business owners, and gig economy workers such as Uber drivers).

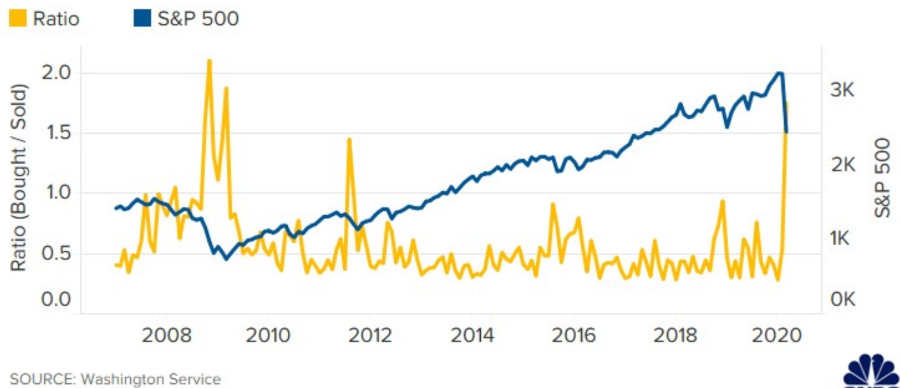
In the US, the $2 trillion-dollar stimulus package that was passed this March, is twice as large as the stimulus package passed in 2009. *Washington is also now talking about an additional $2 trillion-dollar stimulus bill, which would put the total at four times of that in the financial crisis of 2008*[4]*.* As part of the current stimulus package, US tax filers will be receiving a non-taxable cheque of $1,200 and $2,400 for joint filers, along with an additional $2,400/month on top of normal unemployment benefits[5].

[2] https://www.newyorkfed.org/markets/ambs_operation_schedule#tabs-2, https://www.newyorkfed.org/markets/opolicy/operating_policy_200323
[3] https://www.cnbc.com/2019/07/30/this-chart-shows-why-stock-investors-say-dont-fight-the-fed.html
[4] https://www.cnbc.com/2020/03/31/coronavirus-stimulus-trump-calls-for-2-trillion-infrastructure-plan.html
[5] https://www.nytimes.com/2020/03/25/business/2-trillion-stimulus-coronavirus-bill.html

We've already seen way more monetary and fiscal stimulus than during the great financial crisis, with more coming.

<u>What happens when governments press 'Play' again?</u> I will want to be invested. I hear from many investors that 'they want to invest when things get better'. On March 6TH, 2009, the Dow Jones hit a low. Eight months later, in October 2009, the US unemployment rate peaked. From the March lows to October, the Dow Jones was up 60%, while the unemployment rate continued to climb. By the time you wait for things to get better, you could be missing out on a lot of gains. The stock market is forward looking and doesn't wait for things to get better. *<u>Trying to time the market can wreak havoc on your long-term returns. From January 1st, 1980, to the end of 2018, a $10,000 investment into the S&P500 would have grown to $708,143. Missing out on the best 5 days in the market, your return would be reduced to $458,476, and missing out on the 10 best days your return would be reduced to $341,484[6].</u>*

Currently, company insiders have also been buying up shares in their companies. Insider buying in companies have outpaced inside selling by the most since 2009. Who knows what's happening inside of a company better than their employees?



Portfolio Manager, Bill Miller (who outperformed the market for 15 straight years while working at Legg Mason) was quoted on March 13TH, 2020 by CNBC: "There have been four great buying opportunities in my adult lifetime. The first was in 1973 and '74, the second was in 1982, the third was in 1987 and the fourth was in 2008 and 2009. And this is the fifth one."[7]

WHAT TO WATCH FOR!

As I mentioned in my newsletter a year ago, there is a big difference between the Canadian and the US consumer. Here in Canada, we carry massive levels of debts, making us one of the most indebted nations in the world. Our debt level is currently 100.3% of Canada's GDP, higher than any other nation except for Denmark, and almost twice the G20 average at 59.5%. The US is at 75%[8]. Even before COVID-19 crippled the Canadian economy, delinquency rates across Canada were the highest since 2012, with 90+ day delinquency rate on non-mortgage payments up 11% year over year in December[9]. According to the MNP's survey that was conducted before the Canadian economy was shutdown, half of Canadians are close to the brink of insolvency[10].

Many investors are looking at the investment playbook for 2009. The 2009 playbook says – 'Own Canadian Banks!' Why? Because Canadian banks came out of the 2009 financial crisis relatively unscathed. Investors who had bought them in 2009 were well rewarded. The average Canadian consumer continued to borrow more and more, which was very good for the banking business. The average Canadian is in much worse shape than last time. Even before COVID-19, Canadian consumers were running out of capacity to borrow. Canadian banks are valued as some of the most expensive banks in the world and

[6] https://www.thesimpledollar.com/investing/stocks/tempted-to-sell-missing-just-a-handful-of-the-best-stock-market-days-can-tank-your-returns/
[7] https://www.cnbc.com/2020/03/18/investor-bill-miller-one-of-the-best-buying-opportunities-of-his-life.html
[8] https://business.financialpost.com/executive/posthaste-canadas-world-leading-debt-could-be-its-downfall-in-global-downturn-report-warns
[9] https://globalnews.ca/news/6634564/equifax-canada-delinquency-rate/
[10] https://www.bnnbloomberg.ca/nearly-half-of-canadians-on-the-brink-of-insolvency-survey-finds-1.1414488

their customers are in horrible financial shape. We have avoided investments that rely heavily on the indebted Canadian consumer. The problem for most investors, is that our financial sector is twice as large as any other sector in Canada, making up 30% of our markets. So, most investors are overexposed to the indebted Canadian consumer.

WHAT ARE WE DOING?

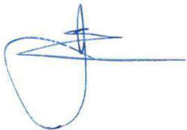
With large market movements, fear and panic, come generational opportunities. We are taking advantage of the volatility. The greater the market volatility, the greater the potential disconnect between security values and intrinsic values. This quarter we saw all investments sold off with little regard for the fundamentals. Governments' and central banks' actions will provide a massive boost to the economy. In our portfolios', we've provided downside protection to investors through very high-quality fixed income exposure, and alternatives investments (which have significantly outperformed this quarter), limiting portfolio volatility, and providing access to cash to clients who need it. We've been re-balancing portfolios to take advantage of the incredible bargains being presented. We are carefully analyzing companies for strong balance sheets and good growth potential that will do well when restrictions are lifted, and the economy gets back to normal. These are the exact types of market environments we shine in. We are well prepared for whatever comes next. I'm not a medical expert, and I don't know when the economy re-opens, but I do know that when it does, we are ready.

If you had any questions on your portfolio, don't hesitate to reach out to me.

Please stay safe, listen to the experts and we will get through this.

Did you know that the Spanish Influenza lasted from January 1918 to December 1920? Cities around the world were locked down. A quarter of the world's population, or 500 million people were infected. The death toll was estimated to be between 50 to 100 million. The DOW Jones Index was up 10.5% in 1918. The following year it was up 30.5%. From 1921 it rose 500% over the decade. The US FED didn't cut rates or add any monetary stimulus, and the US government provided no fiscal stimulus.

-Kind regards,



Joshua Brown, CFA

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