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Market update

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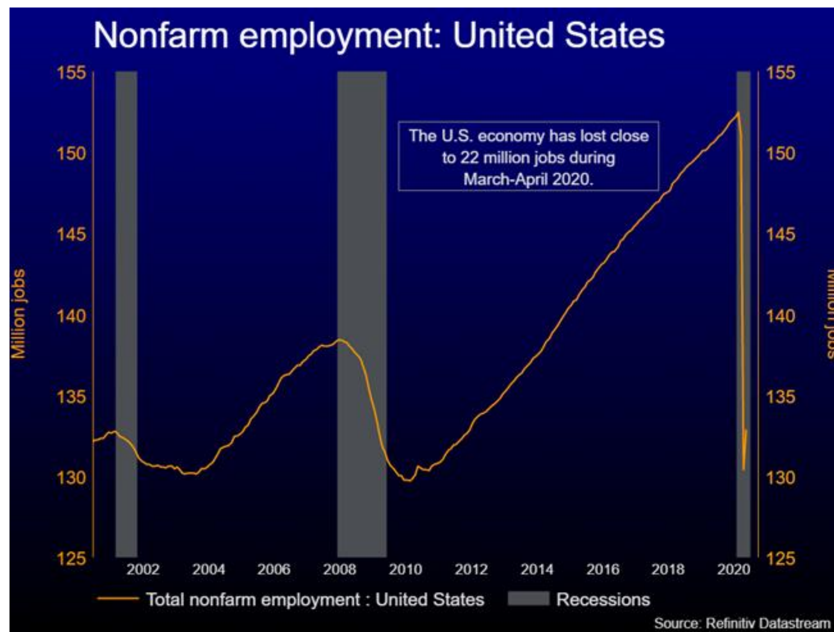
Before the coronavirus had broadened its reach into every corner of the Earth, the financial markets had kicked off the year strongly and some stock market indexes even hit new heights. The trade agreement between China and the United States, which had been announced a few months earlier and had been greeted enthusiastically by investors, boded well for an upswing in international trade and faster global economic growth.

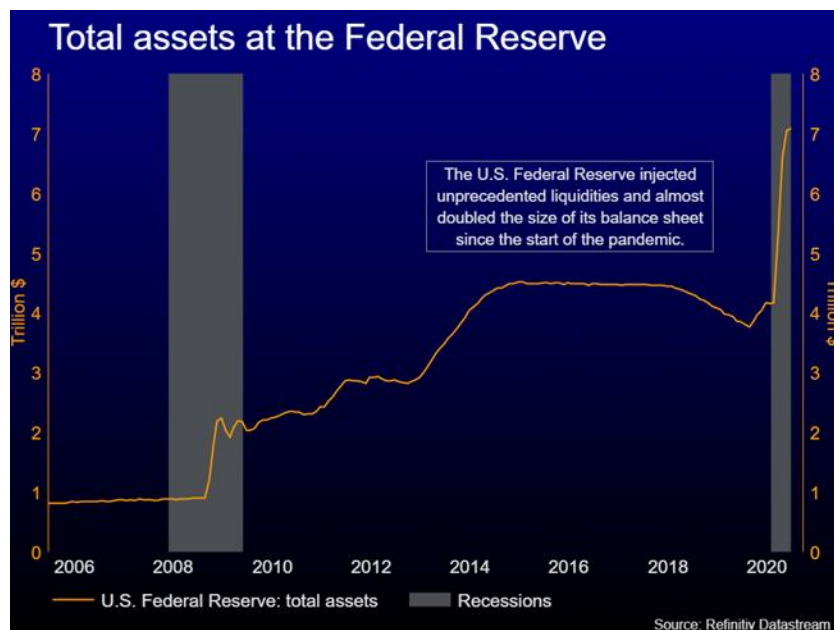
Investors did not seem concerned at all with the prevailing issues at that time: fairly high valuations for certain market indexes, left-leaning policy positions taken by some Democrats vying to be the next U.S. presidential candidate, and the first cases of COVID-19 already emerging in China. It seemed to be smooth sailing until the pandemic sideswiped the entire planet. A few weeks later, the global economy had entered a recession and the markets were plunging. The cause of the recession is unique and its severity is unprecedented. Historical data show that economic activity has never declined so much in so short a time. To ensure public health and avoid a catastrophic scenario, governments had no choice but to impose drastic measures. Then the global economy came to a standstill. Economists are expecting U.S. GDP to contract by about 30% on an annualized basis in the second quarter of 2020 from the previous quarter. The figures will be released in the coming weeks.

The chart below paints a telling picture of this recession's scope, with the U.S. losing 22 million jobs in March and April 2020 alone. In contrast, during the financial meltdown in 2008–2009, nearly 9 million jobs disappeared over a timeframe of slightly more than 24 months.



Outlook for the coming months

As the economy reopens in various countries and social distancing rules are eased around the world, the global economy should rebound strongly starting in the third quarter. It is important to note that without massive intervention by governments and central banks, the economy could never snap back so quickly. For consumers who have temporarily lost their jobs, the numerous government assistance programs will enable them to get back on track sooner. And thanks to the liquidity injections by central banks, a large number of businesses have been able to continue funding their operations and avoid bankruptcy. The U.S. Federal Reserve has taken a particularly aggressive approach since the pandemic started, as demonstrated by its balance sheet, which has almost doubled in a few months.



As for the fourth quarter of 2020 and the year 2021, forecasting how the economy will perform is quite difficult because it will depend partly on how COVID-19 progresses as well as the effectiveness of new treatments and an eventual vaccine. In the past couple of months, the trend in terms of new cases of infection was rather encouraging but last week's developments were more worrisome. The number of cases has risen rapidly in certain countries such as Brazil and India. In the U.S., some states have experienced sudden jumps in the number of new cases. And recently, China had to take action to contain a few potential cluster sites. In the coming months, we will be able to see more clearly but for now a variety of scenarios are still possible. A very plausible scenario is that the economy will recover much more gradually after a definite bounceback in the third quarter. Moreover, the U.S. Federal Reserve believes we will have to wait until 2022 before the economy returns to pre-pandemic levels of activity.

As is generally the case, the stock market indexes quickly priced in the upcoming economic improvement, moving back up since March 2020. The S&P 500 index, for example, is now less than 10% from its peak, which may seem optimistic in light of the current uncertainty and the wide range of scenarios that are still possible. As shown in the following chart, we think the S&P 500 is somewhat costly at this stage based on projected earnings for 2021.

However, the extremely low interest rates almost everywhere in the world are helping to push up valuations for riskier assets such as equities. In that context, the multiple for the equity market could be lifted above its historic norm as investors search for better returns. The enormous holdings in cash are another factor that could support higher equity valuations. Indeed, the data on U.S. money market funds show that the amount of cash being held by investors, both institutions and individuals, is at a record level. The chart below indicates that institutions and individuals are sitting on a total of about $4,700 billion in money market funds.

In analyzing the performance of the S&P 500 since its March low point, we observed that its outstanding performance was partly attributable to the very large proportion of equities from companies operating in the technology and healthcare industries, which have been havens since the pandemic began. However, those sectors' performance is obscuring a very different reality for many other companies. In particular, various names in industrial, banking, energy and certain consumer discretionary and real estate segments are still well below their pre-pandemic levels. Sooner or later, this crisis will end and many businesses will be as profitable as ever. With that in mind, we believe a rotation into sectors that have suffered the most from this recession is a very likely scenario for the year ahead and we are gradually repositioning our portfolios to take advantage of it.

Portfolio management

Our portfolio management task is especially difficult in the current environment. Not only are economic conditions unprecedented, the range of probable scenarios, from the most pessimistic to the most optimistic, is very broad. The impacts on financial markets are just as varied. We will therefore have to continue navigating carefully and stay focused on our investment philosophy, prioritizing the quality of holdings. We will also need to have a good understanding of how the pandemic will affect the long-term outlook for the businesses we invest in. Certain sectors could take much longer to recover from the crisis or could even undergo major transformations. Most probably, ways of operating will change and consumers will adopt new habits. Some companies could benefit from those changes while others not at all. For example, once the crisis ends, more people are expected to be working from home and e-commerce is likely to expand. There will be favourable or unfavourable longer-term consequences for the telecommunications, technology, real estate, food service and retail sectors.

Over the past few months, we have progressively redeployed part of our cash holdings into equities. Our investment choices have often targeted stocks that have fallen considerably since the pandemic's start. After applying our usual investment criteria (low debt levels, high cash flows, superior returns on invested capital, strong management teams, etc.), we also examined the companies' business models and we are confident they will not be altered by the crisis. Those businesses will emerge from this recession intact and some of them may even be in a better position.

The banking industry has taken a dive since the crisis began. This major hit to banking stocks, particularly in the U.S., reflects expectations of rising loan losses in the coming quarters. Bank profitability will therefore be severely compressed but we believe prices have already adjusted to take into account most of the sector's challenging conditions.

As a result, under our primary strategy, we have boosted our position in JP Morgan and initiated a position in National Bank of Canada. Both those banks are in excellent shape and will quickly regain their profitability once the economy has made up the lost ground. In the consumer sector, we initiated a position in Coca-Cola and added to our existing investment in Diageo. Those companies' revenues were affected when bars and restaurants closed but the businesses remain highly profitable. In addition, they pay good dividends and we think that with a little patience, those stocks will eventually climb back up to their respective peaks. In the industrial sector, we added Emerson Electric, a quality company that pays a good dividend. Long before COVID-19, the company had started cutting costs and improving its margins so it is now very well positioned for bigger profits when the economy picks up.

In the real estate sector, we expanded our existing position in the Choice real estate investment trust (REIT). The share price dropped even though this REIT, which operates in the commercial segment, is one of the industry's least affected by the pandemic. Its distribution, coming in at nearly 6%, also makes it attractive. Within that same sector, we added the Prologis REIT to our portfolio. It has a very solid footing in distribution centres and will benefit from expanding e-commerce in the years ahead. In the materials sector, we increased our weightings in Dow, Corteva and Nutrien. Dow is very sensitive to an uptick in economic activity and its share price should revive under that scenario. Corteva and Nutrien, for their part, are well positioned to capitalize on growing demand for agricultural products. The final addition to the portfolio was Fortis, an electric utility that has not been significantly affected by the pandemic but whose share price has dipped during that timespan. Fortis pays a good dividend, which should continue to climb in the next few years.

To fund part of those purchases, we sold off Costco and pared back Apple and Amazon. Those three stocks have performed extremely well during the crisis and we believe their potential returns have become relatively less impressive.

Since the start of the year, our U.S. equity portfolio has outperformed its benchmark index while our Canadian portfolio has lagged behind its S&P/TSX benchmark. That underperformance was caused mainly by our lack of participation in the gold sector combined with the explosive performance of Shopify, a stock we do not hold and that now accounts for about 6% of the Canadian index! It is important to note that gold companies generally do not meet our selection criteria. And when it comes to Shopify shares, their valuation is sky high. Moreover, our U.S. equity portfolio is already well weighted in technology.

On the fixed income side, we gradually increased our exposure to corporate bonds with superior credit ratings as well as high-quality preferred shares. We believe the yields on those bonds will outpace those on government issues, which are currently trading at unattractive levels.

Even though we reduced our cash holdings in recent months, they are still above our long-term target. If opportunities arise, we could deploy those funds.

In a context of such low interest rates, expected returns on fixed income securities are not very appealing right now. To earn returns matching previous years' levels, investors will have to review their portfolio asset mixes and possibly consider taking on more risk. For investors whose horizons are long enough, corporate bonds, preferred shares and common shares will likely have to take up more space in their portfolios, at the expense of government bonds. Of course, any change in strategy must take into consideration each individual's risk tolerance and various other personal factors.

We would be pleased to discuss your needs with you during our next meetings.

Wealth Management
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