# Quiet Counsel

Winter 2021
Investment Outlook

Quiet Money.®

# A Return to Normalcy?

*"It's hard to make predictions, especially about the future."*
*Never in our lifetimes has Yogi Berra's proverb seemed more appropriate than in the current environment of uncertainty. While we don't try to predict the future, given recent market strength, it's worth doing a sanity check.*

Investors selling their stock in the March 2020 trough held little hope of a recovery within years, let alone quarters or months. Today, while the uncertainty of *whether* a vaccine could be developed has now passed, the range of potential outcomes we face remains wide. The new focal points for assessing a return to normal have shifted to the *distribution rates* of the vaccine and the *efficacy* of the vaccine against new emerging strains of the virus. Things have improved but we are not out of the woods just yet. Economic growth remains anemic. Unemployment remains elevated. The strain of a year of hardship is showing in myriad ways.

And yet, prices keep rising. What gives?

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## Why are Stock Markets at All-Time Highs?

Given the ongoing uncertainty, it's fair to ask why the prices for stocks, government and corporate bonds, and

real assets like infrastructure and property have ascended almost without pause, off the March bottom. Why aren't investors demanding a higher level of compensation (paying lower prices) given the persisting uncertainty?

The answer, we believe, is government policy – both monetary policy (by central banks) and fiscal policy (by Treasury departments) aimed at dampening that uncertainty.

Let's first consider a real-world example: in an effort to reduce *employment uncertainty*, governments in the US and Canada supplemented individual incomes directly and provided employers with financing to both keep them solvent and incentivize them to retain staff. Ultimately, their goal is to stave off bankruptcies and encourage citizens to continue spending, preventing the negative feedback loops that cause economies to spiral into recession or worse.

Federal governments (via central banks) have also been intervening to reduce the volatility caused by *capital markets uncertainty*. It's done this by lowering short-term interest rates, and by buying government and corporate bonds (including high yield bond issues) at maturities beyond one year. These purchases lower interest rates and credit spreads (boosting bond prices), and help companies refinance existing debt at lower rates with longer maturities, which buys them some breathing room.

Low borrowing rates also help equity prices, as investors worry less about insolvency risk and ascribe more value to cash flows further into the future. Low rates tend to favour Growth stocks (whose bigger expected cash flows tend to be further out), and so falling rates supported Growth stock prices through most of the 2010s, and then accelerated in the March to September 2020 timeframe. However, the rally in Growth stocks ended in the fourth quarter. Value is now back in a big way.

## Value or Growth?

We wrote at length last summer and fall about how Value and Growth stocks were responding to the early phase of the pandemic (here, here, and here). The pandemic hit all sectors of the market in the early weeks, followed quickly by strength in Technology stocks and defensive Staples and Utilities, all of which were already expensive heading into 2020. By June 2020, the valuation gap between Growth and Value stocks had widened to a very significant ten multiple points.

That point in time represented a rare opportunity to buy quality, real-economy businesses in the Consumer Services, Financials and Industrials sectors at prices that only come up once or maybe twice in a generation – because they were trading as if COVID-19 would permanently impair their revenues. As usual, the market was far too pessimistic on the way down, and as news of vaccines emerged late in the year these Value stocks snapped back sharply, driving a surge in our results in the 4th quarter.

But we are not done yet. The cycle favouring Growth stocks was quite lengthy, and will not correct in a single quarter. By trading extensively in 2020 we have a better-quality portfolio with asymmetric upside acquired at a large discount to the broad indices. As a result, we expect our companies to deliver better earnings growth than the broader market. Our companies are coming off depressed earnings during 2020, and are still much cheaper than the "click and stream" stocks that the market loves.

A recovery in earnings is common for a Value portfolio coming out of a recession, and usually brings significant outperformance. It happened after the Tech Bubble and the Great Financial Crisis, and we expect the same again. As the economy continues to improve over the next couple of years, consumers return to regular spending (rather than spending time betting online on stocks!), and governments spend on infrastructure, Value should participate fully.

## Are We Headed for Inflation?[1]

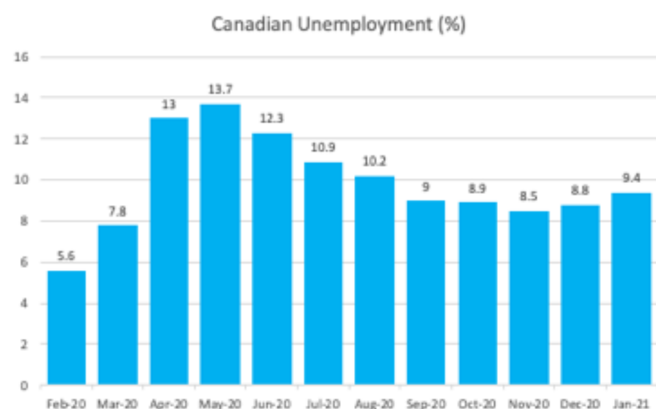
With Canada spending close to 20 per cent of GDP (including provincial deficits) and the Bank of Canada cutting short-term interest rates and injecting liquidity into the market ...Surely this must be inflationary?

We don't think so, at least in the medium term.

The Canadian core inflation rate has now been below the Bank of Canada's mid-point target of two per cent since 2010. Our view is that we will remain in a subdued

1 In the midst of the crisis, when governments were first furiously running up deficits and printing money to pay off the debt, we published "Averting a Depression and Your Cheques for Free" to explain how these things can coexist and not spell disaster for the economy. We recently contributed an article to Benefits & Pensions Monitor, "Defusing Inflation Fears" to provide an update and outlook, which we've excerpted below with permission to provide context for the ongoing spend-and-print approach.

inflationary environment over the next three to five years as demand remains weak, and substantial excess capacity – including a Canadian unemployment rate which spiked from 5.6 per cent in February 2020 to 13.7 per cent in May before retracing half the distance to 9.4 per cent in January 2021 – remains in the economy.



Source: Trading Economics. Canada Unemployment Rate 1966 – 2021.

When looking at the historical path of inflation and predicting its future direction, it is important to understand what is driving pricing pressures. A number of key factors such as technological advances, demographics, and globalization have all played significant roles in dampening inflationary pressures over the past decade. In particular, increased trade openness, higher competition as a result of economic integration, automation, and the global division of labour have all resulted in lower bargaining power for wage increases and other production costs.

These unique factors may put a brake on inflation, but can countries just print money with impunity? To get a better understanding, let's break down the two main tools at work: monetary policy and fiscal policy.

***Monetary Policy***

In 2020 the Bank of Canada (BOC) cut interest rates to close to zero and implemented quantitative easing, which essentially involves the BOC purchasing bonds from commercial banks, increasing the banks' cash balances. In a recession, banks are less willing to lend and companies, facing an uncertain future, are reluctant to borrow. As a result, bank reserves grow, but the circulation of money remains unchanged. The net result is that the Central Bank increases the monetary base but the funds are not deployed and are, in a sense, trapped in the financial system. There is therefore little inflationary pressure.

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Quantitative easing also plays a very important role in the current crisis as it provides governments with a means of effectively eliminating the new debt they are incurring to fund their massive fiscal spending programs. Central banks are printing new money and using it to buy assets to support the economy.

***Fiscal Policy***

Sustained *fiscal* stimulus can, however, be inflationary over the medium term. When fiscal policy funds things like spending on infrastructure or services, it injects funds directly into the real economy and can work quickly to stimulate growth, but if the funds flow to areas of the economy that don't have the capacity to absorb them (i.e., more demand for goods or services than supply), it can exert upward pressure on prices (cause inflation) over time.

***Better Inflation than Deflation***

We believe, however, that somewhat higher inflation is not actually a bad thing at this point as it further reduces the chance of *deflation*. Among the many compounding factors that prolonged the pain of the Great Depression, price deflation was among the worst culprits as it discouraged investment. Starting from a point today where the market is anticipating less than one per cent inflation over the next 30 years, there is room for inflation to tick up without having a negative impact on the economy.

## What is Normal Now?

While "normal" may be a 2021 concept to aspire to, given how much the pandemic has upset the way we earn and spend, the better question may be: What will normal look like now?

Remote working arrangements have become more acceptable for knowledge workers, but their legacy impacts on urbanization, commercial real estate,

transportation, the geographic democratization of recruiting and the resulting shifts in economic activity remain uncertain.

Online commerce adoption leapt years of progress in a few months, thrusting a constellation of Technology stars into orbit. On Main Street, bricks and mortar retailers have languished and expired in the thousands, while many more continue to limp along on government aid programs and scaled down capacity – when they are permitted and able to attract customers at all.

Business travel has evaporated, but will return to some (unknown) degree while leisure travel will most certainly explode when the all clear is sounded... assuming the airlines, hotels, and other travel companies can survive until then.

The challenge to *investing* in this environment is calibrating the long-term impacts of the pandemic on the real-world economy – determining which sectors are undergoing fundamental changes and which will revert to old patterns. While these will only reveal themselves in time, investors with a bottom-up, fundamental approach that focuses on quality and recognizes short-term volatility as an opportunity should be be rewarded.

## Wrapping Up Risk

With the prospect of sustained low interest rates, investors have pushed further into equities, credit products, and real assets. Despite the recent run, given the low expected returns from bonds relative to equities we are more inclined to overweight equities while being more defensive (underweight) fixed income. (We still believe bonds play an important role in balanced portfolios, however).

As mentioned, we expect a return to normalcy will continue to benefit our Value style. We continue to favour cyclical stocks, which we view as having more attractive valuations and better return prospects.

The deluge of monetary and fiscal stimulus will tamp down uncertainty until the spigots are shut off or they are no longer needed. Inflation does not appear to be a big risk in the near-term, however. As long as government stimulus can generate economic growth greater than inflation, it will be able to pay for itself.

IMPORTANT NOTE: This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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