RICHARDSONGMP CONNECTED WEALTH

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Investor Strategy

September 2020

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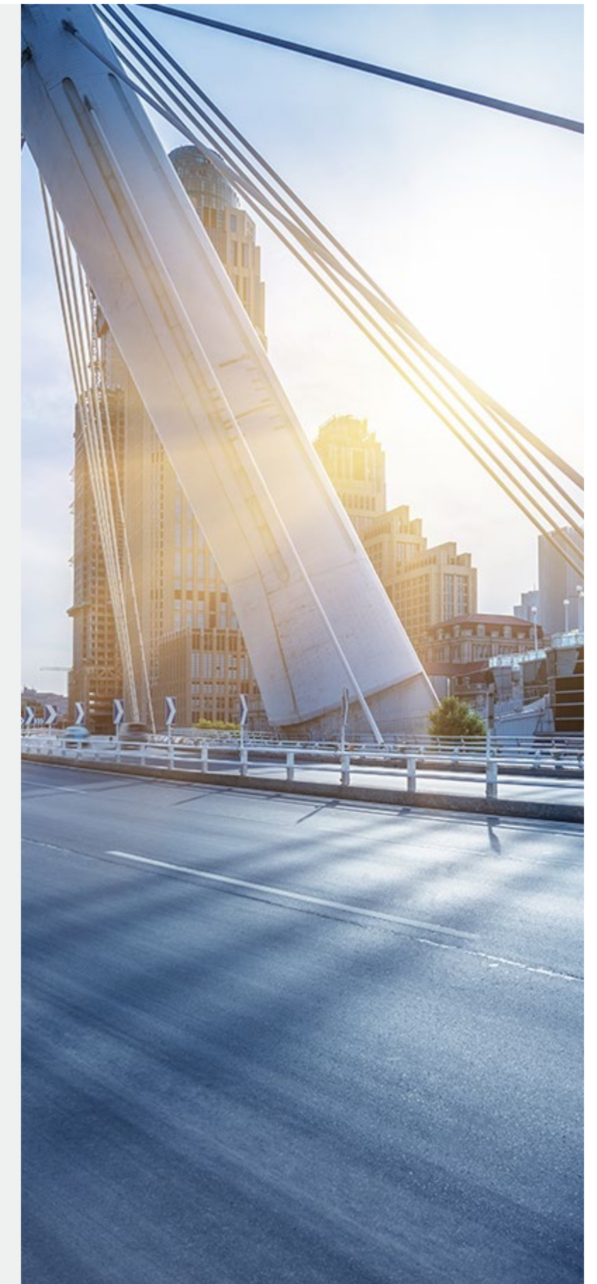


Executive Summary

- **Part 1: Market recap – So much for the summer doldrums**
  - Recap of a good summer in the markets, impact of a falling U.S. dollar and a reversal of many past trends to start the month of September.
- **Part 2: Asset allocation – Investment implication of deglobalization**
  - Global trade growth began slowing long before the pandemic hit. This changing trend could have growth, currency and diversification implications.
- **Part 3: Asset allocation – Winter is coming for the static 60/40**
  - Given valuations and yields, the static 60/40 asset allocation may be ill-equipped to deliver in the 2020s.
- **Part 4: Asset allocation – Market cycle and portfolio positioning**
  - Still leaning on defense with slight underweight in equities and elevated cash. Minor overweight in international equity and alternatives.
- **Part 5: Equities – Could a vaccine trigger a correction?**
  - Parts of the market that have benefitted from recent changes to behaviour are in a bubble. A vaccine could reverse this and other recent trends.
- **Part 6: Fixed Income – The 20s will be a tough decade**
  - With low yields and credit spreads, we continue to underweight fixed income as return expectations are suppressed.
- **Part 7: Managed Portfolios – Dialling back on gold and adding to international**
  - Recent portfolio changes had us taking some profits on gold and increasing our international equity weight, including some emerging markets (EM).

Market Recap – So much for the summer doldrums

Derek Benedet

Chart 1: Good summer, tough start to September

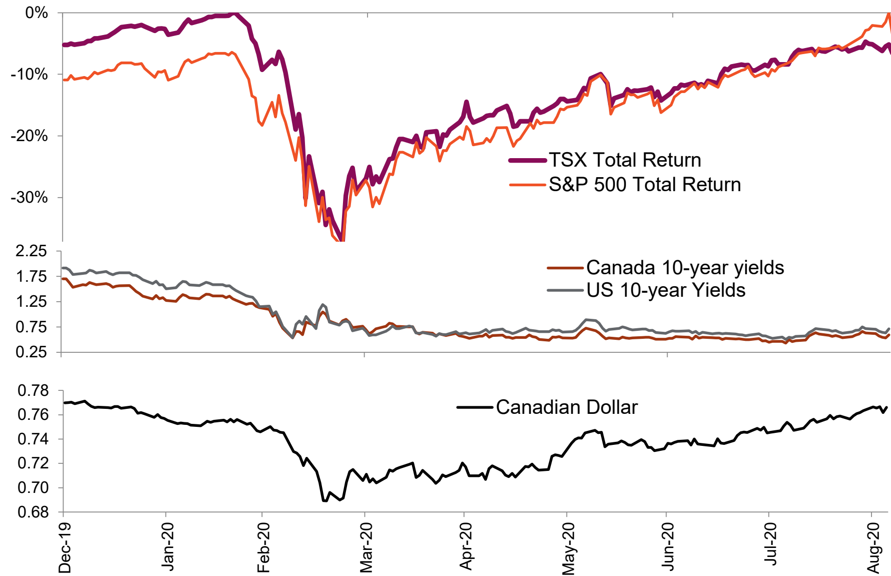
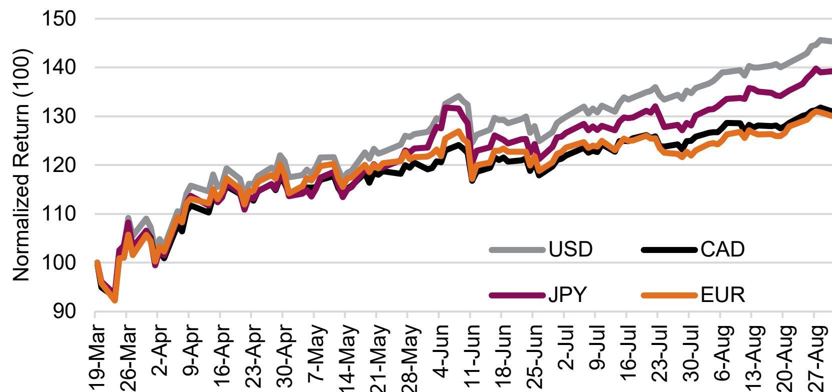


Chart 2: S&P 500 Recovery has not been as substantial in other currencies



- 2020 has been a crazy year – what haven't we experienced yet in 2020? There are many variations of how people are living these days, but we are all experiencing a unique market. The year-to-date numbers for a small selection of stocks is staggeringly positive. The concentration risk is near unprecedented levels, but "risk" isn't a popular thought when markets are making new highs. Euphoria is in the air, and overconfidence has a way of making you believe this unique market is sustainable.

- Optimism about the possibility of an eventual treatment for COVID-19 brought equity indices up in August, with the S&P 500 gaining 7.0% for the month and now up 8.3% YTD. The Dow, which was in the headlines because of constituent changes following Apple's stock split, posted a 7.6% gain. The NASDAQ, which is where much of the action is, rose 9.6%. Meanwhile, Canada lagged considerably, rising a mere 2.1%. Canadians also had to deal with the Canadian dollar rising 2.79% to $1.3047 CAD/USD, which also reduced returns for unhedged U.S.-denominated investments.

- U.S. markets continued to make new all-time highs despite a growing list of technical red flags and signs that the economy is losing steam. Labour market weakness was a common theme over the course of the month, as was slowing alternative economic data measures that give a glimpse of what's coming. The upcoming U.S. election has also been a hot topic, a sign that it is no longer an afterthought, but a key catalyst on the horizon.

- Adding to the belief that the powerful recovery will continue, the U.S. Federal Reserve (Fed) communicated a shift in policy to average inflation targeting, implying lower rates for longer. One wildcard is the September 15-16th Federal Open Market Committee (FOMC) meeting, when the Fed will announce the conclusion of its long review and formalize the shift in direction. Despite the policy implications, bond yields rose with the 10-year U.S. Treasury's yielding 0.70% to close the month. Inflation expectations also rose, driving real bond yields to new lows and driving gold prices to a new all-time high of 2,063/oz mid-month.

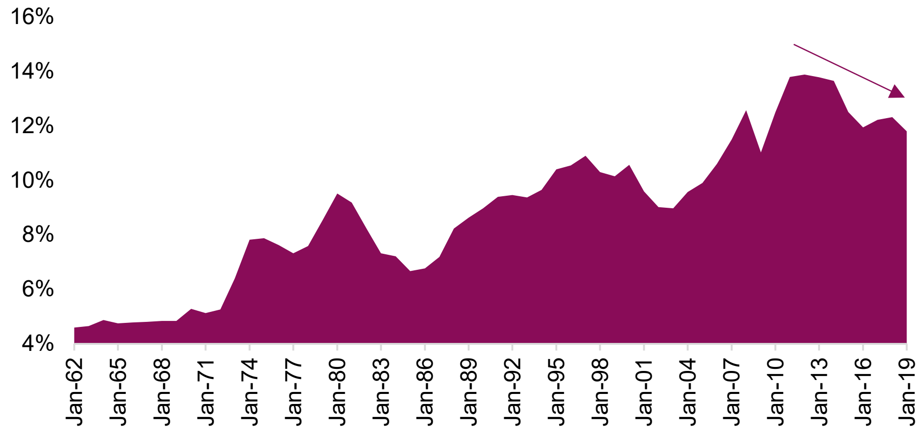
- Aiding gold's advance was the continued theme of U.S. dollar weakness, a sign that American exceptionalism is waning. After making fresh 2-year lows, the dollar appears to be consolidating after a substantial trend decline in the past two months. The dollar's weakness adds another version of the impressive rise of U.S. stocks. **Chart 2** shows that outsiders have experienced a vastly different return profile.

- But along came September and so far, many of the trends that have been in place for the past few months reversed. Is this yet another brief stumble in the recovery or a deflating of some bubbles, which have been inflating for months…time will tell.

Asset Allocation - Investment implications of deglobalization

Chris Kerlow

Chart 3: Exports at a % of Global GDP have started to trend lower



- Like gasoline on a burning fire, many of the pre-existing trends coming into this pandemic are now burning at a much quicker pace. At the forefront is protectionism, as the pandemic made governments realize they were too reliant on efficiency rather than being reliant on supply chains.
- This has intensified trade wars and expedited deglobalization. Repatriating your supply chain not only makes it pandemic proof but helps avoid geopolitical risk – both of which are front and center in 2020.
- Slowing globalization shown by slowing global trade as a percentage of GDP was evident before the pandemic. (**Chart 3)**
- Slowing trade will be a headwind for economic growth, but it shouldn't be forgotten that in 2019 global trade fell and GDP still rose. Even this year, the World Trade Organization (WTO) expects trade to fall by as much as 32%, which is far more than the most bearish GDP contraction estimates. There will be winners and losers.
- Globalization was also a negative for diversification because it increased correlation among global markets. This made equities sensitive to isolated issues that now have a contagion effect across the globe.
- Deglobalization will likely create greater diversity in economic growth rates around the world and could lead to increased benefits from geographic diversification.
- We are already seeing production brought onshore from emerging markets to developed markets (PPE, ventilators, vaccine production). This will be a slow and painful process as it moves into other types of goods and drives cost-push inflation. A lot of these products are feedstock to parts of the value chain, adding price pressure to items already manufactured domestically.
- Deglobalization will also lower the interdependence of countries around the globe and will lead to more geo-political instability.
- Protectionism will limit the movement of human capital and reduce the synergies of moving highly skilled labour to countries that need it and vice versa. This will crimp innovation and add more inflationary pressure.
- Not only will the movement of goods and people be restricted but the mobility of capital will also be crimped. Foreign investment will be limited, tax revenue reduced, rate differentials would expand.
- Constraints on the flow of capital and rate differentials is part of the reason for USD weakness.

Asset Allocation - Winter is coming for the static 60/40

Craig Basinger

Chart 4: Approximate current yields on various bond or income categories

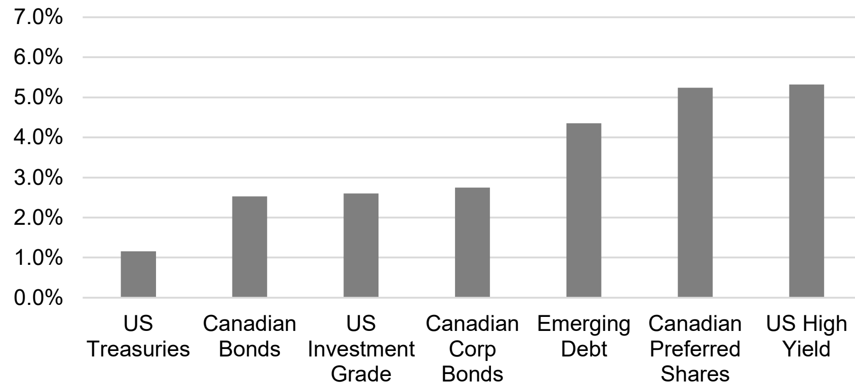
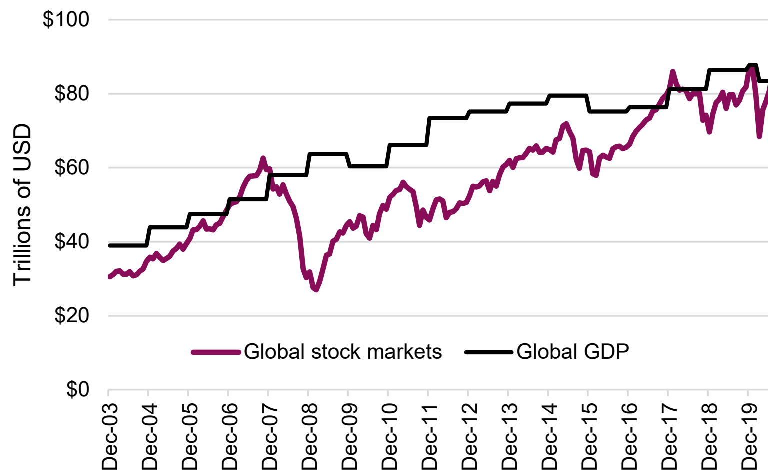


Chart 5: it is rare to see the global equity markets worth more than the global economy. Implies lower expected returns going forward



Excerpt from Market Ethos, August 24, 2020. For the full version Click HERE

- Investing is not easy but given strong performance in both equities and bonds over the past 30 years, it has not been that difficult either. Canadian equities, global equities (in C$) and Canadian bonds have all enjoyed annualized returns between 7 and 7.5% over three decades.
- What about the next 5 or 10 years? This is when things get a little more sobering. The Canadian bond universe, will be hard pressed to continue its historical performance trend. The yield is currently about 2.5% (**Chart 4**), which means that to maintain a 7% total return, price appreciation would need to contribute about 4.5% a year. Given current duration, we would need yields to drop deep into negative territory for government bonds and maybe even investment grade in the coming years.
- Let's assume yields, along with credit spreads, remain flat over the next 5 years, a broad-based bond allocation will then generate about 2.5% annually. If bonds are "doing" 2.5%, that means for the 60/40 to maintain its 7.0% annualized nominal return, the 60% in equity has to do a lot heavier lifting. It works out to annualizing about 10% for equities, not unheard of over several years but not common.
- Equities may be hard-pressed to achieve this based on current levels or valuations. A good long-term valuation gauge is the value of the global stock markets to the global economy. While the equity markets and the economy can diverge for periods given fluctuations in the earnings multiple, there is a long-term correlation. Currently, the total value of global equities is a little higher than the global economy ($86 trillion versus $83 trillion). This is rare (**Chart 5**), and certainly adds to the case for more muted equity market returns in the years ahead.
- In a world with lower return expectations, there are strategies to mitigate, but all come with different risks.
  - Stretch for yield by taking on more credit risk. Enhances the return expectations for the bond component but with clearly added risk.
  - Alternative strategies can offer enhanced returns given less efficient markets or an illiquidity premium. Again with more or different risks.
  - Leverage can be used given rates are so low. Leverage works both ways though, not kind in falling markets.
  - Become more tactical, not simply holding the 60/40 static.

Not dispensing with 60/40, but a few adjustments should be made for the 2020s

Asset Allocation - Market cycle & positioning

Chart 6: Bullish indicators rising with re-opening

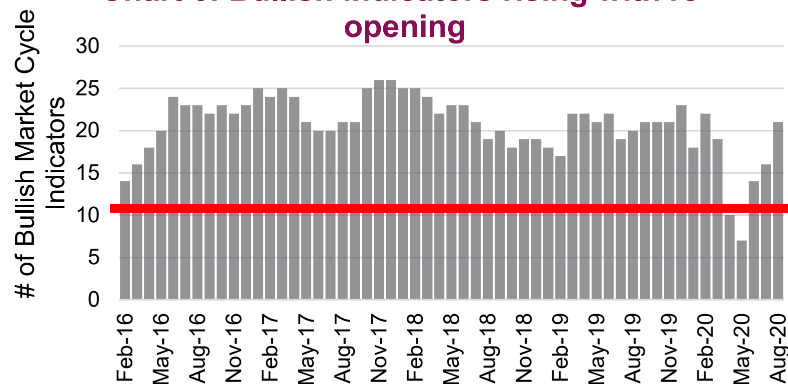


Chart 7: Current Allocations

Overall Asset Allocation	Balanced MP	Baseline	-				+
Equities	45.0%	54.0%		■			
Fixed Income	34.8%	34.2%			■		
Cash	4.5%	1.8%				■	
Alternatives & Real Assets	15.6%	10.0%				■	
Global Equities			**-**				**+**
Canada	17.4%	27.0%		■			
U.S.	10.0%	13.5%		■			
Euro Area	10.0%	6.8%				■	
Japan	6.8%	4.5%				■	
Emerging Markets	2.2%	2.3%		■			
Fixed Income			**-**				**+**
Canada				■			
U.S.					■		
Government					■		
Investment Grade					■		
High Yield			■				
EM Debt			■				
Prefs					■		
Duration				■			
Credit				■			
Currencies			**-**				**+**
CAD Short Term (3m)				■			
CAD Longer Term (1yr)				■			

Craig Basinger

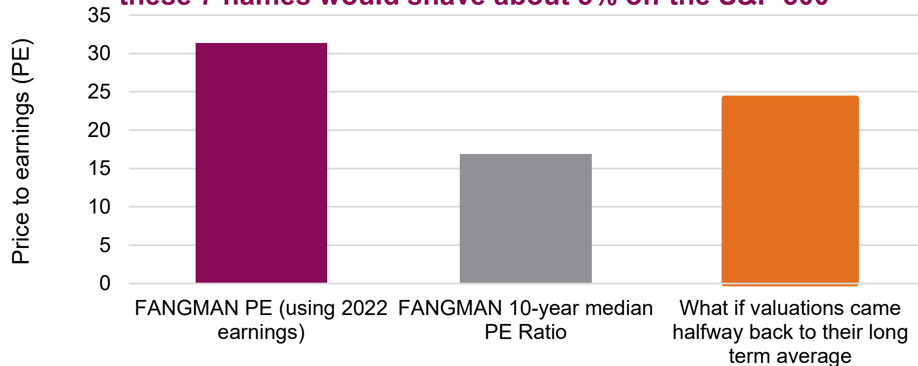
- We were aware (and indicated early on) our Market Cycle indicators would not be useful heading into this recession given it was self induced to combat a pandemic. The indicators are more tuned to capturing an improving or deteriorating economy, risk appetite, sentiment, etc. As we come out the other side, the efficacy of the indicators has returned and will be useful particularly to understand if this economic recovery will faulter or not.
- The indicators have certainly been on the mend. This is not surprising given many measure current readings compared to months ago. Overall, economic issues as well as risk and sentiment have improved a lot over the past few months.
- Within the various indicators, market momentum has clearly been strong with many markets either reaching new highs or at least continuing to recover. The global economic indicators have been improving considerably as well. This continues to support our overweight international view.
- The U.S. indicators are slightly more mixed but have been generally improving. Transportation and manufacturing are areas of strength while employment continues to be a headwind. Valuations also remain in the bearish camp, given how far the price of the market has come while earnings and the economy certainly have not.
- We continue to hold our slight underweight in equities, which means we are either wrong or early as the markets have enjoyed a very strong summer. Given how far the markets advanced since March, trade tensions rising, election risk and still a very uncertain path for the economic recovery, we remain committed to our more defensive posture.
- We are still holding an elevated cash balance which isn't a bad thing. Given spreads and yields, there just isn't much of a performance pickup in bonds. And we would like to be opportunistic if a period of weakness does materialize in the final months of 2020.

Note: Balanced MP is our current allocation based on the Managed Portfolio Balanced mandate. Bullion and Tactical are considered alternative in this framework.

Equities – Could a vaccine trigger a correction?

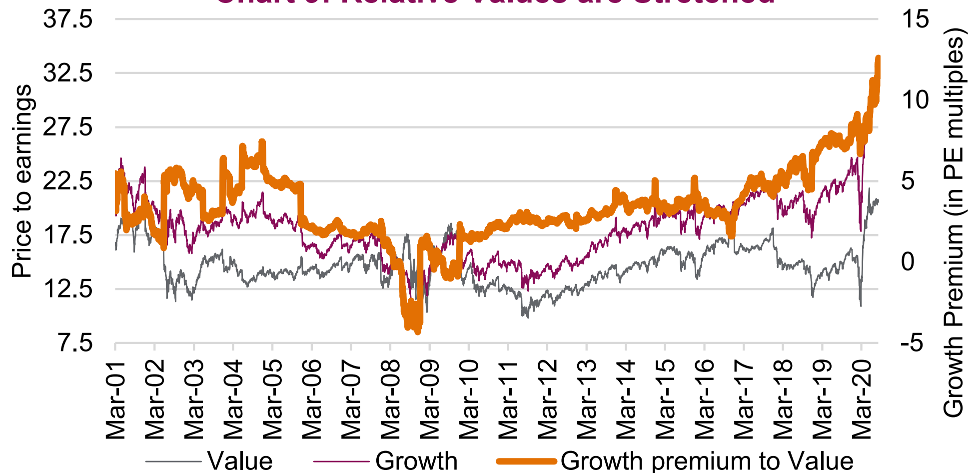
Craig Basinger

Chart 8: If FANGMAN valuations dropped from current levels to just halfway back to their long term averages, these 7 names would shave about 5% off the S&P 500



FANGMAN = Facebook, Apple, Netflix, Google, Microsoft, Amazon and Nvidia

Chart 9: Relative Values are Stretched



- All things come to an end – bull markets, bear markets, economic cycles, even pandemics. And we believe that in the coming months investors should begin to increasingly position themselves for the other side of the current environment. We are not implying things will be back to normal, but they will likely be a lot more normal in six months than they are today. That means there are both opportunities and risks in today's market, as what has worked well in the past six months may not do so in the next six.
- The pandemic's path remains unknown, with much attention now being focused on vaccine development. There are literally hundreds of companies and governments feverishly working on vaccine development and trials.
- [Note, we wrote this before the pullback in early September] Could a successful vaccine trigger a correction? This may sound crazy, but it just might. It would be great for humanity and the global economy but less so for the markets. The markets look forward and a successful vaccine, even before actual roll out, would likely cause a dramatic reversal in many of the trades that have worked so well or so poorly during this pandemic. What could this look like?
  - Inflation expectations, which are super low currently, would rise, lifting nominal and real yields.
  - This would be positive for financials that have come under pressure from low yields and client default risk.
  - Pandemic "losers" such as office real estate, leisure and travel would likely bounce.
  - Assumptions currently priced into e-commerce and work-from-home enabling technology companies would be challenged.
  - The biggest impact may come from the discount rate used in equity valuations. Higher yields would raise the discount rate from the current very low level. Valuations are based on applying a discount rate to expected future cash flow or earnings. A lower discount rate increases today's value of future earnings, even if many years down the road. If this discount rate rises, the valuation on many high-growth "dream" stocks will come under pressure. Given their current valuations and weight in the index, this could be a big problem.
- We are not suggesting giving up on higher-flying growth companies – many of these companies will transform the world over the years; however, this is a bubble. And while bubbles can last longer than many would normally expect, they often end painfully (**Chart 8**). This could be an opportune time to revisit your balance between growth and value, with taking profits in growth and adding to the depressed value style (**Chart 9**).
- Companies that will benefit from a vaccine and a more normal economy can often be found in the value style.

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Fixed Income: The 20s will be a tough decade

Joey Mack

Chart 10: Canadian Yield Curve - 12 month forecasts

	This Week	Consensus Forecast	High Forecast	Low Forecast
Overnight	0.25%	0.25%	0.25%	0.25%
2-year	0.27%	0.43%	0.55%	0.35%
10-year	0.59%	0.95%	1.29%	0.60%
30-year	1.10%	1.40%	1.60%	1.10%

Chart 11: Canadian Bonds 1-year forecast returns

	2-year bond	10-year bond	30-year bond
Current Yield	0.27%	0.59%	1.10%
Consensus Forecast Return	0.13%	-2.31%	-5.72%
High Yield Forecast Return	0.02%	-4.97%	-9.89%
Low Yield Forecast Return	0.20%	0.52%	0.99%

- A strong predictor of fixed income returns over the next decade is the current yield on the 10-year bond
- Today, that sits at just 0.6% in Canada, and 0.7% in the US. Notably, this is well below the rate of inflation in both countries
- That return however is the total return over the entire time period. During this time, you will see many swings of positive and negative returns
- We believe that the ongoing signs of recovery as economic activity returns gradually after lockdowns, combined with a high likelihood of treatments and vaccinations being discovered in the coming months and years, means we have already seen the low in 10-year yields
- Consensus forecasts agree – economists on average expect yields to rise in the coming months, led by the long end. Even the lowest yield forecast is equal to or higher than we are today, meaning returns will be below 1%, even under the most optimistic forecast.
- This will weigh significantly on fixed income prices in the near term.
- For this reason, we continue to recommend that investors remain underweight fixed income as an asset class, and within fixed income, holdings should be in shorter maturities.
- Investment-grade corporate bonds do offer an attractive yield pick up over government securities, but there is not enough incremental yield to offset expected price declines due to the overall rise in interest rates. Although we would be overweight investment-grade versus governments, we are not expecting positive returns.
- High yield, preferred shares, and emerging market bonds should, however, provide positive absolute returns over the near to medium term.

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Managed Portfolios – Dialling back on gold and adding to global

Chart 12: Managed Portfolio's changing gold exposure

Chart 13: Historical Drawdown: Gold Equity vs. Gold bullion (C$)

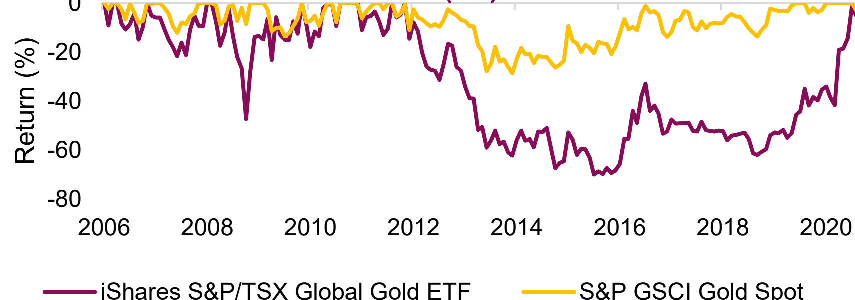
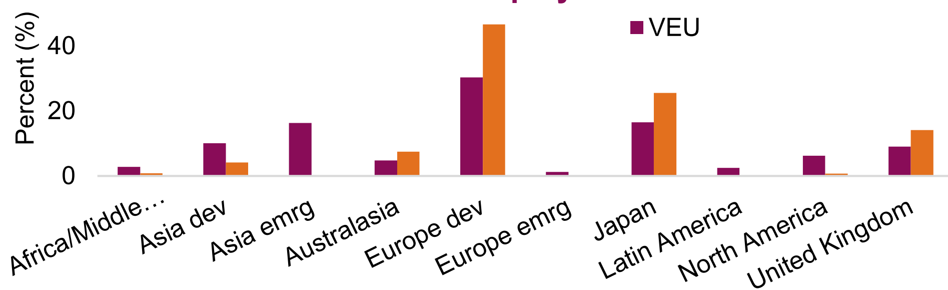


Chart 14: Accessing more corners of the International Equity market



Source: Morningstar Direct.

An Nguyen

- Resilience is the ability to recover after falling on tough times. Building portfolio *resilience* is therefore an important factor in a portfolio's ability to meet longer-term performance objectives. In **Managed Portfolios**, we look to build portfolio *resilience* in several ways: at the asset allocation level, fund level and individual security/constituent level.
- As Global equity markets continue their ascent, we believe there is a higher risk of a near-term correction should any news or economic data disappoint. Beyond further tilting the portfolio's asset allocation towards bonds, which we did earlier this year, we shifted our focus to the equity portion of the portfolio. We sold the portfolio's iShares Gold ETF (gold miners) in favour of gold bullion, as well as increased the overall international equity exposure with the objective of further diversifying the portfolio's geographic allocation outside of developed European and Asian markets. We believe these changes will help to enhance the portfolio's ability to be more *resilient* while remaining positioned to take advantage of longer-term trends.
- Up to this point, the exposure to gold within **Managed Portfolios** was exclusively through gold equity securities (gold miners). Exposure was through the portfolio's investment in the iShares Gold ETF (XGD), and through investments in the actively managed Purpose Core Equity Income Fund and the passively managed S&P/TSX Index (XIC), both of which own gold equity securities. The sale of XGD accomplished two things; it trimmed the portfolio's aggregate exposure to gold back to beginning-year levels, and it also changed the composition of the gold exposure in the portfolio (**Chart 12**). We believe the introduction of gold bullion over gold equity should help the portfolio achieve a number of objectives; gold bullion should provide a better drawdown profile (**Chart 13**), it should also provide relatively better diversification benefits (gold bullion is negatively correlated to a broader number of asset classes), and it should help provide a more consistent return stream (gold bullion returns have historically been less volatile than gold equity security returns). We still believe gold will benefit from longer-term trends – low real rates, rising inflation expectations, a lower U.S. dollar as well as broad strength in real assets – but wanted to reduce our overall leverage to the gold sector given the recent strength.
- Global diversification remains an important component to building a *resilient* portfolio. With many countries signalling a more insular approach to the growth of their economies, deglobalization will continue to be a theme in the years ahead. With the potential for economies to slowly become less intertwined, where economic growth rates and policies will differ, investors should benefit from owning a geographically diverse basket of securities across the globe. The addition of the Vanguard FTSE All World ex US ETF (VEU) gives the portfolio broader access to economies around the world. Holding VEU shifts the portfolio's passive international equity exposure beyond the developed economies. While the portfolio's previous holding in the iShares Core EAFE (IEFA) was focused on developed Europe and Japan, VEU does this while also investing in several developing economies, specifically in Asia (**Chart 14**).

Disclaimer

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.

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