Investor Strategy

Opening Up

July 6, 2020

Part 1: Market recap – A state of purgatory

- Despite many markets recouping much of their losses over the second quarter, uncertainty lingers as the VIX finished the quarter at an elevated level.
- Consequently, the potential for a market correction in the near term remains more elevated than ever. This comes as the recent surge in virus cases has sparked fears of a potentially imminent second wave. But it's anyone's guess when the market will begin to care about fundamentals, or what an "adequate" improvement in the health data looks like. We continue to carefully monitor this space.

Part 2: Asset allocation – Still tapping the brakes

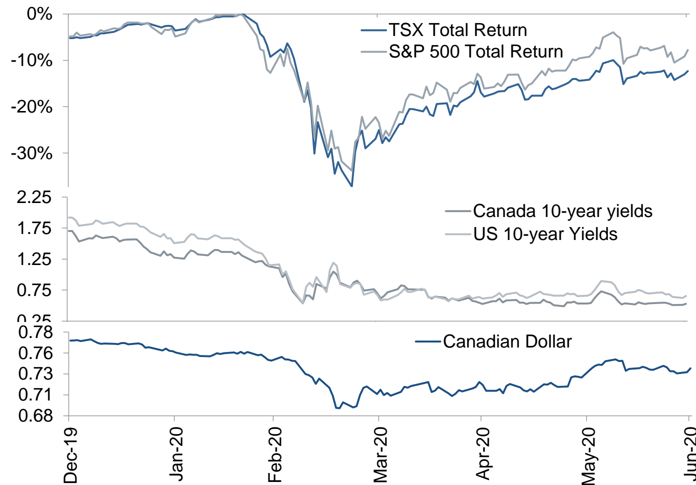
- We continue to have a mild underweight in equities, which we trimmed slightly further in June. We're holding extra cash to be opportunistic for a potential pullback.
- We have turned more positive on U.S. dollar exposure in the near term.
- Market cycle indicators continue to improve.

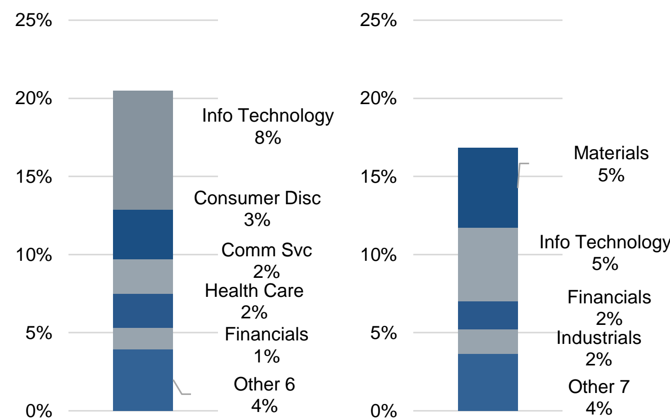
Part 3: Equities – International

- Without resorting to overly simplistic causal thinking, we are cautiously optimistic on developed Europe, and still recommend a low-to-no-weight in Emerging Markets. We have moved to slightly underweight U.S. equities.
- Concentration risk has been accelerated during this year's pandemic-influenced market as mega-cap names in the U.S. have benefited from changing behavior.
- To reduce the risk in the market structure posed by capitalization-weighted indices, we opted to pivot some of our U.S. equity exposure from a market capitalization weighted ETF to an equal-weighted one.

Part 4: Fixed income

- Remain defensive in fixed income.
- We recommend portfolio duration be positioned below that of benchmark bond indices.
- Inflation-protected bonds currently appear attractive as do preferred shares.





- **This is *not* the way we expected to wrap up the first six months of the new decade.** A year that opened with decent – albeit shaky – economic prospects faced an abrupt and unprecedented economic contraction resulting from the COVID-19 pandemic. In more recent months, expectations over re-opening and a V-shaped recovery set the stage for remarkable comebacks across most asset classes.
- Central banks – most notably the Federal Reserve ("Fed") – appeared to have developed a "vaccine" for capital markets in the form of aggressive monetary policy and curve control, the long-term efficacy of which has yet to be truly tested. Government agencies also stepped in with aggressive fiscal policy support in an effort to stymie the pain of reduced economic activity, record-breaking jobless claims and unemployment.
- Both these measures, coupled with gradual economic re-openings, set the stage for +20.5% and +17.0% recoveries in the S&P 500 and TSX, respectively, during 2Q (**Chart 1**). For the U.S., this was the largest quarterly gain since 1998. It's hard to imagine, but **year-to-date, U.S. and Canadian markets are down only -3.1% and -7.5%, respectively**. Global equities fell -14.1% in 1Q but regained losses with a +14.1% recovery in 2Q, as measured by the MSCI World Index in Canadian dollar terms. Despite many markets recouping much of their losses, uncertainty lingers as the VIX finished the quarter at an elevated level of 30.
- Looking at 2Q sector-level attributions, technology and consumer discretionary sectors led the way in the U.S. recovery. With all sectors contributing in the quarter, market leadership has remained narrow with most of the lifting came from just a few sectors. The same occurred in Canada, but with materials leading, followed by technology (**Chart 2**).
- It was also an equally unforgettable period for bonds and credit. The first half of 2020 was characterized by extreme volatility. Liquidity was the overarching issue in February and March, as bids disappeared for many corporate bonds. This proved to be a temporary wobble as central banks stepped in with liquidity support. This has helped credit spreads narrow and normalcy return.
- The energy complex continues to claw back from the depths of its trough, with much success. WTI crude futures posted a staggering +92% return in 2Q and finished the quarter at US$39.27/bbl. Meanwhile, spot gold neared the US$1,800/oz mark and posted a +13% quarter, the best quarterly return since 2016. Elsewhere, after posting a +2.7% gain in 1Q, the U.S. dollar gave up some of its safe-haven gains in 2Q. The DXY index closed the 1H at 97.39, down -1.7% for 2Q. The Canadian dollar has benefitted considerably from this and recovered +3.6% to $0.74 CAD/USD at the close of 2Q.
- Valuations remain elevated: the S&P 500 and TSX P/E ratios sit at 21.8x and 19.2x, respectively. It's difficult to pinpoint what exactly market participants are focused on nowadays; earnings are likely not part of this list at the moment. With countries beginning to reopen, sentiment has certainly improved. However, a recent surge in virus cases has sparked fears of a potentially imminent second wave. As it stands, near-term corrective action risks remain more elevated than ever. It's anyone's guess when the market will begin to care about fundamentals, or what an "adequate" improvement in the health data looks like. For now, it's anyone's game.

Asset allocation – Still tapping the brakes

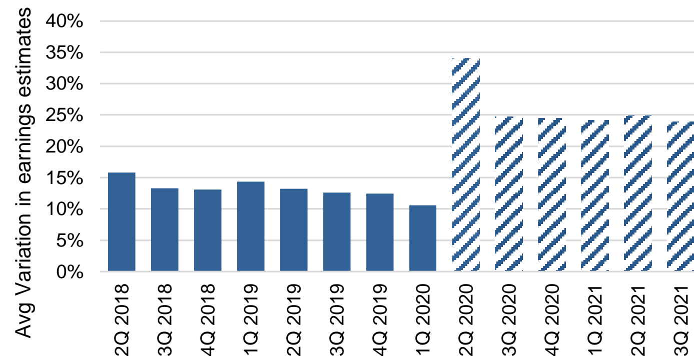
Chart 3: Current allocations heading into Q3

Overall Asset Allocation	Current*	Neutral	-				+
Equities	55.0%	60.0%		■			
Fixed Income	39.6%	39.0%			■		
Cash	5.3%	1.0%				■	
Global Equities			-				+
Canada	24.8%	30.0%		■			
U.S.	13.5%	15.0%		■			
Europe	10.8%	7.5%				■	
Asia	5.7%	5.0%			■		
Emerging Markets**	1.4%	5.0%	■				
Fixed Income			-				+
Canada	18.9%	20.0%		■			
U.S.	13.2%	11.5%			■		
International	4.9%	5.0%			■		
Prefs	2.6%	2.5%			■		

* Current allocation is based on Managed Portfolio Balanced Portfolio

** EM allocation is also included in Euro Area and Asia allocations

Chart 4: Heightened uncertainty for Q2 S&P 500 earnings with analyst estimates are all over the place



Markets continue to recover, the pandemic continues to get worse and the economic data recovery has exceeded forecasts.

- Welcome to the early portion of the V-shaped recovery. With economies gradually opening up, albeit not uniformly, the data has been rebounding hard off trough levels, exceeding consensus forecasts. This has been the sweet spot for markets, helping many major equity index levels rise to be within a stone's throw of previous highs.
- The economic data has been truly impressive. The Citigroup economic surprise index for the U.S. has never been this high since the index inception in 2003. Yet even with 7.5 million jobs added in the last two months (May & June), the U.S. economy still has 14 million jobs to go before returning to January levels.
- This euphoric phase has been enough to offset the continued rise in new COVID-19 cases globally, mainly centered in emerging economies and the U.S. This is evident in a new record number of cases reported in the last week of June while the S&P 500 managed a +4% gain.
- The rapid rise in cases has slowed the relaxation of social distancing in some jurisdictions. This is likely the dance that continues for the foreseeable future, hopefully two steps forward with only one step back.
- The economic rebound will likely enter a much tougher phase shortly. Some jobs and other economic activity can be turned back on just as quickly as it was turned off – think many leisure and hospitality businesses. Others will not. Many of the suddenly unemployed may find their employer gone, or patiently waiting for economic activity to pick up before re-hiring or taking this opportunity to cull. Any way you cut it, there has been real economic damage done despite unprecedented policy support programs.
- Earnings reporting season for the 2Q (April-June) starts in early July, providing increased visibility on how the abrupt recession is impacting the bottom line. S&P 500 consensus estimates for the quarter have been revised from $40.80 at the start of the year to $23.36 – a clear buzzcut. This is similar in magnitude compared to Q1. But Q1 only experienced a few weeks of social distancing near the end while Q2 was dominated by social distancing. We will see if these estimates have been revised enough. Adding to the uncertainty, nobody has a clue. Many companies have removed guidance (about 80%) due to the unknowns and analyst forecasts are all over the map measured by the variation in estimates **(Chart 2).**
- Earnings season will be full of surprises, although the market has continued to gloss over fundamentals. We believe this will change in the coming months, perhaps even in July.

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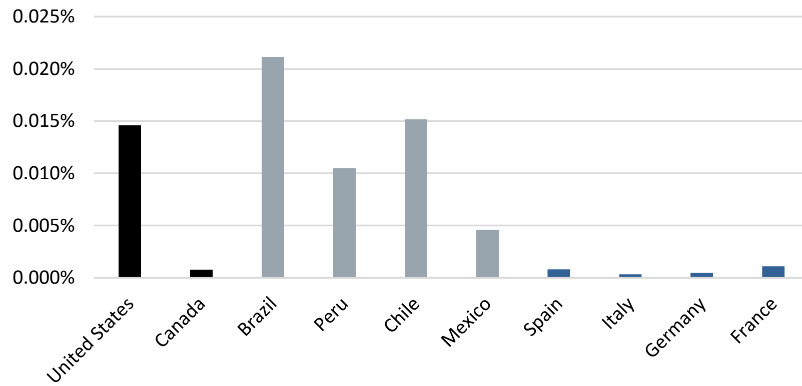
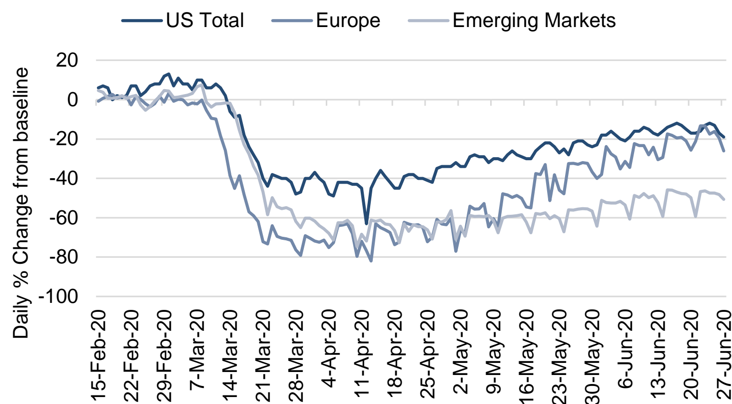




- Europe was arguably the second epicenter of the disease after China. It was also quick to move through the life cycle of the infection curve and has yet to be hard hit by a second wave of infections. European and many Asian economies therefore have a head start on reopening their economies compared to the U.S. and many emerging economies.
    - The successful restart combined with encouraging policy responses from the European Union rewarded European equities in June. The Euro Stoxx 50 was up 5.9% (CAD) in June, compared to 0.6% for the S&P 500 (CAD).
- Even after a strong June, European equities remain about 14% off their February highs compared to the S&P 500, down just 6%. The valuation discount for Europe also remains with Europe trading at 18x compared to 22x for the S&P 500.
- **If European nations prove more adept at managing this pandemic, this should bode well for their economic recovery.**
- **Chart 5** shows the percentage of the population infected with the virus over the past seven days. You can see that Europe, like Canada, seems to have things relatively under control. But the problem is only intensifying in areas like Mexico and other regions.
- The U.S. is experiencing its own hot spots, which have migrated south to the sunbelt (Florida, Texas, California, Arizona).
- Emerging Markets also out performed in June, posting a 5.5% increase for the month. But unfortunately, many Emerging Markets, particularly in Latin America were the last spot to see explosive growth in infections and are still dealing with thousands of daily infections. For instance in Chile, 1.5% of the population has now tested positive.
- Latin America is only a small part of the Emerging Market complex but draws the parallel to many developing markets in that they rely much more on tourism and micro- to small-sized businesses to support their economy. These industries rely on the mobility of the population, which is limited by virus-related social distancing. Using real-time mobility data from Google, we can see that retail and recreation have been slow to recover in a select group of Emerging Markets ex China (**Chart 6**).
- These economies are likely going to feel a deeper drawn-out recession and should be invested in selectively and with caution at this point of the cycle. Although still not back to all-time highs in most cases, the recovery rally has pushed valuations and the opportunity away from inevitability in our opinion.
- We cannot use causal thinking and simply assume stock markets will rise or fall with infection cases. But looking at mobility provides insight into real-time economic activity, which impacts businesses in those regions.
- When comparing the economic reality with virus data and valuations, we are sanguine (*cautiously optimistic*) on developed Europe, and still recommend a low-to-no-weight in Emerging Markets and have moved to slightly underweight U.S. equities. (**Chart 3 on previous page**).

Chart 7: The S&P has become very top heavy, which is a risk

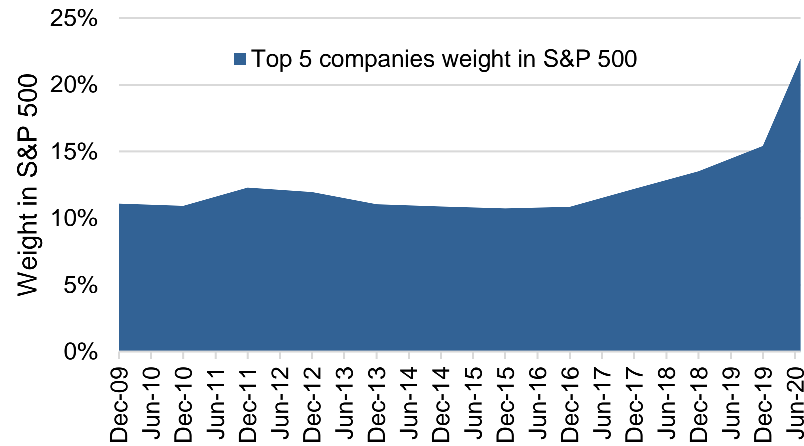
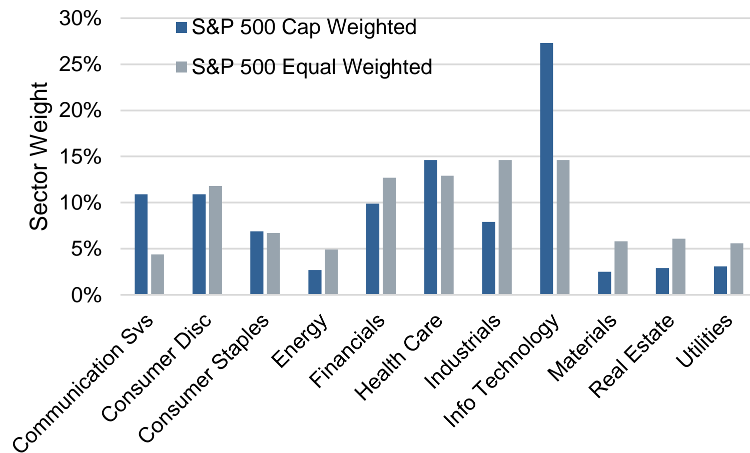


Chart 8: equal weighted is much better diversified across sectors



- Houston, we may have a problem. The top 5 companies in the S&P 500 now have a combined weight of over 22% and an average price-to-earnings ratio of 40x, lofty by anyone's standards. That is a lot of market cap being supported by not so much earnings. These top 5 comprise Microsoft, Apple, Amazon, Facebook and Alphabet.
- If you are thinking this is reminiscent of the late 1990s, you would be mistaken. Even at the peak of the tech bubble, the top 5 of the broader S&P were still pretty well diversified, including in order of market cap GE, Exxon, Pfizer, Citigroup and Cisco. Intel and Microsoft were among the top 10, but nothing compared to the tech-heavy top names of the S&P 500 of today.
- This concentration risk has been accelerated during this year's pandemic-influenced market as these mega-cap names have benefited from changing behaviours. These include increased online shopping to avoid being physically present to transact, or facilitating the new work-from-home mantra with hardware such a surface or apps like teams. Plus, with social distancing, phone and online activities have increased. And let's not forget the fortress balance sheets of these companies.
- ETF and quant-driven macro flows out of the market in February/March and back in during April to June also have fed the momentum of mega-caps. These flows likely accelerated the downdraft and the subsequent recovery. For instance, a billion dollars allocated to the S&P 500 has to buy $220M worth of these five names, feeding the momentum of the bigger names.
- While we are not suggesting exiting these mega names, this is now an elevated risk in the market structure due to capitalization-weighted indices. To reduce this risk, we opted to pivot some of our U.S. equity exposure from a market capitalization weighted ETF to an equal-weighted one.

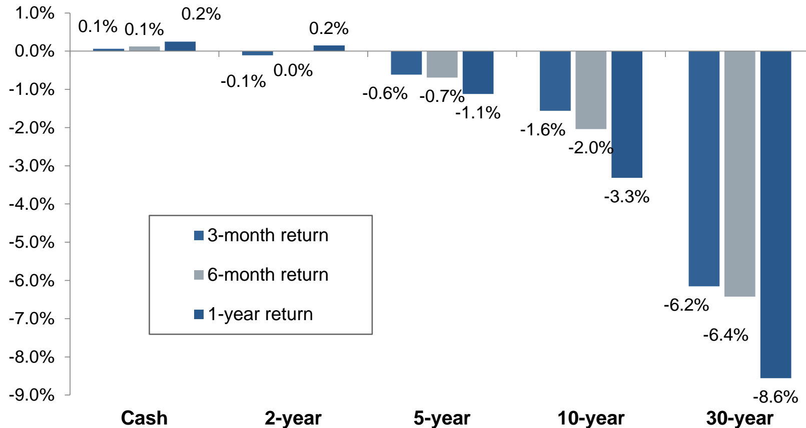
Low rates and expected returns – Stay defensive in fixed income

Chart 9: Canadian Yield Curve - Changes and Consensus Forecasts

	Last Week	This Week	Change	3-month Forecast	6-month Forecast	12-month Forecast
Overnight	0.25%	0.25%	0.00%	0.25%	0.25%	0.25%
2-year	0.28%	0.29%	0.01%	0.39%	0.44%	0.63%
5-year	0.35%	0.38%	0.03%	0.54%	0.60%	0.81%
10-year	0.50%	0.55%	0.06%	0.78%	0.86%	1.10%
30-year	0.98%	1.00%	0.02%	1.26%	1.29%	1.43%

Source: Bloomberg, RF Securities Clearing L.P.

Chart 10: Consensus Forecast Returns



- **Remain defensive in fixed income** - Consensus forecasts continue to call for short-term yields to remain anchored close to zero, but as the economy recovers, longer-term bond yields should begin to rise, which will weigh on returns.
- **Portfolio duration should be below benchmark** - The yield curve has flattened again, and although longer-term yields appear to be in the middle of a technical trading range, longer-term forecasts suggest yields will rise. As such, we recommend portfolio duration be positioned below that of benchmark bond indices.
- **Overweight credit** – Credit spreads have widened slightly in the past few weeks, and are well above the levels reached prior to the pandemic. Based on expectations for an economic recovery in the year ahead, spreads should begin to narrow again, supported in part by central bank purchases.
- **Inflation-protected bonds look attractive** - The spread between nominal and inflation-protected bonds remains below 1.0% in Canada, well below longer-term inflation levels and the Bank of Canada's target 1-3% band.
- **Preferred shares are cheap** – Preferred share yields are well above those of investment grade bonds of the same issuer, and this is before taking into account the benefits of the dividend tax credit. With absolute yields higher than many junk bonds, but guaranteed by investment-grade entities, preferred shares remain attractive.

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Charts are sourced to Bloomberg L.P. unless otherwise noted.

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