Investor Strategy

Little Mania to Start 2021

February 1, 2021

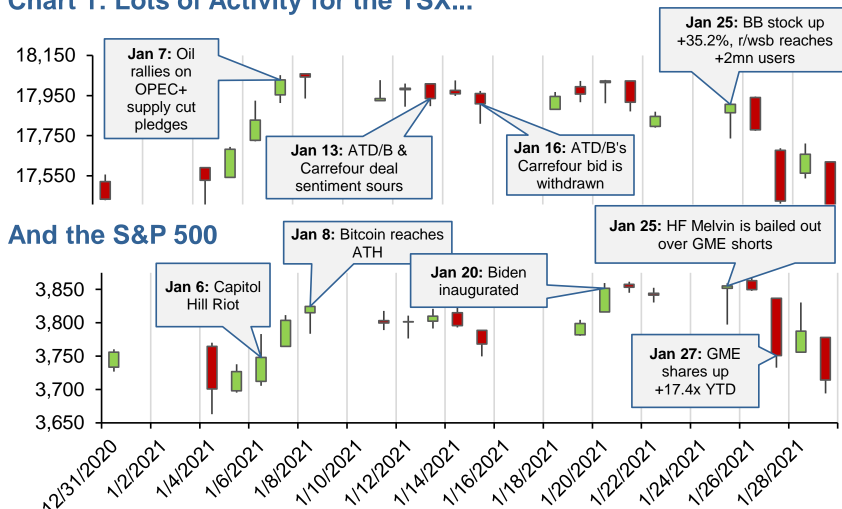
The contents of this publication were researched, written and produced by Richardson Wealth Limited and are used herein under a non-exclusive license by Echelon Wealth Partners Inc. ("Echelon") for information purposes only. The statements and statistics contained herein are based on material believed to be reliable but there is no guarantee they are accurate or complete. Particular investments or trading strategies should be evaluated relative to each individual's objectives in consultation with their Echelon representative.

Executive Summary

- **Part 1: Market Recap – The roaring 20s, again**
  - A look back at the first month of 2021: Good start, soft finish
- **Part 2: Asset Allocation – FOMO alive & well**
  - With some manic trading in a few names, FOMO has resurfaced among many ‘new’ investors
- **Part 3: Asset Allocation – Manic malaise**
  - # of companies doubling in 3 months while markets are at highs, a combo not seen since 1999
- **Part 4: Asset Allocation – 2021 Good economy, bad market?**
  - The economy continues to mend while the markets look to be at risk
- **Part 5: Fixed Income – Cheaper and steeper**
  - The yield curve has started to steepen, driven by falling prices of longer bonds
- **Part 6: Preferred Shares – Is anyone looking?**
  - Prefs have enjoyed a strong recovery, and still offer some relative value

Market Recap – The roaring 20s, again

Chart 1: Lots of Activity for the TSX…



And the S&P 500

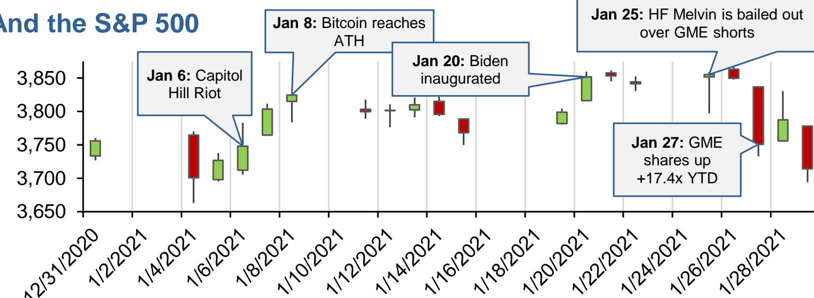
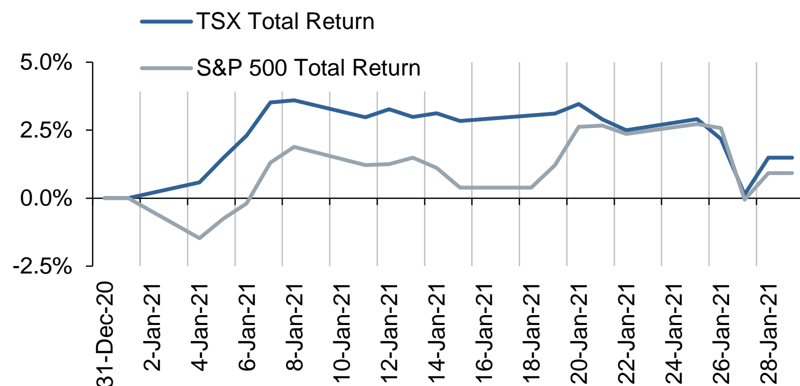


Chart 2: A strong start that receded in the back half



- The first month of 2021 saw an extension of last year's tumultuous momentum. Market participants were dealt a hand comprised of **1)** A seemingly incessant rise in COVID-19 cases; **2)** Ever-changing global vaccine supply chain & distribution technical; **3)** A muscular surge in speculative Bitcoin interest that pushed the cryptocurrency to an all-time high of ~US$41,981; **4)** The violent storming of the U.S. Capitol against its then incumbent Chamber of Congress; **5)** The subsequent exchange of power between the Trump and Biden administration; and **6)** A sudden influx of euphoric equity-market speculation, driven by an online Reddit community of retail investors – r/wallstreetbets – that grew +182% YTD to ~5mn users (**Chart 1**).
- Amid the volatile economic and political backdrop, North American equity markets rose considerably throughout January but pared gains as the month drew closer to its end. In local currency terms, the S&P 500 Total Return Index was down -1.01% while the TSX Composite Total Return Index was down -32 bps (**Chart 2**). Emerging market equities fared better, with the MSCI Emerging Markets Index returning a total of +3.35% for the month (in CAD terms).
- Capital markets froth exhibited no signs of subsiding; there have been 67 U.S. SPAC IPOs this month raising an aggregate US$19.1bn (~54% of raised U.S. IPO capital YTD), bringing the blank check universe from ~US$116bn to ~US$152bn in total market capitalization. In Canada, C$2.36bn in total equity capital was raised.
- U.S. and Canadian 10-year yields continued their rise to end the month at 1.07% and 0.91%, respectively. It's worth noting that higher yields for longer-dated bonds have created a steeper yield curve, of which implications will be detailed later in this report.
- Elsewhere, the U.S. dollar strengthened against its basket of currencies while gold prices edged lower as risk-on sentiment continued to sweep the market by storm. The energy market breathed a sigh of relief as OPEC+ pledged supply cuts and indications of meaningful global inventory drawdowns emerged. The new Biden administration, however, adds another layer of complexity that investors will have to grapple with in the coming months.
- It appears that we have reached a critical moment in the market cycle. Speculative froth has stretched equity markets beyond what was initially expected, with S&P 500 and TSX forward P/E ratios appearing overextended at 22.1x and 16.6x, respectively. Despite hopes for a less eventful year, we may not be party to that pleasure after all if this month is any indication of what is yet to come.

FOMO alive and well

Chart 3: Volume Spikes vs. r/WSB Users

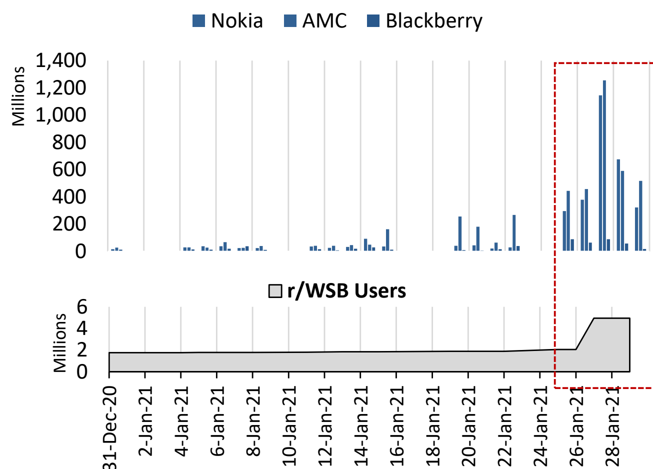
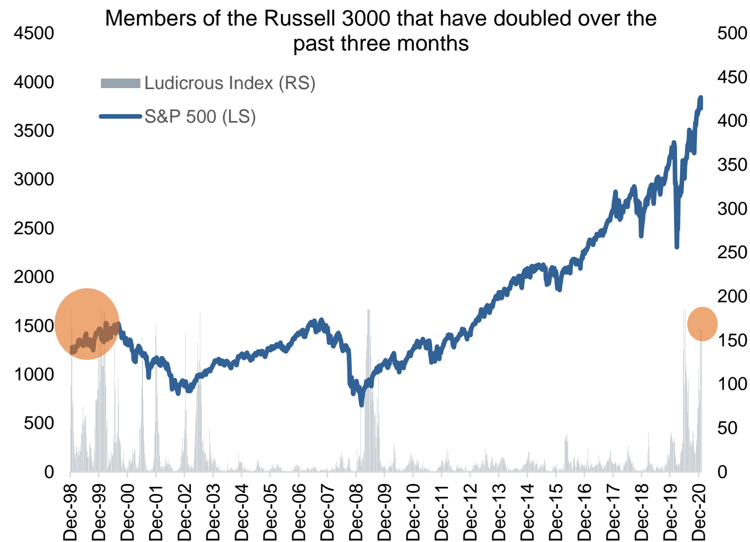
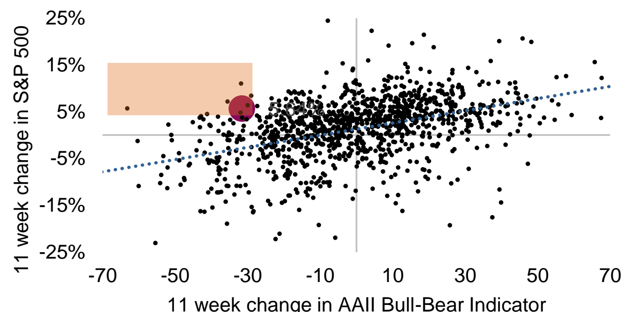


Chart 4: Past bubble ingredient list

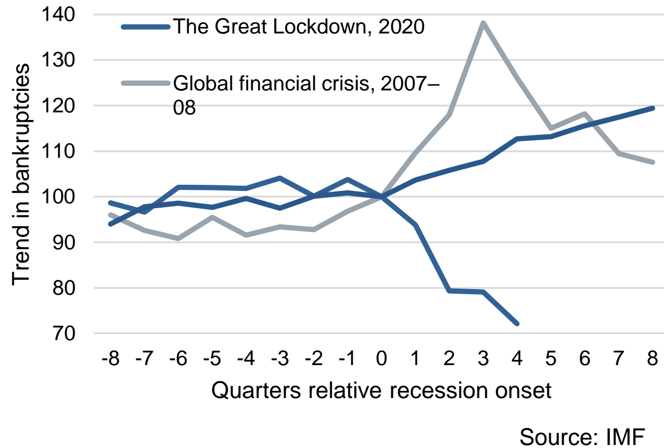
Bubble	Easy Money	Leverage	Regulation Inflate	Disruptive Technology	Demand/Supply mismatch	Broad Public Speculation
Tulip Mania (1630s)	■	■				■
Railway Mania (1840s)	■	■		■		■
Roaring 20s	■	■		■		■
Dotcom (1990s)	■	■		■		■
Housing Bubble (2005-07)	■	■	■			■
Commodities (2001-11)	■	■			■	■
Reddit Army Short Squeeze	■	■			■	■

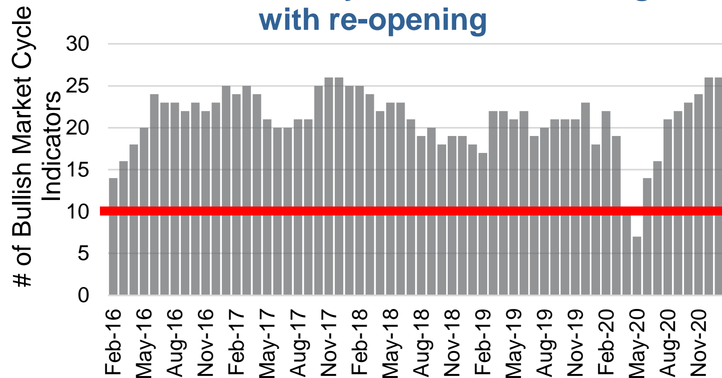
- After the successful attack on GameStop we saw the Reddit Army expand their attack to stocks such as Nokia, AMC, Blackberry and others. What was happening was a swath of new traders all coming in at the same time, mostly on one side of the trade, in a tactical pursuit to destroy short sellers and inevitably pushing the stock prices higher.
- People do not often think of stocks in the context of the market in which they trade. The fact is there is a buyer and seller on either side of every trade agreeing on a price to trade the stock. In these cases there is clearly a current imbalance of buyers over sellers.
- **Chart 3** shows the spike in volume in these heavily shorted stocks as the Reddit army grew*;* annotated by Wall Street Bets subscribers, a popular Reddit forum.
- The fear of missing out (FOMO) is real and has captivated the attention of many investors around the globe – *take it from one of the newest Reddit subscribers*. My subscription was partly to better understand the sequence of events driving this mania.
- Behavioural mistakes and feedback loops are evident in almost every bubble and clear as ever in last week's episodic melt up. The reposts, net new Reddit subscribers and volume on thinly traded stocks are evidence that feedback loops are fuelling investor FOMO.
- Is this a bubble? We have written about and warned about bubbles in the past, such as crypto in 2017 and cannabis in 2018. And we've highlighted the often similar characteristics of bubbles, such as easy money, access to leverage, regulation change, new technology, extended mismatch between supply and demand and increasingly broad adoption or speculation.
- Money can't come easier than the government sending you a cheque like we saw in pandemic relief funds. The options market has provided the access to leverage. This bubble is missing the regulation inflate but trading halts on specific names and regulators stepping in could deflate the trade. The new technology provided by discount brokerages and social media are certainly providing the necessary platform ingredients. In terms of the supply/demand mismatch, there is certainly mass speculation on which name the army will attack next.
- The one commonality of every bubble is that they all end, usually very abruptly. There is money made along the way but there is also money lost by those who get involved late. This is similar to a pyramid scheme, albeit not an illegal one.
- We all suffer from behavioural mistakes and missteps when investing. To avoid them or even profit from them involves making a strategic plan in advance of making an investment decision. Sticking to that plan is the hard part as we battle the internal feelings these biases instill. But working with a trusted advisor can be key to helping avoid those mistakes.
- Having a tactical or momentum strategy can be part of a holistic portfolio but certainly not a material part. So if you are going to chase this phenomenon, approach it systematically, size your position small and stick to the plan, getting out before it's too late because like previous bubbles this hype wont last forever.





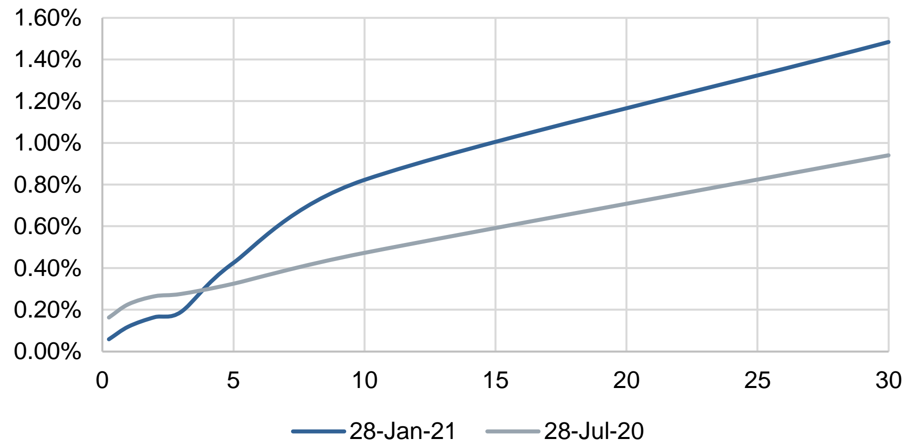
- Trying to get a read on market sentiment is often described as more of an art than a science. At its core, market sentiment tries to both quantify and qualify the overall market attitude towards a particular group of stocks or even the overall market. If it were a feeling, we'd classify the present version as *manic malaise*. From a crowd psychology standpoint, there are more than a few bubbles, valuations don't appear to matter, option volumes are at all-time highs and retail day traders are in the news. This is a mania. The most evident was last week's adventures in r/wallstreetbets driving dizzying returns in such long-forgotten stocks such as GameStop, AMC, Nokia and BlackBerry. When the stock market starts making waves in all media outlets and is brought up in conversation from unexpected acquaintances, we'd be careless if we didn't take note. A classic Wall Street sentiment indicator was the magazine cover; the 21st century equivalent is the app-store indicator. The top-trending apps on the Google play store last week had online brokers and Reddit all in the top 5.
- In honor of Tesla, the godfather of r/wallstreetbets, we bring you the Ludicrous Index, which tracks the number of stocks within the Russell 3000 that have doubled over the past three months. We haven't seen this type of manic activity in over a decade. The initial spike after the quick bear is not surprising; one would expect phenomenal returns after a bear market, but the latest spike is more concerning as it coincides with a market top. The last time we saw a spike in companies doubling over three months and markets near their highs was 1999.
- The manic tendencies have been building since the U.S. election. Small caps have enjoyed some fantastic returns in a relatively short period of time, rising over 30%. The bulls have been emboldened by the lack of losses and this tends to breed optimism. Small caps and Emerging Markets have had only one (not including last week) losing week since the end of October 2020.
- For those who can peel themselves away from the great distraction that was GameStop, we would like to highlight other markets that point to a growing sense of uncertainty. Riskier currencies such as the commodity-linked Canadian and Aussie dollars have all fallen to multi-week lows against the U.S. dollar. This is a clear sign of souring risk sentiment in global markets. Bond yields have quietly been slipping lower, and even credit spreads, which were making headlines earlier in the month for being so low, have quietly begun to rise over the past few trading sessions. The VIX, which had been flat for most of the month, has also spiked to its highest level since the fall.
- Surveys have been building bearish sentiment, despite markets making new highs. The AAII Bull-Bear index just turned negative for the first time since mid-October. The over 30-point drop since the U.S. presidential election is very rare considering the market has gained over 5% in that time period. Typically, these shifts in sentiment coincide with market sell offs. In fact, looking back to 1999, we can only find three other weeks that had a similar or greater fall in sentiment with similar market returns.

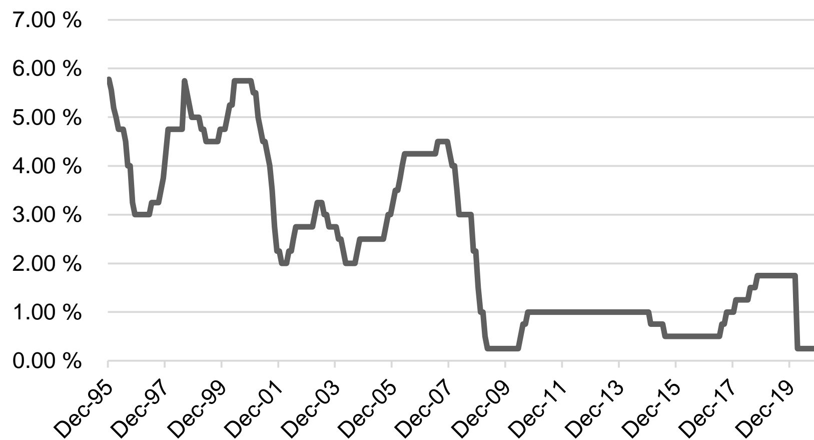




- There are many reasons to be optimistic. Individual investors are taking an increasingly active role in markets, with an enthusiasm not seen since the 1990s. The pace of new COVID-19 cases has started to steadily decline. The vaccine rollout, with its share of bumps/delays, continues towards herd immunity. And the economic data marches along the road to recovery. Meanwhile, the central banks and government-spending programs continue to backstop any material slippages. The bond market is open for just about anyone to raise money and even retailers selling used video games are thriving (*if only Blockbuster had held on a while longer*).
- The liquidity support has clearly worked as corporate bond markets are once again breaking past records for dollars issued. This has made it really difficult for companies that are large enough to access the bond market to go bankrupt. But don't take our word for it, **Chart 7** contrasts trends in bankruptcies during past recessions, during the financial crisis (2008) and the 2020 lockdown. A recession like no other.
- Liquidity support arguably saved the markets in 2020 and helped drive many of them to new highs. But liquidity is not a precise instrument and while it has been very effective, there are second- and third-order ramifications. Broader asset price inflation is leading to some bubble behaviour in pockets of the market. The unintended consequences are rising. And of course the ramification of increased debt is a longer-term issue. The longer term can become short term very quickly though. Add in valuations and the risk of a market correction is elevated.
- While the market may be at higher risk, the economic recovery has been, by most measures, a pleasant surprise based on most expectations. It is impressive how many industries have pivoted or adjusted their operations to manage in a pandemic world. And as the vaccine continues to open up those industries left behind, economic growth could really surprise later in 2021.
- Our market cycle framework continues to point to a recovering economy, not just in North America but globally. In fact, economic-driven signals are almost unanimously bullish. This isn't a surprise, given many of these readings are based on the rate of change over various time periods and the depressed readings from 6-12 months ago make comparisons very positive. The sustainability of these positive signals will be a function of the vaccine rollout allowing for a more fulsome recovery.
- 2020 ended up being a great year for markets and a terrible year for the global economy. Given the valuations, elevated index levels, low bond yields and volatile investor sentiment, 2021 could very well prove to be a great year for the economy and a tougher year for the markets. While we are not bearish on equities, neither are we overly bullish despite this being so early in a new cycle – *if it is a new cycle.* (See page 4, Investor Strategy January 2021 issue HERE). Sitting on the fence may not be comfortable, but when it comes to portfolio construction we continue to recommend a balance of some offense and some strong defense.

Fixed Income – Cheaper and steeper

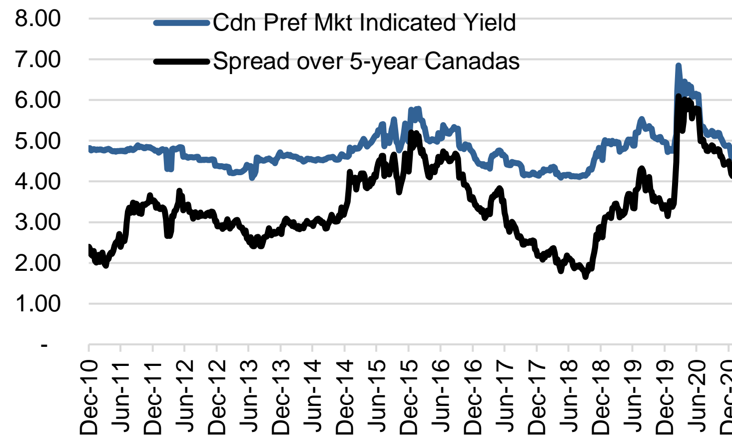




- Yields have continued to rise for the past five months, led by the long end of the yield curve. US 10-year yields are back above 1.0%, more than doubling from the all-time low of 0.51% set in August of last year, and the difference between 2-year and 30-year U.S. yields has reached +1.70%, up from +0.66% a year ago
- The move in Canadian yields has been more muted, but we have also seen a steepening of the yield curve north of the border, with the spread between 2-year and 30-year Government of Canada yields now at +1.30%
- This move to "cheaper" bonds and especially in the long end is the normal move to a "steeper" yield curve, as the market is pricing in higher short-term rates in the future
- Since moving to scheduled rate announcements in the 1990s, the period between the last rate cut and the first rate hike was typically less than 12 months. This held in Canada until 2015-2017, but in the U.S., the great financial crisis in 2008 saw a 7-year period in the U.S. between moves.
- This cycle is expected to be another protracted period of rates being held low. Consensus forecasts are calling for the first rate hike to happen in early 2023, more than two years from now.
- Therefore, we do not think the move to cheaper bonds and a steeper curve is done. Yields will continue to rise, and the spread between 2-year and 30-year bonds will likely get closer to +2.00% before the move is done – that would put long bond yields closer to 2.25-2.50%.
- Until that occurs, we continue to recommend:
    - Fixed income remaining at the low end of your strategic asset allocation band.
    - The duration of your fixed income holdings be below that of the benchmark index.
    - Although credit spreads are tight, the additional yield provides some cushion, so remain overweight corporate bonds versus government guarantees.
    - Look to alternative strategies including long-short credit mandates to diversify and enhance returns.

ECHELON WEALTH PARTNERS

Preferred Shares – Is anyone looking?



- Equity markets are looking positively bubbly, as everyone looks to social media sites for stock advice. REITS, heavily shorted stocks, and whatever name the social media crowds decide to focus on are subject to huge jumps. We have entered the end-phase. We aren't sure if this is the beginning of the end or the end of the end, but it looks, feels and smells a lot like previous euphoric phases.
- We haven't known a bull market to end without some euphoric phase, and while the preferred share market seems tame compared to the trading action we are seeing in GameStop, Blackberry, Tesla and AMC, prefs had their euphoric period in 2010-2011. This was when a unique set of circumstances between Canada yields, credit spreads and investor demand for income combined with a relatively newly structured and poorly understood form of prefs known as the rate reset to create a mini-euphoria in preferred shares.
- The 2011 mini-euphoria allowed issuance to come in at very skinny premiums to Canada yields. BMO, BNS, TRP, BCE , GWO among many others able to issue with a coupon floating well under 200 basis points over Canada bonds seemed normal at the time, but now seems extraordinarily cheap financing (or expensive for investors). Of course, in 2011, yields had "nowhere to go but up" as we heard over and over at the time... the 5-year reference yield of 2.5% at the time now appears to be a pipe dream to the current 0.40%. And coupons on those prefs have reset and dropped accordingly.
- CSCO still trades 40% below its 2000 peak. Should we expect some of the low-spread rate-resets to have the same fate? Luckily, it doesn't matter. If you are long, crystalize your loss and reposition. Today's yields are attractive. While we believe that pref volatility will continue to be unpalatable for most investors as it has been since 2014, the yields are compelling – especially when tax-adjusted.
- We are hesitant to rush out and buy this shrinking, illiquid, but undervalued market. That said, steady hands that aren't negatively influenced by drawdowns should take note at the great after-tax yields and earn some income.
- Tactical investors should note that since the lows in March, prefs have returned the same as the S&P 500 index with less than half the volatility. Buying preferred shares on the dips (providing liquidity where there is little) has thrice proved to be an amazing investing strategy. It will be next time as well.
- This isn't your grandparent's asset class. Buy at par and redeem at par won't cut it, but a skilled and attentive manager should pay attention to prefs.

Disclaimer

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

Forward-looking statements are based on current expectations, estimates, forecasts and projections based on beliefs and assumptions made by author. These statements involve risks and uncertainties and are not guarantees of future performance or results and no assurance can be given that these estimates and expectations will prove to have been correct, and actual outcomes and results may differ materially from what is expressed, implied or projected in such forward-looking statements.

The opinions expressed in this report are the opinions of the author and readers should not assume they reflect the opinions or recommendations of Echelon Wealth Partners Inc. or its affiliates. Assumptions, opinions and estimates constitute the author's judgment as of the date of this material and are subject to change without notice. We do not warrant the completeness or accuracy of this material, and it should not be relied upon as such. Before acting on any recommendation, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. These estimates and expectations involve risks and uncertainties and are not guarantees of future performance or results and no assurance can be given that these estimates and expectations will prove to have been correct, and actual outcomes and results may differ materially from what is expressed, implied or projected in such forward-looking statements.

The particulars contained herein were obtained from sources which we believe are reliable, but are not guaranteed by us and may be incomplete. The information contained has not been approved by and are not those of Echelon Wealth Partners Inc. ("Echelon"), its subsidiaries, affiliates, or divisions including but not limited to Chevron Wealth Preservation Inc. This is not an official publication or research report of Echelon, the author is not an Echelon research analyst and this is not to be used as a solicitation in a jurisdiction where this Echelon representative is not registered.

The opinions expressed in this report are the opinions of its author, Richardson Wealth Limited ("Richardson"), used under a non-exclusive license and readers should not assume they reflect the opinions or recommendations of Echelon Wealth Partners Inc. ("Echelon") or its affiliates.

This is not an official publication or research report of Echelon, the author is not an Echelon research analyst and this is not to be used as a solicitation in a jurisdiction where this Echelon representative is not registered. The information contained has not been approved by and are not those of Echelon, its subsidiaries, affiliates, or divisions including but not limited to Chevron Wealth Preservation Inc. The particulars contained herein were obtained from sources which we believe are reliable, but are not guaranteed by us and may be incomplete.

Assumptions, opinions and estimates constitute the author's judgment as of the date of this material and are subject to change without notice. Echelon and Richardson do not warrant the completeness or accuracy of this material, and it should not be relied upon as such. Before acting on any recommendation, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. These estimates and expectations involve risks and uncertainties and are not guarantees of future performance or results and no assurance can be given that these estimates and expectations will prove to have been correct, and actual outcomes and results may differ materially from what is expressed, implied or projected in such forward-looking statements.

Forward-looking statements are based on current expectations, estimates, forecasts and projections based on beliefs and assumptions made by author. These statements involve risks and uncertainties and are not guarantees of future performance or results and no assurance can be given that these estimates and expectations will prove to have been correct, and actual outcomes and results may differ materially from what is expressed, implied or projected in such forward-looking statements.