2020 Second Quarter Review

"There is a Chinese curse which says 'May he live in interesting times.' Like it or not, we live in interesting times." - Robert Kennedy

Few would have predicted that, in the face of the devastating COVID-19 global pandemic, **world equities would deliver double-digit growth in the second quarter** - but they did thanks to central banks keeping interest rates very low and governments spending trillions to help consumers and businesses stay afloat. Even so, the economic pain on so-called "Main Street" remained very real throughout the quarter, and whether such investor enthusiasm was justified will depend largely on how successfully the pandemic is managed going forward.

Canadian equities rebounded strongly, up 17% as measured by the S&P/TSX Composite Index. The Bank of Canada (BoC) held interest rates at 0.25% after sharply lowering them three times in March. Upon his appointment in June, the new Governor of the BoC, Tiff Macklem, said the focus will be to **keep interest rates low for the foreseeable future** in what he expected to be a drawn-out economic recovery. Fortunately, and only through concerted effort by Canadians, new cases of COVID-19 were steadily declining by June, leading provinces to begin lifting restrictions with the goal of managing risk while charting a path forward to sustainable growth.

Unfortunately, the US was not very effective in controlling the spread of the virus. With only 4% of the world's population, by the end of June they accounted for about 25% of global COVID-19 cases. Nevertheless, **US equities rallied strongly, particularly technology stocks which benefited from the "stay-at-home" environment**. Even the broader S&P 500 Index, which tracks the 500 largest US companies, was up 16.2% (CAD) for the quarter and 1.8% (CAD) year-to-date, being driven primarily by the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix and Google). The Federal Reserve kept interest rates unchanged at a range of 0-0.25%.

Abroad, developed and emerging-markets stocks were up 10.8% (CAD) and 13.9% (CAD) for the quarter, respectively. However, one very big concern surfaced in late June when **China announced a new security law, effectively ending their commitment to the "one country, two systems"** agreement with Hong Kong. Tensions escalated with many countries, including the UK, US and Canada, who were quick to criticize China and take steps to revise trading policies with Hong Kong, particularly with regards to military equipment and technology.

Global interest rates fell to historical lows last quarter, with yields on fixed income securities following suit. Investors favoured shorter maturities, waiting for yields on longer ones to improve with a better economy. A basket of short-term Canadian government bonds returned 2.2%.

Following are the returns for major indices for the period ended June 30th, 2020:

	2nd quarter actual	YTD actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.1	0.5	1.4	1.3	1.0	0.9
Canadian Bonds (FTSE Short Term Bond)	2.2	4.0	4.5	3.0	2.1	2.6
Canadian Stocks (S&P/TSX Comp.)	17.0	-7.5	-2.2	3.9	4.5	6.4
U.S. Stocks (S&P 500)	16.2	1.8	11.8	12.5	12.7	16.9
Non-North American Dev. Stocks (EAFE)	10.8	-6.9	-1.4	2.4	3.9	8.4
Emerging Markets Stocks (FTSE / MSCI Emerging)*	13.9	-5.2	0.9	3.7	3.8	5.9

* 2nd quarter, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook

**"All of us might wish at times that we lived in a more tranquil world, but we don't.
And if our times are difficult and perplexing, so are they challenging and filled with opportunity." - Robert Kennedy**

For investors, the second half of 2020 will involve the continuing push and pull between two things: **optimism over signs of economic improvement versus the sobering reality that COVID-19 still presents serious difficulties for the global economy**. In the US, where two successive months of better-than-expected jobs numbers boosted hope for a faster recovery, the virus is now surging in places where restrictions were relaxed too quickly. Lacking a federally coordinated US public health strategy, states are left to manage on their own with several, such as Texas, California, Arizona and Florida, now slowing the pace of reopening.

In general, it is now widely accepted that until a future vaccine is distributed globally, all countries must try to function while they manage inevitable COVID-19 outbreaks that can strain health care systems. This is a tricky balancing act and **global markets are likely to remain volatile** until we have better medical remedies. Right now, the US is gearing up for the election in November and it is troubling to see that simple preventive measures, like the wearing of a mask in closed spaces and avoiding large indoor crowds, have become politicized there. And while the virus remains the chief concern for investors, rising tension with China over trade and human rights issues - not to mention the pandemic's origin itself - is also a worry.

Against this backdrop of elevated risk, the consensus view is that the market lows of last March, from which prices bounced back significantly, are not likely to be retested. **Investors are drawing confidence from the massive fiscal and monetary stimulus provided by the world's governments and central banks**. For example, US fiscal stimulus of over $2 trillion amounts to a whopping 12% of GDP, and more targeted stimulus is expected this quarter.

Similarly, the US Federal Reserve has vowed to use all its monetary tools to support financial stability - indefinitely. The old Wall Street mantra, **"Don't fight the Fed"**, is popular once again when media discusses a "floor" for stock prices. Of course, there is also some unease about the amount of debt being issued to fund this support, but because interest rates are so low, the burden is thankfully less worrisome than otherwise. In addition, these same low interest rates are driving money into stocks because more stable assets are providing negligible yields.

A closer look into the mechanics of the recovery in stock prices shows that leadership is coming from those companies that thrive in an environment where activities outside the home are limited. These "stay at home" industries include technology, consumer staples and online retail. The health care sector is also outperforming due to its importance in developing potential treatments and a vaccine. On the flipside, stocks that would benefit from a more normal (pre-COVID-19) economy are lagging. These include leisure and travel, banks, real estate, energy and instore retail categories. Another factor in favour of stocks is the vast amount of cash known to be sitting idle in investor accounts - funds being held on the sidelines for the time when confidence returns to out-of-favour segments of the market. The Wall Street Journal estimates it at close to $4.6US trillion.

Keep in mind that consumers could alter their behaviour quickly and radically once any effective medical breakthrough against this novel coronavirus is found. But no one has any way to predict the timing of such an event. What we can be sure of is that the **pandemic's presence will continue disrupting people's lives** until then.

Portfolio Strategy

More than ever, this year's market volatility is reminding investors of the importance of **maintaining a disciplined portfolio strategy in times of uncertainty**. Although global stocks have rebounded strongly from their March lows with regional equity returns performing somewhat similarly during the last quarter, **longer term returns have favoured the US market by a wide margin**. This is partly due to the relative strength of the US economy compared to other developed countries, but more importantly, it reflects the weighting of a few large technology-oriented companies in US stock indices. The technology sector, including Microsoft and Apple, accounts for almost 27% of the S&P 500 Index, for example, while global markets excluding the US have only 11%. Further, the original FANG stocks (FAANG excluding Apple) are categorized as a mixture of communications and consumer sectors, i.e., they are not in the technology sector. But, added together, US tech-oriented companies comprise about 40% of the S&P 500.

It is not just the overall size of US tech-related exposure to consider either: five companies dominate. In order of size, they are: Microsoft, Apple, Amazon, Alphabet (Google) and Facebook - now representing almost 23% of the entire S&P 500 Index. This is the highest concentration of a few behemoths since the early 1970s. Back then, the top five were IBM, AT&T, GM, Kodak and Exxon - Sears Roebuck was sixth. This is a great illustration of how **market leadership changes over longer periods of time**.

As you well know, Milestone's focus is ***not*** to chase today's hot sector, but rather to invest in a well-diversified global equity portfolio with exposure to large and small stocks. We "tilt" towards more value-oriented companies which trade at more attractive prices relative to their earnings. For example, Amazon currently trades at almost 150 times its earnings of the past 12 months compared to about 20 times for the overall S&P 500. This is astonishing. Of course, Microsoft and the FAANGs are great companies, but eventually, valuations must reflect future expected returns. It is challenging to explain how their stock prices can continue to defy the economic reality of "Main Street", where very little is functioning normally.

Therefore, in equity portfolios we continue to **emphasize diversification and disciplined rebalancing**. Given the strong relative performance of US stocks, in many instances this involves trimming US exposure. Financial stocks have lagged during the pandemic, but their attractive dividends should provide support as the economy gradually recovers. Fixed income investments may seem unrewarding in today's low interest-rate environment, but they are essential in moderating return variability and providing a source of cash flow during periods of uncertainty.

Overall, investors should brace themselves for **continued volatility** as long as COVID-19 is in our midst. And, while we are likely to encounter some setbacks going forward, the continued efforts by governments and central banks to support their citizens and stabilize economies in this difficult environment should help stabilize financial markets as well. Nevertheless, we live in interesting times.