2020 Third Quarter Review

"You may have to fight a battle more than once to win it." **- Margaret Thatcher**

Global stocks remained resilient throughout most of the third quarter (Q3) before dipping in late September over worries of COVID-19's second wave. With public-health guidelines having been relaxed over the summer, most countries saw **new COVID-19 cases begin to surge** as people resumed foregone activities, including school for millions of children. With cold weather approaching, it seemed likely that governments would reimpose some of the constraints of last spring. Yet, despite the global economy having suffered its biggest shock since WWII, most countries held up quite well thanks to central banks providing **massive liquidity** and **rock-bottom interest rates**, and g**overnments sending emergency cash to consumers and businesses**.

Canadian stocks, as measured by the S&P/TSX Composite Index, were up 4.7% in Q3 but still down 3.1% year-to-date. Economic data for August showed continued improvement relative to Q2 when GDP experienced its pandemic-related collapse. Nevertheless, the **unemployment rate remained sticky** at 10.2% (from a high level of 13.7% in February) as many businesses struggled to resume operations. On the other hand, **house sales and prices were strong**, helped by low borrowing costs as the Bank of Canada (BoC) held its bank rate steady at 0.25%.

US stocks, as measured by the S&P 500, returned an impressive 6.6% (CAD) in Q3 and 8.5% (CAD) year-to-date. **November's upcoming presidential election garnered increasing attention** by investors grown weary of the pandemic's unyielding threat. Recent news of a coronavirus outbreak in the White House itself, including the president, kept short-term market sentiment skittish with investors parsing every rumour and tweet. In particular, **technology stocks pulled back from stretched valuations**. Meanwhile in the real economy, of the 22.2 million US jobs lost due to shutdowns, just over half had been regained according to most recent data. But even with the jobs rebound below expectations, analysts noted the **resilience of consumers and businesses** in the face of such unprecedented challenges. And to help, the Federal Reserve (the Fed) promised to keep interest rates low (currently between 0% and 0.25%) until 2023.

Overseas, international and emerging-markets stocks gained ground, returning 2.6% (CAD) and 6.9% (CAD), respectively. But post-Brexit, the UK and EU negotiations for a new trade deal remained testy heading into their self-imposed year-end deadline. At the same time, China's ongoing effort to impose greater economic power throughout the Asian region (and beyond) kept ratcheting up tensions with other major countries. **Diplomacy seemed in short supply**.

Global bond yields remained at all-time lows as central banks promised to keep them there for the foreseeable future. Although interest rates in Canada and the US remained slightly above zero, in the EU and Japan they have been negative for quite some time. A basket of short-term Canadian government bonds yielded 0.7% in Q3 and were up 4.8% year-to-date.

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

	3rd 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	0.6	1.0	1.3	1.0	0.9
Canadian Bonds (FTSE Short Term Bond)	0.7	4.8	4.9	3.4	2.3	2.5
Canadian Stocks (S&P/TSX Comp.)	4.7	-3.1	0.0	4.3	7.2	5.8
U.S. Stocks (S&P 500)	6.6	8.5	15.8	14.7	14.0	16.7
Non-North American Dev. Stocks (EAFE)	2.6	-4.5	1.1	2.8	5.2	7.4
Emerging Markets Stocks (FTSE / MSCI Emerging)*	6.9	1.3	10.5	4.8	8.1	5.2

* 3rd 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

"The two most powerful warriors are patience and time." - Leo Tolstoy

Before this challenging year ends, investors will need to assimilate a substantial slate of news, much of it likely to produce more short-term volatility in equity prices. Not only will markets try to assess the broad economic consequences (domestically and beyond) of the US election's outcome but also, with the second wave of COVID-19 causing growing havoc in many places, everyone awaits positive news of better treatments and vaccine trial results. The sustainability of the economic recovery going into 2021 will almost certainly depend on **supportive economic policy decisions** until a vaccine is widely delivered.

More specifically, the result of the US election will have important ramifications on personal and corporate taxes, on healthcare policy and climate-change initiatives, on foreign relations and international trade and even on next year's plan for dealing with the pandemic. Since both tax and trade policies most directly impact markets, **stock prices are already reflecting the chance of higher taxes and the potential benefits of better international trade relations** - especially if there were to be a change in administration.

But whether it's a Republican or a Democrat in the White House, we believe the unprecedented needs of this unique time will largely dictate future fiscal and monetary policy. This should be constructive for stocks which, contrary to popular opinion, have thrived under either party: the key is whether political decisions support or hamper the actions of businesses and consumers. That's because, ultimately, **stock prices are a function of corporate earnings** which grow over time. Currently, earnings stand to benefit from renewed consumer demand, not to mention the benefits of innovation, advances in technology, very favourable interest rates and globalization.

That said, the predicted second wave has arrived, with infections spiking in Canada, the US and overseas. For the most part, authorities are trying to respond with a targeted approach as they employ specific regional restrictions while hopefully avoiding full-scale lockdowns. The virus continues to confound us all, but people are learning to live with it until further inroads are made to effective treatments and vaccines. Our ability to adapt to this new reality is showing up in recent economic data: **Q3 saw robust US manufacturing numbers, jobs growth and home sales**. Investors are hoping to see this resiliency continue in Q4.

Yet despite data showing promising economic recovery overall, significant financial pressures threaten those sectors hit hardest by the pandemic. For example, **in-person retail and services, travel, tourism and commercial real estate remain very depressed**. Therefore, we expect governments and central banks to continue providing stimulus as much as possible. Low interest rates are a key factor: they not only encourage growth but also lesson the future burden of servicing the massive government debt which the pandemic has engendered. One thorny reality for investors is that until rates move meaningfully higher again, which is looking to be well down the road, they will have to seek alternatives such as stocks for a source of income.

To summarize, equity markets may remain choppy in Q4, depending on how events transpire in politics, health and science. However, there are reasons for long-term investors to look forward to 2021. As concerns over the pandemic eventually subside and economies rebuild, the massive amount of sidelined cash waiting to be reinvested could combine with accommodative monetary and fiscal policy to act as a significant boon to stocks going forward.

Everyone knows it is impossible to predict the short-term direction of markets, but the current uncertainty and confusion surrounding COVID-19 and the global policy response have expanded the expected range of possible outcomes much more than usual. With central banks buying bonds to keep interest rates low and governments strapping on massive debt, some economists predict inflation will result. Other experts are convinced deflation is even more of a risk, given elevated asset prices. The reality is that what central banks are doing to support the global economy is unprecedented. It's no wonder the question is in dispute.

Historically, the traditional 60%-equity portfolio has served both individual investors and pension plans very well: stocks provided the needed growth and bonds supplied needed cash flow and moderated return variability. Most of the time, bond prices rose during periods of economic and/or stock market weakness, stabilizing portfolios. Now however, interest rates are exceptionally low in North America and even negative in many other developed countries, leaving the **upside potential for fixed income securities very limited**. In fact, at current levels, a typical fixed income portfolio has a negative "real" rate of return expectation going forward, meaning it is **not expected to keep pace with inflation**. This problem is leading some pension experts to reassess the future weighting of bonds in a typical pension plan portfolio.

While pension-plan issues differ from a private investor's in some respects, a shared predicament would be interest rates staying very low for an extended time. The Fed has recently pledged to keep rates at these low levels for at least the next three years and we would expect the BoC to act similarly. For our clients who already have enough assets to see them through retirement, even in a low return environment, taking on additional risk to generate higher returns and more income may not be of interest. But, income-oriented clients may be inclined to consider alternative sources of income generation. **Canadian dividend-paying stocks would be a good option**, but only if a boost in equity allocation with its attendant elevated risk profile is consistent with one's specific investment time horizon and risk-tolerance personality.

Rising inflation has other implications for fixed income assets as well: they quickly fall in price when interest rates are raised to combat inflationary pressure. (Bond prices move in the opposite direction of interest rates.) That said, an investor who holds bonds to their maturity at par need not be concerned with interim price behaviour and cash flow would not be affected. Of course, **rampant inflation would eventually hamper stock prices as well**, reminding us that too much inflation is no investor's friend.

All this to say these times are complicated and a globally diversified portfolio spread across a wide range of asset classes is strongly advised. We continue to rebalance portfolios accordingly, depending on individual client objectives. Given the very low rates on GICs and to enhance portfolio liquidity, we are reinvesting fixed income maturities into global bond funds. Low interest rates mean bond returns will remain below average for the next few years, but their **stability is an essential element for many portfolios**, particularly when cash flow is required. And **some investors may need to augment stock positions** to achieve their longer-term goals.