2020 Fourth Quarter Review

"Year's end is neither an end nor a beginning but a going on, with all the wisdom that experience can instill in us." - **Hal Borland**

We know Borland's words are true, but have we ever been happier to see a year end? With all the damaging, chaotic disruption of almost every aspect of our lives, 2020 will be long remembered. In such a year, very few people might have expected financial markets to thrive, especially after falling as much as 35% last March. But they did. And, in spite of worsening public health realities in most countries at year's end, **global equity markets finished on a very positive note**, mostly buoyed by the expectation that vaccines and treatments now provide the first light at the end of the tunnel.

In Canada, the S&P/TSX Composite was up an astonishing 9.0% last quarter and 5.6% for the year. With about 80% of the jobs lost to COVID having been recovered, markets seemed to ignore December's data, which was negative for the first time since last April due to a second round of mandated shut-downs. Retail and housing reports were positive, but expected to slow for the same reason. Regardless, investors took their cue from other economic data: **low interest rates, ongoing government stimulus and pent-up consumer demand**, all of which helped drive the index to a record high to end the year.

In the US, markets greeted November's election results with enthusiasm, believing the **new administration will provide significantly more financial support to a struggling economy in 2021**. At the same time, markets welcomed news that the Federal Reserve was committed to holding interest rates (currently between 0% and 0.25%) at very low levels for the foreseeable future. The S&P 500, an index of the largest US companies, was up an unexpected 7.4% (CAD) last quarter; 16.5% (CAD) for the year.

In Asia, **Chinese stocks also rebounded**. The CSI 300, an index of the largest stocks traded on the Shanghai and Shenzhen exchange, hit its highest level since 2008. In Europe, a **Brexit trade deal was finally enacted into law** after more than four painful years of UK/EU wrangling. For the year, international-developed and emerging-market stocks returned 6.1% (CAD) and 13.5% (CAD), respectively.

Globally, **bond yields remained at historical lows** as monetary policy focused on the economic challenges of the ongoing pandemic. Investors seeking decent fixed income returns were hard-pressed to find them in this asset class. **Shorter-term yields declined further**, given the effort by central banks to keep interest rates extremely low. However, **longer-term yields inched slightly higher** over vaccine hopes. A basket of short-term Canadian government bonds returned 0.5% for the quarter and 5.3% for the year.

Following are the returns for major indices for the period ended December 31st, 2020:

	4th quarter actual	YTD actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.0	0.6	0.6	1.2	0.9	0.9
Canadian Bonds (FTSE Short Term Bond)	0.5	5.3	5.3	3.4	2.3	2.5
Canadian Stocks (S&P/TSX Comp.)	9.0	5.6	5.6	5.7	9.3	5.8
U.S. Stocks (S&P 500)	7.4	16.5	16.5	14.9	13.4	16.8
Non-North American Dev. Stocks (EAFE)	11.1	6.1	6.1	5.0	5.7	8.2
Emerging Markets Stocks (FTSE / MSCI Emerging)*	12.1	13.5	13.5	6.4	9.8	6.2

* 4th 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

"No winter lasts forever; no spring skips its turn." - Hal Borland

With the events of 2020 in the rear-view mirror, investors look forward to 2021 with more enthusiasm than caution. They reason a new US administration will be more welcoming to global trade. There is promise of a **prolonged period of historically low interest rates** and governments around the world are expected to deliver **additional targeted fiscal stimulus** to their economies. All of the above should **bode well for stock prices**.

By historical standards though, **stock valuations already appear to be stretched**, with broad US market benchmarks hitting all-time highs. For example, consider the price-to-earnings (P/E) ratio which measures stock valuations relative to company profits. For the aggregate of companies in the S&P 500 Index, this metric is already close to 22 times their expected earnings in 2021, a level well above the historical average of 16 times.

That said, further analysis reveals an important feature of the market's current structure which tells a different story on valuations: the **S&P 500 has become both concentrated and bifurcated**. There is a big performance gap between so-called COVID "haves" and COVID "have-nots". In fact, the initial market recovery after last March's sharp sell-off was mostly for stocks of companies poised to succeed in a COVID world. And those companies were mainly technology-oriented "growth" stocks - several of them market behemoths.

This group - **giants like Facebook, Amazon, Apple, Alphabet (Google) and Netflix** - have now grown so large they represent a surprisingly **dominant 17% of the bellwether S&P 500 Index**. If we include other technology and communication companies with the so-called "FAANG" stocks, they total almost 40% of the index! This amount of concentration in the supposedly diversified S&P 500 is unprecedented - and is not a welcome feature. But it does help explain why the US market, so rich in technology stocks, **outperformed Canadian and international markets** with their greater composition of "have-nots".

"Have-not" companies tend to be more conventional industries with a history of generating consistent cash flow, such as those in the challenged energy, industrial, real estate, travel-related, in-person retail and financials sectors. **Many lagged significantly last year until November** when announcements about imminent vaccines finally prompted investors to take an interest in them again. They still have relatively depressed prices and can fairly be classified as "value" investments.

The vaccine news flipped the narrative a little; it sparked a stock rotation whereby investors are not only **trimming back holdings of "growth" stocks** but also employing their idle cash into more **value-oriented opportunities**, many of which have not fully recovered to pre-COVID levels. Such stocks are in industries that should benefit from a more normalized, pre-pandemic life, allowing Canadian and overseas markets to play some catch up to the US.

We know that markets are forward-looking and that current prices reflect the business conditions expected many months ahead. Even so, considering the all-time highs we've seen so recently, it would be no surprise if **stocks take a breather sometime in the first half of 2021**. Investors will have a lot of news to digest. It will probably include some **dismal economic data** in this prolonged winter of lockdowns and vaccination hiccups. While low interest rates and ongoing government stimulus measures should provide a level of support until the pandemic abates, any major disruption to the eventual economic recovery could be a drag on stock prices, particularly those with overextended valuations, such as some in the hot technology sector.

As a result, we think portfolios are well-served to hold positions where there is more attractive relative value. This would mean **downplaying the over-inflated sectors** we've discussed and **boosting those with more reasonable valuations** where a performance gap still exists, such as those in the "have-not" sectors.

Portfolio Strategy

Last year was a reminder of the importance of maintaining a disciplined long-term focus through market turmoil. Investors know that **equity markets will rise over time** even when events might knock them off course in the short term, but last year was a doozy. Few predicted in the depths of last March that we would **end 2020 with many equity markets at or near all-time highs** while still in the middle of a worsening pandemic, that is for sure.

At Milestone, our focus is to grow our clients' assets responsibly over time through well-diversified global portfolios, with **exposure to all companies, large and small, and with a tilt towards value**. We are long-term investors, not traders, and we avoid the temptation to chase the hot sector of the day.

Given historically high equity valuations and the uncertainty surrounding the pending vaccine rollout, we remain generally cautious on equities this year. Nevertheless, when compared to their fixed income alternatives, equities look more reasonable. In this sustained low-interest rate environment, **investors wanting income might consider Canadian dividend-paying stocks** as a compelling choice. The yield on these stocks when compared to bonds, especially after tax, is relatively much more attractive. Historically, bond yields have been in the 3% range (pre-tax) compared to Canadian dividend-stock yields in the 4% range (pre-tax). The spread is much wider today: **dividend stocks yield more than 4% compared to less than 1% for high-quality bonds**.

This is not to diminish the importance of the fixed income asset class in portfolios. Although expected rates of return on fixed income securities will likely be muted for a few years, **high-quality bonds help reduce portfolio volatility and also provide a source of liquidity for cash-flow needs**. Currently, we are typically re-investing maturing GIC proceeds into a DFA bond fund or into the RP Fixed Income Fund, which provides exposure to short-term corporate bonds as an enhancement to expected returns.

In equities, we expect more broadly-based returns in 2021 as the world starts to recover from the pandemic. Given the outperformance of US stocks last year, our rebalancing efforts typically involve **reducing US exposure and adding to other equity components**. We may also be **adding to real estate holdings** in portfolios as it becomes more apparent that conditions are improving for the sector, given their significant underperformance last year and their attractive yields.

No one can ignore these uncertain times and, no doubt, 2021 may hold some set-backs. If so, we believe central banks and governments will provide continued support for the global economy. This is beneficial right now in getting through the pandemic but it almost certainly sets up longer-term challenges as the accumulating debt needs to be funded and unwound. We believe a **globally-diversified portfolio will be essential** to successfully navigate markets, now and in the years ahead.