STONEBROOKE
ASSET MANAGEMENT

The Commentary

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The Unreal Reality

The timeless solution to fighting economic downturns is with an expansion of fiscal and monetary largess. This is the classical neo-Keynesian response attempting to stimulate demand and preventing a cascading deflation. This time is no different except that the catalyst to the downturn is a pandemic. This time the monetary stimulus machine is well oiled and is quick out of the gate. The old playbook is still fresh in the minds of policy makers.

In the U.S. the stimulus is massive in scale with numerous government programs having been put into place; Families First, the CARES Act, Paycheck Protection Program, and likely coming soon, the Heroes Act. The total amount of stimulus spending exceeds $3 trillion. These relief programs are the largest in U.S. history and send cheques directly to individuals and business affected by the coronavirus.

In addition, the U.S. Federal Reserve has established its own programs including the Commercial Paper Funding Facility (CPFF), and Corporate Credit Facilities for both the Primary and the Secondary Markets, PMCCF and the SMCCF. A variety of lending programs have also been established for small and medium sized businesses, as well as for municipalities. All told the amount of lending is north of $3 trillion.

Here at home the Canadian government has not been idle. It launched an emergency response benefit (CERB) and an emergency wage subsidy program (CEWS) along with interest free loans under the Emergency Business Account (CEBA) program. The governments Covid-19 Bill gave the Liberal government carte blanche. With spending up and revenues down the recent "fiscal snapshot" announced a deficit of $343 billion. A staggering amount which is expected to soon push the accumulated Federal debt outstanding to over $1 trillion.

The fiscal snapshot has projected a decline of GDP of 6.8% in 2020, the largest on record. Unemployment is projected at just under 10%. Program expenses are all up from initial estimates and will likely continue to rise.

The Bank of Canada initiated its first quantitative easing (QE) program and announced the purchase of government bonds. The Government Bond Purchase Program (GBPP) has accumulated approximately $200 billion. Since February, total assets at the BOC have surged by over $400 billion, a rise equivalent to 18% of GDP. The rate of growth may finally slow as it plans to reduce the number of bonds purchased at primary auctions from 40% down to 20%.

S&P/TSX : 15,515	90 Day T-Bills : .20%	Oil : $39.25 US	Cdn $: .734 US
S&P 500 : 3,100	10 Yr Cda Bond : .52%	Gold : 1,784 US	Euro : 1.53 Cdn

The Fanciful "V" Shaped Recovery

While there are still many economic commentators that expect a "V" shape recovery, the evidence is becoming clearer that such hopes are fanciful. The labour markets should be rebounding sharply by now. Instead, the continuing unemployment claims data in the U.S. remains elevated. These are the worst readings since the 2008/2009 financial crises, and the fastest deceleration ever. The economy is unlikely to recover at an accelerating pace.

Were it not for the support of Central Banks buying financial assets, the stock and bond markets would not be trading at current valuation levels. Central banks around the world have thrown in the proverbial "kitchen sink" at trying to prevent a financial panic. It has worked so far, and the hope is the economy quickly responds by getting back to work and normalizing soon. Obviously, this is dependent on the virus and whether it continues to spread. The lifting of lockdowns in some of the southern U.S. states is causing a resurgence of cases. Parts of Europe, especially in Spain, are witnessing a sharp increase. The next several weeks appear critical in determining if this virus has a potentially disastrous second wave. Even the experts in the fields of virology and immunology are undecided on the characteristics of this virus. This is a new coronavirus and information on it is advancing daily. At present the world must cope with the continuing threat and guard against it spreading.

The service sector of the economy, retail, restaurants, travel, and leisure have been hardest hit. With social distancing in force, even as we come out of lockdown, these sectors are unlikely to recover very quickly.

Supply chains are in disarray. Companies are scrambling logistically as bottlenecks develop. Not only are supply shortages developing in some goods but distribution is challenged as certain customers cancel orders and others order more. The dairy industry as an example has an oversupply situation in certain markets and is forced to dump milk. The closure of hotels and restaurants is the primary reason. The contracting service economy is causing cutbacks and shifts in production across many industry sectors.

The global economy faces a challenging period ahead. A "V" shape recovery is highly unlikely. It will eventually be recognized that many businesses will not rebound quickly, and many will never reopen. Some economists are even suggesting the economic recovery will bring structural changes. David Rosenberg, of Rosenberg Research, recently penned the following, "*What the world looks like when the crisis ends is truly anyone's guess, but I will say with 100% clarity that it is going to look a lot different than it did before. Months of isolation and distancing and fear of a return of the pandemic are going to fundamentally alter lifestyles and will have a profound influence not just on the way we live but how we conduct ourselves in our business and commercial lives'.*

Consumer behaviour has clearly already changed and perhaps some of the changes will be permanent. We are all reflecting and prioritizing on what is most important in life and this virus is drawing out some of our weaknesses and vulnerabilities. Far too many people are living paycheck to paycheck. A rise in the personal savings rate is likely to be one of those permanent changes in behaviour. Maybe stocking the pantry with emergency food supplies will also become a feature of the post pandemic environment.

Then again, we are social animals and have fading memories. Given enough time much of our behaviours and habits may just return back to normal. This certainly appeared to be the case 100 years ago after the Spanish flu. The 1920's after all was a roaring decade.

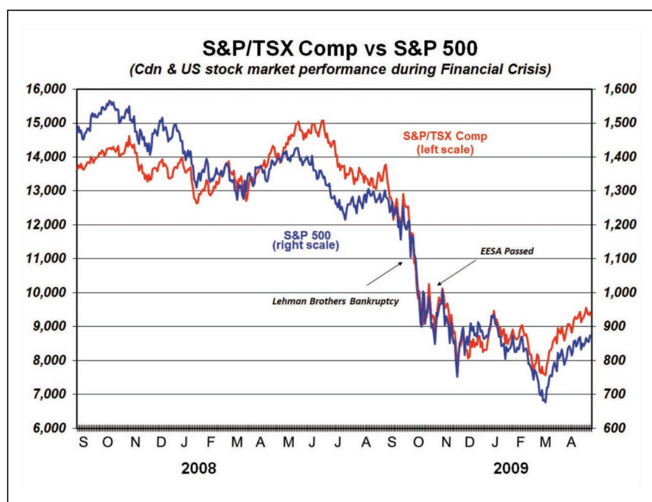
Will Inflation be a Consequence?

The response by the world's central banks to this Covid-19 led economic crisis is to print money, lots of it. There is little discussion of inflation and central banks boldly claim interest rates will be low for a long time to come. Yet the classic cause of inflation is too much money chasing fewer goods. Bank accounts are flush, confirmed by the increase in U.S. M1 money supply which is up by almost 23% in the past three months.

The lockdowns and the general level of economic uncertainty has prevented the money from being spent. When a full recovery finally arrives, it could usher in a bout of inflation. Interest rates would then surely rise. This is the classic reaction to inflation. Yet consensus opinion is not expecting inflation to emerge any time soon. In fact, comparisons are being made to the period following the Second World War when government debt also skyrocketed. Inflation was a concern then however it did not materialize after the war. Except that during WWII the people supported the war effort by lending their savings to the government and purchasing war bonds. Money was not created out of thin air. The parallels are not at all similar. Inflation will certainly need to be monitored as it could very well become an unintended consequence of today's monetary excesses.

Reviewing the Last Downturn

Reviewing the last market cycle downturn can provide some helpful comparisons. The Great Financial Crisis of 2008/9 was a banking crisis centered in U.S. real estate. While no two economic and financial market downturns are the same, as Mark Twain famously said, "they do rhyme". They rhyme primarily in that the Federal Reserve is typically called upon to save the day. Hank Paulson, at the time the Treasury secretary, went to Congress in a panic and demanded a bailout for the banks of $700 billion. The money would be to buy bad mortgages and bonds which were at risk of defaulting. Congress at first refused, causing more panic in the financial markets until finally in early October the Emergency Economic Stabilization Act (EESA) was signed into law by President Bush. While markets temporarily stabilized, they were to drop another 20% over the course of the next five months finally reaching a bottom in March of 2009. The accompanying chart shows the decline in the stock market over this period.



2008 was also a Presidential election year. The stock market decline was not helpful for the incumbent party and the timing of the Lehman Brothers collapse in October was especially troublesome. In the Presidential election year of 2000, at the end of Bill Clinton's two terms in office, the dot com bust was just getting under way. The NASDAQ index, home to the technology sector, peaked in March of that year. By the summer, the index was down 25%. George Bush won the election in November of that year. Considering this history Donald Trump's fixation on the stock market is understandable.

The economic crisis today is different in that the damage was swift. The Federal Reserve, and all central banks, have acted quickly with stimulus in an unprecedented way. The astonishing amount of central bank stimulus this time comes at the very beginning of the economic downturn. Since a downturn caused by a pandemic is unprecedented, it is not easy to analyze since there is no historical context. The Spanish Flu and the Depression are offered as examples of periods which may be similar to today, however we believe they are poor comparisons. Governments were not as dominant as they are today and a century ago the economy was mainly agrarian.

Ten years ago, the global economy had the benefit of a powerful and accelerating expansion in China and in the emerging markets. At the time Beijing pushed through a $600 billion stimulus package and encouraged an aggressive monetary policy which saw total Chinese bank lending inflate by more than $10 trillion in the first five years following the crisis. According to the Institute of International Finance, total debt outstanding has now ballooned to over $40 trillion and represents over 300% of GDP. This pace of debt growth and the resulting economic expansion is unlikely to be repeated – and relations with China are now strained.

In a Sea of Uncertainty, Investors Are Certain

It is impossible to forecast the length and severity of the unfolding economic recession. In the best-case scenario, the coronavirus subsides over the coming weeks and months, and a viable treatment is discovered while we await the production of a vaccine. Even under a best-case scenario, economies around the world will be in poor shape. The majority of corporations are not fully confident and forward guidance is very uncertain due to the virus. Strangely, in a sea of corporate uncertainty investors are expressing the exact opposite reaction. Their rush to buy stocks is truly remarkable.

Of course, the free money is the reason. It is finding its way into the stock market as many first-time investors open new brokerage accounts. Online broker Robinhood Markets Inc. has attracted 13 million users to their trading platform, with 50% being new users. By some accounts, monies normally spent on sports betting and gaming (casinos) are being channeled into the stock market speculating on "chart patterns". If even only partially correct, the flow of new investor money could be quite substantial. According to figures from the American Gaming Association, gaming is a $240 billion industry.

Jeremy Grantham, co-founder of Boston based investment manager GMO, recently remarked he thought the stock market was likely in the fourth bubble of his long career, exclaiming "this is crazy stuff. It's a rally without precedence". While he and other value-based managers are concerned about steep valuations and the risks of a market setback, there are still plenty of others in the spotlight forecasting much higher prices ahead. They are either convinced the bad news does not matter and the stock market is looking ahead to stronger earnings in 2021 and 2022 (courtesy of a V shape recovery), or that you should never "fight the Fed". The Federal Reserve has your back and will continue to do whatever it takes to support the financial markets.

Portfolio Strategy

Many corporations in the most vulnerable sectors of the economy, travel and leisure, restaurants, and entertainment, are heavily indebted. They are not generating enough cash to service debts. Selling assets to reduce debt is not ideal because in many cases asset prices have dropped in value and/or there are few buyers.

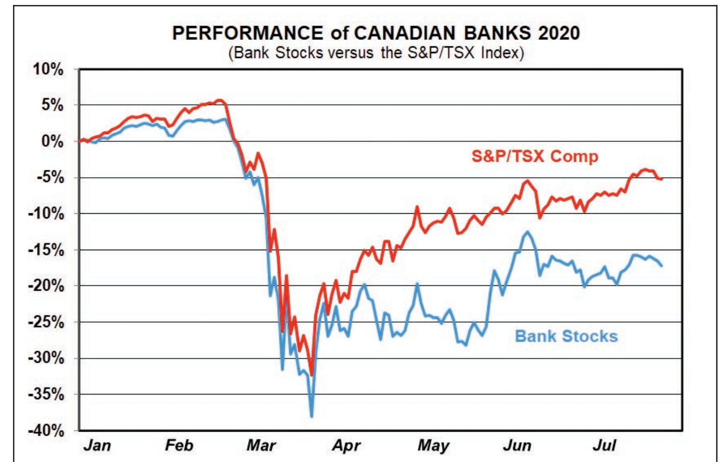
The current situation reminds us of Warren Buffett's famous line, "only when the tide goes out do you discover who's been swimming naked". The coronavirus has exposed the wobbly capital structure that exists in many industry sectors. A record amount of junk bonds was sold in the U.S. over the past ten years. The total corporate debt market has grown to over $11 trillion representing 47% of GDP, the highest on record. In addition to this, the amount of lower grade BBB debt makes up over 50% of the market. According to some estimates, as much as $1 trillion of bonds will migrate from investment grade into high-yield, or junk, this year.

The low interest rate policy by Central Banks was designed to keep credit flowing and support economic growth. Investors, by "chasing yield" were buying higher interest rate products without understanding or caring about the underlying risks. The Fed will not be able to bail out every firm in trouble. Interest rates were very volatile back in March during the peak of the financial panic. Bond prices could again come under pressure. Shorter term maturities are still the right choice in this environment.

The chart above shows the year to date performance of the Canadian and the U.S. stock markets. The S&P/TSX Composite in Canada has lagged the U.S. stock market (S&P 500) since the March panic low. The major reason is the outperformance of the high technology sector of which the U.S. has several dominant companies. The advance from the March low has been highly concentrated and is due to the outperformance of just a handful of the largest companies. The advance has been extremely narrow. In Canada, just one company, Shopify, which has become the largest company in the country by market capitalization, exceeding the Royal Bank, is responsible for a good part of the recovery in the stock market index.

The Canadian bank stocks have lagged on the way up over the past four months. As a group they remain 20% below their February highs – (adjacent chart). They continue to represent the dominant weight in the Canadian stock market. For the index to perform well going forward the banks will need to catch up.

Many stocks are again at extreme price levels that make little economic sense. Tesla is perhaps the poster child of the current



speculative surge in stock prices. At its current price, the entire value of the company represents about 40% of the entire world's automobile industry. Tesla is now the largest company, larger than Toyota, and is worth more that GM, Ford, and Volkswagen combined. This defies common sense.

Hertz is another prime example that speculation is alive and well. The rental car company declared bankruptcy and the stock price plunged to well under $1.00 per share. The stock price then abruptly rallied to over $6. The company became a favourite with the Robinhood crowd and "factor-based" funds which buy stocks indiscriminately based on mathematical metrics. These buying programs have no idea the company has declared bankruptcy.

A recent Initial Public Offering (IPO) named Hudson Executive Investment Corp., referred to as a "blank check" company, raised $360 million in the stock market without having any underlying business. They "plan" to acquire a business in either the Fintech or HealthCare industry. Seriously? It is silly season in the stock market.

Microsoft, the largest or second largest company depending on the price of Apple shares, has a market valuation of $1.5 trillion dollars. Annualized revenues are approximately $140 billion, and they earn a profit of about $46 billion. Dividing $1.5 trillion by $140 billion equals a price to sales ratio (P/S) of 11 times. Dividing $1.5 trillion by $46 billion gives a price to earnings ratio (P/E) of 33 times. In 2000, at the peak of the dot com bubble those ratios were 14 and 40 times. We have come full circle in twenty years for Microsoft.

The top 5 companies in the NASDAQ represent over 40% of the index value. (Apple, Microsoft, Amazon, Google & Facebook). The infatuation with high technology stocks is overwhelming.

Value stocks and the more defensive higher dividend yielding companies are underperforming. Some market analysts are suggesting the stock market is now ripe for a rotation into value stocks. This is never a smooth process as the major indices are supported by the big cap names. The more defensive and higher yielding companies and exchange traded funds will outperform when volatility returns. We recommend an emphasis on these groups and lower weightings in stocks overall within a balanced portfolio structure.