

Third Quarter

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Economic Recovery Stalling

As the second Covid-19 wave appears to have begun, the imposition of lockdowns may be right around the corner. This will jeopardize the struggling economy and endanger the frequently predicted V-shaped economic recovery.

The recovery began to stall in August. Still, annualized third quarter Canadian GDP is estimated to rebound by well over 35%. This compares to the second quarter plunge of -39%, the worst ever recorded. Estimates for the fourth quarter growth rate have been falling sharply and are now just 2 to 3%, down from over 10% just two months ago.

In the U.S. the economic statistics show comparable numbers. Their second quarter was down 31%. While third quarter estimates forecast a solid rebound, the recovery is stalling. Case counts per capita in the U.S. are higher. A return to lockdowns in certain states is a distinct possibility. Even without lockdowns, behavioural attitudes and continued social distancing mean a tepid economy over the next couple of quarters.

A fast and furious recovery was always a bit fanciful. The virus was not likely to disappear overnight and major sectors of the economy including travel, leisure and entertainment are still in serious distress.

For perspective, the decline in U.S. Gross Domestic Product (GDP) this year is almost \$2.2 trillion, bringing the total annualized GDP to just under \$20 trillion. This

compares to a decline in GDP of about \$500 billion during the Great Financial Crisis of 2008/9. This puts the 2020 economic contraction as the worst since the Great Depression.



Central Bank Stimulus

The incredible amount of monetary stimulus injected to assist the global economy is truly remarkable and unprecedented. The U.S. has been the most lavish amongst the major developed markets with the Federal Reserve providing over \$3 trillion in liquidity. They have set up no less than 14 liquidity facilities to support the real economy and the banking/financial sector, pledging unlimited asset purchases.

Coincidentally, the U.S. fiscal deficit for 2020 (Sept 30 year-end) is estimated by the Congressional Budget Office (CBO) at \$3.1 trillion. Next year, many forecasts have the deficit rising to \$4 trillion, dependent of course on the pandemic. The 2020 deficit did not begin in earnest until March, six months into the fiscal year. Another fiscal stimulus package is on the way which will likely add at least \$2 trillion to the debt early in the 2021 fiscal year.

Central banks cannot guarantee the constant supply of liquidity. There is a limit. At some point, the enormous amount of money creation should ignite inflation, if for only a short period of time. Yet there is no strong opinion on this



critical matter. The shape and strength of the ultimate recovery remains an unknown.

Importantly, investors must make a judgement call whether Central Banks will be successful in their monetary stimulus efforts. So far, they have, injecting trillions to keep the economy afloat. Investors “animal spirits” have also played a large role in sending stock prices higher. This is not a normal

economy nor is it a normal financial market. Financial markets will remain volatile if only due to their over-dependence on Central Bank liquidity.

With financial markets showing continued strength in the midst of a stalling economy, financial commentators have changed the narrative once again. Markets, apparently, are prepared for and expect a dismal short-term outlook.

They are focusing instead on the next stimulus package and a full recovery later in 2021. Maybe. The only problem with this view is that financial market participants are notoriously fickle. Markets have likely already priced in a considerably better environment ahead. The recession however must first run its course.

Vaccines To The Rescue

Companies around the world are racing to develop and manufacture a vaccine, using a number of technology platforms. There are now more than a dozen in Phase 3 clinical trials - large-scale testing. While it is expected the majority of these efforts will fail in being effective and/or safe, several will succeed and produce effective antibodies to fight this virus.

The US government, under Operation Warp Speed, has already awarded massive contracts to start producing doses of a number of vaccines before they are approved by the Food & Drug Administration (FDA). The Chair of the FDA, Dr. Stephen Hahn has stated the agency is prepared to approve a vaccine on an emergency basis before Phase 3 clinical trials are completed, should the agency believe the benefits outweigh the risks. The U.S. military is putting together the logistics to administer the vaccines as soon as they are ready.

According to leading companies like Moderna and Pfizer, a vaccine will not likely be readily available until next spring at the very earliest. Importantly, while a vaccine will be available sometime in 2021, according to recent polls, only a slim majority of Americans would take the vaccine.

In the meantime, we must brace for a second wave of the virus which is beginning as caseloads are rising in many parts of the world. We will have a better idea over the next several weeks if the virus is spreading rapidly.

The good news is that the increase in case counts are resulting in less hospitalizations and fewer deaths. Nevertheless, governments are going to act based on the case count. They will institute rules and regulations in order to restrict mobility and slow down the spread. This also means a second Covid-19 wave may really slow down economic activity.



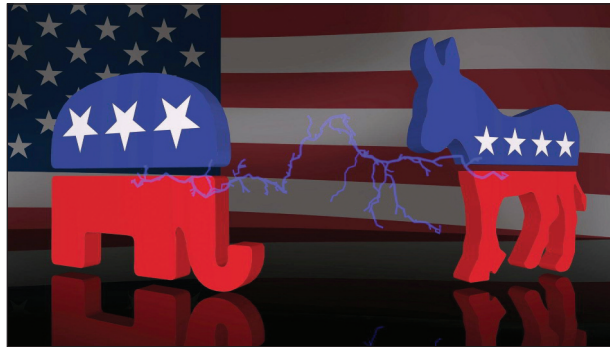
A Contested U.S. Election

The pandemic has created an environment ripe for a contested U.S. election. A record number of Americans will be staying away from the polling booths and mailing-in their ballots instead. As a result, the winner may not be declared on election night as all the mail-in ballots will not have been counted. A number of experts have opined that mail-in balloting is largely expected to favour Democrats. On election night Trump may have enough votes to win and could declare victory. Over the next several days as the mail-in ballots come in the results may overturn the Trump victory and declare Joe Biden as the next President. It is a very likely scenario and one that many in the Republican camp will be calling for a recount or investigation claiming the election was illegitimate.

Americans have never been so polarized. It is plausible that neither side will accept the defeat of their candidate. The post-election climate will be bitter. Many have forecast a

heightened level of protests no matter who wins the election.

How will the stock market react is anyone's guess. One thing the market does not like is uncertainty. The uncertainty could very easily result in a 10-15% correction. In fact, in the



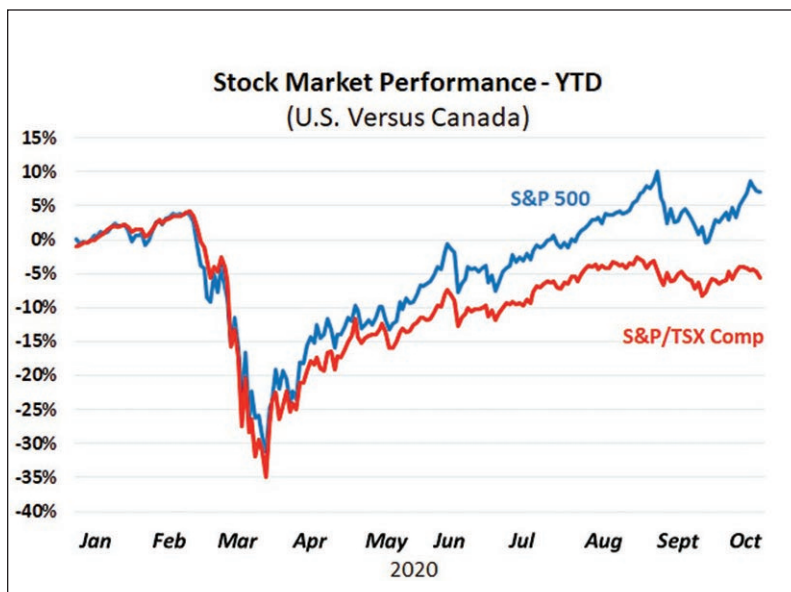
2000 contested election between George Bush and Al Gore, the S&P 500 declined by almost 15%. The worst-case scenario would be for the Supreme Court to intervene and rule on the result. In that scenario a winner may not be declared before January 20th. This scenario could be very destabilizing.

In 2016, Hillary Clinton was widely anticipated to defeat Donald Trump. Even the exit polls had her winning. Many market pundits at the time were forecasting a terrible outlook for the stock market if Trump won. The market did plunge briefly overnight when Trump was elected President. The rest of course is history.

Equity Markets

Stock markets have benefited from monetary stimulus. Investors are currently focused on a new stimulus bill and on the upcoming U.S. election. Corporate earnings and valuation levels, the fundamental yardsticks used by investors to make rational investment decisions have simply not taken precedent.

The S&P 500 stock index in the U.S. has recovered to within 5% of its February highs based mainly on the performance of just a small group of technology companies. In Canada, the S&P/TSX Composite has lagged, mainly due to the higher concentration of the financial services sector.



The dispersion in sector performance so far in 2020 has been unprecedented. Year-to-date, the U.S. technology sector is up almost 30%, the financial sectors in both Canada and the U.S. are down about 20%, and the energy sector has plunged, down around 50%. These are historic sector dispersions and unlikely to continue into 2021.

The famous FAANG's – Facebook, Amazon, Apple, Microsoft, and Google continue to dominate. These expensively valued companies have significantly outperformed and are influential Growth companies. The chart below shows the divergence of Growth versus Value, as defined by Standard & Poors. The Value index is made up of moderately priced companies with higher dividend yields and would include for instance the banking sector, consumer staples, pharmaceuticals, and utilities. Value stocks have essentially underperformed for the past ten years and this underperformance has only become more exaggerated in 2020.

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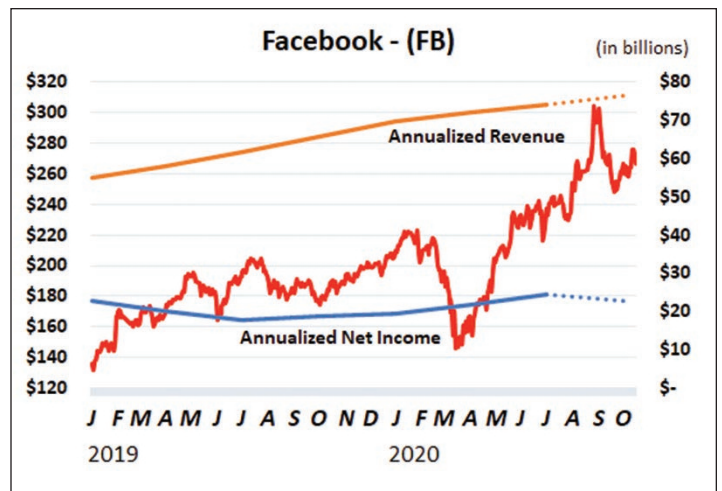
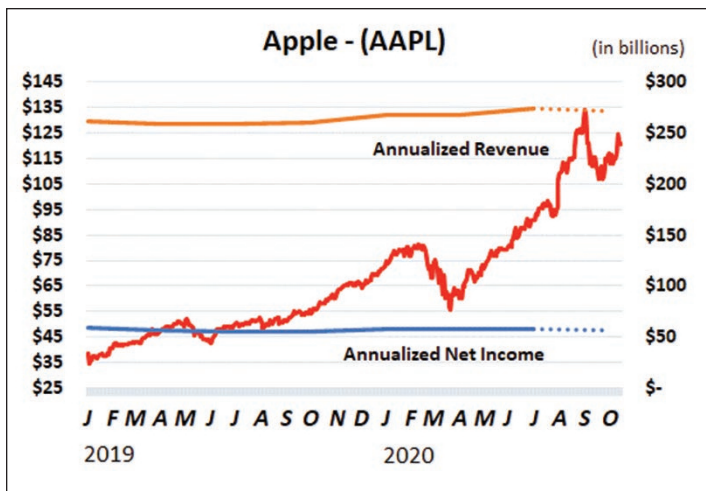


An extreme example of the dispersion between sectors and between growth and value can be observed in just one company, that of Zoom Communications. Its valuation has, well, zoomed, to \$140 billion. In comparison, the entire U.S. airline industry has an \$80 billion market valuation. We are witnessing a very frothy and uneven market.

This will one day reverse as the divergence in valuations are excessive. Stocks have a habit of "reverting to the mean". Endorsing the Value companies are their higher dividend yields and lower volatility, characteristics that will one day be appreciated again.

While the FAANG's do represent great technology companies, recent growth rates in sales and profits have not necessarily been terrific. Certainly not enough to justify the doubling in stock prices. Take for example Apple. For the longest time the company traded at a price to earnings

ratio (P/E ratio), between 12 to 15 times. Currently this ratio has exploded to 35 times. The chart below shows the two-year trend line in revenue and net income growth compared to the "growth" in the stock price. Does Apple really deserve such a revaluation? It is now the largest company in the S&P 500 with a market valuation of \$2 Trillion. Investors are certainly not buying Apple for its growth rate. Revenues and profits are flat. Facebook is another example. The rise in the stock price far exceeds the rise in revenues, and profits are trending down.



The major U.S. and Canadian banks have recently reported quarterly earnings. While profits were generally in line with estimates, bank executives were sounding wary on the near-term economic outlook. Wells Fargo CEO Charles Scharf stated, "there remains a significant risk to recovery". Citigroup CFO Mark Mason cautioned that we are "still in the midst of a crisis". Despite generally improved conditions for the major banks, the next one or two quarters remain uncertain.

Still, with the continued support of Central banks the stock markets may be lifted higher even as the recovery remains uneven. We do not, however, expect the major technology companies to lead going forward. As we get closer to producing an effective vaccine, we would expect it to be highly beneficial for many of the lagging stocks in various distressed sectors of the economy, leisure, travel, and entertainment to name a few. Many of the companies in these sectors of the economy have been troubled financially. A return to some normality in 2021 will be highly rewarding for their shareholders. We will be looking for opportunities in these sectors, with many of these companies representing Value characteristics.

Overall, we plan on maintaining a more cautious outlook with portfolio weightings in stocks at the lower range of investment mandates. We are now more reliant on central banks holding the financial markets together than ever before. The risk reward relationship in our opinion does not currently favour an aggressive posture.