Manulife Securities

ROYDS REPORT

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Good News and Bad News

There are a couple of vaccines showing huge promise. The fastest vaccine ever previously developed took 4 yrs. **COVID vaccines could be out in a year to 18 months**. Some human testing is underway and more vaccines are expected to start human trials in Sept. More than one kind of vaccine could prove successful and pharmaceutical/biotech companies have hinted they make then vaccines available pretty much at cost. It won't help their profits, but it will help the world, especially poorer countries.

The results of a Canadian Consumer Confidence Survey were just announced on BNN Bloomberg on Jun 20, 2020, in which **consumer confidence rose**. **Before, we had half of all Canadians say they were only $200 away each month from not being able to pay their bills. Now that number is down to 44%**. It's still a terrible number of Canadians living paycheque to paycheque, but it's quite a significant improvement. It's attributed to 2 things. First, government-initiated programs, like CERB and rent breaks/mortgage rate deferrals, may be leaving people with more cash flow, than when they were working. Secondly, with many people not spending so much on commuting costs, restaurant meals, vacations, entertainment outings, work wardrobe etc, they have more of their paycheque left at the end of each month. The hope is that people are using that extra cash flow to pay down debt or to build an emergency reserve. When the government programs end, hopefully people will be able to resume making their normal rent or mortgage payments and live on their employment income. After the 2008/2009 Great Recession, when Americans were the ones who were so indebted, there was a change in behaviour. Americans started saving more. Some expect that the pandemic will be the turning point for Canadians to start saving more. (However a U.S. Census survey from mid-July, published by USA Today in their daily email on July 25, 2020, reported **that 24 Million Americans say there is a slight or no chance to make their mortgage payments once current enhanced EI payments and the moratorium on evictions end**. And Americans are less in debt than Canadians on average!)

The Hamilton Spectator reported on July 18, 2020, that 1,000,000 more people were employed in Canada in June than in May, that 27% fewer people were absent from work because of COVID, that only

3.1 Million workers were economically affected by COVID-19 in June compared to 5.1 Million earlier, and that 167,000 fewer people were unemployed. Of course, there are a ton of people still negatively affected economically by COVID-19, but fewer than before, and that's good news. We've seen the worst and the situation is improving, albeit more slowly than anyone would wish.

"**U.S. retail sales rose 7.5% in June, beating market expectations in a second straight month of gains**. In May, retail sales surged 18.2%. June's figure brings retail sales close to their pre-pandemic level." (Source: Sun Life email July 21, 2020) In Canada too, retail activity has rebounded quicker than expected.

The obvious bad news is that COVID-19 is rampant in so many parts of the world, and trade and political tensions between the US and China are heating up. Less obvious bad news is what Bloomberg's July 29, 2020 daily e-mail reported about the previous week, namely **that 30 Million Americans or over 1/12 of the population didn't have enough to eat sometime in the week**.

At the other end of the spectrum, Bloomberg's July 22, 2020 daily email reported that **a blood test has been developed that should detect cancer 4 years before symptoms appear**! There were no details on how long this will take to come into general use or on how accurate the test is, but what a positive gamechanger this could be.

The Bifurcated Market and High Tech

Almost every day in early July the NASDAQ stock index (that is most heavily weighted in high tech companies, especially the **FAANG+M stocks, Facebook, Amazon, Apple, Netflix, Google and Microsoft, or what are now called AFATMAN to include Tesla**) was reaching new high levels. The core stock market index for the US, the S&P 500, certainly rose, with its considerable high-tech exposure as well, but the rise was nowhere near as strong. A look at the breakdown of the 505 stocks within the index gives a lot more clarity as to what is actually happening in the market. **Outside of the large tech companies there sure wasn't much recovery in stock prices. The smaller the company, the more the price is down so far this yea**r. (Historically though, small companies recover first!) The parts of the market that are benefitting from the pandemic are really up, and the rest are not. The index clouds that and makes people think the market is crazy for hitting new highs, just as we get earnings reports of the economic pain that most companies are suffering. Earnings for small American companies are expected to report a 90% earnings drop, mid-caps 67% and "only" 44% for large companies. *(Source: Globe and Mail July 18, 2020)* So, the economy and smaller companies are having an "L" shaped recovery (sharp down and then slow recovery), while the market indices had a "V" shaped recovery.

The following chart compares the capitalization/size and market value in terms o P/E and Price/Book Value of the largest 10 companies on the US S&P 500 stock index, of the 151-200th biggest companies, and of the 451-505th largest, plus how their stock prices have fared since Dec 31. (And yes, for those really paying attention there are slightly more than 500 stocks in the S&P 500 index, because 5 stocks have more than 1 stock listing like Buffett's Berkshire Hathaway that trades A and B class shares) (For historical context, banks trade at .9 (90%) of book value when they are considered super cheap, usually because they are in trouble. When banks are considered expensive, they trade for up to 2 times book value. A company trading for 6 times its book value is not usual. P/E (Price/Earnings) is the ratio of a companies' stock values compared to their earnings. So, a 20 P/E means that a stock is selling for 20 times the value of its last year's earnings. In recent years, stocks traded on average at about 18 times earnings. At that level, if a company paid out half its earnings in the form of dividends, it would take about 36 yrs for a company to pay out dividends equal to the investor's purchase price. The retained

and reinvested half of the dividends make to company more valuable. Compare that to a GIC today where it would take about 65 years for a GIC to pay out its purchase price and there is no capital gains possible in the end value of the GIC.)

	Average Market Cap	P/E	Price/Book	YTD Return
10 Biggest	$848.5 Billion	31.4	6.3	+9.60%
201-250th Biggest	$24.6 Billion	24.4	3.2	-9.30%
451-505th Biggest	$5.1 Billion	13.9	1.2	-38.50%

Source: Ycharts courtesy of Dynamic Funds as of June 30, 2020

The trend of **expensive prices for the largest companies to relatively cheaper prices for smaller companies is fairly consistent** across each group of 50 stocks by size, as is the amount of stock market recovery or lack thereof. Generally speaking, **investors needed to own the AFATMAN stocks (Apple, Facebook, Amazon, Tesla, Microsoft, Alphabet (Google's parent) and Netflix) or at least stocks of the biggest 50 companies to have positive growth in their US investments for the first half of the year, OR they needed to hold some of the Growth At A Reasonable Price (GARP) funds that we have used, which have gone up more than the market without being heavy into the AFATMAN stocks**!! We should point out two things though. The high prices compared to last year's earnings won't seem so high, if the earnings grow a lot. And indeed, that is why the market often buys stocks at a high P/E, because they expect a lot of growth in earnings. And secondly, if any company's earnings fall and stay down because of societal changes or other factors from COVID-19, then the P/E being paid compared to future earnings rises, and the companies may not be as cheap as they appear now before reduced earnings are reported. These snapshot price measurements have their uses, but don't give an accurate idea of a companies true value, let alone its potential, and that's what we rely on our fund managers to analyse what is selling at a good price and what isn't.

Canada's S&P TSX Composite Index is bifurcated too. Most stocks haven't come close to fully rebounding from the market bottom of Mar 23. But the index has moved up quite a bit, mostly because of one stock – Shopify. If we look at the other **heavyweights on the Canadian stock exchange, the banks, they are down as of mid-July by about 18%-30%**. More loan losses are expected when CERB and mortgage deferrals end. (US banks are still down about 34%. Top US banks just announced $30 Billion of loan losses and loan loss reserves, because of the loan defaults expected.) There is some concern that Shopify could be way overpriced. According to thereformedbroker.com on July 10, 2020, Shopify with its $30 Billion in revenue (not profit) is valued the same as Walgreens, Kroeger and Target combined, even though they have $350 Billion in revenue. **Shopify is trading at 2000 times its estimated 2020 earnings**. This sure looks like some tech stocks in the year 2000 before the Tech Wreck, when tech stock prices fell about 95%. On the other hand, 2020 is a very different time from 2000. Most tech companies are mature and profitable, while they were still start ups 20 yrs ago. And Shopify is doing terrific business (and a great service to small retailers in North America) during this pandemic. Still, it seems super expensive, and is definitely skewing the index.

One of the most successful fund managers in the country, Noah Blackstein of Dynamic Funds, in a conference call on July 7, 2020 used a baseball analogy to explain how much growth potential there is in some of today's hot companies. He said that cloud computing is in the 3rd inning (so quite a way to go yet) and that healthcare companies are still in spring training! So, as much as some companies have gone up during COVID-19, their potential for growth and price appreciation might be far from over in

that area. He also said that **the pandemic made collaboration and cloud computing a need, whereas before it was just a want.** Further on that theme, he said that "**the pandemic paused the present, but accelerated the future**." A big theme with him is digitization – of medicine, payment systems, retail, business applications and generally everything. On an unrelated topic, he commented that the US market doesn't really care whether Trump or Biden win the election. Biden is expected to be less harmful to non-American companies and countries however.

When it was officially announced that the drug Remdesivir had been proven to reduce COVID-19 deaths, within hours the North American markets went from being marginally negative to 1.5% positive (July 20, 2020). We have seen even bigger swings in the market, when there has been other good or bad news. Based on this, **we would hate to be sitting on the sidelines rather than being fully invested on the day that a successfully vaccine rollout is announced**. The rally that day could be huge.

The Wrong Lesson for Young "Investors"

The big American trading app we mentioned in the last newsletter, Robinhood, has "one-click trading, easy access to complex investment products [just what beginning investors need] and **features such as falling confetti and emoji-filled phone notifications that made it feel like a game**…**part of Robinhood's success appears to have been built on a Silicon Valley playbook of behavioural nudges and push notifications, which has drawn inexperienced investors into the riskiest trading**, according to an analysis of industry data and legal filings, as well as interviews with current and former Robinhood employees and more than a dozen customers…. In the first three months of 2020, Robinhood users traded nine times as many shares as E-Trade customers and 40 times as many shares as Charles Schwab customers, per dollar in the average customer account in the most recent quarter. They also bought and sold 88 times as many risky option contracts as Schwab customers, relative to the average account size…. The **more often small investors trade stocks, the worse their returns are likely to be, studies have shown**. The returns are even worse when they get involved with options, research has found…. Robinhood's average customer is young and lacks investing know-how. The average age is 31, the company said, and half its customers had never invested before. Some have visited Robinhood's headquarters in Menlo Park, Calif., in recent years to confront the staff about their losses…the startup installed bulletproof glass at the front entrance….It does not charge fees for trading, but it is still paid more if its customers trade more. That is because it makes money through a complex practice known as "payment for order flow"…. Firms pay Robinhood for the right [to process the buys or sells] because they engage in a form of arbitrage by trying to buy or sell the stock for a profit over what they give the Robinhood customer." (Source: The Globe and Mail July 20, 2020)

Free trades may not really be so free. The young people who are getting burned by their initial investing experience with stock investing on sites like these may never come back to the market, and that could really harm their long-term financial wellbeing.

Many of you have heard Elaine talk about how she learned about investing at the breakfast table from her father and grandfather and some of their actual experiences, rather than words, that formed her investment philosophy (before she learned about Buffett). Did you know **that most people form their attitude about money (how to use debt, credit cards, invest etc) from their family**? Does your family even talk about money or investing? The more educated your children are about finances and investing, the less likely it should be that they'll run up unmanageable debt or spend a lifetime stuck in the GIC world. And hopefully they would never play at investing as though it were a video game, complete with falling confetti! So, if you aren't talking about money with your children, maybe you want to start.

Where Might We Be in 18 Months

We haven't acquired a crystal ball, but one of the 3 economists we most trust, Philip Petursson, Manulife Asset Management's Chief Investment Strategist, made some forecasts in his weekly conference call on Jul 22, 2020. His team's analysis shows that equities (the stock market) should be between 5-15% (or more) higher 18 months from now. They feel stocks are fairly priced now, given companies' prospects. As earnings recover, stock prices will not rise equally. The P/E ratio should retract a bit. He also predicted that, because oil could go up to the $50 per barrel range, the **Canadian dollar should be between $0.73 and $0.77 over the next 18 months**. The Canadian dollar has remained 85% correlated to the price of oil and is less correlated to the difference in interest rates between the US and Canada. Also, inflation could lead to a weaker US dollar, which could help our dollar reach that $0.77 level, or higher. Lastly, he predicted **interest rates will stay low till 2025**. Goldman Sachs' chief economist, as quoted by Bloomberg on July 27, 2020, also projected interest rates will stay low till 2025.

Opposite Views on Inflation and Interest Rates

The **US and Canadian central banks said they wouldn't raise their rates till 2022**. The new Bank of Canada governor, Tiff Macklem, said on Jul 15 that the BOC would even buy government bonds in the market to make sure that interest rates don't rise in the bond market. Currently there is even $36 Billion of global bonds with negative yields. People are buying the bonds for more money than they will get back at maturity plus all the interest paid**. Because of negative interest rates, some businesses in Europe are storing their cash in vaults, rather than try to invest the money anywhere. Some people are buying government bonds, knowing that they'll get less capital back than they invested, to have a safe haven for their money**. This would be because they are afraid of the stock market and don't want to put cash in banks, for fear that they could go bankrupt (as they do in many parts of the world, even in the US and Europe). Some investors or speculators are apparently buying negative yielding bonds, because if yields get even more negative, they'll be able to sell their bonds for a profit. (Remember that as bond yields drop, the price of existing bonds rises, and visa versa.) Of course, if those speculators are wrong and interest rates go up, they will experience a capital loss on their bonds! So, interest rates are at historic low levels now, making fixed income investments like bonds quite unattractive. It's a really good situation for borrowers, and a bad situation for investors who try to make money by loaning it out.

But after these efforts to artificially keep interest rates low, then what? In Manulife's Summer 2020 Advisor Focus Magazine there were two articles arguing that interest rates would remain low for a very long time, because of demographics. The articles point out that **our population's average age will increase hugely, because of the low birth rate in developed countries**. The birth rate is just above 1 in North America (it needs to be over 2 to sustain the size of a population). If we look at **countries which already have older populations than ours, like Japan and Germany, we see they are among the countries which have had negative interest rates. If we look at countries with younger populations, like Brazil, interest rates are at least 6 times higher than ours** (although there are several other contributing factors for that]. So, statistically, with an aging population, we could expect interest rates to say very low. One article explains that **because older people save more, as opposed to young people buying their first homes, cars etc, there is a glut of money available to loan out and a dearth of young people wanting to borrow it. Rates therefore have to be very attractive (low) to entice people to borrow.**

Interest rates however may NOT stay really low for a long time (past 2022). An opposing view on interest rates was put forth by George Athanassakkos, a finance professor from the University of Western Ontario, who wrote in the Globe and Mail on July 7, 2020 that he feels **higher interest rates and inflation are the long term trend (after rates are no longer artificially being kept low**).

The professor starts with a lesson on interest rates and inflation, the understanding of which can really help as we make investment decisions. He explains that **interest rates paid on bonds are comprised of 3 components. First, there is a reward to the investor for postponing consumption by loaning out the money to the bond issuer, rather than spending that money on goods and services. Secondly, there is a premium built into interest rates to make up for the expected inflation that will erode one's buying power while the money is tied up in the bonds, and thirdly there is the risk premium for taking a chance loaning the money to a company which might go bankrupt and not pay back one's capital when the bond matures**. This all makes sense, because obviously, a restaurant would have to pay a lot higher interest to induce you to loan them money now compared to what Loblaw or Royal Bank would have to pay. And you should want a higher interest rate to give up the use of your money with a 30 year bond than with a 3 year bond. And when inflation was 14% back in 1981, GICs paid 18% to get people to loan the banks money in the form of a GIC.

However, he explains further**, in the short run interest rates, aside from the inflation protection component, are driven by the business cycle**. When the economy is booming, rates net of inflation, rise and when the economy contracts, rates fall. This makes sense. When the economy contracts and stock markets fall, people pull out of stocks and go into bonds or GICs and there is a glut of money that people want to earn interest on. When stock markets are going strong, people want stocks, not bonds. So, interest rates have to rise to compete with stock market returns better. In the long run though, only technology and demographics affect rates, he says, and those factors change very slowly.

In the short run, how strong an economy is will heighten or lessen demand for labour and commodities (copper, lumber etc) which raises or reduces the price that has to be paid in wages or for goods. But **in the long run, taxes, productivity and efficiency affect inflation**. After all, if your big employers change to robotic assembly and automated customer service representatives, their automation reduces labour demand and people will work for less just to have a job.

Currently, he feels **the long term aging of our population (demographics) should be making interest rates rise. He points out that baby boomers are retiring and stopping saving. They are in a de-accumulation phase, withdrawing income. This is decreasing the supply of capital** at a time when companies are needing more and more cash for new technologies and government are needing more money to fund their continuous deficits. To balance the difference between the shrinking supply of money to be invested and the increased demand for government and corporate borrowing, interest rates have to rise (to induce people to loan out more and to discourage companies from borrowing as much).

In the short term, inflation is kept down by the subdued demand for many goods and services because of COVID-19. However, we may have reached peak productivity as experienced baby boomers are replaced by less experienced workers. And because there are relatively few workers to replace the large group retiring, the in-demand young workers will demand higher wages, which is inflationary. Add to that higher taxes, that may come to mend system inequalities and to pay for all that governments spent keeping the economy breathing during the pandemic, and costs will go up further. **If companies are no longer so willing to have everything manufactured offshore, because of the difficulties that occurred**

during COVID-19 by not having domestic production, then higher cost, local manufacturing will add to inflation. This will further increase the demand for domestic labour, causing wages to rise more, and bring more inflation. Companies will have to pay more in wages and for raw materials, but high quality companies who can pass those rates on to customers will be reasonably fine.

The worst affected investments will be bonds whose yields are not linked to inflation (which is almost all bonds). Back in 1994, interest rates almost doubled in less than 6 months and the bond market fell 40%. 1% interest rates could quintuple over the next decade, the market value of existing bonds could be smashed. Real estate will benefit by higher inflation but will be hurt by higher mortgage rates. The growth companies which have benefited so much by being able to borrow money cheaply for the last decade won't be able to borrow so cheaply and may not grow as fast or be as profitable. So parts of the stock market may benefit and parts will face headwinds.

So, where are interest rates and inflation really going, up or down? We don't know, although Elaine has always been a big proponent of the Kondratiev Wave. Kondratiev showed that for about 440 years interest rates cycles have consistently lasted about 60-70 years, going from peak to peak or trough to trough. They go up for long periods of time, hang around the top for a bit, and then fall for quite a while and stay at the bottom for a bit. We just finished a 40 yr drop in interest rates and now we have been hanging around historic low levels for a few years. The only place for interest rates to move much is up. Maybe we have several years to stay at the bottom, because the population is not going to get substantially younger anytime soon. However, it seems unlikely that demographics can keep interest rates low forever. To us, it's a matter of timing when interest rates eventually go up. It is important for people trying to figure our what rates they might pay for a mortgage or how housing prices will be affected, but there's no crystal ball for the timing.

In order to control inflation due to labour shortages as our population ages, some have gone as far as to say that Canada's 1% of population/yr immigration rate needs to be increased. Some analysts have even called for Canada to double its population before countries close their borders, so that younger employees can't leave! It's a thought.

US Dollar Weakness and Gold

The US dollar is at an 18 month low relative to the Euro, but is pretty much back to where it has been for the last few years relative to the Canadian dollar. The weakness is reportedly caused by fear of a new shutdown due to the coronavirus strength in so many states. A weaker USD helps with exports and all the profits on American assets held outside the US are worth more when converted to US dollars. So a weaker USD is not necessarily bad for American stocks.

Gold is at an all-time high. There are conflicting views as to why. Some say the strong price of gold reflects optimism that the economy is picking up and this could lead to inflation (gold historically goes up with inflation). Others feel that people are so worried about a collapsing economy that they want to own hard assets that are a historically good store of value in tough times. Some people may be buying because the US dollar has been going down and gold is priced in US dollars. So as the US dollars falls, the price of gold goes up to keep it constant in terms of all other currencies. And once gold started rising in price, there was also an element of FOMO – fear of missing out, that caused many to buy gold. Buffett has said he sees no reason to own gold (for the long-term). Why own an asset that costs you money to store and insure and doesn't earn you anything, like a business could? And when you look

back to gold's peak price of around $800 40 years ago, you have to wonder what the attraction is to an asset that only rose 150% in 40 years.

Personal News

Many of you asked Elaine to let you know in July when she became a grandmother and Jordan an uncle. On July 16, Elijah (Eli) Royds was born to Jordan's brother and his wife. We are so thrilled about it. Sometime soon Elaine will start taking every Wed afternoon off to "grandparent".

Elaine

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