Manulife Securities

ROYDS REPORT

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US Election's Impact on Your Investment

In Sept, we had the chance to listen to a lot of economists and fund managers in the US and Canada talk about the US Election and the stock market. The message was pretty much the same across the board. The biggest influence on stock market returns is the monetary policy of the Federal Reserve, or the Bank of Canada, rather than which political leader a country has. And, we can expect increased market volatility for the 3 months before any presidential election.

Here are "10 Truths" that Talley Leger of Invesco presented in a webinar on Sept 23/20:

- Stocks have performed well under both parties (neither US party seems to be better for the market)
- Investors are better off ignoring politics and staying fully invested at all times
- Over the last 82 yrs, government expenditure, business investment, and consumption have remained at fairly constant percentages of GDP regardless of which party was in power or what policy programs they implemented
- A president usually only gets a couple of major pieces of legislation passed and the impact the legislation will have on the economy is often unexpected (for example, the Affordable Care Act of 2010, which required US employers of a certain size to provide medical benefits, was expected to hurt small business but small business job creation continued at a pace consistent with the past)
- Historical narratives about a government's impact may not mesh with what you remember, because predicted impacts may not have happened. For example, Obama's policies were expected to be inflationary, but actual inflation was low. And Trump's corporate tax cuts were projected to increase capital expenditure, but corporate expenditure actually lessened.
- The economic environment and market leadership can be slow to change. Trends in place before a change in government could take years to turn around.

- Monetary policy matters more than politics. Easing interest rates helps the economy and raising rates (called "fed tightening") hurts growth
- The stock market doesn't care if the president is unpopular. Some of the best market returns in history have come when the president's approval rating was in the 35-50% range.
- This present and the Trump/Clinton campaigns are not any more vitriolic than some of the past. George Washington complained about the "malicious falsehoods" being told about himself; Jefferson said that nothing printed in a newspaper could be believed; Aaron Burr and Alexander Hamilton fought a pistol duel over an election.
- The Misery Index is the most reliable predictor of election outcomes. If the unemployment and inflation rates added together are on the rise, the incumbent has historically lost.

That said, most analysts expect healthcare companies to prosper more under Biden, and companies in industries that do better with little regulation to prosper under Trump. That could take a long time to play out, and it is by no means guaranteed, especially since there are numerous possible outcomes to the US election (depending on whether the Democrats or Republicans control the Senate, who the specific individuals are who get newly elected, etc.).

Some are expecting it to be bad for the market if Biden gets in, because he will roll back the corporate tax cuts that Trump instituted (eventually). However, Biden is expected to have greater stimulus spending, which could be very good for the economy and market. No one really knows. It's best to invest for the long-term and filter out short-term political noise.

Today's Economic and Market News is Brought to You by the Letter K

To take a page from Sesame Street, let's feature the letter K today. In the spring, there was a lot of concern about whether the market recovery would look like a U, V, W, L, etc. If you just look at the index, it would appear that we have a V-shaped recovery. There was a very steep, quick drop, followed by a quick, sharp rise. However, closer examination reveals that it was really a K-shaped recovery. Most stocks fell precipitously, but tech stocks only fell a fraction as much (say to the half way point in the down stroke of the K). Then the biggest tech stocks had a tremendous recovery and continued growth beyond that, like the sharply rising sloped part of the K. The other stocks have continued down further and had some rebound, but are mostly still down considerably, like the downward sloped part of the K. (Bloomberg Daily Bulletin of Sept 2/20 and Frances Donald, Economist for Manulife Asset Management Sept 29/20)

This dichotomy in how stocks behaved is a continuation of a 13 yr theme, namely of Growth stocks outperforming value stocks. At some point, the great value of value stocks should be recognized and they will take over the leadership on the stock market, as happened in 2001 after the huge tech rally. We just don't know what or when the catalyst will be for the switch to value stock leadership.

Some say that the story of lost jobs during COVID is also like the letter K. White collar workers held on to their jobs and prospered, so they are the upstroke in the letter K. Blue collar and service industry jobs were the ones lost, and those were mostly renters who lost their income. However, as things open up, we're seeing that the blue collar and service industry jobs were largely only temporarily lost. The barista and the hairdresser knew their jobs were waiting for them when things re-opened. However, there are many industries scaling back and whole companies shutting down. In fact, there are one million new unemployment claims per month in the US happening now, and most of those are permanent, white collar job losses, and mostly people who are home owners. There will surely be an impact on the home market from this. (Frances Donald, Economist for Manulife Asset Management Sept 29/20)

A question many people are asking is why we aren't seeing even more carnage in the stock market, when we are in the midst of the greatest recession (not depression) in history. Here are two answers we are hearing:

- It was the service industry which suffered the biggest shutdown, not manufacturing. Manufacturing is only 10% of the economy, but it's 50% of the stock market. So, manufacturing's standing up through the pandemic is disproportionately keeping the stock market from hurting as much as the economy.
- $1 Trillion of wages were lost due to Covid-19, but the government increased spending (including wage replacement programs) by $3 trillion. So, there was tons of offsetting stimulus to the economy. The average wage of low-income workers actually rose during COVID.
  (Frances Donald, Economist for Manulife Asset Management Sept 29/20)

We're also hearing that:

- Interest rates may not rise for at least 5 years
- Inflation isn't going to be significant in the short-term, but could really rise longer term as a result of the spending going on now
- Valuations of US companies are higher than usual compared to valuations of global companies
- US/China conflicts will continue long-term
- The long-term rally of the US dollar may be over and may reverse (as the US loses international influence and China's economic strength rises). A weaker US dollar should help Emerging Markets
- US growth trends will be below historical growth trends for years
- There will be rising social unrest which will impact policies and therefore the economy and investment opportunities
  (Jeremy Burge, the Portfolio Manager of Capital Group Global Equity Sept 29/20)

"Economists at the Organization for Economic Co-operation and Development expect China's GDP will actually grow by 1.8 per cent this year, making it the only member of the Group of 20 countries that will not suffer a recession this year." "Surging metal prices underline China's pandemic rebound". Copper, which is used in wiring for power transmission, construction and car manufacturing, and has long been seen as a barometer for the world's industrial economy, is … up around 25 per cent." "We think copper is the market trying to tell us that the economy is stronger than we expect" according to Strategas Research. Source: The Globe & Mail on Sept 28/20

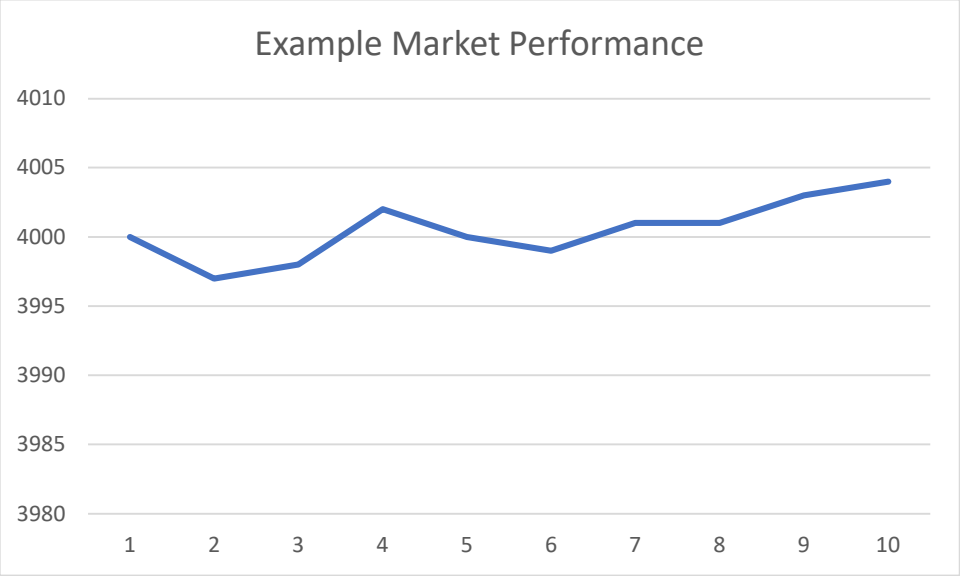
Markets and our portfolios were up very nicely in July, a bit in August and then fell back quite some in Sept, but mostly because high tech companies fell sharply. Shopify, for example, hit a high of $1487 in Sept and then fell to $1183, before rebounding a fair bit. Our portfolios did not soar like some of the high tech stocks, nor plummet like them either. The market indices are not reflecting what happened for the majority of stocks on the market. When the Nasdaq and S&P500 were hitting record highs in Sept, it was because 181 stocks were up, while the other 6,337 of the stocks on those 2 markets were down! Utility, energy, banking and real estate investment trust stocks are still down quite a bit and aren't expected to rebound any too quickly. Luckily, our portfolios have little exposure to those sectors.

Also still down are small and mid cap companies, which in the US means companies between $2 to $20 billion big. They fell hard in March. We aren't worried about them coming back though, because they always fall hard when investors lose confidence in the market. After the recessions and market drops of 1990, 1998, 2002 and 2008, it was the mid cap companies that, as a group, usually had the strongest

returns, followed by the small companies. In all instances, the largest companies gained the least. So, we are expecting the small and mid cap to outperform over the next year, because of their historical performance, but also because of fundamentals. Normally small cap stocks trade at a 30% premium to the Price to Earnings ration of companies on the S&P 500. Now however, small caps are trading at a 30% discount. On a price to book basis, small caps also usually trade at a 10% premium, but now they are trading at a 50% discount. Small caps are trading at the biggest price discount in a decade. Eventually the market will notice companies that are selling too cheaply and bid them up. That's why we are not concerned that our small and mid cap funds are not keeping up with the large cap funds at the moment. When their day comes, we'll be glad to own them. (Source: Steve MacMillan of Fidelity Investments Oct 1/20)

We also see that Emerging Markets are starting to outperform. It helps that their currencies are strengthening against the US dollar and that GDP growth in India and China are forecast to be 4.2% and 6.1%, compared to 1.7% for Developed Markets. (Source: Bloomberg and 1832 Asset Management, courtesy of Dynamic Funds)

As a reminder, it's **not a good idea** to watch your portfolio on a daily basis. Brandes Investments sent us a chart that shows that the market is only up on 59% of all days. So it you look at your portfolio daily, you are more likely to find it down from a previous high than to find it up. Fidelity Investments just sent us a new chart (using Bloomberg data) that shows that for the last 120 years, 64% of the time, the market was not above its previous high. That's fine though. We all know the market doesn't go up in a straight line. Below is an example of market growth where on 2/3 of the days, the market is lower than its previous peak.



In this example, the market rises, then pulls back a bit and then rises, usually to a higher peak, and then falls back. Even though this shows a gain over 10 trading days, on days 5, 6, 7 and 8, when the market was below its previous peak, someone looking at it could have been disappointed. It's human nature not to notice that that on those day it was still above the level on days 2& 3. If someone only looked on day 1 and then on day 10, they would be happy though because they'd only see the longer term gain. That's why it's a good idea only to look at your portfolio once every few months.

Is It Time to Panic and Get out of the Market?

We were lucky enough in early October to hear Rob Almeida, a strategist for MFS. Massachusetts Financial Services (MFS), now bought out by Sun Life, started the first mutual fund in 1924. They have been named the top performing fund family by Barron's, a top financial industry publication. Rob delivered a powerful message. His main points were these:

- Companies had their highest profit margins in 100 years in 2018. That is, the percentage of sales that a company earned as profit peaked before the pandemic started and profits were already falling before the 2020 crisis. Profits peaked per dollar of capital invested back in 2018 because companies had increased borrowing and had bought back their own shares. Profits didn't peak because of increased productivity or innovation.
- The market is signalling that it is certain that companies will regain their peak profits. This is not likely. Profits are a function of the volume of sales, the cost of goods and the prices a company can charge. Costs will be up though due to extra costs to keep customers and employees safe. Sales will be lower in many cases because of lower production capacity. And online shopping often increases price competition, which hurts profit margins. Also, profit is usually greatest on the last 10% of sales. However, if sales are down because people don't have wages to spend, or don't have a need (for example for a car which they don't need when they're working from home), then those most profitable sales don't happen.
- Corporate revenue growth is historically twice the rate of GDP growth. These days revenue growth is less than GDP growth. In fact, revenue growth in the US is the weakest it has been in the last 150 years.
- Third quarter 2020 bankruptcies were the worst they've been in years, despite the fact that "central banks [have been] socializing operating losses of businesses". What this means is that due to federal support programs during COVID bad companies are surviving that shouldn't. This distorts the natural selection of markets. Camera film processing companies, video rental companies, typewriter repair shops, Gestetner makers (ask an older person if you don't know what a Gestetner is), buggy whip makers, blacksmith shops and stagecoach operators are all businesses that needed to evolve or else go out of business. There are businesses like that today, but they aren't going bankrupt because government money is keeping them alive during COVID. Apparently 40% of small companies in the US were unprofitable before COVID hit and shouldn't have continued. Of course, the government had no way to quickly judge which companies not to provide financial support to during the pandemic. As soon as COVID support ends, these bad companies who make something people don't need or can get elsewhere more cheaply will fail – as they should.

All of the above news from the MFS strategist is pretty bleak. However, he also had this to say: companies with good quality (low debt) balance sheets, high barriers to entry and advanced intellectual property will thrive. And because such companies may be scarce, they will deserve to be priced higher. His last message is perhaps the most important. Active GARP managers who can assess quality, growth prospects and attractive prices can choose investments that should never end up in a permanent loss for an investor and should give good long-term returns. There are still opportunities out there, because lots of non-high tech, dull companies are being ignored today and are relatively cheap. Passive investors who buy ETFs that include all companies in the index, whether the companies are failing or overpriced, could face some real losses. Passive investing works in good times, because rising tides lift all boats. But to paraphrase Warren Buffett, when the tide goes out, you see who is wearing a bathing suit. You see

what companies are solid businesses worth their price. It's in these difficult times that a good active GARP manager can save you from losses and position you for good gains.

Volatility is Normal

Everyone knows that markets don't just go up, but it may surprise you to know just how often the market drops significantly. This chart from 1832 Asset Management and Bloomberg, courtesy of Dynamic Funds, shows how much volatility has been normal over the last 70 years in the US:

Amount the S&P 500 Market Fell	How Frequently	How Long the Market Stayed Down
5% or more	3 times per year	2 months
10% or more	Once a year	6 months
15% or more	Every 4 yrs	12 months
20% or more	Every 6 yrs	20 months

The 10% drop that occurs once a year on average and then lasts 6 months means you should expect your portfolio be down from its high about half of the year. Still, over the longer terms, the market still made substantial money.

Fidelity Investment's Justin Timmer sent out this information by e-mail on Sept 9, 2020, based on 64 years of data, that 64% of the time over the last 120 yrs, the market was down up to 5% from its previous high. The Dynamic information showed 11% of the time, the market was down up to 35% or more from its previous high. So down markets happen all the time, and they last a while. However, we shouldn't panic. Fidelity also quoted what FMRCo calculated as the returns someone could have earned over the last 64 yrs ending Sept 02, 2020, by following different strategies:

Strategy	Return
S&P 500 Buy and Hold	11%
Dollar Cost Averaging, Buying more Monthly	9.9%
Investing when Mutual Fund & ETF Inflows Exceeded Outflows	6.1%
Staying out of the Market in favour of Government T Bills	4.3%.

As you can see, the best returns went to those who remained invested the whole time. Market timing (the third option where one jumps in and out of the market depending on perceived risk and opportunity) resulted in just over half the long-term returns of the strategy of staying invested. Especially since we keep money needed in the short to mid-term out of pure equity fund, so as to avoid the full extent of market swings, just staying invested is the strategy most likely to give us the best long-term returns.

In conclusion, it isn't time to panic or get out of the market. We need to stay invested, but we need to use funds with active management that invests in quality companies with low debt and competitive advantages that are purchased cheaper than their fair market value, and only change those holdings to move to better companies or companies at better prices.

Tax Planning

Fourth quarter is a good time to do tax planning, especially this year. Here are 3 reasons you might want to take action now to reduce taxes later:

- COVID has cost the government a lot of money. With interest rates so low, the government can afford to carry the debt, but there is talk of raising taxes eventually to reduce the debt. One rumour going around is that the government might start with raising the capital gains inclusion rate from 50% to 75% or 100% (we have seen such higher levels in the past)! Right now, only half of all capital gains is taxable, and only then when it is triggered by a sale of the security. If the inclusion rate goes up, more of the gain will be taxable and there will be less after-tax profit left. You may want to sell some winners and pay tax on the gains now, rather than later.
- If you have capital gains that could cost a lot of tax, you might offset them with losses. If you have holdings in an unregistered account (usually with account numbers ending in "A") that are in a loss position, you might sell them to trigger the loss to offset a gain elsewhere. And not all gains occur because you sold something. Sometimes it's your fund manager who sold something in your fund that can't be written off against expenses. The fund may allocate that gain to you on a tax slip. We have no control over that. We don't usually even get an estimate of those gains till mid-Nov. Crystallizing a tax loss by selling by Dec 29 might offset those capital gains too.
- Lastly, if you are worried that you have a lot of untriggered capital gains and/or you have a lot of taxable registered assets (RRSPs, RRIFs, LIFs), you might consider triggering some income from those registered accounts or triggering some capital gains now. That could save you later on from having your Old Age Security clawed back by the government (on income over about $78,000) or could save your estate from paying up to 53.3% tax when you pass on. If you are interested in spreading out your taxable income in years when your income isn't that high, to prevent exorbitant tax rates later, give us a call.

RESPs

If you have an RESP, remember that the deadline for contributing money to use the 2020 contribution room is Dec 29 (so any purchase settles by Dec 31). This is particularly important if your child turned 17 in 2020, because this is the last year you can get 20% free money from the government in the form of grant money. It's also important if you are trying to catch up for past years. For each child, you can contribute $2,500 for this year and $2,500 for a past year (until you've contributed $36,000 over the years or until it's after the year the child turned 17) and get 20% free matching grant money. Remember signatures are needed to put money into your RESP, so don't leave it too late in the year.

COVID Resurgence

Many people don't want to go into buildings unnecessarily while COVID is still so prevalent. Remember that we can do conference calls or Zoom meetings too, so we can still have planning or consultation meetings. And there is lots we can now do with scanned or electronic signatures, or failing that using paper mail. We are limiting the number of in-person office meetings in one day, so we have time to sanitize between visits and so people don't run into others in the reception area. We have an acrylic barrier down the centre of the boardroom table as added protection and of course hand sanitizer is available in the office and the hallways of our office building. It's entirely up to you if you want to come in or just talk on the phone. There's just no reason not to keep on top of your financial matters or investments.

On a Personal Note

Did you wonder why Jordan took some Fridays off this summer?

As you can see from his 2020 season's 21 trophies and plaques (17 of them for first place finishes and the biggest trophy not back from the engraver's yet), he had a great road racing season. Jordan won 3 championships this year for 1000 cc bikes, including the Sprint Cup Series, which pitted pros against amateurs. (The very best pros in the country didn't race in this series, because there wasn't money in it for them.) Next year Jordan will race against all pros, as he moves from the amateur to the professional class. Professional is just a designation for those who did too well at the amateur level to be allowed to keep competing there. All but one pro still have day jobs. Thanks to COVID, many races in the national series were cancelled, including all outside of Ontario. So even though Jordan was the winningest racer in the national level races that still ran, he couldn't win the Canadian Amateur National Superbike Championship. No national amateur championships were awarded due to the shortened schedule this year. He'll have to be content with having set lap records in both regional and national level races. It was also a great year because he had no injury worse than a scraped elbow. Yeah! By the way, the picture below on the right is not of Jordan crashing. It just shows the normal angle he is at, when he goes around a corner.

Have a safe fall and please stay in touch.

Elaine

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