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The Goodreid Gauge

Spring 2020

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In the age of coronavirus, everything other than health issues take a backseat in terms of relative importance, but there are many other important issues to deal with, nonetheless. Candidly, we have struggled with this quarter's message and have put words to paper in several different formats and tones only to return to the drawing board several times. Our intent is not to address the unknowable unknowns we are all grappling with, but rather to simply 'stay in our lane' by offering perspective and context on what has unfolded and what we believe lies ahead for investors.

Returns for the first quarter of 2020 were very poor, with the exception of bonds, which provided cover for investors with balanced mandates. Also, of note was the relative weakness of the CAD dollar, as investors worldwide flocked to the U.S. greenback in a search for safety.

Markets are 'a discounting mechanism', meaning that today's price attempts to correctly place a fair value on a perpetual (theoretically) stream of cash flows in the case of stocks and a finite series of cash flows corresponding to the maturity of the bond, in the case of bonds. To state the obvious, the degree of confidence investors have about those cash flows is inordinately low at this time, as questions abound about the evolution of the virus and the timing of the introduction of a vaccine, and crucially, the duration of the social and economic lockdowns the world will have to endure. From a financial standpoint, it is critical to recognize that the necessary economic measures taken by governments around the world are analogous to a patient being placed in an induced coma, to heighten the prospects of a good medical outcome. In this case workers have been told to stay home, and as such the massive unemployment that is occurring is self-induced. Given that, we differ from some of the more dire prognosticators in assessing the aftermath of this COVID-19 epidemic. This is neither a cyclical recession, brought about by unduly tight monetary policy or inventory de-stocking nor is it a structural recession brought about by imbalances and financial bubbles. This is an event driven recession, and while there will be widespread economic dislocation, if history is a guide the reparation will be swifter and more comprehensive than that of other types of recessions.

Asset Class	Q1 Return
Canadian Large Cap Equities	-20.9%
U.S. Large Cap Equities	-19.6% (USD); -11.75% (CAD)
U.S. Small Cap Equities	-30.6% (USD); -24.4% (CAD)
Canadian Short Term Corp Bonds	+1.8%
Preferred Shares	-25.0%

Life support systems have been invoked which are unparalleled in their size and scope, with a $2 trillion federal stimulus package unleashed by U.S. Congress to support businesses and citizens through this difficult lockdown period, and a commensurately large response by the Canadian government. The fiscal stimulus deployed by Canada and the United States dwarfs the "shock and awe" measures that were taken in the wake of the financial crisis in 2008-9 and approximate 10% of each country's respective gross domestic product (i.e. the entirety of their annual economic output). These measures will buy time for adequate COVID-19 testing to be rolled out, for effective treatments to be developed and ultimately for a vaccine to be discovered. Complementary measures have been taken by central banks to lower interest rates to ease the pressure on households, businesses and banks. Banks have an important role to play, because modern economies run on credit and confidence. Starving an economy of either is like depriving a fire of oxygen – it cannot help but burn out. With that in mind, banks have been tasked

by their regulators to work collaboratively with borrowers to defer required repayments on home mortgages, to ease lending covenants for corporate borrowers, and to lower punitively high interest rates on credit cards, all with the assurance that the central banks "have their backs" with liquidity support and relief from normal credit provisioning and capital adequacy rules. The importance of these measures cannot be understated, as they also buy time for borrowers to recover from their current cash flow crunch.

The question then necessarily turns not to "whether" our economies will survive, but rather how soon and how steep will be the recovery and what will be the collateral damage from both the virus and the economic countermeasures taken by governments. The severity of a recession is measured by its depth, duration and diffusion. This recession is virtually certain to be deeper than any in modern records. The diffusion of it is likely to be wider spread than virtually any other – this is not a dot.com bubble, confined to the tech and telecom sector, nor is it merely a commodities bust, confined to the oil patch and other extractive industries, nor is it a narrow manufacturing contraction. But while the depth and breadth of the recession will be epic, we have some confidence that it is unlikely to be a long recession. A plausible scenario would see social distancing rules relaxed once health authorities are confident the virus spread has been contained. From there, growth in the hardest hit sectors, for instance in bars and restaurants would be astronomical in percentage terms as revenues go from effectively zero to something meaningfully larger, but by no means immediately returning to pre-crisis levels. The multiplier effect that would result from all these furloughed workers returning to work and slowly easing back into normal lifestyle and spending patterns would be large as lower income workers generally spend nearly 100% of their incomes. A second wave of economic acceleration could take hold as pent up demand for goods and services deemed non-essential during the lockdown period is unleashed. From there, a general improvement in consumer and business confidence could take root as safety and security (both physical and economic) concerns are slowly laid to rest, paving the way for hiring and business investment decisions to be made. The exercise is, of course, necessarily theoretical given that economics is an imprecise social science, but the big picture point is that an otherwise healthy 'patient' can be revived from a medically induced coma and in the medium term return to his or her normal daily life without lasting damage from the extended timeout.

To be sure, there will be some limited pockets of structural change and there will be lingering questions about the viability of certain businesses like the cruise lines, for instance. There are also pre-existing economic woes for certain areas of the economy, like the oil producers, and these will not miraculously be cured by the lifting of social distancing rules. But these are manageable normal course risks that we address routinely in portfolio construction, risk management and the company research that we undertake. Even the drama of the upcoming U.S. elections and the trade war files will seem trivial by comparison once the worst of the COVID-19 epidemic is behind us. What is arguably the biggest risk to the type of recovery described above unfolding is an ill-conceived and premature lifting of social distancing restrictions that allows for a second wave of coronavirus outbreaks to again swamp healthcare resources before a vaccine can be developed, compelling another massive draw on government financial resources with the economy slammed a second or even a third time by social distancing orders.

As a final thought, we consider how best to assess the value offered by stocks today. One of the most common measures investors use to gauge the attractiveness of a stock or group of stocks is the price to earnings ratio, which measures the number of years of current earnings investors are paying for with today's share price. Today, analysts are forecasting earnings for the S&P 500 Index in 2020 of $151 vs. the 2019 earnings of $152. On that basis, the S&P 500 would be trading at 17.8x expected earnings. But let's take that estimate with a grain of salt, as it could well prove to be optimistic. Analysts are often wrong, and particularly so at major economic turning points and thus must hastily ratchet down their initial expectations. But given that stock markets are a discounting mechanism, we can look for equity markets to decisively turn up before corporate earnings have bottomed, just as they did in the Spring of 2009. The expected fair values of stocks on March 9th, 2009 when the markets bottomed after the financial crisis were unrelated to what they earned in 2008…at that point that number was nothing more than history…and they were only loosely related to what they might earn in 2009…rather though, stocks were priced off of the entire net present value of the expected stream of earnings that would follow that date, theoretically in perpetuity. With the benefit of hindsight, we now know that S&P 500 earnings have nearly tripled over the 11 years since that low point.

We don't 'rent' stocks for this quarter or next quarter or even this year's earnings. We buy them - fully expecting to benefit from years and years or even decades of growing earnings that will flow from the company assets, both hard and soft/intangible. It is therefore an egregious error to price a company or a basket of companies like the S&P 500 or the S&P/TSX Composite solely and strictly off of one year's expected earnings, particularly at or near an economic extreme (like a recession), when those assets are significantly underearning their long term economic potential. It is an error akin to valuing a rental property at zero because a tenant deferred their rental payment this month. A better approach is to normalize the current earnings to 'mid-cycle' levels, either by averaging actual earnings over the last ten years, or by applying an expected long-term average level of return on shareholders equity to the company's productive assets. On that basis, we think the mid-cycle earnings power of the S&P 500 Index is somewhere between $112 and $144, depending on the technique used. As such, the index is trading somewhere between 19x and 24x its normalized earnings, which is a meaningful discount to its

30-year average price to normalized earnings ratio of 27x.

The bottom line is that times are tough, but we are confident that stock prices now afford investors (not traders) a very good prospective return in both Canadian and U.S. stocks, regardless of the path to economic recovery.