Goodreid
INVESTMENT COUNSEL

87 Front Street East
2nd Floor
Toronto, ON M5E 1B8

T. 416 364 0890
TF. 1 888 466 3734
goodreid.com

The Goodreid Gauge

Summer 2020

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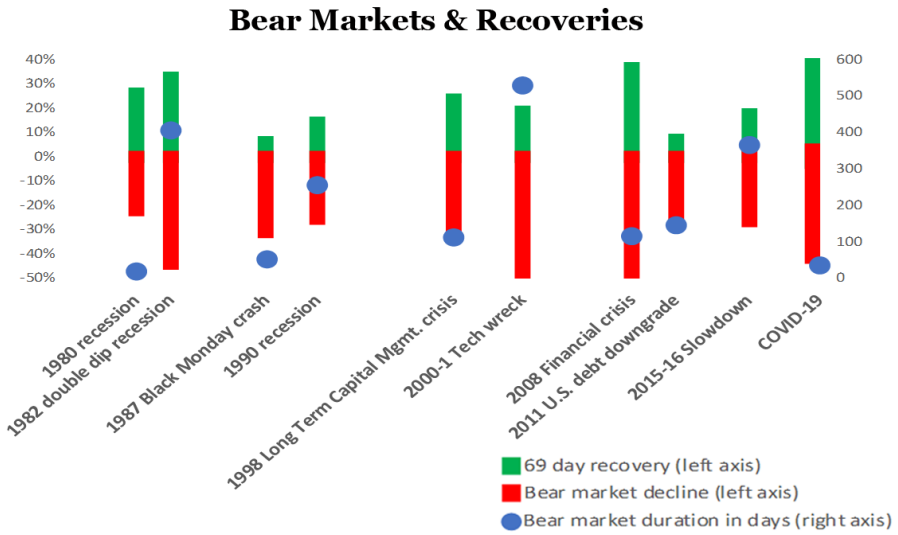
Global stock markets roared back to life late in March and continued to recover from the COVID-19 induced recession throughout the second quarter. The initial rally in equity markets was narrowly focused, with mega-cap technology stocks in the United States and gold stocks in Canada outperforming virtually everything else and growth stocks trouncing value stocks. These sectors and styles are still market leaders, but encouragingly, the rally within equities has seen sporadic attempts to broadened out (the so-called reopening trade), which is a healthy sign. The Canadian S&P TSX Composite Index posted a gain of 17% in the second quarter, cutting the year-to-date loss to 7.5%. Stateside, the S&P 500 Index mounted an impressive 20.5% rally in US$ and 15.4% in C$ terms, reducing year-to-date losses to 3.1% in greenbacks and actually turning in a modestly positive year-to-date return of 1.8% measured in Canadian currency. In the bond markets, the FTSE Canada Overall Short Term Bond Index earned a total return of 2.2%, lifting the year-to-date tally to 4%. Preferred shares also recovered, with the Solactive Laddered Canadian Preferred Share Index mustering a total return of 15.2%, damping the year-to-date loss to 13.6%.

Most investors seem relieved rather than jubilant after the impressive Q2 showing, no doubt a product of the dreadful quarter that preceded it. We can breathe a sigh of relief that for the most part, governments and central banks acted decisively, swiftly and massively to soften the blow of the harsh economic lockdowns that were imposed earlier in the year on the best advice of health officials. We also know that many investors are skeptical of the rally in stock prices amidst what is undoubtedly still a weak but recovering real economy, but would note that skepticism is a hallmark of all nascent bull markets. For context, consider the path of recovery in stock prices 69 days after prior bear market lows, which is the number of trading days that elapsed between the low point in stock markets on March 23rd and June 30th. The S&P TSX Composite index's recovery from the COVID-19 pandemic is, by a narrow margin, the strongest recovery the index has seen coming out of the ten bear markets since 1977 when the daily index price series begins. On average, after 69 days the index has risen 21.8% above the bear market low, but it's also worthwhile noting that the steepness of the recovery is somewhat related to both the magnitude and the duration of the preceding bear market. Deeper than average bear markets (1982, 2008) were associated with sharper than average recoveries, and similarly, shorter than average bear markets (1980, 1998, 2008) were associated with stronger than



	69 Day Recovery	Bear Market Decline	Bear Market Duration In Days
Average	21.8%	-34.5%	203
Max	38.2%	-22.3%	528
Min	5.7%	-50.3%	19

average recoveries. Since the current bear market is both deeper and shorter than average, the most relevant analogue for the current recovery is probably the recovery markets experienced post the 2008 Great Financial Crisis, which was also short and deep. During that episode, the S&P TSX Composite index gained 36.2% over the 69 days after the bear market low - just a hair's breadth below the current recovery of 38.2% since March 23rd. We recognize that markets are leading indicators of both corporate earnings and the broader economy, but are nevertheless cautious, as markets are pricing in high hopes and expectations for a swift and smooth recovery, which may or may not unfold.

Our long-held view is that investors should always have a strategic, primary position in the equity markets, as countless studies have dispelled the notion that timing the market can be done with any consistent success. But in light of the seemingly asymmetric risk/reward profile at hand currently, with expectations and valuations relatively high and the risk of secondary COVID-19 outbreaks and U.S. election upheaval (to name just a couple of the myriad risks facing investors) similarly high, we have opted to take a cautious approach. We are currently tactically underweight equities in most accounts, having pared holdings where the fundamental outlook has been more than briefly impaired due to the recession and resultant regulatory and societal changes. We are also emphasizing quality, profitability, long operating tenure, financial strength, and industry leadership in both our Canadian and U.S. equity portfolios. The Canadian banks would exemplify these characteristics, and we continue to own three of them as cornerstones of the portfolio, and in the U.S., companies like Apple, Alphabet (Google), and Home Depot would similarly check all these boxes. Around the periphery of our portfolios we own some cyclical stocks that are leveraged to economic recovery, but that are nevertheless financially resilient enough to survive a prolonged recession, should a second wave of infections necessitate more lockdowns. The antithesis of our approach would be companies like Hertz, which is actually bankrupt, and the cruise lines which although not bankrupt per se are financially very fragile, but have nevertheless seen rampant and frenzied speculation and outsized gains in their share prices, most likely driven by novice investors and day traders. It is harsh and Darwinian, but true to say that one of the functions of the stock market is to take money away from people who should never have had it in the first place. Our clients are categorically not part of that group and we will not put their hard-earned dollars at risk in that manner, which is why we are tactically underweight equities and emphasizing quality within portfolios. Managing risk is more important at this juncture than chasing returns. Put another way, we would rather sacrifice a little opportunity than sacrifice capital.

Our intent is to redeploy cash balances into stocks selectively as fundamentally attractive opportunities arise, or more broadly on weakness should a secondary outbreak of COVID-19 reset prices and expectations lower. Alternatively, weakness in equity markets might emerge if investors' current complacency about the longer term consequences of the massive monetary and fiscal stimulus authorities have unleased give way to a more sober assessment of what it all means for companies earnings power over the economic cycle. To put some numbers to it, consider that Canada has forecasted a budget deficit for fiscal 2020-21 of $343B – up more than twelvefold since the December 2019 projections and nearly 6 times greater than the second highest budget deficit on record of $56B which was incurred in 2008-9. Today's deficit is necessarily tomorrow's tax hike or spending cut, both of which will represent contractionary forces in the economy. While Canada is fortunate to be in an enviable fiscal position today relative to most G7 countries, and accordingly can borrow money at stunningly low interest rates, we are not bulletproof, and the downgrading of Canada's sovereign credit rating by the Fitch rating agency in late June serves as a warning shot across the bow in this regard. Deficits of this size, while arguably defensible amidst a crisis are ruinous in the long run, and will be reversed, whether by the current government or a successor to it. The Bank of Canada has also done its part to dull the economic shock of the Covid-19 recession by cutting overnight rates to 0.25% from 1.75% at the start of the year, and nearly tripling the size of its balance sheet since the start of the year. The result has been a flood of liquidity that has functioned as designed to keep the banking system stable and the credit markets open, but which has had the unintended consequence of crowding risk averse investors out of low risk assets like GICs, treasury bills and government bonds and into riskier assets like high yield bonds and stocks, pushing their prices higher. Even housing has been impacted, as home prices in many parts of the country are counterintuitively hitting all time highs even amidst the highest unemployment rates most of us have seen in our lifetimes, as cheap money makes larger mortgages more affordable.

The short-term measures implemented, while arguably necessary, carry with them longer term consequences that monetary authorities are well-aware of. Successful investors too will have to understand the recalibration of the economic backdrop and recognize that both reward and risk have been re-aligned. There are many unknowns ahead of us. We don't know how strong the disincentive to return to work may be for recipients of government transfer programs or whether and how inflationary this might be for companies in the service sectors employing lower wage workers. We don't know how long social distancing rules will limit capacity in restaurants and bars or how long they will keep professional sports, concerts and festivals on hiatus, nor do we

know how quickly people will return to previous travel habits. We don't know how much it will cost to equip front line workers with personal protective equipment or what the costs will be to renovate businesses and storefronts to accommodate these rules. But suffice it to say, all these things will have a dampening effect on corporations' profitability.

In summary, we reiterate our view expressed last quarter that the economy was deliberately and thoughtfully placed into something akin to a medically induced coma earlier this year to ensure the best possible outcomes for citizens as the world battled COVID-19. For the most part, we think these unprecedented measures have worked, particularly here in Canada, and the economy is now recovering, just as an otherwise healthy 'patient' does when revived from a medically induced coma. In the medium and longer term the patient returns to his or her normal daily life without debilitating damage from the extended timeout, but there remains some physical and emotional scarring. We witnessed that after the 2008-09 financial crisis, and some would argue that it was a beneficial ingredient in the economic and market expansion of the past decade, acting as a governor to excesses that invariable accompany success. Our portfolio positioning remains alert to any shocks or negative surprises that might unfold as the economy returns to growth and as the COVID-19 crisis eventually fades into the rear-view mirror.