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Wealth Management

Quarterly Economic and Market Comments
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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair."

As of December 31st, there were 84 million cases of Covid-19 and 1.8 million deaths on a worldwide basis. In April, more than 90% of the world's population were living in a country with partially or fully closed borders and 40% were living in countries with borders completely closed to citizens and non-citizens. In November, more than half of Americans said they personally knew someone who had died or had been hospitalized due to Covid-19. Global trade fell twice as much in April as during the worst month of the global Financial Crisis of 2008. In August, more than 40% of Americans said someone in their family had been laid off, lost their job, or taken a pay cut. The percentage of young Americans between 18 and 29 living with their parents jumped from 47% in February to 52% in July, a record level since at least 1900. According to Bloomberg, more than 100,000 restaurants in the United States have closed permanently and, in October, one-third of small business owners couldn't pay their rent. New claims for unemployment insurance in the United States have been above 700,000 for 42 consecutive weeks and counting when never before, including during the Global Financial Crisis, had there been a single week above that level. Layoff announcements from large American corporations rose 135% in December from the previous year. The economies of more than 85% of the world's countries shrank in 2020, the most widespread global recession by far since the post-WWII recession. India saw its biggest economic contraction since it became an independent country and the British economy suffered its worst year in more than three centuries. The season of Darkness and winter of despair for many.

Yet, if the 31% annualized drop in the U.S. economy in the second quarter far exceeded the next worst quarterly annualized decline of 13% in 1932, the annual growth rate of 33% in the third quarter was the most powerful in U.S. history. If the 37% drop in the U.S. stock market in 40 days in March was the biggest waterfall decline since 1929, the rally back to the February high in only six months was the fastest recovery in history from a decline of 30% or more, far quicker than the previous record of two years and an average of more than five. If $30 trillion of global equity market capitalization evaporated in March, $40 trillion was added in the rally from the March low. After demand for oil collapsed so quickly in April that the price went negative, oil had its best quarter ever. The rush to safety pushed the U.S. dollar to a two-year high in March and the rush away from safety the rest of the year pushed it to a two-year low. The juxtaposition of what has been the worst of times for many and strongly rallying commodities and financial markets seems incongruous.

In part, however, it reflects the reality, for those who didn't know, that the Dow Jones Industrial Average is not a barometer of world peace or social and economic progress. In the short run, it reflects liquidity and animal spirits. Never has more liquidity been injected into the economy and financial markets than in 2020 and zero percent interest rates, among other things, have caused an explosion in animal spirits. Furthermore, if 2020 was the worst of times for many, it was indeed the best of times for some. It took Amazon 25 years to get half a million employees. Now it's added half a million in 12 months as shipping and packaging volume was 70% higher in June 2020 than a year earlier. Amazon's profits in the third quarter tripled from the previous year as the already fast-growing e-commerce sector saw 40% gains. Jeff Bezos' net worth increased 65% from the March lows to more than $180 billion. Nor was it

just Amazon, of course. Growth in digital ad spending helped push Mark Zuckerberg's net worth up 90% to $100 billion. Streaming was a big winner as people were cooped up at home. Companies like Doordash and Zoom, which were largely unknown before the pandemic, are now household names with multi-billion dollar market capitalizations. It took Apple four decades to get to a trillion dollars of market capitalization, but only 20 weeks to go from one trillion to two trillion. One thing that Covid has done is to take a number of trends in society and business and to pull them forward into 2020. This has created both winners and losers which partly accounts for the performance of financial markets in 2020. The six U.S. stocks with the biggest market capitalization are all technology/online/new economy companies and they all rose in price by at least 30%. The seventh biggest stock, Warren Buffett's Berkshire Hathaway, which has a position in Apple, but which nonetheless basically represents a wide slice of U.S. business, rose by less than 2.5%. Notwithstanding a furious rally in the fourth quarter by a broad array of stocks, after it was announced that a highly effective coronavirus vaccine had been developed, growth stocks, primarily technology and related areas, outperformed so-called value stocks, such as energy and financials, by the most on record. The net result was a huge dispersion of returns, from more than 40% gains for technology, to 25% - 35% for some Asian markets, notably China, that handled Covid effectively, to a gain of just over 7% for the Dow Jones Industrial Average, to a mere 2% rise in the Toronto market with its concentration in energy and financials.

While there is undoubtedly a certain logic behind the performance of the markets in 2020, it is still the case that there is what the well-known financial commentator, Mohamed El-Erian, calls "a great disconnect" between Wall Street and Main Street. "Throughout this pandemic year", he notes, "we have experienced a further sharp widening of an already remarkable gap between financial markets and the economy. The stock market is not the economy, but the economy is a reflection of the very thing that supports higher asset prices - corporate profits." Indeed, over the past 75 years, not surprisingly, American corporate earnings have grown at almost the same pace as the economy as a whole. So, what is the economic outlook? January is the time of year when economists, investment strategists and advisors make forecasts for the year ahead. They are inevitably positive. This year is no exception and not without reason. First, the vaccine. It is no surprise that world equity markets, and especially those sectors most affected by the coronavirus, soared when the news came that a vaccine had been developed that was more than 90% effective. Since then, more vaccines are being developed and rolled out and a return to normal - a "new" normal, admittedly - is in sight. Second, government stimulus. Once again, markets are rallying as the news comes in that Democrats will control the Senate. More cash payments to individual Americans. A major infrastructure bill. Forgiveness of student debt. All manner of government largesse is on the table. Nor is it just America. Japan is compiling a new 73 trillion (!) yen stimulus package even as sovereign debt as a percentage of GDP around the world reaches historic levels. Central bankers, of course, continue to beaver away. The average G-10 central bank policy rate remains below zero. The outstanding bonds held by OECD central banks, which totaled around one trillion dollars prior to the Global Financial Crisis, exceed 16 trillion today. According to Goldman Sachs, financial conditions in the U.S. are the loosest on record and the money supply in major global economies is growing at double-digit rates. The poster boy for the current monetary world is Denmark where potential homeowners can get a twenty-year mortgage at a fixed rate of zero.

So, a booming world economy is conceivable later in 2021. Yet conceivable does not mean inevitable. If 2020 taught us one thing, it's that forecasters should be humble. Even if there are no major surprises, there are plenty of uncertainties. Exactly how quickly the world will get back to "normal" is uncertain. Potential production and distribution of the vaccines approved so far appears insufficient to cover the most vulnerable around the world by the end of the third quarter. More importantly, what "normal" will look like is equally uncertain. The pandemic has no doubt permanently changed parts of

the economy. One third of workers say they will look for a new job if they are forced to go back to the office five days a week. Many businesses have learned that they can make do with significantly less travel. These changes will no doubt cascade through the economy. Manhattan office vacancies have surged to their highest level of the century and the median rent dropped 20% between March and November. How this will play out over the next couple of years remains to be seen. Similarly, before the pandemic about 40% of U.S. passenger vehicle miles were for commuting or shopping. As people work at home more and order more products online, demand for vehicles will fall by 5% according to the consulting firm KPMG.

Even if the world economy meets the most optimistic expectations in 2021, world equity markets appear to have already discounted a lot of good news and investors will be looking forward to 2022 and beyond. As it happens, a number of forecasters have taken to doing just that and their conclusion is, if anything, more positive than the consensus outlook for 2021; indeed, a number have concluded that the next decade will be the 21st century version of the 1920s. "Ready for the Roaring 20s?" asks Fortune magazine. The concept seems to be that the pandemic-induced pessimism of 2020 will give way to a wave of optimism and a stock market boom as happened after the Spanish Flu. This is Dickens' "epoch of belief and incredulity" on display as this narrative is not just wrong, but reality turned upside down. For starters, in 1921, in the wake of the carnage of WW1, the Spanish Flu, and the Depression of 1920-21, U.S. stocks were as cheap as they have ever been. Today, they are as expensive as they have ever been, more akin to 1929 than 1921. Secondly, the world today is emerging from a decade of slow growth and low inflation; whereas, in 1920, there was a global commodity boom with inflation reaching 24%. Thirdly, during the lengthy, deep depression of 1920-1921, governments and central bankers saw fit to do … nothing, as opposed to the manic fiscal and monetary stimulus after one month of economic and market mayhem in 2020. During the 1920s, the U.S. government consistently paid off its debt incurred during WW1; whereas, over the next five years, the U.S. government is expected to borrow more than $20 trillion. While the 1920s analogy may tell us nothing about the next decade, it does tell us a lot about investor psychology today.

If the next decade is not going to be a replay of the 1920s, what is it going to look like? For many, the answer is a period of rising consumer price inflation. Surely the epic fiscal and monetary ease must be inflationary? It sounds logical, yet the same argument has been made in Europe and the United States to no avail over the past decade. Then there's Japan. Total debt in the U.S. represents 366% of GDP. Federal debt to GDP is 128%. The central bank balance sheet is 33% of GDP. The comparable numbers in Japan are 662%, 220%, and 128%. Despite this, over the past 20 years, real growth in Japan has averaged 0.4% per annum and inflation 0.5%. So, while accelerating inflation may be conceivable, it seems far from inevitable at this point. What does seem inevitable is slow growth. Population growth continues to wane. As only one example, South Korea's population has begun to shrink for the first time. While fiscal stimulus may boost the economy in 2021, the research is clear that high debt levels undermine economic growth in the long run. The third element of growth - productivity - has been on a slowing trend for years. Many interesting technological developments suggest this could possibly change, but, at this point, the world economy still seems caught in a debt trap, a condition in which too much debt weakens growth, which elicits a policy response that creates more debt, which results, in turn, in more disappointing growth. Over the past decade, the low interest rates and excess liquidity resulting from policymakers' efforts to stimulate growth have been a boon to financial markets and have more than offset slow economic growth, but it is unclear to what extent this is sustainable going forward.

Against this backdrop of technological disruption, market volatility, slow growth, and historic fiscal and monetary ease, the majority of investors are following one of two paths. On the one hand, an ever-

increasing amount of money – many trillions of dollars - is being invested passively in something approaching a 60% equity/40% fixed asset mix. This has been a winning approach over the past century and over shorter time frames as well, but, with miniscule bond yields and U.S. equity indices at record highs, such a portfolio today is priced to produce very disappointing returns over the next 10 -15 years at best and negative returns at worst. Paradoxically, an increasing number of investors have taken to speculating in everything from Bitcoin, to shares of Tesla, to initial public offerings of the latest "new economy" stocks, to Special Purpose Acquisition Vehicles, often using one form of leverage or another. History and common sense tell us that this can only end in tears. Rarely, if ever, has an active investment management approach that is value-based and emphasizes risk mitigation seemed more appropriate; rarely, if ever, have the challenges facing those active managers - and, indeed, all investors - seemed greater.