April 6, 2020

Investor Strategy

Helping investors reach their long-term wealth goals

RICHARDSON GMP

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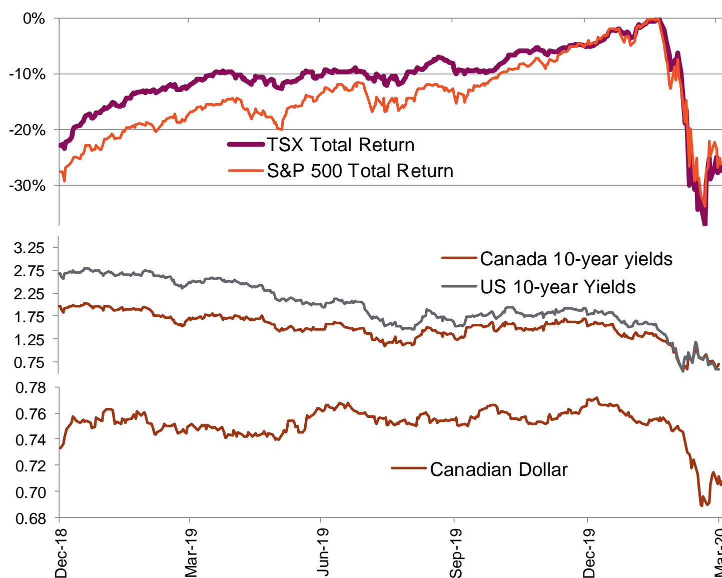
I. Market recap – Goodbye bull, hello bear

That's a wrap on Q1. Not quite the beginning of a new decade that we all had in mind, when the focus was on trade wars, democratic nominations and the clean energy revolution. Hindsight always provides a perfect lens, and with it we can see markets were full of hubris. Unforeseen events can and will continue to have a massive impact on markets. This was not a black swan event, but a white swan that nobody cared to pay attention to. To be blunt, this was a quarter that didn't end well. The bull market, old by any definition, ended on March 12 when the S&P 500 closed 26.9% from its peak set on February 19. Bull to bear in just 16 days – this was one of the fastest bear markets in history.

The overarching issue in March was COVID-19, an amorphous viral enemy that is frightening, and the uncertainty prompted by an economic shutdown. The debate continues on how long it will last and how widely it will spread. Over the course of the month, countries around the globe went from believing it was someone else's problem, to realizing it was everyone's problem. Economies have had to shut down as social isolation becomes the primary tool to combat this health crisis. This unfortunately has created a self-induced recession and wild amounts of volatility in every corner of financial markets. The VIX spiked to

Chart 1: Goodbye Bull, Hello Bear



an all-time high of 82.7 on March 16, ultimately finishing the month at 53.5. Besides stock markets tumbling, March saw emergency rate cuts to soften the economic blow, circuit breakers getting lots of use, record lows for bond yields, a massive spike in credit spreads, big currency swings, massive moves in gold, and funding concerns and liquidity issues in the bond market.

The U.S. Federal Reserve (Fed) ran through the 2008 playbook on a quickened timeline. Emergency rate cuts by the Fed and the Bank of Canada were only the beginning of the response. Governments and central banks were quick to act, unleashing an unprecedented fiscal response and “unlimited” Quantitative Easing (QE). These measures renewed optimism that the bottom was in and kicked off a big rally off the low, which was set on March 23. After a blistering three-day rally, the S&P 500 posted a gain of over 20%, which appears now to be more of a bull run in a bear market, or dead cat bounce. Despite the big rally, markets still finished the month in poor fashion.

Global equities fell 8.6% in March (down 14.1% in the quarter to date), as measured by the MSCI World Index in Canadian dollars. All countries declined during the month and the quarter. Looking at Canada, the S&P/TSX Composite was down 17.4% in the month, and 20.9% year-to-date. The S&P 500 was down, although not as much as Canadian markets, managing a -7.4% return in Canadian dollar terms. Peak to trough it declined 34% and fell 12.1% in the first quarter, leading to its worst quarter since 2008. Small-caps and mid-caps were both disproportionately affected. As COVID-19 dominated the global stage in March, every headline index suffered losses.

Looking at individual sectors, classically defensive sectors such as Staples and Utilities held up better relatively, in Q1. Technology was down the least falling at 3.8%. Energy had the worst quarter of any sector in 20 years. Let’s put that into perspective: It performed worse in the first quarter than Technology did when the tech bubble burst, and Financials did during 2008. Quite an unwanted achievement.

The show of strength in the big rally off the bottom was impressive. Unfortunately, it looks like so far investors sold what they wanted to, not what they had to, as they do when bear markets typically end. Looking ahead, there are big question marks surrounding the path of active daily virus cases, who survives the oil war, the fate of dividends, earnings uncertainty and measuring the full extent of the economic impact. With over 2 billion people around the world under some kind of lockdown, many of us will experience Q2 from our makeshift home offices. Goodbye bull, hello bear.

II. Flipped radical

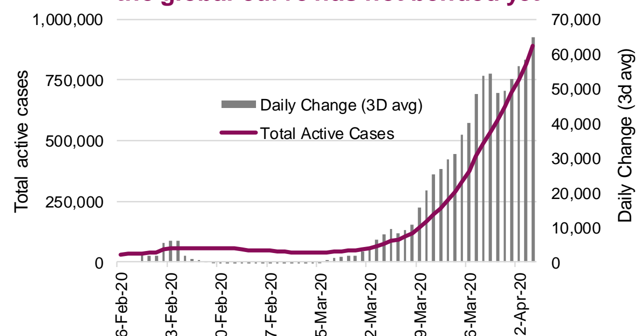
There are knowns and there are unknowns. We know society will get through this pandemic, but we do not know when counter measures will meaningfully ‘bend the curve’. The broad-based counter measures of isolation/social distancing/quarantine are effective and we would encourage all to remain vigulent. We know the global economy is in a recession, induced by the efforts to defeat COVID-19. Think of it like an induced coma – a necessary ‘evil’ imposed on the ‘patient’ to help them heal and recover, although it’s unknown how long this will take. We know unemployment has already jumped to deep recessionary levels, some companies will go bankrupt, and there will be bond defaults and downgrades. Critically, the market knows this as well – remember, it’s new information that moves prices.

In our view there are two big outstanding questions that remain unknown: one is pandemic related while the other is economic.

1) When will active cases stop rising and start declining, allowing for the inevitable relaxation of social distancing efforts?

While the headline of over 1 milion confirmed cases globally last week is disheartening to hear, most nations are starting to see declines in daily confirmed cases. True, Chart 2 would imply this is not the case; however, the U.S. continues to drive the global total higher as did France’s reporting of sizable cases. U.S. confirmed cases represented about 35% of the new cases over the past week. The daily data is volatile and given testing delays and backlogs, it is slightly backward looking. Nonetheless, there are signs that the social distancing/isolation strategies are working (*keep it up everyone*).

Chart 2: While there are improvements, the global curve has not bended yet



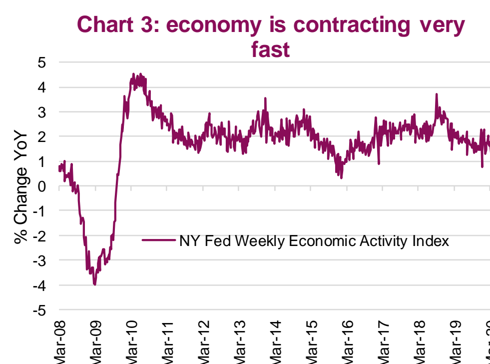
The weekly change in active cases has rolled over in most countries that instituted social-distancing measures. Italy, which was one of the early-it nations, had 18K net new active cases over

the past week. This measurement peaked on March 26 at nearly 29K and has been steadily declining. Clearly, this isn't fast enough but certainly in the right direction. China and South Korea had experienced negative net new active cases by this time.

Until we see the number of active cases starting to decline in more jurisdictions, the market will continue to have trouble s eeing through the path of this pandemic. Once the market can see a path, that will be new news and very positive.

2) We have pushed the economy in a deep recession/partial halt to fight this health crisis. With unprecented policy responses to soften the blow or help bridge the chasm, is the market discounting enough bad economic news?

It is safe to say that most economic/market models can be thrown out the window. This isn't a 'recession' caused by excesses building up within pockets of the economy, unwinding and infecting other parts of the economy. We, as a society, are doing this on purpose. This makes it either totally unprecedented or potentially somewhat similar to war-time mobilization, with the Ford Motor Company manufacturing ventilators instead of Shermans.



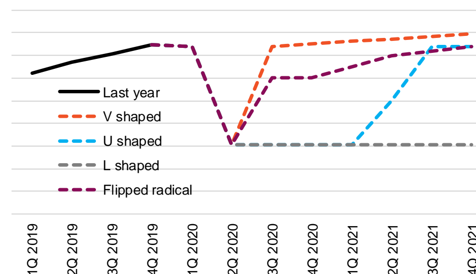
Economic data is always delayed to various degrees and given how fast the economy has been slowed, only the fastest data are of any use at the moment. Initial jobless claims and continuing claims are indicative. Initial claims were 3.3 million on March 20 and 6.6 million on March 27. There is no historical context for these numbers, but it's safe to say the official unemployment rate is going to quickly move over 10% and could reach 20%. The NY Fed has a weekly economic index based on faster data from same-store sales, sentiment, initial jobless claims, steel production, fuel sales and electricity consumption (chart 3). The last reading was March 21, so this is likely going to keep dropping. However, it's worth noting that if you look at the inputs, this index would be very sensitive to the current isolation-driven strategy.

The market already knows the economic data is heading south really fast, earnings are going to take a huge hit and even dividends will be cut. The market does appear to be pricing in a recession, albeit not a prolonged one. Equity markets are down 25% and credit spreads high, but not nosebleed high. We believe the market is pricing in a V-shaped recovery, in the form of a 10-20% drop in Q2 GDP followed by a strong recovery starting in Q3. The V denotes a fast decline in economic activity (**** part of the V), followed by a strong rebound in economic activity (**/** part of the V).

There is good evidence for this view. Central banks and governments are instituting programs to bridge the chasm of economic activity to reduce the longer-term damage and enable a quick recovery as social distancing is relaxed. Canada's wage strategy that could put one-third of all salaries on the government's tab is designed to avoid the layoff/rehire process that would slow down a recovery. The U.S. is not doing this, instead opting for loans with attractive terms. Still, the U.S. COVID-19 phase 1-3 programs total about 10% of GDP. Similar efforts and programs have been announced in most countries.

These efforts are to keep markets functioning and reduce the chance of an "L" or "U"-shaped cycle ("L" is a drop in economic activity that doesn't return while a "U" is a drop in activity, a long period of slow or negative growth, then eventually a recovery). We believe the government programs and the nature of this recession should help us avoid the dreaded L or U. However, we are not convinced of the V.

⌐√ This symbol denotes a flipped radical, which we believe to be the more likely economic path. This means a large drop in economic activity followed by an initial strong recovery, but then stagnation. The strong initial rebound will be driven by the rapid return to work by so many individuals plus the return of corporate spending. Corporations and individuals have cut most discr etionary spending. Corporations have done this to conserve liquidity given the unknown duration of the induced recession. But this discretionary spending could recover quickly. Once they're able to spend and any unemployment fears subside, many consumers are likely to unleash their pent up desire to spend beyond groceries, beer and Amazon.

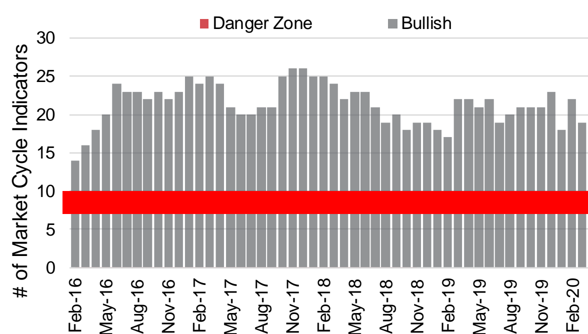


After the initial rebound, our changed behaviours will slow the recovery down. It's likely that our willingness to travel and be in large groups will be materially lower than before this pandemic – at least until a vaccine emerges or our collective memory starts to fade. Neither is likely anytime soon. Plus, the lesson of having a number of months of personal liquidity (cash reserves) has been re-taught. This reversion to saving as opposed to spending – similar to the situation after the last recession – means less consumer activity and therefore slower economic growth, which in turn helps keep yields lower for a time given increased savers.

Now that many have experienced working remotely, this may also speed up widespread adoption of this pratice. This recent experience may also have ramifications for business travel in the future. Our team, for example, has hosted over a dozen client events during the past couple weeks for advisors with audiences exceeding 100 at times. No time has been spent travelling or staying in a hotel. Meanwhile, online educational learning has also taken hold for many students. There is something appealling to listening to a top-ranked professor on a subject as opposed to the one in your local school.

Market cycle – Not built for pandemics

Chart 5: This will breach



Earlier in my career I had the pleasure to work for one of the most reknowned quantitative strategists in the U.S. While this was too brief given other factors, one lesson really stuck. Anyone can create a model that works historically and implement it. The real value add comes when you understand under what scenario it will and won't work.

Turning to our Market Cycle framework, it was not designed for a scenario in which society abruptly hits the pause button on the economy, triggering a recession and government intervention in the trillions. It is designed to better sniff out early signs of recession in a more normal cycle. With that, we still have 13 bullish signals but rest assured these will likely disappear as the data and earnings catch up with the reality of the world.

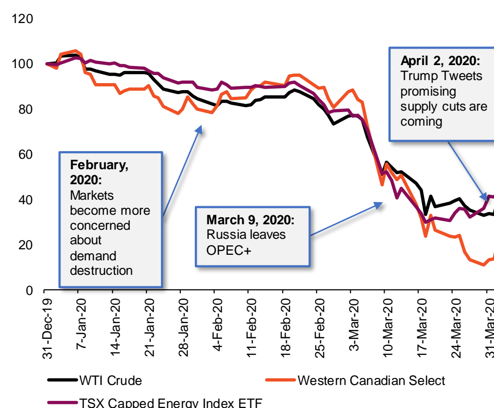
III. Energy's tale of woe

The fluidity in oil markets this week makes this the seventh iteration of our oil market update. This story begins in January, when we started to hear about the cases of COVID-19 growing rapidly in China. We all know what happened next: Governments across the globe enforced social distancing, isolation, and lockdowns. These measures should help chop the top off the curve, but also slashed oil demand in a big way. Estimates for global oil demand have fallen precipitously for the month of April from forecasters around the world (Table 1). Typically, the global oil market is nearly in balance with the supply of oil coming out of the ground being consumed on a daily basis, *give or take a million barrels.* However, the speed of this drop in demand is leading to significant surplus expansion, to the point that some storage infrastructure is nearing the 'all-full' level.

Table 1: Forecasted April Crude Oil Demand Loss (barrels per day)

Research Institute	Forecast	Commentary
Trafigura Group	-22 million	The demand destruction is unprecedented, according to Ben Luckock, co-head of oil trading
Goldman Sachs	-18.7 million	A shock of this magnitude will overwhelm any supply response including any OPEC freeze or cut
Standard Chartered	-18 million	Surpluses are so large that global spare storage capacity could be full by mid-May
FGE	-17.4 million	Recent lockdowns in India and the U.S. have the potential to curb oil consumption severely
Rystad Energy	-16 million	Biggest hit to consumption will be in April, demand in 2020 to fall by 4.9 million b/d from 2019
Energy Aspects	-15 million	Saudi Arabia won't succeed in forcing Russia to return to the table to agree on joint supply cuts

Chart 6: Annotated Performance Chart

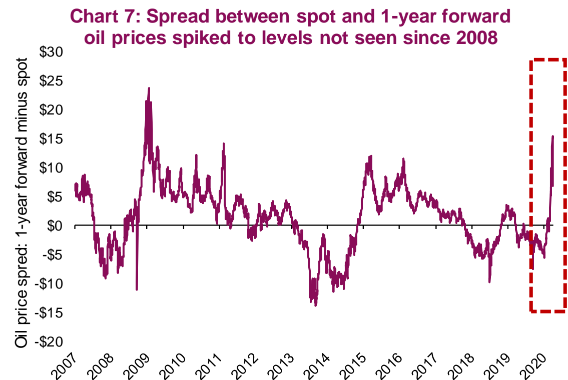


Adding fuel to the fire, on March 6 Russia's oil minister Alexander Novak stepped away from an OPEC+ meeting, refusing to participate in the proposed cut in output of around 1.5 million barrels a day. Moscow's view is that U.S. shale has been the beneficiary of curtailments over the past few years and so they want to see action out of the U.S.. Saudi Arabia immediately responded by cutting prices by $7 a barrel to Chinese customers and said they would increase output by 2 million barrels a day. This is the 'opening of the taps' at a time when demand is declining rapidly.

This caused oil to gap lower, falling by almost 35% over a weekend. Russia seemingly desires not only hurt against U.S. shale producers, but North America in general. That pain travelled north of the border to the Canadian energy complex as well. Last week Whiting Petroleum was the first major energy company to file for bankruptcy.

It appears the U.S. administration was crying uncle when Donald Trump tweeted on April 2 that he is working on a deal to cut 10 -15 million barrels of global production. The market initially reacted to the news but quickly faded Trump's optimism on making a deal, reminding him this is not a reality TV show. However, the administration did meet with U.S. oil executives on April 3. There was supposed to be a virtual meeting held April 6 between OPEC+, but that has now been pushed until April 9, **and the markets are once again retreating on the news.**

Chart 7: Spread between spot and 1-year forward oil prices spiked to levels not seen since 2008



Even if a deal is reached, fundamental problems still remain. Firstly, global compliance is going to be extremely challenging. This will be a quintessential 'prisoner's dilemma', where there is a risk that everyone acts in their own interest and this fails to produce the optimal outcome. Even if 15 million barrels were removed from the system, which seems like an audacious goal, that still leaves a supply surplus with storage quickly filling up. This has caused the steepest contango curve since the great financial crisis (Chart 7). Contango occurs when the price of oil futures contracts are higher in the future than in the spot market. This has started to normalized as the spot price rallied over the past few days.

What does this mean?

For the global economy and consumer, lower oil prices tend to be a boon because they spur consumption as less money is spent at the pump and more is injected into other parts of the economy. The problem at the moment is that there is nobody driving because we are all in lockdown.

The solution isn't quite as simple as turning off the taps. Shale wells can be capped, and new ones not built, but a lot of the land acquisition have clauses that stipulate that if you aren't producing on the land, you lose the rights. Therefore, in some cases, producers have to decide to operate at a loss or lose the asset. For Canadian SAGD (steam-assisted gravity drainage) operations, there is no cap. These operations have to heat millions of litres of solvent to pump steam constantly into the ground. Allowing that steam to cool would present massive restart costs to the operation and could consequently degrade the asset.

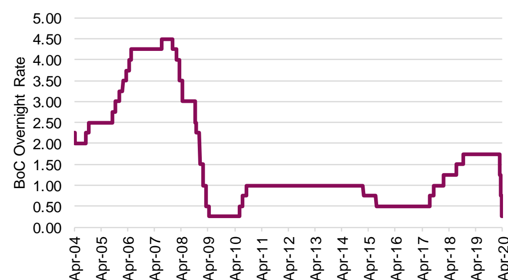
Further intensifying the problem for the oil industry is debt. Many producers levered up their balance sheet using low rates to buy up assets and companies. Now those same banks that lent them the money are going to 'shut off their taps'. Bank lending to oil companies is a function of the future cash flows of their asset base. This is done semi-annually using a future spot price, discounting those cash flows to present and lending against somewhere between 60% and 70% of that value. Under the current environment, the level of funding is going to go down for three reasons: 1. The commodity price is significantly lower; 2. The discount rate is likely going to rise; and 3. The asset base is going to decline.

Portfolio implications

If the current environment persists for an extended period of time you are going to see more bankruptcies occur from levered operators unable to refinance their debt load. There will likely also be industry consolidations as financially stable companies pick up assets at rock-bottom prices. Production cuts are going to take time, demand is not going to snap back as social-distancing measures will be in place across the globe for days, weeks and potentially months to come. Limiting exposure to energy companies with solid balances sheets and hedged or limited exposure to the commodity price seems prudent at this point. The space is battered and does present large upside potential once normalcy is in sight, but should be left to only those with higher risk tolerances.

IV. Bank of Canada update

The Bank of Canada (BoC) lowered rates by a cumulative 1.50% in March, to 0.25%, bringing the policy rate to its lowest level since the financial crisis in 2009-2010. According to the BoC, policy rates are now at their effective lower bound, meaning this is as low as they will go. Consensus forecasts from economists now suggest rates will remain down here until at least the third quarter of 2021, which would be longer than during financial crisis, when the target for the overnight rate remained at 0.25% for just under 14 months.



In addition to lowering interest rates, the BoC also announced new programs in order to alleviate strains and provide support to Canada's financial system and the economy during the COVID-19 pandemic:

1. A Standing Term Liquidity Facility (STLF) that allows eligible financial institutions to borrow from the BoC by pledging a broad set of collateral, including mortgages.
2. Provincial Money Market (PMMP), Bankers' Acceptance (BAPP), and Commercial Paper (CPPP) Purchase Programs where the BoC will conduct primary and secondary market purchases with a term of up to three months of sufficiently high quality, broadly equivalent to a minimum short-term credit rating of R-1 (low).
3. A bond purchase program to address strains in the Government of Canada debt market. The BoC has begun acquiring Government of Canada securities in the secondary market, targeting a minimum of $5 billion per week, across the yield curve.

The cumulative impact of these programs will see the BoC's balance sheet expand substantially. As of April 2, PMMP purchases have totalled $1.325 billion, the BAPP $20 billion, while the CPPP has been slow to get underway. Coupled with the bond purchase program, the total amount of the BoC's purchases will end up in the area of $300-500 billion. To put this in perspective, net Federal Government borrowing before the pandemic was in the area of $700 billion, and total outstanding in the short-term paper market was in the area of $250 billion (40% of which are Bankers Acceptances). If the $300-500 billion estimates are accurate, this could end up with the BoC owning upwards of half of the current outstanding borrowing in the marketplace, on par with the Bank of Japan's ownership of its domestic bond market.

There are risks to this strategy, such as creating further pressure on credit spreads as Canada bonds become scarce. The door is open to expand the target of purchases, with Canada Housing Trust, Provincial, Municipal, and Corporate guarantees all possible in the future, should we begin to experience any further market disruption. Spreads have already begun to narrow in credit markets alongside the rebound in equity markets in the last week of March, and last week we saw a substantial reduction in spreads in short-term money markets as the programs came into effect. Overall, they appear to be very supportive for financial market liquidity, though for now, credit spreads continue to remain elevated, and bid-offer spreads remain wide, even in government bond markets.

V. Liquidity and credit markets

When it comes to investing, we've long said that of the three main types of risk, liquidity is our favourite. Investors face credit risk – the possibility that the companies we are invested in fail. We face market risk in which volatility in the broader markets cause us to lose on our investments. Lastly, we face liquidity risk – a more complex risk, which for companies, can exacerbate one of the above two risks, and for investors can be game changers.

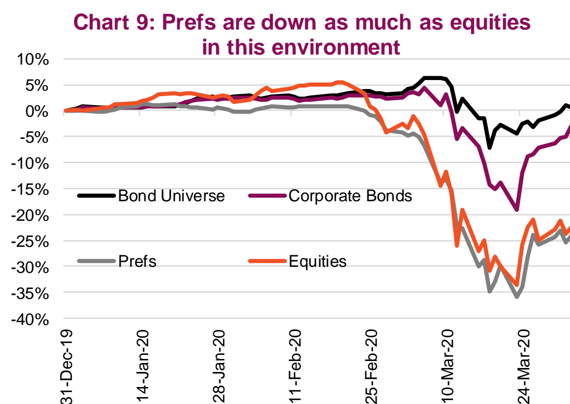
The "illiquidity premium" of an investment is the incremental return one earns for giving up their ability to sell the investment whenever they want. Some say private equity returns are greater than public equity because of that illiquidity premium. Once you have made the decision to buy, it is very hard to sell. Similarly, one of the greatest advantages in investing is having liquidity when it is scarce. As Warren Buffet has shown, for example, in the case of buying Goldman Sachs preferred shares in 2008, the ability to provide liquidity to those in need can reap great advantages.

We are in one of those markets where liquidity is paramount, and rearing its head in many places. For example, many of the companies that are hardest hit in this bear market are those with lots of debt. Their ability to refinance that debt has now come into question, and the equity then becomes troubled. Leverage, whether financial or operational, is the driving factor during this bear.

The bond market and preferred share markets have also shown that lack of trading liquidity can cause problems. The bond market is run by a network of dealers acting as agent and principal among themselves and investors. Their own balance sheets only allow them to buy so many corporate bonds – an amount dictated by both their risk management divisions and the banking regulators (in the case of bank-owned dealers). So, what happens when there are more sellers than buyers in the bond market? Prices gap down and volumes slow significantly. This was the case in March when we saw many bond ETFs, many of which own hundreds of individual issues, disconnect from their stated Net Asset Values (NAVs). But what is the NAV when some of the bonds held haven't traded in a couple of weeks? Is the last traded price reliable when it is old and markets are moving fast? Our belief is that the prices that the ETFs were trading at were probably closer to the reality of their underlying basket than was the stated prices of all the underlying bonds themselves (the NAV).

Sometimes, an illiquid market can be public too. The preferred (pref) share market has its own liquidity problems – one which has hurt long-term investors but similarly offer opportunity for those who can deploy funds now. With almost 10% of the market cap of the entire pref market owned by just the top-three pref ETFs, the issue here is slightly different, but the results are similar. Investors buy the ETFs for ease and diversification, but those ETFs must sell the underlying basket, where there are far fewer investors and many of the holders are small and do not trade often. This created a case where prefs underperformed even equities between February 19 and March 23. Now, the fundamentals were terrible too; both credit risk appetite and interest rates, the two major contributors to pricing prefs, were going quickly in the wrong direction. However, we would generally expect preferred shares to outperform in a bear market, as they did in the deeper U.S. market for prefs.

Chart 9: Prefs are down as much as equities in this environment



That said, indiscriminate selling out of the ETFs has created some opportunities in the stronger credit names among the index. That same illiquidity has had the prefs bounce back since the March 23 (current) lows, outperforming the broad equity index by about 5%.

Things move quickly in these markets; yields of the preferred indexes exceed 7%, giving investors over 680 basis points of additional yield over Canada government bonds. The high-yield index at the time provided 850 basis points of additional yield while the investment-grade index provided 150. That spread is down to just 570 basis points only a week later.

Still, this is good value for yield-seeking investors. We believe the downside is somewhat mitigated in the pref market by already-low government yields and the seniority of dividend payments, and encourage the use of active management to try help pick the best and stronger credits, and navigate the quickly changing interest rate universe. Just as the subsequent returns coming of the 2015 bear market closely matched that of equities, we believe the risk/reward going forward looks favourable.

Picking the right names is very important, however. We don't know how long this recession will last, and we haven't even started seeing major defaults yet. Strong balance sheets and cash flows to maintain dividends and interest payments will be important should this be prolonged.

VI. Portfolio positioning

It would seem the markets are going through the Kubler-Ross five-stage grief model. First the market was in **Denial** that a problem in China would become anyone elses problem. This wasn't totally unfounded given MERS, Ebola and some other instances that kept these health crisis localized. Denial was replaced with **Anger** over how poorly China initially handled the outbreak, which started to spread elsewhere. This anger was also pointed at other leaders who did not take this seriously (*you know who*). Then **Depression** set in as society and the markets became keenly aware this was going to be a global issue with no quick or easy resolution. And the solution is very painful, with social distancing putting the breaks on the economy and prompting us to sit at home watching too much news media. This was likely in mid March and now we are in the **Bargaining** phase, which sees us trying to find meaning and reaching out to others. Have you been on a few virtual gatherings lately? Now the good news – next up is **Acceptance**. We get over it by adapting to the new world and continuing with life. It won't be the same world, but 'new-normal' will become more manageable, and after a while it will be 'normal normal'.

Portfolio Implications – If the market is pricing in a V-shaped recovery, the risk would be that the sheer magnitude of the negative economic data pushes some to reconsider. This could lead to a further dip in equity prices. It is rare in bear markets for a bottom to be formed without some degree of retesting. The close on March 23 was 2,237 for the S&P 500, which is 10% below current levels. This too could be broken or retested. There are mispriced assets out there though, although there is higher risk associated with them. Focusing on the balance sheet and survivability is now perhaps the most important consideration within investment analysis.

We are focusing on trends in active virus cases, which if they start to improve, should pave the way to add some risk assets. Alternatively, if we get a big down draft on economic data, that too could prove even more opportunistic. This is a very volatile market and the key is, if you are making changes, make them incrementally. Moving too fast or too slow are risks. Making incremental changes diversifies this execution risk.

Overall Asset Allocation	-				+
Equities			■		
Fixed Income		■			
Cash				■	
Global Equities	-				+
Canada		■			
U.S.			■		
Euro Area				■	
Japan			■		
Emerging Markets	■				
Fixed Income	-				+
Canada		■			
U.S.			■		
Government			■		
Investment Grade		■			
High Yield	■				
EM Debt	■				
Prefs		■			
Duration		■			
Credit	■				
Currencies	-				+
CAD Short Term (3m)			■		
CAD Longer Term (1yr)		■			

Charts are sourced to Bloomberg L.P. & Richardson GMP unless otherwise noted

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.

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