Serber Speaking

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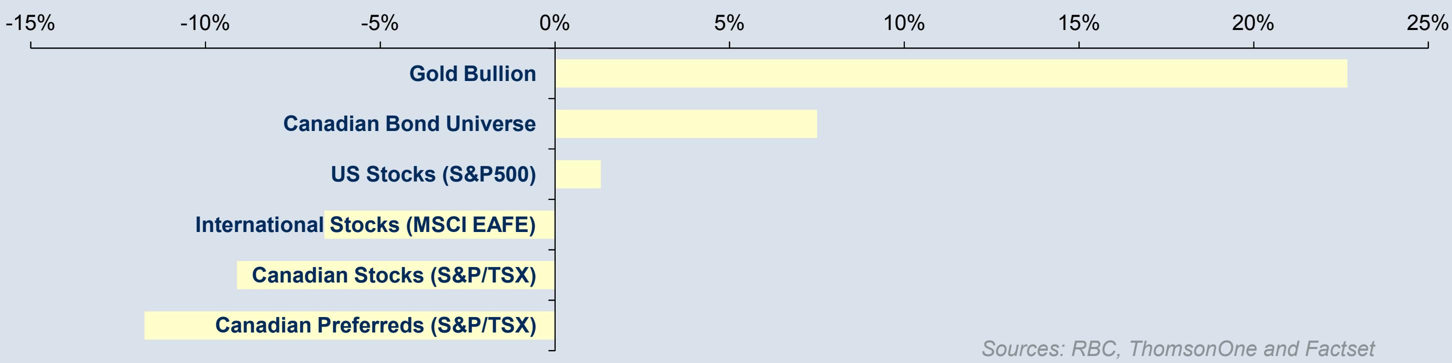
Commentary for the quarter ended June 30, 2020

Crisis? What Crisis?

When I wrote my last quarterly report, at the end of March, the world and financial markets were tilting, and much of the global economy had ground to a halt. “Unprecedented” doesn’t really capture these strange and scary times. Call it what you will, it was and is a disaster for the millions harmed by the pandemic directly, and the billions who rely on a functioning economy for their livelihoods. As a result of the shock to global economic prospects, stock markets everywhere fell sharply in the first quarter, including a breathtaking drop of some 35 percent from the February highs to the March lows.

As the second quarter evolved, the early pandemic epicentres such as Wuhan, Northern Italy and New York showed a clear infection pattern of a sharp peak followed by a steady decline. Thankfully, each former hotspot is now generating only a small number of new daily cases. To be sure, there are and will continue to be new epicentres, but they, like the earlier ones, will presumably peak and decline in similar fashion. Much has been made of the “second wave” now occurring in the US, but it is more properly understood as a rolling continuation of the first wave. The new epicentres in Arizona, Florida and elsewhere will perhaps get worse before they get better. But infection rates and adverse results will probably peak and then decline there, as they have elsewhere, within a couple months.

Performance by Asset Class: January 1 to June 30, 2020 (in Canadian $)



Sources: RBC, ThomsonOne and Factset

Reflecting the fact that infection outbreaks appear to be relatively short-lived, financial markets took a decidedly more optimistic turn in the second quarter. Global stock markets are now down just five percent, year to-date (MSCI World Index), and the US market is actually up about two percent, in Canadian-dollar terms. Crisis, what crisis, indeed?

As seen on the chart above, gold is showing continued strong gains, even after the worst of COVID-19-inspired market fears have faded. This reflects the realization that governments have printed, and will continue to print, copious amounts of money to keep their economies afloat, which will tend to devalue their currencies. Appreciation in the price of gold can be seen as simply the depreciation in the value of paper money. As a result, I continue to hold gold (both bullion funds and gold mining stocks) in client portfolios.

On the less positive side, Canadian preferred shares remain at the bottom of the performance heap, having recovered less than common stocks since their lows in March. Part of the reason for the stocks’ rebound is lower interest rates. Unfortunately for preferred shares, however, lower rates are more of a headwind than a tailwind.

It Takes Two to Tango

One comment I have heard often recently is “This stock market makes no sense.” How, people wonder, can stocks be up 30 percent or more from their March lows when infection rates are still rising worldwide, the economy is busted, the second wave is coming, or already here, not to mention the US election, etc.? Indeed, it is very hard to understand the stock market if you try to connect its movements to today’s news headlines. This is because investment markets reflect expectations for the future, not what happened yesterday.

So, if the current news doesn’t tell us what should be happening with stock prices, what does? To answer this question, I present a simplified framework in which only two things matter: future profits and interest rates.

Investment Concept: The value of any investment is the present value of future profits.

One easily understands that a $100 10-year bond, paying $5 per year in interest, generates an annual profit, or return, of five percent. However, if you owned that bond and wanted to sell, how would you figure out a price that “makes sense” today? We know that future profits are $5 per year, but how do we determine the present value? The answer lies in the present value formula. This formula provides a current price that reflects a specified rate of return over time. Based on current rates, say I decide that I require a 2.5-percent return to buy your bond. We punch these numbers into a financial calculator and it tells us that the present value is $122. So, if I pay you $122 for your $100 bond, which pays $5 per year for the next 10 years, I will make a rate of return of 2.5 percent.

(Quick math check: $50 interest collected over 10 years, less the loss of $22 since $122 was paid for the bond and only $100 received back at maturity, means net profit is $28. And $28/$122 = 23 percent or about 2.3 percent per year. The actual figure of 2.5 percent more accurately accounts for the timing of the various payments in and out.)

So far so good, I hope. Now, let’s move on to stocks, which are a lot more complicated. Or are they?

Conceptually, the approach to valuing a stock is the same as for a bond. We are in search of the present value of the company’s future profits. The difference is that, unlike a bond where future profit is a known amount of annual interest, in the case of stocks, future corporate profit can only be estimated.

Prior to COVID-19, the S&P500 Index of the largest US companies was expected to generate an aggregate profit of about $175 per share this year, rising slowly from there in 2021 and beyond. To find a reasonable level for the S&P500, we could have applied an appropriate discount rate to those estimated future profits and found the present value. Skipping a few steps for brevity’s sake, it turns out that a discount rate of about 7.5 percent, applied pre-COVID-19, yielded an S&P500 present value of about 3,400, which is roughly where it was at the beginning of the year.

Then came COVID-19. Suddenly, the idea of the S&P500 companies generating $175 per share in profit was out the window. What would it be instead -- $100? $50? Zero? During the free-fall in February and early March, nobody had a clue, so the market tanked. Then two important things happened. First, central banks, led by the US Federal Reserve, slashed interest rates. Then, the number of new daily COVID-19 cases in the first Western epicentres of Italy and Spain, which saw infections spike and peak in late March, began to steadily decline. This implied that the situation, while difficult, would probably be manageable.

By late April, analysts were better able to forecast future business activity and, hence, profits. Expectations for S&P500 profits are, of course, lower now than they were prior to COVID-19. If that was all there was to the story then, indeed, stock prices should be a lot lower than they are today. But we know that the present value of an investment requires both the expected future profits *and* a discount rate. Since interest rates are lower today than they were pre-COVID-19, the discount rate for our formula is also lower. If we apply a discount rate of 6.5 percent (instead of the previous 7.5 percent) to a lowered earnings forecast for the S&P500 companies, we get a present S&P500 index value of about 3,200 -- roughly where it is today.

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So -- does the current stock market level make sense? The short answer is yes, it probably does. However, this doesn't tell us where the market is going tomorrow. The future path will depend on whether profit forecasts in the coming months fall, rise, or stay roughly the same. It will also depend heavily on interest rates and their impact on the discount rate investors will apply to those future profits.

While outbreaks will likely continue for a prolonged period going forward, it is doubtful they will result in the "total lockdown" response we experienced in the Spring. It is, therefore, likely that economic recovery will continue apace, supporting stock prices. Also, central bankers have signalled that rates will likely not be moving up until 2022 at the earliest. All of which provides a reasonable backdrop for investment markets over the coming 12 months. As usual, a correction in the 10-percent-range may happen any time. If so, I will use it as an opportunity to put some cash to work.

From the Planning Notebook

The importance of your Will

A valid Will is an important document that all adults should have and maintain. Unfortunately, while the need for this document is widely accepted, creating a Will, or updating it when needed, is often postponed or avoided altogether.

Your Will should be prepared within the context of an overall estate plan. This may include alternative methods of passing assets to your beneficiaries, for example by designating a beneficiary on a registered plan or insurance policy, or by holding assets in joint names with a right of survivorship.

If you die without a valid Will or if your Will cannot be located, you are considered to have died "intestate." Similarly, if you do not dispose of all your assets in your Will, you are considered to have died "partially intestate." In either case, your estate will generally be administered under the intestate succession legislation for the province or territory where you lived at the time of death. However, real property—a house or land—owned by you elsewhere will be distributed in accordance with the governing intestate succession legislation in the place where it is located.

If you die intestate, your property will be distributed to your next closest surviving relatives, beginning first with your spouse and/or child(ren), followed by more distant relatives, in accordance with the laws in each jurisdiction.

If you are interested in a complimentary Will & Estate Review with an RBC Wealth Management consultant please let me know. Please ensure you consult tax and legal experts before implementing any estate strategies.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.