Serber Speaking

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Commentary for the quarter ended September 30, 2020

How Many Waves Does it Take to Sink the Economy?

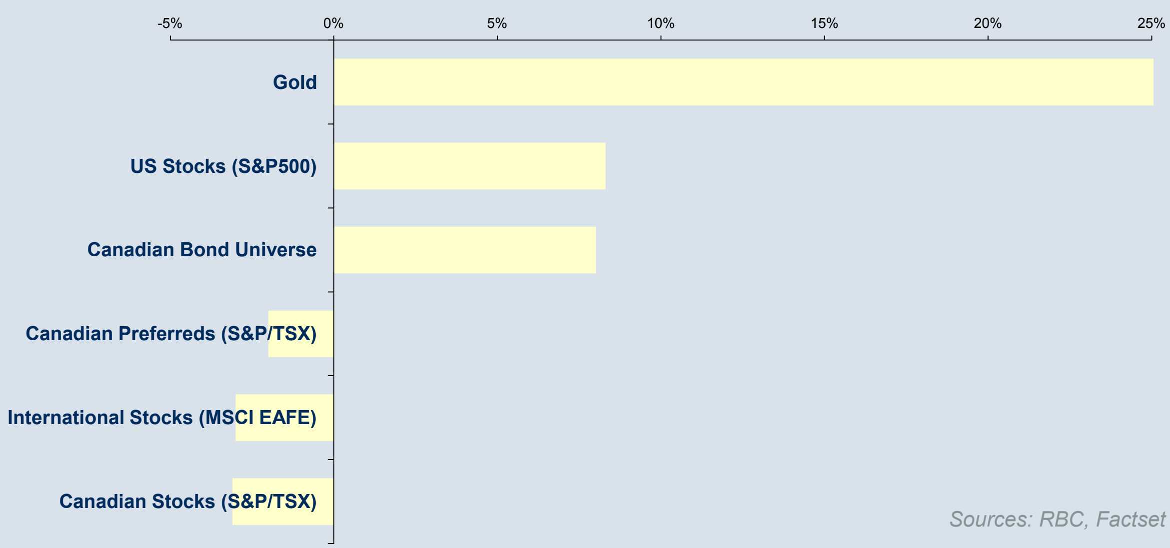
The third quarter of 2020 *began* with continued progress in the battle to contain COVID-19. Financial markets responded positively, and for two months, between July 1 and August 31, global stock markets rose seven percent (MSCI World Index in CAD$). As the "second wave" began to spread in September, some of these gains were lost. Still, the index managed to close out the quarter with a gain of about five percent, resulting in a year to-date **gain** of around three percent overall. Considering the level of disruption to the world economy caused by the pandemic, this is a truly remarkable result. Is the market unsinkable? What's going on?

First, let's take a look to see where this three-percent-return came from. We see on the chart below that US stocks posted a gain of about eight percent, while Canadian and international markets were down about three percent. Since the US market represents some two-thirds of the MSCI World Index, it is clear that the US stock market's gain kept the World Index in positive territory this year. Within the US market, the positive performance has been concentrated in the "new economy" and technology sectors. To wit, if we split the stocks in the S&P500 into two groups, we see that growth stocks (think new economy and tech) were up 24 percent year-to-date, while value stocks (think old economy, dividend stocks, banks) were down nine percent. More about this later. Overall, while many businesses are indeed suffering, it is also true that many are thriving, significantly.

In addition, the loss of income in hard-hit business sectors has been offset with handouts, as governments of the world are near unanimous in delivering extreme monetary and fiscal measures to support their economies, which for now limits downside risk. Unless and until a bout of inflation forces governments to rein in spending, the global economy, and financial markets by extension, should remain afloat.

Moving past the pandemic presumably requires an effective vaccine, and hopes are running high with more than 80 percent of forecasters expecting a COVID-19 vaccine to be widely distributed by mid-2021, up from only 35 percent in June (see www.goodjudgment.io). Let's hope they are right.

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



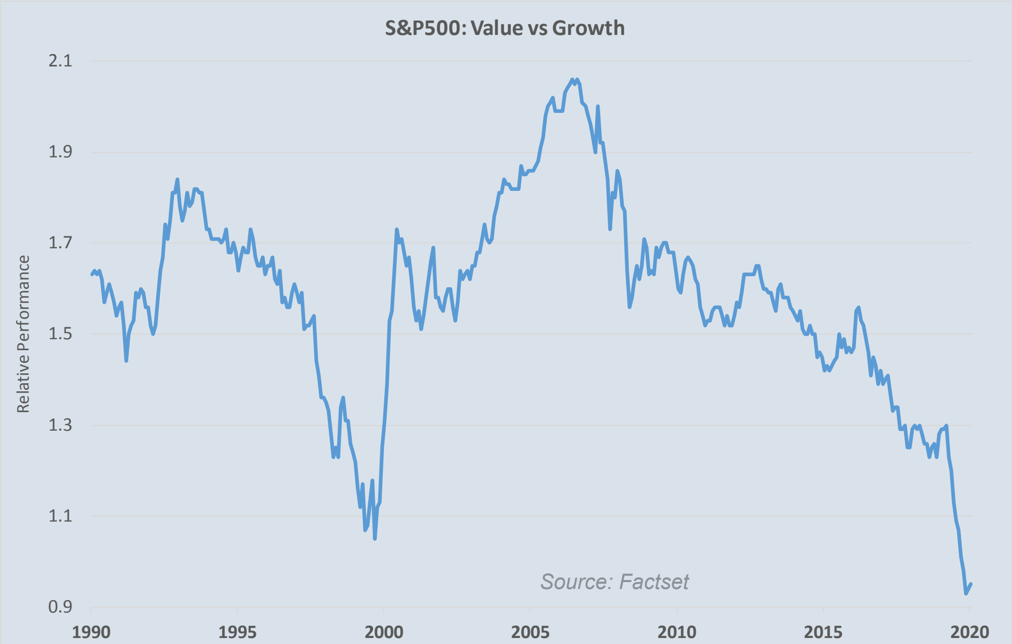
Sources: RBC, Factset

Also noteworthy on the asset performance chart is the large gain for gold. There are at least three reasons for gold's rise: 1) extremely high levels of monetary and fiscal stimulus, mentioned earlier, create fear of inflation down the road; 2) near-zero interest rates means there is little opportunity cost in holding gold versus cash and 3) gold miners have not invested in new mines in nearly a decade, as the gold price was low. Since it takes many years to bring new mines online, demand rising faster than supply means higher prices.

Speaking of inflation, the US central bank, the Federal Reserve (the Fed), recently announced a significant change in its policy framework. The Fed has long held an inflation target of two percent. Historically, this target was considered a maximum rate. In other words, if the inflation rate topped two percent, the Fed would immediately take steps to cool the economy. However, the Fed recently changed, or clarified, its inflation target framework. Rather than saying two percent is a maximum, they now will treat two percent as a long-term average goal. This means, for example, if inflation ran at one percent for five years, they are presumably prepared to allow it to run at three percent for five years, roughly speaking, to wind up with an average of two percent. This is a subtle but profound change in monetary policy, allowing markets to discount "easy" monetary policy, i.e., low interest rates, going further into the future than the Fed would have previously tolerated. The risk, however, is that easy money is somewhat addictive, and it may prove politically difficulty to reign in inflation once it gets underway. This is precisely what happened in the late 1960s and 1970s. Short answer: own some gold in your portfolio (and other tangible assets), just in case.

There's Value in Value Stocks

As mentioned on the previous page, growth stocks have significantly outperformed value stocks so far in 2020 by a huge margin of plus 24 percent versus minus nine percent. Indeed, growth stocks have significantly outperformed value stocks for more than 10 years, as seen on the chart at right. The level of relative underperformance by value stocks, compared to growth stocks, is at its lowest level in more than 30 years.



Some clients and pundits interpret the incredible performance of growth stocks such as Apple, Microsoft, Netflix, Amazon, etc., as a sign that this is the best part of the market to invest in. I take the opposite view. Investment history is littered with the sad results of buying into a trend near its peak -- think dot-com stocks in 1999 or oil stocks in 2008 (remember the "peak oil thesis?"). It seems to me that going against the crowd -- when the crowd has moved to an extreme, is a better plan.

That is the point we seem to be at now. Investors' preference for growth stocks has hit an extreme level, and I would warn against jumping on the bandwagon. Rather, I encourage a contrarian approach: take some profits on growth stocks and accumulate value stocks at currently discounted prices. Practical examples abound - but here's one to illustrate: Suncor Energy is one of Canada's largest integrated energy producers. Suncor's share price hit a high of about CAD$70 in the aforementioned "peak oil peak" of 2008. The price today is about CAD$16 - down almost 80 percent. With a five-percent-dividend yield, and a good chance the shares will more than double or over the next five years, Suncor is a definite buy. People were tripping over themselves to buy at $70 but won't touch it at $16. I get it - the oil business is fraught with issues. But you cannot buy assets for cheap when everything is going swimmingly.

One way I am reflecting this possible trend change in clients' portfolios is by shifting some money from S&P500 ETFs (example IVV), heavily weighted in the large-cap tech growth names, into S&P Value Index ETFs (example IVE).

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From the Planning Notebook

A Financial Health Checklist

It's important to remember that a good investment plan is only one part of an overall effective financial plan. Here are some topics to consider towards the goal of having your overall financial house in order.

1. Maintain a financial projection. Projecting your expected income, expenses, assets and liabilities into the future will help you make better decisions today. Our proprietary "myGPS" program provides invaluable insight, so you can see where your financial life is headed, through retirement and estate planning.

2. Understand your asset allocation. If you have multiple investment accounts at different financial institutions, make sure you create an aggregate view of your overall exposure level to risk (stocks) and capital preservation (bonds, GICs, cash, etc). This mix should be reviewed with a financial advisor, and not arrived at haphazardly.

3. Consider family income-splitting structures. For families with high-income as well as low-income earners, this is a great way to reduce the family tax bill. If you are interested, let me know and I can provide more details and suggest money-saving strategies.

4. Consider life insurance. For those who expect to outlive their wealth, permanent (not term) life insurance is a great tax-free estate planning tool - it's like a TFSA on steroids. If you think this may be a fit for you, please contact me for an initial discussion.

5. Use credit effectively. If you use borrowed money and also have investments, make sure the loans are arranged in such a way that the interest payments are tax deductible.

6. Make sure your Will and Powers of Attorney are up to date. Also review beneficiary designations for any registered plans and life insurance policies to ensure they are up to date. Anyone who has had to deal with a messy estate will tell you this should be a top priority.

7. Review charitable giving plans. Larger personal donations should always be made with appreciated shares, if possible - not with cash. CRA does not charge tax on the capital gain for such donations, and the tax receipt is for the full amount given.

8. Simplify your financial life. If you have too many accounts with too many institutions, consider consolidation. It takes some effort up front but makes your life, and estate planning, a bit easier to manage.

If you would like to discuss any of the above topics in more detail, I am happy to oblige. In any event, please ensure you consult tax and legal experts before implementing any tax or estate strategies.

Until next time, best regards,

David Serber

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

RBC Wealth Management
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