THE COERENTE VIEW

2ND QUARTER 2020

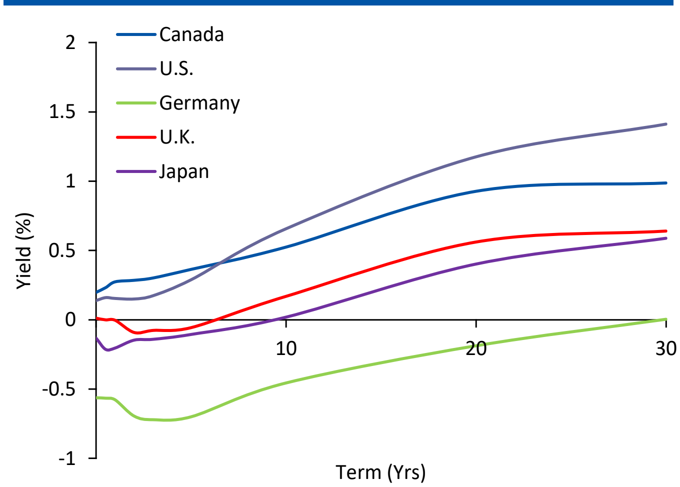
Market Statistics

	Jun/20	Mar/20	Dec/19	Jun/19
Yields (%)				
90 Day T-Bill	0.21	0.26	1.66	1.66
10 Yr. Canada Bond	0.53	0.70	1.70	1.47
30 Yr. Canada Bond	0.99	1.31	1.76	1.69
Rates				
C.P.I. (annual %)	-0.37	0.89	2.25	2.02
US$/C$	0.74	0.71	0.77	0.76
Euro/C$	0.65	0.64	0.69	0.67
Prices (US$)				
Crude Oil (bbl.)	39	20	61	58
Natural Gas (mm)	1.75	1.64	2.19	2.31
Gold (oz.)	1,793	1,583	1,520	1,410

Market Returns

	Periods Ending Jun. 30/20			
			Annualized	
	3 Mo.	1 Yr.	5 Yrs.	10 Yrs.
S&P/TSX	17.0	-2.2	4.5	6.3
S&P 500 (C$)	15.8	11.9	12.7	16.9
S&P 500 (US$)	20.5	7.5	10.7	14.0
MSCI EAFE Net (C$)	10.4	-1.2	3.9	8.4
MSCI EAFE Net (US$)	14.9	-5.1	2.1	5.7
MSCI World Net (C$)	14.7	7.1	8.8	12.7
MSCI World Net (US$)	19.4	2.8	6.9	10.0
Bond Universe	5.9	7.9	4.2	4.6
91 Day T-Bills	0.1	1.6	1.0	0.9

Yield Curves



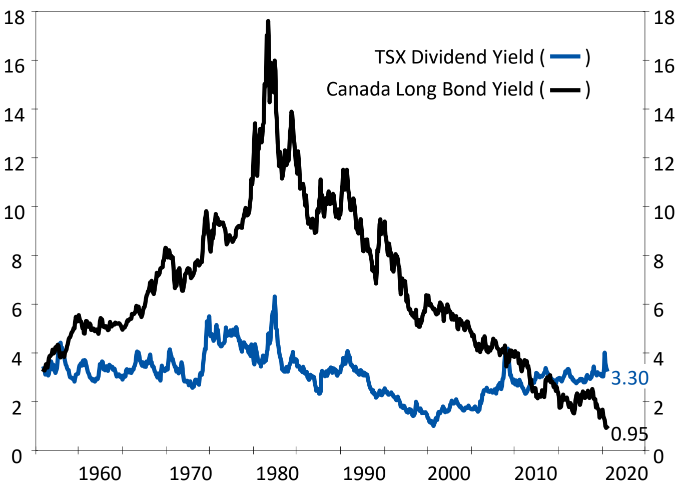
The Economy

You can see it in everyday life. People striving to get back to some kind normalcy. The same is true for corporations as they look to adapt to a new environment pre and post a Covid 19 vaccine. The U.S. has been a good example of what can be expected in a pre-vaccine environment. Coming out of the depths of the pandemic the unemployment rate fell to 11.1% in June, down from 14.7%, but still a far cry from the 3.5% level in February 2020. Not unexpectedly, 40% of the employment gains in June came from the lower wage paying leisure and hospitality sector. Unfortunately, in the larger U.S. states where restaurants and bars re-opened early, another significant rise in infections is being seen. Hospitals are once again reaching their limits in capacity to treat the most severely affected. Shut-downs and restrictions that will hinder employment gains for 2020 and beyond are being reimplemented.

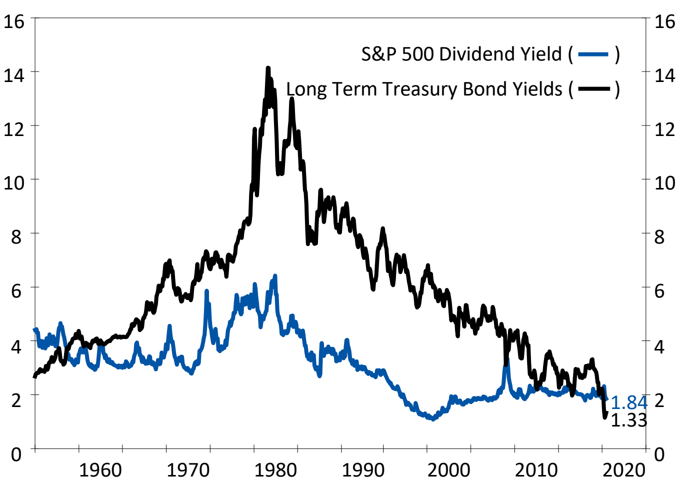
We have seen the evidence in China, South Korea and elsewhere, that as you open up the economy, you will get flare ups in the level of virus infections. Despite individual and corporate desires, the process back to normalcy must be carefully managed. A number of drug companies are suggesting they may have a vaccine by year-end but issues with regard to its effectiveness, safety and distribution will exist. Even in a scenario where a vaccine that is proven to be 70% effective becomes available, it will still be untested for longer-term safety, some people will not want to be vaccinated and among those who do wish to receive the initial doses, determining who should receive them will be a challenge. Furthermore, for those that are inoculated, life does not simply go back to normal as immunity is not guaranteed. Ongoing limits on larger gatherings and mask wearing in public are real possibilities.

The above scenario is an example of one potential medical outcome but most others also suggest that what at first appeared to be an economic recession for 2020, will now likely include at least a sluggish 2021. All the major economies face the same outlook with those that were economically healthy (better balance sheets and higher growth) going into the pandemic having the best outlook moving forward. Massive fiscal deficits are being generated, similar to war years, and central banks are lowering interest rates and buying longer-term bonds at unprecedented levels to hold down both long- and short-term interest rates. “Managing the yield curve” is how some have termed it. Short-term interest rates are near zero and long-term government bond yields have now sunk to the 1% level in Canada and only slightly higher in the U.S. (See chart on left.)

S&P/TSX Dividend Yield vs. Canada Long Bond Yield

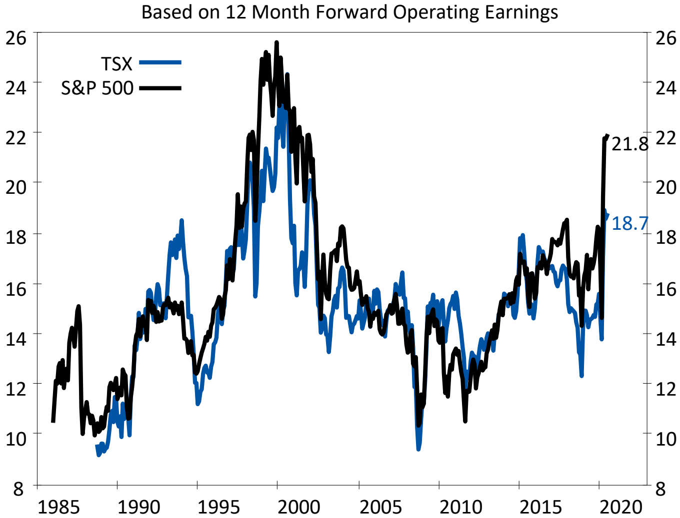


S&P 500 Dividend Yield vs. U.S. Long Bond Yield



Price-Earnings Multiples

Based on 12 Month Forward Operating Earnings



In the U.S., the deficit is now near $2 trillion and a reloading of subsidy and incentive programs is expected to push this into the $3-4 trillion range. Politicians will do everything they can to demonstrate a path to health and economic recovery as elections loom in November. The Canadian deficit will exceed $340 billion and more spending is to come. As all countries overspend it is a race to the bottom with regard to currency values.

The Markets

The second quarter provided a strong recovery from the losses incurred during the first three months of the year. North American equity markets led the world as a result of their sizable weighting in technology stocks. In the U.S., technology-related companies (including those outside the technology subsector - most notably Amazon, Alphabet and Facebook) now comprise almost 40% of the S&P 500 index and they contributed 55% of the index's second quarter return. Their products and services suggest they will do well in a pandemic or post-pandemic environment but valuations are an issue with some companies having very little earnings. Canada is not an exception as Shopify is now the largest company in the country by market value. In the second quarter, its stock alone contributed 4.0% of the 17.0% TSX return while trading at an astounding 60 times sales. Commodity stocks were next in terms of performance but their longer-term prospects appear limited given the slower growth environment facing global economies.

Bonds were also strong in North America as interest rates continued to grind lower. It is now difficult to achieve a 1.0-1.5% yield in any government bond regardless of the maturity. Our use of quality corporate bonds and select preferred shares has allowed us to improve the overall fixed-income yield in portfolios to the 2.5% level. This is, however, still less than the dividend yield available in a portfolio of high-quality equities which remain our favoured asset class.

Valuation levels for stocks have increased as shown by the Price-Earnings chart at left. While the chart uses consensus forecasted earnings to smooth out the major drop in 2020 earnings, reaching an estimate has become more difficult as approximately 40% of companies have suspended giving guidance due to Covid 19. **Clearly, share prices have risen faster than earnings but part of the increase in valuation is directly related to lower interest rates which will not be rising any time soon.** We find greater comfort in having a portfolio dominated by shares of companies in the consumer and healthcare sectors, where earnings are more consistent with dividend streams secure and higher than bond yields.