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The Goodreid Gauge

Spring 2021

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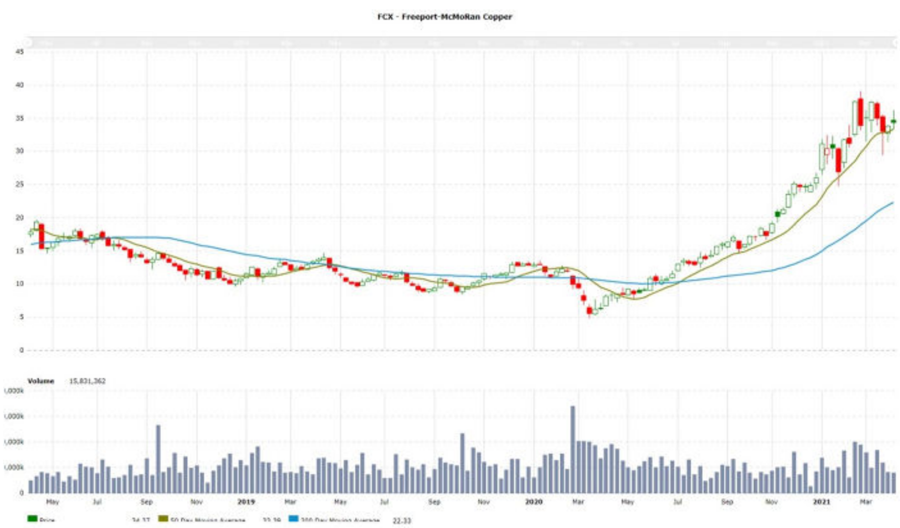
The first quarter of 2021 saw Canadian and U.S. stock markets breaking out to fresh all-time high levels, with total returns of 8.1% for the S&P TSX Composite Index and 6.2% for the S&P 500 Index. In C$ terms, the S&P 500 returned 4.5% as our C$ inched ever higher against the greenback, turning in the best year to date return among G10 currencies. The bond market, as measured by the FTSE Canada Overall Short-Term Bond Index partially offset equity market strength in balanced accounts, with a loss of 0.7%. Finally, the Solactive Laddered Canadian Preferred Share Index tallied a 12.1% total return as the favourable interest rate sensitivity of rate-reset preferred shares regained favour among investors anticipating higher interest rates as the economic recovery strengthens. We concede this asset class has been volatile, having round tripped several times in price terms over the past six years, but reiterate our view that patience is rewarded in preferred shares as they remain a high income, tax advantaged diversifier in an otherwise bond and equity-centric portfolio.

Within the Canadian stock market, sector and style rotation was evident and cyclicality the preferred theme, with standout performances in the energy, financials and consumer discretionary sectors, topped only by the 38% return of the health care sector, which in Canada is a de facto cannabis sector, given the dearth of traditional health care companies in this country. Only the materials sector, which is heavily weighted to gold producers, and the technology sector, which in Canada proxies for the "work from home" theme, suffered losses this past quarter. In the United States all eleven sectors posted gains, but technology stalwarts gave up their longstanding stranglehold on market leadership in favour of energy, financials, industrials and materials – all sectors with characteristically high cyclicality. Healthy and sustainable bull markets feature broad based participation, with most stocks rising, and indeed this was the case this past quarter with 170 of the 230 S&P TSX index constituents rising, and with 400 of 505 S&P 500 index members rising. Also noteworthy was the fact that more than half of index members in both countries outperformed the index itself, or stated differently, the equal weighted indices outperformed the traditional market capitalization weighted indices. This is a significant change from trends of recent years, which if sustained, bodes very well for concentrated and high conviction actively managed portfolios, such as our own, relative to index funds or exchange traded funds which have been so prevalent and popular in recent years, due to their low cost, simplicity and ubiquity. The famous Irish poet Oscar Wilde once quipped that "A fool is someone who knows the price of everything and the value of nothing". We look forward to him being proved right as this economic cycle and bull market plays out.

We remain adamant in our view that a particularly strong economic recovery is unfolding and providing the fundamental foundation that the current bull market in stocks rests upon and will point to several indicators that bear this out. Firstly, and most importantly, the job market is recovering, with net new job creation in 8 of the last ten months creating a cumulative a 2.4 million jobs in Canada during this time frame, and with March payrolls expected to have added a further 100k new jobs. Similar results, albeit on a larger scale have occurred in the United States with net new job creation in ten of the last eleven months creating a cumulative 14 million jobs. Skeptics will note that overall employment remains 3% and 5% below prior peaks in Canada and the United States respectively, and admittedly the "man-in-the-street" perception of recession vs. economic expansion likely differs radically from the economics textbook and investment practitioner understanding of these terms. In fact, though, recessions end, and expansions begin when growth resumes – not when economic data surpass their prior peaks, and there is little doubt that markets respond to this framework, rather than the more populist conception of recession and economic growth. Other important economic indicators have however surpassed their prior peaks, including retail sales, which in Canada exploded upwards out of last April's lockdown induced black hole and now stand 2% above year end 2019 levels, on a seasonally adjusted basis. U.S retail sales followed a similar path such that they are now 7% above year end 2019 levels. Housing prices have rocketed to all time highs in both countries and new housing starts are running about 20% above recent trend levels in Canada and 10% above recent trend levels in the U.S. Robust consumer demand has driven commodity prices (Refinitiv/Core-Commodity CRB Index of 19 major commodities) up a stunning 82% off their year ago lows and back to levels seen at the end of 2019, all while creating supply chain bottlenecks in trucking, rail and most prominently in seaborne freight as the recent grounding of the Ever Given container ship in the Suez Canal brought into focus. The debate rages on as to whether and which commodities may be poised for another commodity "supercycle" versus a garden variety cyclical upturn, with the electrification of the vehicle fleet and the greening of the power grid. For our part, we have recently stepped up our exposure to commodities as well as to robust demand for consumer-packaged goods via ownership of Freeport-McMoRan, a U.S. copper miner and Transcontinental Inc., a Canadian printing and packaging company, both shown below.



Freeport-McMoRan Inc.

Transcontinental Inc.

Without doubt, governments on both sides of the border throughout the last ten months have boldly backstopped households and businesses and overall economic growth along with them, via support programs and transfer payments. A further $1.9 trillion of fiscal stimulus is poised to flow imminently to U.S. households. Beyond this, the Biden administration has tabled an ambitious $2.2 trillion multi-year infrastructure bill that stands a reasonable chance of making its way through Congress in the months ahead. Canada, with its own initiatives has surpassed even these massive U.S. relief and stimulus efforts, considering the relative size of our two economies. The jury is still out as to whether the Trudeau government has political license to keep the fiscal taps wide open in the upcoming budget, but whether they do or do not, the ripple effect of these U.S. programs will favourably impact our own economy, given the trade linkages between the two countries.

Looking forward, North American economies should continue to benefit from the lagged effect of stimulus programs and the ongoing flow of money. When coupled with the pent-up demand for the service sectors of the economy once we move past the pandemic, it is difficult to envision anything but a powerful economic recovery. Certainly, anecdotal evidence and "soft" economic data from surveys indicate that this expectation is widespread and deeply held. The Institute for Supply Management manufacturing purchasing managers index, a widely followed economic expectations survey of 300 large U.S manufacturers recently recorded a reading of 64.7, its highest level since 1983. High levels of corporate confidence are also evidenced by the healthy slate of large-scale mergers and acquisitions - a classically procyclical behaviour among corporations - with the Rogers merger with Shaw Communications, the CP Rail acquisition of Kansas City Southern and the Brookfield Infrastructure takeover bid for Inter Pipeline just three of many examples. Investor appetite for risk taking is evident in several ways, including the fastest start to a year for Canadian initial public offerings in fifteen years, with 32 firms raising a total of $3.26B during the first quarter – more than ten times the Q1 2020 volume - according to data from Bloomberg LP. Elsewhere, investor appetite for SPACs (Special Purpose Acquisition Corporations…. essentially "blank cheque" companies that investors fund in the hopes management will eventually acquire some unspecified business with the proceeds) is off the charts, and who can forget the frenzied orgy of rampant speculation that took place in penny stocks and near bankrupt companies like Gamestop early in the quarter? We welcome the return of corporate and investor confidence and we applaud the libertarian goal of empowering everyday investors that brokerages and robo-advisors like Wealthsimple and Robinhood espouse, but we have watched some of this speculation unfold from the sidelines with at times amusement, at times disbelief and at times consternation. Empowering investors is good but handing a toddler a loaded handgun is not, and we remain concerned that this "empowerment" may come at a very high price to many novice investors.

Finally, returning to the housing market – the largest item on most household balance sheets – household incomes, savings and confidence all remain high, and thus demand is very strong in the face of structurally inadequate supply. Resale market prices are accordingly rising rapidly in many parts of the country. We welcome this tangible sign of household confidence too, but taking a pragmatic and balanced view, we cannot help but wonder when or if we might reach the point of "too much of a good thing". Government and central bankers are now openly musing about and floating the unlikely and surely deeply unpopular idea of eliminating capital gains tax exemptions on the sale of principal residences. Monetary policy is a blunt instrument that cannot easily be micro-targeted to certain sectors of the economy while bypassing others, and thus the situation is somewhat akin to driving with one foot on the gas and one foot on the brake. The monetary policy accelerator is pressed firmly to the floor, with the Bank of Canada having cut overnight interest rates to near zero to ensure smooth functioning of the financial system during the pandemic, but with the attendant side effect of pouring low mortgage rate rocket fuel on the very housing market the federal government wants to tap the brakes on to preserve affordability for first time buyers. The Bank of Canada in a recent speech recognized their role in all of this and signalled their intention to very soon taper their intervention in bond markets, prompting a "taper tantrum" that saw long dated bonds – the likes of which we have deliberately avoided owning – sell off significantly, with the 30 year Canada benchmark bond, for instance, now trading a whopping 25% off it's year ago high – a rather bitter pill indeed for investors in a supposedly risk free asset to swallow. We hope and expect that this situation will be self-correcting as rising bond yields trickle through to mortgage rates, as housing starts support the supply backdrop, and as the work-from-home fever crests. This sector nevertheless bears close watching in the quarters ahead.

As always, there will be both bullish and bearish data and news flow daily. Style, size and sector rotations will occur within the markets, and a great deal of ink will be spilled prognosticating about what it all means, but we believe investors will be better served by resisting the urge to draw sweeping conclusions based on daily gyrations in the markets and the related news flow. The Reddit and Wall Street Bets crowds, if they so choose, can continue their frenzied speculation and over-analysis of every uptick and downtick in micro and macroeconomic data, lining the pockets of their brokers with commission dollars in the process, but in our assessment, the bullish data over time will meaningfully outweigh and outnumber the bearish data - a welcome and investor-friendly scenario indeed, particularly when coupled with what looks like nascent stirrings of a very target rich environment for active and high conviction investment managers like ourselves. Our best counsel to investors is patience and an even temperament, and we, at Goodreid, intend to continue practicing what we preach.

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