Too Far, Too Fast?

EXECUTIVE SUMMARY

glc asset management

2020 Mid-Year
Capital Market Outlook

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Data as of June 15, 2020, unless otherwise stated.

Too Far, Too Fast?

We're moving forward. Society and the economy are encouragingly adapting to COVID-19. But is it enough to justify the extent of the April to June equity market rebound? We don't think so.

"I think we consider too much the good luck of the early bird and not enough the bad luck of the early worm."

~ Franklin D. Roosevelt, 32nd president of the United States,1882-1945.

The economy has begun to heal – economic indicators show early positive signs toward a new, different normal – and we are celebrating. BUT, it's still early days and knowing exactly what the 'new normal' will look like is nearly impossible (see our ***GLC Insights: Crises are Trend Accelerators*** for more). Even putting aside the unfortunate potential for a second-wave setback, we think the sharp recovery for equity markets up to June 15, 2020 is too far, too fast. We anticipate a return of volatility. As such, we currently stand defensively positioned, poised to seize on shifts in sentiment and the expectation of assets repricing from frothy levels.

We hail safe reopening efforts and are encouraged by the better-than-feared early progress. But we must separate hope from strategy, and fundamentals from emotions. While the economic fundamentals are better than expected and we're optimistic about achieving some of the better-case-scenarios, stock markets appear to be getting ahead of themselves, declaring victory when it's barely at half time in what will surely be a long game.

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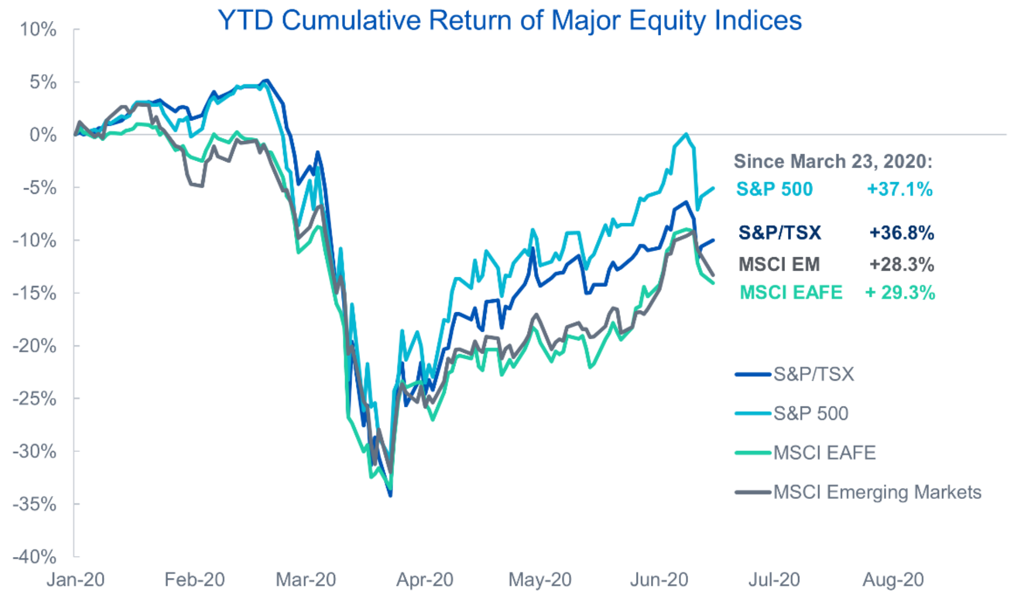
Too Far, Too Fast



The current recession is expected to be (and could turn out to be) deep, but short. This doesn't change the fact that recessions of any kind bring some level of business failures, defaults, restructurings and longer-term damage. The magnitude and extent of these 'second-order impacts' are the focus of our attention as to where we see risks and opportunities in capital markets.

It's all about the fallout and the lasting blow to confidence

As economies re-open and societies adjust, after the euphoria of the initial first steps toward a return to normal fade, we expect lingering damage to consumer, business and investor behaviour and confidence.

Debt – a double-edged sword

Another second-order impact will be managing, coping and moving forward under the massive piles of debt across households, businesses and governments. These now larger debt burdens will restrain economic growth.

Emergency support can't last forever

Globally, equities are being fueled by ample liquidity, including extraordinary government supports. These actions may continue to support equity markets (and risk assets more broadly) despite weak fundamentals. Monetary and fiscal authorities are flooding the system with money that's fueling prices of all assets, both risky and safe, leaving equity markets expensive and sovereign bond yields low. This combination delivers a muted return outlook for the time being.

Bottom line: Our current stance may require patience since the current momentum in equities is very positive. Likewise, room remains for a rotation trade to play out: plenty of bearish views persist; mountains of cash are sitting on the sidelines; and, many individual stocks remain cheap and well off their highs. All these factors are prime fuel that may lead equity markets to further overshoot in the short term. Our view considers this near-term possibility, but then looks further ahead in the investment horizon for the next six to 12 months. We forecast a low single-digit return for fixed income; and a difficult path through year-end for equity markets.

Our base-case scenario:

- Markets experience an initial euphoric release as lockdowns are lifted; bond yields rise mildly and equities overshoot to the upside – this is underway and may have further to run.
- Eventually, sober realities will set in that medium- to longer-term damage has been inflicted and will result in a reckoning that negative second-order impacts are real and will be a drag on growth.
- Markets will recognize the drag on growth and that the winnowing, or removal of, government support measures, will require the economy to stand more on its own.
- There is also the bruising reality that all the efforts and emergency measures to bridge the gap come with costs – higher taxes, lower spending and heavier debt burdens.

GLC Outlook Summary

[1] From November 2019. **Change in view[1]** **Under** **Neutral** **Over**

Fixed income

Bond yields have bounced off historical lows, stabilising at low levels. Credit spreads have come in off their highs. Central bank responses, lower inflation through commodity price pass-through and risk aversion will keep yields lower for longer. Bond yields reflect a greater degree of pessimism than equities, more consistent with a recession. We recommend an overweight to high-quality fixed income as it continues to offer downside protection in the face of elevated uncertainty.

Government bonds, including cash

Government bonds are attractive for their superior risk-mitigation qualities. We see sovereign yields in a 0.30% to 0.90% trading range. We will opportunistically take advantage of relative-duration opportunities within this range.

Investment-grade corporate bonds

Investment-grade (I.G.) corporate bonds are attractive given their mix of yield pickup and modest safety. I.G. spreads widened materially and retreated somewhat with the aid of expansive policy backstops. There's room for price appreciation through time on narrowing spreads, meanwhile there is attractive relative running yield versus the risk.

High-yield corporate bonds

High-yield spreads widened, but by less than moves for other risk assets would suggest. Spreads have narrowed somewhat, running yield is attractive. The U.S. Fed is backstopping U.S. high yield, not so in Canada. Our active fixed-income managers continue to uncover selected unique opportunities through individual security selection where the risk/return trade-offs are appealing.

Equity

A global economic recovery from the COVID-19 containment efforts is unfolding. The magnitude of the rebound is uncertain. Current equity market levels can be justified with select enthusiastically positive scenarios. A sufficient number of other scenarios exist, with reasonable probabilities, that continue to make us cautious. Valuations are elevated. We recommend an underweight position given the uncertainties that may lie ahead.

Canada

Canadian equities face the double impact of a global recession and the collapse in energy prices. The sector composition (favouring cyclicals and value) is poised to see an outsized rebound on improving sentiment, but the outlook for the energy sector warrants some caution. The hefty 3.3% dividend yield provides some buffer.

U.S.

U.S. equities continue to trade at a premium valuation. Fiscal and monetary stimulus are most forceful in the U.S., but the S&P 500 derives significant revenue from global operations. Elevated valuations drive muted return prospects and the 1.8% dividend yield is modest relative to other markets.

International

Longer-term domestic structural issues and a heavily export-oriented footprint for EAFE corporations makes them less attractive in a global recession, impaired global trade and tourism backdrop. Valuations are elevated (but cheaper than peers). A 3% dividend yield is attractive, dividend cut risks are high (historical precedent, plus government restrictions).

Emerging markets

EM equities are sensitive to weak global economic conditions, trade frictions and deglobalization. Abundant global liquidity and softening global financial conditions on waning U.S. dollar strength offset these headwinds. EM equities present a stark risk/reward trade off most appropriate for those with higher risk tolerance and longer time horizons.

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