LORICA
INVESTMENT COUNSEL INC.

September 2020

What We Think…

We are now in the third quarter since the pandemic became a pandemic (according to the World Health Organisation). It is questionable as to whether we are much wiser at dealing with the myriad of problems associated with COVID-19, although we are undeniably, more knowledgeable. We are not scrambling to build more ventilators, because we now know that there are preferable treatments, such as steroids, that have less damaging side effects and better efficacy. And we are not as scared of surface transmission of the virus having seen little evidence of broad spread in this way. But we have not been able to prevent a second wave, and we appear to be facing the same struggles navigating through the rise in cases that we faced in March and April, if not with more difficulty.

In our minds, the prospects for the global economy since the onset of the virus has been all about the prospects for the virus. Of course, outcomes will vary by region, related to ability to mitigate and manage waves of the virus, and dependent upon makeup of specific economies. In most of the west, there are no easy shortcuts, and policies, will only be effective at softening the impact. In contrast, China with its authoritarian government has managed to contain spread and return its domestic economy to something more resembling pre-pandemic activity. Unlike in the spring when populations in the northern hemisphere were heading outdoors, moving indoors with the onset of winter is expected to exacerbate the transmission of the virus. We believe that until there is a widely distributed vaccine or an effective treatment, there is no escaping the stricter societal and behavioural changes that will again be necessary to control the virus. We believe, that even if government policies permit more economic freedom, we would eventually see the consequences of more transmission, that we doubt governments or even individuals would ignore.

Through the summer months, the economic data was cause for some optimism, but always came with the caveat that schools were closed, businesses mostly uninhabited, travel limited and, most importantly, people mostly interacting outdoors. With the transition to fall, the opening of schools and universities and greater movement, was always going to be fraught with difficulties – just how severe, is currently unfolding. It is clear that we are seeing a rise in cases in many parts of Europe and North America. In Canada, it is appearing as a second wave, as it has in France, Spain, England and other European Countries. In some parts of the US, a second wave is also evident, while in other parts, it almost feels that the first wave never really disappeared.

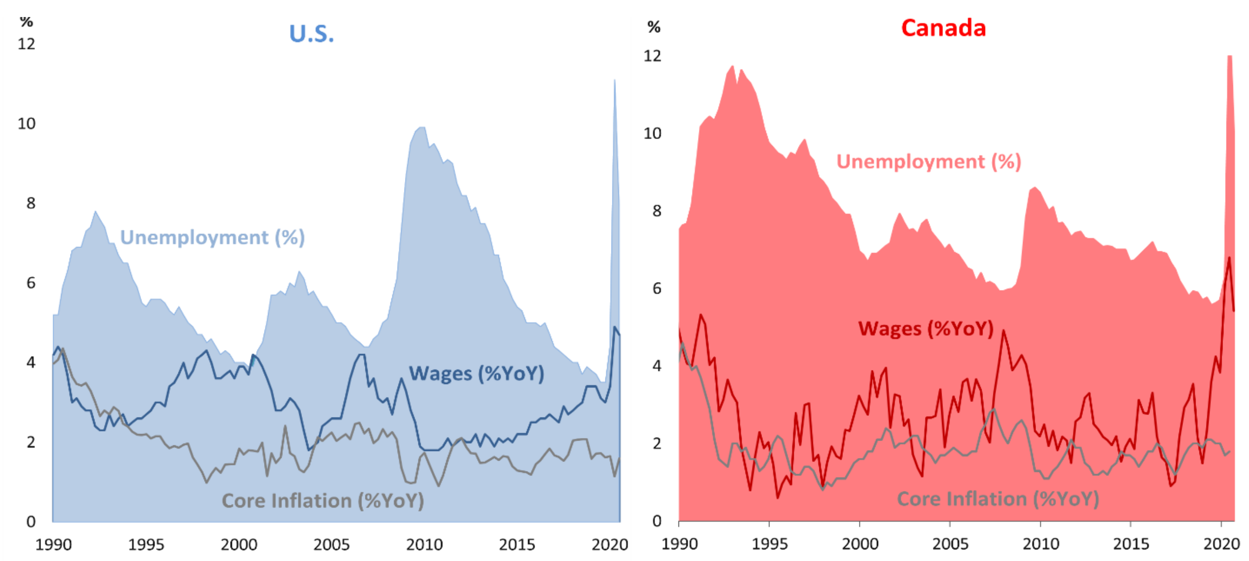
The second wave's arrival comes at a very precarious time. A combination of skepticism and impatience over health policies is making this wave more difficult to deal with than the first. Citizen groups are more vocal in their challenge of government policies and are frustrated by the ongoing personal sacrifices they are being asked to make. Governments are treading a finer line, more reluctant to replay the draconian shut-downs imposed during the first wave, while risking even-more severe outbreaks. In Canada, we have seen significant criticism of some governments in some of the largest provinces – a notable contrast from the spring when there was a feeling of all "being in it together." The situation is even more problematic in the US, with the federal election only weeks away and the electorate more polarised than ever.

More jurisdictions are now tightening restrictions on their service sector in response to a rise in positive COVID cases. Here in Ontario, we have not quite gone back to stage 2, but gyms and bars are closed, and restaurants are restricted to outside dining – something that will be more difficult to sustain as temperatures drop. There is no doubt the economy will inevitably slow from its summertime bounce, perhaps causing us to revisit where we were at the beginning of the pandemic. The spring shutdown led many businesses to furlough workers until their doors could reopen, likely some months later – this was ultimately the case. For those business who have been shutdown again, it is very possible that their doors will not re-open. For other businesses, who have been hanging-on by a thread over the summer, but are now facing a restricted winter, it is possible they will shutdown voluntarily.

The initial rise in unemployment followed by a reversal in the summer is likely to reverse again as some businesses once again furlough workers, downsize permanently, or close altogether. On a global scale, the prospects for employment will depend upon government approaches to business subsidy. In the US, where governments have historically tended to take more of a hands-off approach, one might expect there to be somewhat less likelihood of support for "zombie businesses" and their payrolls. However, the current stalemate between President Trump and Congress over an additional stimulus package, suggests that depth of support for businesses will ultimately depend upon the outcome of the US election. In Canada, additional business support is forthcoming and likely to cushion employment numbers. Just how far the Canadian government will go to support the most challenged sectors such as energy and travel is still in question. Interestingly, many European countries have enacted various forms of worker support schemes, keeping companies afloat and workers employed, albeit not necessarily at work. Ultimately, it may be the least supported economies that prove to be the fastest to recover, but the most volatile in the short-run.

We have little doubt that governments will continue to support households through various welfare schemes. However, in contrast to Q1, when governments blanketed households with cheques, we expect payments to be far more targeted and less generous. Unlike the second and third quarters, when household income actually rose, we believe that this is less likely to be the case going forward. Notably, employed average weekly earnings have seen a substantial increase since the beginning of 2019, which could still be the case going forward. Initially, the increase in wages reflected tight labour markets – unemployment was 4% and falling in the US (see Figure 1) – but, we believe, the recent spike reflects the substantial decline in lower wage service sector employment. Unfortunately, the pandemic has disproportionately targeted lower income workers, who are more likely to be employed in service sector jobs facing restrictions.

Figure 1: US & Canada Unemployment, Wages & Core Inflation

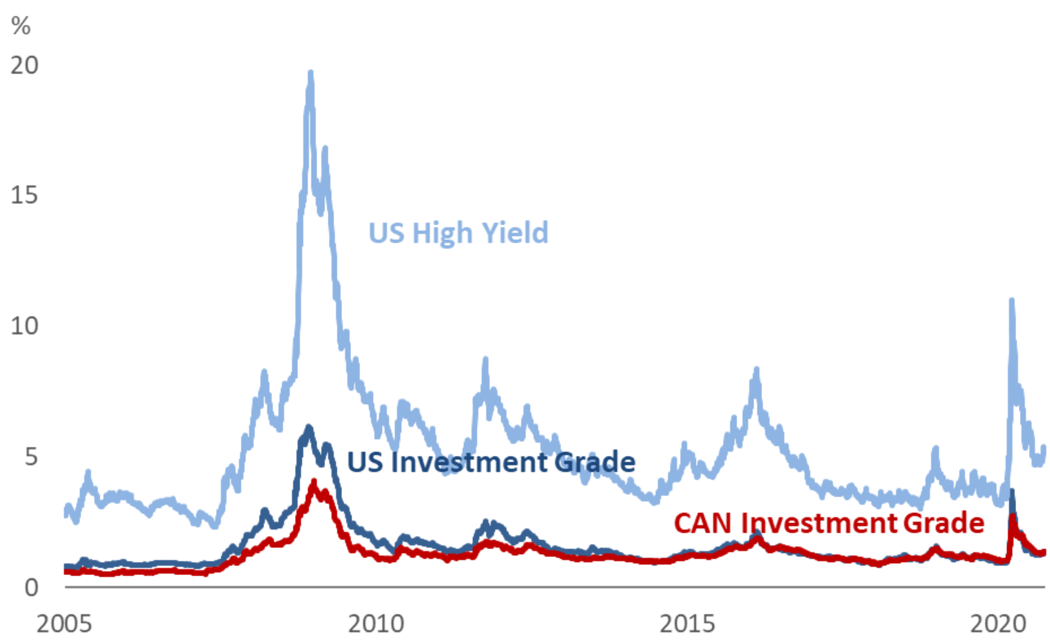


Source: Bloomberg, Bureau of Labor Statistics & Lorica Investment Counsel Inc., October 2020

We expect monetary policies to continue to support the economy as long as the virus is in play. The Fed has indicated its desire to hold rates low through blips of the inflation rate (targeting average inflation), and the Bank of Canada is expected to make similar overtures. Bond purchase programs will continue as long as bond issuance requires it and there is the possibility of yields and yield spreads rising. We have not seen quantitative easing translate to yield curve control (YCC), but we believe it remains a possibility. (See June's commentary for a brief discussion of YCC.) While both the Fed and the BoC have implemented corporate bond purchase programs, neither have actually made significant bond purchases. Both programs, represent a kind-of insurance for the functioning of their respective corporate bond markets and are effective, simply as potential tools to provide liquidity, if necessary.

The implications of a prolonged low-rate and flat-yield curve environment are reminiscent of the period following the financial crisis. (Some may argue that we never really left that environment.) The benefits to the economy of near zero interest rate policy was never really experienced by businesses. It is true that unemployment gradually declined to historical lows, but capital investment and productivity remained disappointing through the twenty-teens. Households did benefit from lower borrowing costs, with debt repayment noticeable in the US, but with unfortunate increase of leverage in Canada. Wage growth, however, was disappointing, only showing positive signs in the last couple of years, and then not well distributed across wage bands. The biggest beneficiary of low-rate policies was capital markets, risk assets in particular. We expect the current environment to be similar. Corporate yield spreads, after an initial knee-jerk widening, have narrowed, even for high yield (see Figure 2). Equity markets are close to historical highs, although high valuations are concentrated in stocks perceived as benefitting from the structural changes hastened by the virus. Arguably, asset valuations do not reflect the risks associated with the underlying economy, but like the period following the credit crisis, investors are betting that monetary policies will sustain the markets until a recovery is in place.

Figure 2: US & Canada Corporate Yield Spreads



Source: Bloomberg & Lorica Investment Counsel Inc., October 2020

The strength of the housing market, particularly in single family dwellings, in both Canada and the US has been an interesting, if not surprising, in light of the pandemic. Low rates have undoubtedly helped families in search of more space, suburban locations and vacation properties. Pent-up demand and less other things to spend money on (such as entertainment and vacations) have also contributed. The uneven impact of the pandemic across wage bands has also meant that homebuyers have been less impacted then renters. Not surprisingly, rents have fallen, and condominium prices have not risen materially. Nonetheless, after some improvement to household balance sheets early-on in the pandemic, households are again taking on more debt, which could signal more problems down the road, especially if the economy is slow to improve. Once again, house prices look particularly vulnerable to higher rates, but not a scenario we would worry about in the medium-term.

The combination of government support and low interest rates is likely to unwittingly sustain undesirable businesses and forestall the eventual economic rebound. However, the longer it takes to broadly distribute a vaccine or deliver effective treatments, the more likely it is that vulnerable businesses will fail. From a credit market perspective, we are more comfortable with businesses that are essential, are not suffering the effects of restrictions, or, better-still, facing increasing demand. A substantial portion of Canadian corporate credits fall into these categories, including financials, utilities, consumer products and communication – roughly half of the Canadian investment grade corporate bond market (according to the FTSE Canada Corporate Bond Index). However, there will also be other tactical opportunities within the balance of the corporate bond market, as investors weigh the fortunes of more vulnerable industries that will fluctuate with the outlook for the virus.

Although the summer months, demonstrated that there can be a sharp rebound in consumer demand, with lesser restrictions, we were then only recovering from several months of restrictions. We do not yet know what is in store for the winter, but there is the potential for a more prolonged period of restraint. By most account, wide deployment of a vaccine is unlikely this year. There are currently eleven vaccines under phase 3 testing (according to the New York Times) of which one Russian and four Chinese developed vaccines have been approved for early or limited use. There are another 14 vaccines in phase 2 testing, and 29 more in phase 1. A couple in phase 3 have already experienced some difficulties (not entirely unexpected). It is also plausible that as we get closer to a viable vaccine, testing becomes more complicated, as the arrival of the best candidates impedes the progress of testing others.

We are positioning our portfolios with the expectation that government yields will remain low for the foreseeable future. The economic hole being dug will take much time to fill and central banks will be compelled to maintain easy policy. We think that it is unlikely that the Fed or the BoC will lower policy rates below zero. However, further stimulus may be required to either put a lid on longer term rates or lower them further. Either way, the goal will be to sustain the flow of credit to business and consumers. The side-effect could be more appreciation to risk-asset valuation. If there was one lesson that we learned during the credit crisis, it was that capital markets will feed on low rates despite poor underlying economic fundamentals.

Gary Morris, CFA
President
T. 647.776.8111 E. info@loricaic.com www.loricaic.com