CHARTBOOK

Market Comment

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Market Comment

Thank you for reading our chartbook, which will now be published on a monthly basis on the first Friday of each month, rather than the previous quarterly schedule. We will continue to publish chartbooks more frequently than monthly during crises, such as we did during March, April and May this year.

As many feared, we have begun to see a resurgence in virus cases in many countries, most notably the United States. Texas, a new virus hotspot, recently announced new closures and restrictions on businesses like bars and restaurants after re-opening just a few weeks ago. This is certainly concerning for the impact it will have on the ability of economies everywhere to re-open without causing new virus flare-ups. Surprisingly, the stock markets have not had much of a reaction to this news, and most markets remain near their recent highs.

Other re-openings have been more successful than this, including in most of Europe, where there have been minimal flare-ups. Europe has been an encouraging example that, if managed well, economies can safely re-open. We are watching the reports of progress toward a vaccine with great interest. Pharmaceutical giants AstraZeneca and Moderna are leading the race. Moving at lightning speed, they are already in mid-to-late stage trials. The successful development of a vaccine this year would be the fastest a vaccine has ever been developed.

We are also closely watching inflation. With so much government spending, we believe that a successful re-opening and/or vaccine coupled with populations returning to employment could be a highly inflationary environment. After the government has handed out relief money to the unemployed, if they return to work they will have money to spend, and may well have pent-up demand to go out and shop after being in lockdown. When everyone is spending, prices tend to rise. This would have a number of very significant consequences for investors and the economy.

Source: Ocean Front Wealth Management, Johns Hopkins University[1], Financial Post[2]

The “Fiscal Cliff”

You may have heard discussions of the “Fiscal Cliff” we may be heading towards. This refers to the end of government and other stimulus measures for individuals and corporations, when these entities will be on their own to support themselves unless stimulus measures are extended.

In Canada, the Canada Emergency Response Benefit (CERB) lasts for 24 weeks. For a worker that started receiving benefits in March or April it will run out in September or October. The Canada Emergency Wage Subsidy (CEWS) ends August 29.

There are other relief measures available to individuals through the banks, utility companies and others. TD Bank, Scotiabank, RBC and CIBC are all offering mortgage payment deferrals for 6 months. Scotiabank advertises that customers can receive payment deferrals on their principal residence as well as three non-principal residences. Financial Post reports that 14% of all mortgages held by chartered Canadian banks are in deferral.

All of this means that these major financial relief measures will begin to run out around the same time September 2020 (if they are not extended). Unemployment in Canada is around 13%. The focus must now be on returning people to work and getting economies running again before we reach this “Fiscal Cliff” in September. It’s difficult for an unemployed person to make mortgage payments, which could have implications for the Canadian real estate market.

Source: Ocean Front Wealth Management, Government of Canada, RBC, TD Bank, Scotiabank, CIBC, Financial Post[3]

The Risks to Bonds

Two of the most important risk factors bonds face are interest rates and inflation. The price of a bond generally moves in the opposite direction to changes in interest rates, so when rates fall like they have been recently, bond market values rise.

Inflation affects bonds in two ways. One way is by reducing the purchasing power of each dollar as prices rise. As a bond investor, you get paid a fixed interest rate (usually) and when the bond matures your principal is returned to you (a fixed amount). If inflation is significant, by the time your principal is returned to you it may purchase significantly fewer goods than it did before you purchased the bond. Note: we are not discussing inflation-linked bonds as they are a relatively small part of the bond market.

The other effect inflation has on bonds is via the interest rate. Interest rates and inflation have an inverse relationship. When interest rates are low, inflation tends to be pushed higher, and when rates are high they tend to push inflation down. For this reason, central banks use the interest rate as a tool to keep inflation at a desirable level, which is usually 2%. This means that when inflation runs higher than 2%, central banks will often raise interest rates to counteract it.

In a situation where there is significant inflation, bond investors are likely to be hit with a double whammy of inflation eroding their purchasing power and central banks raising rates to combat inflation. Furthermore, bond yields are already so low that we feel investors are not being adequately compensated to bear these risks. A 10-year Government of Canada bond currently yields 0.51%, which means that normal inflation of 2% would result in a *real* (inflation-adjusted) return of -1.49%, before any potential interest rate effects.

Inflation is also quite detrimental to cash holdings.

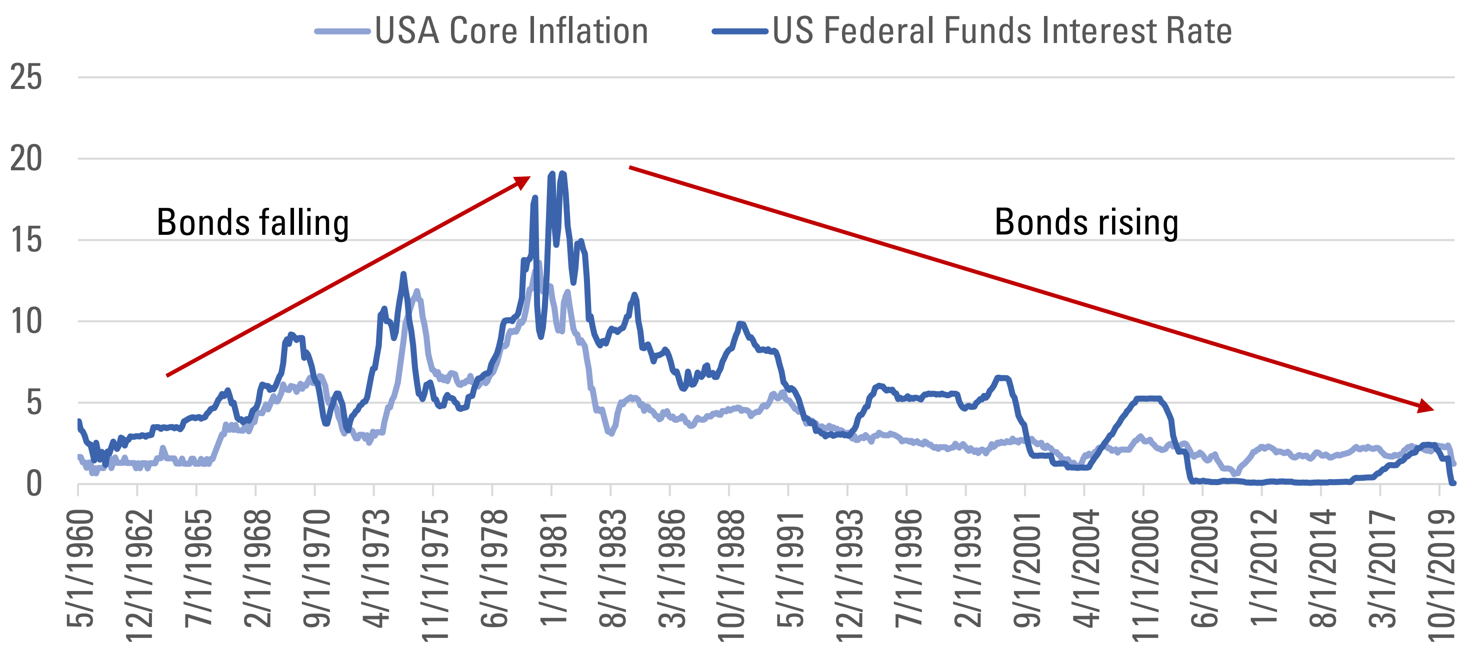
Source: Ocean Front Wealth Management, ritholtz.com[4]

Managing the Risks to Bonds

You can see the relationship between inflation and interest rates below. Notice how inflation reached almost 15% in the 1980's. The Federal Reserve managed to get inflation under control by raising interest rates to almost 20%. Since then, interest rates have fallen to around 0% all over the world, and we even have negative rates in some places. This has been a huge boon to bonds, as their prices rise when interest rates fall.

With rates already at or near zero, bonds will not benefit from a fall in rates like they have since 1980. Without that benefit, the only return to bonds would be from their yield. The average yield on a Aaa rated corporate bond in the US is about 2.4%, inflation and/or rising interest rates could make this return zero or negative. The 1960-1980 period was very poor for bond returns.

We are managing this risk in a combination of ways in our different portfolio mandates. For example, certain assets tend to increase in price with inflation, including gold and stocks. One of our strategies in portfolios with a fixed income component is to hold a mix of these assets because gold, stocks and bonds tend to have somewhat complementary risk/return profiles. This helps to balance some of their respective risks, and finding the right mix is important.



Another strategy is to own some higher-yielding assets such as high-yield bonds and/or certain dividend paying stocks, as these provide a greater margin of safety against inflation due to their higher yield.

Source: Ocean Front Wealth Management, US Federal Reserve Bank of St. Louis[6], ritholtz.com[4]

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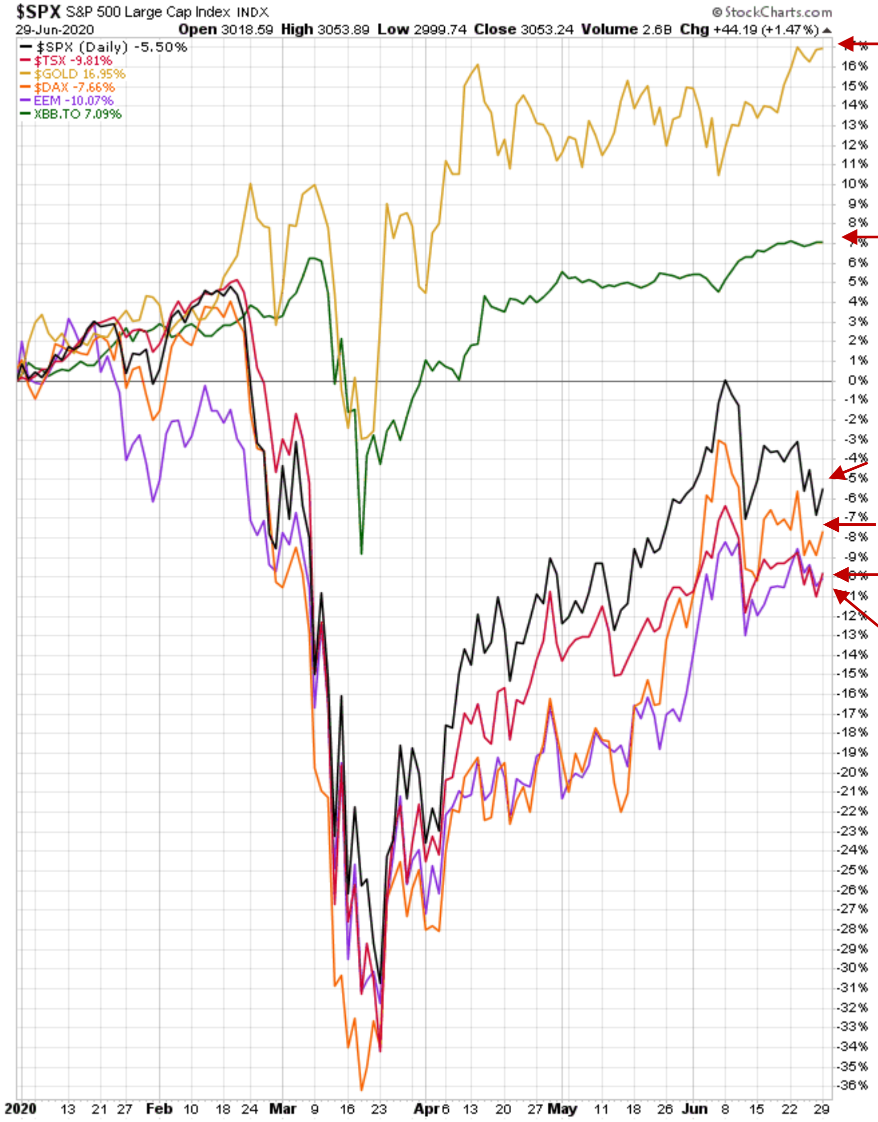
Select Asset Returns Year-to-date



Gold: 17%

Canadian Bond Universe Index: 7.1%

S&P500: -5.5%

German DAX: -7.7%

TSX: -9.8%

Emerging Market Equity: -10.1%

This year it has paid to own a mix of assets, as the returns of gold and bonds have balanced some of the negative returns of equities.

Earlier this year we added to and/or initiated positions in gold bullion across all of our portfolio mandates with the exception of equity-only mandates, in part as a hedge against inflation as it presents a significant risk to bond holdings (as discussed in previous slides).

Returns as of June 29, 2020

Source: Ocean Front Wealth Management, Stockcharts.com

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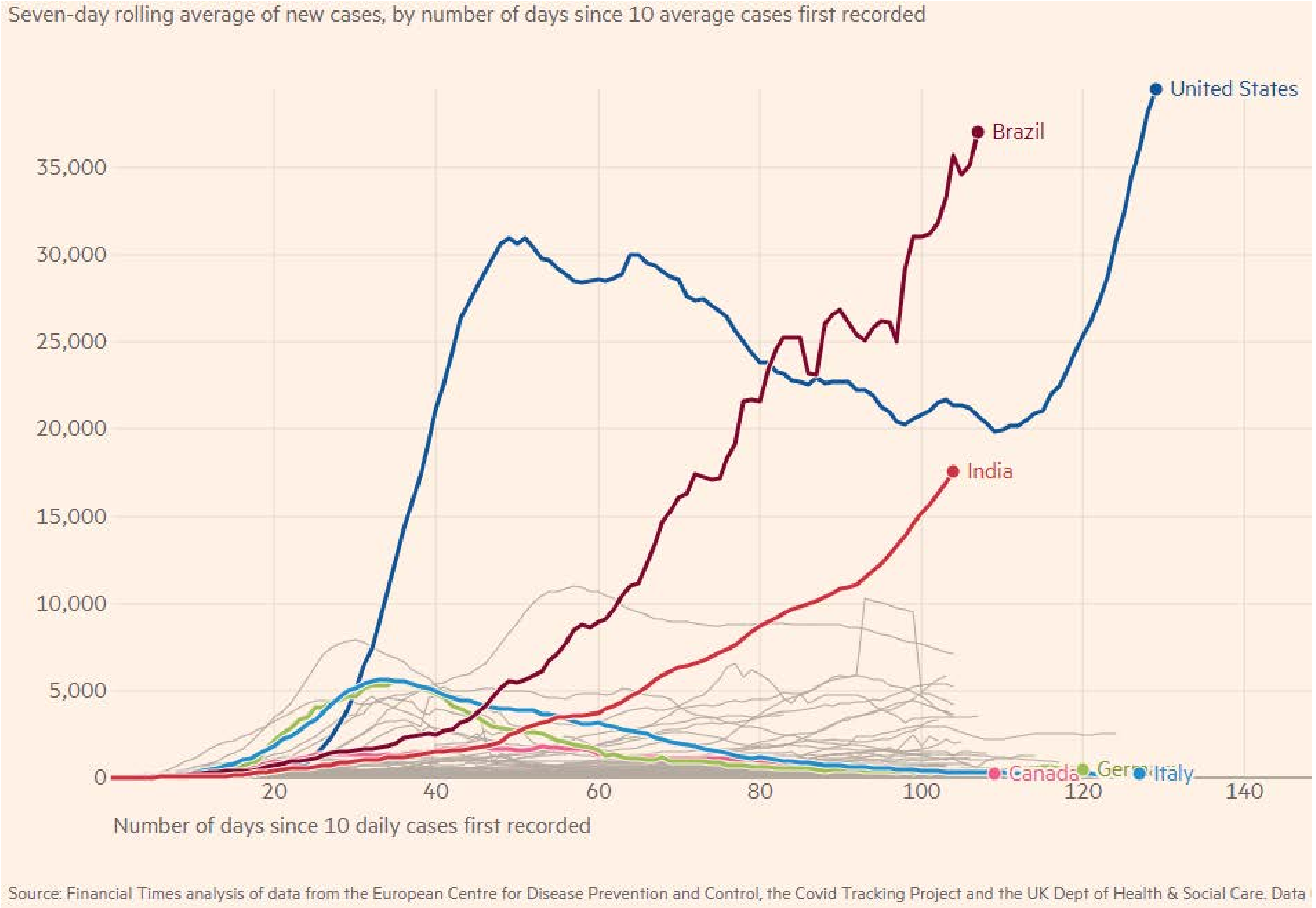
COVID-19 New Case Growth in Select Countries

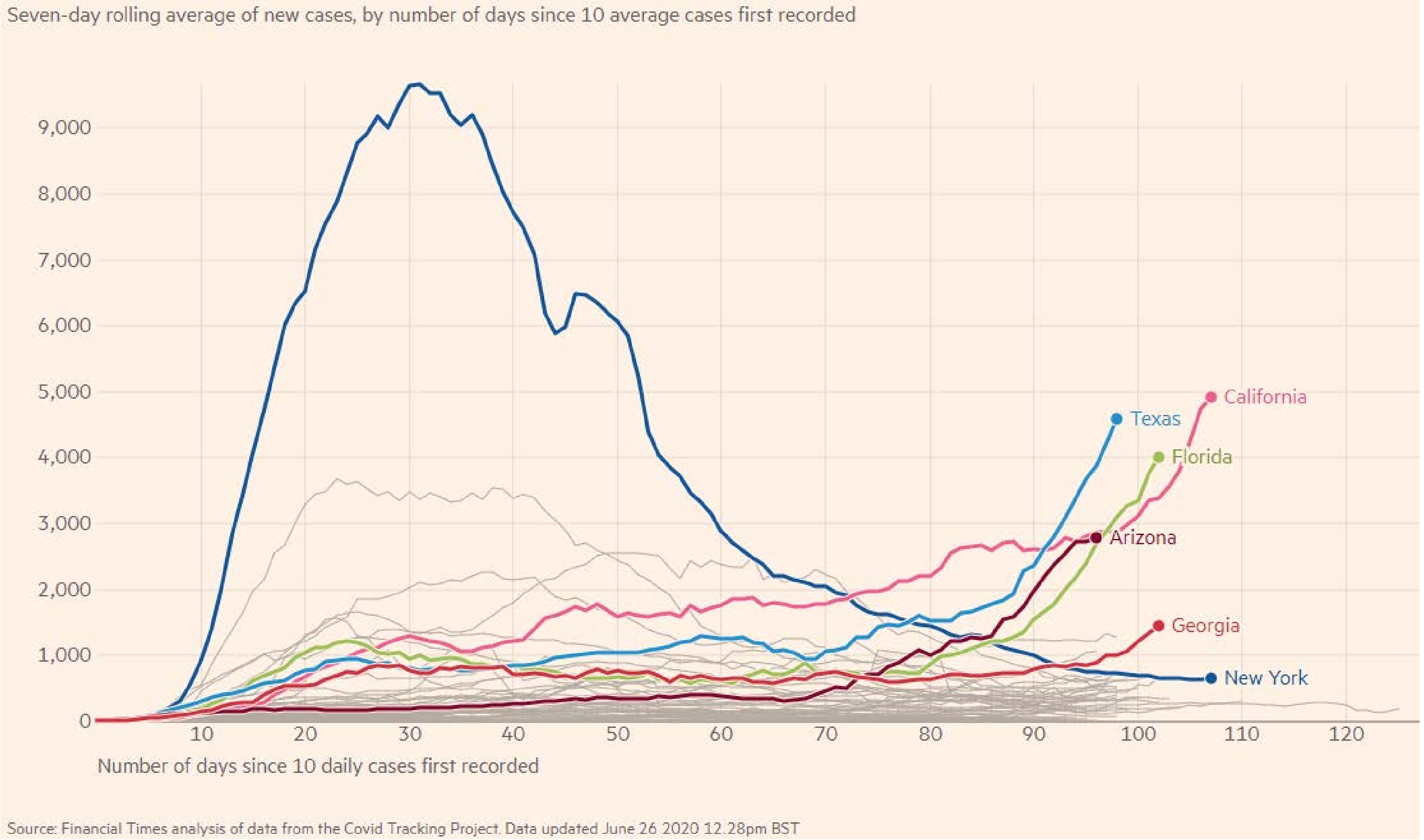


US case growth has re-accelerated and is growing exponentially along with Brazil's and India's. Unlike the US, most western countries have maintained low levels of growth since the initial spike, including Canada, Germany and Italy.

Trump has blamed the increased case numbers on the increase of testing in the US, but the positive test rate has also increased.

Source: Financial Times[5], Ocean Front Wealth Management

COVID-19 New Case Growth in US States



The virus has subsided in New York, but is now growing rapidly in Texas, California, Florida, Arizona and Georgia.

This could potentially have implications for the US election in November if voters in these states disapprove of the Trump administration's handling of the virus response. With the exception of California, these hard-hit states are probably must-wins for Trump.

Source: Financial Times[5], Ocean Front Wealth Management

Stock Market Election Predictor Model

PRESIDENTIAL PREDICTOR: The S&P 500's Price Return July 31 thru Oct. 31 Has Typically Been a Reliable Indicator of Reelection or Replacement

Election Year	Candidates: Democrat	Candidates: Republican	S&P 500 Aug.-Oct.	Correct Prediction?: Reelection	Correct Prediction?: Replacement
1944	FDR	Dewey	0.6	1	
1948	Truman	Dewey	4.4	1	
1952	Stevenson	Eisenhower	(3.5)		1
1956	Stevenson	Eisenhower	(7.7)		0
1960	Kennedy	Nixon	(3.8)		1
1964	Johnson	Goldwater	2.0	1	
1968	Humphrey	Nixon	5.8	0	
1972	McGovern	Nixon	3.9	1	
1976	Carter	Ford	(0.5)		1
1980	Carter	Reagan	4.8	0	
1984	Mondale	Reagan	10.2	1	
1988	Dukakis	Bush	2.6	1	
1992	Clinton	Bush	(1.3)		1
1996	Clinton	Dole	10.2	1	
2000	Gore	Bush	(0.1)		1
2004	Kerry	Bush	2.6	1	
2008	Obama	McCain	(23.6)		1
2012	Obama	Romney	2.4	1	
			Success Rate	82%	86%

Source: S&P Global Market Intelligence. Past performance is no guarantee of future results.

Dating back to 1944, the return on the S&P500 in the three months prior to a presidential election has been a reliable predictor of the election result: an 82% success rate predicting reelection and an 86% success rate predicting replacement.

If the market return is positive from July 31 – Oct 31, it predicts the candidate from the incumbent party will win. A negative return predicts a change of the party controlling the White House.

2016 is not shown here, but the S&P500 return of -2.2% from July 31, 2016 to Oct 31, 2016 correctly predicted the Democrats being replaced in the White House.

The next slide explores what impact the election could have on portfolio returns.

Source: Ocean Front Wealth Management, S&P Global Market Intelligence

Market Returns Under US Governments

S&P 500 Calendar Year Price Returns During Periods of U.S. Political Unity and Gridlock

Political Scenarios	% Change	# Years
Unified Government	10.9%	28
>Democratic President	9.8%	22
>Republican President	15.1%	6
Unified Congress	7.2%	32
>Democratic President	12.1%	10
>Republican President	4.9%	22
Split Congress	6.9%	12
>Democratic President	13.6%	4
>Republican President	3.5%	8
All Years	**8.6%**	**72**

Source: S&P Global Market Intelligence. Data: 12/31/44-12/31/1
Past performance is no guarantee of future results.

The chart on the left shows the return of the S&P500 under different US governments, classified by which party controls the presidency and each house of congress.

Although it is a small sample size in the chart, markets tend to perform better when the Republican party has control of all three options (highlighted) as right-wing policies like lower corporate taxes and less regulation favor businesses. That combination is highly unlikely to occur this time, as the Democrats are favored to hold the house, Republicans to hold the senate, and Biden is leading Trump in the polls. This suggests one of the "Split Congress" combinations.

Notice that although there is a wide range of possible returns, all the returns are positive. This is a good example of how stock markets tend to rise over the long term.

Source: Ocean Front Wealth Management, S&P Global Market Intelligence

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Source: Ocean Front Wealth Management

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