GUARDIAN CAPITAL

Economic Outlook

SUMMARY

- The outlook has improved markedly and broadly in recent months, thanks to the rapid development of evidently highly effective vaccines (plural!), which have raised the odds of returning to something close to what was the norm just a year ago when a global pandemic was simply an extreme and low probability scenario for risk models.
- The expectation of strong, above-trend growth over the coming year, combined with the commitment from central banks around the world to keep monetary policy highly accommodative for the foreseeable future, suggests the general economic backdrop for 2021 should be constructive for risk assets such as equities and corporate credit.
- But, with that in mind, the more near-term outlook remains challenging and the recovery is likely to take a step back as the resurgence of COVID-19 has necessitated reinstituting lockdowns across the world, particularly in the Developed Markets.
- In other words, after making some material progress through the middle of last year, the global economic recovery took a step back as 2020 ended and is starting the New Year on its back foot.
- As such, the prospect of a sentiment-driven resurgence of market volatility in the coming weeks and months remains very much on the table.
- There is reason, however, to argue that there is plenty of scope for the global economy to get its feet under it in earnest, such that it can again take cautious steps forward in the not-too-distant future and pick up the pace to a brisk run by year-end.
- As such, maintaining a disciplined and long-term focus on broader underlying macroeconomic themes, and managing risk exposures accordingly, will likely be paramount in helping block out any near-term market noise.
- Last year was tumultuous and the coming months are likely to be challenging, but it appears that better days do lie ahead and they may well be here sooner rather than later.

2021: Moving forward hopefully, but not before taking a step back

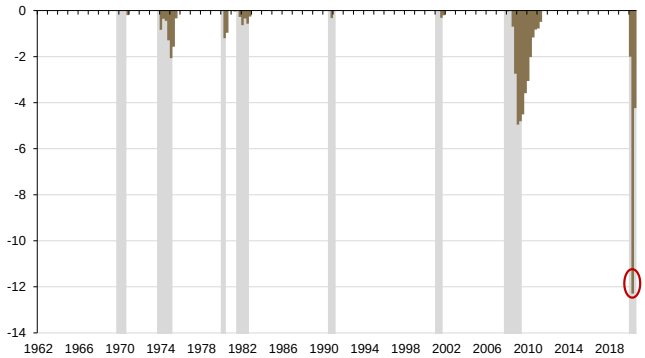
The start of a new year always brings with it the hopes of better things to come. And after what the entire world endured in 2020 — especially the last 10 months in which the frequency of using the word "unprecedented" was… unprecedented — such aspirations have rarely ever been so great (and desperate) for so many as they are right now; as the calendar rolls over into 2021.

The public health crisis that turned into a global economic crisis dealt a shock to the world of a magnitude with no parallel in modern times.

Activity plunged across the G7 economies (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States which, cumulatively, account for roughly one-third of global output) in the first half of 2020, more than doubling the peak-to-trough drop recorded in the aftermath of the financial crisis of 2008/09, a period that had served as the multi-generational recessionary benchmark.

CHART 1: LONGING FOR PRECEDENTED TIMES

G7 real gross domestic product drawdown from peak
(percent)



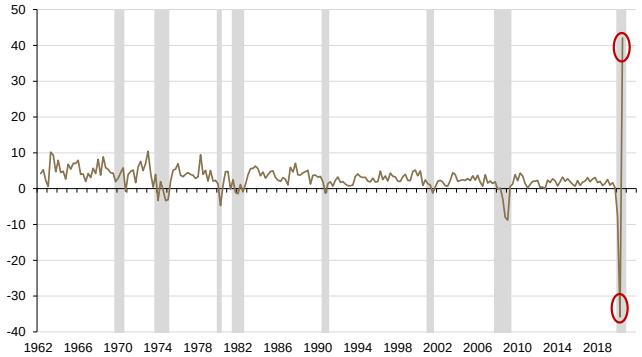
Data to Q3 2020
Shaded regions represent periods of US recession
Source: IMF, OECD, Bloomberg, Guardian Capital

As has been noted in this space before, though, the nature of this shock is distinctly different from those experienced in modern times. The collapse in activity was not the result of overly tight credit conditions that stymied both business and household demand but, instead, was due to a supply-side shock that prevented business from carrying on.

Indeed, as restrictions on activity were eased globally through the late spring and summer, in response to the falling rates of contagion, activity snapped back in historically rapid fashion.

CHART 2: GROWTH ABOUT-FACE

G7 real gross domestic product growth
(quarter-over-quarter percent change; annualized rate)

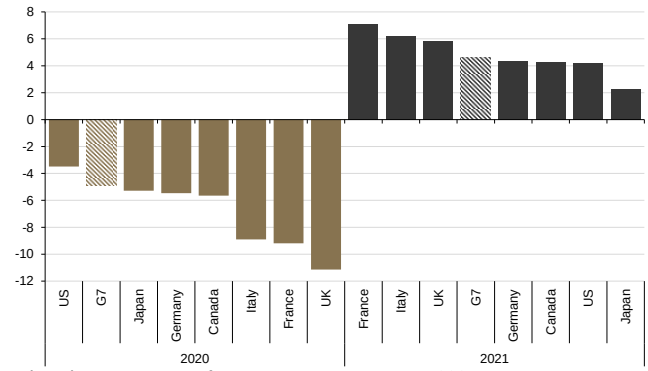


Data to Q3 2020
Shaded regions represent periods of US recession
Source: IMF, OECD Bloomberg, Guardian Capital

In a similar manner, the expectation is that after the sharp and broad decline in output in 2020, the anticipated reopening of activity over the coming year will give way to synchronized and above-prior-trend growth across the world in 2021.

CHART 3: LOOKING UP FOR THE OUTLOOK

Real gross domestic product growth
(year-over-year percent change)



Bloomberg consensus forecasts as at January 15, 2021
Source: OECD, IMF, Bloomberg, Guardian Capital

Just one thing

Of course, for these expectations to be fully realized there is one fairly big caveat: the world must make considerable progress in managing the pandemic.

There is no separating the economic outlook and that of the health of those comprising the economy.

If the population is ill, or concerned about getting ill, there is no way things return to what used to be normal. No matter the degree that governments remove restrictions on activity, the persistent threat of contracting the severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2), or COVID-19, will be enough to keep a material portion of the population from fully re-engaging in the economy.

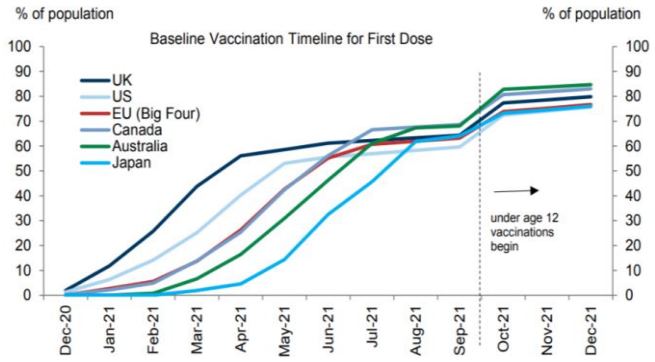
Thankfully, though, the miracle of modern science has provided plenty of reason to be optimistic that this main source of the hardships experienced in 2020 will soon be in the rearview mirror.

It is truly a testament to the capabilities of humankind that in only a year since the first recorded case of the disease caused by the SARS-CoV-2 (COVID-19) there are *multiple* vaccines that have not only been developed, but also passed through full phase trials, gone into mass production and are already being distributed and administered.

As things currently stand, the expectation is that inoculation of a majority of the population in Developed Markets (DM) will occur in the first half of 2021, and effectively anybody that wants a shot will have been able to get a dose by the end of this year.

CHART 4: A SHOT IN THE ARM

Baseline timeline for first dose of COVID-19 vaccine



Estimates as at January 10, 2021
Source: Goldman Sachs Investment Research

That is truly remarkable and represents a bright light at the end of the tunnel following a year that largely had the world feeling around blindly in the dark, merely searching for the handrails.

As such, there is hope for the coming year that life could well return to something close to the norm of just a scant 12 months ago, when a global pandemic was simply an extreme and low probability scenario for risk models.

Not quite yet

While closing this chapter of world history is something to which virtually everybody is greatly looking forward, that bright light remains on the horizon, and the world remains very much in the tunnel. In fact, based on the vaccination timeline, basically, we are sitting right at the halfway point.

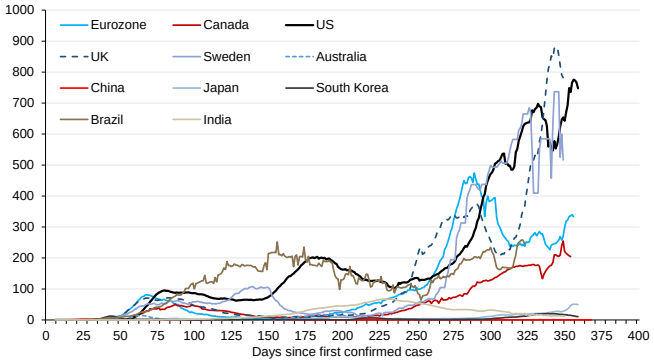
Furthermore, the next stretch of track is looking like it is in pretty rough shape, which could well result in more starts and stops over the near-term that could hinder the economic locomotive's ability to get back up to cruising speed.

The pandemic is not yet over and, after moderating over the summer, there has been an aggressive resurgence of the spread of COVID-19 (especially in the Western world).

CHART 5: SCALING NEW HEIGHTS

New confirmed cases of COVID-19

(case per million people, seven-day moving average)

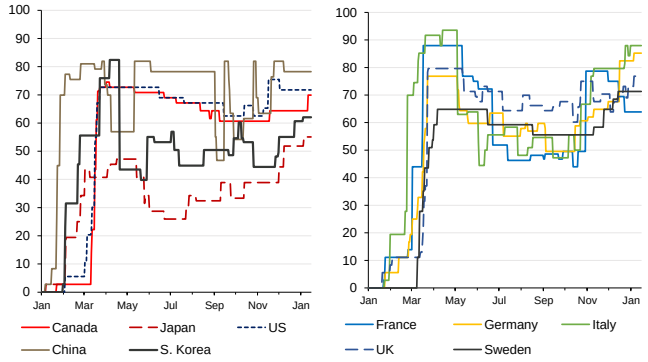


Data to January 14, 2020
Source: Bloomberg, Johns Hopkins University, Guardian Capital

While it is not at all desirable or generally politically palatable, the contagion has once again necessitated implementing stringent restrictions on activity to try to prevent further spread and mitigate the strain on healthcare systems. Across the world, we see reinstituted lockdown measures.

CHART 6: TIGHTENING UP… AGAIN…

Government response stringency index
(index)

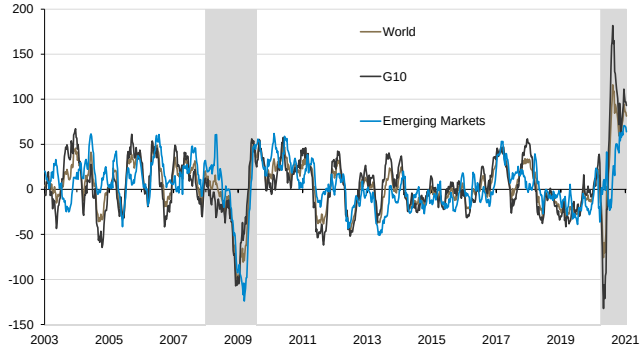


Data to January 15, 2021
Source: Oxford COVID-19 Government Response Tracker, Guardian Capital

To this point in the new wave of infection, however, macroeconomic indicators have proven to be fairly resilient. The dataflow has persistently held up much better than expected, as indicated by "economic surprise" indexes across the globe remaining well entrenched in positive territory.

CHART 7: I HAVE TO ADMIT I'M QUITE SURPRISED

Citi economic surprise index
(diffusion index; >0 denotes reports exceeding expectations)



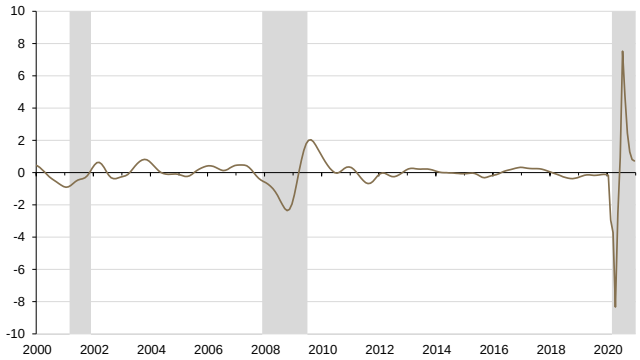
Data to January 15, 2021
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

That said, there is a difference between "better than expected" and better in an absolute sense. It seems as though the strong readings for these "surprise" indicators are more due to deteriorating expectations amid renewed COVID-19 lockdown measures than actual overtly positive data points.

Indeed, growth in the aggregated composite leading economic indicator for the 37 industrialized economies of the Organisation for Economic Cooperation and Development (OECD) and six other major Emerging Market (EM) economies has slowed — though remained positive — in recent months in a sign that the global economic recovery is quickly losing momentum.

CHART 8: FOLLOW THE LEADER

OECD+ Composite Leading Economic Indicator
(index; >100 denotes above trend growth)

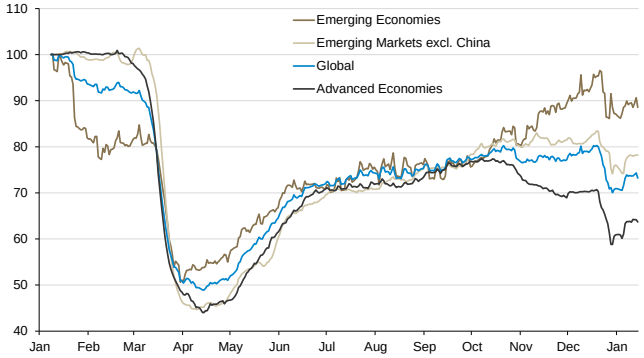


Data to December 2020
Shaded regions represent periods of US recession
Source: OECD, Bloomberg, Guardian Capital

Further, other indicators that capture high-frequency consumer mobility data show activity fell off notably through Q4 and started the New Year on a low note as COVID-19 related lockdowns once again idled large swaths of the economy (especially in the DM).

CHART 9: SHELTER IN PLACE

Bloomberg alternative high-frequency activity indicator
(index; January 8, 2020 = 100)

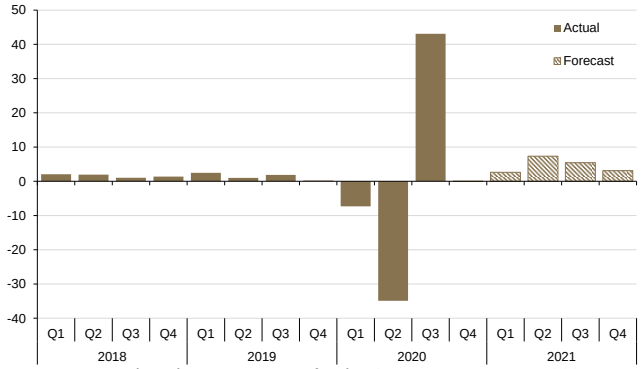


Data to January 14, 2021
Source: Bloomberg, Guardian Capital

Against this, expectations are rising that the New Year will start with more commiseration than celebration as the global economy's strong rebound from last spring's pandemic-induced (broader scale) shutdowns takes a step back, until there are signs that the rate of infection starts to slow materially, and the growing strain on the healthcare system's increasingly limited capacity is somewhat alleviated.

CHART 10: STARTING THE NEW YEAR FROM A STOP

G7 real gross domestic product growth
(annualized quarter-over-quarter percent change)



Forecasts are Bloomberg consensus for the G7 as at January 15, 2021
Source: IMF, OECD, Bloomberg, Guardian Capital

In other words, after making some material progress through the middle of last year, the global economic recovery took a step back as 2020 ended and is starting 2021 on its back foot.

Conspicuous consumption

There is reason, however, to argue that there is plenty of scope for the global economy to get its feet under it in earnest, such that it can again take cautious steps forward in the not-too-distant future and pick up the pace to a brisk run thereafter.

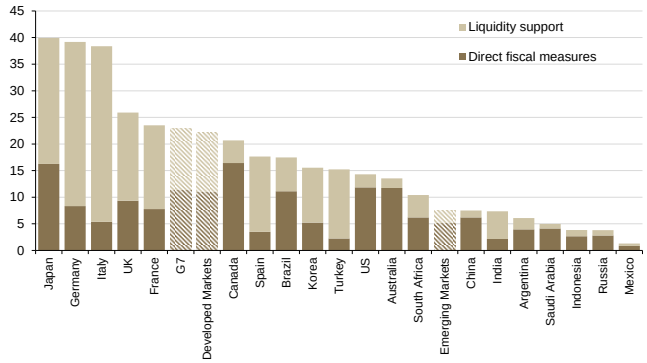
In addition to the vaccine-related optimism, there are some other fundamental reasons to anticipate that better days are, in fact, ahead.

For starters, while it has indeed been the case that there has been substantial job loss as a result of economic stringency measures, governments worldwide have unleashed a torrent of fiscal aid to help keep households and businesses afloat through theses crises.

The International Monetary Fund (IMF) estimated in October the G7 had committed more than US$8.5 trillion (equivalent to nearly a quarter of the group's aggregated gross domestic product) to COVID-19-related relief measures and other initiatives (such as private loan payment deferral programs). That tally has since increased with the recently passed US$900 billion package in the US that will likely be supplemented by further stimulus under the new and unified American government in the coming months (though, the Democrats' slim margin in the Senate will likely restrict the ability to pass other large-scale spending initiatives).

CHART 11: QUITE THE RESPONSE

G20 COVID-19 fiscal response
(percent of gross domestic product)

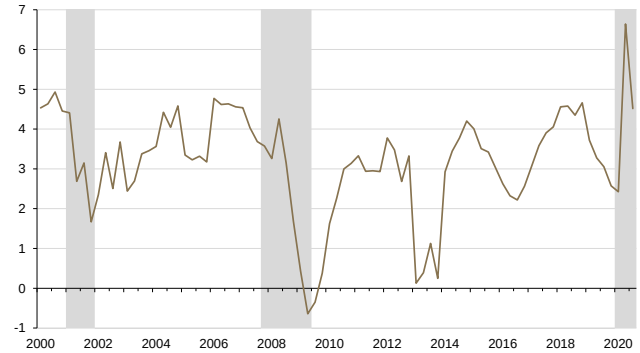


Data as per the IMF's October 2020 Fiscal Monitor
Source: IMF, Guardian Capital

One of the biggest effects of these direct cash transfers from the government is that, in contrast to other period of recession, household disposable incomes have actually increased (and markedly so) even as output collapsed across the G7 economies.

CHART 12: BREAKING THE CYCLE

G7 personal disposable income growth
(year-over-year percent change)



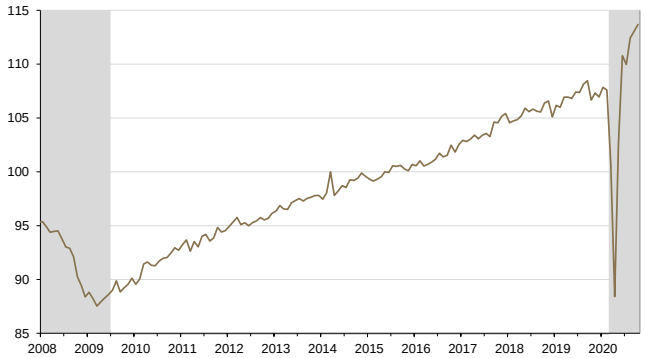
Data to Q3 2020
Shaded regions represent periods of US recession
Source: IMF, OECD, Bloomberg, Guardian Capital

Unsurprisingly, this cash infusion played a large role in underpinning the rapid recovery in consumer spending (which accounts for nearly two-thirds of economic output across the major DM), that drove the broader snapback in global growth last year.

For example, retail sales across the G7 recovered from their March and April plunge in just two months and have maintained a strong upward trajectory.

CHART 13: RETAIL RECOVERY

G7 retail trade volumes
(index; 2015=100)



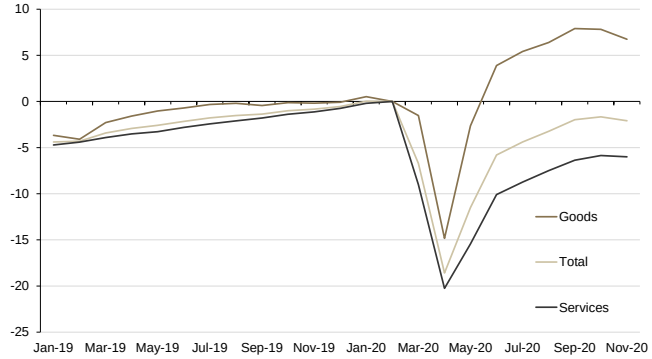
Data to October 2020
Shaded regions represent periods of US recession
Source: OECD, Bloomberg, Guardian Capital

Importantly, though, retail sales predominantly reflect tangible goods (for which brick-and-mortar shopping can readily be replaced with home delivery) rather than consumer services (which cannot). Typically the latter accounts for the bulk of household spending.

So, while it has been the case that consumers have been able to continue to buy goods as normal, the lockdown measures in place have prevented overall household spending from staging a full recovery.

CHART 14: IN NEED OF SERVICE

US nominal personal consumer expenditure
(percent change since February 2020)

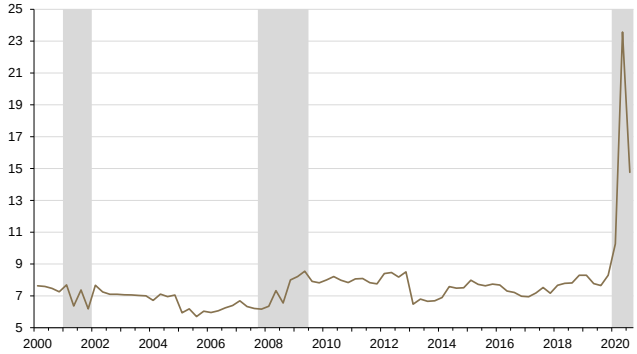


Data to November 2020
Source: US Bureau of Economic Analysis, Bloomberg, Guardian Capital

The strength in income and the still subdued overall spending has resulted in a surplus of funds. In contrast to a typical recessionary environment, where households are forced to drain rainy day funds to make ends meet during more difficult labour markets, savings rates have spiked.

CHART 15: BURSTING PIGGY BANKS

G7 personal savings rate
(savings as a percent of disposable income)



Data to Q3 2020
Source: OECD, Bloomberg, Guardian Capital

That would suggest that there is still ample scope for consumers to play a big role in recovery going forward. This is a big part of the emerging narrative positing that the world could be in store for a repeat of the "Roaring Twenties", where people that have been living under restrictions go on a multi-year spending binge once the coast is clear; mirroring the experience in the 1920s in the aftermath of World War I and the Spanish Flu. In our current situation, it might well just be going to movies, attending sporting events, traveling, etc., those luxuries of life that had to be forgone during the pandemic.

Home is where the heart is

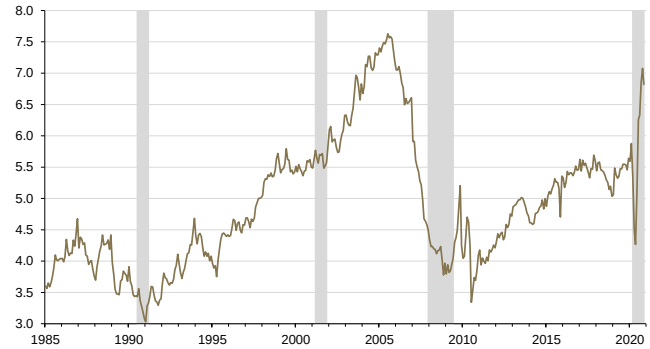
The surge in savings also provides support to housing markets that have so far also proven to be uncharacteristically strong through this crisis period.

To date, the combination of income support, low interest rates and people forced to spend more time at home than ever before has clearly supported a sharp rise in demand for housing upgrades.

Sales of new and existing single-family homes in the US have jumped to their best levels in a decade and a half, and are among their highest on record.

CHART 16: MOVIN' ON UP

US new and existing single-family home sales
(millions of units, annualized rate)



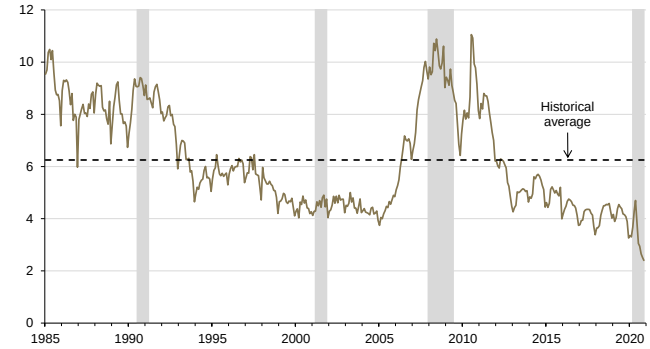
Data to November 2020
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

The boom in demand for residential real estate has, however, not yet been met by a corresponding jump in homes on the market. The first-wave-lockdown-induced halt in homebuilding, combined with reticence of people putting their homes up for sale amid a pandemic, has generated a dearth of homes that are actually available to buy.

For example, the estimated months' supply of new and existing single-family homes on the market in the US has plunged to levels not ever seen in the data back to 1985.

CHART 17: A SELLERS' MARKET

US months' supply of single-family homes for sale
(months)



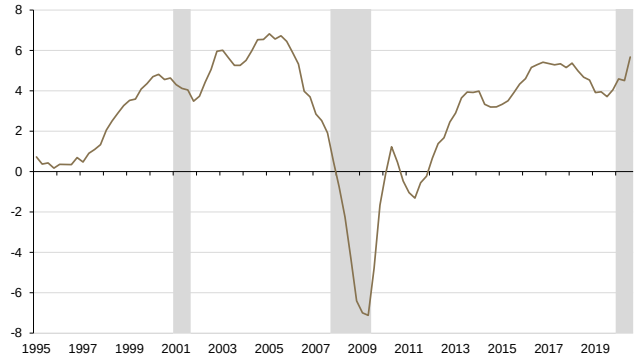
Data to November 2020
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

When the supply of something is scarce while demand is high, prices rise — and that is what has been happening in housing markets across developed economies (not just the US).

G7 housing data show that home prices have been on a sharp rising trend, with Q3's pace of appreciation the highest rate since 2005.

CHART 18: HOME PRICES MOVIN' ON UP

G7 house price index
(year-over-year percent change)

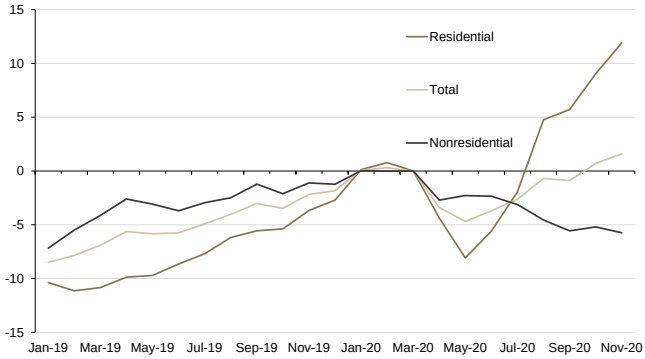


Data to Q3 2020
Shaded regions represent periods of US recession
Source: OECD, Guardian Capital

Rapidly increasing home prices are a clear draw for new residential construction. As well, the historically low supply (even in absolute terms) and that homebuilding lends itself well to social distancing protocols (suggesting it can avoid shutdowns), provides scope for a pickup in activity to help offset softness in the nonresidential space even if housing demand were to take a step back.

CHART 19: HOME IS WHERE THE GROWTH IS

US construction spending
(percent change since February 2020)



Data to November 2020
Source: US Census Bureau, Bloomberg, Guardian Capital

Manufacturing momentum

With that said, there is even reason to anticipate that there is potential for a pickup in construction activity outside of the housing market as well.

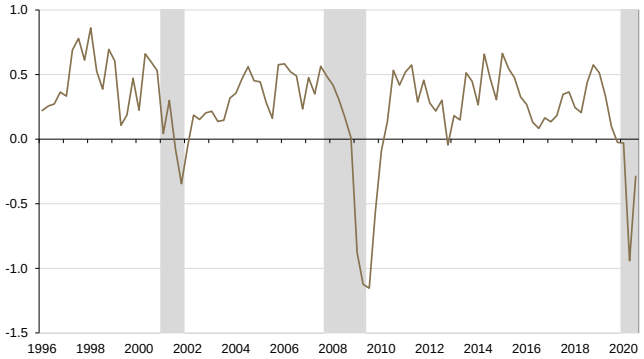
Given the persistent uncertainty clouding the economic outlook, it is understandable that businesses have been hesitant to commit to longer-term capital projects, such as plant expansion. Goods producers' hands may, however, be forced to increase investment in 2021.

Producers and suppliers of many goods, particularly consumer products, have struggled to keep up with demand due to a combination of forced closures of operations and related supply chain issues.

As a result, such firms have had to draw down inventories in order to fill orders and G7 economies have seen stockpiles depleted by a significant degree.

CHART 20: DRAINING STOCKPILES

G7 change in inventories share of gross domestic product
(percent)



Data to Q3 2020
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

This suggests that businesses will need to work to replenish inventories to their more normal levels.

Furthermore, there appears to be good reason for businesses to target even higher inventory levels than were standard pre-pandemic as a precaution against any potential shocks to the global supply chain resulting from expanded lockdowns.

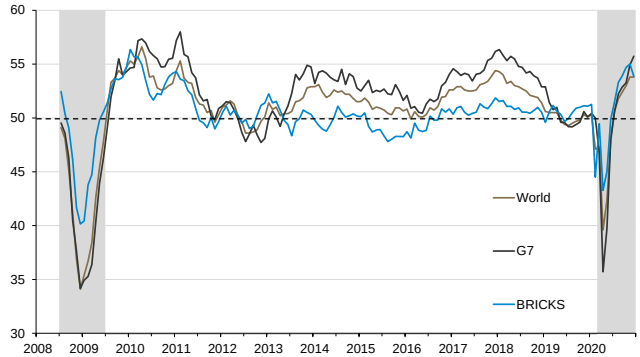
The scope for an upswing in the global inventory cycle is constructive for industrial production even in the absence of further increase in final demand and, combined with the record low costs of capital, could provide a catalyst for increased capital investment.

Indeed, manufacturing has continued to gain traction even as the broader economy has seen a loss of momentum through the end of 2020.

The global manufacturing purchasing managers' index (PMI), a forward-looking gauge of sentiment in the factory sector, has been on a notable upward trajectory since its cycle low in April, and finished last year at its highest level since the start of 2018, when the macroeconomic narrative was one of synchronized global growth.

CHART 21: FACTORIES ON FIRE

Global manufacturing purchasing managers' indexes
(index; >50 denotes expansion)



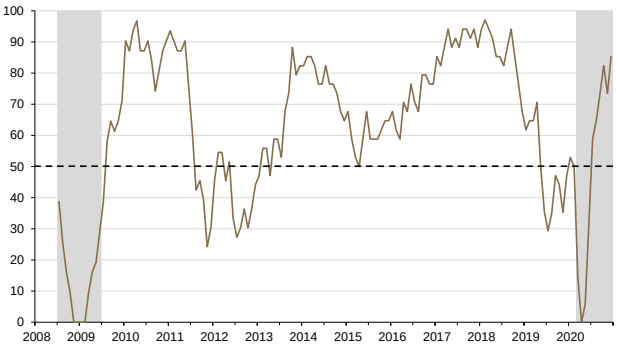
Data to December 2020
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

Also positive is that this pickup through the second half of 2020 was not simply due to strength among the large economies (though factory performance in China and the US was quite solid), but the product of broad-based improvements.

Fully 85% of the countries that produce a PMI came in above the growth break-even threshold in December, the best breadth of expansion in nearly three years.

CHART 22: NOT GASPING FOR BREADTH

Share of countries with manufacturing PMI above 50
(percent)

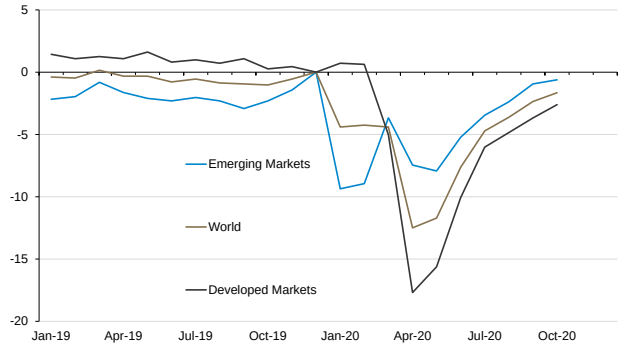


Data to December 2020
Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

The broad-based improvement is seemingly needed, since the recovery in actual factory output in the DM has not been able to keep up with the recovery in demand to this point and continues to track well below pre-pandemic levels.

CHART 23: OUTSOURCING PRODUCTION

Industrial production
(percent change versus December 2019)



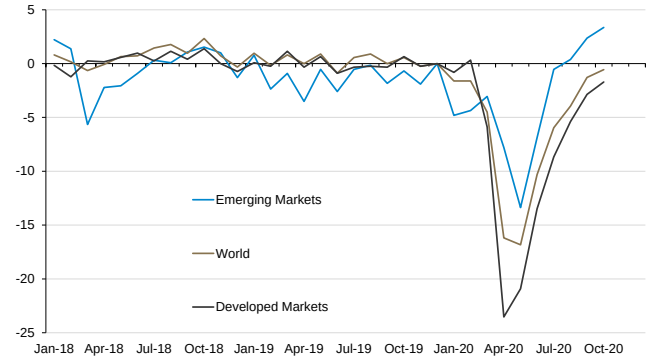
Data to October 2020
Source: Netherlands' Centraal Planbureau, Bloomberg, Guardian Capital

That has meant that Western suppliers have been increasingly relying on outsourced production, which has underpinned the relatively stronger rebound in EM manufacturing.

Accordingly, there has been a revitalization of international trade, an area of the global economy that had largely stagnated since 2018, due to the backdrop of heightened tensions and rising tariffs and other barriers.

CHART 24: TRADE WINDS ARE BLOWING

International Trade/Export volumes
(percent change versus December 2019)



Data to October 2020
Source: Netherlands' Centraal Planbureau,, Bloomberg, Guardian Capital

In addition to this cyclical momentum, international economic relations are also poised to take a turn for the better as the new leadership in the White House likely adopts a less hostile approach compared to its predecessor. The new Administration bodes a potential welcome development in terms of the broader outlook, since trade is mutually beneficial for all parties involved and helps spread wealth among countries.

Pricing power

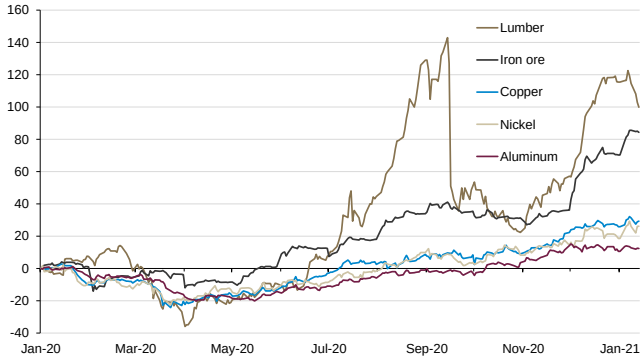
Another positive side effect of these recent trends can be seen for those commodity-producing nations (though less so for the consumers of these inputs).

Clearly, the rise in demand for consumer goods and construction, and potential for rising capital expenditure, brings with it a concurrent rise in demand for raw materials.

Commodity prices, particularly those of base metals and building materials, surged through the second half of 2020. These prices remain on an upward trajectory.

CHART 25: MATERIAL INCREASES

Generic first commodity futures contract prices
(percent change versus December 2019)

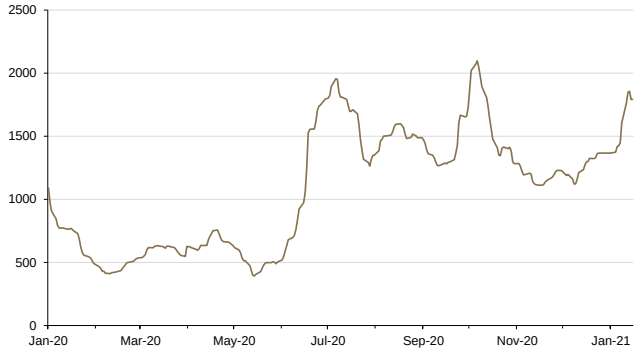


Data to January 15 2020
Source: Bloomberg, Guardian Capital

Given the leading indications of the Baltic Dry Index (a gauge of shipping costs for raw materials seen as a bellwether for the natural resource sector), there appears to be growing anticipation for sustained firming in industrial commodity markets.

CHART 26: NO FREE SHIPPING

Baltic Dry Index*
(index; US dollar basis)

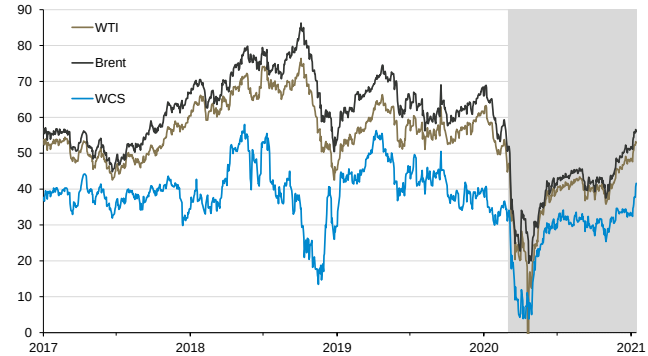


**Baltic dry index is a composite of the dry bulk timecharter averages of Capesize, Panamax and Supramax ships*
Data to January 15, 2020
Source: Bloomberg, Guardian Capital

Even crude oil, which continues to face a sizable inventory overhang (the recent Organization of Petroleum Exporting Countries decision to ease production curbs is not likely to help), has found some footing as benchmark prices are retesting levels not seen since pre-pandemic days.

CHART 27: SOME FIRE UNDER OIL PRICES

Benchmark crude oil generic first futures contract prices
(US dollars per barrel)



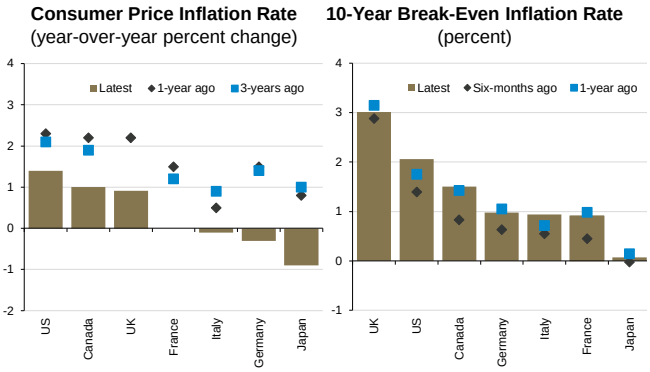
Data to January 15, 2020
Shaded region represents period of US recession
Source: Bloomberg, Guardian Capital

The strengthening in commodity markets could also serve as a catalyst for a pickup in capital spending.

As well, the move in raw input prices and the persistent supply constraints in the goods-producing sector have combined with the improvement in the economic outlook to filter into inflation expectations.

While it is currently the case that price pressures are highly subdued everywhere, thanks to the drop in energy prices over the last year and ample cyclical slack in the global economy, market-based measures of inflation expectations have shifted higher in recent months. This is especially true in the US, where 10-year break-even inflation rates have risen to their highest levels since early 2018.

CHART 28: WHAT DID YOU EXPECT?



Data as at January 15, 2020
Shaded region represents period of US recession
Source: Bloomberg, Guardian Capital

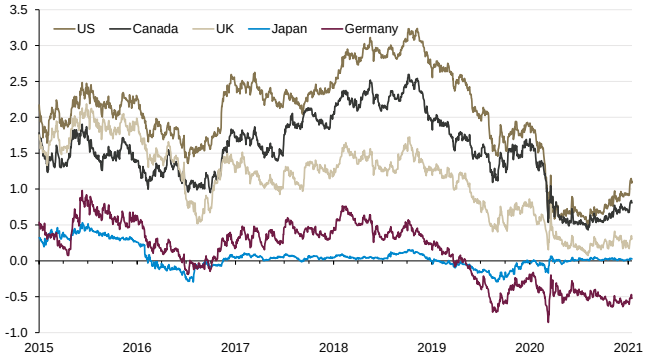
Fraying bonds

The shift in expectations for the longer-term economic outlook have been reflected in an increase in the risk premia embedded in fixed income markets that have resulted in government bond yield curves bear-steepening.

While this is as would be expected, the moves so far have been fairly gradual and limited — 10-year US Treasury note yields are now just a hair above 1%, while the equivalent in Japan is still anchored at zero and those in the Western Europe's major markets remain in negative territory.

CHART 29: SMALL RIPPLES

10-year government bond yield
(percent)



Data to January 15, 2020
Source: Bloomberg, Guardian Capital

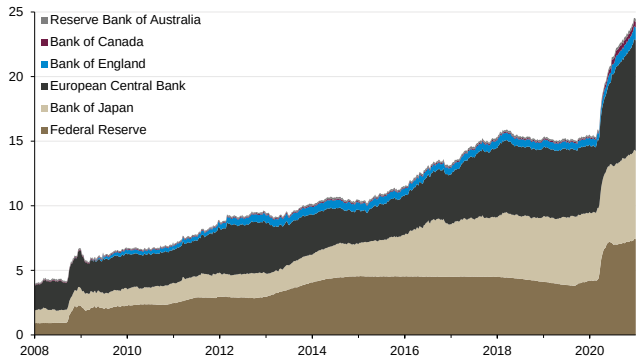
The modest adjustment to the vaccine-lifted forecasts to this point reflects the fact that market forces continue to be overwhelmed by monetary policy.

Not only have central banks pledged to keep policy rates at levels viewed as their effective lower bounds for the foreseeable future (the US Federal Reserve's latest *Summary of Economy Projections* indicated that policymakers anticipate keeping rates on hold through 2023), but they continue to exert significant direct force in the market as well.

Thanks to ongoing (and recently enhanced in the case of the European Central Bank) bond buying programs, major global monetary authorities have now amassed nearly US$25 trillion worth of bonds onto their balance sheets, equivalent to more than one-third (36%) of the market value of the Bloomberg Barclays Global Bond Index.

CHART 30: BLOATED BALANCE SHEETS

Central bank asset holdings
(trillions of US dollars)



Data to January 15, 2020
Source: Bloomberg, Guardian Capital

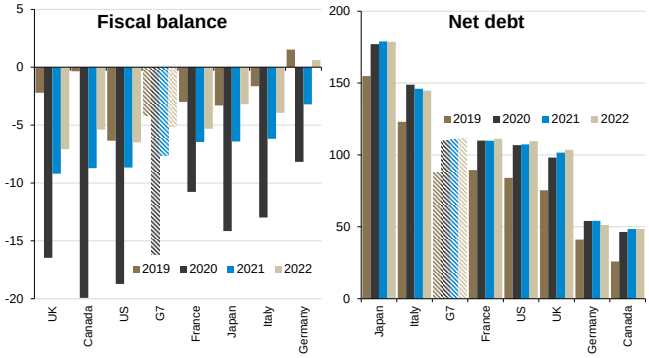
The continued presence of these massive, price-insensitive buyers and well-anchored policy expectations means that a drastic near-term move higher in market interest rates is not a high probability event. Plainly, rates are likely to remain low for the foreseeable future.

But at the same time, central banks have already expended much of their major firepower, leaving somewhat limited scope for rates to break sustainably lower — notwithstanding potential near-term risk-aversion trading in response to headline shocks with respect to growth or the pandemic.

For one thing, while the expectation is for general improvement in fiscal balances to over the coming year as counter-cyclical spending ebbs, the persistence of deficits means that governments (particularly the US) are expected to continue issuing sizable amounts of debt and push the already record-high debt levels even higher.

CHART 31: FAR FROM FISCAL FITNESS

General government fiscal balance and net debt
(percent of gross domestic product)



Forecast data as per the IMF's October 2020 Fiscal Monitor
Source: IMF, Guardian Capital

Combine the increasing supply of debt with the current outlook for growth and inflation and it would appear that the path of least resistance for the benchmark risk-free rates in the marketplace is higher — albeit, likely only fairly modestly and in a rather gradual fashion.

While such an environment is not outright bearish for fixed income, it is less than constructive for government bonds, particularly longer-duration (and thus more interest-rate-sensitive) securities.

The low prevailing yields provide negligible cushion for even a small rise in market rates — and that's providing a government debt issue offers a positive yield to begin with, given that there is US$17 trillion worth of bonds that provide a negative carry and leave investors starting in a hole.

As such, the base-case of gradual and modest increases in yields would suggest negative total returns could well be in the cards in 2021.

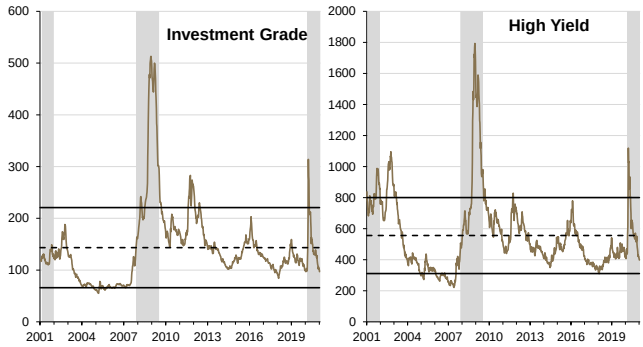
Credit check

There is better protection from rising interest rates in corporate credit, which offer higher yields and lower average duration, making it a somewhat more compelling asset class in the fixed income space.

With that said, their yield spreads over government bonds have narrowed significantly from the crisis highs and are again testing the recent pre-pandemic lows.

CHART 32: SOME CASH FOR CARRY

Global option-adjusted bond yield spreads
(basis points)



Investment Grade = Bloomberg Barclays Global Aggregate Corporate Index; High Yield = Bloomberg Barclays Global High Yield Index
Data to January 15, 2020
Shaded regions represent periods of US recession; dashed line is series average; black lines are +/-1 standard deviation from the average
Source: Bloomberg, Guardian Capital

History shows that spreads can tighten further, which would underpin performance even in the face of rising sovereign yields — and an environment of strengthening growth and easy financial conditions would appear to be supportive of such an outcome.

That said, the scope for such gains is clearly much smaller now than it was last spring.

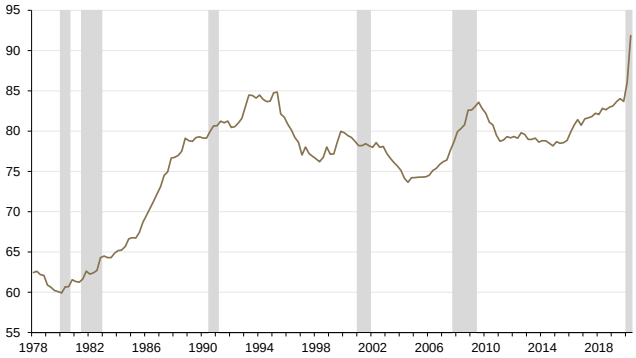
As well, the tradeoff for the higher coupons on corporate debt is that investors are taking on additional credit risk. On this front, there are some rising concerns.

Much like governments, businesses have taken on a significant amount of debt in recent years against declining costs of capital — and corporations aggressively tapped the mark in the first half of 2020 to shore up liquidity.

Data from the Bank for International Settlements indicate that total credit outstanding to G7 nonfinancial corporations rose by US$2 trillion over the first six months of 2020 to end Q2 at a total of US$35 trillion, equivalent to a record 92% of the group's GDP.

CHART 33: DEBT BINGE

G7 nonfinancial corporate credit-to-gross domestic product
(percent)



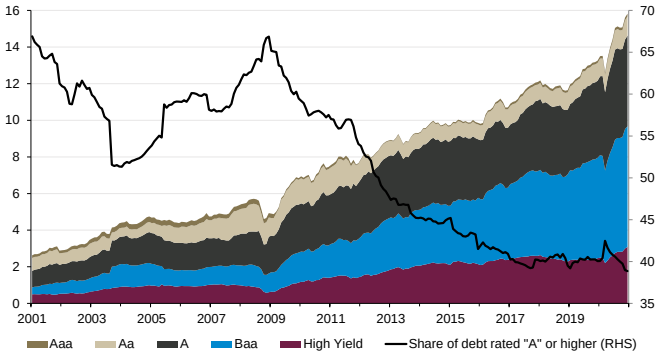
Data to Q2 2020
Shaded regions represent periods of US recession
Source: Bank for International Settlements, Guardian Capital

Given that businesses in general are now currently flush with cash because of these financing operations and debt-servicing costs are low, that debt levels have increased is not inherently a sign of imminent problems.

It is concerning, however, that global corporate debt in aggregate has seen a steady deterioration in quality, with 2020 ending the year with the lowest share of "A" rated credit on record.

CHART 34: CREDIT CHECK

Global corporate debt outstanding* by credit rating
(trillions of US dollars) (percent)



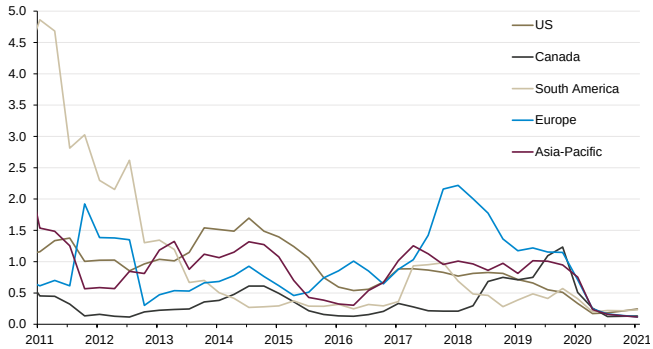
**Based on the market value of Bloomberg Barclays global bond indexes*
Data to December 2020
Source: Bloomberg, Guardian Capital

This shift no doubt reflects increased issuance of lower-quality credit amid heightened market demand for higher-yielding debt, however, there has also been a trend (especially over the last year) toward ratings downgrades over upgrades across the globe that have put issues into lower brackets.

CHART 35: GRADING ON A SCALE

Ratio of S&P Credit Ratings Upgrade-to-Downgrades

(ratio)



Data to January 15, 2021 based on [S&P 500] Index
Source: Bloomberg, Guardian Capital

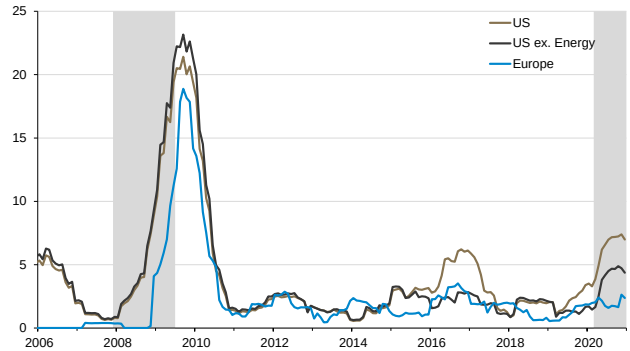
The prospect of a near-term setback in the economic recovery due to increasing lockdown measures therefore raises the prospect of less creditworthy bond issuers (especially those in COVID-19-impacted industries) facing further financial distress, even with government liquidity programs, and downgrades.

Default rates, which have come off peaks in recent months, are likely to remain elevated in the near term before trending lower later in the year with the expected improvement in the global economy.

CHART 36: DEFAULT SETTING

High Yield bond par-weighted default rate

(percent)



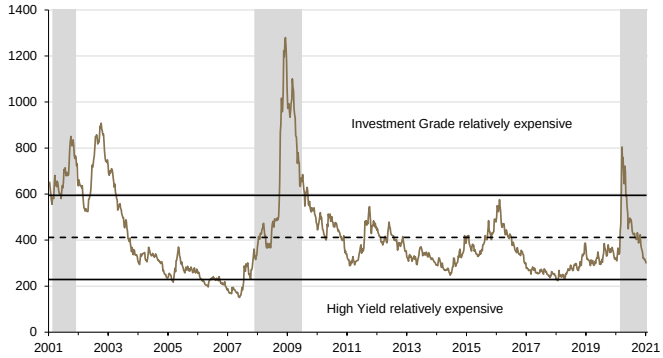
Data to December 2020.
Shaded regions represent period of US recession
Source: Bank of America Merrill Lynch, Guardian Capital

That said the prospect of overall improving growth and low interest rates for the coming year should be reasonably constructive for corporate credit. The ongoing risks and uncertainties do, however, favour focusing more on the higher-end of the quality curve — something that echoes in the tilt in relative value favouring the higher-quality Investment Grade debt over High Yield.

CHART 37: QUALITY OVER QUANTITY OF YIELD

Global High Yield index yield spread over Investment Grade

(basis points)



Based on Bloomberg Barclays Global Aggregate Corporate Index and Bloomberg Barclays Global High Yield IndexData to January 15, 2021
Shaded regions represent periods of US recession; dashed lines represents series average, black lines are +/-1 standard deviation from the average
Source: Bloomberg, Guardian Capital

The best of what's around

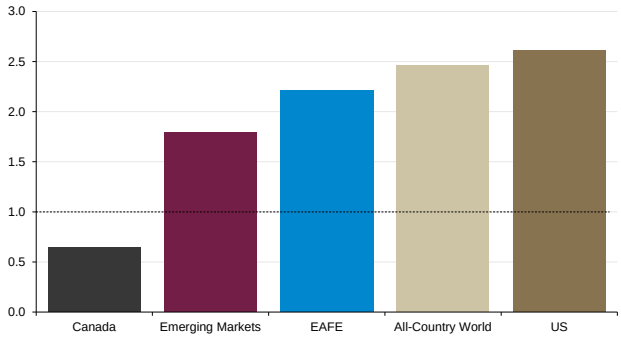
The asset class that appear best positioned for the current outlook is once again equities.

It is undoubtedly the case that valuations in equity markets globally are historically elevated. The MSCI All-Country World Index is trading at 21x its 12-months' expected earnings, nearly two-and-a-half standard deviations above its longer-term average.

CHART 38: HIGHLY VALUED ASSETS

MSCI country index forward price-to-earnings ratio

(standard deviations from 15-year average)



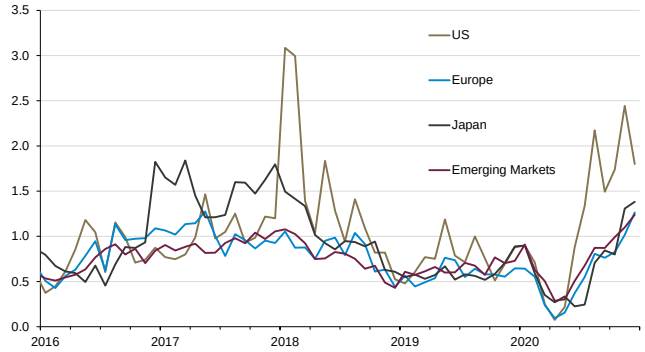
Based on MSCI All-Country World Index, MSCI Emerging Market Index, MSCI EAFE Index, MSCI US Index and MSCI Canada Index As at January 15, 2021Source: Bloomberg, Guardian Capital

However, in the context of the trajectory of expected earnings growth, these valuations appear not only to be largely justified, but offer scope for continued solid performance.

The progress on the COVID-19 vaccine has led to a re-rating of the prospects for a broad swath of companies worldwide in recent months, especially those most affected by the pandemic, resulting in analysts making more upgrades/fewer downgrades that has pushed revision ratios to 2018 levels.

CHART 39: UPON REVISION

One-month analyst earnings per share revision ratio
(ratio of upgrades-to-downgrades)

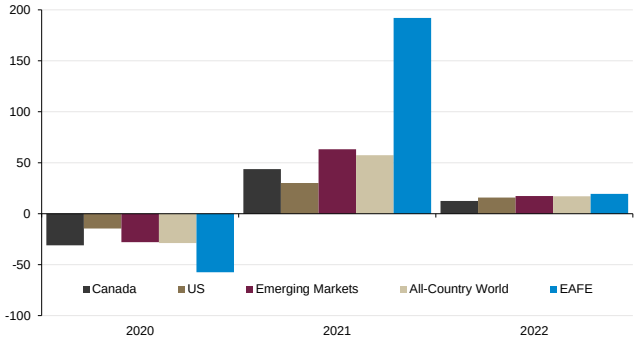


Data to December 2020
Source: Bank of America Merrill Lynch Guardian Capital

As a result, expectations are for robust and broad-based rebound in earnings growth, with those regions hardest hit over the last year poised to register the biggest improvements.

CHART 40: I HAVE TO ADMIT IT'S GETTING BETTER

Earnings per share growth forecasts
(year-over-year percent)



Based on MSCI All-Country World Index, MSCI Emerging Market Index, MSCI EAFE Index, MSCI US Index and MSCI Canada Index
As at January 15, 2021 Source: Bloomberg, Guardian Capital

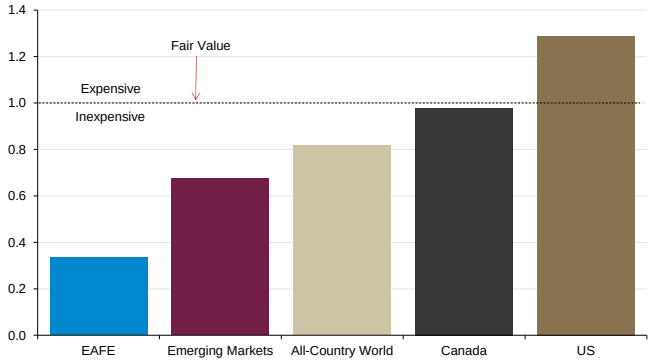
Given that, at a fundamental level, equity prices represent the present value of future cash flows generated by the underlying companies, expectations for sustained above-trend earnings growth would support higher-than-normal valuations.

Further to this, scaling the price-to-earnings ratios to the average growth forecasts for the coming three years (the price-to-earnings-to-growth or PEG ratio) provides an indication that global equities are actually reasonably priced.

In fact, outside of the US, which handily outpaced its international peers throughout 2020 (thanks to strong performance of a few mega-cap companies), there appears to be room for equities to appreciate more broadly should the downside risks diminish and the strength of the outlook be realized.

CHART 41: ROOM FOR GROWTH

Forward price-to-earnings-to growth* ratio
(ratio)



Based on MSCI All-Country World Index, MSCI Emerging Market Index, MSCI EAFE Index, MSCI US Index and MSCI Canada Index
**compound annualized growth rate of earnings forecasts to 2023As at January 15, 2021*
Source: Bloomberg, Guardian Capital

Of course, it is arguable that the confidence intervals on aggregated stock market earnings forecasts outside the US are wider and, thus, warranting of a greater discount now, while the prospect of continued strength from the COVID-19-resistent and heavily-weighted American Tech firms offers better earnings visibility stateside and supports US markets trading at a relative premium at current.

Either way, this longer-term perspective suggests valuations are less of a headwind than otherwise would be assumed.

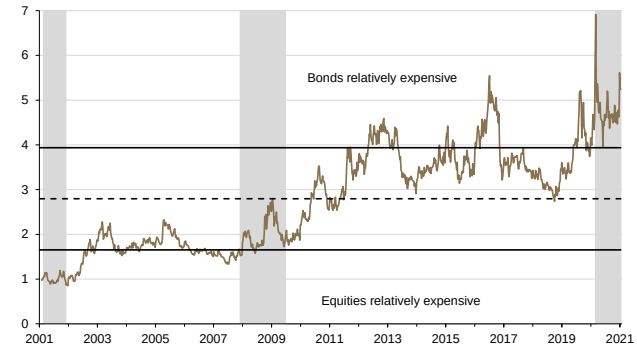
Another important note worth making is that the current elevated equity valuations are also undeniably a product of the low interest rate environment.

Just as higher future growth increases the "present value" calculation, so too does a lower rate at which those future flows are discounted. All else being the same, lower rates mean fundamentally higher valuations.

Further to this point, plotting the current forward earnings yield (the inverse of the price-to-earnings ratio) against the prevailing yields in the broad bond market points to there being further relative potential upside in stocks to bring the respective markets back into balance (even in the face of modestly higher interest rates).

CHART 42: IT'S ALL RELATIVE

Global equity forward earnings yield to global bond yield*
(ratio)



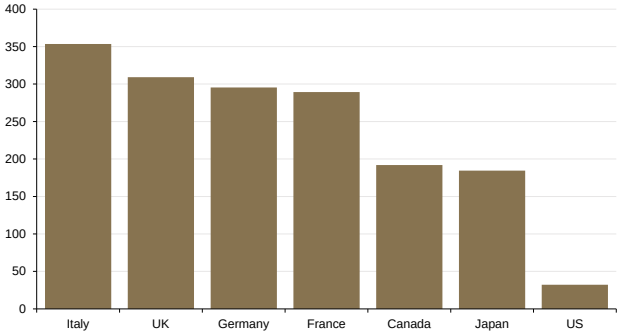
**Global equity=MSCI World Index; Global Bond=Bloomberg Barclays Global Aggregate Index Data to January 15, 2021*
Shaded regions represent periods of US recession; dashed lines represents series average, black lines are +/-1 standard deviation from the average
Source: Bloomberg, Guardian Capital

Further, in comparison to bond markets, stocks markets provide superior yield pickup opportunities.

The dividend yields offered in broad stock markets remain well above the yields available in domestic bond markets — and that is not even adopting a bias to companies paying above-average dividends.

CHART 43: OVER AND ABOVE

Stock market dividend yield versus bond index* yield
(basis points)



**Stock market=MSCI country index; bond market = Bloomberg Barclays aggregate country index*
As at January 15, 2020 Source: Bloomberg, Guardian Capital

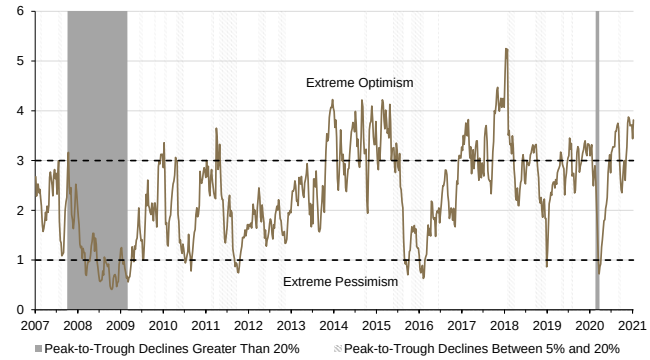
Moreover, the improving economic outlook could provide companies with the potential to resume growing dividends over the coming year, providing additional incentive and further speaking to a continued preference to tilt balanced portfolio asset mixes in favour of stocks (and underweight fixed income).

Of course, while the main market focus is the future, the near-term is likely to provide some distractions that may impact investor sentiment.

Disappointments with respect to the dataflow or pandemic-related developments could be a trigger for a shift toward risk-aversion, which could be dramatic, even if brief, given that market sentiment skews heavily toward excessive optimism over the outlook.

CHART 44: HERD MENTALITY

Investors Intelligence bull-to-bear ratio
(ratio of "bullish" survey respondents to "bearish")



Data to January 13, 2021
Source: Investors Intelligence, Wall Street Journal, Guardian Capital

While that could suggest some prudence for battening down the hatches until the potential storm has passed, making a call by trying to anticipate when the winds of change will hit is never a sound investment strategy.

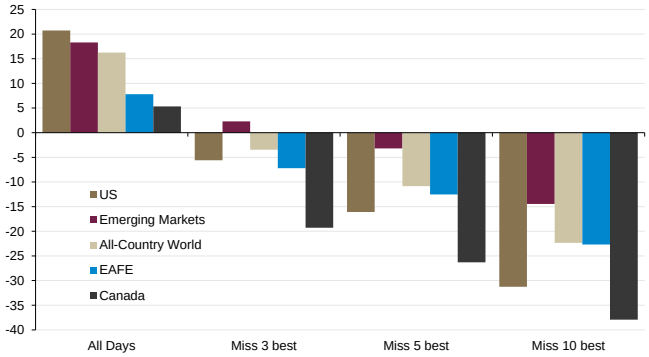
For sure, avoiding a downdraft in the markets would significantly improve performance, but timing the market is exceedingly difficult — and such trading involves not only being correct about when to get out but also when to get back in.

Even being a day late with respect to rejoining the party can have significant negative performance implications — reinforcing the idea that "time in" rather than "timing" the market is what is important.

For example, if investors had bought and held the MSCI All-Country World Index for all of 2020, the total return for the year would have been +16%. Had investors, however, missed just the three best trading days of 2020 — all of which occurred amid the heighten volatility from mid-March to early April, so not unreasonable to assume many did — that return would have been -3%; showing the more of the best days missed, the greater the underperformance.

CHART 45: TIME IN, NOT TIMING, THE MARKET

MSCI index net total return, 2020
(percent, US dollar basis)



Based on MSCI All-Country World Index, MSCI Emerging Market Index, MSCI EAFE Index, MSCI US Index and MSCI Canada Index
Data covers calendar year ended December 31, 2020
Source: Bloomberg, Guardian Capital

The best is yet to come…

The outlook has improved markedly and broadly in recent months, thanks to the rapid development of evidently highly effective vaccines (plural!) which have raised the odds of a return to something close to the norm of just a year ago, when a global pandemic was simply an extreme and low probability scenario for risk models.

The expectation of strong, above-trend growth over the coming year, combined with the commitment from central banks around the world to keep monetary policy highly accommodative for the foreseeable future, suggests the general economic backdrop for 2021 should be constructive for risk assets such as equities and corporate credit.

But, with that in mind, the more near-term outlook remains challenging and the recovery is likely to take a step back as the resurgence of COVID-19 has necessitated reinstituting lockdowns across the world, particularly in the DM.

In other words, after making some material progress through the middle of last year, the global economic recovery took a step back as 2020 ended and is starting the New Year on its back foot.

As such, the prospect of a sentiment-driven resurgence of market volatility in the coming weeks and months remains very much on the table.

There is reason, however, to argue that there is plenty of scope for the global economy to get its feet under it in earnest such that it can, again, take cautious steps forward in the not-too-distant future and pick up the pace to a brisk run by year-end.

As such, maintaining a disciplined and long-term focus on broader underlying macroeconomic themes and managing risk exposures accordingly, will likely be paramount in helping block out any near-term market noise.

Last year was tumultuous and the coming months are likely to be challenging, but it appears that better days do lie ahead and they may well be here sooner rather than later.

Balanced fund summary views

Equities	+	Fixed Income	—
Canadian Equity	+	Government Bonds	—
US Equity	+	Investment Grade Credit	+
EAFE Equity	+	High Yield Credit	Neutral
Emerging Markets	+		

Source: Guardian Capital January 15, 2021

Market Returns at December 31, 2020 All returns in CAD except where noted.

CANADIAN EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
S&P/TSX Composite	1.7	9.0	5.6	5.6	9.3	5.8
S&P/TSX 60	1.4	7.9	5.6	5.6	9.6	6.2
S&P/TSX Completion	2.9	13.3	6.0	6.0	8.5	4.5
S&P/TSX SmallCap	5.8	23.5	12.9	12.9	8.8	1.3
S&P/TSX Composite High Dividend	0.0	13.6	-7.4	-7.4	7.5	5.4
S&P/TSX Composite Dividend	1.4	8.5	1.1	1.1	8.8	6.1

S&P/TSX SECTOR RETURNS (%)						
Communication Services	-0.6	3.7	-3.7	-3.7	7.3	10.3
Consumer Discretionary	5.8	21.0	17.1	17.1	9.0	11.2
Consumer Staples	-0.6	-5.6	4.3	4.3	7.1	14.3
Energy	0.7	14.7	-26.6	-26.6	-1.7	-3.7
Financials	1.9	16.7	1.6	1.6	9.5	9.5
Health Care	-10.3	30.1	-23.0	-23.0	-30.1	-5.1
Industrials	2.8	7.1	17.0	17.0	16.1	14.2
Information Technology	3.1	7.6	80.7	80.7	32.8	15.1
Materials	3.2	-3.7	21.2	21.2	15.7	-1.7
Real Estate	-2.5	9.7	-8.7	-8.7	6.7	9.3
Utilities	0.8	5.6	15.3	15.3	13.5	8.4

U.S. EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
S&P 500	2.1	7.0	16.3	16.3	13.3	16.7
Dow Jones Industrial Average	1.7	5.6	7.8	7.8	12.8	15.8
NASDAQ	3.9	10.1	41.1	41.1	18.8	20.1
Russell 1000	2.5	8.4	18.8	18.8	13.7	16.9
Russell 2000	6.8	25.3	17.9	17.9	11.4	14.0
Russell 3000	2.7	9.4	18.8	18.8	13.5	16.6
Russell 1000 Growth	2.8	6.2	36.1	36.1	19.0	20.1
Russell 1000 Value	2.1	10.9	1.0	1.0	7.9	13.3

S&P 500 SECTOR RETURNS (%)						
Communication Services	1.3	8.6	21.4	21.4	10.0	12.8
Consumer Discretionary	0.8	3.0	31.0	31.0	15.6	20.6
Consumer Staples	0.1	1.4	8.8	8.8	7.3	14.6
Energy	2.6	21.9	-34.8	-34.8	-6.8	-0.2
Financials	4.5	17.5	-3.4	-3.4	9.3	13.6
Health Care	2.2	3.0	11.5	11.5	9.8	18.8
Industrials	-0.5	10.3	9.1	9.1	10.5	14.8
Information Technology	4.0	6.6	41.4	41.4	25.7	23.7
Materials	0.8	9.2	18.6	18.6	11.3	11.7
Real Estate	-0.2	0.1	-3.9	-3.9	N/A	N/A
Utilities	-1.0	1.6	-1.3	-1.3	9.7	14.1

INTERNATIONAL EQUITIES

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
MSCI World Index (Net, C$)	2.5	8.7	13.9	13.9	10.4	12.6
MSCI EAFE Index (Net, C$)	2.9	10.7	5.9	5.9	5.7	8.2
MSCI ACWI (C$)	2.9	9.4	14.2	14.2	10.4	11.9
MSCI France (C$)	1.1	14.8	2.2	2.2	7.2	8.5
MSCI Germany (C$)	4.2	6.3	9.6	9.6	4.8	8.1
MSCI Japan (C$)	2.4	9.9	12.5	12.5	6.9	9.2
MSCI U.K. (C$)	3.7	11.5	-12.0	-12.0	0.9	5.6
S&P/IFC Investable (Emerging Markets)	5.6	14.5	15.6	15.6	10.9	6.8
MSCI EAFE Growth (Gross, C$)	3.1	7.9	16.6	16.6	9.1	10.6
MSCI EAFE Value (Gross, C$)	2.7	13.7	-3.8	-3.8	3.1	6.6

Sources: Bloomberg Finance L.P., FTSE Bond Analytics, TD Securities, Thomson Financial

INTERNATIONAL EQUITIES

MSCI EAFE SECTOR RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Communication Services	3.0	11.0	10.6	10.6	1.4	7.7
Consumer Discretionary	5.1	16.7	13.7	13.7	6.6	10.4
Consumer Staples	2.0	2.0	3.9	3.9	4.5	10.1
Energy	2.4	25.1	-28.8	-28.8	0.5	0.7
Financials	2.3	19.6	-5.6	-5.6	1.0	5.7
Health Care	0.2	-0.8	9.4	9.4	5.7	12.8
Industrials	1.8	10.5	9.0	9.0	8.6	9.2
Information Technology	5.6	11.5	26.1	26.1	14.7	12.4
Materials	6.9	14.6	18.5	18.5	13.4	5.7
Real Estate	1.4	9.5	-8.5	-8.5	N/A	N/A
Utilities	2.0	8.3	12.2	12.2	7.4	6.4

Market Returns at December 31, 2021 All returns in CDN $, except where noted.

CANADIAN FIXED INCOME – CA$

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
FTSE Canada 91 Day TBill	0.0	0.0	0.9	0.9	1.0	1.0
FTSE Canada Short Term Overall Bond	0.2	0.5	5.3	5.3	2.3	2.5
FTSE Canada Mid Term Overall Bond	0.6	0.6	10.1	10.1	4.0	4.9
FTSE Canada Long Term Overall Bond	0.4	0.8	11.9	11.9	6.8	7.0
FTSE Canada Universe Bond	0.4	0.6	8.7	8.7	4.2	4.5
FTSE Canada High Yield Overall Bond	1.3	4.1	6.7	6.7	8.7	5.9
FTSE Canada Real Return Bond Overall	0.3	1.8	13.0	13.0	4.8	4.5
SECTOR RETURNS (%)						
FTSE Canada Federal Bond	0.0	-0.2	7.3	7.3	2.7	3.3
FTSE Canada Provincial Bond	0.4	0.6	9.9	9.9	5.1	5.5
FTSE Canada All Corporate Bond	0.7	1.8	8.7	8.7	5.0	5.0

GLOBAL FIXED INCOME

INDEX RETURNS (%)	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
FTSE World Government Bond	-0.4	-2.0	8.2	8.2	3.1	4.9

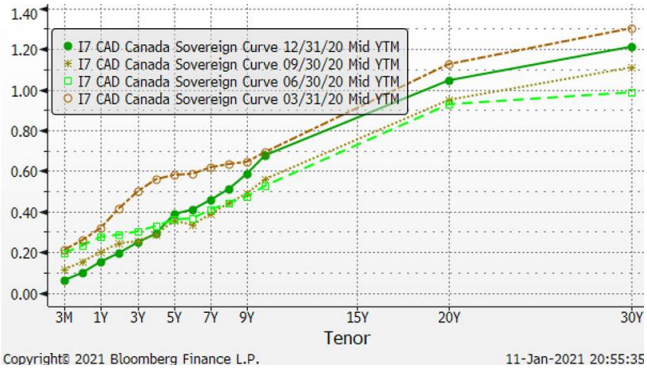
COMMODITY

	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Bloomberg WTI Cushing Crude Oil Spot Price	5.2	15.1	-21.9	-21.9	3.8	-3.8
Bloomberg European Dated Brent BFOE Price	6.6	19.2	-24.3	-24.3	5.7	-3.6
Edmonton Crude Oil Syncrude Sweet Blend FOB Spot	6.2	12.4	-27.0	-27.0	1.7	-4.3
S&P GSCI Nat Gas Index Spot	-13.4	-4.2	14.0	14.0	0.0	-3.0
S&P GSCI Copper Index Spot	0.7	10.9	23.6	23.6	8.7	0.3
S&P GSCI Gold Index Spot	4.6	-4.6	22.2	22.2	10.5	5.5

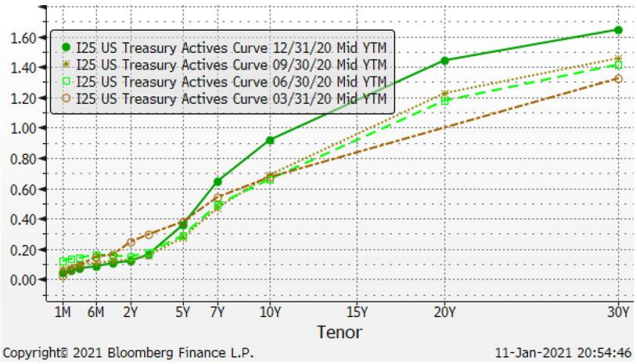
CURRENCY

	1 Mo	3 Mos	YTD	1 Yr	5 Yrs	10 Yrs
Canadian $/U.S. $ (% chg)	-1.7	-4.6	-1.8	-1.8	-1.6	2.5
Canadian $/Yen (% chg)	-0.7	-2.5	3.4	3.4	1.4	0.0
Canadian $/GBP (% chg)	0.7	0.8	1.4	1.4	-3.1	1.2
Canadian $/Euro (% chg)	0.6	-0.5	7.1	7.1	0.7	1.6

GOVERNMENT OF CANADA YIELD CURVE



U.S. TREASURY YIELD CURVE



Sources: Bloomberg Finance L.P., FTSE Bond Analytics, TD Securities, Thomson

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