August Monthly Market Comments

September 10, 2021

A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty

- *Winston Churchill*

What is your favourite holiday of the year? According to statuaryholidays.com, 41% of Canadians surveyed selected Christmas as their favourite holiday followed by Canada Day (15.5%), Halloween (7.6%) and Thanksgiving (6.8%). For those who have children, you may agree that Back to School is the best time of the year, especially after last year! In my mind, early September signals not only back to school but also when Toronto Maple Leaf fans begin prognosticating a championship, as hockey season is just around the corner. There are times being an 'eternal optimists' comes at the expense of one's mental health. For example, a Toronto Maple Leaf fan. If that means nothing to you, just think of a group of people that annually plan a parade to celebrate a championship only to see opportunity after opportunity wasted leading to early exits let alone a championship. While Leaf fans have yet to be rewarded for their optimism, investors more often than not are rewarded for being 'eternal optimists'. It just doesn't pay to be negative as an investor. In this months investment note we will address:

- Taking a look back at capital market returns year-to-date
- Look at the factors that may trigger a pullback
- Discuss reasons to be optimistic, and
- Highlight the pitfalls that may exist within a portfolios

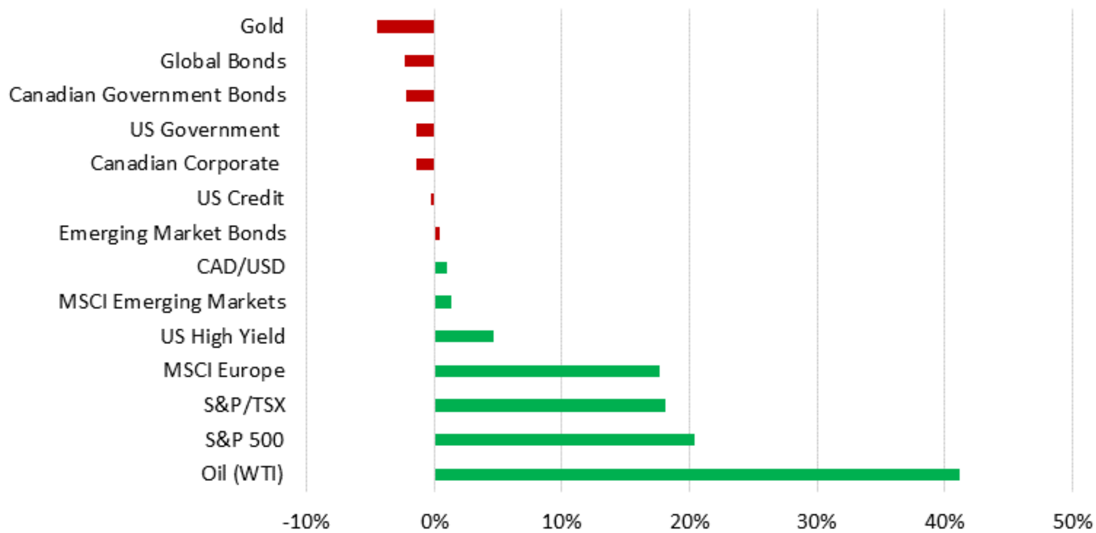
Let's take a look back

Before looking ahead, it's always a good idea to know where we came from. The majority of major global equity markets have continued their strong rally from 2020 through the first eight months of 2021. The US equity market, represented by the S&P 500 index, has led the way with a price return of 20.4% (USD), closely followed by Canada and Europe, with the S&P/STX index and MSCI Europe index returning 18.1% (CAD) and 17.6% (USD), respectively. The only equity market that has been struggling has been the emerging markets represented by the MSCI Emerging Market Index with a return of 1.3% (USD). Chinese equities have been the primary cause for the underperformance as the region's equities have faced challenges stemming from monetary and regulatory concerns.

In fixed income, high yield bonds have been the lone bright spot, as the ICE BofA US High Yield Constrained index returned 4.6% in USD terms over the first eight months of 2021. Government bonds have been hurt by a steeper yield curve and remain underwater despite a rally over the last five months. Despite the recent fall in yields, the US 10-year yield is 40 bps higher than where it started the year.

Bookending the chart, are commodities, with oil, as measured by West Texas Intermediate (WTI), having the strongest year-to-date performance, growing by 41.2% in USD terms and gold performing the worst, down 4.5% in USD terms.

Asset Class Returns year-to-date



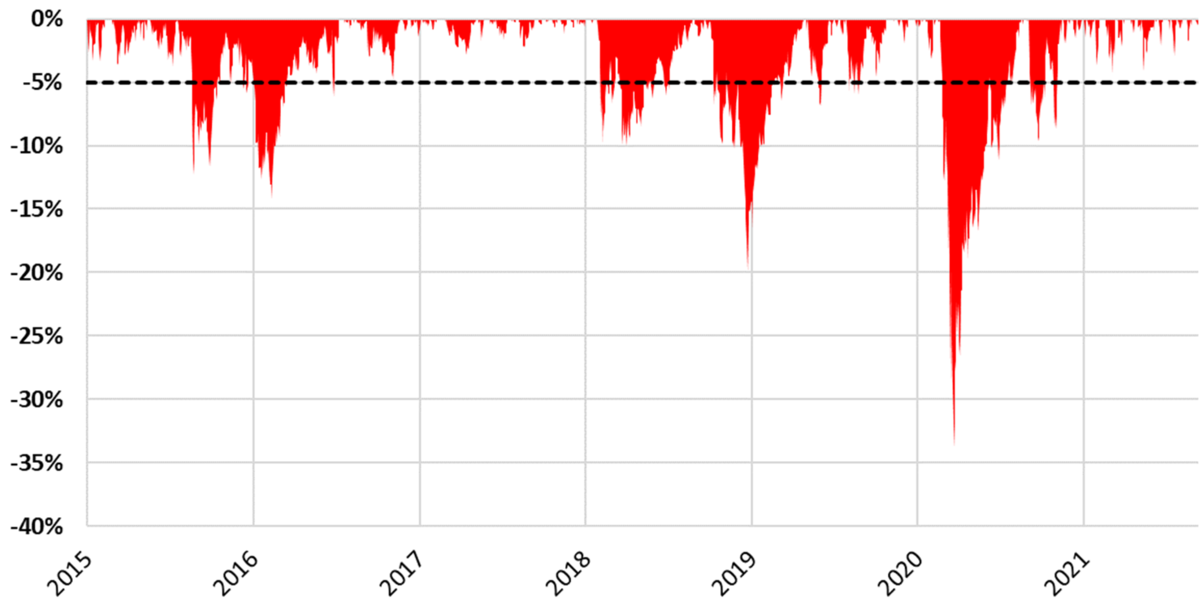
*As of August 31, 2021

Equity markets have performed very much in line with what I expected with the reopening thesis set out earlier in the year. What we saw last year, was much the same as 1991, as the S&P 500 had a strong rally on the back of P/E expansion, while earnings were a drag on performance. Then this year, the P/E multiple has begun to moderate, and returns have been driven by strong earnings growth. I believe that the next few years could see average returns with risk to the upside, as the P/E multiple continues to moderate, and earnings growth slows.

Also, very similar to the early 90's is the level of complacency by investors. In 1992, the S&P 500 only had two very brief pullbacks of greater than 5% while this year we have yet to see even one. It is extremely rare for the S&P 500 Index to not experience at least one pullback of greater than 5% during a calendar year. Since 1980, only once, in 2017, did the S&P 500 not drop at least 5% from its peak with the average correction per calendar year coming in at

14.3%.   Investing is a probability-based decision and history would suggest that downside volatility is likely to occur at some point before the end of the year.

S&P 500 Price Index drawdowns greater than 5% (2015 – current)



Reasons for a pullback?

Despite the robust global equity returns and lack of volatility, I get the sense talking with clients that there is some hesitancy about the return profile for the rest of the year. Some of this can be explained by Behavior Biases. In their study "Prospect Theory: An Analysis of Decision under Risk," behavioral finance pioneers, Dan Kahneman and Amos Taversky, found that investors are more sensitive to loss than to risk and possible return. In short, people prefer to avoid loss over acquiring an equivalent gain. I believe there are three main factors that may cause an investor to be cautious.

1) Increase in the delta variant

The world is dealing with the highly transmissible delta variant which has led to a renewed surge in cases and hospitalization rates leading to stricter rules in certain countries. We have also seen the increase in the delta variant in the United States have an impact on consumer confidence. There is a strong correlation between the fall in consumer confidence since April and the increase in the delta variant during the same period. In the University of Michigan's August survey of consumer sentiment, the surge in the delta variant was identified as one of the key reasons for consumer's negative sentiment as it highlights '*dashed hopes that the pandemic would soon end, and life could return to normal* '.

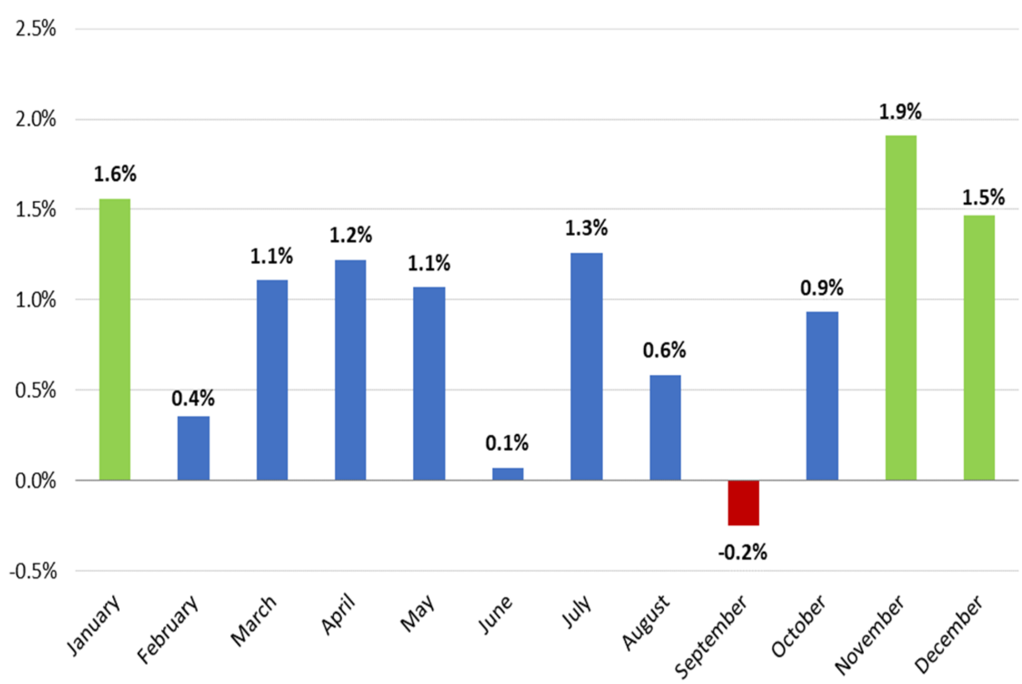
2) Risk of a taper tantrum impacting equity markets

The debate whether the US Federal Reserve's very accommodating policy will result in either 'transitory' or 'enduring' in goods inflation is still occurring. However, there is no doubt that it has led to inflation in financial assets. For example, the S&P 500 price index has rallied 100% from its Covid trough of 2,237.40 on March 23, 2020 on a closing basis. It took the market 354 trading days to get there, marking the fastest bull-market doubling off a bottom since World War II. Investors have grown accustomed to very loose monetary policy and a change may alter sentiment.

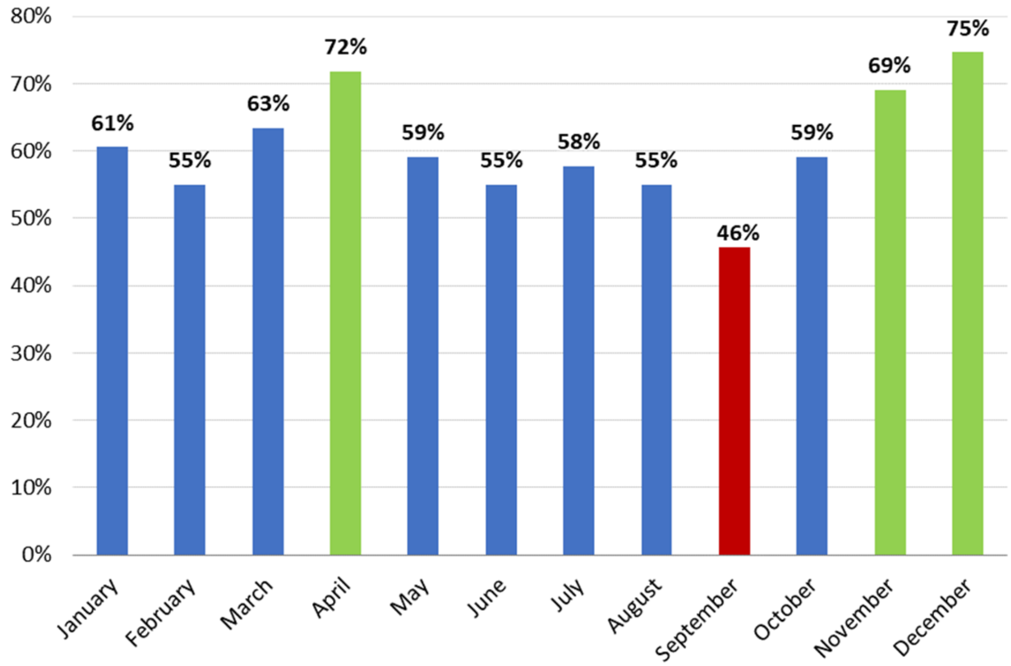
3) September is historically the weakest month for the S&P 500

Since 1950, September has been provided investors with the weakest monthly return of -0.2 percent. November through January has historically been a very positive period. The odds of positive monthly return for September are also the lowest at 46%. December by comparison has been positive 75% of the time since 1950. There is some truth to the 'Santa Claus' rally.

<u>S&P 500 median monthly returns (1950 – 2020)</u>



S&P 500 odds of a Positive Monthly Return



Reasons to be Optimistic

1) Monetary Policy

The markets liked what they heard from Federal Reserve chief Jay Powell after his speech at Jackson Hole at the end of August. While it is likely that the Federal Reserve will begin to taper the amount of bonds it buys in the coming months, it will be a very slow removal of its pandemic-era stimulus measures. The proverbial Federal Reserve punchbowl is still here but we will likely have to use a spoon instead of a ladle to fill our cups.

2) Peak doesn't mean weak

Equity markets seem to be reacting more to day-to-day headline news than longer term fundamentals. Some of the negative headlines surround the resurgence of covid cases and the potential impact on global markets and economic growth. While others cover the risks associated with peak data, as the base effects, from last year's trough, roll over. Hitting the peak of something conjures images of the best being behind us. While that may be the case, when it comes to underlying market data, peak doesn't necessarily mean weak. Any rolling over of data merely suggests that the growth rate is slower, not negative.

Take the Institute for Supply Management's Manufacturers Purchasing Managers' Index (ISM PMI) as an example. The results for the August survey indicated a slight bump to 59.9 from July's 59.5 but much further away from the peak in March at 64.7. A figure above 50 indicates growth and August marks the 15th consecutive month of a reading above 50. While the index has declined slightly and is expected to continue to decline, it is fully expected it to remain well above 50 for the foreseeable future. There remains many supply chain disruptions and elevated backlogs, not to mention strong demand for goods that should continue throughout the global economic reopening.

3) Strong earnings growth

A continued strong ISM PMI level should also lead to solid earnings growth. However, the recent index results would suggest that year-over-year earnings growth for the U.S. will likely peak in the third quarter but should still be attractive well into 2022.

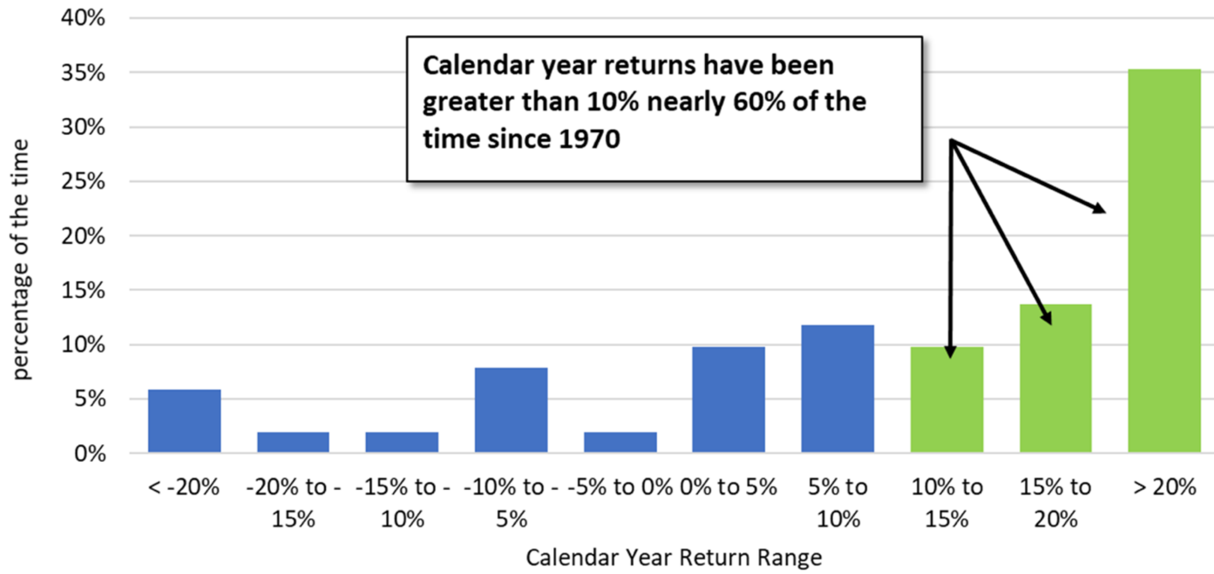
4) Markets are less expensive today

We have seen a very strong earnings recovery globally which has been the primary driver of returns. Despite global markets being at or near all times, valuations based on trailing price to earnings ratios have moderated due to strong earnings growth. Today, investors are paying anywhere between 3-5 multiple points less than they were are the beginning of the year, depending on the region.

5) Strong returns can continue

Don't underestimate the markets tendency to produce above average return. While the average calendar year price return for the S&P 500 index being 12.2%, many investors may be surprised to learn that the actual return is rarely average. In fact, calendar year returns are more often above 20% than they are negative. Calendar year returns have been greater than 10% nearly 60% of the time since 1970 and greater than 20% nearly 35% of the time!

S&P 500 Index frequency of calendar year price returns (1970 – 2020)



6) Odds are in your favour

The equity markets reward those investors who are 'eternal optimists' despite the headlines. The table below illustrates that over the past thirty years investor's returns have been positive nearly 75% of the time on a one year rolling basis.

Probability of positive returns by time frame

S&P 500 Price Return

Time Frame	% Positive
1 Day	52%
1 Week	56%
1 Month	60%
3 Months	64%
6 Months	67%
1 Year	69%
2 Years	76%
3 Years	78%

S&P 500 Total Return

Time Frame	% Positive
1 Month	63%
3 Months	68%
6 Months	71%
1 Year	75%
2 Years	82%
3 Years	84%
5 Years	89%
10 Years	94%

5 Years	79%
10 Years	88%
20 Years	96%
30 Years	100%

20 Years	100%
30 Years	100%

Watch out for pitfalls!

Despite the need to maintain an optimistic view, it is always important to keep an eye out for potential pitfalls in your asset allocation. While keeping your eyes on the "prize" investors need to treat their portfolios, optimism over the longer term, while keeping an eye on potential near term bumps.

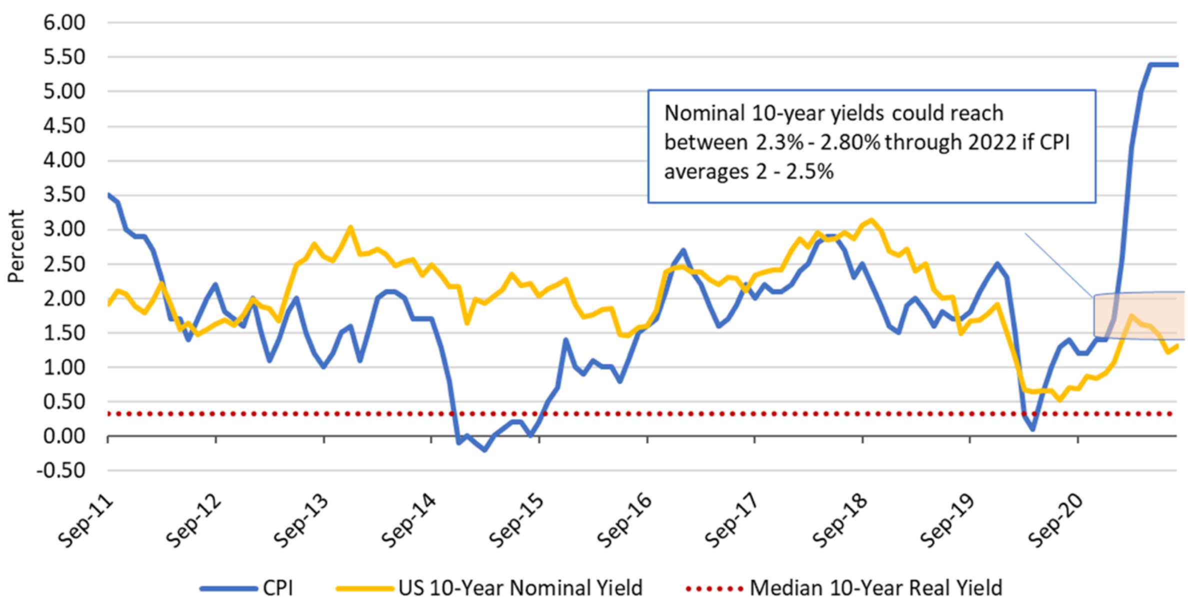
- **Inflation will remain above 2%**

The US Federal Reserve has been using the term "transitory" to explain the current levels of inflation that is hovering near 5% year-over-year. But what exactly is transitory? It depends on how you define it. Is it in measure of time or magnitude? While we certainly agree that CPI will not remain at current levels into next year, we still believe that it will remain above the Federal Reserve's target of 2% for some time. While it's unlikely that the Federal Reserve will begin to increase their overnight rate over the next year, it is more likely that they will begin 'tapering' soon. The bond markets will likely react ahead of it to incorporate the change in policy decision.

- **Real yields are well below where they should be**

So far, the bond market has not fully digested the potential for higher rates. Today, there is a real negative yield on 10-year treasuries and history suggests that it is unlikely that investors will continue to accept a negative real yield. The 'real' yield is what investors are left with after incorporating inflation. A simplistic way of looking at the real US-10 Year Treasury yield is to reduce the yield by current inflation. Over the last 10 years the median real yield has been 32 bps. If we were to apply that to inflation between 2.0% - 2.5% that would imply a 10-Year yield of approximately 2.30% - 2.80%.

US 10-Year Treasury Yields vs. CPI (last 10 years through July 2021)



A constant test is trying to decide where the balance of risk lies. When it comes to the current fixed-income markets, we must ask ourselves, “What’s the risk of being wrong?” If you’re positioned with a shorter duration and yields fall, you may gain a little on your fixed-income investment. However, if you ‘re positioned with a longer duration and yields rise, then you‘re at risk of having a negative return. Given the strong economic growth and what we believe is sustainable inflation above 2%, it’s more likely that the 10-year Treasury yield trends higher, not lower, over the next 12 months. For this reason, I continue to favour a shorter duration posture, with a tilt toward credit within a fixed income portfolio.

While being an eternal optimist can be both exciting and frustrating at the same time, like a good sports fan, investors always need to keep an eye on the short-term reality. This doesn’t mean that we should be pessimistic either. It merely suggests that the reality of investments requires a logical approach to portfolio construction.

I appreciate you taking time out of your day to read this month’s commentary and I hope you found this insightful and of value. Thanks for your continued trust and support.

Warmly,

Aaron Pedlar