Market Review
Fourth Quarter 2020

Annualized Performance in Canadian dollars (%)

	4th Quarter	1 year	3 years	5 years
Bonds	0.8	8.7	5.6	4.2
Canadian equities	9.0	5.6	5.7	9.3
U.S. equities	7.6	16.5	14.9	13.4
Euro-Pacific equities	11.3	6.1	4.9	5.7
Emerging markets equities	14.8	16.4	6.8	11.0
Real estate investment trusts	13.3	-12.1	4.7	8.2
Canadian/U.S. dollar	4.6	2.0	-0.4	1.7

Source: Bloomberg, December 31, 2020

The stock markets continued to rise in the fourth quarter, driven first by the U.S. election result and then by the unexpectedly quick arrival of vaccines, while interest rates rose slightly. The outcome for 2020 can be summarized as follows: the stock markets were up around the world, especially in the United States, where technology has the greatest weighting, and interest rates were down, to the point where real rates turned negative for better-quality bonds.

When analyzing the outlook for 2021, we must take into account the dual personality that the stock markets have gradually developed in recent years – a disparity that only increased in 2020 as a result of the pandemic. On the one hand, we have technology stocks driven upward by the pandemic and, on the other hand, we have the rest of the market. The S&P 500 Index advanced 18% in 2020, but gained only 6% if Microsoft, Facebook, Apple, Amazon, Netflix and Google are excluded. The Canadian stock market, which has fewer technology stocks, was up 6%, but only 2% if Shopify is excluded. The six stocks referred to above trade at an average of 44 times 12-month forward earnings, while the market trades at 22 times. When such a concentration occurred in the past, the most popular stocks were not the best performers in the following five years and often underwent a severe correction.

The outlook for stocks, excluding technology, is positive as long as interest rates remain low. One of the most closely followed equity valuation metrics is the Shiller price-earnings ratio, which compares the price of a stock index (P) with the earnings of the past 10 years (E). The ratio is currently 33 times earnings, whereas its historical average is 16. Robert Shiller recently developed a new model that compares PE ratios with interest rates. It shows that stocks are inexpensive when the negative real interest rate on long-term bonds is taken into account.

But will interest rates remain low for long? The central banks in the developed countries all have very expansionary policies, including the United States, Europe and Japan. The U.S. Federal Reserve has even promised not to raise rates in the near future; but central banks have little control over long-term rates, and in the past expansionary policies have been followed by a bond yield increase of about 0.5%, even in the absence of a short-term rate hike.

Economic activity

The pandemic has created the sharpest and deepest recession in modern times; but it is also likely to be the shortest and will be followed by an economic boom once the majority of the population has been vaccinated. The combination of record household savings and pent-up demand portends a strong recovery in consumer spending. In China, for example, where the virus is almost non-existent, industrial production now exceeds its prepandemic level.

Productivity

A number of economists think the recession will cause productivity to fall over the next few years because some production capital will have been destroyed. If that were the case, inflation would return as soon as demand reached the reduced production-capacity threshold. A more likely assumption is that, instead, productivity will increase because the pandemic has accelerated the adoption of new technologies, such as e-commerce and remote work.

It is important to note that the digital revolution is fundamentally different from the Industrial Revolution because it makes existing infrastructure more efficient. In the jargon of economics, this phenomenon is called "capital deepening." When the steam locomotive appeared, train tracks had to be laid everywhere. It was the same with electrification. In contrast, the Google Maps application, for example, allows delivery trucks to get to their destinations more efficiently, without any major investment. Remote work will allow for better use of offices and housing, while reducing congestion on downtown streets.

Inflation

The trend in the rate of goods inflation has been 1% for a number of years. Inflation in the services sector, however, has varied widely, particularly the housing cost component. After a strong jobs recovery over the next two years, rents will resume rising and will push the overall inflation rate upward. It could even exceed 2% in the United States for a short time.

Interest rates

Central banks have their foot on the accelerator and will keep it there for much of 2021. Real short-term rates are negative and very close to the lower limit of what a central bank can do. As a result, central bankers cannot take the risk of raising rates too early in the recovery for fear of causing the economy to relapse, as it did in Europe after the Great Recession of 2008-09.

Even so, long-term rates are expected to go up. The 10-year Government of Canada bond currently yields slightly less than 1%. The yield could rise to 1.5% in the recovery.

U.S. stock market

Returning to the analogy of the dual personality, we can conclude that technology stocks are expensive and may be in a speculative bubble, as evidenced by the absurd valuations for technology IPOs. The rest of the market is inexpensive and much less risky. The difference between the “rest-of-the-market” dividend yield and bond yields is large enough that share prices could continue to rise even with a moderate increase in long-term yields. For the time being, the adage “the trend is your friend” applies.

Canadian stock market

The Canadian stock market has underperformed the U.S. stock market for a number of years because Canada has fewer technology companies; but the dual-personality approach applies here as well. Canadian equities are currently inexpensive, and various sectors of the Canadian market will be favoured in the global economic recovery of 2021, especially banks, miners and oil companies.

REITs

Real estate investment trusts operate with a high level of debt and therefore their greatest risk is a lack of liquidity. It is therefore not surprising that they have issued a record volume of long-term debentures in recent months. And the market has welcomed them with very accommodating financing terms.

Canadian REITs are down 20% from their February peak, even though interest rates have fallen and their liquidity risk is almost zero. Investors are concerned about short-term performance, given that many tenants cannot pay their rent, and also about the pandemic’s long-term impact on lifestyle and work habits. As a result, the difference in yield between REITs and their bonds is very favourable to REITs at present.

Asset allocation model

Our model selects those assets that have performed best in the past nine to 12 months. It eliminates gold and avoids bonds, investing mainly in the NASDAQ Index, emerging markets and the S&P 500. The portfolio’s positioning is the most concentrated and riskiest it has been in years. It returned 19% in 2020.

Dashboard as at December 31st, 2020

Canada	
Canadian dollar versus U.S. dollar	=
Corporate bonds	-
Long-term government bonds	--
TSX 60	+
REITs	++
United States	
U.S. dollar versus euro	-
Long-term Treasury bonds	--

S&P 500	=
NASDAQ	-
Europe	
Euro versus U.S. dollar	=
MSCI Europe	+
Asia	
Yen versus U.S. dollar	=
MSCI Japan	+
Emerging markets	
MSCI Emerging Markets	+

= : neutral + : overweight – : underweight