Third Quarter Investment Commentary 2021

It is hard to believe that it has almost been two years since the first outbreak of COVID-19 in Wuhan, China. In Ontario, it looks like things continue to get better, with positivity rates declining, and vaccination numbers increasing, all while restrictions continue to lift, and our economy opens further. I am sure that we are all hopeful that we can continue to return to our pre-COVID routines as much as possible, and we hope you have been able to resume at least some of your activities and reunions with family and friends.

At the start of the year, many were calling for a robust recovery, with some even suggesting a global synchronized growth environment. This was after many cheered the approval for emergency use of several vaccines (with +90% efficacy levels) by US and European regulators. While we agreed with the robust recovery narrative, we felt that a global synchronized recovery was too aggressive of a stance to maintain, given the difficulties and uncertainties associated with manufacturing, distributing, and administering the vaccines to the global population. The successful reopening of the global economy and the pace and strength of this recovery will largely remain contingent on the effectiveness of vaccination programs. This sounds simple enough, but what the last 9-months has shown is that it is difficult to jab ~7.9 billion people with a vaccine, let alone do it twice and now maybe three times.

While strong progress has been made over the past year, the prime beneficiaries have been mostly the advanced economies who have had preferential access to vaccines versus their developing/emerging market peers. The uneven distribution of vaccines has resulted in a bifurcated global economic recovery/reopening process with some regions heading back into partial/full-lockdowns, as new and more contagious virus strains have emerged (e.g., Delta). This has resulted in a slower return to pre-pandemic activity, with increasing tensions in global trade and supply chains.

The OECD is now forecasting global output to rise by 5.7% in 2021 and 4.5% in 2022, which under all accounts is quite robust and up from the contraction in 2020. While global GDP has now surpassed its pre-pandemic level, output and employment gaps remain in countries, particularly across emerging and developing economies where vaccination rates remain low. Several high frequency activity indicators, which measure retail and recreation mobility, suggest global activity continued to show strength in recent months, specifically across Europe, India, and Latin America. Despite all the near-term noise including softness in the global Purchasing Managers' Index® (PMI) indicators, PMIs remain above 50, and consistent with a continued global growth outlook. That said, we continue to maintain an overweight allocation to developed markets versus emerging/developing markets because of higher relative vaccination rates, a recovery in employment, and supportive monetary and fiscal programs.

Recent macro releases have shown signs of slowing in the Canadian economy. This was most clear in the Q2 real GDP print, which showed the economy declined by -1.1% on a seasonally adjusted basis. The miss was primarily driven by a meaningful drop in residential investment (-12.4% Q/Q; +42.3% Y/Y), and exports (-15.0% Q/Q; +12.0% Y/Y). Housing, which has emerged as a key contributor to economic activities and capital stock since Q3/2020, declined due to lower home resale activity in the quarter, while exports were hurt by supply chain disruptions, in particular the semiconductor shortage, which had an adverse effect on the auto sector. The decline left GDP around 2% below pre-pandemic (Q4/2019) levels during a quarter many were expecting would mark a return to pre-pandemic economic activity. We expect some of this growth to be pushed forward to 2022. However, on a positive note, real disposable incomes rose again in Q2 (+6.1% Q/Q), while household spending remained flat during the period, leaving the savings rate at 14.2%. The savings rate in Q2 was the highest it has been since Q2/2020, and continues to support our view that sufficient pent-up demand remains on the sidelines across Canadian households.

U.S. economic growth was strong in the first half of 2021. GDP growth averaged a 6.4% annual rate over the first two quarters, but that significantly understates the strengthening in domestic demand. Consumer spending advanced at an 11.6% pace and business fixed investment rose at an 11.1% pace. GDP growth appears to have slowed in Q3/2021, reflecting the Delta surge and the impact of the semiconductor shortage on motor vehicle production (pushing some growth into 2023). We believe that, despite the near-term softness in the economy, growth will rebound as the fourth wave of the virus loses steam and supply chain/labour challenges ease. We expect past gains in income, employment, and savings should fuel stronger growth in consumption and business investment next year. In addition to the economic recovery, we expect firms will continue to rebuild their low inventory levels. As we look ahead, real GDP is expected to remain above the current trend.

As of the end of September, the TSX composite index posted a year-to-date return of 15.13%. The S&P 500 continued to slightly underperform this year with a year-to-date return of 14.68%. We did see some general weakness through the month of September and markets were down approx. 2.5% on the TSX composite, and about 4.75% on the S&P 500. It was in fact the worst performing month since March 2020, and ended a 10-month clip of higher monthly values on the equity model. Early fall does seem to be a seasonally soft time of year for stocks, and these losses have since been made up.

The current walls of worry include supply chain disruption, inflation, current market valuations, Chinese relations, quantitative easing and a possible 4th wave of COVID. We do believe however that we are in a mid to late early phase of the economic cycle. Interest rates may move up in 2022 but they are expected to be maintained near low levels. There continues to be government support and central banks will work hard to ensure that global growth remains intact. There is pent up savings that will eventually make its way to the economy which should support growth.

While there will be “bumps” along the way we maintain our constructive outlook for equities and they continue to offer relatively better valuation than fixed income. We have therefore not changed our tactical asset allocation for any of our model portfolios and are equity investments are balanced between dividend and cyclical stocks and include a diverse grouping of Canadian and global equities.

We hope you have been able to enjoy the fall and we also hope that this holiday season, which will soon be upon us, you will be able to enjoy with family and friends. Please know we are always here to discuss any concerns or questions you may have please do not hesitate to contact any one of us.

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