Month in Review - May 2021

Equity

Markets were mixed in May with the TSX Composite Index rising 3.48% and the S&P 500 (in CAD) falling 1.61%. The Canadian Bond Universe Index finally rallied for its first monthly gain of the year, increasing 0.38% and the 10 Year Government of Canada Bond rate closing at 1.49%. With bond rates so low and now more correlated to stocks, we continue to use private debt and private real estate as an alternative to bonds for the safety portion of your portfolios Both focus on producing income month over month, and because they are private assets their prices do not fluctuate daily like stocks and bonds.

The Markets

The biggest news for the markets came early in the month when the US Consumer Price Index number showed a big inflationary spike (see the chart below) Should the big move in the CPI continue without an increase in wages, then the middle and lower class face tougher times which will likely result in less discretionary spending over the long run and would be deflationary.

Source: Bloomberg

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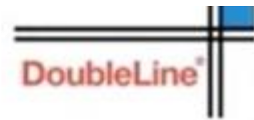
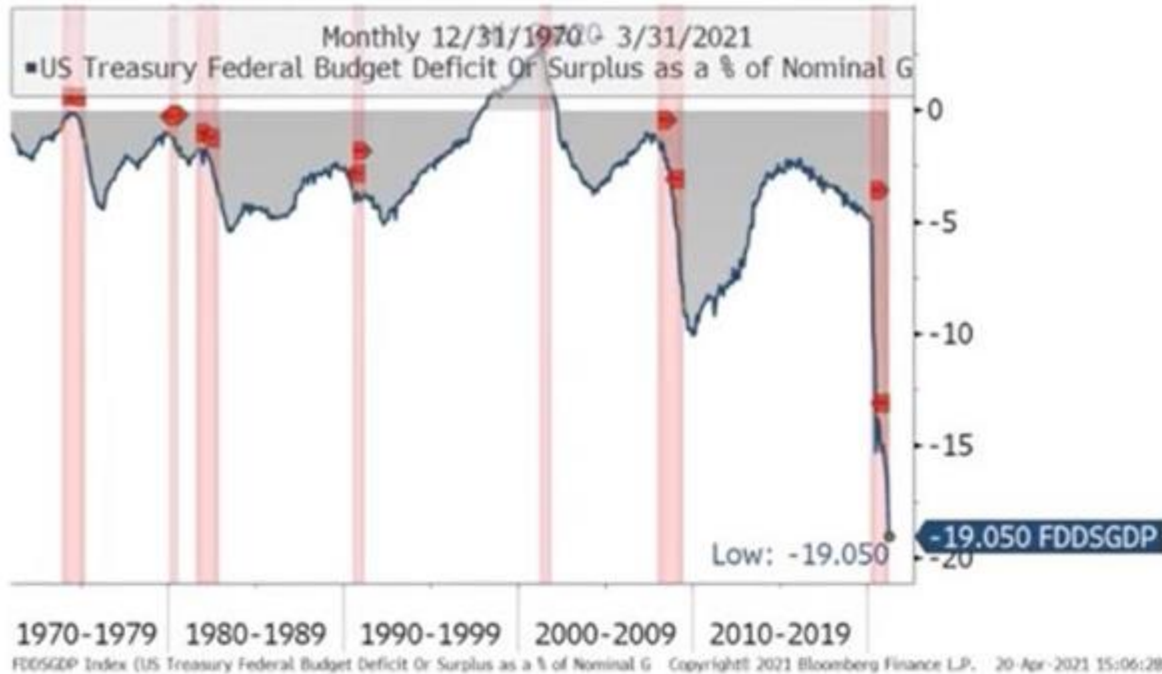
The most important factor for stocks with respect to inflation is that the US Central bank (the FED) continues to believe that inflation is “Transitory" meaning the recent price increases will be temporary and will soon level off. They may be correct, as technology is clearly deflationary over the long run, making our lives easier and reducing the time and cost of producing goods However, it is unlikely that grocery stores or restaurants will lower the prices shortly after an extended period of raising prices We believe the recent price increases are likely to stay over the short term (again hard for businesses to lower prices once they increase them) and should wages rise too, then inflation will likely persist longer. Most importantly for markets is the FED’s policy towards inflation We believe easy monetary policy will remain because they are trapped.

1. The US deficit continues to grow at a faster pace each year (see chart below) and, few elected officials talk about reining in the spending, most run on the promise of more spending.
2. This means the US Treasury needs to issue more debt to finance the spending.
3. Currently, the FED is buying that debt and, if they slow down, then someone else will need to step in, which likely would cause higher interest rates on US debt.
4. With the increased amount of debt in the economy, we believe that interest rates cannot rise, for if they do, they will likely cause a big correction in both the economy, stock market, and US housing market.

U.S. Budget Deficit Watch



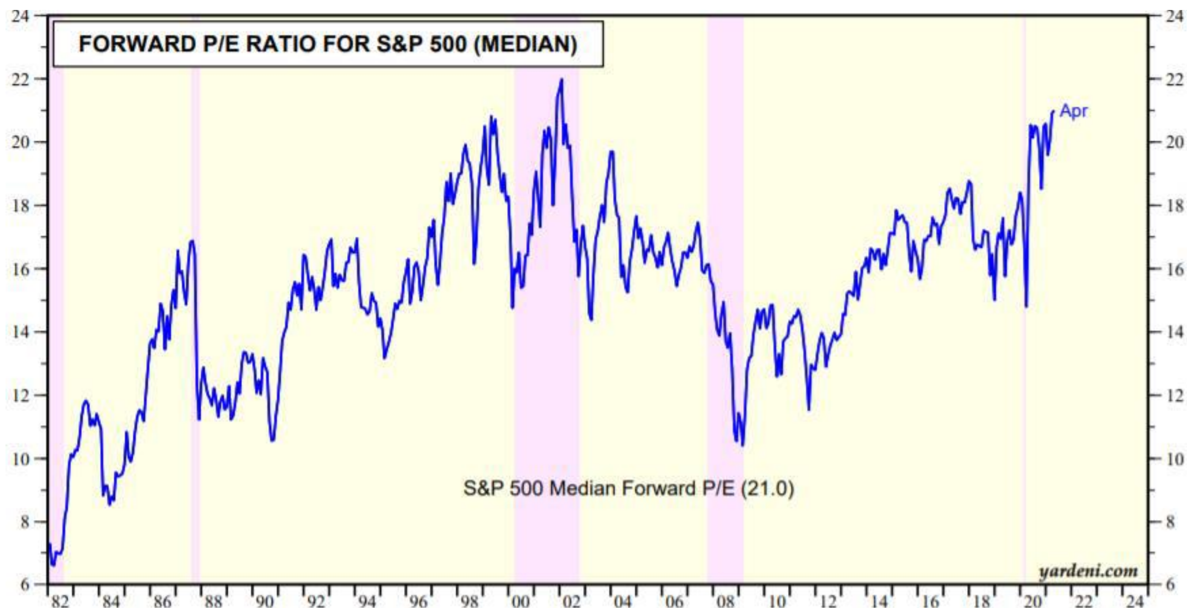


With easy monetary policy remaining in place because of the reasons listed above, we believe equities will continue upward from here However, as other central banks reduce liquidity, while the US remains accommodative, the US dollar could weaken enough for the FED to change policy and begin to tighten but, we feel that will not happen until later 2021 or early 2022 The portfolios remain tilted towards equity (which includes private real estate) but balanced between growth companies with strong earnings and more established companies with stable earnings Furthermore, we continue to hold private debt and private real estate for the safety portion of the portfolios, and both will benefit should inflation persist while providing excellent income if it subdues.

June 2021 Commentary

Stock markets continued to move higher in June with the S&P 500 (CAD) rising 5.06% bringing the index up 6.42% for the second quarter. The TSX Composite, rose 1.84% in June closing out a strong quarter up 7.91%, primarily off big gains in energy companies. There was not much news for the markets to digest

this in June except for the regular 6-week meeting of the US Central Bank (The FED). These meetings are for the discussion of economic policy and how the FED will act with respect to interest rates and the buying of US Government Bonds. The market was awaiting word on both of these items. While there was no clear consensus, it appears that Jay Powell the head of the FED will continue on the current path of lower rates for longer and continued bond buying at the current pace. They cited the still high unemployment numbers as key reason for holding the course. The equity markets reacted favourably to this news. While this news gives investors confidence, the result is that stock valuations as measured by the Forward Price/Earnings ratio (the price we pay to buy $1 of future S&P 500 earnings) are rising again. As this chart below from Refinitiv shows us the median P/E ratio for US stocks is approaching levels not seen since the technology bubble in 2000.



Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv.

It appears the FED is likely early in repeating past mistakes (1999/2000, 2007/2008, and 2019/2020) where they provide easy monetary policy for too long and then decide to tighten too late. With equity valuations approaching all-time highs and economies re opening, we believe they should currently be taking their foot off the accelerator. Nonetheless, both bond and stock markets remain happy with the current policy so stocks should continue to move higher. In our public equity pools, Northgate and Springfield we are seeing a bit of divergence in approach. While Northgate is remaining fully invested in equities, the Springfield Equity Pool has exited a number of positions in the past month and has not made new purchases to equities. The manager is looking for a short-term, moderate pull back in prices to put this money back to work. On the defensive side, we continue to hold private debt and private real estate which have continued to provide consistent income with almost no volatility. The result is well diversified portfolios that are providing strong returns with minimal drawdowns from short term noise in the markets.

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