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Where Do We Go From Here?

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The last few months have been one of the most unusual periods in memory regardless of your age. Many sectors within the global economy shut down and the impact has been even more widespread. While U.S. gross domestic product (GDP) is expected to fall by at least 10% this year compared to 2019, the aggregate price of stocks, as measured by the market capitalization of the Russell 3000 Index, is up by 10% as at September 1, 2020.

Government and central bank spending

Just when we thought we had seen the most dramatic central bank response to combat the global financial crisis in 2008-09, the action this time has been far more aggressive. The U.S. Federal Reserve (the Fed) expanded its balance sheet by US$3 trillion in just three months. In other words, the U.S. central bank "printed" US$3 trillion out of… nothing. The Fed is not alone as all major central banks, including the European Central Bank, Bank of England, Bank of Japan, Bank of Australia and Bank of Canada followed similar strategies.

Governments also spent aggressively, including stimulus checks to citizens regardless of whether they qualified or not. Their goal to boost asset prices through both monetary and fiscal stimulus was met but, just as it did in 2009, flooding a large supply of money against a finite amount of assets in a short time period leads to higher prices. We have seen the impact on stocks almost immediately; higher prices reflect the decreased value in currencies, while the actual value of assets has not increased during the pandemic.

Everything's on sale, but at what cost?

Naturally, this money did not flow into one place or evenly everywhere. Imagine if you knew your money would be worth less the next minute, what would you do? You would go out and buy whatever necessities at any price. Why any price? Because you have no time to decide. This mentality led investors to buy heavily into companies that were the most obvious and relevant to our lifestyle; Apple Inc., Microsoft Corp., Amazon.com Inc., Facebook Inc. and Alphabet Inc. (Google). These stocks are now trading at all-time high prices when their valuations were already elevated before the pandemic.

Apple, for example, is the largest company in the world with a market capitalization of over US$2 trillion. That's more than ALL the companies in the Canadian S&P/TSX Composite Index. Its price-to-earnings ratio is 40, meaning you are paying $40 for one dollar of future earnings, i.e. 40 years to break even; not great.

However, the uncertainty or upward surprise is the growth rate. If Apple's earnings continue to grow, that price-to-earnings ratio will fall and investors will break even sooner. There are two sources for growth; first, organically, as Apple continues to expand product lines and sales; and second, inflation. Typically, in a recession investors discount both factors, but not this time. Chief Executive Officer of Apple, Tim Cook may be brilliant, but what is different this time is the unprecedented central bank response. We often say good companies are not necessarily great investments as value is another factor. Now central banks have crushed the concept of value in investing with a sea of new money chasing investments at any price.

What's next?

So, where do we go from here? Money will likely flow outside of investors' comfort zones as economies reopen. We will return to work/school, travel, consuming not only for necessities but for fun, and many companies that were overlooked at the moment will be bought. The timing of this transformation is uncertain, but the likelihood is high. When it does occur, we see it happening in three stages:

1. In the first stage, investors favour certainty. Certainty is higher with better growth prospects, whereas companies that are shrinking are less certain and are being avoided.
2. As we overcome fear, investors will realize the combination of low borrowing costs and a growing economy will reward leverage. Look for interest in real estate and increasing mergers and acquisitions.
3. Finally, as we return to a "new normal" lifestyle, companies that are discounted for uncertain prospects will outperform as improving economies benefit everyone and management teams execute recovering strategies.

Right now, we are probably at the second half of the first stage. This means growth is still favourable, but some investments are starting to get expensive as the growth is already priced in. It's a time to consider transitioning, but also to be careful as there are many moving parts. The timing of a vaccine is uncertain and economies could return to shut down. Central banks could hit the print button again and then the rush to buy would return. Investors need to stay nimble and not overly exposed. At the end of the day, stock markets are not the new casinos.

Combined top 15 equity holdings as of August 31, 2020 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft Corp.	6. Franco-Nevada Corp.	11. Humana Inc.
2. Amazon.com, Inc.	7. Brookfield Asset Management Inc.	12. Royal Bank of Canada
3. Visa Inc.	8. Alphabet Inc.	13. Empire Company Ltd.
4. Apple Inc.	9. Enbridge Inc.	14. Toronto-Dominion Bank
5. Prologis Inc.	10. Fortis Inc.	15. Facebook Inc.

Source: Bloomberg Finance L.P. and CI Multi-Asset Management as at September 9, 2020.