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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

Covid August Summer Update

As of early August 2020 the US market has recovered to within 5% of its pre-Covid record high, while the tech-oriented NASDAQ index is 10% above its pre-Covid high. This strong V-shaped recovery has prompted a number of clients to ask: Is the market too high? What about the predicted 2nd wave of Covid 19? With all the bad news – global pandemic, Trump in the White House, and race riots, the markets flirt with record highs. Isn't the market obviously unsustainable and another significant decline inevitable?

They are reasonable questions. The answers are: yes, and no. Sorry, but it is a bit complicated.

Yes:

Of course we'll have a market decline somewhere here. The average intra-year decline is just shy of 15%[1], while 10% declines – called corrections - are even more frequent. In addition, when markets have experienced either a large rise or decline, especially like we've just had, a significant move in the opposite direction, called a retracement, is common. So a drop will be no surprise.

The next little decline will conspire with the predominant emotion in the public psychology today, which is fear. Public confidence, weak since the financial crisis 12 years ago, is as negative as I recall in 30 years. The fear will be fanned by even more alarming headlines about why it will get worse.

The fear is understandable: the March declines took 35% off equity market prices in a record 30 days. Another sharp decline soon, even a modest 10 or 15%, could trigger a rush for the doors. A slow, drifting decline will produce frustration and an equally dangerous temptation to 'do something different'. We have a whiff of smoke in the theater, and a nervous audience eyeing the exit doors.

Funnily enough, even as many investors are apprehensive, the sharp v-shaped market rebound has encouraged a new generation of neophyte speculators. Dave Portnoy, a sports betting pundit without a job, is leading an army of day traders trying their hands at day trading stocks. These people tend to be cannon fodder as they rush for the exits in a down market.

So a random little decline could be more entertaining (read: scarier) than it would normally be.

No:

The 'No' part of the answer is the important one.

The real question behind the questions above is, 'Can I avoid the danger?' This question is really just the 2020 version of the classic: 'I think things look terrible, let's trade out, and get back in when the danger has passed.'

I'll address the questions, beginning with a brief restatement of what we're trying to do, and then we'll look at the uncertainties around Covid and the economy.

Rationality Under Uncertainty

First, *the success of your financial strategy does not depend on how the current pandemic resolves.*

Many unfortunate souls, including many in the financial industry, labor under the delusion that financial experts can see the future. They think investment success results from such clairvoyance. I do not. To paraphrase Dick Cheney: I know that I don't know, and I don't pretend to know what the next 6 or 12 months holds. But also Churchill: The further back into history I look, the further into the future I can see.

As financial planners, we practice the application of rationality under uncertainty. We look at the broad lessons of history; our goal is to have you and your families in the best position to meet your personal financial goals over the next 5, 10, 20 or more years. A reasonable horizon, since a newly-retired 65 year-old couple can expect to live another 30 years. And some of you have actually been with me almost 30 years!

Investment failure begins when a short-term forecast is allowed to dominate your thinking: the focus of your attention drops from the horizon where it ought to be; soon you are looking at your toes, and are lost. Successful investors work from a long-term philosophy; they do not let the unforecastable short-term fluctuations push them off course. Failed investors destroy themselves by chasing short term market views.

Declines Temporary, Advances Permanent

Your investment strategy is built on several core principles, first of which is that a diversified portfolio of equity securities is highly likely to generate returns significantly greater than, if not multiples of both inflation and bonds or GICs (particularly so today). In 1990 the S&P500 was at 340; today it is 3200, an increase of almost 10-fold, while inflation has doubled the cost of living.

But it isn't a free ride. Equities experience temporary price declines averaging 30% at equally unpredictable intervals. Since 1990 there have been three declines of more than 30%, (two were 50%) yet each time, markets recover and go on to new highs. This is why we say, 'the advances are permanent, the declines are temporary'.

We design your portfolio and your financial plan to withstand these temporary but severe fluctuations without damage to your plan. We don't merely anticipate bear market declines, *we plan for them*.

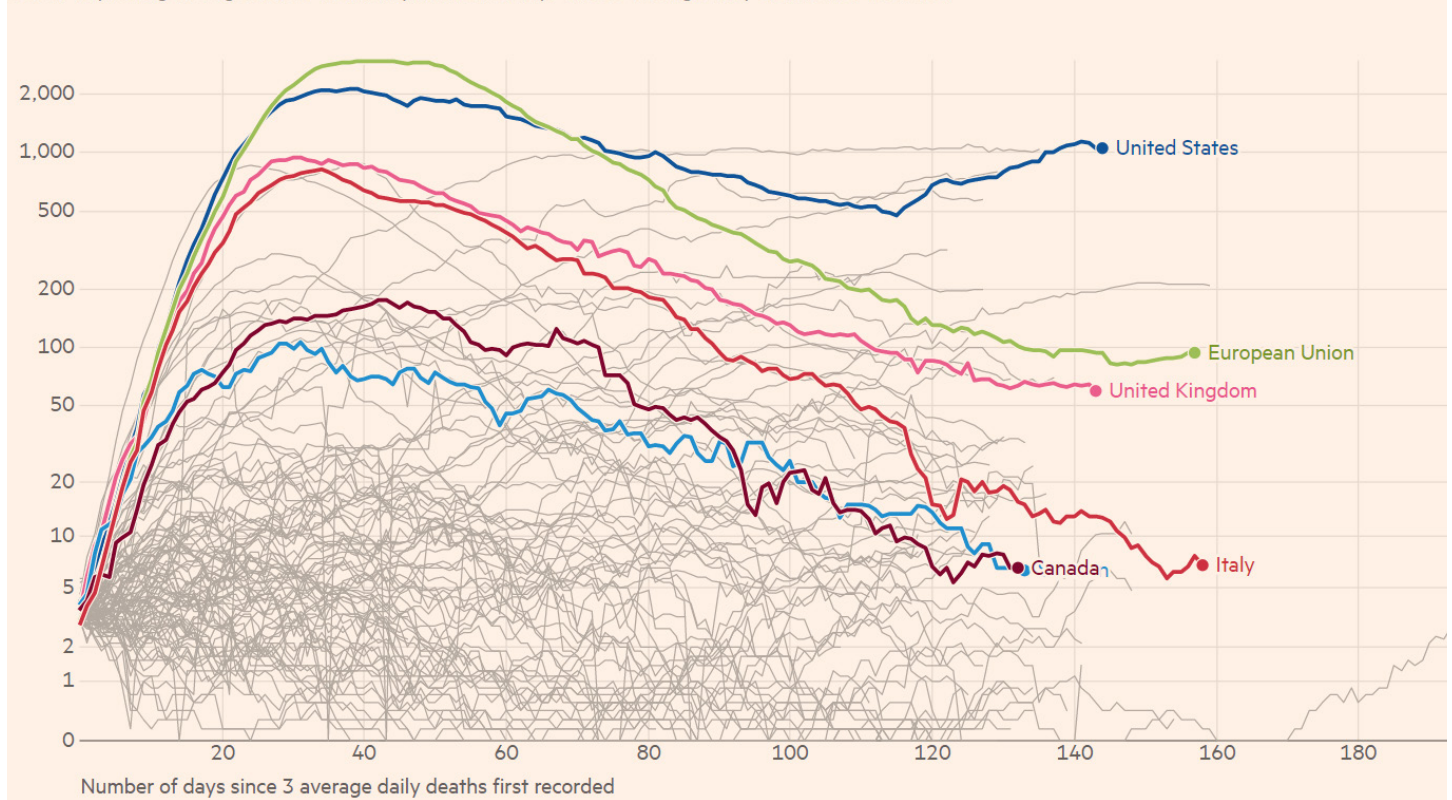
By far the greatest challenge in investing is that the normal human mind is programmed – by hard-wired antediluvian reflex - to sell in fear during market declines, and conversely to overbuy in confidence at market tops. This behavior results in permanent capital destruction that costs investors between 2% and 15% per year on average and results in them underperforming the actual investments that they hold. ('per year on average' actually understates the severity because the losses tend to be episodic and large.) So your question about selling now is also quite normal.

One of the main values I provide is therefore as a behavioral coach: an emotional counterweight to provide courage in times of fear and caution in times of exuberance; behavior that is often the opposite of the hard-wired proclivities of the human brain discussed above, and certainly runs counter to the popular or accepted opinions of the day.

Looking Across the Valley

Markets look to the future. Markets are looking out 6, 12, 24 months, ‘across the valley’, and they see the Covid-19 virus is being brought under control. (The news media by contrast considers only the most negative aspect of the present instantaneous moment and extrapolates it indefinitely.) While today the pandemic has not yet run its course, it can be managed, and economies will be able to function.

In Italy, as shown in the chart, deaths attributed to Covid have fallen from about 800 per day at the peak to about 10. In the UK, deaths have fallen from 1000 per day to under 100; Canada, from 200 to 10. Even Sweden, with no serious lockdown, deaths have fallen from about 100 per day to about 10. The EU as a whole has seen deaths fall from about 3000 per day to less than 100, more than a 97% decline.



Vertical scale exponential
Source: Financial Times, August 6 2020

Europe is showing the world that the virus can be controlled. In a population of 446 million, adoption of certain behaviors can dramatically slow the infection rate.

The US peaked at over 2000 deaths per day in late April, fell to under 500 by June and is currently running at 1000 per day. Americans don't like being told what to do - and bless them for that, most of the time – but in this case the virus is showing us – and Americans will learn - that if various measures aren't followed, it will be back with a vengeance.

Back to the Question

The questions remain: What if the Covid pandemic lasts much longer than your naïve optimism suggests? Shouldn't I sell now to avoid another downleg in the markets?

Short answer: NO!

Can't time markets

Longer answer: It is not possible to time a temporary exit and re-entry into a market reliably, and trying to do so is highly likely to inflict permanent damage on your long-term returns. Just as nobody, in the vast multitude of economic forecasters, analysts and other pundits, foresaw a 30%+ decline in 30 days, they didn't see the V-shaped recovery, and they have no idea how this will play out.

The problem is that you don't know how much farther prices will rise before they fall. And then you don't know if prices will fall far enough below the point you sold at to make selling worthwhile. You have to be exquisitely correct, not once but twice – and twice in a row. It's one of those things in life: a short-cut that looks obvious and easy, but only in retrospect. Looking forward, in real time, it is fiendishly difficult.

Trying to time market fluctuations is a loser's game. It's why Warren Buffett says he can't do it, and he doesn't even know anyone who knows someone who can do it consistently. But many people have wasted their fortunes trying.

Your portfolio has been designed for bear markets such as this, and the next one too. If you are retired or nearing the point where we will be making withdrawals, you already have a significant proportion of your mix in lower volatility income-oriented assets precisely to protect the portfolio from excessive volatility and to provide for withdrawals in times like this.

Nevertheless, today's situation involves several currents or trends which make things especially interesting. These currents are not new, but the pandemic and the policy-induced economic full-stop, which has no precedent in economic history, will accentuate or accelerate the trends.

The Covid Virus

We are learning things about the virus every day that will help us tailor our responses and get the economy moving. Here are three I think are important.

Case Rates Misleading

Testing for active cases is important because it tells us where we need to tailor measures to keep the virus under control. The number of cases, however, is misleading as an indicator of the overall prevalence of the disease because case rates are directly influenced by the amount of testing performed. With testing now at much higher volumes, many more cases are being discovered. The case rate appears to be going up, when in fact very little testing was done in March and April.

(Newsmedia is well aware of this, but only comments on it in the alarming context: a recent report in the Wall Street Journal stated that US cases had fallen to their lowest level in 2 weeks, but then pointed out, just so you would remain alarmed, that the lower case numbers resulted from reduced testing over the holiday weekend. This is laughable: lower numbers are from reduced testing, higher numbers are cause for alarm. See antediluvian reflex above.)

In any case (sorry), the recent surges are mostly younger people, who are more cavalier about distancing and partying, and they seem to be less impacted by the virus anyway. Many of these cases are asymptomatic or mild.

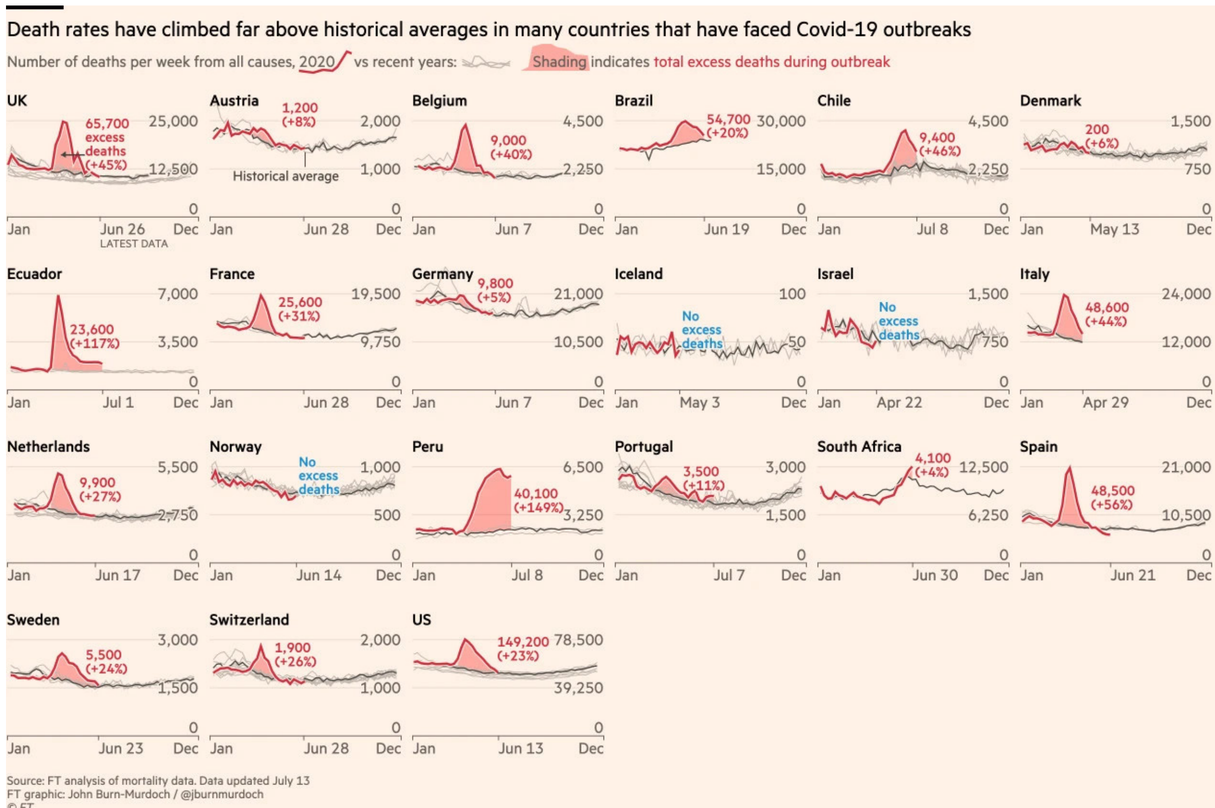
The key data - which we don't yet have – is antibody testing. Testing a representative sample of the population will tell us how many people have been exposed to the virus and now have significant immunity. We can also then estimate the true mortality of the disease.

Antibody testing in New York City shows that a surprising 68% of Queens has developed antibodies and therefore has at least a degree of immunity[2]. Other boroughs were lower, but this strongly suggests that a significant percentage of the population already has a degree of immunity. It also appears that the disease is much less potent than earlier believed because many more people have been infected and recovered. This means there is less to fear from a 2nd wave.

Excess Mortality

The number of deaths as an indicator is also somewhat flawed because of data collection issues, such as nursing homes, where patients are likely to be failing for multiple reasons, so it isn't clear that a death can be fairly attributed to Covid and not something else.

A much better statistic is the current death or mortality rate compared to the historical average for the same period in the past. This is known as excess mortality. If London averages 200 deaths per week in March and April for the last 75 years, and in 2020 deaths are 400 per week then you have a good indicator of the severity of the outbreak.



This excess mortality was 25% to 100% above the historical norm in March and April, as shown in the table. It is interesting to note that mortality calculated this way was actually much higher than official data at the time, indicating problems with official mortality data. The Financial Times estimated that as at mid-June, excess mortality was 50% - 100% higher than official statistics.

As the chart shows, mortality has sharply declined and has fallen back to normal or very close to, as of mid-July. The US mortality rate spiked 25% above normal and by mid-July had returned to normal. (The Financial Times makes the data and explanations available to nonsubscribers; Google FT excess mortality.)

Looking at cities, New York City was +250%, Madrid +157%, London +99%, while very interestingly, Stockholm was only +67% above normal; all have returned to normal or very close to normal.

At Risk Over 70

We are also learning clearly the cohort that is most susceptible is over age 70: Ontario public health data shows 96% of fatalities are over 60; 90% are over 70. A large percentage also had comorbidities such as asthma, emphysema, previous pneumonia, or a compromised immune system. Nursing homes, were particularly hard hit.

The virus seems to have little effect on children, and interestingly, often presents only normal flu symptoms in healthy adults regardless of age. Of course there are exceptions, and we all have our examples, but very clearly, our society's considerable resources should be directed at the most susceptible group – instead of locking people up in solitary confinement and shutting down the economy. Neither is sustainable; the cost in mental health alone is too high.

Looking Forward: Investment Implications

The pandemic and the policy responses will have several significant and long-lasting effects that will influence the design and behavior of your portfolio, and that your money managers will be incorporating into their thinking at the individual security level. These effects are not new, but are extensions of existing trends that are being accelerated by the policy responses and behavior changes in response to the pandemic.

Uncertainty

These trends or economic currents are playing out in a highly uncertain environment. All the major variables, from deficits to employment to international trade to virus immunity, are being impacted by rapidly changing forces. The next 6 months will not be like the last 6 months. In a swirling environment such as this, it is important to be very careful making investment decisions. I think it was the psychologist Daniel Kahneman who said 'If you make a change to your investments, you are likely to be wrong; if you do it with urgency, you are almost certain to be wrong'.

Zero Interest Rates

While we expected interest rates to go to zero in the next recession, we didn't expect to get there quite so quickly. The 10-year bond is now yielding less than 0.5%, while the 30-year US Treasury bond is yielding 1.25%. The implications for retirement and investment planning are enormous.

A reasonable estimate of bond returns for the next few years is the current yield on the 10-year bond: 0.5%. If you were to target income of $30,000 per year from a portfolio of bonds, you would need $6 million! Government bonds are no longer useful as income-producing instruments.

It gets worse. Traditionally, bonds have played an important role in diversifying a portfolio, because bond prices often move in the opposite direction to stocks, thus dampening portfolio fluctuations. (Bonds rise in price when interest rates decline.) If rates are now zero, it is difficult to reduce them further, so bonds cannot be counted on to rise in price in a recession when stock prices might also be falling.

Both these things – no income and little diversification – mean that investors are forced to take on more volatility to earn income. I deal with each briefly below.

Income Investing

Investors requiring income can invest in other income-producing securities such as corporate bonds, real estate trusts, and infrastructure such as highways, pipelines, and other utilities. Canadian bank stocks have been in this category. These businesses are yielding income in the neighborhood of 3% - 6%, which is a good base. However, not only are the prices of corporate bonds and other income securities much more volatile than government bonds, their volatility tends to be in the same direction as equity markets. So your portfolio will be more volatile. We saw this in spades in March, as the income side of your portfolio fell in price, to a lesser degree but still fell, along with the common stock part of the mix.

The good news is that the income produced by these instruments is consistent, so they do have an important role to play in a retiree's portfolio, even if the market price in the short term isn't as stable as government bonds. The point is that income investing is not a matter of buying a few bonds and collecting interest. Income securities require individual analysis and active management.

Monetary Policy Finished

Another implication of interest rates at zero is that monetary policy no longer has a role to play in economic management. Interest rates can't be dropped to stimulate economic activity in a recession. This means that fiscal policy – government spending and taxation – are the only tools remaining. We are in a different world now, since interest rates have never been at zero before.

So yes, it is different this time. At least until the time when interest rates need to be raised.

The US unleashed over $2.5 trillion spending in various aid programs to keep consumers afloat as people stopped working during the lockdown. This spectacular cash injection was necessary to fill the deflationary hole until the economy can get going again. With the CARES Act sending $1,200/week and the UI top-up of $600/week, many low-income families in the US are making more now than they were before the pandemic, but Drummond Brodeur of Signature Advisors calls the stimulus a 'sugar high' that will wear off soon, and the pain of getting back to work will begin.

Deficits of this magnitude are totally unsustainable and so the spending will have to stop. A fourth US stimulus package is expected, but it is simply not possible to predict how quickly or smoothly the economy will get going again. It is likely, given the persistence of the virus and the time that will be required to produce and administer hundreds of millions of vaccinations, that it takes another 6 – 12 months before people feel fully confident getting going again (see comment on antibody testing). Look for the economic data to show a significant economic recession as the fiscal stimulus tapers off this fall.

Politicians at the Controls

A final aspect of the end of monetary policy is that because fiscal policy will be the only economic management tool available, the policy response to any problem will be 'spend more'. If all you have is a hammer, every problem looks like a nail.

In Canada and the US, as well of course as southern Europe, political leaders have happily lacked the will to balance budgets during good economic times, which has reduced the capacity for borrowing now. Instead of having a tight-fisted central banker in the room, policy will be in the hands of the same politicians whose responsibility for sound fiscal management has been abdicated over the past decades.

We should all be very uncomfortable with the political classes' grubby hands on the trillion dollar till: the temptation to funnel public money to political friends is proving irresistible already in Canada. Looking into the longer distance future, maybe 5 or more years, the temptation to reduce the national debt by devaluing the currency through inflation may prove as irresistible as it was to borrow in the first place.

Getting Going Again

The problem is that we've never been through a full economic stop, so we don't know what a restart looks like. This is not a cyclical recession. We literally turned off almost all economic activity in a matter of days. As a result, one of the most important uncertainties is how the economy will restart. It is likely that some businesses – travel, hotels, spectator sports – will not reach pre-Covid levels for some time. Small and mid-sized businesses that rely on these industries may not be viable at only 70% or 80% capacity , and some – restaurants for example – will have to close.

Nevertheless, early indications are positive: There are supply shortages in everything from barbeque briquets to aluminum eavestrough and lumber. This is because of supply shortages and peak demand: the mills were shut down for two months, and although they are running at full capacity now, it is peak demand season for construction, and supply can't catch up.

The good news is that consumers are chomping at the bit to get going again. A large percentage of postponed vacation travel has been rescheduled into next year, so the prospects for a strong bounce-back are in place. Watch for false signals here: the price spikes in lumber are not a sign of high demand or rekindling inflation, they are a price spike in response to supply shortage during the normal high demand period. The mills will catch up later this year, and prices will fall back to normal. Let's hope the businesses can survive all the disruption and turmoil.

Slow Global Growth

Looking at the bigger picture, China has been the major contributor to global growth for much of the last 20 years. (One of the most important achievements in human history, bringing a billion people out of Communist poverty in just 40 years.) China has now abandoned their 6% growth target, amid zero population growth (!) and the unfortunate trade and political friction with the US, but China will still be a major contributor to global growth. Europe and Japan, hobbled by demographic and structural issues, have growth potential between 0 and 1%.

The US demographics are much better than Europe's because of Americans' historical openness to immigration and assimilation, however, politics has stalled immigration, and growth potential is now below 2%: not bad, but not stellar. US economic growth will be curtailed by the necessity to reduce fiscal deficits.

Once again, a major uncertainty in how the post-Covid world unfolds.

The result of all this is likely slower global growth as countries wrestle with aging demographics and deficits in the wake of the pandemic. There will still be good investment opportunities as economic forces enhance the prospects for certain firms (eg pharmaceuticals and technology) while demand for other industries, such as retail, continue to erode. Active investment management will have to carefully discern between the winners and losers.

For instance, the adoption of digital technology generally has been accelerated by the shutdown. This is not the tech bubble of the late 1990s, although I believe there are technology stocks in bubble territory (Tesla comes to mind), there are others whose businesses are sustainable and very profitable, and meet your managers criteria for inclusion in your portfolio (eg Microsoft, Amazon).

Balance between growth and value

In today's investment environment, equity investment opportunities will be in a mid-zone between the high-growth, popular stocks that will be overpriced, and the out-of-favor stocks that typically made up the deep-discount value-style investments. The former will not be able to meet expectations, while the latter lack catalysts for turnaround. Value today seems to be where companies with reasonable growth prospects and profitability, generating free cash flow, are selling at reasonable valuations because they are below the popular radar.

The disruption of industries by digital technologies is a major trend that is receiving a boost from the pandemic. Markets are rewarding the perceived winners with rich valuations, while the losers (eg retail) are priced accordingly. Companies that are supporting the technology revolution, such as Accenture, SAP, or ADP, are also poised to do well as technology increases demand for their services.

Conclusion: Yo-yo recovery

The snap-back in economic activity will be strong because of pent-up demand, but GDP likely won't surpass pre-Covid levels for some time. This shortfall will be touted as a recession by news media. The recovery will likely be bifurcated into winners and losers: some industries are already back on track, and some will struggle for longer.

But the virus can and will be contained in the short term by behavior, most importantly by protecting the at-risk cohort while allowing others to get back to their lives. The data is showing that this is happening now. The Americans are getting on board fast, once they figure it out, as they do. Antibody testing and vaccines will go a long way to relieving worry about the risk of airline travel and other public activity.

Bright Spots

In the meantime, copper and iron ore prices, two bellwethers of the global economy, have recovered strongly. Retail sales in the US were up 18% in May, after falling 15% in April. Borders are open and tourism is back on in Europe, albeit in a limited way. China's economy is rebounding strongly. Several highly reputable companies say they should have a vaccine ready by December, if not sooner.

Thank you

These may be unnerving times. Today is a godsend for alarmist journalism. Times like these require courage, and judgement.

If you are worried about your portfolio, financial plan, Covid or anything else, please call or email and we'll arrange a time to meet, either in my office if you'd like, or by phone, or any other way.

Finally, be of good cheer. This too shall pass. Optimism remains the only long-term realism. In the meantime, thank you for trusting me with your financial affairs and your portfolio. It is a privilege to serve you.

Endnotes

1 Chris Horan, Financial Advisor "On Declines" March 2016. Average intra-year decline since 1980: -14.5%.
2 Wall Street Journal

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