THE INVESTMENT JUNCTION

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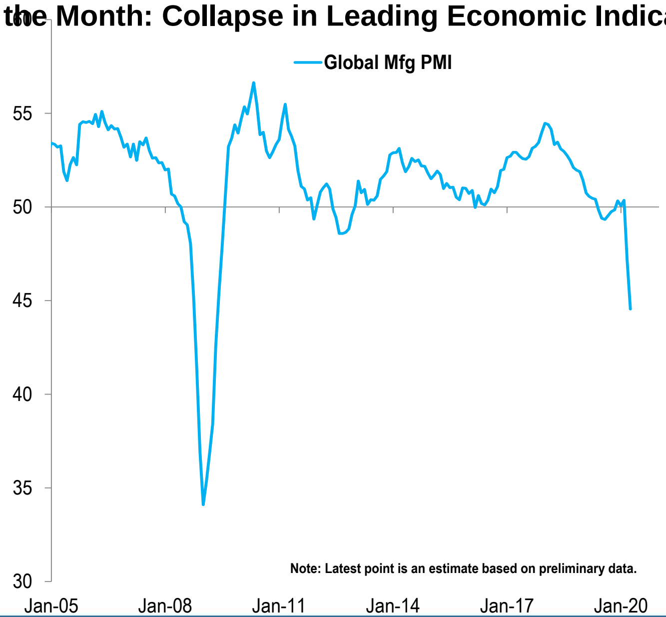
- **The global health crisis has short-circuited economic activity.** Widespread social distancing has hit both the supply side (e.g., the labor force, supply chains) and the demand side (e.g., loan demand) of the economy. We are now bracing for a deep economic and earnings recession, with the duration of the downturn still impossible to ascertain.
- **Policymakers have been called to action.** The amount of fiscal and monetary stimulus injected into the system already surpasses that seen during the 2007-09 Great Recession. This provides a necessary income buffer and the support needed to ensure the ongoing functioning of financial markets. There will be more stimulus in the days and weeks to come.
- **Riskier asset prices remain under pressure.** The recent surge in equity market prices seems typical of bear market rallies in the past. Outsized rallies and sell-offs are expected. A floor under prices usually starts to harden once the leading economic data begins to turn up (**Chart of the Month**). There is no evidence yet of this dynamic starting to play out.
- **Valuations for many asset classes are starting to look more attractive.** Investors like pension funds, or those less sensitive to short-term swings, are already starting to nibble on the hardest hit securities. We suspect that they will be rewarded on an investment horizon in excess of one year.
- **In our opinion, the COVID-19 spread is a key factor to watch.** Once caseload growth begins to level off, many of the negative forces acting on the economy and financial markets will start to reverse. China is a great example, with activity starting to come back online. Given that they are so far ahead of the rest of the world in this battle, it will be equally important to monitor whether the country can thwart a second wave of contagion.

Chart of the Month: Collapse in Leading Economic Indicators



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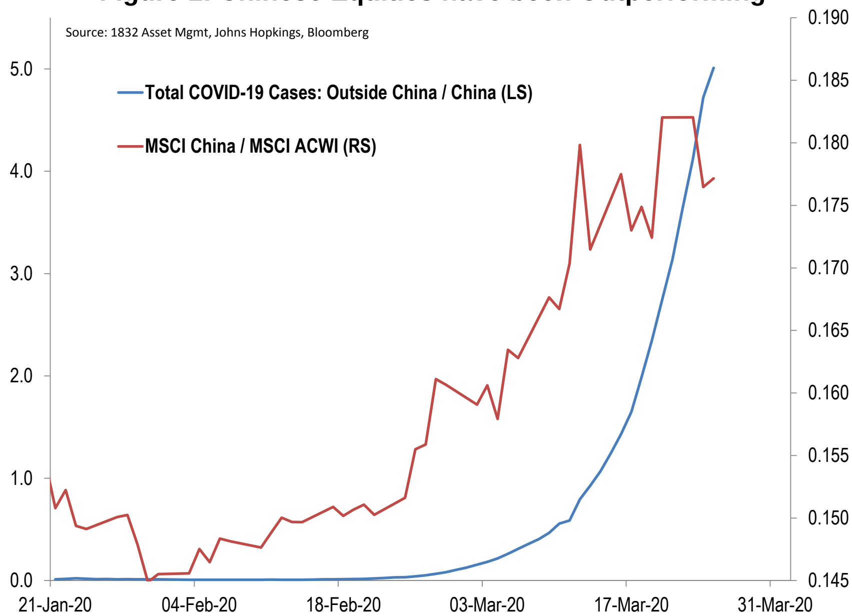
More Challenges Ahead

This crisis is distinct in many ways from those of the recent past, even while sharing some important similarities. Health is its bedrock, unlike say the 2008 crisis whose root cause was a bursting real estate bubble. But the similarities, like a deep economic recession, dislocation in credit markets, and rapidly falling asset values are similar.

It is near impossible to know when market volatility will subside and a sustained recovery in asset prices can begin, but we suspect that it will be around the time that COVID-19 case growth begins to slow. Some support for this idea can be found with China. Notice that its equity market began outperforming in late February, about one month after the government first instituted rigorous lockdowns. The ongoing moderation in case growth has extended the period of China's equity market outperformance (Figure 1).

Figure 1: Chinese Equities have been Outperforming

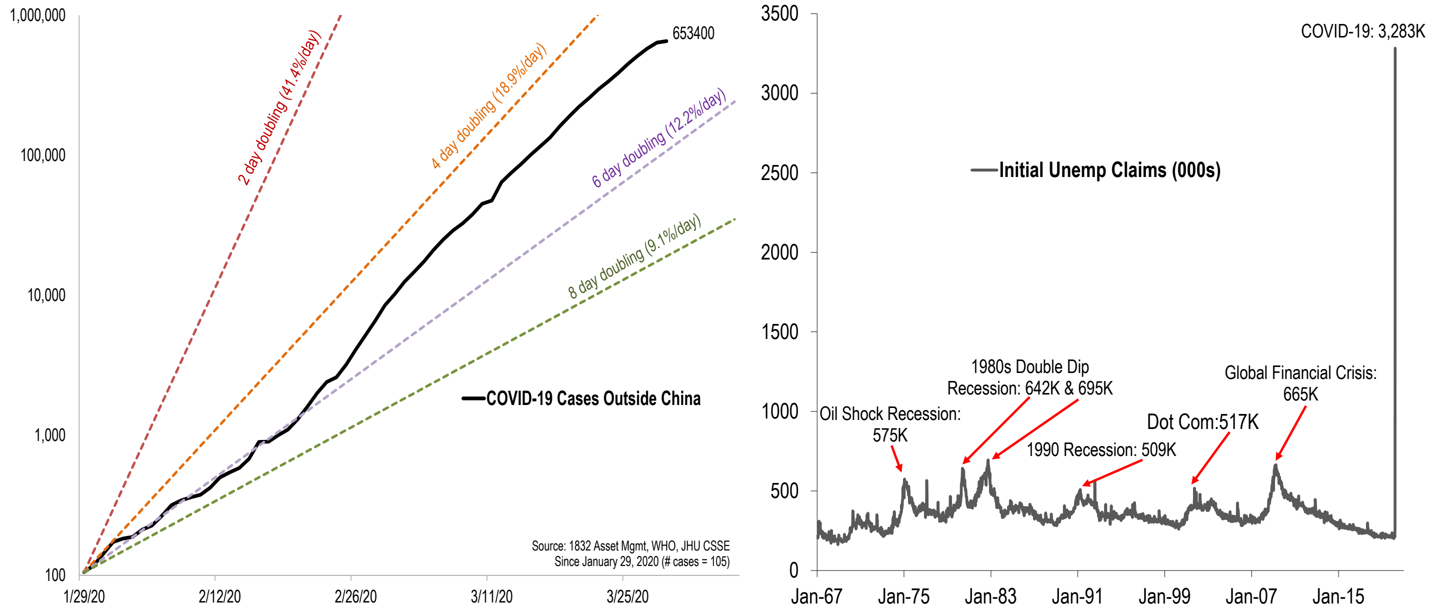


This connection doesn't seem like too much of a stretch. Shortly after the viral caseload began to moderate, our Chinese contacts were telling us that activity was coming back online across the country. Slowly, yes, but it was returning. As activity levels begin to pick up, so too will the fundamental support for share prices. And it is important to note that the country's progress continues, as evidenced by the government's decision late last week to lift many controls that were in place on tens of millions of people for the prior two months in Hubei, the Mainland's hardest hit province.

Were case growth in the rest of the world to taper off then, perhaps, world economies and equity markets would be able to find a more reliable footing. But, that is a big "if", at least within the context of the next 1-3 months. Countries that have shown success in the battle, such as Korea and China, have successfully implemented the following combination of interventions: (1) strict travel restrictions; (2) broad-based testing and contact tracing; and (3) widespread lockdowns. The track record, to this stage, suggests that any one measure doesn't work all that well, but all three working together can move the situation to a more manageable level.

As of now, it appears as though the virus has the upper hand. Daily growth is running at a pretty steady pace, generating a caseload doubling time of between 4-6 days (Figure 2, LHS). The longer this goes on, the more deeply it will interfere with the functioning of the economy and, the more costly it will be for all of society.

Figure 2: COVID-19 Caseload Doubling Time between 4-6 days; Once in My Lifetime Event!



The economic and social strains from this crisis are clearly visible. Leading activity indicators are falling around the world, in an "off a cliff" like manner. It is as if an economic switch was turned off. We are seeing the effects on people through labor market indicators, like the recent weekly data for U.S. unemployment insurance claims (Figure 2, RHS). These numbers spiked to over 3.2 million applicants based on last week's data, a surge unlike anything seen before. A rapidly increasing number of people are losing their primary source of income. Surveys, such as last week's Angus Reid Poll, showed that the number one concern for 53% of Canadian households is "not being able to afford good quality groceries". It is hard to imagine the struggles for people that are dealing with COVID-19 and situated in less fortunate countries.

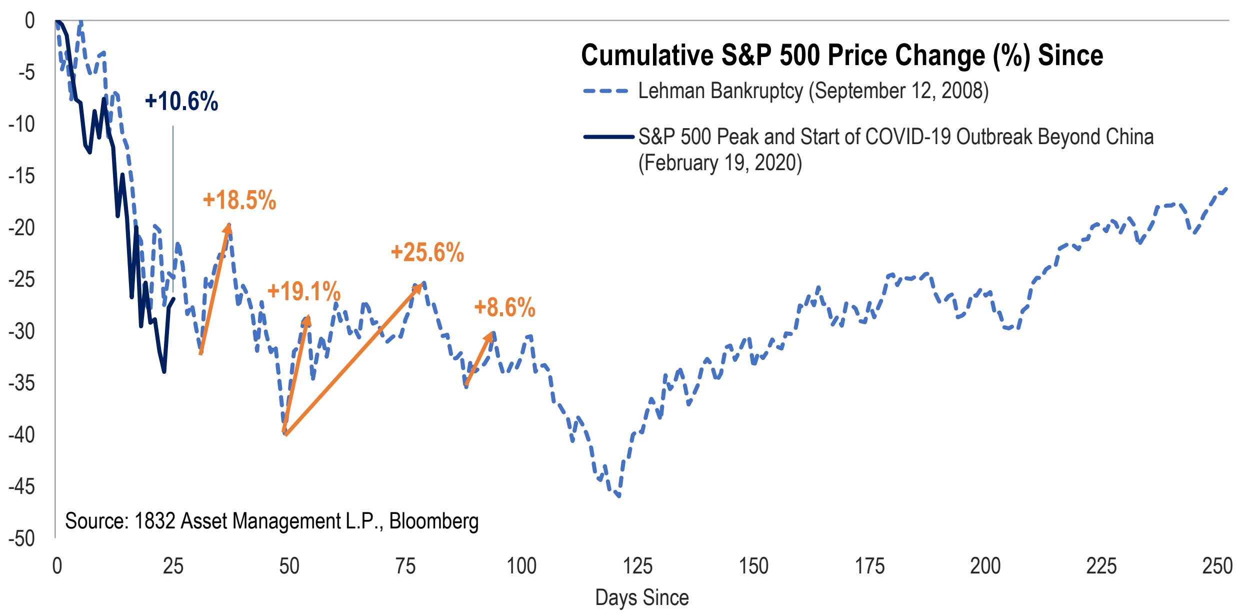
Global policy makers have been called to action. The G20 leaders in a joint statement last week said that they are committed to doing whatever it takes to overcome the virus. In their words, "We are strongly committed to presenting a unified front against a common threat. We will continue to conduct bold and large-scale fiscal support. The magnitude and scope of this response will get the global economy back on its feet and set a strong basis for the protection of jobs and the recovery of growth". The purse strings are wide open, with this group of nations already having injected more than $5 trillion into the economy. The response only a couple of months into this crisis already dwarfs the estimated $2 trillion in government spending used during the 2007-09 Great Recession.

Monetary policy makers have responded in kind. Central banks have been slashing interest rates, accelerating their purchases of a widening menu of assets from the primary and secondary markets, while providing backstops and liquidity support for various fixed income markets. Throughout this process, the Federal Reserve has quickly become the de facto lender of last resort for corporate America. As a result of these extreme interventions, credit spreads have stopped widening and funding spreads have dropped. It seems that the central banks have, for now, mitigated the risks of both a credit and liquidity crunch.

Bombed out asset prices are bouncing, actually surging, higher as the mountain of policy stimulus reduces the immediate left-tailed risks. The S&P 500, for example, rallied by 17% from the intra-day low it set on March 23rd. Corporate bonds have advanced by 16% over roughly the same time period. Investors have been calmed by this monster injection of global policy stimulus.

While the policy authorities have provided much needed support to the economy, and the functioning of financial markets, none of the measures provide better treatment for symptoms, solutions to stop the viral spread, or a fix for hospital overcrowding. They simply buy some time by pushing out the risk of mass bankruptcies, loan defaults, and permanent layoffs. Again, that is important. But, policy stimulus needs to work in tandem with containment strategies in order limit the severity of the crisis on a more lasting basis. Across much of the world, non-essential travel continues, people are free to cross borders within their own countries, and many non-essential businesses remain open. President Trump was even suggesting this might all be over by Easter. That seems much too optimistic. We don't even know, yet, whether the return to work in China might possibly ignite a second wave of outbreaks. A lot of uncertainty still lingers.

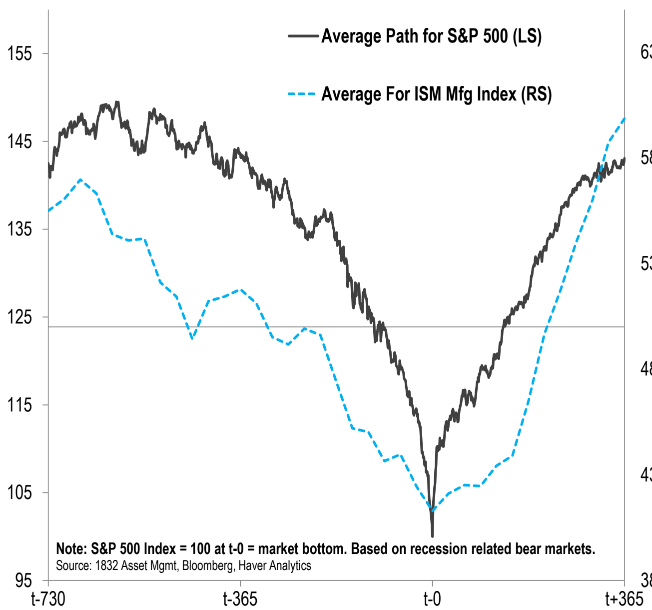
Figure 3: Rhyming with the 2007-08 Bear Market?



Similar story lines have played out through history. Take the equity market action during the 2007-09 crisis as a case in point (Figure 3).There were several big rallies during that bear market, all of which were followed by reversals to fresh lows. The same can be said for the 2000-03 or the 1929-32 bear markets. Sharp rallies and sell offs are characteristic of every bear market. What seems to help separate a bear market rally from one which is likely to be more lasting is the underlying economic dynamic. Selling pressure has typically remained in place for as long as the economy continues to deteriorate. Once the economy moves from a state of bad to "less bad", as indicated by an early inflection upward in leading economy data, selling pressure subsides on a more lasting basis. It is only around this time period when we can gain more confidence that a floor is hardening under asset prices. Notice in Figure 4 (left chart), however, that despite the coincident bottoms for equities and the leading economic indicator, that this approach could still leave us 1-3 months late in real-time given the lag in confirmation from the data's release. However, it also reduces the risk of being pulled into a bull market trap. At this stage, we do not see a single leading economic indicator anywhere in the world that has inflected upward, which leaves us very concerned that the latest surge in market prices is a false signal.

Investment tactics are not for everybody. Pension funds, sovereign wealth funds, endowments and others take a much longer term view in their investment process. Our contacts on Wall Street's trading desks tell us that many of these types of money managers are already starting to inch back into riskier asset classes. This is because the valuations for equities and some areas of the credit market have fallen to levels that have raised long-term expected returns to more attractive levels. Meanwhile, the huge rally in government bonds has lowered their long-term attractiveness. Let's take a closer look at the global equity market from the lens of one of these investors. The sell-off over the past couple of months has moved valuations down to the 21st percentile of their historic range. The average forward two-year return from these valuation levels has been 40%, with a hit rate of over 90% (Figure 4, RHS). This doesn't mean that equity prices can't still move lower from current levels, but for those less worried about timing it is starting to look like a more attractive entry point back into the market.

Figure 4: Awaiting Macro Economic Improvement; Valuations Point to Favorable Longer-term Equity Returns



Average Valuation %'tile		Average Forward Return (%)			
from	to	3m	6m	12m	24m
0	10	4	10	17	25
10	20	2	5	12	32
20	30	2	5	14	40
30	40	3	4	7	13
40	50	1	1	5	14
50	60	2	4	11	20
60	70	3	6	7	12
70	80	2	5	9	14
80	90	2	4	5	16
90	100	-2	-3	-3	-3

Source: Goldman Sachs

The differences in investment approach are what make a market. For longer-term investors, the window of opportunity has started to open. For those more sensitive to timing, based on the guidance of history, it still seems a bit too early to buy into the market. One really needs to know beforehand who they are as an investor in order to make a decision that can be lived with because the equity market can be an expensive place to find out. Our role for those with a more active approach to investing is to keep up to date and share our thoughts on the economic and market dynamics. As of now, we do not think that economic activity has hit bottom and this means that the downside risks to asset prices have yet to subside.

Market Performance

	7 Day	1-mo	3-mo	12 Mo	QTD	YTD
S&P 500	10.3%	-14.7%	-21.6%	-9.4%	-21.3%	-21.3%
S&P 400	13.0%	-23.2%	-31.0%	-24.1%	-31.0%	-31.0%
S&P 600	10.8%	-25.6%	-34.3%	-28.0%	-34.4%	-34.4%
S&P 500 Energy	12.2%	-35.9%	-52.2%	-55.5%	-52.3%	-52.3%
S&P 500 Materials	9.5%	-16.9%	-27.6%	-18.5%	-27.9%	-27.9%
S&P 500 Industrials	15.4%	-20.4%	-28.0%	-19.8%	-27.6%	-27.6%
S&P 500 Consumer Disc	11.1%	-14.4%	-20.3%	-11.4%	-19.9%	-19.9%
S&P 500 Consumer Stap	6.5%	-9.5%	-15.4%	-4.1%	-15.0%	-15.0%
S&P 500 Health Care	8.1%	-9.2%	-16.9%	-5.4%	-16.6%	-16.6%
S&P 500 Financials	11.8%	-22.7%	-31.7%	-17.2%	-31.6%	-31.6%
S&P 500 Technology	10.5%	-10.0%	-14.3%	7.9%	-14.2%	-14.2%
S&P 500 Comm Services	5.5%	-14.6%	-20.3%	-7.7%	-19.7%	-19.7%
S&P 500 Utilities	17.7%	-12.8%	-13.4%	-4.7%	-13.8%	-13.8%
TSX	7.1%	-24.1%	-26.1%	-21.4%	-25.6%	-25.6%
TSX 60	6.9%	-22.6%	-24.5%	-19.6%	-23.9%	-23.9%
TSX Energy	5.6%	-40.6%	-45.6%	-44.9%	-45.4%	-45.4%
TSX Materials	11.7%	-14.9%	-18.8%	-10.1%	-19.1%	-19.1%
TSX Industrials	4.6%	-19.5%	-20.4%	-12.6%	-19.5%	-19.5%
TSX Consumer Disc	14.5%	-28.2%	-34.9%	-31.5%	-34.2%	-34.2%
TSX Consumer Stap	-1.4%	-13.7%	-14.0%	-9.8%	-12.6%	-12.6%
TSX Health Care	13.1%	-25.0%	-35.4%	-62.7%	-37.6%	-37.6%
TSX Financials	7.5%	-25.1%	-26.7%	-21.6%	-26.3%	-26.3%
TSX Technology	11.2%	-47.6%	-56.2%	-58.1%	-56.8%	-56.8%
TSX Telecom	2.6%	-14.9%	-15.4%	-15.3%	-14.9%	-14.9%
TSX Utilities	7.6%	-19.4%	-13.5%	-0.6%	-12.8%	-12.8%
WTI Crude	-3.4%	-53.8%	-64.0%	-62.8%	-63.5%	-63.5%
Gold	10.9%	0.2%	7.9%	22.2%	7.5%	7.5%
Copper	-0.1%	-15.6%	-23.6%	-24.9%	-22.7%	-22.7%
US 10-yr Treasury (bps)	-17	-58	-120	-169	-124	-124
10-yr BoC Bond (bps)	-13	-42	-86	-79	-96	-96
USD per CAD	2.6%	-4.3%	-6.6%	-4.2%	-7.2%	-7.2%

As of March 27, 2020.

Source: Bloomberg