

Investment Commentary

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Delayed Take-Off

Scott Blair, CFA
Chief Investment Officer

One of the most frustrating things about flying is the delays. We're usually excited to get to our destination, and the last thing we want to hear is that takeoff has been pushed back by a few hours. This kind of anticipation is analogous to our current situation in Canada.

Vaccines are being distributed, the weather is getting nicer, we're excited to get out of the house and back to our regular activities – but we're now being told to wait little bit longer! At the time of writing this, Ontario is signalling a return to lockdown and BC is once again restricting indoor dining. Other jurisdictions, both here and abroad, are again looking to tighten up amid rising COVID-19 variant cases.

Although disappointing, we view this as a detour on the return to normal road – not something that's taking us off course.

“We now have a template for what return to normal looks like, and that is Israel.”

Well over half of the population of Israel is vaccinated. Once vaccination levels neared 40%, Israel saw a lasting drop in cases. That doesn't mean the virus is gone today, but the waves and surges have stopped.

During the recent Passover holiday, Israelis were permitted to gather in groups of 20 indoors and 50 outside. The UK is the only other major country with over 40% of the population to have received at least one dose of the COVID-19 vaccine. They too relaxed restrictions recently with groups of six allowed to meet outside, sports facilities reopening and the stay-at-home rule ending.

The U.S. should come close to a 40% vaccination rate in April. Most other developed nations have 10-15% of their population vaccinated (including Canada). For these countries, June is a reasonable goal for meaningful relief of restrictions. However, by increasing lockdowns now and targeting the most vulnerable populations for vaccinations, we could see significantly better days in May.

So what does all this mean for our economic recovery? We still see very strong economic growth ahead. In fact, we think this year's growth will likely surprise to the upside. There's enormous pent up demand, low interest rates and extremely high savings levels. It's a powerful combination, with reopening being the catalyst to unleash the growth. We're already seeing businesses anticipate the recovery, with Canada's major airlines announcing a more normal summer schedule for instance.

Strong growth often brings talk of inflation and, of course, that's a realistic fear and is getting a lot of media coverage. Undoubtedly, we'll see pockets of inflation. Just as we saw shortages of some goods over the past year because we all demanded the same stay-at-home products, we'll likely see shortages again as our demands shift to the re-opening products and services.

Of course, businesses that were hurt the most from being locked down will also benefit the most from re-opening, and there should be strong demand for workers in these spaces which could lead to wage inflation. Although we don't see runaway inflation anytime soon, we do think it will rise to more normal levels and could overshoot to the high side.

The past twelve months have been fantastic for major stock markets - many of which are up 40 or 50%. Though it's highly unlikely that we'll see 50% returns in the next twelve months, we are positive on the markets and see continued movement towards more economically-sensitive stocks like financials and industrials.

Over the past year, growth (stay-at-home tech names) performed well early in the pandemic. The spread between the S&P Growth and Value indices peaked in August, and began to narrow in November once the vaccines became a reality. The spread has continued to narrow in Value's (more economically sensitive stocks) favour ever since (Figure 1).

Figure 1: Growth of \$100 – S&P Value vs. S&P Growth



Source: Bloomberg

The second quarter of 2021 should be a transition quarter for Canada. Hopefully, one that sees easing of many restrictions as we move towards the summer. Think of it like the plane on the tarmac, starting to move slowly forward at first before accelerating into takeoff.

Fixed Income



WATCHING

Understandably, investor sentiment is biased towards a strong recovery and a return to normal. Investors feel that there is a point where central bankers will be able to stop being accommodative. The European Central Bank is forecasting a slower recovery in Europe, and thus sees accommodation staying in place for longer. The Fed is seeing good growth in U.S. They have expressed a desire to allow the economy to “run hot” in order to see some inflation. In particular, they have noted a desire to make sure the recovery benefits all Americans, including those more vulnerable citizens who saw a higher economic burden from COVID.

The Bank of Canada (BoC) is seeing good growth, and a potentially troubling high level of central bank ownership of Canadian bonds. They have spoken of starting to reduce their bond purchases, and may be the first central bank to start removing accommodation. Note that the BoC is talking about slowing its buying program rather than reversing it.

Inflation is currently tame. Further, there are few immediate signs of friction in labour markets or base commodity markets. As we progress through a post-vaccination recovery, inflation is likely to emerge. We are seeing increases in market expectations of future inflation. Increased inflation expectations put upwards pressure on yields, but we expect this to be temporary.

THINKING

We are expecting Canada and U.S. yield curves to continue to move upwards, and to steepen. Both central banks have expressed reservations on raising the respective bank rates any time soon. At the same time, they are noting increasing long-term economic activity. Long term rates are likely to rise based on long term inflation expectations. Short term rates are likely anchored reflecting no change in the bank rate.



Malcolm Jones, MBA, CFA
Senior Portfolio Manager

With Canada and the U.S. showing strong relative economic growth, and with high yields (relative to other developed nations), there is pressure for international investment money to flow towards North America. This can manifest itself in any combination of higher bond prices, higher currency or higher equity prices. Given strong economic growth and rising inflation expectations, we feel that it is unlikely that bonds will see much capital appreciation. Returns will come from the coupon.

DOING

Reflecting our expectation of rising rates, we have decreased our duration (exposure to interest rate movement) this quarter. We reduced duration in our provincial bonds. We have maintained a very short duration in government bonds. With an expectation of rising long rates and no credit spread, our expectations for long sovereign bond returns is quite poor though sovereign bonds still play a strong role in risk control.

Credit bonds have a spread to cushion losses on long rates rising. We feel there is opportunity to find some extra return in longer dated credit bonds. With provincial bonds we feel the best risk/return trade off is in mid-term bonds, while corporate bonds do still offer some opportunities in long-dated bonds.

Canada

WATCHING

The Canadian stock market picked up in the first quarter of 2021, right where it left off in the last quarter of 2020, by gaining over 8%. The Canadian market skews towards smaller firms and companies that are sensitive to economic conditions, both of which outperformed in the quarter and helped make Canada one of the top performing markets worldwide. Two of the top performing sectors within the market were Energy (up 20%) and Financials (up almost 14%) both of which benefitted from an improving economic outlook. Canadian banks reported strong earnings as excess provisions for anticipated bad loans, resulting from the pandemic, are now being reversed. Loan repayments and credit are good. Furthermore, the banks also saw growth in most or all of their retail banking, wealth management and capital markets businesses. Improving fundamentals at our banks is a positive sign for economic growth in our economy.

THINKING

The Canadian equity market is up over 40% in the last year. Ordinarily, such returns would make us somewhat cautious, however, there are a couple of mitigating factors this time around. First, March 2020 was a historic downturn in the market. If we go back fifteen months instead of twelve, the returns are not as exceptional. Second, valuations are high but reasonable when you consider how low interest rates are. Finally, we are on the cusp of what we believe are two great years of economic growth ahead. As stated above, this is a good environment for the Canadian market.



Gil Lamothe, CFA
Senior Portfolio Manager

DOING

The early signs of global post-pandemic recovery mean strong demand for basic materials, primarily in Asia. We expect this to continue in the short to medium term, and it gives us confidence in both the materials and energy sectors.

We have added Methanex and Nutrien over the past few months. Both companies convert raw materials into value-added products that are used as feedstocks in other industries. Methanex converts natural gas into methanol, which is used in a variety of chemical industries and as a fuel additive. Nutrien is a fertilizer producer and retailer, supplying both potash and ammonia fertilizers internationally. These companies have management strength in both operations and distribution, and give us exposure to global recovery and demand growth at a basic level. We have also recently added Suncor back to the portfolio, increasing our exposure to energy producers.

In concert with this, we have reduced our exposure to gold miners. The pandemic-induced fear that was driving the price of gold has largely dissipated. We continue to hold Agnico Eagle (AEM) as a best of breed gold miner in Canada.

With the strong performance in banks, we have added Bank of Montreal (BMO) to the portfolio. BMO had particularly strong results this quarter, and offers some unique exposure to the U.S. commercial lending market.

U.S.



WATCHING

The U.S. economy outperformed most developed economies in Q1 thanks to aggressive vaccination campaigns and additional fiscal support. The U.S. is ahead of most countries on the vaccination front and its fiscal policy has been more generous than elsewhere.

Many states saw some form of easing in lockdown measures and the \$1.9 billion relief package signed into law on March 11 has already resulted in an uptick in consumer spending and confidence. Retail, dining, and hospitality businesses that have recently reopened saw significant increase in demand, with restaurant occupancy getting closer to pre-pandemic levels.

Turning to the equity markets, the rally continued into 2021, with the S&P 500 up 5.8% (4.4% in CAD) in Q1. The rally that started a bit over a year ago has been extraordinary, and while stock participation was initially more focused in certain stocks and sectors (FANGs, Technology), we are now witnessing much broader equity participation.

The rotation from defensives to cyclicals and from growth to value started in November of last year, and continued throughout the first quarter. For the first time since 2016, we have seen a long stretch of value outperforming growth (to clarify, we're only talking about is six months).



Liliana Tzvetkova, CFA
Portfolio Manager



Saket Mundra, CFA, MBA
Portfolio Manager

THINKING

We continue to expect a strong economic recovery throughout the year, barring any hiccups due to variant strains of COVID-19 or other external shocks. The Q4 earnings season was strong with earnings and sales both increasing 4% year over year, significantly higher than what was expected with a large share of companies beating expectations.

Furthermore, comments from management teams were largely positive and supportive of strong growth. The market is expecting earnings per share (EPS) to grow 24% and 15% in the next two years. This bodes well for U.S. equities and we expect stocks to do well, especially if the Fed stays put and does not increase interest rates, which is what they have telegraphed.

The rotation from defensives to cyclicals is not surprising considering these sectors will benefit the most as expansion advances. These sectors also lagged last year, and for some, even longer. We expect this rotation to continue with valuations remaining attractive. If the economic recovery proves to be stronger than anticipated, it will likely mean stronger earnings than expected for value/cyclical stocks – which is positive for share prices. With the significant increase in long-term government yields, the yield curve has steepened, which is bullish for bank earnings and returns.

DOING

The rotation to value and away from growth helped our U.S. holdings this quarter. We increased our weight in banks and economically sensitive sectors and trimmed our exposure in Utilities, Staples, and Gold. We added to names like Disney, Booking Holdings, Alphabet, and TJX, and sold our Pepsi and P&G positions. We also used weakness in some of our long-term core holdings in the Technology sector, such as Visa and Microsoft, and added to these positions.

Finally, we also added two new names to the U.S. portfolio – Cintas and Waters. Cintas is the largest uniform rental provider in the U.S., with a history of increasing market share and generating above average returns. Waters is a health care company providing necessary tools in the discovery of new drugs and other materials. Both companies should benefit from the reopening of the economy.

International



WATCHING

Although International markets lagged the US and Canadian markets, broad indices were still up over 2% in Canadian Dollar terms in the quarter. Monetary policy continues to impact market dynamics as it has over the last year and decade. Interest rates are near historically low levels. As global economies continue to recover from the COVID-19 induced recession, central bank monetary policies will continue to play a key role in the evolution of the overall and intra-market performance. Cyclical companies in Europe have outperformed defensive businesses by over 50%, from the lows in 2020. Although the recovery backdrop is conducive to continued outperformance of economically sensitive stocks its unlikely we will continue to see this level of divergence.

THINKING

The yield curve has steepened significantly in recent months as longer-term yields have risen, while short-term yields have remained low. Despite the steepening, yields are still below prior peaks. We believe, however, there is a real risk that yields will spike above previous levels as central banks have indicated a willingness to let inflation run hot as the economy heals. A steepening yield curve should be beneficial for cyclical companies and Europe, which is a pro-cyclical market.

We believe that an improving macro-outlook and a higher inflationary regime should provide a material earnings boost for cyclical names where earnings projections have not recovered to pre-pandemic levels.



Ric Palombi, CFA
Director of Research

DOING

As mentioned earlier, a steepening yield curve environment should be beneficial for the financial sector, while an improving economic outlook should continue to provide an earnings recovery and a boost for cyclical companies. The portfolio continues to maintain healthy exposure to these themes, while at the same time we have trimmed some of our heaviest cyclical names such as Sony, Prada, Maersk and Antofagasta to reflect their changing risk/reward profile following their stock price rallies.

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