Q1 2021 Outlook Commentary

January 2021

McLean & Partners
Wealth Management

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International

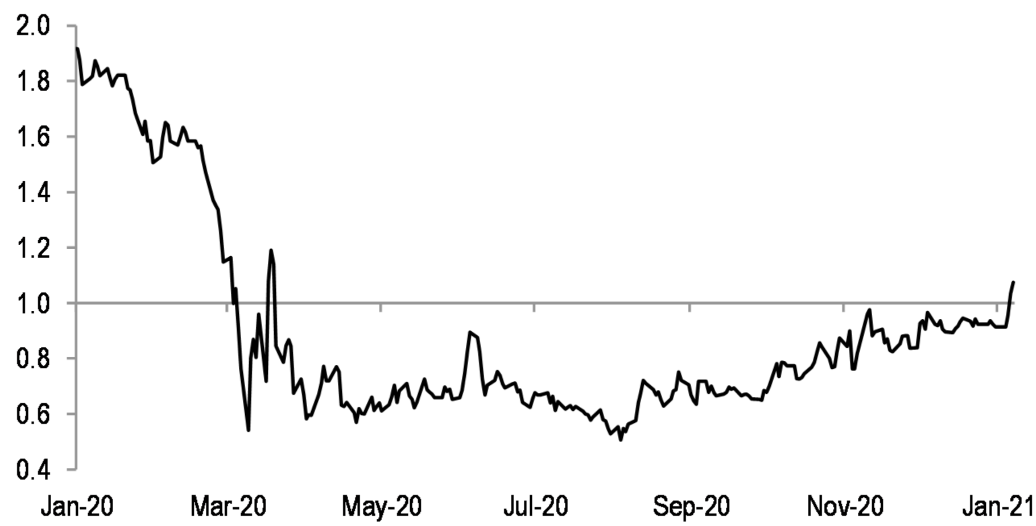
In our view, 2021 will be characterized by a return to a more normal, or dare we say “new normal”, path of the global economy as it enters the next phase of recovery on its way to reaching its pre COVID-19 GDP level. We believe the following five turn-of-year developments will be key in the reflation trade, and the continued value rotation in equities, which is now entering its fourth month:

1) A democratic sweep, U.S. fiscal stimulus
2) Strong global growth momentum
3) Vaccine rollout as the single biggest determinant of normalcy
4) A soft Brexit (but still a helpful one)
5) Saudi Arabia’s unilateral oil supply cut

A corollary effect of these developments, and a key theme for both equity and fixed income markets in 2021, will be rising bond yields and a steeper yield curve.

As shown in Figure 1, over the past six months, the 10-year U.S. Government bond yield has risen 60 basis points and climbed over the 1% psychological barrier, currently at 1.10%.

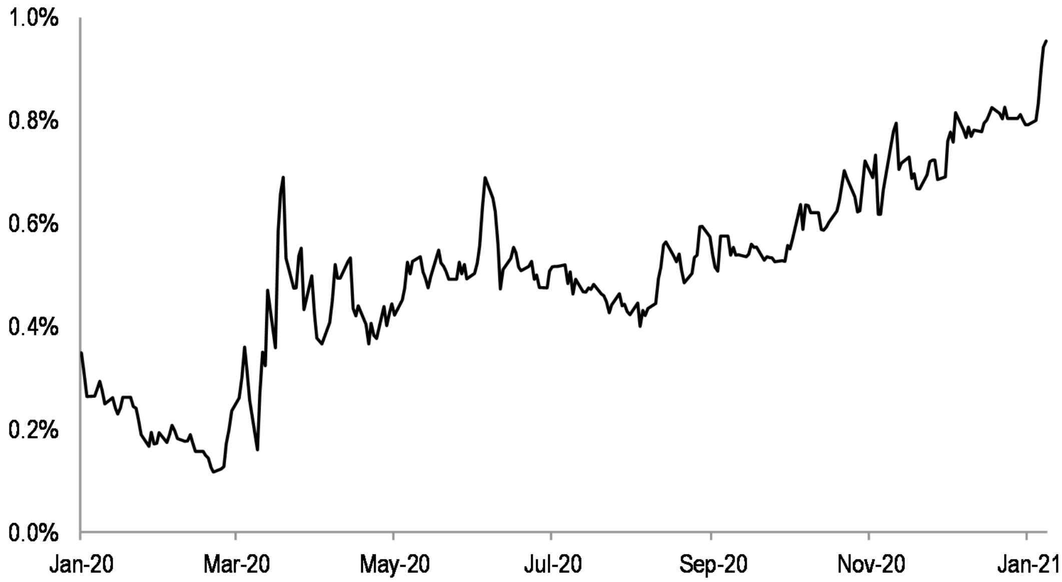
Figure 1: U.S. 10-year bond yield (%)



Source: J.P. Morgan

Although the absolute level of yield is key, the actual shape of the yield curve is even more important. As the economy gathers momentum, yields in the short end of the curve, normally defined as two years or less rise more slowly than yields at the long end, normally defined as 10 years and above, which creates the effect of steepening the curve. As you can see in Figure 2, this is exactly what has been happening.

Figure 2: U.S. yield curve (10Y-2Y)



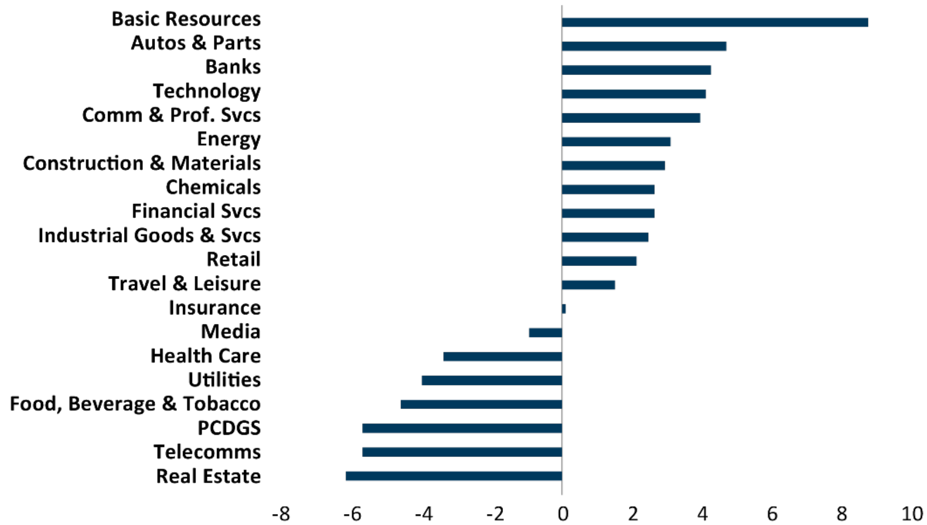
Source: J.P. Morgan

As seen above, the difference between the U.S. 10-year and two-year bond yields has climbed to approximately 1%. As our five turn-of-year developments gather pace and the U.S. Federal Reserve holds short-term interest rates firm, we expect the yield curve will continue steepening in 2021.

Historically, periods of rising U.S. bond yields and steeper yield curves have been very positive for global equities. Over the past 20 years, MSCI World has risen 6.6% on average during such a period (with a frequency of 92%). While both U.S. and European equities have tended to fare well in absolute terms too (rising by 5.9% and 6.3% on average respectively, with frequency of 100%), it is notable that European equities have actually outperformed U.S. equities in this environment.

In breaking performance down further to a sector level, it’s not surprising to see that the sectors which benefit most from the improving economic cycle, such as Resources, Autos (Industrials), Banks and Materials, perform the best compared to more defensive sectors, as can be seen on Figure 3.

Figure 3: Average European sector performance during prior periods of rising 10Y UST yields and steepening U.S. 2s 10s YC %



Source: J.P. Morgan Market Intelligence

The bottom line

From a portfolio perspective, we believe the International Pool is very well positioned to take advantage of certain themes emerging in 2021.

First, geographically speaking, we continue to favour Europe as a key beneficiary of higher yields and steeper curves, with a 73.7% weight in the portfolio allocated to Western Europe versus 39% in the benchmark, as can be seen on Figure 4.

Figure 4: Regional allocation of the International Equity Pool

	International Equity Pool	ACWI ex US
North America	-	9.4%
South & Central America	3.7%	2%
Western Europe	73.7%	39%
Asia Pacific	18.6%	45.4%
Eastern Europe	-	1.3%
Central Asia	1.8%	0.4%
Africa/Middle East	-	2.7%

Source: Bloomberg

Second, from a sector perspective our exposure to pro-cyclical areas of the market such as Industrials (17% of the portfolio), Materials (8%), Financials (16%) and Consumer Discretionary (25%) will also benefit. Finally, at the stock level we see favourable risk/reward for Auto stocks like Daimler and Renault, Industrial stocks like Maersk and SKF, Material stocks such as HeidelbergCement and Antofagasta, and Bank stocks such as Intesa Sanpaolo, BNP and Credit Agricole.

A rapidly growing economy – even if it is coming off of a deep recession – is a good environment for international markets, and may signal a shift in investment performance leadership from the U.S. to more cyclical markets.

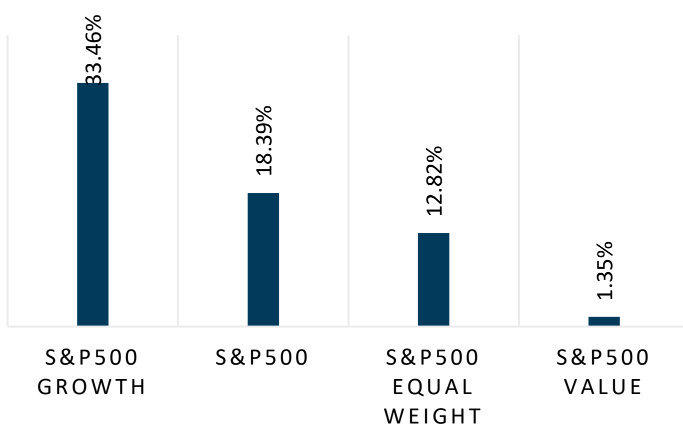
U.S.

2020 has been a rather peculiar year for most of us. The pandemic brought about health concerns, which quickly transpired into economic and financial concerns for a vast majority of individuals. On the brighter side, we saw the benefits of technological advances that allowed us to survive and fight back. Whether it's the ability to work from home, order groceries online or develop vaccines in record time – technology had a major role to play.

Who would have thought that the U.S. markets would end the year with high double-digit gains? If one had invested in the S&P 500 on January 1, 2020 and only looked at the returns on December 31, 2020, they would be oblivious to the fact that, at one point during the year, the markets were down almost 35%.

While the markets were up significantly in 2020, not every company did well or yielded similar returns as shown on in Figure 5. A handful of companies deemed to be secular growers (represented by S&P 500 Growth index) by market participants, seemed to have gotten a disproportionate share of love compared to the rest of the companies (evidenced by return difference in S&P 500 and S&P 500 equal weight index). Granted, some of these lesser-loved companies did suffer more during the crisis as their businesses were put to test due to lockdowns, such as travel-related companies.

Figure 5: Total USD Returns in 2020



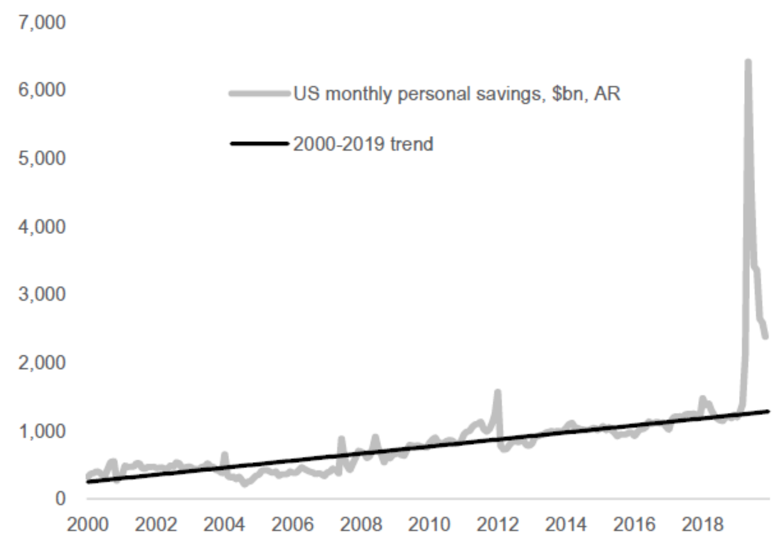
Source: Bloomberg

The government and central bank played a major role in this swift recovery for the markets. Their actions ensured that consumers and businesses had ample means to survive the crisis until a solution could be found.

With U.S. election uncertainty behind us and the announcement of a vaccine, some of these lesser-loved companies returned to play catch-up during the last two months of the year. Going forward, we anticipate that some of these businesses will continue to do well, and benefit from a combination of policy support and healthy consumer spending given the excess savings rate.

Figure 6 below shows the excess savings that U.S. consumers have garnered during the crisis, which we think will support health consumption demand when the economy normalizes. Further, the new political establishment might lead to a less volatile policy environment, which will benefit the overall economy and many businesses.

Figure 6: There is around $1.5tr of excess savings



Source: Credit Suisse

The key risk is how the recovery will play out considering the high expectations already built in the markets. While we do see an economic normalization in the longer run, the path could be different than expectations – and more muddled.

As fundamental investors, it's our job to take a balanced view of both the opportunities and risks ahead of us, and position the portfolio accordingly. We invest in quality businesses that may be going through some transitory issues, providing us the opportunity to buy them below their intrinsic value. Our long time horizon allows us to sit tight and ride through the volatility in the short-term in order to reap the rewards down the road.

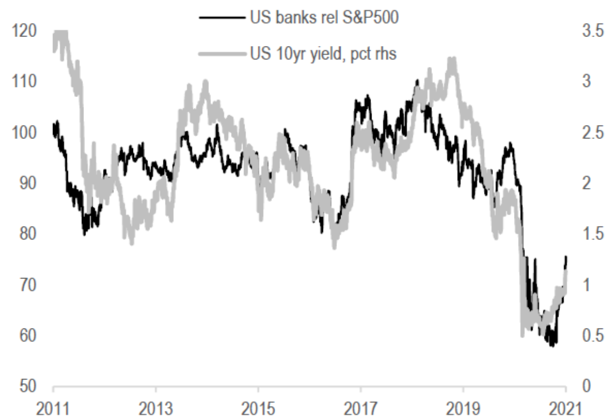
In an environment of rising interest rates and a steeper yield curve, a sector that we find compelling from a risk/reward perspective is the banking sector. As such, we initiated a position during October 2020 in arguably in one of the best run banks in the U.S., J.P. Morgan Chase, which we have added to our position since. It is the largest bank in the U.S. with a global footprint, diversified business model and strong execution track record.

In our analysis of this bank, we focused on the following macro and micro aspects:

Macro headwinds turning to tailwinds

- Healthy consumer balance sheets, reducing the risk of loan defaults
- Stabilizing and rising yields, which benefits bank earnings significantly, as seen on Figure 7, and typically drives stock prices

Figure 7: Banks tend to outperform as yields rise



Source: Credit Suisse

Micro strength of the franchise

- Adequately reserved and "fortress" balance sheet
- Significant earnings and book value growth as the economic and jobs recovery unfold

While every investment has its risks, we felt the valuation was compelling enough to compensate us for the uncertainty that prevails. Although we've had significant returns on the investment since initiation, we remain disciplined and continue to hold our position for further gains.

We understand that there could be volatility going forward, and periods of underperformance may ensue. However, we remain steadfast in our process and continue to hold quality franchises, such as J.P Morgan, for the long run. In the end, we believe that a disciplined execution of our process, patience and perseverance with our investments will yield superior returns.

Canada

While 2020 was a challenging year, our portfolio direction remained focused on our process and philosophy, allowing us to prepare for what we believe will be a strong economic recovery once the COVID-19 pandemic is over.

As equities declined and fear gripped the markets, we took advantage of the extremely low valuations and volatility by increasing our weights in banks, industrial and the consumer discretionary sectors.

Throughout the crisis, we maintained an overweight position in the banks. We also further increased our weight in certain banks that we believe will perform strongly when the economy normalizes, such as Toronto-Dominion Bank, Scotiabank and Equitable Group. TD's stock was impacted due to its high sensitivity to interest rates, and Equitable's stock was impacted by concerns of decline in housing activity.

The unfolding economic crisis also led banks to record large reserves against potential loan losses. However, now that bond yields and inflation expectations are rising, banks are expected to perform strongly. Bank interest margins are expected to increase, stronger economic growth is expected to lead to stronger loan growth and strong housing activity and, importantly, to reversals of some of the reserves mentioned earlier. Specifically, TD's margins are expected to increase sharply with rising yields. Equitable's business remained strong throughout the crisis, yet its stock is significantly undervalued. TD and Scotiabank are the best reserved banks so, as the economy normalizes, we believe their earnings will increase the most as these reserves are released.

We also increased our weight in the Consumer Discretionary sector. Low valuations prompted us to research companies in the space as we believed that the unprecedented government support to consumers, both in Canada and the U.S., would help consumers continue spending money on consumer goods, despite significant market concerns to the contrary.

A good example of a consumer discretionary company that benefited from a drive to spend more time outdoors is Bombardier Recreational products (BRP). This company produces all-terrain vehicles, Ski-Doos and Sea-Doos. Concerns of a sharp decline in consumer spending took the stock down by almost 80%. We believed that the strong government support and the lower risk of COVID-19 outdoors would drive more consumers to their products. Also, this is one of the best-managed and most innovative companies in the space. As such, we initiated a position in BRP in March 2020. The company has since reported several times, validating our belief, and the stock is now back to its level before the crisis.

We had increased our weight in mid-cap stocks (companies with market capitalization of under $5 billion) that do not make a significant weight in the benchmark. Mid-cap stocks also contributed significantly to our performance this year, as Figure 8 below shows.

Figure 8: Weight allocations and contribution to returns in Canadian Pool and TSX

	Canadian Equity Pool	**TSX**
Weight		
Large-cap	67.62%	90.01%
Mid-cap	28.38%	9.74%
Contribution to returns		
Large-cap	6.56%	6.51%
Mid-cap	3.46%	-0.77%

Source: Bloomberg

This table shows that we hold almost 30% in mid-cap stocks, and that they contributed 3.46% to the fund's performance in 2020 compared to negative return in the TSX.

The major benefit of our active investing approach is that we look at the entire Canadian market – not just the largest companies in the benchmark. Some of the largest mid-cap stocks in the portfolio are companies like Equitable, Sleep Country, Northwest, Richelieu and Labrador Iron Ore, which all recorded strong performance in 2020.

Other stocks that were mid-cap when we bought them, such as TFI International and BRP, grew out of that category but still recorded a strong contribution to the portfolio, which is included in the large-cap performance. The bottom line is that we believe active investing can be a strong contributor to a portfolio's performance, and a differentiator from passive investing.

As expectations for economic recovery took hold and many of our stocks outperformed the market, we looked for other opportunities that have not yet caught up with the market. So for the first time in a decade in our Canadian portfolio, we initiated a position in the telecom sector by buying Rogers.

Stock in focus

Rogers is the third largest telecom company in Canada. It offers fixed and mobile phone services, as well as cable TV, internet and media services. For a long time, we found the telecom sector in Canada to be quite expensive for the growth that it delivers and sought better opportunities elsewhere.

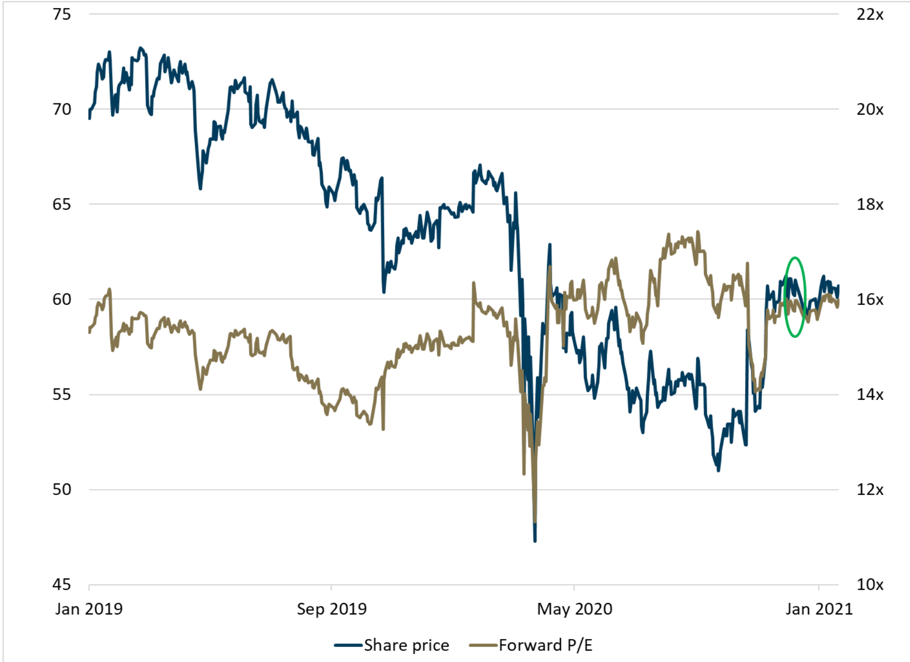
In mid-2019, the Canadian Radio-television and Telecommunications Commission (CRTC) announced that they would do a review of the mobile market with a focus on Mobile Virtual Network Operators (MVNOs). MVNOs are companies that buy space on an existing mobile network at a discount and resell it to customers. Such operators do not incur any capital spending, so they can offer plans at a cheaper price than the large network providers. Due to the impact that MVNOs may have on pricing and competition in the market, the telecom stocks declined following that announcement.

Further pressuring these stocks was the introduction of unlimited data plans, which is expected to basically eliminate data overage fees and last throughout the COVID-19 crisis, significantly cutting roaming fees for travellers.

We initiated a position in the company for the following reasons:

- In August, the government made a statement regarding internet pricing, indicating that it would like to see robust investment in the industry. Though the statement pertained to internet providers, it reaffirmed the government stand that it prefers facility-based operators or, in other words, companies that own and operate their networks, which excludes MVNOs.
- Though the unlimited plans cut overage fees, they prepared consumers for the benefits of 5G services. 5G applications are expected to consume large amounts of data. By educating consumers to use large amounts of data, this should make the introduction of 5G plans much easier, even though they will be slightly more expensive than current plans.
- Valuation and growth potential – Mobile telephony makes up the largest share of revenues of all the major players in Canada and has the highest margin. As such, Rogers has the most to gain from no introduction, or less market disruptive introduction of MVNOs to the Canadian market.
  For a while, Rogers traded at P/E of 18x, which we found expensive. However, following the review and during the crisis, the stock dropped to 14x, as shown on Figure 9. We eventually bought the stock around 16x.

Figure 9: Rogers share price and forward P/E



Source: Bloomberg

In summary, Rogers has several catalysts that we believe can drive the stock higher, for instance, once the federal government makes its final decision on the MVNOs sometime in Q1 2021 and 5G becomes more engrained among consumers.

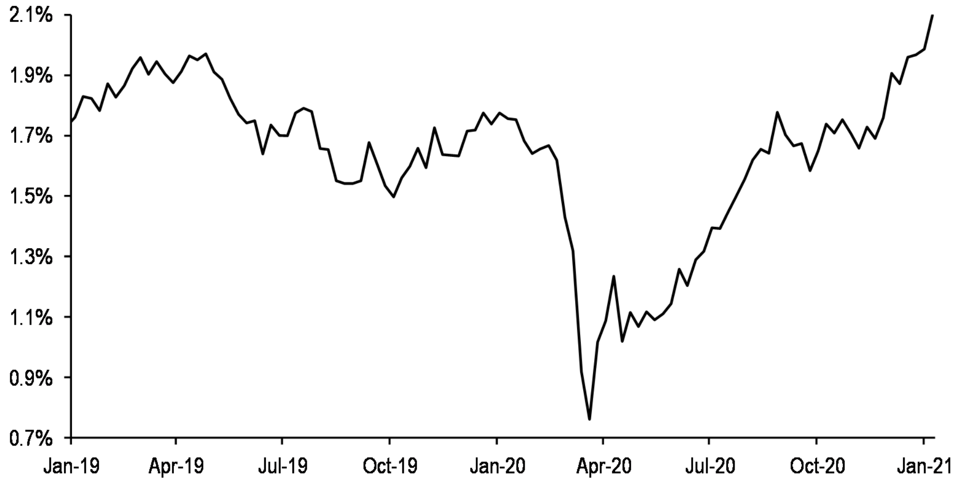
Fixed Income

Normally, the prospects of rising yields and steepening yield curves send shivers down the spine of most fixed income managers. This is because rising yields cause the price of most bonds to decline, in turn causing the value of most fixed income portfolios to decline.

The current environment has not been much fun for traditional fixed income. As bond yields collapsed under the weight of the COVID-19 crisis and global central banks promised to keep interest rates low for years to come, an interesting dynamic has begun to emerge. Once left for dead, inflation is now starting to come back on the radar of fixed income investors.

The Figure 10 below can be thought of as a measure of where investors believe inflation will be in 10 years. After the COVID-19 collapse, which drove the breakeven inflation to well below 1%, it has now steadily climbed higher to over 2%, not coincidentally where the U.S. Federal Reserve would ultimately want inflation to be.

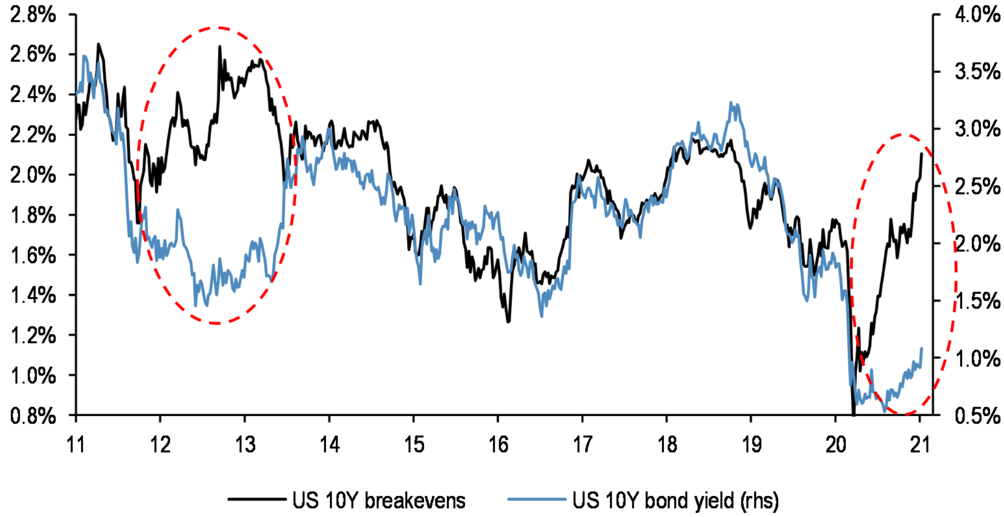
Figure 10: U.S. 10Y breakevens



Source: J.P. Morgan

As can be seen on Figure 11, historically, there was a very tight correlation between breakevens and bond yields. A notable break was seen in 2012, where forwards moved higher, but bond yields didn't follow. We think this was a result of the Eurozone peripheral crisis where policymakers flooded the market with liquidity, keeping bond yields subdued. Eventually, the gap closed from both sides. There was some move lower in forwards, and a clear move up in bond yields.

Figure 11: Breakevens and bond yields correlation



Source: J.P. Morgan

The gap that opened up over the past 12 months is similar. In the aftermath of the COVID-19 shock, bond yields were kept subdued due to exceptional central bank action and have diverged from inflation forwards. We think it's unlikely that inflation expectations will come down in a year of a cyclical growth recovery, so bond yields are likely to end up grinding higher.

So, why the move higher? We believe there are three main factors:

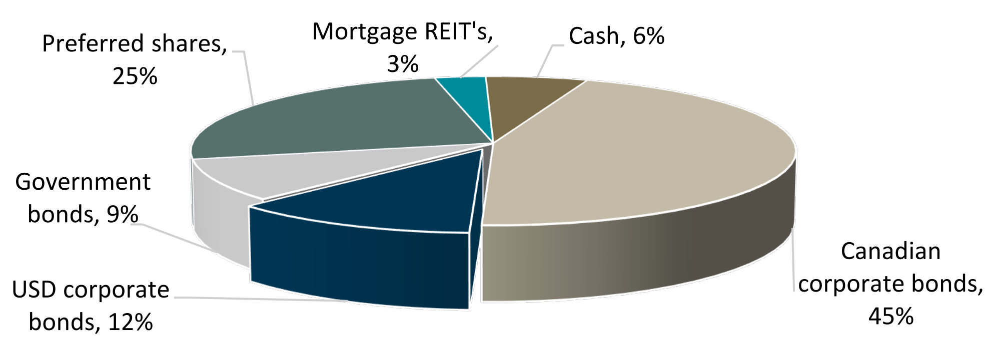
1.) Policy makers are attempting to run a red-hot economy. The purpose is to restore the U.S. economy to full employment, which is at or below an unemployment rate of 4%.
2.) Private sector risk appetite has experienced limited scarring. The pandemic was an exogenous shock. Policy makers were unfettered by moral hazard concerns and had little hesitation about underwriting household and corporate income losses to an unprecedented degree. In particular, while unemployment cost U.S. households US$330 billion in wage income, they have already received US$1 trillion in aggregate in transfers – a figure that will rise as the second round of fiscal stimulus kicks in. Excess savings of about US$1.4 trillion will provide fuel for pent-up demand to drive a sharp rebound in growth once economies fully reopen.
3.) The Fed is committed to its 2% average inflation goal: The consensus believes that it is one thing to target a 2% average inflation goal and another to actually get it. But, in previous cycles, the Fed has tightened monetary policy well before inflation moved above 2% sustainably. This is unlikely to be the case this time, hence any initial rises in inflation will have more time to take hold.

Portfolio implications

As mentioned earlier, with the 60-basis-point increase in the U.S. 10-year government bond yield and the yield above 1%, fixed income investors are suffering through a very difficult period, down 2% since the beginning of the year. In contrast, we believe we are well positioned in an environment where interest rates continue to normalize. Consider the following characteristics of the DFI portfolio on Figure 12 below.

Figure 12: Asset Allocation in Fixed Income Portfolio

Yield YTM: 4% Duration: 4.8 years



With a yield to maturity of approximately 4% and a duration of 4.8 years, DFI provides much higher income than government bonds, taking much less interest rate risk. Recall that duration is the sensitivity to interest rates, so the lower the duration, the less sensitive the portfolio is to rising rates. By comparison, the benchmark has duration of approximately eight years.

Conclusion

As the economic impact of COVID-19 continues to fade, we believe the economy will continue to heal and return to longer-term trend. In turn, interest rates will continue to normalize. Moreover, as inflation expectations become more engrained, bond yields will continue to adjust putting increased pricing pressure on sovereign bonds. In light of these considerations, our fixed income portfolio is well positioned to protect and enhance client purchasing power, while balancing the need for income and capital appreciation.