Luft Financial Model Portfolios

2020 Semi-Annual Review & Outlook

July 24, 2020

HollisWealth®

Your Vision Our Goal

Robert Luft, CIM, CFP®
Luft Financial
Portfolio Manager
Director, Private Client Group
HollisWealth, a division of Industrial Alliance Securities Inc.
Robert.Luft@holliswealth.com

Elvis Picardo, CFA, CIM
Portfolio Manager
Director, Private Client Group
HollisWealth, a division of Industrial Alliance Securities Inc.
Elvis.Picardo@holliswealth.com

Aaron Arnold, CIM, BA
Investment Advisor
HollisWealth, a division of Industrial Alliance Securities Inc.
Aaron.Arnold@holliswealth.com

Semi-Annual Review (First Half of 2020)

An Extremely Volatile First-Half for Global Equities

A risk factor that was barely acknowledged by market participants at the beginning of 2020 turned out to be a “Black Swan” event for the record books, as the worst pandemic in a century engulfed the global economy and brought it to a shuddering halt. The near-total stoppage of all economic activity triggered the “Coronavirus Crash” in March that led to markets around the world posting their biggest monthly decline in decades. However, prompt action by the U.S. Federal Reserve and trillions in fiscal stimulus by key economies, combined with gradual reopening in most nations, sparked a historic rally that enabled equity indices to trim the majority of their Q1 losses in Q2 (Figure 1).

The TSX Composite plunged almost 18% in March to finish the quarter down 21.6%, before rebounding 16% in Q2, for a year-to-date decline (as of July 22) of just over 5%. Similarly, the S&P 500 plummeted 20% in Q1 before surging by an identical percentage in Q2. The bellwether index is in positive territory with a YTD gain of 1.4%, which seemed barely conceivable when it collapsed by 35% in a little over a month after peaking on February 19, the fastest bear market on record. But this performance pales in comparison to that of the Nasdaq Composite, as insatiable investor appetite for technology mega-caps propelled the index to a record high on July 21. The dominant technology platforms of companies like Amazon, Netflix, Microsoft, Apple and Google made them the biggest beneficiaries of the “Great Lockdown” and the work-from-home phenomenon. The relative resilience of technology companies to the market crash enabled the Nasdaq to soar 63.5% from its March 23 low, for a YTD gain of 19%. On the flip side, European indices like the FTSE 100 and Euro Stoxx 50 are still down by double-digits YTD.

Figure 1: Nasdaq Composite hits record high to lead major indices

Source: FactSet, Luft Financial ***YTD figures are as of 22-July-2020**

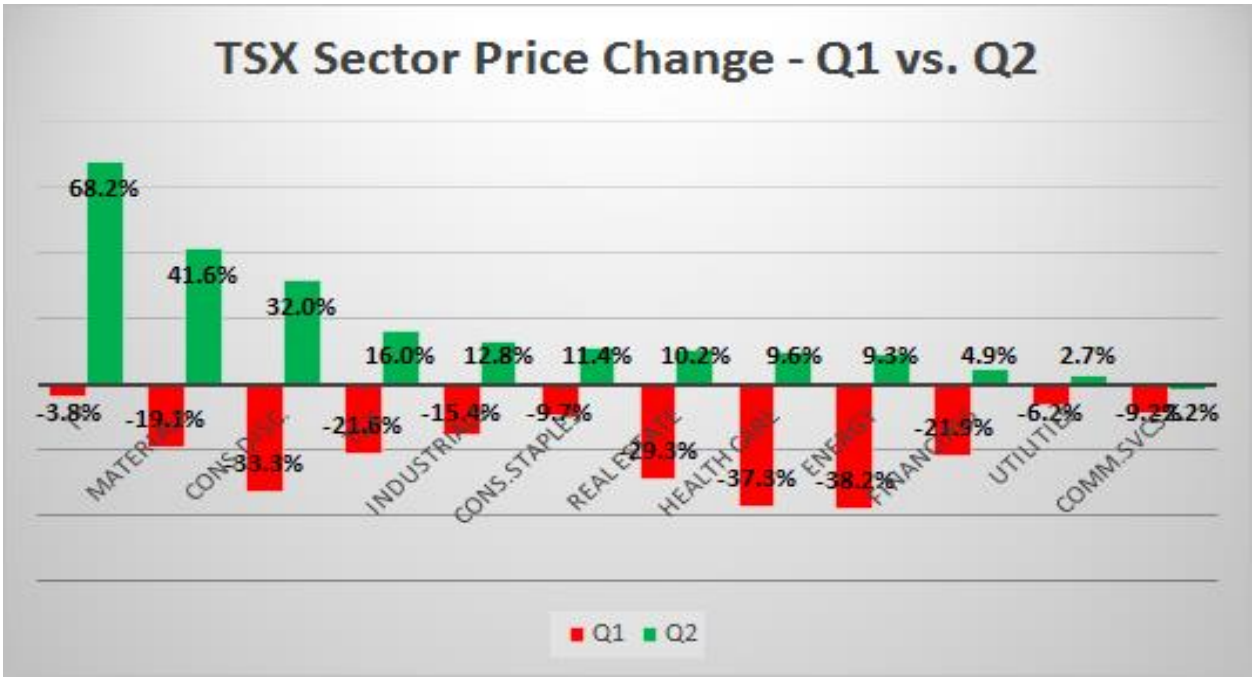
2020 Semi-Annual Review

TSX Sector Performance – A Mixed Bag

All 11 TSX sectors plunged in Q1, and all but one of them rebounded in Q2 (Figure 2), paring most of the index's 38% peak-to-trough plunge. The Information Technology sector, the best performer in the previous two years, continued its winning streak in the first half. The IT sector was up 63% YTD (as of July 22) primarily due to the soaring stock price of Shopify Inc, its largest constituent with a weight of 61%. Shopify has surged 148% so far this year to become the biggest Canadian company with a market capitalization of $150 billion. The Materials sector is in second place with a gain of 26% YTD, with gold producers dominating the ranks of the best performers on the TSX as the precious metal approaches a record high. Consumer Staples ranks third with a YTD gain of 5.5%.

But those are the only bright spots on the TSX, with six of its sectors still in the red for the year (excluding Utilities and Industrials, which are barely on the plus side). Health Care (-31%) is the worst performer YTD, with Energy close behind at -30% as the price of crude oil has slumped by almost one-third this year. The Real Estate sector is -21% YTD, as commercial and office REITs have been badly affected by concerns about their ability to collect rents from their tenants. The heavyweight Financials sector – which currently makes up 28.5% of the TSX – is down almost 16% YTD, as low interest rates and recessionary economic conditions take their toll on Canadian banks and insurers. But as we had pointed out in a recent "Macroscope" article, the shrinking weight of the three biggest TSX sectors (Financials, Materials and Energy) – which now account for 55% of the index compared with 65% to 70% a few years ago – might prove to be a blessing in disguise for Canadian investors as the diminishing influence of these cyclical sectors reduces volatility and generates more stable returns in future.

Figure 2: TSX Composite Sector Price Change – Q1 vs. Q2 (excluding dividends)



Source: FactSet, Luft Financial

2020 Semi-Annual Review

Portfolio Constituents – Major Movers

- Our client portfolios have held up very well in an extremely volatile period, on account of their diversified investments, significant weight in fixed income and instruments that are non-correlated with equities, and US dollar-denominated holdings.
- As was the case in 2019, our Top Ten performers are a diverse bunch (Figure 3). Five of these were among the best performers last year as well – **Barrick Gold**, **Invesco S&P 500 Top 50 ETF**, **Hydro One**, **Qualcomm** and **Visa**.
- In terms of contribution to portfolio return – which is based on portfolio weight and total returns – the five biggest positive contributors to our large model portfolios were **Invesco S&P 500 Top 50 ETF**, **AGF Global Select Fund**, **TD Fixed Income Pool**, **Mackenzie Ivy Foreign Equity Fund**, and **Dynamic Alpha Fund**.
- Our biggest decliners in the first half of 2020 were **Wells Fargo**, **General Electric**, **Pembina Pipeline** and **Manulife Financial**.

Figure 3: Portfolio Constituents' Top Performers YTD* (Total Returns in CAD)

Security	Symbol	Type	Sector	YTD Gains
Barrick Gold	ABX	Stock	Precious Metals	59.6%
AGF Global Select Fund	AGF808	Fund	Global Equity	21.0%
Invesco S&P 500 Top 50	XLG	ETF	S&P 500 Top 50 Stocks	13.0%
Hydro One	H	Stock	Utilities	12.4%
Canadian National Railway	CNR	Stock	Transportation	11.7%
Qualcomm	QCOM	Stock	Technology	10.1%
Visa Inc.	V	Stock	Financials (Services)	9.7%
Johnson & Johnson	JNJ	Stock	Healthcare	7.7%
Mackenzie Ivy Foreign Equity	MFC077	Fund	Global Equity	6.9%
Dynamic Alpha	DYN394	Fund	Alternatives (Hedge Fund)	6.8%

Source: SIACharts.com ***YTD figures are as of 22-July-2020**

Portfolio Changes

- Having sold off most of our laggards in Q4 of 2019, we were comfortable with our portfolio positioning as 2020 commenced. Our balanced portfolios were able to withstand the worst of the market carnage, with a maximum drawdown of less than one-half that of the TSX Composite and S&P 500.
- We rebalanced client portfolios on multiple occasions during the March selloff. Our asset allocation was little changed, except for a marginal increase in the equity weight of our Pension model to 60% as the market rebound gathered momentum.
- We added **(Walt) Disney Co**. to our large model portfolios in mid-March, based on its compelling growth profile and valuation characteristics. We expect the stock to outperform the broad market once a vaccine for Covid-19 becomes available and life returns to normal.
- None of our investments were affected by the liquidity squeeze at the height of the March selloff. Rise Properties Trust temporarily stopped accepting new subscriptions for about five weeks as it was unable to accurately value its properties. Rise returned to market from May 1 and after we completed our due diligence, we resumed buying the units for growth-oriented portfolios this month.

2020 Second-Half Outlook

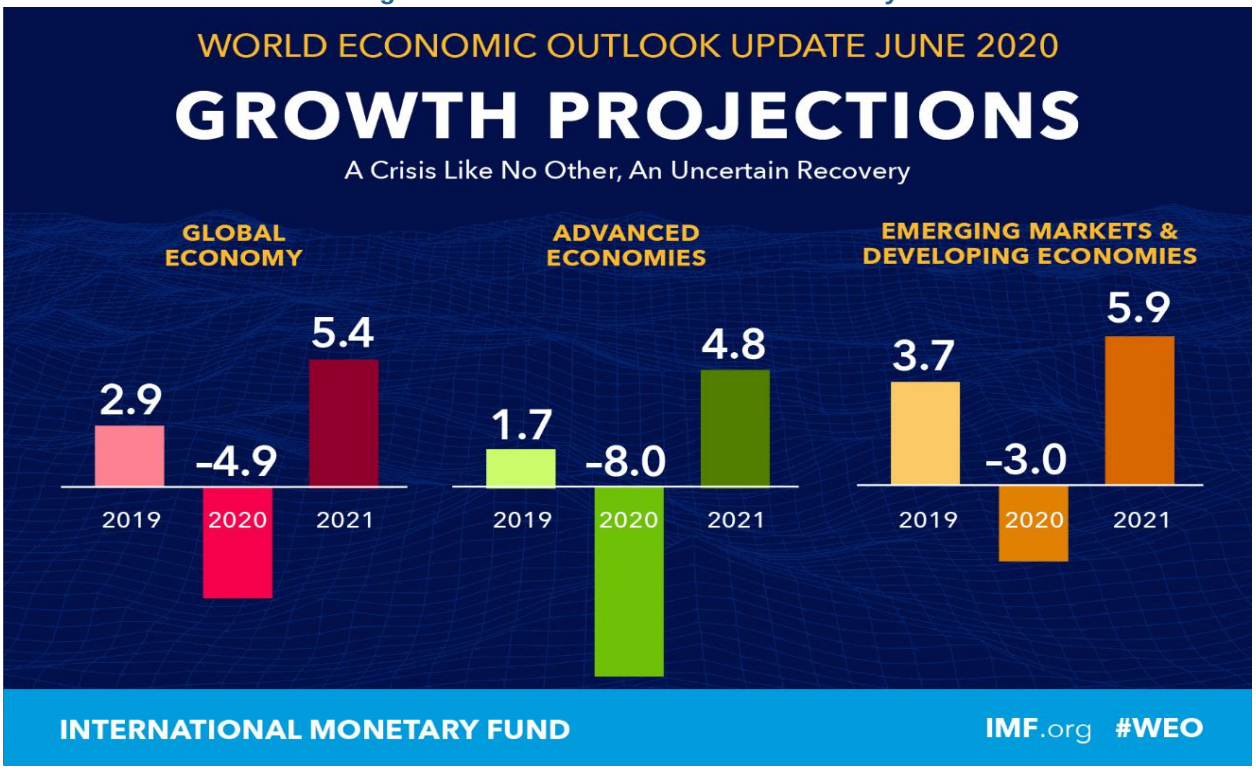
Huge Disconnect Between Main Street and Wall Street / Bay Street

The International Monetary Fund, in its World Economic Outlook (WEO) released about a month ago, began its report with these ominous words: "Global growth is projected at -4.9% in 2020, 1.9 percentage points below the April 2020 WEO forecast. The Covid-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast. In 2021 global growth is projected at 5.4%" (Figure 4).

It is difficult to reconcile this gloomy assessment with the fact that the S&P 500 is only 3.5% away from its record high, while the MSCI All-Country World Index is 5% away from its peak. There is admittedly a huge disconnect between the "real" economy or Main Street, and the equity markets or Wall St / Bay St., using just one key metric – jobless claims – as an example (Figure 5). That said, there are valid reasons to justify both the bull case and the bear case.

The bull case is buttressed by macro factors such as economic data that – although still well below pre-Covid levels – is improving and exceeding expectations (Figure 6), while "low for long" interest rates and the Federal Reserve's tacit support for the markets has significantly improved risk appetite. In addition, the risk of another nationwide lockdown in the U.S. is seen as low. On the coronavirus front, there is a great deal of optimism that a vaccine may be available in record time, and traders are hopeful that despite rising Covid-19 cases in the U.S. and globally, disastrous scenarios like the ones witnessed in Italy and New York during the peak infection phase can be avoided.

Figure 4: IMF Forecast for Global Economy

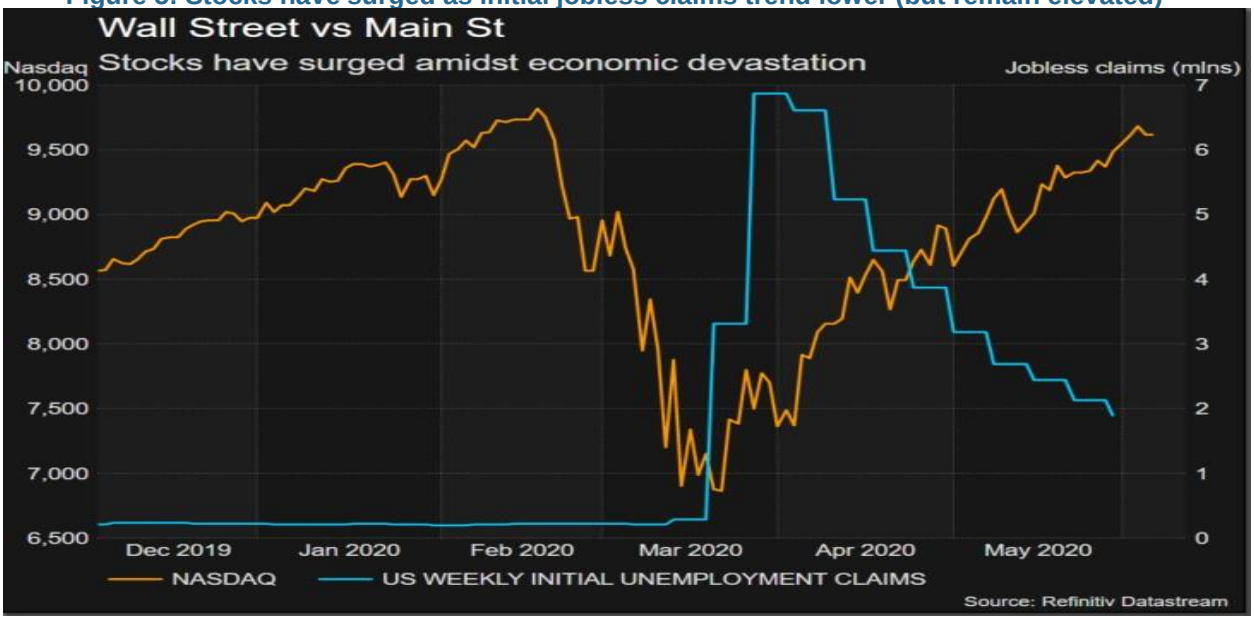


Source: IMF World Economic Outlook June 2020

2020 Second-Half Outlook

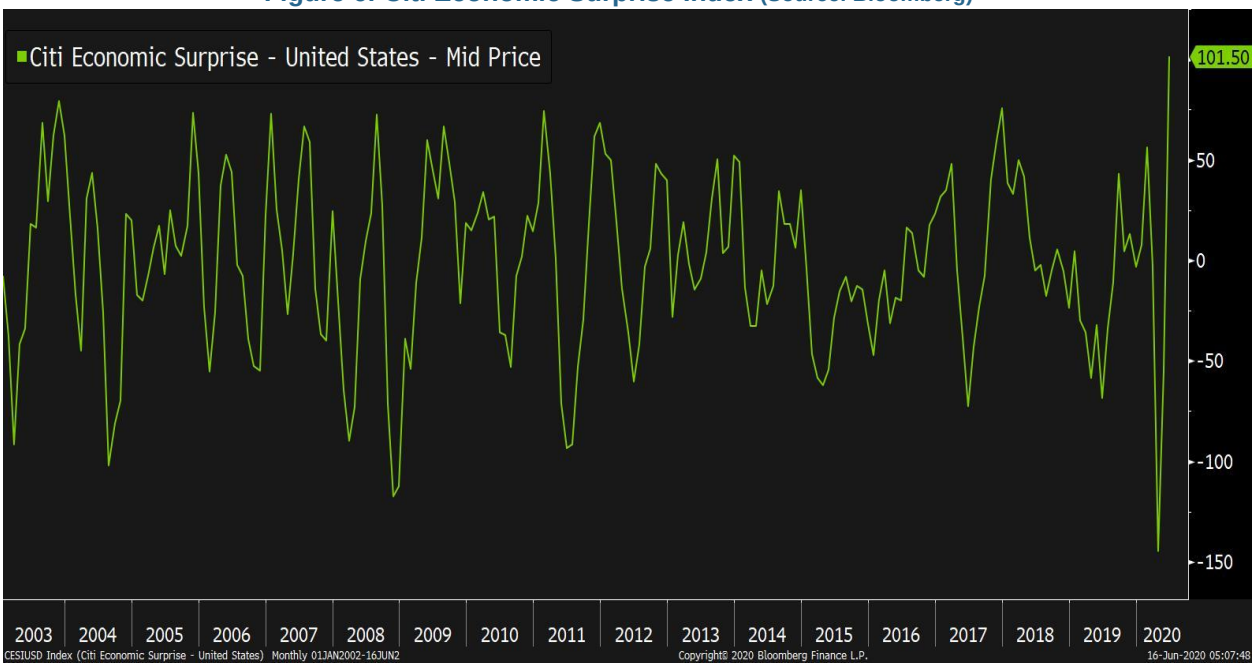
The charts below show that even if the absolute numbers remain abysmal, as long as the trend is in the right direction, investors remain willing to look beyond dismal data ("light at the end of the tunnel"). At the time of writing, U.S. stocks have snapped a four-day winning streak after initial jobless claims rose for the first time since March, although the 16.2 million who filed for continuing benefits in the period ended July 11 was below the prior week's number and lower than the 17.1 million forecast.

Figure 5: Stocks have surged as initial jobless claims trend lower (but remain elevated)



Source: Refinitiv Datastream

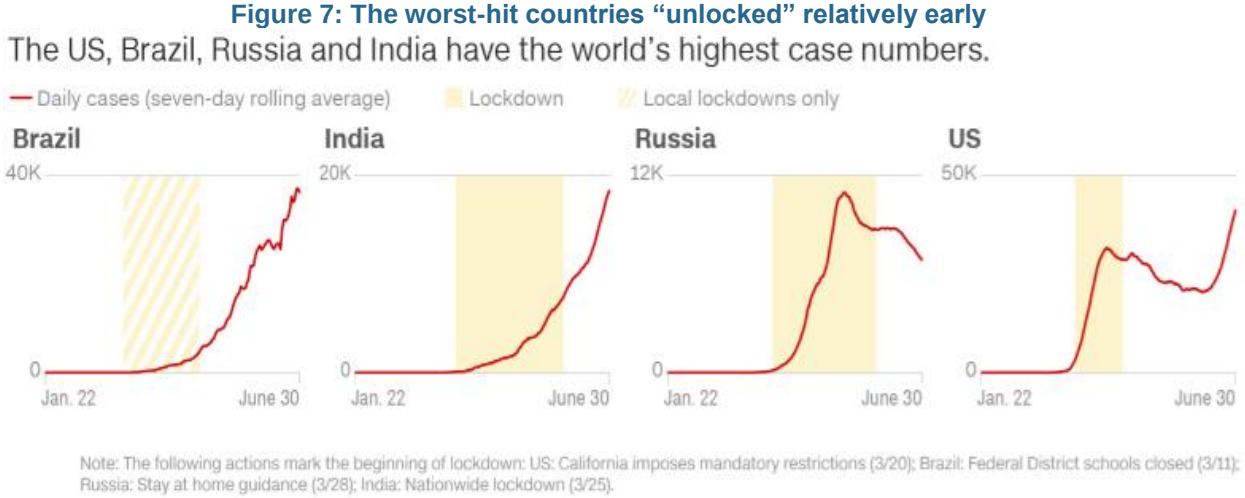
Figure 6: Citi Economic Surprise Index (Source: Bloomberg)



2020 Second-Half Outlook

On the other hand, there is no shortage of fodder for the bearish camp. Covid-19 cases have been surging in recent weeks, exceeding 15 million globally and 4 million in the U.S. alone as of July 23 (of which a quarter occurred over the past 15 days). With over 143,000 deaths, the U.S also accounts for 23% of the global toll of 624,000. The virulence of Covid-19 and the fact that it has been running rampant for more than six months has doused hopes that it would be overcome quickly, while the problems being faced by some of the biggest economies that reopened too soon (Figure 7) highlights the importance of social distancing as one of the most effective measures to combat the pandemic.

Figure 7: The worst-hit countries "unlocked" relatively early



Source: CNN, John Hopkins University

Some experts including Anthony Fauci, Director of the U.S. National Institute of Allergy and Infectious Diseases, believe that first doses of a vaccine could be available as soon as this year if vaccine developers can avoid major setbacks. However, others view that timeline as being too ambitious, since the process of developing a conventional vaccine from start to finish takes nearly 11 years on average, and only 6% of experimental vaccines are successful.

The possibility of Covid-19 continuing to pose a threat to public health well into 2021 represents a major threat to the global economy and financial markets. Other risk factors include – significant deterioration in U.S.–China relations recently; consumer spending constrained by the upcoming expiration of special unemployment benefits (extra payments of $600 per week in the U.S. run out at the end of July; in Canada, the $2,000 monthly CERB payment runs until October 3); U.S. political uncertainty; and market valuations.

The MSCI AC World Index presently trades at a forward Price/Earnings (P/E) multiple of 20, a valuation that prevailed during the dot-com bubble two decades ago. Current market valuations are based on a V-shaped earnings recovery in 2021; if that does not occur, valuations would look quite stretched.

2020 Second-Half Outlook

According to FactSet estimates, earnings for the TSX are forecast to tumble by 34% this year to $691, before rebounding 48% to $1,020 in 2021. The TSX Composite's July 23 closing price of 16,018 implies that the index is trading at an expensive 23.2x 2020 EPS and at a much more reasonable 15.7x 2021 EPS. A similar pattern is evident in earnings estimates for the S&P 500, with EPS projected to fall 22% to $126 this year, before rebounding 29% to set a new earnings record of $162 in 2021. The S&P 500's current level of 3,235 implies valuation multiples of 25.7x 2020 EPS and 20.1x 2021 EPS.

Thus, the market's direction over the rest of the year may be determined by investors' assessment of a recovery in corporate earnings next year, which in turn depends on if the pandemic can be quelled and whether a full-blown economic recovery can take root. While the number of variables makes it difficult to assess future returns with any degree of confidence, we believe there is a risk of some downside in the near term. Should that occur, however, we believe our disciplined approach to asset allocation – as demonstrated in this chart from JP Morgan – will benefit client portfolios in a challenging environment.

Fig. 8: Divergence in asset class returns highlights importance of disciplined asset allocation

																2005 - 2019	
2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD	Ann.	Vol.
EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Fixed Income 6.1%	Large Cap 9.0%	REITs 22.2%
Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	Cash 0.5%	REITs 8.3%	EM Equity 22.1%
DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.1%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap -3.1%	Small Cap 7.9%	Comdty. 18.6%
REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. -4.5%	EM Equity 7.8%	Small Cap 17.7%
Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 11.6%	Large Cap -4.4%	Asset Alloc. 19.5%	High Yield -4.7%	High Yield 7.2%	DM Equity 17.3%
Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 25.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	EM Equity -9.7%	Asset Alloc. 6.6%	Large Cap 14.0%
Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	DM Equity -11.1%	DM Equity 5.3%	High Yield 10.9%
High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Small Cap -13.0%	Fixed Income 4.1%	Asset Alloc. 10.0%
Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	REITs -13.3%	Cash 1.3%	Fixed Income 3.4%
Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	Comdty. -19.4%	Comdty. -2.6%	Cash 1.0%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg Barclays 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/04 – 12/31/19. Please see disclosure page at end for index definitions. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2020.

J.P.Morgan Asset Management

Source: J.P.Morgan Asset Management

2020 Semi-Annual Review & Outlook

DISCLAIMER

This information has been prepared by Robert Luft and Elvis Picardo, who are Portfolio Managers, and Aaron Arnold, who is an Investment Advisor, for HollisWealth® and does not necessarily reflect the opinion of HollisWealth®. HollisWealth® is a division of Industrial Alliance Securities Inc., a member of the Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada. The information contained in this newsletter comes from sources we believe reliable, but we cannot guarantee its accuracy or reliability. The opinions expressed are based on an analysis and interpretation dating from the date of publication and are subject to change without notice. Furthermore, they do not constitute an offer or solicitation to buy or sell any of the securities mentioned. The information contained herein may not apply to all types of investors. Robert Luft, Elvis Picardo and Aaron Arnold can open accounts only in the provinces in which they are registered. For more information about HollisWealth, please consult the official website at www.holliswealth.com. Luft Financial is a personal trade name of Robert Luft.