FOR PRIVATE CLIENTS ONLY

LUFT FINANCIAL MODEL PORTFOLIOS

2020 REVIEW & 2021 OUTLOOK

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Your Vision

Our Goal

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RECORD REBOUND AFTER HISTORIC DECLINE

A year ago, global equities were coasting along at near-record highs, with investors paying little heed to the growing number of cases of a mysterious virus in China. That complacency was shattered within a few weeks, as the exponential growth in Covid-19 cases around the world led to the worst pandemic in a century.

The global economy slowly ground to a virtual halt in March, triggering a market crash and the worst monthly decline in decades for most major indices. Three of the 25 biggest daily declines in the S&P 500 occurred within the span of one week in March 2020; the TSX Composite endured a 12.4% plunge on March 12, its worst one-day performance since 1940.

Prompt action by the U.S. Federal Reserve and trillions in fiscal stimulus by key economies pulled the global economy back from the brink of a financial precipice. Timely monetary and fiscal policy measures, 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, before going on to set new highs in the second half of the year.

If investors were shocked by the speed of the March plunge – the S&P 500 fell as much as 34% in a 33-day period ended March 23 – the rapidity of the rebound also surprised many, with the index regaining its previous high in 163 days. By way of comparison, the S&P 500 took almost 66 *months* to reclaim its previous high after the financial crisis of 2007-08. Although there was significant divergence in the performance of major indices over the year, the MSCI World Index also reached new records in 2020 (bottom chart), with global market capitalization surpassing $100 trillion for the first time.

Source: Visual Capitalist

SOLID RETURNS BY MOST ASSET CLASSES

Most asset classes rebounded swiftly from their March lows to solid returns in 2020. Silver and gold topped the performance charts, while crude oil plunged 20.5% (oil prices actually fell well below $0 per barrel for the very first time on April 20). Thanks to the stellar returns of the FAANG megacaps, the Nasdaq Composite surged 43.6%, the best performance among major equity indices, while the S&P 500 gained 16.3% and the Dow Jones advanced 7.3% over the year. The TSX lagged the S&P 500 in its recovery from the March lows (see Chart below), to finish the year with a meagre 2.2% gain. Despite double-digit gains in Q4, most European indices finished 2020 in the red, as the continent bore the brunt of the pandemic in the first half of the year. The additional uncertainty caused by Brexit led to the UK's FTSE-100 tumbling 14.3%. In the largest emerging markets, India and China outperformed with gains of 15.4% and 13.9% respectively (Data Source: FactSet).

TECH TOPS TSX FOR THIRD STRAIGHT YEAR

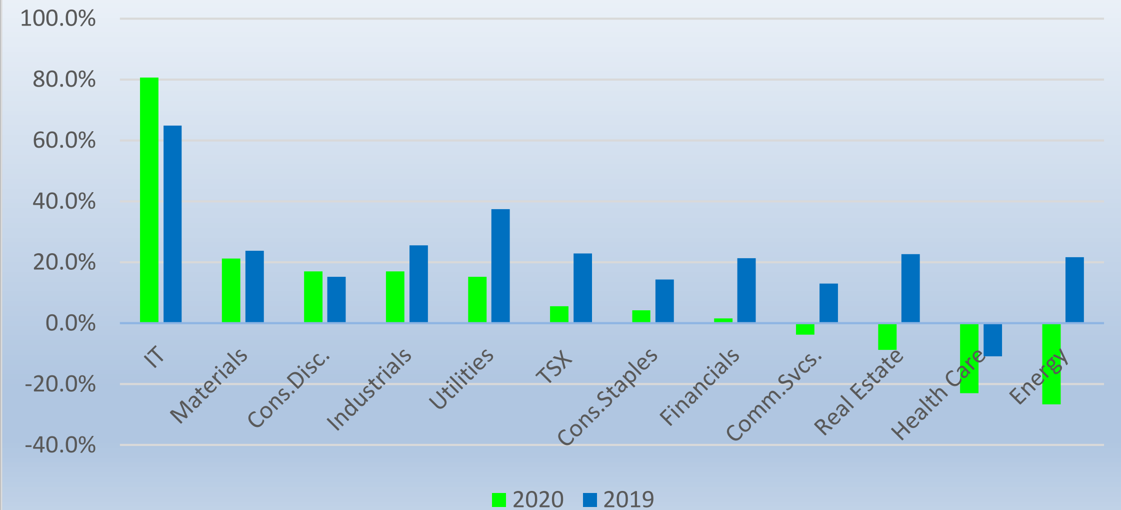
On a total return basis (price change plus dividends), the TSX returned 5.6% in 2020, compared with 22.9% in 2019 which was its best showing in a decade. The technology sector topped the index for the third straight year with a total return of 80.7% in 2020, after returning 64.9% in 2019.

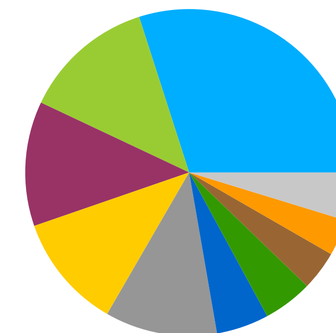
The underperformance of the TSX in comparison to the S&P 500 can largely be attributed to its heavy weighting in cyclical sectors such as financials, resources and energy. The combination of recessionary conditions that prevailed in the Canadian and global economy for much of the year and record low interest rates led to the financials sector posting a return of only 1.6% in 2020. Surging prices for precious metals enabled the materials sector to finish second with a 23.8% return. The energy sector slumped to the bottom of the performance table due to sharply lower crude oil prices, while the health care and real estate groups also posted significant negative returns.

As a result of the technology sector's huge gains over the past couple of years, it now has the fifth-biggest weight on the TSX at 11% (bottom chart). Shopify dominates the 10-member TSX IT sub-index with a 62.5% weighting. Shopify's meteoric 178% gain in 2020, on the heels of a 173% gain in 2019, have made it the biggest Canadian company with a market cap approaching $200 billion.

Notwithstanding their tremendous contribution to the Canadian economy, the diminishing influence of the traditional big three TSX sectors – with a combined weight of 55%, compared with 65% to 70% in recent years – is an encouraging trend. The lower contribution from cyclical sectors, coupled with the rise of other sectors such as technology, industrials and utilities, will increase sector diversification on the TSX, which should reduce index volatility and generate more stable returns in future.

(Data and Charts Source: FactSet)





PORTFOLIO REVIEW: CONTRIBUTORS AND DETRACTORS – PENSION MODEL PORTFOLIO

	Rescaled Weight	Return	Contribution
Invesco S&P 500® Top 50 ETF	12.41	22.09	2.43
AGF Global Select Series F	6.87	42.25	2.39
Qualcomm Inc	2.49	73.90	1.44
Mackenzie Ivy Foreign Equity F	10.16	14.81	1.30
The Walt Disney Co	1.88	48.62	1.04
BMO Asian Growth & Income F	4.88	13.92	0.58
Magna International Inc Class A	1.92	30.83	0.50
Hydro One Ltd	2.41	18.51	0.47
Canadian National Railway Co	2.18	21.37	0.43
Visa Inc Class A	2.28	15.08	0.37

	Rescaled Weight	Return	Contribution
Wells Fargo & Co	2.12	-42.69	-1.16
General Electric Co	0.90	-35.55	-0.80
Pembina Pipeline Corp	1.73	-32.57	-0.35
BMO International Dividend ETF	6.61	-5.62	-0.29
Russell Inv Global Infrastructure Pool F	5.06	-6.21	-0.29
CI First Asset Canadian REIT ETF Comm	4.84	-6.99	-0.23
Shaw Communications Inc Class B	2.12	-10.80	-0.21
Manulife Financial Corp	1.82	-9.11	-0.19
CVS Health Corp	2.39	-6.81	-0.17
Westshore Terminals Investment Corp	1.90	-14.15	-0.16

Source: Morningstar, Luft Financial

- In our Pension (Balanced Growth) model, the biggest contributors to performance were U.S. ETFs and stocks – Invesco S&P 500 Top 50 ETF (XLG), Qualcomm, Disney and Visa – or equity funds with substantial U.S. exposure (AGF Global Select, Mackenzie Ivy Foreign Equity), followed by an emerging markets fund (BMO Asian Growth & Income) and Canadian blue-chips such as Magna, Hydro One and Canadian National Railway.
- The top three detractors included a couple of stocks – Wells Fargo and General Electric – whose nascent turnaround was interrupted by the Covid-induced global slowdown. We sold Wells Fargo in December and replaced it with a diversified U.S. financial sector ETF (XLF), while GE continues to be transitioned out of the portfolio. We remain confident about the long-term prospects for stocks that underperformed in this model, like Pembina Pipeline, Shaw, Manulife and CVS Health. The BMO International Dividend ETF consists of leading companies in Europe and Asia; we are optimistic about the outlook for ETFs and funds that have an ex-North American focus, as investor funds gravitate to underperforming regions with solid fundamentals. We believe infrastructure and REITs are among the best re-opening plays as the global economy continues to recover; these two sectors are represented by the Russell Global Infrastructure Pool and CI First Canadian REIT ETF respectively in our Pension model.

PORTFOLIO REVIEW: CONTRIBUTORS AND DETRACTORS – PROGRESS BALANCED GROWTH MODEL PORTFOLIO

	Rescaled Weight	Return	Contribution
Fidelity Canadian Opportunities Sr F	33.58	29.07	9.41
TD U.S. Blue Chip Equity F	31.99	31.34	8.83
BMO MSCI Emerging Markets ETF	4.80	15.36	0.80
Starlight Global Infrastructure F	6.65	3.82	0.31
CI First Asset Canadian REIT ETF Comm	6.68	-6.99	-0.26
BMO International Dividend ETF	16.30	-5.62	-0.33

	Rescaled Weight	Return	Contribution
BMO International Dividend ETF	16.30	-5.62	-0.33
CI First Asset Canadian REIT ETF Comm	6.68	-6.99	-0.26
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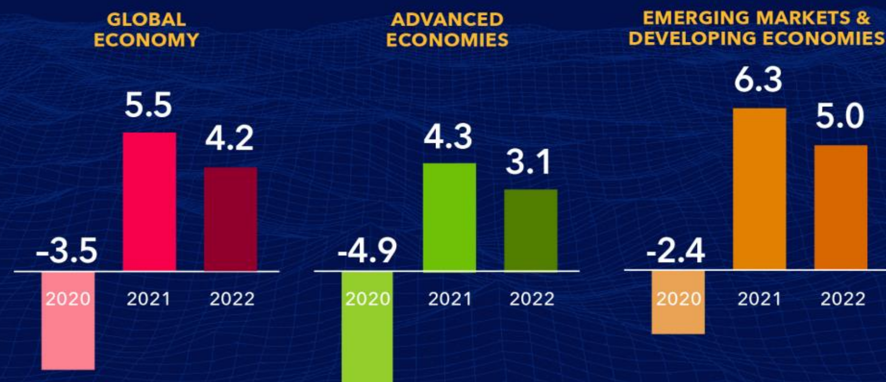
Source: Morningstar, Luft Financial

- Our smaller Progress model portfolios have far fewer securities than our larger models like Pension (Balanced Growth) and Pursuit (Growth), as they consist of ETFs and funds but do not include single stocks.
- In our Progress Balanced Growth model portfolio, the biggest contributors to performance were two mutual funds that have been long-term outperformers and did extraordinarily well in 2020. The Fidelity Canadian Opportunities Fund, a diversified fund that includes stocks such as Dollarama and Brookfield Renewable Partners among its top holdings, had a return of 29.1% in 2020. The TD US Blue Chip Equity Fund, which returned 31.3% in 2020, had a 60% weight in technology and communication services at year-end; its top five holdings were Amazon.com, Alphabet, Facebook, Microsoft and Apple. Both these funds are the two biggest holdings in our Pedestal model portfolios for small accounts.
- The only two securities with negative returns in the Progress Balanced Growth model portfolios were BMO International Dividend ETF and CI First Asset Canadian REIT ETF. As discussed earlier, we are optimistic about the outlook for ex-North American equities and Canadian REITs.

PORTFOLIO CHANGES AND REBALANCES SUMMARY

- The flurry of changes we had made to our model portfolios in 2019 served us well in 2020, as the inherent diversification of our portfolios enabled them to withstand the worst of the steep market correction in March. The maximum drawdown of our balanced portfolios was less than 50% that of the TSX Composite and S&P 500.
- Our asset allocation was little changed over the course of the year, except for a marginal increase in the total equity component of our Pension model to just over 60% as the market rebound gathered momentum.
- We added (Walt) Disney Co. to our large model portfolios in the first week of March, based on its compelling growth profile and valuation; the stock surged 55% from our entry point by year-end, as tremendous growth in Disney's streaming service offset closures of its marquee theme parks and other businesses. We sold Wells Fargo in the first week of December to harvest tax losses, replacing it with a diversified U.S. financial sector ETF.
- 2020 was undoubtedly one of our most active years in terms of portfolio rebalancing activity. We rebalanced client portfolios on numerous occasions to take advantage of rapidly changing market conditions, trimming gains in equities and adding to fixed income positions at the market highs in February and August, and adding aggressively to equities and deploying cash at the March lows.
- Our final bout of rebalancing for 2020 occurred on the eve of the U.S. Presidential election (specifically between October 30 and November 3), when we added to positions in value stocks and other securities that had lagged the broad rally since March. The rebalance decision turned out to be a timely one, as news of Pfizer's Covid-19 vaccine results spurred the biggest outperformance of value stocks over their growth counterparts in at least two decades. The combination of positive vaccine news and declining U.S. political uncertainty as a result of President Biden's victory triggered massive risk-on appetite globally, with the MSCI World Index up by a record 11.3% in November.
- As we expect significantly lower market volatility this year compared to 2020, we anticipate fewer rebalances in 2021, based on our rules-based methodology.



	Monetary Policy	Fiscal Policy
U.S.	Rates cut to 0-0.25%. Unlimited asset purchases.	$3.8 trillion stimulus (18% of GDP).
Japan	Short-term rate at -0.1%; 10-year yield target at 0%, with no limit on JGB purchases. REIT and ETF purchases doubled. CB and CP purchases more than tripled.	¥308 trillion yen stimulus (57% of GDP). Package includes existing measures.
Germany	ECB deposit rate unchanged at -0.5%. Rates on TLTRO as low as -1.0% from Jun-20 to Jun-22.	€267 billion stimulus (8.1% of GDP).
France	Existing asset purchases expanded by €120 billion by end-2020.	€84 billion stimulus (3.7% of GDP).
Italy	Net asset purchases under Pandemic Emergency Purchase Program to run to until Mar-22, with an envelope of €1.85 trillion.	€100 billion stimulus (5.6% of GDP).
U.K.	Rates cut to 0.1%. Purchase of £450 billion in bonds.	£280 billion stimulus (14% of GDP).
Canada	Rates cut to 0.25%. Program to buy C$4 billion a week of government bonds.	Support worth C$438 billion into 2021, around 20% of 2020 GDP.

Note: Green = adequate policy response
Orange = partial policy response
Red = so far policy response insufficient
Colors based on Bloomberg Economics' judgement, noting limited space for conventional monetary response.

IMF EXPECTS POLICY SUPPORT AND VACCINES TO BOOST GLOBAL ECONOMY

- In its World Economic Outlook update released last month, the International Monetary Fund forecast a sustainable recovery amid "exceptional uncertainty." The IMF estimates that global GDP will rebound 5.5% this year, from -3.5% in 2020, and expand 4.2% in 2022 (chart on left).

- The 2021 forecast was revised up by 0.3 percentage point from its October estimate, reflecting expectations of a vaccine-powered strengthening of activity later this year and additional policy support in some large economies. (As can be seen in the bottom chart, several governments and central banks have certainly opened the fiscal and monetary spigots to keep their economies afloat). The 2020 estimated contraction was also improved by 0.9 percentage point from the October forecast due to stronger than expected momentum in the second half of the year.

- The IMF's concerns surrounding the economic outlook are mostly centred around the pandemic, including surging infections and new variants of the virus, the prospect of renewed lockdowns and logistical problems with vaccine distribution.

- The IMF projects the strength of the recovery to vary significantly across countries. Emerging market and developing economies are forecast to grow faster than advanced economies – albeit with divergent recovery paths – after contracting by half as much in 2020.

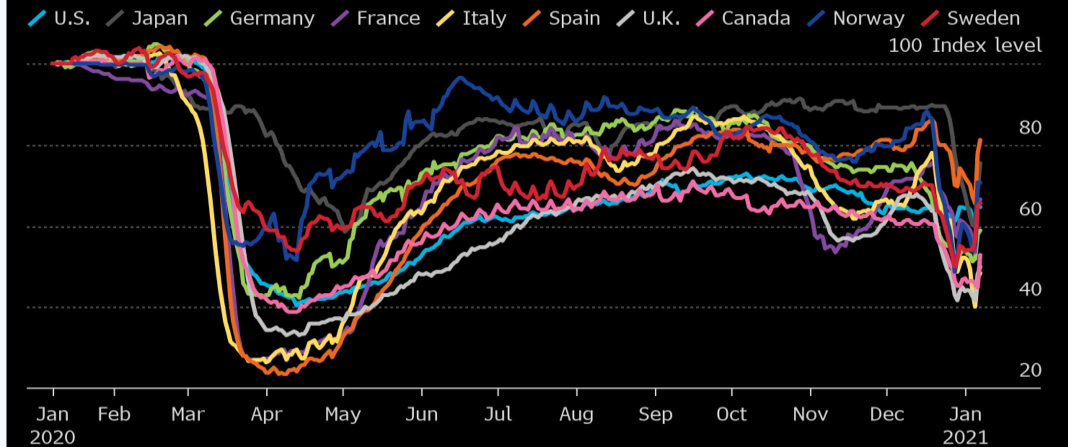
- The IMF's growth forecasts for select economies are as follows (2020,2021,2022) - Canada (-5.5%, 3.6%, 4.1%); United States (-3.4%, 5.1%, 2.5%); Euro Area (-7.2%, 4.2%, 3.6%); United Kingdom (-10.0%, 4.5%, 5.0%); Japan (-5.1%, 3.1%, 2.4%); China (2.3%, 8.1%, 5.6%); India (-8.0%, 11.5%, 6.8%).

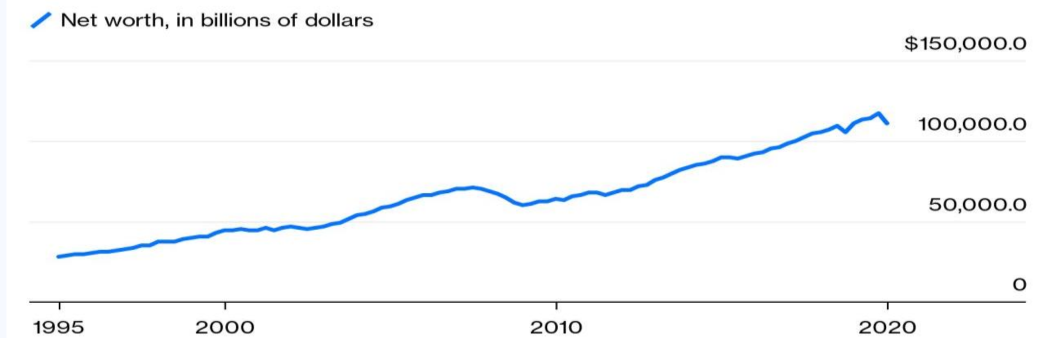
Sources: IMF.org (top chart), Bloomberg Economics (bottom chart)

MARKETS AT PEAK, ECONOMIES FAR FROM IT

As global equities have marched to new highs even as economic activity in numerous nations remains well below the pre-pandemic peak (top chart), the trillion-dollar question that arises is – what accounts for this huge disconnect? Here are five reasons:

- **Strong earnings growth** – Investors expect the pandemic to have a temporary effect on earnings growth and have been willing to look past the slump in 2020 to better times ahead. Earnings for the S&P 500 are forecast to grow almost 25% this year – rebounding from a 15% decline in 2020 – and 16% in 2022. The TSX is forecast to post an even more dramatic recovery, with earnings expected to surge 49% this year after a 31% slump in 2020 and grow 13% in 2022 (earnings estimates compiled by FactSet).
- **Surging tech giants** – The five largest companies in the S&P 500 (FAAMG), representing almost 20% of the index's total market capitalization, surged by an average 52.6% in 2020.
- **Steady improvement in economic activity**– Despite blips along the way, economic activity in most nations is well above the lows seen during the global shutdown in spring of 2020.
- **Abundant fiscal and monetary stimulus** – Stimulus cheques in some nations including Canada and the U.S., and record low interest rates in many countries, have provided tremendous support and cushioned the financial blow for consumers.
- **Net worth has held up**: Booming equity and housing markets have contributed to consumers' "wealth effect," while their cash hoard has increased thanks to income from relief measures but few options available for discretionary spending. Household net worth has hardly been dented in the U.S. (bottom chart) and has gone up in Canada.

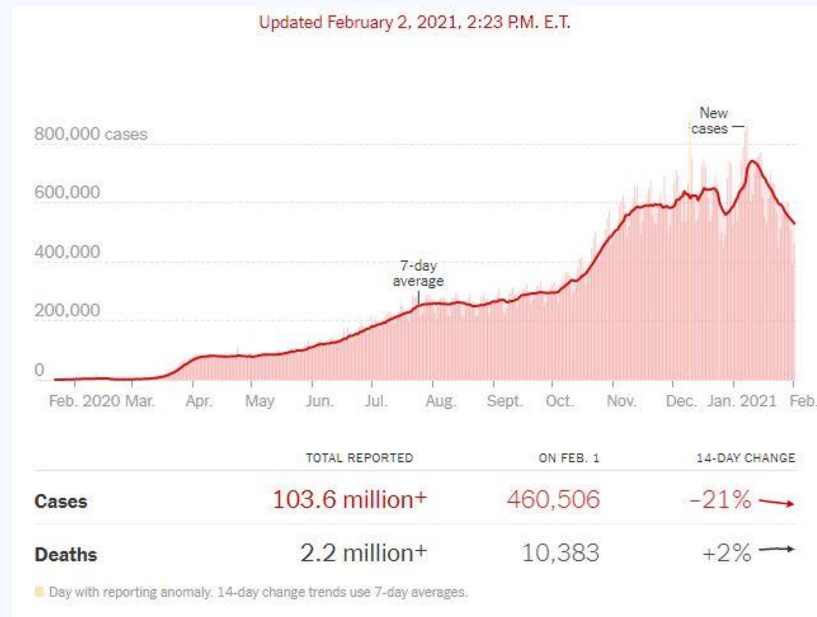




IS THE SECOND WAVE ROLLING OVER?

GLOBAL COVID-19 CASES

As of February 2, global cases of Covid-19 exceeded 103 million, with more than 2.2 million deaths. While the pandemic is ebbing in some of the countries that were among the worst affected early on, the number of new cases is growing rapidly worldwide, with more than 500,000 reported on average daily. Hope is on the horizon, however, with the vaccine rollout picking up steam and the warmer months of spring around the corner.



Source: NYTimes.com

CANADA-WIDE COVID-19 CASES

Total Covid-19 cases across Canada were approaching 790,000 as of February 2. Although case counts are declining steadily, the 7-day average of over 4,000 cases is still more than double the peak of the first wave. On an encouraging note, hospitalisations have fallen 12% and deaths have declined by 28%. The government's goal to vaccinate every Canadian who wants to be vaccinated against Covid-19 over the next eight months is likely ambitious, given current uncertainties in vaccine supply.

Source: CTV.ca

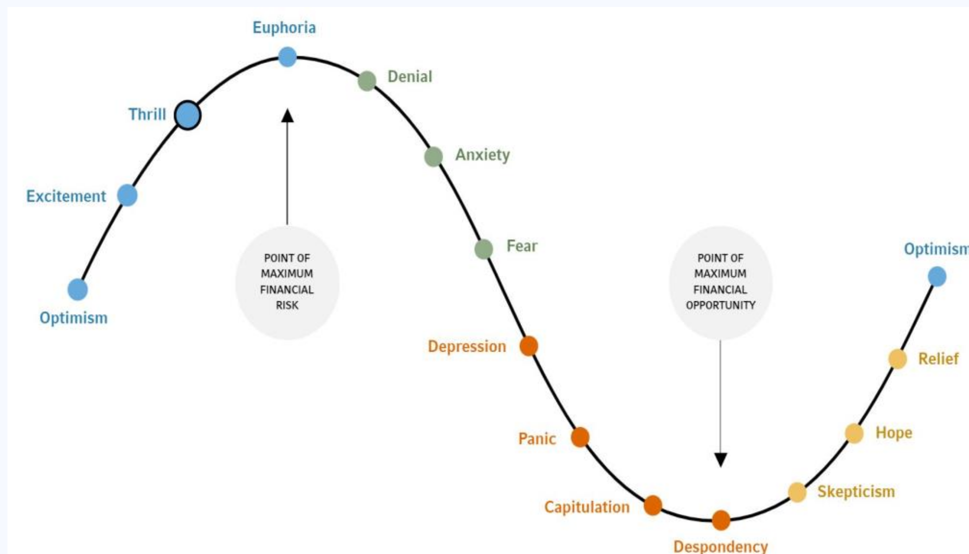
PORTFOLIO STRATEGY – A BULL CASE FOR EQUITIES

- As noted in the preceding section, the global economy is forecast to rebound strongly this year and next. Although soaring cases of Covid-19 globally and new virus variants inject considerable uncertainty into the outlook, there are early indications that the dreaded second wave may have peaked, as shown on Page 9. The rollout of multiple vaccines should ramp up globally in the months ahead, enabling some degree of "herd immunity" to be achieved in multiple nations before next winter.
- Based on these assumptions, as well as the earnings trajectory forecast for this year and next (Page 8), equities would seem to be the place to be for the next couple of years, given that bond yields in North America have risen appreciably from their record lows (thereby having a negative impact on bond prices), while yields on cash are non-existent.
- Despite pockets of speculation in certain areas – for example, huge demand for SPACs (Special Purpose Acquisition Company); the Reddit-fuelled buying of GameStop and other heavily shorted companies; enormous appetite for anything related to electric vehicles – equities should be supported by a host of factors, including earnings growth, improving economic data and tacit Federal Reserve support.
- What about valuations? The S&P 500 trades at 22.5x this year's EPS forecast of $170.57 (based on analyst estimates compiled by FactSet), which is above the historical average but should be weighed against the backdrop of 25% EPS growth expected this year. The TSX trades at 16.6x the 2020 EPS forecast of $1079.65, compared with expected EPS growth of 49%. Equity valuations may become an issue only if those EPS projections prove to be too optimistic.
- Strategists' forecasts compiled by FactSet show an average end-2021 target of 20,516 for the S&P 500 and 4,295 for the S&P 500. Based on February 3 closing levels (17,915 for the TSX, 3,830 for the S&P 500), expected total return – including dividend yield of 3.0% – is 17.5% for the TSX and 13.6% for the S&P 500 (including dividend yield of 1.5%).
- Asset allocation for our main models and investment mandates is shown on page 12.

WHERE ARE WE NOW IN THE CYCLE OF INVESTOR EMOTIONS ?

CYCLE OF INVESTOR EMOTIONS

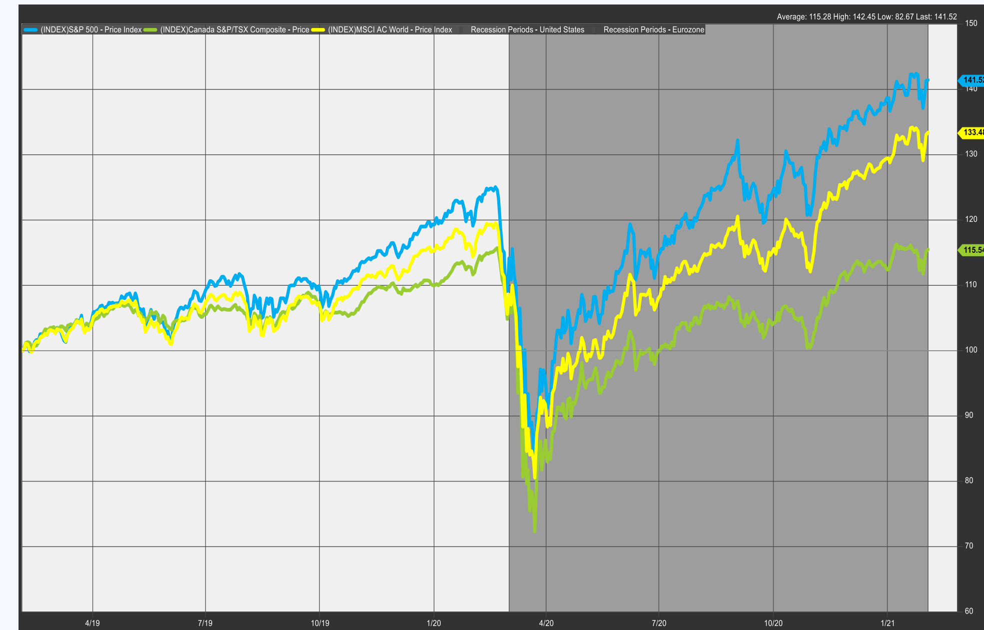
The chart below, courtesy of Russell Investments, shows the typical cycle of investor emotions over a full market cycle. The point of maximum financial risk is at the euphoric stage, while the point of maximum financial opportunity is during periods of utter despondency, which generally occur at market bottoms.



Source: Russell Investments

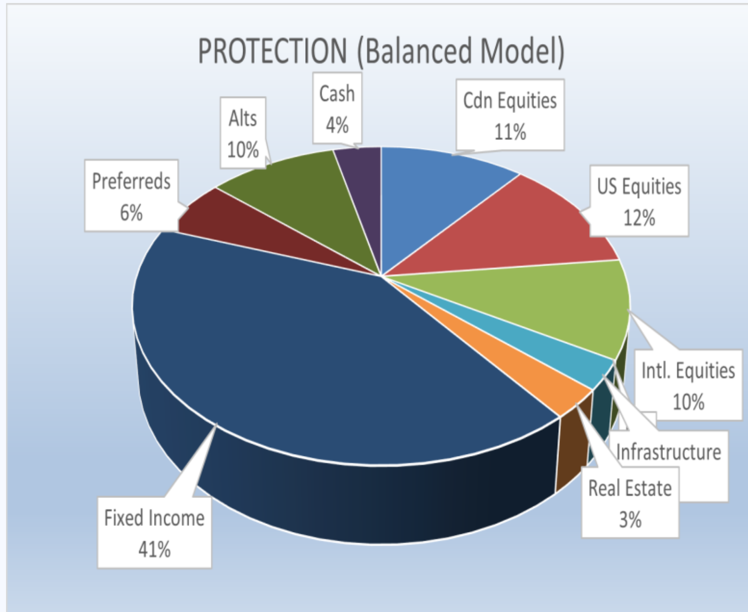
TSX VS. S&P 500 & MSCI WORLD

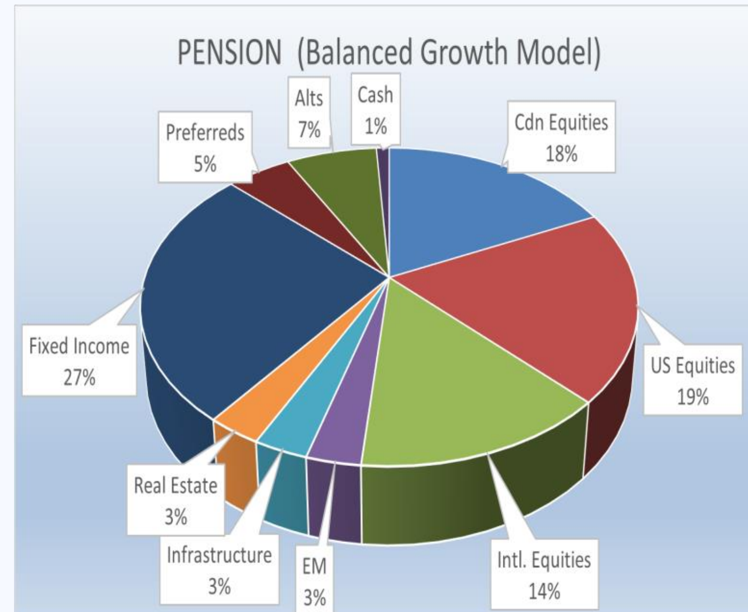
This chart shows the change in the TSX, S&P 500 and MSCI World Index over a two-year period, with a normalized value of 100 as of February 1, 2019. In hindsight, the point of maximum opportunity was at the market bottom on March 23, 2020, with the three indices up by an average of 67% since then. At the present time, although equity indices are near record highs, investor sentiment seems to be one of unbridled optimism rather than outright euphoria, in our opinion.

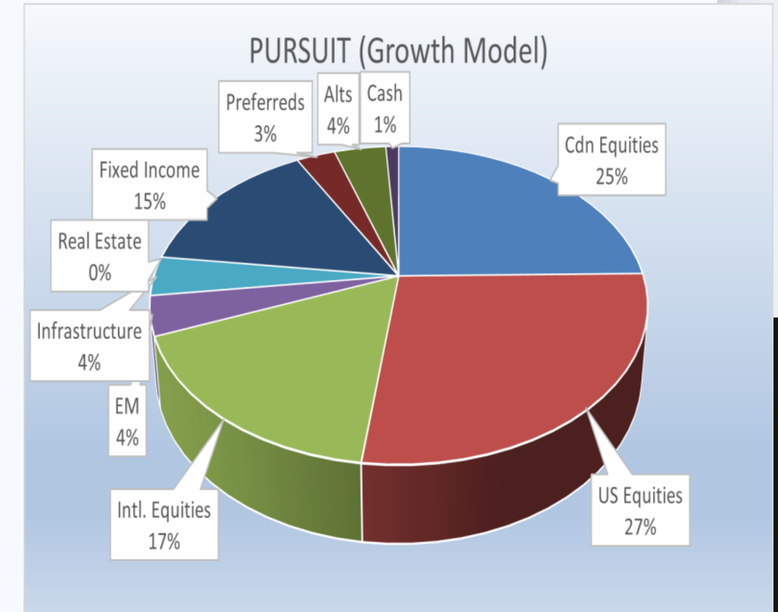


Source: FactSet

MAIN MODELS ASSET ALLOCATION







PROTECTION **PENSION** **PURSUIT**

IN CONCLUSION….

- Although global equities are at or near record highs, as they were a year ago, the environment is markedly different this time. A year ago, the pandemic was just beginning its worldwide explosion and its root cause was a virus about which little was known. At the present time, with multiple vaccines developed in record time to counter Covid-19, there is widespread expectation that the global economy will return to a semblance of normalcy sometime in the second half of 2021.

- Reasons for optimism include – ramping up of vaccination efforts in the months ahead, some evidence that the second wave may have peaked, and the advent of warmer spring and summer months (which should reduce transmission as more people head outdoors). It will still require a herculean effort to vaccinate hundreds of millions before next winter, but there's a reasonable possibility of achieving that goal.

- The prospect of a strong economic rebound over the next couple of years lends support to the forecast for surging corporate earnings over this period. While bond yields have already risen appreciably from their record lows, expected total returns of 17.5% for the TSX Composite and 13.6% for the S&P 500 make equities an attractive proposition. Valuations are definitely on the higher side by historical norms – especially for the S&P 500 – but may become a concern only if earnings growth forecasts prove to be too optimistic.

- The "reflation" trade appears to be picking up speed, as faster economic growth translates into higher bond yields and provides a tailwind for cyclical and small-cap stocks. This trend should benefit the TSX, which is dominated by cyclical sectors such as financials, commodities and energy, which are in turn chockfull of value stocks that are finally finding favour with investors.

- The Canadian dollar has gained 14.5% versus the USD since its March 23 low; it may continue to appreciate if crude oil and the TSX trend higher. While a stronger CAD may impact our portfolio returns to a limited extent, we believe there is greater benefit to leaving our USD exposure unhedged, since it mitigates our downside risk when markets tumble (as CAD generally declines during such times).

- We believe our client portfolios are adequately positioned with an appropriate mix of cyclical and growth securities, and do not foresee much change to our current asset allocation. That said, we remain vigilant to dynamic market conditions and will make portfolio changes accordingly.

DISCLAIMER

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