Seymour Investment Management

April 17, 2021

The market continued to post strong returns into the first three months of 2021. The TSX Composite Total Return Index (TSX) returned 8.1% for the quarter, outpacing its U.S. counterpart, the S&P 500 Total Return Index (S&P 500), which returned 6.2%. The MSCI World Total Return Index was up 3.8% for the quarter.

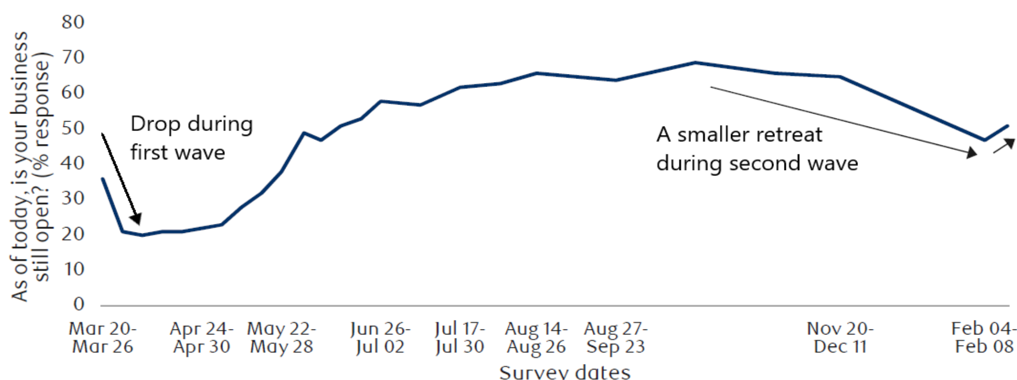
With the March 2020 lows now just over a year behind us, these quarterly returns bring the 12 month trailing figures to a considerable 44.2% for the TSX and 56.4% for the S&P 500. This is a decisive example of the short-term volatility that is commonplace over the long-term course of equity investing, and why we continue to advocate that clients not try to time the market.

In most cases, the fallout from the 'second wave' was milder than forecast

Through the challenges faced during the fall and winter months as global case numbers rose, many economies, Canada included, remained remarkably resilient to tightening restrictions and lockdown measures. In most cases, the fallout from the 'second wave' was milder than forecast, noted in Exhibit 1.

As we look toward summer in the Northern Hemisphere and the continued rollout of vaccines globally, there is a mix of optimism and trepidation amongst investors. The economy, supported by significant stimulus, remains constructive with most economies forecasted to achieve pre-pandemic levels of output this year or next. However, there continues to be uncertainty surrounding the distribution of vaccines and the efficacy against new variants. As well, which we touch on in our letter below, increasing inflation and interest rates have recently been making headlines.

Exhibit 1: Canadian Businesses Resilient During Fallout of 'Second Wave'



Source: Canadian Federation of Independent Business, RBC GAM

In a swift and global effort, governments and central banks around the world jumped to action deploying trillions of dollars in stimulus payments. Coupled with historically low interest rates and increased money printing, this has created some of the most accommodative financial conditions on record.

<u>Record Deficits Leading to Rising Public Debt</u>

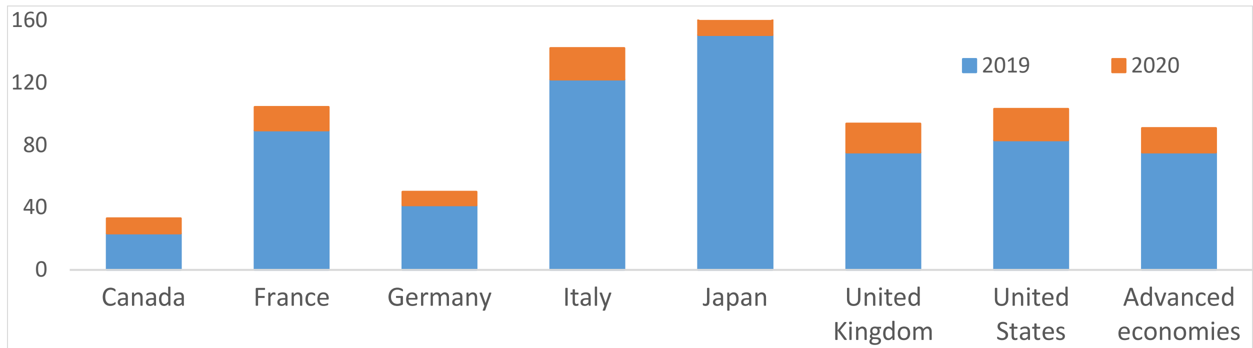
With debt levels continuing to climb unlike ever before, government balance sheets are coming under increased scrutiny. As depicted by the graph below, Canada entered the crisis from the enviable position of having the lowest net debt-to-Gross Domestic Product (GDP) ratio among the Group of Seven (G7) countries, as reported by the International Monetary Fund (IMF). The gap narrowed in 2020 as the net general government debt jumped from 23.4% in 2019 to 33.0%, representing a 41% increase, the largest

annual increase to date. This increase was triggered in large part by the federal government's record deficit of $354 billion in 2020, nearly 20% of GDP.

Canada entered the crisis having the lowest net debt-to-Gross Domestic Product (GDP) ratio among the Group of Seven (G7)

Exhibit 2: G7 General Government Net Debt as Percent of GDP

Net debt equal to gross debt minus financial assets corresponding to debt instruments



Source: International Monetary Fund Data 2021

The current historically low interest rates are helping to keep the surging debt levels relatively affordable. For comparison, the government debt service ratio ended the year in 2020 lower than during the 1980s despite considerably higher debt levels today. Households are similarly experiencing the impact of 'easy money' with the cost to service debt falling, as depicted in the chart below. Although overall Canadian household debt is higher than pre-COVID levels, the share of household disposable income going towards debt payments has dropped.

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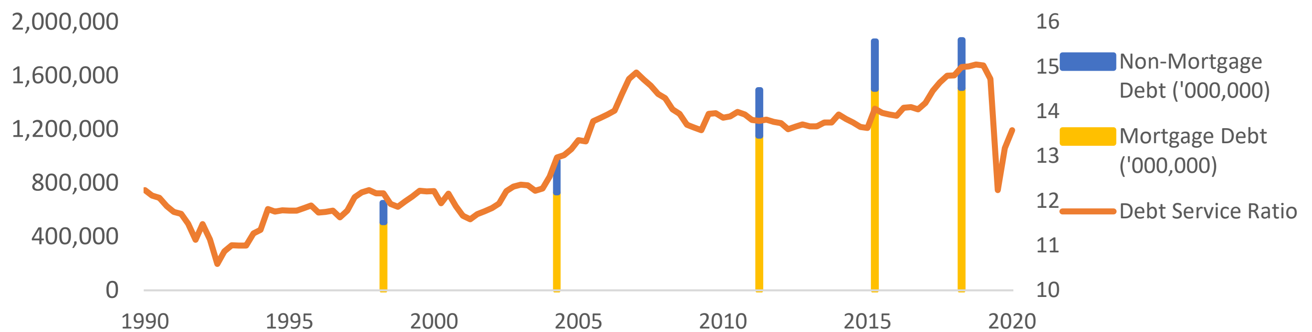
Exhibit 3: Household Debt Service Ratio



Source: Statistics Canada, Finance Canada Q2 Dataset

From a household debt perspective, some Canadian-specific positives are worth mentioning: Canadians are historically excellent at servicing debt through various economic ups and downs. More than 80% of Canadian household debt is made up of mortgage debt, of which more than half is held in 5-year fixed rate mortgages. It will take time for the effects of rising rates to be felt by the consumer. Finally, Canada has a comparatively conservative mortgage regulatory regime providing some oversight to the industry.

From a government debt perspective, as much as we prefer to not see governments' balance sheets ballooning, there is academic theory suggesting a certain level of government debt sustainability can be achieved even amidst rising debt levels. The *Bank Credit Analyst* provides detail on this theory, pointing out the key caveat: debt sustainability can be reached as long as government borrowing rates are below the growth rate of the economy.

Unfortunately, low interest rates are by no means guaranteed to stay low forever. Recently we have seen yields beginning to climb from their historically low levels.

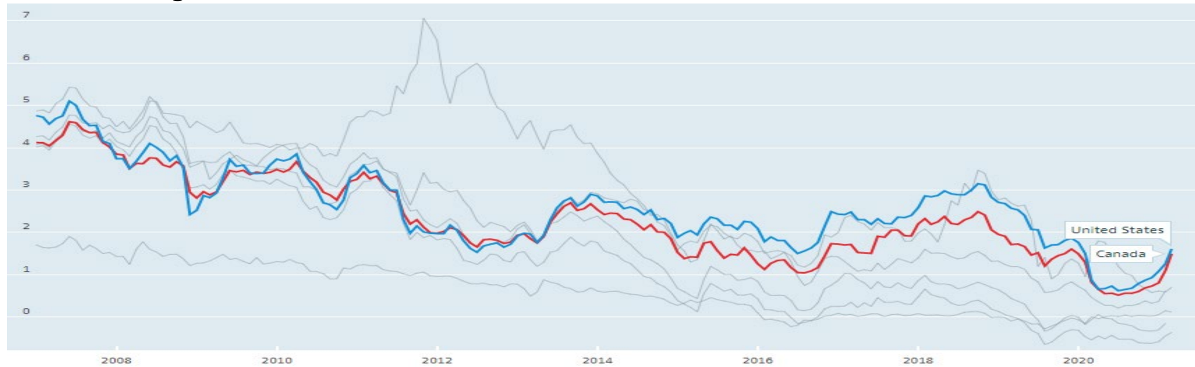
Historically Low Interest Rates

From a starting point of already record low interest rates at the start of the pandemic, policy rates were pushed to near-zero around the world, driving bond yields well below long-term averages. In the fall of 2020, almost 60% of developed countries had government bonds that were negative yielding; Canada, along with the US, UK, Australia, New Zealand and Singapore were the few exceptions.

The Government of Canada 10-year yield jumped from a low of 0.5% to approximately 1.5% a few months later in March of 2021

Into the start of the New Year, interest rates have bounced upwards. The Government of Canada 10-year yield jumped from a low of 0.5% to approximately 1.5% a few months later in March of 2021. As noted in the chart below, while this is a significant relative increase, it remains below the 5-year high of 2.6%, and similar to pre-pandemic levels.

Exhibit 4: Long Term Interest Rates



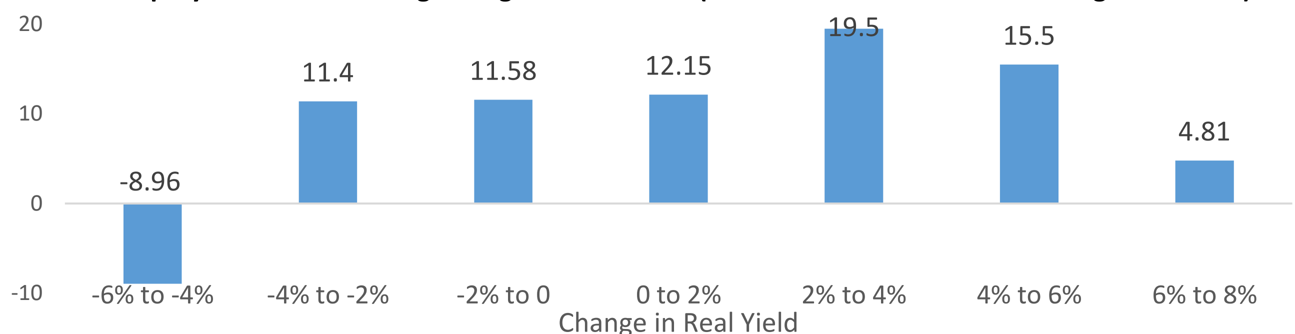
Source: Organization for Economic Co-operation and Development (OECD)

As we have written about in previous letters, low and stable interest rates present a favourable backdrop for equities. One of the most significant drivers of equity markets is the level and direction of interest rates. Not only does it lend well to company valuations and encourage spending, but it allows companies to take advantage of potentially accretive capital expenditures and growth initiatives. Conversely, rising interest rates, in general, present headwinds to economic growth.

However, research suggests, as long as rates do not rise significantly enough to cause a recession, equities will typically shrug off the effect of higher yields. Over the past half century, in the year following a rise in real yields between 0 – 2% the equity market has had a mean return of 12.2% as reported by RBC Capital Markets' US Economics team in the chart below. The reasons for this lie in the 'goldilocks' environment, as termed by Jamie Dimon in the JP Morgan annual letter, of interest rates and inflation rising gently, but not too much, supported by underlying and sustained economic growth.

Historically equities have typically shrugged off the effect of higher yields

Exhibit 5: Equity Returns Following Change in Real Rates (S&P 500 total return in following 12 months)

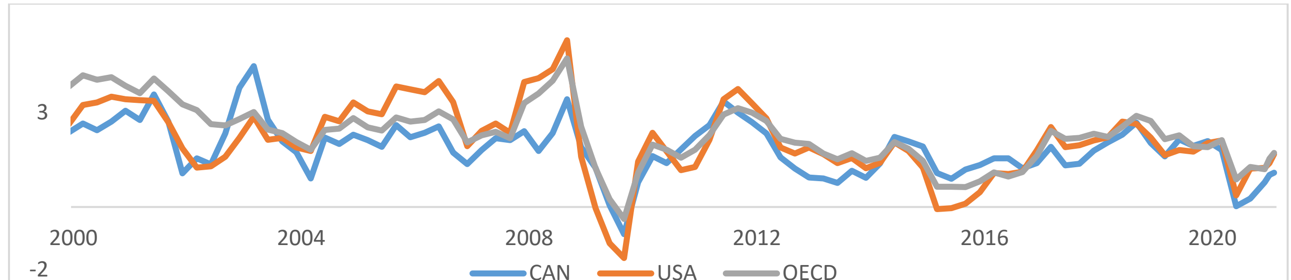


Source: RBC Capital Markets US Economics, Haver Analytics

Inflation Possibility on the (Longer Term) Horizon

In recent weeks we are seeing early signs of inflation, as measured by the Consumer Price Index (CPI). Notably CPI, which reflects the cost of an average basket of goods and services, in the US rose 0.6% in March, following a similar increase of 0.4% in February. These monthly figures caught the attention of headlines as they represent the highest increase since June 2009 as reported by Desjardins. Even with the recent increase, inflation levels remain below historical averages, sitting around 1.1% in Canada.

Exhibit 6: Inflation, Total Annual Growth Rate



Source: Organization for Economic Co-operation and development (OECD)

Central banks have voiced their support to maintain interest rates at their lower bounds until economic slack is absorbed

On both sides of the border, the central banks have voiced their support to maintain interest rates at their lower bounds until economic slack is absorbed with the target being a 'sustainably achieved' inflation level of 2%.

Higher inflation is a double edged sword. On one hand it contributes to rising nominal income growth which helps reduce the debt to GDP ratio, on the other it adds destabilizing effects to the economy as it reduces consumers' purchasing power and has negative effects in particular for bond holders. Although deflationary pressures exist - notably driven by advancements in technology, health care and education, aging demographics, and a globalizing labour market - as the economy regains steam helped along by low and accommodative rates and increasing money supply, the likelihood of rising inflation increases.

As we move towards the end of the pandemic, the economic backdrop continues to be supportive for equities, backed by the ongoing fiscal stimulus, accommodative monetary policy, and pent-up demand. However, as we are reminded with recent COVID-related restrictions and escalating variants, uncertainties remain.

We remind investors of the importance of taking a long-term approach to investing. Over the long term, we can be confident that inflation and interest rates will eventually normalize. We remain focused on our long term strategy, to find and invest in world-class organizations that are well capitalized and well positioned to navigate through whatever comes their way.

We hope you and your family are staying safe and healthy.

Sincerely,

The Seymour Team