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A Lost Decade for Stocks?

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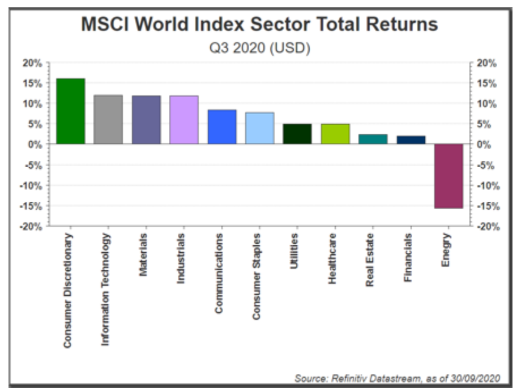
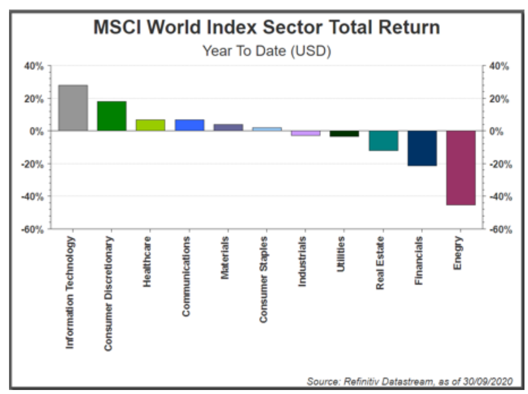
After the severe downturn in equity markets in February and March, equities continued their recovery over the summer. The MSCI World Index returned 8.0% in USD terms (and 5.6% in CAD terms) in Q3. The quarterly returns were sufficient to push year-to-date equity market returns from negative to positive. Stocks recovered mostly because the global economy improved as the quarter progressed and, as such, the Q2 earnings reporting season was better than feared. Investors opted to look through the immediate impact of the COVID-19 inspired economic downturn to a recovery in the not too distant future.

The below chart (left) illustrates how S&P 500 forward earnings per share estimates rose by approximately $15 over the summer (after having plunged by roughly $35 in late winter and early spring). While the near term earnings outlook has improved and S&P 500 forward earnings per share currently sit at $155, it should be acknowledged that this is still a good $20 below the peak estimate prior to the COVID-19 downturn. A key area of market focus will be the pace at which the prior peak earnings forecast is recaptured. The quick rebound in equities since April suggests that, for the moment, rightly or wrongly, Mr. Market sees a “V Shaped” earnings recovery. The rebound in earnings estimates was confirmed by the Citi Economic Surprise Index, which measures how (primarily macro) economic data points are coming in vs. consensus expectations. The alignment of the two charts’ trajectories suggests that conditions aren’t as bad as feared, or perhaps that growing parts of the economy are partially offsetting the industries that have been turned upside down by the pandemic.

Technology stocks continued their leadership during the quarter, but certain high multiple tech stocks came under pressure as NASDAQ endured a correction in September. Breadth on a sector level improved during the quarter, but index performance this year is still being overwhelmingly driven by a relatively small number of technology and, to a lesser extent, consumer discretionary stocks (Amazon and Tesla are both members of the latter sector).





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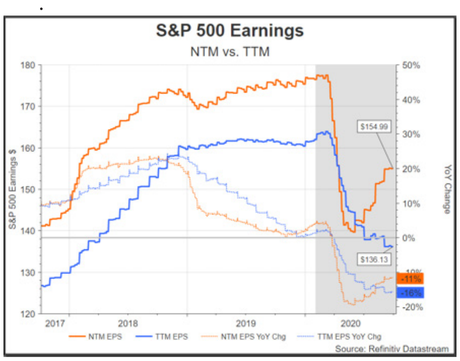

Geographically, U.S. equities continued to outpace returns elsewhere, though this is intertwined with their heavier weight in technology (technology stocks have a weight of 28.2% in the S&P 500 vs. just 7.7% in MSCI Europe, for example).

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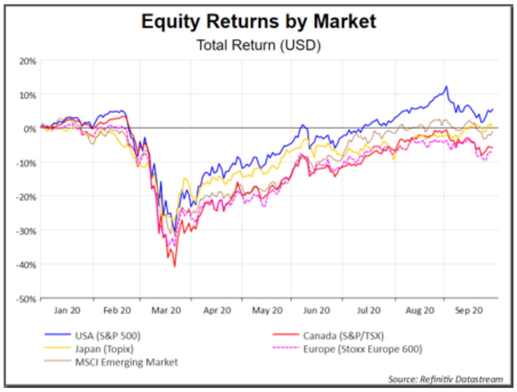
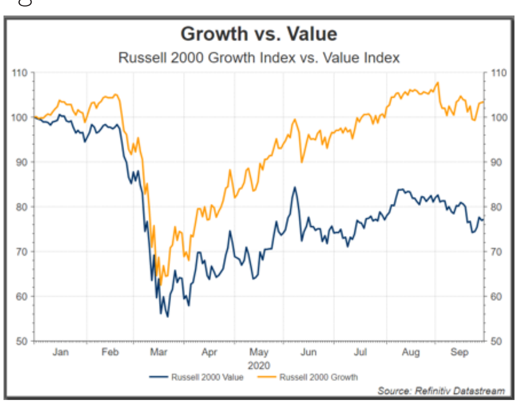


The starkest differentials in performance can however be illustrated in the style divergence between Growth and Value stocks. The Value camp is well represented by financials services, energy and other natural resources stocks that have fared poorly this year, whereas Growth is unsurprisingly dominated by technology. The Russell 2000 Growth and Value style indices of U.S. equities had a year-to-date performance differential of well over 25% at quarter end. Significant ink has been spilled in the business press and in academia about if and when Value can re-assert its historic outperformance vs. Growth. While there are a few catalysts, better global nominal GDP growth would certainly help those financial services, energy and other natural resource stocks enjoy earnings estimate upgrades, and start beating those rising estimates on a far more consistent basis.



During the quarter, the Cidel Global Equity strategy purchased two new stocks and exited two positions:

- We have started building a position in French software firm Dassault Systemes SE. Dassault is a leading provider of Product Lifecycle and Computer Assisted Design software. Its products are used by a host of industries including life sciences and pharmaceutical, aviation, industrial machinery and automotive. Dassault's software enables modelling and simulation to enable even more automated manufacturing processes. The company has a very strong balance sheet, predictable cash flow generation and good organic growth prospects.

- We have started building a position in British business services firm RELX plc. RELX has four businesses, three of which are highly resilient and the fourth is highly cyclical. RELX publishes research papers for academia, the scientific and medical community, offers risk management software to insurers, and provides databases to the legal profession. Their final business segment is organizing exhibitions; this segment has obviously come to a virtual standstill in 2020, but we think the shares should start to appreciate as it recovers in 2022. RELX shares are also a good example of the valuation discount that non- U.S. equities have vs. their American counterparts (more on this below). RELX shares trade for approximately 20 times forward earnings whereas American peers are trading as high as 30 times.

- We have sold our position in Starbucks. As the COVID-19 pandemic looks as though it will continue well into 2021, the ultimate shift in consumer habits and the nature of office work remain uncertain. As a result, we believe that many Starbucks locations in central business districts will either suffer a prolonged period of poor sales or need to be closed or reduced in size. Restaurants with a heavy skew towards breakfast sales (such as Starbucks) have been particularly hurt by the work from home trend. The proceeds of this sale were mainly used to fund the RELX purchase.

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- We have sold our position in Mid American Apartment (MAA) REIT. The main reason for the sale was to serve as a source of cash to fund the purchase of Dassault Systemes SE. Mid American's portfolio of primarily sunbelt apartments had been performing remarkably well thus far during the downturn and, over the long term, the REIT's prospects remain sound. However, one of the negative consequences of the rise of passive investing and program trading is that individual equities can more easily get dislodged from their fundamentals during bouts of market volatility. There were multiple occasions during the spring when MAA's shares sold off with the rest of the REIT complex, despite having a much more resilient business and a far better balance sheet. As such, the shares weren't serving their intended purpose in the portfolio as a lower volatility equity or as a diversifier.

Investors have understandably struggled to make sense of the extreme market volatility this year. The bear market of spring 2020 will go down as one of the shortest on record! The strength of the subsequent rally, culminating in a return to record highs on the S&P 500 in the month of August, seems wildly inconsistent with the unprecedented severity of economic contraction in Q2. While equities lead economic fundamentals, rising in advance of a recovery and falling in advance of a downturn, the speed and magnitude of this year's market moves are unusual. That whipsaw effect in turn leaves investors facing a disconnect between high stock prices and diminished earnings, the result of which is high valuations. The chart below shows that the S&P 500 is trading at 21x forward earnings, a level not seen since the last tech stock inspired rally of the 1990s, and about 27% more expensive than the 25 year average forward price to earnings ratio of 16.5x.

These valuations have left many investors wondering what prospective returns are on the horizon. Several prominent investors, including Blackstone's Executive Vice Chairman Tony James (in a mid September interview on CNBC), and Bridgewater Associate's Ray Dalio (in a June newsletter) questioned whether or not we faced a "lost decade for equities". Such a lost decade would be reminiscent of the 1990s for Japanese equities, or indeed the nearly 13 year period for U.S. equities where the August 2000 close of 1518 wasn't eclipsed until October of 2007, and was only decisively broken through in March of 2013.

But, how despondent should equity investors be when it comes to the prospects for future returns. Let's review the key assumptions that underpin the "Lost Decade" prognosis:

1. "Rising interest rates will depress Price to Earnings multiples". This statement is problematic for a whole host of reasons. It is far from certain that interest rates will rise materially, as the quantitative easing bond buying programmes seem to be increasingly permanent. Long term rates are also hugely influenced by growth and inflation expectations and, while these have both perked up since March, the outlook is mixed at best. If rates do move higher, it is entirely possible that they do so due to higher growth expectations, and such expectations

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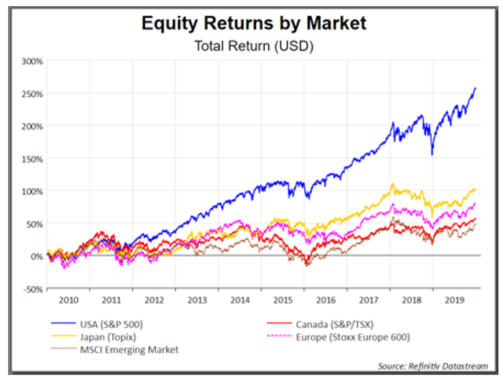
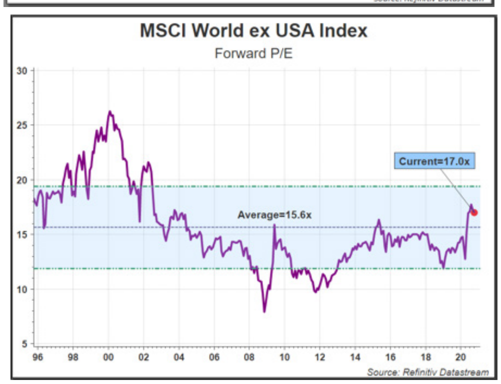
would benefit many stocks especially the above described long suffering value stocks in the financial, industrial, consumer and natural resources (and probably real estate) sectors. So, while higher rates may pose a risk to some of the sky high valuations on new tech IPOs, many parts of the equity market may well benefit from higher rates. Finally, as a courtesy to our readers, we won't delve into the upward pressure on intrinsic valuation multiples that lower discount rates necessitate.

2. "Margins face a number of headwinds, including de-globalization". This concern has merit. S&P 500 operating margins have risen from the 8-9% range at the start of the 2010s to a peak of 12.3% in Q3 2019. While part of this is a natural mix shift of ever higher margins from the largest (consistently technology) constituents, many public companies have sought to take costs out as a means to achieve profit growth in the low economic (and thus revenue) growth environment of the past 10 years. But, rising trade tensions and COVID-19 induced shortages have combined to lead many companies to now seek to improve the resiliency of their supply chains, as opposed to simply managing cost efficiency. Further, a host of U.S. cities and states have introduced legislation raising the minimum wage, which will pressure margins in a host of industries. Finally, the speed with which OECD governments can roll back COVID-19 related social spending is uncertain; raising corporate taxes is a politically palatable solution to help limit the damage to government finances, but will lower after tax margins.

3. Finally – and most importantly - the "Lost Decade" thesis suffers from one of the most common cognitive biases in investing: the Home Country bias. It is a decidedly American-centric notion.

Investors in Canadian, Asian, European and Emerging Market equities are surely hoping that their "Lost Decade" after the Global Financial Crisis is coming to a close. The unremarkable, mid-single digit annualized returns on non-U.S. equity indices means that, unlike U.S. equities, non-American equities are not priced near 25 year highs. The chart below (left) notes how key equity markets have hugely trailed the U.S. from 2010- 2019, and that unsurprisingly non-U.S. equities, unlike U.S. equities, are not priced near 25 year highs.





Regardless of the oscillations to the economy brought about by the COVID-19 pandemic, our philosophy remains unchanged: We will continue to invest – alongside our clients – in a diversified portfolio of highly profitable, well run companies that generate significant cash flow, and whose shares we can acquire at fair prices.

October 2020