

Looking Forward

Five Thoughts for 2021

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With the announcement of COVID-19 vaccines, the fourth quarter concluded with optimism, the polar opposite of the despondency that existed in March. We have gone from a point where any equity exposure was perceived as too much to a point where anything less than a 100% equity allocation is seen as a very risky proposition. Investor emotional swings were more pronounced this year than at any time in recent memory. When emotions run high, it is a good time to pause, take a breath, forget about recent market moves and consider what could be the main market drivers going forward. Five main themes that will likely impact investment portfolios during the coming year are discussed below.

1. Environmental, Social, and Governance (ESG)

The ESG (Environmental, Social, and Governance) movement will continue to gain strength. There is a growing shift in investor focus from shareholder returns at any cost to investing in companies that take into account all stakeholders. Investors, particularly young investors, want to use their wealth to make a positive difference in the world. Concerns about global warming are being considered by not only individuals but pension funds, foundations and even nations as they divest from carbon emitters. Recognizing the change in attitudes, many corporations are now producing ESG reports that provide investors with the transparency to understand what a company is doing beyond just the financial statements. Accelerating this movement is the improving economics behind many green technologies. To illustrate, the price of solar power has dropped 89% during the past 10 years. No longer is their profitability always tied to government subsidies. The stand-alone economics are tilting towards renewables and offer compelling returns to investors. In contrast, many long established businesses are finding their business models challenged. Considering ESG factors is more critical than ever to identifying opportunities and risks in investments.

2. Fiscal stimulus

A key component of a strong sustained recovery will be continued large fiscal stimulus. The financial aid that governments around the world have provided in response to the COVID-19 pandemic has been staggering in size. Few would argue that governments did not need to adopt the fiscal measures they have to deal with what would likely have been an economic catastrophe. The problem is that more and significant stimulus will be required for economies to fully recover and it remains to be seen whether there will be the political will to engage in this quantum of stimulus. Real interest rates (after inflation) are negative, allowing governments to borrow at rates that have not been seen in generations. This affords them a unique opportunity to deal with the backlog of infrastructure repairs and improvements at essentially a zero cost. In addition to stimulating the economy, it has the potential benefit of passing on brand new infrastructure to future generations that will increase their ability to grow the economy in the future. In the absence of additional government spending, many of the COVID-related job losses will become permanent and we will experience a slowly growing economy along with a growing backlog of required infrastructure improvements.

3. Impact on Imports and Exports

During the Trump administration, tariffs were used to deal with trade issues with other nations focusing solely on imports. The COVID-19 pandemic highlighted the vulnerabilities of global supply chains when national interests are more important than uninhibited trade. For instance, faced with a shortage of PPE (personal protective equipment) the Trump administration quickly limited exports. In the coming years, governments will not only focus on imports but increasingly

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on exports of goods and commodities which they believe are in the national interest. Prioritising domestic manufacturing of national interest goods or commodities will increasingly become part of domestic economic policy, further eroding trade relationships between countries. It would not be surprising to see domestic businesses lobbying the government to become part of a group of companies that are deemed to operate in the national interest. As a result of the implementation of tariffs or export restrictions, prices of goods will rise and push inflation upwards. It is likely that the increased inflation will be a one-time event but such an increase will likely be accompanied by a decline in bond prices.

4. Cyberattacks

In the midst of the turbulent events over the past few months, the issue of cyberattacks has not garnered the attention that one would have expected. The recent successful Russian attacks of major multinational corporations and the U.S. government itself serve to highlight how important cybersecurity is to the modern economy. No one really knows where the damage from this recent attack ends. Yet, there is not enough focus by governments on this growing vulnerability. We expect there will be renewed focus on cybersecurity in the coming year which will be good news for some service providers but bad news for companies that will see an increased IT spend or more cumbersome security procedures for employees, suppliers and clients alike.

5. New Business Models

Lastly, businesses will likely continue their rapid adoption of new business models. The pandemic absolutely played a role in its recent acceleration, whether it was work from home, e-commerce or remote meetings. This trend will only intensify as companies try to adapt to new expectations and pressures from consumers and employees alike. For instance, remote

presentations or meetings prior to COVID were gradually gaining acceptance. That said, most customers still expected to have face-to-face meetings particularly to negotiate large contracts. In the space of six months, customers are now comfortable with remote meetings because they see it as a normal business practice and are familiar with the various technology platforms. In the absence of this catalyst, business travel would have continued and this transformation would have likely spanned years, not months. The same goes for traditional brick and mortar retailers accelerating their online presence to offset the loss of foot traffic. Similar observations can be made for the use of electronic payments instead of cash. The examples are all around us and, even as vaccines allow us to go back to normal, the change in business models will persist.

As we move into 2021 it is all too easy to listen only to the narrative on an investment rather than taking the time and effort to validate the story through the numbers. Reflecting on the list above, many of the risk and opportunities are not readily apparent in a cursory view of a company and its financial statements. Without a disciplined investment process, one risks letting emotion rather than reason drive decision-making.

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