



REVIEW AND COMMENTARY 2nd QUARTER – 2020

Our Review and Commentary last quarter suggested that the March 2020 lows would most likely hold unless the second wave of the virus ruptured the economy further. Lower earnings, additional cuts in dividends, and further economic demand destruction would lead to all this. So far, economic repairs are underway and there is no evidence of significant deterioration thus far.

While the last round of reported earnings from publicly listed companies in North America provided lower profits, they were, for the most part, within expectation levels. While there are some travel and entertainment companies that will take longer to recover, economies are re-opening. While this appears to be contributing to an uptick in COVID19 cases, it does appear that those countries who continue to exercise caution when it comes to social distancing and donning of face masks (Oh, Canada) are succeeding in reducing the number of new cases. Even those countries who had initial success with reducing the number of outbreaks are experiencing a second wave. To date, the numbers appear to be considerably less than the initial outbreak.

It will be hard to tell if closing economies was the best solution to combat COVID 19. It will likely take years of study and modelling to establish a better theoretical approach however it appears that this strategy, at the time, was sound. However, capitalistic democracies realize that closing the economy a second time will be too costly a solution. The U.S. Administration, in the face of increasing recent numbers of infections, seem to be leaning more on the hopes of an early vaccine rather than sticking traditional protective measures outlined by the CDC. The irony should not be lost that after deriding Science since their first days of office, they are now depending heavily on it to combat the disease. Regardless, the success of the recovery in the U.S., given the size of their economy, will have a significant influence on the global recovery.

Another topic we discussed in our last quarterly was the price of oil. It had been under constant pressure from a variety of sources, none arguably greater, than Saudi-Russian tensions. While we discussed pressures continuing, we did see prices

recovering. While we had not expected such a quick and dramatic price turnaround (WTI closed the second quarter over \$40 per barrel) we also never expected that the price for a barrel of oil would be negative. For the first time in the history of trading, buyers got paid to buy the commodity. Of course, there were extenuating circumstances such as an expiring contract and little available storage capacity, but it was, and hopefully will be, unprecedented.

While the equity indexes provided significant returns this past quarter, it is important to understand that these indexes can be significantly influenced by a few companies. One company can have undue influence on an index. For seasoned investors, think back to Nortel. When it traded at its highest level, it presented approximately one third of the TSE Composite Index (TCI). Nowadays, Shopify has taken over that mantle. Its market capitalization is the largest among all stocks listed on the SPTSX Composite (formerly TCI). While its market capitalization is now larger than Royal Bank, thankfully it does not equal the level of influence Nortel did at its height. However, it remains significant now representing approximately 7% of the SPTSX index. Shopify has increased by over 168% year-to-date. Royal Bank and the other major Canadian Banks during the same period lost almost 16%. Utilities and Energy also provided negative returns over the same period. Due to its proprietary technology, Shopify will not be as negatively impacted by the pandemic or the economic downturn but the present valuation is as equally as lofty as Nortel was over a decade ago. By no means, are we commenting on the future of Shopify or its technology- it certainly looks promising but we certainly have concerns on its valuation- much like we did with Nortel and we do with a few more popular stocks today such as Amazon and Netflix. Given the valuations of these companies and their significant influence on the major indexes, it is clear that the indexes have run too far, too quickly. But if you take into account the undue influence of a few stocks the remainder of equities have not run up too quickly. In fact, they are slowly recovering as will our portfolios.

There are periods of time when our style has been out of favour and there may be times again in the future. If we look only at the major Canadian banks as investments, there seems to be a significant disconnect among investors. In many cases, major Canadian banks' offer lower interest rates on their mortgages than you would receive if you bought their common stock. Recessions and fear lead to irrationality and while we may be close to the lowest interest rates we may see in a lifetime, it is hard to fathom why those well financed companies, which pay dividends, aren't considered more attractive by investors. Time will tell if 'cash flow is king' still rings true. We believe it will.