The Market in Review

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This week's articles and insights

1. *The Poet Knows It*
2. *Fire and Ice*
3. *Golden Days*
4. *Markets This Week*
5. *A Blessing in Disguise?*

"In three words, I can sum up everything I've learned about life: it goes on."

- ***Robert Frost***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,652	- 0.31%	- 6.61%
S&P 500	3,236	+ 0.62%	+0.15%
TSX	16,019	- 0.04%	- 6.12%

The Poet Knows It

Forty-nine years ago this week, Robert Frost was named Poet Laureate of the State of Vermont. Although he never graduated from college, he received over

40 honorary degrees. Princeton, Oxford and Cambridge universities all honoured him, as did President Kennedy with a Congressional Gold Medal in recognition of his poetry “which has enriched the culture of the United States.” He died in 1963.

Perhaps Robert Frost should have been an economist. His words have been studied for their literary value for decades, but they also contain a great deal of sense when it come to the world of money.

For example, the *it goes on* quote about life above. I remember my first manager telling me how badly he felt when the stocks he had chosen for clients plunged in the bear market of 1982. He hung his head and went for a walk, expecting to see the world as morose as he was. Instead, he saw people driving and walking around, talking and laughing like they did most every day. He was so worried that the world was ending because of his economic woes that he forgot that *life goes on*. The world sorted itself out despite all his angst.

Such is likely to be the case this time, as well. Yes, we have a contentious U.S. election ahead, tension with China, and yet-another scandal involving the Canadian Prime Minister. Not to mention a pandemic that just won’t end.

The world will sort itself out, somehow. It always does.

Fire and Ice

A great deal of ink has been spilled these days about the debt we are accumulating. How are we ever going to repay it?

Robert Frost’s **Fire and Ice** - his most famous poem – encapsulates the two sides of the argument well:

Some say the world will end in fire,
Some say in ice.
From what I’ve tasted of desire
I hold with those who favor fire.
But if it had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice.

In economic circles, fire is inflation. Many economists believe that central bank spigots pouring out newly-printed money must end in higher prices for everything. Indeed, Canada just recorded a jump in inflation this month led by food prices. With suppliers cutting inventories and stores with half-full shelves, the rush of shoppers in June caught both by surprise and pushed up prices.

Now imagine this scenario in the context of US $18 trillion in stimulus since March. This is the total amount of global stimulus (plus or minus a few hundred billion) that has been printed, loaned, and granted since the pandemic swept over the world. If inflation truly is *more money chasing fewer goods,* then we will see inflation in the years ahead. Gold's rise to its highest price since 2011 also appears to confirm what lies ahead.

But wait a minute.

Mr. Frost says we also have to consider the ice scenario – deflation. In a deflationary world, interest rates fall and the velocity of money – how fast cash comes into and leaves your wallet – declines. Slow money velocity is often the handmaiden of excessive debt which, no one needs reminding, we are awash in.

The country that most personifies deflation today is Japan. Japan began its debt build-up after 1990 when its stock market peaked. Unwilling to let any of its companies fall, it printed money and lowered interest rates. The government purchased the bonds of corporations to prop them up, but did not choose between good and bad companies. The phrase *"zombie companies*" came into being then when some firms survived at the whim of government, never growing but always needing another bailout.

Today, central banks in Canada and the U.S. are buying the debts of weak companies to prop them up. This is a first for both nations.

"When central banks sustain failing businesses, resources are tied up in nonproductive firms and therefore unavailable for new firms that can contribute to economic growth."

- *Lacy Hunt, Hoisington & Associates*

Japan was also the first nation to get old. Japan's population began to decline in 2011 and just fell to a new low after shrinking 0.2% in 2019.

The U.S. and Canada are nowhere near shrinking, but some estimates say that between 300,000 and 500,000 babies will <u>not</u> be born this year due to economic delays and divorces caused by the pandemic.

The biggest impact of whether we get fire (inflation) or ice (deflation) will be through interest rates:

- The **Fire** scenario says we will see higher rates in the not-too-distant future. Avoid bonds at all costs - why lock into 1% if rates will be 5% in just a few years?
- The **Ice** scenario says we will see even lower interest rates in the years ahead. Despite more and more borrowing, Japan has fallen further into deflation. Investors there can only dream of 1% yields today as their 5-year bonds yield
  -0.13% per year. You <u>pay</u> the government interest when you buy their bonds.

Is there any asset class that survives in both scenarios? Let’s look to Japan again.

Stocks in large companies have stood up best. Sony, Fujitsu, Honda Motors and many other Japanese giants have survived and thrived over the years. They learned not to borrow as their own government was doing – Japanese companies now have some of the best balance sheets in the world. These stocks pay an average dividend of 2%, which is far better than negative-yielding bonds.

Life goes on in Japan. And so have Japanese stocks.

Golden Days

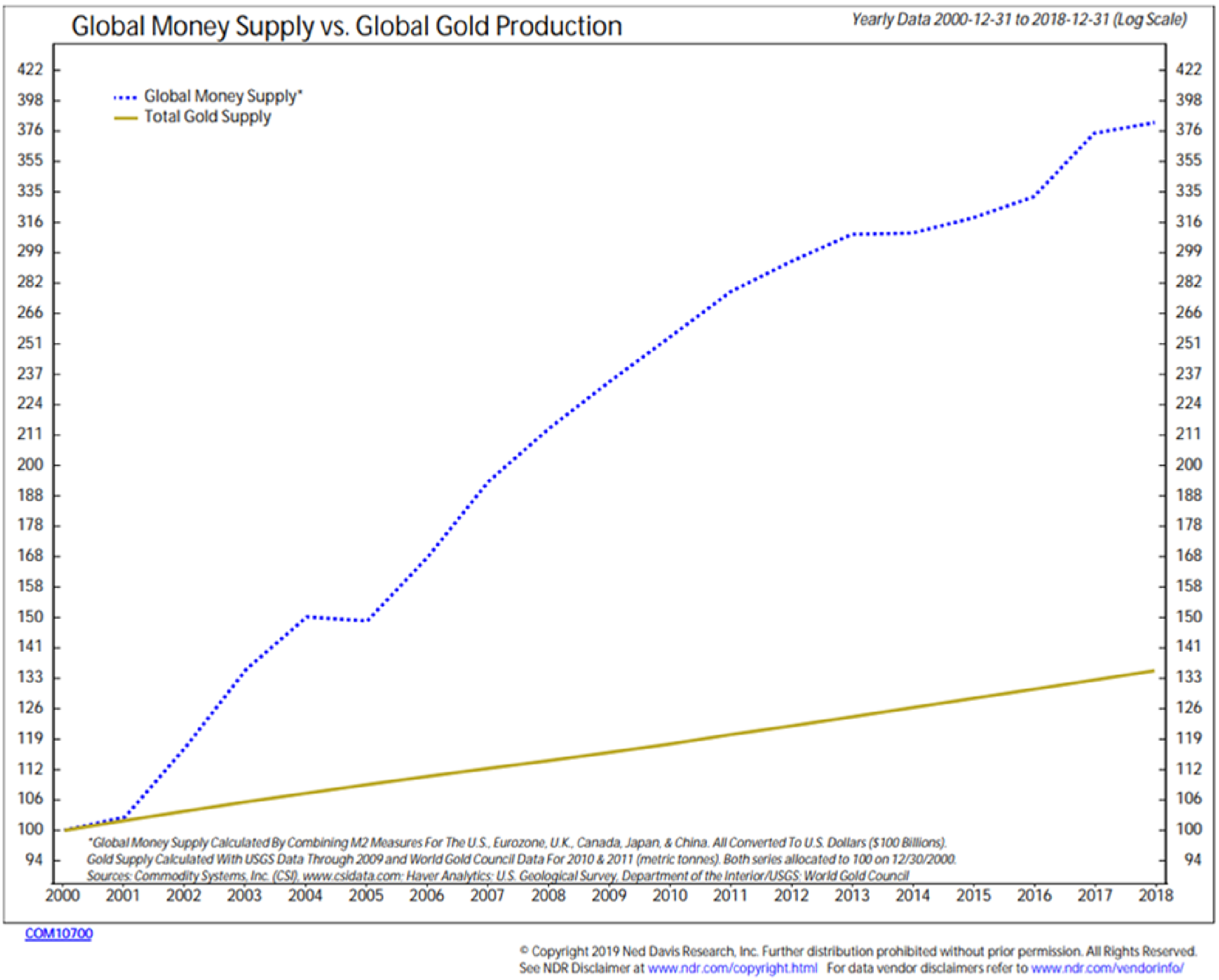
Nature’s first green is gold,
Her hardest hue to hold.

- *Nothing Gold Can Stay, by Robert Frost,*

Mr. Frost also reminds us in his poem *Nothing Gold Can Stay* that gold was our first currency – our “first green”. Gold has been one of the best investments in the world this year.

Gold pays no interest and is only now at its price of 2011. Gold bugs have been waiting nine years just to break even! It has responded violently to 2020’s trade discord and excessive money printing.

As the chart below shows, production of new gold has not kept up with the growth of paper (and digital money) since 2001. It is also a year out of date and does not include the enormous addition of global debts over the last six months:



Gold has rocketed up lately to over US $1,890 per ounce. More and more newsletters are calling for gold to reach $2,000, $3,000 and even $10,000 per ounce in the years ahead. Will they be right?

It is hard to say, but we do know this: when the gold bugs start to crow and optimism hits excessive levels (as measured by summing up the bullishness of newsletter writers), gold is due for a pause. Optimism is high now and silver – the frantic cousin to gold – is on an even bigger run.

Gold can perform well in both inflationary and deflationary times, so there is a case to be made for owning some gold in a portfolio.

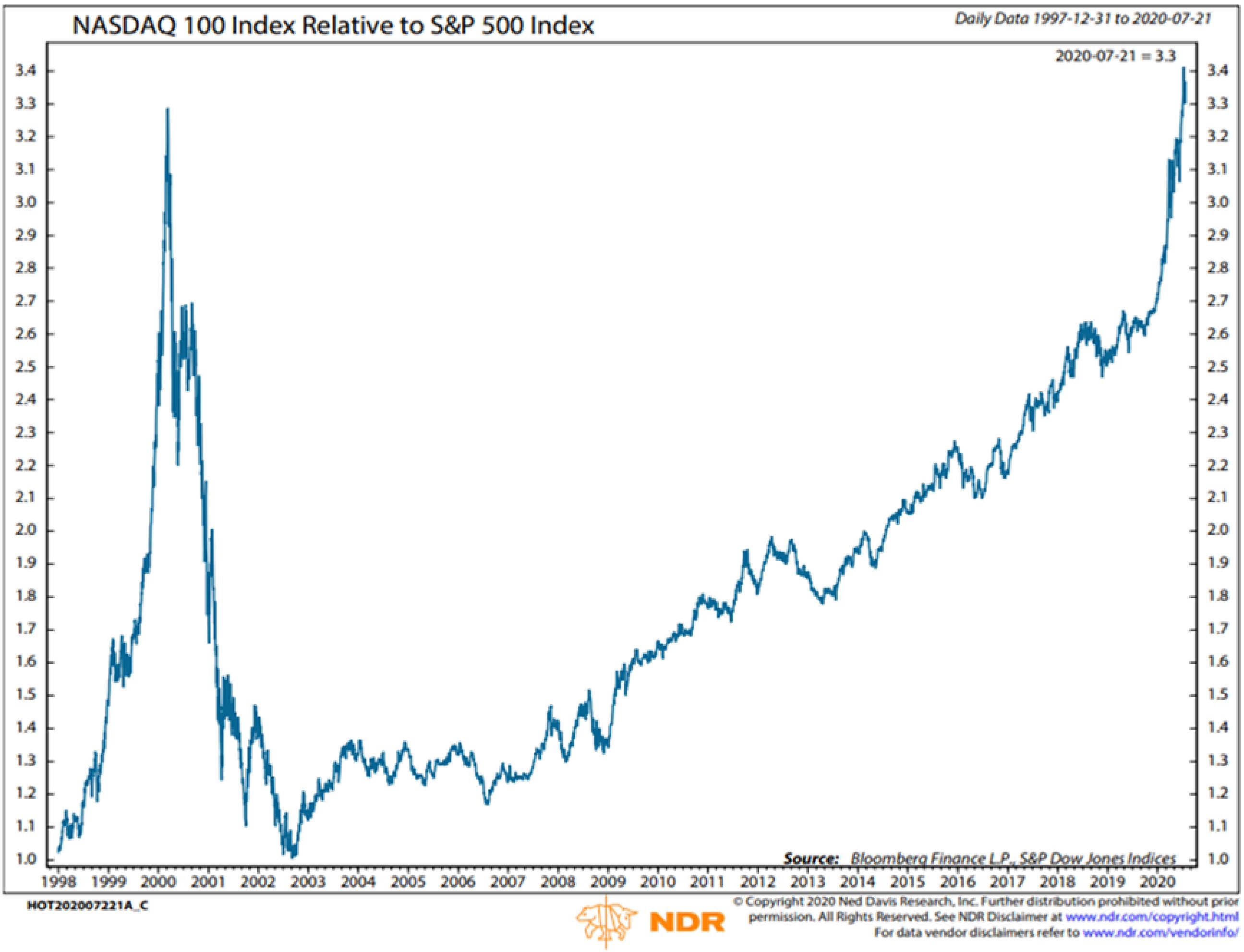
But right now is probably not a great time to start new positions. It is a little too popular and a little too loved at the moment.

Markets This Week

Canada's S&P/TSX index and the Dow Jones Industrial Average were both up approximately +1% this week, while the NASDAQ was closer to +2%.

Another week where the technology-heavy NASDAQ outperformed the more staid S&P 500 and Dow Jones Industrial Average. The last time one Nasdaq unit was 3x that of an S&P 500 unit was in 2000. It didn't last:

NASDAQ 100 relative to S&P 500 higher than in 2000



To be fair, valuations for technology and growth companies are much better than they were back in 2000. But they ain't cheap.

What followed the decline in the telecom leaders of 2000 was a resurgence in value stocks, something many of us have been waiting for for several years. In the end, you have to own a bit of both because growth companies outperform for longer periods of time than value outperforms growth.

A recent study of periods analyzed 10-year periods when growth outperformed value since 1927. There have been 77 such instances out of 1,100 in that time. In each case, the following 10 years saw value stocks outperform growth by 8.3% per year (source: Eric D. Nelson).

The other meaningful item this week was Europe's passing of a €750 billion recovery package. For the first time, the European Commission will be borrowing as a single entity for all 27 member nations. Some have likened this to Europe's

“Hamilton Moment” in reference to Alexander Hamilton’s federalizing of U.S. state debt into national debt in 1790.

It is early to envision a fiscal union like that of the U.S. or Canada, but it is a step in that direction. This is very significant for Europe’s future!

A Blessing in Disguise?

Two roads diverged in a wood, and I
I took the one less traveled by,
And that has made all the difference.

- *“The Road Not Taken” by Robert Frost*

The virus may be mankind’s oldest enemy. Rising seemingly out of nowhere, new strains emerge every few decades and cause countless deaths until our population develops herd immunity.

By most viral standards, COVID-19 is letting us off lightly. The Spanish Flu of 1918 killed 50 million worldwide. COVID-19 deaths will be a fraction of this, thankfully. We can thank modern medicine and hospitals for much of our success.

The pandemic has also accelerated virus research *light years ahead* of where we were just six months ago. In the “travelled road” of the recent past, influenza vaccines were grown in egg cultures. This meant at least six months between identifying the next season’s flu strains and when a vaccination would be ready. Months that gave the flu ample time to mutate into something quite different.

Now, new “roads less travelled” are opening up. We cracked the COVID-19 genome within weeks using artificial intelligence. We then used Big Data systems to eliminate millions of potential vaccine candidates to a handful within weeks. DNA and RNA techniques developed for cancer therapies were then applied to grow vaccines in weeks instead of months, meaning once a vaccination is approved, we should see actual injections much more quickly.

With billions being spent on over 100 different vaccine candidates today, this knowledge will circle back to cancer and other diseases. It is as if we squeezed a decade’s worth of research into a single year. This should mean more effective seasonal flu vaccinations in the years ahead, and possibly even a cure for the common cold (someday!). Doctors have learned so much about inflammation and how this virus turns our bodies against ourselves that we now have new insights into other diseases like arthritis and bacterial infections.

And this does not even include the strides made in artificial intelligence. This has also accelerated in the search for vaccine candidates.

Vaccination research stopped after the SARS outbreak ended in 2004 and the MERS one in 2012 because they died out naturally. This left years of half-completed research collecting dust on drug company shelves. This time, we will reach the finish line, and humanity be that much better prepared for whatever nature throws at us next.

Thank you for your referrals this month! They are always handled with great care and discretion.

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