The Market in Review

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This week's articles and insights

1. *Chill Out*
2. *Do Deficits Even Matter?*
3. *Fighting the Last War*

"The pandemic paused the present, but accelerated the future."

- ***Noah Blackstein***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,706	- 0.47%	- 9.92%
S&P 500	3,152	+ 0.70%	- 2.44%
TSX	15,569	- 0.34%	- 8.76%

Chill Out

At the turn of the century, a Brooklyn printing company was having problems with the sweltering summer humidity. The moisture in the air was causing its paper to wrinkle and change size, leading to problems during the inking process. It turned to a young engineer named Willis Carrier to design a machine to reduce the humidity so they could print their flyers. Carrier's bulky machine – called an *Apparatus for Treating Air* - did just that. However, when he noticed workers hanging around the printing room to cool off (so the story goes), a lightbulb went on. He began designing these "air conditioners" not for just humidity control, but also for comfort. Soon, movie theatres and sports stadiums across the country were using Carrier air conditioners to draw people in from the heat. Carrier is still one of the largest HVAC (heating, ventilation, and air conditioning) companies in the world today, after over a century, and was just spun off as an independent company in a recent merger.

The question of how Covid-19 spreads in air has ignited new interest in air quality. Hospital operating rooms and semiconductor plants have long had the cleanest air, but we are now going to expect the same quality in our airplanes, restaurants, and even our homes. One interesting example of what is coming is how aircraft manufacturers are looking to change the direction of airflows. Going to floor-up-to-ceiling air flow removes germs much more quickly than the ceiling-down-to-floor air flow now used.

Now, if summer would only start, making us actually <u>need</u> air conditioning in 2020…

Do Deficits Even Matter?

Both stocks and bonds were essentially unchanged this week, even as the economy is slowly improving. Unemployment is dropping and leading indicators (air travel, restaurant bookings) are picking up. It is a grinding process, but there is improvement.

The stock market continues to be divided into two camps. There are the “stocks of tomorrow” (electric cars, technology companies) that never seem to stop going up, and there are the “stocks of yesterday” (utilities, pipelines, telephone companies) that seem to be eroding away. The spread between the two is becoming very wide and is approaching that of the late 1990s. In fact, the yields on many of these Old Economy stocks are as far above government bonds as any time since the 1940s.

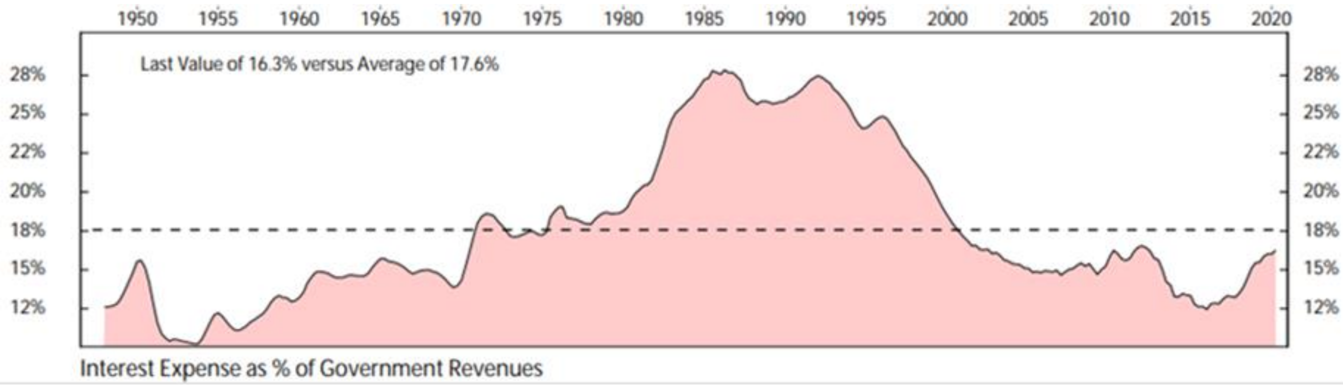
At some point, Old will rise and New will fall, just as they did during the recession of 2000. We can’t say when this will happen, but the gap is just too wide.

Meanwhile, Canada announced a $343 billion deficit for the fiscal year. The Canadian dollar actually rose on the news, leading to the question: *do deficits even matter*?

The US federal deficit is expected to be approximately $3.7 trillion this year. Canada has prided itself on running smaller deficits, until now. We are 10% of the size of the US in most measures and so our deficit should be roughly 10% of the US deficit. Ours is now comparable, sadly.

The $343-billion deficit is six times higher than the worst deficit before this one, a $56-billion shortfall (adjusted for today’s dollars) posted by the Harper government during the 2008-2009 economic recession. Canada has racked up $765 billion in accumulated federal debt since Confederation in 1867. This year alone sends us 45% higher to $1.2 trillion - in a single year. The surprising math is that our debt service costs are actually going to be lower this year than last year because of the decline in interest rates.

It is like buying a bigger and bigger house because your mortgage rate keeps dropping . The graph below of US interest expense shows the impact of falling interest rates. Debt has gone up since 1992, but our ability to service it has improved
because rates have dropped:



10-year bond rates were 10% in 1995. Today, they are 0.55%. We have a far bigger "mortgage" today, but it costs us less than it did then.

For us old-school taxpayers, these deficit numbers are horrifying. Surely there will be a piper to be paid at some point in the future. Surely?

There are two possible scenarios:

1. We actually pay the debt back. This might be through choice, as Prime Minister Harper did from 2009 to 2015 when he took us from the largest deficit in history to surplus budgets in six years. Or, rising interest rates could force austerity, as we saw with Prime Minister Chretien in 1995. Canada almost had to approach the IMF for a bailout, and was forced to slash services and hike taxes until the national debt declined.

Already, there are articles proposing annual wealth taxes on people with $20 million in assets and higher, as well as calls for a higher Goods and Service Tax (our national sales tax).

2. Or we follow Japan's example. It has run massive deficits for years, but has held interest rates low. As a result, they are one of the most highly-indebted countries on Earth, and yet they pay very little for it. When you owe the bank and you <u>are</u> the bank, it can work in your favour. Japan's plan appears to just keep printing money and never truly pay it back.

One result of this burden of debt is that Japan’s growth rate is very slow. It also has the oldest population on Earth, which contributes to this.

Both scenarios – never pay it back, or pay it back only when forced to – can continue for a time. We just don’t know how long that time is.

The main implication is that interest rates are likely to stay at rock-bottom levels for years. This means there will be a scramble for yield for some time to come.

One beneficiary is mortgage rates. 30-year fixed mortgage rates fell to the lowest in almost 30 years this week. This is pushing home building stocks higher as well as the Canadian wood stocks.

Meanwhile, gold has now risen to its highest price since 2011. It might be telling us something.

Fighting the Last War

The U.S. now has far more confirmed cases of Covid-19 than it had in March, and yet the market is not collapsing. What this is telling us is that the world may still fear the virus, but it is no longer surprised by it. The virus is now an identified risk where we know the worst it can throw at us.

There is a saying in the military that generals always fight the last war. Picture horses charging howitzers in WW1 and tanks driving around trenches in WW2. It is similar with investors and the press when it comes to bear markets. We worry more about things that have already happened than we do about risks that are not yet apparent.

For example, even after new rules were put into effect to prevent market meltdowns like the one in October 1987, investors worried for years that we would see another 20% decline in a single day. We are still waiting.

After 2008-2009, when the banks brought ruin by selling subprime mortgages, the sector was punished by investors and hasn’t truly been trusted since. Thanks to higher capital requirements and hundreds of new regulations, most North American banks today have stronger balance sheets than they have had in decades.

Today, the pandemic is fading. More people have tested positive for the virus, but this is largely because we are testing so much more. The press and the internet are loathe to lose our interest, however, so are already searching for “the next pandemic”. We have seen stories of bubonic plague and swine flu in the last week, even as these are known and small risks. There may be a second wave of the virus, and it could make things rocky for a time, but the market has moved on.

“When the investment world gets laser focused on a certain issue, that issue generally loses its power. Surprises move markets, and as investors fight the last war, they drain its surprise potential.”

- Ken Fisher, Fisher Investments

What is the market going to focus on in the months ahead?

Earnings and guidance. Earnings this quarter will encompass April through June, the hardest hit months. The numbers will be horrid.

However, this should mark the bottom of the recession, as shown in the graph below. Losses should bottom this quarter.

Investors are now focused on recovery and a sequential improvement over the next year. Some areas will recover faster while some will suffer for some time to come. Disney (**NYSE DIS**), for example, is opening its Florida Disney World theme park while California remains closed. The airline industry is not as fortunate. A recent poll showed that almost 50% of people have little interest in getting on a plane yet.

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