The Market in Review

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This week's articles and insights

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"Accept what life offers you and try to drink from every cup. All wines should be tasted; some should only be sipped, but with others, drink the whole bottle."

— Paulo Coelho, Brida

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	28,492	+ 2.71%	- 0.16%
S&P 500	3,485	+ 2.93%	+7.85%
TSX	16,731	+ 0.75%	- 1.95%

The Grape Escape

My wife Sue and I just returned from a week in the Okanagan Valley. Many of us don’t think we need a vacation after having spent so much time at home this year. This is wrong – people need a break from the same four walls more than ever.

Our first purpose was to see family and the second was to do some wine-tasting. The two blurred together, as these things often do in wine country.

I grew up in Kelowna which, in the 1960s, was a small town nestled in a valley full of fruit orchards. Our yard had three pear trees which were once part of the largest pear orchard in North America. The sides of the highways were crowded with fruit stands selling boxes of fresh, and very cheap, cherries, apples, apricots, peaches, pears, plums, and a few grapes. Grapes were not a big crop back then. Canada’s wine industry was tiny and very protected by taxes and tariffs.

As a result, there were essentially just two Okanagan wineries in the 1970s. Each of these had a grand total of two wines: Vin Rouge and Vin Blanc. My father’s only decision, other than colour, was *bottle* or *jug*. The biggest innovations of the era, as I recall, were Baby Duck, a carbonated wine aimed at teenagers (i.e. me and my thirsty friends) and boxed wine aimed at budget-conscious buyers (i.e. my dad). The wine industry stumbled along under the shelter of sealed borders and strict importation quotas until the Free Trade Agreement came into force in January of 1989.

The growers and distillers panicked. Free Trade meant they would be exposed to the much better and cheaper wines of California, and B.C was not at all prepared. In a very rare coordinated move by industry and government – made even more rare in that it was successful - “the Great Pullout” saw 2,400 acres of old vines torn out and European *vitis vinifera* vines planted. These were varietals from France that government scientists had proven could thrive in the dry heat of southern British Columbia’s desert interior.

And so, the modern-day Okanagan wine industry was born. Just five years later in 1994, Mission Hill won an international award for best Chardonnay in the world. The industry has never looked back.

When we last visited the wine region about eight years ago, there were approximately 140 wineries. Today, there are close to 300 in the Okanagan. It has changed the face of agriculture in the entire valley, with grapes replacing many of the old apple and pear orchards, although we are seeing many of these being replanted to feed the growing cider industry.

Where is the money coming from? Anywhere and everywhere, it seems. There are giants, like Mission Hill and Andrew Peller (**TSX ADW.A**) that are buying up land and smaller wineries. There are foreign buyers, many from China and Europe, seeking virgin land, new markets, and the prestige of owning their own label. One new winery is being funded by the owner of the dating site *Plenty of Fish.* As with all real estate, there is probably a great deal of borrowed money involved as well.

The situation in Kelowna in 1989 is not unlike the world today. The world the wineries knew in 1989 was coming to an end and the future was extremely uncertain. To buy the Canadian wine industry time, government money built a bridge of support until growers could replant and rebuild their stocks. Today, government has built a similar bridge through monthly support cheques, but the future – the "replant and rebuild" part - is not yet clear. Do old restaurants reopen in new ways, for example, or are we doomed to a future of take-out dining? One report suggests that close to 50% of US restaurants will never reopen. The years from 1990-1993 were hard ones as anxious vintners waited for their new vines to mature. But, they were patient because they had a plan.

Several of the wine managers we spoke to mentioned how difficult it is today to find workers. Many people have chosen to collect emergency relief instead of working.

The question for Canada and the rest of the world is: what is our plan for growth once the pandemic subsides?

A Not So Simple Question

Somewhere between sips of chilled Pinot Gris and floral Cabernet Franc (to be honest, there may have been a few tastings in the middle that are now lost in the sunshine of memories), my wife Sue wondered if the palatial winery we were sitting in was paid for with cash, or was financed with borrowed money. Our talk turned to the larger world and the exact same question.

"Are there any countries not borrowing money today? Are any not in deficit?" she asked.

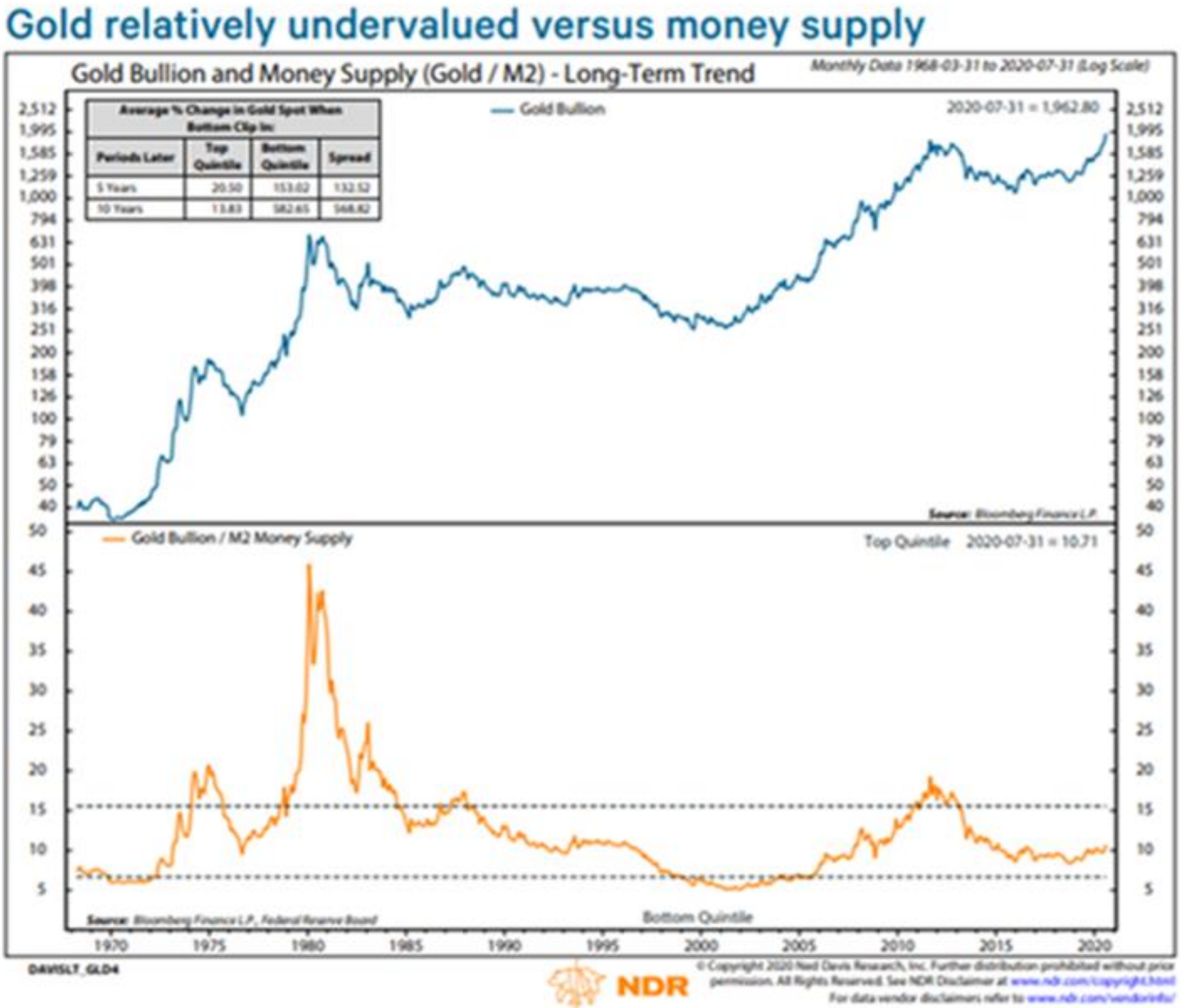
It is not a simple question, and nor does it have a simple answer.

There are a handful of countries that have managed to record surplus budgets for years. Until 2020, that is. Hong Kong has run surplus budgets until recording a $280 billion deficit this year. Same for Macau – its $6.27 billion deficit is its first red ink since 1999. Brunei, an oil-rich sultanate, is $1.47 billion in the hole this year. Estonia, another surplus country, will have a deficit equal to 10.1% of its GDP in 2020.

The only country that will stay in the black this year is Norway, and that is because of their massive sovereign wealth fund. This is where the country has stuffed its surplus oil revenue for years. Norway is overspending by US $44 billion in 2020, but because they have over $1 trillion tucked away for a rainy day, they are able to record a balanced budget by withdrawing from their savings.

It is the only balanced-budget country we could find left in the world. This will have implications in the years ahead because every country – except Norway – is printing currency to fund their deficits. An excess of anything brings its value down, but against what? We are already seeing record prices for both lumber and gold, while other hard assets like copper are also on the rise.

The U.S. money supply is at record levels, thanks to all the stimulus. Gold has risen with it, but not nearly as much (yet):

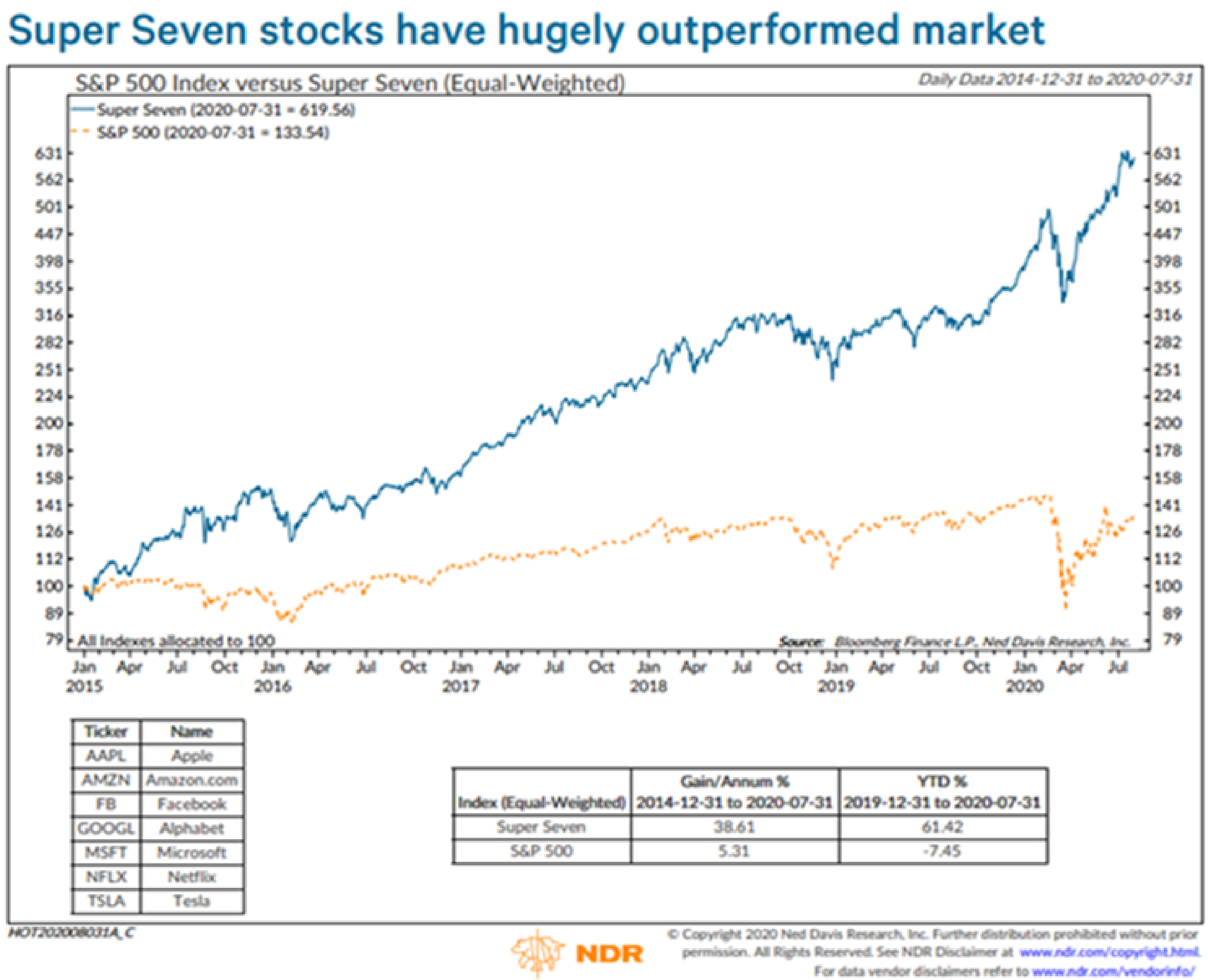


Decades often announce themselves with new trends, such as the rise of inflation in 1970, the rise of Japan in 1980, and the fall of technology in 2000. Today may be reminiscent of the 1970s when gold, commodities, and real estate were the biggest winners.

Markets This Week

We had good news on the vaccine front with Pfizer (**NYSE PFE**) announcing that its candidate could be ready for approval by October. They are preparing to ship 100 million doses worldwide by the end of the year and plan on manufacturing enough for 20% of the world's population by the end of 2021. Home sales and industrial production also improved this week.

Markets responded by rising another 2-3%, led by the same seven stocks that have led the whole way since March:

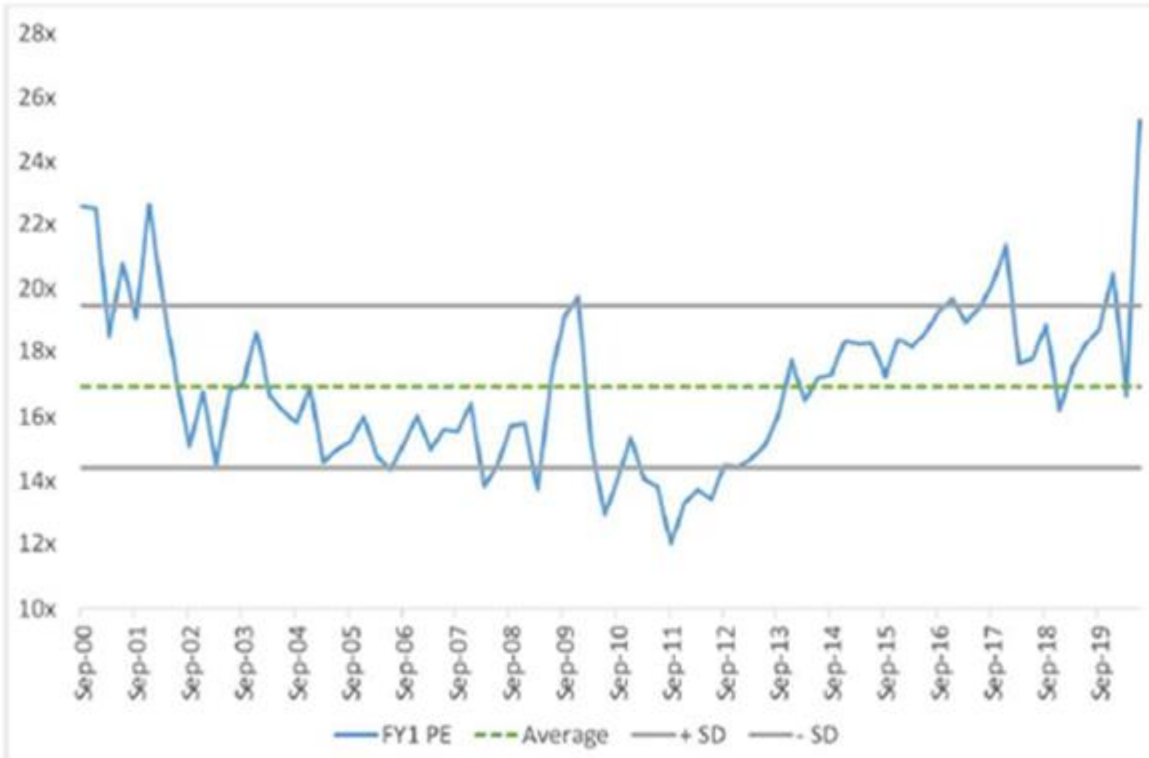


This graph shows the Super Seven rising 61% from January to July, compared to the overall market at -7%. We are investing today in an extremely narrow market.

To be honest, this has confounded many of the market's oldest and richest investors. It is reminiscent of 1999, when the dot.com stocks were flying and everything else was not.

We are not advocating bailing out of markets, for today's technology companies are more profitable than any were in 1999, and they can rise further than we think.

However, as Warren Buffett points out, valuations are even higher than they were in 2000, the last high point:



Source: FactSet, Raymond James

We are cautious as September approaches. September and October can be two of the weakest months, in terms of market performance, and we have Chinese trade tensions and a contentious U.S. election just nine weeks away. Mr. Buffett is holding a large amount of cash today, likely in anticipation of going shopping if there is a decline.

How Now, Dow Jones?

The Dow Jones Industrial Average made some big changes this week. It booted out Exxon Mobil (**NYSE XOM**) after 92 years in the index, as well as Pfizer and Raytheon Technologies (**NYSE RTX**).

Why? Well, Apple (**NASDAQ AAPL**) is splitting its stock, which will make it much smaller in the DJIA. Exxon has faced declining performance for a decade (as has every energy company), Pfizer is “old pharma” versus “new biotech” and Raytheon now looks too much like Boeing after its recent merger with United Technologies. Over the years, the Dow – the world’s oldest average - shed declining industries, such as steel, rubber, and department store retail, as the landscape of America changed. Dow Jones may be feeling left behind by technology today, though. It wants to fill the Apple hole with more technology exposure.

Salesforce (**NYSE CRM**) comes in, as does Honeywell (**NYSE HON**) and Amgen (**NASDAQ AMGN**). Salesforce is a big player in cloud computing, Honeywell is big in industrial automation while Amgen is a biotech giant.

The interesting thing to remember is that the index is run by humans. As such, it is prone to the same performance-chasing behaviour as ordinary investors are. For example, many oil and oil service stocks were added after the big energy boom of the late 1970s and early 1980s. Several technology stocks – Intel (**NASDAQ INTC**) and Hewlett-Packard (**NYSE HPQ**) - were added in the late 1990s near the end of the tech boom. Both struggled for years just to get back to their originally-added prices.

Sometimes they just get it wrong completely. IBM (**NYSE IBM**) was booted from the Dow in 1939, just two years after it launched its new Tabulating Machine Data Center that would transform it into the world’s leading computer company. It was finally added back in 1979. If it had been kept in, the Dow Jones Industrial Average would be more than double what it is today.

Stocks sold from the Dow Jones Industrial Average often go on to ***outperform the index*** over the next few years. Why is this?

“When investor demand for a particular sector is high, such as for the oil service stocks in the 1978-80 energy bubble or the technology and telecommunications stocks in the 1998-2000 bubble, these stocks become candidates for admission to the index. Their high price relative to fundamentals leads to a downward bias to future returns.”

- Jeremy Siegel, Wharton University finance professor

Salesforce is a great company, but it now trades for 94x p/e and 7x book value (hint: that's expensive). The three companies being replaced actually look pretty decent:

- Exxon – Oil exploration has reached a decade low, even as demand continues to climb. The stock is very cheap today - it trades below book value.
- Pfizer – the leader in the Covid-19 vaccine race. It is as much a biotech company as Amgen is.
- Raytheon – the world leader in missile technology and electronic military applications.

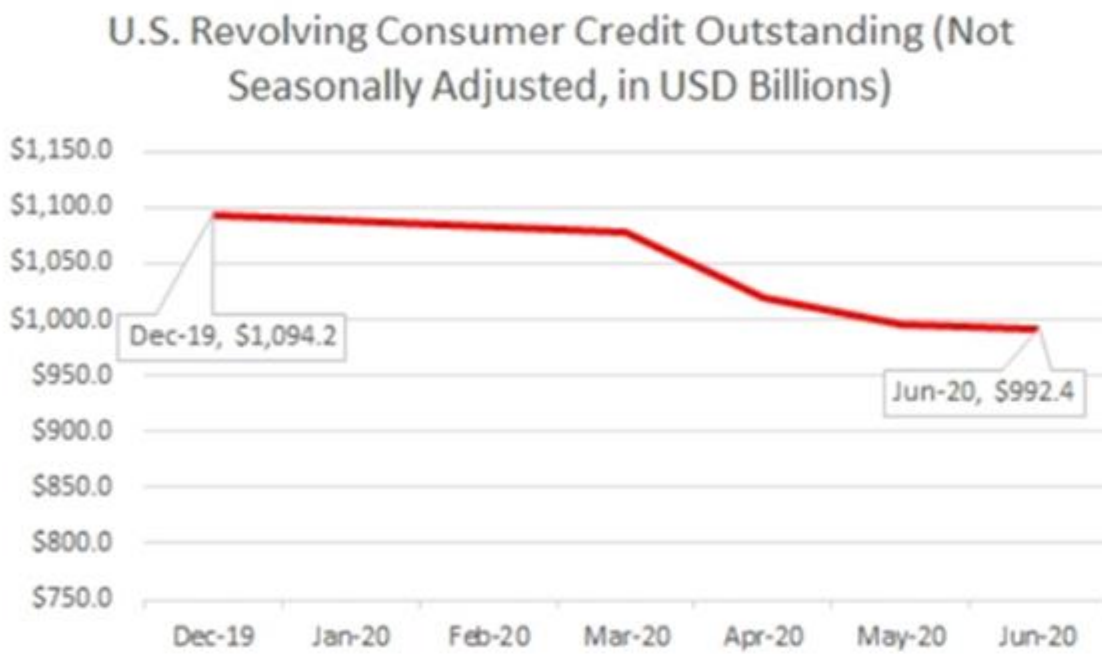
If inflation is on the horizon, old-line commodity companies could make a comeback. It will be interesting to see what transpires in the next few years for the sorry three that were just "involuntarily furloughed" from the Dow Jones Industrial Average.

A "Saving" Grace

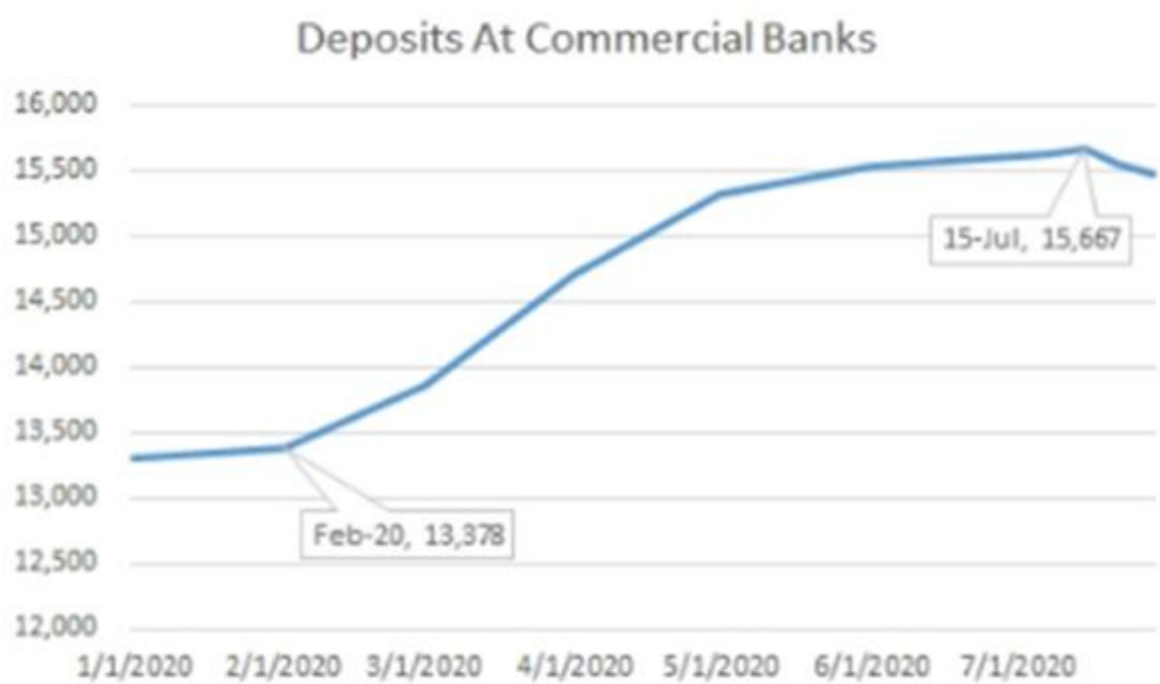
One benefit of being shut inside for months is that the average person has saved money. This makes sense, with vacations cancelled and restaurants closed.

It is also because of the massive transfer of wealth from governments to individuals. In the US, wages and income fell by $854 billion as jobs were lost. However, the government stepped in with $2.24 trillion in transfer payments (Stephanie Pomboy, Macromavens) for a net gift of $1.386 trillion from the government to people's pockets. Where did it go?

For starters, Americans paid down $100 billion in credit card debt:



They then deposited over $2 trillion into savings and chequing accounts:



Source: FactSet, Raymond James research

This may be a key reason why on-line spending has surged. Consumer spending is actually higher in the pandemic than it was when more people were working.

It is also why we continue to be positive on the banks, despite the rise in loan losses. They are swimming in deposits, which is an enormous and profitable cushion. The banks will be fine.

At some point, stimulus payments, mortgage deferrals, and loan forgiveness will end. These savings trends suggest consumers will be in much better shape when this happens.

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

http://www.dividendvaluepartners.com

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Prices shown as of August 27th, 2020