Real life requires active management. January 31,2021

E.Q Trendwatch™

Tough sledding

"Years of initial over-optimism and subsequent disappointments have not been limited to global recessions. Even after country-specific adverse events, long-term growth forecasts for the countries concerned had to be repeatedly downgraded." — World Bank Outlook, Jan 2021

"When those who want to stay rich start acting like those who want to get rich, it suggests a late-stage speculative blow-off."—Michael Hartnett, B of America, Jan 21, 2021

Venable Park Investment Counsel Inc.

33 Clapperton St.
Barrie ON L4M 3E6

Tel: (705) 792-3991
Toll Free: 866-792- 3991
Fax: (705) 792-3992

Cory Venable

CIM, FCSI, CMT
Market Analyst

Danielle Park

LL.B., CFP, CFA
Portfolio Manager

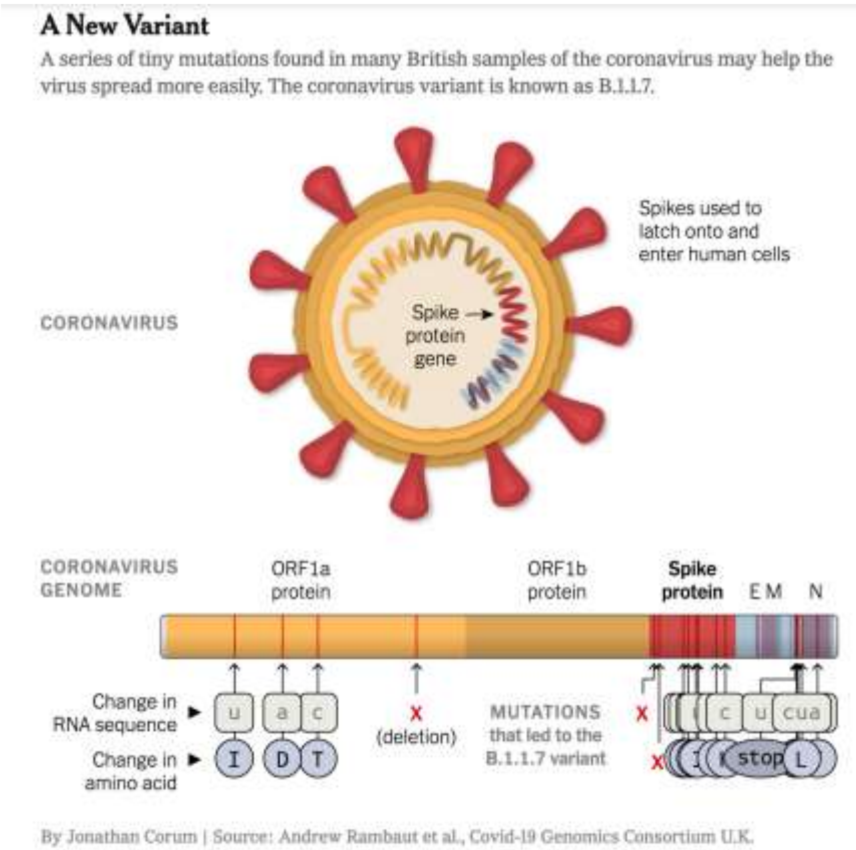
Venable Park Investment Counsel Inc.
www.venablepark.com

In this edition: Some 40% of North American respondents surveyed admit to not following public health guidelines on social distancing, and an adaptive virus is using the opportunity to spread and morph for easier transmission. New variants may be up to 70% more contagious and less susceptible to current vaccines. After some recovery between March and November 2020, the global economy is double-dipping into 2021. The World Bank 2021 Global Forecast Report, released this month, warns that the downturn has already reversed a decade or more of per capita income gains in more than 30% of the world. While optimism is good, over-confidence is a problem. All previous recessions since World War II—all more moderate than the present one—took years to recover lost jobs and previous trend growth. Meanwhile, January registered some of the most extreme readings of financial mania in history. With the euphoric sentiment index hitting an all-time high this month, even best-case recovery outcomes are likely to disappoint return expectations for present holders. The last three most comparable episodes—1929, 2000 and 2007—saw the largest stock averages lose 84%, 78% and 57% respectively over 34, 31, and 17 months thereafter, and spend years before recovering prior highs. Months of forced liquidation, on the other hand, brought valuable entry points for investment.

Record high market sentiment and asset valuations suggest the COVID-19 pandemic and global recession are done and dusted; reality is much less sanguine. The global COVID spread continues amid distancing fatigue and an adaptive virus that is morphing for easier transmission.

According to recent North American surveys, some 40% of respondents said they are not following public health guidelines such as physical distancing and staying away from people in other households. Infection rates confirm this. The longer and wider the virus spreads the more opportunity it is afforded to mutate (WHO).

This month the U.K. variant (B117), first identified in southeast England in December, was reported throughout Canada and the US. Up to 70% more contagious and more deadly (source link) than the original strain, B117 is driving a leap in infection, hospitalization and fatalities.



A study this month from the Centers for Disease Control and Prevention (CDC) projects that B117 will be the dominant strain in the United States and Canada by March (source link).

Other variants now dominant in South Africa ("501Y. V2" named after the N501Y mutation in its spike protein used to enter cells) and Brazil appear to be even more aggressive and have spread to more than 50 countries including the US. Japan's National Institute of Infectious Diseases (NIID) has said that the new variant comes from the B.1.1.248 lineage of the virus and has at least 12 known mutations, including N501Y and E484K, in its spike proteins (source link).

New, fast-spreading variants of the coronavirus may reduce the protective effects of the leading vaccines. Dr. John Bell of Oxford University explained this month that *"the mutations associated with the South African form are really pretty substantial changes in the structure of the (virus' spike) protein,"* and raised questions as to whether the Pfizer/BioNTech and Oxford University/AstraZeneca vaccines would be "disabled" in the presence of such mutations. See *Covid variant in South Africa 'more of a problem' than one in UK, official says*.

A study published on Nature.com this month (source link) noted that three to fourteen weeks after receiving a second jab of the Moderna or Pfizer-BioNTech vaccines, some neutralizing antibodies were effective against viruses carrying mutations of the original COVID strain, but some were only one-third as effective.

Where the more contagious versions take hold, infection levels are doubling every few days. In our hometown of Barrie, Ontario, a long-term care center of 129 residents drew international attention when an outbreak of the UK strain on January 8 saw 99% of the residents and majority of staff infected, with 53 dead within 21 days. Dr. Charles Gardner, county medical officer, warned community spread is underway:

> *"This virus, this variant, has proven to be highly infectious. It rapidly progressed through the home despite best efforts and has now infected many workers and our partners who responded to the situation, and even some household members of staff and of those who responded to this situation, so I'm very concerned about its spread. What we have here we probably won't be able to contain."*

With cases far surpassing the initial spring wave, Ontario—Canada's most populous province—joined many other regions of the world in reinstating strict lockdowns this month. Over half of Ontario's hospitals are already reporting fewer than two free intensive care beds. Without disciplined distancing, daily new infections were projected to hit 10,000 by mid-February at a 3% growth rate, 25,000 at 5% and 40,000 at 7%.

An Irish study (source link) found that over a third of hospitalized COVID-19 patients were still experiencing various "neurological reactions" like cognitive deficits, hyposmia, and postural tremor six months later; 87% reported at least one lingering symptom.

It has been widely publicized by producers that their leading COVID vaccines have very high 'efficacy' rates: Pfizer/BioNTech boasts a 95% efficacy, the Oxford/AstraZeneca an average of 70%, and the Moderna vaccine, reportedly a 94.1% efficacy.

While commonly used interchangeably, 'efficacy' refers to how a vaccine performs under ideal lab conditions, while 'effectiveness' refers to how it performs in the real world. In a clinical trial, a 90% efficacy means that there are 90% fewer cases of disease in the group receiving the vaccine compared with the placebo group. In clinical trials, however, participants tend to be healthier and younger than those in the general population, and they generally have no underlying conditions, nor include children and pregnant women.

So, while a vaccine may prevent disease in a trial, it is typical for effectiveness to drop significantly when administered to the wider population. The seasonal flu shot, for example, has an effectiveness of 40–60%, according to the CDC, and experts—independent of the producing companies—note that COVID-19 vaccines would do well if they have similar results.

William A. Haseltine, infectious disease expert, chair and president of the global health think tank ACCESS Health International opined in Project Syndicate this month that there is only a slim chance that the vaccine will stop the COVID pandemic this year, and slowing the spread will require ongoing personal discipline and distancing for many months to come (source link). Others warn that COVID-19 cases are likely to spike again later this year when vaccinated people (who may still be contagious) return to crowded activities.

Optimism is good, over-confidence is a problem. The World Bank's 2021 Economic Forecast Report this month (source link) notes that in the 12 years after the 2008 global recession, global growth fell short of consensus expectations in every year but 2010. This added up: by 2019, long-term growth expectations were 0.8% lower than forecast a decade earlier, and this warns against economic over-optimism now:

> *"History suggests that the adverse effects on investment of the pandemic will linger. After epidemics in the past, losses to investment have been deeper and longer lasting than GDP losses, perhaps because of lasting effects of uncertainty and risk aversion on investment. These same mechanisms, along with sharply lower corporate profits, can be expected to constrain investment during and after the COVID-19 pandemic."*

It is recommended that recovery prospects can be supported with productivity-enhancing structural reforms, promoting education, effective public investment, reallocation away from competition-quashing legacy sectors, improved governance, and investment in green infrastructure projects that support sustainable long-run growth while reducing the compounding waste and costs of pollution and climate change.

Near-term, focus must be on containing the virus long enough for effective vaccines to be widely administered. The World Bank report outlines four scenarios. The most optimistic presumes swift and effective vaccination with wide public cooperation allowing the roll back of precautionary measures by the end of 2021, and a return to 2019 trend growth by 2022 (ie., three years of lost spending and investment).

Their base case scenario, however, presumes a more gradual inoculation and reduction in distancing measures, with global gross domestic product (GDP) still 4.4% below pre-pandemic projections by 2022 and 5% below by 2025—for a cumulative output loss over 2020-25 equivalent to 36% of 2019 global GDP.

Emerging and developing countries are expected to recover even slower from the "pandemic depression" that has, so far, wiped out a decade of per capita income gains in about a third of the countries:

> *"Past global recessions were associated with highly persistent output losses. The pandemic-induced global recession has already reversed a decade or more of per capita income gains in roughly 30 percent of emerging market and developing economies (EMDEs)... in more than half of these economies, at least half a decade of income gains has been reversed. In Latin America and the Caribbean and in the Middle East and North Africa, income gains of at least half a decade were reversed in 80 percent of countries. As a result, the number of people living in poverty, globally, is estimated to rise by more than a hundred million by 2021 compared to pre-pandemic trends, reversing several years of poverty reduction (World Bank 2020b; Lakner et al., forthcoming)."*

Downside impacts see ongoing logistical problems with inoculation and aversion to contact-intensive services for a prolonged global recession that erodes corporate balance sheets and triggers widespread defaults and stress in bank balance sheets.

After some rebound between April and November, North America is also double-dipping in 2021. In December and January, jobless claims rose in Canada and the US, and Canada's unemployment rate moved back to 8.6% versus 5.6% last February (and 13.7% after the first wave shutdowns in May). Overall, in 2020, small North American firms lost 4.8 million net jobs, and large firms 5.3 million. **It took more than six years for the US to recover the 8.7 million jobs lost in the last recession (2007-09). This one is unlikely to be different.**

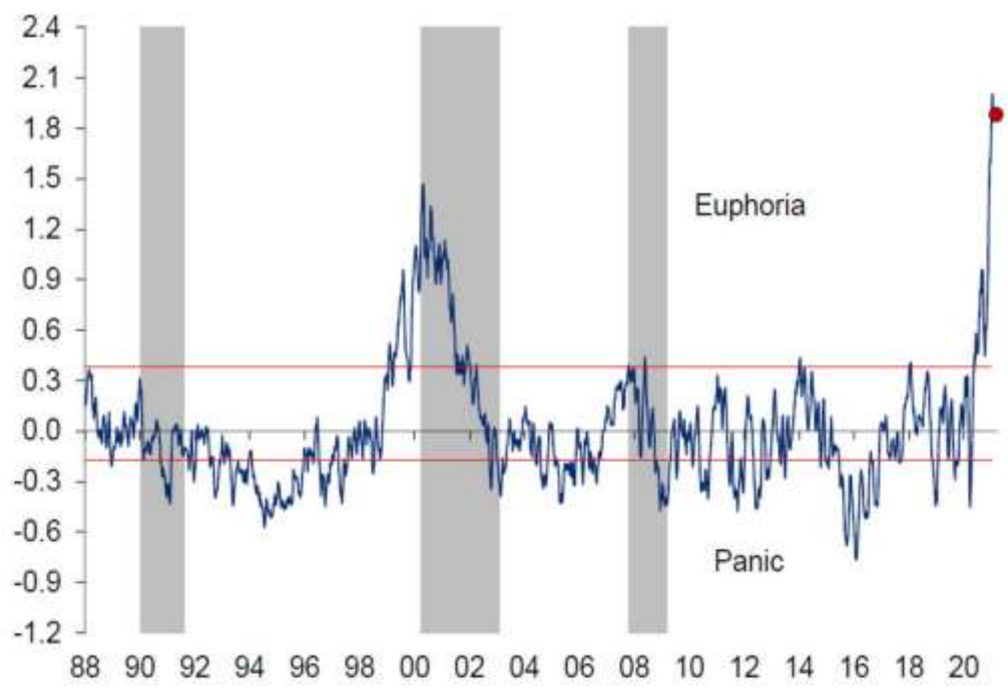
The Bureau of Labor Statistics' figures show that small firms (less than 500 employees) accounted for 63% of the private net job creation from 2010 to 2019. The Canadian Federation of Independent Business (CFIB) reported that one in six Canadian small business owners surveyed this month said they were seriously contemplating shutting down (about 181,000 and up from one in seven last month) in addition to the 58,000 that stopped operating in 2020.

Business longevity is tricky in the best of times. Historically, 20% have ceased to exist two years after their opening; 45% within five years, 65% within ten, and 75% within 15 years. Record debts and a pandemic make business failure odds higher than average today (see Canada's small biz and rolling restrictions.)

Meanwhile, market euphoria has inflated the securities of publicly traded companies to such a degree that even best-case recovery scenarios are likely to bring disappointing capital returns from here**.**

The Citi Research "Panic/Euphoria" index (shown below since 1987) combines several market investor mood indicators. Over the past 34 years, stock prices have topped out when this index approached the euphoria line shown around .40. An exception was 1998 to 2000 when euphoria continued to a 1.50 peak before collapsing with asset prices from 2000 through 2003. The 1.80 parabolic move in recent months is not only unprecedented and breathtaking, it should also be encouraging for those waiting to buy market assets once the present mania finally reverts to panic selling once more.

Figure 8. The Panic/Euphoria



Source: Citi Research, Haver

As the pandemic news spread in February 2020, market participants began liquidating corporate securities and commodities and flooding into the relative safety of government bonds and the US dollar. Then, on March 23, the promise of 'warp speed' vaccines and central bank superpowers reignited another wave of speculative fever enabled by emergency relief cheques, idle time and borrowed funds.

Since then, retail participants have borrowed record amounts to bet on stocks, as shown in the chart on the right of margin debt since 1999. As asset prices have rebounded and the US dollar weakened since March, asset managers too have increased their long bets on equities and commodities as well as cut their dollar positioning to the bottom 1.5% of historical incidents (below in red since 2003).

In January, a record 92% of respondents in Bank of America's Fund Manager Survey expected higher inflation in the next 12 months. **Shown below since 1995, when the consensus was this confident about inflation expectations, the opposite has happened.** Statistics Canada reported this month that 0.7% was the average monthly inflation rate for 2020—the weakest year since the 2008 recession. Globally, private and public debt has risen from 320% of GDP in 2019 to a record 365% of GDP at the end of 2020. Economist Dr. Lacy Hunt reviewed inflation prospects in this month's Hoisington Fourth Quarter 2020 Review and Outlook as follows:

Exhibit 4: Inflation expectations at an all-time high

Source: BofA Global Fund Manager Survey

"Provided there are no major changes by Congress to the Federal Reserve Act, we believe it is prudent to expect that long dated U.S. Treasury rates will eventually gravitate to lower levels as inflation continues to recede…First, the massive void in economic activity and destruction of wealth created by the virus and related shutdowns of businesses in the U.S. and abroad will take years to fill. Second, U.S. fiscal multipliers are generally negative, rendering much of the government spending counter-productive in terms of stimulating economic growth. Third, monetary policy becomes much less impactful since the debt overhang was massive before the pandemic and is now even worse, not just in the United States but in virtually all parts of the world."

While commodity prices dipped in the first half of 2020, China—the world's dominant consumer of them—stockpiled supplies including crude oil, copper and iron ore. The risk is that China's 2020 imports are now presumed to continue in 2021, amid the consensus view that vaccines will soon end the pandemic and spur a robust global recovery. There is significant downside risk in this expectation. Trade data for December showed that China's buying spree appeared to be ending as economic lockdowns resumed in many countries. (See *China's commodity imports saved 2020; this year may be different*.)

Some further US dollar weakness could continue the risk-on rally in global stocks, commodities and corporate debt a little further. But after already correcting 13% against the basket of world currencies since March and holding long-term support in the $89 - $90 range in January, the next wave of dollar strength may be at hand, bringing with it the next round of drubbing for global risk assets on the other end of the US dollar teeter totter.

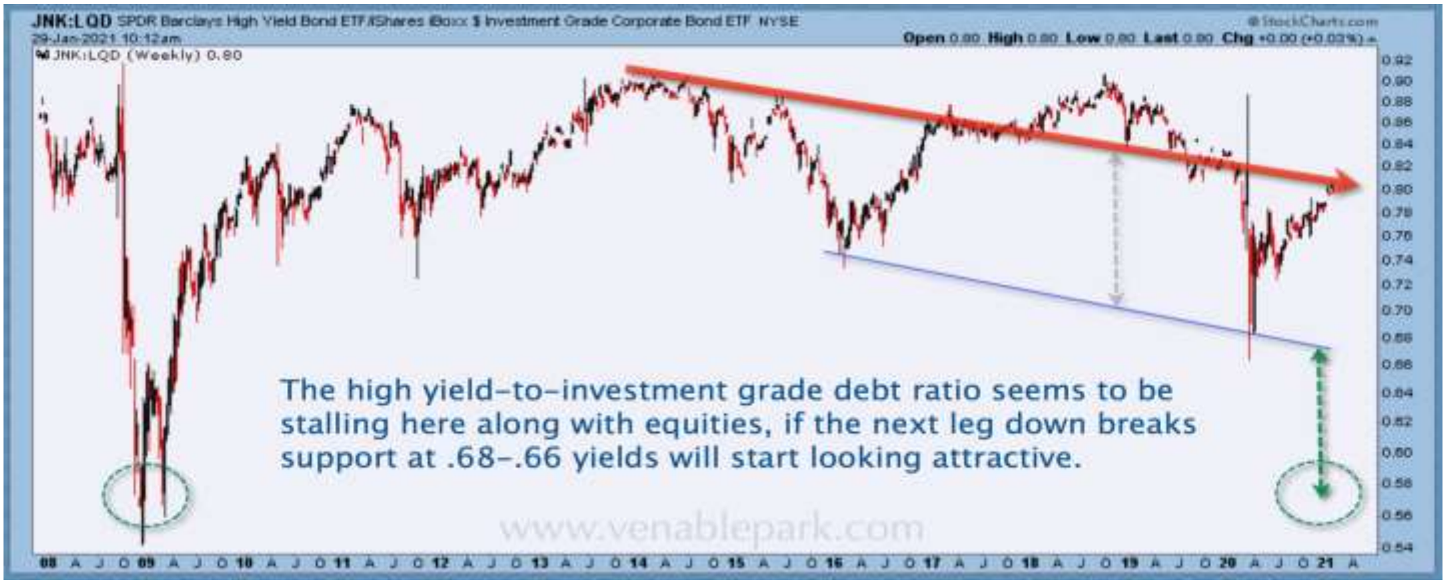
As shown in the chart below of the US dollar index in red (versus the Euro, Yen, Pound, C$, Swiss franc and Swedish krona) and the S&P 500 in blue since 2000, periods of dollar strength (green rectangles) force liquidation cycles in risky assets just when the confident consensus is expecting it the least.

Most financial commentators are, as usual, discounting the warning signs noting that the financial chorus remains optimistic and interest rates are well below historic averages. They're remiss not to mention that the consensus only turns negative *at the bottom of price cycles*, and <u>in the three periods where market euphoria has been most comparable to the present—1929, 2000 and 2007—large cap stock indices lost 84%, 78% and 57% respectively over 34, 31, and 17 months, and took years thereafter for prices to recover their prior highs.</u> Months of forced liquidation, on the other hand, produced rewarding entry points for value-focused investors.

The US dollar (here since 2006) weakened against the loonie in January, and now retests support around the $1.29 CAD level (yellow band). As tough as things are in America today, the economic prospects for Canada are presently worse. A strong CAD will not help. The CAD typically moves with the equity cycle, so a retest of the March 2020 lows for stocks should also retest the USD highs in the $1.40 CAD range once more.

Oil (WTIC below since 2012 priced in U$) has rebounded sharply from its dramatic plunge in March 2020, closing January just over $52 a barrel—the same price it was at the end of January 2005, 16 years ago! The rebound is incentivizing producers worldwide to ramp production just as the new Biden administration is implementing policies geared at increasing energy efficiency, renewable power and electric vehicles. The path of least resistance for oil remains lower; a retest of the $30/barrel range (purple arrow) is one to watch.

Prices for the lowest quality corporate 'junk' bonds (JNK) dropped relative to the highest-grade issues (LQD) from 2008 to 2009 and recently from 2018 to March 2020 (below since 2007) before bouncing with equities into year-end. This month, these bonds lost momentum again as equity markets faltered. We look to buy corporate bonds when their prices have dropped and yields blow higher (near circle), as we did in 2009.

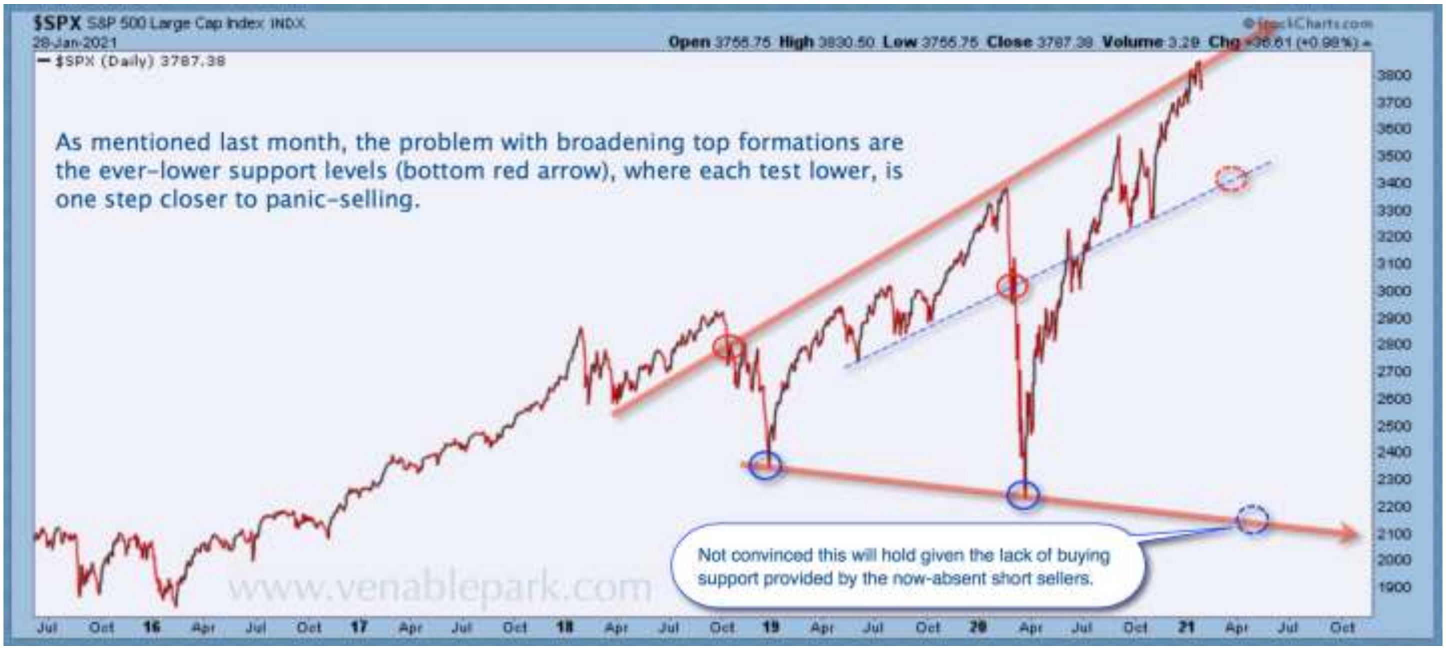


US Treasury 10-year minus 2-year yield (here since 1995) continued their positive sloping trend (short rates below long) this month. Equity prices and bank shares, in particular, typically fall as this yield spread rises and do not bottom until the spread tops in the 2.6% range as in 2003 and 2009 (arrows). Recent progress is noted.

The US 10-year treasury yield (here since 2015) has moved higher since August but remains well within the downward channel that has held since 2018. The ongoing bid for government bonds despite historically low yields is a non-confidence vote for the risk rally and its growth and inflation expectations for 2021.

Canada's 10-year government bond yield (here since 2012) has doubled since August, but at .89 remains moribund under the weight of Canada's record debt and a double-dipping economy in 2021. While growth bulls are all calling for inflation and higher bond yields, we suspect lower for longer is likely to persist.

S&P 500's broadening top formation since 2019 suggests next downside test in the 2100 area—45% below present levels. Extreme over-confidence and record leverage have managed to inflate prices long enough this cycle to close out the majority of short sellers who would normally have to buy once prices have fallen. The absence of this self-correcting force makes it more likely that the 2100 level (lower red arrow) may not hold.



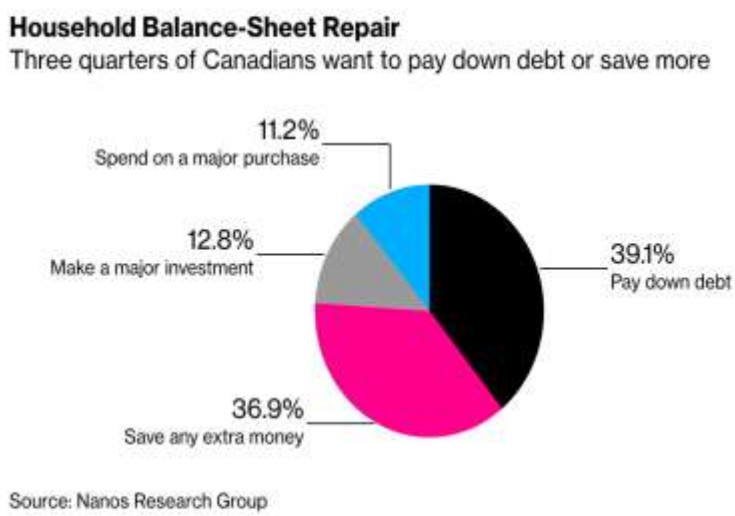
Canada's TSX composite (here since 2015) retested its February 2020 top this month before rolling over. A revisit of the 16750 level is now suggested and a failure there would open room for a retest of the March 23, 2020 low in the weeks or months ahead. We look forward to a sustainable entry opportunity.

Happy February! At least masks help to keep our faces warm.

"This is the most speculative and momentum-driven market on record. Tesla Inc. rose 743 per cent in 2020. Bitcoin soared 305 per cent. More than 200 special-purpose acquisitions companies (SPACs) raised more than US$80 billion. This is pure speculation. There is US$21 billion sitting in exchange-traded funds that only track momentum, the most in at least a decade. This was a year in which average daily trading volume in the options market topped 30 million — by far a record and topping the 19 million shares that traded hands in 2019. The bear market in rational thinking, that was the true hallmark in 2020, can't last indefinitely." --David Rosenberg, Rosenberg Research, Jan 4, 2021

…The World Health Organization's chief scientist warned it is highly unlikely that herd immunity – which would require at least 70 per cent of the globe to be vaccinated – will be achieved this year. As the disaster has demonstrated, it is not enough to snuff out the virus in a few places. "Even if it happens in a couple of pockets, in a few countries, it's not going to protect people across the world," Dr. Soumya Swaminathan said this week.

Health experts fear, too, that if shots are not distributed widely and fast enough, it could give the virus time to mutate and defeat the vaccine – "my nightmare scenario," as Dr. Jha put it. UN Secretary General Antonio Guterres said the two million milestone "has been made worse by the absence of a global coordinated effort." He added: "Science has succeeded, but solidarity has failed."
--Covid death toll hits 2 million amid immense, uneven vaccine roll out, Jan 15, 2021



"I see better than 60–70% odds that the robust recovery scenarios many see for the latter half of 2021 will prove too optimistic. Further, all this talk of "pent-up demand," is unrealistic. People aren't going to take two vacations when the virus is defeated. Caution will be the rule of the day…[It's possible this experience] will scar a generation every bit as much as the Great Depression did in the 1930s. We will see higher saving rates and less consumption for years. Given all the other adjustments that COVID-19 has forced upon us, this "recovery" will likely be slower than others, especially given the increasing debt." –John Mauldin, Jan 14, 2021

"The risks around the economic outlook are huge. There are risks in both directions, but I'd argue the preponderance are to the downside –toward less positive growth outcomes, less positive virus outcomes, less positive vaccine outcomes." --James Athey, Aberdeen Standard, Jan 2021

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