2021: Hopefully Two Steps Forward, But Not Before One Step Back

Equity Markets

After a tumultuous quarter to start the year, developed equity markets made a steady ascent over the remainder of 2020, punctuated by excellent gains over the final three months. The domestic S&P/TSX Composite Index rose 9.0% over the quarter, with the move sufficient to push the benchmark into positive territory with a 5.6% total return in 2020. The strength of the domestic equity market in the quarter was nearly matched by a fortified Canadian dollar, rising 4.9% and diminishing the returns for Canadian investors from international securities. However, even with the currency headwind, the MSCI EAFE benchmark rose 10.7% in Canadian dollar terms in the quarter, with the strength sufficient to eliminate earlier losses and end the year with a 5.9% gain for the index. In the United States, a 1.8% rise in Canadian dollar terms brought 2020 performance to 16.3%, a remarkable result given the crippling economic impact of COVID-19 over the majority of 2020.

Investors were concerned about choppy markets going into the US Presidential election; however, stock markets quickly embraced a contested outcome that produced a balance of power between Republicans and Democrats, diminishing the odds of major policy shifts. The approval of COVID-19 vaccines was a second market catalyst in the quarter, a surprisingly rapid development of a highly effective inoculation that has sparked a glimmer of hope for a return to normal life. Equity investors responded with broad-based buying in markets worldwide, with most sectors across every region rising this quarter. The most cyclically depressed groups of Energy and Financials led the way in Canada, the US, and internationally, reflecting an improved demand outlook for products like gasoline and jet fuel, alongside the potential for better loan and credit conditions in 2021. Gains for more defensive sectors, such as Consumer Staples and Health Care, were quite staid in comparison, as these groups performed more admirably earlier in the year given their more economically resilient business characteristics. Going forward, the relative performance of these two categories will depend upon the balance of new infections against vaccine adoption, with the backdrop being more fulsome market valuations for many 'Pandemic Resistant' corporations as we start 2021.

Fixed Income Markets

Canadian government bonds and investment grade bonds returned 0.2% and 1.8%, respectively in the quarter, and high yield bonds returned 4.1%. Bond performance continued to contribute positively to balanced portfolios for the period and the calendar year. For the year, Canadian government bonds and investment grade bonds both returned 8.7%.

Both the Canadian and US Treasury yield curves began 2020 mildly inverted, meaning some bonds of shorter-term offered more all-in yield than longer-dated issues; both yield curves are more normally sloped finishing 2020, with bonds of longer-term offering higher all-in yields. In response to the economic upheaval caused by COVID-19 disruptions, both the Bank of Canada and the US Federal Reserve (Fed) dropped their overnight lending rates to near-zero, in an attempt to stimulate economic activity. Both the Bank of Canada and the Fed began 2020 with their overnight lending rate set at 1.75%. That rate was lowered sharply, and there is every expectation they will maintain this rate policy for the foreseeable future. Both the Bank of Canada and the Fed have undertaken massive bond-buying programs, expanding their purchase mandates from only government and agency debt to corporate bonds. In the case of the Fed, some high yield exchange-traded funds.

Economic uncertainty going into 2021 remains high, which is supportive of fixed income markets. Yields may leak slightly higher – from their current near-historic lows – as the tone of economic news improves and the likelihood of further rate cuts or broader quantitative easing lessens. However, they are not expected to move quickly or sharply entering 2021 given the extent of the COVID-19-related economic contraction.

Commentary

The start of a new year always brings with it the hopes of better things to come. After what the entire world endured through the last year – especially the last 10-month period in which the use of the word "unprecedented" was… unprecedented – such aspirations have rarely ever been so great (and desperate) for so many as the calendar rolls over into 2021.

Thanks to the miracle of modern science, there are reasons (at least three and counting, actually) to anticipate that the main source of the hardships experienced in 2020 will be put in the rearview mirror.

It is truly a testament to the capabilities of humankind that in a year since the first recorded case of coronavirus 2 (SARS-CoV-2), *multiple* vaccines have not only been developed but passed through full phase trials, gone into mass production, *and* already started to be distributed and administered. Currently, the expectation is that a majority of the population in developed markets will be inoculated in the first half of 2021, with the anticipation that anybody in Canada who wants immunization will obtain their doses by the end of September.

The vaccine development is truly remarkable and represents an extremely bright light at the end of the tunnel, following what has been a year that largely had the world feeling around blindly in the dark, merely searching for the rails.

There is plenty of hope for the coming year, with a real possibility that life could return to something close to what was the norm just a scant 12 months ago. A time when a global pandemic was simply an extreme, low probability scenario for risk models and COVID-19 was not in the public's vernacular.

While closing this (likely to be much dissected) chapter of world history is something to which everybody is greatly looking forward to, that bright light remains a ways away still and we remain very much in the tunnel – based on the timeline, we are likely sitting right at the halfway point.

The next stretch of the track continues to look pretty rough, which could well result in more starts and stops over the near-term that may hinder the ability to get the economic locomotive back up to cruising speed.

The aggressive resurgence of the spread of COVID-19 in the Western world has once again necessitated the implementation of stringent restrictions on activity. To this point in the new wave of contagion, macro indicators have proven to be fairly resilient, but momentum has started to fade as lockdowns have been re-instituted and large swaths of the economy (particularly the hard-hit service sector that was still only operating at a fraction of its pre-pandemic levels) are once again forced to close their doors.

There is a rising expectation that the New Year could start with more commiseration than celebration. The global economy's strong rebound – versus spring's pandemic-induced (broader scale) shutdowns – will take a step back until it sees signs that rate of infections are slowing, and alleviating the growing strain on the healthcare system's increasingly limited capacity.

While we are stuck living in the present, financial markets' forward-looking nature means that they have the luxury of living in the future. Given that the outlook has improved markedly and broadly thanks to the rapid development of vaccines while central banks around the world have committed to keeping interest rates low, the backdrop is highly constructive for risk assets such as equities.

Though this environment would portend that interest rates could move higher and provide a drag to safe haven assets (such as government bonds and gold) that performed admirably amid last year's ample uncertainty-created volatility, any such moves are anticipated to be gradual and fairly benign, with yields remaining at low levels. Moreover, the potential for near-term stumbles and sentiment swings to headlines, mean that these more risk-averse investment choices will likely continue to be popular for investors.

The bottom line is that while there is a lot of reason for optimism for the days to come, the need for caution remains, as we are not yet in the clear. It remains prudent for investors to take a disciplined approach to manage risk exposures. It starts with constructing a diversified and balanced portfolio that may generate returns over the long-term while weathering the market volatility. Being tethered to guidelines embedded in a well-designed investment policy statement restrains investors from succumbing to the fear of missing out in euphoric markets while keeping them from cashing out in down markets.