The Stan Clark Financial Team's

PERSPECTIVES

Year-End REVIEW

Volume 12 - Issue 1 January 2021

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Welcome to our special year-end review

How were the stock markets in 2020? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2021 and beyond.

We hope you find this review informative and useful.

Enjoy!

Stan

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Year-End Review: Despite the pandemic, stocks kept rising

By Stan Clark - Senior Investment Advisor and Michael Chu - Investment Advisor

Looking back at 2020, we see a year dominated by the pandemic. However, another standout is the stock market's incredible comeback following the March lows induced by COVID-19. This comeback is especially remarkable given that economies were left reeling by the severe blow of lockdowns. Meanwhile millions of people are still relying on government support to make it through this precarious period. Yet, counter-intuitively, despite restrictions and rising infections, investors have propelled the stock market to record highs.

So, while the economy may be slow and unemployment high, markets seem to be looking beyond that into what happens next. Three very positive conditions have given investors optimism going forward: positive vaccine developments; central banks vowing to maintain ultra-low interest rates; and households sitting on excess cash ready to release pent-up demand once restrictions are lifted.

While 2020 was a very volatile year, most major markets ended the year in positive territory. The World Equity Index, a gauge of stocks around the world, was up 13.5% (in C$). At home, the TSX was up 5.6%. The chart below shows the returns of markets around the world. Note that these returns are in Canadian dollars, so the effects of currency changes are included.

Valuations

Buying when stocks are most loved and highly valued can be hazardous to your wealth. For example, at the height of the dot-com boom, investors scrambled to buy tech stocks. The S&P 500 tech sector made up 24% of the market cap, but only 18% of the earnings. The forward price-to-earnings (P/E) ratio for tech companies was 48.3 before the bubble burst, resulting in significant losses for investors. To compare, today the tech sector P/E is "only" about 26, as the E in P/E is much higher than 21 years ago. Based on P/E, today's tech companies are 46% cheaper than they were when the dot-com bubble burst.

Determining whether something is over- or undervalued can be very tricky. While we can use various models and rules-of-thumb, some parts are just not that predictable. Some aspects, such as future earnings estimates, are by nature subjective. Others are relative. For example, stocks now might look expensive compared to stocks

	Q1	Q2	Q3	Q4	2020
Canada (S&P/TSX)	-22.9%	20.0%	4.7%	9.0%	5.6%
U.S. (S&P 500)	-11.6%	14.5%	6.9%	7.1%	16.0%
EAFE (Europe, Australasia, Far East)	-16.5%	11.0%	2.8%	10.9%	5.6%
Emerging Markets	-17.3%	14.0%	7.5%	14.4%	15.9%
World	-14.5%	15.2%	5.9%	8.9%	13.5%

Source: Bloomberg

in the past, but they look very cheap when compared to bonds. This is especially true in Canada. We can see this in the table below. Earnings yields and dividend yields are far higher than bond yields. This difference makes stocks look much more *undervalued relative to bonds* than at most times in the past. And remember: When you buy a 10-year bond, that interest rate is fixed for the 10-year term. With stocks, both earnings and dividends tend to grow. For example, dividends in the U.S. have been growing 6% per year since 1946.

Whatever the method, it's generally better to buy when valuations are low and sell when valuations are high. With higher prices, all else being equal, it means that returns going forward will be lower. Some experts swear by a *reversion-to-the-mean* approach to timing the market. That is, if valuations get higher than the historical mean (or average), you sell; if they get lower than the historical mean, you buy. This makes intuitive sense, but these simple models can be wrong for several reasons. First, the mean in mean reversion can change over time. Second, the models also can't predict how far things can go before they revert, and exactly when such a reversion might begin. History has shown that valuations can be stretched for a long time. As John Maynard Keynes famously remarked, "The markets can remain irrational longer than you can remain solvent." And third, future earnings can grow faster than in the past, allowing company earnings to catch up with prices. So, trying to time the market using mean reversion is not as easy as it sounds.

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds
Canada	23.5	4.2%	3.0%	0.7%
U.S.	32.1	3.1%	1.5%	0.9%
EAFE (Europe, Australasia, Far East)	23.1	4.3%	2.4%	
Emerging Markets	21.7	4.6%	2.0%	
World	28.4	3.5%	1.8%	

Source: Bloomberg

Past vs. future

The earnings used in P/E ratios can be trailing or forward earnings. Trailing earnings are those over the last 12 months. Forward earnings are what analysts expect over the *next* 12 months, after considering all the factors that might affect earnings.

Corporate earnings were unusually depressed in 2020 due to the pandemic and are expected to increase by about 20% in 2021. This makes P/E ratios and earnings yields on a forward basis look much more reasonable than trailing.

We show these for Canada and the U.S. in the table below. We also included the measures for the stocks we own in our strategies. They are better value than the markets on both a trailing and forward basis. (Note the below table is operating earnings which does not include extraordinary items like write-offs. This is different from the earlier table which uses reported earnings which does include extraordinary items. Both are commonly used, but just need to make sure we are comparing apples to apples.)

	P/E ratios		Earnings Yield	
	Trailing Earnings	Forward Earnings	Trailing Earnings	Forward Earnings
S&P 500	27.5	22.7	3.6%	4.4%
U.S. Strategy	24	20.4	4.2%	4.9%
TSX	22.2	17.1	4.5%	5.8%
Candian Strategy	19.6	16.6	5.1%	6.0%

Source: Yardeni, CPMS

How did we do?

Our strategies had fairly good returns in 2020, but roughly in line with the benchmarks.

Stan Clark Financial Team Strategy Returns

Composite	2020 Strategy	2020 Benchmark	10 year Strategy	10 year Benchmark
Disciplined Canadian Stock	3.9%	5.6%	9.6%	5.8%
Disciplined U.S. Stock (in US$)	19.2%	18.4%	12.6%	13.9%
Disciplined World Equity	11.4%	10.3%	11.6%	9.8%
Dividend Select World Equity	11.0%	10.4%	10.5%	8.8%
Disciplined North America Equity	15.4%	12.1%		

Our Canadian stock strategies (Disciplined Canadian Stock) returned 3.9%; the TSX Index was 5.6%. Our U.S. stock strategies (Disciplined U.S. Stock), returned 19.2%; the S&P 500 was 18.4% (in US$).

We also have two global portfolios made up of our multiple stock strategies. The Disciplined World Equity composite returned 11.4%, compared to a benchmark 10.3%. This portfolio is roughly 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned 11.0%, compared to a benchmark of 10.4%. This portfolio has a slightly higher weighting in Canada and dividend payers.

We also have a North American composite, which returned 15.4%, compared to the benchmark of 12.1%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are just for stocks. Clients with less than 100% in stocks will have proportionately lower returns. These returns are also before fees.

Shrugging off bad news

The stock market has shrugged off so many recent negative events. Take, for example, the blue sweep of the White House and Congress. Stocks rallied strongly against the notion of one party having monopoly power, especially the Democratic Party, which favours tax increases and more regulations. The Democrats have now prevailed, winning both the White House and majorities in Congress. This would seem to be negative for companies – yet it didn't bother the stock market. Other events such as the Capitol intrusion and massive cyberattack on U.S. assets didn't seem to matter, either. Not only that, but the market continues to chug happily along despite high stock valuations, a weak jobs report and a slow vaccination rollout.

Instead, markets focused on the likelihood that vaccines will still ultimately reopen the economy, and that necessary fiscal stimulus is more likely to be forthcoming. These factors, along with a Federal Reserve committed to aggressive quantitative easing for as long as it takes, should all help push 2021 earnings higher. Higher taxes are probably coming in the U.S., but the extent of these are not certain, nor do they appear imminent.

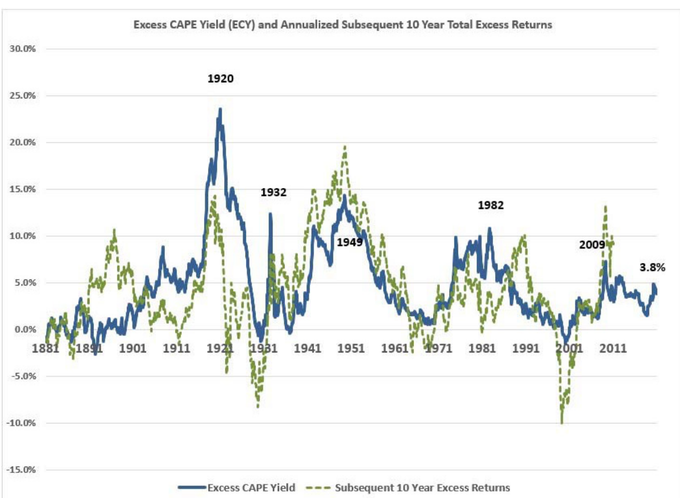
Not a bubble?

The U.S. stock market looks very expensive when compared to trailing 12 months' earnings, but does that mean it's a bubble waiting to burst? The big counter-argument is rock-bottom interest rates. While the market may be in the grips of exuberance, when compared to interest rates it's quite possibly rational exuberance as opposed to irrational exuberance.

Nobel Prize-winning economist and Yale professor Robert J. Shiller, who built a reputation by predicting the market bubbles that burst in 2000 and 2008, writes, "Many have been puzzled that the world's stock markets haven't collapsed in the face of the COVID-19 pandemic and the economic downturn it has wrought. But with interest rates low and likely to stay there, equities will continue to look attractive, particularly when compared to bonds."

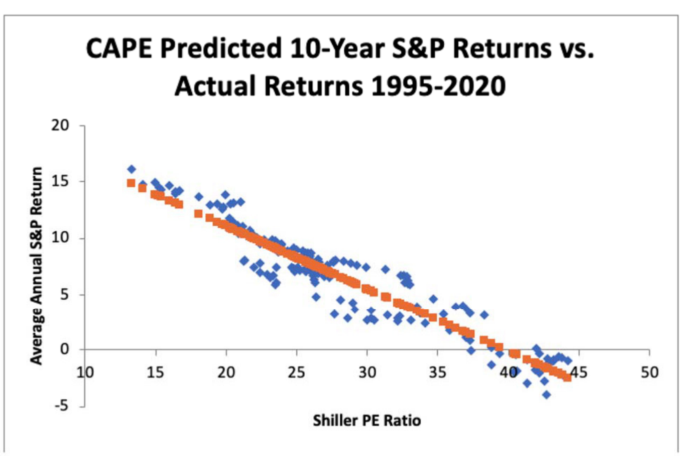
Shiller's famous CAPE (cyclically adjusted price earnings) ratio compares share prices to average inflation-adjusted earnings over the previous 10 years (to even out the effects of the economic cycle). The current CAPE ratio is around 34 times. The only time it was more expensive was near the top of the dot-com bubble. That might seem frightening – until you compare it to interest rates. At the end of 1999, 10-year bonds were yielding about 6%. That was twice as high as the 3% earnings yield on stocks. Today, 10-year bonds are yielding only around 1%. So, bonds are now yielding a third as much as stocks. Viewed this way, it makes stocks seem super cheap in comparison.

By combining CAPE and interest rates into a new factor he calls the "Excess Cape Yield," Shiller shows that this measure has done a great job of predicting subsequent returns over the next 10 years. This suggests that the U.S. market should be in line for real annual returns (i.e., returns above inflation) of about 5% per year for the next decade. If inflation is 2% per year, that would mean stocks would return 7% per year. That doesn't seem so bad. By comparison, bonds yielding 1% per year would be losing 1% per year in real terms.



Source: Robert Shiller

We've pointed out before that the original CAPE ratio on its own has done a reasonable job of predicting long-term returns. The original CAPE is predicting real returns of around 3% per year for the next decade. Combining the two theories, perhaps we should be looking at somewhere between 3% and 5% real returns for stocks, which would equate to 5% to 7% per year if we assume 2% annual inflation.



The key takeaway from the CAPE and the Excess CAPE Yield models is that U.S. stocks, while not cheap, are still very attractive when compared to the low interest rates that may be with us for a while. Down the line, interest rates may rise and equity valuations may be reset. But with high government and private debt levels in almost every corner of the world, there is a limit on how high interest rates can rise. And with the slack that exists in most economies, it will likely be some time before they do rise. So, for the time being, valuations don't look that bad. Shiller made his name by publicly denouncing the dot-com bubble and then the housing bubble, but he isn't prepared to call the current situation a bubble.

On the other hand...

On the other hand, read what Jeremy Grantham, the 82-year-old legendary market seer, has to say: "The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000." These are scary claims! Grantham defines a successful bear market call as simply that "sooner or later there will become a time when an investor is pleased to have been out of the market." His definition of success has nothing to do with precise timing. He further states that overvaluation is a necessary but not sufficient condition for a bubble-bursting, and that precisely calling a market top is all but impossible.

Grantham made a good call by exiting and re-entering the stock market around the Great Financial Crisis, but he was early in calling an exit to the dot-com boom. Grantham says that "valuations aren't the best indicator of a top, it's crazy investor behavior." And he sees a lot of that today, whether it's Bitcoin, higher volumes of small retail purchases, or special purpose acquisition companies (SPACs). SPACs own and do nothing, but hope to buy another business to skip the initial public offering (IPO) process – which kind of reminds you of companies that IPO'd without profits or even revenues in 1999. Grantham also calls out Shiller, one of the few economists he respects. He says Shiller is hedging his bets. Grantham makes the point that Shiller's revised CAPE ratio shows less overvaluation when compared to bonds:

"The one reality that you can never change is that a higher-priced asset will produce a lower return than a lower-priced asset. You can't have your cake and eat it. You can enjoy it now, or you can enjoy it steadily in the distant future, but not both – and the price we pay for having this market go higher and higher is a lower 10-year return from the peak."

Grantham's suggestion is not to avoid stocks altogether. Rather, he notes, there are cheaper stocks such as value stocks around the world, as well as emerging markets. Just avoid U.S. growth stocks, he advises.

Growth vs. value

Growth stocks have meaningfully outperformed value stocks for the last 13 years. Again, we find ourselves asking whether this is a permanent condition. According to investor and writer Howard Marks, most types of investments go through periods of outperformance and underperformance. Marks believes there are many arguments for a resurgence in value investing and also arguments for its permanent impairment. But his key point is that value investing isn't just about finding low-priced stocks. Marks says the goal is to find out what companies are worth and then buy them if they're available for less. The difference, he says, is that value investors shouldn't necessarily shy away from a higher valuation if it can be justified.

At the Stan Clark Financial Team, our stock strategies have a value bias – and they also include a growth/momentum component that has strongly helped their performance, compared to simple value investing. But they have still been negatively affected with value underperforming. We believe the strong trend against value investing will eventually weaken or reverse, which should help our strategies significantly. We have introduced some new strategies to provide a more balanced approach going forward.

Party like it's 1999

The pandemic is raging like never before, yet investors seem to be partying with reckless abandon. Most stock markets are continuing their melt-up into record high territory. As of the end of 2020, the S&P 500, Nasdaq and TSX were up 70.2%, 89.1% and 59.4% respectively from their March 2020 lows.

According to top economist Ed Yardeni, the S&P 500 forward P/E rose to a record 25.7 during July 1999, about nine months before the dot-com bubble burst. At the end of 2020, it was about 22.7, or about 11% cheaper. The forward P/E of the S&P 500 tech sector peaked at 48.3. At the end of 2020, it was 26.0, about 46% cheaper. Thus while the index values are at record territory today, after factoring in earnings they're still high, but not as overvalued compared to the peak of the dot-com bubble.

Yardeni expects the S&P 500 to rise to 4300 (up 14.5%) by the end of 2021 and 4800 by the end of 2022 (up 11.6%). His fear is that we could get to those levels faster than expected, resulting in stretched valuations and markets increasingly vulnerable to a meltdown. Yardeni believes today's valuations can be justified by near-record low interest rates. However, 10-year rates bottomed in August 2020 at 0.52% and have risen to near 1% at the end of 2020. If they rise more, this would make stocks increasingly less attractive in comparison.

Yardeni also believes that now, as in 1999, there are mounting signs of irrational exuberance. Combined with today's ultra-stimulative fiscal and monetary policies, this could lead to the mother of all melt-ups. Consider the following:

1. The blue wave is here. With Democrats in control of the White House and Congress for the next two years, federal stimulus is likely to continue to grow.
2. The U.S. budget deficit is at a record $3.2 trillion. While deficits in the past have caused rates to rise, this has not been the case in recent years. Deficits have risen in every major country, and central banks around the world have helped keep rates low. If rates stay low, as has been promised by the Fed, stocks could rise much more yet.
3. Vaccines are coming. Although cases and deaths continue to skyrocket, and are being made worse with a mutating virus, there is light at the end of the tunnel. While there have been major mistakes made in the initial rollout, these will eventually be sorted and the pandemic will end. This will be a huge relief to many, and could unleash a torrent of pent-up demand and spending later in 2021.

Blue vs. Red

According to Yardeni, the U.S. economy has performed remarkably well despite Washington. Presidents take credit for jobs created, but the reality is that businesses, not politicians, create jobs. Businesses probably do a better job when they aren't burdened by Washington meddling in their affairs. This leads us to believe that the economy and stock market do best when Washington's politicians are gridlocked: Divided government is bullish while unified government is bearish, or at least less bullish.

Many investors assume that a blue wave would be bad, with increased federal spending, rising taxes, more regulations, etc. But high taxes and regulations could be offset by increased business and consumer spending. Plus, we shouldn't assume hugely higher corporate taxes. With a fragile 50/50 majority in Congress, and a growing theme of reconciliation, it seems more likely that any increases could be more symbolic than substantive.

Let's look at the performance of the S&P 500 under unified and divided governments since 1933. In the previous six blue waves, the S&P 500 increased 56% on average. During the three red waves, the index was up 35% on average. During seven periods of divided government, the index was up 60%. This suggests that gridlock is indeed more bullish than the two unified alternatives, which are still bullish but less so, with blue waves more bullish than red waves. Could it be that the government doesn't matter as much as, say, the Fed? Yardeni thinks so, and he also thinks the Fed has much more influence than the politicians. Perhaps the Fed's chair is the most important person in Washington.

Remember, we should be cautious about attributing stock returns to political environments. Even though this study goes back to 1933, that's only 21 data points, not enough to make a meaningful conclusion. Perhaps the real lesson is that we should be careful about making any predictions on the stock market based on politics.

What happens if we finally get inflation?

Interest rates plunged after the Great Financial Crisis. High debt levels, and the slow and steady recovery since then, have helped to keep inflation and interest rates low over the past 12 years. The pandemic-fuelled slack in the labour markets and the economy should help keep rates low for some time to come. But we've also seen an immense amount of government spending, and that looks to continue for at least the first part of this year, especially with a Democratic-controlled U.S. government. With all the fiscal stimulus and pent-up spending, once the economic slack gets taken up we could see ourselves in a situation where spending leads to higher inflation and thus higher interest rates.

If inflation does rise, what will that mean for the stock market? According to Ben Carlson of Ritholtz Wealth Management, the current inflation rate is 1.2%, while the average rate in the 2010s was 1.8%; and, in the 1990s when the economy was strong, 3%. The difference is that in the '90s, inflation was falling over the decade. The chart below shows how the stock market performed under two inflation scenarios from 1928-2019. As you can see, the stock market does much better when inflation is below 3%.

	S&P 500 Returns	
Inflation Rate	**Average**	**Median**
Above 3%	6.3%	6.0%
Below 3%	15.6%	18.2%

Source: Ben Carlson

But the stock market may care more about the *change* in inflation than the *level* of inflation itself. The table below looks at how the market was affected by rising or falling inflation. Historically, it seems the stock market prefers falling inflation than rising inflation.

	S&P 500 Returns	
Inflation Rate	**Average**	**Median**
Rising	6.7%	6.2%
Falling	16.5%	18.9%

Source: Ben Carlson

So, an economic boom with rising inflation could be a risk for stock market returns. Company earnings might benefit from inflation, but this could be more than offset by increased competition from higher interest rates. While rising inflation might cause a drag on stock returns, it would likely be very bad for bond holders as bonds are often severely punished during inflationary periods.

Even if inflation rises, we're still at very low levels, and many central bankers continue to be more worried about deflation than inflation. Indeed, the Fed has been trying hard to get inflation off the ground since the Great Financial Crisis, but it hasn't succeeded yet. Therefore, while we might be at some risk of higher inflation, it cannot be guaranteed. We believe inflation might rise modestly above the 2% targets for a period of two to three years. But given high global debt levels, we see little risk of it rising dramatically.

Looking ahead

The script for 2021 will depend a lot on the speed and success rates of the vaccination programs. This is especially important considering the increased speed with which the virus seems to spread due to mutation. If vaccination goes well, it should help economies recover after such a destructive year for workers and businesses. But a brighter economic future should still be accompanied with caution as valuations are lofty, driven by low interest rates and investor optimism. Most of the good news we've had may already be embedded in today's prices, which is a cause for concern. But low interest rates can justify valuations that otherwise would appear stretched. Remember that rates can change and so can investor emotions. Inflation is also a concern, but more likely a longer-term risk than something just around the corner.

Uncertainty and volatility will always be around. They're just part of investing. But at the Stan Clark Financial Team, our approach will remain consistent – and this includes having a financial plan with an established equity target to help us navigate the future. ■

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