- FINANCIAL LETTER -
SECOND QUARTER 2020

Our current view

At the time of writing, in mid-July 2020, the Coronavirus outbreak seems to be resurfacing – in particular in the United States, India, Brazil, South Africa, but also locally in various other countries – following the deconfinement implemented by governments. The economic outlook has deteriorated considerably in the past few weeks and the World Health Organization predicts that the health crisis caused by the Coronavirus will worsen in many places. The International Monetary Fund lowered its forecasts for this year's world economic growth from -3.0% to -4.9% and for 2021 from +5.8% to +5.4%. Trying to predict the economy, never an easy task, is even more difficult now since the Coronavirus could take very different paths, depending on measures put in place by governments and on medical discoveries. The Bank of Canada has announced that interest rates will remain low for a long time. It estimates in a 'base case scenario' that the Canadian economy will fall by 7.8% in 2020 and will grow by 5.1% in 2021 and 3.7% in 2022. This scenario expects no strong second wave of the Coronavirus, that there will be no vaccine and that the pandemic will be resolved by mid-2022. But the bank warns that a second wave is the biggest risk to its scenario, which would weaken the recovery.

The markets, which had fallen by around 35% from mid-February to March 23, rose sharply by around 46% in the United States and by around 43% in Canada by mid-July, propelled by the massive and unprecedented measures taken by central banks and governments to cushion the shock. Profits for S&P 500 companies in the United States fell about 14% in the first quarter and 22% for S&P TSX companies in Canada. But it was especially the second quarter that suffered the shock of the closing of economies; currently, analysts expect the S&P 500's profits to drop by around 44% over the period from April to June, but the dispersion of forecasts is very large. For the third quarter (June to September) the forecasts expect a 25% decline and a 13% decline for the fourth quarter of 2020. The result is a Price/Earnings ratio (P/E) currently of around 22 on estimated profits for the next 12 months, a very high number.

To reconcile the divergence between rising stock markets and declining profits, we can assume that the markets have decided to look out much further than usual (probably 2 to 3 years instead of 9 to 12 months) and hope that 2021 and 2022 will see a strong recovery in profits. Another element is that interest rates at almost 0% are pushing people to take more risks to achieve their financial goals by buying stocks, driving stock market valuations. Also, in the United States, the S&P 500's P/E is highly distorted by large technology multinationals. Finally, the markets surely expect even more monetary and fiscal stimuli if the pandemic continues.

How to invest

In the short term, we believe the downside risks to the markets are now higher. In June, we sold the equivalent of 49% in dollars of what we had invested in March during the correction. Our sales were concentrated in accounts of customers with a shorter investment horizon. The stocks sold are not necessarily those bought in March.

Most importantly, we are continuing our reflection on what might be the more lasting consequences of the pandemic. Obviously, a scenario with an effective and massively distributed vaccine and a scenario without an effective vaccine should be considered.

In a scenario where no vaccine is successful and no treatment can easily cure or lessen the worst medical effects of the virus, we might think that governments will rely on a gradual control of the infection rate in the hope of reaching collective immunity without overburdening health care systems. This implies targeted social distancing measures and economic restrictions. In this scenario, the economy would take longer to recover and the economic sectors where social distancing is difficult would see their activities restricted for longer (airlines, hotels, restaurants, cinemas and shows, schools, offices, sports, some retailers, etc.) leading to more bankruptcies and restructurings. The airline industry, for example, does not expect a return to normal before 2023. In a scenario where a vaccine is found and produced and administered massively, activity could resume more quickly in the affected sectors.

Even in the event of a vaccine, the difficult question we ask ourselves is: will there be lasting economic or social changes? Some believe that there will be an acceleration of the decarbonization of the economy and transport, more local production of certain products considered essential (reshoring) and an acceleration of the digitalization of the economy.

In either case, it is important to be invested in sectors that can continue to grow in the next decade. These include the bio-pharmaceutical sector, information technology (in particular software), residential construction and renovation, infrastructure, green technologies and renewable energy, logistics / delivery / packaging, food, financial services, certain business services, telecommunications equipment (5G, Wifi 6, Security, IA), etc.

We will have to keep a flexible mind and be even more on the lookout for innovations, because any crisis sparks accelerated changes and often better ways of doing things, leading to the disappearance of companies that are too static. Our portfolio should focus on innovative companies, with an emphasis on research and development; companies with pioneering methods, non-traditional offers and who know how to challenge conventional ideas. **All of our companies must demonstrate a strong culture of innovation, even those operating in traditional sectors.**

(*The following sections are reserved for clients*)