Préfontaine Capital Inc.

- FINANCIAL LETTER -

THIRD QUARTER OF 2020

Outlook

The International Monetary Fund (IMF) forecasts a contraction of the world economy of -4.4% in 2020, better than initially expected (-5.2%) and growth of +5.2% in 2021, slightly worse than initially expected (+5.4%). In Canada, the estimates are -7.1% in 2020 and +5.2% in 2021. In the United States, they are -4.3% and +3.1%. According to the IMF, the 2020-2025 period will only partially catch up to the world production that was forecast before the pandemic. The IMF assumes social distancing measures will remain in place until the end of 2021, after which they are expected to gradually ease in 2022. The IMF warns that the uncertainty surrounding its projections is unusually high. As of September 11, governments around the world have spent US $11.7 trillion or 12% of global GDP, a massive stimulus, resulting in a budget deficit of 9% of global GDP, and cumulative debt of about 100% of global GDP. Central banks, in addition to cutting interest rates, have bought bonds worth US $7.5 trillion. Few economists dispute the merits of these measures, which were necessary to avoid a dangerous downward spiral of the world economy, provoking consequences considered worse than the detrimental long-term effects that these measures and this indebtedness can cause.

In response, equity markets advanced strongly in the third quarter, especially in the United States where the technology sector is dominant. Interest rates practically at 0% and the massive scale of money printing pushed up the price of all assets; central banks have hinted that they expect rates to stay low for years to come. One consequence of rates at almost 0% is that the entire capital market line is lower, because the risk-free rate of return is practically at 0%. Some might also argue that the return premium on risky assets has been compressed by increasing central bank action over the past 10 years, leading investors to now expect to be rescued in every crisis. In addition, low rates increase the valuation of assets with the highest expected growth and, in our opinion, lower their future returns. Finally, the massive indebtedness of governments can only lead to higher taxes and a corresponding compression of corporate profit margins in the years to come. Our view is that investors should lower their expectations on the future returns of all assets, whether they are fixed income, publicly traded stocks, private investments, infrastructure, commodities or real estate. Those who think they can take shelter with private investments, real estate or infrastructure will have to lower their expectations as well; the returns on these assets will also be lower than usual (on top of there being more dollars chasing the same projects and higher intermediary and liquidity risk).

How to invest

In general, it would be misguided in our opinion to increase the risks to try to achieve the returns that we have been accustomed to, especially as this is what the crowds of investors overwhelmingly seem to be doing right now. It is best to play defensively when the vast majority of investors are on the offensive. Thus, we took profits after the sharp rise in the stock markets to create a little more "dry powder". For the next few months, our goal is to be selective and seek out assets offering the best risk-adjusted returns on a relative basis by comparing all of our options. Although the equity markets are currently overvalued in many sectors, some stocks that we track are reasonably priced in our opinion, considering their business risks. All the excitement around tech stocks presents opportunities to invest in less popular stocks that we believe will perform well over the next five to ten years.

We have technology stocks in our portfolio, but we refuse to pay excessive prices based on highly optimistic growth expectations. The gigantic size of Apple, Google (Alphabet), Amazon, Facebook, etc. combined with their very high valuation multiples are worth pondering. For example, a price/earnings multiple of 129x (95x on a one-year expectation basis) for Amazon implies very high expected profit growth for a very long time. With current sales of US $322B, one should project strong sales growth and/or an increase in profit margins, say over 10 years. It seems very unlikely to us that governments would allow a private company to generate profits which represent a high percentage of their national production without intervening to break up that company or regulate away its excess profits. We got a taste of this in Europe and now in the US with the government's announced lawsuit against Google. The Chinese also have an interest in reducing the power of these American companies. In our opinion, mega-tech companies deserve lower valuation multiples than they currently enjoy.

We also try to diversify and calibrate our portfolios to consider different scenarios. We believe it is prudent at this time to assume an extended pandemic as the primary scenario and a long period before an effective and safe vaccine is widely administered (possibly during 2022). However, we do expect improved medical treatments and testing methods in the coming quarters. Finally, we prefer to keep cash reserves in case the second wave of the pandemic accelerates and governments cannot adequately compensate for the lost income, which would bring down the stock markets and allow us to buy quality assets at a better price.

Warren Buffett: 86% of his current fortune was created after the age of sixty-five

We were amazed to learn that US $70B of Warren Buffett's (90 years old) current US $81B fortune was created after he turned sixty-five. This deserves some reflection on our asset allocation. We are not Warren Buffett and every case is different, but always keep in mind that the exponential effect of compounding returns becomes more pronounced later in life.

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