Préfontaine Capital Inc.

- FINANCIAL LETTER -
THIRD QUARTER 2021

Outlook

In its October report, the International Monetary Fund (IMF) slightly reduced its forecast for global growth for 2021 to 5.9% from the 6.0% it expected in July, and for 2022 kept it at 4.9%. The IMF mentions the headwinds of resurgence of new strains of COVID-19 and limited access to vaccines in most countries around the world. It also highlights other challenges, including rising inflation, supply chain disruptions, climate change, food insecurity and shrinking human resources. After 2022, the IMF forecasts global growth of around 3.3% over the medium term.

Real GDP outlook, annual percentage change

	2020	2021	2022
World	-3.1%	5.9%	4.9%
United States	-3.4%	6.0%	5.2%
Canada	-5.3%	5.7%	4.9%
Euro Area	-6.3%	5.0%	4.3%

Although the IMF admits that the outlook for inflation is highly uncertain, it forecasts inflation for advanced economies at 2.8% in 2021 and 2.3% in 2022 and for emerging economies at 5.5% in 2021 and 4.9% in 2022. The IMF expects for the moment that the unusual rise in inflation is temporary and should subside towards the end of 2022.

The annualized rate of inflation in Canada in September was 4.4% (4.1% in August), while in the United States it was 5.4% in September and 5.3% in August. Executives of Canadian banks, unlike the Bank of Canada, believe that there are more structural factors to inflation that could persist after the pandemic: in particular, the aging of the population combined with a drop in immigration which reduces the labor pool; restructuring of global supply chains towards more local production; the fight against climate change which will increase energy costs.

The stock markets continued to advance in the third quarter with an increase of 0.2% in Canada and 2.9% for the S&P 500 (in CAD). Stock market valuations are very high compared to their historical average (current 12-month price-to-earnings ratio of around 30x for the S&P 500 vs a long-term average of around 16x), reflecting interest rates at 0% and the absence of a fixed income alternative. This is 87% higher than the historical average.

How to invest

Those who have been invested with us for a long time know that we tend to be more cautious when things are going well in the stock market but more optimistic when things are going badly. Currently, we are more cautious because there is a huge excess of liquidity created by central banks, which prompts those who have capital to often buy anything at any price. In addition, governments are spending more than ever, especially on transfers to citizens who have more money to buy consumer goods. These two trends happening at the same time are inflationary for both the value of assets and that of consumer goods. In such an environment, we weigh risks even more carefully. The two main risks for the short and medium term on the stock market in our view are firstly, a persistent rise in inflation which could lead to more severe and more pronounced monetary tightening than what the markets are currently perceiving, which could then cause the stock markets to fall. The fact that the US and European central banks announced for the first time that they wanted to withdraw liquidity at the same time could accentuate this fall. The US Federal Reserve plans to reduce its bond purchases (currently $120B per month) by $15B per month starting in November until exhausted in eight months (July 2022) and then to raise interest rates depending on the level of inflation. The second risk in our view is a persistence of the pandemic with new variants taking hold in countries with low vaccination rates.

An environment where the risks of a shock are perhaps underestimated and where stock market valuations are generally high militates for a gradual reduction of the allocation to equities, especially for those whose investment horizon is shorter. During 2021, we reduced our exposure to equities in many accounts as they increased in value (on average we made a return of 17.5% on a year-to-date basis as of September 30, 2021), so that at the consolidated level, at the end of September, we are 2.1% lower in equities (71.2%) than in January (73.3%). If we hadn't sold, we would be at approximately 76.3% in equities on a consolidated basis. We will continue to gradually reduce equities if stock markets continue to increase, to rebalance portfolios and increase our safety cushion. We reduce the securities that we consider the most expensive based on the expected return / risk ratio and their concentration in each portfolio.

This does not preclude us buying the stocks of high-quality companies if they are in our opinion at acceptable prices and depending on the allocation of equities in each portfolio and the individual circumstances of each family. Indeed, in a period of higher inflation, being invested in dominant companies that can increase their prices is one of the best strategies. In addition to following up on each of the portfolio companies, we have in recent quarters studied to accumulate knowledge in different industries, including power generation and transmission (and their suppliers), mergers & acquisitions and restructuring advisory, home health services, media & entertainment (content creators) and home builders. Our primary objective is the resilience of our portfolios to shocks. There have always been shocks and there will be more in the future. We are therefore looking for exceptionally well-managed companies in new sectors of economic activity to strengthen our diversification.

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