It's safe to say that 2020 will have a lasting imprint on our memories. The COVID-19 virus has affected almost everyone around the world in some way or another. The "lucky" ones have had to distance themselves from friends and family, turn their dining rooms into home offices, and adapt to face masks as a daily wardrobe piece. The unlucky ones have lost their jobs or their businesses, have become ill, or worse, have succumbed to the virus, often alone and isolated from family. There are few other events in history that have had such a wide-reaching impact.

While we are now many months past the initial shock and life has evolved into somewhat of a new normal, we recognize that there are many lingering uncertainties that may be contributing to a heightened sense of anxiety or unease. Other than the current health crisis which is top of mind for most, the world remains in a global recession of historic proportions, and financial markets and investment portfolios have been subjected to intense levels of volatility. The following sections will briefly discuss the current landscape of each of these themes and provide some clarity and perspective on where we're at.

COVID-19

COVID-19 is the most significant and pervasive source of uncertainty present today and its future path will be highly influential to most parts of our lives. It is clear that the pandemic will need to be controlled or conquered before life can go back to "normal". Unfortunately, as we enter the fall season, it appears that Canada and other nations are beginning to experience a rising level of new cases – a possible second wave. It remains to be seen if a potential second wave will ultimately result in stricter lockdown measures similar to those imposed earlier in the year – with the associated implications.

The good news is that we are better prepared now compared to the initial days of the pandemic as the virus is understood to a greater degree, hospitals and manufacturers have had some time to build out capacity and catch up to demand for personal protective equipment, and daily mask use is common in public spaces. Significant investments are also being made into developing a vaccine, with current estimates by the World Health Organization for widespread vaccinations beginning in mid-2021.

As of early October, there are eleven vaccines in "phase 3" trials – the final testing stage before full approval. Phase 3 trials involve testing on thousands of people in order to confirm its safety and effectiveness, and to identify any rare side effects. As vaccines are approved, the main priority will be to produce at scale and distribute efficiently.

In the meantime, it is important to remain diligent by following proper safety precautions and listening to the advice of our health experts.

Global Recession

The global economy was pushed into the deepest recession since World War II as a side effect of the necessary steps taken to contain the pandemic this year. Although we may be through the worst of it, millions of people remain unemployed and many businesses – especially small businesses – have suffered severely. According to a recent survey[1], only 70% of Canadian small businesses have fully reopened, 42% are fully staffed, and more than two-thirds have not returned to prior sales levels. Recent reports of significant job cuts at large multinational companies also suggest that some of the

[1] https://www.newswire.ca/news-releases/small-business-faces-unsustainable-l-shaped-recovery-if-sales-remain-at-a-crawl-806741721.html

initial temporary layoffs will be more permanent in nature. It is understandable that people may be concerned about job security or the stability of their business at this time.

In order to mitigate some of these negative economic impacts, central banks and governments have stepped in to provide massive amounts of monetary and fiscal stimulus, and are expected to continue to do so until the economy is back on track. Some of the fiscal programs include enhanced unemployment benefits, wage subsidies, and interest free loans to struggling businesses. Interest rates are likely to remain low for at least a few years, allowing individuals, businesses, and governments to more easily service higher levels of debt.

Going forward, recovery on the economic front will be influenced by recovery on the pandemic front. Further pandemic-related shutdowns will slow or reverse the economic recovery that has already begun while virus containment and vaccine progress will accelerate the recovery. Because the current recession was induced due to an external event, unlike most recessions which are caused by policy decisions or fundamental imbalances in the economy, economic activity has the potential to bounce back more quickly, in theory – a "V" shaped recovery. Economic data throughout the summer was largely positive and seemed to support a quick recovery but more recent data indicates a slowing pace of recovery, possibly influenced by rising COVID infections. At this point it is still too early to tell if a "V" shaped economic recovery will be achieved.

Financial Markets

Global equity markets have experienced extreme volatility during 2020, both on the downside and on the upside. As of early October, equity markets have mostly recovered from the steep declines experienced in March, with some developed economy stock market indices posting positive returns overall for 2020 so far. How can this be the case when millions are still unemployed and growth expectations are well below pre-pandemic levels?

The stock market is not the economy – it merely represents a collection of publicly traded companies and their values in the market. A market index is comprised of a sample of those publicly traded companies intended to represent the entire stock market of a particular region or market segment. The commonly followed S&P 500 Index is an example of an index that is intended to represent the U.S. stock market for large and developed companies. The economy is much more expansive and relates to the broader production and consumption activities and overall "health" of a system. For example, the U.S. economy not only encompasses publicly traded companies (i.e. the stock market), it also includes private businesses, government, and consumers. The economic activity within publicly traded companies (i.e. the stock market) does not represent the majority of all economic activity.

In order to understand what is driving stock market index performance, we need to understand what that index is composed of and what influences valuation levels in general. For example, the S&P 500 Index is comprised of 500 large U.S. based companies weighted by size (total value of shares or market capitalization). The composition of those 500 stocks changes over time as companies are added to or deleted from the index as per a committee selection process, and as the individual weighting of each company in the index fluctuates based on their market capitalization. As a result, the S&P 500 today looks very different than the S&P 500 thirty years ago.

In recent years, the S&P 500 has trended towards a higher concentration in the technology sector in general, which now represents approximately 28% of the index compared to 16% just five years ago. Additionally, the concentration within the top five largest companies is at historically high levels with the FAAMG stocks (Facebook, Apple, Amazon, Microsoft, Google) accounting for over 22% of the index. These index changes represent a shift towards companies that are typically more "growth" style investment based versus "value" style based. This shift is important to understand in order to interpret the performance of the overall index.

Continuing with the S&P 500 example, key drivers of the swift market recovery this year include:

- **Technology Outperformance:** Technology related companies have benefitted as consumers and businesses adapted to physical distancing measures through online shopping, software services, and digital entertainment. While this has resulted in generally increased profits for these companies, valuations have risen at a faster pace. In other words, prices have risen significantly, outpacing the underlying fundamentals and accordingly have become more "expensive".
- **Forward Looking vs. Backward Looking:** Financial markets are driven by expectations about the future whereas economic data is historically focused. Markets are looking ahead to an eventual economic recovery and greater pandemic control.
- **Low Interest Rates:** Interest rates are at historically low levels and are expected to remain there for a number of years. Low rates provide incentive to investors to move away from fixed income markets and towards equity markets in search of higher returns. Higher demand for equities supports positive performance but can also increase stock prices ahead of fundamental values. This is accelerated for stocks where future growth expectations are high. Accordingly, this has an even more pronounced effect on "growth" style investments as a higher proportion of the stock price is based on expected (but not certain) growth of cash flows in the future.
- **Large Cap vs. Small Cap:** Large capitalization companies have fared better than smaller companies as they have a greater ability to withstand short term issues and have better access to financing and liquidity.

As a result of these factors, equity performance has been strong but valuation (i.e. how expensive a stock is) levels have increased. While this is most pronounced in the U.S. equity market, it is a common theme among most developed markets to varying degrees. Going forward, an increased level of risk exists as high valuations can be subject to quick reversals.

Another source of potential volatility in the near term is the U.S. election, which is likely to be contentious and more emotionally charged than previous elections. Our next newsletter will discuss the election in further detail. Regardless of the result, any additional associated volatility in the capital markets can be expected to be short lived.

At Quadrant, we believe that it is particularly important at this time to manage downside risk as well as exposure to unwarranted valuation levels in certain segments of the equity market. Our best in class managers are diligent in this regard and operate with a long-term focus. Investors should also remember that properly structured investment portfolios tailored to their personal circumstances are built to withstand volatility and market turbulence over time.

We are certainly living through unusual times and understand that there is no shortage of things to feel anxious about. During times like this it is useful to concentrate efforts on things that we can control versus things that are out of our control. At Quadrant we are focused on staying healthy, communicating with our clients, ensuring wealth plans are up to date and on track, and managing risk with respect to investment portfolios.

We sincerely hope you and your families are staying well. We are ready and available to assist you in any way possible.

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