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Investing in the Eye of the COVID Storm

By Drummond Brodeur, Senior Vice-President and Global Strategist
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We enter the second quarter in a virtual lockdown as the world reels from the impact of the global COVID-19 pandemic. Having exploded across China in February, the virus spread quickly through the developed world in March and, we fear, may continue to make explosive inroads into many emerging economies in the coming month(s). It has been and continues to be an unprecedented shock to society, to economies and to markets. It has and will continue to impact just about everyone in a multitude of ways well into the future. At Signature, as portfolio managers entrusted with managing the savings of our clients, our job is to cut through the uncertainty and turmoil specifically as it pertains to asset markets. As we seek to navigate the investment implications from these unfolding events, it is important to stress the unprecedented nature of the shock. Hence, there is way more that we do not understand or know than we do. We are acutely aware of this fact, and it is a factor in all our discussions and in the actions we have undertaken across our portfolios. But we also spend a lot of time and effort to cut through the noise to determine what is based on facts and supported by data vs what is mere conjecture, driven more often by fear and emotion. This is particularly true when it comes to understanding likely paths forward for the virus itself. From my perspective, there has been a distinct lack of fact-based analysis on many public news sites and from many elected officials. While I have not seen evidence of strong leadership from our elected officials in terms of their public communications, at least in Canada we have, thankfully, seen a far better public policy response, despite much of the communication being driven by emotion and fear of worst-case scenarios rather than reasoned analysis of the underlying data.

The Signature investment philosophy has always revolved around a delegated specialist model whereby our team of investment specialists can achieve a far deeper understanding of their respective industries and asset classes than our more generalist competitors. This specialist approach has helped immensely as the current pandemic has unfolded. Within the Signature team we are fortunate to have Dr. Jeff Elliott as head of our health care investment team. With a PhD in Molecular Biology and Biochemistry, Jeff is uniquely positioned to help our team focus clearly on the actual data and the potential and likely paths for the pandemic. We have benefited greatly from daily briefings by Jeff as the crisis has unfolded. Understanding the path of the virus will continue to be an important input into assessing likely market outcomes. My purpose here is not to spend a lot of time on the virus itself, but rather to assess the economic, market and policy responses related to the pandemic. For a more in-depth look at the virus itself, Jeff has published a couple of pieces on our blog site.

The pandemic is best thought of as an exogenous shock that is triggering a dramatic collapse in global economic activity. One thing we know about fighting the spread of the virus is that physical distancing does work. Hence, the overall policy approach being adopted is akin to economic chemotherapy, as we shut down the economy in the hopes that the spread of the virus can be curtailed before the underlying economy is damaged beyond its ability to be resurrected. This is unlike any recession we have previously experienced, and therefore so will be the path forward. The depth of the economic contraction, the duration, the pace of recovery, and the level of economic activity that eventually returns are all critically important variables in assessing how to invest. Unfortunately, all are also impossible to know.

Also unknown is the full extent and efficacy of various government policy responses that are being ramped up on a truly spectacular scale – measured in the multiple trillions of dollars. Current fiscal policies being implemented, particularly in North America, are designed to bridge the economy across the shutdown by replacing the lost income of households and businesses with government handouts. This is being done in the hope that most households and businesses will be able to re-start when we re-open the economies (i.e. keep the patient alive until we can get back to business). It is important to note that this is not economic stimulus designed to boost economic growth, but rather to replace lost income during the shutdown. Other things being equal it would suggest that economic growth on the other side of the shutdown will be slower than before the crisis. Not all sectors, businesses and jobs will return at the same pace, and many will be gone forever. I expect the combined impact from both the virus and the resulting fiscal and monetary stimulus announced to date will be deflationary over the long term, not inflationary as global output gaps widen significantly.

At Signature, we are conceptually categorizing the economic effects into three buckets – demand destruction, demand deferral, and demand enhancement – as a framework to understand what the economic landscape, and hence investment opportunities, will look like as we emerge on the other side of the crisis. While we do not know how deep or long the contraction will be, we do have some guideposts that can inform our thinking. We have seen the progression of the virus curtailed through economic lockdown in China and Korea, and today both countries are well on their way to re-opening their economies. Economic lockdowns in Europe outside of the U.K. appear to have halted the pace of the spread. There are tentative signs of infections plateauing and rolling over in several European countries, leading to early discussions of when and how to begin a re-opening process. Infections in the U.K., which was slower to lockdown, are still accelerating, while in the U.S., the lack of any consistent national action has led to a patchwork of differing state-by-state measures and pace of infections. While

New York remains the epicentre, other regions are rising fast. Nevertheless, the White House appears to be pushing hard to re-start the economy and we are likely to see some form of a rolling re-start by late April/early May. The strategy of shutting down to slow the virus spread then re-starting appears to be effective, but there are clear execution risks that can have significant consequences. We have seen this in countries that did not implement effective and timely shutdowns, and there is a significant risk of virus re-acceleration if relaxation of the shutdown measures come too soon or are not effectively managed.

Into the abyss

With the unknowns clearly in mind, it is reasonable to expect that many countries will re-start their economies later this month or in May, with a staged economic ramp into summertime. This would allow them to enter the fall back on their feet, a little unsteady and badly bruised in places, but back on a slower-but-positive trend growth path. In fact, I would expect to see an initial growth spurt as deferred expenditures catch up (everyone will need a haircut or root touch-up!) before settling back down to a slower trend path in 2021 with some permanently altered behaviour patterns. Questions around whether the economic recovery will be V, U, L or W-shaped are, in my opinion, misplaced. The economy has literally fallen off a cliff and is plunging to an unknown and unprecedented depth. It will bottom and rebound beginning on the day we start to re-open the economy. The initial bounce will be sharp and very much V-shaped, but there is no way we will see the overall level of GDP return to its pre-crisis level for quite some time. A virus relapse also poses the potential need to return to a lockdown position precipitating a W-type economy, but increased testing and research about the virus could result in a far more targeted shutdown approach. Even though the drop in GDP will open a significant output gap in developed economies which theoretically could enable a period of faster growth as we catch up, I expect that beyond the bounce, there will be more lasting adverse impacts from the crisis that will lead to a lower trend growth rate well into 2021/22.

In a world where the global economy is back up and running by the fourth quarter, we can start to frame what the new normal environment might look like as we enter 2021 to help guide our portfolio positioning. Two key expectations for the new normal that I believe are relevant are: 1. trend growth will be slower everywhere, and 2. interest rates are now at ZERO across the developed world and are unlikely to increase any time soon. We are now truly living in a slow growth, ZERO interest rate world. For savers this is a massively challenging world of pain, as we have discussed before. Both structural growth and sustainable income will be increasingly scarce. Here is a simple investment guideline: buy what is scarce; it will attract a premium. With sustainable growth and sustainable income increasingly scarce, we want to tilt portfolios

heavily towards those companies and assets that can deliver either (or ideally both) sustainable growth or income, and away from those that generate no growth and no income.

The eye of the storm

The title of this piece, Investing in The Eye of the Covid Storm, refers to the economic storm we are tipping into and the significant unknows that still lie ahead. I have provided a framework for how we at Signature are thinking about what is coming and how we are positioning our portfolios in response. We recognize that the fundamental impact on the economy and earnings are a significant concern in the minds of most investors, with many fearful of investing before the storm has even hit. That is a fair point. But missed by many fundamental investors is that to be in the eye of the storm implies we have already gone through a storm. Indeed, the Covid pandemic unleashed two massive storms – the first being a market liquidity collapse, the second the upcoming economic collapse. And there have been two massive policy responses to these, the first being monetary policies from global central banks aimed squarely (and successfully) at the liquidity crisis, the second being the massive fiscal response now rolling out to bridge both household and small business incomes, and relief for severely impacted sectors (such as airlines).

Having discussed our thought process regarding the upcoming economic impact, I want to turn to how we have navigated the initial liquidity storm that lashed capital markets through the latter half of March, as evidence of the global spread of the Covid pandemic unleashed waves of panic everywhere. Mass shortages of toilet paper emerged as everyone rushed out to stock up and hoard basic essentials. Images of empty shelves dominated newscasts. There was, in fact, no shortage of toilet paper but stores only stock enough for regular demand patterns. When everyone tries to buy at the same time there is nowhere near enough on the shelves, but there is plenty in the broader supply chain; it just takes time to re-stock (it is available in stores now). As shelves were re-stocked peak panic subsided, and price gouging dissipated. The toilet paper crisis was a very visible and easy panic to understand. Less obvious is that the exact same panic unfolded across capital markets as the virus jumped around the globe. As everyone attempted to hoard cash, liquidity disappeared, and capital markets began shutting down as no one was willing to provide capital. Funding channels closed, spreads widened dramatically as forced sellers found no buyers, and money market, investment-grade credit and high-yield markets all effectively shut down. Even some U.S. Treasury ETFs were reportedly trading at discounts to NAV of up to 5%! That is a mind-blowing scenario and illustrative of the scale of the liquidity crisis and degree of market dislocation the panic had created.

The Fed and the bazooka

Central banks were created primarily for one purpose: to be the lender of last resort. To step up and provide liquidity in the face of a bank run and prevent a liquidity crisis from becoming solvency crisis. While banks are not the cause of the current crisis as they were in 2008, the effect is the same. The U.S. Federal Reserve (Fed) has seen this before, and they wasted little time in rolling out the 2008 playbook – and more. The Fed response has been fast and massive in scale: provide liquidity to all, re-open capital markets at any cost, and do whatever it takes to prevent the liquidity crisis from morphing into a solvency crisis and imploding the entire economic system. Interest rates dropped straight to zero, and trillions of dollars were made available to flood liquidity throughout the financial system to ensure markets could re-open and that companies and households could access liquidity, roll over debt, refinance etc. We give a huge hat tip to the Fed and other central banks around the world for nipping the pending liquidity crisis. It worked and beginning the week of March 23 we have seen a progressive re-opening of capital markets including record investment-grade issuance and even new high-yield issuance over the past two weeks.

As liquidity returned to markets and panic subsided, we have seen ongoing normalization in many markets and the return of more accurate price discovery. Significantly elevated uncertainty remains around the fundamentals and how those risks should be priced, but there is no longer the uncertainty as to whether capital markets would continue to function as an effective price discovery mechanism. Credit spreads remain wider than pre-crisis and equity markets are significantly lower, as is appropriate. But markets are returning to functioning in a rational manner with enough liquidity to enable participants to transact as buyers or sellers at prices that reflect their outlook. For a market to function, liquidity must be available on both sides of the trade. Commensurate with markets returning to normal, the VIX, a volatility index often referred to as the fear index for the S&P 500 Index, has fallen by half, having spiked from 15 to 80 and now sitting below 45. This level is still very elevated, reflecting the coming economic storm, but well down from the lashings of the now-departing liquidity storm.

Trust in our signals

For Signature, financial market conditions have always been central to our core market views. When markets are wide open or opening, it is a signal to engage risk. When markets are stressed, closed or closing, it is a signal to protect capital. It is very rare to experience a full seizing of capital markets as we saw in March, and such events can present a once in a decade or two-type of buying opportunity for select asset classes or securities. We may see further significant broad drawdowns in asset markets in coming months, but for many asset classes and securities, particularly those closely tied to credit markets (for example, bond proxies and REITs) and those whose balance sheets are robust enough to withstand the economic

shutdown, the 30-50%+ sell-down left many with dividend yields upwards of 7-8%. For companies where the dividend is expected to be secure, an 8% dividend yield is not sustainable when rates are at ZERO. If the dividend is not cut, the stock price will rise – a lot. While many dividends will be cut, where they look sustainable you just have to act.

We were fortunate to have come into 2020 with a defensive posture across our funds, underweight equities, overweight rates and holding some gold. We clearly had not forecast a pandemic but were luckily already defensive. As the liquidity crisis unfolded and as it became apparent that the Fed was pulling out the 2008 playbook, we re-engaged in equities. Having been at 53% equity weight in Signature Global Income & Growth Fund, we have added roughly 10% to take us up to 64%. For the first time in over a year this mandate is overweight equities relative to our 60% neutral level. We have also reduced our government bond exposure below 20%, close to our lower bound.

Our decisions were driven by the belief that the liquidity crisis discounts in markets were exaggerating the fundamental risks from the unfolding pandemic and we wanted exposure as financial stress eased in the face of the unprecedented policy responses, both monetary and fiscal. For many equity markets and companies, a 20% price correction from pre-crisis levels may make sense, but many were down 30-50% or more, which looked too cheap to us. We still have a long way to go before the full economic impact of the pandemic is known, and I expect markets will continue to bounce around for months to come, potentially retesting recent lows. I expect markets will find a broad sideways trading range, perhaps between 2400 and 2800 for the S&P 500. I also expect we would look to trim equities at the upper end of the range and re-engage at the lower end. I see no reason to chase rallies beyond the initial bounce of March, as many challenges remain ahead. While we are cautiously hopeful regarding the future trajectory of the virus and hence economies, we are by no means confident and want to respect the elevated nature of the risks, and how much we don’t know about the path in the coming several months as we sail into uncharted territory.

Source: Bloomberg Finance L.P. and Signature Global Asset Management, as at April 10, 2020.

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