Market Update

May 2020 : The Continuing Rally

The market has continued its rally, now on its ninth week. From the panic selling lows of March 23 the Canadian markets have risen 35% and the US markets have risen 36%. They are now down year-to-date only 11% and 6%.

As a result, the question still most often asked is whether this rally has gone too far? Too fast?

Last month we discussed the fact that the market was being led higher by only a handful of companies and that entire assets classes have barely experienced the rebound. This remains true. Preferred shares, Small Cap, Emerging Markets, Real Estate, and more, have only rebounded slightly. Such a 'narrow' rally is not a healthy sign. Only in the last week have we started to see a small indication of a more broad based rebound that signifies a market recovery.

However, this month I would like to consider the possibilities that while such a rally is not preferable, the market may be fairly valued and in fact may still have legs and rise further.

1. Valuations may be fair

Earnings (profit) are obviously key to the value of any company, and as discussed previously, investors weigh the expected future earnings of a company to determine its value. So let us consider this today, looking at the expected earnings of the US index.

Not surprising, second-quarter results for the S&P500 index are expected to be terrible. According to FactSet, second-quarter earnings are expected to plunge approximately 42% on average. Therefore if we earned $1 in the second quarter last year we are going to earn only 58 cents this quarter. While terrible, this is not nearly as bad as was expected in March.

So let us consider the possibility that the second quarter earnings repeats throughout 2020 but that 2021 returns to the earnings figures posted in 2019 (note clearly that this would only occur

with some companies providing much larger earnings than they did in 2019 to replace the earnings of those companies providing far less). In this case, using a present value calculation, the value of the index should be down 7%.

However, if the poor earnings of 2020 are replicated in 2021 then the market should be down 20%.

We are within this range (-7% to -20%) but clearly leaning to the former, more optimistic future. We would expect that the market will bounce around within this range until we gain more clarity.

2. Interest Rate are extremely low and staying low

However, the present value calculation done above used an expected return of 10% - the long term average of the stock market.

This 10% can be viewed as a 5% premium over the long term 30 year bond average yield of 5%. But today's 30 year bond is yielding 1.4%, so we should use a 6.4% return.

This 10% can also be viewed as a 6.5% premium over the long term rate of inflation of 3.5%. But today's inflation rate is about 1.5% so we should use 8.0%

If we do the above valuation calculations using 6.5% instead of 10%, the present value calculation results point to the index being down between 6% and 14%. This is where we are.

Lastly, with rates so low, many investors are choosing to buy dividend stocks instead of bonds. The S&P500 dividend yield is 2% while a 5 year bond yields only 0.3%, a 10 year bond yields only 0.65% and a 30 year bond yields only 1.4%. With rates staying low longer, more and more investable assets will end up in the stock market. There is simply nowhere else to go.

Governments and Central Banks are inflating asset prices

Importantly, central banks around the world have provided large (huge) amounts of funds to help companies and individuals get through the pandemic. One of the results has been the inflation of asset prices as more money gets invested. In fact, one study claimed that a third of the amount mailed out through government cheques has made its way into the markets.

There is an adage "Don't fight the Fed". In short this is a recommendation not to take a position opposite the Federal Reserve. If the Feds want to inflate asset prices and bring down interest rates and keep them low, it is best to invest in line with them.

Therefore, as long as the government continues to provide financial support, we may see the markets continue to rise.

Looking Forward

While countries are opening up and the markets have taken this as a positive sign (which it is) we still have a long way to go. Some countries are seeing an increase in cases and considering if and how to impose a second quarantine. So while any news of a possible vaccine or an advance in treatment will drive the markets higher, we can also expect to see their failure and any unexpected increase in cases drive the markets lower. We expect this volatility to continue.

As for investing, we like the positions we hold and do not wish to sell. In fact we are continuing to buy, though selectively. Many stocks and bonds are inexpensive, and we remain convinced that superior companies and investments will rebound in time, providing attractive long-term returns. Our managers have divided the world into those that will emerge stronger, those that are not affected, and those that will take a long time (if ever) to recover. Buying the first, holding the second and selling the third grouping has been their focus for the past several weeks and we look forward to the future. In the meantime we remain focused, selective and patient.

For the Month, the bond market was up 0.2%, the Canadian market was up 1.9%, the US market was up 4.8%, International markets were up 5.8%, the Emerging markets were up 2.2%, the Real Estate market was up 1.0% and the preferred market was down 1.6%. (Reuters 5/31/20)

Year-to-date, the bond market was up 5.4%, the Canadian market was down 8.8%, the US market was down 5.7%, International markets were down 13.6%, the Emerging markets were down 9.1%, the Real Estate market was down 23.1% and the preferred market was down 15.1%. (Reuters 5/31/20)

Have a great month and let us know if there is anything we can do for you,

- Meir

Meir J. Rotenberg, MBA, CFA®
Vice President & Investment Advisor
meir.rotenberg@td.com

Adam D. Shona, B.Comm
Associate Investment Advisor
T: 416 512 7645
adam.shona@td.com

Nelson Gordon
Client Service Associate
T: 416 512 6813
nelson.gordon@td.com

TD Wealth Private Investment Advice
5140 Yonge Street, Suite 1600
North York, Ontario M2N 6L7
Tel: 416 512 6689
Fax: 416 512 6224
Cell: 416 602 1614
Toll: 800 382 4964

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