Recovery Mode

What a difference a few months can make. An optimistic start to 2020 that promised an extended economic cycle and buoyant equity markets turned for the worse in late February when it was clear that COVID-19 couldn't be contained and the tragedy of a global pandemic was inevitable. Now, heading into the second half of the year, the global economy is beginning to recover from one of the deepest recessions in history and, after a solid rally off the March bottom, markets are on more solid footing.

Members of AGF's Office of the Chief Investment Officer recently sat down to discuss the ongoing crisis and what investors should expect over the next six months as it continues to play out.

Questions and answers that follow have been edited for clarity and length.

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>
> **– Kevin McCreadie**

The COVID-19 pandemic will go down as one of the most extreme economic and market crises in history. What stands out most about the past few months?

Kevin McCreadie (KM): There was a lot to look forward to at the start of the year. Phase one of the U.S.-China trade deal was done, Brexit was no longer an imminent risk and green shoots were starting to re-emerge, suggesting there were still a few more innings left in the already-extended economic cycle. But then COVID-19 hit and everything changed. Not immediately, however, as there was a good deal of complacency early on, but once it was clear that the initial outbreak wasn't contained and that economies around the world were going to shut down to keep the pandemic from spreading further, that's when panic started to set in. In fact, you could argue that the black swan event that caused the crisis wasn't the virus itself, but the economic lockdown that followed. I'm not sure anyone saw that coming. So, it's been a gut-wrenching few months, but it looks like we may be through the worst of it. Of course, that will depend on whether we can fully move on from the pandemic and one of the questions facing investors heading into the back half of the year is how quickly and seamlessly the economy can recover from the deep recession suffered in the second quarter.

David Stonehouse (DS): The extent of the economic downturn has been remarkable. The past three months will end up being the worst quarter of U.S. growth in over 250 years and so this has been a period of depression not just recession, by many standards. Given that, the policy response is what has stood out to me perhaps most. Not only did governments do what was necessary to keep the pandemic from spreading uncontrollably, they also recognized the gaping hole in the economy that lockdown actions would leave and acted swiftly alongside central banks to provide aid to households and small businesses, as well as the necessary stimulus to keep markets operating smoothly.

Stephen Way (SW): Usually we're well into a recession before fiscal initiatives are initiated in any big fashion like they have been this time around. And even though we're going through a very deep contraction, the fact that we've frontloaded it with so much stimulus makes for a very different environment. It's a large part of why we've seen equity markets bounce back so strongly off the March bottom.

Mark Stacey (MS): There have been a lot of comparisons made to the Great Financial Crisis and one of the big differences between now and then has been the speed of the response. The U.S. Federal Reserve, in particular, hasn't hesitated in applying the lessons it learned in 2008-09 and largely because of that, markets have rebounded swiftly and have not retested the March lows. The response in factors has been equally swift. Risk-off factors such as low-beta, large-cap stocks performed relatively well into the March lows whereas risk-on factors such as high-beta, small-cap stocks have performed better off the market bottom.

John Christofilos (JC): It really has been a mixed bag when it comes to markets so far this year. When you consider things like trading volume or bid/ask spreads, the year started on a very positive note, but then turned sour from late February through early April with spreads blowing out and liquidity drying up. It was a very difficult time to execute trades, but since then, spreads have narrowed

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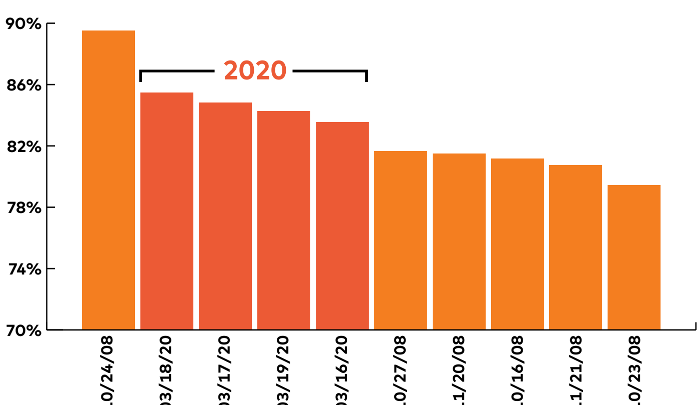
again, liquidity is good, and volumes are extremely strong because of the increase in retail participation we're seeing today. Sentiment has also oscillated from bullish to bearish and back to bullish over the past six months and cash positions have fluctuated in equal measure.

Rune Sollihaug (RS): It has been an interesting ride. From a risk perspective, it's required greater focus to analyze our portfolios given the heightened volatility—especially early in the crisis. The CBOE Volatility Index (VIX), for example, was at one point well above 80 for the first time since the Great Financial Crisis. In fact, the only time its been higher was on October 24, 2008, [otherwise known as Bloody Friday.] But then the sharp rebound in stocks has been equally amazing, especially on the growth side, where more than a few names are near or at all-time highs again.

CBOE Volatility Index (VIX):
Top 10 Highest Levels Reached Since 1990



Source: Chicago Board Options Exchange as of June 24, 2020.

Regarding the global economy, will the second half of the year be defined by recession or recovery?

DS: It may be less a question of recession-versus-recovery than it is recovery-versus-relapse. It's very unlikely that GDP growth gets worse than it was in the second quarter going forward into the third and fourth quarters of the year. If we do get a relapse, it's most likely to be caused by the pandemic coming back in a significant way or by a serious policy miscue, which seems unlikely given just how committed governments and central banks are in getting us through the crisis. Even then, anything that is negative from this point forward is likely to be more of an aftershock than the original shock. Think of a five or six magnitude on the Richter scale as opposed to the eight or nine that we just experienced.

MS: I think it's a recovery story. The question is what shape it will take. Will it be a V-recovery, or U, or W? A lot of that will depend on whether there is a second wave of infections and enough policy support going forward, but clearly this experience has impacted consumer behaviour and that's also going to play a role in how quickly the recovery unfolds and what parts of the economy rebound more or less than others.

RS: A second wave of the virus is a risk in the fall—especially without a vaccine in place. I don't think we'll see another shutdown of the economy on the same scale that we just experienced if that happens, but even isolated restrictions could hinder the strength of the economy. Meanwhile, there are parts of the economy including the entertainment and sports industries that won't be the same even if the re-start continues without too much of a

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hitch. There's also a lot of small businesses and mom and pop shops struggling today that may not make it through so any recovery from here is likely to be rocky.

How do you see the rest of the year unfolding for stock markets given this backdrop?

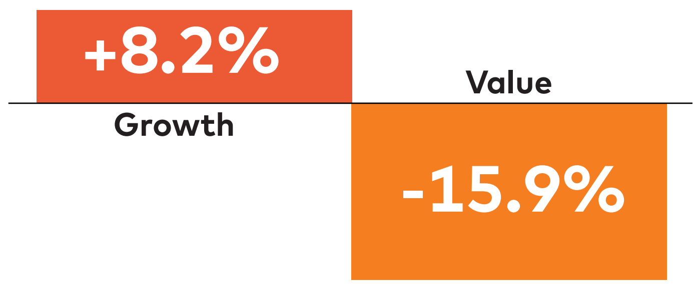
JC: I believe stock markets will be higher by the end of the year and don't see a retest of March lows or major correction happening. It'll be volatile and we may experience some smaller, single-digit pullbacks, but there's too much support for markets to collapse again like they did back in late February and March.

SW: That's my view as well. The environment should remain supportive of equities and global stock markets, on average, should be higher, at least 12 months from now, than they are today. That doesn't mean there won't be short-term volatility, but investors should be able to look through that if there's enough stimulus to help bridge the road to recovery.

KM: There's a chance that equity markets get back to all-time highs, but this is still one of the most uncertain environments that many of us have ever experienced and there is going to be a lot of volatility ahead. And markets have already moved well in front of the recovery, so the economic data needs to be strong over the next two quarters and there may need to be other catalysts along the way such as progress on a vaccine and/or drug therapies to fight the virus. It's also important to recognize how unusual the market rally off the bottom has been to date. In the U.S., it's been the five or six largest index names, which reflect the stay-at-home world, that have driven the market higher, while the broader market has lagged. That's not normal and how that plays out over the next few months may determine what direction markets take from here.

MS: To that end, what might happen is more of a rotation across different parts of the market based on investor sentiment and/or economic data going forward. For instance, we've seen a move recently towards value or cyclical sectors of the market that were ignored earlier in the year for growth-ier sectors like technology and healthcare.

Growth versus Value: Performance Returns Year-to-Date



Source: Bloomberg LP. Based on year-to-date returns through June 23, 2020 for the iShares S&P 500 Growth Index ETF and iShares S&P 500 Value Index ETF.

SW: That's an important point. Whether it's technology and healthcare versus cyclicals or the focus on strong balance sheets versus weak balance sheets, the bifurcation in markets has been extreme. Given that, it's likely that equity markets broaden out a bit in the second half of the year, with some of the more heavily weighted stocks that have been leading the market higher rolling over a bit.

KM: I think that's right. To the extent the economic recovery strengthens, value stocks, which tend to be more cyclical, will likely benefit more than growth stocks and

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the so-called stay-at-home portfolio that has done so well during the past few months. As we sit here mid-year, growth indices have set new highs despite the pandemic, while value indices have lagged significantly.

DS: As a caveat, while the cyclical value trade looks promising in the short- and even medium-term, it can't be ignored that we remain in a secular environment defined by slow growth, low rates and high debt. Eventually, companies with good free cash flow and above-average pricing power and growth rates will be embraced by the market again.

Where do the best opportunities lie globally in this environment?

SW: If the modest pickup in global growth continues as anticipated, and long-term interest rates start to rise and the U.S. dollar weakens as it has of late, that should favour non-U.S. markets, including Japan, which looks particularly attractive in this environment. Europe could do well too, but the political backdrop demands extra caution.

MS: Canada's equity market may also benefit from a cyclical upturn. It's heavily weighted towards energy and materials—as well as financials—and could get a boost if the U.S. dollar weakens and inflation picks up a bit, and commodity prices rise.

SW: EM equity valuations look attractive as well and are supported by EM currencies that haven't been this compelling since the Asian crisis. However, volatility is likely to persist. The economic uncertainty associated with the spread of COVID-19 as well as the noise coming from politics and trade mean investors should remain selective.

What broader investment themes could resonate with investors in the back half of the year?

RS: Environmental, social and governance (ESG) strategies held up well in the crisis and have shown investors that sustainable investing is more than a bull market luxury. As an example, ESG ETF flows in the U.S. and Canada have climbed higher every month so far this year, according TD Securities research. Given the trend, the appetite for ESG is likely to continue as it relates to both equities and bonds.

MS: Infrastructure is another theme that may gain more traction. President Trump's proposal earlier this month for a US$1-trillion stimulus package focused on roads, bridges, tunnels, 5G wireless infrastructure and rural broadband could be a huge catalyst if it's passed.

SW: There may be increased focus on dividend-paying stocks as well. with interest rates as low they are now and expected to remain that way for some time, dividend yields are relatively attractive when compared to government bond yields, but investors need to be extra careful about the names they own given the added stress on balance sheets these days. In Europe, meanwhile, regulators are prohibiting the banks from paying out dividends and/or buying back shares until at least the fall if not longer.

What risks to the equity outlook haven't we discussed so far?

KM: The U.S. election is a risk that has taken a back seat to everything else going on around it, but it's going to become a more important issue as we get closer to November. If the electorate starts swinging more clearly

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towards Joe Biden, as recent polls have shown, and the Democrats look poised to sweep the Senate, the House of Representatives and the White House, that could be negative for equity markets because it raises the spectre of higher taxes. And that creates additional earnings risk at a time when corporate profits are already fragile.

RS: I agree. As the election draws closer, more accurate polls will start to come out and markets will start to pay more attention. It could have a profound effect on how equity markets end the year.

JC: A Democrat sweep would likely be a headwind, but President Trump may be the biggest wildcard and his willingness to do whatever he thinks he needs to do to get re-elected may create volatility all on its own. If he needs to step up his rhetoric against China to appeal to his base, then he will. If he needs to throw more money at the economy by promising more stimulus or a tax break, chances are he will. The President can't risk a bad economy given how unpopular he is with large parts of the electorate.

MS: U.S.-China relations are still a big risk to markets that can't be forgotten. Another, maybe, less immediate concern, is the possibility that we experience a market melt-up from all the stimulus that's now in the system. We've seen this before, and retail participation has not been this fervent since the 1990s.

SW: There's also Brexit, which is still unresolved, and the risk of the European Commission's newly proposed €750-billion recovery fund being blocked. The market is assuming that both things will work out favourably, but those are wildcards that could turn negative, and would certainly have an impact on European stocks, if not global stocks as well.

Let's talk about fixed income for a bit. What's in store for bonds?

DS: There's not a lot of value left in government bonds that, in the U.S., now yield well below 1% for maturities of 10 years or less and not much higher than 1% for longer-term issues. But the risk of a substantial rise in the short-to-medium part of the yield curve is not very high either, given the U.S. Federal Reserve's current plans to keep interest rates near zero for the next three years. What's going to be critical, however, and we're already starting to see it, is how much steeper the yield curve gets as the yields on the long end rise. We think there's a fair amount of room for that to happen as the economy improves, but not to the extent it has during previous recoveries. We think the Fed will want to keep a lid on long bond yields given the incredible amount of fiscal stimulus now in play. It won't want borrowing costs to rise excessively.

KM: Bond investors need to be careful. The U.S. Treasury market is going to be remain volatile. The Fed may help anchor yields in place by keeping interest rates low, but a strong economic recovery may negate some of that and at these levels, it only takes a small jump in yields to makes a big dent in returns.

And what about credit markets?

DS: We're favourable on credit in the medium-term. It's had a good run over the past few months and not unlike equity markets, we may experience another pullback of 5% to 10% with spreads widening by 25 basis points on investment grade issues and by 100 points on high-yield issues. But even if defaults continue to rise over the next few months, the improving economic prospects should lead to tighter spreads eventually—especially given the

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backstop of the U.S. Federal Reserve's corporate bond buying program—and we expect there to be plenty of good buying opportunities going forward. Alternatively, convertible corporate bonds may be an attractive option for investors going forward because they capture some of the upside of the equity market and yet get much better downside protection than equities straight-up provide.

Finally, any thoughts on asset allocation and/or managing a portfolio of stocks, bonds or other asset classes going forward?

KM: It makes sense to be biased toward equities over fixed income right now, but investors need to accept the fact that both buckets are going to experience a good deal of volatility and some type of weighting to an alternative asset class or strategy that is less correlated to stocks and bonds and provides a hedge to the downside is critical in this type of environment.

DS: Whether it's between or within asset classes, managing correlations should be front and centre in this environment. Investors might think they're properly diversified just by having exposure to Europe and Asia and the U.S., or because they own financials as well as technology and energy, but often their diversification lacks because of underlying similarities that lead to higher correlations than anticipated.

MS: It's also important to be more tactical than may otherwise be the case, because otherwise you're going to get caught offside. As we've seen this past month, what normally seems to play out over a few weeks is now playing out in days and if investors aren't paying attention, exposures can be thrown out of a whack in an instant.

RS: I agree. These are all aspects of sound portfolio management and risk management. And not just during a period of heightened volatility. Investors need to practice them every single day.

Kevin McCreadie

CEO and Chief Investment Officer

AGF Management Limited

In the role of CEO, Kevin is responsible for the overall success of AGF, overseeing the firm's mission, vision and strategic direction. He also leads AGF's Executive Management Team and serves as its liaison with AGF's Board of Directors. As Chief Investment Officer, Kevin provides direction and leadership to AGF's investment management teams and leads the firm's global institutional business. In carrying out these responsibilities, he leverages The Office of the Chief Investment Officer, a structure put in place in August 2018 that encourages collaboration and active accountability across AGF's investment management teams and broader organization, capitalizing on the firm's depth of talent while driving forward the teamwork that is necessary for the long-term success of its investment management.

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John leads a team responsible for trading the more than $36 billion in Assets Under Management across AGF's Retail, Institutional, High-Net-Worth and ETF portfolios. He is also a member of AGF's Business Development unit with responsibility for reviewing and leading Capital Markets opportunities and technology advancements. John is also a member of AGF's Office of the Chief Investment Officer.

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Mark leads the firm's investment management functions for AGF's quantitative investment platform, AGFiQ. AGFiQ's team approach is grounded in the belief that investment outcomes can be improved by assessing and targeting the factors that drive market returns. Mark is also a member of AGF's Office of the Chief Investment Officer.

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David oversees AGF's North American and Specialty Investments teams while maintaining direct portfolio management responsibilities for his current mandates. With more than two decades of experience managing both fixed income and balanced mandates, David employs a rigorous and disciplined investment process combining a top-down approach to duration and asset allocation with a bottom-up approach to security selection. David is also a member of AGF's Office of the Chief Investment Officer.

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Stephen leads AGF's global equity team in Toronto, while maintaining portfolio management responsibilities for global equity and emerging markets mandates. As the architect of the Economic Value Added (EVA)-based investment process used for these industry-leading mandates, he is supported by a team that uses its collective experience to locate opportunities unrecognized by the market. Stephen is also a member of AGF's Office of the Chief Investment Officer.

For more information, visit AGF.com

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