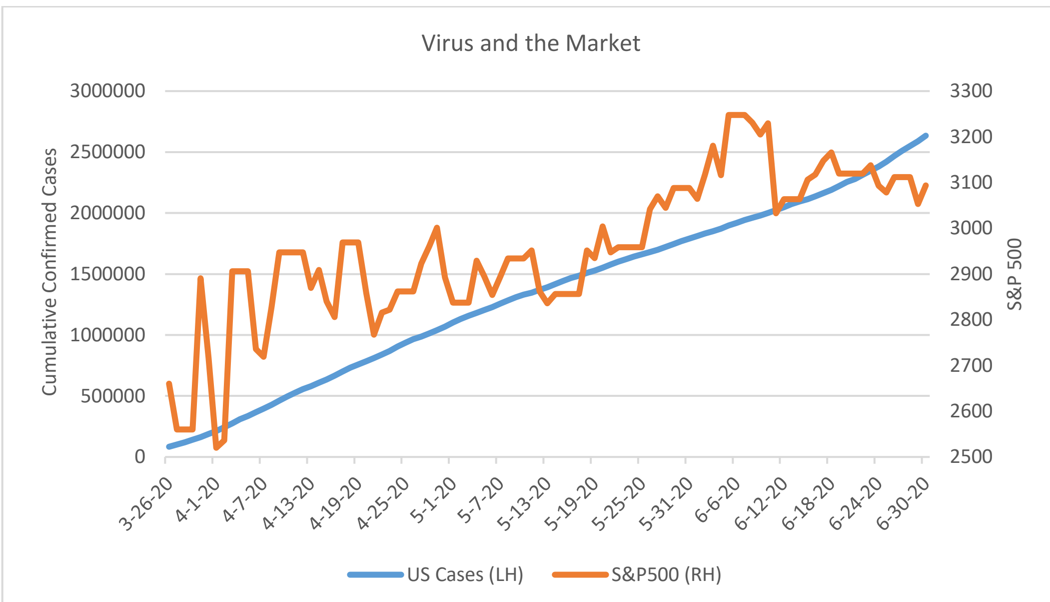
Massive Monetary and Fiscal Forces Meet Coronavirus

While being sheltered in place, investors have had a front row seat watching the forces behind the massive and somewhat unlikely market rally. To illustrate this odd correlation between the number of Coronavirus cases and the market, the following chart plots cumulative US cases versus the S&P 500's rally from the bottom of the correction in March against the continued rise to date.



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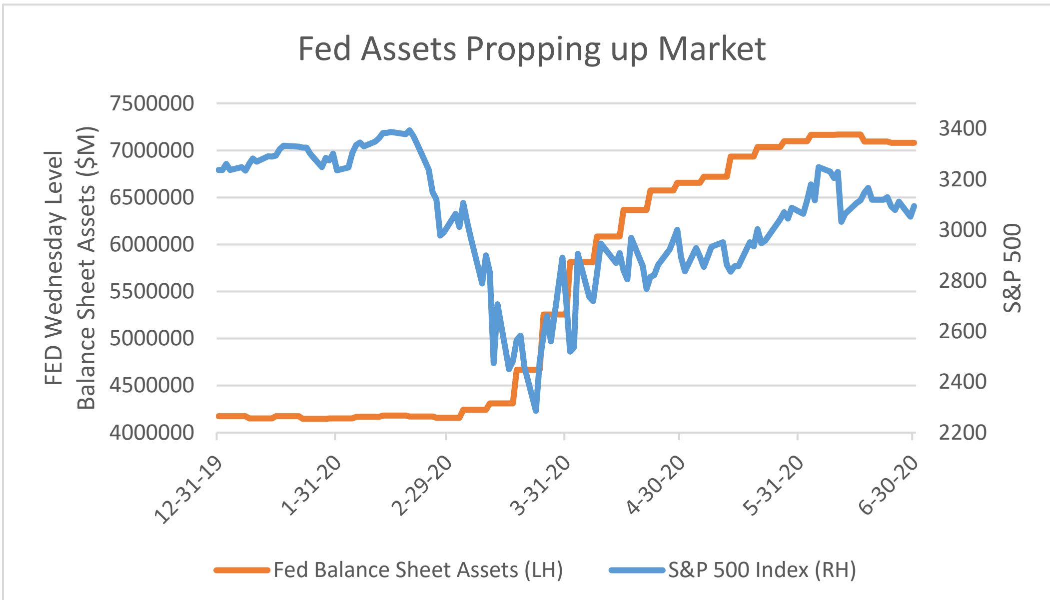
While the spread of the virus has occurred across the world to varying degrees, it is the United States with 5% of the global population that has accounted for more than 25% of total cases and the highest percentage of deaths. At present, some states are re-opening in stages while others are experiencing virus spikes that have led to pauses in the process. What is abundantly clear is that Covid-19 will persist longer than originally expected and will have a dampening effect on both employment and economic activity until a proven vaccine is widely available.

Unlike previous economic contractions, this one is very different and has been likened to a medically induced coma, a global shut down intended to benefit the societal whole. To predict the future course of the pandemic is a fool's errand. As Fed Chairman Powell will monitor and shepherd federal reserves carefully, we will do the same with our portfolios. To make sense of the equity market rally, it is important to recognize the sheer size of the monetary intervention that has liquefied the banking system. The Fed's unprecedented bond purchase program and commitment to maintaining low interest rates has resulted in an equity market backstop. The following chart demonstrates the amount of monetary fuel that has been added to the US economy resulting in the sharp rebound in stocks. Very little forward looking corporate guidance has been provided and upcoming earnings reports will test investors' resolve in the face of mostly bad news.



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The $3 trillion balance sheet expansion is significantly greater than that in 2008-2009. Money has been created out of thin air and in combination with the massive fiscal spending packages has provided a temporary crutch to the unemployed. Debt at both the corporate and government levels has never been higher in relation to Gross Domestic Product. Moreover, in both Canada and the United States, some of these supportive fiscal measures will soon run out if not immediately extended. The level of uncertainty concerning the US economy has never been higher, with the virus and the election cycle both acting as wild cards that are hard to predict with any degree of confidence.

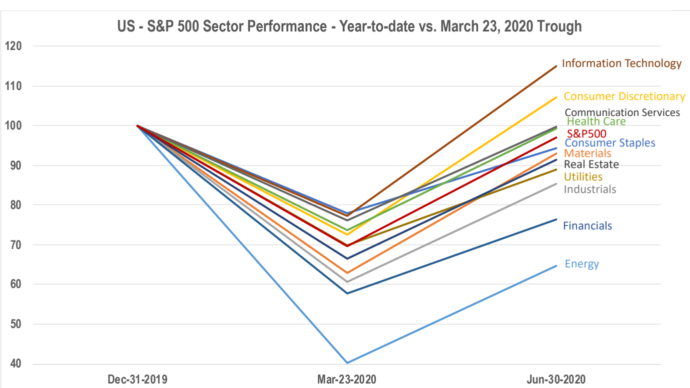
In developed economies that responded faster to contain the spread of the virus, green shoots are appearing. These may be predictive of how a meaningful recovery can eventually develop in North America. In short, the macro picture is filled with many 'known unknowns'. As illustrated in the following chart, a bifurcation has developed between stock prices and their forward earnings estimates. This has been concentrated in large-cap technology stocks (for the S&P 500 this includes Amazon in the consumer discretionary sector as well as Alphabet/Google and Facebook in communication services). On the contrary, energy, financials and industrials have been laggards.

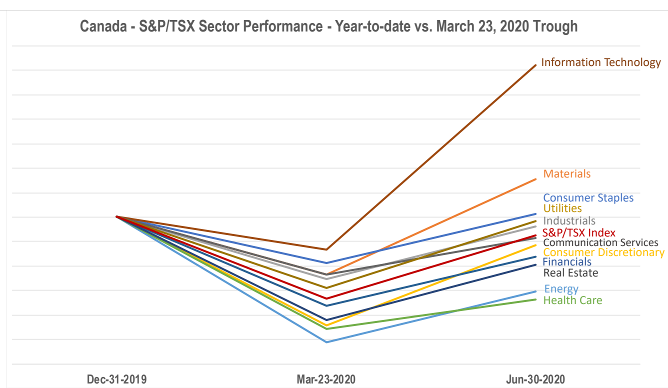
The US banking industry is in a much stronger position today than it was during the Great Financial Crisis, yet financial institutions collectively sell at historically low valuations. It is clear that the new normal will be quite different. The shift to online retailing has greatly accelerated while working remotely may have implications for real estate assets forcing governments to consider policies regarding child care and possibly some form of guaranteed minimum income. However, one cannot ignore the fact that the virus is still in charge. As a result, one can expect to see bankruptcies and consolidations throughout various industries. The new normal that will emerge is likely to favour companies with strong balance sheets and adaptable business plans.

With rising stock prices and falling earnings expectations, there are many conflicting forces at work that make traditional, fundamental research difficult. The course of the viral outbreak is almost impossible to preordain, and many monetary and fiscal decisions will be made in part for political reasons that defy rational analysis. In the section that follows, our response focuses on the proven philosophy of knowing companies well, and the concentration of equity assets in top quality businesses at reasonable valuations.

Portfolio Performance

Portfolios saw strong positive returns in Q2 2020 as markets rebounded from the March lows. However, Manitou's largest mandates, the Global Equity Fund and the North American Equity Mandate lagged their respective indices while the Canadian Equity Mandate, the Focus 5+ Mandate and the International Equity Fund outperformed for the 6-month period relative to the index year-to-date to June 30th, 2020.





With respect to stock selection, what immediately stands out is the strength of the "innovators", defined as companies that provide products and services that are currently cushioned from the impact of the Coronavirus. They continue to reinvest in their businesses to sustain their competitive position. Among Manitou's various mandates and funds, examples of significant contributors include Real Matters, Microsoft, Apple, Sika and Kingspan.

As the majority of children and the working population remain at home, demand spiked for computer hardware and software. Previous face-to-face transactions are now occurring remotely and by all accounts will continue to do so. This shift has benefited such holdings as Microsoft, which has seen an increase in demand for its Teams remote video, desktop software and cloud services. Apple also outperformed due to the heightened use of its devices and mobile apps.

Our investment in Real Matters, which is held in both the Canadian Equity and Focus 5+ Mandates, is a software platform servicing the US real estate inspection market that has outperformed over the period by capitalizing on heightened refinance activity in this low interest rate environment.

Interestingly two non-tech international names are highlighted; Sika and Kingspan. Both are considered niche players within the global building materials industry that provide greener solutions to the construction chemical additives and insulation markets.

The detractors as mentioned were primarily the banks and specifically our positions in Wells Fargo and Berkshire Hathaway. In spite of the underperformance of the sector, we remain comfortable with these holdings. Wells, in particular, has been under deep, and arguably unfair scrutiny, by the regulatory bodies. We have confidence that the plans put forth by the new CEO, Charles Scharf, will enable Wells to resume industry leading financial metrics.

While the results for the First Half of 2020 could be characterized as “mixed”, we have remained true to our investment philosophy and process designed to preserve and grow capital over time. By definition a diversified portfolio is one that will hold businesses that, in their own right, are ‘preserving’ while others are ‘growing’. The common denominator amongst them is a commitment to investing for the long-term. This requires forward, innovative thinking and diligence in pursuit of delighting customers.

Despite the uncertain economic and social environment caused by Covid-19, adhering to these principles, be it as owner-operators of Manitou or as investors in companies run by like-minded business people, is the safest and truest way to preserve and grow wealth over time.