STONE ASSET MANAGEMENT LIMITED

Sleep well.

MARKET COMMENTARY & FORECAST

September 30, 2020

UP, UP AND AWAY WITH MOMENTUM INVESTING

It is our opinion that the markets are being driven higher by momentum style investing and less so by valuation and economic data. When momentum dominates the tape action, it's very difficult to be a seller and one hopes to get it right with raising cash at the time when momentum investing has run its course. All good things must come to an end and the surging stock market and technology shares were reminded of this in September. Given the uncertain path of the virus, the inability for the US government to pass an additional coronavirus relief bill, slower economic re-openings, children returning to school and the risk of a contentious US election, stimulus-addicted investors went on a buyer's strike in September.

The surge in technology stocks continued to lift markets higher over the summer and many stocks and indices were shattering records, replacing those that should have been set by the delayed Tokyo Summer Olympics. The high-flying Nasdaq hit correction territory (down over 10%) over a three-day period early in September. This was the speediest correction on record for the Nasdaq. The markets were zig-zagging the rest of the month but were down for their 4th consecutive week by the end of September. The third quarter, however, was a positive performance quarter for all North American indices. On the global front, the MSCI World Index dropped 3.59% in September (while up 7.52% for the quarter) as investors called for a time-out on the recent gains. The US markets were lower with the S&P down 3.92% for the month and +8.47% for the quarter while the technology-heavy Nasdaq dropped 5.16% and up 11.02% for Q3. The Dow Jones had lagged the other indices due to its heavier weights in industrials/value names and was only down 2.28% in September (and up 7.63% for the quarter). The resource rich TSX suffered a loss of 2.38% for the month but was still up 3.91% for the quarter.

Market returns (price returns as at 09/30/20 in native currencies):

Index	September	Q3 Returns
MSCI World Index	-3.59%	+7.52%%
TSX Composite Index	-2.38%	+3.91%
S&P 500 Index	-3.92%	+8.47%
DOW Jones Industrial Average	-2.28%	+7.63%
Nasdaq Composite	-5.16%	+11.02%
Hang Seng Index	-6.82%	-3.96%

The price of gold pulled back 1.5% in September after earlier piercing through the $2000 mark as investors continued to seek a haven for their assets amid the daunting economic, geopolitical, and pandemic-related news. The gold equities suffered a 4.86% loss after rallying 40% for the year while its weight on the TSX has almost doubled from 5.2% in 2018 to the current 9.9%. The yellow metal is still up 25% YTD at about $1900/oz. Looking at energy, the crude oil price continued to sell off below the $40 mark, down 38% for the year. The heavyweight energy index was down a whopping 18.25% for the month and an even more astounding 55.5% for the year. The weight of the energy index on the TSX has been cut in half from over 20% in 2018 to the current 10.76%. The balance of the market performance for the TSX was driven by financials, which also came in with a loss of 3.73% as investors continued to be concerned about Banks' loan loss provisions and lower net interest margins. Investors rushed to the safety of consumer staples stocks and utilities with those sectors up 6.97% and 6.03% for the month, defying the downdraft in the overall markets. Statistics Canada chimed in estimating that GDP fell by 12% in Q2, equating to a severe 40% annualized drop.

The US economy suffered its worst economic drop in Q2 in decades. DP fell 9.5% in Q2 from Q1, which equals an annualized pace of 32.9%. This was the steepest economic drop since 1947. If we once again take a trip down memory lane, this time let's look at the top songs in 1947 which were Francis Craig with "Near You", the Harmonicats with "Peg o' My Heart" and Ted Weems with "Heartaches". These artists and songs are way before our time. The dire financial figures of 1947 and those of today were driven by different factors and lay bare the extent of the economic devastation today resulting from the government-ordered lockdown and stay-at-home orders which were meant to slow the spread of the COVID-19 pandemic. We're not sure these policies achieved the desired success and while sorry for the families affected by human loss, we expect experience to provide society with better results during the second and third waves of the pandemic.

Employment, corporate spending and output have improved since re-openings picked up, benefited by both fiscal and monetary massive stimulus plans which reached the wallets of consumers. Employers have created 11 million jobs, recovering about half of the 22 million lost at the start of the pandemic. Factory activity has rebounded as measured by the Institute for Supply Management (ISM) figure registering 55.4 in September, its fourth consecutive month of expansion. However, the recent surge of infections in such populous states as California, Texas, Arizona, and Florida have tempered the pace of the recovery. Critical lifelines in the pandemic, such as the US$600/week in unemployment benefits, have expired just as the economic recovery is searching for a footing to build a foundation for expansion and growth. This will put a damper on the recuperation of the US economy and makes the V-shape recovery highly unlikely.

The federal and state conflicts which are amplified by political allegiance continue to be powerful headwinds to managing the reopening of society, executing stimulus programs targeted to the weakest parts of the economy and creating filibustering by governments at the expense of the citizens they serve. Should you want validation of how poorly governments work together based on their political allegiances, one must only suffer through a recording of the deplorable first presidential debate between President Trump and Vice President Biden. In our opinion the true loser is the United States of America and its citizens. Like kids playing baseball in the backyard, having a do-over with new candidates would be wonderful. President Trump is not good for humanity, just the media, and we fear that Vice President Biden will not be good for the economy, the government's balance sheet and foreign affairs. Neither candidate is the right choice. We wish America the best for the next four years.

Whoever is President has real issues that affect human beings that they must manage, and to do so will have to be done with policy and not ideology. For many American families (as well as Canadian) Maslow's hierarchy of needs is in play for their survival. Shell, Disney and Allstate have announced massive job cuts. Airlines, cruise ship operators, casino companies and entertainment companies continue to lag in the economic recovery. Many of these people will be in dire straits going forward and real policy to deal with real issues is what's required. The leaders of the world have been tested, and none have earned a passing grade.

Other countries are also suffering as quarterly GDP declines were also shattering records. This was witnessed by Germany's 10.1% decline in Q2, marking the biggest quarterly decline since WWII. On an annual basis, the German economy shrank 34.7% keeping pace with the US contraction in the same period. Weakness in Germany is ominous for the rest of Europe as German manufacturers are closely intertwined with others in the continent. The President of General Motors, Charles Wilson, when being nominated in 1953 as US Secretary of Defence said "… for years, I thought what was good for our country was good for General Motors, and vice versa" could be modified for Europe as "… for years I thought what was good for Germany was good for the European Union, and vice versa."

The US stock markets continue to be bifurcated with the large cap technology companies benefiting from the work-from-home environment. Facebook, Amazon and Apple are all reporting stellar financial numbers. The market's momentum focusing on a narrow group of companies has rewarded investors with these companies having their share prices hitting all-time highs. Apple's current $2T market capitalization is higher than the value of many individual countries' capital markets. Meanwhile many traditional non-technology companies' share prices continue to lag due to being out of favour with momentum investors. As stated in this commentary's opening, we are concerned that momentum investing has created a risk to the price of shares by disconnecting the price from valuation and economic issues that do not support shares valued at a price beyond perfection. Perhaps an investor would be prudent to ensure that their portfolio has some bias to preservation of their capital. Our belief is without capital, you can't build wealth and in today's market it would be prudent to expose your portfolio to the capability of preserving your capital.

We use our proprietary investment process daily and in volatile market conditions such as these, we seek to ensure that we can manage downside risk and adjust the portfolios accordingly while seeking to achieve our long-term investment goals for our clients.

We remain invested and are committed to companies that provide revenue growth, improving free cash flow and higher earnings per share. We are active portfolio managers with a disciplined investment process including the implementation of various risk management tools to benefit our investors.

Kindest Regards,

STONE ASSET MANAGEMENT LIMITED

Richard G. Stone, Chief Investment Officer

CANADIAN FACTS – COMPOUND STEAM ENGINE: THE MORE EFFICIENT GENERATOR

Innovation is not usually invention. The compound steam engine is a perfect example of how smart thinking can make a good thing even better. In this case, the thinker was Fredericton, New Brunswick native Benjamin Tibbets. The problem he considered was the wastage of heated steam in engines. Before Benjamin put his mind to the problem, steam engines required vast amounts of carbon fuel to produce vapour, which was then used briefly to produce power and subsequently exhausted into the atmosphere. In 1853, he built a new kind of steam engine incorporating a reservoir and a second cylinder. These two features enabled the engine to take the steam discharged from the main high-pressure cylinder and put it to further use as low-pressure steam. The result was a more efficient power generator that used much less fuel per unit of usable energy. The concept, refined by others, was subsequently incorporated into all steam engines with immediate impact. The additional power made developments such as long-distance train travel a reality at last.

Adapted from *Ingenious - How Canadian Innovators Made the World Smarter, Smaller, Kinder, Safer, Healthier, Wealthier, and Happier*

STONE ASSET MANAGEMENT LIMITED
Sleep well.

40 University Ave, Suite 901
Toronto, ON M5J 1T1
Toll free. 800 336 9528
Fax. 416 364 8456

www.stoneco.com
info@stoneco.com

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