The Navigator

A Quarterly Newsletter for Clients and Friends of Lighthouse Wealth Management

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We hope this letter finds you well, healthy and keeping busy as the warm days of summer approach. Our world has changed so much in the last 90 days and we expect that more changes are coming in the months and years ahead. While change can be more difficult in periods of stress, we firmly believe it creates opportunities for those who are flexible and challenge their assumptions on a regular basis. As stewards of your capital, we believe it is incumbent upon us to challenge our assumptions on a regular basis as we monitor developments, seek to maximize risk adjusted returns, and align wealth with client objectives and economic realities.

If you found the past 90 days unsettling and have questions and concerns about the future, take comfort that you are not alone, and thus far, the spread and impacts of the virus in North America are tracking better than the Base scenario we modeled in our last Beacon publication (available here). We are cautiously optimistic for our prospects, but understand that we are not out of the woods yet.

Sadly, not all places in the world chose, or were able to, offer an effective response to the pandemic and its effects that we saw in Canada and elsewhere to effectively combat COVID-19. This resulted in far more infections, greater loss of life, and higher socio-economic and human costs. We hope for better days ahead for hard hit areas, though we recognize that improving these outcomes will require a global effort: the cooperation for such a coordinated and expensive action is sorely lacking amongst global leaders, particularly as they struggle to deal with their own domestic issues.

Closer to home, we are fortunate to have had particularly good health and economic outcomes relative to many other parts of Canada, and especially compared to many places abroad. Many people, ourselves included, credit Chief Health Officer Dr. Bonnie Henry, who may be the international gold standard for pandemic management and crisis communication - setting the example for her counterparts and other leaders in Canada who we believe are performing admirably compared to other leaders. For this, we are very thankful.

For this newsletter we want to summarize and discuss events of the last few months. We also want to update you on our thinking about financial markets and the economy and how it relates to your investments in this environment of heightened uncertainty and change. We will conclude with a few updates on how we are adapting operationally to new realities of doing business.

Review & Discussion of Events Since Our Last Newsletter

Many noteworthy developments resulted from the pandemic and related economic and social measures enacted in Canada, the US, and elsewhere to slow and combat the spread of the disease - to "flatten the curve" as these measures were explained by officials. Our belief is that these measures, where taken seriously, very much flattened the curve relative to delayed action, or worse, no action, saving many lives in the process as social and economic activity ground to a halt in late-March and April.

While painful economically, taking these precautions now allows for plans to gradually re-open economies - at least for the time being - and why our health care systems are not overwhelmed by a mass spread of the virus. Others were reluctant to shutter economic activity, believing it better to have the virus run its course through their population. The divergence of health outcomes proves sufficiently, to us at least, the effectiveness of isolation measures and shutdowns in combating the spread of the virus and the societal consequences that arise when panic sets in. This lesson may make authorities quicker to respond to a second wave or a new virus by imposing isolation measures. If so, the last three months may serve as a good model to forecast potential outcomes.

What is noteworthy to us is a second wave of the virus is a non-trivial risk in our forecast models. Should it arise prior to the development of a vaccine or effective treatment, North America could well be forced back into self-isolation just as we are starting to emerge from our first round of it.

While we are likely better prepared to treat infected patients by ramping up production of key protective and medical equpment after being caught flat-footed, we remain woefully short of supply to cope with a spike of infections and the societal costs of such an outcome would be substantial. Therefore, even without a second wave, fear of a second wave or another novel disease has likely permanently altered a subset of behaviours of households, businesses and government officials, affecting the economy and altering the kind of business models that will thrive. This is a key reason why we are so skeptical of index investing at this time.

While many, ourselves included, would like to believe that the worst of the pandemic is over, this remains a mid-to-best case outcome and we need to be realistic about the possibility of a spike in infection rates as the economy gradually re-opens. The recent mass gatherings of people protesting the death of George Floyd and systemic racism in our society is unlikely to contribute to a lowering of infection rates and may serve to increase them. It is too early to tell at this point, though we are observing spikes in infection rates in some areas that are concerning.

To be sure, we are long overdue for outright equality and fairness as guiding principles of our society, least of all because it will contribute to a culture of meritocracy, likely improving productivity growth. Our hope is that recent events, coming at a time of societal strain and change that has exposed gross inequalities in society, will finally level the playing field and reward hard work, skill, and effort.

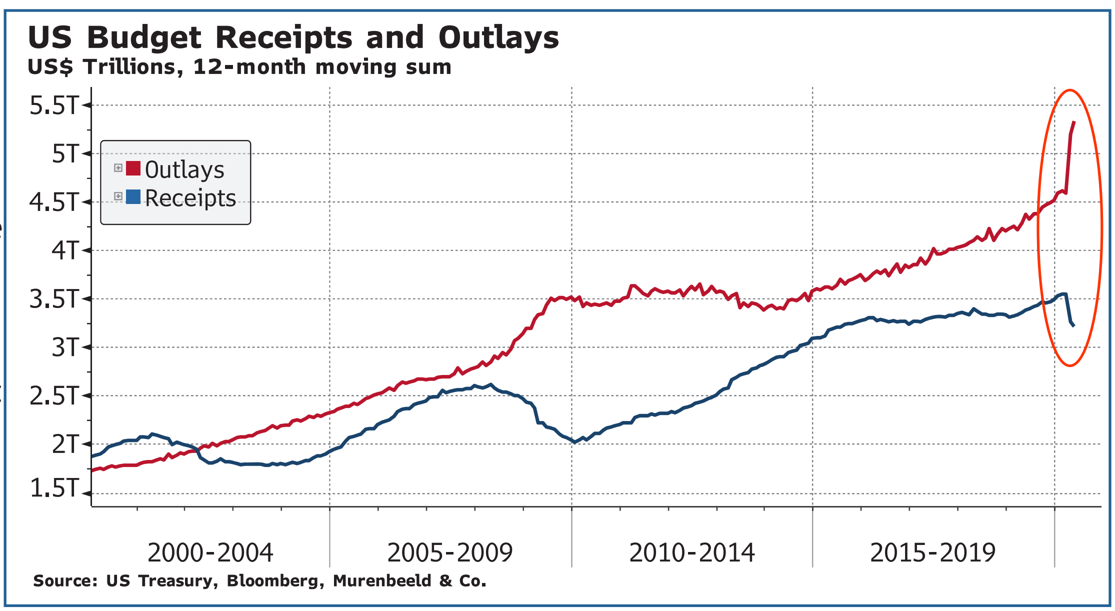
From the perspective of containing the virus, continued success requires staying vigilant with good hygiene habits and social distancing. This does not necessarily mean shutting down all social and economic activities and isolating, but being mindful of risks in activities and striking the right balance, combined with following the best health and social practices. This will mean change and adaptation, hopefully for the better in many cases as our society has much healing to do in the coming years.

Looking at conditions from an investment and business management perspective, we should be skeptical of those believing adaptation will not add costs for businesses and households and that demand will rapidly return to pre-pandemic levels. When we issued our Scenario forecasts in late-March, even in our best case, the economy did not reach its pre-pandemic level of output until 2021 - a forecast also recently issued by the OECD (a very interesting interactive chart summarizing their forecasts is available here). Needless to say, even their best case outcome represents a significant set-back to the economy and predicts a slow and uneven recovery.

As societies and economies adapt, we expect many of the jobs that were lost when the economy was shuttered will never be replaced and this will have real implications for people. It is not so much that those whose jobs were lost never find employment again, more so that different jobs will need to be created - ones that may not yet exist - and displaced workers will require financial support and assistance as they acquire new skills and training, a process that could take years for some and may never occur for others.

The pandemic and other changes in our society have served to greatly expand the perceived role of government in financially supporting citizens and businesses as they seek to maintain economic growth and prosperity. This level of support will put pressure on government budgets and likely raise future taxation requirements - suggesting that the savings from smart tax and financial planning are likely to rise as governments, already saddled with the debts incurred during the pandemic try to reboot their economies and care for vulnerable segments of their populations.

The accompanying chart from our friends at Murenbeeld and Co. show the sharp increase in government spending in the US to shelter citizens and businesses from the economic impacts of shutting down the economy to combat the pandemic. It also shows a significant reduction in receipts, highlighting the decline in economic activity and job losses. The net effect on the government's budget is staggering, rivaling the impact of the Global



Financial Crisis and cannot be ignored in our view.

The obvious challenge of indebted governments being asked to provide more for their citizens and businesses while they struggle with the debt hangover of the Global Financial Crisis and rising inequality is a tall order, let alone during a pandemic that results in shutting down large swaths of the economy to fight the spread of the virus. The path to maintaining acceptable rates of economic growth and inflation while already fighting a peristent deflationary environment has important implications for society and investors about how fiscal and monetary policy will evolve in the coming years.

This dynamic will have to be managed against what is currently a trend toward deglobalization, localization of supply chains, and trade restrictions which by their very nature, will increase cost, destroy productivity, both of which are expected to increase inflation. It may well be the case that consumers will need to adjust to higher costs and less selection for the goods and services they regularily consume - though perhaps not for some time as is the initial shock of the pandemic is quite deflationary and authorities maintain a significant war chest of measures to delay natural adjustments in the economy.

When US Federal Reserve Chair Jerome Powell addressed the media after the Fed's latest interest rate decision, it was made very clear that monetary policy will remain supportive and interest rates will remain low for the foreseeable future. The questions we have are whether or not this leads to a positive long-term outcome in terms of living standards, and how long it can persist until the inflationary impacts of these policies overwhelms the deflationary forces that have impacted the economy for more than a decade? Will we see a sharp rise in interest rates before long to combat inflation?

What is not obvious from the chart and is glossed over in press conferences is the vulnerable position governments, businesses, and households were in prior to the onset of the pandemic. This broad vulnerablity brought on by excessive leverage across all sectors and made worse by rising inequality is chief among reasons why government and central bank support during the pandemic needed to be so large and far reaching in the first place.

Despite the obvious moral hazard risk of running ultra loose monetary policy and backstopping households and businesses across the credit risk spectrum, the fear of societal and economic consequences of allowing businesses and households to fail is politically unpalatable for now. While it is not our place to offer judgement on such a policy, we do expect that if economic activity does not recover in a relatively short period of time, governments will be forced to choose winners and losers as not all those seeking assistance will be able to receive support. This would no doubt be a painful adjustment process, though we believe it would ultimately allow the economy to function better once it was complete.

In sum, we believe we were approaching a transformational period in financial markets where excessive leverage needed to be dealt with to restore financial stability, and to allow the benefits of economic growth to be spread more widely. We believe that asset prices have greatly benefited from the creation of debt and those who have not had access to these financial products have been left behind.

The trade-off for better health outcomes, in this case at least, was a flattening of the economic activity curve, and in the process, exposing underlying economic weakness, financial imbalances, and over-indebtedness of many households and corporations. While bond markets continue to price in a low-growth world with a slow and uneven recovery, equity indices have approached their February peak, pricing in a "V" shaped recovery and a normalization of economic activity and earnings. While we are cautiously optimistic that the worst of the virus is over, we are a long way from the rosy scenario painted by equity markets and believe it best to tread cautiously.

We believe that equity markets are very much counting on stimulative monetary and fiscal policy to support the economy until the pandemic has passed and the economy can recover to where it was prior to COVID-19. While we do not rule out this positive outcome, our concern about a second wave of the virus, authorities' capacity and willingness to provide a second round of support packages, and questions about how effective these measures are likely to be, give us reason to pause and question the likelihood of the positive scenario that equity markets have priced in. In the event that the economy does not recover as fully or quickly as equity markets expect, we would expect to see a meaningful drop in the earnings multiple paid for them.

Office update

You may recall we introduced a staffing change late in 2019. Sarah successfully transitioned to a different role that allowed her more flexibility and time to devote to their daughter and Amanda moved into our admin role in early December. While financial services was a new experience for Amanda, she impressed with her organization and ability to learn quickly. In mid-February, she informed us the position didn't suit her and we parted ways. Since that time, we are taking care of our own administrative tasks.

We've wondered for some time how necessary an admin position is for us, as technology has greatly changed workflows with much less paperwork. The past four months have confirmed that we're both very comfortable dealing with the daily tasks that we previously delegated.

We will continue to work from home on most days through the summer months. We're available by phone or email and have started doing "virtual" meetings as well. As there is often no one at the office, a gentle reminder to please contact us before "dropping in".

Working from home has quickly become acceptable and we believe it will continue to grow and evolve. Relaxed dress codes, fewer commuters and less business travel were immediate outcomes with physical distancing. We believe these will be the largest and most permanent shifts to come from the COVID-19 restrictions. Societal norms and practices were changing rapidly before COVID and we believe physical distancing practices have simply accelerated the timeline. Our challenge is to understand how these changes will alter social trends and the impact on investment themes.

What We Believe You Should Know:

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Lighthouse Wealth Management is a personal trade name of David Charlebois and Stephen Gaskin.

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