THE NAVIGATOR

A Quarterly Newsletter for Clients and Friends of Lighthouse Wealth Management

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Fall 2020

We hope you are well and healthy: an accomplishment in what has been a difficult year for many. As we look to autumn, this quarter's newsletter provides updates on financial markets, the economy, and our key investment themes. Indeed, there is much to discuss. Like many businesses, we are adapting our service offerings to better meet your needs in today's evolving reality. To conclude, we discuss the changes we have already made and our future plans.

Economic and Financial Market Update

A lot has happened since we wrote our Summer newsletter and our goal is not to capture everything here, but to highlight key developments and explain how these impact our key investment themes. It's not surprising that market movements have been erratic given the inherent risks introduced by the pandemic and the geopolitical environment, though we cannot overlook the increased use of electronic trading and how our connected world allows significant amounts of central bank created liquidity to rapidly move between assets.

At the risk of sounding cliché, we believe our world is in uncharted territory in some ways as it continues to respond to the health and economic impacts of the pandemic, but also to the other long-term trends already in place. We have watched as new, unconventional and sizable policy interventions were deployed to try to revive the economy and financial markets. Add to this, touching zero percent for policy interest rates in North America for the first time, and the potential, if not the overt suggestion by the President of United States he would contest an election defeat and create a very chaotic transition of power. For this to occur in what many view as the bastion of democracy, we struggle to find a period comparable to the current financial and geopolitical environment from which to draw inferences. But wait, there's more.

Most recently, the positive COVID-19 test of the President and the First lady, as well as others in President Trump's inner circle – though not entirely surprising to us considering the President's views and handling of the virus – is nevertheless unfortunate for those infected and throws a lot of additional uncertainty into the mix. The untimely passing of Ruth Bader Ginsberg and the rushed nomination of Judge Amy Coney Barrett to the US Supreme Court – the institution that may ultimately decide the outcome of a contested election – has turned this election into a referendum on American values and the role of the United States in the global community. To say that the stakes on November 3 are high is a gross understatement.

Despite our concerns, we take some comfort that many of the long-term economic trends (see section below) we write about remain very much intact, in some cases, amplified and pulled forward by the pandemic and the response to it.

As we have observed the news and data in recent months, we believe we are moving toward our lower-for-longer, growth-is-scarce (LLGS) scenario. While this scenario is typically viewed as a very negative one (especially by governments and central banks), we do not necessarily see it this way and have trouble imagining infinite economic growth in a world with finite resources - a point we believe is becoming increasingly clear as the environment struggles to cope with the existing demands on it. It is also worth pointing out that Japan is the quintessential example of economic stagnation in a developed nation, yet per capita GDP, a key measure of living standards, rose steadily across this period.

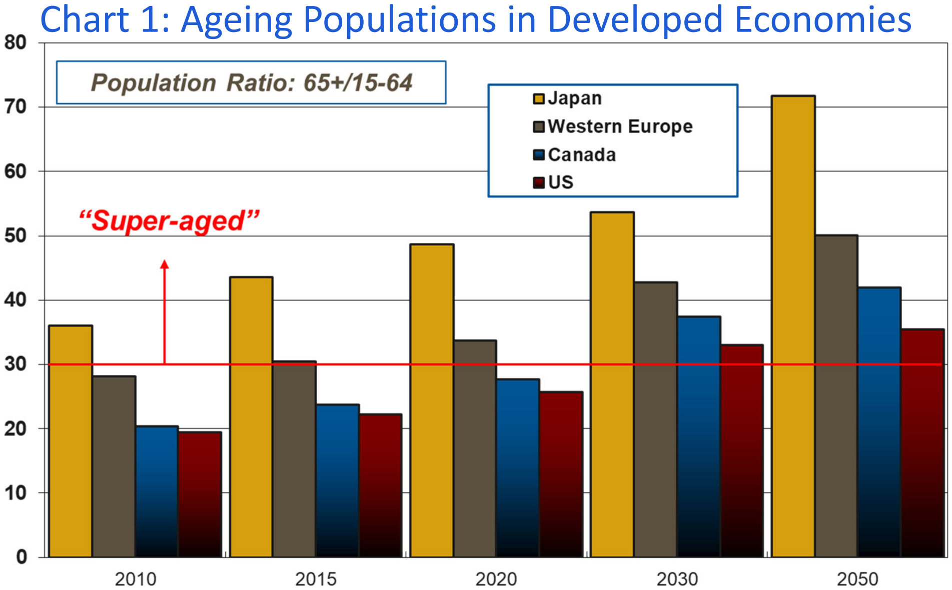
We are happy to discuss the implications of this scenario fully with you; for this newsletter we will examine the Japanese experience because we believe in its usefulness in building forecasts in our own markets, though we realize there are many critical differences.

The Japanese Example

Should we be heading further down the LLGS scenario in North America and Western European countries, being driven in large part by aging populations (see Chart 1), high debt levels (see Chart 5) and other deflationary trends, the Japanese example is likely to prove useful to understand how economies and markets may be affected and how policy may evolve. We are careful to recognize there are some key differences between Japan 40 years ago and the economies of North America and Western Europe, and to some extent China, now.

Studies on the Japanese economy, unique in having the world's oldest population amongst other factors, have been written by many notable economists. Former US Federal Reserve Chairman, Ben Bernanke, is one of the most notable scholars to study Japan, and we believe the lessons learned were applied in the Global Financial Crisis (GFC).

Chart 1: Ageing Populations in Developed Economies



Source: Murenbeeld and Associates, United Nations Department of Economic and Social Affairs

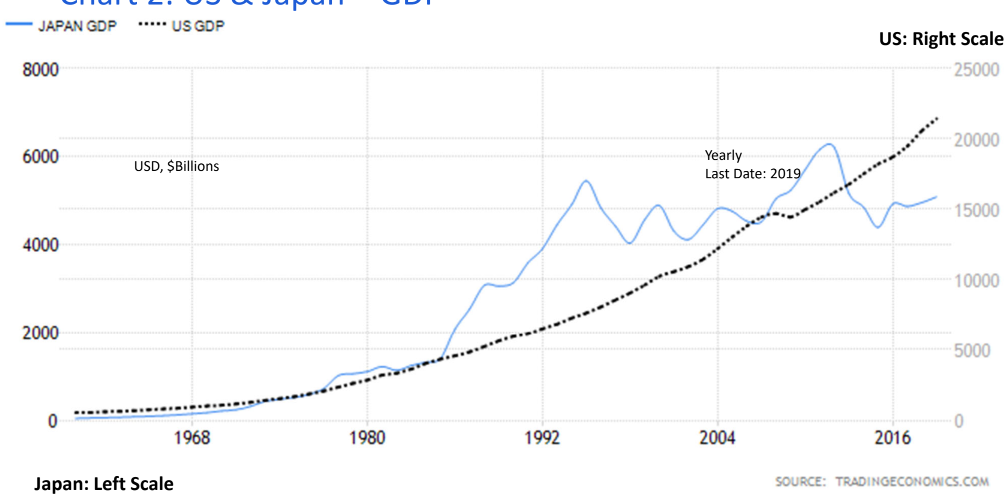
A long-held view in Economics and championed by Nobel Prize winning economist Milton Friedman, is that inflation is created when the quantity of money grows faster than real output. Subscribers to this view believe that central banks are able to create inflation, and to some extent manage it to achieve socio-economic targets. This school of thought was instrumental when many central banks in developed countries adopted some form of inflation targeting as their monetary policy goal. Canada adopted the 2%, plus or minus 1%, objective in 1991.

The Japanese experience, beginning in the late 1990s, is directly contrary to this widely held belief. As North American economies continue to trend toward stagnation, brought much closer by the pandemic, it will be interesting to see if these economies can avoid the Japanese experience. Indeed many prominent economists and policy makers believe so, but the toolkit may need to expand beyond Quantitative Easing (QE) and extend into Modern Monetary Theory (MMT).

Getting to the Japanese experience, after expansionary fiscal and monetary policy during most of the 1980s inflated asset prices, the BOJ raised interest rates by 350 basis points (3.5%) in eighteen months - starting in April 1989 at 2.5% and ending at 6% by August 1990 (see Chart 1 Appendix). This sharp increase contributed strongly to the asset bubble popping in the early 1990s. The impact of the Plaza Accord of September 1985, which increased the value of the Yen relative to the USD dollar by more than 50% in three years cannot be overlooked, acting as a strong headwind against Japanese exports and economic growth (see Chart 2 Appendix).

With growth slowing sharply, in June 1991 the BOJ began aggressively cutting interest rates, taking its policy rate down to 0.5% by September 1995. During this decade, there were also numerous fiscal stimulus packages deployed which failed to restore growth and inflation to desired levels. This decade, characterized by multiple recessions, anemic growth, and deflation, prompted the BOJ in October 1997 to begin the process we now call Quantitative Easing - printing money to purchase assets, but the program ended only a year later.

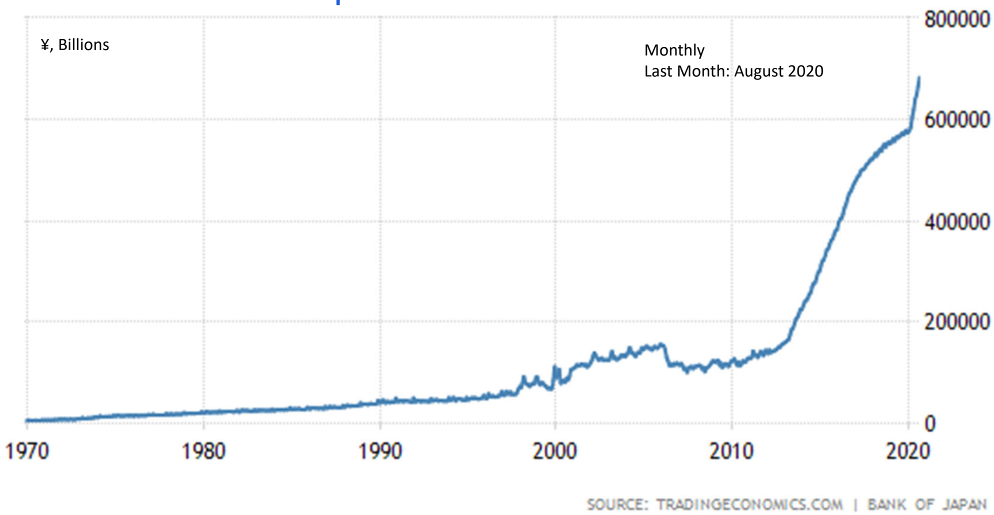
Chart 2: US & Japan – GDP



Common criticisms against the BOJ are it was late to respond, the response was not aggressive enough, and what many believe to be an underappreciated factor, it was only a temporary move which did not allow inflation expectations formed over years of deflation to reset higher. It is generally accepted that inflation expectations adjust quite slowly (see Chart 3).

The BOJ decided in 2001 to ease further in response to continued economic maliase, this time for a period of about five years. This was a shorter period of time than it allowed between the bursting of the asset bubble and its first token easing campaign. Moreover, after completing this easing cycle, the BOJ allowed its balance sheet to shrink (and the growth rate of money to decline - see Chart 3 Appendix) during the GFC. The BOJ did not ease in response to the GFC until 2013, well after the US Federal Reserve acted, when it did finally make aggressive and sustained actions. Interestingly, in response to the pandemic, the BOJ was quick to sharply increase its rate of asset purchases, behaving much more like its Western counterparts, likely having learned from past mistakes.

Chart 3: Bank of Japan – Central Bank Balance Sheet



Despite a couple of false starts most notably in the mid-to-late-2000s, Japanese GDP, in USD terms is at the same level it was in the mid-1990s (see Chart 2). North American and Western European countries fear this is happening as populations continue to age, amongst other issues like high debt levels (see Chart 5).

Fall Outlook

We expect news and events will continue to surprise financial markets as we approach the US election on November 3, 2020 and the second wave of the pandemic produces frightening headlines as case counts rise. Fortunately, our systems and knowledge of treatment options continue to adapt and improve. We are seeing lower rates of mortality, despite spikes in infection rates. There potentially could be a very chaotic transition of power with a Biden victory. We do not view this as our Base Case, but in this election, even choosing a Base Case outcome is no small task. Our preference is to focus on what we have some insight into, which is why we have looked at Japan, as we believe North American policy makers are determined to avoid its fate and will be very aggressive with all policy levers at their disposal.

Assuming we are in a LLGS scenario, with the pandemic pulling us further in this direction as it lingers and depresses large parts of the economy, we expect that central banks will take critiques of BOJ policy seriously, erring on the side of doing more than less when intervening. We also believe the central banks will focus closely on inflation expectations (continue focusing on forward guidance), working hard to prop up expectations amongst a myriad of deflationary factors. We anticipate this will have significant implications for asset prices that will be important to understand.

We believe this is a key reason why central banks in the US, Canada, and Europe have recently adjusted their monetary policy targets - allowing inflation to run hot for a time to make up for lost ground (these central banks have chronically underperformed their 2% inflation targets), and setting a higher threshold for inflation before policy interest rates will be increased or asset purchases curtailed.

We also believe expectations mattered when we saw a “Bazooka” response to the GFC from the US Federal Reserve, led by Ben Bernanke. If there is any confusion as to how new Bank of Canada Governor Tiff Macklem will respond to crisis, his recent interview with David Parkinson is very clear in our minds. When asked how to respond to an economic crisis, Governor Macklem’s response was

“Crush it. When you’re faced with a real crisis, you have to step beyond the normal responses. You have to have the mentality that you need to overwhelm this crisis. You have to do probably more than you think you’re going to need to do, and certainly more than many people will tell you you need to do.”

The Globe and Mail, October 2, 2020 - Crush it: Bank of Canada Governor Tiff Macklem says a crisis is no time for half measures, theglobeandmail.com.

Much like the economic recovery, the recovery in equity markets has been “K” shaped with some sectors coming back strongly while others remain well below pre-pandemic levels. We mentioned in our last newsletter the idea of an uneven recovery, and evidence thus far suggests this has been the case and will continue for the foreseeable future – at least until a vaccine is widely available – the timing of which remains uncertain. Once a vaccine is developed, how will it be distributed? At what cost? What about inoculation rates in world where many are skeptical of vaccinations?

As growth remains weak and policymakers become increasingly concerned about the diminished returns of monetary policy, we are likely to see a wider range of assets purchased, going up the risk curve, and greater coordination with fiscal policy beyond what we have already seen. As high debt levels (see Charts 4 & 5, next page) are already a drag on growth, central banks may start directly monetizing the government debt, and possibly adopting yield curve controls to keep a lid on market interest rates (apparently already discussed at the Federal Reserve). These policies are likely to widen the wealth (and health) divide, meaning we are also likely to see a wide range of redistributive policies - as we already are - leading to a basic income and funded by new taxes targetting assets more than income.

In early September the broad US equity indices (S&P500 & NASDAQ) optimistically and briefly eclipsed pre-pandemic levels on the back of economic recovery prospects and continuing policy support. However, when we look at the equal weighted S&P500 index (an equity index constructed so each constituent is equally weighted as opposed to weighting by market capitalization as the headline S&P 500 does - giving FAANG stocks an out-sized impact on index returns) has not eclipsed pre-pandemic levels. This suggests a lack of broad participation in the equity market recovery, despite good headlines.

The economic data supports our view that we are a long way from a broad-based recovery, the recession (depression?) is not over. This period also highlights to us that when growth is scarce, good businesses that are truly growing trade at rich valuations. The trick will be discerning which companies are really growing, as opposed to those whose growth is dependent on record low interest rates and expansionary fiscal policy. In a world where growth is scarce, perhaps many value stocks are termed this for a reason and may remain in the value bin for a while despite many believing there will be a rotation in

Chart 4: Debt-to-GDP Ratio

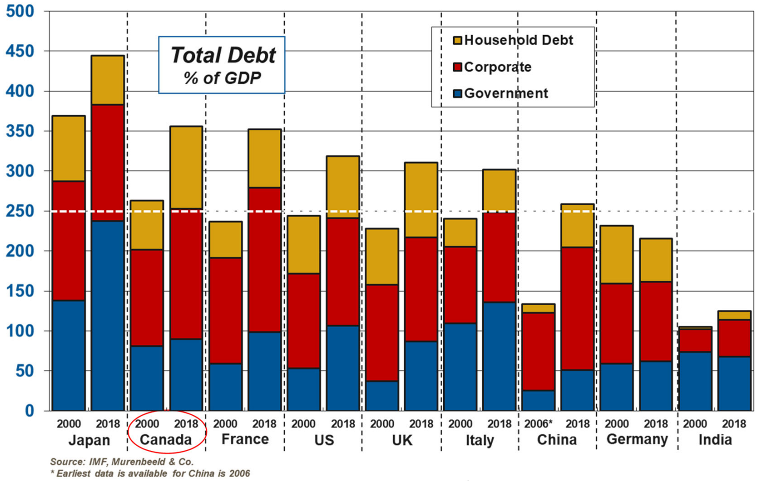
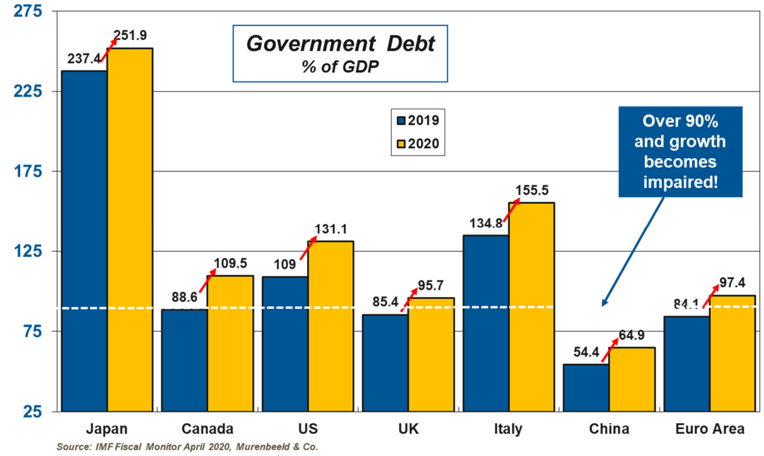


Chart 5: Government Debt-to-GDP Ratio



the market from growth into value.

The shape of the economic recovery also reinforces what we said in our last newsletter: investors should be very selective in the sectors they invest in. We believe even conservative investors should hold some equities in their portfolio as the returns on fixed income are below inflation and many equities offer attractive yields, suitable to our current environment. However, we *stress* that risk levels are elevated, so quality and balance remain essential, as does sector selection. Gone, in our view, at least during the pandemic, are the days of holding the index.

Lastly, while our base case remains the LLGS scenario, we encourage investors to maintain some exposure to precious metals in the event authorities are successful in generating the desired rate of inflation, and to reduce overall portfolio fluctuations in this volatile environment. Precious metals tend to be uncorrelated with equities and are historically a safe-haven asset, though not to be overdone.

Office Update:

In our Summer newsletter we wrote about changes taking place in our office and ours plans through the summer. After a period of adaptation, it's apparent many behavioral changes, such as social distancing, are likely with us for the foreseeable future. Moreover, trends that were already in their "early days" have leapt forward and accelerated out of necessity. These trends include, but are not limited to:

- Working from home,
- Digitization of processes and information
- Virtual technology to replace face-to-face contact
- Usage of electronic documentation
- Less travel, shorter trips, fewer public activities, smaller gatherings

Make no mistake, we miss seeing and meeting clients in person, as well as being able to go out without concern of getting sick. Nothing replaces human contact and social interaction. Until a vaccine is proven successful, we must continue to operate in a safe and healthy environment.

Dave "attended" the annual HollisWealth conference in late September. Originally scheduled for downtown Toronto, the conference was held online over two days. One of his key learnings was "virtual is the way of the now, not the future."

What does this mean for you?

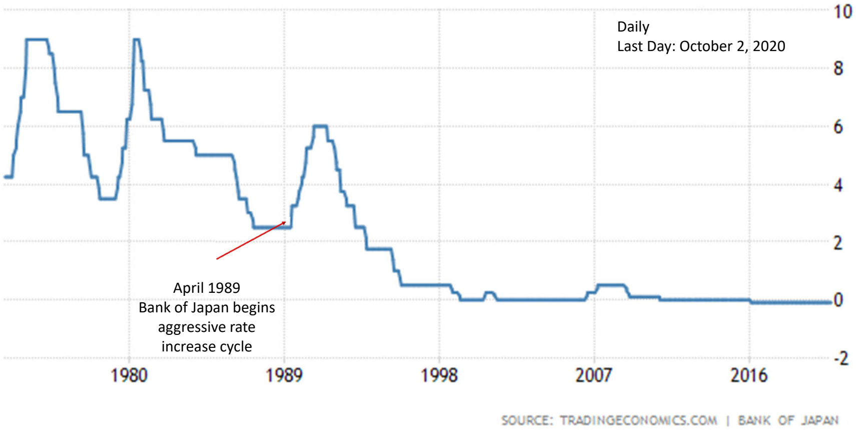
- We will continue to mostly work from home. If you call us, please leave a message and we will respond as quickly as possible.
- Email is the best way to reach us. We remind you that we are unable to accept email instructions on your investment accounts and will continue to reach out to confirm any instructions.
- Dave is taking care of most of the admin tasks. Given his early morning work preferences, it fits well with his daily routines.
- Digital signing of documents. HollisWealth has introduced a new digital document solution that we are now using to open new accounts and update existing ones. Thanks to those who have helped us through the early days to work through some challenges. Please note that for ID purposes and digital security, you must have an individual email address. If you share a single email between family members, we are unable to use this with you.
- We're getting more comfortable with online meetings. We have many ways (MS Teams, Zoom, Face Time, What's App) to make these work and will be doing more of these through the rest of the year.

Closing Thoughts:

- Take advantage of this period of relative calm to address important items.
- Review your portfolio to potentially make changes to reduce risk, improve asset quality, and create appropriate liquidity. We expect the trend to be up, with peaks and valleys along the way.
- Understand that investing during this period is likely to be more volatile and challenging. Adjust your expectations and plans accordingly while you have the option.
- Have a disciplined investment and risk management approach; a balanced portfolio will be important, but that does mean simply holding everything.
- It will remain important to think critically and come to your own conclusions. Be wary of those claiming to be immediate experts, and those that make it sound too easy.
- Be kind, be calm, be safe.

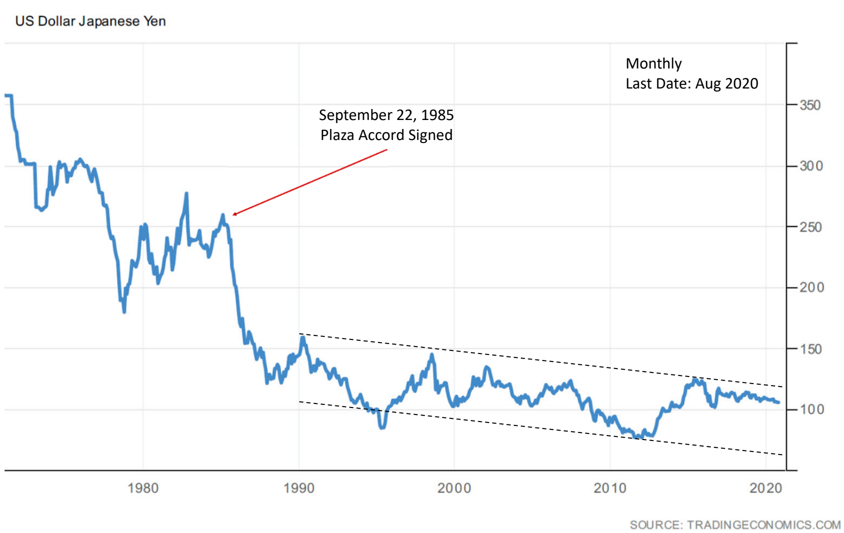
Chart Appendix:

Appendix 1: Japan Policy Interest Rates



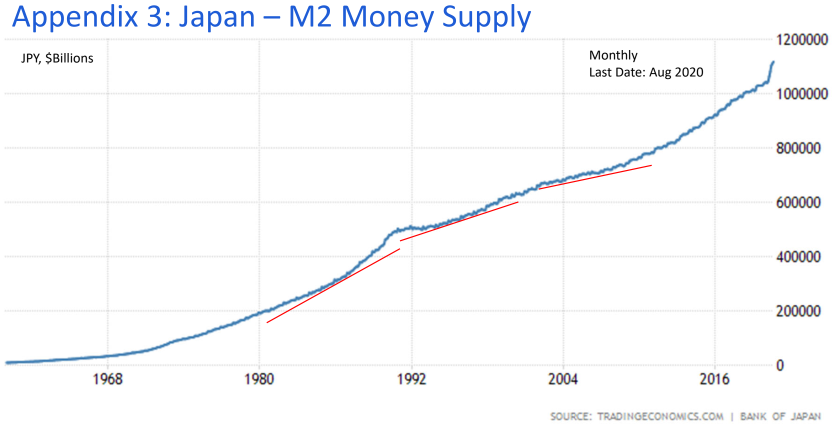
The Bank of Japan first reduced its policy rate to 0% in 1999, where it largely remained before going negative for the first time in January 2016. The Bank of Japan is the first central bank to cut its policy rate below zero.

Appendix 2: USD/JPY



The USD dollar has declined steadily against the Yen since the mid-1980s. Prior to the Plaza Accord, converting USD $1 yielded about ¥ 250. Presently it yields only ¥ 105.

Appendix 3: Japan – M2 Money Supply



The Bank of Japan was also criticized for letting the growth rate of the money supply slow to rates lower than before the bubble popped - the rate people came to expect after years.

What We Believe You Should Know:

The views and opinions in this report are our own and we have prepared all of the information. These views and opinions could be incorrect, and while we believe we have sourced the information in the report from reliable sources, we cannot warrant their accuracy. The content of this report should not be considered investment advice as it may not be suitable for your personal circumstances, and is not a solicitation to buy or sell securites. We encourage you to speak to an investment professional before making any investment related decisions. This report may also discuss topics that overlap with tax-related matters. We are not tax advisors and we recommend that you seek independent advice from a professional advisor on tax-related matters.

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

What You Need to Know:

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