As at December 31, 2020

Group Savings and Retirement

Outlook for 2021: after the virus comes the vaccine!

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The year 2020 will forever live in our memory as the "year of the virus." Everyone's daily life has changed in ways we would never have predicted in the early months of the year, when the longest-ever bull market came to an abrupt end. It is clear from our current perspective that 2021 will be the "year of the vaccine."

No year in recent history has held more economic uncertainty than 2020. As in a science-fiction film, the world was struck by a pandemic, whole populations went into lockdown, and the President of the United States refuses to recognize the result of the November election.

As we look ahead to 2021, we see a great deal of continuing uncertainty; however, some features are becoming more discernible.

First of all, the enormous volume of budget stimulus injected into the world economy (equivalent on average to more than 10% of GDP in developed countries and to 16% in Canada[1]) will act as a tail wind in 2021. Why? We know that households have saved a considerable portion of this financial aid and will seek to increase their spending as the economy re-opens.

Second, central banks are likely to keep interest rates low and continue to inject liquidity in the world economy through their quantitative easing programs. According to the U.S. Federal Reserve, there is no plan to do away with this "bag of goodies" for a few more years yet.

Third, we cannot imagine a more effective economic stimulus measure than a worldwide vaccination campaign against the pandemic. With the economy gradually re-opening, there will very likely be a large-scale release of pent-up demand, triggering a few quarters of above-potential economic growth, both in developed countries and emerging economies.

Will the New Year meet our expectations? It is too early to say. The early months of 2021 may well be hectic, but we continue to believe that the planets are aligned for an economic rebound and decent market performance.

World: China shows all the signs of being a well-positioned global economy

Despite the severity of the global pandemic, the world economy is in a good position to usher in a new economic cycle. That, at least, is what data published in China suggest.

To begin with, the fact that China was able to mitigate the spread of the virus domestically enabled its economy to maintain a steady level of performance in 2020. According to the Organisation for Economic Co-operation and Development (OECD), the Chinese economy was the only one in the world to display growth in 2020, namely, 1.8%. Also according to the OECD, China's economy will probably grow at a rate of 8.0% in 2021, slightly outperforming India at 7.9%, as the synchronization throughout the world economy and the massive vaccination campaign stimulate business and trade.

Admittedly, China's economic figures for 2020 are astonishing.

Industrial production, which is the leading metric for international demand, is heading for a year of positive growth, and the first 11 months of 2020 displayed – despite the pandemic – an upswing of 2.3% as compared with the first 11 months of 2019.

In 2020, capital investments also displayed net growth after 11 months as compared with the same period in 2019, posting a rate of 2.6% and reflecting the Chinese business sector's and government's high level of confidence in the years ahead.

Retail sales, however, will likely show a slight drop in 2020, despite an increase in year-end shopping, mainly for luxury goods.

Chinese consumers still exhibit some caution with regard to outlays for entertainment and restaurant outings, preferring to stay at home and making 2020 a year for maximizing savings. To stimulate domestic demand, China's administration continues to signal its intention to announce stimulus measures designed to encourage consumption, which would add to the tail wind propelling the world economy.

In sum, the Chinese economy is performing well and its data reflect the stunning resilience of the world's emerging economies.

Across the world, the fourth quarter was marked by the signing of a major free-trade agreement by 15 Pacific Rim countries. With the stroke of a pen, Australia, China, Japan, South Korea, New Zealand, and all members of the Association of Southeast Asian Nations (ASEAN) ratified their decision to create the world's largest trade bloc.

The accord, which has been the subject of negotiations since 2012, is important for two key reasons.

First, this is the first multilateral agreement that China has signed, enabling the country to extend its influence as the world's future largest economy and, ironically, a champion of free trade.

Second, this new agreement signals that globalization is not dead despite the concerns that may have been raised following four years of Trumpism in the White House. One of the lessons the world is sure to draw from the global pandemic is that supply chains must become increasingly local so as to endow the world's various economies with maximum self-reliance; however, cooperation among nations that share borders or similar ideologies appears to be a permanent fixture.

Indeed, as soon as the signing of this agreement was announced, the European Union approached President-Elect Joe Biden to promote closer economic and public health ties between the EU and the U.S. in response to this emerging rival. It seems clear that globalization will survive after all and that sound economic competition between East and West is in the offing.

Europe: a challenging quarter, but efforts are paying off

The European economy spent much of the fourth quarter operating at low output as the authorities focused their efforts on dealing with the second wave of COVID-19 propagation. In various countries, including Germany, France, and Spain, decision-makers did not hesitate to impose curfews, business closures, and other distancing measures despite public grumbling.

As the quarter draws to a close, it would seem that these efforts are paying off!

[1] www.statista.com/statistics/1107572/covid-19-value-g20-stimulus-packages-share-gdp/

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The number of new daily cases per 100,000 inhabitants, which had been following an accelerating trend in October, going from 10 to 50 in only 30 days, quickly fell to about 27 in mid-December. The battle against the pandemic, however, is hardly won. In fact, just before the Holiday Season, the U.K. announced a complete lockdown for the Greater London area due to the spread of a new and more contagious variant of the virus. For the time being, it is unclear if the vaccines will be effective against this new mutation, but initial expert opinion appears to be encouraging.

Still, the arrival of the vaccines in December should be welcome news for Europe, which is in a good position to alleviate distancing measures as a result of the vaccination campaign – a luxury that North America can probably not afford. Consequently, the European economy is in a good position to outperform the U.S. economy in early 2021, even if a slight contraction is likely on both sides of the Atlantic as the current COVID-19 wave impacts economic data.

That seems to be the finding of various surveys of households and businesses that express almost unanimous confidence in the years ahead despite current challenges and difficulties.

The most recent European economic activity estimates show increasing stability in the services sector and continuing growth in the manufacturing sector. Hiring intentions have also stabilized and point to a drop in the unemployment rate in 2021.

Christine Lagarde, President of the European Central Bank (ECB), displayed cautious optimism by declaring that the coming vaccination campaign made her more confident that the public health crisis would soon be resolved. She noted, however, that achieving widespread immunity would take time, thereby potentially giving rise to new economic challenges in the short term. This view seems to be shared by other members of the governing board at the ECB, which has announced that its monetary policy will continue to be accommodating for a few more years.

In the political arena, negotiations between the U.K. and the E.U. continued right to the last minute, but the parties finally came to a post-Brexit agreement. It was a long haul, but the fact is that achieving such a complex agreement in so little time during a pandemic is nothing short of astounding.

The agreement's most complex components involve fishing rights, rules that apply to travellers, the guarantee that no business shall have a competitive advantage over its rivals due to its head-office location, and, of course, the dispute-resolution mechanism.

Now that this sensitive issue is resolved, Europe can focus its efforts on post-COVID management. The Old World faces major challenges, but we believe that investors will be increasing their exposure to European equities in 2021.

United States: turning the page on the Trump Presidency

In 2021, the country that will be in the limelight is undoubtedly the United States.

The extended saga that has followed Donald Trump's defeat in the presidential election in November is coming to an end, and Joe Biden will officially become the 46th President of the United States. We will spare our readers the reality soap opera of the past few months and simply state that American democracy, which our neighbours to the south take pride in, has resisted the assaults of the Trump team.

The new President of the United States will face many tough challenges in a divided America.

To name just a few of these challenges, Mr. Biden will have to restore confidence in public institutions among a sizable portion of the population that has become wary of them and rebuild diplomatic relationships that have been weakened and even damaged in the course of the past four years.

From an economic standpoint, President Biden's task will not be easy; however, he will be aided by the tail winds blowing in his favour in the years ahead, including a massive vaccination campaign (after all, vaccination is the greatest imaginable stimulus following a global pandemic), a huge fiscal stimulus injected into the economy in 2020, and central banks deploying their arsenal of monetary accommodation measures.

One of the first initiatives undertaken by the new President will likely be to implement a new round of targeted fiscal stimulus designed to reinvigorate the labour market and, let us not forget, provide the states with the resources they need to carry out their vaccination programs.

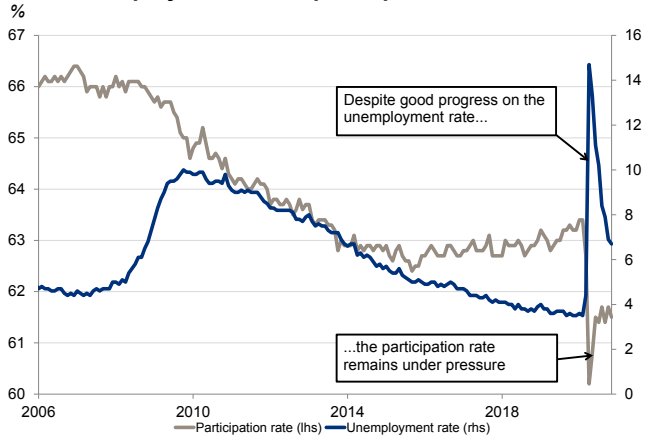
The United States' labour market is an important piece of the puzzle and will be key during the first years of the economic cycle now getting under way. Job creation certainly rebounded impressively in the summer, but it has begun to reverse course as the end of the year approaches.

The most concerning indicators to us are the labour-force participation rate, the number of long-term unemployed, and the number of new employment-insurance recipients.

First, the labour-force participation rate in the U.S. dropped – as was the case everywhere around the world – going from 63.4% in February to 60.2% in April. Since summer 2020, it has struggled to rise back up and has hovered around 61.5% (see Graph 1). A healthy labour market rests on an active population that views its prospects of finding new work with confidence; conversely, declining labour-force participation reflects the population's growing dejection.

Graph 1

U.S.: Unemployment rate & participation rate



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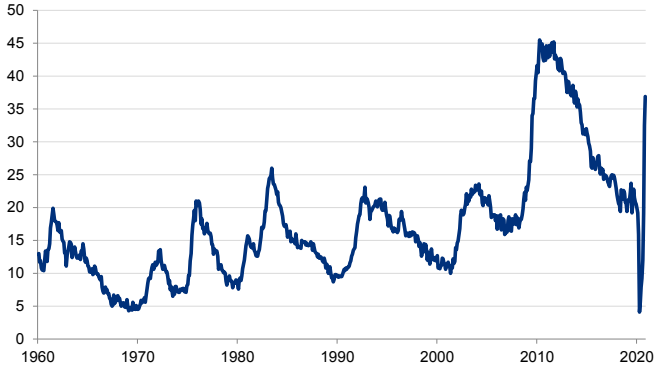
Second, and along the same lines, the number of Americans who have been unemployed for more than 27 weeks (the definition of long-term unemployment) is constantly on the rise and is quickly approaching its historic peak set in the aftermath of the 2008 financial crisis (see Graph 2). It is a well-documented fact that a person who has been unemployed for more than 27 weeks faces increasing challenges when trying to re-enter the labour market. In many such cases, job seekers must return to school to upgrade their skills or move to another location where their qualifications may be needed.

Graph 2

U.S.: Long-term unemployment rate headed towards a new record?

Persons unemployed for 27 weeks or more, as a % of total unemployed

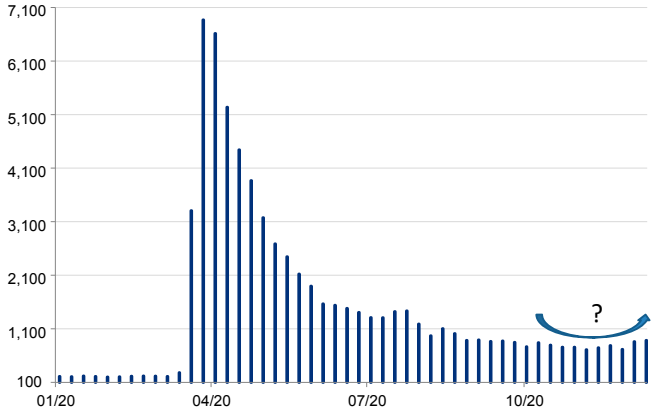


Third, one of the most monitored labour market indices of 2020, namely, new employment-insurance requests, stabilized in the summer, but unfortunately rose again in the autumn following the noteworthy summertime improvement (see Graph 3). Is this simply due to new local social-distancing measures or is the labour market shrinking again? Data to be published in the first half of 2021 will probably provide an answer to this question.

Graph 3

U.S.: Jobless Claims

As of December 11, 2020, in thousands



Among the positive developments, the announcement of the nomination of former Chair of the Federal Reserve Janet Yellen to the cabinet position of Secretary of the Treasury is good news since she is renowned for her extensive labour-market expertise. She will surely guide the new administration ably in the pivotal period just ahead.

In his most recent press conference, the current Chair of the Federal Reserve, Jerome Powell, stated his intention of maintaining an expansive monetary policy for a few more years. In his view, the U.S. economy remains vulnerable in the short term and requires, once again, a combination of an injection of liquidity and a policy rate close to 0%. Or, at least, until the data show "substantial" progress with regard to employment and inflation – an intentionally vague statement that suggests that the Federal Reserve intends to stay present on the markets for at least a few more years.

Canada: well-positioned for economic outperformance

At home, our economy is doing rather well as the year comes to a close.

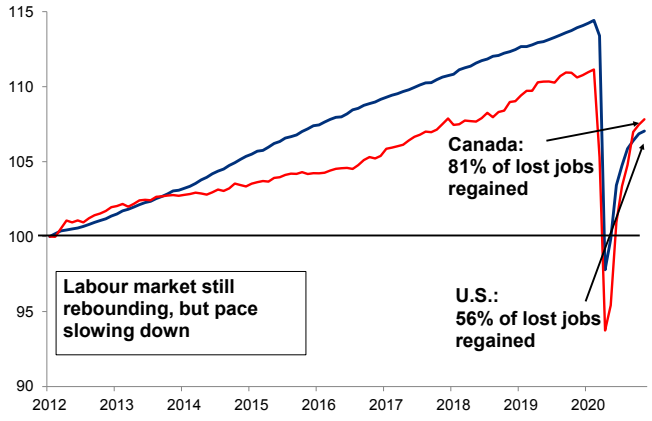
First and foremost, the labour market in Canada has already recovered more than 80% of the jobs that were lost at the beginning of the year, a key achievement that suggests a solid and sustainable recovery in 2021 and beyond.

Let us recall that the federal government's decision to preserve the employment relationship between employers and employees via wage subsidies was questioned by many critics, who preferred direct payments to the population as a whole. As it turns out, the Trudeau government made the right decision: as shown in Graph 4, the U.S. labour market had recovered only 56% of lost jobs by the end of November despite the U.S. government's strategy of making direct payments to the population.

Graph 4

Total jobs, Canada vs U.S.

Index, January 2012 = 100, as at November 30, 2020



Another piece of good news is that, unlike our neighbours to the south, there is no intention at the moment to cut back government support. One of the advantages of the Canadian political system is that in times of crisis a majority government has the latitude it needs to implement its action plan without having to negotiate endless compromises, as is the case in the U.S. where the House of Representatives and the Senate are governed by a Democratic and Republican majority, respectively.

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All of the above suggests that in the next few years of this new economic cycle, we will likely see the Canadian economy performing well. This positive economic performance is all the more important in that the sharp increase in debt will be countered, at least in part, by an increase in tax revenues.

According to the economic update delivered by Finance Minister Chrystia Freeland on November 30[2], the projected budget deficit will reach $382 billion in 2020-21 and dwindle to $121 billion in 2021-22 and $51 billion in 2022-23.

At first glance, these figures may seem high; however, we must not forget that Canada has a $2 trillion economy and that as a percentage of GDP, the Canadian government's post-crisis level of indebtedness will compare favourably with that of other G7 nations.

Also according to the government's economic update, the ratio of debt to GDP will rise to 52.6% in 2021-22 and begin to dip as of 2022-23, as economic growth exceeds the expected interest amount due on the debt. The net result is that the federal government's debt ratio will rise – in only 2 years – from 31.2% in 2019-20 to more than 50.0%. This sharp an increase has not been observed since early 2000.

We firmly believe that a vigorous government response to the pandemic was exactly what was needed and that the option of doing nothing would have been much more costly in the long run. The example of the Great Depression of the 1930s demonstrated the role that government can play during slumps in demand and continues to guide public policy-makers nearly a century later.

In sum, we have high expectations for the Canadian economy in 2021. We believe it will easily outperform the U.S. economy, thereby bolstering Canadian equities and currency, which should rise in value to US$0.83 to US$0.85 during the course of the year. Also, it is worth mentioning that improved relations with our largest trading partner will do no harm…

Markets: against all odds, 2020 was a good year for investors

As the fourth quarter of 2020 comes to a close, we see that stock markets around the world have again achieved new peaks. The combination of massive fiscal stimulus, liquidity injection by central banks, and, news in November of the imminent launch of vaccination campaigns worldwide have boosted risk-laden equities in this final quarter.

Among the highlights of 2020, let us first mention the performance posted by the NASDAQ technology sector index, with an annual return of nearly 40.0%, despite its losing nearly 25.0% of its value from December 31, 2019 to March 23, 2020. During the recovery begun in late March, Wall Street's flagship index, the S&P 500, was also buoyed by tech giants, thereby finishing ahead of major stock indices around the world at year-end.

The second half of 2020 was also pivotal for emerging markets, which posted growth exceeding 25.0% since late June following a shaky rebound in the second quarter; as a result, after 13 years, they have finally overtaken the historic peak achieved by the MSCI Emerging Markets Index in 2007.

Closer to home, Canadian stock markets have also shown year-end strength following a period of consolidation in the third quarter. As 2020 comes to an end, Canadian indices are once again in the black despite a drop of nearly 35.0% from the beginning of the year to March 23.

As it turns out, the star of the final quarter of 2020 was the Russell 2000 Index, a small-capitalization index in the U.S. that ended the year with the strongest quarter in its history, posting an increase of more than 30.0% in the last three months of the year. Here is an interesting fact: history tells us that a strong quarterly performance by small caps generally ushers in positive above-average returns in subsequent quarters.

Undoubtedly, the most beneficial development for Canadian stock markets, including emerging markets and small-cap indices, was the announcement that vaccines were coming. The promise of vaccination has practically guaranteed a solid and widespread economic recovery worldwide, thereby fostering investor interest in the cyclical sectors that are strongly represented by indices beyond the United States. These indices include European stock markets that showed a strong rebound in November following 5 months of consolidation.

While global equity markets have, since the month of March, experienced the strongest recovery in their history, achieving near-record peaks, we are optimistic regarding the outlook for revenues in 2021. This level of optimism may seem excessive as the year comes to a close. History, however, tells us not only that December is often the best-performing month of the year, but that strong performance on Wall Street (in early December, no fewer than 93% of companies listed on the S&P 500 were performing above their 200-day moving average) is often associated with a strong probability of additional gains in the subsequent 12-month period.

The underlying turnover we see in the markets should favour additional gains in equities throughout the year, but imponderable factors associated with the current pandemic will surely bring about a fair amount of volatility. While we expect positive returns in equities in the range of 5% to 10%, investor attitudes will go through ups and downs. Since U.S. stock markets significantly outpaced other indices around the world in the past decade, we advise investors to turn toward emerging markets, Europe, and even Canada in 2021 since the current environment favours these more cyclical markets.

Bonds, however, may experience a more difficult year. The world economy seems increasingly ready to perform at full capacity, and the long-term post-COVID outlook seems brighter. Long-term interest rates are probably too low and may increase next year, which may result in negative returns for bond portfolios. Consequently, fixed-income diversification becomes critically important, and our managers will surely be able to add value with reasonable credit exposure to high-quality companies and make timely adjustments to investment positions.

In the fourth quarter, the Canadian bond market, gauged by the FTSE TMX Canada Universe Bond Index, returned 0.6% (8.7% in 2020). As for the FTSE TMX Canada Short Term Bond Index, it returned 0.5% (5.3% in 2020). The FTSE TMX Canada Long Term Bond Index lost 0.8% (11.9% in 2020).

U.S. stocks listed on the S&P 500 Index provided an overall return of 12.1% in the fourth quarter (7.0% in Canadian dollars). Canadian stocks listed on the S&P/TSX Index returned 9.0%

European equities represented by the MSCI Europe Index returned 10.3% in the fourth quarter (10.3% in Canadian dollars). The MSCI EAFE Index rose by 11.4% during the quarter (10.7% in Canadian dollars). The MSCI World Index returned 12.4% during the quarter (8.7% in Canadian dollars). Emerging markets, as shown by the MSCI Emerging Markets Index, returned 16.1% in the quarter (14.4% in Canadian dollars).

Strategy: Looking ahead to 2021

As in the past, 2021 is likely to favour active portfolio managers and those willing to take a little more risk than they normally would.

[2] www.budget.gc.ca/fes-eea/2020/report-rapport/chap4-en.html#44-Fiscal-Outlook

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Just as we did last year, we present below our strategic outlook for 2021 by issue.

1. Where are the opportunities?

COVID-19 brought the longest business cycle and the longest bull market ever to an abrupt end in early 2020, meaning that we are now officially in an early-cycle market environment. The early-cycle playbook is based on strong economic growth with limited inflationary pressures in the first few years, as the massive output gap that was created during the COVID recession gradually closes. The investment implications are fairly clear: equities should outperform bonds; the yield curve should gradually steepen; small and mid-caps should outperform large caps; cyclicals should outperform tech; and, finally, value should do better than growth.

We would also advise investors to spread their overweight on equities to multiple parts of the world. The U.S. stock market has dominated all the other main markets over the last decade, and is now relatively expensive. With the ongoing rotation towards value and cyclicals, we expect the U.S. market to underperform in 2021, with emerging markets, EAFE, and Canada having a good year.

2. What are the challenges?

The COVID situation continues to generate uncertainty, and one may argue that equities pricing may bring about good news early in 2021. While we remain optimistic about the reopening of the economy and the expectations for strong earnings growth over the next few years, we caution against overreaching for risk and favour a sound risk-management approach for all investment decisions. As the great Warren Buffet has said, price is what you pay, and value is what you get.

Counterintuitively, there is also the risk that the economic recovery becomes a bit too strong and inflation sticks its neck out, as the immense quantities of stimulus injected in 2020 translate into a strong and swift rise in interest rates. Such a scenario may create the fear that central banks would tighten monetary conditions earlier than expected, which would weigh on risk appetite.

In fact, the current environment – with its considerable uncertainty regarding macro fundamentals – calls for investors to display a good deal of humility.

3. How are you positioning the Funds?

Our strategy is to overweight equities relative to bonds and spread this overweight around the planet. The equity risk premium (calculated by subtracting the 10-year U.S. rate from the earnings yield on the S&P 500) is still sitting at historically elevated levels, even though typical valuation measures (like the P/E ratio) suggest that the market is expensive. We use this measure to remind our readers that asset allocation deals with the relative valuation of assets, and, currently, with interest rates still at nearly all-time lows, equities as an asset class are quite attractive when compared to bonds.

While we acknowledge that it is always risky to underweight the U.S. stock market, we are positioning our funds so that the overweight on equities is spread to regions that have underperformed over the last few years and are now ripe for revaluation. As a result, we favour emerging markets, EAFE, and Canada, as all three indices are well positioned to benefit from the underlying market rotations, from growth to value to cyclicals.

On the fixed income side of the equation, we prefer to maintain low duration, as interest rates are likely to move progressively higher in 2021, and to favour corporate bonds over government bonds to benefit from their additional yield.

Regarding the Canadian dollar, we expect that the global economic recovery will push the loonie higher relative to the U.S. dollar, and we will continue to hedge our exposure to the U.S. dollar actively throughout the year.

Finally, we are still holding a small position on gold – a good diversifier in periods of geopolitical uncertainty – which should allow us to benefit from the low-rate environment that we expect over the next few years.

4. Why is this the right approach for 2021?

As we mentioned in the opening comments above, we see 2020 as the year of the virus and 2021 as the year of the vaccine. This means that the world will slowly get back to normal and to an economy swimming in liquidity. Such an environment should be supportive of risky assets, but diversification will remain key as lingering uncertainty will likely create bursts of volatility throughout the year.

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Chart 1
Returns of the Canadian Bond Market as at December 31, 2020

Index	Returns (%)	
	3 months	YTD
FTSE Canada Universe Bond Index	0.6	8.7
FTSE Canada Short Term Bond Index	0.5	5.3
FTSE Canada Mid Term Bond Index	0.6	10.1
FTSE Canada Long Term Bond Index	0.8	11.9
FTSE Canada Federal	(0.2)	7.3
FTSE Canada Provincial	0.6	9.9
FTSE Canada Municipal	0.7	10.1
FTSE Canada Corporate	1.8	8.7

Chart 2
Market Returns as at December 31, 2020

Index	Returns (%)	
	3 months	YTD
FTSE Canada 91 Day T-Bill Index	0.0	0.9
FTSE Canada Universe Bond Index	0.6	8.7
S&P/TSX Composite Index	9.0	5.6
S&P 500 (Can. $)	7.0	16.3
MSCI - EAFE (Can. $)	10.7	5.9
MSCI - World (Can. $)	8.7	13.9
Exchange Rate (Can. $ / US $)	(4.6)	(1.8)

Chart 3
Market Returns as at December 31, 2020

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector returns		
Energy	14.7	(26.5)
Materials	(3.7)	21.2
Industrials	7.1	17.0
Consumer Discretionary	21.0	17.1
Consumer Staples	(5.6)	4.3
Health Care	30.1	(22.9)
Financials	16.7	1.6
Information Technology	7.6	80.7
Communication Services	3.7	(3.7)
Utilities	5.6	15.3
Real Estate	9.7	(8.7)
S&P/TSX Composite Index	9.0	5.6

Chart 4

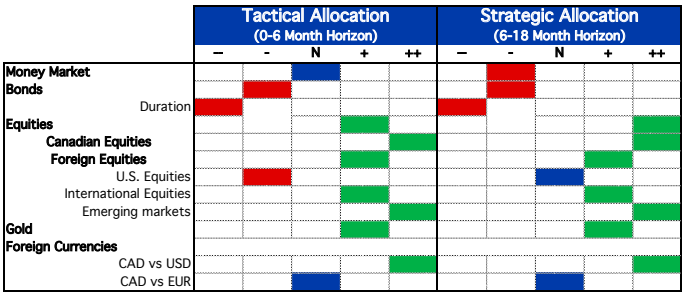

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Chart 5
Economic and financial scenarios

Economic scenario

							Change since September 30, 2020	
		2018	2019	2020	2021	2022	2020	2021
U.S.	Real GDP	3.0%	2.2%	-3.5%	4.5%	3.1%	+1.5%	+0.4%
	Inflation rate	2.5%	1.8%	1.0%	2.0%	2.2%	-0.1%	-0.1%
	Unemployment rate	3.9%	3.7%	8.1%	6.0%	5.0%	-1.6%	-1.5%
Canada	Real GDP	2.0%	1.7%	-5.6%	4.0%	3.5%	+0.2%	-1.0%
	Inflation rate	2.3%	1.9%	0.7%	2.0%	2.3%	--	+0.3%
	Unemployment rate	5.8%	5.7%	9.5%	7.9%	6.3%	--	-0.1%

Financial scenario*

			Targets			Change since September 30, 2020	
		Actual	June 2021	Dec. 2021	June 2022	June 2021	Dec. 2021
Interest rate	Canada 10 years rates	0.68%	0.95%	1.15%	1.35%	-0.30%	-0.35%
	U.S. 10 years rates	0.91%	1.25%	1.45%	1.65%	+0.25%	+0.25%
Exchange rate	US $/Can. $	0.79	0.80	0.81	0.83	+0.02	+0.01
	US $/Eur	1.22	1.23	1.24	1.25	+0.02	+0.01
	Oil price (WTI). US $	49	52	55	58	+9	+11
	S&P 500	3,756	3,900	4,035	4,200	+275	+285
	S&P/TSX	17,433	18,500	19,500	20,400	+800	+900

* end of period