ETERNA FINANCIAL GROUP

# QUARTERLY REVIEW — DECEMBER 2020

## ASSET SUMMARY AND ALLOCATION

Market conditions were ultimately generous in 2020. The last quarter is particularly noteworthy, when U.S. stock market indices reached new highs. Recent months witnessed sector rotation towards smaller-cap stocks and previously overlooked sectors. The indices were propelled by the GAFA+. As a result, the U.S. S&P 500 Index provided a total return of 18.4% in 2020, a gain of 16.5% in Canadian dollars; the loonie appreciated by 2%. Meanwhile, the Canadian S&P TSX Index produced a 5.6% total return, bolstered by the Spotify technology stock, while industrial and materials sectors were equally strong. The FTSE Canada Universe Bond Index generated a total return of 8.7%. Interest rates were lower than at year-end 2019 and short-term rates are near zero percent.

Even with a dramatic rebound in activity during deconfinement, the pace of growth relented and service sectors are depressed; the underemployment situation in the U.S. and its social consequences are a matter of particular concern. The new U.S. administration is facing an uphill climb.

Canadian support programs continue to be among the world's most comprehensive and recovery from the crisis may be an issue for future expansion. There is optimism for the new year, with the immunization roll-out and encouraging economic policies. A turnaround is likely this year and a stronger recovery may emerge if the pandemic subsides, as anticipated, before the fall. While stock market indices appear highly valued, it is only because of a handful of stocks and several sectors are undervalued. These sectors are where we focus our style and our strategies.

- **Stock markets were buoyant in the last quarter of 2020; U.S. indices reached new highs.**
- **The dramatic rebound in activity after the summer's deconfinement was followed by a slowdown as contagion accelerated and new restrictions were applied.**
- **As 2021 began with a resurgence of the pandemic, the first quarter could prove difficult for growth; if all goes well, there will be strong recovery in the second half of the year.**
- **Governments spent unprecedented sums of money supporting households and businesses. The pace of growth will partly rely on their response to the end of these programs.**
- **Stock market indices were boosted by so-called GAFA+ stocks (Google, Amazon, Facebook, Apple, Microsoft, Tesla). Other sectors were weak and we believe a sectoral shift will favour them.**
- **Interest rates, especially short-term, can no longer be lowered. However, their increase appears limited for the moment.**

## STATISTICS ON DECEMBER 31, 2020

| CANADA | | |
|---|---|---|
| Unemploy. rate (Nov.) | 8.5 % | ↓ |
| C.P.I. (Nov.) | 1 % | ↑ |
| 3 months treasury bills | 0.08 % | ↓ |
| Bonds 5 years | 0.39 % | ↓ |
| Bonds 10 years | 0.68 % | ↑ |
| S&P/TSX | 17 433 | ↑ |

| UNITED STATE OF AMERICA | | |
|---|---|---|
| Unemploy. rate (Nov.) | 6.7 % | ↓ |
| C.P.I. (Nov.) | 1.2 % | |
| 3 mths treasury bills | 0.06 % | ↓ |
| Bonds 5 years | 0.36 % | |
| Bonds 10 years | 0.91 % | ↑ |
| Dow Jones - Industrial | 30 606 | ↑ |
| S&P 500 | 3 756 | ↑ |

| CURRENCIES | | |
|---|---|---|
| $ É.-U. / $ CAN | 0.79 | ↓ |
| $ É.-U. / € Euro | 1.22 | ↓ |
| ¥ Yen / $ É.-U. | 103.25 | ↑ |

The arrow indicates the trend since the publication of the last monthly data or end of the month.

## ECONOMY AND FIXED-INCOME SECURITIES

The bond markets yielded positive returns during the last quarter. The FTSE Canada Universe Bond Index returned a total of 0.6% in the fourth quarter of 2020, with significant gaps between corporate and federal sectors. The federal sub-index returned -0.25% versus +1.8% for the corporate index. This difference is even greater as we move further along the maturity curve. On one hand, it reflects higher interest rates and, on the other hand, the narrower spreads demanded by investors for holding corporate, provincial and municipal credit bonds. For 2020 as a whole, the FTSE Canada Universe Bond Index returned 8.7%, compared to 5.3% for the 1–5 year bond index. Even with higher bond yields in the fourth quarter, bond rates ended the year at 150 basis points below their level of a year ago, with 2-year federal rates at 0.2% and 30-year rates at 1.2%, or 50 basis points lower than a year ago.

The short-term rates, from 1 day to 5 years, are temporarily frozen as the U.S. Federal Reserve and the Bank of Canada announced a delay in raising administered rates, such as the discount rate, until the recessionary output gap is closed and inflation exceeds 2% over a period of time. Market participants understand that this will probably not happen before 2022 or even 2023.

The third-quarter GDP figures were impressive, with +40.5% in Canada and +33.4% in the U.S. on an annualized basis, although it was expected after the historic collapse of the first two quarters. Activity is still 3% lower compared to a year ago. Underemployment in the United States is particularly worrisome. Similar to Canada, there is considerable support for households forced out of work due to lockdowns; employers also received support, with almost 20 million Americans receiving assistance. Although several measures were renewed at year's end with a $900 billion plan, many believe this will be insufficient. The re-acceleration of COVID-19 in December, and possibly January, is not a good omen for the statistics of these two months. Retail sales in the U.S. declined in October and November, as well as disposable income. However, goods-producing sectors are holding their own, and residential construction and real estate sectors are robust. The key to recovery in the U.S., Canada, and elsewhere is the speed at which the vaccine will be delivered. Predictions are always risky, but even more so in this context. However, we are confident of successful recovery if everything continues to go well; in other words, if vaccination is quick, effective and problem-free. Our confidence stems from comprehensive fiscal and monetary policies implemented in 2020. It remains to be seen, however, exactly what households will do when support programs end, as they won't last forever. There are already concerns about government deficits and debt. American households had low debt and healthy savings rates before the crisis, but the picture is different in Canada, where consumer debt is already a cause for concern. Only time will tell. Right now, we expect slow growth in early 2021, but a potentially sharp increase later in the year.

In this scenario, bond market participants can order higher bond rates to hedge against inflationary and monetary policy implications of expansion over time. This may translate into a 2- to 5-year rate hike before year-end, consistent with previous cycles, where bond rates invariably jump before a change in central bank policy. This environment usually favours credit securities, especially corporate issues. Corporate spreads also performed very well in recent months. We might be going overboard just a bit, but we want to highlight the logical progression of recovery and expansion in late 2021 and early 2022.

Our bond strategies, which focus on managing credit securities, increased the weight of these securities in our portfolios since the spring, particularly corporate securities, while retaining exposure to Quebec municipalities. We will preserve these exposures in the first quarter and adjust duration in line with rate movements, as we usually do with our actively managed funds, but we realize that we may need to adjust medium- and long-term maturities in the coming quarters.

**Michel Pelletier**, Vice-President and Senior Fixed Income Manager

**Bobby Bureau**, Fixed Income Analyst and Manager

## NORTH AMERICAN STOCK MARKET

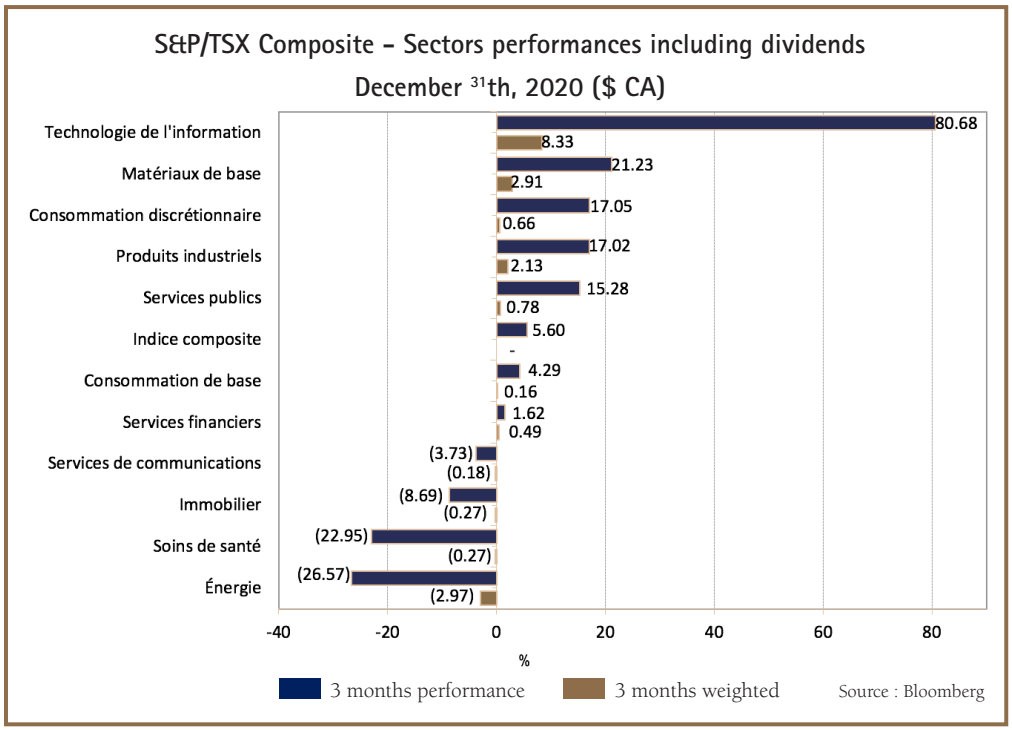
At the beginning of this year, it is evident that stock markets once again disregarded fears propagated by traditional media and some pessimistic investors, while generating returns that exceeded expectations in 2020. The coordinated efforts of central banks and governments since the start of the pandemic helped restore optimism about the direction of the economy and financial markets. At this point, it is difficult to gauge the true economic and market impact of the surge of money in circulation, but we must recognize that businesses and individuals are better able to weather the current crisis.

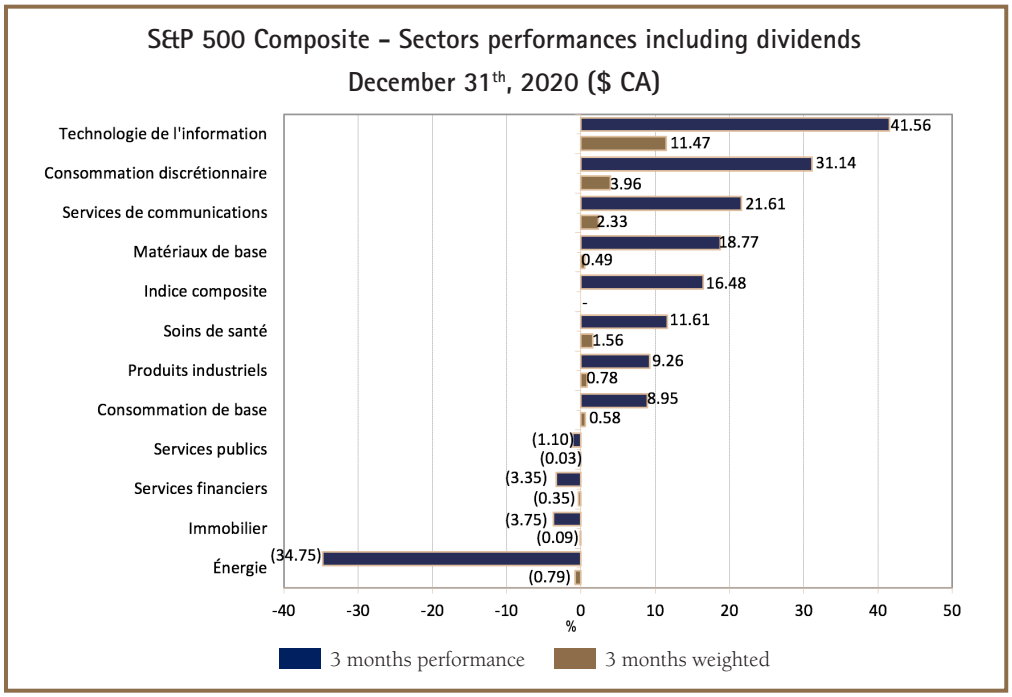
The last quarter saw an astonishing market performance, with the Canadian index up 8.97% and the S&P500 U.S. index, when converted into Canadian dollars, up 7.57%. It is worth mentioning that our currency appreciated by 4.46% during the quarter. This is largely due to higher prices for industrial metals and energy. These prices rose in the last quarter following much stronger demand, a consequence of Asian economic growth.

Since the start of the year, the top sectors in the U.S. market were Information Technology, Consumer Discretionary and Telecommunications, with respective gains of 41.6%, 31.1% and 21.6%. In contrast, the worst-performing sectors were Energy (-34.8%), Real Estate (-3.8%) and Financial Services (-3.4%). Canadian technology companies had the highest return at 80.7%. This was strongly influenced by Shopify, which gained more than 178%. Shopify now has higher representation in the Canadian index than the Royal Bank.

| Raw materials | Variations (%) | |
|---|---|---|
| | Last trimestre | Year 2020 |
| Aluminum | 15,4 | 11,1 |
| Copper | 16,2 | 26,2 |
| Nickel | 14,3 | 18,6 |
| Iron | 32,1 | 72,3 |
| WTI crude oil | 20,5 | -21,0 |
| Index S&P GSCI (Raw materials) | 16,9 | -6,1 |

Expectations for potential earnings are very high, and those who are interested in owning the stock have to pay over 300 times each dollar of anticipated earnings. Our management style, which focuses on buying profitable companies at reasonable prices, is not consistent with this type of company. Nevertheless, we were able to provide solid returns in 2020, largely through impressive fourth-quarter returns of the companies in your portfolios. Other Canadian sectors making progress were Materials, Consumer Discretionary, Industrial Products and Utilities, with respective gains of 21.2%, 17.1%, 17.0% and 15.3%. As with the U.S., the worst performing sector was Energy, which fell by 26.6%, closely followed by Health Care (-23%) and Real Estate (-8.7%).




In a crisis situation, it is very difficult to gauge stock market valuations.

Except for a few companies benefiting from the pandemic situation, the most recent quarterly results showed declining profitability compared to the previous year. We are confident that recovery will accelerate with evidence that the pandemic is under control, particularly with the arrival of vaccines. We are thus facing a period where it is difficult, perhaps even futile, to accurately assess stock market levels on a strictly fundamental basis. A key criterion to consider is that most forecasters expect profitability to grow by the first quarter of 2022. Meanwhile, we should experience volatility in the wake of both positive and negative news. These market valuation adjustments will provide us with interesting investment opportunities over a longer-term horizon. We have no doubt that there will be a sustained economic recovery, although it could take a little longer to materialize. The important factor is the long-term trend of the recovery.

**Overview:**

- We believe that equities will need to pause and volatility will provide us with attractive opportunities.
- In the short term, we expect a contraction in earnings and a return to pre-COVID levels is only expected in the first quarter of 2022.
- The risk of dividend reduction is less pronounced.
- In our North American strategies, we favour the financial, energy, industrial products, consumer discretionary and information technology sectors.

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**Jean Duguay**, Senior Vice-Chair, Senior Manager and Co-Chief Investment Officer

**Éric Warren**, Portfolio Manager

## INTERNATIONAL EQUITIES

In 2020 the gross returns of the Global fund, EAFE fund and US fund respectively were 23.7%, 18.3% and 17.9%.

The year 2020, without any doubt, will be reserved a special place in future history books. The Coronavirus pandemic is the obvious reason. However, on the positive side, we think there is a good chance that historians will look at the past year as the greatest catalyst for progress and creativity in human history.

We already have evidence that the pandemic is unlocking new ideas and fostering global forms of collaboration of an unprecedented scale.

In less than a year after the first Covid case in the North America, we have:

- Multiple approved vaccines, a process which previously took many years. More importantly, we now have a new platform for drug development (mRNA based) for future vaccines and potentially even many more applications (e.g. certain types of cancer) which represents a major breakthrough for medicine.
- An increasing number of companies hiring people from around the globe connected though the internet. Companies like Google or Microsoft can tap into engineering talent in countries like India or Bangladesh to work on projects that in the past were reserved to local workforce only.
- A generation used to learning online. Following the path of online shopping (e.g. Amazon) or online entertainment (e.g. Netflix) education will increasingly be delivered over the internet. It is way more cost efficient and better tailored to the individual needs of the student.
- Increased digital adoption and new channels for previously-offline businesses. Companies like Shopify allow small and medium sized companies to get a professional online presence (including payments, inventory management and marketing services) within a couple of hours. This opens the whole world as a potential end-market to companies that previously only operated on a local scale.
- New ways of collaborating that previously seemed impossible. When Moderna designed the Corona vaccine they did not have a sample of the virus. All they needed was its DNA sequence). Here is how the New Yorker described the situation:

Moderna's mRNA-1273 had been designed by January 13. This was just two days after the genetic sequence had been made public in an act of scientific and humanitarian generosity ... In Massachusetts, the Moderna vaccine design took all of one weekend. It was completed before China had even acknowledged that the disease could be transmitted from human to human, more than a week before the first confirmed coronavirus case in the United States. … This is the fastest timeline of development in the history of vaccines.

Unfortunately, this progress is not noticed by most people because they don't consult statistics; they read media headlines.

It is worth repeating what we wrote one year ago:

In the long run, advances in science, technology and the spread of reason will benefit the living standards of increasing parts of humanity and the sales and profitability of companies who cater to them directly or indirectly. The most lucrative way to participate in these advances is to own equities in quality companies for long periods of time.

There are reasons to be optimistic in spite of the current dire situation. We concur with Warren Buffett who observed that «Babies born today are the luckiest crop in history». Have a healthy and prosperous 2021.

**Markus Koebler**, Vice-president and Senior Global Equity Manager

**Market Indices in Canadian Dollars as of December 31, 2020**

| | 1 month | 1 year | 3 years[1] | 5 years[1] |
|---|---|---|---|---|
| FTSE/TMX - 91 Day Tbill | 0.02 % | 0.86 % | 1.30 % | 0.99 % |
| **Bonds** | | | | |
| FTSE Canada Universe Bond Index | 0.37 % | 8.68 % | 5.61 % | 4.19 % |
| FTSE Canada Short Term Overall Bond Index | 0.23 % | 5.29 % | 3.42 % | 2.26 % |
| Eterna Adapted Private Wealth Index [2] | 0.38 % | 7.19 % | 4.40 % | 2.96 % |
| FTSE Canada Medium Term Universe Bond Index | 0.60 % | 10.08 % | 5.86 % | 4.01 % |
| FTSE Canada Long Term Overall Bond Index | 0.37 % | 11.90 % | 8.15 % | 6.77 % |
| **North American Stock Indices** | | | | |
| Canada - S&P/TSX | 1.72 % | 5.60 % | 5.74 % | 9.33 % |
| USA - Standard & Poor's 500 | 2.17 % | 16.48 % | 14.91 % | 13.39 % |
| USA - Dow Jones | 1.74 % | 7.95 % | 10.60 % | 12.84 % |
| **International Stock Market Indices** | | | | |
| United Kingdom - FTSE-100 | 3.89 % | -10.43 % | -0.86 % | 1.55 % |
| France - CAC-40 | 1.22 % | -0.54 % | 2.69 % | 4.46 % |
| Germany - DAX | 4.39 % | 10.96 % | 3.43 % | 5.74 % |
| Japan - Nikkei-225 | 3.17 % | 19.60 % | 10.24 % | 9.14 % |
| Hong Kong - Hang Seng | 1.70 % | -4.53 % | -2.23 % | 2.78 % |
| Australia - S&P/ASX 200 | 3.99 % | 6.20 % | 2.92 % | 3.92 % |
| **Currencies** | | | | |
| $ CAN versus $ É.-U. | -2.12 % | -2.04 % | 0.41 % | -1.66 % |

Source : Bloomberg

1. Annual compounded total return.
2. The Eterna Adapted Private Wealth Index is made up of 60% of FTSE Canada Short Term Overall Bond Index and of 40% of FTSE Canada Mid Term Overall Bond Index.

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