LetkoBrosseau

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An extraordinary year in review

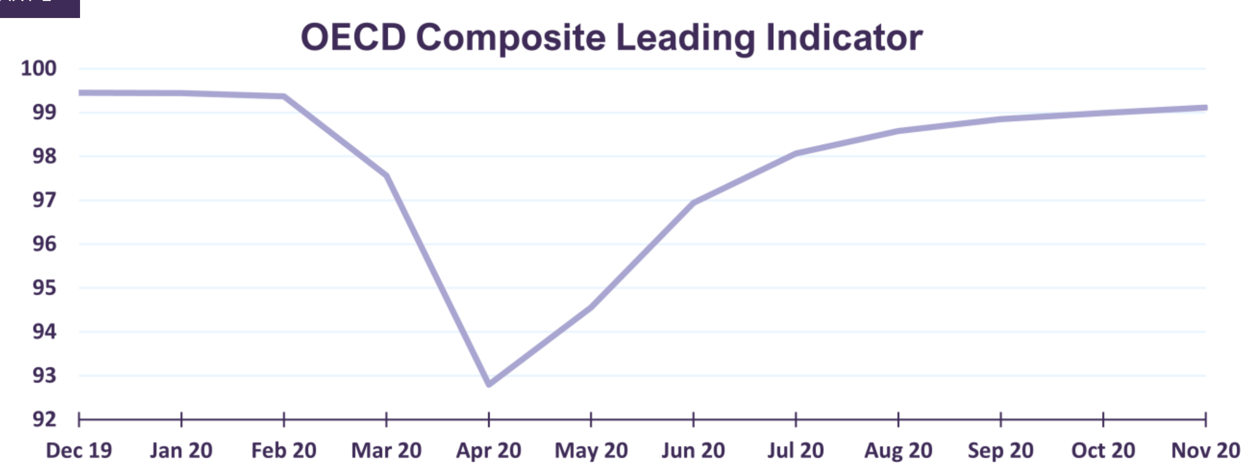
It is worth taking a moment to reflect on the extraordinary events that took place in 2020 with the COVID-19 pandemic that plunged the world into its worst recession since the Great Depression.

The year started on a positive note following a breakthrough trade agreement between China and the United States. While the agreement was far from perfect, it was key in boosting investor confidence that a trade war and recession were unlikely. With most global indicators signalling a modest acceleration of economic growth and a backdrop of low interest rates and subdued inflation, we were optimistic that the economic cycle still had considerable room to expand. This was driven by strong global demand led by the growing unmet needs of the 6.5 billion developing country inhabitants looking to provide better lives for their families.

In February, we learned that COVID-19 had begun to spread outside of China. This sent financial markets into a tailspin: from February 19th to March 23rd, the S&P 500 Index fell by 34%, the fastest decline in stock market history. The Letko Brosseau investment team had been performing extensive reviews and stress testing of all investments. Our goal was twofold: identify those companies that could manage through the pandemic and thrive after a global return to normal, and reduce or eliminate exposure to companies that we judged vulnerable to a protracted period of economic difficulty. Thus, cash balances in portfolios were raised. Despite these efforts, our portfolios remained relatively exposed to sectors operating in the real economy, and they declined in value by more than their benchmarks by the end of the first quarter.

We estimate that COVID-19 will have resulted in a loss of global economic output of $3.7 trillion. It was as if an economic tsunami hit the world without warning and quickly curtailed global activity. However, it is worth observing that the low point was felt in the early part of the year, and that the recovery began in April (Chart 1).

CHART 1



Source: OECD

This recovery has been made possible by the unprecedented level of monetary and fiscal support. Indeed, central banks and governments around the world injected more than $28.5 trillion or 33% of world GDP into the global economy in 2020. This is the equivalent of adding close to 1.5 times the size of the U.S. economy by way of new stimulus. Not only did this help avoid a full-blown economic depression, it set the stage for a strong rebound. According to the IMF, global economic activity should expand by 5.2% in 2021. We expect our portfolio companies that are exposed to the physical economy to benefit greatly as business conditions normalize over a period that should extend beyond the next year.

Our investment strategies did not exceed their respective benchmarks in 2020, but they have outperformed since the recovery began in April. This momentum accelerated in October and particularly in November, when Pfizer-BioNTech and Moderna announced the outstanding effectiveness of their COVID-19 vaccines. Investors began to see that an end to the pandemic was in sight.

There are many reasons to be optimistic about our investment strategy for 2021 and beyond. First, our portfolios are trading at very reasonable valuations and at a substantial discount to broad market indices. This is despite greater earnings expectations over the next two years driven by improving demand and a return to more normal business conditions. We expect industries such as energy, materials, autos, financials and transportation—among the biggest underperformers in the early stage of the pandemic—to benefit from a global upswing.

TABLE 1

LBA equity portfolio metrics

		Weight	Price / Earnings 2021	Price / Earnings 2022	2020-'22 Earnings Growth
Canadian Equities	LBA "Real Economy" stocks*	69.6%	12.9	11.2	88.9%**
	LBA total portfolio	100.0%	13.3	11.6	76.5%**
	S&P / TSX	**100.0%**	**16.4**	**15.0**	**57.4%**
Non-Canadian Equities	LBA "Real Economy" stocks*	42.0%	13.6	11.0	111.1%**
	LBA total portfolio	100.0%	14.4	12.2	96.2%**
	MSCI World	**100.0%**	**21.7**	**16.9**	**43.7%**

*Real Economy = Energy, Materials, Financials, Autos, Transportation **based on the weighted average of the portfolio company earnings
Source: Bloomberg consensus estimates and LBA calculations, Letko Brosseau Canadian Equity Fund, Letko Brosseau International Equity Fund

Second, as we discussed in our recent note on the history of value investing, 2020 has been the worst year on record for value investors. It is interesting to note that half of this underperformance can be attributed to lower profitability resulting from the pandemic, while the other half is due to a decline in the valuation of value stocks that are now trading at their cheapest level in history relative to higher-multiple growth stocks. We believe this situation can and will reverse in the coming years as the profitability of value stocks recovers to pre-pandemic levels. We also believe that the excessive valuation of high-multiple stocks may correct itself due to a combination of companies failing to deliver on the unrealistic expectations that investors have embedded in their stock prices and bond yields starting to normalize.

Finally, the record level of monetary and fiscal stimulus could eventually lead to higher inflation, and a consequent normalization of bond yields. We see elevated risks in long-duration investments such as long bonds and high-multiple, speculative stocks having little near-term support from earnings and cash flows. We continue to recommend holding high-quality, short-duration bonds for both liquidity and capital preservation purposes in the fixed-income component of portfolios. We favour equities trading at low multiples of current earnings and cash flows with higher dividend yields. We expect cyclical stocks to outperform and commodity prices to firm up as industries return to their pre-pandemic demand levels.

It is safe to say that 2020 was a very challenging, unique period that we will remember for the rest of our lives. We firmly believe that our investment principles remain valid and that staying true to them will deliver satisfactory performance in the years ahead. Our view is that the global economy will grow strongly in 2021 and beyond, surpassing its pre-pandemic level. We believe that industries that were hit the hardest by the pandemic will see their profit margins restored and their stock prices recover.

We wish you and your families joy, good health and prosperity in the year ahead.

Sincerely,

The Letko Brosseau Team

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