## Economic Outlook

The human and economic impact from the COVID-19 pandemic will be felt for years to come. Fortunately, remarkable progress on vaccines in the fourth quarter means there is now a visible light at the end of the tunnel. Economic prospects are indeed brighter amid the availability of many vaccines, but the benefits will not likely begin to take effect until the second half of 2021, as inoculating the world's population will take time.

Between now and the latter half of 2021, global economies still have many challenges to navigate, including rising COVID-19 case counts, renewed lockdowns and the mass distribution of vaccines worldwide. In an optimistic scenario, the vaccine roll-out should give consumers and companies the confidence to spend and invest. On the flip side, a pessimistic scenario would entail the continued spread of COVID-19, extended lockdowns, an inefficient distribution of the vaccine, and a general unwillingness by the population to fully reengage in the economy until the situation stabilizes. Amid all this near-term uncertainty, additional fiscal support measures from governments will continue to provide much needed stability and help bridge the gap on the road to economic recovery.

### Global Economic Growth

Around the world, economic growth in the fourth quarter of 2020 varied widely depending on the tightness and timing of pandemic containment measures.

EUROPE: In Europe, renewed lockdown measures succeeded in lowering new daily cases of the virus from their peak in November, but these lockdowns came at the steep economic price of weakened growth. At this point, it appears likely that fourth quarter growth, as measured by Gross Domestic Product (GDP), will have contracted quarter-over-quarter (Q/Q) in both continental Europe and the United Kingdom.

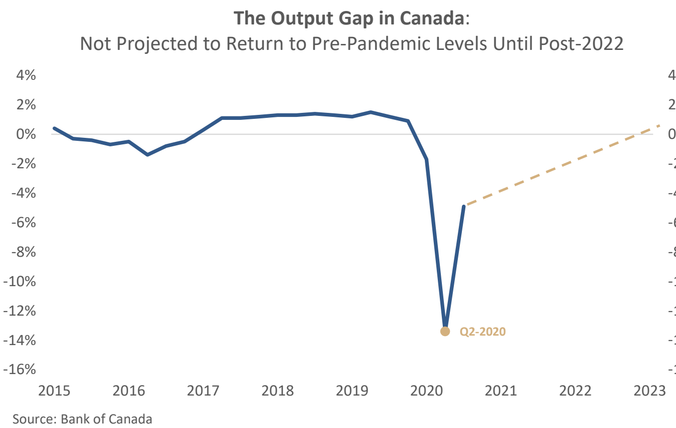
UNITED STATES: In contrast to Europe and the U.K., pandemic containment measures in the U.S. have been less restrictive. As a result, consumer spending, housing, and inventory restocking should propel U.S. GDP growth higher Q/Q. However, with the number of new daily cases at record highs at the end of 2020, it would not be surprising to see the reintroduction of lockdowns in the U.S. over the coming weeks as a new presidential administration takes over. The announcement of a roughly $900 billion federal stimulus package from the U.S. Congress in late December should once again act as an important stabilization tool for the economy.

CANADA: Canada's economic performance will most likely fall somewhere in between the U.S. and Europe as stricter lockdowns were reinstated late in the year. Undoubtedly the start of 2021 will be slow as a result, but the $100 billion federal stimulus package announced in early December should prove to be an important source of stability to help see the economy through a challenging first quarter of 2021.

CHINA: China has weathered the pandemic better than any other major country and has shown the rest of the world that both health and economic recovery is achievable. Several economic indicators reflect this relative strength: exports, manufacturing and service sector measures all fully recovered from early 2020 levels. China's exports have benefitted from sustained global demand for goods throughout the pandemic, particularly from the U.S. However, global growth is expected to moderate in the near-term amid renewed lockdowns and this could lead to a slowdown in demand for goods from China. With no additional fiscal support expected from China's government, this slowdown in global demand will weigh on economic output, at least until the global economy enters a sustainable, organic, vaccine-driven recovery – one that is not fueled by governments and central banks.

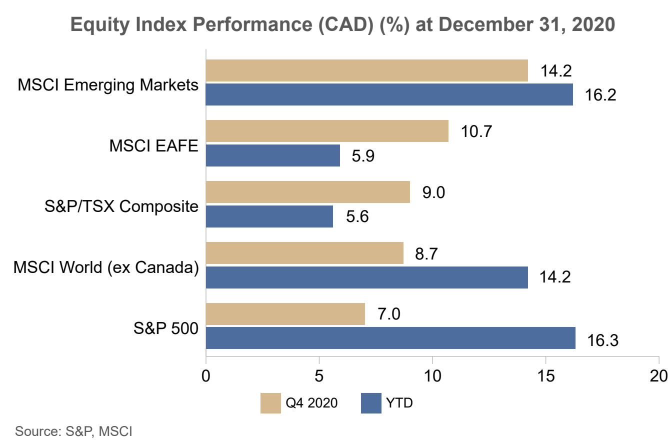
### Inflation, Employment And The Output Gap

When the global growth recovery does begin, we expect central banks to remain accommodative and stimulative. While year-over-year inflation is expected to be higher relative to the pandemic-induced drop in prices seen last spring, we do not expect any meaningful inflation risk. The Bank of Canada (BoC) and the U.S. Federal Reserve (the Fed) have made clear that they are comfortable with inflation running above their target rates of 2% to compensate for the time it has been stuck below 2%. Employment remains below pre-pandemic levels and, given the continued challenges faced by the service sector in particular, it is unlikely that a complete recovery is forthcoming in 2021. The same can be said about the economy as measured by the output gap, which measures the difference between the actual output of the economy and its potential output, expressed as a percentage of GDP. Not surprisingly, the output gap is now quite large and closing it will take two to three years according to central bank forecasts. In the meantime, short-term interest rates are expected to remain accommodative (low).

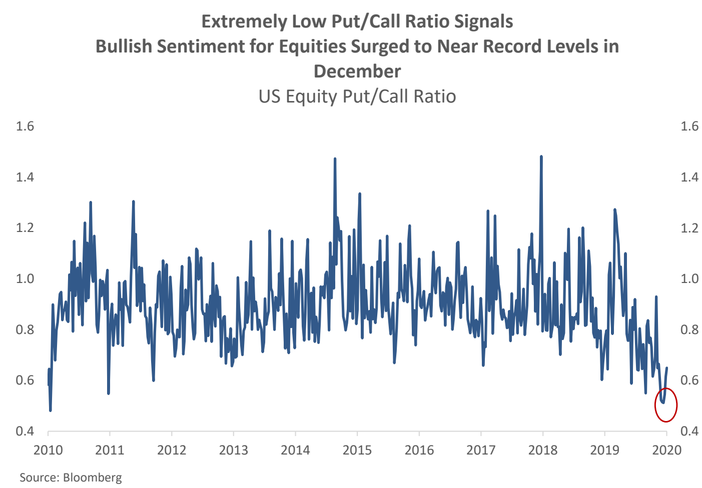



## Market Outlook

### Equity Markets: Recovery In Small Cap And Value Positive; Near Term Risks Remain




A key beneficiary of continued government and central bank largesse remains the equity market. The final quarter of the year provided investors with double digit returns in most major global markets largely led by indices in North America. For the year, most indices produced positive local-currency returns. Of those that did have a negative return, most were impacted by country-specific events such as Brexit in the U.K. (now resolved) and ongoing China tensions in Hong Kong. Leading the way for 2020 with a total return of over 40% was the tech-heavy Nasdaq market in the U.S., but perhaps more interesting is that small cap indices in both the U.S. and Canada outperformed the Nasdaq during the second half of the year. Gains for the S&P/TSX Small Cap Index in Canada were more than double that of the large cap S&P/TSX Composite for the year. The performance of small cap companies is notable because they can be an early indicator of recovery and tend to outperform their large cap peers coming out of a recession and into an expansion. The MSCI Emerging Markets index marginally beat the MSCI Developed Markets index as Latin American indices experienced a strong bounce in the fourth quarter after a mostly difficult year.




Arguably, overall equity market valuations are somewhat stretched in part due to very accommodative interest rates, and lower returns on fixed income investments. Bullish sentiment has surged to record levels. One such measure of investor sentiment is the put-call ratio. An extremely low put-call ratio – as was the case at the end of 2020 – signals the equity market is too bullish and may be vulnerable to a short-term correction. This situation would be consistent with the view that the economic outlook over the next few months is more uncertain than the outlook for the second half of 2021. Nevertheless, over the course of 2021, the arrival of effective vaccines and continued monetary and fiscal support, in addition to an expectation of improved earnings as the economy continues to recover, are all supportive for equities. A key attraction for Canadian investors is that, relative to long-term government bond yields, the domestic dividend yield is historically high. Canadian large cap companies generally have better yields versus global peers.

## Bond Markets: Steeper Yield Curve Is Positive For Economy

Turning to bond markets, short term interest rates were stable in the fourth quarter – not surprising given that the BoC and the Fed made no rate policy changes, although quantitative easing measures remained in place. Longer-term yields did rise modestly as the central banks continued to make it clear that higher inflation is a desired outcome. The total return for long bond indices in both Canada and the U.S. this quarter was negative. The yield curves in both countries continued to steepen. The steepness of the yield curve is calculated by subtracting the yield on short term (2-year) bonds from the yield on the 30-year Government bond. The greater the difference, the 'steeper' the curve. Both Canada and U.S. yield curves steepened by over 100 basis points since February and ended the year at their steepest level since the third quarter of 2017. A steeper yield curve is indicative of stronger future growth and is traditionally a positive sign for the economy.

Canadian corporate credit spreads were well supported this quarter and have now tightened to pre-pandemic levels. The high yield bond market performed even better than investment grade bonds, as high yield spreads ended 2020 at their tightest level for the year. Like the Canadian equity market, corporate bonds remain supported by accommodative monetary and fiscal policy, market demand for higher yields, and an expected rebound in economic growth. Preferred shares in Canada also benefitted from these dynamics, delivering strong overall performance in 2020 and appear set to continue offering compelling value heading into the new year. Provincial government bonds fared better than federal government bonds but continued to lag corporate bonds in general.

## Currency Markets: Weak USD Positive For Global Growth

In currency markets, U.S. dollar (USD) weakness remains a notable theme. The U.S. Dollar (DXY) Index, a measure of the value of the USD relative to a basket of U.S. trading partners' currencies, continued its descent, losing 4.2% in the quarter and about 6.7% in 2020. The DXY ended the year at its lowest level since April 2018. Like many developed market currencies, the Canadian dollar (CAD) improved against the USD this year but did less well relative to the other major currencies. On balance USD/CAD increased from $0.77 to $0.78 in 2020. The BoC, which is usually sensitive to exchange rate movements as a CAD appreciation can negatively impact our export sector, has been mostly silent with regards to currency movements, instead maintaining its focus on helping the economy through this difficult year. The good news is that USD weakness generally reflects stronger global growth prospects outside of the U.S. The weaker USD should therefore provide another source of support for global growth in 2021.

## Conclusion

Given that interest rates remain very, very low, and since the strong performance from equity markets during an unsettling period of history was unexpected, returns for stocks and bonds in the new year should be tempered. While vaccines are expected to push the global economy back on track, we are concerned that the influence of monetary and fiscal stimulus could lift equity valuations above – and bond yields below – economic fundamentals. The sustainability of government deficit spending, funded by record bond borrowing, will become a greater concern as the economy recovers from the pandemic.

Despite these risks, investment opportunities are still available – Canadian cyclicals, including those in the Materials, Energy and Financials sectors, stand to benefit from a global recovery. Select corporate bonds and higher-yielding preferred shares still provide an important source of yield in this low interest rate environment. Also, emerging market equities, particularly those in Latin America, continue to appear attractive given their low valuations and good long-term growth prospects. Here's to a happier and healthier 2021!

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Investment returns and assets under management are expressed in Canadian dollars unless otherwise noted. Investment returns are gross of investment management fees, net of fund expenses for FGP pooled funds, and include reinvestment of dividends and income. Returns are time weighted and annualized for periods greater than one year. Values change frequently and past investment performance may not be repeated.

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