



Economic and Stock Market Recovery

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Keith: Welcome to episode 24 of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode. How are you doing today, Marcelo?

Marcelo: I'm great, Keith. Every time I'm back on the show, this show is super exciting, by the way. Fun to have you back on.

Keith: In today's episode, we are going to be discussing economic recovery and stock market recovery. We will review, we will look back in time, and take a peek at what's happened in the last 12 months. We'll compare that recovery—economic and stock market—to previous recessions that we've gone through. We'll discuss stock market valuations and expected returns within specific types of stocks. And then finally, we're going to review investment styles and factors and how they have done in previous recoveries from recessions. So Marcelo, walk us through a little bit about what happened last year. Summarize from an economic perspective what Canadians had to deal with.

Marcelo: Yeah, everybody knows it was a very interesting year that we just lived through, but in purely economic terms, Keith, it was an interesting one because historically we've gone through a lot of recessions and really bad periods economically. But I think this one, given the nature of it and how it was pushed by public policy and forced lockdowns, we knew we were going to see a major impact in the economy. If we look at the second quarter in Canada and in the U.S., in an annualized number, in Canada, the decline for the second quarter was 38.1%. That's a big number. In the U.S., you're looking at a decline of 31.4%. So second-quarter numbers, we knew it was going to be bad.

Keith: And that's essentially, Marcelo, you're talking about the period from the end of March, so April, May, June, when the government and provincial



governments ended up going into massive lockdowns. And so that is the economic impact that came from those lockdowns. So the recent numbers have come out pretty much by most economic organizations that track the 2020 numbers. What do the entire year numbers look like? Because we did have some economic recovery during Q3 and Q4, but at the end of the year, what did the entire year look like?

Marcelo: Yeah. Great question. For Canada, we are looking at a decline of minus 7.1%. The U.S., you're talking about a decline of minus 3.7%. The UK was about 11%, so that was a really bad one. And if you followed the news, you knew Europe was getting hit hard, not just on the cases but also economically. Italy and France, you're looking at 10%. And the global economy as a whole, a decline of minus 3%, which is crazy.

Keith: Yeah. I actually think, if I'm not mistaken, China was the only country that posted positive growth last year, right? Of about 1.8%, plus or minus. So globally we come in somewhere in the vicinity of minus 3%, minus 4%. How does that minus 3%, minus 4% compare to, let's say, the last recession we went through, which was called the Great Financial Crisis?

Marcelo: Yeah. So the 2009 year, when we were coming out of the Great Financial Crisis, as you mentioned, that was barely negative. So we almost ended the year flat. Whereas now you're looking at minus 3% for the global economy. The U.S. lost about minus 3.7%. So people may not know this, but it is rare when you get economic shocks to finish the year negative. So we've seen many instances where we see recessions or an economic shock, and it doesn't translate into a negative full year of GDP. What you're looking at, the worst ones are World War II and the Great Depression. And this was a similar year in terms of that—that we ended the year negative in terms of GDP.

Keith: Yeah, you're raising a very good point. From an economic perspective, the recession is defined as two negative quarters. So you can have two slightly negative quarters and it basically means the economy is just not growing. It's stalled and slightly negative. You're in a recession. And often over the 12-month period, the calendar year, you're still slightly positive. And what we saw this time was a sharp contraction. While we're on the contractions, Marcelo, what are the world economic organizations talking about for 2021? What are they suggesting in terms of economic growth?



Marcelo: So the expectation is that the global economy is going to grow at 4%. Now obviously it's a model, it's an abstraction of reality, it's integrating all the expectations that we have now and bearing any surprises. I think they've come up with this number and said, given everything that we know now about the vaccines and how things are looking, we're projecting a 4% growth, which is a high number. When you look at it in pure economic terms, normal numbers are between 2% and 3%.

Keith: 4% are back in sort of the high growth phases that we saw pre-2000s.

Marcelo: Right.

Keith: So this is pretty much the economic front. And for Canadians, there's a lot of challenges out there in various different sectors of the economy. How did stocks do throughout this process? Because this show is about the recovery. And so there's two parts of a recovery. There's an economic recovery—what's going on Main Street. And then there's the stock market recovery. The two are not linked. Often the stock market is forward-thinking, looking out into the future and pricing things accordingly. Last year, we had our stock market correction in March. What did that look like? How long did it take to go down and what was the depth of that correction?

Marcelo: I get asked a lot by clients how it is possible that we're still getting positive numbers in the stock market after the year we just went through. But like you said, it's just proof that the stock market and the economy, sometimes they're not related. So if you look at the numbers, I'm going to run you through the S&P 500, which is the market most people know. So the top, Keith, was February 19. So that's the day the S&P 500 peaked. Okay. So from that day on, we started going down. So you're looking at a drawdown or a decline of about 30.63%. That took from February 19 until March 23. So March 23 was the bottom. So you're looking at February 19 to March 23. That's one month and three days. So that's how long it took to go from the peak to the bottom. Okay. So this is where it gets interesting. And it's remarkable that this happened so quickly. So you're at the bottom, you lost 30.63%. It takes four months and 20 days to go back from the bottom to the peak value again. The exact date is August 12, and we finish the year. The S&P ends up returning 16.45% for the year. That's a quick, sharp recovery.

Keith: Yeah. And so let's look at that compared to other economic contractions and other recessions, Marcelo. I know that we've got this document that we



often refer to called the Lifeboat Drill. And thanks to Rob McClellan in Toronto, he shared that with us many years ago, but it is still one of our favorite communication pieces. With that, we go back and we look at the past six or seven recessions and we actually track things like how long it took for stocks to get to the bottom, how long it did take to recover. And one of the things that we always mention is that every recession, every economic contraction will look and feel different. You cannot just say, because this is happening, "Oh, and if I look at something else, this is what's going to happen right now." So there are major differences in these periods. So what do you see in some of these differences and how do you compare what we've just lived through to some of the previous contractions, Marcelo?

Marcelo: Yeah, you raise a great point. No two recessions or two bear markets are the same because I think psychology and the way human beings act, it's pretty much the same, but context and the things we have around us do matter in the way we react and we behave. So if we look historically, we've had about six or seven major crises in history that we have in this nice chart that we call the Lifeboat Drill, but essentially we've got three where we lost 30% or more, which is a type of drawdown that we're dealing with here. So when you look at the ones people can remember the most, which are recent "quote-unquote," right? If you look at it relatively, you're looking at the dot-com crisis, which was the year 2000. So that, Keith, it took about 31 months to go from the peak to the bottom.

Keith: Tell me about it, Marcelo. Thirty-one months. That was probably the most painful recession I've lived through as an advisor. So imagine that, Marcelo, you do a review, you do an annual review, your portfolio is down 8% or 9% and it feels bad. And then a year later, it's down another 8% or 9%. That's 24 months in a row now. And so now you're down 24% after 24 months. And then you've got to go almost another full year or at least a half a year. That's a long drawdown. That's a painful recession. It's difficult, very different from last year. Last year is an emotional, quick contraction. It had its own challenges. We would hear clients talk about—they'd say things like, "I've lived through recessions before, but I've never seen a lockdown."

Marcelo: Yeah, absolutely.

Keith: So it feels different. So talk about the recovery then. You said, how long did it take? And how does that feel relative to other recoveries from a time perspective?



Marcelo: So as we said again, 31 months is what it took to go from the peak value to the bottom. So you're at the bottom. It took another 21 months to go from the bottom to the peak, right? When you look at the full cycle of going through the peak, going to the bottom, and then back at the peak, you're looking at 52 months for the dot-com bubble. So that's a hell of a ride.

Keith: Yeah. And if I'm not mistaken, you've got pretty similar numbers for the housing crisis. So the last two recessions that Canadians lived through, you've essentially got four and a half to five years to get through the downturn and then the recovery. So compare that to, from a stock market perspective, what you were saying, five months—a month to go down, maybe six months—a month to go down and five to come back up. Dramatically different. So what would you say that looked like, Marcelo? There's always debate. While we're in these drawdowns, lots of people talk about, is it going to be a V? Is it going to be a U? Is it going to be a W stock market recovery? Or is it going to be an L? What did we end up getting here?

Marcelo: This one was clearly a V, Keith. You look at the 30% drawdown and five months later, you're back at where you were before and then you end up the year positive. It's definitely a V. And the interesting thing is, and I'm sure you live this and everybody who's an advisor probably lived this as well, is I remember clients calling me just when we were going down and living through this, and some of them wanted to move into a cash portfolio or something. And obviously, we never recommend that. That's the whole point of the Lifeboat Drill, to show people that you should stay invested, right? It's just so important. And it goes to show how hard it is to do market timing because you don't only have to get out at the right moment but get back in. And you miss those few days. If you would have missed those few days—four months of the recovery—and then get back in, that would have a huge impact long term on people.

Keith: Absolutely.

Marcelo: That is a fantastic point, Marcelo. So for this show, we've broken the recovery portion into a few segments. Again, there's the economic recovery, which is something people are talking about that's coming in the year 2021 and maybe '22, but there was the stock market recovery, and stocks move in advance of economies. While they're not linked, they are forward-thinking. So we've talked about this idea of what appears to be a few phases, and we're breaking it down into these phases to discuss how things have worked from a



stock market valuation perspective. What were the stocks that were appreciating? And all this is based on phases. So we've got phase one, which is from the moment the pandemic hit till the moment the vaccines were announced. And then we have phase two, which is from the moment the vaccines were announced till where we are now. So we can talk about what's happened in those two phases. And then phase three is we're here today. What might things look like in the next year or two? So Marcelo, let's talk about phase one. What did you see happen in phase one?

Marcelo: To bring it back to what we mentioned at the top, you have a forced lockdown where people are forced to stay home. Obviously, the first thing you think about is exactly what we saw. Airline companies, anything related to travel, restaurants, hospitality got absolutely crushed. Then you have the companies who equip people for working from home: the Zooms, the Googles, the Amazons, Shopify—anything that pushes the ability for you to do stuff at home. So an incredible recovery, and not only recovery, but incredible growth.

Keith: Okay, so Marcelo, what you're talking about here are the social distancing stocks, the technology stocks that were allowing people to work from home, stay clear, be safe, and everybody got super excited about those and started bidding up the prices. That changed or appeared to change once vaccines came out. So since vaccines have come out and signaled that we're going to be able to—I'm not going to say return to normal—but we're going to be able to come back more than before and get to some form of normalcy, what has happened within the stock market?

Marcelo: We've seen a rotation, and small company stocks and value stocks and even that whole area of small value have done remarkably well compared to the stuff that did really well during the pandemic, which is growth companies, small companies, small growth companies, and even surprisingly, small growth companies that had no revenue and no profits. So we're seeing now the companies that pretty much got hammered, for lack of a better term, during the pandemic, they're turning around and doing way better than the rest of the market.

Keith: Yeah. And so how did valuations end the year? Let's say December 31, 2021. We've got a nice chart here which shows essentially the valuations of various different stocks. So it's the quadrant in the United States. We're looking at U.S. stocks here where we've got all the different growth stocks—large, medium, and small. We have neutral stocks, and we have value stocks—



large, medium, small. How did the year end in terms of earnings or valuations relative to 20-year valuations? What got really expensive and is still expensive, and what got perhaps less expensive?

Marcelo: So when you look at the chart I have in front of me here, if you look at value and small, for example, the current price-to-earnings ratio is 18, and the historical 20-year price-to-earnings ratio is 16.8. So that represents about 107% of its historical 20-year. When you look at the other side of the matrix, which would be small growth, which is exactly what did well during the pandemic, you're looking at a valuation of 76.2 price-to-earnings current versus the 20-year average, which is 38.4. So that represents, in percentage terms, about 198% of the historical price-to-earnings value. So what happens is, if you're looking at a valuation where you have 18 against 16 of the 20-year period, your expected return is way higher than if you have a premium of about 200%. So that's what we're looking at now.

Keith: Yeah. What you're alluding to is, when stocks get really expensive, the future expected returns are low. And when stocks have not appreciated as much relative to historicals, the future expected returns are higher. Correct. So let's move into phase three here. Now, of course, this is going into from here on a go-forward basis, and we never do this. We never try to predict the future. We never try to tell people what's going to happen, but let's, for the sake of this sort of recovery discussion, talk about what people are expecting to happen. Let's start with the economic front here. What are people expecting?

Marcelo: I think economically the expectation is, because you have various things, actually, you have government stimulus going on. You also have all this pent-up energy that people have in terms of savings. So if you look at the savings ratio in Canada, historically, it's about 3.2%. The current number that went up to 28.2% during the pandemic, and it's logic, right? If you're locked down, you're getting paid the same, you're not spending money. It's just common sense, right? Then in the U.S., the savings ratio went from 7.2% to 33.7%. Now, when things open up—and this is the theory, right? It's just a hypothesis. If things open up and everybody gets vaccinated, you know that people will just go out and spend and travel and do all the things that they weren't allowed to do. If that's what diets don't work, right? There's nothing for a human being that feels deprived.

Keith: Yeah, that's right.



Marcelo: So what you're talking about is savings which will technically lead to pent-up demand, which is the growth that people are talking about right now. And whether we're going to get travel this year or next year, in general, the concept is just more spending, more going out and about, a little less staying at home, chilling out and watching Netflix, and a little bit more activity. Okay. So what are the other issues around the economy that you might want to comment on? Is there anything else with regards to what people are talking about?

Marcelo: There's a lot of technicalities about unemployment and how we're not at full capacity in terms of the production of the economy, which is more industrial stuff. But I think that's it. Some economists are saying we may get inflation, but this is a tricky one because I was telling you off mic a few days ago that I have a good story about this and how hard it is to predict, even for super well-trained economists who have won Nobel Prizes, right? I remember being a super excited student back in 2009 when we got the Great Financial Crisis, and I was all excited. I was not making much money, and I remember getting a subscription to The Economist that represented probably 50% of my income back then. So I go, "Tell me, Marcel. How old were you back then?" I must have been like 20 years old.

Keith: Yeah. So I don't know many 20-year-olds that would get a subscription to The Economist. So good for you.

Marcelo: Yeah, but I was studying economics too. So I'm learning about all these things about money supply and inflation. And I remember the narrative back then is, because of all this money printing that the central banks were doing to stimulate the economy after this great crisis that we just had, people were talking about hyperinflation and how we're going to be like Weimar Germany and going through massive periods of inflation. And that never panned out. We've never seen lower inflation in the last 10 years that we've ever seen, right? It's hovering between 1.5% and 2%. And to me, that's relevant now because it brought me back to what the narrative was back then into what people were talking. So it just highlights the danger of a model is just an abstraction of reality at the end of the day. It'll never pan out. It just integrates expectations. So that's why it's hard to say it'll happen exactly what the economists are saying. I think there's a lot of nuance in between.

Keith: Yeah. And there's a lot of discussion right now. Even interest rates, as we record the show, have spiked up. U.S. treasuries have spiked up to 1.5%.



Last year they were in the 0.7%. So these are big moves. And part of that is the worry about inflation, right? The counter side to that is we unfortunately still have in North America, both in the United States and Canada, a lot of unemployed individuals who need to find work again. And there's a worry that while jobs will open up and the economy will open up, some jobs are going to take longer to get there. So we may actually have higher levels of unemployment for a little bit longer than people want. And that's tough. And that puts a damper potentially on inflation. So there's a real tug of war here between, is inflation going to come through or not? So yeah, those are the big parts of the economic recovery. Suffice it to say that most economists definitely feel that we're going to see growth this year. What about stocks, Marcelo? So we've had almost essentially one could argue that the stocks are almost fully recovered. In fact, in growth stocks, one could argue that they're more recovered than they might deserve to be. We're going to speak about a research piece done by Research Affiliates.

Marcelo: Great paper, by the way.

Keith: Yeah, it was produced last year in the summer and it was really talking about, in particular, how value stocks do in recessions and then recoveries. And they did study a whole series of factors. So they studied essentially value companies, low-volatility companies, quality companies, small-cap companies—so small companies—and momentum companies. Tell us a little bit about the study. What did they try to do?

Marcelo: Yeah, I like the study because it looked at six different recessions and it looked at pretty much three time periods. So it looked at the peak to bottom, which is what we talked about before. So how long it took from the peak to go down to the bottom. Then it looked at two years after, and then it looked at the full period. So peak to bottom and then back to recovery, right? So it gives you a good sense of what these stocks or these factors go through during the recession, after, and through the whole cycle. So it was a good paper. I like the distinction they make too between different crises because they broke it down within, so you have two types of crises essentially. One that's behavioral or what they call a bubble, which would be like the nifty 50 and the stock bubble of 2000—the tech bubble. And then they looked at more shocks to the fundamentals, like the Great Financial Crisis, that we have a great credit crisis and things like this. So they do make the distinction.



Keith: Yeah. So one is an economic problem that creates a fundamental shock. And another one is stock market valuations that all of a sudden are unsustainable and come down, even though you may not have an economic challenge. Okay. Very cool. Okay.

Marcelo: I like that distinction because I do feel that people do behave differently. Companies also behave differently whether you have a shock to the fundamentals or whether you have what they call irrational exuberance in the market, right?

Keith: All right, Marcelo. So we're talking about recoveries here. What does the report speak to? What styles seem to do better? What styles or factors seem to produce higher returns in a recovery phase?

Marcelo: Surprisingly, the ones that do the worst in the recovery process are low-volatility and momentum stocks. So those actually have negative outperformance during a recovery. And then when you look at the best performance during a recovery, you have value at 23.9%, quality, and small-cap stocks. And unequivocally, if you look at the chart, you're looking at outperformance returns of 23.9% for value, small-cap 22%, and quality, you're looking at 22.4%.

Keith: And so when you talk about these percentages, these are out-performances relative to the market.

Marcelo: Correct. Correct.

Keith: Yeah. Okay. So the numbers are actually dramatic. So what you end up seeing here is you've got the three areas that Marcelo mentions: value, quality, and small companies outperforming coming out of a recovery. And the big shocker there is momentum stocks. So momentum stocks have historically done poorly coming out of recoveries. And if you think about last year, momentum stocks in the last six months of the year were on fire. It was speculative, and momentum was pushing forward. So we're not in the prediction business, as we mentioned before, but you look at something like this and you sit back and say, gee, some of those stocks that were on fire in Q4 may have a rougher time in the next three years. And some of the ones that didn't do so well may shine in the next three years. Marcelo, what are your takeaways when we talk about recoveries and what investors can think about and what they might want to do?



Marcelo: Yeah. For me, the takeaway is, and I know I'm going to sound like a broken record, but all these things that we lived through in 2020, I think it's a testament to how important it is to have a well-crafted plan and a well-defined investment philosophy. Because otherwise, you're going to be just like a dog running after a squirrel because there's so many things happening. The economy is going down, the stock market is going down, it's bouncing back quickly. If you don't have a well-crafted plan put to paper, man, that's going to be tough.

Keith: Yep. That's outstanding. It's great. It's a classic message that we have within the episodes here, but I think everything that we've just lived through demonstrates the value of thinking that way. So yeah, I agree 100%. I would also add, as a takeaway for investors who have been chasing, stop that behavior because you'll get burnt. Momentum stocks may have a hard time. Stay diversified. I think tilting, like we do for pretty much all of our client portfolios, tilting towards value and small companies or including a little bit more of those companies will have their day in the sun again. And a recovery is not a six-month recovery. When we think of recoveries, we think two, three, four years here. So I think we've got to stay vigilant and keep the long-term perspective. Last words to you, Marcelo.

Marcelo: The other thing that came to mind in terms of takeaways is a lot of people have the misconception, when you have an investment philosophy, that whether it's based on indexing or evidence-based, that it's passive or people are not doing anything, but it's not about what you do during the bad periods, it's what you do from the get-go when you set up a plan for a client in an asset allocation. It's the initial setup that's really going to make a difference in all these periods because if you set up that well and you have a strong foundation, when you go through these periods, it'll all make sense in the long term after.

Keith: Absolutely. 100%. Agreed. All right, Marcelo. As always, great having you on as a co-host in today's show. And on behalf of all of us at Tulett, Matthews & Associates, we want to wish our clients, friends, contacts, and all our listeners great health, happiness, and safety in the next few months. Thank you, everybody.

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