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MONTHLY



Global Investment Letter



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APRES MOI, LE DELUGE..... (PART DEUX)

We have used this headline previously, but it seems fitting to use it again this month given the circumstances surrounding the U.S. election. We have delayed our writing of this piece to gain more clarity as to its outcome. As we write this, Joe Biden has just pulled into the lead in Pennsylvania and now seems assured of becoming the next President of the United States. Donald Trump has reportedly stated that he will refuse to concede, which creates the possibility of Secret Service agents having to bodily carry him from office in January so that Biden can assume the presidency. It is a sad commentary on our times that the last sentence is not completely facetious.

Though Biden appears to be the clear winner of the election, the period leading up to inauguration day is likely to be politically turbulent and a test of the U.S. justice system. As we have long suspected, this will be a contested election that will involve myriad lawsuits from Trump as he seeks to denigrate and reverse the election result. Such lawsuits appear to have little chance of success, but the probability that they may complicate or delay the inauguration of Biden is not zero. As well, Trump may issue blanket pardons for his associates before leaving office to protect them from legal jeopardy. He may even seek to pardon himself, which would present an interesting test for the American constitution. In sum, we cannot assume an orderly transition of power in the United States.

A failure of the Democrats to win control of the Senate will hamper Biden's ability to implement his election platform, especially substantial fiscal stimulus for the U.S. economy. Senate Republicans have already made it clear that they do not favour the type of major stimulus package envisioned by the Democrats, which is thought to be about \$3 trillion. Biden can use executive orders to provide some measure of fiscal stimulus, but not nearly the level desired by his party.

The Republican control of the Senate, therefore, will put the onus on the Federal Reserve to provide support to an economy whose recovery is showing evidence of weakening. The Fed's ability to influence the economy diminishes, of course, with each round of stimulus. Adjustment of the interest rate remains its most effective tool, which is why we expect negative interest rates in the United States in 2021.

Outside of the U.S., the United Kingdom is also expected to adopt negative rates next year in a bid to counter the negative economic effects of Brexit. This is in addition to already negative rates in Europe and Japan. The prospect of most of the world's economy adopting negative interest rates by the end of 2021 lends more credibility to our view that the investment environment will be particularly volatile. Negative interest rates create significant economic distortions that, in our opinion, cannot be maintained indefinitely.

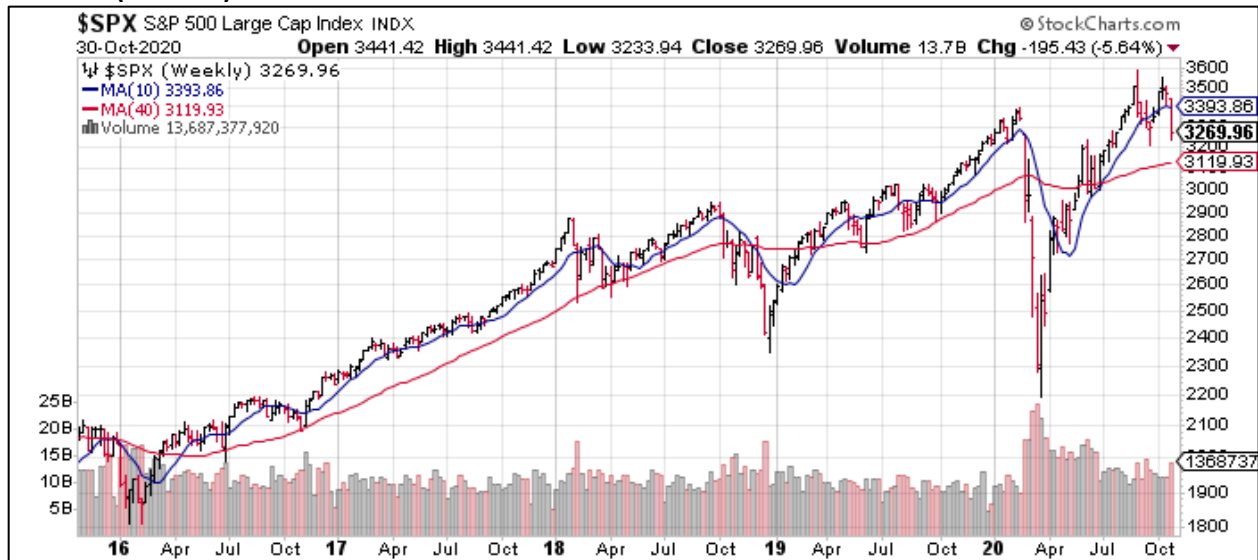
The coming era of near-universal negative interest rates will create its own set of risks and opportunities for investors. The eventual effort to restore interest rates to historic norms, which we expect later this decade, in part be driven by an effort to save the pension industry, will present a second set of risks and opportunities. The fragile nature of the global economy will make both eras unusually volatile.

The unprecedented nature of the current global economic and political climate means the law of unintended consequences will continue to have a significant effect on investment returns and limit the usefulness of long-term assumptions.

The years ahead are going to be volatile in every sense of the word. We will continue to use the pragmatic approach that has proven effective and be prepared to adapt to changing circumstances.

EQUITIES COMMENT

S&P 500 (WEEKLY)



The S&P 500 posted its second consecutive monthly decline in October, supporting the cautious stance we assumed moving into the fall. The negative seasonal influence of September and October has persisted for well over a century. In addition to the seasonality, the sharp rally from the March low was due for a period of consolidation.

The seasonal influence has now turned decidedly positive, with November through April being the strongest period on the calendar for equities. The ability of the S&P 500 to remain well above its long-term 40-week moving average, despite two negative months, is also a bullish indication.

The continued relative strength of the market leaders, the FAANGs, Microsoft et al, is an additional positive for U.S. stocks going forward. Major trend changes typically occur when market-leading stocks begin to break down, which we have seen. These market leaders have been driven higher by substantial capital flows from passive strategies and a new generation of retail investors who favours momentum stocks. The relative strength of these stocks will ensure the continuation of these capital flows.

Given this scenario, it follows that market leadership will continue to be narrow. It will require a sustained bear market to disrupt the capital flows moving into these stocks from passive and retail investors.

The last, but not least, reason to be positive on equities is the support that can be expected from the Fed. There is truth in the maxim, "Don't fight the Fed." We expect the Fed to both move to negative rates and continue to expand the money supply in 2021.

Offsetting this positive narrative is the current pandemic-induced global recession, which will likely compromise corporate earnings for several years. The Fed-inspired recovery from the March low is faltering with the return of the Coronavirus. The measures required to contain the virus over the winter likely will act as a drag on the economy.

Much hope is placed in the appearance of an effective vaccine in 2021. It remains to be seen if a proposed vaccine can successfully pass clinical trials. The challenge lies in the nature of the Coronavirus. The viruses that cause the common cold are coronaviruses, and no effective vaccine has ever been developed to combat a cold.

It should be added that while central banks can wield considerable power, their power has limits. The Bank of Japan and European Central Bank instituted negative interest rates some time ago, but their respective stock markets have posted uninspiring performance.

We maintain our cautious stance but note that there are enough positive catalysts available to fuel another move higher by U.S. equities. We would turn bullish once again on a breakout to new highs by the S&P 500 and expect the current market leaders to continue to outperform the index benchmark.

VOLATILITY TRADE

S&P 500 VOLATILITY INDEX (VIX) (DAILY)

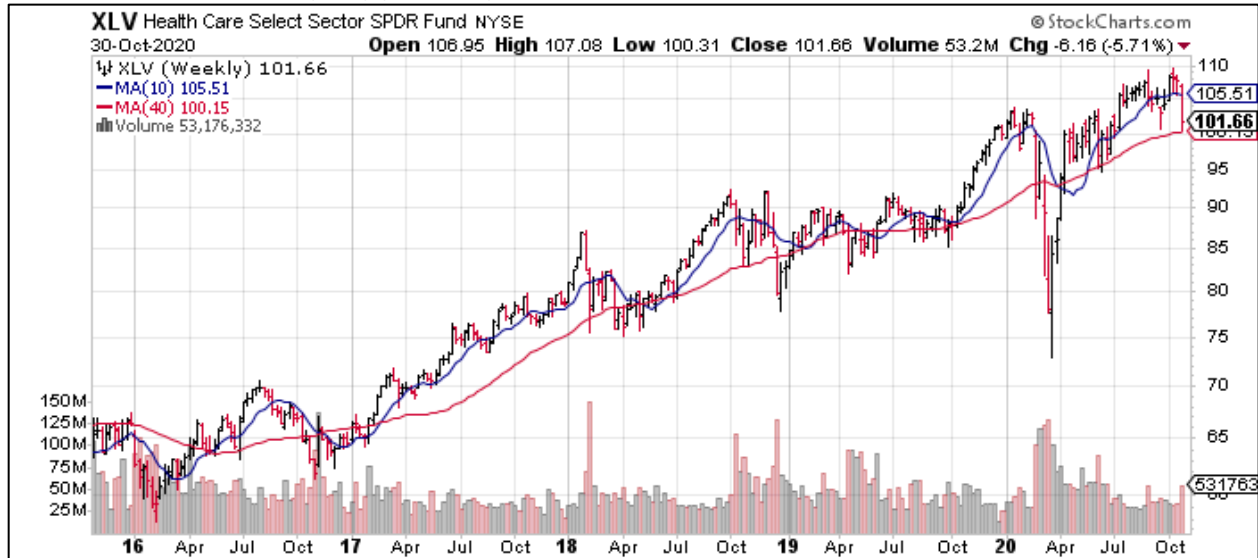


As we commented in the last issue, we intended to hold our long volatility position through the U.S. election on November 3. We did so and sold at the circa 34 level. We established our position at the circa 30 level, which produced a modest gain of 4 points in two months. This does translate into a handsome annualized percentage return but falls short of the circa 300% gain secured by our volatility trade that caught the market break of earlier this year.

We are now flat and will await another opportunity. Our methodology continues to produce attractive returns, though the larger trade opportunities in the VIX are infrequent.

HEALTH CARE TRADE

HEALTH CARE SPDR ETF (XLV) (WEEKLY)



Health care is one of our favourite long-term investment themes. The combination of ageing populations in developed countries and the emergence of new medical treatments will drive revenue growth for decades to come.

We stated in the last issue that our bullish view of the health care sector, as reflected by our proxy, the XLV ETF, would only change on a price break below the 40-week moving average. XLV closed the month above the 40-week moving average, so our bullish view remains intact.

We favour participation in the health care sector on a diversified basis, such as through an ETF, because of the risks (i.e., failed clinical trials, successful drugs moving off-patent, or evolving technology) associated with the sector.

The prospect of a Biden Presidency, but a Republican Senate, suggests that the prospect of legislation that would dramatically alter the U.S. health care sector is reasonably low. This limits a key risk of exposure to the health care sector.

FTSE 100 (DAILY)



We have long been, and quite profitably so, bearish on the London FTSE 100 index and see no reason to change our view.

The negative economic impact of the pandemic has significantly slowed an already mediocre British economy. The impending departure of Britain from the European Union at year-end will further slow the economy.

While we are currently bearish, we do see a potential buying opportunity in British stocks in 2021 in response to a Brexit driven market downturn should it produce an oversold condition. It remains to be seen if such an opportunity will present itself.

In the meantime, we remain wary of the FTSE.

DAX INDEX (WEEKLY)



The DAX declined sharply in late October in response to a host of issues, including the appearance of the second wave of the pandemic, slowing economic recovery and the effects of a higher euro, which is felt most acutely by the export-dependent German economy.

Our concern, expressed in the last issue, of the consequences of the return of deflationary pressures in Germany, was justified by the performance of the DAX last month. Further market weakness can be expected in the absence of an announcement of significant additional stimulus programs by the European Central Bank and the German government.

We continue our bearish view of the DAX until evidence of a change of trend is presented.

CAC 40 (WEEKLY)



The index fell sharply in late October, justifying our negative view of this index.

The stresses imposed by the arrival of the second wave of the Coronavirus have exacerbated the effects on an already fading economic recovery in the European Union. Diminished hopes for a durable economic rebound are being reflected by the CAC as are the ramifications of Brexit at year-end. France has been the major transit point for trade between Britain and the Continent. A “hard” Brexit with no trade agreement is expected to reduce trade volumes, thereby impacting the French economy.

The CAC 40 has sustained a good deal of technical damage. It will likely be some time before an attractive buying opportunity is presented.

NIKKEI INDEX (WEEKLY)



We cannot get enthused about purchasing Japanese equities until the Nikkei clears the circa 24000 level, which has proven to be a rally killer on three previous occasions.

A sustained move through the 24000 level would be very bullish and suggest much higher prices. However, until that occurs, we will defer taking a position in the Nikkei.

SENSEX (WEEKLY)



The proximity of the Bombay SENSEX index to its all-time high of 42000 prompts us to stay cautious, as experience has taught that major price highs often prove to be turning points for rallies. Therefore, the risk/reward is unattractive at current prices.

We captured attractive profits from the previous SENSEX rally and India remains our favourite emerging market for long-term investors. However, we do not believe that now is an optimal time to establish positions in Indian equities.

EMERGING MARKETS ETF (EEM) (WEEKLY)



Our proxy for emerging markets, the EEM ETF, performed solidly in October before pulling back late in the month. That the retracement occurred at the previous 2020 high is likely not a coincidence. The circa 46 level is an important price hurdle for EEM, as is the 48 price point. A move higher through 48 would be very bullish indeed.

Emerging markets performed strongly in October versus their developed counterparts for reasons that are not clear. Certainly, the relative weakness of the U.S. dollar this year has made the commodities that constitute an important part of many developing economies more attractively priced. Nevertheless, the prospect of renewed weakness on the part of the global economy amid a resurgent pandemic causes us to continue our cautious view of emerging market equities.

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



The 10-year Treasuries declined slightly in October to finish the month resting at the index’s 40-week moving average. The pullback from its very tight recent trading pattern would normally produce concern about the prospect of a much larger decline. However, we suspect the 40-week moving average will provide price support, as it did in late 2019. We would only grow concerned about the possibility of a significant retracement should the 10-year note trade below its long-term average and the circa 137 price point.

While President Biden (if confirmed) would have the ability to provide a measure of stimulus through executive orders, any major legislation would have to be passed by the Senate. Senate leader McConnell has not been disposed to further large-scale stimulus packages. This puts the onus on the Federal Reserve to attempt to support an economy that is slowing from the effects of the ongoing pandemic and the absence of substantial government stimulus. Further interest rate cuts would seem to be the Fed’s most expedient tool to combat the current recession.

We maintain our bullish view of Treasuries based on the rising probability that our expectation of negative interest rates in 2021 will be realized.

CURRENCY COMMENT

US DOLLAR INDEX (DXY)(WEEKLY)



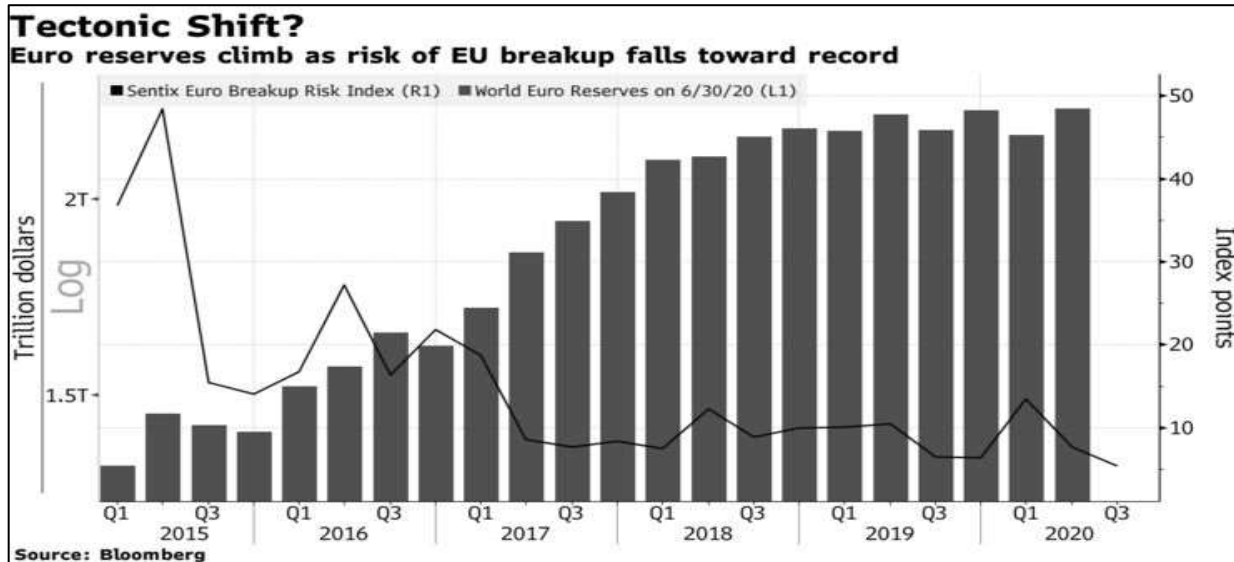
Given our view that all markets are interconnected, particular attention needs to be paid to the U.S. dollar given that its behaviour going forward will significantly influence a host of markets.

We have been dollar bulls since, at least, 2015 and only changed our view earlier this year in response to clear evidence of a trend change and rising enthusiasm for the euro as a result of the European Union’s historic financial accord in August.

We recently returned to our bullish dollar stance because we felt that the optimism generated for the euro (which comprises over 50% of the Dollar Index) was waning and because of the dollar’s positive interest rate differential and its traditional role as the world’s reserve currency. We remain bullish but must be prepared to change our view given that the dollar continues to trade well below its 40-week moving average, which is typically a bearish indication.

Two major factors, one potentially bearish, the other bullish, appear set to play major roles in the direction of the dollar in the months and years to come.

The first is the potential for the euro to at least partially displace the dollar as the world’s reserve currency. The chart on the following page depicts a growing tendency on the part of financial institutions to hold larger amounts of euros as reserves. This trend is strongly correlated to greater confidence in the resilience and sustainability of the EU.



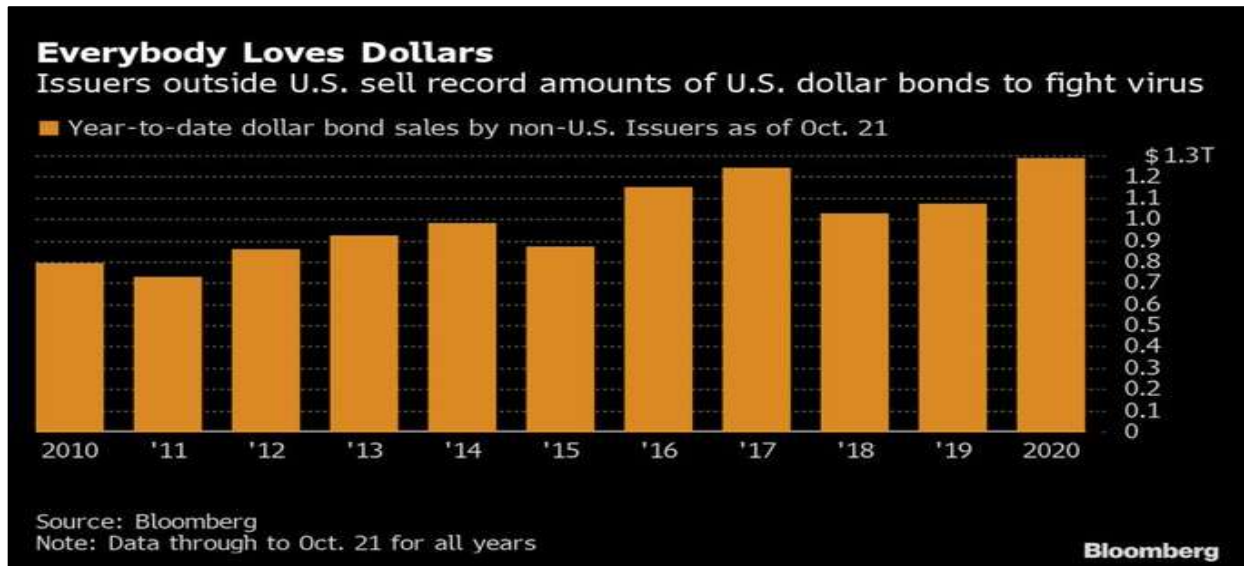
It is noteworthy that the rise in euro reserves in the chart above reflects reserves as of June 30, 2020, and does not reflect the financial agreement reached in August. Given that the agreement has further bolstered confidence in the political future of the EU, euro reserves presumably should continue to rise.

We have commented on the great political achievement by the EU in obtaining unanimous agreement to a financial plan that would see the more affluent northern members (e.g., Germany, France) provide financial support to the economically fragile southern members. The agreement's intent is to strengthen the financial, and therefore political, integrity of the EU.

We believe the August agreement has accomplished this goal in the short-term and has bought the EU time to address its considerable underlying economic and political challenges. However, we believe the benefits of the agreement will last only until the next major financial crisis appears later this decade. The stresses imposed by the next financial crisis will exacerbate the financial and cultural differences between members and produce an existential crisis for the EU.

We anticipate that the EU will continue as an organization, but not as it is currently constituted. We anticipate the end of the euro, in favour of EU members returning to the use of their national currencies, which they can then price for their own interests.

Until such an existential challenge presents itself, the general confidence felt in the long-term future of the EU will serve as support for the euro as an alternative to the dollar and, therefore, provide a headwind to dollar strength.



The chart above illustrates how popular the selling of U.S. dollar-denominated bonds is with foreign issuers. This year has set a record.

What is less appreciated is that the selling of these bonds establishes a short position in dollars, in that the debt must eventually be repaid in kind. The total dollar short position represented by foreign-issued bonds now exceeds \$12 trillion, which represents a considerable source of demand for dollars going forward.

In conclusion, we maintain our bullish view of the dollar. However, a dollar bull market is not firmly established from a technical perspective, and our opinion would change should the dollar index trade down to the circa 91.5 area. A move to 91.5 makes a test of the lows at the circa 89 level very likely. A decline below the lows of early 2018 would be very bearish indeed.

We continue to believe the U.S. dollar will remain the world's reserve currency in the long-term, mainly because of a lack of attractive alternatives. In the shorter-term, factors such as investor confidence in the euro and political considerations could provide challenges to our expectation of a long-term dollar bull market.

CAD/USD (WEEKLY)



The Canadian dollar declined sharply in late October in concert with a similar decline in the price of oil. We have referred to the strong correlation between the two regularly in these pages and can be counted on to do so again. Our view on the price of oil plays a large role in our analysis of the prospects for the Canadian dollar.

The risk/reward for long exposure to the Canadian dollar is not attractive. The upside potential for the dollar appears limited to the circa US\$0.77 level, which represents formidable resistance. The downside potential will be largely determined by the behaviour of the price of oil. As well, we remain of the view that the Bank of Canada favours a cheaper Canadian dollar versus its American counterpart to make Canadian exports more price competitive.

On balance, we anticipate a lower Canadian dollar. It will require a breakout above the important US\$0.77 level (which appears unlikely) for us to consider changing our bearish view.

EUR/USD (WEEKLY)



As per our earlier discussion of the Dollar Index, the euro has enjoyed a strong 2020 versus its American counterpart as events have conspired to greatly reduce concerns about the prospects of the European Union, the ongoing contretemps with Britain over Brexit notwithstanding.

The enthusiasm generated by the financial agreement reached in August seems to have dissipated somewhat, resulting in the euro weakness that was experienced in October.

Our return to a bearish stance on the euro in our last issue was well-timed (at least in the short-term). We maintain that bearish view, but note that a move higher through 1.20 would be a bullish indication that would suggest a test of the circa 1.26 level.

POUND/USD (WEEKLY)



The pound rose in October for reasons that remain obscure to this writer. The burden of the second wave of the pandemic and Brexit at the start of 2021 represent considerable challenges to the British economy. Indeed, the Bank of England has already stated that they have considered adopting negative interest rates. We believe negative rates are highly likely for Britain in 2021.

It remains very difficult to construct an argument for a higher pound versus the dollar. Therefore, we maintain our long-held bearish view.

YEN/USD (WEEKLY)



The yen has strengthened against the dollar over the past few months. However, it remains in a broad sideways trading pattern that has yet to indicate a clear trend, bullish or bearish.

Therefore, we defer taking a position in this market until we discern the establishment of a clear trend.

YUAN/USD (DAILY)



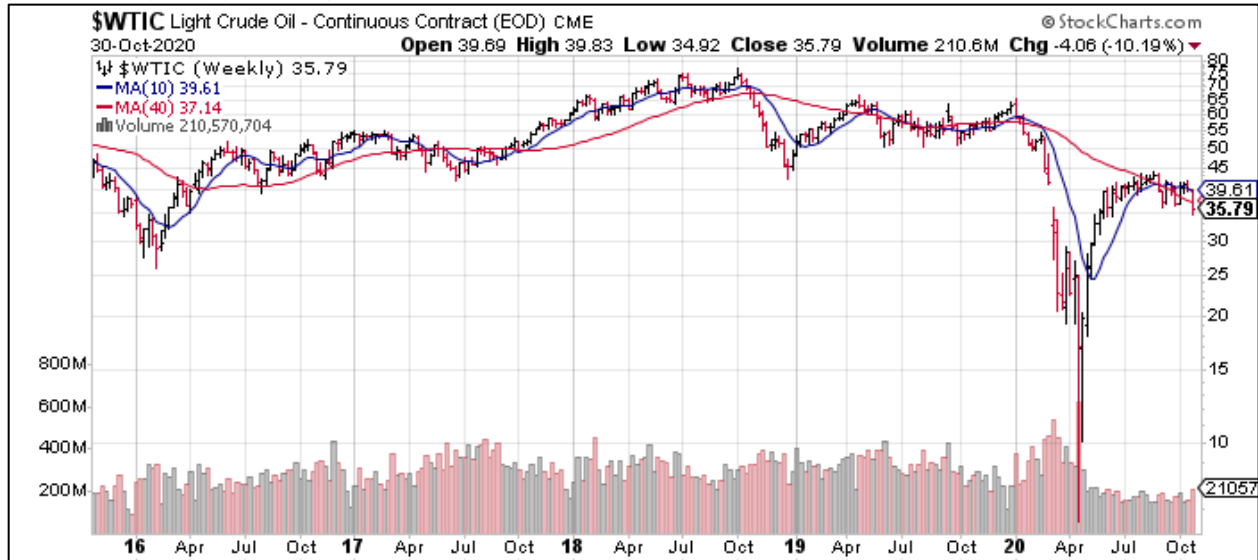
The strength of the yuan against the American dollar in 2020 has been surprising (not least to us).

The yuan has normally acted as a reasonable barometer of the state of Sino-American relations. That relationship has broken down this year, given that the yuan has risen while relations between the two countries has deteriorated.

We remain skeptical of this yuan strength and believe a weaker currency will be required by China in the years ahead.

OIL COMMENT

CRUDE OIL (WTI) (WEEKLY)

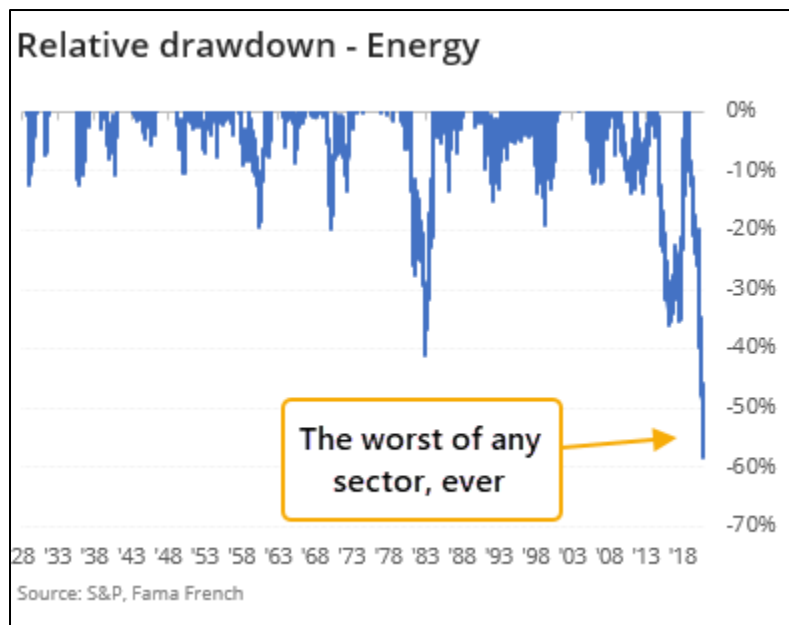


It has long been our belief that the 40-week moving average would be a formidable barrier to the rally in oil from its March low. This assumption appears to have been justified.

The arrival of the second wave of the Coronavirus is resulting in renewed “lockdown” measures in Europe and North America, which will surely hurt the already soft demand for oil. This resulted in a sharp late October decline in the oil price.

The supply side of the market also looks unattractive. OPEC has exercised unusual discipline in maintaining reductions in oil production. However, the economic pain being felt by OPEC members through the combination of depressed oil prices and reduced production means that any meaningful strength in oil prices will be met with increased supply. This supply overhang is likely to limit the appreciation potential of oil prices to the \$45-\$50 per barrel level, especially considering the large volume of American shale oil that can be counted on to appear should prices be sustained in the mid-\$40s or higher.

The underperformance of energy stocks has been a subject of discussion for some time, but the scale of the decline by the sector versus the S&P 500 is not widely appreciated. The energy sector has declined by almost 60% more than the S&P, which represents the worst performance of any sector to date.



Declines of this magnitude usually accompany important changes in secular trends. This deeply out-of-favour sector will be of interest to value investors seeking mispriced securities. However, buyers of oil stocks at this time for more than a short-term bounce must assume a rapid recovery by the global economy capable of spurring demand and boosting prices.

There may be a short-term trading opportunity in oil equities, but sustained oil prices at much higher levels are necessary for a durable bull market in oil stocks. Our current calculation of the factors influencing supply/demand makes that seem unlikely.

In conclusion, we do not believe that oil represents an attractive risk/reward proposition at this time.

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA)(WEEKLY)



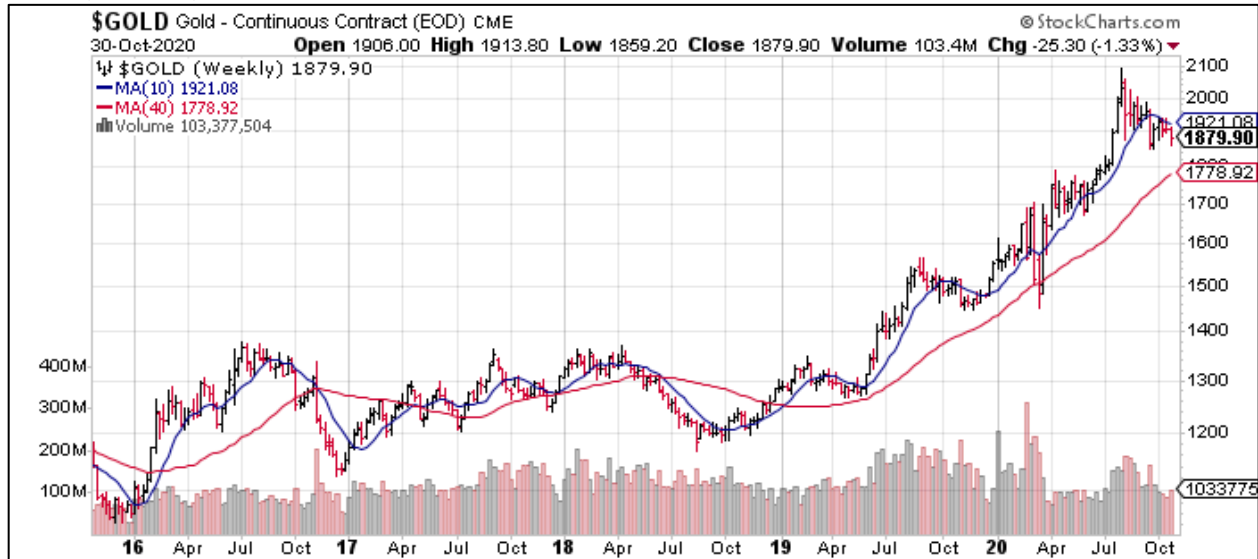
While the defence sector remains one of our long-term investment themes, we must continue to adopt a bearish view of our proxy for the sector, the ITA ETF, because of its uninspiring performance over the past few months. We continue to believe that the combination of deteriorating global geopolitics and rapid technological evolution will produce substantial demand for military hardware. However, current market conditions do not currently present a compelling risk/reward for establishing positions.

The opportunity to re-enter this sector, which produced solid gains for our subscribers previously, will eventually occur. We continue to favour companies, such as aerospace firms, whose products incorporate the highest technology. We also believe that geographic diversification is desirable as geopolitical turmoil can affect alliances and, hence, buying patterns.

Defence companies worthy of consideration for eventual purchase include Northrup Grumman, Lockheed Martin, BAE Systems, General Dynamics, Thales and L3 Systems.

GOLD COMMENTARY

GOLD (WEEKLY)



We remain bullish on gold as it continued its pullback and consolidation in October following the high made in the summer. Gold continues to trade comfortably above its 40-week moving average, and its chart appears to be forming a bullish continuation pattern. As well, the recent contraction in its trading volatility suggests a sharp move may be in the offing, with a fresh move higher being the more likely outcome.

The macro-environment, with unprecedented monetary expansion and a steadily deteriorating global geopolitical scene, could hardly be better for gold.

We remain positive on the merits of purchasing gold stocks in this environment but repeat our caution to avoid companies with production in geopolitically unstable nations. Our preferred jurisdictions are Australia, Canada and the United States. Companies worth consideration in this category are, among others, Barrick Gold, Newmont, Newcrest and Agnico Eagle.

ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process, and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.

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