Fickel's Focus

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Third Quarter 2019 Investment Commentary

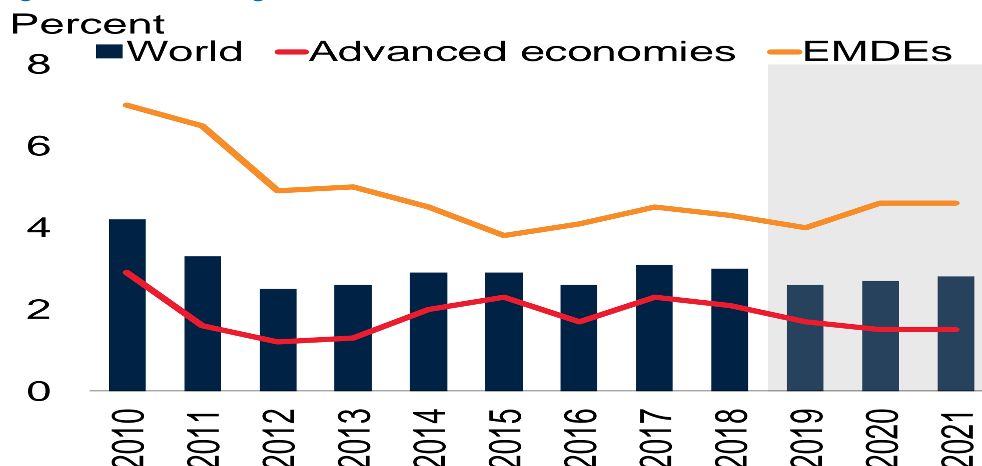
Global equity markets were up nicely in Q3. The S&P/TSX and the S&P 500 increased by 2.5% and 2.9% in $Cdn respectively. Accounts on board for the full quarter and migrated to their appropriate models produced strong positive absolute returns and outperformed the Balanced Benchmark.

On a personal note, we would like to congratulate Nathan Fickel for completing the third and final level of the Chartered Financial Analyst program (CFA).

Economic Overview

The global economy continued to expand in the third quarter, albeit at a slower pace. Estimated global growth for 2019 has been revised down to 3% which would be the slowest rate since the Great Financial Crisis (Figure 1). The persistent U.S.-China trade war, pullbacks in corporate investment and hiring, and a contraction in the manufacturing sector are contributing to the synchronized slowdown. Consumers remain in good shape and are supported by strong labour markets and easy financial conditions (low borrowing/debt servicing costs).

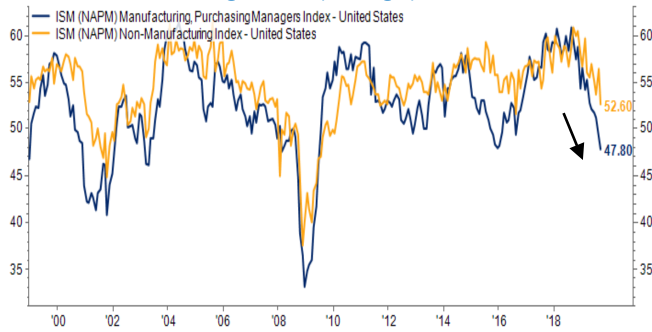
Figure 1: Global GDP growth to 2021



Source: World Bank

The data coming out of the manufacturing sector has gone from bad to worse. Physical goods producers continue to report slowing activity and an increasingly pessimistic outlook. The September U.S. manufacturing report, published by the Institute for Supply Management, registered 47.8% (Figure 2). A reading below 50 indicates contraction.

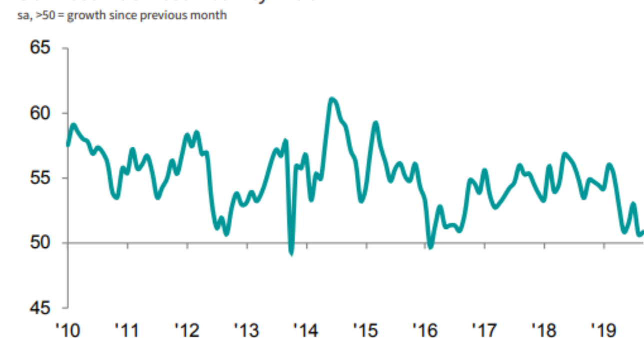
Figure 2: ISM manufacturing index (blue) and ISM non-manufacturing index (orange)



Source: FactSet

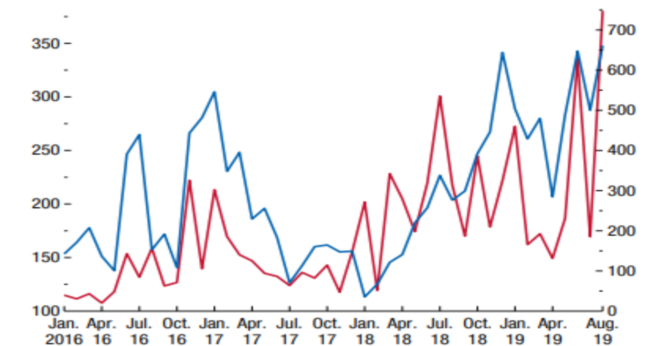
The services sector accounts for a larger portion of GDP than manufacturing and is beginning to exhibit softness. According to the IHS Markit's Services Business Activity Index, the third quarter survey signaled the weakest U.S. activity since 2016 (Figure 3). Lackluster growth in new orders, particularly from overseas, and lower expectations for the year ahead are being reported by services-oriented companies. Global trade is one of the most significant issues facing multinational companies and has dampened business sentiment. Elevated levels of policy and trade uncertainty (Figure 4) are causing firms to adopt a cost-conscious mentality. For the first time since early-2010, services sector firms signaled a contraction in employment.

Figure 3: U.S. business activity expectations



Source: IHS Markit

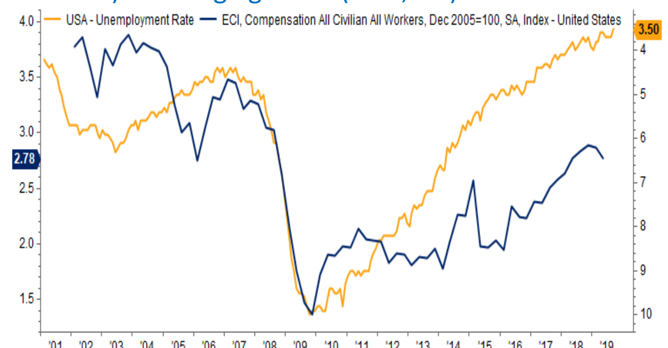
Figure 4: Global economic policy uncertainty (blue, LHS) and U.S. trade policy uncertainty (red)



Source: Baker, Bloom, and Davis (2016)

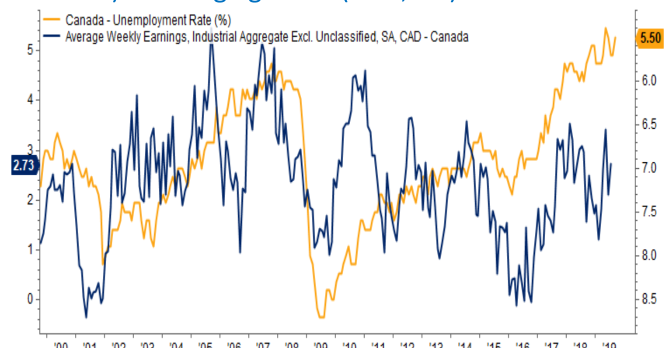
Despite the weakness in business activity consumers generally remain healthy around the world. In Canada and the U.S. they continue to benefit from very low levels of unemployment and decent wage growth (Figures 5 and 6). Weekly jobless claims are muted and delinquency rates presently show no cause for concern. Healthy labour markets combined with low interest rates bode well for consumer spending and debt-servicing capability (although in Canada already-high levels of debt may hinder loan growth and ultimately future consumption).

Figure 5: U.S. unemployment rate (orange, rhs, inverted) and wage growth (blue, lhs)



Source: FactSet

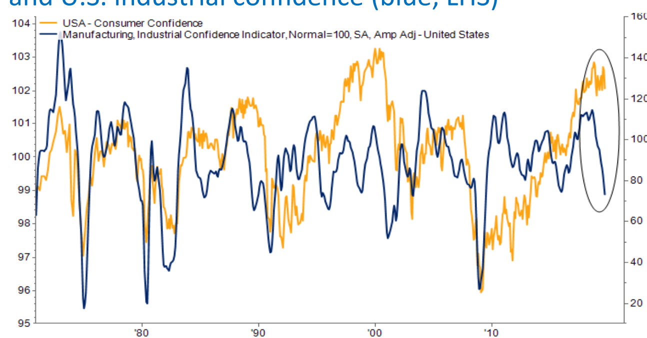
Figure 6: Canada unemployment rate (orange, rhs, inverted) and wage growth (blue, lhs)



Source: FactSet

Sentiment among businesses and consumers have clearly decoupled (Figure 7). Divergences have not persisted historically. We think a rebound in manufacturing is a prerequisite for sustaining consumer confidence and continuing the economic expansion. Fortunately, there is progress being made in the trade war between China and the U.S. which is a crucial step towards restoring business confidence. At a minimum, it appears likely that a shallow deal will be achieved in the near-term. Such a deal will probably target the low hanging fruit and leave contenscious issues unresolved, but it is a step in the right direction.

Figure 7: U.S. consumer confidence (orange, RHS) and U.S. industrial confidence (blue, LHS)



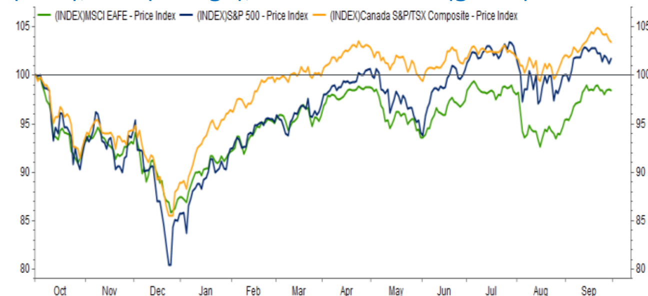
Source: FactSet

Equity Commentary

Equity weightings remained below the benchmark in all portfolio objectives. Balanced accounts' equity weightings are approximately 52.56% on average versus the benchmark weight of 55%. Developed economies continue to exhibit classic late-cycle characteristics including tight labour markets, higher wage growth, peaking profit margins, and inverted yield curves. We favour reducing risk and focusing on high-quality and defensive equities in this environment, particularly as the uncertainty related to trade persists.

Equity markets advanced in the third quarter, building on their strong year-to-date gains. Since the beginning of the year, the S&P 500, S&P/TSX, and MSCI EAFE are up around 17%, 19.1%, and 6.6% in Canadian dollars, respectively. To keep returns in perspective, one-year returns since October of 2018 are modestly positive (Figure 8).

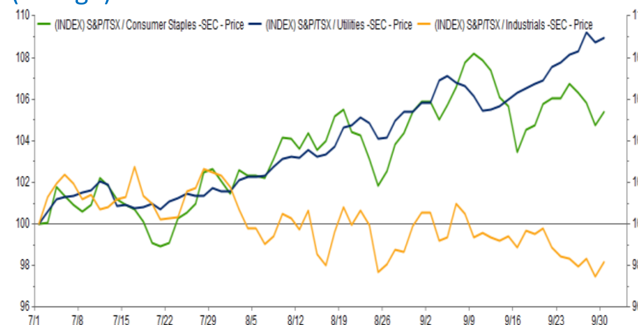
Figure 8: One-year price performance of S&P 500 (blue), TSX (orange), and MSCI EAFE (green)



Source: FactSet

The third-quarter advance in equities generally favoured defensive sectors at the expense of cyclicals (Figure 9). In Canada the Utilities, Consumer Staples and Real Estate sectors posted strong positive returns while Materials, Industrials and Energy lagged the index.

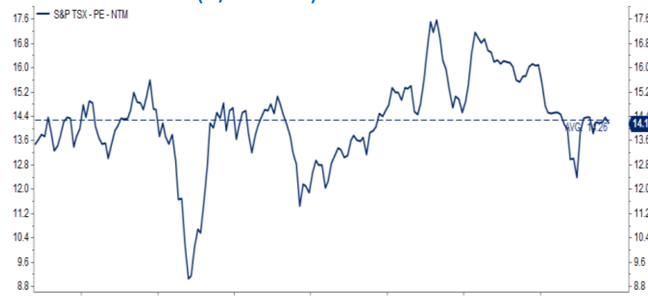
Figure 9: Third quarter price returns of Utilities (blue), Consumer Staples (green), and Industrials (orange) in Canada



Source: FactSet

The S&P/TSX trades at a reasonable valuation on a price-to-earnings basis (P/E) and is in-line with its historical average (Figure 10).

Figure 10: S&P/TSX price-to-earnings ratio over next twelve months (P/E NTM)



Source: FactSet

On a relative basis, Canadian stocks look attractive and trade at a steep discount to U.S. equities (Figure 11).

Figure 11: S&P/TSX (Canada) price-to-earnings ratio relative to S&P 500 (U.S.)

Source: FactSet

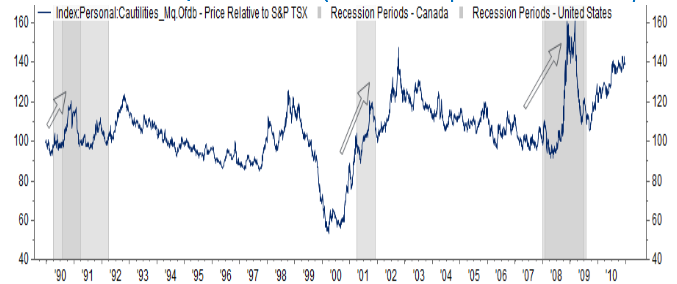
Some of the discount is warranted given the Canadian index's composition – higher exposure underperforming sectors (energy, materials, and recently financials) and lack of exposure to technology. Still, we believe there is value to be found in the Canadian market. We continue to like the Utilities sector although we acknowledge it is no longer inexpensive after its year-to-date rally of 34.8%. The sector trades at 17.7x forward earnings, about in-line with its historical average valuation. Compared to the U.S., however, the sector trade near its 15-year low relative valuation on a P/E basis (Figure 12).

Figure 12: S&P/TSX Utilities sector P/E relative to S&P 500 Utilities

Source: FactSet

Utilities stocks still offer an attractive yield of around 4.3% and we like their defensive characteristics as we approach the end of the business cycle. We remind ourselves that the sector has historically outperformed the broader S&P/TSX index significantly during economic downturns (Figure 13).

Figure 13: S&P/TSX Utilities sector price performance relative to S&P/TSX Index (recession periods shaded)



Source: FactSet

We remain underweight Canadian financials as the sector continues to face a multitude of headwinds. Canadians are heavily indebted and are paying an unprecedented percentage of disposable income to service their debts (Figure 14). High levels of leverage combined with unaffordable housing will likely hinder loan growth at the Canadian banks over the near to medium term.

Figure 14: Canadian household debt service ratio

Source: Statistics Canada, Veritas Research

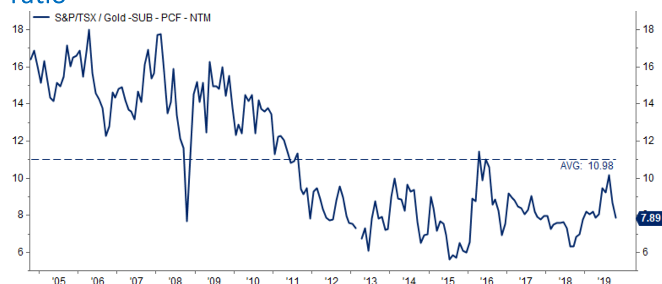
Due to the flattening (and now negative) yield curve (Figure 15), banks are unable to offset slowing loan volume growth through higher prices. Short-term interest rates (which banks pay on deposits) are higher than the longer-term rates that banks receive on their loans.

Figure 15: Canada 10-year bond yield minus Canada 3-month bond yield

Source: FactSet

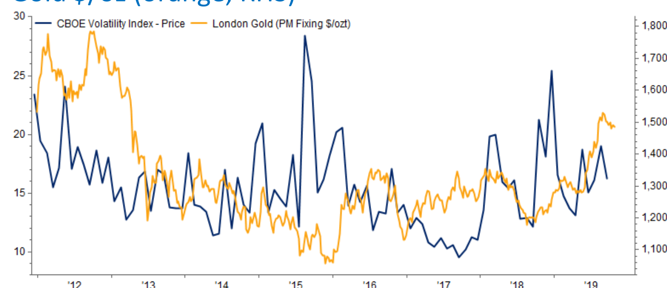
We believe there is a place for gold in the portfolios (Balanced portfolios have ~2.5% in Newmont Goldcorp). Canadian gold miners are cheaply valued despite having risen 31.5% year-to-date (Figure 16). We were initially attracted to the sector's forecasted free-cash-flow when gold was trading at $1,300 USD. With gold currently trading around $1,500 USD, Canadian gold miners are positioned to be cash-flow-gushing machines. An added benefit is gold's natural hedge against market volatility which is a common late-cycle phenomenom (Figure 17).

Figure 16: S&P/TSX gold sector price-to-cash flow ratio



Source: FactSet

Figure 17: CBOE Volatility Index (blue line, LHS) and Gold $/oz (orange, RHS)



Source: FactSet

It was a relatively quiet quarter for our portfolios. Transactions for the quarter include:

Total was sold in July and the proceeds were used to purchase **Suncor**. Suncor is Canada's largest integrated oil and gas company. While we still like Total, Suncor is a more compelling investment going forward. Much of the negative news relating to production curtailments and pipeline risk have been priced into the shares and we think there is a greater chance that the outlook for the sector will improve rather than regress. Suncor also has minimal exposure to currency and exploration risks that are inherent in Total's business model. Suncor has exited a period of investment and we like the company's strategy of harvesting cash flow from these past capital expenditures. At a U.S. $60 oil price, Suncor generates over $4 per share of free cash flow a year which is earmarked for debt reduction, dividend growth, and share buybacks.

In August, we initiated a position in the Canadian Imperial Bank of Commerce. **CIBC** is Canada's fifth largest bank as measured by loans, assets and market capitalization. Relative to the other Canadian banks, CIBC offers greater exposure to the domestic market than its peers. The share price has materially underperformed our current bank holdings of TD and RBC over the last year, dropping from a share price north of $120 to just over $100 at the time of purchase. The stock offers a very attractive yield close to 5.5%, the highest among the major Canadian banks. Management has guided for fiscal 2019 results to be very similar to the previous year due to increased investment in consumer distribution capabilities and client-facing operations but expects earnings growth to resume at a 5-10% pace.

We trimmed positions in **AT&T** in September. The stock had performed well year-to-date and benefitted from the rotation into defensive and high-dividend equities. The share price took another move higher in September after it was revealed that activist hedge fund Elliott, a significant shareholder, issued a letter to company management outlining an array of changes that it felt would improve returns including introducing a new plan for cost cutting, detailing leverage and capital return targets and committing to no further acquisitions in the near future. While we remain attracted to AT&T for its defensive characteristics, cash flow and sizable yield, we have also been concerned most recently by the departure of several high-level executives since its acquisition of Time Warner and late entry into a streaming market that is very competitive.

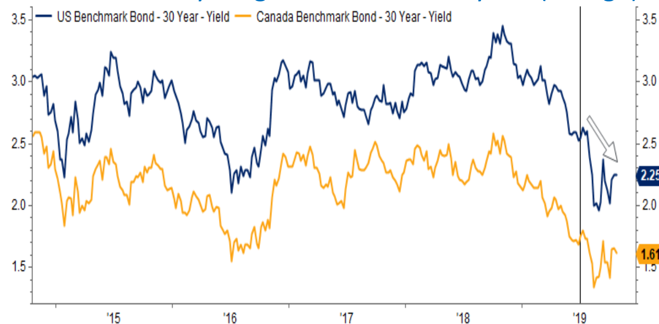
We took profits from our Utilities holdings in September by trimming both **Northland Power** and **Emera**. Both companies have been helped by a market shift towards high-yielding and less cyclically-exposed stocks. Northland Power operates 26 facilities that produce electricity from natural gas and renewable sources including wind, hydro, solar and thermal. Emera's share price was up over 20% from our original purchase not including dividends. Our total returns for Emera are higher as we added to positions when the stock fell after our original

purchase. Emera has also benefitted from greater clarity on its future funding outlook after reaching an agreement to sell its none-core utility assets in Maine and New England for a price greater than the market had expected. We continue to like the defensive characteristics and attractive yields of these Utilities in the current market environment and maintain positions in each.

Fixed Income

The Canadian broad bond composite posted a solid return of 1.2% in the third quarter. Long bond yields moved lower in Canada and the U.S. as investors sought out defensive assets (Figure 18).

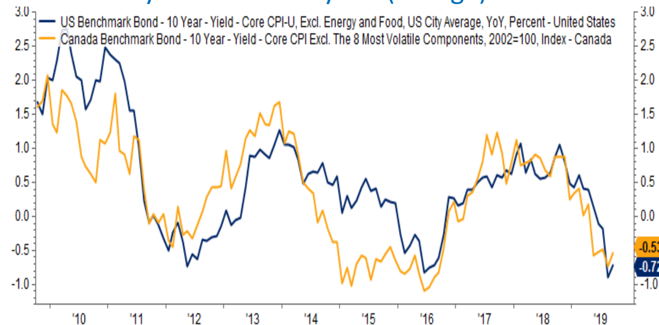
Figure 18: U.S. 30-year government bond yield (blue) and Canada 30-year government bond yield (orange)



Source: FactSet

We remain underweight bonds in our portfolios. Yields are incredibly unattractive, particularly after adjusting for inflation. Real yields on 10-year government bonds in Canada and the U.S. are -0.53% and -0.72%, respectively (Figure 19).

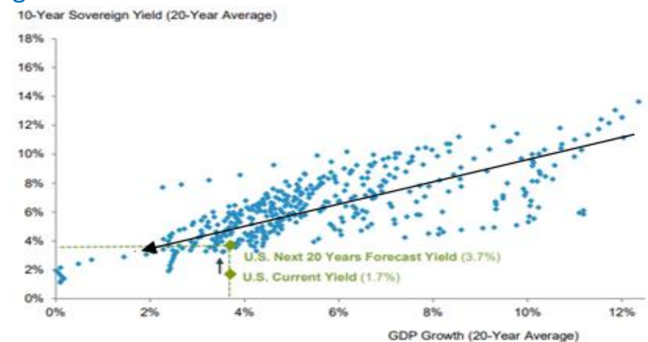
Figure 19: U.S. 10-year bond real yield (blue) and Canada 10-year bond real yield (orange)



Source: FactSet

Over long periods of time, long-term government bond yields generally average the same rate as nominal GDP growth (Figure 20). The U.S. is forecast to grow at a nominal rate of 3.7% suggesting that U.S. 10-year Treasuries should be yielding significantly higher than their current 1.7%. We are skeptical of the notion of yields doubling from current levels, but we think they could face some upward pressure over the medium term which would not bode well for the asset class (bond prices and yields move inversely).

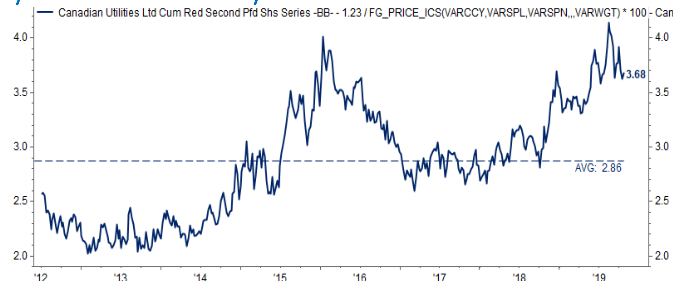
Figure 20: Nominal government bond yields and GDP growth



Source: Official country estimates, Haver Analyitics, Fidelity Investments

Equity markets look fairly valued and bonds (all types – government, investment grade, and junk) are incredibly expensive. We continue think the Canadian preferred share market is one of the few assets classes that offers decent value. Portfolios hold around 18% in preferred shares (half of fixed income), constituted of high-quality floating rate, rate-reset, and perpetual issues. Yielding around 5.3% (equivalent to a bond yield of 6.9% thanks to the dividend tax credit), perpetual preferred shares are particularly attractive on both an absolute and relative basis. One of the perpetual issues we own, Canadian Utilities series BB, yields 3.68% more than a 30-year Canada government bond (Figure 21). We are comfortable holding this issue (and others like it) for a long time, riding out price volatility and collecting juicy dividends.

Figure 21: Canadian Utilities preferred Series BB: yield minus GoC 30-year bond



Source: FactSet

Performance

Our portfolios were up nicely in Q3 and significantly outperformed the Balanced Benchmark. Our Canadian, U.S., and International equities all outperformed their respective benchmarks. Stock selection contributed significantly to our equity returns while asset allocation (underweight equities) detracted slightly. Fixed income returns were modestly above the benchmark.

Overweight defensive sectors contributed to the outperformance in Canada. Loblaw (+12.54%), Emera (+8.69%), BCE (+7.55%), and Hydro One (+7.22%) were all notable outperformers.

Our U.S. equities were up around 6.56% (CND dollar), significantly ahead of the S&P 500 return of 2.3% (CND dollar). AT&T (+14.20%) led, followed by Alphabet (+14.05%), Home Depot (12.82%), Costco (+10.26%), and BB&T (+9.86%). Johnson & Johnson was a notable laggard (-6.06%).

International stocks slightly outperformed their benchmark. Medtronic PLC (+12.79%) and GlaxoSmithKline (+7.76%) were among the better performers. Axa (-2.06%) and Rio Tinto (-15.57%) lagged.

Our fixed-income modestly outperformed the broad bond composite gain of 1.2%. Underweight bonds and being primarily invested in the short-end of the curve hurt returns, though this was more than offset by our preferred share performance. Our preferred shares were up ~1.6%, outperforming the S&P/TSX Preferred Share Index return of 0.55%.

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- In-depth **Financial Planning** – financial planning specialists will prepare a comprehensive Compass Financial Plan to help identify and address any financial planning concerns or opportunities you may have
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- **Will & Estate consultation** – help you structure the succession of your estate in an efficient and tax effective manner
- **Insurance assessment** – Estate planning specialists assess the need and suitability of tax-exempt insurance

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Wealth Management
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