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Investor Strategy

Helping investors reach their long-term wealth goals

Choppy

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Summary

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- **II. Market cycle – It's the economy again**
- **III. Consumer – You shall not pass!**
- **IV. Credit conundrum**
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I. Market recap – Bumpy quarter

Heading into the third quarter, market concerns were centered around the ongoing uncertainty of the trade war between the United States and China. Despite solid year-to-date returns, market sentiment proved to be fickle. The S&P TSX/Composite rose 1.7% in the third quarter and the S&P 500 rose 1.4% in Canadian dollar terms. This was the third positive quarter in a row. However, despite the positive returns, investors had to deal with a swift sell-off in August, only to have stocks bid back up on the de-escalation of tensions with hopes now pinned on early October talks. The rebound was global in scale with 38 of 50 countries represented in the global index posting gains. Despite easing tensions, equity markets ended the quarter on a mixed note. Business confidence is eroding amid continued deterioration in economic data and rising recession risks. Key concerns center on the ongoing manufacturing malaise, prolonged yield curve inversions and now a presidential impeachment inquiry.

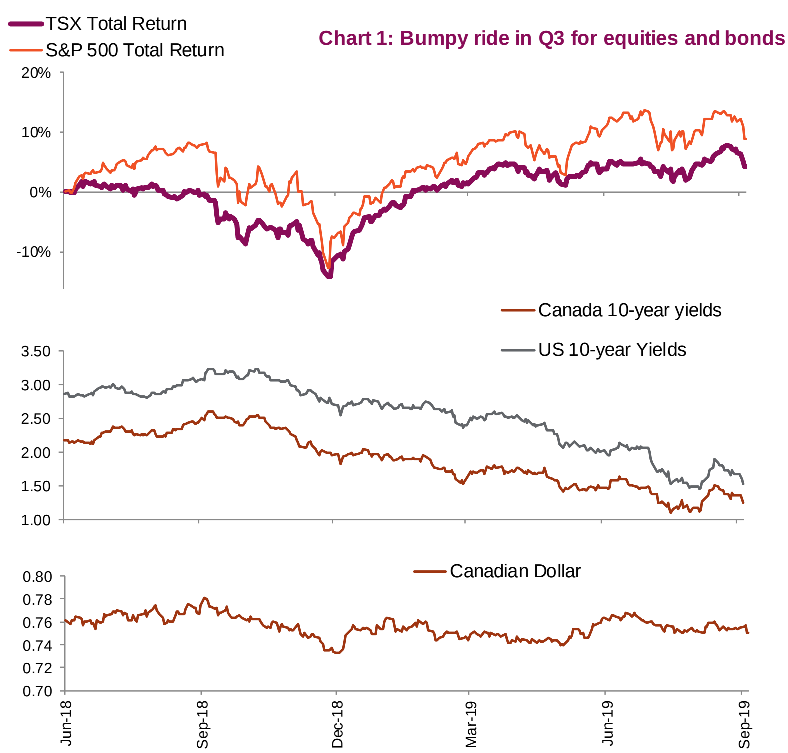


Chart 1: Bumpy ride in Q3 for equities and bonds

Safe-haven trades worked out particularly well this quarter: Real Estate and Utilities were the two best-performing sectors in Canada and the U.S., followed by Consumer Staples. Health Care was the largest detractor in Canada while Energy was the worst-performing sector in the U.S. The energy complex struggled on both demand and supply concerns. The one-time spike in oil prices following a drone attack in Saudi Arabia proved to be a short-lived event.

Gold continues to prove the doubters wrong, rising nearly 4% over the quarter. Miners rose as high as 20% but gave some back, ending the quarter 10% higher. U.S. dollar appreciation was a headwind, with the U.S. dollar index climbing to its highest level since early 2017.

The bond market proved to be a hotbed of activity. Yields plummeted in late-summer trading, with yields reaching multi-year lows. Bonds were clearly in demand: the FTSE TMX Universe Bond index finished the quarter positive. U.S. 10-year bond yields fell from a high of 3.25% in 2018 to a low of 1.43% in August 2019. The trend has been relentless, aided by central banks pivoting and now going down the path of easing monetary policy to fend off a recession. The bond market continues to deal with pervasive negative yields around the world – these amount to $15 trillion, or 30% of the bond market.

In a world struggling to grow, low inflation and growing fears of an economic downturn, central banks have decidedly shifted gears. The U.S. Federal Reserve (Fed) cut rates twice this past quarter and looks set to continue down the easing path. The European Central Bank (ECB) also cut rates and indicated that they plan another round of expanded bond buying. The Bank of Canada (BoC) held steady for now but noted concerns over global trade. They also made several references to the worsening effects of trade tensions on the world economy. While surprising to some, the Canadian economy has held up, but there are now heightened expectations of a slower fourth quarter. BoC Governor Stephen Poloz has a decidedly dovish tone, noting the bank is prepared to cut rates if necessary.

While we would expect the U.S. and China to focus on de-escalating tensions with an upcoming U.S. election now just over a year away and China's domestic fears around social instability, particularly in Hong Kong. We do not have a crystal ball as to how the geopolitical cards will play out, but employment numbers remain healthy and we're yet to see meaningful cracks in the consumer. Crucially, we believe a more neutral stance with moderated bets is the best course of action.

II. Market cycle

It's the economy again

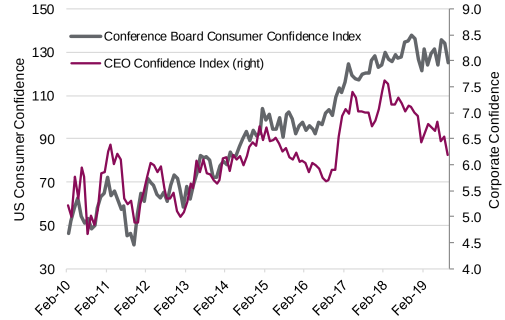
The global economy, even the U.S. or Canadian economies for that matter, are rather complex. You have millions of people (billions for the global economy) making decisions every day that are largely meaningless in themselves. But add them all together and even a small net change in attitudes towards spending or saving, or in confidence can have a dramatic impact on the overall economy. There are also millions of companies that make countless decisions: whether to greenlight an expansion plan or cut back on travel to reduce expenses, hire or not hire. The result? Any money spent (*aka expenses*) by an individual or a company – even for something as insignificant as coffee pods – represent another person's or company's revenue. A single person or company won't move the needle but, collectively, the domino effect of one's decision on the next amounts to the economy.

The cascade or domino effect in the economy is important at the moment. For the most part, there was little concern when developing economies started to show slower economic growth a few years ago, but this gradually spread to impact developed economies that are more trade sensitive, such as Europe and Asia. Now the fallout of this slower growth has spread, slowly, to the U.S. This has lead to a slowdown in global manufacturing, perhaps even a 'manufacturing recession' as some coin it. Trade uncertaintly has exacerbated this slowing and sapped corporate confidence. So here we are today:

- Global growth continues to slow, most evidently in the more cyclical manufacturing industries.
- Trade uncertainty and corporate confidence continues to fall, leading to more conservatism.
- Companies have been dialling back corporate spending (remember, one company's spending is another's income).

BUT, the dominos have not reached the consumer and that is the crux (Chart 2 compares corporate & consumer confidence). We have gone through

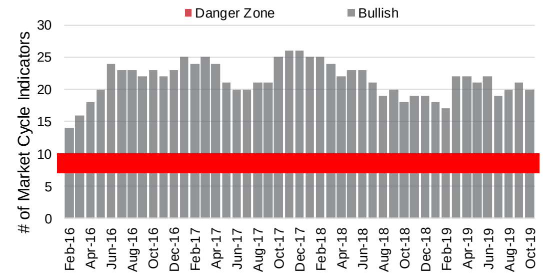
Chart 2: Critical that declining confidence does not spread to the consumer



manufacturing/corporate spending slowdowns before and if they persist long enough or become deep enough, companies begin firing instead of hiring, which then impacts the consumer. Companies will cut all sorts of expenses before they begin laying people off as it is expensive to re-hire and because company's have hearts too.

So far the consumer sector has not been impacted and remains healthy, especially in the U.S., which makes up a substantial portion of the global economy. In the next section we will share further analysis and our thoughts on the consumer, but for now this is the saving grace. There are other positives as well. Remember, while manufacturing is more cyclical than other industries, it is a smaller and smaller part of the economy. Money and credit trends are now very supportive with just about every central bank becoming more accomodative. Lower bond yields have helped. While we believe the efficacy of monetary policy on the economy has fallen over the years, we are not denying it still impacts some industries. U.S. housing has seen a revival of activity which is positive.

Chart 3: Market Cycle indicators still stable



Market Momentum				
Canada				✓
US				✓
Consumer Model		✓		
HY Spreads			✓	
US Economy				
Leading Ind (3m)			✓	
Leading Ind (6m)			✓	
PMI	✓			
PMI New Orders		✓		
Cons Sentiment		✓		
Cars		✓		
Homes				✓
Credit				✓
Chemical Activity			✓	
Rail		✓		
Energy Demand			✓	
Trucking			✓	
Phili Coinc				✓
US Unemployment			✓	
Rates				
Fed Funds				✓
Yield Curve	✓			
Yield Curve Change			✓	
Fundamentals				
Valuation Canada			✓	
Valuation US		✓		
Earnings Growth				✓
Sales Growth				✓
Margins				✓
Global Economy				
CRB		✓		
Oil		✓		
Copper	✓			
Baltic Freight				✓
KOSPI		✓		
Emerging Mkts	✓			
Global PMI			✓	
Total	4	9	10	10

Data often conflicts with some pointing to positive trends and other to negative developments. This is why we use our **Market Cycle framework**, comprising key data: economic, technical, sentiment, fundamentals and rates. There is no one model or signal that will work consistently for predicting the markets or economy, so we use a cross-section that have each shown some efficacy historically. The good news is that while there has been some weakness or loss of momentum, the Market Cycle indicators have remained relatively stable.

While we rely upon the aggregate number of market cycle indicators that are bullish or bearish in our assessment of the health of the current economic cycle, the devil is often in the details. Comparing the current data with three months ago, we see some interesting changes. The most notable is that the global economy has continued to lose momentum relative to the start of last quarter, but has improved over the past month. U.S. economic indicators have also seen some declines, not surprisingly, centred around manufacturing. Housing has returned as a bullish contributor. Finally, rates have become more positive. The Fed has cut rates and while the yield curve is still inverted, it has steepened somewhat (i.e. it is less inverted).

This has us in a more cautious stance regarding the overall market with extra emphasis or focus on whether or not slowing growth will spread to the consumer. At this point, that spells the difference between a continuation of the current aging bull or the rise of a bear market. If you want to help, you can always go out and buy something!

III. You shall not pass!!

It is becoming apparent that it is all up to the consumer to stop the spread of slowing economic growth currently centered on manufacturing and corporate spending. The good news is that the consumer is very healthy, notably the U.S. consumer. So, if anyone is equipped to handle the job of drawing a line in the sand to stop slowing economic growth from spreading, it's the consumer. After more than a decade of deleveraging, the U.S. consumer now enjoys a debt-to-disposable income ratio of below 100%. This peaked in 2008 and has been falling ever since. Plus, the savings rate has been hovering around 7-8%, as the consumer continues to make improvements on their personal balance sheets. Add to this unemployment below 4% and real wage growth over 3%, and indications are that the U.S. consumer overall is healthy and wealthy.

The U.S. consumer is further buttressed by an improving housing industry, from both prices and building activity. While equity markets have slightly declined of late, the wealth effect remains a positive boost. So, it really comes down to whether slowing manufacturing/corporate spending begins to impact hiring activity, which could then impact the consumer and spending habits. At this point there have only been signs of weakness on the margin.

When it comes to the U.S. labour market, the major economic indicator is the monthly nonfarm payrolls data. For September, the U.S. added 136,000 jobs, slightly below expectations, but last month was revised higher. And the unemployment rate dropped from

3.7% to 3.5%, the lowest reading since 1968. Offering further encouragement is the weekly initial jobless claims. This metric enjoys a few benefits over nonfarm payrolls and the unemployment rate as it is a weekly release (and therefore timelier) and is often an earlier mover when the trend is changing direction. So far, jobless claims have remained historically low providing support that hiring activities have not been negatively impacted by slowing economic activity at this point.

Somewhat less encouraging is the survey data. The Purchasing Managers surveys for manufacturing companies certainly point to falling employment expectations. This is not surprising given that economic weakness has been more evident in these industries. However, we are seeing declining employment expectations in the non-manufacturing component of this survey as well.

At this point we believe the consumer is well positioned to weather this economic slowdown – perhaps akin to what we went through in 2015. However, should we see a change in initial jobless claims, total employment under nonfarm payrolls or other indicators for hiring practices, we would likely change our tune. As we discussed the domino effect earlier, we would point out that whenever the unemployment rate rises just half a percent, a recession has followed for the U.S. When the unemployed cut back on spending, this impacts someone else's income, which leads to more layoffs and then BAM! you have a recession.

Chart 4: U.S. Consumer is healthy and getting wealthier

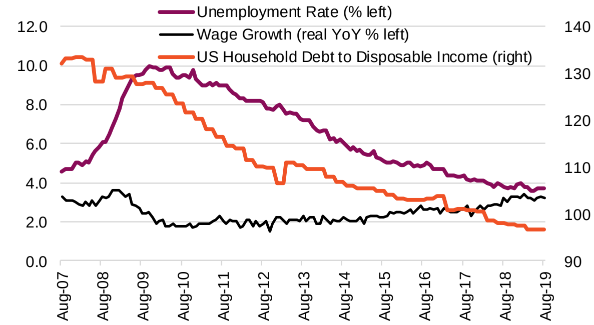
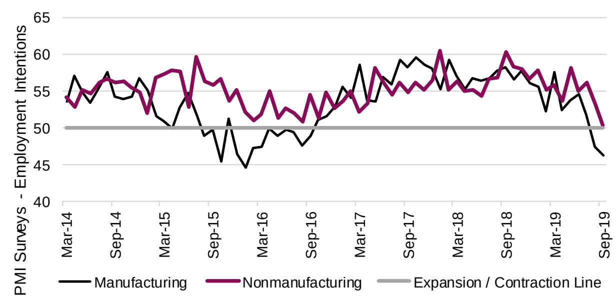


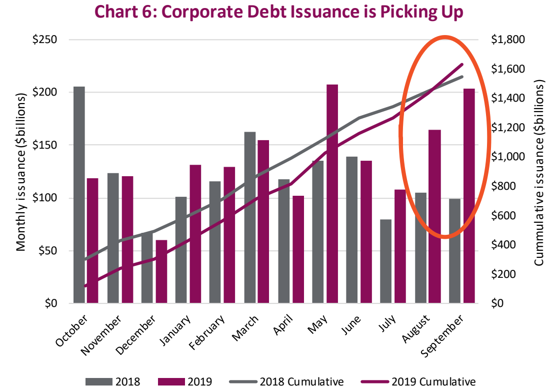
Chart 5: Employment survey data is pointing to slowing employment intentions, even outside manufacturing



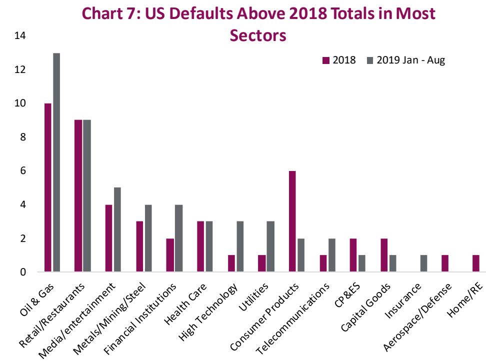
IV. Credit conundrum

Coming into 2019, we found more companies starting to become more judicious in their use of debt with the pace of issuance lagging what we had seen in 2018 (see Chart 6) and previous years. This is a potential sign of rising conservatism at the corporate level and is somewhat welcome when you consider how much corporate debt has been added over the past decade. However, with yields falling this conservative trend appears to have reversed in August and September, pushing cumulative issuance over the past 12 months to higher levels than a year back. If the recent trend continues, 2019 could prove to be another record in issuance but there is some good news. The average coupon on new issues was 19 basis points lower than a year earlier, as of the end of August. For those refinancing, the current environment is enabling some to enhance their credit profile, extending maturities and lower interest costs. Therefore, we need to look below the surface when analyzing debt issuance by companies we invest in.

Chart 6: Corporate Debt Issuance is Picking Up



As we alluded to above, uncertainty remains awash in the market and companies with stretched balance sheets, at this point of the cycle, could be at risk of slowing economic growth. While corporate defaults remain very low, there has been an uptick with more defaults through three quarters than all of 2018. Not surprisingly, this was led by the beleaguered Energy and Retail sectors, but the uptick is concerning, particularly considering rates are falling (see Chart 7).



One of the more accretive capital-management strategies of the past decade has been to borrow money, at historically low rates, and buy back your own stock. Think of it as creative corporate accounting to boost near-term results. In this form of financial engineering, the level of your outstanding shares drops, and now the numerator (earnings) of the earnings per share (EPS) equation is divided by a smaller denominator (shares). This equates to higher EPS growth. The inherent problem is that the strategy increases financial leverage and can act in the opposite direction to accelerate EPS losses should we face a challenging economic environment.

As we move through this business cycle, we are placing a greater level of emphasis on the degree of financial leverage in the businesses we buy stock in. **To avoid being distracted by engineered EPS growth, we place a higher degree of emphasis on free cash flow growth, which is not impacted by share count and other factors that can be potentially manipulated.** Concurrently, we expanded our liability analysis looking closely at changes in credit ratings and probabilities of default. Both of these factors or indicators are a calculation based on traditional liquidity measures such as debt/equity, interest coverage and earnings before interest and taxes (EBIT)/interest expense, to name a few.

V. Portfolio positioning

Overall Asset Allocation	-				+
Equities				■	
Fixed Income		■			
Cash				■	
Global Equities	**-**				**+**
Canada		■			
U.S.				■	
Euro Area			■		
Japan			■		
Emerging Markets	■				
Fixed Income	**-**				**+**
Canada		■			
U.S.			■		
Government			■		
Investment Grade		■			
High Yield	■				
EM Debt	■				
Prefs		■			
Duration	■				
Credit		■			

We did not make any changes to our asset or geographic allocations in September. We continue to believe this period of weakness, while not necessarily over, will prove to be a correction at worst. But the degree of the pullback is not enough to have us deploy any dry powder on a short-term trade basis.

We have a minor underweight in Canada with an overweight U.S. equities and market weight international. Our low duration stance has been the wrong one this year. However, where yields sit today, inverted across much of the curve, we have no desire to add duration and remain focused on short-term fixed income with higher credit quality.

With Market Cycle indicators appearing healthy, we believe this cycle still has room to go. Central banks have pivoted to a more accomodative position, which is encouraging. Countering this is the continued uncertainty around the trade war and the implications for slower economic growth. There are certainly areas of concern in the market place, as there always are, but at this point we do not believe the negatives have flared up enough to spell the end of a market cycle.

Charts are sourced to Bloomberg L.P. unless otherwise noted

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