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Commentary & Outlook

Stay the Course

Almost like clockwork, both Canadian and U.S. stock markets began to sell off the first of May lending some credibility to the adage "Sell in May and Go Away". Was this a self-fulfilling prophecy or just the byproduct of an overbought market, hypersensitive to trade war headlines and President Trump's Twitter feed?

Regardless of the reason, the major Canadian and U.S. stock market indices spent the entire month of May in a downtrend, although it is worth noting that Canadian stocks outperformed their U.S. counterparts with Canadian Technology, Utilities, and Consumer Staples sectors showing modest gains.

As we highlighted in last month's Portfolio Managers' Brief, after stock prices continued to stretch into all-time highs during the month of April we were expecting a snap back, leading us to be positioned accordingly when May markets corrected.

While we do expect that trade war headlines will continue to drive market volatility both here and abroad, we don't believe it has anything to do with the imposed Tariffs.

Once Tariffs are announced, share prices of impacted companies seem to adjust very quickly and efficiently. What we believe investors are currently grappling with is the uncertainty that comes from the cascading effects of tariffs on growth, investment and employment as production shifts and pricing power changes.

All that said, economic data continues to show strength and stocks seem to have found a short-term bottom based on the reversal in markets the first week of June, suggesting that until economic fundamentals deteriorate, markets will be supported despite the uncertainty.

Conservative Portfolios

Our more conservative portfolios continue to hold high quality companies that appear to be trading at discounted share prices compared to their underlying fundamentals. We also continue to include strategies and assets that are negatively correlated to the stock market in general along with an active option writing overlay to enhance cash flow.

Regarding asset allocation, overall exposure to Fixed Income within our Income Fund was increased by 5% to 65% while equity and Covered Call Exposure was reduced. The Bear Put Calendar Spread on the QQQ's (a form of equity insurance) was also increased by 50%.

Exposure to the Materials sector was reduced after price appreciation in the sector, and the Fund manager switched from one real estate holding to another that is trading at a higher discount. The Financial and Consumer Staples sectors were added via a Short Put strategy, selecting quality companies that had experienced a perceived temporary pullback in the securities' prices. Exposure to Utilities was also trimmed to adjust for higher valuations.

Growth Portfolios

A similar approach is being applied in our growth-oriented portfolios. While we still anticipate stock market upside, it's going to be a bumpy ride and uncertainty will remain a headwind. This outlook tends to lead to more range-bound share prices and higher option premiums, which are ideal for active management as stock prices bounce between key support and resistance levels.

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As equity market risk over the month increased, money flowed into bonds and, in a flight to safety, with the bidding up of bond prices bond yields fell. The IRC took advantage of this "risk-off environment" as an opportunity to add securities with lower volatility characteristics and strong cash flow profiles to the Equity Fund, contributing to portfolio stability. Securities were also selected based on high dividend yields as dividends become more attractive when bond yields fall.

In Conclusion

Defensiveness remains the overall theme for the firm's approach to managing investments across all risk levels, including:

- Active profit taking
- Holding higher levels of cash
- The utilization of hedges
- Careful security selection
- Patience when looking for price entry points on stocks on our watch list.

While economic data remains supportive, and stock markets are a long way from the December 2018 lows, we can't discount what's been happening in the bond market. The yield curve inversions in both Canada and the U.S. historically suggest an aging business cycle and probable recession.

To summarize, we are maintaining our outlook for modest growth over the next 12 months, but as more investors and money managers move into longer dated bonds, a recession remains a risk and the stock market will continue to be sensitive.

Overall, we will stay the defensive course, despite how tempting each successive stock market up trend looks over the next few months, until our analysis of economic conditions and the geo-political landscape suggest otherwise.

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