ISSUE
20
JAN
2020

CROFT
FINANCIAL GROUP

January 2020 Commentary & Outlook

Onward and Upward

There was very little holding the U.S. and Canadian stock markets back in December. We had identified a possible headwind with a proposed round of tariffs set to take effect on December 15th. However, with a “Phase 1” trade agreement reached between the U.S. and China instead, and Trump’s impeachment being of no consequence to the markets, investor optimism continued to push stocks higher into the close of 2019.

Much of this optimism was and continues to be supported on several fronts:

1. Monetary policy continues to be accommodative, which keeps money cheap, in turn supporting business growth and development, corporate share buy-backs, and consumer spending;

2. A strong labor market and global wage growth along with healthy household balance sheets are both supporting consumer spending and fostering general investor optimism;

3. As well as what appears to be a stabilization and even potential increase in projections for global trade, manufacturing and overall growth, which should bode well for further foreign investment both in Canada and emerging markets, where earnings revisions have already begun to trend higher.

Altogether, these are considered to be signs pointing towards what should be a another positive, albeit modest year of growth for global markets.

What are the risks?

Trade frictions and deglobalization risks continue to weigh on growth and have the potential to boost inflation. Also, as we have learned, investors and by association the stock market can be influenced by headlines, especially when company valuations are stretched, and markets are at all time highs.

A primary risk to growth in the coming year will be a breakdown in U.S.-China talks. This would undermine business confidence and cut growth short of expectations. Although a phase-one deal seems imminent, there has been little progress in solving structural difficulties of market access, state subsidies and intellectual property right violations and many current tariffs will remain in place.

Although there will likely be some turbulence along the way, both China and the U.S. have incentives to pause on their trade conflict in 2020. If trade pressures dissipate, that should allow global trading activity some breathing room in the coming year.

While accommodative monetary policies around the world continue to support the potential for an upswing in global growth, interest rates are nearing lower bounds and monetary policy will likely be less of a driver in markets this year.

CROFT
FINANCIAL GROUP

January 2020 Commentary & Outlook

With more modest expectations for growth in 2020, there is less room for the kind of dovish surprises from central banks that fueled multiple expansion in 2019.

Inflation may also be a risk this year in the U.S. due to increases in capacity utilization, tighter labor markets and rising wages. Supply chain disruptions from deglobalization have also added costs at a time when tariffs have already raised input prices, U.S. labor markets are tight and there is rising wage growth overall.

Middle East Tension

The recent escalating issue between the U.S. and Iran regarding the Trump-ordered assassination of Iranian Guard commander Soleimani initially caused significant pressure in the overnight futures markets. However, this potential confrontation was quickly discounted as immaterial to the current uptrend as Iran's military response was limited and both sides seem to have de-escalated.

Nonetheless, if these actions strain relationships in the Middle East further, the knock-on effects on energy prices and trade may factor into to capital spending plans for many companies and slow global growth expectations overall.

Markets Ahead of Themselves?

With U.S. and Canadian stock markets beginning 2020 at all time highs, company valuations are stretched, meaning that share prices are expensive, which begs the question as to whether the markets have gotten a little ahead of themselves.

Because markets never move in a straight line, a moderate pull back may be a growing probability in the short term. We are watching to see how this latest round of corporate earnings go since, in order to support current valuations and further growth, we need to see earnings revisions to the upside. This would be a contrast to much of what we heard in the early part of 2019 and suggest companies are considering better days to come.

The Political Wild Card

This leaves us with the political wild card in the U.S. As we mentioned last month, the prospect of a Democrat in the White House could certainly have a negative impact on stocks as the election process unfolds. Additionally, with the recent tensions between the U.S. and Iran, one can't discount the possibility that Trump will look to keep the heat on as the threat of war could go a long way towards securing his commander-in-chief position for another term.

If Trump is re-elected, the risk of more global trade disruptions increases. Alternatively, if a Democrat is elected companies face higher corporate taxes and tightening regulation.

Conservative Portfolios

The TCG534 Income Pool outperformed its benchmark in 2019, having its best year since it's 2008 inception.

ISSUE
20
JAN
2020

CROFT
FINANCIAL GROUP

January 2020 Commentary & Outlook

Over the past year the Income Pool has transitioned to a more conservative solution to better compliment the other two funds that compose the Croft 3-Pool Mandates.

Closing out December, the IRC increased the Fixed Income exposure by 6% within the Income Pool while maintaining the exposure to preferred shares at 16%.

Also, to reduce the potential for further volatility, the covered call strategy applied to a portion of stocks within the fund has evolved into a collar strategy. This involves the sale of a call option for income generation while holding a protective put to offset some of the downside risk.

As referenced, the current market is trading at heightened and optimistic valuations. To offset the growing risk of a sharp drawdown we will continue to manage the Income Pool more conservatively while the market is trading at a premium.

Growth Portfolios

The TCG531 Equity Pool performed well in 2019 considering its more defensive positioning. The modest underperformance when compared to the major equity indices, including its S&P/TSX benchmark, can be attributed to the allocation of some capital towards downside protection throughout the year, including holding a greater than average amount of cash.

The IRC's defensiveness will carry through into the first quarter of 2020 based on the heightened valuations of the stock market and the risks mentioned above.

This includes reserving some cash for deployment in any market pullback. In this event, the case for buying the dip will be reinforced by the lack of recessionary economic trends and continued investment value support from low interest rates.

For now, while stocks are still advancing, we will continue to maintain our market hedges while overweighting:

- Technology (software having some of the best growth rates)
- Communication Services (implementation of 5G, combination of value and growth)
- Consumer Discretionary (strong consumer and low unemployment)

We will also continue using option strategies to realize capital gains and capture premium. covered calls and put writes should also offer enhanced returns with any increase in implied volatility in equity markets should company share prices cease to advance.

Alternative Strategies Pool

In order to diversify our approach to the markets we are launching our TCG538 Alternative Strategies Pool this month. This Pool is being added to the Croft 3-Pool Mandates, allowing us to diversify our approach to the markets with a focus on more tactical bullish and bearish option

January 2020 Commentary & Outlook

strategies to help us enhance returns and reduce overall portfolio volatility.

General Market Stance

Based on our continuing analysis of market risk and opportunity, we are set to remain actively defensive in managing assets across all pools and investor mandates through the first quarter of 2020.

This means we will continue to be selective in which companies we invest in, actively taking profits and cutting losses and ensuring we have cash on hand to take advantage of the pullbacks.

Earnings surprises, EPS revisions and company guidance will have to be monitored closely. While 2019 experienced a bit of an earnings recession and comparisons year-over-year should be easier, companies will have to beat expectations to get analysts to increase price targets. In the coming year just meeting expectations could be viewed as negative.

If earnings revisions adjust higher and evidence of a turnaround in global growth continues to be supported by the economic indicators, we will also look to expand our exposure into the emerging markets and other EAFE investments outside North America.

R N Croft Financial Group
1.877.249.2884
www.croftgroup.com

Investment Committee

Jason Ayres, DMS	CEO
Richard Croft	CIO
Kenneth Mulders, CFA	PM
Christopher Croft, CFA	PM
Alex Brandolini, CFA	PM
Mark McAdam, CFA	PM
Jack Morris, CIM	PM
Paul Fettes, CFA	PM
Christopher Heaman, CIM	PM
Bo Chew, CIM	PM
Robyn Thompson, CFP, CIM, FCSI	APM
Rod Burylo, CIM, FCSI	APM
Kevin Gebert, CIM, CFP	APM
Kelly Morris	Analyst