ISSUE
12
MAY
2019

CROFT
FINANCIAL GROUP

Commentary & Outlook

Sell in May?

Despite headlines suggesting a slowing global economy and an uncertain geo-political back drop, major stock market indices in both Canada and the United States continued to climb through the month of April, stretching into all-time highs much like an elastic band. Fear of missing out may have been part of the rally, but a deeper dive into the key drivers suggest that the accommodative monetary policy of the Central Banks has been the major tailwind.

The reason is simple – when money is cheap assets such as stocks become expensive as companies borrow cash to buy back their shares, which boosts their share price. Low rates also motivate companies to borrow money to hire more people and invest in growing their business, which supports the economy.

While there may be room for further upside, company share prices are getting expensive compared to their future growth prospects. We also must not lose sight of the recent yield curve inversions in the bond markets, which historically precede a recession.

With recent yield curve inversions, unsettled U.S. Trade relations with China, and an uncertain outlook for global growth, our expectation is that this impressive recovery of the stock market is likely to slow and snap back, much like a stretched elastic band.

Year-to-date, our investor portfolios have mostly rallied with the major indices, but more moderately as we have maintained a more defensive stance. In general, we have under-weighted the traditional high-flyers, holding fewer tech-related companies, which have been leading the current trend to the upside, and instead focused on finding undervalued companies with stable business models and recurring revenue streams that historically do well in slowing economies and uncertain economic conditions. I'll add that this is like finding a needle in a haystack at current market highs.

Conservative Portfolios

Our more conservative, income-focused portfolios continue to overweight bonds and fixed income investments while owning stocks that pay consistent dividends and exhibit the stability mentioned earlier. Option writing also continues to be an important strategy on a portion of the portfolio, which helps generate income beyond the traditional approach and reduces the impact of some of the day-to-day price swings.

To dig deeper into the Income Fund, the fund exited the cyclical Financial sector was and exposure to the defensive Healthcare sector was increased to 8.54% from 5.73%. AEM, a Canadian gold miner that exhibits negative correlation to the market, was introduced with a covered call strategy, which should help offset some volatility in the portfolio associated with broader market weakness.

Brookfield Infrastructure (BIP.UN), Algonquin Power Utilities Corp (AQN) as well as Exchange Income Corporation (EIF), which had rallied during the month of April, were all trimmed back during the month of May to their desired levels.

Growth Portfolios

Within many of our more growth-oriented portfolios, we continue to take advantage of an inexpensive option market to help offset the risk of another pullback. In simple terms, certain options and other forms of 'stock insurance' have been relatively inexpensive, and we have been taking advantage of these tactics that, much like any insurance, come with a cost to bottom line performance. However, we believe it's a price currently worth paying to offset the risk of an uncertain global market outlook.

Our more growth-oriented portfolios also continue to trim more volatile, higher-performing assets and thus hold higher levels of cash. We feel this serves our investors well both as part of our hedging strategy and by allowing us to take advantage of a drop in the market as the shares in companies on our watch list sell down to more attractive entry points.

The consensus within the IRC is that trade war headlines continue to drive market volatility. But tariffs are not the culprit when it comes to market volatility. Once announced, the market can quickly and easily price in the effect of tariffs on stock prices. What the market is currently grappling with is the uncertainty that comes with the cascading effects of tariffs on growth, production shifts, pricing power changes, investment and employment.

As new information is released about current trade frictions between the U.S. and China, markets appear to sell off and then recover quickly within a matter of days. If things were so bad, one wouldn't expect to see this type of market behavior.

Looking further into the underlying fundamentals, the economic environment continues to be strong despite what some of the headlines may indicate. U.S. unemployment continues to hover near multiyear lows with no uptick from jobless claims, which would typically lead the unemployment rate. The ISM Purchasing Managers' Index also remains above 50 suggesting a stable outlook for the manufacturing sector. Many semiconductor stocks have recovered far more than the average index stocks despite these companies having more exposure to China.

What all of this points to is that the market doesn't really believe the trade wars will escalate, or not to such a point as they will derail global growth. However, as new measures continue to be announced from current administrations, we think markets will continue to be volatile. That coupled with a mature macroeconomic cycle and late-stage market dynamics makes us believe this is a trader's market and a good market for option premiums.

Over the past month, the Equity Pool continued to hold hedges while selling option premiums to pay for those hedges (covered calls on VXX). Put options were also sold on Health Care and Industrial stocks (UNH and NOC). These companies were chosen because of stable business model properties and higher implied volatility due to sector noise. The Equity Pool also maintained a higher-than-average allocation to cash for deployment into new opportunities.

In Conclusion

Investing is a marathon, not a sprint, and there are times to deploy capital to take advantage of opportunities, and there are times to be defensive. While the fourth quarter of 2018 took many investors on a detour, we appear to be back on track for 2019. However, we continue expect there to be bumps along the way as there always have been, which is again evident as we close out the month of May. We have managed though these conditions before and will continue to maintain our defensive stance, poised to add additional risk when market conditions are more attractive and as opportunities present themselves.

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