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October Q3 2019 Commentary & Outlook

Further Distractions

All things considered, North American markets managed to deliver modest returns for the month of September, closing out a positive 3rd quarter.

The launch in September of an official impeachment enquiry over U.S. President Trump's alleged abuse of power is proving to be an interesting distraction, however we do not believe this will have a material impact on the stock markets.

Instead, we remain focused on three familiar themes: the U.S. China Trade War; slowing global growth; and central bank interventions and more accommodative monetary policies. Driven by daily sentiment on these issues, investors continue to ride a market roller coaster with no real resolution in sight. The fact that further 'distractions' such as the Trump impeachment enquiry or the Saudi oil refinery attack result in so little effect only re-enforces our expectation that this market dynamic is now likely to drag on into 2020.

The U.S.-China trade dispute continues to hold back business investment, which does impact economic growth, and may pose a challenge to the low U.S. unemployment rate in the future if a resolution is not found. Since 43% of sales of S&P 500 companies come from outside the United States, with these same large U.S. multinational firms being responsible for more than two thirds of job creation this year, the U.S. job market remains vulnerable to further escalation in the current trade war.

To compound these risks, global trade flows have been decelerating. Composite PMI indices in Europe indicate the euro zone is growing at the slowest pace in years, although the services sector is providing some offset to weak manufacturing. This has prompted the European Central Bank in September, during the waning weeks of Mario Draghi's tenure, to cut rates by a further 10 basis points and reinstate a new round of quantitative easing to help stimulate their economy.

China has also been active in its attempts to boost its weakened economy with the People's Bank of China cutting its reserve ratio to stimulate lending in early September. While the cut in China's bank reserve ratio increases liquidity and thus decreases economic risk in the near term, only 75% of short-term lending is currently supplied by the banks, and any shift to the remaining so-called 'shadow banking' sector increases default risk in the long term.

And yet, while Canada and the U.S. are also seeing a slowdown in manufacturing, the services sector is picking up the slack in both countries. In the U.S., hours worked along with non-farm payrolls have been increasing and wage growth has been healthy. Full-time employment is also strong in the 25–54 age group, and this demographic is important to overall spending on durable goods.

In Canada, unemployment is near all-time lows and wages are also increasing. Given high household debt loads and an already accommodative monetary policy, which has resulted in lower 'affordability' of housing in major urban centres, the Bank of Canada has been less inclined to provide additional stimulus from fiscal policy and rate cuts. Furthermore, if upcoming elections result in a minority government, implementation of new stimulus may be challenging. This makes the outlook for growth in Canada still positive, but less optimistic overall.

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Overall, the shift towards a more accommodative monetary policy by central banks around the world has investors discounting the many headwinds we have addressed. While the early history of our current economic recovery has shown interest rate cuts and quantitative easing to be effective tools, with rates near record lows and balance sheets at record highs, it's yet to be seen whether these tools remain sufficient to stimulate developed economies given the warning signals of an impending global recession.

In a perfect world, stock markets rally on their own merits, with a healthy economy, solid underlying fundamentals and functional trade relations being the catalyst. However, we can't discount the positive impact that an accommodative central bank can have on market direction. When money is cheap, businesses and individuals borrow and spend more. Asset prices also adjust higher. Given this year's rally in both the U.S. and Canadian stock markets driven by the momentum and the fear of missing out, one can't discount the potential for further upside.

Conservative Portfolios

Our conservative, income-focused portfolios continued to outpace their benchmarks in the third quarter of this year.

During September the TCG534 Income Fund increased the exposure to Fixed Income by 10% to a total allocation of 60.7%. The Fund also maintained its exposure to preferred shares at 15.7%. The allocation to Covered Call strategies was reduced by 13% as the Fund transitioned to a more defensive stance.

The overall strategy has been to rotate out of assets and sectors that are trading at heightened multiples and into assets and sectors that are trading at depressed values compared to their historical ranges. With the unwinding of several Covered Call positions, the Pool reduced its exposure to the Healthcare, Materials, Financial and Consumer Discretionary sectors. In addition, while still focusing on defensive assets, we have been selectively buying good companies that have experienced a sell off due to shorter-term issues and concerns.

During the quarter, we also reduced exposure to split-corp preferred shares and deployed the cash into a deep-in-the-money Covered Call on QQQ (Nasdaq ETF). This strategy has been generating a higher return for a similar level of market risk.

Similarly, the Income Fund also continues to employ a highly profitable QQQ weekly Calendar Put Spread as well as a Bear Put Spread on BYND to enhance income in an uncertain market environment.

Growth Portfolios

Our growth-oriented portfolios are also outpacing their benchmark, both in the quarter and year-to-date.

The TCG531 Equity Fund continues to hold a higher allocation to cash and a preference for tactical/active trading. Having a higher allocation to value stocks resulted in a sizable jump in performance in September as investors moved out of momentum stocks and into value. That said, given our views, we continue to remain defensive. While we hold exposure to more volatile sectors such as Technology, we are using an option strategy overlay to increase cash flow and reduce risk. We also favor high dividend yielding companies because of their attractiveness in a low-rate environment.

Over the month we sold one of our Technology stocks (DOCU) that was close to hitting its target price on good quarterly results. We replaced this with another Technology holding (SQ) given its strong business model, return potential and favorable pricing.

We also took profits from our Energy exposure (SU) during the recent period of heightened tension with Iran, and we increased Health Care exposure (UNH) based on recurring revenue properties that are attractive during slow downs.

Our Positioning Into the 4th Quarter

While we may have missed some of the equity upside in the first half of the year, our defensiveness is paying off as we continue to gain ground while managing risk in uncertain, range-bound financial markets.

When analyzing the underlying economic fundamentals, the likelihood for a global growth slowdown, or even recession, and the associated risks to the stock market are clear. This outlook continues to support our active, tactical and defensive management approach into the 4th quarter. That said, we have learned never to underestimate the power of certain factors, such as an increase in accommodative central banking monetary policy, to flip the financial markets' switch back to "risk on". If this occurs, we will adjust our position accordingly.

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