ISSUE
14
July
2019

Q2 Commentary & Outlook

Climbing a Wall of Worry

The end of June marked the close of the second quarter of 2019 and the halfway point in the year. In reflecting on the past 6 months, the old saying that the market climbs a wall of worry really seems to be quite fitting.

Uncertainties around trade relations between the U.S. and China, and almost everybody now, continued to make headlines, and will quite likely continue to do so into next year.

However, it was really the inversion of the yield curves both here in Canada and south of the border that motivated many investors and money managers to proceed with caution. The risk of a slowing economy and the potential of a recession are both valid reasons to remain defensive.

And yet, expectations for the Central Banks to act preemptively by rolling back interest rates to support the potential risk of a slowing economy and the continued melt up in stocks driven by a fear of missing out, have moved markets back up to, and in some cases beyond, their all-time highs.

Canada

BANK OF CANADA
BANQUE DU CANADA

On the Canadian front, the recent Bank of Canada Business Outlook Survey came in relatively positive with an expectation for increased sales growth over the next 12 months. While the June employment numbers showed a slight decline, jobless numbers are still at 40-year lows and wages are rising. This, among other indicators suggests there may be some gas left in the tank for the Canadian economy.

The U.S. Remains Center Stage

As always, the U.S. tends to take center stage and, interestingly, U.S. Employment numbers released July 5th came in strong. Great news in that more people than expected have jobs, however not so great news in support of an interest rate reduction, which for the most part has been supporting this market melt up.

CROFT
FINANCIAL GROUP

Q2 Commentary & Outlook

Trump continues to take credit for the rally, as referenced in his June 25th Tweet.


Donald J. Trump
@realDonaldTrump

Stock Market is heading for one of the best months (June) in the history of our Country. Thank you Mr. President!

111K 8:11 AM - Jun 25, 2019

47.2K people are talking about this

www.twitter.com

He also continues his bullying efforts towards the Federal Reserve Open Market Committee (FOMC) for a rate cut. As referenced the quote below:

"....Think of what it could have been if the Fed had gotten it right,"

"Thousands of points higher on the Dow, and GDP in the 4's or even 5's. Now they stick, like a stubborn child, when we need rates cuts, & easing, to make up for what other countries are doing against us. Blew it!"

TRUMP, June 24th, 2019

and in a series of jabs through his Twitter account:


Donald J. Trump
@realDonaldTrump

China, the European Union and others have been manipulating their currencies and interest rates lower, while the U.S. is raising rates while the dollars gets stronger and stronger with each passing day - taking away our big competitive edge. As usual, not a level playing field...

66K 8:43 AM - Jul 20, 2018

24.7K people are talking about this

www.twitter.com

Trump believes a cheaper dollar is what's required for the U.S. to be competitive in today's global trade arena. And it does seem as though the stock market is betting that he is going to get his way. We'll know more on July 31st, when the U.S. Federal Reserve is set to make their Federal Funds Rate announcement.

Now, this is not to say that there isn't further upside in stocks, just more evidence of a market that is very much dependent on headlines and something we as Portfolio Managers need to be cognizant of.

Continued Defensiveness

And therein lies the reason for our continued defensiveness. In analyzing stock prices or company valuations on a sector by sector basis, we find that most are considered expensive given growth forecasts and underlying conditions. Making it a continued challenge to find opportunities where fundamental analysis supports the share price at current levels.

Conservative Portfolios

Our more conservative portfolios continue to hold a higher exposure to bonds and fixed income investments, low beta and dividend paying stocks while benefiting from an active option writing overlay.

As an example of some of our trades, the Income Fund added a 2.8% exposure to the Consumer Staples Sector which is a defensive sector. Additionally, we increased the Consumer Discretionary allocation to 7.6% from 5.4%, adding a high yielding equity that is trading at historic lows.

The Financial and Materials sector exposures were both exited as financials rallied 6.7% and the Material sector benefited from the strong rally in gold as a result of low inflation and interest rates.

As the stock market rallied, several of the companies we held were sold and profits taken. The cash was redeployed into selected companies that had pulled back or were trading at a discount to their historical mean. The following securities were closed out as a result of price appreciation and expanded multiples, Constellation Brands Inc (STZ) reported strong earnings, Alphabet Inc (GOOGL) recovered after its sell off as a result of an overreaction to political concerns and Service Corporation International (SCI) rallied 6%.

New additions included Maple Leaf Foods Inc (MFI), Cineplex Inc (CGX) and Advanced Auto Parts Inc (AAP). All these securities are trading at depressed multiples and have either high dividend yields or defensive type properties.

The overall strategy continues to be:

1. A rotation out of companies that are trading at heightened multiples into companies that are trading at depressed values compared to their historical ranges.

2. Purchasing companies that have experienced a sell off from issues that are deemed to be temporary.

3. Focusing on defensive type assets.

We continue to be highly selective and patient with adding new securities.

Growth Portfolios

As reference earlier in the commentary, ten years into the secular bull market, valuations appear to be fueled by an expectation of lower interest rates. During the month of June, the S&P 500 hit a new high as markets priced in easier monetary policy on the back of some weaker economic data points. In addition, President Trump and President Xi were able to announce a truce at the G20 meeting where Trump signaled the U.S. would not impose any further tariffs. Markets cheered these developments, but after diving into the details, higher stock prices may be constrained as much will depend on an improvement in the earnings outlook, which hinges on trade policy.

While markets have responded favorably to the expectation of lower interest rates due to recent weaker than expected manufacturing numbers, U.S. manufacturing is still in growth territory. As well, unemployment and jobless claims also continue to be supportive of equity markets. Beyond the importance of employment to business activity and equity markets, unemployment figures are a primary factor in the Fed's decision to lower interest rates. Admittedly, Fed Chair Powell has cited global risks as a reason to consider lowering rates. However, should the Fed delay, it could set up disappointment for the market and the charge to new highs may stall.

Within the equity space, cyclical stocks have propelled momentum in the market. In 2018, momentum stocks were responsible

CROFT
FINANCIAL GROUP

Q2 Commentary & Outlook

for the strong performance of the first three quarters, and most responsible for the crash in the fourth quarter. Given the characteristics of momentum stocks and questions around the speed of Fed policy, stretched valuations and a cloudy outlook, some caution in equity positioning should be added.

Over the past month, the Equity Fund continued to hold hedges while selling option premiums to pay for those hedges (covered calls on VXX). Put options were strategically sold to capture premiums on Technology and Consumer Discretionary stocks (CRM, DOCU and BABA). These strategies were executed to capture high premiums while limiting exposure to higher risk names through the expiry dates of the options. The Equity Fund also maintained a higher than average allocation to cash for deployment into new opportunities.

Looking Forward

In line with last months "stay the course" theme we remain disciplined in our approach. Despite this stock market melt up, we will not fall into the fear of missing out trap. We will continue to stay focused on the big picture and will remain active but cautious as we move into the second half of the year.

R N Croft Financial Group
877.249.2884
www.croftgroup.com

Investment Committee

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
Jason Ayres, DMS	CEO
Kelly Morris	Analyst
Kevin Gebert, CIM, CFP	APM