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Investor Strategy

Helping investors reach their long-term wealth goals

RICHARDSON GMP

To Trade or Not to Trade, That is the Question

Craig Basinger, Chris Kerlow, Derek Benedet, Alexander Tjiang, Gerald Cheng

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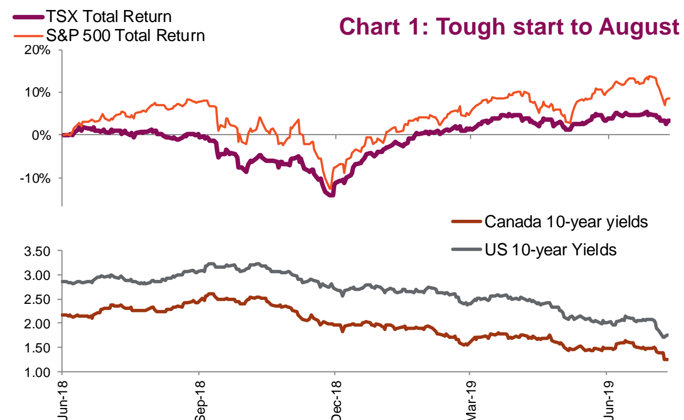


I. Market recap – That accelerated quickly

This season is best spent with your feet in the lake at a cottage or enjoying a refreshing beverage on a patio. Unfortunately, this is also the time of year that markets tend to see a bout of weakness, and if market action in the past couple of weeks is any indication, this year is no exception. The S&P 500 hit a new all-time high recently (July 26); at the same time the TSX was close to its high. The U.S. Federal Reserve then cut rates on July 31, as expected, but the accompanying speech made it clear that the market should not expect this to be the start of an extended rate-easing cycle. In other words, the Fed chairman implied it could be a one-and-done rate cut (time will tell). Immediately after, President Trump cranked up the trade dispute with China, announcing that new tariffs will start September 1. Beijing responded with a decision to stop purchasing U.S. agriculture products, and the yuan's subsequent devaluation prompted the U.S. to label China a currency manipulator.

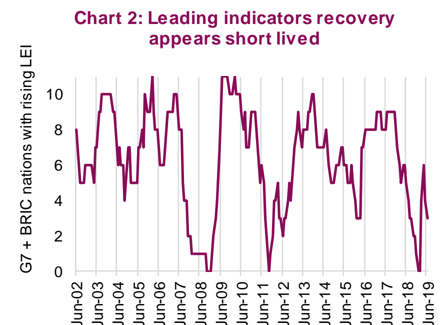
While the trade war moving from a gentle simmer to a vigorous boil may have been the trigger for this market weakness, continued soft global economic data has made the market susceptible to the negative headlines, of which there are plenty. Still, the bond market may be even more impactful than the equities pullback, which is understandable given the advance from January to July. Central banks are starting to cut rates more aggressively around the globe and longer bond yields are falling as well, fast. In fact, in August we have seen the the yield

on the 10-year Canada drop from 1.50% to 1.21%. There appears to be a big risk-off trade afoot, this comes only a few days into August-October, which are a seasonally not a good time for North American equities.

SNR is key

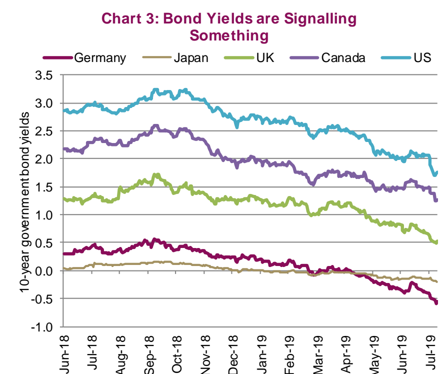
In engineering, the Signal-to-Noise (SNR) ratio compares the level of a desired signal to the level of background noise. A ratio of greater than one would denote more signal than noise, which is a good thing. Turning back to the markets, the SNR mindset can be useful – even if investing is more of a social science than a hard science. For instance, is the recent flare up of the trade dispute between the U.S. and China more of a signal or more noise? As we have seen a few times in the past year, rhetoric is cranked up and then down fairly quickly. Sounds like noise. What isn't noise are three surprise rate cuts – from Thailand, India and New Zealand – plus the recent plummeting of global bond yields. We think this is much more signal than noise and the signal indicates the risk of a global recession is mounting.

Chart 2: Leading indicators recovery appears short lived



So, what else can we argue is more signal than noise? Leading Economic Indicators (LEI) are a good one, after all the index is literally a composite of various economic and market readings that have historically given an early signal to changes in the overall trend. The bad news here is that while a few months back a number of countries were experiencing their LEIs rising, that number has dropped of late. In fact, only Brazil, China and France have three-month LEIs that are rising among the G7+BRIC nations.

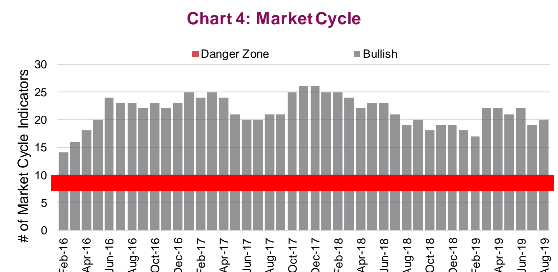
Chart 3: Bond Yields are Signalling Something



Bond yields are clearly signalling something dire. While yields had been falling in most major markets since the fourth quarter of 2018, the speed has accelerated over the past few weeks. This is likely more signal than noise and now is a perfect time to jump into our Market Cycle framework to see how the basket of signals is holding up.

II. Market cycle

Chart 4: Market Cycle



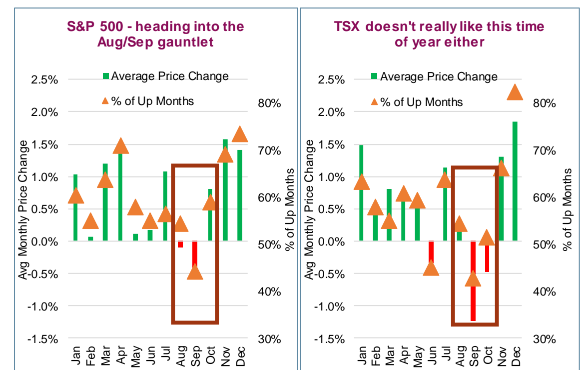
Hanging in there

Our market cycle indicators continue to remain relatively healthy (add an intonation of some level of surprise). We continue to expect more indicators to turn bearish in the near term on the economic data side. We appear to be in a manufacturing/capex recession and this is gradually spilling over to other areas of the economy. How much spillover there is will of course be crucial for the path of this economic cycle. Still, we now have 20 positive indicators out of a possible 33, which is fairly healthy. To put this into perspective, remember that period of economic weakness in late 2015/early 2016 that had oil trade down into the $20s? Well, the market cycle indicators got as low as 14 positive during that period, and that was clearly not the end of the bull cycle.

Since our July report, there have been some changes. The Consumer Model moved from mild bullish to mild bearish. This model tracks the relative performance of the U.S. consumer discretionary sector versus the consumer staples sector. It measures a degree of risk appetite in the market, which has been declining of late. The U.S. economic indicators remained stable in aggregate with leading indicators (three-month change) turning bearish along with chemical activity. Offsetting these were both Consumer Sentiment and Car sales moving from bearish to bullish. The biggest move was likely the Fed Funds, which moved from bearish to bullish given the Fed rate cuts. And given the direction of the economic data and global bond yields, there may be more to come.

Overall, we continue to see enough positive indicators that this market cycle should not be ending in the near term. Of course the data may change and if it does, then we could change our minds.

Elevated correction risk

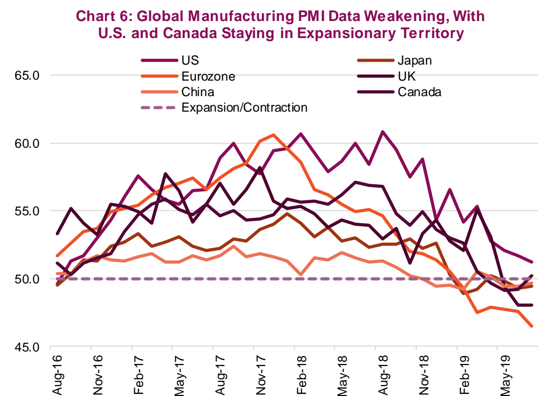


Even though we are not seeing the economic data fall aggressively and our market cycle indicators are hanging in, we have become more cautious. This included a defensive trade in our asset allocation service at the start of August. While the trade tussel as a market issue could fade as quickly as it returned, we are seeing a lack of risk appetite that could easily cascade into a correction in the coming weeks. Not helping matters is the fact that we have entered a seasonal time that often sees bouts of short-term market weakness. But it goes a bit deeper than the investors almanac.

Evidence of this risk-off mindset is not hard to find: Gold prices spiking, bond yields falling, safe haven currencies rising, riskier currencies falling, the list goes on. Or just look at ETF flows. In the past two weeks there have been about $11 billion of net selling in equities, $2 billion of buying in commodities (mainly gold) and $3 billion of outflows from bonds. The bond outflows are most interesting as government bond ETFs saw $0.6 billion of buying, aggregate bond ETFs saw $1.4 billion of buying and corporate bond ETFs saw $6 billion of outflows. Risk-off!!!

If the economic data softens more in the coming weeks, we believe the market will throw a little tantrum about a potential recession. And it's August.

III. Manufacturing recession?



Perhaps the biggest concern for investors and market pundits alike has been the in-step slowdown in global manufacturing. Activity has been slowing for over a year and currently sits in negative territory in almost every major region except the U.S. based on PMI survey data (Chart 6). For some time, manufacturing has served as a closely watched leading economic indicator given the more timely reporting of PMI data compared with slow-moving broad-based measures such as GDP and unemployment. Manufacturing only accounts for about 10% of U.S. GDP yet has an outsized impact on S&P 500 earnings. Despite it being a smaller part of the economy than it once was, however, the effects of this slow down undoubtedly feeds into other parts of the economy and corporate sentiment.

Chinese PMI data came in slightly better than expected, edging closer to the breakeven level between contraction and expansion. Yet, industrial profits shrunk despite production intensifying; not a very encouraging sign for corporate sentiment. The U.S., Canada and other major economies released data with mixed, but generally soft, results. The composition of the reports were mixed. The new orders component increased, but production and employment segments pulled back. Construction spending decreased in June, but growth in prior months was revised upwards. Other reasons behind the contraction are likely U.S. dollar strength and an inventory adjustment lower, both of which are cyclical in nature and tend towards mean reversion. However, we note that the U.S. manufacturing reading has been falling rather sharply since last summer, suggesting that manufacturing will act as a heavy drag on the economy in the coming periods.

The problem with a contraction in manufacturing is that it weighs on sentiment and crimps investment, thereby slowing job growth and heightening the chances of a weaker global economic expansion. Needless to say, the escalation of the U.S.-China trade war will likely remain a key impetus for weaker incoming manufacturing activity. Without resolution, these tensions will likely act as a negative overhang on global demand outlook.

With global manufacturing in the dumps, the big question remains how much of this will spread to other areas of the global economy. Most developed economies are much more service oriented in this day and age, but are still not immune to a manufacturing slowdown. Time will tell as we have started to see the headwinds spread.

IV. Energy – Once bitten, twice shy

It's been a tough start to the year for the Canadian energy complex. Even during the period of rising oil prices from January through April, most energy companies simply didn't follow the commodity along. Energy's demise has also ratcheted up provincial tensions. Year-to-date, the Canadian and U.S. Oil & Gas Exploration sub indices are down 12% and 1%, respectively; these are especially poor when compared with the excellent returns so far this year in the overall market.

Canadian energy is just not what it used to be. A little over a decade ago, money flowed into Canada to fund expanded production and the energy sector represented a weight of almost one-third of the TSX. Today it is below 20%. To gauge investor interest, we looked across the Canadian mutual fund landscape and looked at the average Energy sector weight across various fund categories. Looking back three years, current Energy exposure is well below historical averages. The current Energy weight in the Canadian Equity category, for instance, is just 14.5%, an underweight of 2.5%. Clearly, institutional money managers are not chomping at the bit, despite what appear to be attractive valuations. As the old saying goes, "once bitten twice shy"; unpleasant experiences typically induce an additional sense of caution. This would explain the general apathy towards the sector, and leaves us to wonder what will it take to garner broader interest with investors?

Fund flows are a bit of a mixed bag. On the positive side, ETF fund flows have been beginning to pick up since bottoming on May 24, for XEG (iShares Energy ETF). In the U.S., there has also been a slight increase off of the lows, but holdings are still materially lower than levels seen just last year (Chart 8). Still, not much to get excited about, but current depressed values are beginning to earn some mild interest in Canada.

Valuations across North American energy companies are rather attractive. However, we remain skeptical of a minefield of value traps. Many high-quality companies are trading at attractive levels. Focusing on price to cash flow, you can see in Chart 9 that Canadian E&P companies are now trading in aggregate at 2.93 price to cash flow, compared with 4.1x in the U.S, a 30% discount.

Capital austerity continues to be the trend due to unwilling capital markets thanks to volatile spot prices and persistently weak gas prices. The shift is transforming the industry to more of a development and production model, with less focus on growth. Weaker spending may support near-term free cash flow, with a renewed focus on returning excess cash to shareholders and improving stretched balance sheets. Before investors get interested in the space again the burden on the industry is to put up better numbers, plain and simple.

Chart 7: Canadian Mutual Fund Energy Exposure

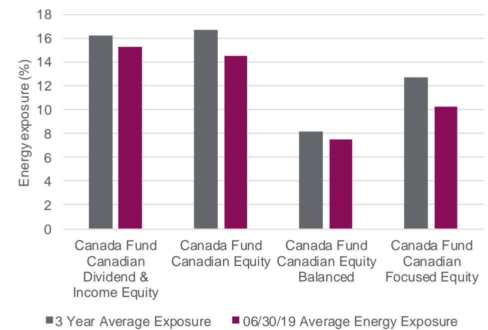


Chart 8: Energy ETF shares outstanding on the rise in Canada

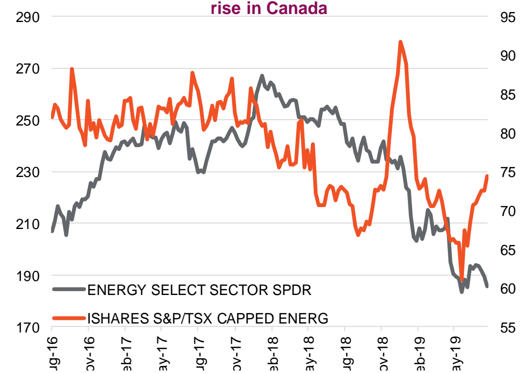
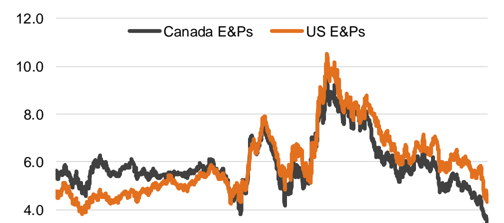
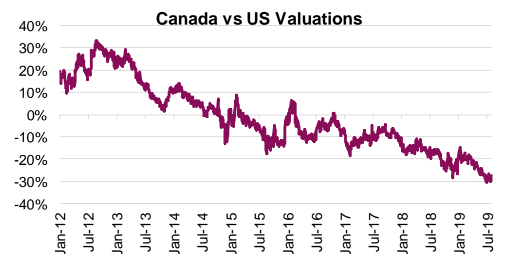


Chart 9: E&Ps Price-to-Cash Flow



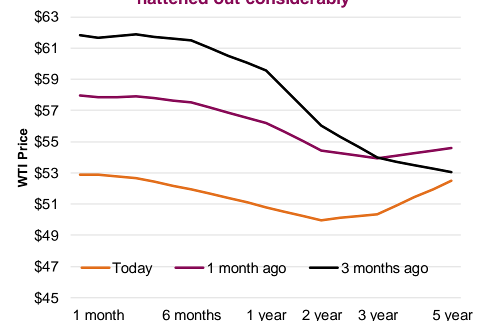


Macro outlook

It has been a volatile first half for oil prices, the wild swings causing investors to lose their appetite.

The current term structure in the oil market has flattened out materially from the high levels of backwardation seen several months ago. Backwardation is when later-dated contracts trade at lower levels than current spot prices, which signals supply fears have largely evaporated. The long end of the curve remains rather anchored to the $51-$55 range. We would expect rangebound WTI at $50-$60 absent a recession. Gyrations around this price reflect near-term sentiment shifts on global demand as well as geopolitical risk. The key point is that like stocks, sentiment plays a large role in oil prices.

Chart 10: Term structure for WTI has flattened out considerably



Supply stories have been a mix of rising U.S. production (now over 12 million bpd), sanctions on Iran and Venezuela and production curtailments by OPEC as well as Canada. Alberta by the way, just announced that beginning in September, production will increase by 25,000 barrels per day over the August limit, in recognition of lower oil storage levels and more volumes shipped by rail and pipeline. We expect the slowdown in U.S. supply growth, due to the decline in rigs deployed, confirms a slower cadence ahead.

Recent fears center not so much on the supply side, but on demand. As trade war fears continue to escalate, the fact that crude prices can swing 8% on just a tweet from the President of the United States demonstrates just how delicate sentiment is. Outside of global growth fears, however, North American refinery demand continues to show high utilization. Inventories have also been undergoing an atypical seasonal draw, which continues to beat expectations. We're seeing green shoots that oil demand is finally starting to exceed beaten-down expectation thanks to robust consumer and refiner demand.

While the narrative is still mixed, improved macroeconomic data combined with low net oil speculative positioning could lead to the demand side of the equation to be supportive of oil prices after all.

Conclusion

Though subdued sentiment will likely persist, we recommend focusing on quality stocks that can weather spot price volatility. The strong will continue to get stronger in our view, supporting the case that size and scale in conjunction with a solid balance sheet is where investors should focus their attention; put plainly, look for stronger operations that produce consistently high free cash flows. The fact that sentiment is so low should be a good thing. Low sentiment is a great starting point for positive surprises, as we reiterate our expectations that economic growth will surprise to the upside.

V. Portfolio positioning

We have a more cautious stance within our asset allocation based on recent changes we have made to our Managed Portfolios. Specifically, we reduced Canada to a minor underweight and pivoted some U.S. equity exposure from the broad market to a more defensive strategy. Overall, we still have a minor overweight in equities focused on the U.S. market (with a defensive tilt). Fixed income remains a mild underweight with elevated cash levels.

Based on our Market Cycle we do not believe this period of economic weakness is signalling the end of the bull, but with bond yields retreating our confidence is less. A recovery in the data would help at this point, but so far has proven elusive. The recent volatility is likely going to be the norm in the coming months and quarters. If we see a material pullback in equity prices and our Market Cycle remains constructive, this could produce an opportunistic scenario to deploy cash and increase market exposure. Or should the Market Cycle become more bearish, we have taken the first step in becoming more defensive.

Overall Asset Allocation	-				+
Equities				■	
Fixed Income		■			
Cash				■	
Global Equities	-				+
Canada		■			
U.S.				■	
Euro Area			■		
Japan			■		
Emerging Markets	■				
Fixed Income	-				+
Canada		■			
U.S.			■		
Government			■		
Investment Grade		■			
High Yield	■				
EM Debt	■				
Prefs		■			
Duration	■				
Credit		■			

Charts are sourced to Bloomberg L.P. unless otherwise noted

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