December 2, 2019

Investor Strategy

Helping investors reach their long-term wealth goals

RICHARDSON GMP

Some Improving Signs

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

Summary

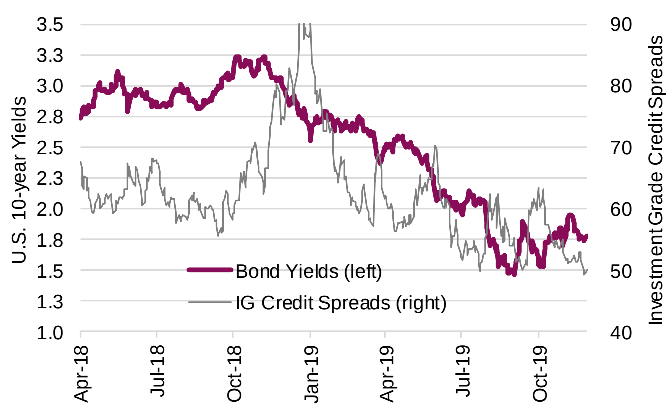
I. **Market recap – A good month**
II. **Market cycle – Steady; Plus, defining the red line**
III. **Some encouraging signs on the horizon**
IV. **Portfolio positioning**

I. Market recap – A good month

Equity markets continued their climb up the wall of worry despite lingering anxiety over geopolitical tensions. Uncertainty is never good for the business environment, yet despite this uncertainty, equity markets have continued to reach new highs. Market sentiment has shifted from moderately bullish to a neutral stance; curiously, sentiment is beginning to fall considering the risk-on rally. Once again we are in one of those unloved bull markets. Perhaps it's this uncertainty that's making it difficult for investors to adequately price risk, leaving a sense of reluctance to fully embrace the bull. It would seem that complicated political and economic factors are making it difficult for investors to feel fully confident in their choices.

This reluctance is most evident in the bond market, where a curious dichotomy continues to be evident. Bond yields have failed to maintain their upward trajectory, with yields across developed nations retreating after rising briefly a few months ago. As of the end of November, the U.S. 10-year bond yield was 1.76%, while the Canadian 10-year is at 1.46%. This is still at the low end of the range at a time when the data is getting slightly better and credit spreads are approaching their narrowest levels this cycle.

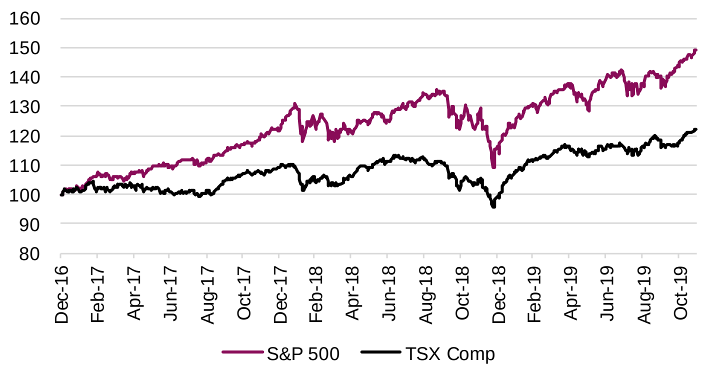
Chart 1: Bond yields remain low and credit spreads have fallen to near cycle lows



The near constant barrage of positive messaging towards a 'phase one' deal has driven risk assets to successive new all-time highs. The S&P 500 continues its run with trust in the U.S. Federal Reserve (Fed) now eclipsing even trade uncertainty. The S&P 500 and the TSX rose 3.6% last month. Year-to-date numbers continue to impress, with the U.S edging out Canada, posting a 27.6% gain versus 22.3%, respectively (local currency returns including dividends).

Gold prices continue to consolidate recent gains, falling 3.2% in the month. We continue to believe in the diversification benefits of some gold exposure in your portfolio and that the patient investor will be rewarded. Energy markets had a good month going until the last day of trading reversed gains. Commodity prices have remained choppy in general, mainly on demand concerns.

Chart 2: Markets making new highs



Proving the doubters wrong in the near term (including us), the U.S. dollar has strengthened both against the Canadian dollar and a global basket. Risks to the downside remain due to elevated valuations and converging growth levels with the rest of the developed world. For now, the greenback continues to benefit from its standing as a high-yielding safe-haven currency.

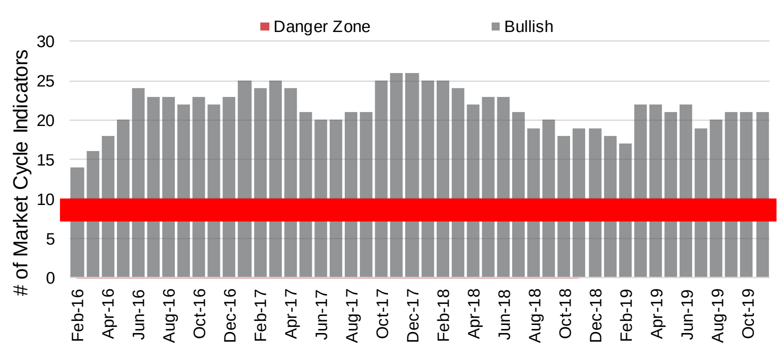
While our models and indicators continue to be supportive for economic growth and a continuation of the cycle, valuations are high and credit spreads are narrow, reflecting growing signs of ebullience. It's becoming increasingly difficult to reconcile these signs of optimism with bond yields so low. The recent shift in favour of cyclical stocks shows that investors believe we'll get a resolution on the trade front. Perhaps the market is pricing in a bit too much optimism, it sure would be nice to see some more improving economic data to provide a more solid foundation compared to tweets and talk of a phase-1 deal.

II. Market cycle

Steady as she goes

Our proprietary Market Cycle framework continued to hold steady during November with 21 bullish signals and 12 bearish. This was the third month in a row when the tally remained the same, although some signals continued to move about beneath the surface. There is no question that equities are taking the 'glass half full' view with many key equity benchmarks advancing during November and reaching new highs. Meanwhile, credit spreads are back down to cycle lows. Certainly this is encouraging, but we should note that the economic backdrop remains tepid with slowing growth. So either the economic data will have to improve to justify the move in the markets, or we are at risk of a re-valuation of the prospects should the data fail to improve. This is often the case, and we should take solace that with 21 bullish signals, we don't see much risk of an end to the cycle in the short term.

Chart 3: Market Cycle holding steady



There were a few notable moves in November, alongside some significant 'non-moves'. Below we provide additional context on each of the signal categories.

Market Momentum. Two of these signals are based on the market momentum of the S&P and TSX, so it's not surprising that with both making new all-time highs, these remain strongly bullish. With the last bear market having fallen off the back of 10-year return measurements, these numbers are impressive (and inflated). The TSX, including dividends, has enjoyed a 7.2% annualized return for the past decade, while the cycle-leading U.S. equity market has enjoyed a 13.5% pace which rises to 16.1% in Canadian dollar terms. The Consumer Model, which measures the relative performance of the U.S. Consumer Discretionary sector versus Consumer Staples, remains in the mild bearish camp. Discretionary stocks such as autos, apparel and retailing tend to be much more cyclical, while staples are more popular when investors are looking for safer equities. This metric captures aggregate investor risk appetite, which remains tepid. Finally, high-yield spreads are another measure of aggregate risk appetite, and since these spreads have been falling, this signal is bullish.

Market Momentum	Bearish	Mild Bearish	Mild Bullish	Bullish
Canada				✓
US				✓
Consumer Model		✓		
HY Spreads				✓
US Economy				
Leading Ind (3m)		✓		
Leading Ind (6m)		✓		
PMI		✓		
PMI New Orders		✓		
Cons Sentiment		✓		
Cars			✓	
Homes			✓	
Credit				✓
Chemical Activity			✓	
Rail		✓		
Energy Demand		✓		
Trucking			✓	
Phili Coinc			✓	
US Unemployment			✓	
Rates				
Fed Funds				✓
Yield Curve		✓		
Yield Curve Change				✓
Fundamentals				
Valuation Canada		✓		
Valuation US		✓		
Earnings Growth				✓
Sales Growth				✓
Margins				✓
Global Economy				
CRB				✓
Oil				✓
Copper			✓	
Baltic Freight	✓			
KOSPI				✓
Emerging Mkts			✓	
Global PMI			✓	
Total	1	11	9	12

U.S. Economy. Given the size of the U.S. economy, its health remains paramount for the market cycle. Signals in this group eroded slightly from last month. In October we had 1 bearish, 5 mild bearish, 6 mild bullish and 2 bullish signals. This changed to 0, 7, 6, and 1, respectively. While this isn't a material erosion, it's a minor dip nonetheless.

Both Leading indicators dropped from mild bullish to mild bearish. These are not dropping matierally, but given leading indicators are a composite of 10 different forward-looking indicators, this is a signal that should merit greater attention. The Philly Fed Coincident Index dropped from strongly bullish to mild bullish. While not a leading indicator, it provides a different lens into the economy as of right now.

Energy demand moved from mild bullish to mild bearish. This is a year over year measure given seasonal changes in energy demand and useage. While it is down slightly, not a material drop.

On the improving side, Chemical activity picked up in November. We measure this because chemical use is far up in the supply chain and can provide an early signal for rising or falling economic activity. Rail volumes are still bearish but rose to be only mildy bearish. If things are moving around the U.S., it means the economy is growing. Of note, Intermodal picked up a lot which is encouraging. Cars, via auto sales, rose from mild bearish to mild bullish; but don't get too excited. We measure the six-month change and this looks likely to turn back to mild bearish in December given recent trends and tougher comps.

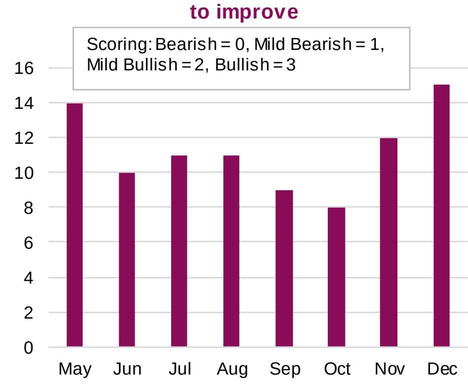
Overall, the U.S. economy is still doing OK.

Rates. This captures the Fed changing rates, the slope of the yield curve and the changes in the slope of the yield curve. There haven't been any changes since last month. The Fed has become more accomodative and the yield curve has steepened over the past three months. However, it remains flat. We measure the 3-month versus 10-year and while it isn't inverted anymore, the flatness is still a negative sign.

Fundamentals. This category captures North American equity valuations, compared to their historical values and other company fundamental data points. With the recent rise of the TSX, valuations have risen and the signal moved from mild bullish to mild bearish. The other signals did not move. We have noticed margins have come in a little, but remain healthy. And while year-over-year earnings growth remains only slightly positive, comparables are about to become less challenging.

Global economy. These signals have been improving over the past six months, and the latest readings continued this trend (Chart 4). Oil and copper are key commodities used in the global economy. While supply can fluctuate in the long term, shorter-term fluctuations are most often driven by changing demand. CRB, which is the Thomson Reuters Commodity Index and captures a large basket of commodities, moved from mild bullish to bullish. Oil prices rose, pushing this signal from mild bearish to bullish and copper moved from mild bearish to mild bullish. The Baltic Freight index is the cost of moving goods by sea. This index weakened from mild bearish to bearish. With changes to emmissions going into effect shortly, supply has been volatile due to ships going into dry dock for upgrades so this indicator may not be as reliable at the moment. The Korean stock index, or KOSPI, is often an early indicator for the global economy given the country's reliance on global trade. This improved while emerging markets in general slipped a little, with both remaining in the green.

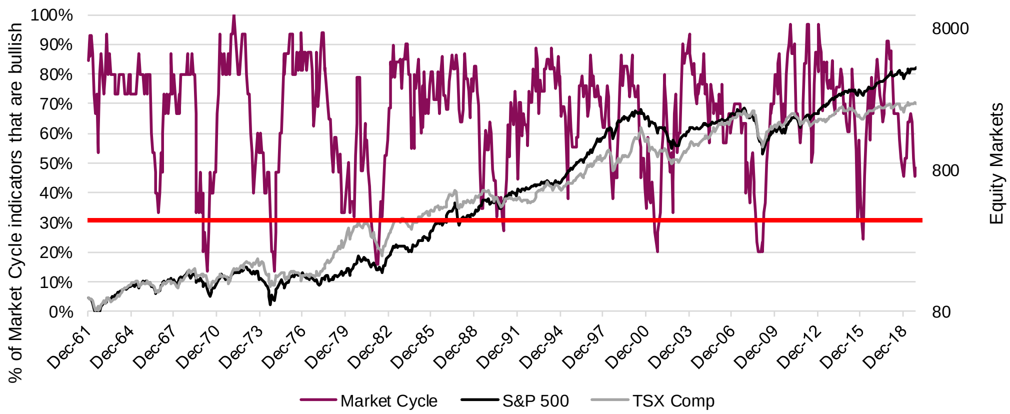
Chart 4: Global Economy - continues to improve



Overall, the global economy continues to look more encouraging, offsetting the slippage in U.S. economic data. At this point, we see limited risk that the cycle is ending in the near term.

Why is the red line where the red line is?

Chart 5: Market Cycle back tested over the years



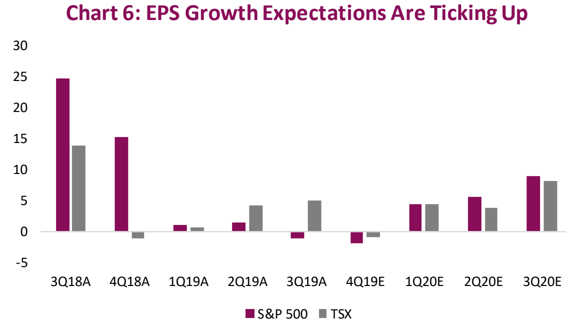
The Market Cycle framework is based on the view that there is no one model or indicator that works all the time. Some work during some cycles, some work best during others. By combining a number of models, which all have a degree of efficacy in warning us if there is real trouble coming, we are diversifying by model or signal. So why do we put the red line, *titled 'danger zone'* in and around the 10 bullish signals or less? We have taken our models back in time, to the 1960s. Notably, some signals have a history that goes back that far, others do not. As a result, we have found that when the percentage signals that are bullish drop to 30% or below, it is often the end of a bull market. It doesn't work perfectly – *sadly, nothing does* – but it does appear to provide an emotion-free framework to indicate when the stresses in the data are likely signalling the start of a bear market.

Two charts help to demonstrate this hypothesis. Chart 4 represents the percentage of bullish signals over time with a red line at the 30% danger level. Naturally, the bigger question is: If you reduced equity exposure during periods that the Market Cycle indicators were in the danger zone, what would this do over time? While nobody should ever go from 100% equity to 100% cash, as an exercise we measured a buy-and-hold strategy consisting of 50% S&P and 50% TSX, compared with one that went to cash whenever the bullish signals dropped below 30%. Only measuring price returns (aka no dividends), buy-and-hold enjoyed a 6.3% annualized return since the early 1960s. This rises to 7.2% based on the Market Cycle rules. **Nobody should ever do this, BUT we believe using the Market Cycle as a guide as to when to tilt more towards defense can add value over time.**

III. Some encouraging signs on the horizon

Looking ahead, the outlook for economic growth is encouraging. Manufacturing data appears to be starting to improve (*it may still be too early to pop the champagne though*), earnings are expected to return to growth after what is expected to be a weak fourth quarter, monetary policy is accommodative, and inflation remains benign. We remain keenly focused on consumer data to see if the lagged effects of trade uncertainty and weak manufacturing bleed into consumer spending to any material degree. So far, we are just seeing some signs of softness around the edges of the labour market.

Chart 6: EPS Growth Expectations Are Ticking Up

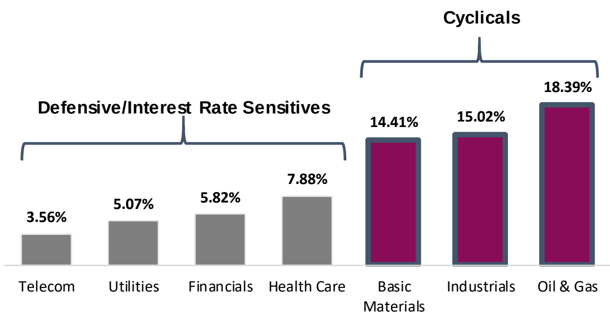


The U.S. and China trade tussle will likely continue to drive the appetite for risk or fear, depending on how these negotiations progress. The market certainly appears to believe this first phase will be successful. This clearly has not transmitted into the economic data at this point. Purchasing managers have adopted a destocking and "wait and see" approach to their management style as of late.

Additionally, Canadian and U.S. corporate earnings are forecast to pick up in 2020 (Chart 6). The pro-cyclical outlook has caused a shift in market leadership to cyclically oriented industries from interest-rate sensitive ones.

We still advocate and have a tilt towards cyclical yield stocks, but we are beginning to fade this trade on recent strength. As a result, we are currently looking to opportunistically add to rate sensitives on expressed weakness. If the recovery does flutter or the can gets kicked down the road on trade, these economically sensitive sectors will bear the brunt of the blow. Expectations are also highest for the cyclical sectors, leaving more room for downward revisions versus more defensive sectors. (Chart 7)

Chart 7: Earnings Expectations FY20

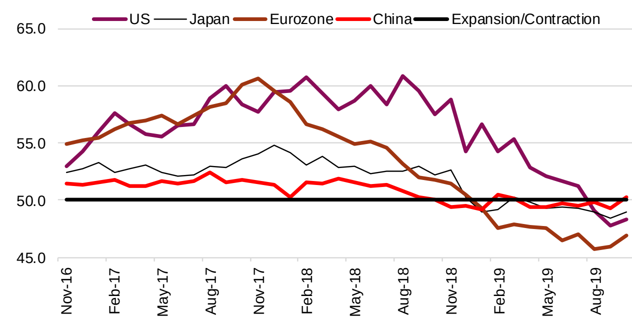


Compared to August, when equities last underwent a period of pronounced weakness, the backdrop remains the same as it has in many areas. China is still slowing; however, because of its sheer size, it still acts as an additive to global GDP growth. Monetary policy remains accommodative and the three rate cuts made earlier this year are still making their way through the system and should provide a tailwind as we look out to the back half of 2020. Other regions such as Europe and Japan are expected to continue to loosen monetary policy, and we would not be surprised to see Canada follow suit.

Elsewhere, we are seeing encouraging signs that emerging markets are regaining momentum. This could be an early warning signal for developed markets as these economies were the eye of the storm during the last bout of economic weakness. The manufacturing survey data has shown some signs of improvement. Notably China moving back above 50 for the 1st time since April. Certainly, early signs and this could reverse, but there has been a move higher in most PMI manufacturing data points over the past month.

Though many green shoots of growth are beginning to re-emerge, global equities are up over 10% since the lows in August. Hence, it appears much of the improvement has already been priced into stocks. Valuations are back to where they were late last year, but still below the cycle highs we observed in 2017.

Chart 8: Global Manufacturing in contraction mode (PMIs)



While valuations are a bit elevated, our market cycle framework remains encouraging for a continuation of this aging cycle. More accommodative central banks and benign inflation is certainly helping. And if the early signs of improving global data continue, this would continue to be positive for risk-assets. 2020 will be hard pressed to even come close to matching the returns of 2019 (assuming December is ok). However, at this point we don't see the market getting blindsided by a recession in the coming quarters. In Keynesian fashion we would like to remind you that if the facts change, so will our opinion.

IV. Portfolio positioning

There are no material changes to our asset allocations over November. We remain market weight equities, encouraged by our Market Cycle signals, but cautious given the age of the cycle. The changes from October have brought our U.S. overweight to market weight and Europe as a minor overweight – valuations are simply more appealing overseas. We have a minor underweight in Canada. On the bond side, we remain low duration and focused on higher credit quality.

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