Luft Financial Model Portfolios

Q3 2018 Review

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Our Goal

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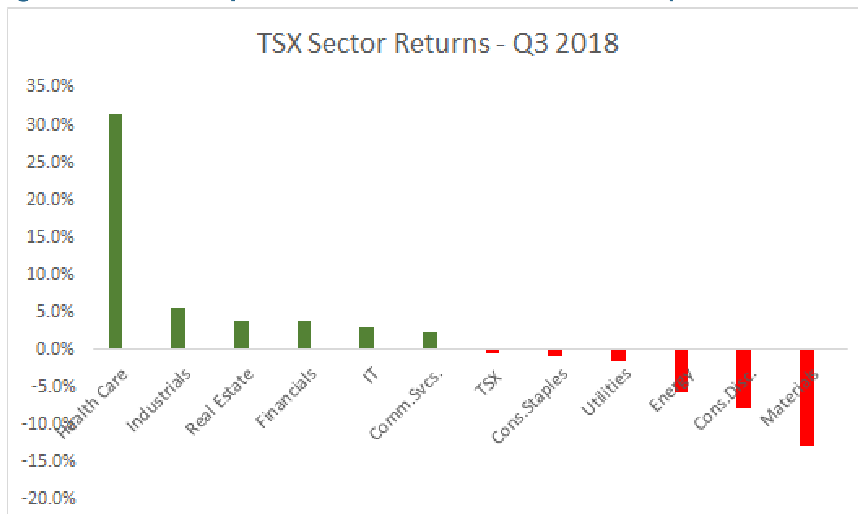
TSX pared part of its strong Q2 gains in Q3 on trade uncertainty, lower oil

The TSX Composite retreated 1.3% in the third quarter (Q3), paring part of its 5.9% gain in Q2 that was the index's best quarterly performance in more than four years. After outperforming U.S. indices in Q2, the TSX underperformed them by a wide margin in Q3, as the Dow Jones Industrial Average surged 9.0% and the S&P 500 rose 7.2%. Overseas, European indices turned in a mixed performance for the second successive quarter, while emerging markets stabilized, with strong rebounds in markets that had endured double-digit declines in Q2, such as Argentina, Thailand and Brazil (source: FactSet).

The TSX had commenced the quarter on a solid note as Q2's positive momentum carried through to Q3, resulting in the index reaching a record high of 16,586.46 on July 13. After a 1.2% gain in July, the index declined 0.8% in August and 0.9% in September, weighed down by a couple of negative developments. In the last week of August, an unexpected trade pact between the U.S. and Mexico heightened concerns that Canada could potentially be excluded from the contentious rewrite of NAFTA, while a Federal Court of Appeal overturned approval of the Trans Mountain pipeline expansion, just months after the Canadian government announced it would pay $4.5 billion to nationalize the pipeline.

While six of the 11 TSX sectors had positive total returns (price change plus dividends) in the quarter, negative returns by the commodity and consumer groups resulted in a return of -0.6% for the index over the quarter (Figure 1). The Materials group plunged 13%, led by precious metals producers; the Energy sector fell 6% as Canadian producers obtained lower realized prices for crude oil after the local benchmark Western Canada Select (WCS) traded at a growing discount to West Texas Intermediate (WTI) over the quarter. The Consumer Discretionary sector was another laggard, down 8% as fears about tariffs led auto component-makers lower. The Health Care sector surged 31% in the quarter, led by marijuana-related stocks, while the Industrial, REIT and Financial sectors also posted robust returns.

Figure 1: TSX Composite Sector Returns for Q2 2018 (Source: FactSet)



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Portfolio Constituents – Major Movers

- As many as nine securities in our model portfolios had total returns of at least 5% in Q3 (compared with 10 such securities in Q2), of which seven were U.S. stocks and only two were Canadian. Based on total returns in Canadian dollars, the best performers among our portfolio constituents in Q3 were:
  - Qualcomm (NASDAQ: QCOM, +27.2%)
  - Westshore Terminals (TSX: WTE, +13.3%)
  - Berkshire Hathaway (NYSE: BRK.B, +12.7%)
  - Johnson & Johnson (NYSE: JNJ, +12.6%)
  - Astra-Zeneca ADRs (NYSE: AZN, +12.0%)

  Other portfolio constituents with gains above 5% in Q3 were Visa (NYSE: V, +11.5%), Canadian National Railway (TSX: CNR, +8.2%), Altria (NYSE: MO, +5.7%), and Verizon (NYSE: VZ, +5.5%).

- The three worst performers among our portfolio constituents in Q3 were: High Liner Foods (TSX: HLF, -19.4%), General Electric (NYSE: GE, -17.7%) and Barrick Gold (TSX: ABX, -17.0%). Other significant portfolio decliners were Magna (TSX: MG, -10.7%), SNC-Lavalin (TSX: SNC, -8.8%) and Wells Fargo (NYSE: WFC, -6.2%). (Source: FactSet).

Portfolio Changes and Rationale

- We rebalanced all client portfolios in the last week of July. With the TSX and S&P 500 near record highs at that time, we took profits in some of the best portfolio performers and allocated the proceeds to securities that had lagged the rally.

- We had deployed new client funds judiciously over the spring and summer, by spreading out purchases over a period of weeks, so as to have cash readily available for investment in the event of a market correction. Subsequent to the quarter, we rebalanced all client portfolios in the first week of October. The rebalance decision was based on an improved outlook for the Canadian economy and TSX, arising from the successful renegotiation of NAFTA and positive news-flow for the Canadian energy patch, including approval of the $40-billion LNG project in northern BC by its main partners.

- We also selectively added to positions in the first two weeks of October in stocks that have been disproportionately sold off, such as insurance giant Manulife, auto-parts maker Magna and engineering firm SNC-Lavalin. The pullback in these sector leaders presented a great opportunity to add to positions at discounted valuations.

- In Q3, we launched a Socially Responsible Investing (SRI) portfolio that replaces holdings in sectors such as energy, pipelines and mining with an actively-managed environmental fund. (For additional details, please contact any team member at Luft Financial).

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Looking Ahead

If 2017 was a year when practically every asset class was up, 2018 has proved to be the polar opposite so far, with most stocks, bonds and commodities down year-to-date (Fig.2). We had noted in our “2017 Review” report in February that 2017 could well be remembered as the year of the proverbial calm before the storm. While two mini-corrections this year – one in February and the other in this month – have made last year’s record low U.S. market volatility seem like a distant memory, we have a growing degree of conviction that volatility will continue to trend higher in 2019.

Financial markets are presently experiencing a renewed bout of volatility on account of two major concerns – the impact of higher interest rates / bond yields on the U.S. economy, and an escalating trade conflict between the U.S. and China. Market participants are currently factoring in four interest rate increases by the Federal Reserve and the Bank of Canada over the next year. While North American economic momentum should enable these rate hikes to be absorbed in the short term, it may be a different story in 2019, as the rate hikes begin to have a discernible effect on economic activity, especially in Canada where household debt is at record levels.

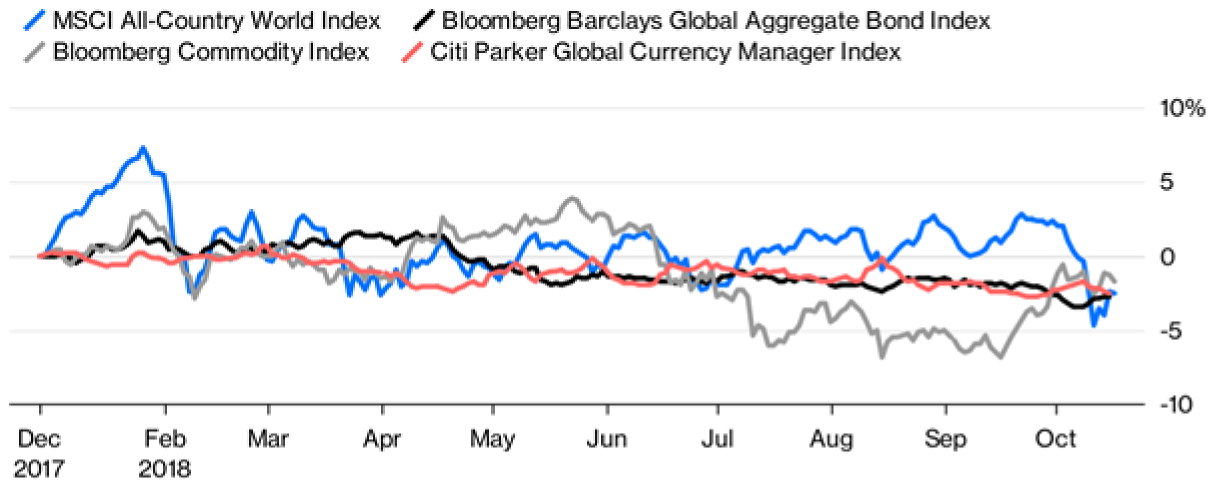
The mounting consensus that global economic growth will be slower than optimistic expectations at the beginning of 2018 was echoed in the IMF’s recent “World Economic Outlook.” The IMF lowered its growth forecast for this year and next by 0.2 percentage points to 3.7%, highlighting trade tensions and the potential shift away from a multilateral trading system (and towards protectionism) as key threats.

However, those risks do not yet appear to be reflected in earnings forecasts. For the TSX Composite, corporate earnings are forecast to grow by 12.7% to $1050 this year, and by 13.2% to $1189 in 2019 (based on FactSet estimates). For the S&P 500, earnings are forecast to surge 21.9% to $161 this year (partly as a result of the U.S. tax cuts), and by 10% to $177 in 2019. On that basis, forward multiples for the two indexes continue to appear reasonable, at 14.7x and 17.2x for the TSX and S&P 500 respectively (based on 2018 forecast EPS), and at 13.0x and 15.7x (based on 2019 forecast EPS).

2018 has so far been a challenging year for investors and investment professionals alike, with most balanced portfolios in the red as stocks and bonds struggle to make headway. Nevertheless, we expect to end the year on a stronger note as seasonal market trends kick in and strong corporate earnings fuel a return to “risk on” trades. Key risks that we are currently monitoring as they could affect the near-term outlook include the U.S. mid-term elections – where an unexpected result may trigger market volatility – and the ferocious market correction in China.

With the resolution of NAFTA (now the USMCA) having eliminated a major source of uncertainty for the Canadian economy, the TSX should benefit once risk appetite returns. A potential rotation into the value stocks that comprise most of the TSX could have a positive impact on our client portfolios and also enable the index to narrow its performance gap versus the S&P 500.

Figure 2: Performance of Global Asset Classes in 2018



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