Luft Financial Model Portfolios

Q2 2018 Review

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TSX hits record high in Q2 with best quarterly performance in 4½ years

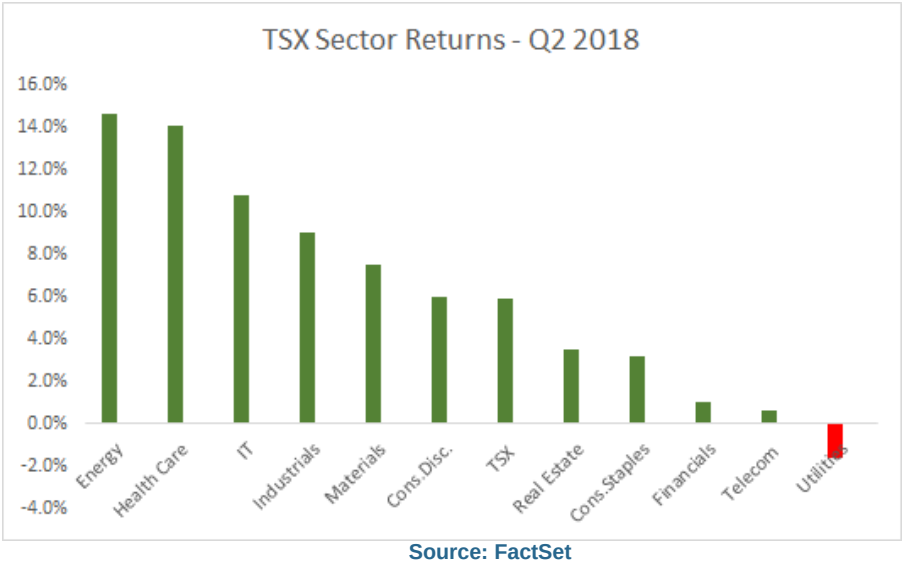
The TSX Composite was the unexpected star among North American indices in Q2, reaching a new record high with its best quarterly performance since Q4 of 2013 (source: FactSet). The index made amends for its dismal 5.2% slump in Q1 with a gain of 5.9% in Q2, easily surpassing the Dow Jones Industrial Average and S&P 500's 0.7% and 2.9% gains respectively, and keeping pace with the mighty Nasdaq, which was up 6.3% in the quarter.

The TSX's performance was especially remarkable as it occurred against the backdrop of a deteriorating outlook for global trade, as trade rhetoric flew fast and furious between the U.S. on one side and Canada, China and the European Union on the other. Also noteworthy was the breadth of the advance, with 10 of the index's 11 groups in the green (Figure 1) and Utilities the only laggard.

Of the four major sectors that collectively account for 75% of the TSX, two groups – Energy and Industrials – were among the best performers in Q2. Energy producers benefited from higher realized prices as West Texas Intermediate (WTI) crude oil surged 14.3% to a 3½-year high of US$74.15 by end-Q2, while the local benchmark Western Canada Select (WCS) traded at a smaller discount to WTI over the quarter. The Industrials group gained 9%, led by Bombardier (+38.7%) and the railroads, even as airline stocks Air Canada and WestJet plummeted more than 20%. The Health Care sector advanced 14.1% in the quarter, as Bausch Health Companies (formerly Valeant Pharmaceuticals) surged 49.2%.

Overseas, European indices were mixed, while emerging markets were rattled by a toxic combination of trade tensions, plunging currencies, and lower risk appetite, leading to double-digit declines in the equity benchmarks for China, Thailand, Brazil, Turkey and Argentina.

Figure 1: TSX Composite Sector Returns for Q2 2018



Source: FactSet

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Portfolio Constituents – Major Movers

- As many as 10 securities in our model portfolios had total returns of at least 5% in Q2, as a reassertion of their strong fundamentals enabled them to rebound from Q1's oversold levels. Based on total returns in Canadian dollars, the best performers among our portfolio constituents in Q2 were:
    - Pembina Pipeline (TSX: PPL, +14.7%)
    - Canadian National Railway (TSX: CNR, +14.7%)
    - Visa Inc. (NYSE: V, +13.2%)
    - BMO Equal Weight Oil & Gas Index ETF (TSX: ZEO, +11.7%)
    - Shaw Communications (TSX: SJR.B, +9.1%)
- The three worst performers among our portfolio constituents in Q2 were: High Liner Foods (TSX: HLF, -7.5%), Altria Group (NYSE: MO, -5.9%), and Hydro One (TSX: H, -3.1%) (Source: FactSet).

Portfolio Changes and Rationale

- We made some changes to the U.S. component of our portfolios in May. We took profits in the U.S. Consumer Discretionary SPDR ETF (NYSE: XLY) and sold the IA Clarington Sarbit U.S. Equity Fund which focuses on small and mid-cap U.S. equities. This fund has underperformed in recent months largely because of its substantial cash weighting (51.6% at April 30, 2018).
- We used the proceeds of these sales to buy chipmaker Qualcomm (NASDAQ: QCOM) and megabank Wells Fargo (NYSE: WFC). At the time of purchase, both these stocks were trading at significant discounts to their peers on account of factors that we viewed as being transitory in nature.
- Qualcomm, the world's biggest provider of mobile chips, has yet to receive approval from China for its pending acquisition of Dutch chipmaker NXP Semiconductors (China is the only one of nine regulators globally yet to approve the deal), and is also embroiled in a licensing dispute with leading smartphone makers including Apple and Samsung. In our opinion, the favorable resolution of one or both of those issues should boost Qualcomm's shares. Additionally, downside protection is provided by Qualcomm's intention to buy back $20 - $30 billion[1] of its shares in case the NXP deal does not go through; the stock also offers a dividend yield in excess of 4%.
- Wells Fargo has been enmeshed in scandals and lawsuits for the past couple of years, and while these have taken their toll on the stock, the bank unexpectedly emerged as one of the biggest winners in the recent stress tests conducted by the Federal Reserve [2, 3]. While the Fed had earlier this year ordered Wells Fargo to cap its assets until it could demonstrate improved operational controls, its approval of the bank's capital return plan – in the form of higher dividends and an enhanced share buyback – was viewed positively by analysts and could lead to additional stock gains.
- We also added to positions in Hydro One (TSX: H), after the stock was adversely affected by the focus on Ontario's high power prices as a hot-button issue in the provincial elections. While the new Premier Doug Ford duly replaced Hydro One's CEO and Board of Directors on July 11 to keep his election promise, the utility's diversified operations and strong balance sheet should enable it to overcome these short-term issues, in our view. As we had noted in a recent article penned for "The MoneyLetter" (available on the Luft Financial blog), political and regulatory noise can occasionally create buying opportunities in blue-chips like Qualcomm and Hydro One.

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Looking Ahead

At the present time, trade tensions seem to be having limited impact on the markets, perhaps based on the viewpoint that cooler heads will prevail before a full-blown trade war erupts. The bigger issue appears to be the upward trajectory of interest rates in North America. In the U.S., higher short-term rate could lead to a potential yield curve inversion – a powerful signal of a recession[4] – by 2019[5] , while tighter monetary policy in Canada may create economic stress due to record levels of household debt.

Although expectations for strong global growth have been tempered in recent months, forecasts for earnings growth in 2018 continue to be robust, at 14.4% for the TSX Composite and 21.3% for the S&P 500 (based on FactSet estimates). On that basis, forward P/E multiples for the two indexes still appear reasonable, at about 15.5x for the TSX and 17.5x for the S&P 500.

Given their high degree of correlation with the TSX, our portfolios displayed much improved performance in Q2, as we had forecast in our Q1 review. Although we continue to expect greater volatility over the remainder of 2018, we are comfortable with our portfolio positioning. We use some of the world's best fund managers to manage specific components of our client portfolios, and most of our stock picks are leaders in their field with solid long-term business prospects. On an interesting note, RBC recently released a report titled "Imagine 2025" of 70 global stocks that are well-positioned for the future[6]; of the 12 Canadian stocks included in that list, we have been long-term holders of five stocks.

[1] https://www.nytimes.com/2018/07/19/technology/qualcomm-nxp-trade-war.html

[2] https://money.usnews.com/investing/stock-market-news/articles/2018-06-29/wells-fargo-co-wfc-stock

[3] https://www.cnbc.com/2018/07/02/morgan-stanley-upgrades-wells-fargo-due-to-its-positive-stress-test.html

[4] https://www.bloomberg.com/news/articles/2018-04-17/fed-s-williams-says-inverted-yield-curve-powerful-recession-sign

[5] https://www.bloomberg.com/news/articles/2018-07-18/yield-curve-inversion-imminent-for-some-long-way-off-for-others

[6] https://www.rbccm.com/en/insights/story.page?dcr=templatedata/article/insights/data/2018/07/the_imagine_2025_portfolio

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