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TSX tumult underscores importance of diversification

The near-record plunge in the TSX Composite in the first quarter of 2020 illustrates yet again the fragility of an index that is heavily exposed to cyclical sectors; it also underscores the importance of geographic diversification for Canadian investors.

The index plunged 17.7% in March and overall, plummeted 21.6% in Q1 (Figure 1). Only a mini rebound of 5.5% in the last two days of the month enabled the index to finish a tad better than the 23.5% plunge registered in the fourth quarter of 2008. Along the way, the index had tremendous bouts of volatility – three daily declines of about 10% or more including a single-day drop of 12.3% on March 12, its worst one-day performance in 80 years – and a record 12% advance on March 24.

The S&P 500 in the U.S. performed relatively better than the TSX, tumbling 12.5% in March for a Q1 plunge of 20.0%. So why did the TSX underperform the S&P 500 yet again, despite the U.S. rapidly emerging as the potential new epicenter of the coronavirus pandemic?

The answer lies in the unique challenges facing the export-oriented Canadian economy, which continues to be heavily exposed to the caprices of the global economic cycle. At a time when the coronavirus has crushed consumer demand for everything from cars to commodities, Canada must also contend with a jaw-dropping plunge in the price of crude oil, which nosedived 65% in Q1. Energy accounts for over 10% of Canadian GDP[1], the highest proportion of the G-7 nations.

In addition, Canada's real estate market might come under pressure if a recession takes hold; real estate, rental and leasing activities contribute about 13% to Canada's GDP. So that's two key sectors of the economy facing an outlook that is getting increasingly murky. And we haven't even considered the toll that rising unemployment will take on the over-leveraged Canadian consumer and hence on consumer demand, the main driver of the economy.

The perpetual investment dilemma faced by Canadian investors is this – how does one reduce the degree of over-exposure to the cyclically-oriented TSX, which has almost one-third of its weights in financials and another 25% in energy and commodities (Fig. 2)? The answer lies south of the border. The S&P 500 is much better diversified than the TSX, with substantial weights in groups like technology and health care that have been in the vanguard of the bull market and which have minimal representation on the TSX.

The depreciation of the Canadian dollar against the US dollar in times of economic stress is an added incentive for significant U.S. exposure in diversified portfolios. Holding assets denominated in US dollars helps during turbulent times, given the greenback's time-tested status as a safe haven. As an example, the S&P 500's 20% decline in the just-concluded quarter works out to -12.2% in Canadian dollar terms, since the CAD depreciated 9% against the USD over the quarter.

In our client portfolios, one of our favored ways to increase U.S. exposure is through the Invesco S&P 500 Top 50 ETF (XLG), one of our biggest holdings, which includes global leaders such as Amazon, Apple, Microsoft and Google.

After last month's rout, the TSX has now returned just 145% on a cumulative basis from the March 2009 lows (based on FactSet data) or 8.5% annually, compared with total returns for the S&P 500 (in USD) of 380% or 15.2% annually. Investors who were hopeful that the TSX would make up for its sustained underperformance versus the S&P 500 over the past decade may be in for a prolonged wait.

[1] https://www.nrcan.gc.ca/science-data/data-analysis/energy-data-analysis/energy-facts/energy-and-economy/20062

Figure 1: TSX Composite: Near-record plunge in Q1

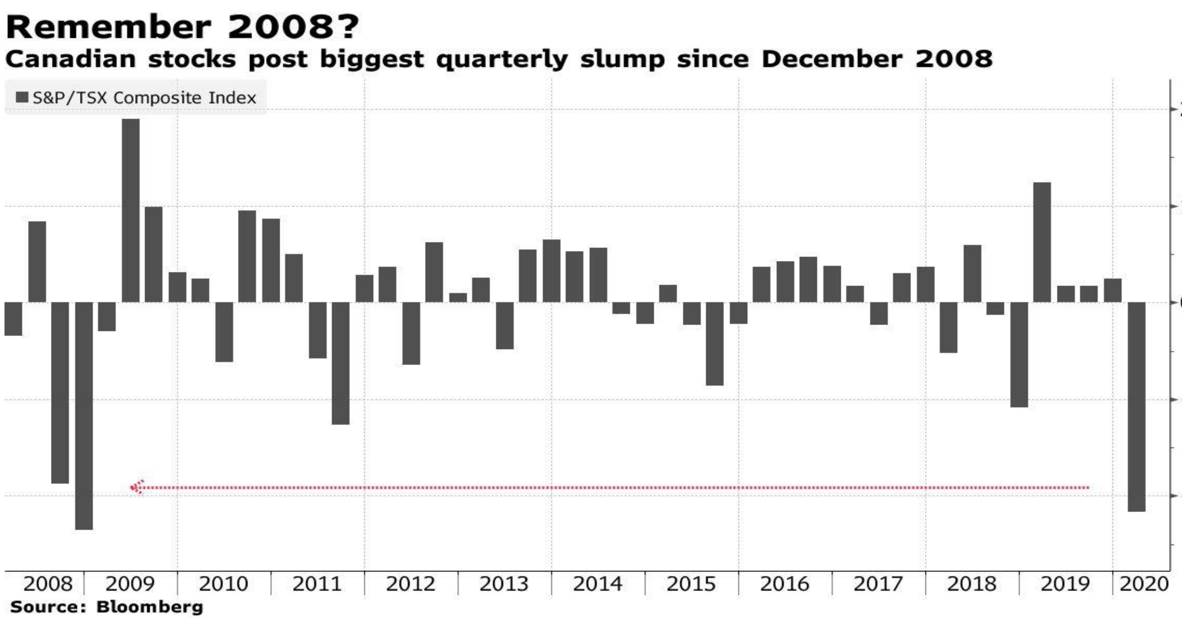

Figure 2: Sector weights for TSX Composite (left) and S&P 500 (right) Source: FactSet