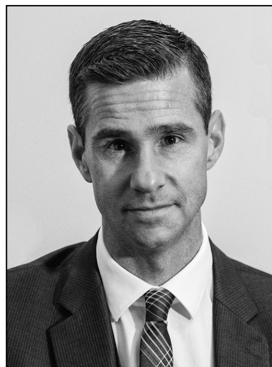
Portfolio Management Commentary

Quarter Ending September 30, 2018



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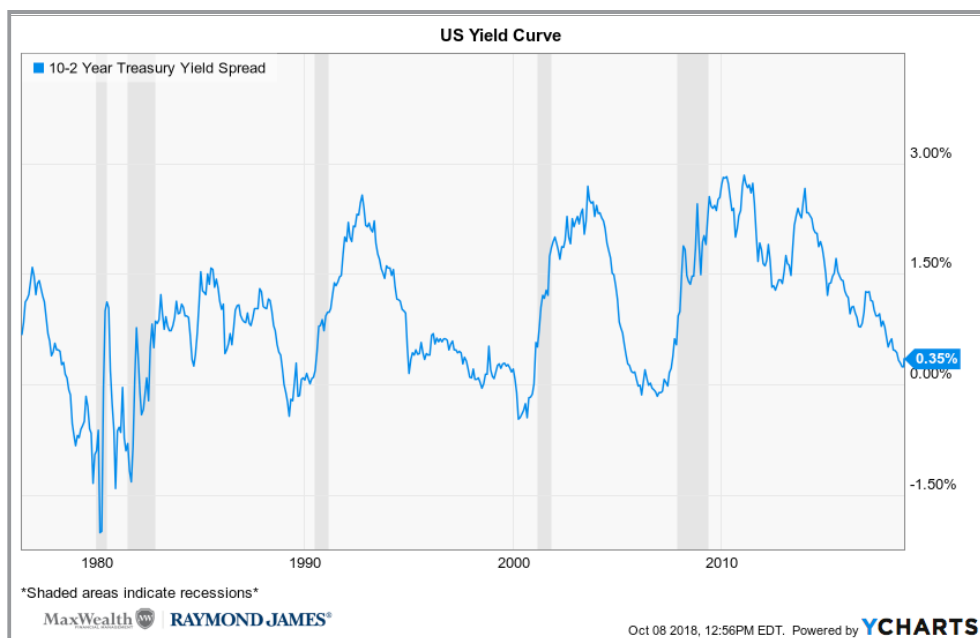
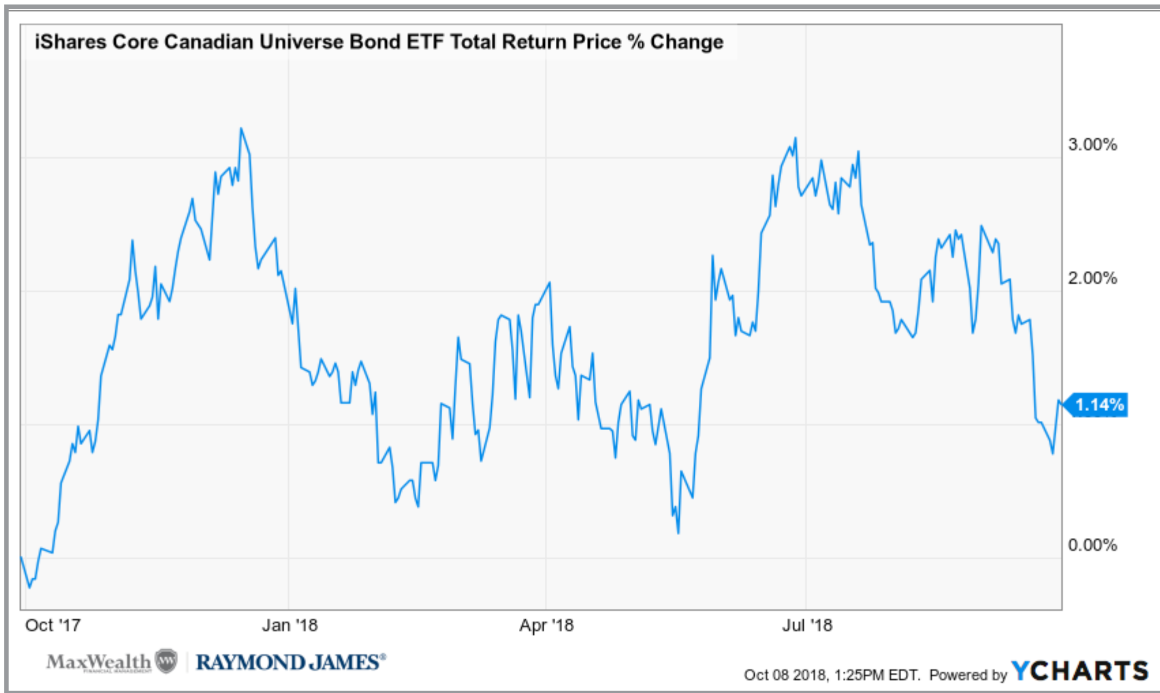
The third quarter of 2018 posted moderate gains for most global investors. Unfortunately, the May rally of the TSX lost steam and broke down through the 200-day moving average on an intra-day basis. Clearly, the uncertainty surrounding the NAFTA negotiations has generated negative pressure on Canadian markets. With a hand-shake deal now in place, we believe that this pressure should dissipate and provide a more constructive backdrop for future potential returns. Volatility is picking up south of our border as the US gets ready to vote for midterm elections on November 6, 2018. Nate Silver's FiveThirtyEight currently gives the Democrats three in four odds for the House, and the Republicans a seven in nine chance to keep control of the Senate. Be wary of predictions, however. The bookies got it dead wrong on Brexit and the US presidential election in 2016.

There has been a lot of talk recently about the US yield curve and recessions. The gist is quite simple. The yield curve illustrates the spread between the 10-year and 2-year US government Treasury yields. When it is normal, short rates are lower than long rates. When it is flat, they are the same. When it is inverted, short rates are higher than long rates and economists get concerned. Why? The cost of short-term borrowing increases causing pressure on corporations and consumers alike. It also seen as a leading indicator of a recession. If the short term is more attractive than the long term then optimism is waning. Illustrated below is the current US yield curve since 1976. Even though the spread is narrowing, it is still normal. Notice how the yield curve inverted (went below zero) before all of the five recessions depicted by the gray vertical bars:



Furthermore, the average time to recession, after it went below zero, was roughly 17 months. So here are the takeaways: 1) the yield curve is normal. 2) the time from inversion to recession is almost 1 ½ years on average. 3) it's not the bottom of the yield curve that's important, it's the abrupt steepening after that we need to be aware of. A final observation to consider is that the short rate, depicted by the 2-year treasury, may not be the best option for analysis. Some experts argue that the 3-month treasury is a much better proxy for short maturities. Currently, the spread between the 10-year and 3-month treasury is wider at 0.97%.

Keeping with the fixed income theme I thought it would be meaningful to review the total performance of Canadian bonds for the past year ending on September 30, 2018. As you can clearly see, bonds as represented by the iShares Core Canadian Universe Bond ETF (XBB.TO), have not provided much in the way of absolute return. So why hold bonds? Bonds are important for three reasons: 1) they offer you another asset class or choice to place your money. In other words, diversity. 2) Income. Bonds pay interest. In low interest rate environments that may not be much, but they provide cash flows. 3) Safety of capital. High quality bonds backed by prudent governments and corporations give your invested capital back at maturity. So, as you can tell, bonds are more than just about return. They are important building blocks for a more risk sensitive investor and a great way to add another asset class to any portfolio.



Your Portfolio

Trading for all portfolios was reasonably light for the quarter as we made some minor adjustments to our investments. As previously mentioned in June's trading commentary, we opted to upgrade our US financial exposure by selling Lincoln National Corp (LNC) and buying Berkshire Hathaway (BRK.B) in the Moderate and Growth portfolios. Yes, you are now invested in Warren Buffet and Charlie Munger's famous company. Growth portfolio holders saw a late entry to the portfolio at the end of September when we added a 3% position in Alphabet (GOOGL). If you are unaware, Alphabet is the parent company of Google. In my opinion, Google is a force of nature. It is probably the one thing we cannot live without in the modern age. Think about it. Imagine if you couldn't Google something? Enough said. For our Income portfolio participants, we reduced our exposure to long-term rates by selling our position in BMO Long Term Corporate Bond ETF (ZLC.TO). The increased yield in this position wasn't enough compensation to hold it any longer. Our decision turned out to be a good one as its price has dropped over 5% since then.

Final Thoughts

As we enter the final quarter of 2018 I am cautiously optimistic. We are approaching a positive seasonal trend for equities, the Spectre of NAFTA has been removed, composite US economic activity remains robust, US corporate earnings remain intact, valuations are not extreme, and investor sentiment is not too euphoric. Volatility, I believe, will pick up as we digest and move through the US mid-term elections, Brexit implications, China-US tariffs, and country-specific issues in Europe. I think it is wise at this moment in time to quote the sage words of the father of fundamental investing, Benjamin Graham:

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."

And at this juncture, the weight of evidence points to further prosperity for the patient and prudent investor.

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