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Finding New High-Quality Holdings in Q2

2020 has been a difficult year for the world economy, to say the least. We are now past the halfway point, and there are new trends in place that will likely last for years, including huge amounts of government and central bank support for companies and workers. We may not like these trends, but we did not choose this new reality – it chose us. We are adapting to current trends while staying with our strategy of buying high quality investments at undervalued prices. To begin this second quarter (Q2) edition of our Newsletter, we will highlight some of our recent purchases in our discretionary portfolios. This should help clients understand how we are handling the current environment. Later on, we will comment further on certain trends that could continue for years.

We believe that many of the biggest negative surprises are probably already behind us. Today, the COVID-19 global pandemic is better understood, both medically and in terms of its effect on the economy. Recently, we are seeing new waves of cases in the U.S. and Canada. Fortunately the fatality rate seems to be dropping far below initial estimates, perhaps because many of the cases are younger people. Efforts to find a vaccine are showing some promise, but no near term approvals are imminent. Employment levels have begun a long recovery, but we could be waiting until late 2022 or 2023 to reach 2019 levels.

After severe volatility in Q1, during which North American equity markets fell around 35%, many equities and bonds have staged a strong rally. These gains may reflect government assistance equally as much as they indicate improving economic reality. Many of the top gaining equities in Q2 are in technology and benefit from work from home trends. While we do own some profitable large technology companies, such as Apple Inc. (NASDAQ:AAPL) and Alphabet Inc. (NASDAQ:GOOGL), most of the surging technology stocks seem overvalued and too risky for our portfolios at this time. We continue to focus on well-established, profitable companies that will benefit during a gradual economic reopening process. Overall, our portfolios remain somewhat cautious, even after we made several purchases of high-quality companies in Q2 at attractive prices. We believe that an additional equity market correction of 10% or more could easily happen as we approach year-end and face the uncertainty surrounding the November U.S. election.

Q2 Portfolio Highlights

So far in 2020, precious metals appear to be attractive holdings, with interest rates near record lows, and huge amounts of currency creation happening around the world. Rather than look to mining companies, we have kept it simple and added some direct exposure to gold. On May 28, in both our Total Return Portfolio and our Balanced Portfolio, we purchased modest positions in the Canadian version of the IShares Gold Bullion ETF (TSX:CGL.C) at a price of $20.55 per unit. The gold price may fall if the pandemic ends rapidly and interest rates rebound significantly. If this happens, other assets in our portfolios will benefit from the economic improvement.

Low interest rates are among the factors getting us more interested in lumber producers. U.S. new home construction is a key driver of lumber prices. Due to cautious practices by U.S. homebuilders stung by the 2008-09 financial crisis, the number of new homes built annually in the U.S. over the past decade may fail to meet the longer-term demand of the large millennial demographic. In the High Yield Portfolio and the Balanced Portfolio, we therefore purchased Weyerhaeuser Co. (NYSE:WY) on April 17 at US$19.84 per share. Weyerhaeuser is a lumber producer but is also one of the largest private landowners in the U.S. with massive timberland holdings.

On May 28, in the Total Return Portfolio, we added to our existing position in West Fraser Timber Co. Ltd. (TSX:WFT)[1], a low cost North American lumber producer. Our purchase price this time was $39.89 per share. It is interesting that B.C. billionaire Jim Pattison acquired more shares of West Fraser in March and now owns 14% of the company.[2] As of July 21, lumber prices have already rallied significantly, boosting West Fraser and Weyerhaeuser. There are some signs around North America that demand for new single family homes, in some cases outside of the major cities, is stronger than expected.

Also on May 28, we purchased units of Brookfield Property Partners L.P. (TSX:BPY.UN)[3] for all three of our discretionary portfolios at a price of $14.89 per unit. While the units are heavily discounted compared with years past, we acknowledge that times are tough for commercial real estate investment trusts (REITs). Some tenants are not currently paying. Brookfield Property has certain major advantages, including some very high quality properties in major international cities, as well as financial support from its parent company Brookfield Asset Management. In early July, the parent company announced a bid for up to US$890 million of Brookfield Property units at a price of US$12 per unit (approximately CDN$16).[4] Also, we should note that today's low interest rates help REITs like Brookfield Property refinance debts quite cheaply as they come due.

Credit and debit card companies Visa Inc. (NYSE:V) and Mastercard Inc. (NYSE:MA) looked attractive to us in April, so we purchased shares for the Total Return Portfolio. Our entry price for Visa was US$167.76, and we paid US$257.76 per share for Mastercard. Central banks are trying to stimulate the economy at the same time that the use of physical cash has been discouraged. This could further entrench the competitive position of Visa and Mastercard, as the longstanding trend towards electronic payment continues.

Also, our June purchases of communications companies Telus Corp. (TSX:T)[5] and BCE Inc. (TSX:BCE)[6] are worth mentioning. On June 18, we bought Telus at $23.51 per share for both the High Yield Portfolio and the Balanced Portfolio. Then on June 22, we bought BCE in the same portfolios at a price of $57.50. We view these holdings as reasonable, given the overall circumstances. Most customers will still require cell phone service and internet access despite the current recession. Both companies offer substantial dividend payouts, and will likely maintain their strong competitive position in Canada. Overall, we reduced our cash weightings in all three portfolios during Q2, as we gained slightly more clarity on the economic effects of the pandemic and policy response. Despite the signs of recovery during Q2, we are staying somewhat cautious, as markets now appear to be pricing in a fair bit of optimism at a time when the economic reality for many people is still challenging.

Economic and Policy Trends

Governments and central banks have been staging massive economic interventions in recent months. Whether we agree with the actions or not, they will have consequences. Some of these trends may linger for years and raise the likelihood of higher taxation and higher inflation in years to come.

In most countries, government spending is surging and so are debt and deficits. In Canada, the federal government deficit is enormous this year, and our national debt is expected to cross $1 trillion for the first time. In addition to loose fiscal policy, central banks around the world are taking unprecedented monetary policy measures, such as buying corporate bonds, to support the economy.

In isolation, these actions seem justified, because there is an urgent need to assist North American workers and business owners. However, if we zoom out from the present, we can see how we got here, and was a series of decisions meant to avoid short-term pain. Nobody wants to pay the bill for all of this economic support, and it just keeps getting larger.

Will Policy Trends Become Policy Traps?

With the economy as shaky as it is today, policy makers all agree that the interventions must continue. These include ultra-low interest rates, quantitative easing, corporate bailouts, house price support, and moving industries offshore. It seems like we are now trapped by these policies, as they are hard to reverse now that so many households and companies rely on them.

Ultra-low interest rates were supposed to increase economic growth. In reality, developed world economies have become increasingly indebted and financialized. Economic growth has consistently disappointed, and a lot of borrowed money simply flows towards real estate and financial assets. Even so, our policy makers are determined to continue on this path. The Bank of Canada's new governor Tiff Macklem recently stated that Canadian interest rates will remain low for years. Anyone who is heavily invested in housing, stocks or precious metals will not complain. Conservative savers with low risk tolerance who purchase GICs have had a rough decade.

Quantitative easing or "QE" is the policy of central banks buying assets with freshly-printed money. It theoretically helps the economy by increasing the supply of money and keeping interest rates low. The U.S. Federal Reserve has conducted QE extensively over the past decade. Yet U.S. growth has been slow by historical standards.

Corporate bailouts have been going on for a long time, but the global financial crisis of 2008-09 entrenched them as a policy option. In theory, capitalism works through "creative destruction." The best businesses survive and the uncompetitive businesses fail, costing bad executives their jobs and stock and bondholders their money. Our version of "capitalism" no longer works this way, as governments are propping up companies that would otherwise fail.

There is no explicit promise of house price support by governments, but many different policies, such as artificially low interest rates, first time buyer incentives and government-backed mortgages, act in unison to keep prices high. The justification is once again that it will help economic growth. But now that we have had these policies for decades, can we really consider them successful? Housing seems unaffordable to many workers with good jobs.

Finally, we will mention moving industries offshore. While private companies made many of the specific decisions, governments created the trade agreements and incentives. The goal was cheaper labor and higher profits, but we also hollowed out our manufacturing base and increased our wealth inequality and social problems. Now there are many crucial goods, such as medical products, that we are unable to produce domestically. Even if most would agree that the results of offshoring have been poor, the policies are hard to reverse today, as they would require a lot of investment capital and would probably raise consumer costs for a lot of products.

Consequences

So what is the solution to our current situation? There is no obvious path forward that will avoid pain. Someone will get stuck with the bill for all of the government spending and money printing. Higher taxes in Canada and the U.S. are almost certainly coming. What form they take is yet to be determined.

Some policy makers also see higher inflation as a potential way out. Many clients would hesitate to call that a "solution", as they experienced the high inflation of the 1970s and early 1980s personally. We are a long way from those days. But if central banks are determined to increase inflation by creating unlimited amounts of cash, they will at some point succeed.

As investors we will be watching closely, and may need to make further adjustments beyond owning modest amounts of gold in portfolios. In this economic environment, we have to pay attention to policy actions a bit more than usual, so we can continue to make good investment decisions.

Conclusion

We are now past the halfway point in 2020, a difficult year. As mentioned above, our portfolios remain somewhat cautious despite several new purchases at attractive prices in Q2. An additional equity market correction of 10% or more could easily happen as we approach the end of the year and the potential volatility surrounding the November U.S. election.

That said, short-term caution should not be mistaken for pessimism. No matter the external environment, there are always investment opportunities, some of them created by new trends in society. Despite the great uncertainty of the moment, we hope to identify some additional great long-term investment opportunities in the coming quarters. Right now, we believe that clients are positioned appropriately based on their investment objectives and risk tolerance. Thank you for reading our Q2 Newsletter. We look forward to serving you during the rest of 2020 and beyond.

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APPENDIX “A”

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.

[2] https://www.bnnbloomberg.ca/west-fraser-timber-poison-pill-stirs-speculation-about-pattison-s-role-1.1420925

[3] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.

[4] https://bpy.brookfield.com/press-releases/2020/07-02-2020-115030154

[5] The equity securities of this company are non-voting shares. This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company. An executive committee member or director of Canadian Imperial Bank of Commerce, the parent company to CIBC World Markets Inc. and CIBC World Markets Corp., or a member of his/her household is an officer, director or advisory board member of this company or one of its subsidiaries.

[6] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.