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# Finding the Right Balance

We are approaching the end of 2019, and North American equity markets have generally performed well, in contrast to their severe declines in late 2018. Our current asset allocation remains somewhat cautious, with higher than normal weightings in fixed-income and cash. This stance helped protect client portfolios in 2018. A lot of uncertainty remains regarding global economic policy, including central bank decisions and ongoing trade disputes. There have also been increasing signs of a slowdown in the global economy. North American equity markets have generally ignored these issues, but we are paying attention. Our general views on markets have not changed in recent months. We are therefore going to keep this third quarter (Q3) Newsletter brief and simply provide clients with a few updates on our thinking. In our year-end Newsletter, scheduled for late January, we will take a more in-depth look at the outlook for 2020 and beyond.

## U.S. – China Trade Dispute

We continue to view the U.S. – China trade dispute as very significant to the global economy and to equity markets. The countries appear to have reached a phase one trade agreement that will involve China purchasing around US$50 billion annually of U.S. farm products.[1] Apparently this agreement will be signed in mid-November. While this is good news, China's willingness to purchase U.S. farm products has never been the sticking point between the countries. Therefore, this phase one agreement may not progress smoothly to a comprehensive trade agreement.

Many equity investors still seem to believe that the U.S. – China trade dispute will end quickly enough to avoid serious global economic consequences. The U.S. side has fed the media a consistent diet of positive comments on the potential for an agreement since late 2018. Almost every comment about an imminent deal has been proven false, yet equity investors still seem to react positively to the comments. We aren't complaining, as the strong equity markets have made our job of generating returns easier. We are simply concerned that the real probability of a comprehensive trade agreement may be lower than expected, exposing equities to some future downside. The U.S. – China trade dispute has therefore increased our level of caution with all investment decisions this year.

## Most Central Banks Cutting Rates

Lower interest rates can be good for asset prices, such as equities, real estate and longer-term bonds. That said, it is important to understand why rates are rising or falling. What is the underlying economic reason for the change? Currently, many central banks around the world are cutting rates, and the reason is clearly slowing global economic growth.

Many investors are so focused on North America that they are missing this development. While we always hear about actions from the U.S. Federal Reserve and the Bank of Canada in the financial media, central banks in other significant countries, such as South Korea, Russia, India and Brazil are also cutting rates.[2]

This raises two difficult questions. First, how much of the global economic slowdown is just part of the natural business cycle and is unrelated to current trade disputes? Second, what are the current probabilities of various countries around the world entering recession? We do suspect that a significant part of the current global slowdown is just normal business cycle slowing and would have happened regardless of trade disputes. This is concerning, and is another factor that has increased our level of caution with all investment decisions this year.

**Selected Economic Data**

In recent Newsletters, we have explained that we do not believe that a Canadian and U.S. recession is imminent, but the odds of one are rising. We do believe that we are nearing the peak of this economic cycle, which has been among the longest on record. It is important for us to review economic data on an ongoing basis, so we can revise our beliefs if they do not reflect reality.

The North American consumer seems to be holding up relatively well. Unemployment rates are very low in the U.S. and Canada. U.S. consumer confidence data remains near record levels.[3] Recent U.S. retail sales data has been a bit choppy, but we can't yet conclude that a negative trend is in place.[4] Auto sales have been a well understood weak spot around the world, and manufacturing generally is in a downturn.[5] Overall the global economic data looks worse to us than it did a year ago.

Unemployment and consumer confidence data typically lacks predictive value, as it does not turn lower until the economy is very close to recession. Also, retail sales can sometimes stay fairly buoyant even if the economy does enter recession, as they did in 2001-2002. Overall, recent economic data has not changed any of our views much in recent months.

**Appetite for Risk Declining**

We discussed the recent surge of initial public offerings (IPOs) in our Q1 2019 Newsletter, which mainly involve high-growth, high-risk companies. We pointed out that the timing of these IPOs is not random. Companies come to market with their shares when they can - when markets are strong and risk tolerance is high.

Now we may be seeing the beginning of some risk aversion among investors, but it is hard to know. For example, investors have been resistant to funding flexible office space provider WeWork in recent weeks. Several months ago, it was touted as a potential high-value IPO. Now it needs financing in order to survive.

Looking at some of the big-name IPOs we discussed back in April, many are trading near their lows, including ridesharing companies Uber Technologies Inc. (NYSE:UBER) and Lyft Inc. (NASDAQ:LYFT), social media company Pinterest Inc. (NYSE:PINS) and videoconferencing company Zoom Video Communications Inc. (NASDAQ:ZM). It is possible that the window of opportunity for riskier loss-making companies to achieve high valuations through IPOs is starting to close. While North American equity markets are still strong, it is the larger, profitable companies that are providing most of the gains at this stage in the market cycle.

**Selected Portfolio Transactions**

For the past five years, we have generally avoided investing in the forest products industry, but we recently made two very small purchases. In the Total Return Portfolio, we purchased a 1% weighting in West Fraser Timber Co. Ltd. (TSX:WFT)[6] in early September. In 2018, the company's shares peaked at close to $100. Our purchase price was $50. The company is now North America's largest lumber producer, with exposure to the U.S. south as well as B.C. and Alberta. Lumber prices have not done well recently, and that has led to the opportunity to buy the shares well below its 2018 highs. We believe that construction of new U.S. homes will not drop off as much as it has in past downturns, as there was little evidence of overbuilding in recent years.

In the High Yield Portfolio, we purchased a 1% weighting in Weyerhaeuser Co. (NYSE:WY) in early September. Weyerhaeuser is an American real estate investment trust and the world's largest private owner of timberlands, with 12.4 million acres in the U.S.[7] Weyerhaeuser also is a large manufacturer of wood products. As the High Yield Portfolio is focused on generating income plus modest capital gains, the annual distribution of close to 5% offered by Weyerhaeuser fits the portfolio's objectives. Our purchase price was US$27.89 per share.

With our small purchases of West Fraser and Weyerhaeuser, we are seeking good value. We understand that these businesses are cyclical, but we are buying shares at major discounts to where they have traded for much of the past five years. In our opinion, there is pessimism already built into the share prices, creating some potential upside if their operating results are decent. Patience will likely be required for us to benefit from better North American lumber pricing. We also found it interesting that a company controlled by B.C. billionaire Jim Pattison recently bid to take forest products company Canfor Corp. (TSX:CFP) private. Pattison is known for patient long-term ownership of various businesses and having a sharp eye for value.

In the Total Return Portfolio, we purchased a 1% position in Nutrien Ltd. (TSX:NTR)[8] at $68.15 per share in early September. In early 2018, Agrium Inc. and Potash Corporation of Saskatchewan merged to form Nutrien. The company is the one of the largest fertilizer producers in the world. Its customers are agriculture businesses such as farmers. In addition to producing potash, nitrogen and phosphate fertilizers, Nutrien owns and operates over 1,700 retail locations, mainly in North America.[9]

We believe the company will be able to grow its earnings and dividend significantly within the next five years. In the coming years, the company intends to expand fertilizer production, expand its retail network, return capital to shareholders through dividends and share buybacks, and continue reducing corporate costs as planned in connection with the Agrium - Potash merger. In the short run, earnings could be negatively affected by difficult operating conditions for U.S. farmers.

In addition to their individual characteristics, West Fraser, Weyerhaeuser and Nutrien all offer some diversification benefits to our portfolios, as they are operating in industry sectors that we have minimal exposure to as investors.

## Conclusion

The past twelve months have been about finding the right balance between risk and return potential in client portfolios. Late in an economic cycle, the risk of an economic downturn rises. Despite that risk, asset prices often perform quite well. It is a difficult balancing act to attempt to participate in the remaining upside in asset prices while not exposing portfolios to large losses if an imminent recession becomes obvious to all investors.

One way we are balancing risk and return in this environment is to be a bit more cautious in our discretionary portfolios. In practical terms, this means allocating more capital than normal to fixed-income holdings or cash. It also means heavily scrutinizing the quality and purchase prices of our equity holdings. Sometimes this can test our patience if markets do not provide good buying opportunities. Even so, overpaying for equities prior to a downturn can damage long-term returns, so patience is required.

Thank you for reading our Q3 Newsletter. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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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] https://www.cnbc.com/2019/10/19/trump-says-he-hopes-us-china-trade-deal-will-be-signed-by-mid-november.html
[2] https://www.reuters.com/article/us-emerging-rates-graphic/down-is-the-only-way-emerging-central-banks-deliver-more-rate-cuts-idUSKBN1WG3Y2
[3] https://advisoranalyst.com/2019/10/22/ceo-confidence-plunges-consumers-wont-like-what-happens-next.html/
[4] https://www.cnbc.com/2019/10/16/us-retail-sales-september-2019.html
[5] https://blogs.imf.org/2019/10/15/the-world-economy-synchronized-slowdown-precarious-outlook/
[6] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
[7] Value Line Report on Weyerhaeuser dated September 20, 2019.
[8] 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.
[9] Value Line Report on Nutrien dated July 5, 2019.