Market Research #008

This is the eighth in a series of Independent research produced by the Murray Wealth Group Research Team. The purpose of this series is to provide insight into our portfolio construction and how our research shapes our investment decisions. We welcome any feedback or questions you may have on these monthly commentaries.

2019 Outlook

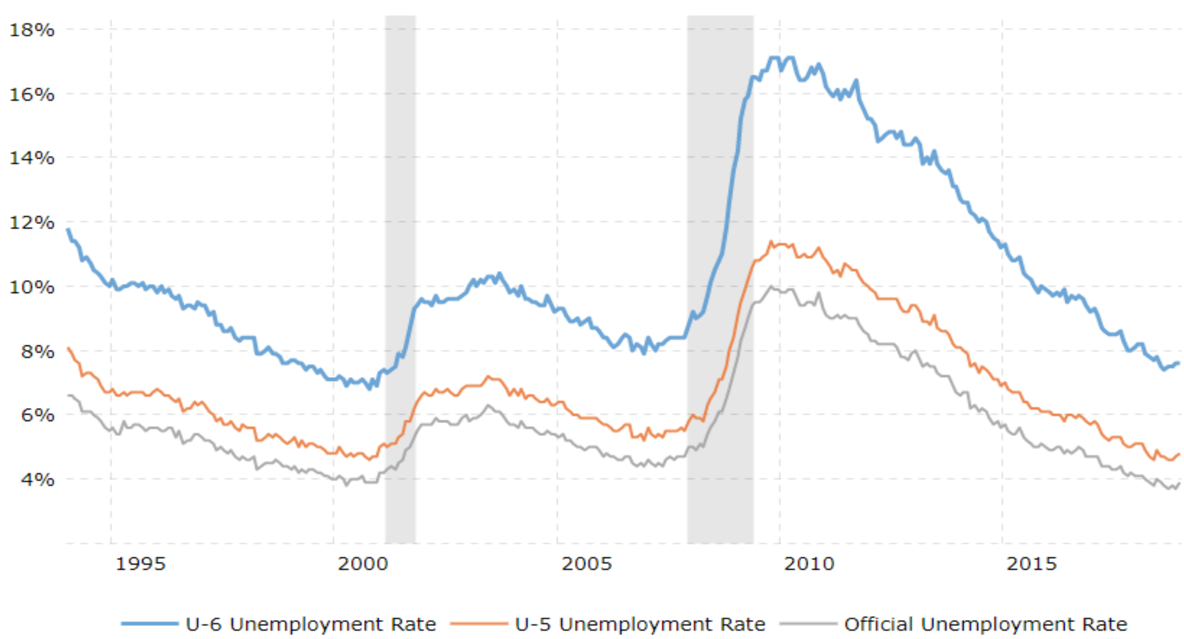
For our monthly research note, we are presenting our 2019 investment outlook.

Globally, asset classes were mired with negative returns in 2018. Equity markets in developed economies performed well through September but a large correction in the fourth quarter of 2018, together with increased volatility, led to negative returns. Rising interest rates negatively affected credit instruments (although we saw a sharp decline in longer-term interest rates in December as expectations of future interest rate hikes decreased).

Looking out to 2019, the current earnings estimate for the S&P 500 index is 174, a 7% increase from the estimated $162 earned in 2018. Looking ahead to 2020, earnings are projected to rise by an additional 3%, although we assume most forecasters are hedging their outlook given the uncertainty surrounding economic growth. Stock multiples have contracted from peak levels in the summer of 2018, when the S&P 500 traded at ~17x forward earnings, to ~ 14x currently to reflect this perceived slowdown in earnings growth.

U.S. approaching full employment. By any metric, the U.S. unemployment rate has reached its structural low, with the official U3[1] rate dropping to 3.7% in November 2018. The argument presented by bearish market participants is simple: if it cannot go lower, then it must go higher. It's hard to disagree with this high-level assumption, but as we argued in our December monthly commentary, the timing and magnitude of a long-rumoured U.S. recession will determine the course of equity prices. At this point, we do not see any other convincing indicators to suggest a recession is imminent and thus we believe the strong employment levels in the U.S. will provide for additional profit growth and share price increases for some time to come.

Figure 1: U.S. Unemployment Rates by unemployment measure suggest the U.S. is at full employment

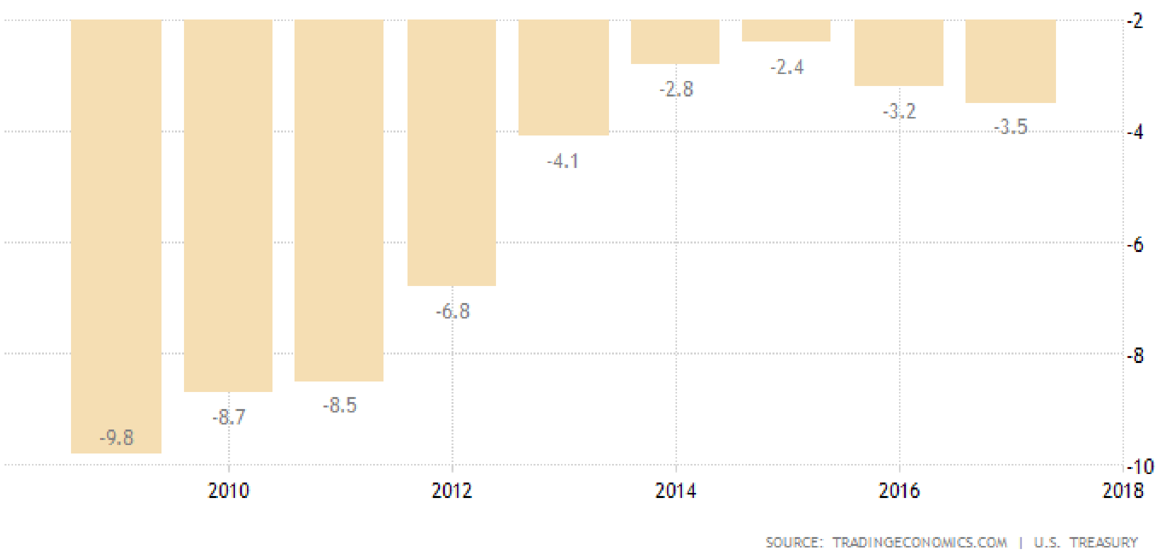


Source: Macrotrends

[1] *Definitions U-3 = official unemployment rate; U-5 = includes discouraged workers; U-6 = includes part-time workers looking for full time work.*

Stimulus provided by U.S. deficit a market tailwind for now. The U.S. typically runs a budget deficit, which proves beneficial given that the inherent strength of the U.S. dollar (as the reserve currency globally) creates positive borrowing conditions. Normally the budget deficit shrinks to levels approaching a balance during times of prosperity given a higher tax base and lower requirements for stimulus as witnessed from 2009 to 2016 as the US economy recovered from the great recession. However, in part due to the massive tax cuts implemented last year by the Trump Administration, the deficit increased by 140 basis points to -3.9% of GDP in 2018 from its 2016 post-recession low. This additional liquidity is helpful to the economy in the short term, but there is a growing risk that GDP growth may not be sufficient to sustain current deficit levels. Given that interest rates are likely to rise over time, the U.S. debt/deficit may take on more importance this decade.

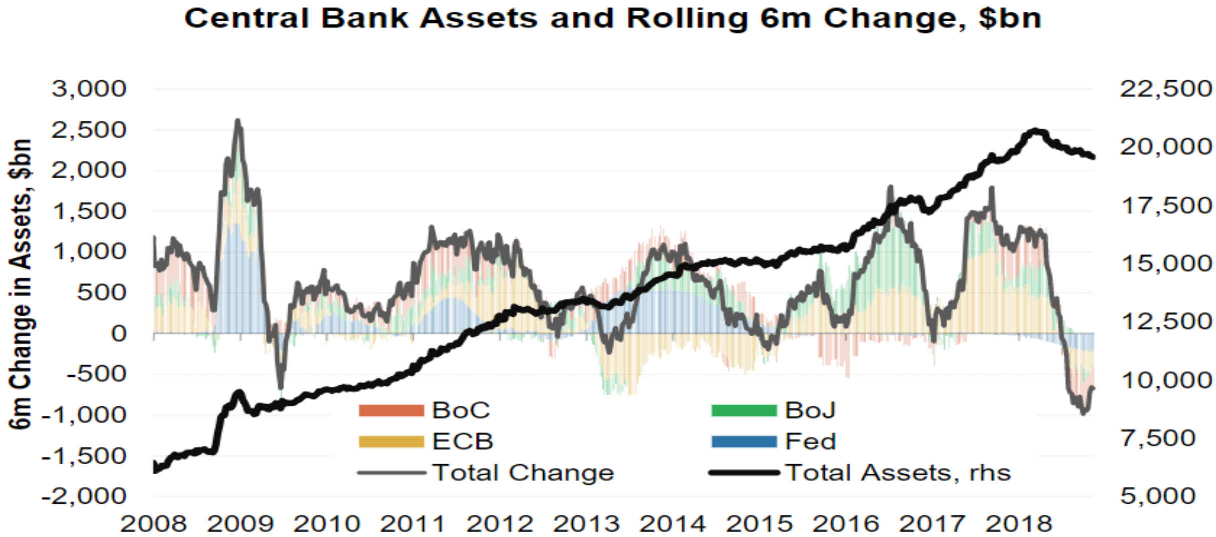
Figure 2: U.S. Budget Deficit has increased during the Trump Administration despite strong economy



Source: Trading Economics

Central Bank Tightening reducing liquidity by selling bong holdings. In the wake of the 2009 financial crisis, the Central banks around the world committed to maintaining ample liquidity and low interest rates by purchasing government bonds, thereby pumping new money into the economy and lowering interest rates. This practice started to wind down and reverse in 2018, removing the excess liquidity and at a time when interest rate hikes were already straining liquidity. Recently, the tone out of the Federal Reserve has softened with regard to future rate hike expectations. However, we are still in unchartered territory with such a large roll-off of assets from the Federal Reserve's balance sheet in the works.

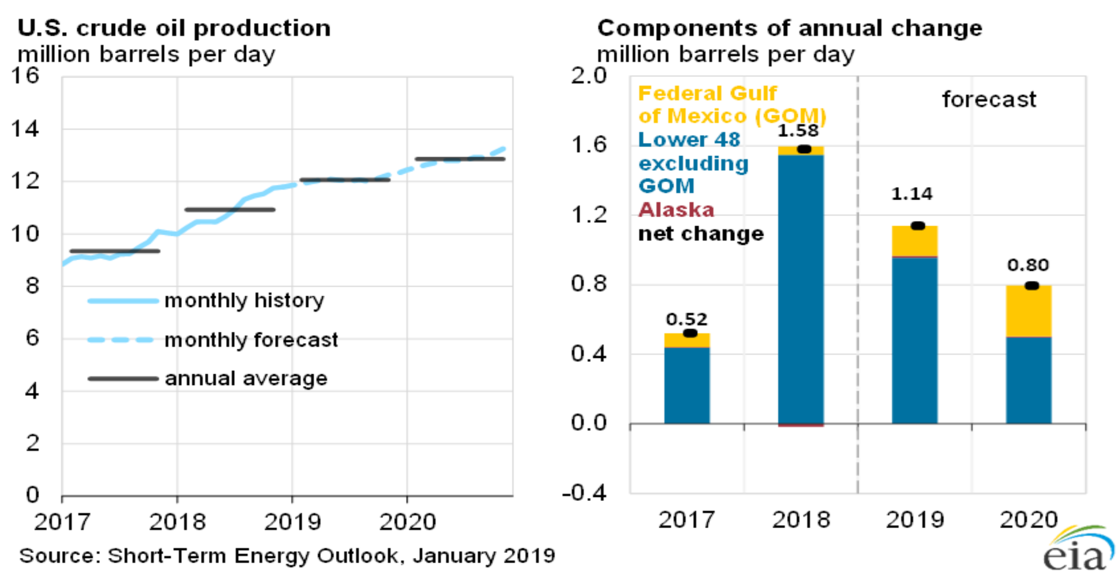
Figure 3: Globally, Central Banks are reducing their assets, known as quantitative tightening



Source: JPMorgan

Oil prices will remain rangebound. At Murray Wealth Group, our funds have limited exposure to energy companies. While global demand continues to increase by about 1 million barrels per day every year, global supply has easily kept pace. The U.S. shale revolution has provided bountiful new supply at prices well below the global marginal cost. Figure 4 below highlights ~2 million barrels per day of new supply, which should satisfy growth in global demand (new growth projects in the rest of world will balance declines from countries such as Venezuela). Without a catalyst to accelerate global demand, we believe that long-term investment returns in the energy sector will be underwhelming as oil prices trade between US$45-$60 per barrel.

Figure 4: U.S. Shale production is still growing rapidly and should satisfy global demand growth



Canadian Dollar weakness should persist through 2019. We do not forecast a meaningful appreciation in the Canadian dollar relative to the U.S. dollar given that the disparity in key drivers of capital flows all tilt in favour of the U.S. We believe the Canadian dollar will trade in a range of US$0.72-0.78 (currently US$0.755). The major criteria we consider in this forecast are set out below:

- Oil prices remain low and foreign investment has been exiting the Canadian energy sector.
- Interest Rates remain higher in the U.S.
- Canadian housing has peaked and, combined with a slowdown of demand from Chinese buyers, should see its contribution to GDP growth shrink
- Business investment conditions in the U.S. (regulations, tax rates) are increasingly more favourable relative to Canada

Figure 5: The loonie will likely remain weak and trade around its current level of US$0.75

Source: Refinitiv

Our core investment thesis remains intact:

- The U.S. economy and consumer are strong
- Internet-based technology will continue to take share of the global economy from traditional businesses where possible
- Inflation, and hence interest rates, will remain subdued due to the deflationary effect of technology
- Natural resource prices will remain low due to the absence of a major source of new demand and a plethora of supply
- The Canadian dollar will continue to exhibit weakness versus the United States dollar
- Health care needs and expenditures will continue to grow globally

Global Growth Fund

Focus sectors. Not only has our investment stance not shifted from 2018, but we positioned ourselves slightly more aggressively following the 4th quarter 2018 selloff. We have added higher growth retailers Nike, Aritzia and Spin Master on weakness while selling consumer staples such as Mondelez (confectionary), Alimentation Couche-Tard (Circle K) and Restaurant Brands (Tim Hortons/Burger King). Consumer Discretionary is one of our favourite sectors, with a 28.7% weighting in our Global Growth Portfolio.

Information Technology is our second largest sector, with a weighting of 27.1%. We expect that we will see continued strong growth rates out of internet companies like Google, Amazon, Facebook and Microsoft. The thesis is fairly simple; these companies trade at reasonable multiples, generate billions of dollars of cash flow and are growing revenue at 20% per annum. We believe the growth runway is long and expect share prices to grow roughly in line with revenues.

Health care is our third largest weighting at 19%. We own firms engaged in the development of drugs, biotechnology assets and medical technology. An early success is a takeover proposal for Celgene, our third largest holding in the fund (at the time), by Bristol-Meyers Squibb. We will continue to monitor the sector for opportunities to rotate into attractively priced companies as we did in 2018, when we sold Pfizer and Medtronic (at higher than current prices) and purchased Teleflex, Boston Scientific and Eli Lilly (at this writing, we are in a net gain on all three).

Financials are our last major sub-group, with a 10% weighting. We believe the shares of North American financial companies are attractively valued given the strong economy and excellent financial health of the industry. Although there is a lack of visible catalysts to compel a re-rating of the sector, low expectations for the group could provide an opportunity for positive surprises and outperformance.

Income Growth Fund

Focus sectors. Given the relative tax advantages of Canadian dividends, we will continue to hold approximately 80% of the Fund in Canadian Securities. In contrast to the Global Growth Fund, which uses a sector and stock selection approach focused on growth, our security selection in this Fund focuses on finding high yielding companies that should be able to sustain and grow their dividends.

Within the Fund, we hold a 44% weighting in shares of financial companies. This includes Bank of Nova Scotia, TD Bank and Royal Bank as well as companies such as Power Financial, IGM Financial, Blackstone Group and REITs with niche positions in attractive markets. We expect to maintain a large weighting in financial shares (likely between 40-50%) based on the strength of the Canadian Financial system and the attractive yields available in the market.

The remainder of the portfolio is spread across individual equities that we have identified and evaluated through bottom-up analysis focused on dividend security and growth. Given our bullish economic outlook, we have found opportunities in less defensive stocks, where we are compensated with higher yields than available in more traditional dividend stocks like utilities and telecom. We will briefly discuss our top 3 non-financial holdings (at December 31, 2018).

- **Enbridge Inc (6.2% weighting, 6.25% dividend yield).** We recently increased our weighting in Enbridge Inc. following its acquisition of Enbridge Income Fund and purchased additional shares in November 2018 when the shares were yielding over 7%. The company has restructured its businesses, providing better visibility on financing its growth projects, and expects 10% annual dividend growth through 2020 and 5% thereafter.
- **Capital Power (5.2% weighting, 6.27% dividend yield).** Capital Power has been a core holding in the Fund since Q4/17. The company has guided to 7% annual dividend increases through 2021 and maintains a conservative 45-55% payout ratio. The power producer continues to increase its percentage of contracted power generation, which yields a lower risk cash flow that provides more stability in its income stream to fund dividends.
- **AT&T Inc. (4.9% weighting, 6.68% dividend yield).** AT&T had several missteps in 2018 that led to weaker-than-expected financial results. This, when combined with the overhang that followed the large acquisition of Time Warner in June 2018, led to poor share price performance. The dividend remains safe at current levels of spending, and the shares could rebound if the company can improve its operating results and complete the sale of non-core assets to reduce debt. The company will also launch its streaming service in late 2019, featuring shows from HBO and TBS, and will likely benefit from increased wireless data demand as 5G cellular technology rolls out over the next decade.