MURRAY WEALTH GROUP

Equity Market Commentary

January Thoughts: Are we buying the dip again?

A popular term and trading strategy the last ten years during this great bull market has been 'Buy the Dip'. What traders picked up on is that during every market sell-off (regardless of the concern leading to the decline) a flood of liquidity from Central Banks and the rebounding global economy would overwhelm any disruptive force and send the market higher. The October 2018 selloff was the second instance (late 2015 being the first) where the market made a lower low after an initial sharp sell-off. At that point, the thinking was that rising interest rates, Chinese growth concerns and debt-laden companies were going to crush earnings and push the economy into a recession. Buying the Dip in October was not the correct call.

Fast forward to 2019. The U.S. equity market is up 15% from its lows, benchmark interest rates have settled at 2.7% after peaking in November at 3.25% and the volatility index is back in the teens. Halfway through earnings season, it appears conditions for additional market rallies are re-forming.

The Chinese economy remains a concern, and we have seen technology hardware companies with large exposure to China (Apple, for example) cut their sales forecasts on weakening Chinese demand. Encouragingly, many affected companies have seen share prices rally after announcing their results, even if they reduced earnings guidance, as the market is starting to believe that the worst-case scenario is baked into share prices.

So if we concede that profit growth is slowing and could decelerate further, then why do we remain optimistic? Equities are priced off multiples to their earnings, which in turn are based off growth and discount rates. Discount rates are based on the expected rate of return of an asset class and move up/down with interest rates or the perceived risk of the investment. Thus, as interest rates have fallen from November highs, and the Federal Reserve has backed off its planned hikes, we should assume a lower discount rate and hence a higher multiple for equities.

Of course, further interest rate increases would negate our thesis. Interest rates are impacted by inflation expectations. U.S. inflation has risen at just 1.8% annually since 2010, underperforming the Federal Reserve target of 2%. Moreover, inflation has remained below target during a period of decreasing unemployment (the unemployment rate went from 9% to below 4%). As employment peaks and wages remain stagnant, deflationary pressures from technology and demographics are winning the war. It is likely that inflation remains subdued, and hence interest rates have little reason to move higher, with the Fed on the sidelines for now.

An article on the Sure Dividend website examines what P/E ratio is fair for the market given the low interest rate environment. At the time of writing in Summer of 2018, the U.S. 10-year yield was 2.8%, slightly higher than today. Considering trailing 1 year and average 10 year P/E ratios, the analysis concluded that P/E ratios should be higher than the current 18x trailing multiple and closer to 24-25x. We agree that multiples should expand, and as the market gains comfort with 2019 earnings estimates, believe that Buy the Dip will once again be the right course of action.

January 2018

MWG Scoreboard

	Close	YTD	1 year
TSX Comp.	15541	8.5%	-2.6%
S&P 500	2704	7.9%	-4.2%
NASDAQ	7282	9.7%	-1.8%
MSCI World	491	7.8%	-9.3%
Volatility	16.57	-34.8%	22.4%
CAD/USD	$0.76	3.9%	-6.2%
WTI	55.26	21.7%	-16.9%
Gold	1319.7	3.2%	-1.4%

Interest Rates (absolute levels)

	Jan19	Dec18	Jan18
Canada 2 yr	1.84%	1.86%	1.86%
Canada 10 yr	1.88%	1.97%	2.29%
U.S. 2 yr	2.46%	2.50%	2.15%
U.S. 10 yr	2.64%	2.69%	2.72%

MWG Portfolio Returns	YTD	1 year
Global Grwth	8.78%	6.11%
Income Grwth	8.43%	0.78%

Global Equity Growth Fund

Target Weighting Changes

↑ STZ.N

↓

Additions/Deletions

\+ TPR.N

− DLTR.N

In the fourth quarter, we increased our equity beta (exposure) by purchasing higher growth stocks that had sold off more than the market. In so doing, we believed we were adequately positioned for a market rally in January. The Global Equity Growth Fund returned 8.8% in January, boosted by strong performance from some 2018 underperformers: Celgene (+38% on a takeout offer from Bristol Meyers Squibb), Facebook (+27%, blowout earnings), NFLX (+27%, Birdbox/N.A. price increase) and Royal Caribbean (+23%, great earnings). Only one position was negative in the month, drug maker Astra-Zeneca (-3%), as executive departures weighed on the shares.

During the quarter, we re-initiated a 2% position in Tapestry, the luxury handbag maker. Tapestry's brands include Coach, Kate Spade and Stuart Weitzman. We originally traded the shares from US$42 to US$51 in 2017/18 and re-entered the name at US$36.45. We think the shares can trade back up to the US$50 range with strong execution, including a turnaround in the Coach brand and improving margins out of the recently acquired Kate Spade brand.

We also raised our weighting in Constellation Brands to 4% (from 3%) as the market punished the shares for a small operational hiccup and making a large investment in cannabis leader Canopy Growth. We believe it will take years to judge the merits of the investment (global legalization of cannabis and acceptance of cannabis beverages are key milestones) but currently Constellation is up 25% on paper.

We sold our position in Dollar Tree as the shares rallied on renewed optimism that the company will transact on its underperforming Family Dollar store line. While there is upside in the stock with better execution, Dollar Tree has had several strategic missteps in the past couple of years and an entrenched management team that has resisted change. We believe the two stocks discussed above will prove to be better investments.

Income Growth Fund

Target Weighting Changes

↑ PWF.TO, EIF.TO

↓ DR.TO

Additions/Deletions

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The Income Growth Fund returned 8.4% in January, reversing its 2018 loss. We suspect many names in the fund were sold for tax-loss purposes in late 2018. Top performers in the month were Chorus Aviation (+26%, extension of Air Canada contract), High Arctic (+20%, oil price rebound), Corus Entertainment (+17%, strong financial results) and Intertape Polymer (+16%, improving industry conditions). Four positions were negative in the month, most notably, a 13% decline in Qualcomm on semiconductor concerns and ongoing legal/patent disputes. Drug maker Astra-Zeneca (-3%), Cardinal Energy (-2%) and Evertz Technology (-0.1%) were also negative.

During the quarter, we increased our weighting in Power Financial to 4% on account of its discount to Net Asset Value (Power Financial owns shares in Great West Life Insurance and Investors Group) which led to a higher dividend yield versus owning Great West Life shares and Investors Group shares separately. We also increased our position in Exchange Income Fund as its 7.5% dividend is attractive considering the strong company fundamentals.

To fund these purchases, we reduced our weighting in Medical Facilities to 3% as the shares rallied to a 52-week high with no news or change in thesis.