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Financial Conditions Point to a Soft Landing

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September 12, 2019

For the asset management industry, early September is the beginning of a new campaign year. Clients are back from vacation, refreshed and ready to look at their investments, and ready to make "necessary" changes. However, too frequently they tend to take what has been working and extrapolate those returns into the future.

For much of the past 18 months, I have been writing about the characteristics of late-cycle markets. Indeed, I was talking about a potential inversion of the yield curve in 2019. (It came faster than I expected.) In terms of portfolio construction, I was suggesting you get back to at least your neutral asset mix. In the fixed-income portfolio, the time was coming when you should eliminate floating-rate investments, and in the rates portfolio (i.e., government bonds) you should consider moving from short-duration to long-duration bonds. My August 15, 2018 commentary included this specific recommendation: "I would be a seller of high-yield and floating-rate debt and a buyer of longer-dated government bonds. In a world with rising macro confusion and tightening monetary policy, I find it unlikely that we are going to have a material spike in safe-haven yields."

I was probably early on the high-yield call, but any opportunity cost was more than offset by the collapse in long-term bond yields in 2019. The rest of the article dealt with the risks inherent in high-valuation popular stocks. The concluding comments on equities were: "Remember, the sectors that have been the leaders are large sectors that absorbed billions of dollars in inflows. The defensive sectors are much smaller sectors, both individually and in aggregate. They are more easily moved by much smaller flows. Portfolios that had excess exposure to the narrow group of winners will be showing greater-than-market volatility and greater-than-market losses. This process can go on for a long time. There is an old stock market saying: 'Selling begets selling.' In my view, we are early in this corrective process. Defence wins championships."

Since August 15, 2018, the S&P 500 Index has made new highs in September 2018 and April and July of 2019, and we experienced a baby bear market in the fourth quarter of 2018. Overall, the index is up less than 6%, and the markets have experienced a lot of volatility. If you invested defensively, you had great results.

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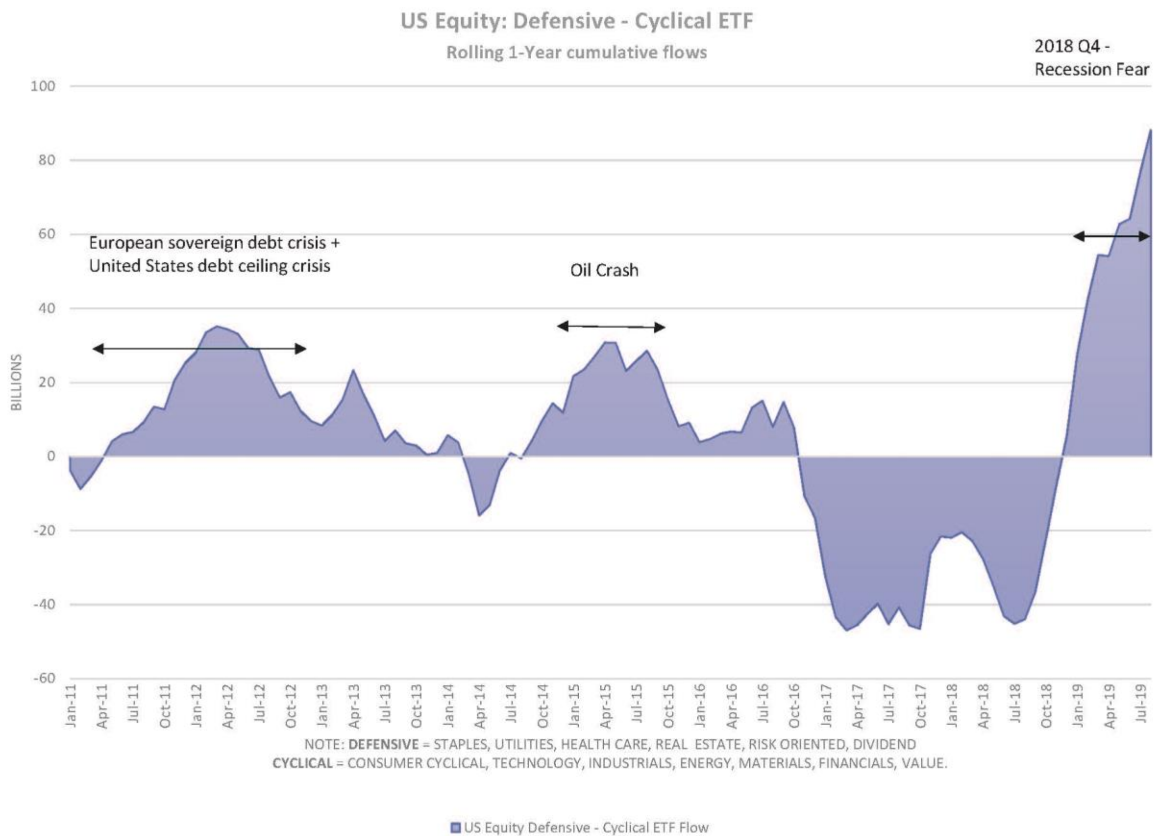
One of the great side benefits of exchange-traded funds (ETFs) is we can track where the money is flowing with a great deal of accuracy. It's a bit like Facebook; you may think you're invisible, but the data aggregators know exactly what you are doing. Bloomberg and Morningstar are the market's Facebook.

The flow data that we can get from ETFs enables us to know how crowded a trade is. And when you contrast flows for different key factors (so-called smart beta), you can tell/hope much of the crowd has rushed to one area of the market. The chart below looks at flows into defensive ETFs, including dividend and low-volatility ETFs (noted as "risk oriented" in the chart's legend) and subtracts the flows into cyclical ETFs, including value ETFs. When investors are afraid they rush to the safe side of the market, and when they are optimistic they rush to the cyclical side. The rush to safety over the past year has been extreme. The ferry boat is listing badly. Will it sink?



Source: Morningstar Research Inc., CI Investments Inc. As at August 31, 2019

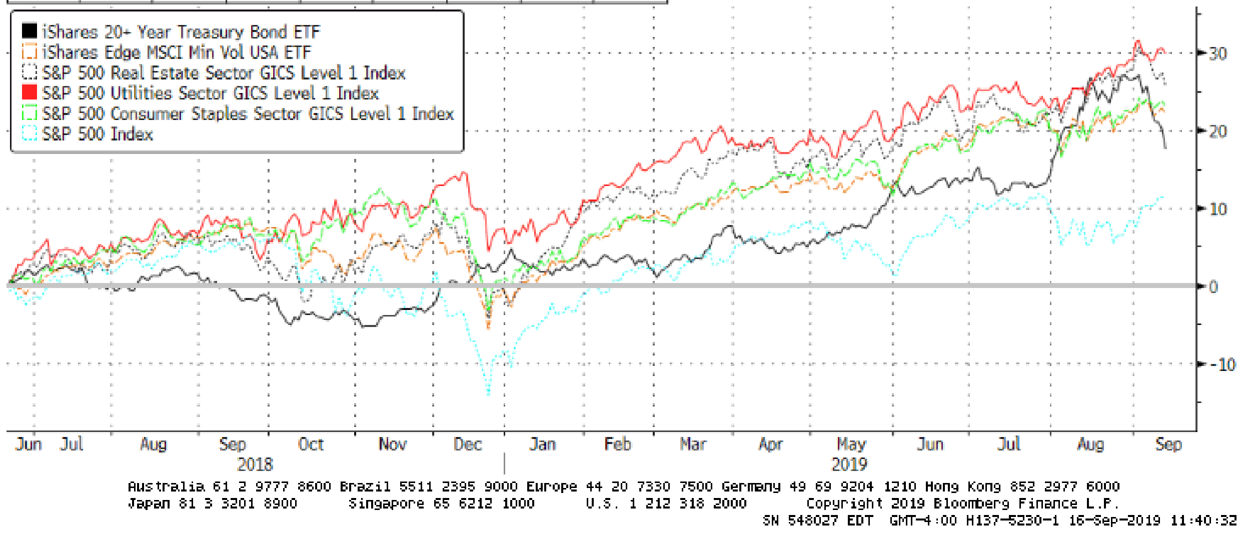
Over the past few days, the S&P 500 Index has been trying to break out of a trading range; the surface of the market seems calm but underneath the surface there are rip tides.

Broker dealers love to provide baskets of securities for their clients to trade. Most of the baskets are geared to exploit various factors. Morgan Stanley has a popular US Momentum Long Basket that takes the top 15% of the Russell 3000 Index based on a 12-month return, rebalanced monthly. On September 9, 2019, the S&P 500 Index declined approximately 25 basis points (bps). The US Momentum Long Basket declined 3.3% and was down a further 5% the morning of September 10. The safe sectors that are disproportionately included in this basket are health care (13.71%), consumer staples (9.70%) and real estate (6.3%).

Morgan Stanley also has a US Momentum Short Basket. Its largest representation is in energy sector at 25.65%. The US Momentum Short Basket was down 3.3% on September 9 and up over 6% in early trading on September 10! Of course, being run by New Yorkers, Morgan Stanley packages the two baskets together; long the US Momentum Long Basket and short the US Momentum Short Basket. The packaged product is the MSCI USA Momentum Index (MSZZMOMO Index on Bloomberg). This index peaked at 160.58 on August 27, 2019 and was (as 133.23 (at September 10, 2019), down 17%. Below is a screen shot of the three days of trading between September 6 and 10, 2019.

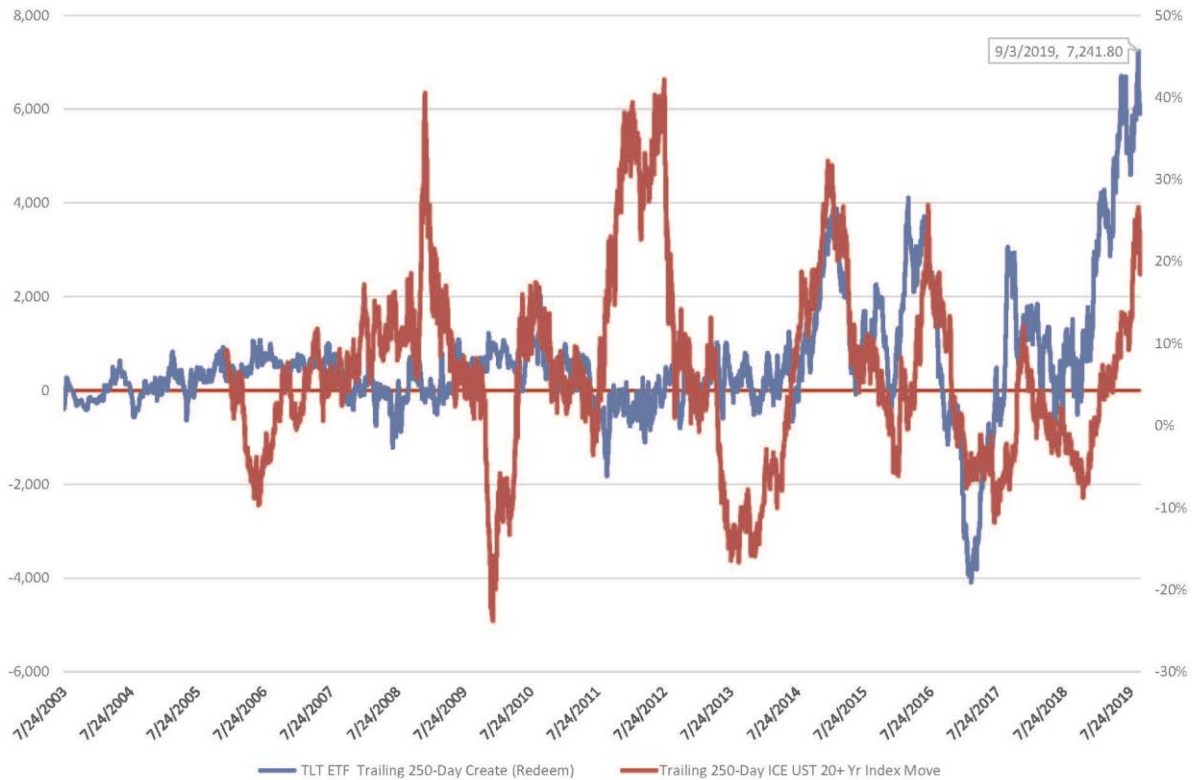
Cross currents are dangerous when your longs are crashing and your shorts are ripping.

The iShares 20+ Year Treasury Bond ETF (ticker symbol TLT) is a great proxy to follow for money into and out of duration, just as iShares Edge MSCI Min Vol USA ETF (ticker symbol USMV) and Invesco S&P 500 Low Volatility ETF are proxies for money flows into and out of "safe factors." The flows into these entities over the past 15 months have been exceptional, as has their performance, until the week of September 9.



	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	TLT US Equity	USD	13.87%	17.63%	-4.60%	14.08%
2)	USMV US Equity	USD	19.15%	22.23%	--	17.68%
3)	S5RLST Index	USD	20.78%	25.85%	3.62%	20.50%
4)	S5UTIL Index	USD	24.47%	29.82%	7.59%	23.57%
5)	S5CONS Index	USD	18.48%	23.02%	.79%	18.30%
6)	SPX Index	USD	8.68%	11.42%	-10.81%	9.17%

You can see in the TLT chart below that the flows into the ETF have become tightly correlated with the performance of the underlying index. After an over 25% positive move in the index over the past 250 trading days, it is likely time to fade from this trade. No harm in taking profits. Does the long bond potentially go to zero? Only in a very deep recession. The risk/reward is too asymmetrical. The most recently issued 30-year Treasury bond (2.25%, maturing August 15, 2049) yielded 2.11% on September 9, 2019. A 50-bp backup in yield to 2.61% is a 10.5% hit to capital. That is almost five years' worth of income.



Sources: Bloomberg Finance L.P. and CI Investments Inc.

As at September 13, 2019

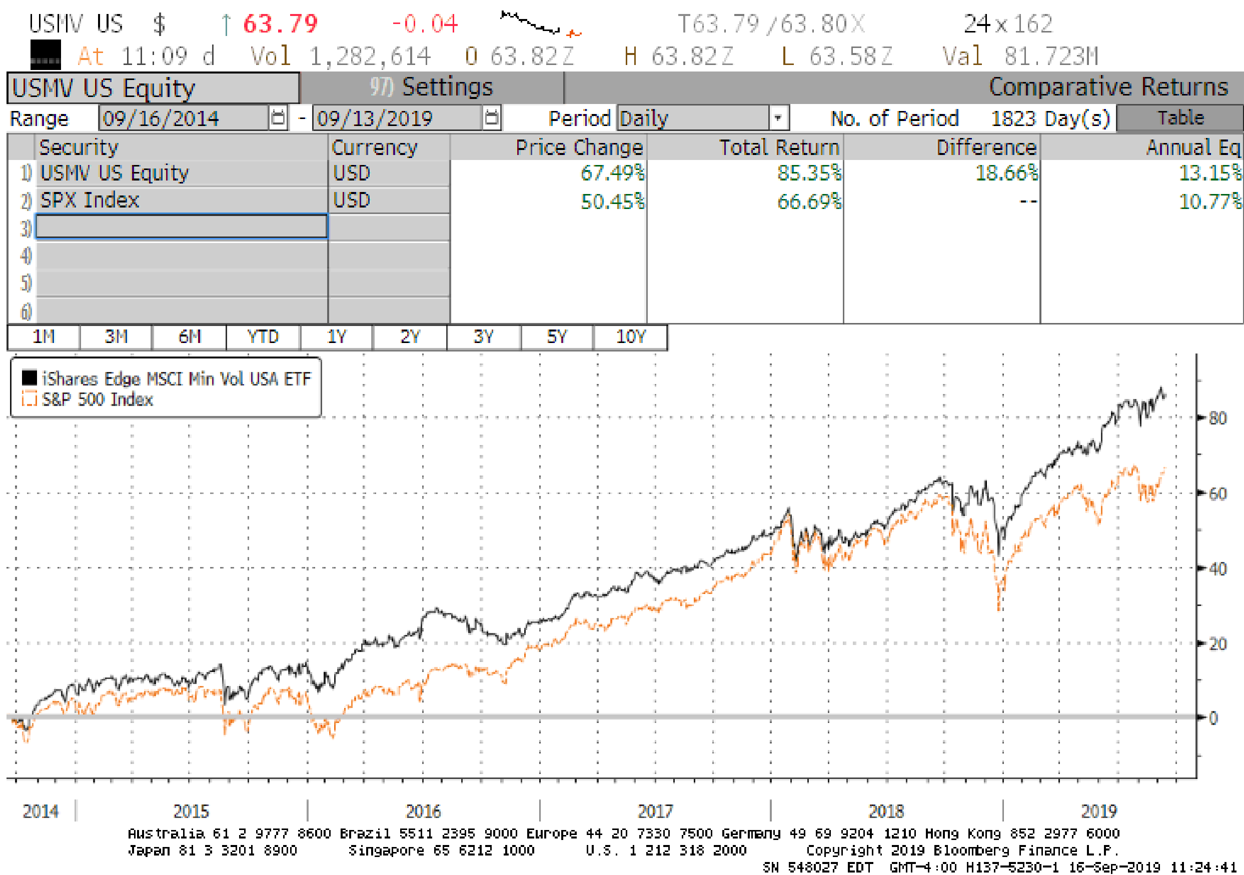
The flows into "defensive/safe" equities are even more extreme, as shown in the chart below, which shows trailing 250-day flows into the two largest low-volatility ETFs. The correlation with the underlying index for the larger of the two funds, USMV, and its underlying index is not as extreme as the long-bond correlation.

iShares Edge MSCI Minimum Volatility USA & Invesco S&P 500 Low Volatility ETFs
Trailing 250 day net inflow/outflow

As at September 13, 2019

Sources: Bloomberg Finance L.P. and CI Investments Inc.

Where the flow impact for low volatility shows up is in relative performance. The next chart compares the total return of USMV with the S&P 500 Index.



When the spread between USMV (the black line) and the S&P 500 Index (the red line) is widening, low volatility is outperforming the broad market (mid-2015 to mid-2016 is when flows into low volatility peaked). When the lines are converging, low volatility is underperforming (mid-2016 to early 2018 as the strategy fell out of fashion). Since the bear market in late 2018 the outperformance of low volatility and defensive strategies is as extreme as it has ever been. This is likely unsustainable, I'd begin to fade the trade. These are slow-growth defensive industry sectors that are no longer inexpensive. Indeed, they are expensive relative to their growth characteristics.

The following table looks at some current valuation metrics for the sectors that comprise the S&P 500. The sectors that are core to most low volatility and defensive strategies are Consumer Staples, Health Care, Real Estate and Utilities. The data compares current valuations to the

average over the past decade. It also provides earnings growth over the past five years. Generally faster growing earnings streams are deemed to be more valuable.

S&P 500 Index sector valuation comparison

Sector	Index Weight	PE	PE as % of 10 Yr avg PE	Dividend Yield	Dividend yield as % of 10 Yr avg Yld	Return on Equity	Return on Equity as % of 10 Yr avg ROE	Earnings growth over 5 years
InfoTech	22.03	23.15	121.2%	1.25	106.0%	22.29	150.0%	74.1%
Health Care	13.62	21.08	105.0%	1.55	97.4%	15.22	106.7%	65.1%
Financials	12.98	17.44	84.2%	1.61	119.5%	8.48	145.5%	62.2%
Communications Services	10.51	14.28	128.1%	5.43	28.2%	16.85	102.6%	-22.6%
Consumer Discretionary	10.27	21.80	119.9%	1.42	82.2%	20.98	138.3%	48.2%
Industrials	9.26	21.19	102.8%	2.02	93.7%	20.11	114.0%	42.1%
Consumer Staples	7.52	21.02	114.5%	2.92	96.2%	27.24	96.7%	21.0%
Energy	4.54	38.95	62.1%	3.42	148.1%	1.80	102.7%	-37.9%
Utilities	3.40	19.49	131.0%	3.30	82.2%	6.24	102.8%	14.7%
Real Estate*	3.22	45.66	114.2%	3.28	85.4%	10.00	107.3%	17.8%
Materials	2.66	23.77	86.0%	1.98	101.8%	11.75	62.7%	40.3%

* from September 15, 2016

Sources: Bloomberg Finance L.P. and CI Investments Inc. As at Sept. 9, 2019

The defensive sectors are frequently bundled into factor-driven portfolios (ETFs, mutual funds, baskets), with the most typical being low-volatility and dividend portfolios. Together they comprise approximately 27% of the S&P 500 Index. The cyclical sectors in our flow study – consumer discretionary, information technology, communication services, industrials, energy, materials and financials – comprise approximately 73% of the index. The flows have clearly tilted the boat to the side of the market that has the least natural liquidity. Are they also good value? Where would a natural buyer who is attracted to the growth characteristics of the defensive sectors step in when the "tourists" depart?

I'll pick on utilities. They trade at elevated valuations relative to the past 10 years (post the financial crisis of 2008–09) with the price-earnings ratio (PE) at a 31% premium to the 10-year average. The yield is 17.8% below the 10-year average yield and the return on equity of 6.24% is pathetic, as is earnings growth. The current PE of 19.49 times earnings is essentially the same as the S&P 500 Index's 19.42 times earnings. So, the utilities sector is an overvalued sector, as is real estate and, to a lesser degree, consumer staples.

What would I do now? First the market has not broken out to new highs. There remains structural weakness in the global economy, and the internals of U.S. Institute for Supply Management indices indicate the next two or three months will be tricky. I would not be adding net new money into equities unless you are dollar-cost averaging. I am slowly building my portfolio and recently redeemed a portion of my bond holdings for reasons stated above and added the proceeds plus some of my cash to my North American equity portfolio (i.e., Sentry Canadian Income Fund).

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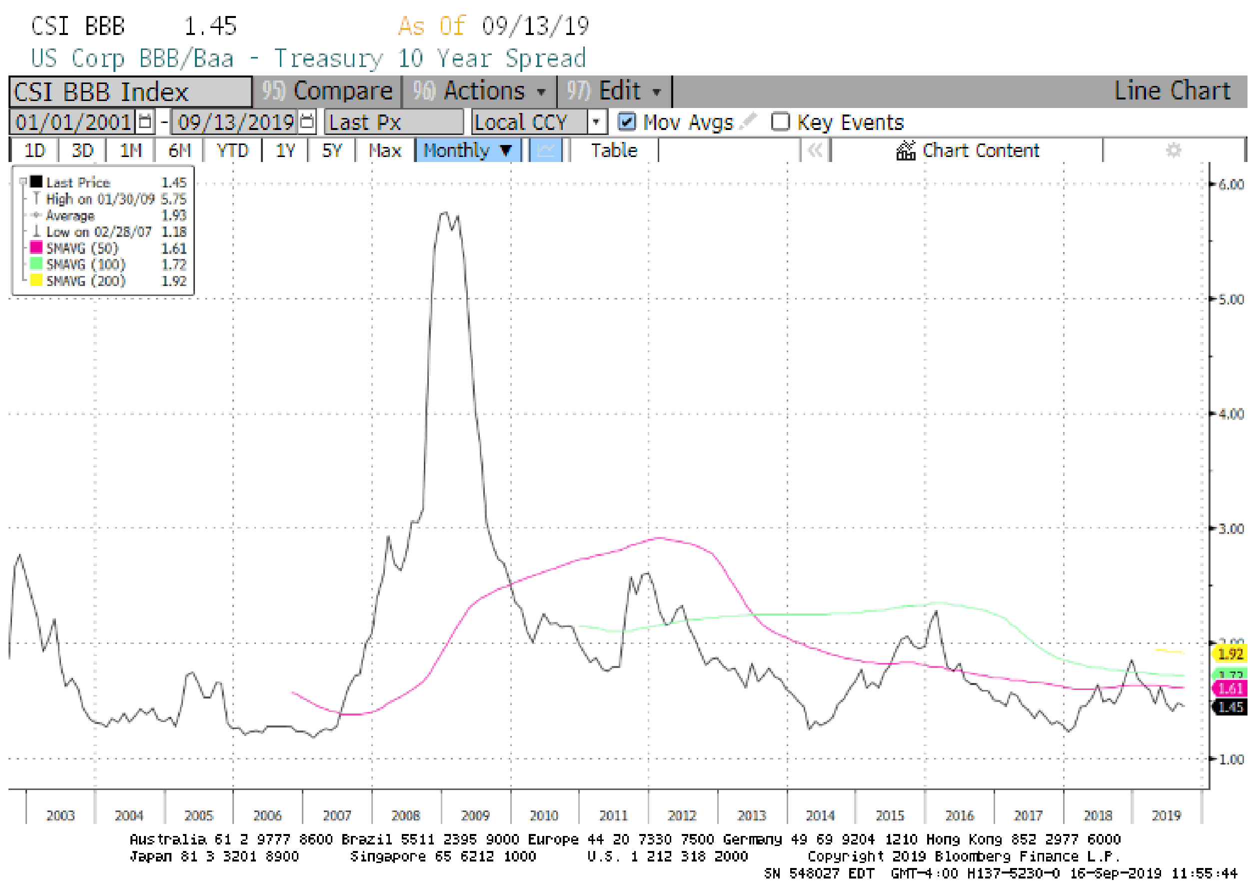
I remain of the view that a recession in North America is unlikely and that the current soft patch in the economy will resolve into a soft landing/earnings recession. Why? Credit spreads are very orderly. Bonds rated BBB are the largest part of the corporate bond market; they are sensitive to corporate fundamentals and the spread begins to widen well before a recession.



High yield has strong equity correlation due to the sensitivity of the issuers to changing economic conditions. High yield spreads always widen into a recession and generally will fall before equity markets rally. They are a very good leading indicator for equity-market direction.

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High yield spreads widened with the stock market sell-offs of May and August of 2019, but have been falling since the second week of August. Credit markets appear to be saying a soft landing for the U.S. economy is in our future, not a recession. The cure for a credit crisis is a long period of stable economic growth. There is zero reason to want a recession at this point. Easy financial conditions should prevail. It's a soft landing.

Sources: Bloomberg Finance L.P., Morningstar Research Inc. and Ci Investments Inc., as at September 12, 2019.

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Published September 19, 2019.