LEE, TURNER & ASSOCIATES INC.
INVESTMENT QUARTERLY

REVIEW July 2019

The second quarter was a good one for the investment markets. Stock markets started off fast and furious. Investors spent April enthusiastically bidding up stock prices as if they were still intoxicated by the impressive performance that stocks had put on over the first quarter. Stock markets advanced strongly; a few global indexes reached new all-time highs including our TSX. Then early in May, the US made good on its threat to impose higher import tariffs on goods originating from China. Of course, China wasted no time reciprocating with similar tariff hikes against its US imports. The specter of a widening and deepening US vs China trade dispute quickly dampened investor enthusiasm and the stock markets retreated. Investors then spent June consolidating their emotions and looking for signs of softening in trade tensions. In the end, investors concluded that optimism should be maintained, and stock markets once again approached record highs. Over the quarter, the Dow Jones Industrials Average edged up 2.6% while the S&P/TSX Composite Index came in with an identical advance. Bond prices strengthened when the Central Bankers softened their tone in reference to their interest rate intentions for the balance of this year. Bond prices climbed across the entire maturity spectrum. The Canadian Bond Index came through with a 2.5% total rate of return.

FORECAST

Even though the North American economic engine was only running at an idle over the past half year or so, it still managed to provide enough torque to drive the economy forward, albeit just slowly. While trade related issues had put the brakes on economic growth over recent months, record low unemployment and contained inflation were able to offset those deleterious effects. Looking further down the road, we see the North American economies maintaining their moderate growth outlook without any danger of stalling. We see the Central Bankers having good enough driving skills to keep their economic vehicles on track. These Bankers have sent out clear messages to investors that while they are currently happy to leave their economies on coast, feet off the brake pedal as well as the accelerator pedal, they are ready to step on the appropriate one at a moment's notice.

The Canadian economy is facing a couple of unique challenges where monetary policy aids would be of little help. A significant portion of our agricultural exports to China has been and will likely continue to be curtailed due to a troubling diplomatic row. Additionally, our energy sector seems quite incapable of escaping the hostile regulatory morass that it has found itself in. Market prices for western Canadian oil production continue to be suppressed due to a lack of transport alternatives. Put together, Canada will likely fail to reach its economic potential for the rest of this year. Whether the other components of our economy can pick up the slack remains to be seen. The Bank of Canada might feel the urge to cut interest rates to stimulate the overall economy to compensate for the growth deficiency, but we would doubt that it will.

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INCOME STRATEGY

Bonds

Both the US and the Canadian bond yield curves have taken on a similarly unusual shape over the past few months. To visualize these yield curves is to picture a saucer viewed from its side, where the two ends are at the same level while the middle sags a little. Looking at the Canadian data plots of its curve, yield versus term to maturity, we see that if we were to invest for either 30 days or 30 years (at either end of the two extremes), we would achieve the same yield of about 1.67%. But, if we were to invest for between 2 to 10 years (the middle of the saucer), we would receive a lower rate of return of just 1.45%. Yes, that is right, short term money parked for 30 days yields as much as bonds committed for 30 years; in other words, there is no added compensation for investors who must wait another 29 years and 11 months for the return of their capital. And if any investor chooses to invest for a medium termed time frame, they will be punished with a lower yield. Indeed, this is a very strange twist to the yield curve. The only explanation to account for this current bond market behavior is that the market must be expecting the Central Bankers to cut their interest rates, the very short termed ones, sometime within the next 2 years. From our perspective, we really do not care about this yield curve anomaly. Given that all bonds have to offer, regardless of where we set our desired term to maturity, is between 1.45% yield and 1.67% yield, we simply cannot satisfy our income needs. We would just avoid bonds altogether.

Income Trusts

Our largest holding in income trusts is the A&W Royalties Income Fund. The operating basis of this fund is simple and straightforward, it receives 3% of gross sales of all A&W restaurants in Canada and then distributes nearly all of it, less minimal management expenses, to its unitholders monthly. Of late, this fund has attracted investor attention given its forward-thinking menu innovations. A&W restaurants were the first in Canada to offer the Beyond Meat burger a year ago, well before the current consumer craze for meatless alternatives. This fund has amply rewarded us with exceptional returns since our initial investment some 17 years ago. Today, we are writing about this fund not so much to promote its meals but to highlight its investment model, a simple and effective means of returning income and delivering capital gains to its investors. To have a direct, reliable and growing stream of income flowing straight from its restaurants' tills into our wallets is precisely why the A&W Royalties Income Fund will remain a core holding for us.

EQUITY STRATEGY

Stock prices overall are essentially unchanged from a year ago while the economy stayed on track and marched ahead comfortably. As prices have remained flat in face of higher reported earnings and dividends, the fundamental valuation metrics for stocks have of course improved. Looking ahead, even as we adjust for an elevated level of trade related economic risks, we are still quite comfortable with the general level of stock prices today. We feel that an over weighted position in the interest sensitive sectors is warranted. On a relative basis, the advantage of stocks' dividend yield over bonds' yield has grown unusually high. Our favoured interest sensitive sectors are the utilities and the banks.

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