Second Quarter 2019

Countdown to Recession Begins

Equity Markets Near All-Time High Despite An Inverted US Yield Curve, Global Manufacturing at a 7 Year Low, Waning US Employment Growth

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PIMG Balanced Growth Model

The model gained 1.2% during the quarter. Performance figures for other periods are in the appendix.

There were no buy or sell transactions during the second quarter of 2019.

PIMG Balanced Income Model

The model gained 0.8% during the quarter. Performance figures for other periods are in the appendix.

There were no buy or sell transactions during the second quarter of 2019.

Quarterly Summary and How We're Positioning for Q3

We were on pause in the second quarter as economic data showed a gradually weaker and weaker global economy. Most notably, the JP Morgan Global Manufacturing PMI fell to 49.4 in June (50 demarcates expansion from contraction), meaning the global manufacturing sector is officially shrinking. This is the lowest level since late 2012, when the European sovereign debt crisis was threatening the resolve of the European Union. Also of note is that according to May and June ADP US Employment surveys, US employment growth experienced the worst back-to-back months since 2010. The labour market data is typically one of the last to turn so this may hint at a sooner than expected recession.

Investors have been betting that the US Federal Reserve will come to the rescue and save equity markets from a downturn. As of the end of the Q2, based on bond market pricing, there is a 100% chance of a US interest rate cut at the July FOMC meeting and investors are currently expecting three interest rate cuts by April 2020. While cutting interest rates directly, as well as indirectly through quantitative easing, boosted investor sentiment and equity market prices earlier in this economic cycle, we believe a market rally due to lower rates is unlikely at this time for three reasons.

Firstly, previous US interest rate cuts in this economic cycle occurred when actual US GDP was well below potential GDP. Now that actual GDP is well above potential GDP, mostly due to full employment in the US economy, we believe cutting interest rates now as "insurance" will lead to malinvestment of capital and make an inevitable economic downturn that much worse (i.e. a recession averted in the short-term for a more severe recession in the medium-term).

Secondly, considering equity market performance and volatility are indirect factors in the US Federal Reserve's assessment of recession risk, we believe the US Federal Reserve is unlikely to cut interest rates with the US equity market at an all-time high unless it is seeing a high risk of recession in the economic data.

Finally, in the post-war era, the US equity market was either already in a bear market or facing a near-term recession every time the US Federal Reserve cut interest rates while the US yield curve was inverted (i.e. the US 10-year bond yield was below the federal funds rate). So unless equity markets fall 20%+ first, it would be unprecedented for a US rate cut to occur now and the economy avoid a recession.

In light of the above, history supports taking a cautious approach to equity markets at the current time. While equity markets have performed well this year, this performance has been driven by defensive stocks in the utilities, consumer staples, health care and real estate sectors while cyclical stocks have largely been left out of the rally. This highlights that we are not the only ones that are growing concerned about the global economic outlook and that investors may be becoming more bearish than headlines about the broad equity markets would suggest.

Our favoured indicator, the US Senior Loan Officer Opinion Survey on Bank Lending Practices, is not yet ringing any alarm bells with the cost of capital falling and loan access improving for most businesses as of the last reading in April. Loan demand has been falling rather consistently over the past few years. This is consistent with an economy that is running out of steam but not necessarily in trouble. We will have a keen eye on the July/August release of the survey to see if the worsening global manufacturing picture as well as the turn in the US labour market has had an effect on bank lending. If US lending activity has worsened as per this survey and the US Federal Reserve cuts its key interest rate, this would be one of the most conclusively negative indicators for equity markets based on the past 70 years of market history.

As we noted in our last commentary, China is one of the few nations that could quickly decide to avert a global recession if it is willing to inject sufficient capital into infrastructure and housing. That said, such a capital injection has previously come with malinvestment and an unsustainable debt buildups in parts of its economy. China did inject capital into infrastructure in early 2019 and its economy experienced a rebound in March and April but this rebound has since waned and China appears hesitant to inject more capital. Chinese stimulus efforts will have a meaningful effect on the world economy either way but that this point it appears Chinese stimulus efforts are insufficient to carry the global economy.

US-China Trade War

During the quarter, the US ratcheted up its tariff campaign increasing its tariff rate from 10% to 25% on the $200 billion in Chinese goods initially tariffed in September 2018. The US also cracked down on Chinese tech companies, Huawei in particular, on national security grounds. Chinese authorities countered with tariffs on $60 billion worth of US goods.

The two sides have since agreed to a “truce” wherein no further tariffs will be applied and agreed to restart active negotiations.

Oil Price Summary

The price of oil was flat from quarter-end to quarter-end, finishing the Q2 at ~US$59 (WTI) versus ~US$60 (WTI) at the end Q1. This hides the significant volatility experienced during the quarter. Oil traded in a range of US$51 to US$67 as the commodity was pulled in different directions due to falling oil demand expectations related to waning global growth, rising investor sentiment due to higher expected monetary stimulus and inflation and supply concerns due to alleged Iranian attacks on tanker ships and US military drones in the Strait of Hormuz.

Model Positioning Heading into Q3

As of June 30, 2019, the asset allocations of the Balanced Growth and the Balanced Income models are 18% cash, 12% fixed income, 9% preferred equity and 61% common equity and 18% cash, 23% fixed income, 17% preferred equity and 42% common equity, respectively.

We remain cautious towards equity markets due to the inversion of the US yield curve and weakening global economic data. We believe it makes sense to maintain meaningful equity market exposure at this time as it remains possible for the economy to rebound from current levels and interest rate cuts be avoided. History tells us that it makes sense to be overweight the defensive stocks but to maintain some cyclical equity exposure (e.g. financials, industrials, technology) as a potential economic rebound would likely benefit cyclical stocks in an outsized way.

If US lending activity worsens markedly as per the US Senior Loan Officer Opinion Survey on Bank Lending Practices and the US Federal Reserve cuts its key interest rate, we would be decisive in taking a much more defensive approach to equity markets, both common and preferred, and boost our allocation to fixed income and/or cash.

As per usual, there are always shorter term opportunities that may exist in equity markets and we may act to participate in these opportunities as they arise. Aside from being on watch for these shorter term opportunities, we remain laser focused on the deteriorating economic picture and watching for what we see as the critical data points and policymaker actions that would warrant a tactical shift in asset allocation.

Sincerely,

Steele Wealth Management

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Appendix

Model	3-mos	6-mos	1-yr	3-yr	Since Inception
Balanced Growth	1.2%	5.2%	-2.5%	4.2%	3.8%
Balanced Income	0.8%	4.0%	-1.0%	3.1%	4.1%

The above performance data is current as June 30, 2019. The returns above incorporate a 1.0% (Balanced Growth) and 1.25% (Balanced Income) annual investment management fee, charged monthly, which is also subject to 13% HST, charged monthly, for a total cost of 1.13% and 1.41% annually, respectively. Inception date for the Balanced Growth model and Balanced Income model is January 15, 2014. Performance figures for periods greater than 1-year are annualized.