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Taking Stock with Steele

Your Monthly Newsletter

The purpose of this newsletter is to share insights and expertise. Our goal is to ensure that our clients are well informed of changes affecting local business decisions and our investment recommendations. We believe Knowledge Pays and we want our knowledge to help pay for you.

PORTFOLIO DE-RISKING CYCLICALS AND DEFENSIVES? WHAT ARE THEY?

There are two major categorizations of stocks. Cyclicals, whose returns and risk are driven by the strength and length of the economic/business cycle, and defensives, whose returns are less impacted by the ebbs and flows of the economic/business cycle. One could expect cyclicals as a group to perform very well during an economic expansion and not very well during economic recession. Alternately, one could expect defensives as a group to perform worse than average during economic expansion and better than average during economic recession.

What Makes a Stock Defensive and/or Cyclical?

There are various ways to determine whether a stock is and will act like a cyclical or defensive going forward.

First is the stock's ***sector***. Investors generally talk about cyclicals and defensives as sectors. For example, the utilities, health care, telecom and consumer staples sectors are seen as defensive sectors as revenues and earnings in these sectors are somewhat stable while the industrials, technology, materials, financials, energy and consumer discretionary sectors are seen as cyclical sectors as revenues vary based on consumer spending and business investment. That said, a stock's sector classification is not enough, as subsectors exist. Cannabis stocks are classified as "Health Care" and it is doubtful they will provide defensive characteristics in an economic downturn.

Second is the stock's ***correlation to the broad equity market, or "beta"***. A beta of less than 1 signifies that stock has acted defensively in the past while a beta of more than 1 signifies it has acted like a cyclical in the past. While past trading behaviour does not guarantee how a stock will act in future, it is a good indicator. A key factor that is potentially not captured by a stock's beta is…

The stock's ***financial risk***. A stock's sector does not necessarily dictate whether it is a defensive or cyclical stock. Stocks with excessive debt obligations or other liabilities are sensitive to economic/credit conditions irrespective of their sector. This is especially true for companies that have used bridge financing for an acquisition. Pinpointing what level of debt is "excessive" is difficult, even for professional investors, but it is likely the most important factor in determining a stock's cyclicality.

How Do We Use Defensives and Cyclicals When Managing a Portfolio?

It should be obvious that we want to own cyclicals when our equity market outlook is positive and defensives when our equity market outlook is negative. Maintaining a balance during most periods makes sense to limit portfolio volatility but leaning one way or the other makes sense depending on market outlook.

Current Rates & Data

Govt of Canada

90 day	1.65%
1 year	1.65%
2 year	1.60%
5 year	1.54%
10 year	1.65%
30 year	1.97%

U.S. Treasury

90 day	2.45%
1 year	2.50%
2 year	2.40%
5 year	2.32%
10 year	2.53%
30 year	2.97%

Canada Prime Rate

3.95%

U.S. Prime Rate

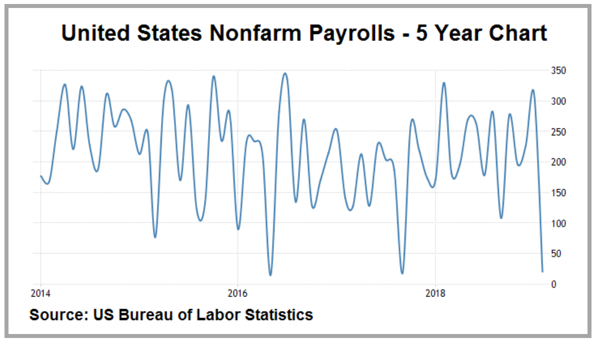
5.50%

Exchange Rates

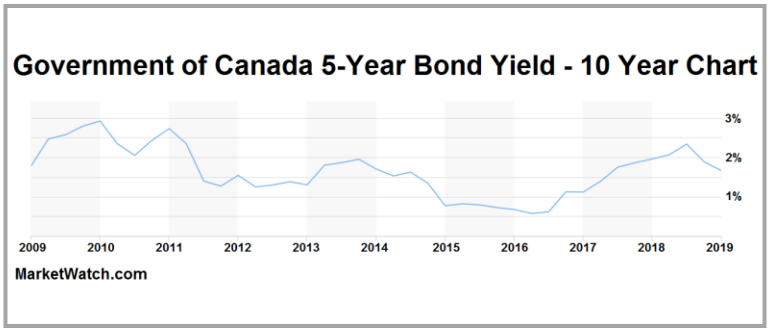
CAD/USD	0.748
USD/EUR	1.137
JPY/USD	110.9

ECONOMIC TIDBITS FEBRUARY US JOBS NUMBERS MISS BIG TIME & BANK OF CANADA AND ECB DOWNSHIFT

- US nonfarm payrolls increased only by 20,000 in February, below expectations of 180,000. While the number was a disappointment, this is the third time nonfarm payrolls missed expectations to this degree – in early 2016 amidst the energy market downturn and in mid-2017. The decline may be related to the US government shutdown and would only be seen as indicative if weak employment growth continued.



- The Bank of Canada offered up a worse than expected economic outlook in March, contradicting a lot of economic data and stoking fears that the economy was in worse shape than investors think. The European Central Bank followed soon after, lowering growth expectations and announcing further stimulus starting in late 2019. Central bank pivots are often the most telling economic signals.



LE JIT A "JUST-IN-TIME" RUNDOWN OF OUR CURRENT INVESTMENT THEME

It May Be a Good Time to Own Low Volatility and Defensive Stocks As Global Growth Slows

- **BMO Low Vol US Equity ETF (ZLU/ZLH)** and **BMO Global Consumer Staples ETF (STPL)** fit this theme.
- **ZLU (USD Version)** and **ZLH (CAD Hedged Version)** are designed to provide exposure to a low beta weighted portfolio of US stocks. They use a rules based methodology meaning they incorporate rankings based on volatility and sector weighting. These ETFs have high weightings in the utilities, consumer staples, consumer discretionary and health care sectors and are a good counterbalance to Canadian financials, energy and other cyclical exposure. ZLH should perform well toward the end of a current economic/market cycle and its ~0.5 beta means it could experience about half of equity market downside during an equity market decline. These ETFs have reasonable MERs of 0.33%.
- **STPL (CAD Hedged)** seeks to mimic the performance of the Russell Developed Large Cap Consumer Staples Capped 100% Hedged to CAD Index. This ETF provides exposure to a diversified basket of global consumer staples companies, a sector that is otherwise difficult for Canadian investors to access without accepting US dollar currency exposure. STPL should perform well toward the end of a current economic/market cycle and its ~0.6 beta means it could experience just over half of equity market downside during an equity market decline. This ETF has a reasonable MER of 0.41%.

  Key risk points: The historical beta of these ETFs may not reflect future volatility or correlation to the broad equity market. A selloff, major or minor, could be focused on the low volatility sectors in future.

JEANNINE'S TIP O' THE MONTH New Addition to the Steele Wealth Management Team!

Steele Wealth Management welcomes Elizabeth Kernohan to our team.

Elizabeth has been a practicing tax and estate planning consultant for more than thirty years. She holds an Honours Bachelor of Mathematics degree from the University of Waterloo.

She will be providing technical support in a number of areas to enhance our client service.

This newsletter has been brought to you by Steele Wealth Management

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