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Seizing opportunities

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Over the first quarter of 2019, global economies continued to slow, Brexit and U.S.-China trade remained uncertain, but the key theme was the pivot in U.S. Federal Reserve policy. Expectations went from rate hike to rate cut within a month, one of the most dramatic changes in the Fed's history, and all asset classes rallied during the first quarter as a result. While corporate earnings are expected to decline, equity price-earnings ratios, which are a measure of investors' willingness to pay for future earnings, has increased to support this rally. In fixed income, even though central bank rates have not yet changed course, the markets are pricing for rate cuts soon. Investors are buying bonds to lock in current rates, assuming that future rates will be lower.

We tactically position our portfolios based on short-term elements in the markets. The recent changes in central bank policy are an important catalyst. There is no denying the risk of persistent drawdown is low in the near term given central banks' propensity to react to any downturn. This is a significant shift from a year ago, when the Bank of Canada and the Fed were keen on hiking rates back to normal. We were concerned the hikes would eventually cause a recession (like they have in previous cycles) and positioned our portfolios defensively for most of 2018. There is no doubt global economies are now in the late cycle and investors should exercise caution. However, central banks are trying hard to prolong this cycle and with this strong backing, we believe equity markets should perform well.

As a result, we have made some changes in the portfolios to capture more upside. We have removed the long put option program that we implemented in 2018. The put option strategy was designed to provide cost-effective downside protection, and it added value throughout the year as there were a number of periods when volatility spiked. However, in our view the shift in central bank policy will lead to lower volatility and put a floor on asset prices, so holding long put options is redundant. We will continue to monitor markets to determine if there is an opportunity to re-introduce the strategy to benefit from rising volatility.

The Global Equity Allocation Pool is used to implement our asset allocation views in the equity portion of our portfolios. When the pool was launched in October, weights in gold (9%) and cash (18%) were high because we believed conservative positioning was prudent. When markets sold off and gold rallied throughout the fourth quarter, we started to take profits on the gold position and put cash to work in equities. Today, the gold position has been eliminated and the pool is fully invested in equities. In particular, the international equity allocation in our portfolios has risen significantly as we have found compelling opportunities in emerging markets and Japan that we are accessing through passive ETFs. We believe that these regions offer attractive upside potential with relatively limited downside due to depressed valuations.

The Enhanced Income Pool is used to implement our asset allocation views in the income portion of our portfolios. Our thesis that the Fed would not be able to continue the expected pace of rate hikes was correct and we benefited from long duration holdings as yields dropped significantly in the quarter. Today, we are trimming our government bond position on strength and reducing our duration as prices are gravitating towards fair value. We are starting to favour cash because with an inverted yield curve, we can earn the same interest on three-month government bonds as on 10-year government bonds – there is no compensation for locking in rates. We took the profits in government bonds and re-invested the proceeds in equity and real estate. We remain underweight high yield because we are finding better risk-reward opportunities in equities.

Some investors may be concerned by the fact the yield curve is now inverted (shorter-term interest rates are higher than longer-term rates), as that has historically been a leading indicator for recession. We believe the yield curve is currently "artificially" inverted, because the front end of the curve has been affected by central banks talking down the rate outlook, but they have not followed up by actually cutting rates. On the long end, ending quantitative tightening is effectively killing supply and it is not hard to imagine those long-term bonds are getting aggressive bids. The Fed and the Bank of Canada will likely fulfill their "promise" by cutting interest rates within the next six to 12 months.

Combined top 15 equity holdings as of March 31, 2019 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Enbridge	6. AltaGas	11. Dollarama
2. Microsoft	7. Gilead Sciences	12. Alphabet
3. Atco	8. Apple	13. George Weston
4. Toronto-Dominion Bank	9. Canadian Pacific Railway	14. Prologis
5. Bank of Nova Scotia	10. IA Financial	15. Royal Bank of Canada

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