The Internet Wealth Builder

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THE WINNERS SO FAR

By Gordon Pape, Editor and Publisher

The year is almost half over and, so far, it has been a good one for stocks despite all the worries over trade wars, a slowing economy, and inverted yield curves.

As of the close of trading on Friday, the S&P/TSX Composite was showing a year-to-date gain of 15.4%, better than most people expected at the start of 2019. In New York, the S&P 500 was ahead 17.7%, the Dow was up 18.8%, and the Nasdaq Composite had gained 21%.

Some of our recommendations have done much better than those averages. Here's a look at five of our top performers thus far in 2019.

Shopify (TSX, NDQ: SHOP). This Ottawa-based software company is our number one winner this year by a wide margin. The stock finished 2018 at $188.79 and now sits at $431.50, a gain of 129% in less than six months.

Shopify, which is a recommendation of contributing editor Glenn Rogers, has more than 800,000 customers in 175 countries. The company provides multi-channel commerce platforms that merchants can use for all aspects of their business including payments, inventory, and marketing. The company also just announced that it will spend over a billion dollars to build warehouses near major population centres that customers can use to store and ship merchandise.

The rapid rise in the stock price has been propelled by faster than expected revenue increases and a perception that the company has strong international growth potential.

First-quarter revenue was US$320.5 million, an increase of 50% from the same period in 2018. The company forecasts full-year revenue in the range of US$1.48 to US$1.5 billion.

Shopify is not focused on making a profit at this point, preferring to reinvest revenue in expanding the quality and range of services it offers. However, it did show adjusted net income for the quarter of US$10.3 million (US$0.09 per share) compared to US$4.2 million (US$0.04 per share) the year before.

The gain so far this year is obviously very impressive, but we shouldn't expect it to continue at this rate. At this point, we rate the stock as a hold due to the high valuation.

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Winners – continued from page 1…

Boyd Group Income Fund (TSX: BYD.UN, OYC: BFGIF). Just because a stock has had a big run-up doesn't mean it's going to stop. Momentum counts for a lot in the stock market. Boyd Group is a case in point. This auto collision and glass repair company is the single biggest gainer in our history.

It was first recommended by contributing editor Ryan Irvine in August 2010 at $5.50. The stock closed on Friday at $168.32 for a profit of 2,960% since the original recommendation. This year it is up 49% from a 2018 closing price of $112.95.

Boyd's business isn't very exciting, but the company continues to deliver strong financial results. First-quarter figures saw sales increase by 23.1% to $557.9 million from $453.3 million in the same period of 2018. Same-store sales growth was 5.3%. Adjusted net earnings increased 39.7% to $29.2 million ($1.47 per unit) compared with $20.9 million ($1.06 per unit) in 2018.

For the latest update on this stock, see the issue of May 19 (#21919).

General Electric (NYSE: GE). When he recommended GE stock last November at US$7.57, contributing editor Glenn Rogers described the Wall Street fallen idol as "a mess" but suggested we were at a point "where it's so bad that it's good". He cited the new leadership of CEO Larry Culp and the fact the conglomerate still owns some very good businesses for his optimism.

Glenn suggested the stock was for "patient" investors but the pay-off has come faster than expected. GE shares ended 2018 at US$7.28 but are now trading at $10.48, for a year-to-date gain of 44%.

The stock moved sharply higher after the release of first-quarter results that showed the company swung from a loss of US$1.2 billion (US-$0.14 per share, fully diluted) last year to a profit of US$3.5 billion (US$0.40 per share) this year. Revenue was down 2% year-over-year to US$27.3 billion.

Mr. Culp commented: "I am encouraged by the improvements we are making inside GE. This is one quarter in what will be a multi-year transformation, and 2019 remains a reset year for us. We continue to focus on reducing leverage and improving the underlying performance of our businesses to create sustainable, long-term value for our customers, employees, and shareholders."

eBay Inc. (NDQ: EBAY). With all the attention focused on Facebook, Amazon, and Alphabet these days, eBay has become lost in the high-tech shuffle. But the company is still around and doing quite well, thanks. The stock closed 2018 at US$28.07 and now trades at US$40.05, for a gain so far this year of 43%.

Compared to the companies mentioned, eBay is a relatively small player in the technology sector. First-quarter revenue was US$2.7 billion, a modest 2% increase over the same period in 2018, and future growth projections aren't a lot better.

But the company is operating more efficiently. Net income based on GAAP standards was US$518 million in the quarter, a 27% improvement over US$407 million in the first quarter of 2018. Fully diluted earnings per share came in at US$0.57, an improvement of 42.5% over last year's US$0.40 per share.

The per share gains are larger because the company is actively buying back stock. It spent $1.5 billion in the quarter to buy back 42 million shares and over the past year has reduced its weighted number of outstanding shares by over 100 million.

CAE Ltd. (TSX, NYSE: CAE). For most of the past three years, the share price of this Montreal-based flight simulator company has been locked in a trading range of $18-$25. It finished 2018 at the top end of that range at $25.09.

But that log jam is over. This year the shares are touching one new high after another, closing on Friday at $34.95. That's a gain of 39% so far this year.

There are all sorts of reasons for this breakout. For starters, the company recently reported record fourth-quarter and year-end results for the 2019 fiscal year (to March 31). Fourth-quarter revenue was up 42% to $1 billion while full-year revenue was ahead 17% to $3.3 billion. The annual order intake was a record $4 billion. Total backlog at the end of the fiscal year was $9.5 billion.

Net income before specific items for the year was $335.2 million ($1.25 per share) compared to $297.9 million ($1.11 per share) in fiscal 2018.

Since those results came out, the company has announced several new contracts that should continue to grow revenues and profits going forward. They include a deal with the U.S. Navy to train UC-12 Huron aircrews, a five-year extension of its exclusive long-term pilot and cabin crew training contract with SAS, and a similar extension to train pilots for Air Europa.

The company also announced it has signed a new five-year training agreement for AirAsia's A320 pilots in the Philippines. The agreement extends the use of the CAE Rise training system to a third AirAsia affiliate.

Other big movers (25%+) so far this year include Alimentation Couche-Tard, Starbucks, and Visa.

MARKET MELT-UP?

By Richard Croft, Associate Publisher

Back in 2008 we experienced what was a classic market meltdown – a rapid plunge in the value of stocks triggered by panic selling after the collapse of Lehman Brothers.

Today we may be witnessing the reverse – a stock market melt-up. That's defined by Investopedia "as a dramatic and unexpected improvement in the investment performance of an asset class, driven partly by a stampede of investors who don't want to miss out on its rise, rather than by fundamental improvements in the economy".

There are several reasons why this could happen. In order of importance, they are the collapse of medium to long-term bond yields, a dovish policy shift at the U.S. Federal Reserve (Fed), the potential for re-starting trade talks with China as President Trump and Chinese Premier Xi Jiping agree to meet one-on-one at the June G-20 talks in Japan, and the presumptive ratification of the new USMCA.

With that in mind, let's review each factor within the context of global equity markets. What we know is that U.S. stocks, trading at 20.5 times forward earnings, are not cheap. However, they are not expensive when compared to the yield on ten-year government bonds.

The four melt-up metrics

There are four key elements that would underpin a market melt-up, one that could take the S&P 500 index well past the 3,000 level. The most important is the attitude of the Federal Open Market Committee (the key Fed members who set interest rate policy), who are clearly focused on the yield curve.

There are three common shapes to the yield curve:

1) Normal sloping where long bonds yield more than short-term bonds.

2) Humped, where medium maturities provide a higher yield than both short- and long-term bonds.

3) The inverted curve, where short-term bonds yield more than long-term fixed income assets.

The fear is that the U.S. government yield curve could invert, which is seen by some, Fed members included, as a precursor to a recession – with the caveat, that the predictive value of an inverted yield curve is subject to much scrutiny. Inverted yield curves have predicted ten of the last six recessions.

That said, what's most important is how the Fed interprets the curve. Clearly, financial markets want the Fed to cut rates as a way to mitigate recessionary fears. And from what I can tell, the Fed seems to be listening. It held the line on rates last week, but the dovish comments of chairman Jerome Powell appeared to signal that two to three rate cuts are on the way this year, perhaps starting as early as July.

"We will use our tools to maintain the expansion," Mr. Powell said after last week's meeting.

This is hard to fathom…really! Current economic conditions in the U.S. do not warrant a rate cut. Low unemployment, 2% plus growth, a solid housing market, and record high stock prices. What more could one want?

Economists provide some underpinning for a rate cut by pointing to a marked slowdown in economic activity in China and the EU. Unfortunately, the EU has little room to maneuver on the rate front given the mountain of debt that is yielding negative returns. Note that the ten-year German bonds trading at a negative 32 basis points. The EU's option, and to some extent China's option, is another round of quantitative easing. But again, much depends on the action taken by the Fed.

In my opinion, the Fed ushered in a change in tone at the June meeting, effectively setting the stage for a series of interest rate cuts. Make no mistake, if they cut rates in July – a better than 70% probability – we would likely see another two cuts before year end. That would tell the financial markets that the Fed has their back, which will drive the risk-on strategy.

The second key metric is the trade war between the U.S. and China. President Trump has arranged a one-on-one sit down with President Xi Jiping at the G-20 summit in Japan. I suspect that both sides will come to some sort of accommodation. While we will not likely see a deal, we will see a path forward. In this negotiation it is all about saving face. The Chinese do not want to acquiesce to Trump's bully pulpit and Trump needs a win coming into next year's Presidential election cycle.

President Trump could offer to put off any increase in new tariffs. China would likely agree to buy more U.S. goods

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Melt-up – continued from page 3…

and services and would agree to begin a legislative process that would allow companies to sell to the Chinese market without forfeiting their technology secrets. That process would probably not be completed until after the U.S. election next November.

President Trump could claim a victory with new sales abroad. China could save face by showing that their hard-line stance got the U.S. to change its mind about additional tariffs. In this negotiation, both sides need to get a deal and save face at the same time. This process solves both of those issues.

The third metric is the ratification of the USMCA (NAFTA 2.0). Mexico has already ratified the deal and the U.S. Trade Representative Robert Lighthizer was recently in front of Congress walking the Congressional leaders through the fine print of the agreement. Prime Minister Justin Trudeau pressed House Speaker Nancy Pelosi to move forward during his visit to Washington on Thursday. I assign a 50-50 probability that USMCA will get ratified by a Democratic House of Representatives. On the one hand, they don't want to give Trump a victory; on the other the deal is good for the U.S. economy and if the Dems choose not to ratify it could politically backfire.

The final metric is global growth. If a trade deal with China gets back on track, that could lubricate supply chains, which would increase efficiencies. On its own, that would not be enough to kick start global growth, but it could position economies to stabilize. You have to stop the bleeding before you can begin a recovery.

After the melt-up

A lot has to happen for stocks to melt up. It would be a quick rally as algorithmic trading would kick start equity markets. If my assumptions are correct, retail traders would come into the market, as they often do, at the end of a cycle. That would push prices higher, which is where we have to get concerned. The fallout from that type of melt-up would be rapid and severe.

The challenge with any market move is the speed at which it takes place. That limits the ability to take defensive action after the fact. Better to position your portfolio ahead of time to limit risk should we experience a significant correction.

With that in mind, investors who want to ride the melt-up wave might consider buying a call option on the S&P 500 Depositary Receipts (NYSE: SPY). The CBOE Volatility Index (VIX) is trading at 14.63, which is below the 200-day moving average.

When the VIX is below the 200-day moving average, it is telling you that options on the S&P 500 index are reasonable. Buying call options provides leverage where a few dollars can do the work of many. You also have limited risk as the most you can lose is the cost of the call.

If you less concerned about catching a melt-up wave, you might think about buying SPY puts to hedge your portfolio should we experience a sell-off. Because the VIX is relatively benign, there is a moderate cost to buy downside protection.

RICHARD CROFT RECOMMENDS SPY CALLS

If you want to ride a melt-up wave, I recommend the purchase of SPY March 295 calls at $15.50. (Prices in U.S. dollars.)

Each call option grants you the right to buy 100 shares of the underlying stock (SPY in this case) at the strike price of the option ($295 per share) until expiration (March 20, 2020). Each call option contract will cost $1,550.

SPY, which trades at 1/10th the value of the S&P 500, closed Friday at $294. At that closing price, the recommended calls are said to be at-the-money. If I am right and the S&P 500 eclipses 3,000 level, SPY will be trading at $300 per share. That would make one option contract worth between $18 ($1,800 per contract) and $22 ($2,200 per contract) depending on how quick the market moves. A melt-up to say 3,200 would put SPY at $320, of $32 ($3,200) per contract. That would represent a doubling of your initial investment. Again, a few dollars doing the work of many.

If we do see a surge in the U.S. markets and you purchase more than one contract, I would sell half the position when you have a 50% profit. That would allow you to hold the remainder of your position with significantly less risk. Cash management is a critical element when dealing with leverage.

If I am wrong, because one of the aforementioned metrics does not go as expected, the most you can lose is the cost of the option. Moreover, if we witness a sharp market sell-off, volatility would increase which would mitigate some of the downside risk in the option contract.

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Spy calls – continued from page 4…

Hedging the Wave

If you prefer to protect your portfolio at its current valuation, you might look at buy the SPY March 290 puts at $12.90.

Each put option grants you the right to sell 100 shares of the underlying stock (SPY in this case) at the strike price of the option ($290 per share) until expiration (March 20, 2020). Each put option contract will cost $1,290.

My recommendation is for the SPY calls, but the put option is there for those who believe the market is heading down.

Make no mistake: these are aggressive trades and you should only use capital you can afford to lose. While it is unlikely you would lose the entire investment, there is always the chance that some losses would occur. This is a case of putting eggs – setting up for a rise or fall in the market – in one basket and watching the basket very closely.

Richard Croft has been in the investment business for more than 40 years and is the founder of R.N. Croft Financial Group. As a global portfolio manager and option specialist, his focus is helping investors clarify their goals and risk tolerances, leading to an appropriate risk-adjusted portfolio. He can be contacted at rcroft@croftgroup.com.

GORDON PAPE'S UPDATES

Simon Property Group (NYSE: SPG)

Originally recommended by Tom Slee on March 2/14 (#21409) at $159.91. Closed Friday at $164.09. (All figures in U.S. dollars.)

Background: Simon Property is a global leader in retail real estate ownership, management, and development and a S&P 100 company. The company owns and operates retail properties and investments across North America, Europe, and Asia and generates billions in annual retail sales.

Performance: The shares have been drifting down and hit a low of $159.69 earlier this month before staging a small rally.

Recent developments: First-quarter results were positive. Net income attributable to common stockholders was $548.5 million, ($1.78 per share, fully diluted). That compared to $620.7 million, ($2 per share) in 2018 but the prior year period included gains of $135.3 million ($0.38 per share), primarily related to dispositions. Adjusting for the $0.38 one-time gain, net income per share attributable to common stockholders increased 9.9%.

Funds from operations (FFO) was $1.08 billion ($3.04 per share), as compared to $1.03 billion ($2.87 per share) in the prior year period, an increase of 5.9% per share.

U.S. malls and premium outlets reported retailer sales per square foot of $660, an increase of 3.1% for the trailing 12-month period to March 31. Occupancy was 95.1%, compared to 94.6% the year before. Base minimum rent per square foot was $54.34.

At quarter-end, redevelopment and expansion projects, including the redevelopment of former department store spaces, was underway at more than 30 properties in the U.S., Canada, Asia, and Europe. Simon's share of the costs of all these projects was more than $1.4 billion. One of the major projects is a 251,000 square foot upscale outlet located in Bangkok, Thailand, projected to open in February 2020. Simon owns 50%

The company reaffirmed its previous financial guidance. It estimates net income to be within a range of $7.30 to $7.40 per diluted share for the year ending Dec. 31, 2019 and that FFO will be within a range of $12.30 to $12.40 per share.

Dividend and buybacks: The board of directors approved a dividend increase of 5.1%, bringing the quarterly payment to $2.05 ($8.20 per year). The shares yield 5% at the current price.

The company also announced that the board has approved a new common stock repurchase program under which the company may buy back up to $2 billion of its common stock over the next 24 months, as market conditions warrant.

Conclusion: These are difficult times for shopping mall companies and the slippage in the share price shows that investors are concerned about future prospects. This stock has become strictly a yield play, with limited growth potential.

Action now: Sell. I don't like the downward drift of this stock, especially in a time of rising markets.

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Gordon Pape's updates – continued from page 5…

Norfolk Southern Corp. (NYSE: NSC)

Originally recommended by Tom Slee on Nov. 13/09 (#2944) at $52.22. Closed Friday at $197.19. (All figures in U.S. dollars.)

Background: Norfolk Southern Railway operates almost 20,000 route miles in 22 states and the District of Columbia. It serves every major container port in the eastern United States, operates the most extensive intermodal network in the East, and is a major transporter of coal, automotive, and industrial products.

Performance: When I last reviewed this stock in December, I advised taking half profits at $163.58 for a gain of 213%. So, we are now playing with house money, having pocketed a nice profit already. The shares rose as high as $211.46 in April before retreating to the current level.

Recent developments: The company reported very strong first-quarter results. Railway operating revenue was $2.8 billion, up 5% from the year before and a first-quarter record. The company said the increase was due to higher revenue per unit, resulting from increased rates as well as higher fuel surcharge revenue. Railway operating expenses were $1.9 billion, a decrease of $8 million from last year. Fuel price declines and lower compensation and benefits expenses were offset by increased purchased services and rents.

Net income was $677 million, up 23% year-over-year, a result of a 16% increase in income from railway operations and an increase in other income. Diluted earnings per share were $2.51, up 30% year-over-year and a first-quarter record.

"Our first-quarter results reflect the initial steps in the implementation of our new strategic plan that are transforming our company," said CEO James A. Squires. "We set company records for many financial measures in the first quarter, while improving our service product for our customers. We are intensely focused on the execution of the initiatives in our strategic plan that will drive shareholder value."

Dividend: The company increased its dividend by 7.5% to $0.86 per quarter ($3.44 per year), effective with the February payment. The stock yields 1.7% at the current price.

Conclusion: This is an economically sensitive company. As long as the U.S. economy remains strong, it will prosper. But if the economy slows, this stock will take a hit.

Action now: Hold.

McKesson Corp. (NYSE: MCK)

Originally recommended on Feb. 27/17 (#21709) at $150.85. Closed Friday at $133.06. (All figures in U.S. dollars.)

Background: This company provides a variety of services to the pharmaceutical industry but one of the main ones is drug distribution. Along with two other companies (Cardinal Health and AmeriSource Bergen) it acts as the middleman between drug manufacturers and dispensers (pharmacies, hospitals, doctors, etc.). Those three firms operate as an oligarchy in their segment of the economy, similar to the big five banks in the Canadian financial sector.

Performance: The stock hit a 12-month low $106.11 in late December. It jumped to $135 in February, then plunged to the $112 range in early March before rebounding again. As you can see, it has been a roller-coaster ride for investors.

Recent developments: The company released fourth-quarter and full year results for fiscal 2009 and they showed very modest year-over-year improvements. Revenues for the quarter ended March 31 were $52.4 billion compared to $51.6 billion a year ago, an increase of 2%. For the fiscal year, McKesson had revenues of $214.3 billion, compared to $208.4 billion a year ago, an increase of 3%.

On the basis of U.S. generally accepted accounting principles (GAAP), fourth-quarter loss per diluted share from continuing operations was $4.17, compared to loss per diluted share of $5.58 a year ago. Full-year GAAP earnings per diluted share from continuing operations was $0.17, compared to $0.30 a year ago. Fourth-quarter loss per share and full-year earnings per share included after-tax net charges totaling approximately $1.5 billion ($7.63 per share) and $2.2 billion ($11 per share), respectively. This reflected non-cash goodwill and long-lived asset impairment charges, as well as restructuring charges, largely in the company's European businesses.

Fourth-quarter adjusted earnings per share was $3.69, an increase of 6% compared to $3.49 a year ago. This was primarily driven by a lower share count and growth in the Medical-Surgical business. Full-year adjusted earnings per share was $13.57, an increase of 8% compared to $12.62 for the prior year.

Dividend and buybacks: The company pays a quarterly dividend of $0.39 per share ($1.56 per year) to yield 1.2% at the current price. Based on history, we should see an increase in the dividend in the next quarter. McKesson bought back $1.6 billion worth of common stock during the year.

Conclusion: We're not seeing much momentum from this company and the dividend yield is small.

Action now: Sell. There are better alternatives for your money right now.

YOUR QUESTIONS

Buying IPOs

Q – We are retired and manage our own investments through an online brokerage investment service with one of the major banks. For the most part we have been quite successful and feel we have enough knowledge to continue to do so. We do find we are missing out on some opportunities, though, and would like to understand our options.

We receive email alerts of "new issues" but have found that any of the better options (e.g. two Canadian bank rate reset preferred share options that were issued recently) were closed before we could even get online to make a purchase. I can recall someone referring to these announcements as "tombstones" by the time they reach the consumer, and it seems they are correct.

Are we limited to using a broker and paying a management fee on all of our funds in order to gain access to such services? This seems counterintuitive, as any gains we would make in this case would be consumed by fees. – Mary M.

A – Unfortunately, do-it-yourself investors are usually left out in the cold when it comes to initial public offerings (IPOs), especially hot ones. The underwriters allocate the shares to brokers, with preference given to those within their own firms. The brokers in turn offer positions to their clients. If the new issue is in demand, the allocation is usually rationed and only the best customers get a chance to buy in. The only time a DIY investor might get a crack at an IPO is if the issue fails to sell out quickly. That usually means it's a dud and you don't want it anyway.

You can advise your online broker of your interest in new IPOs but don't expect much to happen. If you really want to participate you would need to open an account with an active advisor, preferably at a firm that does a lot of underwriting. RBC Dominion Securities and CIBC Wood Gundy are two examples. – G.P.

Where to invest inheritance?

Q – I need suggestions as to how best to proceed. A little about my situation so you are able to best make recommendations. I will be 64 in September, net income per month is $2,000, will be debt free, no RRSPs, and an inheritance which will leave me (after paying off debt) $50,000. So, the basic question, which you have been asked thousands of times is: How best to proceed? – Ray N.

A – You say you have no RRSPs, so I assume you do not have a TFSA either. That means you could put the full $50,000 from the inheritance into a TFSA and I suggest you do that. As of Jan. 1, the lifetime contribution limit for anyone 18 or older in 2009 and has not had a plan is $63,500.

These plans work well for low-income people because the money is not taxed when it comes out. That means any withdrawals won't affect your eligibility for the Guaranteed Income Supplement, which you should apply for when you become eligible for Old Age Security at 65.

When you set up the TFSA, you have to decide how much risk you want to take with the money. A very conservative route would be to keep it all in a high-interest savings account and/or guaranteed investment certificates. You won't receive much in the way of interest but anything you do earn will be tax free. Alternatively, you might consider a portfolio of mutual funds or ETFs, which would offer more return potential but with higher risk. Given your age I would suggest a 50-50 split between bond funds and equity funds. – G.P.

HOUSEKEEPING

The following securities have been deleted from our on-line Recommended List. Sell advisories were issued some time ago so this notice is for record-keeping purposes only.

Athabasca Minerals. Recommended Jan. 29/12 by Ryan Irvine at $0.485. Sold Oct. 5/15 at $0.26.

Grenville Strategic Royalty Corp. Recommended July 20/15 by Ryan Irvine at $0.90. Sold June 6/16 at $0.415.

High Arctic Energy. Recommended Sept. 2/13 by Ryan Irvine at $2.85. Sold Feb. 6/17 at $5.92.

Long Run Exploration. Recommended Sept. 15/14 by Tom Slee at $4.99. Sold April 6/15 at $0.68.

Luxor Industrial Corporation. Recommended Sept. 26/16 by Ryan Irvine at $0.39. Sold March 6/17 at $0.035.

Macro Enterprises Inc. Recommended June 2/13 by Ryan Irvine at $3.63. Sold May 11/15 at $2.50.

McCoy Corporation. Recommended Dec. 4/11 by Ryan Irvine at $2.95. Sold Sept. 29/14 at $5.59.