Update Edition

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BIG GAINS FOR BONDS

By Gordon Pape, Editor and Publisher

Stocks have held up remarkedly well so far this year. As of the close of trading on June 7, the S&P/TSX Composite Index was showing a gain of 13.3% for 2019, well ahead of last January's expectations. Even if the TSX does nothing more than hold its ground for the rest of the year, it will have been a great 12 months for investors.

The major U.S. indexes are also ahead, with the S&P 500 gaining 14.6%, the Dow up 11.4%, and the Nasdaq leading the way at 16.7% despite the recent weakness in the big tech stocks.

In Toronto, the market has been buoyed by strong results from traditional defensive stocks: REITs, utilities, and telecoms. These securities form the backbone of The Income Investor's Recommended List, so readers have benefitted from the rebound in these sectors.

As of the June 7 close, the utilities sub-index was ahead 20.2% for the year while REITs were up 13.3% and telecoms by 11%.

Those results are a surprise, considering where investor sentiment was just six months ago. But here is an even bigger shocker. Some bond indexes are showing gains that rival those of stocks this year.

The abrupt about-face by the Bank of Canada and the Federal Reserve Board has send bond yields down and prices higher (bond prices have an inverse relationship with yields). Fed chairman Jerome Powell has even dropped hints that the Board may cut U.S. interest rates if the economy continues to slow. It wasn't that long ago that the conventional wisdom was that the Fed would raise rates at least once this year and perhaps twice. That's probably not going to happen.

Here at home, Bank of Canada Governor Stephen Poloz has also been dovish in his comments. It's now anticipated the Bank will not raise interest rates this year.

These moves, combined with investor concerns about trade wars and a slowdown in global growth, have created a bull market in bonds unlike any we have seen in several years.

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Bonds – continued from page 1…

As of June 7, the FTSE Canada Universe Bond Index was up 6% year-to-date. That is a truly amazing performance in less than six months.

But many of the sub-indexes were up even more – not as much as the TSX but getting close. The Long-Term Bond Index is ahead 10.7% for the year. Long-term bonds are the most sensitive to interest rate movements; they gain more when rates drop and lose more when they rise. Corporate long-term bonds have gained 10.4% as a group while provincial long-term bonds are up 11.7%.

Remember, I'm not quoted yields here. The percentage gains refer to the increase in the prices investors are willing to pay for these bonds.

We don't recommend long-term bonds in this newsletter because of the high risk attached to them. Most of our bond selections are ETFs, which offer a diversified portfolio of issues. Let's see how some of them are performing. All prices are as of the close on June 7.

GORDON PAPE'S BOND ETF UPDATES

PIMCO Monthly Income ETF (TSX: PMIF)

Type: Exchange-traded fund
Originally recommended: Nov. 24/17 at $20.07
Current price: $20.04
Annual payout: $0.649 (trailing 12 months)
Yield: 3.23%
Risk Rating: Moderate risk
Recommended by: Gordon Pape
Website: www.pimco.ca

Comments: This is an actively-managed ETF that invests in a portfolio of high-quality non-Canadian dollar bonds with a goal of maximizing current income while minimizing risk.

This is a good companion fund for XBB since it invests in a completely different segment of the bond universe. Most of the securities held are short-term; the fund has a duration of 2.26 years.

There are two issues to consider before putting any money here, however. The first is the MER, which at 0.85% is very high for a bond fund. Based on that, I would not recommend this fund except for the fact that Pimco is regarded as one of the world's leading experts in bonds. You have to pay for that kind of expertise.

My second concern is that anyone looking for steady cash flow is going to be disappointed. The fund makes monthly distributions, but they vary widely in the amounts paid. For example, the January payment was only $0.023 per unit but in February it was more than double that at $0.484 per unit. Anyone trying to operate on a budget based on this fund's payments would be tearing out their hair!

That said, this is a well-balanced, low risk portfolio with a top team of managers. It's a good choice if you're willing to pay a price for international bond exposure.

Action now: Hold.

iShares Core Canadian Universe Bond Index ETF (TSX: XBB)

Type: Exchange Traded Fund
Originally recommended: Dec. 14/04 at $29.43
Current price: $31.87
Annual payout: $0.887
Yield: 2.8% (12-month trailing)
Risk: Conservative
Recommended by: Eric Kirzner
Updated by: Gordon Pape
Website: www.blackrock.com/ca

If you only own one bond ETF, it should be this one. It tracks the performance of all investment-grade Canadian bonds, government and corporate, so you have exposure to the full market and all maturities.

The fund had a below average year in 2018, gaining only 1.28% in the face of rising rate headwinds. But it has bounced back strongly this year with a gain to date of 5.85%. Since inception in November 2000, the fund has generated an average annual return of 5.18%.

All the bonds in the portfolio have a credit rating of BBB or better, which means default risk is very low. Almost 38% of the assets are in federal government or province of Ontario issues. Just over 43% of the portfolio is in short-term issues (matures in five years or less) while 22.29% is in long-term bonds (20 years or more to maturity).

The management expense ratio is very low at 0.10%.

Action now: Buy.

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Bond ETFs – continued from page 2…

iShares Core International Aggregate Bond ETF (BATS: IAGG)

Type: Exchange-traded fund
Originally recommended: Sept. 1/17 at $51.95
Current price: $54.04
Annual payout: $1.315 (trailing 12 months)
Yield: 2.43%
Risk rating: Moderate
Recommended by: Gordon Pape
Website: www.blackrock.com

Comments: This is a lower-cost alternative to the Pimco fund. The mandate is to invest in a portfolio of investment-grade bonds that are not denominated in U.S. dollars. The main holdings are issues from Japan, France, Italy, Germany, and the U.K. Most of the bonds are investment-grade (BBB or higher), so credit risk is minimal. This fund has performed well for us since it was recommended in September 2017. We have a capital gain to date of just over 4% and the yield is a respectable 2.43%. However, as with the Pimco fund, the monthly distributions can vary significantly in amount. The MER is a very low 0.09%.

Action now: Buy.

iShares Core Total USD Bond Market ETF (NDQ: IUSB)

Type: Exchange-traded fund
Originally recommended: Sept. 1/17 at $51.28
Current price: $51.24
Annual payout: $1.542 (trailing 12 months)
Yield: 3%
Risk rating: Moderate
Recommended by: Gordon Pape
Website: www.blackrock.com

This ETF invests in a portfolio of U.S. dollar-denominated bonds that is somewhat unusual, in that the holdings can be both investment grade and high yield. That said, only about 7% of the portfolio actually falls into the high-yield category. The fund was marginally down in 2018 with a loss of 0.38% but it has rebounded strongly this year with a gain so far of 5.5%. Since inception (June 2014) it has averaged 2.77% annually. The MER is very low at 0.06%.

Although it has recovered well this year, the fund's market value is almost exactly the same as when it was recommended in 2017. The yield of 3% is decent but doesn't warrant keeping this unusual fund on our Recommended List.

Action now: Sell.

iShares Canadian Corporate Bond Index ETF (TSX: XCB)

Type: Exchange-traded fund (ETF)
Originally recommended: Jan. 21/09 at $18.77
Current price: $21.60
Annual payout: $0.637 (trailing 12 months)
Yield: 2.95%
Risk Rating: Moderate risk
Recommended by: Gordon Pape
Website: www.ishares.ca

Comments: As the name suggests, this ETF invests in a portfolio of investment-grade Canadian corporate bonds with a maturity of at least one year. It has been consistently profitable, even in 2018 which was a tough year for bonds. The 10-year average annual compound rate of return, which is roughly the time frame since it was first recommended, is 4.89% (to May 31).

Unlike some of the other funds we looked at in this issue, this one has an excellent record of consistency in its monthly distributions. The current rate is $0.053 per unit ($0.636 a year). The portfolio is heavily focused on issues from the five major banks. Together, they account for almost 25% of all holdings. Just over half the fund is invested in short-term maturities (five years or less). The MER is a little on the high side at 0.44%.

Action now: Buy.

GORDON PAPE'S STOCK UPDATES

Algonquin Power and Utilities (TSX, NYSE: AQN)

Type: Common stock
Originally recommended: July 28/16 at C$12.45, US$9.45
Current price: C$16.28, US$12.27
Annual payout: US$0.564
Yield: 4.6%
Risk: Moderate risk
Recommended by: Gordon Pape
Website: www.algonquinpower.com

Comments: There have been a lot of ups and downs along the way, but the stock of this Oakville, Ontario based company has moved up by 31% over the past twelve months. The shares touched an all-time high of $16.38 last week.

On June 3, Algonquin announced a deal to acquire

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Ascendant Group Ltd., the parent company of Bermuda Electric Light Company for US$365 million. Bermuda Electric provides power to the island's 63,000 residents. The all-cash deal is expected to be accretive to Algonquin's fiscal 2020 earnings per share. It is expected to close late this year after receiving shareholder and regulatory approval.

"The acquisition of Bermuda Electric Light Company builds materially on our international growth program through the addition of this high-quality utility, an acquisition which will be immediately accretive to earnings," said CEO Ian Robertson.

Earlier, Algonquin released results for the first quarter of fiscal 2019. Revenue was down 4% to $477.2 million (the company reports in U.S. currency). Discounting the one-time effect of U.S. tax reform in the first quarter of last year, adjusted earnings per share came in at $0.30, down from $0.32 the year before. Adjusted funds from operations were $173.5 million compared to $179.9 million in 2018.

Despite the decline in revenue and earnings, the company is increasing its dividend by 10%, effective with the July payment. The new quarterly amount will be US$0.141 per share (US$0.564 per year, to yield 4.6% at the current price.

Action now: Buy.

Enbridge Inc.
(TSX, NYSE: ENB)

Type: Common stock
Originally recommended: Nov. 21/06 at C$19.58
Current price: C$47.14, US$35.51
Annual payout: $2.952
Yield: 6.3%
Risk: Moderate risk
Recommended by: Gordon Pape
Website: www.enbridge.com

Comments: Things haven't been going so well for Enbridge lately.

The company has run into major problems in the U.S. over plans to replace two of its aging pipelines. It's not just the company's bottom line that's at risk. Failure to complete either or both of these projects on time will have a significant impact on the export capacity for Alberta oil and could lead to more mandated production cuts.

The first blow was a ruling by a Minnesota court that the environment impact report for the company's Line 3 replacement was inadequate. The pipeline runs from the storage terminals in Hardisty, Alberta to Superior, Wisconsin and, at a projected cost of $5.3 billion, this is the largest project in the company's history. All permits had been received and Enbridge expected to complete the final stages of the work by the end of this year. Now the Minnesota court ruling has thrown a wrench into the plans and at this point no one has a clear idea of when the replacement pipeline will be completed.

The company is also in conflict with the state of Michigan over plans to replace Line 5, which is 65 years old. The line runs under the Straits of Mackinaw and Enbridge proposes to spend $500 million to build a concrete underwater tunnel to house the new line. The company says this would reduce the risk of a spill that could contaminate the Great Lakes "to virtually zero".

The problem is that under Enbridge's timetable, and an agreement signed with the state's previous government, the project won't be finished until 2024. Michigan's new governor, Gretchen Whitmer, wants Enbridge to shut down the existing line in two years. The company says there is no way it can meet that timetable and has filed an action with the Michigan Court of Claims asking that the original agreement with the state be upheld.

More legal actions, more delays. The economic cost of these disruptions is incalculable.

Enbridge shares, which hit $51.22 in late May, have fallen on the news.

Earlier, the company reported first-quarter earnings on a GAAP basis of $1.9 billion ($0.94 per share). That compared to $445 million ($0.26 per share) in the first quarter of 2018. Adjusted earnings were $1.6 billion ($0.81 per share) compared to $1.4 billion ($0.82 per share) last year.

Distributable cash flow was $2.8 billion compared to $2.3 billion for the first quarter of 2018.

Enbridge raised its dividend in February by 10% to $0.738 per quarter ($2.952 per year).

Action now: Hold. The news on the pipeline front is discouraging but the high (and safe) yield continues to be enticing.