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BONDS SHINE

By Gordon Pape, Editor and Publisher

Last Monday, The Dow Jones Industrial Average suffered its sixth-worst day in terms of point decline, dropping 767 points.

But that wasn't the biggest financial story of the week. Investors were even more concerned about the melt-up in bond prices as yields sagged to their lowest level in years.

By the end of trading on Thursday, yields on 10-year Canada bonds were down to 1.22% while 10-year U.S. Treasuries were yielding 1.72%.

A year ago at this time, Canada 10-year issues were yielding 2.10% while U.S. bonds were at 2.96%.

The dramatic decline in yields has been a surprise windfall for bond investors (prices rise as yields drop). A year ago, the U.S., Federal Reserve Board was in the midst of raising its rates four times in an effort to get back to more normal conditions. No one suspected at that point that the Fed would do an about turn this year which would revive the bull market in bonds that most people thought was dead.

But a combination of slowing global growth, escalating trade wars, and strongarm pressure to cut rates from President Trump has changed the whole outlook.

And it's not just the U.S. that's turned dovish. New Zealand, India, and Thailand all announced rate cuts on Wednesday. The European Central Bank is expected to cut its rate in September and its deposit rate is already negative, at -0.4%. According to Deutsche Bank, about $15 trillion worth of sovereign bonds now have negative yields, meaning you have to pay governments or central banks to hold your money.

The Bank of England held the line at its August meeting, although it cut its growth forecast for next year and put the odds of a U.K. recession at one in three even if the country is able to negotiate a Brexit deal with Europe. A no-deal Brexit on Oct. 31 would almost certainly result in a massive rate cut.

I've been advising readers for a long time to ensure you have some bond holdings to cushion your portfolio against a potential stock market decline. Until recently, those investments were not generating great returns but now all that has changed. Bonds not only act as an insurance policy but they are also contributing to your bottom line.

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For most people, the easiest way to add bonds to a portfolio is to buy ETFs that invest in them. Here are three I recommend.

iShares Core Canadian Universe Bond Index ETF (TSX: XBB). This fund is a proxy for the entire Canadian bond sector, government and corporate. It was first recommended in the IWB in March 2007 at $29.44 and closed on Friday at $32.40.

Virtually all the bonds in the portfolio are investment grade (BBB) or higher. About 70% is in federal and provincial bonds, 2% in municipals, and the rest in corporates. Over 23% of the holdings are in long-term bonds, which are the most sensitive to rate changes. When rates decline, the price of long-term issues soars.

The fund earned only 1.28% in 2018 but it has been hot this year with a gain of 8.32% to Aug. 8. Distributions are paid monthly and are currently $0.074 per unit ($0.888 annually). The MER is only 0.1%.

iShares Core U.S. Aggregate Bond ETF (NYSE: AGG). This is the U.S. equivalent of XBB. It tracks the performance of the entire U.S. investment-grade bond sector. It was first recommended in this newsletter in January 2015 at US$111.97. The closing price on Friday was US$112.64.

The credit quality of this fund is excellent, with almost 72% of the portfolio invested in AAA bonds. However, it has more exposure to short-term bonds (five years or less) than XBB and less to long-term issues (20+ years). That explains why the year-to-date gain is slightly less at 7.83%.

This fund actually lost a fraction in 2018 (-0.05%) but has more than made up for it this year. Distributions are paid monthly and are currently about US$0.26 per unit ($3.12 per year) for a yield of 2.8%. The MER is a miniscule 0.05%.

iShares Global Government Bond Index ETF (CAD-Hedged) (TSX: XGGB). This fund seeks to track the FTSE World Government Bond Index, hedged back to Canadian dollars. It's a new fund, launched in September 2017 so we don't have much performance history. It only gained 1.82% in 2018 but this year it's ahead 7.37% year-to-date.

Just under 40% of the portfolio is invested in U.S. bonds. Other major countries represented are Japan (19.35%), France (8.27%), Italy (7.32%), Germany (5.29%), and Great Britain (5.08%). Just over half the portfolio is AAA rated and only a fraction is below BBB.

Distributions are paid monthly and are currently $0.029 per unit ($0.348 per year) to yield 1.6%. The MER is on the high side for a bond fund at 0.4%. The closing price on Aug. 9 was $21.34. We will add this ETF to the IWB Recommended List.

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TARIFFS AND THE U.S. STEEL INDUSTRY

Donald Trump delights in calling himself "tariff man". He seems to have convinced himself that there is no problem the U.S. can't solve by imposing tariffs.

One example is his attempt to resurrect the shrinking American steel industry by imposing tariffs on imports (including those from Canada until recently). How is that working out? Not very well, according to Dr. Merrill Matthews of the independent Institute for Policy Innovation, based in Dallas. This article was published in RealClearEnergy.

Dr. Matthews writes:

U.S. Steel, one of America's largest metal makers, just announced it will idle two blast furnaces in the coming months. That could put hundreds of workers out of a job.

The announcement is just the latest indication that President Trump's 25% tariff on steel imports may have unintended consequences.

When the president announced the tariff in March 2018, he predicted the taxes on foreign steel imports – taxes that Americans, not foreigners, must pay – would "help our domestic steel industry to revive idled facilities, open closed mills, preserve necessary skills by hiring new steel workers, and maintain or increase production."

The tariff failed for two main reasons. First, they raised production costs for thousands of companies ranging from auto manufacturers to oil and gas firms. Many companies scaled back their expansion plans and therefore had less need for steel products, whether foreign or domestic.

Second, the trade war has cooled the global economy, depriving U.S. steel plants of export opportunities.

To be sure, the tariff did give the U.S. steel industry an initial boost. United States Steel Corp. reopened two blast

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furnaces. And many domestic plants began raising prices. Thanks to the tariff, they could charge more and still be less expensive than foreign manufacturers.

Preliminary data from the Bureau of Labor Statistics shows that the number of people working in iron and steel mills grew from 82,087 in April of 2018, just after the steel tariff implementation, to 84,913 last December. That's an increase of about 2,800 jobs. And U.S. steel manufacturer stock prices initially surged.

But those initial job and share price gains proved fleeting. U.S. Steel's stock hit a record $45.39 in early March of last year. At the time of writing it was $15 – about a 70% drop. (Ed. Note: now $12.05, figures in U.S. dollrs.)

And the firm is not alone.

Nucor Corp.'s stock dropped from its peak of nearly $70 a share in January of last year to $55.50 (now $51.06). And Steel Dynamics Corp. has declined from its peak of $50.74 in early June of last year to $31 (now $28.19).

These firms' share prices are plummeting even as most stock indices are hitting record highs. Why? Steel prices are falling. The price of hot-rolled steel has declined 35% since reaching a near-decade high last summer, according to S&P Global Platts.

Steel manufacturers' fortunes are tied to the health of a number of other industries. Steel companies can't succeed if those industries are struggling—and many of them are.

Consider agriculture. China responded to President Trump's steel tariff by imposing its own tariffs, including many on agricultural products. Sales of soybeans and many other products have tanked since the implementation of tariffs. And decreased sales mean prices have also tanked – so much so that the President has twice announced that he is making federal tax dollars available to farmers who have been hardest hit.

Agricultural firms use steel in everything from barns to combines. When farmers suffer, so do steel manufacturers.

Likewise, the energy industry is a major buyer of steel. Energy firms use steel for drilling rigs, pipelines, refineries, and tankers that carry liquefied natural gas to other countries. Almost every aspect of energy production requires steel.

The automotive industry is also facing economic headwinds. After bottoming out in early 2009, due to the recession, auto sales rose steadily until early 2016. Since then they have remained flat, which is odd given the relatively strong economy.

President Trump has complained, correctly, that other countries imposed higher tariffs on the United States than the United States did on them. And he was the first to aggressively call out China for its tech transfer and intellectual property indiscretions.

But it isn't clear that pulling the steel tariff trigger so quickly – and so often – was the best and wisest way to address these foreign policy challenges. We are well over a year into the trade war and it's not clear that an end – especially a desirable end – is in sight.

President Trump presumably wants to help the steel industry prosper. To do that, his administration needs to find an acceptable tariff exit strategy as quickly as possible.

EDUCATION CRISIS OFFERS OPPORTUNITY

Contributing editor Glenn Rogers is with us this week. He is increasingly alarmed by the escalating U.S.-China trade war and has been searching for companies that are immune to its impact. He has found one to recommend today. Glenn has worked with private equity and venture groups on a variety of projects leading to successful exits for investors. Previously he worked in senior executive positions in both Canada and the U.S. and is a successful investor himself. He lives with his family in southern California.

Glenn Rogers writes:

We have been searching for stocks that will not be swept up this crazy trade war Trump has started. On Monday, the Chinese devalued their currency, which is certain to provoke another poorly thought out response from the White House.

The sad truth is this trade war is likely to spiral out of control until the 2020 elections are over. If Trump wins it will continue for a long time; if he doesn't it will be over shortly thereafter. In the meantime, buckle up – the markets are going to be a very volatile and scary place to be.

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So, it seems to me the places you want to be are emerging market bond funds for yield and U.S. companies that are not involved in manufacturing, importing, or exporting to China and that do not rely on sales within China. That would rule out companies like Apple, semiconductor companies, McDonalds, etc. It will also rule out most commodity businesses other than gold and silver, which have been performing well lately.

A company that meets my criteria is Chegg Inc. (NYSE: CHGG). It provides services and textbook rentals to students throughout America. Most of our readers are in Canada so have not been as negatively affected from a cost of education point of view as we have here in the U.S. Our university costs have soared for years leaving students and their parents with levels of debt that would be unimaginable a generation ago.

The reality is that the U.S. is gripped in an education debt crisis. How big a problem is it? Here are some recent statistics. About 43 million adult Americans – roughly one-sixth of the U.S. population over 18 – currently carry a federal student loan and owe $1.5 trillion in federal loan debt (figures in U.S. currency). Plus, there are an estimated $119 billion in student loans from private sources that are not backed by the government. These stunning numbers are a ticking time bomb, not dissimilar to the housing crisis we experienced in 2008.

Chegg has identified this market as an enormous opportunity since students and their parents are looking for ways to save money but also ways to improve their chances of successfully graduating from high school and university. There are 20 million university students and 16 million high school students for a total addressable market of 36 million that could benefit from Chegg's services. Their entire model is based online, and it is U.S. centric, so there are no issues around trade.

Since 1997, in-state tuition of public colleges has increased by 243%. The private colleges are worse. A total of 39% of students take remedial courses and 37% of them don't graduate.

Chegg services, which represent 79% of total revenues, are based on study programs, writing programs, math programs, and Chegg tutors. About 21% of the revenue comes from the textbook rental business, which is useful in supporting the brand and bringing students to other services. Evidently, students are finding the services valuable since they have grown from 300 subscribers in 2012 to over three million last year. Year-over-year growth from 2017 was 38% and the company had a compound average growth rate of 45% from 2012-2018.

Chegg Study has provided 25 million expert answers to students queries and five million step-by-step textbook solution sets. The company's library has over 30 million solution sets and expert answers. Over time, this database will become even more valuable and is a significant barrier to entry for competitors.

Last year Chegg had 198 million content views, which is 25% higher than the previous year. There are similar numbers for the writing and math segments, and it is useful to know that currently parents and students are spending over $3 billion annually on remedial courses at the college level. Additionally, parents are spending between $5 and $7 billion a year for tutoring in all subjects.

So, it's a big addressable market with an ongoing need. With continuing education required for retraining due to job losses in many industries, the service has lots of room to grow. Also, the company is well known, with 87% of college students reporting having heard of the company's services.

Today 64% of high school students are not prepared for college level math. Over 40% of college students must take at least one remedial math or English course.

The company is still in growth mode and revenues are increasing strongly, up 30% year-over-year. Annual revenue guidance was increased to between $398 million and $402 million with an adjusted EBIDA projected to be $121 million to $124 million. The company's gross margins will be 74%.

Recently the company reported second-quarter earnings which beat the street, with quarterly earnings of $0.23 per share. That was a 91.7% increase year-over-year.

The company's stock gapped up over 11% with that news and hit an all-time high of $48.22 in late July. But thanks to the last week's stock market meltdown you have an opportunity to buy back in at a reasonable price.

Action now: Buy with a target of $55. The shares closed on Friday at $43.68.

GLENN ROGERS'S UPDATES

Bank of American (NYSE: BAC)

Originally recommended on Sept. 20/10 (#20133) at $13.40. Closed Friday at $28.33. (All figures in U.S. dollars.)

Citigroup (NYSE: C)

Originally recommended on Sept. 20/10 (#20133) at $39.50. Closed Friday at $66.05. (All figures in U.S. dollars.)

Background: These are two of America's largest financial institutions.

Performance: Bank stocks as a whole have not been doing well lately and that situation is likely to continue for some time. Bank of America is off about 9% from its year-to-date high while Citigroup is down about 12%.

We recommended Bank of America many years ago when it was trading at $13.40. Since then it has run up to the high $20s and basically stayed there for the last few months. Citigroup was recommended at $39.50. I updated it last June when it was trading at $67.28. It's basically been flat since, trading within a very narrow range other than last December's meltdown.

Recent developments: Both companies released second-quarter results last month and share prices initially moved higher on decent numbers. However, the Fed's decision to lower interest rates hit bank stocks hard.

Bank of America reported an 8% increase in net income to $7.3 billion. Diluted earnings per share were up 17% to $0.74. Revenue increased by 2% to $23.1 billion. Net interest yield rose three basis points to 2.44%.

Citigroup reported net income of $4.8 billion ($1.95 per diluted share), on revenues of $18.8 billion. This compared to net income of $4.5 billion ($1.63 per share) on revenues of $18.5 billion for the second quarter 2018.

The sell-off after the Fed's rate announcement suggests that the market believes that lower interest rates will hit bank profits in the second half of the year.

Dividend: BAC pays a quarterly dividend of $0.15 per share ($0.60 a year) to yield 2.1%. Citigroup just raised its dividend by 13% to $0.51 per quarter ($2.04 per year) for a yield of 3.1%.

Outlook: If the Fed continues to reduce rates (a real possibility if Donald Trump persists in escalating his trade war with China) it will be bad news for bank stocks. Lower interest rates reduce the net interest margin (NIM), the difference between the rates that banks charge lenders and what they pay to savers.

I like Bank of America more than Citigroup because it has less exposure to international trade and foreign markets in general.

I think it's okay to own little BAC at this point but until all the trade nonsense settles down and the Fed stops easing rates financials are just not a great place to be.

Action now: Hold of Bank of America. Sell Citigroup for a gain of 67%.

Shopify (TSX, NDQ: SHOP)

Originally recommended on Feb. 22/16 (#21608) at C$28.34, US$20.57. Closed Friday at C$488.36, US$369.95.

Background: Shopify is a cloud-based, multi-channel commerce platform designed for small and medium-sized businesses. Merchants use the software to design, set up, and manage their stores across multiple sales channels, including web, mobile, social media, marketplaces, brick-and-mortar locations, and pop-up stores. Shopify currently powers over 800,000 businesses in approximately 175 countries. The company is based in Ottawa.

Performance: This stock is been an absolute monster. We recommended it in February 2016 when it was trading at $28.34. It closed Friday in Toronto at $488.36 after setting a new all-time high last week, for a massive game of 1,623% since it was recommended.

Recent developments: The latest quarterly results were stellar. The company reported adjusted earnings per share of $0.14, well above the Wall Street consensus forecast (the company reports in U.S. dollars and in accordance with U.S. GAAP). However, non-adjusted net income is still in the red because of heavy capital investment. The company reported a net loss of $28.7 million in the quarter compared to a loss of $24 million the year before.

Revenue was up 48% year-over-year to $362 million, versus expectations of $350.5 million. At June 30 the company held $2 billion in cash and marketable securities.

The company also raised its forecasts for the full year. It

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Glenn Rogers's updates – continued from page 5…

now expects 2019 revenue to be in the range of $1.51-$1.53 billion with adjusted operating income in the range of $20-$30 million.

The company announced that it is continuing to expand its operations world-wide. It launched native language capabilities in eleven more languages (Traditional Chinese, Simplified Chinese, Danish, Dutch, Finnish, Hindi, Malay, Norwegian, Swedish, Korean, and Thai), bringing the total number of languages in which the Shopify platform is available to 18.

The stock rose 7% after the results were released.

Dividend: None.

Outlook: The stock is up 150% year to date and looks like it can go higher still. I've been hoping for a pullback so I can buy more but no luck so far. This is the only viable alternative to Amazon and it's not affected by Trump's trade policies.

Action now: Hold. This is my largest personal position and every time I've been tempted to take profits it keeps going higher.

Freeport-McMoRan Inc. (NYSE: FCX)

Originally recommended on Feb. 15/10 (#20107) at $36.84. Closed Friday at $9.75. (All figures in U.S. dollars.)

Background: Freeport-McMoRan bills itself as "the world's premier publicly-traded copper company". Headquartered in Phoenix, its portfolio of assets includes the Grasberg minerals district in Indonesia, one of the world's largest copper and gold deposits, and significant mining operations in North and South America, including the large-scale Morenci minerals district in Arizona and the Cerro Verde operation in Peru.

Performance: This huge copper company has been a real disappointment. The stock is well down from where we recommended it, and from the last update when it was trading at $19.54.

Recent developments: The company reported a drop of 31% in second-quarter revenue compared to the same period in 2018, to $3.5 billion. Copper production dropped by 23% and the average realized price per pound fell to $2.75 from $3.08. Meanwhile, the unit cash costs of production rose from $0.96 to $1.92, due in part to the transition from open pit to underground mining at the Indonesia mine. Gold production declined by 79%. None of this is encouraging.

Dividend: The stock pays a quarterly dividend of $0.05 per share ($0.20 annually) to yield 2.1%.

Outlook: All commodities are to be avoided right now. Take the loss and wait to see if we ever see signs of inflation, or global growth picking up, or the end of the trade war. There's nothing wrong with the company. This is just a terrible market for everything metal except gold and silver.

Action now: Sell.

RICHARD CROFT'S UPDATES

iPath Series B S&P 500 VIX Short-Term Futures ETN (NYSE: VXX)

Originally recommended on July 29/19 (#21928) at $21.64. Closed Friday at $26.92. (All figures in U.S. dollars.)

Background: VXX provides exposure to a daily rolling long position in the first and second month VIX futures. Bottom line, it is the easiest way to replicate the short-term performance of VIX (stock volatility index).

Performance: The price bounced up and down like a yo-yo last week, in line with the big dips and rallies we saw in the market. Since it was recommended at $21.64 in the issue of July 29, it has traded as low as $21.59 and as high as $30.09. It closed on Friday at $26.92, for a gain of 24% over the recommended price in just two weeks.

Comments: At the time of my recommendation, I stressed that this was a way to provide short-term insurance for your portfolio in the event of a sharp market drop. It is highly volatile (six times more than the S&P 500) and is not a long-term hold by any means.

This ETN has acted just as I predicted. It has given you some upside in a losing week on the markets, thereby cushioning some of the overall losses you may have experienced.

Action now: Sell. VXX has done its job. Take your profit and exit now.

GORDON PAPE'S UPDATES

Amazon.com (NDQ: AMZN)

Originally recommended on Jan. 16/17 (#21703) at $817.14. Closed Friday at $1,807.58. (All figures in U.S. dollars.)

Background: Amazon is the largest on-line retailer in the world, but the company is also involved in many other businesses including cloud storage, video streaming, film production, voice-activated software (Alexa), and more.

Performance: The stock topped $2,000 in July but sold off after reporting its first profit miss in two years after investing heavily in technology to speed up delivery times.

Recent developments: On July 25, the retailing giant announced second-quarter results. Net sales were up 20% to $63.4 billion compared to $52.9 billion in the same period last year. However, the improvement in the bottom line was nowhere near as impressive. Profit was $2.6 billion ($5.22 per share, fully diluted) compared to $2.5 billion ($5.07 per share) the year before.

Part of the reason for the profit disappointment was an expenditure of more than $800 million to cut delivery times to Amazon Prime members to one day. The company is coming under increasing pressure from rivals like Walmart to reduce delivery times to an absolute minimum.

The push for faster delivery is also going to hit third-quarter results. The company forecast that, while revenue is expected to increase between 17% and 24%, operating income is expected to be between $2.1 billion and $3.1 billion, compared with $3.7 billion in the third quarter of 2018.

Potential acquisition: CIBC reported last week that Amazon is negotiating to buy a 26% stake in India's Reliance Industries, that country's largest traditional (bricks and mortar) retailer.

Outlook: Profit for the rest of the year will be impacted by capital investment but the continued rapid growth in sales is an encouraging sign for the long term.

Action now: Buy. Take advantage of the price pull-back. RBC Capital Markets has a target of $2,250 on the stock, with an "outperform" rating.

Alphabet Inc. (NDQ: GOOGL)

Originally recommended on June 16/14 (#21421) at $607.40. Closed Friday at $1,188.90. (All figures in U.S. dollars.)

Background: Alphabet is the umbrella company that owns Google (which includes Android and YouTube}, Nest (home automation), Calico (anti-aging research), Fiber (high-speed Internet), Google Ventures (new company investments), Sidewalk Labs (city infrastructure), and Waymo (driverless cars).

Share split: The stock split 2 for 1 shortly after we recommended it. If you owned 100 shares at that time, you now have 100 each of GOOG (non-voting C shares) and 100 of GOOGL (voting A shares). We track only GOOGL, as it represents the original shares acquired.

Performance: The shares moved up nicely following the release of strong second-quarter results. But they were hit in the big sell-off that followed the Federal Reserve Board's interest rate announcement, which disappointed investors.

Recent developments: The company released second-quarter results on July 25 and the closely-watched revenue figure beat analysts' expectations. Alphabet reported revenue of $38.9 billion compared to $32.7 billion last year. That was an increase of 22% in constant currency terms.

For the first six months of the fiscal year, revenue was $75.3 billion, up from $63.8 billion in the first half of 2018.

Net income for the quarter was $9.9 billion ($14.21 per share, fully diluted) compared to $3.2 billion ($4.54 per share) the year before. The 2018 quarter was hit by a $5 billion fine levied by the European Union for anti-trust violations. Analysts had expected earnings per share of $11.32.

For the six months, the company posted earnings of $16.6 billion ($23.71 per share) compared to $12.6 billion ($17.89 per share) in 2018.

Free cash flow for the quarter was $6.5 billion.

Dividend and buybacks: The stock does not pay a dividend. However, the company has a share buyback program and the board recently authorized the purchase of an additional $25 billion worth of Class C shares.

Action now: Buy. The market sell-off offers an entry opportunity.