Vancity Investment Management

RESPONSIBLE INVESTING NEWSLETTER – NOVEMBER 2018

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A cautious approach to cannabis

On October 17, the government of Canada removed the prohibition on recreational use and possession of cannabis by individuals over the age of 18. The stated purpose is to reduce illegal activities and the burden on the criminal justice system, while providing access to quality-controlled products and enhancing public awareness of the health risks associated with cannabis use. Broad public support for legalization is evidence of shifting attitudes toward a commonly used recreational drug. According to Statistics Canada, 43% of Canadians aged 15 or older have tried marijuana, and 33.5% have used it more than once.

Legalization is a major shift in public policy with potential for positive and negative impacts. It is expected to largely eliminate a black market that currently forms a major source of revenue for organized crime. And by legalizing and regulating the cannabis market, federal, provincial and municipal governments will capture revenue from sales, licensing and taxation.

On the negative side, chronic consumption can lead to increased substance abuse and other health problems. Smoking cannabis will expose users and others to carcinogens, contribute to respiratory problems and increase risks of heart disease. Driving under the influence of cannabis may also result in decreased road safety.

Some government revenue will likely be used to address the social and health costs associated with recreational cannabis use. Law enforcement can direct more resources towards preventing impaired drivers from operating motor vehicles. Education programs and mass communications can be tailored to deliver realistic messages on the impact of chronic consumption. Treatment and intervention programs can help mitigate some of the anticipated social costs when cannabis use is normalized.

The introduction of recreational cannabis into the legal marketplace raises specific concerns for socially responsible investors. In addition to moral or ethical issues related to potential substance abuse, there are regulatory, litigation and social impact risks. For example, exposure of non-users to combustion by-products could result in litigation against producers and distributors. Similarly, impairment of cannabis users could lead to accidents or other incidents in the workplace, resulting in further regulation, litigation or reputational risk for employers who are responsible for maintaining healthy and safe work environments. There is also a concern that social impacts associated with alcohol abuse may be exacerbated when cannabis is used in combination with alcohol. All we know for certain is that the full extent of social costs and impacts resulting from widespread use of legal cannabis are not fully understood, but will become more evident with time.

Despite the obvious risks inherent in any new business venture, investors have been moving capital into the sector. Over the past year, publicly traded companies involved in the production or distribution of legal medical cannabis have seen stock prices soar or plummet in direct response to news or events regarding legalization of recreational cannabis. In anticipation of a new sub-sector in the Canadian market, there is a cannabis-themed index – and ETFs that track it – comprised of companies based in Canada and the U.S. While the U.S. federal government maintains its prohibition on cannabis, 30 states have legalized its use for either medical or recreational purposes. As of October 16, the day before legalization, the market capitalization of the 18 Canadian producers in the Canadian Marijuana Index was $57 billion.

In selecting suitable investments for the IA Clarington Inhance SRI funds, Vancity Investment Management Ltd. is taking a cautious approach to companies with exposure to the cannabis industry. In the near term, we will be excluding companies that derive more than 5% of annual revenue from recreational cannabis production, distribution or sales. We will re-examine the appropriateness of investing in these companies as the industry matures, the social implications of legalization become clearer and the regulatory system evolves. Companies involved in the sale of medicinal cannabis products will remain eligible for investment if they meet our ESG and financial criteria.

Dermot Foley, CFA, is Portfolio Manager – ESG Analysis, at Vancity Investment Management Ltd.

If opportunity doesn't knock, build a door

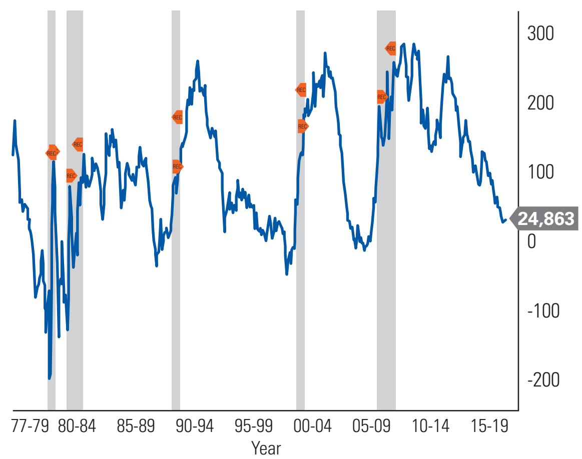
November saw Americans go to the polls for mid-term elections and, as many expected, they delivered a split Congress. The U.S. Federal Reserve left its benchmark rate unchanged at 2.25% and reaffirmed its gradual tightening stance. The potential for a December hike was reinforced by U.S. producer price inflation accelerating to 2.9% year-over-year in October, from 2.6% in September.

What will the remainder of 2018 bring us? In the wake of October's market pullback, developed market benchmarks recorded a month-end decline of between 5% and 7% in Canadian dollar terms. This was after a broad-based recovery in the final week of October. Although the concerns that precipitated the October sell-off – rising interest rates, trade tensions and the global economic slowdown – have not dissipated, we see similarities between October's drop and the correction we experienced in February. Remember that following the February sell off, the S&P 500 Index went on to post all-time highs within six months.

It is worthwhile to look at what has changed in the economic indicators we follow.

The yield curve has not inverted, with the spread between the 10-year and 2-year Treasury curves holding firm at +25 basis points (bps). Historically, a negative spread between 2-year and 10-year rates (i.e. 2-year rates higher than 10-year rates) has been a precursor of recession. We have never had a recession without a yield curve inversion, and the S&P 500 Index historically peaks about a year after an inversion.

10-year/2-year Treasury yield spread (basis points)

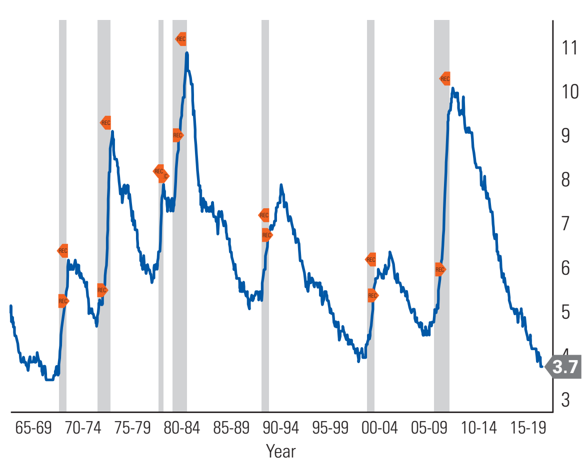


Source: Bloomberg, as at November 14, 2018.

Credit spreads over risk-free government bonds typically widen significantly ahead of a downturn as conservative investors in corporate debt become more apprehensive about a company's ability repay and require a higher return to take on the perceived increase in risk. Previous cycles have seen U.S. high-yield credit spreads widen by 400 bps. Currently, U.S. high-yield spreads are only 40 bps off cycle lows.

Unemployment rates usually bottom out about a year ahead of a recession. Economists currently forecast U.S. unemployment to continue declining to 3.2% in Q4 2019.

U.S. unemployment rate (%)



Source: Bloomberg, as at October 31, 2018.

Previous recessions have shown corporate earnings usually overshoot trend levels at the peak of a market cycle. When strategists look back on previous recessions, we see that market peaks in U.S. earnings per share have overshot trend levels by 10–50%. For example, the most recent peak earnings prior to a recession was in 2007, when earnings were 29% above trend levels. Currently, U.S. earnings are calculated at 13% above trend levels; if you adjust for the Trump tax cuts, the ex-tax earnings level is just 6% above trend. This suggests there may be a fair amount of room before earnings peak in the current cycle.

It seems that since the beginning of the year investors have been reluctant to pay up for future company earnings. We have seen this reflected in a de-rating of market multiples from a P/E ratio of 18.5× in January to a trough of 15.3× at the October lows. With the next 12-months forecast earnings per share for the S&P 500 Index at $174, the current forecast P/E ratio of 15.7× is slightly below long-term average levels for the index.

Milton Berle's remark that, "When opportunity doesn't knock, build a door" aligns with our view that it's not time to head for the exits. We believe that in times of market volatility, investment opportunities will present themselves if we stick to our responsible investment process, which integrates environmental, social and governance analysis with in-depth financial analysis. We believe this process adds value through enhanced risk management and superior return potential.

Andrew Simpson, CFA, is Director – Investment Management, at Vancity Investment Management Ltd.

DEFINITION OF TERMS

Basis point – One one-hundredth of one percent (0.01%); Benchmark rate – Refers to the interest rate set by the U.S. Federal Reserve

Corporate debt – A bond issued by a corporation

Credit spread – The yield difference between two types of credit instrument, typically expressed in percentage points or basis points

Environmental, social and governance (ESG) – Some portfolio managers will only invest in companies with progressive environmental, social and corporate governance policies;

Exchange-traded fund (ETF) – An ETF, or exchange traded fund, is a security that trades openly on a stock exchange and represents an underlying basket of securities (frequently an index). The price of an ETF is determined by supply and demand on the stock exchange, and not (as with mutual funds) by daily net asset value;

High-yield bond – A fixed-income security with higher risk and higher yield than investment grade bonds. High-yield bonds are rated below BBB (S&P) or Baa (Moody's);

Market cycle – A full market cycle includes a peak, downturn, trough and rise to another peak;

Multiple – A ratio that measures a company's financial health and indicates how much investors are willing to pay for a security;

P/E ratio – An important stock valuation metric that measures the price of a company's shares relative to per-share earnings;

Treasurys – Debt instruments issued by the U.S. government with fixed interest rates and maturities that range from one to 10 years;

Yield curve – Graphically illustrates the yields and maturities of bonds of similar credit quality. A normal yield curve slopes upwards (i.e. bond yields rise as maturities lengthen). A flat yield curve indicates that yields on long- and short-maturity debt instruments are roughly the same. An inverted yield curve represents market conditions in which long-term debt instruments have lower yields than short-term debt instruments. An inverted yield curve has historically been a leading indicator of recession. The long or back end of the yield curve is the part of the curve that plots longer-dated bonds. The short or front end of the yield curve is the part of the curve that plots shorter-dated maturities.

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And we will be invested in you.

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