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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

The troubled TSX

ANYWHERE BUT UP

Keith Richards

The trouble with the TSX index is that it is a concentrated index. In truth, that's because the Canadian market is a concentrated market economy. For instance, the TSX 300 index holds:

☛ 32 per cent weighting in financials.

☛ 16 per cent is in energy…We're talking almost 50 per cent of the index in just 2 sectors!!!

After that…Industrials and minerals come in at around 11 per cent each. Then smaller amounts in other sectors. So we're talking around 70 per cent of the index focused on 4 sectors.

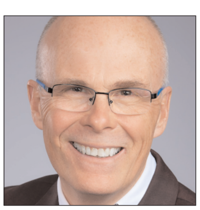
I bring this issue of a focused market index up because of the seemingly never-ending flat performance seen on the TSX. Take a look at the TSX 300 index in January of 2018. As I write this article, almost two years later, it is just a percent or so higher than where it was way back then. One might have been fooled into believing in new life for the TSX when the composite took out its former high level of around 16,500 back in September. The TSX Composite almost reached 17,000 (16,947 to be exact) that month. A solid move above resistance….or so it seemed!

The problem with that "breakout" move in September was that it was on the back of an oil threat coming after the drone attack in Saudi Arabia. Energy - representing 16 per cent of the TSX 300 index, temporarily popped on that news. This move on energy ended up driving the TSX momentarily higher. When things calmed down a few days later, energy prices, and the TSX, fell back. The concentration of energy within the TSX Composite allows for a false breakout. Such a move may fool technically driven investors like ourselves to read more bullishly into a situation than is merited. Unless, that is, you use a 3-bar breakout rule as I have discussed on this blog before, and in my book, *Sideways*.

My take: Before we prognosticate about the potential for the TSX index, we need to look at those top 4 sectors that make up 70 per cent of the TSX's return. We need to pay particular attention to financials and energy, given the 50 per cent weighting of their presence in the index. Let's look at these sector charts for clues as to the merits of buying a TSX index ETF or similar vehicle

Financials

The recent breakout on the iShares TSX financials ETF (XFN-T) didn't include too much influence from Canadian banks. Banks, the larger influence on this sector –followed oil's rally and decline in September, which presented a false breakout at that time. Since then, the banks have rallied a bit, but haven't made too much of an effort



Keith Richards is a Portfolio Manager at ValueTrend Wealth Management. Sponsoring investment dealer: Worldsource Securities Inc. Member: CIPF and IIROC. He provides commentaries on equity markets and stocks during television and radio interviews and is a frequent guest on Business News Network. He also writes a monthly business column for Investor's Digest of Canada.

krichards@valuetrend.ca.

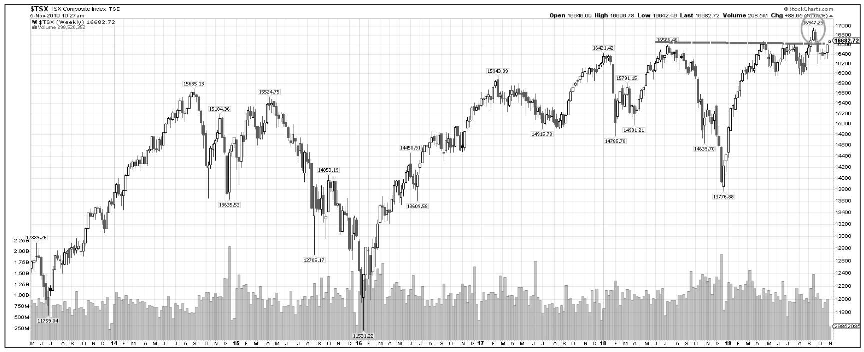
at putting in new highs. The banks have settled back into their “holding pattern” of sideways returns. Meanwhile, the broad financial ETF (XFN-T) has broken out, mainly on the back of a very few select names in that index. Namely, Element Financial (EFN-T) and the insurance names in the ETF. So, what we have here is a very narrow leadership within a sector that represents 32 per cent of the returns for the TSX 300 index!

Energy

Take a look at the iShares Energy Producers ETF (XEG-T). It doesn’t take a highly trained Technical Analyst to spot the September pop on oil stocks as just another lower high in a series. Clearly, the energy sector, weighing in at 16 per cent of the vote, is not supporting a new breakout for the TSX 300 index. Note the lower lows and lower highs. That’d be a downtrend, folks! The trend should be assumed as bearish until a base and breakout occur. Perhaps energy is basing now, having put in a couple of flatter lows recently. But it’s far too early to become bullish on the sector. The broad index isn’t going to get much help from the energy sector until that downtrend reverses.

Industrials

A small rally in September for the Canadian Industrials (BMO ZIN ETF) didn’t last long. The sector is consolidating. What is important is to note that the sector is not looking like it’s going to help the broader TSX index make new highs, at least at this time. It’s a weak looking chart until that old high of just under $30 is taken out.



Materials & mining

Another questionable breakout. The iShares Materials ETF (XMA-T) hit $15.11 in September, barely beating out its early 2018 high of $14.98. This sector, as seen via the ETF, seems to hit a ceiling at $15 or so, then fall like a brick. The sector is stuck in a 4-year consolidation pattern. A great ETF if you are a swing trader. But the sector is not as great as a market leader. It's hard to call this chart supportive of a new bull market for the TSX 300.

Conclusion

The breakout by the TSX back in September was less about the strength of the Canadian stock market. It was more about a temporary action by the leading sectors – specifically the energy and financial sectors. They reacted to a single, unique political event. That event (the Saudi air drone attack) was expected to pressure oil prices upwards. Canada's economy and its growth are dependent to a certain degree on energy (are you listening, pipeline haters?). When reality settled in and energy prices returned to lower levels, the TSX 300 returned to no-man's land. Meanwhile, the U.S. market went on to new highs.

Beyond financials – The leading sectors within the TSX 300 index do not support a lasting bull market at this time. Sure, the financial sector may drive the index to another new high in the short term. But that pop, if and when it occurs, may not be so long lasting. You need broad, sector participation to sustain a bull market. Oil needs to find a bid. Industrials and materials need to participate to some degree as well. The financials can influence the market for a period, but not for the longer term. A healthy market should display wide participation in most of the sectors. As Red Green (the iconic Canadian comedy show starring Steve Smith) used to say: "We're all in this together". Certainly, in the case of a market index, this is true. ▼

Keith Richards, President & Chief Portfolio Manager of ValueTrend Wealth Mgmt., can be contacted at krichards@valuetrend.ca. *He may hold positions in the securities mentioned. The information provided is general in nature and does not represent investment advice. It is subject to change without notice and is based on the perspectives and opinions of the writer only. It may also contain projections or other "forward-looking statements." There is significant risk that forward looking statements will not prove to be accurate and actual results, performance, or achievements could differ materially from any future results, performance, or achievements that may be expressed or implied by such forward-looking statements and you will not unduly rely on such forward-looking statements. Every effort has been made to compile this material from reliable sources; however, no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please consult an appropriate professional regarding your particular circumstances*