The Harbour Group
of RBC Dominion Securities

Wealth Management
Dominion Securities

Harbour Monthly

An Exclusive Newsletter for Our Clients and Friends | June 2017

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Fixed income and currency – the times they are a-changin'

- Government bond yields continue to be low, though they are up from year-ago levels.
- Canada's economy is performing well, but bond yields are still at levels more associated with economic weakness.
- The Bank of Canada is finally suggesting that higher interest rates are on the way.
- Corporate and high yield bonds continue to perform well as company fundamentals remain robust, as evidenced by first quarter earnings.
- The preferred share market got off to a strong start in 2017, with gains moderating in recent weeks as interest rates have drifted lower.
- The Canadian dollar has taken a sharp turn higher with the Bank of Canada's unexpected change in tune.
- We continue to believe the risk to interest rates is higher, and feel that corporate bonds and preferred shares are best poised to deliver returns in such an environment.
- Despite low yields, high-quality fixed income can play a role in buffering volatility in challenging markets.

Ever since the recession in 2008/2009, traditional fixed-income solutions such as government bonds and GICs have been less about return ON capital and more about return OF capital. As we reach the mid-point of 2017, that unfortunately hasn't changed all that much as the Bank of Canada has kept interest rates at ultra-low levels, despite an economy that has recovered nicely from the energy slump. Interest rates on government bonds and GIC continue to reflect that fact, but we think we are in the early innings of change.

Government bonds continue to underprice risks …

Exhibit 1 (next page) depicts Canada's nominal GDP growth (real GDP growth plus inflation) and 10-year government bond yields. It shows that for most of the post-2008 era, the economy and yields have largely moved in the same direction, as one would expect. However, in 2017, 10-year bond yields have stubbornly moved down while growth continues to gain momentum as Canada emerges from the challenges in the oil patch to lead the G7 in first-quarter GDP growth. With inflation currently trending at 1.6%, and the 10-year Canadian government bond yield at 1.56% as of June 13, 2017, investors are earning less than inflation, and that is before taxes are taken into account. In other words, these securities are not even providing return OF capital with inflation taken into account.

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The risk with yields at such low levels is a sharp increase in bond yields like those seen in 2013 and 2016 as investors wake up to the stronger growth numbers in Canada. With coupon income so close to zero, these securities can only withstand small losses before total returns on an annual basis turn negative, which is not what fixed-income investors signed up for.

While there is always room in portfolios for high-quality government bonds to preserve capital during times of extreme volatility, this is not a sector we are keen on at current valuations. If and when yields start to more accurately reflect economic reality, we would consider increasing allocations.

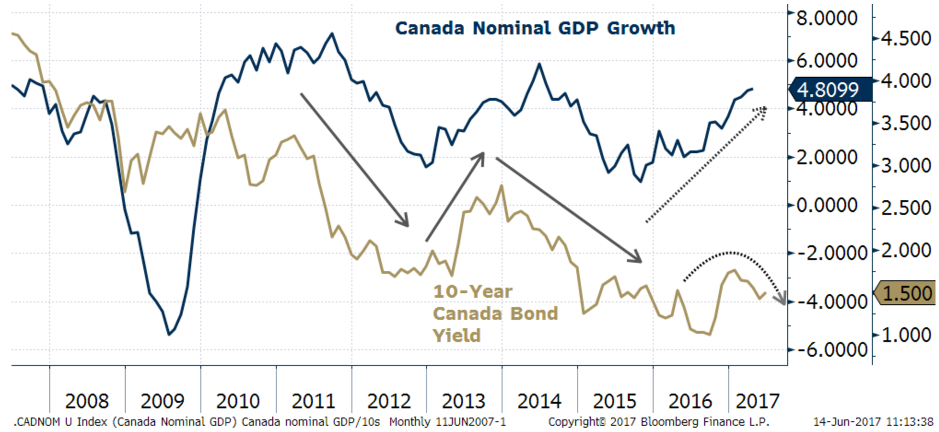
… as the Bank of Canada looks set to nudge rates higher

With the Federal Reserve raising interest rates for the second time this year on June 14, the Bank of Canada has lagged the Fed's moves, last raising rates in 2010, and of course famously cutting interest rates twice in 2015. The Bank of Canada typically moves in concert with the Federal Reserve, but it has lagged so far this cycle.

Canadian economic growth has bounced back strongly, as has employment, while wage growth appears to be bottoming. Throw in runaway housing markets in Toronto (at least until recently) and Vancouver, and the case for higher interest rates is clear. The Bank seems to recognize this, as Deputy Governor Carolyn Wilkins in a June 12 speech said that the Bank is assessing whether less stimulus is needed, a notable change in tone from the Bank. This was followed up by Governor Stephen Poloz the next day suggesting consumers think "about what their finances would look like were interest rates to be a little higher when they renew their mortgage."

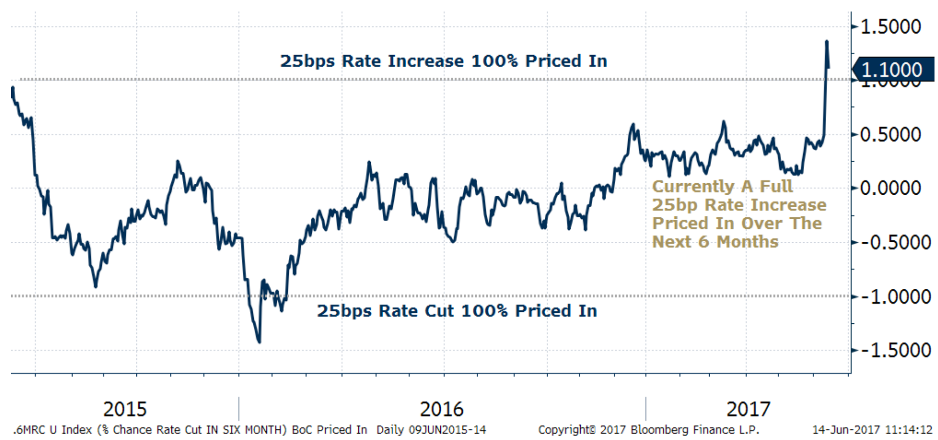
RBC sees the first rate increase in the second quarter of 2018, but derivatives markets are now pricing in a full rate hike in the next six months as seen in Exhibit 2. In our opinion, higher rates from the Bank of Canada can't come soon enough, as we believe savers have been punished by negative real interest rates for too long.

Exhibit 1 – Canadian growth and bond yields



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 2 – Six-month probability of Bank of Canada rate increase



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Corporate bonds reflect strong corporate fundamentals …

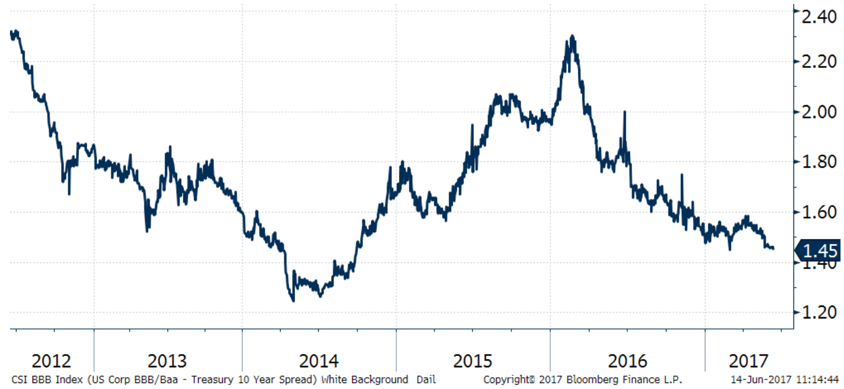
With government bond yields unappetizing, our preference has run toward corporate bonds, and these securities have performed strongly over the last year, and particularly since early 2016, when corporate bonds were stressed by the turmoil in energy markets. Since that time, credit spreads for corporate bonds (the extra yield that they pay over and above a government bond of the same term, Exhibit 3) have come down considerably, adding to performance as lower yield spreads equal higher prices, all else equal. We believe this sector of the bond market is fairly valued and reflects the fundamentals of corporations which by and large continue to improve.

… while the preferred share recovery builds

To say that 2015 and early 2016 were challenging times for the preferred share market is an understatement, but since this market reached its nadir in January 2016, the recovery has been quite substantial. The pain in the preferred share market was driven by government bond yields hitting new lows while credit spreads were high, a nasty combination for preferred shares, particularly those of the rate-reset variety as investors feared getting their dividend reset at substantially lower levels.

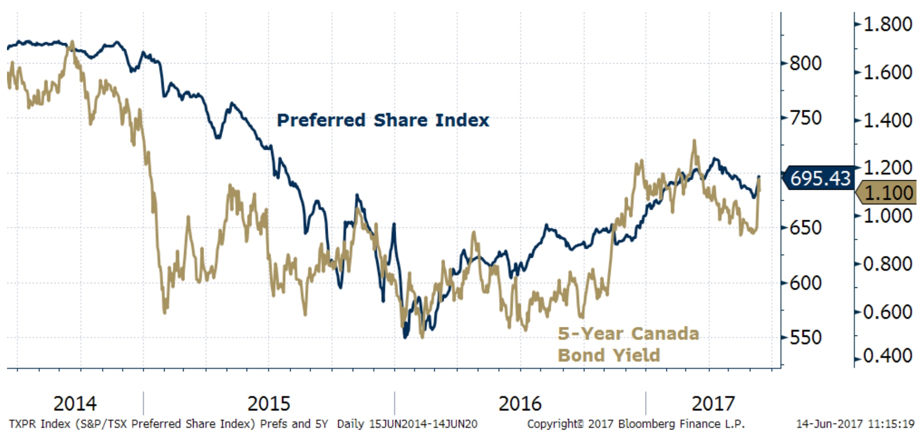
Fast forward to today, and 5-year Government of Canada bonds yield double what they did in January 2016 and credit spreads have decreased substantially. The distressed nature of the preferred market at that stage also led to a new breed of institutional investors entering the market, adding an important new source of demand for this asset class. With interest rates rising sharply post the U.S. election, the preferred market followed, with rate-resets in particular seeing strong gains in early 2017. Those gains have moderated somewhat as bond yields have fallen a bit, but we would expect renewed performance from rate-reset preferreds should the Bank of Canada hint further at rate hikes and drive 5-year bond yields higher in the process. With a combination of attractive current yields and its status as one of the only asset classes set to do well when bond yields rise, we want to maintain exposure to the rate reset preferred share market.

Exhibit 3 – BBB corporate credit spreads



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 4 – Preferred Shares and 5-Year Bond Yields



Source: Harbour Group of RBC Dominion Securities, Bloomberg

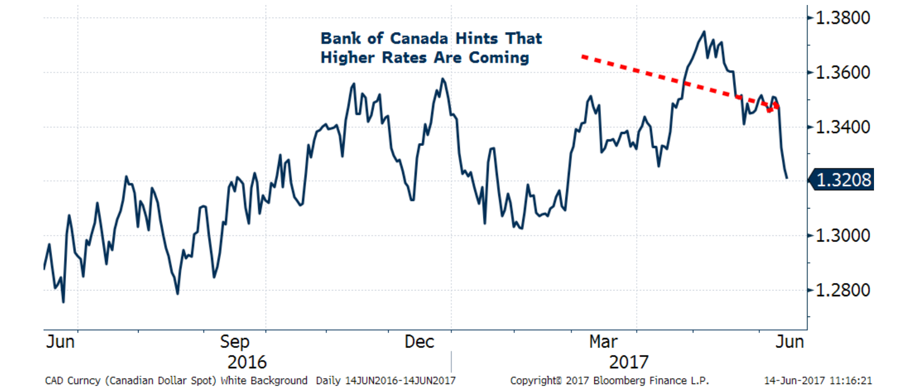
Canadian dollar reacts to new tone from the Bank of Canada

The Canadian dollar strengthened materially (Exhibit 5) after the Bank of Canada changed its view on the future path of interest rates. The move higher in the Canadian dollar was exacerbated by the fact that hedge funds and other leveraged investors are currently betting heavily against the Canadian dollar as seen in Exhibit 6. The short position in Canadian dollar futures contracts recently hit a record, suggesting that a significant amount of money is betting on further Canadian dollar weakness.

With the currency jumping higher, many of these investors are likely reversing their positions, putting more upward pressure on the currency.

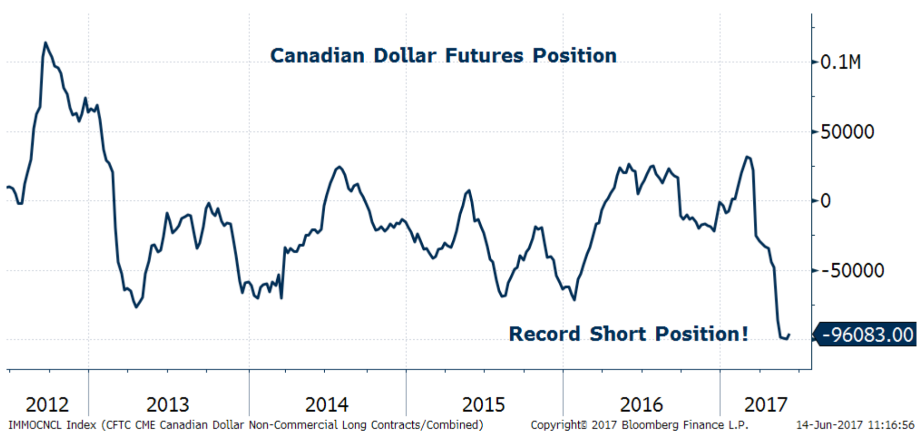
RBC's forecast for the Canadian dollar currently sits at 1.40 per USD for year-end 2017, but foreign exchange markets are challenging that view. Should the Bank indeed raise interest rates before year-end, forecasters street-wide will likely need to reassess their calls. The fact remains that the Federal Reserve is also on a path to higher rates and that likely limits the degree to which the Canadian dollar can strengthen, and our bias continues to be to accumulate U.S. dollars. Recall that when the Canadian dollar last traded anywhere near parity, the U.S. was at zero interest rates and engaged in quantitative easing (printing money to buy government bonds) while the Bank of Canada was threatening higher interest rates, a situation that looks unlikely to be repeated any time soon.

Exhibit 5 – Canadian dollars per U.S. dollar



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 6 – Canadian dollar futures position



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Bottom line

Traditional fixed-income options like government bonds and GICs are still offering yields well below what we deem to be attractive but we are optimistic that this will improve in the coming months and years. The Federal Reserve is raising interest rates and now that the Bank of Canada looks set to follow we see an opportunity to layer on additional U.S. dollar exposure.

As the business cycle ages we should see interest rates approaching fair value which could provide an opportunity to shift asset allocation toward traditional fixed income for the first time in years. In the meantime, we believe the extra yield provided by corporate bonds and preferred shares is an attractive alternative, while the added protection from higher bond yields embedded in rate reset preferred shares is a unique attribute not easily found in any asset class.

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