RBC Dominion Securities Inc.

# Fickel's Focus

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## First Quarter Investment Commentary

### Economic Overview

The International Monetary Fund (IMF) projects global growth of 3.2% for 2016, broadly in line with last year. The bulk of the world's countries are suffering unusually tepid expansions. The IMF notes "…that unfavorable demographic trends, low productivity growth, and legacies from the global financial crisis continue to hamper a more robust pickup in activity. While accommodative monetary policy and lower oil prices support domestic demand, still weak external demand and tighter financial conditions will weigh on the recovery." Central bank's efforts to revive growth using traditional monetary stimulus are meeting with less success than usual. There is a growing chorus of support now for fiscal intervention.

The Federal Reserve's (FED) most recent assessment of the U.S. economy strikes a relatively positive tone. The FED noted that residential activity strengthened, manufacturing activity improved modestly, capital spending increased on balance, labour markets continued to strengthen, wages jumped in most regions, and it was difficult to fill jobs in many districts. Were it not for the assortment of geopolitical risks, the FED would likely adopt a more aggressive monetary stance.

Europe is benefitting from weak energy prices, low rates, currency depreciation and less fiscal drag. Leading indicators remain favorable. Money supply growth signals faster economic growth, banks are easing credit conditions, consumer confidence is at a four-year high and measures of manufacturing activity are firmly in expansion territory. At 10.2%, unemployment is at its lowest level in four years and companies are hiring at the fastest pace since the financial crisis. The European Central Bank's (ECB) 80 billion euros a month sovereign bond buying program should support growth of 2.0% in 2016.

*Continued from page 1*

The Bank of Canada (BOC) recently revised its growth forecast upward for 2016 to 1.7% followed by a respectable 2.3% for 2017. The upgrade reflects a firm handoff from 2015, a stronger than forecast Q1, 2016 and the contribution to growth from the Liberal government spending program. A weak Canadian dollar and a firm U.S. economy should boost export growth in 2016 with trade providing a meaningful 0.5% lift to GDP. Core inflation close to 2% along with average annual wage gains of 3% suggest no further BOC easing.

China's stimulus measures seem to be stabilizing growth and helping to ease global financial market concerns. Q1 GDP expanded 6.7% as retail spending, factory output and investment picked up. A surge in new credit spurred a rebound in the property sector while raising fresh questions over the sustainability of the debt-fueled expansion.

Concerns persist about excess leverage (and a real estate bubble) as condos in large cities go for about 30x income. The IMF noted that bad loans on Chinese bank balance sheets could be as much as USD$1.3 trillion. However, a foreclosure crisis like that in the U.S. is unlikely. Only 18% of homes have a mortgage compared to approximately 50% in the U.S. The minimum down payment is 30% and it's commonplace for family and friends to help younger people buy these massively expensive properties. This is made possible by China's high savings rate of 30%.

## Investment Outlook and Equity Commentary

One of the major drivers of the S&P 500's advance since the financial crisis – stock buybacks – looks to be sagging. Buybacks are on pace for their weakest year since 2012. This is in part due to declining cash flow, which is forecast to be flat for Q2 and fall in Q3 according to Thomson Reuters I/B/E/S. Buybacks have helped earnings look better than the weakened revenue figures suggest by lowering the share count. Companies could mitigate this to some extent by taking advantage of low interest rates, leveraging their balance sheets and borrowing to buy back stock.

The S&P 500 earnings yield of 5.7% (inverse of P/E) compares favorably to long U.S. Government Bond yields of 2.7%, making equities relatively attractive versus bonds. On an absolute basis, U.S. stocks are fairly/fully valued trading at 17x forward earnings, modestly above the long-term historical average. Fairly valued equities, slow global growth, peak U.S. corporate profit margins and poor productivity suggest a mediocre outlook for the S&P 500 with the prospect for mid- single digit returns. In view of this, we are now marketweight U.S. stocks (approximately 18% to 20% versus the Balanced benchmark of 20%) having sold Dow Chemical, GE, Honeywell, and JP Morgan. The proceeds were converted to Canadian dollars. Our U.S. exposure continues to be concentrated in defensive consumer and health care equities that are less sensitive to sluggish global activity. Names include Abbott, Costco, Google, Home Depot, Johnson & Johnson, Merck, Proctor & Gamble, Time Warner, and Walgreens Boots.

We are overweight Europe (approximately 8% to 9% versus a Balanced benchmark of 5%). The Euro area recovery remains on track. While far from strong, the trajectory for bank lending is higher and this is supportive for growth. European stocks are inexpensive, trading at less than 14X forward earnings, yield over 3.4%, and typically outperform U.S. equities in the year following U.S. rate increases. European stocks offer good value relative to government bonds with dividend yields trading at wide spreads versus 10-year bond yields. We recently purchased Iberdrola, Telefonica and Total with the proceeds sourced from a partial reduction of the ERUO STOXX 50 Index Fund. Comments on these companies are included near the end of this report.

We are underweight Canadian equities (about 24% to 26% versus the Balanced benchmark of 30%) but are now more inclined to be buyers given an improving growth outlook. The TSX Composite, ex-energy is trading at a price-to-earnings ratio in-line with its long-term average. Canadian banks offer reasonable value trading at low p/e multiples (10x) and provide attractive dividend yields (4.7%). Oil prices look like they have bottomed with the possibility that energy supply/demand is near balance by year end.

The International Energy Agency (IEA) projects the world surplus will diminish to 200,000 barrels a day in the last six months of the year from 1.5 million in the first half (see chart). Production outside the Organization of Petroleum Exporting Countries will decline by the most since 1992 as the U.S. shale oil boom falters. According to the IEA, "There are signs that the much-anticipated slide in production of shale oil in the U.S. is gathering pace. Crude production fell below 9 million barrels a day in early April for the first time

**Shrinking Surplus**

The International Energy Agency says the global oil surplus will start fading in the second half.


Source: IEA estimates for supply, demand and change in global oil inventories

Bloomberg

*Continued from page 2*

in 18 months." The glut is also being tempered as Iran restores exports only gradually with financial barriers to sales persisting even after the lifting of international sanctions. India is close to surpassing China as "the main engine of global demand growth," according to the agency.

Over the last three months, we completed the following transactions (+adds, -sells):

**Energy:** +Total SA (TOT) is the fifth largest publicly traded oil company (EURO 91 billion market capitalization). It has both upstream (exploration and production) and downstream (refining and marketing) operations. Operating expenses are declining and the company's refining business is benefitting from cheaper oil. Production is growing and capital expenditures, which peaked at USD$28 billion in 2013, are forecast to fall to USD$17 billion in 2017. Every USD$1 decline in capex translates into a USD$5 per barrel decline in TOT's cash flow break even oil price. TOT's production growth is forecast at 4% for both 2016/17, the stock trades at reasonable price/earnings and price/cash flow multiples of about 9.5x and 4.5x 2017 estimates (using $56 WTI) and yields approximately 6%.

**Telecommunications:** +Telefonica SA (TEF) is global telecom company (EURO 42 billion market capitalization) having significant operations in Spain, United Kingdom, Germany, Brazil and Mexico. TEF is rapidly moving to consolidate its core markets. It has acquired rivals in Brazil and Germany. TEF is rumored to be considering merging its Mexican operations with Televisa to create the second largest cable/telecom operator. The synergies would be substantial. TEF trades at a reasonable p/e of about 16x 2017 estimates and yields about 7.5%.

**Utilities:** + Iberdrola SA (IBDRY) is a large multinational electric utility company (ERUO 38 billion) that focuses on regulated networks and renewable energy. It has a strong foundation of regulated activities (generation, supply and distribution) and possesses material growth from renewable energies. It operates on four continents, serves 32 million customers with approximately 41.6%, 24.2%, 23.2%, 6.4%, and 2.6% of its operating earnings coming from Spain, United States, United Kingdom, Mexico, and Brazil. IBDRY trades at reasonable valuation metrics (14.3x 2017 eps estimates, 9.4x ev/ebitda); has a decent dividend yield of nearly 5% and solid growth prospects of 6% per annum over the next five years.

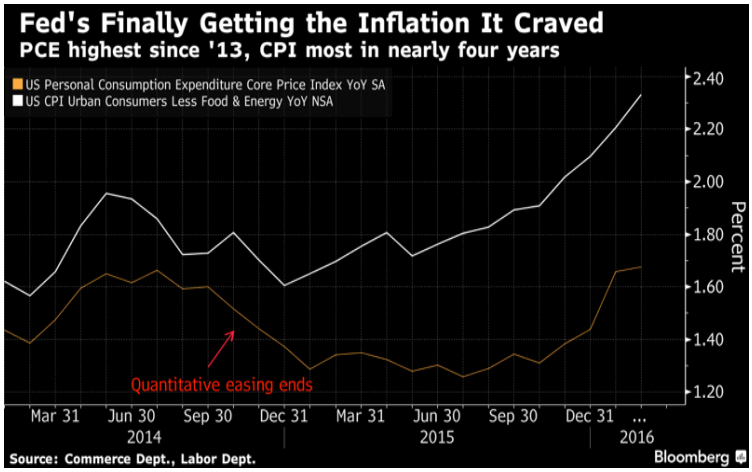
**Index Fund:** - Euro Stoxx 50 Index Fund weighting was reduced to provide funds for the international purchases previously noted.

**Industrial Products:** We sold long-time holdings of- Dow Chemical (concern about global petrochemical expansions coming on stream in 2016/2017); - General Electric (concern about the Q4, 2015 revenues miss, back-end weighted 2016 earnings guidance, significant oil and gas exposure, weakness in rail locomotives, deteriorating trends for aviation engines and high valuation); and – Honeywell (disproportionate exposure to Brazil, China and Russia, 25% of total sales in Europe, softening trends in aerospace and a lofty valuation).These companies are all economically sensitive and while the global recovery continues, it does so at a slow and fragile pace. These sales allowed us to lower our relatively large exposure to U.S. currency as we converted most of the proceeds to Canadian dollars.

**Financials:** - JP Morgan was sold given the intense pressures it faces in some of its business lines. Relatively low interest rates continue to squeeze net interest margins while business remains sluggish for investment banking, mergers and acquisitions.

## Fixed Income

Inflation may be finally showing signs of life in the world's biggest economies. JP Morgan (JPM) economists' estimate the average core rate of inflation in the 33 economies they monitor is running around 2.2%, near a 15-year high.




U.S. core inflation – stripping out food and energy costs – rose to 2.3% in March (see chart on page 3) as Americans paid more for services including rents and medical care. Shelter costs rose at a lofty 3.2% and account for 42% of core CPI. They are headed higher as rental vacancy rates remain at their lowest level since 1994.

*Continued from page 3*

Health care costs, which represent about 10% of core CPI, rose 3.3% in March, and are set to rise in 2016 as the impact of the 2015 Obamacare cuts to Medicare and Medicaid roll off. Employment growth is strong and wage gains solid. The minimum wage is set to increase meaningfully in many states.

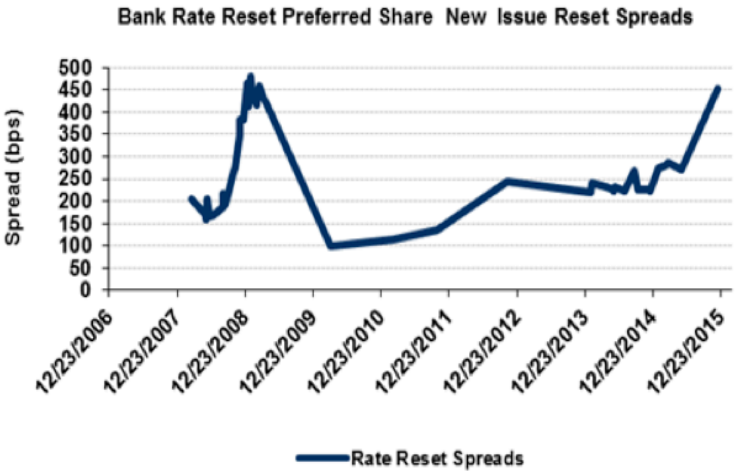
By keeping rates so low, some economists believe the Federal Reserve is playing with fire, suggesting the line between spurring just enough and too much inflation is vanishingly fine, and history shows that once consumer prices do start to pick up in earnest, they're hard to rein in.

Since mid-February, the outlook for consumer-price gains has soared from post-crisis lows as oil rebounds and Chair Janet Yellen signals a willingness to let the U.S. economy run hot before raising interest rates. Market expectations for inflation (see chart) rose last month by the most since 2011.


We are underweight fixed-income as real yields on bonds remain low and the likelihood high that inflation moves up from current levels. We hold about one-third of targeted fixed-income exposure in short-term positions (mainly cash). Government bonds are expensive and represent a near-guaranteed loss of purchasing power at current interest rates if held to maturity. Normalization of economic conditions would likely make them among the worst performing investments as rising yields would wipe out their meagre coupons.

Fully transitioned portfolios hold about 25% in preferred shares through a combination of floating, fixed-reset and perpetual instruments. Preferred yields are near historical highs versus bond yields.

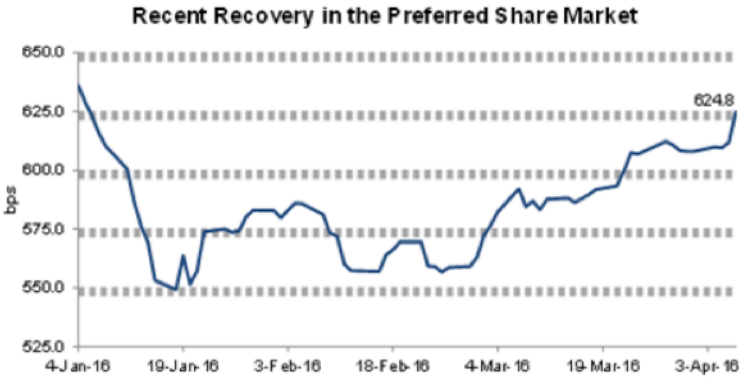
During Q1, we added Bank of Nova Scotia, Royal Bank and TD Bank 5-year 5.50% rate reset preferred share new issues, which carry reset spreads of 472, 480 and 466 basis point over 5-year Canada Government bonds respectively. These reset spreads are the largest offered by a major Canadian bank since the financial crisis (see chart). The 5.5% yields are equivalent to pre-tax bond yields of 7.15%.




Source: Bloomberg, RBC Wealth Management

The S&P/TSX Preferred Share Index reached a 3-month high at the end of March and has rallied 2.8% thus far in April (see chart). A stabilization in interest rates, a narrowing of credit spreads and marked improvement in the performance of new issues have all supported the move. Preferred shares remain undervalued in our view.

## S&P/TSX Preferred Share Index (YTD)




Source: Bloomberg, RBC Wealth Management

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## Performance as of Mar 31/16

| Indices | 3 mths (%) | 6 mths (%) |
|---|---|---|
| 3mth Cda T-Bill | 0.10 | 0.23 |
| Bond Composite | 1.40 | 2.38 |
| TSX Total Return | 4.50 | 3.08 |
| S&P 500 Total Return (CAD$) | -4.70 | 5.90 |
| EAFE Total Return (CAD$) | -9.11 | -1.65 |
| *Benchmarks(%) | | |
| Balanced Benchmark Objective | 0.52 | 2.99 |
| Range of Client Returns | -3.15 to -0.05 | 2.92 to 4.09 |
| *Balance Benchmark Composition: 5% T-Bills, 40% Bonds, 30% TSX, 20% S&P 500, 5% EAFE | | |

Portfolio returns for balanced objectives were less than benchmark returns in Q1 for several reasons. Overweight U.S. stocks and U.S. cash hurt given the strong showing for the Canadian dollar (+ 6.71% versus $U.S.). Slightly overweight Europe (primarily through the EURO STOXX Index Fund) hurt in view of poor returns from that region (EAFE was down 9.11%). Modestly underweight, the TSX also hurt as Canadian stocks were among the globe's best performing (+4.50%). Underweight bonds detracted as well. Performance for the six months ending March 31, 2016, typically met or exceeded benchmark returns.

We note that there was quite a range of returns for Balanced accounts during Q1. Some portfolios had higher weightings in U.S. legacy positions coming into Q1 given our reluctance to sell before year end in view of large embedded capital gains. Although we have reduced our U.S. exposure in 2016, the weak U.S. dollar weighed on returns for the accounts that had higher U.S. exposure. However, we note that these accounts did benefit more than others in Q4 from being overweight U.S. We continue to transition accounts towards our models.

According to GIPs methodology, in order to be included in the range of returns, accounts must be on board for the full quarter. We also exclude accounts that have additions/withdrawals of 5% or more during the quarter, have equity weightings more than +/- 7% from the average equity weighting, and fixed-income weightings that exceed +/- 5% during the quarter.