RBC Dominion Securities Inc.

Fickel's Focus

FALL 2015

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Third Quarter Investment Commentary

Economic Overview

Sluggish demand and limited inflation remain the hallmark of this recovery. This is the second consecutive year where developed market growth has improved relative to emerging market activity. Decelerating growth in China and continuing weakness in emerging markets will likely be offset by solid growth in the U.S., Europe, UK and India, improving activity in Canada and Japan, helped by the stimulatory effects from low energy prices and near zero interest rates. Global growth will be about 3% for the third consecutive year.

U.S. reports were relatively firm with Q2 GDP growth revised higher to 3.9%. Home sales reached their highest level since before the recession, auto sales are running at decade highs, consumer confidence touched a near cycle high and unemployment fell to 5.1%. The U.S. JOLTS Index (Job Openings and Labour Turnover Survey), a measure of job openings and voluntary labour turnover, reached a cycle high, confirming strength in the labour market. Although the U.S. economy is approaching full employment, the tightening labour market has yet to generate upward pressure on wages with average hourly earnings growing 2.2%. The strong U.S. dollar is helping to keep inflation in check with core CPI rising 1.3%.

European Q2 GDP was revised higher to 0.4%, its fastest pace since 2011. Growth was evenly balanced supported by both domestic and external demand. Europe continues to benefit from weak energy prices, low rates, currency depreciation and less fiscal drag. Inflation remains subdued with the consumer price index rising a paltry 0.1% in August. The unemployment rate unexpectedly declined in July to 10.9%, its lowest level in more than three years (see following chart).

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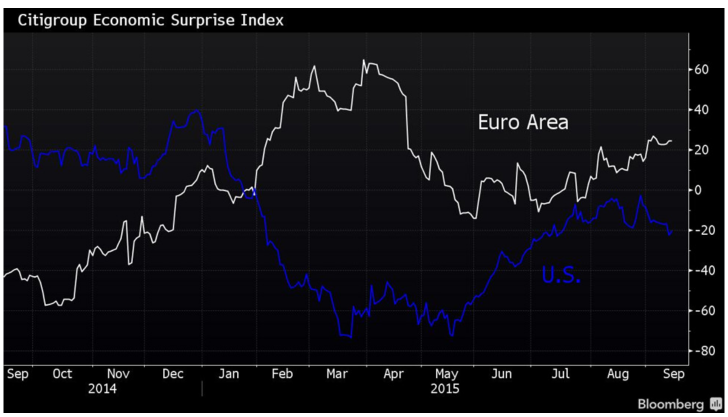
Absent in recent years, the Eurozone consumer is now contributing to economic growth. This is critically important as household expenditures account for one-half of real spending in the economy.

According to the Citigroup Economic Surprise Index (CESI), European economic data has been topping projections whereas U.S. releases have been more or less in line with estimates (see CESI chart).



The European Central Bank (ECB) is expected to announce additional easing measures soon extending the 60 billion euros a month sovereign bond buying program beyond September 2016 in an attempt to move inflation higher and support growth which should reach 1.5% in 2015 and 2.0% in 2016.

UK Q2 data was solid with GDP up 2.6% and unemployment steady at 5.6%. UK inflation was 0% in June held back by lower energy prices. New orders, service sector indicators and trade readings along with positive PMIs suggest similar growth ahead. We expect economic growth of 2.5% in 2015 and 2.5% in 2016.

Japanese growth slowed in Q2 but firming in leading indicators, PMIs, corporate earnings and business confidence all suggest improving activity ahead. We forecast economic growth of about 0.8% in 2015 and 1.8% in 2016.

After declining 0.9% over the first five months of 2015, Canada's economy rebounded 0.8% in the past two months. Economists are now forecasting Q3 GDP of between 2.5% and 3%, well above the 1.5% recently projected by the Bank of Canada (BOC). A weak Canadian dollar and a firm U.S. economy are beginning to spur manufacturing, with factory activity up 1.7% in July led by vehicle sales. Housing sales and prices are holding firm in major centers. Core inflation is under control growing 2.1%. Recent data including an average annual wage gain of 3.4% suggest the economy is recovering and no further BOC easing is necessary. We forecast GDP growth of 1.2% in 2015 and 2.2% in 2016.

Chinese data remains mixed. China is attempting to lesson its dependence on exports and investment, repositioning the economy to a more balanced one by placing more emphasis on consumer spending and services. Recent data confirm that the "real" side of the economy is slowing as fixed-asset investment and industrial production decelerated in September to their lowest level since March 2009. The transition away from manufacturing towards services combined with weakness in other emerging market economies is hurting global commodity consumption and prices. Consumer spending is showing some improvement but not enough to offset the decline in manufacturing. GDP is forecast to slow to 6.5% and 6% in 2015 and 2016 respectively.

Emerging Markets (EM) are stuck in a multi-year adjustment phase challenged with weak productivity growth, excess capacity particularly in Asia, high debt levels and aging populations. There is some concern that EM weakness will be transmitted to Developed Markets via weakened trade and lower currency adjusted profits for multinational companies. EM growth is likely to decelerate further in 2015 before turning higher in 2016.

Investment Outlook and Equity Commentary

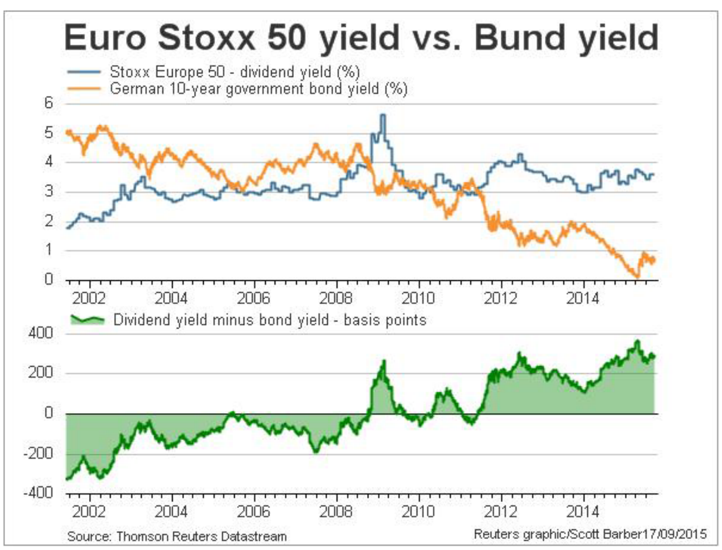
When U.S. activity expands as it is now and as we expect in 2016, the S&P 500 has generated a positive return about 85% of the time and a return greater than 10% almost 70% of the time. Bear markets are almost always associated with recessions and in view of recent data, we don't believe a recession is imminent. Every U.S. post-war recession has been preceded by a flattening or inversion of the yield curve, however, the yield curve remains very steep.

Granted, global growth is slow by historical standards. Typically, this is not favourable for the commodity/economy sectors (notably energy and materials), as modest growth weighs on both pricing and demand. On the other hand, the consumer side of the economy (autos, housing, pharmaceuticals, retail and financials) benefits from low commodity prices. We are underweight economy sensitive investments and overweight non-resource sectors.

The summer setback in global equity markets has brought valuations back to more reasonable levels. The S&P 500 earnings yield of 6.67% (inverse of P/E) compares favorably to long U.S. Government Bond yields of 2.2%, making equities attractive versus bonds. The S&P 500 trades at an undemanding 15x prospective 12 month earnings and offers high single digit returns. We remain overweight U.S. stocks emphasizing consumer "type" equities such as Abbott, Costco, Home Depot, Johnson & Johnson, Medtronic, Time Warner, Walgreens Boots and Wells Fargo.

Europe continues as our largest relative overweight through a combination of individual securities and the SPDR Euro Stoxx 50 Index Fund. European stocks are trading at less than 14X forward earnings with growth more than double that of U.S. equities.

Investors are betting that profit growth will continue in Europe and that the ECB will remain accommodative. Money has flowed into European equity funds in 16 of the last 17 weeks. European earnings are growing quicker than those in the U.S. where valuations are higher. The opportunity is greater for profit growth in Europe as profit margins are significantly below those of U.S. companies. European equities have historically risen about 6.5% on average in the year following U.S. rate increases, almost three times more than U.S. stocks. European stocks offer good value relative to bonds with dividend yields trading at wide spreads versus 10-year bond yields (see chart).



We remain underweight Canadian equities given the preponderance of stocks geared to the resource/commodity sector which is suffering from modest global growth and excess supply. That said, the TSX Composite, ex-energy stocks, is trading at a price-to-earnings ratio below its long-term average.

Over the last three months, we have completed the transactions detailed below (for unconstrained accounts) to harmonize portfolios with our models:

Energy: -Cenovus (CVE), -Baytex (BTE) part of tax loss, energy weight reduction strategy

Materials: -Goldcorp (G) part of tax loss, capital reallocation strategy (some of proceeds were added to Agnico Eagle)

Industrials: +Canadian National Railway (CNR) was purchased having declined 20% from recent highs. This setback is a rare opportunity to acquire one of North America's best run railways. Although the volume outlook remains a bit fuzzy over the next several quarters, CNR demonstrates an uncanny ability to adjust resources quickly, control costs and grow earnings. Its intermodal segment is a compelling growth story. The stock trades at about 16x 2016 estimates and yields nearly 2%.

Consumer Staples: +Proctor & Gamble (PG) was added during the severe down draft in August having declined to 17x earnings and yielding 4%. P&G faces numerous headwinds including foreign currency issues and competition from lower priced generic products. However, the company rates well on free cash flow and is restructuring selling off some of its underperforming divisions.

Financial Services: Recent market weakness provided a compelling opportunity to purchase +Bank of Montreal (BMO) at 10x estimates and yielding 5%. BMO's oil and gas loan exposure is small relative to its capital structure. Bank stocks in general have retreated to a point where the entire sector looks interesting.

Utilities: +Canadian Utilities (CU) dropped 20% from recent highs, hurt by the negative perception surrounding the oil and gas industry in Alberta and a weaker outlook for its non-regulated segments (which accounts for 20% of profits). CU has an above average utility growth profile, driven by expansion in its regulated utility assets which represent 80% of earnings. CU trades at about 15x 2016 estimates, a discount to the utility sector, yields 3.4%, and is a consistent dividend grower.

Real Estate: +Crombie Real Estate Investment Trust (CRR.un) was purchased after reporting solid second quarter cash flow growth of 8%. CRR trades at approximately 12.5x adjusted funds from operations (AFFO) on 2016 estimates, a nearly three multiple point discount to its competitors and yields about 7%. +RioCan Real Estate Investment Trust (REI.un) was added after declining 20% from recent highs which significantly reduced the premium AFFO multiple that historically existed between it and other retail REITs. RioCan, Canada's largest REIT, offers scale, diversification, liquidity and yields nearly 6%. REI owns 350 retail centres across North America encompassing 54 million square feet.

Healthcare: +Merck and Company Inc. (MRK) and -Valeant Pharmaceutical International Inc (VRX). MRK's earnings should grow nicely over the next three to five years given its strong pipeline of treatments for Alzheimer's, Cancer, and Hep-C, and continued strength from existing franchises. MRK trades at a reasonable multiple of about 14x next year's estimate and yields about 3.5%. –Valeant Pharmaceuticals (VRX), an inherited position, was used as a source of funds.

Technology: -Select Sector SPDR Technology Index Fund (XLK) and -Qualcomm (QCOM). XLK was sold with a view to purchase an individual security while QCOM was an inherited position that we divested.

Index Funds:-iShares MCSI EAFE ETF (EFA) and –iShares MSCI Emerging Markets ETF (EEM) were sold in order to provide funds for the purchases noted. Emerging Market (EM) valuations are nearing 2009 financial crisis levels on a price/book basis and look attractive longer-term. However, near-term, EM remain vulnerable to continuing U.S. dollar strength and weak commodity prices amplified by recent weakness in China. Unlike the last EM crisis, many countries have built up large foreign currency reserves providing them with staying power. Nevertheless, they are likely to remain under pressure until the U.S. dollar stabilizes and commodity prices stabilize.

Fixed Income

We are underweight fixed-income holding about one-half of our targeted exposure in short-term positions (mainly cash) as we await better opportunities. Portfolios hold about 10% to 12% in preferred shares.

Preferred Shares performed poorly during the first two months of the third quarter as low rates in Canada weighed heavily on fixed-reset and floating rate shares. This trend seemed to change during September as preferred shares rose during the first three weeks of the month. However, new supply at month end weighed on returns. The S&P/TSX Preferred Share Index has declined to within 2% of the lows reached during the financial crisis.We believe all segments of the preferred share market offer very good value.

During Q3, we purchased several perpetual preferred shares including the Bank of Montreal Class B Preferred Shares (BMO.Z). The BMO.Z yielded about 5.25% when initially purchased. For taxable high income earning investors, this is equivalent to a pre-tax bond yield of 6.85% which compares favourably to Government of Canada 30-year bonds yielding 2.3%.

We are reviewing our Preferred Shares with a view to realize some tax losses and switching the proceeds into other Preferred Shares with similar characteristics and quality.

Performance

It was the worst quarter since 2011 for stock markets with weak economic news from China weighing on investor sentiment. Losses were widespread among global indices with steep declines (in Canadian dollars) incurred by the TSX -7.9%, S&P 500 -0.2%, MSCI EAFE Index -4.8%, and MSCI Emerging Markets -13.1%.

We estimate that the Q3 benchmark return was -2.65% for a balanced portfolio whose composition would be 30% Canadian equities, 20% U.S. stocks, 5% EAFE, 40% Canadian bonds and 5% cash. Our balanced portfolio returns ranged from about -3% to -3.75%. During the quarter, we migrated many accounts to our models. The majority of the underperformance is attributed to poor returns from preferred shares which hurt performance by about 1.3% to 1.5%. Having some exposure to emerging markets also weighed on returns. Collectively, these offset the benefits from being overweight U.S. stocks and $US.