RBC WEALTH MANAGEMENT

GLOBAL INSIGHT

FOCUS ARTICLE

Pockets of Strength

Selective opportunities to add exposure to Canadian equities have emerged. We favour a market weight stance .

Matt Barasch

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Focus Article

Pockets of Strength

Matt Barasch
Toronto, Canada
matt.barasch@rbc.com

Investors should look for the pockets of strength that exist in Canada's stock market. Banks, life insurance, and energy have the quality businesses we look for, and with reasonable valuations and solid growth prospects now is the time to add exposure. Our long-term conviction toward Canadian equities is growing and we favour a market weight stance.

Last month, we upgraded our recommendation for Canadian stocks to market weight from underweight.

The primary drivers of this more positive view were: (1) increasing confidence that the Canadian banks and life insurance companies ("lifecos") will offer good returns over the next several years and (2) the strong free cash flow (FCF) growth and modest valuations of the large-cap energy names.

Collectively, these three groups comprise approximately one-half the market cap weighting of the S&P/TSX.

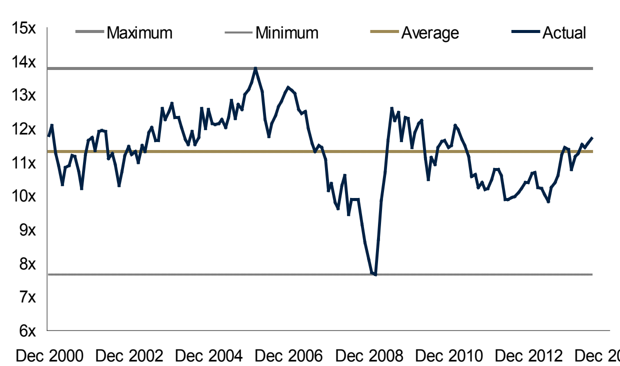
Banks: Well-Positioned for Higher Rates

Much has been written about the potential that Canada's housing market is in a bubble. However, while there are indeed some cities that have seen prices push well beyond traditional metrics for affordability, we believe that on the whole, the data does not support the "nationwide bubble" thesis.

Rather, we believe Canada is likely to experience a deceleration in pricing gains in the years to come. Against this backdrop, we believe the Canadian banks offer compelling value.

Retail lending is likely to slow against the backdrop of a cooling housing market; however, commercial lending should provide some offset to this, while the banks' "other businesses," which include capital markets, wealth management, and insurance, should provide some tailwind as well.

Average Forward P/E Multiple of the Canadian Banks



Source - RBC Capital Markets Quantitative Research, RBC Capital Markets, RBC Dominion Securities Inc.

P/E multiples on the banks are near their long-term averages.

Gradually rising rates and strong capital positions should propel lifecos.

Furthermore, it is our view that interest rates will begin to gradually rise over the next several years.

One of the largest sources of earnings for the banks is net interest margins (NIM), which have been at depressed levels for the past several years as low rates across the yield curve have held back this earnings lever. As rates rise, NIM should expand, which will provide further earnings torque for the banks.

Against this backdrop, the Canadian banks are trading at roughly the midpoint of their historical range, while they are collectively very well capitalized.

Lifecos: Improving Fundamentals

Over the past five years, the lifecos have been intensely focused on repairing their capital bases, de-risking their business models, and targeting new markets such as emerging Asia.

Fast forward to today and the group has collectively built up significant amounts of capital that are well above both internal and regulatory requirements, and have significantly lowered their sensitivity to the ebbs and flows of equity and bond markets. Should our interest rate call play out, the lifecos would be poised to benefit as many of their businesses have been hurt by the extremely low level of interest rates.

As with the banks, the valuations on the lifecos are close to historical norms; however, we believe that potential capital deployment and higher rates could provide a strong earnings tailwind over the next several years.

Energy: Attractive Entry Point

While it is difficult to forecast oil prices out several years, we believe that high global production costs, a lack of growth in global supply, and recovering developed economies should, at the very least, keep a floor underneath prices. The large-cap Canadian energy names should generate mid-single-digit production per share growth out to the end of the decade, which should unlock significant pools of FCF.

Over the past several years, we have seen many of the large-cap names adopt shareholder-friendly approaches, including consistently growing dividends and opportunistic share buyback programs. We expect this to continue going forward.

Despite this, the large-cap energy names continue to trade at low valuation levels relative to historical norms, and thus, we see a compelling long-term opportunity.

Growing Longer-Term Conviction

Our focus tends to be on businesses that can compound shareholder wealth over many years. These types of businesses tend to have well-respected management teams that have a track record of success, significant capital bases, strong FCF, and reasonable and sustainable dividend and share buyback policies.

If this can be achieved at what we believe are reasonable valuation levels, then our comfort level in terms of allocating new capital will tend to grow. Given that the above three groups comprise roughly one-half of the market cap weighting in the S&P/TSX, we believe that a market weight stance is more appropriate.

Research Resources

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