RBC Dominion Securities Inc.

Wealth Management REVIEW

Wealth Management
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In brief

Empowering Canadian youth

A recent RBC survey of more than 2,000 Canadians aged 15-24 has found that, across every province and major city, youth are feeling hopeful, but nervous about their future employment prospects. To help young people turn that hope and nervousness into confidence, RBC has created an online resource using the most current Canadian labour market data to help young people understand how their past experiences and current skills will help prepare them for the jobs of tomorrow. RBC Upskill™ is part of our $500-million RBC Future Launch commitment designed to help Canadian youth succeed in a rapidly changing workplace.

To learn more, please visit: rbc.com/futurelaunch

Mind the gap

The case for Canadian equities

By Tim Corney, Joseph Wu and Jim Allworth

2018 was not a great year for equities in Canada or, for that matter, anywhere. In our view, 2019 should be a better one, if only because the starting point is comparatively depressed vis-à-vis the highs of last year.

Beyond that, we think a constructive case can be made for improved stock market performance in the coming year. Bear markets in equities have always been associated with U.S. recessions. But economic expansion remains in gear in the U.S., and in most important economies including Canada's. The overt tightening of credit conditions and deterioration in the labour market that would suggest a recession is on the way is not evident.

Our U.S. GDP growth forecast for 2019 is at 2.5% with most quarterly postings expected to be in the low "2s." That will be markedly slower than the tax cut-juiced quarterly readings delivered in the second and third quarters of 2018. Quarterly GDP growth rates that subside back toward the lower-than-average 2.2% rate that prevailed in the U.S. from the end of the recession in 2009 until the beginning of last year should keep inflation tamed. This, in turn, should permit the Fed to stay on hold through much of next year.

Canada's GDP growth will be somewhat slower at 1.75%-2.0% and inflation contained, leaving the Bank of Canada in no hurry to tighten further.

Without more aggressive credit tightening, we expect both U.S. and Canadian economies will go on growing through 2019 and into 2020. So too should corporate profits and the value of businesses.

When it comes to differences between the two equity markets, what stands out is the yawning gap in both performance and valuation. Despite delivering earnings growth similar to the U.S. S&P 500 since 2016, the Canadian TSX is actually down on a price basis compared to a 15% gain for the S&P 500 in Canadian-dollar terms. Over the past two years, the Canadian index has suffered a 20% drop in its forward P/E ratio against a much more benign 7% squeeze for the U.S. benchmark.

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In our view, this poor relative performance stems from three broad concerns:

1. Eroding relative competitiveness

Once much higher than the posted Canadian rate, the U.S. corporate tax rate is now somewhat lower. Additionally, the U.S. has aggressively slashed regulations, while Canada has increased them, e.g. recent legislation aimed at protecting the environment. At the same time, provinces across Canada upped minimum wages in 2018.

2. Indebted households

Canadian household debt levels surged to around 170% of annual income as of the third quarter of 2018, up from around 130% at the start of 2006. Ultra-low interest rates that have pushed debt servicing costs to historically low levels, together with a bull market in real estate prices have resulted in larger mortgages and, to a lesser extent, debt-financed consumption. This has raised concerns about future financial system profitability and long-term growth prospects. These concerns have important implications for the economy and stock market because the financial sector comprises over a third of the TSX, and personal consumption accounts for nearly 60% of Canadian GDP.

3. Commodity dependence

The commodities complex is crucial for the TSX. Despite the correction in commodity prices in recent years, natural resource stocks still make up almost 30% of the TSX. By comparison, natural resources comprise about 16% of Canada's GDP. Without higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011. Canadian oil looks set for now to continue trading at a deeper-than-usual discount compared to West Texas Intermediate, and investor interest in Canadian energy companies is likely to remain listless.

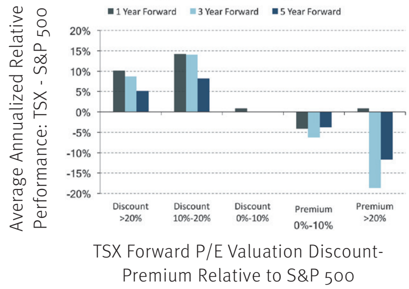
Many of the headwinds facing the Canadian market are already meaningfully priced into the valuations of Canadian businesses. Can things go from bad to worse? That's always possible, but an investor should assess opportunity across a range of reasonable outcomes, giving consideration to what one is paying for a basket of high-quality Canadian businesses.

From an absolute valuation standpoint, the TSX presently trades at roughly 13x forward earnings, an unusually wide 11% discount compared to its long-term average of 14.6x. On a relative basis, while the forward P/E multiples for the TSX and the S&P 500 have tended to move in sync historically, a big gap has opened up over the past two years. The TSX currently trades at an extraordinarily deep 15% discount to the S&P 500 on a forward P/E basis.

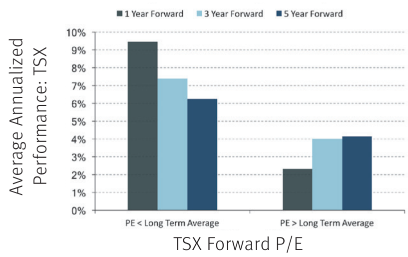
The Canadian market has rarely been this cheap. As the chart shows, the forward returns for the TSX were, on average, quite a bit more attractive if one had invested when the forward P/E was below its historical average.

What about performance versus the S&P 500? The TSX has tended to outperform the S&P 500, on average, across all time horizons when it was purchased at discounts in excess of 10% compared to the U.S. market on a forward P/E basis.

Valuations eventually matter ... in the longer term



Lower starting valuations elevates average future return potential



We think the unusually wide valuation gap that has opened up between the TSX and the S&P 500 invites a contrarian look at the Canadian market. Some headwinds facing the Canadian market are unlikely to abate in the short term, but the market appears to be fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

For a more detailed update on our outlook for fixed income and equity markets, ask for the latest edition of RBC Wealth Management's *Global Insight* publication.

Tim Corney, Joseph Wu and Jim Allworth are members of the RBC Wealth Management Global Portfolio Advisory Committee.

Happy 10th birthday, Tax-Free Savings Account!

Long the neglected “younger sibling” of the RRSP, the Tax-Free Savings Account has grown up to represent a critically important savings and investment opportunity for Canadians.

With the Tax-Free Savings Account (TFSA) contribution limit rising to $6,000 for 2019 and the eligible accumulated lifetime contribution limit now at $63,500, what was once a convenient if rather limited tax-savings vehicle has grown since its inception to become a huge opportunity for Canadians focused on building their nest egg and reaching their financial goals.

Since its introduction in 2009, Canadians have gradually become more aware of the TFSA in general, and its many benefits in particular. As of 2016, the latest year statistics are available from the government, there are more than 18.2 million TFSAs in Canada, holding a whopping $233 billion in assets (by fair market value).

The ABCs of TFSAs

In general, TFSAs are easy to understand and take advantage of for financial planning purposes. Here are the basics and some of the benefits of TFSAs:

The basics

- **Eligibility:** All “of age” or adult Canadians (18 or 19 depending upon your province of residence) are eligible to contribute. Every adult Canadian is eligible to contribute to a TFSA regardless of income.
- **Contribution room:** You accumulate contribution room per year of your eligibility and your eligible limit is carried forward indefinitely. You do not receive a tax deduction for contributions to a TFSA.

TFSA contribution limits (per calendar year)	
2009-2012	$5,000
2013-2014	$5,500
2015	$10,000
2016-2018	$5,500
2019	$6,000

- **Withdrawals:** You can withdraw any amount from your TFSA tax-free, and no investment income or capital gains are taxed or added to your income. Withdrawals can be made at any time and the contribution room is never lost – it is added back to your limit on January 1 of the following year.
- **Tax-free sheltering:** There is no tax on any of the income (interest, dividends or capital gains) earned from the qualified investments held within your TFSA.
- **No time limit:** TFSAs are for life – unlike other registered accounts, they do not need to be closed or converted to an income stream at a certain age.

The benefits

- **Flexibility:** Unlimited tax-free withdrawals, no loss of contribution limits, and no time limit to the life of the TFSA.
- **Multi-purposed:** Your TFSA funds can be used to meet a variety of your financial goals, including:
  - Build long-term wealth through the tax-free growth of your investments
  - Generate tax-free retirement income
  - Fund major purchases
  - Provide emergency funding
- **Compounding:** Because there are no taxes levied on the earnings within your TFSA, you have a larger benefit from the power of compounding, or earning income on income. Over time, this has a powerful impact on your earnings growth.

The gift that keeps on giving: 10 smart tips to make the most of your TFSA

On the occasion of its 10th birthday, here are 10 great presents from your TFSA – or strategies you can use to help achieve your financial goals:

1. Help a child or grandchild fund their education above and beyond their Registered Education Savings Plan (RESP) and/or family trust.
2. If your income is likely to be as high or higher in retirement than at the time you are considering contributing to your RRSP, contributing to your TFSA instead might make more sense – especially if your income is large enough that even making the maximum RRSP contribution will have little impact on your taxable income.
3. Shelter some of your taxable capital gains, dividends and

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interest currently being earned in a regular taxable account.

4. Expand your retirement savings beyond your RRSP.

5. Earn tax-free income on surplus RRIF payments when you don't need the funds immediately.

6. Take advantage of family income splitting to reduce your overall tax bill by gifting amounts from your bank account to your lower-income spouse or adult children to contribute to their own TFSAs.

7. In provinces and territories where it is permitted, consider naming a beneficiary on your TFSA to minimize probate.

8. Consider naming your spouse as successor holder (instead of beneficiary) on your TFSA to simplify administration upon your death.

9. When the tax impact of RRSP contributions will be limited, negligible or nil, save your excess funds into a TFSA to benefit from the tax-free growth, then withdraw them and contribute to your RRSP when the tax benefits are more meaningful.

10. Contribute to your RRSP to generate a refund then invest that refund into your TFSA – you will gain from the income reduction of the RRSP contribution, while taking advantage of the tax-free compounding available through both accounts.

For more information, please contact us today.

Interest rates applied to account balances as of December 22, 2018*

	Canadian dollar accounts	U.S. dollar accounts
All credit balances	0.05%	0.05%
Debit balances under $10,000	5.95%	7.75%
Debit balances $10,000 – $24,999	5.70%	7.50%
Debit balances $25,000 – $49,999	5.45%	7.25%
Debit balances $50,000 – $99,999	5.20%	7.00%
Debit balances $100,000 and over	4.95%	6.75%
All debit balances for registered accounts	5.95%	7.75%
All credit balances for registered accounts	0.05%	0.05%

The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with the Royal Bank prime rate as follows:

Debit balances	Canadian dollar rates†	U.S. dollar rates†
Under $10,000	CAD Prime + 2.00%	USD Prime + 2.25%
$10,000 – $24,999	CAD Prime + 1.75%	USD Prime + 2.00%
$25,000 – $49,999	CAD Prime + 1.50%	USD Prime + 1.75%
$50,000 – $99,999	CAD Prime + 1.25%	USD Prime + 1.50%
$100,000 and over	CAD Prime + 1.00%	USD Prime + 1.25%

† Based on Royal Bank prime rates as of December 22, 2018. CAD Prime = 3.95% and USD Prime = 5.50%. Rates are subject to change*.

* RBC retains the right to change interest rates on a discretionary basis. A committee comprised of individuals representing various authorities within RBC Dominion Securities administers these interest rates. These rates are adjusted from time to time based on various factors, including, but not limited to, competitive analysis, Bank of Canada and other bellwether rates and/or cash rates. Interest amounts less than $5 are neither charged nor paid on regular accounts, and interest amounts less than $1 are neither charged nor paid on special product accounts. Rate changes of less than 1% will be processed on the 22nd of the month. The average daily cash balance for the month determines the tier that will be used to establish the rate. For interest rates on balances other than CAD or USD, speak to your advisor, or go to www.rbcds.com/cash-margin-rates.html.

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