Wealth Management
Dominion Securities

2020 Q1 Commentary

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Emerging from the COVID-19 pandemic

Jon Mitchell, Portfolio Manager

"There are decades when nothing happens; and there are weeks where decades happen."

– Vladimir Illyich Lenin

"We didn't see COVID-19 coming, and like everyone else, we're working hard to manage our way through the global crisis it's created. All of our businesses (36 in total) will be affected by the crisis. A few will suffer near total shutdown for some time. During that time, they will consume cash, and much of that cash will be lost for all time. Then, those businesses will re-open and again serve their customers and generate cash. That's why it's so critically important for all of our businesses to have balance sheets created for sustainability."

– March 27, letter to shareholders by Gerry Schwartz, CEO of Onex Corp

"For some time, I have been concerned that when the next economic downturn would come, it would lead to hitting the 0 % interest rate floor, with a lot of debt outstanding and big wealth and political gaps, in the same way that the configuration of events happened in the 1930s. The coronavirus was the thing to cause the downturn, which surprised me. While it is an extremely serious infectious disease that will produce many harmful economic impacts, these things alone don't scare me; however, when combined with long-term interest rates hitting the 0 % floor, it really worries me."

– March 17, Ray Dalio, author and CEO of Bridgewater Associates

"Historically, when U.S. high-yield spread levels have crossed +900 basis points, prospective long-term returns have, on average (based on median annualized index returns for 12-month, 24-month, 36-month, 48-month and 60-month periods), been in the double-digit range.

– Navigating Volatily in Global Non-Investment Grade Credit Markets, Neubergen Berman white paper, April 2020

"I fully expect unemployment in Alberta to be at least 25 per cent – at least half a million unemployed Albertans – and it could be significantly higher than that. This will be the most challenging period in our economy, in relative terms, since the Great Depression. There is simply no doubt about it."

– April 7, Jason Kenney, Premier of Alberta, address to Albertans

"The most important determinant in my career of the gold price – I'm not trying to say that there haven't been geopolitical events or other things moving the price of gold – but the thing that's moved the price of gold mostly in my career has been faith, or lack of faith, in the ongoing purchasing power of the U.S. dollar, most importantly, the U.S. dollar expressed by the U.S. 10-year Treasury (currently at 0.72 %)."

– March 31, Rick Rule, 40-year gold investor and CEO, Sprott USA Holdings Inc.

Continued on page 2

Emerging from the COVID-19 pandemic

Continued from page 1

I must first apologize for the length and scope of this commentary, but given the situation we are all in, and the amount of time most people have to read, I thought it was best to put as many thoughts down in one letter and then let you digest it over a few hours or days.

I moved from our south side Edmonton branch office on St Patrick's Day and have been working from my home office since then. In the weeks since, I have received hundreds of emails from all types of investment firms and newsletters, as well as clients. We receive daily updates on RBC's response to COVID-19, including details on work-from-home provisions, curtailment of face-to-face meetings, reduced hours of RBC bank branches, reduced operations at our branch office, as well as letters (which were updated at least once a week) that we can send to our clients. Here is the most recent one, which we received on Thursday, April 9:

It has been another eventful week with meaningful global developments with respect to the health care crisis. We share our key thoughts below.

Coronavirus

The past week has delivered some confirmation of the positive signs that emerged in Europe last week. Specifically, we've seen a slowing rate of new infections across countries such as Italy, Spain and Germany, among others. To be clear, there are still new infections being announced daily. Unfortunately, many people are still losing their lives every day. But the rate of change is improving and this potentially bodes well for the weeks to come. The hope is that North America will also experience this relatively soon. There have been some early signs in the state of New York, the epicenter of the crisis in the U.S., that suggest new cases may no longer be accelerating at the pace of a week ago. More evidence is needed nationally and across Canada to confirm that an improving trend is indeed in place.

Exit strategy

Another important development occurred this week in the Chinese city of Wuhan, the original epicenter of the coronavirus crisis. Officials there lifted the lockdown that had been in place for 76 days. This is a meaningful milestone. But it also represents the beginning of a new chapter in this saga, namely, one of recovery. And with it come many questions that are likely to weigh on the minds of most citizens, households, business owners, investors and government officials. What does life look like after a peak in this health crisis? Does everything reopen at once? What restrictions, if any, are still needed? Will people's behaviour be any different? Does economic activity bounce back sharply or gradually? In some ways, this is a concern for another day, as we are still in the middle of a serious crisis, where the welfare of our family, friends and clients are top of mind. But these are questions that equity and bond markets will have to grapple with in the not-too-distant future.

Looking forward

A few weeks ago, volatility was extreme and markets were selling off sharply. More recently, volatility, while still elevated, has moderated and equity markets have retraced some of their losses. This has happened despite terrible economic data that has illustrated the extent of the global shutdown. It has served as a good reminder that markets tend to be forward-looking in nature. While the data is likely to remain poor and even worsen in the weeks to come, investors have grown hopeful that a peak in the healthcare crisis is near and a return of economic activity may be on the horizon by the summer. But much uncertainty remains, given the exit strategies discussed above that remain unknown at this point. As a result, we continue to brace for volatility to remain elevated in the months to come.

Over the course of the past few months, as news of the virus started to build, I have had many conversations with clients discussing what is happening and what the appropriate response should be with their portfolios. As you can see from the comments that I including at the beginning of this commentary, there is a wide range of opinions surrounding what to invest in, when to make additional investments, or what to be concerned with in the coming weeks and months. Here is what I have gleaned in the last month:

- We are in a recession, globally, and there will be little chance of normality until there is a medical solution to COVID-19. The world requires either a successful medical therapy that can used quickly to treat infected people or a vaccine with sufficient effectiveness and availability for large-scale vaccinations. Most estimates for a vaccine are in the range of late 2020 to mid-2021.
- Restarting the economy will likely happen in fits and starts, with considerable assistance from governments. Canada will be closely monitoring European countries, some of which are trying their restart as early as next week (Norway, Germany and Austria). Expect more widespread

Continued on page 3

Emerging from the COVID-19 pandemic

Continued from page 2

testing for the virus and general temperature-testing in all kinds of settings. Expect higher-than-normal unemployment, as many small businesses will not be able to reopen despite the amount of government support / loans being offered today, or will not be able to rehire their entire staff due to uncertainty in demand. Expect much more stringent protocols for air travel, especially for any international flights.

- The scale of the additions to government debt at all levels will be staggering, and the consequences of this debt will likely be significant. This is not a "today" problem, but will be in later years. That said, we need to start to begin thinking about this issue in the coming year.
- Short-term interest rates for most developed countries are close to 0%, and are expected to be there for a number of years, punishing savers and conservative investors again. This will likely have more serious issues for pension plans, insurance companies and government programs like Old Age Security, all of which have future payouts and uncertainty with respect to fixed income yields from government bonds.
- No one knows if we have hit "bottom" in the equity or fixed income markets. I am telling clients that I have less conviction that the leadership stocks with impeccable balance sheets like Microsoft or Johnson & Johnson will test their March lows.
- Investors need be willing to sell their weaker positions into any market rallies and focus on businesses with the strongest balance sheets, as well as sectors that are more resilient in recessions such as consumer staples, utilities, certain industrial businesses, technology, healthcare and telecommunications.
- Profit margins of many large Canadian and U.S. businesses was already in decline over 2018 and 2019. A lot of the gains in the equity markets had resulted from massive share buybacks (using debt financing), which improved the companies' earnings per share. Most analysts are expecting a major decline in share buybacks in the coming years, with the possible exception of the best-capitalized companies.
- Canadian and U.S. banks were better financially prepared for a recession today, as compared to 2008/09 financial crisis. Canadian banks will be impacted on several fronts, with lower net interest margins (as the banks reduced fully the cut in their prime lending rate to match the amount that the Bank of Canada cut in their overnight lending rate) and the prospect of higher commercial loan losses if the recession lasts longer than a few quarters. That said, I have not read any research that is expecting the major banks to reduce their dividends.
- The energy sector will likely be volatile, even with the coordinated OPEC / G20 production cuts announced on April 11. Energy demand is down at least 30% and I expect it will come back gradually. Canada has had five years of belt-tightening in this sector, so we may do incrementally better than the U.S. shale oil producers, which generally require higher prices and access to the high-yield debt markets, which is evaporating quickly for them in the current environment.
- Many of the leadership sectors like technology experienced the mildest sell-off in their shares. This is likely due to a couple of observations: strong balance sheets with high cash balances, and alignment of their business with trends focused on online business, which was well established with above-average growth rates.
- In past recessions, much of the stimulus provided by governments did not go into end demand, it went into individual savings. I expect that for many people, they are using up their savings and bank accounts to tide them over through this period of isolation and forced layoffs. They will therefore likely be inclined to rebuild their savings rather than to resume consumption at their previous rate.
- The coming year or years are likely to be deflationary in terms of many asset prices (land, certain commodities, residential and commercial real estate, used cars and equipment).
- The investment class of exception is gold bullion, which has historically gained on a relative basis to other investments over the next 3-5 years. For Canadians, which saw their dollar depreciate against the USD by nearly 8% in three months, gold bullion in Canadian dollar terms gained over 13%, closing the quarter at C$2,244 per ounce (it has gained another $C200 to April

Continued on page 4

Emerging from the COVID-19 pandemic

Continued from page 3

9). Large gold mining companies historically out-perform, as they are one of the few sectors demonstrating earnings growth, as their revenues are climbing with higher bullion prices, while many of their costs are declining (fuel, electricity, availability of most talented labour).

- Credit or fixed income (especially high-yield) is becoming much more attractive in the last month. Having a contractual obligation to receive an interest payment and your capital back at a stated time may be more desirable than certain dividends if the recessions drags on for a longer time period, and as more businesses may have to resort to reducing or eliminating their dividend. In the table that I produce at the end of my quarterly commentary, I have added a line for the Barclays High Yield Index (in C$).

In conclusion, we have come through a lot in a short few weeks, and indeed, with the "whatever it takes" response from central banks and governments to stabilize credit markets, provide bridge and personal income support to businesses and individuals, the markets have staged an impressive rally in the past two weeks. Is the worst behind us, or ahead? That is the question for us today, at least economically.

Here is the conclusion of one of Canada's largest investment alternative managers, Picton Mahoney:

"Risk assets have staged a significant recovery rally from their March 23 lows. Significant oversold conditions have been alleviated somewhat, and major pension rebalancing from bonds to equities has occurred. Markets could sell off again at any point on negative virus-related developments. However, the GFC playbook has been applied with full force, and we believe pullbacks should be used to boost risk exposures, especially if a credible plan soon emerges to restart the global economy in safe and effective manner."

– Q2 2020 Investment Review and Outlook, the GFC Playbook for the War on COVID-19

The grim reality is that the virus does not care about the economy or stimulus or employment support programs. When there is no proven therapy or vaccine, the reality is that life is not normal, rather, it remains precarious and we are cautious, vigilant and very careful. We wait, look after our families, keep in touch by phone or Skype or Zoom, and continue to support those in our community who are putting their own lives at risk in hospitals, grocery stores, essential businesses and services. We are saying "hello" more to strangers and waving to people as we go for walks. The human spirit is alive and well, and that will see us through this time in the wilderness until science provides us all with some kind of treatment.

Team members Tina and Pauline are working from home as well. If you need income tax information or have any other questions, they are happy to assist you.

Finally, I would recommend that you circle back to our website from time to time, as I am using that as one of my points of contact to post salient articles on our firm's views, along with details of the government programs and announcements. You can access it here: https://ca.rbcwealthmanagement.com/web/jon.mitchell/

Stay safe and take care. We will get through this, and one day, we will be telling our children and grandchildren about the COVID-19 pandemic – what we did during it and the little nuggets of inspiration that we clung to throughout the ordeal. I can imagine so many movies and TV series about this for years to come.

P.S. As I predicted in October, Renée Zellweger won the Oscar for Best Actress in a Leading Role.

Set out below is a table of the performance of various sectors of the market in the first quarter of 2020 and for the 2020 results / three-year rolling periods:

Investment index	Q1 2020 return	2020 return	3-year compound Return
S&P/ TSX Composite Index	-20.9 %	-20.9 %	-1.9 %
S&P 500 (C$)	-13.0 %	-13.0 %	7.0 %
Short Term Comp Bond Index	1.6 %	1.6 %	3.7 %
iShares U.S. High Yield Bond Index ETF (XHY, C$ Hedged)	-14.8 %	-14.8 %	-2.1 %
US$ / C$	8.3 %	8.3 %	1.8 %
Gold Bullion (C$)	13.5 %	13.5 %	10.5 %

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