DIARY OF A PORTFOLIO MANAGER

Q1 2019 Recap

What a quarter!

Global capital markets reversed course after a notably difficult end to 2018, rebounding strongly to post mainly positive results for the first quarter of 2019. Equity markets appeared to be lifted by the prospect of easier monetary policy, while bond markets benefited from economic data showing slowing global growth.

The MSCI World Index, which reflects equity market results for 23 developed market economies, climbed 10.3% in Canadian dollar terms, with broad-based gains across markets in North America, Europe and Asia. In the U.S., the S&P 500 Index finished the quarter with a gain of 11.3% (also in Canadian currency), led by strong results for the information technology, energy and industrials sectors. Emerging markets equities also made gains during the quarter.

The Canadian benchmark S&P/TSX Composite Index posted a robust quarterly gain of 12.4%. Although most sectors added value, Canada's resource heavy market was particularly buoyed by higher oil prices, while the industrials, information technology and health care sectors also performed well.

The equity rebound came despite economic data indicating growing slack in the global economy, and central banks responded by striking a more dovish tone in the first quarter. After moving to raise interest rates several times in 2018, the U.S. Federal Reserve left rates unchanged and put further increases for 2019 on hold. Yields for 10-year U.S. Treasury Bonds moved lower through the period as bond prices rose. The Bank of Canada also left rates unchanged, and 10-year Canadian government bond yields declined as investors discounted the probability of further rate cuts in the near term.
The FTSE Canada Universe Bond Index, a broad measure of Canadian government and corporate bonds, returned 3.9% for the quarter.

Since the bull market in North American equities began more than 10 years ago, investors have drawn confidence from the gradual expansion of the global economy, particularly in the U.S. where corporate

earnings have been healthy and employment, housing and consumer spending data have been strong. However, late in the economic cycle, corporate earnings are slowing, along with global economic growth. While interest rates remain low and help to support business investment and equity prices in the near term, the market volatility we have seen over the past few quarters may become a more common occurrence as the cycle matures. The fourth quarter's steep decline and the dramatic reversal in the first quarter of this year is a timely reminder of how quickly markets can turn, and underscores the importance of staying invested for the longer term.

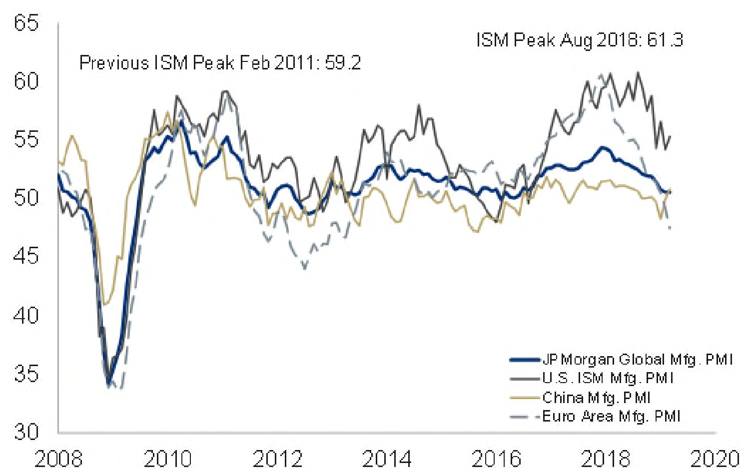
Given this backdrop, I continue to believe investors are best served by a diversified approach to investing – one that provides exposure to a broad range of actively managed investments from equities to bonds, depending on your personal objectives.

Slides of Interest from various RBC Groups

The economy

- After strong growth in 2017 and 2018, economic momentum has waned and we expect this trend to continue this year and next.
- The three main risks to our outlook are protectionism, Chinese growth and the U.S. business cycle. Although protectionism is no longer actively deteriorating, the actions taken thus far are starting to inflict economic damage through slowing global trade.
- We have argued for some time that the probability of a U.S. recession is in the realm of 35% for 2019 and 40% for 2020. With the recent inversion of the yield curve, formal recession models are starting to agree with that assessment.

Global purchasing managers' indices



Source: Haver Analytics, RBC GAM

As of March 31, 2019

Report card

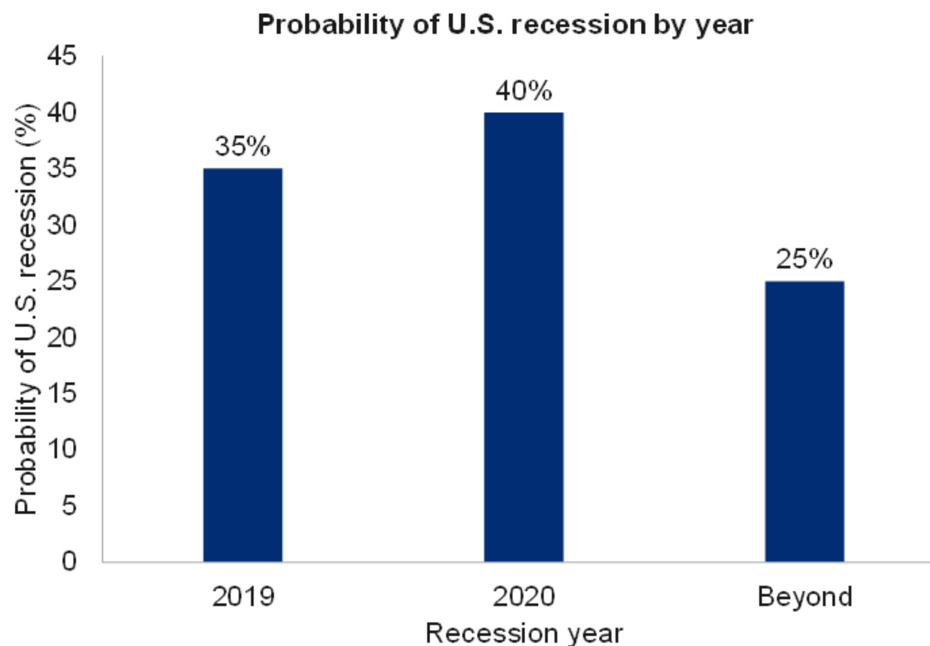
POSITIVE DEVELOPMENTS ✓	**NEGATIVE DEVELOPMENTS** ✗	**INTERESTING** !
• Dovish Fed and ECB	• Global macro data still weak	• Brexit in flux
• Credit market signals still positive	• Yield curve inverts	• U.S. politics: Mueller report; Trump investigations
• U.S.-China trade negotiations making progress	• U.S. bond yields fell	• U.S. Q1 GDP forecast tracking higher
• Growth slowing, but OK rate	• Canadian headwinds: debt, housing	• Canadian federal budget
• Higher oil prices		• Italy joined China's Belt and Road Initiative

Markets price out Fed hike, now expect cut

Note: As of 3/27/2019. Source: Bloomberg, RBC GAM

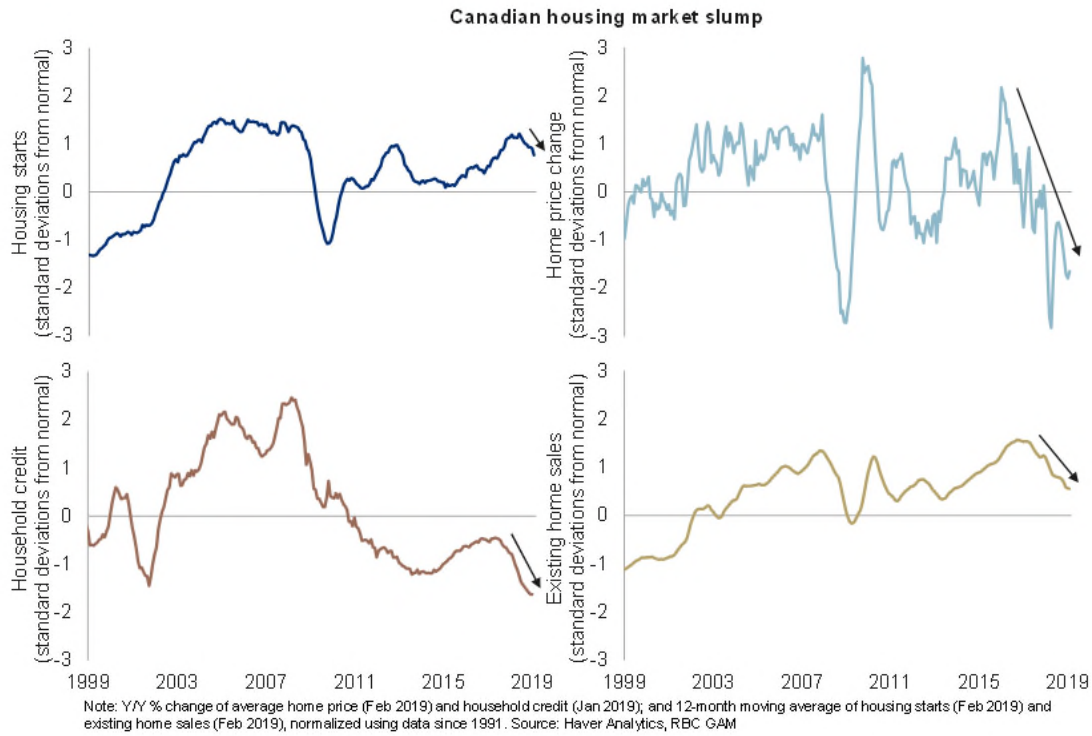
This chart shows how Fed expectations for the fed funds rate at the end of 2019 rose considerably over the past few years but have recently retreated as economic and market conditions have deteriorated. This retreat should help to stabilize the stock market.

We are not overly worried about the Fed as central banks are sensitive to macro conditions and capable of course corrections. We expect only cautious tightening in 2019 – perhaps slightly ahead of what the market prices in, but less than what the Fed imagines.

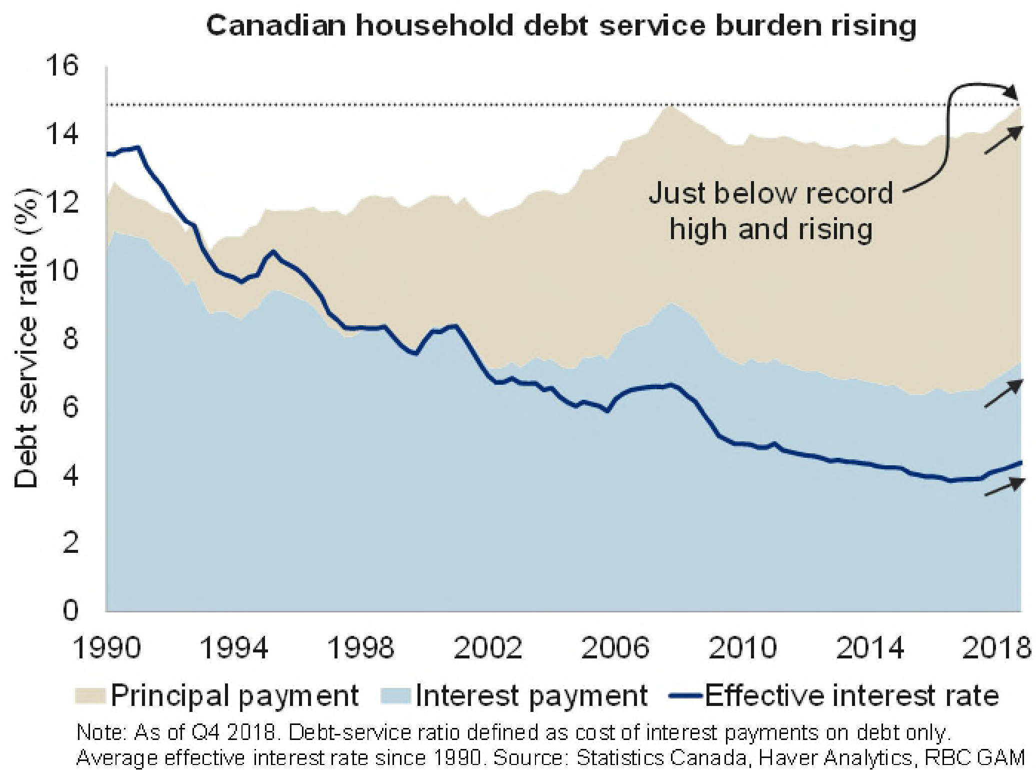


There has been notable deceleration in both household and business credit growth in Canada. We believe Canadian housing will remain cooler than it has been for many years, though falling short of a housing crunch. Vancouver home prices are actively falling, though Toronto has stabilized. Housing was a big driver of Canadian GDP for many years, and is now set to act as a more neutral or slightly negative influence.

Canadian housing market restrained by new mortgage rules



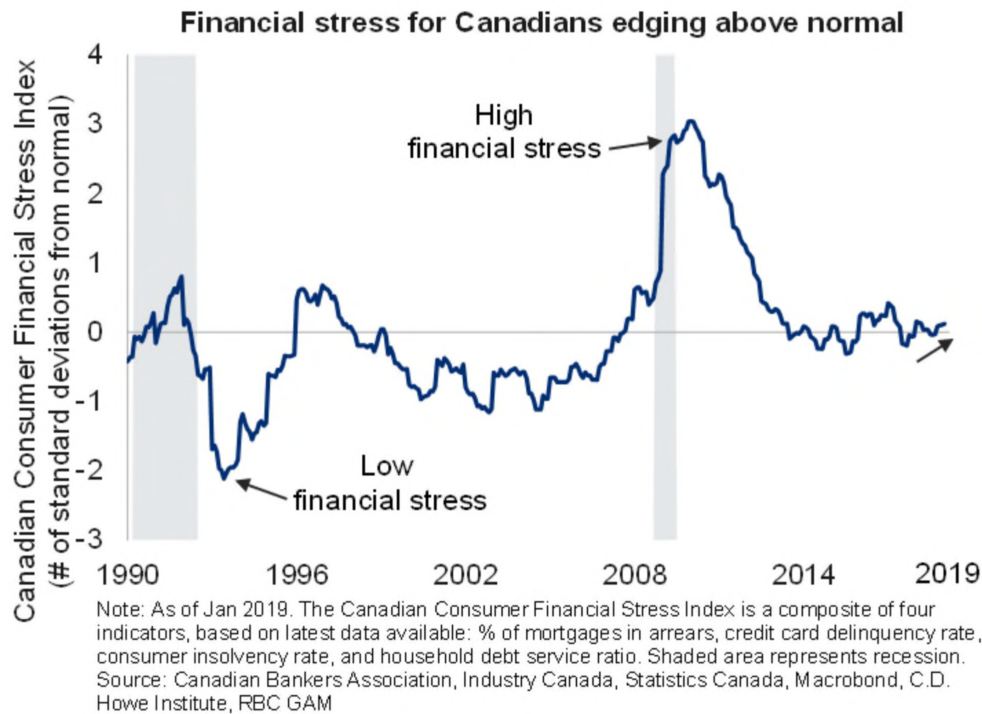
Canadian household debt not sustainable if rates rise further



Note: As of Q4 2018. Debt-service ratio defined as cost of interest payments on debt only. Average effective interest rate since 1990. Source: Statistics Canada, Haver Analytics, RBC GAM

While the overall fraction of Canadian income dedicated to servicing debt is normal, the composition is worrying. The interest portion is at record lows, while the principal portion is at record highs. When interest rates start to rise, the interest portion could rise significantly. Were interest rates to fully normalize (a stretch, but nevertheless illustrative), Canada's household debt service ratio would easily reach a record high, signaling debt distress for Canada.

Canadian consumer finances worth watching



You Can't Retire on a Benchmark

I recently read an article with the above title geared towards advisors like me but in the U.S. I found it so interesting that I am borrowing heavily from it and rewriting to aim it towards you, the client.

"Over a decade ago, a colleague of mine made a statement that I will never forget. He said, "I don't know why investors are so focused on beating the S&P 500. You can't retire on the S&P!" I've thought about this statement a lot over the last ten years.

I've thought about how the media focuses so much on benchmark relative performance that it has become a primary driver of the investment decision-making process. This is also somewhat ironic given the first few paragraphs of this newsletter discuss benchmark performance.

Unfortunately, as an industry we don't provide a lot of education around index construction. We don't discuss the basic facts that indexes don't have fees or pay taxes. Also, you can't invest directly in an index and a tracking exchange traded fund does have fees and taxes.

Is it realistic to compare your investment experience when you consider these basic facts? Indexes were originally developed as tools to effectively evaluate active money managers in defined benefit plans.

Today, there is a tremendous amount of emphasis placed on index performance by individual investors.

Choosing a proper benchmark to measure success

Recently, I've noticed that some client statements may have the S&P 500 listed along with the Bloomberg Barclays US Aggregate Bond Index. Yet the investor's investment portfolio is comprised of globally diversified investment solutions along with real assets. It's like comparing an apple to an orange.

What should be the proper benchmark? Isn't it your desired outcome or goal that matters most?

Let's say in January of 1998 an investor had a 10-year goal to save aggressively for retirement. She chose to invest with a reputable US Large Cap manager and outperformed every year for the next 10 years.

By the end of 2008, her annualized return was 1% better than the benchmark. Would you call that a success? The benchmark relative performance would have been terrific; however, the client would have had a 10-year annualized return of 0%. Did that meet the investor's desired outcome?

Focus on the right outcome

What should be the correct measurement of success? Many investors have a plan that is designed around an expected rate of return. The goal of the investment portfolio should be to achieve the expected return with a tolerable amount of risk.

In the case of the investor aggressively saving for retirement, had she used a multi-asset approach from 1998–2008 the outcome over the 10-year period would have been more desirable than the prior example as defined by the balanced allocation. An outcome-oriented benchmark of 4%, 5% or 6% may make more sense to a long-term investor than a single index-based benchmark.

Market returns cannot be predicted. Advisors and investors alike can plan, but they can't 100% accurately predict future returns. In fact, it's shocking to some investors when they see that emerging markets had the best performance from January 2000-2018. During that time, many investors would not have been able to stomach being invested in emerging markets.

Know how much you are losing to taxes

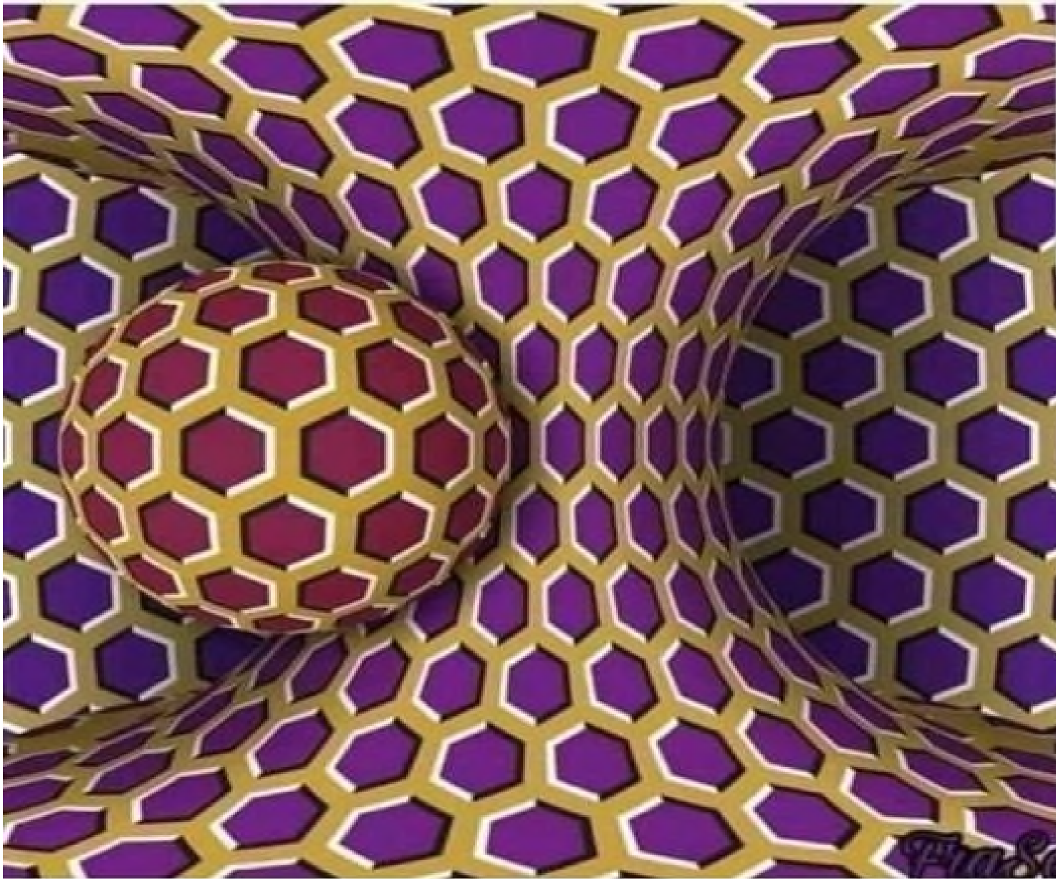
Finally, **taxes should also be taken into consideration when evaluating success over time**. An outcome-oriented benchmark should be considered after fees and taxes. Investors have historically evaluated success based on the rate of return seen on their statements compared to an index. Again, these numbers for both the individual and index don't take taxes into account. Each year investors can lose quite a bit of their return to taxes.

When making decisions are where investments should go in the overall portfolio is done with a few things in mind but taxes are the main one.   We believe focusing on growing *after-tax wealth* and working to minimize the performance headwind caused by taxes—may help achieve better outcomes for you.

Popular indexes are and will continue to be effective tools for investments professionals to measure the skill of active managers. We work with investors to develop more outcome-oriented benchmarks while incorporating after-tax wealth into their plan.

The bottom line

After looking at the evidence, it's fair to say that you cannot retire on a benchmark. My colleague made a very insightful point 10 years ago. However, our industry has still not created a goals-based or outcome-oriented benchmark that is listed on statements. We're of the belief that our job is to help you shift their mindset away from a benchmark while staying focused on your outcome.



This image was created by a Japanese neurologist. If the image is still, you are calm, if the image moves a bit, stressed and if it moves like a carousel, you are very stressed.

If you have any questions about the above topics or your financial plan, please do not hesitate to contact me anytime at 613-566-4582.

As always, thank you for the opportunity to serve you and your family.

Todd Kennedy
Vice President and Portfolio Manager

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities.