December 2018

RBC WEALTH MANAGEMENT

Global Insight

Special Report

Oh Canada: Value emerging from an unloved market

While Canadian equities are getting the cold shoulder from investors, the Canadian market has rarely been this cheap, which we think creates an interesting opportunity.

Joseph Wu, CFA & Tim Corney, CFA

For important and required non-U.S. analyst disclosures, see page 7

All values in Canadian dollars and priced as of Nov. 30, 2018, market close, unless otherwise noted.

RBC Wealth Management

Special report

Oh Canada: Value emerging from an unloved market

Joseph Wu, CFA
Toronto, Canada
joseph.wu@rbc.com

Tim Corney, CFA
Toronto, Canada
tim.corney@rbc.com

While Canadian equities are getting the cold shoulder from investors, we think they're failing to see a salient fact—the Canadian market has rarely been this cheap. We acknowledge that the market outlook remains challenging, but we explain how this valuation opportunity has piqued our interest.

Nobody knows you, when you're down and out – Jimmy Cox

Investors in Canadian equities will be forgiven if the temptation to "throw in the towel" on Canada's market and buy more U.S. (or, frankly, anything else…how is bitcoin doing?) feels like the right approach. Investor sentiment towards Canada is terrible. That makes this a time when it may pay to consider the contrarian view. We discuss the headwinds facing the Canadian economy and look at the valuations of the TSX on both an absolute and a relative basis. Although the Canadian market outlook doesn't engender much excitement at the moment, the multiple compression of the TSX over the past two years reflects very pessimistic expectations, in our view. The "wall of worry" is clearly in place. Things may only need to get incrementally better for the TSX to recover some of its mojo.

No love for the TSX

Despite delivering levels of earnings growth similar to the S&P 500 since 2016 (see the table below), the TSX is actually down 1% on a price basis compared to a 22% gain for the S&P 500 in CAD terms. Over the past two years the Canadian index has suffered a 19% haircut on its forward P/E ratio against a more benign 7% squeeze for the U.S. benchmark.

TSX earnings growth and forward P/E ratio between Dec. 2016 and Nov. 2018

	Trailing EPS			Index Level			Forward P/E		
	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ
TSX Composite	$669.04	$918.05	37%	15,288	15,198	-1%	16.5	13.3	-19%
S&P 500	$142.79	$194.35	36%	3,011	3,672	22%	17.0	15.8	-7%

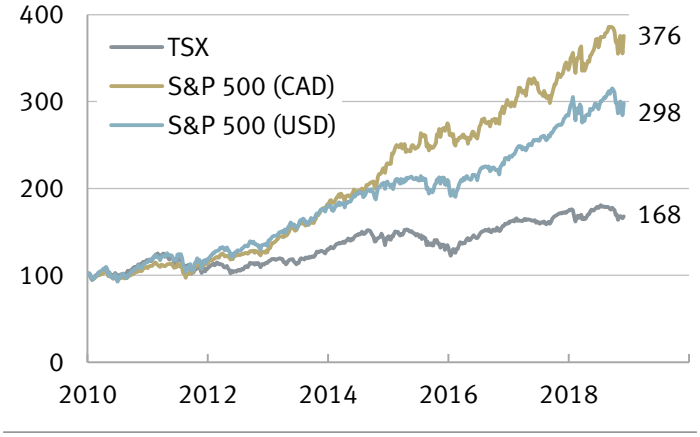
Source - Bloomberg; all data in CAD; "Δ" (delta) indicates percentage change over the time period shown.

The poor relative performance goes back even further. Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years as shown in the chart on the next page. While the Canadian economy and corporate earnings have recovered smartly from the oil-price-induced crunch four years ago, sentiment towards Canadian equities has remained unusually depressed.

Diagnosing the Canadian market

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

TSX total returns vs. S&P 500



Source - Bloomberg; 1/1/10 indexed to 100; data through 12/20/18

Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years.

- **Eroding relative competitiveness:** Most notably, the relative competitiveness of Canadian corporations has been hit by the big cut in U.S. corporate tax rates. Once much higher than the posted Canadian rate, the U.S. rate is now somewhat lower. Additionally, the Trump administration has pursued an aggressive deregulatory agenda since 2016, while the regulatory burden in Canada has moved in the opposite direction, as environmental commitments and labour laws have become less business-friendly. At the same time, all provinces have raised the minimum wage.
- **Indebted households:** Canadian household debt levels have surged to around 170% of annual income as of Q3 2018, up from around 130% at the start of 2006. The rise has been driven by ultra-low interest rates that have pushed debt servicing costs to historically low levels, together with a strong bull market in real estate prices. Results have included larger mortgages and, to a lesser extent, debt-financed consumption. This has raised concerns about future financial system vulnerability (e.g., loan defaults) and long-term growth prospects. These concerns have important implications for the economy and stock market because the Financials sector comprises over a third of the TSX, and personal consumption accounts for nearly 60% of Canadian GDP.
- **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. Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011. The Energy sector is contending with inadequate pipeline capacity to move Canadian crude to export markets, forcing producers to ship greatly reduced volumes via more-expensive rail and truck and at heavily discounted prices. Given pipeline constraints are unlikely to be resolved in the near future, all this means Canadian oil could continue to trade at a deeper-than-usual discount compared with WTI, while investor interest in Canadian Energy companies is likely to remain listless.

Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011.

Half empty or half full?

There is a growing temptation to “throw in the towel” on Canadian equities, and buying more U.S. equities may seem like the right approach. However, we are reminded of the words of wisdom from the father of value investing, Benjamin Graham:

"In the short run, the market is like a voting machine—tallying up which firms are popular and unpopular. But in the long run the market is like a weighing machine—assessing the substance of each company."

Nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market.

In this case, almost all of Canada is universally unpopular at the present time. Yet despite this, nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market: net foreign purchases of Canadian equities have held up well in recent years, amounting to CAD183B since 2013.

Because stock markets are discounting mechanisms, 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 heavy consideration to what one is paying for a basket of high-quality Canadian businesses.

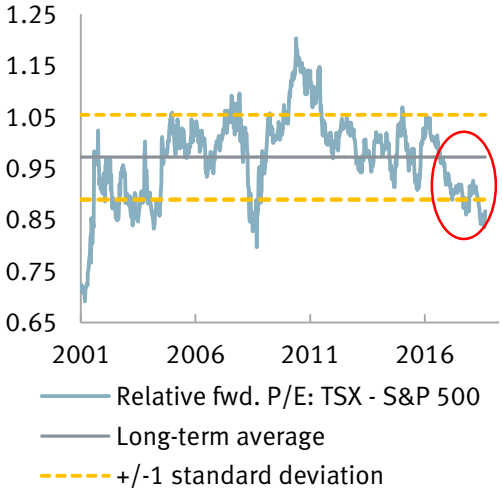
From an absolute valuation standpoint, the TSX trades at roughly 13.1x forward earnings, an 11% discount compared to its long-term average of 14.6x; that's almost one standard deviation below the historical average. On a relative basis, while the forward P/E multiples for the TSX and the S&P 500 have tended to move in sync historically, a big gap has opened up, as shown in the charts below. The TSX currently trades at an extraordinarily deep 15% discount to the S&P 500 on a forward P/E basis.

P/E multiples for TSX and S&P 500

Forward P/E multiples for TSX and S&P 500 tended to move together...

Relative forward P/E: TSX – S&P 500

...but valuations have dramatically diverged since 2016.



Source - Bloomberg

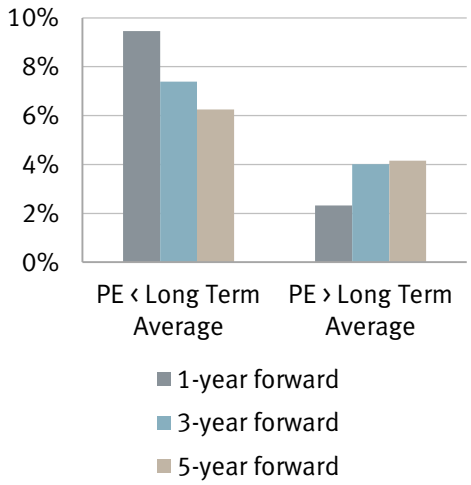
At current valuations, the Canadian market has rarely been this cheap. If we ignore the global financial crisis (because it was *the* global financial crisis), we have to go back to the early 2000s to find the last time Canada looked this cheap relative to the U.S. However, at that time the U.S. market was still dealing with the hangover of the dot-com era and valuations were very expensive—Walmart was trading at 57x earnings. It wasn't so much about Canada trading cheaply as it was the U.S. trading at historically expensive multiples.

Valuations are seldom useful for timing entry points, but they are strong determinants of future long-term return potential. The chart at left below shows the 1-, 3- and 5-year forward returns for the TSX based on entry points that were either above or below the historical average. Unsurprisingly, forward return prospects were, on average, quite a bit more attractive across all time horizons if one had invested in the TSX when its forward P/E was below the 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 trades at discounts in excess of 10% compared to the U.S. market on a forward P/E basis, as shown in the chart at right below. In stark contrast, the TSX has meaningfully lagged after trading more expensively than the S&P 500.

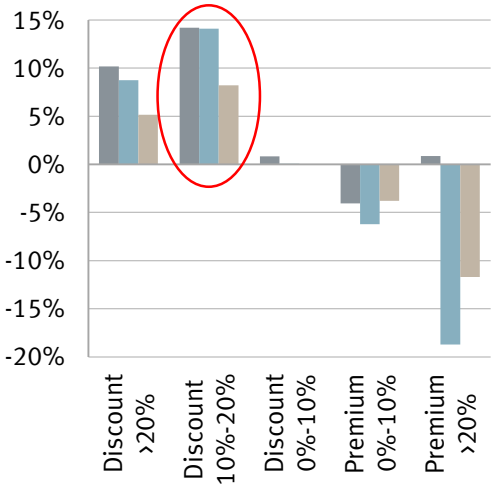
TSX returns when investing below and above historical average P/E

Lower starting valuations elevate average future return potential



Average annualized relative performance of the TSX vs. the S&P 500

Valuations eventually matter… in the longer term



Source - Bloomberg; based on price index

Parting thoughts on Canada

Investor sentiment towards Canada remains quite negative. That said, we think the unusually wide valuation gap that has opened up between the TSX and the S&P 500 warrants looking at the Canadian market through contrarian eyes. We acknowledge that some headwinds facing the Canadian market are unlikely to abate in the short term, but we contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

We contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

Perhaps some combination of OPEC and Alberta production cuts and/or progress on pipeline approvals will re-energize the energy market. Or perhaps a split U.S. Congress will soften the Trump administration's hardline trade stance. And soon, the leaders of both countries will turn their sights towards reelection, which may result in market-friendly policies in the near term. These are three possible outcomes to which the market is essentially assigning a zero probability. Investors are already behaving as if not much can get better, which is piquing our interest. Remember, in the words of Warren Buffett: be greedy only when others are fearful.

Research resources

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities. The Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee, providing additional tactical and thematic support utilizing research from the RBC Investment Strategy Committee, RBC Capital Markets, and third-party resources.

Global Portfolio Advisory Committee members:

Jim Allworth – Co-chair; Investment Strategist, RBC Dominion Securities Inc.

Kelly Bogdanova – Co-chair; Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – U.S. Equities, RBC Capital Markets, LLC

Frédérique Carrier – Co-chair; Managing Director, Head of Investment Strategies, Royal Bank of Canada Investment Management (U.K.) Limited

Mark Bayko, CFA – Head, Portfolio Management, RBC Dominion Securities Inc.

Craig Bishop – Lead Strategist, U.S. Fixed Income Strategies Group, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Laura Cooper – Head of FX Solutions and Strategy, Royal Bank of Canada Investment Management (U.K.) Limited

Janet Engels – Head of Portfolio Advisory Group U.S., RBC Wealth Management, RBC Capital Markets, LLC

Tom Garretson, CFA – Fixed Income Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Christopher Girdler, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Patrick McAllister, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Jay Roberts, CFA – Head of Investment Solutions & Products, RBC Wealth Management Hong Kong, RBC Investment Services (Asia) Limited

Alan Robinson – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – U.S. Equities, RBC Capital Markets, LLC

Alastair Whitfield – Head of Fixed Income – British Isles, Royal Bank of Canada Investment Management (U.K.) Limited

The RBC Investment Strategy Committee (RISC) consists of senior investment professionals drawn from individual, client-focused business units within RBC, including the Portfolio Advisory Group. The RISC builds a broad global investment outlook and develops specific guidelines that can be used to manage portfolios. The RISC is chaired by Daniel Chornous, CFA, Chief Investment Officer of RBC Global Asset Management Inc.

Additional Global Insight authors:

Joseph Wu, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Tim Corney, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Required disclosures

Analyst Certification
All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

Important Disclosures

In the U.S., RBC Wealth Management operates as a division of RBC Capital Markets, LLC. In Canada, RBC Wealth Management includes, without limitation, RBC Dominion Securities Inc., which is a foreign affiliate of RBC Capital Markets, LLC. This report has been prepared by RBC Capital Markets, LLC which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada.

Non-U.S. Analyst Disclosure: Tim Corney and Joseph Wu, employees of RBC Wealth Management USA's foreign affiliate RBC Dominion Securities Inc. contributed to the preparation of this publication. These individuals are not registered with or qualified as research analysts with the U.S. Financial Industry Regulatory Authority ("FINRA") and, since they are not associated persons of RBC Wealth Management, they may not be subject to FINRA Rule 2241 governing communications with subject companies, the making of public appearances, and the trading of securities in accounts held by research analysts.

In the event that this is a compendium report (covers six or more companies), RBC Wealth Management may choose to provide important disclosure information by reference. To access current disclosures, clients should refer to https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2 to view disclosures regarding RBC Wealth Management and its affiliated firms. Such information is also available upon request to RBC Wealth Management Publishing, 60 South Sixth St, Minneapolis, MN 55402.

References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), the Guided Portfolio: All Cap Growth (RL 12), and former lists called the Guided Portfolio: Large Cap (RL 7), the Guided Portfolio: Midcap 111 (RL 9), and the Guided Portfolio: Global Equity (U.S.) (RL 11). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

Distribution of Ratings
For the purpose of ratings distributions, regulatory rules require member firms to assign ratings to one of three rating categories - Buy, Hold/Neutral, or Sell - regardless of a firm's own rating categories. Although RBC Capital Markets, LLC ratings of Top Pick/Outperform, Sector Perform, and Underperform most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because our ratings are determined on a relative basis.

Explanation of RBC Capital Markets, LLC Equity Rating System
An analyst's "sector" is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector average.

Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of September 30, 2018

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	859	54.33	251	29.22
Hold [Sector Perform]	646	40.86	125	19.35
Sell [Underperform]	76	4.81	5	6.58

Ratings: Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. **Outperform (O):** Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months. **Restricted (R)**: RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR)**: The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

Risk Rating: The **Speculative** risk rating reflects a security's lower level of financial or operating predictability, illiquid share trading volumes, high balance sheet leverage, or limited operating history that result in a higher expectation of financial and/or stock price volatility.

Valuation and Risks to Rating and Price Target
When RBC Wealth Management assigns a value to a company in a research report, FINRA Rules and NYSE Rules (as

incorporated into the FINRA Rulebook) require that the basis for the valuation and the impediments to obtaining that valuation be described. Where applicable, this information is included in the text of our research in the sections entitled "Valuation" and "Risks to Rating and Price Target", respectively.

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of RBC Capital Markets, LLC, and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets, LLC and its affiliates.

Other Disclosures

Prepared with the assistance of our national research sources. RBC Wealth Management prepared this report and takes sole responsibility for its content and distribution. The content may have been based, at least in part, on material provided by our third-party correspondent research services. Our third-party correspondent has given RBC Wealth Management general permission to use its research reports as source materials, but has not reviewed or approved this report, nor has it been informed of its publication. Our third-party correspondent may from time to time have long or short positions in, effect transactions in, and make markets in securities referred to herein. Our third-party correspondent may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report.

RBC Wealth Management endeavors to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. In certain investment advisory accounts, RBC Wealth Management or a designated third party will act as overlay manager for our clients and will initiate transactions in the securities referenced herein for those accounts upon receipt of this report. These transactions may occur before or after your receipt of this report and may have a short-term impact on the market price of the securities in which transactions occur. RBC Wealth Management research is posted to our proprietary Web sites to ensure eligible clients receive coverage initiations and changes in rating, targets, and opinions in a timely manner. Additional distribution may be done by sales personnel via e-mail, fax, or regular mail. Clients may also receive our research via third-party vendors. Please contact your RBC Wealth Management Financial Advisor for more information regarding RBC Wealth Management research.

Conflicts Disclosure: RBC Wealth Management is registered with the Securities and Exchange Commission as a broker/dealer and an investment adviser, offering both brokerage and investment advisory services. RBC Wealth Management's Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on our Web site at https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2. Conflicts of interests related to our investment advisory business can be found in Part 2A Appendix 1 of the Firm's Form ADV or the RBC Advisory Programs Disclosure Document. Copies of any of these documents are available upon request through your Financial Advisor. We reserve the right to amend or supplement this policy, Part 2A Appendix 1 of the Form ADV, or RBC Advisory Programs Disclosure Document at any time.

The authors are employed by one of the following entities: RBC Wealth Management USA, a division of RBC Capital Markets, LLC, a securities broker-dealer with principal offices located in Minnesota and New York, USA; by RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Toronto, Canada; by RBC Investment Services (Asia) Limited, a subsidiary of RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Hong Kong, China; and by Royal Bank of Canada Investment Management (U.K.) Limited, an investment management company with principal offices located in London, United Kingdom.

Third-party disclaimers

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc. ("MSCI") and Standard & Poor's Financial Services LLC ("S&P") and is licensed for use by RBC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

References herein to "LIBOR", "LIBO Rate", "L" or other LIBOR abbreviations means the London interbank offered rate as administered by ICE Benchmark Administration (or any other person that takes over the administration of such rate).

Disclaimer

The information contained in this report has been compiled by RBC Wealth Management, a division of RBC Capital Markets, LLC, from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC Wealth Management's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients, including clients who are affiliates of Royal Bank of Canada, and does not have regard to the particular circumstances or needs of any specific person who may read it. The investments or services contained in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about the suitability of such investments or