Fickel's Focus

First quarter investment commentary

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Global markets are being held hostage to political rhetoric

Despite a solid global economic and investment backdrop, most stock markets declined during Q1, weighed down by geopolitical issues and trade war concerns.

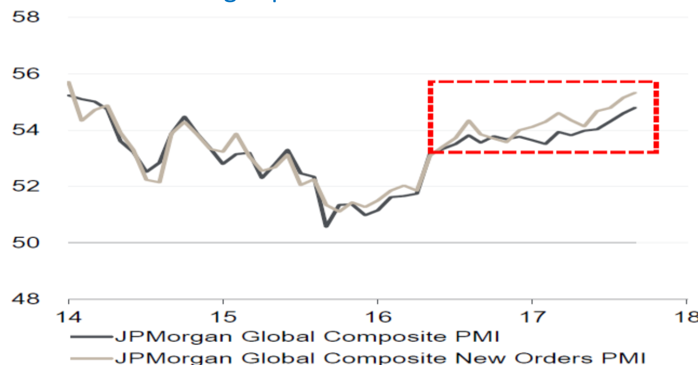
Bond and preferred share returns were also unspectacular.

Accounts on board for the full quarter and migrated to their appropriate models modestly underperformed the Q1 balanced benchmark return. Please contact us to further discuss the performance of your portfolio.

Economic Overview

The global economy is experiencing its broadest expansion since 2010. Economic indicators from manufacturing (PMIs) to confidence (business and consumer) suggest that strong growth will continue in 2018 (see following 2 charts).

Global manufacturing expansion continues



Source: Bloomberg, RBC Wealth Management

Global confidence is high

Source: J.P. Morgan, RBC Wealth Management, March 2018

At this point, it seems that the main risk to the global economic outlook stems more from the possibility of political missteps rather than the business cycle itself.

Equity Commentary

The average equity weight in fully-invested balanced portfolios is 58.95%, modestly above the balanced benchmark weight of 55%.

Global equity markets, with the exception of the S&P 500, are trading about 10-15% below their long-term averages - U.S. stock markets trade in line. One could reasonably argue that valuations should be higher than average given that interest rates are at multi-decade lows.

World stock markets are supported by a strong outlook for global profits. Corporate earnings (EPS) are closely linked with the Global Manufacturing Composite PMI which is trending higher (see chart).

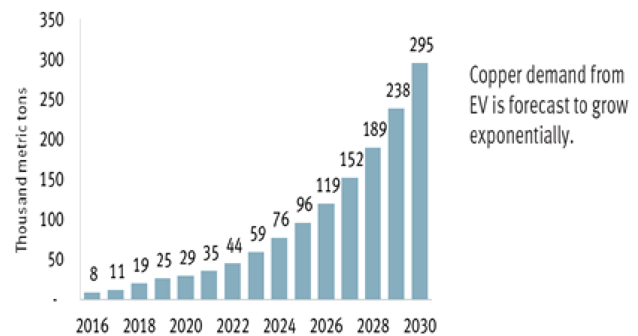
Global EPS are rising

Source: IBES, Markit, March 2018

Fully invested balanced portfolios are slightly overweight Canadian stocks (average 32.24% versus 30% balanced benchmark). The TSX trades near a 15-year relative low to the S&P 500. Improving economic activity and higher commodity prices should help narrow this gap.

We are overweight Materials. This sector includes metals, golds, chemicals and forest products - all of which benefit from improving global growth.

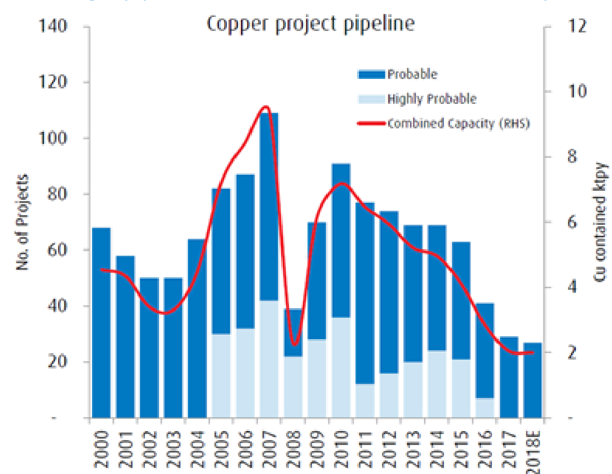
We like the outlook for copper. Demand is forecast to rise for the foreseeable future. Bloomberg forecasts that by 2030, 295,000 tons will be needed annually for electric vehicle batteries (see chart).



Source: RBC Capital Markets, Bloomberg, Bloomberg News Energy Finance

It's unlikely there will be sufficient supply of copper to satisfy demand (see chart).

The number of copper projects classified as probable and highly probable is the lowest this century

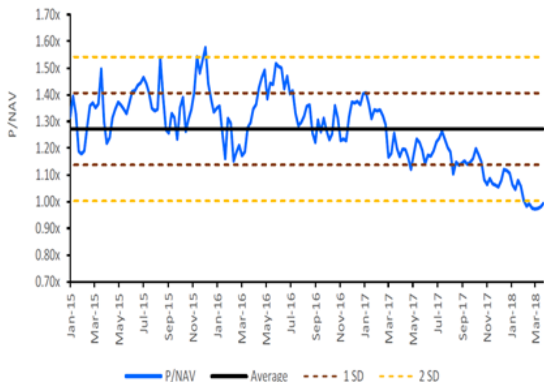


Source: Wood Mackenzie, BMO Capital Markets

First Quantum (FM) is our preferred way to invest in copper. FM has a top-tier growth profile with copper and gold production expected to increase by over 50% through 2019.

We believe there is a place for gold in portfolios at the present time. Gold stocks are attractive following the disconnect between weak equity prices and the strong gold price. Gold producers trade at a 2.1 standard deviation discount to their recent Price/Net-Asset-Value range (see chart). At current share prices, investors get the "safe haven" option at a discount.

Precious metal equities Price/Net-Asset-Value



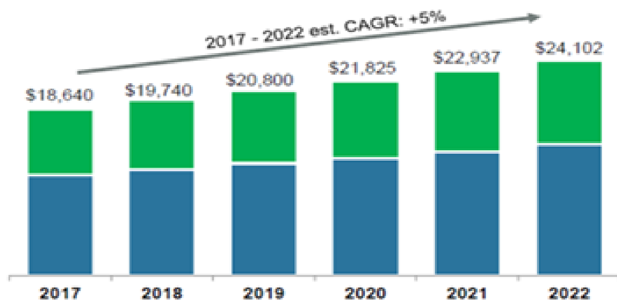
Source: RBC Capital Market estimates at spot commodity prices and currencies as of March 21, 2018

Clients own two gold stocks, Goldcorp (G) and Yamana (YRI). Both companies have good production growth and trade at low price-to-free-cash flow levels.

We are overweight utilities and have recently added to our Hydro One (H) and Canadian Utilities (CU) positions. We like their defensive characteristics, high dividend yields, relatively low valuations and modest growth prospects.

H is attractively valued trading at approximately 15x forward earnings and yielding about 4.3%. H has roughly 5 years of low-risk utility rate base growth which will boost earnings and dividends (see chart).

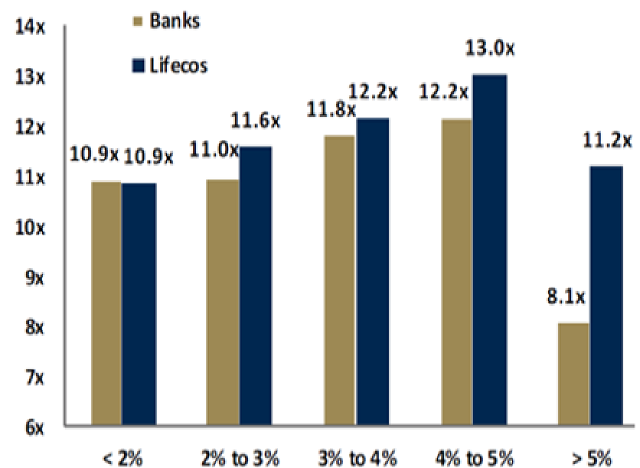
Projected rate base growth (blue is transmission, green distribution)



Source: Company reports

Clients are well represented in Canadian financials. Banks and insurance companies perform well when interest rates are rising. Using the 10-year Government of Canada (GOC) bond yield as a proxy for rates (horizontal axis), P/E multiples (vertical axis) expand as yields increase up to the 4-5% range (see chart). Currently, the 10-year GOC bond yield is 2.15%. GOC yields can rise significantly before P/E ratios fall.

Higher rates = multiple expansion



Source: Bloomberg; RBC CM Canadian Equity Strategy

Investors have raised concerns with Canadian banks' exposure to real estate at a time when personal debt levels are very high. However, it appears that bank lending practices have been conservative. The average loan-to-value ratio on uninsured mortgages is only 53%. Also, Canadian banks have multiple sources of income and are geographically diversified.

Fully invested balanced portfolios are underweight U.S. stocks (average 15.49% versus 20% balanced benchmark).

The recent 10% decline in U.S. equities has brought the S&P 500 valuation back towards a normal level (16.2x P/E versus the long-term average of 15.8x).

Volatility has been high of late, but this does not mean that the bull market is over. The S&P 500 has experienced drops of 3% or more 15 times since 2008; 6 months later, the index was materially higher. Historically, recessions end bull markets. At this point, there is virtually no evidence that a recession is on the horizon.

Rising interest rates can be problematic for stocks. That said, the S&P 500 has performed well when the increase in the 10-year bond yield is less than 275 basis points from trough to peak. When this is the case, the S&P 500 has returned 19.4% on average (see chart). If the past is a prologue to the future, the 10-year U.S. Treasury bond yield would have to rise to 4.11% (1.36% + 2.75%) before rates weigh on stocks. This is a long way from the current yield of 2.8%.

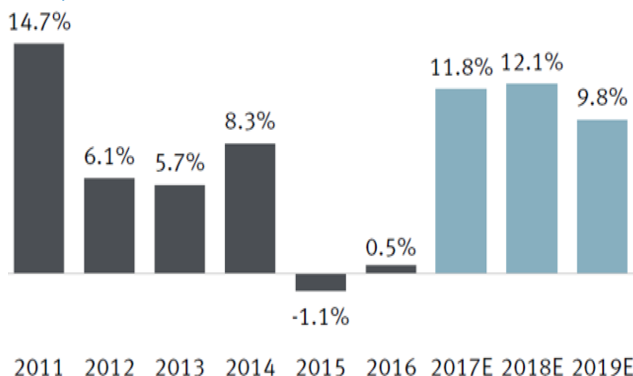
Average and median S&P 500 performance during periods of rising interest rates

	# Times	Average	Median
All Periods	18	10.7%	7.7%
Rate Increase < 275 bps	11	19.4%	14.4%
Rate Increase > 275 bps	7	-3.0%	-1.4%
10 Year Yield Low of Current Environment	1.36		
10 Year Yield Low + 275 bps Threshold	4.11		

Source: RBC U.S. Equity Strategy, Bloomberg

Historically, U.S. stocks have responded well to earnings growth. U.S. corporate profits are forecast to rise significantly over the next 2 years thanks in large part to corporate tax reform (see chart).

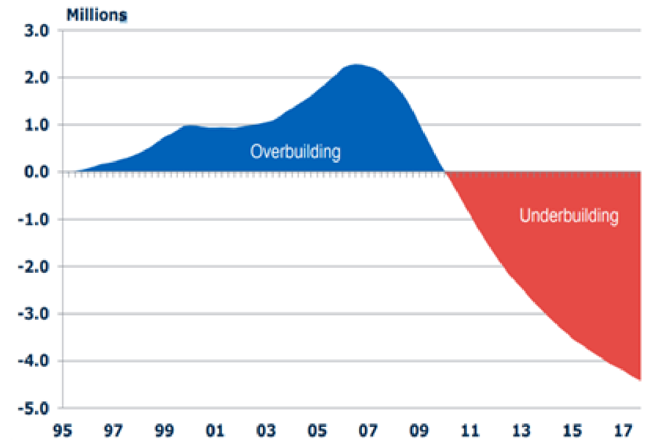
S&P 500 EPS growth (actual in gray, consensus in blue)



Thomson Reuters I/B/E/S; data through 11/29/17

We like housing related investments. The U.S. housing market recovery will continue over the next 12-18 months led by job growth, wage gains and affordability. 2008-2014 comprised the seven worst years for housing starts in over half a century resulting in a chronic shortage of new homes (see chart).

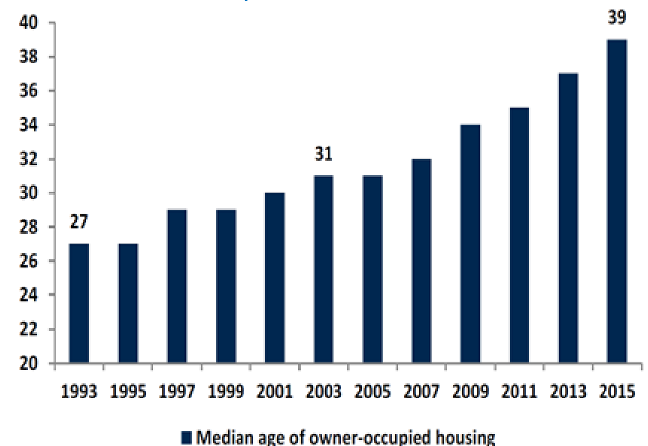
Chronic underbuilding in the U.S. housing market since the financial crisis



Source: FEA

56% of U.S. owner-occupied homes were built before 1980 (see chart). An "aged" U.S. housing stock combined with a lack of available homes for sale bodes well for residential repair and remodeling expenditures and by implication, client holdings of Costco, Home Depot, and West Fraser.

Existing U.S. housing stock has aged considerably over the last 10-15 years



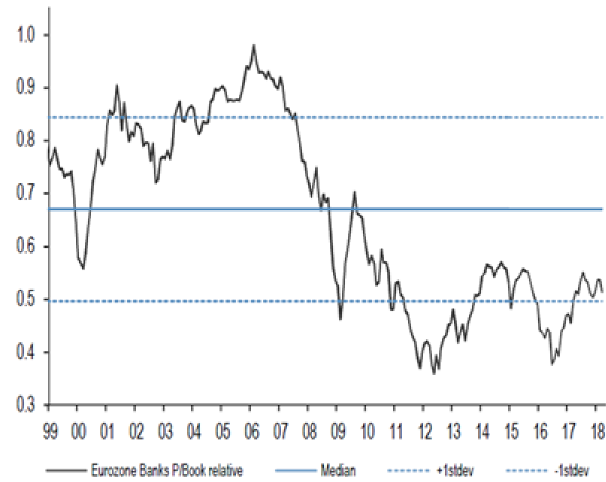
Source: FEA, U.S. Census Bureau, RBC Capital Markets

Fully invested portfolios are overweight International stocks at 11.44% (balanced benchmark is 5%). Global equities trade below their historical average price-to-earnings (P/E) multiples and at a steep (P/E) discount to the S&P 500.

The majority of our International exposure is in European financials. European banks have gone through a massive clean-up process. At the same time, credit growth is improving across the region. Meanwhile, valuations are attractive with price/book measures remaining well below their long-term

averages (see chart).

Eurozone banks relative price to book value is below historical average



Source: Datastream

Fixed Income

The average fixed-income weight in fully invested balanced portfolios is 25.92%. This compares to 40% for the balanced benchmark. We remain very defensive in the fixed-income component of portfolios.

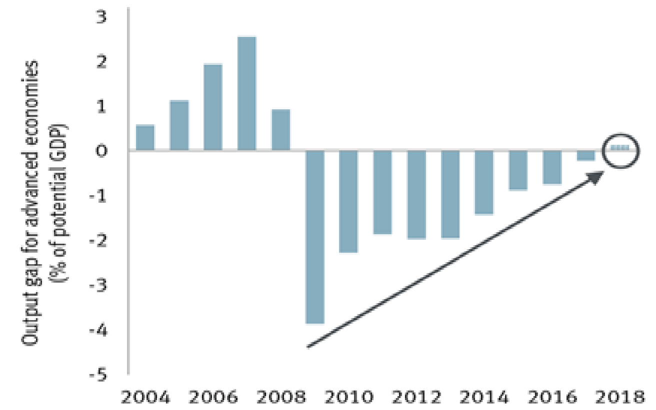
Global inflation readings are rising (see chart) on the back of strengthening labour markets and higher commodity prices.

Global inflation surprises on the upside

Source: Citigroup, Bloomberg, RBC GAM

Economic slack is finally gone in the developed world with the closing of the output gap for the first time in a decade (see chart). It is not unreasonable to expect higher inflation with demand now exceeding supply. Historically, this has led to higher interest rates.

Output gap has closed in the developed world with "excess capacity" turning into "not enough capacity"



Source: IMF, Haver Analytics, RBC Global Asset Management

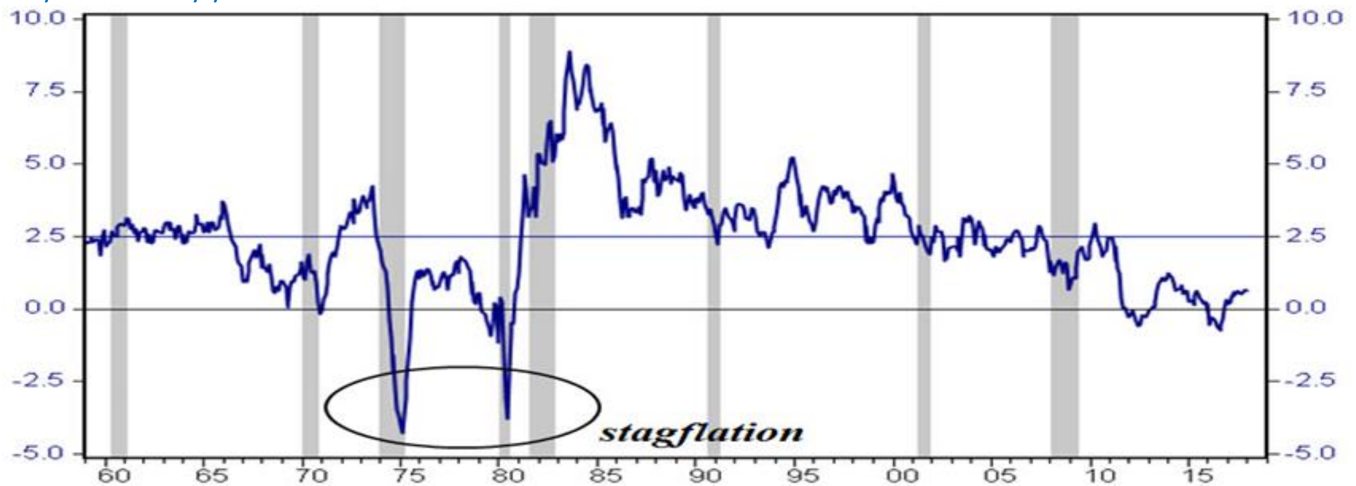
U.S. core inflation (CPI) rose at an annual rate of 2.1% in March. The most recent 6-month price gain jumped to 2.6% (see chart). This firming in price pressures reinforces the Federal Reserve's bias to continue raising rates.

U.S. Core CPI growth (%)

Source: Bureau of Labor Statistics, RBC Economics Research

Interest rates are too low in the U.S., particularly with inflation rising. The real (inflation-adjusted) 10-year U.S. Treasury bond yield is 80 basis points (see chart on next page). The historical long-term average is about 250 basis points. This implies that the 10-year bond yield would have to rise about 170 basis points in order to bring it back to its average long-term inflation adjusted yield. Mid to long-term bond prices would get crushed if this happened.

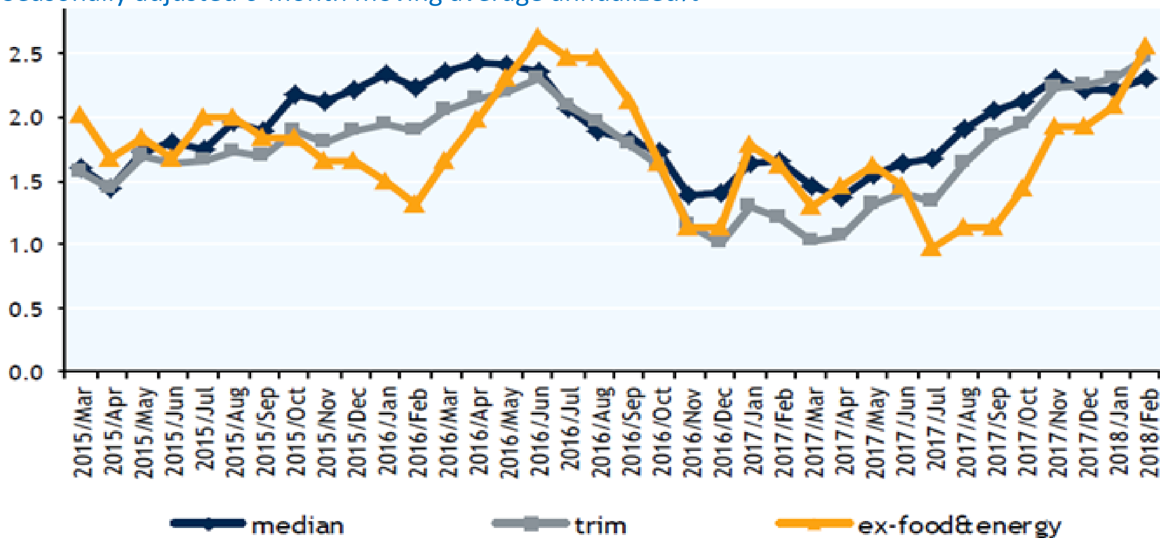
10-year Treasury yield minus core CPI



Source: RBC Capital Markets U.S. Economics/Haver

Canada's core inflation (CPI) rose 2.2% Y/Y in February, the highest since October 2014. The 6-month rolling average for the ex-food and energy inflation rate is tracking at a 2.6% pace (see chart). The March unemployment rate was 5.8%, the lowest level since the mid-70's. The average hourly wage growth rate strengthened to 3.3% in March. With the economy running at close to its capacity limits and inflation reaching the Bank of Canada's 2% target, we expect interest rates to grind higher this year and next. This does not bode well for Canadian government bonds which currently offer an inflation adjusted return near 0%. Mid to long-term bond prices would get punished if yields revert back to their long-term inflation adjusted levels.

Seasonally adjusted 6-month moving average annualized%



Source: Statistics Canada, RBC Economics calculations

We remain defensive in the fixed-income component of portfolios (owning mostly preferred shares). Clients hold 3 types of preferred shares: floating, fixed rate reset, and perpetual. This strategy accomplishes several objectives - stable income via perpetuals and interest rate protection through floating and rate reset shares. Although preferred shares still represent good value, we modestly pared back our holdings using the proceeds to purchase some short-term bonds. We added a small weight (1.25% each) in five high quality, short-term bonds, primarily for diversification and preservation of capital.

Performance

We modestly underperformed the balance benchmark during Q1.

As the year began, we increased our weighting in more defensive, high yielding stocks. We believed that higher interest rates were already baked into their share prices. Q1 proved that we were a bit early in this transition as ironically, the defensive names hurt performance. BCE (-8.2%), Canadian Utilities (-8.3%), Emera (-13.3%), Enbridge (-14.7%), Hydro One (-6.9%), Power Corp (-9.3%) and Trans Canada (-13.3%) were all sharply lower. Investors chose to focus on more aggressive, “growthier” names. Other than Enbridge, we still own all of these companies and in fact, added to Hydro One and Canadian Utilities on weakness. Collectively, these defensive holdings have an average P/E of less than 15x and yield approximately 5%.

We chose to exit Enbridge after an unexpected regulatory ruling raised some concerns about the company’s ability to raise capital on reasonable terms to fund its significant expansion plans.

We own several gold stocks as a hedge against political uncertainty and that helped during Q1 with Goldcorp rising 10.9%. West Fraser returned 9.2% as lumber prices continued to soar.

Modestly underweight U.S. stocks hurt performance given the S&P 500’s positive return in $Cdn. Again, defensive names hurt returns. Johnson & Johnson (-6%), AT&T (-6.1%), and Walgreen (-7.7%) underperformed. Collectively, these companies have an average P/E of less than 13x and yield of 3.6%.

Returns from our international names lagged the MSCI EAFE Index. That was mainly due to the weakness in AXA (-8.2%) following its $U.S. 15 bln acquisition of XL Group. The combination of these two creates one of the globe’s largest property and casualty insurance companies. We added to AXA on weakness. The stock trades at a compelling P/E of 9x and has an attractive yield of 5%.

Our preferred shares bettered the S&P/TSX Preferred Share Index return and the broad bond composite. The BCE floating rate preferred shares returned more than 4%, helped by rising interest rates.

Wealth services for our valued clients

A number of our clients have recently taken advantage of RBC Wealth Management’s services including:

- **Strategic tax minimization** – In-house tax specialists review the effectiveness of particular strategies
- In-depth **Financial Planning** – financial planning specialists will prepare a comprehensive Compass Financial Plan to help identify and address any financial planning concerns or opportunities you may have
- **Business owner planning** – help you explore succession, tax, retirement and estate planning issues you face as a business owner
- **Will & Estate consultation** – help you structure the succession of your estate in an efficient and tax effective manner
- **Insurance assessment** – Estate planning specialists assess the need and suitability of tax-exempt insurance

These services are complimentary for our clients. If you would like to take advantage of any of the wealth management services, please call ***Jaana*** at ***416-960-7880*** to schedule an appointment.

Wealth Management
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