Fickel's Focus

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First Quarter 2020 Investment Commentary

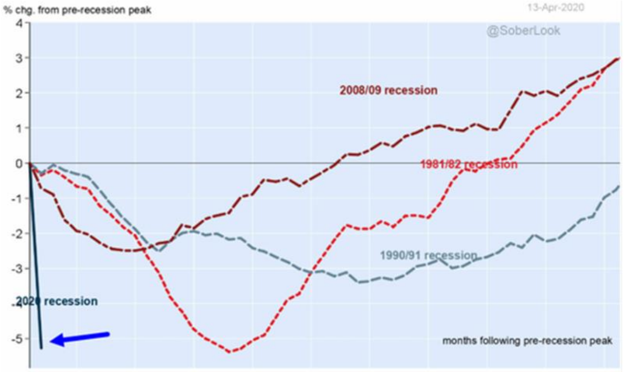
Global equity markets collapsed in the first quarter while the bond index increased modestly. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased/decreased by -20.9%, -13%, and +1.6% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced negative returns during the quarter and outperformed their respective benchmark.

Economic Overview

At the end of 2019 the global economy was exhibiting tentative signs that a 'mini-cycle' recovery was underway. Global manufacturing inflected higher, optimism was growing among businesses and consumers, and central banks were providing significant policy stimulus. The COVID-19 outbreak halted the recovery entirely and has almost ensured a global recession in the first half of 2020. Government mandated business closures and social distancing have devastated many parts of the global economy. Due to the unpredictable nature of the virus economic forecasts are operating in a fog, though J.P. Morgan estimates that U.S. GDP growth will be -40% in Q2. Fortunately, it is widely accepted that a significant recovery will occur at some point as the virus outbreak resembles a natural disaster more than a business/consumer led recession. Consensus expectations are for the recovery to take place in the second half of 2020 though investors still search for clarity around the exact timing and scale of the rebound.

We are starting to get some hard data on the magnitude of the economic crisis. As expected the contraction is abrupt, deep, and widespread. Businesses are not facing 'normal' recessionary declines. Forced shut downs are seeing operating capacity reduce from 100% to 70%, 50%, or even 0% for businesses deemed non-essential that cannot be operated remotely/online. In response, businesses have conducted mass layoffs and drastically reduced working hours to shore up cash and simply focus on remaining solvent until the economy reopens. Over the past three weeks jobless claims in the U.S. have cumulated to 16.8 million and estimates suggest the number could go to 25 million by the end of April. Canadian businesses are being forced to take similar measures. In March the Canadian labour market lost 1.01 million jobs, and since March 15 the Canadian government has received more than 5 million applications for emergency income support. The pace at which Canadians are losing jobs is the fastest ever recorded in Canada (Figure 1).

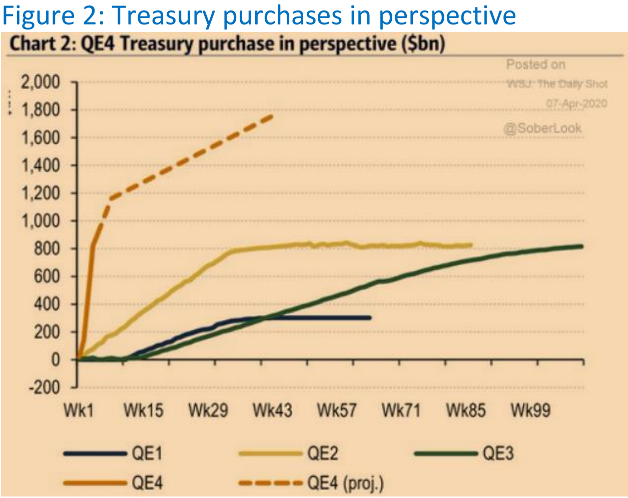
Figure 1: Canadian employment during recessions



Source: WSJ Daily Shot

Fortunately, central banks are doing their part to support the economy. The Federal Reserve has announced planned asset purchases of at least $700 billion and no ceiling on how much they are willing to spend. The size and force behind the current round of stimulus from the Fed is like nothing seen before (Figure 2).

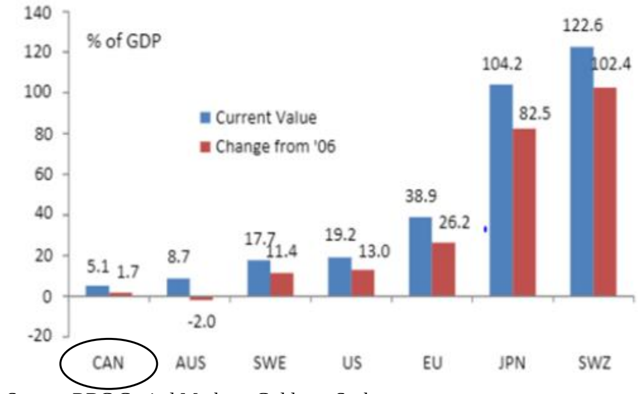
Figure 2: Treasury purchases in perspective



Source: RBC Capital Markets

The Bank of Canada is also doing everything it can to shore up the economy and financial markets, including embarking on its first quantitative easing program in history. This will support Canadian risk assets and put downward pressure on interest rates, both of which should boost market sentiment. National Bank estimates that the central bank could see its holdings quadruple in the coming months from 5% to roughly 22% of GDP. Compared to other central banks, the Bank of Canada's balance sheet remains relatively small and gives it ample room to implement supportive policy (Figure 3).

Figure 3: Central bank balance sheets



Source: RBC Capital Markets, Goldman Sachs

Monetary policy plays an important role for financial markets but it doesn't directly put cash in Canadian's pockets which is desperately needed. That's where the federal and provincial governments are stepping in and delivering massive fiscal stimulus. Wage subsidies, loan guarantees, tax deferrals, and other forms of emergency aid have been deployed to help households and business owners stay afloat. Its estimated that policy measures deployed thus far across Canada total $315 billion and all levels of government have indicated a willingness to spend more if needed.

As long as governments can continue to bankroll households and businesses until normalcy is restored a powerful economic recovery is likely to emerge. Relaxing the mandatory restrictions on activity is the obvious prerequite for a meaningful pickup. The timeline for this is very unclear. In Wuhan, China it took about 10 weeks of isolation before a gradual easing of restrictions began, though much of the city still remains closed. In Canada, at the time of writing, we are in week five of isolation, suggesting the mandated curtailments could be lifted at the end of May at the earliest. This will likely be a gradual process and could be interrupted by further outbreaks. We think its prudent to assume that it will be quite some time before the economy fully reopens.

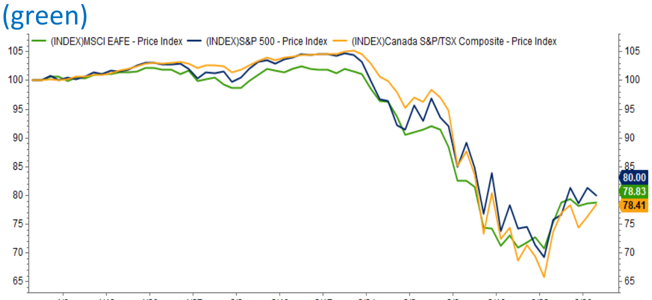
Without a reliable timeline of events the degree of lasting economic damage remains unclear. J.P. Morgan estimates an unrecoverable loss in the level of U.S. output between 5% and 15%. This seems reasonable as it is difficult to expect a stronger global economy emerging from the crisis. Business and consumer confidence will likely remain depressed after suffering a significant loss of income and wealth. Households and companies will reign in their spending as they catch up on deferred liabilities and focus on repairing their balance sheets. Employment may not entirely recover as lost revenues or efficiencies gained during the shutdown don't justify previously held positions. Lastly, central banks and governments will carry more debt and have limited capability to offset headwinds or stimulate the economy.

Equity Commentary

Equity weightings are below the benchmark in all portfolio objectives. Balanced accounts' equity weightings are approximately 51.18% on average versus the benchmark weight of 55%.

Equity markets collapsed in February as concerns over COVID-19 grew and investors simultaneously rushed for the exit. At the peak of the selling frenzy, the S&P/TSX was down almost 35% and the S&P 500 almost 31%. Transmission of the virus was rapid and new cases were being reported at a parabolic rate. Towards the end of March, new case growth slowed in the initially hard-hit countries and the markets started considering what a post COVID-19 world would look like. Subsequently, the Canadian and U.S. markets rallied double digits, bringing their year to date returns to roughly -20.9% and -13% in $Cdn respectivey (Figure 4).

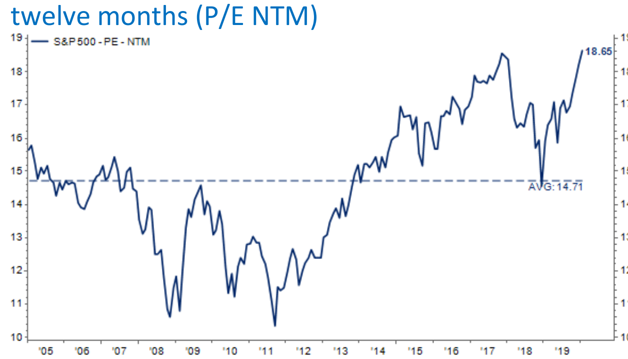
Figure 4: Year-to-date indexed price performance of S&P 500 (blue), TSX (orange), and MSCI EAFE (green)



Source: FactSet

It is difficult to establish a fair value estimate for the markets when future earnings are so unclear. Companies are facing tremendous uncertainty and are reluctant to provide investors with information, and nearly 20% of S&P 500 companies have withdrawn their forward looking guidance. As we navigate through the fog we think it's important to remain cognizant of two things when considering where the markets are heading. The first is earnings are unlikely to bounce back to pre-crisis levels anytime soon. We don't have a reliable estimate as to when normalcy will be fully restored, but experts say a vaccine is the only sure way to conquer the virus and that takes anywhere from 12-18 months to develop. Activity may not fully recover until that happens and any loss in GDP will filter through to corporate profits. Second, the valuations that investors are willing to pay for stocks is likely to decline. Prior to the crisis investors enjoyed around 10 years of strong, nearly uninterrupted equity market returns. High demand for solid performing stocks and low interest rates propelled valuations to levels well above their long term average (Figure 5). Considering we are in the midst of a global pandemic and perhaps the greatest challenge faced since WWII, demand for equities is likely to decline and with it the premium valuation investors have recently been willing to pay.

Figure 5: S&P 500 price-to-earnings ratio over next twelve months (P/E NTM)



Source: FactSet

Lower corporate earnings and valuation contraction will be headwinds for the markets. We are not expecting another collapse in equities but rather highlighting that a V-shaped rebound will be difficult to achieve and is perhaps less likely than anticipated by investors. We acknowledge there are powerful forces that will support a speedy economic recovery including massive central bank and government stimulus and a pre-existing economic upswing that was just underway when the crisis began. Still, we think it is prudent to proceed cautiously given the amount of uncertainty and the risk surrounding the duration of the government mandated business closures.

Given the nature of the crisis a lot of the data available has minimal predictive utility. Instead of walking through information that is literally off the charts and likely a transitory blip we will discuss how we have positioned portfolios and the changes made during the first quarter.

In a market that saw a rapid decline and high volatility, our goal from a trading perspective was to upgrade the quality of the portfolio to companies that possess strong balance sheets, healthy free cash flow and have sustainable competitive advantages in a post-virus market. To that end, we were active in trading during the quarter.

Prior to the virus, we trimmed **GlaxoSmithKline** and exited our position in **Northland Power**.
GlaxoSmithKline is a UK-based pharmaceutical company known for their HIV treatments. They have been seeing strong demand and sales growth for their highly-effective shingles drug, Shingrix. The company has a desirable pipeline and pays an attractive yield of approximately 5%. We trimmed the stock in February due to valuations that started to look expensive.

Northland Power builds, owns and operates power generation facilities in Canada, the United States and Europe. The company operates 26 facilities that produce electricity from natural gas and renewable sources including wind, hydro, solar and thermal. We took a stake through a bought deal in March 2019 when the company made additional shares available to the public float at a 9% discount to the price on the open market at the time. The stock performed very well since and we trimmed our positions twice in 2019 before liquidating the rest of our holdings in February.

Once the market sell off began, we exited positions in **Rio Tinto**, **Axa**, **Aviva**, **AT&T** and **Loblaw**. **Rio Tinto** is one of the world's largest metals & mining companies and a major global producer of iron ore and copper. It was sold to reduce our exposure to economically sensitive sectors as well as falling metals prices from global industrial production grinding to a standstill. We still like the company and would consider adding it back in the future.

Aviva and **Axa** are European insurance companies. We were attracted to the stocks for their sizable yields and cheap valuations. Both companies, however, carry substantial debt on their balance sheets from large acquisitions with Aviva purchasing Friends Life in 2014 and Axa purchasing XL Group in 2018. **AT&T** also carries a bloated balance sheet from its 2018 purchase of Time Warner. In an environment where revenues will be impaired for an undetermined period of time, we felt there were better investment options elsewhere in companies whose debt burdens are much less likely to become problematic if the life of the virus becomes extended. We exited our position in **Loblaw** in the midst of the market's March selloff. As a grocer whose business is an essential service, the share price held up. The stock had a nice run since our original purchase in 2018 and valuations were no longer cheap. We sold our holdings with the intention of allocating the proceeds into quality companies that are more geared to a rebound when the virus is under control while retaining grocery exposure in the U.S. through Costco.

We initiated a position in **Disney** in March. The company owns several leading entertainment properties including ABC, ESPN, Pixar, Marvel, Lucasfilms and 20th Century Fox. Although it has outsized exposure to virus concerns due to its theme park and motion picture businesses, we view it as a best-in-class entertainment company available at a discounted price. Disney has shown a great ability to drive growth from its traditional businesses by monetizing its popular characters and franchises across multiple platforms. It also offers a new growth driver in the form of its recently launched streaming service that attracted 26.5 million subscribers in its initial quarter.

One industry that we are increasing exposure to in this downturn is U.S. housing. Activity will no doubt slow in the current environment but we expect it will rebound quickly. There is significant pent-up demand for housing in the U.S. after years of underbuilding to go along with favourable demographic trends, which should provide a steady tailwind in the years ahead. In addition, the U.S. consumer has been deleveraging since the financial crisis unlike Canadians and as a result is in better shape. We added new positions in the quarter to **Stanley Black & Decker** and **Lennar**. Stanley Black & Decker's main business is manufacturing hand, power and industrial tools. It owns several leading brands including DeWalt, Irwin, Craftsman, Porter

Cable, MAC Tools in addition to its namesake brands. The company has paid a dividend for 144 consecutive years and raised it in each of the past 53. The stock was hit hard earlier than most U.S. equities as it has significant production facilities in China, which the company reported were back to 50-60% utilization rates by mid-March. Lennar is the largest homebuilder in the U.S. by revenue and controls an ample land supply. The fall of interest rates to historical lows figures to be a strong tailwind for housing once the economy returns to normal. Home construction activity has not been as affected as most industries to this point with homebuilders indicating that construction has largely continued to this point and home closings have been aided by digital advances in recent years. We added an initial weight to Lennar across portfolios but plan to increase further as opportunities present themselves.

We have been underweight large cap technology names recently and unwilling to pay the rich valuations being afforded to most industry heavyweights. As the market selloff became virtually indiscriminant, we made a move to position two leaders in their fields with pristine balance sheets in **Microsoft** and **Facebook**. Microsoft has long been known for its Windows operating systems and Office productivity suite that offer significant recurring revenues from a massive installed base that remains very stable due to the high costs of switching. Its Azure cloud offering has quickly developed into a market leader and provides a significant growth driver with a good runway to the business. Facebook operates two of the world's leading social networking sites in its namesake platform and Instagram. It has about 2.5 billion monthly active users worldwide and generates virtually all of its revenue from selling advertising. The company has been a large beneficiary of companies moving ad spending to digital platforms from traditional areas. Opportunities exist in the future for the monetization of its WhatsApp and Messenger platforms. Corporate advertising budgets will no doubt be cut back temporarily and the company is still facing regulatory issues but we feel those risks were well discounted in price we paid for the shares.

We also initiated a new position in **Air Canada**. Airlines are among the most affected industry to the virus with global air travel essentially coming to a halt. We put in a half weight in portfolios with the intention of adding to it as the fallout of the virus evolves. In hindsight, we were early on adding this name as the stock price continued to fall when it became apparent that North America's efforts to flatten the viral spread by enacting earlier social distancing and shutdowns than Europe have mostly been ineffective. Air Canada entered the downturn in good shape but still figures to receive substantial government aid to navigate this period as the business remains significantly important to the country. As of writing, our plans are to add to our small existing positions when further clarity emerges on the resumption of air travel and path of the virus.

The beverage industry attracted our attention in March as even the best companies in the space were not spared the market's selling action despite being in a business that figures to be quite resilient even under current circumstances. We took new positions in **Coca-Cola** and **Pepsico** when both stocks yielded approximately 4%. Coca-Cola remains a stable behemoth in the soft drink industry and has been successful in expanding its energy and non-carbonated drink businesses. Pepsi owns a strong snack business in Frito-Lay and has been the more innovative of the two with strong performance from brand extensions to Gatorade and the emergence of Bubly sparkling water. Both companies are benefitting from a surge in bottled water sales and "pantry loading" in the current market.

In addition, we topped up underweight positions in client accounts of several companies that we view as leaders in their respective industries with sustainable competitive advantages including **Johnson & Johnson**, **Medtronic**, **Home Depot**, **Alphabet** and **Costco**.

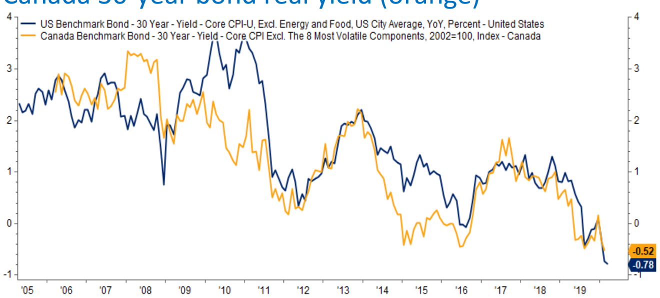
Fixed Income

We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 39.70% on average versus the benchmark weight of 40%, with about half of that in bonds.

Bond investors were rewarded quite nicely relative to equity investors in Q1. The Canadian Broad Bond Composite gained 1.6% as interest rates continued their decent, sending bond prices modestly higher. Our bond holdings served to preserve capital and our allocation to high-quality issuers (mostly government) benefitted portfolios as junk/low-quality debt experienced price declines in the quarter.

After the latest move lower in interest rates bonds do not even serve to preserve capital very well. Real yields (inflation adjusted) for U.S. and Canada 30-year government bonds are -0.78% and -0.52% respectively (Figure 6). If bond investors are seeking a positive real return they are relying exclusively on capital appreciation (lower interest rates = higher bond prices). Betting on lower rates is a risky proposition considering they are nearing their zero lower bound. They could go beyond zero, but negative interest rate policy has largely been deemed a failure in Japan and Europe as it didn't accomplish its intended goals and wreaked havoc on the financial system and investors who need yield.

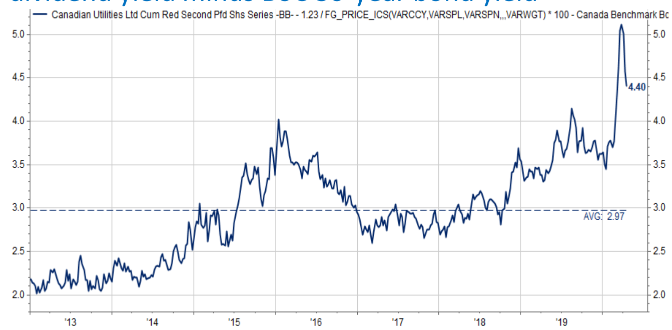
Figure 6: U.S. 30-year bond real yield (blue) and Canada 30-year bond real yield (orange)



Source: FactSet

We continue to see value in allocating some of the fixed income component of portfolios to preferred shares. Preferreds have characteristics of both bonds and equities. Fittingly, the preferreds we own are down around 10% year to date, in between the S&P/TSX return and the Canadian Broad Bond Composite return. At these levels parts of the preferred share market offer tremendous value. We like perpetual preferred shares issued by high quality companies. These pay the same dividend into perpetuity and their perpetual coupon becomes more attractive as bond yields go down. One of the issues we own is the Canadian Utilities Series E perpetual. Its 5.7% dividend yield is 4.4% higher than a 30-year Government of Canada bond yield (Figure 7). The preferential tax treatment on dividend income makes this even more attractive when held in a taxable account. Patient investors with a medium to long-term time horizon can ride out price volatility and collect very attractive income from these issues and likely outperform government bonds.

Figure 7: Canadian Utilities Series E perpetual dividend yield minus BoC 30-year bond yield



Source: FactSet

We have always invested in the highest quality issuers in the preferred space from various industries including the Canadian banks, insurance and telecommunications companies, pipelines and utilities to limit credit risk. We remain comfortable with the reliability of dividend streams from the issues we own as common shares dividends would have to be reduced to zero prior to preferred share dividends being cut. Many of the preferred share issues we own are also cumulative, meaning that any missed preferred dividends would have to be paid prior to a common share dividend being reestablished.

Performance

Portfolios fell with the broader markets in Q1. Returns were slightly above the balanced benchmark as a result of our conservative equity positioning in both asset allocation (underweight equities) and stock selection (overweight defensive sectors). Accounts with a balanced objective benefitted from their approximately 5 to 6% weights in US Treasury bonds as the $US rose 8.3% versus the $CDN.

Underweight Canadian equities contributed to relative returns as the TSX declined 20.9%. Notable performers were Northland Power (+14.9%), Loblaw (+0.5%), our largest single Canadian holding, Hydro One (-0.3%), and Emera (-0.9%). Our long-term care/

retirement home stocks, Sienna Senior Living (-33.8%) and Extendicare (-32.0%), were adversely impacted with the onset of COVID-19. We are significantly underweight energy. That said, our small weight in Suncor (-47.8%) got caught in the cross-hairs of the dispute between Saudi Arabia and Russia.

Our U.S. stocks outperformed the 13.0% decline for S&P 500. Overall negative returns were mitigated by our largest position in portfolios, Newmont Goldcorp (+13.0% in Canadian dollars). New positions added near the end of March captured a late-quarter rebound including Lennar (+26.9%), Coca-Cola (+18.2%), Pepsico (+13.1%), and Microsoft (+8.1%). A long favoured holding, Costco (+5.2%), was a huge beneficiary of the rush to prepare for the “stay at home” directives. The recent purchases moved U.S. equities from underweight to overweight. Global financials were among the hardest hit sectors as pending economic weakness raised concerns about rising bad debt levels and the impact that lower interest rates would have on banks’ net interest margins. Our single US financial, Truist (-40.6%), suffered along with its competitors.

International equity returns were dismal this quarter and significantly underperformed their benchmark. Insurance providers Axa (-53.2%) and Aviva (-52.1%) were notable laggards before we exited the positions in portfolio repositioning late in the quarter. Portfolios closed the quarter underweight in International equity after starting the year in an overweight position

Our fixed income investments underperformed in the first quarter of the year as a result of our underweight positioning in bonds and exposure to preferred shares. Preferred shares endured pressure as investors sold risk assets in a move to cash. The selling was exacerbated by the illiquidity in the preferred share market. We have seen this before, most recently during the financial crisis in 2008 as well as the market pullback in 2015. In both cases, the preferred market generated a return of roughly 30% in the 15-months following their lows.

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.

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