Fickel's Focus

Wealth Management
Dominion Securities

First Quarter Investment Commentary

David Fickel, CFA
Vice-President &
Portfolio Manager
416-966-0612
david.fickel@rbc.com

Shawn Willemse, CFA
Associate Advisor
416-960-7881
shawn.willemse@rbc.com

Jaana Sauso
Administrative Assistant
416-960-7880
jaana.sauso@rbc.com

Nathan Fickel
Associate
416-960-6816
nathan.fickel@rbc.com

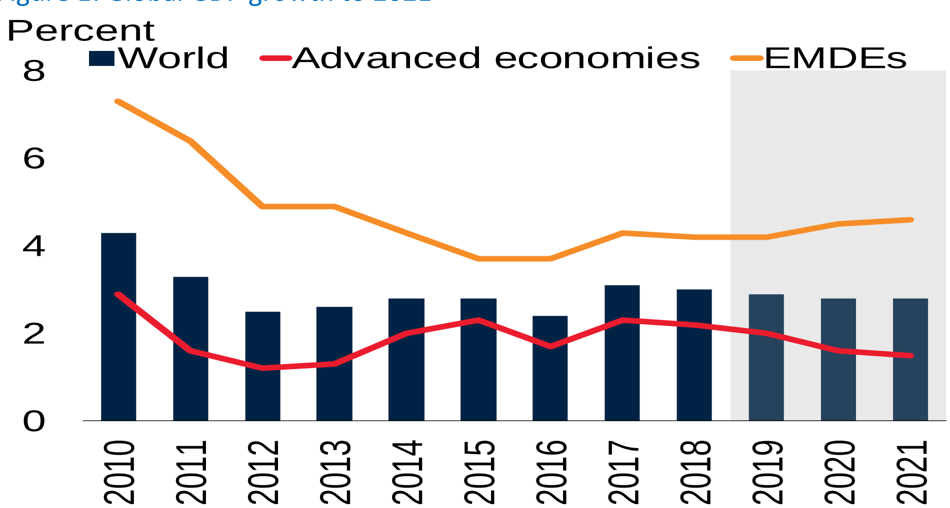
Global equity markets rallied sharply in Q1. The S&P/TSX and the S&P 500 increased by 13.3% and 11.2% in $Cdn respectively.

Accounts on board for the full quarter and migrated to their appropriate models produced very positive absolute returns but underperformed the Balanced Benchmark due to a more conservative asset mix.

Economic Overview

The global economy continued to expand in the first quarter and is estimated to have grown around 2.6% (q/q annualized). Forecasts for 2019 GDP growth range from 2.8%-3.5% (Figure 1) but have generally been notched down due to weakness in industrial activity. The services sector, which accounts for the majority of developed countries' GDP, remains decent and is offsetting weakness in industry. Low unemployment levels and wage growth are supporting consumption and central banks are maintaining accommodative policy.

Figure 1: Global GDP growth to 2021



Source: Bloomberg, Haver Analytics, World Bank

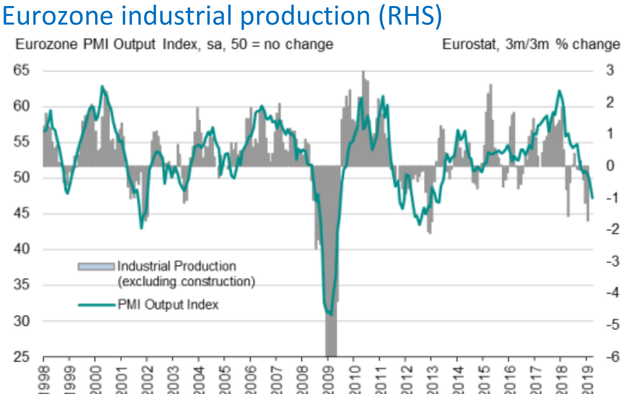
Trade tensions, national security, and lingering political uncertainty are taking their toll on business confidence. The net balance of firms predicting output growth in the coming 12-month period is the lowest in 2 ½ years (Figure 2).

Figure 2: Global business activity expectations

Source: IHS Markit

Much of the pain is being felt in the manufacturing sector. The ratio of orders to inventories has been creeping downward and is at multi-year lows in some areas (Europe, Canada). Companies are erring on the side of caution and signaling a preference for using up existing inventories and postponing manufacturing and purchasing plans. This is particularly pronounced in Europe where manufacturing is contracting (Figure 3).

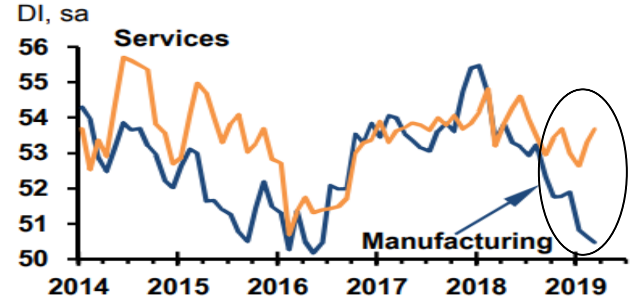
Figure 3: Eurozone manufacturing PMI (LHS) and Eurozone industrial production (RHS)



Source: IHS Markit, Eurostat

Fortunately, the manufacturing weakness has been generally contained and has not spilled over into the services sector. The J.P. Morgan Global Services PMI Index, a poll of senior executives in private sector services companies, increased in March to 53.7, a four-month high. Divergences between the manufacturing sector and the services sector have not persisted for long historically (Figure 4). Absent a stabilization and rebound in industry, weakness in the services sector is likely.

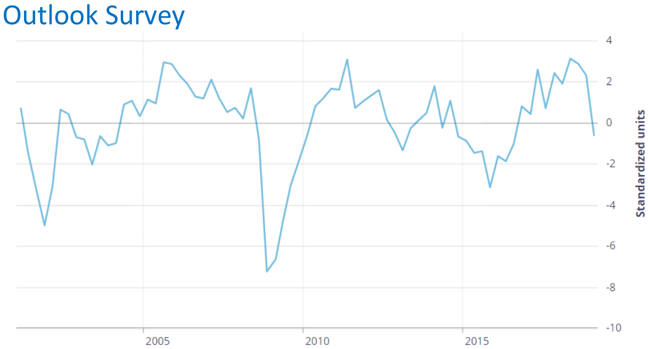
Figure 4: J.P. Morgan Global Composite PMI



Source: Markit, J.P. Morgan

The Bank of Canada's Spring Business Outlook Survey was relatively downbeat and the indicator turned negative for the first time since 2016 (Figure 5). Businesses across the country are reporting softening (though still positive) expectations for sales growth and lower investment and employment intensions. The main headwinds are a more uncertain outlook in the Canadian energy sector, weakness in housing-related activity, and elevated trade tensions.

Figure 5: The Bank of Canada Spring Business Outlook Survey

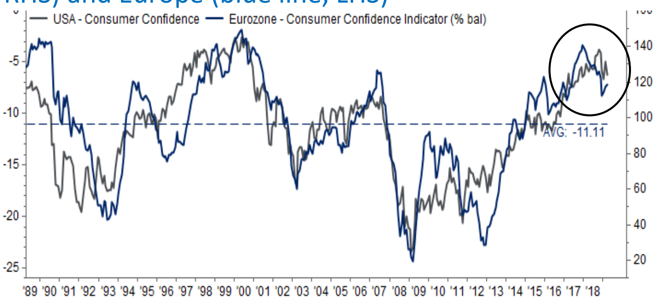


Source: Bank of Canada

Rising oil prices coupled with Alberta's contract to ship more oil to the U.S. bodes well for the energy sector and suggests a near-term rebound in activity. However, with exports accounting for nearly 30% of Canadian GDP (about 76% of which goes to the U.S.), a resolution of trade disputes and cooperation between the U.S. and Canada is necessary to restore confidence in Canadian companies. While it is difficult to get a read on how the USMCA (U.S.-Mexico-Canada Trade Agreement) is progressing, it is in everyone's best interest to finalize the deal as quickly as possible.

The growing pessimism among businesses has, for the most part, not fed through to consumers. In the United States and the Eurozone, consumer confidence is resilent (Figure 6).

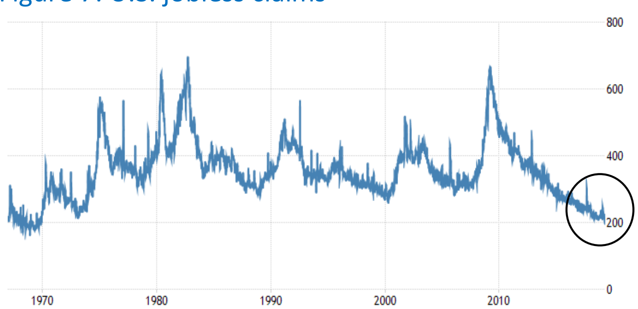
Figure 6: Consumer confidence in the U.S. (grey line, RHS) and Europe (blue line, LHS)



Source: FactSet

Consumers around the world are benefitting from low levels of unemployment and decent real wage gains. In March, the U.S. economy added 196,000 jobs and the weekly jobless claims dropped to the lowest level since 1969 (Figure 7).

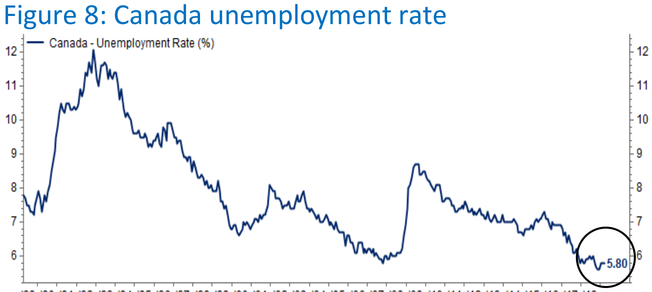
Figure 7: U.S. jobless claims



Source: U.S. Department of Labor

The labour market remains healthy in Canada as well. Canada's economy added 290,000 jobs between August and February. The party came to an end in March when employment fell by 7,200 jobs, but, some weakness was anticipated given the unusually strong run in gains. The unemployment rate remains at historically low levels (Figure 8).

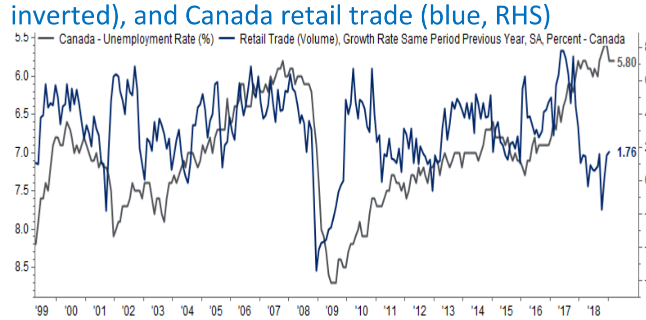
Figure 8: Canada unemployment rate



Source: FactSet

It's more than likely that we are at or nearing a point where tight labour markets will constrain economic growth. There is a strong positive correlation between employment growth and consumption (Figure 9). Aging demographics are putting downward pressure on the working-age population and it's hard to imagine the unemployment rate moving significantly lower. We think consumption growth will continue to moderate to levels in line with real wage gains (~0.5% right now).

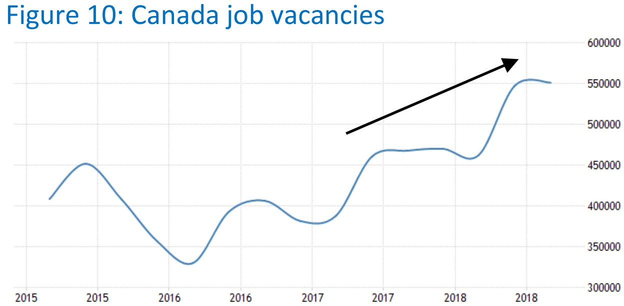
Figure 9: Canada unemployment rate (grey, LHS, inverted), and Canada retail trade (blue, RHS)



Source: FactSet

Tight labour markets are also making it difficult for businesses to find qualified employees. Reports of labour shortages in Canada are increasing and job vacancies have been ticking higher (Figure 10). A widening mismatch between skills sought out by employers and skills possessed by job seekers is intensifying these tight labour-market forces.

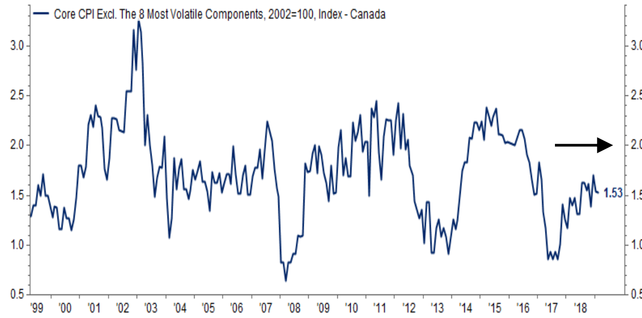
Figure 10: Canada job vacancies



Source: Statistics Canada

Despite a likely moderation in employment growth, the environment is supportive for households. Core inflation has been holding steady around 1.5% in Canada (Figure 11) and it doesn't look like there will be much upward pressure over the next few months. Low inflation means less erosion to households' real income.

Figure 11: Canada core CPI (consumer price index)

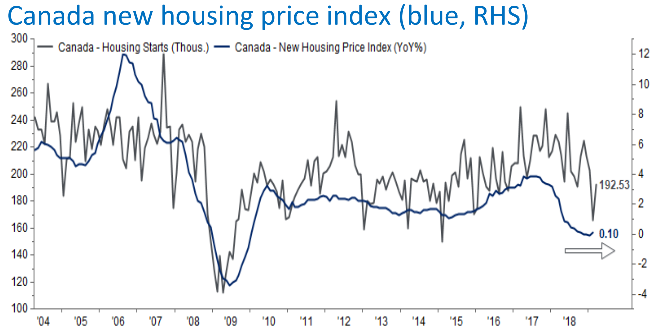


Source: FactSet

Perhaps even more important are the implications this has for the Bank of Canada (and Federal Reserve in the U.S.). Steady core inflation should make for a patient central bank (not hike interest rates any time soon) and put less upward pressure on borrowing costs. This is particularly important for indebted Canadian consumers.

The housing sector in Canada had a weak first quarter but showed some signs of stabilizing in March. Starts for the quarter came in at their slowest pace since 2015, though this speaks more to the strength over the past two years than the weakness this year. The effects of government intervention in 2018 (higher stress tests/mortgage qualification requirements) are still being felt by homebuyers but housing prices are stabilizing and starts rebounded in March (Figure 12).

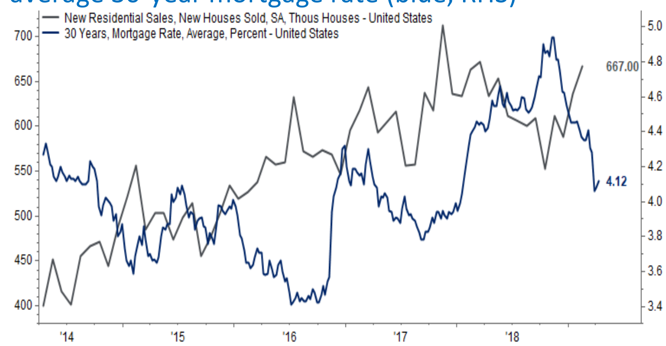
Figure 12: Canada housing starts (grey, LHS) and Canada new housing price index (blue, RHS)



Source: FactSet

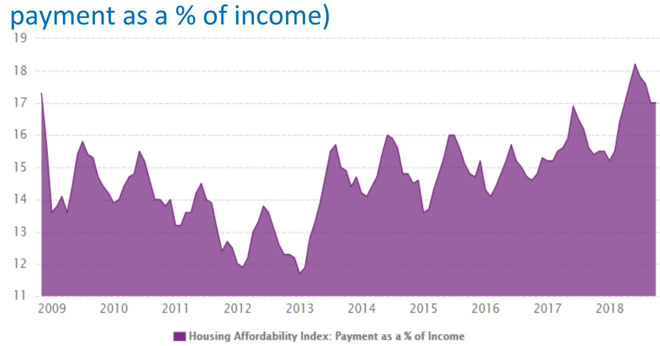
After a tough year in 2018 the U.S. housing sector is experiencing very positive momentum. Affordability issues plagued the sector last year, as rising home prices, rising interest rates, and low housing inventories kept potential homebuyers on the sidelines. Since November, a decrease in 30-year mortgage rates has provided homebuyers with some relief and new home sales have correspondingly increased (Figure 13). Despite positive developments, we still think further alleviation of affordability issues is needed to sustain home sales growth. We note that just last year the housing affordability index was at a 10-year low (Figure 14).

Figure 13: U.S. new residential sales (grey, LHS) and average 30-year mortgage rate (blue, RHS)



Source: FactSet

Figure 14: U.S. housing affordability index (monthly payment as a % of income)



Source: National Association of Realtors

Equity Commentary

Equity weightings were increased slightly but remained below the benchmark in all portfolio objectives. Balanced accounts' equity weightings are approximately 50.5% on average versus their benchmark weights of 55%. We maintained a defensive posture within equities as well, being overweight Utilities, Telecommunications (Communication Services), Consumer Staples, Health Care, and Real Estate (REITs).

We are market weight Canadian equities. The S&P/TSX price-to-earnings ratio (P/E) trades in line with its 15-year average (Figure 15).

Figure 15: TSX trades in line with historical valuation (price-to-earnings ratio)

Source: FactSet

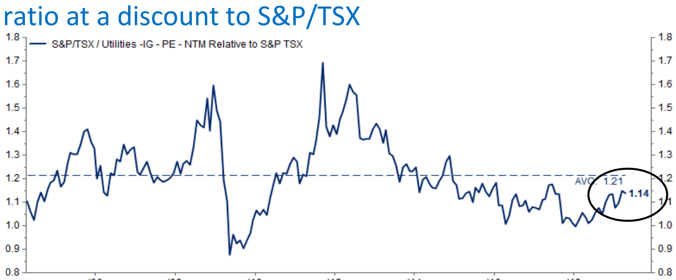
The markets are clearly factoring in relatively weak prospects for Canadian companies. The S&P/TSX trades at a steep discount to the U.S. (Figure 16).

Figure 16: Canadian stock market trades at a deep discount to U.S. market

Source: FactSet

We think there is value to be found in the Canadian market, particularly in companies that offer high dividend payouts and stable earnings outlooks. We continue to like the utilities sector in Canada. Their defensive characteristics (high yields, low valuations, and visible earnings growth) are attractive. The sector trades at about a 5% relative P/E discount to the S&P/TSX historical average (Figure 17).

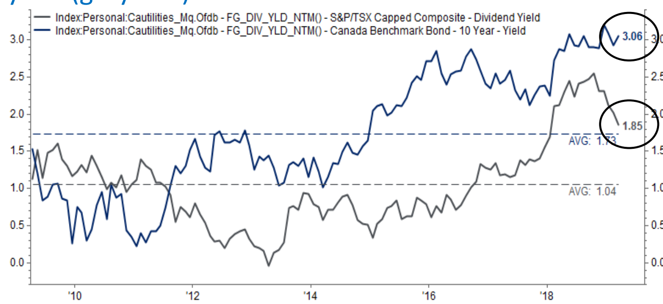
Figure 17: Utilities sector relative price-to-earnings ratio at a discount to S&P/TSX



Source: FactSet

While the sector has mostly re-rated and is nearly trading in line with the broader market, we continue to like the relative attractiveness of the utilities stocks' dividend yields. The average yield of our utilities is 3.06% higher than 10-year Government of Canada bonds and 1.85% higher than the yield on the S&P/TSX, well above their 10-year averages (Figure 18).

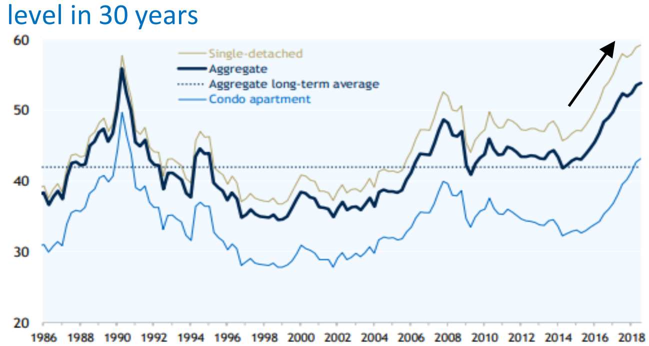
Figure 18: Utilities' yield minus GoC 10-year bond yield (blue line) and utilities' yield minus S&P/TSX yield (grey line)



Source: FactSet

We remain underweight Canadian financials (particularly banks) given the numerous headwinds the industry is facing. Residential loan growth is likely to continue slowing. Home affordability in Canada is at its worst level in 30 years (Figure 19).

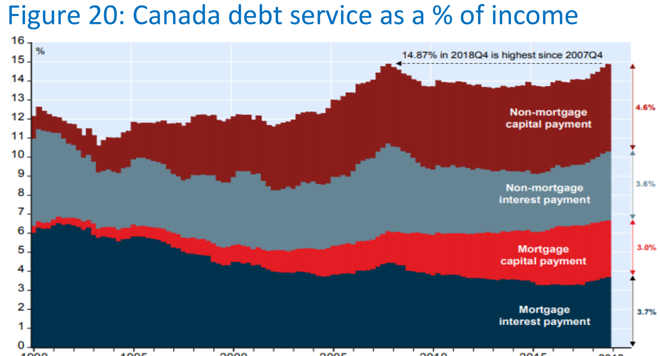
Figure 19: Canadian housing affordability at worst level in 30 years



Source: Canadian Real Estate Association, RBC Economics Research

Making matters worse, Canadian consumers have very little capacity for additional debt. Debt servicing costs as a percentage of disposable income reached the second highest on record at 14.9% (Figure 20).

Figure 20: Canada debt service as a % of income



Source: NBF Economics and Strategy (data from Statistics Canada)

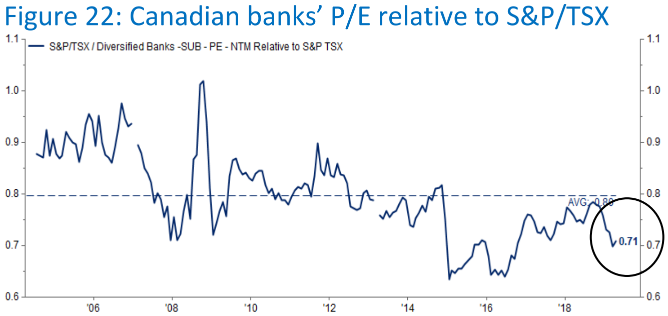
Lastly, the profitability of the banks' lending operations has come under pressure. In March, the 10-year – 3-month yield curve inverted, meaning that 10-year GoC bond yields were lower than 3-month GoC bond yields (Figure 21). Recent curve flattening and now inversion is eroding the banks' net interest margins as they are forced to pay rates on deposits that are higher than the rates they receive on longer-term loans. This is a disincentive for banks to lend.

Figure 21: GoC 10-yr yield minus GoC 3-month yield

Source: FactSet

The markets are discounting these issues and the Canadian banks are trading at a ~12% relative P/E discount to the S&P/TSX historical average (Figure 22). This should offer some support to share prices.

Figure 22: Canadian banks' P/E relative to S&P/TSX



Source: FactSet

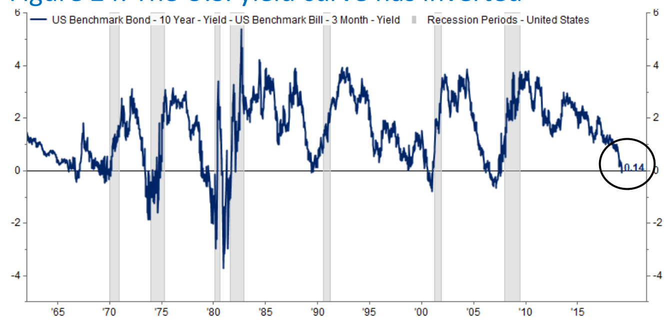
Fully invested balanced portfolios are underweight U.S. stocks (average 13.16% versus 20% balanced benchmark). The U.S. market rebounded sharply from its December lows and is trading at ~15% premium to its P/E average (Figure 23).

Figure 23: S&P 500 P/E

Source: FactSet

As is the case in Canada, the U.S. 10-year – 3-month yield curve inverted in March (Figure 24). The yield curve has been a powerful leading indicator in the past, essentially predicting every U.S. recession since 1950 with only one "false" signal, which preceded the 1967 credit crunch and slowdown in production.

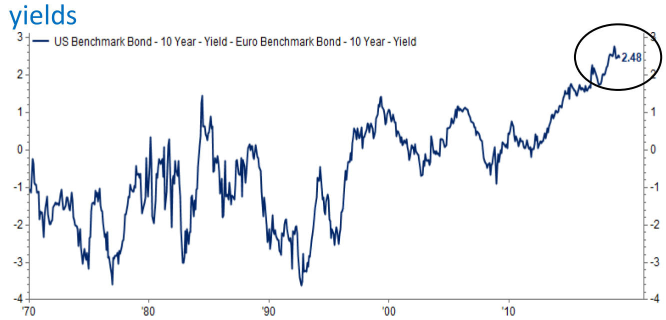
Figure 24: The U.S. yield curve has inverted



Source: FactSet

Market proponents are suggesting that the yield curve's predictive power has been compromised and "it is different this time." One explanation is that quantitative easing has artificially lowered rates around the world and demand for relatively higher yielding U.S. government bonds is depressing long U.S. rates. This is a possibility considering the difference between U.S. 10-year yields and Euro 10-year yields is near all-time highs (Figure 25).

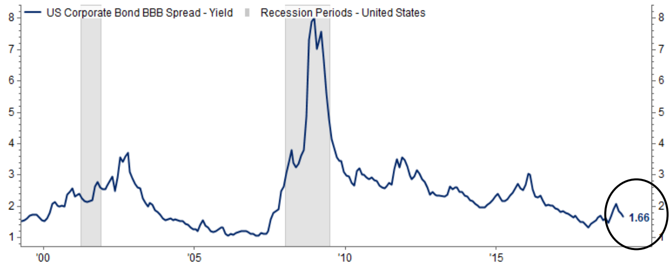
Figure 25: 10-year U.S. treasury yields –10-year Euro yields



Source: FactSet

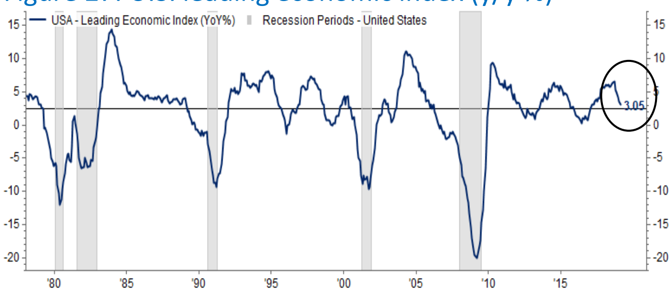
There are other indicators supporting the notion that a recession is not imminent. The bond market is saying that U.S. corporations are in good health as BBB bond spreads remain low (Figure 26). Bond spreads spiked prior to the last recession as investors demanded higher credit premiums. As well, the U.S. leading economic index (a collection of leading indicators) is still indicating expansion (Figure 27).

Figure 26: U.S. BBB corporate bond spreads



Source: FactSet

Figure 27: U.S. leading economic index (y/y %)

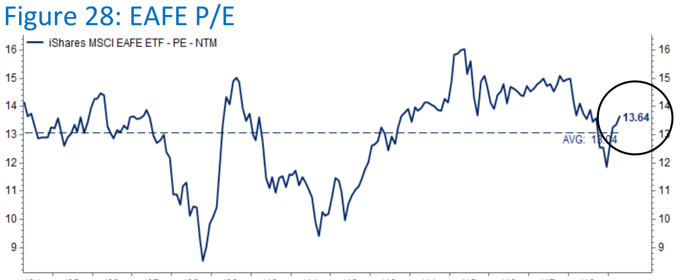


Source: FactSet

The contradicting data is difficult to interpret. There are reasonable arguments disputing the predictive power of the yield curve and a case can be made for a resumption in global growth (government stimulus and global trade cooperation). However, we are reminded that a yield curve inversion has, at a minimum, indicated a slowdown in growth 100% of time. We think a defensive posture is warranted considering that we are in the late stages of the business cycle, equity markets are near all-time highs, corporate profit margins are at all-time highs, and geo-political/international trade tensions remain elevated. We continue to overweight less cyclical sectors in the U.S. including Health Care and Consumer Staples.

Fully invested portfolios are slightly overweight international stocks at 6.8% (balanced benchmark is 5%). EAFE (Europe, Australia and Far East) looks reasonably valued, trading in-line with its historical price-to-earnings ratio (Figure 28).

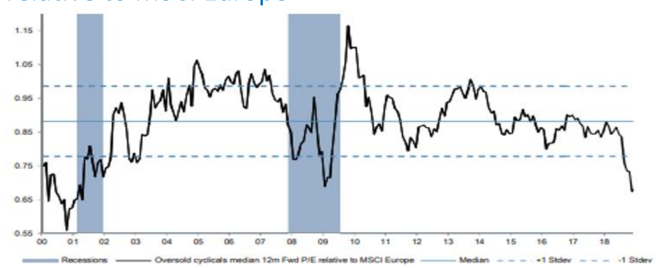
Figure 28: EAFE P/E



Source: FactSet

We extend our preference for defensive holdings in the international component of portfolios, holding ~3% in Health Care. However, we also have some cyclicality through holdings in Total SA and Rio Tinto. These companies offer attractive dividend yields (5.2% and 5.1%, respectively), cheap valuations (Figure 29), and exposure to a rebound in capital expenditures and commodity prices. Rio Tinto is also benefitting from increased Chinese steel demand as the government is ramping up its stimulus program.

Figure 29: Oversold cyclical 12-month forward P/E relative to MSCI Europe



Source: IBES, J.P. Morgan

It was an active quarter for our equity portfolios. Transactions for the quarter include:

We added to our position in **Constellation Brands (STZ-US)** in January after a pullback. The company is the fourth largest brewer in the U.S. market with a portfolio of brands that includes Corona and Modelo. Constellation Brands is in the process of selling their lower-end wine brands with the proceeds possibly earmarked for debt reduction after a sizable investment in the cannabis market through the purchase of a large stake in Canopy Growth. The sale of the wine business will reduce earnings but would increase margins and the earnings growth profile of the company to double-digits in percentage terms. The stock trades at a depressed multiple even after accounting for the wine sale dilution and affixing zero value for its investment in a potentially significant growth market in Canopy.

Northland Power (NPI) builds, owns and operates power generation facilities in Canada, the United States and Europe. The company currently 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 at a 9% discount to the price on the open market at the time. Along with cash on hand, the purchase of Northland Power was funded by trimming holdings in

Emera (EMA). Emera's share price was up 14% in the first quarter of 2019. The company was helped by a market shift to high-yield stocks as the outlook for interest rate increases dampened along with the company reaching an agreement to sell its none-core utility assets in Maine and New England for a price greater than the market had expected. This sale provided greater clarity on their funding needs and reduced the likelihood of Emera raising funds through an equity offering that would be dilutive to current shareholders.

Choice Properties (CHP.UN) REIT owns approximately 750 properties with roughly 67 million square feet of gross leasable area. Loblaw originally spun out a portion of the company in 2013 in order to maximize the value of real estate that it owned primarily for its grocery operations. Choice owns some of the most attractive real estate in major urban centers and is in the midst of a long-term plan to develop parcels into mixed-use commercial and residential space. We originally received a small amount of shares through our holding in Loblaw through a spin-out in November 2018. We added to these holdings at the beginning of January to bring it to a full position. The stock was up over 20% in the first quarter of 2019 as high-yield stocks became more attractive to investors as expectations of interest rate hikes by the Bank of Canada were reduced.

We repurchased **Goldcorp (G)** at the beginning of the new year. Just two weeks after repositioning it in our portfolios, **Newmont (NEM)** made an agreement to acquire the firm in an all-stock deal valued at roughly $10 billion. This represented a 7.5% premium to the previous day's closing price. Goldcorp shareholders will own approximately 35% of the new company when the deal closes. Management expects the combined company to have sustainable production of 6-7 million ounces of gold annually. On the flip side, we exited our positions in **Yamana (YRI)** during the quarter. Yamana has been a disappointment with management unable to deliver the consistent operational results or sustainable free cash flow that we both had expected. We intend to maintain our positions in Newmont once the deal with Goldcorp closes as we like the fact that gold has historically retained its value in times of financial uncertainty but also geopolitical uncertainty.

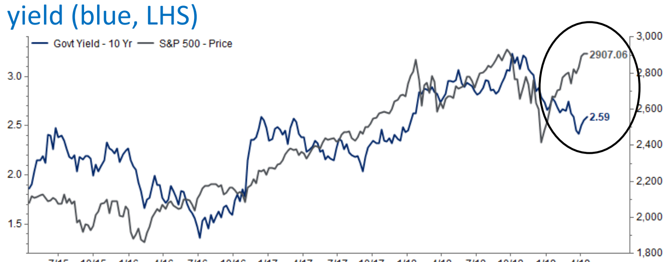
We initiated positions in all of our accounts in an **Enbridge** US-dollar Series 1 rate-reset preferred. Enbridge owns and operates the world's largest crude oil pipeline network. We have been encouraged by the company's substantial progress recently in simplifying an overly complex capital structure and addressing future funding requirements. This US-dollar preferred reset in June 2018, meaning it cannot be called by the company until 2023. We find the current yield of ~7% to be highly attractive relative to other fixed income investments, particularly the benchmark US 10-year treasury that yielded roughly 2.5% at the end of the quarter.

We trimmed positions of **Merck (MRK-US)** during the quarter after a strong run. Merck is a global health care company whose share price has been driven by their standout cancer drug Keytruda. Quarterly sales of Keytruda recently surpassed $2 billion for the first time as the drug has gradually gained approval for treatment of a broader set of cancers. Some of the funds from this sale were redirected to add to positions in **GlaxoSmithKline (GSK-US)**, a UK-based pharmaceutical company known for their HIV treatments. Glaxo has been seeing strong demand and sales growth for their highly-effective shingles drug, Shingrix. The company has a strong pipeline and pays an attractive yield of approximately 5%.

Fixed Income

Bonds surprisingly posted positive returns in the first quarter. The risk-on sentiment in equities is not being reflected in the bond market as there appears to be demand for safe assets. A synchronized rally in both markets is unusual (Figure 30).

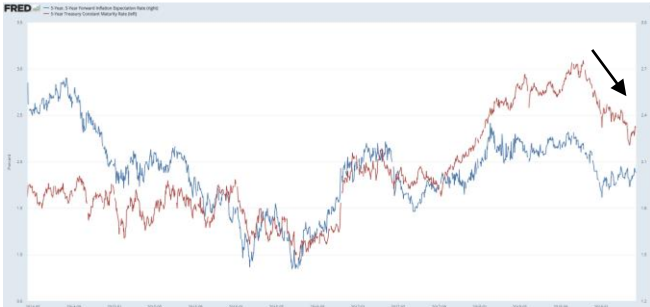
Figure 30: Bond yields diverge from equity markets - S&P 500 price (grey, RHS) and U.S. 10-year Treasury yield (blue, LHS)



Source: FactSet

Bonds rallied due to a combination of higher recession fears and lower inflation expectations. The 5-year forward expected U.S. inflation rate is around 2%, down from 2.3% last quarter (Figure 31).

Figure 31: U.S. 5-year Treasury yield (red, LHS) and U.S. 5-year expected inflation rate (blue, RHS)

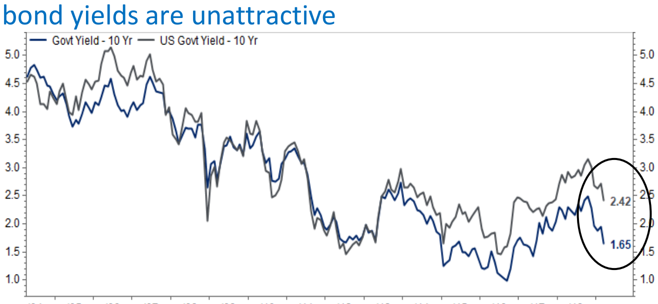


Source: Board of Governors, St. Louis Fed

The outlook for higher interest rates continues to be challenged. Weak economic growth and subdued inflation is allowing the Bank of Canada and the Federal Reserve to remain patient. Interest rate hikes are almost certainly off the table for 2019, and the markets are actually forecasting the next policy change to be a rate cut. We think there is a decent chance that interest rates reached their near-term upper bound in 2018 and question the economy's ability to tolerate higher rates, particularly considering the affordability issues facing consumers (homes and automobiles).

We remain underweight bonds in the fixed-income component of portfolios. Nominal yields are still unattractive, especially after their recent decline (Figure 32).

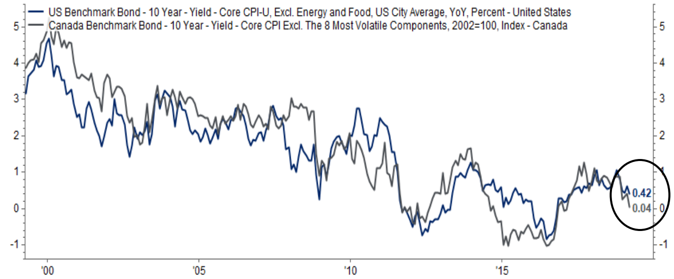
Figure 32: U.S. 10-year Treasuries and GoC 10-year bond yields are unattractive



Source: FactSet

Bonds are even less attractive when we consider inflation-adjusted returns (Figure 33). The real yields on 10-year U.S. treasuries and 10-year Canada bonds are 0.42% and 0.04%, respectively.

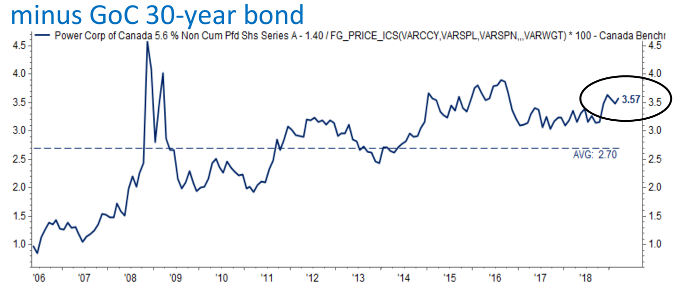
Figure 33: Real yields on 10-year U.S. Treasuries and 10-year GoC bonds (GoC grey line, U.S. blue line)



Source: FactSet

We still see good value in the Canadian preferred share market. We maintain a preference for high-yielding perpetuals and rate-resets (with high reset spreads) over the floating rate issues as our expectations for higher rates in Canada have moderated. Perpetual preferred shares are still very attractive relative to bonds (Figure 34).

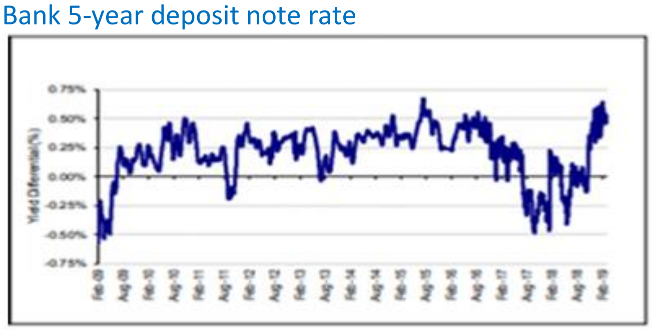
Figure 34: Power Corp. (POW.PR.A – perpetual) yield minus GoC 30-year bond



Source: FactSet

GIC rates still look compelling versus bond yields (Figure 35) and offer a timely opportunity to lock in an attractive relative yield and upgrade credit quality. We added to our positions which generally consist of a combination of 1, 2, and 3 year GICs offering an average yield of ~3%.

Figure 35: Royal Bank 5-year GIC rate minus Royal Bank 5-year deposit note rate



Source: Bloomberg, RBC DS

Performance

Our portfolios were up nicely in Q1 but underperformed the Balanced Benchmark. Canadian and international equities outperformed while U.S. stocks lagged their respective benchmarks. Fixed income returns were modestly below the benchmark.

Both asset allocation and stock selection helped our Canadian equity returns. Overweight defensive sectors contributed to the outperformance as our real estate, health care, and utilities holdings outperformed – Choice Properties (+21.70%), Sienna Sr Living (+20.08%), Extendicare (+18.74%), Canadian Utilities (+16.12%), and Emera (+14.21%). Other notable Canadian performers were Power Corp (+26.90%), TransCanada Corporation (+23.10%) and Canadian National Railway (+18.08%).

Our U.S. equities were up around 9% on average, lagging the S&P 500 return of 11.20%. Underweight equities and stock selection hurt returns. Our defensive posture weighed on relative returns in the U.S., as our consumer staples and health care stocks underperformed the benchmark – Wallgreen Boots Alliance (-9.36%), Constellation Brands (+6.72%), Johnson & Johnson (+6.03%), and Merck (+6.55%). Costco (+16.35%) and Visa (+15.88) were notable U.S. outperformers.

International stocks slightly outperformed their benchmark. Rio Tinto (+18.77%) and AXA (+15.08%) were major contributors.

Our fixed-income returns lagged the broad bond composite gain of 3.9%. Underweight bonds and being primarily invested in the short-end of the curve hurt returns. Our preferred shares gained ~1.35%, outperforming the S&P/TSX Preferred Share Index return of 1.1%. Our preferred share outperformance is not reflected in comparative returns, as the S&P/TSX Preferred Share Index is not included in the benchmark.

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
Dominion Securities