Fickel's Focus

Wealth Management
Dominion Securities

First Quarter 2021 Investment Commentary


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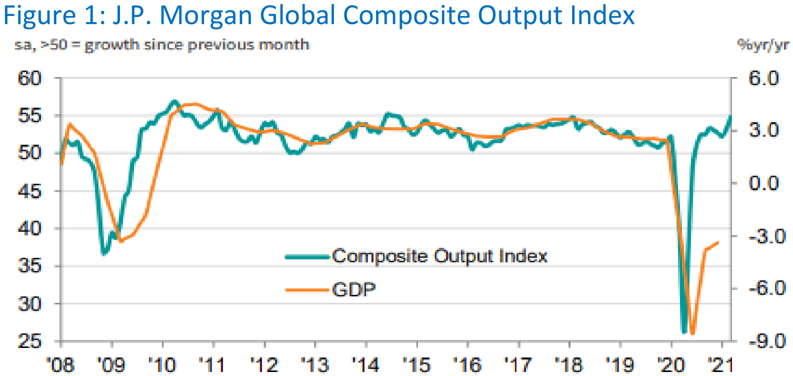
Global equities soared in the first quarter while bonds retreated. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased by 8.1%, 4.7%, and -5.0% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced strong positive returns well ahead of their respective benchmarks.

Economic Overview

The global economy continued its recovery in Q1 at a pace that generally exceeded expectations. To our pleasant surprise, faster than expected vaccine roll-outs and reopening schedules (on balance, however uneven) were contributing factors to the economic bounce. Though it is not yet reflected in our day-to-day lives, there is indeed a light at the end of the tunnel and a way out of this health and economic crisis is becoming increasingly visible. Widespread immunization, which will pave the way to normalcy, looks to be achieved in most developed countries by the end of the third quarter (September 2021). A faster than anticipated recovery has seen global growth forecasts revised higher for this year and the next (6% in 2021 and 4.4% in 2022, according to the IMF).

Global GDP remains below pre-pandemic levels but it is trending in the right direction. J.P. Morgan's Global PMI Composite Output Index hit a 79-month high in March (Figure 1), signaling increased optimism shared among 27,000 companies around the world that make up roughly 89% of global GDP. The report highlighted a considerable increase in Q1 job creation and business confidence.

Figure 1: J.P. Morgan Global Composite Output Index

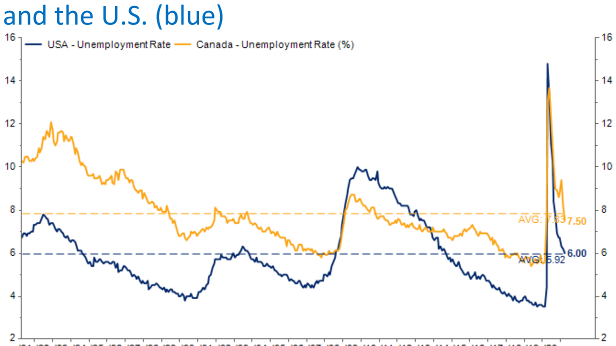


Source: J.P.Morgan, IHS Markit

As we have written before, the path of the virus remains the greatest risk for the global economy. Pharmaceutical companies are still attempting to demonstrate vaccine efficacy against new variants and countries around the world are struggling with containing new cases (Canada in particular). Fortunately, preclinical data suggests that vaccine technology can be adapted effectively against new variants. If this proves to be true, the worst is almost certainly behind us and we are well on our way back to a state of pre-pandemic normalcy (on a global scale). We still anticipate a bumpy recovery as certain regions are challenged with balancing new case growth and mobility restrictions/business shutdowns, but extraordinarily generous government support programs and accommodative monetary policy should continue to help ‘bridge the gap’.

Labour markets are reflecting the phenomenal bounce in Q1 economic activity. Unemployment rates are grinding lower around the world and are now close to their 30-year averages in Canada and the U.S. (Figure 2). March saw impressive job creation in Canada and the U.S., with 303,000 and 916,000 jobs added respectively. Canada has recovered roughly 90% of the jobs lost since the beginning of the pandemic while the U.S. is a little further behind at nearly 65%.

Figure 2: Unemployment rate in Canada (orange) and the U.S. (blue)



Source: FactSet

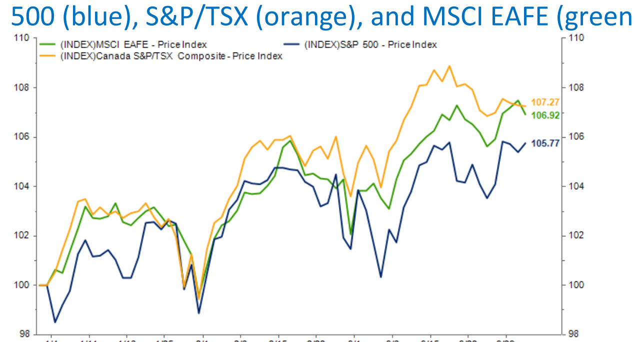
Government spending has been a key pillar of the global recovery and the U.S. is leading the pack. President Biden’s $1.8 trillion American Rescue Plan is set to supercharge the U.S. economy, and this comes on top of the $900 billion of stimulus passed in December. The U.S. is expected to be the fastest growing developed country in 2021 which will certainly have positive spillover effects for Canada, one of its largest trading partners. Canada has also seen its fair share of government spending, with roughly $270 billion deployed in 2020 to combat the pandemic. We don’t anticipate the stimulus taps will turn off any time soon. Support programs will be extended to get the economy through the final stages of the pandemic and the Liberal party already has $100 billion earmarked to support the recovery over the next three years. All in all, powerful fiscal support, easy monetary policy, excess household savings, pent-up consumer demand, and accelerating vaccination timelines bode well for economic growth in the short term.

Equity Commentary

Equity weightings are above the benchmark. Balanced accounts’ equity weightings are approximately 59.83% on average versus the benchmark weight of 55%.

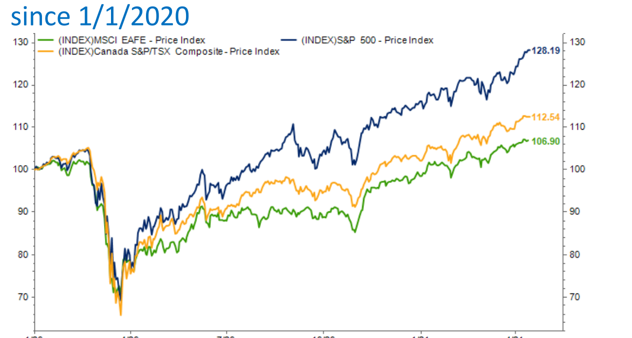
Equity markets staged an impressive rally in the first quarter (Figure 3), leaving each of the U.S. S&P 500, Canada S&P/TSX and MSCI EAFE in positive territory since the beginning of 2020 (Figure 4).

Figure 3: 3-month indexed price performance of S&P 500 (blue), S&P/TSX (orange), and MSCI EAFE (green)



Source: FactSet

Figure 4: Indexed price performance of S&P 500 (blue), S&P/TSX (orange), and MSCI EAFE (green) since 1/1/2020

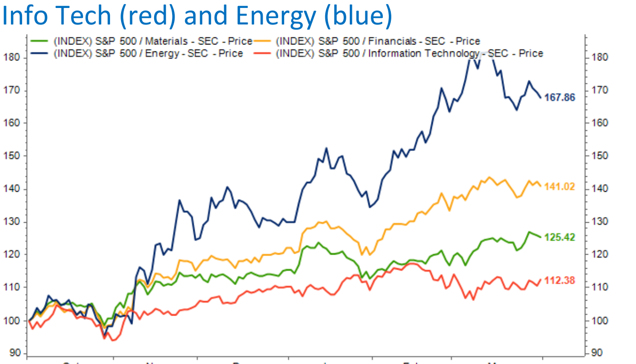


Source: FactSet

Pandemic-related losses have been fully recouped and equity markets have actually pushed higher to produce impressive gains despite the ongoing battle with COVID-19 (since 1/1/2020, the S&P 500 is up ~28%). Investors are completely overlooking any economic/company weakness owing to the pandemic and are focusing on what the post-COVID-19 world will look like. We fully agree with this line of reasoning. The stage is set for a powerful earnings recovery as vaccinations roll-out, restrictions ease, and consumers and businesses unleash pent up demand. Add on top of that unprecedented fiscal stimulus from governments and highly accomodative policy from central banks (low interest rates) and the result will surely be a period of 'above-trend' growth. While these dynamic will likely persist into 2022, we can't help but start to wonder - how do expectations get any better than this? It is difficult to see the environment getting any sweeter for equities and we are cognizant of the challenges on the horizon; higher interest rates, expensive stock valuations, balooning government debt that will likely necessitate higher taxes, rising civil unrest and socio-economic inequality, and potential 'big tech' regulation. We are not anticipating a major correction in equities, but are beginning to think about trimming our overweight allocation that we maintined during the recovery.

Cyclically oriented stocks continued their outperformance that began in Q4 2020 (Figure 5).

Figure 5: 6-month indexed price performance of S&P 500 sectors – Materials (green), Financials (orange), Info Tech (red) and Energy (blue)

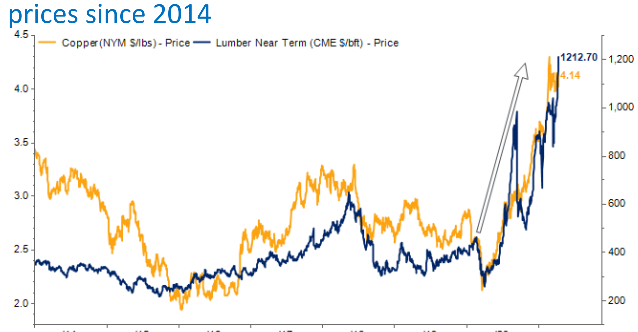


Source: FactSet

As global growth gains steam, companies that are highly levered to economic activity tend to outperform those that are more stable in nature. Energy and materials companies are performing well on the back of strong demand for commodities, while financials are improving thanks to increasing transaction volume and rising interest rates (steeper yield curve helps bank profitability). Lately, cyclical stocks have come into favour largely at the expense of technology stocks, and particularly the large capitalization FAANG group (Facebook, Apple, Amazon, Netflix and Google) which makes up roughly 24% of the S&P 500 index. High valuations, rising interest rates, and a return to pre-pandemic normalcy that will likely see less technological utilization (versus working from home) are headwinds for the FAANG stocks and the broader technology sector. Any material underperformance for this group will present an opportune time to add to these dominant, secular winners.

Unusual supply and demand conditions have, without a doubt, contributed to the strength in some cylical sectors – particularly those exposed to the production and distribution of commodities. Many companies were forced to cutback production at some point, or perhaps multiple times, during the pandemic. Amid the disruptions to supply, government spending and transfer payments to households cushioned the blow to demand, and in some cases actually increased demand for certain commodities. Copper and lumber are experiencing this phenomenon and have experienced record pace price appreciation (Figure 6).

Figure 6: Lumber (right side) and Copper (left side) prices since 2014



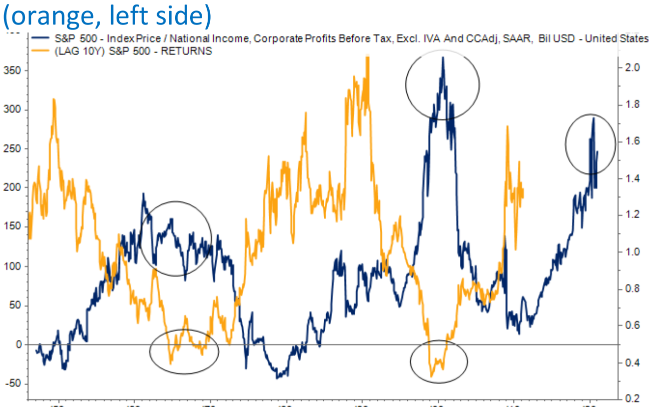
Source: FactSet

Client portfolios have benefitted from their holdings in lumber producer West Fraser Timber (WFG) and Teck Resources Ltd (TECK.B), a mining and development company that derives 40% of its earnings from copper. We continue to like the outlook for the copper and lumber markets. Copper is heaviliy used in electric vehicles and a supply shortfall is predicted in 2025 and beyond. The lumber market is highly correlated to U.S. housing, which is primed for a powerful expansion thanks to the combination of low interest rates, pent-up demand from millennials, and a decade of underbuilding. We expect lumber, copper, and other commodity prices to normalize as supply and demand move towards equilibrium, but West Fraser, Teck Resources, and other producers will experience above-average profitability in the meantime and will continue to benefit from secular tailwinds in their respective markets.

With the economy running hot we think cyclical stocks have more room to run. They should experience relatively higher earnings growth and they are not burdened by high valuations. Along the same vein, we continue to like the prospects for companies in the 'reopening' category, that is, companies that will do well as mobility and lockdown restrictions are lifted. Delta Airlines and Air Canada, which clients hold in portfolios, fall into this category.

Low interest rates and strong demand for equities have certainly propelled valuations higher. The chart below demonstrates the negative correlation between starting valuations and the subsequent 10-year forward returns (Figure 7). The blue line represents the S&P 500 index price divided by U.S. corporate profits before taxes. The orange line charts the forward 10-year return for the S&P 500. Periods of high stock market valuations (blue line) tend to correspond with underwhelming 10-year forward returns, and vise versa.

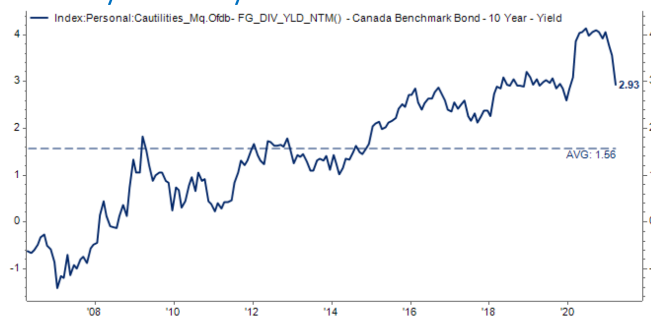
Figure 7: S&P 500/U.S. corporate profits before tax (blue, right side) and S&P 500 forward 10-year return (orange, left side)



Source: FactSet

In this environment we think its prudent to focus on earnings growth and total return versus prospects for valuation (multiple) expansion. We continue to like the utility sector in Canada. It offers high quality, albeit low, rate-base earnings growth and attractive dividend yields (Figure 8). Combined, these offer a compelling total return in an environment where we see plenty of uncertainty.

Figure 8: Our Canadian utility stocks (Emera, Hydro One, and Canadian Utilities) dividend yield minus the GoC 10-year bond yield



Source: FactSet

The first quarter of the year saw a reasonable amount of trading within client portfolios that was generally predicated on expectations of a rebound in bond yields and increasing inflationary pressures.

In early January we sold the long-dated U.S. Treasury in anticipation of rising interest rates (as interest rates rise, bond prices go down). Since then, bond yields have risen substantially and the 2046 U.S. Treasury is down roughly 12%. From the initial purchase of the bond, we realized a 27% gain in U.S. dollar terms.

A Government of Canada bond matured during the first quarter. Similar to last quarter and in light of ultra-low bond yields, we reallocated these funds to equities for income generation. We increased our weights in **BCE** (~6% yield) and **Emera** (~5% yield), but then subsequently trimmed the latter later in the quarter after its stock price moved to the upper end of its recent trading range.

In early February, we exited our position in **GlaxoSmithKline**, a UK-based pharmaceutical company known for HIV treatments. We purchased the stock originally in August of 2018 because of its highly-effective shingles drug, Shingrix, its attractive yield of 5%, and a promising drug pipeline. Positions were trimmed in February 2020 after holdings were up approximately 10% from original purchase excluding dividends. Since then, drug pipeline announcements have disappointed and the sustainability of the dividend has come into question. We think there are better opportunities elsewhere.

Holdings in **Merck** were added to during the period. At 9.5x 2023 earnings estimates, the stock price traded at cheap valuations. It lagged the broader index in 2020 because of the impact that mandatory shutdowns had on its physician-delivered vaccine business. Investors are also growingly concerned about the dependence on its blockbuster cancer drug, Keytruda. We think the weakness in vaccines is transitory and will rebound once things return to normal. As for Keytruda, patent protection is likely to extend through to 2028 (and longer in some geographies), giving Merck plenty of time to develop new innovative drugs and generate solid growth for shareholders.

In February, we added to our positions in **Toronto Dominion Bank** in anticipation of rising interest rates. TD is Canada's second largest bank by market capitalization. Banks are one of the biggest beneficiaries of higher interest rates (especially if the yield curve steepens) as this allows them to charge more on their loans. Transaction volumes are increasing as well and the stock yields 4%.

For the second consecutive quarter we trimmed weights in **West Fraser Timber**. Over the last 12 months the stock is up roughly 214%. A massive supply shortage of lumber is being met with strong demand from hot housing markets in Canada and the U.S. The lumber producer will remain highly profitable amid elevated lumber prices, but we think it's prudent to take some profits at all-time highs after the historic move.

A second housing-related stock we trimmed during the quarter was **Lennar**. The company is the largest homebuilder in the United States by revenue and controls an attractive land bank. The homebuilding industry was one of the few industries that thrived during the pandemic as the drop in interest rates improved housing affordability dramatically. While we continue to like the housing supply and demand conditions in the U.S., the recent run up in interest rates (and pass through to mortgage rates) brings affordability issues back into question. Similar to West Fraser Timber, we think it's prudent to take profits on this cyclical winner, especially near all-time high prices.

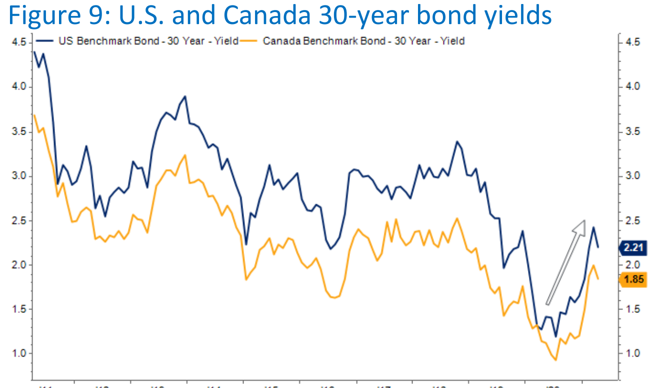
Weights in **Delta Air Lines** were pared back in March at a price of $51.44. We initiated positions in May 2020 at $22.43 on the thesis that the industry would be among the biggest beneficiaries of the development of a vaccine and the company would receive government support in the interim. The stock rallied strongly as the vaccination program in the United States gained momentum and evidence of pent up demand for air travel became more apparent. With good news priced into the stock and a significant overweight in airlines, we felt it was prudent to reduce our exposure to the industry.

Fixed Income

We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 30.04% on average versus the benchmark weight of 40%, with about half of that in preferred shares.

Underweight bonds benefitted client portfolios in Q1 as the Canadian Broad Bond Composite Index delivered a pathetic -5.0%. Bond yields are rising from their recession lows as GDP growth accelerates and inflation expectations rise (higher bond yields = lower bond prices, they are inversely correlated). Yields are likely to face more upward as economic momentum persists.

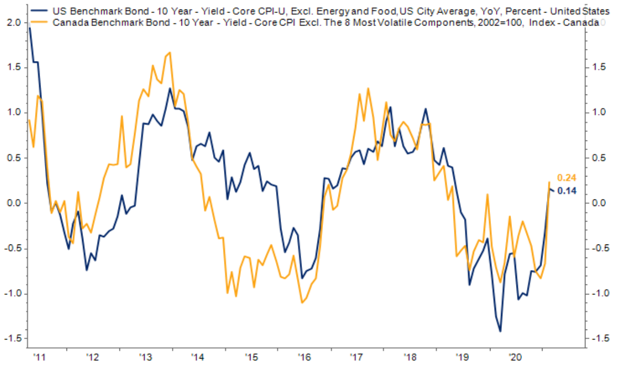
Figure 9: U.S. and Canada 30-year bond yields



Source: FactSet

Real yields have moved higher as well and are now in-line with their 10-year averages (Figure 10). Despite the latest move higher in rates, treasuries still barely serve to preserve capital.

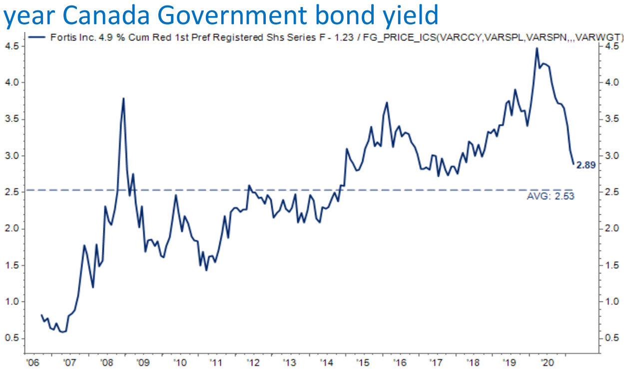
Figure 10: 10-year government bond real yields in Canada (orange) and the U.S. (blue)



Source: FactSet

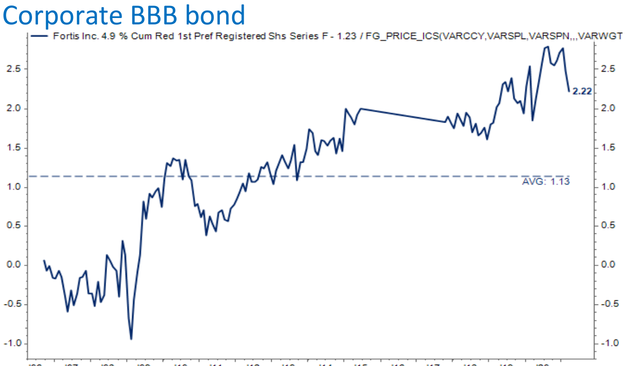
In anticipation of additional bond weakness we continue to prefer allocating clients' fixed income to preferred shares. Following their latest rally, preferred valuations are not as attractive as they were in previous years. Still, they offer compelling returns relative to bonds. Fortis F, one of our perpetual issues, is yielding nearly 3% more than a Canada 10-year bond (Figure 11). Preferred shares are also attractive relative to lower credit-quality bonds (Figure 12).

Figure 11: Fortis Series F dividend yield minus 30-year Canada Government bond yield



Source: FactSet

Figure 12: Fortis Series F dividend yield minus Canada Corporate BBB bond



Source: FactSet

Performance

Client accounts significantly outperformed their benchmarks in the opening quarter of 2021 after fees. This was driven by a combination of asset allocation (overweight equities and preferred shares) and stock selection.

Fixed income holdings within client portfolios strongly outperformed the benchmark due to a significant underweight in bonds (Canadian Broad Bond Composite was -5.0% in Q1). Allocating the majority of clients' fixed income to preferred shares benefitted returns substantially.

Our Canadian equity holdings exceeded the 8.1% total return from the S&P/TSX Index during the quarter. Positive performance was broad-based with all Canada-domiciled companies held in client portfolios producing positive returns during the quarter. Financials and Pipelines led the way with double-digit returns. Top performers within portfolios were Manulife (+19.2%), Air Canada (+14.8%), Toronto-Dominion (+13.9%) and Enbridge (+12.3%). The poorest performing holding during the period was Hydro One, which still delivered a healthy 2.0% positive return in addition to its regular quarterly dividend.

Likewise, U.S. stocks in client portfolios outperformed the S&P 500 4.7% total return in Canadian dollars during the quarter. Stocks exposed to housing fared well again. Lennar led the way with a 31.6% return (all returns in Canadian dollar terms) while Home Depot (+13.5%) and Stanley, Black & Decker (+10.2%) both provided double-digit gains. Elsewhere, Truist Financial posted a second consecutive 20% quarterly return (+20.2%). Other strong outperformers include two of our larger holdings in Delta Air Lines (+18.6%) and Alphabet (+16.6%). Non-cyclical companies understandably lagged as vaccinations ramped up. Big-box retailer Costco (-7.6%), utility PG&E (-7.2%), pharmaceutical company Merck (-6.9%) along with soft drink companies Pepsico (-5.8%) and Coca-Cola (-5.1%) came under pressure as investors sought more exposure to the recovery.

We sold our only international equity holding, GlaxoSmithKline, in the first quarter. The underweight was a relative benefit as the international MSCI EAFE benchmark underperformed North American equity markets with a return of 1.4% in Canadian dollars.

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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