RBC Dominion Securities Inc.

Fickel's Focus

Wealth Management
Dominion Securities

Second Quarter 2020 Investment Commentary

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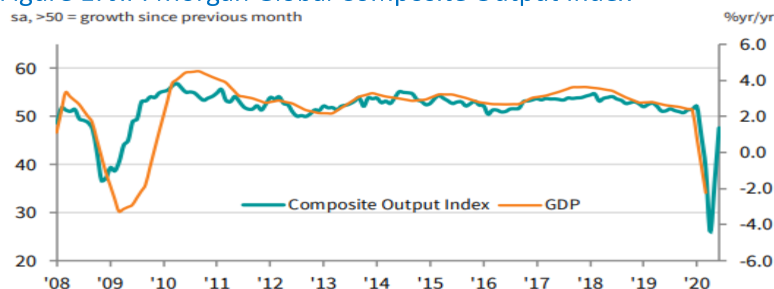
Global equity markets staged a remarkable rally in the second quarter and recovered most of their Q1 losses. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased by 17%, 16.4%, and 5.9% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced strong positive returns during the quarter.

Economic Overview

The global economy entered a deep recession in the first quarter as a result of social distancing and government mandated business closures. The 'mini-cycle' recovery that was underway at the beginning of the year was quickly derailed and an abrupt, deep and widespread slowdown ensued. It is estimated that global GDP contracted by 16% (annualized) in the first half of the year. Despite the magnitude of the collapse in activity, synchronized policy responses from governments and central banks generated the most dramatic growth swing in history and global GDP is expected to rebound 20% in the second half of 2020. While an eventual recovery is inevitable, investors continue to grapple with significant uncertainty around the evolution of the virus and the timing and extent of economic normalization.

Economic data improved significantly in June as lockdown restrictions eased and businesses reopened around much of the world. The J.P. Morgan Global PMI Composite Output Index conducts surveys in over 40 countries to gauge activity in the manufacturing and services sectors. While still signaling a contractionary environment, the composite rose to a five-month high and saw improvements in total output, business confidence and employment.

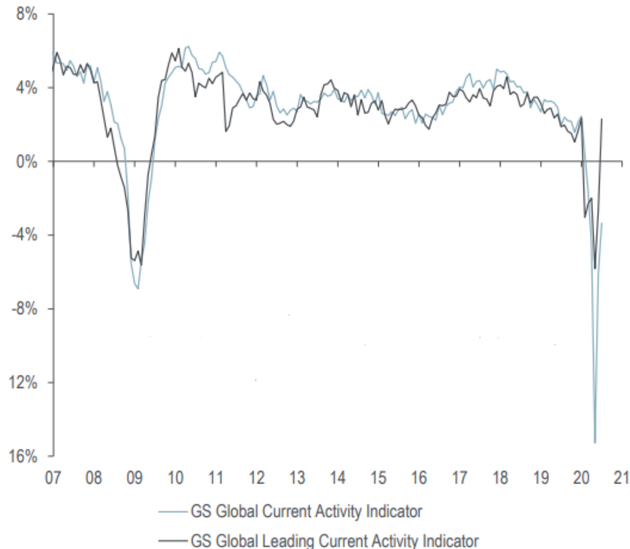
Figure 1: J.P. Morgan Global Composite Output Index



Source: J.P.Morgan, HIS Markit

Similarly the Goldman Sachs current and leading activity indicators are both signaling improving conditions (Figure 2). Q2 will likely mark the worst of the downtown.

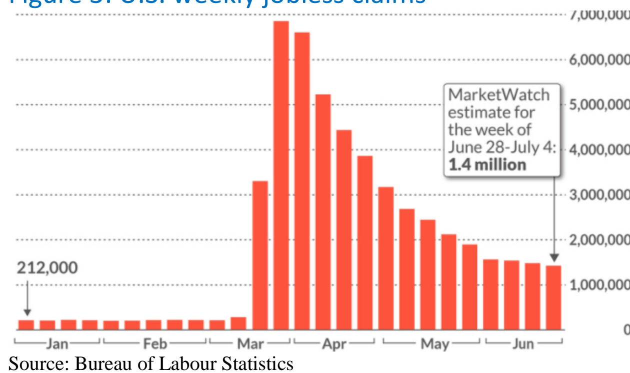
Figure 2: Goldman Sachs global current and leading indicators



Source: RBC Wealth Management, Bloomberg, Goldman Sachs

Easing activity restrictions and reopening economies has given businesses the jumpstart they desperately needed but it is difficult to gauge the state of consumers (which account for most of GDP) and the labour market. The United States posted a strong employment gain in June adding 4.8 million jobs. Still, the labour market has 15 million fewer employees than in February and weekly jobless claims continue to hover above 1 million (Figure 3).

Figure 3: U.S. weekly jobless claims

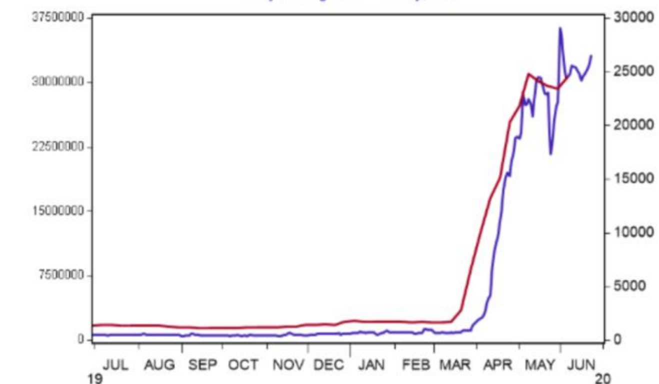


Source: Bureau of Labour Statistics

Amid the elevated uncertainty companies are operating in a fog and more than 40% of the S&P 500 has been forced to withdraw forward guidance. It is seemingly unlikely businesses will rush to bring back temporarily laid off employees when future revenue prospects are so unclear. Some companies are still cutting costs and operating in survival mode. Just last week United Airlines announced that half of its front-line workers, 36,000 employees, could be furloughed due to the pandemic. What's more, a major part of the rebound in employment depends on the percentage of temporarily laid off workers regaining permanent employment. It is possible that companies downsized or became more efficient during the crisis and require less manpower than before the shutdown.

Fortunately governments around the world have deployed significant capital to support households and bridge their financing needs until normalcy is restored. The Canadian federal government has paid out more than $212 billion to individuals and businesses, representing nearly 14% of GDP. Similarly, the U.S. has seen its transfer payments from governments to individuals increase by $3 trillion which has actually resulted in a net increase in personal income. As long as programs remain this generous, total unemployment claims are likely to remain elevated and by extension, so will the unemployment rate (Figure 4).

Figure 4: Continuing unemployment claims (red, right side) and unemployment benefits paid out (blue, left side)



Source: RBC Capital Markets

While we question how governments will fund all this debt, the support programs are clearly cushioning the income blow for households today. Consumer spending in Canada continues to recover from its March and April lows when it was down 37% from a year earlier (Figure 5). It is a similar story in the U.S.

Figure 5: Canadian consumer spending (% change)

Source: RBC Data & Analytics, RBC Economics

Unforunately, as social distancing restrictions ease, COVID-19 cases are rising again, particularly in Southern and Western parts of the U.S. The biggest risk to the economy and the markets is a large second wave of cases which could force governments to postpone or even reverse the process of reopening economies. We do not forsee a total lockdown scenario occuring as hospitals and societies are better equipped to deal with another outbreak, but any slowdown in the reopening process will be a headwind for economic growth.

Equity Commentary

Equity weightings are below the benchmark in all portfolio objectives. Balanced accounts' equity weightings are approximately 52.15% on average versus the benchmark weight of 55%.

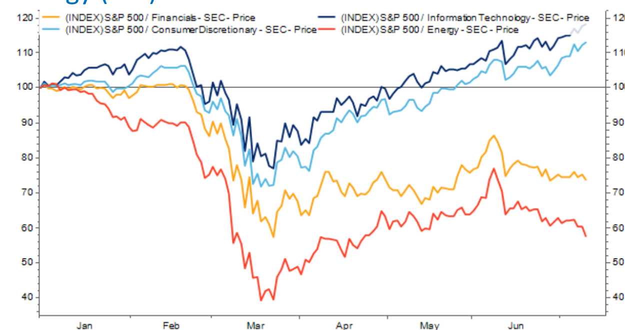
Equity markets came roaring back in Q2 as concerns over COVID-19 diminished and investors turned optimistc on what the post pandemic world will look like. The S&P 500 has almost recouped all of its year-to-date losses while the S&P/TSX and the MSCI EAFE are still down around 10%. (Figure 6).

Figure 6: Year-to-date indexed price performance of S&P 500 (blue), TSX (orange), and MSCI EAFE (green)

Source: FactSet

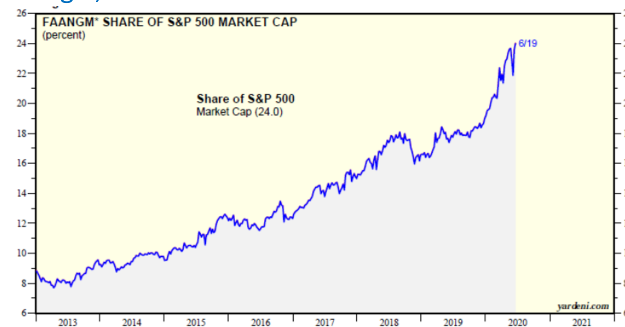
Not all sectors have fared equally. In the U.S. and elsewhere, market leadership has been heavily concentrated in the technology and consumer discretionary sectors (Figure 7). Investors are herding into companies perceived to be secular growers at the expense of more traditional, value oriented sectors such as energy and financials. The combined market capitalization of technology and internet bellwethers hit a record and now represents 24% of the S&P 500 (Figure 8). Our accounts (that are fully invested to our model) hold Google, Facebook and Microsoft.

Figure 7: Year-to-date indexed price performance of S&P 500 sectors – technology (dark blue), consumer discretionary (light blue), financials (orange) and energy (red)



Source: FactSet

Figure 8: Market cap of Facebook, Apple, Amazon, Google, Netflix and Microsoft as % of S&P 500

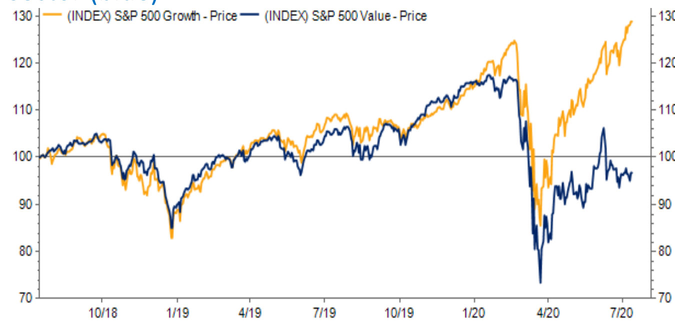


Source: FactSet

The divergence in sector performance can also be seen when comparing growth and value stocks. Growth oriented companies have dominated their value counterparts over the past decade and continued to do so year-to-date (Figure 9). Heightened skepticism around economic growth this year pushed investors into companies that have visible opportunities for expansion. This has seen growth sectors' (ie technology) valuations increase from an already elevated level on both an absolute (Figure 10) and relative basis (Figure 11). This trend

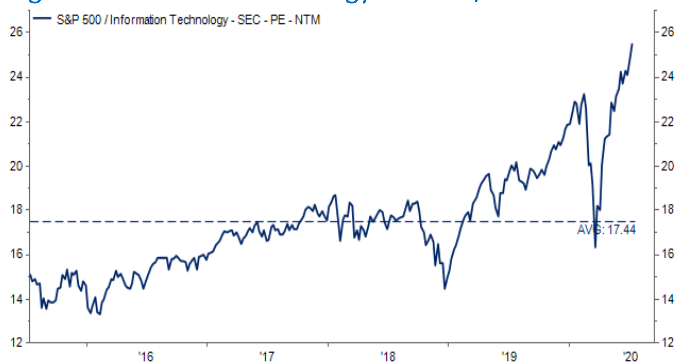
will likely continue if economic growth remains subdued, however a meaningful pickup in activity could see value-oriented companies close the performance gap.

Figure 9: Year-to-date indexed price performance of S&P 500 growth sector (orange) and S&P 500 value sector (blue)



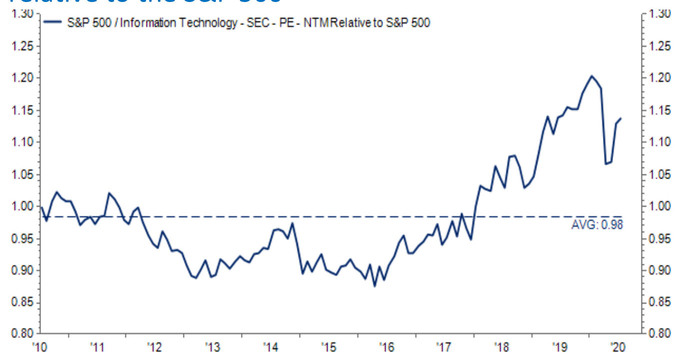
Source: FactSet

Figure 10: S&P 500 technology sector P/E ratio



Source: FactSet

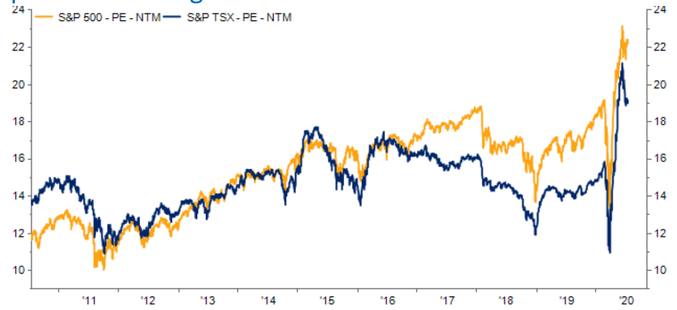
Figure 11: S&P 500 technology sector P/E ratio relative to the S&P 500



Source: FactSet

With the latest rally in equity markets valuations are looking expensive. The S&P 500 and S&P/TSX are trading around 22x and 19x price-to-earnings versus their 10-year averages of 15x and 14x respectively (Figure 12). Granted, earnings per share (the P/E ratio denominator) will recover from the pandemic lows and bring valuations towards normal levels, but it tells us that investors are already pricing in a recovery.

Figure 12: S&P 500 (orange) and S&P/TSX (blue) price-to-earnings ratio

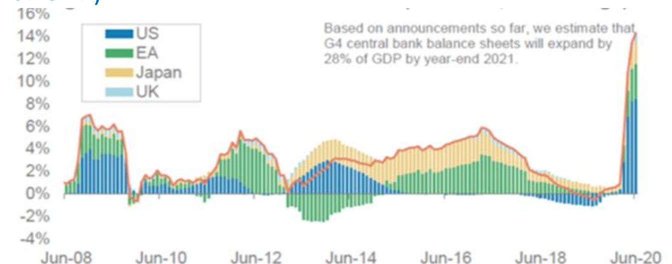


Source: FactSet

Balanced portfolio equity weightings are modestly below the benchmark weight reflecting our cautious but optimistic view over the short to medium term. The latest move higher in equity markets worsened the risk/reward dynamic and exposes equities to greater risk of a pullback. Our chief concern is the virus lingering. While the presence of COVID-19 may not result in governments reversing their policies or reinstating mandatory social distancing, it will certainly alter private sector behavior and likely weigh on consumption. As well, we question how households will fare when government fiscal supports are halted. Large emergency measures aimed at boosting household income, preserving jobs and subsidizing credit to businesses are set to expire, some as early as next quarter. Unemployment will likely not fully recover by the time these programs end and households may experience income loss to levels seen before the pandemic.

Central bank purchases surged in 2020 in attempt to improve liquidity and put downward pressure on interest rates (Figure 13). Central banks' roles in supporting financial markets are not well defined and we question when and to what extent will they step in to prop up asset prices.

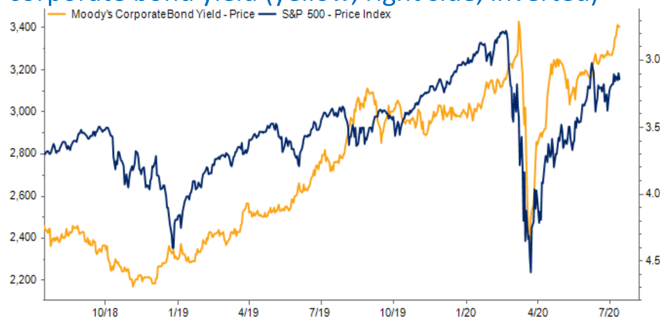
Figure 13: change in central bank balance sheets (% of GDP)



Source: Fed, ECB, BoJ, Morgan Stanley Research

The Federal Reserve's quantitative easing program was directed largely towards purchasing bonds but equities were also a benefactor. There is a strong negative correlation between corporate interest rates, which the Fed pressured lower, and the S&P 500 (Figure 14). The Federal Reserve and other central banks will likely be providers of liquidity and asset price stability going forward, but their increased involvement and market manipulation is a wildcard for investors.

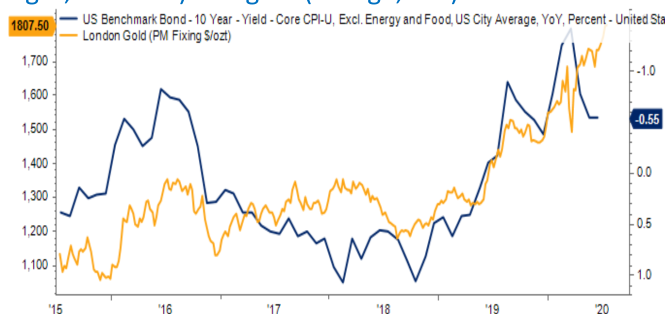
Figure 14: S&P 500 price (blue, left side) and Moody's corporate bond yield (yellow, right side, inverted)



Source: FactSet

Gold has been a significant beneficiary of stimulative central bank policies and lower interest rates (Figure 15). With nominal rates excessively low and real interest rates (nominal rate minus inflation) negative, investors aren't sacrificing any yield to own the precious metal. Gold also serves as an inflation hedge (M2/money supply growth has gone parabolic) and a general risk hedge. Given the persistent uncertainty in the markets and the possibility of a recovery shortfall/incomplete economic normalization we think it is prudent to have some gold exposure. Client portfolios continue to own Newmont Corporation and have benefitted from its strong year-to-date rally.

Figure 15: U.S. 10 year treasury real yields (blue, right, inverted) and gold (orange, left)



Source: FactSet

We underwent a heavier quarter of trading within client accounts, not unexpected given the volatility and rapidly evolving conditions brought on by COVID-19. On the buy side, we initiated a position in **Manulife Financial** in the latter stages of the quarter. Manulife is Canada's largest insurer and a leading provider of financial protection and wealth management products and services. The company has been successful in reducing costs in recent years and has an attractive footprint that includes higher growth markets in Asia ex-Japan. We believe that interest rate cuts have largely been completed to stimulate the economy and insurers will benefit from any increase in interest rates as the economy recovers. While that does not appear to be happening in the immediate future, the stock pays an attractive dividend of close to 6%.

West Fraser is both the largest and lowest-cost producer of lumber in North America. We positioned it in late June at a price that was half of what we sold it at in August of 2018. The company has operations in British Columbia, Alberta and the U.S. South region. While lumber is a highly cyclical industry, we believe the historically low interest rates will provide an additional long-term tailwind in housing, particularly in the United States where there is an abundance of pent-up demand from favourable demographics and a generation of underbuilding in residential home construction. In addition, we added to our positions in **Lennar** during the quarter. We had initiated a position during the market sell off in March. Lennar is the largest homebuilder in the U.S. by revenue and controls an attractive land bank.

We established a position in U.S. utility **PG&E** just prior to quarter end in late June. The company generates and transmits electricity for 5 million customers and transports and stores natural gas for 4 million people in Northern California. PG&E is exiting bankruptcy after settling claims related to wildfires in the state in 2017-18. California has a pro-growth regulator and the company is set to play a key role in implementing the state's aggressive energy and environmental policies. This is expected to translate into substantial rate base growth in the high single digits over the next five years, among the best in the industry. We find the risk-reward trade off to be very attractive at current price levels.

We swapped our position in **Air Canada** for **Delta Air Lines** during the quarter. Airlines are facing a long road to recovery but the industry stands to be among the greatest beneficiaries of the development of a vaccine, which many experts believe could come late this year or early in 2021. Among airlines, we like both Air Canada and Delta for their balance sheet strength. Delta stands to benefit more early on from its geographical location as the United States is pushing an earlier and more aggressive reopening than Canada with more of its citizens appearing to be willing to risk air travel. We expect both companies to be survivors in a worst-case scenario.

We exited our positions in **Extendicare** and **Sienna Senior Living**. Retirement homes have been among the worst hit by the virus. Negative headlines emerged during the pandemic exposing a need for some homes to immediately raise their standard of care which will require additional costs. Occupancy levels continue to drift lower as move-in restrictions remain in place. We liked the stocks for their attractive yields but are mindful that payout ratios could now be at risk.

RioCan was also sold in client accounts during the quarter. We remain admirers of company management but the fallout from COVID-19 as it relates to the negative impact on current tenants along with future demand for office space with work-from-home business models becoming advanced has led us to move out of our position in the company. We have become increasingly concerned with the heavy toll on non-essential retailers and the ability of the company to quickly reduce vacancy rates as the virus has increased the velocity of the shift to online shopping and home delivery.

Newmont Goldcorp was trimmed during the quarter. Gold as an asset class performed very strongly in the market sell off in March and the holding had grown to the highest weighting in client portfolios. We felt it was prudent to pare back holdings. It remains at or near the top in terms of weight in portfolios and we are still attracted to gold as an excellent hedge against potential market volatility and pull backs due to a second wave of COVID-19. Operationally, Newmont also provides the prospect of upside in the form of increasing dividends and an improved earnings outlook through a higher gold price and cost-saving synergies while integrating the Goldcorp assets.

Holdings in **Suncor** were exited in mid-April. Although a world-class company, the oil industry continues to grapple with a drop in demand from the impacts of COVID-19. The glut of oil in inventories will take time to work down once economies fully open at an undetermined point down the road and there appears to be more desire from OPEC producers to continue pumping oil at low price levels than work together to curtail production to boost prices. This has dampened prospects for our investment thesis to continue to play out, which is an investment in a strong cash flow generator capable of paying a large dividend and engaging in substantial share buybacks to boost earnings due to a depressed price for crude. As a result, we are presently hold no oil producing companies within client portfolios.

Visibility around the recovery remains low and we anticipate that the coming period will be volatile as the market interprets the economic data and path of the virus. We have positioned client portfolios for whatever scenario comes next. If the market declines and the recovery is slow to materialize, we own many defensive holdings including **Costco**, **BCE**, **Coca-Cola**, **Pepsico**, **Hydro One** and **Choice Properties** (through its primary tenant, Loblaws). Should the continuing damage of the virus be less than feared or a vaccination discovered, we own high-quality names that will materially benefit such as **West Fraser Timber**, **Walt Disney**, **Delta Airlines**, **Lennar** and **Stanley Black & Decker**. We also own stocks that we feel will be long-term winners regardless of outcome in secular growth names such as **Microsoft**, **Alphabet** (Google), **Home Depot**, **Canadian National Railway** and **Visa**.

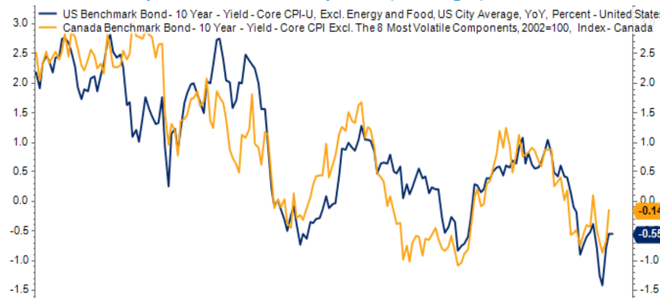
Fixed Income

We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 36.37% on average versus the benchmark weight of 40%, with about half of that in bonds.

Bond investors were rewarded handsomely in Q2. The Canadian Broad Bond Composite gained 5.9% as interest rates continued their decent, sending bond

prices higher. We continue to remain defensive in the bond portion of portfolios, focusing on high quality and short term issues. Bond yields are even less attractive after their latest move lower. Real yields (inflation adjusted) for U.S. and Canada 10-year government bonds are -0.55% and -0.14% respectively (Figure 16). If bond investors are seeking a positive real return they are relying exclusively on capital appreciation (lower interest rates = higher bond prices), a risky proposition considering how low rates already are.

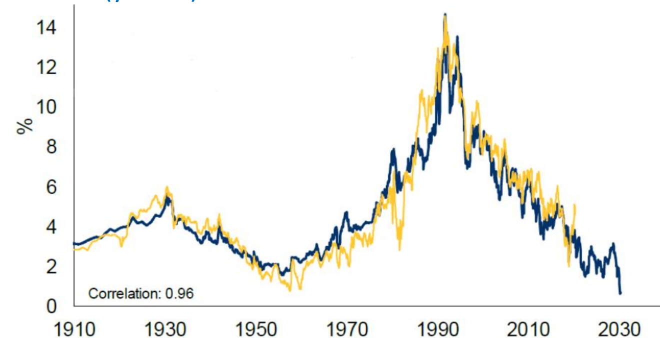
Figure 16: U.S. 10-year bond real yield (blue) and Canada 10-year bond real yield (orange)



Source: FactSet

We have remained underinvested in bonds for a number of years now and watched yields move from low to excessively low (and prices higher). Quantitative easing and negative interest rate monetary policy have been powerful tailwinds for the bond market that were largely unpredictable. Looking forward, the expected return for government bonds over the next ~10 years is particularly meagre. There is a strong correlation between the current yield on bonds and the subsequent realized 10-year annual return and historical evidence suggests we can expect around 1-2% over the next decade (Figure 17).

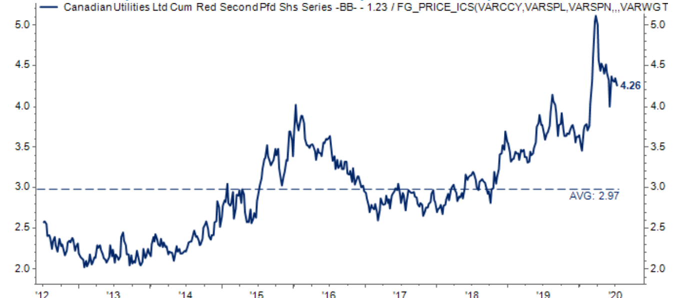
Figure 17: U.S. 10-year treasury (blue, advanced 10 years) and subsequent realized 10-year annual returns (yellow)



Source: RBC DS, Bloomberg

We continue to see value in allocating some of the fixed income component of portfolios to preferred shares. One of the issues we own is the Canadian Utilities Series E perpetual. Its 5.4% dividend yield is 4.26% higher than a 30-year Government of Canada bond yield (Figure 18).

Figure 18: Canadian Utilities Series E perpetual dividend yield minus BoC 30-year bond yield



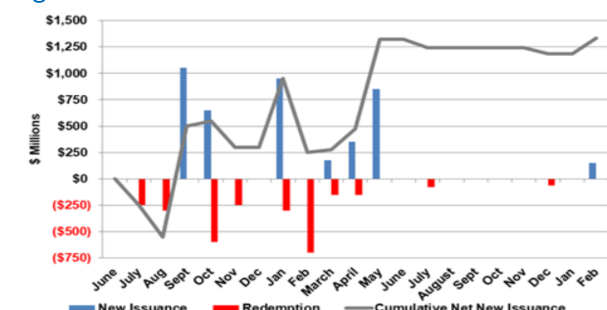
Source: FactSet

Credit spreads in the preferred share market have blown out (Figure 19). Rate reset preferred shares are trading at levels where they have historically delivered large positive returns and even kept pace with equities. These pricing dynamics have contributed to a lack of new supply as preferreds are currently an expensive funding vehicle for issuers (bad for companies, good for investors - Figure 20).

Figure 19: Effective spread of a basket of rate reset preferred shares

Source: RBC Dominion Securities, Bloomberg

Figure 20: Preferred share net issuance



Source: RBC Dominion Securities, Bloomberg

Performance

Client accounts experienced a strong quarter in absolute terms along with broader markets in Q2. Returns were below the balanced benchmark as a result of our conservative equity positioning in both asset allocation (underweight equities) and stock selection (overweight defensive sectors), two factors that helped when markets fell in Q1. In addition, our overweight position in U.S.-domiciled investments was a headwind during Q2 as the Canadian dollar appreciated by 4% relative to the U.S. dollar during the period.

Our Canadian equity holdings lagged the 17.0% return from the S&P/TSX Index during the quarter. This is a result of our positioning in Canada mostly allocated to stable, defensive-oriented stocks while the vast majority of our cyclical investments reside in the United States. Notable laggards included investments in high-yielding pipelines and utilities such as TC Energy (-7.2%) and Emera (-3.7%). The TSX return was skewed by a 119% return in the quarter by the heaviest-weighted stock in the index, Shopify.

U.S. stocks in client portfolios outperformed the 16.4% return in Canadian dollar terms of the S&P 500 during the quarter. A number of holdings experienced big rebounds led by Lennar (+55.6%), Stanley Black & Decker (+34.5%), Newmont (+31.5%), Facebook (+31.3%), Home Depot (+29.4%) and Microsoft (+24.5%). Holdings in defensive sectors such as Health Care (Merck -3.0%, Johnson & Johnson +3.5%) and Staples (Coca-Cola -2.6% and Costco +2.6%) generally held their value in the market's move up after adding significant relative value in the first quarter of the year.

Our lone International equity holding, GlaxoSmithKline (+3.9% in Canadian dollars), lagged the return of the MSCI EAFE of 10.2% during the quarter.

The broad Canadian Bond Index advanced 5.9% during the quarter, a very strong return from an asset class that has seen its yield shrink. Our underweight in bonds was mitigated by a very strong rebound in preferred shares, which saw double-digit returns during the quarter. We continue to see preferred shares as offering some of the most appealing risk-reward trade off. While they exhibit bouts of volatility not unlike equities, in an environment where the 30-year Canadian government bond yields just 1%, preferred yields in the 5-6% range look very appealing. Few stocks offer this type of yield and even bonds that carry below investment grade ratings offer yields that are significantly lower than the preferreds we hold in client portfolios, which hold far superior credit ratings.

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

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- 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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