RBC Dominion Securities Inc.

Fickel's Focus

Wealth Management
Dominion Securities

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Second Quarter Investment Commentary

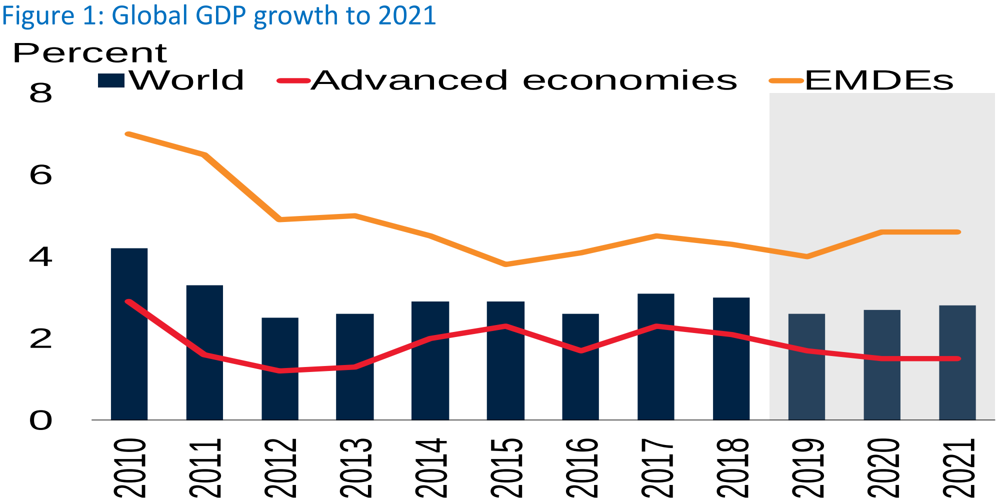
Global equity markets were up modestly in Q2. The S&P/TSX and the S&P 500 increased by 2.6% and 2.3% in $Cdn respectively.

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

Economic Overview

Global economic growth slowed in the second quarter to an estimated 2.3% from 3.0% in Q1 (q/q). Idiosyncratic factors weighed on activity in Developed Economies against a backdrop of increasing trade policy uncertainty and weak business sentiment. Manufacturing activity continued to decline and some of the weakness has spilled over to the important services sector. Consumers remain in good shape, supported by tight labour markets and decent balance sheets.

Figure 1: Global GDP growth to 2021



Source: World Bank

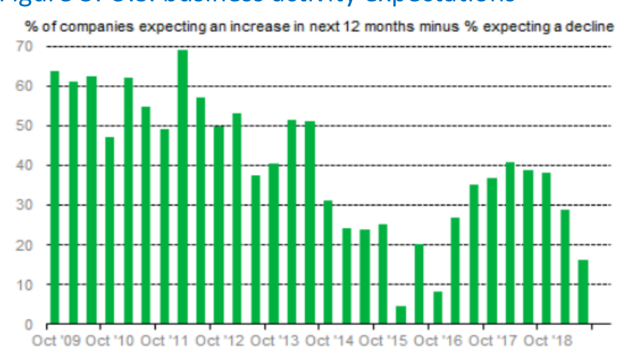
Business sentiment has clearly become more cautious. Global activity expectations for the next 12 months have fallen to the lowest level since 2009 (Figure 2).

Figure 2: Global business activity expectations

Source: IHS Markit

Sentiment weakened among U.S. companies in particular (Figure 3) with tariffs and the U.S.-China trade-war firmly coming into focus. So far this earnings season, 40% of S&P 500 companies that have reported 2Q19 results have discussed the trade-war. Companies are increasingly citing difficulty realizing prices sufficient to offset tariffs and inflation. Perhaps more concerning is that cost savings initiatives are on the rise. 45% of companies that have reported so far have emphasized cutting costs, most commonly through cutbacks in hiring and investment spending.

Figure 3: U.S. business activity expectations

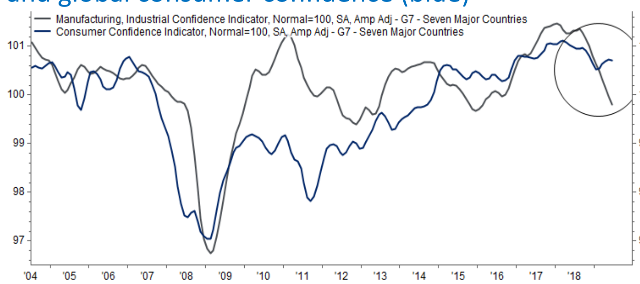


Source: IHS Markit

There is currently no end in sight for the trade-war. Equity markets expect a resolution to be reached ahead of Trump's 2020 re-election campaign, though it is possible China waits for a more conventional and respectful president. As well, there has been little progress made on key issues that the U.S. appears unwilling to budge on (IP protection, forced technology transfer, cyber security, etc.). The full pain of the tariffs has yet to be felt and business expectations continue to slide. We think a trade-war resolution is a prerequisite for a sustainable rebound in activity.

Consumer confidence is holding up against a backdrop of strong labour markets, low borrowing costs and decent balance sheets. Divergences between the state of consumers and businesses have not persisted for long historically (Figure 4). Absent a rebound in business activity, we expect to see some weakness among consumers.

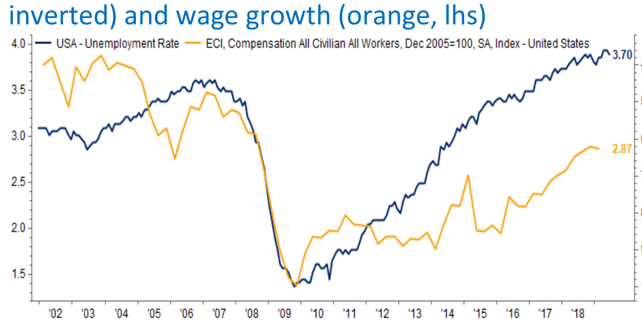
Figure 4: Global manufacturing confidence (grey) and global consumer confidence (blue)



Source: FactSet

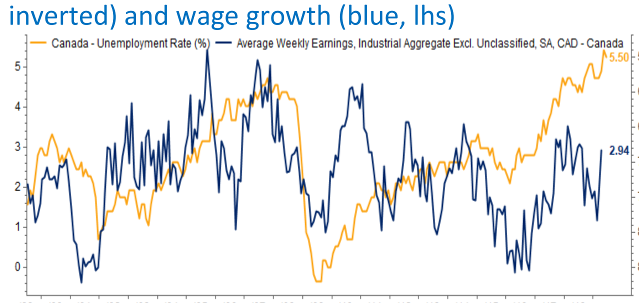
Employment gains were choppy during the second quarter in Canada and the U.S., but unemployment rates remain near record lows, real wages are growing and jobless claims are muted (Figures 5-7).

Figure 5: U.S. unemployment rate (blue, rhs, inverted) and wage growth (orange, lhs)



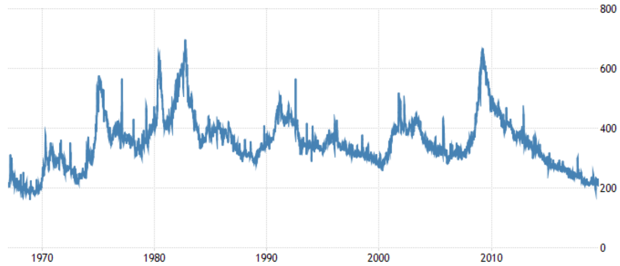
Source: FactSet

Figure 6: Canada unemployment rate (orange, rhs, inverted) and wage growth (blue, lhs)



Source: FactSet

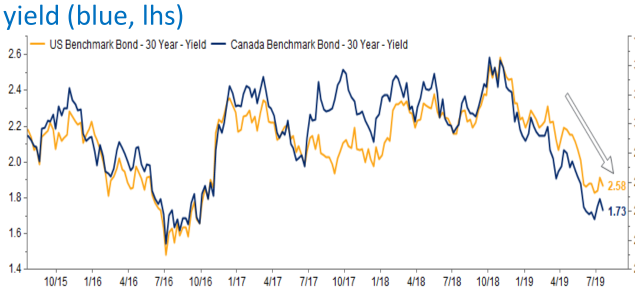
Figure 7: U.S. jobless claims



Source: U.S. Department of Labor

Inflation levels are moderate and continue to run below most central banks' targets in developed markets. Low inflation means less erosion to households' real income. It can also indicate economies are not at risk of overheating and allows central banks to be patient or engage in loose monetary policy (lower interest rates). The Federal Reserve has implied that it will reduce interest rates in response to the recent economic weakness and the markets are currently pricing in 3 interest rate cuts. Bond yields have plummeted on this news, which should support credit creation and debt service costs (Figure 8).

Figure 8: U.S. 30-year government bond yield (orange, rhs) and Canada 30-year government bond yield (blue, lhs)



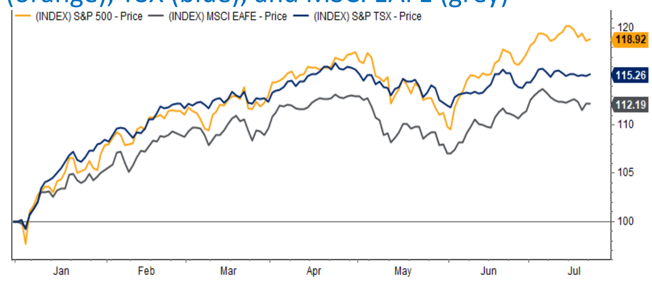
Source: FactSet

Equity Commentary

Equity weightings remained below the benchmark in all portfolio objectives. Balanced accounts' equity weightings are approximately 50% 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).

Equity markets held onto their first quarter gains in Q2 (Figure 9). To date, the S&P 500, S&P/TSX, and MSCI EAFE are up around 19%, 15%, and 12% respectively.

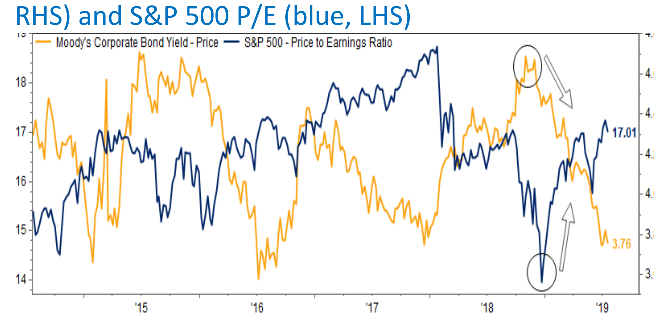
Figure 9: Year-to-date price performance of S&P 500 (orange), TSX (blue), and MSCI EAFE (grey)



Source: FactSet

Higher share prices are encouraging, though we are not fully convinced this rally is sustainable. Stock prices are ultimately driven by higher earnings. Earnings growth continues to deteriorate and, since Q1, ~65% of EPS (earnings per share) estimate revisions have been negative. In lieu of higher earnings growth, the rally is predicated on hopes for a U.S.-China trade-war ceasefire and China stimulus reaccelerating global activity. The latest tailwind for stocks came from central banks as they shifted their bias towards easing and indicated a willingness to cut interest rates. The prospect of accommodative policy sent bond yields lower and had a direct positive impact on equity valuations (Figure 10).

Figure 10: Moody's corporate bond yields (orange, RHS) and S&P 500 P/E (blue, LHS)

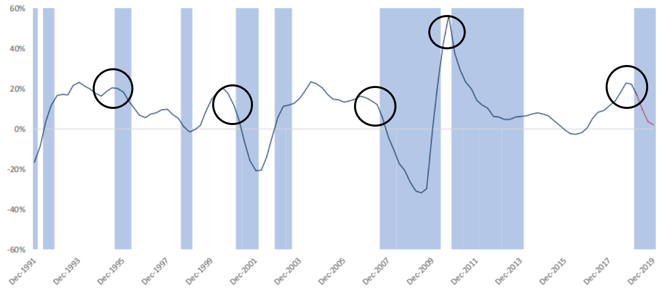


Source: FactSet

The interaction between stocks and interest rates is somewhat counterintuitive. Traditional valuation methodology explicitly states that lower interest rates justify higher valuations (stock prices). However, the reason for lower interest rates should be considered. Central banks are pursuing monetary stimulus because economic conditions are deteriorating. Historically, periods of central bank easing have not been prosperous times for U.S. companies and have typically seen EPS growth slow

(Figure 11). This contradicts the broadly accepted notion that lower interest rates stimulate economic activity. In a low interest rate world, where nearly $13 trillion of debt is negative yielding, we question whether cheap money is as stimulative as it was in the past.

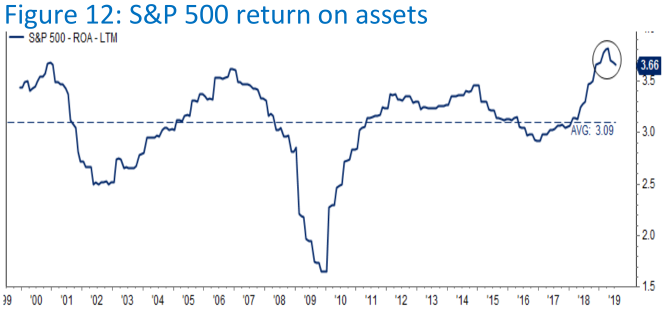
Figure 11: EPS growth (line) and Federal Reserve easing (shaded area)



Source: RBC US Equity Strategy, FactSet/Thomson, Haver

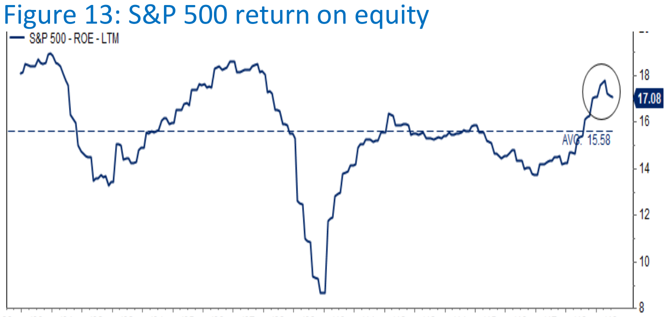
Adding to our concerns, the U.S. (and most developed markets) is firmly in the late-cycle phase. Near-term recession risk remains low, though the outlook for a sustainable increase in profitability is bleak. Economic activity has slowed and will likely pressure revenue growth. At the same time, companies are reporting difficulties offsetting costs from tariffs and rising labour expenses. Companies are operating at incredibly efficient levels that will be difficult to maintain (Figures 12 and 13).

Figure 12: S&P 500 return on assets



Source: FactSet

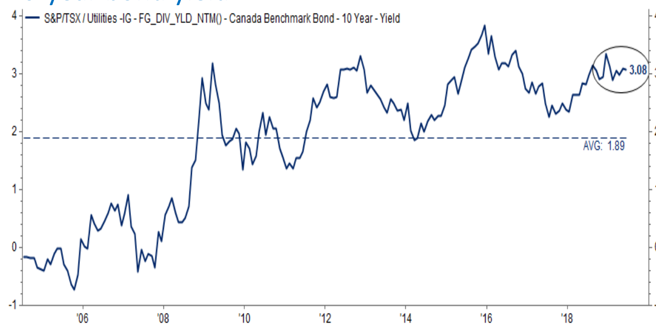
Figure 13: S&P 500 return on equity



Source: FactSet

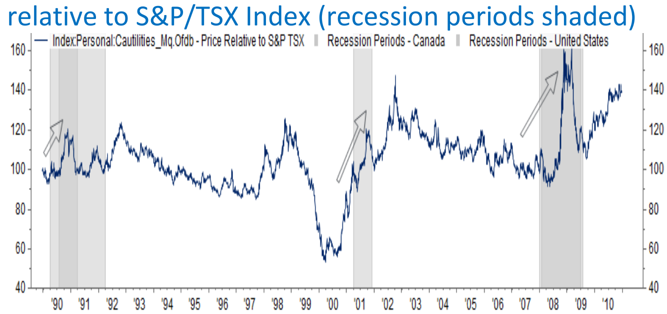
We continue to overweight the Utilities sector. It offers a dividend yield of 4.5% which is particularly attractive when compared to 10-year Government of Canada bonds yielding 1.5% (Figure 14). Though a near-term recession looks unlikely, we note that the sector has significantly outperformed the broader S&P/TSX index during economic downturns (Figure 15).

Figure 14: S&P/TSX Utilities sector yield minus GoC 10-year bond yield



Source: FactSet

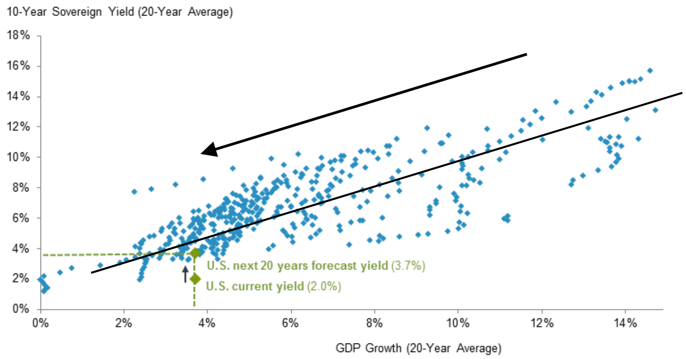
Figure 15: S&P/TSX Utilities sector price performance relative to S&P/TSX Index (recession periods shaded)



Source: FactSet

We continue to maintain an underweight position in Canadian financials. We have written extensively about the challenges facing the banks, including slowing mortgage growth due to unaffordable housing, the indebtedness of Canadians, and the flattening yield curve compressing margins. These challenges linger and keep us unenthusiastic about the sector. Longer term, we are concerned about the effects of low interest rates on the banks' profitability. Over long periods of time, government bond yields are closely correlated with GDP growth (Figure 16). It is reasonable to expect that GDP growth will continue to decline as developed countries mature.

Figure 16: Nominal U.S. government bond yields and GDP growth



Source: Fidelity Investments

Negative policy rates have been introduced in Japan and Europe and have run counter to their intended goals. In particular, negative rates reduced spending as consumers were forced to increase their savings rate to offset lower rates of return. Bank lending margins were also hurt. Combined, the effects of negative policy rates significantly reduced bank loan origination. It is likely this played a role in the underperformance of European and Japanese banks relative to U.S. banks (Figure 17). If interest rates are destined to go lower in the long-run, we worry that U.S. and Canadian banks will face the same challenges as their European and Japanese peers.

Figure 17: Global bank stocks

Source: Fidelity Investments

It was a quiet quarter for our portfolios. Transactions for the quarter include:

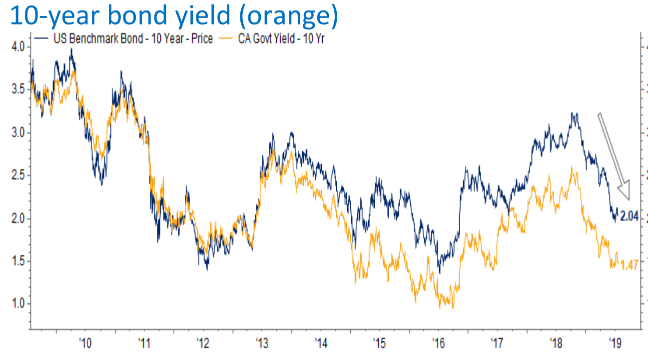
Power Corporation was sold in May after Great-West Life reported very disappointing quarterly earnings. Higher taxes and weaker results in Canada, the U.S. and Europe led to earnings per share well below consensus estimates. Great-West Life makes up approximately half of Power Corporation's net asset value. Heading into the report, Power had performed very well on the back of a large share buyback program initiation. Due to our dampened outlook on Great-West Life, we decided to sell our shares in Power and reallocate them into an investment where we saw more potential for share price appreciation.

Given our significant underweight position in financials, we purchased U.S. regional bank **BB&T** with the proceeds from the Power Corporation sale. BB&T announced a merger of equals with SunTrust to form a superregional bank with assets of $442 billion. The deal is accretive to earnings and tangible book value. The two banks are concentrated in the Southeastern United States, which is one of the fastest growing regions in the country. The combined entity offers plenty of opportunities for synergies over the next few years through branch consolidation and scale. The two entities will combine different strengths that complement each other with BB&T owning a leading insurance brokerage business that SunTrust lacked and SunTrust owning much stronger positions in investment banking and commercial banking that improves the overall positioning of both firms.

Fixed Income

Bonds posted strong positive returns again in the second quarter. The Federal Reserve and the Bank of Canada firmly shifted their tone and have adopted a more accommodative stance. Expectations of rate cuts sent yields sharply lower in Canada and the U.S. (Figure 18).

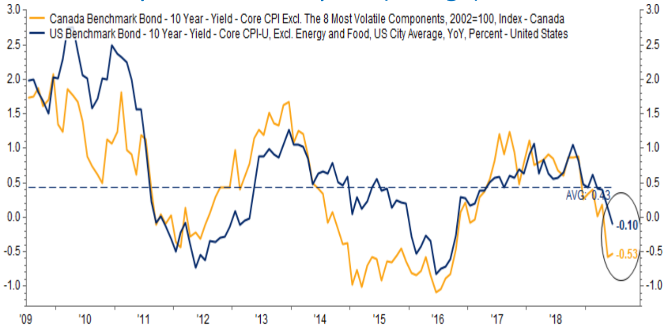
Figure 18: U.S. 10-year bond yield (blue) and Canada 10-year bond yield (orange)



Source: FactSet

We remain underweight bonds in our portfolios. Yields remain incredibly unattractive, particularly after adjusting for inflation. Real yields on 10-year government bonds in Canada and the U.S. are -0.53% and -0.10% respectively.

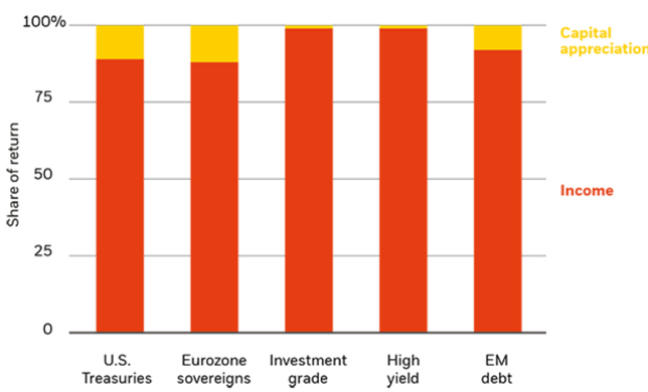
Figure 19: U.S. 10-year bond real yield (blue) and Canada 10-year bond real yield (orange)



Source: FactSet

Investors have enjoyed strong capital gains in fixed income lately given the decline in yields. We are hesitant to extrapolate this performance forward. Historically, coupon income has made up the majority of total return across global fixed income markets, not capital appreciation (Figure 20). Given how low coupons are, it is reasonable to expect future bond returns will moderate substantially.

Figure 20: Return sources of fixed income markets from 2001-2019



Source: BlackRock Investment Institute, Bloomberg

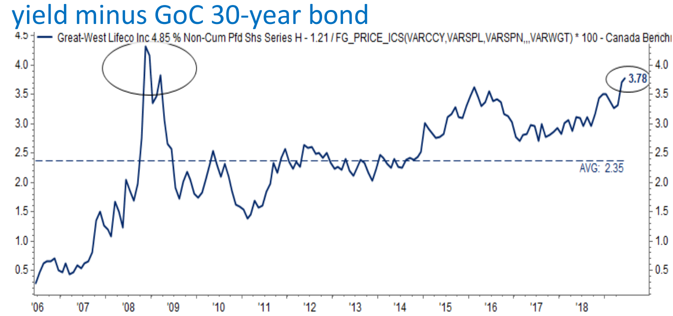
Canadian preferred shares continue to offer great value. Perpetual preferred shares are especially attractive. On average, our perpetuals yield around 5.40% (pre-tax bond equivalent yield of 7.02%), significantly more than 30 year Government of Canada bonds (Figure 21).

Figure 21: Canadian Utilities preferred Series BB: yield minus GoC 30-year bond

Source: FactSet

Spreads of perpetual issues over Government of Canada bonds have widened out to extreme levels and are near where they were during the peak of the Great Financial Crisis (Figure 22). There is a significant amount of risk priced into preferred shares already. Should the economy enter a downturn, preferred shares will certainly suffer. However, these extreme starting levels should support share prices.

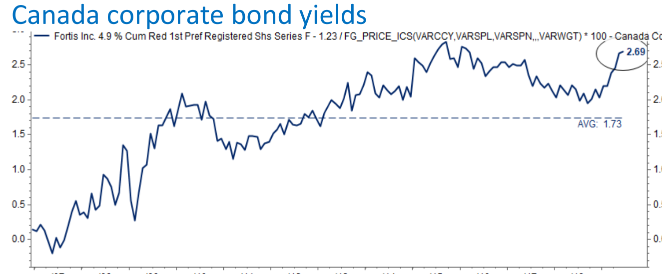
Figure 22: Great-West Lifeco Inc preferred Series H: yield minus GoC 30-year bond



Source: FactSet

Preferred shares are not only attravtive relative to government bonds, but also corporate bonds (Figure 23). The difference between preferred share yields and corporate bond yields is at all-time highs. This bodes well for preferreds as investors continue their search for yield in today's low interest rate environment.

Figure 23: Fortis Inc preferred Series F: yield minus Canada corporate bond yields



Source: FactSet

Performance

Our portfolios were up modestly in Q2 but slightly underperformed the Balanced Benchmark. Canadian equities outperformed while U.S. and international stocks lagged their respective benchmarks. Fixed income returns were below the benchmark.

Both asset allocation and stock selection helped our Canadian equity returns. Overweight defensive sectors contributed to the outperformance as our health care and utilities holdings outperformed. Extendicare (+11.27%), Hydro One (+10.02%), TC Energy (formerly TransCanada +8.16%), Northland Power Inc. (+8.05%) and Emera Inc. (+7.08%) were all notable outperformers.

Our U.S. equities were up around 1.5%, lagging the S&P 500 return of 2.3% (CND dollar). 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. Walgreen Boots Alliance (-15.32%) and Alphabet (-9.72%) were notable detractors. Constellation Brands (+10.08%), Visa Inc. (+8.89%), and Costco (+6.95%) had solid quarters.

International stocks slightly underperformed their benchmark. Medtronic PLC (+4.79%) and Rio Tinto PLC (+4.07%) were among the better performers.

Our fixed-income returns lagged the broad bond composite gain of 2.5%. Underweight bonds and being primarily invested in the short-end of the curve hurt returns. Our preferred shares were down ~0.5%, outperforming the S&P/TSX Preferred Share Index return of -2.02%. 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.

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