RBC Dominion Securities Inc.

Fickel’s Focus

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Second Quarter 2021 Investment Commentary

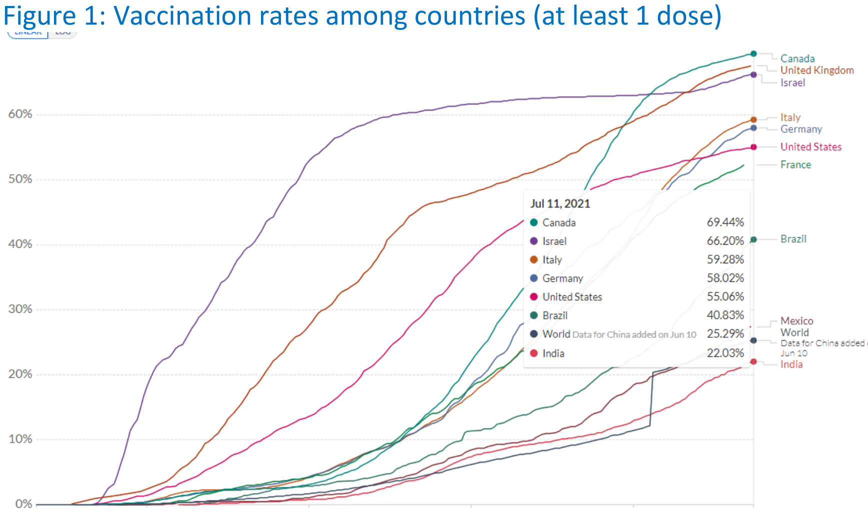
Global equities delivered extraordinary returns during the quarter while bonds increased modestly. Accounts on board for the full period and migrated to their appropriate models produced strong positive returns.

Economic Overview

Global growth accelerated in Q2 as vaccination rates ramped up and business/mobility restrictions were lifted. The pace of the economic recovery has been remarkable. J.P.Morgan forecasts that Q2 real GDP grew 7.7% year-over-year in developed markets and that the U.S. led the pack at 9% yoy. Hindered by lockdowns and restrictions on activity, Canada’s Q2 real GDP growth is expected to have lagged its developed counterparts at 3% yoy (J.P.Morgan).

It is safe to assume that widespread immunization is a prerequisite for reopening. Canada is leading the vaccine campaign having inoculated nearly 70% of its population with at least 1 dose at the time of writing (Figure 1). With vaccination efforts ramping up globally, expect other regions to start catching up.

Figure 1: Vaccination rates among countries (at least 1 dose)



Source: COVID19Tracker.ca

While perhaps unrelated to the economic backdrop, we are pleased to see higher vaccination rates concentrated among those deemed "at risk" (Figure 2). Hopefully this translates into reduced hospitalizations, a speedier return to normalcy, and most importantly, fewer COVID-19 related deaths.

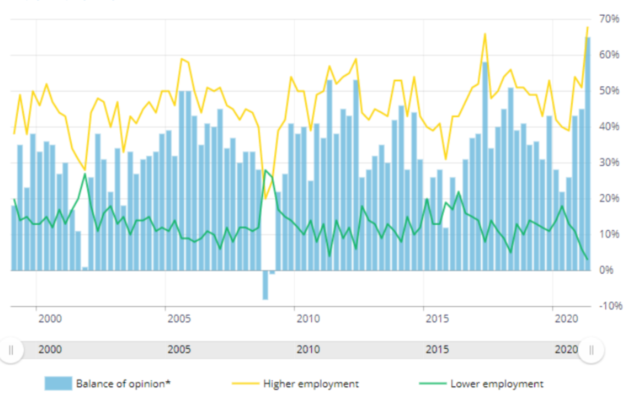
Figure 2: People who have received at least one dose in Canada by age group

Age group (years)	At least one dose
0 to 11	0.22% (10,382)
12 to 17	66.31% (1,620,238)
18 to 29	65.30% (3,929,376)
30 to 39	70.13% (3,711,672)
40 to 49	76.79% (3,727,624)
50 to 59	80.63% (4,188,484)
60 to 69	89.16% (4,215,153)
70 to 79	94.04% (2,825,804)
80 and older	94.08% (1,565,250)

Source: Government of Canada

Demand for labour remains healthy amid the ongoing reopening. Following a strong jobs report in June (+230,000 jobs), Canadians have recovered roughly 90% of the jobs lost at the beginning of the pandemic. At 7.8%, the unemployment rate is still well above pre-pandemic levels, but elevated hiring intentions (Figure 3) shared among Canadian businesses implies solid job creation over the coming quarters.

Figure 3: Bank of Canada BOS – business' hiring intentions



Source: Bank of Canada Business Outlook Survey

On top of an improving labour market, Canadian consumers, and by implication consumption, are also benefitting from government stimulus and financial and house asset appreciation. It is estimated that wages fell by $36 billion in 2020 while government transfers to households exceeded $117 billion. We expect built-up savings to support consumer spending in the near term.

South of the border, only about 65% of jobs lost to the pandemic have been regained. While we continue to search for clarity on this, it looks like a combination of factors are contributing to the sluggish employment recovery, including generous unemployment benefits, unavailable and/or unaffordable childcare, and fears of contracting COVID-19. With a record 9.3 million job openings in the U.S., we are confident job creation will pickup in the fall as schools reopen and government-funded benefits lapse.

Similar forces are underway outside of North America, with divergences typically owing to varying vaccination rates. The Eurozone has immunized roughly 45% of its population (1 dose), lagging the U.S. and Canada. Vaccination rates and GDP growth in the Euro area are expected to accelerate meaningfully in the second half of the year.

As has been the case since the beginning of the pandemic, the path of the virus will dictate the speed and magnitude of the recovery. That said, higher vaccination rates, healthy consumers (labour markets + savings), and a strong inventory cycle for businesses bode well for the global economic backdrop.

Equity Commentary

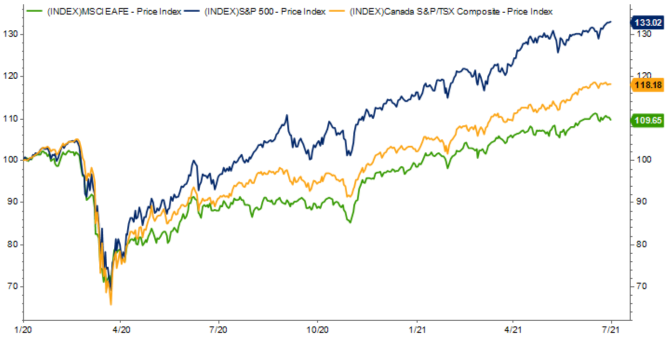
Investors were rewarded handsomely for owning equities in the second quarter, building on already strong gains in Q1 (Figure 4). Looking back further, the S&P/TSX, S&P 500, and MSCI EAFE indexes are well above their pre-pandemic levels (Figure 5).

Figure 4: Benchmark equity returns this year

Market	Q1	Q2	YTD
S&P/TSX	8.10%	8.50%	17.30%
S&P 500	4.70%	7.10%	12.20%
MSCI EAFE	1.40%	3.00%	4.50%
* returns in $CAD			

Source: RBC Capital Markets

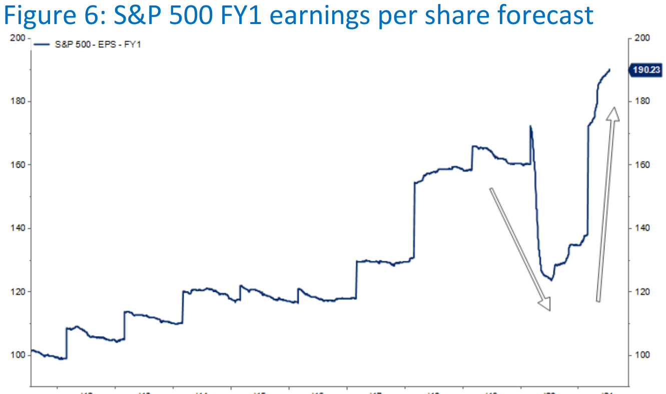
Figure 5: S&P 500 (blue), S&P/TSX (orange), and MSCI EAFE (green) indexed price from 1/1/2020



Source: FactSet

As has been the case for some time now, investors continue to position portfolios according to post-COVID-19 expectations, and rightfully so. Corporate earnings are skyrocketing higher. Q1 S&P 500 earnings grew 52% year over year versus an expected 24%, and Q2 earnings are predicted to come in even higher at 63% yoy. To be fair, high growth rates should be easily achieved as we lap last year's depressed pandemic levels. However it's worth noting that earnings projections for this year have already eclipsed 2019 levels by a wide margin (Figure 6) and healthy growth of about 10% is forecasted for 2022 and 2023.

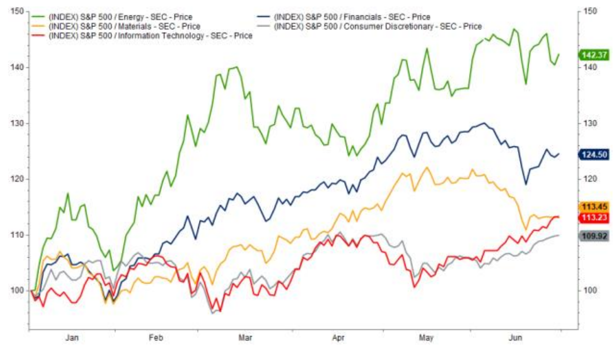
Figure 6: S&P 500 FY1 earnings per share forecast



Source: FactSet

As expected during periods of strong economic momentum, cyclically-oriented sectors have performed well (Figure 7). The Energy, Financial, and Materials sectors are leading the pack year-to-date. Our exposure to banks, Canadian pipelines, and natural resources have benefitted client portfolios. Momentum should continue to be propelled by a combination of powerful tailwinds including massive central bank liquidity, excess household savings from fiscal stimulus, vaccine traction, and a general unleashing of pent-up demand.

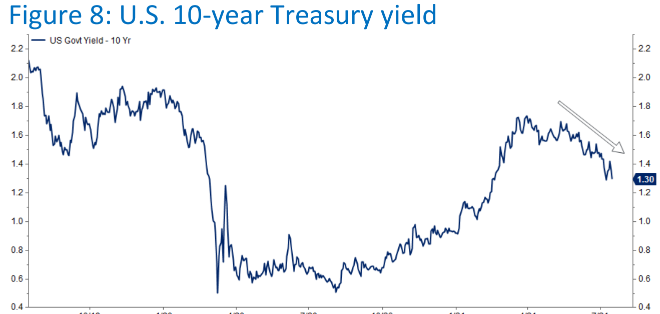
Figure 7: Year-to-date indexed price performance of Energy (green), Financials (blue), Materials (orange), Info Tech (red) and Consumer Discretionary (grey)



Source: FactSet

The questions now become how long will this momentum continue and, more importantly, what level is sustainable after the government stimulus winds down? Markets started exhibiting cautious sentiment at the end of the second quarter which persisted into July, partly evidenced by the recent decline in Treasury yields (often corresponding with slower growth).

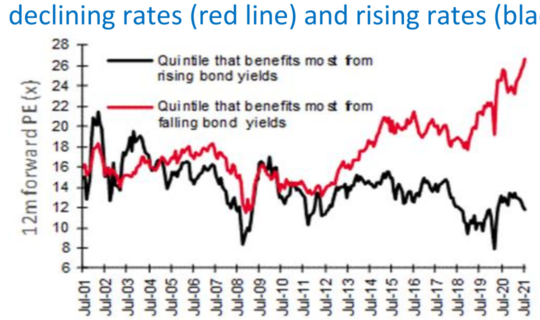
Figure 8: U.S. 10-year Treasury yield



Source: FactSet

Along the same vein, as shown in Figure 9, equity investors started rotating back into stocks that benefit most from lower interest rates (a phenomenon that started over a decade ago but paused during the pandemic recovery).

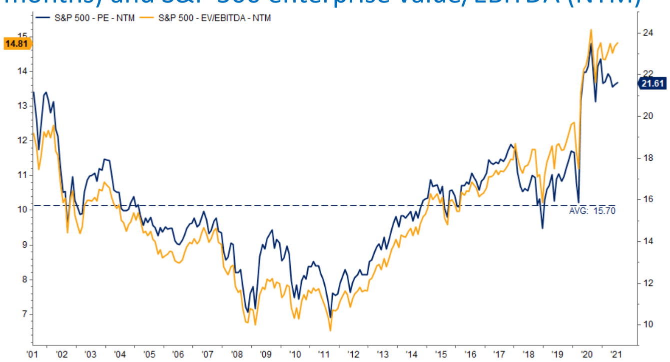
Figure 9: Valuations of companies that benefit from declining rates (red line) and rising rates (black line)



Source: Bloomberg

It is difficult to determine where the balance lies when looking at growth beyond the pandemic. Complicating matters more are expensive valuations for equities (Figure 10). Slowly-growing mature economies and low interest rates have led to a dearth of opportunities for investors around the world. The opportunity cost of holding cash is high – investors can bite the bullet and pay up for equities, which will likely produce below average but still positive real returns, or, earn negative real returns on their cash. We anticipate this line of reasoning will keep a floor on valuatons that is above long-term averages. It is worth noting that today's highly cash generative and asset-light companies differ from their predecessors and deserve higher valuations.

Figure 10: S&P 500 price/earnings ratio (next twelve months) and S&P 500 enterprise value/EBITDA (NTM)



Source: FactSet

We maintain an overweight postion to equities in our balanced portfolios, predicated on the view that equity premiums are warranted and still more attractive than low-yielding bonds. Within equities, we continue to like predictable, stable companies that offer investors income. Our utilities (Hydro One, Emera, and Canadian Utilities) and Bell Canada (BCE) collectively yield ~3.4% more than Canada 10-year bonds, well above the long term average (Figure 11).

Figure 11: Our CA utilities and BCE dividend yield minus GoC 10-year treasury yield

Source: FactSet

We think the pandemic recovery trade has a little more room to run and that reopening beneficiaries can move higher. Our equities most levered to this theme are the airlines, Air Canada and Delta Air Lines. These stocks have pulled back as of late due to concerns over the Delta variant and the uneven nature of travel recovery – the U.S. is well ahead of the rest of the world. If you believe that COVID-19 will eventually be in the rear view mirror, which we do, then these stocks should offer some decent appreciation from current levels. Air Canada and Delta trade at roughly 50% and 75% of their pre-pandemic prices.

The recent rotation out of cyclicals and into low-interest rate beneficiaries may prove to be premature. Powerful tailwinds are still behind the global economy and should remain in place for some time. The ongoing recovery should benefit our economically sensitive holdings, including the financials (Royal Bank, TD Bank, Truist Bank – potentially higher interest rates, lower credit losses, rising loan growth) and the raw materials (Teck Resources, Enbridge, TC Energy – rising capital expenditures, renewed inventory cycle, growing energy demand).

Large capitalization technology stocks have dominated the indexes during the pandemic largely due to accelerating digital adoption. They trade at excessive valuations, but we continue to own these companies for their diverse earnings streams, organic growth opportunities and sheer dominance in their respective markets (Alphabet, Microsoft, Facebook and Visa).

Trading activity was light during the second quarter of the year.

Positions in **Air Canada** were added to in May as vaccinations ramped up. The company has undergone significant cost cutting measures and raised capital during the past nine months to better position itself to capitalize on a recovery in air travel.

Holdings in **Merck** were added to during the period. The company's major product segments are in oncology, vaccines and animal health. Merck's blockbuster cancer drug, Keytruda, is the key growth driver for the company. The drug has patent protection until 2028, which gives them plenty of time to generate significant cash flow, develop its pipeline and deliver solid returns to shareholders. The stock has lagged during the pandemic, creating an attractive entry valuation around 12x next year's earnings per share.

We added to positions in **Truist Financial** in the final days of the quarter. Truist is the sixth largest U.S. bank by assets and has an attractive footprint heavily concentrated in higher growth southeastern states. We expect the recently merged BB&T and Sun Trust entity to continue to realize cost synergies in the near term and will benefit from the economic recovery.

Holdings in **West Fraser Timber**, the largest and lowest-cost producer of lumber in North America, were trimmed for a third consecutive quarter. Pent up housing demand among Millennials, limited housing supply in the U.S., and ultra-low interest rates unleashed demand for lumber during the pandemic. Despite lumber prices still being well above their 10-year average, we think it's time to take profits given the cyclicality of the commodity and the recent decline in prices. We trimmed the shares in May at $92.72 after purchasing them last year at $45.19.

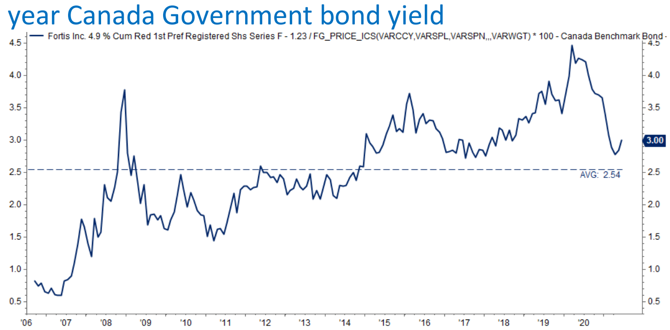
Fixed Income

The fixed income realm is being dominated by conversations on inflation and whether the elevated prices we're experiencing today are transitory or here to stay. From a bond allocation perspective, our thoughts on the topic would quite simply be, does it matter? Real bond yields in Canada and the U.S. are near all-time lows, at -0.79% and -2.44% respectively (30-year government bonds). Higher inflation would make those already dismal yields even worse. If inflation came in below estimates, bondholders could potentially experience a capital gain, but that would require nominal rates to move even lower from historically ultra-low levels. From our perch, the risk/reward is very unattractive and we prefer to allocate more weight to high-dividend equities.

Regarding the inflation debate, higher prices are most definitely being felt and will likely persist into 2022 and possibly 2023. Looking out beyond 2023 we question how the environment will have changed from the past decade during which inflation was pretty tame. Especially considering the fact that the labour market isn't expected to return to full employment for some time (which is often a prerequisite for higher inflation). That said, once inflation gets out, it can be very difficult to reign in. We hold a small portion of floating rate preferred shares that would benefit from an inflationary environment.

We continue to own perpetual preferred shares in client portfolios. These issues pay the same dividend into perpetuity and currently offer yields around 4.5-5%. While these preferreds have performed well and their absolute dividends are now below average, they still offer significantly more yield than Canada bonds (Figure 12).

Figure 12: Fortis Series F dividend yield minus 30-year Canada Government bond yield



Source: FactSet

Performance

Client portfolios remain comfortably ahead of their respective benchmarks after fees both on a year-to-date and 1-year basis. In the second quarter, accounts produced strong positive returns but underperformed their respective benchmarks.

Fixed income holdings delivered returns that were in line with the benchmark for the quarter. Underweight bonds and being short duration detracted from relative performance but was offset by strong returns from our preferred share holdings. Preferreds that are sensitive to interest rates outperformed. The **BCE** floating rate shares and the **Enbridge** U.S. dollar rate reset, both widely held in portfolios, delivered double digit returns during the quarter.

Canadian equity holdings enjoyed solid positive returns but fell short of the 8.5% total return from the S&P/TSX Index during the quarter. **Teck Resources** (+18.6%) was the top performer as the company benefitted from multi-year highs in commodity prices. The largest weight in accounts, **BCE** (+9.3%), aided relative returns after providing an encouraging outlook during their quarterly earnings call. Two stocks were notable detractors. **Manulife** (-9.7%) retreated as bond yields fell and **Canadian National Railway** (-10.3%) slipped on news that it reached an agreement to purchase Kansas City Southern railway. While the market felt the price paid was expensive, we believe this deal will deliver excellent value over the long term due to the very limited overlap of the two company's networks. It is next to impossible to build new railway lines in North America and the combined operation, if approved by regulators, will provide CNR with a competitive advantage in terms of network reach that is unlikely to be matched by competitors.

Balanced portfolios benefitted from a significant overweight position in U.S. equities with an average weight of approximately 32% versus 20% in the benchmark. Client holdings slightly underperformed the S&P 500 7.1% total return (in $Cdn) as growth stocks came back into favour. Top performers among client holdings were dominated by technology-related names including **Alphabet** (+19.5%), **Facebook** (+16.4%), **Microsoft** (+13.3%) and **Visa** (+8.9%). Big-box retailer **Costco** had a notable rebound (+10.7%) after experiencing a pullback during the first quarter of the year. Utility **PG&E** (-14.4%) was a notable decliner as dry climate conditions in California persist and fire concerns remain elevated. The utility has been spending heavily on fire mitigation and remains very cheap on a valuation basis. **Delta Air Lines**, a position we trimmed near its post-pandemic highs in Q1, retreated on concerns over the Delta COVID variant depressing air travel. **Truist** (-6.2%) dipped as bond yields drifted lower which will impact banks' profitability.

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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