RBC Dominion Securities Inc.

Fickel's Focus

Wealth Management
Dominion Securities

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, CFA
Associate Advisor
416-960-6816
nathan.fickel@rbc.com

Second Quarter 2022 Investment Commentary

The second quarter was incredibly difficult for almost all investors as both equities and bonds delivered sharp capital losses. The S&P/TSX, S&P 500 and MSCI EAFE indices finished down 13.2%, 13.6%, and 15.4% respectively (in $CAD). The Canadian Broad Bond Composite declined 5.7%. We are pleased to write that accounts on board for the full period and migrated to their appropriate models outperformed their respective benchmarks.

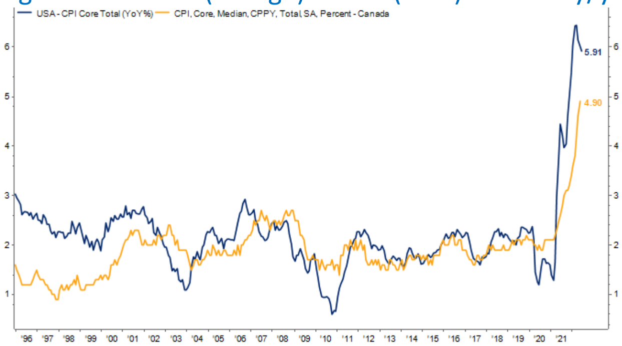
Overview

A challenging quarter for investors is, unfortunately, quite the understatement. Equities sold off globally and the S&P 500 officially reached bear market territory in Q2. Bonds, which for many are held to provide portfolio ballast, were not exempt from the carnage. Our defensive positioning mitigated some of the declines though portfolios still endured negative absolute returns. In the wake of these sharp corrections we're beginning to see silver linings emerge. Equity sentiment indicators are deeply oversold offering *some* reassurance that markets have accounted for much of the bad news. The credit market sell-off has seen yields move markedly higher to levels that we think are reasonable for bond investors. Perhaps even more important, the improved attractiveness of bonds should allow the asset class to re-establish itself as a portfolio diversifier.

Headwinds that emerged prior to Q2 continue to linger and are worsening in some cases. Elevated inflation is particularly painful for households and businesses with little evidence of moderating to tolerable levels anytime soon. As headline inflation nears double digits year over year, households are only modestly growing their nominal spending which is translating into negative real consumption growth. In other words, consumers are spending a similar amount of money as they did last year but receiving fewer goods and services. Higher interest rates, which in essence is the cost of money, is also challenging for anyone seeking financing or servicing outstanding debt. Canadians in general appear to be vulnerable to this phenomenon given our high level of debt to disposable income, contrasting households south of the border that have broadly de-levered in the wake of the Great Financial Crisis. The culmination of these difficulties and others yet to be mentioned is a growing consensus view that a recession is on the horizon. Whether or not the technical definition of recession will be met, a slowdown is certainly in the cards. The question now becomes to what degree and duration.

Multi-decade highs in inflation (Figure 1) are squeezing household purchasing power and wages are not keeping up (Figure 2).

Figure 1: Canada (orange) & U.S. (blue) core CPI y/y



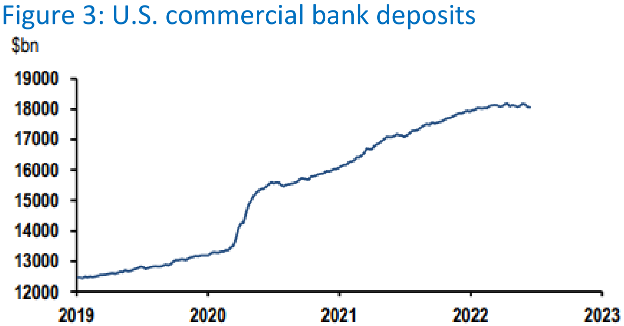
Source: FactSet

Figure 2: U.S. wage growth minus core CPI

Source: FactSet

A slowdown in real (after inflation) spending is inevitable but fortunately households still possess a significant level of savings that should offer some cushion. Although down slightly over the past few months, nominal deposits and other cash-like assets still remain well above pre-COVID levels (Figure 3).

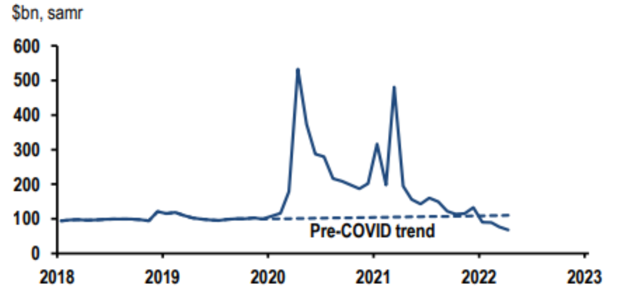
Figure 3: U.S. commercial bank deposits



Source: FRB

These accumulated deposits are however being drawn on as households dip into their savings to meet their spending requirements (Figure 4). The personal savings rate dropped to 5.4% in May, one of the lowest levels since 2008. We expect this to continue as households try to keep up with inflation but we are cognizant of the fact that it cannot carry on indefinitely.

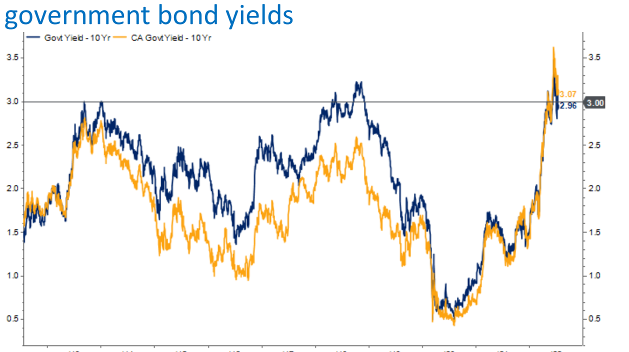
Figure 4: U.S. personal savings rate



Source: BEA, J.P. Morgan

On top of inflation, higher interest rates are a headwind for borrowers in nearly all developed markets right now. In Canada and the U.S., yields are near 10-year highs (Figure 5) and putting upward pressure on the cost of capital.

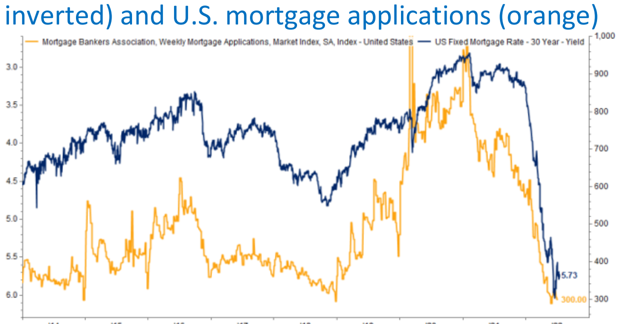
Figure 5: Canada (orange) and U.S. (blue) 10 year government bond yields



Source: FactSet

Housing in particular is vulnerable to a slowdown induced by higher borrowing costs. Mortgage applications surged during the pandemic as mortgage rates declined to historic lows (Figure 6). This dynamic has since reversed and we believe it is only a matter of time before tepid buying activity translates into lower home prices.

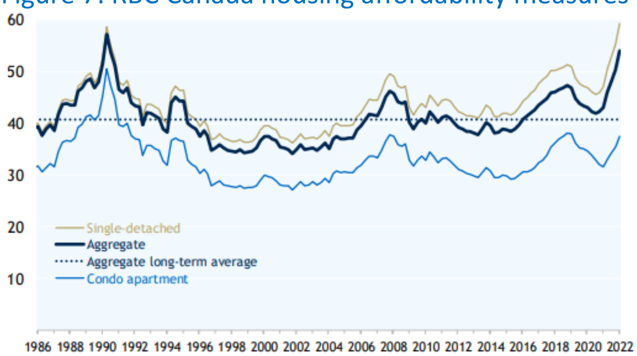
Figure 6: U.S. 30-year mortgage rate (blue, left, inverted) and U.S. mortgage applications (orange)



Source: FactSet

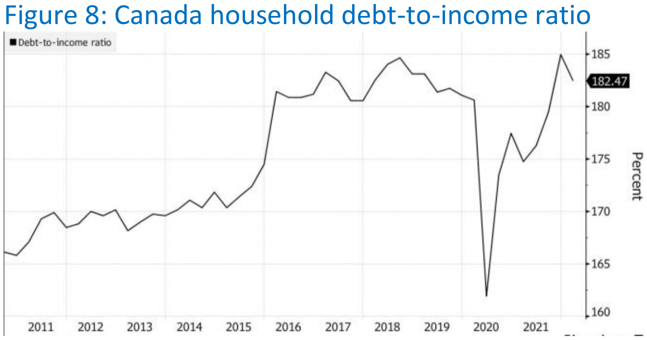
It is a very similar story in Canada although unaffordability and high debt levels pose greater risks. RBC's aggregate affordability measure for Canada rose to the worst level since the early 1990s (Figure 7). Home prices have declined slightly from earlier this year but the rise in interest rates has more than outweighed that moderation and affordability has worsened. All the while Canadians' household debt-to-income ratio is at very high levels historically speaking (Figure 8). We see only two ways out of this affordability challenge: a sharp price correction or lower interest rates. Unfortunately, persistently high inflation is handcuffing central banks and we anticipate a limited appetite for rate cuts from the Bank of Canada for the foreseeable future.

Figure 7: RBC Canada housing affordability measures



Source: RBC Economics

Figure 8: Canada household debt-to-income ratio



Source: Statistics Canada

Flying in the face of these headwinds are strong labour markets which should continue to cushion the economic slowdown. Following the latest June reports, unemployment rates in Canada the U.S. are at 4.9% and 3.6% respectively, very low levels historically speaking. What's more, job seekers continue to be in the driver's seat as job openings remain elevated in Canada and the U.S. at roughly 1 million and 11 million. With the employment backdrop so strong we don't foresee widespread layoffs which is generally a pre-requisite for a deep, prolonged downturn. Still, as headwinds persist and continue to work through the system we view the risks as skewed to the downside.

Equity Commentary

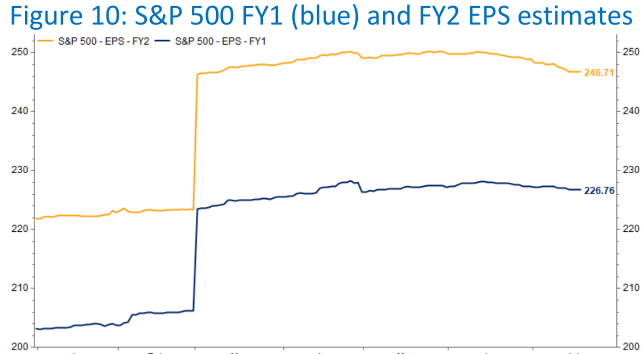
Equity investors suffered in Q2 as markets delivered losses across the board (Figure 9).

Figure 9: Benchmark equity returns this year

Index	Q1	Q2	YTD
S&P/TSX	3.8%	-13.2%	-9.9%
S&P 500	-5.6%	-13.6%	-18.5%
MSCI EAFE Index	-7.6%	-12.8%	-19.5%
*Returns in $CAD			

Interestingly, and perhaps somewhat counterintuitive, earnings projections have actually increased for FY1 (2022) and FY2 (2023) so far this year (Figure 10).

Figure 10: S&P 500 FY1 (blue) and FY2 EPS estimates



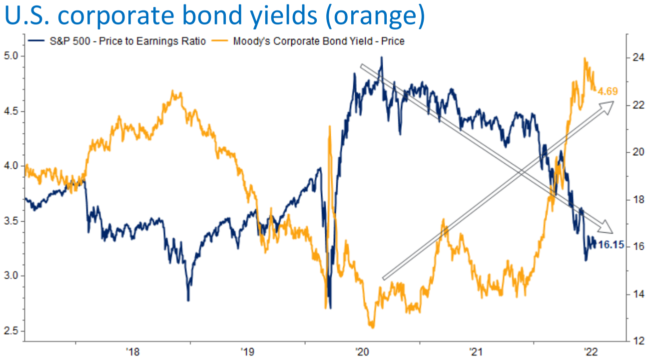
Source: FactSet

The increase in earnings estimates and simultaneous selloff in equity prices means that, by definition, valuations have compressed. The price-to-earnings multiple for the S&P 500 is down roughly 25% so far this year and now sits at about 16x (Figure 11) . We have repeatedly flagged risks around high valuations which was one the key reasons we entered the year defensively positioned. Valuation multiples continue to demonstrate an inverse correlation to interest rates which remain at elevated levels (Figure 12).

Figure 11: S&P 500 P/E multiple, indexed to 100

Source: FactSet

Figure 12: S&P 500 P/E multiple (blue, right side) and U.S. corporate bond yields (orange)

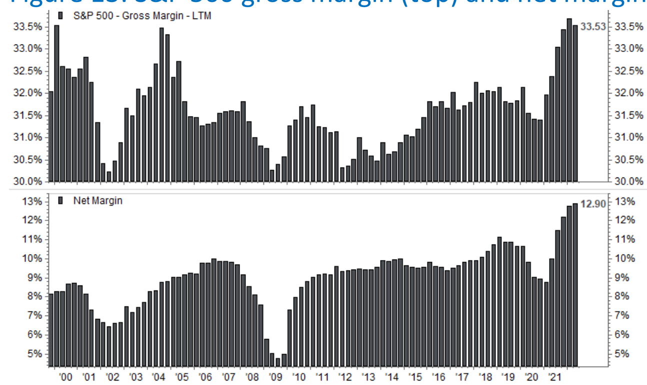


Source: FactSet

Strategists are increasingly prescribing to the idea that an economic slowdown or recession will lead to central banks lowering interest rates and ultimately propel valuations higher. While we understand the argument, we believe its adoption is premature. Firstly, central banks are fully committed to raising interest rates in order to bring down inflation. It would take a great deal of economic pain for them to waver or pivot into a stimulative position. In such a scenario, corporate earnings would almost certainly be challenged and stock prices negatively affected. Secondly, we are just beginning to enter a phase of quantitative tightening which, come September, will see the Federal Reserve potentially shrink its $8 trillion balance sheet to the tune of $95 billion a month. The effects of removing liquidity from the system are difficult to quantify, but, if quantitative easing was intended to depress interest rates, the quid pro quo of quantitative tightening should be a higher cost of capital.

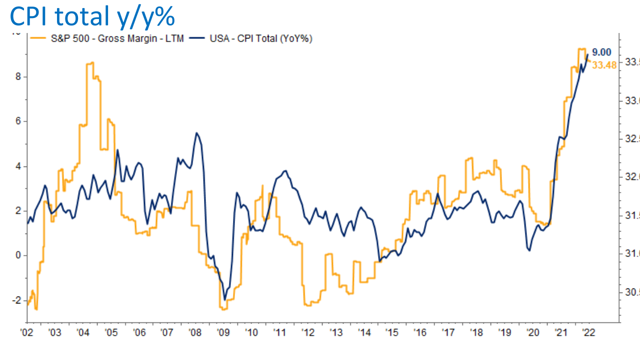
Beyond the macroeconomic headwinds facing stocks, we are cautious on earnings projections. It is remarkable that, in the face of a slowing global economy, earnings have been so resilient. Revenues are generally a function of GDP growth which has seen multiple downward revisions this year. At the same time, peak margins (Figure 13) will be difficult to maintain. The latter will be true particularly when inflation begins to rollover (Figure 14).

Figure 13: S&P 500 gross margin (top) and net margin



Source: FactSet

Figure 14: S&P 500 gross margin (orange) and U.S. CPI total y/y%



Source: FactSet

Based on the headwinds discussed we continue to maintain a defensive posture in portfolios and an underweight allocation to equities. Risks are abound, and our focus remains centred around capital preservation as opposed to being fearful of missing out on the next rally. Defensive positioning has benefitted client portfolios, preserving more capital than the benchmark and enabling us to better take advantage of future opportunities.

Trading

As was the case in the first quarter, equity trading activity in fully invested client accounts was predominantly on the sell side as we reduced risk and lowered equity weights. We executed a number of sales and trims in early April including an exit of our position in **Stanley Black & Decker** as we became increasingly concerned about the effect rising mortgage rates would have on housing-related companies. We also trimmed our 'bond proxy' equities in anticipation of higher yields. Pipelines **Enbridge** and **TC Energy** along with utilities **Hydro One**, **Canadian Utilities** and **Emera** were all taken down in position size. **Manulife** was reduced and we took gains in diversified miner **Teck Resources** at the same time after a big move on the back of strong commodity prices.

In the middle of May, we reduced risk further by removing Corona beer producer **Constellation Brands** and **Delta Air Lines** from portfolios.

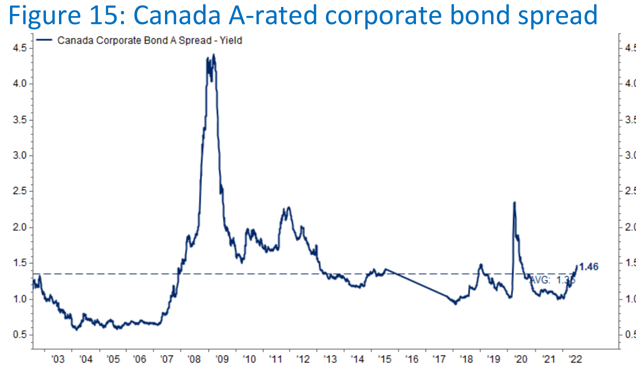
Balanced portfolios are conservatively invested at the mid-point of the calendar year with average equity positions at 43%, well below our benchmark weight of 55%. Average equity weights are down from 54% at the end of the first quarter and 58% at the beginning of the year. A greater share of this reduction has been from our U.S. stocks, which are more growth-oriented and trade at higher valuation multiples compared to our Canadian holdings.

We substantially increased our fixed income allocation which was at 46% by the end of June. Corporate bonds were the main addition, although we also added high-yielding GICs. A bond ladder strategy was implemented and by the end of Q2, portfolios held at least one bond issue maturing every year from 2023 to 2031. Yields are attractive in this part of the curve and, at around 3-4 years, our average bond duration is more conservative than the benchmark's meaning they will exhibit greater price stability. Should an opportunity arise, we would not hesitate to trim our fixed income and deploy the proceeds into equities.

Fixed Income

Interest rates moved higher in Canada in Q2, sending the Canadian Broad Bond Composite down 5.7%. This brings the total YTD performance of the Canadian bond index to -12.2%. Following this year's selloff, we're starting to see decent opportunities in the fixed income space. Firstly, nominal yields are at their highest level in about 10 years. The Government of Canada 10 year yield is over 3%, a level not seen since 2011. Secondly, credit spreads for high-quality Canadian corporates have widened to levels roughly in line with their 20 year average (Figure 15). Though not trading at bargain levels, this suggests that corporate credit is reasonably priced. Lastly, debt issued during the pandemic, when the GoC 10 year yield dipped as low as 0.46%, is trading at significant discounts to par. Capital gains will constitute the majority of the total return for these notes, offering non-registered account holders a significant after-tax benefit. Consider for example an issue owned in portfolios, the TD Bank 2028 maturity in Figure 16. It yields 4.72%, but because of its price below par, it has a taxable equivalent yield of 6.37%. That means you would need a 6.37% GIC (or bond trading at $100) to receive the same after tax return. That kind of after tax return has not been available in well over a decade.

Figure 15: Canada A-rated corporate bond spread



Source: FactSet

Figure 16: TD Bank bond

Bond	Coupon	Price	Yield	Taxable Equivalent Yield
TD Bank 9/11/2028	1.896%	$85.09	4.72%	6.37%

We prefer to invest in the short to medium part of the fixed income curve. If interest rates move higher, our bonds will be more defensive than longer duration bonds. The opposite is true in that if rates go lower, our holdings will participate less in the upside than the benchmark. That said, capital appreciation is not our objective in the fixed income space and we are pleased with the current level of income portfolios are generating.

Performance

Client balanced portfolios fully invested to model significantly outperformed the benchmark return of –9.6% after fees in Q2. Over the past twelve months, we have mitigated some of the market damage with portfolio returns after fees being modestly negative versus the balanced benchmark at –7.74%.

Fixed income holdings outperformed the -5.7% benchmark return in the second quarter. Our conservative bond positioning, consisting of a sizable underweight and short duration, was the key driver of positive relative performance. Returns from client-held preferred shares were a detractor during the period but closed the quarter with yields in the 6% area for many issues with excellent credit ratings. Client holdings in preferred shares have been gradually reduced into strength over the past year with several large issues called and not replaced. Average weights in preferred shares within client portfolios have dropped from 18% to 10% in the last 12 months. GIC holdings added positive returns with recent issues offering yields well above 4% at quarter-end, which is CDIC insured.

Canadian equity holdings in client portfolios easily outpaced the -13.2% total return from the S&P/TSX Index during the quarter. Oil and utilities were the best performing areas with positive returns delivered by **Suncor Energy** (+11.0%), **Hydro One** (+2.2%) and **Canadian Utilities** (+0.2%). Holdings hit hardest in the risk-off transition during the quarter were **Air Canada** (-33.9%), **Teck Resources** (-22.0%) and **Manulife** (-16.3%). We trimmed holdings in both Teck and Manulife near their peaks in April.

Our U.S. holdings outperformed the benchmark S&P 500 total returns in the second quarter. Defensive holdings **Coca-Cola** (+4.5%) **and Johnson & Johnson** (+3.2%) were helped by a flight to safety. Internet-exposed companies suffered the worst, with **Walt Disney** (-29.1%), **Meta Platforms** (Facebook, -25.3%) and **Alphabet** (Google, - 19.3%) hardest hit.

We held no international equities in our balanced model during the quarter.

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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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