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

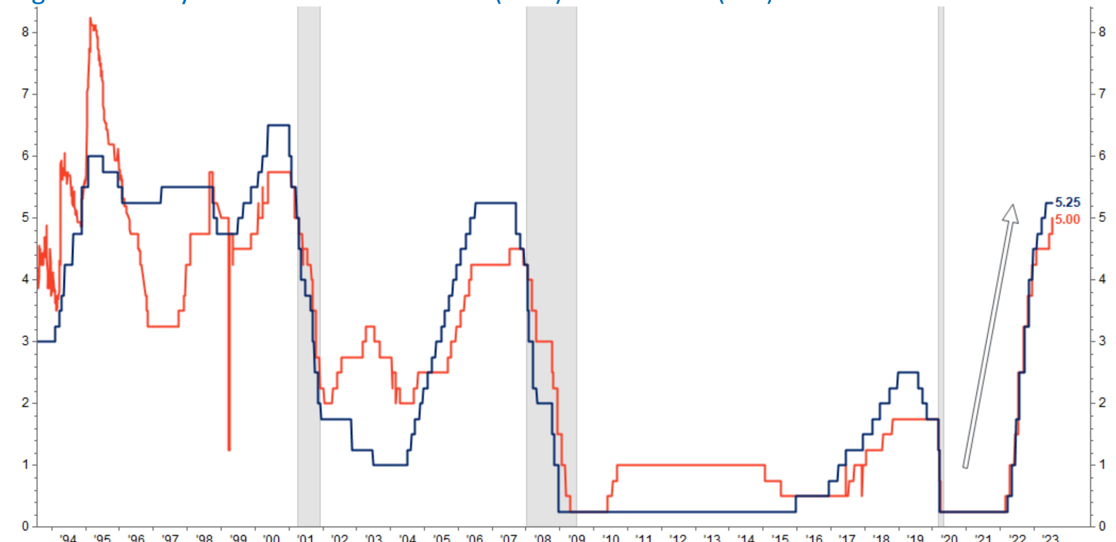
Second Quarter 2023 Investment Commentary

Equity markets built on their strong start to the year in the second quarter. The S&P/TSX, S&P 500 and MSCI EAFE were up 1.1%, 6.5%, and 0.66% respectively in Q2 (returns in CAD). The Canadian Broad Bond Composite was down -0.7% as interest rates increased modestly during the quarter.

Economic Overview

Economic growth has been admirably resilient so far this year with GDP expanding well above expectations in Canada and the U.S. The Eurozone avoided what seemed to be an inevitable recession helped by warmer weather, lower energy prices and the reopening/lifting of restrictions in China, the Union's largest trading partner. All told, growth has been robust, a remarkable feat considering the rapid pace of policy rate increases from central banks around the world (Figure 1).

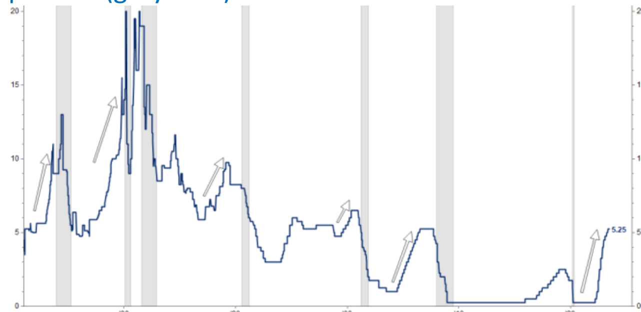
Figure 1: Policy interest rates in the U.S. (blue) and Canada (red)



Source: FactSet

Headlines are dominated by central bank activity right now, and rightfully so. Nearly every hiking cycle from the Federal Reserve has preceded a recession since 1970 (Figure 2).

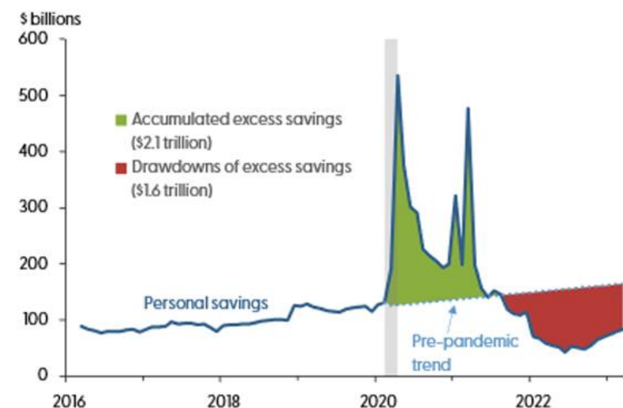
Figure 2: U.S. Fed Funds rate (blue) and recession periods (grey bars)



Source: FactSet

Has the nature of the relationship between monetary policy and economic growth changed or even broken down? Possibly, but unlikely. We continue to expect that higher interest rates will weigh on future activity, although the effects may be delayed this time around. Households are still sitting on excess cash that was accumulated during the pandemic. We've commented on this before, but the drawdown of these savings has been overestimated. Relative to the pre-pandemic trend, there is still some $500 billion of excess savings in the U.S. economy that the Bureau of Economic Analysis estimates will last until 2024.

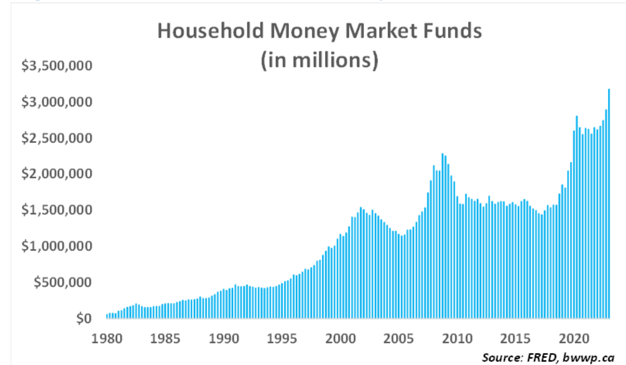
Figure 3: Excess household savings in the U.S.



Source: Bureau of Economic Analysis

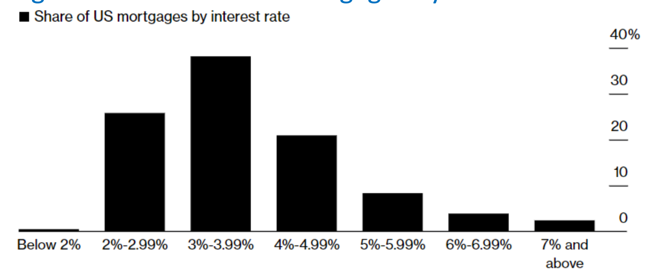
Ironically, thanks to higher interest rates, these savings are now earning significant rates of return. Household money market funds in the U.S. have gone somewhat parabolic in recent months, reaching about $3.2 trillion (Figure 4). Assuming a yield of 5%, these funds are currently generating $160 billion annually or, roughly 0.7% of U.S. GDP – not an insignificant amount. To put it in perspective, in 2022, the roughly $2.6 trillion in money market funds were earning a yield of about 0.5%, amounting to $13 billion annually.

Figure 4: U.S. household money market funds



Excess savings and higher yields are helping the asset side of households' balance sheets, what about their liabilities? Some good news there as well. Unlike in Canada, mortgage rates in the U.S. can be locked in for as long as 30-years. Roughly 96% of existing mortgages in the U.S. are locked in for 25-30 years, many of which are at rates much lower than today's. As shown in Figure 5, about 64% of mortgages are below 4%, and 85% below 5%. This is a different story in Canada where most mortgages are on a 5-year term which presents a risk to households as they renew at higher rates. The rate increases become quite significant for renewals beyond mid-2024.

Figure 5: Share of U.S. mortgages by interest rate



Source: Black Knight, Bloomberg

Clearly household balance sheets remain in good shape, and labour markets are healthy, too. Employment gains continue to be strong in Canada and the U.S. and the unemployment rates low. In the U.S., there's roughly 1.6 jobs available for each unemployed person – down from 2 but still elevated.

While nothing short of impressive, everything just described speaks more to the economy's ability to absorb a shock/higher interest rates rather than grow, especially while monetary policy is so restrictive. We continue to expect slow growth going forward until inflation falls to a level that permits central banks to reverse some of their rate increases.

Equity Commentary

U.S. equities performed very strongly in the second quarter while Canadian and international stocks were up modestly (Figure 6). Year to date returns have been impressive for all three regions.

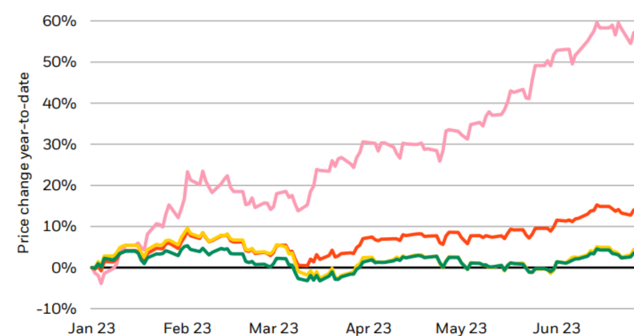
Figure 6: Benchmark equity returns in $CAD

Index	Q1	Q2
S&P/TSX	4.6%	1.1%
S&P 500	7.2%	6.5%
MSCI EAFE	7.0%	0.6%

Source: RBC Capital Markets Quant Research

As was the case in the first quarter, returns were not evenly distributed in Q2. Growth stocks, particularly those of large cap companies, outperformed the markets dramatically. The seven largest companies in the S&P 500 are now up 81% on average so far this year and are responsible for nearly three quarters of the total market return. With 40% of the S&P 500 (200/500 companies) negative as of June 30, the dispersion of returns is extreme. Figure 7 highlights just how wide the margin of outperformance has been for Mega cap companies versus the index.

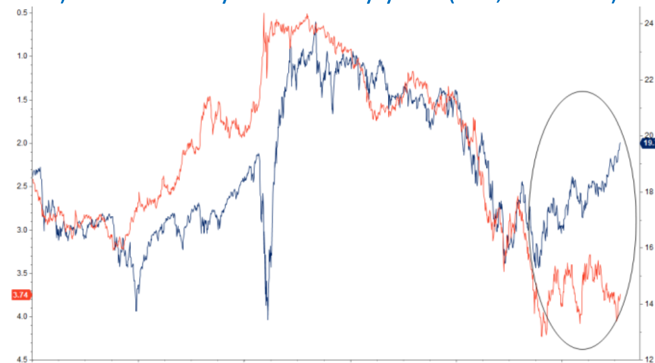
Figure 7: Year to date returns for the S&P 500 (red), S&P 500 Mega Cap (pink), S&P 500 ex Mega Cap (green), and S&P 500 equal weight (yellow)



Source: BlackRock Investment Institute

We continue to be surprised by the U.S. market's resilience despite higher interest rates. Valuations and rates are negatively correlated, but the S&P 500 price to earnings ratio still trades at a large premium to its long-term average (Figure 8).

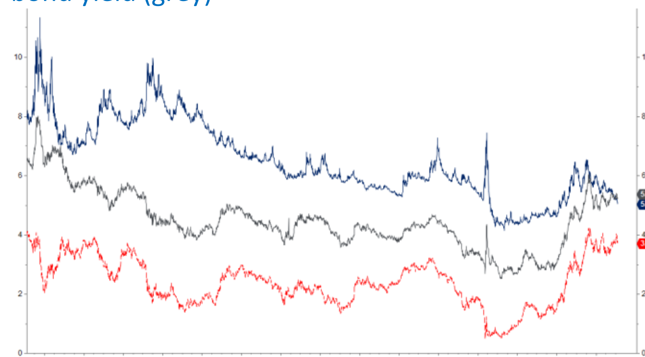
Figure 8: S&P 500 price to earnings ratio (blue, right side) and U.S. 10-year treasury yield (red, inverted)



Source: FactSet

Higher interest rates affect the discounting methodology used in financial models (higher rates = lower valuations), but they also impact the relative attractiveness of equities versus fixed income. The earnings yield, which equals earnings per share divided by price (EPS/share price), can be compared to bond yields to assess relative value and the risk premium equity investors are assuming for owning common shares. The earnings yield premium for the S&P 500 versus U.S. Treasury yields has narrowed to the lowest level in 15 years. Over the same period and for the first time, U.S. corporate bond yields now exceed the S&P 500 earnings yield (Figure 9).

Figure 9: S&P 500 earnings yield (EPS/price, blue), U.S. 10-year treasury yield (red), and U.S. corporate bond yield (grey)

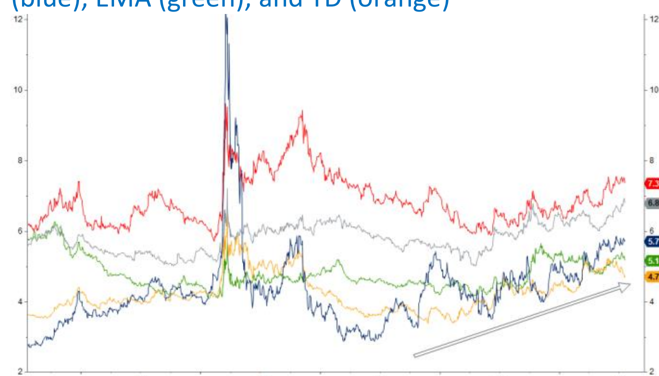


Source: FactSet

We are modestly underweight U.S. equities versus the benchmark. Above average valuations, high interest rates, and late cycle/sluggish economic growth could weigh on the region's forward returns.

Up 1.1%, it was a sluggish quarter for Canadian equities, but they have performed well so far this year thanks to strong gains in Q1. Still, many core Canadian holdings have been relatively lousy performers this year, including banks, telecomunications companies, utilities, as well as energy-related names. We think this is likely due to, again, rising interest rates, and the diminishing relative appeal of Canadian dividends. That said, dividend yields have risen and are getting close to levels that should provide a floor for share prices, particularly if interest rates plateau. A handful of company dividend yields are highlighed in Figure 10, including Enbridge – 7.37%, BCE – 6.82%, and Suncor – 5.73%.

Figure 10: Dividend yield for ENB (red), BCE (grey), SU (blue), EMA (green), and TD (orange)



Source: FactSet

Despite some opportunities emerging, we continue to remain underweight Canadian equities and allocate more to fixed income.

Trading activity during the quarter started off by reestablishing a position in U.S. utility PG&E. The company generates and transmits electricity for 5 million customers and transports and stores natural gas for 4 million in Northern California. The utility offers the highest rate base growth in the sector at 8%+ compounded annually over the next five years and trades at a discount to peers. Longer term, PG&E will invest meaningfully in electrification and wildfire mitigation that should support a premium growth rate beyond this time frame. We have been very impressed with CEO Patti Poppe and the efforts she has taken to repair the company's image since taking over in January 2021.

We trimmed our positions in BCE in June. Competition is picking up in the industry and the stock's valuation had become expensive. We also sold our U.S. telecom holding, AT&T, due to growing speculation that Amazon is preparing to offer phone plans to Prime members. AT&T also lost some of our confidence after a large free cash flow miss in Q1.

Holdings in Canadian Apartments REIT and Minto Apartment REIT were sold in June. Both companies hold a large share of their rental portfolio in the Greater Toronto Area and have been benefitting from record high rents. Newly elected Toronto mayor Olivia Chow has threatened to lobby for expanded rent control to all units in the city including those being turned over to new tenants, potentially squashing these companies' ability to take advantage of high renewal rates amid a housing shortage and record immigration levels.

We initiated a position in pharmaceutical giant Pfizer in May. The stock had sold off over the past several months as the company moved past the boost from COVID vaccines. Pfizer's pipeline includes a promising oral obesity drug, and the stock sports a high dividend yield of 4.5% and a cheap valuation.

Fixed Income

Interest rates moved a bit higher during the second quarter and fixed income asset prices declined modestly. We continue to see a strong case for holding fixed income in client portfolios when considering equity valuations and potentially slowing economic growth. Corporate bonds are a key pillar of our fixed income, boasting an average yield to maturity of 5.2% (Figure 11). Even more compelling is their taxable equivalent yield which is now 7.03% on average, meaning a GIC yielding 7.03% would be required to earn the same after tax yield of this bond portfolio (assuming the highest tax rate and held outside a registered account). We also continue to like GICs which yield north of 5% right now, preferred shares yielding around 6-8% depending on the issue, and strcutured notes yielding 7.5-8%. Though initially painful, higher interest rates have improved prospective returns. Client balanced portfolios have an average yield of 4.7% between fixed income and equities. Even modest capital appreciation from stocks will result in solid total returns.

Figure 11: Corporate bonds

Bond	Price	Yield	Taxable Equivalent Yield
BANK OF NOVA SCOTIA 1/10/2025 1.95%	$94.75	5.68%	7.84%
ROYAL BANK OF CANADA 5/01/2025 1.936%	$93.85	5.58%	7.70%
TORONTO-DOMINION BANK 12/09/2025 1.128%	$90.47	5.41%	7.93%
CIBC 1/19/2026 1.1%	$89.91	5.45%	8.02%
ROYAL BANK OF CANADA 5/04/2026 1.589%	$90.28	5.36%	7.58%
WELLS FARGO & CO 2/18/2027 2.493%	$90.04	5.59%	7.37%
TORONTO-DOMINION BANK 9/11/2028 1.896%	$85.62	5.10%	6.98%
BELL CANADA 9/10/2029 2.9%	$88.72	5.05%	6.27%
TELUS CORPORATION 10/07/2030 2.05%	$81.05	5.23%	7.09%
HYDRO ONE 1/16/2031 1.69%	$81.82	4.58%	6.28%
Average Yield	5.22%		
Average Taxable Equivalent Yield	7.03%		
Average Term	4.6 years		

Performance

Client balanced portfolios fully invested to model posted a slightly positive return on average after fees in the second quarter of 2023 but underperformed the benchmark.

Canadian equity holdings modestly underperformed the 1.1% total return from the S&P/TSX Index during the quarter. Positive contributors for the period included Air Canada (+30.5%), which benefitted from strong demand in destination travel, and Teck Resources (+12.9%) as takeover speculation persisted. Alberta-exposed stocks Canadian Utilities (-8.9%) and Suncor Energy (-7.4%) weighed on performance.

Our U.S. equity holdings underperformed the S&P 500 total return of 6.5% in Canadian dollars during the quarter. Microsoft (+15.8%) and Google-parent Alphabet (+14.0%) benefitted from the technology rally. Medical devices producer Medtronic (+7.1%) also posted a strong quarter. Offsetting this strength were pullbacks from our bank holding Truist (-12.8%) and Walt Disney (-12.6%).

Fixed Income holdings in client portfolios were in line with the benchmark's -0.7% return. Short duration positioning in our bond portfolio benefited performance as yields rose slightly. Returns from client-held preferred shares detracted from relative performance as they gave back much of their gains from the first quarter of the year. Client GIC positions outperformed both bonds and preferreds.

Wealth Management
Dominion Securities

Securities or investment strategies mentioned in this newsletter may not be suitable for all investors or portfolios. The information contained in this newsletter is not intended as a recommendation directed to a particular investor or class of investors and is not intended as a recommendation in view of the particular circumstances of a specific investor, class of investors or a specific portfolio. You should not take any action with respect to any securities or investment strategy mentioned in this newsletter without first consulting your own investment advisor in order to ascertain whether the securities or investment strategy mentioned are suitable in your particular circumstances. This information is not a substitute for obtaining professional advice from your Investment Advisor. The commentary, opinions and conclusions, if any, included in this newsletter represent the personal and subjective view of the investment advisor [named above] who is not employed as an analyst and do not purport to represent the views of RBC Dominion Securities Inc.

The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof.

RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. © RBC Dominion Securities Inc. 2023. All rights reserved.