Wealth Management
Dominion Securities

Fickel's Focus

Third Quarter Investment Commentary

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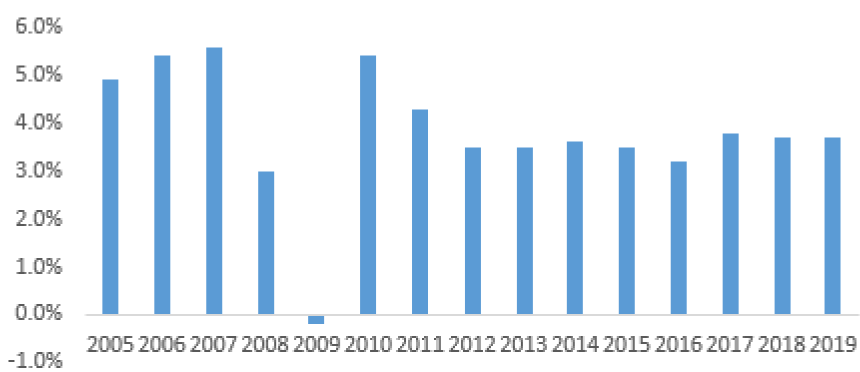
It was a negative quarter for global stock markets with the U.S. the main exception

Accounts on board for the full quarter and migrated to their appropriate models were largely unchanged and underperformed the balanced benchmark. Please contact us to further discuss the performance of your portfolio.

Economic Overview

The current global expansion has entered its 10th year, making this the second longest in history. The International Monetary Fund forecasts the global economy to grow at 3.7% in 2018/19 reflecting strong momentum in both emerging and developing economies (Figure 1).

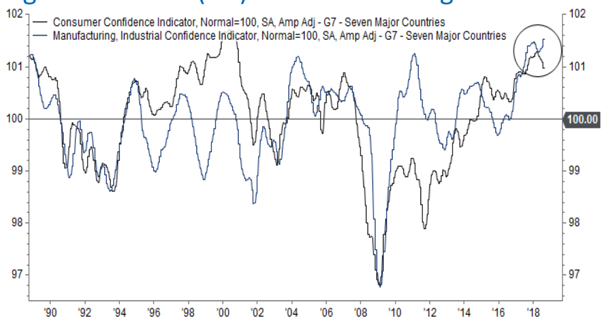
Figure 1: Global GDP growth to 2019



Source: International Monetary Fund, RBC Capital Markets

We see more positive than negative economic developments underway. Global consumer confidence – a gauge of the important consumption component of GDP – and global industrial confidence are near all-time highs (Figure 2).

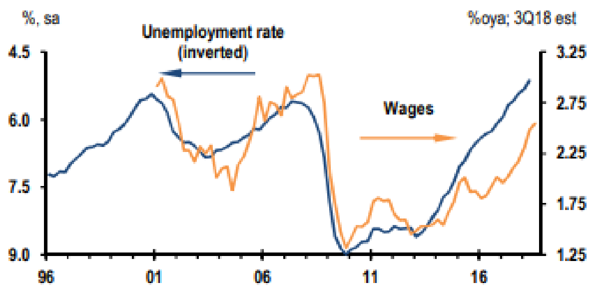
Figure 2: Global (G7) confidence is high



Source: FactSet

Global labour markets are strong. The Developed Market unemployment rate reached 5.0% in July, the lowest level since 1980. Declining labour supply is pushing wages higher (Figure 3).

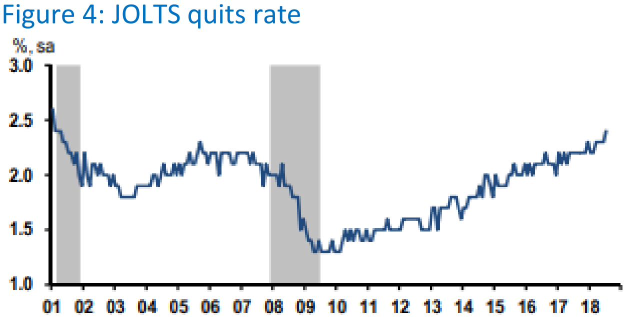
Figure 3: Low unemployment in the Developed Market is pressuring wages higher



Source: J.P. Morgan

The U.S. labour market is exceptionally strong. The JOLTS quits rate (the number of people who voluntarily leave their job as a share of overall employment) rose to 2.4%, a level exceeded only once, in January 2001 (Figure 4). Individuals typically quit their jobs when they have confidence in their ability to secure another job.

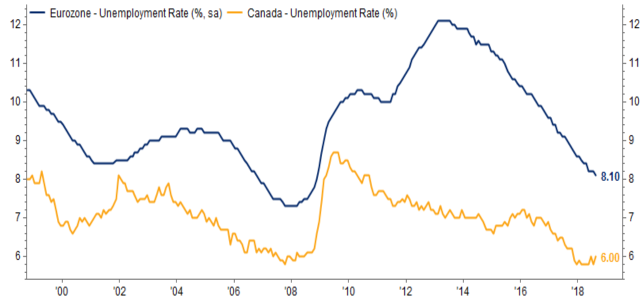
Figure 4: JOLTS quits rate



Source: BLS, J.P. Morgan

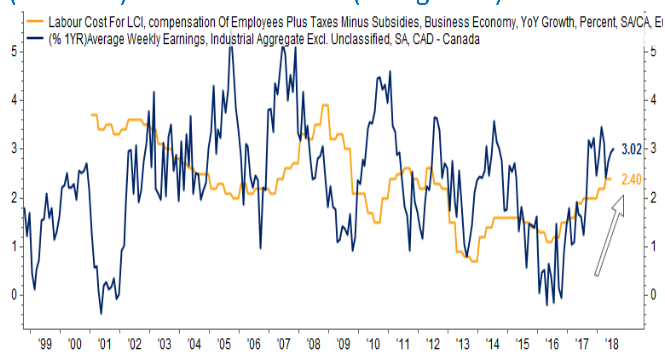
Labour markets in Canada and the Eurozone are also enjoying low unemployment (Figure 5) and rising wages (Figure 6).

Figure 5: Unemployment rates in Canada (orange) and the Eurozone (blue) are low



Source: FactSet

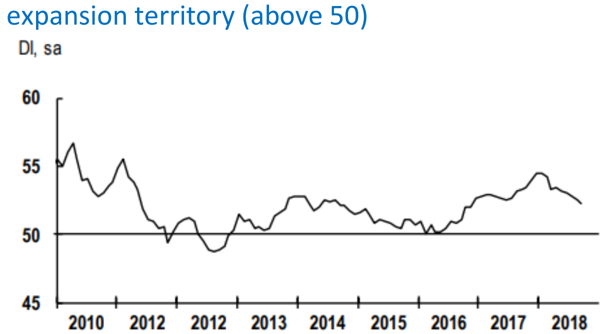
Figure 6: Labour costs (wages) are rising in Canada (blue line) and the Eurozone (orange line)



Source: FactSet

Global manufacturing output growth – measured by the Purchasing Managers Index (PMI) – disappointed in September but remained in expansion territory (Figure 7). The performance of Emerging Markets was the main drag, while the U.S. remained a bright spot, rising to a four-month high. The Eurozone also posted above the global PMI average.

Figure 7: J.P. Morgan Global Manufacturing PMI (Purchasing Managers Index) declined but is still in expansion territory (above 50)

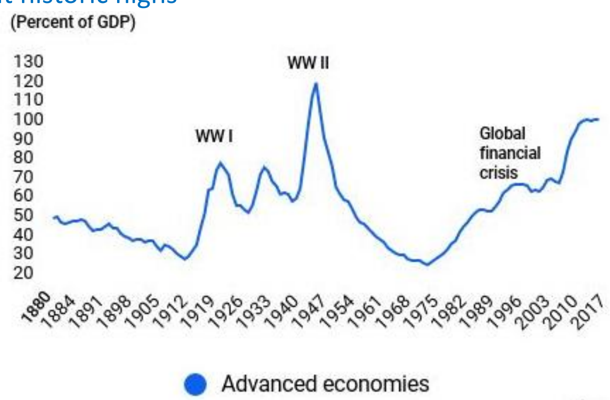


Source: J.P. Morgan

A few red flags have emerged that we are keeping a watchful eye on. At the forefront of our concerns is elevated trade tensions between the U.S. and China. J.P. Morgan estimates that a 25% tariff on all Chinese imports – the worst case scenario – would cost U.S. buyers an additional $40 billion for their imports. Though not insignificant, this would only be a 0.2% drag on the U.S.'s $20 trillion GDP. The main risk is if business confidence suffers more than expected and companies reduce investment and hiring. We do not see any indications of this yet.

After nearly a decade of ultra-low interest rates, Developed Market governments have significantly increased their public sector debt as a percentage of GDP (Figure 8).

Figure 8: Developed Market debt-to-GDP ratios are at historic highs

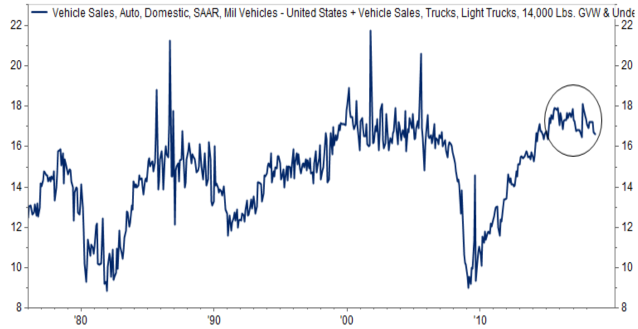


Source: April 2018 Fiscal monitor

The IMF recently expressed its concern about rising government debt levels. U.S. government debt is expected to increase to 117% of GDP in 2023 as the Trump administration widens the budget deficit in pursuit of economic expansion. Elevated public debt levels alone do not cause recessions, but they can exacerbate disruptions and limit a government's ability to deploy supportive fiscal stimulus.

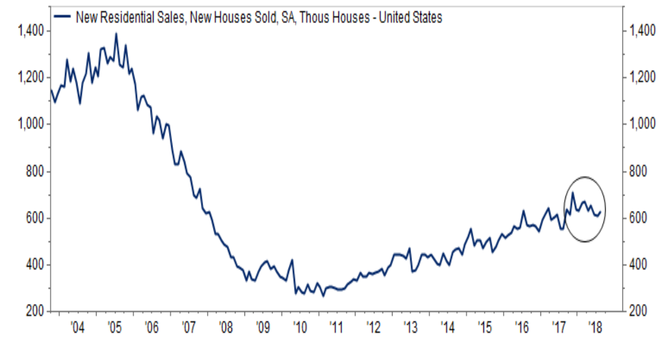
Flying in the face of the U.S.'s ultra-tight labour market – the hallmark of this expansion – two indicators could be signaling that the U.S. consumer is not as well off as most think. U.S. auto sales and U.S. new residential sales have stalled and may be rolling over (Figure 9 and Figure 10).

Figure 9: U.S. auto sales



Source: FactSet

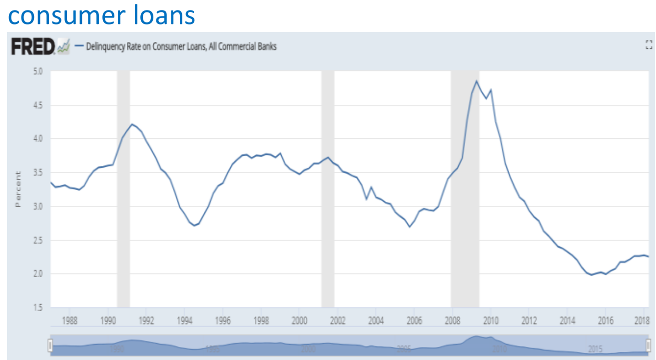
Figure 10: U.S. new residential sales



Source: FactSet

We attribute this to affordability issues in these industries rather than deteriorating consumer fundamentals. Automobile and home prices have increased substantially in recent years and rising interest rates are exacerbating impaired affordability. The average U.S. monthly car payment hit an all-time high this year at $525. U.S. mortgage payments accounted for 17.7% of income in May, a five-year high. Affordability will remain an issue over the near term but should gradually improve as tight labour markets promote higher wages. We are encouraged by the low level of delinquencies on consumer loans (Figure 11).

Figure 11: Delinquency rates on all commercial bank consumer loans

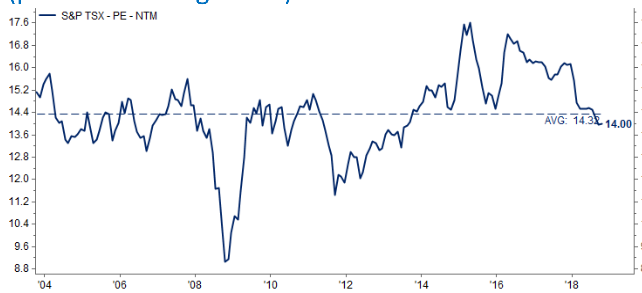


Source: Board of Governors of the Federal Reserve System (U.S.)

Equity Commentary

We are marketweight Canadian equities. The S&P/TSX price-to-earnings ratio trades in line with its 15 year average (Figure 12).

Figure 12: TSX trades in line with historical valuation (price-to-earnings ratio)



Source: FactSet

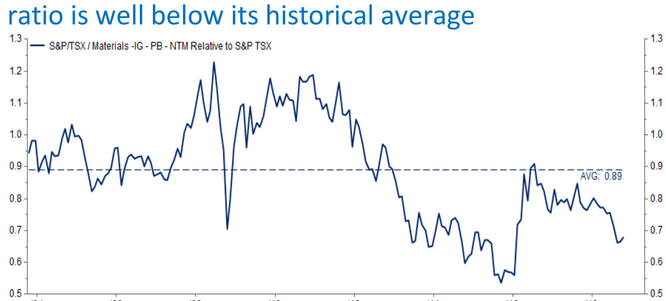
On a relative basis, the S&P/TSX trades at a steep discount to the U.S. (Figure 13).

Figure 13: Canadian stock market trades at a deep discount to U.S. market

Source: FactSet

We continue to like the Canadian Materials sector. The sector trades at an attractive price-to-book valuation (Figure 14).

Figure 14: S&P/TSX Materials sector's price/book ratio is well below its historical average

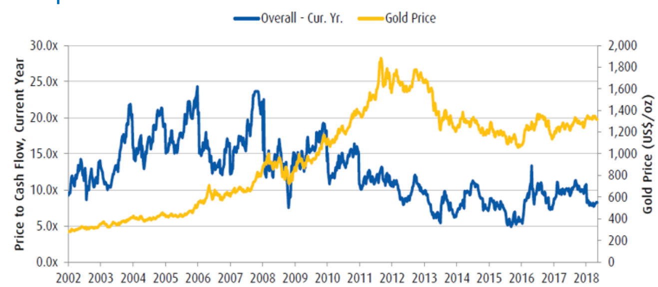


Source: FactSet

We believe there is a place for gold in portfolios. We are attracted to Canadian gold miners' cheap valuations and positive earnings outlook (Figure 15).

An added benefit is gold's natural hedge against rising inflation and political instability. The strong U.S. dollar has been a headwind for gold recently, but we expect this to reverse over the medium term as global interest rates and economic growth converge with the U.S.

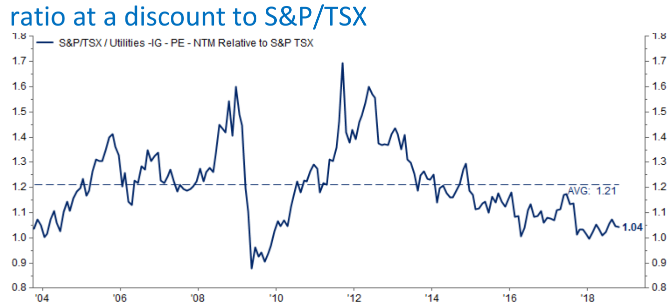
Figure 15: Gold sector price-to-cash flow (P/CF) multiples look attractive



Source: BMO Capital Markets

We are overweight utilities in Canada. We like their defensive characteristics, high dividend yields, low valuations and modest growth prospects. The utility sector is trading at about a 15% relative P/E discount to the S&P/TSX historical average (Figure 16).

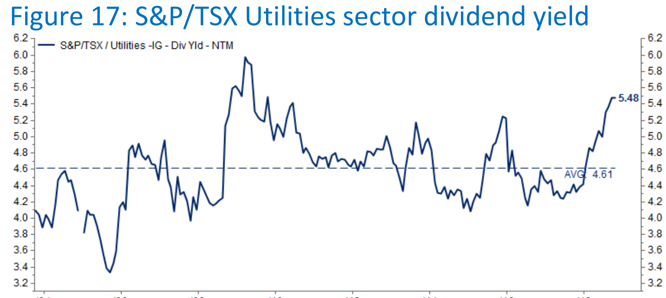
Figure 16: Utilities sector relative price-to-earnings ratio at a discount to S&P/TSX



Source: FactSet

Dividend increases over the next twelve months will take the S&P/TSX Utilities sector's yield to 5.5%, close to its all-time high (Figure 17).

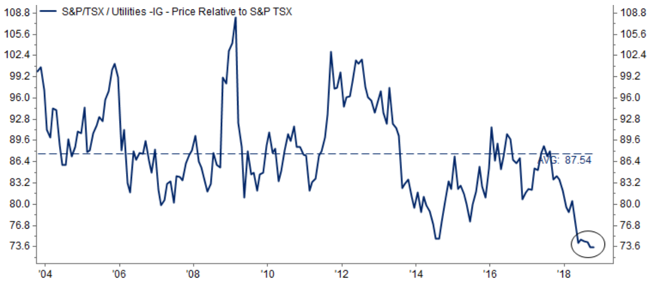
Figure 17: S&P/TSX Utilities sector dividend yield



Source: FactSet

Canadian utilities have underperformed the S&P/TSX over the past several years, recently reaching a multi-decade relative performance low (Figure 18). We expect this trend to reverse over the next year.

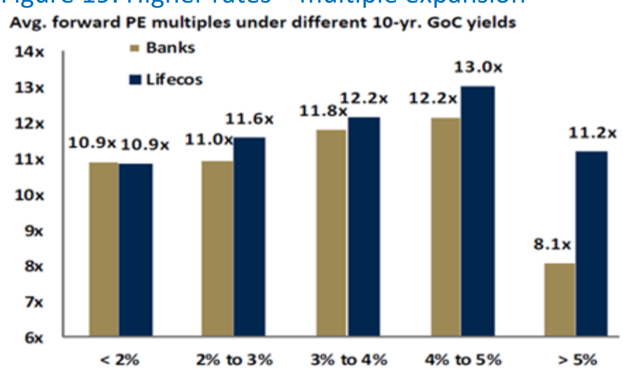
Figure 18: Utilities sector reached a price performance low relative to the TSX



Source: FactSet

We are market weight in Canadian financials. Banks and insurance companies trade at reasonable forward P/E ratios of 11x and 9x respectively. We expect the 10-year GOC yield to continue creeping up which should be positive for the financials' valuations (Figure 19).

Figure 19: Higher rates = multiple expansion

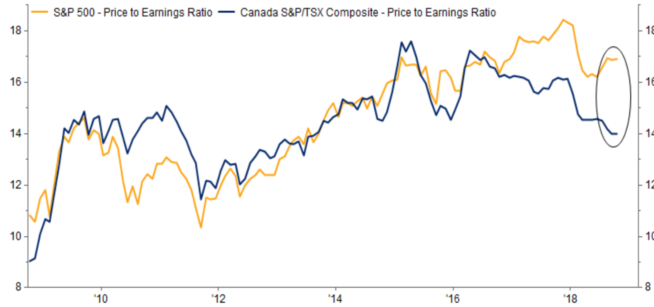


Source: Bloomberg; RBC CM Canadian Equity Strategy

Fears about Canadian banks' exposure to real estate seem overblown. Lending practices have been quite conservative. The average loan-to-value ratio on uninsured mortgages is only 53%.

Fully invested balanced portfolios are underweight U.S. stocks (average 15.21% versus 20% balanced benchmark). The S&P 500 is trading at a near record P/E premium to the TSX (Figure20).

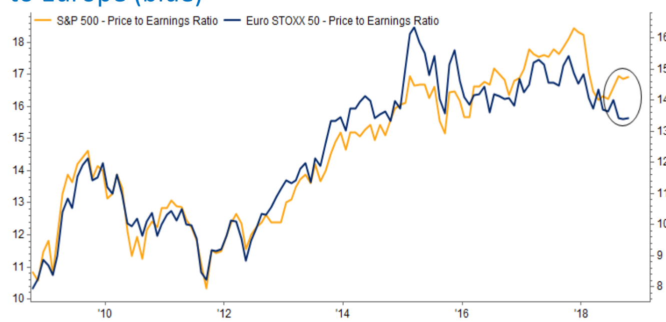
Figure 20: Canada (blue) and U.S. (orange) historically in-line valuations have diverged



Source: FactSet

The S&P 500 is also trading at a historically wide premium to the Euro STOXX 50 (Figure 21).

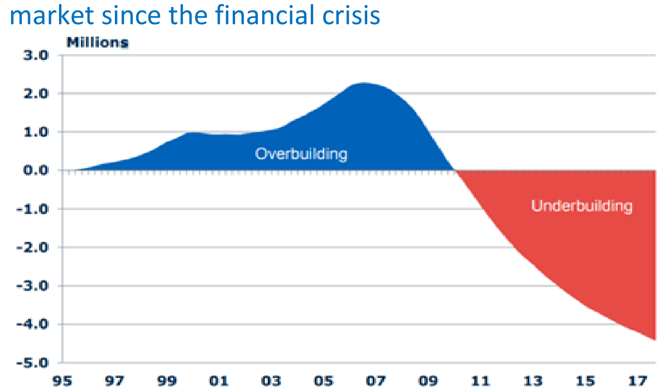
Figure 21: The U.S. (orange) is trading at a premium to Europe (blue)



Source: FactSet

We like the long-term outlook for U.S. housing as strong demand from millennials is being met with insufficient supply. First-time homebuyers entered the market in the first six months of 2018 at the fastest pace than any other year since 2005. Eager millennials are faced with a chronic shortage of new homes as 2008-2014 comprised the seven worst years for housing starts in over half a century (Figure 22).

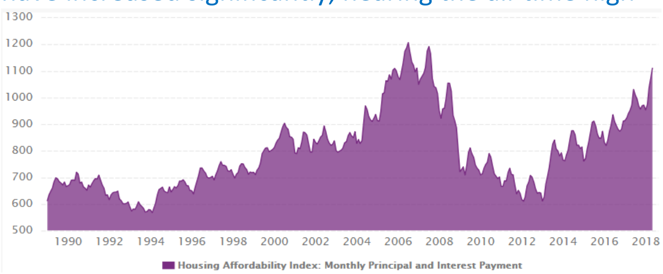
Figure 22: Chronic underbuilding in the U.S. housing market since the financial crisis



Source: FEA

That said, housing sales have softened lately due to deteriorating affordability. The combined effects of rising mortgage rates and rising home prices has caused monthly mortgage payments to increase by 67% since 2013, well above the increase in wages over that time period (Figure 23).

Figure 23: Monthly principal and interest payments have increased significantly, nearing the all-time high

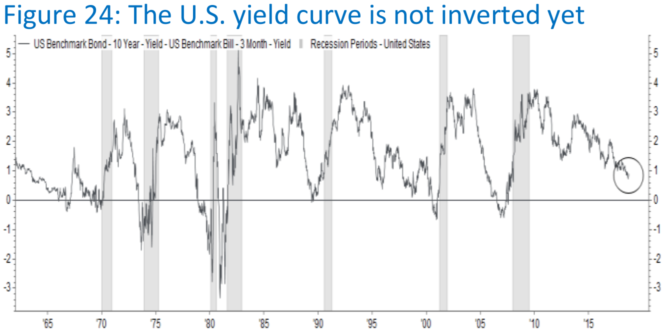


Source: CEICDATA, National Association of Realtors

Against this backdrop along with significant share price increases, we have sold West Fraser Timber Co. (after a near-tripling of share price from its original purchase) and trimmed positions of Costco and Home Depot (valuations at all-time highs).

The U.S. economic cycle is getting long in the tooth but we don't believe it's over yet. There has never been a recession start before the U.S. 10-year – 3-month yield curve inverted. The current U.S. 10-year bond yield is 3.05%, still 87 basis points higher than the 3-month U.S. Treasury bill of 2.18% (Figure 24).

Figure 24: The U.S. yield curve is not inverted yet

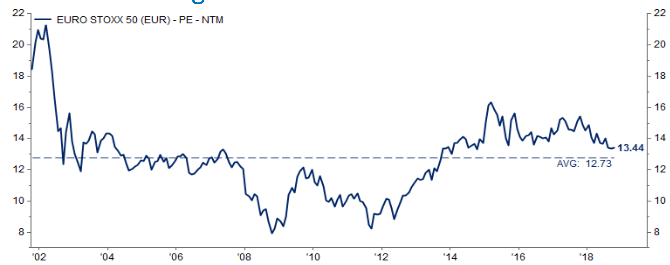


Source: FactSet

When the yield curve inverts, investors have historically had some time to reduce equities before the bear market sets in. On average, stocks have peaked about 11 months after the curve inverted. Recessions have occurred about 16 months on average after the curve inverted.

Fully invested portfolios are overweight International stocks at 11.09% (balanced benchmark is 5%). looks reasonably valued trading in line with its historical price-to-earnings ratio (Figure 25).

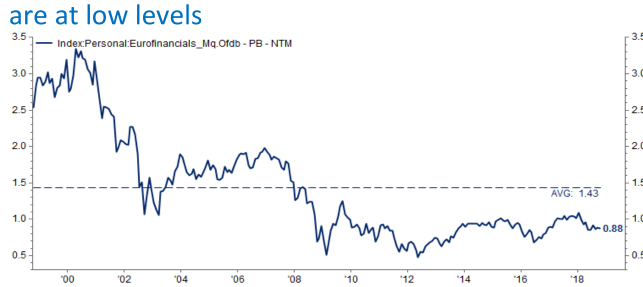
Figure 25: Eurozone P/E NTM multiple in line with historical average



Source: FactSet

We own several Eurozone financials: Banco Santander, ING Groep, Allianz, and AXA. Balance sheets have substantially improved and credit is growing again. Valuations are attractive with price/book measures remaining well below their long-term averages (Figure 26).

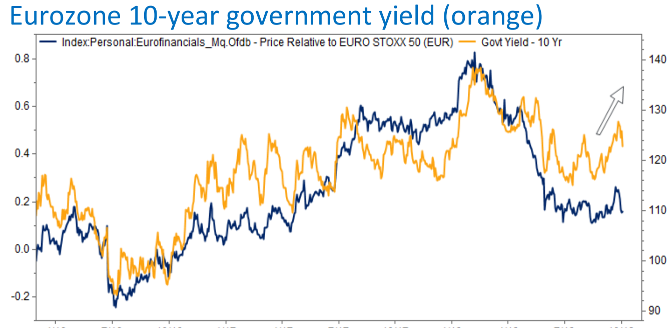
Figure 26: European financials' price-to-book ratios are at low levels



Source: FactSet

Political concerns and depressed interest rates have weighed on the Eurozone financials. As sentiment improves and the European Central Bank ends its quantitative easing program, we expect interest rates will move higher and the Eurozone financials to follow suit. Historically they have tracked the movement of interest rates quite closely (Figure 27).

Figure 27: Eurozone financials' prices (blue) and the Eurozone 10-year government yield (orange)



Source: FactSet

It was an active quarter for our equity portfolios as we added seven new positions and fully exited two.

We added a 1% weight in Athabasca Oil Corp. The company has spent the last eight years building out its facilities and has now reached targeted production of ~40,000 bbls/day which is forecast to grow to 50,000 bbls/day in 2021. Debt metrics are improving rapidly and the stock trades at 50% of its net asset value and at an extremely low price/cash flow ratio. Through a joint venture the company has an option for a 30% working interest in the highly prolific Duvernay region but only has to invest 7.5% of the funds spent on development.

We added a 1.5% weight in Visa Inc. Visa dominates the global market for electronic payments, accounting for 50% of all credit card transactions and an even higher percentage of debit card transactions. Visa should flourish for years to come as consumer spending around the world grows and digital methods continue to take share from cash. Visa is not an inexpensive stock, trading at 27x next year's EPS estimate. However, in our view, it is extremely difficult to replicate Visa's franchise. It is the standard for card payment.

We added a 1% weight to Constellation Brands. The company dominates the U.S. Mexican import beer market with its power brands that include Corona and Modelo. Constellation Brands has made worldwide headlines recently with its decision to use excess free cash flow to increase its stake in Canopy Growth Corp. It's virtually impossible to estimate the near-term financial impact of this transaction, but some preliminary estimates forecast global sales for cannabis to reach $200 billion by 2032. At this point, all we can say with certainty is that Constellation Brands has "first mover" status and has the distribution network and marketing capability to compete. The company generates significant free cash flow and trades at a reasonable valuation of 17x 2020 EPS.

We added a 1.5% weight in GlaxoSmithKline (GSK), the World's sixth largest pharmaceutical company. GSK's outlook is improving. It has replaced its blockbuster asthma drug, Advair, which has come off patent, and GSK's once-a-month injection for controlling HIV has proven effective in trials. Perhaps most exciting is its relatively new drug for Shingles, Shingrex, which analysts forecast will generate $2 billion in sales by 2021. The shares are inexpensive trading at 12.5x 2020 EPS and offer a dividend yield of 5%.

We added a 1% weight to Sienna Senior Living (SIA). Sienna operates long-term care facilities in Ontario and British Columbia. Supply and demand characteristics are favourable for this industry. Growth in long-term care capacity in Ontario has been non-existent over the past several years which has resulted in the provincial waitlist reaching 30,000 people. Shares trade at a reasonable price/cash flow ratio of 12x and offer a very attractive dividend yield of 5.2%. The dividend payout ratio is a low 60% of cash flow.

We added a 1.5% weight to Loblaw Companies Ltd. We purchased Loblaw after the company announced the spin out of its interest in Choice Properties REIT to parent company George Weston. Loblaw shareholders will receive .135 shares of WN for each L share. We believe that Loblaw shares do not fully reflect the underlying value of the company's real estate and this transaction will help surface this.

We added 1% in Rio Tinto PLC after the company's shares sold off due to tariff concerns. Rio is a global mining giant that is inexpensively valued on all metrics. It currently trades at a steep discount to its net asset value, at a very low enterprise value/EBITDA multiple, and at a 10% free cash flow yield. Rio is forecast to be debt free by the end of 2019 and offers a juicy dividend yield of 6.4%.

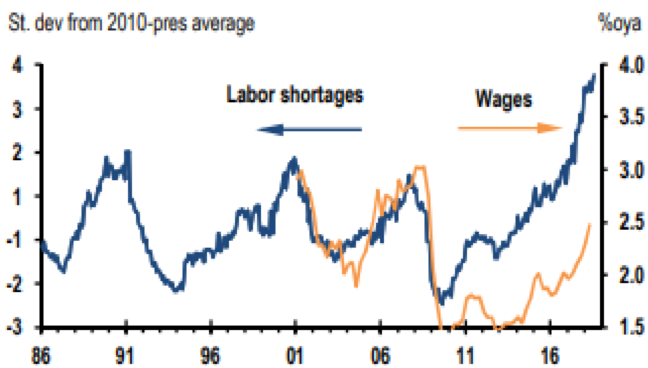
We fully liquidated our holdings of Facebook and West Fraser Timber Co. Facebook was a difficult decision. It is a high profile company that has treated us well, however, some concerning trends have surfaced. Advertising revenues could come under pressure as younger generations spend less time on the platform and lower engagement metrics emerge. This in conjunction with heightened regulatory scrutiny and privacy issues has led us to step aside, at least for the time being. West Fraser was sold after nearly tripling. It is a well-managed company with a pristine balance sheet and was appropriately positioned to take full advantage of the U.S. housing recovery. However, WFT operates in a cyclical industry and its valuations reached the upper end of historical norms.

Fixed Income

The average fixed-income weight in fully invested balanced portfolios rose from 33% at the end of Q2 to 36.39% in Q3 (compared to 40% for the balanced benchmark). We continue to add short-term bonds as their yields rise and they provide higher rates than money markets. The additions were mostly sourced from cash.

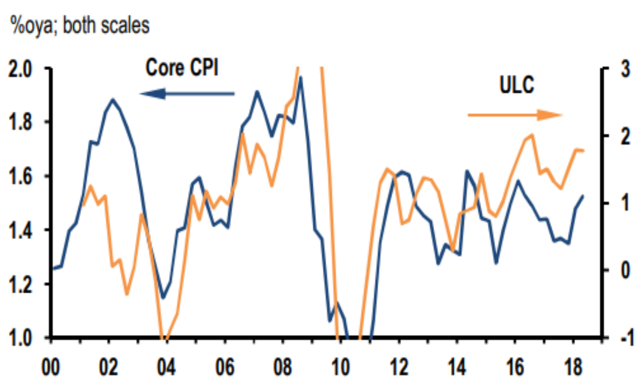
Bond yields marched higher in Q3 2018 as inflationary pressures firmed and central banks in Canada and the U.S. raised benchmark interest rates. This trend looks poised to continue. Tight labour markets – characterized by low unemployment and surging labour shortages – are promoting faster wage gains which companies are passing on to consumers (see Figure 28 and Figure 29).

Figure 28: Developed Market labour shortages are driving wages higher



Source: J.P. Morgan

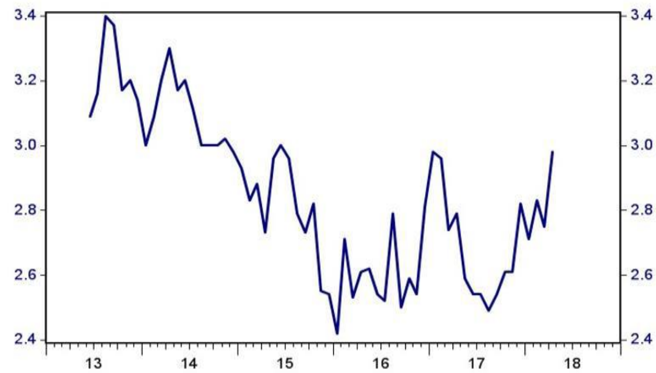
Figure 29: Rising unit labour costs (ULC) are pressuring core inflation (CPI) higher



Source: J.P. Morgan

The U.S. has the tightest labour market and is leading the wage inflation cycle. Rising employment costs are filtering through to inflation. The one-year ahead expected inflation rate remained elevated at 3% in September (Figure 30).

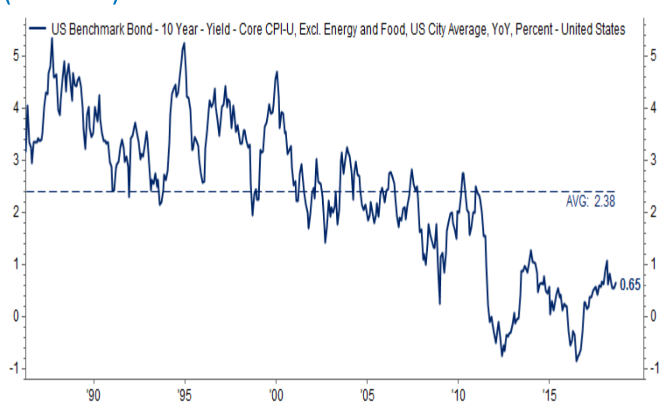
Figure 30: Inflation expectations: median one-year ahead expected inflation rate



Source: RBC Capital Markets U.S. Economics/FRBNY/Haver

U.S. interest rates are too low. The real (inflation-adjusted) 10-year U.S. Treasury bond yield is 0.65% (Figure 31). The historical long-term average is about 2.5%. The 10-year U.S. bond yield would need to rise by 1.85% in order to bring it back to its average long-term inflation adjusted yield. Mid to long-term bond prices would get crushed if this happened.

Figure 31: 10-year U.S. Treasury yield minus core CPI (inflation)

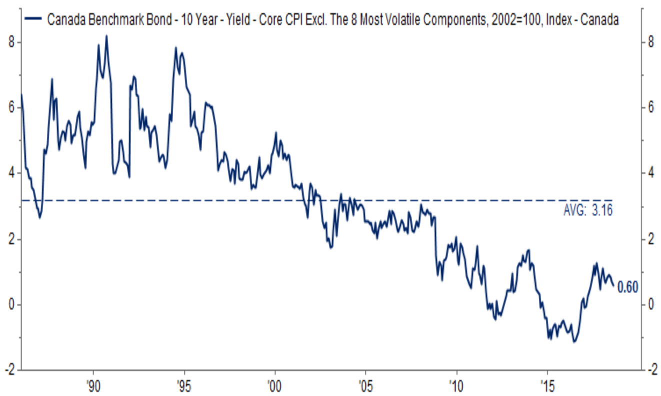


Source: FactSet

It is even uglier in Canada. The real 10-year Canada Treasury bond yield is 0.6% (Figure 32). The 10-year

Canada bond yield would need to rise by about 2.5% in order to bring it back to its average long-term inflation adjusted yield.

Figure 32: 10-year Canada Treasury yield minus core CPI (inflation)



Source: FactSet

We remain very defensive in the fixed-income component of portfolios. Clients hold about half of their fixed-income portfolios in preferred shares. Preferred shares offer greater yields than bonds (Figure 33), and the floating rate and fixed rate-reset preferreds provide interest rate protection through their adjustable dividend mechanism. The remainder of clients' fixed-income is invested in very short-term, high-quality bonds. The bonds are laddered by maturity date with the view that as they mature, the proceeds can be reinvested in higher yielding, longer-dated bonds.

Figure 33: Preferred share yields are much more attractive than bond yields, especially on an after-tax basis

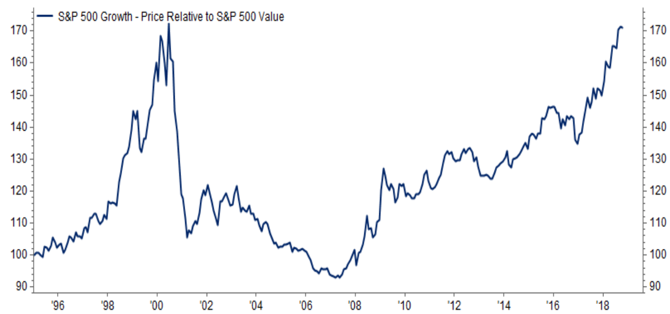
Bonds	Pre-tax Yield	After-tax Yield
Federal Gov	2.39%	1.11%
Provincial Gov	2.12%	0.98%
Corporate	2.74%	1.27%
Total Bond Portfolio	***2.50%***	***1.12%***

Preferred Shares	Pre-tax Yield	After-tax Yield
Floating Rate	4.45%	3.73%
Fixed Reset	5.07%	4.24%
Perpetual	5.05%	4.23%
Total Preferred Portfolio	***4.96%***	***4.15%***

Performance

We underperformed the Balanced Benchmark during Q3 and year-to-date. Some of this underperformance can be attributed to our value style of investing as growth stocks significantly outperformed value stocks over this time frame (Figure 34). Our value stock selection has served clients well over many decades and we remain confident in our process.

Figure 34: S&P 500 growth stocks relative to value stocks



Source: FactSet

Our Canadian stock selection and industry weightings weighed on returns during Q3.

Overweight utilities and utility stock selection weighed on returns as the sector underperformed the TSX and our holdings underperformed the sector. Notable laggards were Emera (EMA) and Canadian Utilities (CU), which declined 6.4% and 4.7% respectively. As noted earlier, we believe this defensive group is oversold and represents very good value.

Our commodity exposure also hurt returns. Metal prices were weak during the quarter, as investors worried about the impact of U.S. tariffs on China's growth. The abrupt decline of our favored metal, copper, pushed First Quantum's (FM) share prices lower by 24%.

Our gold holdings of Goldcorp (G) and Yamana (YRI) hurt returns as they dropped 27% and 16.7% respectively. They were adversely impacted by the strong $U.S. and to a lesser extent, the Argentinian tax on gold exports from that country. Again, as expressed previously, we believe these stocks represent excellent value as they are cheap and will generate significant free cash flow over the next few years. They also offer a hedge against future market and political turbulence.

Despite the significant rise in oil, the energy index declined 5.6%. Our defensive holdings of Freehold Royalties (FRU) and TransCanada Pipelines (TRP), which both yield about 5.5%, fell more than the index, declining by 10.2% and 8.1% respectively.

On average, our international stocks recorded positive returns and outperformed the EAFE Index. Medtronic (+12.9%), Axa (+7.9%) and Allianz (+6.4%) led the way. ING and Banco Santander were the notable losers, down 11% and 8.1% respectively.

We were modestly underweight the U.S. stock market, the top performing global index with a gain of 7.7%. However, stock selection helped offset this underweight with notable performances from Walgreens (+19.4%), Merck (+14.8%), Johnson & Johnson (11.9%) and Costco (+10.4%).

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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