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
416-960-6816
nathan.fickel@rbc.com

Third Quarter 2020 Investment Commentary

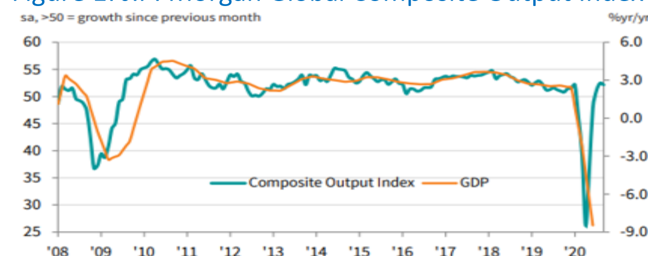
Global equities marched higher in the third quarter as the economy continues to recover from the pandemic-induced recession. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased by 4.7%, 6.9%, and 0.4% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced strong positive returns and outperformed their respective benchmarks during the quarter.

Economic Overview

The global economy has regained its footing after enduring one of the deepest and most widespread recessions on record. Though not out of the woods yet, a visible recovery is underway and it should be sustained as long as lockdown restrictions don't intensify and governments maintain their supportive policies. A resurgence of COVID-19 cases has emerged in recent weeks and threatens to derail the recovery, but we are encouraged by lower hospitalization and death rates, as well as societies' overall preparedness to deal with the second wave. Governments are reinstating lockdown measures but in a localized and targeted fashion, hopefully allowing businesses to navigate this second wave significantly easier than the first.

Economic activity is picking up. J.P. Morgan's Global Composite Output Index registered 52.4 in August, its highest level since March of 2019 (Figure 1). This marks the second month in a row of signaled expansion following five consecutive months of decline. As a reminder, the composite measures whether global output is expanding or contracting relative to the previous month. The actual level of GDP is still well below pre-pandemic levels but trending in the right direction.

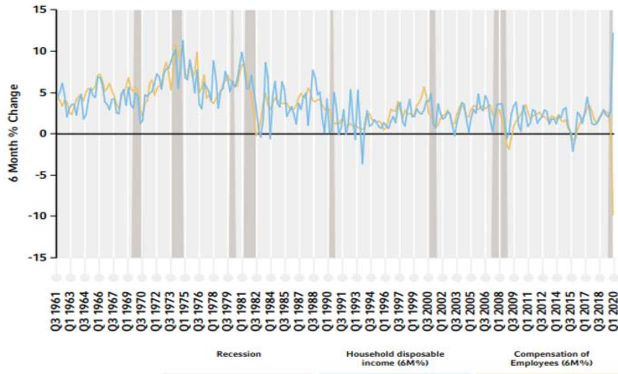
Figure 1: J.P. Morgan Global Composite Output Index



Source: J.P.Morgan, IHS Markit

This will likely be one of the most unusual recessions we witness in our lifetime. For starters, it was primarily self-induced and a result of social distancing and government mandated closures. Fortunately, as these self-imposed restrictions are lifted, the pace of the recovery has been and should continue to be similar to the pace of the contraction. Perhaps more unusual, and almost inconceivable, is the fact that people around the world have seen their disposable income actually increase during the pandemic (Figure 2).

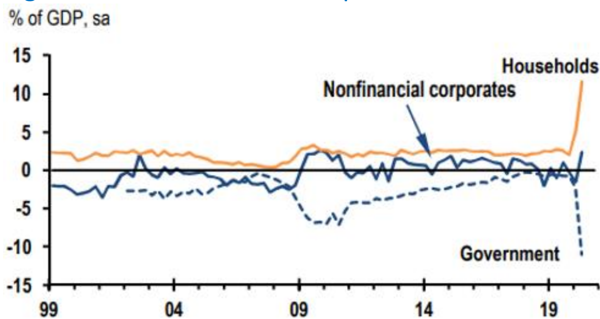
Figure 2: Disposable income growth (blue) and compensation growth (orange) in Canada



Source: Refinitiv Datastream, Russell Investments

While work-related compensation (wages) has declined, government handouts have more than offset this for many. The implications are huge. Households have been enabled to maintain a big chunk of their typical expenditures and also continue servicing their debts. Figure 3 shows how the financial positions of Euro area households and non-financial corporates has actually improved in 2020.

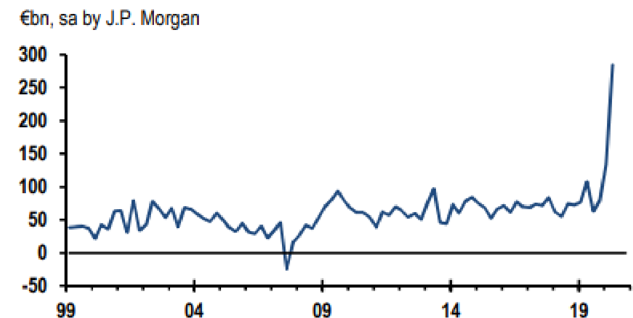
Figure 3: Euro area financial positions of sectors



Source: Eurostat, national statistical institutes, J.P. Morgan

What's more, the improved financial position of households has resulted in large savings gains. In Europe, the household savings rate increased from 12% in 4Q2019 to 25% in the second quarter of this year, and in Canada it jumped to a historic high of 28%. This bodes well for the strength and longevity of the recovery underway as households possess significant scope to mobilize and deploy their savings. Interestingly, the bulk of these savings ended up in financial assets (Figure 4). Most of the new assets were bank deposits, though equities have been a large benefactor as well.

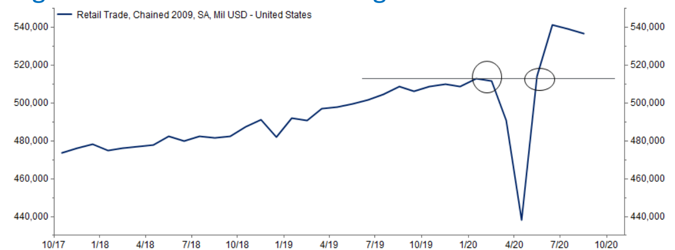
Figure 4: Euro area household net acquisition of financial assets



Source: Eurostat, ECB, J.P. Morgan

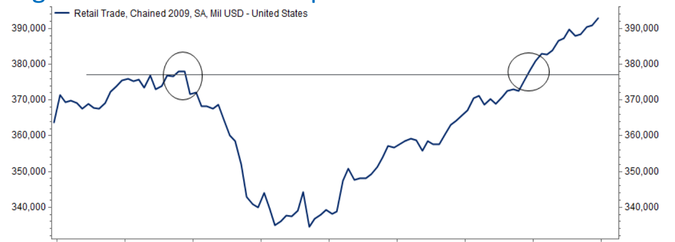
When compared to other recessions, household incomes have been relatively smooth. This partly explains why retail sales have bounced back so quickly after plunging in the first half of 2020. Surprisingly, only two quarters after the outbreak and onset of the economic crisis, retail sales have recovered to their pre-pandemic levels and made new highs (Figure 5). What took only two quarters during this recession took almost five years after the Great Financial Crisis (Figure 6).

Figure 5: U.S. retail sales during this recession



Source: FactSet

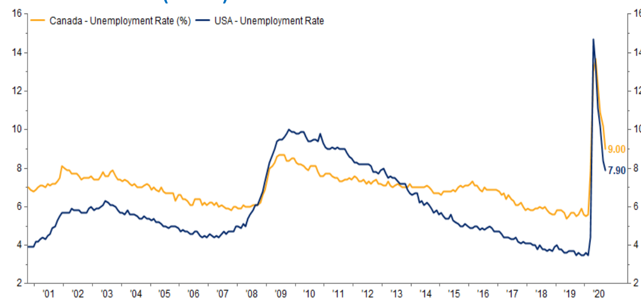
Figure 6: U.S. retail sales post Great Financial Crisis



Source: FactSet

Of course, some of the V-shaped recovery is explained simply by the nature of this recession and the easing of self-imposed economic restrictions. However, not all areas of the economy have fully recovered, and one of them is the labour market (Figure 7). After an impressive string of monthly job gains employment growth is starting to slow. It seems likely that in order to make the next advance in employment we need to achieve normalization in the sectors most affected by the pandemic, particularly tourism and hospitality.

Figure 7: Unemployment rate in Canada (orange) and the U.S. (blue)



Source: FactSet

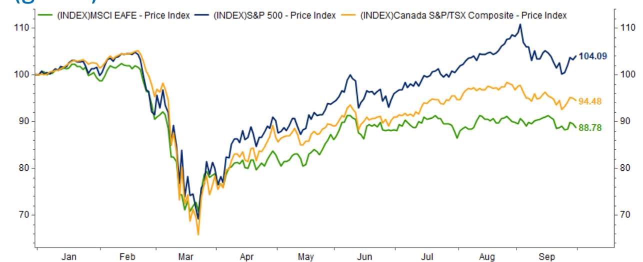
Looking forward, we still believe the path of the virus is the most important factor for the economy's recovery. A widespread return to Stage 1 would, as observed earlier this year, have a devastating impact on businesses. Hopefully a definitive, targeted containment approach to hotspot metropolitan areas will alleviate the toll on activity. Perhaps almost as important as the path of the virus, for the economy at least, is future government aid. This has been one of the key pillars of the speedy, V-shaped recovery, and it will probably be needed well into 2021. Additional government aid is likely in Canada, with Chrystia Freeland stepping into her new role as Finance Minister announcing an additional $37 billion in income support measures. With the election coming up in the U.S. the outlook for government support is a little more clouded. Early polls and betting markets are favouring a blue wave outcome (Democratic sweep) which would allow Biden to deliver additional stimulus without significant Republican opposition. A divided congress is a worst-case outcome, which could result in more political gridlock.

Equity Commentary

Equity weightings are generally in-line with the benchmark. Balanced accounts' equity weightings are approximately 55.1% on average versus the benchmark weight of 55%.

Equity markets moved higher in the third quarter. The U.S. S&P 500 is in positive territory for the year and the Canadian TSX is only five percentage points away from breaking even (Figure 8).

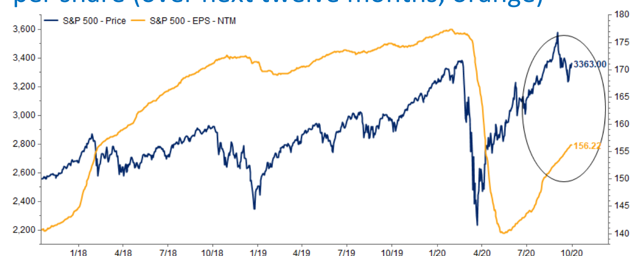
Figure 8: Year-to-date indexed price performance of S&P 500 (blue), TSX (orange), and MSCI EAFE (green)



Source: FactSet

Investors continue to look beyond the pandemic and are pricing in an earnings recovery (Figure 9). While we don't disagree with this, we think the markets are optimistic and possibly underappreciating some of the uncertainties that linger. Chief among them of course is a resurgence in cases and broadbased business shutdowns. As well, we still don't know what kind of lasting damage this recession will cause. Will future consumer and business behaviour be altered? Relative to the pre-crisis path, what level of GDP shortfall will be experienced? Limited visibility makes it difficult to assess these questions.

Figure 9: S&P 500 price (blue, left side) and earnings per share (over next twelve months, orange)

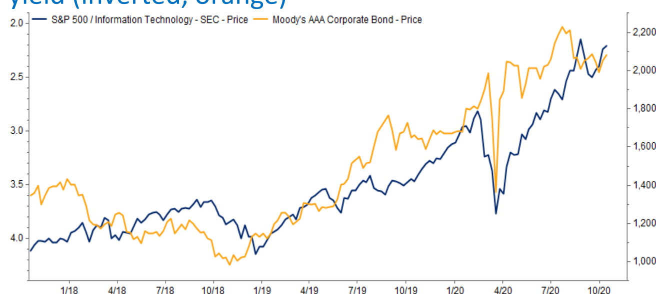


Source: FactSet

The upcoming U.S. election poses another risk to the markets. Investor views have generally converged around the baseline scenario of a benign Democratic sweep that would enable the delivery of sizable fiscal stimulus with little Republican opposition. The overwhelming acceptance of this base case suggests the markets are complacent and that an alternate election outcome could cause some turbulence. As well, with the focus on fiscal stimulus, investors are paying little attention to the possibility of Biden raising corporate taxes or implementing stricter regulatory policies on large technology companies. Information technology represents nearly 30% of the S&P 500, and without the strong performance of Facebook, Apple, Amazon, Netflix, Google and Microsoft, the S&P 500 would have declined by 4% year-to-date (as of September 30).

Technology companies have primarily benefitted from two things during the pandemic, lower interest rates and an increase in the use of their products and services. These two forces could soon become headwinds for the sector. Tech companies are often considered to be long duration because they are expected to grow earnings well into the future. The present value of those earnings increases when interest rates decline. Figure 10 demonstrates this correlation. If the economic recovery is sustained, interest rates are likely to remain range bound or could even start to creep higher. Central banks have limited capacity to cut rates and are unlikely to use it if the economy is recovering. Secondly, as society returns to normal people may see their technology engagement decline. Streaming and online shopping surged to levels that in some cases were not projected to be achieved until 2030. This tremendous growth is unsustainable and will slow as societal normalcy is restored.

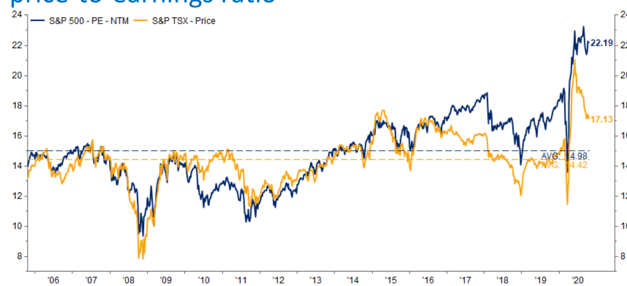
Figure 10: S&P 500 information technology sector price (blue, right) and Moody's AAA corporate bond yield (inverted, orange)



Source: FactSet

While our views on equities are not outright negative, we think the risk/reward tradeoff has deteriorated. The S&P 500 and S&P/TSX are trading at premium valuations on a price-to-earnings basis, although this is partly justified given low interest rates (Figure 11).

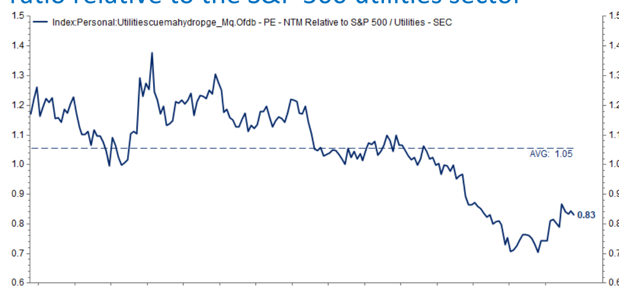
Figure 11: S&P 500 (blue) and S&P/TSX (orange) price-to-earnings ratio



Source: FactSet

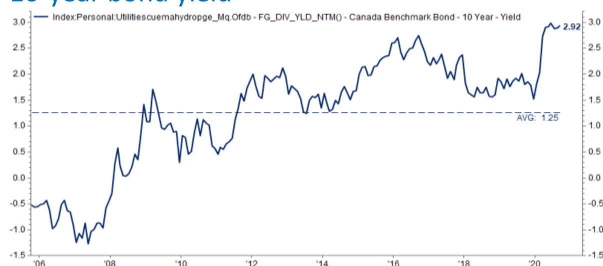
As uncertainty remains elevated, we favour sectors and companies that have recurring, visible earnings growth and trade at reasonable valuations. Utility companies continue to be an overweight in client portfolios. At around a 16x price-to-earnings ratio, they trade in-line with their historical valuation and also at a significant discount to their American peers (Figure 12). They pay an attractive dividend, especially when compared to Government of Canada bond yields (Figure 13).

Figure 12: Our utilities composite price-to-earnings ratio relative to the S&P 500 utilities sector



Source: FactSet

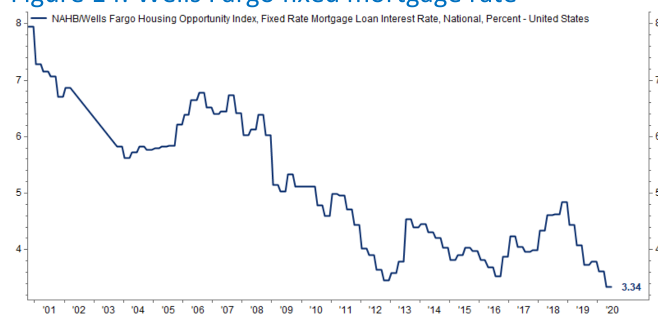
Figure 13: Our utilities composite yield minus GoC 10-year bond yield



Source: FactSet

In addition to Utilities, we continue to like housing-related stocks. To the surprise of many, the U.S. housing market has been a star during the pandemic. Client portfolios have benefitted from strong gains in Home Depot, West Fraser, Lennar, and Stanley Black & Decker. Pent up demand from millennials living in their parents' homes has been unleashed by record low mortgage rates (Figure 14). A shift to working from home has also contributed as relatively less expensive suburban homes become more desirable. Inventory remains scarce after a decade of underbuilding. Low mortgage rates and favorable demographics bode well the homebuilders and related companies.

Figure 14: Wells Fargo fixed mortgage rate



Source: FactSet

Following a heavy quarter of trading activity within client accounts, transactions were notably light in Q3 as market volatility settled with the realities of COVID already set in. We purposely aligned client portfolios in Q2 for whatever scenario unfolded and we maintain that stance as the most recent quarter concluded. If the market declines and the recovery is slow to materialize, we own many defensive holdings including Costco, BCE, Hydro One and Choice Properties (through its primary tenant, Loblaws). Should the continuing damage of the virus be less than feared or a vaccination is discovered, we have maintained ownership in high-quality names that will materially benefit such as West Fraser Timber, Walt Disney, Delta Airlines and Stanley Black & Decker. We also own stocks that we are confident will be long-term winners regardless of outcome in secular growth names such as Microsoft, Alphabet (Google), Home Depot, Canadian National Railway and Visa.

The bulk of our trading during the quarter involved adding to existing positions in Canada that offered attractive yields. We added to positions in Canadian Utilities (5.5% yield at month end), BCE (6.0%), Choice Properties (5.8%) and Toronto Dominion Bank (5.1%). These are stable companies that offer substantially more attractive yields than even below investment grade bonds at the present time. Portfolios saw the maturity of a Bank of Montreal bond during the second quarter and rather than reinvesting these funds into another corporate bond offering 1% or less, we allocated funds into equities where we find the income stream much more attractive. BCE, a company with reliable cash flows to sustain its dividend, closed the quarter with a 5.6% yield spread over a 5-year Government of Canada bond.

We also selectively added to two of our U.S. equity holdings during the quarter in Walt Disney and PG&E. Disney owns several leading entertainment properties including ABC, ESPN, Pixar, Marvel, Lucasfilms and 20th Century Fox. Despite having outsized exposure to virus concerns through its theme park and motion picture businesses, we view it as a best-in-class entertainment company available at a discounted price. Disney has shown a great ability to drive growth from its traditional businesses by monetizing its popular characters and franchises across multiple platforms. Our decision to build positions in the name stems from the increased confidence we have in their latest growth driver, the Disney+ streaming service. The platform has attracted 60 million subscribers in the nine months since its launch, substantially outpacing even the most optimistic estimates. JPMorgan originally estimated the company would attract 15 million subscribers in the first year when it was introduced in November 2019. Achieving scale puts the service on a path to become profitable far ahead of original expectations.

We established a position in U.S. utility PG&E in late June and added to our holdings in late July. The company generates and transmits electricity for 5 million customers and transports and stores natural gas for 4 million people in Northern California. PG&E is exiting bankruptcy after settling claims related to wildfires in the state in 2017-18. The utility offers premium rate base growth of 8% compounded annually over the next five years, has a pro-growth regulator and trades at a significant discount to peers due to its exit from bankruptcy. PG&E is set to play a key role in implementing California's aggressive energy and environmental policies. It looks increasingly likely that the company will successfully

reduce its debt and reinstate the dividend over the next few years.

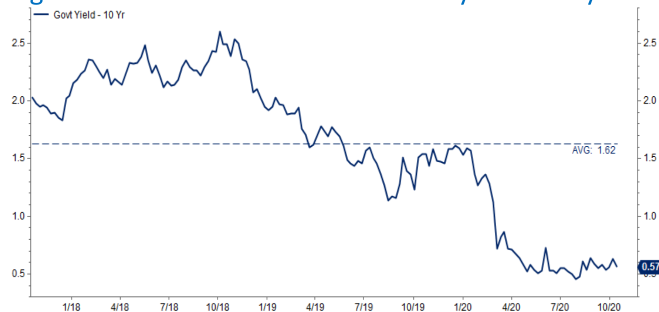
Fixed Income

We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 35.8% on average versus the benchmark weight of 40%, with about half of that in preferred shares.

The Canadian Broad Bond Composite Index only returned 0.4% in the third quarter after posting strong gains in Q1 and Q2. This brings its year-to-date return to and impressive 8%.

The fixed income space poses a challenge for investors. Over the last three years the Canadian Broad Bond Composite has returned approximately 6% annually even though the average yield on a BoC 10-year bond was 1.62% (Figure 15). This suggests that most of the total return from bonds over this period came from capital gains which are a direct result of interest rates declining. With the Canada 10-year yield at 0.57%, interest rates don't have much room to decline further before they hit zero and go into negative territory. This deteriorates the outlook for additional capital gains and suggests that total returns for bonds could be limited to their coupons which, at 0.57% for 10 years, are very unattractive.

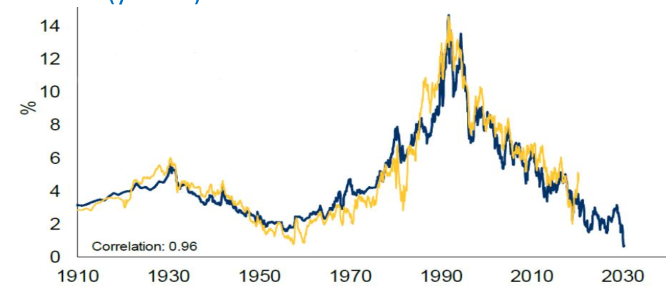
Figure 15: Government of Canada 10-year bond yield



Source: FactSet

This line of reasoning is reinforced by the strong correlation that exists between the current yield on bonds and the subsequently realized 10-year annual return (Figure 16). Historical evidence suggests that we can expect 1-2% from U.S. 10-year treasuries over the next decade.

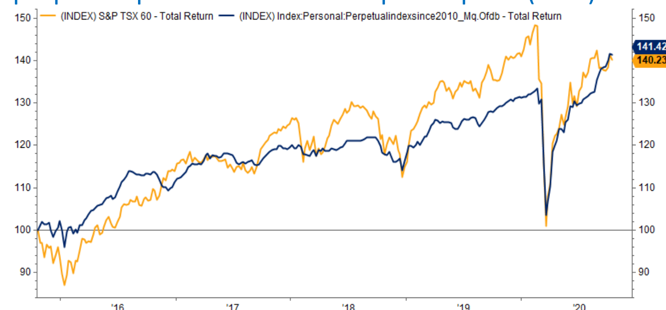
Figure 16: U.S. 10-year treasury (blue, advanced 10 years) and subsequent realized 10-year annual returns (yellow)



Source: RBC DS, Bloomberg

Our underweight allocation to bonds and overweight to preferred shares is nothing new. We continue to like preferreds for their attractive dividend yields of 5%+. To get an equivalent after-tax return from a bond it would need to yield 6.5% which is significantly more than what's currently offered. Our preferred shares have served client portfolios well as we have avoided areas of the market that are highly levered to interest rates. We continue to like perpetual issues which exceeded our expectations over the last five years. Since 2015, perpetuals have produced a total return of approximately 41% and actually outperformed the S&P TSX 60 while experiencing less volatility (Figure 17).

Figure 17: S&P TSX 60 indexed price (orange) and perpetual preferred share composite price (blue)



Source: FactSet

Performance

Client accounts performed well during the third quarter with strong absolute returns that outperformed their benchmarks after fees.

The primary driver of this outperformance was our allocation in preferred shares within fixed income. The broad Canadian Bond Index delivered a modest 0.4%

return during the quarter as yields held steady at historically low levels. In contrast, our holdings in preferred shares posted returns in the mid-single digits. Preferred shares experienced a tailwind with the introduction of Limited Recourse Capital Notes (LRCN) from banks during the quarter. LRCNs represent a new and cheaper alternative source of funding for banks. This has led to speculation that banks will call several more expensive preferred share issues over the next several quarters. The result provided a tailwind to the entire preferred share market as issues were bid higher and closer to their $25 call price. From our standpoint, there simply are no other options that can provide an income stream in the 5% area from high quality companies. For reference, the junk bond index in Canada is yielding around 5%. As a result, we remain overweight preferreds within our fixed income holdings and underweight bonds.

Our Canadian equity holdings slightly lagged the 4.7% return from the S&P/TSX Index during the quarter. Some of this is a result of our current defensive positioning in Canada while our more growth-oriented investments are domiciled south of the border. Mixed results saw notable laggards in high-yield stocks Canadian Utilities (-6.4%), Enbridge (-5.8%) and TC Energy (-3.6%). This was offset by strong returns from West Fraser Timber (+30.0%), Canadian National Railway (+17.7%) and Hydro One (+9.9%).

Both asset allocation (overweight U.S. equities) and stock selection helped our U.S. equity returns. We saw another quarter of strong returns from our housing-related holdings in U.S. homebuilder Lennar (+30.0%), tools-maker Stanley Black & Decker (+14.1%) and Home Depot (+8.7%). Several other holdings produced above-market returns including Costco (+14.8%), Facebook (+13.1%) and Medtronic (+11.1%). Strength came from all areas with all U.S. equity holdings in client portfolios posting positive total returns in the quarter.

Our sole International equity holding, GlaxoSmithKline (-9.5% in Canadian dollars), lagged the return of the MSCI EAFE during the quarter. Accounts did benefit, however, from an underweight position in international holdings as these markets lagged the overall 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.

Wealth Management
Dominion Securities

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. 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. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. 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. Insurance products are offered through RBC Wealth Management Financial Services Inc. ("RBC WMFS"), a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC WMFS. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC WMFS. RBC DS WMFS is licensed as a financial services firm in the province of Quebec. ®Registered trademarks of Royal Bank of Canada. Used under license. © 2019 RBC Dominion Securities Inc. All rights reserved.