Fickel's Focus

Wealth Management
Dominion Securities

Third Quarter 2021 Investment Commentary

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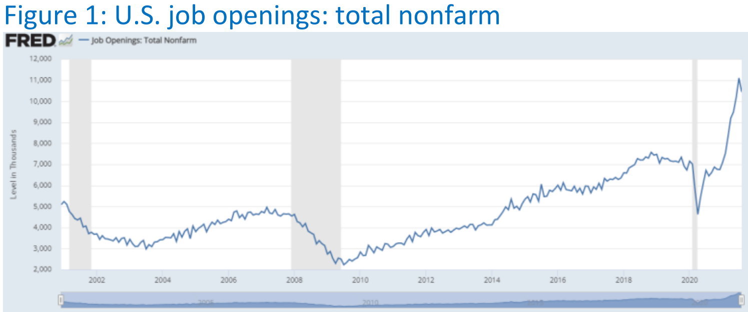
North American equities climbed the wall of worry and delivered modest, positive returns while bonds sold off slightly in the third quarter. Accounts on board for the full period and migrated to their appropriate models produced positive returns and outperformed their respective benchmarks after fees.

Economic Overview

The post-lockdown recovery is still well underway though global growth appears to be slowing from a rolling boil to a simmer. J.P. Morgan now calls for 5.9% and 4.3% global real GDP growth in 2021 and 2022 following downgrades to estimates made earlier this year. Supply chain delays, labour shortages, a slowdown in Chinese growth and Delta variant concerns were all contributing factors. Despite lowered expectations, global growth is anticipated to remain well above trend and we see reasons to stay optimistic. High vaccination rates have demonstrated efficacy keeping a lid on serious infections, and promising antiviral drugs intended to treat COVID-19 are close to coming to market (Merck). While we are not out of the woods yet, we see COVID-19 risks fading materially into 2022. As well, ample liquidity in the financial system, cheap access to capital (low interest rates), and governments maintaining a propensity to spend all bode well for the economic outlook.

The labour markets are in focus right now as investors keenly watch employment growth, a key pillar to this recovery. Interestingly, the U.S. economy has only recovered around 80% of the jobs lost at the beginning of the pandemic (~5 million shortfall) but companies are already struggling tremendously to hire and retain employees. According to the U.S. Bureau of Labor Statistics, there are over 10 million job openings (Figure 1).

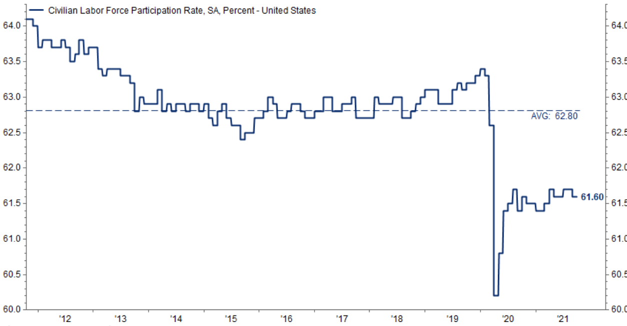
Figure 1: U.S. job openings: total nonfarm



Source: U.S. Bureau of Labor Statistics

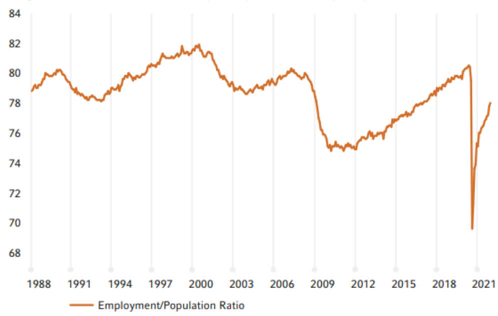
More working-age Americans are on the sidelines and out of the labour market than before the pandemic, evidenced by the labour participation rate and the employment to population ratio (Figures 2 and 3).

Figure 2: U.S. labour participation rate



Source: FactSet

Figure 3: U.S. employment/population ratio



Source: U.S. Bureau of Labor Statistics

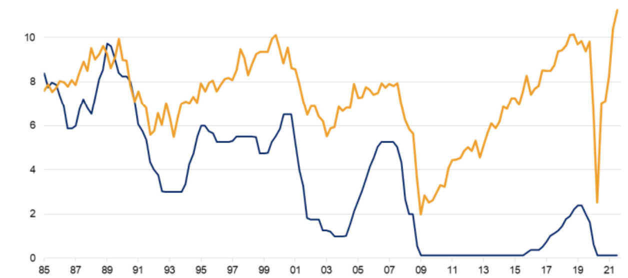
Generous government benefits are likely contributing to this phenomenon (as well as other factors – COVID-19 fears and unqualified applicants). With the bulk of pandemic relief expiring in early September, we anticipate strong employment growth over the coming months as Americans return to the workforce. Hopefully this happens sooner than later, as companies are reporting labour shortages across the board. This is not unique to the U.S. (Figure 4).

Figure 4: Intensity of labour shortages in Canada

Source: Bank of Canada Business Outlook Survey

While plenty of job opportunities for Americans seems like a good problem to have, companies are being forced to raise hiring incentives and wages to attract talent, both of which contribute to inflation. RBC's Labour Tightness Index is at an all-time high which has corresponded with interest rate hikes from the Federal Reserve in the past (Figure 5). This measure considers factors such as jobless claims, business surveys for hiring plans, the job openings/hires ratio, the job leavers rate and the quits rate.

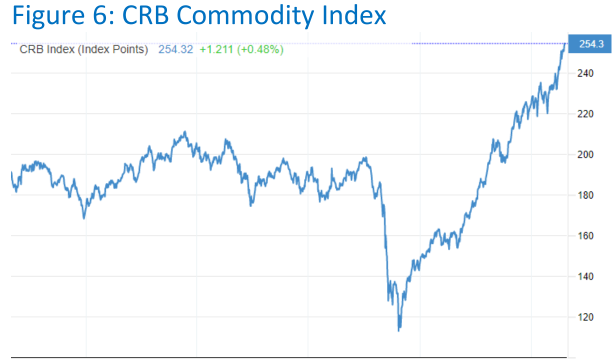
Figure 5: Labour Tightness Index (gold) and the Fed Funds target rate (blue)



Source: Haver, RBC Capital Markets US Economics

Concerns about inflation are not only related to rising wages. Ripples from the pandemic related shutdowns are still being felt around the world and in many cases resulting in supply chain bottlenecks and raw material shortages. Microchips are one example where demand massively outstrips supply, but imbalances are widespread and this phenomenon has been widely coined 'the everything shortage'. The CRB Commodity Index, which is comprised of 19 different commodities (energy and agriculture are the largest), is trading near a five-year high (Figure 6).

Figure 6: CRB Commodity Index



Source: Trading Economics

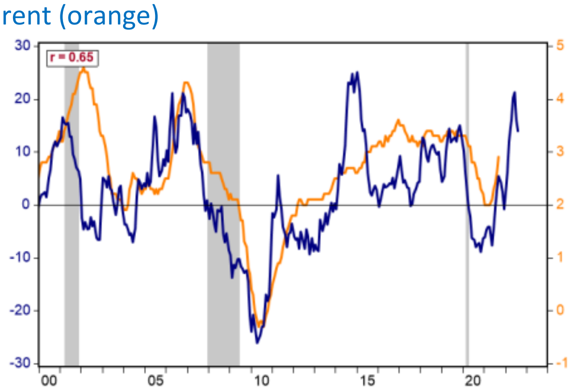
The cost of transporting these raw materials, which can be measured by the Baltic Dry Index, is near decade highs (Figure 7). Actions have been taken to alleviate these pressures, such as allowing or mandating ports to operate 24/7, but the situation remains challenging.

Figure 7: Baltic Dry Index

Source: Trading Economics

COVID-19 and the related shutdowns are likely the root cause of all these imbalances. Like the coronavirus, the everything shortage will be transitory and prices and inventory levels will eventually return to normal (knock on wood). Still, that doesn't mean there won't be pain in the short-term. For example, Americans heating their homes with natural gas (~50% of all U.S. homes) are expected to pay an average of 30% more on their bills this winter (more if this winter is colder than average). Housing costs are expected to rise as well, particularly for renters. The significant home price gains experienced last year are starting to filter their way into rents (Figure 8).

Figure 8: Housing affordability (blue line, left side, higher = more unaffordable) and owner's equivalent rent (orange)



Source: NAR, BLS/Haver

All of this has major implications for companies (input/output prices, margins), consumers (real inflation-adjusted spending ability) and the Federal Reserve. The Fed has recently acknowledged that today's inflation may be more pervasive than initially suspected. We would not be surprised to see a tapering announcement relating to their bond purchasing program sometime in the coming months as well as an interest rate hike next year.

Equity Commentary

Equity investors saw their gains moderate in Q3 relative to previous quarters this year (Figure 9).

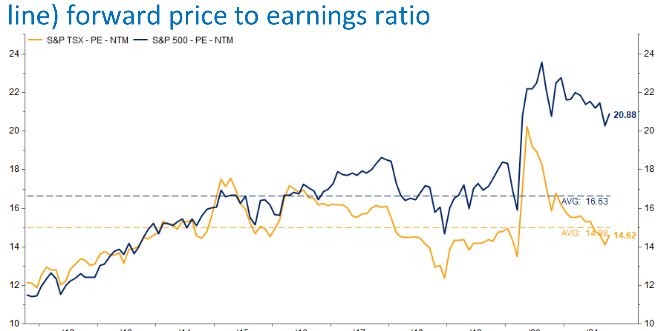
Figure 9: Benchmark equity returns this year

Index	Q1	Q2	Q3
S&P/TSX	8.10%	8.50%	0.20%
S&P 500	4.70%	7.10%	2.90%
MSCI EAFE	1.40%	3.00%	1.20%
* returns in $CAD			

Source: RBC Capital Markets

The markets had advanced around 3-5% heading into September but struggled during the last month of the quarter. Rising commodity prices, wage inflation, general inflation, and supply chain chaos are notable headwinds for stocks. All the while U.S. equities trade at relatively high valuations (Figure 10). Canadian S&P/TSX valutions are more palatable, though the index has much less technology exposure than the U.S. which carries lower multiples.

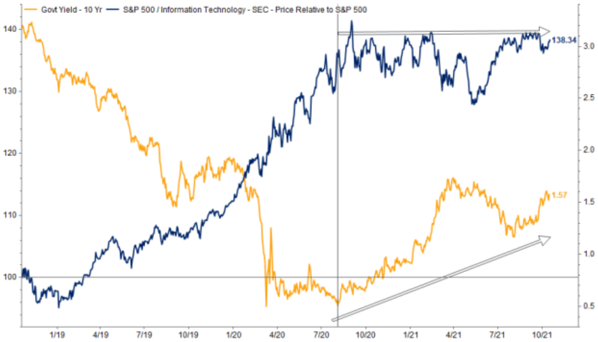
Figure 10: S&P 500 (blue line) and S&P/TSX (orange line) forward price to earnings ratio



Source: FactSet

Higher inflation often leads to higher interest rates, which we started to see again at the end of the third quarter. This typically is negative for stock valuations for a number of reasons. One of them is simply that analysts discount the future cash flows of a company at a higher rate which translates to a lower net present value today. This disproportionately hurts stocks that derive more of their value from long-term earnings expectations, including technology companies. The near decade long outperformance of the technology sector has recently stalled and rising rates are likely playing a role (Figure 11).

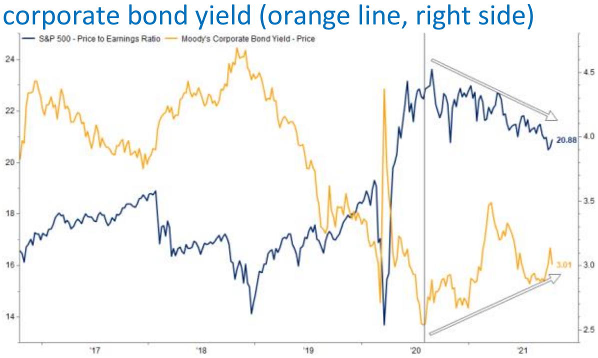
Figure 11: S&P 500 Info. Tech. sector price relative to S&P 500 (blue) and U.S. 10-year gov. yields (orange)



Source: FactSet

If higher rates are symptomatic of an overheating economy central banks will intervene and raise the overnight lending rate (Fed Funds rate in the U.S.), which, if raised too high, can choke off economic growth. S&P 500 valuations as a whole have slightly declined with the recent rise in rates (Figure 12).

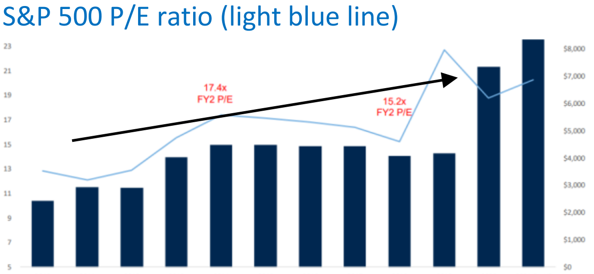
Figure 12: S&P 500 P/E ratio (blue line) and Moody's corporate bond yield (orange line, right side)



Source: FactSet

There is no doubt that stock prices have benefitted from the past decade of central banks purchasing bonds to provide liquidity and supress rates. Valuations are positively correlated with central bank balance sheets (Figure 13).

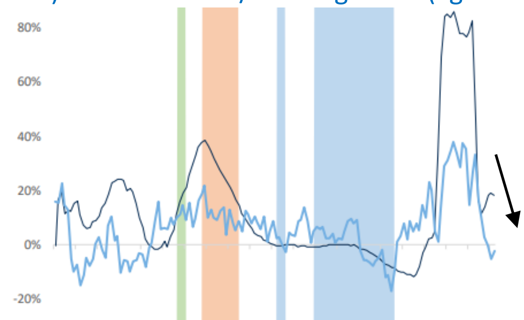
Figure 13: Federal Reserve balance sheet (bars) and S&P 500 P/E ratio (light blue line)



Source: RBC US Equity Strategy, Bloomberg, FactSet

Following massive central bank spending during the pandemic we anticipate a slowdown in the pace of bond buying which has always been a headwind for stock valuations (Figure 14).

Figure 14: Fed Reserve total assets growth (dark blue line) and S&P 500 P/E ratio growth (light blue line)



Source: RBC US Equity Strategy, Bloomberg, FactSet

Does this mean we expect a large correction in equity markets? Absolutely not. From our perch, the most likely outcome is a modest contraction in valuations that will be outweighed by rising corporate earnings. For example, analysts are forecasting ~10% earnings per share growth in 2022. If valuations contract by half of that, investors can expect a total return around 5% next year. Single digit returns going forward seem reasonable following five years of relatively strong equity performance (Figure 15).

Figure 15: Historical returns in Canada and the U.S.

Index	5 Yr Compounded Annually ($CAD)	Compounded Annual Since Dec. 1979 (CAD)
S&P/TSX	9.60%	8.70%
S&P 500	16.10%	12.20%

Source: RBC Capital Markets

With those forward expectations in mind, we continue to see value in lower-multiple stocks that can sustainably distribute dividends to shareholders and grow earnings modestly (ie. total return ~5-8%). The risk/reward tradeoff for high-growth companies that are vulnerable to a valuation contraction if expected growth does not materialize is less attractive at today's prices. That's not to say we don't continue to own technology companies. Diversification is a key tenet of our team, and we still maintain positions in companies like Alphabet, Microsoft, Facebook and Visa for their diverse earnings streams, organic growth opportunities and sheer dominance in their respective markets.

Accounts saw increased trading activity in Q3 from Q2 with greater selling activity late in the quarter when the markets began struggling in September.

West Fraser Timber was exited in mid-July, marking the fourth consecutive quarter that we trimmed or sold the position (purchased at $45.19, sold at $90.57). Warning signs of cyclical highs in the lumber industry have emerged – waning demand from do-it-yourself renovators due to sticker shock, producers ramping up supply and major announcements of new sawmills being green-lighted.

We initiated a position in **Suncor Energy** at the end of July. The company is one of Canada's leaders in oil production and integrated with refining and upgrading operations. Suncor paid an attractive dividend yield of 3.5% at the time of purchase with relatively low capital spending requirements going forward. Suncor's dividend is covered around $40/bbl Brent which is currently trading at $84, and it generates around a 19% free cash flow yield.

Holdings in California-based utility **PG&E** were sold in August due to the uncertainty around the company's future liabilities relating to the Dixie blaze that became the second largest wildfire in state history. The inability to quantify this risk forced us to the sidelines despite the fact that we believe the company has a strong new CEO who has the utility pointed in the right direction. We originally purchased the stock in June 2020 at $9.29 and exited at $8.32, though we may very well add it back when we gain more clarity.

In late July, we trimmed larger positions in **Visa**. Visa retains a leading network and collects fees on credit, debit or mobile transactions but is facing increased competition from a number of rapidly growing payment companies that have emerged over the last several years. The stock trades at a growth multiple and we took some profits on our investment that was originally made in April 2018.

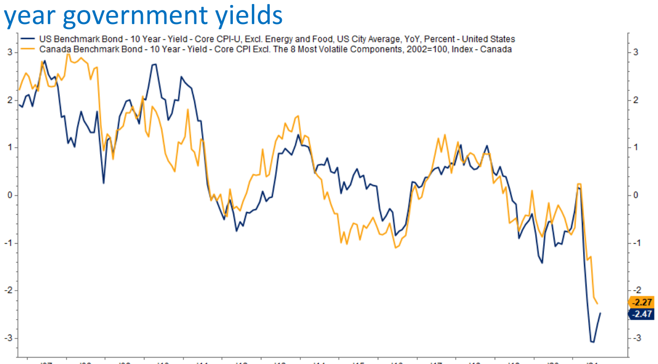
One of our largest positions, **BCE**, was lightened in the middle of September. This action was based on its premium valuation relative to history. We still like the stock for its stable earnings and cash flow that allow it to pay a high dividend yield of 5.4%. We added to BCE in November 2020 and February 2021 as a substitute for bonds as the valuation was very reasonable for the ~ 6% yield it was paying at the time. With the share price up close to 20% year-to-date, we felt it was prudent to pare our positions back as the risk-reward outlook has become more balanced.

As the quarter closed, we took a more cautious stance in client portfolios. We exited our entire position in U.S. homebuilder **Lennar** as rising interest rates typically act as a headwind for the housing industry. We originally purchased Lennar in March 2020 at $29.85 (and added to it in April at $42.29) on the premise that rapidly falling rates would stimulate mortgage growth. We closed out our positions at a price of $95.33. We also pared back holdings in **Home Depot**, **Canadian National Railway** and **Costco** to model weight following a period of strong performance.

Fixed Income

The prices of bonds declined in Q3 as interest rates rose (inverse relationship). The Canadian Bond Broad Composite was down -0.5% for the three months ending September 30, 2021, bringing the year-to-date performance to -3.9%. Our underweight allocation to bonds as well as the shorter-than-benchmark duration benefitted client portfolios during the quarter. Increasingly widespread inflation is likely to pressure interest rates higher, causing us to maintain an underweight allocation to bonds going forward. Real yields (nominal yield minus inflation) for Canadian and U.S. 10-year government bonds are deeply negative and still very unattractive (Figure 16).

Figure 16: Canada (orange) and U.S. (blue) real 10-year government yields



Source: FactSet

We continue to allocate money to preferred shares but acknowledge they are reaching their fair value. Perpetual issues, which pay the same dividend into perpetuity, are now yielding around 4.75%, well below the 5.5%+ yields they carried when we added them. Still, they are more attractive than bonds and pay tax friendly dividends (versus bond interest). Floating rate issues have performed very well with the latest move higher in interest rates.

Performance

Client portfolios outperformed their benchmarks after fees in the third quarter and remain comfortably ahead of benchmarks after fees both on a year-to-date and 1-year basis.

Fixed income holdings within client portfolios outperformed their benchmark during the quarter. A significant underweight and the short duration of client bond holdings contributed to relative performance. Client portfolios hold a sizable weight in preferred shares, which delivered solid positive returns during the period.

Canadian equity holdings in client portfolios enjoyed solid positive returns and easily outpaced the 0.2% total return from the S&P/TSX Index during the quarter. **Canadian National Railway** (+12.2%) led the way as well as commodity-related stocks **Teck Resources** (+10.4%) and **Suncor Energy** (+9.1%). A notable detractor in client portfolios was **Air Canada** (-9.3%) as the fourth wave of the Coronavirus and its Delta variant dampened demand for air travel.

Account holdings in U.S. equities delivered a positive return but fell short of the S&P 500 benchmark total return of 2.9% (owing almost entirely to the $CAD). The top performing holdings among client holdings were broad-based in terms of industry. Big-box retailer **Costco** (+16.1% in Canadian dollars) led the way as well as **Alphabet** (+8.7%) and **Truist** (+8.0%). Offsetting these winners was the disappointment of California utility **PG&E** (-17.0%), whose power lines are suspected to have caused the Dixie forest fire. **Newmont Mining** (-12.6%) fell during the period on softness in gold prices along with **Constellation Brands** (-7.9%) which was weak due to seltzer inventory issues and exposure to cannabis despite strong results in its core beer business.

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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