RBC Dominion Securities Inc.

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Dominion Securities

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Third Quarter 2023 Investment Commentary

It was a challenging third quarter for markets, with the S&P/TSX, S&P 500 and MSCI EAFE down -2.2%, -0.8%, and -2.3% respectively (returns in CAD – the S&P 500 was -3.3% in USD). Interest rates rose significantly during the quarter, sending the Canadian Broad Bond Composite down -3.9%.

Economic Overview

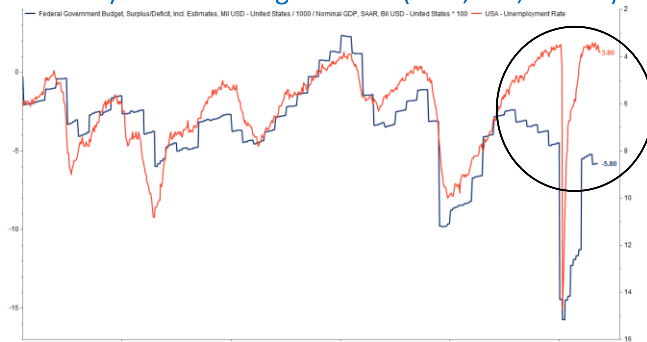
"Resilient" may be the most overused word when it comes to describing the global economy this year. While we're tired of hearing it, we certainly cannot argue otherwise. The wall of worry is daunting and includes challenging financial conditions, disjointed domestic politics and a fraught geopolitical situation. Still, real GDP (inflation adjusted) for developed economies is projected to have expanded by nearly 2% in the third quarter. Growth in the United States has been particularly impressive, with Q3 real GDP having increased by an estimated 4.3% (only 0.8% in Canada). The pace of continued global expansion is a welcomed surprise, especially considering global policy rates are at their highest levels since July 1995 (Figure 1).

Figure 1: Global policy rates

Source: Bespoke Investment Group

The United States has definitively pulled away from the pack and is outpacing Canada and other developed nations. Key sources of strength have been its tight labour market, a less interest rate-sensitive mortgage market, and a nearly complete depletion of pandemic savings – all things we have written on in the past. Major federal stimulus has been another tailwind, and while this isn't unique to the U.S., the magnitude has been extraordinary. For the fiscal year ending September 30, the U.S. deficit as a percentage of GDP increased by 4% from the previous year. That's the third largest annual increase since 1950, ranking behind 2009 and 2020. A fiscal surplus doesn't appear to be on the horizon either following the recent passage of major spending bills – CHIPS Act, Infrastructure & Jobs Act, Inflation Reduction Act. While all this government spending is a direct contribution to GDP growth, it appears to be unsustainable and has resulted in consistent budget deficit widening (Figure 2). Perhaps more concerning is the fact that this stimulus has occurred during a period of economic strength; effectively the opposite of saving for a rainy day. The red line in Figure 2 is the U.S. unemployment rate, inverted, and can be used as a proxy for economic health. Lower unemployment rates (higher red line as it's inverted) have historically been associated with improving fiscal budgets. We can't help but wonder if today's weaker financial position will inhibit the government's ability to cushion any future economic downturns.

Figure 2: U.S. unemployment (red, right side, inverted) and U.S. budget deficit (blue, left, % GDP)

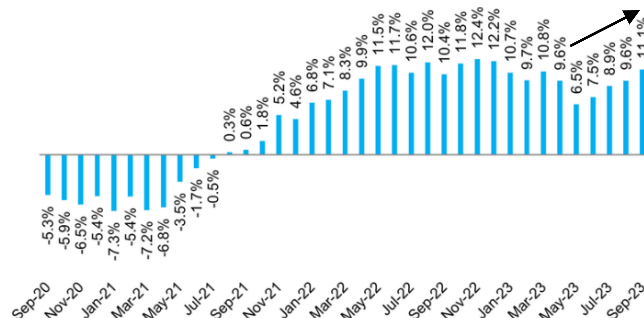


Source: FactSet

Apart from the deteriorating federal balance sheet, the U.S. economy has been remarkable. The domestic outlook is a bit more challenged as we see a few causes for concern here in Canada. Canadians are relatively more indebted and exposed to rising interest rates, primarily through floating and fixed-rate mortgages. The greatest challenge will take place in 2025 and 2026, as mortgages with ultra-low rates from 2020 and 2021 rollover. Still, next year's renewals and rate increases are not insignificant. We expect rising debt-servicing costs to weigh on household consumption for the foreseeable future.

Higher borrowing rates have put Canadians in this predicament, and, in the same fashion, lower rates are a potential solution. However, one prerequisite for the Bank of Canada to change its policy rate course is lower inflation. While great progress has been made on this front, we see challenges ahead. Wage growth is still running at high levels (~5% annually), propelled by greater labour bargaining power and improving minimum wage. Soaring shelter costs, which are the largest component of CPI, are another major hurdle. Unlike in the U.S. where rents are declining, the cost-of-living crisis in Canada has yet to relent. Figure 3 shows the annual change in average asking rent has perked up significantly since May. This will filter into CPI over the next twelve months.

Figure 3: Annual change in average rent in Canada



Source: Urbanation, Rentals.ca

Immigration, a strong U.S. dollar (weak CAD), and extremely high government spending here at home are adding to the price growth. If inflation remains above target for much longer, Canadian households will almost certainly be pinched by higher borrowing costs. We do see a potential scenario where the Bank of Canada is permitted to cut rates before the bulk of mortgage renewals, but that likely requires weaker-than-expected growth, perhaps even a mild recession. We continue to maintain a cautious outlook and, at a minimum, have a hard time seeing the economy accelerate materially from here.

Equity Commentary

Equities performed poorly in the third quarter with all three benchmark indexes posting losses (Figure 4). Year-to-date returns remained in positive territory with U.S. equities leading the pack.

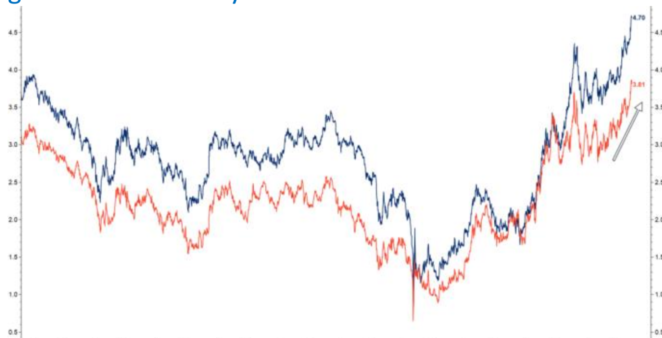
Figure 4: Benchmark equity returns in $CAD

Index	Q1	Q2	Q3	YTD
S&P/TSX	4.6%	1.10%	-2.20%	3.40%
S&P 500	7.2%	6.50%	-0.80%	13.10%
MSCI EAFE	7.0%	0.66%	-2.30%	4.70%

Source: RBC Capital Markets Quant Research

An increase in bond yields was a key reason for the equity market weakness. Higher interest rates are not only negative for stock valuations but also present competition for equity investors. Canada and U.S. bond yields are at their highest levels in over 10 years (Figure 5).

Figure 5: Canada (red) & U.S. (blue) 30-yr government bond yields



Source: FactSet

GICs, money market funds, and high-quality bonds now yield over 5% which has reduced demand for dividend-paying stocks. Sectors like Utilities, Telecommunications, Pipelines, and Banks have experienced steep share price declines. It appears their valuations have adjusted to the higher cost of capital environment somewhat faster than the rest of the market, although that's also due to their higher debt loads and increased refinancing risks. Still, if the Bank of Canada is nearing the end of its rate-hiking cycle and interest rates are close to their peaks, forward returns for these sectors could be attractive. Ignoring the interest rate outlook, dividend yields and valuations are *beginning* to look compelling for some of the companies in these sectors (Figure 6 – as of writing).

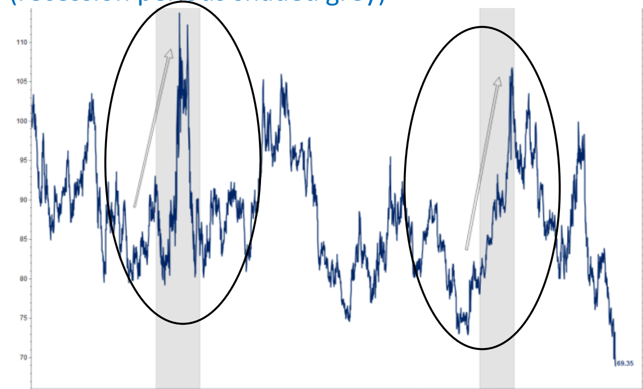
Figure 6: Canadian dividend stocks – year-to-date return, dividend yield and price-to-earnings ratio

Company	YTD Return	Div Yield	P/E
Hydro One	-4.49%	3.42%	19x
Canadian Utilities	-21.28%	6.22%	13x
Emera Inc.	-12.66%	6.35%	14x
BCE Inc.	-13.99%	7.56%	16x
Enbridge	-16.89%	8.07%	15x
TC Energy	-13.69%	7.98%	11x
Royal Bank	-12.55%	4.85%	10x
TD Bank	-12.41%	5.01%	9x

Source: FactSet

Some sectors probably need more clarity on the direction of the economy before they start performing – Banks and Pipelines included. Others, like Telecommunications and Utilities, should do just fine in a variety of environments, though the direction of rates is important. Between immigrants and non-permanent residents, Canada welcomed over 1 million newcomers last year. Lofty immigration targets have been adopted for the foreseeable future to boost growth and offset our aging population. This should result in increased demand for cellular/internet services and electricity, benefitting companies like BCE, Hydro One, Emera and CU. Historically, these have been the companies to own heading into economic downturns. Figure 7 highlights the relative outperformance of Utilities versus the broader Canadian stock market during recessions.

Figure 7: TSX Utilities sector price relative to TSX (recession periods shaded grey)



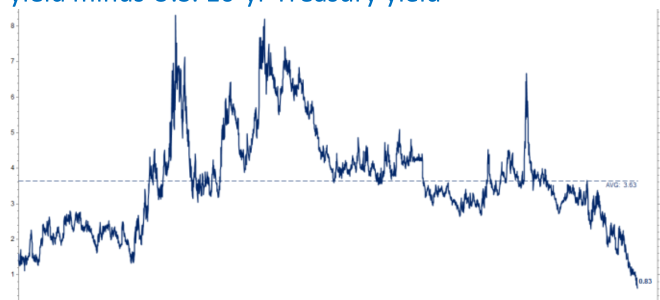
Source: FactSet

Utilities are also uniquely positioned to pass on expenses relating to their higher cost of capital. Future rate-base applications to regulators will include provisions for said expenses, ultimately

mitigating some of the impact of rising interest rates over time.

Our balanced accounts continue to remain underweight in equities, particularly to stocks trading at valuations well above their long-term averages. The rapid increase in bond yields has seen a tremendous deterioration in the relative attractiveness of stocks. The *equity risk premium* compares the stock market earnings yield (total earnings per share / index price) to a 10-year treasury yield and simply compares the two asset classes. While it fails to account for future earnings growth which will certainly benefit from the AI revolution, it's current reading of 0.83% is a 20-year low (Figure 8).

Figure 8: Equity risk premium – S&P 500 earnings yield minus U.S. 10-yr Treasury yield



Source: FactSet

Activity in client accounts was relatively muted during Q3. Late in the quarter, we trimmed our exposure to Canadian bank holdings **Toronto-Dominion** and **Royal Bank**. Slow loan growth, a challenging mortgage backdrop and higher loan loss provisions will be headwinds. The banks trade at cheap valuations and will perform well when the Canadian economy picks up, but uncertainty remains high. We also modestly trimmed our positions in **Suncor Energy** earlier in September as oil prices closed in on $90.

We added to holdings of pipeline **TC Energy** when its dividend yield touched 8%. Its valuation had dropped to levels last seen during the Financial Crisis while the completion of the large Coastal Gaslink project, expected by the end of the year, removes a source of cost risk within the company's portfolio.

Within fixed income, we modestly increased duration in our bond ladder by selling a **2024 Bell Canada** bond and adding a **2030 Intact Financial** bond.

Fixed Income

Interest rates moved sharply higher during the third quarter and fixed income asset prices declined. The selloff has continued to the time of writing and it looks like bond markets are headed for an unprecedented third year of losses. The Canadian Bond Composite lost -3.9% in Q3. Our relatively short-duration fixed income portfolio has performed well in this rising rate environment.

While today's rates are not out of the ordinary from a historical point of view, the adjustment higher from the 2020/2021 lows has been shocking. All fixed income assets have been impacted (Figure 9).

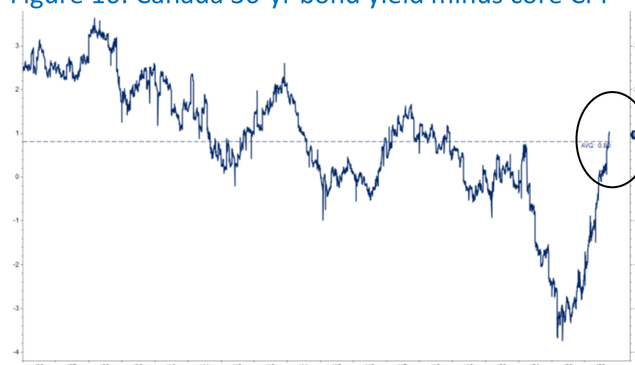
Figure 9: Fixed income asset yields

Fixed Income Assets	Recent Low Yield	Current Yield
Canada 1-Yr Bond	0.1%	5.3%
Canada 5-Yr Bond	0.3%	4.3%
Canada 30-Yr Bond	0.7%	3.7%
GIC	1.5%	5.5%
Canada Corporate Bond Avg.	1.7%	6.1%
Perpetual Preferred Shares	4.8%	7.0%
Structured Notes	N/A	8.0%

Source: FactSet

Value has emerged throughout the fixed income universe especially on a relative basis to equities. We do, however, remain cautious on long government bonds. A Canada 30-year bond, for example, offers less than 1% on an inflation-adjusted basis (Figure 10). It has increased significantly but looks underwhelming on a historical basis.

Figure 10: Canada 30-yr bond yield minus core CPI



Source: FactSet

A short-to-medium term laddered approach remains our preferred strategy in today's fixed income markets. As upcoming government bonds, high-quality corporate bonds, and GICs come due, we are re-investing them further out at higher yields. We continue to slowly extend duration as interest rates rise, effectively locking-in higher yields for longer. Of course, discount bonds have been a focus, and we continue to collect incredibly attractive after-tax yields that would compare to GICs over 7%.

Going forward, we are much more optimistic on fixed than we have been in some time. While the adjustment higher in yields is unlikely to have concluded, current levels offer investors something they haven't in years – reliable yield and/or income. This will enhance the stability of blended portfolios going forward. It has been a bumpy ride, but future returns are greatly improved. Along the same vein, equities have languished recently; the S&P/TSX is up only 1.8% over the past two years on a compound annual basis, and the S&P 500 only 1.4% (in USD). History would suggest those are dismal returns, but we are quite pleased that capital has been preserved given the dramatic rise in rates, and we see investors well-positioned to take advantage of opportunities as they emerge.

Performance

Balanced accounts modestly outperformed the benchmark's return during Q3. Fixed income was the primary contributor to the outperformance, as our short bonds and GICs outpaced the Canadian Bond Benchmark return of -3.9%. Preferred shares were slightly ahead of the benchmark.

Canadian equity holdings underperformed the -2.2% total return from the S&P/TSX Index during the quarter. High dividend payers **Canadian Utilities** (-16.4%), **BCE** (-14.2%), **Emera** (-13.1%) and **TC Energy** (-12.8%) suffered. **Air Canada** (-22.4%) was the biggest detractor, reversing most of its 30%+ gain in Q2 as oil expenses surged. Offsetting this was strong positive performance from **Suncor** (+20.2%) and copper miner **Teck Resources** (+4.9%).

Our U.S. equity holdings were in line with the S&P 500 total return of -0.8% in Canadian dollars during the quarter. Google-parent **Alphabet** (+11.8%) and **Costco** (+7.6%) stood out on the upside. Healthcare sector holdings reversed last quarter's gains with **Medtronic** (-8.8%) and **Pfizer** (-7.3%) leading the downside.

We held no international equities in our balanced model during the quarter, which was a net benefit to relative performance as the benchmark MSCI EAFE Index posted a negative return in Canadian dollars.

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