Fourth Quarter 2020 Investment Commentary

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

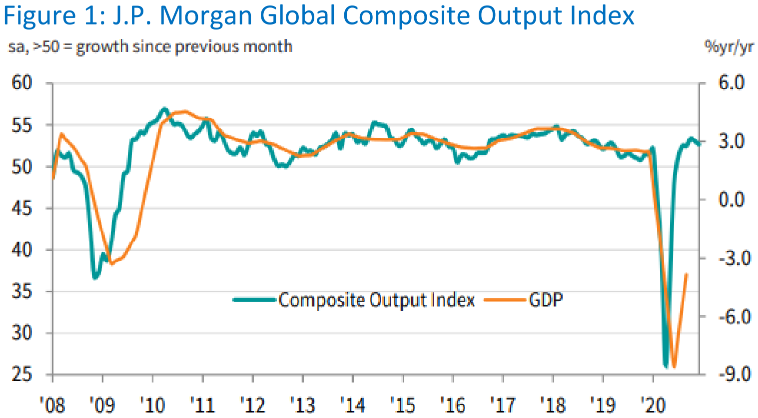
Nathan Fickel, CFA
Associate Advisor
416-960-6816
nathan.fickel@rbc.com

Global equities moved sharply higher in the fourth quarter on the back of the realization of at least three viable COVID-19 vaccines. Bond returns were modest during the quarter. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased by 9.0%, 7.2%, and 0.6% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced strong positive returns in line with their respective benchmarks.

Economic Overview

Global economic activity perked up nicely in the fourth quarter. Consumers and businesses are faring better during the second-wave lockdowns that are far more targeted and less stringent than those imposed in April of last year. With more e-commerce channels in place and big box stores remaining open during the latest lockdowns the economic impact has been somewhat mitigated. Q4 GDP growth looks to have been impressive, with J.P. Morgan estimating the global economy expanded at 6.1% q/q. Also encouraging is the pickup in J.P. Morgan's Global Composite Output Index which registered 52.7 in December (Figure 1). This marks the fifth 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.

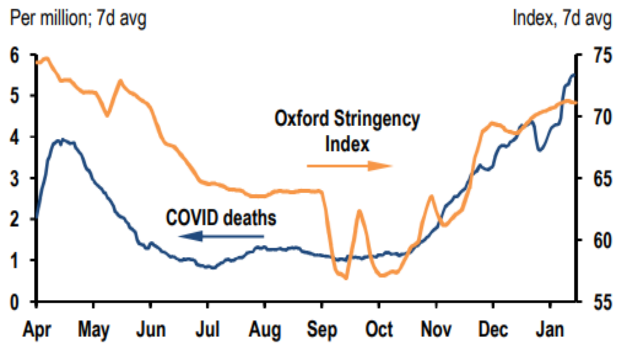
Figure 1: J.P. Morgan Global Composite Output Index



Source: J.P.Morgan, IHS Markit

Still, the global economy remains highly sensitive to the path of the virus and, at least from a public health perspective, the second wave is proving to be worse than the first (Figure 2). The economic impacts from the latest containment policies announced around the world (Toronto and Montreal for example) are yet to be felt. We expect they will yield a growth soft-patch which will reverse when new case growth slows and curtailment measures are lifted.

Figure 2: Global COVID-19 deaths and lockdowns



Source: J.P. Morgan, Our World in Data, Oxford Univ.

The December employment data reflect the deterioration in activity and sentiment related to the second wave. Canada and the U.S. posted employment losses of 62,600 and 140,000 respectively, both ending seven consecutive months of jobs growth. The brunt of the job losses were in industries highly vulnerable to the spread of the virus, particularly restaurants and bars. This puts Canada's recovery of jobs lost since February at about 80%.

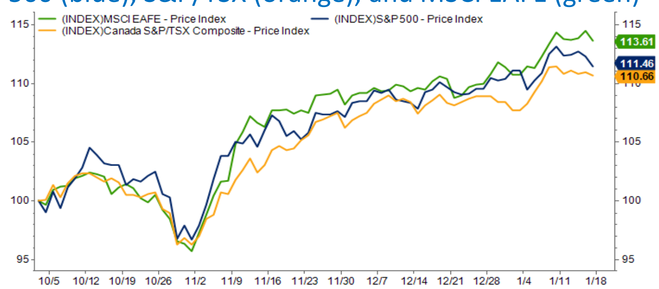
Despite the second-wave intensification, vaccine rollouts are brightening the light at the end of the tunnel. The timeline is still murky, but experts suggest that 'herd immunity' can be achieved by the end of the year or possibly earlier. Investors applauded this news and financial markets rallied on the increased likelihood of economic normalization in 2022. This warrants plenty of optimism when looking out beyond this year, but in the near-term countries and the global economy will continue to struggle with the balancing act between virus spread and business shutdowns. Accommodative central banks and extraordinarily generous government support programs will help cushion some of the economic weakness.

Equity Commentary

Equity weightings are above the benchmark. Balanced accounts' equity weightings are approximately 60.59% on average versus the benchmark weight of 55%.

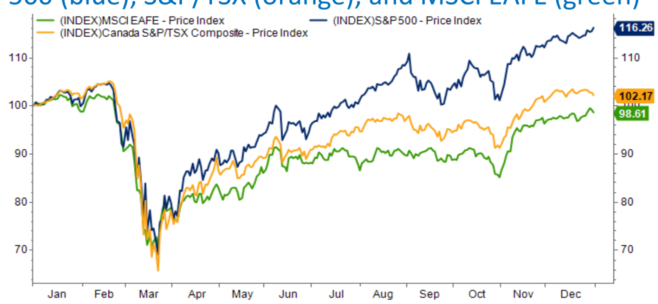
Equity markets staged an impressive rally in the fourth quarter (Figure 3), leaving the U.S. S&P 500 deep in positive territory and the S&P/TSX and MSCI EAFE about flat for the year (Figure 4).

Figure 3: 3-month indexed price performance of S&P 500 (blue), S&P/TSX (orange), and MSCI EAFE (green)



Source: FactSet

Figure 4: 2020 indexed price performance of S&P 500 (blue), S&P/TSX (orange), and MSCI EAFE (green)

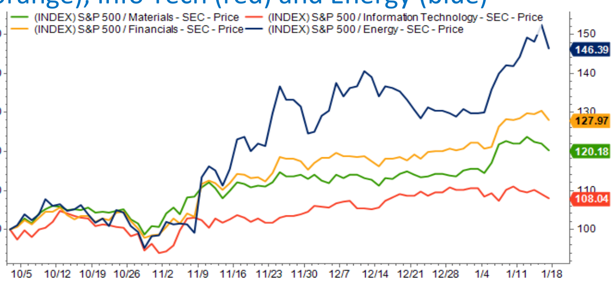


Source: FactSet

Equities had an impressive year outside North America and Europe too. The MSCI World Index price return for 2020 was 11.8%. It is difficult to comprehend how investors enjoyed positive returns in the face of the pandemic and the corresponding economic recession. And these weren't the only challenges faced in 2020. Rising civil unrest and geopolitical tensions, ballooning government debt levels that will likely necessitate higher taxes, election uncertainty, de-globalization, and expensive stock valuations have been and will continue to be headwinds for investors. Still, the markets continue to look out beyond 2021 at a world where much of the population is inoculated, lockdown restrictions are lifted and an economic recovery is in full swing.

The latest rally in equities confirms the improvement in sentiment among investors. Energy, Financial, and Material sectors, which are relatively cyclical, outperformed the broader index in the U.S. and the Information Technology sector over the last three months (Figure 5). This is an important change in leadership that signals greater acceptance of the economic recovery.

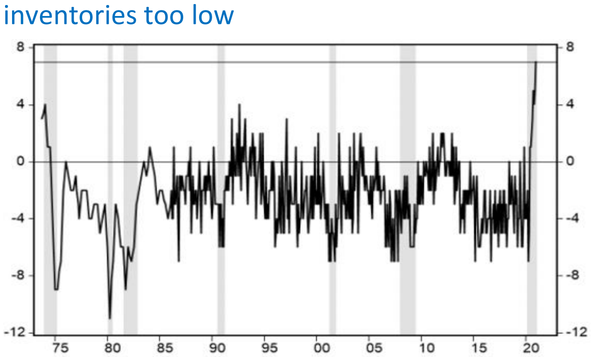
Figure 5: 3-month indexed price performance of S&P 500 sectors – Materials (green), Financials (orange), Info Tech (red) and Energy (blue)



Source: FactSet

We anticipate investors and the markets to continue focusing on 2022 and beyond while overlooking most of this year's economic weakness that's owed to the pandemic. Barring a significant delay in the vaccination rollout we see a positive backdrop for equities during the recovery phase of this cycle. Earnings will continue to rebound as global demand returns to normal levels and profit margins should benefit from massive cost re-engineering that took place last year, particularly for 'epicenter' companies. As societal normalcy is gradually restored corporate fears should ease, leading to a revival of capital expenditures and hiring. What's more, the stage is set for a powerful inventory cycle as the share of small firms reporting inventories are too low right now rose to the highest level in history (Figure 6).

Figure 6: NFIB: percent reporting current inventories too low



Source: NFIB/Haver/RBC Capital Markets US Economics

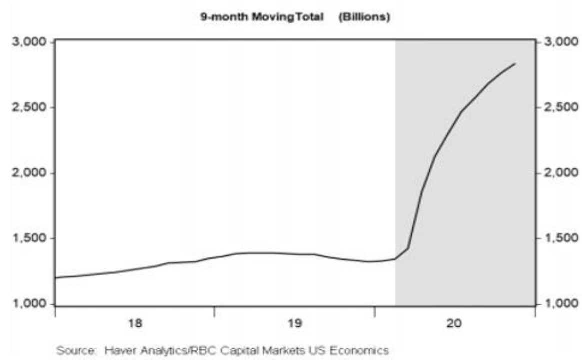
On top of all this, consumers are likely in the best shape ever after exiting a recession thanks to generous government handouts and central bank liquidity (Figures 7, 8 and 9). This bodes well for consumer spending as households possess significant scope to mobilize and deploy savings.

Figure 7: Global stimulus to fight COVID-19

	Central Bank Liquidity Injection		Government Fiscal Stimulus		Government Bank Liquidity Injection & Gov't Fiscal Stimulus	
	$ TLN	% GDP	$ TLN	% GDP	$ TLN	% GDP
US	$4.80	22.4%	$2.71	12.7%	$7.51	35.0%
Euro Zone	$1.10	8.3%	$0.80	6.0%	$1.90	14.3%
Japan	$0.20	3.9%	$0.99	19.2%	$1.19	23.1%
UK	$0.25	9.0%	$0.07	2.4%	$0.31	11.4%
China	$1.27	8.9%	$0.54	3.8%	$1.81	12.8%
Others*	$0.62		$1.66		$2.28	
TOTAL	$8.24	9.5%	$6.77	7.8%	$15.01	17.3%

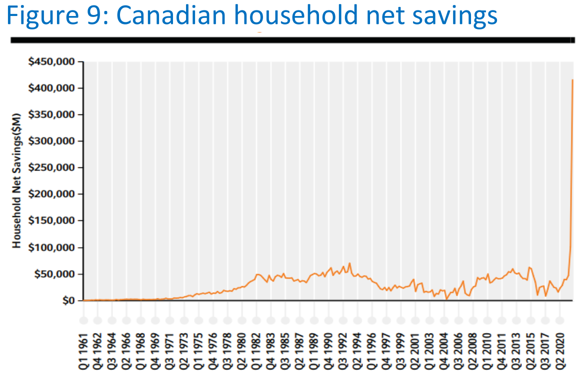
Source: Veritas Investment Research

Figure 8: U.S. disposable income less consumption



Source: Haver Analytics/RBC Capital Markets US Economics

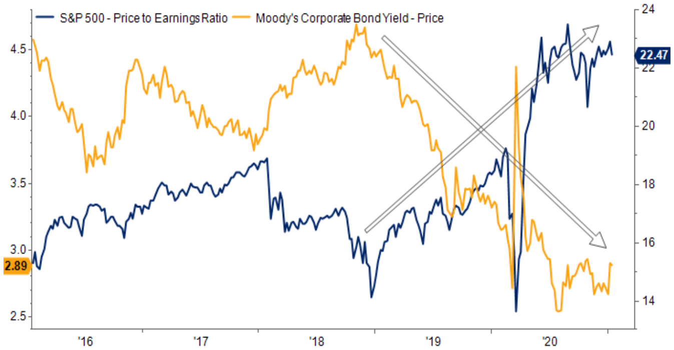
Figure 9: Canadian household net savings



Source: Refinitiv DataStream, Russell Investments

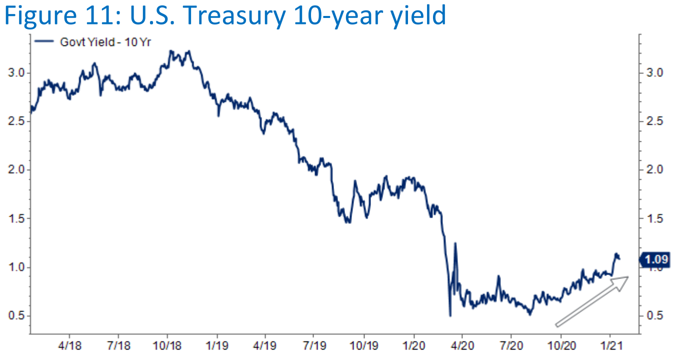
While we are optimistic in our outlook for earnings growth we do have concerns with regards to equity valuations. Accomodative central bank policies and unprecedented liquidity injections have taken interest rates to all-time lows and propelled valuation multiples higher (Figure 10). Interest rates have since moved up modestly, but a material move higher would put downward pressure on elevated stock valuations (Figure 11).

Figure 10: S&P 500 P/E NTM (blue) and Moody's corporate bond yield (orange)



Source: FactSet

Figure 11: U.S. Treasury 10-year yield



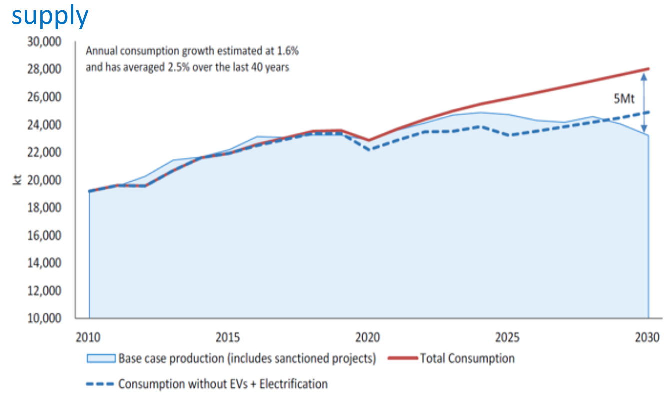
Source: FactSet

The upside risk to interest rates is inflation. A sustainable pickup in inflation will not only erode the value of bond coupon payments and cause bondholders to demand higher rates, but also pressure central banks to raise policy targets. It's likely that inflation will jump higher this year. Businesses have been shutdown resulting in a significant supply shock and demand has held up thanks to tremendous helicopter money (direct payments to individuals). Add in supply chain disruptions, low inventory levels, and elevated household salvings and the consequence is textbook higher inflation. However, its quite possible that capacity underutilization and an incomplete labour market recovery will reign in any jump in inflation back to normal levels which should be OK for equity valuations. As well, central banks have indicated minimal desire to raise rates anytime soon and are willing to let inflation run above their target for an extended period of time before implementing a policy change.

Trading in client portfolios was more active in the fourth quarter than the third. With additional clarity provided from the successful development of vaccines, we added cyclicality to accounts by increasing exposure to companies that stand to benefit from the eventual removal of constraints imposed to limit the transmission of the COVID-19 virus.

We added Teck Resources to portfolios in late November. Teck is a diversified Canadian mining company with an attractive geopolitical footprint. It derives approximately 40% of its earnings from copper and also has exposure to long-life, high-quality coking coal, zinc, and bitumen production. The company holds an 8% share of the global seaborne coking coal market and is the world's third-largest zinc producer. Longer-term, the company has a portfolio of five copper developmental growth projects in the Americas and is in a strong financial position. Copper remains one of our favourite metals due to a lack of investment during the previous decade and a foreseeable supply shortfall beyond 2025 (Figure 12).

Figure 12: Copper estimated total consumption and supply



Source: Bloomberg, Wood Mackenzie, RBC Capital Markets

Positions in Air Canada were reestablished the day positive study results were announced from Pfizer and BioNTech in regard to their COVID vaccine. The airline was founded in 1937 as a government-owned monopoly and over time has added many coveted international routes as Canada's industry flag carrier. Air Canada became a publicly traded company once again in 2006 and has had no government ownership in over two decades. With vaccines providing a path back to the previous norms of air travel, we believe Air Canada has material upside potential long term. Lower jet fuel prices, significant cost cutting measures and a capital raise during the past nine months have the company well positioned. A position in U.S. utility PG&E was established in late June and we added to our holdings in late July and again in early October. The company generates and transmits electricity for five million customers and transports and stores natural gas for four million people in Northern California. PG&E is exiting bankruptcy after settling claims related to wildfires 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. PG&E is set to play a key role in implementing California's aggressive energy and environmental policies. We added to our weight in this name after we gained increased confidence in its ability to reduce debt and reinstate the dividend over the next few years.

We continued to seek conservative, high-yielding stocks as a substitute for bonds in today's low yield environment. This is a trend we started earlier in the year due to the meagre income offered in bonds. Client portfolios saw a U.S. government treasury bond mature during the quarter. We increased our weights in BCE, which offered a 6.25% yield at the time of purchase, rather than reinvest these funds into another government or corporate bond offering a yield of 1% or less. We believe BCE will continue to maintain its long-held status as a safe haven due to its size, liquidity and stability of cash flows.

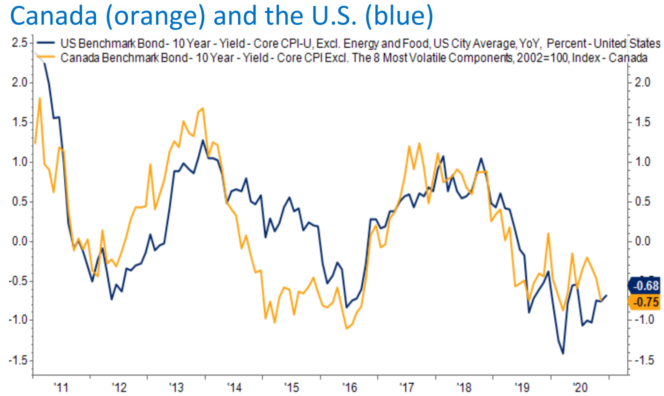
Gains in West Fraser Timber and Newmont were partially realized during the quarter. We originally purchased West Fraser in June at $45.19 in our balanced mandates as a play on the housing market that was beginning to experience a substantial tailwind from record low interest rates. The company is both the largest and lowest-cost producer of lumber in North America. It has operations in British Columbia, Alberta and the U.S. South region. We recognize lumber is a highly cyclical industry and realized gains in November at $71.30. We trimmed our positions in Newmont in late November. Gold prices and resultantly Newmont's share price had a significant run in 2020. As we enter the recovery phase of the cycle we see better opportunity in cyclical companies like Teck Resources. Newmont remains a decent size in client portfolios in terms of weight as we are still attracted to gold as a hedge against market volatility and inflation. Newmont also provides the prospect of upside in the form of increasing dividends and an improved earnings outlook through a higher gold price and cost-saving synergies while integrating the Goldcorp assets.

Fixed Income

We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 33.31% on average versus the benchmark weight of 40%, with about half of that in preferred shares.

The Canadian Broad Bond Composite Index returned 0.6% in the fourth quarter, bringing its 2020 total return to an impressive 8.7%. Nearly all of that came from capital gains, not collecting coupons (interest rates go down, bond prices go up). Bond yields went from low to lower during 2020, and currently offer investors very little in the way of income or prospective capital gains. Real yields on 10-year government bonds in Canada and the U.S. are -0.75% and -0.68% and don't even serve to preserve capital after inflation (Figure 13). Low yields could be acceptable for bondholders if they expected interest rates to decline (and correspondingly bond prices to rise) but the recovery phase of the economic cycle will likely place more upward than downward pressure on rates.

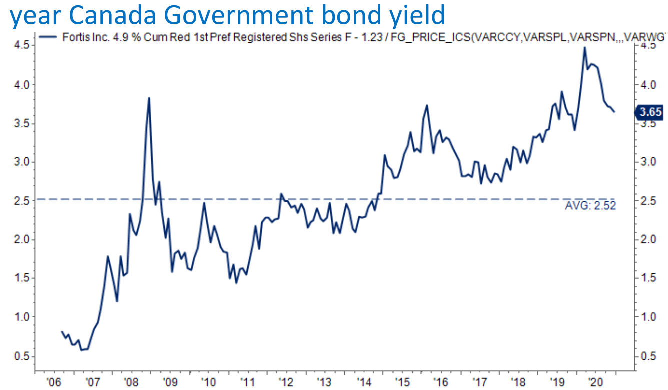
Figure 13: 10-year government bond real yields in Canada (orange) and the U.S. (blue)



Source: FactSet

We continue to like preferred shares as an alternative to bonds. Our preferred share portfolio holds a combination of fixed rate reset, floating, and perpetual issues that generate a dividend yield around 5%. Nearly all of the preferred shares we own are issued by high-quality, core Canadian companies that we are confident will provide long-term dividend sustainability. We currently favour perpetual preferred shares which pay the same dividend into perpetuity. Fortis' Series F perpetual preferred share, for example, yields 4.86%, which is 3.65% higher than Canada Government 30-year bonds yields (Figure 14). This spread is well above its historical average. Patient investors with a medium to long-term time horizon can ride out volatility and collect very attractive income from issues like these and likely outperform government bonds.

Figure 14: Fortis Series F dividend yield minus 30-year Canada Government bond yield



Source: FactSet

Performance

Fixed income holdings within client portfolios slightly underperformed the all-Canadian benchmark owing to our modest exposure to U.S. dollar-denominated bonds and the USD/CAD exchange depreciating by 4.5%. The majority of our holdings in preferred shares delivered similar returns to the bond index of 0.6% although portfolios benefitted from solid gains in floating-rate BCE preferred shares which were up over 10% during the period.

Our Canadian equity holdings produced inline returns to the 9.0% return from the S&P/TSX Index during the quarter. Companies that stand to benefit most from reflation and a reopening of the economy led the way with strong returns produced by lumber company **West Fraser Timber** (+32.2%), insurer **Manulife** (+22.3%), **Toronto-Dominion Bank** (+16.7%), **Royal Bank** (+11.9%) and miner **Teck Resources** (+10.7% from purchase). Detractors from relative performance were primarily stocks that are sensitive to upward moves in interest rates including **TC Energy** (-7.4%), **Canadian Utilities** (-2.1%), **BCE** (-1.4%) and **Emera** (-1.1%). In the case of these stocks, we would be content with collecting the 5-6% annual dividends with stable stock prices, particularly with yields on bonds being so unappealing at the present time.

U.S. stocks in client portfolios also performed in line with the S&P 500 return of 7.2% in Canadian dollars. However, client portfolios are overweight the benchmark at an average weight of 31% versus 20%, which materially benefitted clients. Three of our bigger bets initiated earlier in the year paid off with the successful discovery of a vaccine. **Walt Disney** (+39.5%) was boosted by the prospect of theme parks and movie theatres reopening along with the rapid scale their streaming service is building. **PG&E** (+26.8%) is a turnaround story that has gained investor interest due to its cheap valuation relative to growth runway after exiting bankruptcy. **Delta Airlines** (+25.6%) bounced strongly on the prospect of increased air travel in 2021. **Truist Financial** (+20.3%), a notable laggard earlier in the year, saw a rebound as value stocks gained favour after positive vaccine news. The largest detractors from returns were made up of three stocks that were pandemic winners earlier in the year including U.S. homebuilder **Lennar** (-10.8%), gold miner **Newmont** (-9.8%) and do-it-yourself retailer **Home Depot** (-8.6%).

Our sole International equity holding, **GlaxoSmithKline** (-6.5% in Canadian dollars), significantly lagged the Canadian dollar return of the MSCI EAFE of 10.6% during the quarter. Some of the underperformance owing to the underweight in international holdings was mitigated with the overweight positions clients have in U.S. equities. The S&P 500 returned 16.26% in 2020.

Our balanced portfolios enter the first quarter of 2021 with a bullish tilt geared towards an economic recovery. Average fixed income weights are at 33%, below our benchmark weight of 40%. Equity positions average 61% versus our benchmark of 55%. Part of the overweight in equities is a result of our aforementioned preference for stable high yielding stocks over bonds.

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.

RBC Wealth Management Dominion Securities