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Fourth Quarter Investment Commentary

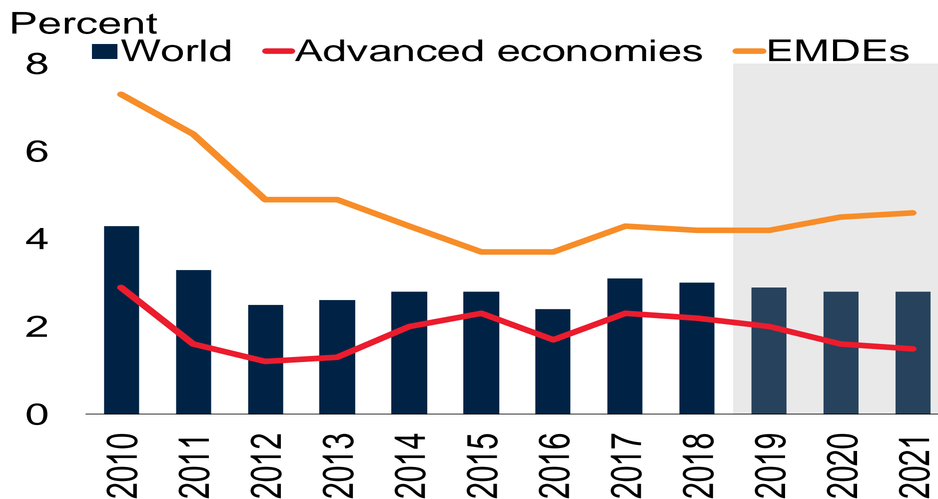
Global equity markets sold off sharply in Q4. The S&P/TSX and the S&P 500 declined by 10.1% and 8.6% in $Cdn respectively.

Accounts on board for the full quarter and migrated to their appropriate models outperformed the balanced benchmark return of -4.45%. Please contact us to further discuss the performance of your portfolio.

Economic Overview

The current global expansion is in its 10th year and is poised to continue through 2019, which would make it the longest in history. While it is likely we are in the late stages of the cycle, expansions do not die of old age and the fundamental backdrop remains decent. The World Bank forecasts global GDP growth of 2.9% in 2019 (Figure 1), a modest deceleration from last year. Strong labour markets are bolstering consumption while softer industrial activity and trade are weighing on global growth and investor sentiment.

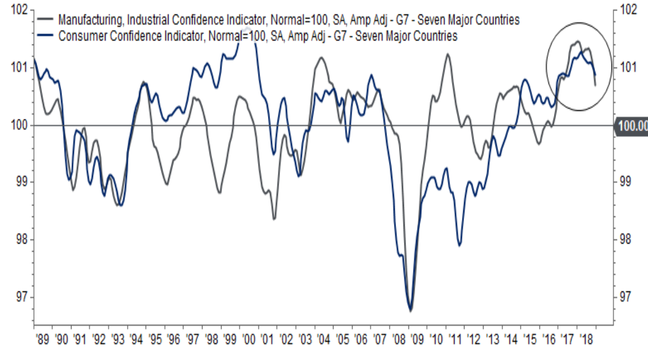
Figure 1: Global GDP growth to 2021



Source: Bloomberg, Haver Analytics, World Bank

The economic backdrop softened in the fourth quarter. Manufacturing activity lost some steam and trade tensions remained high. Concerns about slower growth are having an effect on global consumer and business confidence (Figure 2).

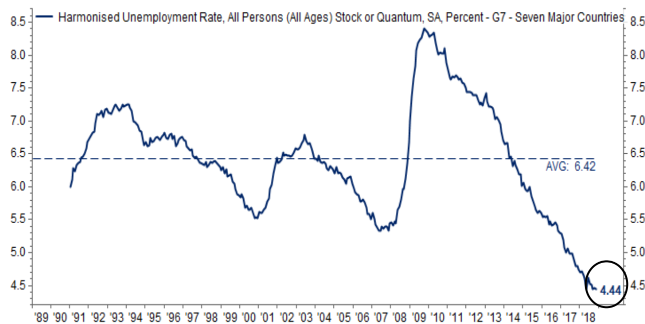
Figure 2: Global (G7) confidence has rolled over



Source: FactSet

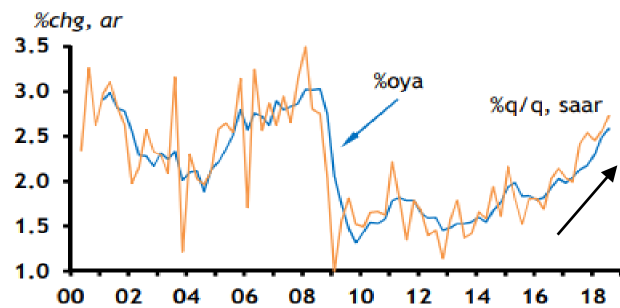
Labour markets are resilient despite weaker sentiment. The unemployment rate in G7 countries is at a multi-decade low of 4.44% (Figure 3) and wage growth in developed markets continues to accelerate (Figure 4).

Figure 3: G7 unemployment rate at multi-decade low



Source: FactSet

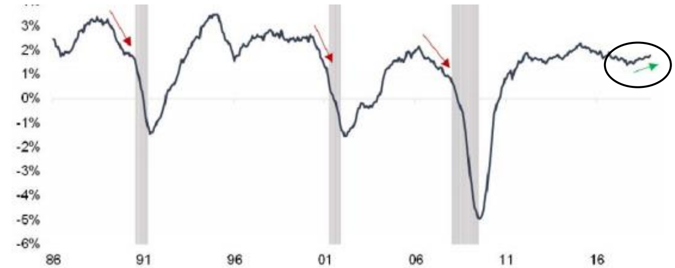
Figure 4: Wage growth in advanced economies



Source: J.P. Morgan

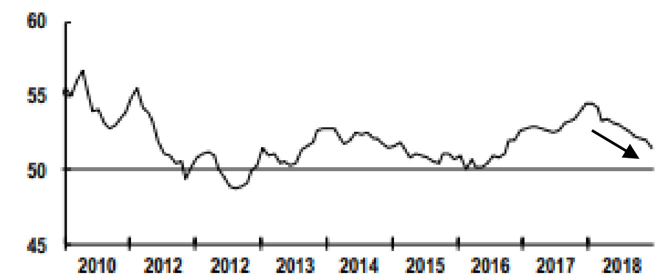
The U.S. labour market is exceptionally strong. 312,000 jobs were created in December. To put this into perspective, around 120-130,000 jobs are needed each month to maintain the unemployment rate. Absolute employment levels are a coincident indicator of economic downturns and tend to lag financial market price movements. However, peaks in employment growth have historically come well ahead of recessions and equity market turns (Figure 5).

Figure 5: U.S. employment growth as a recessionary indicator



The global manufacturing sector ended 2018 on a subdued footing. The J.P. Morgan Global Manufacturing PMI composite index fell to a 27-month low of 51.5 in December (Figure 6). Strength in the consumer goods sector – which rose to an eight-month high – was more than offset by continued weakness in business activity (new orders and trade). While the composite remains in expansionary territory, it has deteriorated quickly and we are concerned about the growing reliance on consumer spending.

Figure 6: J.P. Morgan Global Manufacturing PMI (Purchasing Managers Index) declined but is still in expansion territory (above 50)



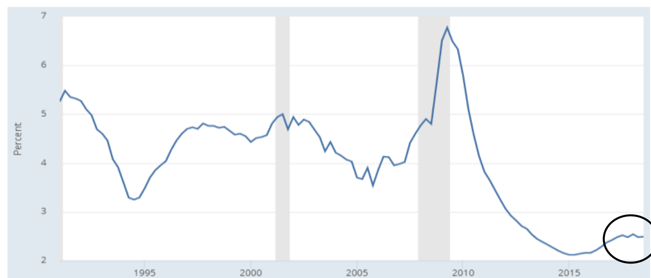
Source: J.P. Morgan

Some recent developments should promote an end to this downward momentum. Supportive policy in China – tax cuts, fiscal subsidies for household durable goods purchases, and infrastructure spending – should serve to stabilize growth. Trade

negotiations appear to have made some progress in early 2019 which would certainly benefit global business sentiment. We are cognizant, however, that large gaps remain regarding needed structural changes in China (IP protection, forced technology transfer, cyber security, etc.) before a deal is reached. There is a case for consumer spending to remain firm in the near-term as declines in energy and global food prices boost household purchasing power. Against this backdrop, the Federal Reserve and the Bank of Canada have indicated they will likely pause hiking rates, giving debt-laden (in Canada) consumers a much needed break from rising interest payments.

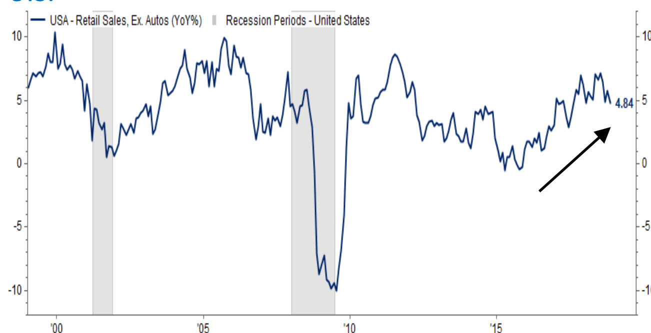
Given the global economy's reliance on consumption (particularly in the U.S.), we are paying close attention to the state of consumers. In the U.S., we are encouraged by strong employment, low levels of loan delinquencies (Figure 7), firm retail sales (Figure 8), and a relatively high personal savings rate over the last decade (Figure 9).

Figure 7: Delinquency rates on credit card loans are low



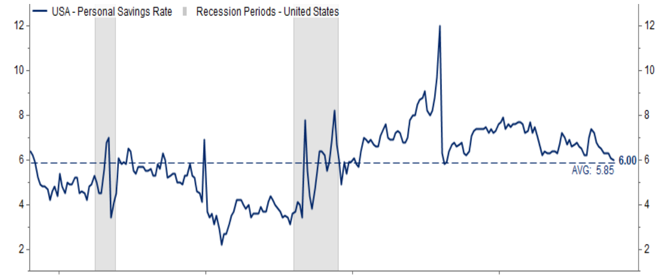
Source: Board of Governors of the Federal Reserve System (U.S.)

Figure 8: Retail sales (ex. autos) remain firm in the U.S.



Source: FactSet

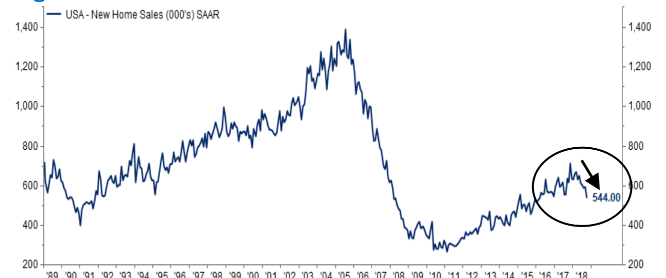
Figure 9: U.S. personal savings above average over last decade



Source: FactSet

We continue to see affordability issues in the U.S. automobile and housing industries. Automobile sales held up well in 2018, but the outlook for 2019 is grim. Auto loan rates are at a more than seven-year high and affordability is further worsened by rising average car prices, tariffs on steel and aluminum, and changes to federal income tax that will lower allowable auto-related deductions. New home sales in the U.S. have clearly rolled over (Figure 10) and the monthly supply of houses in the U.S. (ratio of homes for sale to homes sold) has spiked (Figure 11). Potential homebuyers are struggling with the combined effects of rising home prices and mortgage rates. Monthly mortgage payments have increased by 67% since 2013, well above the increase in wages over that time period.

Figure 10: U.S. new home sales have rolled over



Source: FactSet

Figure 11: Monthly supply of houses in the U.S. (ratio of houses for sale to houses sold) has increased

Source: U.S. Bureau of the Census and U.S. Department of Housing and Urban Development

Equity Commentary

Equity weightings were lowered in all portfolio objectives as we continued to de-risk the portfolios in the fourth quarter. Balanced accounts' equity weightings are approximately 48.5% on average versus their benchmarks weights of 55%. We maintained a defensive posture within equities as well, being overweight Utilities, Telecommunications, Consumer Staples, Health Care, and REITs.

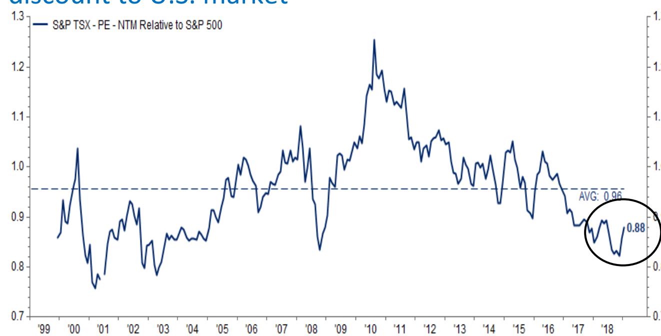
We are marketweight Canadian equities. The S&P/TSX price-to-earnings ratio trades at a modest discount to its 15-year average (Figure 12).

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).

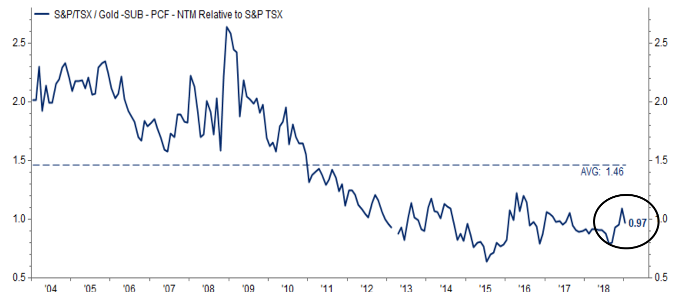
Figure 13: Canadian stock market trades at a deep discount to U.S. market



Source: FactSet

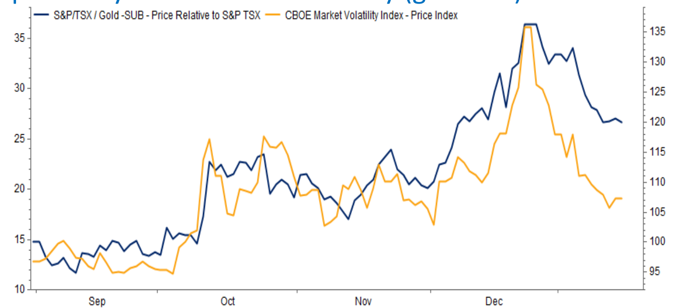
We continue to believe there is a place for gold in the portfolios. We are attracted to Canadian gold miners' cheap valuations and positive earnings outlook (Figure 14). An added benefit is gold's natural hedge against rising inflation, political instability, and market volatility (Figure 15).

Figure 14: Gold sector price to cash flow relative to the TSX



Source: FactSet

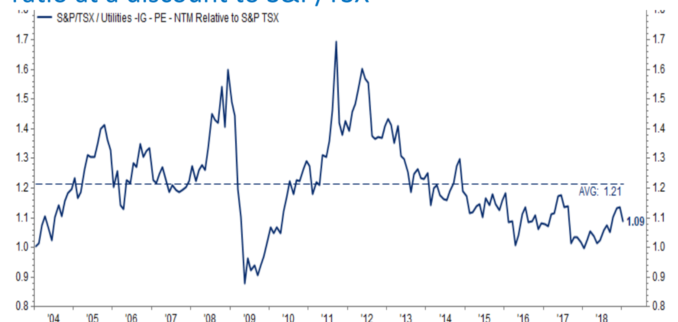
Figure 15: The S&P/TSX Gold Sector (blue line) is positively correlated to volatility (gold line)



Source: FactSet

We remain overweight utilities in Canada. We like their defensive characteristics, high dividend yields, low valuations and visible earnings growth. The utility sector is trading at about a 10% relative P/E discount to the S&P/TSX historical average (Figure 16).

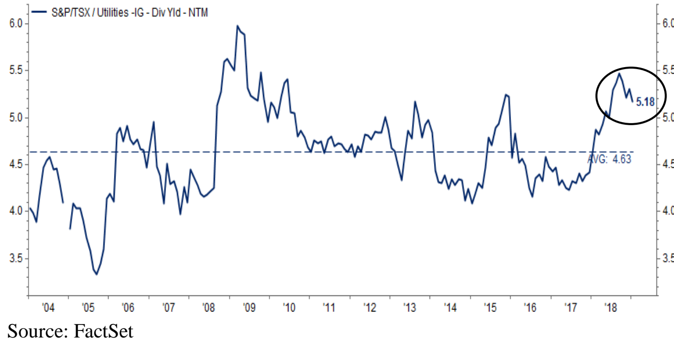
Figure 16: Utilities sector relative price-to-earnings ratio at a discount to S&P/TSX



Source: FactSet

Dividend increases over the next twelve months will take the S&P/TSX Utilities sector yield to 5.2%, close to its all-time high (Figure 17).

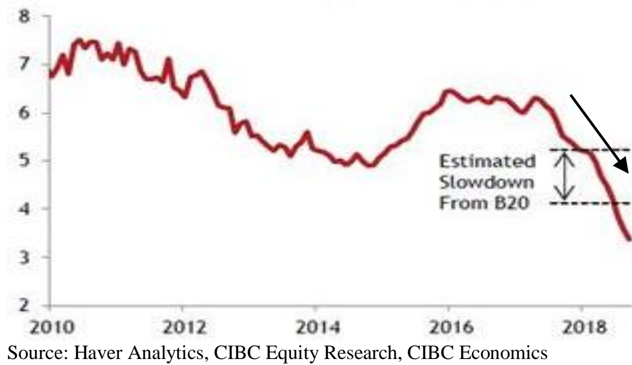
Figure 17: S&P/TSX Utilities sector dividend yield



Source: FactSet

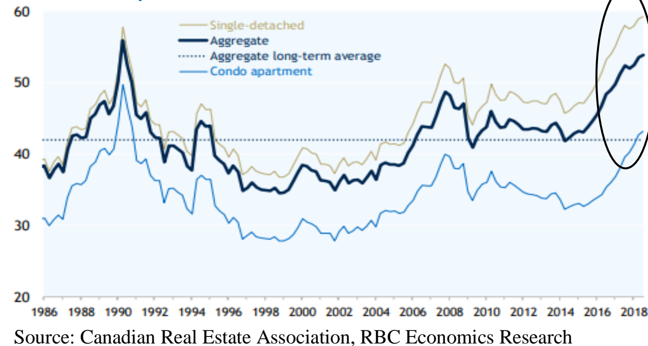
We are underweight Canadian financials despite attractive valuations for the banks and insurance companies (forward P/E ratios of 10x and 8.5x respectively). We think the environment has become more challenging for the Canadian banks. Residential loan growth has slowed (Figure 18) and a near-term rebound seems unlikely given how unaffordable homes are (Figure 19).

Figure 18: Residential mortgage growth (YoY, %) – B20 is the new lending regulations as of January 1, 2018



Source: Haver Analytics, CIBC Equity Research, CIBC Economics

Figure 19: Canadian housing affordability at worst level in 30 years



Source: Canadian Real Estate Association, RBC Economics Research

Making matters worse, the flattening yield curve in Canada (Figure 20) is eroding the banks' net interest margins as they are forced to pay higher rates on deposits while receiving lower rates on longer-term loans.

Figure 20: GoC 10-year yield minus 3-month yield

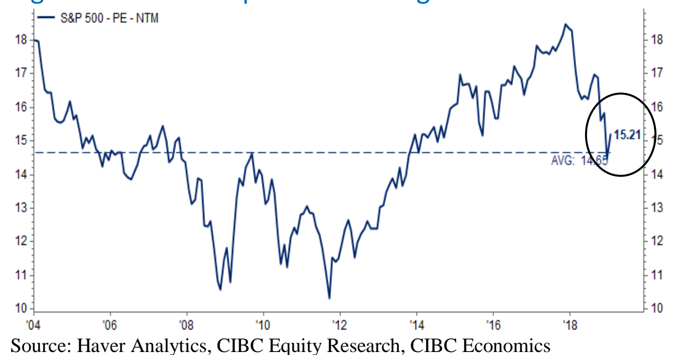
Source: FactSet

Lastly, Wealth Management's contribution to the banks' earnings has grown over the years. Market weakness could result in lower assets under management and meaningfully impact the bottom line.

Despite the anticipated slowdown in mortgage growth, 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). Following the sharp selloff, the S&P 500 trades roughly in-line with its historical P/E valuation (Figure 21).

Figure 21: S&P 500 price to earnings ratio

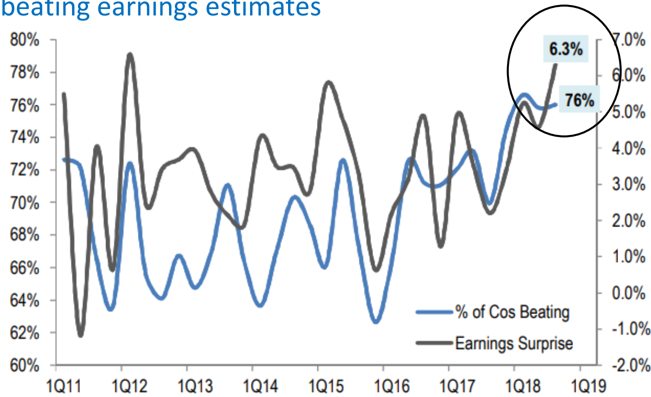


Source: Haver Analytics, CIBC Equity Research, CIBC Economics

The S&P 500 is down ~10% from its 2018 high, and that's after the late December/early January rebound of ~10%. The outlook for U.S. equities has become clouded. Economic indicators are slowing, growth abroad is contracting, policy is less supportive, and market volatility is high. While some of the downward momentum has been priced into the markets, it is difficult to estimate how much further activity will soften. A negative feedback loop is conceivable, where slowing activity dampens

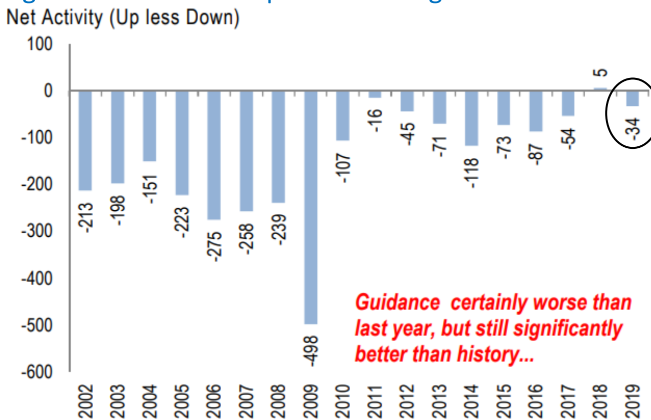
business confidence, businesses reduce hiring and investment and ultimately reinforce the initial deceleration in activity. However, there are positive developments underway that should mitigate some of the aforementioned headwinds. First and foremost is strong profit delivery from U.S. companies. Despite recent downward revisions, estimated 2019 earnings growth for S&P 500 companies is a healthy 6%, supported by sales growth and stable margins. What's more, earnings reports and forward guidance have been relatively solid (Figures 22 and 23), a theme that has been overlooked as investors focus on a handful of disappointing results from 'bell-weather' multinationals (FedEx, Apple, etc.). Lastly, there are signs of a more supportive macroeconomic backdrop for U.S. companies, including a lower $US, falling Federal Reserve rate hike expectations, moderating inflation/input costs, and increasing China stimulus.

Figure 22: Breadth and magnitude of U.S. companies beating earnings estimates



Source: J.P. Morgan US Equity Strategy and Quantitative Research

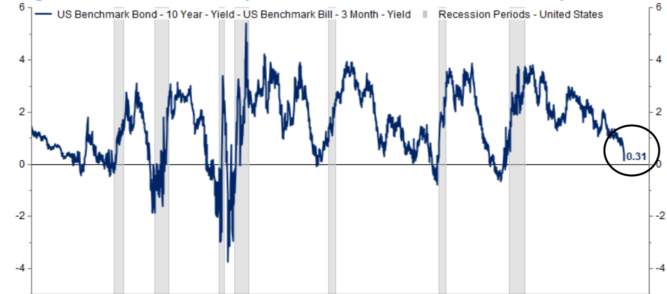
Figure 23: # of U.S. companies revising estimates higher minus # of companies revising lower



Source: J.P. Morgan US Equity Strategy and Quantitative Research

The U.S. economic cycle is undoubtedly 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 2.73%, still 31 basis points higher than the 3-month U.S. Treasury bill of 2.42% (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.

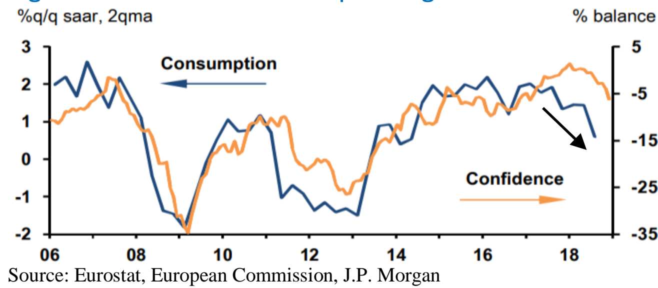
Fully invested portfolios are market-weight International stocks at 6.1% (balanced benchmark is 5%). Europe looks reasonably valued trading in line with its historical price to earnings ratio (Figure 25).

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

Source: FactSet

Growth in the Euro area continues to disappoint. Some of the weakness relates to temporary factors such as French protests and automobile production delays, but underlying growth looks soft. Purchasing Managers Index surveys are deteriorating and the outlook for household spending and confidence is poor (Figure 26).

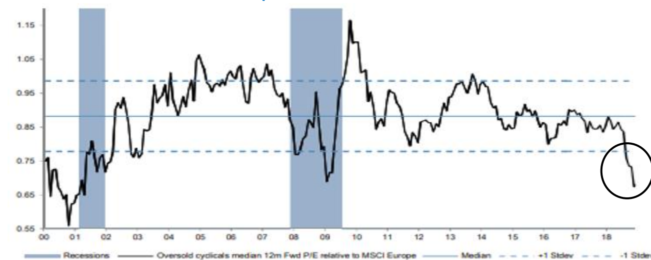
Figure 26: Euro household spending and confidence



Source: Eurostat, European Commission, J.P. Morgan

We are overweight Health Care in the International part of portfolios (Medtronic PLC and GlaxoSmithKline), but we also add some cyclicality through holdings in Total and Rio Tinto PLC. These companies offer attractive dividend yields (4.5% and 5% respectively), cheap valuations (Figure 27), and exposure to a rebound in capital expenditures and commodity prices – typical late-cycle phenomena. As well, we prefer to own these international giants versus their Canadian peers due to operational issues specific to Canada.

Figure 27: Oversold cyclical 12-month forward P/E relative to MSCI Europe


Source: IBES, J.P. Morgan

It was an active quarter for our equity portfolios. Recent purchases have focused on companies that are defensive in nature, have high dividend yields and visible earnings growth. New additions include:

Enbridge (ENB) The company owns and operates the world's longest crude oil pipeline system. Its natural gas distribution business serves approximately 3.7 million customers. Management has made significant progress in simplifying an overly complex capital structure and addressing future funding requirements (two reasons why we sold the stock in early 2018). ENB yields an attractive 7% and trades at a low P/E of 13x 2020 earnings estimates. Earnings and dividends are forecast to grow about 5% per year for the next few years.

Goldcorp (G) We repurchased Goldcorp in taxable accounts having sold it for a tax loss. G is a low-cost senior gold producer with gold production expected to rise from 2.3 million ounces in 2018 to 3.0 million ounces by 2021. G's operating costs are expected to decline significantly over this time frame as new mines come on stream. G trades at a very low price to cash flow multiple of about 5x and an attractive free cash flow yield of approximately 8.5%.

Extendicare (EXE) EXE is an owner/operator of long-term care facilities, home health care services, and retirement homes. Favourable supply and demand characteristics support income stability. Long-term care is needs driven and should be relatively unaffected by economic cycles. The Ontario wait-list totals 33,000 residents. The majority of EXE's future growth will come from expanding its retirement home platform. The number of retirement suites has grown from 348 in 2015 to 769 currently. EXE offers good value trading at 10x price to cash flow yield and has a dividend yield of 7.6%.

Sienna Senior Living Inc. (SIA) SIA is an owner/operator of long-term care facilities and retirement homes. It benefits from the same industry dynamics that impact Extendicare. SIA is further along the development curve in building out its retirement home business than EXE. SIA trades at a reasonable forecast price to cash flow multiple of 11x and pays a dividend yield of 5.7%.

A number of equities were sold as part of an overall risk reduction strategy. Specifically, we sold some of the more economically oriented names including BHP Group and First Quantum Minerals. In addition, we lowered our exposure to the European financial sector, selling Allianz, Banco Santander and ING Groep. Moderating economic growth in Europe will likely result in interest rates staying lower for longer, negatively impacting profit margins.

Other sales include:

Athabasca Oil (ATH) ATH remains a very undervalued company, but is now caught between opposing views regarding pipeline expansion. We added ATH after the Federal government's purchase of Trans Mountain Pipeline, however, the Federal courts subsequently ruled against expanding this pipeline, which effectively land locks some of ATH's oil production. We then sold ATH as it is difficult to

foresee a near term resolution.

Bank of Montreal (BMO) We lowered our exposure to domestic banks by selling BMO. We have some concern that growth will slow in many of BMO's business segments. A highly indebted consumer will limit personal lending growth.

ManuLife (MFC) MFC was sold over concerns that surfaced in regards to one of its insurance contracts. MFC was being challenged in court regarding a specific clause that could potentially allow policy holders to deposit unlimited amounts of money with MFC and earn a very high guaranteed rate of return. An adverse ruling could be quite detrimental to earnings.

SNC-Lavalin (SNC) We sold SNC after the surprising news broke that the Federal Government opted not to let SNC settle allegations of foreign bribery charges outside of court. Typically, a matter of this type would be dealt with using the Deferred Prosecution Agreement (DFA) which permits businesses to defer prosecution in exchange for fines. SNC fully replaced the management team and board of directors and anticipated settling using the DFA process. Going to court creates a lot of uncertainty, bringing into question, among other things, SNC's eligibility to bid on government contracts.

Fixed Income

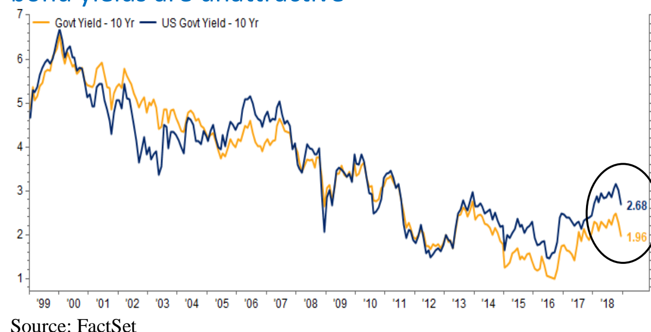
The average fixed-income weight in fully invested balanced portfolios rose from 33% at the end of Q2 to 36.39% in Q4 (compared to 40% for the balanced benchmark).

Bonds generally had positive returns in the fourth quarter. Concerns about slowing global growth and rising equity market volatility sparked a flight into government bonds and high quality corporate bonds. High-yield (junk) fixed income suffered as spreads over government bonds widened.

The outlook for higher interest rates has become challenged. Decelerating activity and lower commodity prices are alleviating inflationary pressures. As well, weakness in rate-sensitive sectors (housing and automobile) suggest consumers are not tolerating higher rates well. Against this backdrop, the Bank of Canada and the Federal Reserve are both signaling intent to wait for more data before hiking interest rates again. With central banks on hold, it looks like rates will remain range bound over the near-term. Baring a recession (or significantly negative geopolitical events), we foresee a resumption in interest rate hikes later this year as growth stabilizes, spare capacity diminishes globally, and labour markets tighten further. We think it is worth noting, however, that there is a decent chance that interest rates have seen their upper-bound and may not have much room to rise from here.

We remain defensive in the fixed-income component of portfolios. Despite having risen over the past three years, nominal yields are unattractive. U.S. 10-year Treasuries yield ~2.7% and Government of Canada 10-year bonds yield ~2%, low by historical standards (Figure 28).

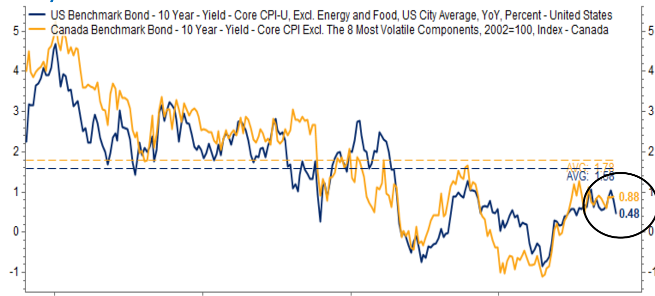
Figure 28: U.S. 10-year Treasuries and GoC 10-year bond yields are unattractive



Source: FactSet

The attractiveness of bonds is even worse when we consider inflation-adjusted returns. The real yields on U.S. 10-year Treasuries and Government of Canada 10-year bonds are 0.48% and 0.88% respectively, again very low by historical measures (Figure 29).

Figure 29: Real yields on 10-year U.S. Treasuries and 10-year GoC bonds

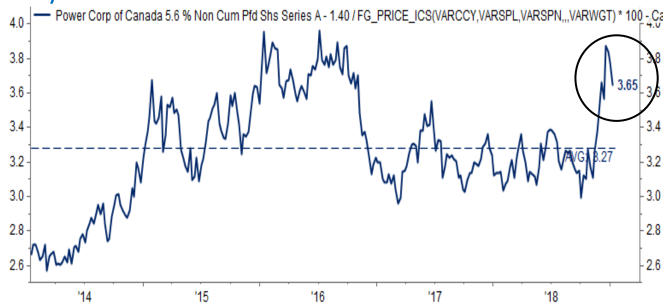


Source: FactSet

We still see good value in the Canadian preferred share market. We trimmed the floating rate preferred shares as our expectations for higher rates in Canada have moderated. The proceeds were allocated to perpetual preferred shares and GICs.

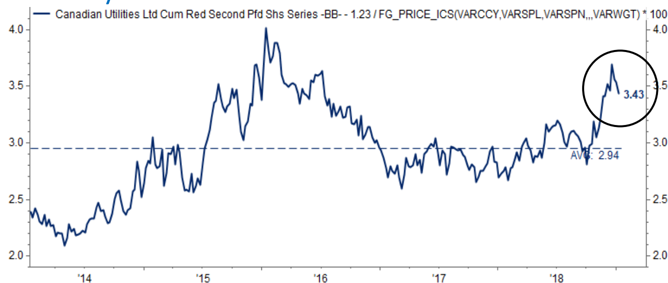
Perpetuals offer high dividend yields and should be less volatile in a range-bound interest rate environment. We highlight the relative yield attractiveness of some of the perpetual preferred shares we hold in portfolios in Figures 30 and 31. Due to the dividend tax credit, preferred shares also offer higher after-tax returns than bonds for Canadian taxable investors.

Figure 30: Power Corp. (POW.PR.A) yield minus GoC 30-year bond



Source: FactSet

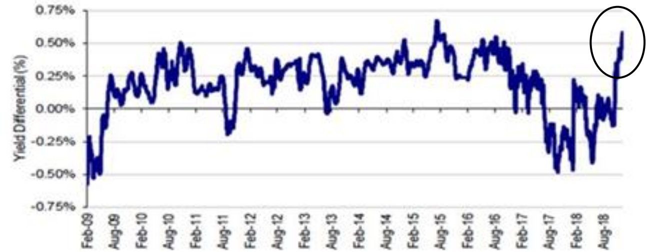
Figure 31: Canadian Utilities (CU.PR.E) yield minus GoC 30-year bond



Source: FactSet

GIC rates and bond yields diverged during the fourth quarter (Figure 32) and presented a timely opportunity to lock in decent yield while preserving capital. We added a combination of 1, 2 and 3 year GICs offering an average yield of ~3% to clients' portfolios.

Figure 32: Royal Bank GIC rate vs. Royal Bank 5-year bond yield



Source: RBC Capital Markets

Performance

We outperformed the Balanced Benchmark during Q4. Canadian and U.S. equities handily beat their respective benchmarks while international stocks were in line. Fixed income returns were below the benchmark.

While it's difficult to get excited about anything that occurred during Q4, we note that our Canadian stocks declined on average by about one-half of the S&P/TSX. We attribute this to our defensive posture going into Q4. We were nearly triple weight utilities and collectively, our utility holdings rose – Canadian Utilities (-1.4%); Emera (+8.8%); and Hydro One (+3.1%). Overweight telecommunications and golds also helped – BCE (+3.1%) and Yamana (-0.3%). The other Canadian holdings were lower with double digit declines in the Canadian Banks and oil stocks.

Our U.S. stocks declined by about two-thirds of the S&P 500. Again, our defensive posture helped as we were approximately double weight health care. Notable performers were Merck (+13.9%) and Johnson & Johnson (-1.2%). Our other U.S. stocks were down in line with the S&P 500.

Our International stock returns were in line with the EAFE index. Again, our health care stocks did exceedingly well while the European financials

underperformed. Our fixed-income returns lagged the broad bond composite gain of 1.8%. Underweight bonds and being primarily invested in the short-end of the curve hurt returns. Our preferred shares lost -4.4% but significantly exceeded the S&P/TSX Preferred Share Index return of -10.1%. Our preferred share outperformance is not reflected in comparative returns, as the S&P/TSX Preferred Share Index is not included in the benchmark. This had the effect of understating our relative performance.

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
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