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

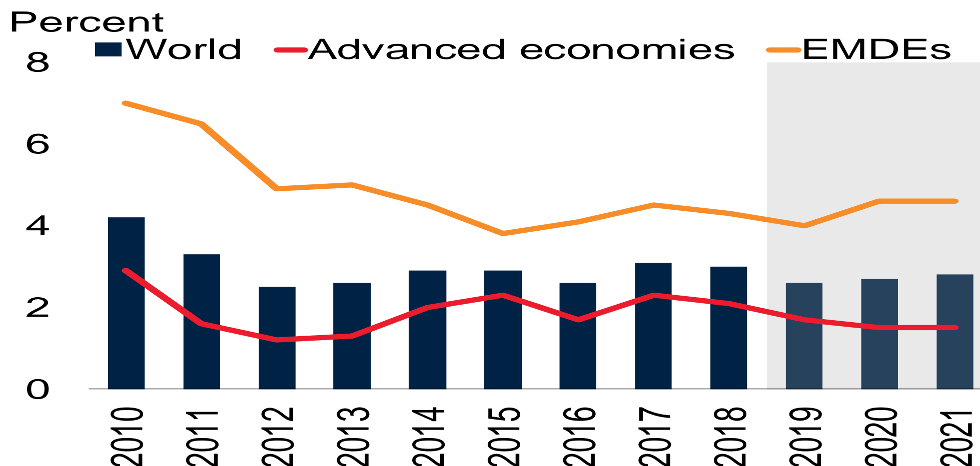
Fourth Quarter 2019 Investment Commentary

Global equity markets posted solid positive returns in Q4 while bonds declined modestly. The S&P/TSX, S&P 500, and Canadian Broad Bond composite increased/decreased by 3.2%, 7.0%, and -0.8% in $Cdn respectively. Accounts on board for the full period and migrated to their appropriate models produced positive returns during the quarter and double-digit gains over the year.

Economic Overview

Global growth remained subdued in the fourth quarter but showed signs that conditions are no longer deteriorating. The global economy is projected to have risen 2.9% in 2019 which would be the slowest rate since the Great Financial Crisis, though growth is projected to rebound in 2020 and 2021 to 3.3% and 3.4% respectively (Figure 1). Tentative signs of a bottoming out in manufacturing and global trade buoyed sentiment in the fourth quarter, as did positive developments in the U.S.-China trade negotiations, a shift towards accommodative monetary policy, and diminished fears of a no-deal Brexit. Consumers remained in good shape and continue to benefit from strong labour markets and easy financial conditions (low borrowing/debt servicing costs).

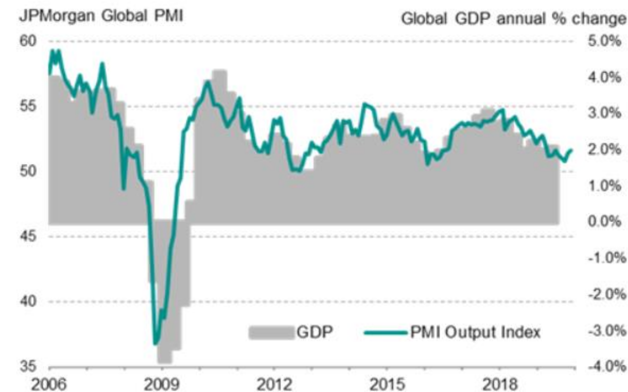
Figure 1: Global GDP growth to 2021



Source: World Bank

The global economy finished 2019 on a brighter note. The JPMorgan Global PMI (Purchasing Managers' Index), a survey of purchasing managers from around the world, rose to an eight-month high in December (Figure 2). Employment, new orders and business expectations all lifted higher indicating a probable near-term acceleration.

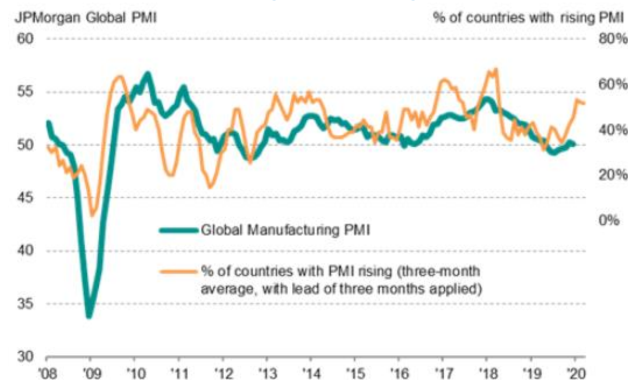
Figure 2: Global GDP (grey) and Global PMI (green)



Source: IHS Markit, JPMorgan, Datastream

The survey also signaled marginal improvement for goods manufacturers (Figure 3), though the sector is not out of the woods yet. Ongoing trade friction is still dragging down manufacturing activity, evidenced by exports falling for a sixteenth consecutive month in December. Nevertheless, the decline in exports was the smallest since last January and both manufacturing new orders and output edged up in December.

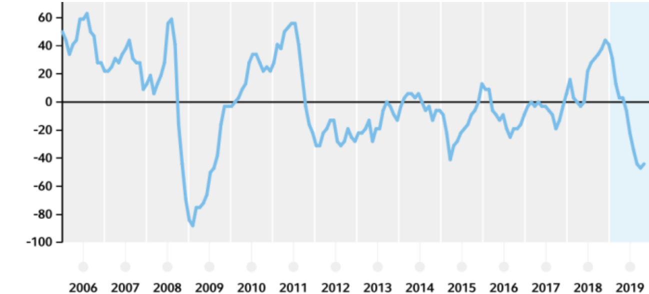
Figure 3: Global Manufacturing PMI (green) and % of countries with rising PMI (orange)



Source: IHS Markit, JPMorgan

With global business activity perking up and manufacturing showing signs of stabilizing it is possible that we are on the cusp of a "mini-cycle" recovery. Central banks are playing their part, providing significant policy stimulus in the form of lower interest rates and quantitative easing – the European Central Bank and the Federal Reserve are purchasing €20 billion and $60 billion ($USD) of securities (bonds) a month respectively. 2019 saw the largest amount of central bank easing since the 2008 financial crisis (Figure 4).

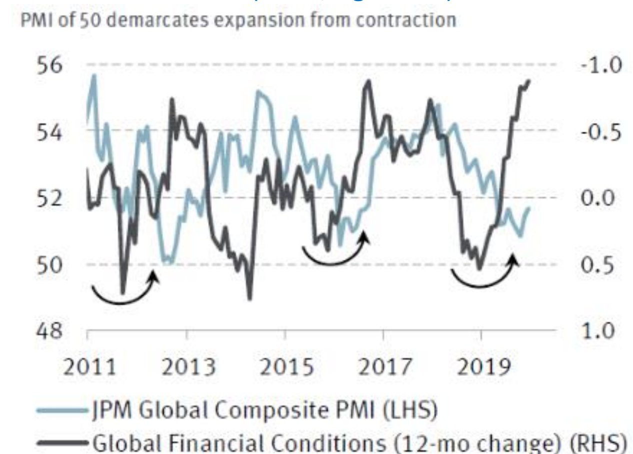
Figure 4: Net % of central banks tightening



Source: Refinitiv Datastream, Russell Investments

Lower interest rates allow easier access to capital for companies, alleviate debt servicing costs for debtholders and have historically been stimulative for growth (Figure 5). The Federal Reserve has indicated a willingness to maintain supportive policy and nuture economic growth which should support asset prices.

Figure 5: JPM Global PMI (blue, left side) and global financial conditions (black, right side)

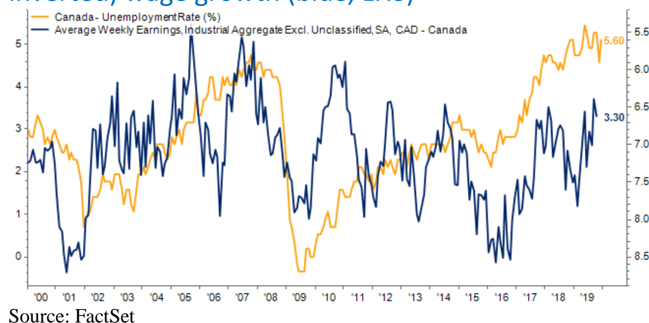


Source: RBC Wealth Management, Bloomberg, FRED Economic Data, St. Louis Fed

Consumers entered 2020 on solid footing and continue to benefit from low levels of unemployment and higher wages in both Canada and the U.S. (Figures 6 and 7 respectively). Canada added 320,000 jobs in 2019, the second highest annual employment gain since 2007. Encouragingly, most of the positions gained were full-time. The U.S. added 175,000 jobs a month in 2019, down from

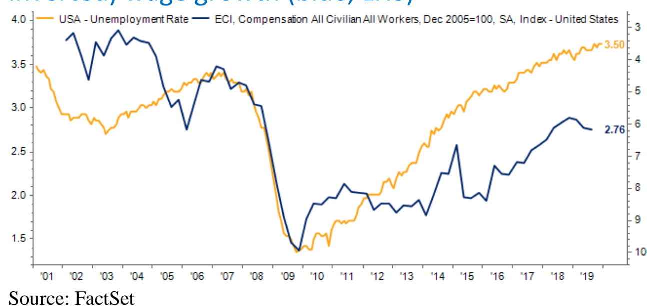
225,000 in 2018 but well above the level estimated to maintain the unemployment rate which is at a half century low.

Figure 6: Canada unemployment rate (orange, RHS, inverted) wage growth (blue, LHS)



Source: FactSet

Figure 7: U.S. unemployment rate (orange, RHS, inverted) wage growth (blue, LHS)



Source: FactSet

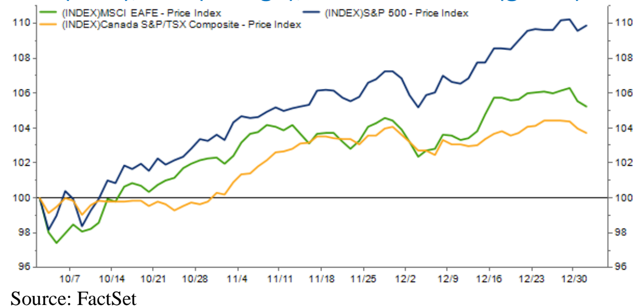
A healthy backdrop for consumption (which accounts for around 70% of developed nations' GDP) and early signs of rebounding business activity suggest this economic expansion will last beyond 2020, staving off short-term recession fears. Still, we maintain a cautiously optimistic outlook as risks persist, including elevated debt levels (particularly among Canadians), a mature business cycle, and a potential re-escalation of geopolitical tensions.

Equity Commentary

Equity weightings are modestly below the benchmark in all portfolio objectives as we err on the side of caution and prefer a conservative asset allocation in portfolios. Balanced accounts' equity weightings are approximately 52.87% on average versus the benchmark weight of 55%.

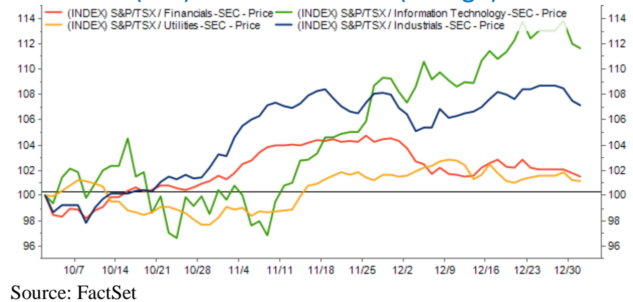
Equity markets generated strong returns in the fourth quarter with the S&P 500 (U.S. market) leading the way (Figure 8). Cyclically exposed industries generally outperformed their defensive counterparts (ie. industrials vs utilities), as did growth stocks compared to value stocks (ie. technology vs financials – Figure 9).

Figure 8: Fourth quarter price performance of S&P 500 (blue), TSX (orange), and MSCI EAFE (green)



Source: FactSet

Figure 9: Fourth quarter price performance of TSX Technology (green), TSX Industrials (blue), TSX Financials (red) and TSX Utilities (orange)



Source: FactSet

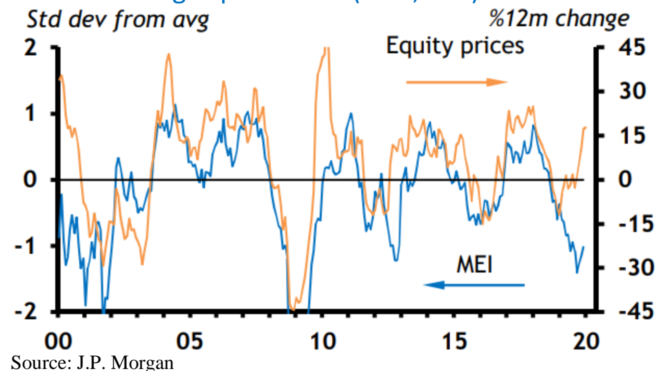
Earnings growth typically drives companies' stock prices over time. 2019 earnings growth for the S&P 500 is projected to have been around 1% though the index surged 25.2% (in $Cdn) during the year. Absent earnings growth, returns were almost entirely generated by valuation expansion. On a price-to-earnings basis, the U.S. market (S&P 500) looks expensive (Figure 10).

Figure 10: S&P 500 price-to-earnings ratio over next twelve months (P/E NTM)

Source: FactSet

Higher future growth potential does justify higher valuations. It's sensible that equity prices are rising in advance of the likely pickup in business activity. However, we think investors have just about fully priced in a recovery and we question whether expectations are achievable (Figure 11).

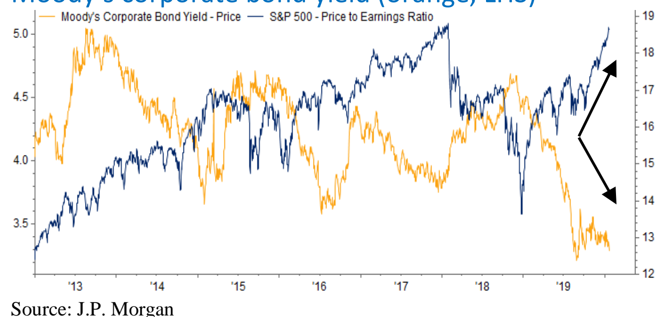
Figure 11: Equity prices (orange, RHS) and manufacturing expectations (blue, LHS)



Source: J.P. Morgan

Higher stock prices are also a product of lower interest rates (Figure 12). Equities relative attraction increases as yields on interest-bearing securities decline. Central banks delivered a hefty dose of monetary stimulus over the past year, and while they have indicated a willingness to nurture growth they have also signaled that further near-term policy easing is unlikely. It's possible this powerful tailwind for stocks moderates in the short-term.

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



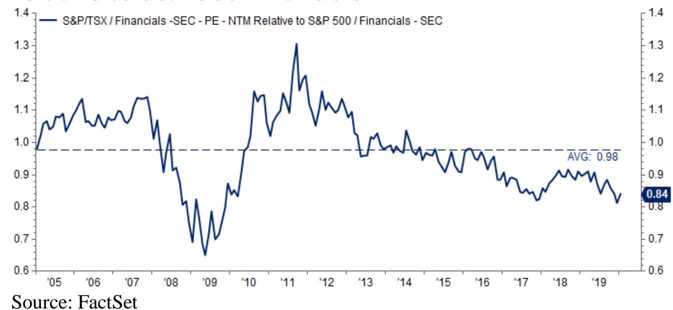
Source: J.P. Morgan

The S&P/TSX (Canada) trades at a significant price-to-earnings discount to the S&P 500 (Figure 13). As we have discussed before, much of the discount is warranted given the Canadian market's higher exposure to underperforming sectors (ie. energy). Still, we think the Canadian market offers relative value in a few sectors including utilities and financials (Figures 14 and 15 respectively).

Figure 13: S&P/TSX (Canada) price-to-earnings ratio relative to S&P 500 (U.S.)

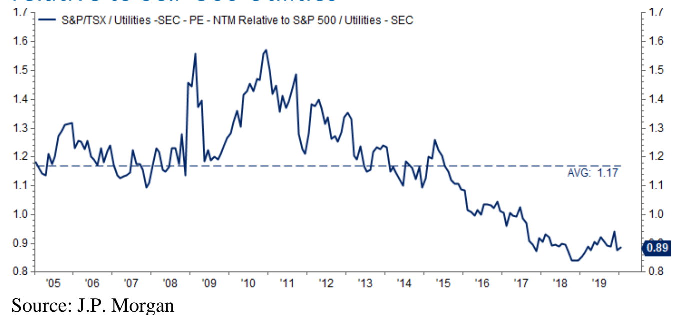
Source: FactSet

Figure 14: S&P/TSX Financials price-to-earnings ratio relative to S&P 500 Financials



Source: FactSet

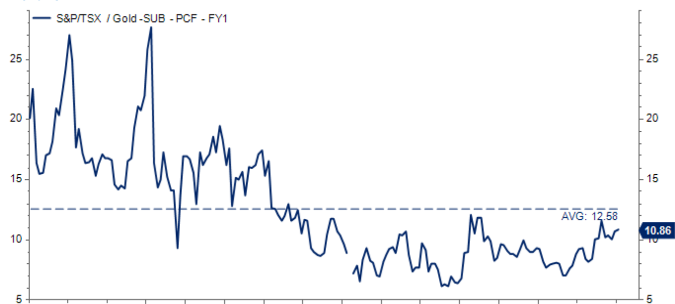
Figure 15: S&P/TSX Utilities price-to-earnings ratio relative to S&P 500 Utilities



Source: J.P. Morgan

As the business cycle reaches a very mature stage we think it's prudent to own high quality, defensive companies with stable cash flows. At this point the risk/reward appears skewed in favour of companies with reasonable growth prospects and attractive dividends relative to high growth companies with expensive valuation premiums. Diversification remains as important as ever and portfolios continue to own Canadian, U.S. and International securities across many sectors. We still think there is a place for gold in portfolios. Central banks continue to manipulate interest rates in an unprecedented manner, geopolitical tensions have cooled as of late but could escalate, and goldminers have become effiecient operators with attractive valuations (Figure 16).

Figure 16: S&P/TSX gold sector price-to-cash flow ratio



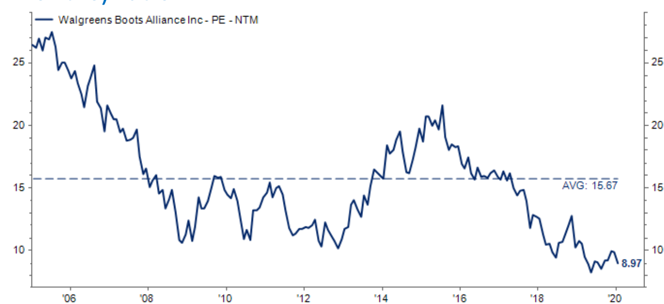
Source: FactSet

It was a relatively quiet quarter for our portfolios. Transactions for the quarter include:

In November, we initiated a new position in Aviva, a U.K.-based general and life insurance company. Aviva has operations in Canada, Europe and parts of Asia. The stock trades at a cheap valuation and pays an attractive dividend yield of 7% that is supported by the company's strong cash flow generation. Aviva acquired Friends Life in 2014 which resulted in significant shareholder dilution. Today, management is focused on improving organic growth and boosting earnings through cost-cutting and deleveraging after integrating Friends Life over the past few years. To fund the purchase we took some profits and partially sold Northland Power and Suncor. Northland Power produces electricity from natural gas and renewable sources including wind, hydro, solar and thermal while Suncor is Canada's largest integrated oil and gas entity. We continue to like both companies but feel they are trading near their fair values.

In December we harvested some tax losses and exited positions in Walgreens Boots Alliance across taxable accounts. Walgreens has struggled more than expected from downward pressure on reimbursements from drug insurers in its core pharmacy business along with lower prices on branded drugs. We have maintained positions in tax sheltered accounts as valuations trade at extremely attractive levels (Figure 17) and the company is committed to increasing its dividend (which it has done for the past 44 consecutive years).

Figure 17: Walgreens Boots Alliance P/E (next twelve months) ratio



Source: FactSet

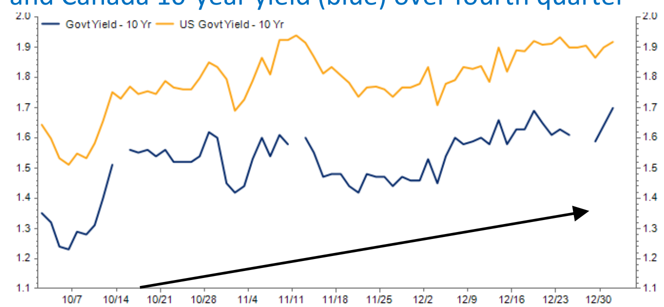
In late October, we added to floating rate preferred shares. Positive developments in the U.S.-China trade dispute along with some evidence of stabilizing economic data set the stage for interest rates to rise modestly. At the time, BCE floating rate preferreds were offering an attractive yield in the 6.5% area. They have rallied nicely since and still offer an attractive yield around 6.2%.

In early October, we added to our holdings in Newmont Goldcorp. Newmont offers potential upside through higher shareholder returns and has an improved earnings outlook as the company realizes synergies from the integration of the recently acquired Goldcorp assets.

Fixed Income

Bonds posted strong returns in 2019 but ended the year on a softer note as interest rates rose modestly and bond prices declined (Figure 18). An improving global outlook and steps towards a trade dispute resolution saw investor appetite for "safe" assets diminish.

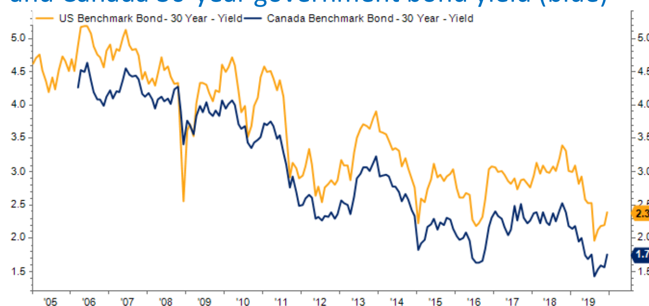
Figure 18: U.S. 10-year Treasury bond yield (orange) and Canada 10-year yield (blue) over fourth quarter



Source: FactSet

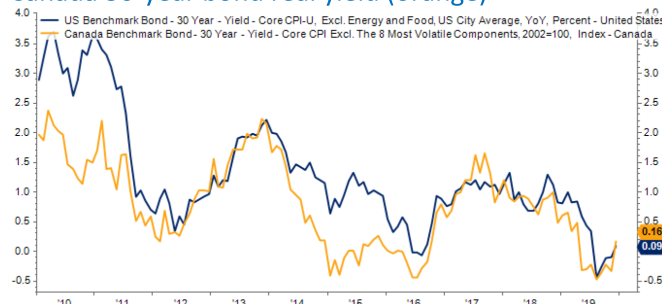
We remain underweight bonds relative to the benchmark. Balanced accounts' fixed income weightings are approximately 39.67% on average versus the benchmark weight of 40%, but about half of the fixed income is in preferred shares. Bonds remain very unattractive despite yields moving higher. Long bonds (30 years) in the U.S. and Canada are yielding 2.39% and 1.76% respectively (Figure 19). Bonds are particularly unattractive after accounting for inflation as long bond investors are barely preserving their purchasing power (Figure 20). After inflation, 30-year U.S. and Canada government bonds are yielding 0.09% and 0.16% respectively.

Figure 19: U.S. 30-year Treasury bond yield (orange) and Canada 30-year government bond yield (blue)



Source: FactSet

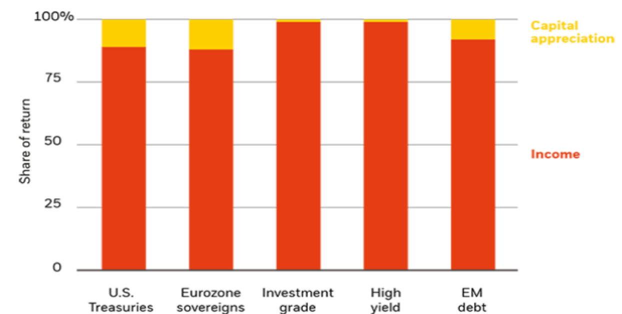
Figure 20: U.S. 30-year bond real yield (blue) and Canada 30-year bond real yield (orange)



Source: FactSet

If bond investors are seeking any real return (after inflation) they are relying exclusively on capital appreciation. This is a risky proposition, especially considering that interest income (not rising prices) has historically made up the majority of total return across global fixed income markets (Figure 21). Perhaps equally concerning is that lower interest rates have resulted in greater bond price volatility (lower coupon bonds have higher duration). Over the past 5 years, a long U.S. Treasury has experienced short-term drawdowns of 7-20% at least 3 times (Figure 22). A long-bond investor could see their capital erode quickly if interest rates normalized (moved higher), leaving them underwater and collecting a very low coupon until the bond matures.

Figure 21: Return sources of fixed income markets from 2001-2019



Source: BlackRock Investment Institute, Bloomberg

Figure 22: Indexed price return of U.S. 2042 Treasury over last 5 years

Source: FactSet

There certainly could be a saving grace for bond investors which is lower, possibly negative interest rates induced by central banks. Global debt has amassed to $244 trillion dollars (USD) and the debt train is unlikely to stop anytime soon. Despite rising global debt, declining interest rates have kept interest payments nearly flat over the past 20 years (Figure 23). This will undoubtedly keep a ceiling on interest rates, but it is very difficult to increase risk under this assumption.

Figure 23: Global debt (blue), Global GDP (orange) and interest paid on debt (grey)

Source: IMF

Equity markets look fairly valued and bonds (all types – government, investment grade corporates, and junk) are incredibly expensive. We continue to think the Canadian preferred share market is one of the few assets classes that offers decent value. Portfolios hold a combination of high-quality floating-rate, rate-reset, and perpetual issues yielding anywhere from 4.7% - 6.7% (equivalent to a bond yield of 6.1% - 8.7% thanks to the dividend tax credit). We are comfortable holding our preferreds for a long time, riding out price volatility and collecting juicy dividends.

Performance

Portfolios were up nicely in Q4 to finish off a very strong year for returns. Returns were less than the balanced benchmark during the quarter and for the year as a result of our conservative positioning (trade uncertainty, expensive valuations, late cycle), both in asset allocation (underweight equities) and stock selection (overweight defensive sectors).

Overweight defensive sectors detracted from returns in Canada. Loblaw (-11.2%), BCE (-6.1%), and Sienna Senior Living (-4.2%) were big underperformers. Enbridge (+11%) and Northland Power (+7%) were notable outperformers.

Our U.S. equities were up very nicely led by Newmont Goldcorp (+12.3%), Johnson & Johnson (+10.5%), and Alphabet (Google, +7.5%). Constellation Brands (-10.3%) hurt U.S. equity returns as did an unusual quarter from Home Depot (-7.7%), however Home Depot has rebounded nicely since.

Our International stocks had a stellar quarter and significantly outperformed their benchmark. Rio Tinto (+12%), Axa (+9%), and GlaxoSmithKline (+8.2%) were all big contributors.

Our fixed-income outperformed the broad bond composite loss of -0.8%. Underweight bonds and being primarily invested in the short-end of the curve helped returns. Our preferred shares were up around 2.4% and also contributed to the outperformance.

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.