RBC Dominion Securities Inc.

Fickel's Focus

Wealth Management Dominion Securities

Fourth Quarter 2021 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

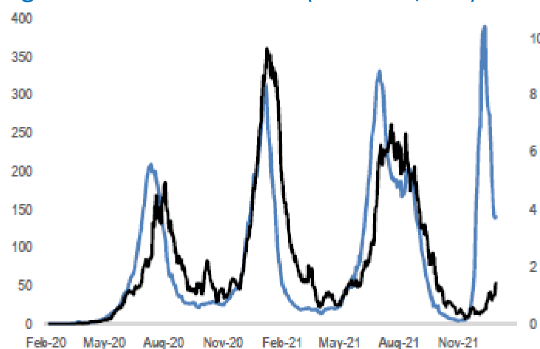
Nathan Fickel, CFA
Associate Advisor
416-960-6816
nathan.fickel@rbc.com

Equity markets soared higher in the fourth quarter despite the negative implications posed by the Omicron variant. The S&P/TSX, S&P 500, and EAFE Index were up 6.5%, 10.6%, and 2.0% in Canadian dollars. The Canadian Broad Bond Composite posted a modest gain of 1.5%. Accounts on board for the full period and migrated to their appropriate models produced strong returns during the quarter and outperformed their respective benchmarks for the calendar year.

Economic Overview

The global economic recovery remains intact and healthy, but still heavily influenced by the path of COVID-19. The emergence of the highly transmissible Omicron variant forced countries around the world to enact restrictions designed to contain the virus. Once again, lockdowns have handicapped global growth. With regards to Omicron, there are reasons to be optimistic, chief among them is that this variant is relatively mild. In South Africa, where Omicron was first detected, deaths appear to have peaked at a fraction of previous records despite the high case count (Figure 1). Also encouraging is that new cases in the region have been falling for weeks, suggesting that this wave may be relatively short-lived. Lastly, and we are well aware this may be a stretch, there is growing consideration that COVID-19 will continue mutating into 'milder' variants, eventually reaching something comparable to the seasonal flu. While this remains to be seen and near-term visibility is somewhat clouded, we see the Omicron drag on growth subsiding in the coming quarters without meaningfully deteriorating the recovery that is underway.

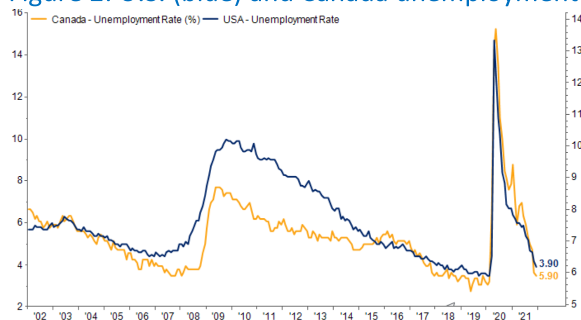
Figure 1: COVID-19 cases (blue line, left) and deaths (black line) in South Africa



Source: J.P. Morgan

Despite the recent slowdown in activity, growth estimates for 2022 remain impressive and above trend. J.P. Morgan calls for real GDP growth of 3.6%, 3.7%, and 4.6% this year for Canada, the U.S. and the Eurozone respectively (versus ~2.2% growth in the U.S. over the past 10 years). Many of the factors propelling the economy this year will be the same as those that were in place last year: strong consumer and business balance sheets, pent-up demand, and 'reopening economies'. In recent editions we've highlighted the financial condition of consumers and the fantastic shape that they are in. This continues to be the case, particularly in the U.S., where consumers are not only relatively deleveraged versus the past, but they are also sitting on plenty of excess savings. Employment growth continues to support the consumption backdrop. As of the latest monthly reports, the unemployment rates in Canada and the U.S. dropped to post-pandemic lows (Figure 2).

Figure 2: U.S. (blue) and Canada unemployment rate

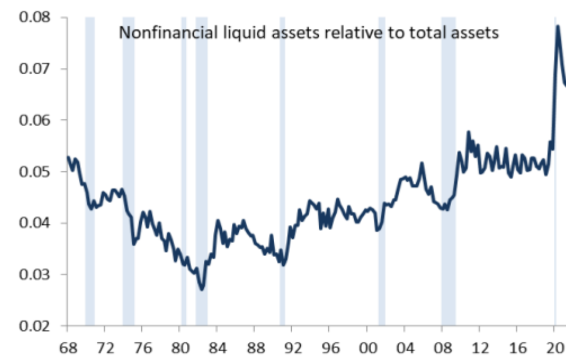


Source: FactSet

Still, workers in the U.S. have been slow to rejoin the labour force. Total employment south of the border remains ~3.5 million jobs shy of the pre-pandemic level, likely owing to a combination of generous pandemic aid, inadequate childcare, school closures and early retirements. We expect those on the sidelines to return to work over time, incentivized by strong wage growth and plentiful job opportunities. There are currently about 1.5 jobs for every unemployed worker in the U.S.

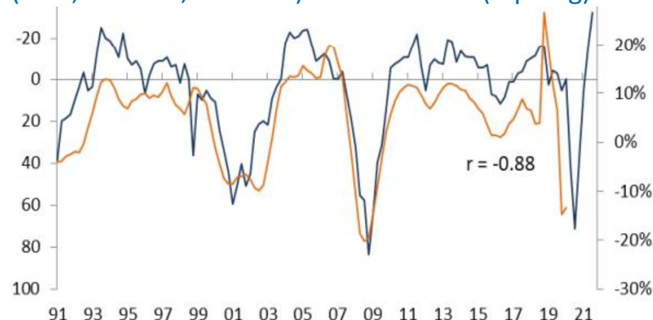
The condition of consumers is not the only bright spot. Sitting on mountains of cash, businesses are also quite comfortable (Figure 3). Some of this cash will get returned to shareholders, but we also anticipate a pickup in capital expenditures. Supporting this theory is the fact that bank lending standards for commercial and industrial loans are easing significantly (Figure 4). A rise in C&I loans almost always follows, and these are the classic route for engaging in productivity type investments.

Figure 3: U.S. nonfinancial corporations' liquid assets relative to total assets



Source: Haver, RBC Capital Markets US Economics

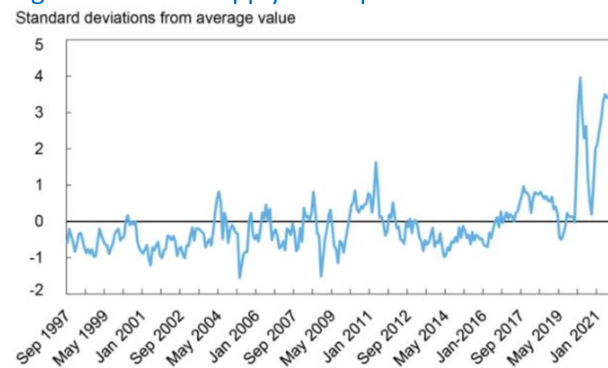
Figure 4: Banks tightening C&I loan standards (blue, left side, inverted) and C&I loans (6qrt lag)



Source: RBC Capital Markets US Economics, Haver

With consumers eager and able to spend, businesses primed for a capital expenditure cycle, and labour markets strong, the backdrop for this year looks quite positive. Some of these factors may even spill into 2023. However we are keenly aware that the main risk to the global economy, besides another damaging COVID-19 variant, is inflation. Supply chain disruptions are still elevated and will persist into the year (Figure 5).

Figure 5: Global supply chain pressure index



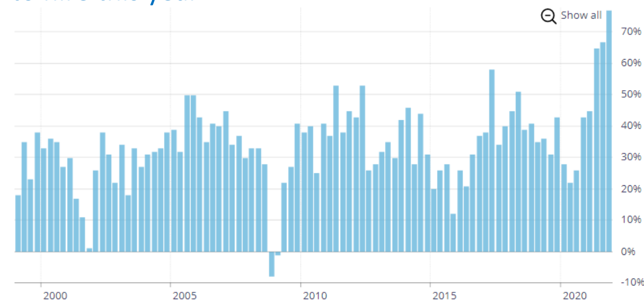
Source: NY Fed – Liberty Street Economics

The result has been too many dollars chasing too few finished goods, and inflation has overshot nearly all economists' expectations. Compounding matters are tight labour markets and businesses increasingly competing for employees. According to the Bank of Canada's 4Q 2021 survey, Canadian businesses are facing the most intense labour shortages on record and, at the same time, businesses are desparate to hire (Figures 6 and 7).

Figure 6: Bank of Canada survey: Intensity of labour shortages

Source: Bank of Canada

Figure 7: Bank of Canada survey: % of firms expecting to hire this year



Source: Bank of Canada

Central banks have taken notice and the Bank of Canada and Federal Reserve are expected to roll out their 'cooling' policy tools this year. The markets are currently pricing in 5 interest rate hikes in Canada and 4 in the U.S. Policymakers now find themselves in the not so desirable position of seeking to moderate inflation without incidentally derailing the economic recovery (raise rates too high). If the past is a prologue to the future, a policy misstep is certainly a possibility. However, we think the messaging from central banks has been reassuring and we anticipate a gradual tightening. After all, central bankers are well aware of the high levels of sovereign debt. They will not want to raise the cost of servicing that debt too high too quickly. As well, the knock-on effects of asset prices (stocks/real estate) are more important than ever for household consumption. We think central banks will likely do their best to preserve financial asset valuations.

Equity Commentary

Despite surging COVID-19 cases, equity investors were rewarded handsomely in the fourth quarter. The market's reaction to Omicron was short lived, and after a few days of weak performance the major indexes continued marching to fresh highs. Not all sectors fared equally, however, and it was the usual suspects that did most of the heavy lifting. Technology, consumer discretionary, and growth stocks in general outperformed the market into the end of the year (Costco, Home Depot, Microsoft in client portfolios). Value stocks, particularly those leveraged to the economic 'reopening' (airlines, cruise operators, payments processors), languished during the quarter.

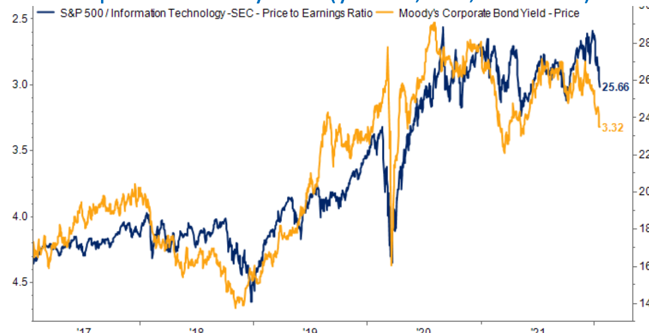
Figure 8: Benchmark equity returns this year

Index	Q1	Q2	Q3	Q4
S&P/TSX	8.10%	8.50%	0.20%	6.50%
S&P 500	4.70%	7.10%	2.90%	10.60%
MSCI EAFE Index	1.40%	3.00%	1.20%	2.00%
*returns in $CAD				

Source: RBC Capital Markets

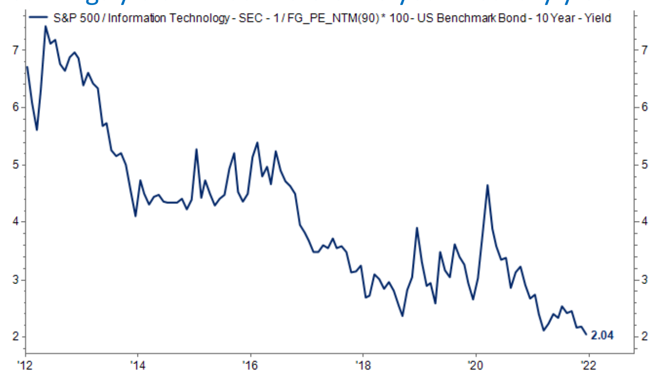
Turning the corner into the new year, this trend has reversed in a signifcant way. High valuation companies' stock prices have come under pressure in the face of central banks raising interest rates. This has been on our radar and in previous editions we've highlighted the excessive and potentially vulnerable valuations in equity markets, particularly in the U.S. Figure 9 demonstrates the negative correlation between the P/E ratio of the S&P 500 Technology sector and corporate bond yields. Higher yields and higher valuations are not mutually exclusive, but increasing bond yields do erode the relative attractiveness of equities. A useful measure of this that has been used for decades is the Fed Model, which compares the earnings yield on equities to the U.S. 10-year bond yield (Fed Model = [earnings per share/price] - U.S. 10yr yield). This suggests that, relative to bonds, U.S. technology stocks are less attractive today and nearing overvalued levels (Figure 10).

Figure 9: S&P 500 Info. Tech. sector P/E (blue, right) and corporate bond yields (yellow, left, inverted)



Source: FactSet

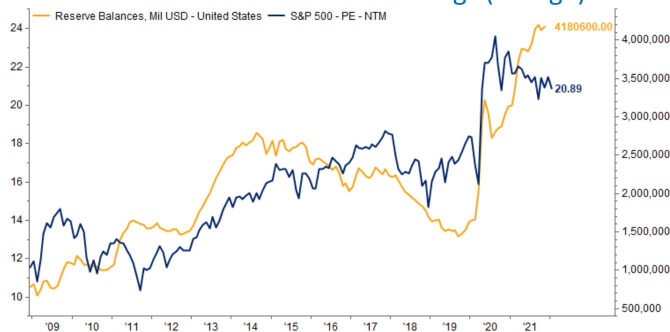
Figure 10: Fed Model - S&P 500 Info. Tech. sector earnings yield minus the U.S. 10 year treasury yield



Source: FactSet

On top of rising rates, the markets will have another challenge to grapple with this year – an end to quantitative easing. The Bank of Canada has already halted its liquidity injections (bond purchases) and the Federal Reserve is set to do the same shortly. As liquidity from central banks shifts from abundance to scarcitiy, the markets will lose a powerful tailwind. Figure 11 illustrates the positive correlation between equity valuations and central bank balance sheets.

Figure 11: S&P 500 P/E ratio (blue line, left) and Federal Reserve balance sheet holdings (orange)



Source: FactSet

2022 is shaping up to be all about equity valuations. With the economy humming along nicely and GDP forecasts above average, companies will likely deliver solid earnings growth (usually around 4-7x real GDP growth). The consensus EPS growth estimate for the S&P 500 is around 10%, but J.P. Morgan is more optimistic and sees earnings growing at 20%. It is important to remember that, even if valuations do contract, as long as earnings grow by more than the contraction, stock prices can move higher. We are optimistic that this scenario plays out in 2022, but, given some of the risks highlighted, we have lowered balanced accounts' equity weights to 58% (from close to 60% in Q3).

Client portfolios remain diversified across sectors, geographies and asset classes. However, with a potential valuation squeeze on the horizon, we maintain a slight tilt towards companies trading at relatively cheaper multiples. Included in that category are companies in the financial, energy, materials, utility, and travel sectors. Interestingly, these businesses are generally more economically sensitive and tend to do well when rates are rising and when GDP growth is above average.

Trading was lighter than normal in the final quarter of the year. In October, we took profits on two occasions from **Teck Resources**, a diversified Canadian miner with significant interests in metallurgical coal and oil sands. We find the company's large and growing copper production to be its most appealing attribute due to the transition to electric vehicles and underinvestment in new copper projects over the last decade. In highly cyclical holdings like Teck, we often will trim them following big gains. We initiated the stock in November 2020 at $20.87 on the belief that reopening would provide a tailwind to commodities and trimmed the holding in early October at $31.41 and in mid-October at $36.30.

In early November, Pfizer announced that its Paxlovid oral treatment was found to reduce the risk of hospitalization or death by 89% in non-hospitalized high-risk adults with COVID-19. We felt that this, along with rapid testing, would represent a tailwind for travel stocks and initiated a position in cruise line operator **Carnival**. Travel stocks did see an initial surge but this move quickly reversed later in

the month with the emergence of Omicron. With too many unknowns about the path of the new variant we decided it was prudent to reduce risk in portfolios and sold our position in Carnival. At the same time, we also exited our position in **Banco Santander**, a Spanish-domiciled bank that we purchased earlier in the month due to its significant exposure to higher growth emerging markets in South America.

We funded the purchase of Carnival with the sale of **Merck**. We exited Merck after Pfizer's Paxlovid was found to be more effective in clinical studies than Merck's COVID-19 oral antiviral treatment, Molnupiravir. Merck is a cheap stock but the market is concerned about the 2028 patent expiry for its blockbuster drug, Keytruda.

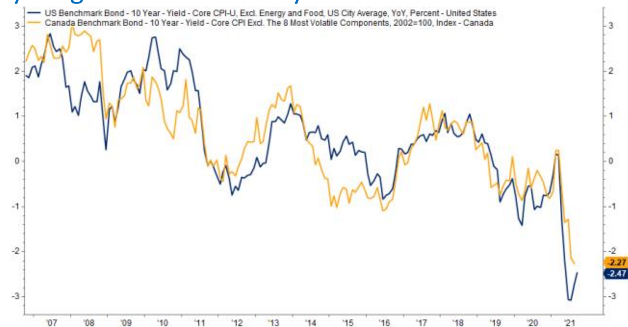
AT&T was added to non-taxable accounts in December. The stock has been a significant underperformer in 2021 and became too cheap to ignore. The core wireless business has been strong and generates large, stable cash flows. Investor disinterest stems from the company's planned dividend cut to 5% and pending simplification of the business, which will result in a taxable spinoff in non-registered accounts. These events are expected to take place in 2022 and we believe the valuation and cleaner business will move the share price higher while we collect an attractive yield.

Additions were made to the fixed income side of portfolios during the quarter. Two corporate bonds were added in the back half of November after yields moved higher and bond prices became cheaper. We also took a position in a 3-year principle-protected note during the period. It pays an annual yield of 0.5% plus, at maturity, half of the price return of a basket of Canada's big six banks. Based on historical returns of the Canadian bank stocks over rolling 3-year periods, we believe this investment could provide a fixed income return in the mid-single digits with no principle risk if held to maturity versus a 10-year Government of Canada bond that was yielding around 1.5%.

Fixed Income

The prices of bonds rose modestly in Q4 as interest rates declined (inverse relationship). The Canadian Bond Broad Composite finished up 1.5% for the quarter, bringing the 2021 full year return to -2.5%. Our underweight allocation to bonds as well as the shorter-than-benchmark duration benefitted client portfolios for the year. The outlook for bonds remains challenging with higher rates seemingly inevitable as central banks gear up to hike their policy rates. Elevated and sticky inflation is rubbing salt in the wound for bond investors, leaving them with incredibly unattractive real returns (Figure 12).

Figure 12: Canada (orange) and U.S. (blue) real 10-year government bond yields



Source: FactSet

Preferred shares continue to offer compelling yields ~4.5% but are no longer undervalued. We anticipate clients' preferred share holdings will shrink over time and we intend to opportunistically add bonds as interest rates move higher and we approach the final innings of the economic cycle. We recently added a few percent of GICs in client portfolios and took advantage of the wide gap between GIC rates and Government of Canada bond yields (Figure 13).

Figure 13: 3yr GIC yield minus 3yr GoC bond yield

Source: RBC Portfolio Advisory Group

Performance

Client portfolios fully invested to model underperformed in the final quarter of 2021 but outperformed their benchmark after fees over the full year.

Fixed income returns within client portfolios fell short of their benchmark during Q4. A significant underweight in bonds detracted from relative performance as the bond index returned a surprising 1.5%. Preferred share returns were mixed - floating rate holdings delivering double digit gains while the perpetual issues were slightly negative. The preferred shares strongly outperformed the fixed income benchmark over the course of the full year.

Canadian equity holdings in client portfolios were in line with the 6.5% total return from the S&P/TSX Index during the quarter. Commodity-related stocks outperformed with **Suncor Energy** (+20.5%) and **Teck Resources** (+15.5%) benefitting from high prices for steel-making coal, copper and oil. **Toronto-Dominion Bank** (+15.7%) and utility holdings also delivered strong returns. Detracting during the final quarter was **Air Canada** (-8.6%).

Account holdings in U.S. equities delivered a solid positive return but fell short of the S&P 500 benchmark total return of 10.6% in Canadian dollars. Some of the underperformance was mitigated via a significant overweight in U.S. equities. **Carnival** (-26.3%) was caught in the crosshairs of the Omicron variant that also depressed returns for **Delta Air Lines** (-8.4%) and **Walt Disney** (-8.4%). Medical device maker **Medtronic** (-17.6%) retreated as postponed elective procedures were exacerbated by a recall of some of the company's insulin infusion pumps. Offsetting this were very strong returns from several holdings including **Home Depot** (+26.3%), **Costco** (+26.2%), **Microsoft** (+19.2%), **Constellation Brands** (+19.0%), **Pepsico** (+15.7) and **Newmont** (+14.1%).

Our underweight in International equities was a relative tailwind during the quarter with the EAFE Index lagging North American markets with a price return in CAD of 2.0%. We exited **Banco Santander** (-16.3%), our lone holding in November to reduce risk when the Omicron variant emerged with little known about its severity.

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. © 2021 RBC Dominion Securities Inc. All rights reserved.