Fickel's Focus

Wealth Management
Dominion Securities

Fall 2016

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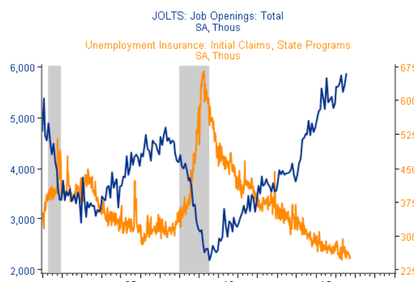
Third quarter investment commentary

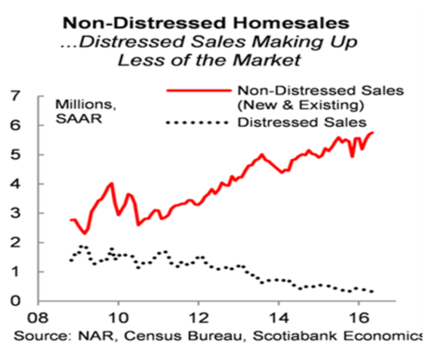
Economic overview

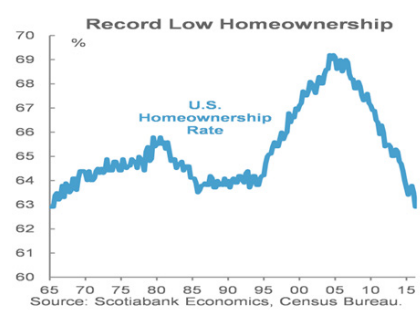
2016 will be the fourth consecutive year of sluggish global growth at less than 3%. Unfavorable demographic trends, low productivity growth and legacies from the global financial crisis will limit a more robust pickup.

The U.S. economy is improving after a slow first half. GDP growth is being led by consumer spending, wages and employment. Unemployment insurance claims (see chart) continue to decline suggesting no stress in the labour market. Job openings remain at cycle highs (see chart) pointing to robust demand for labour.



The important housing sector is doing well with new and existing home sales at their highest level since 2007 (see following chart). Median household income rose 5.2% in 2015, the first increase since 2007. Record low homeownership (second chart below), rising incomes and low unemployment provides a favourable backdrop for the housing industry and related equities. We do find equity valuations in North America to be rather full, but would use market weakness to invest some of our cash.





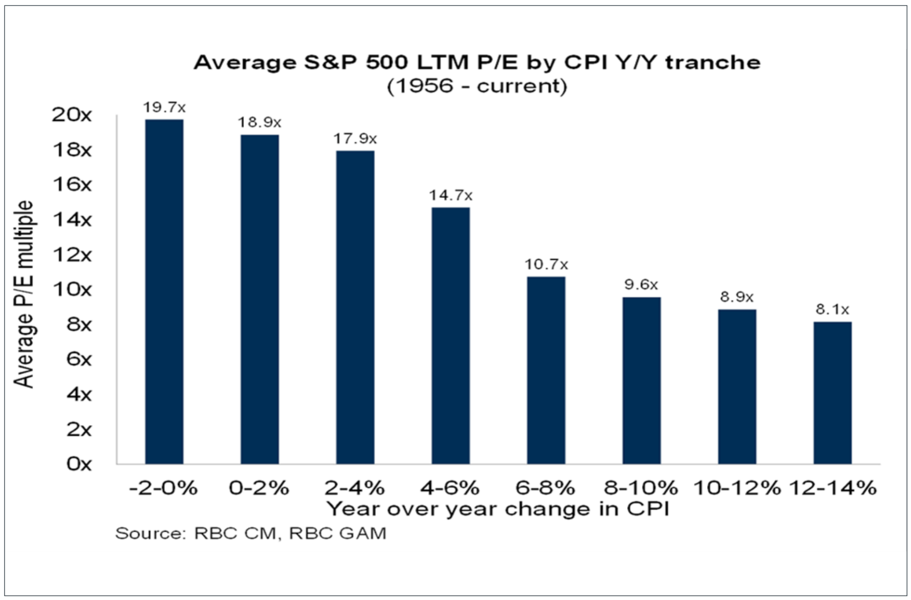
Eurozone recovery continues at a modest pace. Companies are hiring at the fastest rate since the financial crisis. Q2 employment reached a new post crisis high, up 1.4% year-over-year, and upward earnings revisions are close to their highest level since 2010.

Canada's economy is recovering. June and July recorded the strongest back-to-back gains in output in five years. The expansion was broad-based with mining and oil/gas leading the way. The weak Canadian dollar is helping exports and we expect a boost from the $150 bln infrastructure stimulus package.

Central bank efforts in China seem to be paying off as August Industrial Production, Retail Sales and Fixed-Investment rose sharply.

Equity commentary

Our average equity weight in fully-invested balanced portfolios is 58%, above the benchmark weight of 55%. Our stock exposure is concentrated mainly in large-cap, high quality, dividend paying companies.



U.S. stocks are relatively attractive versus bonds with the S&P 500 earnings yield of 5.7% (inverse of the p/e) comparing favorably to bond yields (10-year U.S. Treasury yield is 1.72%). However, on an absolute basis, U.S. equities are fairly valued, trading at about 18.5x trailing earnings. The chart to the right illustrates that when inflation is 2-4% (it is presently 2.3%), the average p/e multiple is 17.9x, compared to 18.5x currently.

Fully invested balanced portfolios are market weight U.S. stocks (average 20.8% versus 20% balanced benchmark). We are overweight healthcare through ownership of Abbott Labs, Johnson & Johnson, Medtronic, Merck, and Pfizer. The IMS Institute for Healthcare Informatics estimates that pharmaceutical spending will touch US $1.4 trillion by 2020, an increase of 32% from 2015.

We added a small weight in Facebook (FB). FB operates the world's leading social networking site. FB has approximately 4.4% of global advertising which allows for considerable growth. FB is growing faster than other large technology companies yet trades at a reasonable multiple of 18x 2018 estimates.

Fully invested balance portfolios are overweight international equities (average 8.5% versus 5% balanced benchmark) with exposure to energy, materials, telecom and utilities. European stocks trade at a reasonable p/e ratio of about 16x and economic data is improving. During Q3, we purchased BHP, the world's largest mining company. BHP provides exposure to a broad basket of commodities including coal, oil/gas, copper, iron ore and nickel. Commodity prices have moved higher lately and BHP's share price has followed suit.

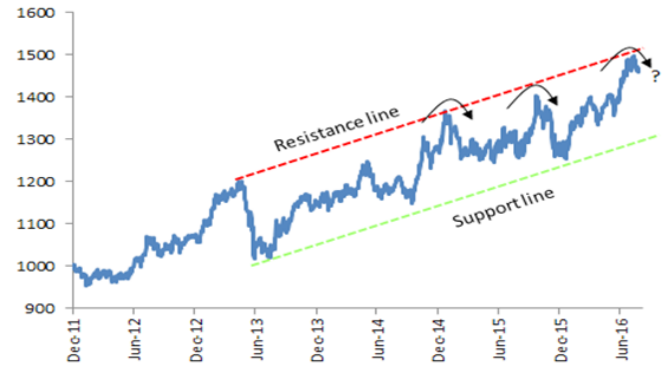
Fully invested balance portfolios are marketweight Canadian equities (average 29.4% compared to the balanced benchmark weight of 30%). Earnings estimates for the TSX have been rising, up 8.6% from their March/April lows. Our largest weightings are in banks and insurance companies, namely Bank of Montreal, Royal Bank, TD Bank, ManuLife and Power Corp. During Q3, we trimmed a number of our interest-sensitive holdings, including BCE, TransCanada Pipelines, Crombie REIT, RioCan REIT, Hydro One and Canadian Utilities. Good performance from these companies/sectors (see charts on page 3) resulted in expensive stock valuations.

Sale proceeds from interest-sensitive stocks were used to purchase ManuLife (MFC) and Power Corporation (POW). Life insurance company valuations appear too compelling to ignore. Historically, the 12-month forward price/earnings ratio for lifecos has been about 1.15x that of the banks. Currently, this ratio is below 0.9x (see chart). The median 12-month return for lifecos when this ratio falls below 1x has been 24% and the relative median outperformance to banks has been 7.5%. MFC & POW have attractive dividend yields of 4.1% and 4.8% respectively which provides downside protection.

We purchased Freehold Royalties Ltd (FRU). The majority of FRU's cash flow is generated from long-life royalty assets that carry no operating or capital cost commitments. FRU's revenue stream comes straight off the top line. FRU fully covers its $0.48 dividend (4.1% yield) at $US45/bbl WTI and has virtually no debt. In addition, FRU generates about $0.33/share of free cash allowing for future dividend increases. OPEC's decision to consider reducing oil supply, if successful, would provide a favourable backdrop for the energy industry.

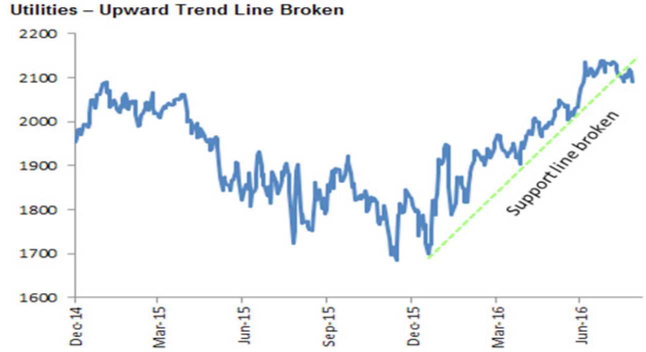
We fully exited Agnico Eagle (AEM) in August at $71.86/share as it reached levels where we considered it to be overvalued. The cost base for most accounts was close to $30/share.

Telecom Hits A Resistance Zone



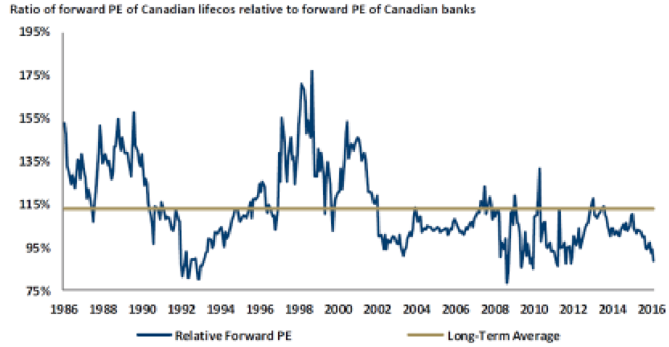
Source: Scotiabank GBM Portfolio Strategy, Bloomberg

Utilities – Upward Trend Line Broken



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

Ratio of forward PE of Canadian lifecos relative to forward PE of Canadian banks

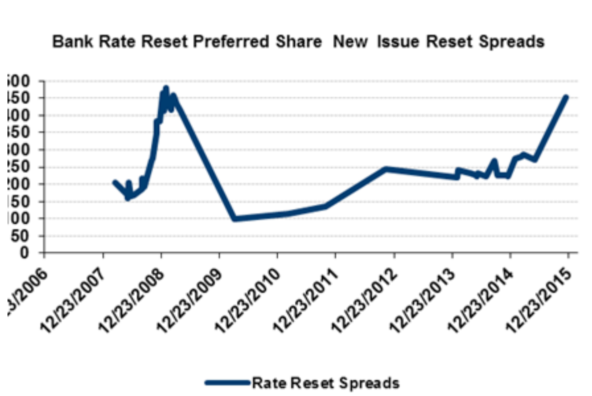


Source: RBC Capital Markets Quantitative Research. Through August 31, 2016

Fixed income

Fixed income weighting in fully invested balance portfolios is 30.7% on average (compared to 40% for the balanced benchmark) with the majority invested in preferred shares. Government bonds are very expensive as real yields remain low (and represent a near-guaranteed loss of purchasing power at current interest rates if held to maturity). On the other hand, preferred shares are attractive as their yields are near historical high spreads versus bond yields.

We have a large weighting in bank rate reset preferreds. Earlier issues offered a 5.5% yield (pre-tax bond equivalent yield of 7.15%) with generous 5-year reset spreads of 4.66% to 4.80% over 5-year Canada Government bonds. These were the largest reset spreads offered by Canadian banks since the financial crisis. More recent issues, which we have also purchased, have lower, but still attractive yields of 4.85% (pre-tax bond equivalent yield of 6.31%) and carry reset spreads of 4.12% to 4.19%. Fully transitioned portfolios hold about 25% in preferred shares through a combination of floating, fixed-reset, and perpetual instruments.



Source: Bloomberg, RBC Wealth Management

Performance as of September 30, 2016	3 months	12 months
*Balanced benchmark objective	3.04%	9.31%
Range of client returns	3.20% to 4.66%	9.16% to 10.71%
*Balanced benchmark composition	5% T-Bills, 40% Bonds, 30% TSX, 20% S&P 500, 5% EAFE	
Return net of fees		

Portfolio returns exceeded their balanced objective return for Q3. The majority of outperformance came from the approximately 25% weight in **preferred shares.** The S&P/TSX Preferred Share Index, a proxy for our preferred share returns, was up 4.66% during Q3, significantly exceeding the Broad Bond Composite Index return of 1.2%.

Our **Canadian stocks** performed in line with the S&P/TSX with a similar number of equities outperforming the index as underperforming. Economy-sensitive stocks did well, with Magna (+24.2%), CNR (+12.4%), and West Fraser (+7.0%) leading the way. On the other hand, interest-sensitive stocks underperformed (we trimmed many names near their highs) with RioCan (-7.2%), BCE (-0.9%), Canadian Utilities (-1.1%), and Hydro One (-0.2%) all down for Q3.

U.S. equities did very well with solid price gains (in Canadian dollars) from Prudential Financial (+16.0%), Google (+13.9%), Merck (+9.90%), Time Warner (+9.8%), Abbott Labs (+9.3%) and Proctor & Gamble (+7.6%). Wells Fargo (-4.9%) was the notable laggard, a result of an ongoing inquiry into fraudulent account openings. While obviously not a positive, we note that many good companies have stumbled at some point in their history and view this setback as an opportunity to add at reasonable valuations.

The range of returns for one year was in line with the benchmark (after fees). We are pleased with our performance as the investing environment hasn't been without its challenges this year.

According to GIPs methodology, in order to be included in the range of returns, accounts must be on board for the full quarter. We exclude accounts that have additions/ withdrawls of 5% or more during the quarter, have equity weightings more than +/- 7% from the average equity weighting, and fixed-income weightings that exceed +/- 5%.

Wealth services for our valued clients

A number of our clients have recently taken advantage of the services offered by RBC Wealth Management which include:

- Financial planning – In-depth financial planning suitable for most situations
- Will & Estate consultation – Information for tax-effective structuring; report outlining various opportunities that may be explored with legal counsel
- Insurance assessment – Estate planning specialists assess the need and suitability of tax-exempt insurance
- Strategic tax minimization – In-house tax specialists review the effectiveness of particular strategies
- Business owner planning – In-house business owner specialist helps you explore succession, tax, retirement and estate planning issues you face as a business owner

These services are complimentary for our valued clients. If you would like to take advantage of any of the wealth management services, please call Jaana to schedule an appointment.

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