Fickel's Focus

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Second quarter investment commentary

Global Markets Extend Winning Ways in Q2, 2017

Global equity markets recorded decent local currency performance in Q2. However, these gains were mitigated somewhat when converted into $Canadian. The TSX was the notable laggard finishing down as weak commodity prices weighed on stocks.

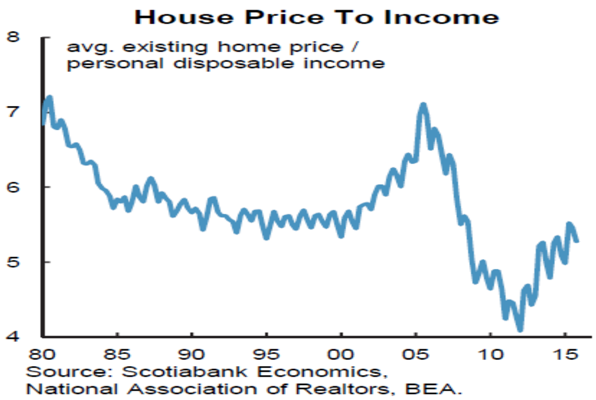
Domestic bond and preferred share indices fared reasonably well, each up about 1%.

Client portfolio performance slightly exceeded benchmark returns for accounts on board for the full quarter and migrated to their appropriate model. Please contact us to further discuss performance of your portfolio.

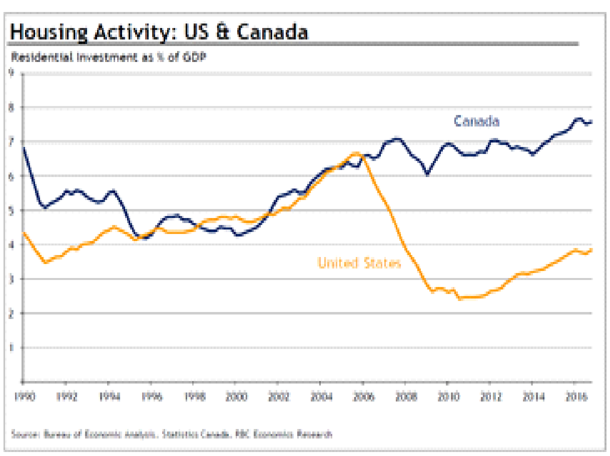
Economic Overview

2017 will be the first synchronized global recovery since 2009. Manufacturing and consumer spending are picking up. Government expenditures are rising and inflation is forecast to move higher on the back of strengthening labour markets. The need for extremely low interest rates is diminishing.

U.S. growth is being led by employment and wage gains. The economic backdrop is very supportive for the important housing sector where affordability is high and home ownership is at record lows (see charts on next page).



Although housing sales have picked up following the 2008 recession, the recovery looks to be in the early stages. Americans have spent significantly less on residential investment over the past decade compared to Canadians (see chart). This gap should narrow as consumer confidence improves. A strong housing market bodes well for client holdings of Costco, Home Depot, and West Fraser.



Positive momentum continued in the Eurozone with GDP rising 1.9%. Bank lending and business hirings grew at their quickest pace since the financial crisis.

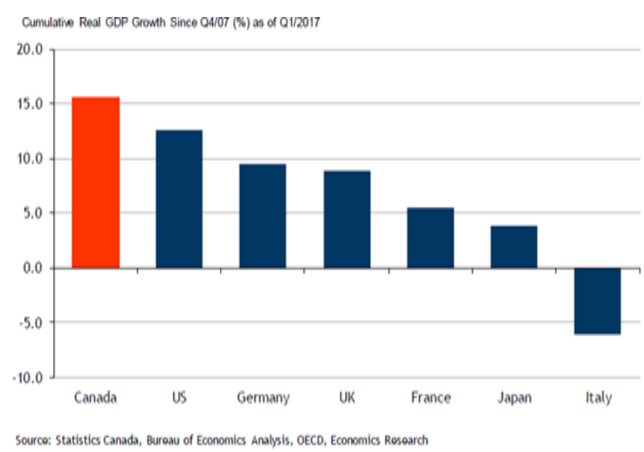
The Purchasing Managers Index (PMI), a gauge for manufacturing, reached a post-recession high and is consistent with GDP growth of 3.0% (equities have historically been up 1, 3, and 6 months following PMI readings at this level). Eurozone growth is converging with U.S. growth (see chart).

Eurozone and U.S. Real GDP Growth

Source: J.P. Morgan Economic Research

Canada's economy is growing. We believe that few investors are aware that Canada's growth has been faster than all other G7 countries dating back to the 2008 recession (see chart).

G7 Real GDP Growth



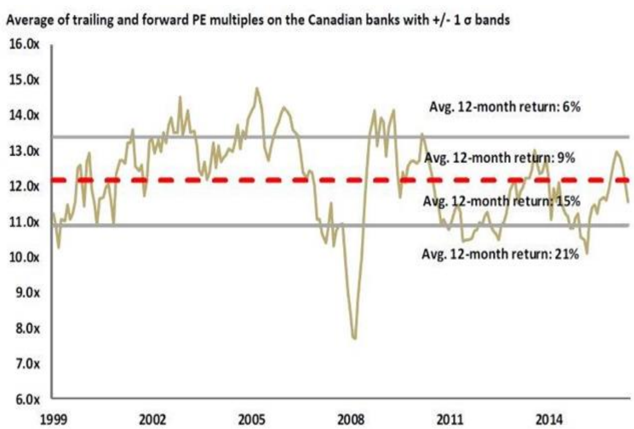
Q1 growth of 3.7% was the fastest pace among the Group of Seven countries. Employment is strong with a whopping 45,300 jobs added in June. Housing starts remain near decade highs. The $150 billion infrastructure stimulus package will boost activity while the weak Canadian dollar is helping exports. Business investment indicators are at 5-year highs suggesting a willingness of Canadian manufacturers to spend on machinery and equipment.

Equity Commentary

The average equity weight in fully-invested balanced portfolios is 52.8%, below the balanced benchmark weight of 55%. Equity weightings declined following some profit taking.

Fully invested balanced portfolios are underweight Canadian stocks (average 26.8% versus 30% balanced benchmark). We sold Magna in view of peaking auto sales, deteriorating used car prices, and rising delinquencies in the subprime auto loan market. West Fraser Timber was trimmed after an approximate 50% gain and ahead of the softwood lumber tariff announcement.

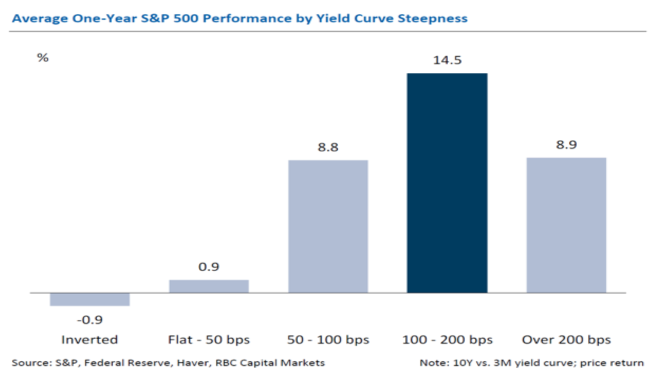
We like the Canadian financial services sector. Having said that, bank weightings were reduced early in Q2 when valuations reached the upper end of historical ranges. However, weightings were subsequently increased (+Royal, +TD, +BMO) after banks declined nearly 10% taking valuations back to reasonable levels. Historically, banks have generated double digit returns from current valuations (see chart).



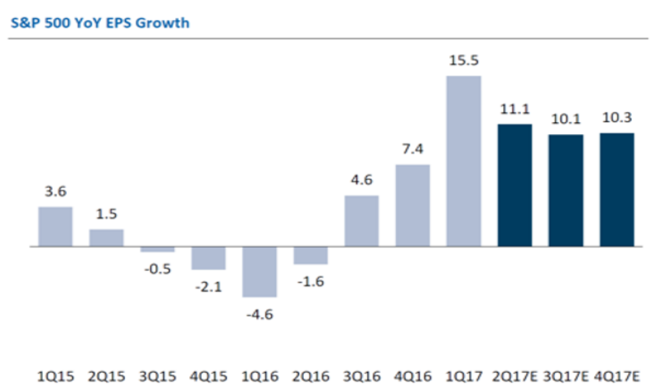
After a dismal Q2, the TSX forward P/E ratio has declined to 15.9x, substantially below the S&P 500 multiple of 18.3x (see next chart). The heavy composition of resources in the TSX has worked against it as they have performed poorly of late. Improving global growth over the next few years should create a more favourable backdrop for commodities and the TSX.

Fully invested portfolios are underweight U.S. stocks (average 14.6% versus 20% balanced benchmark).

The S&P 500 is a difficult call for us. Setting political uncertainty aside, the S&P 500 is expensive on a valuation basis. However, valuation alone does not dictate the direction of equities. The steepness of the yield curve (the difference between the 3-month U.S. Treasury Bill yield and the 10-year U.S. Treasury Bond yield) correlates well with equity returns. The yield curve is currently quite steep at 126 basis points. Historically, returns have been very strong from this level (see chart).

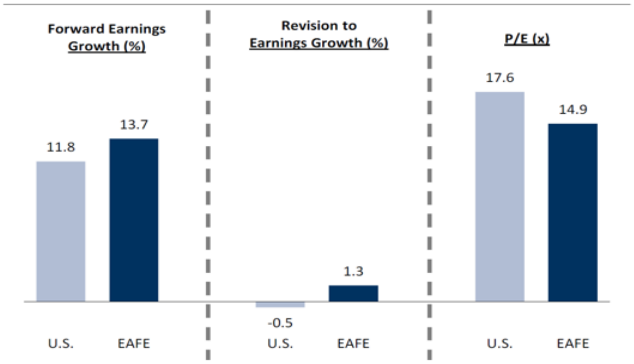


Stocks also respond well to profit growth and corporate earnings are forecast to rise at a decent clip over the next year (see chart).



Fully invested portfolios are overweight International stocks at 11.4% (balanced benchmark is 5%). Europe presently offers an attractive risk/reward profile. The economic environment is improving, earnings are growing, political risks have been reduced, and equity markets trade at a larger-than-normal discount to U.S. stocks. Eurozone profits and sales rose 23% and 10% in Q1 compared to U.S. growth of 14% and 8%. Eurozone equities trade at a lower P/E valuation than U.S. stocks yet the outlook for earnings growth is better (see chart). The majority of our Eurozone exposure is in financials.

Growth, Revisions, and Valuation – EAFE vs. U.S.



Fixed Income

The average fixed-income weight in fully invested balanced portfolios is 23.9%. This compares to 40% for the balanced benchmark.

Global government bonds are unattractive offering investors negative yields in many cases (see chart).

Global Sovereign Interest Rates

%	1-Yr Yield	2-Yr Yield	5-Yr Yield	10-Yr Yield
Portugal	-0.24	0.09	1.29	3.01
U.S.	1.23	1.38	1.89	2.30
Italy	-0.39	-0.13	0.86	2.15
Canada	0.97	1.10	1.39	1.76
Spain	-0.37	-0.28	0.31	1.52
U.K.	0.34	0.36	0.70	1.26
France	-0.56	-0.38	-0.04	0.82
Netherlands	-0.64	-0.58	-0.20	0.65
Sweden	n.a.	-0.64	-0.01	0.65
Germany	-0.65	-0.57	-0.22	0.47
Japan	-0.13	-0.12	-0.06	0.09
Switzerland	-0.86	-0.80	-0.48	-0.02

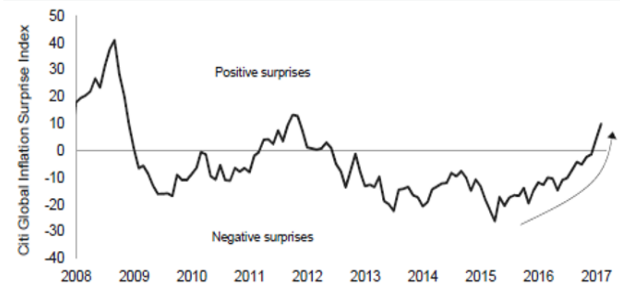
Indicates Negative Yield:

Source: Country's respective Central Bank, Bloomberg, and RBC Capital Markets

Central bank intervention has kept interest rates low. However, one by one, they are becoming less accommodative, which by itself is negative for bonds.

Rising global inflation (beating analysts' expectations in some instances) is also quite negative for bonds (see chart).

Global inflation surprises on the upside



Source: Citigroup, Bloomberg, RBC GAM

We remain very defensive in the fixed-income component of portfolios (owning mostly preferred shares). Clients hold 3 types of preferred shares: fixed rate reset, floating, and perpetual. This strategy accomplishes several objectives- stable income via perpetuals and interest rate protection through rate reset and floating shares.

Performance

The S&P/TSX Preferred Share Index (TR), a proxy for client preferred share holdings, gained 1.22% during Q2, matching the Broad Bond Composite return of 1.1%. However, our high cash component- which is ultimately targeted for bonds- underperformed both bonds and preferreds and weighed slightly on overall performance.

Underweight Canadian & U.S. equities, overweight International stocks, and better stock selection in each of the three regions contributed to overall portfolio outperformance.

Clients' Canadian equities lost less than the S&P/TSX (-1.6%). Strong performances from West Fraser (+10.1%), Canadian National Railway (+7.0%) and Canadian Utilities (+6.7%) offset weak returns from energy and material stocks including Suncor (-7.3%), Agrium (-7.6%) and Freehold Royalties (-3.6%).

U.S. equities fared better than the S&P 500 return of 0.4% ($Cdn). Healthcare stocks Abbott Labs (+6.6%), Medtronic (+7.3%) and Johnson & Johnson (+3.5%), and technology stocks Google (6.7%) and Facebook (+3.5%) outperformed. Consumer Stocks lagged with Costco (-7.1%) and Proctor & Gamble (-5.5%) down. We believe Costco's substantial decline due to Amazon's announced purchase of Whole Foods was an overreaction.

International investments handily beat the EAFE Index return of 2.3% ($Cdn). Financials were smartly higher led by ING (+12.1%), Banco Santander (+7.4%), Allianz (+3.8%), and AXA (+3.6%).

Announcements

On a final note, we are pleased to announce that Shawn Willemse has joined our team.

Shawn brings over 20 years of experience in financial services. He spent the past eleven years working as a Research Associate and Analyst for the Templeton Global Equity Group where he supported the CEO of Franklin Templeton Investments Canada in the portfolio management of Canadian and International equities. During this time, he performed macroeconomic research in addition to specific company, industry, and country research. Prior to his Templeton role, Shawn dealt directly with clients and gained valuable estate and trust experience.

Shawn holds a Bachelor of Arts degree in Economics from the University of Western Ontario and has attained the CFA Institute's Chartered Financial Analyst (CFA) designation and the Canadian Securities Institute's Chartered Investment Manager (CIM) designation. Away from the office, Shawn is an avid jogger and enjoys spending time with his wife and 2 daughters.

Unexpectedly, Miro Czyzewski has resigned for personal reasons and to pursue other interests. We thank him for all his contributions in assisting our clients. We will miss Miro and wish him nothing but the very best in his future endeavors.

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
- **Insurance assessment** – Estate planning specialists assess the need and suitability of tax-exempt insurance
- **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
- In-depth **Financial Planning**

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 at 416-960-7880 to schedule an appointment.

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