Fickel's Focus

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Second Quarter Investment Commentary

Markets rally as robust growth "trumps" rising risks related to trade policy

Stocks rose in Q2 aided by expanding economies and growing earnings.

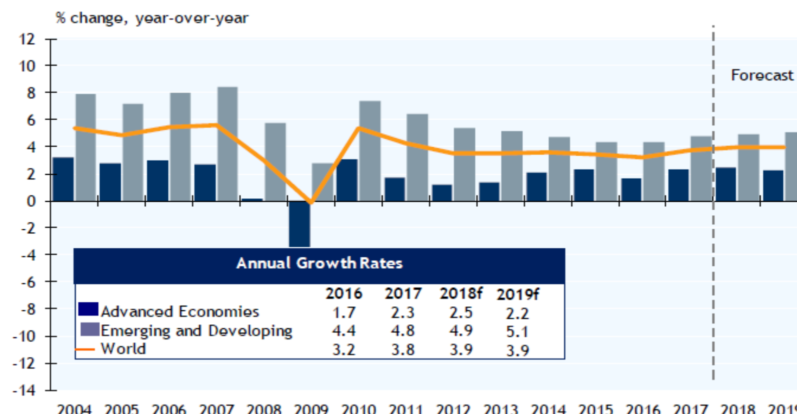
Bond returns were miniscule.

Accounts on board for the full quarter and migrated to their appropriate models recorded positive performance but modestly underperformed the balanced benchmark. Please contact us to further discuss the performance of your portfolio.

Economic Overview

The current global expansion has entered its 10th year, making this the second longest in history. Forecasts for manufacturing activity along with business and consumer confidence readings support continued growth (see following two charts).

Global manufacturing expansion continues



	2016	2017	2018f	2019f
Advanced Economies	1.7	2.3	2.5	2.2
Emerging and Developing	4.4	4.8	4.9	5.1
World	3.2	3.8	3.9	3.9

Source: International Monetary Fund, RBC Economics Research Forecast

Global confidence is high

Source: J.P. Morgan, RBC Wealth Management, March 2018

Equity Commentary

There has been minimal reaction thus far by stocks to rising trade tensions. Investors are downplaying the tariff rhetoric and possibility of an all-out trade war. In our view, the most likely scenario is one where all of the parties involved negotiate trade deals. The alternative is in no-one's best interest.

The average equity weight in fully-invested balanced portfolios is 57.4%, above the balanced benchmark weight of 55%.

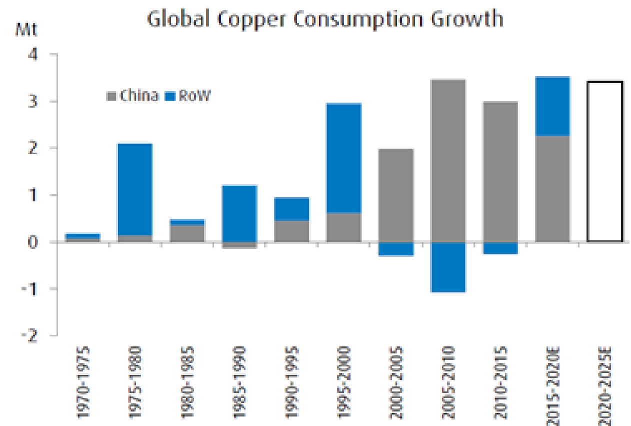
Global equity market valuations are slightly below their long-term averages with the exception of the U.S. market which trades about 15% above. The strong earnings outlook provides a tailwind for stock markets.

Fully invested balanced portfolios are overweight Canadian stocks (average 31.8% versus 30% balanced benchmark). The TSX trades near a 15-year relative low to the S&P 500. Improving economic activity and higher commodity prices should help to narrow this gap.

We are overweight Materials. This sector includes metals, golds, chemicals and forest products - all of which benefit from healthy global growth.

We believe the outlook is favourable for copper. Demand is being fueled by the adoption of electric vehicles (EV) and expanding the infrastructure for renewable energy. EVs use about 3.6x the amount of copper as internal combustion engine automobiles. Renewable energy, led by wind and solar power, requires significant amounts of copper in order to expand the infrastructure grid to connect a large number of widely dispersed generating units.

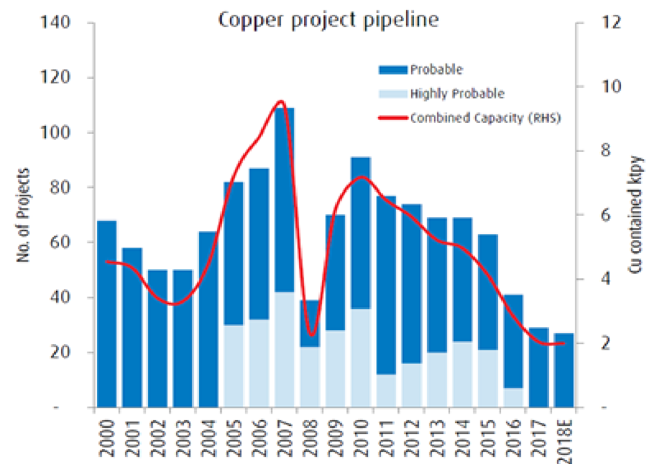
Global copper consumption is forecast to grow at the highest rate in recent history (see chart).



Source: ICSG, BMO Capital Markets

It's unlikely there will be sufficient supply of copper to satisfy demand (see chart).

The number of copper projects classified as probable and highly probable is the lowest this century



Source: Wood Mackenzie, BMO Capital Markets

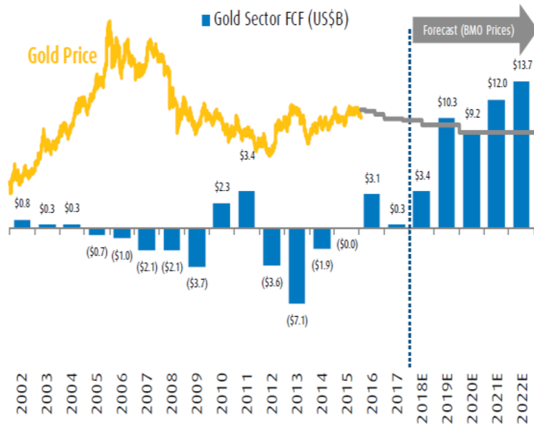
First Quantum (FM) is our preferred way to invest in copper. FM has a top-tier growth profile with copper and gold production expected to increase by over 50% through 2019.

FM has been cited recently in the press as a takeover candidate by the global mining behemoths, BHP and Rio Tinto. The latter are scouring the globe looking for high quality, long-lived copper operations.

We believe there is a place for gold stocks in port-

folios. The gold sector is positioned to generate significant free cash flow over the next few years (see chart). At current share prices, investors get the “safe haven” option at a discount.

Sector free cash flow is on the rise



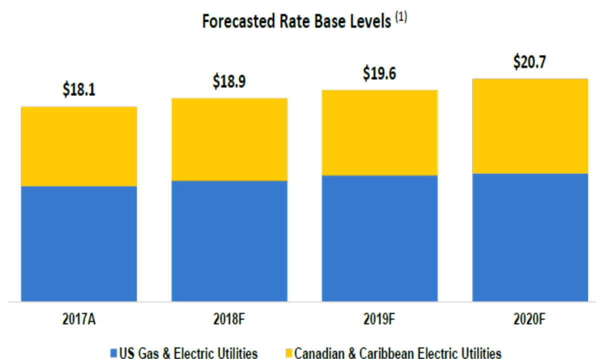
Source: Bloomberg, FactSet, BMO Capital Markets

Clients own two gold stocks, Goldcorp and Yamana. Both companies have good production growth and trade at low price-to-free-cash flow levels.

We are overweight utilities owning Canadian Utilities, Emera (EMA), and Hydro One. We like their defensive characteristics, high dividend yields, low valuations and modest growth prospects.

EMA is a solid defensive investment yielding about 5.5% and trading at about 14x 2019 EPS estimates. The company faces many years of low risk utility rate growth (see chart). The major driver of expansion will be its Florida electric and gas utilities. Recent concern about the negative impact on earnings from U.S. tax reform has unduly depressed EMA’s share price.

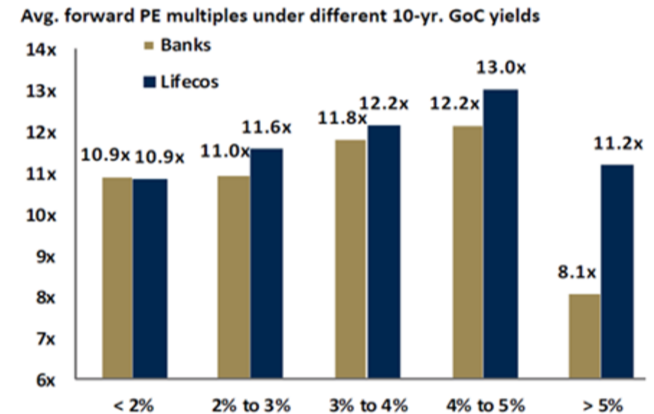
Projected rate base growth



1) In billions of Canadian dollars.
Source: Company reports

Clients are well represented in Canadian financials. Banks and insurance companies do well when rates are rising. Using the 10-year Government of Canada (GOC) bond yield as a proxy for rates (horizontal axis), P/E multiples (vertical axis) expand as yields increase up to the 4-5% range (see chart). Currently, the 10-year GOC bond yield is 2.15%. Rates can rise significantly before P/E ratios decline.

Higher rates = multiple expansion



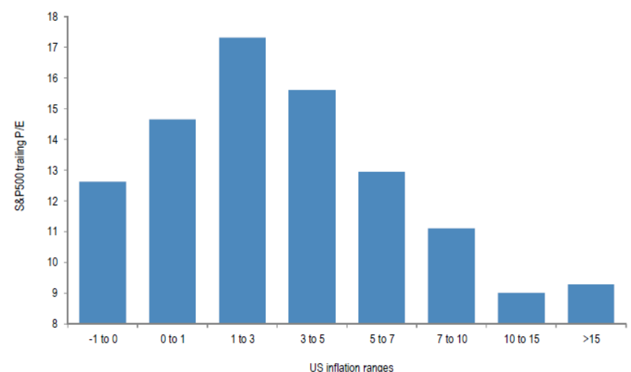
Source: Bloomberg; RBC CM Canadian Equity Strategy

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 14.5% versus 20% balanced benchmark). The S&P 500 is trading about 17x forward earnings, 15% above its long-term average.

However, the S&P 500 can sustain above average P/E multiples as long as inflation remains in the 1% to 3% range (see chart). The current rate of inflation is 2.1% (although the 6-month average is 2.6%).

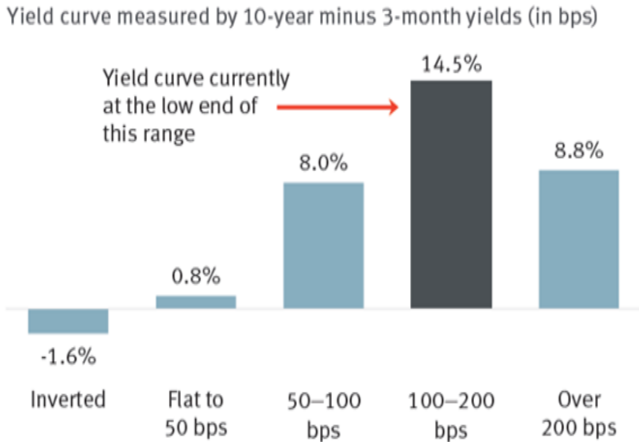
Trailing P/E for S&P 500 in different inflation regimes



Source: Shiller data, since 1872, inflation prints curtailed below -1%

As well, 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. Today this gap is about 94 bps. Historically, annual returns have averaged about 8% at this level (see chart). Stocks perform poorly whenever this gap is less than 50bps.

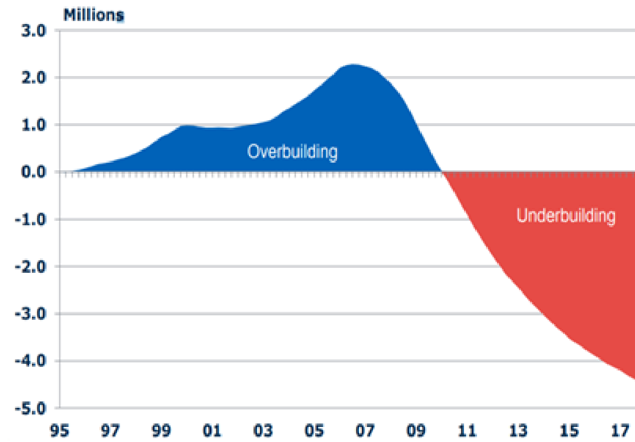
S&P 500 returns by yield curve steepness (%)



Source: S&P, Federal Reserve, Haver, RBC Capital Markets

We like housing related investments. The U.S. housing market recovery will continue over the next 12-18 months helped by job growth, wage gains and affordability. 2008-2014 comprised the seven worst years for housing starts in over half a century resulting in a chronic shortage of new homes (see chart).

Chronic underbuilding in the U.S. housing market since the financial crisis



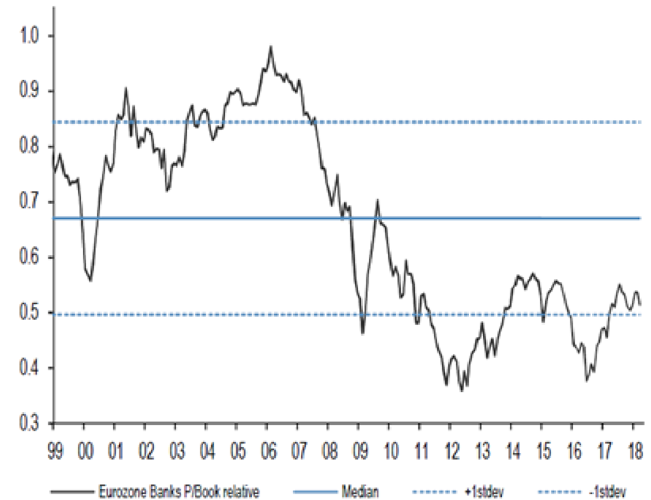
Source: FEA

56% of U.S. owner-occupied homes were built before 1980. An "aged" U.S. housing stock along with the lack of available homes for sale bodes well for residential repair and remodeling expenditures and related companies including client holdings of Costco, Home Depot, and West Fraser.

Fully invested portfolios are overweight International stocks at 11.2% (balanced benchmark is 5%). Global equities trade below their historical average price-to-earnings (P/E) multiples and at a steep (P/E) discount to the S&P 500.

We hold some European financials. European banks have gone through a massive clean-up process. At the same time, credit growth is improving across the region. Valuations are attractive with price/book measures remaining well below their long-term averages (see chart).

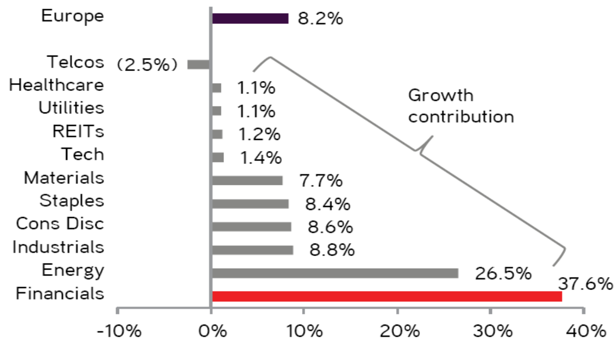
Eurozone banks relative price to book value is below historical average



Source: Datastream

Political concerns and the ECB's decision to postpone interest rate hikes in Europe have weighed on financials recently leading to share price declines that we believe are excessive. The companies we own are geographically diversified and most of their operating units are performing quite well. Financials are forecast to contribute a whopping 37.6% of estimated European earnings growth in 2018 (see chart).

Europe consensus 2018 earnings contribution to growth estimates



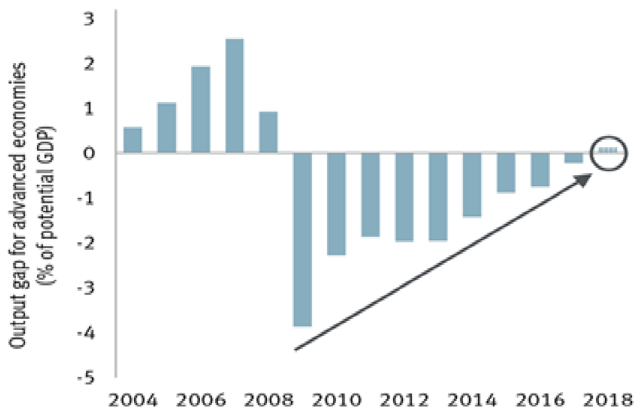
Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

Fixed Income

The average fixed-income weight in fully invested balanced portfolios rose from 26% at the end of Q1 to 32.6% in Q2 (compared to 40% for the balanced benchmark). About 1.6% was sourced from the sale of stocks; the remaining 5% was investing cash in short-term bonds as they provided higher rates than money markets. We remain very defensive in the fixed-income component of portfolios.

Global inflation readings are rising on the back of strengthening labour markets and higher commodity prices. Economic slack is finally gone in the developed world with the closing of the output gap for the first time in a decade (see chart). It is reasonable to expect higher inflation (and interest rates) with demand now exceeding supply.

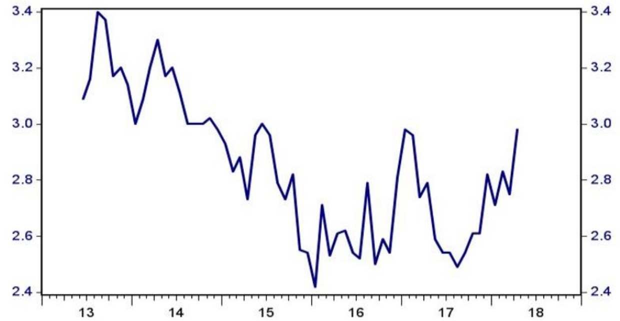
Output gap has closed in the developed world with "excess capacity" turning into "not enough capacity"



Source: IMF, Haver Analytics, RBC Global Asset Management

Inflation expectations are moving higher in the U.S. (see chart).The one-year ahead expected rate has reached 3%.

Inflation expectations: median one-year ahead expected inflation rate



Source: RBC Capital Markets U.S. Economics/FRBNY/Haver

The U.S. unemployment rate of 4.0% is at multi-decade lows. The current annual increase in wages is about 2.7%. Historically, wage gains have exceeded 4% with unemployment rates near current levels (see chart).

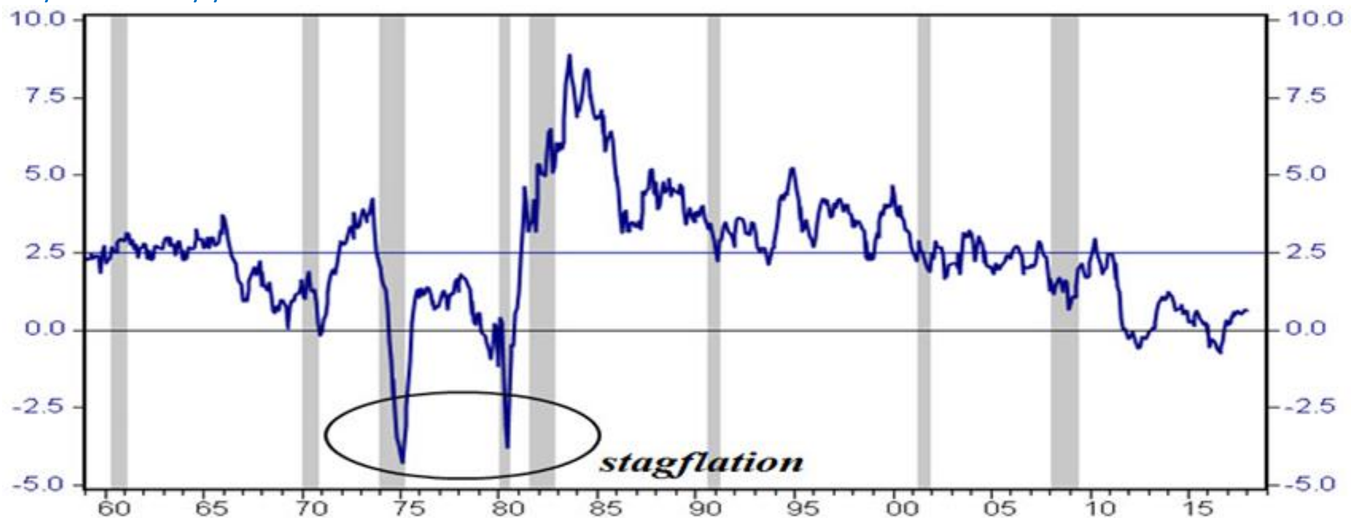
Unemployment rate and average hourly earnings

Source: Bloomberg

The Federal Reserve will continue increasing rates in view of tightening labour markets, the prospect of higher wages and rising inflation expectations.

U.S. interest rates are too low. The real (inflation-adjusted) 10-year U.S. Treasury bond yield is 80 basis points (see chart on next page). The historical long-term average is about 250 basis points. The 10-year bond yield would need to rise about 170 basis points in order to bring it back to its average long-term inflation adjusted yield. Mid to long-term bond prices would get crushed if this happened.

10-year Treasury yield minus core CPI



Source: RBC Capital Markets U.S. Economics/Haver

Canada's core inflation (CPI) rose 2.2% Y/Y in May. The June unemployment rate was 6.0%, near the lowest level since the mid-70's. Average hourly wage growth strengthened to 3.6% in June. With the economy running at close to its capacity limits and inflation reaching the Bank of Canada's 2% target, we expect interest rates to grind higher this year and next. This does not bode well for Canadian government bonds which currently offer an inflation adjusted return near 0%. Mid to long-term bond prices would decline significantly if yields revert back to their long-term inflation adjusted levels.

We remain defensive in the fixed-income component of portfolios. About two-thirds of the fixed-income investments are in preferred shares, the other one-third in high quality bonds.

Clients hold 3 types of preferred shares: floating, fixed rate reset, and perpetual. This strategy accomplishes several objectives - stable income via perpetuals and interest rate protection through floating and rate reset shares.

Clients have about 10% of their assets in high quality, short-term bonds. We have done this primarily for diversification and preservation of capital. The bonds are laddered by maturity date with the view that as they mature, the proceeds can be reinvested in higher yielding, longer-dated bonds.

Performance

Returns were less than the balanced benchmark during Q2.

Overweight Canadian equities was the correct call in Q2. However, underweight Canadian energy stocks hurt returns as this sector accounted for a whopping 46% of the TSX 6.8% Q2 gain. Our overweight in defensive, high yielding telecom and utility stocks weighed on returns with losses, excluding dividends, from BCE (-4.0%), Canadian Utilities (-3.5%), and Hydro One (-4.2%). Emera was the notable exception (+5.0%). We believed, and still do, that higher interest rates were already baked into their share prices. We added to both Hydro One and Emera. Collectively, these two holdings have an average P/E of 15x and yield approximately 5%.

Our Canadian bank and insurance investments lagged the TSX with the following performances from Bank of Montreal (+4.1%), Royal Bank (-0.5%), TD Bank (+4.1), ManuLife (-1.3%) and Power Corporation (+0.2%).

Our cyclically oriented stocks did well led by Canadian National Railway (+14.2%), Yamana Gold (+7.6%), and First Quantum Minerals (+7.1%).

We chose to exit Nutrien after its large share price increase.

U.S. equity selection more than made up for being underweight U.S. stocks. Solid returns were recorded by Alphabet (+10.3%), Costco (+13.1%), Facebook (+24.1%), Home Depot (+11.7%), and Merck (+13.7%), all well ahead of the S&P 500 (+5.4%). Abbott Labs was sold after its tremendous two year performance of nearly 50%.

The international financial stocks were a big drag on portfolio performance. They more than offset solid gains from BHP (+14.8%), Medtronic (+8.9%) and Total (+7.1%). Allianz (-8.0%), AXA (-6.6%), Banco Santander (-16.9%) and ING (-13.7%) collectively prevented us from outperforming the benchmarks. We believe that all of these companies remain attractively valued. They are global in scope, trade at single digit P/E ratios based on 2019 earnings estimates and yield close to 5%.

Our preferred shares lagged the S&P/TSX Preferred Share Index return and the broad bond composite. Specifically, the BCE floating rate preferred shares were down about 3% on average. We expect better performance from these instruments going forward as their dividends will increase with rising interest rates.

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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