Fickel's Focus

Wealth Management
Dominion Securities

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Second quarter investment commentary

Economic overview

The International Monetary Fund (IMF) forecasts a fourth consecutive year of sluggish global growth for 2016 of less than 3%. The global economy will be hard-pressed to accelerate in 2017 as growth looks set to retreat in the UK and moderate in the EU, which account for 3.9% and 23% of worldwide GDP respectively. Unfavorable demographic trends, low productivity growth, legacies from the global financial crisis and modest drag from Britain's decision to leave the EU (Brexit) will limit a more robust pickup. Traditional monetary policy (low interest rates) is having less success than usual and leading to growing support for fiscal intervention (i.e. more government spending).

Restricted EU access could cause the UK economy to meaningfully underperform as trade with the EU accounts for 45% of exports and over 50% of imports. The IMF notes, an EU exit could cut Britain's GDP by 1.5% to 4.5% by 2019. The UK may negotiate some other arrangement as there is a two-year negotiating period, but that's indeterminate at this point. The EU may play hardball to discourage other countries from exiting. The impact of Brexit is much less significant for the EU as it relies on Britain for only 16% of its exports.

Outside of Europe, the impact will be modest with the UK representing 3%, 2.5% and 2.6% of total U.S., Canadian and Chinese trade respectively. S&P 500 company sales to the UK and EU total only 1.2% and 6.7%, thus limiting the potential impact on S&P 500 profits.

Equity commentary

Our average equity weight in fully-invested balanced portfolios is 52.2%, modestly below the benchmark weight of 55%. We do find equity valuations in North America to be rather full, but would use market weakness to invest some of our cash.

U.S. stocks are relatively attractive versus bonds with the S&P 500 earnings yield of 5.6% (inverse of the p/e) comparing favorably to bond yields (10-year U.S. Treasury yield is 1.41%). However, on an absolute basis, U.S. equities are fairly/fully valued trading at about 18x trailing earnings with inflation (CPI) at 2.3%. The following chart (Exhibit 1) illustrates that when inflation is 2-4%, the average p/e multiple is 17.9x, compared to 18x currently.

Fully invested balanced portfolios are modestly underweight U.S. stocks (19.6% versus 20% benchmark). We are overweight health care with exposure to pharmaceutical stocks through ownership of Johnson & Johnson, Merck and Pfizer. Worldwide spending on pharmaceuticals is set to surge. The IMS Institute for Healthcare Informatics estimates that it will touch US$ 1.4 trillion by 2020, an increase of 32% from 2015 (see Exhibit 2). The fastest growth will come from emerging countries like India and China with the U.S. remaining the largest drug market.

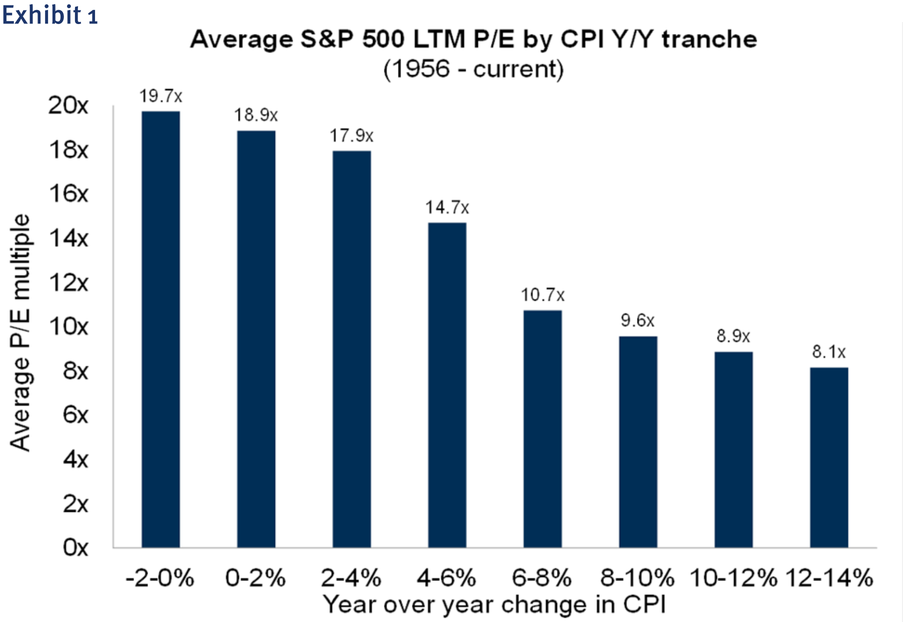
We added to Abbott Labs during Q2 after it declined following the acquisition of St. Jude Medical. This high quality company traded down to a very attractive valuation of 14.5x 2017 estimates.

On average, we are underweight Canadian equities at 25.9% compared to the benchmark weight of 30%. At 18x trailing earnings, the TSX is not inexpensive. Most of our equity exposure is defensive with investments in utilities, REITs and banks. We have some gold exposure through Agnico Eagle.

We are overweight European equities in Balanced Portfolios (6.7% versus benchmark weight 5%). European stocks trade at a reasonable p/e ratio of about 14x, and economic data is improving. Exposure is concentrated in energy, telecom and utilities.

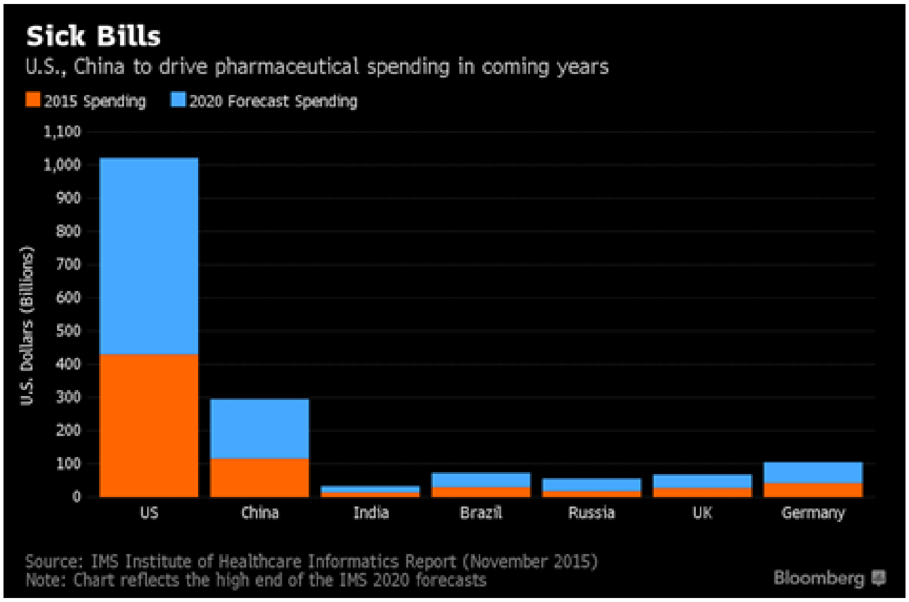
The negative impact from Brexit will result in interest rates staying lower for longer, which hurts European financials. We sold the rest of the European Index Fund (FEZ) in view of its large weighting in banks. Some of the proceeds were added to European Integrated energy companies, namely ENI (E) and Total (TOT). Their major capital expansion programs have been completed, valuations are reasonable (versus

Exhibit 1



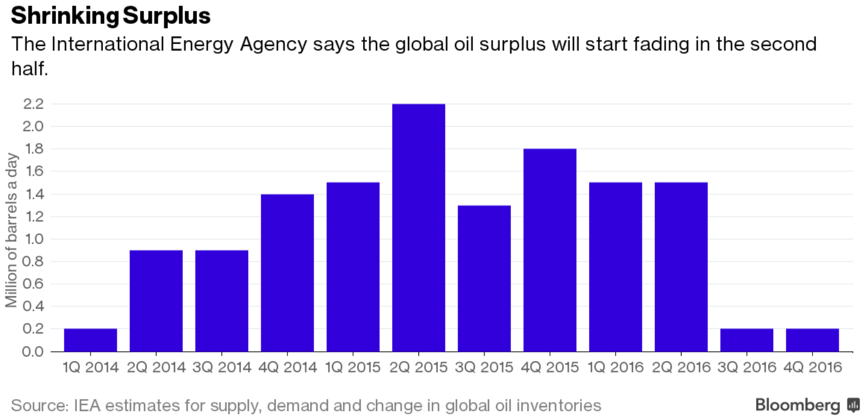
Source: RBC CM, RBC GAM

Exhibit 2



Source: IMS Institute of Healthcare Informatics Report (November 2015)
Note: Chart reflects the high end of the IMS 2020 forecasts

Exhibit 3



Source: IEA estimates for supply, demand and change in global oil inventories international peers) and they have high dividend yields of about 5%. As well, they are positioned to benefit from higher energy prices and lower operating costs.

The International Energy Agency (IEA) projects that the world oil surplus will decline to 200,000 barrels per day by the end of 2016 (see Exhibit 3). This is predicated on a continuing decline in U.S. shale oil inventories, continued economic growth and unplanned outages in higher risk regions such as Nigeria.

RBC Capital Markets has a moderately optimistic view on oil with global supply/demand moving towards balance. RBC has raised its Brent forecast to US$66 per barrel for 2017 (see Exhibit 4).

European Integrated energy company earnings will benefit from downward pressure on spending due to cost deflation (see Exhibit 5). The combination of higher oil prices and lower operating costs should boost Eni and Total's profits.

Fixed income

The U.S. and Canadian inflation rate is about 2.2%. In "normal times," yields would be above 2.2% providing investors with a real after-tax rate rate of return. However, the flight to "safe haven" assets globally has resulted in government bond yields declining to record lows (see Exhibit 6), and in many cases, to negative rates. About US$12 trillion of global government debt carries negative yields. This makes preferred shares yielding 5%+ look attractive.

Exhibit 4

RBC Capital Markets upped its expectations for crude oil

Crude oil forecast (per barrel in U.S. dollars)

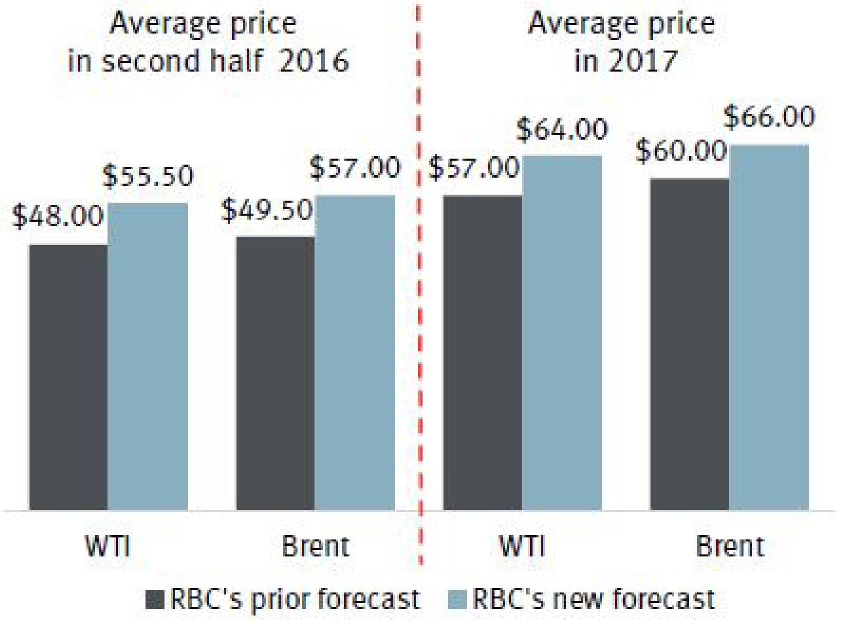
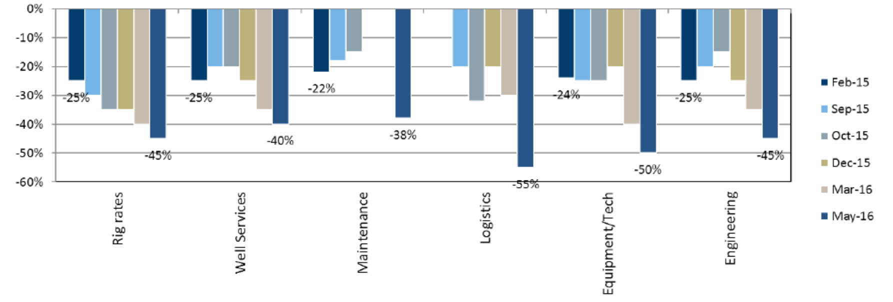


Exhibit 5

Exhibit 1: Breaking down cost reduction by sub-segment

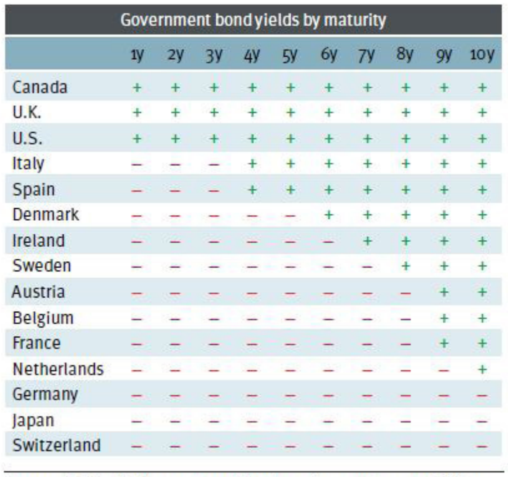


Source: Company reports, RBC Capital Markets. Note: Feb-15=STL, Sep-15=TOT, Oct-15=BP, Dec-15=ENI, Mar-16=Eni, May-16=BP. Some categories include incomplete data set.

Exhibit 6

Negative rates have moved out further along the yield curve

Government bond yields by maturity: negative (-), positive (+)



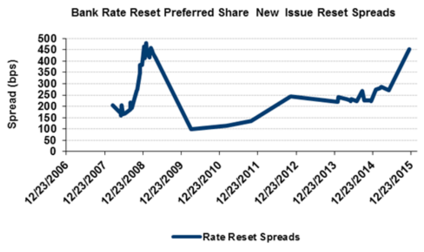
	Government bond yields by maturity									
	1y	2y	3y	4y	5y	6y	7y	8y	9y	10y
Canada	+	+	+	+	+	+	+	+	+	+
U.K.	+	+	+	+	+	+	+	+	+	+
U.S.	+	+	+	+	+	+	+	+	+	+
Italy	–	–	–	+	+	+	+	+	+	+
Spain	–	–	–	+	+	+	+	+	+	+
Denmark	–	–	–	–	–	+	+	+	+	+
Ireland	–	–	–	–	–	–	+	+	+	+
Sweden	–	–	–	–	–	–	–	+	+	+
Austria	–	–	–	–	–	–	–	–	+	+
Belgium	–	–	–	–	–	–	–	–	+	+
France	–	–	–	–	–	–	–	–	+	+
Netherlands	–	–	–	–	–	–	–	–	–	+
Germany	–	–	–	–	–	–	–	–	–	–
Japan	–	–	–	–	–	–	–	–	–	–
Switzerland	–	–	–	–	–	–	–	–	–	–

Source - RBC Wealth Management, Bloomberg; data as of 8:37 pm GMT on 7/1/16

Against this back-drop, we are avoiding government bonds as they represent a near-guaranteed loss of purchasing power if held to maturity. U.S. inflation will stay above 2 percent. Price increases are not letting up for rents and health care (which account for about 50% of CPI). Vacancy rates are at their lowest levels since 1994 and the benefits from the 2015 Obamacare cuts to Medicare and Medicaid roll off in 2016. Tight labour markets are manifesting in higher wages and the minimum wage is set to rise meaningfully in many states.

Fully transitioned portfolios hold about 25% in preferred shares through a combination of floating, fixed-reset and perpetual instruments. Although they have performed very well since issue, we like the Canadian bank rate reset preferred shares for their quality and high reset spreads (see Exhibit 7). The spread on new issues continues in the range of 450 to 490 basis points over 5-year Canada Government bonds. That's close to the highs that occurred during the financial crisis.

Exhibit 7



Source: Bloomberg, RBC Wealth Management

Performance as of June 30/16		
	3 mths (%)	9 mths (%)
*Balanced Benchmark Objective	2.94	6.08
Range of Client Returns	1.87 to 2.59	4.95 to 6.78
*Balance Benchmark Composition 5% T-Bills, 40% Bonds, 30% TSX, 20% S&P 500, 5% EAFE Returns net of fees		

Portfolio returns for the balanced objective modestly lagged their benchmark return for Q2. Underweight Canadian stocks hurt as the TSX was one of the top performing markets up 6.6%. Solid gains from REITs and Utilities stocks were not enough to offset being underweight the material and energy sectors, which were the best performing groups by far, up 31.6% and 13.8% respectively. These sectors were helped by the rebound in gold, oil and other commodities from very depressed levels.

Fully invested balanced portfolios were close to the benchmark weight of 20% in U.S. equities. Overweight health care helped returns, but having no exposure to U.S. energy stocks hurt as that sector was up 11.5% (in $U.S.) versus the S&P 500 up 1.2% (in $U.S.).

Other than Medtronic, which did very well, most of the international exposure was in the European Index Fund (FEZ) and Europe underperformed the World equity benchmark. As previously mentioned, we sold all of the FEZ and purchased individual securities.

We are pleased with the performance of preferred shares during Q2. However, our 15% – 20% cash position weighed negatively on returns as bonds went from being expensive to being even more expensive.

The range of returns for nine months was close to the benchmark (after fees). This has been a very volatile period and we believe that we have fared reasonably well. We are defensively positioned and as always, look to take advantage of opportunities as they are presented.

According to GIPs methodology, in order to be included in the range of returns, accounts must be on board for the full quarter. We also 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% during the quarter.

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