Fickel's Focus

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Fourth quarter investment commentary

"We would like to thank everyone for their loyalty, support and encouragement"

Best wishes for the New Year
David, Jaana, & Miro

2016 Was a Year of Surprises!

The S&P 500 started off 2016 with the worst 5-week return in history. This was followed by electoral upsets that began with Britain's vote to leave the European Union and culminated in Donald Trump's U.S. presidential victory. Despite these unexpected events, most major stock markets finished 2016 in positive territory with the S&P/TSX leading the way, up 21.1%.

Investors stampeded into equities following the U.S. election, focusing on the positive aspects of proposed large-scale tax cuts, infrastructure spending, and regulatory reforms. Expectations for debt-fueled spending and rising interest rates have become consensus. There are potential headwinds, however, that equity markets may be overlooking. These include higher costs associated with restrictions on trade and immigration, congressional opposition to fiscal stimulus, and a more hawkish central bank.

Economic Overview

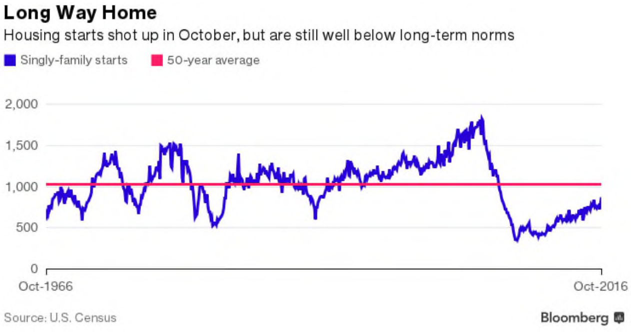
We enter 2017 faced with a wide range of potential outcomes. Based on years of experience, we rule out the more radical scenarios which are beyond measurement. Our working assumption is that President Trump's stimulus measures will be introduced in 2017 and boost U.S. GDP growth by 0.5%. Fiscal policy shifts in other regions including Canada and the Eurozone will also enhance economic activity. Global growth should meet, if not surpass, 3%.

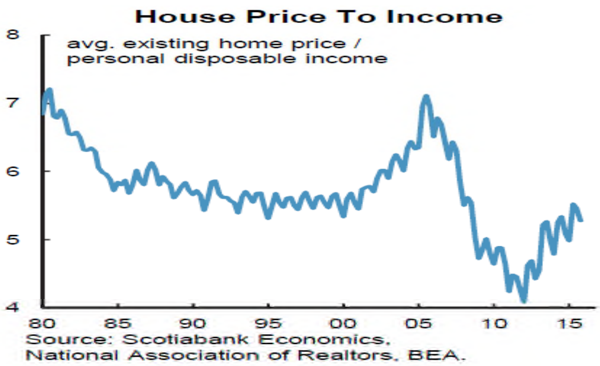
U.S. growth is being fueled by consumer spending, employment and wage gains. Unemployment fell to 4.7% in 2016 with the addition of 2.3 million jobs. Hourly earnings climbed 2.9%, the fastest rate in 7 years. Housing is affordable, home ownership is at record lows, and housing starts remain below average (see charts on next page). We see significant growth potential for the housing industry which will benefit clients' holdings in Costco, Home Depot, and West Fraser.

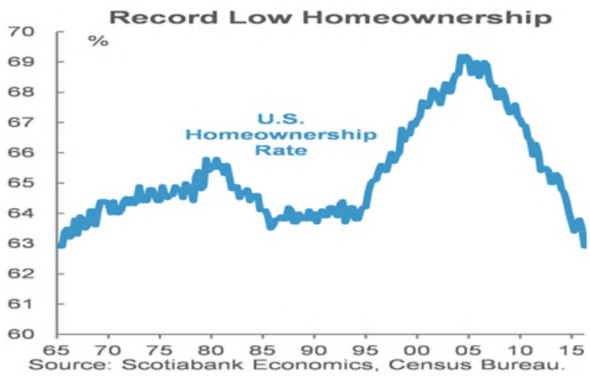
Eurozone momentum ended 2016 on an uptrend, providing a strong handoff to 2017:

- Companies across the continent finished 2016 by ramping up activity at the strongest rate in 5 ½ years (a weak currency is helping exports)
- Businesses are hiring at the quickest pace since the financial crisis
- Germany's jobless rate fell to 6%, the lowest since reunification
- The European Central Bank is making inroads in its battle with deflation as headline CPI rose 1.1% in December
- German consumer prices rose 1.7% in December, the highest rate since July 2013

Canada's economy is positioned for faster growth in 2017 after being battered by falling energy prices and devastating forest fires. Activity in the oil and gas sector is above year-ago levels and unemployment is below 7%. The $150 billion infrastructure stimulus package will boost growth while the weak Canadian dollar is helping exports (exports up 4.3% in October). November wage gains of 2% and core CPI of 1.9% suggest further interest rate reductions are not required.







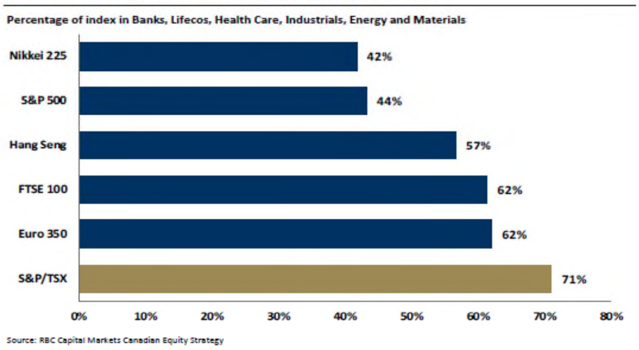
Equity Commentary

The average equity weight in fully-invested balanced portfolios is 61.6%, above the benchmark weight of 55%.

Fully-invested balanced portfolios are marketweight Canadian stocks (average 30.9% versus 30% balanced benchmark). Canadian equity exposure has been trending higher along with earnings estimates for the S&P/TSX. Domestic valuations are lower than those in the U.S. Canadian banks and insurance companies are heavily weighted in client portfolios.

Two-thirds of the S&P/TSX is poised to benefit from President Trump's initiatives. The prospect of pro-growth policies has led to a rapid rise in interest rates and a steeper yield curve. This is positive for banks and life insurance companies. More liberal energy policies will benefit oil and gas companies, and increased infrastructure spending will lead to higher demand for materials. The S&P/TSX has higher weightings in these sectors compared to other developed markets (see chart).

Exhibit 15: The S&P/TSX has a heavy weighting to "good" Trump



The price of oil has doubled from its 2016 low. S&P/TSX performance is highly correlated to changes in the price of oil. Over the past 20 years, oil prices have risen 10% on nine occasions and, on these occasions, the S&P/TSX has outperformed the S&P 500 by an average of 14% (see chart).

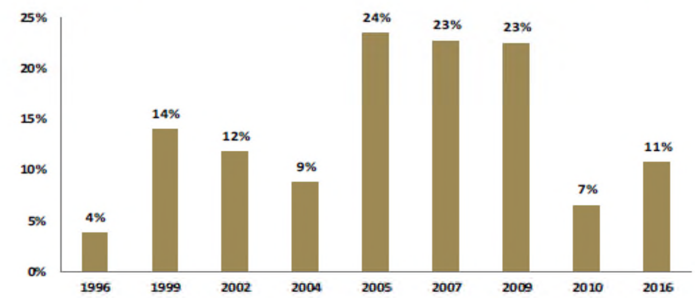
The S&P/TSX forward P/E of 17.5x is slightly above the long-term average of 16.1x (see chart). Valuation is not an impediment for further stock gains as earnings are in the early stages of recovery.

Fully-invested balanced portfolios are marketweight U.S. stocks (average 19.8% versus 20% balanced benchmark). Client equity exposure has been trending lower as valuations are high. J.P. Morgan estimates the trailing 12-month P/E for the S&P 500 is 20.6x, well above the 10-year average of 16.8x (see chart); similarly, at 18.6x, the forward 12-month P/E is well above the 10-year average of 15.2X (see chart).

It is difficult to find cheap U.S. stocks. However, we recently purchased CVS Health (CVS). CVS is one of the largest U.S. drug store chains and pharmacy benefit managers. Its share price declined about 30% due to lost script business in the pharmacy network. We view this as an opportune entry point given the company's ability to win business over the long term through its unique capabilities and value proposition. CVS also stands to gain greatly from any Trump tax reform as it has one of the highest tax rates in the industry. CVS trades at a low multiple of about 13x 2018 estimates. Walgreen (WBA) was sold as it trades at a 4 multiple point premium to CVS. WBA will not benefit to the same extent as CVS from proposed tax changes.

Exhibit 12: The S&P/TSX has consistently outperformed in 10%+ oil years

Performance of the S&P/TSX vs. the S&P 500 (in CAD) during years in which WTI rose 10%+ (1996-2016)



Source: Bloomberg; RBC Capital Markets Canadian Equity Strategy; Priced at as 11/28/16

Exhibit 18: The TSX is roughly 1-turn above its long-term average on a forward multiple basis

Forward PE of S&P/TSX vs. historic average (1996-2016)

Source: RBC Capital Markets Quantitative Research

Figure 79: S&P 500 P/E (Trailing 12 Months)

Source: J.P. Morgan, Bloomberg

Figure 80: S&P 500 P/E (Next 12 Months)

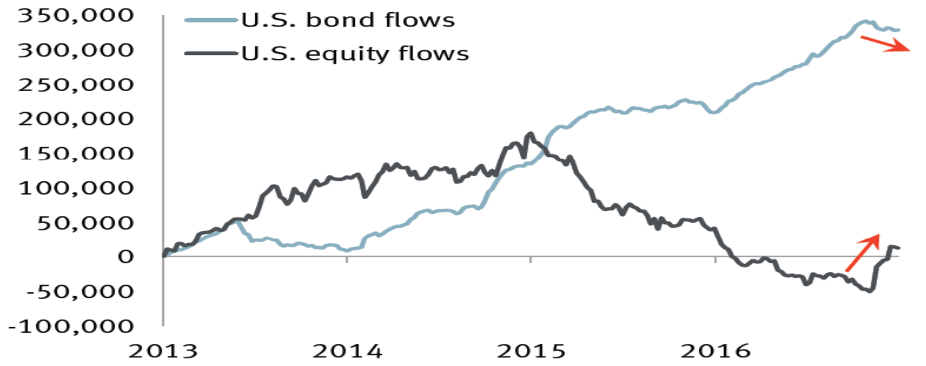
Source: J.P. Morgan, Bloomberg

Clients are overweight U.S. health care. Valuations are reasonable and aging demographics favorable. Worldwide spending on pharmaceuticals will surge over the next few years. The IMS Institute for Healthcare Informatics estimates that spending will touch \$1.4 trillion by 2020, an increase of 32% from 2015. Clients are overweight international stocks (10.9% versus 5% Balanced Benchmark). Eurozone equities trade at a reasonable P/E of about 15x forward earnings, economic data is improving, and upward earnings revisions are at their highest level since 2011. During Q4, we added Eurozone financial exposure, purchasing Allianz, AXA, and ING.

- Allianz is experiencing solid growth in both its life and property and casualty businesses. Allianz currently has a significant cash hoard destined for both share repurchases and M&A activity. It trades at a low P/E multiple of 9x 2017 estimates and yields about 5.3%.

- AXA is a leading global insurance company offering life, health, and property and casualty insurance. It is well represented in the U.S., France, Asia Pacific, and Latin America. It is the #1 international insurer in China and is well positioned to benefit from the expanding middle class in Asia. Aggressive cost cutting, strong solvency ratios, growing cash flow and a rising payout ratio should allow for dividend growth of at least 6% per year through 2018. AXA trades at an undemanding P/E of 9x 2017 estimates and yields 5.6%.

- ING offers growth and value. Earnings are estimated to increase by about 5% in 2017 and 2018. ING's dividend yield is nearly 6%. The company offers a strong direct banking platform, healthy capital position and a low valuation trading at about 11x 2017 EPS estimates.



Source - EPFR Global, RBC Capital Markets, RBC Wealth Management; weekly data through 12/28/16

Fixed Income

China's producer prices surged 5.5% in December, the most in 5 years. The world's second largest economy is poised to export inflation around the globe through its supply chain as manufacturers are forced to raise prices to offset higher input costs.

Hopes of stronger spending under Trump are sparking expectations of stronger U.S. economic growth and inflation. Since the U.S. election, money has flowed out of bonds and into equities (see chart) due to concerns of higher interest rates.

The average fixed income weight in fully-invested balanced portfolios is 27.9%.This compares to 40% for the balanced benchmark. The majority of fixed income is in preferred shares.

During Q4, 5 and 10-year Government of Canada bond yields rose 60 and 80 basis points, respectively. The Broad Bond Composite Index lost 3.4%. The S&P/TSX Preferred Share Index (TR), a proxy for client preferred share holdings, gained 5.3%. Preferred share strength has been driven by higher interest rates, narrowing credit spreads and strong new issue performance. The preferred share market remains the best area to search for value in Canadian fixed income.

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

During Q4 we added to the BCE floating rate preferreds. They provide an attractive yield of 4.75% and protection against higher rates through the adjustment mechanism.

Performance

Portfolio returns significantly exceeded their balanced objective return for Q4. Overweight equities, good stock selection, overweight preferred shares and underweight bonds contributed to outperformance.

Performance was helped by our large investment in preferred shares. The preferred share market outperformed the bond market by 850 basis points in Q4. Notable preferred share gainers (in $CAD) include Enbridge fixed resets (ENB.PF.U, +24.4%), BCE floating rates (BCE.PR.S, +6.8%), and TransCanada floating rates (TRP.PR.F, +7.7%).

The S&P/TSX returned 4.5% in Q4. Clients' Canadian equities outperformed the benchmark. Gains were widespread across various sectors and include Manulife (+29.2%), Suncor (+20.5%), West Fraser (+18.8%), TD Bank (+13.7%), Agrium (+13.6%), Bank of Montreal (+12.3%), Freehold Royalty (+12.0%), and Royal Bank (+11.8%). Interest sensitives languished with weak returns from Hydro One (-9.0%), BCE (-4.2%) and Canadian Utilities (-2.2%).

U.S. equities performed in line with the S&P 500 return of 6.4% during Q4 (in $CAD). Banks and Insurance companies were strong with Prudential (+30.3%) and Wells Fargo (+27.3%) leading the way. On the other hand, healthcare (Medtronic -15.7%), technology (Facebook -8.3%) and consumer products (Proctor & Gamble -4.2%) lagged.

International investments outperformed the Q4 EAFE Index return of 1.5% (in $CAD). Energy, financials, and materials companies were higher with solid gains from AXA (+15.5%), ENI SPA (+14.2%), ING (+7.8%), TOTAL (+9.4%) and BHP Billiton (+5.6%).

The range of returns for fully-invested balanced portfolios was 4.60% to 6.06% for the 3 months ending December 31, 2016. This compares to the benchmark of 1.26%. For the 12 months ending December 31, 2016 the range of returns was 8.35% to 11.42%. This compares to the benchmark of 8.53%. For the 15 months ending December 31, 2016 the range of returns was 11.68% to 12.87%. This compares to the benchmark of 8.94%.

Performance as of December 31, 2016

	3 Months	12 Months	15 Months
*Balanced benchmark objective	1.26%	8.53%	8.94%
Range of client returns	4.6% to 6.06%	8.35% to 11.42%	11.68% to 12.87%
*Balanced benchmark composition: 40% Bonds, 30% TSX, 20% S&P 500, 5% T-bills, 5% EAFE			
Returns are net of fees			
Returns calculated in accordance with GIPS methodology			

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 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 – help 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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