Clarke Wealth Management's
Quarterly Newsletter

Wealth Management
Dominion Securities

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Clarke Wealth Management

RBC Dominion Securities Inc.

Heather Clarke, Vice President, PFP
Investment & Wealth Advisor
Heather.Clarke@rbc.com
604-535-3856

Sean Sullivan
Associate Advisor
Sean.Sullivan@rbc.com
604-535-3848

Jennifer Trumble
Associate
Jennifer.Trumble@rbc.com
604-535-3885

#400-2626 Croydon Drive
Surrey, BC V3Z 0S8
www.clarkewealthmanagement.ca
604-535-3800

Pulse of Canadian Equities

Canadian equities enjoyed a big bounce in 2016, and we turn to RBC Capital Markets' Chief Canadian Equity Strategist to gauge their prospects for the coming year. He explains how the paradigm for outperformance has changed, why he remains positive on Canadian equities, and where investors can find attractive opportunities.

Q. The Canadian equity market outperformed many global benchmarks in 2016. What underlies your continued positive view on domestic stocks?

A. Interestingly, the drivers of our Overweight recommendation have shifted quite significantly. Early last year, the recommendation was driven in large part by two dynamics. First, the presence of expanding Chinese stimulus and a more dovish Fed—factors that have coincided with windows of positive TSX performance in the past. Second, the TSX had approached an all-time low valuation relative to the S&P 500. While the confluence of these factors resulted in an Overweight call with a good deal of conviction, it was one that likely did not have a long life as macro factors shifted and the valuation discount narrowed.

Fast forward to today, and the Donald Trump election victory in the U.S. has really changed the dynamic for the TSX. In a low growth world dominated by monetary policy, there's not a lot to get excited about when it comes to the TSX, which tends to respond to improving economic growth, increased commodity demand, and steeper yield curves. The new backdrop offers the prospect of economic stimulus through lower taxes, increased infrastructure spending, and fewer regulations to drive a pickup in U.S. economic growth not seen with any consistency since before the financial crisis.

Q. In what sectors do you see the most opportunity at present?

A. We continue to like the energy producers. The time to own this group is when oil prices are rising while industry operating costs are contained, leading to margin expansion. We think we're in that window where there is still a lot of labour and equipment slack, which allows producers to earn a healthy return even at US$50 oil. Furthermore, there's not a lot of pressure yet to invest in new projects, which frees up the cash generated to be directed to shareholders by way of debt repayment, share buybacks, and dividend increases.

We also like the lifecos, which have weathered a long and difficult period of low interest rates. With rates moving higher and many of the issues that came in the aftermath of the Great Recession in the rearview mirror, we think there's a sustained opportunity.

Our other two Overweight recommendations are auto parts and gold. The auto parts recommendation is essentially a valuation call as the sector remains historically cheap despite recent strong performance. Gold is more of a hedge as we think the risks of inflation are higher than they have been in some time while U.S. policy uncertainty adds another reason to be long an asset that may zig when others are zagging.

Q. What do you see as the primary risks to your outlook?

A. Uncertainty regarding the Trump administration is the biggest risk. More specifically, anti-trade measures have the potential to be a destabilizing force globally and merits close observation.

The risk of a domestic accident also bears watching as the Canadian economy does not have a lot of drivers at present, debt levels are high, and pockets of the housing market have recently sent mixed signals.

Q. Many market observers have pointed to a weak Canadian dollar as key to boosting the competitiveness of the country's non-commodity exports. Is it reasonable to expect the loonie to remain weak in light of the strong rally in crude oil prices and consensus expectations for further crude strength?

A. The main reason the loonie and oil have tended to be linked is that when oil prices rise it tends to attract investment dollars to new projects, which in turn leads to better economic growth and correspondingly tighter monetary policy in the form of higher interest rates.

The problem for Canada is that much of the country's oil resources are essentially the opposite of the types of projects that companies want to invest in these days. Oil sands projects take several years of development and a huge amount of upfront investment, which will keep companies from sanctioning fresh investments absent a very large and sustained move in oil prices. Until we see these investment dollars return, the mechanism described above really breaks down and probably keeps a lid on the Canadian dollar.

Q. Valuations in traditionally defensive, rate-sensitive sectors, such as Telecommunications, Utilities, and Real Estate, have compressed recently as long-term interest rates have risen. Is a buying opportunity at hand?

A. Investors need to ask themselves what they are seeking; if it is to outperform a benchmark, then probably not. Interest rates have broken some long-term trend lines, and we are potentially going to be living in a higher rate world for a while. Demographics and low growth (by historical standards) probably keep a lid on how high rates eventually go, but, that said, the world does seem to have shifted.

On the flipside, if investors want to own good businesses that pay a reasonable dividend that can grow over time, then buying these names say 10% cheaper than they were six months ago is not a bad strategy. You might underperform a benchmark, but I'm not really sure why that should matter so much to most individual investors.

Q. Given their significance in the benchmark, the outlook for bank stocks is inextricably linked to that of the domestic equity market as a whole. With the valuation expansion enjoyed by the group over the past year, what are your expectations for the remainder of 2017?

A. The Canadian banks are great businesses that have managed through some really rough times better than most of their global peers. We are Market Weight (rather than Overweight) largely on today's higher valuations and some concerns over growth in Canada, but we are pretty confident that the banks will navigate through any headwinds.

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What to do with your tax refund – Strategies to optimize the use of your income tax refund

Saving for your future

If you are expecting to receive an income tax refund from the CRA or have recently received it, then you may be tempted to spend your refund - for example by taking a well deserved vacation or doing a minor renovation to your home. In some cases, this is an appropriate use of the money, depending on your need at the time. You might also consider saving all or a portion of your refund for your future financial security. The "compounding" effect helps even small savings grow significantly over the long term, helping you live the lifestyle you want.

Improve your financial well-being

A good first step in determining the best use for your refund is to review the recommendations in your financial plan. You can then review the areas needing improvement and prioritize what is most important to you. The receipt of an income tax refund can be a great catalyst for you to implement some of the strategies in your financial plan.

Preparing your Will or Power of Attorney, setting up your emergency fund or putting adequate disability or life insurance in place can be easily done with the average tax refund. Of course, saving the refund in an RRSP, RESP, TFSA or paying down debt are all financially wise saving strategies for the funds. Speak to your RBC advisor if you require assistance in reviewing the recommendations in your existing financial plan or if you would like a new financial plan prepared for yourself.

The following are some common financial planning recommendations that you may want to address with your tax refund.

Address risk management strategies

When it comes to managing your finances, you probably understand the benefits of saving on a regular basis, but what is equally important, and sometimes forgotten, is ensuring that you and your family are taken care of in the event of your death or disability. The receipt of your income tax refund can be a catalyst to address the following three common risk management strategies:

1. Meet a lawyer to have a Will and Power of Attorney prepared.

2. Ensure you have adequate disability and critical illness insurance.

3. Ensure you have adequate life insurance.

Education savings

If you plan to help your children or grandchildren with their education costs, you may wish to use your income tax refund to contribute to a Registered Education Savings Plan (RESP). The first $2,500 of RESP contributions attracts a government grant of $500 – $600 depending on your family income. If you have not opened an RESP for your children, the receipt of the CRA refund cheque can be a great way to start making contributions.

Reduce non-deductible debt

Consider paying down an outstanding non-deductible debt subject to a high interest rate. Non-deductible debt includes credit card debt, a personal use car loan, and a line of credit used for personal purposes or the mortgage on your home. As the interest on a loan used for personal purposes is not deductible for income tax purposes, you are paying the interest on the loan with after tax dollars. The higher the interest rate on the loan or the higher your marginal tax rate, the more income you have to earn to pay the interest on this loan, so the more beneficial it is to pay down this debt.

RRSP or non-registered savings

If you do not have high interest nondeductible debt, then another option for your income tax refund is to save your refund in an RRSP or a non-RRSP account. Whether you should save your refund in an RRSP or non-RRSP account depends on your specific circumstances and several financial assumptions. However, the following general observations can be noted:

- If your marginal tax rate in retirement is expected to be the same or lower than your marginal tax rate today, then consider contributing to your RRSP;

- If you are seeking to invest in securities that produce Canadian source dividends and capital gains and are in a low tax bracket today but expect to be in a higher tax bracket in retirement, you are generally better off to save outside an RRSP.

Contribute to a Tax-Free Savings Account (TFSA)

The TFSA provides a further option for investing your tax refund. The TFSA allows you to make a $5,500 (indexed to inflation) annual maximum contribution. All growth, income and withdrawals are tax free. You are also able to gift money to your spouse to invest in a TFSA without being caught by the income attribution rules.

- Choose the TFSA if your expected marginal tax rate in retirement is going to be higher than your marginal tax rate today.
- Choose the RRSP if your expected marginal tax rate in retirement is going to be lower than your marginal tax rate today.

Emergency Fund

A fundamental financial planning strategy is to have some money set aside for unexpected expenses or a job loss. In general, consider keeping approximately three to six months of living expenses within a liquid emergency fund. If you do not have an adequate emergency fund, you may want to direct some or all of your tax refund towards its creation.

As an alternative to directing your income tax refund to a savings vehicle that may earn little interest, consider obtaining or increasing your line of credit for emergency purposes only.

Receive your tax refund earlier

You should ensure that the information you provide to your employer on your CRA Form TD1 – Personal Tax Credits Return is up-to-date. You may have had a change in your personal or family situation since last year allowing you to claim credits for certain items, such as pension income, spouse or common-law partner amount, caregiver amount and disability amount. Letting your employer know of these additional credits will allow your employer to lower income tax deductions at source so you won't have to wait until your tax return is assessed to receive your refund.

If you do not want to wait until after you file your income tax return to receive your tax refund, you can also complete CRA Form T1213 – Request to Reduce Tax Deductions at Source if you have regular tax deductions such as RRSP, child care expenses and alimony. This form is used to ask for reduced tax deductions at source for any deductions or non-refundable tax credits that are not contained on the TD1 Form. If this form is accepted by CRA, they will authorize your employer to reduce the income tax withheld from your paycheque during the year, thereby increasing your net pay. In essence, this will enable you to receive your tax refund periodically throughout the year rather than waiting for a lump-sum tax refund after you file your income tax return.

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