RBC Dominion Securities Inc.

Heather Clarke's

Quarterly Newsletter

March 18, 2016

Views and opinions
for the clients and friends of

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What the Client Relationship Model 2 means to you

You may have heard about it in the news – the Client Relationship Model 2, or simply "CRM2." CRM2 is a new set of industry regulations meant to provide investors with more details on their investment costs and performance. It was developed by the Canadian Securities Administrators, an organization representing Canada's investment industry regulators. All investment firms, including RBC Dominion Securities, will be providing these additional details on your existing statements and in two new reports that will be delivered to you.

The first change took effect in December of last year. Account statements are now required to show a number of additional statement details such as the original or "book" cost of all securities on the statement and, whether mutual funds held in the account may be subject to deferred sales charges.

For our clients, this should be business as usual as RBC Dominion Securities has already been delivering most of this information every quarter. But for some investors in Canada, the new details on statements will provide more information than they are used to receiving.

The more significant changes will occur by mid-2017, when two new reports will be delivered to clients:

1. One report will disclose the costs paid by the client to the firm and other compensation received by the firm in relation to services provided to the client from each account annually.

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What the Client Relationship Model 2 Means to you (Cont..)

2.A second report – an annual performance report – will show an account's returns over certain time periods. Notably, this report will show "money-weighted" rates of return. This is a different way of calculating investment performance than the "time-weighted" method that is currently used by RBC Dominion Securities and across the industry. Some think of money-weighted as a "personal" rate of return because it factors in the impact of the amount and timing of money you deposit into or take out of your account, whereas time-weighted does not.

The effect of these two new reports will be to provide investors with a better understanding of what they are receiving for the money they are paying their advisor's firm for the products and services they receive.

As always, our team' primary objective is for you to achieve your financial goals, but we also want you to understand the value my team and RBC Dominion Securities can provide you with on that journey.

You will hear more about CRM2 over the coming year and in regular updates from me. We fully support these initiatives as they reinforce both RBC Dominion Securities' and our team's commitment to transparency and full disclosure.

If you have questions about the new reports or CRM2 in general, please do not hesitate to call us at any time.

Taking Canada's Pulse

Q. There's been a lot of volatility in the markets which has produced elevated investor concerns about the enconomy and financial markets. Contrast the current environment with the financial crisis.

A. While it's understandable that folks are still scarred by what took place back in 2008 and 2009, what markets are currently experiencing does not have much in common with what we went through back then. There was a "three-sigma" bubble in U.S. housing that had been building up for years and a U.S. banking sector that had massive exposure to this bubble and inadequate capital to deal with it if it went wrong. Of course, it went wrong and that produced a devastating bank balance sheet contraction. It took all the tools in the toolbox to get the global economy going again.

Today, banks are well capitalized, probably even overcapitalized in many cases, while there are no bubbles out there that are bursting around us. Yes, we have had a very large downward move in oil prices and there was a lot of debt issued by oil and gas producers before prices started to come down, but the size of this debt balloon (if we want to extend the analogy) is a drop in the bucket when compared to U.S. housing and the 2008–09 experience. We think today that we are dealing with a bunch of storm clouds coming together at the same time. These include: a Fed rate hiking cycle, which normally carries some wobbles; a Chinese economy that continues to shift from capital expenditure-based to operating expenditure-based, which makes China less predictable and slower growing overall; a U.S. presidential election, which increases uncertainty for markets and has some colorful characters, that probably enhances this uncertainty; and the aforementioned issues with oil. While it might be hard to imagine these storm clouds lifting, they will, and things such as the health of the U.S. consumer, the benefits of lower gasoline and heating oil costs, very stimulative global monetary policy, and compelling valuations on stocks make the outlook pretty interesting.

Q. Can Canadian banks repeat their performance from the last five years over the next five years?

A. The Canadian banks did really well from 2011 to 2014, but the past two years have been a much tougher slog. We think the next five years are likely to be somewhere between these two periods in terms of performance. Look, it's going to be tough for the banks to grow earnings by more than say mid-single digits over the next little while as: (1) the yield curve is as flat as a pancake, which hurts net interest margins; (2) credit losses are going to get worse because of the collapse in oil prices and the likelihood of some loan-loss provisions there; and (3) loan growth is probably not going to be any great shakes as Canadian consumers are pretty leveraged and you can only leverage your population once.
This doesn't sound very encouraging, but the banks are starting from a very low
valuation point relative to historical norms and some of the above will likely not turn out to be as bad as many fear. The Canadian banks have proven to be great stewards of capital over the past 15 years and we suspect that when we see provisions for credit losses over the next couple of quarters, they are not going to be nearly as bad as some suspect. This should help to boost valuations, so even if overall earnings growth is not great, the combination of a good dividend plus a bit of a valuation bump can still deliver an attractive return.

Q. Why are depressed oil prices more of a story in 2016 than in 2015?

A. We're not sure they are more of a story, but it's much more likely we are going to see some things happen in 2016. 2015 was a weird year because most oil companies entered the year pretty well hedged, so even though prices were down sharply, many oil companies had sold forward a chunk of their production at much-higher prices, so there was not a big incentive to cut near-term production. In addition, many of the shale producers "high-graded" their

Taking Canada's Pulse (Cont..)

development, which means they essentiallydrilled the prospects that would give them the most production for the least amount of spending. Add to this additional barrels from Libya, Iraq, and the lifting of sanctions on Iran and it was almost like 2015 was a "punt the football and wait for 2016" year.

2016 is likely to play out much differently. There are no new barrels coming to market aside from what Iran can put together, while high-grading can only work for so long. Add to this about $400B in capital expenditure cuts and there is the potential that supply takes a bigger hit as we get into the later part of the year. Lastly, we'd note that there's a lot of debt that starts to come due this year (although more in 2017 and 2018) and this may force some more production off the market. Thus, it wouldn't surprise us if we were talking about higher prices as we get to later in the year, especially with demand continuing to rise in response to lower prices.

Q. How should Canadians view investing in U.S. equities at this juncture?

A. With the loonie now roughly 20% below fair value, Canadians probably want to throttle back a bit on U.S. exposure. But this does not mean they should take a hatchet to their U.S. exposure as the loonie is likely to trade below fair value (estimated to be in the low-to-mid-US$0.80s) for the next number of years. The Canadian market has not been this cheap relative to the U.S. market for a long time, so there is an opportunity to sell high and buy low for Canadians who went heavily into the U.S. market over the past half-decade. However, because of the diversification opportunities offered by the U.S. market and the likelihood the currency doesn't hurt you too much (won't be a tailwind, but doesn't mean it becomes a big headwind), we would still keep a healthy dollop of U.S. exposure.

March is Kidney Health Month

As many of you are aware, my husband had a kidney transplant on December 14th. It has been almost three months since his surgery and he is doing remarkable well. Alvin is back to work now and becoming more active each day. He is being treated at St. Paul's Hospital through their Kidney Transplant Team. The program works in partnership with the BC Transplant Society and also offers assistance through BC Kidney Foundation.

"Thank you" these two words seem so inadequate for the gift of life. We are extremely grateful to his brother, Gary, for donating a kidney; he has recovered well and also back to work. We couldn't have wished for a better outcome!

The odds of success with a living donor are extremely high, with a living donor; the transplant surgery may take place earlier in the course of the kidney disease. Lucky for us Alvin did not require dialysis before the transplant.

It's pretty amazing the care and technology provided by our health care system when required. St. Paul's and the Kidney Transplant Team offer exceptional care and ongoing after treatment, especially during the first year following the transplant and ongoing for life.

Over 500 British Columbians are currently waiting for organ transplants. Please consider registering as an organ donor, see the link below.

https://register.transplant.bc.ca/

http://www.kidney.ca/bc-home

It’s Different This Time

In recent weeks, volatile market conditions have left many investors fearful that the U.S. economy is tilting toward a recession, or worse, careening toward another 2008–2009-type meltdown. It is our opinion that neither is the case. We believe that the U.S. economy will continue on its slow, but steady growth track of approximately 2.5%; 2008–2009 comparisons represent a lack of understanding of what was at the heart of the Great Recession.

The Heart of the Matter (2008–2009)

Leverage was abundant across both financial institutions’ and households’ balance sheets during the first part of the new century. Low interest rates and easy money—due to lax lending standards—combined with a good dose of financial engineering to create a toxic mix, i.e., banks financing asset growth through leverage in the pursuit of greater return on equity. Yet when the riskiest of those assets, pools of subprime mortgages, declined in value on the back of the housing downturn, the value of bank equity, i.e., their net worth, collapsed at an accelerated pace, thereby leading to insolvency in the case of Lehman Brothers, general panic, and a subsequent credit crunch. The impact upon consumers and financial institutions would prove to be devastating.

Since the depths of the Great Recession, consumers and banks have taken significant steps to deleverage. Heading into the crisis, bank leverage across the eight U.S. systematically important banks, as measured by the Tangible Common Equity Ratio (TCE), averaged 3.86% (or 25:1 assets-to-equity) and peaked near 30:1 during the crisis. In other words, every $31 of bank assets was financed with just $1 of equity and $30 of debt. Today, leverage across the banks has more than halved to approximately 11:1. That reduction in leverage is the result of lessons learned from the crisis, which have led to regulations that require banks to hold more loss-absorbing equity on their balance sheets. Separately, consumers have been driven to bring levels of debt more in line with levels of disposable income—an ongoing process.

Comparing Oil Exposure to the Mortgage Crisis

Some have argued that oil has simply replaced housing as the bad actor in the current environment. We disagree. Currently, the top 20 banks have a total energy exposure of about $354B, or about 4% of the total loans in the banking industry. In contrast, from 2003 through 2007, the banks originated about $3T of subprime mortgages, which equates to about 10x today’s energy exposure. The Energy Sector and its associated debt do not carry the systemic importance of the housing sector, in our view.

Assessing Liquidiidiidity in the Financicial System

Liquidity within the financial system does not appear to be strained. The TED spread, the spread between interbank lending rates and Treasury bill rates, is considered to be a measure of liquidity within the financial system and generally fluctuates between 10 and 50 basis points (bps). Though the TED spread spiked to nearly 50 bps earlier this year, it was a far cry from the 160 bps observed prior to March 17, 2008, when Bear Stearns nearly did not open for business due to liquidity reasons, or the approximately 300+ bps observed during the panic following Lehman’s bankruptcy. The chart illustrates how the TED spread is at normal levels now versus extreme levels of stress during the financial crisis.

In summary, we believe that the concerns over the banks are misplaced. Banks are adjusting for a more-difficult earnings environment, but there aren’t any balance sheet or liquidity issues at the current time, in our opinion.

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