Clarke Wealth Management's
Quarterly Newsletter

Wealth Management
Dominion Securities

November 28th, 2016

Seven signposts for 2017

We believe the pieces are in place for U.S. equities to outperform in 2017 and have upgraded our outlook. Still, investors will have much to consider as they tread the investment path in the coming year. To stay pointed in the right direction, we have identified a series of markers for guidance.

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The dramatic leadership change in Washington will help shape U.S. equity market returns and sector leadership in early 2017 and possibly at other points throughout the year.

Although President-elect Trump's agenda could supersize GDP growth, at least in the first couple years, it isn't the only factor that will impact stock prices. Bread-and-butter fundamentals should play pivotal roles as well. Even before the election, in our view, the economy seemed likely to grow and stocks were well positioned to rise in 2017. The first year of the Trump administration could amplify the moves, but with additional volatility.

We believe the market has the potential to deliver low double-digit total returns in 2017, an above-average rate. We have raised our rating on U.S. equities to Overweight from In-line, which translates into holding an allocation above the recommended strategic weight.

We favor the U.S. over developed markets in Europe and Asia. U.S. earnings growth seems more durable and economic prospects are better—more so if fiscal stimulus measures are passed.

We are focusing on seven signposts that could shape the market's trajectory in 2017.

1 – Recession needle nowhere near the red

It continues to be our view that recession indicators, not the occupant of theWhite House, are the best determinants of whether the equity market can keep advancing. While the actions of the president and Congress can *strengthen* or *weaken* economic trends, Washington's leaders are dependent on business cycle fluctuations.

The market typically switches from bull to bear, and losses pile up, right before a recession occurs or during the early stages of one. That's why we pay close attention to recession gauges.

Currently none of the six main indicators we monitor are signaling a contraction is on the horizon. When a recession is looming, most or all of them have historically been in recessionary territory.

Before the election, our baseline expectation was that U.S. GDP would grow around 2% in 2017 without stimulus from Washington. That's not ideal, but is enough to create opportunities for well-managed companies. If Washington delivers tax cuts and much-needed regulatory reform, which seems quite likely at this stage, GDP could grow faster.

2 – Fiscal therapy

It's difficult to estimate the degree to which a broad package of tax cuts and infrastructure spending could stoke the economy. RBC Global Asset Management's chief economist estimates they could boost GDP by 0.8% per year in 2017 and 2018, but he acknowledges it could be more. If this occurs, that would likely bring GDP growth close to 3% or more each year, much stronger than the 2% average since the financial crisis.

In our view, significant tax cuts on corporations and individuals have the greatest likelihood of passing because a number of Trump's proposals are similar to legislation House Republicans have long advocated. But it may not be easy to push them past the 60-vote threshold needed in the Senate; instead, procedural maneuvers could be used that would require only a majority vote.

There are also obstacles for infrastructure spending. Trump seems to have a large package of $1 trillion over 10 years in mind. To lighten the burden on the deficit and avoid tax hikes to pay for it, reports indicate the package may be designed as a public/private partnership involving business tax credits for companies that fund projects, and it could include private equity and debt components. Regardless, Trump may have a lot of convincing to do in Congress to secure a *significant* infrastructure package. Many Republicans have historically resisted infrastructure spending, especially fiscal hawks who have gained power in recent years. A bipartisan coalition could be necessary.

3 – Expand the horizon

Investor sentiment about the equity market is still tentative and piles of cash remain on the sidelines. That's typically a good indication the market advance has more legs. Bull market cycles usually don't break until investors are "all in," so to speak, and taxi (Uber) drivers are offering stock tips.

Most investors and commentators seem focused on what they think lies immediately ahead, to the exclusion of all else. By contrast, our focus is almost entirely on the long-term forces that shape the economy, corporate earnings, and asset prices. We see those forces aligned in a way that suggests the secular (longterm) bull market that began in 2009, and which was confirmed as the market broke out to a new high in 2013, has the potential for additional upside. Indeed, if this secular bull is anything like the previous two, it could have much further to run.

Each secular bull market has been characterized by unique catalysts. Innovations in the Technology and Health Care sectors, along with technology-driven advances and efficiencies in the Industrials, Financials, and Energy sectors should continue to shape the current secular bull cycle. The demographic bulge of the Millennial generation will likely play an important positive role, so far vastly underappreciated, in our view, as they form families and buy their first homes.

4 – The market's valuation doesn't spell doom

The biggest knock against the U.S. stock market is that it's expensive. To us, that depends on which valuation standard is being used. According to some measures, the market can be viewed as pricey, but based on others it is reasonably valued or even slightly inexpensive.

The most commonly used measures, price-to-earnings ratios (P/E), indicate the S&P 500 valuation is elevated. The market's 17.0x forward P/E based on our $127 per share 2017 estimate would normally be too high to assume additional "easy" multiple expansion is around the corner.

5 – Market mood swings

Benefits that the Trump administration could bring in terms of fiscal stimulus also come with new risks and the potential for heightened market volatility.

For starters, stronger GDP growth can naturally lead to elevated volatility—it already has in the bond market. Additionally, a more active Fed, responding to an improved economy and renormalized inflationary pressures, is likely to produce volatile episodes in equity markets.

Furthermore, the president-elect has a propensity to say what's on his mind, regardless of whether it's politically correct or comports with the typically more cautious language of Wall Street. Controversial statements could create uncertainty and rattle the market at times. More substantively and importantly, Trump's actions on trade or immigration could generate market swings.

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6 – Tolling of the bellwethers

We view the following areas of the market as bellwethers for 2017—if they perform well, the market as a whole should deliver. As opportunities arise, we believe investors should make space in portfolios for stocks, exchange-traded funds, or managed solutions in these categories.

• **Biotech and pharma**: These health care subsectors seem set to trade higher after a challenging 2016 fraught with political headwinds. The Republicans' ability to maintain control of the House diminishes drug price regulation risks, although drug reimportation could surface as an issue. For the first time in history, the largest biotech stocks are trading at a P/E discount to both pharma and the S&P 500. Biotech is also trading below its cycle average, yet it should grow faster than pharma and the S&P 500. At the same time, transformative treatments are in the works.

• **Banks**: Net interest margins should improve as the Fed raises interest rates and if the Treasury yield curve continues to steepen. Loan growth is likely to persist at a mid- to high single-digit rate as the economy keeps expanding. Also, merger and acquisition activity could heat up as banks seek out additional revenue opportunities. During the campaign, Trump signaled he may soften at least some financial regulations, and post-election press reports indicate the rollbacks could be meaningful. Amid this backdrop, the price-to-book value of the bank group relative to the S&P 500 is well below its long-term average. Bank stocks rallied sharply following the election. We prefer to buy on pullbacks.

• **Infrastructure**: Infrastructure stocks could trade higher if the fiscal spending package ends up being anywhere near as large as the $1 trillion over 10 years that Trump is targeting. Investors who are valuation-sensitive should note many of these stocks have already begun to rally in anticipation.

• **Energy**: Trump's proposals to reduce oil and gas regulations and expand pipeline opportunities are positive for the industry, in our view. As long as higher supplies are met with greater demand from curtailed fuel efficiency rules and stronger economic growth, these initiatives would be net supportive of oil prices. But investors should be selective, as some segments of the Energy sector likely stand to gain more than others.

7 – What keeps us up at night? Trade

Our greatest area of concern is the possibility that the Trump agenda will disrupt global trade, and thereby upend the U.S. economy and stock market in the process.

Trump seeks to renegotiate the North American Free Trade Agreement (NAFTA) or cancel it in favor of new bilateral agreements. He has also signaled that if U.S.-based companies move jobs to Mexico or overseas, he could slap a 35% tariff on any related products that are imported into the country. And he has threatened substantial tariffs on Chinese imports.

The U.S. economic system is built around a long-standing global framework-corporations have operated according to multinational trade rules for decades. It may not be the best system, but it's a system corporate executives are used to and it provides a level of certainty that allows them to plan operations for years ahead. If that system is jolted in a meaningful way, uncertainty could abound. The stock market doesn't like uncertainty, nor do business decision-makers.

On the campaign trail, we saw little evidence Trump will moderate his trade views, although at least two of his economic advisors have signaled he may. If Trump handles trade challenges prudently and carefully, they may cause no more than periodic volatility for equity markets. But if trade issues are handled too aggressively or incorrectly, the price could be high for the U.S. and global economies—and for equity markets.

Even though this issue keeps us up at night, we acknowledge hawkish trade moves by presidents don't always have lasting negative repercussions. Throughout his two terms, President Ronald Reagan talked tough on trade and imposed quotas and tariffs on select industries in Japan, the chief trading rival at the time. While the short-term success of those moves was questionable, the U.S. economy grew strongly and the equity market rallied significantly over that period.

Positive on U.S. equities

At the end of the day we are looking for an extension of the bull market, at least through 2017, driven by somewhat faster economic growth and the first meaningful advance in S&P 500 profits in three years. Importantly, the usual harbingers of a recession waiting over the horizon are not in sight. We are increasing our recommended exposure to U.S. equities to Overweight.

Canadian Banks: *A penny saved is a penny earned*

Housing – The regulatory hammer drops

Canadian banks have over $1T invested in residential mortgages. Credit issued to individuals represents the lion's share of bank loan portfolios including roughly 45% in mortgages and 25% in personal loans. With affordability concerns running high for the largest urban centers, investors remain squarely focused on housing as a key risk for Canadian banks.

Vancouver and Toronto – First shot at foreign buying

Vancouver and Toronto represent roughly half of the dollar value of all existing home sales nationwide. Arguably, prices have decoupled from the traditional market foundation in local income levels, and continue to climb. For a typical (median) Toronto household, the cost of owning a single family detached home has reached 72% of pre-tax income, while Vancouver is at 127%. Vancouver's new 15% tax on foreign buyers has sharply reduced sales activity, but prices continue to climb.

Whether the initial government measures prove effective in the long-run has yet to be seen; however, the foreign buyer tax signals that policymakers are responding to public outcry. If needed, there is considerable scope for more to be done. In Australia, for example, there is an outright ban on foreign purchases of existing real estate (new homes permitted). Other measures in Australia have included an absentee owner land tax, higher stamp duties, withholding taxes, and proof of residency and citizenship when buying property in Sydney. In June, Vancouver received legislative clearance to impose a tax on empty housing units, with a new tax to this end expected in January 2017.

National policy tightening

At the national level, policy tightening has been ongoing for years. Last month, regulations changed to rein in stretched buyers with the most impactful, in our view, being the new "stress test." Now, all insured mortgages must be qualified at the Bank of Canada's (BoC) posted five-year rate, which at 4.6% sits some 200+ basis points (bps) above current market rates for strong borrowers. Immediately following this announcement, Canada's largest private mortgage insurer indicated that slightly more than one-third of the mortgages it has insured this year would have had difficulty qualifying under the new rule.

The new rules temper the outlook for Canada's housing market with buyers likely forced to increase down payments or reduce purchase prices. Immediately following the announcement, RBC Capital Markets revised its Canadian banks' mortgage growth forecast to less than half of its prior level.

Putting housing risks in context

While prices and affordability are concerns, several factors mitigate the risks for Canadian banks.

First, Canadian banks only compete in the prime mortgage market (no sub-prime) and have had a very strong track record. Residential loan losses increased only minimally for Canada's largest six banks to 6bps in the 1990s housing downturn when prices fell by 13% nationwide, 31% in Toronto, and 24% in Vancouver. In 2009, loan losses reached just 3bps for the group, up from 1bp in 2007.

Second, home equity levels are solid thanks to rising market prices. Just over 90% of mortgage borrowers who bought from 2011 to 2015 have at least 10% home equity and three-quarters of them have at least 25% home equity.

Third, insulation from rising interest rates is provided by the primarily fixed rate structure of the market with about two-thirds of mortgages on five-year fixed rate terms.

Finally, mortgage default insurance backstops losses. Depending on the individual bank, between one-third and about one-half of bank mortgage exposure is insured.

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