

# Wealth Management & Capital Markets Perspective



Wealth Management  
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Winter 2019

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## We're in the "correction" camp

Written by Jim Allworth

While the market's deep drop put investors on edge, we see the correction giving way to a renewed advance in share prices. Several metrics argue this cycle has some life in it yet.

Equity markets gave investors a rough ride from a late September peak all the way to a Christmas Eve capitulation. There has been something of a revival since then, but opinions are divided as to whether this will prove to be anything more than a brief respite from a downturn/bear market that will reassert itself within a few weeks or months. We are in the camp that holds this has been a correction that will give way to a renewed advance in share prices.

At the very least, the decline has dramatically improved the "internals" of the market. Gone is the complacency that prevailed throughout the summer when a wide majority of investors and forecasters saw no end in sight for the bullish advance in share prices. That persistent optimism gave way to confusion, worry, and several days/weeks of outright fear. By some measures "bears" came to outnumber "bulls" for the first time in years.

Valuations – price-to-earnings (P/E) ratios – also took a big hit but, in the process, became much more attractive. At the September peak the S&P 500 was flirting with a rich 19x earnings. By the December low it was trading at 14.5x. Historically for the S&P 14x-16x trailing earnings has been something of a sweet spot – the market has risen a high percentage of the time in the following 12 months, typically delivering double-digit returns in the process. P/Es fell to even lower, more compelling levels in Canada, the U.K., Europe and Japan.

### Bears are focused on monetary policy and the yield curve

There are still plenty of bears out there. They point to a slowing global manufacturing economy – Purchasing Managers' Indexes (activity indexes) are off their (elevated) highs in Europe and North America while China's manufacturing sector has slipped back into contraction as tariffs bite. They worry the Fed has already gone too

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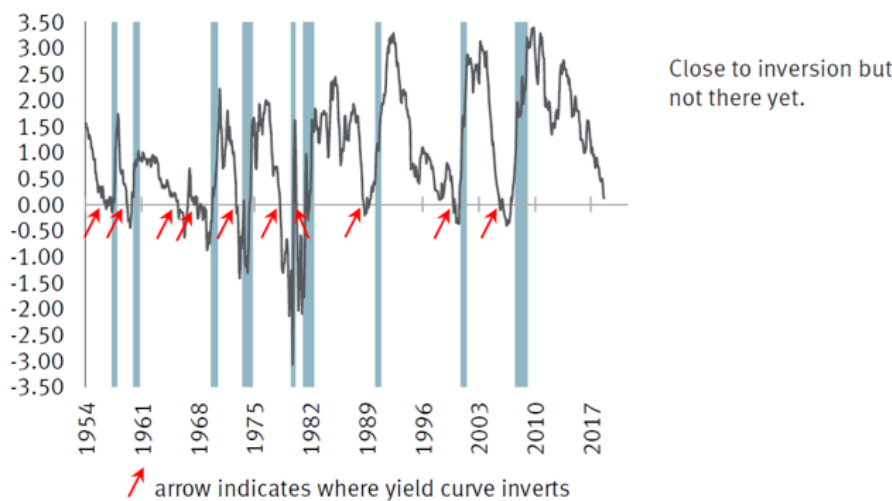
**We're in the correction camp**  
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far in raising rates, making a U.S. recession inevitable which, they contend, the equity market has already begun to discount.

A great deal of attention has been given to the flattening of the yield curve – i.e. the narrowing of the spread between longer-term bond yields and short-term interest rates. If the curve were to invert, with short-term interest rates moving above the 10-year Treasury yield, then the historical record would argue that a recession is on the way with an expected start date about a year out. Since U.S. recessions have been associated with virtually every bear market, so the bearish case goes, a bear market decline would also be on the way and has probably already begun.

**The yield curve**

**Yield differential between the U.S. 10-year Treasury Note and the 1-year Note**



Note: Blue-shaded areas indicate recessions  
Source - RBC Wealth Management, FRED Economic Data St. Louis Fed; data

We are not in that camp. We would point out that the yield curve has not yet inverted (see chart) and it is not a forgone conclusion that it will in the near future. There have been a few near misses in the past and, for the record, there was one outright inversion in the mid-1960s that produced an economic slowdown but no recession. In that case the stock market endured a painful correction but no bear market.

**RBC Wealth Management U.S. economic indicator scorecard**

Indicator	Status		
Yield Curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

Slight slippage with yield curve now showing caution. Others still signaling expansion.

Expansion	Neutral	Recessionary
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Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

We are not counting on a bullish exception from history to repeat itself. And we are concerned about how close to inversion the gap between the one-year rate and the 10-year rate has come. Concerned enough to switch our rating of the yield curve from “positive” – i.e. supportive of the idea that the U.S. economy could go on expanding for another year or more – to “neutral” (see table).

We note that it wasn't the Fed hiking rates by 25 basis points (bps) in December that accounted for most of the recent narrowing between short- and long-term rates; rather, it was the plunge in the 10-year Treasury yield from 3.22% to 2.56% between early November and year-end. This was mostly the result of investors running for cover into the “safe haven” of Treasuries as the debate raged about the correctness of Fed policy and the stock market went into free fall. As those fears have begun to subside, the 10-year yield has moved back up by 17 bps so far. We believe there may be room for the 10-year yield to move up further from here, moving the yield curve further away from the inversion that seemed so imminent just a few days ago.

**Fed ready to be patient**

It helps that short-term interest rates appear to be increasingly anchored by a Fed that has recently gone out of its way to assure financial markets that it has not put policy on “autopilot” and that slower economic growth and tame inflation might forestall some of the rate increases pencilled in for this year and next. Futures markets have priced in no hikes at all for 2019.

The other component of credit conditions is banks' willingness to make loans. The most recent Senior Loan Officers' Survey from the Fed indicates that banks on average continue to lower standards for corporate loans and indeed for most types of loans. The same survey indicates reduced corporate demand for credit. Companies are generating

more cash internally or are able to meet their credit needs elsewhere. Of the small and medium-sized businesses surveyed by the National Federation of Independent Business, only a very low 4% say they can't get the credit they need and a high 50% say they have no need for credit.

### Expansion has further to run, so does the market

Of course, any reprieve may be temporary. So it's worth reminding ourselves that an inversion of the yield curve usually precedes the start of an ensuing recession by 11-14 months and typically precedes the peak of the stock market by 3-6 months. Our two other long-leading indicators – weekly unemployment claims and the Conference Board's Leading Index both suggest to us that the U.S. economy will go on expanding for at least another 9-12 months and conceivably longer.

Our own forecast has U.S. GDP growing at a more subdued 2.5% in 2020, arriving in the form of most quarters printing at a 2.0%–2.3% rate. If, in fact, the Fed is finished as the futures market believes, then it's not unreasonable to look for the economy to go on growing into and perhaps through 2020.

If the U.S. economy goes on growing, so too, in all likelihood, will corporate profits and the value of businesses (i.e., share prices), in our view. While we can't rule out a retest of the recent lows, we also can't rule out the prospect for the market to move back up toward or even above its September all-time highs.

### No breadth breakdown in sight

There is an additional market internal measure that argues for this more bullish outcome. Market breadth – what proportion of the stocks which make up the market is moving in the same direction as the broad averages – is captured in the so-called advance-decline (A/D) line: an index computed by tracking the number of stocks that go up (advance) on a given day minus the number of issues that decline. This index usually moves “in gear” with the broad averages – peaking when they peak and bottoming when they bottom. And that is what the A/D line has done in this latest instance – it peaked at a new high when the S&P 500 did the same in late September and bottomed with the index in late December.

However, looking back over many decades reveals an important exception to this rule. In the run-up to the final stock market peak before the onset of a bear market, the A/D line typically gives up the ghost several months, or even quarters, before the market does. In other words, the market, measured by a broad average like the S&P 500, goes on making new highs but fewer and fewer stocks are doing the heavy lifting. And by the time the S&P is setting its final high of the bull market, a significant number of stocks are already in well-established downtrends.

The good news is that no such negative divergence between the performance of the broad averages and the A/D line has yet appeared. In fact, the A/D line performed much better in the

latest market downturn – down about 12% versus the S&P 500's nearly 20% decline.

### Higher share prices likely ahead ...

We are persuaded that a durable advance in share prices will ultimately unfold due to a number of factors present today:

- The economic expansion looks to be intact, driven by growing employment, wages and profitability
- Our forecast of positive but unremarkable GDP growth and tame inflation is likely to keep the Fed and all other central banks from overtly tightening credit
- Shares are trading at valuations that have usually delivered positive 12-month forward returns
- Measures of market pessimism have recently reached levels consistent with correction lows

### ... but it's not a time to pile in

We are comfortable having a full allocation (i.e. Market Weight) committed to equities in a balanced portfolio. But we are not persuaded this is a time to be piling in. Rather, it is a time to let established equity positions continue to work for the portfolio, hopefully by way of rising dividend payments and internal compounding of shareholders' equity.

# Administrative Corner

## TFSA

- The TFSA annual contribution limit has risen to \$6,000 for 2019.
- The cumulative TFSA contribution limit in 2019 is \$63,500.

## RRSP

- The RRSP contribution deadline for the 2018 tax year is March 1, 2019. The contribution limit is \$26,230 or 18% of your 2017 earned income less any Pension Adjustments (whichever is less).

## CPP

You may have heard that the Government of Canada recently announced plans to expand the Canada Pension Plan (CPP) starting in 2019, and while the Quebec government announced similar changes to the Quebec Pension Plan (QPP).

What has changed?

- Effective January 1, 2019, your payroll deduction will increase from 4.95% to 5.10% if you contribute to CPP.
- Effective January 1, 2019, your payroll deduction will increase from 5.40% to 5.55% if you contribute to QPP.



We would like to introduce you to our newest team member, Yonas Woldu.

A recent graduate of business administration at Centennial College, Yonas has spent the last three years honing his skills with various business segments at RBC Dominion Securities. When not working, he is an avid basketball player and supporter of the Toronto Raptors. We are excited to have him on our team supporting our administrative group.

# Benchmarks

## Equity market 12-month trailing return (for month ending December 31, 2018)

S&P/TSX composite total return index	-8.9%
S&P 500 total return (C\$)	3.7%
S&P 500 total return (U\$)	-4.4%
DJIA total return (C\$)	4.7%
DJIA total return (U\$)	-3.5%
Nasdaq composite price return (C\$)	4.2%
Nasdaq composite price return (U\$)	-3.9%

## RBC Capital Markets Canadian Bond Market indexes 12-month trailing return (for month ending December 31, 2018)

Short-term index	1.9%
Intermediate term	1.9%
Three-month T-Bill (C\$)	1.3%
Three-month T-Bill (U\$)	1.7%



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