The Sandler Quarterly

RBC Wealth Management Dominion Securities

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The first half of 2018 stands in contrast to the relative smooth sailing of 2017. The euphoria following tax reform in January has been replaced with concern about protectionism and a possible global trade war. Inflation and interest rates are no longer at rock bottom and have been trending higher. Against this backdrop, equities have struggled to make the kind of headway that came so easily last year.

Global markets have been volatile, and overall, have not provided any meaningful returns (see *Figure* 1 below). For the six months ending June 30th, the TSX was positive by less than half of one percent, the Dow posted a negative 1.8% return and the S&P500 was up by 1.7% (before dividends). European and Asian markets were predominantly negative with the Chinese market now officially in bear market territory; down over 20% from its January high.

Despite these developments, we believe that economic trends and market prospects remain positive. While trade is grabbing attention in the headlines, there are a number of other important factors that should also be recognized.

- **Solid global economic growth** - RBC estimates the global economy, buoyed by fiscal stimulus (tax reform), will expand by 4% in both 2018 and 2019
- **US dollar strength** - The Loonie ended the quarter at a 12-month low versus the US dollar. We expect this USD strength to continue, not just against the Loonie, but versus a basket of global currencies
- **Inflation seems manageable** - In our Q1 newsletter we discussed the threat of higher inflation. Since then, the consumer price index (CPI) has risen, but for now, it appears under control. We continue to monitor this crucial indicator
- **Equity markets** – Global markets have been directionless in the past quarter and are relatively flat year to date. Optimism fuelled by tax reform and strength in earnings has been offset by fears over a global trade war

***Figure 1**: S&P500, January 1st, 2017 – June 29th, 2018 (Source: Thomson ONE)*

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- **Interest rates** - The Fed raised rates in March and June, and is expected to raise once or twice more this year. The US is enjoying better economic momentum relative to its peers and as such has the ability and room to move interest rates higher. Higher rates south of the border support a strengthening USD as mentioned above. Canada is on a similar path and also raised rates recently

- **Equity valuations and profits** - Corporate profits and margins continue to rise steadily. As of the first quarter, the largest 500 companies in the US have grown their earnings per share by more than 25% year over year (see *Figure 3*). This, together with a pullback from January highs has served to bring valuations down. Stocks are cheaper today at 16x forward earnings versus 18x in January

In speaking with clients, trade tensions and tariff threats are dominating many of our conversations. According to a recent survey by RBC, trade disputes and associated tariffs are the top concern of institutional investors. We are vigilantly monitoring this developing situation and how it affects your investment portfolio. The rules of the game are changing on a daily basis and the likelihood is for this uncertainty to continue. With this in mind, the attached article, *Trade tensions heat up: What investors need to know*, seeks to answer the key questions and provide an outlook on how things will play out.

Welcome Joshua Orr!

Please join us in welcoming Joshua Orr to the Sandler Wealth Management Group. Josh comes to us from Royal Bank where he worked in customer service. He can be reached for administrative matters at 416-842-8676 or joshua.orr@rbc.com

Trying to predict the endgame of these tensions is like handicapping a horse race - there are many potential outcomes and anything can happen. While we have no way of predicting the result, we can apply likelihoods to an array of scenarios. The table below shows our best guess on the possibility of each scenario from both global and NAFTA specific perspectives.

Your portfolio is well positioned to weather the storm. In anticipation of NAFTA negotiations we sought to insulate our accounts and sold Magna, a car parts manufacturer, earlier this year. None of our other Canadian equities have significant exposure to cross border trade. In the US, we own Apple and United Technologies, two companies that have potential exposure should tensions continue to escalate. We will closely monitor these investments and make prudent changes if and when necessary. For now, both of these companies continue to perform very well.

Scenario	Worst case	Negative	Slightly negative	Neutral	Best case
Likelihood	20%	25%	30%	15%	10%
Detail	Trade war w/ blanket tariffs	Substantial increase in tariffs	Small Trump tariffs persist	Reverse Trump tariffs	Foreign barriers fall to pressure
Economic effect	U.S.: -1.0% China: -1.6%	U.S.: -0.3% China: -0.3%	U.S.: -0.1% China: -0.1%	U.S.: 0.0% China: 0.0%	U.S.: positive China: ?

Figure 2*: U.S. trade scenarios (Source: RBC Global Asset Management)*

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Tired of Getting Paper Statements? Sign up for DS Online!

Through our online platform, DS Online, you can view your investment accounts, monthly account statements and trade confirmations all in one convenient location. You can also communicate with us directly through RBC's secure two way messaging. This messaging system is an easy and secure way of instructing us without the requirement of your signature to authorize a variety of tasks. If you do not have DS Online but wish to be set up, please call Sydney Palter at 416-842-6677.

Although the TSX and S&P500 are relatively flat year to date, the energy and technology sectors have managed to buck the trend and post positive returns. In the case of energy, the rising price of crude helped lift shares of the oil producers. In technology, investors continue to expect massive growth from companies like Amazon and Netflix and are willing to pay huge premiums for their shares. The tech heavy Nasdaq index was up over 8% for the first six months of this year. In fact, all of the S&P500's positive performance came from technology; without the tech sector, its return would also be negative.

With the exception of our investment in Apple (a modestly valued dividend payer) we do not have any holdings in these sectors. Our investment philosophy is one that seeks out stable and predictable companies that have a history of paying dividends and have been tested through many business cycles. We favour investments that represent good value rather than expensive high fliers. So far this year, value has been shunned in favour of growth and momentum. Over time, value investing has outperformed growth, and done so with less volatility. We will continue to favour this approach as the most reliable strategy to create wealth.

Interest rates in Canada and the US moved higher again recently. Both central banks have raised their benchmark rates since our last newsletter. Banks have bumped their prime lending and mortgage rates and corporate bonds are giving yields not seen for some time. Your portfolio holds cash, bonds and preferred shares that will benefit from higher yields over the coming months and years. In the case of cash, the positive effect is felt in the near term. Bonds and preferreds benefit as they mature and we reinvest, or as their rates are reset. As mentioned many times, we have purposely structured our fixed income portfolio to take advantage of the rate environment we currently find ourselves in. With yields on the rise, you can expect slow but steady increases to the overall yield on your fixed income portfolio.

In summary, there are positive and negative factors at play in the current economic climate. Based on the known facts, one would lean towards optimism. Based on the unknown (trade concerns), one should be justifiably concerned. We are cautiously optimistic on the equity markets and pleased to see higher rates on fixed income. We maintain a prudent approach to investing and now, more than ever, we are vigilantly monitoring the horizon for signs of approaching storms. The current economic expansion is now nine years old, and while key indicators point to continued growth we must acknowledge that the economy is cyclical. We must find the appropriate balance of investments that will allow us to participate in rising markets yet protect us if and when necessary.

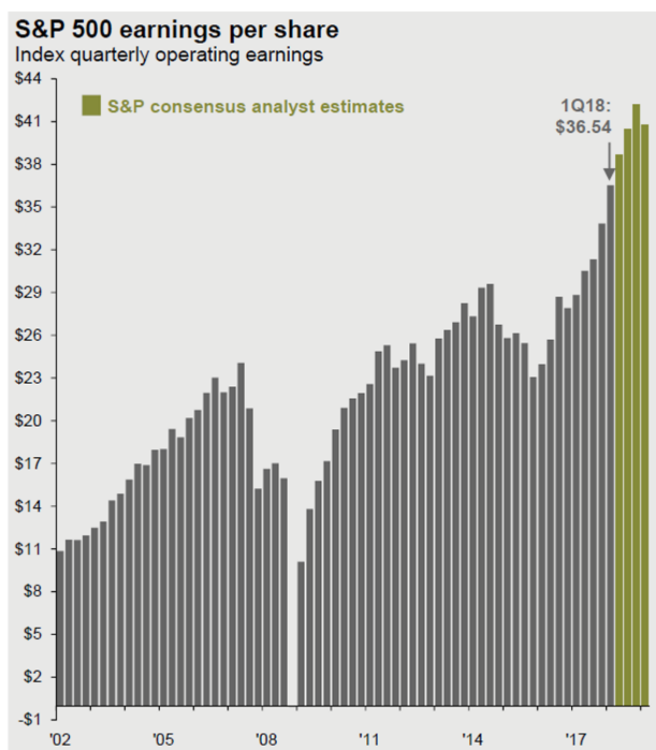

***Figure 3**: S&P500 Earnings (source: JP Morgan)*

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With a diverse client base to communicate with, we strive to find a common ground when writing these newsletters. Our goal is to appeal to all clients, but we realize that this is not always possible. Please call us directly if there is anything you wish to discuss further or if there is a topic you would like more extensive research on. We value your feedback and will continue to work on improving our communication with you.

Thank you for your continued support and the trust that you place in our team.

Sincerely,

Scott Sandler
Vice President & Portfolio Manager

Ronan Clohissey, CIM
Vice President & Portfolio Manager

	YTD**	1 Year**
Indices		
S&P/TSX	0.42%	7.22%
Dow Jones	-1.81%	13.69%
S&P 500	1.67%	12.17%
Nasdaq	8.79%	22.31%
Euro Stoxx	-3.09%	-1.34%
Japan Nikkei	-2.02%	11.34%
India Sensex	4.01%	14.56%
VIX Volatility	45.74%	43.92%
Commodities		
Gold	-3.85%	0.89%
Silver	-4.84%	-3.09%
Copper	-8.08%	11.78%
Oil	22.72%	61.06%
Natural Gas	-16.09%	0.89%
Currency		
CAD	-4.29%	-1.30%
EUR	-2.67%	2.26%
JPY	1.80%	1.49%
AUD	-5.17%	-3.69%
GBP	-2.26%	1.40%

*** ending June 29th, 2018*

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RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Trade tensions heat up: What investors need to know

Kelly Bogdanova – San Francisco

As trade tensions escalate on several fronts, investors are rightly concerned—and confused—about the vulnerability of the economy and markets. Here's what investors should know to help navigate the uncertainty ahead.

Risks associated with trade and tariffs are the top concern of institutional investors, according to a recent survey by RBC Capital Markets. They far outweigh worries about inflation, interest rates, Fed policy, and the economy overall, among many other issues.

Amid the uncertainties, there is a lot of confusion about the trade disputes, especially after a myriad of tariff threats and counter-threats have been lobbed back and forth in recent weeks. Neither the U.S. nor its major trading partners seem willing to back down anytime soon.

In an attempt to cut through the noise, we answer some frequently asked questions:

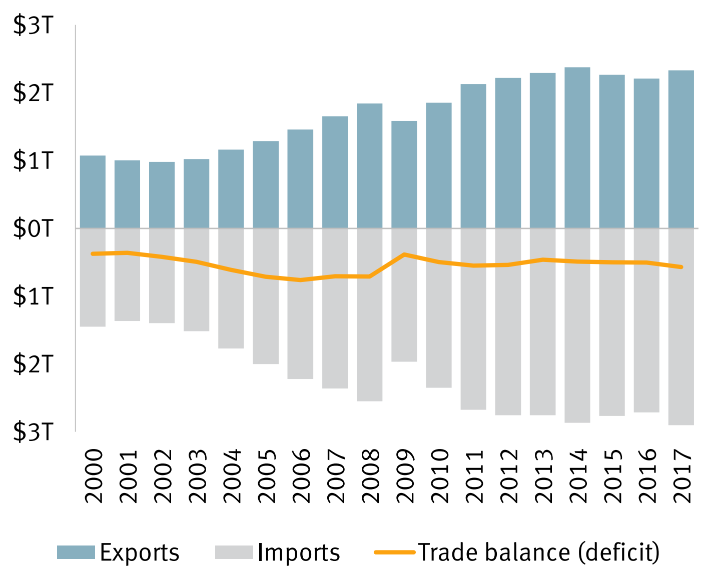
Q: Markets largely ignored trade tensions for months. Why have they reacted recently?

A: Perhaps this has to do with President Trump's unorthodox communications style. For much of his presidency markets have been in "show me" mode—less focused on rhetoric and more focused on actual outcomes.

For example, markets were slow to price in the historic U.S. tax cuts and associated increase in earnings estimates. The reaction to tariff rhetoric has been similar—most markets were mostly unaffected by the war of words until the prospects of multiple tit-for-tat tariffs became nearly assured. This is unusual behavior for equity markets, which normally price in events well in advance.

It's now clear the U.S. administration isn't completely bluffing and there is more to this than just tough rhetoric. What were trade "threats" months ago have begun to turn into actual

U.S. trade and the deficit



Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

Market pulse

policies. Steel and aluminum tariffs have been implemented by the U.S. and counter-tariffs are forthcoming from many trading partners. Also, the first round of U.S.-China tariffs is nearing the implementation phase. We think the additional tariff threats lobbed in the past few weeks by all sides now seem more credible in the eyes of markets.

Q: What is the potential economic impact of tariffs?

A: The trade disputes are being fought on four different fronts: (1) steel and aluminum, which impact many countries; (2) automobiles, which impact auto-producing nations; (3) the U.S. versus China; and (4) the U.S. versus NAFTA partners Canada and Mexico.

Our economists believe there is a very low probability that all of these fronts will ignite at once into an all-out global trade war. They anticipate the parties will ultimately negotiate trade deals for most if not all of these because it is in the economic interests of all countries involved, including the U.S. If a full-on trade war is avoided, the economic damage should be manageable.

That being said, our economists have evaluated some harsh scenarios. For example, if the U.S. and China were to levy 25% tariffs on all imports from each country and China were to include additional non-tariff barriers so as to match the total U.S. tariffs, RBC Capital Markets estimates it would subtract a little more than one-half of a percentage point from annual U.S. GDP growth (the economy would grow 2.4% rather than 2.9%, for example). Keep in mind, the U.S. and China tariff threats currently on the table are much lower than this (25% on the first $50B in goods, followed by a 10% tariff on the equivalent of $400B more in goods).

In another scenario, if the U.S. were to levy a hefty 20% tariff on imports from China, Mexico, and Canada, and each country countered, RBC Global Asset Management's economist estimates it would subtract 4.8% from Mexico's GDP growth (admittedly, a big number), 2.4% from Canada, 1.9% from the U.S., and 0.9% from China. The probability of this occurring is very low, in our view.

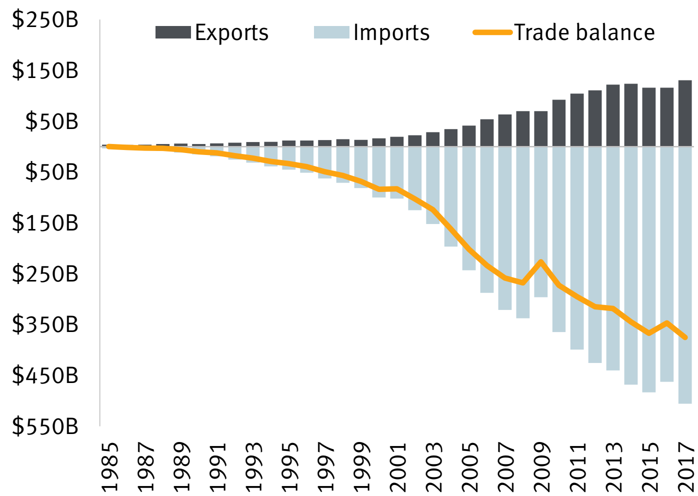
Q: Which U.S. sectors are most vulnerable to tariffs?

A: Theoretically, the U.S. sectors with the highest levels of international revenues—Technology, Materials, Energy, and Industrials—would have the most to lose in a global trade war on goods *and* services, as the bottom chart illustrates. But that's not what is being threatened and this issue is not cut and dried.

Thus far, the tariff threats have focused on goods, not services. The distinction matters because many Tech firms, including internet and some software companies, are services providers.

Trade with China has become more one-sided over the years

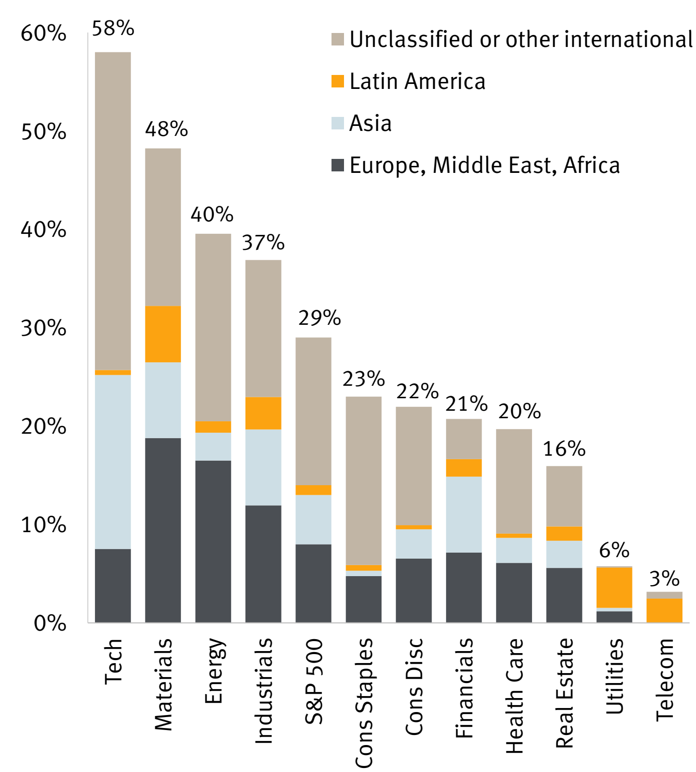
U.S. trade with China



Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

Cyclical sectors are the most internationally exposed

S&P 500 percentage of international revenues by sector



Source - RBC Capital Markets U.S. Equity Strategy, Capital IQ, Standard & Poor's

They manufacture nothing so their risk is low. Within Tech, semiconductor and hardware companies are manufacturers and have significant revenues from overseas, so they are much more exposed to tariff risks.

Another key point: it's difficult to break down the risks by regions or countries. Many S&P 500 companies don't detail the sources of their international revenues, which is why the bulk of international exposure is in the "unclassified or other" category, as shown in the bottom chart on the previous page.

In general, internationally oriented semiconductor, tech hardware, materials, and industrial firms have the most exposure, and some consumer goods companies are vulnerable as well.

Q: What could hasten the end of the trade disputes?

A: A meaningful deterioration in U.S. and global economic indicators and a more pronounced selloff in equity markets could certainly grab the attention of elected officials and push sparring parties to resolve their trade differences. But we don't think it has to get that bad for deals to take place.

Corporate pressure could go a long way toward bringing an end to the trade disputes. A non-trivial share of major trade relationships—whether between the U.S. and China, the U.S. and the EU, or NAFTA members—is business-to-business and involves complex global supply chains with interdependencies that are often misunderstood or underappreciated by government officials. Some tariffs could tie global supply chains in knots. We don't doubt businesses of all sizes in all countries involved will warn governments about this, which could encourage positive movement toward trade deals.

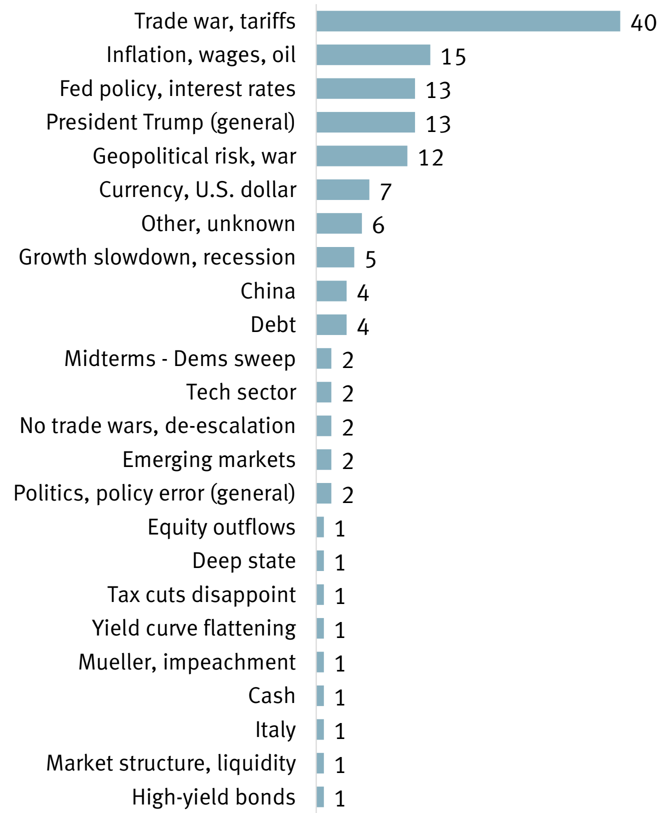
Two U.S. automotive industry groups have already sounded alarms about auto tariffs. ExxonMobil and Chevron warned of the damaging effects of tariffs on steel, which they use for infrastructure maintenance and expansion. High-profile European companies, Daimler and car lights supplier Osram, warned that rising trade tensions could weaken their profit outlooks. Any cautionary comments by U.S. companies during the upcoming Q2 earnings reporting season would likely catch the attention of the free trade advocates in the U.S. administration (Steven Mnuchin, Larry Kudlow). While additional warnings could rattle equity markets, they may also jolt trade negotiators into action.

Cooler heads should ultimately prevail

All sides of the trade disputes have economic incentives to resolve their differences, and we think this will eventually occur. In the meantime there could be more heated rhetoric and additional tariffs implemented that could keep equity markets off balance over the near term.

Survey of institutional investors: What is the biggest tail risk for the U.S. equity market?

Number of responses



Source - RBC Capital Markets U.S. Equity Strategy quarterly investor survey (June 2018), RBC Wealth Management