Wealth Management
Dominion Securities

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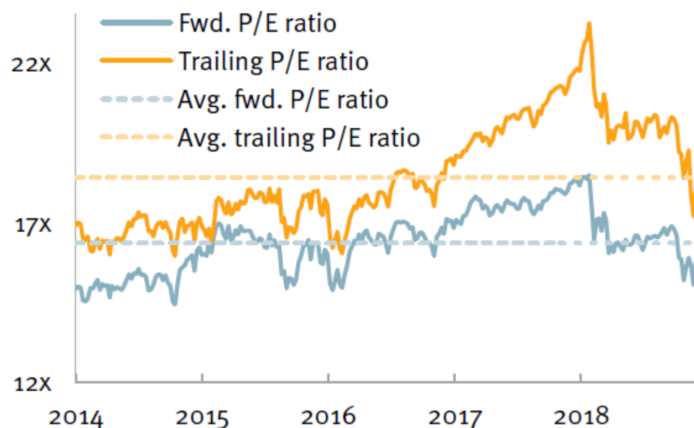
December Rout May Present Opportunities

KEY INSIGHTS

- The December market correction has reset equity valuations to a more reasonable level and created some compelling opportunities. See *chart* below.
- Central banks have acknowledged a potential economic slowdown and tempered the trajectory of interest rate increases this coming year
- Trade tensions between the US and China will continue to be a major wild card; expect uncertain markets to continue until there is clarity on this issue

2018 is now in the rear-view mirror and, thankfully, confined to the history books. Q4 was not for the faint of heart. After reaching new highs in late September, global markets quickly reversed course. By Christmas Eve the S&P500 had fallen 19.8% from its September high and ended the year with the worst December since 1931 (see *Figure 2*). In the following pages we will attempt to explain the reasons behind the market's rapid about-face and how we view the outlook for the coming year.

S&P 500 price-to-earnings (P/E) ratios below averages



The silver lining to the market's decline has been the easing in equity market valuations, which are communicating less onerous expectations in the coming months.

Note: Forward P/E ratio based on next-twelve-month EPS estimates; trailing P/E ratio based on trailing-twelve-month realized EPS
Source - RBC Wealth Management, FactSet; 5 years of weekly data through 12/31/18

Figure 1: *S&P500 valuation, 2014 - Present*

Quarterly Review

Q4 2018

The list of reasons for the sharp sell-off is long. Primary drivers of recent weakness include:

- Concern that the US economy might slow more than expected
- Uncertainty and fear that US China trade relations may continue to deteriorate
- Slowing corporate earnings growth, following a blistering 25% growth rate earlier in the year spurred on by Trump's corporate tax cuts
- Fear that the US Fed, which raised interest rates four times in 2018, might tighten too much and too quickly
- Expensive equity valuations, particularly among growth stocks
- Geopolitical uncertainties, including the US government shutdown, Brexit and Italy's finances, to name but a few

While the severity of the correction was greater than expected, the fact that it happened was not entirely surprising. In our last newsletter at the beginning of October we commented:

> *"Our outlook for equity markets has moved further into defensive territory"*

> *"After almost 10 years of expansion, we are surely getting closer to the late innings of the economic cycle and a market correction. The S&P500 is currently above fair value and in a valuation zone historically consistent with lower returns and higher volatility"*

We entered the fourth quarter conservatively positioned. Your portfolio held more cash and fixed income and less equities than your long term asset allocation target. As a result, we fared quite well versus the US and Canadian indices in the quarter but still ended the year in the red. It is important to note that we do not manage your investments to beat a benchmark. Instead, our goal is to generate positive absolute returns over time. When we reference the indices, it is only to give context, not to excuse a down year. Please see the attached Quarterly Portfolio Review for a detailed breakdown of your short and longer term returns. We are happy to discuss these with you and how they affect your long term needs and goals.

***Figure 2**: S&P500 price chart, 2017 - Present*

We continue to believe that we are at a fairly late stage in the business cycle, but that the December correction has done a good job of resetting valuations to reflect some of the risks that lie ahead. In September, stocks were flirting with an expensive price-to-earnings (P/E) ratio of 20x based on trailing 12 month's earnings. Fast forward to the end of the year and that number has fallen to a more realistic 16x for the S&P500 (see *Figure 1*). In Canada, valuations are even lower, where the TSX trades at a 15% multiple discount to major US indices. In fact, the TSX is at the same level today as it was in June 2008. At current valuations, Canadian equities may present an interesting opportunity. The attached report, "Oh Canada….", discusses such an opportunity and the factors that have caused the Canadian market to underperform its US peers.

Looking forward, we are now cautiously optimistic that equities can deliver positive returns in the coming months. Lower valuations, a Fed that appears to have put rate increases on hold and a potential thawing in US-China trade relations all give us reason to have a more constructive short term outlook for the market than we had in October.

Quarterly Review

Q4 2018

With that in mind, we added to some existing holdings and established a toe hold in a new investment in late December as others were running for the exits.

- ***Brookfield Properties***: This was an existing position and long-time favourite of ours. The company owns a diversified portfolio of some of the world's best real estate. The shares can be purchased at a remarkable 40% discount to the company's net asset value according to our real estate analyst Neil Downey. Management is best in class and the units currently yield in excess of 7%. At our most recent purchase price, near the low for the year, the units yielded in excess of 8%.

- ***Fedex Corporation***: This is a new investment for us. We purchased a small initial position just before Christmas at approximately $157USD, down over 40% from $274 less than a year ago. With expanding e-commerce volumes, Fedex's US business is strong while China and Britain have shown some weakness on the back of economic slowdown. In December, the market chose to see the glass as half empty and focused on the negative. We see this as an essential service in a growing industry. At less than 10x earnings, Fedex is cheaper than it has been since the financial crisis.

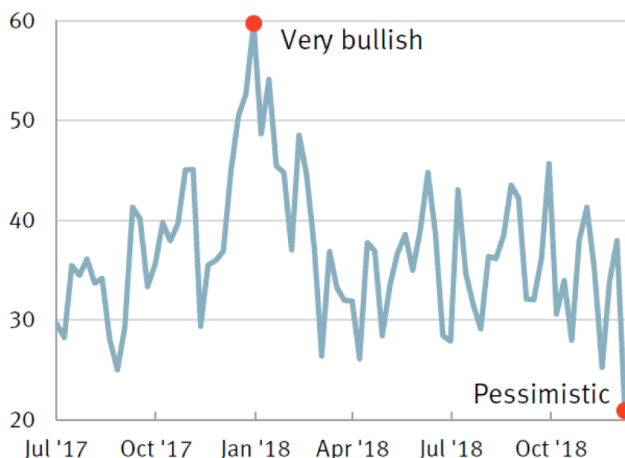


***Figure 3**: Survey of market sentiment*

The two purchases above are examples of great value that we saw amidst recent market weakness. Times like this create opportunity as many investors allow sentiment, rather that fundamentals, to drive their decision making process (see *Figure 3)*. We read recently that computer driven algorithms account for over 80% of stock market volume. These computer programs tend to follow the momentum (do more of what's working) and exacerbate the already heightened volatility. Ultimately, rational investors see true value and step in as buyers.

We are comfortable adding small positions to portfolios but remain underweight equities overall. We believe that the coming 12 months will be best spent preparing for future challenges likely to come with an aging, slowing economic expansion that could slip into recession at some point. There is no need to be a hero. This is a time to focus on ensuring our portfolios are positioned defensively and generating a predictable income stream of interest and dividends. RBC's chief investment strategist advises the following for the coming year:

- ✓ Favour value over growth
- ✓ Favour large caps over small caps
- ✓ Focus on (growing) dividends
- ✓ Have a plan for playing defense and know how to implement it

In fact, these are concepts that we live by in all market conditions. They are particularly important right now, but over longer periods we believe that investing in this way will produce a better risk adjusted return.

Fixed Income

Our last newsletter anticipated continued improvements in bond yields. So far, this has not come to pass. On September 30th, a Government of Canada 5 year bond yielded 2.34%. By December 31st it had fallen to 1.88%. Additionally, central bankers appear to be guiding the market to a slower pace of rate increases as they react to slowing economic growth. For now, we will continue to own high quality bonds with shorter dated maturities. The latter stage of an economic cycle is not a time to reach for yield in lesser quality borrowers.

Quarterly Review

Q4 2018

Preferred shares were a drag on our portfolios this quarter. The majority of the preferreds that we hold are linked to the 5 year Canada bond. Every 5 years they reset their dividend to that rate plus a predetermined additional percentage. As 5 year bond yields fell, so too did the rate at which these preferred shares would reset. In addition, investors were in no mood to take risk in Q4, and while preferred shares are stable investments from quality companies, they suffered from the general negative tone of the market. Preferred shares now are offering very attractive yields and represent a compelling opportunity.

***Figure 4**: USD/CAD exchange rate in 2018*

Currencies

The Canadian dollar was battered by a confluence of factors in 2018, with only a modest recovery anticipated later in 2019. Plunging crude oil prices aggravated earlier pressures emanating from rate dynamics that favored the US dollar (see *Figure 4*). The diminished growth outlook on the back of depressed energy prices will likely keep the Bank of Canada from raising policy rates in early 2019, in our view, limiting any near-term upside for the currency.

The US dollar advanced against nearly every major currency in 2018 as US growth outperformance and rising yields boosted appetite for the currency. These supportive factors are poised to fade through 2019 as the economy slows to a more sustainable pace and the Fed looks to ease up on its path of monetary tightening. There is still scope for modest dollar gains in early 2019, in RBC's view, in advance of growth conditions improving elsewhere and other major central banks tightening policy.

Early 2019 Tax Tips

Tax-Free Savings Account (TFSA)

Consider making a contribution to your TFSA early in the 2019 calendar year to maximize the tax-free growth in your plan. The TFSA contribution limit for 2019 is $6,000. If you've been eligible for a TFSA since 2009 and have not yet contributed to one, your contribution limit would be $63,500 as of January 1, 2019.

2018 RRSP Contribution Deadline

The deadline for you to make a contribution to your RRSP that can be claimed as a 2018 tax deduction falls on March 1, 2019.

If you have not done so, please let us know if you would like us to arrange for your TFSA or RSP contribution to be made.

Supporting Homeless Youth at Eva's Place

The team strapped on their aprons in the New Year to make soup for youth at Eva's Place. Eva's is an organization that provides shelter, traditional housing and programs for young people to build a brighter future.

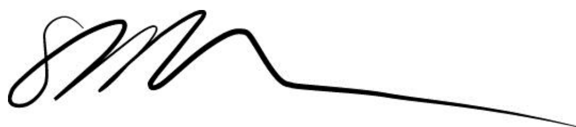
Quarterly Review

Q4 2018

Insurance Strategies

In 2018 we helped many clients with their insurance needs. A number of clients have discussed insurance from a traditional risk management perspective; giving their loved ones financial protection in the event of death. More common these days is the desire to use insurance as a tax and estate planning tool. With the top marginal tax rate now above 50%, insurance is often used to transfer wealth to the next generation in a tax advantaged way. Typically, individuals with capital in excess of their lifestyle spending needs can take advantage of the preferable tax treatment that insurance benefits provide.

Sincerely,



Scott Sandler
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	Q4*	2018
Indices		
S&P/TSX	-10.89%	-11.64%
Dow Jones	-11.83%	-5.63%
S&P 500	-13.97%	-6.24%
Nasdaq	-17.54%	-3.88%
Euro Stoxx	-11.70%	-14.34%
Japan Nikkei	-17.02%	-12.08%
India Sensex	-0.42%	5.93%
VIX Volatility	133.83%	156.70%
Commodities		
Gold	7.86%	-2.66%
Silver	6.94%	-9.86%
Copper	-4.95%	-16.92%
Oil	-39.69%	-24.78%
Natural Gas	1.51%	-55.32%
Currency		
CAD	-6.05%	-8.26%
EUR	-0.96%	-4.91%
JPY	3.93%	2.44%
AUD	-2.42%	-9.97%
GBP	-2.21%	-6.15%

** ending December 31st, 2018*

Wealth Management
Dominion Securities

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Special report

Oh Canada: Value emerging from an unloved market

While Canadian equities are getting the cold shoulder from investors, we think they're failing to see a salient fact—the Canadian market has rarely been this cheap. We acknowledge that the market outlook remains challenging, but we explain how this valuation opportunity has piqued our interest.

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Nobody knows you, when you're down and out – Jimmy Cox

Investors in Canadian equities will be forgiven if the temptation to "throw in the towel" on Canada's market and buy more U.S. (or, frankly, anything else…how is bitcoin doing?) feels like the right approach. Investor sentiment towards Canada is terrible. That makes this a time when it may pay to consider the contrarian view. We discuss the headwinds facing the Canadian economy and look at the valuations of the TSX on both an absolute and a relative basis. Although the Canadian market outlook doesn't engender much excitement at the moment, the multiple compression of the TSX over the past two years reflects very pessimistic expectations, in our view. The "wall of worry" is clearly in place. Things may only need to get incrementally better for the TSX to recover some of its mojo.

No love for the TSX

Despite delivering levels of earnings growth similar to the S&P 500 since 2016 (see the table below), the TSX is actually down 1% on a price basis compared to a 22% gain for the S&P 500 in CAD terms. Over the past two years the Canadian index has suffered a 19% haircut on its forward P/E ratio against a more benign 7% squeeze for the U.S. benchmark.

TSX earnings growth and forward P/E ratio between Dec. 2016 and Nov. 2018

	Trailing EPS			Index Level			Forward P/E		
	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ
TSX Composite	$669.04	$918.05	37%	15,288	15,198	-1%	16.5	13.3	-19%
S&P 500	$142.79	$194.35	36%	3,011	3,672	22%	17.0	15.8	-7%

Source - Bloomberg; all data in CAD; "Δ" (delta) indicates percentage change over the time period shown.

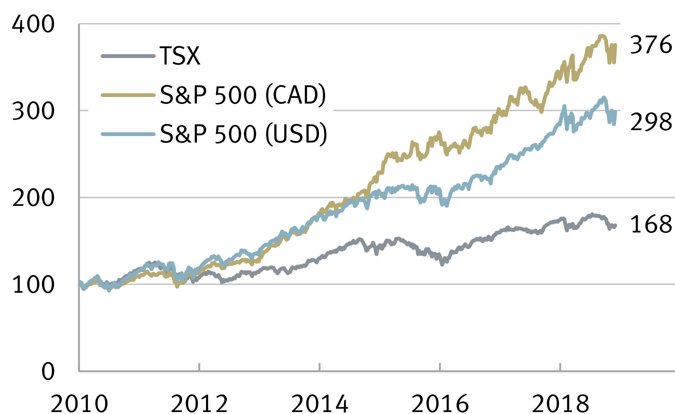
The poor relative performance goes back even further. Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years as shown in the chart on the next page. While the Canadian economy and corporate earnings have recovered smartly from the oil-price-induced crunch four years ago, sentiment towards Canadian equities has remained unusually depressed.

Diagnosing the Canadian market

In our view, this poor relative performance stems from three broad concerns.

Value in the Canadian market

TSX total returns vs. S&P 500



Source - Bloomberg; 1/1/10 indexed to 100; data through 12/20/18

Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years.

- **Eroding relative competitiveness:** Most notably, the relative competitiveness of Canadian corporations has been hit by the big cut in U.S. corporate tax rates. Once much higher than the posted Canadian rate, the U.S. rate is now somewhat lower. Additionally, the Trump administration has pursued an aggressive deregulatory agenda since 2017, while the regulatory burden in Canada has moved in the opposite direction, as environmental commitments and labour laws have become less business-friendly. At the same time, all provinces have raised the minimum wage.
- **Indebted households:** Canadian household debt levels have surged to around 170% of annual income as of Q3 2018, up from around 130% at the start of 2006. The rise has been driven by ultra-low interest rates that have pushed debt servicing costs to historically low levels, together with a strong bull market in real estate prices. Results have included larger mortgages and, to a lesser extent, debt-financed consumption. This has raised concerns about future financial system vulnerability (e.g., loan defaults) and long-term growth prospects. These concerns have important implications for the economy and stock market because the Financials sector comprises over a third of the TSX, and personal consumption accounts for nearly 60% of Canadian GDP.

Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011.

- **Commodity dependence:** The commodities complex is crucial for the TSX. Despite the correction in commodity prices in recent years, natural resource stocks still make up almost 30% of the TSX. Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011. The Energy sector is contending with inadequate pipeline capacity to move Canadian crude to export markets, forcing producers to ship greatly reduced volumes via more-expensive rail and truck and at heavily discounted prices. Given pipeline constraints are unlikely to be resolved in the near future, all this means Canadian oil could continue to trade at a deeper-than-usual discount compared with WTI, while investor interest in Canadian Energy companies is likely to remain listless.

Half empty or half full?

There is a growing temptation to “throw in the towel” on Canadian equities, and buying more U.S. equities may seem like the right approach. However, we are reminded of the words of wisdom from the father of value investing, Benjamin Graham:

Value in the Canadian market

"In the short run, the market is like a voting machine—tallying up which firms are popular and unpopular. But in the long run the market is like a weighing machine—assessing the substance of each company."

In this case, almost all of Canada is universally unpopular at the present time. Yet despite this, nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market: net foreign purchases of Canadian equities have held up well in recent years, amounting to CAD183B since 2013.

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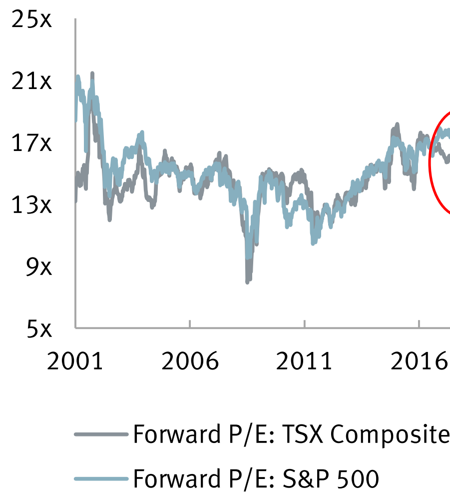
Because stock markets are discounting mechanisms, many of the headwinds facing the Canadian market are already meaningfully priced into the valuations of Canadian businesses. Can things go from bad to worse? That's always possible. But an investor should assess opportunity across a range of reasonable outcomes, giving heavy consideration to what one is paying for a basket of high-quality Canadian businesses.

From an absolute valuation standpoint, the TSX trades at roughly 13.1x forward earnings, an 11% discount compared to its long-term average of 14.6x; that's almost one standard deviation below the historical average. On a relative basis, while the forward P/E multiples for the TSX and the S&P 500 have tended to move in sync historically, a big gap has opened up, as shown in the charts below. The TSX currently trades at an extraordinarily deep 15% discount to the S&P 500 on a forward P/E basis.

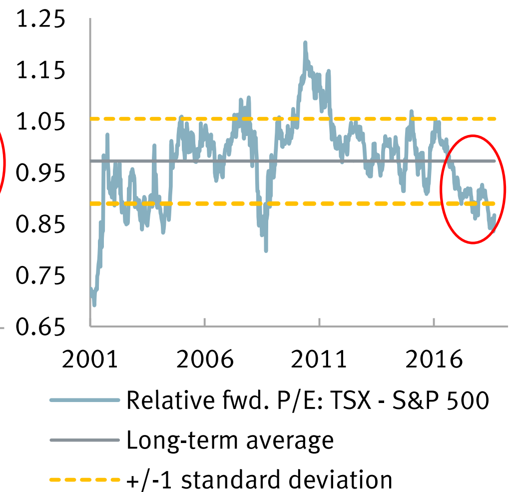
P/E multiples for TSX and S&P 500

Forward P/E multiples for TSX and S&P 500 tended to move together...



Relative forward P/E: TSX – S&P 500

...but valuations have dramatically diverged since 2016.



Source - Bloomberg

At current valuations, the Canadian market has rarely been this cheap. If we ignore the global financial crisis (because it was *the* global financial crisis), we have to go back to the early 2000s to find the last time Canada looked this cheap relative to the U.S. However, at that time the U.S. market was still dealing with the hangover of the dot-com era and valuations were very expensive—Walmart was trading at 57x earnings. It wasn't so much about Canada trading cheaply as it was the U.S. trading at historically expensive multiples.

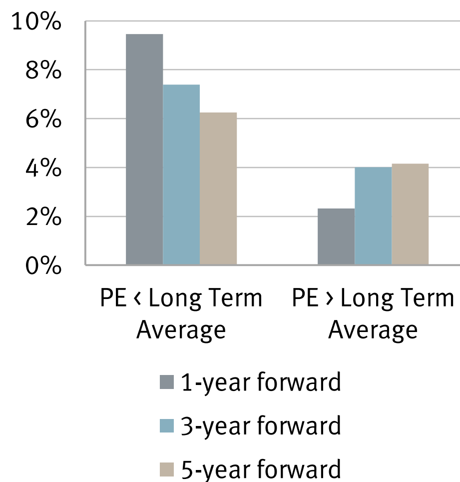
Value in the Canadian market

Valuations are seldom useful for timing entry points, but they are strong determinants of future long-term return potential. The chart at left below shows the 1-, 3- and 5-year forward returns for the TSX based on entry points that were either above or below the historical average. Unsurprisingly, forward return prospects were, on average, quite a bit more attractive across all time horizons if one had invested in the TSX when its forward P/E was below the historical average.

What about performance versus the S&P 500? The TSX has tended to outperform the S&P 500, on average, across all time horizons when it trades at discounts in excess of 10% compared to the U.S. market on a forward P/E basis, as shown in the chart at right below. In stark contrast, the TSX has meaningfully lagged after trading more expensively than the S&P 500.

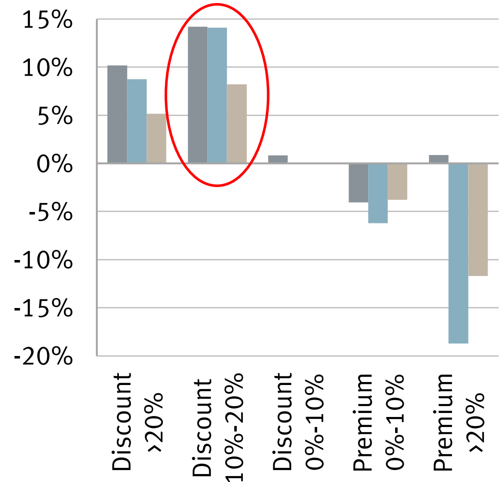
TSX returns when investing below and above historical average P/E

Lower starting valuations elevate average future return potential



Average annualized relative performance of the TSX vs. the S&P 500

Valuations eventually matter... in the longer term



Source - Bloomberg; based on price index

Parting thoughts on Canada

Investor sentiment towards Canada remains quite negative. That said, we think the unusually wide valuation gap that has opened up between the TSX and the S&P 500 warrants looking at the Canadian market through contrarian eyes. We acknowledge that some headwinds facing the Canadian market are unlikely to abate in the short term, but we contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

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Perhaps some combination of OPEC and Alberta production cuts and/or progress on pipeline approvals will re-energize the energy market. Or perhaps a split U.S. Congress will soften the Trump administration's hardline trade stance. And soon, the leaders of both countries will turn their sights towards reelection, which may result in market-friendly policies in the near term. These are three possible outcomes to which the market is essentially assigning a zero probability. Investors are already behaving as if not much can get better, which is piquing our interest. Remember, in the words of Warren Buffett: be greedy only when others are fearful.