



The Sandler Quarterly



Wealth Management
Dominion Securities

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Against The Odds – Markets Higher Despite Headwinds

KEY INSIGHTS

- Positive markets in 2019 despite headwinds and volatility
- Late cycle indicators flash warning signs but economic growth continues
- Low (and negative) interest rates confound a system built on making money
- Unresolved trade tensions continue to weigh on global growth

Year to date, 2019 has been positive for major global markets and, in turn, for our client portfolios. We wanted to begin with that statement, because despite healthy returns, we have spoken to many of you recently who assumed otherwise. It's understandable – if one were to scan the headlines, the obvious conclusion would be that equity markets should be negative. Trade wars, Brexit uncertainty, Hong Kong tensions and an impeachment inquiry (to name but a few) hardly seem like an ideal backdrop against which investors should

be buying equities. Add to that a slowing global economy and increasing talk of a recession, and we fully understand why one might assume the worst.

And yet, through the first nine months of the year, we have witnessed remarkable strength in North American indices, global bond markets and precious metals prices. Please refer to your attached Q3 Portfolio Valuation to see specifically how your investments have performed.

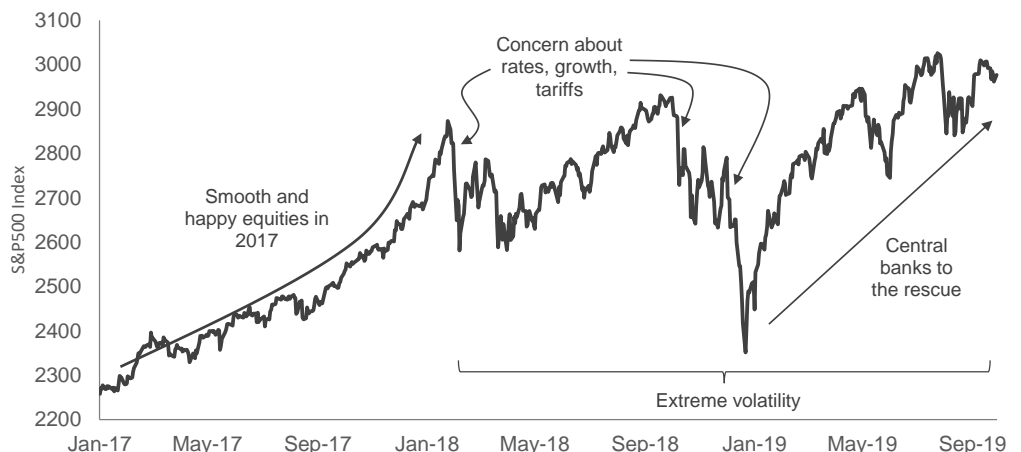


Figure 1: Stock market roiled by trade fears again (Source: WSJ, Haver Analytics, RBC GAM)

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As you know, we are conservative and prudent investors. We seek to generate steady and stable returns over time while trying to avoid market volatility and media drama. Separating what is truly meaningful for the markets versus what is just "noise" is essential. It may seem cliché to say that we are living through uncertain times, but objectively, this is currently the case. An inverted yield curve and a late business cycle are classic harbingers of volatility (see *Figure 1*). The most recent US economic recession scorecard (see *Figure 2*) highlights that two key factors have now slipped from an expansionary position into a neutral or recessionary stance.

RBC Wealth Management U.S. economic recession 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	✓	–	–

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

Figure 2: Q3 US recession scorecard

As portfolio managers, we have dual roles: generating a positive return on your investments, and actively managing risk. Maintaining the right speed on the highway requires a sensitive foot on the gas pedal (and brake pedal). In this regard, 2019 has kept us on our toes as we walk the fine line between making money while managing risk.

One of the ways we achieve this is by insisting that all of our holdings pay us a regular dividend or interest payment, regardless of whether markets are up or down. While we expect all of our equity holdings to generate capital gains over time, we cannot be sure when these gains will happen. We can, however, be more certain of the dividends we receive. Simply put – we want to get paid while we wait.

An ideal example of this is Dream Global REIT. As you may recall, Dream Global owns office buildings in continental Europe (mainly Germany). For long time clients, we bought it originally in 2011 at \$10.00 when it went public. For a number of years it traded at less than its issue price and

many people became disillusioned with its growth prospects. Having visited the properties and met with management numerous times we were more than comfortable with the long term potential. In fact we bought more as the shares declined because we were confident in their ability to pay the 80c annual distribution while we waited for others to recognize the value. That time has now come. US based private equity giant, Blackstone, has offered to buy Dream Global for \$16.79 per share.

For an investor who bought originally at \$10.00 in the 2011 IPO, the total income received to date is \$6.46, while the capital gain (should the proposed deal proceed) would be \$6.79. A capital gain of 67% is great, but the 64% in income received is often overlooked. Also worth mentioning is that the first income was paid nine years ago and has been available for reinvestment while the gains have, even now, yet to be received. In fact, were the dividends reinvested, the total return increases to 214%.

In many cases, companies increase their dividend as their profits grow. An increase in dividend is like a pay raise; it may not seem meaningful at the time but it can have a profound effect over a longer period. We actively seek serial dividend increasers. Of the 15 individual companies that we own, 12 of them have increased their dividends in 2018 or 2019 (two did not increase and one lowered). In fact, eight of them increased more than once during that time period (see *Figure 3*).

Company	Since Jan-18	# of Increases
Bank of Nova Scotia	Increase	4
Wells Fargo	Increase	3
Brookfield Property Partners	Increase	2
Hydro One	Increase	2
Manulife Financial	Increase	2
Power Financial	Increase	2
Toronto Dominion Bank	Increase	2
Apple Inc.	Increase	2
Fedex Corp.	Increase	1
Starbucks Corp.	Increase	1
United Technologies	Increase	1
Walt Disney Co	Increase	1
Smartcentres REIT	Steady	0
Dream Global REIT	Steady	0
Vodafone Group	Decrease	0

Figure 3: Dividend increases by company (source: Thomson)

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Money for Nothing!

You will no doubt have heard about negative interest rates recently and been justifiably confused. It seems to run counter to everything we have ever understood about saving and investing. The major impetus for lower yields has come from a continued slowdown in the global economy, due in part to the escalating trade war between the US and China. Slower growth and investor anxiety about the possible abandonment of a global commitment to free trade have led many to seek safety in government bonds. As buyers rush to the safety of quality bonds they push prices higher, and by consequence, yields lower.

It was recently reported that a bank in Denmark was offering a negative-rate mortgage. In other words, one can borrow money today but pay back less in the future - with no interest payments in the interim. If that doesn't leave you scratching your head, maybe this will.....Greek bonds are now offering negative yields. Ten years ago Greece was bankrupt; today they can borrow money for less than nothing!! Against this backdrop, 2% GICs in Canada seem almost appealing.

As you can imagine, such low interest rates make owning dividend paying common shares all the more attractive. Particularly if, as discussed above, they are actually increasing their dividends. Preferred shares, however, are quite different to their common share cousins. Preferred dividends, for the most part, are determined by using the 5-year Government of Canada bond as a benchmark. As rates have declined, so have preferred share prices. We last saw this in 2015/2016, another period of declining rates. In general, we view this weakness as an interesting opportunity. For example, Enbridge preferreds currently yield ~7% and many trade at a steep discount to their issue price. We are happy to collect those dividends while we

Markets continue to anticipate more rate cuts than Fed officials

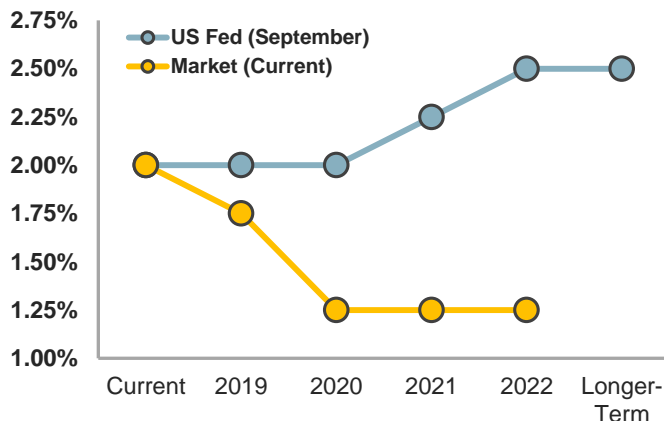


Figure 4: US Federal Funds Rate (Source: Bloomberg, RBC)

wait for the environment to change, at which point these shares could potentially generate capital gains in addition to the income received.

To be clear, interest rates aren't expected to rise anytime soon (see Figure 4). There is no doubt that global growth is slowing; this is not the environment in which central bankers typically increase the cost of borrowing. The IMF now expects that 90% of the world will experience slower growth this year and that "the widespread deceleration means that growth this year will fall to its lowest rate since the beginning of the decade".

Against this backdrop, it is essential to have a defined but flexible thesis on the global economic outlook. Our Chief Investment Strategist, Jim Allworth, helps us in forming our view. His research and opinion are well reasoned and



Remembering Summer...

The past quarter saw the team enjoy a fun-filled day at Ross' farm and participate in the RBC Run for the Kids which supports youth mental health!

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pragmatic. Please find attached a recent report he co-authored entitled "A new phase". In it he describes an environment "that requires more deliberate, careful consideration of portfolio positioning".

Our goal this quarter was to get through this newsletter without mentioning the president of the United States. Alas, we cannot. It is important to note that despite everything discussed above (and by all other market commentators), he holds a trump card. At any point before the next election he may tweet about a wonderful resolution to the trade dispute that he has orchestrated. Regardless of the terms of such an agreement, we can only imagine the glowing terms in which such a deal might be framed. The removal of such uncertainty could propel markets to new highs for a spell. That said, investing your hard earned money in what one unpredictable individual may do or say is not something we would ever do.

The next year will no doubt bring many surprises. In unpredictable times such as these, having a clearly defined investment strategy is essential. Asset allocation, diversification and risk management are all key drivers of long term wealth creation. With these factors in mind, we continually monitor your investments. Please speak directly with us at any time to review your asset allocation and portfolio composition.



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	2019 YTD*	1 Year*
Indices		
S&P/TSX	16.31%	3.64%
Dow Jones	15.38%	1.73%
S&P 500	18.74%	2.15%
Nasdaq	20.55%	-0.58%
Euro Stoxx	18.92%	5.00%
Japan Nikkei	8.69%	-9.80%
India Sensex	7.18%	6.73%
VIX (Volatility)	-42.69%	33.99%
Commodities		
Gold	14.81%	23.65%
Silver	9.69%	15.97%
Copper	-4.27%	-9.07%
Oil	-26.18%	19.07%
Natural Gas	-25.65%	-21.50%
Currency		
CAD	3.01%	-2.49%
EUR	-6.08%	-4.95%
JPY	1.42%	5.20%
AUD	-4.24%	-6.56%
GBP	-5.69%	-3.65%

*As of September 30th, 2019



Wealth Management
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A new phase



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Propelled by the record-long economic expansion, the 10-year equity bull market has pushed past one milestone after another. But the activation of two of our key recessionary tripwires portends a new phase for equities—and investment strategy. Investors may need to get more defensive in coming months, as the risk-reward balance for equities could become less favorable.

The global equity market is entering a new phase—one that requires more deliberate, careful consideration of portfolio positioning.

During the past 10 years of the U.S. economic expansion and equity bull market, none of our major U.S. recession tripwires were activated. The indicators remained in the green despite temporary slowdowns and through periods of overseas instability, signaling that the economic expansion would persist and, in turn, would provide a firm foundation not just for the U.S. equity market but for global stock markets as well.

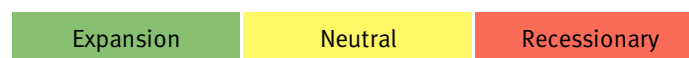
Since the end of the Great Recession in 2009, tracking these persistent signals has enabled us to stay fully invested in equities for all but four of 122 months, and to avoid the distractions of normal pullbacks and corrections. We reasoned that, as long as the U.S. economy seemed set for continued expansion, we could take market volatility in stride and keep equity weightings at a benchmark level or higher in portfolios. The S&P 500 Index has almost tripled during this period.

But the economic terrain is shifting. One of our six recession indicators—the yield curve—is now flashing red for the first time in the current expansion cycle. Another indicator that tracks the manufacturing sector—ISM New Orders minus Inventories—just shifted to a yellow cautionary signal.

RBC Wealth Management U.S. economic recession scorecard

Indicator	Status		
	Green	Yellow	Red
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	✓	–	–

The yield curve indicator has shifted to red and another indicator to yellow, signaling to us that recession risks have risen. However, our other four are still signaling economic expansion—for now.



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

With short-term Treasury yields higher than the 10-year note yield, and the gap between the two widening, the yield curve inversion has become more pronounced. The 2-year to 10-year portion of the curve briefly inverted in August, and we think the gap could widen. Historically, these yield curve movements have been harbingers of a recession arriving a year or so in the future.

These changes come at a time when the U.S. economic expansion is, admittedly, long in the tooth. Weak trends in Europe and Asia, notably in Germany and in China, are weighing on global growth. So too is the trade dispute between the U.S. and China with both sides layering on additional tariffs and more aggressive rhetoric. The longer the trade battle persists, the greater the risk that more consumer confidence data could erode and business confidence could sink further, all to the detriment of not just the global economy but, potentially, the U.S. domestic economy as well.

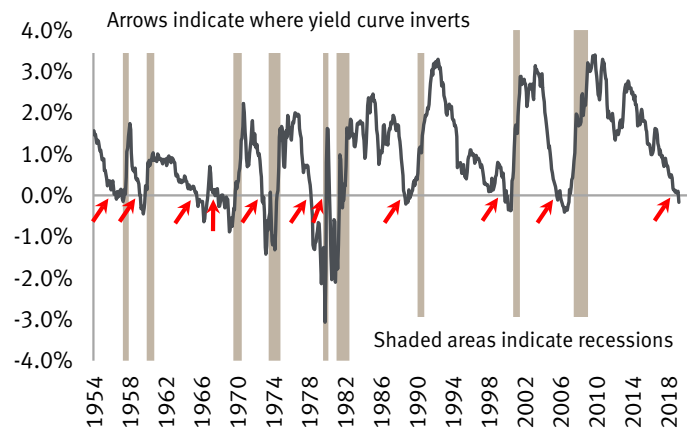
These developments have led us to become incrementally more cautious about equity positioning, with an eye toward recommending more defensive adjustments to portfolios in coming months.

Hazardous curve, or just a curveball?

Reasonable arguments can be made that the U.S. economic expansion and bull market can continue for some time. Our four other recession indicators are still in expansion mode, while the all-important consumer spending remains healthy, supported by steady wage growth and the confidence that comes with a tight labor market.

Importantly, households and businesses still have easy access to credit as banks remain willing to lend. The Fed's most recent Senior Loan Officer Opinion Survey revealed that banks continue to ease lending standards for most types of business and mortgage loans. The latest monthly survey of small and medium-sized businesses by the National Federation of Independent Business found that, as has been true for several years, only a very small percentage of respondents (3% in

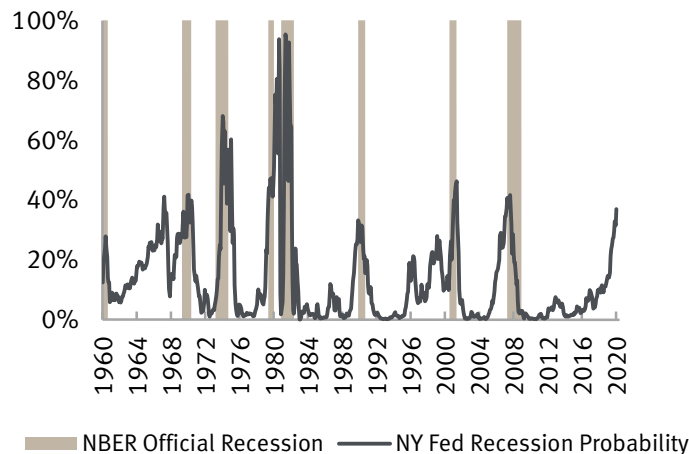
Yield differential between the U.S. 10-year and 1-year Treasury (%)



The yield curve has inverted for the first time this expansion cycle. This is a cautionary signal as all but one previous inversions preceded a recession.

Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve, National Bureau of Economic Research

New York Fed Recession Probability Index



If we were to rely on one indicator, the yield curve (and we don't, we rely on six indicators), the New York Fed calculates a 37% probability of recession one year from now.

Source - RBC Wealth Management, Bloomberg, New York Fed, National Bureau of Economic Research (NBER); data based on spread between 3-month Treasury bill and 10-year Treasury note yields

July) reported that not all their credit needs were met. Only 2% reported that their latest loan had been harder to get than the previous one.

Furthermore, there are circumstances in place that may make the Treasury yield curve a less valuable signal today. Some argue it is more reflective of global growth concerns than domestic U.S. risks, and that the present inversion is a technical anomaly reflecting a global stampede to the perceived safety of Treasuries, which offer relatively high yields compared to the \$16T in negative-yielding sovereign bonds worldwide, especially in much of Europe and Japan.

As has often been the case during yield curve inversions, well-reasoned and compelling arguments like these are being offered in support of the thesis that yield curve inversion no longer matters—or, at least, that it doesn't matter this time. But when the U.S. economy begins to shift from expansion to contraction, there are almost always “unique” circumstances that can be cited to explain away the warning signals. Typically, recessions arrive nonetheless.

The yield curve has a track record as an economic indicator that is hard to ignore. It is usually the first of our indicators to flash a recession warning. But the “inversion signal” has always been hard for investors to get behind, precisely because it typically provides such a long early warning. An inversion is usually followed by several quarters of positive economic growth—the last such interval lasted almost two years.

On average, the yield curve has inverted 14 months before each of the last nine recessions since 1950. Only one false signal was given: in the mid-1960s, when the curve inverted but no recession materialized, although GDP growth slowed sharply to a standstill.

The S&P 500 has peaked about six months after each yield curve inversion, on average. But this is not a reliable market timing mechanism because the gap between inversion and market peak has varied widely, with the shortest occurring two months before inversion and the longest gap stretching to 21 months after

inversion. On a number of occasions, the S&P 500 reached new highs *after* the yield curve inverted, and then shifted into a bear market before or during the ensuing recession.

A broader view of recession risks

Until just a few months ago, our other four recession indicators were unequivocally signaling no recession in sight. Today, while none of them have flipped, all of them are closer to doing so than they were months ago.

(For a look at all six of the U.S. recession indicators we follow, together with our assessment of what each is currently signaling, please see the appendix that follows this article.)

A cautionary tale?

None of these six indicators has a perfect track record—although some come close. And even if one indicator had performed perfectly to date, there's a first time for everything. But looking at these indicators as a group, rather than individually, has given us a reliable picture of how the recession probabilities are shifting.

With the yield curve indicator now flashing red, the manufacturing reading at yellow, and some indicators showing the potential to shift in the months ahead, we think some additional caution is warranted.

While the S&P 500 could conceivably reach another all-time high, as it has after some of the previous yield curve inversions, we think the market has entered a new phase. In one important respect, and within the historical context, the inverting of the yield curve can be seen as opening the door to the arrival of a potential bull market peak for the first time in 10 years. We believe the risk-reward balance for global and U.S. equities will shift to less favorable terms as more recession indicators start to flash caution signs. Once the economy's path shifts decisively toward an eventual U.S. recession, a more cautious and defensive approach to U.S. and global equities will be called for.