RBC Dominion Securities Inc.

Wealth Management
Dominion Securities

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Scott Sandler
VP & Portfolio Manager
scott.sandler@rbc.com
416-842-6684

Ronan Clohissey, CIM
VP & Portfolio Manager
ronan.clohissey@rbc.com
416-842-6683

Michelle Noel-Smith
Associate Advisor
michelle.noelsmith@rbc.com
416-842-8675

Brendan Hollis, CFA
Associate Investment Advisor
brendan.hollis@rbc.com
416-842-8673

Steve James
Associate
steve.james@rbc.com
416-842-8674

Gary Tsang, MBA, CFA
Associate Advisor
gary.h.tsang@rbc.com
416-842-8672

Joshua Orr
Associate
joshua.orr@rbc.com
416-842-8676

Aidan Leyne
Summer Intern
aidan.leyne@rbc.com
416-842-6677

Please visit us at:
www.SandlerWealth.ca

Early cycle indicators flash green

KEY INSIGHTS

- Equity markets post double digit returns and reach new highs
- Major economic indicators point to economic growth as the world reopens
- Persistent low yields drive investors to stocks, real estate in search of a return
- Rising inflation becomes a reality……but for how long?
- Individual investors' return expectations get ahead of themselves

As containment of Covid-19 improves and economies gradually reopen, pent-up consumer and business demand is surging. Permanent scarring from the pandemic seems to be limited so far. The economic recovery has been fanned by massive monetary and fiscal stimulus, while an easing of virus-related restrictions and persistent low interest rates have only served to add fuel to the fire. Extrapolating the potential of this momentum, investors have continued to put cash to work in the market.

Global equities extended their gains in Q2 with most major indexes reaching new highs. North American and European markets are up double digits year to date. The resource heavy TSX has outperformed in 2021 after a number of years of lagging its US counterparts (see *Figure 1*).

We are optimistic and have a positive outlook for the economy and markets. The global economy is cyclical by nature, it goes through periods of expansion and contraction (recession). Historically, the expansionary periods can last many years while recessions tend to be short, sharp, and admittedly painful (see *Figure 2*). We are currently at the beginning of one of these cycles with all indicators pointing to economic growth ahead.

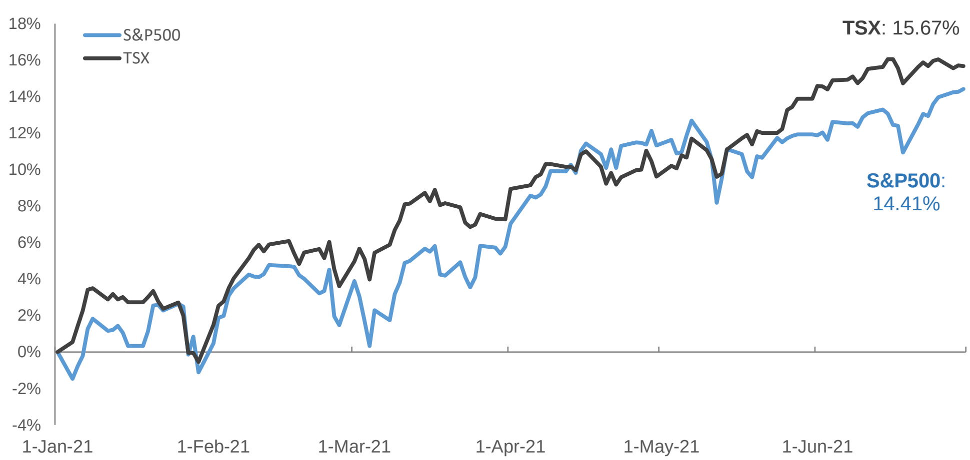


***Figure 1**:* TSX vs. S&P500 price returns - Jan. 1st, 2021 – Jun. 30th, 2021 *(Source: FactSet)*

Quarterly Review

Q2 2021

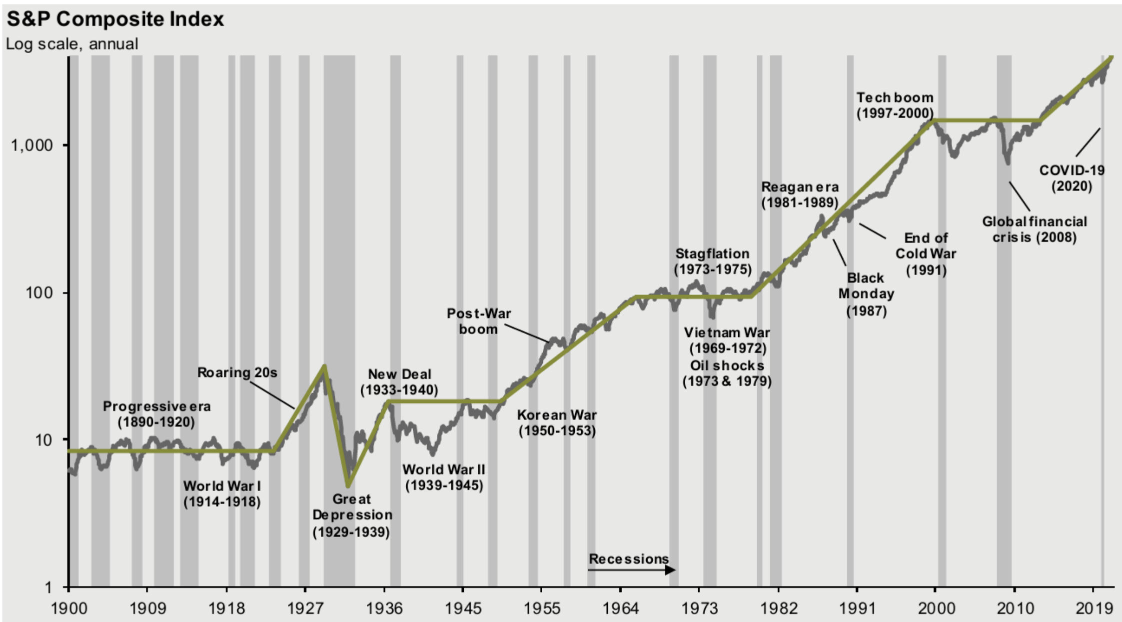


***Figure 2**: S&P500 recessions since 1900 (Source: JPMorgan)*

In the attached report, *[Green light for the economy and markets]*, Chief Investment Strategist Jim Allworth makes the case for robust economic growth and higher markets through 2022. In our almost six years at RBC, this is the first time that Jim's closely followed (and reliable) recession scorecard has ever flashed green across all indicators (see *Figure 3*).

So far, so good then……or is it? Fears of a spike in inflation, Covid variants, higher interest rates, waning economic stimulus, and overvalued markets – the risks are many! But is this not always the case? As the old saying goes, "the market climbs a wall of worry". The investor who

Indicator	Status: Expansion	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)	✓		
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Index	✓		
ISM New Orders minus Inventories	✓		
Fed funds rate vs. nominal GDP growth	✓		

***Figure 3**: RBC US recession scorecard (Source: RBC)*

waits for every risk to resolve itself will watch their whole life from the sidelines waiting to participate.

Predicting what will happen next week or next month is never easy. Guessing how the market will react is tougher still. Short term predictions can make for entertaining banter at a cocktail party, but are sure to humble any investor who acts upon them as a strategy for building wealth.

On the topic of market predictions, a recent [global survey by Natixis] found that individual investors' return expectations have become wildly optimistic. In Canada, the survey found that individuals expect long term investment returns of 11.2%, while financial professionals expect 5.1%. There is clearly a huge disparity here, and a likely over-exuberance on the part of investors. Interestingly, the expectation gap in Canada is actually smaller than most other countries polled (see *Figure 4*).

With such a strong start to the year, our expectation for the second half is for returns to moderate. With a good year's worth of returns delivered in the first six months, we have potentially front-end loaded 2021's outcome. It's possible that equity valuations may take a little time to grow into their current prices. This is not necessarily a bad thing, but it is worth acknowledging that investing is a marathon, not a sprint.

Quarterly Review
Q2 2021

	Investors	Expectation Gap	Financial Professionals[1]
Argentina/Uruguay	15.0%	173%	5.5%
Australia	14.4%	140%	6.0%
Canada	11.2%	120%	5.1%
Chile	16.4%	173%	6.0%
Colombia/Peru	16.6%	213%	5.3%
France	12.1%	157%	4.7%
Germany	10.7%	118%	4.9%
Hong Kong	13.6%	162%	5.2%
Italy	11.6%	205%	3.8%
Mexico	16.2%	252%	4.6%
Singapore	13.4%	158%	5.2%
Spain	15.3%	122%	6.9%
Switzerland	13.4%	163%	5.1%
UK	14.1%	207%	4.6%
US	17.5%	161%	6.7%

Figure 4: Investor vs. Advisor return expectations *(Source: Natixis)*

While we have a positive outlook for the market, we are always anticipating and prepared for the next correction. Our portfolios hold cash and high quality fixed income that is used to buy equities when they go on sale. Systematically rebalancing your portfolio back to its target asset allocation results in buying equities when the market corrects. In March and April of 2020, with investors panicking, we were adding to existing positions and establishing new ones. In the absence of being able to predict the future, a methodical and pragmatic plan is the next best thing.

We have spoken at length on the topic of inflation over the past year. In conversations with clients and in our last four quarterly newsletters we have made the case for rising inflation. There is now no doubt that higher prices are upon us (see *Figure 5*). Experts are divided as to whether this trend is a transitory readjustment to a reopening economy or a sustainable new reality. Whatever the outcome, it is important to understand that inflation essentially reduces the future purchasing power of a dollar.

Remaining invested in businesses that have the ability to pass inflation through to their customers is one way to keep pace with inflation. A company that can increase prices and revenues at the rate of inflation is somewhat insulated from it. On the other hand, cash sitting in a bank account is powerless to keep up. Holding some cash in reserve is always prudent but holding more cash than one might need over the coming year or two is likely unadvisable in such an environment.

We are monitoring inflation closely and have made some portfolio adjustments as a result. Ultimately, your target asset allocation will have the greatest influence on investment outcomes and inflation protection. We regularly review each client's Investment Policy Statement (IPS) to ensure that appropriate targets are in place. Please discuss this with us at any time should you feel an adjustment is required or if you have had any material changes in your financial profile.

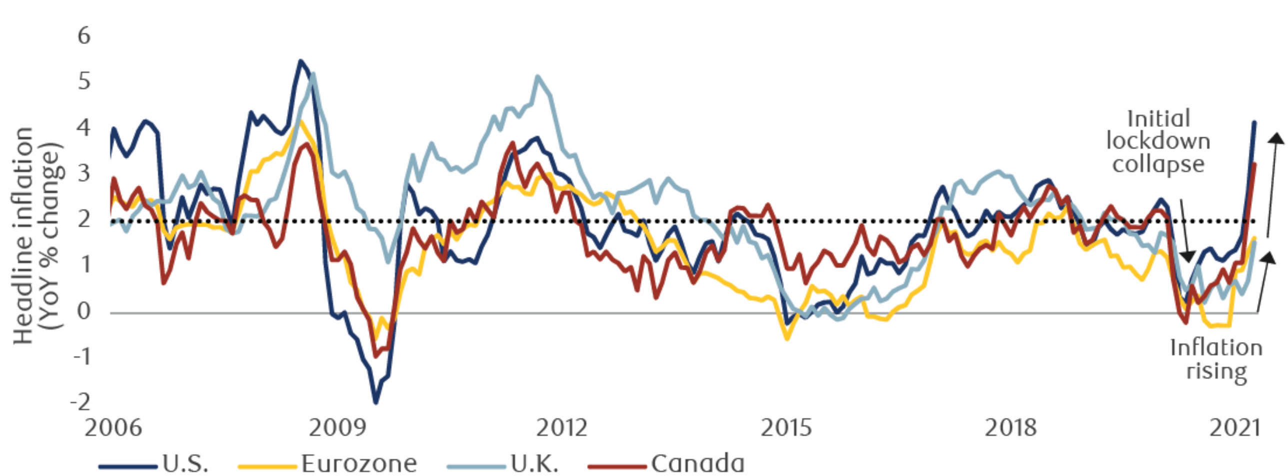


Figure 5: Inflation rising in major economies *(Source: RBC)*

Quarterly Review

Q2 2021

As the world comes back to life, there are an untold number of directions and trends that could emerge. With this in mind, the following (taken from a recent piece published by RBC's global advisory committee) summarizes our philosophy in a way that we find hard to improve upon.

> *Long-term investors should trust in diversification and asset allocation. Whether inflation is transitory, and how the Fed will respond if it is not, are important questions, but the range of possible outcomes is wide. We believe investors should seek an investment strategy adaptable to a broad range of scenarios; a diversified portfolio, rebalanced appropriately, is among the soundest methods of dealing with uncertainty.*
>
> *While the pandemic has created unique challenges for policymakers and investors alike, it has also reinforced basic investment principles—including the importance of sound asset allocation, consistent with risk tolerances. In our view, investors would be well-served to focus on core principles and avoid hasty responses to minor changes in the timing of potential Fed policy adjustments.*

As of July 19th we are delighted to report that we will have 3 of our 8 team members back in the office full time. Downtown Toronto is finally awaking from its long hibernation; office towers are no longer ghost towns, patio reservations can be hard to come by and traffic (the one thing none of us want back) is increasing.

We look forward to seeing you in person soon. Until then, enjoy the summer and the freedoms it promises.

Scott Sandler
VP & Portfolio Manager

Ronan Clohissey, CIM
VP & Portfolio Manager

Please be aware

Our Summer Intern may be in touch over the coming weeks. He is working on a project to refresh some documents that require periodic updates.

These may include an update to your Investment Policy Statement (IPS) and tax residency declarations.

If you see an email from **Aidan Leyne**, please know that this is a legitimate request.

	TTM	YTD
Indices		
S&P/TSX	29.97%	15.67%
Dow Jones	33.66%	12.73%
S&P 500	38.62%	14.41%
Nasdaq	44.19%	12.54%
Euro Stoxx	25.67%	14.40%
Japan Nikkei	23.13%	16.01%
India Sensex	50.31%	9.91%
VIX (Volatility)	-47.98%	-30.42%
Commodities		
Gold	-0.61%	-6.76%
Silver	43.50%	-1.05%
Copper	55.74%	20.68%
Oil	87.09%	51.42%
Natural Gas	117.29%	55.65%
Currency		
CAD	9.50%	2.71%
EUR	5.55%	-2.93%
JPY	-2.86%	-7.02%
AUD	8.62%	-2.55%
GBP	11.53%	1.18%

Values as of June 30th, 2021

Wealth Management
Dominion Securities

GLOBAL
Equity

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

Green light for economy and markets

In our view, nothing that has transpired in the past six months has fundamentally changed our outlook for the remainder of 2021 or for 2022. We expect all of the developed economies, led by the U.S., will post above-average GDP growth compared to last year's slump. Absent a vigorous return of the pandemic, the momentum provided by repeated applications of fiscal stimulus from governments—supported by entrenched accommodative monetary policies—should keep most economies powering on through next year and probably beyond. Robust growth this year followed by slower, but still above-average growth next year looks to be the likely outcome.

For the all-important U.S. economy, this view is supported by our economic recession scorecard. All six of the leading indicators of recession we track are giving the economy a decisive green light, and are strong enough to suggest that even an "early warning" phase lies a long way off.

Looking at just one of these indicators, we note that the fed funds rate has almost always risen above the nominal growth rate of the economy (i.e., the rate before adjusting for inflation) before a recession gets underway. The year-over-year nominal growth rate of the U.S. economy was 2.7% as of Q1, is rising sharply, and should be in the 9% neighbourhood by year end, slowing to 6% by the end of 2022. In order for the fed funds rate to rise above that 6% level, and risk inducing a recession, the Fed would need to raise rates a by one-quarter point 24 times—a nearly inconceivable scenario, in our view, especially because the Fed sees no rate increases before 2023.

In our view, the next recession, when it eventually arrives, will likely be triggered the good old-fashioned way—by a tightening of credit conditions sufficient to make interest rates prohibitively expensive and banks more cautious about lending. However, no tightening of that magnitude appears nearby.

No recession on the horizon

Recessions are the enemy of the equity investor, as they have always formed the economic backdrop associated with bear markets. So

U.S. recession scorecard

	Status		
Indicator	Expansion	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)	✓		
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Index	✓		
ISM New Orders minus Inventories	✓		
Fed funds rate vs. nominal GDP growth	✓		

Source - RBC Wealth Management

GLOBAL EQUITY

seeing a recession coming ahead of time is extremely useful from a portfolio-management perspective. We believe, as yet, and probably for some time, no recession appears on the horizon.

While a bear market-inducing recession may not be in the offing anytime soon, there is always the potential for fears arising from a growth slowdown to induce a market correction. In several bull markets over the past 70 years, such worries have led to a correction 12–18 months after the start of the new economic advance. However, these were always eventually superseded by another substantial leg up for the economy, corporate profits, and the equity market.

History lessons

Another way to plot the path ahead is suggested by Eric Savoie, investment strategist at RBC Global Asset Management Inc. He points out that in the U.S. there have been 17 Federal Reserve tightening cycles since 1954, with eight of them producing enough credit tightening to bring on a recession.

Looking at equity market performance over the 12 months leading up to the first Fed rate hike in each cycle, Savoie notes that the median return for the S&P 500 over that stretch was 16.8%. Switching to look at what the market does in the year *after* the first rate hike reveals a median return of an above-average 9%.

So, the year before the first rate hike and the year after are both generally pretty good for the stock market. If the Fed tightening cycle is going to cause trouble for the stock market, that trouble usually arrives a ways down the road from the first rate hike, if it arrives at all, keeping in mind that nine Fed tightening cycles produced no recession or any equity bear market.

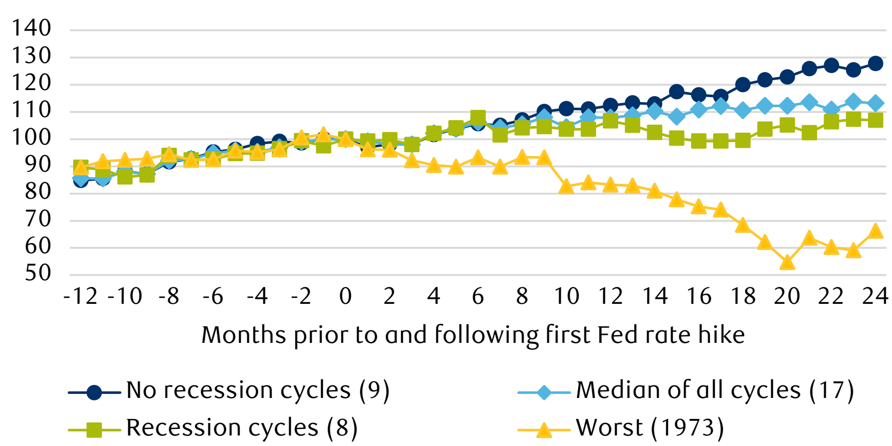
The Fed, while always reserving the right to change its mind, has told us there will be no rate hike before early 2023. Counting backward one year, the historical probabilities would suggest the stock market will deliver positive, probably above-average returns for two consecutive years starting in early 2022.

Correction always possible, but not a given

Of course, even years that feature above-average stock market returns can contain within them rocky periods of correction and

Don't fear the rate hike; stocks can still rally as long as hikes don't trigger recessions

Median S&P 500 level before and after first rate hike
Normalized, with level at first hike = 100



Source - RBC Global Asset Management, RBC Wealth Management; data range: 1954-2018

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consolidation. It's always possible that one lies just around the corner. As usual, there is a long list of things investors are worried about, including inflation, the pandemic, geopolitics, and severe weather (ranging from heavy rains to drought conditions). In one sense, investors are right to expect a correction, because they are not uncommon. But they rarely announce their arrival (or conclusion) in a timely enough fashion to allow even a nimble investor to wring much advantage out of that knowledge.

There are also plenty of factors that would argue against a correction occurring:

- Most economies are reopening as the vaccine rollout diminishes the impact of the pandemic;
- Earnings are very strong (GDP-based U.S. corporate profits are already above their pre-pandemic peak) and forward-year earnings estimates have been revised sharply higher over the past six months (S&P 500 by 15% and TSX by 13%);
- CEO confidence, as measured by The Conference Board, is near an 18-year high, while business confidence is high and rising in Germany, France, and Canada, and improving in the UK and Japan;
- Corporate bond yields remain very low and access to credit plentiful; and
- Capital spending is extremely strong, which is good news for productivity and inflation.

It's worth remembering that should a market correction occur without an accompanying downturn in economic activity and corporate profits, then even though share prices are falling for a few months, the intrinsic, underlying value of most businesses goes on compounding upward at a rate driven by earnings growth.

Global equities likely to advance

We are left with a constructive outlook for global equities for the coming 12 months. We expect the impact of the pandemic will continue to subside over the remainder of this year and through 2022. The forecast rising tide of GDP and earnings should permit broad market indexes to advance further from today's levels. We recommend a global balanced portfolio remain moderately Overweight equities.